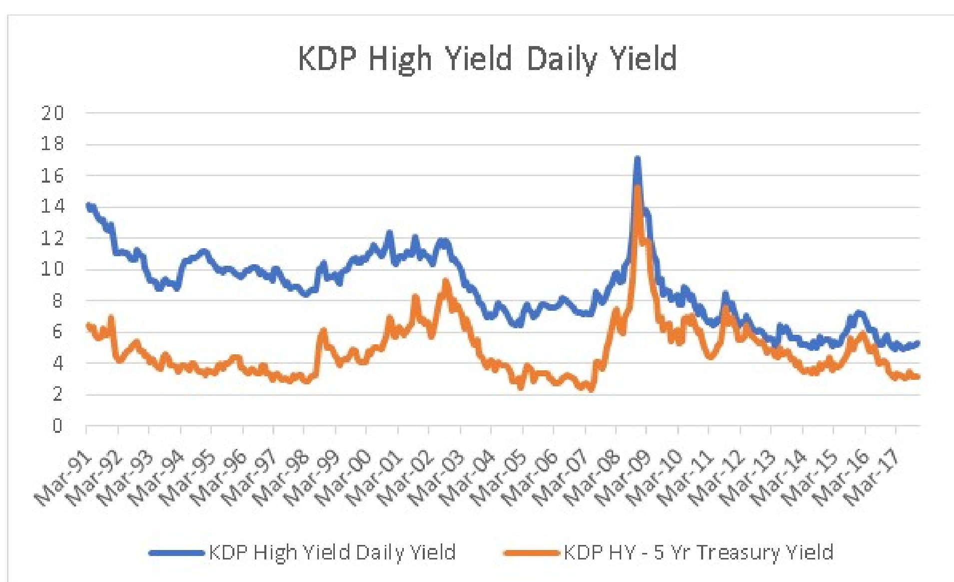
THE SHORT SELLING CYCLE AND ITS PROFIT CENTRES

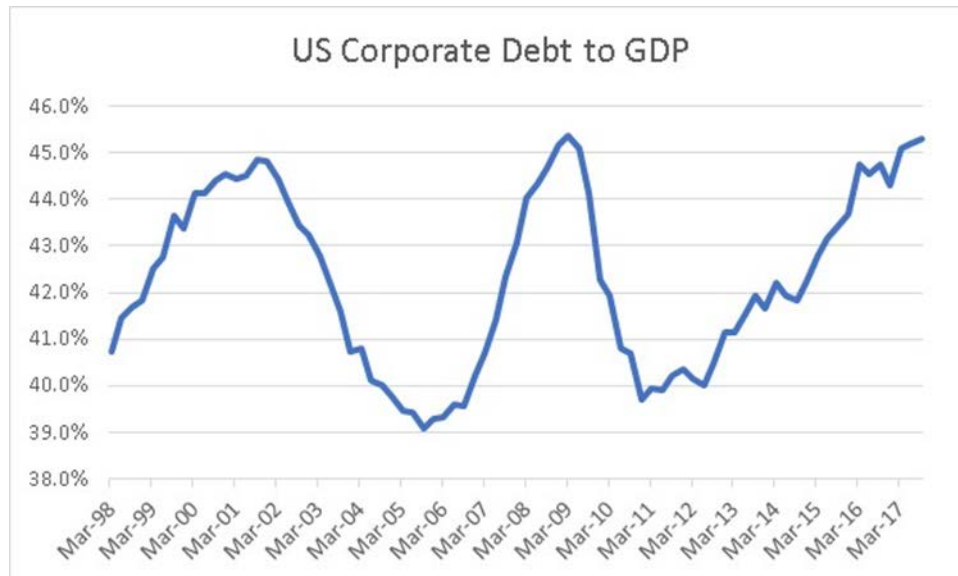
There are three profit centres of short selling: the profits or losses from the movement in the share price; the cost of carry; and foreign exchange gain. All three of these profit centres have been headwinds for the last few years. The intriguing aspect for me is that all three separate profit centres are beginning to show signs of turning from headwinds to tailwinds, and making the outlook for short selling favourable.

