

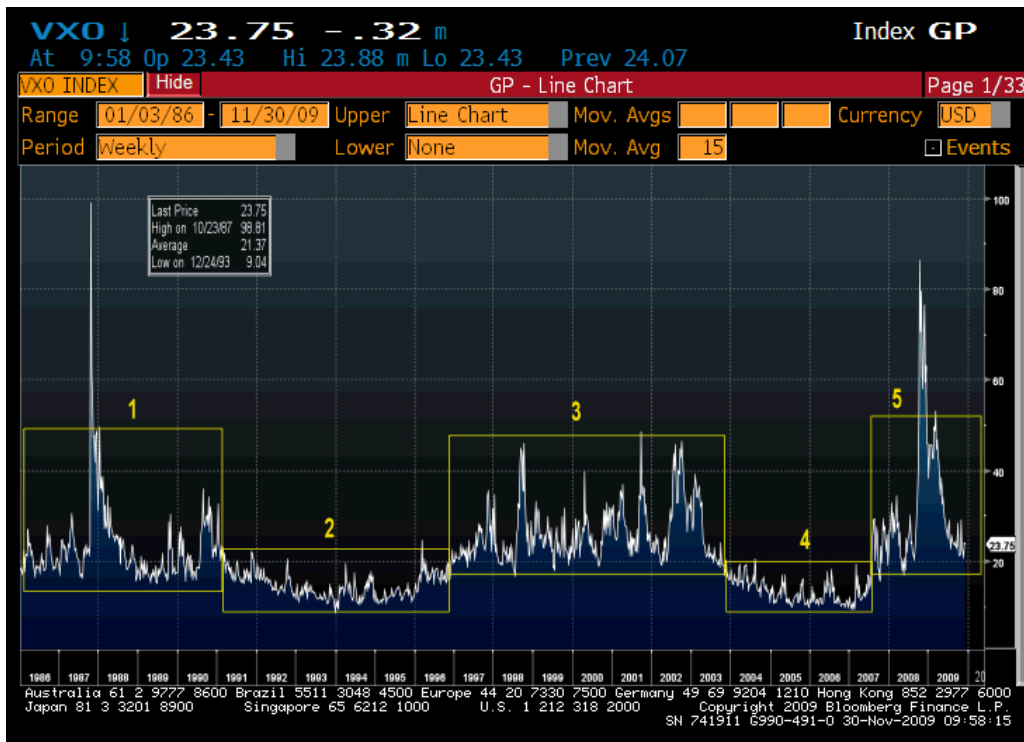
Derivatives Strategy

December 2, 2009

A Leery Eye on VIX

We remain constructive on equities into 2010, believing that earnings momentum will drive shares higher. That said, following two recent VIX spikes from the 20 level, we would view intermittent declines towards that lower limit as a signal to harvest gains or hedge long exposure.

In our note [“All Aboard the Momentum Train”](#) on November 23, we recommended long exposure to stocks that have emerged from the recession trough with solid earnings momentum via outright calls with mid-2010 expiries.



The list of 25 companies was dominated by energy names, followed by retailers and diversified financials. We note that a critical addendum to this constructive market view is the recognition of the current volatility cycle.

On October 21 spot VIX approached 20 intraday, then jumped 57% to 31.8 over the next week due to skittishness about the strength of economic data. The S&P 500 Index declined 6.3% during the same period. Last week, spot VIX approached 20 intraday before reversing sharply and jumping 27%

