S&P 500 Weekly Forecast 1/31

From: SqueezeMetrics <info@sqzme.co>
To: SqueezeMetrics <info@sqzme.co>
Subject: S&P 500 Weekly Forecast 1/31
Date: Sunday, January 31, 2021 9:04 PM
Size: 338 KB

Hey everyone,

Consider the truism, *"For every buyer, there's a seller."*

It's evocative. We imagine buyers meeting sellers under Buttonwood trees, transacting company stock at what they determine to be a fair price, splitting the difference between supply and demand. Supply and demand then shift with new information, and the market price more-or-less-efficiently reacquires that equilibrium price. It's the "free market." It is our individual and Collective Will, the Invisible Hand that guides capitalism.

Now let's talk about the stonk market.

One of the few stocks in the National Market System where "buyers have been meeting sellers" recently is GameStop (GME). People -- *real people and real funds* -- are buying and selling 50-150mm shares per day *to each other*, either in shares or through the agency of option positions. This is not normal. Nor is it what you'd call "efficient."

And that's because our modern idea of efficient stock markets is predicated on the dominant presence of some kind of "specialist" making a market in a stock. In the era of HFT, those specialists intermediate nearly every transaction, and process an incredible amount of information, market-wide, when they quote a spread. They care about the liquidity rebate, the information content of your order, recent filled and quoted orders, potential news, existing inventory, and existing correlated and uncorrelated inventory, including indices and ETFs. Broadly, *they want to anticipate future volatility,* because if they get it really wrong, then quoting a tight spread is going to lose them money. Volatility means everything to the specialist.

This obsession with volatility on the part of the specialist, who is dominant (and this applies both to stock market-makers and option market-makers), is the only reason for the freakishly low transaction costs that we incur when we trade. The specialist has a vision for, and the means to enforce, an incredibly efficient order book, visible only to himself. Sitting in the midst of stock and option flows, with order book data from across a hundred different exchanges (lit and dark, option and stock), *only he* is able to maintain arbitrage relationships, to the extent that it's possible.

The fact that trading stocks costs $0 should demonstrate how well this works. It's amazing. When you trade, you trade with this specialist, and because the specialist is focused on volatility (again, that's how he keeps the spread tight), the "volatility of volatility" is remarkably low.

But what happens when a stock, or stock option, is so popular, and two-sided, that for every buyer there actually *is* a seller. Well, the specialist ends up with very little inventory, and thus very little risk -- and when the specialist has very little risk, he also has very little risk to *manage*. Where he'd usually firm up the bid on a down-move, or the ask on an up-move, or hedge his deltas, he now needn't intervene at all. Where he'd usually quote IVs in line with his own need to hedge, he now needn't intervene at all.

The specialist hasn't left, or been priced out. He isn't in danger. He's solvent *and* he's making lots of money. But... he's no longer the dominant force in pricing. Instead, the dominant force, and the driver of price and volatility, is Chad and Deborah yelling at each other under the Buttonwood tree. Free markets. Capitalism. A buyer for every seller, in the true sense.

Ironically, *this* is where true Risk (volatility of volatility) arises. Because suddenly, Chad's meager breakfast and Deborah's longtime gambling addiction matter more to the market than the specialist's control and precision. Suddenly, psychology is in charge. Like the good ol' days!

Is this happening right now in GameStop? What about in the broader market?

1. What happened
2. What will happen
3. A soft disintermediation

What happened
We came into the week long gamma and short delta (long 100-wide ATM put spread), but long "shadow deltas" through February VIX. On Wednesday, we had the good fortune to monetize that put spread right at the short strike, and with VIX pushing 37, we sold *more* February VIX.

Though we came out a bit ahead, it wasn't by much. It was a fascinating week to be trading, as overblown sentiment and a strong penchant for single-name call-buying and short-squeezing buffeted the whole market.

But aside for the extent of the VIX move, we'd like to point out that this week's action is pretty much exactly what we were betting on: A near-term "left shoulder" event, but *not* a left tail.

What will happen
You probably already know where we stand. We still have a bundle of short February VIX, and we maintain the belief that the market is amply prepared for this, and insulated against "risk" (vol-of-vol). Hence the short VIX position, which is at heart a short vol-of-vol trade.

