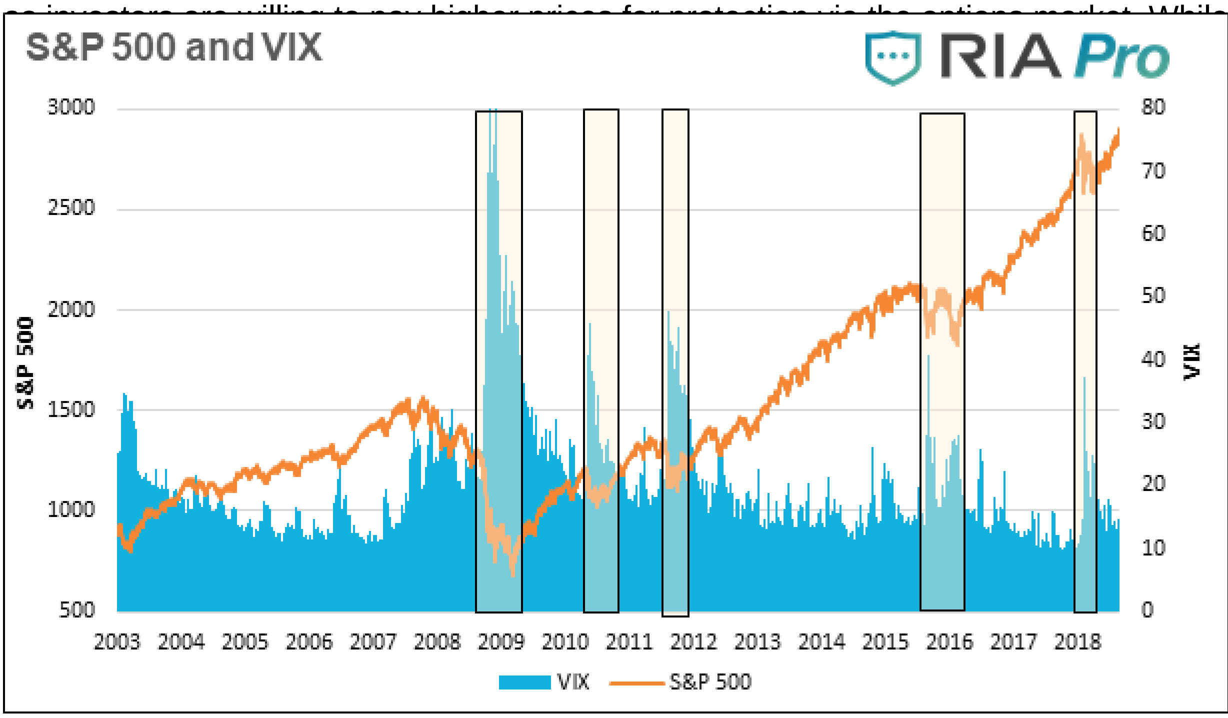
Following Signs Others Ignore : VIX

?In fact, the crowd sees hardly anything out there that might end this market party.? Michael Santoli made the above statement during CNBC?s closing market wrap on January 26th, 2018. He had reason to throw caution to the wind as the S&P 500 closed the day up by more than 1%, setting another record high. In the first 18 trading days of 2018, the S&P 500 set 14 record highs and amassed a generous 7.50% return for the year. As quoted, CNBC and most other financial media outlets were exuberant over the prospects for further gains. Wall Street analysts fell right in line. Despite the fact it was not even February, some Wall Street banks were furiously revising their year-end S&P 500 forecasts higher. On January 27th, the S&P 500 closed down 0.70%, and in less than three weeks, the index fell over 10% from the January 26th high. Very few investors harbored any concern that the rare down day on the 27th was the first in a string of losses that would more than erase 2018?s gains to that point. Looking back at the January swoon, there were a few indicators that CNBC, others in the media, and those on Wall Street failed to notice. In mid-January, we noticed an anomaly which proved to be a strong leading indicator of what was

ultimately to transpire. The purpose of this article is to re-introduce you to this indicator, as it may once again prove helpful. We?ll also remind you why ignoring media and Wall Street driven hype is important.

