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Monthly Market Report

September 2019

With commentary from David Stevenson

I think it's fair to say that UK investors have seen better days. Uncertainty is rife and the national economy suddenly looks a tiny bit tender. Politics is clearly playing a major role here with uncertainty about Brexit legion. But I think it is possible to see a way through the fog of uncertainty via some form of political catharsis, with a no deal Brexit on October 31st acting as the catalyst. It could even end up being hugely positive for UK equities.

In this possible scenario, Boris might actually pull off what former PM May had hoped for in 2017 namely a convincing majority win with the opposition vote badly divided. Once safely ensconced in power the Prime Minister might then lean more aggressively towards his One Nation tendencies and really loosen the purse strings. Obviously, there are a whole number of factors that could go wrong in my scenario, not least that he doesn't get No Deal through or he loses said election, but on balance I think the more probable scenario is the way I have traced out. The key, to repeat the point, is to deliver an exit on Oct 31st no matter what to remove the national uncertainty (and bugger the consequences of a No Deal hit).

From an investor point of view, the key factor here is that uncertainty. Get out of the EU on Oct 31st, call a snap election and reboot the economy and you have a decisive end to the era of uncertainty. In this scenario, we could see an aggressive bounce in UK focused equities as domestic businesses make up for lost time. That would also serve to accentuate what has also been apparent - that UK equities have underperformed and are good value in relative terms. I was struck by a recent note from wealth firm Killik which called a possible buy-in UK equities. Four charts from their pack stood out. The first two are below and remind us that the FTSE All in GBP terms has underperformed the All World by around 20%. UK Small Caps and Mid Caps have shouldered the bulk of that underperformance while the FTSE 100 looks less compelling value.

Chart 1: Relative returns in GBP terms[1]: FTSE All Share Index vs FTSE All World ex UK Index. Material underperformance only partly explained by currency movement.

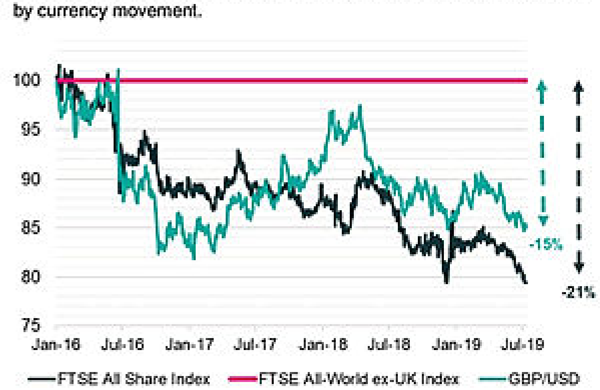
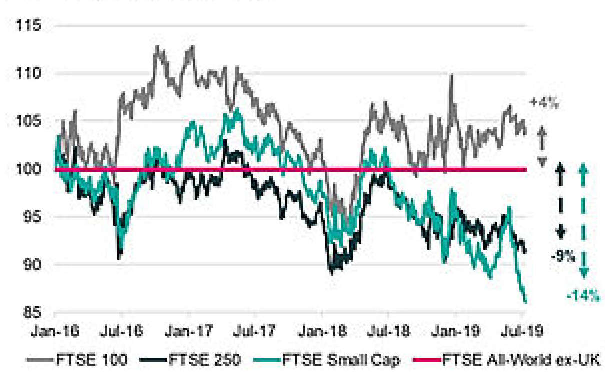


Chart 2: Relative returns in local currency terms[1]: FTSE 100; FTSE 250; and FTSE Small Cap Indices (all components of FTSE All Share Index) vs FTSE All World ex UK Index.

