Morgan Stanley

Risk Markets into the UK Referendum

ECB BMCG

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Summary of Views

Hedging Brexit has proven more complicated than was anticipated…

- Conviction on outcomes has been low all along. UK policy reaction to Brexit uncertain.
- Classic hedges have been volatile and ability of investor to sustain adverse P&L is limited given weak performance in recent quarters.
- Do not ignore that this is an emotional issue for many UK based market participants.

The real money community has mostly hedged via delayed investment allocations in recent months

- I believe investors are under-invested relative to the interest rate outlook with 4y1y rates at 10 year lows and 5s30s curves are steep given rate outlook.

Other macro risk events also loom large

- The path of US rates policy and, eventually, US elections.
- Spillovers of Brexit into wider Europe: risk of EU breakup risk picking up in combination with Spanish elections, extent of risks in the Italian banking system
- Historically low yields

Overview of Positioning into Brexit

Fixed income markets

- The investor base is generally under-hedged for a Brexit outcome. Possible policy responses and the sharp rise in vol have made it difficult to find cheap liquid hedges. Investors looking at Euro, SPX and global risk assets as more liquid alternatives.
- Among our investor base only LN hedge funds have largely executed their Brexit plans with limited adjustments expected in the coming days. There may be some moves from Cable hedges to Euro or SPX hedges. European RM is sitting on larger than usual cash balances as a hedge and has trimmed risk a little bit though investment strategy largely unchanged.
- I have seen our US/Asia investor base is only coming up to speed on implications and risks of Brexit and find many of the natural hedges to be expensive here.
- Key debates around post-Brexit landscape centred around policy reaction. Split view over whether ECB will aggressively defend risk markets from spillovers (periphery in particular). BoE expected to ensure orderly markets but has no capacity to defend an FX level. Longer term BoE measures dependent on gravity of economic fallout. .

Equity markets

- Markets “risk off” with GRDI -3SD, VSTOXX at 37 at 2011 highs and European market’s PE near LT average. SX5E pricing in 5.5% event day move while FTSE is pricing in c5%.
- However, just 2 out of 42 investors polled at Provence CIO conference expect Brexit.
- Flows also suggest complacency. Meaningfully better to sell “Brexit” stocks Jan-Mar, better to buy since Apr. Small selling since then. PB exposure for European investors at 196.5% gross (near 12mth high) and Net up to 39%.
- Recent pick up in Brexit hedging (via puts on FTSE250.)

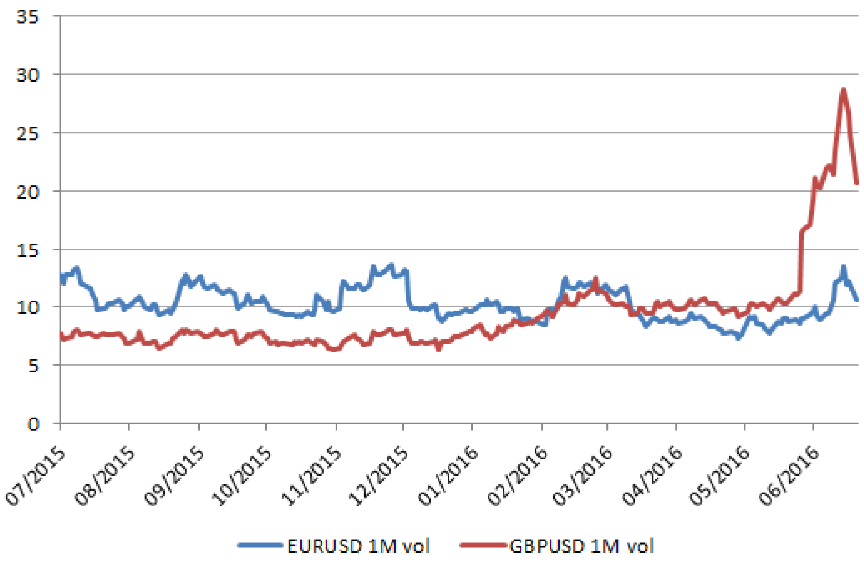
Cable Volatility has Been a Favorite Hedging Instrument

Cable Vol Became Expensive

Probability weighting of outcomes meant that vol became a very expensive hedge as the recent move has shown.

