The Volatility You Can See Coming

By Richard Thies

As we reflect upon the strong year for markets in 2017, and ahead to 2018, we are reminded of the many subjects in popular market literature that have bothered us over the last few years. While we do not intend to make this commentary a public airing of all our grievances (in keeping with Festivus tradition), we do think that a discussion of a few of them is important for understanding how to navigate the year ahead. We see the general market obsession with low volatility as missing the bigger point that actual economic volatility has been extremely low and is set to rise.

Beyond that, we have some comments on how to think about the dollar in 2018 and the dangers of the oversimplified, common view that the dollar strengthens when the Federal Reserve (Fed) tightens. We will not, however, be focusing the discussion on the obsessive nature of cryptocurrency commentary in financial news (and the egregious know-it-all perspectives of commentators on both sides); this and other grievances will be tabled until next Festivus!

Market Volatility is Historically Low!

What are you supposed to do with that information? I'm not sure either. In the wake of both the volatility spikes in late 2011 and 2015, the common reaction was one of seeming shock and smug 'this won't end well,' as if the authors knew that volatility really was supposed to be higher but nobody else understood it yet. Frequently, the same bemoaning of the low volatility regime would blame the Fed for preventing instability with its quantitative easing (QE) program; the fact that new purchases stopped over two years ago hasn't stopped this line of thinking.

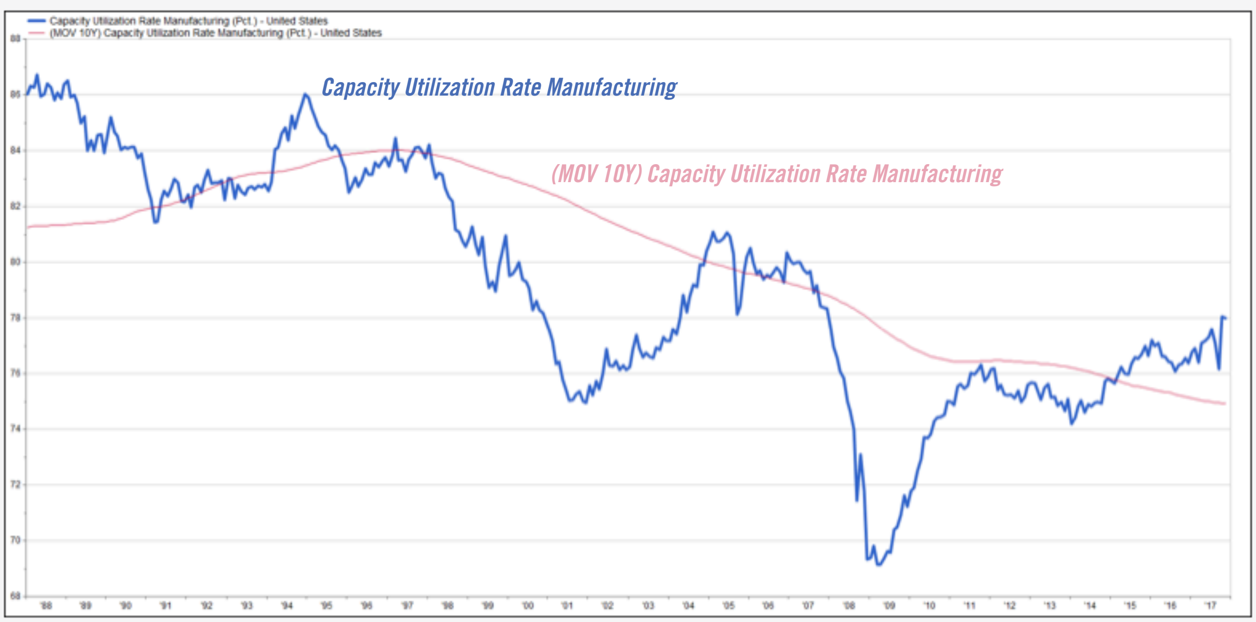
EXHIBIT 1: Volatility at historical lows

Source: Bloomberg

Our interest in the low levels of market volatility is focused on economic volatility, something we view to be a contributing factor which never receives much attention, and has also been very low in recent years. Aside from the instability resulting from the collapse in oil prices in 2014/2015, which also pushed the Chicago Board Options Exchange Volatility Index (VIX) up into the 20s for months, the variance in economic data has been quite low. Intuitively, it makes sense that such a period should coincide with low market volatility given that it means future uncertainty is lower and outcomes are generally easier to forecast. Services activity, by nature, is less cyclical and therefore less volatile than things like capital expenditure (capex) during normal times, and it has been services that has led the expansion in the post-crisis period but there is evidence that this is changing.

