Multi-Asset Insights: Normalisation of the volatility environment

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Our multi-asset team provides its insights on current market trends and latest asset allocation views.

Normalisation of the volatility environment

Derivative markets can provide us with hints about the current market perception of risk. Figure 1 shows the CFTC (Commodity Futures Trading Commission) VIX futures Net “Non-Commercial” positions. “Non-Commercials” are market participants who either buy or sell volatility because they have a view on it (for example they could buy VIX futures as a hedge against an equity market correction).

Figure 1: CFTC VIX futures net non-commercial positions

Source: Schroders, Bloomberg, 4 November 2014.

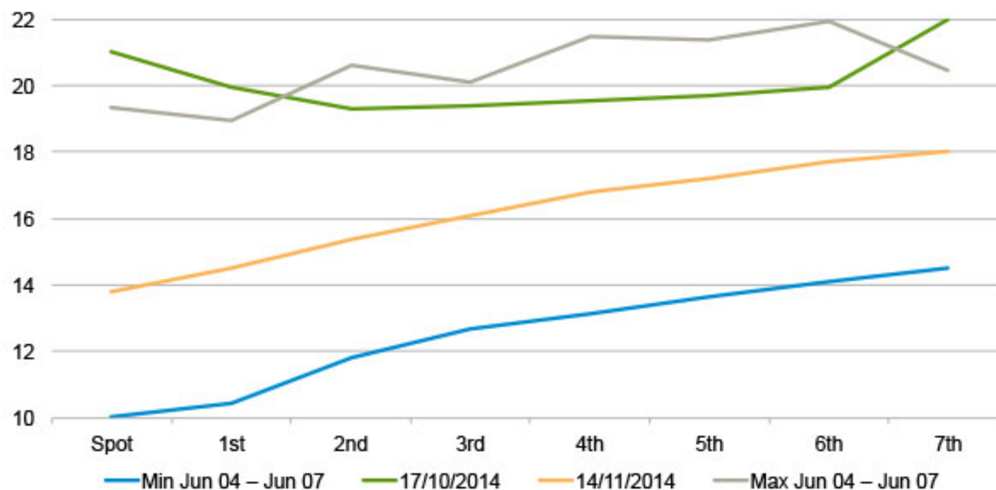
Since 2011 onwards, many investment banks and hedge fund strategies extracted a carry from the curvature of the volatility curve by selling short maturity and buying longer maturity contracts. This has led to “Non-Commercials” historically being net short VIX futures. However, we see that in October these short positions were closed for the first time since 2011. Many of these strategies have suffered negative returns since 2013 and holders may have finally closed out of their positions after the recent equity correction in October.

At the same time, looking at open interest data for options, we suspect that asset managers were relatively well-protected against a tail risk event over the summer. They look to have taken profit in October. This could be a sign of renewed confidence going into the new year.

Whilst we believe that equity markets are currently still in a low volatility regime, there are signs that volatility is increasing towards its long-term average. In October, the shape of the VIX futures curve moved from contango (upward sloping & concave) to backwardation (downward sloping) as short term risk aversion increased. This aversion was justified by negative global economic surprises and a drop in confidence ahead of the announcement by the Fed of the end of Quantitative Easing. However, the scale of the increase in volatility was at a level not seen since 2011 with the VIX reaching 31.

Following a series of dovish communications from central banks (Fed, BoJ, ECB), the shape of the VIX futures curve moved back into contango and is now exhibiting a higher curvature than we have seen for some time (Figure 2). We expect this higher carry and curvature to persist as market participants will require to be sufficiently compensated to short volatility going forward.

Figure 2: VIX futures curve movement over time



Source: Schroders, Bloomberg, 17 October 2014.