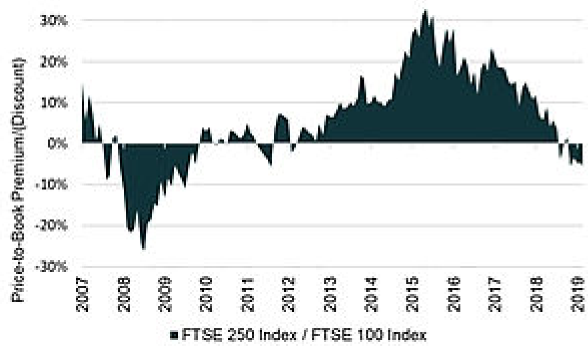


The next two charts, also from Killk suggest that this underperformance has resulted on a relatively low valuation with the FTSE All currently running at a discount of around 20% compared to the FTSE All

World.

Chart 3: Price-to-book of the UK Market[1] (FTSE All Share Index) and the Global Market (FTSE All World ex UK Index)

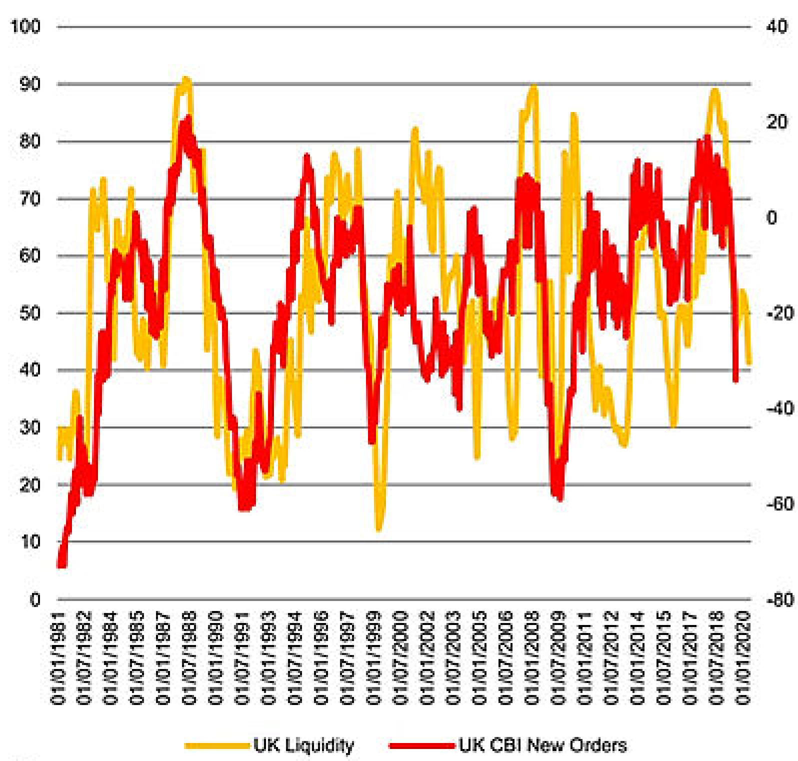
Chart 4: Relative Price-to-book of UK mid-caps[1] (FTSE 250 Index) compared to UK large-caps (FTSE 100 Index)



The reasons for this underperformance are varied. UK equities are almost certainly under-owned at the global level but investors have also been spooked by macroeconomic factors. I would also suggest that the Bank of England has also been rather too eager to tighten the screws whilst keeping interest rates low.

The next chart below is from research firm Cross Border and shows how overall UK liquidity (they measure both private sector and central bank forms) has collapsed over the last year. That has coincided with a rapid decline in one key UK macro metric - UK CBI numbers. These numbers are currently signalling a sharp recession. My own reading is that the evident fog of uncertainty has led to a sharp decline in new orders.

Figure 1
Total UK Liquidity Index (Advanced 12 months) and CBI Balance of New Orders Monthly Indexes 1981-2019



Source
CrossBorder Capital, Bank of England

So, bringing this all together I think there is a growing possibility that after much of the fog of uncertainty (Brexit/Corbyn) has cleared at the end of the year - assuming the Conservatives do pull off a win of course, which is by no means assured - we could see a strong bounce back in UK equities, especially as the Bank of England works with the Treasury to turn on the liquidity taps.

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Headline Numbers

Inflation redux??

