S&P 500 Weekly Forecast 12/5

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Hey everyone,

It's a good week for some freewheeling volatility commentary, so let's just jump right into it.

1. Context
Last week, on the Wednesday before the Thanksgiving holiday, VIX was 18. If you multiply 18 by the square root of 1/365, you get an approximation of the market's expected standard deviation of daily returns. If you subsequently multiply by the square root of two over pi, you convert that standard deviation to a mean absolute deviation, or the average expected daily move.

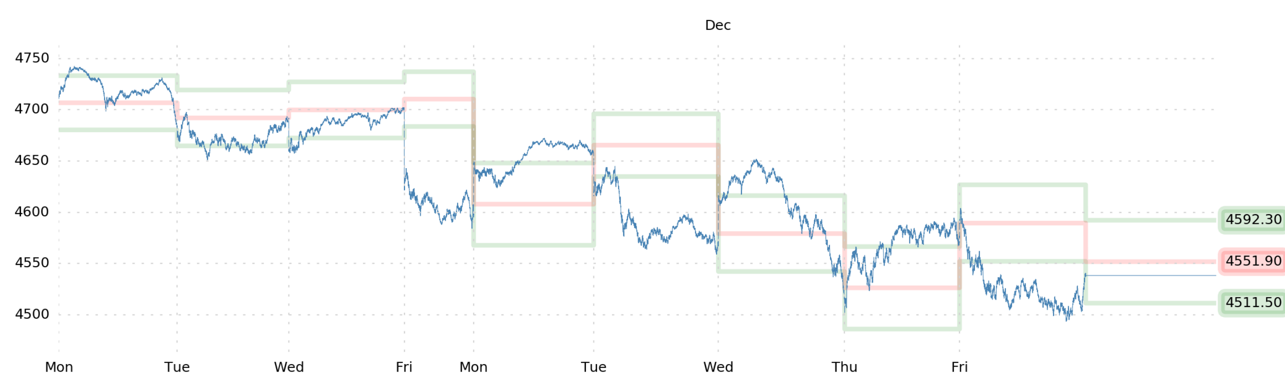
$18 * \sqrt{(1/365)} * \sqrt{(2/\pi)} = \mathbf{0.75\%}$

This means that the market "expected," more or less, a 0.75% move on Friday. But when Friday finally arrived, the S&P 500 fell *2.27%*. This was about *three times* the expected average move. *This was a pretty big deal!* Subsequently, for most of this past week, VIX spent its time around 30.

$30 * \sqrt{(1/365)} * \sqrt{(2/\pi)} = \mathbf{1.25\%}$

VIX around 30 "expects" 1.25% daily moves. The average close-to-close daily move this week in the S&P 500 has been 1.33%. That's *not* a big deal. For this week to have been as *intense* as last Friday, one of the days would have needed to return around ±3.75%. Not even close.

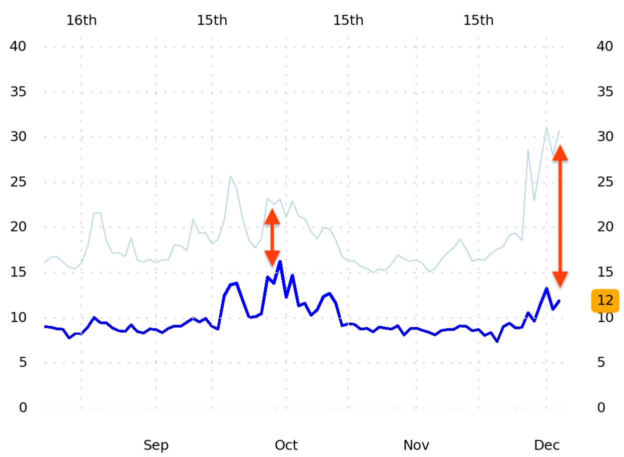
If you recall, we were short VIX last Friday. Fortunately, it wasn't a large position, but it still wiped out *two months* of pretty PnL in 3.5 hours. As VIX rose to 30, we took on a large short VIX position, and spent the rest of the week gently scaling in and out as SPX ping-ponged around. The fancy footwork didn't help much, though—we're still deep in the hole we dug ourselves into on Friday, and we're still meaningfully short vol.

