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Uber and Lyft's Initial Public Offering

By Jordan Ng and Jonathan Zaionz

At last, two of the most anticipated IPOs this year, Uber and Lyft have entered the chat.
The two ride-hailing giants issued public shares consisting of a 10% stake in their companies. However, at the close of the first day of trading, both traded well below their initial public offering (IPO). Lyft (NASDAQ: LYFT) debuted in late-March, started trading at $72 and spiked as high as $88.60, closing at $57.10 on the first day. Likewise, Uber (NASDAQ: UBER) became public mid-May with an IPO of $45 and closed at $41.57, ruled as the largest first day dollar loss for an IPO in the US since 1975. Morgan Stanley, the IPO stabilization agent in the offering, attempted to support trading of the shares but by the close shares still remained down.
Early on in talks, Uber's valuation floated by Morgan Stanley and Goldman Sachs was as high as US$120b, but at an IPO of US$45 per share the realized valuation was closer to US$80b - making the IPO a disappointment to many.

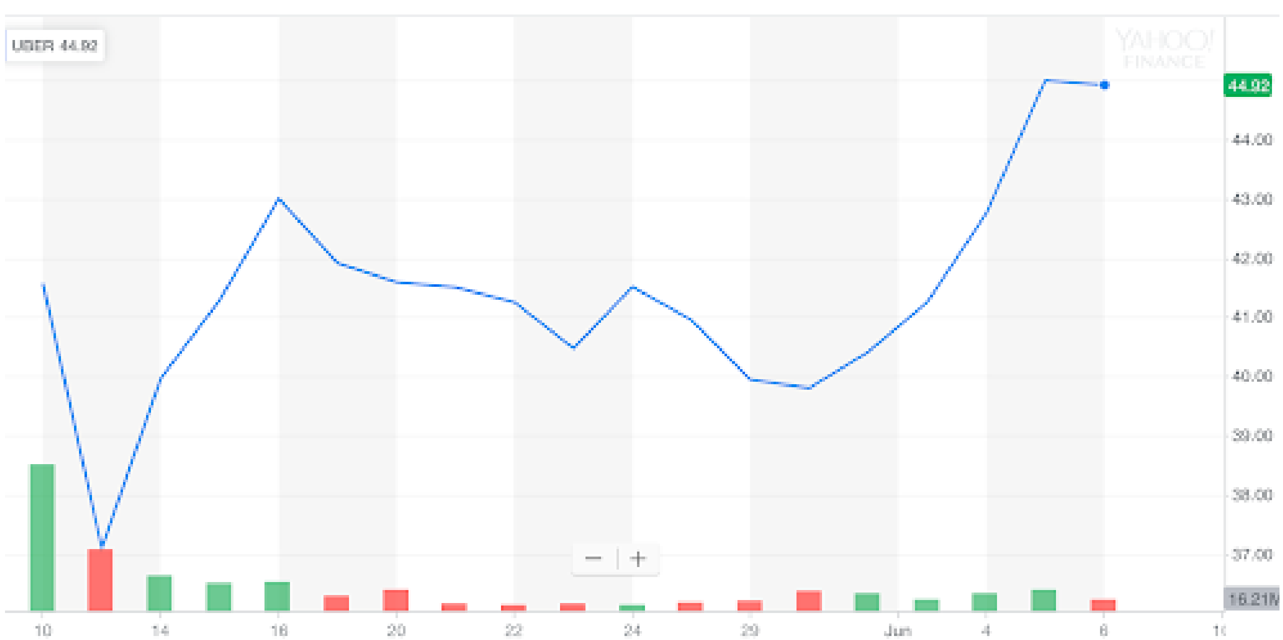

Figure 1: Uber's stock trend since IPO on May 10

Figure 2: Lyft's stock trend since IPO on March 29

What's the reason behind this?

The price decreases can be attributed to the fact that Wall Street is not confident in the long-term profitability of the ride-sharing companies. Uber and Lyft are engaged in competition over industry pricing power as both consumers and investors have struggled to differentiate between these products. They have made expensive acquisitions and poured profits and capital into funding their bold ambitions of autonomous vehicles. Due to this capital allocation, there is a difference in valuation between venture capitalists (VCs) and public market investors. According to Kathleen Smith, principal of Renaissance Capital, "The problem is that these companies have been valued privately at levels that have not followed through in the public market." Some investors have also opted out of investing in Uber at IPO as they had already invested at cheaper prices. Since its founding in 2009 the company has taken over US$10b in investment from mutual funds and private equity firms, and therefore the stock was already widely held.

