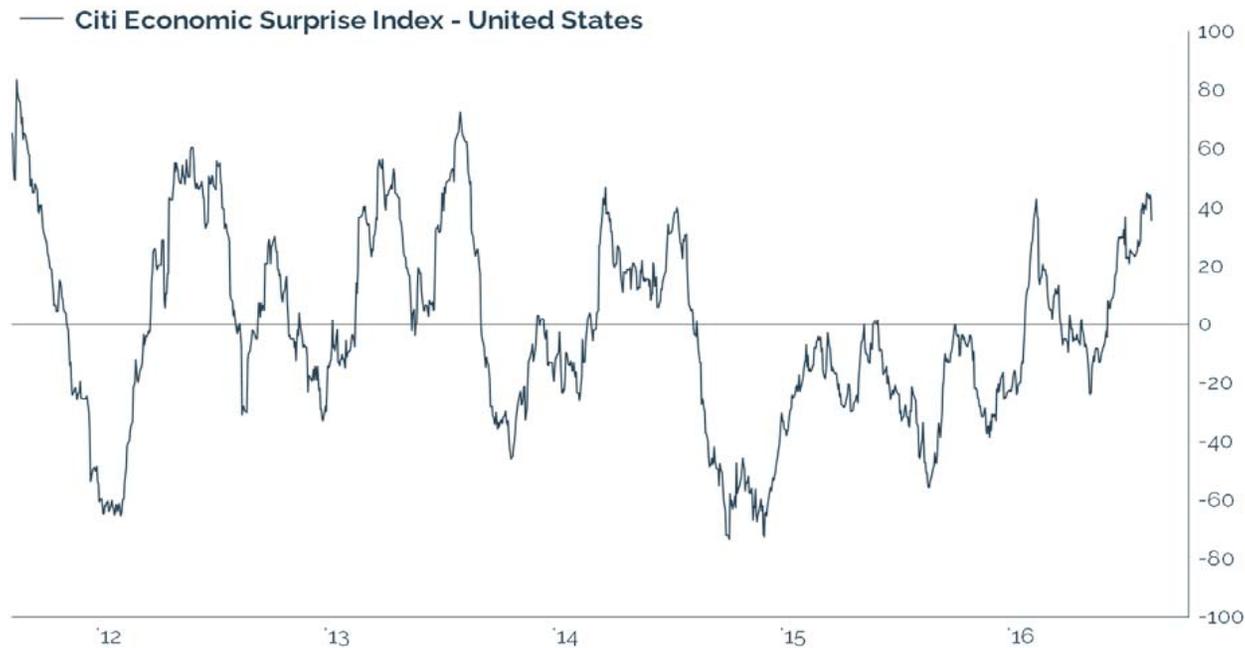


## Complacency & Expectations

Something is in the air and water. You can just feel the energy. It has been years since the markets have felt this invincible. There is seemingly nothing that can stop this market from going higher, except for maybe a tweet by POTUS. Corporate earnings have exited a year and a half long recession. Macro-economic indicators have all been improving over the past few months, as shown by multi-year highs in the Citigroup Economic Surprise Index.



