

## Equities: Calm Before the Volatility Storm?



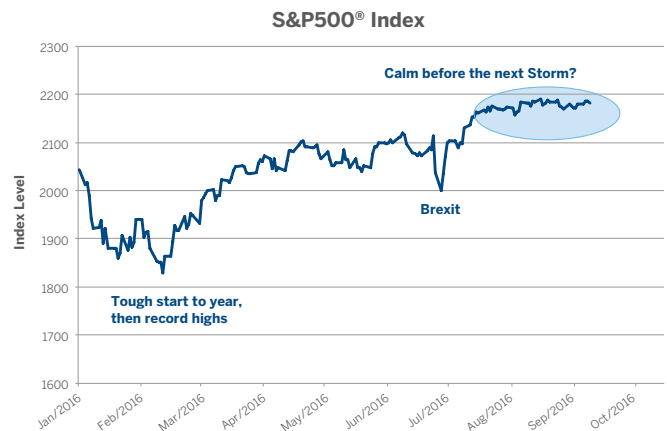
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U.S. equity volatility has been exceptionally low during the summer of 2016. Other than the sell-off in the two trading days right after the U.K.'s "Brexit" referendum in late June, the stock market has been unusually calm. We can probably give monetary policy in the U.S., Europe, and Japan some of the credit, while noting that there was an absence of earnings surprises and unexpectedly strong or weak economic data. However, plenty of political risk, and the possibility of a relatively weak earnings season full of cautious forward guidance may lie ahead.

### Monetary Policy and Record-High Equity Markets

Monetary policy in the U.S., Europe, and Japan has been highly accommodative for eight years now. Quick action by the Federal Reserve (Fed), European Central Bank (ECB), and the Bank of England (BoE) back in late 2008 and early 2009 probably prevented the financial panic of September 2008 from spiraling into an economic depression. Since economic growth resumed in late 2009 and early 2010, however, the pace of economic activity has been quite modest, and virtually no inflation pressure has developed despite trillions of dollars of asset purchases and zero or even negative rates. **What has happened is that monetary policy has pushed government bond yields ever lower, which has provided the equity markets with a historically low hurdle rate.** And, with U.S. stocks paying dividends comfortably above the U.S. Treasury 10-year Note yield, **stocks have gone to record highs on lower volatility, even in the face of relatively weak earnings growth.**

Figure 1



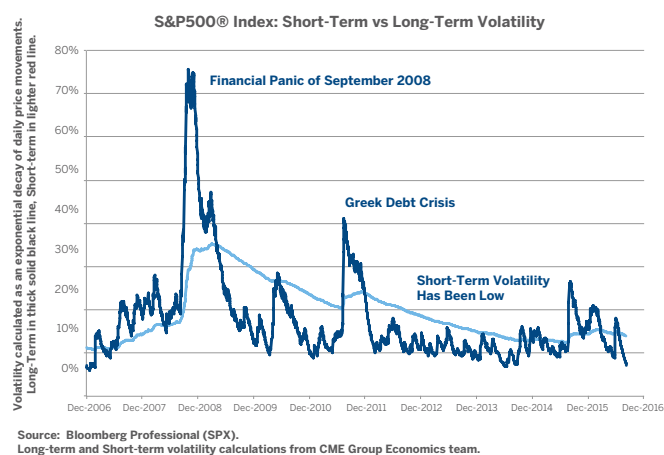
Source: Bloomberg Professional (SPX).

### Volatility is Usually Mean Reverting

Volatility in equity markets is one of the more dependable mean-reverting indicators. This is simply because the world goes only so long without some economic and financial surprises. So, **monetary policy can certainly create the conditions for upside potential in equities with low volatility.** However, one still has to be on the lookout for potential risks. The big risks on the political horizon have to do with elections – in the U.S. and Europe.

The U.S. will have a new President and a new Congress in 2017. More gridlock may be forthcoming, but the first 100 days of any new Administration are usually the ones that set the new course. And **given the propensity for each of the last several Presidents to expand the use of executive privilege to go around a deadlocked Congress, this means considerable tax and regulatory risks are possible even without new legislation.**

**Figure 2**



On the economic and market side of the equation, the source of risks has shifted. Since the 2008 financial panic, banks are more highly regulated, hold more capital, and do less proprietary trading. Does this mean financial risks are lower? Probably not. Risks have just been shifted to the non-bank sector. **The risks in the asset management and Exchange-Traded Funds (ETF) sector revolve around liquidity. As asset managers and their investors have gone on a major search for yield, they have been driven by central bank policies into much less liquid portfolios.** If there is any event which causes investors to become even a little more cautious, the run for the narrow door could easily spiral into a liquidity crisis resulting in considerable market volatility. Timing is everything, though, and while the probability of volatility-inducing events is certainly rising, timing is quite uncertain.

In Europe, the issue is how to handle the U.K.-European Union (EU) exit negotiations. With some tightly contested elections coming up in France, Germany, Austria and the Netherlands in late 2016 and 2017, how anti-EU and anti-immigration parties do at the polls may divert attention from a unified effort among the 27 countries staying in the EU on how to negotiate with Britain. **The Brexit discussions could easily become a pawn in the larger battle of how some countries within the EU want to reshape and reduce the power of Brussels.**

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