

US Equity Derivatives Strategy

It's complicated: Return of the 'R' word derailing the Goldilocks trade. The good, the bad, and the *not so ugly*...

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We've had four core views this year:

1. [Employment data would be the key](#) to index volatility (and vol-of-vol) rising, per our Macro Cookbook framework
2. If the macro data wasn't enough to dispel the record levels of [dispersion keeping correlations and volatility suppressed](#), it would be a [breaking in the AI tailwind](#) that would drive correlations higher
3. For [sustainable outperformance in small caps](#), we would want to see a [soft landing come to fruition](#), amongst other factors – close, but no cigar just yet...
4. Equity volatility was likely to rise relative to bond volatility, as it has [historically done ahead of Fed cutting cycles](#), particularly when equity/bond yield correlation flips positive

Shock and aw, man...: Coordinated disappointment in macro and earnings data driving volatility higher

Similar to what we witnessed amidst the small cap rotation a few weeks ago, the *degree* of moves was clearly exacerbated by stretched positioning, in our view. The difference today is there is fundamental backing to elevated levels of risk premia, from both a macro and earnings perspective. *But have we gone too far, too fast?*

Aggressive rate cuts priced into the market post-NFPs and the coincident move in the front-end of the yield curve [appears to be an overshooting](#), per our Rates Strategists. Our US Equity Strategists flagged that [VIX > 25 has historically been a buying opportunity](#) for stocks. We echo this sentiment, but note the risks appear to be skewed more asymmetrically to the downside. **Here's where we stand today:**

The good (albeit not many to list)...:

- [Correlations have picked up off the zero bound](#), but are still relatively low, all things considered
- [Momentum has barely rolled over](#) given the [flight to Quality](#) – Low Quality pockets (e.g. small caps, Regional Banks) which have recently caught a bid could have more room to unwind

...the bad...:

- AI tailwind has net net begun to falter as investors have started to lose patience on monetization timelines – [We previously flagged](#) that concentration risk in the theme has grown, with electrification companies to copper miners to data centers getting sucked into its wake
- VIX move [may be overextended](#), but is also warranted unlike the [spike back in mid-April](#) – Short-dated realized volatility is back to early 2023 highs as a function of the souring macro and earnings backdrop, and [investor options positioning](#) once again [led to higher VIX reactivity](#), in our view – VIX outperformed its typical beta to SPX by ~3x at its intraday peak, a degree last seen in November 2021 (Omicron) and February 2018 (Volmageddon)
- Growth slowdown fears creeping back up – [Goldilocks probability](#) has come in sharply amidst recent data

- [Sharp rotation into Defensives](#) and out of Cyclical
- Increasing geopolitical and US election uncertainty at the margin with polling now at 50/50, spurring an unwind of the [Trump 2.0 trade](#)

...and the *not so ugly*:

- Per our models, the probability of Goldilocks has declined considerably, but the [probability of recession](#) still flags as close to zero
- [VIX has historically risen into rate cut cycles](#), then retraced thereafter, unless accompanied by recession
- [Equity/bond yield correlation is close to flipping positive](#) – Positive equity/bond yield correlation (i.e. stocks down, yields down) has typically produced higher volatility environments, but again usually due to recession
- [Monetization of hedges](#) could drive further VIX normalization in the near-term
- [VIX has retraced half its spike in ~10-15 trading days](#) recently – This could be the case this time around, but we think a higher lower bound has been established for the time being (i.e. VIX > YTD lows of ~12)

Our take:

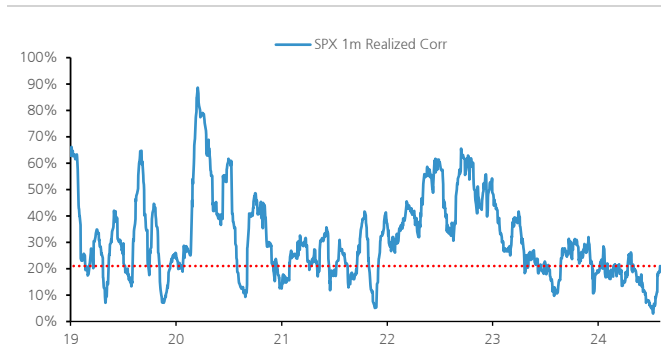
- Per the [Early Warning Signal](#), the probability of larger index moves has increased substantially over the last couple of weeks – One of the largest drivers has been a shift in Fed policy expectations
- Per the [Narrative Radar](#), the largest drivers of recent moves are real yields and the AI narrative – Unless we see a continued souring in the macro data ('bad is *really* bad') and the AI narrative continuing to falter, we see scope for some normalization in VIX as hedges are monetized and markets settle from here
- We see little room for the small cap rotation to continue in the near-term, and see scope for Quality continuing to outperform amidst waning sentiment

Trade ideas to consider (pricing indicative a/o 02 August):

Investors may consider VIX Aug put flies, with Aug expiry capturing Jackson Hole and September FOMC event risk, which we think further warrants a higher lower bound in the near-term. Alternatively, investors may consider selling QQQ Sep puts to fund IWM Sep puts to position for a potential continuation of the low Quality unwind.

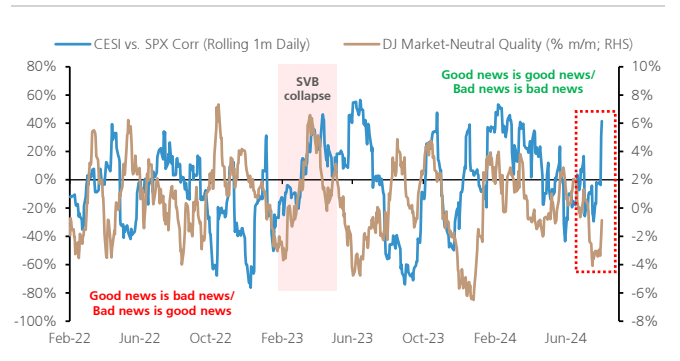
- **Return to normalcy, but slowly:** VIX Aug 18/16/14 put fly, pay \$0.47 (-7% delta; 3.3x max net payout; UXQ4 ref = 21.85)
- **Flight to Quality:** IWM/QQQ Sep 25-delta put switch, 1:1 for flat premium (buying IWM puts; ~94% moneyness; IWM ref = 208.92; QQQ ref = 448.75)

Figure 1: Intra-index realized correlations remain relatively low despite the recent jump off the zero-bound, driven by AI earnings fears



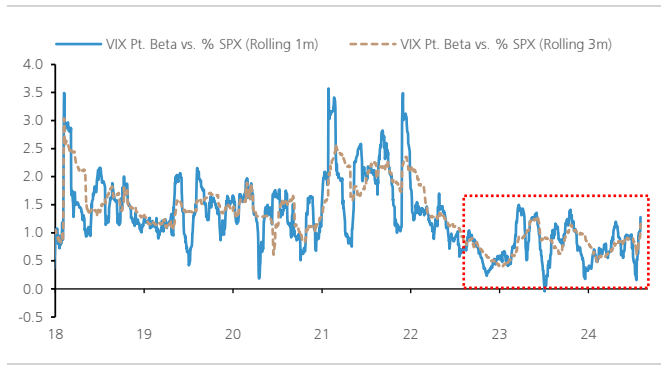
Source: Bloomberg, UBS

Figure 2: Return to a 'bad is bad' environment driving a flight to Quality, as it has done previously



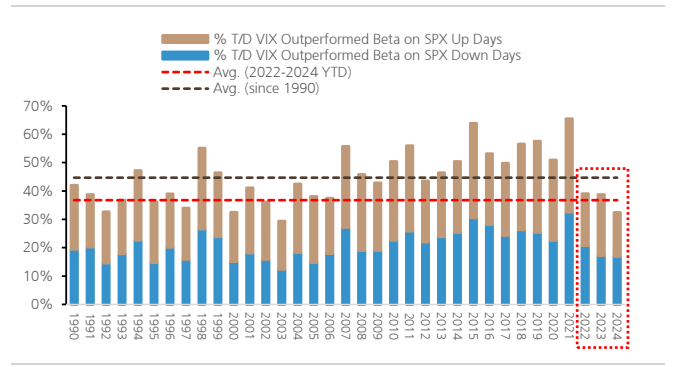
Source: Bloomberg, UBS

Figure 3: Despite the large VIX spike, VIX reactivity still remains very low relative to history...



