US Equity Downturn Fears Deserve Attention
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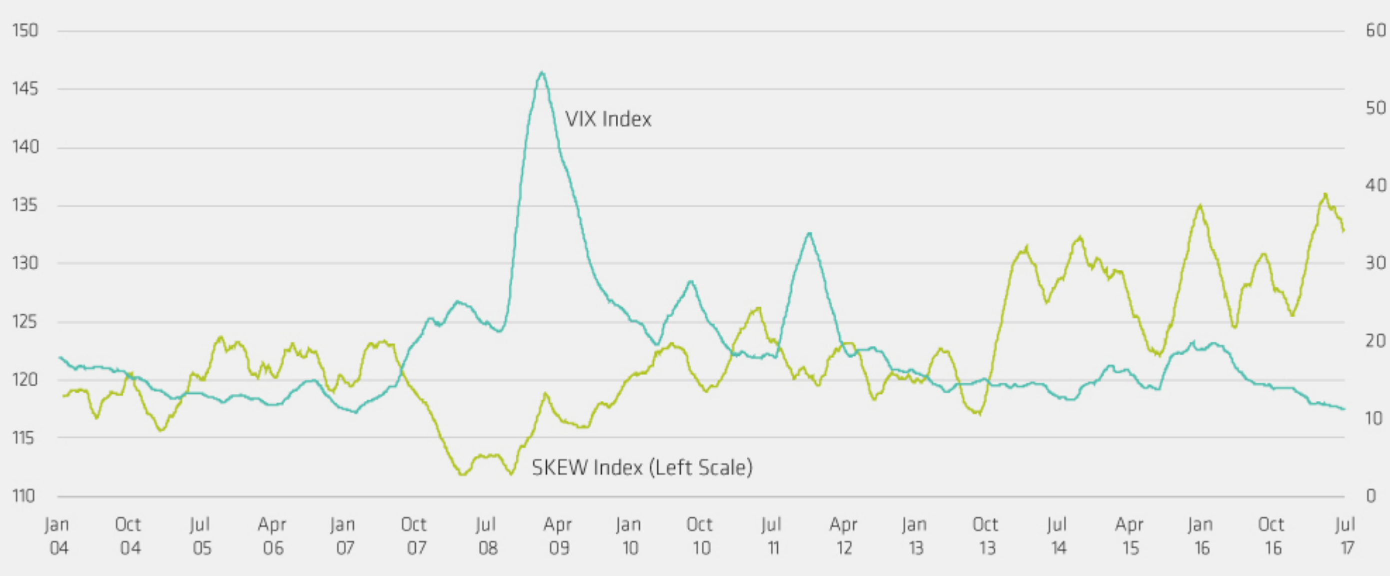
Even amid the midsummer lull, more investors are hunkering down and preparing for a potential correction. As the S&P 500 Index continues its relentless grind higher, we think it's worth considering proactive steps for a change in the environment.

US equity market volatility remains subdued. According to the Chicago Board Options Exchange (CBOE) Volatility Index, also known as the VIX, US stock market volatility hasn't been this low in more than a decade. It might seem as though investors are complacent, but looking beyond the low VIX, we can see that is not the case. Beneath the surface, we believe that the volatility of the underlying members of the S&P is considerably higher.

SKEW INDEX SIGNALS RISK

In fact, the CBOE SKEW Index, another measure of investor fear, has been moving up. This index rises as more investors buy insurance for a downturn through out-of-the-money put options. This index reached a 90-day moving average of 136 before falling modestly to 133 at July month-end. As the index level increases from 100 to 150, there is more perceived risk in the market (*Display*).

Mixed Signals from Volatility Indicators
90-Day Average



Through July 31, 2017
Past performance does not guarantee future results.
Source: Bloomberg, Chicago Board Options Exchange and AB

UNDERLYING CONDITIONS ARE ROBUST

It's true, the market hasn't experienced a correction for a very long time. Valuations are elevated and US stocks have now posted nine straight years of positive returns, which suggests that a downturn is possible. That said, we believe that underlying market conditions are robust and that even if the market takes a leg down it would be a healthy correction.

Interest rates continue to support the market. Despite the Federal Reserve continuing to increase the fed funds rate, long-term interest rates remain low.

The recent recovery in oil prices and subsequent US dollar weakness are also helping. Both have pressured corporate earnings in recent years, but it seems that these headwinds are beginning to abate. The secondquarter-earnings season has been upbeat, with 77% of companies reporting beating consensus analyst estimates, as of August 4. And strong business conditions have triggered upward revisions to S&P 500 earnings-per-share estimates in recent weeks. To us, this scenario makes a strong case for US equities going forward.

VOLATILITY DOESN'T ALWAYS MEAN DECLINES

Even if volatility does rise, it doesn't mean that the market will take a hit. For example, the VIX rose from 11 to 25 from June 1995 through December 1999, while the S&P 500 Total Return Index rose by an annualized 27%. And even if the market takes a leg down, it's worth remembering that equities usually end the year in positive territory even after suffering a peak-to-trough decline of more than 10% during the year.

But, if investors are concerned about a possible correction, steps can be taken to prepare. First, we advocate maintaining equity allocations, because it's almost impossible to time inflection points in the market. Second, consider shifting toward lower-risk strategies, such as lower-volatility equities, core equities or equity long/short portfolios.

Long/short strategies can be especially helpful for investors seeking to maintain equity market exposure while incorporating downside protection. Historically, these types of strategies have helped minimize drawdowns during difficult environments). For example, from January 1, 2000, through June 30, 2017, long/short funds experienced a maximum drawdown of 31% while the S&P 500 saw peak-to-trough losses of 51% (*Display*). By minimizing these drawdowns, long/short investors have been able to reduce volatility, remain in the market and build wealth over the long term.

Long/Short Portfolios Help Provide Downside Protection

Monthly Drawdown

Through June 30, 2017

Past performance does not guarantee future results.

Long/short funds represented by the HFRI Equity Hedge Index

Drawdown is the peak-to-trough decline during a specific record period of an investment. A drawdown is usually quoted as the percentage between the peak and the trough.

Source: Hedge Fund Research, S&P and AB

It would be imprudent to deny the possibility of a US equity downturn in the coming months. But since equity fundamentals are strong and are supported by improving macroeconomic trends, we think the scale of any correction is likely to be limited. If investors believe that markets are due for a pullback, that doesn't mean that they should exit their equity positions entirely. But the time is right to take proactive steps that can help to keep you invested through bouts of turbulence, while identifying attractive investment opportunities for an eventual long-term recovery.

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