The option market and the bond market continue to tell very different stories about the state of capital markets and the economy. The contrast is notable because prices in both markets have forward-looking elements to them. The implied volatility component of the S&P 500® Index options—measured by the Chicago Board Options Exchange® Volatility Index (the VIX®)—is an indicator of investor expectations of future volatility, while changes in the shape of the yield curve for U.S. Treasury issues of various maturities are indicators of investor expectations for future interest rates. As uncertainty about trade policy and its impact on global economic growth has increased, the option market response has been muted while the bond market response has been stark.

VIX® had surprisingly few readings above its historical average in August despite an equity market decline of nearly 6% from its peak and three one-day plunges of more than 2.5% for the S&P 500® Index. Meanwhile, investor demand for the safety of U.S. Treasuries drove the yield on the 30-year bond to an all-time low and the yield on the 10-year to within 20 basis points of its all-time low. Demand for longer-term issues was so strong that the yield on the 10-year dropped below the yield on the 2-year note, a rare inversion of their normal relationship that has historically preceded periods of economic recession. Moreover, bond futures prices began to reflect a high probability of multiple cuts in the Federal Funds rate over the course of the Federal Reserve's (the Fed) three remaining policy meetings in 2019.

In May's Market Perspective, we noted that VIX® levels observed as the equity market declined more than 6% in May were low relative to VIX® levels during other months in history with similar losses. While May's market decline was relatively significant, it lacked large single-day declines that typically cause VIX® to spike and persist at elevated levels. Amid the increasing uncertainty of August, the equity market also had a sizeable peak-to-trough decline and that decline included multiple days of large losses, but VIX® was still relatively subdued.

Months with three or more daily losses of 2.5% or greater in the domestic equity market are rare. As the table below shows, the last time it occurred was in September 2011 when markets were still reeling from the credit rating downgrade of the U.S. government. Also, note that August 2019 had a much lower average VIX® level than other months with three daily losses of greater than 2.5%.

Months with three or more daily losses of 2.5% or greater are rare

	# of days with losses of 2.5% or greater*	VIX® Monthly Average	Realized Volatility (%)
Nov 2008	7	62.64	71.09
Oct 2008	9	61.18	79.95
Dec 2008	4	52.41	49.74
Feb 2009	3	45.57	36.37
Mar 2009	3	44.80	48.50
Jan 2009	4	44.68	39.42
Sep 2002	3	37.65	30.10
Sep 2011	4	36.53	29.12
Aug 2011	5	35.03	47.18
Jul 2002	5	34.05	42.24
Aug 1998	3	31.59	32.89
Sep 2008	6	30.24	55.12
Jan 2000	3	23.20	26.10
Sep 1998	3	19.89	16.55
Aug 2019	3	18.98	22.83

An important driver of VIX® spikes and elevated levels during times of uncertainty and market decline is increased demand for the protection provided by index put options. The increase in index put prices expresses itself in higher implied volatility and VIX® levels. Similarly, a desire for safety and protection increases investor demand for U.S. Treasury issues, driving up their prices and lowering their yields.

If the contrasting response of volatility pricing and bond pricing in recent months is an indicator that bonds are a better source of protection against equity losses than index put options, it potentially creates the conditions for increased downside risks and higher volatility in the equity market. If investors are buying bonds with the expectation of much lower policy rates in the future, as the Fed lowers rates in response to deteriorating economic conditions, both the equity market and the bond market may be susceptible to additional downside risks and higher volatility if the Fed's rhetoric and policy actions do not match investor expectations.

Uncertainty has always presented risks for investors, but risks associated with monetary policy and trade policy are changing the landscape of uncertainty and investors need to adapt. Gateway's investment philosophy holds that consistency is the key to long-term investment success and that generating cash flow, rather than seeking to forecast the rise and fall of the market, can be a lower risk means to participate in equity markets. By staying true to its philosophy and consistently managing strategies aligned with its historical approach, Gateway will continue to assist investors in managing risk while pursuing long-term returns in this increasingly uncertain environment.

IMPORTANT INFORMATION

Sources: Morningstar Direct℠, Bloomberg, L.P.

For more information and access to additional insights from Gateway Investment Advisers, LLC, please visit www.gia.com/insights.