# Why is volatility low ?
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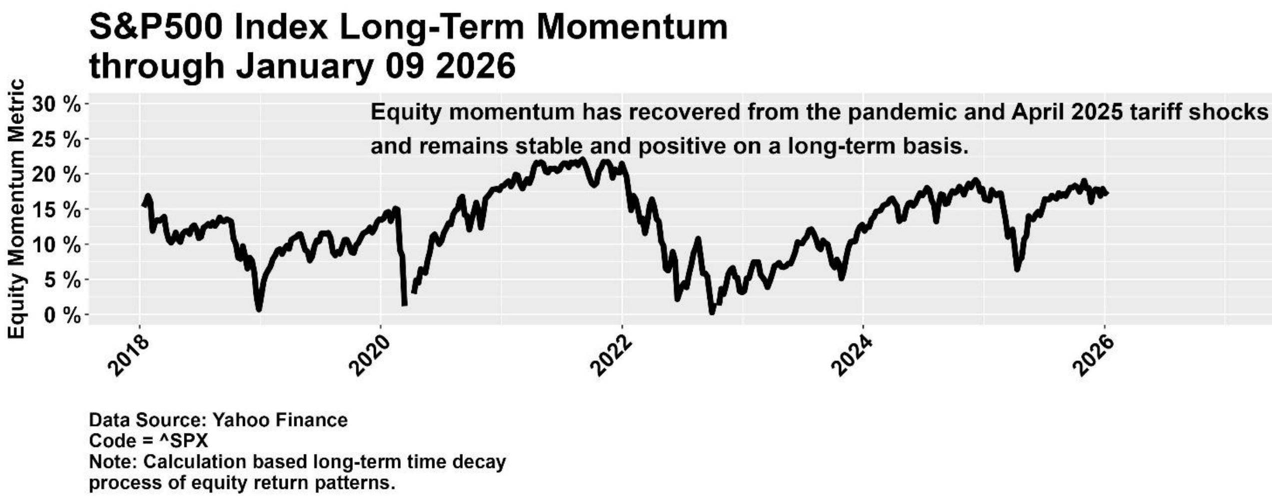
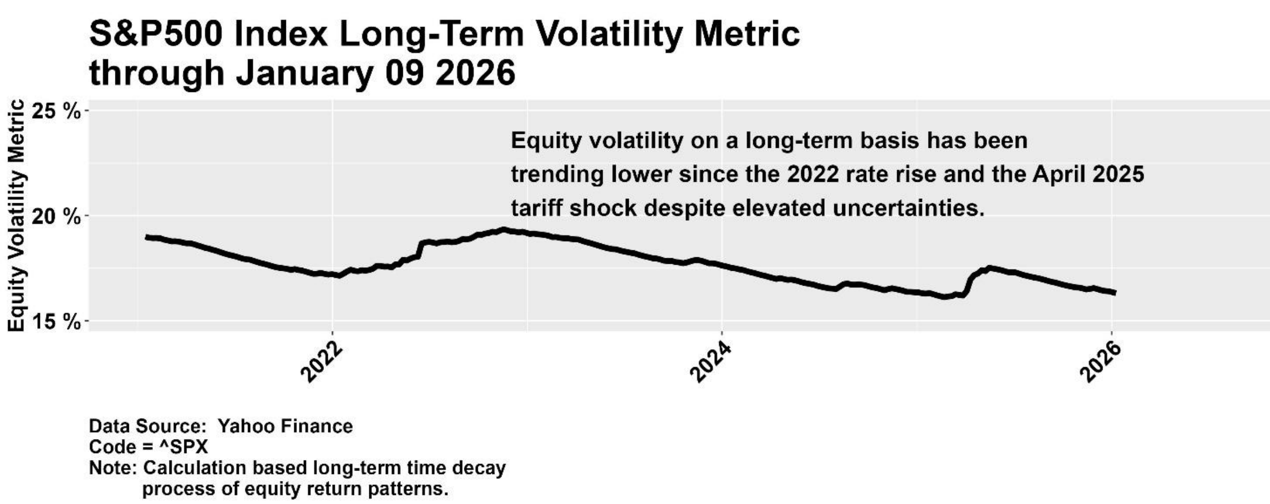
Uncertainties abound even as observed longer-term momentum and the volatility of major US equity indexes send messages of relative calm. We think there are at least three important reasons that equities have been able to continue climbing what appears to be a steep wall of worry. In this research, we will explore (1) the Federal Reserve's commitment to calming markets; (2) the offsetting positive and negative uncertainties coming from geopolitics, artificial intelligence, and tariffs; and (c) the appreciation that volatility is a very poor measure of the risks that worry traders and investors. Environments with distinctly different competing narratives, such as we have with some of the uncertainties, can create out-sized activity in far-out of-the-money options to hedge the big moves where direction is unknown. Competing narrative conditions can allow for calm before the storm hits.



