Market Insight:
Getting Back to Normal can be Volatile

Beata Caranci, SVP & Chief Economist | 416-982-8067
James Orlando, CFA, Senior Economist | 416-413-3180

April 26, 2018

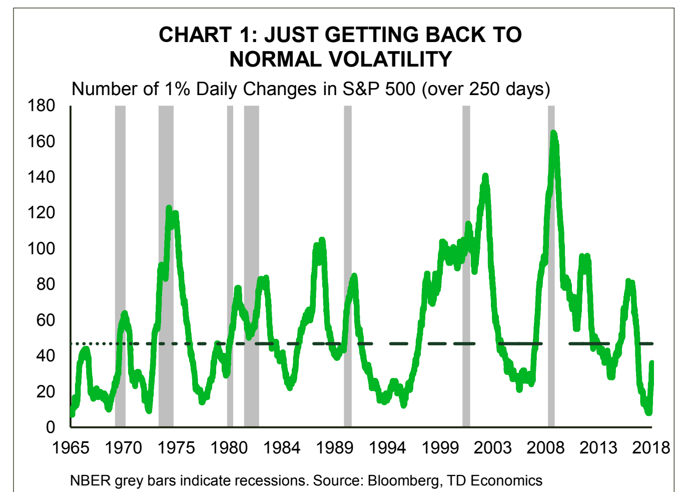
Highlights

- 2018 will be marked as the year that volatility returned to equity markets after an unusual persistent period of complacency that extended two years.
- Although the memory may be short on what is considered a "normal" amount of volatility, recent market gyrations are not enough to alter our economic outlook. In fact, the return of a more critical lens with respect to risk and fundamentals on asset classes mitigates downside risks to the economic outlook stemming from potential overvaluations.

The return of equity market volatility has led clients to ask if it's here to stay. History suggests the answer is yes. The years 2016 and 2017 were marked with such an unusual lull in volatility that it may have led us to forget what are considered normal market gyrations. The return of volatility has certainly corresponded with a greater number of trading days where equities moved more than 1%. This is apparent looking at the three month time period since February. The trigger, in part, stemmed from a greater market alignment to the Fed's view of higher rates, coupled with some deterioration in international sentiment. However, market sentiment is merely returning volatility to normal levels. When comparing the degree of volatility based on a 1-year rolling change of equity valuations, the day-to-day movement is inching towards its long-term average (chart 1). Here we can see that 2017 was truly the outlier of the pack and should not be used as a reference period. For that year as a whole, there were only eight instances of a 1% move. This was the lowest print going back to 1965.

Separate market volatility from economics

So what does the return of volatility mean for our economic forecast? Not much. We were more concerned during the prior two-year period of complacency, as that can result in hubris and an overvaluation in financial assets. This would leave risk assets more susceptible to a severe correction. But, just as we didn't overreact and dramatically lift our growth forecasts when equities soared last year, likewise we don't perceive the current amount of volatility as a force that undermines the near-term outlook. Aside from the fact that we are not seeing a particularly unusual or alarming amount of volatility as of yet, equities are also not widely held and wealth effects are lower than, say, housing wealth derived from rising

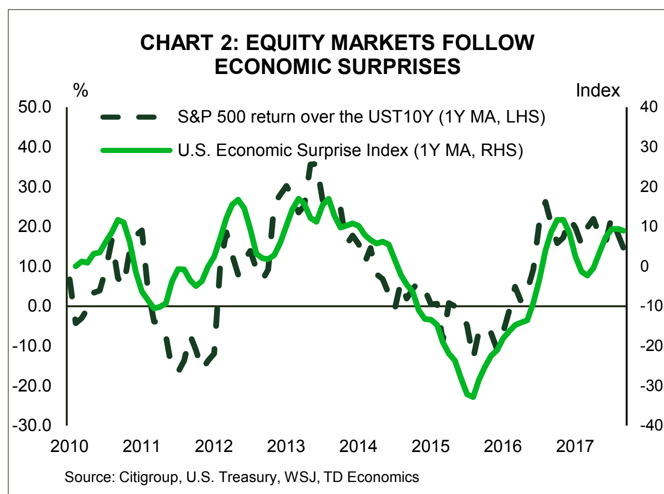


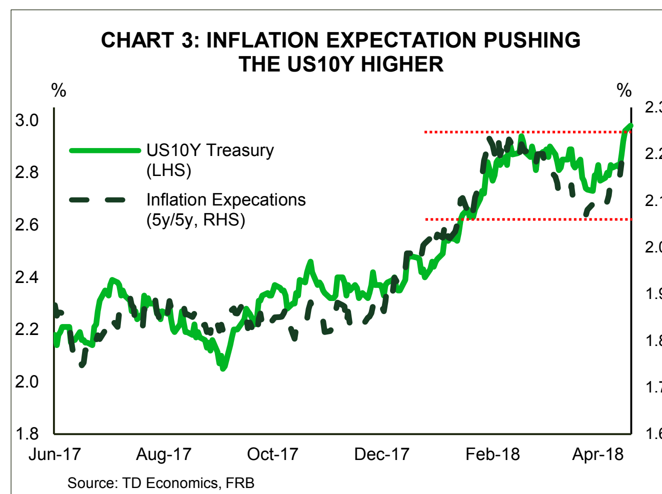
home values. Certainly, a severe equity correction that is extended over a period of weeks can impact consumer spending and business investment via the confidence channel. However, that would require a higher volatility threshold to be met before we would reopen our spending assumptions, such as a 20% bear market sell-off that fails to rebound quickly.

The return of volatility, however, is an important turn of events. It means that investors are now responding to market events instead of shrugging off negative news. The prior period of complacency typically happens when a strong growth narrative takes hold. For the most recent case, U.S. corporate tax cuts combined with a synchronized global growth upturn resulted in an upward re-evaluation of corporate profits. In this sense, a rising tide lifted all boats. But, the tables have now turned. After more than a year of global growth surprising to the upside, GDP forecasts for the developed world (ex-U.S.) are moving back to their potential pace (chart 2). We consider this a normalization to a more sustainable growth path, which was already built into our economic projections. However, investors are readjusting their lens to this reality, finally placing a more critical focus on emerging risks.

New normal brings focus to fundamentals

Contrary to how the market "feels" with many more days of ups and downs, a greater alignment to economic and financial risks can actually help mitigate future risks of asset mispricing. Take the U.S. Treasury curve. We've repeatedly noted in previous publications that inflation is finally starting to firm and a wave of Treasury supply was





coming. In turn, inflation/interest rate risk would need to be priced into the Treasury curve. Market participants are now starting to embed this reality into asset prices. The UST 10-year has finally tested a tight 3-month trading band when it kissed the psychological 3% level this week (chart 3). Economic fundamentals suggest it has more to go, and we are sticking to our long-held view that the UST 10-year yield will settle around 3.15% by year-end. With respect to currency valuations, we see the greenback continuing to trade above its long-term equilibrium value versus major currencies for the duration of this year. This forecast is based on interest rate differentials, wherein the Federal Reserve will proceed with raising its policy rate, causing a more dramatic interest rate spread relative to other major central banks.

Forecasting in the time of volatility

Volatility is back. Though it sounds like a negative, it's actually not. Markets are responding to risks in a more rational way. And, risks do exist. There is risk that fiscal stimulus, trade frictions, and tight labor markets will lead to stronger inflationary forces. Coupled with greater Treasury supply coming into the market via the need to fund larger deficits and the Federal Reserve's extraction from prior asset purchases, also places a risk that long-yields will rise more than markets currently expect.