Market Chronicles

Navigating Volatility, Election Uncertainty, and Structural Shifts. Oh My!

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Q3 market insights: Resilience in the face of uncertainty

As we reflect on the third quarter, a few key trends stand out. First, volatility spiked and quickly reversed in early August. Second, the equity market showed remarkable resilience in the face of seasonal, macro, and micro headwinds. Finally, institutional volumes remained robust despite some pockets of reprieve, the solid continuous helping to support higher prices.

This year's market backdrop has been shaped by a convergence of factors: the steady participation from traditional asset managers in the US markets, which has been a surprising year-long theme, reduced volatility and stronger correlations. As the 2024 macro picture started to peel away—inflation under control, the jobs market no longer falling off a cliff, a better sense of a soft-landing scenario, certitude of rates adjustment, etc.—institutional asset managers got involved in a noticeable way and created the healthiest trading backdrop since pre-Covid. Depth of book, continuous volumes and block availability helped traders and portfolio managers navigate positions more seamlessly and impact costs in conditions reminiscent of pre-pandemic markets.

Looking at the US Top 500, the drop in liquidity post-August volatility was noticeable but, overall, liquidity at the touch has remained much better than in recent years. The markets' resilience, even in the face of the largest systematic fund unwind of US equities since the pandemic, speaks to the strength of current trading conditions. We must keep in mind, though, there has been a dip as we moved into September, raising a few concerns that could cause manager trepidation: seasonality, severity of rate cuts, slowing corporate buyback calendar and valuation. Overall, markets never experienced the typical summer slowdown.

After the Fed's surprise decision to cut rates by 50 bps on September 18th, there has been some institutional action which has interestingly failed to lead to a rise in real price volatility, which liquidity vacuums can cause. Maybe a repressed memory, but if we take a look at the daily price action of the S&P 500 in 2022 compared with 2023 and 2024, we see that 2022 was marked by once-in-a-generation levels of cash raise, 2023 was the needed runway to lift institutional apprehension, and 2024 has been the low volatility environment that brought attention back.

With inflation concerns receding and focus shifting onto the jobs market, next week is shaping up to be relatively quiet—albeit with some nervousness around key metrics like the September payrolls (due October 4) and the CPI report (due October 11). What hasn't yet come into full focus is the US presidential election. Historically, election-driven volatility tends to be absorbed by the markets, and the current liquidity backdrop suggests that this could be the case again. But while markets seem to be betting on a soft landing and manageable inflation, election uncertainty remains an overhang.

So, about that election: What lies ahead

Prediction analytics and historical trends indicate that election volatility is typically short-lived. While comparisons to 1968, with its political turmoil and economic uncertainty, have been made, what's more relevant is how resilient markets have historically been in election years. In 1968, for instance, the S&P 500 rose by 7%, which is the historical average for election years. While many market participants can't remember 1968, the divisiveness and uncertainty around politics seems like it might have been just as thick as it is now.

From a policy standpoint, both candidates have outlined tax proposals that could significantly impact corporate earnings. Trump's potential reduction of the corporate tax rate to 15% would likely boost S&P 500 earnings, while Harris's proposal to raise the rate to 28% could have the opposite effect. However, these proposals are just one piece of the puzzle, and their actual implementation will depend on the broader legislative landscape. If Trump's 2017 tax cuts were to expire, he has also indicated that he would move the corporate tax rate to 15% from 21%. Economists equate this to about a 4% rise in S&P 500 earnings. Harris' proposal is to raise the corporate rate to 28%, which has been forecasted to have a negative effect of roughly 5%.

So while the US presidential election looms large, potentially bringing moments of trepidation, this market is particularly well-poised to absorb volatility around the event. In past cycles, markets have shown resilience in the face of political uncertainty, focusing instead on core macroeconomic data points. With the likelihood of a soft landing increasing, and inflation and employment data aligning with rate cut expectations, market participants are betting that these fundamentals will drive the market's performance.

The SEC's market structure overhaul

Market structure is obviously up for grabs with a changing presidential administration. As anticipated, with the election bearing down, the SEC recently approved a few components of the Market Structure Overhaul Proposal that were originally presented over 1.5 years ago.

Tick Sizes, or updated Rule 612, will establish half-cent minimum increments ($.005) for quotation and orders in NMS stocks (priced above $1), with a time weighted average of 1.5 cents or less. Market participants from all angles were in agreement that a change could help here, but the 1.5 cent spread was a bit more aggressive than some suggestions and opens the program up to a larger number of eligible stocks

In line with reducing tick increments, the SEC has also approved the Access Fee revision. Once implemented, the top fee exchanges can charge to access their best quotes is capped at 10mils, a substantial cut from the previous 30mils. Similar to the tick-size adjustment, the scope was broader than many market participants had pushed for. An access fee cap of 15mils, to the tick constrained bucket of symbols, would have been proportional to the minimum quoting increment.

The Access Fee and Tick Size adjustments were the headline events. So was the Tiered Pricing Determinism and Odd Lot. Further transparency will be expected in terms of fees and rebates. Odd lots now move to a more protected quote status, which, at this point, they have probably earned. Odd lot volume has spiked in recent years, pushing towards 20% of total market volumes at times, and consolidated feeds will now have to disclose the best odd lot bid/offer prices.

These reforms are set to take effect in November of 2025. Ultimately, the onus to comply will fall on the broker/dealers and exchanges to adjust data feeds and the SIP. Firms will need to rewrite code to ATSs, like Liquidnet, and will likely have to rework pricing structures to observe different lists for tick sizes and fee structures. Not only will the mechanics of how stocks trade change but also the behavior of street algorithms.

Importantly, these approvals were not passed along partisan lines with a 3-2 vote but rather 5-0. This will fortify its position to withstand challenges. While the tick size change will allow for many names to trade closer to their "natural" spread, the list was expansive enough to alarm concern of a future growth of eligible names and further fragmentation within the quote. The move to 10mils on access fees was more intrusive than expected. From the exchanges perspective, their top-line fees are being cut drastically, and market makers are seeing significant margin compression. The possibility of both exchanges and market makers to sue the SEC is very real.

In summary

As we look toward the end of the year, US markets have shown remarkable resilience in navigating a complex macro environment. With institutional volumes still providing a solid foundation, the upcoming election, policy shifts, and market structure reforms will all play pivotal roles in shaping what lies ahead.

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