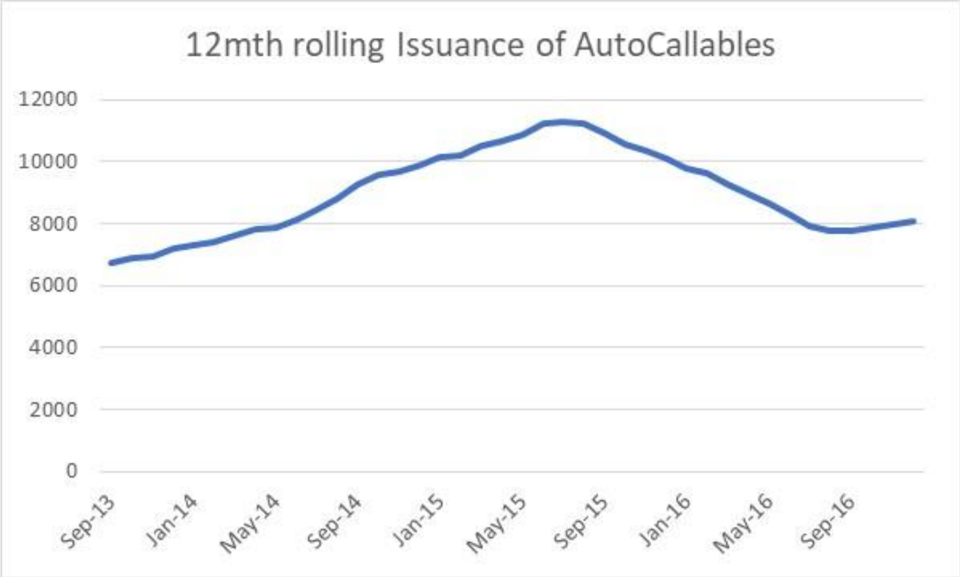
AN AUTOCALLABLE BUBBLE

Russell Clark's
Market Views

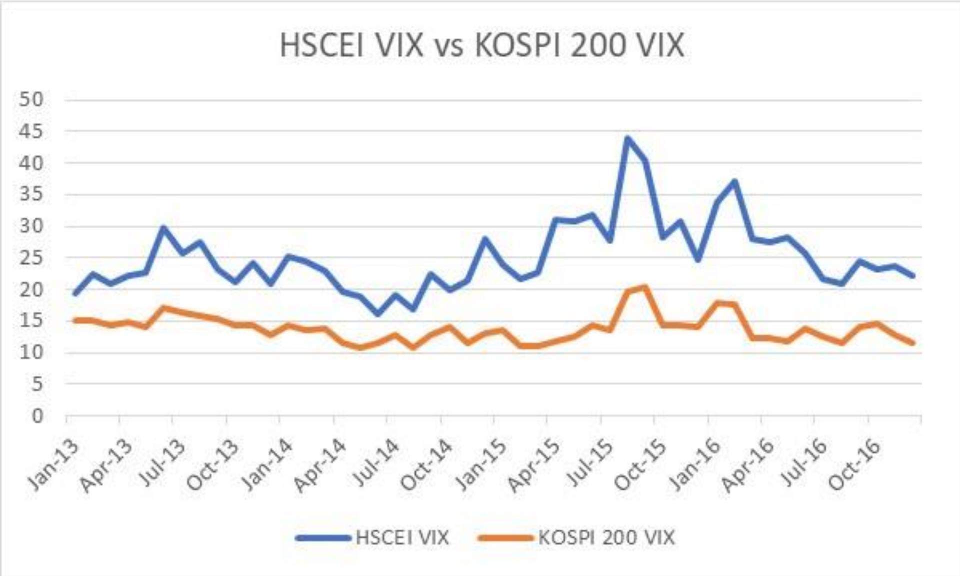
"Dividend futures tend to track equities closely, so their divergence can indicate an autocallable bubble."