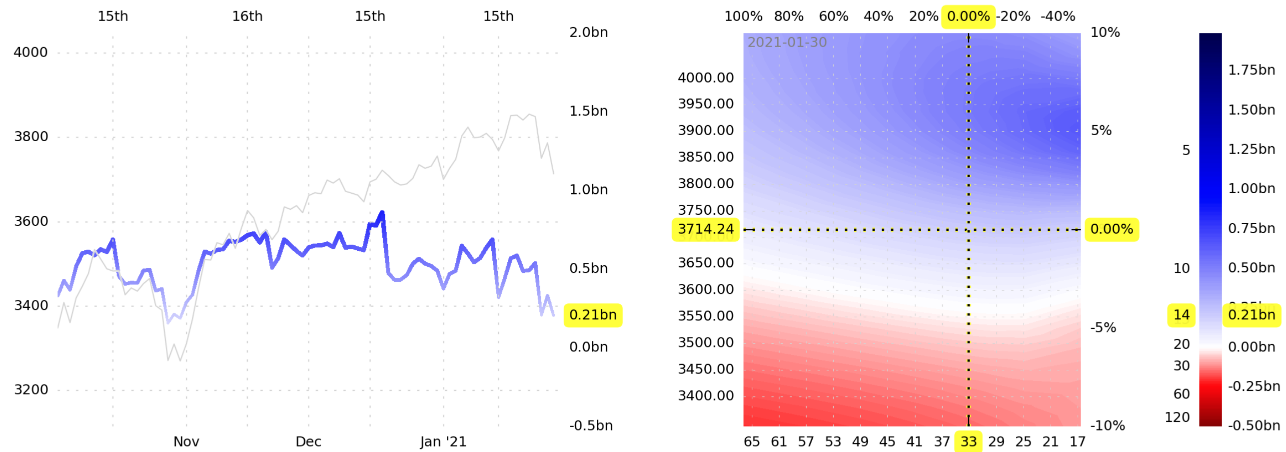
With that said, the index is pricing in average >1.00% daily moves wherever you look. So don't be blindsided by that.

Net put delta (NPD) at -5.16 lines up with recent history: A steady stream of modest put-buying. Had it not been for this, we'd have been purely long vol last week, but this level of NPD provides protection against the left tail.

The customer vanna-gamma ratio (VGR), which has been telling of a fragile situation w/r/t spot-vol sensitivity for weeks now, is finally at a more sane level, -7.05. Here, we would say that VIX is too high, relative to vanna positioning.

DIX, which had been hovering around 40% (more like 37%, ex-Tesla) into this dip, is still uncertain at 41.7%. We'd still be reluctant to just buy SPX.

Lastly, to visualize the situation, let's consult the heatmap of dealer gamma-vanna (GEX+) positioning.



GEX+ is low, and another 5% loss (~3550) to the index brings us to the cusp of sustained volatility. But even the most extreme case, a -10% correction (~3350) and VIX to 65, would not bring volatility "offsides."

Combine this with customer positioning now being tame (with VGR no longer at -3), and you have relative stability.

So basically, even if you're bearish, you're not wanting to be long vol.

A soft disintermediation

We left off with Chad and Deborah. Naturally, Chad is long GameStop calls because this whole thing is funny and markets are a joke, and Deborah is long GameStop puts because this whole thing is *not* funny, and markets are sacred. In terms of "The Implied Order Book," Chad has a bunch of buy stops *above* the market and Deborah has a bunch of sell stops *below* the market.

You know how, in a "normal" situation, the order book has limit sells *above* the market and limit buys *below* the market? People offer to buy when it falls, and sell when it rises. The equilibrium price of a stock is the mean price of all those orders. Right now, GameStop is the opposite. A bunch of people are competing to buy if it goes up and sell if it goes down. It's an inverted order book. It's absurd.

But it's also a good example of what we'll call "soft disintermediation." Here, customers have swapped shares and swapped option deltas, and they stand perfectly opposed to each other in the most extreme fashion imaginable. Here, "the specialist" plays no role except going with the flow. *Share price is no longer intermediated:* Rather, a psychological tug-of-war is playing out. But importantly, this disintermediation is not because the specialist was hurt or endangered. He's just necessarily on the sidelines, with no incentive or ability to rein things in.

Not only absurd volatility, but absurd *vol-of-vol* (capital-R Risk) commences. Tomorrow could be up 100%, down 50%, flat, or all three. The chart becomes emotional and unpredictable. Depending on your preferences, it's a gold mine or a nightmare scenario, but it is what it is.

This is why GME IVs are frequently in excess of 1000%.

It has nothing to do with volatility *per se*. It has everything to do with the volatility of volatility. When vol-of-vol is high, volatility itself has to rise to accommodate it, because realized volatility might be 12% tomorrow and

3000% the next day, and how the heck do you hedge something like that (you don't).

But despite all this Risk... nothing is really broken. And despite the fear of contagion across the S&P 500 (and the high vol-of-vol priced into a VIX at 33), we see no reason to fear breakage. This is because we know what a "soft disintermediation" looks like, and it only happens, ironically, *when people are actually trading with each other, instead of with a specialist.*

When customers transact amongst themselves -- *when there's actually a real buyer for every real seller* -- that's when Risk arises. This is happening in GameStop... but it is not happening in the broader market. Nor will it. Customers are long puts, skew is steep, and in increase in correlations is already priced in.

Regardless -- enjoy what's sure to be another dramatic week!

The SqueezeMetrics Team