

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com

Christofer.Langner@bankfab.com

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Volatility is on its way down, but it may become more volatile

◆ The VIX CBOE Volatility index jumped 26.5% on Thursday as the Nasdaq 100 tumbled 5.2%.

◆ VIX futures suggested the index would rise again today as US equity futures pointed at a weaker open.

◆ However, history suggests that volatility is likely to move lower over the next months because of low interest rates and excess liquidity.

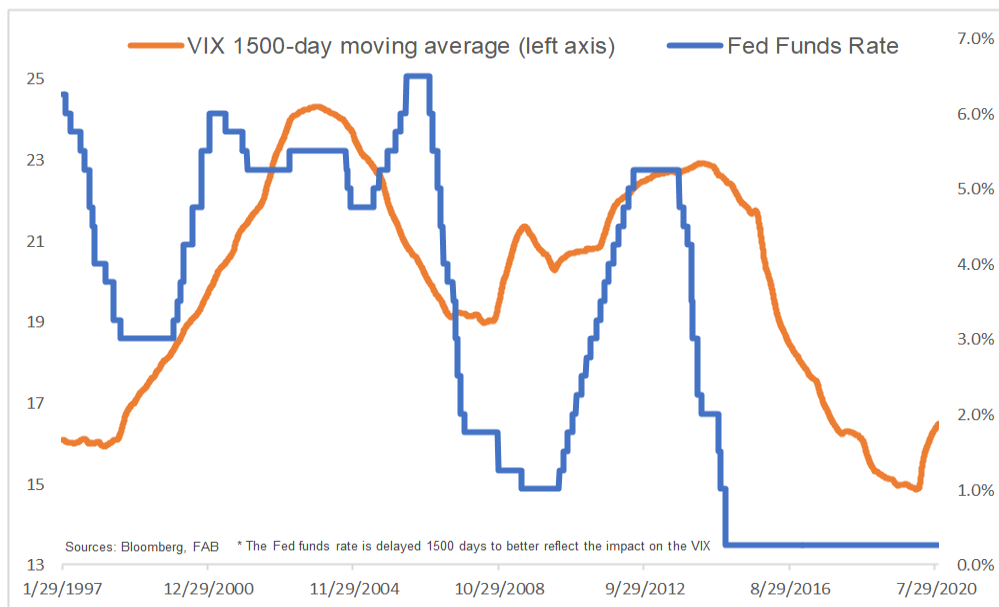
◆ During the decade of near-zero rates in the US, following the 2008 financial crisis, volatility fell markedly, but the number of sudden sharp moves in the VIX increased tenfold.

◆ The FAB AAC remains underweight equities while favouring gold and investment-grade debt.

US stock market futures were pointing at a continuation of what happened towards the end of last week as Wall Street returns from the Labor Day holiday. The VIX CBOE Volatility index, in particular, was trading at 35.48 at the time of writing, its highest level since late June.

While the spike in the VIX has vindicated investors who were expecting big market swings ahead of the US presidential election, and could continue today and for a while still, it may be premature to say that high volatility will be the new normal. In fact, if history is any guide, the opposite could be true.

Amid near-zero rates, the VIX dropped steadily after the 2008 financial crisis. Between March 2010 and that month in 2019, the VIX averaged 17.00, compared to 22.00 in the previous decade.



By January 2018, the index was trading at all-time lows of 9.1, before expectations of higher interest rates sent it soaring that year. On the flip-side, the 82.69 print on 16 March was the highest in the index's history. It has come down a lot from that, but even at the recent low of 21.35, marked on 17 August, the VIX remains higher than anytime in the year of 2017.

In simple terms, the overall direction for volatility should be down from here. However, something else changed in the period of low rates following the 2008 financial crisis. The number of times that the VIX had very sharp moves skyrocketed. To be precise, there were 10 times more two standard deviation moves in the VIX in the past 10 years than there were in the previous decade.

Hence, the volatility of the VIX increased. And that is likely to happen again. So, while investors can look forward to lower volatility generally, they also must brace for more frequent volatility events.

The VIX's long-term average has fallen with rates, but spikes are now more common

For investors, that usually means two things: being able to ignore occasional sell-offs, no matter how sharp they are, or learning how to take advantage of these moments to increase returns.

Ignoring the noise is always good for long-term investors. People who started the year invested in the NASDAQ composite index, for instance would be up 26% year-to-date, as long as they did not panic and sell their holdings in March.

Meanwhile, those who bought the same NASDAQ on 23 March, the recent nadir, would have gained nearly 65% so far this year. To be sure, timing the market is very difficult, so investors are usually better off just ignoring the noise and knowing that things are likely to get better eventually.

Investment Strategy Update

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