To view this email in your browser, please click here

UK | Structured ™ Products Association

Monthly Market Report

November 2019

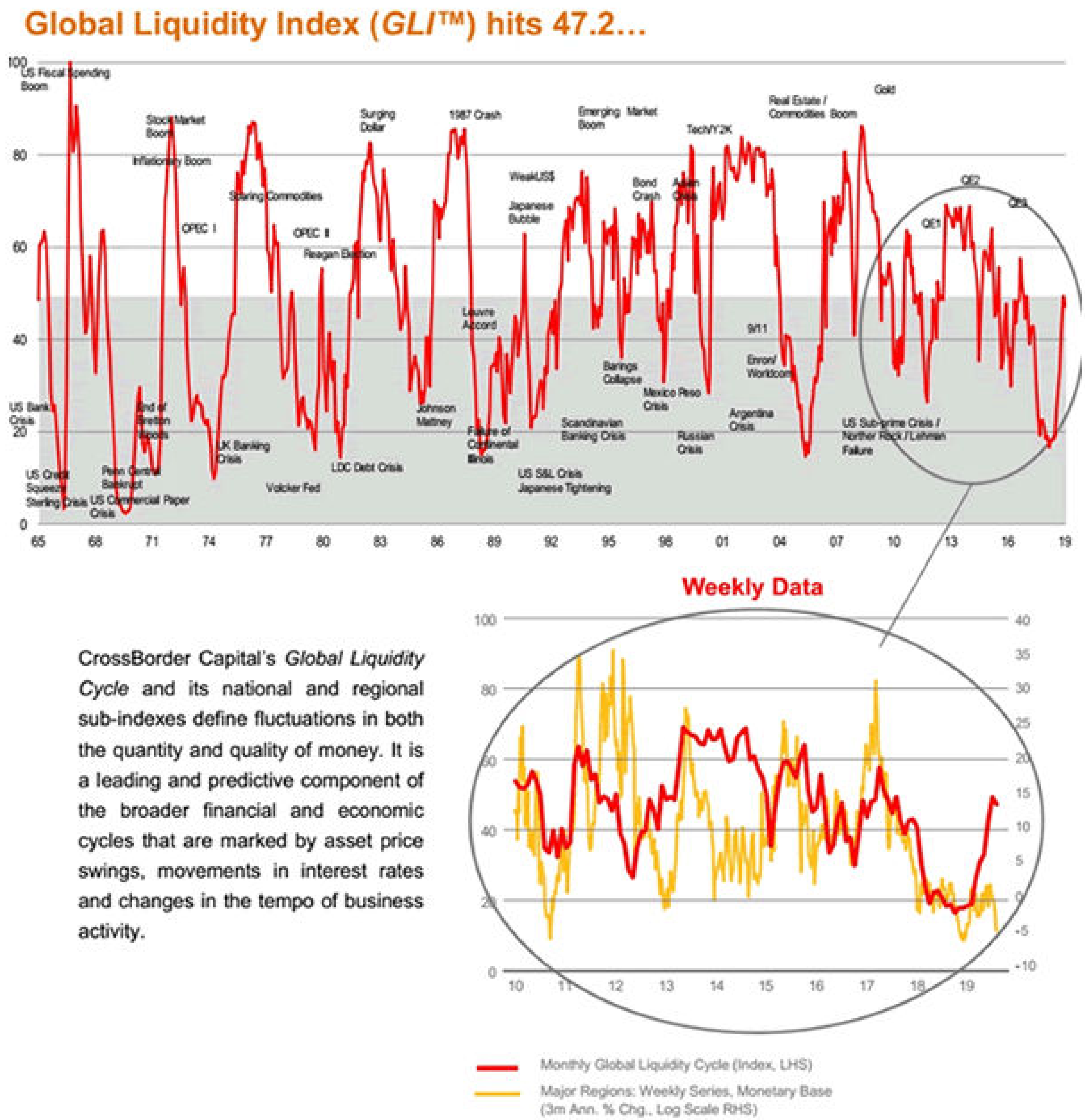
With commentary from David Stevenson

My hunch is that at the global level we are not about to enter into a recession. This is another of those synchronized, global slowdowns where markets pause for breath. It could turn into a proper slowdown and a recession for any number of reasons but on balance, I think the probability is that we'll have a Q4 bounce back in stock markets.

