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Expect Higher Stock Volatility in 2015

Rising corporate leverage should increase market

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A year ago, we wrote that rising leverage in the corporate sector would cause corporate bond spreads to widen, and that Treasury returns would likely outpace returns on corporate bonds in 2014. More recently, we wrote to our clients about another consequence of that rising leverage: a shift towards a higher range of volatility for at least the next several quarters.

It is no coincidence that corporate leverage and stock market volatility tend to move together. As we argued at the end of 2013, rising leverage foreshadows widening corporate bond spreads, which reflect growing business sector financial vulnerability and thus tend to contribute to higher volatility.

Indeed, volatility across asset classes has been trending higher since mid June 2014, when the VIX had reached a seven-year low and currency volatility had fallen to its lowest level since 2011. Not only equity markets, but also currency and fixed income markets have experienced rising turbulence since that time.

Two developments suggest a stronger linkage between leverage and market volatility in this cycle than before.

First, leverage is rising from historically high levels. (It is a common misimpression that our economy has “deleveraged” and is ready to leverage up again.) Second, capital markets have increasingly displaced bank loans and other loans in corporate financing. As a result, borrowing has become increasingly sensitive to capital market conditions. Therefore, widening spreads and higher volatility can dry up liquidity, hinder debt issuance and raise rollover risk, which all affect business activity and in turn feed back into higher risk perceptions.

Other factors than leverage are also pushing volatility higher.

With inflation already down to worrisome levels, falling inflation expectations will stoke market turmoil. With private sector balance sheets bloated, policy interest rates near the floor across most of the developed world, and inflation at low levels, the threat of deflation is always lurking in the background. Recently, forward inflation expectations have plunged. If the global economy turns down and pulls the U.S. economy down with it, the United States will experience at least some periods of modest deflation. Even if a downturn is avoided, given the weak global economy and the strong dollar, the threat of deflation will persist, stoking volatility.

Falling oil prices are also contributing to higher market volatility, and they could aggravate geopolitical tensions. Energy stocks have accounted for a significant proportion of the recent spikes in S&P 500 volatility. Moreover, oil and gas exploration companies have been large issuers of high yield debt, and the fall in oil prices has sharply widened spreads on their bonds.

Oil prices at present levels also pose substantial risks to political stability in the Middle East and Russia. Most Middle Eastern countries are almost entirely dependent on oil revenues to fund generous welfare programs that support social stability. At current prices, many of these countries have substantial budget deficits that will increase pressure to cut back on these programs, fomenting unrest.

An increase in market expectations of imminent Fed rate hikes would be an added source of market turmoil. If market expectations were to rise just to meet the most recently announced policy rate expectations of the Fed governors, it would imply the front of the yield curve steepening substantially. Higher U.S. interest rates—and the stronger dollar that would probably accompany them—would increase the debt-service problems of emerging market firms and fuel capital flight, aggravating their already fragile economies.

The market uncertainty around higher rate expectations is compounded by the conflicting pressures facing the Fed. On the one hand, the U.S. economy is relatively strong at present, and labor market slack has been gradually diminishing. Any hints of a pickup in wages would induce more voices to call for rate “normalization.” On the other hand, global economic conditions have weakened in recent months. Unsurprisingly, markets have found it difficult to resolve the net influence on Fed policy, and the confusion has likely only grown greater as conflicting statements have come from Fed officials in recent weeks.

Markets are relatively calm at present, but one should not bet on long-lasting tranquility. Rising corporate leverage, the specter of deflation, the decline in oil prices, and the conflicting pressures on the Fed all portend rising risk in the financial markets.

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