Special Premium RECO : Volatility

Like Odysseus in the epic poem the global economy is trapped between the monsters of Scylla and Charybdis. We risk one to avoid the other. From one world's end to the next sometimes I wonder if decades from now we will look back with the hindsight that we were all hedging the wrong tail.

Today the existential fear of world's end deflation *(see our previous comment* **) is so powerful investors are willing to pay the highest prices for portfolio insurance in nearly two decades.** The market for forward volatility has become unhinged as the SPX variance and VIX futures curves sustain historically high premiums over low spot vol.

My argument is not that this extreme fear is misplaced but that it is mispriced.

I have been arguing for a while that the injection of huge amounts of QE-money into the system — the equivalent of a giant put option – has undoubtedly had an impact on volatility markets, and most likely in ways we don't really understand. *Yet.*

I can't tell you if hyperinflation will ever occur but what I do know is that the single most undervalued asset class to hedge against this rare event is volatility itself

Volatility, as measured by the CBOE Volatility Index (VIX), provides us a gauge of fear in the stock market. The VIX measures the market's expectation of stock market volatility over the next month. It represents a weighted blend of prices for a range of options on the S&P 500 index. As the market begins to price in higher volatility, premiums on S&P 500 options rise. Theoretically, as S&P 500 prices show increased volatility, option premiums rise. Therefore, the VIX becomes a bit of a lagging indicator.

I like to use it as a confirming indicator, however, as it tends to trend higher in bear markets and lower during bull markets. Many popular technical analysis tools designed to help traders with indexes and stocks simply don't work when analyzing the VIX. Why? Because volatility rises and falls very quickly based on investor mentality. The use of moving averages is rendered almost useless.

The key for me is whether the VIX confirms the trend taking place on the S&P 500. Think about it. If the pricing of the VIX is based on the behavior of options that track the S&P 500, then it makes sense that the VIX should follow the S&P 500. It actually follows it INVERSELY. When the S&P 500 drops, fear in the market rises. That sends the VIX higher, reflecting this expected increase in volatility. Therefore each new low in the S&P 500 should be accompanied by a higher VIX - in theory. And a new high in the S&P 500 should be accompanied by a lower VIX - again, in theory.

The two don't always move together, however, and that's where we can glean some possible clues to help us from an S&P 500 directional standpoint.

Take a look at recent action in the VIX and the accompanying price action in the S&P 500:

As expected, the VIX continued to fall with every movement higher in the S&P 500. This makes perfect sense because volatility tends to dry up during a period of rising equity prices and this creates a narrowing of price movement. That's the general rule, although the late-1990s proved to be one exception. But as you look at the VIX chart above, note that the last rise in the S&P 500 was accompanied by an INCREASE in expected volatility (VIX).

Increases in expected volatility normally are associated with declining equity prices, so was it a precursor of a drop in the S&P 500? Well, hindsight is 20/20, but we do know

there is a clear relationship between the movement in the S&P 500 and the behavior in the VIX so, if nothing else, it should have at least raised a few eyebrows.

I indicated above how the moving averages tend to prove virtually useless when trying to determine which way the VIX is heading. As an illustration, check this chart out:

I've highlighted (red circle) the late-March and early-April period as it shows how many false signals you can receive in a very short time frame. Instead, focus on the overall TREND in the VIX - that's what I use to determine whether the VIX is confirming price behavior in the S&P 500 or suggesting that a change in direction may occur.

The interesting part right now is that there's been significant rotation into defensive areas of the stock market.

For the month of April alone, utilities, healthcare and consumer staples have all gained more than 3%, while energy, materials, industrials and technology have all lost more than 3%. That's more than a 6 percentage point swing in just three weeks between these two very different groups of stocks.

Clearly, traders are nervous as they're willing to commit to equities, but only the defensive groups. Defensive sector outperformance should be interpreted as increased fear by market participants.