

## AUTOCALLABLES, VOLATILITY COMPRESSION AND EUROSTOXX

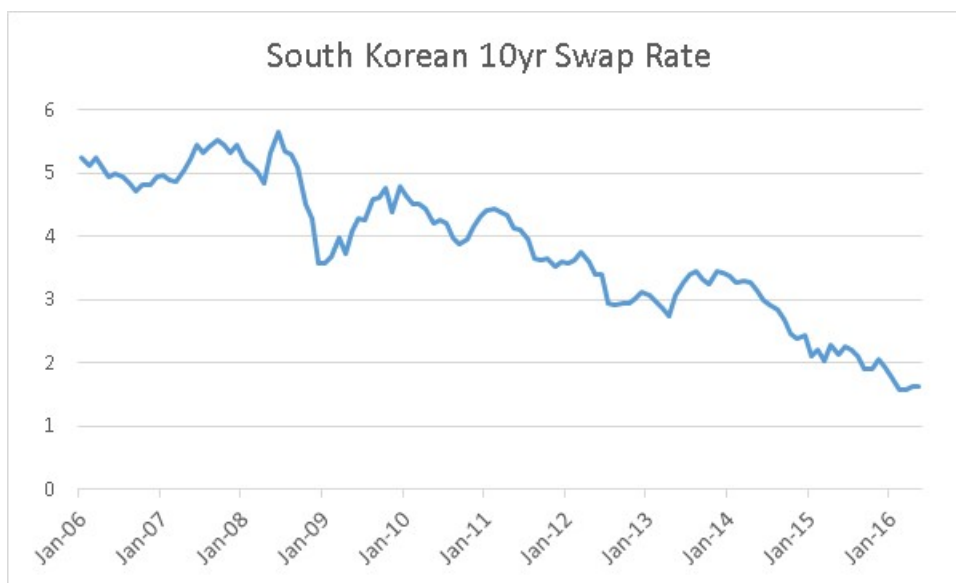


Russell Clark's  
Market Views

“Autocallables (or reverse convertible securities) are products that first gained popularity in Japan in the 1990s. They are short-term coupon bearing notes, which are designed to enhance yields. Autocallables can be fiendishly hard to understand, as they often have various barriers based on an index which will determine the payout.”

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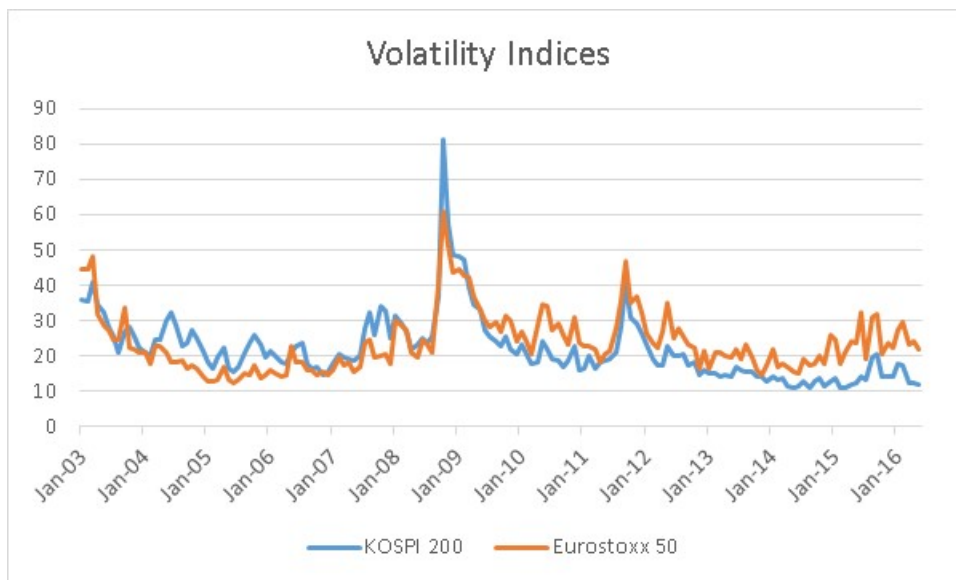
Like much of the world, Korea has seen interest rates move relentlessly lower since the financial crisis. In 2007, 10 year Korean bonds offered rates about 5%. Now they are well below 2%. The graph below shows the swap rate which tracks South Korean Government bond yields.



