Low Volatility Markets: to be Feared or Embraced? - A Macro Perspective

Presentation at 36 South Conference, Zurich October 2014

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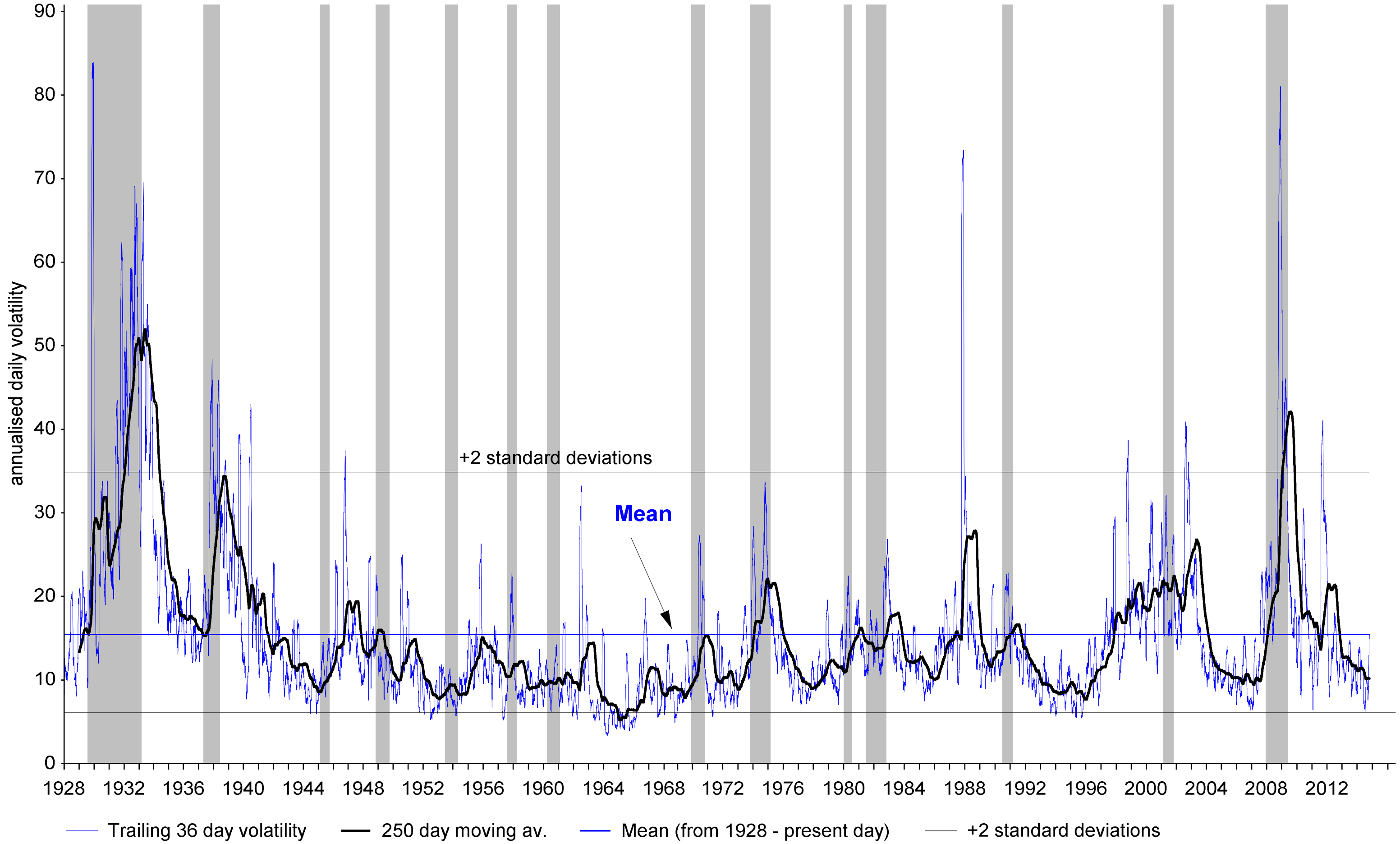
(US) Equity Volatility: Close to Record Lows (July '14)