Uber and Lyft have grown at substantial rates in recent years that are expected to continue. Revenue growth has begun to slow but remains robust for both companies with some acceleration expected in 2020 for Uber. Gross margins for both companies have seen expansion while EBITDA margins have been variable due to S&M expense volatility driven by market competition.

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The Inverted US Treasury Yield Curve

By Jack Yao and Samuel Benedict

What does bond yield have to do with the economy?

The price of a bond and its yield, the return earned from holding the bond, are inversely related to each other. When interest rates rise, new bonds will have higher coupon rates, causing demand for existing bonds to fall, lowering the bond price. In most cases, the longer the maturity date of the bond, the higher the yield. This is because the investor's money will be "frozen" for a longer time period and thus a higher coupon rate is given to compensate investors for the additional risk.

From an economic perspective, when a country's economy is growing, there is a tendency for inflation to rise as well. A rise in expected inflation, all else held equal, will shift the demand curve for government bonds leftwards since investors worry that they will not get a high enough coupon rate to cope with the rate of inflation. On the other hand, the bond supply curve will shift rightwards as institutions can borrow money for a lower real interest rate. As visualized in Figure 1, this results in a lower price of bonds and a rise in the equilibrium rate of interest to resolve investors' fears, hence creating a higher yield.

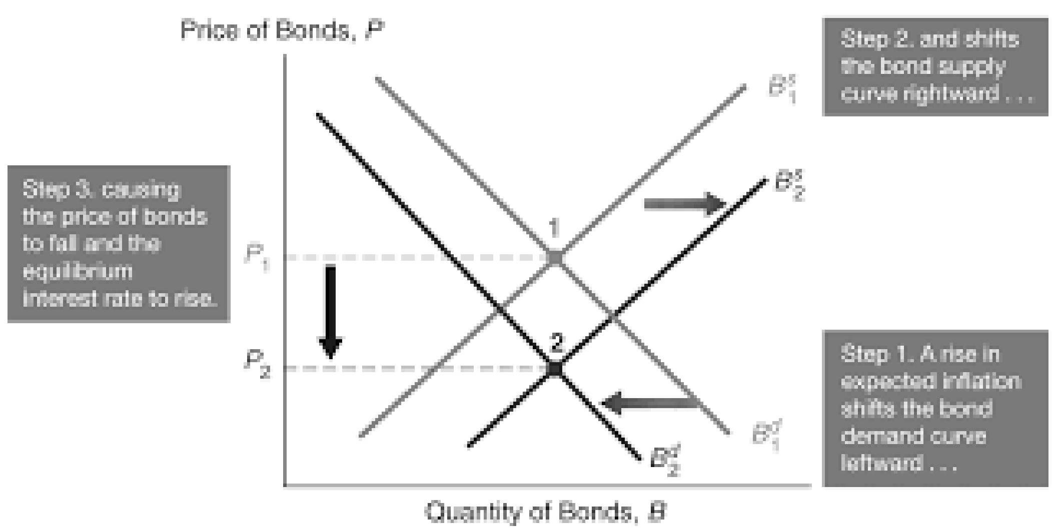

Figure 1: The effect of expected inflation towards demand and supply for long-term bonds

Conversely, if a country is facing a recession, investors are cautious towards riskier assets like equities, and many will decide to play safely with risk-free fixed income securities like US Treasury bills. This creates an increase in demand, resulting in a higher price of bonds that lowers the yield. Moreover, to cope with the recession, the government will usually lower interest rates so that businesses are able to obtain investment capital at a lower cost, in an effort to “jump-start” the country’s weak economy. The lower interest rates decrease the yield for long-term securities.

The Yield Curve Inversion

When the yield on long-term bonds becomes lower than that of short-term bonds, a yield inversion is created. At the end of May, the yield curve inverted between the 3-month U.S. Treasury bill and the 10-year U.S. Treasury note and widened to its deepest level since the financial crisis of 2008. As established before, investors who lock their money into long term investments such as the 10-year Treasury note are compensated with a higher yield. However, recent events have driven investors to frantically invest in long term bonds. With this sudden increase in demand, the price of these bonds have hiked and thus the yield has dropped to a point below the yield for short term bonds. Investors are wary of investing in the equity market of late and are willing to lock-in an annual return on investment with fixed income securities such as the 10-year Treasury note. This market sentiment signals a poor long term economic outlook and low investor confidence.

