ornico KNOW HOW TO GROW

Publication		
COVER		
Page	Date	AVE (ZAR)
40-41	Fri 01 Sep 2017	28093.52

World markets' low volatility: Beware of hidden dangers

Coface, the international trade credit insurance company

The CBOE Volatility Index (VIX) is at a record low, close to its lowest level of 1993. Meanwhile the S&P 500 and the Dow Jones Industrial Average (DJIA) indices reached record highs.

On July 21st, the VIX reached a low point of 9.36 %, the S&P 500 reached 2,472 points and the DJIA 21,580 points. The VIX, a fear gauge, measures investors' expectations of market volatility, reflecting their levels of concern. Its current level is extremely low, meaning that investors have rarely been as calm as they are at moment.

1. In the context of ample liquidity, low market volatility can be partly explained by low political and economic uncertainty.

Markets have been benefitting from excess liquidity. Moreover, there have been no recent or significant negative changes in the outlook for growth, inflation, or the political environment – any of which can lead to higher volatility.

On the political side, political risks have considerably eased. Since the unexpected victories of Brexit and Trump, investors seem to have learned not to overreact to political changes.

Moreover, according to the Economic Policy Uncertainty Index, political risks have contracted since the beginning of the year, especially following the outcome of the French election in May 2017. Vox EU noticed that high political uncertainty no longer necessarily leads to increased volatility in the financial markets. This new phenomenon has been seen with Trump administration policies that are "unreliable and difficult to interpret" for investors[1].

On the economic side, the US is experiencing a moderate recovery, recording 1.2% growth rate in the first quarter of 2017. This has kept the Federal Reserve from over-tightening its monetary policy and reassured investors.

Europe is stacking up more good news. Growth is exceeding market expectations (+1.9 % Y-o-Y in the first quarter), business confidence is at its highest for six years, consumer confidence is rising and business insolvencies are declining. These trends are expected to continue this year. In China, industrial production and retail sales beat market expectations in the first half of 2017, and growth reached +6.9 % Y-o-Y in the first and second quarters.

2. Strong investor confidence is generally associated with good financial performance

An analysis of previous data shows that the VIX has fallen 82% of the time when the S&P 500 has risen. The VIX and equity indexes are negatively correlated (see Chart). Over the last twenty years, volatility was as low as this for a long period between 2004 and 2006. This was due to economic growth and a strong stock market after the tech bubble burst at the beginning of the 2000 period.

RISKS

1. Learning from the past

If the future pans out anything like the past, this low volatility needs to be closely monitored. Prior to 2008, the VIX had never been above 40, but it skyrocketed to 81 in November

2008 (up to 47 in September), before declining again. Looking at the current situation, there is legitimate cause for concern that a new peak of volatility could be on its way.

2. Investors could potentially underestimate the current risks

If investors are too relaxed, they could become vulnerable and overreact to the slightest changes in the economic or political outlook. This raises the question of whether the financial system has become disconnected from the real economy.

The markets are beating records, but global growth remains moderate and the geopolitical situation remains tense. The excess of liquidity is a concern. The Bank of America Merrill Lynch Fund Manager Survey revealed that 44% of respondents thought that equities were currently overvalued. This is the highest percentage since 1999 – just before the tech bubble burst. These excesses in the financial system could therefore trigger a liquidity crisis.

3. Several factors could lead to more volatility

Eventually, even if monetary policies are not excessively restrictive, Central Banks are reducing (or will be gradually reducing) their support of the economy. Mario Draghi has not announced any increases in interest rates in the euro area and the Bank of Japan has postponed its 2% inflation target to 2019.

Nevertheless, the Fed rate (between 1% and 1.25% since June) could increase again before the end of the year. Until now, the improvement of financial markets and the easing in credit conditions have helped companies improve their financial situations and to invest. A change in monetary policy could change market perceptions and therefore affect financial conditions.

The lack of clarity over the future of US policy is causing uncertainty for investors. The US economic situation is not particularly positive and its policies are unclear. Coface forecasts moderate growth for 2017, at 1.8%. Moreover, US policy is unclear. During his campaign, President Trump promised investor-friendly policies (such as tax reforms and deregulation of the market) and expenditure on infrastructures, in order to foster growth and reduce unemployment.

Since Trump came into office, not much of this has come into fruition. Fears are rising, as Trump's reactions are unpredictable and this threatens the stability of his policies and the markets.

Geopolitical risks are still high. Tensions in the China Sea (including the North Korean issue) and in several Middle Eastern countries (Qatar's embargo and tensions between the Gulf States, Syria, Iraq, Yemen) remain serious and there could be a new peak in these tensions.

1. Explaining the puzzle of high policy uncertainty and low market volatility, Lubos Pastor, Pietro Veronesi, 25 May 2017