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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