Thackray Report

Get Ready for Volatility

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Stock market volatility on a seasonal basis tends to increase in August and September, into October. Recently, stock market volatility has been declining, but could be setting up for a spike higher in the near future.

There are a number of ways to measure volatility. The bellwether measurement that Wall Street uses is the CBOE Volatility Index (VIX). The VIX uses S&P 500 equity option pricing to establish an expected level of volatility for the S&P 500 in the next thirty days. A higher value in the VIX indicates that investors are expecting greater volatility in the stock market and vice versa.

The VIX is often called the fear gauge as it helps to indicate investor sentiment towards fear in the markets. Over the long-term, from 1990 to 2020. The average value of the VIX has been 19.5. In more recent years, the average value for the VIX has declined. From 2016 to 2020 the average value of the VIX has been 18.

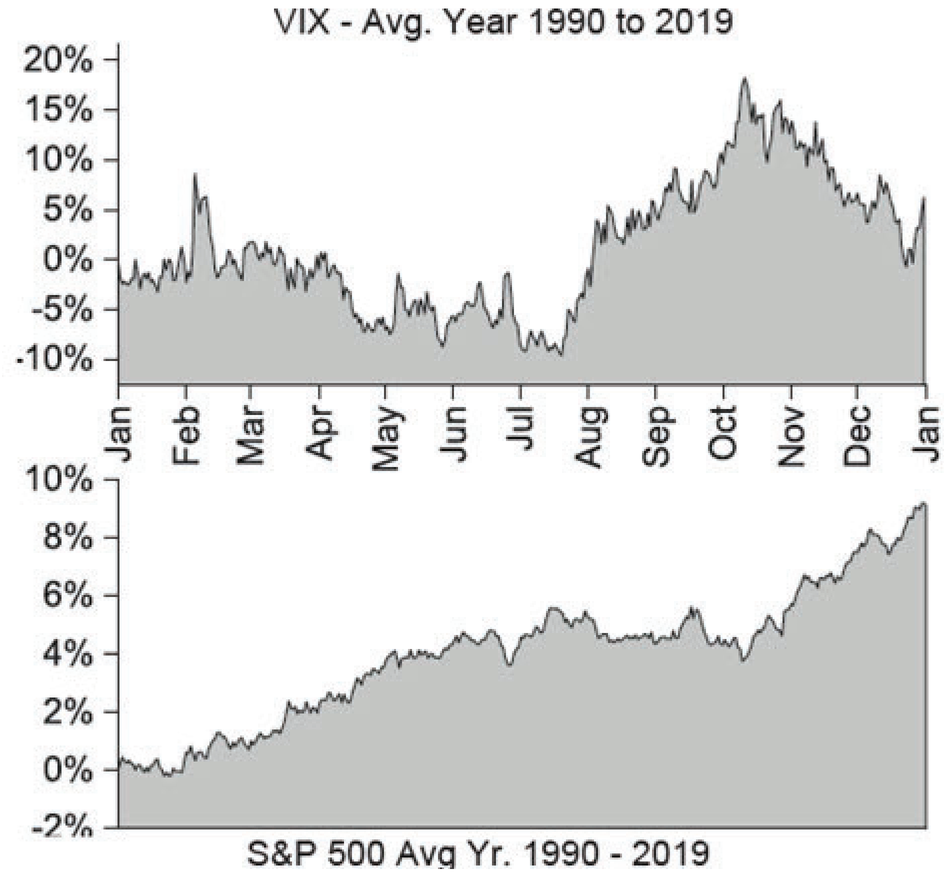
Investors tend to use the 20/40 rule for the VIX to help establish the condition of the stock market. A VIX above 20 typically indicates that the stock market has an increased probability of heading lower. If the VIX manages to get to 40, then this often indicates that the stock market has become oversold and indicates a good buying opportunity. Levels below 20 are viewed as favorable for the stock market to move higher. However, when levels get to 10 or lower (which is a fairly rare occurrence), it is viewed that investors have become very complacent and the stock market is in a state of fragility and could suffer a major setback with a negative catalyst.

After the VIX has spiked close to 40, it can take some time for the VIX to work its way back to a level below 20 as investors have to recalibrate. Large stock market returns can be made in the process of the VIX returning to normal levels. It is the direction of the VIX that is important. Declining volatility typically leads to higher markets and vice versa.

So, where does the VIX stand today? After a sharp peak in volatility in March of 2020, the VIX has been "stair-stepping" down in a channel and currently is just below 20. In other words, it has moved back to levels close to "normal." The VIX has now created overhead room to run higher on any negative catalysts.

On a seasonal basis, volatility tends to increase in the late summer into autumn. This trend coincides with the stock market tending not to perform well during this time period. On average, over the long-term, the stock market tends to perform poorly in August and September. In fact, these two months are the worst two contiguous months of the year. Of course, in any one year, the stock market can perform well in this time period.

The graph below shows the general relationship of an inverse correlation between the VIX and the S&P 500. The VIX tends to decline when the S&P 500 is rising and vice versa. The VIX on average tends to bottom in July and peak in mid- October. In my *Thackray's 2021 Investor's Guide* I indicate that the VIX has risen 73% of the time between July 3 and October 9, from 1990 to 2019.



Currently, the VIX is in its normal range which is indicating that investors are not particularly concerned about a stock market correction at this time. Given that the stock market is at record valuations and the growth in the economy appears to be decelerating, a negative catalyst for the economy or stock market could push the stock market into a correction, despite continued stimulus from the Federal Reserve and government. Now that the VIX has reached a more normal level, directional changes in the value of the VIX will probably assist in determining the direction of the S&P 500. Given that the VIX tends to increase at this time of year, it is particularly important to monitor at this time. If the VIX were to move above 20 for more than a few days, this would increase the likelihood that the stock market could be starting a correction in its weak period in August and September.