portfolio construction forum

Market volatility – has it turned?

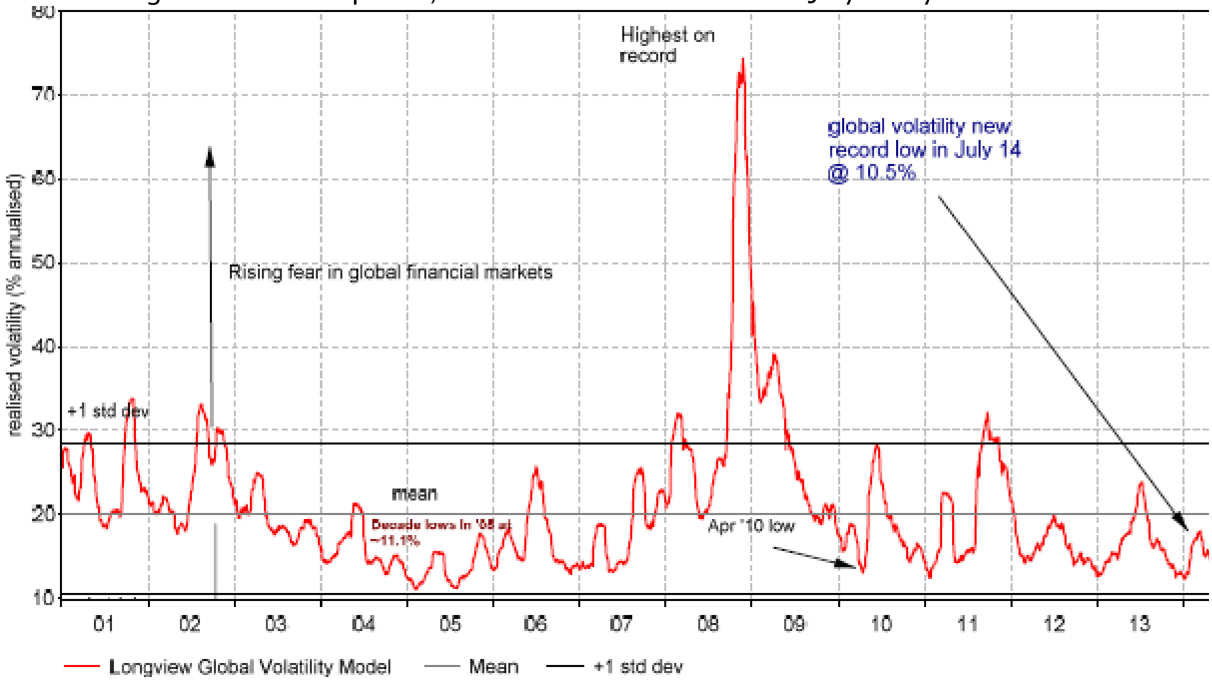
Chris Watling | Longview Economics | 13 October 2014

Earlier this year, volatility across a whole range of key global assets reached major multi-year lows. On 3 July, implied equity volatility (as measured by the widely followed VIX) reached its lowest since February 2007. Short-term realised (i.e. actual rather than implied) volatility reached its lowest since 2005 (Figure 6 below). It has been the longest period since 2006 without a 10% correction in the S&P500. The volatility message from other assets has been similar. Bond volatility earlier this year reached one of its lowest levels in the past three decades. Average currency volatility was at its lowest since 2007 while Longview's global volatility indicator (Figure 1), which averages realised volatility across 150 asset classes, set a new record low in July (i.e. since 2001).

The key question investors have to ask is what is behind this lack of volatility and is this a "new normal" environment? That is, with many key central banks around the globe printing money (i.e. enacting their own version of QE), have policy makers really "got investors' backs"? Or, alternatively, with equities offering a real return of 7% (i.e. a 7% earnings yield) and bonds returning approximately a 0% real yield, should investors be relaxed or concerned?

Figure 1: Longview Global Volatility Model

Global volatility, which averages short-term realised volatility across 150 global financial prices, reached a record low low in July this year.

