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Four takeaways from the recent volatility spike

Russ Koesterich | BlackRock | 29 October 2014

Last week market volatility spiked to the highest level since 2011. To some degree, this should not come as a shock; we've been in an unusually quiet period that was due to end at some point and now has.

Nevertheless, last week's volatility surprised many, which raises the question of how to position portfolios. What does this recent bout of volatility tell us about the economy and financial markets?

Volatility is returning to its long-term average. First, to a large extent, the recent rise in volatility points to a return to a more typical market environment. While imperfect, the VIX Index provides a good illustration of this phenomenon. Between 1990 and the end of 2011, the VIX Index averaged roughly 20%. Since the start of 2012, it has hovered around 15% and, during the first eight months of this year, the average fell to a little over 13%. More or less, volatility has recently simply reverted to its long-term average.

The increase in volatility is consistent with past cycles. While no factor alone is responsible for the changed environment, I believe the pickup in volatility is reasonable in light of diminished expectations for global growth and less benign credit markets.

Historically, big drivers of financial market volatility have been forward looking economic conditions, credit conditions and market momentum, all of which have deteriorated over the past two months. To the extent that momentum has declined, investors expect less robust growth, and credit conditions – while still easy – are less benign than several months ago.

As the investment climate changes, it;s important to consider the investing implications of higher volatility. Here are my four key takeaways.

1. Momentum is likely to be less effective as a trading strategy. A change in the volatility regime can affect investor behavior. For example, during periods of extreme risk aversion, such as in 2008 and again in 2011, investors demanded liquidity and correlations climbed, temporarily negating the benefits of diversification. Obviously, the current environment is a long way from 2008 or 2011 – but, at the margin, higher volatility is likely to impact behavior. Specifically, a more normal volatility environment will arguably dampen enthusiasm for momentum trades.

2. Europe is now discounting a lot of bad news. European equities are now trading at levels that suggest investors are discounting another recession; the dividend on the DAX Index is at roughly four times the level of German Bund yields. While eurozone stocks will need the

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support of some earnings growth to move forward, this will not be difficult in light of very modest expectations.

3. Japan looks cheap, and there is a catalyst. I continue to see opportunities in Japanese equities, which benefit not only from very inexpensive valuations but also a reallocation trend to domestic stocks from Japanese pension funds. Just this week the GPIF, the world's largest pension fund, suggested that they would lift their domestic equity allocation.

4. Stick with US large caps and high yield. Within the United States, I recognise opportunities, particularly in large cap, cyclical names. On the fixed income side, high yield now represents an attractive option given recent spread widening.

To be sure, the relative value offered varies segment by segment, and you can read more on my specific country and segment outlooks in my latest *Investment Directions* monthly market outlook.

Looking forward, financial markets remain vulnerable, particularly if we see a further tightening of monetary conditions because of a stronger US dollar. For now, however, I view the recent volatility upsurge as an indication of markets returning to normal after several years of investor complacency and uncommonly low volatility.

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