Equity investors: Are they ignoring risks?

Peter Szopo

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The year 2016 was full of surprises. It was, for example, the year, when an outsider overcame odds of 5000 to 1 to win the Premier League. It was also the year, when the lyrics of three-minute pop songs were acknowledged to be an art form worth the Literature Nobel. Most importantly, however, politics in the Western hemisphere surprised big time with the vote for Brexit and the election of Donald Trump as the next US president.

While Leicester and Dylan will remain historical footnotes, the political events of last year could be the trigger of something bigger to come. 2016 may well turn out as the year, when US exceptionalism has ended, European integration got derailed and the trend toward globalization and free trade has gone into reverse.

Equity investors: calm despite political shocks

Against a backdrop of a seemingly massive rise in global uncertainty, equity markets have remained unimpressed. US, Canadian, German, French and British equity markets (in local currencies) all posted gains last year, with some indices exceeding or touching previous all-time highs. Even more surprisingly, market volatility was subdued most of the time.

Cliff Asness, one of the most renowned US fund managers and financial market pundits, pointed out in his blog recently that 2016 was a "pretty darn normal" year for US equities. Whether one looks at annualized volatility (13.1%), the biggest (rolling) one-month return (10.4%) or the gain from the year's low in February to its high in December (24.2%) – all metrics were close to their average over the past decades. In contrast, in European markets volatility was slightly elevated, with annualized volatility in Frankfurt, London and Paris 7%, 5% and 3.5% (percent not percentage points!) above their long-term averages, but despite a number of Europe-specific shocks – Brexit, Italian referendum, the rise of terrorism – plus the emergence of US policy risks (Fed) there were no signs of dramatically stressed markets anytime during the year.

Political uncertainty still elevated

The tranquility of markets is astonishing because during the second half of 2016 uncertainty about the future of economic policy surged, as shown by the Baker-Bloom-Davis Economic Policy Uncertainty Index (see charts below). While policy uncertainty has grown on both sides of the Atlantic, implied stock market volatilities have fallen. Recently, the policy uncertainty index in the US has been more than 100% above its longer-term average, while the equity market volatility (VIX) has traded 20% below its average. In Europe, the situation was similar but not as extreme, with the uncertainty index a third above its average, while V2X, the Euro Stoxx implied volatility index, was 17% below its three-year average.

*Source: Bloomberg; Erste Asset Management. *) Uncertainty Index, VIX: Deviation from 3-year average; rolling 4-week averages*

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There are three possibilities to explain the disconnect between stock markets and measured policy uncertainty:

First, equity investors just don't believe that the political events of 2016 will be game changers and, therefore, assume that economic policy uncertainty will recede in the near term. Brexit may happen only in a toned down version; and President Trump will – against his own rhetoric – fall in line with the Republican mainstream; and European elections will not fuel centrifugal political forces any further.

Second, investors believe that the economic backdrop actually has changed in recent months and assume that stocks will benefit relative to other asset classes under the new circumstances. Given a stronger global growth outlook, the end of the earnings recession in the second half of 2016, a pick-up in inflation expectations and the turnaround in interest rates, stocks are seen advancing even as uncertainty stays elevated.

Or third, equity investors are simply too calm, i.e. ignoring looming risks. Thus, there is a chance that they are in for a negative shock, as soon as markets begin discounting a longer period of elevated uncertainty, a more aggressive Fed and the consequences of a more protectionist policy environment.

The first scenario does not appear likely, mostly because it requires optimism on various fronts – in the US as well as in Europe – at the same time. More importantly, it is not supported by the data. While volatility indicators in currency and bond markets are not alarming, they have not fallen since the fourth quarter, in contrast to stock market volatility. It is not plausible to assume that investors in asset classes outside equities have a different view on how the Trump presidency or Brexit or upcoming European elections will play out.

*Source: Bloomberg; Erste Asset Management. *) Deviation from 2016 average.*

There is some support for the second scenario. Basically, the broadly advertised “reflation trade” that has gained prominence since mid-2016 rests on the assumption that the macroeconomic backdrop has turned beneficial for stocks, while the turn in interest rates together with a more expansionary fiscal policy and a pickup in inflation expectations is creating a rough environment for fixed income assets. That said, developed stock markets already gained 24% since February, 16% since June (Brexit vote) and 10% after the election of Donald Trump. Therefore, also the third scenario – that equity investors are too sanguine at present – cannot be excluded. Despite an improving backdrop for stocks, there is a fair chance that the gap between volatility and broader uncertainty indicators will narrow from below, i.e. that stock market volatility will markedly go up in the course of 2017.

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