The first profit centre is the easiest to understand. A short seller will borrow shares from a long-term owner (most likely a passive fund these days). They will then sell those shares in the market, and receive cash in return. If the shares fall in value, then the short seller can buy back the shares and return them to the owner, and pocket the difference.

Most people view expensive valuations as a sign to short sell, this is not always the case. Far more important is the credit cycle. When the credit cycle is extended, and credit is cheap and starting to get expensive is typically the best time to contemplate short selling. High-yield bond yields are at very low levels both in absolute terms, and relative to five-year treasury yields. Yields are no longer falling.

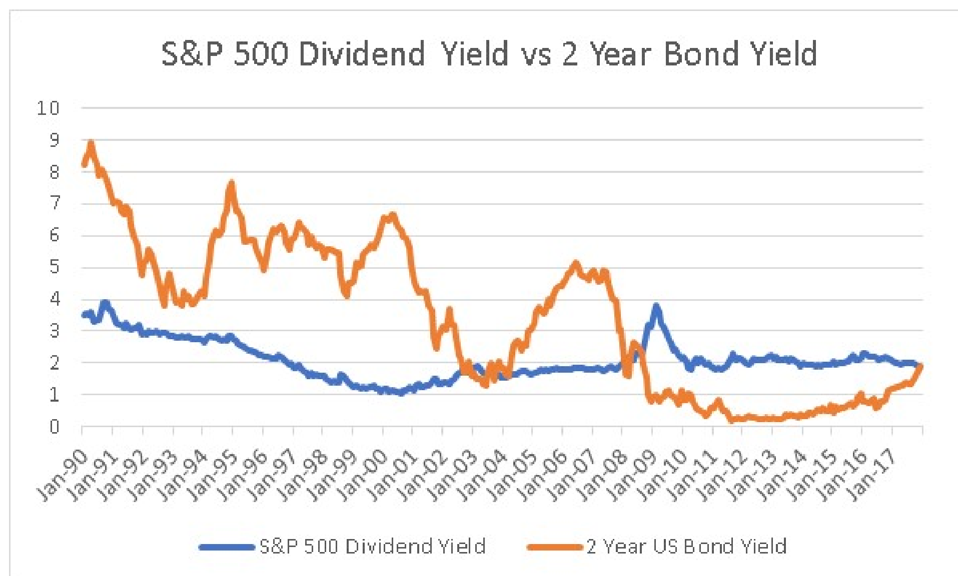


While low yields are a sign of loose credit conditions, we can also see US corporate debt to GDP has returned to levels seen at the top of the last two cycles. Equities tend to suffer when credit cycles turn.

