Flash Economics

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There is no hedge against "catastrophic risks" for investors

What kind of "catastrophic risk" could hit financial markets at present (fall in share prices, rise in risk premia on different risky bonds)?

- One can always mention a recession in the United States, a financial crisis in China, a debt crisis in the euro zone or protectionism. But these events are highly unlikely;
- Among other catastrophic risks, this then leaves a serious geopolitical crisis (North Korea, Middle East), the election of a populist party in a large European country (Italy in 2018?) or a serious political crisis in Europe (the crisis in Catalonia is a recent example).

How can investors hedge their equity or credit (corporate bond) portfolios against catastrophic risks? We look at the link between the risk level in the financial markets and:

- Interest rates on US and German government bonds;
- The Swiss franc's exchange rate;
- Oil prices;
- The gold price.

We see that an increase in risk perception in the financial markets is not correlated with any of these assets: none provides a robust hedge.

If the perceived catastrophic risk is a sharp increase in oil prices, with its effect on interest rates and borrower solvency, then a good hedge is obviously oil itself.

Patrick Artus
Tel. (33 1) 58 55 15 00
patrick.artus@natixis.com
@PatrickArtus

What catastrophic risks are possible today?

Currently, share prices are rising **(Chart 1)** and credit spreads **(Charts 2A** and **B)**, peripheral euro-zone bond spreads **(Chart 3A)** and bank bond spreads **(Chart 3B)** have tightened.

Chart 1
Stock market indices (2002:1 = 100)

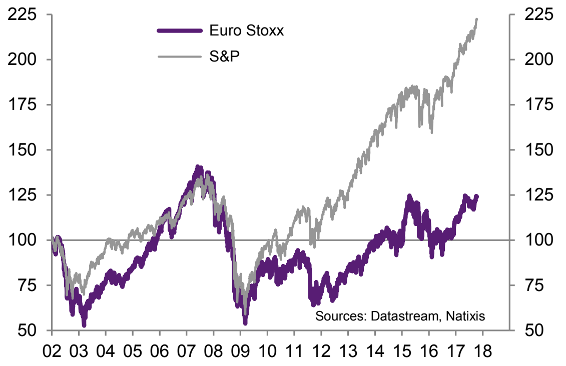


Chart 2A
United States: Credit spreads (asset swaps, in bp)

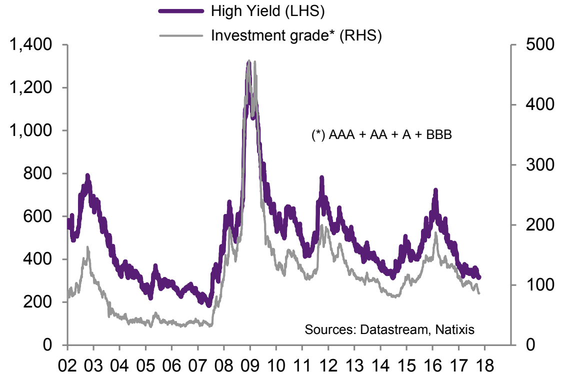


Chart 2B
Euro zone: Credit spreads (asset swaps, in bp)

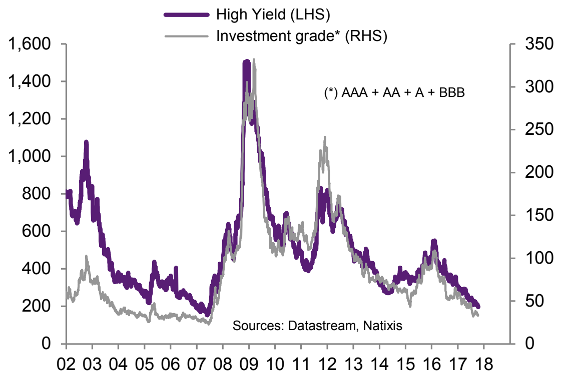


Chart 3A
Yield spread on 10-year government bonds against Germany (as %)

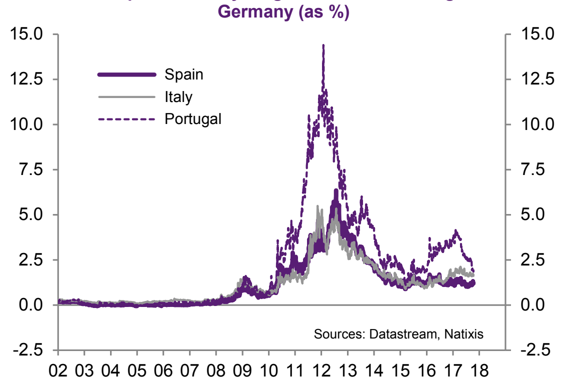
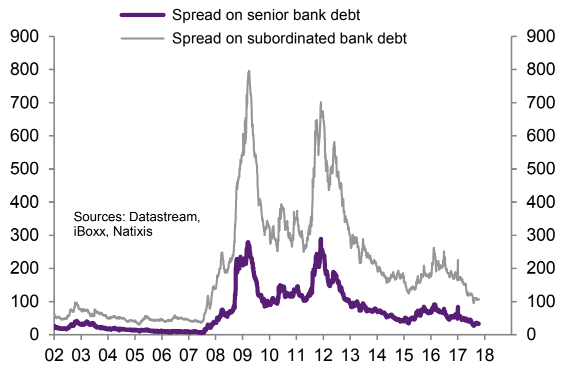


Chart 3B
Euro zone: Spread against swaps (in bp)



What "catastrophic risks" could cause share prices to fall and risk premia on risky bonds to rise?