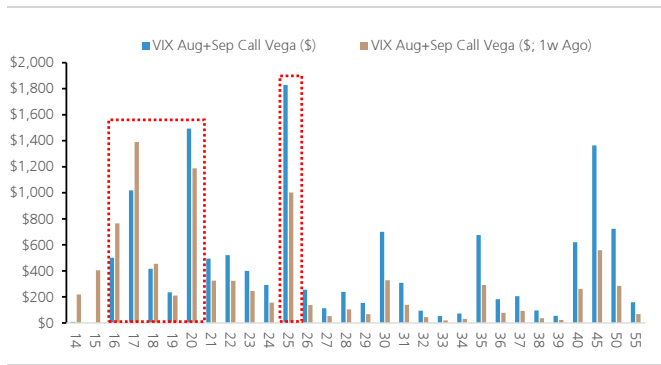
Source: Bloomberg, UBS

Figure 4: ...and 2024 remains the lowest VIX reactivity year on record



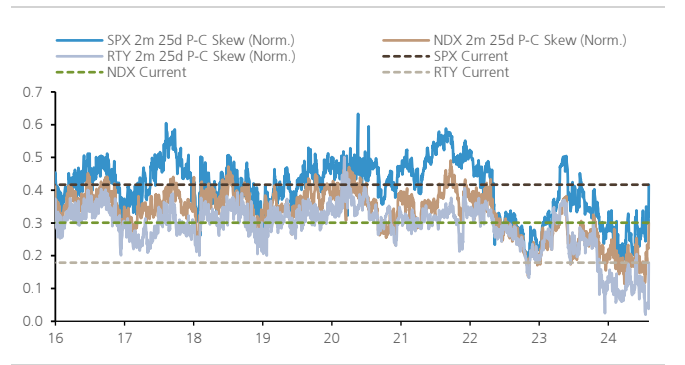
Source: Bloomberg, UBS

Figure 5: Some evidence of VIX call monetization post-Friday's spike, hence why we likely saw a ~6pt. dip from the intraday peak into the close



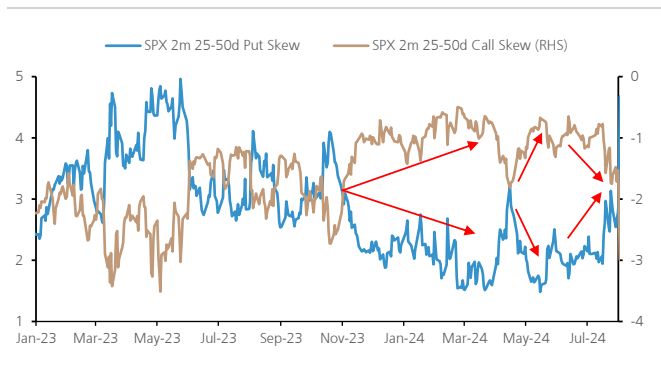
Source: Bloomberg, UBS

Figure 6: Skew has normalized substantially after several months of suppression, which we previously noted was due in part to lower (higher) put (call) demand



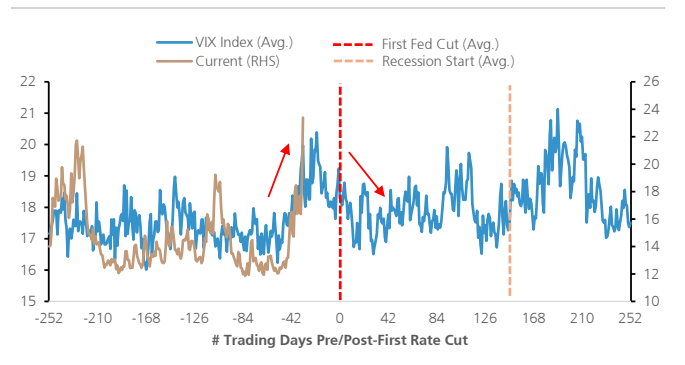
Source: Bloomberg, UBS

Figure 7: 'Tale of two tails' no more – Index put and call skew have now converged as investors rush to hedge downside risk 'just in time'