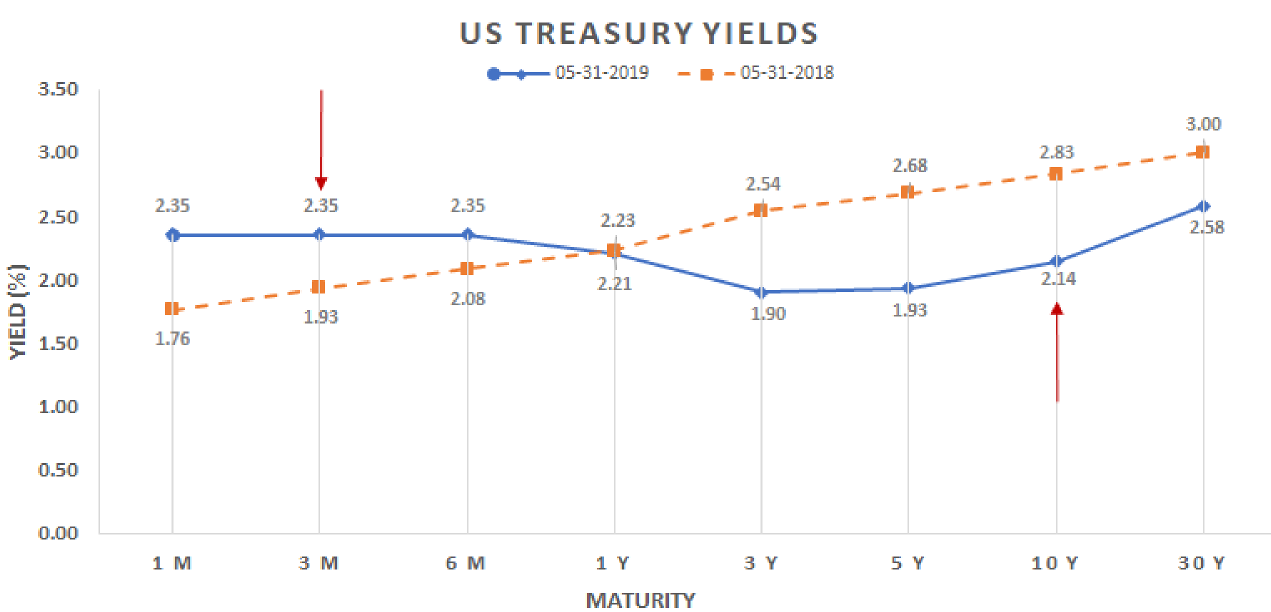

Figure 2: The inversion of the yield curve: 2019 vs 2018

As seen in the above Figure 2, the US Treasury yield curve in May 2018 (orange) represents a healthy curve, with the yield line trending upwards for longer maturity terms. The May 2019 (blue) trendline highlights the inverted curve with short term yields higher than long term yields. Why has this happened?

Recent Update on US-China Trade War

The Trade War between the US and China is heating up again as the Trump administration recently increased tariffs from 10% to 25% on US$200 billion worth of Chinese goods, triggering China to retaliate by increasing tariffs on US$60 billion worth of US goods. This only adds more companies to the list of those affected by previous tariffs imposed on export products, such as aluminium. These companies will now have to find ways to remain competitive in the market, most of which decide to either decrease their original prices or lay off employees. The fact that the trade war is lasting longer than analysts had predicted, along with little signs of a deal being made, is stoking investors' fears that there will be more long term, negative impact on the U.S. and global stock markets. Therefore, investors are shifting their portfolios toward long-term U.S. Treasuries to guarantee the safety of their investments. Despite decreasing yields, higher bond prices are causing the demand for long-term U.S. Treasuries to continue to rise, causing their yields to decrease even more.

