Markets In Turmoil

SYNOPSIS

- The VIX is the de facto measurement for volatility in the stock market, and it is a mean-reverting index that tends to move towards its long-term average over time.
- Financial news networks are the only entities that benefit from watching the VIX over time.
- Volatility should be viewed as an opportunity, and by doing so an investor will realize that opportunities arise in financial markets all the time.

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A Powerful Chart

The Volatility Index (VIX) computed by the Chicago Board of Options Exchange (CBOE) is the de facto standard for measuring and tracking volatility. Investors often refer to the VIX to as the "fear gauge" of the stock market, and the chart below shows the VIX from 2007 - 2013.

Source: Bloomberg

VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets. Notice the three spikes in the chart that sent the VIX well above 30:

- **White Arrow:** This is the financial crisis of 2008, where volatility hit levels never seen before.
- **Red Arrow:** This represents the "flash crash" and the beginning of the European sovereign debt crisis.
- **Green Arrow:** This time period represents the U.S. debt downgrade during the summer of 2011.

Volatility is what mathematicians refer to as "mean reverting," which is a geeky way of saying that when volatility is really high, it tends to fall over time to its long-term average, and when it's very low, it tends to rise up to the same average value.

Up until today, the U.S. stock market had been eerily calm with the VIX well below its long-term average of around 20. History tells us that the VIX was to rise at some point, but timing these moves is impossible and not worth the effort to even try.

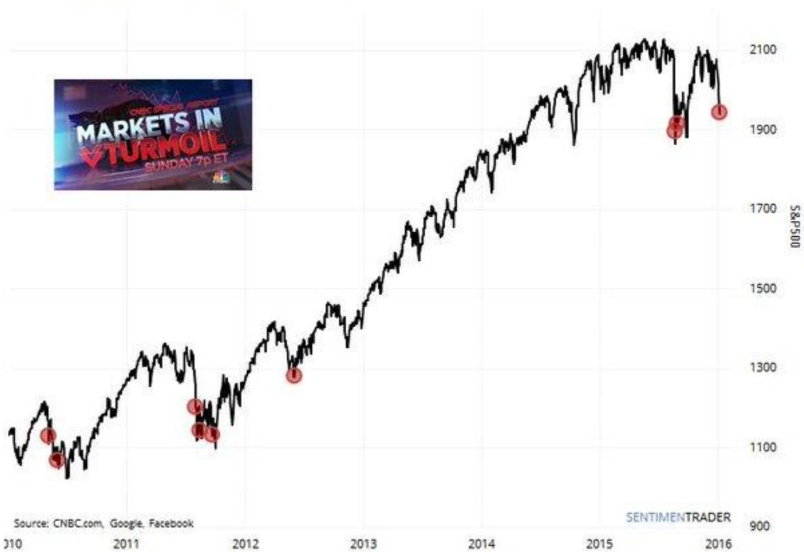
Furthermore, there is next to no correlation between moves in the VIX and the direction of our economy, so trying to time volatility spikes offers no benefit whatsoever to a long-term investor.

The real reason why the VIX is so closely followed is because the media absolutely loves watching it. When the VIX spikes, the networks jump on the story and do nothing more than throw gasoline on the flame.

During times of surging volatility, as we witnessed earlier this year, CNBC broadcasts a special program called *Markets in Turmoil*. This show dives into the causes of the volatility, and market pundits give their take on if it is the beginning of a recession.

I came across a chart posted on a financial blog called Sentiment Trader a few weeks ago that depicts a rather humorous, yet incredibly valuable pattern for long-term investors.

Figure 1: Airings of CNBC Special Report: Markets In Turmoil



Source: www.sentimenttrader.com

This chart shows the S&P 500 index over the last six years and highlights each time this show aired, indicated by the red circles. Notice how the index appears to not only recover but soar higher each time after this show is aired.

This pattern is no coincidence, and the reason why it's been so reliable over time has to do with the difference between investors who watch financial news networks and those who pay more attention to economic data.

Those not watching *Markets in Turmoil* are sitting patiently, waiting for "blood in the water" before they strike. This cohort views volatility as an opportunity rather than real risk, and they remain calm until the fear and panic become so intense and the VIX spikes so high that the bargains become too good to be true.

This is their cue to start buying, which ultimately fuels the imminent reversal. They are able to remain confident and disciplined because instead of watching television, they are paying attention to the economic data that is telling them that it's not all that bad out there right now.

Implications for Investors

There are so many potential sources of volatility that could strike at any time over the next six months. Consider the following: Brexit, Trump, Hillary, Middle East turmoil, Greece, oil collapsing, oil surging, China, terrorism, Zika, and many more.

But these do not indicate in any way that today is any more or less volatile than any other time period. The reality of the world we live in is that there is always going to be a list of scary stuff that could cause markets to panic. Emotional reactions from such events will continue to dominate the short-term movements in stocks. This will never change.

What can change is how investors view volatility. Those who always seem to come in the market when financial news networks are reporting the worst do so because they see opportunity rather than panic.

The bottom line is the next time a financial news network responds to rising volatility with a “special program,” simply change the channel.

Sincerely,

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