S&P 500 Weekly Forecast 8/23

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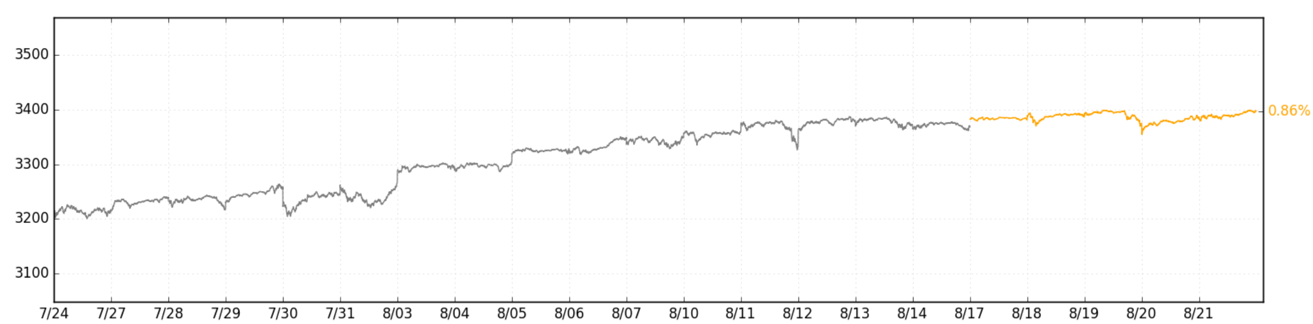
Hey everyone,

Gamma Week was just about as exciting as you'd expect, ending **+0.86%** with some crazy low volatility. Like we said on Tuesday, we think this is largely because a lot of traders now know about GEX, and -- in a glorious feedback loop -- expect big expiration weeks to be muted. So they basically take the week off, anticipating volatility to resume on Monday.

Question is: Will it resume?

1. Gamma Week
2. Un-gamma Week
3. Juice

Gamma Week
The week did this. It was boring.



Our bet was against volatility (iron fly centered at 3380), so we managed to profit from the boring. We mentioned in Wednesday how, even though some of our derived numbers were incredibly wrong, the trade was still good.

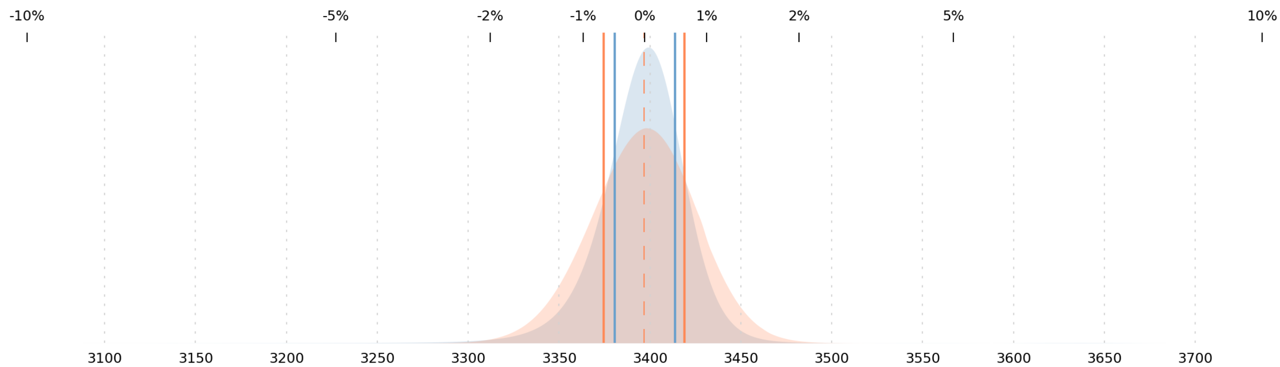
> Oog. Embarrassment time. So after a few more days of running our sizing algorithm and trying to figure out how it actually works, we figured out that Sunday's "average rate of return (ARR)" calculations were stupid, owing to a bug. And while this *doesn't* at all take away from the fact that the suggested iron fly was the optimal position to take out of the millions tested, it *does* take away from the hope that we'd have precisely one bajillion percent gains every year.

Weekly index return on the week prior was 0.55%. So these two weeks have been *very* flat, and all of our trades (including short VXX -- what's left of our position) have been doing well. Not much else to say.

Un-gamma Week

So, GEX+ fell from almost $900mm to $640mm on Friday as the SPX options disappeared. This does potentially open volatility up a tad: In the language of gamma-implied volatility (GIV), it raises the average expected daily move something like 0.05%. So, that doesn't sound like a very big deal, *but* there are two things that make it a bit more interesting.