VIX

VIX is the abbreviation for the Chicago Board of Options Exchange (CBOE) Volatility Index, which gauges the amount of implied volatility in the S&P 500 as measured by pricing in the equity options market. When optimism runs high, investors tend to seek less downside protection and as such VIX tends to decline. Conversely, when markets are more fearful of the downside, VIX tends to rise as investors are willing to pay higher prices for protection via the options market. While not a hard

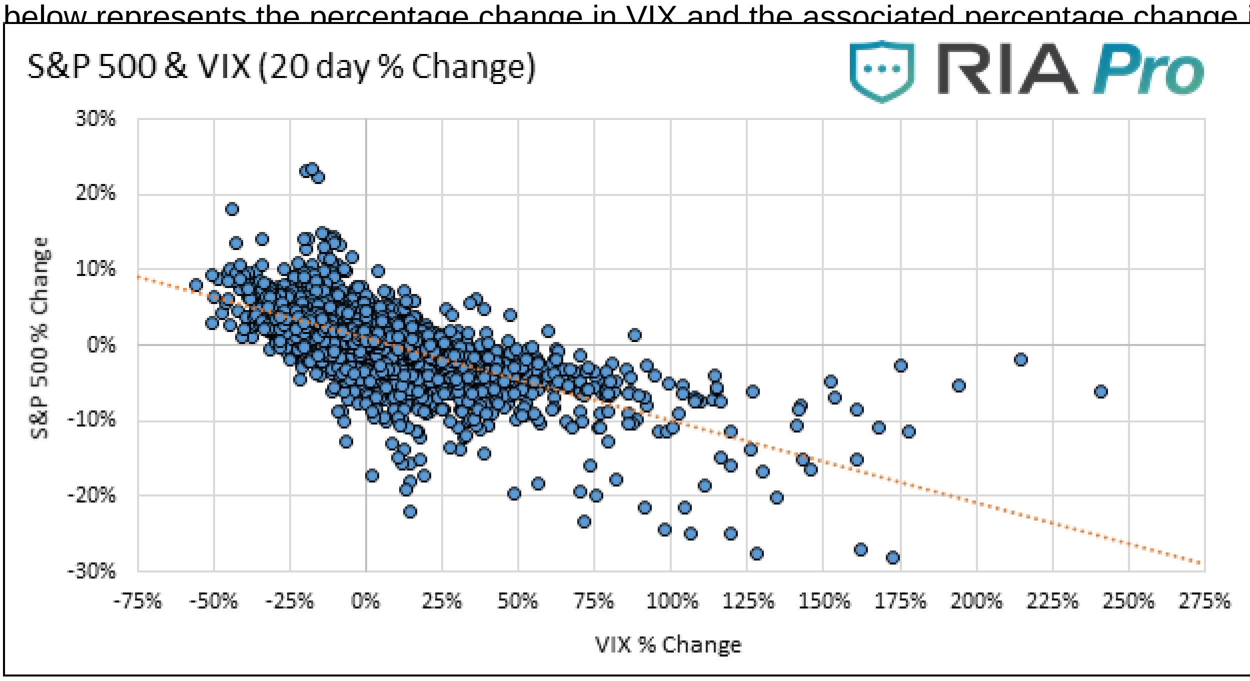


s. This

wdowns

Data

Courtesy Bloomberg Another way to show the relationship is with a scatter plot. Each dot in the plot below represents the percentage change in VIX and the associated percentage change in the S&P



