Concerned about Share Prices?

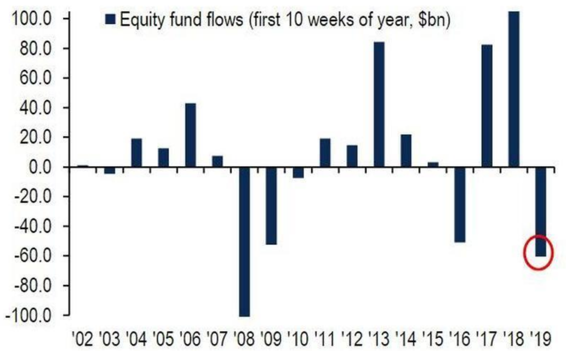
17th April 2019

You can't predict the markets right? Well maybe not, but there are times when the probabilities favour one outcome over another. We may be seeing one such situation at the moment in US equities.

Consider the following:

- The current bull market has been running for 10 years
- Investors are net sellers of US equities but this is being more than offset by Trump tax cut driven company buy-backs. We are now facing blackout where companies cannot buy back their stock whilst 1st quarter reporting is underway.
- Investors' expectations of earnings growth are demanding with valuations stretched. The price to book ratio of the S&P 500 is around the highest since the early 2000s
- An increasing number of IPOs have negative earnings
- Volatility of the S&P as measured by the VIX is at a low 12.01
- The S&P 500 has risen 24% since the end of December 2018
- Recent rise in the probability of a US recession

Chart 1: Worst start to year for equity flows since 2008



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

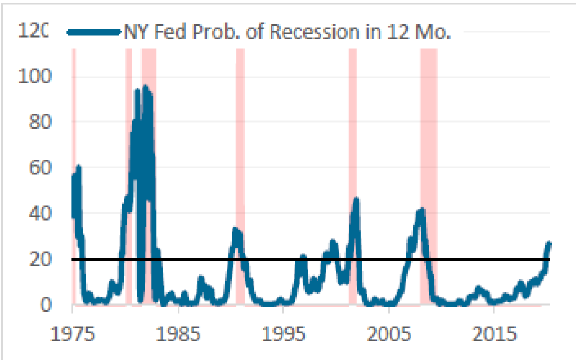
Decomposing demand

Net US equity demand ($ billions)

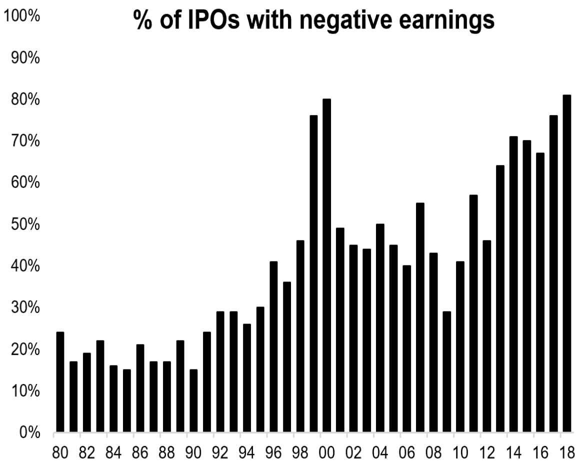
Category	2014	2015	2016	2017	2018
Corporations	$ 442	$ 508	$ 697	$ 296	$ 509
Households	95	(138)	(151)	226	191
Life Insurance	(5)	31	98	(45)	(18)
Foreign Investors	114	(191)	(188)	125	(94)
Mutual Funds	95	58	(112)	(134)	(124)
Pension Funds	(272)	(7)	(217)	(162)	(243)
Other	12	(7)	(12)	(17)	9
less					
Foreign equities by US	432	197	22	167	128
Credit ETFs	50	57	96	123	100
Included among holders above are:					
Equity ETF purchase:	$ 191	$ 174	$ 188	$ 347	$ 210

Source: Federal Reserve Board and Goldman Sachs Global Investment Research.

Figure 4: Recession Prob. Above 20% – Red Flag or Red Herring?



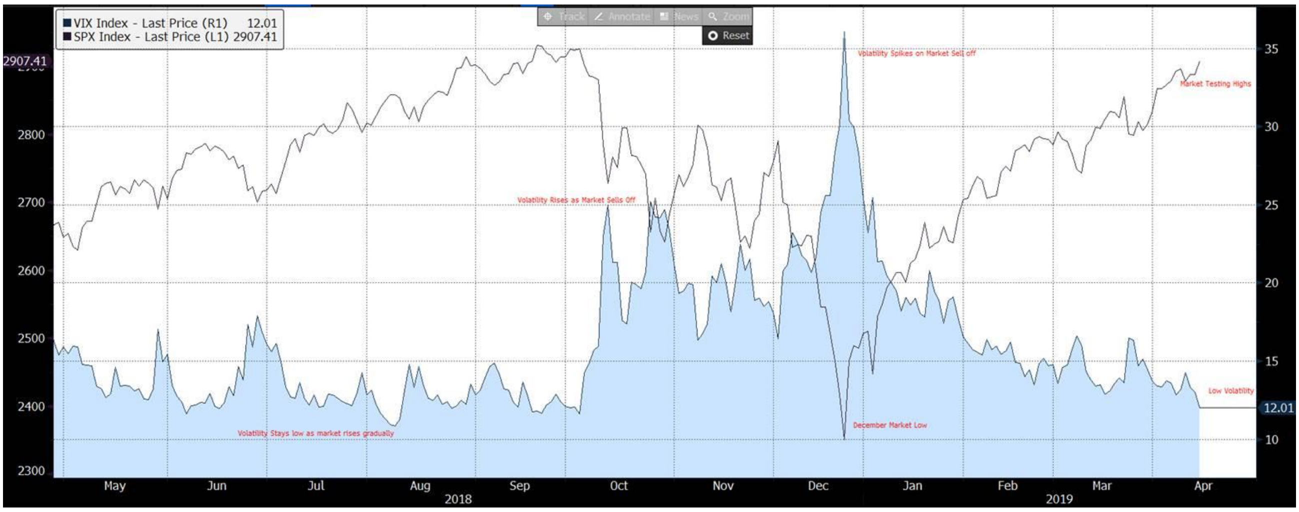
Source: Bloomberg, BTIG



Source: Topdown Charts, Jay R. Ritter   topdowncharts.com

Is there a way of hedging equity exposure against a fall in the market such as the 20% fall that occurred between October and December 2018?

One way of achieving this is to buy put options on the S&P Index. The key to option pricing is volatility. The VIX is a measure of the theoretical expectation of stock market volatility in the near future (30 Days). When the VIX is low, as it is now, option prices are low.



The 20 Dec 2019 270 put cost 7.07 on 12 April 2019 (Implied Volatility of 16.27%)

The table below shows the option prices at different volatility levels.

Volatility	Price
15.00%	6.01
16.27%	7.07
20.00%	10.07
30.00%	18.74

Strategy

Put options on the SPY (ETF: S&P 500 Index tracker) will increase in value if share prices fall and volatility increases making this a good broad hedge for US equities and for any equities that have a high correlation to the US equity market including Australia.

10 contracts of 270 SPY Puts expiring on 20 December 2019 will give you the option to sell USD 270,000 worth of equities at around 93% of the current price.

The cost of this "insurance" would be USD 7,070 or 2.62% of the amount hedged.

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