The Fed's Demand for Treasurys

On March 19-20, 2019, The Federal Open Market Committee (FOMC) Meeting arrived at an agreement to change some of the policies for US Treasuries. For instance, the System Open Market Account (SOMA), a monetary policy tool that holds assets gathered from the open market, was impacted by the Federal Reserve's (Feds) decision to acquire more Treasuries. Before the FOMC Meeting, the SOMA's Treasury portfolio should have decreased from \$3.7 trillion to \$2.7 trillion, with outstanding Treasurys going from \$2 trillion to \$1.5 trillion. However, after the meeting, The Fed agreed to add assets so that the SOMA portfolio will hold \$3.5 trillion in assets flat until 2021. Interestingly, The Fed will gradually increase the proportion of added assets towards more US Treasury bonds. This increase in demand will cause an \$850 billion addition of long-term Treasury bonds outstanding at the end of 2021. Thus, it results in a lower long-term Treasury bond yield that leads to the Treasury yield curve becoming inverted.

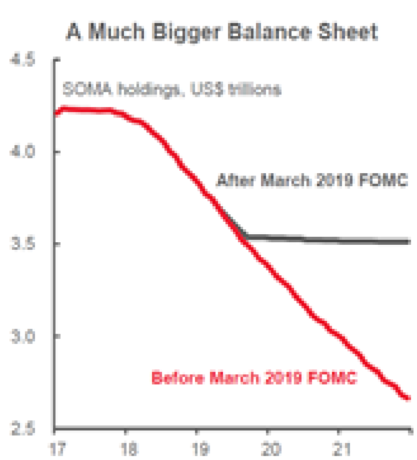

Figure 3: SOMA portfolio before and after FOMC Meeting

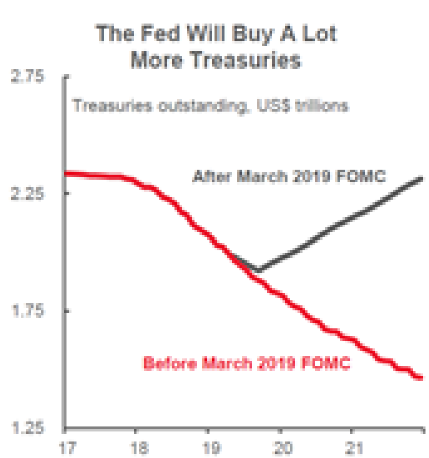

Figure 4: Treasuries outstanding before and after FOMC Meeting

Future Outlook

Looking to the future, the recent inversion of the US Treasurys yield curve might be a potential signal for an upcoming recession, especially with the increasing Trade War tension between US and China. Although an inverted yield curve has historically been correlated with US recessions, there is no guarantee one will occur. This is especially true since The Feds' own decisions play a major part in the 2019 inverted yield curve. However, if the curve remains inverted consistently, this may be a big indicator that rough times are ahead for the US economy.

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Corporate Hedging Strategies

By Shanda Feng and John Li

Hedging: What is it and how do corporations use it?

In the mid-1800s, grain farmers in Chicago competed with each other to sell their crops to dealers through contracts that locked the price for a limited quantity of grain delivered during harvest. Today, this is known formally as hedging, an investment process in which corporations aim to reduce potential financial risks by offsetting them against losses/gains. For example, if there is a high risk of potential loss, corporations may invest in derivatives of underlying securities that have the opposite or offsetting effect. This causes those losses to be mitigated with the gain created by the hedge. Similarly, an initial investment may turn out favourable but a hedge may still be made to guarantee at least a certain amount of gain, in the event that the security begins moving in an adverse direction.

With that being said, the most popular hedges are against foreign exchange risk, interest rate risk and commodity risk. Hedging against foreign exchange risk is used by both financial investors to deflect the risks encountered when investing abroad and by non-financial investors in the global economy for whom multi-currency activities are a necessary evil. Interest rate risk is the risk that the relative value of an interest-bearing liability, such as a loan or bond, will worsen due to interest rate increases. Hedging strategies like fixed-income instruments and interest rate swaps reduce this type of risk. Commodity risk is risk that arises from potential movements in the value of commodity contracts, which include agricultural products, metals and energy products.

A common question asked about hedging is why bother when it is so complex? A good example to answer this is Netflix. In the second quarter of 2018, Netflix failed to make use of a proper hedging strategy against foreign exchange risk. As a result of a faster than expected increase in the U.S dollar and a wide global presence, Netflix's worldwide earnings suffered when converted to its home currency. Without a proper hedging plan in place, this risk was not mitigated. Thus, this caused Netflix to lower its year operating margins expectations to the lower end of the original 10-11%. Clearly, failure to hedge cost Netflix a lot of its bottom line in Q2, making it a lesson to reduce volatility by hedging in the future.