US S&P500 realised short term daily volatility (%, annualised): 1928 - 2014

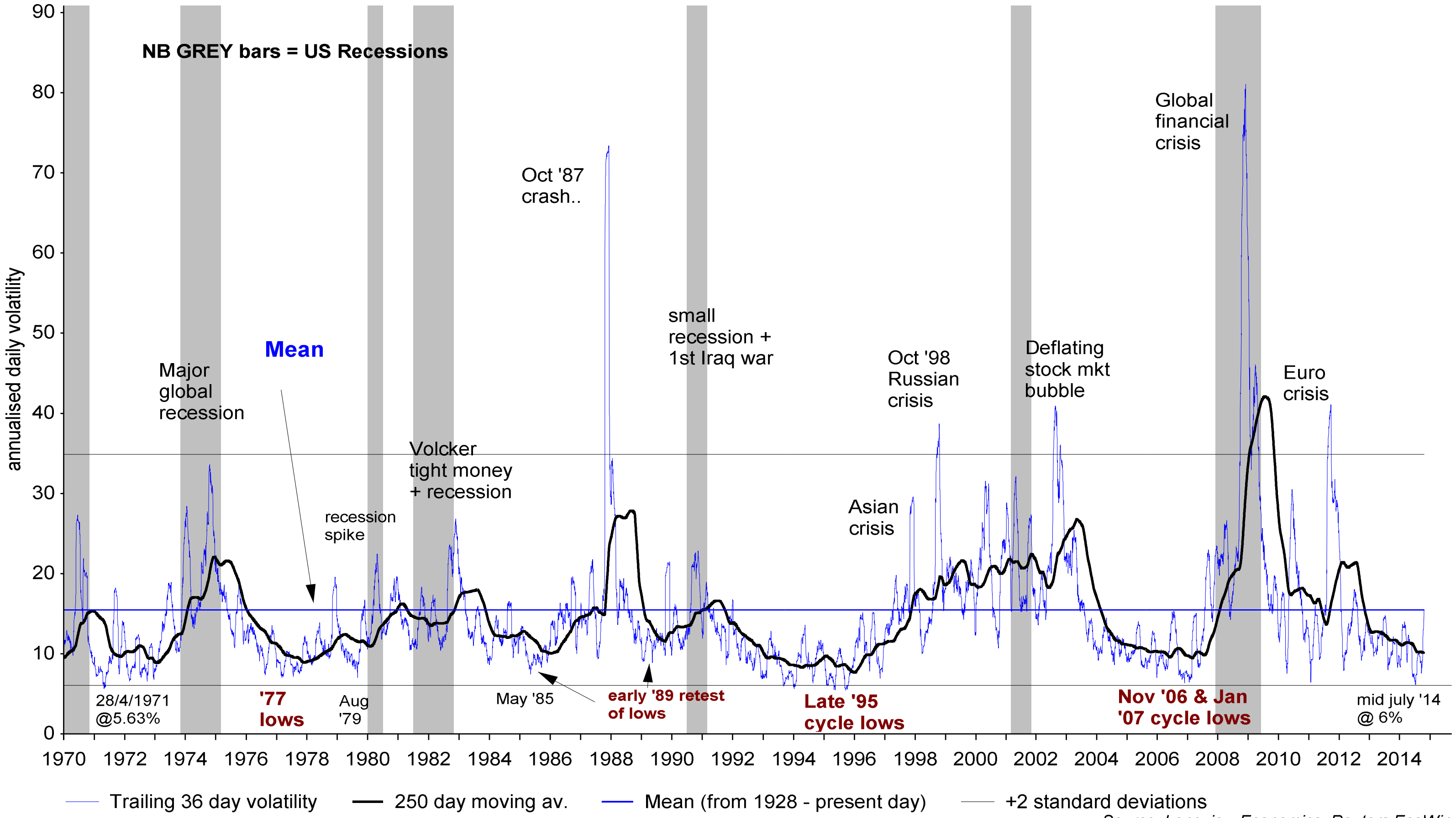


Source: Longview Economics, Reuters EcoWin

(US) Equity Volatility : **Zooming in!**

(i.e. in the post Breton Woods era)

US S&P500 realised short term daily volatility (%, annualised): 1971 - 2014

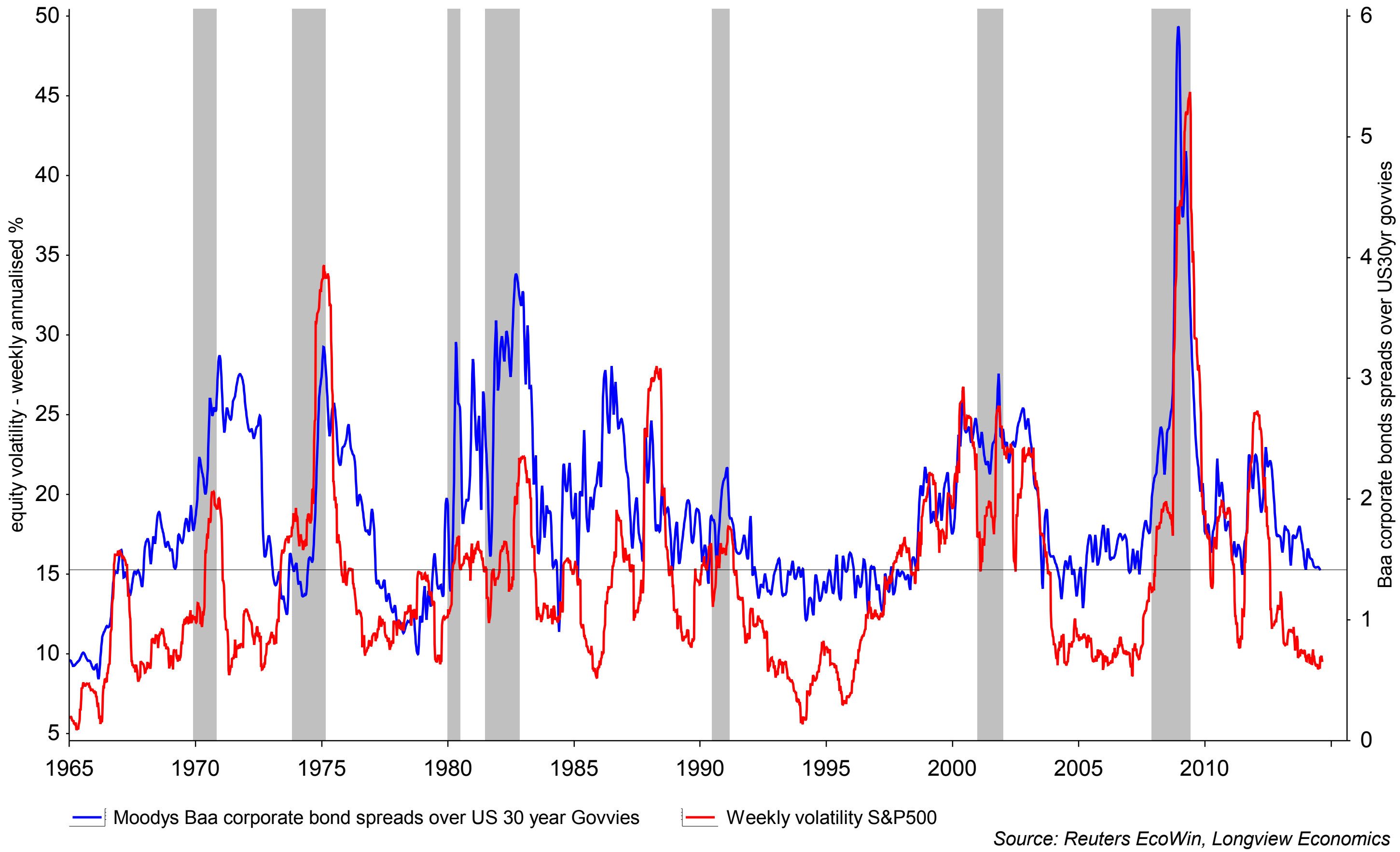


Source: Longview Economics, Reuters EcoWin

What drives it?

