

Is The Volatility Index VIX Too Low Compared to High-Yield Spreads?

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In the previous post entitled [Relationship Between Credit Default Swaps and Equity Options](#) we discussed about the link between corporate credit spreads and [equity volatility](#). We also provided an academic reference that formally proved their relationship. Basically, there is a high degree of correlation between the VIX and corporate credit spreads.

Recently, John Lonski of Moody published an interesting report in which he presented the [correlation](#) between the VIX index and the high-yield credit spread. However, the difference here is that the high-yield credit spread was shifted by 3 months. His calculation also showed a high degree of correlation:

The VIX index's moving yearlong average generates a very strong correlation of 0.89 with the high-yield default rate of three-months later.

The high lagged-correlation is consistent with another observation presented in the article: the VIX is a leading indicator of where the high-yield credit spread is going:

Throughout much of 2016, the VIX index proved to be a reliable leading indicator of where the high-yield spread was headed.

These are very interesting observations, indeed.

Finally the author also pointed out:

Nevertheless, if only because the VIX index now resides in the bottom percentile of its historical sample, a higher VIX index is practically inevitable. Once the VIX index approaches its mean, the high-yield spread will be much wider than the recent 377 bp.

The VIX index's latest moving yearlong average of 13.4 points favors a 1.6% midpoint for August 2017's default rate, which is less than the 3.3% predicted by both May -to -date's high -yield EDF (expected default frequency) metric and Moody's Credit Policy Group. An August 2017 default rate of 1.6% seems improbable given April 2017's much higher default rate of 4.5%. (Figure 4.)

Profits growth is key to realizing lower default rates, as well as avoiding both a deep plunge by share prices and a ballooning of corporate bond yield spreads. Given how today's substantial overvaluation of equities heightens the vulnerability of earnings-sensitive markets to adverse developments, the imperative of achieving profits growth cannot be understated. For now, the weight of the available evidence suggests a mild rise of 2% to 7% for 2017's pretax profits from current production. [Read more](#)

The above seems to say that the VIX index will have to rise in order for the VIX-HY credit spread differential to contract. This is in agreement with a recent comment made by Bill Gross that high-yield bond spreads have become too tight and can only widen going forward:

Gross, who manages the \$2 billion Janus Global Unconstrained Bond Fund, is betting that high-yield bond spreads have gotten too tight and can only widen after reaching an almost three-year low in March. The so-called Trump trade, which has buoyed risk assets, will gradually unwind as markets are overpriced because investors are too optimistic about the president's ability to boost U.S. economic growth to 3 percent. [Read more](#)

So the consensus is that the high-yield spread will not go lower and the VIX will rise in order to catch up.

But does this mean that **the high-yield spread is leading the VIX**? Let us know what you think.

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