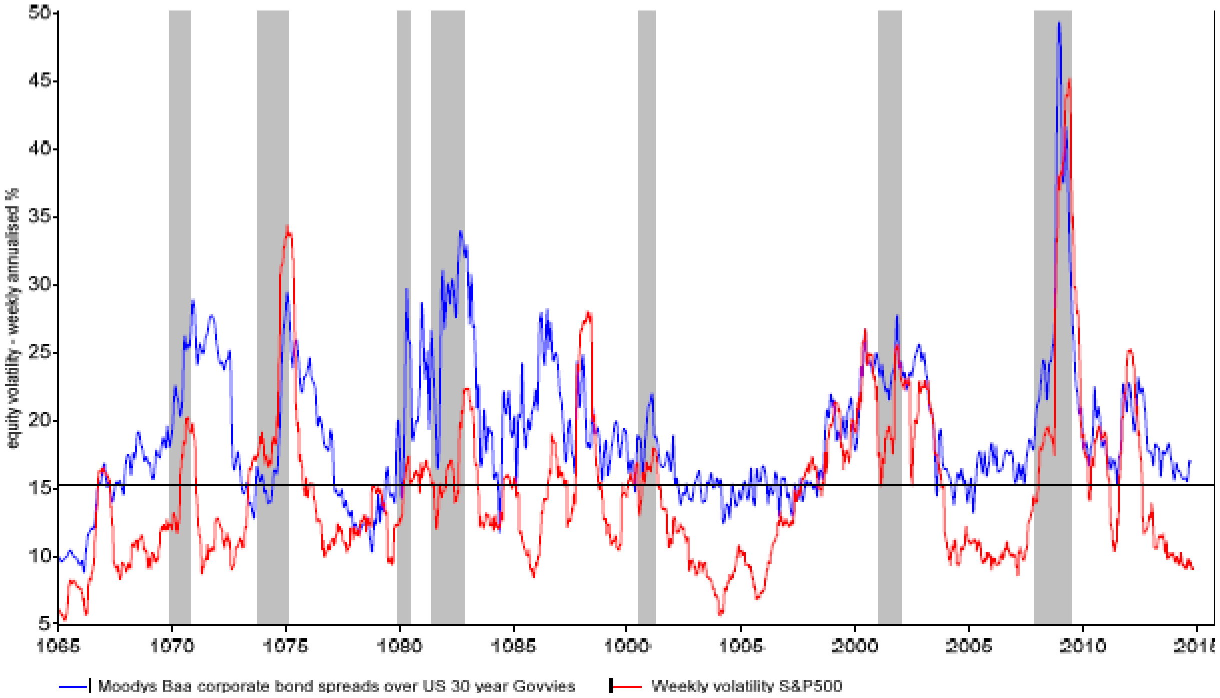


Sources: Longview Economics, Reuters EcoWin.

The key to understanding equity volatility is appreciating that it is a measure of corporate sector risk. That is, it is related to the health of the corporate sector and, in particular, the strength of the corporate sector's cashflow (i.e. the vulnerability of its P&L to rising costs and/or slowing revenue growth). Corporate sector bond yields also reflect corporate sector risk - that is, they reflect the risk premium the market places on the corporate sector. Given that both reflect corporate sector risk, it is only natural that both are highly correlated. Indeed, as Figure 2 shows, both have moved closely in tandem for many years. For further analysis of this relationship see our August 2005 "Equity volatility low and set to stay low".

Figure 2: Corporate bond spreads (i.e. Moodys Baa over US 30 yrs) vs. S&P500 realised volatility

US equity volatility and corporate bond spreads are tightly correlated as both measure the level of risk in the corporate sector.



Sources: Longview Economics, Reuters EcoWin.

Most critically therefore, in that respect, it is essential to understand and determine at which stage we are at in the economic cycle. Deteriorating cashflow, expected rising wage inflation and likely rising interest rates over the next 12 months all point to a late stage in the cycle – probably the last quarter. Indeed, our analysis of cashflow earnings less buybacks and dividends in the US (Figure 3) shows deterioration over the last 18 months in the US corporate sector's cash flow. Cash earnings have fallen sharply since the start of 2013 in a manner similar to 2006 into 2007.

