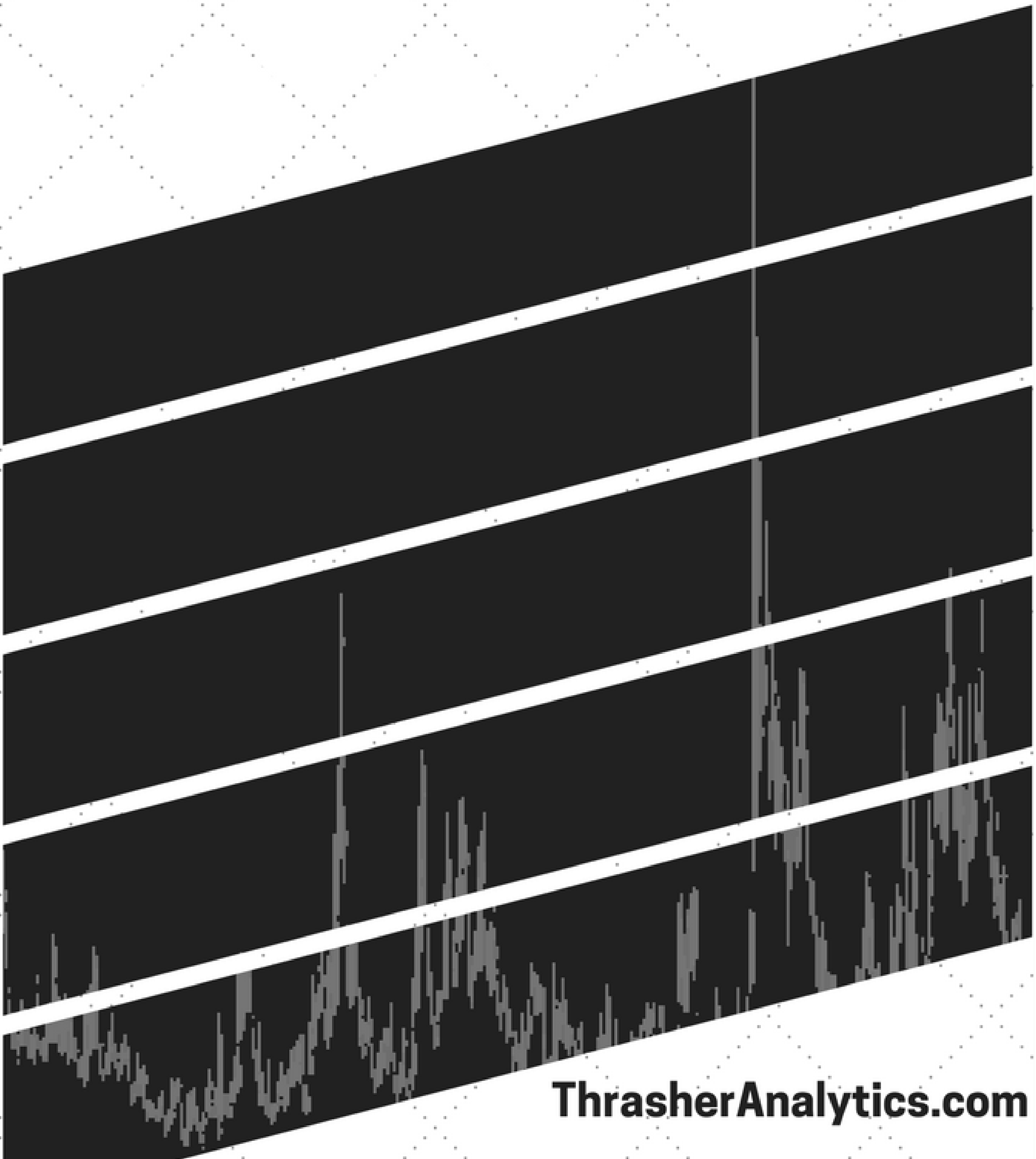
THRASHER ANALYTICS

BI-WEEKLY RESEARCH & ANALYSIS



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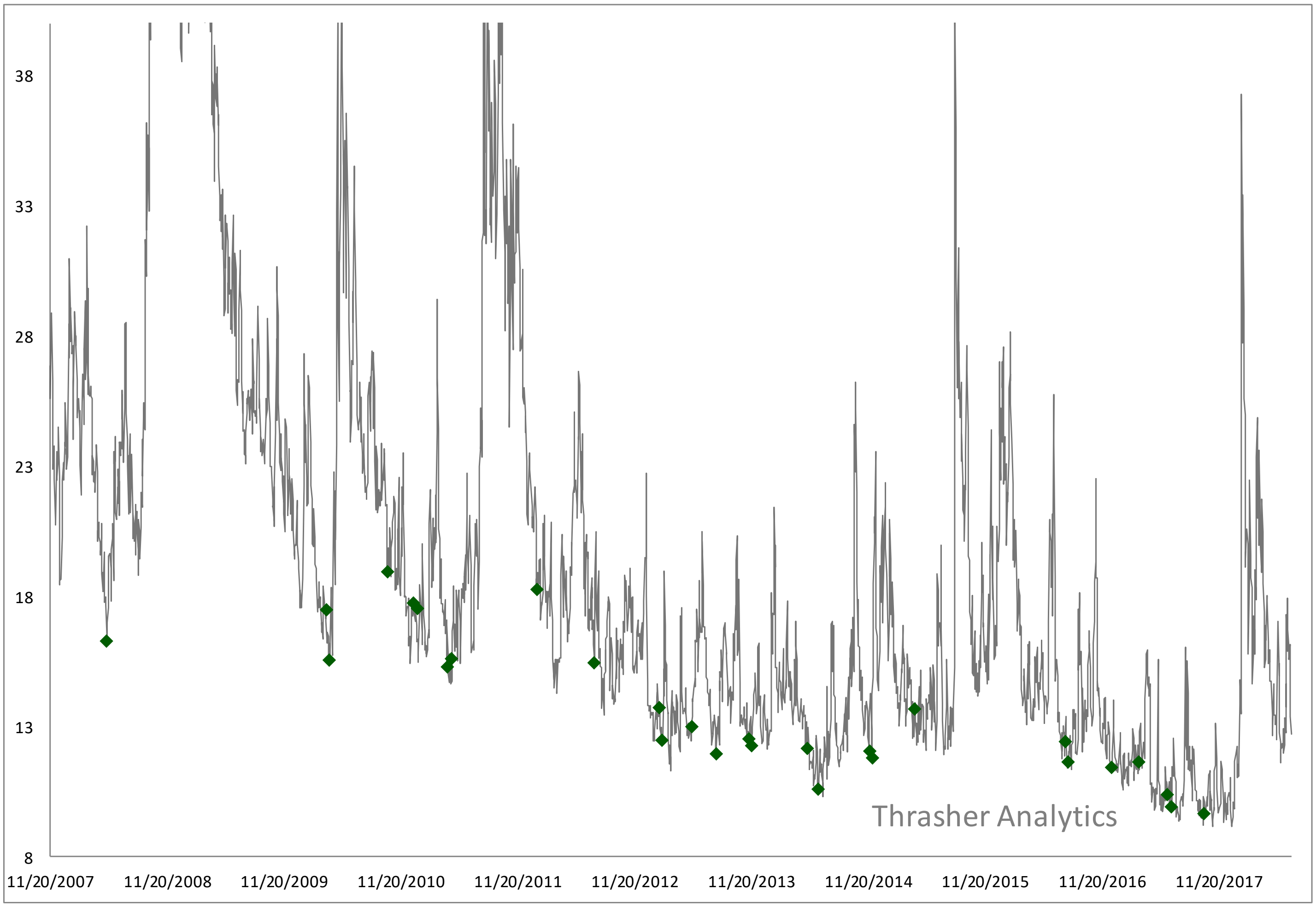
VOLATILITY RISK TRIGGER (VRT)



