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Hedging against volatility fed by Chinese currency policy

Investors will recall 2015 as a mediocre and trying year. The memorable events were the Greek saga, the commodity market rout, the Chinese devaluation and the first rate hike in the US in over a decade. To everyone's surprise, the economic slowdown in China had the largest impact on global markets, with the fear of competitive devaluation re-emerging. However, the consensus among market pundits was that the emerging markets economic slowdown would not be able to derail the developed market recovery. Our world has never been economically and financially interconnected to that extent. The global economic power shift away from established to developing economies is no longer questioned and projections for the coming years are further supporting this trend.

The US equity market, which basically went up in a straight line over the recent years, showed signs of nervousness. On August 24th, it experienced a flash crash, as illustrated by the Dow Jones Industrial Index which dropped close to 1,100 points in the first minutes of trading. From a volatility perspective, the VIX, also known observation we are tempted to draw is that global investors are getting much more sensitive to any currency policy adjustment made by Chinese authorities by swiftly moving into panic mode (see chart). If economic fundamentals continue to deteriorate, currency adjustments will naturally follow. Additionally, Central banks have less ability to act counter-cyclically at this stage and the Fed embarked on a rate hike cycle. Equity valuations are getting stretched in some regions of the world, and emerging market woes are far from being solved. In short, volatility is here to stay! Markets are subject to tail events which are recurring in nature, although the type, depth and duration may vary. After seven years of positive return for the S&P 500 (including dividend, 2011 and 2015 were positive), the probability of a market correction happening in the medium term has significantly increased. Therefore, hedging against tail events has more importance today than ever before.

In the implementation of a hedging program, fundamental and tactical views are generally the foremost considerations. The challenge with this approach remains

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as the fear index, which is a measure of market expectations of near-term volatility derived from S&P 500 stock index option prices, recorded a one week spike of +113% in August. The short-dated derivative contracts on the VIX skyrocketed on the flash crash day and their value surged by over 10 times at market opening.

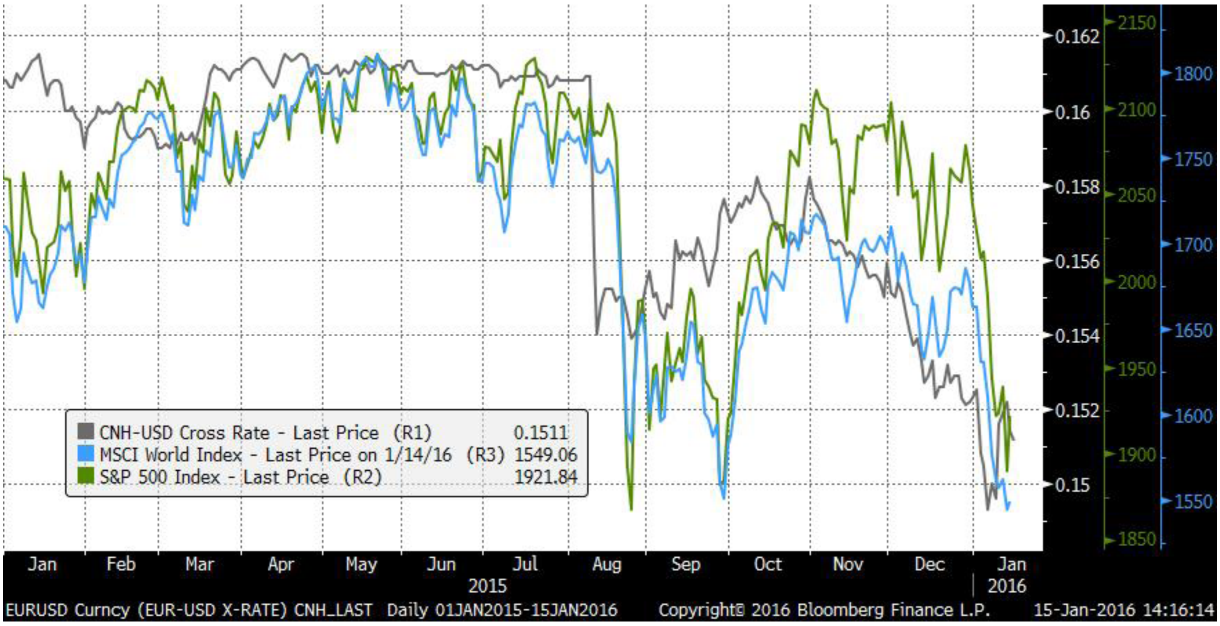
The wake-up call on the first trading days of this year came as a hammer blow for investors. The Chinese equity market plummeted over 7% due to weak manufacturing data, sparking a halt in trading of shares. The sell-off spread to the rest of the world and reminded investors for the second time in less than six months that billions of market value could evaporate in a matter of days and most importantly, the need for efficient risk management and hedges in a portfolio context.

Does this set the tone for the rest of the year? The timing and appropriate sizing. The risk of adopting a discretionary approach to hedging is to be out of the market when a tail event happens. Embarking into the construction of hedges in the middle of the storm could prove very costly and ineffective. In the absence of strong views, a systematic approach to hedging should be adopted with a pre-defined budget deployed throughout the year.

Meaningful enhancement to risk-adjusted returns can be achieved by integrating a hedging component in the asset allocation mix. The use of volatility based hedges represents one of the efficient ways to benefit from multiple standard deviation events. The strong negative correlation between the equity market and volatility makes it a useful tool for portfolio diversification. Volatility became a tradable asset with CBOE introducing the first VIX futures contracts in 2004 and VIX options two years later. Given the increased liquidity, VIX derivatives have now become popular and accessible to any investor. These instruments provide asymmetrical returns and tend to outperform in larger selloffs. When comparing VIX calls and VIX futures, calls generally offer better risk/reward and higher leverage during selloff periods but have lower liquidity and are less reactive to slowly declining markets. In terms of maturity to consider, longer-term volatility has typically lower holding cost with less reactivity to panic selling, which is well expressed by the inversion of the VIX term structure in such circumstances. Also, academic studies demonstrate a relatively strong relationship between credit spreads and implied equity volatility, supporting the use of volatility based instruments as an indirect hedge against stress in credit markets.

Involvement in tail hedging programs requires patience, which is one of the virtues taken away from market participants nowadays. The demand for hedging evolved over the years from intense focus on buying tail risk protection at any price to a more nuanced stance. Preserving capital during market downturn periods is of utmost importance, especially in a slow growth world where currency debasement has become the economic weapon of choice. In this context, derivatives on volatility can play an important hedging role.

Strong relationship between Chinese currency policy and global equities:



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