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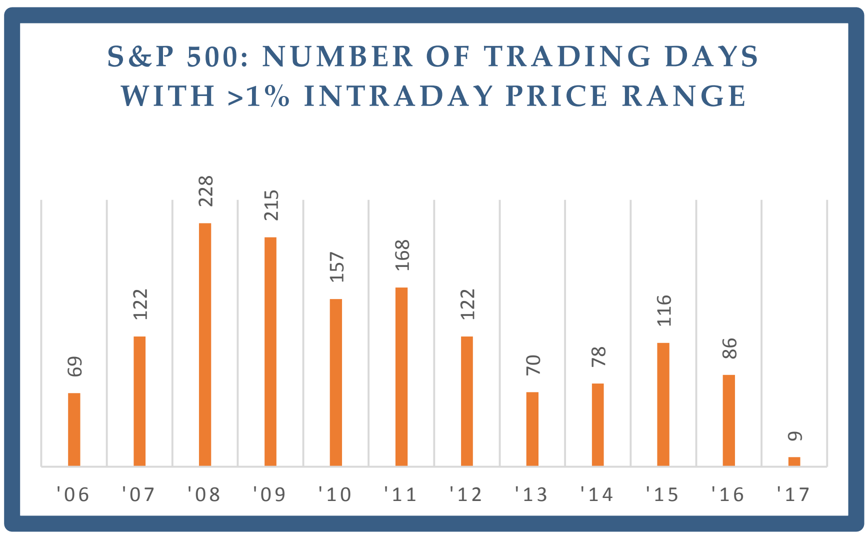
Insight

Groundhog Day

-Manchester Capital Management Strategy Group

This year reminds us of the 1993 classic comedy "Groundhog Day" starring Bill Murray as Phil Connors, a reporter who finds himself caught in a time loop while covering the annual Groundhog Day event in Punxsutawney, Pennsylvania. We wonder if we are in a similar time loop as most days seem the same – the equity markets grind a bit higher, volatility remains low, and bond yields move by, at most, a few basis points in either direction.

Consider that there are an average of 252 trading days in a year. During the financial crisis of 2008 and subsequent rebound in 2009, the S&P 500's intraday price range as a percent of the closing price was at least 1% almost 90% of the time. By contrast, we have only had nine such days so far this year, or only 4% of the time! Even in more "normal" years, the intraday price range will be at least 1% on around 30% of trading days. Looking at trading ranges is interesting but other, more quantitative measures, show a similar lack of trading volatility.



Source: Bloomberg

So far this year, there have only been nine days where the S&P 500's intraday price range went above 1%.

Part of the reason for low volatility could be attributed to a lack of trading. A dearth of "market-moving" news and the increased use of passive investments give investors less reason to trade. The lack of trading can be interpreted bullishly or bearishly. On the positive side, investors may feel confident enough about the future and therefore see no reason to sell. On the other hand, less trading could mean that investors feel the market is too expensive and they see no reason to buy. Average daily trading volume across the major U.S. exchanges is down 22% this month compared to last year's average. The decline in trading volume may be tied to lower volatility. When volatility is low, there are fewer opportunities to "buy the dips" and less need to hedge against losses. Not much has changed on the macroeconomic or political fronts since the beginning of the year. Inflation remains benign, interest rates are low, government policy changes are virtually non-existent and global election results have yielded few surprises. Other than occasional worries about North Korea, there has been little to fluster the markets.

The most-watched indicator of volatility (or complacency) is the Chicago Board Options Exchange Volatility Index, or VIX. It measures the market's expectation of volatility over the upcoming 30 days by looking at the implied volatilities of a range of S&P 500 index options. The VIX is often referred to as the "Fear and Greed" index because it closely tracks investor appetite for risk-taking. When investors feel confident and volatility is low, they purchase fewer put options (which give investors the right to sell at a certain strike price) and option price spreads narrow, causing the VIX to fall.

To get a feel for the level of complacency in the market, one can look at the ratio of implied to realized volatility. The realized volatility is simply the standard deviation (variability) of returns over the last 20 trading days. Implied volatility (as measured by the VIX) is usually higher than realized volatility as investors are willing to pay a premium for the insurance provided by put options. The ratio of implied to realized volatility is near parity today, indicating little fear in the market. Many investors are actually selling short the VIX, betting that volatility will remain low or go lower. In our opinion, this has become an overly popular trade and it will eventually disappoint those investors. What could cause it to reverse? Anything that increases fear or uncertainty in the market. Among the issues we are monitoring to signal an increase in "fear" and a reduction in "greed" are a slowdown in GDP growth, disappointing corporate earnings or revenue growth, a rise in inflation, or an aggressive Fed policy. In the interim, we will continue to monitor the VIX for any sentiment changes that could indicate an end to our time loop.