Opinion

Why Wall Street's fear index remains calm

The Vix index is a 30-day measure and does not give weight to long-tailed risks

The Exchange

Traders at work in the S&P 500 options pit at the CBOE © Getty

8 HOURS AGO by Dambisa Moyo

For the past several weeks the Chicago Board Options Exchange volatility index has hovered at notable lows. The Vix measures the turbulence of a wide range S&P 500 index options, and reflects the market's expectation of a 30-day period. It is often used as a proxy for the level of "fear" in the financial markets and influences asset prices.

At a time of considerable geopolitical and economic uncertainty — the threat of an attack by North Korea, instability in Venezuela and its effects on global oil prices, Europe's perennial political discord and policy uncertainty (trade protectionism and a failing legislative policy agenda in healthcare and tax reform) in the US — many market participants are puzzled that the Vix is trading at around 10, against a historical average of about 20. The broader uncertainty in the global economic and political backdrop implies the Vix should be higher.

At least three reasons could explain why the index remains relatively calm.

First, high-frequency trading, which utilises technological tools and computer algorithms to rapidly trade financial securities, has narrowed the band between where traders can buy on dips and sell on

highs, so there is little scope for asset volatility to break out.

Second, the index may be low because global economic conditions are benign to constructive. In particular, US gross domestic product forecasts remain firm — pointing to 2.2 per cent growth for 2017, China and Europe are growing either modestly or better and, more generally, the International Monetary Fund and World Bank have recently revised global GDP estimates upward. Underlying economic data on the real economy are less volatile than over the past recoveries, and this is reflected in the financial markets.

However, the Vix's 30-day measure means it does not give appropriate weight to longer tailed risks, thereby discounting possible concerns such as an unsustainable debt burden, escalating population growth and the potential political consequences of worsening income inequality.

Third, because interest rates remain historically low and credit is tight, market participants believe that turbulence will remain low. In order to earn income in such an environment, traders are buying structured instruments that offer an attractive headline income but whose underlying form leaves them short volatility whether they realise it or not, and keeps the Vix low

There is a considerable danger that financial asset prices (including, stocks and bonds) are discounting volatility and risk, and so are overpriced. In such a scenario, if the Vix were to recalibrate more appropriately to reflect the manifold risks to the global economy, many assets could sell off considerably.

More specifically, a pick-up in volatility of the underlying real economy factors that drive asset prices and financial markets — such as rising interest rates, GDP, earnings or inflation — would drive up the turbulence in financial assets and cause people who are short volatility to lose money.

When such investors begin to incur losses from their portfolio positions their likely reaction will be to sell the assets that are short volatility, and because these investments have been a key driver in the buying power that has supported the stock markets, the selling pressure is likely to force the markets down.

Essentially, a reversal in the buying power that has pushed many bourses to record highs could cause a considerable correction in asset prices.

The writer is a global economist and the author most recently of 'Winner Take All'. She serves on the boards of Barclays Bank, Barrick Gold, Chevron and Seagate Technology

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