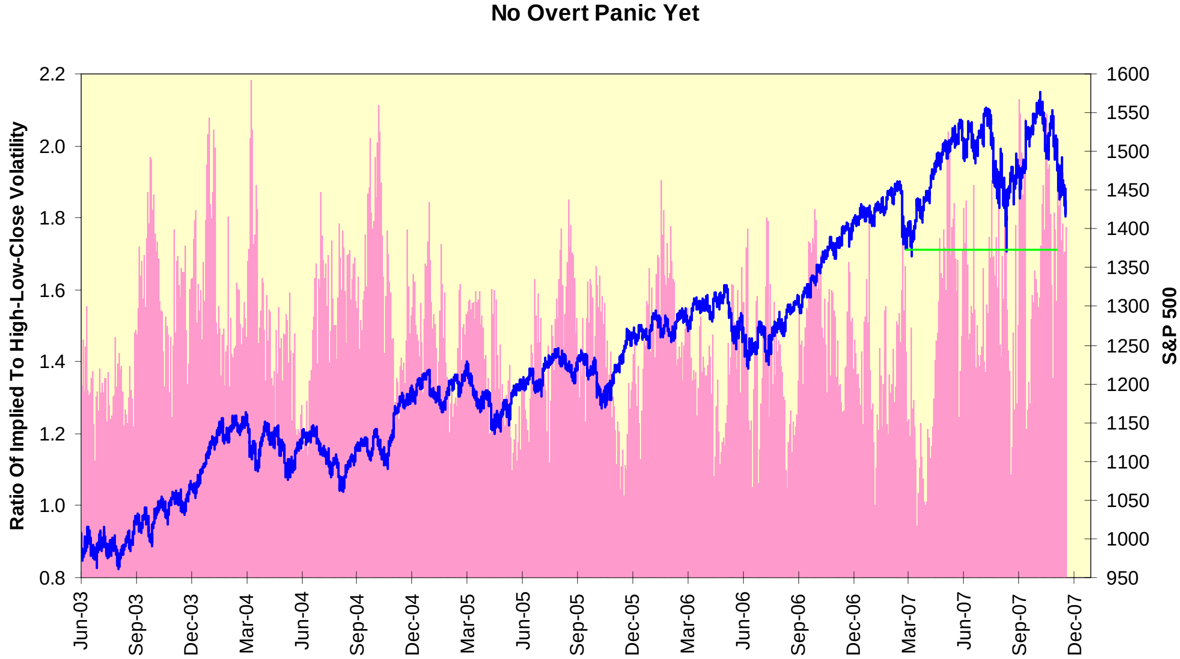
# Markets Not As Complacent As They Look

Everyone is a contrarian, even if they work in a cubicle. I always have thought the real cornerstone of contrarian analysis' popularity is its premise your fellow traders are a bunch of mindless dolts perennially chasing the latest hot investment, buying tops and selling bottoms along the way and acting in a generally buffoonish manner. In addition, there are numerous Biblical parables about someone getting whacked upside the head because they were not sufficiently contrite.

Nearly all of us declaim we act in such a manner even though by demonstrable evidence a significant percentage of us do. One aspect of current market chatter is why there has not been a greater degree of panic during the present selloff. Here is a surprise: We are panicking just fine, thank you very much.

The absolute levels of volatility – the only measure of market sentiment that actually means anything as they are based on trader action, not some opinions detached from consequence – are high. The relative level of volatility, by which we mean the ratio of option-implied volatility to high-low-close volatility, has been declining of late, and that may deceive the contrarians into thinking there is insufficient panic.



