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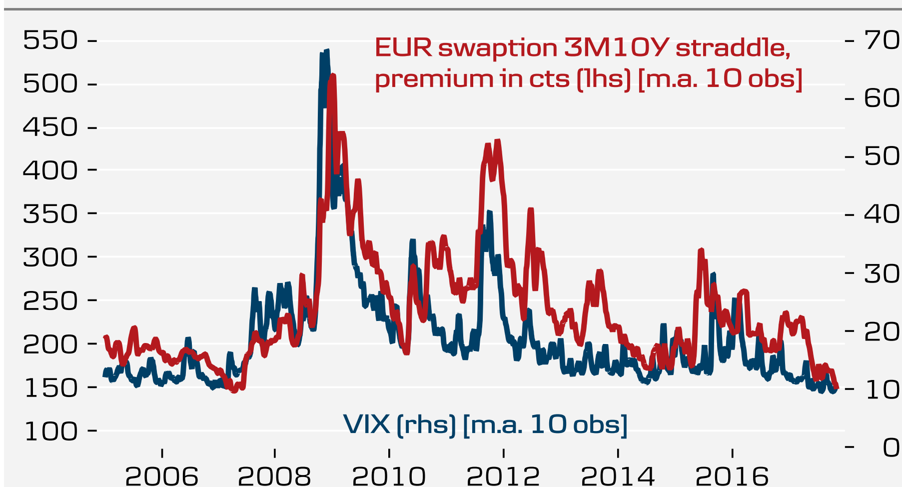
Strategy

Low volatility favours 'hunt for yield' but warning from IMF

Implied or traded volatility has continued to fall this autumn. VIX (equity) volatility fell close to a record low in October. The same pattern is seen in rates volatility, with 3M10Y swaption volatility falling to a level not seen since 2015 in USD and close to, or at, the lowest level in EUR since the introduction of the euro.

Chart 1. Implied volatility near or at record low in financial markets



Source: Bloomberg, Danske Bank

Key points

- Volatility has continued to fall, as central bank predictability is considered high and as the macroeconomic outlook looks increasingly stable.
- We argue that it bodes well for continued focus on 'carry' or 'hunt for yield' strategies.
- 'Hunt for yield', ECB QE and a solid budget surplus also mitigate the upside pressure on German long yields from the macro economy.
- The IMF warns 'financial products tied to equity volatility [bought] by investors such as pension funds are creating unknown risks that could result in severe shock to financial markets'.

Low yields and low volatility add to leverage and 'hunt for yield'

The predictability of global central banks – that given low global inflation pressure they are eager not to tighten too fast – is one reason for both the low realised and implied volatility. The ECB plans to continue QE for another nine months and has soft forward guidance; the centrist Jerome Powell has been appointed to succeed Janet Yellen and in Japan the yield-control policy is firmly in place – all examples of central bank policies that have enhanced the perception of central bank predictability.

The macroeconomic stability that has emerged over the past couple of years has also added to the low volatility regime. There are simply too few hot spots in the global economy to concern investors about at present. Catalonia, North Korea and Donald Trump are no longer able to derail investor optimism.

When volatility is low it is more attractive, or some might even say tempting, to increase leverage. The different risk measures, such as VaR, depend on historical volatility. In particular, when yields are low or even negative, it is almost a necessity to use leverage to achieve a 'decent' return or carry. We often call this **'hunt for yield and carry'** behaviour. When investors are hunting 'yield' or 'carry', they themselves add to the low volatility environment, as even the slightest mispricing or adverse market move is quickly reversed.

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We see room for more 'hunt for yield'

In our view, the message from the ECB in particular will prolong the 'hunt for yield/carry' theme, which has dominated over the past couple of years and is likely to do so well into 2018.

This means we expect more performance for the periphery bonds. We also expect spreads in general to continue to tighten. An example could be covered bonds in Scandinavia, which we expect to tighten versus swaps and government bonds, as any extra yield pickup would be increasingly picked up by investors.

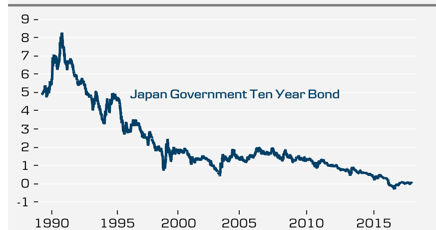
'Hunt for yield' mitigates the upside pressure on long yields from the macro economy

The improvement in the global macro economy, with stronger labour markets in both the eurozone and the US, speaks in favour of a steeper yield curve in Germany, as the ECB holds a tight leash at the front end of the curve but not at the long end.

However, it might be a few months too early to enter the big 'end of QE steepening trade'. We are entering 2018 with a confirmation of QE for nine months and a budget surplus in Germany that points to a negative net supply of bonds when we consider redemptions of EUR10bn. If we then add QE from the ECB, an estimated EUR50bn would be removed from the German government bond market in 2018. Hence, the chronic lack of Bunds in the market is not about to be resolved. This, coupled with investors once again being forced out on the curve to get a higher yield, in our view mitigates the upward pressure on long yields from the macro side for now. These mitigating effects could change as we approach spring 2018.