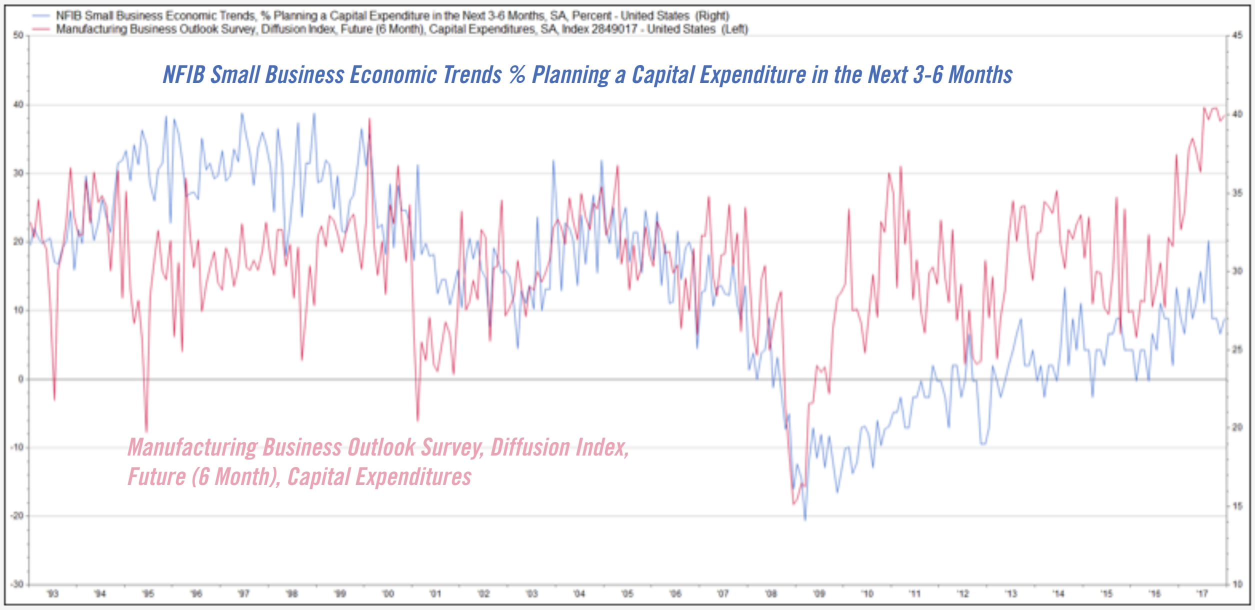
While we are not smart enough to be able to predict specific future events, we do think we have enough information to say that the things that have created this low economic volatility environment are changing. In our view, this calm economic backdrop has persisted in recent years for too many reasons to list, but a core reason is that business investment and capex have been restrained relative to services activity. A central dynamic of the post-crisis period is that the presence of surplus labor supply has been pervasive in developed markets. This is a major limiting factor on capex as it's often cheaper to utilize that surplus labor than it is to invest in capacity expansion. Related to the high levels of excess labor supply over the past years, has been the poor demand conditions on aggregate; weak demand conditions are, of course, a primary reason a company would be hesitant to invest. Today, we see utilization levels significantly above 10 year averages (Exhibit 2) and reported capex intentions are moving to new highs across the board, particularly for larger companies (Exhibit 3). In short, we finally see clear evidence that this is changing and capex is accelerating. While the secular stagnation thesis is not dying, as it is primarily demographically-driven, it may look like it is dying in 2018.