Part of that reason for my (guarded) optimism is that the central banks still seem willing to buy off-market volatility by turning the monetary taps back on. I'm not sure this is a sensible strategy for the long term, but it is what it is, and the recent 25 basis point cut by the US Fed - and the ECBs signalling that QE continues - is I think a clear signal. The Powell Put is in place, sitting alongside the Yellen and Bernanke Put, all overshadowed of course by the Trump requirement to have a healthy stock market ahead of his election.

At this point, most investors then start to babble on about events in the bond markets where yields have slumped, and all the talk is of negative interest rates and bond yields. My own suspicion is that what we are seeing in fixed income is not a flashing red light for a global recession, more a specific set of circumstances engineered by central banks in their recent quest to tighten balance sheets. Analysts at Cross Border Capital Research put it very succinctly when they suggest that *"there is a shortage of 'safe' assets in global financial markets caused by fiscal austerity policies, compounded ironically by Central Bank quantitative policies and worsened by flight capital from Emerging Markets. These forces have triggered an excess demand for 'safe' assets which has driven up US Treasury prices and, simultaneously, hammered down term premia. Assuming that the recent Global Liquidity upturn continues, this may be enough to reverse the downtrend in term premia and normalise markets."*

The chart below gives us a nice historical overview of global financial market liquidity. In recent months the monetary base has tightened but now we are at the start of an expansion of global liquidity. "In short", Cross Border suggests "there is a strong upturn in the Liquidity Cycle, which is normally bullish for risk assets, against a widespread preference among investors for 'safe' assets."


Global Liquidity Index (GLI™) hits 47.2…
US Fiscal Spending Boom
Stock Market Boom
Inflationary Boom
OPEC I
Soaring Commodities
OPEC II
Reagan Election
Surging Dollar
1987 Crash
Weak US$
Japanese Bubble
Emerging Market Boom
Bond Crash
Asian Crisis
Tech/Y2K
Real Estate / Commodities Boom
Gold
QE1
QE2
QE3
Louvre Accord
9/11
Enron/ Worldcom
Barings Collapse
Mexico Peso Crisis
Russian Crisis
Argentina Crisis
US Banking Crisis
US Credit Squeeze
Sterling Crisis
US Commercial Paper Crisis
Penn Central Bankrupt
End of Bretton Woods
UK Banking Crisis
Volcker Fed
LDC Debt Crisis
Johnson Matthey
Failure of Continental Illinois
US S&L Crisis
Japanese Tightening
Scandinavian Banking Crisis
US Sub-prime Crisis / Norther Rock / Lehman Failure
Weekly Data
CrossBorder Capital's *Global Liquidity Cycle* and its national and regional sub-indexes define fluctuations in both the quantity and quality of money. It is a leading and predictive component of the broader financial and economic cycles that are marked by asset price swings, movements in interest rates and changes in the tempo of business activity.
Monthly Global Liquidity Cycle (Index, LHS)
Major Regions: Weekly Series, Monetary Base (3m Ann. % Chg., Log Scale RHS)

Contents

Headline Numbers

My suspicion is that if you were looking for a central consensus position on most things' macro-based at the moment, you couldn't get a more mainstream institution than Pimco. Its focus is on bonds, but its views are widely respected and on occasion, it can move markets. So, if we're looking for a baseline snapshot of where we are at the moment than Pimco's regular 6 to 12-month outlook should suffice. It is called *"Cyclical Outlook: Window of Weakness"* and is penned by Joachim Fels, PIMCO Global Economic Advisor, and Andrew Balls, PIMCO Chief Investment Officer of Global Fixed Income.

