ECOWEEK

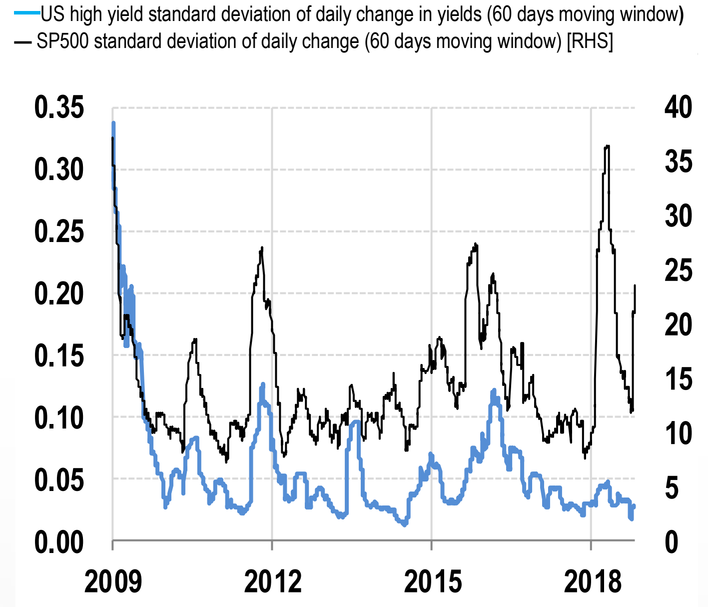
No. 18-39, 26 October 2018

What explains the increase in equity market volatility?

■ Equity markets continue to be particularly volatile ■ Understandably this has weighed on government bond yields ■ The volatility of high yield bonds remains low however. This could indicate that recent equity market swings are driven by other factors than worries about the outlook for GDP growth or monetary policy

In recent days equity markets have again witnessed big swings. The standard deviation of daily changes of the S&P500 over a 60 day moving window has jumped and although earlier this year the move was even more impressive, chart 1 shows that 2018 is the year of the comeback of volatility. Theoretically, the underlying causes are possibly concern about the interest rate outlook, about prospects for growth or simply fluctuations in the required risk premium. This last factor might reflect swings in uncertainty about economic fundamentals (economic or earnings growth, interest rates) or economic policy (protectionist fears), geopolitical developments, etc.
The nature of the underlying source of volatility is not without importance: growth uncertainty may end up causing a growth slowdown whereas interest rate uncertainty might have a more limited impact on subsequent growth. In order to shed light on this, the chart also shows the volatility of the daily change of the US high yield bond index. A growth downturn causes an increase in defaults, so increased uncertainty about growth should see a pickup in high yield bond volatility. What about interest rate uncertainty? The corporate bond yield consists of a 'risk free' rate (the yield on treasury bonds) and a risk premium (the credit spread), so fluctuations in interest expectations should be reflected in increased high yield bond volatility, both via the volatility of the risk free component and the spread component (expectations of tighter policy can end up triggering concerns about a pickup in corporate defaults). Most of the time, equity volatility and high yield bond volatility are highly correlated which suggests they are driven by common factors (the growth and interest outlook, fluctuations in risk appetite). Early on this year, the increase in high yield bond volatility was limited considering the jump in equity volatility and the relationship between the two in previous years. The disconnect has been even more outspoken as of late. This could mean that 1) corporate bond investors are complacent, which begs the question why 2) that changes in the outlook for interest rates and growth have not been the driving factor behind the equity market swings 3) that equity investors are far more jittery and, in comparison to high yield bond investors, tend to overreact to macro news or 4) that equity markets are driven by worries about individual company earnings rather than by macro developments.

US: VOLATILITY OF EQUITIES AND HIGH YIELD BONDS



Sources:Thomson Reuters, BNP Paribas

William De Vijlder

Eco WEEK

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world