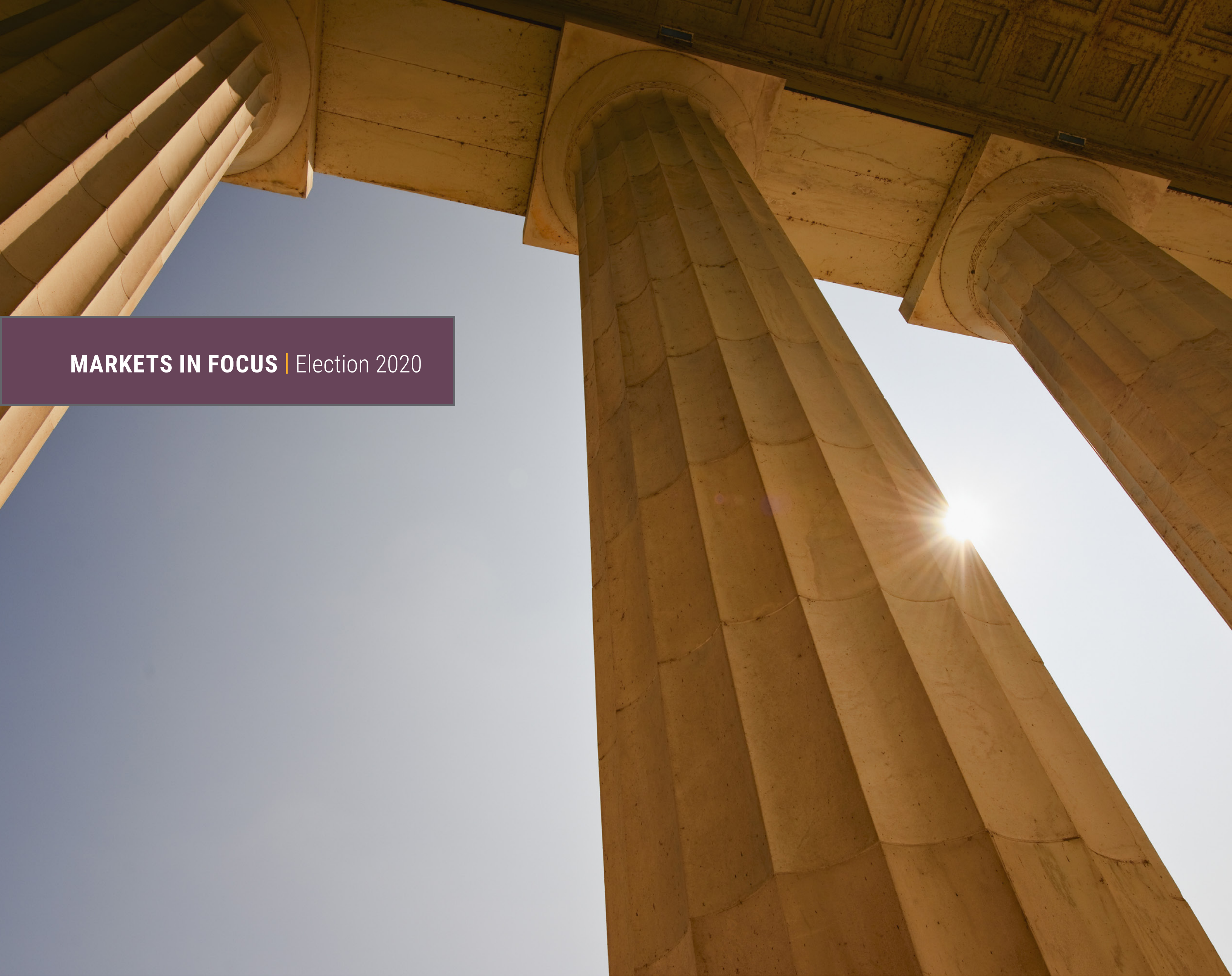


Beware of Volatility Hype

CARILLON TOWER ADVISERS

Do elections move markets?