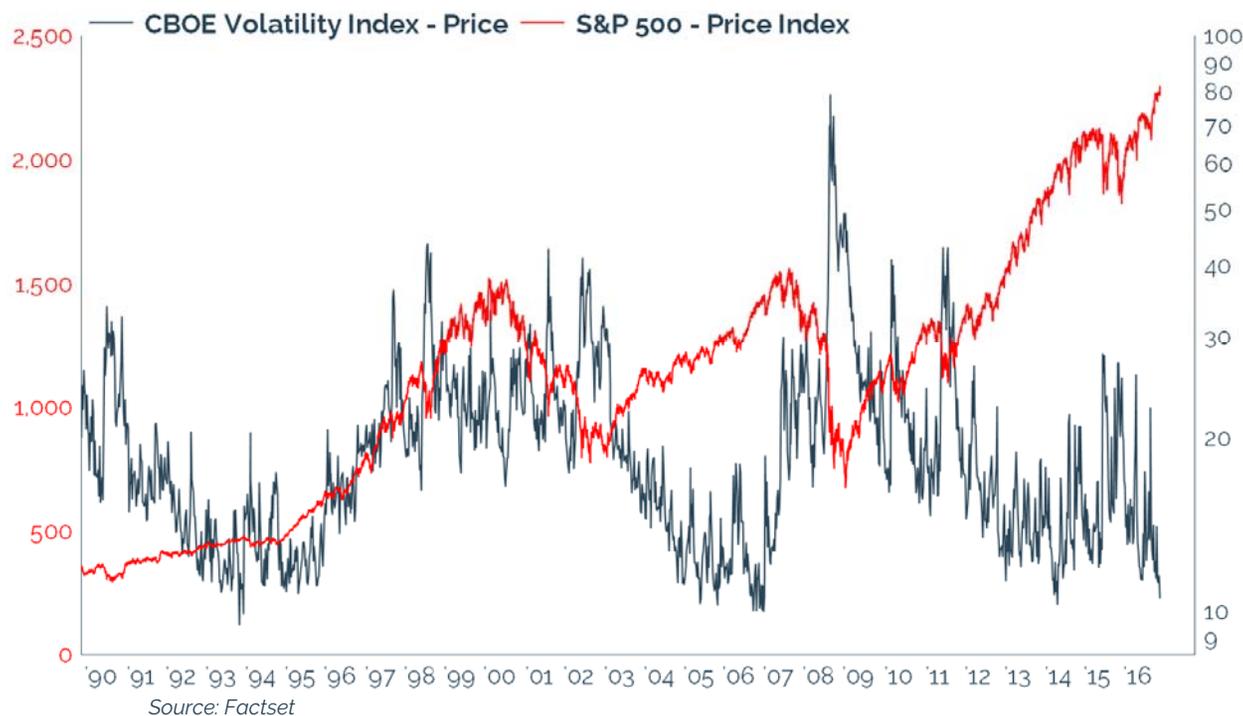
Source: Factset

And, U.S. equity indices just broke through large, round psychological numbers. The Dow has shot through 20,000 and the S&P breached 2,300. Animal spirits are alive and well!

As we recently discussed in the January edition of *The TANDEM Report*, there is one major headwind to future return expectations – valuations. However, even historically high valuation levels don't seem to matter too much right now. Equity valuations were also considered historically high when they were at this same level by the end of 1997. As we all know, the S&P 500 P/E ratio based on operating earnings went up another 40% and the index finally topped out 2 years later and 60%

higher. We've learned from the past that sometimes valuations are ignored for a lengthy period of time. But, at the end of the day, valuations will matter again and the market will re-price accordingly. That time just doesn't seem to be right now.

One indicator showing downright complacency is the VIX. The VIX, or the so called "fear gauge", is the market's expectation of 30-day volatility in the stock market. At a current level of 10.58, which was the most recent weekly close, the market expects a daily move of +/- 0.55%. This is extremely low. To put this VIX level into perspective, since 1990 there have been 1,413 weekly closing prices. Only 12 weeks or 0.85% of the time has the level of the VIX been lower than where it closed on January 27<sup>th</sup>, 2017. Some would say this is a pretty rare event.



You'll notice in the chart above that there were three other points in time since 1990 that the VIX traded around current levels – '93/'94, '06/'07 and '14. In all the instances, the VIX did not spend much time at the lower bound. There was some short-term weakness, but the S&P 500 ended up making new highs within a year or two. The 2007 signal was the only one where a new high was set, but it was promptly followed by a bear market. Granted the sample size is not huge, which makes the VIX's current level all that more interesting.

The real question is whether this information tells us anything about future return expectations. You often hear financial pundits tell you that it's a good time to invest in the stock market when the VIX is low. And, you should heed caution when the VIX is high. To be honest, this seems a little counterintuitive to me. If the rationale is that stocks tend to drift higher in a low volatility environment and stocks move lower amidst elevated volatility, then this is the very definition of buy high and sell low.

