

POLITICAL UNREST: AN UNDERESTIMATED RISK FACTOR

Volatility – a measure for variation of the price of a financial instrument over time. Historic volatility is derived from time series of past market prices while actual future volatility refers to the volatility of a financial instrument over a specified period starting at the current time and ending at a future date. The higher the volatility, the riskier the security (E-Study Guide for Risk Management. Google Books).

Amazingly, the increasing number of political conflicts occurring in Europe, the Far East and the Middle East has had nominal impact on the U.S., European and Asian financial markets. But is geopolitical risk being underestimated and market volatility artificially suppressed? One expert cautions that investors may face an October surprise — albeit a bit earlier than expected.

Money Masking Volatility

According to Raj Hindocha, a research analyst in London, the reason the mounting crises and conflicts around the world have not brought about significant market volatility is due to the liquidity afforded by open monetary policies at the U.S. Federal Reserve, European Central Bank and Bank of Japan: “It’s the abundant liquidity that has numbed the markets. Nobody wants to bet against that firepower,” Hindocha said in a recent interview.

Volatility Indicator Up

The Chicago Board Options Exchange (CBOE) trades a Volatility Index® which their website describes as “a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world’s premier barometer of investor sentiment and market volatility.” That index is up 8.56 percent so far this month – which some see as a sign that volatility is gradually returning to the market.

Geopolitical Risk Concerns Double

A June survey found that 14 percent of investors cited geopolitical unrest as the “biggest risk”; this month the percentage is up to 28 percent, a rise that is cause for alarm despite the fact that the ramifications of such unease have yet to be felt in terms of market volatility. But all of that could change in an instant according to Mr. Hindocha: “All of these risks that have been drowned out because of liquidity could be a trigger for people to take a more bearish view of the market.” Moreover, he warns that a shift in Federal Reserve monetary policy in September could be the catalyst for investor reticence.

Local Concerns Trump Global Ones

“All politics is local” is the quote attributed to former Speaker of the House Tip O’Neill, and some market analysts are in agreement with that sentiment over Mr. Hindocha’s. They cite U.S. and Chinese economic recovery and stability as more important factors than global discord elsewhere and note that the conflicts enumerated are strictly localized— so far.

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