Volatility has once again begun to compress with it's daily dispersion narrowing beyond the threshold I discuss in my "Forecasting a Volatility Tsunami" paper. While daily dispersion is just one input of the Volatility Risk Trigger (VRT), we will need to see some more data for it to trigger a warning of a major spike in the Volatility Index.

What we do know now is that the 'window' for a spike has opened. As a reminder, we very rarely see a large spike in the VIX when dispersion is not narrow (as it is now) but it's possible for dispersion to narrow without the 'fear index' spiking higher. So we now are in an environment for a move in volatility, the next step is to better time the likelihood of such a move.

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Broad Market Commentary

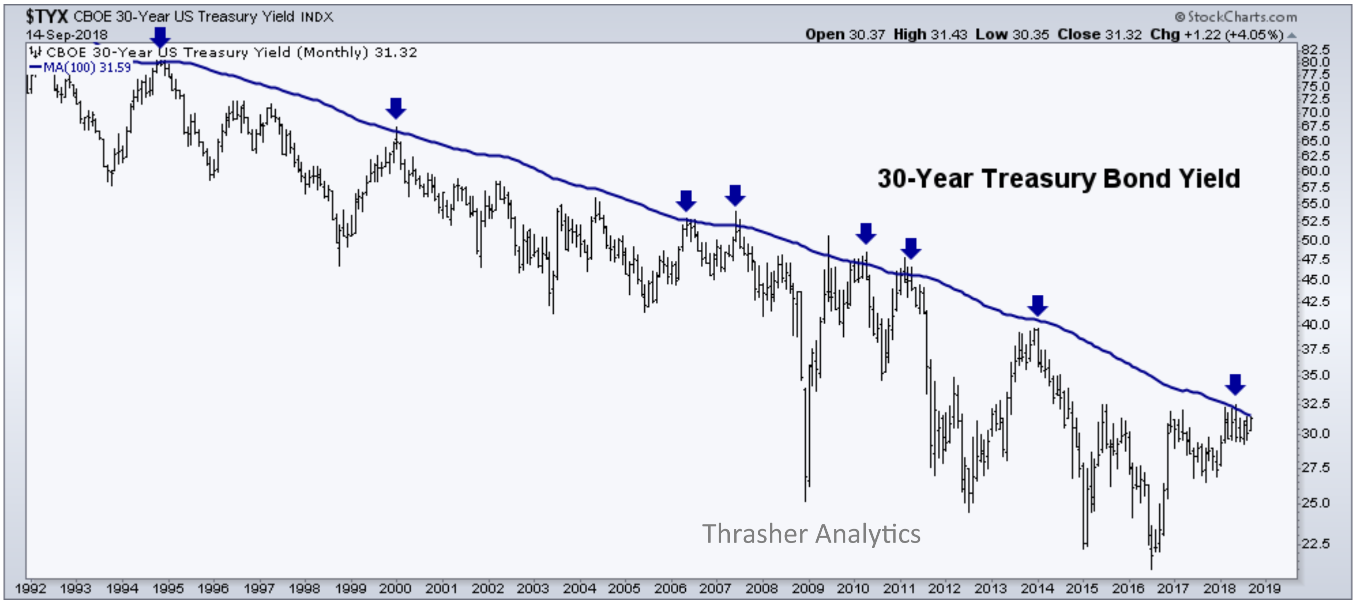
With the weakness we saw in late-August in equities, the S&P 500 put in a test of the January high which did an excellent job of holding. It was clear buyers were coming in to defend the breakout level. We can see above average volume entered the market after the test of support, an encouraging sign that equities are on firmer footing than I would have initially had guessed. The focus now shifts towards setting another new high, at which point we'll be able to evaluate the level of participation in the move higher. My assumption is that I'll once again see less 52-week highs, but we'll wait for the break, if it does come, before making that judgement.

Intermediate Stock Market Breadth

While the cumulative Advance-Decline Line is what gains the most attention, I also like to look at shorter lookback periods of the A-D Line to get a more time sensitive view of the breadth of a rally. Above we have the 10-day Average of the A-D Line (not accumulative) as well as the 5-day total of net new highs. As you can seen, there's much more activity with these gauges, as they are much more intermediate-term focused.

