Year to Q3 Review:

The Set Up for Q4 Liquidity Conditions

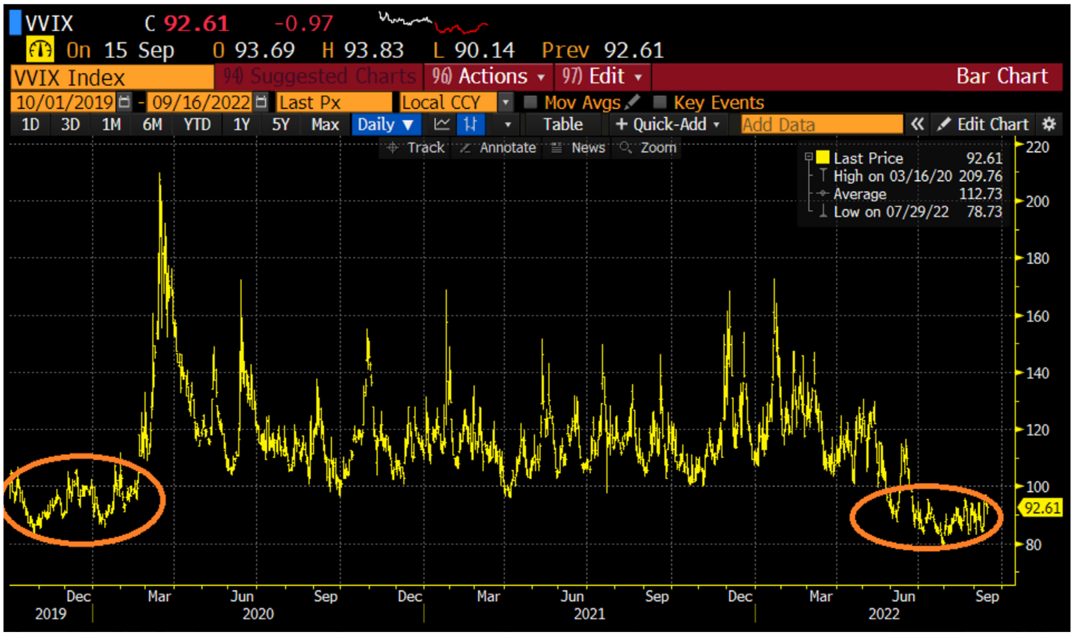
We've just entered Q4 and somewhat of a microcosm of current sentiment—i.e., a 2.5%+ move in the S&P 500, which equates to only a 1.7 standard deviation; a standard deviation low enough to indicate a commonality to such a move. Of course, that move was in the wrong direction, considering the path of least resistance has been lower, but **such real price volatility with relatively low traditional readings of volatility was the norm to end Q3**.

The loudest signal on this front came on September 13 when the S&P dropped over 4%, the largest single day percentage sell-off since June 2020. **What may have been more remarkable than the directional certitude of the sell-off, however, was the lack of power to go along with it.** Volume metrics that day, both from an internal perspective at Liquidnet and externally, pointed to very little in the way of conviction. **A capitulation is going to need more noise** and as it turns out, the S&P dropped another 8% from that point to the end of the quarter.

Just to put in perspective, the next closest comparable sell-off in June 2020 happened on volumes 35% higher and a VIX reading 62% higher, **the September 13 sell-off being the worst ever single day drop with a VIX reading below 30**. Much is being driven by the sentiment in the options market—an extreme bearish positioning and a ceiling that is hard to break, coupled with net cash positions at extreme high levels which reduces demand for protection in addition to an extreme counter effect of not trying to miss out on any rally. This is leading to demand for bullish call options but regardless, **the market move was remarkably high while the signals, sentiment, and micro-structure surrounding it was extremely low**.