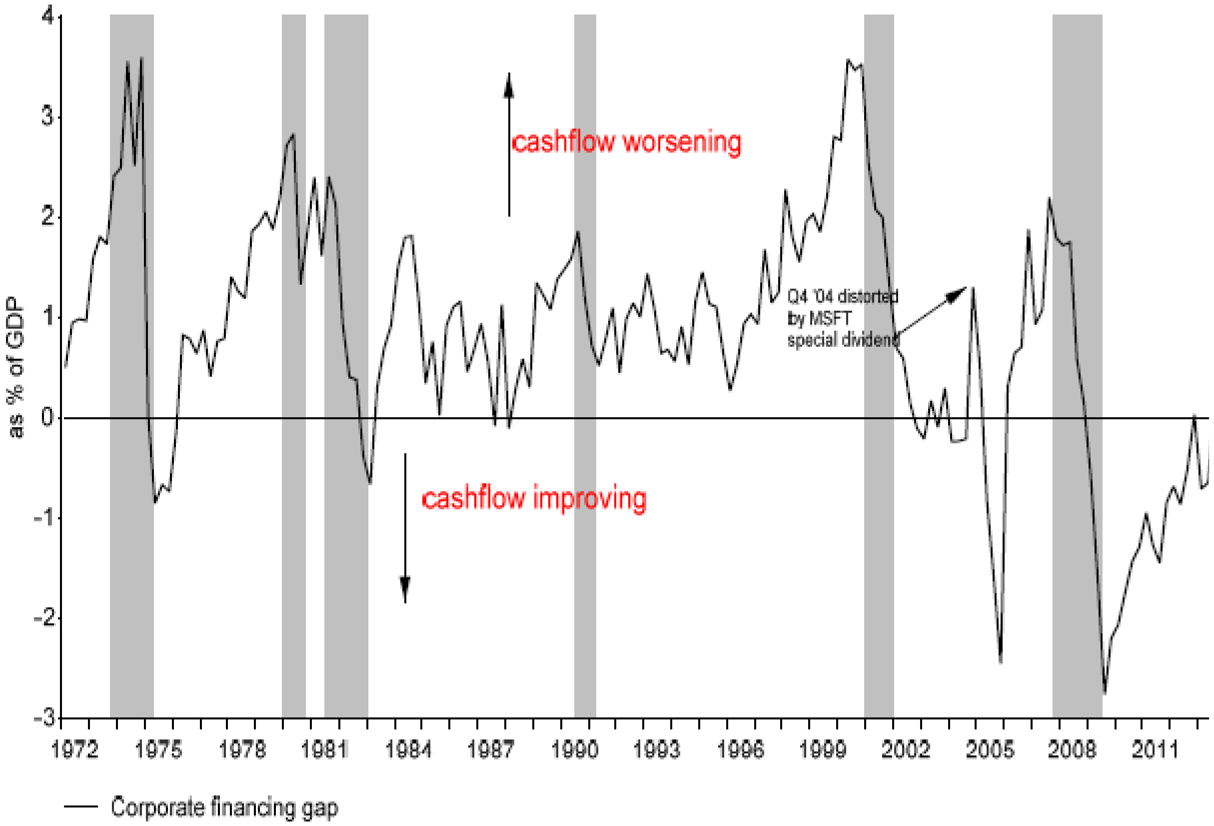
Figure 3: US corporate sector (non financial): Cashflow Earnings less Cashflow Uses

US (non-financial) corporates are increasingly spending more cash than they are earning (increasing their cashflow deficit).

Sources: Reuters EcoWin. Notes: This model measures cash earnings less capex cash costs, buybacks and dividends.

Added to that, as shown in Figure 4, the more traditional US corporate financing gap (after recent revisions) also shows deterioration in cash flow trends (note, this is a more traditional measure of cash flow which doesn't account for buybacks). Figures 3 and 4 hint at the recent pick-up in equity volatility (and corporate bond spreads) as heralding a major late cycle turn.

