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Global Markets Daily: Drawdown risk is up — assessing equity correction risk (Ferrario/Mueller-Glissmann)

- After a positive 2024 for US equities, equity drawdown risk has picked up at the start of 2025 – according to our framework, the probability of an equity drawdown has increased to almost 30%. While this level is above unconditional, it is still far from previous peaks and historically the most extreme outcomes have happened only after the probability crossed 35%.
- Most of the increase in drawdown probability has been driven by inflation momentum turning from negative to positive and by more equity valuation expansion last year. Market variables have contributed the most to the increase in inflation momentum, while macro data still point to moderate negative momentum. Similarly, an increase in trade and economic policy uncertainty has increased equity drawdown risk since the US election.
- Our asset allocation remains modestly pro-risk into 2025, but we focus on selective tail risk hedges given the higher drawdown risk. We like shorter-dated S&P 500 put spreads to hedge near-term correction risk due to negative growth surprises, policy uncertainty into the US Presidential inauguration or misses in the January earnings season. S&P 500 down/EURUSD down hybrids can be attractive to hedge the rising rates and tariff risk.

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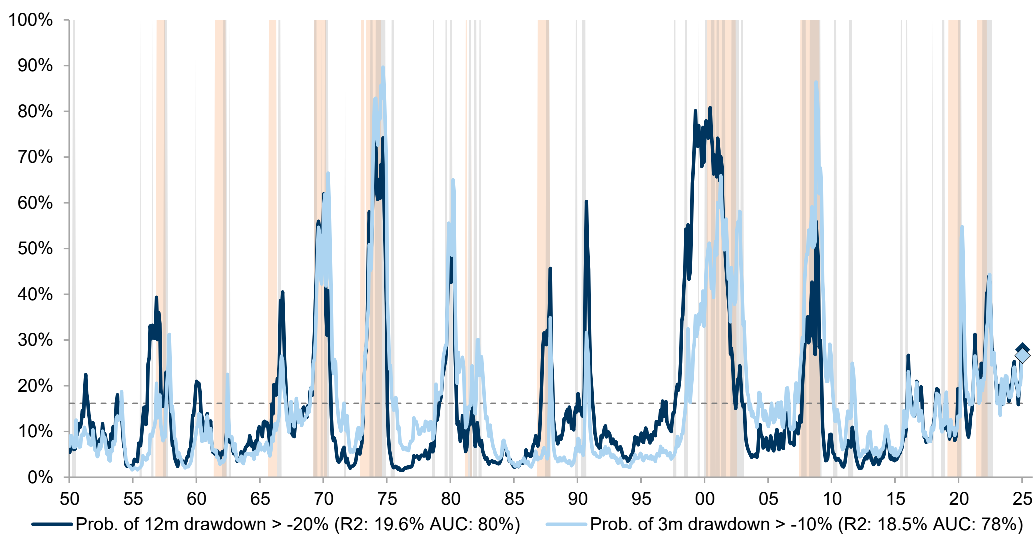
Drawdown risk is up — assessing equity correction risk

After a positive 2024 for US equities, equity drawdown risk has picked up into the start of 2025. We recently developed a new framework combining business cycle metrics, sentiment cycle metrics, valuations and leading growth indicators to estimate equity drawdown risk over different horizons. According to that framework, the probability of an equity drawdown of more than 20%/10% over 12m/3m respectively has increased to almost 30% currently from relatively low levels in Q4 last year. While the current drawdown probability is far from previous peaks, it is well above its unconditional level reached in September.