Figure 1

Volatility of Volatility Index (VVIX): Docile considering the extreme conditions abound



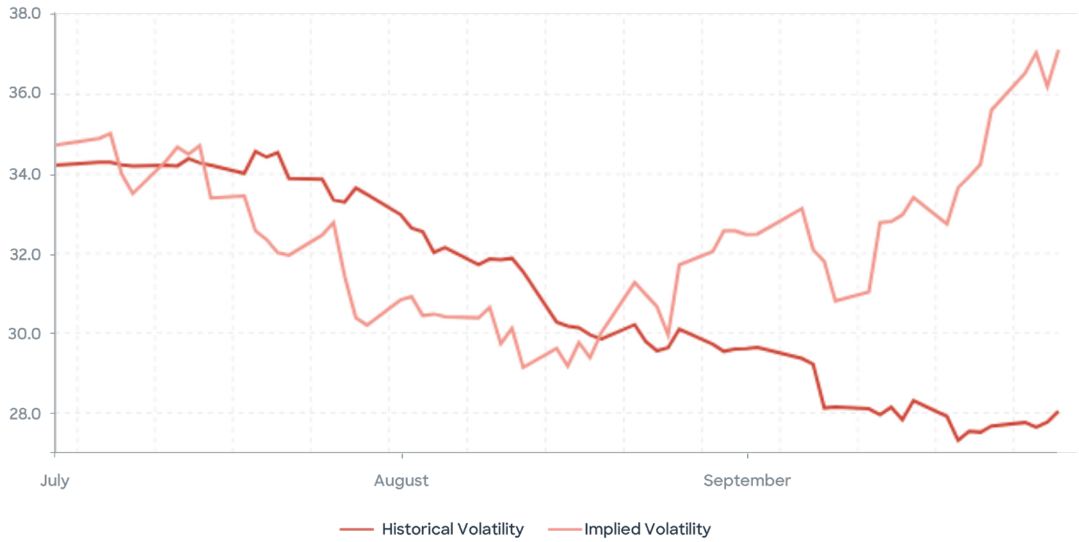
Source: Bloomberg

Liquidnet

One major conundrum is the relatively low level of the VIX despite being in a bear market, which seems to go hand-in-hand with less equity positioning due to extreme macro conditions. **The disconnect between Historical and Implied Volatility is becoming noticeable (S&P 500).**

Figure 2

Q4 Historical and Implied Volatility

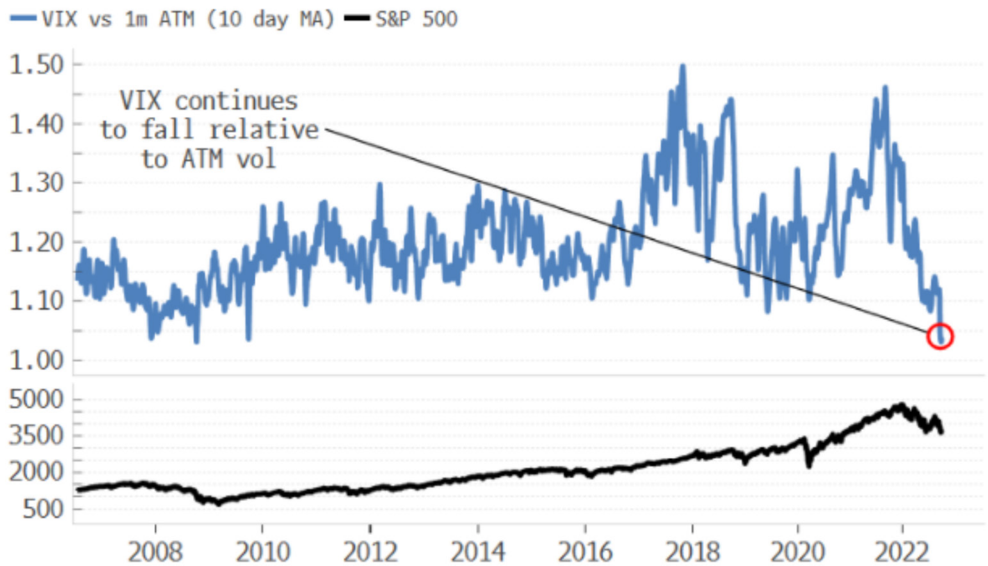


Source: Liquidnet Analytics

The below chart from Bloomberg speaks to At The Money Volatility—**a lessening demand for crash insurance**. The VIX is low relative implied, longer-term, and cross-asset volatility but see the extreme versus ATM volatility below.

Figure 3

VIX still low vs. 1-month ATM implied



Source: Bloomberg

Of course, we have to keep in mind volumes, and in particular volume sources. They all are questionable these days from the sense that much volume isn't being driven by traditional money manager flows—as indicated by prime brokerage reports on cash (see short term treasury bill yields below) and an overall equities underweight not seen since 2008.