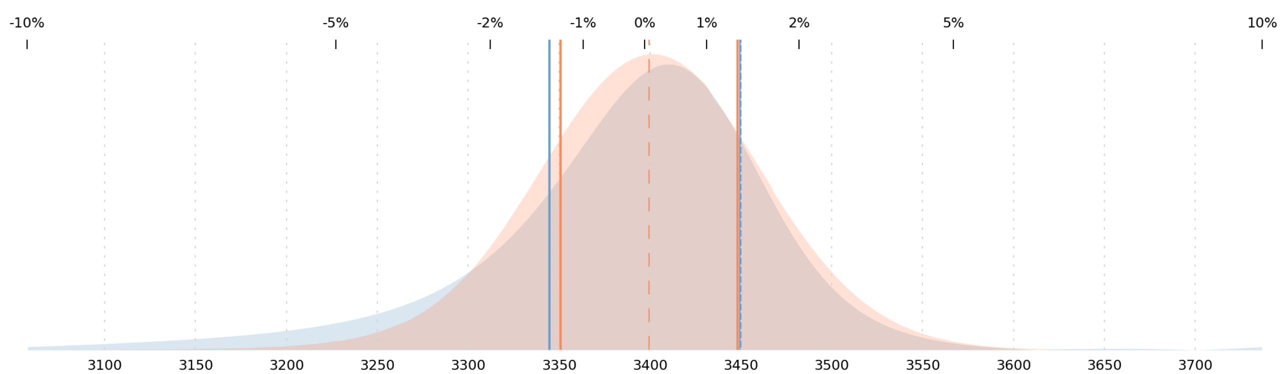
First of all, near-term S&P 500 volatility is really low. You can see from the Probability Page that the 1-day market-derived probability density below (the blue) is noticeably narrower than what GEX+ implies (the orange). If you stick this 1-day discrepancy into the Juicer (the optimization algo), it tells us that we can make an average of 2.3% (1-day) gain by betting on the shoulders of that distribution.



Specifically, that means buying a straddle at 3400 and selling a strangle at 3350/3450 (some might call this a "short iron fly," and the algo says buy 151 of them per $1mm bankroll). So you're not betting on a *tail* event, but rather on movement being a bit higher than what the market was expecting (*actually* betting on 1-day terminal distributions with end-of-day data as your guide is a bet of a stretch, though). In any case, even if this is a difficult trade to actually execute, this sounds like a pretty good summary of a good intra-week trade for this coming week: *You're not betting on a tail event, but rather on movement being a bit higher than what the market was expecting.*

This leads to the second thing that makes this coming week interesting: *People already think it will be.* This is a potentially interesting scenario -- a lot of people seem to be betting on a rise in volatility here, and even though we estimate that any uptick in vol would be short-lived, there still may be a small trade here. (We have a tiny long OTM put position that we'll take a quick profit on if IVs spike.)

Why are we even bothering with all this weird strategy stuff? Well, because the 5-day probability densities just aren't quite appealing enough to trade. The least-worst trade seems to be betting on a small move lower (-1%), since that's where the orange density is taller than the blue, but when you actually try to price this out, there really isn't enough edge to make it worth paying the bid-ask spread.



So to the extent that we think there's a trade *at all* to be made this week, it's *entirely* predicated on a hunch that some folks might temporarily crowd into long vol after the monthly option expiration. That's all there is to it, because according to the GEX+ probabilities, there's not much else to bother betting on. Weirdly, we found Gamma Week more exciting than this.

And while the above is not exactly "bearish" talk, you might notice, dear reader, that this is probably the first time we haven't felt *bullish* about the index since late March. At 3400 SPX, sentiment seems to be shifting more toward "neutral."

Juice

Speaking of sentiment, we were supposed to be building a "Sentiment Sheet" (the third daily PDF document to go along with the Risk Report and the Probability Page) right about now -- and in case you were wondering, no we did not forget. For the last two weeks, we've been exploring this concept of Kelly-optimizing option positions (a concept that we've named "Juice") because it was relevant to the release of the Probability Page and how one ought to approach probability densities.

And by now (after these past two weeks of yapping about it) we're pretty sure that Juice is going to become a central component of the way we view risk in the market. However -- especially after this week's mushy sentiment talk -- we *do* need to get back to building a Sentiment Sheet. So that's what we'll start talking about next week.

Sunday notes from now on, though, will have our Juice algorithm weigh in on the weekly probabilities. And we'll keep you posted on progress with the concepts. Getting it right is going to take some time and care, but we've no doubt it's going to be worth it.

Enjoy the week!

The SqueezeMetrics Team