The Return of Volatility May Signal a Buying Opportunity, Not a Bear Market

Why fluctuating asset prices need not cause alarm.

September 2021

Nikolaj Schmidt
Chief International Economist

Judging from the performance of equity markets alone, the past four to six weeks appear to have followed the theme of the previous 12 months: a relentless rally in risk assets. When other markets are considered, though, a very different picture emerges. The U.S. dollar has strengthened, and core bond markets have rallied strongly—both typical features of bear markets.

Is it, then, time for equity investors to take a more defensive stance? Perhaps not yet. Broadly, we are still in the early stages of the business cycle expansion, which is a supportive environment for stocks. And while equity market volatility has begun to increase and will likely remain elevated until the end of the year, I believe any drawdowns should probably be viewed as buying opportunities rather than a sign that the rally is coming to an end.

To understand why a volatile stock market this autumn likely will not signal a looming bear market, we need to consider the macro developments that have propelled markets over the past few months. The recent rally in the core bond markets has caused much confusion as it has come amid rising inflation and robust activity—features that normally cause interest rates to rise rather than fall. Some of the forces that have fueled the bond market rally, such as investor positioning and seasonal patterns, are technical in nature, but there are also more fundamental forces at play.

A Chinese Slowdown Would Have Global Repercussions

For example, while growth in developed economies remains strong, new COVID-19 outbreaks have raised concerns about whether this will continue. The fear is not so much about outbreaks in developed markets themselves—which are generally highly vaccinated and will likely be able to cope with outbreaks with minimal disruption—but rather about potential future outbreaks in China, where low vaccine efficacy and a “zero tolerance” policy on COVID-19, combined with policy tightening, has raised the specter of a precipitous growth slowdown. China accounts for

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roughly 20% of global gross domestic product[1] and a much greater share of global commodities demand, so a major slowdown there will likely have global repercussions.

Another important fundamental factor is the fact that the pandemic has thrown global supply chains into disarray, and global shortages have weighed on both supply and demand. This has led to some signs of softness in the global data flow.

Against this slightly unsettled backdrop, the Federal Reserve has suggested that it is time to dial back the asset purchases. In itself, this would not usually cause too much alarm; however, the combination of slower global growth prospects and U.S. tightening has begun to dent investor confidence. As confidence wanes, the prices investors are willing to pay for lower risk assets, like the U.S. dollar and government bonds, are increased.

In addition to the support from central bank asset purchases, liquidity conditions have also been boosted by the U.S. Treasury running down its cash account with the Fed. Consequently, the liquidity that originates from the Fed's asset purchases has, over the past six months, been augmented by USD 1.2 trillion of U.S. Treasury spending. Liquidity surges tend to lift asset prices, and over the past couple of months, it appears that the liquidity has found its way into the government bond market as well as into the market for risky assets.

Unfortunately, the Treasury's cash account with the Fed is almost depleted and, as we progress toward the end of the year, the U.S. Treasury will rebuild its cash buffer. Consequently, I believe we are on the cusp of a transition from a world of ever-expanding liquidity toward one of tightening liquidity. The latter world is highly unlikely to be as benign for risky assets as the former.

Pent-Up Demand Will Likely Continue to Support Risk Assets

To summarize, I expect equity market volatility to rise this autumn for three main reasons: (1) slowing global growth driven by COVID-19 and a policy-engineered slowing in China, (2) the Federal Reserve tapering its asset purchases, and (3) the transition to a world of less abundant liquidity.

I believe this will be a world of higher equity volatility, but not one that is outright bearish for equities. First, we remain at the early stage of the business cycle expansion and there is still a fair amount of pent-up demand that, over the coming couple of quarters will be released onto the world stage. Second, we expect the Chinese authorities to curb the growth slowdown and start to roll out some policy support over the coming months.

To put it simply: We are leaving a period of strong support for risk assets and low volatility and entering one in which the business cycle remains supportive, but declining liquidity conditions will likely lead to higher volatility. In my view, this new volatility will provide opportunities for investors rather than herald the emergence of an outright bear market.

[1] Source: IMF.

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ID0004502 (09/2021)
202109-1818414