Another thing we keep an eye on when looking at yield curves in Europe is the Bank of Japan, which confirmed this week that the 10-year yield target is firmly in place at about zero. It means that the Japanese investor will continue to look abroad when 'hunting yield and carry'. The US would be the obvious choice but a growing short-term interest rate differential makes the rolling FX hedge increasingly expensive. This is different when investing in European bond markets, where the FX hedge adds a small extra yield pickup. For the US investor, the extra pickup from a rolling FX hedge in EUR or Scandi currencies is also sizeable, making up for the lower outright yield level. Hence, foreign demand for European bonds should be intact for now. This is particularly so as the ECB would be buying fewer bonds in 2018. The portfolio flows into the eurozone in 2018 are among the reasons we see EUR/USD at 1.25 in 12 months, despite expecting further rate hikes from the Federal Reserve. For more, see *EUR/USD rebound on 'PAUSE' for now – but prepare for PLAY again in 2018*, published on 2 November.

Chart 2. Low 10Y JGB yields continue to push investors towards Europe as the FX hedge here is cheap compared with the US



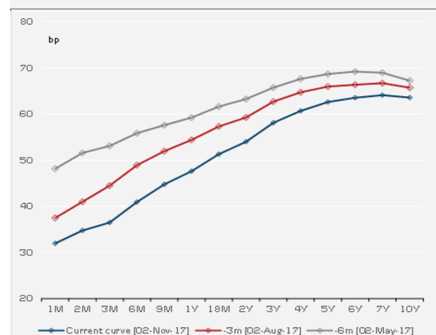
Source: Macrobond Financial

However, the IMF has become concerned

The low volatility regime has not only reinforced the 'hunt for yield and carry' in global bond markets but investors are also increasingly turning to the volatility markets themselves. To benefit from continued low volatility, investors are selling volatility and as volatility curves in both the rates and equity spaces are steep (Chart 3), it provides investors with a positive roll on the curve and a positive return as long as realised volatility stays low.

However, this week the IMF warned in the *Financial Times* that 'financial products tied to equity volatility [bought] by investors such as pension funds are creating unknown risks that could result in severe shock to financial markets'. It also argues that risk models could underestimate the true risk that investors are taking on. According to the article, the IMF estimates that assets invested in volatility equity strategies have risen to USD500bn, up 50% over the past three years. We do not have similar numbers for rates volatility but 'riding' the volatility curve has been very popular given the steepness of the curve.

Chart 3. Steep volatility curves – EUR ATMF swaption implied volatility term-structure for 10Y tenor (bp)



Source: Danske Bank

The IMF warning is certainly something that investors should bear in mind in our view but given our view on global central banks and the macro economy, we keep the view for now that it is not the time yet to go against the 'hunt for yield and carry' and the 'low volatility' themes.

However, this said, from a hedging perspective – both from a rates and FX perspective – it might make sense to use different option solutions (non-linear products) given the fall in volatility and henceforth the decrease in the price of these products. See for example pages 15 and 16 in EUR/USD rebound on 'PAUSE' for now – but prepare for PLAY again in 2018, published on 2 November.

General market themes

Asset class	Main factors
Equities	
Positive on equities	We are positive on equities, as we think the global business cycle is still strong, risks are low and central banks are tightening monetary policy only gradually.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	Inflation set to stay subdued despite decent growth. Stronger euro keeps euro inflation outlook down. ECB to normalise gradually only, due to lack of wage pressure and stronger euro.ECB on hold for a long time.
EU curve – 2Y10Y set to steepen when long yields rise again	The ECB keeps a tight leash on the short end of the curve. With 10Y yields stable, the curve should change little on a 3-6M horizon. Risk is skewed towards a steeper curve but that is a 6M to 12M forecast.
US-euro spread set to widen marginally	The Fed's QT programme (balance sheet reduction) is set to happen at a very gradual pace and the affect on the Treasury market should be benign. Yet, market pricing for Fed hikes is relatively dovish and yields should edge higher on a 12M horizon.
Peripheral spreads – tightening but still some factors to watch	We expect economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy is the big risk factor but very expensive to be short Italian bonds. The focus on Catalonia and its call for independence is a risk for Spanish government bonds.
FX	
EUR/USD – consolidating near term but upside risks in 2018	EUR/USD to remain within 1.1479-1.1880 range near term. We still see the cross moving firmly into mid-1.20s supported by valuation and debt-flow reversal in 2018
EUR/GBP – upside risks remain but GBP to strengthen eventual	Deteriorating growth prospects and Brexit mess to keep EUR/GBP afloat near term. Downward move on Brexit clarification and valuation further out.
USD/JPY – gradually higher longer term but challenged near te	Policy normalisation at the Fed and eventually at the ECB, while the Bank of Japan is staying dovish, means support for EUR/JPY and USD/JPY alike throughout our
EUR/SEK – range near term, gradually lower further out	Riksbank
EUR/NOK – upside risks in Q4 persist, then gradually lower	differentials.
Commodities	
Oil price – range trading	Speculation about deeper output cut from Saudi Arabia. Geopolitical risks looming in the background.
Metal prices – to fall back	Ignoring strong PMIs. Sentiment is turning negative again, as China is set to slow again after National Congress.
Gold price – range-bound	Tug of war between safe-haven demand from rising global geopolitical tensions and negative impact of hawkish Federal Reserve.
Agriculturals – trending higher	Weather-related supply concerns supporting prices.

Source: Danske Bank.

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None.

Date of first publication

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