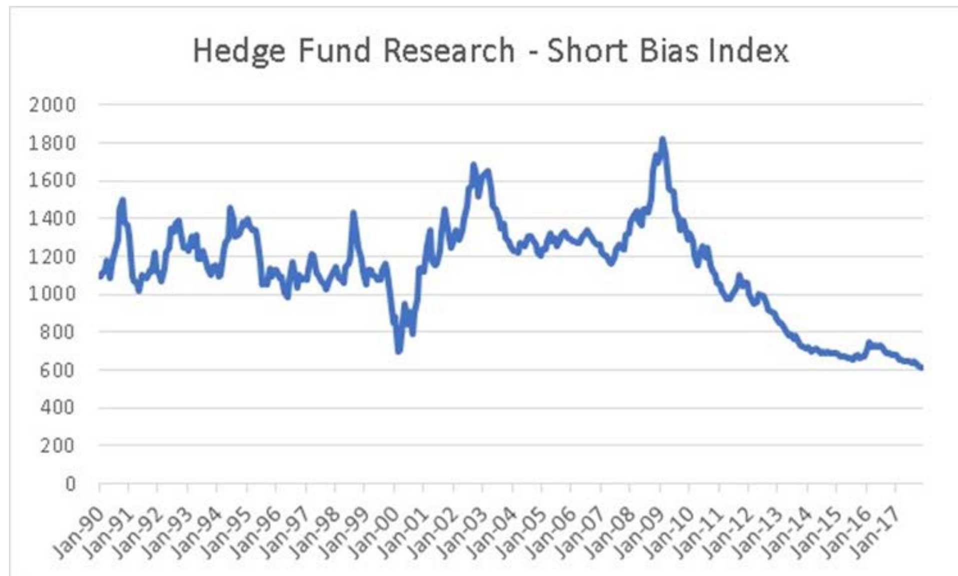


The second profit centre is the carry generated on short selling. A short seller can receive interest on the cash they receive on short selling shares. If the interest they receive is higher than the fee they pay to the borrower and the dividend on the stock, then they will generate a positive carry.

The very low rates since the financial crisis have made the carry cost of short selling very high, and in my view has been the main driver of the huge deterioration of the performance of short selling. Since 2008, the 2 year treasury yield has fallen below the yield on the S&P 500. However, the recent rally in the S&P and rise in bond yields is beginning to make the short selling carry attractive again.



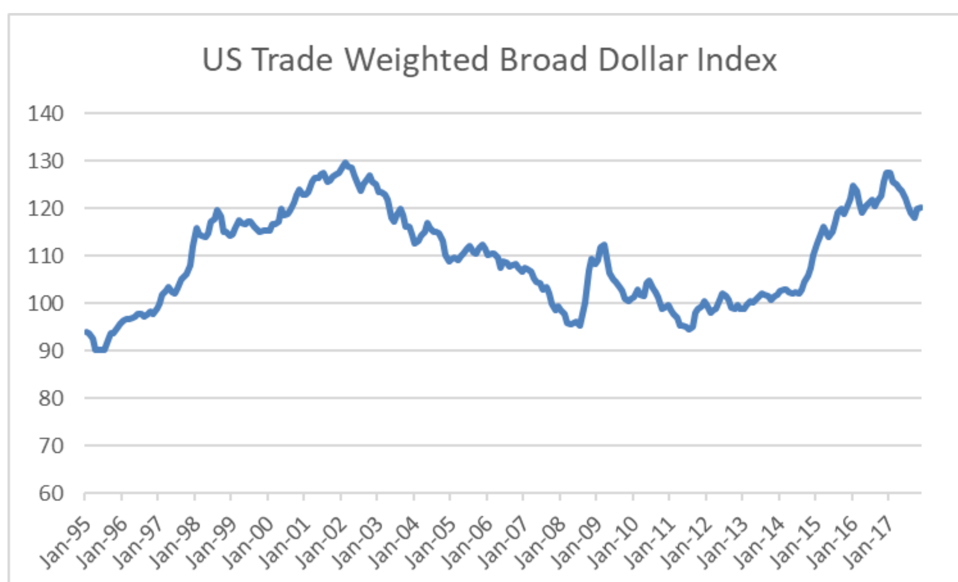
Historically, the carry trade has been a huge support for short selling funds. The loss of the carry trade has had an extremely detrimental effect on short bias funds, as can been seen from the HFRI – Short Bias Index.