EXHIBIT 2:
Capacity Utilization in the U.S. is now significantly above long-term averages



Source: Factset

EXHIBIT 3:
Survey data shows capex intentions increasing notably

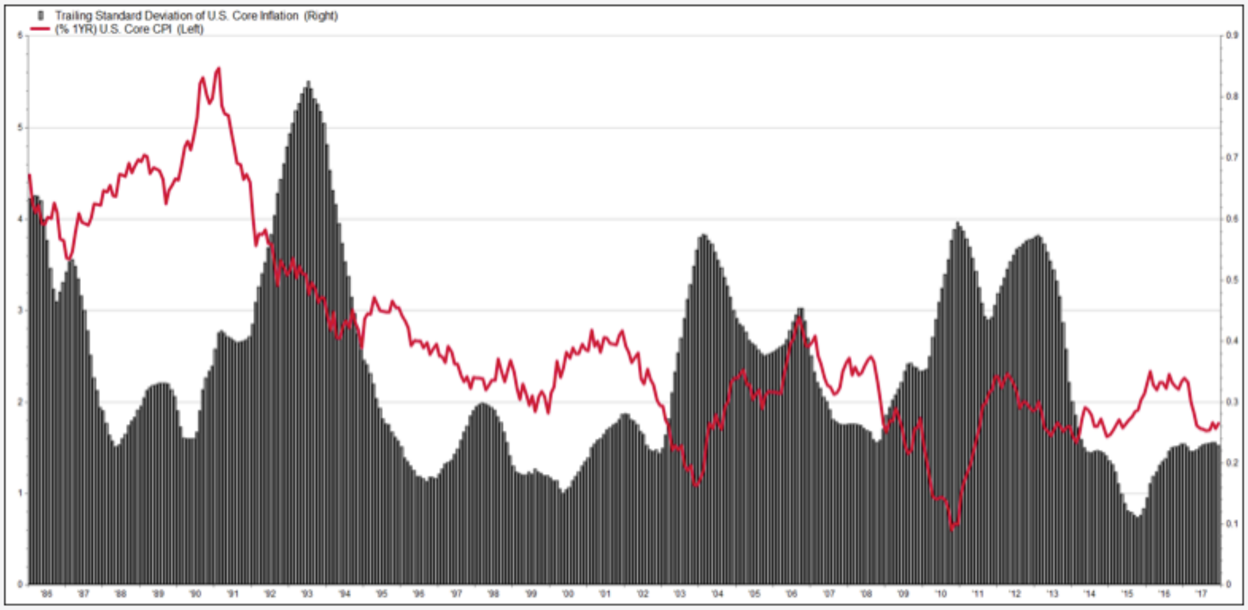


Source: Factset

Though we see a recovery in business spending, and thus a long-awaited return of cyclicality to the economy, as being important to changing the volatility dynamics in the market, we see a number of other dynamics changing as well that will give the cycle additional lift and thus, volatility. The first and most impactful is that the entire global economy is participating in the expansion for the first time since 2009. In the post-crisis period, this is the first prolonged period in which there isn't a meaningful crisis weighing on growth globally. We have no European sovereign debt crisis or emerging markets panic to subdue activity levels. The fact that it's been over eight years since this has happened suggests there should be a certain level of pent-up demand as well and thus the cycle should finally have the strength it has been lacking.