The 5-day total of new highs minus new lows is still well below the January high as well as the June high. The 10-day A-D Line did confirm the rise in equities in August with a higher high but notice the large decline during the brief selling when the S&P 500 test the January high as support - falling below the June low in breadth.

30-year Treasury Bond Yield Tests Resistance



I showed this chart several months ago, which is the monthly chart of the 30-year Treasury Bond Yield going back to 1992. During the 30+ year long-term down trend in bond yields the 100-month Moving Average has done an excellent job had defining the trend and providing resistance during counter-trend rallies.

The 30-year Yield has consolidated under the 100-Month MA and with the recent uptick in yields, once again resistance is being tested. I'll be looking for a major break higher with a close above the 100-month MA as a sign that the trend is changing.

Potential Double Bottom in Latin America

With the currency crisis taking a strong grip on emerging market equities, Latin American countries have been in decline for most of 2018, as shown by the iShares Latin America ETF (ILF). After a counter-trend rally in July, ILF dropped back to its June low and with the test of the prior low has created several positive divergences.

First we have the top panel, the Relative Strength Index (RSI) momentum indicator put in a higher low, a bullish sign that bearish momentum has slowed. Next we have On Balance Volume, which adds the number of shares on positive days and subtracts the number of shares on down days. ILF didn't make a lower low in this volume indicator, which tells us there was an increase in selling activity during the decline into the June price retest. Finally, in the bottom panel we have trend strength, which also is making a higher low.

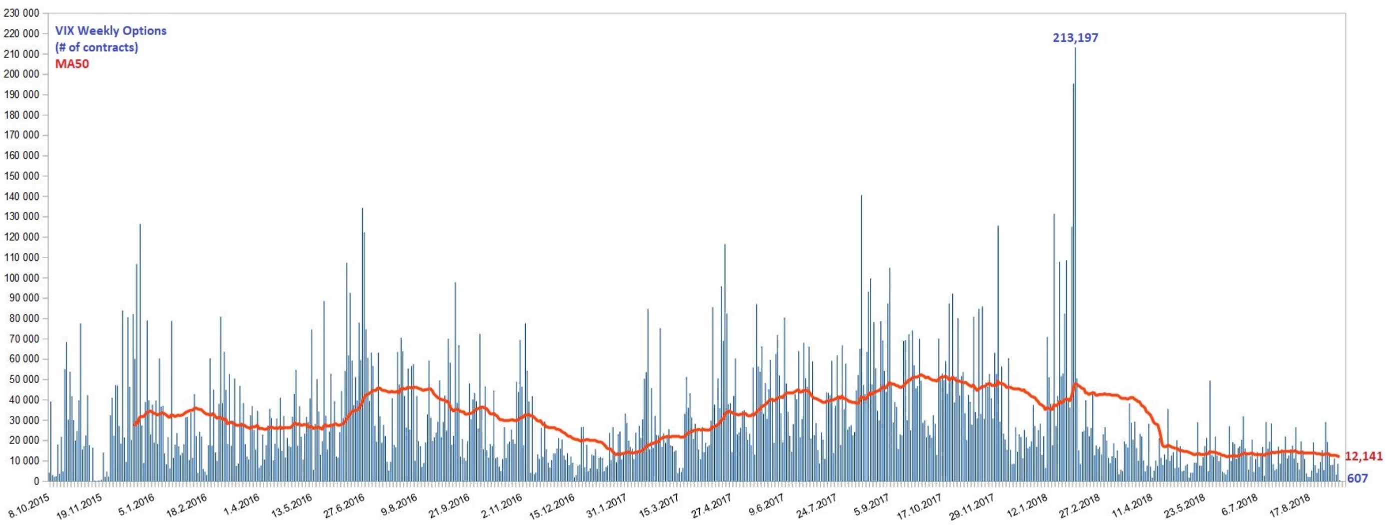
Combining momentum, volume, and trend strength, we have an interesting chart that could be shaping out the a possible bottom in LatAm. It's important to note that there's some major structural issues going on overseas, but from a price perspective, if ILF can stay above $28.50 then we could see a move back to the August high.

Growing Net Short in VIX Futures & Lack of Activity in VIX Options

The total dollar amount that is short Volatility Index futures has risen to $1 billion, exceeding the $350 million than was short prior to the massive volatility spike in February. The above chart comes from Movement Capital and shows we've seen much larger net-short positions in the VIX but it's interesting to see from a sentiment standpoint that traders have become emboldened to push more capital short vol after the shuttering of several short volatility funds as well as the XIV ETN.

Below we can see that weekly option volume has fallen off a cliff, chart courtesy of Ezra Karhan. Total weekly option volume dropped to 607 contracts last week, the lowest level since November 2015. You may remember that spot VIX put in an important low in November 2015 at 14 before rising for several months until it peaked in January 2016.

The fact that there's been a build up in net short volatility futures with a lack of interest in trading of volatility options, in my opinion, is a strong sign that sentiment has gotten frothy. It seems no one wants to purchase protection in equities anymore.

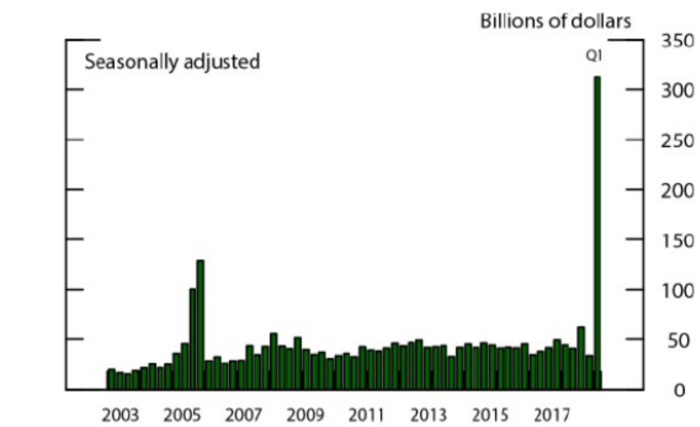


Treasury Volatility Hits New Low

While equity volatility has once again been on the decline, it seems traders are also moving away from Treasury volatility as well. The CBOE TYVIX, which is the 10-year Treasury Volatility Index has fallen to a new record low, surpassing the prior low set in December 2017. The short-term correlation between bond and equity volatility is fairly high so it's interesting to observe such a n important new low in bond vol occurring when equity vol is still above its prior December low.