Figure 4: US corporate financing gap (as % of GDP)



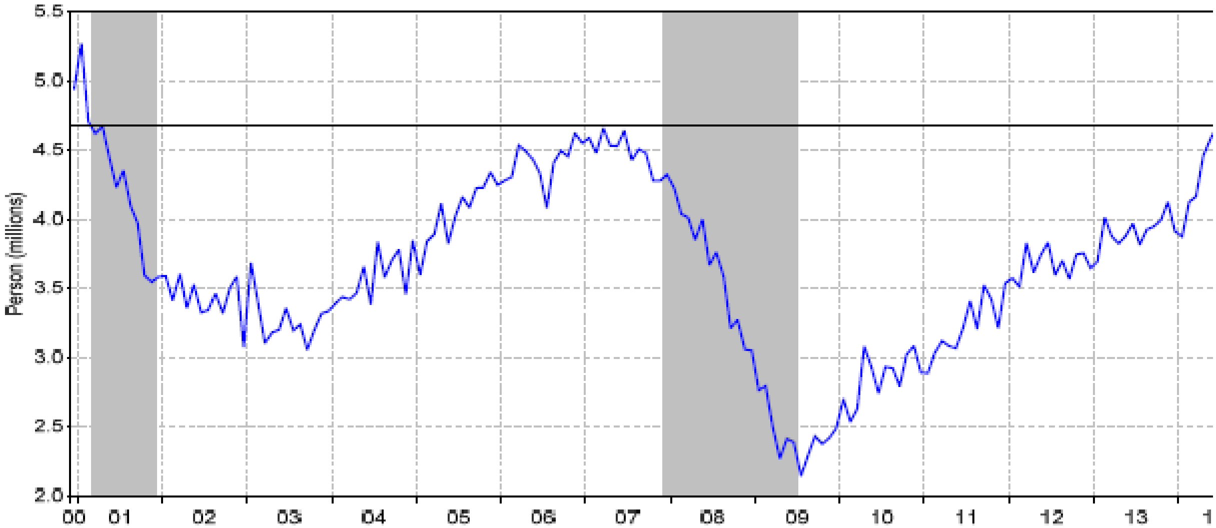
Sources: Longview Economics, US Federal Reserve Flow of Funds, Reuters EcoWin.
Note: This measure of US corporate sector cash flow (which doesn't include the effect of buybacks on cashflow) is also deteriorating (albeit not as dramatically as Figure 3 above).

In addition, US wage inflation also looks set to accelerate over coming quarters. The majority of (flow) labour market indicators point to a tightening labour market – jobs openings, for example, are at a record 13 year high, jobs plentiful less jobs hard to get is at an 8 year high, and Longview's forecast for the US unemployment rate suggests that 4% is likely, on its current trajectory, by sometime in 2016 (depending on one's view of the levels of slack). That level of unemployment, if reached, is clearly full employment. If correct, rising wage inflation will squeeze corporate profit margins and cashflow growth, thereby adding further to risk and volatility in the corporate sector.

All of this suggests that far from "having investors' backs", central banks while fixing the previous crises have engendered the conditions for the next one. What has been will be again. Equity volatility, we expect, has passed it's low for this cycle.

Read "Equity Volatility: Low and set to stay low!"

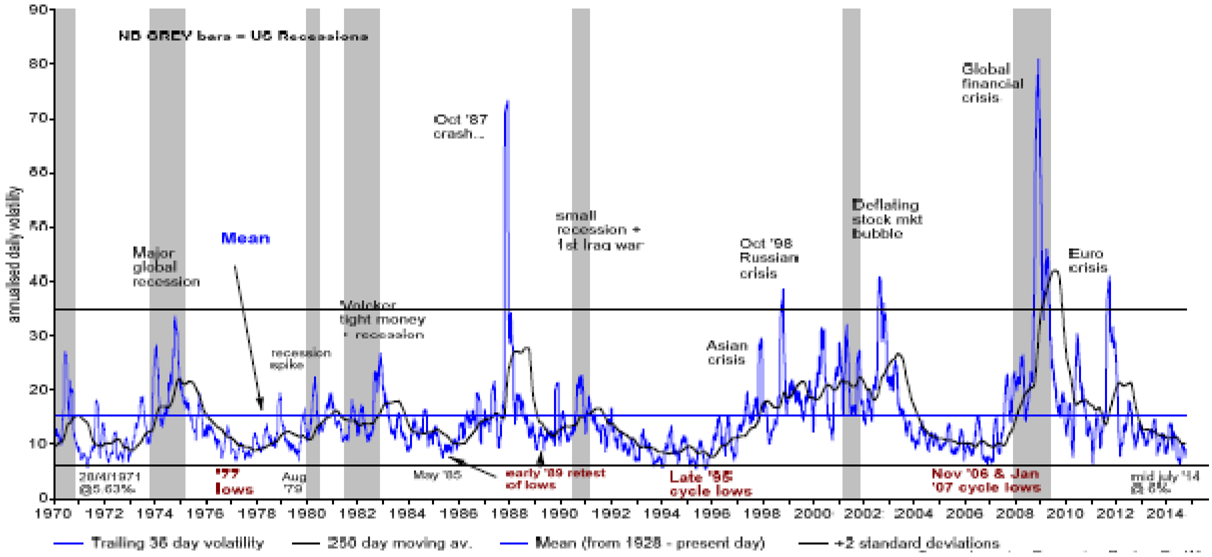
Figure 5: US Job Opening at their highest since 2001



