Preparing for a seasonal downturn in Mexican equities?

Think Brazil's re-election process will increase volatility?

Exercising Your Options

Derivatives can help reduce some of the uncertainty in investing in Latin America by providing downside protection or by containing the range of potential outcomes. Two potential ways to achieve this include a collar strategy for Mexico, and call spread strategies for Brazil.

Short Term Collar Hedge

The Mexican stock market is likely to see weakness in the weeks ahead, given an anticipated seasonal blip in inflation and the resulting probable rise in interest rates and peso volatility. In recent months, interest rate have tracked the downward trend in inflation. The yield on 28-day Cetes has fallen from 31.3% in July to 26.5% in August and to 23.9% in September. Using Merrill Lynch's forward monthly inflation forecasts, the rate reduction in real terms is even more significant, dropping from 9.7% in July to 4.9% in August to 3.5% in September. However, the acute reduction in interest rates, both in real and nominal terms, suggests an upward correction in the coming weeks. With real rates having little further room to drop and inflation likely to pick up in the coming months, nominal rates are likely to rise during the fourth quarter.

A rise in inflation resulting from the seasonal pick up in demand as well as the annual resetting of the minimum wage and public prices such as electricity, oil and public sector services is also likely to put some pressure on the exchange rate in the months ahead. Higher inflation could contribute to a depreciation of the peso toward NP8/US$ by year-end. The continuation of the floating exchange rate regime and the Bank of Mexico's commitment to refrain from intervention in the foreign exchange market leaves open the possibility of a sudden peso correction, as opposed to a more gradual depreciation. The deceleration of export growth from a 21% average growth rate in the first eight months of the year to only 10% in August is likely to lead to growing concern of overvaluation and a sudden correction.

Despite the likelihood of higher minimal interest rates and exchange rate volatility in the short term, the favorable GDP growth outlook should continue to provide the stimulus for improved corporate earnings growth, which should propel the market in the medium and long term. The biggest contributors to the strong industrial production performance are likely to be the construction and manufacturing sectors, which are expected to grow by 11.4% and 10.2%, respectively.

Given the short term bearish outlook, investors can use collars to lim[illegible] portfolio risk exposure to a pre[illegible]mined range. The collar would provide protection in the downside and cap the upside until the investor feels more positive about the Mexican market. Since the longer term outlook is positive, a collar would be a convenient method to contain extreme outcomes temporarily.

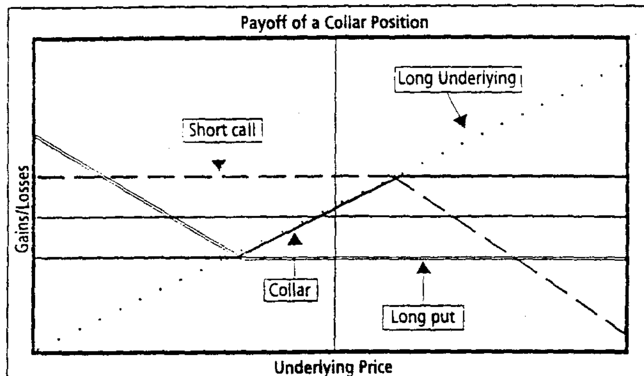
A collar is created by buying out-of-the-money put options and selling out-of-the-money call options on top of the existing long stock portfolio. The resulting payoff pattern is limited downside to the strike price of the put option and capped upside to the strike of the call option.

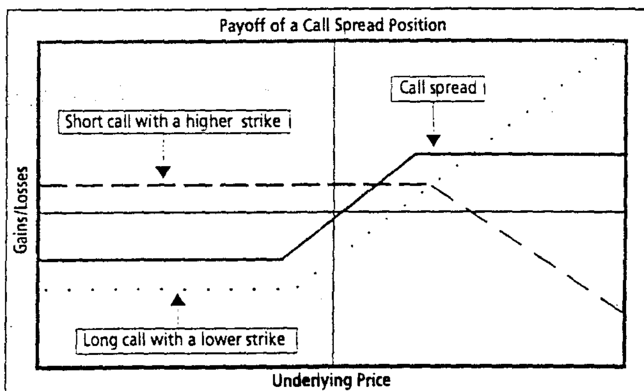
Collars can be structured as zero-premium, in which case the price of the call and put would be equal. The equity exposure range of a zero-premium collar is determined by the pricing skew between out-of-the-money puts and calls. If the pricing is skewed toward puts, investors would have to give up more upside, and if the pricing skew is towards calls, then there would be more upside in the resulting collar position.

