Fighting The Next War With Emerging Market Equities

Your loyal correspondent spent a good deal of his time as a graduate student in international affairs in the mid-1970s with Washington defense intellectuals, several of whom were superannuated Cold Warriors and several of whom would go on to become, for better or for worse, household names over the next three decades. As the Soviet Union was still a military colossus and the U.S. was mired in its Vietnam hangover, the assembled Strangeloves spent a good deal of time worrying about what would happen when the Big One hit. This left at least one youthful participant wondering what difference any of their plans would make as we all would be Crispy Critters or worse if things got out of hand.

So it is with financial crises. You can spend a lot of time worrying about what will happen during the next crisis, as if it will have similar characteristics, causes and ultimately cures as the last one. Even if investors and traders do not do this on their own, they find the playing field has been changed for them. After all, the history of financial regulation is nothing but a series of measures enacted in the aftermath of one crisis that offer little in the way of preventing the next crisis.

Some markets become poster children for financial crisis, or what we might call the "risk-off" portion of the risk-on/risk-off cycle. Emerging market equities certainly fit that bill. Rightly or wrongly, no one advises clients to up their exposure to Indonesia, Malaysia, Mexico, Brazil, et al, once the shooting starts.

Crisis Experience

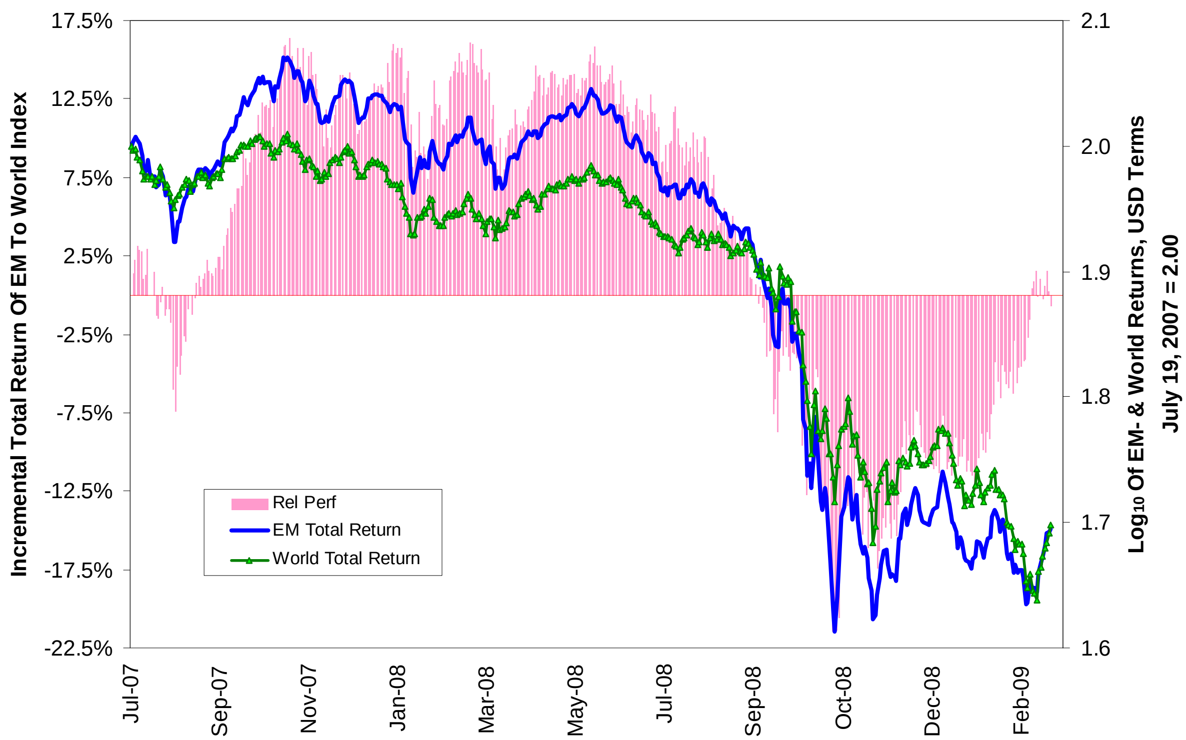
Let's build on last issue's narration of how the Eurodollar market traded through the July 2007 – March 2009 financial crisis (see "Fighting The Last War In The Eurodollar Market," November 2014) by comparing how the MSCI-Barra Emerging Market Free (EM) index traded relative to the MSCI-Barra World Free index over the period.

