Section 3: Blog

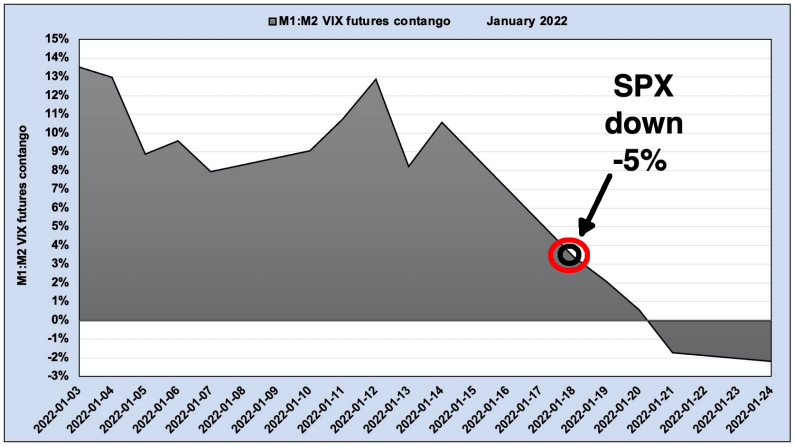
VTS Community,

As I discussed yesterday, this recent market sell off has been very bizarre, dare I say unprecedented? Now the S&P 500 itself is down about 10% which isn't overly unusual.

The strange part is just how slow the volatility metrics have been in responding to it.

I'm very surprised the Volatility Barometer has not breached above the 80% level. In any other past market sell off it surely would have by this point, and to be honest, up to a week sooner. Another way we can illustrate this is by looking at the front two months of the VIX futures, and the level of contango in the month of January.

M1:M2 VIX futures contango in January 2022:

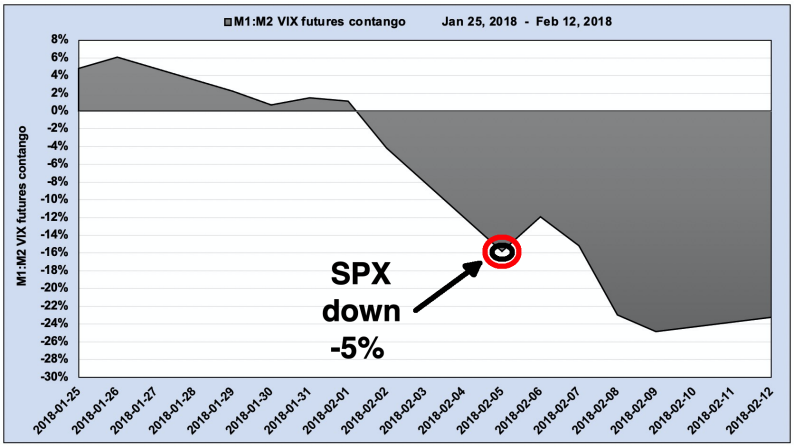


I can't overstate how surprised I am that the front two month VIX futures have only dipped into backwardation the last 2 days, and by less than 3%. Going back to the launch of the VIX futures in 2004, we haven't seen a market sell off ever get taken so lightly before.

Do market participants really think this sell off is a non issue?

I highlighted the point where the S&P 500 crossed below the -5% level, and we can see that when it did the VIX futures were still comfortably in contango at about 4%. 4% isn't that far from the long term median, so it's odd to see it hold so strong given the decline. Let me show you how much of an outlier that is by highlighting the last 3 market sell-offs for comparison.

The February 2018 "Volpocalypse" crash:

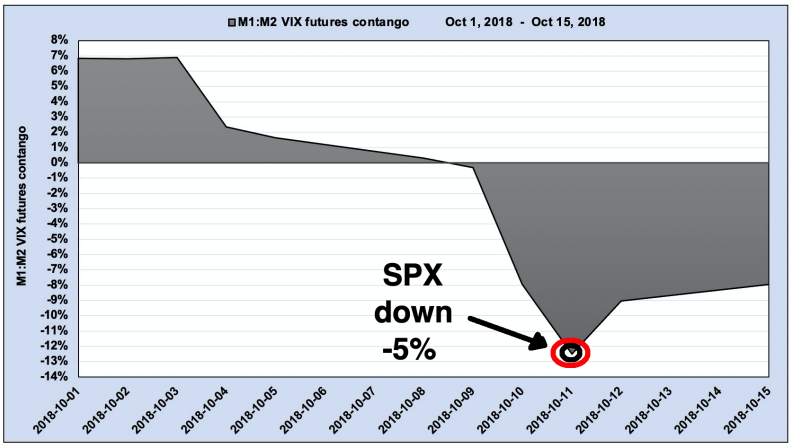


This is far more normal, with the VIX futures going into backwardation well before the S&P 500 ever reached the -5% level. By the time it did the M1:M2 futures were in 15% backwardation, a clear screaming red flag.

The VIX futures are typically very good at telegraphing difficulties in the market, as large institutional hedgers tend to enter pretty early on to build up the protection they need in case there is follow though.

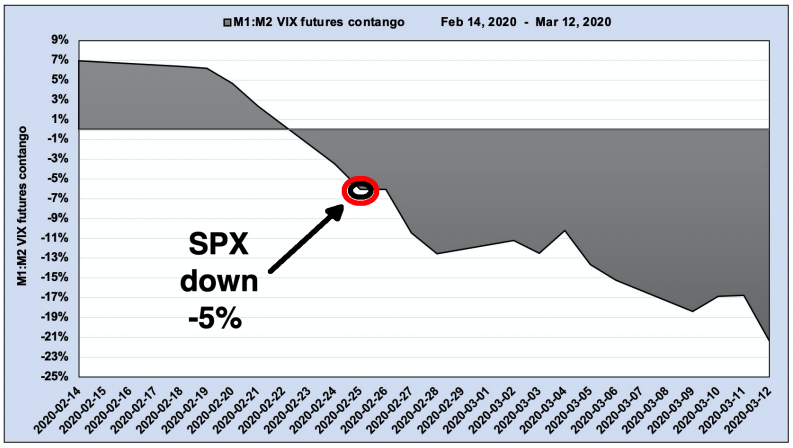
It does appear like in the last week, those same institutional hedgers just didn't bother. Apparently they thought the buy the dip crowd would come in immediately, and at least so far they surely have not.

The Q4 2018 crash:



Again, that is absolutely what we would expect. Institutions and large asset managers get paid exorbitant amounts of money to protect investor capital in the event of a crash. We absolutely expect them to enter the market with strong hedging quite early on in a sell off, and by the time the S&P 500 is down 5% or more we should see it show up in the futures.

The 2020 global pandemic crash:



The pandemic in 2020 happened so fast that it actually took a lot of people by surprise. In fact, when trying to justify their trading losses pretty much every asset manager in the world was using the slow reaction of volatility as the reason they were inadequately hedged ahead of time.

Imagine that. Before this months crash, 2020 was actually an example of a slow to react vol space. Yet in that example the VIX futures were in backwardation before the trouble started, and over 6% backwardation by the time the S&P crosses the -5% threshold.

That was considered a slow reaction, until now

As an investor who relies on the consistency of volatility metrics to signal trouble early on and get me to the sidelines, I have been caught in the rain without an umbrella as well during this crash. Now we were able to get to relative safety by last week, but as it turns out that was a few days too late and we've felt it.