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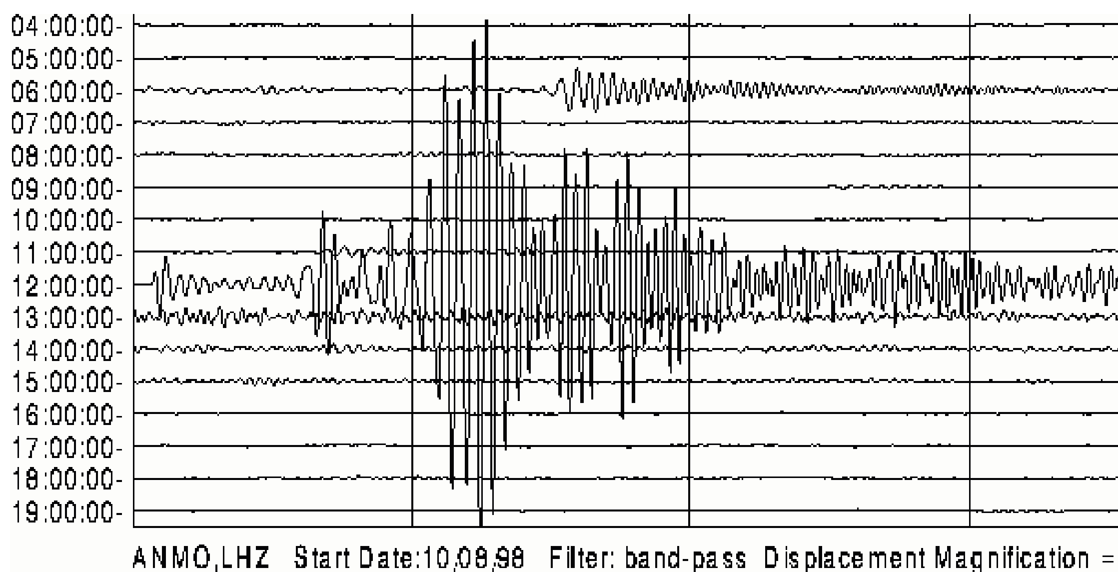


(Volatility) Regime change?

By Kambiz Kazemi Linked in profile ***October 26th, 2018***

A quick note to underline the fact that from our perspective – in light of the indicators and measures we follow on options and volatility across multiple asset classes and our qualitative appraisal of uncertainty levels – we see a high likelihood that we are entering a new a regime in risk pricing.

This does not mean that we are specifically bearish, rather we expect general level of volatility be higher going forward for a protracted period of time: i.e. the low levels of VIX that we saw in particular in 2017 are/will be reset higher, establishing for instance a higher floor and wider range for S&P500 volatility potentially a 15-25 range for the VIX. For now, this reset, is mainly confined to equity markets but we see a potential that risk measures move higher in other markets, in particular currencies and select commodities.

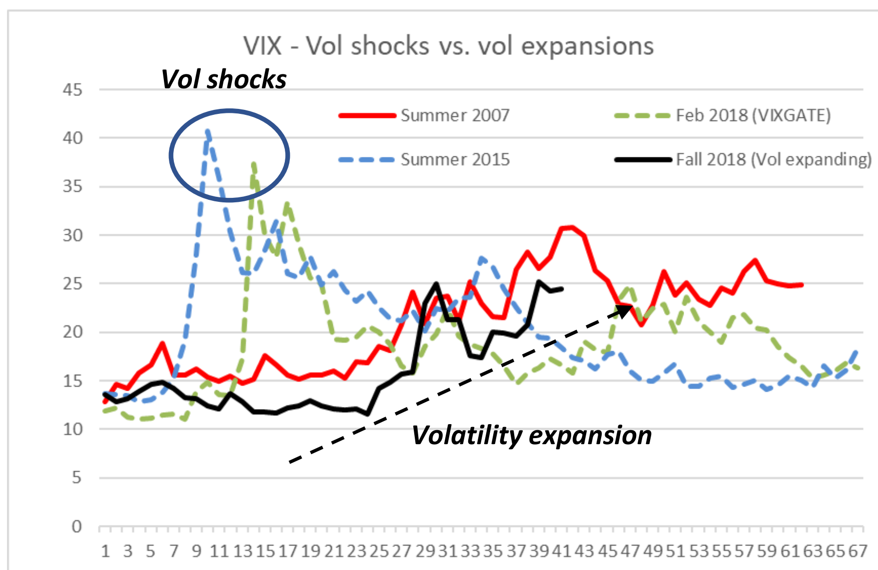
For the purpose of brevity, in this note we will not expand in detail each observation or argument but we are happy to discuss these in detail on a one on one basis.

Here are 3 main observation that comfort us in our view:

I. Markets are witnessing a "volatility expansion" not a volatility shock

The chart below shows the difference of volatility expansion (now and in summer/fall 2007) vs. a volatility shock as we witnessed in summer of 2015 or last February.

Essentially volatility has been "trickling up" over the last few weeks. This has been accompanied with a sustained higher range of intraday moves over a period of weeks. This is in contrast with episodes of abrupt volatility shocks, which are usually due to unexpected events such as the Renminbi depreciation in summer 2015 or the VIX ETP episode of Feb 2018 during which market movements are sudden and they subside quite quickly thereafter. Volatility shocks have conditioned market participants to further trust the "buy the dip" approach. This latest episode does not have the hallmarks of a volatility shock and investors who at first had the "old" (though only a few years old) reflexes are now most probably reviewing their thought framework.