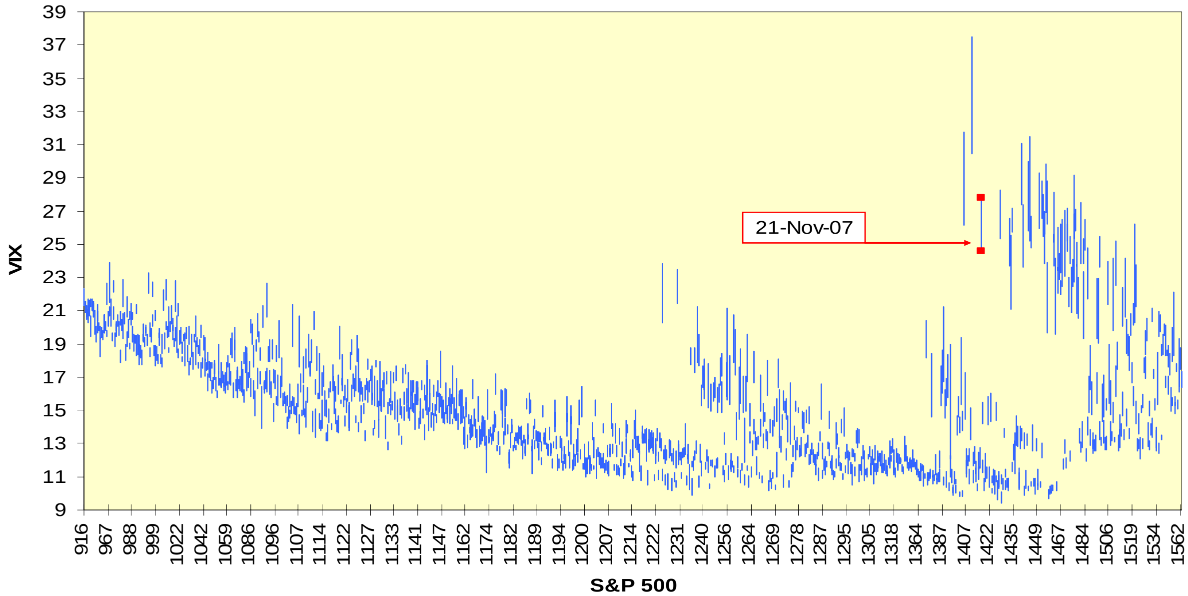

In reality, this ratio, which reflects the extent to which option buyers are insuring themselves over and above the level indicated by actual market volatility, is higher than the level reached at the March 2007 low and on par with the level reached at the August 2007 low, marked with the green horizontal line.

The key thing to remember here is this fraction, those pink columns, can fall for two reasons. The first would be a decline in the VIX; the other would be an increase in high-low-close volatility. As the case would have it, high-low-close volatility is rising faster than the VIX at the moment.

**VIX And Retracement**

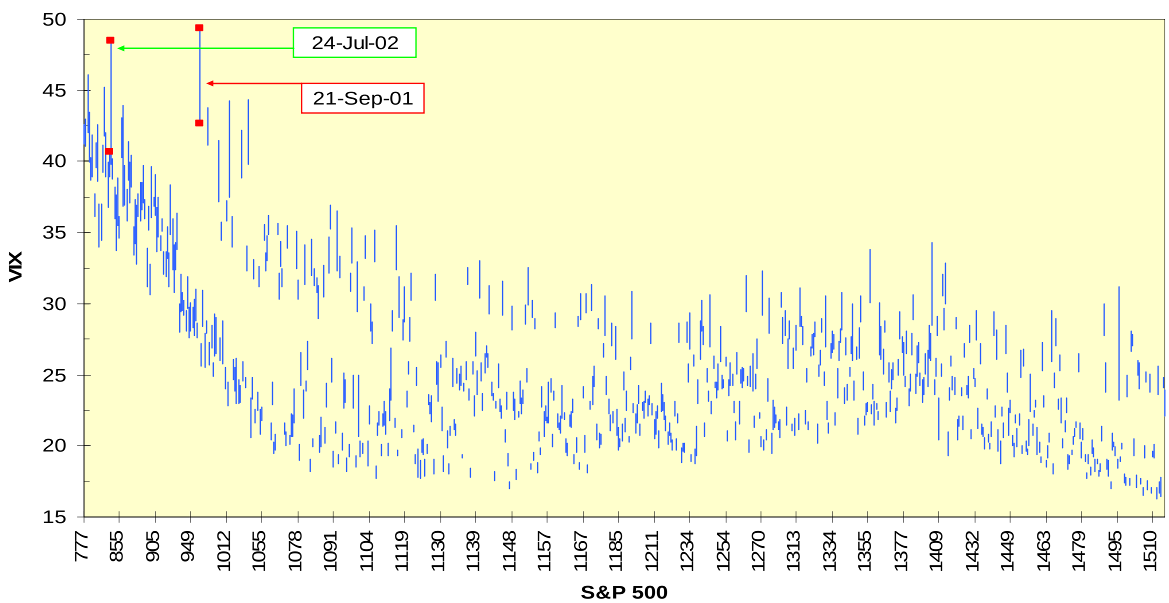
Let's update an analysis introduced early in the July-August selloff, one which maps the VIX' high-low range not against time but against the S&P 500 itself. This is one way of assessing whether we are too complacent. The "you are here" point of November 21, 2007 is pretty clear on the question of whether traders are whistling past the graveyard or not.

