

## The avenging goddess Volatility vents her anger

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Volatility has returned with a vengeance to global asset markets this week after a long absence, posing a challenge for investors who have profited in recent years from predictable patterns in prices for equities, bonds and currencies.

For the first time in many years, investors potentially face a period of risk aversion, which could prove painful for some.

In recent years, a surge in the use of derivatives - reflected in this week's soaring trading volumes - and cheap funding from borrowing in low-yielding currencies such as the yen have accompanied the search for yield across major asset classes.

The drawback of this "stretching for yield" in risky assets is that relationships between various markets have become closer. So a sudden change in the value of the yen this week has apparently sparked selling in emerging market bonds and stocks and rippled across global markets.

"This week's correction in riskier markets and the rise in market volatility is a reminder of the risks that carry trades pose, especially in markets where positions are stretched," said Nikolaos Panigirtzoglou, strategist at JPMorgan.

The sheer size of trading positions and tighter inter-relationships between asset classes have fuelled volatility, say analysts. Even nimble investors such as hedge funds that trade a variety of asset classes are facing difficulties in exiting some of their positions as higher volatility reduces liquidity.

"Nerves are frayed," said Alan Ruskin, chief international strategist at RBS Greenwich Capital, who adds that "stopping prices from feeding on themselves will remain tough".

The psychology of markets means that volatility tends to become a broad concern only when markets tumble, as they have this week. "Risk is a binary event. It's either on or off. There's no dimmer switch," said Douglas Peta, market strategist at J. & W. Seligman & Co.

Amid sliding equity prices, Wall Street's fear gauge, the Chicago Board of Options Exchange Vix index of S&P 500 volatility, has surged as much as 85 per cent higher this week. Merrill Lynch's Move index of 30-day Treasury volatility has risen as much as 21.6 per cent since Monday. Currency volatility has also risen while changes in mortgage securities and interest rate derivatives have also become frenetic.

Karlheinz Muhr, chairman of Volaris, a specialist volatility and asset management group that is part of Credit Suisse, said: "Nobody can predict with certainty when something like this is going to happen. But the wider asset management community just has not got up the learning curve with respect to managing volatility."

When asset prices become less predictable, rising volatility causes a reduction in liquidity across markets as traders become more careful in pricing assets for investors. Some observers believe a broad unwinding of excess liquidity, fostered by persistent low volatility in recent years, has now begun.

"Higher volatility is the story for 2007, and this will extract liquidity and reduce risk taking across markets," said Axel Merk, president of Merk Investments, which manages the Merk Hard Currency Fund.

The unwinding of carry trades, particularly those generated from the Yen and Swiss Franc, will probably

hurt markets that have enjoyed massive gains in recent years. These include popular emerging stock and bond markets such as Brazil, Mexico, Russia and Turkey, say analysts.

The prospect of sustained higher interest rate volatility has implications for banks and their clients, since the structured rate options business has boomed in recent years. A backdrop of well-behaved interest rates and slumbering volatility has boosted the appeal of various rate strategies packaged with the purchase of options.

For dealers and some investors, the business of selling volatility as an outright commodity has been highly profitable amid rangebound rates. Traders in Chicago have long highlighted the preponderance of big banks and money managers selling rate volatility on Treasury futures and other rate products. But if the recent rise in volatility continues, such positions look vulnerable, say traders.

In contrast, investors who have purchased options are insulated against further losses and stand to benefit from outsized gains if market prices move in their favour. Higher volatility could also boost the value of these positions.

Amid the turmoil, Treasuries have attracted safe- haven buying, and the subsequent decline in yields has in turn compounded losses in interest rate products that are valued and hedged against the "risk-free" government bond market.

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