RISING POLITICAL RISK SPURS STRUCTURED SOLUTIONS

Election uncertainty

In an era of accelerating political risk, structured products and hedging have come into their own. David Wigan explains how investment banks are responding to today's volatility.

INVESTORS POSITIONED BASED ON THE BELIEF THAT MR TRUMP WOULD INTRODUCE MASSIVE INVESTMENT

Kokou Agbo-Bloua

FROM THE UK'S VOTE TO LEAVE THE EU to the election of Donald Trump as US president, the number of unexpected political events appears to be rising. As a result, financial markets spanning everything from commodities to equities and fixed income are increasingly in thrall of political outcomes, presenting both challenges and opportunities for investors.

Following the surprise result of the June 2016 Brexit referendum, sterling fell against the euro and dollar by as much as 20%, while gilt yields dropped to an all-time low. Later in the year, yields rose as investors sold debt over concerns about the UK's heavily foreign-funded deficit.

In the US, rates markets sold off in late 2016 as investors contemplated aggressive fiscal expansion following the Trump election, while equity dispersion rose sharply amid moves to pick winners after the president's pledge to prioritise domestic growth. More recently, French bond and equity markets swung to and fro on election speculation and German equity volatility is predicted to rise ahead of its federal elections in September.

POLITICAL RISK IS UP

"From a very broad perspective, if you see risk as a measure of uncertainty over the future, there is no doubt that political risk has substantially increased in most mature economies," says Thierry Apoteker, chairman of research firm TAC Economics. "Unorthodox policies, sudden reversals in decision making, not to mention the tendency by competing politicians to micro-manage businesses or markets, create new uncertainties that investors must address and respond to."

One way to hedge against risk or take a view on increased volatility is through listed derivatives, demand for which rose sharply over the past year. Their average daily exchange turnover rose to $5.2bn in 2016 from $4.6bn the year before, according to the Bank for International Settlements.

Rising volatility also boosted demand for options, with average daily turnover in foreign exchange (FX) and rates volatility contracts rising about 18% in 2016 to $1.5bn. Increased demand for listed derivatives was in contrast to declining over-the-counter (OTC) volumes, which fell last year to a decade-low as post-crisis regulation continued to bite.

One factor driving demand for derivatives is the changing nature of the risk landscape. Events such as this year's French election would not normally generate large amounts of hedging activity, but because markets have become attuned to the increased incidence (and therefore perceived likelihood) of surprises, demand was higher than expected.

"Long-only investors are exposed to sudden changes of market direction and many are not set up to trade OTC derivatives, with the right collateral agreements and legal structures in place," says Adnane Asfalou, head of rates pricing and development for Europe at Société Générale Corporate & Investment Banking (SG CIB).

"For that reason, we have seen a real pick-up in demand for notes that embed hedging characteristics for investors who have learned the lessons of previous events, and want quick and easy access to protection that is also short in tenor to cover specific periods of risk."

INCREASE IN HEDGING

SG CIB reports a surge in demand for cross-asset structured notes, enabling investors to take advantage of the changing political climate's various impacts on commodities, rates, FX, equities and volatility.

"The events we have seen, from the Italian constitutional referendum [in December] to the French elections and Brexit, have been extremely challenging for investors to predict and position for in terms of the distribution of outcomes," says Kokou Agbo-

Bloua, SG CIB's global head of flow strategy and solutions.

"On the other hand, there are clear risks which they feel they cannot ignore. They can either sit on the sidelines with cash, which is not optimal in a period of negative or ultra-low interest rates, or, what we have more commonly seen, is investors deciding they want to hedge or seek to express views."

SG CIB was able to offer long-only asset managers and pension funds a range of structured solutions by leveraging its wider client base, including hedge funds, that were willing to take the other side of trades, for example by selling volatility in the lead-up to the French elections.

"In France it was thought that there was a material chance that [far right-wing candidate] Marine Le Pen would win the election and try to take France out of the European single market, which would lead to redenomination of French debt back into francs, and thus trigger a credit default event," says Mr Agbo-Bloua.

"With the yield on the French government bond heading sharply higher, we were able to structure a 12-month callable note that gave investors the chance to sell options on OATs [French government bonds] and align with the probable impact on the euro, and to recycle that optionality to hedge funds."

SAFE HAVENS

Another trade tied to the chance of Ms Le Pen winning the election allowed investors to bet that a victory would put both the euro and European stocks under pressure, amid rising correlations, and favour safe-haven assets such as bonds, gold and Japanese yen.

SG CIB offered investors notes that allowed them to position for a rise in correlations and volatility through 'worst-of puts' on equities and the euro versus the dollar, or through safe haven plays such as buying call spreads and calls on combinations of gold and euro-dollar.

Another popular trade allowed investors to buy puts on the CAC index against puts on 10-year OATS. In the FX space, investors were able to sell relatively high sterling volatility to fund long euro volatility positions against the dollar.

Given the large number of positions contemplated by investors, SG CIB did not try to offset trades on an individual business, but took a holistic approach that enabled it to arrive at a largely matched book. "We don't separate the options market from structured products or repacks," says Mr Asfalou. "Over the long term we are trying to match these flows because if we tried to hedge on a one-to-one basis it would be impossible."

