

Morning Derivatives

December 27, 2011

Every shock must eventually come to an end. And so it seems the shock we date to early August, when the **CBOE SPX Volatility Index (VIX, 21.16)** initially rose above 25, was completed December 16 with what we expect to be a sustained decline back below that level. If we are correct, than we believe implied volatility should maintain a downward trajectory through the long-term mean for VIX just above 20 and into the 15-18 range. This outcome would likely be commensurate with an upward bias for U.S. equity markets over the same period. Let anyone get too excited, this relatively constructive outlook heading into 2012 represents only a brief reprieve from elevated equity volatility as it traces out the troughing-phase of its wave. Once this portion of the cycle concludes, additional shocks, possibly of similar magnitude to the one most recently experienced, should be expected. The eventual trigger to get more defensive will be a post-trough rise in VIX back above the 20 threshold. Until then, downward-trending implied volatility should bode well for long equity exposure, which we recommend exploiting while it lasts.



The primary shock of 2011 ranks among the three largest-magnitude events since the inception of the VIX in 1990. Its peak at 48 on August 8 is second only to the 80 reading in late October 2008. However, from both a duration (98 days in length) and displacement perspective (measured as the total area under the VIX time series down to the 25 level), it places third, far behind shocks in the fall of 2008 and 2002 that were both more than 200 days in length. Nonetheless, it was an impressive seismic event that has important implications for the volatility cycle going forward.

An interesting phenomena of equity volatility is the tendency of similar magnitude shocks to cluster. At the beginning of the current regime, from July 2007 to September 2008, there were five distinct volatility spikes where VIX peaked around the 30 level. Since the subsequent main shock in October 2008, there have been two events that saw VIX reach the mid- to upper-40s (May 2010 & August 2011) and a more benign event in March 2011 when VIX peaked at 29. Given our view that the high-volatility regime will remain intact at least through 2012, but possibly out to 2014 (see ["2012 Volatility Outlook, Part 1"](#)), we think it is highly likely that additional shocks corresponding to VIX in the mid-40s will occur.

MKM Research Coverage: Top 10 Option Volume Increases

Symb.	Analyst	Rating	Earn. Date	Total Option Volume			Volume 1 Day Ago		Open Interest 1-Week Chg. (%)		
				1 Day Ago	20-Day Avg.	% Chg.	Calls	Puts	Calls	Puts	Total
RYL	M.McGrath	Neutral	1/26/2012	1,014	279	263.4	4	1,010	1.8	1.0	1.2
MVVV	E. Handler	Buy	1/27/2012	3,548	1,100	222.4	3,528	20	2.0	1.0	1.8
NETL	D.Berenbaum	Neutral	2/2/2012	1,032	472	118.8	287	745	1.1	5.2	2.0
WYN	C. Agnew	Buy	2/9/2012	3,240	1,536	110.9	2,534	706	3.2	3.8	3.5
MXIM	D.Berenbaum	Neutral	1/20/2012	1,754	912	92.2	145	1,609	17.3	2.3	10.5
AMD	D.Berenbaum	Sell	1/24/2012	16,141	8,583	88.0	15,667	474	2.9	3.0	2.9
TJX	P. McKeever	Buy	2/22/2012	1,546	996	55.2	1,183	363	6.9	6.5	6.7
HOT	C. Agnew	Buy	2/3/2012	7,634	5,057	51.0	6,888	746	13.4	2.3	7.3
HTZ	C. Agnew	Buy	2/22/2012	2,172	1,496	45.2	2,112	60	0.4	1.3	0.6
EMR	J. Pokrzywinski	Neutral	2/1/2012	3,897	4,581	(14.9)	2,751	1,146	9.7	10.8	10.2

Note: Green = Put/Call ratio <0.5; Red = Put/Call ratio > 2.0.