The stage in cycle

Moodys Baa Corporate bond spreads (i.e. credit risk premium) vs S&P500 realised volatility

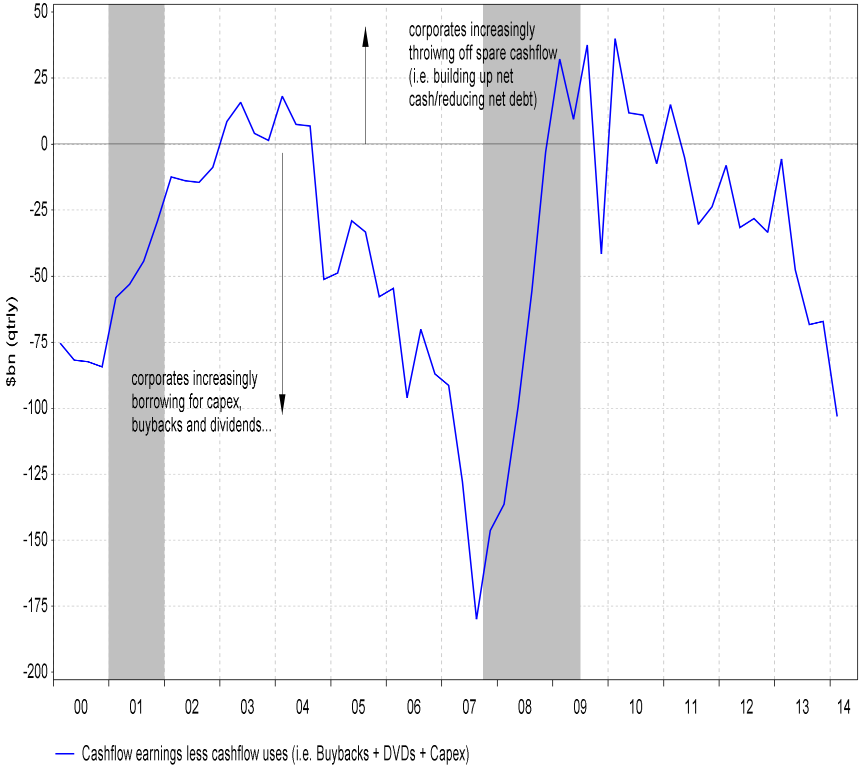


Source: Longview Economics, Reuters Ecowin

Corporate Sector – not as strong as people suppose

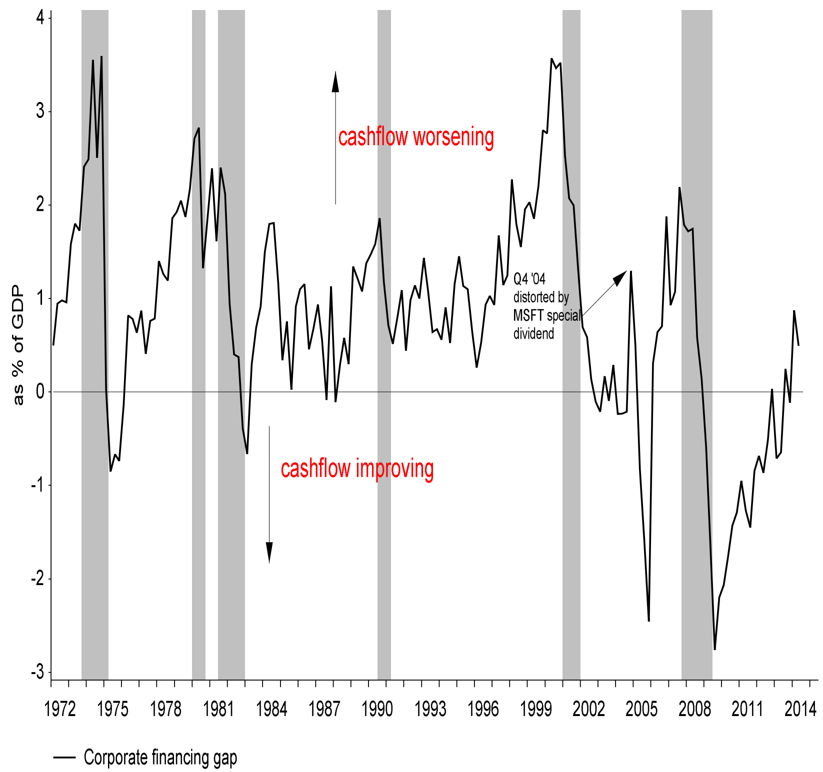
Corporate Sector:
Increasingly cash flow poor

US corporate sector (non financial): Cashflow Earnings less Cashflow Uses



Source: Reuters EcoWin

US corporate financing gap (as % of GDP)

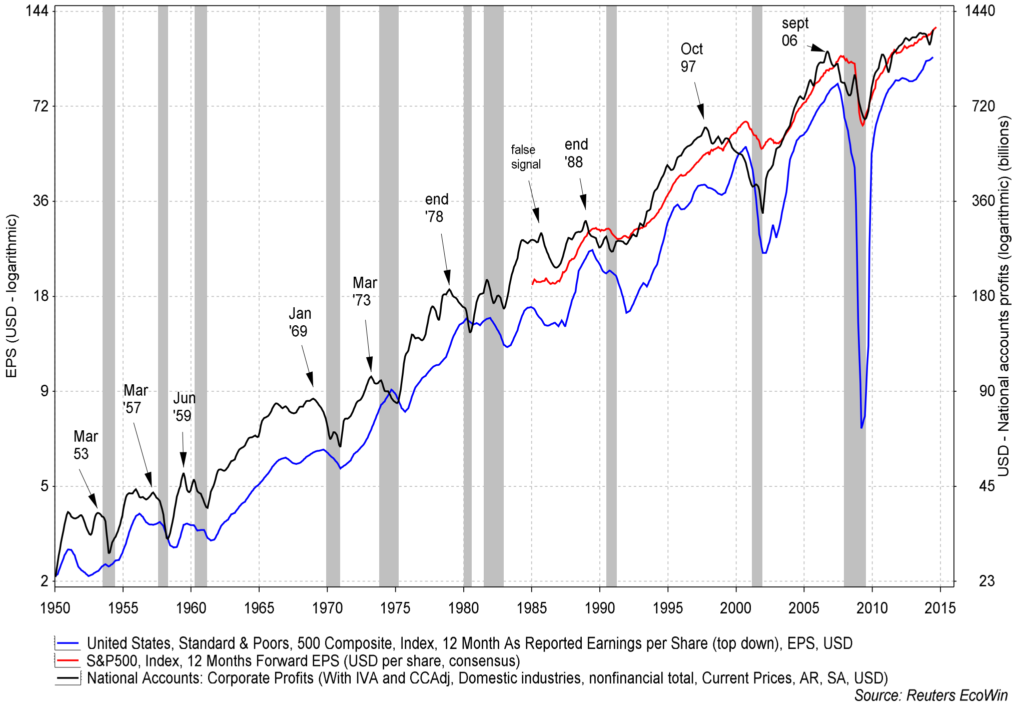


Source: Longview Economics, US Federal Reserve Flow of Funds, Reuters EcoWin

Signposts: Last 1/3 of Cycle

National Accounts Corporate Profits – Peak on average 12.5 months before Recession

