Are investors complacent?

Keith Wade
Chief Economist and Strategist

- Rising equity markets and low volatility raise the question as to whether investors are becoming complacent, especially against a backdrop of falling bond yields and elevated political uncertainty. We look at the macro factors driving risk through the lens of the VIX index.
- A sharp drop in oil prices, or greater than expected Fed tightening threaten the rally. The latter is the greater risk, but will probably not materialise until later in 2018. Meanwhile, investors may find it hard to resist being "complacent" as liquidity will continue to drive markets with the risk being that they move into bubble territory.

> **"Keeping interest rates too low for long could raise financial stability and macroeconomic risks further down the road, as debt continues to pile up and risk-taking in financial markets gathers steam"**
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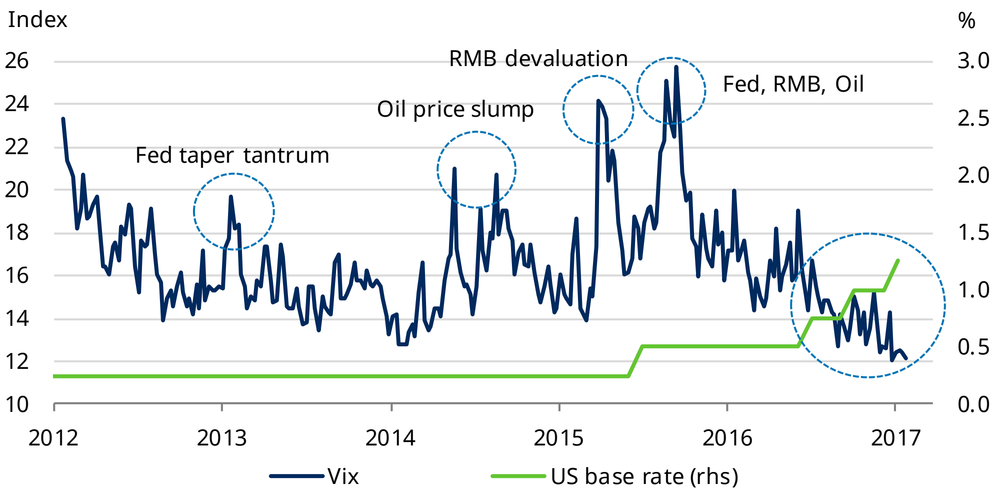
> **Bank for International Settlements, Annual Report 2017**

Equities rally and the fear gauge stays low

The rally in equity markets continues with the MSCI World index reaching new highs in June. However, the strength of equities against a backdrop of falling bond yields and elevated political uncertainty has raised the question as to whether investors are becoming complacent.

Evidence of such can be found in the behaviour of the VIX index, often referred to as the "fear gauge", which has recently touched new lows. The move is particularly surprising given that the US Federal Reserve (the Fed) has just hiked rates for the second time this year and is signalling another move in September as well as balance sheet reduction (chart 1).

Chart 1: Fed tightens, but volatility falls



Source: Thomson Datastream, Schroder Economics Group, 24 June 2017.

We examine the factors driving volatility in more detail below, but first we would note that although the VIX is low, markets are not entirely ignoring the risks as is often claimed. Gold, which is often seen as the ultimate safe haven asset, has performed well this year. In equity markets there has been a rotation away from the cyclicals, which benefitted from the Trump reflation trade, and back toward the high quality dividend payers. These moves are consistent with lower rates and the bull flattening of the yield curve. The surge in technology stocks also reflects strong liquidity and a preference for stocks which can increase earnings when top line growth is scarce.

Until recently Fed tightening has been associated with increased, rather than decreased volatility. For example, the VIX index spiked after the first move in Fed funds in December 2015 and again during the taper tantrum of 2013, when the Fed signalled an end to quantitative easing (QE).

Other factors have also played a role in driving volatility. Prior to the Fed tightening in 2015, concerns that China would significantly devalue the RMB sent the VIX higher in August of that year. Along with worries over Fed tightening, those concerns resurfaced in January 2016.

Another key factor has been the oil price. Sharp falls in the oil price in 2014, 2015 and again in 2016 caused volatility to soar as investors feared an increase in defaults in the energy sector.

Concerns over Fed tightening, China and the oil price have all faded

From this perspective it could be argued that volatility is low because investors are now comfortable with the Fed's tightening policy, China has clarified its position on the RMB and the oil price is more stable. We would add that the current low level of volatility today also owes something to favourable political outcomes in Europe where there has been no swing toward populism. We still have to negotiate the German and Italian elections, but so far voters on the continent have chosen not to join the UK in leaving the European Union (EU).

What could possibly go wrong? Threats to low volatility

Of course this is hardly an exclusive list of the causes of market volatility, but to focus on the three areas – China, oil and the Fed – mentioned above.

