Market Commentary

The return of volatility: Why you don’t need to panic

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The latest sell-off marks the first substantial increase in volatility after a lengthy period of relatively quiet markets. While it may be disconcerting for many, it’s critical to understand the background and context – what’s driving global markets – and what this means for *our* (we’re invested alongside you) investments going forward.

The key advice: There is currently no need to panic. Somewhat counter-intuitively to many individual or retail investors, the markets have been selling off in reaction to the prospect of continuing economic growth in the U.S. and amid strong fundamentals. This growth brings with it the likelihood of rising inflation and therefore higher interest rates – considered by the markets as an impediment to growth and corporate earnings in many cases.

There are also technical reasons behind the latest pull-back. A negative feedback loop has forced some volatility-sensitive investment strategies to exit risk positions. It may blow over quickly (as it did in the summer of 2015) or over the next month, but we don’t expect this to be a problem over the balance of the year. (*For a more technical explanation, see section below: Volatility instruments*).

What happened?

- The S&P 500 and MSCI World indexes sold off 6.5% over the first three trading days of February.
- The VIX (CBOE Volatility Index) has soared over the past few days, settling at over 37 after a prolonged lull (for all of 2017, it averaged ~11).

Why?

From Signature’s perspective, this sell-off appears to have been caused by a chain of events that started with a positive U.S. jobs report on February 2 (specifically, the rise in average hourly earnings growth from 2.5% year-on-year in the December 2017 report to 2.9% in January 2018). This led to a sharp sell-off in bonds and equities based on inflation fears. The selling was exacerbated by the reduction of leverage that many market participants were using to get upside exposure. **In our view, this sell-off is *__not__* driven by a change to company fundamentals.**

How are we affected?

Signature's mandates are defensively positioned versus equity market benchmarks. The funds may be well positioned to outperform equity markets on the way down but high beta (more volatile) names will be at risk (the high beta basket has been the most damaged during the recent downturn).

Outlook and positioning: key takeaways

- The latest sell-off represents a clear-out of much speculative money and has potentially positive ramifications for the market. In our view, the Federal Reserve will not have to intervene to prick this speculative activity and will be more inclined to stick to its plan for a gradual exit from the markets as they effectively correct themselves.
- Interest rates are normalizing. This will likely happen gradually. In the U.S., yield levels may test new highs throughout 2018. Equity markets will have to contend with this situation and may see a repeat of recent circumstances but with less amplitude.
- As central banks gradually exit the markets – effectively withdrawing protection – volatility is normalizing. This is positive for actively managed products.
- Overall, fundamentals remain solid. This extends to business confidence levels, corporates, the banking and credit systems. This may generate substantial mergers and acquisitions activity. Signature has a positive equity view and will remain overweight.

It's worth noting that volatility itself isn't necessarily a bad thing – this can also generate opportunities. Signature is overweight cash in our balanced strategies versus bonds, and is looking to deploy cash and increase equity exposure; however, this will be done selectively as the team finds opportunities.

We also expect bond-like equities to perform well if there is another bump as government bonds are not providing the same level of protection that they used to given the current rising rate environment and pick-up in inflation.

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The technical perspective: volatility "instruments"

Since the global financial crisis, we have seen the creation of instruments (Exchange-Traded Notes or ETNs) that were designed to isolate volatility and convert it into an asset class used by institutional investors to hedge against volatility risk. One example is the VelocityShares Daily Inverse VIX ST ETN (XIV), which tracks the CBOE Volatility Index, or VIX.

Meanwhile, over the last 10 years, easy monetary policy has lowered volatility within equity markets to historic lows, ensuring that anytime a pick-up occurred, central bankers could pump more liquidity into the markets, bringing volatility back down. This has led some participants to game the system and profit from these ETNs each time volatility increased, knowing it would immediately subside. This demand led to more products that allow investors to bet on volatility, some including large amounts of leverage.

Volatility spiked on Monday, February 5, forcing these products to rebalance. In the 15-minute period between 4:00 p.m. and 4:15 p.m., more than 100% of the daily volume traded in these products. This caused volatility to continue to increase and more investors to sell off their short-volatility positions, particularly those with volatility targets.