

Box 4

**FINANCIAL MARKET VOLATILITY – WHAT CAUSED THE RECENT SPIKE?**

In early May 2006, a month-long correction in the financial markets took place. Most equity and commodity markets experienced price falls, and emerging countries' assets and currencies were adversely affected by significant outflows. At the same time, highly liquid and secure G7 government bond markets experienced strong inflows due to safe-haven buying. The sudden change in investors' positions can be broadly traced to three underlying factors: the immediately preceding sharp rise in most equity indices and commodities (see Chart B4.1); an unexpected reappraisal of risks, particularly in emerging markets (see Chart B4.2),<sup>1</sup> and concerns about the US economic outlook.<sup>2</sup> Whereas the net impact on prices was in the end limited,<sup>3</sup> these events could signal risks of volatility surges in the period to come, at least for some asset markets.

- 1 This type of investment had become increasingly attractive before the episode of turbulence in May/June owing to the pursuit of portfolio diversification, prospects of strong growth in most emerging countries, and higher yields. For instance, between 1 January 2004 and 1 May 2006 Saudi Arabia's Tadawul index rose by more than 200%, while Russia's RTS index rose by 190% and Turkey's National 100 index rose by 135%. There is some evidence, however, that some investors failed to make the necessary distinction between countries' risks and the fundamentals. Indeed, some episodes of investor nervousness had already emerged when, for instance, the Saudi stock market fell by 50% between February and May 2006, and a currency crisis affected the Icelandic króna in March and April 2006.
- 2 It is generally agreed that the correction began on 10 May, the same day that the FOMC raised the Federal funds rate by 25 basis points to 5.0%. Even though this decision was widely expected by market participants, the accompanying statement made it clear that further monetary tightening might be needed. Later in May, the release of stronger than expected US inflation data reinforced expectations of higher interest rates, and a growing number of market participants became fearful of the possible impact of the tightening on growth.
- 3 Most equity markets began to recover after mid-June, and most commodity and emerging market assets have since benefited from renewed interest from investors.

**Chart B4.1 Dow Jones EURO STOXX index**

(index value)



Source: Bloomberg.

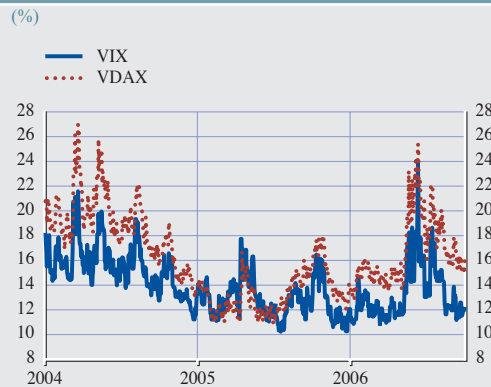
**Chart B4.2 Emerging market USD-denominated bond spreads**

(EMBIG, basis points)



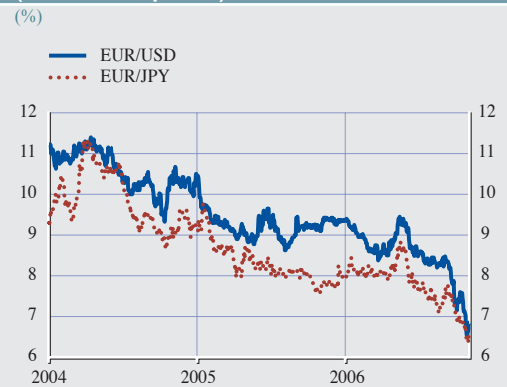
Source: Bloomberg.

**Chart B4.3 Implied volatility for the S&P 500 (VIX) and the DAX (VDAX)**



Source: Bloomberg.

**Chart B4.4 Implied volatility for the EUR/USD and EUR/JPY exchange rates (six-month options)**



Source: Bloomberg.

Implied volatility in the main equity indices remained higher after May 2006, reflecting greater uncertainty among market participants about economic prospects in the US (see Chart B4.3). It is important to note that the rise in implied volatility in the main equity indices only led to a return to historical averages, and there was considerable diversity across other financial markets: bond market volatility remained contained, for example, while volatility continued to decline for the major currency pairs in the foreign exchange markets after a short-lived upturn (see Chart B4.4).

The general correction of May and June 2006 has given some evidence of the correlations that have developed between different financial markets. After the bursting of the technology equity bubble in 2000 and 2001, investors have tried to diversify their asset allocation, searching for instance for new opportunities in emerging markets and commodities. Investment and speculative inflows into these markets have increased, resulting sometimes in an excessive acceleration in prices. A correction beginning in supposedly “marginal” markets such as commodities or emerging markets could eventually affect the main equity and bond markets, as investors try to limit their global risk exposures.