The counter-intuitive effect of Brexit on implied volatility

8th July 2016

So the basic assumption is that when markets fall and/or become more volatile, then the implied volatility assumption that goes into that ever so famous Black Scholes Model goes up, thus making options more expensive. Those net buyers of options/volatility would have to pay more and vice versa. Hence for short volatility structures such as the staple Autocall, it should make sense to make hay whilst the politicians bicker and invest in such structures in times of market turmoil right? Well not necessarily…

Post Brexit we have certainly seen some volatility in the equities market and of course this has translated into higher implied volatility for some equity markets being priced into shorter dated options. However, some might think a slightly counter-intuitive phenomena has occurred within longer dated implied volatility for some equity markets. What has actually happened within that longer dated implied volatility arena, is that it has stayed relatively subdued and range bound, contrary to what some equity markets have done. There is a simple way of rationalising this. The traditional structured product, such as the autocall leaves the **investor selling volatility** and the **banks buyers of volatility**. Nothing earth shatteringly new there. But, think about what happens to that autocall structure when the market falls significantly. Two things happen:

1) the expected maturity of the product will ordinarily extend towards its maturity date as the likelihood of an early autocall recedes and

2) the probability of the knock-in put being activated increases, which consequently results in the trading book becoming longer volatility, but further out in terms of expected maturity.

As we all know, a trader's job in this new world of financial scrutiny and regulation is to hedge their risk and not 'run' positions or 'punt' and as such this increased exposure on their books means they have to sell more volatility in the market and at maturities further out. As we all hopefully remember from our O'Levels (for us oldies) and GCSEs (for the young guns amongst you), the basic law of supply and demand suggests that where supply outstrips demand, you see a price decrease. That is exactly what we have seen within the longer term implied volatility market. As the markets come off, banks have been **forced to sell increasing amounts of longer dated implied volatility further along the 'term structure',** which has resulted in the volatility brought about by the political uncertainty and economic consequences there of being somewhat countered by the supply and demand imbalance.

In summary then, we're not suggesting that it is all doom and gloom with regards to the sellers of longer term volatility. There are significant buyers of volatility outside the world of investment banks, such as pension funds and insurance companies, particularly the latter given the capital savings hedging provides. Given the nature of how banks price and hedge the risks, selling of longer term implied volatility will seemingly still provide good risk adjusted returns. What we are actually saying in a long and convoluted manner is, you don't have to wait for volatile times to sell longer dated vol. There has and still is a deep routed underpinning of longer term implieds, which for sellers of volatility is hopefully here to stay!

For those geeks amongst you, there is a more detailed discussion on this topic in our new Fortem Capital Library, within Resources, at http://www.fortemcapital.com.

Rates (bps)		
	Current	Week Chge
GBP 1yr	53.80	-2.10
GBP 3yr	51.00	1.60
GBP 5yr	57.30	-1.60

Equity Indices (%)		
FTSE 100	6557.12	0.81%
S&P 500	2111.28	0.59%
Nikkei 225	15106.98	-3.01%
Eurostoxx 50	2825.93	-1.35%

Currencies (%)		
GBPUSD	1.2956	-2.67%

5 yr Credit Spreads (bps)		
Citigroup	86.75	-6.54
Credit Suisse	172.32	6.38
Deutsche	245.18	26.89
GS	103.03	-7.61
HSBC	98.23	-1.76
JPM	63.93	-1.25
MS	101.74	-7.36

Commodities (%)		
Gold	1355.56	2.55%
Oil	45.66	-5.52%

3 M Implied (vol pts)		
FTSE 100	17.93%	0.16%
S&P 500	13.64%	-0.55%
Nikkei 225	25.55%	1.48%
Eurostoxx 50	24.35%	1.04%

5 Y Implied (vol pts)		
FTSE 100	19.86%	-0.10%
S&P 500	22.05%	0.30%
Nikkei 225	20.94%	-0.22%
Eurostoxx 50	20.43%	0.15%

Source Bloomberg / Partner Banks
Data as at 8th July 3pm

Indicative Autocall Levels – 6Yr	
FTSE Flat, 65% EKIP	11.20%
FTSE 5% step, 65% EKIP	8.60%
FTSE/S&P 5% step, 60% EKIP	9.10%

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Upcoming Events	
11th	Fortem FTSE Enhanced Dividend Note Launch
14th	BOE MPC Announcement

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