The January sell-off in stocks—a delayed reaction to the Fed?

By Kerry Pechter *Thu, Jan 21, 2016*

'It is possible that we could have seen outflows from U.S. equity funds in December were it not for the year-end rebalancing trend," said Alina Lamy, author of the latest Morningstar Direct Asset Flows Report.

Any possibility of a causal link between the Federal Reserve's quarter-point rate hike in mid-December and the 10.7% correction in equity markets since the start of 2016 seemed to be eliminated by the fact that equities did quite well during the last two weeks of the year.

But a Morningstar analyst remarked in a report this week that the $16.8 billion net flow into U.S. equity funds in the month of December—the most in two years—seemed to be a "cyclical phenomenon that probably has more to do with year-end rebalancing" than with optimism about equities.

Overall, equity funds experienced negative flows after two years of inflows. The exception was international-equity funds. They led all category groups in terms of highest inflows for the calendar year, collecting $207.6 billion.

Asked if year-end re-balancing might have delayed an equity sell-off until January 4, Morningstar's Alina Lamy told *RIJ*, "It is possible. The trend we've repeatedly observed is that managers tend to rebalance in December. The challenge they're facing is that they rebalance in December regardless of whether market conditions are favorable or not. So it is possible that we could have seen outflows from U.S. equity funds in December were it not for the year-end rebalancing trend."

The inflow into U.S. equities in the last month of the year also belied the fact that the S&P500 Index finished the year down 1.4%. "In general, flows tend to follow performance," Lamy wrote in the Morningstar report, "but such a strong inflow into a category that delivered a negative return for the year seems to indicate that investors are looking more toward the future.

"With the Federal Reserve raising rates for the first time in 10 years and the European Union maintaining its quantitative-easing measures, investors seem to believe there is higher potential for growth in Europe and Asia than in the United States. The high inflow to international equity therefore appears more like an anticipatory move at this point.

"Another trend is that a large portion of flows tends to come from funds-of-funds, particularly retirement plans, target-date, and target-risk funds, and these plans have been increasing allocations to international equity. A majority of these large international-equity flows we've seen come through the retirement channel. Vanguard is just one example; they have been enhancing diversification for their target-date funds by increasing their international equity exposure."

Taxable-bond funds sustained the worst outflows by category group in December, $29.0 billion, most of them driven by the high-yield category, which saw outflows of $11.2 billion for the month—the third-largest monthly outflow since 1993.

Third Avenue Management's announcement that it would liquidate its high-yield bond fund, Third Avenue Focused Credit, without allowing investors to redeem their shares right away, along with falling oil prices, helped ignite the selling.

With only a few exceptions, passive funds gained at the expense of active funds in December and in 2015 overall. Indeed, two of only three firms with inflows to their actively managed funds in December were passive shops—Vanguard and State Street.

Franklin Templeton suffered heavy outflows in December, with two of the firm's fixed-income offerings among the active funds with the highest outflows. Templeton Global Bond and Franklin Income had outflows of $2.2 billion and $1.7 billion, respectively.

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