

A tough sell – insurance against a Chinese financial crisis
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Selling insurance against a financial crisis should not be difficult, five years after the last one nearly wrecked the global economy.

But when it comes to China, the world's second-largest economy, the probability of a full-blown crisis is apparently so remote that hardly anyone will buy an insurance policy against it, no matter how cheap.

Financial wizards have been trying to sell peace of mind to investors in China for years, but fewer and fewer of those investors are interested, despite some worrying headlines.

In the past few months alone, China has seen its first domestic bond default, a small bank run, its weakest export performance since the global financial crisis, a marked slowdown in its property market and a rise in labour unrest.

Steve Diggle, a Singapore-based hedge fund manager who crafts strategies to protect investors against financial catastrophes, says investors have faith that the Chinese government, armed with almost US\$4 trillion (RM12.96 trillion) in foreign exchange reserves, will simply not allow things to get out of hand.

He had to close down a fund that used to bet on doomsday outcomes in Asia last year.

"There's a sense you are playing poker against a guy who makes his own chips," Diggle said.

Before the 2008-09 global financial crisis, he had run a successful fund, Artradis, which thrived on volatility in financial markets. Now, he says, hedging against a catastrophe seems to be passe – and not just for China.

Governments and central banks around the world have shown themselves willing to deploy vast sums of money - China alone launched a US\$643 billion stimulus package in late 2008 – to avert a financial meltdown.

"You are no longer in an environment where market forces will play themselves out because you have an extraordinarily powerful and motivated intervention in the market process from someone, such as a central bank or government, who has a strong ability to influence those processes," said Diggle.

There are still some hedge funds that take out insurance against extreme, improbable events – such as the notion that China's economic miracle will end in tears.

Andrew Wong, co-chief investment officer of Fortress Convex Strategies Group, runs a fund that aims to make money from these so-called "black swan" events.

"A pattern we've seen through long cycles is that in the period leading up to a systemic crisis, people buy hedges, lose money and unwind those hedges. Because it hasn't been efficient and has lost money, by the time the real thing happens they may end up being completely unhedged," said Wong.

"It's very hard to time the market precisely, so in general you need to have the insurance before the house is on fire."

For cautious or contrarian investors, taking out insurance on such apparently unlikely events as a China crisis has to be cheap. It is futile to spend large sums of capital on so-called tail-risk bets, waiting for such long odds to pay off.

Hedges can be expensive, though one relatively cheap method is to buy put options on the yuan or on Chinese stocks at strike prices well below current market levels.

Typically, though, the cheapest hedging strategies can also be the most complex. One such strategy involves variance swaps, a financial instrument that tends to pay the investor when volatility of an underlying bond or stock spikes.

In hedging against the risk of a major outbreak of defaults, a straight-forward approach such as buying credit default swaps (CDS) is not the most cost-effective. Instead, funds will offset the cost of buying CDS insurance against a distressed company by also selling CDS protection against a more creditworthy one.

"If they want to hedge, it is relatively cheap," said Camiel Houwen, head of equity derivatives trading at ING Asia. "But not too many people are setting up the trade."

In China's case, some fund managers think investors may be overestimating the hold Chinese authorities have on markets.

"A China hard landing is not our base-case scenario, but if it were to happen, it is one of these events that would have significant implications for a wide number of assets," said Viktor Hjort, head of Asian fixed-income strategy at Morgan Stanley.

"So it is a low-probability, high-impact type of scenario, and against those it always makes sense to consider hedges." – Reuters, April 21, 2014.

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