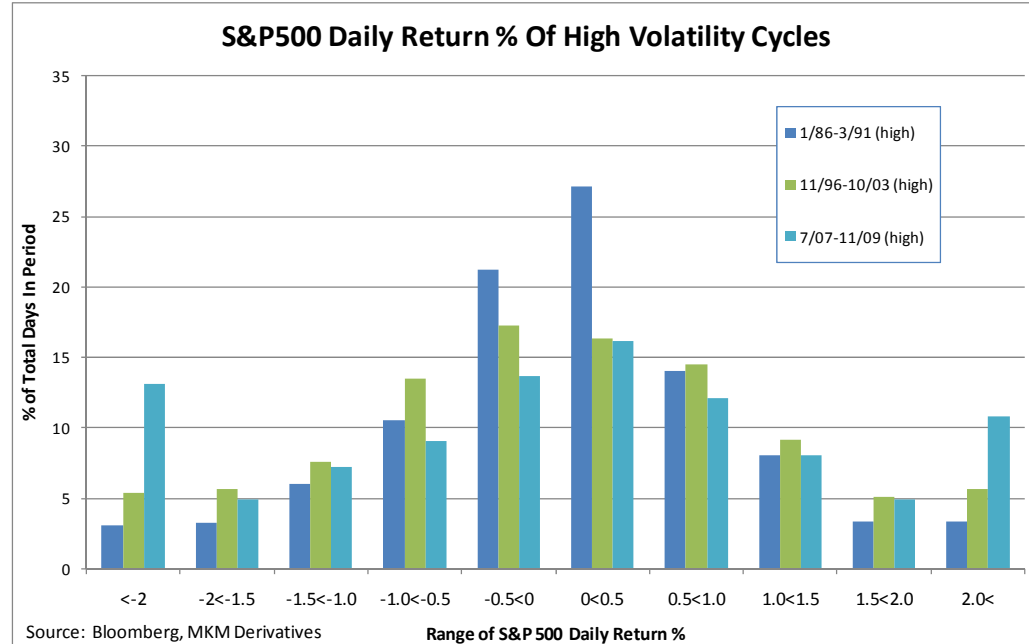
to 25.5. These two occurrences suggest to us that the current high volatility cycle we date to July 2007 has established a range of 20-45, similar to prior cycles in the late-1980's and early 2000's.

There have been four well-defined cycles since the inception of the VXO in 1986 with two periods of high volatility (1 & 3) and two periods of low volatility (2 & 4). Note that we use VXO instead of VIX here to pick up an additional four years of data. These cycles all reflect the underlying economic environment with volatility ramping towards the end of an expansion, remaining elevated through the recession trough, and then subsiding once sustainable growth has been established. As the result, the two low volatility cycles in the 1990's and 2000's correspond to the sweetspot of those economic expansions when real GDP growth averaged over 3% and consumer confidence

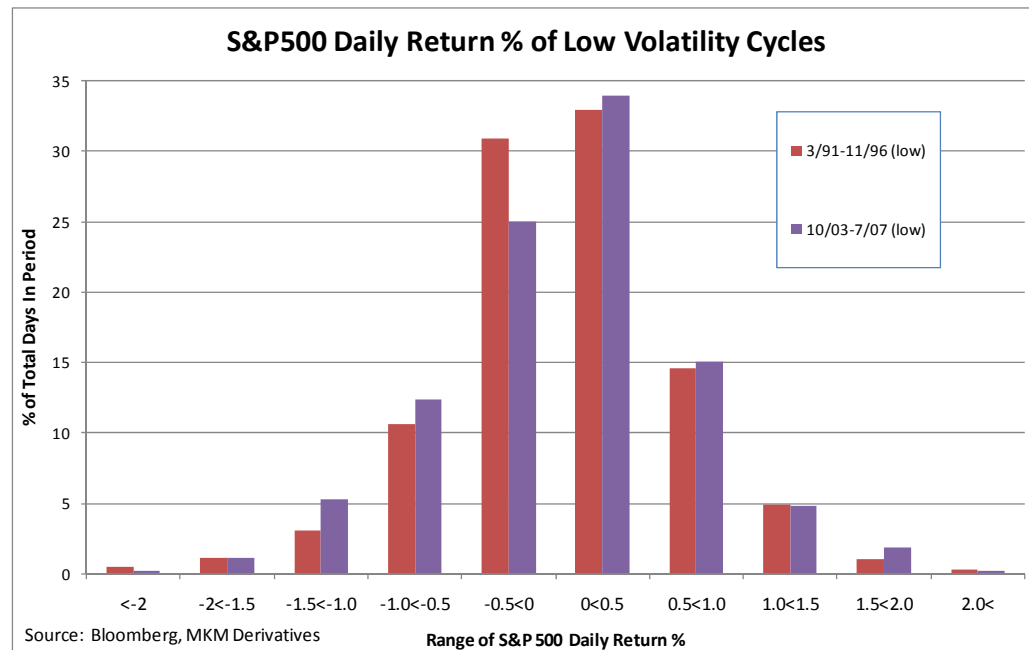
trended sustainably higher. Based on the 5.5 year average duration of these prior cycles, we believe the current high volatility regime could last until 2012.

