31 March 2017

Low Volatility Indicators Belie Global Uncertainty

- Low volatility is prevalent across equities, bond and currency markets. This theme belies the widely followed "global policy uncertainty" indices that suggest heightened uncertainty. There are a number of identifiable risks to the outlook but we'd argue that the outlook is no more uncertain than usual. We think that clear central bank guidance is one factor behind the low vol environment. This removes a large source of uncertainty about the outlook for interest rates.
- Low vol implies high risk appetite. We think that risk appetite is likely to be weaker later in the year and this will be one factor acting as a headwind for the NZD.
- Times of low volatility can provide opportunities for investors to consider buying some cheap(er) protection via options. Hedging structures via options have become more attractive and should be on the radar for exporters and importers.

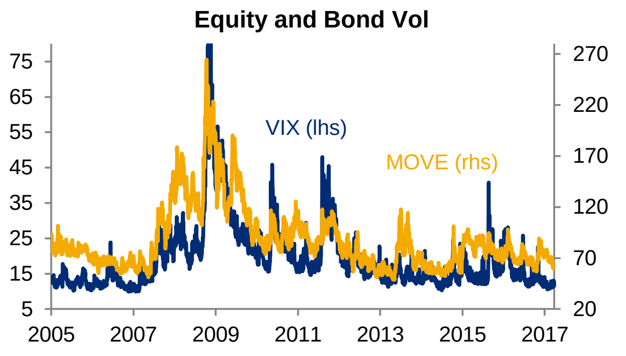
A prevailing theme at present is the depressed volatility of equity, bond and currency markets. The first two charts show implied volatility indices for the US S&P 500 (VIX), US Treasuries (MOVE), a basket of nine currencies (CVIX) and the NZD. Implied volatilities based on option pricing are highly correlated with historical volatility so they simply reflect the fact that actual market volatility is low.

The volatility indices all suggest that market participants are not particularly worried about the future. They are trading as if the outlook about the future is fairly predictable. If there were concerns about the future, then the implied volatilities would be increasing, reflecting a higher price that investors were prepared to pay for some sort of protection to the potential downside in asset prices.

An interesting observation is that a widely followed "Global Economic Policy Uncertainty" index increased from late 2015, against the grain of lower market volatility. The policy uncertainty index is based on archives of thousands of news sources that count the number of articles that contain a triple of terms about the economy, policy and uncertainty. The timing of the divergence between the policy uncertainty index and the VIX index is from towards the end of 2015. This coincided with the rising popularity of Donald Trump and him leading the polls for the Republican Primary election, ahead of November's US Presidential election.

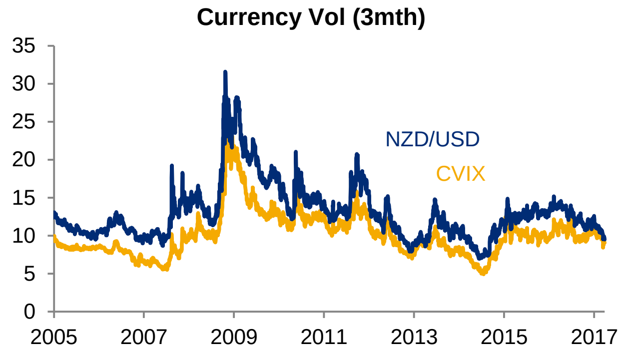
We highlight the global policy uncertainty index because it was mentioned in the February press conference at the release of the RBNZ's Monetary Policy Statement and "uncertainty" was prominent throughout the key chapters.

Low Volatility in Equities and Bonds



Source: BNZ, Bloomberg

Low Volatility in Currencies



Source: BNZ, Bloomberg

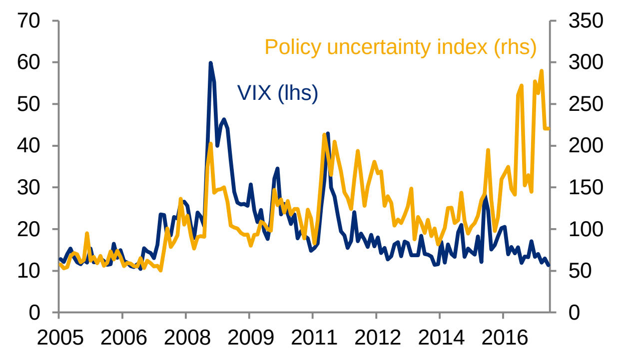
The Bank reiterated its view in last week's OCR review, where it mentioned "extensive" geo-political uncertainty and "numerous" uncertainties. This theme is likely playing a role in the Bank's policy reaction function, and sits behind its view that the OCR could be raised or cut at this juncture.

