Crushing Volatilities and Black Swans

"The higher the risk, the higher the return" – this is one of the most common and basic academic foundations of finance. Volatility is one way to measure this risk, as well as the return one should expect on an investment. The level of volatility is determined by the possible changes in price over a period of time. As the volatility of all financial assets becomes lower, the additional return expected from investing in these assets also decreases.

An unprecedented event in financial history is currently happening across all capital markets: the volatility levels of equities, bonds, commodities and FX rates are crushing to all-time lows. As can be observed in the graphs on page 4, both historic as well as implied (i.e. projected) volatilities are at lows never before witnessed in the history of the financial markets. And this occurs across different markets! This indicates complacency from investors in each of those markets, or in other words, it indicates that investors are not pricing in larger macroeconomic or geopolitical risks. However, is this truly the case? And more importantly, why is this happening?

We believe there are two main reasons, which deal with the existence of highly distorted markets:

1. Super expansive monetary policies from the Fed and other developed central banks like the BOJ and the ECB.

2. Central banks clear communication of policy

1) Super expansive Monetary Policy

We live today in a world with ultra-low interest rates, and they are here to stay for many more years as economic recovery after the Great Recession is sluggish, and labor markets are improving only at a lethargic pace.

We agree that at some point, short term rates such as LIBOR rates will increase, but we feel they might reach a 2% level rather than their historic 4% average. Also, we believe this will be a very gradual process as the Fed has clearly communicated that any change will depend on economic data, and continues to maintain a posture of "whatever it takes".

The other critical point which explains why the process of increasing

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Volatilities are at historic lows across the market spectrum- in equities; bonds; commodities; and currency rates. We believe that this largely due to the heavy central bank intervention we have seen in the markets over the last few years- both the super expansive monetary policy and the clear communication of this policy by the central banks.

Investors can take advantage of these low levels of volatility by buying cheap protection introducing some hedges in their portfolio. The dynamics of highly globally coordinated and expansive monetary policy can only continue for so long, and Black Swans can always arise, usually when least expected.

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rates will take years is the Net New Issuance (NNI) of US Treasuries. This is simply the difference between the Supply and the Demand of Treasuries. In today's world NNI is negative, and we predict this trend is here to stay for a long time. Why is this happening? As governments impose fiscal restrictions/limitations upon themselves, the Supply of securities they need to issue decreases. For example in the US, the fiscal deficit is improving enormously and as such, new supply needs decrease on the margin. On the other hand, Demand for Treasuries is very strong from 4 main sources: Pension Funds, International Central Banks, Banks and the ultimate purchaser, the Fed (whose balance sheet ballooned 5 times since 2007). Pension Funds need a constant income stream to satisfy the demand from retiring baby boomers. Central Banks in Europe, Japan, Switzerland and other countries view the US Treasury as high yielding (as their long term rates are below those in America). Banks are boosting their holdings of US Treasuries as they are awash with cash and are not being aggressive lenders (in the same ways corporate CEOs are not heavily investing in Capex, in a world with low "animal spirits"). And if this is not enough, we have the Fed! Thus, global demand far outstrips global supply.

2) Central Bank communication

Another way to increase the level of economic activity is to reduce the level of uncertainty. If individuals were more confident about the future direction of the market, there would be much higher levels of both investment and consumption taking place. In the past, Central Banks did not release as much information as they do today, causing investors to be glued in front of their television sets awaiting the next big announcement concerning interest rates. These announcements were unpredictable for the most part, therefore there would be significant and rapid changes in monetary policy. Today, the major Central Banks have been able to achieve this goal of increasing certainty by communicating that they intend to hold a fairly predictable monetary policy- one without any radical changes. Interest rates will remain near zero percent and independent from the next economic indicator release. This elimination of uncertainty has also greatly lowered the volatility levels of financial instruments, ranging from long term bonds, commodities, equities and other securities. All of these investment vehicles are tied to the change in interest rates, therefore with a stable and predictable rate, there is more confidence and certainty in the market.

Conclusion

Can a super expansive monetary policy and heavy government interference continue forever? No, of course not. Global demand dynamics for risk-free bonds like US Treasuries can change at any moment (we saw this in June 2013). Another problem with the current state of the markets is that this reduction in volatility encourages people to take on much larger positions in assets that are perceived as safe under the new volatility levels. The problem with these "safe assets" can arise if there is a change in volatility levels towards the opposite direction. Since these positions are now much larger, they are much more exposed and sensitive to even a small change in volatility.

Our base scenario is that due to the new level of low volatility, markets will continue to rise to new heights, at least for another year or so. However, the Black Swan theory can come back to bite us. As the leading writer in this topic, Mr. Nassim Nicholas Taleb, observes: "Black Swan logic makes what you don't know far more relevant than what you do know," because it is the unexpected that shapes our lives. If a Black Swan – an unpredictable or unforeseen event, typically with extreme consequences- does occur, there would be huge losses caused by a spike in volatility risk and the inability of the government to intervene quickly enough.

Thus, we do advise clients to use some Tail Risk hedging. This means budgeting some capital to hedge your portfolio against those situations that you might not be prepared to go through. This depends on each investor's "stomach", but today, there is no doubt that buying protection is cheap! Two classic ways of hedging would be buying protective puts on equity indices (like the S&P500) or purchasing Credit Default Swaps.

Chart 1:: Equities Volatility Indexes – S&P500 and DAX (German Stock Index)

Chart 2: Volatilities in Bonds – US Government (30 day daily historical on price) 7-10 & 10+ sectors

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