With all the things happening in the world, the investment media seem to be obsessed with the current low level of the VIX and what that means. Many think that a low VIX is a sign of complacency and note that the last time the VIX was this low was in 2006, just before the onset of the financial crisis of 2008. Others have called it the “New Neutral” implying that these conditions have never existed before. While the followers of the New Neutral believe this will persist for some time, the complacency crowd think the low VIX is a sign of imminent disaster and the VIX could abruptly revert back to very high levels at any time. At First Quadrant, we have studied volatility regimes extensively and have integrated them into disciplines such as Essential Beta. Research shows that low-volatility regimes, signaled by a low VIX, are a normal part of the business cycle and last for several years, but are quite stable.

Our work in this area shows that unless there is an exogenous shock, such as war or a major earthquake involving a developed country, the stock market is unlikely to abruptly change from low to high volatility. The following chart shows volatility regimes for the composite VIX (CVIX) we use in the Market Risk Index (MRI) for Essential Beta. The CVIX is composed of the three-month S&P 500 VIX future, the EuroStoxx VIX (V2TX) and the Oil VIX (OVX) weighted 60/30/10. The last two components use a three-month moving average. We designate high and low volatility regimes when the CVIX is above and below its long-term median of 21.80 in this chart.

We can see that these periods of low and high volatility typically last for several years. The long low-volatility period in the 1990s lasted for 69 months, and in the 2000s for 45 months. By contrast, the current low-volatility regime began in November 2012 and so has lasted for 20 months with no sign of ending. In addition, the transition from low to high is usually lengthy. The bottom of the CVIX in the 1990s occurred in August 1993, but the regime did not shift until 40 months later in December 1996. Likewise the bottom of the CVIX in the 2000s occurred in February 2005, but did not cross its median until 33 months later in October 2007. In both cases, the transition from low to high was orderly and occurred well before the development of a significant bear market.

Once the shift to high volatility begins occurring, there is ample time to prepare. The rise in the CVIX in the 2000s, which looks rapid in the chart, started in February 2007 and crossed its median in November 2007, nine months later. And this was a year before the market collapse in October 2008. While it is possible that the CVIX is approaching or at its low (the value as of 6/20/14 was 15.73 versus an all-time low of 13.2) we can expect that there is still some time before it will rise towards its median. In addition, none of the other components of the MRI (credit spreads, manufacturing growth, or monetary policy) are near their high-volatility trigger points. All signs are that we are into a low-volatility period like the 4/91 – 12/96 (69 months) or 12/03 – 10/07 (45 months) periods when all MRI factors also pointed towards low volatility. The short low-volatility periods in the chart were not confirmed by the other MRI factors. At 20 months, this low-volatility period is likely only half over.

The volatility spikes that are indicative of “fear” typically happen once the CVIX crosses above its median. So low-volatility periods tend to be more stable.

But the CVIX (and the VIX) are only symptoms of general market conditions. The VIX cannot be taken alone as an indicator since it often gives false signals. Instead, it needs to be combined with other factors which we do in the MRI, combining the CVIX as a stock market indicator, with credit spreads (a bond market indicator), and macro factors (manufacturing growth and monetary policy). When these indicators are all in agreement, we can be fairly confident that we are in a period of high or low uncertainty. Currently, all MRI factors point towards low uncertainty, and historically a low-uncertainty environment carries little risk of a bear market or significant economic contraction, contrary to the fears of the complacency crowd. So we are more in the camp of the New Neutral, though we see the current environment as a normal part of the market cycle rather than something new.

The caveat to this would be, as we have stated in the past, an exogenous shock such as the sudden outbreak of war or a large natural disaster like an earthquake. If such an event were to have economic implications, then the markets would react far more rapidly since they have been “blindsided”, and an overnight shift from low to high volatility is possible. We have a procedure in place for that event which is to go to an MRI of 0.50 (the neutral position halfway between the high and low volatility portfolios listed above) and assess whether the event actually does have long-term implications or the market is overreacting as it did in the Japanese earthquake of 2011.

To summarize, while the current low-volatility environment will not ”last forever” as many have stated, research shows that it is likely to continue for some time. While the bull market has lasted for five years, the low-volatility environment has only been in place for 20 months. It is a good idea to be aware of the low-volatility environment, but we should have ample warning signs that the regime is changing from not only the CVIX but the other factors in the MRI. The current low CVIX and narrow credit spread are more indicative of the low probability of a significant change in the macro environment for investing than market complacency. A stock market correction of about 10% is still possible, however, and should be expected. But in a low-volatility market, corrections typically represent buying opportunities. A significant bear market, on the other hand, is highly unlikely without warning.