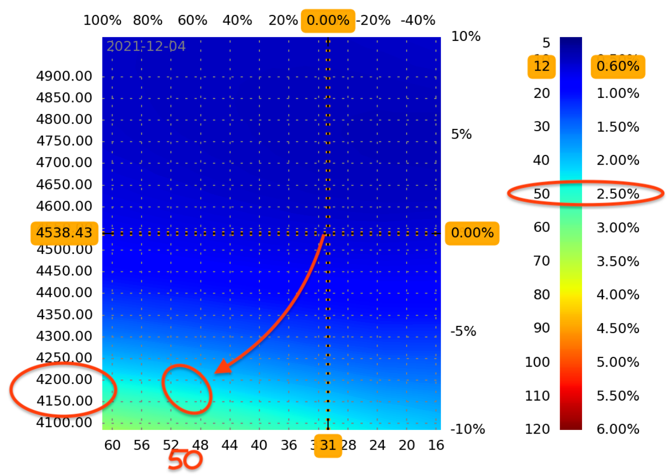


Why do we put ourselves in this uncomfortable situation?

2. A buffer

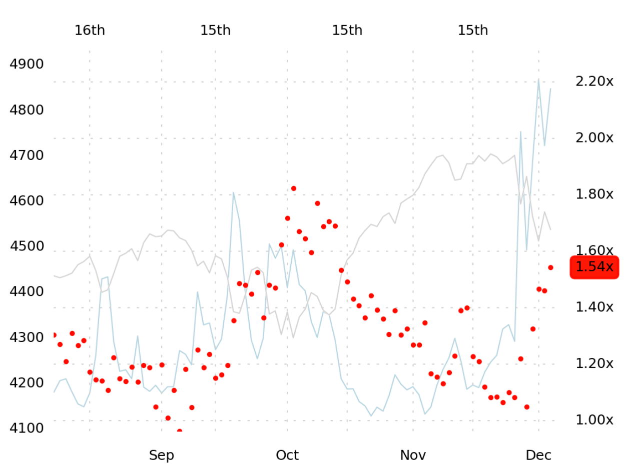
To get a similarly painful follow-up move in VIX right now, you need VIX itself to shoot up to 50. We don't get to reference it very much, but this is an opportunity to pull up our gamma-implied vol (GIV) heatmap and context plot.

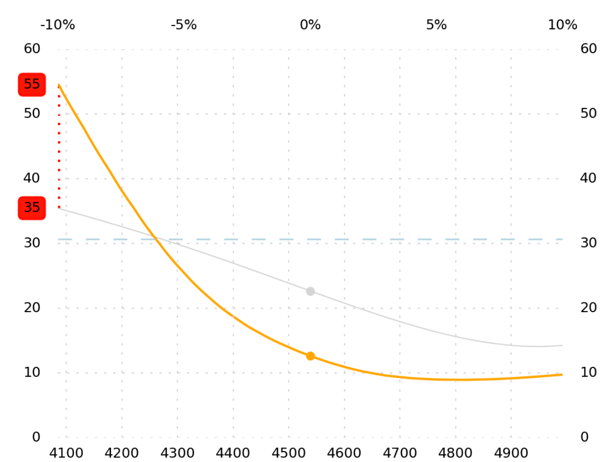




Right now, GIV is 12. That means that, absent the large, liquidity-taking volume that we've been seeing in the past week, SPX dealer positioning would by default give us around 0.60% average daily moves. I.e., there's still quite a lot of dealer long gamma/short vanna on the order book, enforcing stability. Meanwhile, VIX is 30. That's *quite* the spread in expectations, and it makes us think that it'd be *real* tough for VIX to rise exponentially from here. There's still quite a bit of liquidity—relatively speaking, and that means the path down to ~4200 SPX would require some intense discretionary selling.

A derivative of the GIV heatmap (one row lower on the Risk Report) is (a) the Crash Risk multiple and (b) the GIV-IV skew.





Note that crash risk (1.54x) is *below* where it was in October (where VIX peaked at 23), which is very low, and the GIV-IV skew sees IVs pretty consistently too expensive all the way down to SPX 4250. And that means that there is excess liquidity between here and there, providing an *ample* buffer.

3. An analog

When we look through all this stuff and try to synthesize it, we think that the best recent historical analog is from earlier this year, in January, when people were afraid that the GameStop saga was going to spark multiple long-short fund deleveraging events, and put the whole broker-dealer-market-maker system at risk. There was a legitimate fear that liquidity would disappear, and, since the situation was so well telegraphed, that nobody would even *accidentally* provide a bid to the margin-called Melvins of the world—and that this contagion would spread.

VIX moved from 23 to 37 (+61%) in one day on these fears—a quite-similar situation to last Friday (+66%).

