

The Vol Product That Exploded This Week

MARCH 19, 2022 ([HTTPS://OPTIONPIT.COM/THE-VOL-PRODUCT-THAT-EXPLODED-THIS-WEEK/](https://optionpit.com/the-vol-product-that-exploded-this-week/)) BY MARK SEBASTIAN ([HTTPS://OPTIONPIT.COM/AUTHOR/MARK-SEBASTIAN-2/](https://optionpit.com/author/mark-sebastian-2/))

Hey Trader,

With everything going on this week ...

Like the Russia/Ukraine crisis, VIX expiration, PPI numbers, the FOMC meeting, a quadruple witching expiration, to name a few ...

I would understand if you missed the surprising event that rocked the vol world this week.

Let's take a closer look at what happened here.

But First ...

Now, before we can get into the surprising turn of events that led to one of the most popular volatility products completely going rogue ...

Let's first briefly cover what the heck a "vol product" is, anyway.

VIX exchange traded products (or ETPs) are tradeable products that allow traders to get exposure to volatility without trading VIX futures directly (remember, the Cboe Volatility Index, aka the VIX, is an index, not a tradeable product itself!).

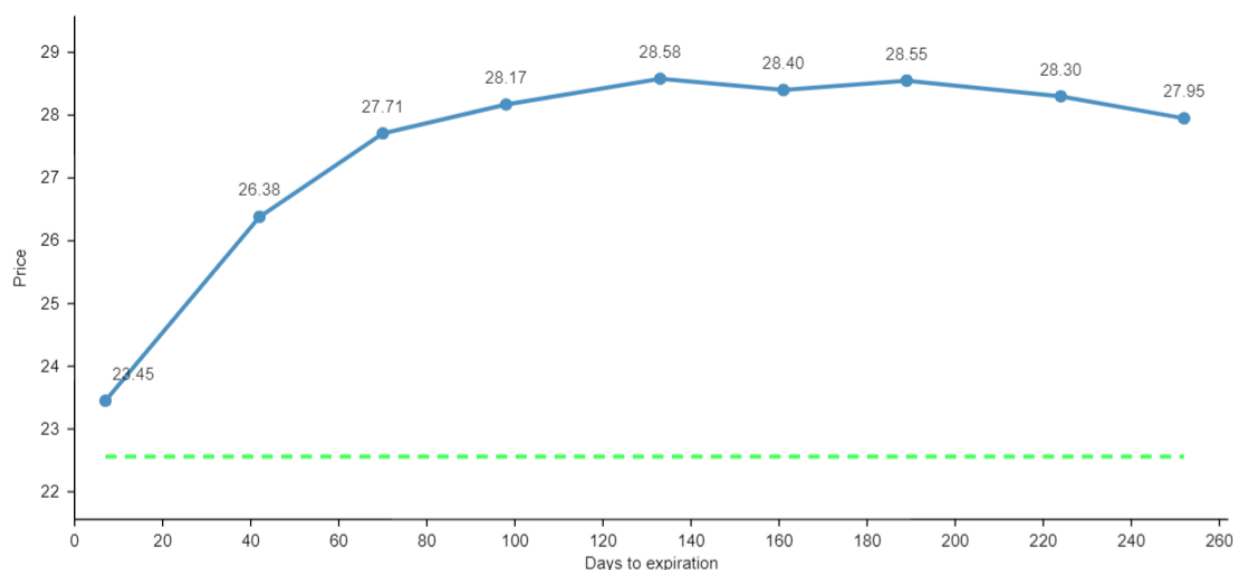
Now, the fact that VIX ETPs are based on VIX futures creates some interesting complexities when it comes to trading them.

Why?

Well, VIX futures do not mirror VIX itself directly (except at expiration).

And the majority of the time, VIX futures are trading in a contango structure ... which means they are trading above the cash VIX, and generally get progressively higher month-over-month.