The nutshell?... *the global economy is about to enter a low growth "window of weakness," which we expect to persist going into 2020 with heightened uncertainty about whether it is a window to recovery or recession. During this window, we think it prudent to focus on capital preservation, to be relatively light in taking top-down macro risk in portfolios, to be cautious on corporate credit and equities, to wait for more clarity, and to take advantage of opportunities as they present themselves.*

	REAL GDP GROWTH (% YOY)			CPI INFLATION (% YOY)		
	2018	2019 forecast	2020 forecast	2018	2019 forecast	2020 forecast
DM[1]	2.2	1.7	0.75 - 1.25	2.1	1.5	1.25 - 1.75
U.S.	2.9	2.2	1.25 - 1.75	2.5	1.8	1.75 - 2.25
Eurozone	1.9	1.1	0.75 - 1.25	1.8	1.2	0.75 - 1.25
U.K.	1.4	1.2	0.75 - 1.25	2.5	1.9	1.75 - 2.25
Japan	0.8	1.1	0.25 - 0.75	1.0	0.5	0.50 - 1.00
EM[2]	5.6	4.9	4.50 - 5.50	2.7	3.0	2.25 - 3.25
China	6.6	6.1	5.00 - 6.00	2.1	2.5	1.50 - 2.50
Brazil	1.1	0.9	1.00 - 2.00	3.7	4.1	3.75 - 4.75
Russia	2.3	1.1	1.50 - 2.50	2.9	4.9	3.50 - 4.50
India	7.4	6.0	6.50 - 7.50	3.9	3.2	3.50 - 4.50
Mexico	2.0	0.5	0.50 - 1.50	4.9	4.1	3.50 - 4.50
World[3]	3.4	2.7	2.00 - 2.50	2.3	2.0	1.75 - 2.25

Note: All data for real GDP and headline inflation are year-over-year (YOY) percentage changes. 2018 is actual data, 2019 is our forecast with actual data to date included, and 2020 is our forecast.

1 DM is the GDP-weighted average of U.S., eurozone, U.K., and Japan.
2 EM is the GDP-weighted average of China, Brazil, Russia, India, and Mexico.
3 World is the GDP-weighted average of all countries listed in table above.
Source: Bloomberg, PIMCO calculations

Ever wondered who's buying Eurozone equities given the worries about deflation and low growth rates? Step forward our friends in the world of private equity who are mid-way through a debt fuelled binge. Back in September the equities team at Morgan Stanley in Europe put out an excellent report called "Macro Meets Micro: Private Equity Returns to Europe" which paints a very compelling picture of unprecedented levels of activity for PE funds in Europe.

Their bottom line? That M&A activity led by private equity is hitting unprecedented levels in Europe (see the chart below). The key sectors experiencing a surge in M&A activity? Media, industrials and telecoms. This level of activity might help support European equity valuations despite all the talk about deflation and a downturn in exports to China. Time to cheer the private equity raiders?

Source: Datastream, Morgan Stanley Research

Measure	Values as of 3rd September, 2019	Values as of 7th October, 2019
UK Government 10 year bond rate	0.35%	0.47%
GDP Growth rate YoY	1.20%	1.30%
CPI Core rate	2.10%	1.70%
RPI Inflation rate	2.80%	2.60%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.76%	0.76%
Government debt to GDP ratio	84.70%	84.70%
Manufacturing PMI	47.4	48.3

Back to menu

Bank CDS options

A few months ago, I ran into a leading American investor who'd made a killing out of investing in (smaller) US banks. He'd made money - big profits - for at least the five years and was still enthusiastic about investing in the sector even at this late stage.

"And what about European banks - interested?" I asked, curiously.

He burst out laughing and said words involving stick, bargepole, and human excrement. "They're bust, and the judgment day is coming".

Those comments stuck in my mind as I read the continuing drumbeat of negative bond yield and interest rate stories. And they popped again when I recently read an excellent analysis by Tuomas Malinen, who runs research consultants GNS Economics. I think it's fair to say that Tuomas (who is Finnish) shares the same withering assessment of my American investor. The chart below tells you the obvious driver behind what he believes will be the impending carnage.

