It only took a 1.4% loss in the S&P 500 Index to produce a surge of over 44% in the VIX, the biggest since May. The probability of the VIX rising to the level of 20 is now much higher than it was two months ago when we warned that the 'low volatility' short VIX trade was getting very dangerous.

Warning of Catastrophic Losses

In June, Marko Kolanovic, JP Morgan's frequently prescient Global Head of Macro Quantitative and Derivatives Strategy warned that the low level of equity market volatility was making the short VIX trade increasingly crowded and very dangerous.

He argued that a jump from a VIX of 10 to around 20 could produce forced exits and catastrophic losses.

Volatility doesn't measure risk

In our What Just Happened? piece on the short VIX trade on 14 June[1], we warned that the 'low volatility' regime in the equity markets did not mean that risk was low.

We noted that the only a tail model consistent with the data could accurately assess the risk that the short VIX strategy was exposed to. And that the upside tail of returns in the VIX was very fat indeed.

Volatility is meaningless in assessing risk. What is required is a tail model that can reliably assess VaR and Expected Shortfall (ES) at realistic probability thresholds. This is the only way of knowing what losses you are exposed to.

Yesterday's drop in the S&P 500 Index was just barely a breach of its 99% VaR. The daily, 2-day and 3-day jumps in the VIX however were all VaR breaches which also breached the 99% ES level.

In spite of 'low volatility', a routine loss in the S&P 500 produced above average VaR breaches in the VIX. But if you had been prepared for the ES, you would have faced only small additional losses.

Triggering Kolanovic's Doomsday Scenario

After yesterday's surge to close over 16, it only takes a further 25% gain to hit 20, the value at which Kolanovic's analysis predicts catastrophic losses.

In June we pointed out that our tail model, which has been accurate over the entire history of the VIX, says that a 3-day gain taking the VIX from 10 to 20 should be expected once every 280 days.

We compared the short VIX trade to playing Russian roulette with one bullet in 280 chambers.

The game has gotten much more dangerous.

After yesterday's surge is added to the data the upper tails for VIX daily, 2-day and 3-day returns are even fatter than they were before.

A single day taking the VIX to 20 from yesterday's close of 16 should now be expected once in 98 days. A 2-day run up from 16 to 20 should occur once in 56 days. And over 3 days we should expect this once every 42 days.

Now the short VIX trade is Russian roulette with one bullet in 42 chambers.

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[1] What Just Happened? The 'low volatility' short VIX trade is getting very dangerous. 14 June 2017. www.OmegaAnalysis.com

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