How Low Can Volatility Go?

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Key Takeaways

- Equity markets are enjoying a backdrop of extremely low volatility, supported by decelerating inflation, the prospect of less restrictive monetary policy, enthusiasm over artificial intelligence, and resilient corporate earnings and economic growth.
- Periods of low implied volatility have historically produced above-average equity market returns. Since 1990, the S&P 500 has generated six- and 12-month respective returns of 8.8% and 13.6% after the CBOE Volatility Index (VIX) closed within its first quintile group (below 13.21).
- However, seasonal VIX trends and rising expectations for increased volatility of volatility suggest the days may be numbered for the current low-volatility backdrop.

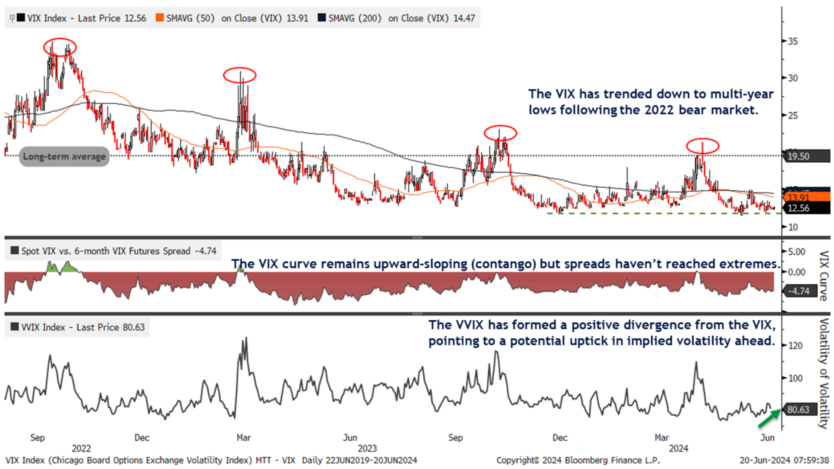
With the S&P 500 generating six record highs over the last seven trading sessions — bringing the index's record-high tally for the year to 31 — it shouldn't come as a surprise that implied volatility is historically low. Receding expectations for market volatility have primarily been supported by easing inflation pressure, relatively less ambiguous monetary policy, impressive earnings, and a resilient U.S. economy.

These factors, along with building excitement and spending on artificial intelligence, have helped drag the VIX down to multi-year lows this year. For reference, this index represents implied 30-day volatility derived from the aggregate values of a weighted basket of S&P 500 puts and calls over a range of strike prices. Generally, a rising VIX is associated with increased fear and uncertainty in the marketplace and falling stock prices, and vice versa for a declining VIX. The VIX is also used as a sentiment gauge and to hedge equity positions.

As highlighted below, the VIX has been trending lower since its highs registered during the bear market in 2022. The shift to a low-volatility backdrop has left the fear gauge near its lowest levels since January 2020 and well below its long-term average of 19.5.

How low can it go? Near-term support for the VIX sets up at 11.86 and 11.52. Furthermore, the steepness of the VIX futures curve, as measured by the spot price less the six-month VIX futures contract has not reached extreme/contrarian levels, suggesting there could be more room for complacency. However, the CBOE VVIX Index, which measures the expected volatility of the VIX over the next 30 days (essentially expected volatility of volatility) has started to tick higher this month, forming a positive divergence with the VIX that points to potential higher volatility ahead.