To provide context for the current regime, we analyzed daily returns of the S&P 500 Index for each of the five cycles, bucketing them into 0.5 percentage point ranges. The normal distribution of the low-volatility cycles shows a pronounced degree of peakedness (lower graph, red and purple bars) relative to the high-volatility cycles (note

that both graphs have the same scale). In fact, the daily change of the S&P 500 Index was less than 1% (up or down), 88% of the time during the two low-volatility cycles versus an average 62% during the high-volatility cycles. Said differently, S&P 500 Index moved more than 1% 38% of the time during the high-volatility cycles. Notably, the S&P 500 Index has moved by at least 1% almost half of the time since July 2007 and has exhibited particularly fat tails with daily changes



greater than 2% 24% of the time. This is represented by the two light blue bars at the left and right extremes of the graph.



Not surprisingly, the shape of each cycle’s return distribution correlates with the median VXO level over the period. For example, the median VXO level in low-volatility cycles 2 and 4 were 14.6% and 13.6%, respectively. In contrast, the much flatter distribution profiles for high-volatility cycles 1, 3 and 5 correspond to median VXOs of 23.4%, 26.5% and 31.6%, respectively.

We view the current environment as ideal for taking directional exposure via listed options. With volatility towards the low-end of the 20-40 range, options are relatively inexpensive, in our view, and the flat return distribution suggests the opportunity exists to capture

historically sharp price movements. With that in mind, we reprint below the table of recommended stocks from our “All Aboard the Momentum Train” note.

Momentum Stocks: Multi-Factor Rank by Earnings Surprise, Estimate Revisions and Distance to Consensus Target								
Rank	Company	Symbol	Industry Group	3Q Earnings Surprise (%)	% of Analysts Revising Up FY10 EPS Estimate Last 4 Weeks (%)	Change from Spot to Consen. Price Target (%)	3-Month ATM Imp. Vol. (%)	3-Month ATM IV Rel. to 5-Year Avg. (%)
1	Anadarko Petroleum	APC	Energy	64.74	77.78	23.46	43.36	10.39
2	EOG Resources	EOG	Energy	23.51	83.33	20.58	38.88	(7.56)
3	Target Corp	TGT	Retailing	16.23	85.71	21.31	30.15	(13.46)
4	Noble Energy Inc	NBL	Energy	34.89	76.19	16.68	38.39	(1.72)
5	Hess Corp	HES	Energy	36.50	60.00	14.81	40.83	(6.93)
6	Kraft Foods Inc	KFT	Food Beverage & Tobacco	14.78	84.62	18.51	22.59	(3.34)
7	Cameron International	CAM	Energy	10.63	75.00	27.40	43.13	3.11
8	Devon Energy Co	DVN	Energy	21.07	50.00	21.94	36.99	(6.26)
9	Williams Cos Inc	WMB	Energy	24.35	33.33	25.31	39.15	(1.56)
10	Ameriprise Financial	AMP	Diversified Financials	62.06	33.33	18.26	44.63	(24.97)
11	Cisco Systems	CSCO	Technology Hardware & Equipment	16.40	82.14	15.25	28.30	(8.12)
12	Ford Motor Company	F	Automobiles & Components	229.41	69.23	10.47	49.54	(17.35)
13	Natl Oilwell Varco	NOV	Energy	19.91	34.78	23.86	46.60	(6.18)
14	Netapp Inc	NTAP	Technology Hardware & Equipment	25.20	77.42	10.87	40.61	(6.92)
15	Blackstone Group	BX	Diversified Financials	73.91	37.50	12.93	58.50	(14.22)
16	Priceline.Com	PCLN	Retailing	18.29	87.50	10.75	42.12	(9.92)
17	Mastercard Inc	MA	Software & Services	18.87	88.89	10.11	32.98	(26.05)
18	Life Technologies	LIFE	Pharmaceuticals, Biotechnology	18.89	72.73	13.88	35.33	4.06
19	Comcast Corp	CMCSA	Media	10.27	50.00	26.14	35.47	10.74
20	Franklin Res Inc	BEN	Diversified Financials	21.43	57.14	12.18	34.45	(1.43)
21	Illinois Tool Works	ITW	Capital Goods	27.38	30.00	13.95	28.94	7.78
22	Microsoft Corp	MSFT	Software & Services	24.84	45.83	10.96	25.11	(3.39)
23	Chevron Corp	CVX	Energy	15.90	44.44	15.69	25.63	(7.51)
24	ITT Corp	ITT	Capital Goods	15.08	53.33	14.36	29.63	6.28
25	Home Depot Inc	HD	Retailing	15.31	48.28	11.70	27.66	(12.72)

Source: Bloomberg, MKM Derivatives

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