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Risk appetite

RISK ON VS RISK OFF

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Disclaimer: This is for educational purposes and cannot be taken as financial advice.

Risk appetite

- Risk appetite is the number one driving force of price action in the market. Risk appetite effectively describes investor demand for “risky” assets (such as stocks, crude oil, AUD, NZD, CAD and EMFX) vs “safe haven” assets (government bonds, JPY, CHF, USD, gold).

Obviously, risk appetite can vary region to region due to regional factors (i.e. US risk assets can outperform European risk assets one day due to something happening in Europe, then the opposite can happen the next day).

But generally speaking, risk appetite in key markets (North America, Europe, Japan, Australia, etc.) is closely correlated.

- Global risk appetite is affected by the ebbing and flowing of key risks to the global economy; examples include the Covid-19 pandemic or the US/China trade war from 2018-2019. There are always risks to the economic outlook out there, and as these risks increase, risk appetite worsens. As they improve or abate, risk appetite improves.

RISK ON

- “Risk on” is how we describe the market when risk assets (stocks, crude, AUD, NZD, CAD, SEK, NOK and EMFX) are strongly outperforming whilst safe havens (government bonds, USD, JPY, CHF, gold) are under pressure

- Generally, an improvement in the market’s appetite for risk happens due to “good news” regarding one of the key risks to the global economic outlook. For example; imagine if they found a cure for Covid-19 tomorrow - you would see perhaps the largest risk on moves in history; stocks may rise 20% in one day, crude may rise 50%, and risk FX would surge. Meanwhile, government bonds, USD, JPY, CHF and gold would all likely be hammered.

RISK OFF

- "Risk off" is Risk assets (stocks, crude, AUD, NZD, CAD, SEK, NOK and EMFX) will all be under pressure, whilst safe havens (government bonds, USD, JPY, CHF, gold) will outperform.

- Generally, a deterioration in risk appetite that results in a risk off market move will happen following "bad news" regarding one of the key risks to the global economic outlook.

- For example; imagine if it was reported and scientifically verified that Covid-19 had mutated to become much deadlier and more contagious, and this new virus was rapidly spreading around the globe. The news would spark panic selling; stocks might drop 20% in a day, crude might again go negative and risk FX would likely be slammed.

THE REALITY

- In reality, what we usually see in the market is gradual ebbing and flowing between risk on and risk off market sentiment.

Perhaps one day, the good news doing the rounds amongst market participants is outweighing the bad news; likely you will see risk assets supported at the expense of havens. Perhaps another, the bad news will slightly outweigh the good, and you will see the opposite.

- Of course, bigger moves can and do happen, usually as a result of big news.
- Think back to most recently when Covid-19 hit Europe and the US - this huge deluge of bad news crushed risk assets for nearly a month (between February 21st and mid-March).
- In terms of a recent example of good news, think back to when reports first suggested that the US and China were going to agree to a Phase One trade deal back in November. Risk assets were jubilant for weeks

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