Fig 1: US National Accounts Corporate profits vs S&P500 as reported & consensus forward EPS



On average national accounts/GDP NIPA profits peak 12.5 months before the start of a recession and 11 months ahead of the peak in S&P500 reported profits – see table 1

Table 1: Peak in National Accounts profits (pre recessions) vs. reported profits peak

Peak in NIPA profits	Peak in corporate profit margins	Peak in S&P reported profits	Start of recession	No of months NIPA peaks ahead of S&P reported EPS (months)	No of months NIPA peaks ahead of start of recession (months)
Mar 1953	Q4 1950	Sept '53	July '53	6	4
Mar 1957	Q2 1955	Sept '57	Aug '57	6	5
Jun 1959	Q2 1959	Sept '59	Apr '60	3	10
Jan 1969	Q1 1966	Sept '69	Dec '69	8	11
Mar 1973	Q1 1973	Sept '74	Nov '73	18	8
Dec 1978	Q4 1978	Mar '80	Jan '80	15	13
Sept 1981	Q3 1981	Dec '81	Jul '81	3	-2
Dec 1988	Q4 1988	Jun '89	Jul '90	6	19
Sept 1997	Q3 1997	Sept '00	Mar '01	36	42
Sept 2006	Q3 2006	Jun '07	Dec '07	9	15
				11 (average)	12.5 (average)

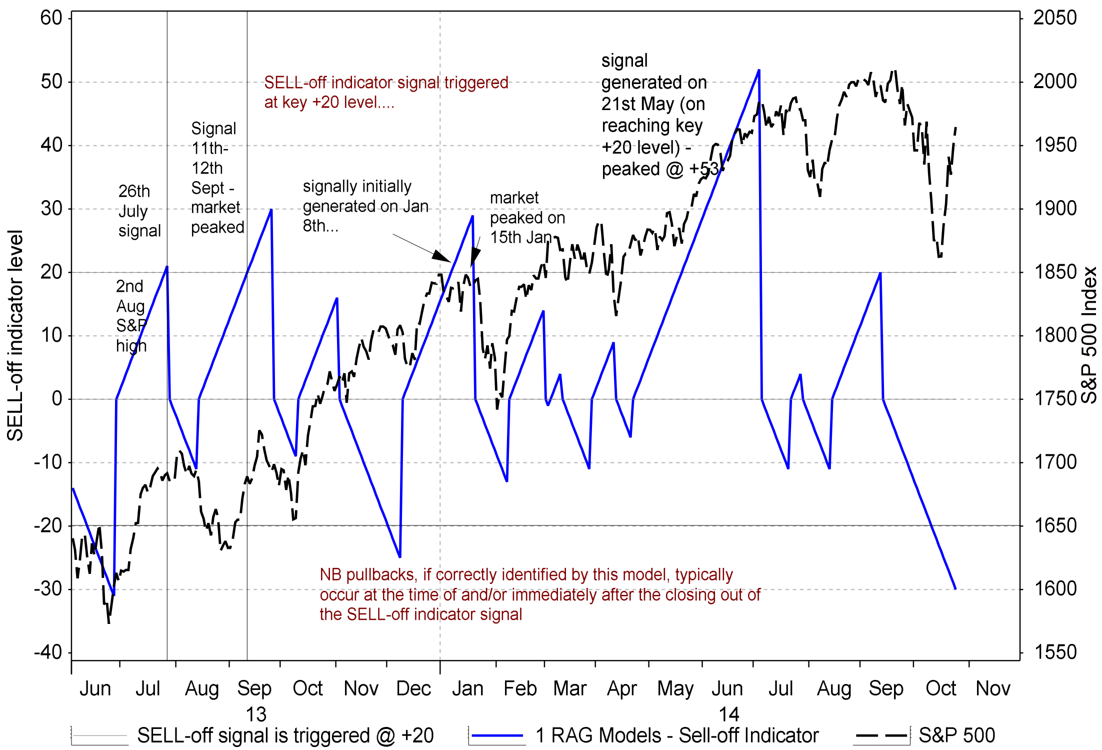
Source: Longview Economics, S&P, NBER

Source: Longview Economics, S&P, NBER

Volatility in a short term trading sense
GREED & FEAR

(Most) SELL-offs are primarily about positioning/complacency

Longview SELL-off indicator vs. S&P500



Source: Longview Economics, Reuters EcoWin

- The majority of non recession based equity market sell-offs are related to positioning in portfolios (& excessive exuberance towards equities).
- Overbought, sentiment and similar types of indicators are not good timing tools for avoiding these sell-offs – as those signals are often months early.
- Longview's SELL-off indicator, by measuring exuberance in global markets is a timely tool for predicting/avoiding market pullbacks

