Axe, and you shall receive: What does an investment bank have in common with a Lumberjack?

30th June 2017

The answer? They're both more useful to our clients with an axe. A touch *wooden* I know…

When talking about a bank, what is an axe exactly? Well, the usage is thought to be derived from the popular phrase "an axe to grind", and refers to a selfish or ulterior motive – this in trading parlance means simply that the bank (or desk within a bank) holds a large position in something that they wish to unload, at as lower a cost to their book as possible. Over the last decade these axes have become more and more relevant, and to our clients, more valuable due to regulatory pressure on the investment banks. *Fir* a detailed explanation of a bank's balance sheet and the various requirements they must adhere to, please see [here for a previous FNL] getting to the *root* of the issue. At a high level, the most important metrics for regulation (and therefore an axe) are Common Equity Tier 1, Risk Weighted assets and the liquidity coverage ratio. The riskier the asset on the balance sheet (measured by volatility, liquidity etc), the higher the level of capitalisation needed to cover that. The more capitalised a bank needs to be (because of the riskier assets), the greater the opportunity cost of holding that capital.

"Lumberjack and Lumberjill"

So why is this potentially *intreeguing*? Well, if they can offload these assets to a willing buyer then they don't have to hold them on their books and can recycle the risk – and importantly, the bank in question *conifer* you better terms than the street because of their desire to offset their position. The assumption of course is that these risky assets are not something anyone would wish to own, however because of the Volcker rule even the best assets need to be moved off book. A second factor to consider is that some assets when sold by a bank are also funded differently; liquid, very common investments such as developed market equities, sovereign bonds and the like are funded via the repo market, whereas positions on hedge funds, private equity vehicles, or something illiquid and quirky are typically funded via debt.

The closer the security is to the latter, the more the bank will have to pay to hold it, and therefore the more competitively it will be priced. There are numerous examples of bank axes – some very vanilla and some a little more esoteric, that appear less frequently. We're going to go through a couple of examples of the more consistent axes that large banks

Recent Launches:

Product	Snowballing Return
Citigroup FTSE 100/Eurostoxx 50 Weekly Accrual Income Note	5.52%

Rates (bps)		
	Current	Week Chge
GBP 1yr	55.10	4.10
GBP 3yr	78.10	10.60
GBP 5yr	96.30	15.00

Equity Indices (%)		
FTSE 100	7,346.39	-1.05%
S&P 500	2,345.96	-3.79%
Nikkei 225	19,445.7	-3.41%
Eurostoxx 50	3,480.57	-1.78%

Currencies (%)		
GBPUSD	1.2985	2.10%

5yr Credit Spreads (bps)		
Citigroup	53.16	-1.17
Credit Suisse	65.47	2.07
Deutsche	80.57	-2.63
GS	67.92	-2.06
HSBC	27.54	-0.93
JPM	47.44	-1.10
MS	62.91	-2.33

Commodities (%)		
Gold	1,243.73	-1.03%
Oil (CLA)	45.32	5.37%

3m Implied (vol pts)		
FTSE 100	11.39%	0.50%
S&P 500	10.69%	0.77%
Nikkei 225	14.00%	0.50%
Eurostoxx 50	15.30%	1.56%

5yr Implied (vol pts)		
FTSE 100	18.27%	0.29%
S&P 500	19.39%	-0.07%
Nikkei 225	18.35%	0.04%
Eurostoxx 50	19.52%	0.03%

Source Bloomberg / Partner Banks
Data as at 30th June, 10.30am

Upcoming events	
30th Jun	UK GDP (Final) % y/y
30th Jun	ECB Speeches in Berlin & Brussels
03rd Jul	BoE's Haldane and FED's Bullard speak in London
05th Jul	FOMC meeting minutes
07th Jul	US non-farm payrolls & unemployment numbers
08th Jul	ECB Interest rate announcement

"If I had 6 hours to chop down a tree, I'd spend the first 4 hours sharpening the axe" – *Abraham Lincoln.*

have, and then one slightly more unique, bank specific current axe. After all, *good things come in trees.* Now, before you get *sycamore* tree puns…

Correlation: When banks sell investment products on multiple underlying equity indices, such as an autocall, basket option, etc, they make certain assumptions as to what the expected correlation between those underlying indices will be. Hopefully it's intuitive that the lower the assumed level of correlation, on something such as the popular autocall product for example, the higher the potential investor returns could be. Critically, there is also a more difficult relationship linking correlation to trading flows, bank inventory and the nature of the market participants. Banks that sell significant amounts of these structured products will be heavily short correlation (effectively, axed) and they will try to shift the risk via correlation swaps, variance swaps and options on baskets vs basket of options. Importantly, the sheer magnitude of product sold outweighs that bought back and as such the banks price correlation cheaply so as to encourage investors to take it off them. How many times have you been pitched a dispersion trade in the last two years… For our clients, make sure to look out for banks that are new to the structured product space (with less of an axe and therefore more capacity) as they will be able to price more aggressively. Please see this FNL for a more detailed look at correlation.

Dividends: Dividends, as an isolated asset class, and dividend futures have become an increasingly utilised financial instrument as transparency, liquidity and understanding have grown. The cost of buying near term future dividend streams tends to be similar to realised levels, offering little opportunity for growth and therefore gains. However, over the medium to longer term, disparities can occur where the costs of buying future dividend streams may be at odds with what analysts predict those dividends will be. i.e. the costs of buying future dividend streams trade at a discount to analysts' forecasts. The primary driver of this is now relatively well known; that being, banks are left long dividends from the options they write (axed). Therefore, they mark them down so as to shift them on to the savvier investors amongst us. At this point it is worth noting that when banks mark down their future dividend estimates this increases the forward for that underlying (Forward = Spot + Interest – Expected Dividends), making the options they write more expensive. Thus, for banks it is a zero-sum game. For investors in dividends though, it provides an opportunity to gain equity like returns, albeit arguably with more defensive features as invariably dividends tend to remain relatively more stable over the short to medium term as corporate board rooms try to maintain or indeed grow dividends, despite probably more volatile earnings and share prices.

And finally, a specific opportunity from Citigroup. In short, Citi is axed through its institutional trading activity to offer exposure to the US High Yield Bond ETF, HYG US, plus a significant spread of 1.25% per annum representing a ~25% premium to the ETF's prevailing yield. While the axe lasts, the indicative terms of the investment are as follows:

Issuer: Citigroup Global Markets Funding Luxembourg (guaranteed by Citigroup Global Markets)
Maturity: 5 Years
Currency: USD
Investment return: HYG US ETF + Spread
For the avoidance of doubt, the notes provide a 1|1 investment return linked to the performance of the underlying HYG US ETF, PLUS a spread as outlined below
Liquidity: Daily liquidity at NAV + Accrued Spread
Spread reset: Occurs monthly, notified one week in advance
Initial Spread: 1.25% p.a.

For clarity, the performance of the note is not subject to any movement in Citi's credit from a M2M perspective.

It is worth noting that these axes appear fairly regularly and on widely varied securities for the large investment banks, from bonds and equities through to varying tenors of volatility and anything else in the investment universe. When appropriate for our market, (which a large portion will certainly not be) we will make sure to keep you updated with anything particularly interesting.

Hopefully we didn't leaf you too stumped…

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