Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

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Markets in High Resolution

Tail Trades for a Spooky October

October is littered with landmines:

- A break in U.S.-China trade relations
- The end of "one country, two systems" in Hong Kong
- A hard Brexit
- U.S. recession
- Impeachment of President Trump

But we can't go around hedging every potential risk that emerges. I'm more worried about some than others. Given a still generally benign view of the underlying fundamentals, **a targeted tail-hedging strategy should prove superior to assuming the full portfolio fetal position**.

Impeachment Risk

I addressed impeachment last week. While it is likely the House will impeach, the odds of a conviction in the Senate are close to zero. The net effect of the process will be to destroy the Biden candidacy and drive Republican turnout in 2020 through the roof. **Impeachment-driven market sell-offs are tactical buying opportunities**. (P.S. Trump poured gas on the impeachment fire today by commenting that both Ukraine and China should investigate the Bidens. Markets rallied on the comments).

Recession Risk

I'd also discount the risk of U.S. recession, so long as the Fed continues on the proper course. My call at the outset of the Fed's easing campaign (The Fed: Shackled at Neutral, 7/17/19) was that 1 or 2 rate cuts would be sufficient to overcome the extant "uncertainty" (which is clearly not exclusive to trade policy) and re-establish the neutral Funds rate that they so blithely overshot. I'll tweak that in light of subsequent bond market performance: **three rate cuts will probably get the Fed back to a sub-neutral rate**. Four would be even better.

The yield curve usually starts to dis-invert once (or shortly before) the Fed starts to ease. The problem in past cycles is that the Fed let a tight monetary stance (as evidenced by an inverted curve) fester for an extended period before acting. **Yield curve inversions into the past three recessions were considerably longer in duration than we have yet witnessed** in this cycle:

Treasury Curve (10y-1y) Inversions: Number of Weeks Flat / Inverted

	1989	1999	2006-2007	Current
sub-10 bps:	40	47	76	23
sub-5bps:	32	37	72	13
Inverted:	32	37	67	10

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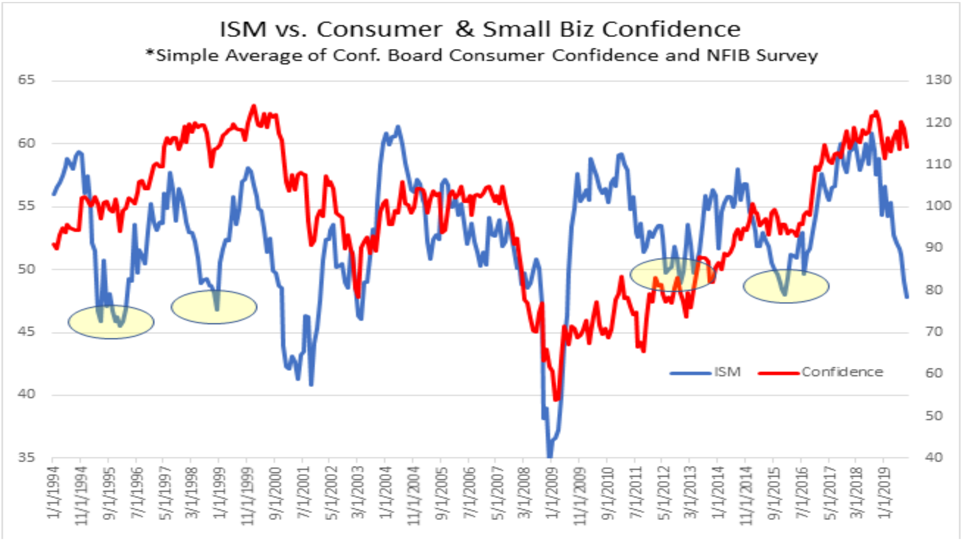
Absent a tail event, this inversion episode should soon be over. If yield-suppressing tail risks pass, we could dis-invert meaningfully in coming months.

Lastly, for what its worth, ISM frequently falls below 50 absent a broader recession...



One more rate hike should be sufficient to dis-invert the yield curve, *assuming none of the major international tails risks hit*. So let's hedge those risks and remain **short the scenario in which everything works out fine overseas but the U.S. still descends into recession or political chaos**.

Brexit Risk

Brexit is potentially messy but not globally systemic. That there appears to be some movement on the Irish impasse is sufficiently positive to suggest that an outright short-GBP hedge is not advisable from these levels.

