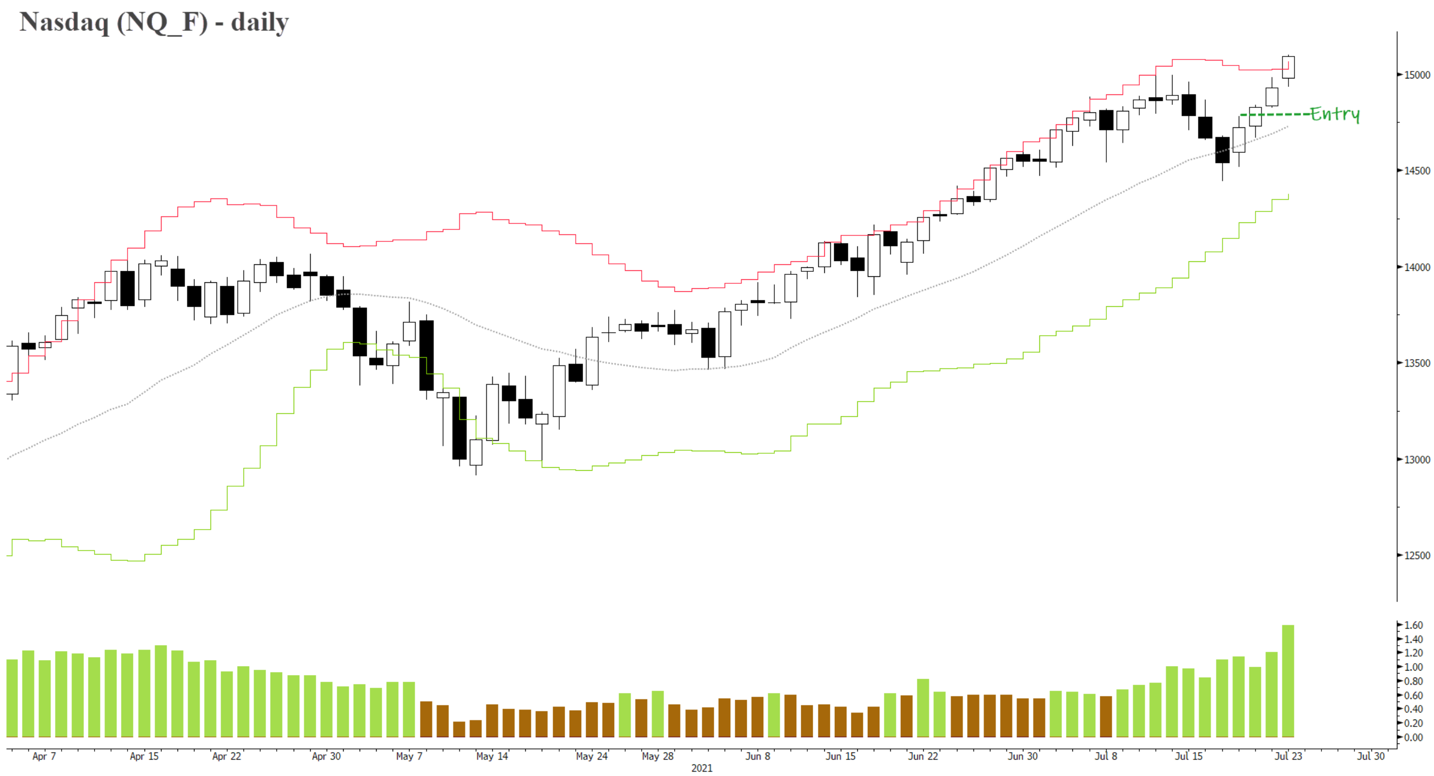
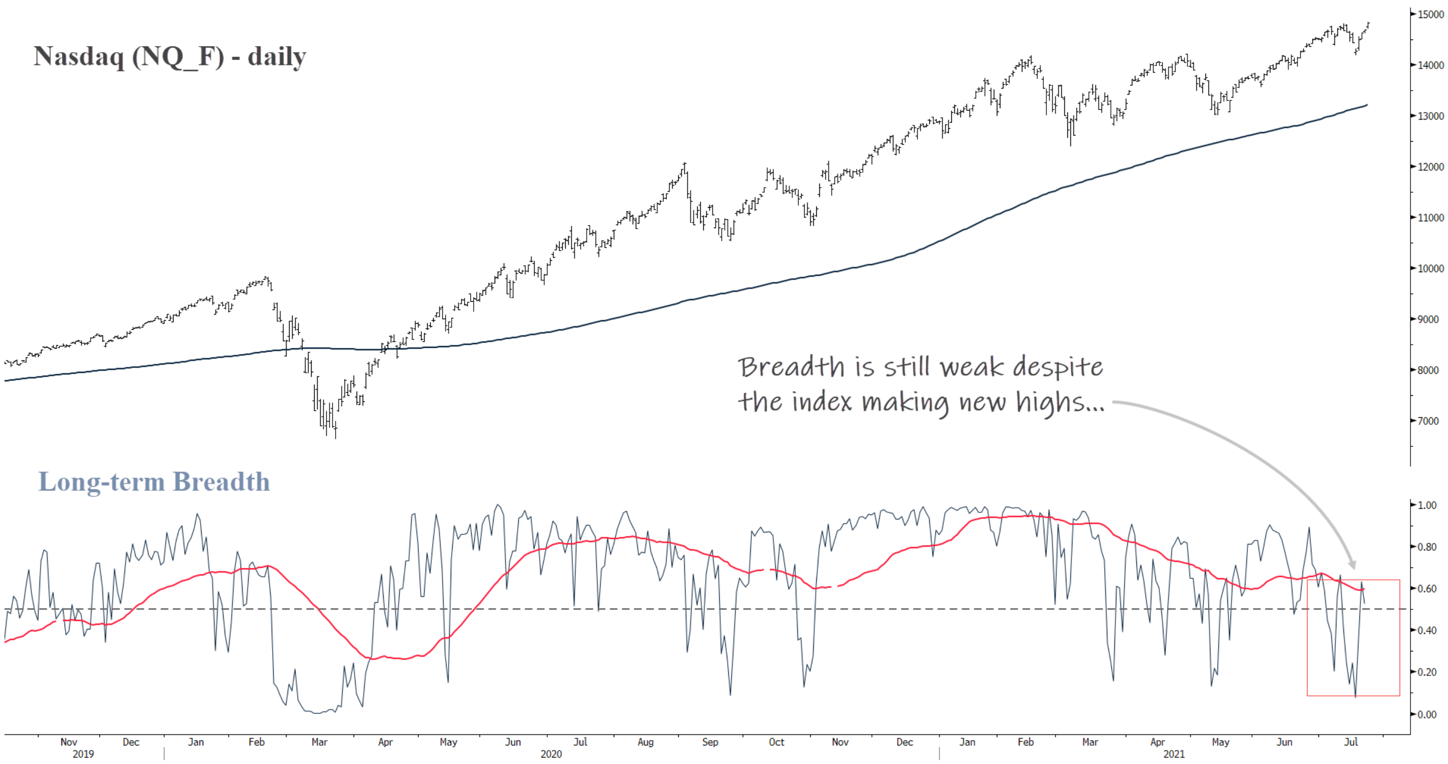
07/23/2021:A VBO In The HG_F...

