S&P 500 Weekly Forecast 8/30

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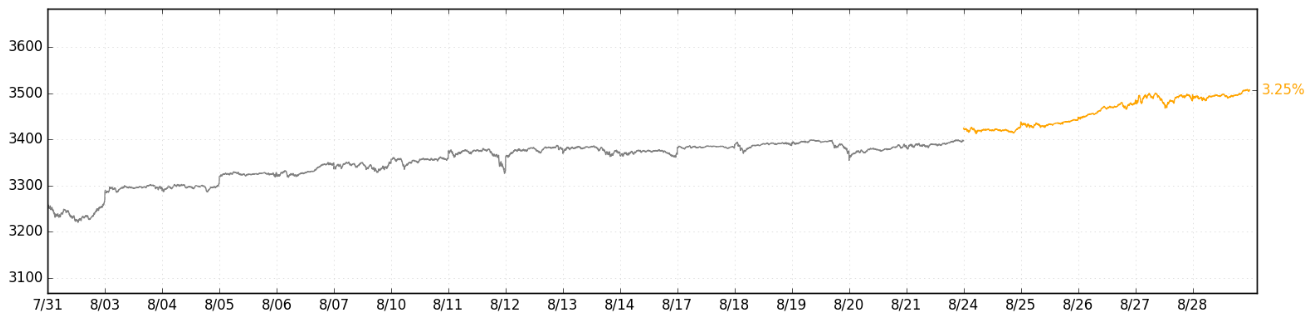
Hey everyone,

Last weekend, we said that we've finally switched from "bullish" to "neutral." The S&P 500 laughed heartily and gained **3.25%**.



We're not going to argue with the market (there are lots of people who can supply that commentary), but SPX is making a symbolic gesture here: The last five days looked like a classic "breakout" chart pattern -- something that only exists in reality by virtue of how many people *believe* in it (like Bigfoot). The market's only going up because the chart looks pretty. In other words, Dave Portnoy is truly the hero we deserve.

The psycho-social aspects of markets aren't really our *forte*. As you know, dear reader, we tend to be more interested in predictable, transactional flows between boring professionals -- and the measurable impacts of these flows (DIX and GEX are *both* about the quotidian business of market-making). So when we consider inherently flaky, psychological things like gamified retail option flows, or Hail Mary plays by underfunded pension plans, or all of the weird ways that incentives impact *humans*, we already feel like we're up to our knees in squishy, swampy sentiment.

> I can calculate the motion of heavenly bodies, but not the madness of people.

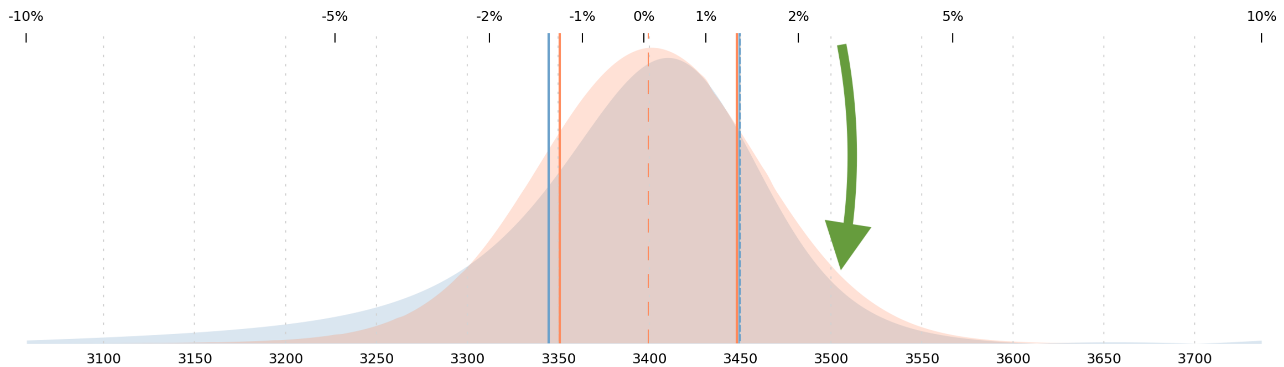
But the trouble with sentiment is *not* that it's bad to try to measure it and act on it. The trouble is that it's slippery and amorphous, and it becomes difficult to translate it into probability -- the language of actual risk-taking. Sentiment analysis easily devolves into all manner of self-justification *prior* to the trade, poor risk management *during* the trade, and then rationalization *after* the trade (the worst of all, if you're trying to make a career of this). To consider the inherent irrationality of market sentiment in your analysis, then, requires of you a certain hyper-rationality to counter the many temptations of "sentiment analysis." Without a real process, mushy brain stuff begets mushy brain stuff.

