S&P 500 Weekly Forecast 7/25

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Hey guys,

On Tuesday morning, we walked back an error in Sunday's research note. Let's reproduce that sentiment here:

> We ran "Script A" when we were actually supposed to run "Script B." [...] the hunch that underlies those charts we showed you is something we're having trouble quantifying. And yet, if you read through Sunday's "panel" and choose a long/short portfolio for Monday (long QQQ, but short DIA, IWM, and EFA; long TLT, long GLD, short SLV, short USO, long UNG...), it's uncanny [...] it went *really* well. And the last month has been working the same way [...]
>
> So here's us pumping the brakes for a moment. Give us some time to collect our thoughts, wrap our brains around this, and run a new test.

And so that's what we did. We took a breather and ran some new tests, all while continuing to trade what we *perceive* to be the signal. And while the imaginary signal continued to do what we intuitively expected it to do, the data did not cooperate. We were unable to derive much meaning from our usual tests—at least nothing that matches our intuition, and what we've been seeing firsthand.

Nothing.

So this weekend, all we can do is gesticulate wildly about what we *believe* is going on, without any data to back it up. This is not something we're terribly comfortable doing, but right now, it's all we've got.

Hopefully, within another month, this will all be obvious (for better or worse), and this note will sound really stupid.

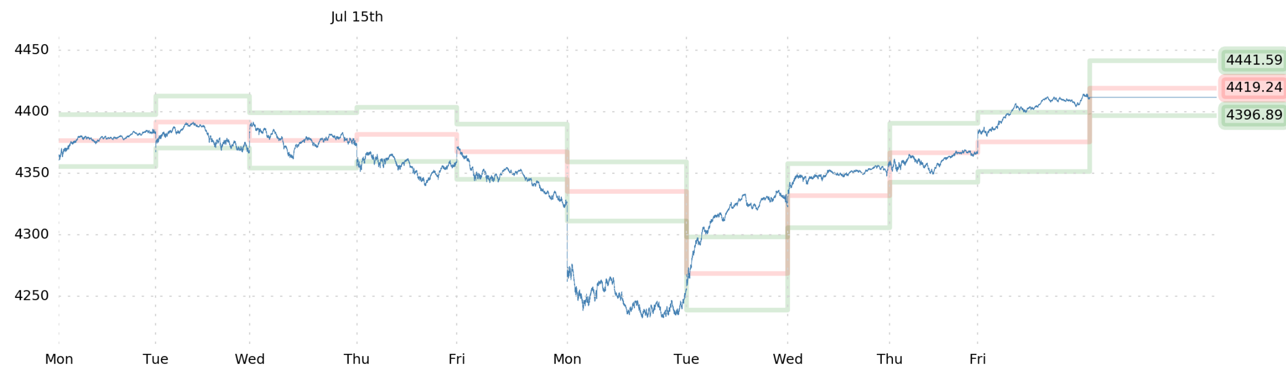
1. Then
2. Now
3. Hopefully Stupid

Then
Last weekend, we were expecting vol-of-vol.

> As we've been saying for the past couple days, SPX net put delta (NPD) is telling us that folks aren't buying their usual put insurance here (-3.63). This means that fewer investors are "protected" against volatility, and that there are ultimately a higher-than-usual number of investors who hold opposite sides of the same put option. (Usually, dealers are short the bulk of the puts, and customers are long.)

> This all adds up to a higher *vol-of-vol* expectation. I.e., a choppy VIX. See, generally, dealers keep volatility in line because they're replicating the payoff of the customer's long put (which has a short gamma impact on the index), but when customers are paired off *against each other,* nobody's doing continuous hedging. This means that, when one or the other customer wants to monetize or roll their option position, *a whole ton of deltas* get dumped on the market all at once, and unpredictably. This makes for choppy vol.

Not only did we get that VIX movement, but as soon as NPD indicated that the put-buyers returned (Tuesday), everything was peachy again.

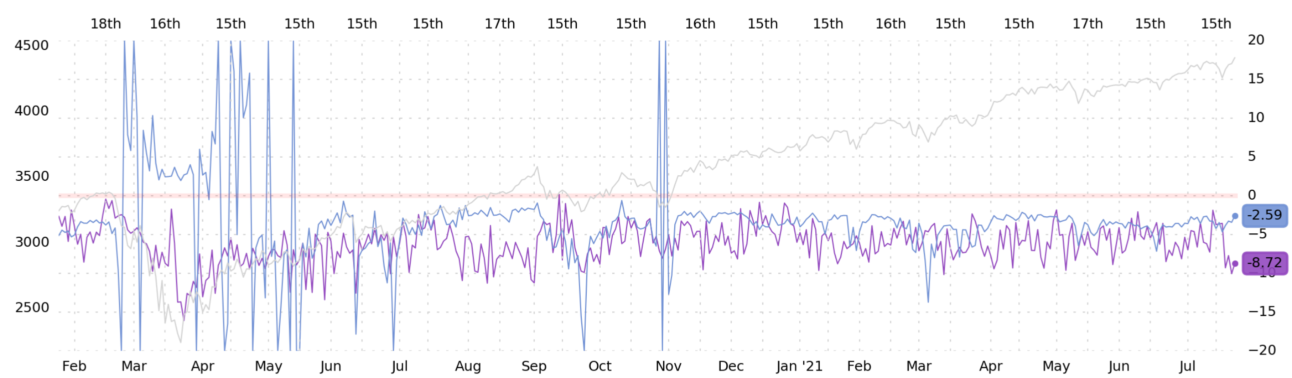


And just about any variety of long SPX became the weapon of choice through the end of the week.

