Negative Message From Implied Correlation

One of the worst aspects of sign-on screens, news roundups and the like is everyone thinks they need an aphorism at the top of the page, some words to make you harrumph and then get on with your day with at least one pearl of wisdom.

Here is mine: When there's not a cloud in the sky, be careful where you step.

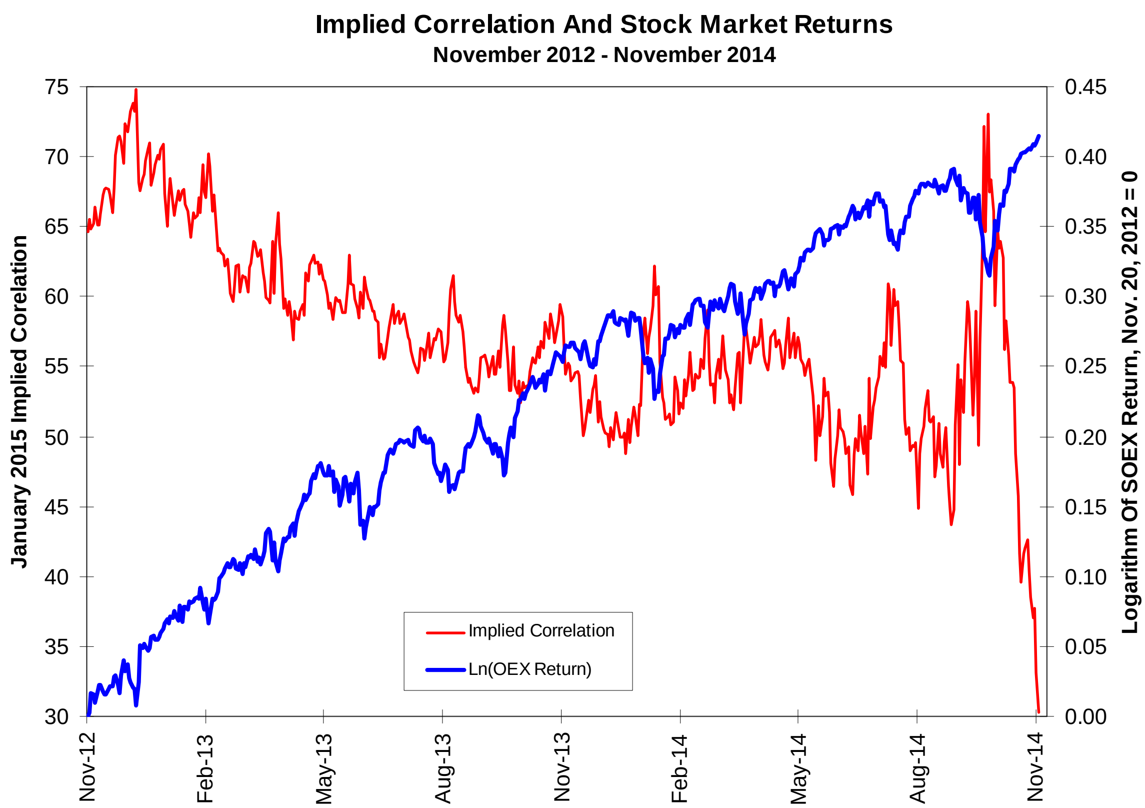
The news flow and market action have been so positive for so long it is easy to think trees will grow to the sky sometime, and that is before we allow for the effects of global warming. We are living in a world where negative interest rates are not low enough, where central banks are competing with each other to flood banking systems with excess reserves and where the U.S. has no problem whatsoever financing itself via the kindness of strangers through carry trades into the dollar. If I do not find something to worry about, and soon, I will lose my membership in good standing in the Pundits' Guild.

Implied Correlation

This brings me to The Chicago Board Options Exchange's S&P 500 Implied Correlation index. It measures "changes in the relative premium between index options and single-stock options;" as such, it differs from the more familiar backward-looking correlation of returns. It uses the expected average correlation of the S&P 500 using implied volatilities for a weighted portfolio of the fifty largest stocks in the index.