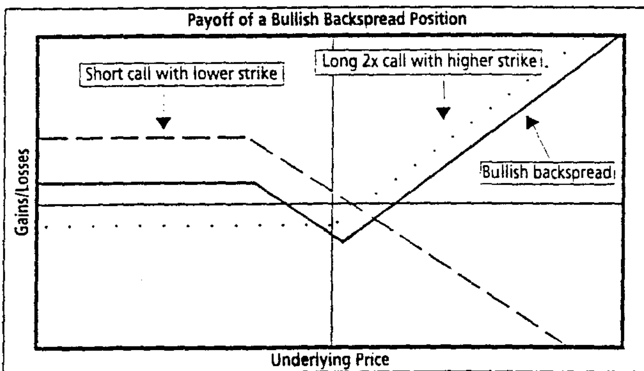
Given the current high in[illegible]t rate environment in Mexico, pe[illegible]nominated collars provide more room on the upside than downside. This is

because higher interest rate results in higher call prices and lower put prices. For example, a recent indicative pricing for a six-month, zero-premium collar for the IPC Bolsa Index in pesos was 97.5% of the notional on the downside and 121% of the notional on the upside. The structure of this collar would have long puts with a strike price at 97.5% of the index to protect potential downside beyond 2.5%, and short calls with a strike price at 121% of the index to finance the long put position.

Collars can also use different approaches. For example, the IPC Bolsa Index collar can be structured in a different currency, such as the US dollar. Due to the lower interest rate environment in the US, the payoff range becomes much more symmetric than that of the peso denominated collar. For example, according to a recent indicative pricing for a six-month, zero-premium collar, the range was 97.5% and 106% of the Bolsa Index. Also, collars can be quoted, in which both the principal and profits and losses of the collar would be protected from exchange rate fluctuations.







Call Spreads on Brazil Equities

The Brazilian stock market is expected to continue on a "wait and see" status as domestic and international players remain cautious about taking new positions before more is known on the telecommunication tariff increase and on the re-election issue. In fact, the political climate is expected to become even more unstable. The main reason is that politicians are expected to continue to be elusive about their position on the re-election proposal.

By avoiding to make a final commitment in favor of or against the re-election issue, politicians increase the value of their vote and consequently gain more political weight. However, the strategy of the government is to foster the re-election debate at all levels so that the pressure to approve the constitutional amendment becomes so great that its approval becomes almost undeniable and those who vote against it become alienated. A recent opinion poll by IBOPE shows that 51% of the population supports the re-election issue and 78% supports the Real Plan.

The importance of the re-election issue cannot be overstated, as it is almost like an anticipated presidential election whereby Cardoso's own re-election is being played out. The failure to approve the re-election constitutional amendment does not doom the Real Plan, since it is not dependent on one man—Cardoso. Instead, the failure to approve the re-election bill could possibly delay the approval of the constitutional reforms and divert the government's attention away from correcting fundamental structural problems and into just trying to survive another two years in power. Consequently, before the re-election issue is resolved, we believe the market will remain cautious as a rapid rally or a market correction could follow the result of the vote on the re-election proposal.

Given the potential for a rise in volatility in Brazil, investors who want exposure to Brazil might consider using a call spread. Call spreads offer investors limited upside and downside (see chart). To create a call spread, the investor would sell a higher strike call option to finance the purchase of a lower strike call option. The range of outcomes is set by the strike prices. The lower strike determines the point at which the downside protection starts and the higher strike is where the cap starts.

The pricing of call spreads depends on the pricing of call options at different strikes. A recent indicative pricing showed that the cost of a one-year European-style Bovespa Index call spread with a 5% upside participation from the current index level was approximately 2%. This structure was created by buying a one-year at-the-money Bovespa call which was trading at 16% of the index, and selling a one-year, 5% out-of-the-money call which was trading at 14% of the index.

Another potential strategy for Brazil is a 1-2 call spread, which provides fixed upside on significant downside and unlimited profit potential on the upside. This strategy is created by selling a lower strike call option to finance two higher strike call options. Also, as with collars these call spread strategies could be structured in different currencies or with currency risk hedged. LF

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