For example, take a look at the VIX futures curve on March 10, 2021:

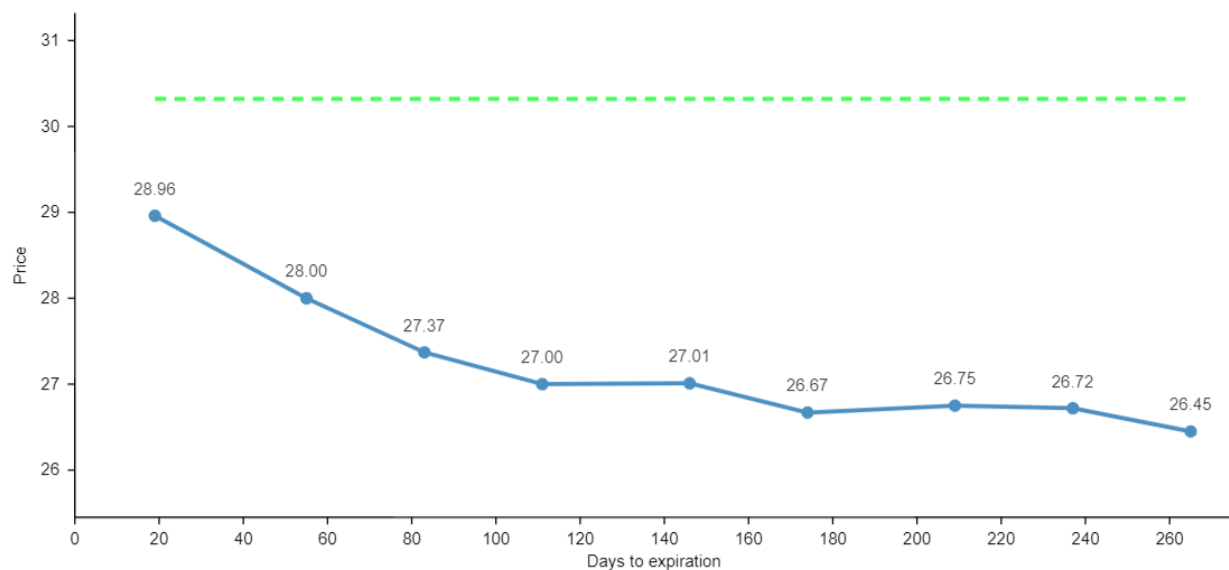


A contango VIX curve shows us traders are more concerned about volatility *in the future*, rather than volatility *right now*.

The VIX futures curve can also enter backwardation, which is when the VIX itself is trading above the futures, which are trading progressively lower.

This is less common than contango, but does happen in times of high uncertainty and volatility. In fact, the VIX futures curve was recently in backwardation for *nearly an entire month*, which is VERY rare!

Here's the VIX curve from February 24, 2022 ... the day Russia invaded Ukraine:



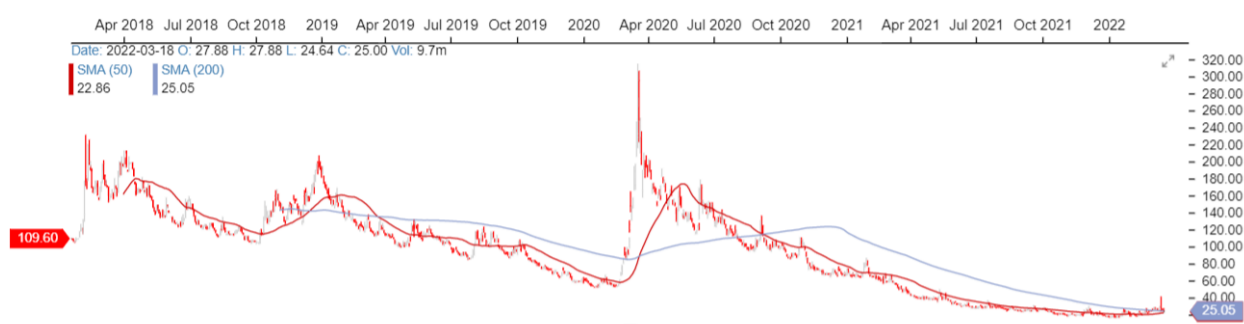
I could get into the nitty gritty details on why VIX futures work this way, and what it means, but that's a whole topic of its own! (Drop a comment below if that's something you'd like me to cover in a future Pit Report!)

What does the VIX futures curve have to do with VIX ETPs?

Actually, everything.

Because VIX futures must equal spot VIX at the time of expiration, and because VIX futures are in a contango about 70% of the time, this means that VIX futures are constantly decaying in value.