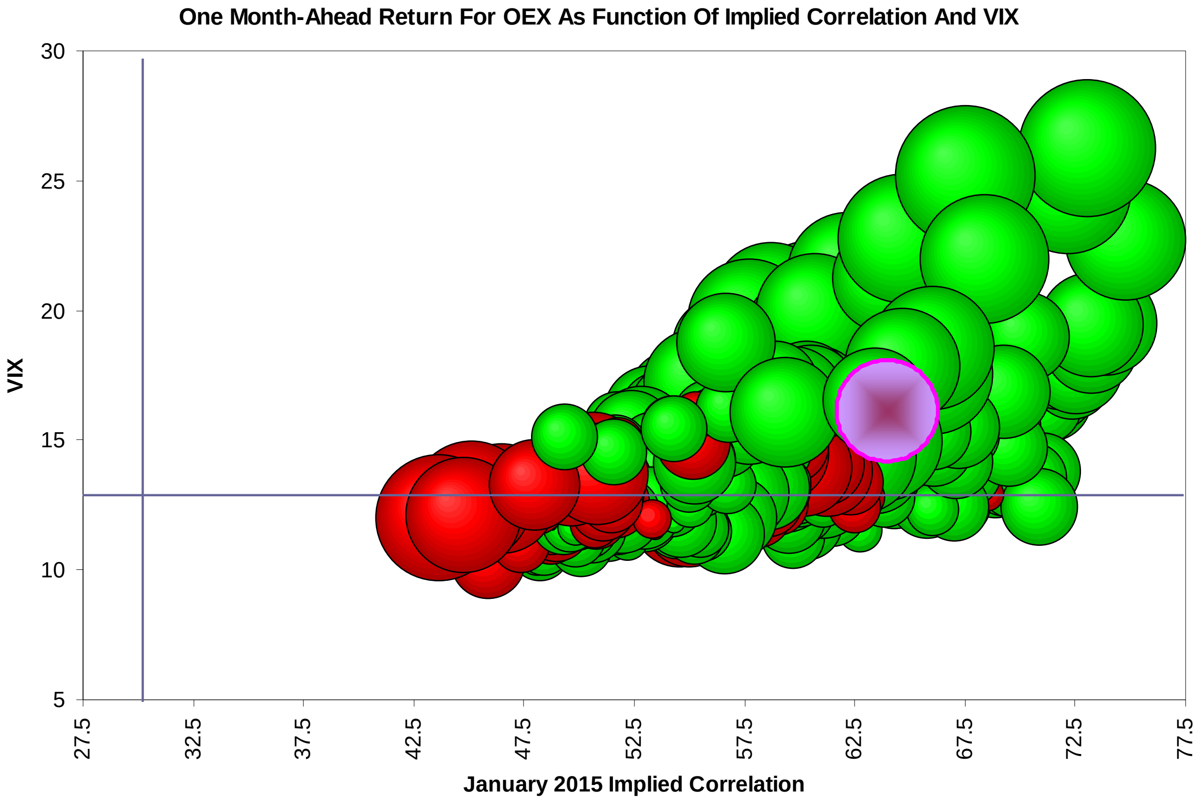
This is a very different measure than correlation of returns or of the VIX. As it is based on forward option expirations, there is a family of indices each with their own ending dates; the January 2015 index is used below. As the 50-stock index resembles the S&P 100 index (OEX) in return characteristics more than the S&P 500, the OEX will be used below with its indexed total return displayed on a logarithmic basis using the November 20, 2012 starting point of the January 2015 correlation index.

Stock market returns and the implied correlation index have had a generally inverse relationship. The present decline to a life-of-index low for the January 2015 implied correlation index is an exaggerated response to the U.S. stock market's steady climb to new highs following the short, sharp downturn in late September and early October.



Prospective Returns

Now let's map the one-month-ahead returns for the OEX as a function of the implied correlation index and the VIX. Green bubbles depict positive prospective returns; red bubbles depict negative prospective returns, with the diameter of the bubbles corresponding to the absolute magnitude of the return. The current environment is highlighted with a gray bombsight and the last datum used is highlighted.



While the data sample is small and the current environment is out of extreme southwest corner of observation, the singular indication is a combination of low implied index volatility and low implied correlation amongst the fifty largest stocks' options should be considered a negative for one month-ahead returns.

There you go; a warning to watch where you step based on everyone else's sunny outlook.