The Death of Volatility? Follow Up

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On December 4, 2017 I published a piece called "The Death of Volatility?" At the time, the VIX (volatility index) was trading at around 11. The point of the article was that a lot of money (retail, professional and institutional) was shorting (selling) volatility in the belief that it was "easy money" because volatility has been falling for years. Typically it's a case of markets going up and volatility going down. But as I wrote in December 4th article, "the problem with picking up nickels in front of a steam roller is that complacency sets in, people stop bothering to even watch the steam roller, and a sudden shift in dynamics causes the steam roller to unpredictably speed up." Last week the steam roller didn't just pick up steam, it looked more like a runaway train, jumping over 350% in a couple of days:

Source: *StockCharts.com as of February9, 2018*

Here is a look at one of many short volatility ETFs (SVXY) that people trade. Notice that it took over five years for this to climb from $8.36 to $138.21 (1,644%), but only five days to fall 93%:

Source: *StockCharts.com as of February9, 2018*

The markets have, to quote the title of the CNBC's special reports, been "In Turmoil." The S&P500 has traded down as much as 11.8% high to low with some pretty wild overnight and intraday swings:

Source: *StockCharts.com as of February9, 2018*

The most recent cover of Barron's (2/10/18) decided to warn readers about the coming volatility. Now? Something about barns and horses comes to mind:

Some interesting data points leading into this volatility spike:

- According to Eric Balchunas, senior ETF analyst at [Bloomberg](), investors injected a record $78.5 billion into ETF's in January, topping the prior monthly record by over 30%.
- According to FINRA's latest [margin statistics](), borrowing by investors in November 2017 stood at an all-time high of $627.4 billion. This is almost a $100 billion increase over margin borrowing at the end of 2016—and more than double the level of borrowing at the end of 2010.
- A [record 66%]() of Americans expect stocks to rise over the next year.
- The Daily Sentiment Index (DSI) for the S&P500 hit a 20-year high of 96% bulls in late January, the highest reading in 20 years, while the Nasdaq hit a record 97% bullishness:

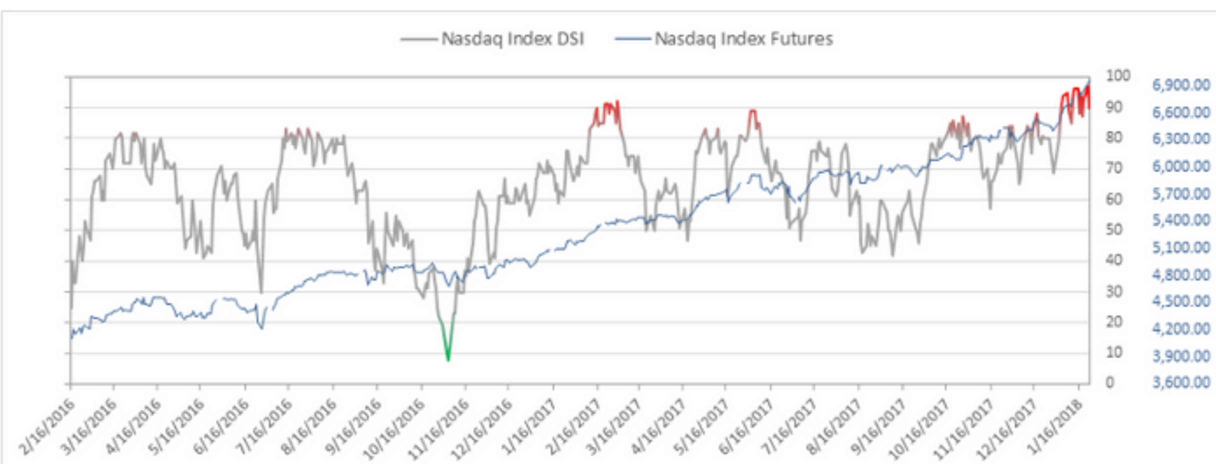

chart from hedgefundtelemetry

And what has happened in the past two weeks?

Drawdowns*

Bitcoin: -58.3%
Shanghai Comp: -13.2%
China A Shares: -11.9%
Nikkei 225: -12.6%
Brazil: -11.6%
Nasdaq: -10.4%
S&P 500: -10.2%
Mexico: -9.4%
Russell 2000: -9.3%
Oil: -9.2%
EuroStoxx 600: -7.2%
India: -5.5%
Gold: -3.5%
Euro: -2.1%

*from recent highs, bloomberg data

There is a great book by Charles Kindelberger titled *Manias, Panics and Crashes – A History of Financial Crises* with a passage I keep close to my computer monitor: "At a late stage, speculation tends to detach itself from really valuable objects and turn to delusive ones. A larger and larger group of people seeks to become rich without any understanding of the processes involved. Not surprisingly, swindlers and catchpenny schemes flourish." Think about that for a minute. Just in the past 20 years we have seen the rise and fall of dot com companies, Beanie Babies and now Cryptocurrencies.

So what does all this mean going forward? Well, most importantly, the Fed is no longer a buyer of Treasury bonds – something they have been doing since 2008. The current plan for the Fed, under their quantitative tapering plan, will be for them reducing their Treasury holdings by almost $250 billion this year. Time and market action will tell us if that plan comes to fruition. At the same time, it is estimated that the Treasury Department will issue over $1.4 trillion in bonds, nearly three times higher than last year's issuance. 2018 will see the Fed flip from buyer to sell of bonds and the Treasury issue 300% more bonds than last year, meaning that a lot of money will have to come into the bond market in order for rates to not move meaningfully higher. It would seem that unless the Fed was to reverse course, there is no where for interest rates to go but up. Something the "bond kings" Bill Gross and Jeffrey Gundlach have both been warning about.

Bonds did not catch a bid this past week as stocks fell, something which usually doesn't happen. The normal thing to see with a weak stock market is money flowing into the safety of Treasury bonds. The 10-year yield is at a precarious spot right now. It could break higher, possibly taking out the 3.0% level, or it could reverse and pullback to the 2.6% breakout level as this weekly chart shows:

Source: *StockCharts.com as of February9, 2018*

This week will be telling on several fronts. Will volatility subside? Will the SPX continue higher having double bottomed off its 200 day moving average? Will the Dollar continue higher putting pressure on metals and commodities? These answers are unknowable. But one thing that is not – 2018 is not starting off like every other year since 2008. Volatility has returned with a vengeance and volume has greatly expanded. Something is different and it will be important for people to pay attention to how all of these highly correlated assets trade, especially in light of central bank changes and global market linkages.

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