

SEMICONDUCTORS, KOSPI INDEX AND SUPPRESSED VOLATILITY



Russell Clark's
Market Views

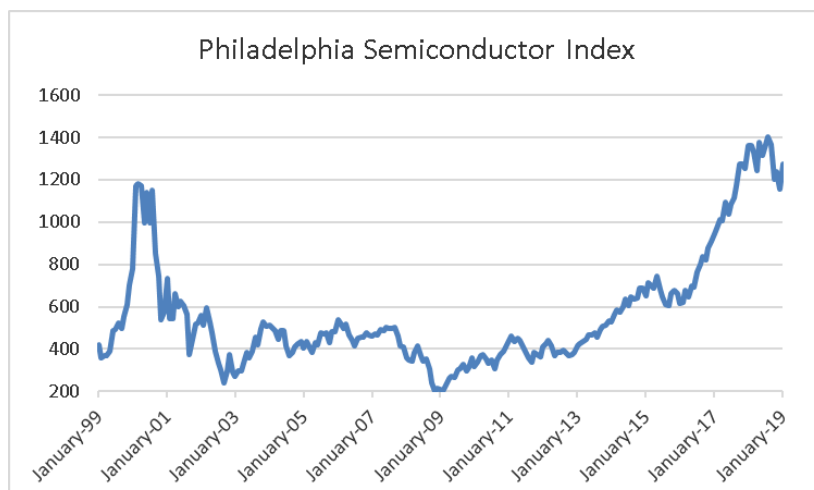
“Historically, the supply and demand of autocallables has been kept in check by rising markets. Could this be about to change?”



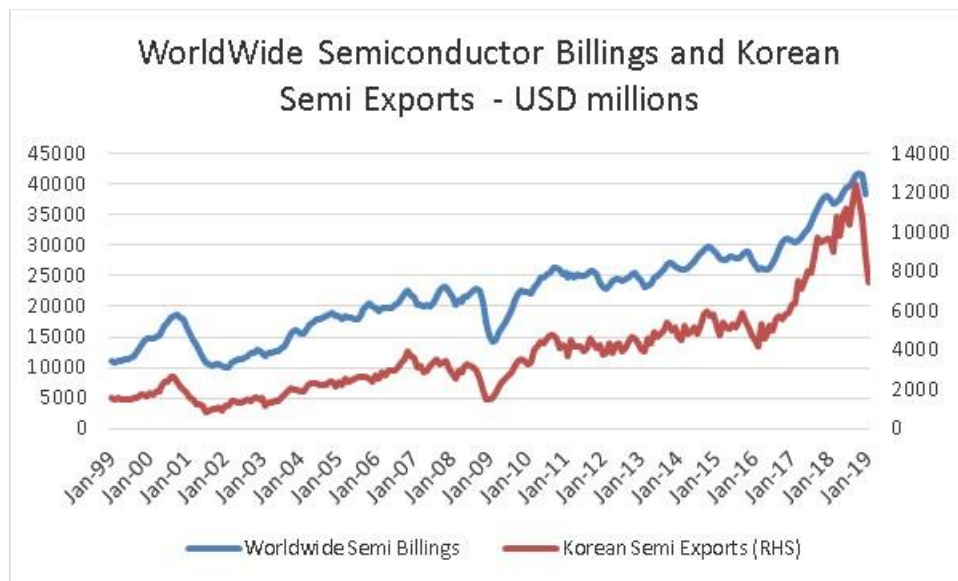
The KOSPI 200 Index like many other equity indices suffered a severe sell-off in Q4 followed by a rally so far in 2019.



Reasons for the resilience of the KOSPI 200 Index are in some ways not hard to find. Semiconductor companies make up the largest single weighting of the KOSPI. Another more widely followed semiconductor index, the Philadelphia Semiconductor Index (SOX Index) also had a weak Q4 followed by a strong rally in 2019.