Now

The way the week ended, though, doesn't favor long SPX *so much as it favors short VXX.* See, long vega won a lot into Friday. I.e., SPY went up a ton, but VXX didn't fall in tandem. As such, we're expecting short vega *specifically* to be the winner early this week. And that means that any trade based on short VIX futures should do well, whether or not you want to be short SPX against them.

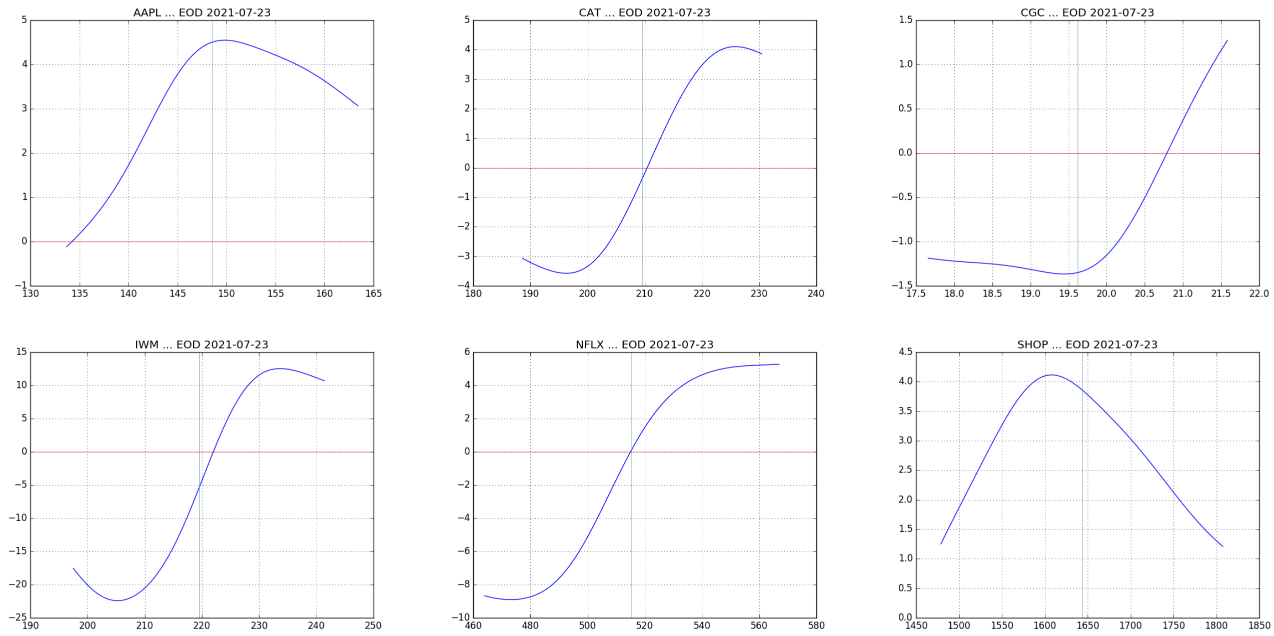
We are currently short SPX / short VIX (as of late Friday), with the expectation that SPX takes a breather and August VIX keeps falling.



In any case, ever since NPD has been printing these nice negative numbers (-9 and such), it feels good to be betting on a persistent, low-grade SPX support with downward pressure on VIX.

Hopefully Stupid

Below are six hastily chosen zomma/tension plots, generated at end-of-day Friday.



When we look at these plots, all we have is a vague theory about what they mean. And since we don't have anything better to offer to you right now, let's expound upon that theory as we walk through each chart.

1. AAPL
Pretty boring, tentatively bullish. Between here and $145 is safe. Below $145 is where some danger begins, as the curve steepens. A steepening curve is indicative of vol-of-vol. I.e., illiquidity. We'd expect sharp price moves to occur below $145. At $135, however, we touch zero zomma, which, by prompting re-positioning, may offer support, and would make you want to consider turning bullish and riding that steep curve back up.

2. CAT
At a crossroads, sitting at zero zomma. It could go either way, and whichever way it chooses, it could easily move 10 points before slowing. The curve is steep in both directions. Wouldn't be surprised to see CAT at around $200 or $220 shortly.

3. CGC
We were recently short this name, to great success! We were short because of that steep slope to the right—except now that steep slope could enhance some *bullish* movements instead. Since liquidity doesn't get any worse to the left, it's a good bet to be long CGC, if only up to the zero zomma (~$20.75).

4. IWM
On Monday, IWM touched $210. This was a trough, and liquidity wouldn't have gotten any worse had IWM kept falling—so it made sense to be long there. But now that it's traversed the space in-between and sits close to zero, it's an easier short again. Would short against, e.g., long SPY.

5. NFLX
Indecisive at zero (like CAT), but not a lot of opportunity to the right. The slope is steeper to the left, making it more favorable to be short.

6. SHOP
Zero isn't even in sight, but the stock is also past its zomma "peak." This makes us think that, while price has indeed gone too high, any selling will be met with ample liquidity, and won't turn into a deeper selloff. It'd really need to get down to $1550 before the slope starts hurting *(and your other, more zomma-sensitive short positions should have already performed very well by the time that's happened)*.

Basically, what we've been doing for the past few weeks is being long stuff that looks like AAPL, and being short stuff that looks like IWM, *with the idea being that as the broad market moves down, our short is more beta-sensitive than our long;* and that as the broad market moves up, we can cut our short if it moves meaningfully into positive zomma territory (and let the long position run while we look for a new short).

This is all a hunch about the steepness of the zomma curve indicating a fundamental illiquidity. This is still fairy dust. Gobbledygook. But we're intent on tracking it down, whatever it takes—because if our hunch is correct, this is, indeed, very useful to know.

Feel free to weigh in. Or just grab some popcorn as we go off the rails entirely.

Enjoy the week!

The SqueezeMetrics Team