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Daily Tweet
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Since '95, the Euro has dropped more than it has this cycle only once. These severe drops are rarely sustained.



A Post-Volatility World

Charles Gave

These are words that I utter with the utmost caution—this time, it really is different. I refer not to central bankers’ scurrilous efforts at monetary debasement, nor the spineless diplomacy of European political leaders, or even the cult of celebrity in the age of social media. In some guise, we have seen all of this before. No, dear reader, for something genuinely new to the modern experience, consider the right hand side of the chart on page two which displays annual variations in the S&P 500 since 1965.

What we see is that at the start of any 12 month period from 1965 to 2011, an investor in US equities could reasonably expect their performance over the coming period to vary between +25% and -10%. The average annual return over this period came in being slightly below 10%. But since 2012 something has changed. I speak only slightly tongue-in-cheek when I suggest that we may have entered a new era of the S&P 500 “exchange standard” whereby the US equity benchmark replaces gold as the asset that cannot go down and, to this effect, is manipulated by central banks.

Checking The Boxes		
Our short take on the latest news		
Fact	Consensus belief	GK Research reaction
China saw its first state-owned enterprises bond default , as a power company failed to make interest payment	Surprising even if it is of low grade; the third listed firm default on an onshore issue	This is healthy, as it lowers moral hazard of sovereign guarantee; and safer done in a bull market
German ZEW economic expectations survey fell to 53.3 in Apr, from 54.8 in March	Lower than 55.3; but current conditions jumped to 70.2 , from 55.1 (beating 56.5 exp.)	Growth is on track, especially the domestic side
Japan posted first trade surplus since 2012, at ¥229bn in Mar, vs -¥425bn in Feb	Above expected ¥45bn; exports rose 8.5% Year-over-year (YoY) while imports fell -14.5% YoY	Export boost from weak yen + commodity price weakness drove surplus; expect stable Japanese Yen
Australia CPI rose 0.2% Quarter-over-quarter (QoQ) during 1Q , unchanged from 4Q	Above exp. 0.1%; sticky core inflation (0.6% QoQ) made some question rate outlook, but...	Growth slowdown and overvalued Australian dollar make rate cuts inevitable

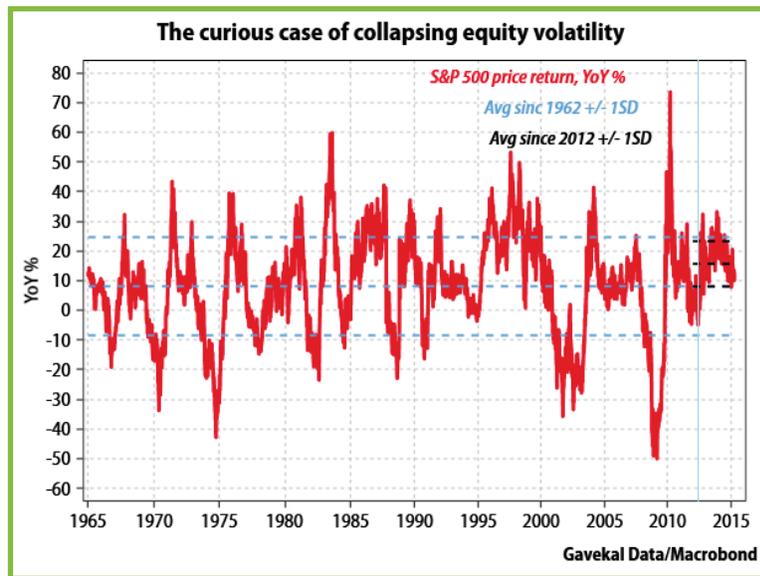
Since early 2012, the upper limit of the S&P 500's normalized performance has remained at about +25%. What has changed is the lower limit which has moved from -10% to +9%, leaving an average year-over-year performance of +16%. Such a performance is remarkable considering that US nominal growth has hovered at a less than impressive 4% through this period.

I have argued before that the new goal of central banks in an age of extreme indebtedness is to ensure that financial markets never again go down. Indeed, it is now clear that the guardians of money—whether the European Central Bank with government bonds or the Federal Reserve with equities—are first and foremost in the business of controlling asset prices. And it turns out they have been highly efficient at this task.

A slight problem may, however, emerge over time. Tools such as options let investors hedge against a downside risk suddenly emerging and have been built on the underlying premise that risk can be measured from the volatility of the underlying asset prices. In the case of US equity options, their value derives from the CBOE Market Volatility Index (VIX). On a minute-by-minute basis the value of the VIX is the critical input to models across the financial industry which aim to capture the value-at-risk. And from this value-at-risk reading, banks and other financial institutions calculate the leverage that they and their clients can “reasonably” take. Put simply, the whole derivative market is priced, one way or the other, from the volatility of the US stock market. In the case of the eurozone, the relevant benchmark for assessing risk tends to be volatility in the bond markets of the periphery.

In the case of US equities what are we to take from volatility being becalmed between +9% and +25%? On the face of it, we seem to have reached a managed nirvana as the market for derivatives and its underlying are “correctly” priced in relation to each other. There is, of course, the possibility of events getting in the way; in this case volatility could make an unplanned return, requiring those Black-Scholes models to be rapidly re-crunched, with obvious implications for option pricing and the amount of leverage that can be “reasonably” tolerated. In this eventuality, there will be a discrepancy between the “new” volatility and the derivative markets. And this re-pricing process could make itself felt on the underlying US equity market through a fierce feedback loop.

Hence, if and when a genuine price for risk reappears, the effect may be greatly magnified as it was in the US housing market a few years back under not dissimilar circumstances. As Karl Popper noted, volatility can be suppressed in a capitalist system, but it must ultimately reappear. Sooner or later, we will face a good deal of fireworks.



Test Your Knowledge

How many multinational companies according to a recent survey use the renminbi for payments outside mainland China?

- a) One in six
- b) One in four
- c) Over half

Answer: c) Over half. A survey of 150 multinational companies showed that more than half have already used the renminbi outside mainland China, with executives citing benefits such as lower transaction- and funding-costs. The renminbi is also the second most used currency for carmakers such as Volkswagen, Daimler, Ford and General Motors, likely due to their big market in China. And if the International Monetary Fund includes the renminbi in its special drawing rights basket later this year, its role in international finance can only expand. Read more [here](#).

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