Source for all charts and tables in this document: Bloomberg, MKM Partners

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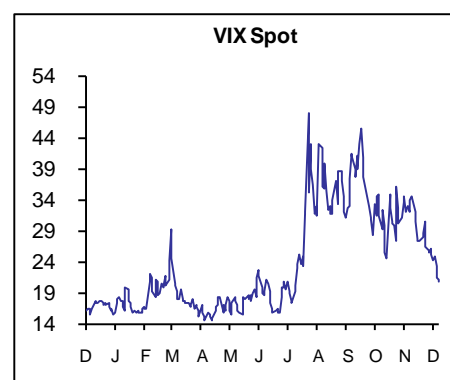
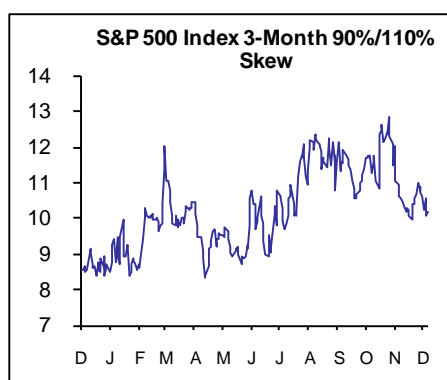
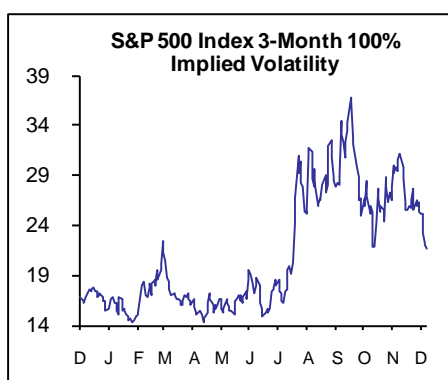
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S&P 500 Index: Sector Option Volumes

Sector	Option Volume 1 Day Ago			Option Volume 20-Day Avg.			Option Volume Change (%)		
	Calls	Puts	Total	Calls	Puts	Total	Calls	Puts	Total
S&P 500 Index	1,781,575	1,155,096	2,936,671	4,219,130	2,118,563	6,337,693	(57.8)	(45.5)	(53.7)
Consumer Discretionary	162,914	126,943	289,857	455,831	281,470	737,300	(64.3)	(54.9)	(60.7)
Consumer Staples	108,845	102,147	210,992	615,620	107,565	723,186	(82.3)	(5.0)	(70.8)
Energy	169,015	94,831	263,846	647,436	177,973	825,409	(73.9)	(46.7)	(68.0)
Financials	322,454	189,882	512,336	617,094	467,490	1,084,584	(47.7)	(59.4)	(52.8)
Health Care	94,061	59,287	153,348	276,350	128,953	405,303	(66.0)	(54.0)	(62.2)
Industrials	143,806	152,092	295,898	396,955	165,707	562,662	(63.8)	(8.2)	(47.4)
Technology	593,457	328,717	922,174	892,662	614,746	1,507,408	(33.5)	(46.5)	(38.8)
Materials	108,055	62,841	170,896	207,677	117,299	324,976	(48.0)	(46.4)	(47.4)
Telecom Services	66,056	31,569	97,625	81,847	47,462	129,309	(19.3)	(33.5)	(24.5)
Utilities	12,912	6,787	19,699	27,657	9,898	37,555	(53.3)	(31.4)	(47.5)

S&P 500 Index: 3-Month Implied Volatility and Normalized Skew, and VIX



S&P 500 Index: Top 15 Option Volume Increases

Symbol	Earnings Date	Total Option Volume			Open Interest		3-M ATM Imp. Vol. (%)		Spot Price	
		Yesterday	20-Day Avg.	% Chg.	Yesterday	1-Week Chg.	Yesterday	1-Day Chg.	Yesterday (\$)	1-Day Chg. (%)
SVU	01/11/12	27,491	3,843	615.3	224,733	2.2	45.0	(2.6)	8.1	2.1
MWW	01/27/12	3,548	1,100	222.4	41,168	1.8	65.5	(1.9)	7.9	0.4
SE	02/03/12	4,238	1,331	218.5	34,648	38.7	19.9	(1.0)	30.9	1.2
TAP	02/10/12	1,935	621	211.5	18,313	18.5	22.3	(2.9)	44.0	1.1
CAM	02/02/12	11,890	3,908	204.2	101,984	4.9	45.3	(0.9)	49.6	(0.4)
SUN	02/03/12	7,568	2,526	199.6	192,277	1.7	31.3	(6.7)	40.7	0.9
DFS	03/22/12	3,870	1,295	198.8	59,546	2.5	34.5	(2.8)	24.5	0.8
MJN	01/27/12	23,121	8,331	177.5	91,881	34.3	46.2	49.7	65.3	(5.0)
IGT	01/20/12	3,865	1,644	135.1	55,131	0.1	36.9	(2.5)	16.6	3.7
MHS	02/22/12	4,859	2,239	117.0	188,228	2.3	39.9	(5.9)	56.1	(0.7)
AET	02/01/12	4,941	2,302	114.6	89,037	1.1	30.0	(4.0)	43.4	2.3
WYN	02/01/12	3,240	1,536	110.9	58,368	3.5	32.7	(2.9)	37.5	2.8
AMD	01/24/12	16,141	8,583	88.0	467,647	2.9	55.5	(5.3)	5.4	(0.7)
DOW	02/03/12	23,276	12,657	83.9	402,148	6.5	36.2	(4.6)	28.8	2.8
VLO	01/26/12	31,067	17,039	82.3	427,935	8.1	45.0	(3.2)	21.0	0.2

