Trade Booster

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To QE or not QE? Buy inverse to hedge ECB's indecision efficiently

Summary

- **Unconventional stimulus talk by the ECB feeds sentiment in risk assets and safe havens anew. The speculation may drive equities, bonds and commodities to move in lockstep.**
- **High correlations across asset classes should persist, undermining the ability of diversified portfolios to reduce volatility and hedge downside risk.**
- **Short ETPs offer investors the inverse exposure to the underlying, enabling efficient tactical and strategic allocations as a means to protecting capital.**
- **Investors who share this sentiment may consider the following Boost ETPs *(www.boostetp.com/products)*:**

Short equities:

1. Boost FTSE 100 3x Short Daily ETP (3UKS)
2. Boost FTSE 100 2x Short Daily ETP (2UKS)
3. Boost FTSE 100 1x Short Daily ETP (SUK1)
4. Boost FTSE 250 1x Short Daily ETP (1MCS)
5. Boost FTSE MIB 3x Short Daily ETP (3ITS)

Short equities:

6. Boost US Large Cap 3x Short Daily ETP (3USS)
7. Boost NASDAQ 100 3x Short Daily ETP (QQQS)
8. Boost TOPIX 1x Short Daily ETP (1JAS)
9. Boost ShortDAX 3x Short Daily ETP (3DES)
10. Boost EURO STOXX 50 3x Short Daily ETP (3EUS)

Source: Boost ETP Research, Bloomberg

* based on weekly USD prices, from 7 Jan 2000 to 25 April 2014. Low (high) volatility periods are where the VIX is trading below (above) its median.

The ECB's stimulus talk beyond a rate cut reverses expectations built around the Fed's unwinding of QE. Such market conditions prolong the high correlations observed between asset classes, with bullish expectations driving risk and safe havens alike up in the same way that bearish news are driving them down. Asset allocators need to move away from conventional and unconventional asset classes to diversifty and hedge their long exposures. Both strategically and tactically, buying the inverse exposure to the underling will provide the efficiency sought through negative correlation. Set against an undecided ECB that could equally delight or dissappoint investors, short ETPs offer investors a viable solution to protect capital and reduce volatility efficiently.

Contact Information: ☏ +44 (0)20 3207 9050 ✉ info@boostetp.com www.boostetp.com

Investors who share this sentiment may consider the following short equity ETPs:

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ECB's QE talk fuels tandem moves in asset classes, undermining the traditional TAA model

Given the spin around deflation fear and an overvalued euro on which the ECB is justifying the need for more monetary stimulus, a potential European style QE may be looming. Coupled with the loose and more aggressive monetary policy stance taken by the BoJ, expectations built around the unwinding of the Fed's QE program have effectively been countered with renewed anticipation of monetary support drivers for risk and safe haven assets . Unlike 2009 , this ECB stimulus program may be targeted towards the asset backed securities market[1], as opposed to the Europe's formerly distressed sovereign issuers where, with yields hovering at between 2 and 3% on Italian and Spanish long dated government bonds, borrowing costs are firmly back at (if not below) pre-crisis levels that no longer justify any ECB intervention. If such an asset purchase program were implemented, European asset backed securities are likely to fall victim to the same conditions as equities and bonds. Fed on expectations that the ECB will become the new large buyer to facilitate lending to SMEs that have been deprived of affordable credit by banks, asset backed securities will, like equities and bonds, fall and rise in tandem with speculation of ECB buying or tapering. As a result, the high correlation between asset classes is unlikely to break any time soon. With the potential of the ECB buying asset backed securities on a large scale, such unconventional asset classes that may previously have been uncorrelated to bonds and equities may start to behave more in tandem with the mainstream asset classes. The result is that tactically rebalancing the portfolio with conventional asset classes with the addition of unconventional asset classes will do little to improve the risk return profile of asset portolios.

The implications are that in an environment of low growth, low interest rates and exceptionally prolonged loose monetary stimulus, asset allocators may need to think increasingly out of the box and move away from conventional and unconventional asset classes to diversifty and hedge their long exposures. As shown in the chart, trying to diversify your long equity portfolio with sovereign or corporate bonds or commodities is unlikely to offer the diversification or the desired hedge they once did. This appears to be an even bigger problem in stable market conditions (see green bars). We have been in such an environment since the ECB put in place the OMT program in August 2012, which together with the period between the post 2000 dotcom bubble burst and pre 2008 credit crisis can be described as a period of subdued risk expectations and low volatilty. In such periods, high correlations between US large-cap equities and major asset classes across different geographies, sectors and styles are observed. Hence, US investors seeking to diversity their portfolios cannot get a lot of diversification out of domestic debt that correlates 0.8 with domestic equities, neither can they get a lot of diversification from European fixed income or major commodity sectors. In fact, in periods of low volatility, the traditional safe havens, US T-bills, US inflation linked securities, German Bunds and even gold, produce relative high correlations with US large cap equities (anywhere between 0.7 and 0.8 when based on weekly USD prices). It is only in episodes of market turmoil that some of the safe havens, most notably German Bunds, US Treasuries and JGBs will offer US equity portfolios some hedging and diversification potential. However, with correlations hovering around 0.4, they remain significantly positive and can hardly be seen as efficient asset classes to protect capital and dampen volatility, especially when considerating that for most of the economies in the developed world, monetary policy remains exceptionally accommodative.

Inverse ETPs offer investors the benefits of negative correlation to hedge efficiently

Short ETPs offer asset allocators an effective solution to the growing inability of conventional asset classes to improve the risk return profile of portfolios. As shown in the far right end of the charts, short equity ETPs with a

[1] This in an effort to offer a targeted response to the struggling SMEs, which have effectively being shut out from obtaining affordable bank loans and are looking to institutional investors, in particular pension funds and insurers, to step in as lenders. The potential for the ECB's to buy large pools of business loans from institutional investors would not only revive the morbidund securitisation markets in Europe, but help unlock new funding for SMEs by institional investors and in so doing, revive the job market.

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geared component do offer the unique negative correlations investors seek. While perfect negatively correlated to the underlying on a daily basis given the nature of daily rebalancing inherent in geared ETPs (short or long), holding short ETPs for longer than one day, such as several weeks will require some rebalancing in order to preserve the desired level of protection. As is also evident in the chart, because the correlations are based on weekly prices as opposed to daily, as well as the fact that the short ETPs on US (Russell 1000), German (DAX 30) and UK (FTSE 100) large caps are taken as inverse proxies to the S&P 500, the correlation readings are less than -1. The highly geared inverse products on the equity market, such is demonstrated with Boost ETP's -3x on US large caps (3USS), German large caps (3DES) and UK large caps (3UKS), may require more frequent rebalancing than ETPs with lower gearing factors (such as -2x or -1x). However, the fact that these are geared ETPs also means that less capital is needed to achieve the same exposure to the conventional delta - 1 products. As such, depending on risk appetite, these offer investors an efficient way of deploying capital; achieve the same inverse exposure to the underlying with less capital, or achieve a multiple of the inverse exposure with the same capital.

The latter example, which describes a way by which exposure to the underlying can be amplified, should gain appeal to return hungry investors at a time when the bond markets offer dismal yields and the equity market's momentum appears to waning. Hence, in terms of strategic portfolio hedging and diversification, as well as in terms of opportunistic short-term positioning, geared inverse ETPs offer investors a viable alternative to a strategy based on rebalancing across different asset classes..

With major economies still reliant on artifical support drivers, the high level of correlations across equities, bond and commodites is expected to persist for longer. Expectations of a Eurozone style QE program could trigger a distorted, across the asset class rally anew, as well as a simultaneous across the board asset class retreat if improved economic conditions indefinitely postpone an unconventional stimulus program by a reluctant looking ECB. In either case, in an environment where market stability is fed on expectations of large liquidity injections, protecting capital or reducing volatility through cross asset class rebalancing is becoming less effective. Inverse ETPs offer investors a viable to alternative.

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Contact Information: ☏ +44 (0)20 3207 9050 ✉ info@boostetp.com www.boostetp.com