So with that huge caveat, we'll talk about some usual stuff, and some sentiment stuff.

1. What has shoulders...
2. *Might* have legs...

3. But has no tail?

What has shoulders...
A 3.25% gain on this past week is a "right shoulder" event.



Shoulders, by nature, bear more weight than tails -- but people still spend a lot more time thinking and talking about tails. This is very sensible when you understand that most people have concerned themselves with linear / delta one products, for which tail events are a big deal, and warrant a lot more attention. For options practitioners, though, any part of the distribution can be "targeted." You don't *need* to have an opinion on tail risk.

Last weekend, we talked about buying the "shoulders" of the Monday 1-day distribution (an admittedly difficult/impractical example) by buying an ATM straddle and selling a strangle: A bet that the shoulders of the distribution were underpriced (a "long iron condor"). We ended up being [trivially] right -- Monday returned +1%, which was about twice what the options were implying.

More important, though, is that we were *non*-trivially right about *not* making the usual weekly trade -- i.e., we thought this past week would be a very *bad* time to try to sell our usual iron fly, and we were right to sit on our hands. The index would have trended far away from our center strikes and probably given us a full loss.

So, disaster averted. But what next?

***Might* have legs...**
"The big question" is a sentiment question, so re-read that extended caveat above, sign some paperwork that says you don't hold us liable for our stupid ideas, then continue.

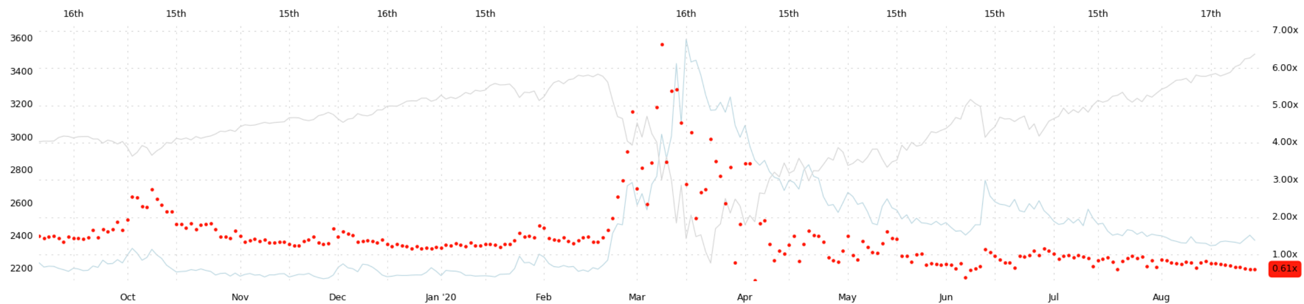
There's this popular idea going around that marginal flows into call options in "Big Tech" stocks are driving upside volatility in a huge chunk of the S&P 500. This popular idea is correct. We talked about it a month ago, but we thought it would end sooner, due to the way vanna and gamma interplay (7/26 note):

> For every moment that the gamma isn't continuing the rally, the vanna will be quietly stifling it, and if IVs are relatively high (and are likely to mean-revert, absent other forces), then there will be latent selling pressure.

What we *didn't* see was that human behavior got in the way -- people kept buying more calls on the tech stuff. We could defend ourselves by saying it's "unprecedented," but why bother? "Blah blah unprecedented" is an excuse, and we're lucky in that our positioning so far hasn't been hurt by the phenomenon.

So... does this stupid retail call-buying rally still have legs? *Sure, why not?* But by golly we don't know how to put a number on that. Fortunately, we can still reason our way to a useful (albeit mushy) conclusion.

But has no tail?
Now that we've moved from "bullish" to "neutral" on the index, only *one* thesis remains intact from March. That thesis is that a crash (a drawdown in excess of 10%) ain't gonna happen. Not only are we hundreds of SPX points away from zero GEX+ (where volatility sustainably picks up), but even if SPX were to fall to ~3100, there is no dangerous, leveraged short put position in the market to cause volatility to be "offsides." That is why our "crash risk" metric is so absurdly low (0.61x).

