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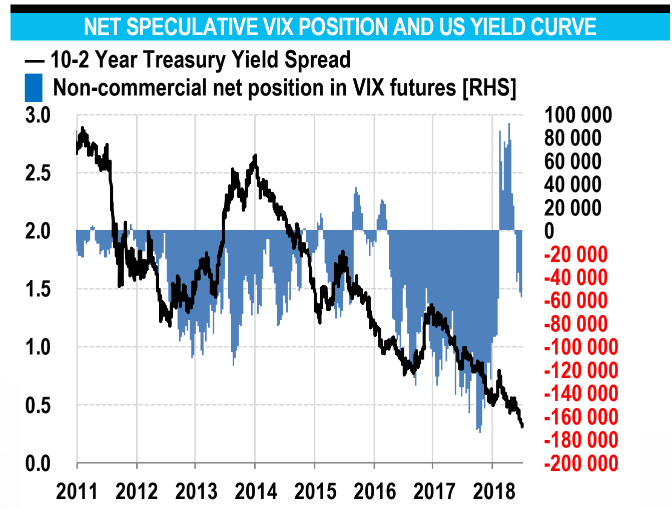
Conflicting perspectives raise eyebrows

■ **Speculative positioning in VIX futures shows investors expect volatility to remain low, which implies an absence of growth or inflation shocks** ■ **The flattening of the US yield curve shows investors expect slower growth** ■ **These conflicting views may reflect differences in investment horizon but in the end, only one of the two can get it right, which is a source of concern**

Beauty is in the eye of the beholder. The expression also applies when gauging the economic environment based on market indicators. The net speculative position in VIX[1] futures gives reason for confidence: after having turned positive briefly in February when the US inflation surprises caused some turmoil, the net position has moved back into negative territory: investors count on inflation, growth and monetary policy, which are obvious potential causes of volatility jumps, to evolve in line with expectations. The flattening of the yield curve tells a different story: despite the monetary policy tightening cycle, the difference between 10 year and 2 year treasury yields continues to shrink and fuels recession fears considering that previous recessions have been preceded by yield curve inversions. The flattening shows that investors consider that the current level of short term rates cannot be maintained forever because eventually growth will slow. It also shows that households, anticipating an economic slowdown, want to protect their income by locking in current long term yields, believing that when the slowdown will have become headline news, yields will already have dropped considerably.

NET SPECULATIVE VIX POSITION AND US YIELD CURVE



Source: Bloomberg, BNP Paribas

Why would the same information cause two market indicators to provide conflicting signals? One explanation is a difference in horizon. This tends to be short in a short VIX strategy: every single day without a jump in implied volatility means money is being made when the curve is in contango (the price of the short term VIX future is below the long term VIX future). In a yield curve flattening strategy the bond investor prefers long-dated paper so as not to miss the start of the cyclical bond rally, even if this means having a volatile performance in the short run. Both investors can be right but not all the time. When the balance tilts in favour of the bond investors' view on the economy things can get tricky causing a jump in volatility and portfolio adjustments (stop losses) by those who had been short VIX until then. It means that from an economic perspective, the conflicting views are a source of concern because they make a jump in volatility with spillovers across markets more likely. This in turn could weigh on sentiment and confidence in the real economy.

[1] The Cboe Volatility Index® (VIX® Index) measures the market's expectation of future volatility of the S&P 500 index over a constant 30-day period. It is based on prices of put and call options of different strike prices on this index. It has led to the creation tradable VIX futures and options (source: www.cboe.com).

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p. 2 Markets Overview

p. 3 Pulse & Calendar

p. 4 Economic scenario

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