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INTERNATIONAL

Central banks are responsible for the low extent of market volatility

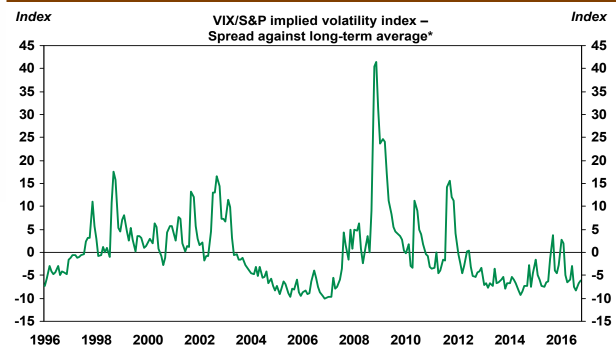
The year 2016 is soon coming to a close, and quite an eventful year it has been. It kicked off on a market rout amid deep preoccupations over the health of European banks, was punctuated by a surprise-decision by the British to severe their membership to the European Union, only to recently feature one of the most bizarre election campaigns in recent U.S. history.

It could have gone awry in many respects in financial markets, but it did not. The S&P 500 is on track to post an eighth consecutive year of positive returns. Bonds have also managed to offer positive returns, with most advanced-country central banks enacting eases at one point or another during the year. To that end, on of the consequences is the remarkably subdued level of market volatility. There were volatility flare-ups, to be sure, such as at the beginning of the year and post-Brexit, but they were fairly brief. Outside of these two events, markets have been particularly placid.

Should we infer that investors are optimistic and confident? That would be a stretch. Last month, the Federal Reserve asked primary dealing firms what they attributed the low volatility to. By far and large, aggressive policies deployed by central banks were determined to be the dominant drivers behind these market conditions. By contrast, only a minority mentioned that it had to do with reduced concerns over the economic outlook, or the political environment.

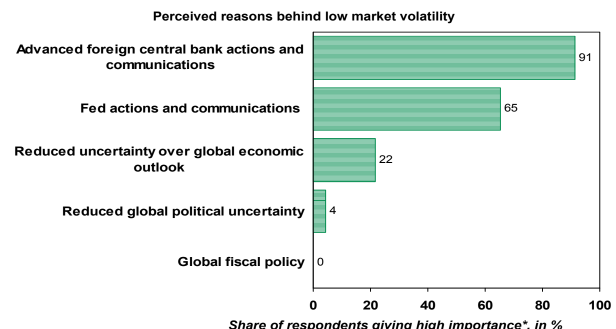
Implications: By reinforcing the expectation that they would attempt to respond to most shocks, central banks have had a sedative effect on markets. As a result, the information retrieved from certain market indicators is less representative of true market sentiment. It would only take less interventionist biases by central banks, especially those of Japan and the Euro area, to orchestrate a change of the volatility regime. Central banks are of course well aware of the potential for disruption, which is why they will proceed carefully with any adjustment.

Stock market volatility still below the long-term average



*Average since 1996
Sources : Bloomberg and Desjardins, Economic Studies

Central banks are overwhelmingly seen as depressing market volatility



* Score of 4 or 5 on a scale of 1 (not important) to 5 (very important)
Sources : Federal Reserve of New York's Survey of Primary Dealers, Desjardins Economic Studies

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