Broader Patterns Of Realized Volatility

• Seasonal patterns of realized volatility in equity and FX markets well-defined over past half a decade

• Broader cyclical patterns apparent over past 25 years

• Seasonal and cyclical patterns converging going into summer?

Probably the most sensible thing to do right now is to use the breathing space afforded by Golden Week to reflect on both the seasonal and cyclical factors impacting realized volatility in the FX markets heading into the summer.

Seasonal factors

The five years since major central banks first introduced negative deposit rates have seen an intensification in already well-established patterns of realized volatility for equity markets. In particular, the lows in average realized volatility for the DJIA seen during the spring and summer over the past half a decade have been particularly well-defined.

In addition there has been a shift in when the peaks and troughs occur. Typically the year has been split with volatility climbing from August to reach a peak in January and February only to collapse in April, May, June and July.

This pattern, in turn, has largely been shadowed by the pattern of realized volatility in the FX markets. 2017 aside,
there is a good argument to be made that heightened volatility in underlying equity markets at the start of the year has fed directly into the price action of the FX markets at the same time. Equally, periods of summer calm have seen reduced realized volatility in FX.

There has, however, been a second observable pattern. This is that while realized volatility in the USD Index has largely shadowed moves in equity market volatility, it’s noticeable that the broad trend in the peaks seen early on in the year has been lower.

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Cyclical factors

Whether or not there is a Fed "put" hardly matters anymore. Instead, what matters is that the market collectively behaves as if such a thing exists. What is particularly interesting is how they have responded.

There is an argument to be made that such moves by central banks could lead to a rise in realized volatility as investors become increasingly reluctant to hold impacted currencies.

However, the evidence of the past two-and-a-half decades is that the opposite has typically happened when central banks have turned the taps on.

From the first collapse in realized volatility seen between 1995 and 1997 as the JPY-funded carry trade came into vogue, through to the 2002-2007 and 2009-2014 QE-driven declines in volatility, a clear pattern of declining volatility has emerged as investors have been forced into a hunt for yield.

complete embargo, together with highest-level sanctions, will be placed on the island of Cuba. Hopefully, all Cuban soldiers will promptly and peacefully return to their island!

2. US/Fed/China: President Trump (@realDonaldTrump) tweets: "China is adding great stimulus to its economy while at the same time keeping interest rates low" He adds: "We have the potential to go ... up like a rocket if we did some lowering of rates, like one point, and some quantitative easing." 

3. Brexit: Incoming ECB Executive Board member Philip Lane says that if there were a negative Brexit outcome there would be a big reaction in financial markets. He adds that the market appears overly optimistic. (via Reuters)

4. Oil: U.S. crude inventories rose by 6.8 mn barrels in the week to April 26, to 466.4 mn. This compares to expectations of an
The post-2015 decline can therefore be seen as being part of this broader pattern.

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There are a few further points to be made. The first is that while 2007 low doesn’t quite fit into the pattern, the broad trend over the past 30 years has been for each major low in realized volatility to be lower than the previous major trough. That seems worth considering as the summer months approach.

The second point is that the latest declines in volatility come despite signals over the past nine months that all might not be well with markets. This was highlighted in particular by the price action seen in equity indices at the end of last year which carried strong echoes of both late 2000 and late 2007.

Finally, the fact that markets have proved so calm despite the increase of 1.5 mn barrels.

On the Radar

May 1, 2019

- UK Apr Markit/CIPS manufacturing PMI (0930 BST): Reuters consensus forecast 53.0; previous 55.1
- US Apr ISM manufacturing PMI (1500 BST): Reuters consensus forecast 55.0; previous 55.3
- US FOMC policy meeting concludes (1900 BST) & Fed Chair press conference (1930 BST)

Featured Article

Brexit: Outlook for the Months Ahead

GBP has proved sensitive to political regime shifts over past 50 years.
a range of major stories emerging (from the continued uncertainty about the political outlook for the UK to the situation in Venezuela) suggests that the search for yield enhancement is now drowning out everything else.

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