SPECIAL BULLETIN
February 7, 2018

XIV reopened, the stock market soared, but most importantly, VVIX remains extremely high at 161+.

That’s what happened yesterday. But I want to turn back the clock to Monday to examine and explain a bit about what happened when a normal down day turned into a nightmare. Because there are a lot of conspiracy theories out there.

I am going to present you with the facts that I have been able to gather. Then I am going to speculate as to what happened. I don’t know for sure, just like no one else knows. And we won’t know unless and until there are some sorts of proceedings that set out to obtain the facts.

But after more than three decades of doing this each and every day, I think my explanation makes the most sense. Because it follows prior patterns of human behavior, and it fits the pattern of Occam’s Razor.

So what is Occam’s Razor? From Wikipedia, “Occam’s Razor is a problem-solving principle that, when presented with competing hypothetical answers to a problem, one should select the one that makes the fewest assumptions.”

In even simpler terms, Occam’s Razor states that when you have competing theories, the simplest one is usually the best. The reason it’s called a “razor” is because you use the principle to “shave away” marginal assumptions.

With that in mind, here is what I believe happened Monday.

Let’s start with the facts. First, and perhaps most important, was the rise in rates. Bond yields had reached the top of their trading range. Further moves up would signify a breakout to even higher rates. Higher rates were likely to lead to higher volatility. So the rise in rates was pressuring stocks on Monday.

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But that wasn't the only thing. In a shocking display of carelessness, Janet Yellen -- who until Friday was the person most responsible for making sure asset bubbles don't inflate -- could not contain herself.

In an interview broadcast Sunday morning, the former Fed chair answered a question about current financial conditions as follows, "Now is that a bubble or is it too high? And there it's very hard to tell. But it is a source of some concern..."

Are you kidding me? NOW she's concerned her policies may have inflated bubbles in stocks and real estate? NOW she's worried???

Talk about throwing fuel on the fire! We've come to expect ill-timed, ill-conceived statements from Alan "Irrational Exuberance" Greenspan. But Yellen? And not even one business day off the job?

So that was the setup Monday. You had pressure early. But nothing that the market couldn't handle. And as the chart below shows, after a brief bout of weakness, you actually saw the stock market move into positive territory. That's right, for a period shortly after the open (around 10:20 am ET where the bars eclipse the horizontal line), stocks were up.

That move into positive territory was followed by selling pressure that was constant until 2 pm ET. After that, the selloff picked up steam.

Even so, it was nothing the market and the various VIX products couldn't handle.

Then, shortly after 3 pm ET (marked by the vertical line in the chart on the prior page), we witnessed one of those Flash Crashes. We have yet to hear what might have prompted that wave of selling. But my money is on some dreaded algorithm gone haywire. [The tell-tale is the speed of the move and the recovery. It's likely that some derivative hit a key number, very likely the 50-day moving average, which triggered a massive sell order with no regard to the liquidity conditions at that moment.]

After the crash, you had a very rapid rebound, followed by another leg down into the 4 pm ET cash close.

It was an ugly day. But like I said before, not anything that couldn't be dealt with as this chart of March VIX futures shows (XIV and securities like XIV, such as SVXY, are based on VIX futures).

Again, you can see that this particular contract went from just shy of 16, down towards 14, all the way up to 20, before settling down around 19.

Not good if you want volatility to hold steady. But not a serious problem as XIV closed just under 100.

However, just because the cash was closed did not mean that the day was done. Because it was *after* the cash close that things fell apart.

Some of you may not know this, but even though the stock market closes at 4 pm ET, index futures remain open for another 15 minutes.

Market pros know that trading in many derivative products continues. But here's the thing: market professionals also know that those 15 minutes are notoriously illiquid. Those 15 minutes are there for two reasons:

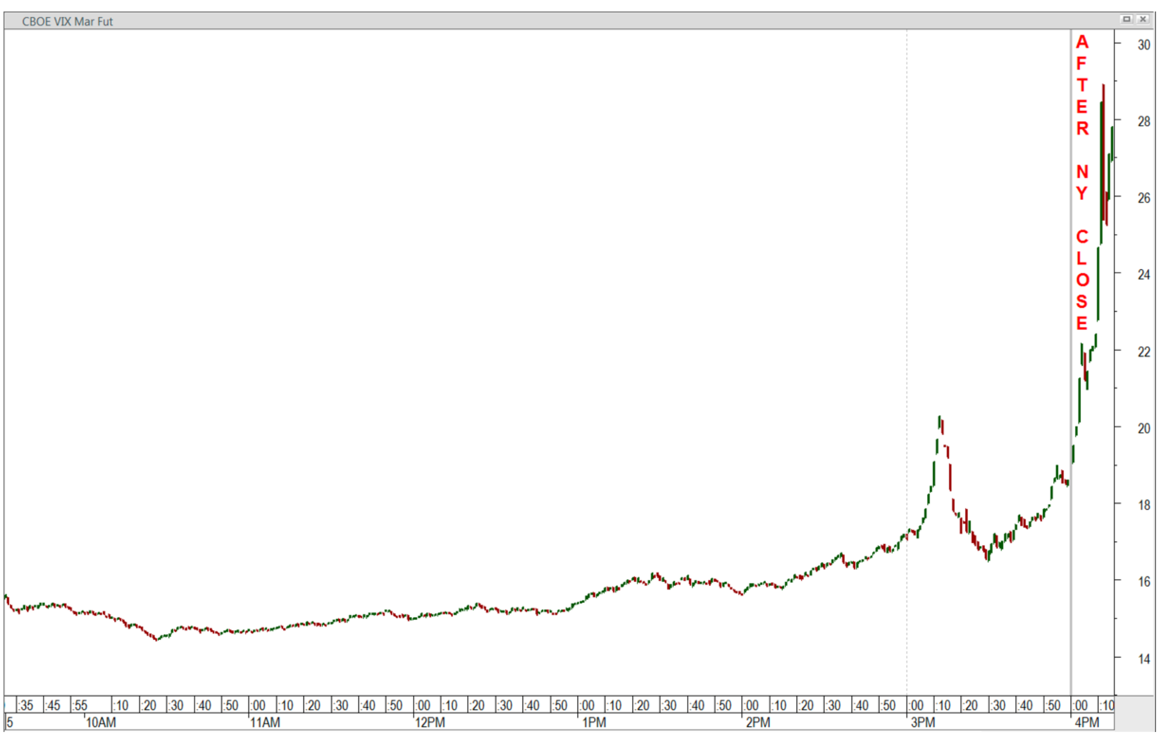
1. So that traders can "clean up" anything from earlier in the day that still needs attention.
2. So any wave of last second orders at the 4 pm ET cash close can be handled.

