<u>Morning Commentary for January 20, 2025</u>

Good morning,

The temporarily neutral constellation of forces between supply and demand in the FDAX, which manifested itself in the form of a doji on the daily chart on Thursday, dissolved to the upside with an impressively strong surge on Friday. As if "pulled by a string", the future reached the 21,000 price level by the time the January contracts of the index options expired and rose by a further 21,050 points at its peak in the course of the afternoon. The FDAX thus reached a new all-time high.

There was much puzzlement in the market as to where the high consistency of the rise came from and a large number of market observers cited covering purchases by those players who repeatedly fished into the rise (built up shorts) and were then forced to cover again and again. "The bull market feeds the bull market" is a popular catchphrase to describe such developments. However, we should not leave it at this sweeping statement, but look deeper.

Let's take a at the daily open interest published by Deutsche Börse / Eurex for index options on the DAX. In the January contracts, we had written extremely high call positions, which were clumped on the short side, primarily in order to capture the daily decreasing theta. These positions had been the books for some time and had been built up based on the expectation that the higher price development probability should have been on the downside in view of the geopolitical and interest rate environment. Good company figures from the previous week, surprisingly good inflation figures in the USA and supportive statements from the future Trump administration pushed the stock markets upwards in the middle of the week, which ultimately hit the rather large option short positions with their explosive gamma development and thus resulted a cascading effect, which we were able to experience in its absolute purest form on Friday.

Anyone familiar with option pricing theory will know that as the term of an option decreases, the gamma around the respective strike price contracts ever more tightly, the change in the option delta to change almost explosively when the BP is reached. I have repeatedly described this effect in previous commentaries - in the market, such a development is also known as the "light switch effect". Every time a strike price with a concentration of written call options is reached/exceeded, a correspondingly large number of negative delta is recorded, especially on the expiry date, forcing the market to cover/buy, which quickly catapults the price (especially when there is little supply) towards the next higher strike price, at which the next explosive load of short calls is located, again catapulting the delta on the short side upwards and forcing further purchases. This sets off a spiral that reveals the often-described comparative effect of a catalyst.

At 12 noon on Friday, the index options with the January expiry date in the Stoxx family expired, and at 1 p.m. the index options on the DAX expired. This eliminated the risk of further new delta shorts on the upside when new highs were reached, but it could certainly be assumed that not all of the shorts that had been started in this context (including the fixing) had been closed, which still forced one or two purchases in the afternoon/evening.

FDAX March contract daily chart

Let's try to formulate an expectation for the further possible price development by first looking at the current starting position. I will start with the most obvious aspect, the most recent order flow. The majority of the traders I spoke to on Friday evening about the trend they had seen judged the buying to be forced buying: "Anyone who bought like that had to buy!" was the broad tenor. This raises the question: has the compulsion to buy now been largely eliminated? Have sentiments calmed down again? The causal gamma short side has weakened considerably with the elimination of the January contracts. The February contracts still have sufficient term, so that any delta changes that occur here will be much smoother, so that we can postpone them for the time being.

Investment levels in the traditional fund industry are very high, which means that there should not necessarily be much need for action on the buy side at current price levels. As far as the retail sector and the hedge fund industry are concerned, which have repeatedly been brought into play as potential drivers in recent days, could be assumed that the latest developments have also forced a lot of action and are now reducing the buying pressure somewhat.

To summarize, opinions in the market in this respect vary to the effect the possible potential on the upside should be limited for the time being, both in terms of time and extent. Opinions that we should have increasing opportunities, at least in terms of a reaction, are therefore beginning to predominate.

From a fundamental perspective, the ECB meeting next week is of course on the horizon. Expectations of a further interest rate cut are high and are seen by the press in particular as an argument for the current bull market.

Reuters also writes that favorable data from China is also having a supportive effect. The economy there grew faster than expected in the fourth quarter of 2024. Gross domestic product increased by 5.4%, while economists had only expected 5.1%. Industrial production also developed better than expected in the fourth quarter.

It is pointed out that all Chinese data should be treated with caution. However, the news portal writes that it appears that the

The government's support measures are an effect. The data had a slightly positive effect on the Chinese stock markets, and the yuan also strengthened somewhat. "This shows that the economy in China is well prepared for a possible tariff war with the future US president," Reuters quotes experts from QC Partners.

The International Monetary Fund has revised its growth forecasts for the US economy upwards. Accordingly, the USA is likely to outperform other major Western economies. In line with this, the latest US economic data has exceeded expectations, which is also brightening the current environment for equities.

Monday will now be interesting in that Europe will largely be left to its own devices in trading. The US stock exchanges will remain closed for Martin Luther King Day.

In conclusion, we note that at least a temporary reaction is increasingly considered likely by the players. A few are expecting sharp falls, but the arguments for this are thin on the ground if they relate to ultra-short time frames. Some experts believe that a bounce or two on the upside is still possible on Monday morning, but here too a reaction is expected afterwards.

For the sake of completeness, I am adjusting the currently valid correction potentials as follows:

Minimum correction:	20.753 / 20.708
Normal correction:	20.600
Maximum correction:	20.492 / 20.456

I wish us all a successful trading week! Uwe Wagner

For those interested in short-term trading: