VAGUE DESTINATION

coddiwomple

verb | cod•di•womple | \kä-də-wäm-pəl
: to travel in a purposeful manner towards a vague destination

Landon D. Whaley
Founder and CEO
Whaley Capital Group

Despite the fact that economies and financial markets constantly march towards Vague Destinations, a successful investor must remain purposeful, which means being data-dependent, process driven and risk conscious.

This week in "Drinking with Mr. Jones," we are going to coddiwomple through the the volatility asset class and the dangers in chasing markets...

Unless you've been on a deserted island with Wilson for the last few months, you've no doubt heard about the record low volatility in U.S. equity markets. Last week, the primary indicator used to gauge U.S. equity volatility, the CBOE VIX index, traded under $10 for the first time since 2007. All year the VIX has been playing a game of limbo so that just when investors think it can't go any lower, it does.

Most gurus and media-types warn that record low volatility is a harbinger of evil things. In contrast, I view decreasing levels of equity volatility as a very bullish quantitative factor, given the current U.S. Fundamental Gravity of accelerating growth. What I hadn't considered until I read an article in the Financial Times was that retail investors would see a declining VIX as an opportunity to outright short volatility.

Shorting financial instruments and company stocks is an invaluable tool which can be used both to dramatically improve the risk profile of a portfolio and as an integral way to generate alpha. That said, shorting financial markets isn't for amateurs. Shorting the "volatility" asset class is as risky as having a glass of Kool Aid with Jim Jones.

Short on Volatility and Brain Cells

According to the FT article, there are now more than 40 exchange-traded products based on the VIX, with aggregate assets under management of almost $4B. The largest of these funds is the iPath S&P 500 VIX Short Term Futures fund (VXX).

The FT points out that the number of shares of short interest in VXX has outpaced the number of new shares created over the last four months. This means more investors are shorting shares of VXX than are buying it. This dynamic has left the short float, which is the percentage of all outstanding shares that are short, at a ridiculous 95%! Let me say that again: 95% of all VXX shares are short!

To put this in perspective, only nine out of 7,000 listed U.S. companies have short interest in excess of 50%; the highest individual short interest registers at 72%.

Even in terms of what is an excessive level of short interest, what's happening in VXX is off the charts.

Not only are retail investors outright shorting volatility, but they have also plowed a record $1.4B into inverse volatility exchanged-traded products.

Investors are chasing volatility lower, believing the downtrend will continue unabated. These investors are about to learn that chasing markets is the quickest way to stack up losses, because the data is indicating that volatility is about to reverse course.

The Floor Is In

After trading below $10 during the week, the VIX closed last Friday at $10.57. This closing price is still lower than 99.2% of all trading days since 1990, which means the VIX has closed lower on only 55 of the last 6,887 trading days. Last week's close puts the VIX within spitting distance of its all-time closing low, back in 1993, of $9.31. What's more, the VIX has closed below $11 on only 2% of all trading days since 1990.

The historical data speaks loudly: it's extremely rare for volatility to be this low. The historical data also tells us that when volatility hits these low levels, it doesn't stay there long.

The Catalysts

There are typically two types of events that drive volatility higher for a sustained period of time. First, geopolitical events like the September 11 terrorist attacks. You can also include in this group any events that cause crude oil prices to spike, like the Saudi embargo in 1973 and the Iraqi invasion of Kuwait in 1990.

The second type of event is the bursting of a financial bubble, like the Dot-Com crash or the Great Recession.

While neither type of event is currently on the horizon, there are a couple of affairs that could cause investors who are short volatility some Kansas City barbecue-type heartburn.

The uncertainty surrounding the French election is largely gone. That said, I remember a certain election, not too long ago, for which every pundit, computer simulation and poll had one candidate winning by a healthy margin. If Brexit and Trump taught us anything, it was that when it comes to politics, anything can happen.

Similarly, tensions with North Korea have been steady for the last several weeks, but they remain elevated, and an unforeseen outcome is still possible.

While I would classify the French election and the North Korean situation as "catalyst outliers," there is one event lurking closer to home that could have a profound impact on volatility.

A Fed rate hike in June is a forgone conclusion, with market-based probabilities currently sitting at 80%. However, if U.S. growth begins to slow at an accelerating pace and the Fed moves forward with normalization anyway, that, my friends, is a volatility catalyst.

Remember January 2016, after the first Fed rate hike in a decade? The Fed raised rates in December in the face of a slowing U.S. economy, and in less than a month the VIX had exploded from $14 to a peak of $32. While the VIX was doubling, the S&P 500 was diving, and in a matter of weeks lost 12% of its value.

Bottom Line

The bottom line is that we are almost certainly at a bottom for the VIX, but without a catalyst we will continue to cruise along this floor for the time being.

Remember, markets don't go straight up or straight down—they are cyclical. The VIX is down 60% since the election, and at some point it will go higher.

The VIX is a unique asset class because of its asymmetry. This means that VIX rallies, in addition to being unpredictable, also tend to be an order of magnitude greater than the downtrend they're escaping from.

Simply put, mean reversion in this market comes fast, quick and in a hurry.

Staying short or initiating new short positions in a market that is down 60% is just plain reckless. If you're one of the investors shorting volatility and drinking Kool Aid with Jim Jones, put down your glass.

Successful investors don't tug on Superman's cape, they don't spit in the wind, and they don't chase markets. As always, stay data dependent, process driven and risk conscious, my friends.

CONTACT US

If you would like to receive Vague Destination each week, please email andrew@whaleycapitalgroup.com.

Whaley Capital Group
400 Locust Avenue, Suite 4, Charlottesville, Virginia 22902
434.202.5072
www.whaleycapitalgroup.com