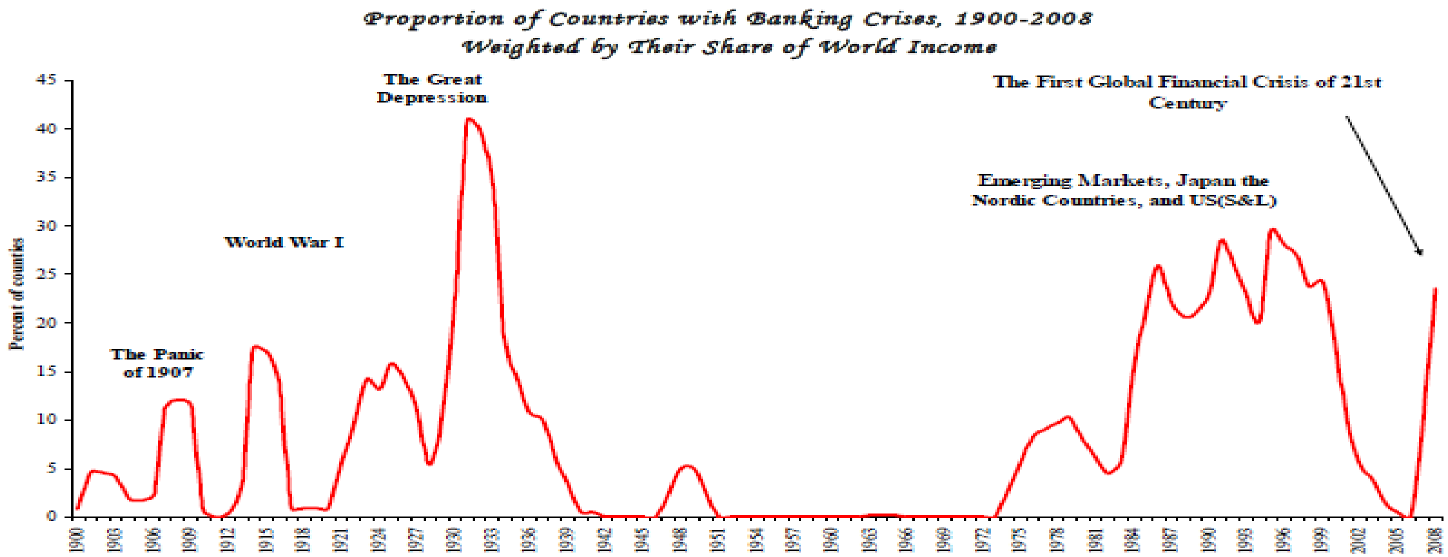
Volatility in a structural framework

Volatility in a secular sense/structural sense (i.e. thinking longer term)

Proportion of key world countries with banking crises

Is the worst past? Or is there more to come?

Figure 1



Sources: Bordo et al. (2001), Caprio et al. (2005), Kaminsky and Reinhart (1999), Jácome (2008), Maddison (2003), and additional sources listed in Appendix II, which provides banking crises dates.
Notes: Sample size includes all 66 countries listed in TableA1 that were independent states in the given year. Three sets of GDP weights are used, 1913 weights for the period 1800–1913, 1990 for the period 1914–1990, and finally 2003 weights for the period 1991–2006. The entries for 2007–2008 list crises in Austria, Belgium, Germany, Hungary, Japan, the Netherlands, Spain, the United Kingdom, and the United States. The figure shows a three-year moving average.

Cyclical Inflation within Structural Deflation: The Structural Backdrop to the Global Economy

Monetary factors:

1. There is a lack of effectiveness of monetary policy - despite almost 6 years of zero interest rates, global growth is still struggling to achieve escape velocity and, more importantly, due to the very low velocity of money, massive liquidity injections have struggled to achieve inflation – albeit some regions are better than others
2. Ultimately high debt levels have to be either: i) inflated or grown away; ii) paid back; and/or iii) forgiven/defaulted on
3. In a post credit boom world, with significant excess capacity, generating inflation is hard – as such its difficult to inflate it all away – in that environment excess liquidity either goes mainly into asset prices and/or sits as reserves at the central bank. Plus raising savings rates to pay back debt, reduces demand*; whereas defaulting creates significant losses in system (and is not considered an option by central banks/politicans).

Real Economy – supply side factors

1. Demographic trends (Europe & Japan especially) have led to lower longer term trend growth rates (i.e. as workforces shrink)
2. Poor productivity trends have further reduced trend GDP growth rates – see slide 13 & 14 for detail/analysis (as such terminal rates are also therefore lower)
3. Added to which, increased regulation in certain Western countries, especially on the banks, is adding to deflationary forces via the theme of definancialisation (i.e. reduced RoE potential & increased capital requirements) and increasing banking regulation
4. While current monetary policies (incl ZIRP & QE), favours the asset rich/financial sector over the rest – leading to rising income inequality (albeit globalisation also drives that rise in income inequality: i.e. Taleb's winner takes all world). Higher income inequality then increases the instability of the Western economies.
5. But....in long term, though, positives factors are in play: i) technological progress; ii) new energy sources; iii) ongoing development of emerging economies - i.e. Indonesia-India etc..

Implication:

1. Cheap money, therefore, from CBs leads to a Longview 'Pass debt' parcel world – i.e. a world of contiguous credit booms and busts across the globe (debt parcel currently in some EM + China)
2. And ultimately….secular stagnation – and overridingly (structurally) deflationary world – most obvious in tradable goods
3. In that world, Global debt to GDP is still growing (i.e. Its just being shifted around from country to country and between sectors within countries)

Necessary Outcome

1. Structural reform is key - as is reframing the debt question – policymakers appear to be increasingly waking up to this need