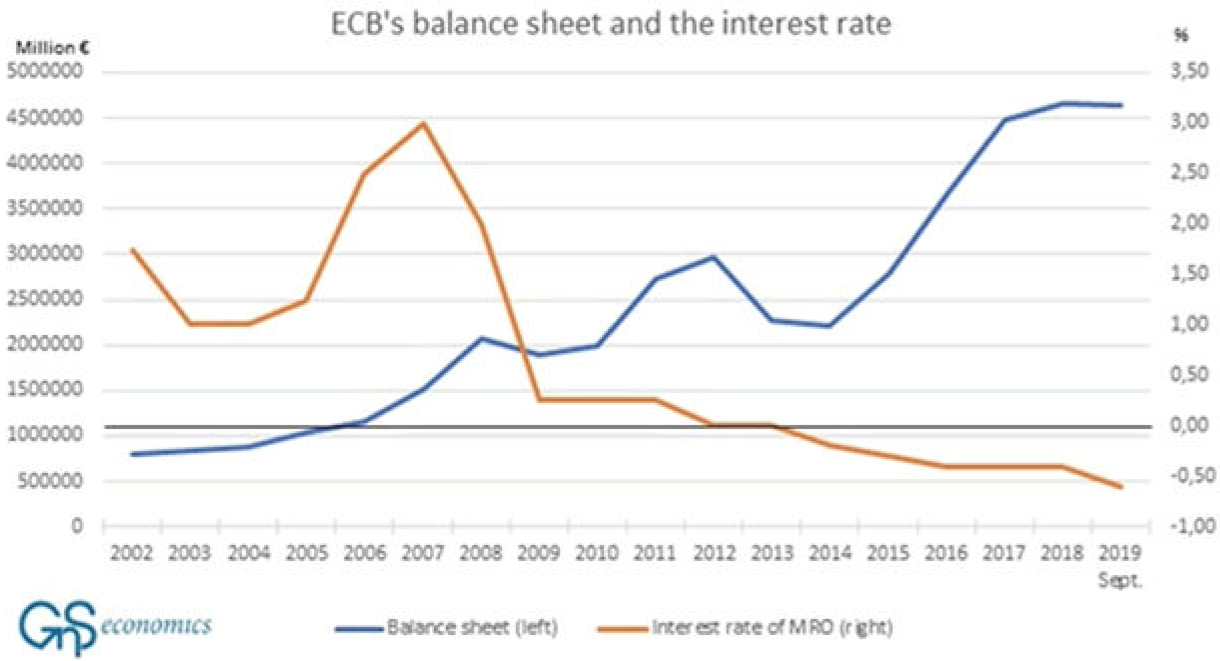


Figure 1. The size of the balance sheet of the ECB in million euros and the interest rate of main refinancing operations (MRO). Source: GnS Economics, ECB

According to Malinen "a large part of the European banking sector has probably been insolvent for the past 10 years, a conclusion that is also suggested by the group's stock price performance for that same period. The sector simply never recovered from the 2008 crisis... How will the 'living dead' European banks cope with the recession that is approaching fast? The only plausible answer is: not well. They are a ticking time-bomb."

If you fancy reading a well-argued horror story read the full article online here.

I'm not sure I'd go quite so far as Malinen but I do think that the European banks are in a hole, one that central banks are making ever deeper by the day. Negative interest rates are simply not good news for both the banks and quite possibly the wider economy. The core concern is that if the big banks can make money from lending/saving they'll simply react but cutting back the lending bit of the equation.

Analysts at big European bank Barclays have also been running the numbers to see how bank balance sheets will be impacted by negative interest rates. Their key concept is something called the reversal rate - the level of interest rates at which accommodative monetary policy becomes contractionary for the real economy. Once that point is reached, its clearly bad news for European banks.

The good news is that so far the aggressive monetary policy seems to have worked - according to Barclays "Euro area lending data show that banks continue to lend in greater volumes and at lower rates. This supports the calm response of policy-makers when discussing the side effects of negative rates and quantitative easing".

But as rates go lower we fast approach that reversal rate which in their case doesn't just come with interest costs but also the moment when banks can no longer grow lending by reducing other activities or costs.