II. The sell-off has been (so far) orderly

It is well-known that when the market goes down the VIX rallies. If we look closer we see that the sell-off since early October has been rather orderly in the sense that the VIX has not been rallying in a panic, i.e. investors have not rushed to buy options to hedge their portfolio. That could be explained by combination of these facts:

- They had some hedges in place before the correction.
- They were/are not overly concerned about the sell-off.
- The sell-off has been "progressive and orderly" as opposed to a sudden drop, providing them with sufficient time to adjust their exposures.

To illustrate this point, the table below shows how many % points the VIX rallied vs. the % drop of S&P500 in recent (albeit rare) market corrections.

	S&P drop	VIX rally	Ratio
Sum'07	-8.1%	141%	-17.3
Sum'15	-12.2%	194%	-15.8
Feb'18	-5.5%	213%	-38.9
Oct'18	-9.6%	104%	-10.8

Low ratio = Increase in VIX has been very muted compared to the drop in S&P500

So far this month VIX has only doubled for a 10% drop in S&P500. In the historical context, this is very muted jump in VIX for the extent of correction in the S&P500, specially when compared to volatility shocks: in the summer of 2015 the VIX tripled for a 12% drop in S&P500). There has been a lack of panic. Though there is no guarantee that should we see a further leg down, investors would still react in a similar manner.

III. Market up and volatility up

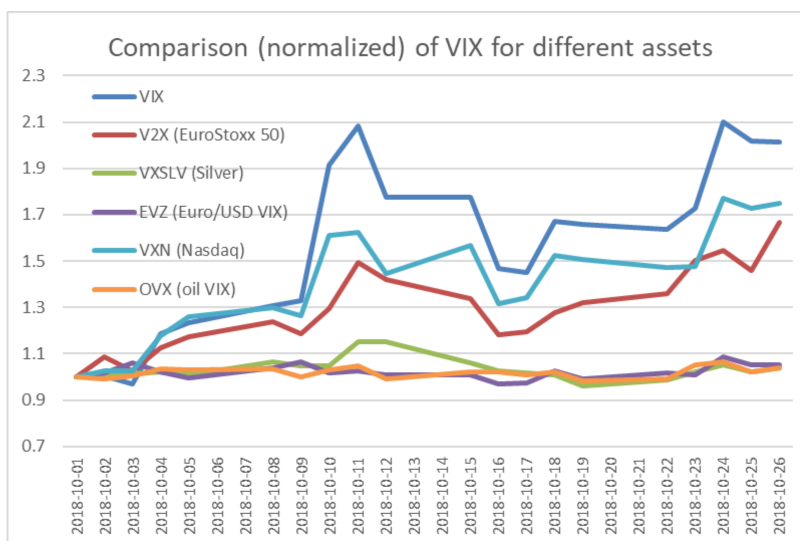
In the present market correction, we have also witnessed a rather rare behavior. On various days when the S&P500 rallied, the VIX barely went down and was even up on a day when the market was up. This can be interpreted as the fact that option market makers expect that the market will continue to exhibit intraday volatility, both to the upside and to the downside (reminder: a 20% VIX level corresponds to a 1.25% per day close-to-close over the coming month). As a result, they are not willing to position themselves for a drop of the "actual" (i.e. realized) market volatility in the short-term.

This observation once again, speaks to the fact that a new (higher volatility) regime is likely upon us.

A snapshot of "risk-land"

Let's have a look at risk pricing (i.e. volatility) on other assets. As the chart below shows that the VIX has expended the most relative to risk on other assets and geographies since October 1st. While VIX has double, the "VIX" for crude oil, Euro/USD currency or silver is virtually unchanged.

Europe's EuroStoxx50 VIX (called V2X) which usually trades at a premium to VIX has also not expanded as much in relative terms.



This brings us to the conclusion that should the underlying stress in the US equity market continue and risk perceptions move higher, then other asset classes offer a more interesting risk/reward for hedging as volatilities could expand from this near all time low levels.

Where to?

While we seem to be at the onset of a new volatility regime, the mid-term elections are a key factor that can affect its speed and evolution. Should the Republicans win control of Congress, one could expect that it will be well-received by the risk markets. Expect some volatility even in this scenario – potentially to the upside - but the volatility expansion which has started could be muted or somewhat reversed if the market perceives that President Trump has free reign to push a (business/deregulation friendly) legislative agenda with the GOP controlling both houses.

However, the underlying dynamics that have led us here will most probably be unchanged – higher rates, being near high of the economic cycle and growing concerns by politicians and market participants alike on the increasing evidence of effects of the White House international politics and trade policy. This will only push back the dynamics of this volatility regime change into the medium-term.

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La Financière Constance Inc
1010 Sherbrooke Ouest, Suite 1800
Montréal, Qc, Canada, H3A 2R7
T: (514) 286-9838

Constance Financial Inc
3080 Yonge Street - Suite 6060
Toronto, ON, Canadam M4N 3N1
T: (647) 255-8894