Alongside the rise in demand for hedges has come increased acceptance of complexity in product structures. One reason, according to bankers, is the distortion of markets caused by central bank quantitative easing programmes over recent years, which has tended to increase correlations and the volatility of multi-asset portfolios. In response, investors have sought engineered solutions that offer higher yields or more efficient hedges.

A TRUMP BASKET

In respect of the former, a popular trade in 2016 aimed to take advantage of an increase in dispersion in stock markets following the election of Mr Trump, with bond proxies tending to sell off and cyclical names outperforming. This dynamic also dampened index volatility against underlyings.

"Investors positioned based on the belief that Mr Trump would introduce massive investment," says Mr Agbo-Bloua. "We saw demand for significant sizes in notes as investors looked to take advantage of idiosyncratic scenarios which, for example, would see basic resources and mining do very well."

One product that saw high demand allowed investors to buy options on a three-month outperformance 'Trump' basket focused on the financial, healthcare and industrial sectors most likely to benefit from the president's planned $1000bn of infrastructure spending. The position was financed by a short position on the Standard & Poor's 500.

The US election was also followed by an increase in Treasury rates across the yield curve, and in recent months there has been an increasing focus on judging the timing of Federal Reserve rate rises. With the US economy showing signs of growing more slowly than previously expected, some investors see limited upside on bond yields and are concerned with managing the cost of carry and refraining from hedging too much and too early.

SG CIB has responded to demand for longer term rate positions with autocallable notes on five-year constant maturity swaps, which they sold through convertible note issuance. The reverse convertibles are one-year structured notes that pay a high coupon, so long as five-year or 10-year swaps rates remained above a strike level until maturity. Conversely, if the referenced swap rate drops below the strike before maturity, the holder begins to lose principal in proportion to »

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Adnane Asfalou

POLITICAL RISK

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the spread of the current swap rate over the initial swap rate until it hits zero.

Another trade enabled investors to take a view on rising correlations between US rates and equities; it was designed to profit from the combination of nominal bond yields rising and small-cap equities selling off, which is more likely if the Federal Reserve tightens interest rates quickly.

The election of Mr Trump had a knock-on effect for US trading partners, particularly Mexico, which saw an immediate sell-off in assets and sharp decline in the peso. Still, rising inflation expectations were offset by central bank moves to raise interest rates and there were positive impacts of the weaker currency, including an expected boost to tourism and increase in value of the $25bn-plus sent home every year by Mexicans living abroad. For many investors, the good news outweighed the bad, leading to an opportunity to go long Mexican equities through call spreads.

BREXIT EFFECT

While European and US elections have sparked much structured note dealflow in recent months, the biggest event in terms of market activity has been the Brexit vote, the implications of which will play out over the short and medium terms. With sterling under sustained pressure, bankers reported a surge in demand for notes that would allow investors to take cross-asset bets on the currency and stocks.

Nearly two-thirds of sales by FTSE 100 companies are from outside the UK, which makes the index a beneficiary of the pound's depreciation, while exporters also benefit from lower interest rates. Investors piled into positions that allowed them to bet on Bank of England easing and hybrid structures combining FX, rates and equities. Some also bought FTSE calls funded by the sale of S&P 500 calls, betting on the US index reaching a top as it traded near record highs.

Mr Asfalou says Brexit has been a huge source of demand for structured solutions, and that investors are looking to take views as much as one or two years out on whether there will be a hard Brexit and what that will look like.

"We have seen a lot of demand to position for moves in sterling against the euro and the dollar, buying covariance and wrapping complex pay-offs in fully funded instruments," he says. "Another popular structure anticipates a poor economic outlook that would lead to a strong fiscal reaction – enabling a hybrid structure that pays if the pounds falls against the dollar and gilt yields rise."

One challenge for SG CIB in providing hedges to a hard Brexit is limiting its own downside. For that reason, many of the products it has sold include a floor or limited pay-off. "A structured note is a funded instrument plus a derivative, and when the derivative is leveraged, there is chance that it will end up exceeding the value of the note itself," says Mr Asfalou. "Obviously the bank needs to protect itself, and one way to do that is put in a floor or mark-to-market triggers, such that if the value of the derivatives rises too much, the note is automatically unwound."

UNWIND PROVISIONS

In the past, investors have shied away from notes with floors or unwind provisions, but in recent months attitudes have started to soften. "We have seen more and more investors making themselves comfortable with features such as unwind triggers, which is a change in mindset for the market," says Mr Asfalou.

"Investors now are willing to put in a lot more effort and due diligence to understand the value of the derivative, and what drives pay-offs and performance. At the same time, the bank spends a lot of time researching target returns and deciding which products are suitable for each category of client."

Given the plethora of structures, asset classes and coupons offered over the past year, some trades have naturally fared better than others. European equity dispersion trades have tended to perform well; the perception of rising political risk, combined with expectations for faster inflation and growth, has lead to a sector rotation and bets that single stock volatility will outperform index volatility. In the US, reflation and fiscal easing expectation have pushed stock dividends higher, benefiting investors that had sold index puts.

Still, some bets did not work out. The many investors that bought June 2017 France's CAC index, funded by selling of June 2017 FTSEMIB (Italian index), were caught out by a strong rally in the Italian index which forced many into short covering. Equally, some of those that bought equity volatility in the US were bewildered by recent months' collapse in price moves, which saw the VIX volatility index trading at record lows. Equally, many of the stocks that performed well post-US election have consistently underperformed since January, a phenomenon now known as the 'Trump slump'. TB