(1) Some risks can be mentioned but they are very unlikely:

- **A recession in the United States after a long expansion period (Chart 4A).** But what would trigger this recession? Inflation remains low, the increase in interest rates will be contained, households have deleveraged and there is no serious asset price bubble;

- **A financial crisis in China due to the high level of debt (Chart 4B)?** But it is important to remember that growth is strong, interest rates are low and savings are highly abundant; the banking system is mostly public;

- **Another debt crisis in the euro zone due to the high level of public debt ratios (Chart 4C)?** But the ECB is going to be cautious, the euro-zone countries have regained fiscal solvency, the peripheral countries no longer have external deficits and therefore can no longer be hit by a balance-of-payments crisis;

- **Protectionism,** feared after Donald Trump was elected, will in all likelihood be averted.

Chart 4A
United States: Real GDP growth (Y/Y as %)

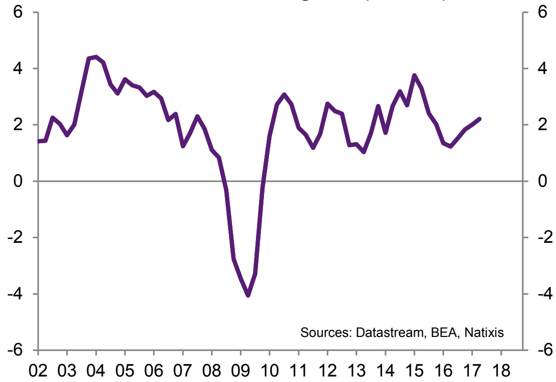


Chart 4B
China: Total debt* (as % of nominal GDP)

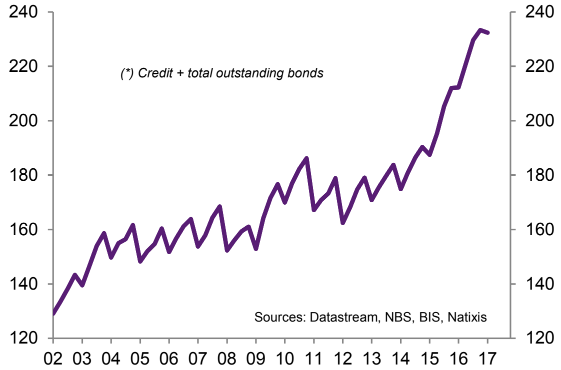
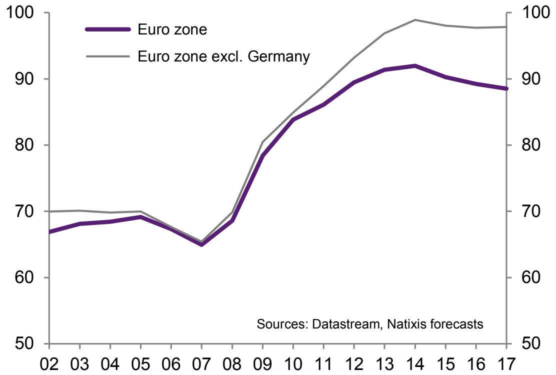


Chart 4C
Public debt (as % of nominal GDP)



(2) So what potential "catastrophic risks" remain?

The following are also potential catastrophic risks:

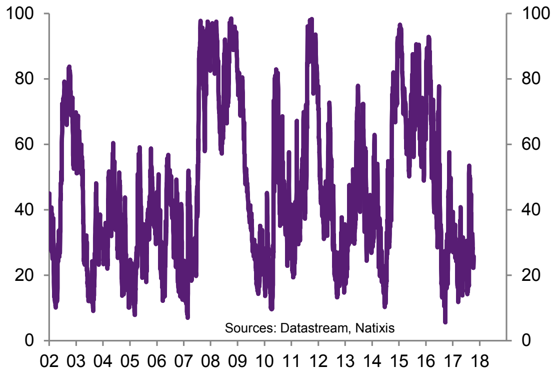
- **A serious geopolitical crisis** (North Korea, Middle East);
- **The election of a populist party in a large European country** (Italy?);
- **A serious political crisis in Europe** (Poland, Hungary, Catalonia, etc.?).

How to hedge an equity or credit portfolio against catastrophic risks?

