

TACTICAL INSIGHTS

IS LOW VOLATILITY A CONTRARIAN SELL SIGNAL?

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One of the most-watched fear gauges on Wall Street has been traded at the lowest levels in decades. The CBOE Volatility Index VIX, which is based on the 30-day options contracts on S&P 500 Index, closed on May 9th at 9.77, the lowest level since Dec. 27, 1993. Despite the spike last week, the VIX remained around 12, which is much lower than the historical long-term average of 20. Such a low level of volatility generated some concerns in the markets. Some contrarian investors suggested that the market participants are becoming too complacent, thus the market downturns may be near.

Obviously, it is hard to imagine that the volatility will decline a lot further from here. The chance of rising volatility is much higher. However, rising volatility is not necessarily correlated with a declining equity market over a longer horizon.

Table 1: CBOE Volatility Index-VIX vs. S&P 500 Index

Date	VIX Index	S&P 500 Index	Change of VIX	S&P 500 Index Price Returns
Dec-90	26.38	330.22		
Dec-91	19.31	417.09	(7.07)	26.3%
Dec-92	12.57	435.71	(6.74)	4.5%
Dec-93	11.66	466.45	(0.91)	7.1%
Dec-94	13.20	459.27	1.54	-1.5%
Dec-95	12.52	615.93	(0.68)	34.1%
Dec-96	20.92	740.74	8.40	20.3%
Dec-97	24.01	970.43	3.09	31.0%
Dec-98	24.42	1229.23	0.41	26.7%
Dec-99	24.64	1469.25	0.22	19.5%
Dec-00	26.85	1320.28	2.21	-10.1%
Dec-01	23.8	1148.08	(3.05)	-13.0%

Dec-02	28.62	879.82	4.82	-23.4%
Dec-03	18.31	1111.92	(10.31)	26.4%
Dec-04	13.29	1211.92	(5.02)	9.0%
Dec-05	12.07	1248.29	(1.22)	3.0%
Dec-06	11.56	1418.3	(0.51)	13.6%
Dec-07	22.50	1468.36	10.94	3.5%
Dec-08	40.00	903.25	17.50	-38.5%
Dec-09	21.68	1115.1	(18.32)	23.5%
Dec-10	17.75	1257.64	(3.93)	12.8%
Dec-11	23.40	1257.6	5.65	0.0%
Dec-12	18.02	1426.19	(5.38)	13.4%
Dec-13	13.72	1848.36	(4.30)	29.6%
Dec-14	19.20	2058.9	5.48	11.4%
Dec-15	18.21	2043.94	(0.99)	-0.7%
Dec-16	14.04	2238.83	(4.17)	9.5%

Data Sources: Bloomberg, Yahoo

Table 1 shows the yearly VIX index and S&P 500 Index levels between 1990 and 2016. There is a clear negative correlation between VIX and S&P 500 Index during the years when VIX declined. In 11 out of 15 years of declining volatility, the S&P 500 Index moved higher. However, the relationship is not as clear cut in the years when VIX rose (the red-shaded rows in the table). Only in 4 out of 11 years of rising volatility, the S&P 500 Index moved lower. In contrary, S&P 500 Index rose over 20% a year on average despite the rising levels of VIX in late 1990's.

Using a low level of volatility as a contrarian sell signal may not be a profitable trade. Instead, investors should focus more on the economic and corporate fundamentals. Continued economic expansion, still- accommodative monetary policies and solid corporate earnings are likely to keep the eight-year old bull market alive for a while.

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