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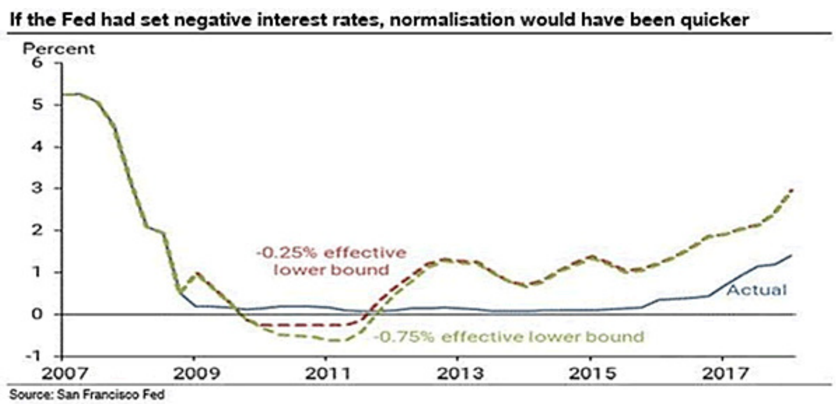
UK Structured Products Association™

Monthly Market Report

March 2019

With commentary from David Stevenson

Of one thing I am increasingly certain. If and when the next big market crash comes - and its probably a matter of when not if - a new, more drastic form of quantitative easing will make its debut. It's implications for risk assets and bonds is obvious - in effect there'll be a price support under current valuations, especially bonds. I'm not alone in thinking this is coming. The City's favourite bear Albert Edwards at SocGen for instance reckons that central bankers will first deploy negative interest rates. He points to a paper from the San Francisco Fed titled "How Much Could Negative Rates Have Helped the Recovery?". According to Edwards, the paper makes the case that if the Fed had cut Fed Funds further, negative interest rates would have helped push CPI inflation back up to target much quicker, as the economy would have been stronger (see chart below).



According to Edwards, *"In the next recession our 'all-knowing' central bankers will pull any and every policy lever they have to hand and that in my view includes the Fed pursuing deeply negative interest rates.... I do not believe the Fed wants to rush to cut Fed Funds into negative territory, but the cost of not doing so will be very high if others are doing it (via a strong dollar). The Fed will be forced to participate as avoiding deflation will be the number 1 priority - not the profitability of the banking sector. Investors should contemplate a brave new world of negative Fed Funds, negative US 10y and 30y bond yields, 15% budget deficits and helicopter money."*

London based research firm Cross Border makes a similar but related point. They think that the global wholesale capital markets have become addicted to central bank liquidity infusions - and that too drastic a tightening of bank balance sheets will tip the global markets into a deep recession. They argue that central bank tightening spooked the markets and caused the December credit sell-off. Since then the US Fed has signalled greater future balance sheet flexibility. Cross Border asks how any new QE, QE4 in their language, will be positioned? "We suggest that a more directed programme is likely, and one that focuses directly on infrastructure spending, rather than asset prices for the wealthy 1%".

I couldn't agree more. As I have said before on these pages, a new version of QE will emerge at some point, although it may not appear for many years hence. But when it comes, any talk of a bonds rout will be over for another decade or so. As I have said many times before, welcome to a multi decade period of low or even zero interest rates.

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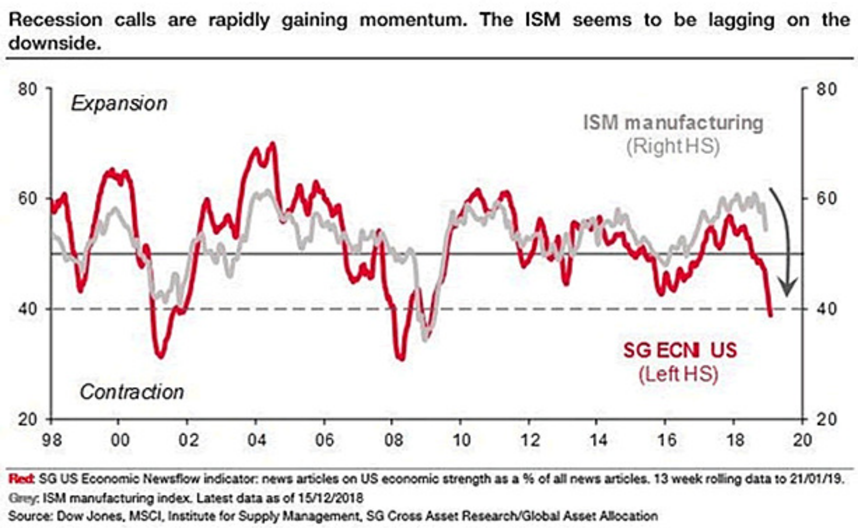
Headline Numbers

