

ASX and Wall Street fall: investors should start to worry when volatility seems low

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Rewind to last week and the volatility index, or VIX, actually predicted low levels of volatility in the share market over the coming 30 days. But the subsequent falls in the Australian and United States share markets should serve as a reminder of the risk of being complacent.

Prolonged periods of low volatility provide ample opportunity for investors to become complacent about risk, and increase the prospect of sharp market corrections. This is certainly what [my research has discovered](#) . I found buying stocks when investor fear is highest, and selling when it is lowest, can be a profitable trading strategy.

Read more: [Explainer: why stock market panic can signal a good time to buy](#)

Now the US S&P 500 index has fallen by over 6% since Thursday (wiping over US\$1 trillion from stock values), the VIX index has more than doubled and now sits at 37.32. While this is the highest level since August 2015, it's still well below the high of 80.06 we saw during the global financial crisis.

The trigger for this surge in investor fear in the US was Friday's release of employment data there. Typically, this [stronger than expected data](#) would be good for stocks. However, this news follows indications from the Federal Reserve that [further rate hikes are likely](#)

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The market has taken strong wage growth as a signal of inflationary pressure, which may lead to more dramatic policy tightening. This is consistent with [prior research](#) that suggests the market response to economic news depends on the business cycle.

Unfortunately, owing to reliance on exports to fuel its economy, the Australian market is not immune to what happens in the US. The All-Ordinaries has fallen by 4% (equivalent to nearly

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A\$90 billion of value) and the A-XVI (an Australian fear gauge) has jumped by 60% in two sessions.

Due for a correction

As of the end of January, the US S&P 500 were 320% higher than at the peak of the 2008 financial crisis, having increased 25% in the past year. While the Australian market has lagged, following the end of the commodity boom, the All-Ordinaries is still 98% higher than in 2008 and 8% higher than at this time last year.

Over the same time, the VIX index has been able to shrug off the affects of a rising geopolitical risk – such as President Trump’s tiff with North Korea.

Over the past year, VIX has averaged just 11.06. This [indicates](#) that in the next 30 days the market expects prices to rise or fall by 6.3% (on approximately 95 days out of 100). This is lower than the average of 14.9 for the prior year, and 18.8 over the past 15 years.

While the VIX has continued to predict low levels of volatility in the near-term (it ended Thursday at 13.47), [researchers at the New York Federal Reserve](#) pointed out that the term structure of implied volatility suggested volatility will not remain low forever. The term structure shows how implied volatility varies for different time periods, and prior to Thursday this was upward sloping - indicating volatility would rise over time.

It’s difficult to predict when the current market sell-off will end, and after the large increase in values over the past few years it could be said that the market is due a correction. While the futures market is predicting further falls in stock prices (and VIX increases) in the near-term, the term structure (which is now downward sloping) is not predicting a lengthy period of volatility.

One risk could be that ongoing gridlock within US Congress leads to another US government shutdown, and associated geopolitical risk finally starts to feed into investor fear.

The lesson remains: investors should be wary when investor fear is low.