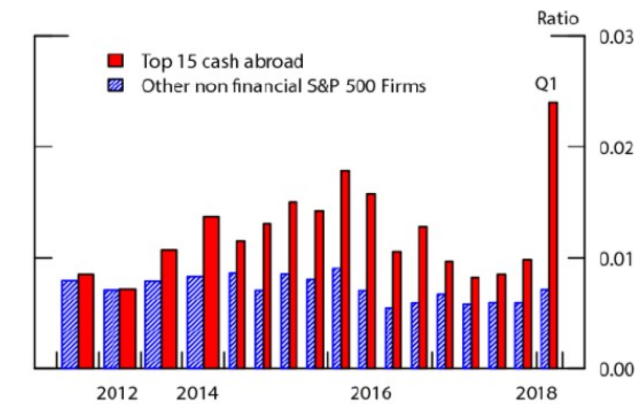
Massive Buybacks The Result of Offshore Earnings Repatriation

Figure 1: Repatriation of Overseas Earnings



Source: BEA Balance of Payments data.

Figure 2: Aggregate Ratio of Share Buybacks to Assets



Note: For years before 2015, annual averages of quarterly values are shown.

Source: Compustat; Bloomberg.

Richard Phillips, Senior Policy Analyst at The Institute on Taxation and Economic Policy, produced the above charts which show a quite startling picture of the result from the 2018 tax policy that included an allowance of U.S. companies to repatriate earnings at a new rate. Many companies have taken advantage of bring offshore earnings stateside, Phillips calculates the figure at $300 billion in the first quarter of this year, as shown in the chart on the left. The chart on the right indicates that those repatriated assets flowed right to shareholders in the form of buybacks rather than in cap-ex spending or hiring.

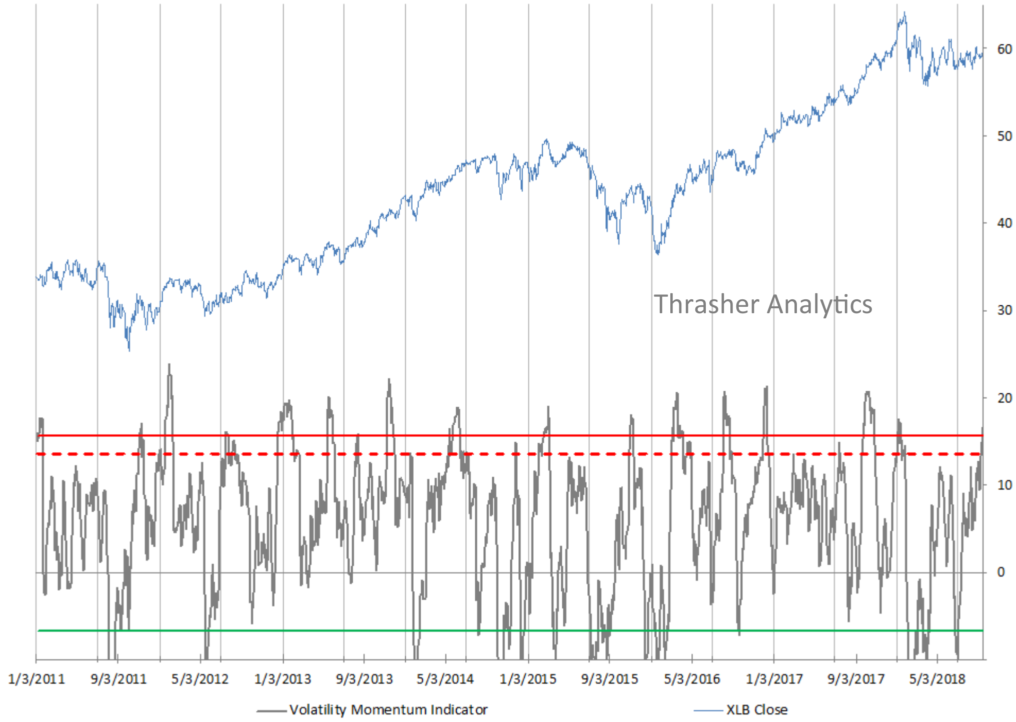
The important takeaway from an investment standpoint is the fuel buybacks have been on pushing stock prices higher this year. While the Fed has been removing its liquidity, it's been temporarily replaced by huge buybacks. Soon the market will be on its own and we'll be able to see if buyers remain to hold prices up without the assistance of the Fed or one-time cash injection by corporations.

New Sector Volatility Charts

For several months I've been working on a new project with a goal of replicating the work I've done in creating the Volatility Risk Trigger and applying it to the main S&P sectors. While I'm extremely pleased with the VRT and it's ability to provide useful insight prior to major spikes in volatility, I wanted to create something that provided the same type of insight into sector volatility and short-term trend changes in the sectors themselves. After exhaustive work in creating a measure of volatility for each sector and applying the analysis that crated the VRT I'm pleased to present the charts and the Volatility Momentum Indicator (VMI). Not only does the VMI apply to sectors but I've applied it to individual stocks and foreign market ETFs as well with great success.

