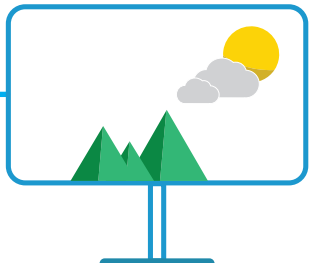
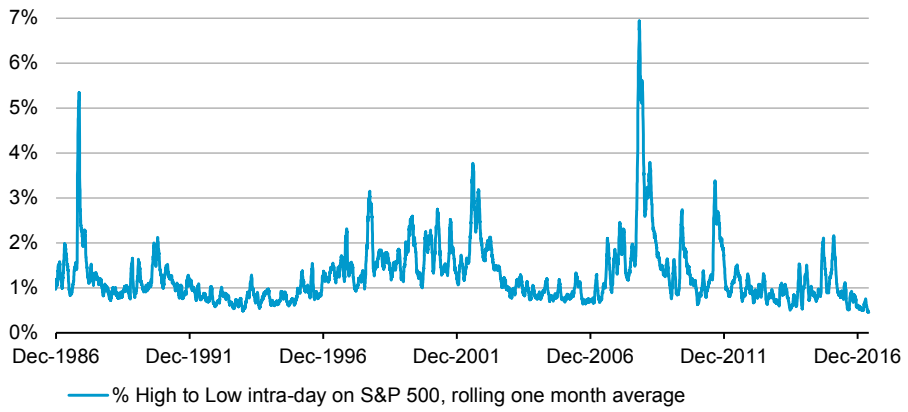
Summer viewing



If 2016 was the financial market equivalent of gripping TV drama and surprise plot twists, 2017 has been the year of test pattern TV. So far in 2017, worries about North Korea, the French elections, or President Trump-related developments have only had short-lived and localised impacts on markets.

To begin, let's see just how quiet it has been in markets. The first measure of this is the daily "mood swing" of the US share market. It shows the intra-day volatility (the difference between the high and low of the US equity index each day) and expresses that range as a percentage. The one-month rolling average is shown below and we are currently at the lowest level for thirty years. It confirms that markets have been very, very quiet.

Figure 1. US Shares Mood Swings



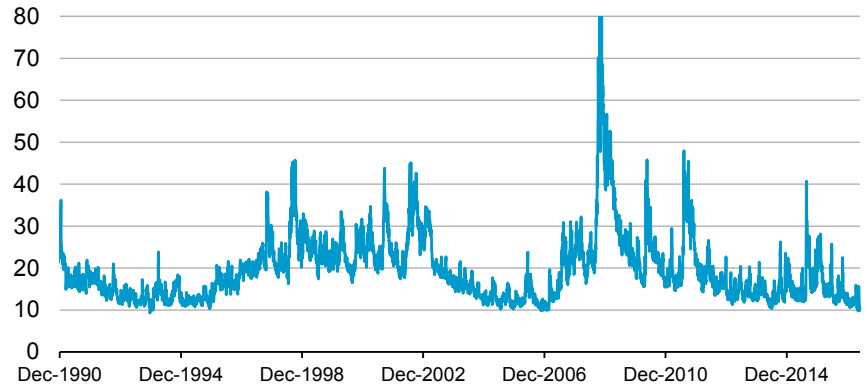
Source: LGIM, Bloomberg L.P.

But does this matter to investors who aren't sat in front of Bloomberg screens or wearing coloured jackets on a trading floor? Not really, although a related measure is often used as an indicator of how complacent markets are. This measure is called the VIX index and is often pointed to as a barometer of how worried markets are about risk. It measures how variable the US share market will be over the next month, as implied from movements in the option markets. The VIX reflects the cost of insurance against share price moves and has also been called the "Fear Index" because when markets are in panic mode it shoots sharply higher. As you can see in figure 2 the VIX is at all-time lows. No panic to see here.

One interpretation of this very low level of the VIX is that it shows that share markets are suffering from a dangerous complacency, and by implication, that markets are headed for an imminent downturn. But is this the case?

We would caution against this somewhat simplistic argument. What is clear from the two charts is that markets can remain quiet for prolonged periods of time, so saying

Figure 2. VIX Index (aka the Fear Index)



Source: LGIM, Bloomberg L.P.

