Buyside Commentary

What a Difference a Day Makes

"A person often meets his destiny on the road he took to avoid it." —Jean de la Fontaine

BY RICH HAWORTH

Several major events that transpired in 2016 are being discounted as insignificant. However, the question remains; were last year's happenings the flapping of butterflies' wings that will cause a hurricane elsewhere in the not too distant future? Facts are often overlooked by markets until they're big and staring at it, and even then, some investors refuse to face reality until the data has smacked them right in the face.

Quite often small clues are hanging around before they enter the consciousness of the market and become very big. Opportunity abounds when small facts become big facts, and anticipated uncomfortable scenarios finally become reality. On June 23, 2016 two important events unfolded within the U.K.: The Glastonbury Festival kicked off with record amounts of mud, which aided the sale of gumboots in the Realm, and residents went to the polls to vote whether to remain in or leave the E.U. This is one seed sown in 2016 that if the crystal ball was clear, investors would be buying volatility and portfolio protection for potentially adverse outcomes.

If Brexit was a warm up, then the success of President Donald Trump in the U.S. elections looked like it was going to be the main event for the long awaited deliverance for long volatility investors. "The birth of a new fact is always a wonderful thing to experience" (Pirsig, Zen and the Art of Motorcycle Maintenance, Pg 314), and the election night marked a seismic shift in risk sentiment. The expectations of large downward moves were squashed the next day as markets completely shrugged off the news. The lack of volatility was the final sucker punch to the last bearish holdouts, and a capitulation has commenced, with intense bullish pressure likely to continue into 2017.

The biggest predictor of future human behaviour assumes consistency with past behaviour. Trump is the double-down king and a casino mogul; although all four of his recent casino enterprises have gone bankrupt, but who's counting? He is now in control of the world's biggest casino. We've given the keys to the printing press to a man who has defined his career with debt and leverage, so why expect anything different of him when he's president. It's binary: Leverage and success or leverage, bankruptcy and then restructure.

If the facts out there that can potentially negatively affect your life but insurance is expensive, then c'est la vie… However, while insurance is on sale, take action. Due to the last year or two of sideways price action in major equity markets, directionality has become cheap. On the back of this, volatility levels are also low, and this is creating interesting asymmetric value opportunities. The underlying macro environment is unstable although higher inflation, increases in government spending, lower taxes and excess liquidity are all tailwinds for the year ahead. Investors are able to position for a continuing bull market while protecting the downside with uncorrelated and convex positions with lower than usual portfolio drag.

These days the swans aren't only black and grey; there is an orange one, and perhaps next year there will be a red, white and blue (tricolore) swan. Global macro risks are increasing while the cost of portfolio insurance is decreasing. There is an illusion of stability. Are past and future events being correctly discounted?

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Positive Expected European Growth Reinforces SX5E Call Spread Attractiveness

Growth expectations in French and German equity in the short-term is reinforcing the attractiveness of Euro Stoxx 50 call spreads.

Société Générale recommended late last year that investors should buy the SX5E June-17 call spread with strikes at 3150-to-3350. German and French equity make up around 70% of the SX5E's constituents, explained Vincent Cassot, head of equity derivatives strategy at Société Générale in Paris. He added that the trade is now "making comfortable profit [for those who initiated the trade] from 84.7 to 183.5 today." He added that the trade is still considered attractive despite the busy political agenda.

Although some market participants have expressed concerns by the potential for political events to increase market volatility this year, many strategists agree 2017 could be the best in terms of European earnings. This is due to the SX5E being more representative of global growth than the U.S., according to strategists. Europe is benefiting from rising global inflation; the Euro Stoxx Banks Index has risen by around 20% since November 2016. This is contributing to a big sector rotation in equities, triggered by the U.S. presidential election.

Praveen Singh, strategist, global asset allocation at Société Générale in Bengaluru, told EQDerivativesthatFrance and German equity offers better return relative to U.K. equity in a historical context." Referring to a recent client note, he added France and Germany are the preferred countries in Europe when looking at the difference in the cost of capital of two countries and how this compares with the historical average.