Here's what we had to say at the time (1/31 note):

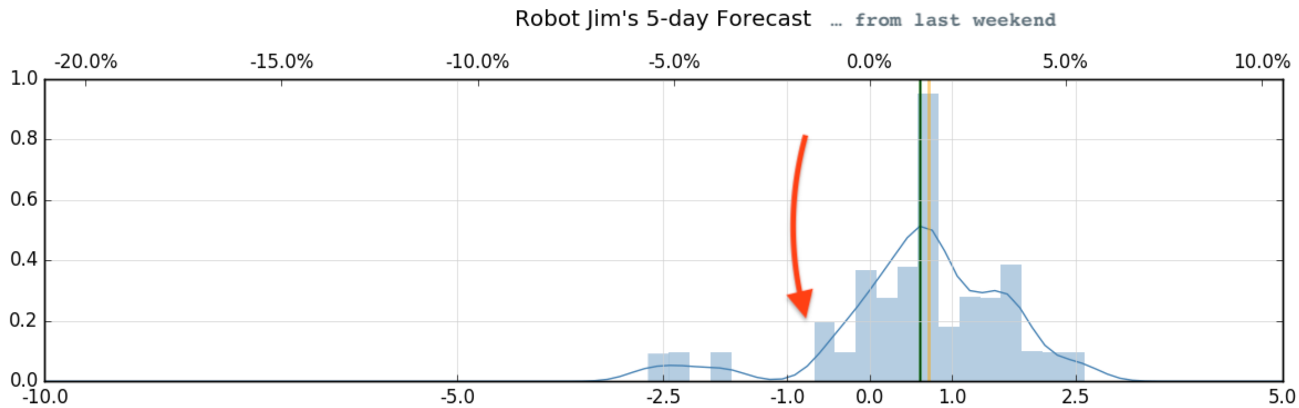
> **What will happen**
> You probably already know where we stand. We still have a bundle of short February VIX, and we maintain the belief that the market is amply prepared for this, and insulated against "risk" (vol-of-vol). Hence the short VIX position, which is at heart a short vol-of-vol trade.
>
> With that said, the index is pricing in average >1.00% daily moves wherever you look. So don't be blindsided by that.
>
> [...]
>
> GEX+ is low, and another 5% loss 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.

And that's pretty much where we stand now. We're willing to keep losing money on a short VIX position because we believe that there is a buffer against vol-of-vol (our only real fear, as true short-vol aficionados). VIX could continue to climb and SPX could continue to fall, in response to systematic and/or discretionary sellers—but the risk-reward of short VIX is still excellent. We can't ignore that.

4. Extrapolating
No historical analog is ever sufficient, though, so let's ponder what's specifically wrong right now. We have more strains of COVID for the global lockdown apocalypse narrative, we have a CPI print coming up on Friday to juice the inflation narrative, we have the debt ceiling concerns stretching out to February, we have Cathie Wood and her minions causing liquidity risk in low-liquidity, high-beta tech, and we have Jay Powell talking about an early tapering schedule.

We tend to think that the Fed is the most pressing concern among these—at least among professionals—and that Powell's comments are hanging most heavily on the index.

But all the Powell stuff was telegraphed on *Tuesday*. SPX is only down a few points from then, really, and VIX is only up 3 points. In the context of a week that led off with VIX at 28, none of this Fed stuff has been very interesting at all. Indeed, Robot Jim's distribution last Sunday looked like this, and the weekly return is at the red arrow.



It was a 1.21% decline on the week. That's not special at all. So what's going on right now? Why is everyone acting so fussy?