I've got a few quick notes on the market and a potential long volatility breakout (VBO) in copper for you today, as well as some docs at the end concerning option theory and a new tail hedge strategy we'll be implementing going forward.

First, the Nasdaq is making new highs today and our swing long trade is up 1R since our entry two days ago. We've moved our stop up to breakeven and will manage this one closely.



Despite the new highs in Qs, breadth continues to sag like a wet rag. The internals look even worse in the Russell 2000 (RTY) where breadth remains at its weakest levels since the COVID bear.



Our TL Score is still nailed down at -3 and while sentiment and positioning have come down some as a result of this recent vol, levels of Trend Fragility remain elevated.

Combine this with the neutral read from credit and we have a strange market indeed. It seems as though we're seeing our *Buy Climax* and our *Summer Doldrums* both play out simultaneously.

There's not much to do but try and play both sides of these diverging trends — stay long what's working, cut what isn't, and tactically short what's rolling over. At least until we get some greater clarity, some semblance of coherence in the trifecta of inputs, allowing us to lean harder in one direction or another…

A tactical trade that's setting up is a potential volatility breakout (VBO) in copper.

Since a number of you who are newer to the Collective have asked about VBOs/FVBOs, let's quickly run through what they are and how to play them, using copper as an example.

Volatility breakouts (VBOs) or "The Squeeze" as the strategy is also known, was a setup first identified by John Bollinger, the inventor of Bollinger Bands. Here's some clips from John discussing the VBO in his book *Bollinger on Bollinger Bands* (which is an older but still excellent trading book):

> *Bollinger Bands are driven by volatility, and The Squeeze is a pure reflection of that volatility.*
>
> *When volatility falls to historically low levels, The Squeeze is on. An indicator called Bandwidth was created in order to measure The Squeeze.... The Squeeze has several definitions. The simplest one — one that will do admirably for our purposes — is that a Squeeze is triggered when the BandWidth drops to its lowest level in six months.*
>
