



# Decoding Volatility Normalization Across Global Capital Markets

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This latest ascension of  
volatility has many roots.

- After reaching historic lows last summer, the BNY Mellon World Volatility Index has risen to slightly above-average levels, reflecting a lengthening list of economic and geopolitical concerns.
- This “normalization” of volatility does not suggest that economic growth in developed markets is likely to falter.
- We expect average to somewhat-above average levels of volatility over the next five years.
- Higher volatility improves the likelihood that active managers will outperform.

A remarkable “volatility void” struck capital markets in the summer of 2014. As shown in our accompanying exhibit of the BNY Mellon World Volatility Index (includes currencies, commodities, equities, and bonds see Figure 1 for additional description), composite volatility sank to just 3.35 on June 27, 2014 – the lowest recorded measurement since 1989, the first year for which performance of all the index components was available, and significantly below the 8.67 quarter-century average.

We believe many factors accounted for the suppression of volatility in the first half of 2014. Foremost, this lull was highly emblematic of mid-cycle economic conditions (at least in the US). Major central bank activities were largely dormant. The range of capital market opinions was highly compressed. Most capital market participants held roughly the same views about most topics. And the concurrent liquidity drought, occasioned by broker-dealers trimming their trading activities in response to regulatory initiatives, also pressed on volatility.

As night follows day, and it always does, we asserted the obvious last summer: this unusual volatility void could not long endure. But we could not and did not offer a more valuable insight on the longevity of this volatility vacuum.

Well, the results are in. Volatility has been trending up over the last eight months. At 9.06 on February 18, 2015, volatility now stands slightly above its long-term average.

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The generation of capital market parameter forecasts is always a tricky business, especially for volatility over short horizons.

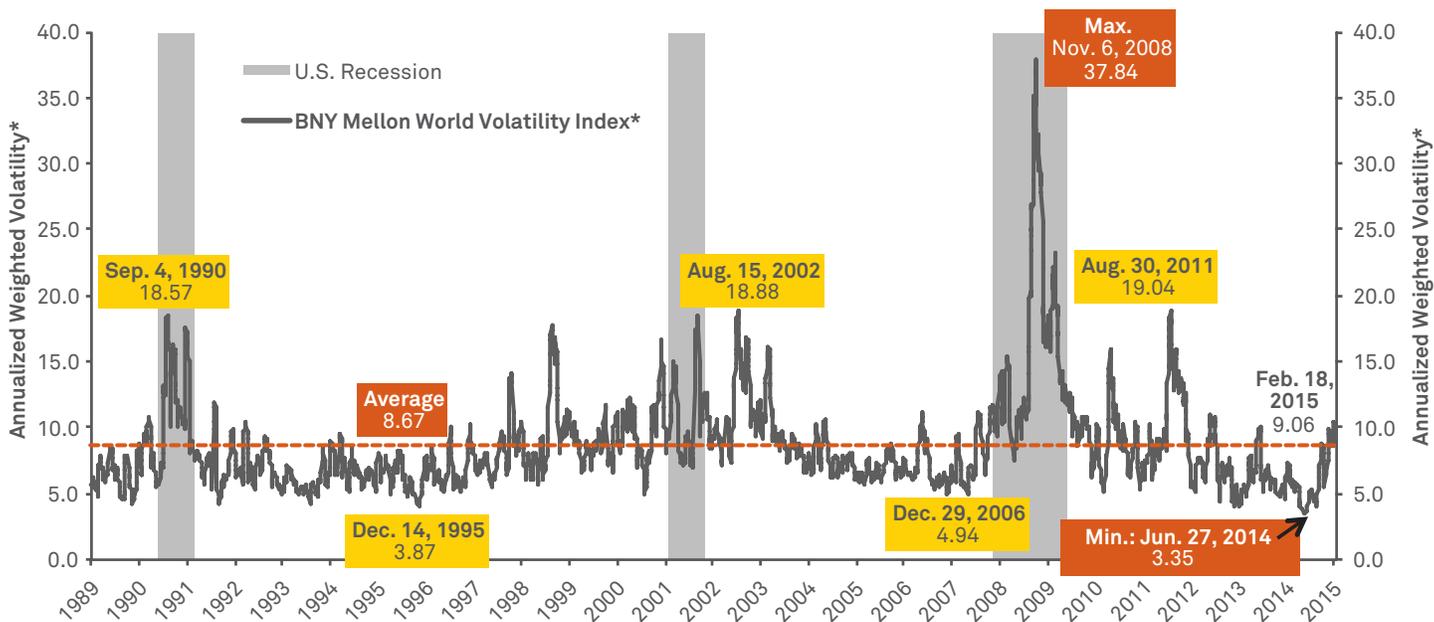
This latest ascension of volatility has many roots. The Ebola-epidemic scare in the third quarter of 2014 inspired some outlook divergence. Weak European economic growth prospects in the second half of 2014 weighed on markets as did the European Central Bank’s ability to launch sovereign QE amid German opposition. Asymmetric central bank policy, particularly pertaining to the wisdom and timing of a probable initial Fed rate hike in 2015, fostered diminished market consensus. The largely-surprising continuation of energy price declines induced a recalibration of market expectations.

More deeply, this “normalization of volatility” reflects a broadening and lengthening list of questions about global economic and market performance over the next 1-5 years.

Respectable and well-justified diverse opinions can be entertained on such questions as: the forward velocity of the Chinese economy; the susceptibility of US corporate profitability and certain EM nations to lower commodity price realizations and the strengthening US dollar; the efficacy of European central bank’s quantitative easing; the economic fate of Greece and, once again, even the euro; the consequences of hyper-low debt yields; the possible richness of equity and high-yield corporate securities; the strategic hazards to possibly bloated financial asset values of eventual central bank normalization of monetary policy; and the outcome of elevated geopolitical risk, as manifest in Ukraine and Middle East.

The generation of capital market parameter forecasts is always a tricky business, especially for volatility over short horizons. Capital market sentiment sometimes can swiftly converge to a rather uniform view and suppress market gyrations. In contrast, the future always holds surprises that can stir markets at irregular and mainly unpredictable intervals. In particular, certain geopolitical events can seed market anxiety and spillover into volatility escalation.

Figure 1: Volatility Normalization Since Mid-June 2014



\*Weighted average of trailing 21-day return standard deviation (annualized) of commodity (10%), equity (40%), fixed income (40%), and Fx (10%).  
**Commodity:** S&P GSCI Index Spot; **Equity:** MSCI AC World Price Index (local currency); **Fixed Income:** Barclays US Aggregate Index from 1989 to August 1997 (total return); Barclays Global Treasury Index (US\$ Hedged, total return) from September 1997 to September 1, 2000; Barclays Multiverse (US\$ Hedged, total return) thereafter; **Fx:** US Majors Dollar Index.

Allowing for this volatility forecast caveat, several general observations nonetheless can be suggested about this volatility resurrection in late 2014-early 2015:

- The global capital market volatility floor for the Teens likely has passed
- Volatility likely will be found in the 8-12 neighborhood, using our scale, over the balance of this decade, with upside spike risk from a significant manifestation of systemic risk levitation from either endogenous or exogenous (political risk) developments
- This normalization of volatility does not presage a near-or medium-term cessation of the expected uplift of advanced economies. Normal volatility is actually characteristic of healthy capital market conditions, especially in the form of improved liquidity. For just about every asset class, the availability of contrasting opinions facilitates the buying and selling of securities. Like the quiet before the storm, volatility deprivation often signals the coming injection of unsettling developments into the capital market valuation calculus
- Higher volatility historically improves the likelihood of active management outperformance. There are more situations to constructively differentiate portfolio performance

Past volatility normalizations have been sudden, unexpected, and painful for markets. In contrast, this unfolding volatility reset to higher ground has been a comparatively gradual and benign process. Hopefully this reversion to more typical capital market conditions will continue to favor the persistence of fair capital market conditions.

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