Exhibit 1: Equity drawdown risk has picked up into 2025

Implied probability of S&P 500 drawdown based on multi-variate logit model (Orange/ light grey shading = S&P 500 subsequent drawdown >20%/>10%. Dashed line = unconditional probability)

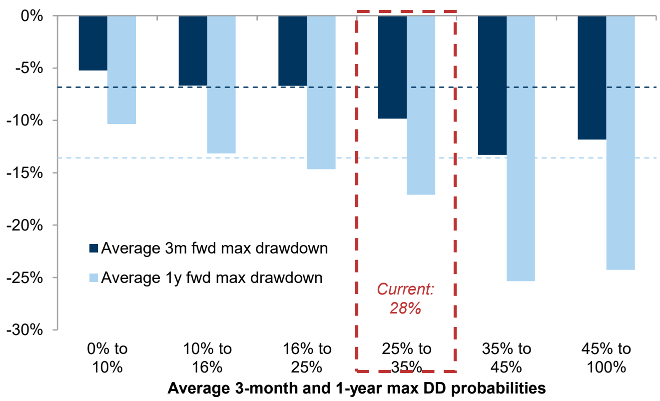


Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Historically, a higher equity drawdown probability has translated into lower forward returns for equities and the risk of deeper max drawdowns (Exhibit 2). That said, the most extreme outcomes happened only after the probability crossed 35%: since 1950, a 3m max drawdown > -10% or a 12m max drawdown > -20% happened about 55% of the times if the drawdown probability was above 35%, and only about 40% of the times if the drawdown probability was between 25% and 35% (vs. an unconditional frequency of 16%, Exhibit 3).

Exhibit 2: Historically, a drawdown probability above 35% indicated deeper...

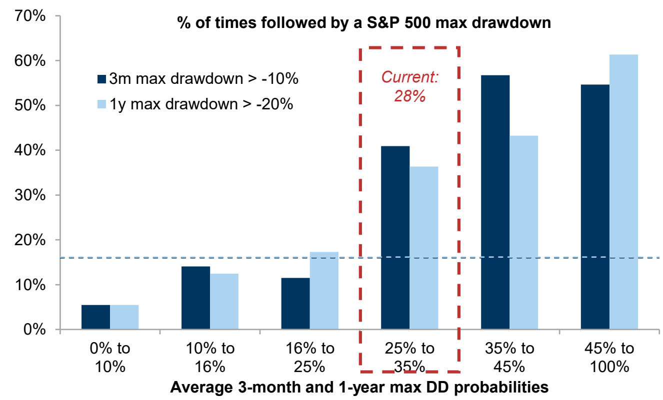
Since 1950. Dashed line = unconditional



Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Exhibit 3: ...and more frequent drawdowns