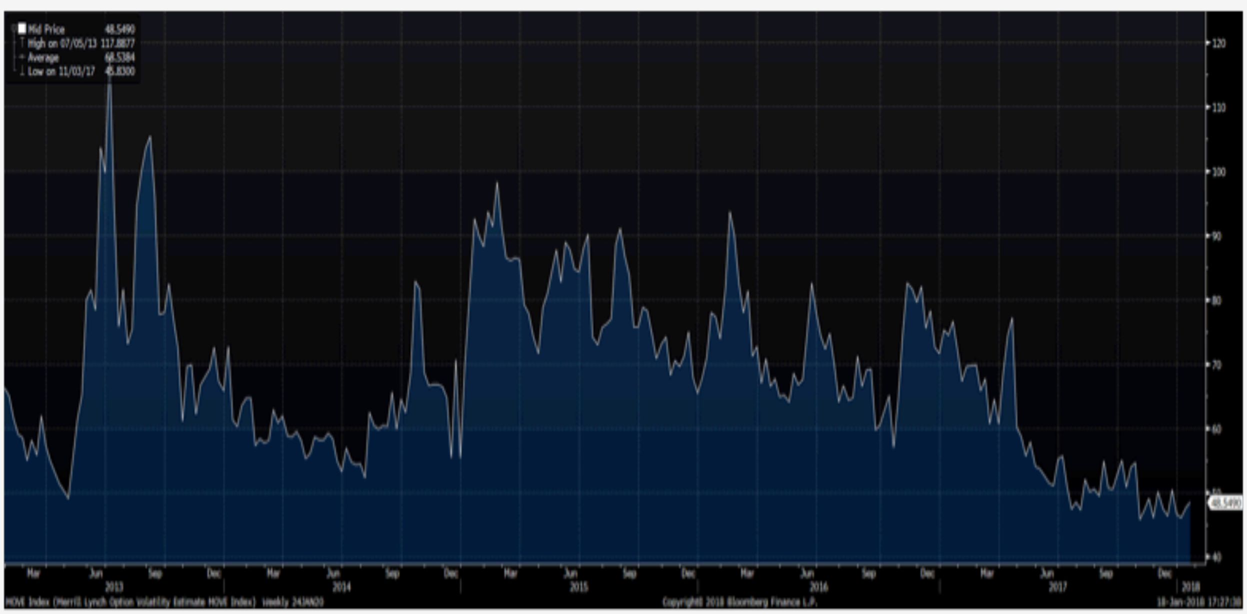
Additionally, we see the volatility of inflation increasing. While it's well-known that inflation levels have been subdued for the past several years, what's less discussed is that there have been incredibly low levels of volatility in these readings (Exhibit 4). This has certainly contributed to the record low levels of interest rate volatility (Exhibit 5) and thus, equity market volatility. We believe the unpredictability of the inflation readings should increase in line with tighter labor supply, clearer evidence of wage increases and thus far, a tenuous impact on goods prices. Further, there are numerous factors that should serve to increase inflation which have not been realized yet, namely the weakness in the US dollar broadly, the strength of the Chinese yuan, and the large increase in producer prices over the past year. Also, as inflation is a strongly lagging indicator, it should be increasing in the coming quarters simply from recent demand strength. Finally, given the uncertain reaction from companies to an unexpected widening in their post-tax margins, we see difficult-to-forecast impacts on inflation from the recently-passed tax bill. For example, will it lead to more aggressive price discounting and will the inflationary impact of that behavior be offset by further increased wages? It's very difficult to say. The easy conclusion here is that the period of low volatility in inflation is ending, which creates a direct link to higher interest rate volatility.

EXHIBIT 4:
Realized volatility in inflation readings has been historically low



Source: Factset

EXHIBIT 5:
Interest Rate volatility has also been at record lows



Source: Factset

The behavior of fiscal policy is another central point in our higher economic volatility thesis. While fiscal policy in the US has quietly been incrementally more supportive to growth over the past two years, the changes have been very gradual. We see the recently-passed tax legislation leading to significantly higher volatility in near-term fiscal results. This has two key impacts, one of which we are already seeing is that the market's extrapolation of more fiscal largesse in the US is directly driving higher yields and a weaker US dollar, in itself creating economic volatility. The second is that the net fiscal stimulus for 2018 will probably add about 40-50 basis points to the growth rate, at a time when most indicators were already suggesting roughly 3% GDP growth. For an economy that has been averaging around 2% real GDP growth since 2010, that's a pretty huge change and if realized, one that will violate many currently held assumptions (and positions) about the state of the economy.

> "...we believe you will see economic volatility coming back to life and have an impact on market volatility going forward."

Finally, fiscal and tax changes are going to have other, more difficult to forecast effects and not all of them positive. For example, some areas will see adverse impacts on housing markets while others will see gains. Similarly, while wages in theory should go somewhat higher from the bill, the outlook for healthcare spending for lower-income groups looks potentially more daunting. More broadly, as the bill is likely to exacerbate existing income inequality and drive asset prices higher, one wonders whether the lower-income consumers' real purchasing power will keep up and how that will impact growth. A final note of caution is warranted just from the extremely high levels of cyclical confidence exhibited by investors at a time when economic data are likely to slow incrementally in the US and particularly, China. (Exhibit 6)

For the reasons above, we believe you will see economic volatility coming back to life and have an impact on market volatility going forward. We see a return to cyclicality, more aggressive fiscal policy, and more volatility in inflation data bringing us into a different kind of economic cycle, one that has faster acceleration and more eventual downside. The return of economic volatility doesn't necessarily have to be a negative, but it will change investment conditions significantly. While it's not necessarily negative, returns are typically highest when market volatility is falling, and given the above, we think the likelihood that it continues to fall is very low.