We believe that the increase in the policy uncertainty index reflects a number of factors, including the initial rise in popularity of Donald Trump and his eventual election.

But he can't take all the credit, and we'd also point to the general wave of "anti-establishment" across the world and rise in populism, Brexit, the tightening cycle of the US Fed, and conflict in the Middle East.

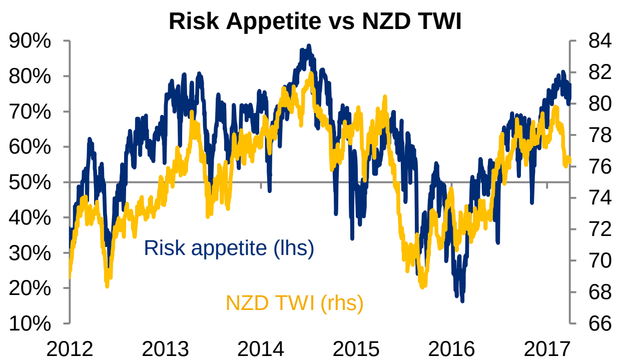
One might even argue that much of the "uncertainty" around the outlook reflects a bit of a media beat-up. The more the media report on it, the higher the index goes!

VIX and Policy Uncertainty Index Diverge



Source: BNZ, Bloomberg

Risk Appetite Likely to Fall From Here; Headwind for NZD



Source: BNZ,

In assessing the outlook for the world economy and financial markets, we would put more weight on the market-based measures of "fear" or uncertainty than an index compiled of media-based reports. The market represents the weight of opinion of millions of investors who are prepared to back their views with real money on the line. All the talk about so-called uncertainty could easily reflect the bias of the media. The political establishment has certainly been disrupted, but whether this is cause for concern is highly debateable.

In many ways, the lower than normal volatility in financial markets can be explained by a number of factors including, but not limited to:

- Lower volatility in GDP growth and inflation, reflecting long-term structural factors (like central banks adopting inflation targeting and globalisation), and the fact that the world economy is about eight years into the economic recovery that began post-GFC.
- Less speculative trading activity, a reflection of new regulations and fewer market players post-GFC.
- Better forward guidance from central banks, which removes a large source of uncertainty about the outlook for interest rates.

The bottom line is that there is some information content in the current measures of volatility. Despite what the global policy uncertainty index is saying, what the media are saying and what the RBNZ is saying, volatility says the world isn't any more uncertain than usual.

The Fed seems to be on a fairly predictable path towards raising short term interest rates, the ECB and BoJ are on fairly predictable paths towards printing money and buying bonds that help keep their yield curves well under control and the RBNZ is on a fairly predictable path towards keeping the OCR stable over the year ahead.

Even US fiscal policy has now become more predictable. The recent failure of Trump's healthcare bill only served to highlight the political gridlock in Washington, even within the ruling Republican party. No doubt this was a humbling experience for the President and he will be more disposed to engage with his party going forward. That'll mean taking a more conservative approach to fiscal policy, so any major tax cuts will be more likely met with offsetting expenditure cuts to keep the deficit under control. It means less concern that the Fed might be behind the curve, as the prospect of much easier fiscal policy has been reduced.

With this predictability on monetary policy and, to some extent fiscal policy, investors aren't inclined to buy protection, resulting in a lower VIX, MOVE and FX vol.

Without wanting to sound too sanguine there are, indeed, a lot of risk factors out there. Brexit, euro-area disintegration, China, and trade wars all remain on the radar, but none are seen to be disruptive enough at this juncture to protect against.

High levels of risk appetite reflect the low vol environment. BNZ's risk appetite index combines the VIX index, emerging market credit spreads and a US high yield spread into a single measure to gauge market sentiment. It has a positive correlation with the NZD, so we can explain much of the strength in the NZD last year by the rise in risk appetite towards a 2½ year high. Over the last few weeks, risk appetite has come off the boil and that has been one factor behind the recent weakness in the NZD.

We think that risk appetite will come under further pressure, not necessarily in the short term, but more certainly later in the year. One factor behind this might be a less positive run of global economic data, following the run of positive surprises. This is expected to put downward pressure on the NZD. Our short-term view on the NZD isn't as negative because, if anything, the NZD looks a little oversold on a short-term basis. Some of the recent weakness might already pre-emptively reflect a weaker risk appetite environment.

Times of low volatility can provide opportunities for investors to consider buying some cheap(er) protection via options. For equity investors, this seems like a good time. For borrowers, a hedging on dips in yield seems like a prudent strategy. Currency vol might be lower than it has been over the past 18 months, but it could still head lower. Hedging strutures via options have become more attractive and should be on the radar for exporters and importers.

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