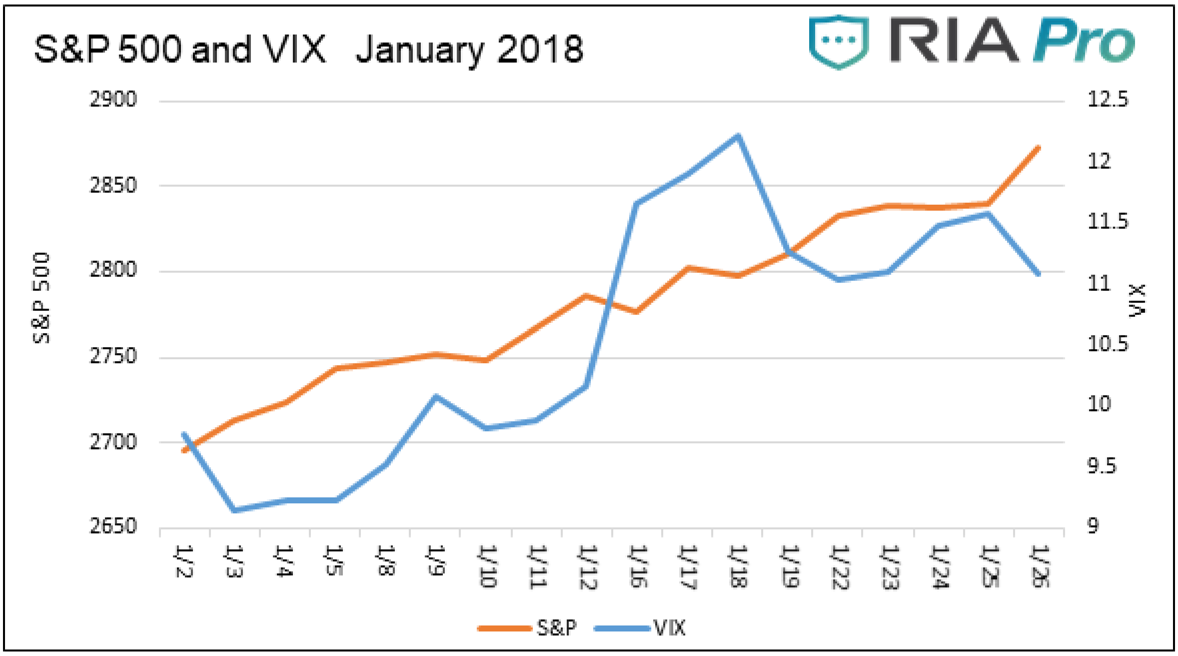
n generally

turns and

Data

Courtesy Bloomberg

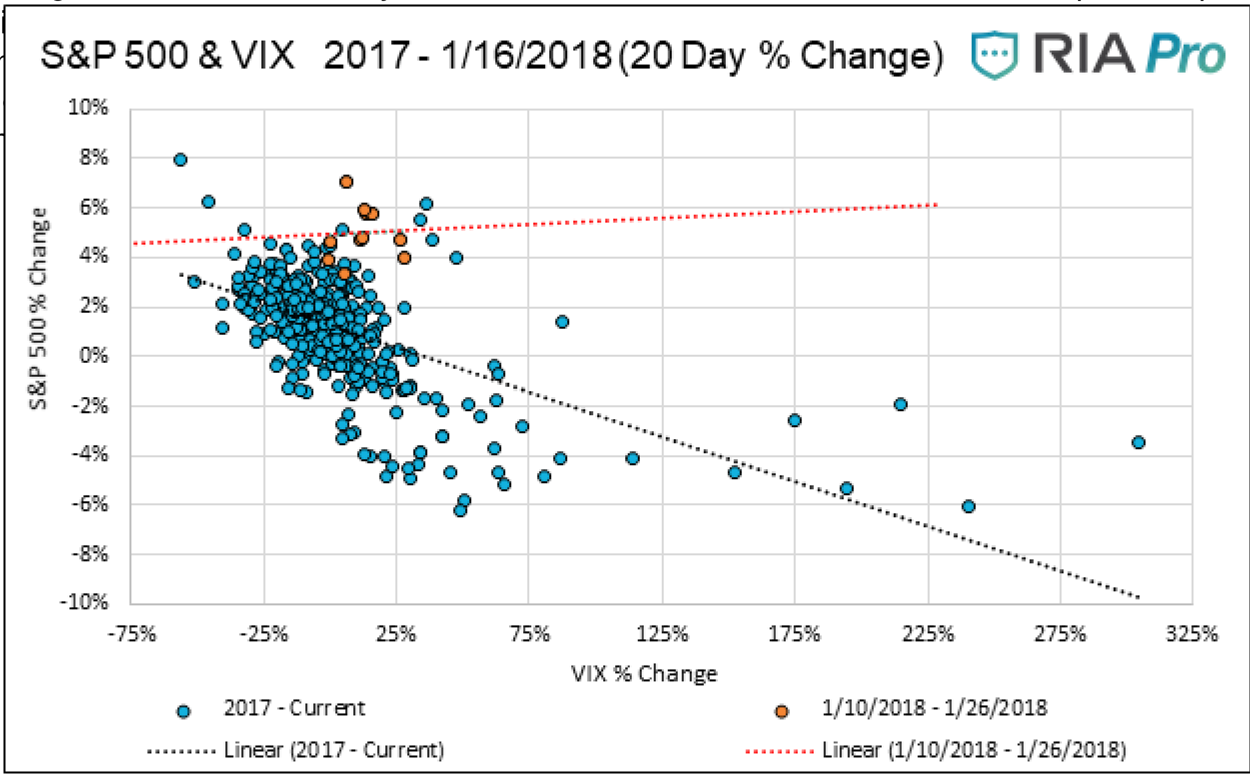
January 10th-26th



we return to and the S&P

