THRASHER ANALYTICS

Volatility Risk Trigger & Sentiment Update

Good evening,

I hope you've all enjoyed your weekend. I just got back from the annual CMT Symposium in New York. The conference was very informative, and it was great getting to connect with many other CMTs I've gotten to know over the years. Last week the 10-year Treasury yield (TNX) moved higher, confirming what I wrote extensively about in my last letter. In fact the 4-day rise in TNX was a 2-sigma event, we'll see if that trends continues this week.

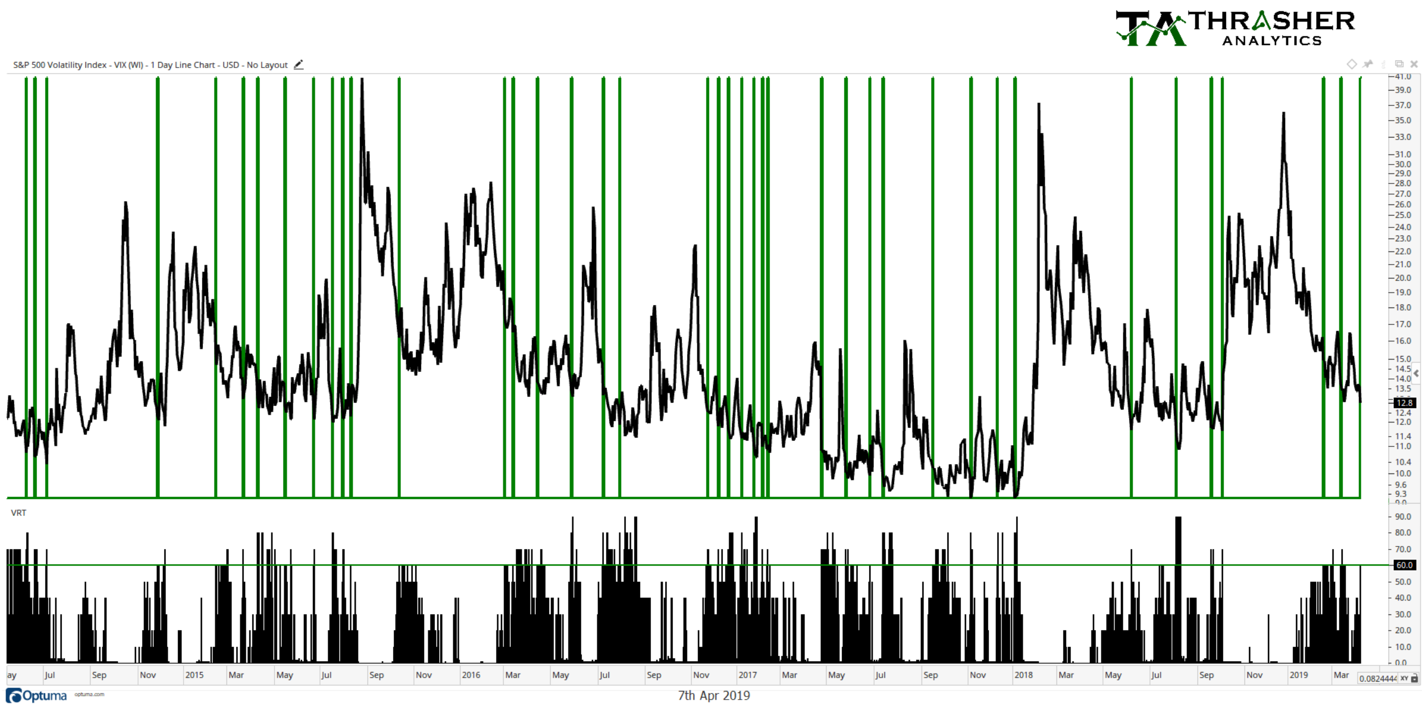
Sentiment Has Become Frothy

One of the biggest standouts from the many presenters over the three days at the CMT Symposium was the level of bullishness being exuded. There wasn't a single speaker, which included hedge fund managers, former mutual fund managers, buy side and sell side strategists, and independent traders, that I recall that wasn't bullish in some respect on equities. This seems to fit what the latest data from the National Association of Active Investment Managers (NAAIM) shows. The NAAIM Exposure Index, which measures the level of equity exposure the respondents currently have in their portfolios, rose 30 points to the highest level since August with a reading of 91.9% (meaning the average manager has 91% net exposure to equities). The most bearish of those surveyed was actually still net-long stocks compared to the prior week being net-short 50%.

