Volatility and Interest Rates

***e*Research Corporation** is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan looks at the volatility of the stock market in the context of rising interest rates.

The article is reproduced below, beginning on the next page, or you can use this link to go to the article directly:

http://www.mcoscillator.com/learning_center/weekly_chart/volatility_and_interest_rates/

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Bob Weir, CFA
Director of Research

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The McClellan Chart-In-Focus

by Tom McClellan (bio at end)

Volatility and Interest Rates

Why is the VIX spiking now? Because now is when it is supposed to do that.

Volatility and interest rates have an interesting relationship, going back many years. Higher interest rates pull money away from the stock market, and thus make it so that prices have to travel farther to find liquidity, after a positive or negative stimulus.

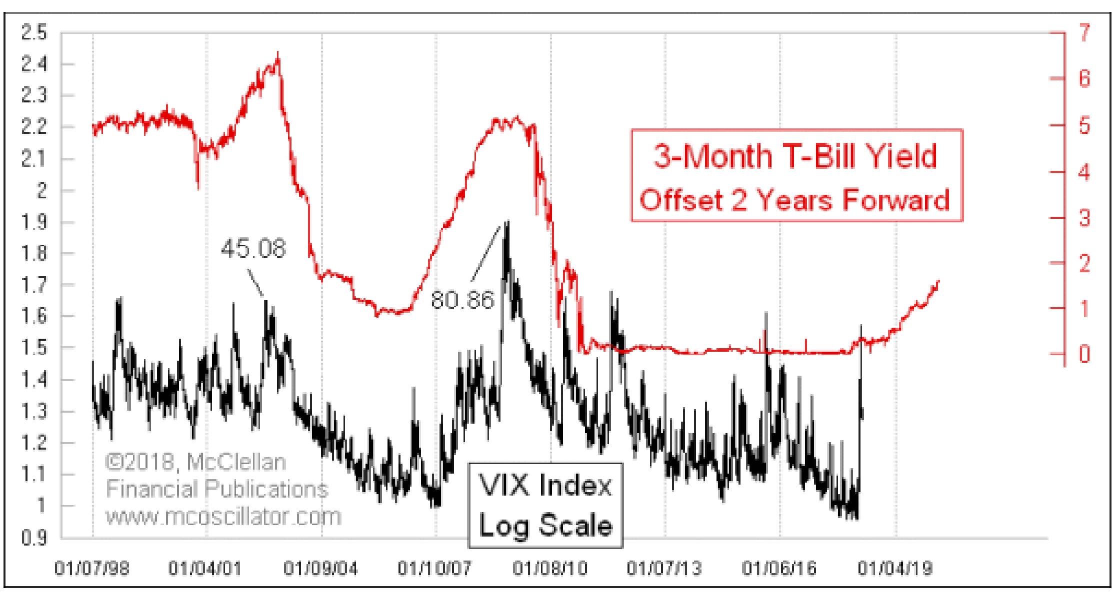
The word "volatility" gets thrown around a lot in our business. We should all remember that it gets borrowed from the world of chemistry. It refers to the amount of reaction you get for a little bit of input. Asphalt is made from tar, which is flammable. But if you drop a lit match onto asphalt, the match will flame out. Asphalt is not very volatile. If you drop a lit match onto a puddle of 30-weight motor oil, it might burn, or it might swallow the match. If it burns, it won't do so very fast. 30W oil is NOT very volatile.

Now, if you drop a lit match onto a puddle of gasoline, you are going to need to grow some new eyebrows. You will get a big FAWOOMP!!, as well as a talking-to from the firefighters who come to bandage you up. Gasoline is very volatile.

In each of these cases, the input stimulus is the same… a lit match. The response varies, though, according to the nature of the organic chemistry of the medium into which the match is dropped.

The stock market is very much the same. A news item which might get no reaction in some periods gets a huge reaction in others. The volatility of the market varies, and for reasons which seem entirely mysterious on the surface. But if we find the key to unlock this mystery, the variability of volatility starts to make more sense.

This week's chart compares the 3-month T-Bill yield to the spot VIX Index on a logarithmic scale.



This is a relationship I uncovered years ago, and which I have talked about in our twice monthly *McClellan Market Report*. But it has not been ripe to talk about here until just now, because the Fed has had its boot on the neck of the bond market until just recently. By finally allowing a couple of years ago for short-term interest rates to start rising again, the Federal Reserve set the stage for volatility to start rising now.

Movements in the VIX seem to lag movements in the 3-month T-Bill yield by about 2 years. We are now just over 2 years advanced from the December 16, 2015 FOMC meeting, when the Fed finally allowed the Fed Funds rate to be lifted from the "0 to 0.25%" target. Right on schedule, we got a volatility spike on the 2-year echo point of that change.

Why is it that 2 years is the magical lag time? I really don't know. But I do know that a 2-year lag time has been a good explainer of the VIX's movements for the last couple of decades, and so at some point I stop questioning it, even if I don't have the "why".

The chart plot of the 3-month T-Bill yield shows an upward rise, but it really did not get started until December 2015. Adding 2 years gets us to December 2017. The spike in the VIX was just over a month late, coming in late January to early February 2018.

Now that we have that spike, what is next? The plot of the 3-month T-Bill yield says that the VIX should pause for a while, and then start trending upward late in 2018. We have been through higher T-Bill rates before, and we will get through this upcoming episode. But the point to understand is that the era of single-digit VIX numbers is behind us.

Tom McClellan, Editor,

The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* follows on the next page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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