**VIX Shock & Regress Since May 1, 2003**

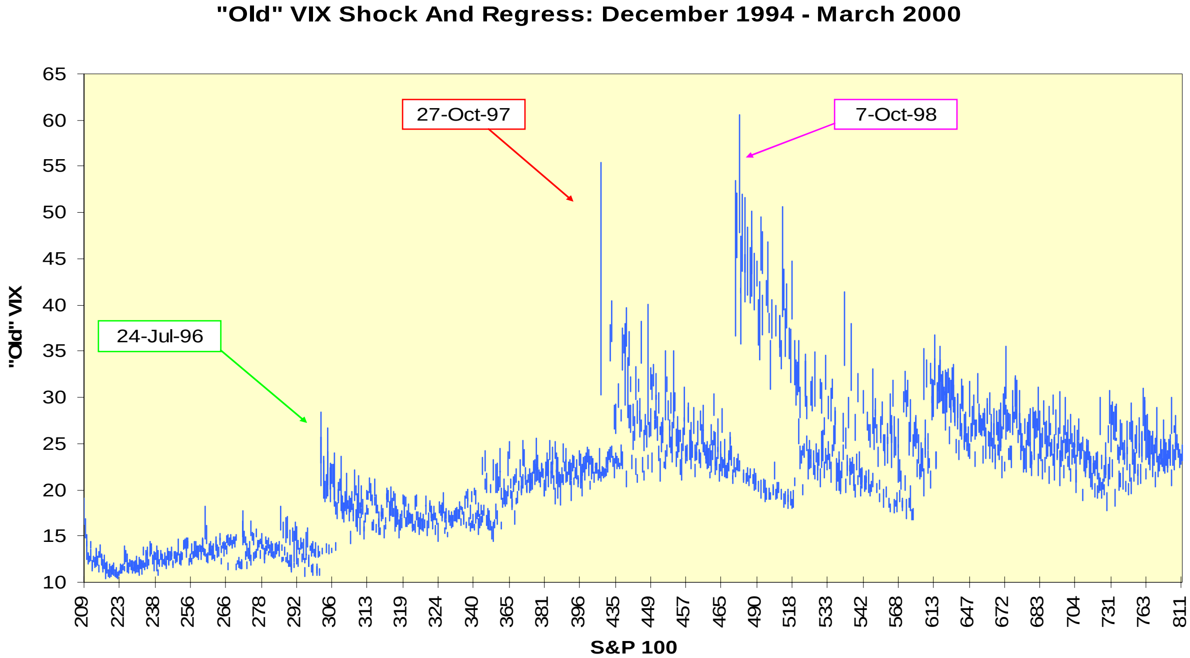



The chart above begins with May 1, 2003. Does it look like a similar chart using a sample from the 2000-2002 bear market? Yes, but here's the cautionary part: Neither of the two dates highlighted represented market lows. Restated, a VIX extreme may mark a local low, but not a "global" low within a market cycle.