Up till now, Barclays reckons that the banks' substantial increase in lending has been manageable because other balance sheet activities have been cut back - notably market-making, repo and OTC derivatives.

"This approach to credit creation is doomed to slow once banks exhaust their capacity to shrink other activities unless there is an increase in loan demand that leads to higher margins on lending. At the limit, the low RoTE that banks generate threatens to keep credit growth constrained at relatively low levels in the euro area (<5%/y)."

Cue the reversal rate. But what can central banks do about this challenge?

"To re-establish bank profitability, regulators need to lower the cost of bank liabilities. One potential solution would be to allow banks to charge negative rates on household deposits, in part or full. But this would be controversial and not without risks for the banking system; we believe that regulators/law-makers would need to step in to make this approach broadly applicable. Other possible solutions include increased non-bank lending or greater wholesale funding of bank balance sheets. The most bank-negative outcome would be if policy-makers accept low credit growth as a "fact of life", which could increase the risk of a low growth/inflation outcome for the euro area... If regulators do not act, the ECB may have to take controversial steps. Should banks hit a wall in lending, as balance-sheet constraints bite or demand weakens, the ECB could be forced to further relax TLTRO conditions or even consider extreme policy actions, such as adding bank securities to its asset purchase programmes."

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	7.06	32.08	-0.65	-41	A -
Barclays	25.74	58.59	-11.58	15.85	A
BNP Parabis	9.56	29.89	-1.33	-23.81	A
Citigroup	13.83	51.61	-11.98	6.83	A
Commerzbank	6.37	40.6	-7.28	n/a	A+
Credit Suisse	15	43.4	-17	-29	A
Deutsche Bank	31.05	70.33	-11.34	10.46	A+
Goldman Sachs	22.77	57.27	-17.93	-0.94	A
HSBC	12.56	51.2	-22.59	-8.75	AA-
Investec*	n/a	60	n/a	n/a	BBB
JP Morgan	14.66	36.44	-22.15	-3.09	A+
Lloyds Banking Group	16.64	73.11	-18.81	-9.75	A
Morgan Stanley	20.46	53.9	-16.30	-0.84	A
Natixis	n/a	44	n/a	n/a	A
Natwest Capital Markets	15.56	75/63	-13.92	6.74	A
Nomura	6.36	80.15	10.77	85.38	A-
Rabobank*	n/a	19.98	-7.07	-39.31	AA-
RBC	21.21	57	n/a	n/a	AA
Soc Gen	8.58	31.79	-4.2	-20.84	A

UBS	5.64	21.34	-2.38	-35.01	A

Source: www.meteoram.com 18th September 2019
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

