

ARTICLE

For professional investors
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The volatile season is about to begin

- Stock market volatility historically peaks in the Autumn
- Some issues to worry about, from the Brexit to Trump
- No need to panic but RIS remains underweight equities

The 'volatile season' is about to begin as investors face what is historically the bumpiest time of the year, with some genuine things to worry about, says Robeco's Lukas Daalder

The August to October period is always nerve-wracking, according to an annualized average of the VIX index, which shows the implied volatility in the equity options market, and is a gauge of how much underlying volatility there is in the US stock market. On average, the VIX index has risen by five points over those three months before falling in the run-up to Christmas.

This does not bode well for stocks, as based on the past relationship, a five point one-day change in the VIX is normally associated with a 3% decline in the S&P 500. "In case you wonder whether we should be all that concerned with a rise in the VIX, the answer is yes," says Daalder, Chief Investment Officer of Robeco Investment Solutions (RIS). "Volatility and returns go hand in hand, at least in the short run."

Daalder says that while this is a statistical tradition that comes true more often than not, there are a number of genuine things for investors to worry about in the next few months. These are:



Lukas Daalder, Chief Investment Officer, Robeco Investment Solutions

'Volatility and returns go hand in hand'

The Brexit. “After the initial shock, financial markets quickly moved to complacency,” says Daalder. “The fact that the Brexit outcome did not lead to a sudden meltdown in either politics, economics or financial institutions was interpreted by the financial markets that the UK leaving the EU would be a non-event. We do not agree with this verdict, as we expect the UK economy to be negatively impacted by the existing uncertainty. The financial markets have clearly not discounted this bad news, which could lead to volatility moving forward.”

Italy. “The problem with the Italian banking sector has received quite some attention in recent weeks, with dire consequences for Italian banking stocks and the broader Italian market (-22% YTD),” Daalder reminds investors. “Reading through the recent country report by the IMF (written before the crisis in the Italian banking sector came to the forefront), it is hard to become optimistic on the medium and longer-term outlook for the Italian economy.” Italy also faces a constitutional referendum in the Autumn to try to make its governments more stable.

Trump. “We can think of a lot of negative things to say about Donald Trump, but there is one thing we cannot deny him: he has shown that he is capable of winning against the odds,” admits Daalder. “And looking at the latest poll, his odds aren’t half as bad as they were when he announced his intentions to become the Republican’s nominee for US President. Although the chances of an actual electoral victory in the November 8 poll currently seem slim, the fact that he has come this far is a clear sign that social cohesion has eroded, and not only in the US.”

Oil. The price of crude oil is back below USD 42 a barrel, down 20% from the high recorded in early June. “At this level, we do not think it poses a threat to stocks, but as we have seen earlier this year, stocks sometimes disagree with us,” says Daalder. The low oil price has benefited consumers and “we have remained pretty upbeat on the prospects for the US economy, and continue to do so,” Daalder says. “We put the odds of a rate hike at only 20% for the next four months; normally, rate hikes lead to higher volatility.”

Is history a good guide?

Daalder says that historically, the Autumn period has seen some major upsets for stocks; the last great stock market crash occurred in October 1987 and the 9/11 terrorist attacks were in September 2001, while the worst of the global financial crisis including the collapse of Lehman occurred in September 2008. “But before concluding that we should sell everything and wait until the storm has passed, it may be sensible to question whether this pattern is indeed as solid as the volatility chart makes it look,” Daalder says.

‘Trump has shown that he is capable of winning against the odds’



Watch out: the volatile period is coming up! Source: Robeco, Bloomberg

“We should not forget that this is an average, and that an average can be dominated by extreme events. Indeed, if we take the low (July 19) and the high (October 13) as turning points, 1998 and 2008 are the clear outliers, with a rise in the VIX index of 24 and 46 points respectively.”

So, should investors sell equities, and wait until things statistically have calmed down in November? Robeco Investment Solutions has been underweight equities since the Brexit vote but doesn’t advise any mass selling based on historical charts. “As it happens we are indeed underweight equities right now, but it would be incorrect to say that this is linked to the seasonal pattern in volatility,” says Daalder.

“Based on the past, volatility seems to have increased more often than not in the late summer, but as there is no compelling reason why this has happened during this timeframe, we are hesitant to invest on the basis of it. We prefer to look at the underlying fundamentals, and for this reason we have gradually lowered our risk profile over the past months. We feel the market has been too complacent on various issues, but this has no link to the timing in the year.”

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