S&P 500 Weekly Forecast 6/6

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Hey everyone,

On Monday, we introduced "zomma," which is an option's change in gamma per unit change of implied volatility (IV). The reason that the relationship between gamma and IV is interesting is that there is a fundamental *tension* between the two, because IV is the *price* of gamma (liquidity). And so, in the same way that the relationship between IVs and RVs (in the "vol triangle") has a substantial impact on whether the underlying goes up or down, we'd hoped that zomma -- by getting to the root of the issue -- would unlock that potential for stocks.

And so far, it's looking lovely! But we have nothing new to share just yet.

So today, we want to introduce something *else* that we've been thinking about -- something that we think will also help clarify what's going on in single stocks. As you well know already, we've done work in the past on dark pool short volume (FINRA Reg SHO data), and we've stood by that research over the years, even though we don't talk about it a lot here in the Yacht Club (only once recently). But as long as things are going to be changing (and as long as the S&P 500 is being boring), we figure it's time to update stocks' dark pool indicator (DPI) with a *consistently normalized DPI* -- a long-overdue undertaking that we'll be working on at the same time as zomma.

So let's talk about this blast from the past, and why it's just as relevant as ever.

But first...

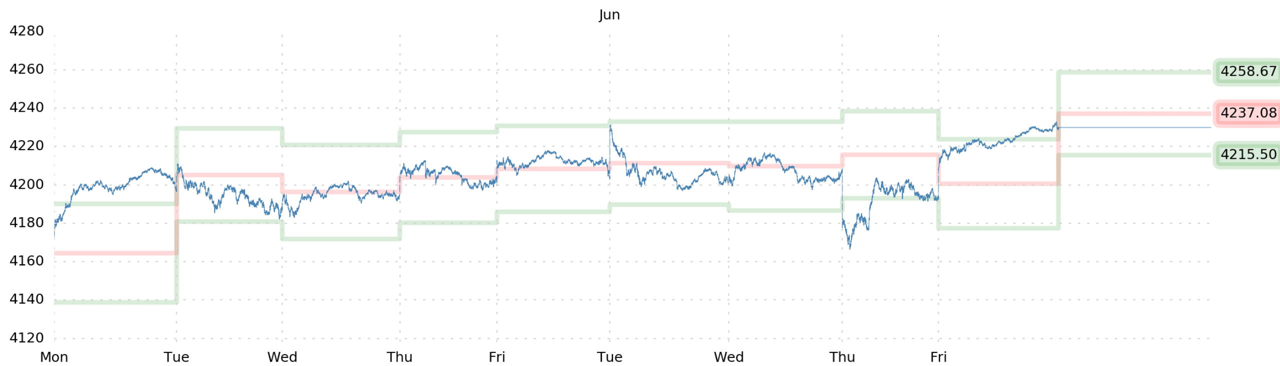
1. Time flies...
2. When you're having fun.
3. Old friends

Time flies...
Our big complaint last weekend, and early this week, was that realized volatility was just too low -- the index hadn't even touched the Support or Momentum bands. And that made us comfortable little more than the long SPX / long VIX trade, simply because it gave us a margin of safety.

> So if there's an increase in realized volatility to the upside, we intend on our long SPX component outperforming; and if there's an increase in realized volatility to the downside, we intend on our long June VIX outperforming (vega has been outperforming on dips). And if SPX wants to drift upward, we intend on June VIX having difficulty falling in tandem, since it's already so low.
>
> However, while VGR is [gently] predicting an increase in VIX, NPD isn't really giving us any "long vol" vibes. So the stars aren't totally aligning on this trade, and we may have to change it up if it doesn't start

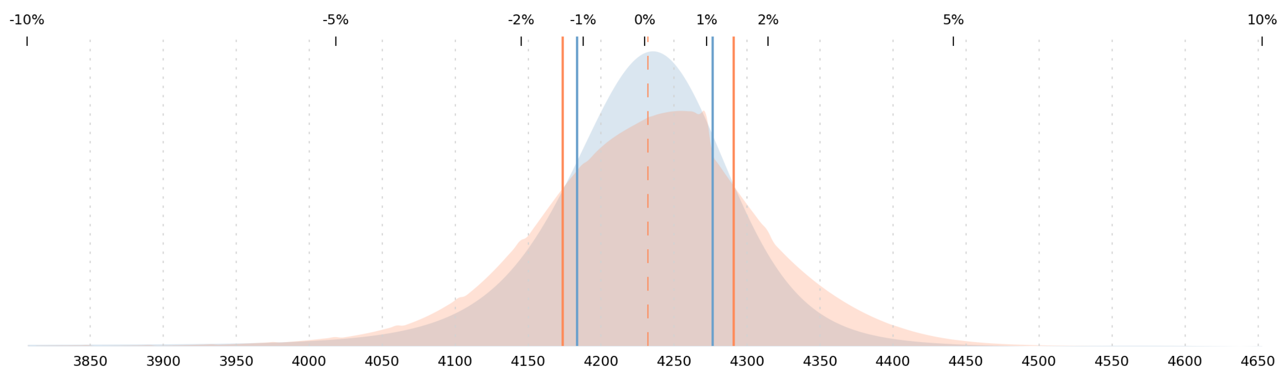
> working for us. Hence the "small" position size.

