MONTHLY MARKET INSIGHTS

September - 2021

ESTIMATED RETURNS:

Dealer Flow: **+1.00%**

Vol Neutral: **+1.19%**

Long Vol: **+4.55%**

INDEX MOVES: Open | High | Low | Close

Index	Open	High	Low	Close
S&P 500	4522.69	4545.85 (9/02)	4305.91 (9/20)	4307.53
NASDAQ	15582.51	15701.40 (9/07)	14689.62 (9/30)	14689.62
DOW	35360.74	35475.40 (9/02)	33613.03 (9/20)	33843.93
RUSSELL	2273.77	2309.97 (9/02)	2155.34 (9/20)	2204.37
VIX	16.49	28.79 (9/20)	15.68 (9/01)	23.13

PERFORMANCE: The SPX saw a decline of 4.76% in September, the worst September since 2011, once again proving what we have known about the "September Effect" for the better part of a century. With the S&P entering the month near all-time highs and a relatively lower basis of implied volatility, our two "negative beta" strategies were able to take advantage of the market correction and increases in implied volatility. The Long Vol fund generated +4.55% and our Vol Neutral strategy produced +1.19% into this market decline. Most impressively, our Dealer Flow strategy was able to navigate through some relatively choppy flows and still return +1.00% on the month, despite the market decline, even after performing well during the recent bull run. This is additional proof of the strategy's non -correlated market exposure.

Whether it was solvency concerns for China's most prolific real estate developer Evergrande, or the shifting tides of future Fed policy, market participants have been well hedged as we saw skew and Volatility Risk Premium (VRP) both in the 90+ percentile going into the month pre-decline. Moreover, implied volatility supply has continued to be incredibly reliable and robust from, among other sources, our long-discussed JP Morgan Hedged Equity Fund's quarterly trade. The Dealer Flow strategy was able to tactically take advantage of this and other similar positioning to profit, even as the market experienced declines ahead of our well documented window of weakness around September options expiration resulting in an almost 4% drop from 9/15 - 9/20. Signal has been challenging given conflicting cross-currents created by liquidation from over leveraged retail equity positioning that have flowed contra secularly bullish buybacks and equity balance sheet flows. We are very pleased with our ability to navigate this challenging landscape and are proud of the non-correlated performance of all three funds during this period.

OUTLOOK: In his book *The Alchemy of Finance,* George Soros writes "Fundamental analysis seeks to establish how underlying values are reflected in stock prices, whereas the theory of reflexivity shows how stock prices can influence underlying values." This theoretical construct of reflexivity has long been a powerful qualitative theory but has languished in the backwaters of finance without quantitative teeth. Monsieur Soros has attributed the success of his numerous well-timed bets over the years to this framework. However, he would be the first to admit that his approach is far from science and has led to a poor hit rate with many limited losses but occasional immense successes, such as when his bet against the pound forced the United Kingdom to withdraw from the European Exchange Rate Mechanism in 1992.

In his own words, Soros has described the difficulty of accurately measuring this reflexivity: "Reading the record, it is striking how many calamities that I anticipated did not in fact materialise. Financial markets constantly anticipate events, both on the positive and on the negative side, which fail to materialise exactly because they have been anticipated. It is an old joke that the stock market has predicted seven of the last two recessions." We would argue that the effect of dealer positioning plays a role in the failed materialisation of market moves due to well-anticipated events.

His recent bet against China is a perfect example. The extent of the Chinese housing bubble has long been widely acknowledged, but it was broadly expected that the Chinese government would support the system and prevent any abrupt collapse. Soros, impressively, saw through this commonly held view and correctly predicted the recent tumult in the Chinese housing market. However, what was missing from his framework was an understanding of the supportive flows in equity markets from dealer positioning. These flows have limited the spread of contagion, dampening the impact of panicked selling.

Oversupplied volatility has led to stair steps down within a largely hedged derivatives market. This has led to a disappointing follow-through in global markets, and a healthy rebalancing with controlled stair steps down. Based on our models this will ultimately contain contagion and the convexity Soros and his team expect, as the concerns are now "anticipated" and accounted for. In our view, this rebalancing of positioning and narrative may continue for a little longer. However a bottoming process and resetting of equilibrium is already well underway, and we are approaching the end of this brief reset.

We believe this rebalancing will soon lead to a continuation of the longer-term trend, and as previously mentioned, will likely result in a final risk-on push to an eventual less-hedged,

more-unbalanced environment 3-12 months from now. Once the final parabolic up-trend is in full swing, well above the likely coming floor, and hedgers begin to slowly abandon long expensive skew in favor of upside convexity, the market will be ready for a 2000 style reversal of eventual secular importance.

This is the way that market cycles reflexively work. Here at Kai Volatility, we refer to this historical dealer positioning cycle as the “Second Move Phenomenon.” If a meaningful volatility event has recently transpired, implied volatility demand and skew tends to be high. Implied volatility sellers have been liquidated in the previous decline and buyers have been rewarded with profits and demand for their services. Market participants are then overly hedged going into the second move, resulting in suppressed implied volatility and skew along with a tampered realized volatility. Of course, once this second move occurs without meaningful implied or realized volatility, the abandoning of implied volatility as a hedge slowly begins by market participants, planting the seeds of the next meaningful volatility event. The cycle repeats.

