



Low Volatility Not a Warning Sign for Stocks

Key Takeaways

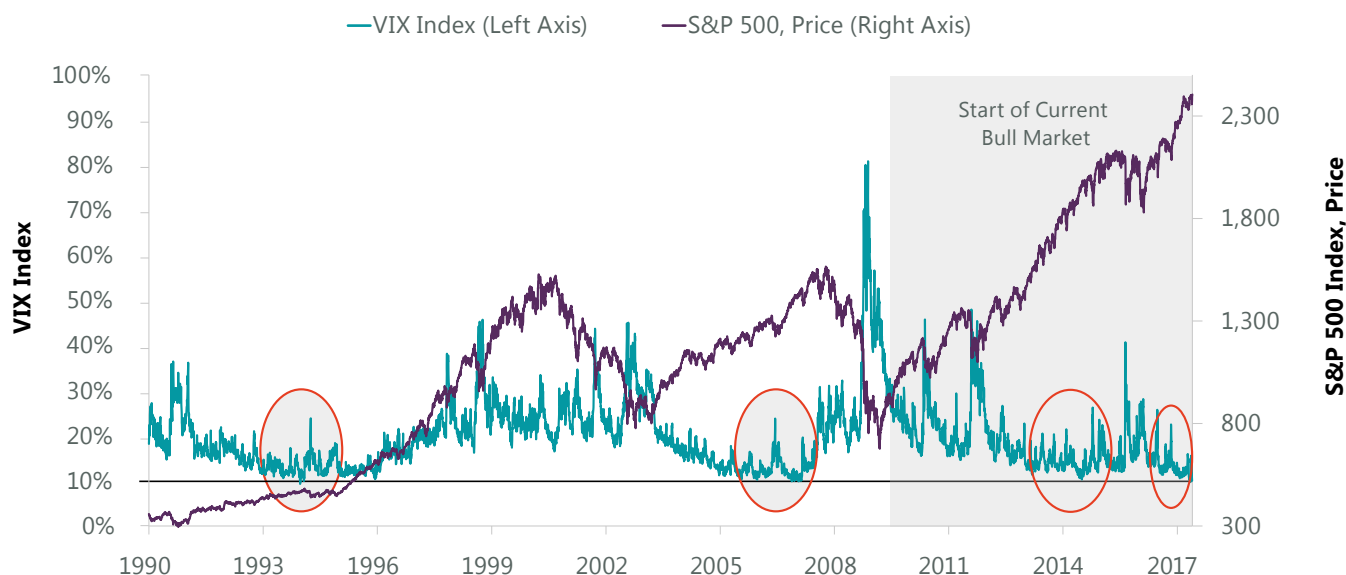
- ▶ Several long-term trends, including accommodative monetary policy and share buybacks, continue to support low levels of equity volatility.
- ▶ Periods of low volatility have not been consistently predictive of future market direction.
- ▶ A measured rise in volatility could be conducive to active strategies that are driven by stock selection.

Higher volatility creates a favorable backdrop for alpha generation and the ability to exploit the mispricings that occur.

The low volatility environment across markets this year – including equities, rates and credit – has raised questions regarding investor complacency and whether this is setting us up for a nasty wake-up call. While investor vigilance is always important, we do not believe there are reasons for serious concern in the near term. The economic outlook in the U.S. and globally is sanguine, liquidity is ample and corporate credit fundamentals remain strong. Importantly, the absence of near-term catalysts for a sharp market reversal stands against the background of several longer-term trends that have and will continue to support low levels of volatility across equities. These include highly accommodative monetary policies across developed economies; sustained high levels of share buybacks (with more likely to come in the event of repatriation); institutional selling of volatility contracts to enhance yield; and continued flows into passive, index-linked strategies from both institutional and retail investors. Perhaps one element of uncertainty that stands out to us is U.S. fiscal policy over the next six months. However, given very limited visibility into the political process in Washington today – made more complicated by the ongoing investigation of President Trump's ties to Russia – investors are unlikely to take large one-sided positions betting on any one policy outcome, creating a delicate equilibrium over market movements.

It is worth noting that these factors coalesce into a very different backdrop compared to other periods of low volatility, notably in the early 1990s. In 1993, investors were fairly levered yet remained complacent in their market outlook, in spite of far greater policy uncertainty from the Federal Reserve than we are currently witnessing. This suggests that a Fed known for openly telegraphing its intentions should contribute to an extension of current restrained volatility. While

Exhibit 1: Markets Have Recently Seen Two Sustained Periods of Low Volatility



As of May 11, 2017. Circles indicate periods of low volatility where the VIX Index touches or nears 10. Source: Bloomberg.

we see several tactical and structural forces also supporting fairly low volatility levels, we note that a rise in volatility would not, by itself, signal significant losses for equity investors, especially if it occurs at a measured pace. On the contrary, such a scenario could be especially conducive to higher returns across active strategies that are driven by stock selection.

Improving Macro Conditions Temper VIX Concerns

The CBOE Volatility Index (VIX) hit one of its lowest levels ever (9.8%) in May, and has hovered in the low double digits for stretches of time since 2013. Temporary, and for the most part, moderate increases in equity volatility over this span have been accompanied by equally short-lived equity market drawdowns. These sell-offs have occurred as part of an overall upward trend for the S&P 500 Index (Exhibit 1).

