The Fear Gauge Goes Quiet—Too Quiet

- By SPENCER JAKAB

Wall Street's famous "fear gauge" is scraping along the bottom once again.

Should that, counter-intuitively, spook investors? Not necessarily, although there probably are more fundamental reasons to wonder if we are now in a period of summertime calm before September storms.

The CBOE Volatility Index, or "Vix," is one of the more poorly understood market barometers. It is now hovering just above 14 and earlier this week broke below 14 for the first time since June 2007.


Associated Press

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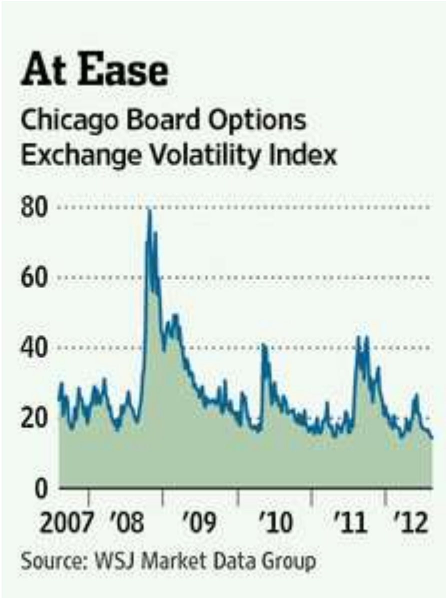
That can be interpreted as a sign of complacency. The Vix peaked near 80 in October 2008, at the scariest juncture of the financial crisis, and has only moved below 15 two other times since Lehman Brothers' demise: April 2011 and March 2012. Market tumbles following those dates could be viewed as a bad omen. But that is too simplistic.

The Vix essentially takes apart the famous Black-Scholes model for valuing options and, holding time and exercise price constant, spits out what investors are paying for expected volatility. The market could be more or less shaky at the time options are purchased than these expectations.

But a low Vix doesn't mean that traders have stopped buying protection or are overly confident in price increases. It just means the price of puts and calls—options that profit from falling and rising prices, respectively—is low.

Since the daily correlation of the Vix and the S&P 500 is sharply negative, a slow and steady rise in prices tends to depress the Vix. Periods like that can last a long time though, as they did between 2004 and 2007.



The unusually low turnover of shares of late is seen as another sign of complacency, but is in fact partly linked to a low VIX. Many hedge funds rely on volatility to make money through complex strategies and frenetic trading. They are now less active.

Even so, it is perplexing how low implied volatility has gotten. After all, a month from now we will know much more about the fates of Greece, Spain and Syria, the odds of further extraordinary Federal Reserve action and how the U.S. presidential race is shaping up into the home stretch.

If not white-knuckled fear, a bit more concern about stock prices would seem more natural.

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