Accidents Waiting to Happen - Short VIX

29 April 2019

The April 23rd net short position in VIX futures was the largest ever reported by the CFTC.

The Short VIX trade is back, with the largest ever recorded net short position in VIX futures[1], 15 months after Short VIX ETFs were wiped out as the VIX surged by 115% in a day— its biggest up day ever. Just 6 months ago, the VIX ran up by 44% in a single day and 59% in 3 days. There's a very high probability that those events will be repeated in spite of the 'low volatility' in the S&P 500 Index.

Déja Vu All Over Again.

By mid 2017 the fact that the Short VIX trade was becoming dangerously crowded was widely reported, as was the VIX Index level that would trigger a meltdown. In June and August of 2017[2] we warned that the probability of the index rising by that amount was so high that the catastrophic event was imminent.

In February 2018, the VIX rose by 115% in a single day and the Short VIX ETFs were largely wiped out. Resulting lawsuits are still underway[3].

What could go wrong this time?

Now, with the S&P 500 Index hitting record highs and volatility damped down, the Short VIX trade has returned. This time the record short exposure is to VIX futures directly[1].

Volatility is *not* a reliable measure of risk. It contains no information whatsoever about how fat the tails of a returns distribution are. And it's precisely the fatness of the tails that answers the question "What could go wrong this time?"

The extremely fat tailed distribution of returns in the S&P 500 Index and the Short VIX position were apparent by Q3 2017. The high probability of outsized moves in fat tailed distributions was precisely what led us to predict that the wipeout which came in February 2018 was imminent.

Now, just as the 'low volatility' of the Index has triggered the largest Short VIX futures position of all time, the fat tails are back and the probability of large losses is high.

How big a drawdown are the VIX Shorts prepared for this time?

As recently as last October, the VIX jumped 43% in a single day when the S&P 500 Index dropped 3.29%.

This was, and remains, the worst single day in the Index since February 2018. According to our tail model we should expect the S&P 500 Index to lose at least this much once every 5 months.

The same technology applied to the Short VIX returns shows that exceeding the 43% loss experienced the last time this happened should be expected *once every 10 months*. Are the record holders in the Short VIX futures position prepared for that?

There's a very high probability that the VIX shorts will be wiped out again.

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[1] https://www.bloomberg.com/news/articles/2019-04-26/hedge-funds-are-shorting-the-vix-at-a-rate-never-seen-before.

[2] The 'low volatility' short VIX trade is getting very dangerous. What Just Happened? 14 June 2017. https://www.omegaanalysis.com/research-archive-2017-i
The danger of very fat tailed VIX in a 'low volatility' period was confirmed yesterday. What Just Happened? 11 August 2017. https://www.omegaanalysis.com/research-archive-2017-ii

[3] https://finance.yahoo.com/news/svxy-proshares-short-vixshort-143500240.html

Omega Analysis Notes

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