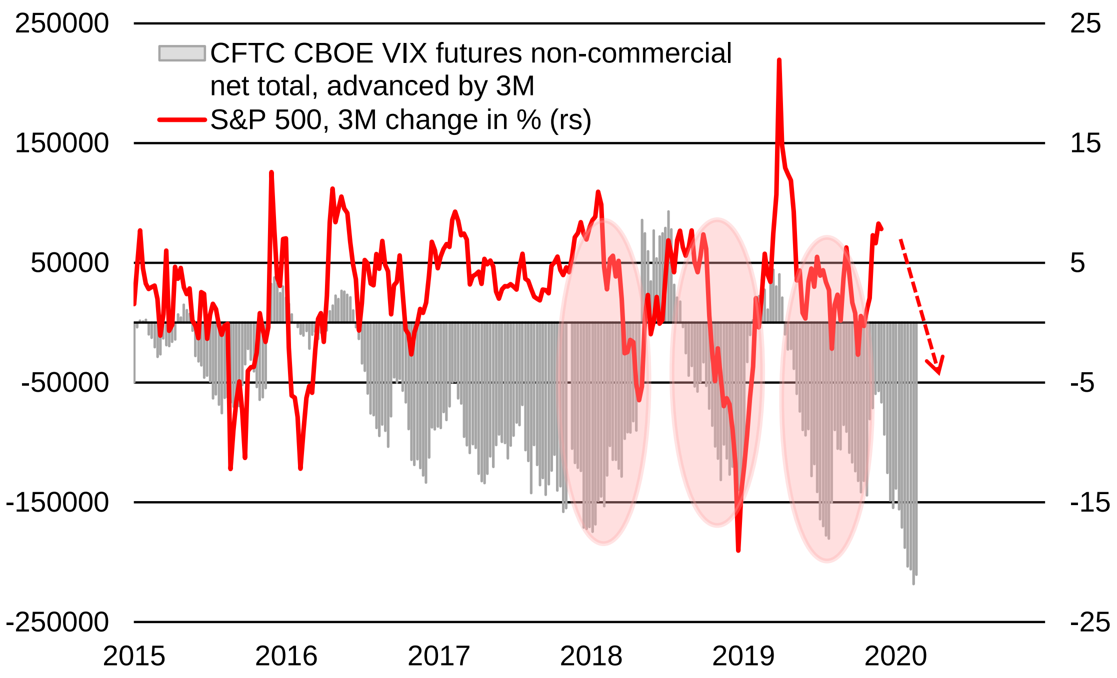
Signs of complacency in equity markets are rising



Source: Bloomberg, UniCredit Research

- Our *Chart of the Week* shows net-short positions in Chicago Board Options Exchange (CBOE) Volatility Index (VIX) futures along with the three-month performance of the S&P 500 (advanced by three months). The amount of net-short positions in the VIX futures recently rose to its highest level since the launch of this instrument in 2004, according to the latest data from the Commodity Futures Trading Commission. This suggests that investors have become comfortable with the current period of low volatility and are expecting volatility to diminish even further in the coming months. However, history has shown that, in an environment of sluggish or slowing economic growth (which we expect will be the case, particularly in the US) and, as a result, decreasing growth in company earnings, implied volatilities in equity markets tend to increase. Against this background, the current high degree of investor complacency in the US could be a harbinger of bigger equity-market swings in the next few months.

- While extraordinarily high short-volatility positioning is certainly no indicator of timing, it may indicate a high degree of investor complacency currently. This could mean that equity markets could become more vulnerable to sentiment shifts and event risk. In the past, such high levels of complacency were often followed by a strong decline in the S&P 500 (such as in February 2018 or in 4Q18), which was also reflected in declines in other developed equity markets, given the world-leading role of US stock markets. Even though past declines in the S&P 500 rarely exceeded 5% on a three-month basis (mainly due to the strong underlying upward trend the S&P 500 is on), a decline of 5% over three months would mean an S&P 500 level of around 2,850 (10% below its current level).

- Over the past few years, spikes in volatility have typically only interrupted an underlying trend of lower implied volatility – and investor expectations of lower volatility. Secular forces, in particular the expansion of central-bank balance sheets, are likely part of the explanation for this underlying trend. In this context, the Fed has recently started expanding its balance sheet again. However, even after underlying trends are taken into account, net-short volatility positioning is unusually high.

- In the short term, with the Fed likely to remain on hold tomorrow, risk-off sentiment could prevail if the US and China do not reach a trade deal and the planned tariffs are implemented on 15 December. Beyond this, in our view, global growth is set to weaken further in 2020, as the US economy is likely to enter a downturn. For this reason, we expect company earnings growth to continue to decline. Consensus expectations project that S&P 500 company earnings will increase by almost 10% in 2020. Based on our economic forecasts, we think such growth rates are exaggerated. In combination with stretched valuations, we see an increasing likelihood of an equity-market correction occurring.

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