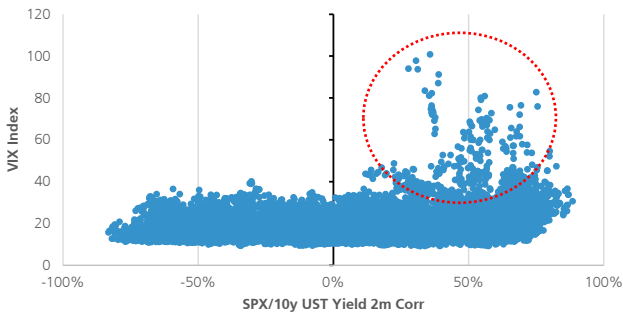
Source: Bloomberg, UBS

Figure 8: VIX has historically risen ahead of rate cuts, but ultimately normalized within the next month, albeit establishing a higher lower bound thereafter



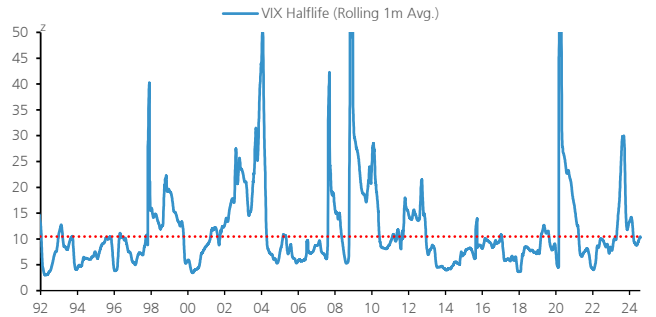
Source: Bloomberg, UBS; Considering all rate cuts back to 1971; VIX data pre-1990 derived from a multifactor linear regression against S&P500 1m exponentially-weighted realized volatility and weekly return stream

Figure 9: Positive equity vs. bond yield correlation environments (i.e. stocks down, yields down and vice versa) has historically produced a higher volatility environment, but typically due to recession



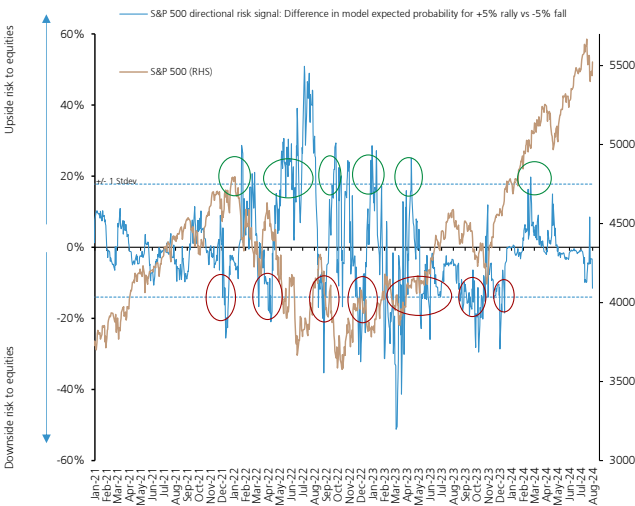
Source: Bloomberg, UBS; Data since 1962; VIX data pre-1990 derived from a multifactor linear regression against S&P500 1m exponentially-weighted realized volatility and weekly return stream

Figure 10: VIX has recently taken ~10-15 trading days to revert back to half its rolling 1y mean, similar to what we saw in mid-to-late April