The chart above tells what I think is still a remarkable story - the quiescence of inflation at a global level. I don't think its difficult to understand why inflation may be subdued in places like the UK (uncertainty over Brexit) or Japan (decades long deflationary pressures) but one might expect US inflation to be rearing its ugly head. The US economy is in very decent shape, with strong jobs growth over the medium term and some evidence of increasing wages. But the chart above tells a very different story. Inflation is flatlining again. If these numbers are to be believed the US Federal Reserve might have some cover for lowering US interest rates even further.

Then again may be inflation might be about to turn. That at least is the theory behind one contrarian trade area recently suggested by State Street via its SPDR ETF research. They observe that core prices "did surprise to the upside at the end of June, at 1.6% versus 1.5%. Nevertheless, that figure was low enough to reinforce the Fed case for a rate cut in July - and further if necessary. Should the dollar weaken as the Fed delivers on market expectations (as of end-June, the market expected more than 100 bps of cuts in 12 months), and if the Fed cuts more than the current dot plots, inflation could surprise to the upside. "Maybe but I have my doubts.

The low inflation rates we've seen in the US have helped underpin increasingly strident calls for interest rate cuts. But what happens if one of the largest components of the price data starts to tick up - if oil prices start to rise? Increased prices for a barrel of oil have been prophesised for most of the last year, helped along by deteriorating geopolitics in the Middle East. But every time the oil price perks up, unconventional oil producers in the US shale regions turn on the taps...and prices drop. We are, we are told, midway through a capital infused productivity bonanza of epic proportions. More oil than ever is being squeezed out of tight holes deep in the ground.

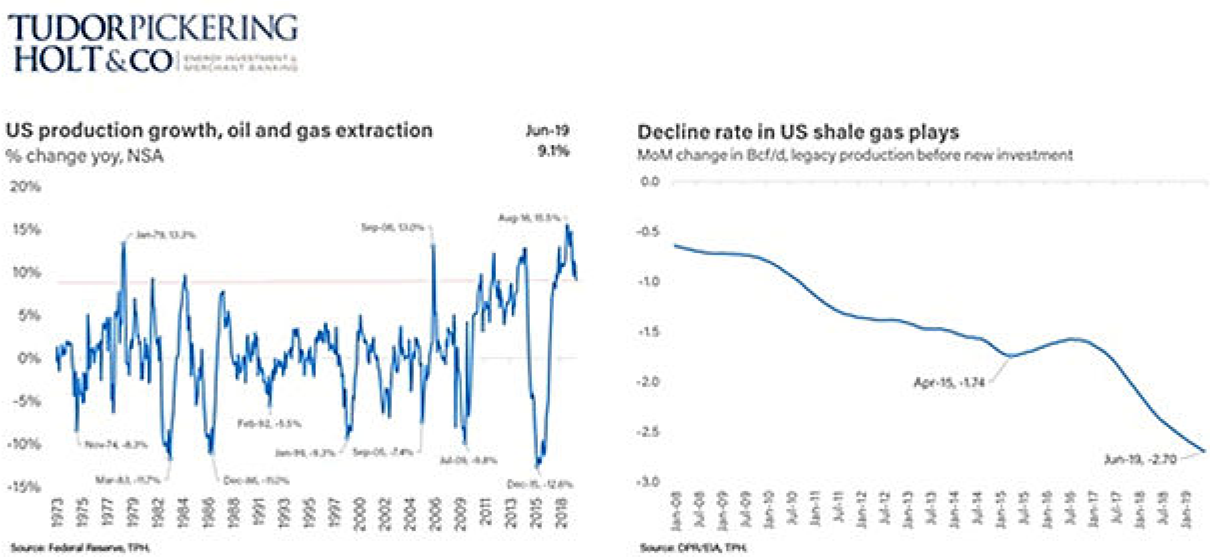
But there is some evidence that this astonishing growth in supply is starting to turn. Take recent data from Tudor Pickering Holt and Co, a US energy bank which claims to have seen a significant deceleration in US oil and gas production. Their take?

