FIRST QUADRANT

FQ INSIGHT:

The Low VIX: Déjà Vu All Over Again?

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The CBOE Volatility Index (VIX) dropped to a multi-year low in early May. As usual, the media and various market pundits have been speculating on what it all means. Is risk actually low? Or are investors complacent? Is the Fed "artificially" keeping volatility low through easy monetary policy? The list goes on and on.

History shows us that low implied volatility is a common symptom of a resilient market environment. We wrote on this back in 2014 ("The Low VIX and the 'New Normal'") when the same controversy was swirling around Wall Street. What we said back then holds true now. The low VIX is an indicator of the resilient market state. Indicators from other markets confirm that the current state is perfectly normal and not an aberration. In fact, the resilient state is historically where growth assets give the best risk-adjusted returns. This short note is to communicate our conviction.

We believe that analysis of the VIX, like anything else, cannot be done in isolation. Here are some basic things to keep in mind:

1) The spot VIX by itself is not a very useful indicator because it can be moved by short-term events.
2) The change in the VIX is not as useful as its relationship to its long-term median.
3) The VIX goes through long periods where it is above or below its median.
   a) Below median signals that markets are "resilient" and bounce back from bad news
   b) Above median warns that markets are "fragile", and bad news can cause long-term bear markets
4) The transition between fragile and resilient market states takes several months, unless there is an exogenous shock like a geopolitical shock or an ecological disaster.

The FQ Market Risk Indicator (MRI) uses implied volatility as an indicator of the risk environment. But to be useful as a macro environment indicator, the VIX needs to be used with some care.

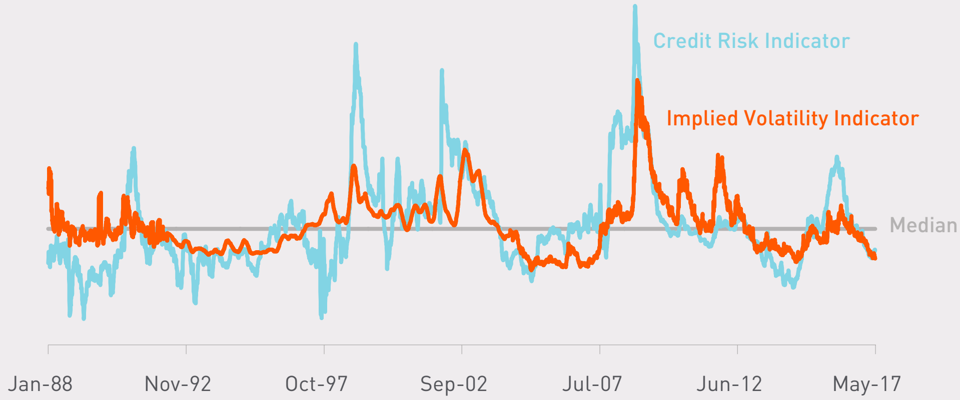
First, the spot VIX is too volatile. So for the S&P 500, we use a continuous maturity three-month VIX future which is a forward-looking measure of risk, but has one-third the volatility of the spot VIX. We also include other implied volatility indicators along with the VIX.

Second, the VIX is a powerful indicator of equity market sentiment but it's not just about volatility. Implied volatility falls out of option pricing. The VIX is a standardized indicator of the cost of hedging an equity portfolio. High VIX means the cost of hedging is high because the option writers are concerned they will have to pay off. Low VIX means that investors believe the chances of a prolonged bear market are low. Our experience is that the VIX is a lousy predictor of realized volatility, though it does indicate whether uncertainty is high or low. This makes the VIX future ideal for the MRI which is used for identifying fragile and resilient market states, not predict volatility.

Third, you can't use the VIX in isolation. The VIX, particularly the spot VIX, is very volatile. Even the VIX future should be used in conjunction with other macro risk variables. The MRI uses the VIX with measures of credit, interest rate

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

FIGURE 01 - STOCK AND CREDIT SENTIMENT INDICATORS*
(JANUARY 1988 – MAY 2017)



*The Implied Volatility Indicator is a customized measure of implied volatility calculated by First Quadrant, L.P. composed of a continuous maturity three-month VIX future, the three-month moving average of the EuroStoxx 50 VIX Index, and the three-month moving average of the CBOE Crude Oil VIX Index. The Credit Risk Indicator is the difference between the yield on the Moody's Aaa and Baa Corporate Bond indices versus a long-term median.

Sources: First Quadrant, L.P., Datastream

and economic risks (See "Risk Cascades", 2015 for details). The chart above shows our implied volatility and credit risk indicators over time relative to their long-term medians.

High risk is signaled when the indicator is above its median and low risk when it is below.

This chart shows that periods of low implied volatility generally coincide with periods of low credit risk and vice versa. We can see that when the two indicators agree that risk is high or low, the result is pretty convincing. Right now, credit risk is also low. While not shown here, the other MRI indicators, monetary risk and economic risk, agree.

The chart also shows that these periods of low uncertainty persist for some time, and when the VIX moves above its median signaling a change in state, the process is orderly and takes place over several months.

But we can also see that it is not unusual for the VIX indicator to bounce off its median from above or below depending on the market state. So now that the VIX is fairly low, it would not be unusual for it to rise towards its median and then fall back again.

This leads us to our last point. A low VIX in conjunction with other low uncertainty indicators historically has meant a period of higher than average returns and lower than average volatility in growth assets (See "Risk Cascades", 2015). It does not mean that there cannot be a correction. If the market is overvalued, as many contend, a correction of up to 10% is not uncommon. But in the resilient market environment, such corrections tend to be short-lived. In trading terms, resilient markets are when you want to "buy on the dips."

In conclusion, the fact that the spot VIX is at the lowest level since 2006 does not mean we are about to enter another 2007 and 2008. In 2006, the spot VIX had been in the 10-11 range for almost three years. While the economic expansion is getting old, we can see from the chart that the VIX cycle is still fairly young. But regardless of economic conditions, a market transition from a resilient to a fragile state is likely to take several months and be confirmed by other indicators. There should be plenty of warning (unless there is an exogenous, non-economic shock, of course). So speculation on the "meaning" of the low VIX is largely irrelevant. In fact, given confirmation by other factors, the low VIX is good news for long-term investors. Yes, the VIX is at the low end of its range, but we've been here before and we'll be here again. It's not a "Groundhog Day" effect, but it is déjà vu all over again.

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