

[Featured Insights]

The Reasons to Justify Betting on Volatility Escalation

Last month, a Bank of America survey revealed that investors are once again embracing the "Goldilocks" outlook, with nearly 90% of respondents believing that the U.S. economy will not enter a recession or will only experience a soft landing. Furthermore, almost 80% of participants expect that to prevent inflation from falling rapidly and to avoid a recession caused by overly tight monetary policy, the Federal Reserve will need to cut interest rates at least twice in the next 12 months. These two viewpoints are in sync and highly optimistic.

We have always been skeptical of such highly unanimous and concentrated expectations (it is important to note that the collapse of expectations also requires a trigger, especially when current economic data has not yet disproved this narrative, just as investors typically do not sell popular stocks solely due to high valuations).

Before the Trump shooting incident, potential reasons that could weaken the "Goldilocks" expectation included the possibility that if the Fed's monetary policy tightening is insufficient, U.S. inflation could remain high or rebound. Another possibility is that if the Fed maintains overly tight monetary policy, employment could deteriorate too quickly, leading the economy into a recession.

Theoretically, the Fed's challenge lies in determining the current position of the economy within the cycle. However, the risk of an inflation rebound cannot be ignored before substantial recession signals emerge. Especially since many of the current U.S. economic data points are still strong, and the healthy leverage levels of American households are a medium- to long-term reason for the potential rebound of inflation.

Following the shooting incident, the probability of Trump's new administration coming to power has further increased, possibly bringing back memories of the inflation trade from the previous Trump era. On the other hand, the market may also worry about the potential for other major economies, including Europe, to jointly resist Trump's "America First" policies, which could lead to some volatility in major tech stocks, as these American tech giants have been benefiting from the high-value-added profits brought by globalization.

Finally, the liquidity in the U.S. Treasury market is currently not very good, and the volatility of U.S. Treasuries may be too low relative to the level of liquidity. Given the high correlation between U.S. stocks and bonds at the moment, any increase in bond volatility, whether in yields rising or falling, could impact the U.S. stock market, especially when corporate earnings and expectations diverge.