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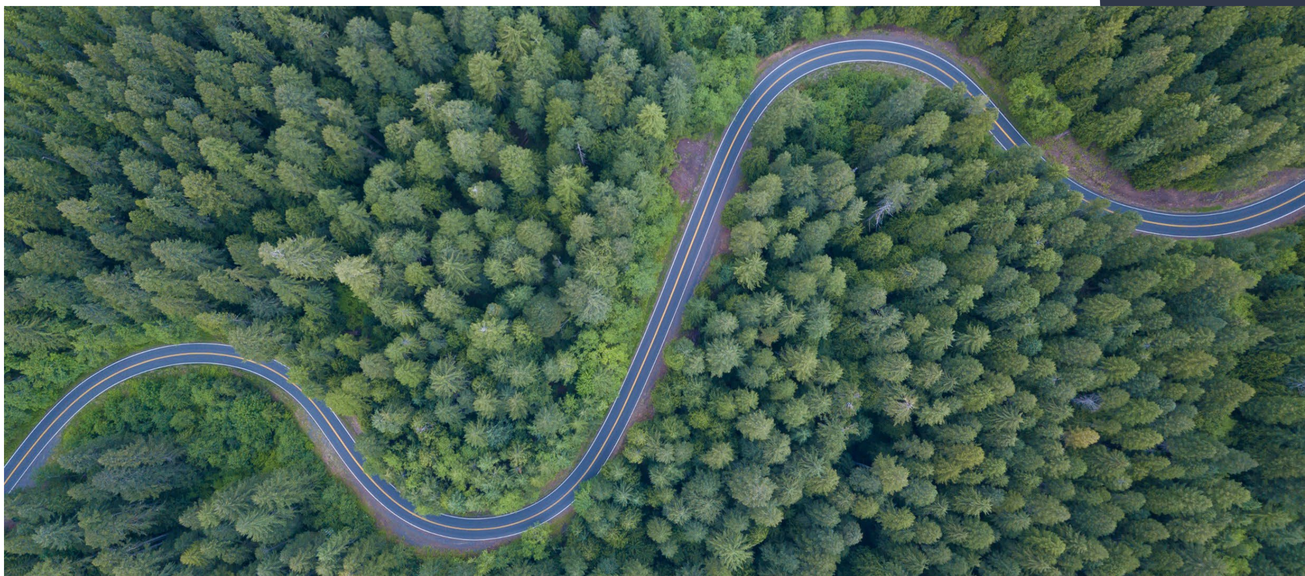
A Tale of Two Tails



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There are few purchases we make that we hope never to have to use. Things that come to mind include any insurance products, fire extinguishers, first aid kits and the packet of Imodium that is a must when travelling to exotic destinations. But they are bought precisely because there is a non-negligible probability that they will be required. In mathematical or actuarial terms, these would be described as tail risks based upon the bell-like shape of a normal distribution curve (or possibly, in these cases, a half-normal curve

because there are only negative outcomes relative to the usual state – it's not as if you might profit from your house not burning down). Tail risks, investors' pricing of them, and their outcomes play a big role in moving markets in the short term.

Buying insurance to profit from highly improbable events affecting others negatively is not something we tend to encounter in the world outside financial markets. The incentives are too skewed. Imagine, for example, if your neighbour bought insurance against your house burning down. You'd be pretty nervous every time you saw them walking by holding a box of matches. But in financial markets, it is normal practice. The buyer of "insurance" could either be someone who is looking to hedge a position they have elsewhere in their portfolio or someone who is taking a directional bet.

One of the most famous cases of a directional tail risk play paying off was George Soros's bet that the UK would exit the Exchange Rate Mechanism in 1992. The big winners during the Global Financial Crisis were the hedge funds which took the view that the US housing market boom was unsustainable. One of their main bets was to buy Credit Default Swaps linked to the bonds of financial institutions which would suffer badly when the housing bubble finally burst. They paid cents on the dollar to receive eventual payouts in the tens of cents. But this was no "get rich quick" scheme. The positions took a long time to play out and had to be funded. The research was painstaking. What might look like an overnight success akin to cleaning out the house in Las Vegas was nothing of the sort.

It also pays to remember the sage words of the economist John Maynard Keynes, who opined that "markets can stay irrational longer than you can stay solvent". You might need deep pockets and a will of iron to make these types of trade.

