36 South Views

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I may be crazy, but…

Volatility is at all-time lows.

Surely that is a good thing?

It means that there is little uncertainty in the world. That everything is working, everybody trusts everybody, assets prices reflect all the risk that is known about the market and those particular assets. There are very few exogenous events which could possibly affect asset prices. That central banks have our back and will not allow asset prices to fluctuate wildly.

Or it means....

The financial system had a heart attack in 2008. Central banks, the trustees of the financial system, were nearly put in front of a firing squad. They vowed never to let events like that happen again on their watch so they pumped massive liquidity into the system, simultaneously reducing interest rates to zero.

In a game of musical chairs, asset managers scrambled for yield wherever they could find it. When all traditional sources of yield were depleted they moved onto second order premium/return garnering, i.e. selling exposure to short volatility and correlation. This is the equivalent of selling the family jewels hoping the rest of the family don't ever look in the safe and find that they are missing.

It has been a good move. Yield-induced selling of volatility, in conjunction with central bank mandated stability has caused the price of volatility assets to tumble to multi-decade lows. We estimate the current price of short dated volatility on the S&P will not even cover the realised volatility due to index changes and dividends!

The preponderance of options has created a further illusion of systemic stability as the buyers attempt to claw back their premium spend by harvesting what little local volatility there is.

What does low volatility mean?

It depends on a number of big questions:

- Has the systemic risk that created the environment for 2008 been mitigated?
- Can central banks control ALL exogenous events?
- Are the current participants in the short side of the volatility market reflecting their view of the price of uncertainty?
- Will they panic if volatility returns?

My view is well known. 2008 was essentially a problem with excessive leverage. If anything this problem has been made worse by central bank action over the last 9 years.

The macro environment is arguably worse with income inequality driving political uncertainty or worse.

Central banks cannot control ALL exogenous events, possible events that could upturn them include a market crash, war, or hyperinflation.

If volatility returns, the short sellers are blissfully unaware of what a precarious position they are in. Everyone will turn buyers if the exogenous shock is big enough to move asset prices significantly. Assets world-wide are becoming super-correlated and potential for a meltdown is now on the front burner.

In addition, equity and bond prices are uniquely correlated by interest rate compression. Should prices in these asset classes go down together, most traditional portfolios have precious little diversification beyond this to fall back on.

> *You may be right, I may be crazy.... but it just may be a lunatic you're looking for.*
>
> Billy Joel

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