I prefer a simple hedge I've recommended previously (Hedge EM Risk with Short EURUSD, 3/28/19). A short in EURUSD is positive carry, negatively correlated to risk assets, super liquid, and unlikely to cost you much (if anything) in the event of a Brexit deal. A no-deal outcome is a negative for the already tottering Eurozone economy, and to the extent a messy Brexit does become globally significant it would drive the Dollar higher.

China & Hong Kong

While downplaying recession risk, impeachment risk, and Brexit risk, **I am seriously concerned about China and Hong Kong**. A clean break on U.S.-China trade is manageable for the U.S. economy (given a proper monetary policy setting), *so long as China doesn't descend into financial crisis* or recession-cum-devaluation.

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I suspect the Trump administration's rough roadmap was to get the tariff wall with China in place and spend 2020 watching China scramble to keep its currency, credit markets, and economy from crumbling, while it engaged in vain in an attempt to co-opt Europe and other Western allies under the rubric of "maintaining the rules-based order." A Trump second term would then usher in the kinds of financial broadsides touted recently, and forge a starker decoupling designed to send China into either isolation of political upheaval.

The good people of Hong Kong have muddled that plan. China now unexpectedly faces a pincer of existential threats U.S. trade relations with the U.S. and a seemingly insoluble political crisis in Hong Kong (not to mention Taiwanese election in January in which pro-independence forces are surging). All of which leave one with a sense of dissonance while watching this:

This framing is not propitious for October 10-11 trade talks, which will require significant flexibility in China's previously demarked "red lines." Furthermore, the imagery is inconsistent with sitting back and letting the protests in Hong Kong – which are increasingly violent and with the apparent potential to morph into an insurgency – simply run their course.

Then there was this:

The President surely knew he'd take media heat for that one, which would be multiplied many times over if he followed it up with capitulation in trade talks. No, the tweet suggests some tough love is coming next week for China and his great friend Xi Jinping. Put more blunty:

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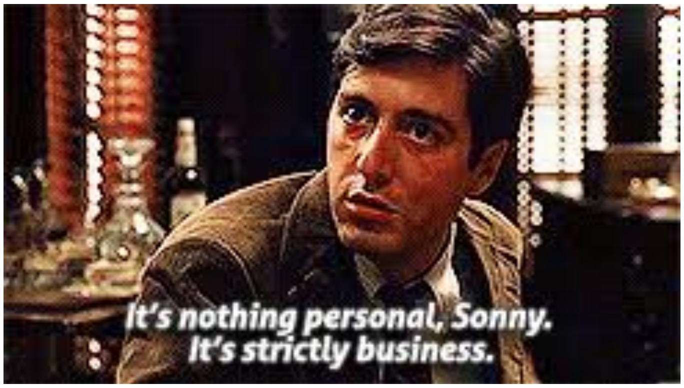

Re: Hong Kong, ignore the spin that "Trump doesn't care about human rights," and the official pronouncements that events in Hong Kong have no bearing on trade talks. The political reality is that **the two situations are inextricably linked politically**. How can the U.S. make a deal of any substance with China given the extant risk that they could roll tanks into Hong Kong?

How can the President Xi one day be presiding over a military force that could wipe out the planet, and the next capitulate *both* to the Western Imperialists and to a rag tag bunch of students in Hong Kong?

Barring the unlikely prospect that Hong Kong spontaneously settles down **there is no path for Xi to a trade deal**. If he cracks down in Hong Kong the U.S. can't make one. If he capitulates in Hong Kong he can't make one.

With no indication that President Trump is interested in an "interim deal" involving little more than Ag purchases, and no indication that China is offering more than that, **these trade talks look like a dud**.

Suggested Hedges

- Buy a 6-month 7.30 USDCNH call option for 1.10% of face

- Long Puts on the Hang Seng Index funded by short puts on the U.S. Russell 2000 Index

USDCNH Calls

I favor the call over an outright position in USDCNH:

- More heavily geared towards the tail outcome
- Defined downside on a trade (USDCNH spot could fall 3% very quickly)
- Vega risk favorably skewed (Vol should spike in a tail and subside gradually in positive outcome)

