PICTET WEALTH MANAGEMENT

2024 Equity Volatility Outlook

2024: Volatility to remain between Low and Mid in H1, shift to Mid-High in H2

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FLASH NOTE

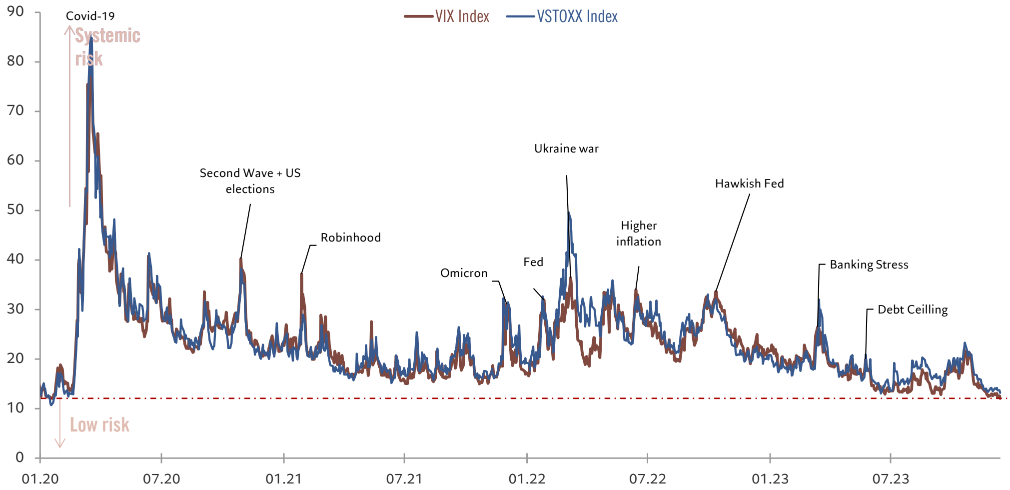
SUMMARY

- Stock market volatility in 2023 has trended downwards, although with fluctuations throughout the year. The VIX index surged in the first quarter but declined rapidly thereafter. Volatility rebounded during the summer due to a surge in long-term interest rates but declined again on rising hopes for rate cuts.
- The US Federal Reserve has aggressively increased interest rates since March 2022. Despite this, corporate profitability has remained strong, thanks in part to government support and the long period of low rates before March 2022. The housing sector has also shown resilience because of low adjustable-rate mortgages. However, monetary tightening is eventually expected to catch up on corporate profits, potentially causing financing challenges for weaker companies.
- The volume of zero-dated (ODTE) options has doubled in 2023, but these should have a limited impact on the S&P 500's volatility as buy and sell flows remain in balance. Short-volatility strategies have lost their appeal due to the prevailing high interest rates. The current low volatility might attract investors towards long-volatility strategies, but this should not dramatically change the overall picture in the coming months.
- Unless a severe recession occurs, we expect volatility to be in a medium-to-low range in the first half of 2024 and a medium-to-high range in the second half. Selling volatility flows are expected to remain low, preventing volatility from persistently decreasing below 12% in 2024.

VOLATILITY DECLINED IN 2023 AMIDST THE MOST AGGRESSIVE HIKING CYCLE IN DECADES

Despite uncertainties surrounding banking crises, interest rates and the risk of recession, stock market volatility has trended down since the first quarter, with the VIX index surging at one stage on 13 March to over 30% following the collapse of Silicon Valley Bank. Equity volatility rapidly declined thereafter and fell below 13% in June. A surge in long-term interest rates led to a rebound in September and October, but since then the growing conviction that the Fed had finished raising rates and could begin cutting them next year has contributed to a sharp decline in volatility again. By the end of November, despite numerous risks, the VIX index had dropped to its pre-pandemic level (see chart 1).

Chart 1: VIX index versus VSTOXX index, 2020-2023



Source: Pictet Wealth Management, FactSet, as of 12.12.2023

A RATE CUT BY THE FED SHOULD ALLEVIATE THE DOWNWARD PRESSURE ON CORRELATION BETWEEN STOCKS

In the most aggressive Fed rate-hiking cycle in decades, the US Federal Reserve (Fed) consistently increased interest rates between March 2022 and July 2023, when the fed funds rate reached 5.25-5.50%. Remarkably, while inflation has come down substantially, the US economy, including the labour market and housing, have remained resilient despite the rise in rates. Concurrently, the equity market is up substantially year to date, primarily driven by large technology companies boosted by the AI boom. Consequently, stock market concentration in the US has reached an all-time high, with the 10 largest stocks accounting for 33% of the S&P 500's market capitalisation. At time of writing (24 November), the S&P 500 had risen by 20.5% (in US dollars) year to date, with approximately 80% of gains attributable to the so-called "Magnificent Seven" tech-related stocks. This highly concentrated, tech-driven rally has led to a decrease in volatility. The trend has also been helped by a decline in the correlation among index components, as companies have reacted differently to the rise in interest rates. With the Fed expected to cut rates in the second half of 2024, correlation between S&P 500 stocks is likely to rise from the current low level. This, in turn, should alleviate some of the downward pressure on volatility.

