2024, A SINGULAR CONTEXT OF VOLATILITY IN THE MARKETS?

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STRUCTURALLY HIGHER INTEREST RATE VOLATILITY

The high level of interest rate volatility questions us for two main reasons.

First, volatility normalised as the focus of monetary policy reverted to rates after years of quantitative policies. During the crisis years, central bank forward guidance ensured that interest rates were anchored at low or even negative levels, moving bond market risk onto longer maturities. The unusual sizes of policy rate changes (increases of 50 or 75 bps) and their frequency since 2022 have restored the historical term structure of volatility. Most of the rate uncertainty should be on the short term (in the forthcoming 2 years) as long-term rates tend to average out cyclical variations. Normality is indeed an inverted term structure of volatility, which again prevailed at the beginning of 2022.

Second, the current hierarchy of the volatilities of the main financial markets seems lopsided. The high volatility of interest rates contrasts with the low volatility of credit, equities and exchange rates. As a result, assets deemed risk-free (no default risk) have become a major source of market risk. The paradox is that the increased variability in the discount factor for risky asset flows has not been offset by an additional risk premium on credit or equities. On the contrary, the volatility of credit or equities has decreased. However, the monetary policy status quo since September 2023 has started to dampen volatility.

EQUITY VOLATILITY: CORRELATION IN THE DRIVING SEAT

To explain this large gap between Rates volatility still high and Equity volatility back to pre-Covid lows, we need to dig below the surface of Equity indices.

To gauge the level of Equity volatility, the investment community often refers to the VIX Index, which is based on the implied volatility of 1-month options on the S&P500 Index. By construction, this index is made from 500 stocks, so for the S&P500 to be volatile, it needs the different stocks to be volatile, but also it needs these stocks to be correlated, to move in sync. And for the past 2 years, all the major narratives driving the market are dividing the index between winners and losers. Higher rates are good for cash rich companies, bad for indebted ones. Artificial intelligence also has its winners and losers. Same for anti-obesity drugs.

As soon as a piece of news hits the tape on a given narrative, winners outperform, losers underperform and overall, the S&P500 doesn't move much as dispersion between stocks dampens the move at the index level.

To measure dispersion, we can look at the implied correlation derived from the index and each single stock implied volatilities. This implied correlation between stocks has collapsed in the past two years, to reach lowest levels since 2005. More than ever, volatility must be actively managed to avoid getting caught on the wrong side of the trade when correlation will rise again and contribute to push index volatility higher.

LOWER EQUITY VOLATILITY: WHY SEEK DIVERSIFICATION

The 2023 momentum of strong outperformance of cyclical and growth segments contrasts with that of 2022 where Value and inflationary themes had largely outperformed. A quantitative analysis of equity market performance confirms the opposition between inflation and growth themes since 2021, mirroring post COVID uncertainties. Specifically, the polarisation between Value and Growth has been the dominant factor since 2021.

This dynamic influences the decline of equity volatility through lower correlations but, in a second step, may also lead to an excessive simplification of the diversification offered by this opposition. A multi-dimensional reading of the analysis highlights two essential aspects: First, the stability of the Value/Growth decorrelation is fragile; secondly, the more defensive segments and the Low Volatility factor are the only ones to play a diversifying role against this axis which has so far been decisive.

It is crucial to recognise that the absence of volatility does not mean the absence of risk; their relationship is not monotonous. In the current context, it is appropriate to revisit diversification, going beyond its simplest binary expression, and to identify truly differentiating market segments. This is the case for less volatile sectors and securities, especially as these are segments whose valuation has not been so relatively attractive compared to riskier segments for more than 20 years.

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