Last time I checked, the ultimate goal to investing was to do the complete opposite. We know from the chart above that the S&P made a higher high in every instance within one to two years. So, maybe we can glean some information on shorter term return expectations. So, I decided to crunch some numbers and analyze the performance of the S&P 500 over a relatively short period of time, as seen below.

**S&P Performance When VIX Is Lower Than Current Level**

	<b><u>1 Week</u></b>	<b><u>1 Month</u></b>	<b><u>3 Month</u></b>	<b><u>6 Month</u></b>	<b><u>1 Year</u></b>
<b>% Positive Periods</b>	16.67%	41.67%	41.67%	50.00%	50.00%
<b>% Negative Periods</b>	83.33%	58.33%	58.33%	50.00%	50.00%
<b>Average Return</b>	-0.57%	-0.92%	-0.75%	-0.50%	0.48%
<b>Maximum Up Capture</b>	0.93%	2.17%	4.62%	8.77%	12.86%
<b>Maximum Down Capture</b>	-2.55%	-6.29%	-8.95%	-8.95%	-12.74%

The table above is sort of what I was expecting and not that surprising. From one week to six months out, the average return was negative. And, even though the one year average return was positive, there was no reason to get too excited about it. Over the very short-term, the probabilities of a positive return were not in your favor when the VIX was trading around current levels. If you were patient, you would've been able to get a better investing opportunity. What is most surprising is the amount of downside capture relative to upside capture. Clearly, the amount of risk you undertook when investing in the "market" when the VIX ended the previous week at 10.58 or lower was not worth the return.

The VIX and valuations are at levels worth noting. Our research suggests future "market" returns may be limited, but that doesn't mean they are necessarily going to be negative. Corporate earnings and the macro picture are improving. However, returns are fairly hard to come by when valuations are high and skepticism is low. We are at a point where patience is key. The probability of lower prices in the near future are leaning in your favor. And, this past weekend it was none other than Barron's who may have solidified our reasoning.



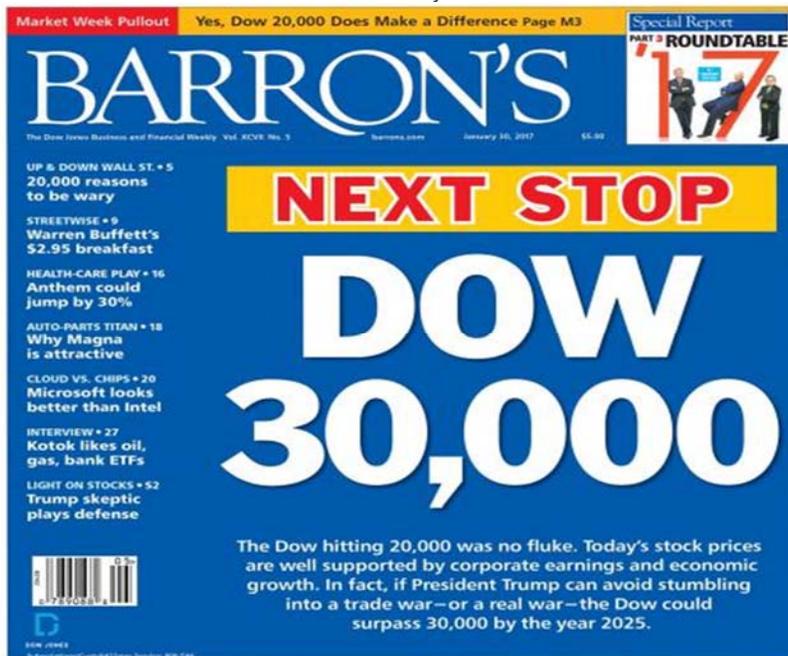
Cover – September 26, 2011



Cover – February 8<sup>th</sup>, 2016



Cover – January 28<sup>th</sup>, 2017



***"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson***

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*\* The purchase price used to calculate the price change was the average price paid by all accounts that bought the specific stock.*