VOLATILITY CYCLE

STOPS & ILLIQUIDITY

- Liquidity driven stop losses force early mean reversion trades out of the market
- VAR reduces available risk as large moves now enter observation window and stress loss calculations incorporate new extremes
- Implied volatility rises dramatically
- Skew and kurtosis become extreme

MARKETS BREAK

- Volatility is triggered by exogenous events, or central bank action
- Implied volatility rises
- RV community often sells the first move aggressively having been starved of opportunity in the previous phase
- This phase cycles with previous one giving false breaks and rewarding mean reversion players

QUIESCENT MARKETS "FOREVER"

- Implied volatility seems superficially cheap
- Realised volatility falls more quickly than implied
- Heavy cost of carry to long volatility positions
- Carry trades dominate encouraged by low volatility and few alternative uses of capital
- Available portfolio risk rises as VAR window incorporates little of previous market turmoil

MARKETS STABILISE & REBOUND

- Monetary authorities act to add liquidity or socialise losses
- Negative real rates or excess liquidity
- Fresh capital enters distressed markets to capture extreme pricing

IMPLIED VOLATILITY & SKEWS FALL

- Liquidity becomes more certain
- Central banks become passive and cautious
- Mean reversion trades begin to work
- More capital added to rebound trades

MEAN REVERSION & CARRY

- Excess liquidity, benign inflation, and slow reaction from central banks
- Risk taking increases as volatile periods drop out of the VAR observation window or risk parameters are adjusted
- Implied volatility falls and carry trades predominate in a reinforcing cycle

Source: Janus Henderson Investors

Janus Henderson INVESTORS