

The 'European VIX' has just bounced off its all time low on French election jitters. But the CAC 40 Index has been showing signs of increasing risk for several months. The tails of the distribution of 5-day returns on the Index are now the fattest they have been since the spring of 1987. If the CAC 40 reacts as strongly to the French election result as it did to the U.K. referendum, drawdowns could be larger than they have been since 2008.

Low Volatility Doesn't Mean Low Risk

Europe's equity 'fear index' the VSTOXX®, like its U.S. counterpart, recently declined to an all time low of just over 11. The index spiked to 40 in June of 2016 for the U.K. referendum but it only managed to get to 25 for the U.S. elections in November.

What the volatility of returns cannot reveal is how fat the tails of the returns distribution are—as we demonstrated prior to the U.S. elections. (WJH 8 November 2016 Market Intel Cauchy Corp).

The fatter the tails, the higher the propensity for extreme losses or gains. This can be seen through the ratio of Expected Shortfall (ES) to Value at Risk (VaR). The fatter the tail grows, the higher this ratio becomes. For 5-day returns on the CAC 40 Index, the ratio of 99% ES to VaR for a long position was 1.5 last November but it's 1.8 now. And on the short side it has gone from 1.5 to 1.7.

The 5-day tails haven't been this fat since the spring of 1987. The 99% ES for a long position in the CAC 40 is currently 13.6% and the 99% ES for a short position is 12.6%.

The fatter the downside tail the more extreme the potential drawdown

In the aftermath of the U.K. referendum the CAC 40 Index had its worst 5 days since the summer of 2015 with a loss of 8.2%. Our tail model indicates that such an event should be expected once every 6 months. It's only prudent to ask what we should expect should such a loss be exceeded.

At the end of 2016, the answer would have been a loss last seen in the summer of 2011 after the U.S. downgrade. But now the tail has fattened to the extent that we should expect a 5-day drawdown larger than anything experienced since October 2008.

Overdue for a Correction?

Like all major equity indices, after the summer of 2011, the CAC 40 Index went through a long Unstable Expansion. These are periods of unsustainable asset price increases which emerge during booms and predict the extent to which markets must subsequently correct.

We expect that the CAC 40 Index will fall to 3,550 or lower. The index is now primed for a large move. Perhaps the election result will provide the trigger.

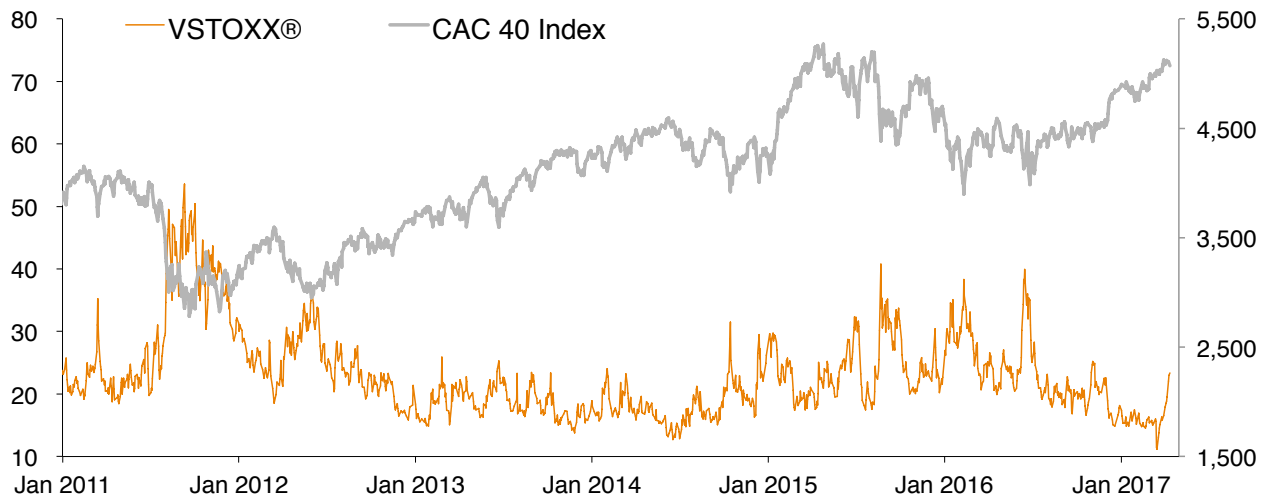


Figure 1. VSTOXX® on left hand scale, CAC 40 Index on right hand scale.

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