

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com

Christofer.Langner@bankfab.com

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Volatility picks up as investors awaken to economic reality

◆ VIX rises nearly eight points since trading below 30 on Monday as the VVIX, the expected volatility of VIX, spikes 27 points.

◆ Lull in earnings and grim warnings from Fed officials have pushed investors to reassess valuations.

◆ US reports deflation in producer prices and Fed Chairman Jerome Powell says that 40% of poorest households in the US lost jobs.

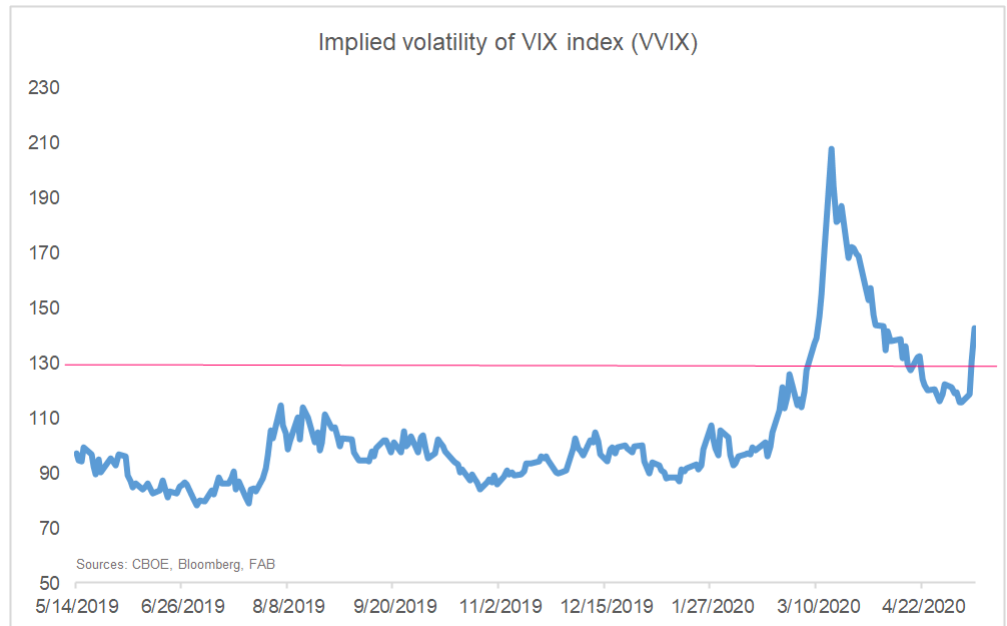
◆ IEA revises slightly up its oil demand forecast for the year, but continues to see supply outpacing consumption.

◆ FAB AAC remains underweight in equities and overweight in gold.

Risk assets tend to discount future expected gains and in that sense they often are seen as a proxy for the future of the economy. However, they are also driven by liquidity (if it is cheap to borrow, it makes sense to invest in higher yielding assets) and sentiment. Lately, these two latter elements have been the key drivers of risk assets.

Since the Federal Reserve and other of the world's largest central banks began unprecedented asset purchases liquidity has again become abundant and was probably the main driver behind a strong rally since 23 March. Sentiment has also helped, since the peak of pessimism seems to have been on that 23 March market drop. After that, it could be argued, investors began to focus more on the recovery and less on the current slump.

A few remarks from policymakers, however, are undermining that optimism



and investors are increasingly coming to terms with the possibility that the recovery will not be as fast as previously expected. Fed Chairman Jerome Powell said effectively that yesterday during a virtual event with the Peterson Institute for International Economics: "The recovery may take some time to gather momentum, and the passage of time can turn liquidity problems into solvency problems," he said.

The remarks echoed earlier comments from St. Louis Fed Governor James Bullard who said the US risked a wave of bankruptcies if Congress did not open the spigots of fiscal stimulus. This comes as the House of Representatives introduced a US\$3 trillion additional fiscal stimulus bill that was rejected by Republicans in the Senate. While that bill has only a small chance of survival, it sets the stage for another stimulus package on top of the nearly US\$2.9 trillion that has already been approved. In other words, more liquidity is coming, but will take a while.

The expected volatility of the VIX, suggesting investors see bigger market swings ahead

Amid that backdrop of pessimism and no new stimulus packages, investors seem to have been forced to go back at looking at the economy. And that hardly paints a nice picture. The US reported that consumer prices dropped in April compared to March, confirming the deflation economists feared. Across the world, at least 200 million jobs were lost and many will take years to come back.

Today, the US showed that 2.98 million more Americans filed for unemployment adding to the 33.5 million who had done so in the past seven weeks. Even if many of those lost jobs might come back soon, things will not be the same for a while, as Fed Chairman Powell highlighted. In such an economy, it is hard to remain optimistic.

Investment Strategy Update

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