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Volatility Market Perspective

May 20, 2022

'The Revolution Will Not Be Televised,' Gil Scott-Heron
‘The Market Bottom Will Not Be TeleVIXed,’ Dennis Davitt

When Gil Scott-Heron wrote that the revolution will not be televised, he meant that the event or experience which will result in a sea change or culture shift, is impossible to capture on film. The moment happened, but it is intangible. Traders will in hindsight point to previous explosions in the VIX as the sign of a capitulation in the equity market and as an indicator to buy the market. This time it will be different, and I hope this short note can shed some light on why there will not be a VIX spike to capture on film.

Supply and demand are the underlying reasons for price action in any market. In the case of the options/volatility market it is important to know not only what the supply demand dynamic is, but also who are the players driving it and why. I feel that investors being short volatility positions has NEVER been the reason for spikes in the VIX, but more to do with the leverage that some short volatility investors had in their portfolios. The most often referred to incident in VIX spikes was Volmageddon in February of 2018, which was driven by the worst type of short volatility leverage. The leverage was massive and 90% of the investors had no idea they held so much risk in their portfolios. The result of this was overnight clearing house liquidation. This sort of liquidation is commonly referred to as “the tap on the shoulder” that resulted in many a legendary short volatility blow-ups, causing a VIX spike and corresponding market capitulation in the underlying equity market.

Because of so many “taps on the shoulders” over the last three years, the AUM in the short volatility community has been decimated, steam rolled, the Bulls post Jordan….   Just look at the news this week of the Allianz PM’s hiding in from the SEC in bathrooms!   The leverage in Short Condor, short exotic variance, and Volatility Risk Premium (VRP) have all experienced outsized losses leading to redemptions. The VIX above 30% is still rarefied air... And yet, if it not coming from the short volatility funds, then why the elevated level? Primarily it has to do with the realized volatility of the underlying market. The realized volatility of the underlying SP 500 is above 27% and with implied volatility of options trading between 24%-27% (this translates to VIX at 30%). It is profitable to own options with such an active and volatile cash market. This is the opposite of 2017 where the VIX was at 10% and the realized was 7%.

The elevated options pricing is not limited to the front month options; going out 18 months we see elevated option prices which may foretell an increase in the volatility of the equity market through this time next year.   So can the VIX go higher, absolutely, but I do not foresee the closing of levered short options positions causing a traditional spike like it has in the past. I do see an options market that will trade in line with a more volatile market, however this time it will not provide an image, The Bottom will not be TeleVIXed.

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