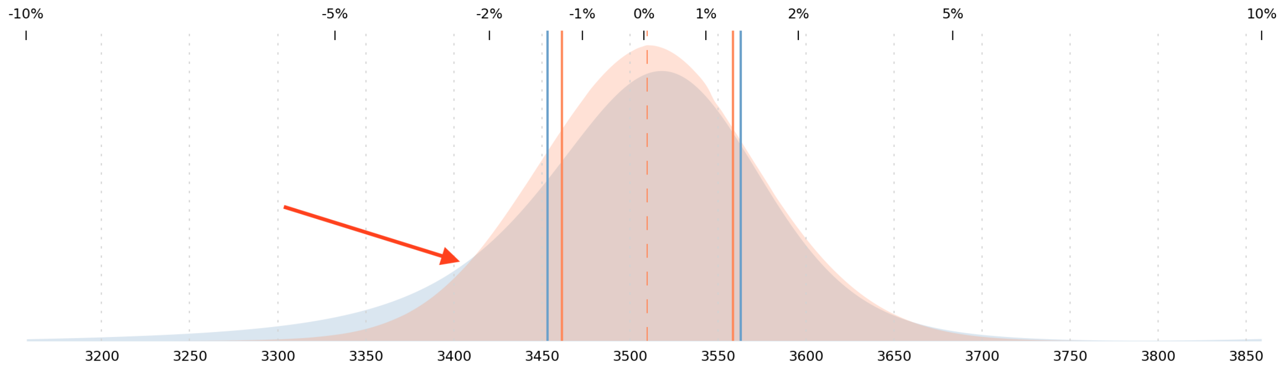


In our VEX paper, we rather forcefully made the point that true crashes are *invariably* a function of excess customer short put positions in the market, since the vanna of those positions ends up taking liquidity from the index precisely when things start falling apart. The customer short put is unique in this way -- it adds top-of-book liquidity, but removes conditional liquidity (depth of book).

Long OTM call positions are also bullish, like short OTM put positions (long delta for the customer), but the gamma and vanna impacts are opposite. Because it's a long option position, it gives dealers short gamma, which takes top-of-book liquidity and exacerbates volatility; and because it's a long OTM position, its delta rises with implied volatility, which provides a bid when IV rises.

Thus, the long OTM call is actually quite a bullish thing for the underlying (if you couldn't tell), because the presence of the calls give gamma-rally potential while at the same time protecting against the worst kind of downside volatility (recall that our prediction from a month ago was for the OTM calls to cause quiet, "latent selling pressure" -- nothing dramatic). Sure, gamma "cuts both ways," and the "FANGMAN" stocks are likely to have oh, -3.00% days, but as soon as those OTM calls become *more* OTM (on a dip), they lose their gamma, and they stop accelerating the decline. In fact, as the stock continues to fall, any concomitant rise in IV actually causes the OTM calls to become higher delta, which compels dealers to buy stock as a hedge -- a *stabilizing* force in book depth.

A *lot* of people want a reversal of fortune for Big Tech, and for the market as a whole. They generally buy puts to express this desire. But by golly if that isn't the way to go. Not only will the high-flying stocks not correct as violently as you expect, but the sold *SPX* calls (yes, SPX calls are still net sold) will continue to provide a cushion to the index. The way we're thinking about it is that dealer long gamma in SPX *plus* dealer short gamma in AAPL, FB, NFLX, etc., *equals* more returns in the shoulders, but not the tails, of the distribution.



With the above 1-week (5-day) density comparison (which is pure GEX+ and none of our stupid sentiment analysis), our Juice algo tells us to secure an average 1.00% portfolio gain by selling a bull put spread, **+3335p -3410p**. For a $1mm bankroll, max Kelly would sell 70 of these spreads. The spread is basically betting that the probability of ending below ~3410 (red arrow) is lower than what the market implies (as evidenced by the blue density having that prominent left tail).

Given what we [think we] know about what's going on in the broader market, this seems like a very boring, but smart, bet in the absence of a clearer volatility edge. Indeed, it seems quite reasonable to view the 1-day and 5-day densities on the Probability Page and to decide to be long the shoulders of the distribution on a daily timeframe (long ICs, gamma scalping with shoulder-width bands, etc.), while being short the tails on the weekly timeframe (short ICs). But that's for you smart people to figure out, not for us.

So here's to betting on another shoulder-width weekly return, and hopefully, *some* indication that the market isn't dominated by YOLO calls for the foreseeable future.

In related news, we're going to start building the Sentiment Sheet PDF this week, in order to make these mushy conversations a bit easier. Because it's about time we starting thinking about that.

Oh look, E-minis are already ramping. Have a lovely week, everyone.

The SqueezeMetrics Team