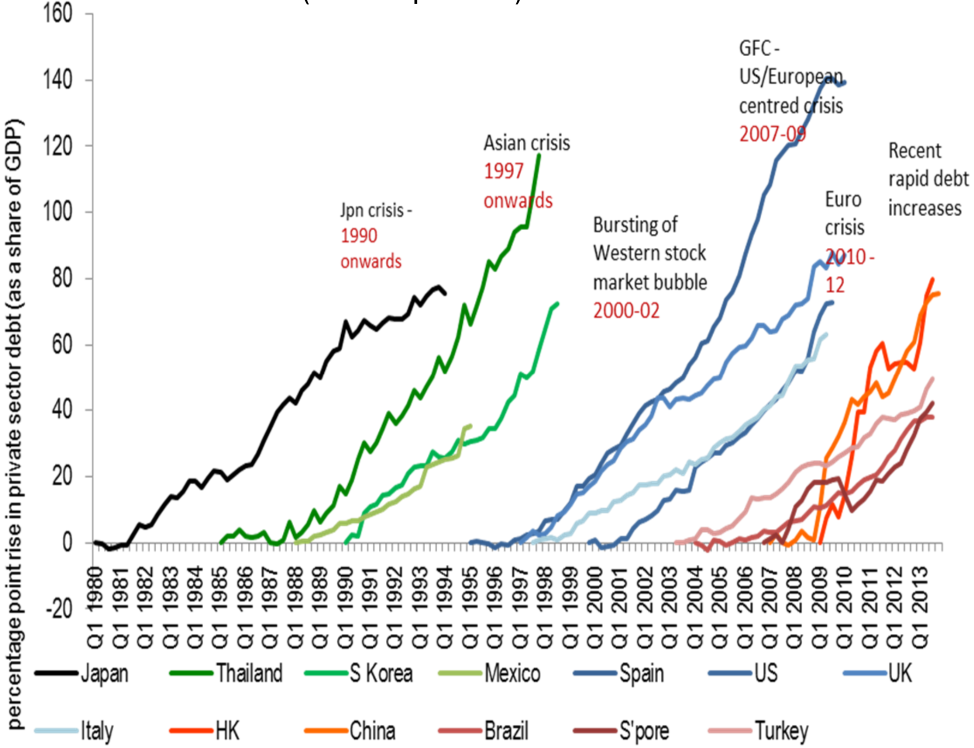
*also monetizing fiscal deficits creates a future demand reduction as governments spend money inefficiently, focused more on consumption than investment (hence low fiscal multipliers). A programme of government spending with the right investment focus could though prove meaningfully beneficial

Pass the Debt Parcel

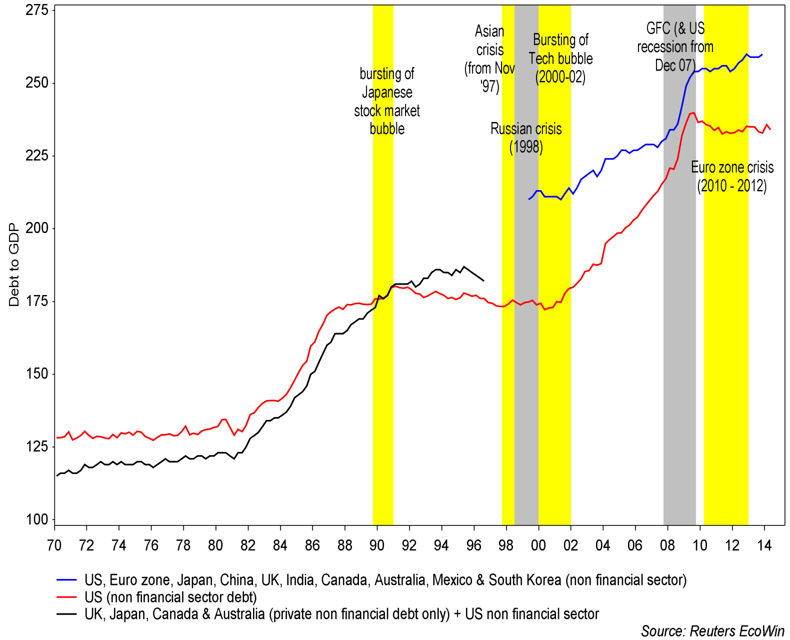
The outcome of Keynesian Economics

(perpetual crises)

Episodes of Rapid Increases in **Private Sector** Debt to GDP ratios – various countries (1980 – present)



World private sector non financial debt (as % of world GDP)

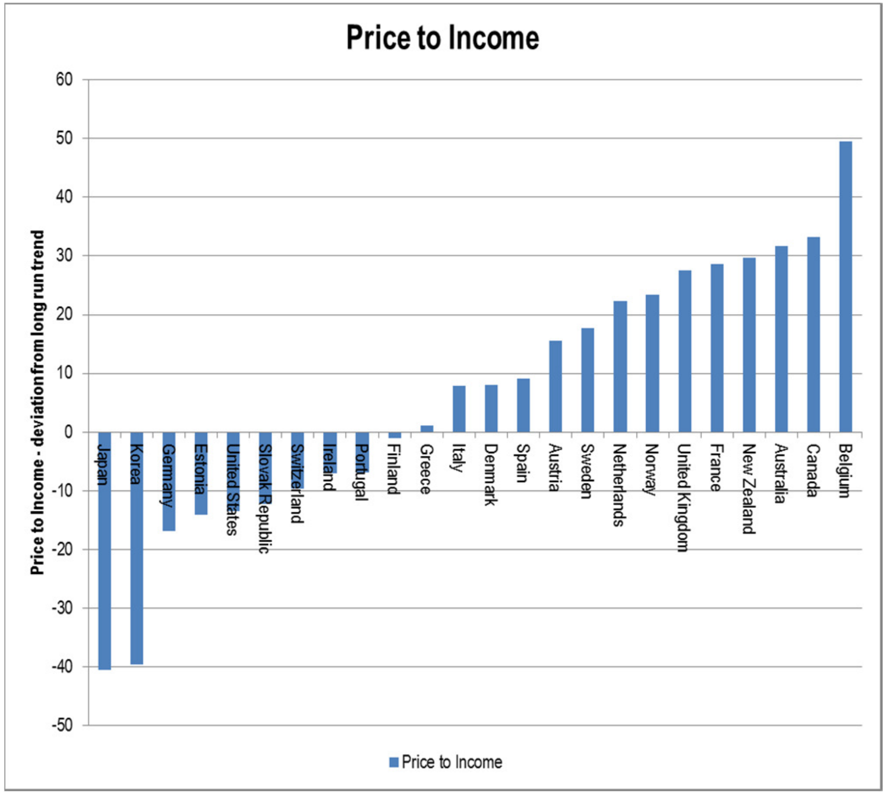


Source: Longview Economics, BIS, Various

Rapid increases in private sector debt (relative to GDP) almost always leads to a crisis (i.e. once debt to GDP has increased, at pace, by more than 30 – 40 pp of GDP) longview economics

