Investment Weekly

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Volatility can provide opportunities if approached the right way

♦ Five-year inflation breakeven rates hit the highest since 2008 last week, as Treasury yields rose after the approval of a US$1.9 trillion relief package.

♦ The move in long-term benchmark yields has impacted technology stocks and emerging market bonds.

♦ The realized volatility in the NASDAQ 100 is near its highest in six months, while the yield on EM dollar bonds is near its highest since November.

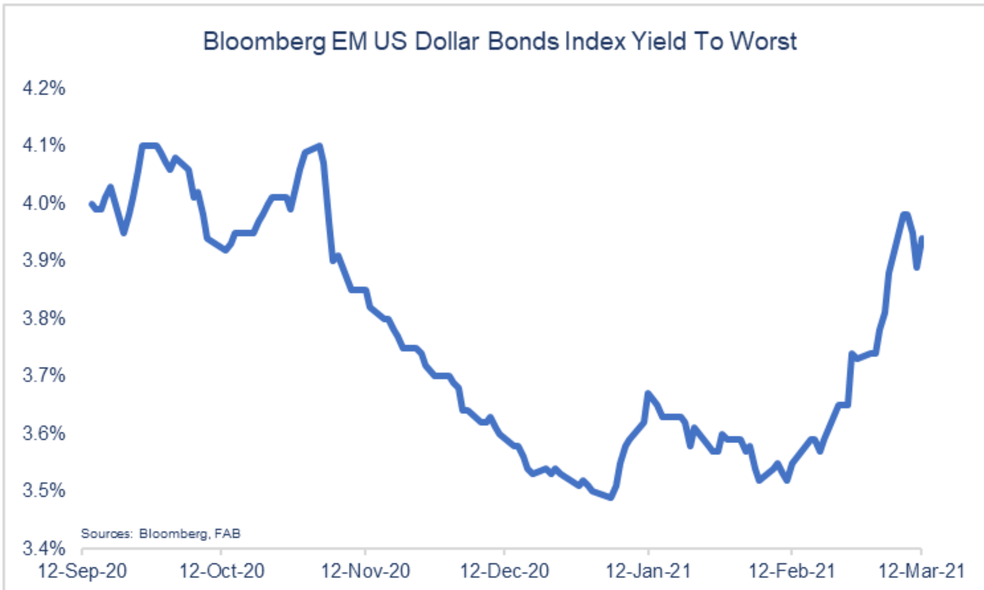
♦ Such moves could be short-lived depending on what the Federal Reserve communicates on Wednesday.

♦ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight in alternatives.

Recent market activity, exactly a year after the markets went into a free fall, are giving nightmares to some investors. However, this time it is different and, if anything, the recent volatility may provide some opportunities for savvy investors to make good returns.

Take the NASDAQ 100, which is often used as a proxy to the performance of the biggest technology firms in the world. The index ended the week up by 2.12%, its first weekly gain in a month. That positive return, however, came amid three days of losses, and two of very strong gains.

To put it in perspective, the normal daily move for the NASDAQ 100 in the three years ending in January last year was 1%. Last week, the standard move was 2.3% either way, while the realized volatility of that index over the past 15 days is the highest since November.



This may be partly a function of higher expectations of inflation, which are being reflected in higher yields for longer-dated Treasury yields. The yield on the 10-year US Treasury bond closed at almost 1.63% on Friday, the highest in a year. The difference between the yields on very short-dated Treasury bills and the longest bonds available, the 30-year, is now the highest since 2017, a time when investors were banking on an inflation resurgence thanks to a corporate tax cut enacted by former President Donald Trump.

They also reflect better expectations for the economy. That is often good news for stocks, because when the economy is growing faster, companies tend to have higher revenues and profits. In this case, though, the higher Treasury yields may have some investors considering whether it is worth taking the risk of investing in some technology companies when being in the safest asset can pay you 1.6% a year. This could make some investors require higher returns for risky stocks.

EM dollar bonds are yielding the most since November amid rising Treasury yields

This affects particularly companies which sport very high valuations. Unfortunately, the number of these in the NASDAQ 100 index has increased significantly lately, making the overall index more vulnerable to increases in market interest rates.

