EQDerivatives
Commentary & News
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ETF/Index Trading

Players Await Higher Vol Despite Complacent Market

While market complacency in U.S. equity has hit extreme levels, market officials are warning the situation can change swiftly, with the CBOE Volatility Index curve pricing in higher levels around fall and the end-of-year.

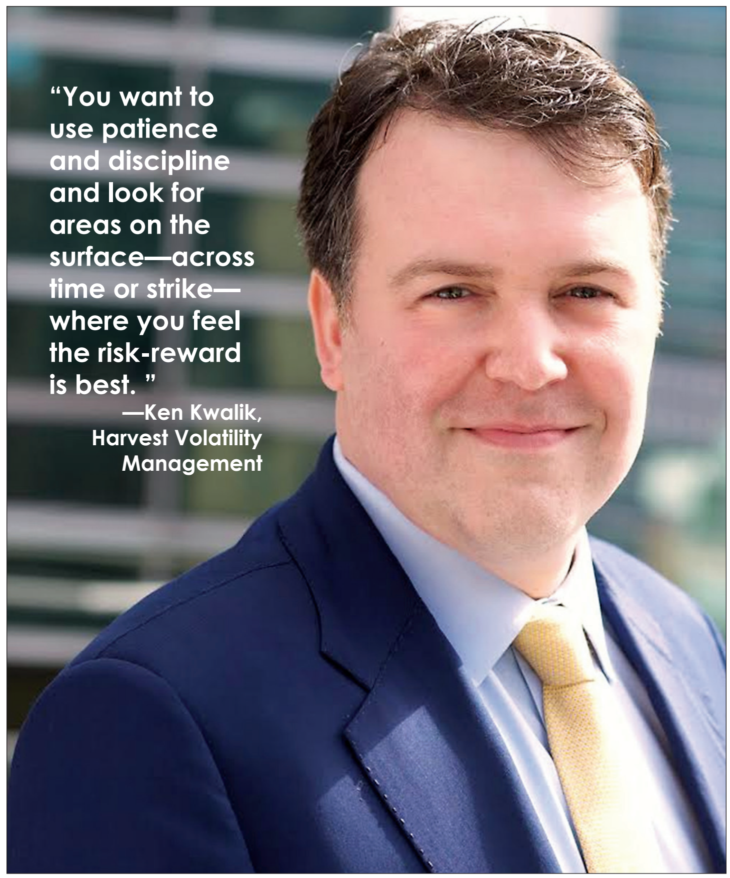
The VIX touched a 52 week low of 11.17 Tuesday, as volatility in U.S. equities continued to decline. Put flow on the index has dominated as investors and traders crowd in to short volatility, even though implied volatility is quite elevated. The VIX was trading at 11.74, down 2.57% during U.S. afternoon hours. ***Daniel O'Leary*** *reports*

Ken Kwalik, Managing Director/Portfolio Manager at Harvest Volatility Management in New York, told EQDerivatives the VIX futures curve was pricing in elevated volatility levels around October. Kwalik, along with Tim Knowles, runs the firm's collateralized put and call writing strategies. "That's where you begin to see the contango kick-in," he said. "Seasonally, the late-August/September time period has seen its share of turbulence in recent years. From these levels—and after a period of low-correlation through the (now-ending) most-recent US corporate earnings cycle—savvy vol-market participants understand that realized volatility will likely move somewhat-higher, but the question is, of course, what will cause that to happen? And when?"

In a recent client note, UBS strategists noted S&P 500 Top 50 three-month implied correlations had fallen below 40% and below realized correlations for the first time since August 5th. This has only happened four other times in the last 10 years, they added. "SPX was biased to the downside the next two months with max loss ranging from -5% (Jul-15 & Nov-15) to -30% (Sep-18), and max gain ranging from 0% (Jul-15 & Nov-15) to +3% (Sep-18)."

They said four main factors could make the market more fragile than last year, namely the SPDR S&P 500 ETF Trust put/call ratio being at its lowest since May 2009 and higher hedge fund gross exposure. They also pointed to the positioning in VIX futures being at its shortest since Oct. 2014, while VIX cross-asset rank remains depressed at the 19th percentile. "In particular, VIX is the most depressed versus HY credit spread since 2013," they added.

Kwalik said in dealing with such moves, it is crucial to stay nimble in positioning—and thus be well-positioned to take advantage when the markets do move sharply again. "With these products in particular –fixed strike put and call writing– as the market moves away from strike you just want to be very thoughtful in how and when you are resetting positions," he said. "You want to use patience and discipline and look for areas on the surface—across time or strike—where you feel the risk-reward is best. Even in a low-volatility environment—again—you stay small and be cautious—which also helps in time of (again, somewhat-seasonal) lower-liquidity, depending on your trading vehicles and overall size. That enables you to be active when markets do make a move."



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The UBS strategists added investors should look at long volatility trades, recommending long SPY Oct. 96% put for USD2.3 or long VIX Sept. 18 – Oct. 22 call calendar spread. "We continue to like VIX Sep/Oct call calendar spread to take advantage of the current steep VIX futures term structure to go long VIX term structure inversion and long vol of vol during market drawdown," they said.