Investors may therefore want to hedge their equity or credit portfolios against one of these possible catastrophic risks. What hedge should they use? To find out, we will compare:

- **The level of risk perception in the financial markets (Chart 5);**

Chart 5
Natixis risk perception index



and:

- **Interest rates on 10-year government bonds in the United States and Germany (Chart 6A);**
- **The Swiss franc's exchange rate against the euro (Chart 6B);**
- **Oil prices (Chart 6C);**
- **The gold price (Chart 6D).**

Chart 6A
Yield spread on 10-year government bonds and Natixis risk perception index

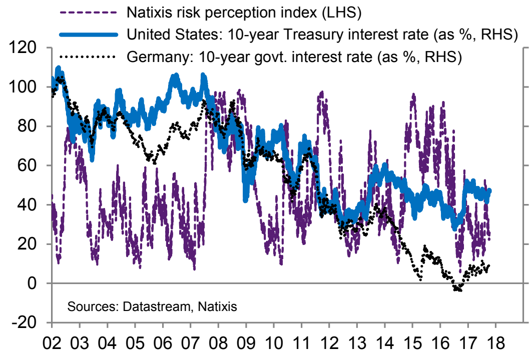


Chart 6B
Swiss franc/euro exchange rate and Natixis risk perception index

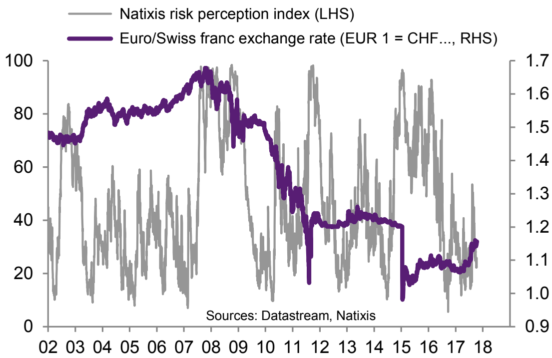


Chart 6C
Oil prices and Natixis risk perception index

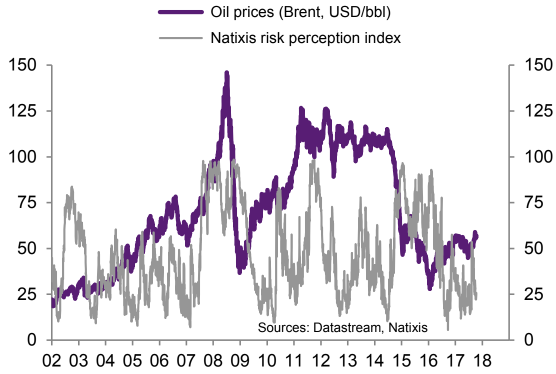
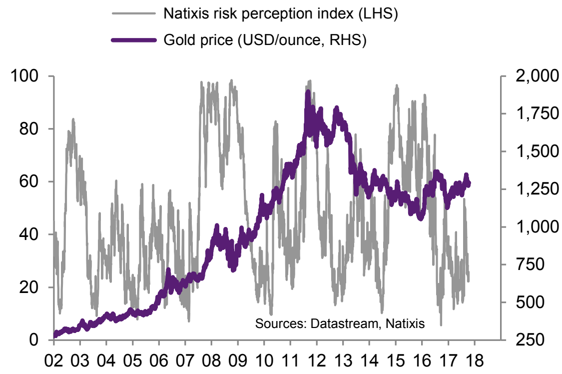
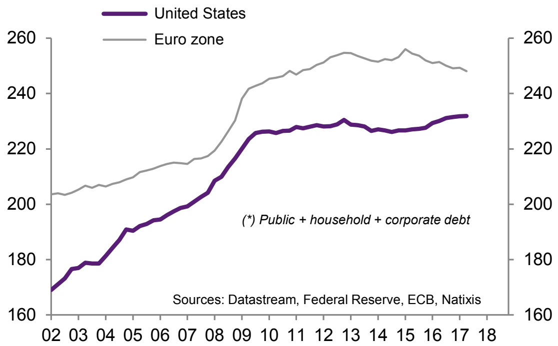


Chart 6D
Gold price and Natixis risk perception index



Oil prices have a particular status, as a sharp increase in oil prices that drove up interest rates would be a catastrophic risk in itself, given the level of debt ratios **(Chart 7).**

Chart 7
Total debt* (as % of nominal GDP)



Charts 6A to **D** and **Table 1** show that **none of these assets provides a hedge against the risk.**

Table 1: Correlation

	Period	United States: 10-year Treasury interest rate (as %)	Germany: 10-year govt. interest rate (as %)
Natixis risk perception index	2002 - 2017	-0.18	-0.04
	2010 - 2017	-0.19	-0.11

	Period	Exchange rate Euro-Swiss Franc (1€ = ...SF)	Oil prices (Brent, $ / baril)	Gold price (USD/ounce)
Natixis risk perception index	2002 - 2017	-0.07	0.11	0.11
	2010 - 2017	-0.22	-0.17	-0.05

Source: Natixis

Conclusion: What can an investor do if they fear a catastrophic risk?

The above shows that if **an investor fears a catastrophic risk that would affect equities and credit, neither long-term interest rates nor the Swiss franc nor gold nor oil prices provide a robust hedge. If the perceived catastrophic risk is a sharp increase in oil prices,** (with its effect on interest rates and borrower solvency), **then a good hedge is obviously oil itself.**

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