INVESTMENT BRIEF

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Markets Are Quiet, But Are They Too Quiet?

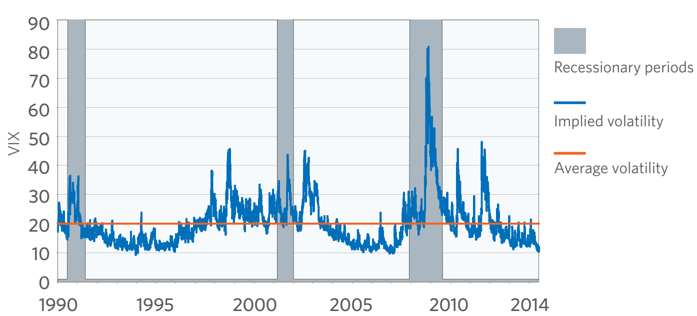
Anyone who has seen a B-grade Western knows that when an unnatural hush settles on the prairie, things are about to get hot. This summer, financial markets have been quiet, but have they been too quiet? This Investment Brief considers what option prices are telling us about expectations for volatility, the reasons why this measure of implied volatility has fallen to low levels, and whether we can expect low levels of volatility to persist.

Implied volatility and risk expectations

Markets are discounting machines. Bond prices reflect expectations for inflation, the future path of short-term interest rates, and the term premium demanded by investors. Stock prices embody the discounted stream of future corporate earnings. Option prices represent a distillation of market expectations for volatility. Indeed, the implied volatility of options on the S&P 500, as measured by the CBOE Volatility Index (VIX) illustrated in the figure below, is often used as a gauge of investor expectations for risk.

Exhibit 1: CBOE Index of Implied Volatility (VIX)

Source: Bloomberg and Federal Reserve



In recent months, the volatility implied by the VIX and comparable options across a wide range of other asset classes – including bonds, currencies, and commodities – has been well below long-term average levels. These developments beg the question: Does low implied volatility across equity, bond, currency, and commodity markets betoken investor complacency or appropriately reflect market fundamentals?

Why is implied volatility so low?

There are a few reasons to suppose that the decline in implied volatility across financial markets is grounded in fundamental factors. First, implied volatility tends to rise in recessions, and subside in recoveries. The types of exogenous shocks that cause recessions also sow uncertainty about the depth and duration of the downturn and lead to spikes in expected volatility. We are now emerging from a deep and protracted recession. It is natural that, with a more stable macroeconomic environment characterized by solidifying growth and stable inflation, expectations for risk should decline. Second, the Fed has been vigorously pursuing a number of extraordinary measures to stabilize the economy. In particular, the Fed's communications strategy has been focused on guiding expectations for the path of the economy and monetary policy. In so doing, it has sought to remove a major element of investor uncertainty, thereby contributing to low implied volatility in financial markets. Finally, there has been real progress in shoring up the balance sheets of households and banks. This improvement constitutes a fundamental decline in risk.

A more stable backdrop for growth and inflation, a well-communicated path for monetary policy decisions, and progress in deleveraging are all fundamental factors contributing to low implied volatility. In addition, with real yields on safe haven assets unusually low, investors are being induced to embark on a "search for yield" that has compressed risk premia across a range of assets. The low implied volatility on options across equity, bond, currency, and commodity markets is yet another aspect of a generalized compression of risk premia spurred by the search for yield. It is this driver of implied volatility that relates less to fundamentals and more to a policy-supported environment that is unlikely to persist.

Sustainability of low implied volatility

Low real yields, compressed risk premia, and low implied volatility are not destined to be permanent features of the financial landscape, but we do not conclude that we are experiencing a lull before an imminent market storm. The fundamental forces dampening risk premia and implied volatility are real. There is, nevertheless, a risk of a self-reinforcing compression of risk premia that could be expected to unravel. So far, valuation levels in equity markets have not been pushed to such extremes. It is, nevertheless, important in this environment that investors ensure that unusually low real yields and low implied volatility do not distort their assessments of fundamental valuations across the investment universe.

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