# Market Perspective

*May 2018*

As we near the mid-point of the year, it is clear that the equity market volatility environment is markedly different from 2017. In 2017, the realized volatility of the S&P 500® Index, as measured by the annualized standard deviation of its daily returns, was just 6.78%, its lowest level since the mid-1960's. Low realized volatility drove down implied volatility as the Cboe® Volatility Index (the VIX®) averaged 11.09 for 2017—its lowest annual average since its creation in 1990. Though volatility levels in 2018 have come down from the extremes witnessed in early February, realized volatility of the S&P 500 Index is tracking at 20.29% on a year-to-date basis through the end of May while the VIX® has averaged 16.86.

Even if we take the extremes of February out of the equation and look at the more normal market environment over the first two months of the second quarter, volatility measures still show a significant increase over 2017. Specifically, from April through May, realized volatility was 14.25% while implied volatility averaged 16.15.

Not only has volatility increased for 2018, but the forces that have contributed to its persistently low levels over the past several years are starting to change. In the historically low volatility environment of 2017, we identified several short-term and longer-term phenomena that were keeping a damper on equity market volatility. Updating the status of these drivers sheds light on the current volatility environment.

Key long-term drivers included post-crisis monetary and regulatory policies and low rates of growth-oriented corporate investment. Monetary policy has changed markedly as the era of quantitative easing has given way to monetary policy normalization and quantitative tightening. Some post-crisis banking reforms have been rolled back, including the recent bill signed by President Trump that exempts small- and mid-sized banks from portions of the Dodd-Frank financial reform act. And it remains to be seen whether tax reform or other forces will facilitate a sustained uptick in capital expenditure, but Q1 2018 earnings reports did indicate a significant increase versus Q1 2017.

One of the key shorter-term drivers of low volatility in 2017 that was previously spotlighted was low correlation across individual stocks. Low correlation among stocks can create a diversification effect that lowers the volatility of the market as a whole. Correlation across the 50 largest stocks in the S&P 500® Index was well below its 5-year average for much of 2017 and even approached zero during the fourth quarter. The correlation dynamic in the stock market so far this year has been quite different.



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Correlation across the 50 largest stocks in the S&P 500® Index rose above its 5-year average as volatility spiked in early February and has since remained above average. This increase in correlation has contributed to higher realized and implied volatility in recent months.

The low volatility equity strategies that Gateway manages benefit from higher implied volatility levels as higher implied volatility results in higher option premiums and higher cash flows from the index option writing components of the strategies. Though encouraged by the recent trend in volatility, Gateway avoids incorporating equity market forecasts into its investment approach and does not attempt to anticipate whether equity market volatility will continue to trend up or return to the lows of 2017. As always, Gateway will continue to apply the market agnostic, risk-first approach that has served its investors well for over 40 years.