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Subject: Position for EM Upside

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Position for EM Upside

BAML continues to believe in the reflation trade, which should lead EM to outperform

With US equities selling off in the last week of January, stabilization in US rates and a struggling USD, the reflation theme is currently taking a break. Longer term, BAML continues to believe in the reflation trade, stemming from strong US macro and fiscal stimulus. Reflation will lead EM to outperform. Between 2001 and 2011, both US and EM equities have been highly correlated with US inflation. US equities have since broken away from this relationship amid QE/ZIRP and the search for growth/quality. That suggests that some catch-up is in order and EM can outperform as the global macro cycle improves. Strong USD remains a risk, but we expect only single-digit returns on DXY in 2017 vs 30% from 2014 to the end-16 peak. (Hauner)

EEM has rallied 10% since Dec 22nd, yet evidence continues to point to light positioning.

- EEM Shares Outstanding have roughly flat-lined since November (EEMSO Index on Bloomberg)
- The Fund Manager Survey highlights the first investor EM equity UW in 9 months, with a current allocation 1.1 st dev below its long term average (Hartnett)
- HSCEI delta-adjusted open interest is currently at US \$7bn, which is over 50% below the Sep-16 and Nov-16 highs while HSCEI was trading around current levels (GEVI)

Interestingly, as EEM has rallied, fixed strike downside vol has been stable, while upside vol has come in substantially.

- Jun'17 33 strike down 25 bps
- Jun'17 37.5 strike down 110 bps
- Jun'17 41 strike down 200 bps

Technically, EEM faces strong resistance at 37.95/38.00. HSCEI and FXI face analogous resistance at 10,000 and 38.00, respectively.

Should EM break above its current trading range, upside option premium holds substantial value.

Structures we like:

Buy the EEM Jun 39 Calls for \$1.03 (ref 37.50) – (iShares MSCI EM ETF)

Buy the FXI Jun 38 Calls for \$1.10 (ref 36.64) – (iShares China ETF)

Please note we would need to book these as OTC listed option lookalikes.

Report Link: [REDACTED]

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