Hedge funds take profit on vol trades with Trump win

FX volatility drops sharply as positions unwind; rates market sees mixed reaction

By Joe Parsons and Bernard Goyder
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Hedge funds that bought foreign exchange options in a bet on increased volatility around the US presidential election have largely unwound their positions, sending vol levels sliding across several currency pairs.

Dealers say the extended period of market volatility they had expected failed to materialise after Donald Trump and the Republican Party's resounding victory.

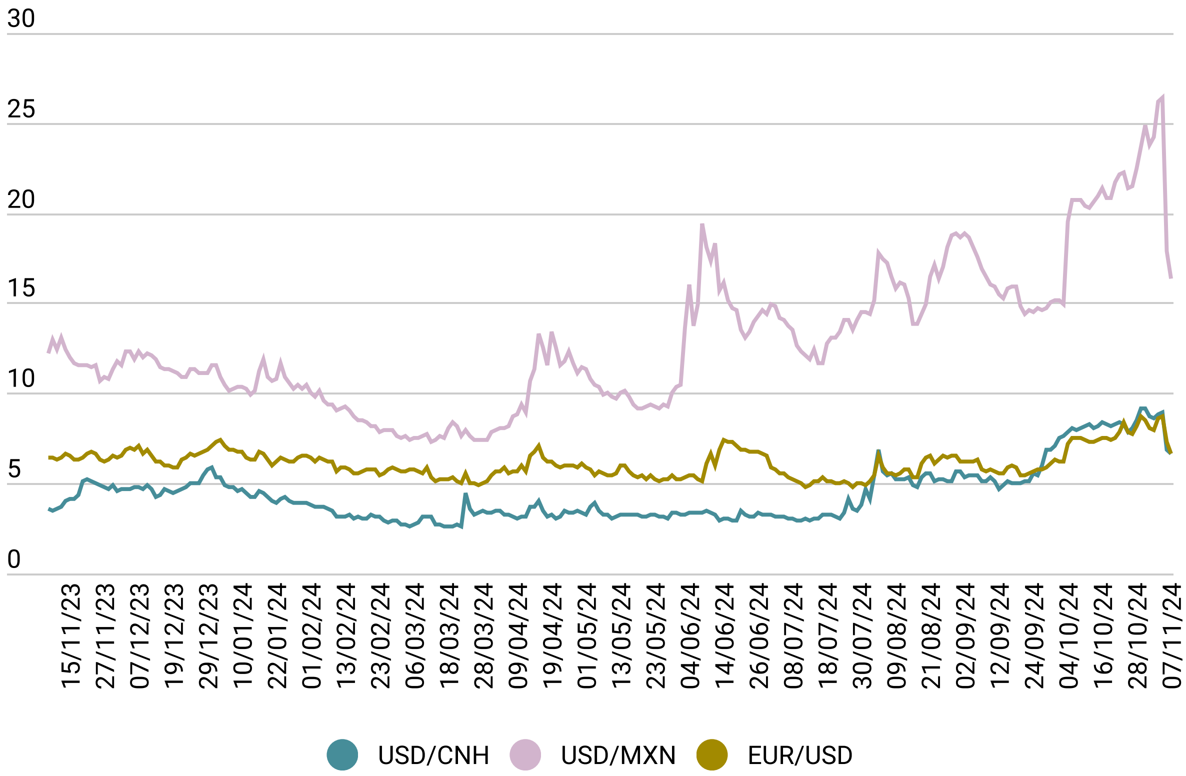
As a result, many hedge funds that bought vanilla positions and 'first generation' exotics such as digitals and call spreads, favouring US dollar strength against the Mexican peso and Chinese renminbi, took profit on the trades. This pushed volatility down just as the event premium that was sustaining high vol levels dissipated.

"The magnitude [of the vol collapse] is only large because there was a large risk premium priced into the election itself. The market was expecting a lot of volatility and for it to persist for a few days post-November 5 in case of recounts and/or disputes," says the head of FX options trading at a Europe-based dealer.

"None of this materialised as the result was resounding and fast. Therefore, all these hedges that were bought were unwound. Fast money was also selling optionality to try to take advantage of the still-elevated vol level."

Going into the election, event premium was priced at some of the highest levels since 2016, most notably in US dollar/ Mexican peso where one-month at-the-money vol levels hit 26.17 and overnight implied volatility reached 95.

One-month at-the-money implied volatility



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Following the election result, these levels were pared back significantly to 16.59 and 26, respectively, as the event risk was priced out.

A lack of movement in spot further exacerbated the selloff. During the day, USD/MXN strengthened from 20.2 to 20.7, before returning to pre-election levels.

“One-month USD/MXN was expected to trade at 20.75 vols and now trades around 16, so we have seen a substantial vol selloff in MXN,” said a senior FX options trader at a large US bank, speaking in the UK during the afternoon of November 6. “This can be explained by the brutal underperformance of spot, as well as some unwinds from clients.”

One-month volatility in other currency pairs, including renminbi and euro, has also experienced a sharp fall.

However, dealers say there is still demand for buying longer-term volatility. One-year volatility for US dollar/yen, for instance, has risen by 0.2 vols since the election result.

"We still see interest in USD-higher structures from both fast and real money," adds the senior FX options trader at the large US bank.

Kristjian Kasikov, global head of quantitative FX investor solutions at Citi, says that going into the election, there was also interest from hedge funds in carry trade strategies that could take advantage of the event premium priced into the trades to sell volatility. But with the election out of the way, there could now be a return to systematic vol selling to capture the difference between implied and realised vol.

"Given the popularity of volatility selling in major crosses like EUR/USD and USD/JPY over the last couple of years, I wouldn't be surprised if, now that event risk has passed, we will see more of that again," says Kasikov.

On the linear FX side, Kasikov notes that hedge funds have been the biggest buyers of US dollar and sellers of euros and emerging market currencies through FX forwards and swaps, according to Citi's flows heatmap data.

"We had about plus two standard deviations' worth of hedge fund USD buying," he says. "[November 6 was] the second biggest day of euro selling in that data's history."

Rates response

On the rates side, a desk strategist at one US bank says extreme volumes were seen in early US hours as the outcome of the election became clear. Ten-year yields rose by 20 basis points from levels on polling day and the volatility led to a 25%

fall in US Treasury order book depth, limiting the ability to execute large risk.

However, he says it was possible to execute risk over the course of a minute rather than instantaneously, but with roughly a 50% increase in execution costs compared to historical averages.

Many hedge funds sat out the event, according to the desk strategist, but those that played it were typically using steepeners on the two- and 10-year points of the US Treasury curve, which performed well.

One trade that didn't work out for some involved UK gilts. A number of funds were said to have purchased the bonds, believing they were cheap following a selloff linked to the UK government's budget announcement on October 30, which saw yields on 10-year gilts jump 20bp on the day to above 4.4%.

But with a Trump presidency considered negative for the UK, gilt yields have continued to rise following the US election result and were hovering around 4.52% at 1pm UK time on November 7, despite a 25bp rate cut from the Bank of England an hour earlier.

Editing by Lukas Becker
