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MARKET INSIGHTS

COULD NORTH KOREA TRIGGER THE NEXT VOLATILITY SPIKE?

OCTOBER 2017

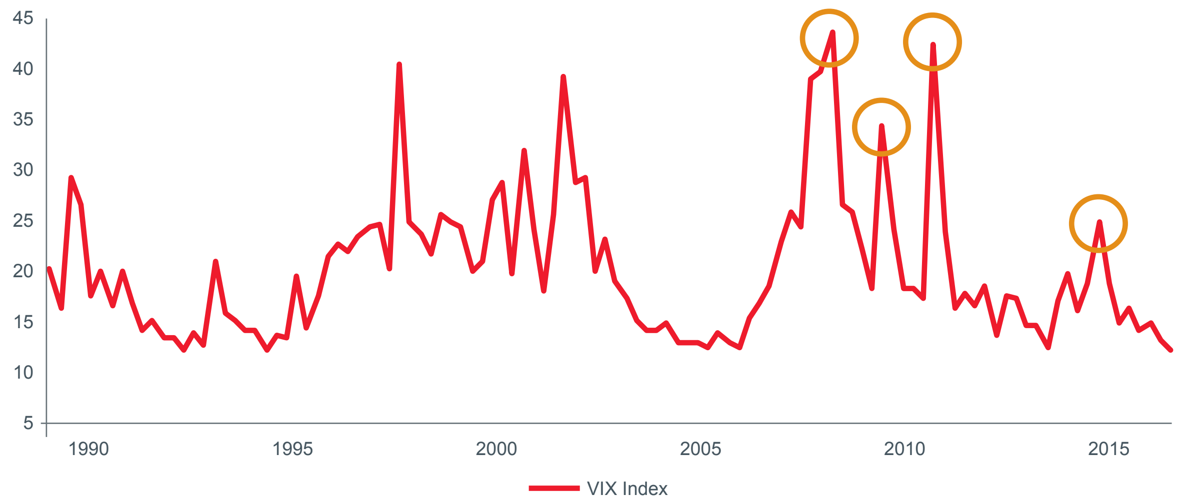
Since the start of the year, major stock markets around the world have been posting healthy returns, while volatility, as measured by the VIX index[1], has remained at record low levels (Fig. 1). Low volatility has been a persistent trend since the US Federal Reserve turned to large-scale easing, but investors should not be lulled into a false sense of security. As we have seen in the past, volatility could spike without warning, with the magnitude especially pronounced during major financial crises. Over the last 10 years, the noticeable spikes in volatility (circled in Fig.1) coincided with the Global Financial Crisis in 2008, the European Debt Crisis in 2010, the US Debt Crisis in 2011, as well as concerns over China growth and the collapse in oil prices in 2015.

With the VIX level at a record low, one may wonder if a turning point is imminent. More important, what would heightened volatility mean for investors and how could one prepare for market turbulence?

WHAT HAPPENS WHEN VOLATILITY SPIKES?

A spike in volatility is usually accompanied by a decline in the markets. Over the 10-year period ended August 2017, major volatility spikes have coincided with sharp market drops (Fig. 2). While stocks have declined en masse, the falls in low-volatility stocks have generally been less severe. Over the period, the MSCI All Country World Minimum Volatility Index

Fig.1. Volatility near all-time low[2]



[1]The Chicago Board Options Exchange Volatility Index (VIX) shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a basket of S&P 500 index options. [2]Bloomberg, data as of 18 Sep 2017. *Average based on quarterly data from 1 Jan, 1990 to 30 Jun, 2017. Please note that there are limitations to the use of such index as a proxy for the past performance in the respective asset classes/sector.

managed to outperform the MSCI All Country World Index, by virtue of losing less during these volatile periods highlighted below.

This holds true on an interday level as well, with the Minimum Volatility Index generally beating the broad market index on days when volatility jumped (Fig. 3). The worst interday volatility spike over the last 10 years saw a 50% one-day jump in the VIX index on Aug 8, 2011, triggered by a downgrade in the US sovereign debt rating from AAA to AA+ as concerns grew over the debt ceiling crisis. However, the low volatility index was less impacted by the sell-off, falling by 3.5% compared to the broad market's 5.1% decline.

FEAR FACTOR: NORTH KOREA

Looking ahead, it may seem difficult to forecast when the next volatility spike would occur or if this would lead to a market sell-off. For example, rising tensions following North Korea's nuclear tests could be a potential trigger.

After its sixth and most powerful nuclear test in early September, which caused a magnitude-6.3 tremor near the test site, North Korean state media claimed that it had developed a thermonuclear warhead that could be fitted into its intercontinental ballistic missile. As North Korea's nuclear tests became more powerful, investors' concerns grew as well, as evidenced by the interday

Fig.2. Volatility spikes and market declines go hand in hand[3]