"The data implies Permian oil production growth has dropped from +735 thousand b/d YoY in June 2019 to what will most likely be just a tick above +600 thousand b/d YoY here in August 2019. Overall production growth across the seven key basins appears likely to be about +950 thousand b/d YoY this month, down markedly from +1.25 million b/d as recently as six weeks ago and well below the +1.1 to +1.3 million b/d YoY pace that anchors many 2020 forecasts.

"US oil and gas production growth, combined, was +9.1% YoY in June 2019, down from +15.5% YoY in August 2018, according to Federal Reserve survey data. The August 2018 growth rate marks the all-time high in a time series that goes back to January 1973. As the chart at left below shows, when US oil and gas extraction decelerates off the highest peaks (1979, 2006, 2014), that growth rate tends to pick up downside momentum".

Analysts at commodity investment firm Westbeck have also sounded the alarm. They've seen data which suggests that *an activity slowdown in Q2. "Comments by the pressure pumping community and the largest land drillers confirm activity will slow down further in Q3. By the end of Q3, land rig count is likely to be 20-25% down vs the recent peak. While budget exhaustion points to a fairly catastrophic Q4 for activity."*

So, why does this matter? A number of observations jump to mind. The first is that this is happening just as a significant bunch of bonds is due to mature. It's also coincided with a multi-year drought of non-shale Capex projects - long-cycle projects. If that is the case one would expect a decline in non-OPEC production, which could, in turn, gobble up OPEC spare capacity.



Measure	Values as of 5th July, 2019	Values as of 12th August, 2019
UK Government 10 year bond rate	0.67%	0.49%

GDP Growth rate YoY	1.80%	1.20%
CPI Core rate	2.00%	2.00%
RPI Inflation rate	3.00%	2.90%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.78%	0.76%
Government debt to GDP ratio	84.70%	84.70%
Manufacturing PMI	48	48

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Bank CDS options

Prices on credit default swaps rose pretty much across the board over the last month, with the biggest increases chalked up HSBC and Lloyds Bank. That said, these rates have bounced off recent short term lows, so we shouldn't read too much into it! One interesting side fact. Swaps on Morgan Stanley's one year paper is now some of the highest in this peer group, only bested by Deutsche Bank whose prices have collapsed dramatically over the last year. One suspects that what's really happened here is that Morgan Stanley's swaps haven't really changed much in price over the last year whereas nearly all of its peers have seen pricing fall sharply, with even troubled Deutsche managing to come within spitting distance.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	7.23	33.75	6.17	-46	A -
Barclays	28.05	69.88	21.76	11.83	A
BNP Parabis	9.76	30.18	7.03	-28.68	A
Citigroup	15.28	58.84	13.86	16.03	A
Commerzbank	6.65	40.47	1.36	n/a	A+
Credit Suisse	19.99	54.42	6.3	-20.86	A
Deutsche Bank	32	71.06	11.83	n/a	A+
Goldman Sachs	24.14	67.68	12.53	21.06	A
HSBC	11.71	37.58	34.05	4.8	AA-
Investec*	n/a	62	n/a	n/a	BBB
JP Morgan	15.28	45.19	21.25	10.78	A+
Lloyds Banking Group	22.12	97.02	25.84	8.04	A
Morgan Stanley	27.17	64.14	18.47	20.19	A
Natixis	n/a	50	n/a	n/a	A
Natwest Capital Markets	16.85	71.30	-0.83	64.92	A-

Nomura	7.19	22.51	9.83	38.40	AA-
Rabobank	n/a	61	n/a	n/a	AA
RBC	22.35	92.78	23.98	11.21	A
Soc Gen	9.29	33.16	10.62	-21	A
UBS	8.08	21.99	4.71	-47	A

