Seasonal Trends Point to Higher Volatility in August

The past is not necessarily a guide to future trends but the tendency for equity markets to underperform through the middle of the year is persistent and established in academic research—the "Hallowe'en effect". Equally, and consequently, we are entering a period of the calendar year when volatility tends to increase while FX safe-havens tend to out-perform.

We've covered seasonality in market volatility and currencies in previous updates over the years but this remains a subject that is worth returning to—especially now as we approach the period of the year when, typically, equity returns tend to fade, volatility picks up and safe havens appreciate.

The mid-year period tends to be somewhat tricky for equity markets. The "sell in May and go away" stock market adage appears to have some validity. Recent history certainly suggests that the (northern hemisphere) summer months are prone to equity market wobbles, perhaps reflecting lower liquidity and participation. Other markets globally tend to experience similar softness, perhaps because US markets set the tone for equities in general.

Empirical research (Jacobsen & Zhang) suggests that this trend is evident in equity market returns going back more than three centuries and covering more than 100 stock markets around the world. Winter returns (Nov/Apr) are 4.52% higher than summer (May/Oct) returns on average and they note that the trend is increasing in strength overall. The average difference over the last 50 years is 6.25%. Something as persistent and meaningful as this should represent an arbitrage opportunity but the trend persists as a challenge to the efficient market hypothesis.

Beyond the implications for timing investment decisions, this trend has clear repercussions for other financial instruments. The VIX index tends to see its largest monthly rise of the year in August and trends tend to remain elevated through to October. Meanwhile, FX safe havens—specifically the JPY—tend to outperform in the August/October period.

There are clearly some factors on the horizon that could worry equity investors and provide a catalyst for a spike in market volatility; the reflation trade has stumbled in recent weeks and US growth expectations are being marked down; COVID concerns remain prevalent and the spread of the Delta variant could derail re-opening expectations; the Fed is edging closer to a decision on tapering asset purchases—which might provoke another "tantrum"; US stock market breadth suggest recent gains in stocks are narrowly-based, making gains perhaps more prone to a correction.

On the other hand, there are some mitigating considerations; even if a Fed tapering decision is closer now, real interest rates remain low (negative) and supportive for risk assets; US equity markets are elevated but not necessarily overvalued; higher volatility in August is by no means a certainty (in the last 30 years, volatility has declined 40% of the time in the month, for example).

But there are clear implications for FX markets from these established trends. Firstly, short-term, implied FX vols which are currently drifting mostly lower would likely move higher in response to heightened market volatility in equities. Secondly, we would expect FX/equity correlations to strengthen in the event of a pick-up in equity market volatility.

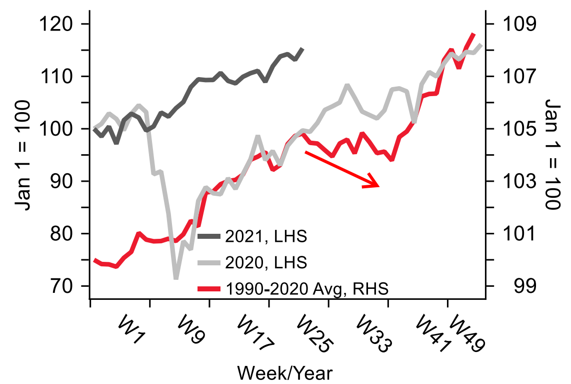
Our correlation studies (rolling 22-day window of daily returns) suggests the JPY is already reconnecting with equity moves after a sustained period of weakly-correlated activity. The JPY (versus the USD) shows a negative 55% correlation with the S&P 500 currently, its strongest, negative correlation since March 2020. Among the

FOLLOW US ON TWITTER @SCOTIABANKFX

Shaun Osborne
Chief FX Strategist
461.945.4538
shaun.osborne@scotiabank.com

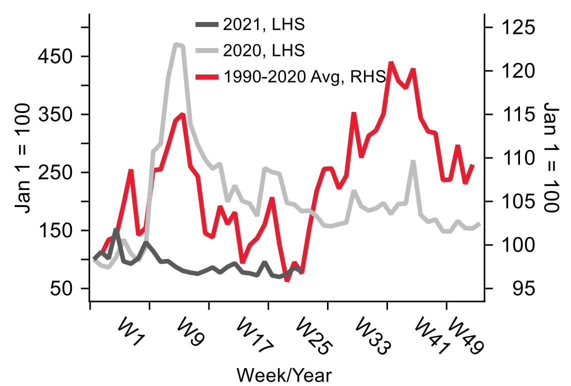
Juan Manuel Herrera
FX Strategist
416.866.6781
juanmanuel.herrera@scotiabank.com

S&P 500 - Seasonal Profile



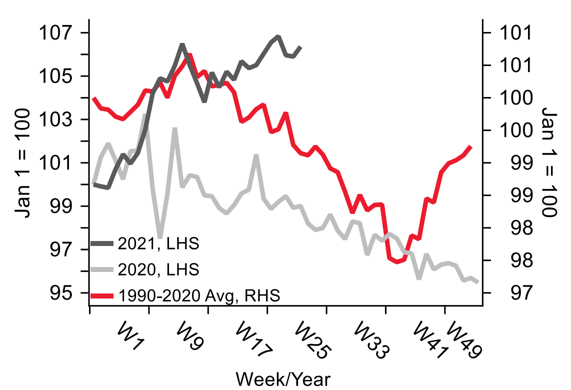
Source: Macrobond, Scotiabank FICC Strategy

VIX - Seasonal Profile



Source: Macrobond, Scotiabank FICC Strategy

USDJPY - Seasonal Profile



Source: Macrobond, Scotiabank FICC Strategy majors, the “usual suspects” - the AUD (+61%) and the CAD (+75%) show the strongest, positive correlation with risk. The GBP—which has acted as something of a high-risk currency since Brexit—shows a positive correlation of 48% (similar to the NZD). The MXN has a 43% positive correlation with US stocks. The EUR (+9%) is a relatively neutral performer in response to risk appetite. Short AUDJPY—the traditional risk on/off FX trade—or short CADJPY would be the most attractive position to capture heightened market volatility, based on our studies.