Well, a whole lot of nothing happened, and we still didn't lose money. So all in all, the trade worked pretty well. And a bit of realized volatility on Thursday and Friday finally broke the SuMo curse, with both a Support and Momentum breach.

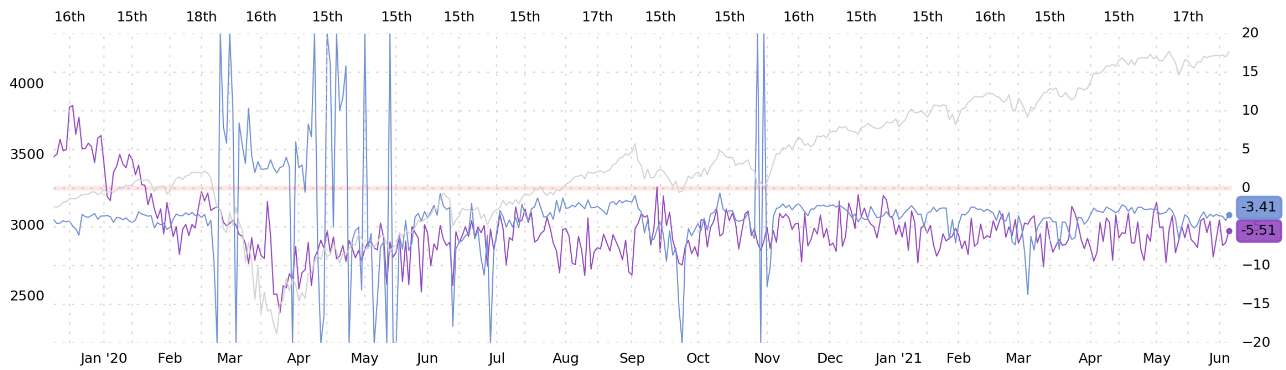


We are *still* long SPX against long [June] VIX. What happens next?

When you're having fun.
It's tough to have a strong opinion here. Near-term options are priced to perfection according to GEX. The 1-week density comparison suggests that betting *against* spot landing where it is right now is a good idea (blue above orange at the peak) -- but a long straddle is nearly always a bad trade (even if it has an edge), and long *strangles* are only really worth the trouble if you believe an outsized move is possible.



And when we look at the Sentiment Sheet, we see some pretty boring stuff: VGR at -3.41 continues to suggest that vols ought to rise a tad, and NPD at -5.51 tells us that there's a normal amount of put-buying. Nothing that screams "outsized moves possible," though.



This leaves us with the impression that the only way to play the week is to be "tactical." And for us, that means riding the long SPX / long VIX position and fussing around with the SuMo bands intraday -- with the impression that VIX isn't likely to fall quickly from here. Really, the thesis is the same as last weekend's.

So let's guess that SPX lands at least 50 points away from 4200 on Friday (<4150 or >4250), but not much more than that. Maybe a 1.50% weekly move or something. And let's guess that we make more money on SuMo than anything else.

On to more exciting things.

Old friends
A year ago (5/31/20), we had this to say:

> But we've always noticed that when smart people look at DIX, there's an undercurrent of skepticism and disbelief. Why? Because people who know stuff about the market (like you, dear reader) have a hard time believing that there are "smart-money stock-pickers" out there driving the S&P 500 by buying stocks in dark pools. That's just not the way the world works anymore, right? Yet, DIX seems to be a valuable signal... so what gives?
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> The answer is that DIX, like everything else, is telling us more about centralized market-making than it is about anything else.
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> A high DIX print doesn't mean that some Warren-Buffettish discretionary manager decided to buy lots of shares of stock in a dark pool -- it means that someone bought so many E-minis, or SPYs, or VOOs, that a market-maker had to go out and assemble a basket of S&P 500 stocks to create ETF shares, or to hedge away the exposure of a futures contract. And nobody in their right mind would do this on a lit exchange if they could help it (much too expensive), so the market-making firms will do as much internally as possible, which happens to be off-exchange (OTC), or "dark." That's it.

And we're bringing this back up again, because while some of you are actively using single-stock dark pool short volume (DPI) as an actionable data point, others are not. And *of* those who are not, a majority probably aren't totally sold on the idea, or think it's only really for "position" or "swing" trading. And to be honest, it's tough to convince people of the efficacy of data they're not already inclined to use.