Since 1950. Dashed line = unconditional

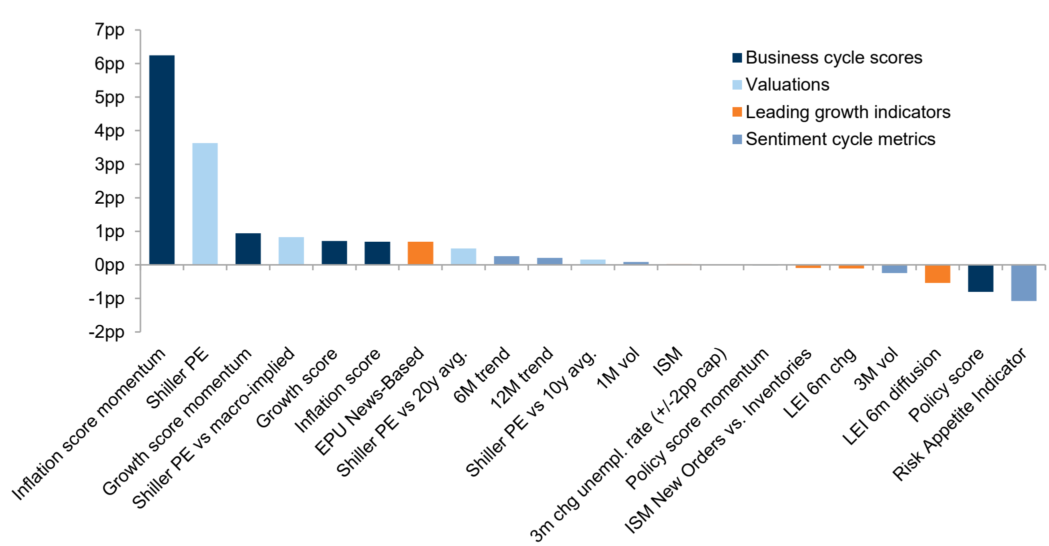


Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Most of the increase in drawdown probability since September has been driven by our business cycle scores (which track US growth, inflation and policy), followed by continued equity valuation expansion (Exhibit 4). Higher equity valuations, both outright and compared with their macro-implied level, tend to increase latent drawdown risk even though they can remain elevated in the near term as long as macro conditions remain supportive. Our Risk Appetite Indicator (RAI) is now at c.0.9 and, together with other still-supportive sentiment metrics for US equities, which indicate a strong macro backdrop, has somewhat lowered the drawdown probability. As we wrote before, elevated RAI levels tend to signal less right tail potential rather than more left tail risk and our Sentiment and Positioning metrics have turned a bit less bullish in recent weeks.

Exhibit 4: Less negative inflation momentum, valuation expansion and higher policy uncertainty have driven the increase in drawdown risk

Contribution to the change since September 2024 in the probability of a 12m drawdown > -20% (data since 1950)



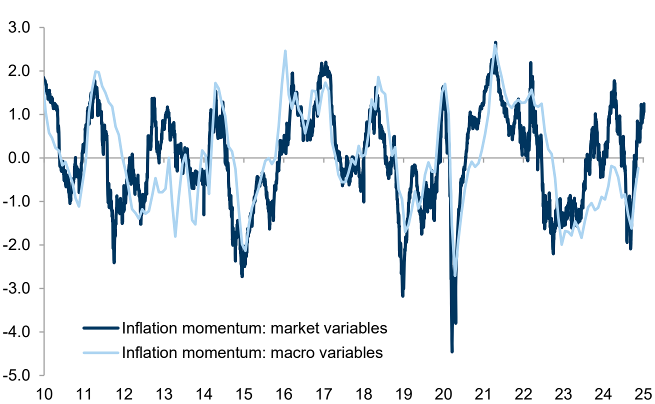
Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

Within our business cycle scores, the main driver of higher equity drawdown risk has been inflation momentum turning from negative to positive. Negative inflation momentum allows central banks to react swiftly in the event of growth shocks, reducing drawdown risk for equities and balanced portfolios. Market variables have contributed the most to the increase in inflation momentum, with both commodity prices and US breakeven inflation increasing over the past few months (Exhibit 5). Macro data still point to a moderation in negative momentum, rather than a re-acceleration in inflation – inflation momentum has turned less negative broadly across DMs. Often shifts in inflation momentum from market and macro variables are closely linked, but there can also be disconnects between the two, for example since mid-2023. While our economists are relatively benign on their US and global inflation outlook, a combination of rising trade tariffs and sticky services inflation globally has somewhat increased inflation risk.

Similarly, an increase in policy uncertainty, captured by the News-based Economic Policy Uncertainty index, has also increased equity drawdown risk (Exhibit 6). Global trade and the risk of US tariffs have been at the epicenter of this surge in uncertainty, with measures of trade policy uncertainty spiking above their 2018-2019 highs. But similar measures also recorded a rise in uncertainty around other US policies, such as regulation and fiscal policy, as well as outside the US – European policy uncertainty at all-time highs has already weighed on European equity relative valuations. While the predictive power of policy uncertainty for equity drawdowns has been mixed, with elevated policy uncertainty and geopolitical risks there is potential for setbacks that are very difficult to anticipate.

Exhibit 5: Market variables suggest more positive inflation momentum

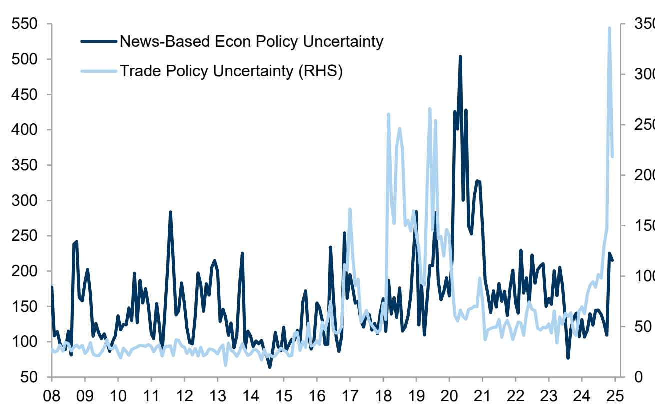
Average 1-year rolling z-score



Market variables: y/y chg WTI price (real), y/y %chg CRP price, US 2y breakevens, US 10y breakevens. Macro variables: US CPI y/y, US core CPI y/y, US PCE price y/y, US PPI y/y.

Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research

Exhibit 6: Economic policy uncertainty has increased since the US election alongside trade policy uncertainty



Source: Haver Analytics, Goldman Sachs Global Investment Research

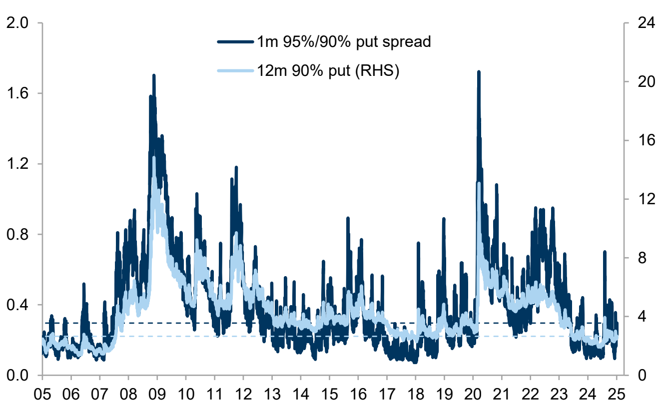
Our asset allocation remains modestly pro-risk into 2025 (OW equities and bonds, N commodities and cash, UW credit), but we focus on more diversification across and within assets and selective tail risk hedges. As we wrote before, a measure of drawdown probability can help lower the cost of hedging – buying option hedges when the drawdown probability was elevated (> 35%) or above 15% with the VIX below 25 (such as now) would have improved risk-adjusted returns without compromising performance excessively.

Given the relatively low level of equity vol, in particular after the re-set from mid-December, and higher skew, we like shorter-dated S&P 500 put spreads to hedge near-term correction risk (Exhibit 7). While we expect the macro backdrop to remain supportive, market sentiment might deteriorate in the event of negative growth surprises, an increase in (geo)political uncertainty around the US Presidential inauguration or misses during the January earnings season. Longer-dated equity puts look attractive for investors concerned about a more severe macro deterioration. After the recent hawkish repricing, longer-dated S&P 500 puts would likely also benefit from falling front-end rates in the event of severe growth shocks.

A renewed pick-up in inflation remains a key risk for equity and multi-asset portfolios. While Dollar longs should be useful to protect from rates and tariff risks, FX implied volatility has increased alongside a stronger Dollar since the US election, making USD calls rather expensive also in the front end (Exhibit 8). Hybrids can be attractive to hedge the risk of rising rates weighing on stocks, in particular S&P 500 down/EURUSD down, but also S&P 500 down/US 10y up double digitals.

Exhibit 7: Equity put options still look attractive to hedge correction risk

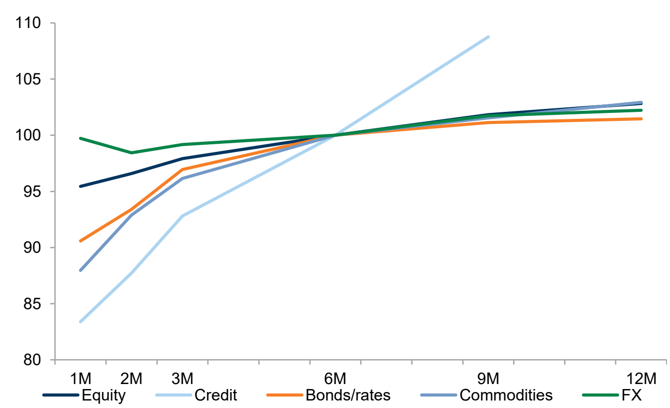
Option price as a % of spot



Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

Exhibit 8: FX vol has increased, also in the front end

ATM volatility indexed to 100 at 6-month



Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

TRADE IDEAS

Best Trade Ideas Across Assets

For pricing and a list of previous recommendations, please visit our Trade Ideas page.