This history is surprisingly simple. The first phase extending to May 2008, the post-Bear Stearns relief rally, was characterized by strong EM outperformance and stable implied volatility. It may seem almost impossible to believe seven years later, but emerging markets outperformed the World index through the August 2007 European Central Bank backstopping of BNP-Paribas and the Federal Reserve's first rate cut en route to its zero percent interest rate policy (ZIRP) by December 2008 and through the Federal Reserve's second rate cut in September 2007. This outperformance started to shrink in May 2008 but did not disappear entirely until Fannie Mae and Freddie Mac were placed into receivership in September 2008.

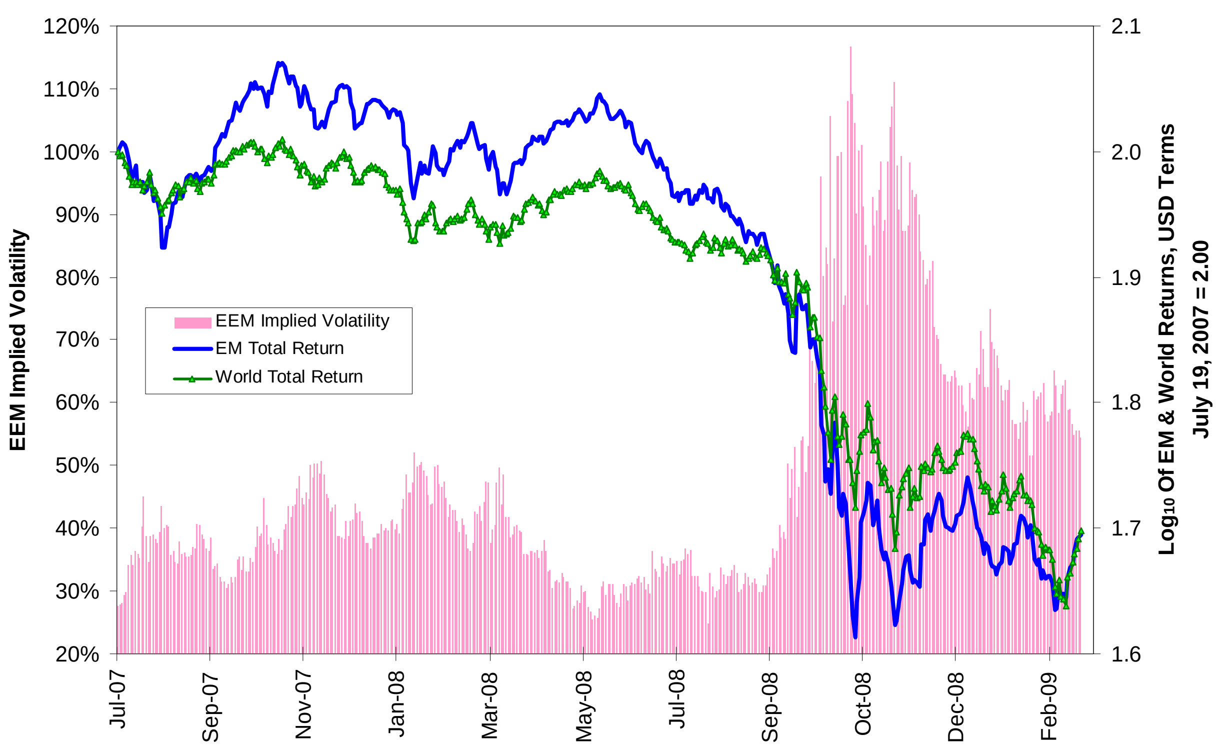
Once the crisis heated up to and through the boiling point with the bankruptcy of Lehman Brothers, the bailout of AIG, the disappearance of Merrill Lynch into Bank of America and the passage of TARP, emerging markets underperformed and underperformed strongly. The implied volatility of the index almost tripled during this period, but this was not unusual given the spirit of the times. After all, the VIX went from levels under 20 in late August 2008 to almost 90 in October 2008. This is the part we remember as it was a risk-off trade in the midst of other risk-off trades.