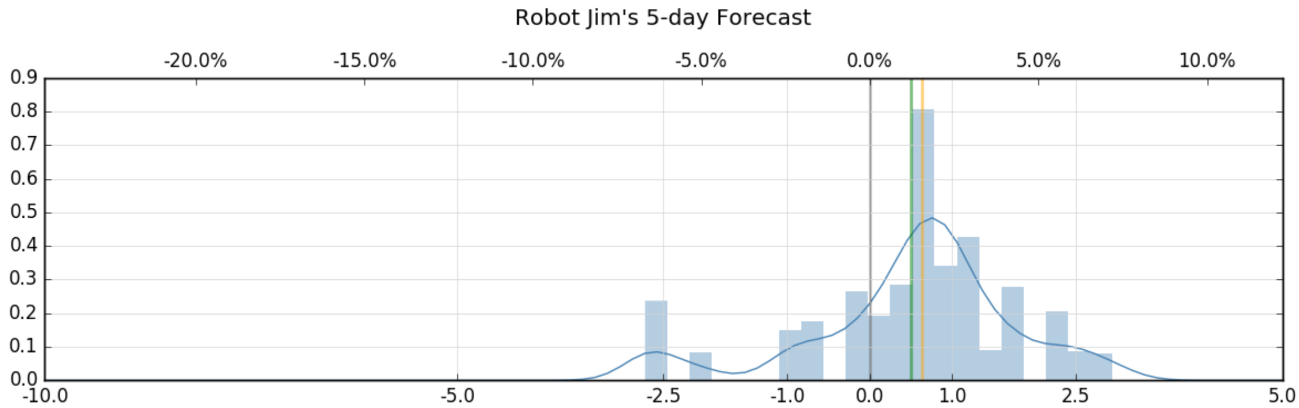
All we can do is fall back on a word that we used just a month ago: *"Foreboding."*

From the 10/31 Sunday note:

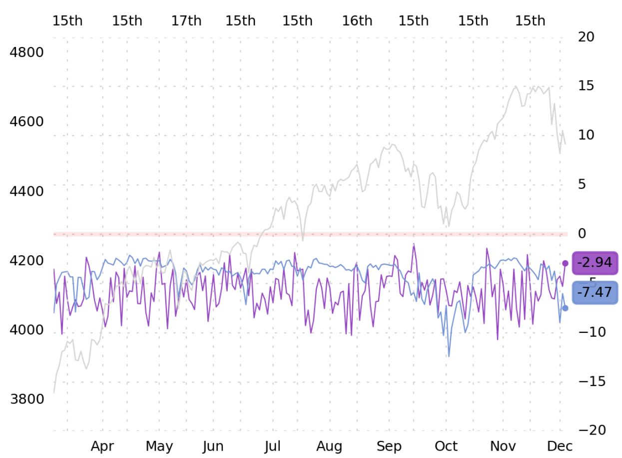
> For the first time since the pandemic, a feeling of foreboding seems to be setting in. The sense that some things are subtly breaking. As degenerate equity and equity vol traders, we try to stay away from the big-picture philosophizing and the macro blabber and to keep thoughts on a weekly timeframe—but sometimes it's hard to ignore the mood coming from the rates nerds and other people who use words like "economy" and "central bank."
>
> [...]
>
> Will "stagflation" fears take root this week? Will the "meme stonk" underpinnings of recent equity returns be suddenly called into question? Probably not. GEX+ is probably still too high to allow a game-changing response to the FOMC minutes, and if things start turning sour, we'll have quite a bit of time to watch it happen. What's more, there's no kindling for a crazy volatility event—so why bother thinking about it?
>
> Well, it just feels smart to be prepared for things to change. And we're finally starting to think about that.

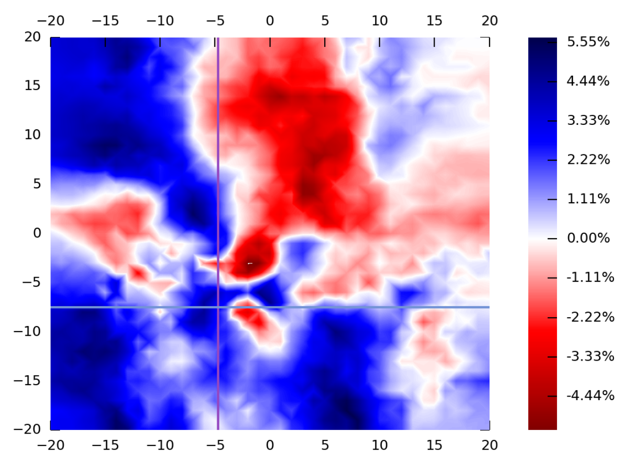
This, we think, is the real reason for this spate of fear, and for a VIX at 30. People *feel* this. It's not any one thing in particular—it's just a big, broad sense of worry that we all can't quite shake...

5. Snap out of it
But hey, that psychological stuff is way above our pay grade, so let's move on.



Robot Jim is stubborn, and while he acknowledges the presence of a left tail (of sorts), he's still gunning for a weekly gain. When we dig a bit into his data, we find that the worst-looking coordinates right now are coming from Net Put Delta (NPD) and its relationship with a few other things. And when we consult the NPD/VGR heatmap to evaluate this ourselves, we *do* see a problem.