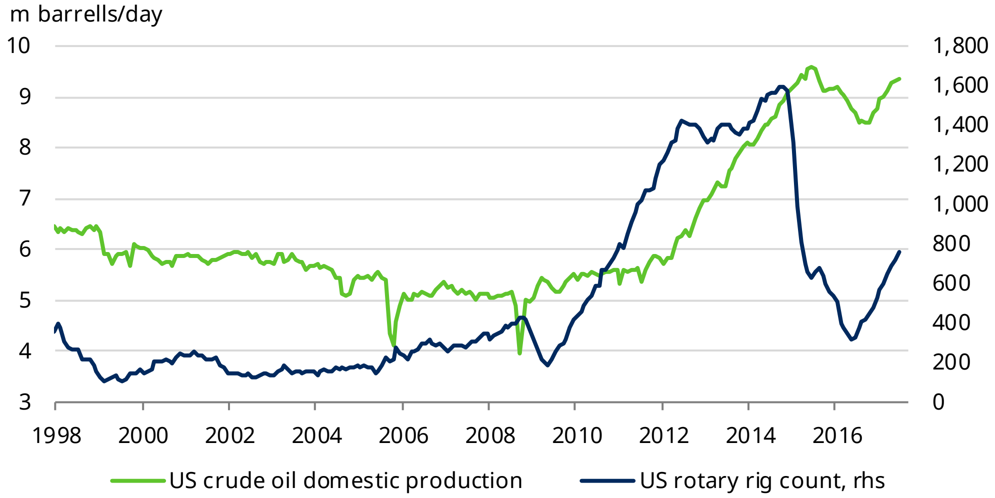
China does seem to be less of a concern as the authorities have regained control over the RMB by reining in capital outflows. Foreign exchange reserves have stabilised and recently the RMB has appreciated. The cost though has been a significant increase in capital controls.

The risk of a further oil price drop remains

There are still worries about oil with the crude price falling recently, although the decline has been modest compared to the past. Nonetheless, the risk of a sharper fall remains and we do have a weaker oil price as one of our key risk scenarios where the OPEC deal breaks down and Brent crude prices drop back to $30 p/b[2]. Despite a significantly lower rig count, US production of crude oil is now close to peak levels thus putting pressure on the ageing cartel. Saudi Arabia's efforts to drive US shale out of business have been for naught.

[2]See Economic and Strategy Viewpoint, June 2017.

Chart 2: The rig count and oil production in the US

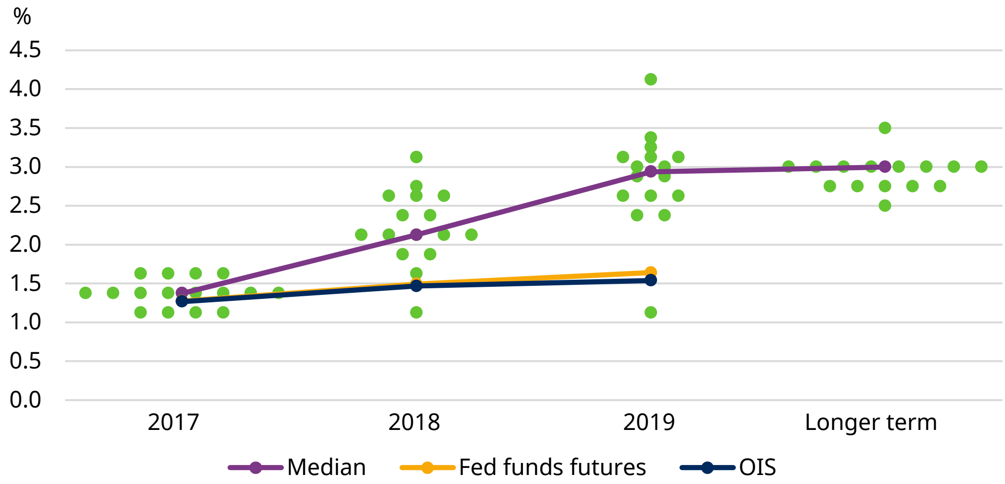


Source: Thomson Datastream, Schroder Economics Group, 26 June 2017.

...and markets are vulnerable to further tightening in US monetary policy

From a volatility perspective, the greater concern is on US interest rates as we see some complacency in market expectations about the degree of tightening by the Fed. At present the market is only discounting one, or possibly two more rate hikes to the end of 2018. Meanwhile, the Fed's FOMC members projections (know as the "dots"), put rates at just over 2% at the end of 2018 (see chart 3).

Chart 3: Fed rate setters expectations (the "dots") well ahead of the market



Source: Thomson Datastream, US Federal Reserve, 24 June 2017.

Despite expecting inflation to remain relatively subdued we also see further rate hikes as the Fed continues to normalise interest rates. Such a view is consistent with models such as the Taylor rule which say rates should be higher given the position of the US in its cycle.

Support for higher interest rates has also come from the Bank for International Settlements (BIS) who recently commented that central banks should be prepared to tighten policy "when demand is strong, even if inflation is weak, so as not to fall behind the curve with respect to the financial cycle"[3].

