The recent stock market correction and subsequent rebound to new all time highs has raised the cry that “volatility is back” from many commentators. Investors have also noticed that buying-on-the-dips has been a profitable strategy for the last couple of years, and the recent market rebound seems to solidify this idea. Our analysis supports the notion that volatility will remain low; but we can expect such pullbacks and rebounds for the foreseeable future. The recent rebound is a sign of a resilient market environment.

Here at First Quadrant (FQ), we have found that markets have two distinct states. There are periods where markets are resilient and tend to bounce back after declines. During these periods, the economy is robust even if growth is below trend. Monetary policy is typically easy with low interest rates supporting what could be higher than average equity valuations. Credit default risk is low as is stock market volatility. In conjunction with stock market volatility, tail risk is low with even a two standard deviation (approximately 2.3%) daily drop or gain being rare. Extreme up or down movements are very rare. Markets are resilient because risks are not concentrated and tend to be diffuse. Investors tend to be optimistic overall. In these periods of resilience, buying-on-the-dips can be a profitable strategy.

However, there are other periods where markets are fragile. These periods are typically characterized by poor macroeconomic conditions as well as stretched valuations both in the stock and credit markets. Monetary policy is typically in tightening mode. When a number of these fundamental risks reach critical points, one crisis can set off the other risks causing a risk cascade. These risk cascades cause significant tail events, where extreme events in both directions become almost commonplace. For instance, a -4.5% daily drop or greater should happen only once every 130 years if markets were a random walk, yet the S&P 500 has experienced 30 of them since 1988. All 30 extreme days have been in the fragile market state. Fragile markets are not periods where buying-on-the-dip strategies typically produce a profit.

Needless to say, we have been in a resilient period which explains the quick recovery from the recent market pull back. In fact, during the September to October correction there was only one event greater than 2% for the S&P 500, which was on October 9th. Here at FQ, we have a proprietary indicator which anticipates these periods of fragility and resilience (see “Using Volatility Regimes: The FQ Market Risk Index (MRI)” for details). According to this indicator, we have been in the resilient state since October 2012. A resilient state historically lasts between 4 and 5 years.

So what can we expect with resilient markets? The graph on the following page plots S&P 500 daily returns from 1/1/88 to 10/31/14 during past resilient and fragile periods as
determined by our indicator. At the extreme left, markets are resilient but become increasingly fragile as we move to the right. The spread in the returns gives an indication of the level of risk. In fragile markets, daily returns can range from -8.8% to +11.6%. But when markets are resilient, the range is much narrower, from -3.1% to +2.2%. As previously stated, we are currently at the lowest reading.

Of course, a correction due to near-term market conditions is always possible, even in resilient markets. For FQ’s current tactical view of equity sectors please see “The Reluctant Equity Market” by Paul Goldwhite and Junyao Zhang. In that paper, we show that within equity markets, sentiment has become more risk averse suggesting a move to the more defensive market sectors. Even so, a bear market drop of -20% is unlikely, though a correction is possible.

However, in the current resilient market environment, we can be fairly confident that the market will continue to bounce back from any such correction, and volatility will continue to be low. While events such as those in October feel more volatile, that is only relative to recent history. The -2.1% drop on October 9th is dwarfed by the range of returns in fragile markets. Compared to a longer market history, recent volatility has been benign and likely to remain so for a considerable time.

![Exhibit 01: S&P 500 Daily Returns and the MRI (January 1988 - October 2014)](image-url)