Figure 4

Govt 3M, 6M, 9M Treasury Yields

Source: Bloomberg

There seem to be three characteristics that define the trends of volume in the market so far this year, none of which are good for liquidity or cost to trade.

First, traditional HFT taking advantage of rising spreads and rising volatility.

Low latency quickness to the quote had its advantages early in the year from a macro perspective, moving from the rising concern around spiking cases of the Omicron strain of COVID-19 and a clean hand-off into the uncertainty around Russia's invasion of Ukraine before ultimately shifting into quickly tightening financial conditions.

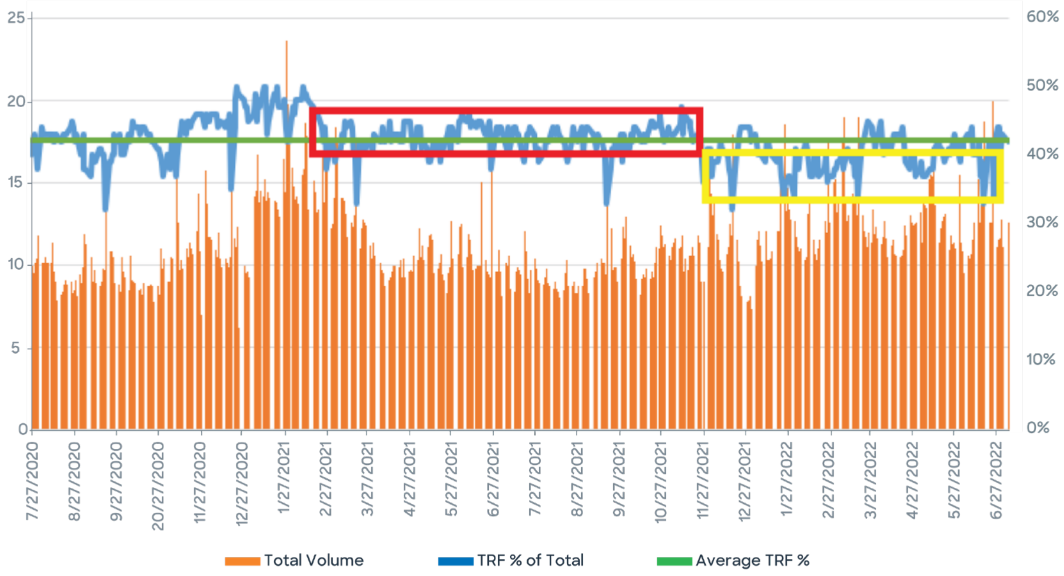
Remember, when volatility is spiking, size of trades in the market decline as market makers avoid dark to get directly to the market. This is evidenced by the extreme low readings of Q1 around FINRA TRF reported trades. Not a traditional trader/PM's favorite contra but maybe not the worst.

Liquidnet

Figure 5 depicts the highest On-Exchange volumes since the pandemic started, sustained through most of the first half of the year.

