

Mystery Solved: Days Like This Are What the VIX Warned About

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► Nasdaq 100 fear gauge rose to highest versus VIX in 16 years

► ‘That’s rarely sustainable’: Interactive Brokers’ Sosnick

Traders professing bafflement over recent ominous moves in volatility indexes got some clarity on Thursday.

The situation -- the VIX’s persistent and unusual advance in tandem with the S&P 500 -- was thought unsustainable. On Thursday, it came asunder, as the biggest selloff in four months swept through U.S. equities, particularly tech stocks.

A host of theories were offered to explain the alignment. Today, the simplest seemed to apply. Traders worried about the straight-up trajectory of stocks were paying up for protection in the market for equity derivatives, boosting options prices. With the Nasdaq 100 down 5% at 12:56 p.m. in New York, that prudence is paying off.

“We were seeing a market that was both risk-averse and highly complacent at once,” said Steve Sosnick, chief strategist at Interactive Brokers. “That’s rarely sustainable.”

To be sure, another hypothesis on why the VIX and the market rose at the same time also plays into today’s action. It’s that newbie traders, not content with 77% gain in the Nasdaq 100 since March, were purchasing call options hand-over-fist to leverage their bets on tech stocks. In that view, today’s fall represents long-overdue comeuppance for people whose euphoria got the best of them.

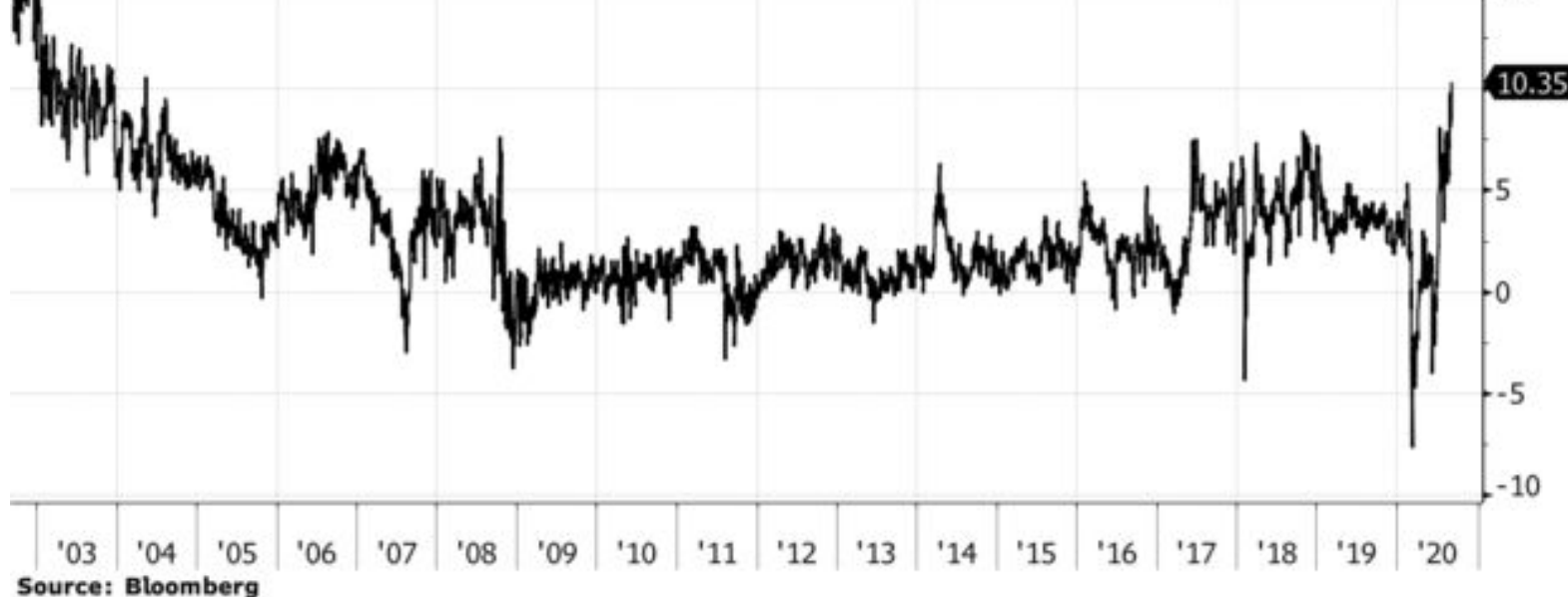
In the three trading sessions through Wednesday, the Nasdaq 100 rose roughly 1% or more each day. At the same time, the Cboe NDX Volatility Index (VXN) also climbed. Usually as stocks go up, measures of implied volatility go down. But lately that relationship has been broken.

Also catching Wall Street’s attention was a growing gap between the Nasdaq 100’s “fear gauge” and a similar version for the broader S&P 500, the VIX. Even though tech shares have been considered quasi safe-havens in the Covid-19 stock market, VXN exploded 10 points higher than the Cboe Volatility Index in recent days -- the widest gap in 16 years.

Megacap Fear

Nasdaq 100 volatility index at extreme levels versus the VIX





The tech-heavy Nasdaq 100's rout comes after an unrelenting run that had pushed the index 30% above its trend-line over the past 200 days. Up over 50% in five months, the benchmark was coming off of its most forceful run since the dot-com era. Now, \$700 billion of value has been erased from the index in a day.

In truth, when markets go up as fast as they have recently, they rarely do it in a straight line -- a fact that bulls can take comfort in as they stare at a 7% drop in Tesla Inc. and a 5% plunge in Apple Inc. In 1999, a year when the Nasdaq 100 doubled, it fell more than 4% on five separate days. Owning hedges is both prudent in such markets and can also be part of a larger bullish position.

One theory for the volatility-stock tandem move held that extreme demand for bullish call options to bet on further gains in megacap tech was further fueling price appreciation as dealers were left to hedge.

Across U.S. exchanges last week, people bought 22 million more call contracts than they did puts, higher than the previous record set in June, according to Sundial Capital Research Inc. As stocks rose, dealers needed to buy more shares to hedge exposure, and at times were forced to turn to the S&P 500 and Nasdaq 100, so the thinking went. Then, to hedge, they bought implied volatility on the indexes too.

The VXN rose above 40 Thursday, the highest level since April.

"Any pivot off freshly made lifetime highs could be the beginning of a bear market," said Michael Purves, chief executive officer of Tallbacken Capital Advisors. "But we suspect this is an overdue consolidation such as we had just after Jan. 2018 and at various other periods during the Nasdaq 100 bull run."

Whether the ramp up in hedging beforehand lessens or accelerates the selling is yet to be seen.

"An interesting question will be whether the large expansion in Nasdaq 100 volatility will help buffer the downside move for this index but also across other assets classes," Purves said. "If investors had protection, that should buffer the broader portfolio shock. On the other hand, the large dealer gamma from the large increase in option volumes also magnifies moves such as the one we are seeing right now."