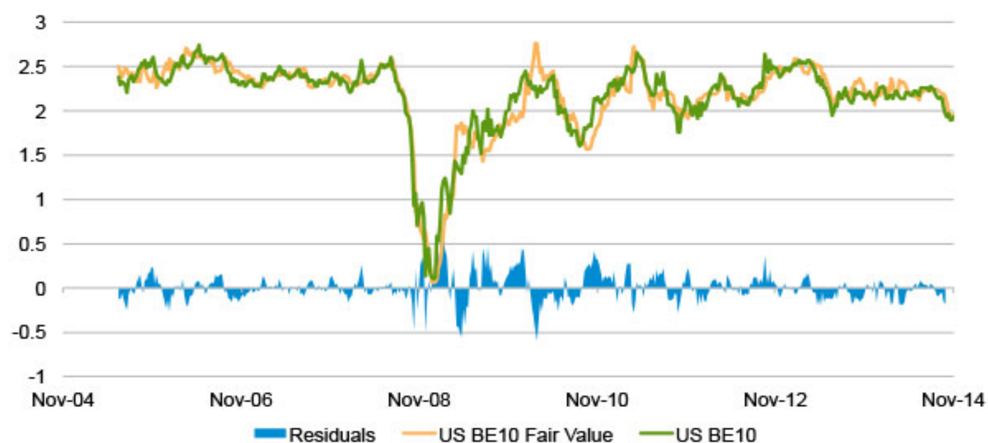
Going into 2015, we believe it will require a combination of lacklustre economic growth (and potentially lower inflation) coupled with liquidity being withdrawn/monetary tightening for volatility to shift to a permanently higher regime. Larger movements driven by these risks could occur two or three times per year based on observations from the last 20 years. We therefore expect equity implied volatility to be higher on average than in the previous two years.

Where are the inflationary pressures?

Investors have become increasingly focused on inflation risk globally as central banks very slowly return to a more normal interest rate cycle. In the US, inflation remains historically low despite some underlying pressures from the labour market. Inflation remains low due to falling commodity prices helped by a stronger US dollar and remaining slack in the overall economy. Labour market data is expected to recover further and lower energy prices will support the US economy via higher disposable income. The US remains one of the few relative winners from low inflation, in contrast to emerging markets and Europe, due to the closed nature of its economy and the increase in disposable incomes from a lower gasoline price.

Our research also indicated that the inflation expectations in the US, driven by the recent weak inflation data, played a significant role in this year's decline in breakeven rates (Figure 3). The breakeven rate is the difference in yield between inflation-protected and nominal debt of the same maturity. It is also worth noting that while the recent decline in energy prices received a lot of attention, its impact on the long end of the breakeven curve remained modest. In addition, given that there are no obvious signs of liquidity concerns in the financial system, the liquidity factor did not play a major role in the movement of breakeven rates this year.

Figure 3: US 10 year breakeven model

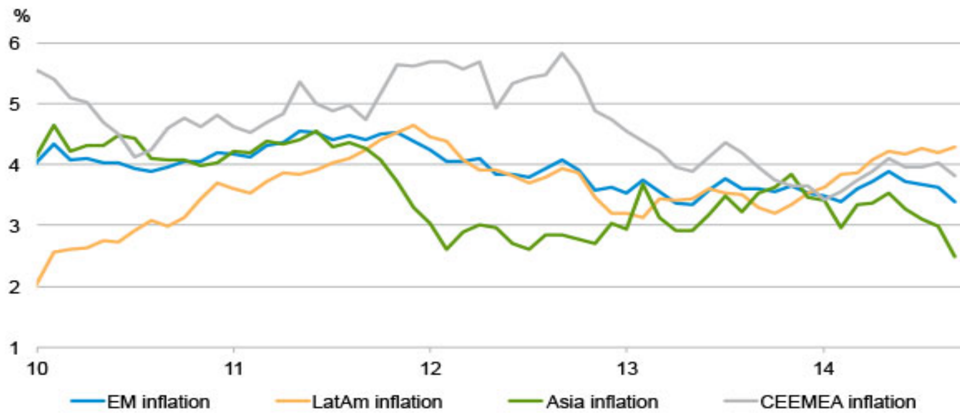


Source: Schroders, Bloomberg. 4 November 2014.

The fall in inflation is helping dampen expectations for further rate hikes in many emerging market economies. A slowdown in emerging markets and stalling European growth could further prolong the low inflationary environment. In the eurozone we expect falling energy prices to keep inflation weak even though the disinflationary impact is reduced by the falling euro. Meanwhile, low inflation has boosted households' purchasing power. So far, we have not seen households take on the Japanese-style behaviour of lower inflation expectations and deferred consumption. Instead, we have seen a slow recovery in spending patterns, supporting our central view that deflation will be avoided.

Latin America is the exception, facing a stagflationary environment due to a combination of domestic factors. Asia, as a consumer of commodities, is facing the largest disinflationary force. Overall we remain cautious towards emerging markets which are vulnerable to Fed policy normalisation and a stronger dollar.

Figure 4: Emerging market inflation is rolling over



Source : Schroders, Bloomberg. 15 October 2014.

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