Arguably an excessive focus on inflation allowed central banks to ignore the build up of debt and excessive risk taking in financial markets which preceded the global financial crisis. While we are some way from that position today, demand is healthy, risk assets are performing strongly and there is talk of bubbles in some markets. The Fed appears to recognise this with chair Janet Yellen playing down low US

[3]See BIS 2017 Annual report.

inflation at her last press conference following the decision to raise rates on 15th June.

Market looking for a weaker economy, or an even more dovish Fed chair?

Meanwhile, financial markets are discounting a benign outcome for interest rates. This could reflect expectations of a weaker economy, or the appointment of a new Fed chair who is reluctant to tighten (perhaps under political pressure from the president). Janet Yellen's term expires next February.

On balance though these are risks rather than the central view. We would certainly put more weight on a fiscal stimulus next year than the market given the political pressures for the Republicans to deliver ahead of the mid-term elections. Consequently, alongside a fall in the oil price, tighter policy from the Fed has the potential to trigger an increase in financial market volatility.

This suggests a note of caution for financial markets, but we would make two points.

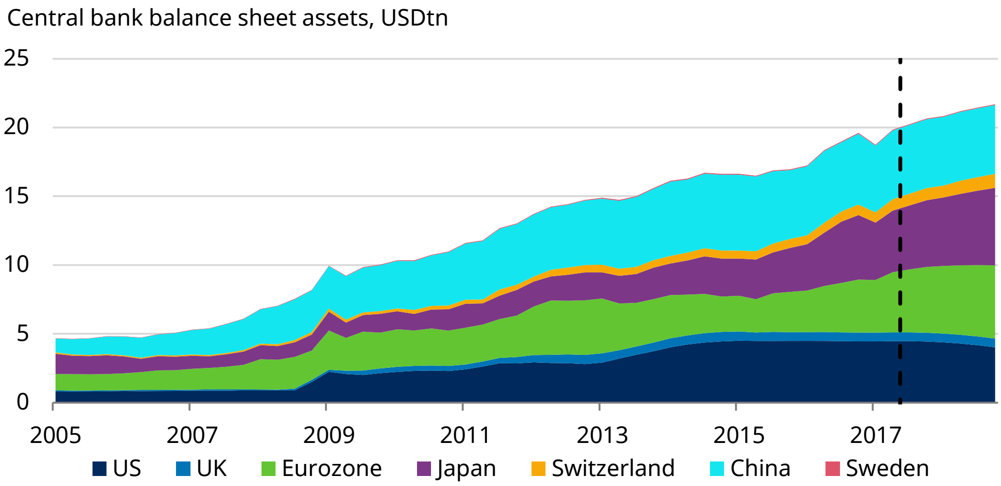
First, global inflation remains low, a trend which is likely to be reinforced by the recent fall in oil prices. Notwithstanding the BIS analysis, central banks are mandated to target inflation and will be reluctant to tighten in a world where there are fears of secular stagnation. If the choice is between a financial market bubble and deflation, the bubble wins every time.

Second, global liquidity will remain supportive. Policy rates in Japan and the eurozone are set to remain in negative territory throughout 2018 and probably beyond. Meanwhile, central bank asset purchases will continue in the eurozone throughout 2018 and in Japan for longer. The latter is some way from hitting its inflation target of 2% or more.

Moreover, on our calculations total central bank asset purchases can be expected to continue to rise over the next 18 months thus maintaining a high level of liquidity in global markets. This largely reflects a view on the Bank of Japan (BoJ). We expect it will gradually raise asset purchases in response to the need to boost inflation and pressure to maintain 10 year government bond yields at close to zero through its yield curve control policy. Rising BoJ purchases offset slower purchases by the European Central bank (ECB) and the reduction in balance sheet at the Fed.

Global liquidity to remain robust even as the Fed reduces its balance sheet

Chart 4: Global liquidity to continue to rise



Source: Thomson Datastream, Schroders Economics Group, 26 June 2017.

Are investors complacent?

The next shock to markets may not be driven by the Fed, oil or China. It could be geopolitical in origin, for while political risks may have eased in Europe they are building in Asia where tensions between the US and China will rise if North Korea does not ease back on its nuclear weapons programme.

Notwithstanding such an outcome, more conventional economic risks are not insignificant. In particular the market appears to be underestimating the potential for US interest rates to rise. The desire to normalise remains high and rates are still well below where most models would have them given where the US is in its cycle.

However, such pressures will not become apparent until further out. Low inflation will keep the Fed cautious and the start of balance sheet reduction will probably see the Fed pause rate rises to monitor any more general tightening of financial conditions. Unless the Fed signals otherwise, the difference of opinion between the market and the "dots" will probably not be resolved until spring next year. Meanwhile, central bank asset purchases are likely to continue to expand. In this environment investors may find it hard to resist being "complacent" as liquidity will continue to drive markets with the risk that they move into bubble territory.