Sources: Reuters EcoWin.

Figure 6: US S&P500 realised short-term daily volatility (%, annualised) 1971-2014

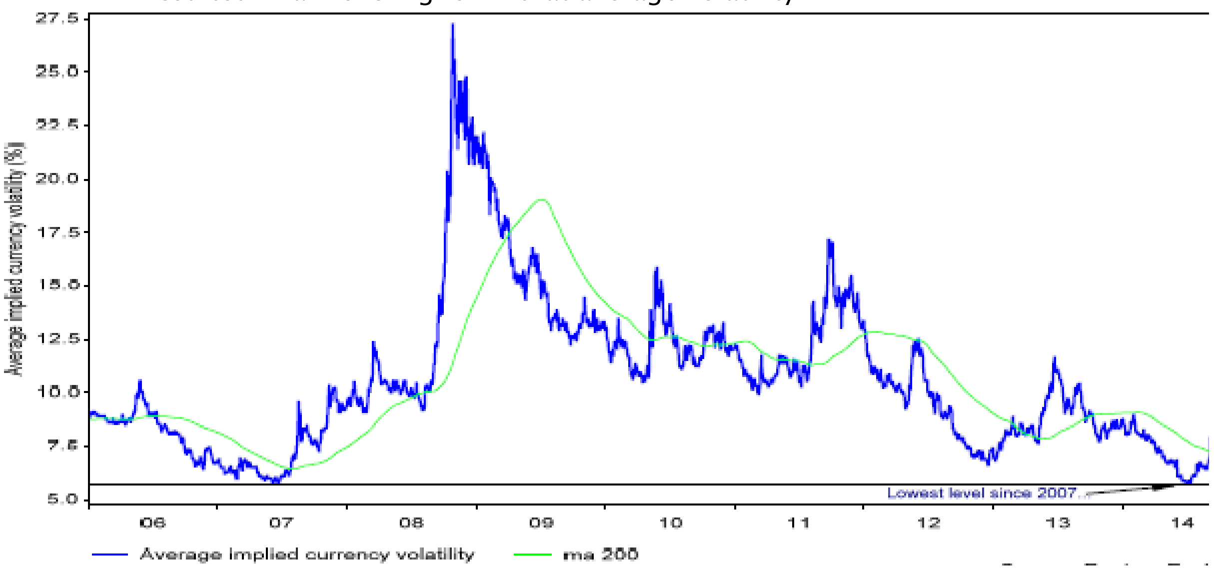
Realised equity volatility is close to record lows (i.e. compared to the past several decades)



Sources: Longview Economics, Reuters EcoWin

Figure 7: Average Currency Volatility – across a range of currency pairs

Currency volatility averaged across a range of major currency pairs was at a seven-year low earlier this year. Recent sharp moves in currencies have resulted in a move higher in that average volatility.



Sources: Reuters EcoWin

Chris Watling is CEO and Chief Market Strategist with Longview Economics. Longview Economics is an independent consultancy specialising in macroeconomic, thematic and commodity research. It offers strong macro and quantitative views across all major asset classes and markets.
Chris is a regular speaker at the PortfolioConstruction Forum Markets Summit each February and PortfolioConstruction Forum Conference each August.