## The Federal Reserve's commitment to calming markets

When one thinks of monetary policy, the emphasis is on how the Fed sets short-term rates by controlling the federal funds rate within its policy-determined range. But the Fed does more than set short-term rates. The Fed also provides lending facilities and uses its balance sheet to protect banks from unusual swings in various overnight markets such as repo transactions (repurchase agreements) or Secured Overnight Financing Rates (SOFR). Unusual fluctuations in these vital short-term money markets often occur at the end of year or end of quarter, or when especially large corporate tax payments are made.

Recently, the Fed began actively buying short-term Treasury bills, a version of quantitative easing or QE to counter any unusual upward spikes in short-term money markets. The Fed argued that this type of QE to counter perceived excessive money markets volatility was not an easing of policy like the massive QE activities during the pandemic or in the 2010-2016 period when the Fed was trying to encourage a little more inflation pressure with its asset purchases. In this case, the policy activity is a quick injection of reserves into the banking system using only Treasury bill purchases. Since T-Bill rates are already largely determined by the federal funds rate target range, the Fed views the smoothing of money market volatility with QE activity as market calming and not as a further easing of policy.

We would tend to agree. If the Fed is actively buying Treasury and mortgage-backed securities of longer durations, then the Fed's actions can depress longer-term note and bond yields which will be reflected in lower home mortgage rates. This was a major factor in past QE activities, but not in this one aimed solely as smoothing the volatility from money markets.

Nevertheless, the Fed concern for bank profitability and desire to see stability in short-term money markets is evidence of the Fed's commitment to make sure the financial system is running smoothly. And if the unemployment rate were to rise toward 5%, the Fed would most likely extend its commitment by lowering rates. ***The Fed "put" remains in place and is one part of the puzzle explaining relatively low volatility in times of elevated uncertainty.***

We also note that a major issue for market participants is Fed independence, and we recommend our research article of January 7, 2026, that took a deep dive into the central bank independence challenge. Regardless of the degree of political independence, the Fed is highly likely to continue to employ policies it thinks can reduce recession risks or disruptions to the banking system.

**Offsetting positive and negative uncertainties**

There are myriad uncertainties. The uncertainty are diverse and do not all point in the same direction. That is, not all uncertainties are indicative of negative impacts, at least not for all players, depending on the company or the sector.

On the positive uncertainty side, we have the artificial intelligence (AI) boom in data center building and expansion of chip production, which has been a major positive for equities. While the AI boom has entered a new phase where there are over- and under-performers in the sector, there is no question that AI capital spending helped the US economy grow much more rapidly in 2025 than the sluggish employment data would have suggested.

Tariff uncertainty cuts both ways for equities, depending on the sector. Tourism from Canada into the US is down some 20% to 25% in response to US tariff policies as well threats to make Canada a US state. If one is in mining or metal-refining businesses, there has been a positive following wind as metals prices from gold, to silver, to copper have been rising sharply. Big box retail stores have had to raise their prices in some instances due to tariffs, cutting into earnings. Agriculture prices have been relatively depressed, unlike metals. Soybeans received a lift recently from indications China would resume buying, but the quantities have been disappointing to US farmers and prices have given up some of the gains. On a more general level, the impact of tariffs on goods inflation has been less than was initially anticipated, providing support for the Fed to lower rates further.

The point is that the uncertainties from AI to geopolitics to tariffs, often cut both ways, depending on the company and sector. ***This mixed picture of uncertainty worries has helped to keep volatility relatively low for the major equities indexes,*** even if there have been major volatility bouts for certain companies, both positive and negative.

**Volatility is not risk**

Our last argument helping to explain relatively low volatility in highly uncertain times has to do with the nature of how risk is perceived and the importance of appreciating the narratives that define market activity. Volatility as measured by historical standard deviations or even implied volatilities from options are not necessarily a good proxy for risk. Market participants worry more about losses than gains, and they especially are worried about the possibility of major events that could cause exceptionally large losses.

If one examines the oil market, for example, one can observe significant activity in far-out-of-the-money calls, reflecting worries about tensions with Iran potentially disrupting world oil supplies. There are buyers and sellers of these call options, so one side may be hedging a risk that might be classified as a "known unknown" –

meaning everyone know about the risk but no one knows how it might be resolved. The other side of the market is willing to take in the premiums to write (or sell) those call options. And then, there are volatility traders, who do not have a view on price direction yet are putting on option strangles that make money only if there is a big move, up or down.

These are all signs of a market with two competing narratives. One narrative sees no disruptions and given the current supply-demand mix expects lower oil prices, while the other narrative with a much smaller probability but a big impact worries about an oil disruption temporarily spiking prices higher. One of the interesting things about markets where there are competing narratives is that one often observes relative calm until one or the other narrative gains the upper hand, and then prices move abruptly to reflect the new reality.

***Our takeaway here is that risk managers, even if they do not trade options, can gain important insights in how the market is pricing risks that go well beyond volatility metrics.*** Volatility metrics typically embed a presumption of a bell-shaped probability distribution when, more likely, the probability distribution may be highly skewed one way or the other or may even have two modes, reflecting the two distinctly different potential outcomes. In these cases, the risk is not that measured volatility rises; instead, the risk is of a very large and abrupt price move that could make for windfall profits or result in a serious disruption of one's business plan or trading strategy.

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