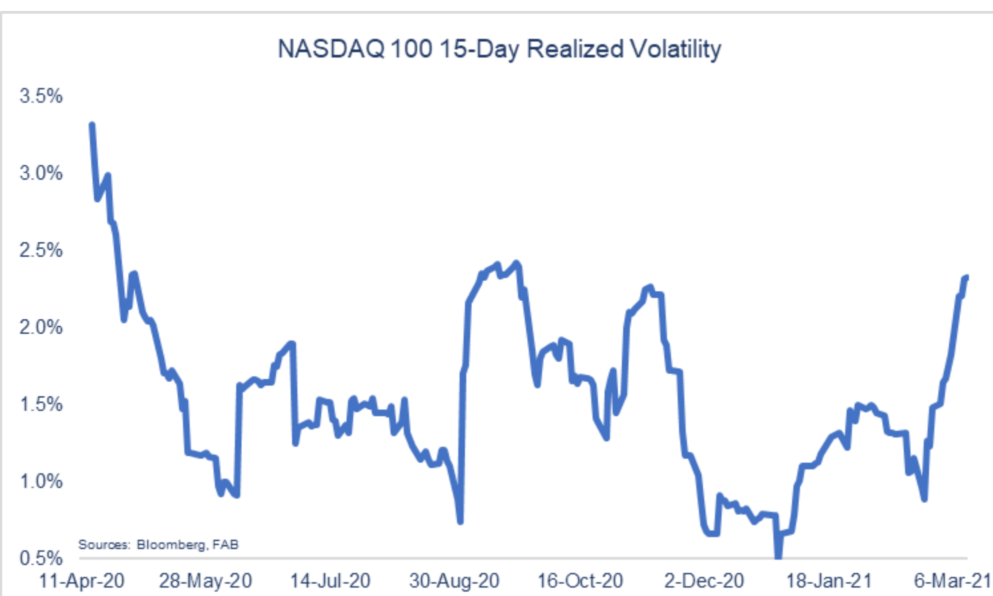
As at 30 September, 2018, when the NASDAQ 100 began a three-month correction, driven partly by expectations of higher interest rates ahead, 13 companies in the index had equity values higher than 50 times their expected earnings in the next 12 months. As of Friday, 18 companies in the index could boast such valuations. To be sure, if those outliers are excluded, the average price to forward 12 month-earnings of the index is not so exuberant at 25.2x, compared to 19.6x on September 30, 2018.

That is a significant difference, but it can probably be accounted for in terms of lower interest rates and still bearish earnings expectations. The average valuation for the whole index, however, has changed much more significantly. It has gone to 28.3x as of Friday, from 21.8x on 30 September, 2018. This is mostly due to those 18 stocks valued at more than 50 times expected earnings, and in particular the seven which are valued at more than 100 times expected earnings.

These companies were among the drivers of the recent sell-off in the NASDAQ 100 and may have even weighed on the price of some stocks which have fair valuations considering their growth prospects. This may have also helped to increase the volatility of technology stocks.

This, however, could be advantageous for savvy investors. When volatility increases, investors can use some structured products to earn a good yield in return for giving other people the option to sell them certain stocks at much lower prices than those currently available. If the stock drops that much, the seller gets the shares at a much lower price. If it does not, the person still gets paid. These products, however, work best when volatility is high.

This is only one of the ways that savvy investors try to use volatility in their favour.



In fact, many hedge funds seem to be using the volatility in the bond market to increase their returns. According to news reports, selling volatility contracts in short-dated bonds and using the proceeds to buy volatility contracts in long-dated bonds has become popular among some fund managers. That strategy hinges on the fact that short-term rates are being anchored by the Fed, while long-term rates are moving with inflation expectations.

This helps to explain why there is an increasing number of short positions in 10-year and 30-year US Treasuries. The sellers of volatility in the long-end of the Treasury curve often short the bond itself to hedge their positions. This, however, creates a self-feeding loop, and could be part of the reason why 10-year Treasury yields have increased by 71 basis points since the first trading day of the year.

Such positioning risks a rude awakening this week. The Federal Reserve is expected to announce its rates decision on Wednesday. While no change is expected, what Chairman Jerome Powell says in a press conference after that will be key.

The 15-day volatility of some technology stocks has spiked as Treasury yields have risen

If he indicates that the Fed is planning to shift more of its bond buying to long-dated US Treasuries (something that two Fed governors suggested they did in the December meeting), these bond volatility plays and short positions in long-end US Treasuries could quickly turn sour. And if they do, the unwind could push long-dated Treasury yields lower very quickly.

One asset class that could benefit from such a shift in the language of the Fed is emerging market debt. The yield to worst of the Bloomberg EM Dollar Bonds index touched 4% last week, its highest since 3 November. This was partly a reflection of a strengthening US dollar and of higher Treasury yields. If the Fed pushes long-dated Treasury yields down, not only will EM bonds become more attractive (especially at these levels), but the dollar could start to retreat again, which favours developing nation borrowers, too.

