Even Wall Street warns: This market is 'weird'

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© BRENDAN MCDERMID A man walks past the New York Stock Exchange in New York City, U.S., May 17, 2017. REUTERS/Brendan McDermid The bull-minded optimists that gravitate toward Wall Street are herded and fed by the major investment banks and brokerages, which because of their commission-based business models, try to encourage broad participation in the financial markets. No surprise then that most Wall Street analysts and brokers tend to find the silver lining in everything. Stocks rising? Better buy now before it's too late. Stocks falling? Great, buy more because shares are on sale.

So it came as something of a shock when Bank of America Merrill Lynch strategist Benjamin Bowler headlined a note to clients last month with the warning that, although it's not obvious on the surface, "these markets are very weird" — marked by prolonged periods of extreme calm, easy gains to record highs and chaotic, rapid selling events like the 1.8 percent drop in the S&P 500 on May 17.

The takeaway? Something is broken. The stock market isn't acting normally.

Whether this will result in a severe market correction of the type not seen in years, or is merely a prelude to even higher prices, remains to be seen. But it's noteworthy, both for the uniqueness of the current market environment and for the willingness of a major Wall Street bank to call it out.

Beneath the surface tranquility, oddities abound. Consider, for instance, that 10-year Treasury bonds — a classic safe-haven asset — saw their yields drop to 2.15 percent on Friday, a level not seen since November, and even after a price drip now yield 2.18 percent.

Also unusual: While the major stock averages are at or near all-time highs, only four of the 11 S&P 500 sectors hit new highs. Moreover, two of them (utilities and consumer staples) are defensive in nature. These are the types of stocks you want to own "when you sniff a recession around the corner," according to Gluskin Sheff strategist David Rosenberg.

Bank of America's Bowler, for his part, highlights just how intense the May 17 drop was: It represented a five-standard deviation event relative to recent volatility (which, in statistics speak, represents a massive shift). Equally odd was the speed at which the bulls reversed the decline: The rebound was the second-fastest retracement of five-sigma decline since 1928, a testament to just how strong the "buy-the-dip" mentality is right now.

Bowler added that similar periods of ultra-low volatility occurred in the early 1950s, mid-1960s, mid-1990s and mid-2000s. What's different now is that we've seen a higher number of large drawdowns interrupt the tranquility. Examples include last June's Brexit selloff and the Sept. 9, 2016 selloff related to chatter the Bank of Japan could sell long-term bonds to release pressure on pension funds.

Looking ahead, what are some potential "Black Swan" events that could result in further five-sigma drawdowns? Societe Generale, as part of its Global Economic Outlook, listed a few. The largest is a lack of progress on U.S. tax cuts this year, to which they assign 30 percent odds. Other worries include European policy shocks (25 percent odds) and an economic slowdown in China (15 percent odds).