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Permanent Market Volatility, Connectivity, Globalization, and Synchronized Panic

By Michael Yoshikami (March 2012)

Investors today are seen to be clamoring for a more normalized environment. Years of impossible events playing out before a stunned investing community have reinforced the desire for normalcy. One could articulate the prevalent emotion as "Perhaps if I wait until conditions are less unstable my investment success will be more assured". However, this sort of thinking would represent hope rather than reality.

Along with increased uncertainty, a new phenomenon defines the world today: increased correlation. This is something that today's asset managers have to factor in. While diversification still has its place in portfolio strategy, new perspectives must be adopted to act in an environment where markets move similarly more often. According to a recent Northern Trust report, "the correlation between U.S. and non-U.S. equities has increased. The correlation between the S&P 500 and MSCI EAFE was a moderately low 0.54 in the 1990s and increased to 0.88 from January 2000 to December 2009. During this period, emerging market equities have exhibited higher correlations with both the developed markets including the U.S. market."

The world today is connected by a variety of forces that will assure volatility will be a permanent part of the investment landscape, and as markets and market participants continue to interconnect, volatility will likely increase in markets and investable assets. Technology has become a business and economic force for change, and one that drives increased fluctuation. When earnings results are broadcast or a news headline breaks, it is a matter of seconds before that information is distributed around the world to a myriad of devices and a vast network of platforms. Computers, cell phones, blogs, and more traditional media like television and radio, are quick to post the information that investors need, and investors are quick to act on this breaking information.

As news is distributed and quickly digested, investors can act quickly on global exchanges around the world. There was a time in the not-too-distant past where trading on a particular security would be off-limits until the markets opened. However, now with the advent of technology and a globalized connected marketplace, trades can be placed in private exchanges and in after-hours markets. Additionally, markets are open around the world on a constant basis where local securities can be traded in some cases despite a closed home market. Markets now are really never closed in terms of the ability to act on one's impulses.

Additionally, social networking has provided a powerful platform for the exchange of information. This new platform for information communication will have significant impact on future volatility. The unfettered exchange of information means that panic and euphoria can be triggered by a Twitter or Facebook post. Recently, the former Prime Minister of Italy actually posted information about the government's perspective on the debt crisis on Facebook. This is a vision of the future as governments, as well as individuals, use social media to disseminate information which can be acted on by investors.

One only needs to look at the adoption of social networking communities like Facebook and Twitter to recognize that the world is connecting with each other now more than ever. And while these two social networking enterprises are not directly connected to economics and market volatility, the statistics do indicate that the slope of connectivity is accelerating and that will have a significant impact on future volatility as information is disseminated freely and rapidly.

For example, according to a recent Socialbakers research report, adoption rates for Facebook continue to climb. The penetration rate in the United States exceeds 50% with Asia rapidly increasing its use of Facebook. Malaysia, for example, currently exceeds a 46% use rate with Singapore exceeding 55%. It is a little known fact that Asia is leading the charge in terms of Twitter usage. In fact, Indonesia, at 21%, is the number one country in terms of adoption rate relative to its overall population, according to a recent Comscore study.

As technology speeds up the transmission of information, there is an additional exacerbating factor which makes for higher volatility. Global economies are now interconnected. While the concept of decoupling was widely presented as a concept whereby different regions act independently of each other, it's clear that monetary agencies and world leaders now have moved towards cooperation. And while coordination might yield certain benefits, it now means that markets move in a way that suggests that decoupling is rapidly becoming a concept that is less relevant than in years past.

It is a fact that different regions will have different GDP trajectories. It is hard to argue against an Asia GDP that will not significantly outpace United States and European GDP. Likewise, it's reasonable to assume that economies with a rapidly rising middle class will outperform more established economies. These economic realities cannot be ignored and for that reason, there will be performance differentials between differing economies.

However, one only needs to examine the fallout from the European debt crisis and its impact on global markets, to see the reality that markets are more connected. According to Kevin Tay, Chief Investment Strategist at UBS Bank, Singapore, the markets in Asia are destined to be volatile in 2012. He points out in a recent interview with BBC that geopolitical events will likely continue to impact markets. Europe, he states, will impact global markets. This perspective is consistent with the views of most global strategists that global events will impact local markets. Said another way, markets are more connected by news and economic developments.

As an example, 10 years ago the world might not have cared that China's GDP was trending towards 7.5%. Today, the world watches with anticipation to see how China might stimulate its economy to avoid a hard landing. And why does the world watch? The rationale is simple: global economists and investors recognize that one region can impact the economy and markets of the world. In a Deutsche Bank report outlining the impact of China on global growth, the authors stated that China contributed 9% to global GDP, up from only 2% in 1980. Additionally, as China is now the largest holder of currency reserves in the world, it is easy to see how economies are more connected than ever now; the vested interests are now more meaningful, and require governments to attempt to work in a coordinated fashion. This leads to more correlation between markets.

The challenge for investors today is how to adapt to an environment that will be permanently volatile. One could wait for the world to calm down before adopting an investment strategy. The problem with this viewpoint is that the assumption is likely not reasonable; volatility is here to stay and so the correct response is not to wait for clear skies. For most investors, the more appropriate response is to find a way to profit from the volatility, or mitigate the risk associated with increased, correlated fluctuation.

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