The influence of tail risk hedging (combined, to be sure, with some directional trading) is currently playing out in interest rate futures markets. This is something I have written about before, but it's worth reiterating the point, because expectations about the price of money are supremely important to the performance of financial assets and to confidence in general. It is especially visible in the apparent expectations of the timing of the first interest rate cuts of the next cycle and in where they will be by the end of the year.

The most important interest rate is the US Federal Funds rate, the effective "base rate" set by the Federal Reserve Bank's Open Market Committee (FOMC). At the beginning of the year, the market was pricing in a cut as soon as the FOMC's March meeting, but that has been pushed back to June, partly owing to inflation being a bit stickier than expected, but, possibly more importantly, owing to the fact that the US economy just keeps growing.

This is where the tail comes in. In the case of interest rates, the "left tail" risk is much lower rates. I'm not talking the gentle reduction that would result from friendly lower inflation; I'm talking much lower rates required because the economy is very weak. As we headed into 2024, there were still many people forecasting a sharp slowdown and this has not materialised. There were also many fully invested investors who were too scared of missing out on more market upside and so they hedged their positions by buying relatively low cost instruments that would pay out a lot if interest rates had to be cut sharply owing to a weak economy. There will also have been funds or banks hedging their reinvestment risk for short duration fixed income products, perhaps because they were too nervous about extending the duration of their investments just in case inflation came roaring back.

As for the year-end rate expectation, at the turn of the year it was around 3.75% and it is now around 4.5%. Remember that the FOMC's own "Dot Plot", which projects the members' median Fed Funds rate forecast, has been sitting at 4.625% since December. Admittedly, the FOMC's forecasting ability is as

suspect as anyone else's, but that 3.75% market pricing was still a pretty big step down. But how was this derived? It is, in reality, only the average of all the positions in the market, not a specific forecast, and so it includes all those tail risk hedges. The rise from 3.75% to 4.5% largely reflects a removal of the left tail risk as the market becomes increasingly comfortable with the belief that the US will avoid a recession. Indeed, the consensus US GDP growth forecast for 2024 has risen from a low of 0.6% last summer to 2%. It was still only 1.3% on January 1st.

And so, reports saying that "the market is pricing in 3.75% Fed Funds by the end of this year" were, I believe, misleading, because they failed to interpret the composition of that number and the motives behind the positioning.

There is an element of what we might describe as "the tail wagging the dog" on display here. This is when financial instruments costing a relatively small amount, but which might lead to a very high profit, can have a big effect on the price of the underlying security. We have seen this a lot recently in the share options market, especially with the growing use of "zero day to expiry" options. They can create a lot of short-term volatility, although there should be some sort of mean reversion towards fair value eventually.

If this is how the market structure is going to evolve - and I suspect it is - I can see that there will be opportune moments to take advantage of such volatility in future, either when markets or individual stocks are showing signs of panic or when they are becoming too frothy. It might not necessarily be appropriate to take big positions in the other direction (bearing Keynes in mind), but more a case of topping and tailing portfolios in an appropriate manner. But it will require being relatively fleet of foot. When tail risks are "priced out", markets tend to move violently, as they did in the final two months of 2023 when a spike in bond yields, much of which was attributable to concerns about the funding of the US federal deficit, reversed rapidly following a series of more helpful news.

This is not solely a US phenomenon. Here in the UK, for example, the futures market on New Year's Day appeared to be pricing in a Bank of England Base Rate by December of 3.5%, implying 1.75% of cuts. That has now risen to 4.5%. And there is a similar picture in Europe, where the implied December 2024 rate has risen from 2% to 3%.

I felt at the start of the year that investors were pricing in an improbable combination of a no or soft landing for the global economy, decent growth in corporate earnings, steadily falling inflation and drastically lower interest rates and that at least one of those would have to give. I would say it's been a combination of rate expectations (mainly) and a little less optimism about inflation.

Economic Commentary

FTSE 100 weekly winners

InterContinental Hotels Group PLC	12.8%
Barclays PLC	11.6%
Rolls-Royce Holdings plc	9.2%
Standard Chartered PLC	6.8%
Lloyds Banking Group plc	5.3%
International Consolidated Airlines Group SA	4.9%
Intertek Group plc	4.9%

FTSE 100 weekly losers

Hargreaves Lansdown plc	-9.7%
Standard Life Aberdeen	-6.6%
HSBC Holdings Plc	-6.5%
Glencore plc	-5.9%
Rio Tinto plc	-5.8%
International Distributions Services plc	-4.0%
BHP Group Ltd	-4.0%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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