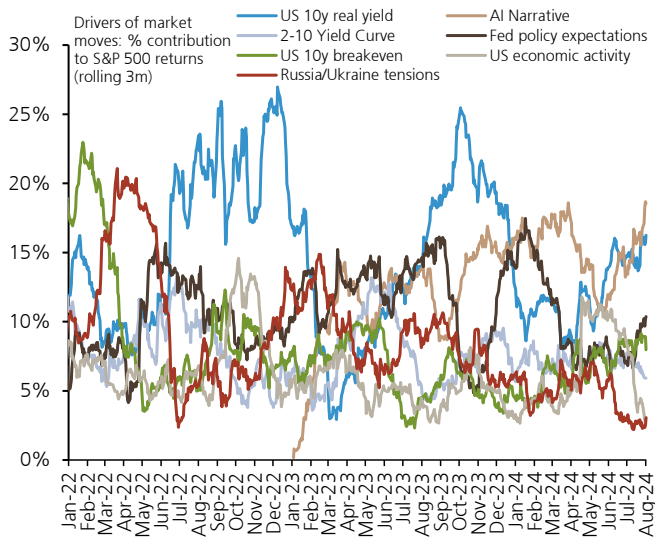
Source: Bloomberg, UBS; Reflects 1m average of # trading days VIX has taken to revert back to half its rolling mean

Figure 11: Ahead of the selloff, our Early Warning Signal had been flagging a higher probability of a >5% absolute move over the next 1m



Source: Bloomberg, FactSet, UBS; More details in our [Tactical Dashboard](#)

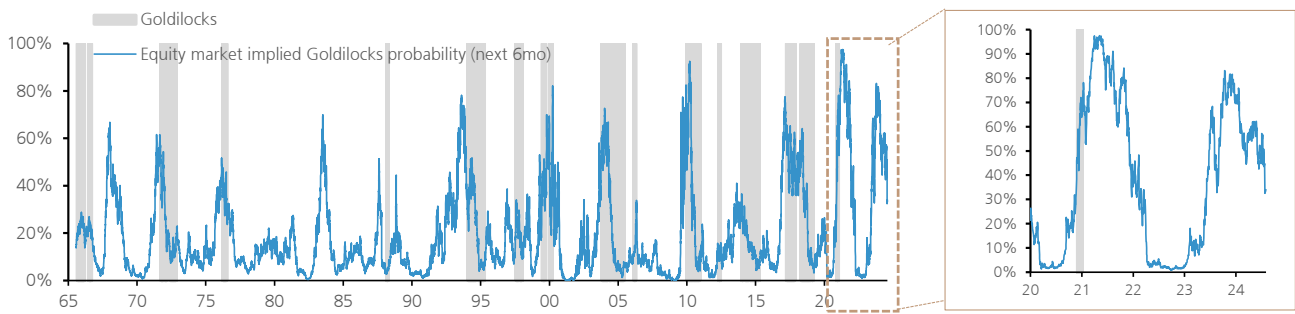
Figure 12: AI narrative and real yields remain the largest drivers of index-level returns over the past few weeks, per our Narrative Radar



Source: Bloomberg, FactSet, UBS; More details in our [Tactical Dashboard](#)

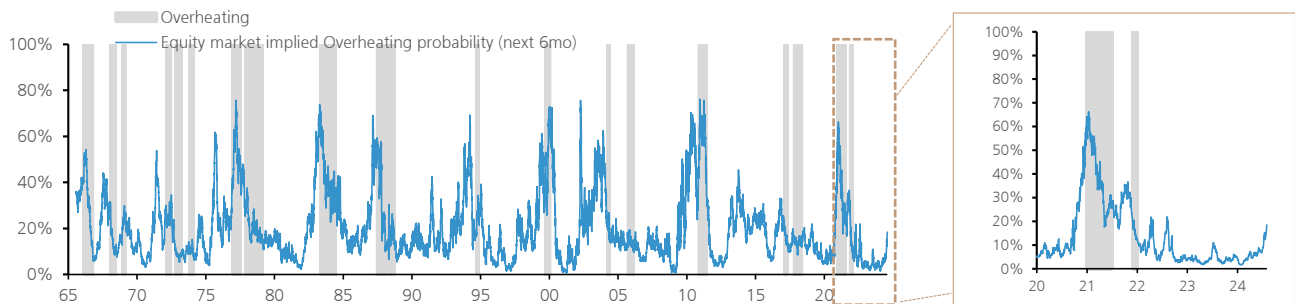
Equity-implied macro probabilities

Figure 13: Equity market implied Goldilocks probability (ISM > 55, CPI 3m ann. <3%)