**VIX Pattern During 2000 - 2002 Bear Market**

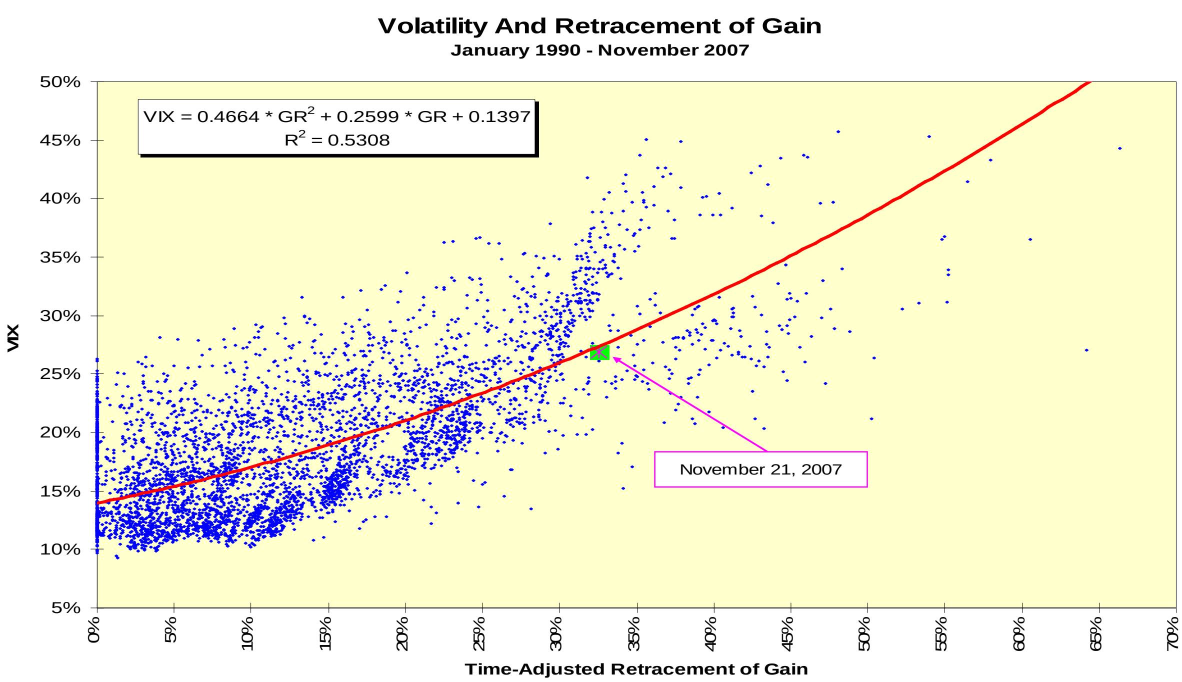



Oh, and just for the giggles all of us can use, let's add some ancient history. The VIX used to be based on the OEX, or S&P 100 index, and was constructed far more simply than it is at present. Here's what a map of the "old VIX" against the OEX looked like during the 1990s bull market.




Most modest students of market history can identify the October 27, 1997 early closure of the market during the old circuit-breaker rules and the October 7, 1998 LTCM panic. What's that one in July 1996? A *Bloomberg* news search for that day attributed to the selloff to a warning from Compaq Computer and some warbling by Elaine Garzarelli. I write enough witticisms; it is your turn now.

Now let's wrap up the issue whether we are duly fearful with an analysis introduced first in April 2000 and modified in April 2003, and that is a map of the VIX against a time-adjusted retracement of gain from the last new high. We are pretty much on the central trend of this relationship.