> *For some years there has been an academic theory in circulation that suggests that while price is neither cyclical nor forecastable, volatility is both…. The bit about volatility is right on, though price does exhibit elements of cyclicity and forecastability… the most important aspect of this theory of volatility, that low volatility begets high volatility, and high volatility begets low.*
>
> *Volatility Breakouts (The Squeeze) anticipates high volatility by taking advantage of the cyclical nature of volatility and looking for extremely low volatility as a precursor of high volatility.*

John used BB width. My buddy ChrisD uses a mix of Bands and Keltner Channels. Some track Average True Range (ATR), and some just eyeball the width of the Bollinger Bands as a way to look for a Squeeze and potential Volatility Breakout (VBO).

The important takeaway is that low vol regimes (compression regimes) beget high vol regimes (expansion/trends). And the more severe the compression the larger the resulting trend tends to be.

This is due to the reflexive yin-yang nature of markets. Just as each rally sows the seeds for its reversal and each reversal sows the seeds for an eventual rally. So to do narrow ranging markets set the stage for large trends.

There are psychological and positioning reasons for why this is so… Turning points or technical criticality are marked by a consensus on price. This consensus can occur in the late stages of a trend which leads to a blow-off top reversal. Or it can happen in a sideways compression regime where there's a disinterested consensus (ie, little disagreement over the current price which is why there's low vol).

When the price is tipped out of this criticality, the consensus is shattered. New players with differentiated views are brought into the market. And the previous holders are forced into action to either agree or disagree with the new price levels (buy or sell). This causes a volatile rerating of expectations and thus large price moves.

We run an equity compression scan on our dashboard (link here). It filters global equities by the following conditions:

- Market cap above $750mn
- Bollinger Bandwidth < 10th percentile of last 3-years
- Implied Volatility < 10th percentile of last 3-years

It’s a good starting point to look for big squeezes and potential DOTM candidates.

But getting back to our Copper VBO setup.

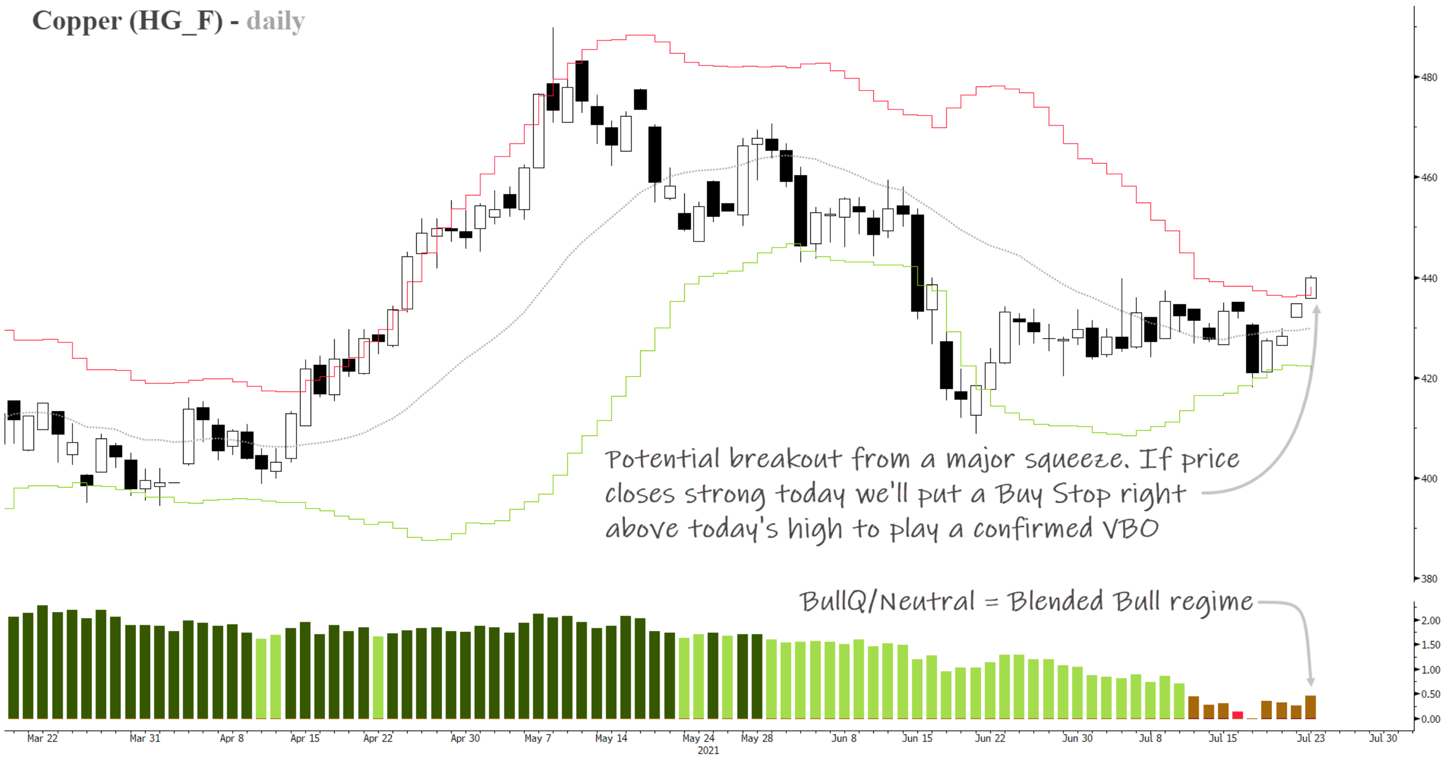
Copper’s BB width recently hit its tightest range since last August. Visually you can see the squeeze on the chart.