Therefore, VIX ETPs, which track VIX futures, are also almost always moving lower. Just take a look at this five-year chart for iPath S&P 500 VIX Short-Term Futures ETN (Ticker: VXX):

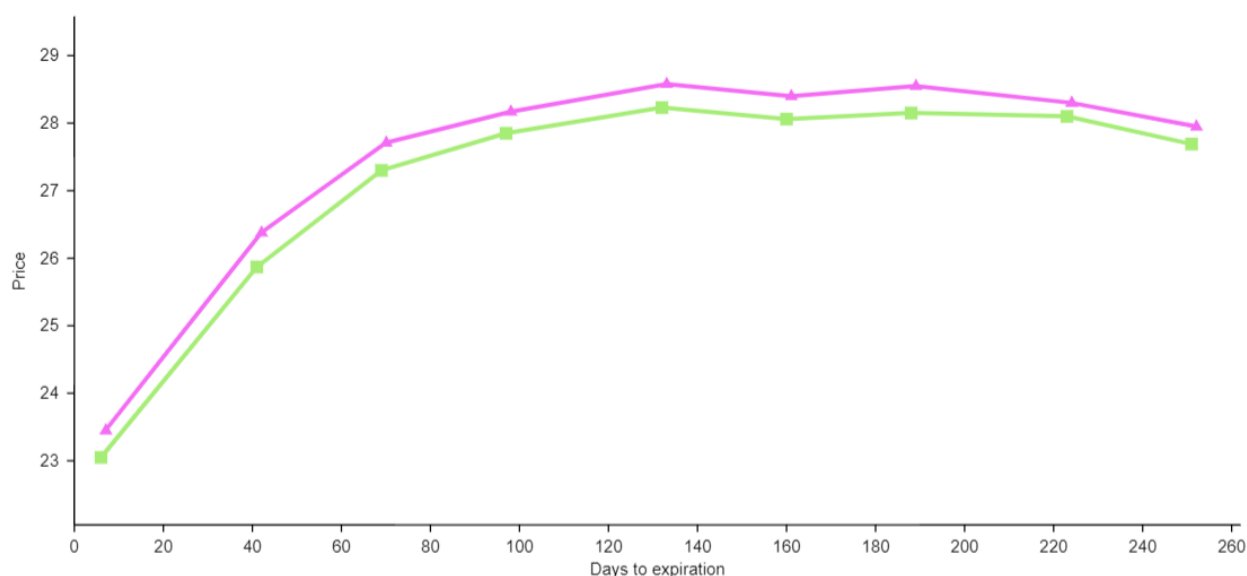


Yes, you get some volatility pops (such as the COVID spike in 2020) but for the most part, the trend is consistently lower.

VXX is designed to track a constant 30-day maturity VIX futures. To maintain its 30-day exposure, VXX holds the two nearest-dated VIX futures contracts, and as the month progresses, it sells the front-month future to buy the next month.

However, like we said, VIX futures are usually decaying into expiration, which means VXX is buying high, and selling low, and suffering from the same constant decay!

Let me illustrate ... below is the VIX futures curve on two consecutive days, with the first day represented by the pink line, while the green line represents day two.



See how the curve moves lower (towards cash VIX) as we get closer to expiration?

That means VIX ETPs like VXX are buying at a high price, and selling lower, constantly depleting their own funds.

This is why you should never, ever buy and hold products like VXX for any length of time.



(Though typically intraday, VXX does usually move with the VIX index, which is what it was designed to do. So this does make it an appropriate tool for short-term vol trades, and VXX can also be used as a hedge, as it will generally explode during times of volatility, such as the previously mentioned 2020 COVID crisis in the chart above.)

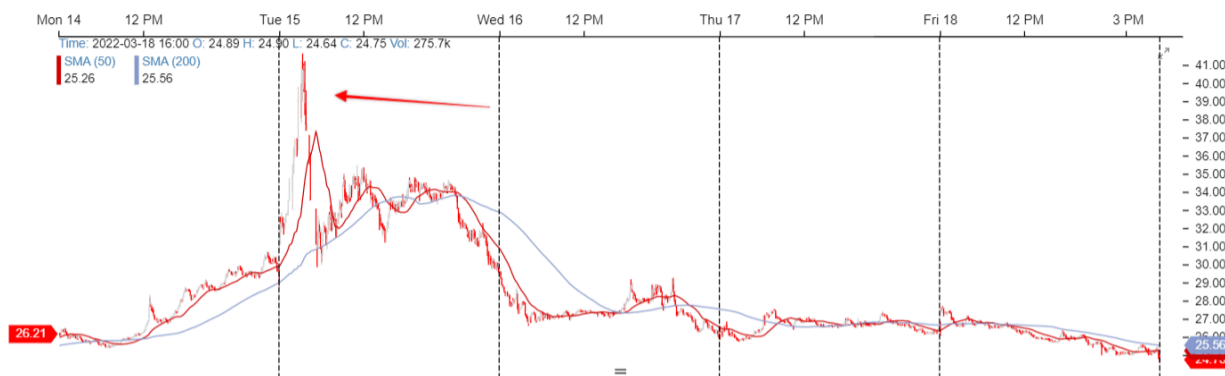
Now let's look at what happened this week ...