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THE IMPACT OF FLOWS ON EQUITY VOLATILITY SHOULD BE RELATIVELY LIMITED NEXT YEAR

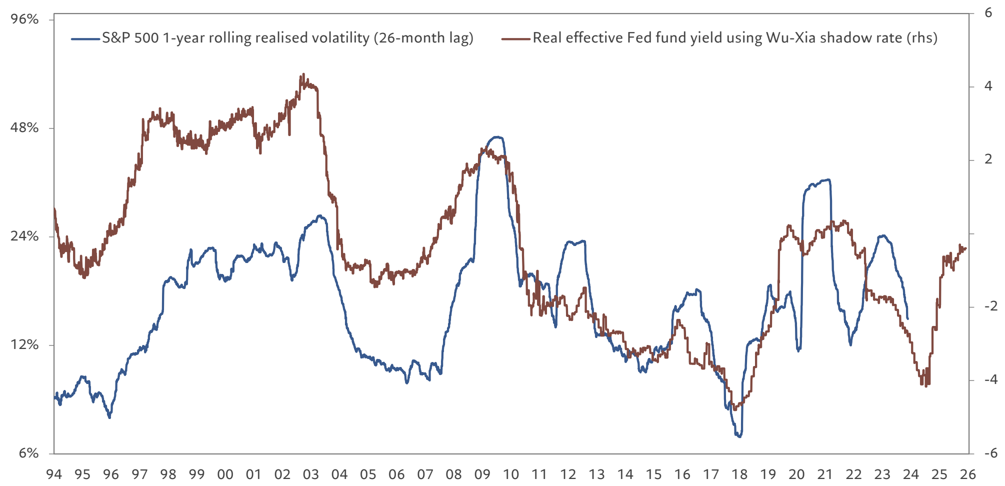
Another notable development in 2023 has been the doubling of the volume of ODTE (zero-dated) options. According to CBOE, ODTE options accounted for 43% of the total volume of S&P 500 index options traded at end-June 2023, raising concerns about their impact on underlying price movements on the S&P 500. To address these concerns, CBOE says that customer flows have been fairly balanced between buys and sells. Dealers' gamma hedging, which includes short- and long-dated options on the S&P 500 index, has returned to the neutral zone after minor deviations, without significantly impacting the underlying market. The S&P 500's implied skew has also decreased since a sell-off between July and September that was driven by uncertainties surrounding interest rates. Throughout this year, the implied skew has remained relatively low compared to the levels seen in 2021 and the first quarter of 2022. By contrast, short volatility strategies have lost their appeal since a squeeze in February 2018. Assets under management in short VIX ETNs and ETFs have failed to recover fully and only a limited number of contracts are presently being traded. The unappealing nature of these strategies is exacerbated by elevated interest rates. Investors are reluctant to take on the additional risk involved in investing in complex strategies when cash and bonds are providing attractive yields. Given the current low level of equity volatility, it is more probable that we see an increase in buying flows rather than selling flows. This could result in a slight uptick in volatility in the upcoming months, although the overall impact should be minimal.

THE SLOW TRANSMISSION OF INTEREST RATES HIKES TO THE REAL ECONOMY

While interest rates have risen since 2022 to levels not seen since before the financial crisis, the impact on companies' profitability has yet to materialise. On the contrary, corporate profitability has reached a record high, still benefiting from the long period of low interest rates before 2022 and government support. As mentioned, the US housing sector has also shown resilience, supported by low adjustable-rate mortgages and relatively stable mortgage costs, which have provided some protection against the impact of higher interest rates. However, an extended period of elevated interest rates entails a gradual increase in net interest payments that will put corporate profits under pressure. Weaker companies could face more pronounced financing challenges, potentially resulting in increased defaults and cost-cutting measures such as job losses. The full impact of rising financing costs on both the US corporate and household sectors may still take several months to materialise. Our US economists expect a rate cut of 125 basis points from the Fed in the second half of 2024. This would still leave the fed funds rate at the relatively high level of 4-4.25%. Unless the Fed cuts rates to 3-4%, which is unlikely, refinancing and borrowing costs will remain high enough to put pressure on corporate profits and the housing sector. Given the long lag in monetary policy transmission, we anticipate that the impact of previous Fed rates will still be felt during the latter half of 2024.

The fundamental volatility model, which is based on real fed fund rates, suggests there is a lag of approximately 26 months between changes in the real Fed fund rates and one-year realised volatility on the S&P 500 index. Applying this model suggests that volatility will bottom out toward the end of H1 24 and rise in H2 (see chart 2) as previous Fed hikes continue to percolate through the economy. Such findings chime with the current economic backdrop: the US economy remains robust as a whole and corporate profitability is holding up, but pressure on profit margins is beginning to emerge. While we expect a meaningful economic slowdown in the US in H1 24, we believe the US equity market will avoid significant stress. A small, gradual pullback should not result in a substantial increase in volatility. Nevertheless, geopolitical tensions and the US presidential elections remain a risk for our volatility forecasts.

Chart 2: S&P 500 1-year realised volatility (with 26 months lag) versus Fed Fund effective rates combined with Wu-Xia shadow rates.



Source: Pictet Wealth Management, FactSet, 28.11.2023

CONCLUSION

In conclusion, we anticipate that the full impact of high interest rates will be felt from the second half of 2024 onwards. Our fundamental volatility model, which is based on the lagged effect of interest rates on realised volatility on the S&P 500, suggests a decline in volatility during the first half of next year, followed by a gradual increase in the second half. However, it is important to note that our model does not account for short-term risks such as data surprises or unpredictable external shocks. These could keep volatility higher than what the model implies in the first half of the year. There is, for example, the possibility of an upside surprise in inflation, which could compel the Fed to raise interest rates again or maintain them at high levels for longer than the market is expecting.

By contrast, we do not believe the flow of funds into volatility strategies will have a significant impact on volatility trends in 2024. The combination of high interest rates and the current low volatility makes short volatility strategies unappealing. Consequently, we do not think the drop in the VIX index below 12 is sustainable.

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The current low volatility level may attract buyers interested in long volatility strategies, but this may not have much of an impact on raising it in 2024. Considering all these factors together, we believe the VIX will stay within a medium-to-low range during the first half of the year and transition to a medium-to-high range in the second half of 2024. In other words, we expect volatility to fluctuate between 12% and 18% for much of the first half of 2024, and between 15% and 22% for most of the second half.

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