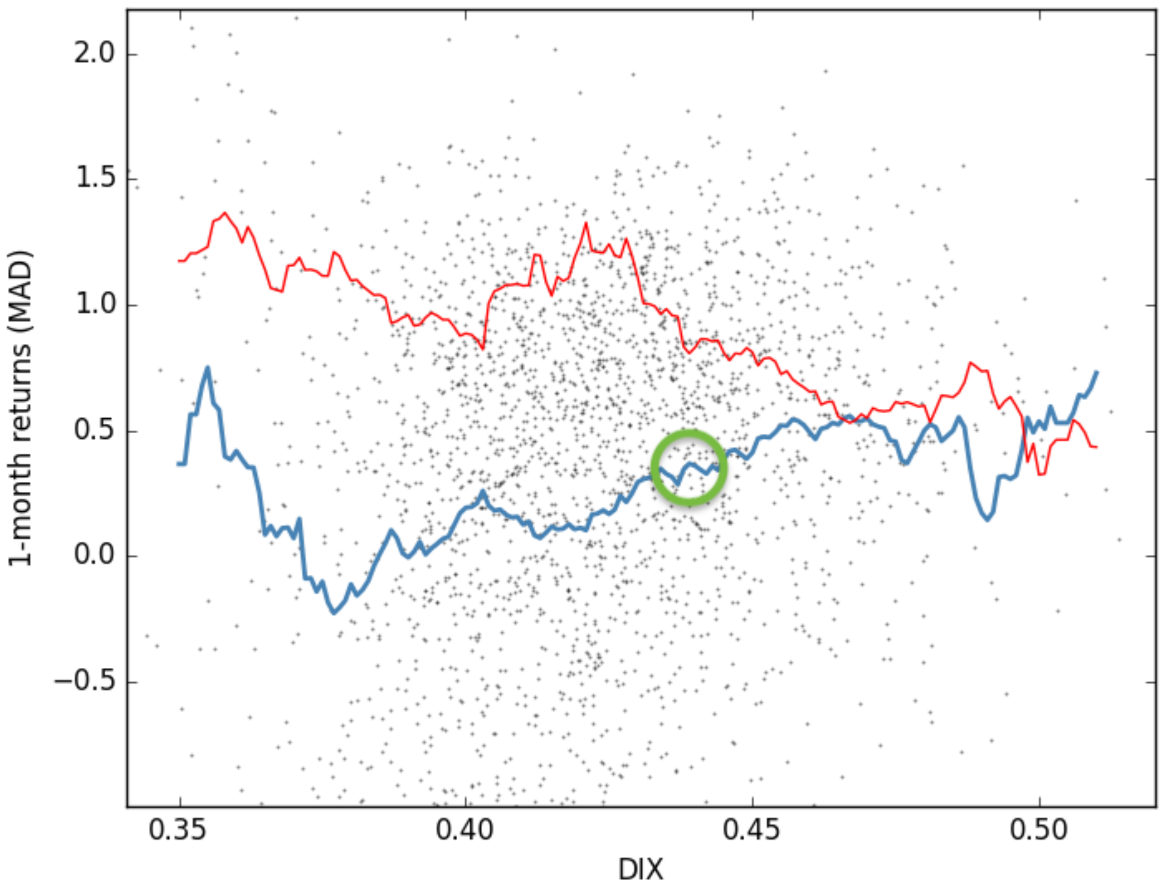


Friday's NPD print was -2.94. That suggests that there wasn't an awful lot of put-buying on Friday. Rather, it suggests that the uptick in vol (VIX hit 34!) during the day was actually some folks getting more or less forced out of short vol positions, and in some fashion, rolling that exposure further out in space or time.

This is not the most bullish data point, since it tells us that there are probably a few overexposed and underhedged folks out there—but 5-day average of NPD prints is still around -5, so we're not freaked out just yet. Especially since VGR is *per se* in a bullish zone, and the combined coordinates of NPD and VGR are "in the blue."

Going forward, we want to watch NPD/VGR closely. A spate of put-buying would have us boarding the bull train through December, but there's been some hesitation among investors on paying up for insurance, apparently. And if that keeps up, a "directionless" market seems more likely.

But before we sign off, let's be sure to call attention to our trusty old DIX, which is still telling a story of "willing buyers and good liquidity," with prints averaging around 44%. That's not amazing, but it's definitely associated with positive mean returns over the following month (data from 2010 to present).



Futures... stable. Up a bit.

Enjoy the week!

The SqueezeMetrics Team