**Volatility Beneficiaries**

This is a difficult topic to address if you fear, as I do, that something might be terribly remiss in the world. If fear is in response to a known cause, it can have a known solution: There's a bear sniffing around outside your tent, and once the bear goes, there's no reason to be afraid of the bear anymore. It is what you cannot see departing the scene that is so scary.

This is not place myself in the dried beans, distilled water and *Guns & Ammo* crowd. As I have noted in the past, my personal fear gauge is a good bottom-indicator, and if I bet on the end of the world and win, how am I going to collect?

But on the odd chance I am asked, “Gee, Howard, the world’s ending. What three stocks should I buy?” I will return to an analysis first offered in July 2005 and updated below. There are 46 industry groups accounting for 36.42% of the S&P 500 by weight with a negative relative performance beta to the VIX. There are 40 industry groups accounting for 40.38% of the S&P 500 by weight with a positive relative performance beta to the VIX. If we sum these weighted betas we get a net impact of the VIX of – a drumroll, please – of 0.00%. In other words, the net impact of the VIX is no impact at all.

**VIX Beta-Weighted Impact On S&P 500**

| | SPX Weight | VIX Beta | Weighted Beta | | SPX Weight | VIX Beta | Weighted Beta |
|---|---|---|---|---|---|---|---|
| Integrated Oil & Gas | 7.41% | 0.017 | -0.12% | Pharmaceuticals | 6.52% | 0.029 | 0.19% |
| Investment Banking & Brokerage | 1.97% | 0.052 | -0.10% | Household Products | 2.43% | 0.037 | 0.09% |
| Communications Equipment | 2.68% | 0.030 | -0.08% | Soft Drinks | 2.07% | 0.041 | 0.08% |
| Semiconductors | 2.19% | 0.026 | -0.06% | Healthcare Equipment | 1.71% | 0.029 | 0.05% |
| Oil & Gas Equipment | 1.85% | 0.029 | -0.05% | Industrial Conglomerates | 3.81% | 0.013 | 0.05% |
| Asset Management & Custodial Banks | 1.33% | 0.030 | -0.04% | Packaged Foods | 1.30% | 0.038 | 0.05% |
| Construction & Farm Machinery | 0.94% | 0.039 | -0.04% | Integrated Telecommunications | 3.07% | 0.015 | 0.05% |
| Internet Software & Services | 1.90% | 0.019 | -0.04% | Tobacco | 1.38% | 0.028 | 0.04% |
| Steel | 0.28% | 0.111 | -0.03% | Electric Utilities | 2.13% | 0.017 | 0.04% |
| Other Diversified Financial Services | 3.83% | 0.007 | -0.03% | Aerospace & Defense | 2.89% | 0.009 | 0.03% |
| Diversified Metals & Mining | 0.29% | 0.084 | -0.02% | Managed Health | 1.44% | 0.016 | 0.02% |
| Oil & Gas Exploration | 1.35% | 0.015 | -0.02% | Multiline Utilities | 1.17% | 0.017 | 0.02% |
| Railroads | 0.76% | 0.025 | -0.02% | Hypercenters & Superstores | 1.10% | 0.018 | 0.02% |
| Oil & Gas Drilling | 0.55% | 0.033 | -0.02% | Data Processing & Outsourcing | 0.76% | 0.019 | 0.01% |
| Industrial Machinery | 0.86% | 0.017 | -0.01% | Drug Retailers | 0.80% | 0.018 | 0.01% |
| Computer Storage & Peripherals | 0.49% | 0.029 | -0.01% | Brewers | 0.35% | 0.037 | 0.01% |
| Semiconductor Equipment | 0.43% | 0.031 | -0.01% | Healthcare Services | 0.47% | 0.023 | 0.01% |