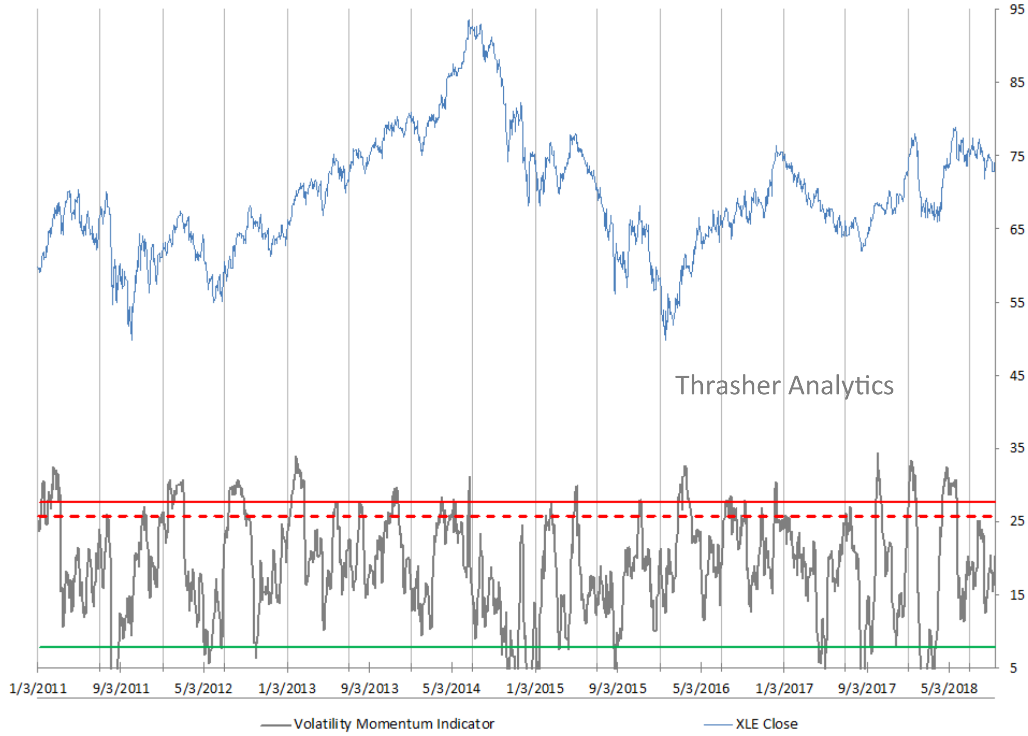
Each chart has three lines, 1 solid red which indicates significant high in VMI, the dotted red line marks moderate high levels in VMI and the solid green line shows when the VMI is at a major low level. The follow pages contain a chart of the VMI and each sector going back to 2011. I've also taken these readings a step forward and looked at the average reading of each sector and how it applies to volatility. It would make sense that if many of the sectors are seeing high readings in the Volatility Momentum Indicator, then that would be telling for the VIX as well—which is exactly what I found. I've included a chart below.

Materials Sector



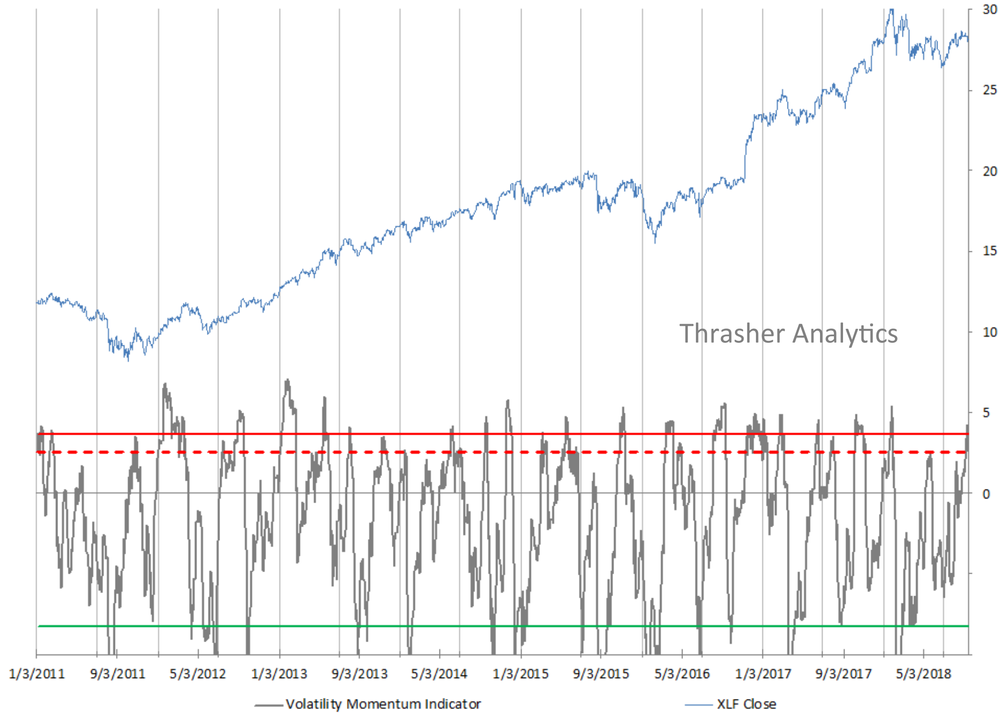
The Materials Sector is currently seeing an elevated reading in the VMI, currently at the highest level since January.

Energy Sector



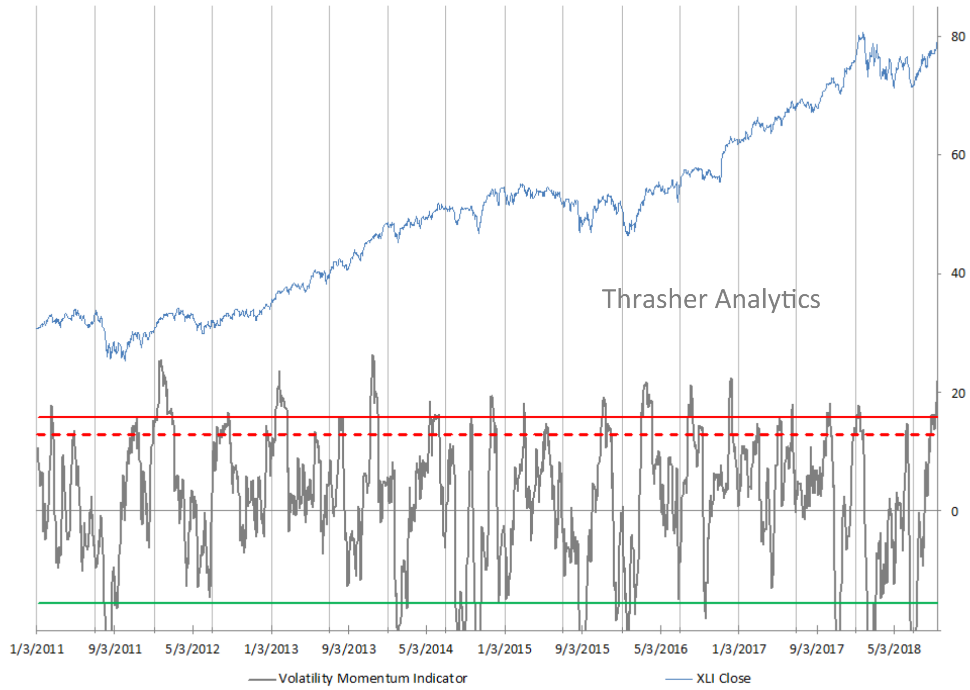
The Energy Sector saw an elevated reading in the VMI at the prior high in XLE just above $75 and has since decline as price has begun trending lower.