1. Stay long MSCI South Africa (MXZA) vs. MSCI EM ex-China (EMXC), opened on May 16, 2024, at 1.48, with a revised target of 1.75, and a revised stop of 1.55, currently trading at 1.59.
2. Close Buy JPY 6m5y payer on 6m 2s5s10s payer fly, opened August 9, 2024, at 0.00, with a target of 0.07, and a stop of -0.04, for a potential gain of 7bps.
3. KRW 2/10Y IRS steepener, opened September 4, 2024, at -12bps, with a target of 30bps, and a stop of -30bps, currently trading at 6bps.
4. Buy USD 6m5y A/A+30/A+60 payer fly, opened September 20, 2024, at 0.05, with a target of 0.15, and a stop of 0.00, currently trading at 0.02.
5. Stay long Indonesia 1Y SRBIs fully FX hedged, opened on October 3, 2024, at 6.90%, with a target of 5.70%, and a stop of 7.50%, currently trading at 7.12%.
6. Receive 2Y2Y IRS in CZK vs. EUR, opened on October 15, 2024, at 139bps, with a target of 95bps and a revised stop of 190bps, currently trading at 155bps.
7. Buy USD 6m5y straddle on 6m 2s5s10s straddle fly, opened November 8, 2024, at 0.01, with a target of 0.16 and a stop of -0.08, currently trading at 0.04.
8. Buy CGB 5Y on an FX-hedged basis, opened November 17, 2024, at 1.69%, with a revised target of 1.20% and a revised stop of 1.60%, currently trading at 1.36%.
9. Receive 5y5y AUD IRS vs pay CAD 5y5y, opened November 18, 2024, at 1.61, with a revised target of 1.20 and a revised stop of 1.60, currently trading at 1.56.
10. Pay 20s on 10s20s30s SOFR fly, opened November 18, 2024, at 19bps, with a target of 25bps and a stop of 15bps, currently trading at 20bps.
11. Stay short EUR/GBP, opened November 22, 2024, at 0.83132, with a target of 0.8210, and a stop of 0.8420, currently trading at 0.829.
12. Stay long South Africa (MXZA) vs. Poland (MXPL), opened November 22, 2024, at 100, with a target of 115, and a revised stop of 85, currently trading at 89.78.
13. Stay long USD/SEK, opened December 5, 2024, at 10.85, with a target of 11.25, and a stop of 10.75, currently trading at 11.12.
14. Stay long USD 5y5y inflation swap, opened December 6, 2024, at 1.62, with a target of 1.80, and a stop of 1.52, currently trading at 1.59.
15. Stay long the sovereign USD bonds of Chile, Costa Rica, Jamaica, Jordan, Oman and the UAE as an equally weighted basket, opened on December 13, 2024, at 0%, with a total return target of 3%, and a revised stop of -3%, currently trading at -1.9%.
16. Stay short EUR/BRL, opened on December 13, 2024, at 100, with a total return

target of 106, and a revised stop of 95, currently trading at 101.4.

17. Buy USD 3m2y A-5/A-35 bp receiver spreads, opened on December 19, 2024, at 0.10, with a target of 0.05 and a stop of 0.20, currently trading at 0.09.
18. Own 2y3y USTs vs SOFR, opened January 2, 2025, at -0.47, with a target of -0.37, and a revised stop of -0.47, currently trading at -0.43.
19. Sell USD 3m 2s10s curve cap, opened January 3, 2025, at 0.14, with a target of 0.05, and a stop of 0.20, currently trading at 0.17.
20. Stay long INR vs. short Asian FX basket (comprising MYR, THB, SGD, TWD and CNH in equal weights), opened January 6, 2025, at 100, with a target of 108, and a stop of 96, currently trading at 99.98.

Disclosure Appendix

Reg AC

We, Andrea Ferrario, Christian Mueller-Glissmann, CFA and Alessandro Giglio, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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