The rationale behind these two ideas can be applied more broadly to other asset classes that are highly sensitive to interest rates, such as corporate investment-grade bonds and real estate investment trusts (REITs). It may be a good time to consider the assets when volatility is high and prices are dropping, if, like now, the Fed is committed to keeping interest rates low.

The key point is that volatility itself is also impacted by interest rates. When interest rates are lower, the overall volatility of risk assets tends to drop over time. Evidence of that is in the CBOE VIX Volatility Index, which is linked to the expected volatility in the S&P 500. In the 10 years between February, 2010, and February, 2020, the average value for the VIX was 16.75, while in the preceding decade it was 22.1.

However, in the past 10 years when the VIX was gradually falling, the standard deviation of its daily moves increased to 8.2% from 6.1% in the previous decade. In simpler terms, volatility is trending down, but its volatility is increasing. That means it is beneficial for investors to understand how to profit from volatility when it rises and, above all, stay invested.

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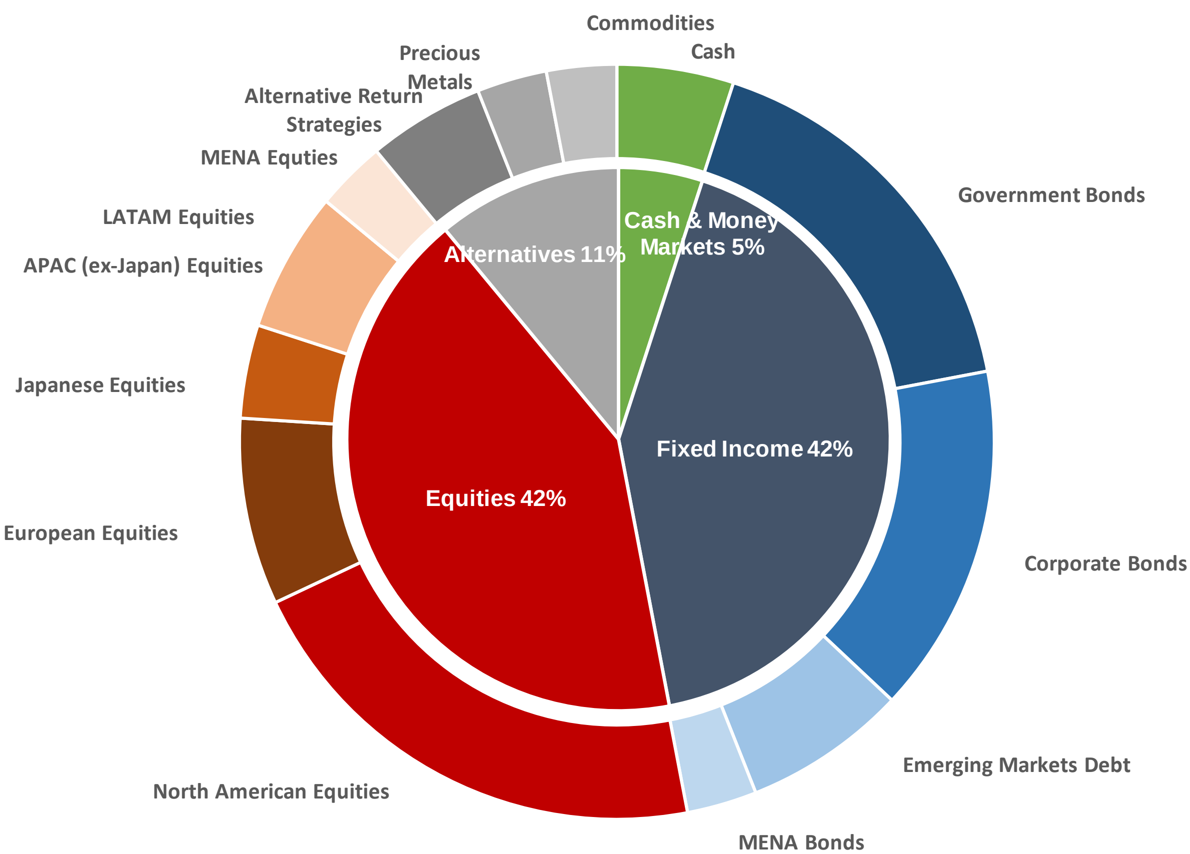
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	Moved into overweight equities position.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Overweight	Slightly overweight Japanese, US and Asia ex-Japan stock markets.
Alternatives	Underweight	However, still marginally overweight in precious metals

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