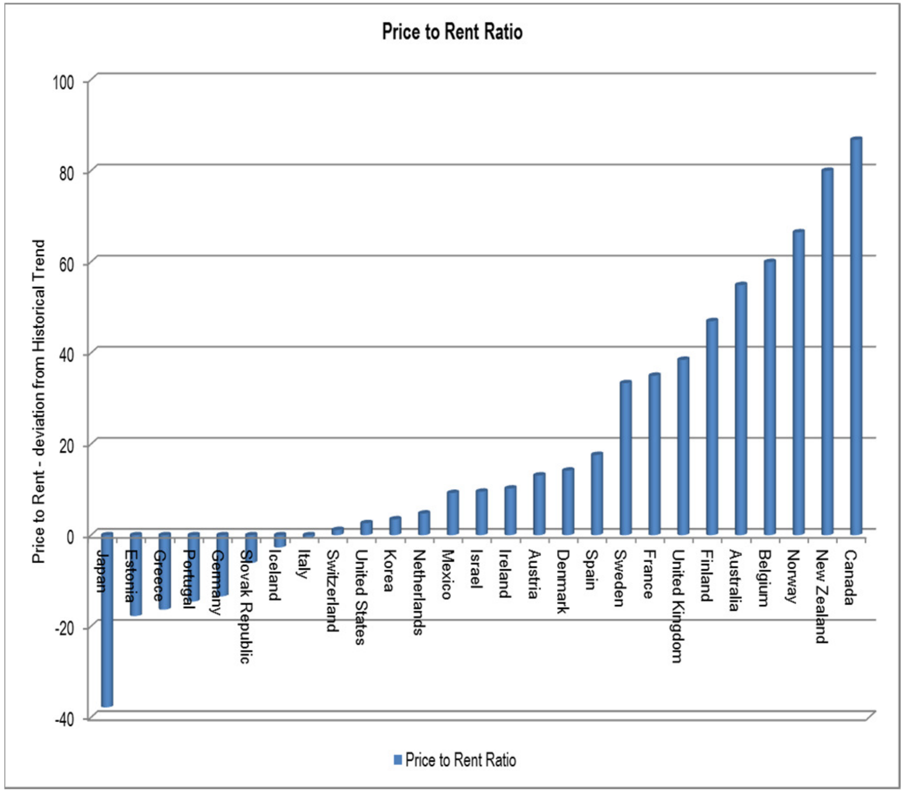
New world; or
Just Overpriced Housing?

Price to Income – deviation from trend (various OECD countries)



Source: IMF, OECD

Price to Rent – deviation from trend (various OECD countries)



Source: IMF, OECD

Consequences of Paper Money:
Crisis Frequency & House Prices

The History of House price inflation:

Analysis of between 100 to 800 years of house price data in a variety of Western economies demonstrates that on average house prices rise in real terms 0.5% to 1.0% per annum (depending on which time series and which country is analysed) – see "Safe as Houses?", N Monnery, 2011.

The same analysis also shows that the 15 years leading up to 2008 were, in historical terms, exceptional for house prices:

"for a total of 37% of the time (ED: i.e. across a variety of countries & 110 years of history), real prices fall for ten years or more. In just under a fifth of cases real house prices increase modestly at between 0% and 1%. In just over a fifth of cases, prices increase by between 1% and 3%, and in just a fifth of cases the rises are above 3%...there were 109 periods in which prices rose by more than a third over the course of a decade (a gain of over 3% each year for a decade). **Nearly half of these have occurred since 1995***..." N Monnery P.135-6**

Source: Longview Economics, Longview Letter no 63: "The History of House Prices & House Price Bubble Deflations" published April 2012

Table 1: Number of Types of Crises under different International Monetary Systems (IMS)

IMS	Banking crises (no. per year)	Currency Crises (no. per year)	External defaults (no. per year)
Gold Standard (1870-1913)	1.3	0.6	0.9
Interwar Period (1925 – 1939)	2.1	1.7	1.5
Bretton Woods (1948 – 1972)	0.1	1.7	0.7
Current (1973 – 2009)	2.6	3.7	1.3

Table 2: Average growth and inflation under different International Monetary Systems (IMS)

	World GDP (per capita)		World Inflation
IMS	Growth – annual average (%)	Volatility (co-efficient of variation)	Average (%)
Gold Standard (1870-1913)	1.3	1.2	0.6
Interwar Period (1925 – 1939)	1.2	3.3	0.0
Bretton Woods (1948 – 1972)	2.8	0.3	3.3
Current (1973 – 2008)	1.8	0.7	4.8

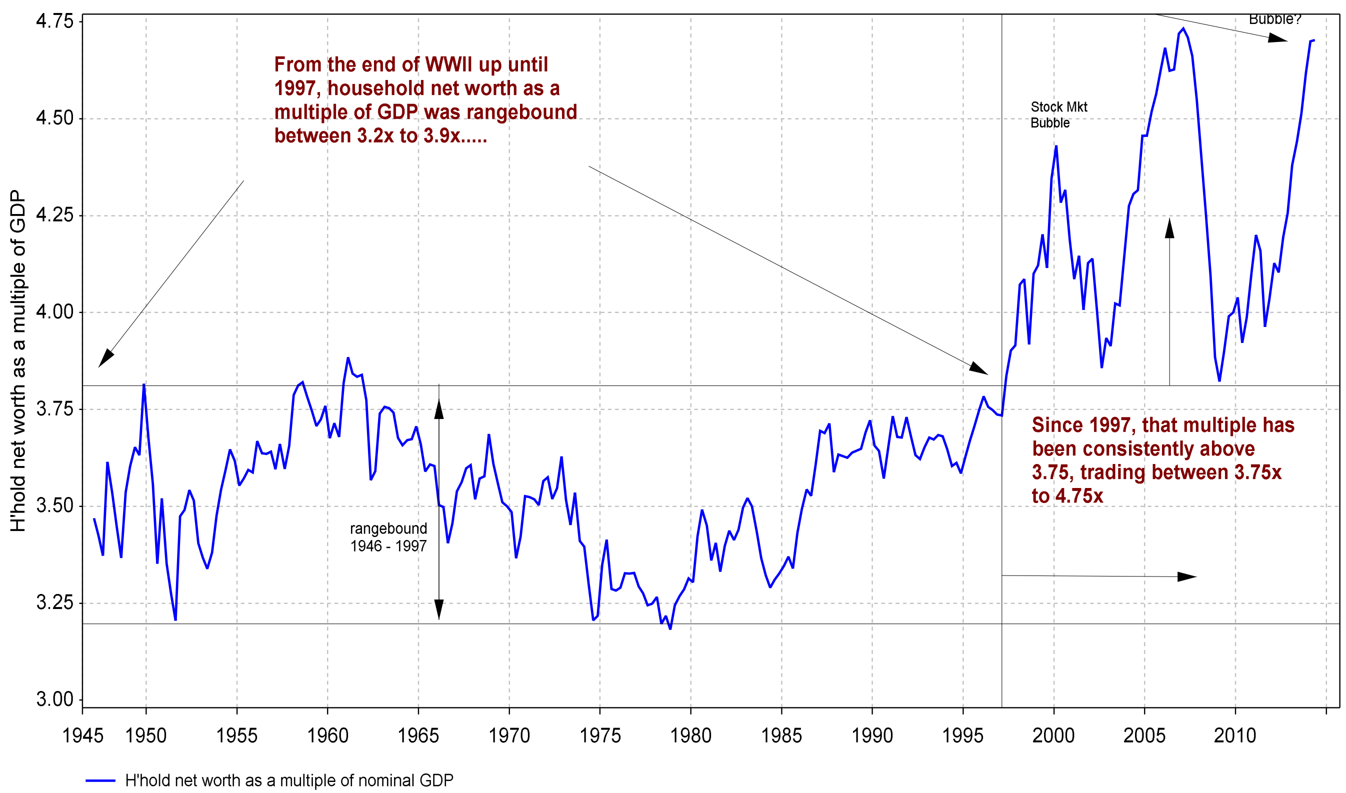
Source: Bank of England, Financial Stability Paper no 13, Dec 2011 longview economics