Now, as we know, most breakouts from sideways trading ranges fail and become failed volatility breakouts (FVBOs). Roughly 80% of them to be exact. This conversely means only 20% of VBOs actually turn into trends.

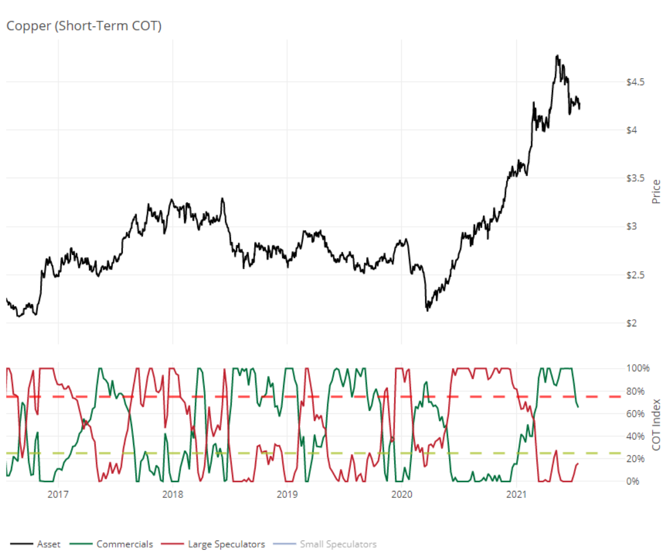
One way to improve your VBO hit rate is to put in a Buy/Sell Stop order above/below the breakout or signal bar.

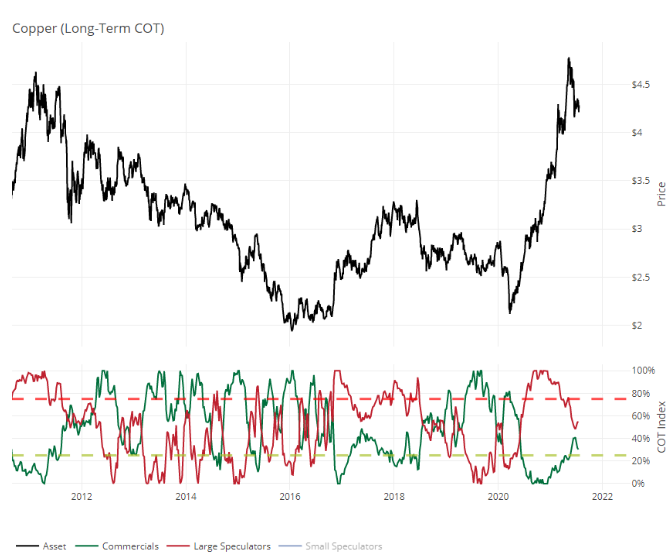
The signal bar is the bar that closes above/below the band, indicating a potential VBO is in process.

Today will be a VBO signal bar should copper hold strong into the close. If it does, we’ll put in a Buy Stop a few ticks above today’s high. That way we let the market pull us into the trade. And we only get long if there’s follow-through, confirming the upside VBO.