Another sentiment reading that's currently hitting extremely high levels is the Daily Sentiment Index (DSI) which uses option data for its calculation. The S&P 500 and Nasdaq are currently registering 91% bullish. The 90% level was breached by the both indices for one day earlier in March, prior to that we'd have to go back to January 2018 when it spent a couple of weeks above 90% before the quick move lower in stock prices.

Volatility Risk Trigger (VRT) Has Signaled

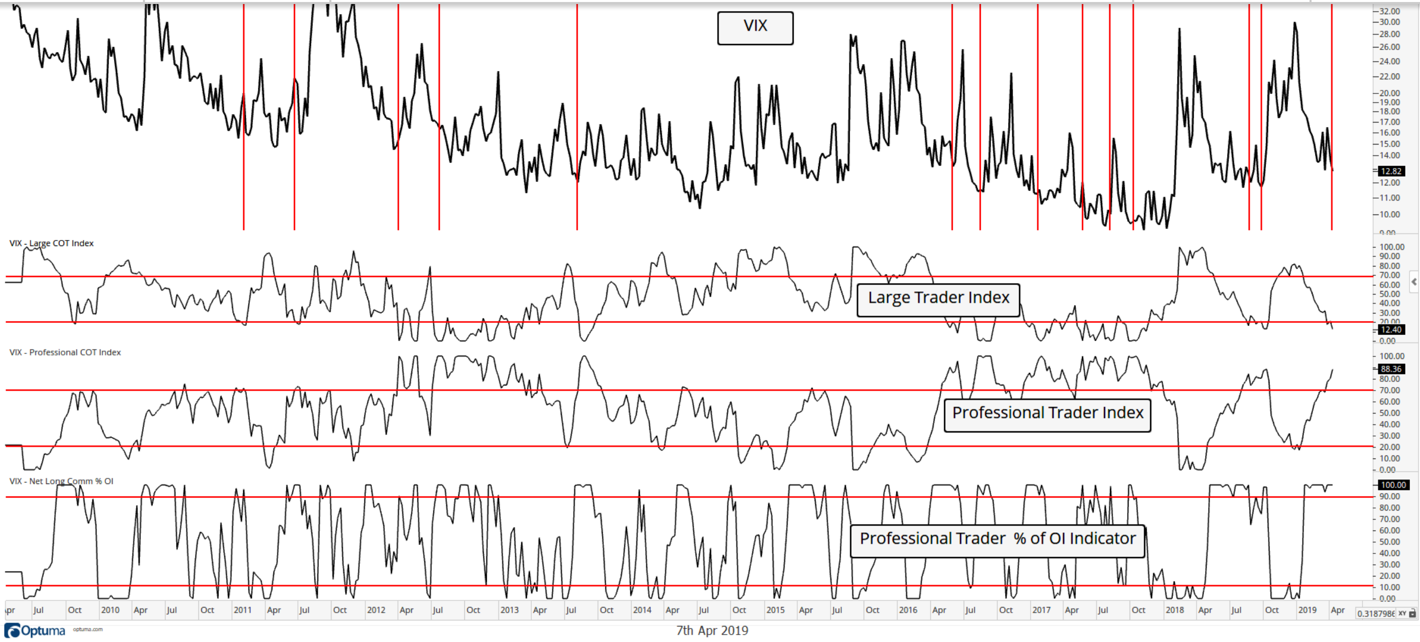
massive spike. The data for volatility and the rise in sentiment are both concerning but the internals for the market still appear positive, which I touched up a little bit last week. Also, I'm not seeing the large discount in volatility that typically appears in the VIX futures curve before some of the largest spikes in volatility that we've seen in the last ten years.