Data Courtesy

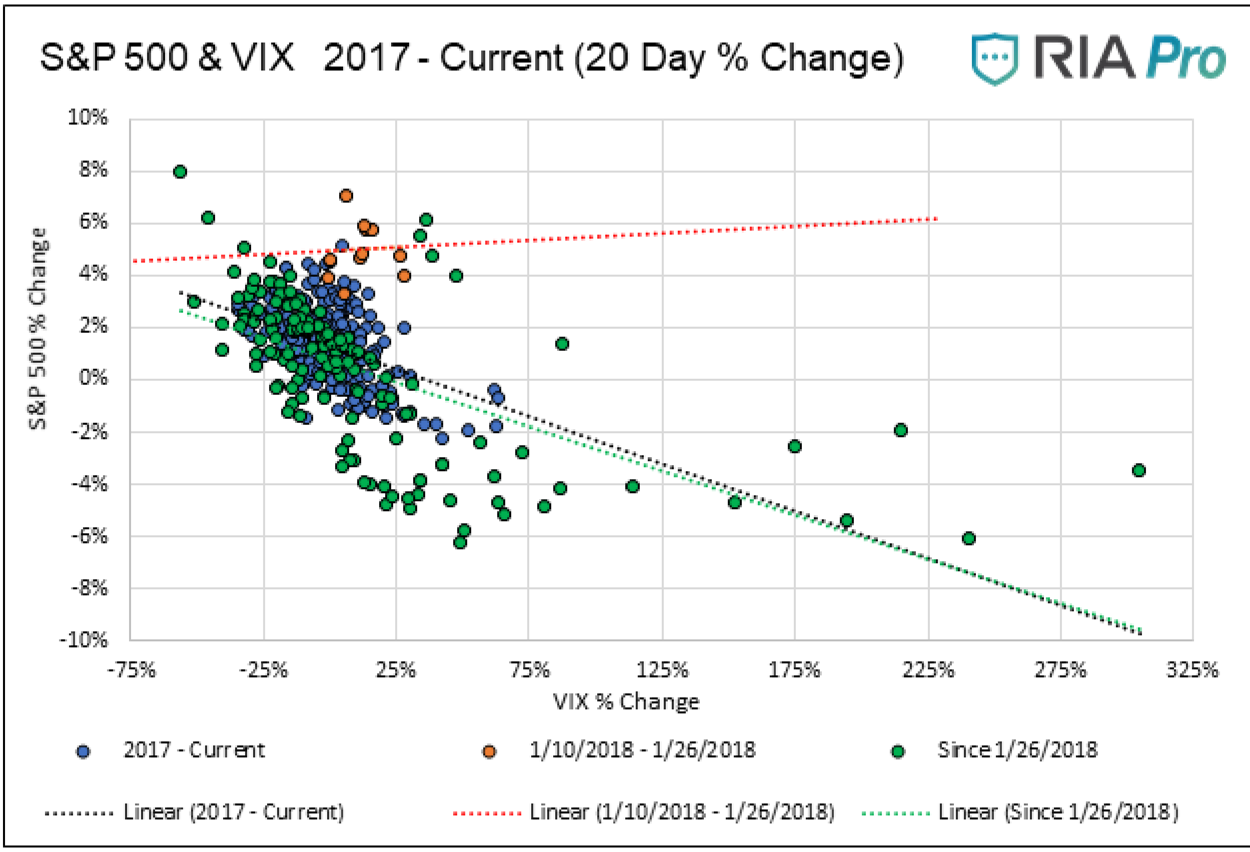
Bloomberg The obvious takeaway is that the VIX and the S&P rose in unison. Despite a euphoric financi demar is diverg 10 th to th t



