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A Slippery Slope: Hedge with Caution in a Volatile Market

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The winter season is upon us, which means skiers everywhere are hitting the slopes. Zipping down a mountain at high speeds while carving through fresh powder can provide the ultimate rush for extreme sports enthusiasts, but it also comes with a cascade of potential dangers such as black ice, changing weather conditions, collisions with those pesky snowboarders, and avalanches. Even the most seasoned skiers can't fully predict their skiing conditions—and the same can be said for many investors who try to outwit the market by hedging their equity bets during volatile market environments.

The odds are stacked against investors who hedge their equities during times of uncertainty, which is why it's important to approach this risk-reducing strategy with caution before it snowballs into dangerous territory. Let's look at some of the reasons our current market requires cautious equity hedging.

What is a hedging strategy?

Like a parka that protects skiers from the elements, an equity hedging strategy seeks to protect an investor's portfolio from market volatility—more specifically the drawdown risk associated with market selloff. While equity hedging can be a risky move during market uncertainty, approaching it with caution is the best way forward if an investor decides it's worth the risk. Think of this cautious approach as the safety helmet that protects a skier from injury while braving the aforementioned potential dangers to find that downhill rush.

Current market conditions

Before we traverse into the factors that contribute to looming market volatility, let's focus on the current state of the market.



After 2018 saw the S&P 500® Index take a loss for the first time since 2008 with a -4.38% return, the first half of 2019 saw returns of more than 20% and all-time highs for most benchmark equity indexes. Just as the equity market started to gain momentum, it began to level out in the second half of the year due to an inverted yield curve over the summer that indicated the possibility of a looming recession. The uncertainty surrounding 2020's market outlook has many cautious investors thinking about hedging—but is it the best thing to do? Below are some reasons hedging might be a challenge in our current global and domestic climates.

Looming recession

For nearly half a century, every recession in the US has been prefaced by an inverted yield curve. While the undesirable trend of long-term security rates being lower than short-term rates doesn't exactly signal immediate danger, it's usually a sign of trouble on the horizon.

Furthermore, the period of time immediately following an inverted yield can be quite deceptive because the equity market generally performs exceptionally well, but like a structurally weak layer of snow that's a light wind gust away from starting an avalanche, the market is undergoing a seismic shift. The result of this shift—based on recent history—has been a reduction of near- to mid-term interest rates and an overall loss of market confidence.

Trade tensions

What started as a disagreement over tariffs has developed into an all-out trade war between the US and China. While the world's two biggest economies continue to raise tariffs on each other, the fractured relationship has resulted in a reduction of global growth, which includes China dropping to a 5.5% annual growth rate after consistently hovering around 7%–8% growth, according to a November 25, 2019 report from CNBC Markets.

With the Trump administration unable to find common ground with China after several unresolved talks, American companies are rethinking their exposure to Chinese manufacturers and spending less money in general. This chain reaction has stunted growth for the S&P Global Ratings®—and caused widespread growth drag. For investors looking to hedge their bets, this means more uncertainty in global equities and increased premiums on securities that appear to not carry as much risk, which can lead to big losses if timed incorrectly.

Elections and geopolitical trends

America is coming up on a presidential election race, and rarely have we experienced this level of foundational division across so many economic issues between the two major parties. While President Trump awaits his sparring partner from the lot of Democratic nominees, one thing that's clear is the uncertainty behind America's voter preferences come next November.

If international election trends are any indicator, the US could be in for a whirlwind of change. In Switzerland, the conservative-leaning Swiss People's Party lost ground to green parties interested in environmental issues. The opposite happened in Canada where liberal Prime Minister Justin Trudeau retained his position, but his party took a backseat to the Conservative Party. In the UK, a controversial vote may decide the outcome of Brexit, which could potentially lead to a separation from the European Union.

The surface-level economic stability shown by the US gives the impression that everything is fine, and will be for some time to come. However, once that metaphorical gust of wind hits that metaphorical weak layer of snow, only time will tell if the economy will get swept up in the avalanche of a downturn or maintain its stability. Heading into a climate of uncertainty would be risky for investors looking to hedge equities.

How to hedge with caution

In periods of market uncertainty, there are ways for investors to equip their portfolios with a fighting chance to reduce market drawdown with hedging. These methods include looking to reduce portfolio volatility, trying to eliminate negative skews, and exploring ways to improve the Sharpe Ratio. Investors looking to apply any of these methods to a hedging strategy must consider the level of associated risk, in addition to deciding if the possible benefits outweigh the costs.

The bottom line

The current state of the global market is in flux, and a future recession seems possible based on historical trends. Investors looking to hedge their bets on short-term equities can prove beneficial if timed correctly, but it should be decided if the benefits are worth the costs and risks. If history is any indicator, the market tends to ebb and flow with the geopolitical and economic trends, which can make long-term equities more appealing if patience can be afforded. While the prospect of safeguarding a portfolio is appealing, hedging during a volatile market can mean high costs and sustained losses if timed incorrectly. Investors who find a hedging strategy appealing could bet on outpacing the risk—but proceeding with caution is a necessity.



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