Financial Sector



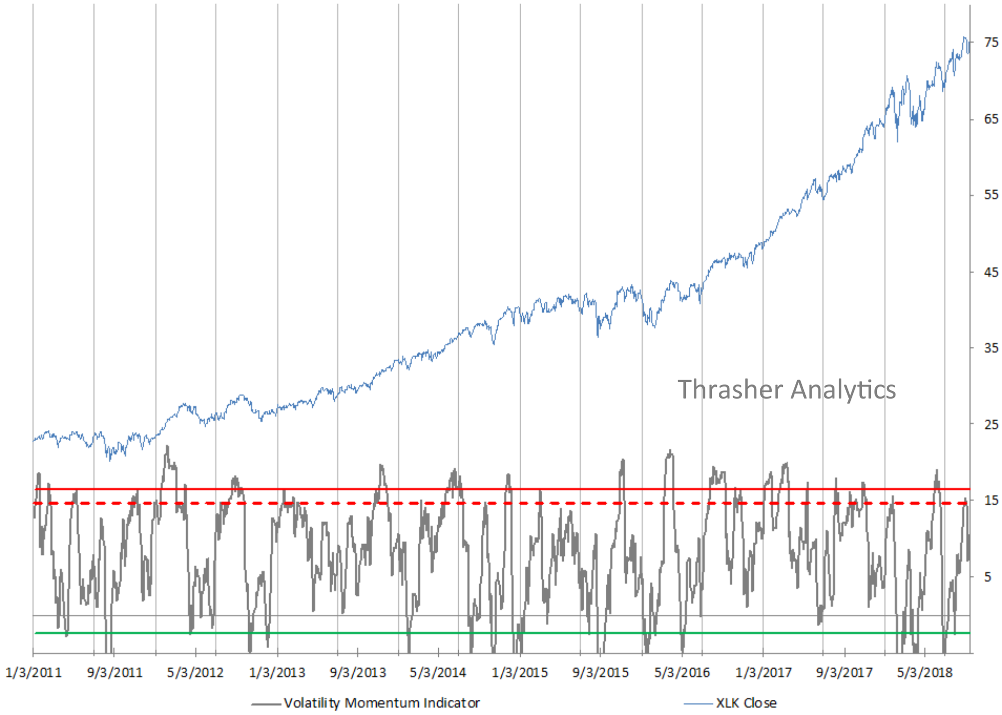
The Financial Sector has seen its VMI rise back near its prior elevated reading set in January.

Industrial Sector



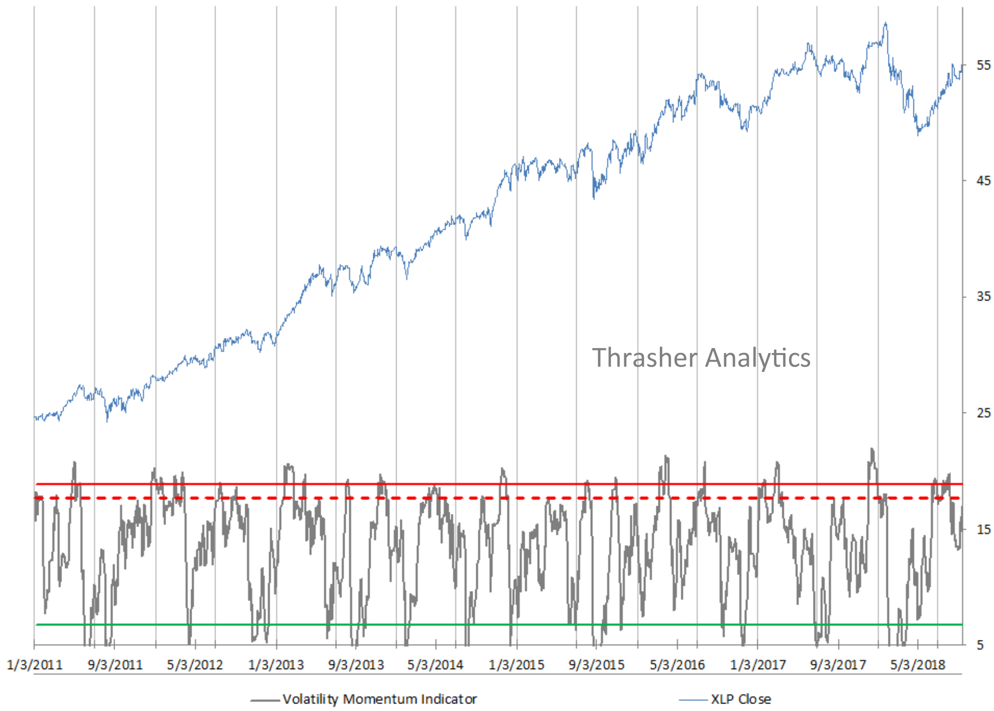
The Industrial Sector VMI has risen to multi-year high, breaking above its elevated threshold like it did in January and December.

