Panic Defused in Stocks With Sharpest VIX Drop Since 2009

By Callie Bost and Eric Lam - Oct 22, 2014

The panic has subsided.

Four consecutive advances in the Standard & Poor’s 500 Index (SPX) have pushed the gauge up 4.2 percent since Oct. 15, recouping half the losses from a selloff that began in mid-September. After surging to a 28-month high last week, the Chicago Board Options Exchange Volatility Index (VIX) has fallen at least a point a day starting Oct. 16, reflecting a dissipation of investor concern that hasn’t occurred in five years.

Investors flocking back to equities are asking what changed to ignite a plunge that erased $2 trillion from American stock values. While falling oil prices spurred a 20 percent drop in energy producers, cheaper fuel is now underpinning a rally in airlines and railroads that is approaching 10 percent. Data showed gains in home sales and consumer confidence and earnings from Apple Inc. (AAPL) to Morgan Stanley exceeded analyst estimates.

“It’s not like we suddenly had a different macro-economic picture,” Justin Golden, a partner at Lake Hill Capital Management LLC in New York, said by phone. “The markets started to roll over and there was forced panic.”

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The 7.4 percent S&P 500 plunge to a six-month low that began Sept. 18 was triggered by selling in leveraged hedge funds, BlackRock Inc. Chief Executive Officer Larry Fink told Bloomberg TV yesterday. He said he would be buying equities now as a long-term investor and that earnings have been good.

VIX Flows

In one sign of optimism, traders are pouring cash into an exchange-traded note that appreciates when markets are calm. About $757 million has been added to the VelocityShares Daily Inverse VIX Short-Term ETN (XIV) in October, the most for any month since the note began trading in 2011, according to data compiled by Bloomberg.

Stocks are probably headed higher and investors shouldn’t be surprised by the recent selloff, according to Bill Merz, a strategist on the derivatives and structured products team at U.S. Bank
Wealth Management. The S&P 500 jumped 2 percent to 1,941.28 yesterday, helped by a rally in airlines and Apple shares.

The VIX has dropped more than 10 percent in each of the past three days, the first time that’s ever happened. The gauge fell 0.9 percent to 15.94 at 10:26 a.m. in New York.

“What we’ve seen in the last couple of weeks is a healthy reset and we’re still constructive on the U.S. equity market,” Merz said by phone. “We still feel like the domestic market is expressing moderate strength and we’re still experiencing non-inflationary growth in the U.S.”

### Alarm Bells

Even so, alarm bells were ringing last week amid concern over the spread of Ebola in the U.S., signs of weakness in the global economy and selling by hedge funds. The S&P 500 fell as much as 3 percent Oct. 15 and the Dow Jones Industrial Average slid more than 450 points.

Markets started to turn around on Oct. 16 after St. Louis Federal Reserve Bank President James Bullard said policy makers should consider delaying the end of quantitative easing. The European Central Bank added to optimism over stimulus by purchasing Italian covered bonds yesterday, according to two people familiar with the matter who asked not to be identified because the information is private.

The global recovery is too weak to drive stock prices much higher, according to Mark Yusko, founder of Morgan Creek Capital Management LLC. The S&P 500 is still down 3.5 percent from an record high reached in September.

### ‘Play Defense’

China faces a “deep structural slowdown and broad uncertainty” in the decade ahead, the Conference Board said in an Oct. 20 report. Government debt in the euro area reached 90.9 percent of gross domestic product at the end of last year, up from 89 percent 12 months earlier, the European Union’s statistics office said yesterday.

“It’s time to be cautious, to play defense, not stretch for those returns,” Yusko, who helps oversee $4.1 billion at Chapel Hill, North Carolina-based Morgan Creek, said by phone. “We’re moving from an expansion to the early stages of a contraction in the global economy.”

In the options market, bets are increasing that the VIX will fall. There are 50 puts outstanding for every 100 calls on the VIX, the highest proportion of bearish contacts in 10 months, according to data compiled by Bloomberg. Ownership of VIX puts climbed to a record 3.54 million contracts this week.

“While the moves were sharp, we haven’t had a tragic de-risking like we did in 2011,” Michael Purves, chief global strategist and head of equity derivatives research at Weeden & Co. in
Greenwich, Connecticut, said by phone. “Real money is saying this is an attractive level to buy stocks.”

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