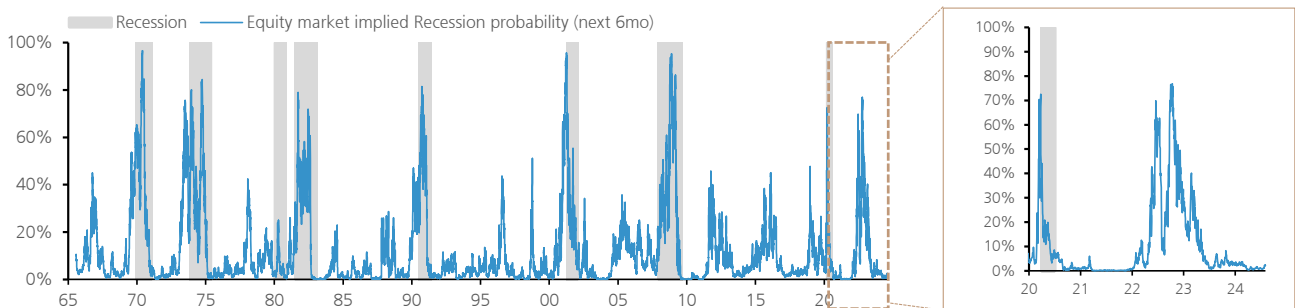
Source: Bloomberg, FactSet, Kenneth French, UBS

Figure 14: Equity market implied overheating probability (ISM >55, CPI 3m ann. > 3%)



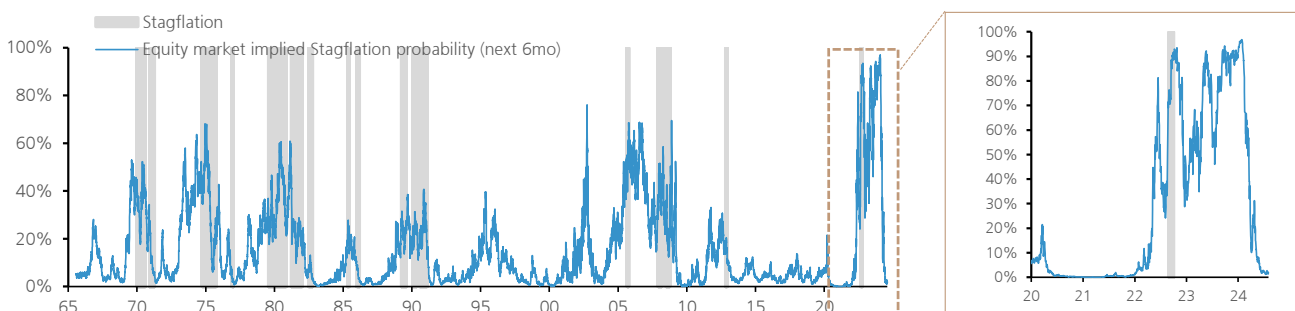
Source: Bloomberg, FactSet, Kenneth French, UBS

Figure 15: Equity market implied recession probability



Source: Bloomberg, FactSet, Kenneth French, UBS

Figure 16: Equity market implied stagflation probability (ISM < 53, CPI 3m ann. > 5%)



Source: Bloomberg, FactSet, Kenneth French, UBS

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Equity market returns are influenced by corporate earnings, interest rates, risk premia, as well as other variables influenced by the business cycle. The outlook for any and all of these variables is subject to change.

Risks of multi-asset investing include but are not limited to market risk, credit risk, interest rate risk, and foreign exchange risk. Correlations of returns among different asset classes may deviate from historical patterns. Geopolitical events and policy shocks pose risks that can reduce asset returns. Valuations may be adversely affected during times of high market volatility, thin liquidity, and economic dislocation.

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