U.S. Exchange-Traded ETFs: Top 20 Daily Increases in Cash Trading Volume

Symb.	Name	Spot Price					20-Day Avg. Cash Volume		Total Option Open Interest
		Spot (\$)	52-Week High (\$)	52-Week Low (\$)	200-Day Mov. Avg. Sprd. (%)	YTD Chg. (%)	Shares	Chg. From 20-Day (%)	Yesterday
DJP	iPath Dow Jones-UBS Commodity Index Total Return	42.3	53.2	40.5	(10.5)	(13.8)	1,134,123	111.76	353
AMJ	JPMorgan Alerian MLP Index ETN	38.5	39.4	31.5	5.4	5.8	1,982,001	103.86	4,102
ILF	iShares S&P Latin America 40 Index Fund	43.0	55.4	36.7	(9.1)	(20.1)	3,486,441	95.16	2,051
ACWI	iShares MSCI ACWI Index Fund	63.0	51.0	37.1	(6.0)	(9.5)	1,144,997	57.38	40
DBC	PowerShares DB Commodity Index Tracking Fund	27.0	32.0	25.2	(6.8)	(2.0)	2,872,683	55.28	44,598
VTI	Vanguard Total Stock Market ETF	64.7	71.1	54.6	(0.3)	(0.3)	3,193,948	51.42	1,133
VNQ	Vanguard REIT ETF	58.2	63.3	47.1	1.4	5.1	2,307,629	32.52	3,210
VEU	Vanguard FTSE All-World ex-US ETF	39.8	52.3	36.7	(12.3)	(16.6)	1,333,490	17.82	1,004
GDXJ	Market Vectors Junior Gold Miners ETF	24.3	42.3	24.2	(28.3)	(38.1)	3,646,509	16.16	73,871
PFF	iShares S&P US Preferred Stock Index Fund	36.0	40.2	32.9	(5.2)	(7.3)	1,089,884	9.70	14,923
CSJ	iShares Barclays 1-3 Year Credit Bond Fund	104.2	105.3	103.4	(0.3)	(0.1)	635,689	5.85	55
VEA	Vanguard MSCI EAFE ETF	30.7	39.9	28.6	(11.6)	(15.2)	2,580,061	1.59	2,155
ACWX	iShares MSCI ACWI ex US Index Fund	36.8	47.9	33.2	(10.8)	(16.5)	519,250	(1.84)	-
TBT	ProShares UltraShort 20+ Year Treasury	19.2	41.5	17.5	(31.5)	(48.3)	8,224,148	(3.51)	406,165
IWD	iShares Russell 1000 Value Index Fund	63.9	70.9	53.4	(0.3)	(1.4)	2,067,116	(6.45)	685
SDY	SPDR S&P Dividend ETF	54.2	55.7	45.7	3.0	4.2	1,059,915	(6.80)	1,827
IWF	iShares Russell 1000 Growth Index Fund	58.2	62.8	50.0	(0.2)	1.6	2,539,649	(7.89)	608
DOG	ProShares Short Dow 30	38.6	46.8	38.6	(6.9)	(13.0)	656,332	(8.04)	615
RWX	SPDR Dow Jones International Real Estate ETF	32.1	41.7	30.6	(13.0)	(17.5)	548,127	(13.69)	-
BSV	Vanguard Short-Term Bond ETF	80.9	81.6	79.3	0.2	1.1	507,828	(15.35)	-

