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Macro Hive: The Gamma That Did Not Bark in the Night

(Thorsten Wegener, 9 March 2022)

Like Sherlock Holmes, sometimes you meet a conundrum that defies ordinary explanations. Market gamma (or better, its implications on markets) is one of these riddles that made me think the other day. It happens.

Gamma used to be a mysterious word. We used it on trading desks to scare the bejesus out of board members – once they ventured out of the relative safety of their plush corner offices into our cage of fools – to satisfy their fearful disposition when markets, as now, turned nasty. Additionally, it made us look smart, indispensable, in control and doubtlessly worthy of a huge bonus.

Unfortunately, these times are long gone. Various service and research providers have done a fantastic job of democratizing the knowledgebase once reserved for the initiated. Even my article, 'What's a Gamma Flip?', had more than 60,000 eyeballs on it and was literally read from Vancouver to Mumbai. It is somewhat surprising for someone who usually serves a far smaller audience with his deliberations on Greeks with funny names.

So, What Does Gamma Do?

Gamma provides or withdraws liquidity to markets. Long gamma is a positive thing that gives you options (pun intended) – we will say it provides additional liquidity. Meanwhile, short gamma withdraws liquidity.

Here are the easiest examples. Say you are in a long-drawn bull market slowly grinding upwards. As it does, dealers and market-makers try to earn time decay and battle decreasing volatility in their long positions. On the flip side, in rapidly deteriorating markets, the same market participants are manically trying to compensate their short gamma, short vola positions by selling lows and buying highs.

So grinding upwards is happening slowly. And it goes on until it eventually stops like an old-age pensioner on an escalator in front of you. Meanwhile, gamma shorts – let us be modest – speed things up.

Sticky and Slippy

To throw in two new terms you might have heard in a different context, markets can be 'sticky and slippy'. In a veritable crash or risk-off market environment like the Covid-19 pandemic in March 2020, you would assume that a market in full-on gamma short mode would cut through the levels with high open interest like – to quote General George Patton – 'a hot knife through shit'.

And that is exactly what happened then. The market was gamma short. Things got a bit awkward, and the ride down the waterslide got exciting until the fat kid hit the wall of the pool. Those 'in the know' had identified the situation and – as was to be expected with a high probability, knowing how gamma normally works – made a buck or two.

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Markets Right Now

Now I am reading the market is under similar duress: inflation, stagnation, Ukraine, Vladimir Putin, nukes, etc. And the market is, according to the professional market observers, again in gamma short land.

However, I switch on my screens after a rough news cycle, in the mood to short all guns blazing, expecting the market to roll over and die. And it recovers every time, especially around the market levels with high open interest. This is usually a sure-fire indication of a market that provides additional liquidity, namely gamma long.

So, what did I not see? Maybe it is my age or intellectual insufficiencies. And it took me a while to fall back on – yes, I am saying it – the scientific method. If you spot a contradiction in an otherwise flawless working model, go back and check your premises.

Are We in Negative Gamma Territory?

The current discussion about the market being south of the gamma flip level and rather deep in negative gamma territory assumes market-makers are still stuck in their conventional business model, buying out-of-the-money calls from their valued customers and selling crash protection to them. Then positive and negative gammas get netted and tell us whether we are gamma short or gamma long (I explain this in 'What's a Gamma Flip'). For now, let us assume this is how market-makers operate generally.

What if, and it is admittedly a big if, we are now seeing a phase shift in the conduct of these market-makers? Clients hardly ever trade their gamma; market makers get paid to do so. Considering my experience, it even makes sense to approach the mystery from this unconventional side. How is that possible you might ask?

Leading you back to my first lines about anxious board members breathing down your neck, I have been there many times before. Just when fear takes over their brilliant minds, they seem to have the uncanny talent to force you to hedge the low. Hedging the low in this context means buying volatility and buying gamma. First, I am forced to buy volatility up, which happened already. Then I am stuck trying to earn my carry by scalping the markets. In other words, I am now providing liquidity instead of withdrawing it.

Where does that happen? Usually at the places with the highest open interest, and this is what I am seeing now. This does not mean the situation will not change when the nukes are flying and the markets are overrun. But it might be an indication that the public operates under the assumption that they see something that is not there. Maybe the reason the dog did not bark in the night is that he was not there to begin with, and the inevitable pain trade might be to the upside.

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