BEWARE OF MARKET COMPLACENCY

In the past month we have seen the volatility index (VIX) drop almost in half, while North American high yield bonds and equities have rallied strongly. These moves suggest that risk levels have dropped substantially. Is this view warranted?

Are risks significantly lower today than they were two months ago? We still live in a word in which central banks are engaging in competitive devaluations. Major central banks are adopting negative interest rates to facilitate devaluation and (hopefully) stimulate economies. Negative interest rates are symptoms of serious economic issues. They are a tool of central banks at a loss as to how to stimulate a slowing global economy, a world economy that is slowing after years of unprecedented central bank intervention. Negative interest rates will further distort an already tenuous world economy. I believe the law of unintended consequences will loom large in the story of negative interest rates.

The sustained decline in the VIX is all the more surprising as we move into first quarter earnings reports in April. Corporate earnings have been less than sensational for some time and expectations for the balance of the year are uninspiring. Complacency moving into earnings season seems ill advised.

There does not appear to be any meaningful change in risks associated with debt levels, geopolitics, etc., to justify the apparent sunny view of the markets.

In early January I wrote that I expected a decline in the first half of this year that might establish an important low for US equities. The market duly did decline and has rebounded. However, I am troubled by the extreme low level of the VIX and the move higher in high yield debt. I have also recently suggested that high yield debt should be avoided, and I still maintain that position. The surprising complacency in the markets suggests to me that we may experience a second pullback in equities in the first half of the year. Markets are said to climb a wall of worry. This wall is very short indeed.

In conclusion, I don't believe that markets are currently pricing risk correctly, unless something fundamental has changed that I have yet to discern. North American equities and high yield debt may continue to move higher, but the odds make that a high risk presumption.

By Jonathan Baird CFA