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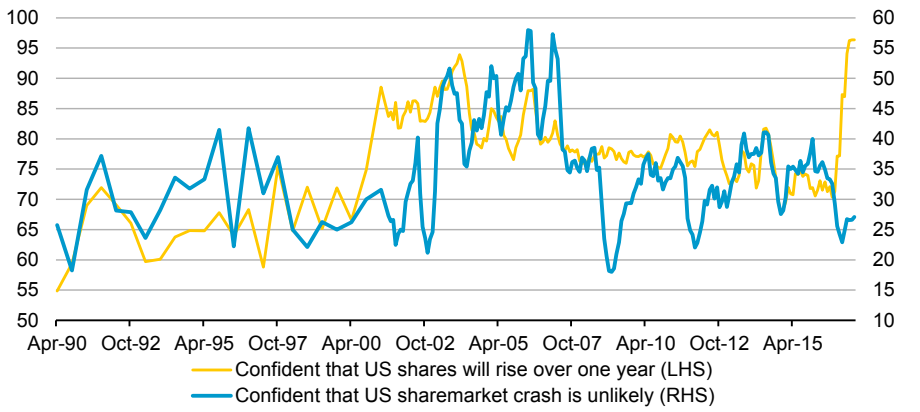
Figure 3. Confident in gains, realistic about loss



Source: LGIM, Yale International Centre for Finance

that these conditions are unlikely to last is very true, but not particularly helpful. The VIX also typically reflects what has recently happened in markets (very low volatility), rather than being a pure barometer of investor complacency.

ARE MARKETS SWITCHED-OFF TO RISKS?

So if these measures tell us little about complacency, how else can we determine this? Fortunately, Yale University has been surveying individual and institutional investors in the US since 1989, and the survey doesn't just ask investors if they are bullish or bearish. Two questions are relevant in answering our question of "are markets complacent?"

The first is the percentage of investors (we average both individual and institutional investors) who believe the US stock market will rise over the coming year. Here we once again come across all-time records; an amazing 96% of surveyed investors believe the stock market will be higher. While this indicator is usually well above 50%, and it tends to follow what markets have done, it does seem that one-year bears are approaching extinction at only 4%!

The second is the percentage of investors who think the chance of a stock market crash in the next six month is less than 10%. Back in 2006, 58% of investors thought that the probability of a crash was less than 10%; this was the era when many believed the economic cycle had been tamed through central bank wisdom. That was clearly not the case. Today, that figure is closer to 27% and towards historic lows. That shows a reasonably healthy awareness of downside risks and not the "you can't lose money" mentality of a bubble.

Other indicators we follow also point to a mildly positive, but not particularly exuberant sentiment amongst investors so no need to be rushing for the equities exit yet.

WHAT TO WATCH NEXT?

When will this quiet time in markets end? There are a number of possible scenarios for the US market going forward, and of course this will have a large influence on equity markets globally:

- **Last of the Summer Wine** – it is quite possible that a balance between structural headwinds to growth and continued low interest rates, keeps the economy in an extended, though sedate, expansion phase.

- **Springwatch** – if animal spirits are ignited and retail flows come back into the US equity market we could start to see markets spring higher, and with that become more volatile, much like it did in the late 1990s.

- **The Late, Late Show** – as the US economy grows it start to use up spare capacity, leading to higher wages and inflation. In order to control this inflation we may see higher interest rates and the risk of a recession. Signs of this late cycle dynamic is one of the key things our economists watch out for.

- **The X Factor** – there are many possible triggers for a sudden shock to markets; North Korea or other geo-political hotspots, further calls for Trump to resign or be impeached, China's currency being devalued, or a policy mistake as the US and European authorities taper the size of money printing.

While we are concerned by some of these scenarios, it is important we keep our minds open to the evidence, and not impose a pre-determined view as to what markets will do next. While markets do display some patterns of past performance, the future won't be an exact re-run of the old episodes. So far these quiet conditions have coincided with solid returns on the Mixed Investment Funds. If markets become more volatile, diversification will become even more valuable as a way to control risk.