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INVESTMENT MANAGEMENT

Point of View

Why Is Market Volatility So Low?

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Question: Why is market volatility so low?
Answer: *Because everyone wants to buy during a market dip.*

Question: Why?
Answer: *Because a surprise U.S. "regime" change caught them with overly high levels of cash and woefully underinvested.*[1]

Question: When will volatility rise?
Answer: *When cash levels drop and everyone is fully invested.*

Many measures of volatility are low today, this is true. But I do not think today's low levels of volatility are fraught with complacency; quite the opposite. Never before had I observed such low volatility with so many people so nervous and uncertain about the future!

So, let's look at volatility differently, mathematically. Volatility is often measured as a distribution and is calculated as the standard deviation of daily changes. As the saying goes, if a stock price goes up 1% each day, the price volatility is zero over the period because the difference of the day-over-day change is zero.

What this means is that low volatility could be the precursor for a long, steady trend of increasing prices. Low volatility does not just mean complacency by investors. In the 1990s and 2000s, the VIX volatility index remained low for a number of years in both

[1] https://www.bloomberg.com/news/articles/2016-10-18/investor-cash-levels-jump-toward-levels-not-seen-since-9-11

expansions. For example, the VIX averaged 13% for over two years in '93-'96 and '05-'07, and stocks, as measured by the S&P 500 Index, went up, respectively, 40% (very strong) and 15% (which is average over two years) but, importantly, the economy and earnings kept growing.[2]

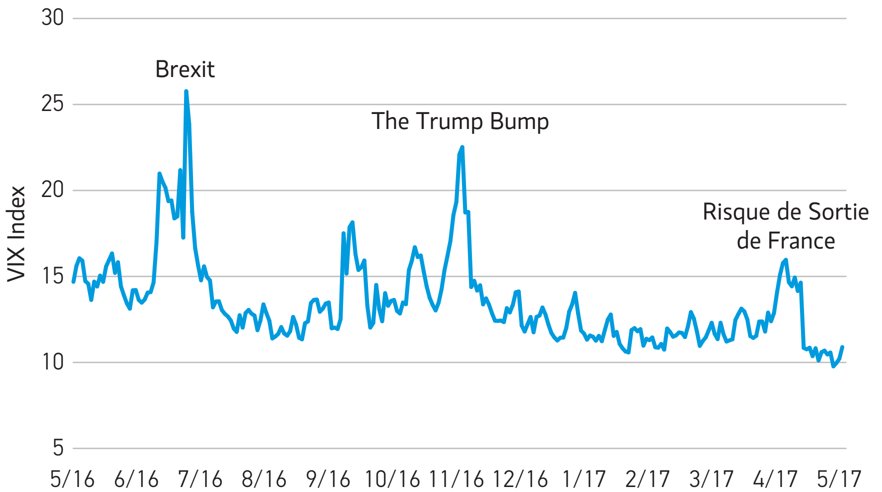
But let's dig a little deeper. Let's say, hypothetically of course, that during the last several years, there was a feeling from investors that policy and the regulatory environment were not friendly toward capital creators, users of capital and risk takers. Investors may respond to this scenario by building up large levels of cash. This was the case in early 4Q16 when global fund managers increased to lofty 5.8% cash levels that rivaled risk-off periods such as the 9/11 terror attack and Brexit *(Display 2)*.

Now let's say, again hypothetically, we enter into a new "regime" where people feel a better risk-taking environment lies ahead. For the sake of argument, let's call this the rising of the **animal spirits**. If such a "regime" change came unexpectedly, say in November '16 with the U.S. presidential election, then investors who had previously held large levels of cash, by definition, would become very underinvested in risk assets.

As a result, **they would look to buy during market dips**. This has been happening as cash levels are seen to have been dropping from a peak of 5.8% on the way to what might be considered a neutral cash base of 4%. Note that while this may seem like a small percentage change, consider that it is on an AUM base of $71 trillion, based on estimates by the Boston Consulting Group, which represents an investment flow of nearly $1.5 trillion into the market-based assets.[3] Going back to the math of volatility, this bid for assets supports the downside in prices and truncates the distribution by shortening the left-tail, and the standard deviation of that distribution falls; said differently, volatility falls.

DISPLAY 1

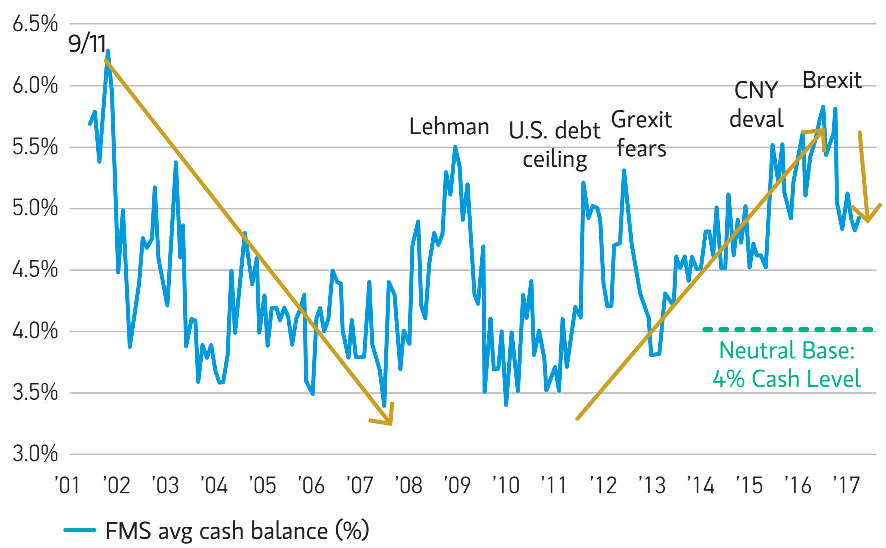
Decreasing Market Volatility as Measured by the VIX Index



Source: MSIM, Bloomberg Data as of May 10, 2017. **Past performance is no guarantee of future results.**

DISPLAY 2

Global Fund Manager Survey (FMS)



Source: Bank of America Fund Manager Survey. Data as of April 30, 2017.

Conclusion

An explanation of why volatility is so low may be because: 1) a "regime" change occurred, 2) animal spirits have risen, and 3) people with high levels of cash suddenly became underinvested. These investors are now looking to buy during market dips, thus stabilizing the market. All else being equal, volatility will rise when cash levels fall to low levels and people feel fully invested.

[2] **Past performance is no guarantee of future results.** The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. See disclosures at back for more information. Evercore ISI Research, May 11, 2017.

[3] Boston Consulting Group, Global Asset Management 2016: Doubling Down on Data, July 2016.

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