Volatility Is Being Sold By Large Traders and Bought By Professional Traders

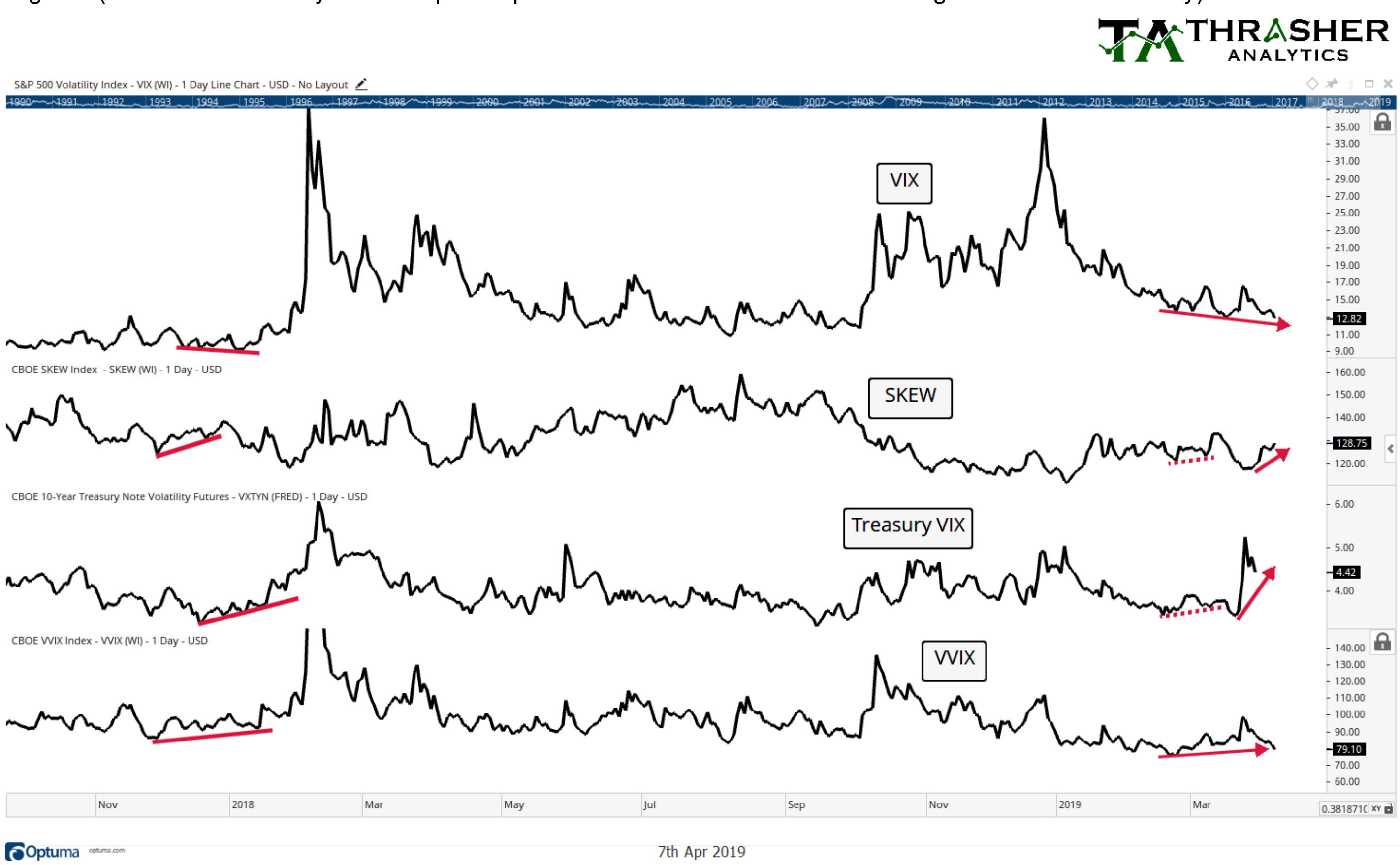
Once the COT data was published on Thursday one chart that seemed to catch a lot of attention was the large build-up in net shorts for Large Traders in VIX futures. However, simply looking at the raw net position is overly simplistic and does not provide a clear picture of the positioning of all the traders in the volatility futures market. Below is a weekly chart of the VIX with the Large Trader Index and Professional (Commercial) Trader Index, both are built comparing their current positions to their historical average. The third panel shows the amount of Open Interest (OI) the Professional Traders currently account for compared to the historical average. While Large Traders have built a large net-short position, this is only important when it's occurring as Professional Traders have created a large historical net-long position and account for a high percent of the OI. Which is what's taking place right now, and I've marked red vertical lines on the chart to show similar occurrences.

Why this is important is because when Professional Traders are taking their net-long position to historical extremes, soaking up the bulk of the OI against a large net-short position by Large Traders (mostly hedge funds and CTAs) then it becomes a battle of the quasi-informed vs. the "smart money." As you can see by the red lines on the chart below, volatility has risen quite a bit following several of these types of setups - most recently in September of last year.

