Waking the dogs

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Financial markets have been eerily calm for most of the past two years. No longer

IT’S not easy sleeping in the Buttonwood family home. The problem is not so much the traffic as the dogs: two affectionate spaniels who begin the night with the daughters and end it with the parents. There they lie, pinning your columnist under one-tenth of a duvet, until, suddenly heeding the call of nature, they stir, stretch, leap off the bed and tug her out the front door for an urgent visit to other parts.

In much the same way, volatility in financial markets is stirring from the mat again. On Monday October 31st, British equities had their biggest day in two-and-a-half years, rising by 2% thanks to some big takeover bids. Across the water, the week of Ben Bernanke’s nomination to replace Alan Greenspan as head of the Federal Reserve saw a steepish sell-off in bonds. The week before that, there was troubled trading in equities as central bankers bombarded the public with inflation warnings. In Japan, too, equity markets have moved relatively sharply of late. So too in emerging Asia.

Is all this just “noise”—in response to specific bits of news, such as better-than-expected personal-income figures or worse-than-expected earnings at Amazon and Boeing? Have investors been treading warily simply because it was October, a month haunted by the ghosts of crashes past? Or is volatility definitely on the increase? And why does it matter?

Volatility is the amount by which asset prices bounce about: the more they bounce, the more uncertainty, or risk, there is. It is “the probability of outlier outcomes”, as Howard Simons, a strategist at Bianco Research, puts it. One way to measure volatility is to look at how prices have fluctuated historically—their “realised” volatility. Spreads on credit-default swaps (insurance contracts against the possibility that debtors will default) provide another indicator. The most commonly followed measure, and one which often moves before the other two, is the implied volatility in options contracts. Equities are generally more volatile than bonds and currencies. And it is here that volatility is stirring most noticeably now.

The Chicago Board Options Exchange’s Volatility Index (VIX) is based on a basket of widely traded options on the S&P 500. The more turbulence investors expect in the underlying shares, the more they are prepared to
pay for options. The VIX is nowhere near the 45 that it hit in August of 2002 but, as the chart shows, it has been slowly rising since mid-July. Germany’s VDAX, an options contract on the DAX index’s 30 companies, has been trending higher too.

Volatility is important for several reasons. Many reckon that it can help to predict returns, though just how remains a subject of hot debate. Much academic work suggests that markets tend to go down when volatility goes sharply up, and vice versa. It doesn’t always work that way, though: during much of the 1990s, for example, both volatility and stockmarkets rose. But higher volatility definitely favours certain kinds of investors: it gives a fair wind to those who target volatility as a strategy, and it offers more opportunities to those who hedge their bets in other grand investment designs. (So why did hedge funds have such a terrible October, by all accounts? Could it be that most of them weren’t actually hedged?)

More broadly, expected volatility has a lot to do with how attractive financial assets are. It is the main parameter in pricing options, so it determines the cost of insuring against uncertain outcomes. When options are cheap, investors are happier to take the plunge in financial markets. When they are expensive—ie, when it costs more to hedge a bet—investors think twice. They tend to commit less capital to “risky” investment and for shorter periods.

So volatility has a bearing on economic growth, and rising uncertainty is not good news for future output. It may seem strange to worry about this now, when America’s third-quarter GDP figures have just come in stronger than expected, Britain’s housing meltdown seems to be on hold and Europe’s company bosses are raiding their cash hoards to acquire other businesses. But there are big question marks ahead. It is no accident that the VIX, often called the “fear gauge”, is rising. In October, State Street’s investor-confidence index hit its lowest since its launch two years ago.

Volatility was uncannily low until recently in large part because inflation and interest rates were too. A tide of liquidity swept through financial markets, exploiting anomalies, arbitraging opportunities and dampening volatility. Long investors saw little need to buy options against the chance that things might take a nasty turn in this best of all possible worlds, while others were all too happy to make a buck selling them. There was plenty of supply and not all that much demand, so the VIX snoozed in the teens.

Defer monetary management also played a role. Investors got used to trusting central banks to keep the financial-market show on the road, as they showed they could and would after the failure of Long-Term Capital Management, a big hedge fund, in 1998 and the bursting of the stockmarket bubble in 2000-01. And the Fed’s new policy of giving forward-looking statements on interest rates also soothed the markets: since August 2003, the expected volatility of Treasury notes has fallen by a third, on one measure.

**Goodbye to all that**
But low inflation, low interest rates and untroubled confidence in safe hands at the helm are fast becoming things of the past. Oil-price hikes have helped to push up inflation around the world. The Fed raised short-term rates again on Tuesday, to 4%—its 12th quarter-point hike since the middle of last year—and looks likely to do so at least once more in the next three months. The European Central Bank may soon follow its tough talk on inflation with some tough action. Japan is more likely to raise rates than to cut them. Alex Ypsilanti, a strategist at Merrill Lynch, points out that over the past ten years the troughs in volatility have come one-and-a-half to two years after the low points in three-month dollar LIBOR (interbank) rates. The Fed started raising rates 16 months ago.

Add to this equation a new Fed chairman, especially one who may tighten just that bit too much in order to live down a reputation of being soft on inflation, and increased volatility looks virtually assured. Indeed, it could scarcely be otherwise. Looking into previous Fed handovers, Goldman Sachs found that financial markets were more unsettled in the first year than in almost all the rest of the new chairman’s time in office.

And finally, while the outlook is not all bleak—far from it—there are risks out there that neither central bankers nor financial markets nor politicians know how to handle yet. These include huge global trade imbalances and the shift in the balance of economic power that these imply; the rapid proliferation of financial instruments (mainly credit derivatives) whose valuation and ownership are not always clear; and the rising indebtedness of households, particularly in America and Britain. Given all that, it is hardly surprising that volatility is stirring again. What is amazing is that it’s not racing down the road and barking.

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