Figure 5

TRF Volume July 2021 Through September 2022

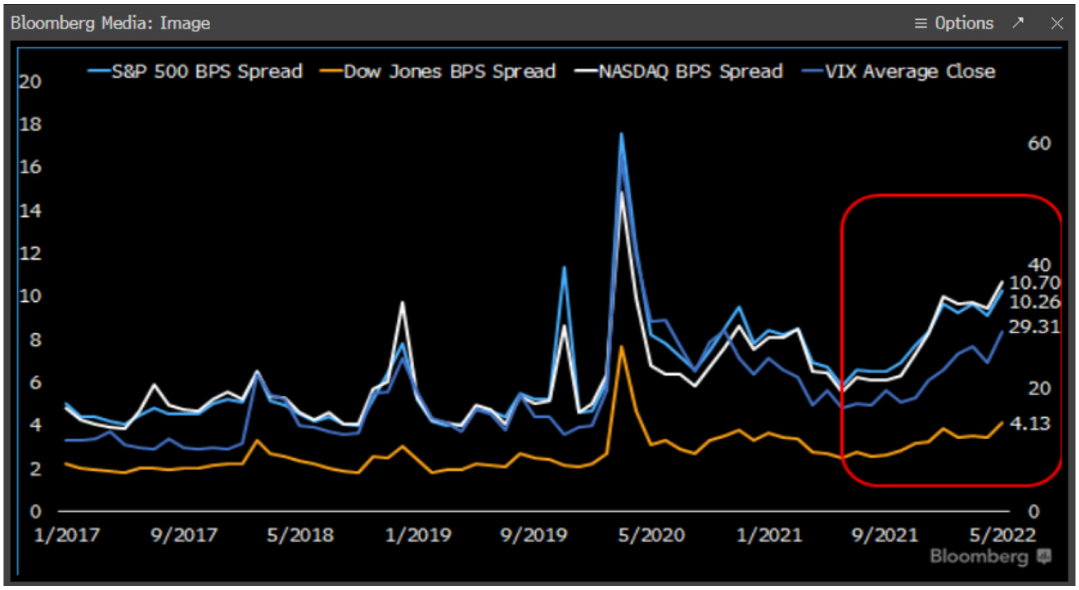


Source: Charts created by Liquidnet personnel based upon data from Bloomberg

Figure 6 includes 1H Volatility boxed in red and ensuing step down in Q3, while real price volatility in yellow remains resilient throughout, hence a 2% move in a major index equating to 1.5 standard deviations.