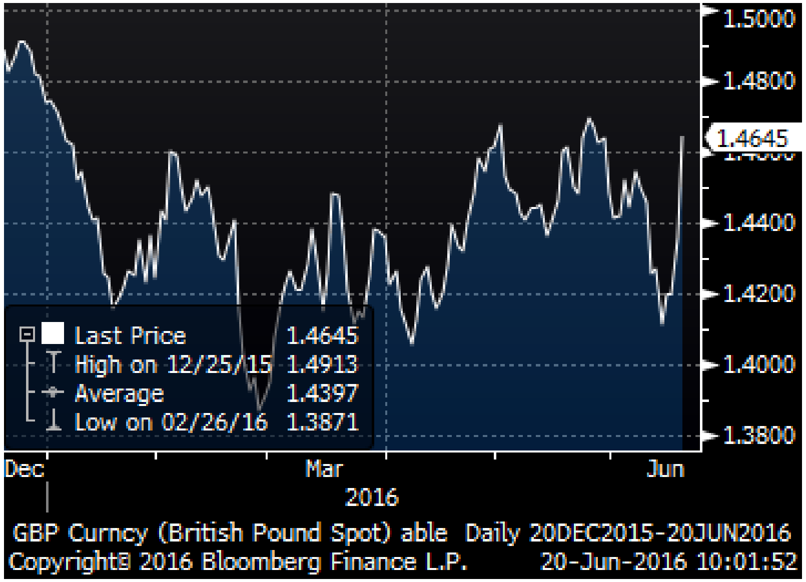
I observed a shift into alternative vol products last week from investors that had delayed or under hedged their Brexit risk

Foreign Exchange Vol



Source: Bloomberg

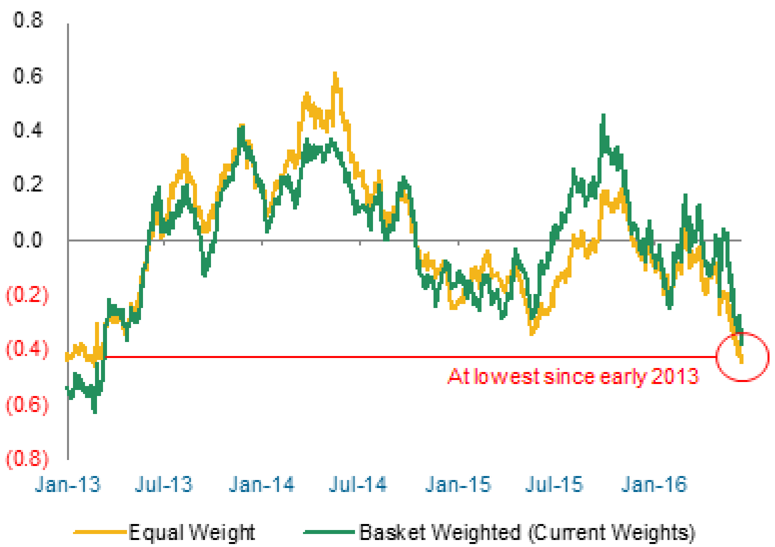
Cable



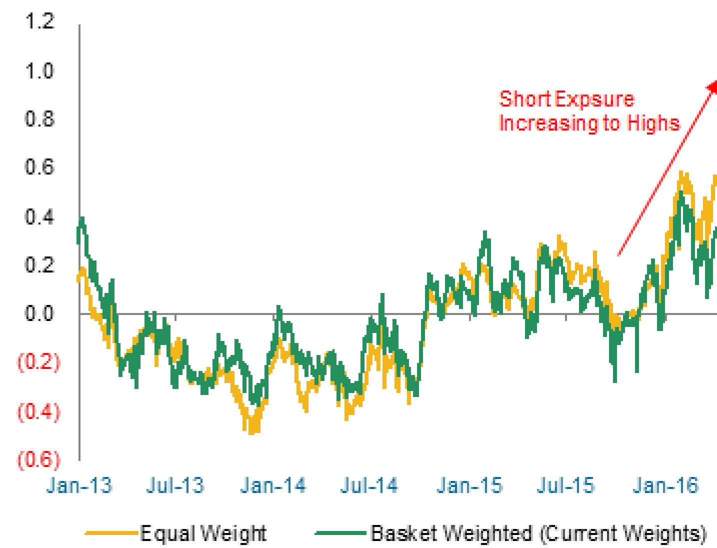
Index of Brexit Sensitive Assets

My index of positioning for Brexit sensitive assets was at the wides as of last week

Brexit index net exposure



Brexit index short exposure



Source: Bloomberg, Morgan Stanley Sales & Trading

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