With the exception of posting only modest performance in the first quarter of 2016, major indexes have been forging ahead with impressive consistency. The past quarter finished, as so many have of late, up with solid single digit returns. Correspondingly, the Financial Times reported that, "Several measures of actual and expected stock market volatility have fallen to post-crisis lows." Summarizing the landscape, the Financial Times added, "Whatever the headlines about Trump, North Korea or the shakiness of Greece and the uncertainty about European electorates, the surfaces of risk-market pools are remarkably calm."

A slightly deeper look into recent performance numbers, however, reveals some interesting disturbances. The Russell indexes, for example, show that the value style hugely outperformed growth in the fourth quarter of 2016 across each size category. The first quarter of 2017 provided almost a mirror image with growth hugely outperforming value. Such dramatic reversals are not normally accompanied by record low volatility. So what's the prognosis? Is it really smooth sailing for stocks or is this the calm before the storm?

A number of respected analysts, for their part, are not buying into persistently low volatility as a "green light" for investing. Citigroup's Matt King weighed in with his opinion, "Central banks appear to have succeeded in squashing the volatility and fear out of markets without removing the underlying risk factors themselves. The more markets rally, the greater is the potential vulnerability."

In addition, Jim Grant expressed his views in the Interest Rate Observer (March 24, 2017): "The avatar of tail risk—that would be the 45th president—has somehow managed to crash the VIX." Christopher Cole, founder of Artemis, a hedge fund that focuses on volatility, reported succinctly to the FT: "I'd be shocked if this market regime of low volatility endured."

The unusually becalmed landscape demands some explanations. An easy one is that investors are simply complacent. Evidence to corroborate this hypothesis comes in the form of sentiment surveys - many of which have been touching new highs. The InvesTech Research newsletter (March 17, 2017) points out, "The vitality evident in business is translating into confidence for the U.S. consumer as indicated by the Bloomberg Consumer Comfort Index. While this gauge hasn’t been as strong as in past economic cycles, Consumer Comfort recently moved to its highest level since 2007."
As John Hussman notes, though, sentiment is not an effective leading indicator. Quite the opposite:
"suffice it to repeat that consumer sentiment is actually a lagging indicator that can be predicted from
past movements in indicators such as capacity utilization, inflation, and unemployment." Put simply,
elevated levels of consumer confidence are less a signal of forthcoming consumer spending as they
are a signal of forthcoming investor losses."

Another explanation for unnaturally low volatility is the immense popularity of passive funds. John
Dizard captured the magnitude of the phenomenon in the Financial Times: "We have created a bubble
in average. Waiters and childhood friends are no longer telling us about miracle gold, oil, or tech stocks
they bought at the right time. They are exchanging stories about low management fees on their index-
tacking exchange-traded funds."

One of the effects of such ardent beliefs in the efficacy of passive investing is that, "Short-term asset
price declines have been reversed by the wall of money coming out of active investment managers and
into the accounts of low-cost index products." The FT goes on to note, however, that this activity bears
a significant cost in that it "comes at the expense of making the eventual decline in a broad range of
asset values not just painful, but catastrophic."

Indeed, after years and years of massive flows of money into passive funds, there are indications that
things have gone too far. John Hussman commented, "Frankly, I don’t believe that what passive
investors are doing here actually represents 'investment' in any valid sense of the word (i.e. purchasing
a stream of future expected cash flows at a price that implies a satisfactory risk-adjusted return), but it
does address the psychological desire to experience the same fluctuations that others do."

Smart beta funds have also likely played a role in suppressing volatility, especially since the "low
volatility" factor is directly related to the observed phenomenon of low volatility. There is good evidence
that things have gone too far here too, though. Rob Arnott has conducted research that indicates,
"Some factors perform well at times when others do not. Buying a factor when it is relatively expensive
(when the stocks it contains are relatively expensive compared to their historical norm), is as bad an
idea as buying a stock when it is expensive."

Indeed, this potential is verified as a current reality. According to the Research Affiliates' smart beta
tool, the "low volatility" factor is currently expected to underperform the market by 3.97%. As John
Authers assessed in the FT, "Smart beta is in danger of getting frightfully silly."

Importantly, the overwhelming popularity of passive investing also happens to be colliding with some
clear and present dangers in the investment landscape. Mohamed El-Erian, for example, recently
noted that "Standalone central bank considerations suggest that government bond markets are
underestimating the gradual regime shift in monetary policy." According to his analysis, "When it
comes to investor positioning, an important takeaway from last month should have been that the
Federal Reserve, less worried about the economic outlook, is becoming more assertive in leading
rather than following markets." The Fed's shift to "leading markets" rather than following them has the
potential to leave some investors dangerously wrong footed.

