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Recent move in US equities was technical, fundamentals still constructive

- **With VIX at all-time lows, short vol ETPs effectively became highly leveraged with a large asymmetric risk profile.** The rebalancing requirements of VIX ETPs exacerbated Monday's vol spike. On Monday's VIX spike, vol ETPs would have needed to buy \$230mn+ vega or ~25% of the VIX futures volume traded on the day. This dynamic led to the NAVs of 2 major short vol ETPs to fall ~95%.
- **Vol spikes may be longer-lived with the short vol ETP complex getting decimated.** Prior moves in VIX were likely exacerbated as traders pre-positioned for a bigger increase in vol due to the mechanical rebalancing requirement of the inverse and 2x levered long VIX ETPs. These spikes were then met with short vol interest as seen in the increase in shares outstanding in the short vol ETPs. This dynamic led to vol spiking and reverting quickly, a behavior which now should change as the vega to trade following an increase in vol is negligible.
- **This has at least two implications:** 1) vol spikes will likely tend to revert less quickly and investors may have more time to unwind VIX calls after an increase in vol; and 2) we would expect a slightly lower vol-of-vol as the much smaller VIX ETP rebalancing will not exacerbate vol moves in both directions.
- **CTA, risk-parity, and vol control funds likely sold \$35bn-\$65bn in US equities as volatility picked-up.** We believe CTAs were responsible for much of the +\$25bn increase in S&P 500 futures exposure by leveraged funds in January and likely de-leveraged quickly. Vol control funds needed to sell ~\$20bn in equities following Monday's -4% sell-off. And we expect \$25-\$40bn of equity selling over several weeks from risk parity.
- **Dealers' options positioning has flipped to short gamma, which removes the dampening impact dealer hedging** had on equity volatility for most of the past 2 years. Net exposure is likely minor right now but the direction is now one that will contribute to higher realized vol and not depress it.

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