Traders know that those 15 minutes are not the time for large scale trading. They were never intended to be for that purpose. Instead, they were intended to be a period where traders dealt with the leftover issues remaining from the period when the cash market is open.

But that is not what happened on Monday. During the following 15 minutes – from 4 to 4:15 – **the largest buy order in the history of VIX futures took place**.

According to Morgan Stanley, on Monday the VIX futures market saw "the biggest net buying pressure on record". The previous record was 78,000 contracts. Monday's action dwarfed that at 282,000.

And as this next chart shows, almost all the action took place between 4 and 4:15.



As you can clearly see, it wasn't a great day prior to 4 pm ET, but it wasn't an abnormal day.

During those key 15 minutes after the cash market closed, however, it was utter chaos. VIX futures skyrocketed, causing the indexes upon which XIV and similar products are based, to plunge.

While all of this was going on, securities like XIV and similar ETPs... WERE CLOSED! Holders were locked in and could not get out because, even though the futures were open, after-hours trading of the securities had not yet resumed.

At the end of the 15 minutes, futures settlement prices were determined, those prices went into the calculations of the various tracking indexes, and people realized the scale of the losses. And that is what led to the after-hours carnage.

So that's what happened. The question is why?

This is here where my speculation, based on my three-decades-plus of experience, along with Occam's Razor, come in.

I think someone at one of these short-volatility funds panicked.

I think that the Flash Crash at 3 pm scared a key person, or a group of key people, into thinking the following:

1. That XIV and other short volatility products were going to get hit with massive requests for redemptions.
2. There was a very real potential that one or more of the Exchange Traded Products could be facing a termination event.

As to the first factor, when an asset gets hit, people want out. So they sell the asset. That leads to a reduction in holders.

In this case, it means the short volatility fund like XIV does not need to have as many contracts sold short, which means any existing shorts need to be "covered" or bought back. That would naturally create buying pressure on VIX futures.

And while that buying pressure is possible, it's not certain. It only becomes necessary if redemptions actually occur. *Given the nervousness of market, it's natural to anticipate the potential for redemptions and the need to close out positions*.

As far as the second factor, many of you are now aware there is a termination provision in most of these products. XIV uses the term "acceleration event". [All Exchange Traded Notes have an end date. But if something goes haywire, the issuer can "accelerate" the end date.]

If there is an acceleration event, the issuer returns cash, not contracts. That means short VIX futures contracts Credit Suisse (for XIV) and other issuers had open would have to be closed. Because the open contracts are short sales, those contracts have to be bought back. Again, this is only necessary if there truly was an acceleration event.

Bottom line, both factors had the potential to cause buying pressure. But neither factor was a certainty... at least not at 4 pm ET.

But that's when human behavior came in.

Someone panicked.

My guess - which is based on the simplest explanation possible, which is human emotion - is that someone was so scared that they believed both factors were not just possible, but imminent.

So what did they do?

They bought back all those short VIX futures...

And they bought...

And they bought...

And they didn't stop buying until...

According to Morgan Stanley estimates, that massive short position was reduced from "short 230,000 contracts to just 4,000".

That's right. The evidence shows that the record setting buying of 282,000 contracts resulted in 230,000 contracts of short covering by short volatility funds. And the bulk of that took place during the 15 minutes in which the cash market was closed!

That's not manipulation. THAT'S SUICIDE!

To sum it all up, here's what happened:

1. Volatility was picking up because of rising rates.
2. Janet Yellen through gas on the fire.
3. An algo went awry, causing a flash crash when a key moving average was breached.
4. The market recovered, but not enough to quell human emotions.
5. After the cash close, someone at some firm, panicked and bought a record amount of VIX futures contracts during an extremely illiquid time period.
6. Those actions in the final 15 minutes wrecked the volatility market.

But that's not the end of the story. Up till now, we've talked about the market as a whole. There are, however, some parts of the market that are different. In fact, there is one security in particular that is very different: XIV.

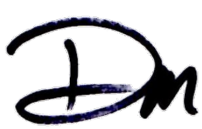
The issuer of XIV has chosen, as is its right, to accelerate the end date of the note. What troubles me about this decision is this…

Why isn't SVXY doing the same thing?

I don't dispute the fact that Credit Suisse can accelerate the termination date. But I do dispute the fact that they chose to when ProShares chose to keep SVXY open.

And it leads me to believe that, if I were someone interested in seeing where all that buying pressure came from in those fateful 15 minutes, the first place I'd look would be at Credit Suisse.

Again, this is speculation on my part. But something just doesn't seem right. It doesn't seem right that ProShares maintains SVXY while Credit Suisse terminates XIV.



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