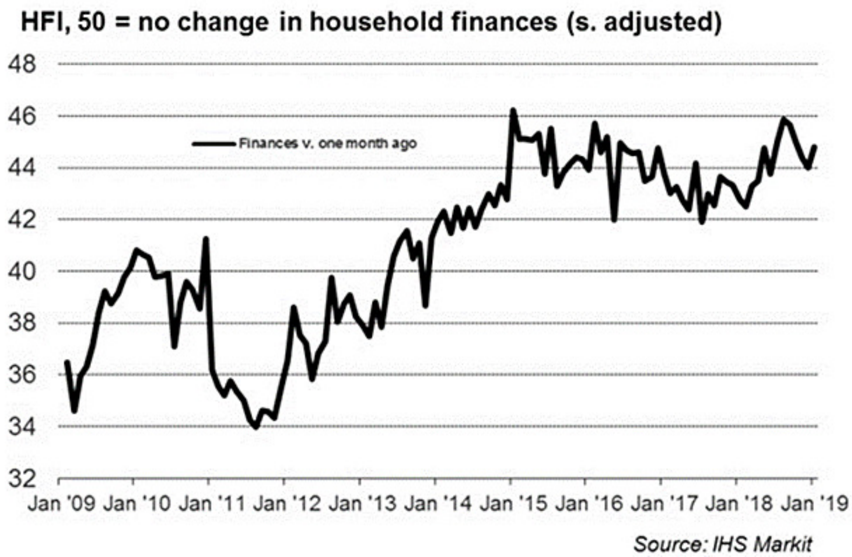
All my talk about central banks and the next form of intervention begs the inevitable question of an imminent recession. Is it coming any time soon? One useful signal is to look at news flow indicators i.e using the power of the crowd and online comment to establish a warning signal. French bank SG runs something called ECNI which zeroes in on these news flow measures.

The model is currently suggesting severe damage to global growth momentum. According to SG "with a typical lead time of around three months, the sharp drop in our indicators suggests a continued contraction of global industrial production". Crucially this tidal wave of negative sentiment isn't just restricted to Europe and China - the US is also being caught up in the deluge of negative headlines. SocGen analysts observe that their US economic news flow indicator (in red in the chart below) is at levels that count among the 7% lowest readings since 1998, justifying comparisons with 2000 and 2007. This conveys a much more cautious message than the ISM index (in grey in the chart below) which seems to be lagging on the downside... Two leading indicators, the US yield curve and our US ECNI, have realigned and are pointing to slower growth." The ECNI newsflow chart from SG is below.



I'd keep a beady eye on the growing valuation gap between UK and Global equities - in simple terms British focused stocks are looking dirt cheap. JP Morgan for instance has created a basket of UK stocks focused on the UK economy to track the impact of Brexit and that basket has fallen 17% in 2018. Sentiment towards UK stocks hasn't been helped by numbers which suggest that UK consumer confidence is faltering. Take the example of the the widely followed IHS Markit UK Household Finance Index. This tracks consumer sentiment and the latest numbers from this week suggests that " UK households remained downbeat on expected financial health in one year's time, with the respective seasonally adjusted index at 46.4, broadly in line with December's four-month low of 46.2 and among the weakest since the start of 2014... financial wellbeing in 12 months' time is still expected to worsen, continuing the trend seen in December. This came amid heightened worries over job security, lower cash availability and weakened optimism about the future of the UK housing market."

Post Brexit - assuming such a thing ever materialises - things might look very different. My anecdotal evidence is that lots of people and businesses are simply delaying decision making - they'll happily start spending again when there is more clarity. Which also underlines another key point - that the UK consumer is not in bad shape. Wages are rising, and unemployment is at a historically low level. There are massive problems for the least privileged, centred around stuff such as low wage and the woeful impact of universal credit, but for most of middle Britain, life isn't too bad. Which is sort of confirmed by the chart below from the HIS Markit index - this shows that household finances are still not far off recent highs.



Returning to the UK stock markets I'd also highlight a recent survey from Link Asset Services. Their latest dividend monitor has just come out and it reveals that "UK dividends reached a record £99.8bn in 2018, just missing the £100.0bn mark by a whisker.... A combination of rising profits slightly better-than-expected special dividends, and the slump in the pound in the second half of the year all contributed to a record annual dividend haul 5.1% higher in headline terms compared to 2017".

So, add it all up.

Cheap equities. Strong corporate cashflows. Bountiful dividends and a more confident UK consumer.

Might UK equities be due an imminent big bounce back??

Measure	Values as of 14th January, 2019	Values as of 7th February, 2019
UK Government 10 year bond rate	1.26%	1.18%
GDP Growth rate YoY	1.50%	1.50%
CPI Core rate	1.80%	1.90%
RPI Inflation rate	3.20%	2.50%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.85%	0.85%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	54.2	52.8

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Bank CDS options

Rates of credit default swaps for major international banks have fallen back sharply in the last month with nearly every major bank seeing a decline of between 15% and 30% in the pricing of its swaps. One curious fact - both Rabobank and UBS now have default swaps that are cheaper (at 1 year and 5 years) than those for the UK government. Maybe an investment bank can be a safer risk than a government with its own currency?

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	23.96	81.89	1.11	104	A -
Barclays	35.06	78.24	-20.31	70	A
BNP Parabis	18.01	56	-26	118	A
Citigroup	26.64	62.08	-26.79	39.8	A
Commerzbank	34.9	108.17	-18	100	A+
Credit Suisse	25.63	80.35	-28.55	67	A
Deutsche Bank	86.40	178.70	-14.81	137	A+
Goldman Sachs	32.19	82.41	-27	48.65	A

HSBC	14.42	37.91	-25	71	AA-
Investec*	n/a	79	n/a	n/a	BBB
JP Morgan	21.63	51.75	-22	26	A+
Lloyds Banking Group	21.10	61.43	-17.81	60	A
Morgan Stanley	29.89	72	-24	35	A
Natixis	27.34	60.77	-1.61	123	A
Nomura	21.63	51.75	-22	16.43	A-
Rabobank	11.51	34.72	-18.71	58.07	AA-
RBC*	18.76	54.53	-4.64	n/a	AA
RBS/Natwest Markets	39.57	130.5	-19.20	72.92	A
Soc Gen	24.2	59	-24.92	119	A
UBS	25.2	69.91	-29	90	A

Source: www.meteoram.com 11th February 2019
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

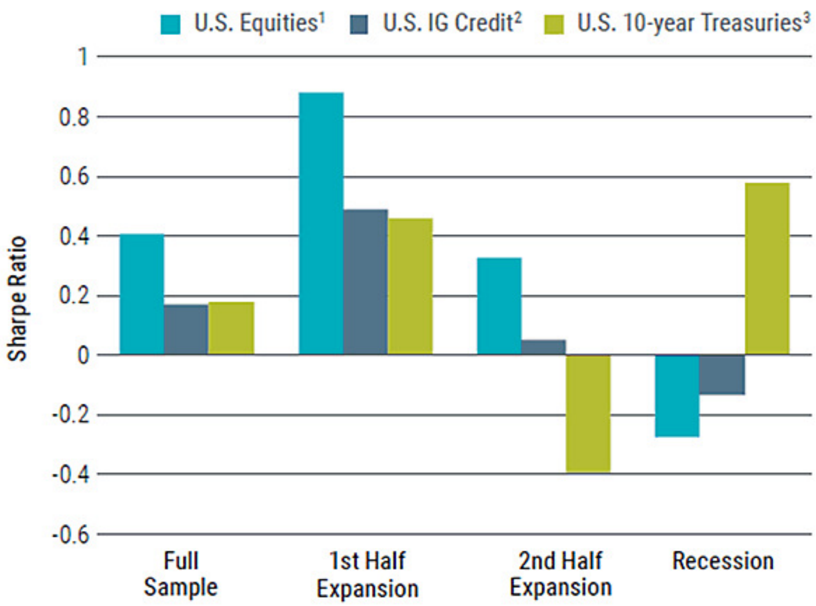
Fixed Income

Over the first few weeks of the New Year, I've been talking to a number of institutional bond and one consistent trade keeps emerging in discussion. In simple terms, it goes something like this in investment narrative terms: we are late in the business cycle, and risky assets tend to do underperform. Within bonds that means that corporate bonds and credit might under perform relative to less risky government bonds. Crucially many weaker corporate borrowers might see their credit ratings downgraded. This might involve previously investment grade issuers falling down a grade or two - or BBB issuers falling ever deeper into junk. For bond investors this suggests an influx of 'fallen angels', whose bonds are suddenly repriced. By contrast cautious investors might find safety in Treasury bonds and gilts (assuming Brexit doesn't completely tarnish the latter).

One of the word's biggest bond investment firms, Pimco, puts it well. "A slowdown in the economy combined with higher interest rates and tightening credit standards presents downgrade risk for BBB credit issued during the recovery, and greater risk of distress or default for high yield bonds. We are particularly wary of the leveraged loan market, which has seen deteriorating underwriting standards and faces rollover risk over the next few years. Within corporate credit, we focus on shorter-dated bonds from high quality issuers with strong liquidity". The chart below from Pimco, nicely sums up this increasingly cautious view about bond investing. In the second half of a long expansion US Treasuries - and other less risky bonds - underperform, but during a recession, expect Treasuries to shine.

Figure 2: Equities and credit tend to perform particularly well in 1st half of expansion; U.S. Treasuries shine in recessions

Risk factor returns over the business cycle (1955-2018)



Source: PIMCO; Gurkaynak, R., Sack, B., and Wright, J. (2006) FEDS paper; Kenneth R. French database; NBER. Data as of 30-Sept-2018

1 From 1955 - 1969, U.S. Equities total returns are taken to be that of the market factor from the Kenneth French database. From 1970 - 1987, U.S. Equities total returns correspond to that of the MSCI USA Index. After 1988, U.S. Equities are the excess returns to the S&P 500.

2 U.S. Credit excess returns are measured over duration-matched Treasuries (all others are measured over cash), per year of spread duration. The history of U.S. Credit excess returns begins in 1973.

3 Historical excess returns to the Treasury series are estimated from par rates provided by Gurkaynak, Sack, and Wright from the "H15" series of constant-maturity yields from the Federal Reserve, and Ibbotson Associates. After 1988, the series is spliced with excess returns to the Bloomberg Barclays U.S. Treasury 7-10 Year Index. Returns are per year of duration.

Recessions and expansions are as defined by NBER. We divide expansions into two equal calendar halves and present Sharpe ratios in these sub-periods as well.

UK Government Bonds 10-year Rate 1.18%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	36.34
Germany	12.41
Japan	19.77
United Kingdom	36.03
Ireland	41
Italy	221
Portugal	87
Spain	74.11

Eurozone peripheral bond yields

Country	January 2019	February 2019	Spread over 10 year
Spain 10 year	1.42%	1.24%	112
Italy 10 year	2.83%	2.95%	283
Greece 10 year	4.29%	4%	388

	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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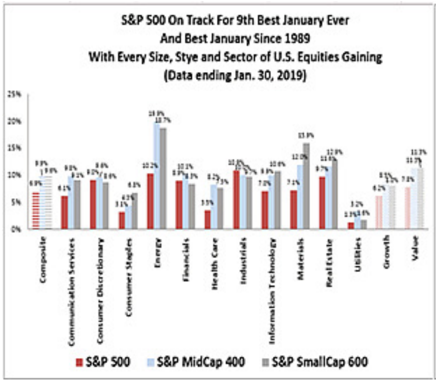
Equity Markets and Dividend Futures

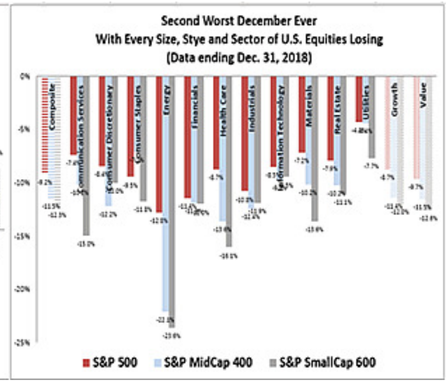
Looking at markets at the end of January, we've had an exceptionally strong start to 2019. S&P Dow Jones for instance reported the S&P 500 is on "track to post its 9th best January on record since 1928, its best January since 1989, and its best month since October 2015 with a gain of 6.95% through Jan. 30, 2019." European index provider Stoxx also observed that its Global 1800 index rebounded 7.7% during January, "kicking off its best start to a year since data begins in 1991."

My own sense is that this rebound is consistent with the archetypal late market rally - which could go on for some time yet. But eventually, the hard numbers of economics come into play. In particular it's worth watching PMI numbers at this point in the cycle. Pretty much across the developed world, these have been signalling a steady deceleration in growth. What happens next? Cue a note from the research team at Morgan Stanley which looks at those PMI numbers globally. They observe that Global PMI peaked in December 2017, while the US ISM PMI saw the largest one-month fall since 2008.

So, should we as investors be concerned? Not yet says the Morgan Stanley team. "The current scenario of medium (neither too hot nor too cold) and falling PMI has historically meant mediocre but still positive returns for DM equities, underperformance in EM equities and credit, strengthening USD and falling US yields."

What we really need to be watching out for is big cross over transitions, where PMI measures move sharply in one direction or another. Watch those February PMI numbers.





Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	4.15	-0.33	-8.1	-2.55	7.94	13.9	7093
S&P 500	5.51	-4.40	-5.89	0.31	49.7	78.2	2690
iShares FTSE UK All Stocks Gilt	1	2.72	1.24	3	17	14.2	13.29
VIX New Methodology	-28	-6	40.7	-44.5	0.589	13.9	15.38

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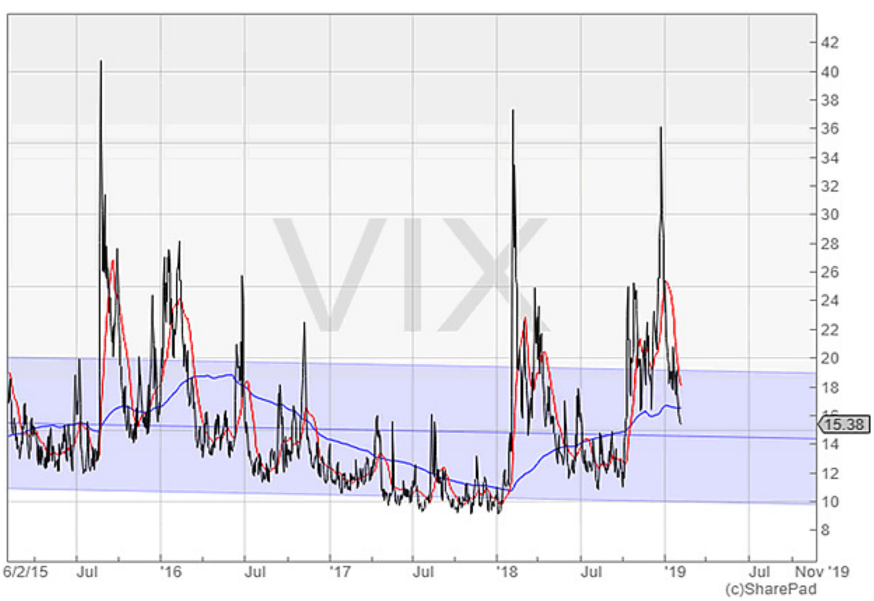
Volatility

As equity markets have roared back into bullish territory, it's not unreasonable to expect that measures of volatility would start to ebb away. And the so called fear gauge, the Vix, has indeed fallen sharply in recent weeks. Crucially though the index is still, as I write, trading above the 15 index level. This underlines a key point - as of Feb 7th, the Vix has now gone 82 consecutive days without dipping below 15, among the longest streaks above that level in history. If the VIX breaks below 15, it's not unreasonable to expect even more bullish equity action. A recent article in US finance magazine, Barrons, reminded investors that "last year, after the early February volatility event, lower highs in the VIX gave way to new lows through the spring and summer, which helped keep the S&P 500's multitooth climb going."



Measure	February Level	January Level	December Level	November Level
Vstoxx Volatility	16.2	18.43	19.16	16.63

VFTSE Volatility	13.72	17.52	17.30	15.5

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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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