Axioma Risk Monitor: June 27, 2016

BREXIT VOTE IGNITES EQUITY MARKET, CURRENCY AND STYLE FACTOR RISK

Not good. The result of Friday's Brexit vote precipitated dramatic changes in equity and currency risk, driven by higher volatility and substantial changes in correlation.

Here is a rundown of some of the most notable shifts:

U.K.

• UK equity risk soared for the week, with short-horizon expected volatility for the FTSE 350 jumping by more than eight percentage points--a 67% leap from the low level of risk in early June. While risk was already on the rise through Thursday (up more than four percentage points from the prior week), Friday's action sent the numbers soaring. The upward blip in Medium-horizon risk was less pronounced, though the 2.7 percentage point increase from the prior week was still substantial for such a short period.

• While factor volatility drove much of the change, factor correlations actually fell in aggregate (from the point of view of the medium-horizon model), all driven by Friday's market action.

• Factor returns went crazy on Friday. The biggest factor move by far was in Exchange Rate Sensitivity[1]. For the five days ending Thursday, the factor return had been quite positive, +1.4%, among the best five-day periods of return the factor has experienced. Friday's return was roughly a six-standard-deviation move in the opposite direction, and the five-day return dropped to -1.5%! In other words, stocks with negative exposures (those that fare better when the currency weakens) far outpced those with positive exposures. While the direction of the moves was not surprising given the moves in the currency, the magnitude of the return was clearly quite unusual. The return to the Size factor was also substantial (almost four standard deviations above average on Friday), meaning larger-cap stocks beat their smaller-cap counterparts. Momentum and Liquidity had quite positive returns on Friday (more than two standard deviations above average), whereas Growth's return was more than five standard deviations below average. In many cases, factor returns were far in the opposite direction from what we saw in other regions, which we will discuss later.

• The biggest change in terms of major model blocks came from industries, although style and stock-specific risk ticked up, too.

• Among sectors, Financials experienced the biggest changes, with their capitalization weight falling, while their contribution to overall FTSE 350 risk climbed--though this change has been brewing for a while.

[1]The Exchange Rate Sensitivity factor measures a stock's sensitivity to movements in its home currency relative to a basket of currencies. A positive exposures indicates that the stocks does well as the local currency strengthens, so it is likely to be an importer. A negative exposure indicates that the stock does well as the currency weakens, so it is likely to be an exporter.

Europe

• Risk for FTSE Developed Europe also shot up, rising about eight percentage points from its early-June low, although the increase was from a higher starting point than in the UK. In addition, medium-horizon horizon risk was up more than five percentage points for the five days ended last Friday, nearly twice the risk increase in the UK.

• In contrast to the single-country UK model, the biggest driver of the change for Europe was higher currency risk (our Europe model is denominated in euros). Still, other components of risk (style, industry, and stock-specific) rose on Friday as well. Interestingly, aggregate country risk seems to show the smallest increase of the major components. While volatility went up in most, the correlation between the UK and a number of European countries fell.

• Interestingly, the UK equity risk factor within the European model saw only a nominal increase in risk from Thursday to Friday, and it remains toward the low end of country risk ranks in both the European and Worldwide models. For most of 2016, the UK's contribution to risk in FTSE Developed Europe has been higher than what would be expected given its capitalization weight, but the gap has widened.

• Factor returns for Europe were also of unusual magnitude in many cases. Momentum (both medium and short-term), and Leverage had returns that were at least two standard deviations above average on Friday, whereas almost all other style factor returns were unusually negative for the day. Since most of these returns reflected a sharp reversal from the prior few days the five-day returns were actually quite unremarkable.

Other markets

• Axioma's maps showing the countries with big changes in volatility and correlation were covered with upward-facing arrows. Almost no countries were spared – the impact of the Brexit vote clearly went well beyond the UK and Europe.

• For most of the other markets we track closely, short-horizon risk ticked up, but to a much smaller degree than in the UK or Europe. Asset-asset correlations were also up sharply, but more so in developed than in emerging markets. Globally, median correlations reached levels rarely seen since the financial crisis.

• While large-cap stocks prevailed in the UK, smaller stocks won the day elsewhere, with returns that were -2 to almost -4 standard deviations below average. Other major differences in the direction of style returns between the UK and other markets (which moved more-or-less in the same direction as each other) included Value, Volatility (most markets saw low Volatility fare well with a multiple-standard-deviation daily return, but in the UK higher Volatility actually did better), market sensitivity (similar to Volatility) and Liquidity. Medium-Term Momentum had a hugely positive day almost across-the-board. Growth had an extremely positive return in the US but negative almost everywhere else. Overall, based on the outsized returns, we expect to see a sudden and sharp increase in style factor volatility.

And now…

So what does it all mean? Risk has taken a sudden turn upward, driven by higher volatility and asset correlations. Thanks to the higher asset correlations, portfolio factor risk will be higher relative to specific risk. The unusual magnitude of returns will likely have caused some havoc in portfolios, but since it was in many cases a reversal from the prior few days' returns, the havoc should be mitigated to some extent. Factor volatility will, of course, be higher, leading to higher active and total portfolio risk. Of course, we will continue to keep a close eye on all of these elements. That said, based on history, we expect market volatility to stop increasing in the not-too-distant future, but it will likely settle at its currently higher level, since significant economic and political uncertainty remains.

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