Volatility Remains Historically Low

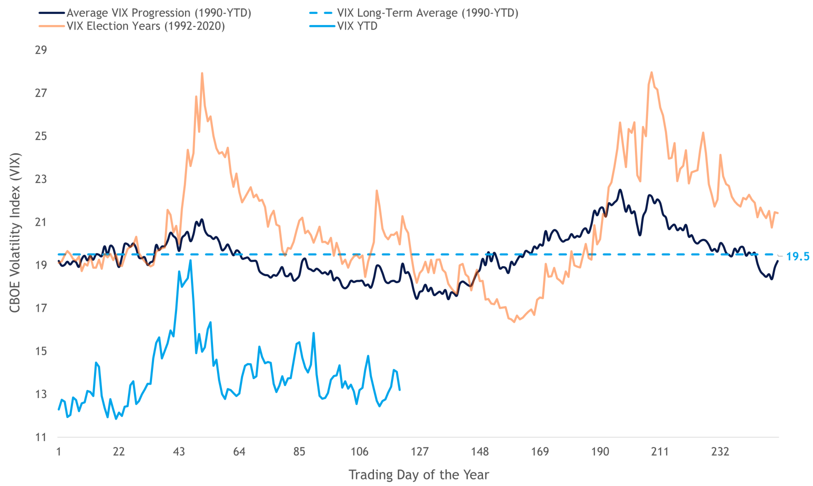


Source: LPL Research, Bloomberg 06/20/24
Disclosures: Past performance is no guarantee of future results. All indexes are unmanaged and can’t be invested in directly. Any futures referenced are being presented as a proxy, not as a recommendation.

Seasonality

Seasonality trends suggest the current low-volatility backdrop could be challenged soon. As highlighted below, the VIX has historically peaked in the first quarter before bottoming out at the beginning of July. The index then typically climbs higher for the remainder of the summer until peaking again in late September/early October. Election year peaks are also more pronounced, and the fall peak has historically been delayed until right around Election Day. The bottom line, VIX seasonality trends imply the lows of the year could be here soon and won’t last long.

Volatility Tracking Along its Seasonal Flight Path



Source: LPL Research, Bloomberg 06/20/24
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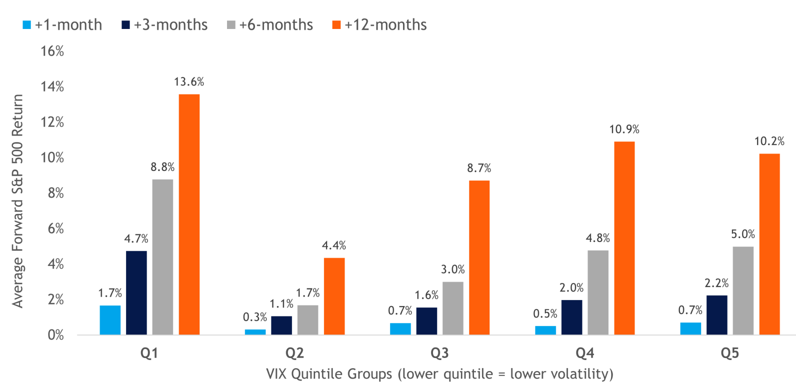
Stock Market Returns vs. Volatility Regimes

Lower volatility backdrops have been supportive of above-average equity returns. The table below breaks down stock market performance across VIX quintile groups. The first quintile represents trading days with the lowest implied volatility, or the bottom 20% of all VIX closes since 1990. The S&P 500 generated respective six- and 12-month average returns of 8.8% and 13.6% when the VIX closed within this group (below 13.21). In contrast, the fifth quintile group represents trading days with the highest implied volatility, or the top 20% of all VIX closes (above 24.36). This group has also posted solid forward returns as market bottoms are often accompanied by periods of extremely high volatility.

S&P 500 Returns Based on VIX Quintile Groups (1990–YTD)



Source: LPL Research, Bloomberg 06/20/24
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Summary

Implied equity market volatility remains supported by a constructive macro backdrop consisting of decelerating inflation, the prospect of less restrictive monetary policy, and resilient corporate earnings and economic growth. The broader market has historically generated above-average returns following periods of extremely low implied volatility. However, seasonal VIX trends and rising expectations for increased volatility of volatility suggest the current low-volatility window could soon be closed. Buckle up!

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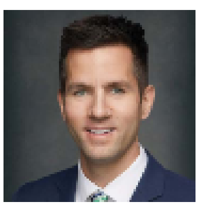

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