ETF Securities FX Research:
Volatility turnaround to drive asset class returns
NOK and GBP to outperform

Summary

- Investor uncertainty remains elevated. However, investors differ with consumers, with consumer sentiment on an uptrend, lifted by jobs and low energy prices.
- Currency volatility expected to moderate as investors convinced by underlying strength, helping support a ‘risk-on’ environment.
- The British Pound has historically had a strong inverse correlation with volatility.
- Currencies battered by volatility to turnaround, with Norwegian Krone and British Pound leading the way higher.

Sentiment divergence

Investor uncertainty, which manifests in greater asset return volatility, has been driven primarily by uncertainty surrounding US central bank policy, the softer growth outlook for China, and plunging oil prices. However, investor sentiment stands in stark contrast to consumer sentiment. As a result, there appears to be a fundamental disconnect between returns for cyclical asset classes and the underlying economic fundamentals, particularly in the US. While market participants appear to be focusing on softening metrics like manufacturing and industrial production, consumer sentiment is breaking higher and likely to underpin activity in both the services and manufacturing sectors.

While there has been a divergence in recent months between the leading economic indicators and consumer sentiment, there has been strong direct correlation historically. The improving trend in consumer sentiment (buoyed by rising jobs and wages and falling energy prices) suggests that the slowdown in manufacturing and services from survey evidence has the potential to reverse in coming months. We expect that such a development could be the catalyst for a reduction in market volatility as investors become more confident in the solid underlying economic fundamentals.

Nonetheless, asset market volatility has been at multi-year highs for many asset classes in 2016. Although volatility has continued to rise in recent weeks for oil (OIV) and for currencies (FXVIX), it has begun to moderate for equities (VIX). During periods of elevated (or depressed volatility), movements tend to be consistent across asset classes.

However, one indicator that could be the herald for more market stability is the volatility of volatility. The volatility of volatility has been moderating for all asset classes, indicating that volatility is lessening. This means that the investor uncertainty might be waning and could lead to a reversal of the ‘risk-off’ trend that has been in vogue in 2016.
What does this mean for currencies?

Certain currencies perform better in high volatility environments while others perform better in low volatility environments. During 2016 thus far, there have been several key currency trends that are worth highlighting as volatility begins to decline to more historical norms. (See relative performance tables below).

The British Pound has been the worst performing G10 currency, with the exception of the New Zealand Dollar. The poor performance is not surprising as GBP tends to be inversely related to volatility. However, in coming months we expect this weakness to moderate as market volatility gradually fades.

The best performing currency by far in 2016, has been the Norwegian Krone, following the sharp rebound in oil prices. If oil prices stabilise in line with volatility, this could be the beginning of a sustained rise for NOK (and its oil counterpart CAD, which has lagged the oil bounce thus far). Indeed, while it has outperformed in 2015, it is still well below its levels of a year ago, with plenty of upside potential.

Implications for the US Dollar

Investor optimism over the strength of the US Dollar is beginning to fade ahead of the key March FOMC meeting.

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