The VIX has dropped back to where it was a year ago. But the 'fear index' can't tell you the probability of a severe drawdown over several days. Omega Metrics® 10-day risk estimates show a high probability of exceeding last summer's worst 10 day loss of 10.4%.
If that happens, the expected loss is 16.2%, matching the drawdown of August 2011.

What the Fear Index Can't Tell You

The VIX, often called the 'fear index', responds in a highly volatile way to losses in the S&P 500 Index as Figure 1 shows. But after its frantic reactions, the fear quickly fades from its 'memory'.

Last August's market rout saw the VIX spike from 14 to over 40. By November it had dropped to 14. February of this year saw a peak of 28 but by the end of May it was back down to 14.

But until this week investment banks have reported the longest run of 'smart money' exits from the equity markets since 2008. Even with the VIX at 14, there's a lot more to be afraid of than there was a year ago.

Measured Not Modelled

Omega Metrics® Multi-day VaR and ES are not modelled by extending the levels for daily returns. They are computed directly from multi-day return history. As market observers know, there are periods where 10-day returns carry less risk than 5-day returns. This is something standard models predict can't happen but which our approach correctly identifies.

Our multi-day VaR estimates have proved their accuracy in over a century of US equity market data. For 10-day returns in that period there were only 10% more VaR breaches than should have been observed. Excluding October 1987, the excess falls to only 6%.

Downside Risk in the S&P 500 Index Has Exploded

Unlike the VIX, which alternates between panic and lethargy, our measured risk levels don't immediately forget what happened a few months ago. In its worst 10 day period last August, the S&P 500 Index lost 10.4%. That loss was 'overdue'. Based on the risk levels we observed at the end of last July, it should have been expected about once in 700 days–and over 1,000 days had passed since the last occurrence.

In the past year, risk has exploded. Omega Metrics 10-day VaR and ES analysis shows that the 99% risk levels have increased by 32%. (Current ES contingent on a breach of the 99% VaR is over 13%.)

A Repeat of August 2011?

It would be foolhardy to assume that a 10 day loss worse than the one last August could never be repeated. In fact, such a loss is again overdue. Our tail fit says that a loss of that size should now be expected once in 170 trading days–and 190 days have already elapsed since the last one.

It is only prudent to ask what we should expect the average loss in excess of 10.4% to be. The answer is that it would be over 16%, a level last seen in August of 2011.

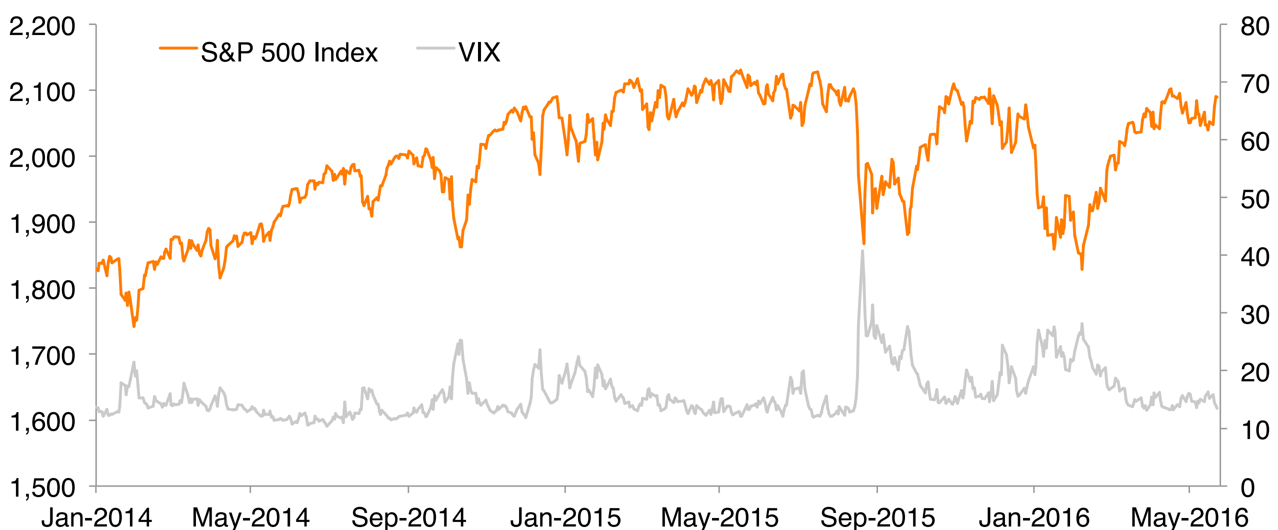

Figure 1. S&P 500 Index and VIX Index, 2014-2016.

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