FIRST QUADRANT

Fear is Not Enough

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The market turmoil over the last week has been disconcerting for many investors. After the placid markets we've had since late 2016, the violent moves of the last few days, culminating in significant moves in the spot VIX on Monday, February 6, feel ominous. The same question is being asked by investors and the media: Is this a bull market correction, or is it the start of a true bear market?

At First Quadrant, we have a proprietary Market Risk Indicator (MRI) that measures the resilience and fragility of the markets. A fragile market is one where fundamental risks build up. A risk cascade occurs when a number of risks are high, so that when one triggers, they all trigger. These risks include risks to the stock market, credit markets, interest rates, and the macro economy. When multiple elements are weak, it doesn't take much to cause the whole edifice to collapse like a house of cards. A fragile market is one that collapses under shocks.

If, however, only one or two of these risks are high, the markets can usually absorb them when they trigger. This characterizes a resilient market. The soundness of the financial ecosystem means that the market can easily absorb shocks. One shock, like a VIX spike, is not enough fear to start a risk cascade in a resilient market. Not surprisingly, FQ's MRI remains in the resilient state.

The events of the past few days are symptomatic of a resilient market shock. The shock was to the stock market – and the rest of the system remained strong. As such, there was no contagion of the kind that would cascade into a bear market and a recession.

But what was the event? It appears to have been tied to the carry trade in the VIX as well as trading in various VIX-oriented securities, particularly ETNs. The market sell-off largely began as a normal market correction. Bond market interest rates began rising in January as evidence from various sources pointed towards a possible resurgence in inflation accompanied by more restrictive monetary policy by the various central banks. Long-term interest rates finally rose to a point where equity markets needed to correct to compensate for their higher valuations. This caused a rise in the VIX from very low levels, leading to a meltdown in short VIX trades as well as short VIX ETNs and other funds. This again fed back into the market causing further selling.

Interestingly, other risk measures such as those we use in the MRI were largely unaffected by the moves in the VIX, which is specifically tied to the S&P 500. Implied volatilities for other equity indices increased, but not near the same magnitude of the VIX. Credit spreads widened slightly. Bonds rallied late on Monday, but not at the type of panic levels that signal a flight to liquidity. In fact, there seemed to be few signs of panic outside of the stock market.

On Tuesday, a few of these VIX-related securities closed or halted trading. Markets largely recovered and the panic appeared to abate.

Looking forward, there are still inflation risks lingering. Those pressures are likely to continue to pressure interest rates. But the global economy continues to be healthy and earnings growth robust. As long as these other risks remain low, a short bout of stock market fear is not enough to start a bear market. For that, we must wait for other risks to build up, but for now markets are resilient to these types of shocks. We will, however, remain vigilant, watching for those more dangerous conditions.

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