This cycle can be seen in the figures below (See Figures 1 & 2). In August 2015, the Yuan Devaluation was a true vol event. It was an 11% drawdown in the market in only 7 days with a 40 point spike in the VIX. So, 6 months later in Feb 2016, amidst the sharp rise in corporate bond yields, a 12% drawdown occurred slowly and methodically over 6 weeks and saw only a 14 point rise in the VIX with massive skew compression into a market decline. Of course, this poor performance of hedges into the largest market decline since 2011 sowed the seeds of the historic implied volatility compression of 2016 -2017. This second move and the complacency that followed ultimately gave rise to February 2018’s XIV blow up (referred to as “Volmageddon”), a 10 session drop of 10% that saw a VIX spike of 39 points.

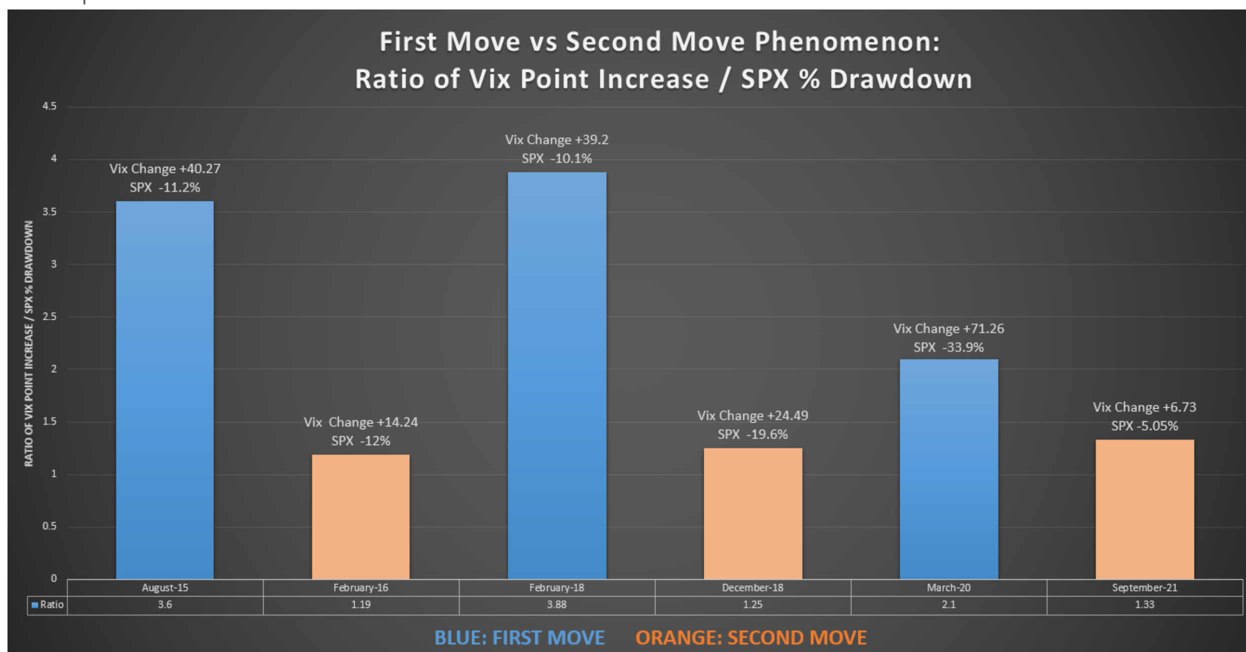

Figure 1

Figure 2

This vol event gave rise to its own second move 8 months later during Powell's rate hike reversal of October-December 2018. This 3 month slow and methodical decline of 19%, much like the second move before it, only saw a VIX increase of 24 points and once again saw the liquidation of skew and fixed strike volatility into the market decline. And much like the cycle before this, it sowed the seed of 14 months of vol compression and eventually exacerbated the speed and scale of the market stress and implied volatility explosion of the Covid Crash in February-March 2020.

This brings us to the present moment: another period of reflexive hedging, elevated skew, and VRP driven by a strong and recent market memory of implied volatility stress. Notably, there is a propensity for "First Moves" to be faster and more violent, but also shorter-lived than their "Second Move" siblings. It is important to realize that a lack of vol liquidation and preparedness does not obviate a large market decline. In fact, there is an argument to be made that when hedges don't perform, equity liquidation can sometimes be worse and the downtrend that takes hold can be harder to reverse. This is due to a lack of cathartic liquidation and the lack of supportive, concentrated Vanna/Charm flows that are helpful in achieving the necessary thrust for an impending rally.

The supportive Vanna/Charm flows of this first week of October, leading into monthly options expiration, are currently facing this exact challenge. Without a cathartic low, it remains to be seen if the weak volatility decline has built up the necessary potential energy to reverse the market's slide. It is a race against time - if the market cannot gain its footing before the current Vanna/Charm flows are exhausted, there is a risk of another controlled market decline. October 11-29th represents a period of potential downside weakness heading into a five-week options expiration cycle.

If this market does not seize the opportunity before it, it will likely be a bumpy several weeks similar to the weeks before with continued stair steps down and continued low volatility liquidation, where the market will begin the hunt for what will be its likely eventual floor somewhere between 4000 and 4125 in the S&P 500.

Like Soros, we await each moment patiently, without dogma or fundamental bias. Unlike Soros, we stand armed with the quantitative tools to measure the reflexive impact of dealer positioning in real-time, step by step.

"...formless, shapeless, like water."

CONTACT US: If you have any questions, concerns, or need any information please feel free to reach out to us at any time by contacting ir@KAIvolatility.com

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