Hedging Tools

Derivatives are the underlying instruments of hedges. They often fit under two categories: futures and options. While both types of derivatives involve a buyer and a seller of an underlying asset, forwards are binding and traded over-the-counter while options are traded on exchanges and give the right to the buyer to exercise the option. Futures may include swaps, forwards and future contracts while options include call and puts along with interest rate caps and floors.

When hedges work, they have many advantages. One of the biggest, as demonstrated with successful hedges below, is their reduction of volatility; increasing certainty and allowing corporations to plan ahead. However, when they fail, it is often because the hedge doesn't completely offset losses/gains, called "basis risk", or that the hedge is more of a speculation. This occurs when the hedge tries to predict market movements rather than mitigating financial risk and can cause havoc when exposed.

Major Hedging Successes and Failures

When hedging strategies are successful, they can have a massive impact on earning potential of a corporation. Back in 2011, Krispy Kreme donuts made a hedge in the commodities futures market. Since it was often exposed to commodities such as flour, sugar and fuel for their delivery trucks, it purchased exchange traded futures and options on commodity contracts in order to lock in future prices and its fluctuations. This helped to guarantee that their costs would not skyrocket due to the market, ensuring reduced earnings volatility and a stable stock price.

While the purpose of hedging is to mitigate risk and counter losses associated with trading a security, if traders are not careful and apply the wrong strategies, it can backfire. In the financial crisis of 2008, hedge fund managers bought multiple credit default swap (CDS) contracts, a derivative tool, to hedge against subprime mortgage-backed securities. These funds paid a premium to major insurance companies such as AIG that guaranteed to pay off mortgages in the case of default, which gave fund managers a false sense of security and led them to purchase more and more swaps. When a large portion of these securities defaulted, insurance companies were able to pay and as a result, the Dodd-Frank Wall Street Reform Act was established to increase regulation on security based swaps.

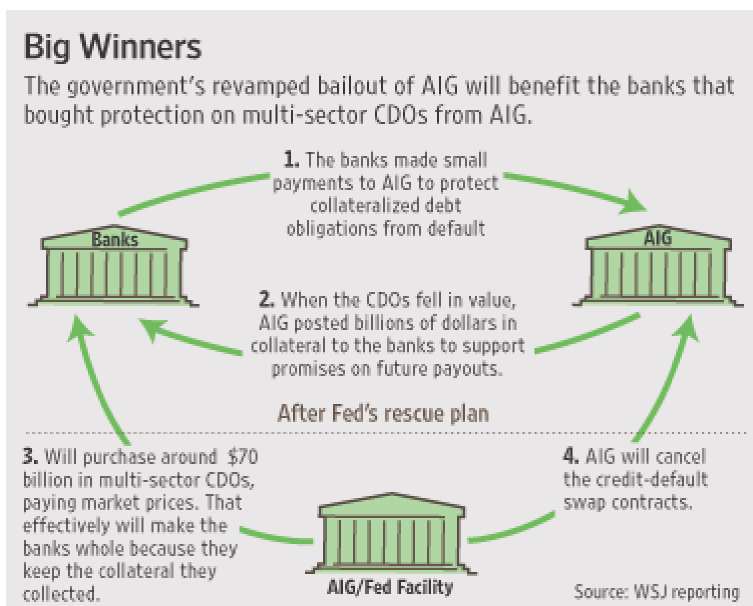

Figure 1: AIG bailout impact

Credit default swaps were pioneered by financial engineers at JP Morgan to hedge against the risk of default in the bank's investments in investment grade and junk corporate bonds. Even so, JP Morgan lost over $2 billion using these financial tools to hedge their bond default risk and had its credit rating cut by Fitch in 2012. This is because credit default swaps are traded thinly, and are illiquid compared to other securities. In addition, the firm layered hedges on top of hedges, resulting in an overly complex structure that reduced the potency of each default swap offsetting losses from different bonds. Today, with consideration to the risks and the consequences of using credit default swaps from the 2008 debacle, there is an ongoing debate on the ban or further restriction of CDS.