U.S. Exchange-Traded ETFs: Top 20 Daily Increases in Option Trading Volume

Symb.	Name	Total Option Volume			Open Interest		3-M ATM Imp. Vol. (%)		Spot Price	
		Yesterday	20-Day Avg.	% Chg.	Yesterday	1-Week Chg.	Yesterday	1-Day Chg.	Yesterday (\$)	1-Day Chg. (%)
TLT	iShares Barclays 20+ Year Treasury Bond Fund	118,318	45,360	160.8	484,067	(24.1)	19.5	(2.7)	119.6	0.4
XOP	SPDR S&P Oil & Gas Exploration & Production ETF	55,602	35,283	57.6	308,898	(53.2)	42.8	(1.5)	52.9	1.7
WWM	iShares Russell 2000 Index Fund	466,511	454,248	2.7	3,578,671	(31.7)	32.7	(0.0)	74.3	0.1
SSO	ProShares Ultra S&P500	19,794	19,348	2.3	98,909	(37.2)	45.6	(1.4)	46.2	1.9
FAS	Direxion Daily Financial Bull 3X Shares	33,740	34,127	(1.1)	388,433	(17.9)	81.1	(0.6)	65.8	5.5
VXX	iPATH S&P 500 VIX Short-Term Futures ETN	51,150	58,221	(12.1)	1,111,466	(18.5)	85.0	0.8	33.8	0.2
TBT	ProShares UltraShort 20+ Year Treasury	40,955	49,504	(17.3)	1,041,807	(23.1)	39.8	na	18.8	(0.7)
FAZ	Direxion Daily Financial Bear 3X Shares	24,109	31,919	(24.5)	305,299	(5.2)	94.1	(0.2)	37.1	(5.5)
TZA	Direxion Daily Small Cap Bear 3X Shares	18,763	25,888	(27.5)	193,609	(19.9)	98.5	(0.7)	26.1	(2.3)
UNG	United States Natural Gas Fund LP	18,859	28,513	(33.9)	1,382,082	(5.2)	40.3	0.9	6.9	(0.3)
DIA	SPDR Dow Jones Industrial Average ETF Trust	33,288	51,910	(35.9)	730,820	(20.6)	21.0	(2.1)	121.5	0.6
SLV	iShares Silver Trust	79,835	128,213	(37.7)	3,452,491	(7.2)	42.1	(0.6)	28.4	(0.8)
XRT	SPDR S&P Retail ETF	19,724	31,764	(37.9)	396,361	(43.3)	28.3	(1.8)	52.6	(0.3)
QQQ	PowerShares QQQ Trust Series 1	253,205	410,340	(38.3)	3,617,687	(27.5)	24.5	2.5	55.6	0.9
SDS	ProShares UltraShort S&P500	29,424	53,102	(44.6)	377,182	(31.8)	48.8	(1.4)	19.4	(1.8)
SPY	SPDR S&P 500 ETF Trust	1,454,335	2,656,025	(45.2)	17,024,147	(25.6)	22.8	(2.1)	125.3	0.9
XLK	Technology Select Sector SPDR Fund	10,640	19,673	(45.9)	707,736	(16.9)	23.4	1.8	25.3	1.2
FXI	iShares FTSE China 25 Index Fund	32,922	63,306	(48.0)	2,251,456	(15.8)	32.4	0.9	35.3	1.6
RSX	Market Vectors Russia ETF	3,488	6,869	(49.2)	242,713	(10.4)	44.9	1.0	27.5	0.7
TNA	Direxion Daily Small Cap Bull 3X Shares	5,841	13,109	(55.4)	88,724	(26.8)	92.5	1.4	45.8	2.3

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"Neutral"	Security is not expected to significantly appreciate or depreciate in value in the next 12 months.
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1. Automatic exercise is limited: All expiring equity options closing in-the-money .01 or more will be eligible for automatic exercise per the contract terms of standardized options issued by the Options Clearing Corporation (OCC). Index options will be exercised automatically if they are in-the-money by any amount.
2. You may be required to request exercise of valuable options: You should note that long equity options that are in-the-money less than .01, or out-of-the money, are not automatically exercised. These options may be exercised, but you must specifically request exercise of these options by 4:00pm ET on the last day of trading before expiration.
3. Consider the risk of exercise or assignment: You should review your positions and consider whether your account can afford to take assignment (or exercise) based on your current equity. You may need to close expiring positions prior to end of the market day in order to avoid risk, or in order to retain the profit from an in-the-money position prior to expiration. In addition, please consider the possibility that short options positions may be exercised against you by the long holder, even if the option is out-of-the money.
4. Spreads face unique risks during expiration: Expiring spreads may require action if the long leg is out-of-the money less than .01, or out-of-the-money while the short leg is in-the-money. Although we use our best efforts to exercise offsetting, expiring long options, the customer is ultimately responsible for taking action on such positions and for the risks associated with any unhedged spread leg expiring in-the-money. In the event that you do not wish to exercise an expiring long leg, you must notify us by 4:00pm ET in order to prevent the possibility that we will exercise this long position on your behalf.
5. The assignment process: According to the policy and practice of our clearing agents, assignments are distributed on a random basis among all holders of eligible options among the accounts carried on their books. Please contact us if you need more information about this process. For any questions relating to the exercise process or regarding expiring options, please contact our Trading Desk at 203-861-9060.

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