“No Shares For You!” – Barclays

Barclays, which manages VXX, announced on Monday that it would stop issuing new shares for VXX (as well as its iPath Pure Beta Crude Oil ETN (Ticker: OIL)).

While they didn't give an official reason for this decision, I am thinking it had something to do with the costs associated with carrying these huge futures positions.

Whatever the reason, VXX exploded on the news, spiking from its close on Monday of 28.81 to as high as 41.65!



Needless to say, this did NOT track with VIX or VIX futures.

Because VXX is such a *great* product for shorting volatility, the news that Barclays would no longer be issuing new shares meant that lots of short positions needed to be covered ...

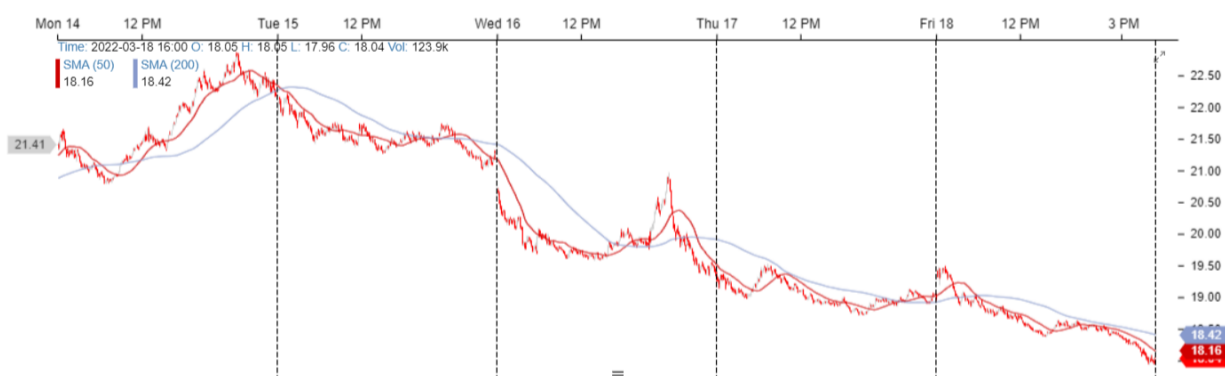
(And it's not unlikely retail trader interest exacerbated the problem.)

Furthermore, because Barclays is no longer creating shares to meet demand, this means instead of tracking the VIX, VXX is now subject to the forces of limited supply and growing demand (which really goes against the whole nature of VXX!).

In the days since its initial pop over 41, the VXX squeeze has faded ... but it is still not tracking like it is supposed to.

For example, take ProShares VIX ShortTerm Futures ETF (Ticker: VIXY), which in theory should trade pretty much in sync with VXX.

VIXY had a pretty standard week ...



Since hitting a near-term peak on March 8 (touching as high as 23.97 intraday, and closing at 23.01), VIXY has shed about 5 points, closing on Friday at 18.04. That's a drop of about 21%.

So in theory, VXX should also be down about 21% over that same timeframe.

But instead, VXX, which closed at 28.15 on March 8, closed on Friday at 25.00 – only an 11% decrease!

So VXX is currently still fairly over-valued. It should be trading closer to 22.24 – instead it is almost three points higher than that!

This is not the first time we have seen this ... it happened previously with a product called VelocityShares Daily 2x VIX Short-Term ENT (Ticker: TVIX) in 2012.

Following its debacle, TVIX took weeks to normalize, until its managing bank, Credit Suisse (Ticker: CS) once again began issuing shares, causing TVIX to plummet 60%.

I would not be surprised if VXX also took several more weeks or months to hit its fair value again, too, and there is always a chance that Barclays will resume issuing shares (they have even said as much).

What does this mean?

First of all, I would still not advise buying and holding VXX. While it isn't impossible we could see another squeeze, I do expect VXX will once again begin to move lower, closer to fair value.

I also expect traders will gradually lose interest (and therefore VXX will move lower), and, like I said, there is the possibility that Barclays decides to offer shares again. This means I see potential in cheap puts, or cheap put spreads, though they would need to have enough time built in to allow the "drama" to fully play out. However, I would also advise making this kind of trade with a hedge of some sort (such as a call spread).

I can not overstate this enough ... any trade involving VXX right now is a VERY risky trade, and not for inexperienced traders.

But there is a nice profit potential, should things go according to plan ...

Your Only Option,

Mark Sebastian

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