By Matt Orton, CFA

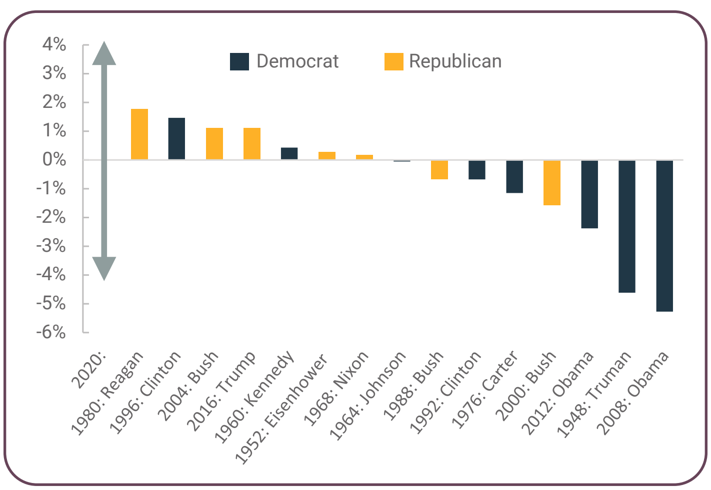
The rally from market lows back in March has been nothing short of spectacular, overcoming challenging economic data and a significant decline in earnings. The U.S. Federal Reserve (Fed) has clearly shown it will do "whatever it takes" and thus reduced the tail risk associated with the COVID-19 pandemic. Fiscal stimulus has further contributed to this reduction of risk in seeing a worst-case scenario.

But a wall of worry continues to grow, with lower market breadth, increasing pockets of COVID-19 cases, and mixed economic data just a few of the concerns for investors. However, the upcoming 2020 U.S. elections probably rank at the top of potential investor concerns given the uncertainty around the outcomes. While there will likely be increased noise around policy as both sides try to appeal to voter bases, elections tend not to trigger significant volatility. We will review election volatility through a historical lens, look at how the market is pricing volatility for this election, and some themes to positon around various outcomes.

Despite the endless media attention and potential policy implications of major U.S. elections, it might come as a surprise to investors that these elections typically do not trigger volatility. In fact, the average S&P 500 one-day post- election move is less than 1.5%. In 2016, the elections did not cause a significant spike in realized volatility. Figure 1 below shows the one-day post-election moves of the S&P 500 for all recent presidential elections—the 4% move that the market is currently pricing for this election appears large relative to history.

Figure 1: Current implied move looks large relative to history

S&P 500 one-day election moves

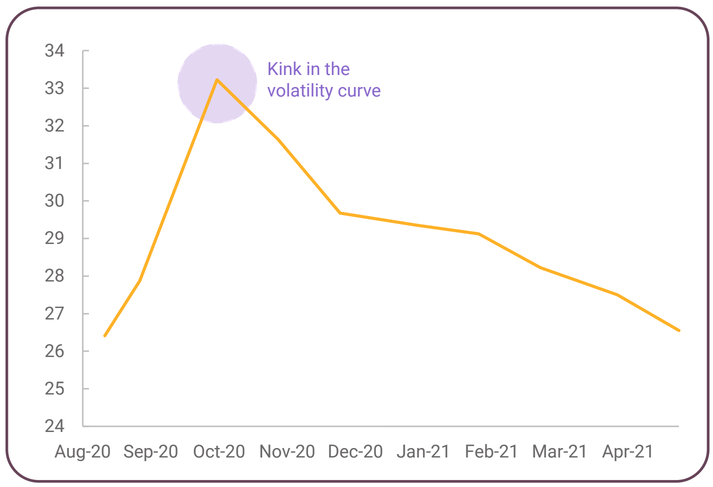


Source: Bloomberg, as of 8/31/2020

It's also interesting to look at the Chicago Board Options Exchange Volatility Index (VIX) futures to see market expectations for volatility heading into the presidential election. As you can see in Figure 2, there is a large kink in the futures curve for October expiration—the last date before the November 3 presidential election—but a quick drop for November. This highlights elevated expectations for uncertainty as candidates posture for last-minute votes, but not an expectation for this volatility to persist. That fits with the historical data which shows that the actual event doesn't lead to significant market shocks.

Figure 2: VIX term structure shows elevated uncertainty in the fall

Value of VIX futures contracts as of 8/31/2020



Source: Bloomberg, as of 8/31/2020

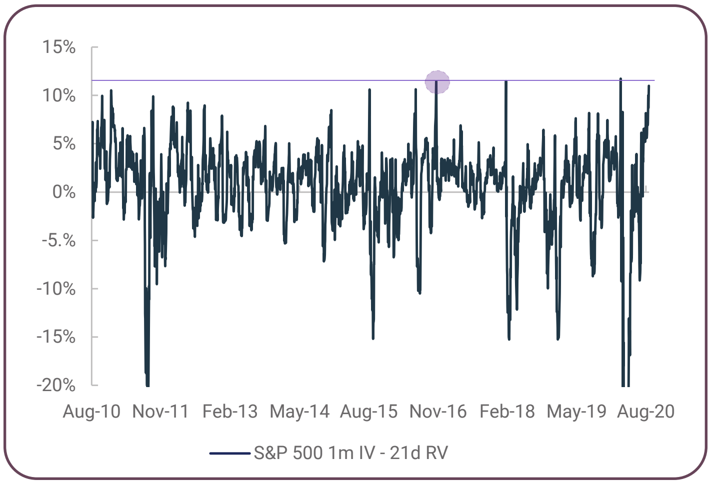
The 2016 election provides a great example of how these dynamics have played out and how the market often overprices election hype. Short-dated implied volatility on the S&P 500 spiked heading into the fall as polling results started to narrow. However, realized volatility (i.e. what the market actually experienced) declined over the same period, leading to one of the largest one-month implied volatility vs. realized volatility premiums in the last decade (Figure 3). It is also worth noting that most of the other elevated instances of volatility risk premiums accompanied market shocks. In other instances, realized volatility caught up with an implied shock. That was not the case in 2016.