Source: www.meteoram.com 4th August 2019
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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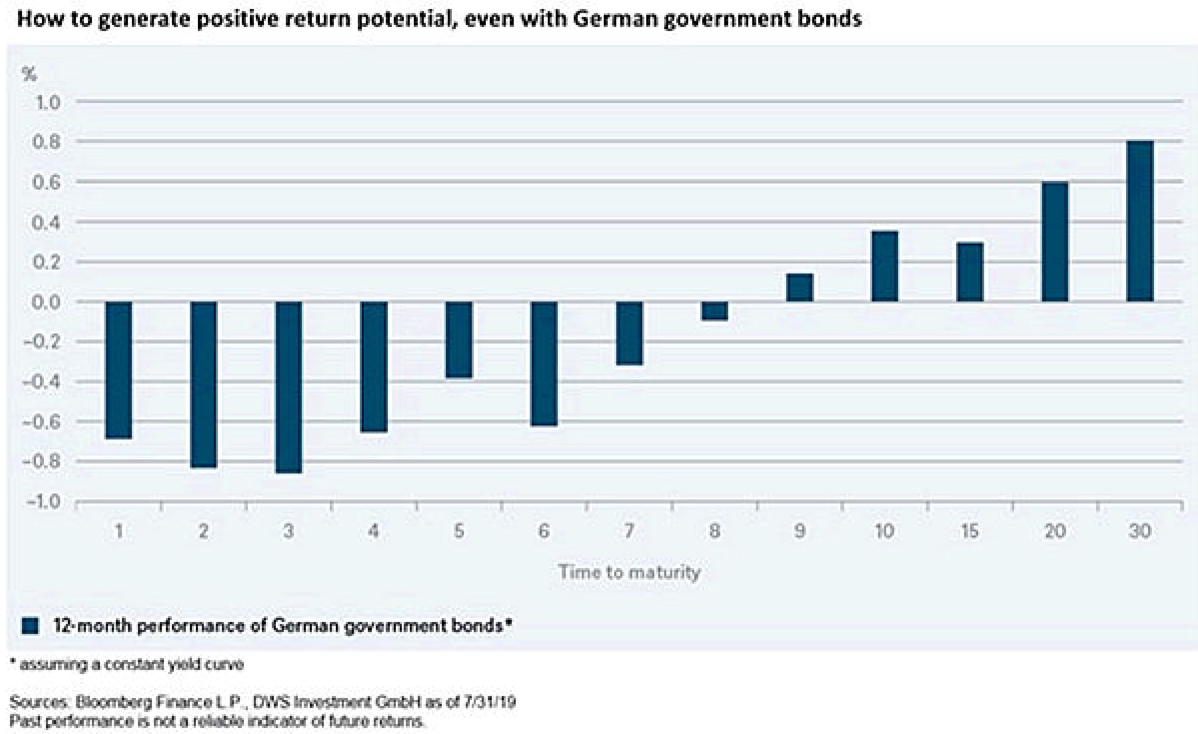
Government Bonds

Fixed Income

We'vealready mentioned a report on bond investing by the SPDR ETFs team at State Street. They've observed that money is now flowing out of US Treasury bonds into Europe. Surely they can't be tempted by the profusion of negative interest rates on the continent? You bet! Investors seem convinced that we'll see a restart of QE, which could benefit Italian bonds for instance. But investors are also buying into some German bonds, which are currently deep in the red in yield terms i.e. producing negative yields. Why on earth would investors be so keen on an investment that loses them money? Some explanation comes from analysts at DWS who have suggested a rather elegant trade idea. One way to make some money is to buy "a German sovereign bond and holding it for just one year, instead of keeping it until maturity. In 12 months, a 10-year bond that currently yields -0.40% will turn into a 9-year bond. The latter trade at -0.49%, meaning that one can achieve a price gain on the sale that would overcompensate for the negative yield."

Sounds intriguing but does it actually work in practice? Cue data from Japan. "On average, 10-year bonds have since traded at a meagre yield of just 0.011%. However, according to ICE Data Services, the average annual performance of indices tracking 7- to 10-year Japanese government bonds was +0.46% since February 2016. Japan proves that strategies exploiting the steepness of the yield curve have also worked in practice".

All trades require someone to be on the wrong end of a strategy. Who's paying for this investment lunacy? DWS suggests its "Investors who hold short-dated bonds have to digest price declines in addition to negative returns.



UK Government Bonds 10-year Rate 0.49%

Source: http://www.tradingeconomics.com/united-kingdom/government-bond-yield

CDS Rates for Sovereign Debt

Country	Five Year
France	22.22
Germany	10.54
Japan	22.26
United Kingdom	34.5

Ireland	33.11
Italy	216.91
Portugal	46.45
Spain	44.90

Eurozone peripheral bond yields

Country	July 2019	August 2019	Spread over 10 year
Spain 10 year	0.25%	0.24%	83
Italy 10 year	1.67%	1.77%	236
Greece 10 year	2.00%	2.18%	277

	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

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Equity Markets and Dividend Futures

The Economist ran a good piece a few weeks ago on declining earnings expectations for US companies. The big story seems to be that we are mid-way through a slowdown in profits growth. But that's probably a more positive story than in Europe where investors have been worried about a sharp slowdown - negative yields on Euro government bonds certainly suggests a real fear of recession (see below). But my hunch - and its nothing more than that - is that investors have been a little too bearish on European equities, especially now that the Eurozone has a new governor who will probably want to signal a clear path towards monetary stimulus.

n this scenario, we could see a surprise rally in Eurozone stocks especially if they surprise to the upside in terms of corporate earnings. We're at the beginning of the Q2 reporting season - what do the numbers tell us? According to Morgan Stanley's European equity team an initial look at these numbers suggests the headline of "another low-quality beat".

Their current analysis of these 2Q numbers suggests *"a modest beat, but helped by lowered consensus expectations. European Earnings have delivered a modest EPS beat so far… We present our initial take on 2Q results on the 46 companies that we have tracked so far. 35% of companies have beaten EPS estimates, while 26% have missed so far, giving a net beat of ~9% of companies. Weighted earnings have beaten by 2.2%, but the median stock has actually missed estimates fractionally (40bp). The downside is that these numbers beating estimates are based on lowered expectations i.e. low quality. Over the last few weeks companies can beat their estimates - and everyone feels positive!"*

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-3.83	0.207	1.19	-5.85	8.82	9.78	7218
S&P 500	-3.16	1.29	6.34	3.01	50.9	72.8	2918
iShares FTSE UK All Stocks Gilt	3.48	5.73	6.36	7.01	21.8	24.1	14.14
VIX New Methodology	36.5	5.41	9.59	28.5	19.7	32	16.91

Index	July 2019	August 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.9	121.6	3324	121.8
FTSE 100 (Dec 17)	324.5	325.3	7218	n/a

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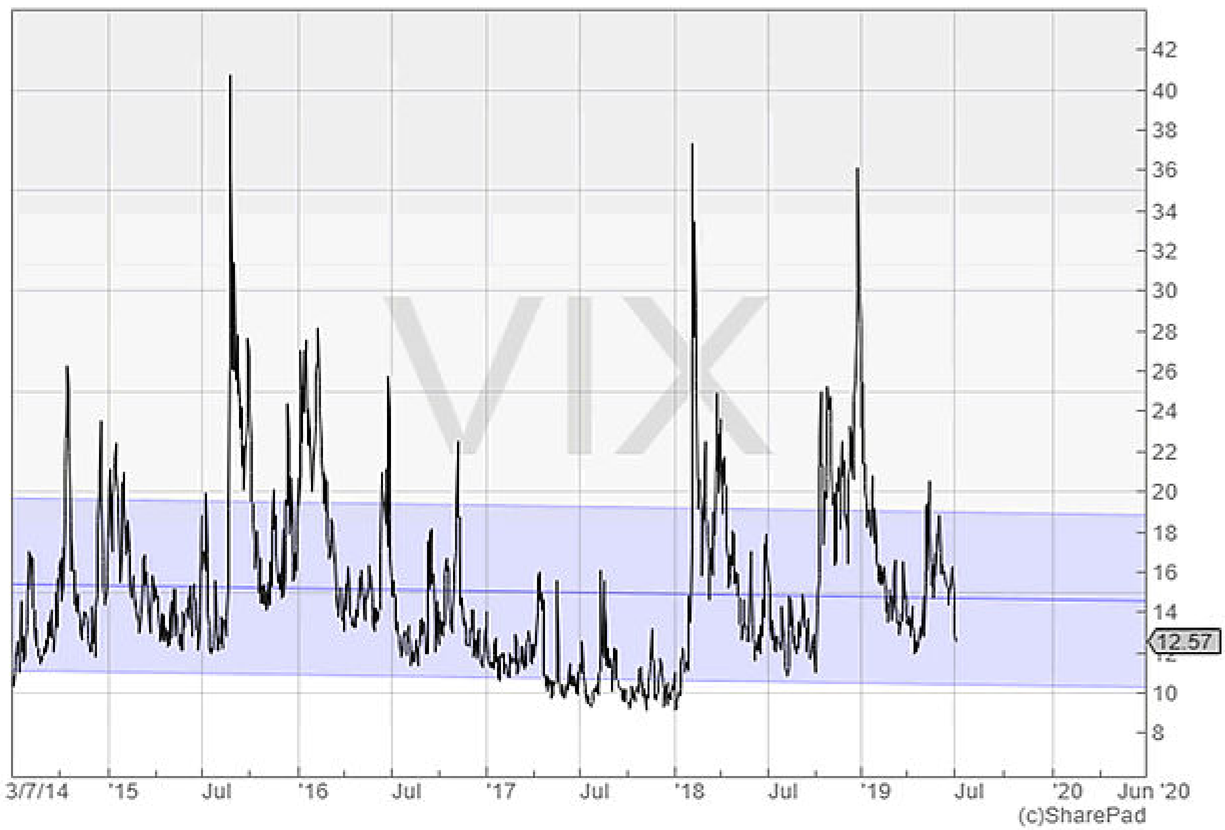
Volatility

Investors have got plenty to worry about. Bond investors are signalling a recession and the US Fed has grown more cautious again about rate cuts. The Iran standoff doesn't look hopeful and President Trump is ramping up the trade tariffs. Not unsurprisingly stock market volatility has shot up, again hitting levels not seen since early January. In fact Yahoo reports that the Vix's surge - see in the chart below from IG - "was so dramatic it set off a signal seen only four other times in the index's history". Yahoo reports one analyst who claimed there "there have been just five times ever when the VIX skyrocketed 100% or more in a matter of just eight sessions (not considering redundant signals). The last time it happened was in mid-October 2018, at the start of the fourth-quarter sell-off. The VIX actually tripled in short order back in early February 2018, which marked the first signal since the August 2015 doldrums. In fact, it's interesting that three of the five signals happened in the month of August, with the first occurring in 2011." So maybe the old adage about selling in May and coming back in the Autumn has returned with a vengeance.

https://www.ig.com/uk/news-and-trade-ideas/watch-vix-in-the-face-of-uncertainty-190808



Measure	August Level	July Level	June Level	May Level
Vstoxx Volatility	18.1	12.9	16.6	18.63
VFTSE Volatility	n/a	10.96	13.54	16.41

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Summary of Pricing Impact on Structured Products

Pricing Parameter	Change	Impact on Structured Product Price
Interest Rates	Up	Down
Underlying Level	Up	Up (unless product offers inverse exposure to the underlying)
Underlying Volatility	Up	Down for capped return/fixed return/capital at risk products. Up for uncapped return/capital protected products.
Investment Term	Up	Down
Issuer Funding Spread	Up	Down
Dividend Yield of Underlying	Up	Down
Correlation (if multiple underlyings)	Up	Up (unless product offers exposure to the best performing underlyings only)

Source: UK Structured Products Association, January 2014

This information is provided for information purposes only, and the impact on a structured product price assumes all other pricing parameters remain constant.

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Explanation of Terms

CDS Spreads and Credit Ratings

A CDS effectively acts like an option insuring at a cost in basis points a bank or government bond in case of default. The higher the basis points, the riskier the market perceives that security. Crucially CDS options are dynamic and change in price all the time. A credit rating is issued by a credit rating firm and tells us how risky the issuer is viewed based on the concept that AAA (triple A) is the least risky and ratings at C and below are regarded as much riskier. CDS and ratings are useful for structured product buyers because they give us an indication of how financial risk is viewed by the market. Crucially a high CDS rate indicates that an issuer of a bond will probably have to pay a higher yield or coupon, which could be good for structured product buyers as bonds are usually a prime source of funding for a structured product. G8 government bonds issued by the likes of the UK and US Treasury are also sometimes used as collateral in some form of investments largely because they are viewed as being low risk. One last small note on credit ratings and CDS rates. A is clearly a good rating for a bond (and much better than B) but AA will be viewed as even safer with triple AAA the least risky. Terms of CDS rates anything much above 100 basis points (1%) would warrant some attention (implying the market has some, small, concern about the possibility of default) while anything above 250 would indicate that the market has major concerns on that day about default.

Why does the yield matter on a bond?

As we have already explained bonds are usually used as part of a structured product. The bonds yield or coupon helps fund the payout. All things being equal a higher bond yield means more funding for the payout. But rising bond yields, especially for benchmark US and UK Treasury 10 year bonds also indicate that the markets expect interest rates to rise in the future. Rising interest rates are not usually a good sign for risky financial assets such as equities.

Volatility measures

Share prices move up and down, as do the indices (the 500 and FTSE100) that track them. This movement up and down in price is both regular and measurable and is called volatility. It is measured by stand alone indices such as the Vix (tracking the volatility of the 500), VStoxx (the Eurozone Dow Jones Eurostoxx 50 index) and VFtse (our own FTSE index). These indices in turn allow the wider market to price options such as puts and calls that pay out as markets become more volatile. In simple terms more volatility implies higher premiums for issuers of options. That can be useful to structured product issuers as these options are usually built into an investment, especially around the barrier level which is usually only ever broken after a spike in volatility. Again all things being equal an increase in volatility (implying something like the Vix moving above 20 in index terms) usually implies higher funding levels for issuers of structured products.

Dividend Futures

These options based contracts measure the likely total dividend payout from a major index such as the FTSE 100 or the Eurozone DJ Eurostoxx 50 index. In simple terms the contract looks at a specific year (say 2015) then examines the total dividend payout from all the companies in the index, adds up the likely payout, and then fixes it as a futures price usually in basis points. Structured product issuers make extensive use of dividend futures largely because they've based payouts on a benchmark index. That means the bank that is hedging the payout will want to be 'long' the index (in order to balance it's own book of risks) but will not want the dividends that come from investing in that benchmark index. They'll look to sell those future possible dividends via these options and then use the premium income generated to help fund their hedging position. In general terms the longer dated a dividend future (say more than a few years out) the lower the likely payout on the dividend future as the market cannot know dividends will keep on increasing in an uncertain future and must his price in some level of uncertainty.

Equity benchmarks

Most structured products use a mainstream well known index such as the FTSE 100 or 500 as a reference for the payout. For investors the key returns periods are 1 year (for most auto calls) and 5 and six years for most 'growth' products. During most though not all five and six year periods it is reasonable to expect an index to increase in value although there have been many periods where this hasn't been the case especially as we lurch into a recession. Risk measures such as the sharpe ratio effectively measure how much risk was taken for a return over a certain period (in our case the last five years using annualised returns). The higher the number the better the risk adjusted return with any value over 1 seen as very good.

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To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,

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