In late 2014 the Chinese government reacted to slowing growth and debt concerns by stimulating the Chinese equity market. The Hang Seng China Enterprise Index (HSCEI) rallied by nearly 40% over 6 months.

At the time the Korean autocallable market was beginning to expand rapidly, with issuance nearly doubling from 2013 to mid-2015.



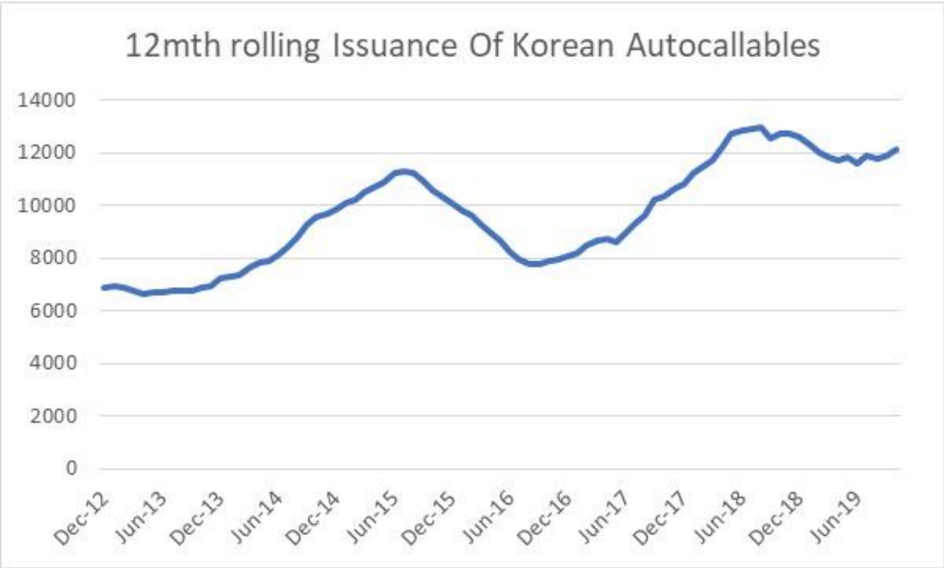
According to the Nice P&I Fixed Income SemiAnnual report for 2015 (note: Korean retail investors consider autocallables a fixed income product) HSCEI was included in 70% of issued autocallables in the first half of 2015. The reason for this was that HSCEI was seen as being supported by the Chinese government while offering substantially higher implied volatility than the KOSPI 200 (note: autocallables sell volatility to generate yield).



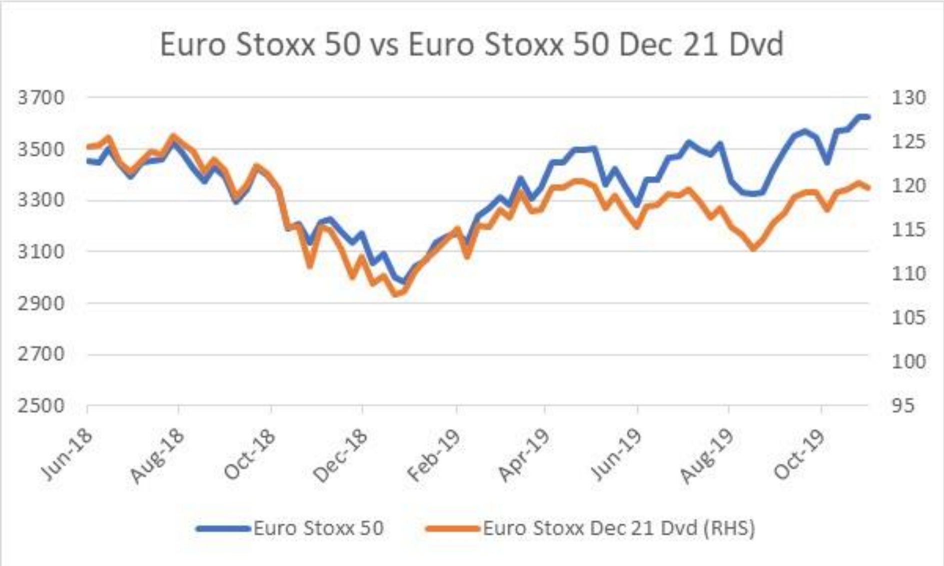
The subsequent decline in the HSCEI in 2015 to early 2016 caused many of the autocallables to lose substantial capital. This partly cause a significant drop in issuance, as many Korean brokers and investors suffered substantial losses. The issuance of autocallables causes volatility selling, which causes volatility targeting strategies to raise equity allocations, therefore autocallable issuance is positive for the market in the first instance. However, it sometimes helps to create a bubble in equities that can subsequently burst, like HSCEI did in 2015.