Two notable exceptions to this occurred in mid-2015 and early-2016 when declines in oil prices and fears of global economic slowdown, led by China, roiled the markets. While these concerns were understandable, we would argue they are unlikely to surface with similar poignancy in the near-term. Major global economies, especially the eurozone and Japan, are experiencing more robust economic growth than they have seen in years. Energy markets are more in balance today than from 2015 to early 2016, and Chinese growth is unlikely to be jeopardized by meaningful withdrawal of official stimulus ahead of the National People's Congress session this fall.

The U.S. economy may be in a more mature stage of the economic cycle than its developed counterparts, but macro fundamentals, including labor market dynamics, consumer balance sheets, and corporate profits, remain robust. While recent Fed communication points to gradual tightening, the overall policy is likely to remain accommodative by historical standards given where we are in the cycle.

We caution not to read too much into low volatility across equities, rates and credit as shown in Exhibit 2. Indeed, thanks to central bank support, liquidity is ample, corporate credit fundamentals are healthy and corporations continue to engage in historically large share buyback programs that have helped buoy equity valuations. Recall that over the past few years, regulatory changes and market dynamics have combined to encourage heretofore unprecedented flows into passive strategies. Index-linked strategies are inherently long the index and thus short volatility. As a result, the momentum and self-perpetuating positive feedback loop that flows into index-linked strategies help drive equity prices higher. Arguably, this is a major structural force behind lower volatility levels.

As you can see in Exhibit 3, that narrative is beginning to change. The flow into passive is starting to slow, which could bode well for an increase in volatility.

Yet there is a negative connotation about higher volatility in financial circles. Higher volatility does not always equate to lower market multiples. During the tail-end of several cycles, notably the late 60s, 70s,

Exhibit 2: Ample Liquidity Keeps Volatility in Check Across Asset Classes



As of May 15, 2017. LIBOR-OIS Spread indicates credit volatility. Source: Bloomberg.

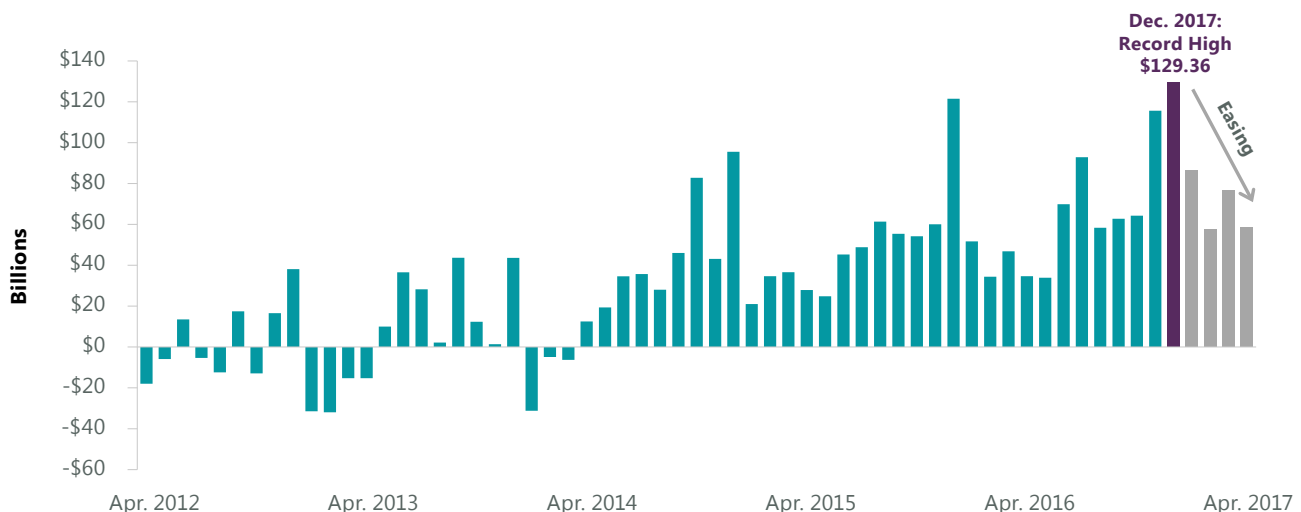
and most recently the 90s, investors enjoyed a positive return profile amidst higher overall market volatility. In fact, as shown in Exhibit 1, the VIX spiked several times in 1997 and 1998 amidst one of the strongest bull markets in history. It is also worth noting that the price level of the S&P 500 increased more than 40% during the low volatility period from mid-1993 through early 1996 that preceded its strongest performance years, according to Evercore ISI. The S&P 500 climbed more than 15% during the next low volatility period from late 2005 to late 2007 but in that instance, muted volatility gave way to the global financial crisis and a significant equity drawdown.

While periods of low volatility do not consistently telegraph market direction, markets do eventually revert

to normal volatility levels. Some of a cycle's best returns have come during the last leg of economic and market expansions and higher volatility is usually a byproduct of such an environment. Strictly from an active management perspective, we embrace higher volatility as it creates a favorable backdrop for alpha generation and the ability to exploit the mispricings that occur.

In sum, we believe there are few reasons for investors to be concerned about current low levels of volatility. Both cyclical and structural causes of low volatility appear to be safely in place for the near term. Beyond that timeframe, volatility may rise. This, however, would not mean that strong equity performance is over; on the contrary, a moderate rise in volatility should be supportive of active equity strategies.

Exhibit 3: Overall Passive/Active Fund Flow Differential



As of April 30, 2017. Source: Morningstar.

About the Author



Jeffrey Schulze, CFA

Director, Investment Strategist

- 12 years of investment industry experience
- Joined ClearBridge Investments in 2014
- Member of the CFA Institute
- BS in Finance from Rutgers University

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960
ClearBridge.com

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