| Fertilizers & Agricultural Chemicals | 0.38% | 0.034 | -0.01% | Restaurants | 0.90% | 0.012 | 0.01% |
| Internet Retailers | 0.29% | 0.040 | -0.01% | Air Freight & Logistics | 0.96% | 0.011 | 0.01% |
| Oil & Gas Refining | 0.41% | 0.026 | -0.01% | Property & Casualty Insurers | 1.14% | 0.009 | 0.01% |
| Department Stores | 0.42% | 0.022 | -0.01% | Healthcare Distributors | 0.42% | 0.018 | 0.01% |
| Thrifts & Mortgages | 0.64% | 0.015 | -0.01% | Broadcast & Cable TV | 0.92% | 0.007 | 0.01% |
| Electrical Components & Equipment | 0.49% | 0.019 | -0.01% | Publishing & Printing | 0.28% | 0.023 | 0.01% |
| Aluminum | 0.25% | 0.034 | -0.01% | Food Retailers | 0.39% | 0.010 | 0.00% |
| Industrial Gases | 0.36% | 0.022 | -0.01% | Insurance Brokers | 0.22% | 0.016 | 0.00% |
| Application Software | 0.44% | 0.016 | -0.01% | Food Distributors | 0.16% | 0.023 | 0.00% |
| Consumer Finance | 0.87% | 0.007 | -0.01% | Casinos & Gaming | 0.24% | 0.015 | 0.00% |
| General Merchandise Retailers | 0.41% | 0.015 | -0.01% | Personal Products | 0.18% | 0.020 | 0.00% |
| Automobile Manufacturers | 0.24% | 0.025 | -0.01% | Advertising | 0.16% | 0.022 | 0.00% |
| Construction & Engineering | 0.17% | 0.034 | -0.01% | Footwear | 0.20% | 0.015 | 0.00% |
| Homebuilding | 0.09% | 0.062 | -0.01% | Distillers & Vintners | 0.08% | 0.028 | 0.00% |
| Apparel & Accessories | 0.22% | 0.018 | 0.00% | Environmental Services | 0.17% | 0.013 | 0.00% |
| Specialty Stores | 0.22% | 0.017 | 0.00% | Housewares & Specialty Stores | 0.16% | 0.014 | 0.00% |
| Employment Services | 0.07% | 0.054 | 0.00% | Office Services & Supplies | 0.11% | 0.015 | 0.00% |
| Electrical Manufacturing Services | 0.20% | 0.017 | 0.00% | Commercial Printers | 0.06% | 0.020 | 0.00% |
| Construction Materials | 0.07% | 0.040 | 0.00% | Healthcare Suppliers | 0.03% | 0.038 | 0.00% |
| Computers & Electronics Retailers | 0.16% | 0.014 | 0.00% | Gas Utilities | 0.09% | 0.010 | 0.00% |
| Forest Products | 0.12% | 0.019 | 0.00% | Diversified Commercial Services | 0.07% | 0.011 | 0.00% |
| Home Entertainment Software | 0.13% | 0.016 | 0.00% | Healthcare Facilities | 0.02% | 0.049 | 0.00% |
| Electrical Equipment Manufacturing | 0.11% | 0.019 | 0.00% | Distributors | 0.06% | 0.008 | 0.00% |
| Paper Products | 0.16% | 0.013 | 0.00% | | | | |
| Tires & Rubber | 0.04% | 0.045 | 0.00% | | | | |
| Household Appliances | 0.14% | 0.013 | 0.00% | | | | |
| Building Products | 0.11% | 0.015 | 0.00% | | | | |
| Paper Packaging | 0.09% | 0.009 | 0.00% | | | | |
| Trading Companies | 0.05% | 0.012 | 0.00% | | | | |
| | | | | Subtotal: | 40.38% | | 0.86% |
| Subtotal: | 36.42% | | -0.86% | **Total:** | **76.80%** | | **0.00%** |

Wrapping everything up, if stocks sell off further from here, it will not be because we were too complacent, it will be because things are going bad now and have the potential to get worse. Contrarians, pay heed: The contrary trade right now is to buy, not to sell. How lucky do you feel?