Figure 6

BPS Spread and Average Close

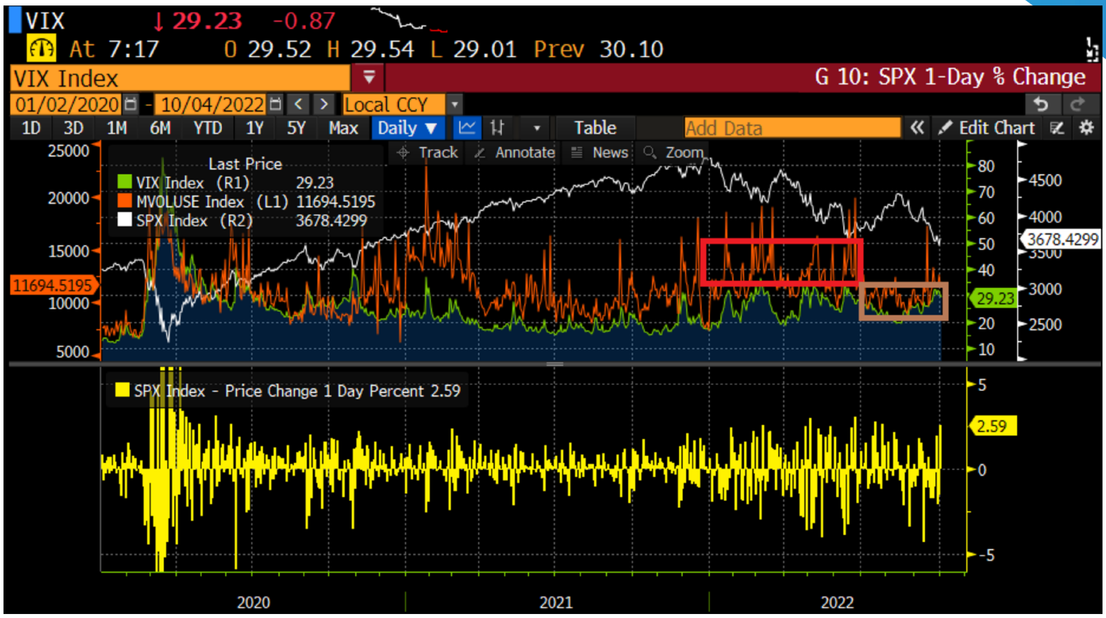


Source: Bloomberg

Liquidnet

Figure 7

VIX Index 2020 – 2022



Source: Bloomberg

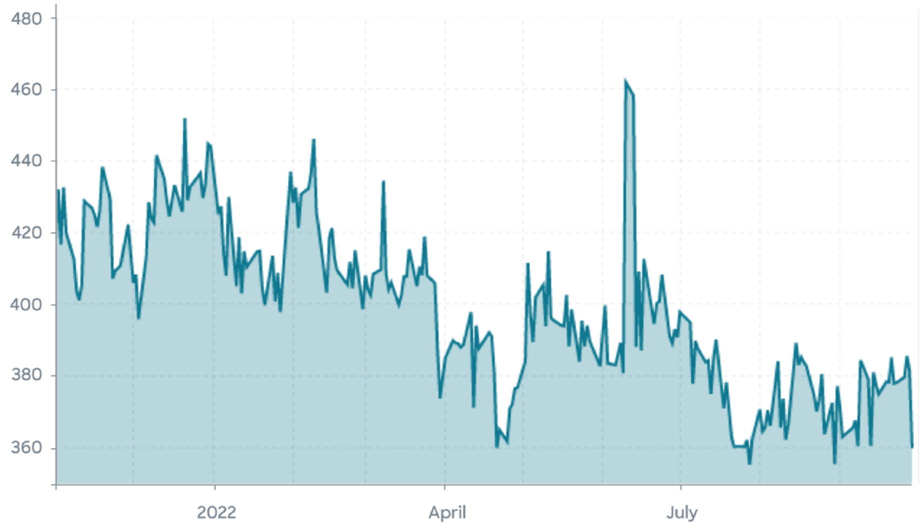
Second trend is the return of performance and the secular trend that retail will follow.

Just as quickly as FINRA TRF volumes disappear due to the aforementioned conditions, equity performance will get the retail army quickly suiting up for battle. The move for equities was impressive from mid-June to mid-July (17% on the S&P) and from a quarterly perspective, Q3 was up 14% through mid-August. Much of this was chalked up to bearish investors covering short positions and maybe some thoughts of peaking inflation but it was fleeting and not sustainable.

The shift back to off-exchange, however, was remarkable with the FINRA TRF reading as high as 47% of overall volumes some days, readings not seen since the Jan./Feb. 2021 GameStop crescendo. 605/606 data can help pinpoint overall retail volumes. When equities are ripe, this quickly goes from low-teens percentage of overall market volumes to pushing 20% **and does considerable damage to the depth of book. See Nasdaq in Figure 8. Liquidity is undeniably poor**.

Figure 8

Liquidity (Top of Book Shares)



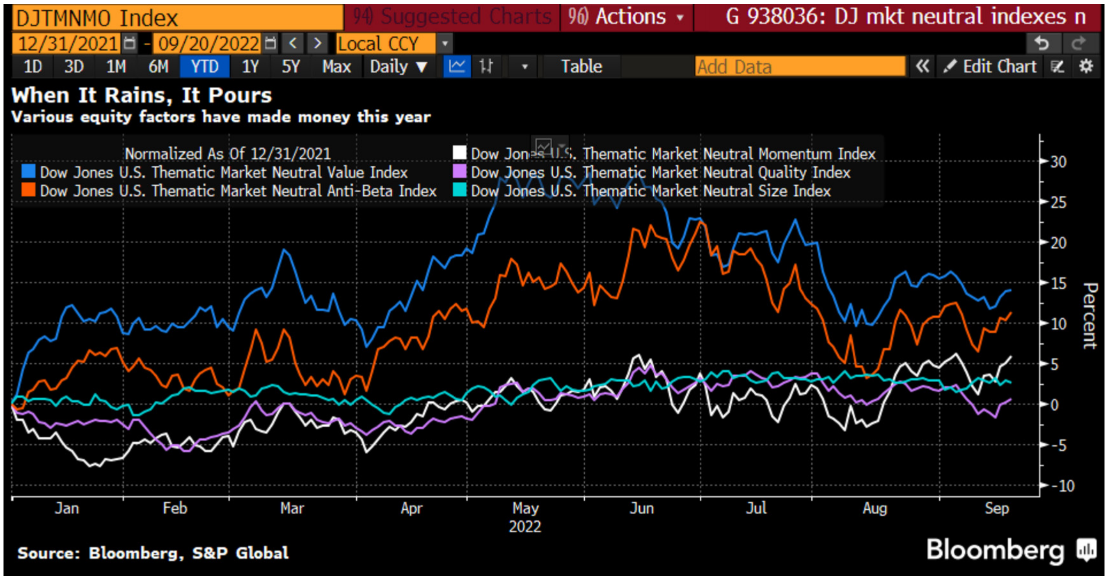
Source: Liquidnet Analytics

The third and final trend is the Systematic/Quant flows driven off factor strategies.