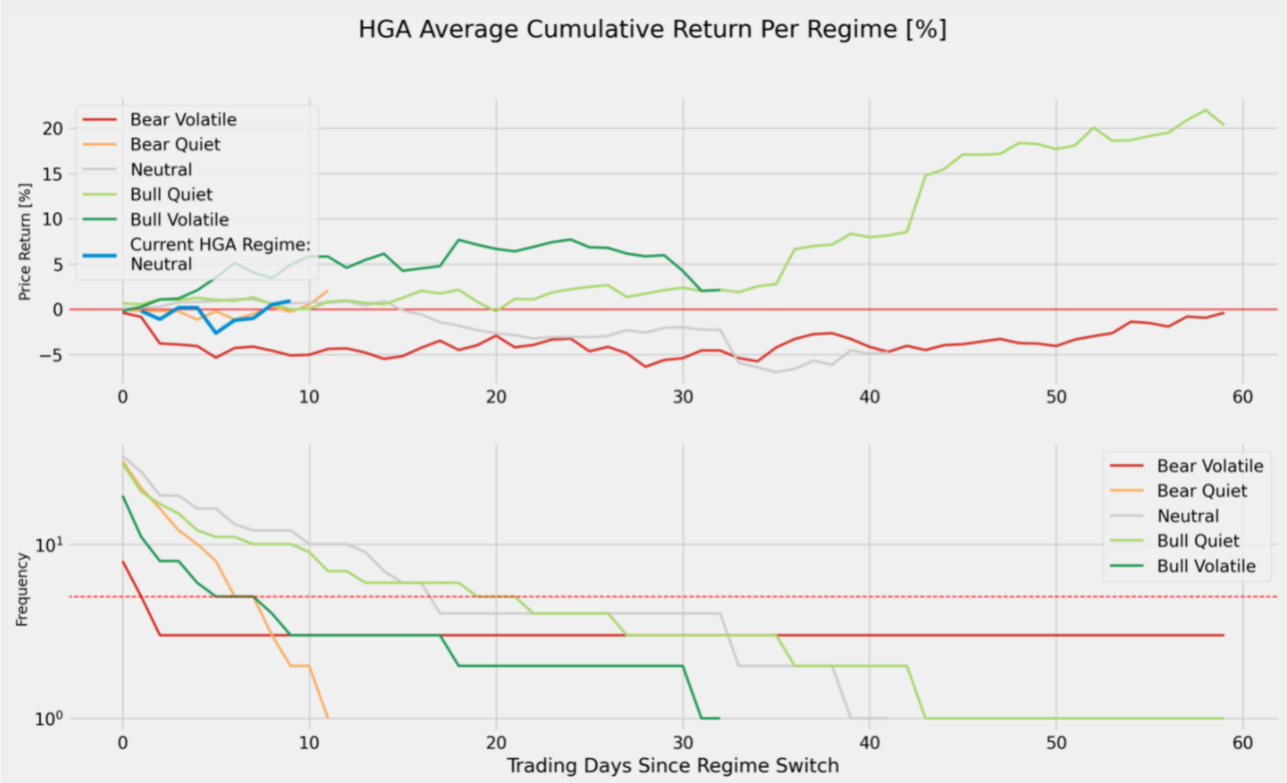
Copper trapped bears with a false breakout to the downside on Monday. Both our short and Long-term CoT Oscillators show that positioning has been reset and is a tailwind over the short term (red is large specs and green is commercials).





Copper is in a neutral/BullQuiet regime (aka, blended bull). The graph below shows that copper spends the majority of its time in these two regimes, and sees its highest returns in a BullQ which we will transition to shortly should this VBO show follow-through.

The first figure and attendant table denotes the average return observed at each time period per regime.



Again, if today closes strong then we'll put in a Buy Stop a few ticks above the high of the day.

With Big Government, Big Fiscal, and Big Green Investments being the ideas du jour, it pays for us to continually take swings to the long side at copper when the conditions present themselves.

Comments like those below from two people who understand the supply/demand dynamics better than anybody, give some additional gravitas to this take...

> "We don't have shovel-ready projects. You will need higher prices, You will need $15,000 copper to encourage a lot of this more difficult investment. People are not going to go to those more difficult parts of the world unless they're certain. We need another two Glencores. That's the scale we're talking about. I don't know how we'll find that much copper to fill that gap." ~ Glasenberg, CEO of Glencore

> "We always say necessity is the mother of invention, but in copper, it's not like the oil industry where there was a new source of supply coming from shale production, all the easy projects have been done." ~ CFO of Freeport McMoran

Combine this with the forced destruction we're seeing of future oil supply and it's easy to imagine the next few years being *interesting* ones in the commodity space…

Here's our latest work into some basic option theory and the new tail hedging strategy we'll be implementing going forward.

- The Conditional 50 Cent Tail Hedge
- Call Ratio Back Spreads
- Option Theory Basics
- Options and Volatility Resource List

You can find all of the above hung up in the Vault as well.

Hit me up in the CC if you have any questions or comments.

Your Macro Operator,

Alex