

Country versus Sector Effects: A Trading Strategy

With the acceleration of globalization in the last 20 years up until 2008 sector risk has risen relative to country risk. The classic example is in Europe where a stock like RWE starts trading less like a German stock and more like a European utility stock. With the credit crisis of 2008 came a number of factors that reversed this phenomenon. World trade was severely affected by both a fall off in demand as well as a sudden withdrawal of trade finance and other related credit. Also, as countries were forced to bailout their financial systems and their economies, country risk had risen as a proportion of total risk.

Globalization has certainly taken a hit and reversed somewhat, but the underlying current remains intact. Economies continue to become more interconnected and interdependent. With time we are likely to see a resumption of the correlation effects seen in the last 10 years pre 2008.

Based on this premise, I expect correlations between stocks to decline within country indices. The way to capture this is to be short country index volatility and long component stock volatility. This leaves the trade net short covariance. This trade makes money as stocks become less correlated at the country index level.

Also based on this premise, I expect correlations between stocks to increase within sector indices. The way to capture this is to be long sector index volatility and short component volatility. This leaves the trade net long covariance. This trade makes money as stocks become more correlated at the country index level.

One can use strangles and straddles to obtain exposure to

volatility in both the index or the components.

Residual delta is hedged with the index futures or component stocks themselves.