Back to menu

Government Bonds

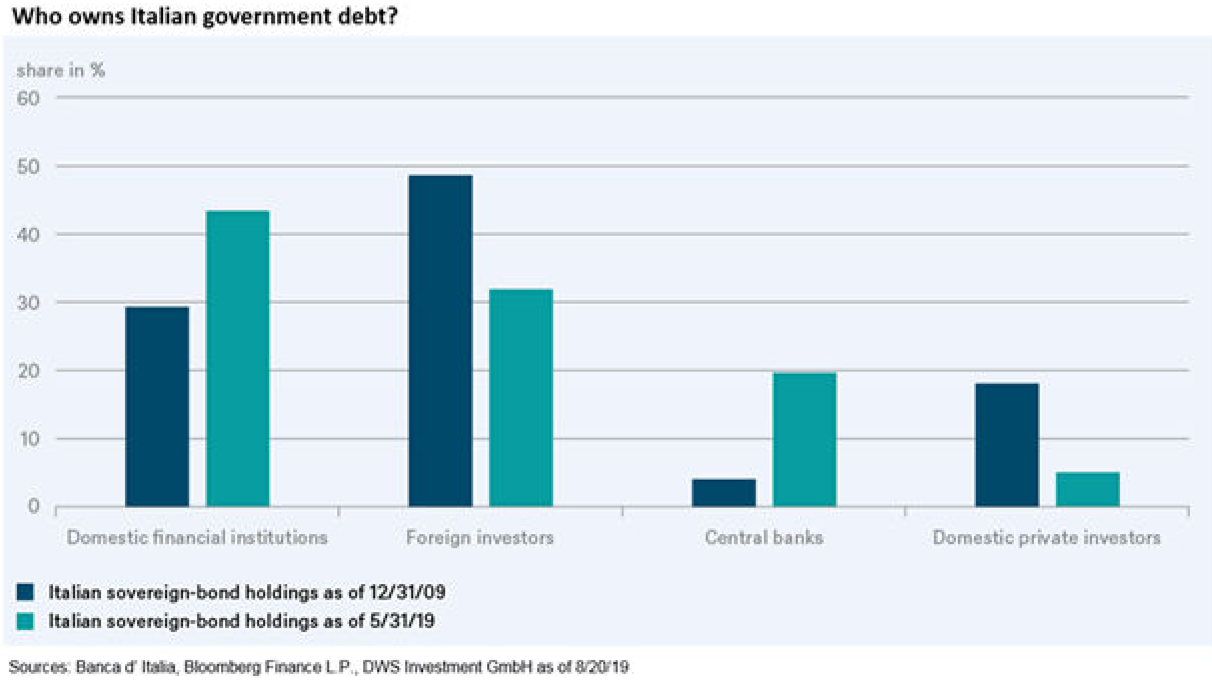
Fixed Income

Over the last few months the yield on Euro area government bonds has consistently come down, hitting negative rates for Germany. Even the Greeks seem to be back on track. In this low or even negative rates environment its hard to find any way for bond investors to juice up returns.

Cue Italy.

Yields have stayed relatively high largely because of political uncertainty. Historians have counted no less than 65 governments since 1946. The latest incarnation is a coalition government involving the Five-Star Movement and the centre-left Partito Democratico. How long this government will last is anyone's guess. But despite these worries, Italian government bond yields don't seem to be have hugely impacted.

The risk premium over German bunds has remained in a fairly steady trading range of between 150 and 250 basis points. One driver of demand for Italian bonds has been bank buying, according to analysts at DWS. A recent analysis for DWS shows that while foreign investors held almost 50% of Italian government bonds at the end of 2009, this share has now come down to just over 30%. The share held directly by Italian private investors fell, too, from just under 20% to only 5% now. "On the other hand, domestic banks and especially the central bank have increased their holdings. The share of the latter rose from 4% to currently almost 20%, which is the equivalent to an increase of 337 billion euros". So, already slightly stressed Eurozone banks buying ever more bonds in a slightly stressed Euro zone government - surely no cause for concern over the long term??!



UK Government Bonds 10-year Rate 0.35%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	20.15
Germany	10.21
Japan	22.75
United Kingdom	31.66
Ireland	32.57

Italy	134
Portugal	40.67
Spain	40.07

Eurozone peripheral bond yields

Country	September 2019	October 2019	Spread over 10 year
Spain 10 year	0.08%	0.13%	72
Italy 10 year	0.90%	0.85%	144
Greece 10 year	1.61%	1.48%	207

	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

Back to menu

Equity Markets and Dividend Futures

Index	September 2019	October 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.2	121.7	3432	121.8
FTSE 100 (Dec 17)	327.5	327	7184	n/a

Equity markets have had a decent start to the autumn. In September overall markets finished up for the month, with MSCI World up 1.9% (in US$) and just about in the black for Q3, with a 0.1% gain. The year-to-date numbers, flattered by the collapse in Q4 2018, show MSCI World up 15.7% so far in 2019. But according to fund flows data from Deutsche analysts in the US **overall** positioning in equities" is still near neutral and not high in absolute, but very high relative to levels seen in prior periods of comparable slow [global macro-economic] growth. Equity market pricing and positioning at current levels represents a strong view macro as well as earnings growth will rebound."

This Deutsche analysis also suggests that the American benchmark index, the S&P 500, is priced for the composite ISM (a key macroeconomic signal) bouncing back to the mid-50s and earnings growth back to 10%. "It is also completely out of line with CEO confidence, which recently plunged to levels last seen in 2008", observes the Deutsche analysts.