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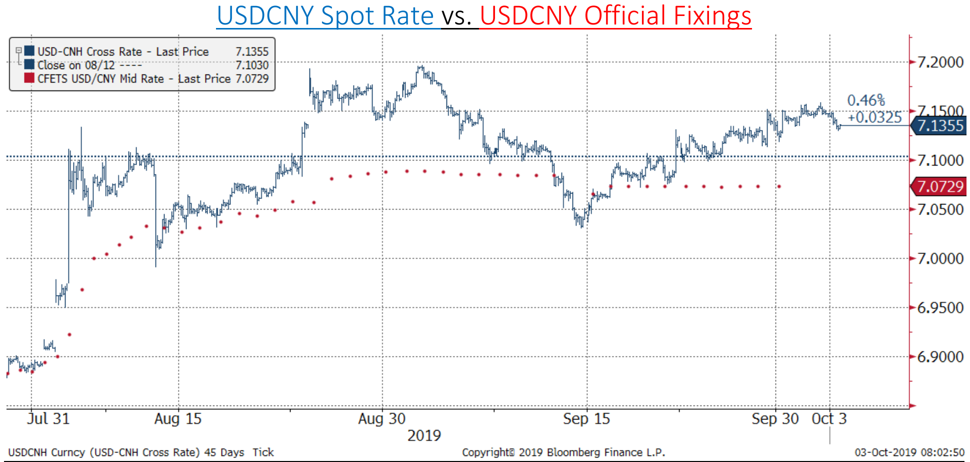
USDCNH vols are not cheap, but they don't seem to embed much tail premium either:

Implied Volatility: USDCNH 6m 35-delta Call

If, the next round of tariffs goes into effect on October 15th, USDCNH will likely spike above 7.20. Attention will quickly turn to the official CNY fixings. **If Chinese policymakers sanction the move by raising the fixings both spot and vol will explode**.

USDCNY Spot Rate vs. USDCNY Official Fixings



If we get a surprise deal this call option will quickly lose half its value (although I'd still bet it ends up ion-the-money by expiry).

If trade talks break down and Chinese authorities sanction a move higher in USDCNH (via the CNY fixings) the option should more than double in value:

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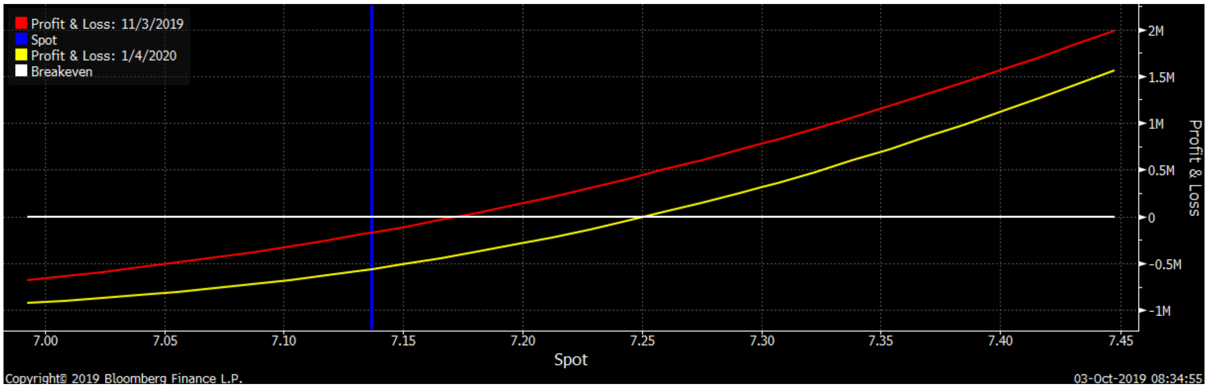
PnL Profile vs spot rate in 1 month and 3 months (vols unchanged)



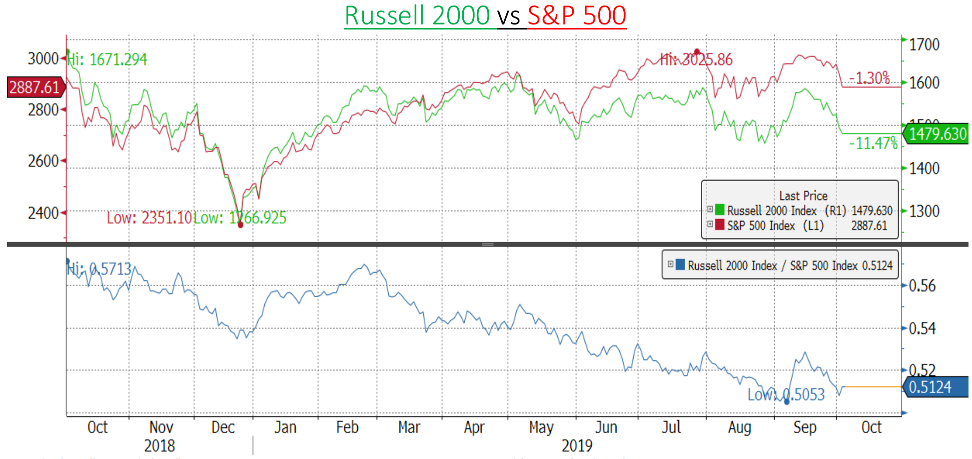
Long Puts on the Hang Seng Index vs Short Puts on the U.S. Russell 2000 ETF