Furthermore, in a report that got remarkably little attention, the CBO recently outlined significant fiscal
risks: "In a just released report from the CBO looking at the long-term US budget outlook, the budget
office forecasts that both government debt and deficits are expected to soar in the coming 30 years, with debt/GDP expected to hit 150% by 2047 if the current government spending picture remains unchanged.

The last qualification, "if the current government spending picture remains unchanged," is an important one. It is a good base assumption mainly because it reflects the path of least resistance. Fashioning a budget that actually reduces deficits would be politically challenging and as such, would require exceptional effort to coalesce sufficient support. Troublingly, there is little reason to expect any help in the form of stronger economic growth either: "The CBO expects 2% or less GDP growth over the next three decades, far below the number proposed by the Trump administration."

The CBO report concluded that there is a "Greater chance of a fiscal crisis" with the rationale being "A large and continuously growing federal debt." Further, in such an event, "policymakers would have only limited—and unattractive—options for responding." In other words, we are playing with fiscal fire and the market doesn't seem to notice.

Some people are starting to take note. As John Dizard reported in the FT, "Increasingly, though, I am hearing large, conservative, real-money investors talking about how they can find relatively low-cost methods to hedge against a crash. Not a grinding decline, but a crash."

As Dizard describes it, "Imagine taking a walk on a sunny day through your favourite park, when you start to notice that many of the other strollers are buckling on armoured vests. No screams, loud sounds or raised voices, but people are getting ready for something." He goes on, "Disconcerting, you would think. And that is what is happening now in the futures markets and among the clients of commodities funds."

One way to make sense of the persistently low volatility, despite such obvious risks, is by way of unnaturally strong demand for the condition. As it turns outs, there are several constituencies interested in such an objective. Baby boomers have a natural interest in reducing risk as they transition into retirement. Even many Millennials and Gen Xers are more risk-averse after the financial crisis than earlier generations at the same age. In addition, Grant’s noted two other constituencies also interested in stability: "The Bank of Yellen has shown no stomach for downside volatility. [And] An administration of billionaires would likely show no greater tolerance."

Here is where the problem really comes into view. With so many investors exuberant about the concepts of low risk and low volatility, they have overlooked the necessity of exercising discipline. When money flows indiscriminately, irrespective of valuations, it is ultimately a risky endeavor, regardless of how the target of such flows is labeled.

If this were the only issue, it could be considered complacency, but it’s not. As the strong preference for low volatility has become evident, it has also created an opportunity for traders to "sell volatility", which, as the FT describes, is "a trade that has proved very profitable in recent years." John Authers describes, how volatility can get depressed through the process of "entering into contracts that pay them if volatility stays low."

All of this creates an unhealthy self-reinforcing feedback loop. Investors want low volatility products. Traders make money selling volatility, which itself suppresses volatility. This creates a patina of stability
in the market which makes stocks appear even more attractive relative to low yielding bonds, which reinforces stock purchases. It is this feedback loop that really helps ensure things get overdone.

For better and worse, the pattern of investors really wanting something, Wall Street and other participants providing it, and big problems arising is non an unfamiliar one. In 1987, investors wanted downside protection so portfolio insurance became a popular product. In the mid 2000s, many banks, especially European ones, wanted high quality and high yielding fixed income investments so mortgage backed securities were proffered. Now, the popular products involve low risk exposure to stocks.

One takeaway from existing market signals is that it does appear as if the unnaturally low volatility represents a calm before the storm much more than it indicates smooth sailing ahead. The existence of several important constituencies sharing an appetite for "low volatility" combined with the incentive and ability of traders to capitalize on those trends is akin to stretching a rubber band. Eventually it breaks - and evidence suggests we are nearing that point.

As a result, the single best thing long term investors can do at this point is to not follow the crowd. Those who are trying to have their cake and eat it too, in the form of retaining exposure to stocks but minimizing volatility, are unlikely to achieve this unrealistic goal. The exceptionally high valuation of the market and Research Affiliates’ significantly negative premium for the "low volatility" factor provide ample analytical support for caution in regards to these passive approaches.

Even more specifically, times like this warrant holding more than usual amounts of cash. Cash is one of the few safe places to be when things break, as proven in the financial crisis of 2008-2009. Further, cash provides useful option value by allowing one to purchase risk assets at a point in time when they are cheaper, and therefore much more likely to provide better returns. Finally, since few money managers or advisors can afford to hold much cash for clients for very long, long term oriented individuals and organizations have a distinct advantage in pursuing this course.

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