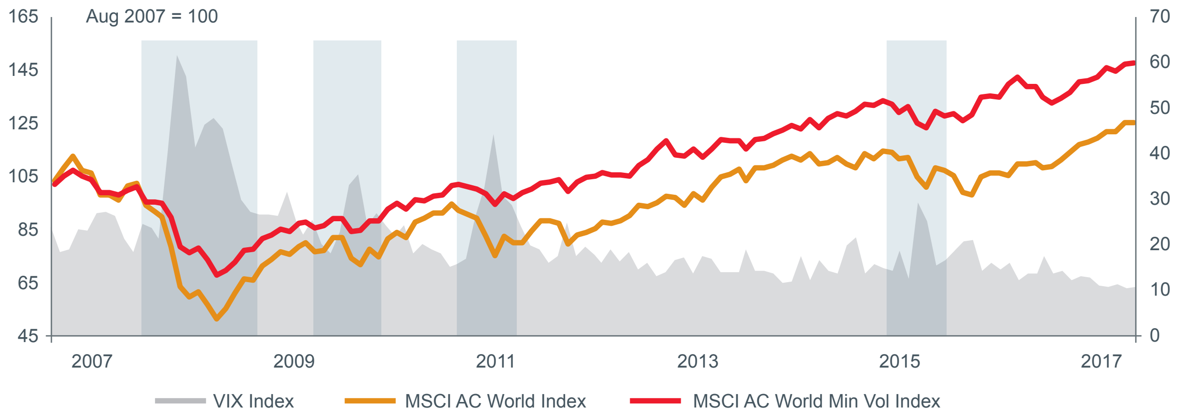
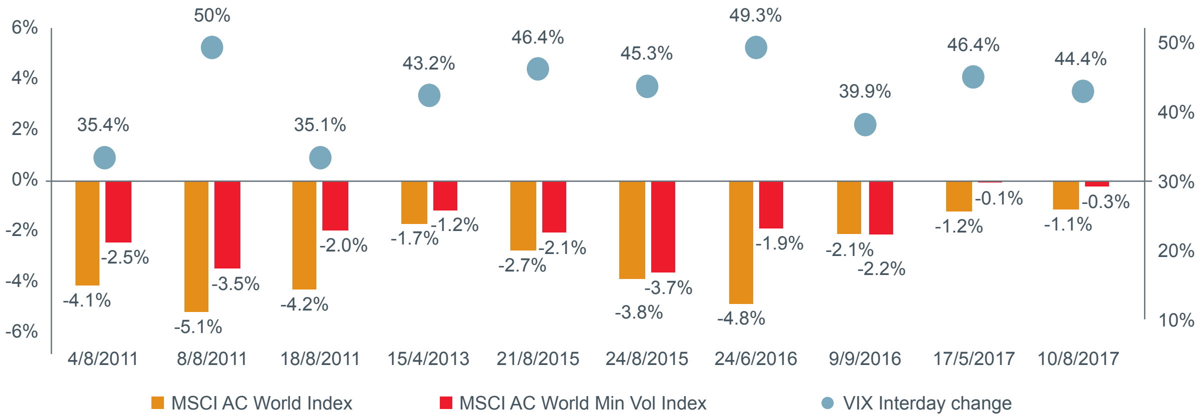


Fig.3. Low volatility outperforms on turbulent days[3]



[3]Bloomberg, data covering 10-year period from 31 Aug 2007 to 31 Aug 2017.

spike in the VIX index following the country's two latest tests (Fig. 4). In comparison, investors seemed relatively unnerved following the earlier tests.

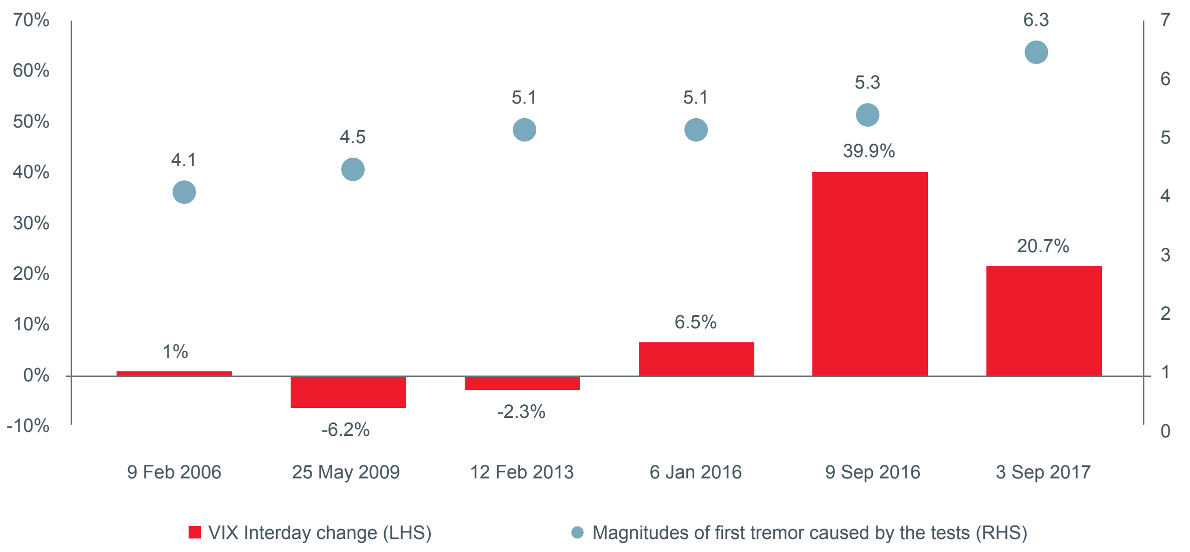
WHY LOW VOLATILITY EQUITY INVESTING WORKS

The outperformance of the low volatility index over the broad market (Fig. 2) resulted from lower drawdowns during adverse market conditions. A portfolio with lower drawdowns helps to accumulate returns over the long term through gaining more by losing less. By having lower drawdowns, the portfolio recoups its losses faster and thus makes it easier to accumulate gains over the long term.

Markets may seem calm for now, as it has been for a while, but could an escalation in the North Korea stand-off trigger the next volatility episode? Given the complexity of the issue, no one knows for certain, as this could lead to a range of outcomes from a peaceful diplomatic solution to a full-on military conflict, or most likely somewhere in between.

But what is for sure is that it helps to be prepared, and one way to prepare against a sudden downturn, while retaining an exposure to equity, is through low volatility equity investing.

Fig.4. North Korea nuclear tests strike fear, especially in recent years[4]



[4]Bloomberg, AFP, data as of 3 Sep 2017

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