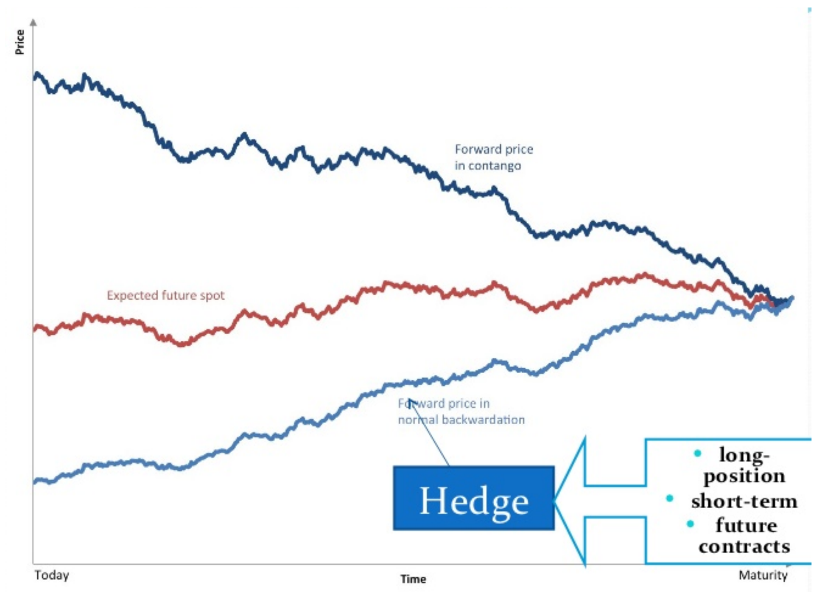

Figure 2

Similarly, another company that suffered heavy losses when hedging is Metallgesellschaft(MG). In 1993, MG, a German company specializing in metals trading lost $2.2 billion in futures trading. It sold long term forwards (forwards that expire later) and hedged that risk by buying short term futures every month and rolling them. Investors engage in a contract roll by closing a future position before the expiration date and purchasing another short term future with a later expiration date. If the market price of crude oil was increasing, the short position on the long term forwards would be losing money since MG would be required to sell crude oil below market price while the long position on short term futures would see gains. However, the short term spot prices fell while long term oil prices rose on the market, a phenomenon known as contango, and as such, each future contract was rolled over with losses made worse by the increasing market price and its effect on the long term forward contract, leading to the liquidation of MG. While this stack and rollover strategy works well if the market had faced opposing conditions, known as backwardation, this demonstrates the volatility of the futures market and how hedging can go wrong.

What can we learn from all this?

As seen with the JP Morgan credit default swap case, over hedging and combining hedges together only serves to decrease the efficacy of each financial tool used. Hedging based on speculated market conditions only works if those speculations are right, as proven by the MG forward and futures hedging strategy. However, a lack of a hedging strategy can leave companies overexposed to risks regarding their assets and securities like Netflix's loss in profit from currency fluctuations. By applying the proper hedging strategies, companies like Krispy Kreme can successfully avoid losses due to price uncertainties. From looking at mistakes committed in the past, what risk to hedge, what securities to use, and how much should be put into hedging should all be considered in detail.

While quantitative analysts and traders learn from history how to successfully hedge risk, the future of hedging strategies seem to be heading towards incorporating machine learning to help model risk and develop complex financial tools. Currently at JP Morgan, machine learning is being applied to better hedge index options, and in the future, can be extended to more securities. From the use of simple olive oil contracts centuries ago to the advanced quantitative strategies applied today, hedging strategies continue to grow and change.

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Indian Market Fluctuations

By Michael Li

On May 23rd, Indian Prime Minister Narendra Modi won a landslide victory for the Bharatiya Janata Party (BJP). However, Prime Minister Narendra Modi’s thumping election victory is dividing analysts on India’s rupee. Some expect Modi’s sweeping win to attract robust overseas inflows to the nation’s assets and see this victory as a signal of the long craved stability. Overseas funds bought $9.4 billion of local shares this year positioned for Modi getting a second term. While others such as Citigroup, are positioned for a weaker rupee using options after the currency’s recent outperformance on the grounds of “Election exuberance fizzling out quickly”, the wider-than-expected trade deficit, cautious outlook toward emerging markets and risks of oil prices.

Post-Election Reality Check

The landslide victory for India's Prime Minister Narendra Modi briefly sent the country's stock markets to record highs as the results started to come in. The Sensex surged 900 points to cross 40,000 for the first time ever after early poll counts gave the NDA a huge lead. The country's other major index, the Nifty, also hit record highs.