					Implied	60-day	
	Spot	Strike	Moneyness	Price	Vol	Hist. Vol	Delta
BUY HSI Index Put	26,110	24,805	-5.3%	1.92%	20.6	16.6	27.5
SELL IWM Equity Put	147.25	137.00	-7.5%	2.09%	25.6	20.2	25.7

Why IWM?

- The U.S. has already tariffed imports of intermediate goods from China, which would be more likely to impact mid-sized manufacturers. At risk now are large caps with either manufacturing facilities in China or large revenue exposure to the Chinese market
- Willing to fade recession fears
- The perhaps naïve assumption that since small caps have underperformed significantly in this year's up-trade they are unlikely to underperform materially in a down trade

Russell 2000 vs S&P 500



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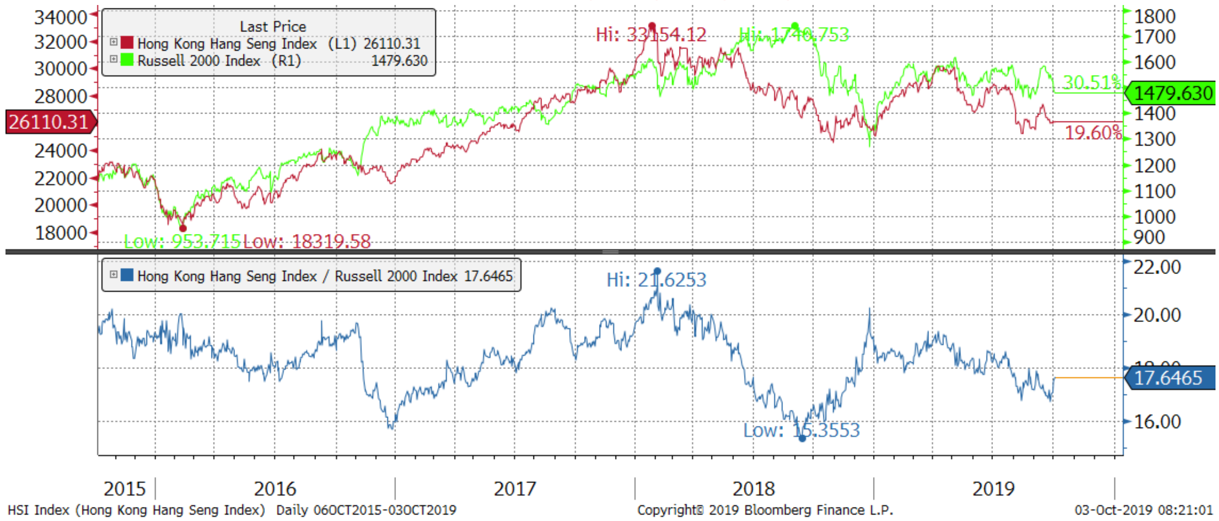
This trade is not without risk. While relative valuation trades in the middle of a multi-year range, IWM has underperformed HSI by nearly 6% in the past week!

Russell 2000 vs Hong Kong Hang Seng Index



Although the HSI / IWM relationship can be extremely noisy, this pairs trade seems a good way to solve for “trade deal / not trade deal.”

- If we get an upside surprise in trade talks, it doesn’t matter if HSI outperforms as both options will become deep out-of-the-money

- If trade talks break down, HSI (a China-heavy index) should retrace its recent outperformance of U.S indices

- If the HK government enacts emergency powers to impose martial law (likely by month-end), HIS should underperform meaningfully

- In the event of a China intrusion into Hong Kong this trade could make 500-1000bps

- The trade is exposed to “recession fever” in the U.S., or to some revelation that turns the Trump impeachment “inquiry” into a more serious risk to his Presidency than it currently poses.

Conclusion

Prospective returns appear non-normally distributed. **Identifiable ”fat tails” argue for targeted hedging strategies as opposed to an broadly defensive posture**.

- Downplay impeachment concerns and U.S. recession risk
- Consider cheap hedges directed at where the most serious risks reside: China and Hong Kong