Macro backdrop has been strong for directional bets and business headlines are pointing to the best performance for the year clearly lying in these categories. Value, momentum, quality, rates, size, and low volatility have all made money in 2022. As flows move back to these rules-based strategies (bid up low volatility, high momentum, etc.), the bets get spread around. This means that **more names are in play but are traded with even more thinning liquidity, i.e., smaller trade sizes across a wider swath of names**.

Figure 9

Various Equity Factors Making Money This Year

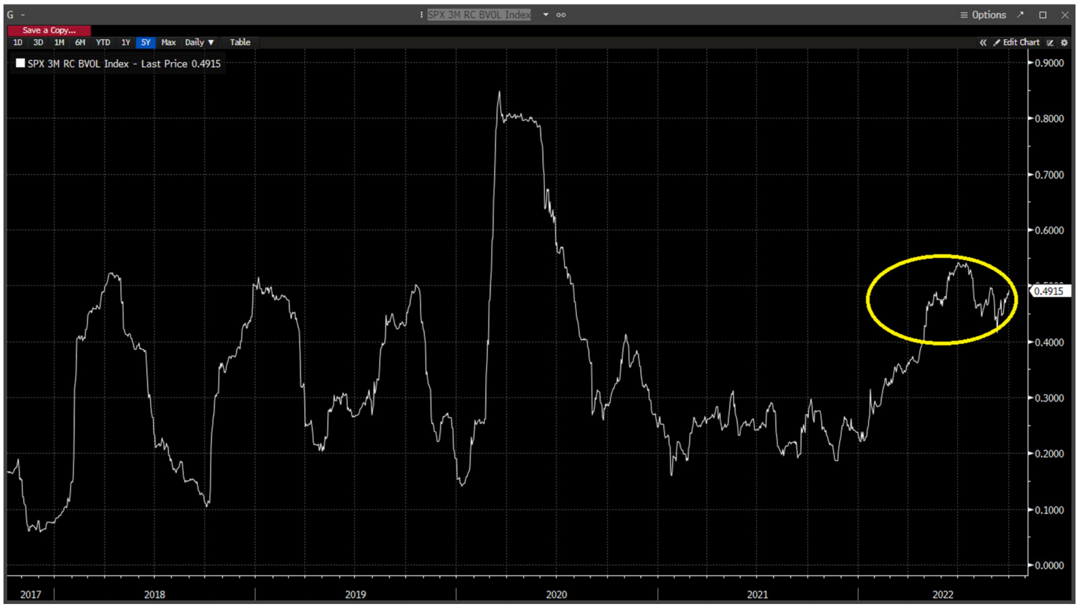


Source: Bloomberg

Importantly, correlations are extremely high not just amongst those factors but also on a realized 3M look at the S&P 500. While it certainly doesn't feel like it, when correlations are as extreme as they are now, it tends to indicate risk is lessening. At the same time, active stock picking becomes a futile exercise as everything is moving in lock-step—i.e., risk on or risk off. Business media outlets are citing that ETF volume has spiked considerably (pushing 30% of total US equity volume).

Figure 10

S&P 500 3M Realized Correlation



Source: Bloomberg

These conditions lead to a "pick your poison" type of backdrop as institutional traders grapple with their daily job of getting in and out of positions. The three conditions mentioned above have equated to less-than-ideal trading conditions across sectors and market caps. While global liquidity around the world tightens around rising rates, the symptomatic conditions have created a significant drying of liquidity from an institutional equity perspective as well.

Of course, each earning season now seems to carry significant weighwt, this time more than ever. **Keep in mind, earnings is rarely the catalyst for market volumes and volatility but that seemed to shift a bit during Q2 earnings season as the myopic focus on economic barometers is extreme.** Consensus estimates are deteriorating quickly. FactSet's latest reading showed the street looking for Q3 S&P 500 EPS 3.2% year-over-year, down sharply from the 9.8% when the quarter started. **Clearly, earnings is the next major focus and seasonality is also on the side of volatility.**

Jeffrey O'Connor
Head of Market Structure, Americas
joconnor@liquidnet.com

Questions? For more information, please contact your Liquidnet Coverage.

US
+1 646 674 2274
eqs-us@liquidnet.com

Canada
+1 416 594 2470
eqs-canada@liquidnet.com

Liquidnet