One feature of the autocallable market is that the higher the market price of volatility, the higher the yield that can be offered on the product. Large issuance of autocallables (or the selling of volatility) can depress market volatility. Korea, which was a famously volatile equity market, now resembles a sea of tranquillity.



As can be seen below, the volatility of the Korean Composite Stock Price Index (KOSPI) rarely was below 20 prior to 2012, but since 2012 has rarely traded above 20 annualised volatility. In contrast volatility in the Eurostoxx has remained relatively high.

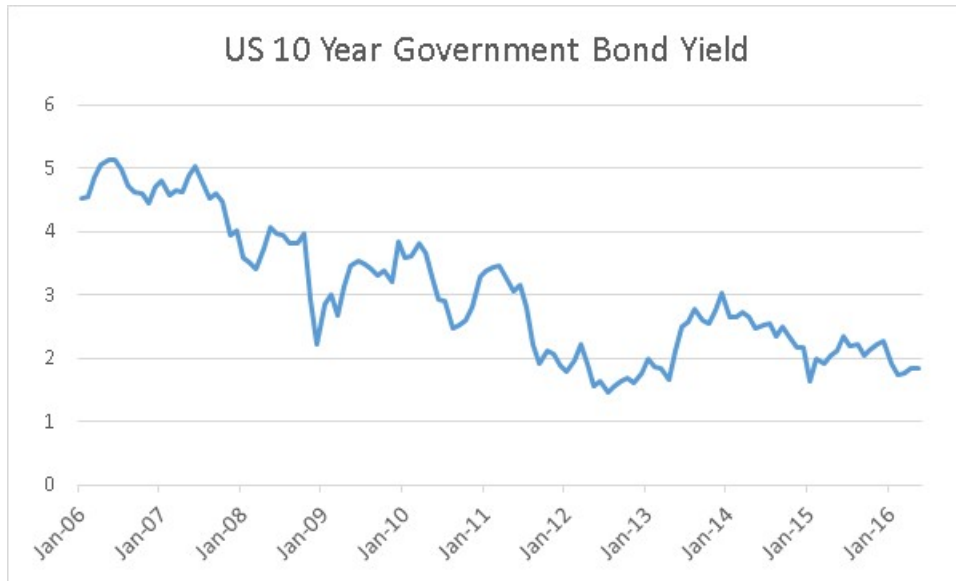


One of the upshots of still declining interest rates in Korea and ever lower volatility in the KOSPI is that as a result, yields have suffered with the decreasing volatility and so Korean autocallable structurers have had to find other ways to sell volatility. Anecdotally the two markets that have been most popular for Korean autocallable structurers have been HSCEI and Eurostoxx 50. The size of flows into HSCEI has been commented on by Bloomberg.