The euphoria of this election result was shortlived as domestic realities came back to focus causing stocks to fall back after rallying to records and the rupee slid as investors refocused on domestic realities. While Modi’s sweeping victory allayed fears of a possible coalition or divided government, his return coincides with a slowing economy, wider budget deficit, volatile oil prices and global trade tensions. The benchmark S&P BSE Sensex pulled back after briefly climbing above the record 40,000 level on Thursday. “The market is likely to quickly revert to near-term concerns: slowing consumption and a brewing non-bank finance company crisis; the combination of weak corporate earnings and elevated multiples,” Sanjay Mookim, India equity strategist at Bank of America Merrill Lynch Ltd. wrote in a report Friday. “We don’t see election results changing these bottom-up concerns.”

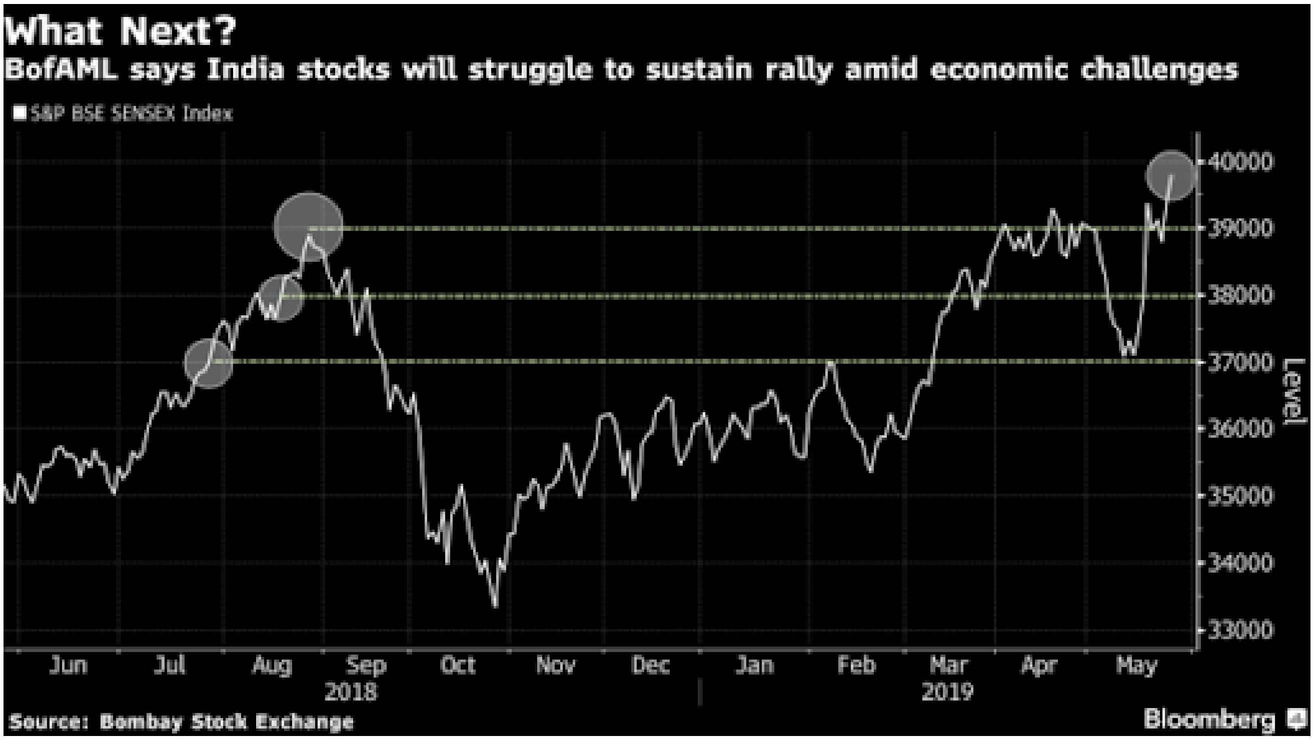

Figure 1: BSE Movement 2018-19

Modi may not be a pro-market Prime Minister

After Modi's 2014 election victory, he made an overture to foreign investors. Finance minister, Arun Jaitley, didn't keep up the promise of making India's tax regime more predictable and less adversarial. In the name of protecting mom-and-pop retailers and the sovereignty of Indian consumers' data, the e-commerce policy now appears to favour Reliance Industry's, Mukesh Ambani over Amazon.com Inc.'s Jeff Bezos. Protectionism has gone up. The Donald Trump administration is far from amused.