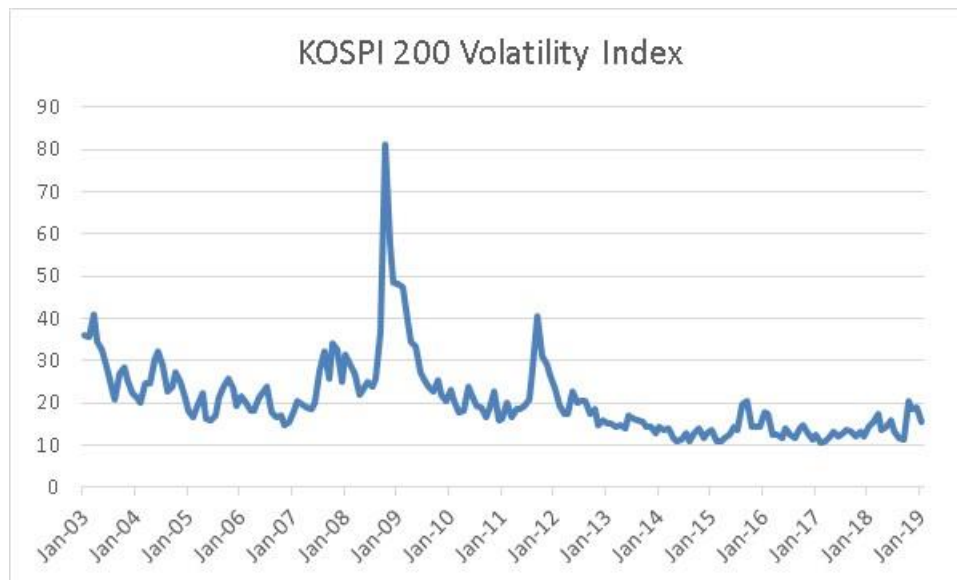
According to the SIA, worldwide billings for semiconductors were at an all-time high in November. December showed some slowdown. In the table below we have added Korean semiconductor export data, which is timelier, with January data added.



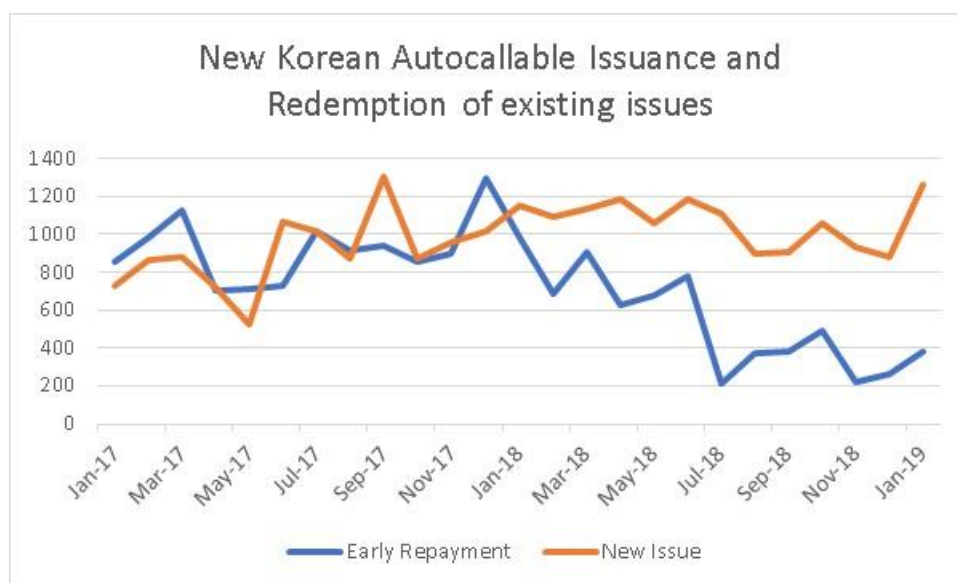
If we look at year on year growth of semiconductor exports from Korea, we can see Korean semiconductor exports have gone from 50% growth to contraction over the last year. The previous periods that have seen such a move were 2001 and 2008.



Bullishly minded investors could look to an indicator such as the Korean Volatility Index which is at very low levels. In my view, the possibility of a major slowdown in semi sales is not priced in at current levels of implied volatility of 14. In prior slowdowns a level twice as high has been seen in Korean volatility markets.



However, my view is that Korean volatility is been kept subdued by a large increase in the amount of autocallables outstanding. We can see this from the NICE P&I annual review of Korean Autocallables; the review gives the number of new issues, as well as existing issues that have been redeemed. Redemption occurs when the underlying index rises above an upper barrier. As markets have been weak over the last year, fewer redemptions have occurred, implying a substantial increase in outstanding autocallables. This would imply not only increased downward pressure on the price of volatility, but also a substantial increase in hedging needed for these products or volatility selling.



Historically, the supply and demand of autocallables has been kept in check by rising markets. If the market rises over an upper barrier, old autocallables are redeemed, reducing supply from the market, alternatively they can be cancelled by being “knocked in” (a situation where the underlying investor no longer receives a yield, but the underlying index is at current value). The lower barrier is usually between 25% and 40% below market levels and if “knocked in” the buyer of the autocallable will lose capital equal to the fall in the index.

In my opinion, the market has become overburdened with autocallables. In the short term they tend to reduce volatility of the underlying market. But if the current deterioration in the semiconductor market continues, then the resulting fall in the KOSPI Index is likely to see autocallables “knocked in” and the pressure on Korean volatility disappear, the resulting rise in Korean volatility will likely lead to significant rise in the price of volatility.

INFORMATION

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