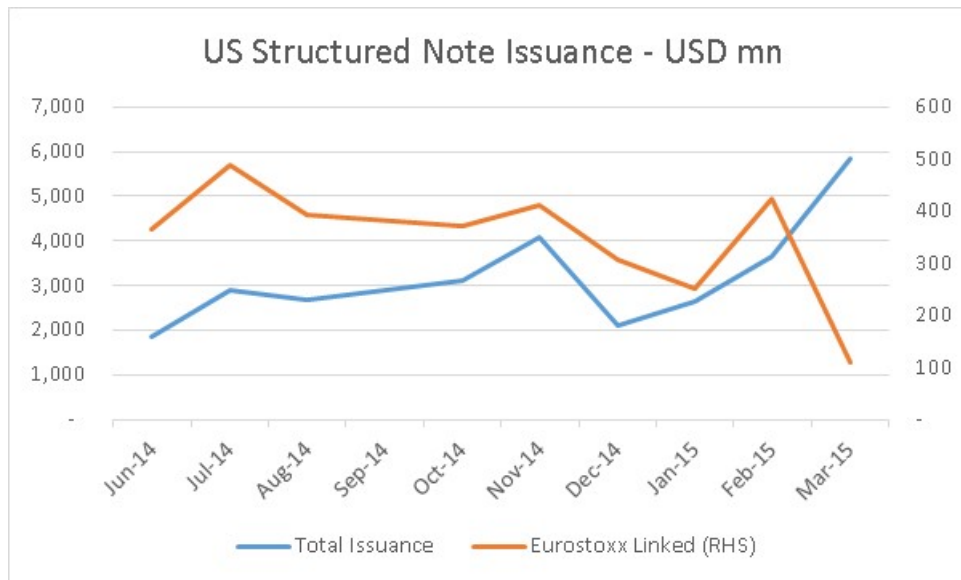
<http://www.bloomberg.com/news/articles/2016-01-21/again-won-t-somebody-please-think-of-the-asian-structured-products->

Bloomberg quotes that Koreans may have USD 12bn of HSCEI exposure via autocalls. Data that we have seen suggest similar sized flows in the Eurostoxx market in recent years.

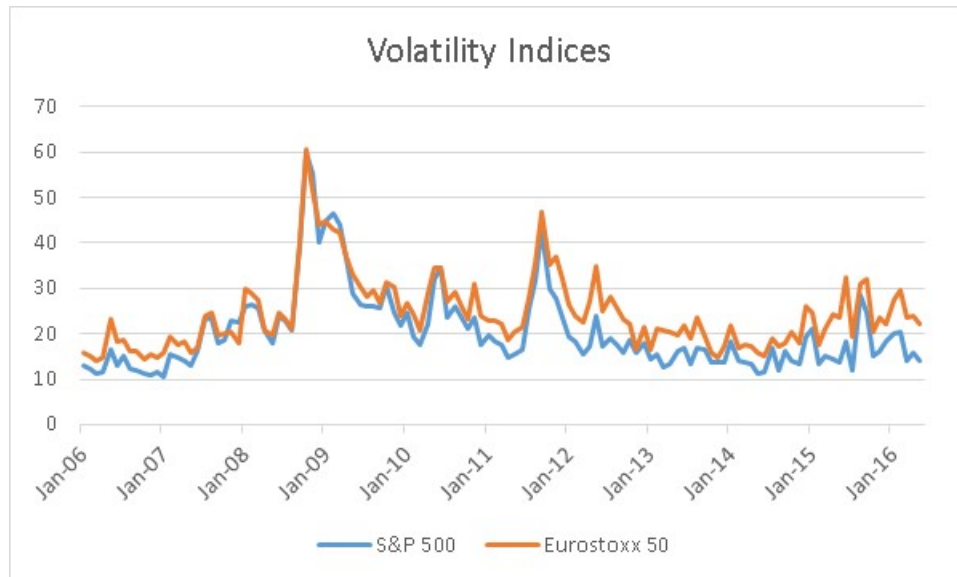
Like Korea, the US has seen available interest rates decline substantially since the financial crisis.



The US has also seen a surge in structured note products; data available from the SEC and gatick.com shows that volume of issuance has tended to increase. Also we started to see a large issuance of Eurostoxx linked products.



Just like Korea, we see that Eurostoxx volatility is higher than S&P 500 volatility which encourages structured note issuers to use the Eurostoxx as an underlying in structured products. We can see in July 2014, peak issuance of Eurostoxx products was 500m USD. We can also see that overall issuance was increasing into the last data point we have in 2015.



The interesting thing about structured products are that they are designed to provide investors with yield and similar to bonds, as the price falls, the yield on the products rise. Unfortunately, if the underlying market falls too much, then the product converts from a fixed income product to an equity product.

This leads to structured products normally being a stabilising feature of the market, as they naturally compress volatility, but in moments of extreme stress they amplify volatility as products convert to equity. With products in both US and Korea using European volatility, a European crisis has the potential to spread contagion via autocalls.

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