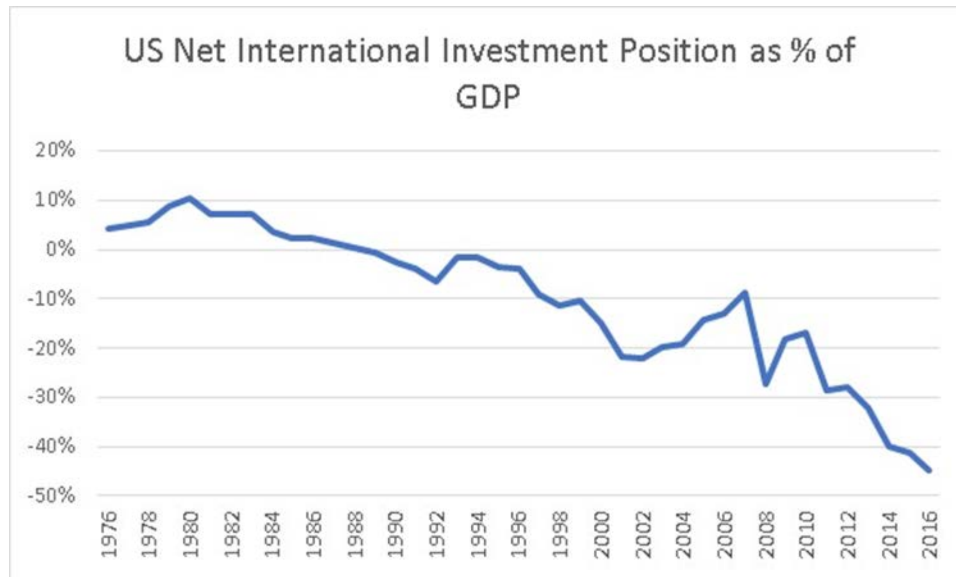
The third profit centre is potentially the most difficult to understand, but also in periods of crisis, the most lucrative. It is best understood through a worked example. For a USD based fund decides to short sell a Japanese auto maker, listed in Japan. The shares that the fund borrows are a Japanese yen liability. The cash received from the selling the shares will be a Japanese yen asset. So at the moment of short selling – before the shares change in value, the fund will have a no currency position in the Japanese yen at all – the asset and liability will exactly match. The fund then has a choice of whether to hedge the cash received or not. In my view, this decision depends on what you think the currency will do when the trade plays out.

If you are shorting Japanese auto makers on a view that the US auto loan cycle has topped out, then more than likely the yen will be strengthening against the dollar at that time, and hence you don't want to hedge. As the Japanese auto stocks fall, the size of Japanese liability (the shares you have borrowed) will be shrinking in value, while your asset (Japanese yen cash received from selling shares) will be rapidly rising in value in dollar terms. For example, the US listing of Toyota fell 50% in 2007/8, while the domestic listed stock, 65%. The dollar profits of a short position in Japan would be even larger in USD terms as the yen rallied from 120 to 90 over the same period.

Given the vast amount of hedge fund money is USD based, a strong dollar in general reduces returns to short selling. The dollar has generally been strengthening since 2012, reducing returns from short selling



As pointed out in a recent note, the US International Investment position has deteriorated to such a level, which implies weak dollar is likely, and dollar weakness has become apparent lately, even with higher interest rates in the US.



Short selling as a hedge fund strategy has been in serial decline since the halcyon days of 2008. However, the structural drivers of the decline now look to all be turning.

INFORMATION

Issue Date:	4th January 2018
Source:	Bloomberg, unless otherwise stated

Investor Relations:	Alain Zakeossian, Samantha Dunn
Email:	info@horsemancapital.com
Telephone:	+44 (0)20 7838 7580
Website:	www.horsemancapital.com

Business and registered address: Horseman Capital Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

DISCLAIMER

This Market View has been prepared and issued by Horseman Capital Management Ltd (the "Firm") authorised and regulated by the Financial Conduct Authority. It has been approved as a financial promotion by the Firm and as such is intended **for professional clients and eligible counterparties only and is not intended for retail client use**. It is not intended for distribution to any country where such distribution or use would be contrary to local law or regulation.

This Market View is provided for information purposes only and should not be regarded as an offer to buy or sell any investments or related services that may be referenced herein. No guarantee is made as to the accuracy of the information provided which has been obtained from sources believed to be reliable. The view expressed in this Market View are the views of the portfolio manager at time of publication and may change over time. Nothing in this Market View constitutes investment, legal tax or other advice nor is it to be relied upon in making an investment decision. No recommendation is made positive or otherwise regarding individual securities mentioned herein. Past performance is not indicative of future performance. The price of investments can go up as well as down and can be affected by changes in the rates of exchange. The information contained in this document is strictly confidential and is intended only for the use of the person who has been provided the Market View by the Firm. No part of this Market View may be divulged to any person, distributed, resold and or reproduced without the prior written permission of the Firm.