

WHAT DOES THE VIX TELL US ABOUT HOW THE STOCK MARKET IS GOING TO PERFORM

The Volatility Index, otherwise known as the VIX, is an index which measures expectations of volatility, or price fluctuations, for the S&P 500 Index. These measures of expectations are what the market thinks about what will transpire in the next 30 days relative to this volatility. Volatility means the rate at which the price of a certain security moves, and as such volatility therefore becomes a measure of risk.

Since the assumptions about volatility are measured through the prices of near-term S&P options, there has been tremendous participation in the options of the SPY, which is a unit investment trust that represents all 500 stocks in the S&P 500 Index and traditionally trades at 1/10th the price of the underlying SPX itself. For instance, with the SPX at 1280, the SPY will trade very close to 128.

The VIX in reality measures the cost of buying put options on indexes that represent the S&P itself, such as the aforementioned SPY, which can also be traded just like a stock itself, or on the SPX index, which cannot be traded, or the S&P futures contracts, which are traded on the Chicago Mercantile Exchange.

The most important thing to remember about the VIX is that it moves inversely to the direction of the stock market itself, and this was illustrated when the VIX rose to its all-time high on October 24, 2008 at 89.50, just at the depths of the financial crisis. Before this high, it reached about 50 in July 2002, just as the market was crashing to the lows after the bursting of the Internet bubble, which caused the major averages to reach what were then record highs in March 2000. During the depths of the European debt crisis last spring, the VIX also reached close to the 50 level as the stock market corrected 17% off of the late April highs.

So in other words, the VIX is a contrary indicator, meaning that when “fear” as represented by these high prices for the VIX is at its most extreme and investors are buying these SPY and SPX puts for supposed “downside protection”, a really astute investor should take advantage of this panic selling in stocks to initiate buy positions at the lower prices that the market is making available to you.

Conversely, when the VIX gets too “low”, and what is low is a bit difficult to quantify exactly, one should consider lightening up on long positions as this “complacency”, the opposite of the “fear” that is represented by high prices for the VIX, means that stocks are vulnerable to some sort of downside correction. We saw this in late April 2010 when the VIX got down to around 15.3 and also last week, when the VIX also reached close to this level. Both times, the market sold off.

On the other hand, there can be periods of really extended low prices for the VIX, all the way down to 10, but no lower, and we saw this during the relatively calm period from 1993 to 1995 before the market started to spurt upward, which meant at the same time that there were also sharp downside corrections. We also saw low levels for the VIX during the 2003 to 2006 period as well, which was also a steady period before the move to all-time highs in the S&P in October 2007, and this also began a period of greater volatility as well.

Disclosures

Don Selkin is the Chief Market Strategist at National Securities Corporation, member FINRA/SIPC, (NSC) and provides the Fair Value analysis for CNBC each morning. The commentary provided in this Market Letter is intended to provide our customers with timely market analysis and should not be considered a research report. This Market Letter may contain, and is limited to: Discussions of broad based indices; Commentaries on economic, political or market conditions; Technical analyses concerning the demand and supply for a sector, index or industry based in trading volume and price; Statistical summaries of multiple companies' financial data, including listings of current ratings; and, Recommendations regarding increasing or decreasing holdings in particular industries or securities. This Market Letter does not make a financial or investment recommendation or otherwise promotes a product or service of the firm. This Market Letter contains only news, facts, and commentary on information previously reported from a news source believed to be accurate and reliable by the author. These news sources include the following: {Bloomberg Financial, Reuters, Associated Press}. It is possible that at any given point in time, the author, NSC, or one or more of its employees or registered individuals associated with NSC, may hold a position, either long, or short, as well as options, bonds, or other instruments in the companies noted in this report. This Market Letter is intended strictly for current National Securities Corporation customers only.