One way to distinguish between a genuine bull market and autocallable bubble is to look at dividend futures. In addition to selling volatility, autocallables pay their clients yield from dividend received on the underlying index. If dividend futures are not moving higher with equities, then it can be sign that it is in an autocallable bubble. Dividend futures tend to track equities closely, but in an autocallable bubble they diverge, as can be seen in May 2015.

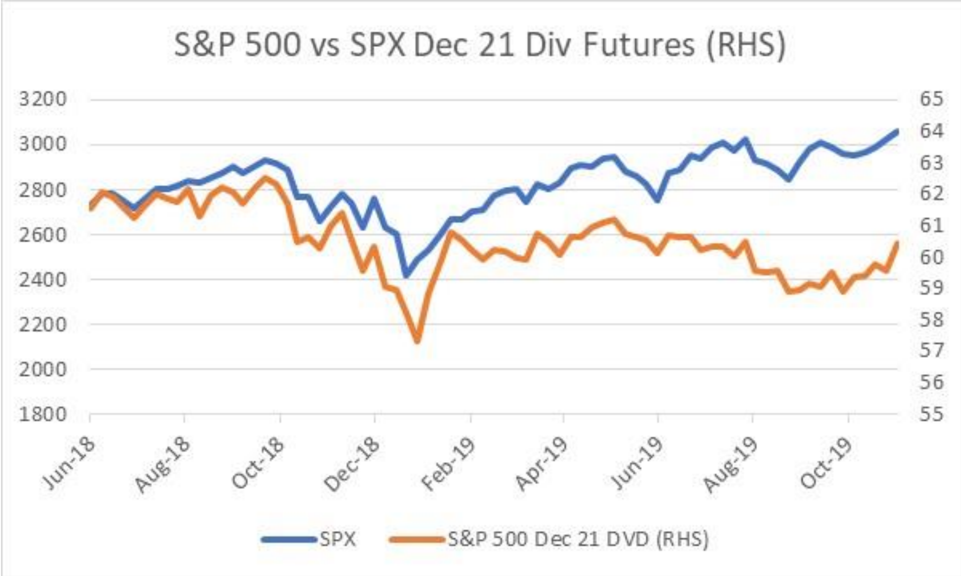
Korean issuance of autocallables is running at record levels, above the levels seen in 2015, and has been doing so for three years.



According to NICE P&I October Fixed Income Report, the two most popular indices for autocallables were the Euro Stoxx 50 and the S&P 500. We can see that recently that Euro Stoxx has begun to diverge from its dividend future.



Recently the S&P 500 has started to trade much more strongly than would be implied by dividend futures.



The most noticeable feature of the HSCEI, Euro Stoxx 50 and S&P 500 is that the dividend futures for all these markets peaked in early 2018 and have yet to move to new highs. The divergence of the S&P 500 and Euro Stoxx 50 to their dividend futures will need to be resolved through either rising dividend futures, or by lower markets. The risks of an autocallable crash in the Euro Stoxx 50 and the S&P 500 are rising.

INFORMATION

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