All of this is not to say that the outcome of the election won't have real policy consequences. In fact, a Democratic sweep is largely viewed as the most "negative" outcome for the markets, largely due to tax headwinds. The 2017 Tax Cuts & Jobs Act (TCJA) triggered large upgrades to consensus earnings forecasts and any potential rollback of this legislation would likely have the opposite effect, albeit of a smaller magnitude. Increases to capital gains taxes could also trigger some short- term selling pressures as investors look to realize gains before any tax increases are applied.

Any more sweeping policy changes would require the removal of the filibuster. However, the risk of a Democratic sweep is already well broadcast and has been increasing in probability over the past few months. Thus, any spike in volatility or a market correction based on this theme could be an opportunity to broaden equity exposure.

Figure 3: Volatility risk premium reached near-decade highs heading into the 2016 election

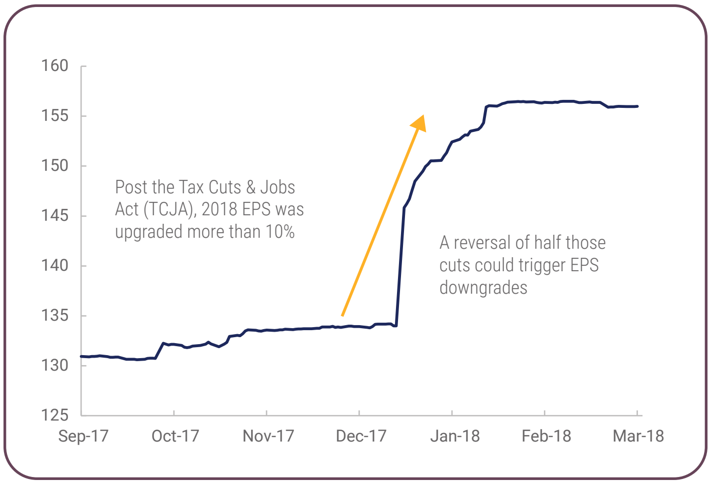
S&P 500 one-month 100% implied volatility (IV) minus 21-day realized volatility (RV)



Source: Bloomberg as of 8/31/2020

Figure 4: Partial reversal of TCJA likely to trigger downgrades

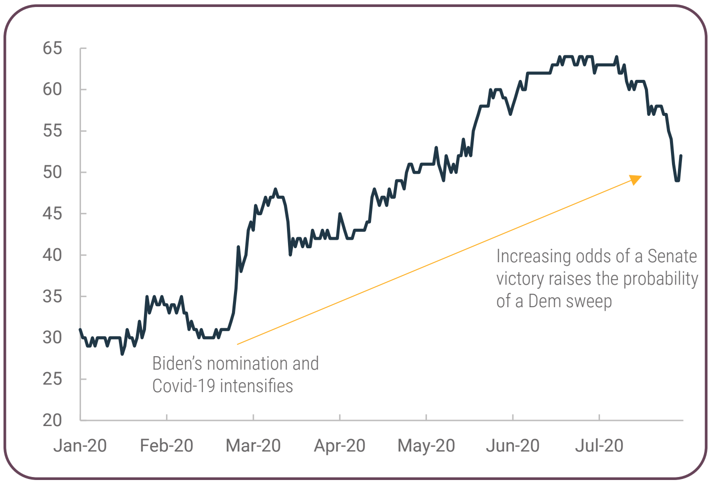
S&P 500 2018 consensus earnings estimates



Source: Bloomberg, Factset as of 8/31/2020

Figure 5: VIX term structure shows elevated uncertainty in the fall

Value of VIX futures contracts as of 8/31/2020



Source: Bloomberg as of 8/31/2020

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The Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 Index options, it provides a measure of market risk and investors' sentiments.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 75% of the investable U.S. equity market.

Implied volatility is a metric that captures the market's view of the likelihood of changes in a given security's price.

Realized volatility is the assessment of variation in returns for an investment product by analyzing its historical returns within a defined time period.

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