Technology Sector



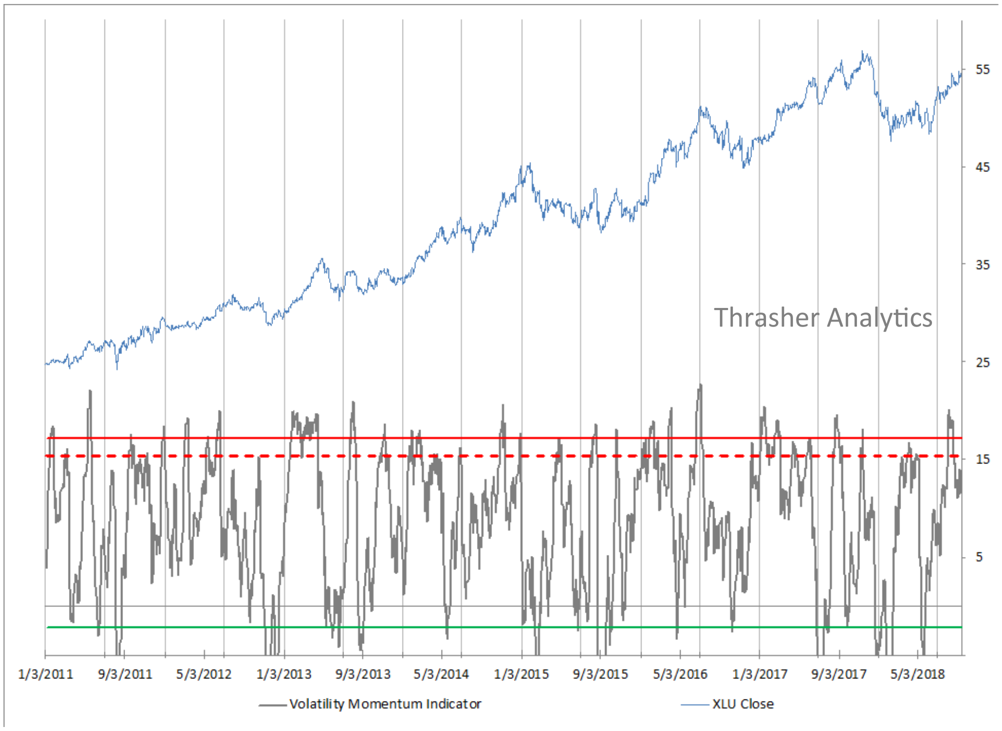
The Tech Sector has been incredibly strong over the last several years, seeing only minor pullbacks when the VMI has gotten too high. The current reading is not elevated.

Consumer Staples Sector



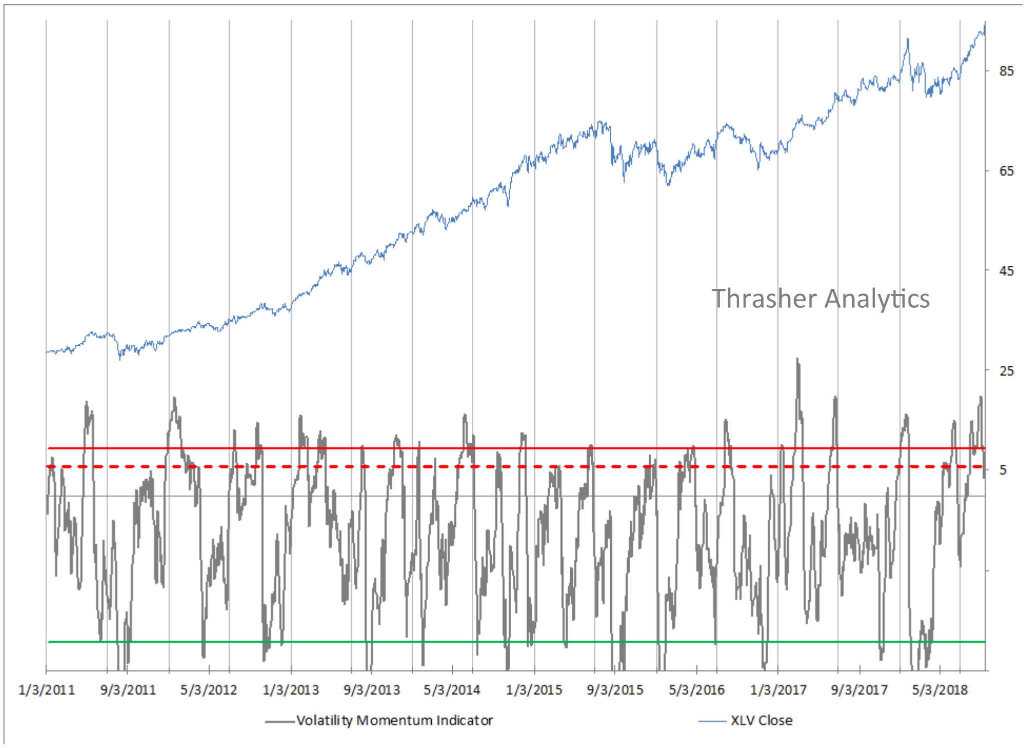
The Consumer Staples Sector saw its VMI rise in January and then once again a few weeks ago but is currently not seeing an elevated reading.

Utilities Sector



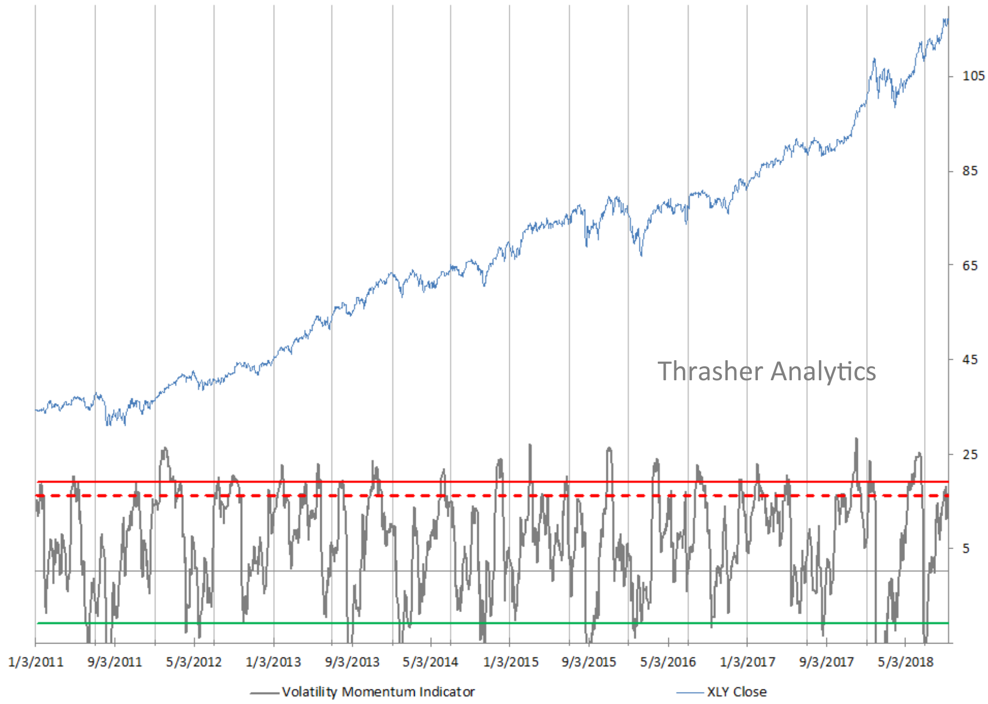
The Utilities Sector has had its VMI decline after being elevated a few weeks ago, and saw a major low reading in the VMI in May before XLU had a strong rally in price.

Health Care Sector



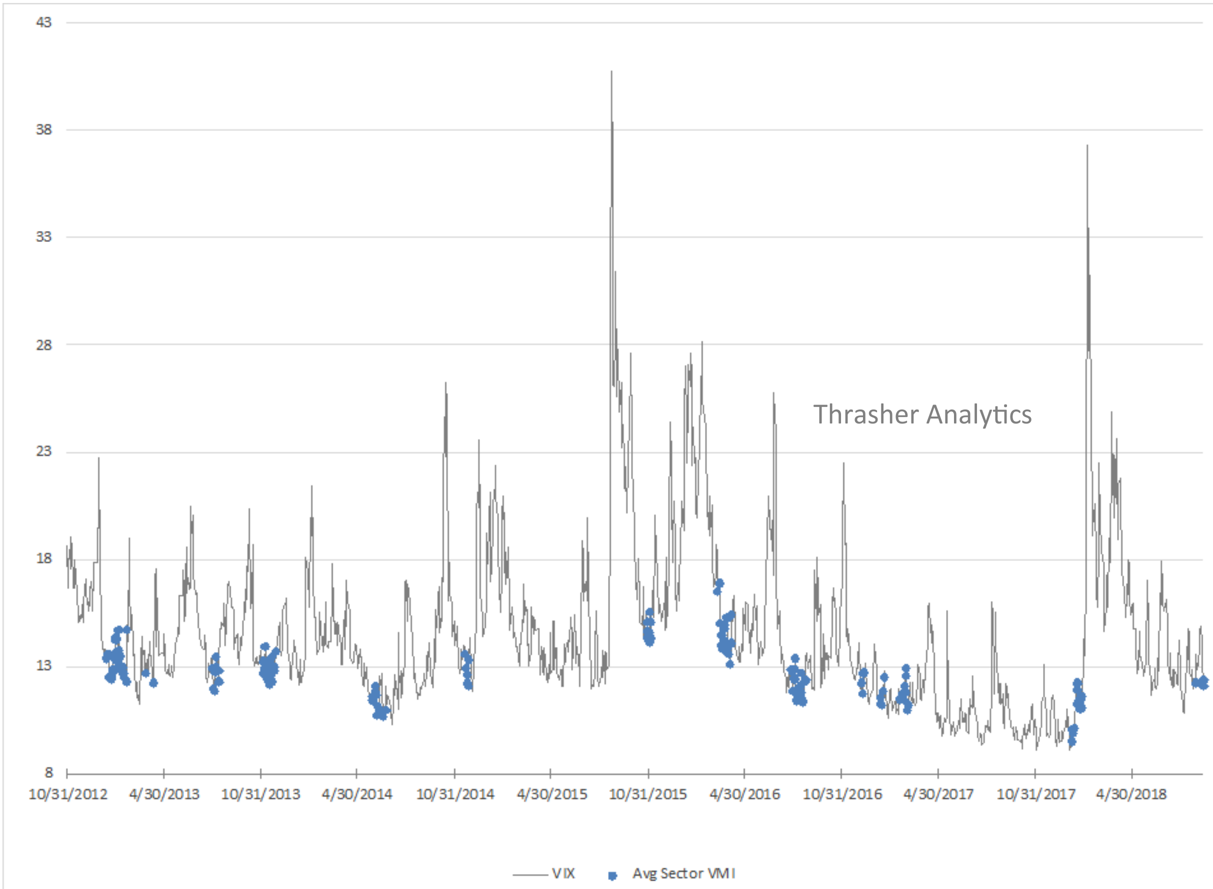
The Health Care sector has had a great rally off the low earlier this year, breaking above its prior January high. With the strong move in price, the VMI has risen as well, seeing an elevated reading for multiple weeks.

Consumer Discretionary Sector



The Consumer Discretionary had a minor pullback in price when the VMI became elevated in May but has seen quickly bounced back with the strong Q2 earnings reports from many retail companies. The VMI currently is not elevated.

Average VMI Sector Reading



The above chart shows the VIX going back to 2012 with blue dots when the average sector VMI reading is greater than 6. When the sector's average Volatility Momentum Indicator is high, a low in the VIX has often been put in. The average VMI for the 9 sectors shown in the prior pages is 6.12, a sign that volatility momentum is way too low and we could see a low in volatility in the coming week or two. I'll be watching to see if the VRT model also shows signs of a possible spike in vol too.

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