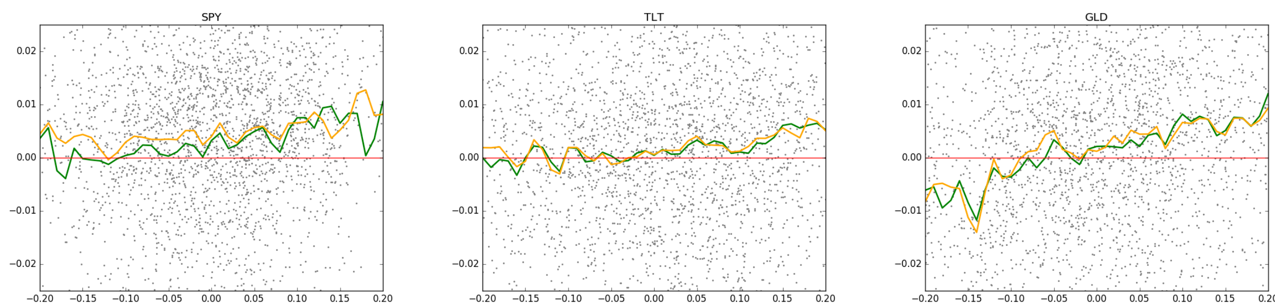
Since we're going to spend a couple months re-imagining some data, though, let's reintroduce this idea: Higher off-exchange short volume, in some stocks/ETFs, is a useful indicator of buying. Because "Short Is Long." You know this already.

One of the first things you notice about the DPI dataset when you take a look at it, though, is that there is no consistency in what DPI percentage means what. In one stock, a 50% DPI seems high, and in another, a 50% DPI seems low. It's all relative, because it all depends on what venues the stock trades in, and how those orders tend to be facilitated. In some stocks, DPI just won't tell us much of anything -- that's the nature of it.

But in many stocks, there's *something* there, and in some, it's very readily visible from the chart. Still, there is an awful lot of room for us to formalize our approach, and to normalize the data so as to be comparable across the whole stock universe -- because as it stands, "70% DPI" doesn't have any meaning *per se*. And hey, if we're going to be building a better way to access the data, then let's make some of it easier to understand while we're at it.

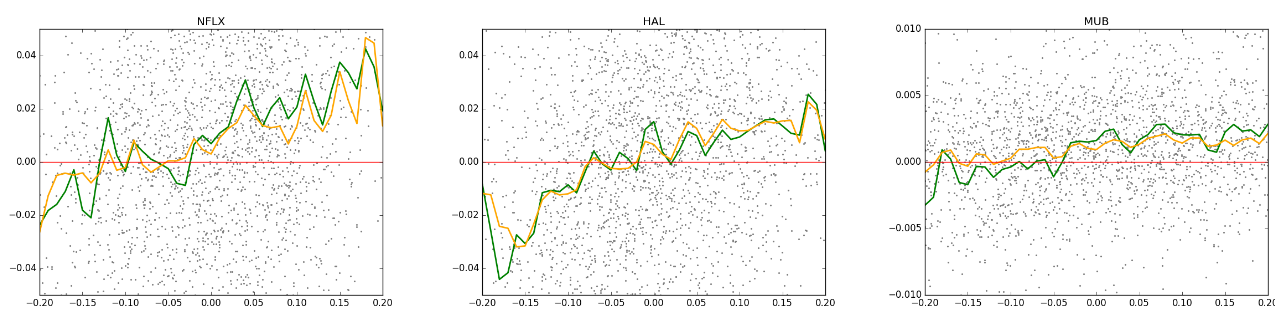
So let's simply measure DPI as an absolute deviation from its mean. So, e.g., +20% DPI means 20% higher than a 1-year average, and -20% means 20% lower. *Easy peasy!*

Now, with that computation in hand, let's look at 1-week returns (y) relative to normalized DPI (x) in a few big-name tickers (2010 to present):



Green is mean return, orange is median. In SPY, TLT, and GLD, a +15% normalized DPI is associated with 1-week mean and median returns of around 0.50%. That's pretty significant, especially since there's no rational reason to believe that these ETFs' dark pool short volumes ought to have an impact on the true underlyings (which are massive).

Just for kicks, let's pick some stock names out of a hat and do the same:



Netflix? Halliburton? A muni bond ETF? Crazy. And each one offers *some* edge in DPI. Do all tickers work this way? Absolutely not. But with a nice, tidy, normalized system, we'll be able to sort according to those that *do* work. *Easy peasy!*

Sometimes you just gotta be happy with what you've got. The rest of the summer is going to be spent on getting this all done, and getting it done right. Rest assured that we'll be rolling out data as soon as we're able, and we'll be yapping about it in the meantime.

Enjoy the week!

P.S. AAPL and TSLA both still have 0% to -2% mean returns expected this week, based on their zommas, just like last week. In case you care.

The SqueezeMetrics Team