EXHIBIT 6:
Despite extreme cyclical excitement, economic data are likely to disappoint from here relative to expectations

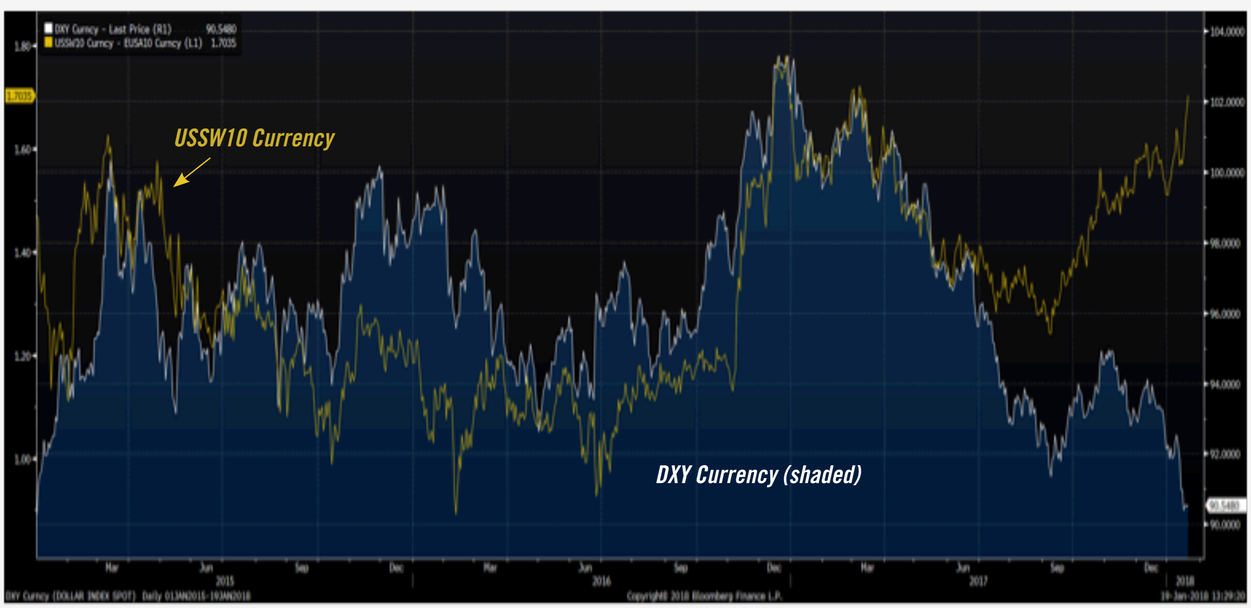
Source: Bloomberg

The Dollar's Relationship with Interest Rates

While it isn't explicit to our view on economic volatility, we need to say a word on the dollar. Long-time readers know that we obsessively follow the dollar for cues on positioning as we see it impacting almost everything in markets, from asset preferences to country preferences to style preferences and a million things in between. With that in mind, what we view to be the most interesting development in markets recently has been the deviation between the US dollar and its core relationship, real interest rates. In short, in normal times the dollar strengthens when its real interest rate differential versus peer currencies widens. As such, the large increase in US real interest rates of late would typically have meant a much stronger US dollar.

We are not surprised this has not been the case this time as a key driver of the higher rates has been the US fiscal deterioration while central banks in other countries have also become more hawkish. Additionally, the US current account deficit has been widening. As we spend a lot of time looking at emerging markets, we're not surprised to see currency weakness when all these things are happening…it's the expected outcome. That said, even though the US looks like an emerging market at times lately, it is not one and spikes in risk premium associated with US assets are typically not enduring. The correction in the US dollar post-tax reform has already been quite significant, as has its deviation from underlying rate differentials (Exhibit 7). As such, we agree the dollar has seen its secular peak for this cycle but we would be nervous about strongly expressing weak-dollar views on a tactical basis at this point. We also are of the view that the dollar would strengthen in a risk-off scenario, different from its recent historical pattern, which could make a downturn in risk sentiment more pronounced.

EXHIBIT 7:
The dollar (white) has already significantly underperformed rate differentials, which call for a much stronger currency



Source: Bloomberg

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

DRIEHAUS CAPITAL MANAGEMENT LLC

Driehaus Capital Management is a privately-held investment management firm based in Chicago, Illinois. Founded in 1982, the firm manages global, emerging markets, US growth equity and alternative investment strategies. The firm has a diverse institutional client base comprised of corporate and public pensions, endowments, foundations, sub-advisory, family offices, wealth managers and financial advisors, globally. Driehaus is a performance-oriented investment management boutique that emphasizes integrity, transparency, and the alignment of the firm's interests with its clients.