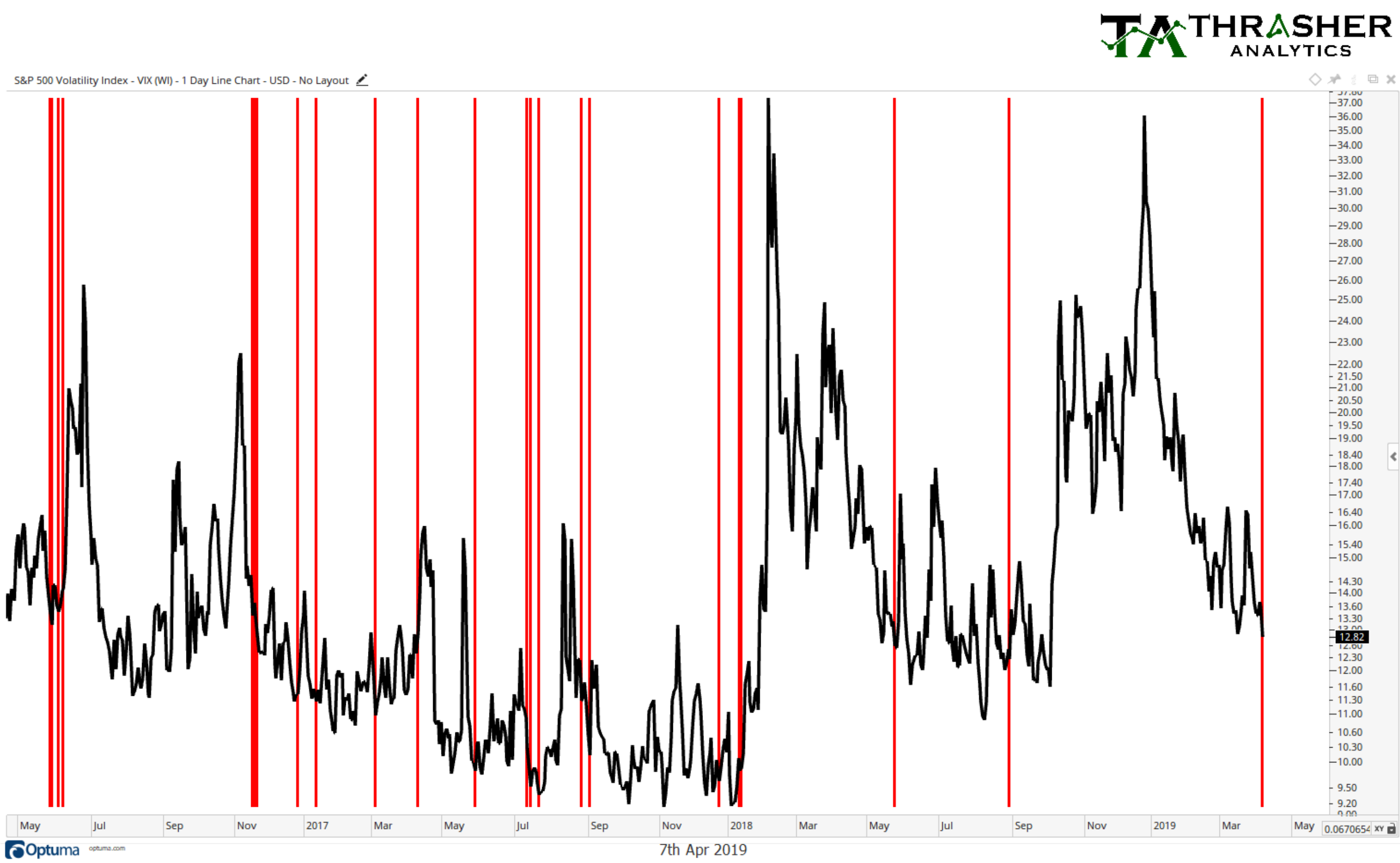


Volatility Divergence

I last showed the chart below in early March before the 5 point rise in the VIX. What was happened then and is happening again now, is the VIX is making lower lows while the SKEW Index, Treasury Volatility Index, and Volatility of the VIX remain above their prior lows. Following the last divergence in volatility the Treasury VIX had a large move higher and has since given back a chunk of that move but still remains elevated. It appears traders are pricing higher OTM options and VIX options more so than what's getting traded in the front month S&P options. This typically results in the VIX playing 'catch up' to varying degrees (like we saw recently with the quick 5 pt move and other times with much large advances in volatility).



a decent-sized spread between 30- and 9-day vol, which when occurring after a 10-day decline in 30-day vol, the VIX has been higher 20 days later 63% of the time with an average move higher of 22.7%. The chart below shows the prior occurrences with red vertical lines.



Conclusion

The S&P 500 is within spitting distance of its prior 2018 high. While I think the risk of volatility moving higher is currently above-average, it's not something that must take place all at once or begin right away. It seems that sentiment has gotten overly complacent and that's showing up in both the sentiment survey data and the pricing of volatility. Hedges have become extremely cheap and presents a nice opportunity going into Q1 earnings season, which many have argued will produce a pretty picture by many U.S.-based companies. This week we get inflation data, a speech by Powell, and FOMC minutes on Wednesday and several big bank earnings announcements on Friday, each could spark the match needed to get volatility moving higher.

Best Regards,

Andrew Thrasher, CMT

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