Expectations for Modi's second term

- Bank mergers will happen along with capitalization; bailout of shadow lenders unlikely unless the problem is systemic. Private banks have a long growth runway.
- Government focus expected to shift to large infrastructure projects; push to fix power supply chain problems.
- Defence budgets unlikely to go up; disinvestment likely to keep the pressure on state-run stocks.
- RBI is likely to cut rates and inject liquidity over the next few months, which should be good for rate-sensitive stocks. Banks, autos, real estate, mortgages to benefit
- BAML Economist expects RBI to transfer $14 billion to $42 billion of surplus reserves, which could provide the government room to recapitalize state-run banks and spend more on infrastructure

Foreign Funds Bought Indian Bonds

Global investors piled a net $216.3 million into Indian bonds on Friday, right after disclosure of the election results.The second-biggest daily inflow in two months turned foreign funds into net buyers of rupee-denominated notes for May, signalling the debt's appeal may be rising as wagers grow that the Reserve Bank of India will soon add to its two interest-rate cuts this year.

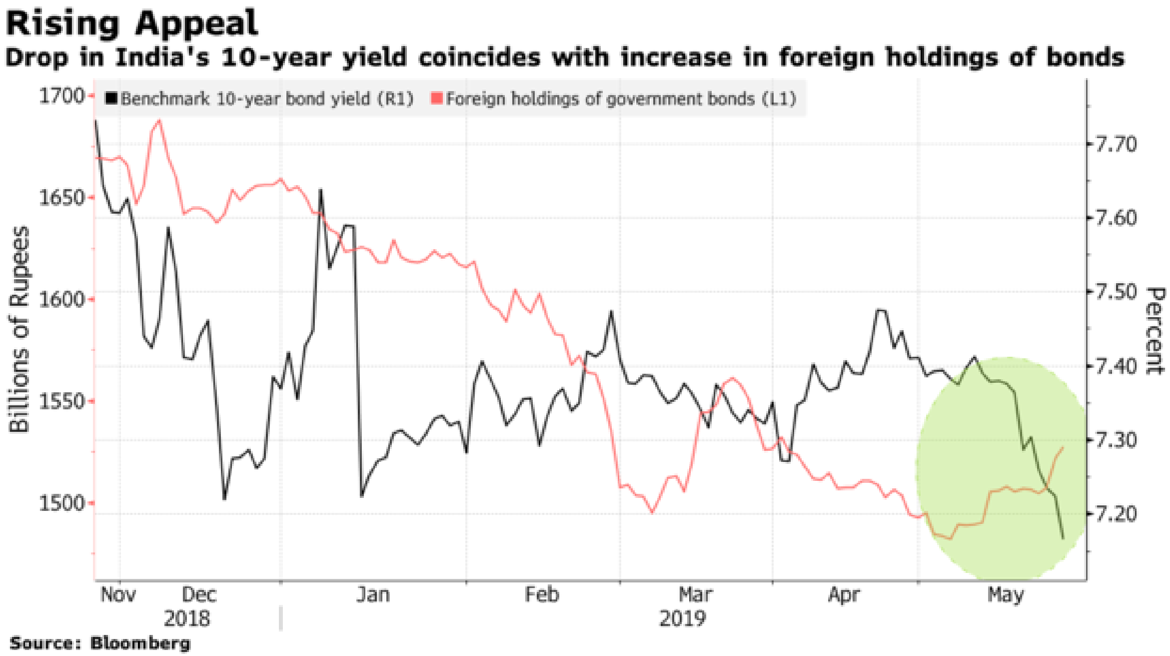

Figure 2: Indian goverment bond yields 2018-19

Modi's re-election put to rest any uncertainty about a diverse group of political parties coming to power at a time when growth is already slowing. The benchmark 10-year yield slipped as much as seven basis points to reach 7.16% on Monday, the lowest since April 2018, with traders citing overseas demand as a reason for the rally in bonds. In the words of Kotak Mahindra's chief investment officer, "If your forwards are bearable and yields are high, that is when they make a nice and attractive carry"