The third and final phase extended into the beginning of the QE era and was marked by a normalization of incremental returns and a halving of implied volatility. By the first week of March 2009, the EM index had outperformed the World index from the July 2007 onset of the crisis onwards. That outperformance would grow through the third quarter of 2010 as the adoption of quantitative easing in the U.S., U.K. and Switzerland in March 2009 opened up some strong carry trades into those markets.

World & Emerging Market Returns During The Financial Crisis



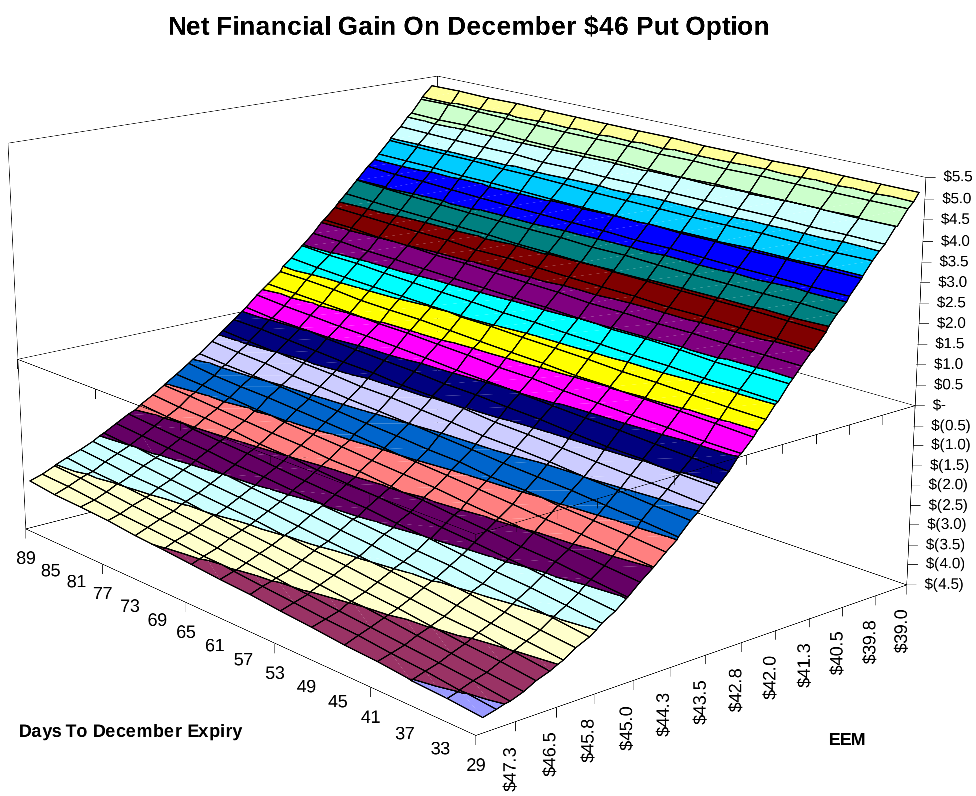
World & Emerging Market Returns & Volatility During The Financial Crisis

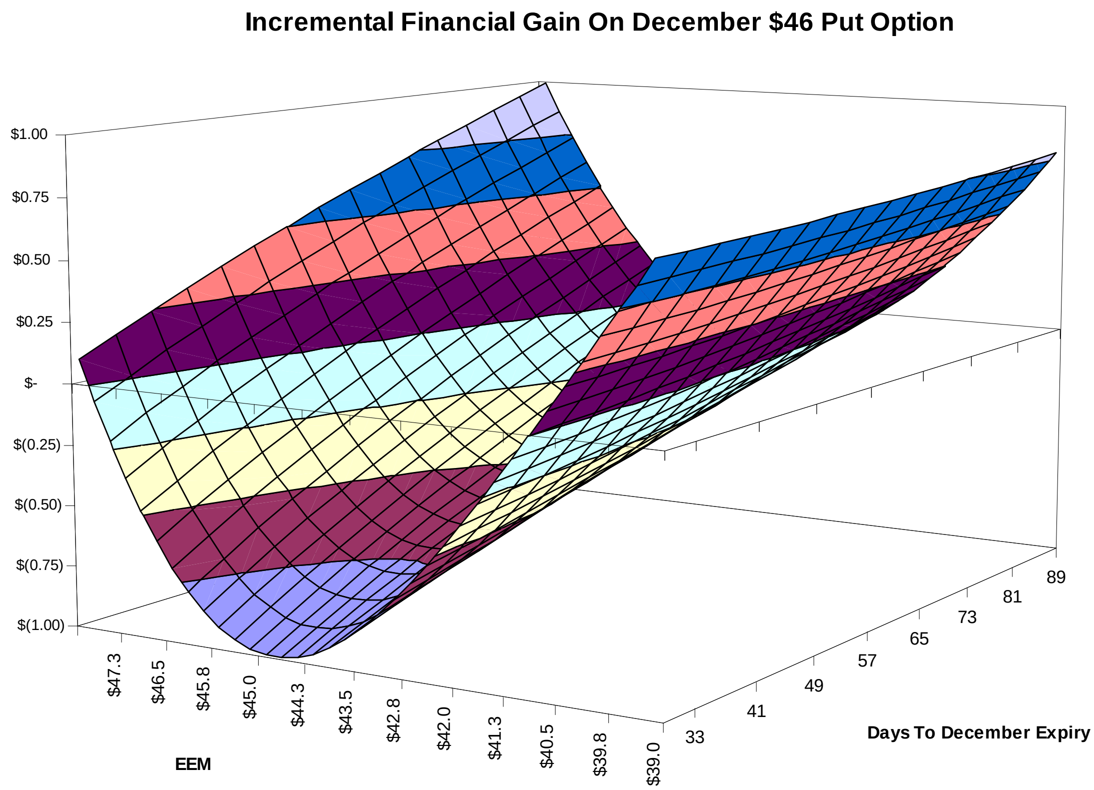


Current Environment
The markets retain their fast-twitch reflexes when it comes to emerging markets. This was seen in January-February 2014 as the tapering of QE in the U.S. was greeted some yen and dollar carry trade unwindings, and in that order. Japan flooded the world anew with cheap yen in November 2012 and again in April 2013, and despite their best-intentioned efforts to destroy their own currency, the yen remained stable as deflationary pressures in Japan offset its monetary expansion. The EM index slid 8.45 percent from the end of 2013 to February 5, 2014; the World index retreated 5.23 percent.

Ours is not to bemoan this response but rather to take advantage of the quick-selling response. The optimal short position on 100 shares of the iShares MSCI Emerging Market Equity ETF (EEM) calculated by the Dynamic Option Selection System (DOSS, see "Using Options The Spec Way," July 1994) on September 19, 2014 was a straight in-the-money put option position of buying 1.4 December $46 puts.

This trade is gamma-positive and as an in-the-money trade will shift quickly into an excess delta situation. Its net financial gain across a range of EEM prices and time remaining to the December 2014 expiration is depicted immediately below. The incremental gain relative to the base case of simply going short the EEM is depicted in the second chart below.





As always, the zone of maximum underperformance occurs within a flat to slightly higher price environment. Oddly, that was the price environment prevailing during the first phase of the financial crisis, from July 2007 through May 2008. Whether this experience will be duplicated in the next crisis, whenever that will arrive, is unknown and unknowable. However, given traders' propensities for fighting the last war and the observed patterns of quick EM selloffs since the financial crisis, the DOSS trade's downside leverage is likely to come into play fairly quickly should the "risk-off" light start shining bright.