Live in Unusual times – evidence: US Household Net Worth

Link to GDP: 1997 paradigm shift

US Household net worth as a Multiple of GDP (1946 to present)

Why so high?



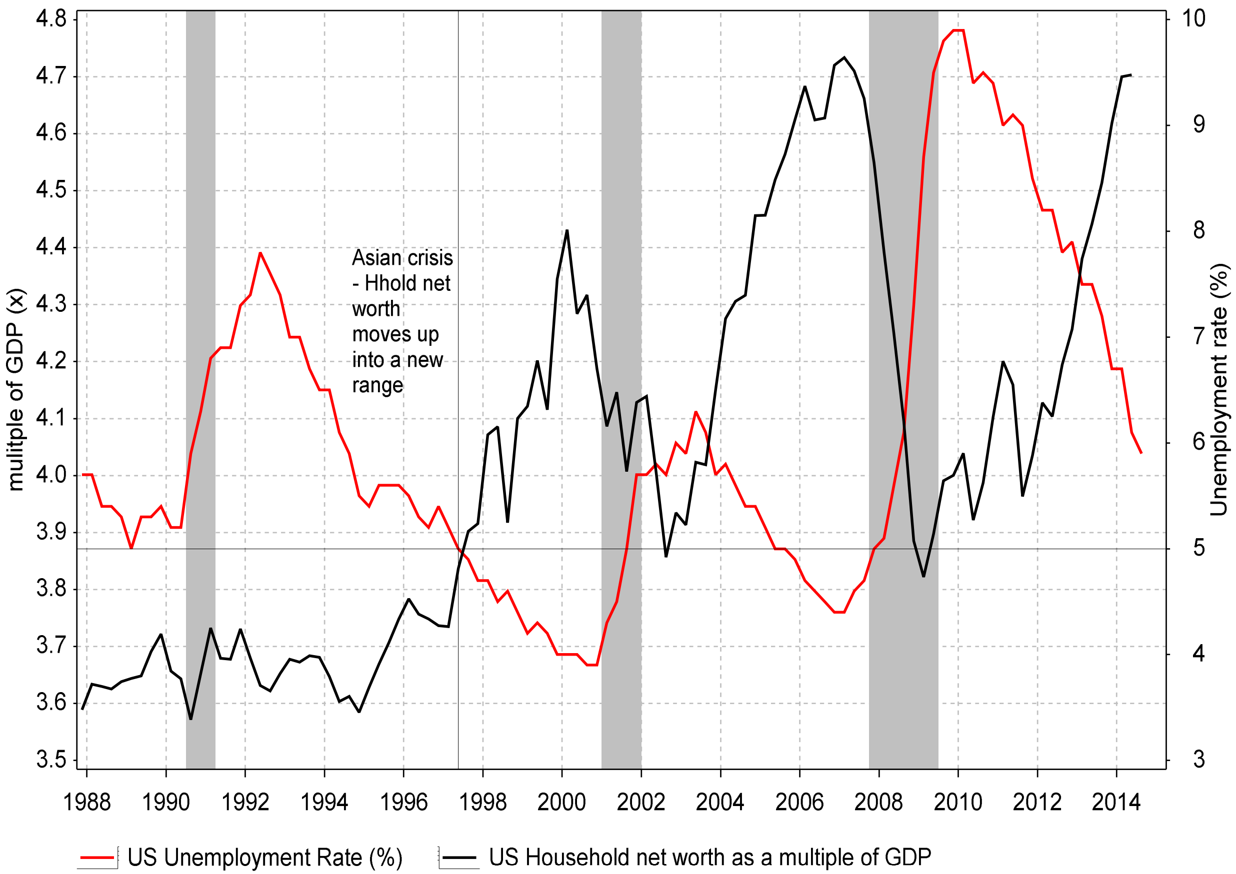
Source: Reuters EcoWin

Topsy-Turvy Economics:
The world of the Pavlovian Fed

Fed's J Bullard Oct 9th
"Right now, "the markets are making a mistake" and expect the Fed to maintain its ultra-easy policy stance longer than Fed officials themselves currently expect, Mr. Bullard said. When it comes to these expectations, "I would prefer that those be better aligned than they are."

Fed's J Bullard Oct 16th: "Inflation expectations are declining in the U.S.," Bullard said. "That's an important consideration for a central bank. And for that reason I think that a logical policy response at this juncture may be to delay the end of the QE."

US Household net worth rel to GDP vs. US unemployment rate (%)



Source: Reuters EcoWin

Low Volatility – to be Feared or Embraced?

Feared!