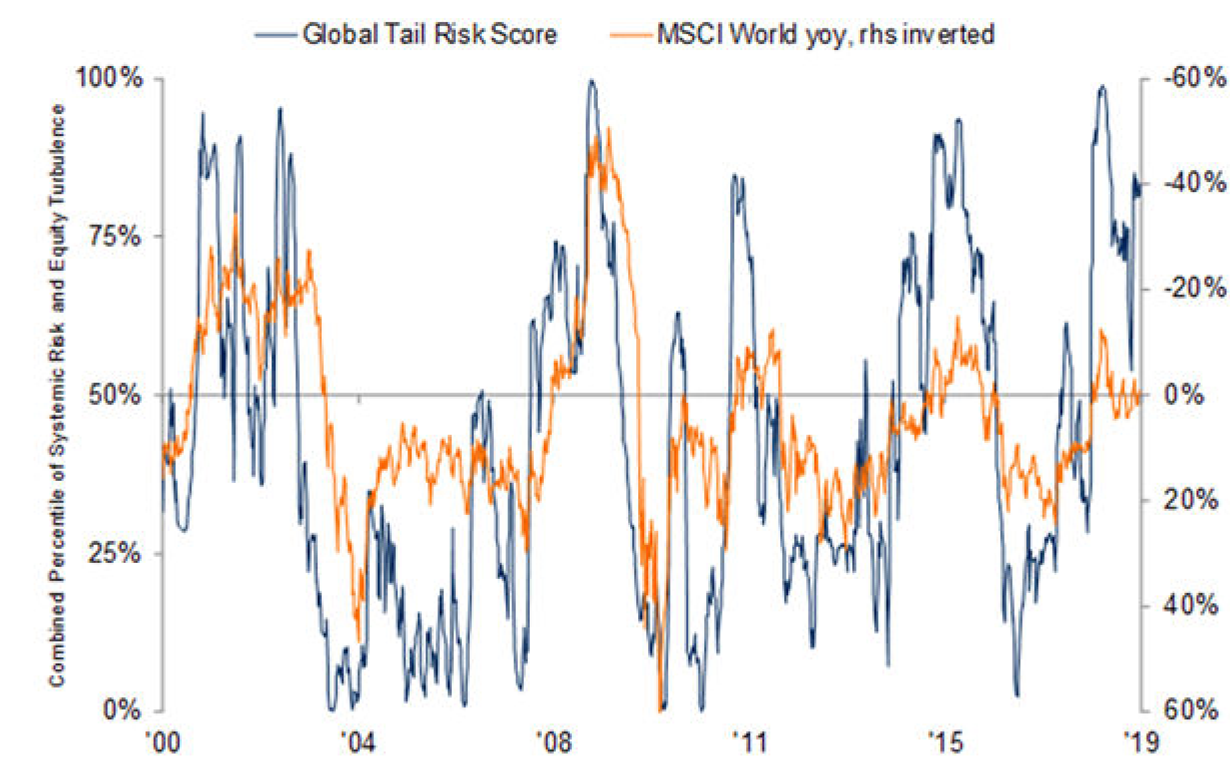
Quant analysts at SocGen have another spin on market developments over the last few months. They observe that value stocks in particular have rebounded heavily. But they worry that investors are "playing a game of chicken: hoping lower bond yields do not lead to a recession, but equally that the global economy remains sufficiently moribund to not cause bond yields to rise and negatively impact expensive defensive and growth stock valuations".

