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Economics Group

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Mutual Funds: Volatility Leads to Demand for Safer Assets

While the massive drop in oil prices seems to have come to an end with prices flattening more recently, there has continued to be volatility—which has trickled into other markets, increasing demand for safer assets.

High Interest in High Grade

One of the most prominent themes in financial markets in recent months has been the precipitous drop in oil prices. More recently we have seen prices stabilize and begin to trend modestly upward, however, with large day-to-day and week-to-week price fluctuations. As a result, we saw more volatility in financial markets corresponding with the steep decline in oil prices, and this had increased investors' appetite for investment grade bonds in Q4-2104 (top chart). As a result, the yield on Aaa rated corporate bonds has trended steeply lower, approaching all-time lows that we experienced towards the end of 2012. With the U.S. economy leading the world in economic growth, we would expect to see further inflows into a wide array of "safe" U.S. assets, keeping downward pressure on yields in the near-term. In the longer-run, we see interest rates increasing, as we currently expect the Fed to raise short-term rates in June, which should put upward pressure on rates across the spectrum.

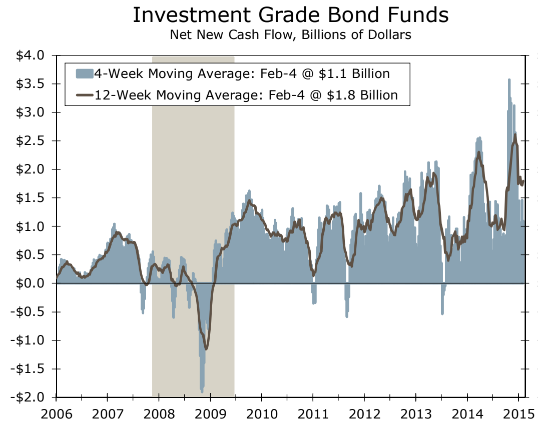
As we have seen demand for "safer" assets rise, we have seen a corresponding fall in net flows into emerging market funds. This is likely a response to recent volatility, and the drop in oil prices, which has had adverse effects on certain emerging market economies that rely on crude oil or other commodities for export growth. Indeed, the 3-month moving average of net new cash flow into emerging markets funds fell into negative territory in December, and may remain that way in the coming few months at the start of the year.

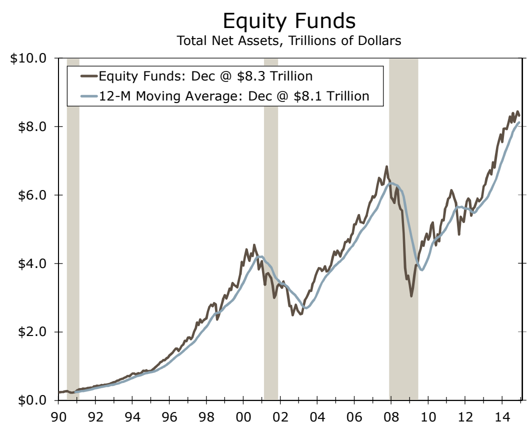
Equity Funds: Upward

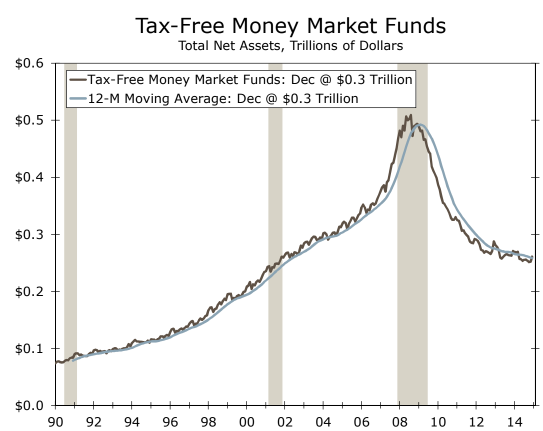
Growth in equity fund holdings has continued to trend upward, although is showing some recent signs of flattening (middle chart). This comes even through some recent volatility, as stocks have continued to edge higher with the S&P 500 closing at an all-time high on Feb. 13. U.S. equity prices have climbed higher as the economy has outperformed other large global economies. Consumer confidence has climbed to levels last seen prior to the recession; as the labor market continues to firm and gasoline prices have fallen 40 percent since this past summer.

Tax-Free Funds Stabilizing

The decreasing trend in total net tax-free money market funds has moderated, following the sharp run-up leading into the recession, then the equally steep decline following the recession (bottom chart). The level of tax-free assets held are now at the lower end of the spectrum of what we experienced during the previous economic expansion. Instead, investors seem to have taken to corporate bonds more recently, likely in a search for yield. Investment grade corporate bond funds may yield quite a bit more than a comparable duration government bond, but would also offer relative safety compared to, say, emerging market bond funds.







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