2018.

Data Courtesy Bloomberg From January 27, 2018 to early March, the VIX was trading over 20, twice the general level that prevailed in early January and throughout most of 2017. The elevated VIX and weak market resulted in a normalization of the typical inverse relationship between

nd green
malization



Data

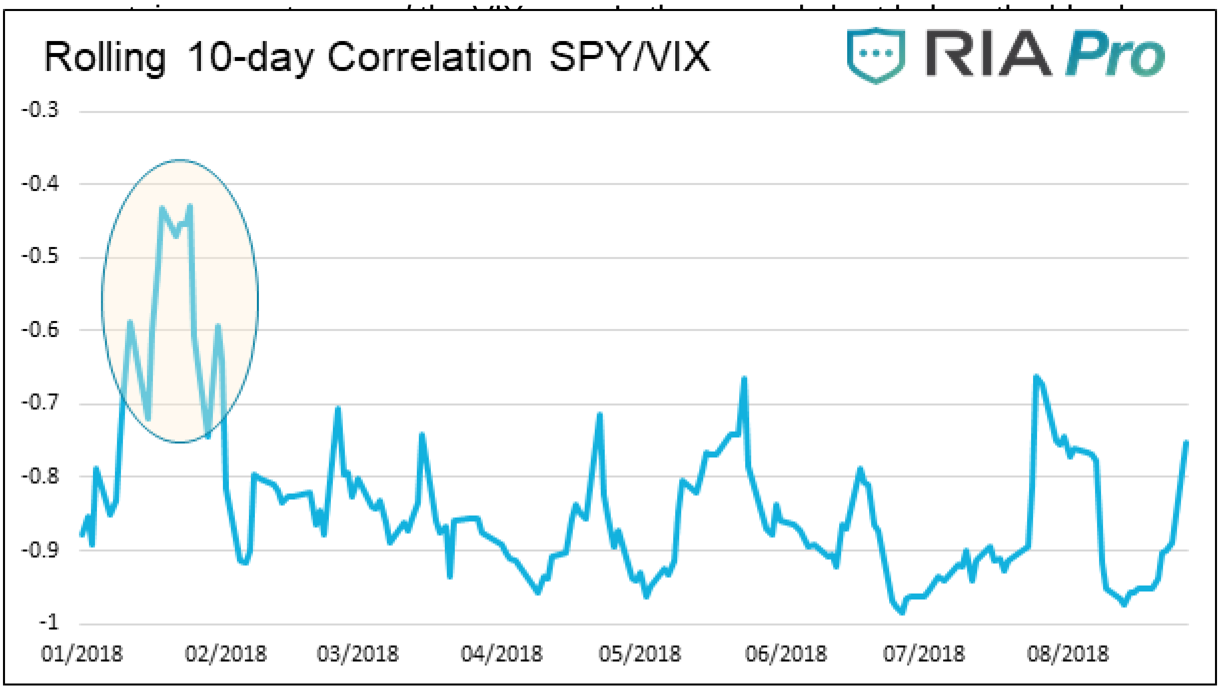
Courtesy Bloomberg

Tracking VIX

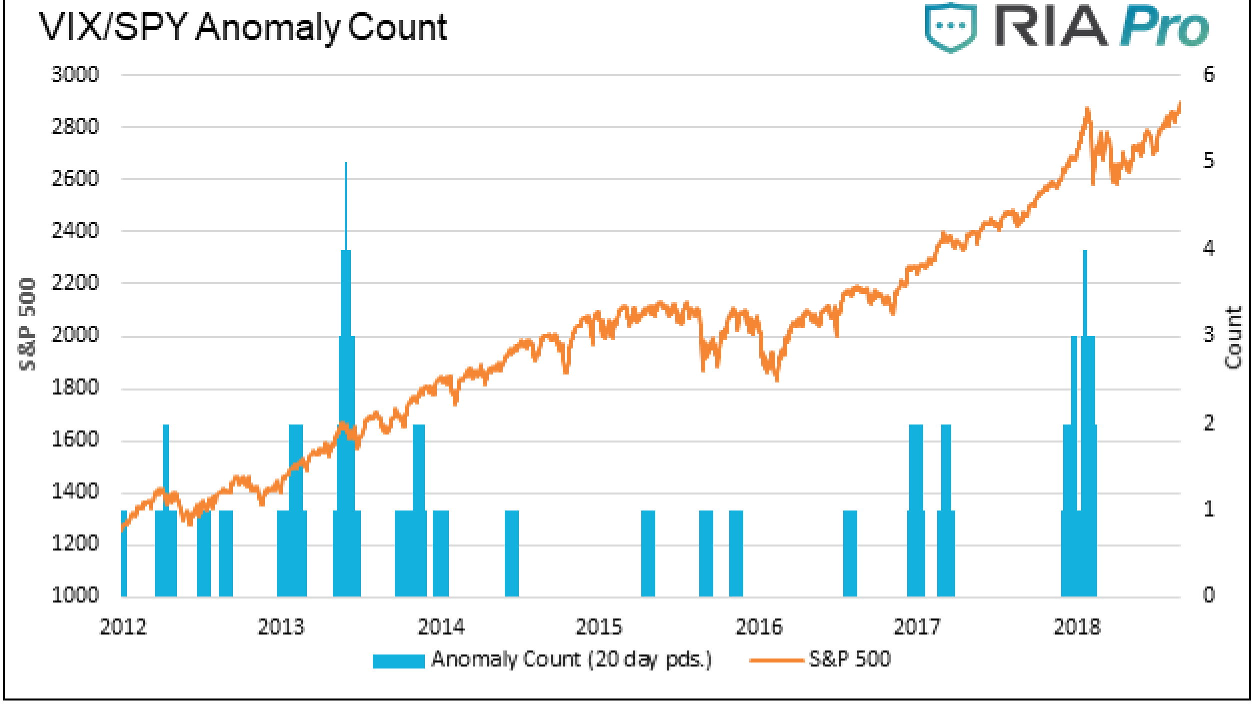
In addition to identifying the relationship as we did in January, we must monitor this relationship going forward. We show two additional metrics for VIX and S&P 500 below that we created to alert us if the typical inverse relationship changes.

- **Running Correlation**: Calculates the correlation between the VIX and the S&P 500 on a rolling 10-day The highlighted area on the line graph below shows the departure from the norm that occurred in mid-January.
- **Anomaly Count**: Counts the number of days in a period in which the S&P was higher by a

present the
than .50%



Data



Data

Courtesy Bloomberg

Summary

Markets do not suddenly drop without providing hints. As we discussed in our article 1987, the devastating Black Monday 22.60% rout was preceded by many clues that investors were unaware of or, more likely, simply chose to ignore. Currently, most technical indicators are flashing bullish signals. Conversely, most measures of valuation point to the risk of a major drawdown. This stark contrast demands our attention and vigilance in looking for any data that can provide further guidance. The VIX is just one of many technical tools investors can use to look for signals. We have little doubt that, when this bull market finally succumbs to overvaluation and the burden of imposing levels of debt, clues will emerge that will help us anticipate those changes and manage risk appropriately.