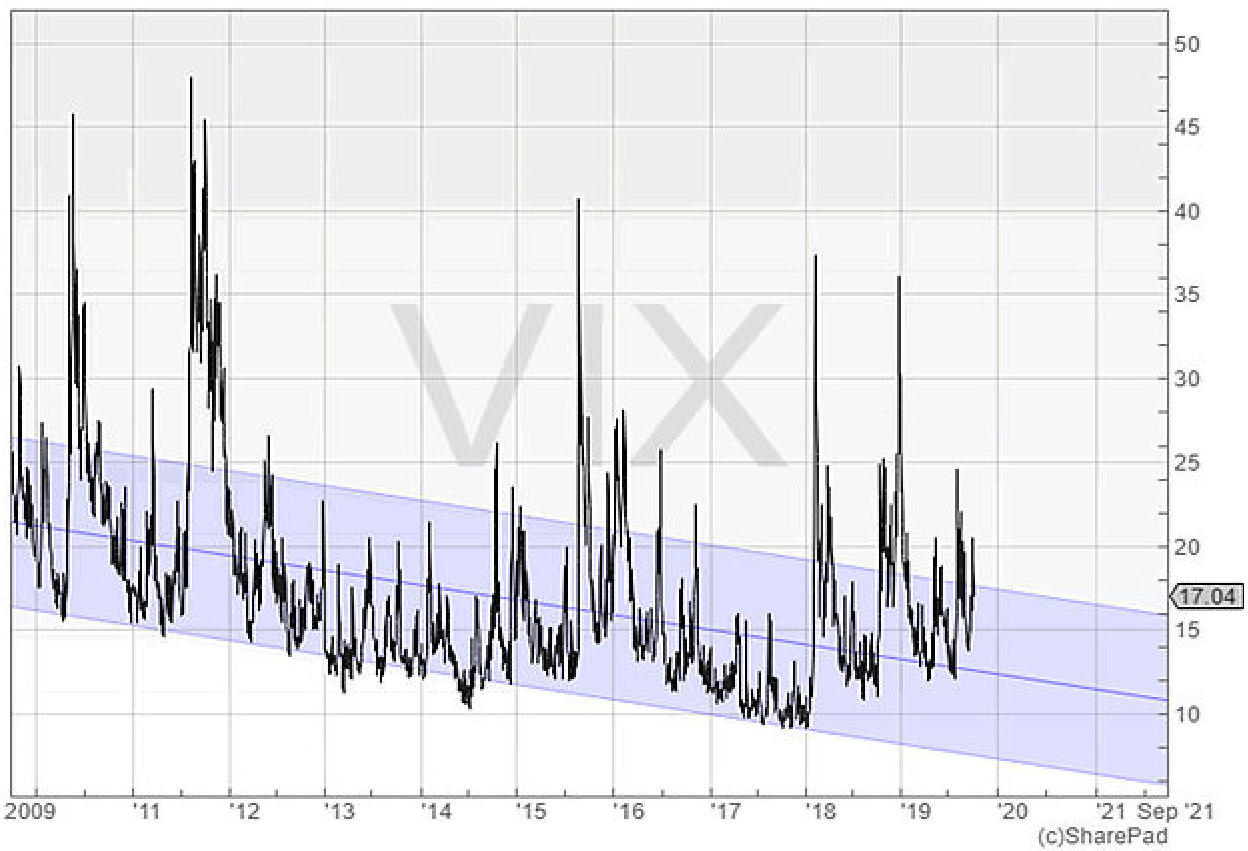
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-1.41	-4.9	-3.66	-0.7444	10.7	12.8	7179
S&P 500	-1.34	-1.25	1.49	1.88	49.3	77.5	2938
iShares FTSE UK All Stocks Gilt	1.33	5.29	8.75	13.7	21.7	27.3	14.55
VIX New Methodology	13.6	22.1	29.3	8.6	12.8	-16.2	17.04

Back to menu

Volatility

An interesting hint that markets may be set for a volatile next few months comes from Tim Graf, head of Global Macro Strategy for EMEA at State Street. They have developed an internal Global Tail Risk score which is currently flagging 'caution'. This signal combines a Systemic Risk Index with a Turbulence index for global equities "capturing unusualness of volatility and correlation. Higher readings of the combined signal indicate an increase in probability of future drawdowns in risky assets... The spike over the last two months would indicate the relative stability of global equities over the last two quarters is under threat."





Measure	October Level	September Level	August Level	July Level
Vstoxx Volatility	18.3	18.15	18.1	12.9
VFTSE Volatility	n/a	n/a	n/a	10.96

Back to menu

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.

Back to menu

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.

Back to menu

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

Kind Regards,

Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk