UK Structured™ Products Association

# Monthly Market Report

July 2019

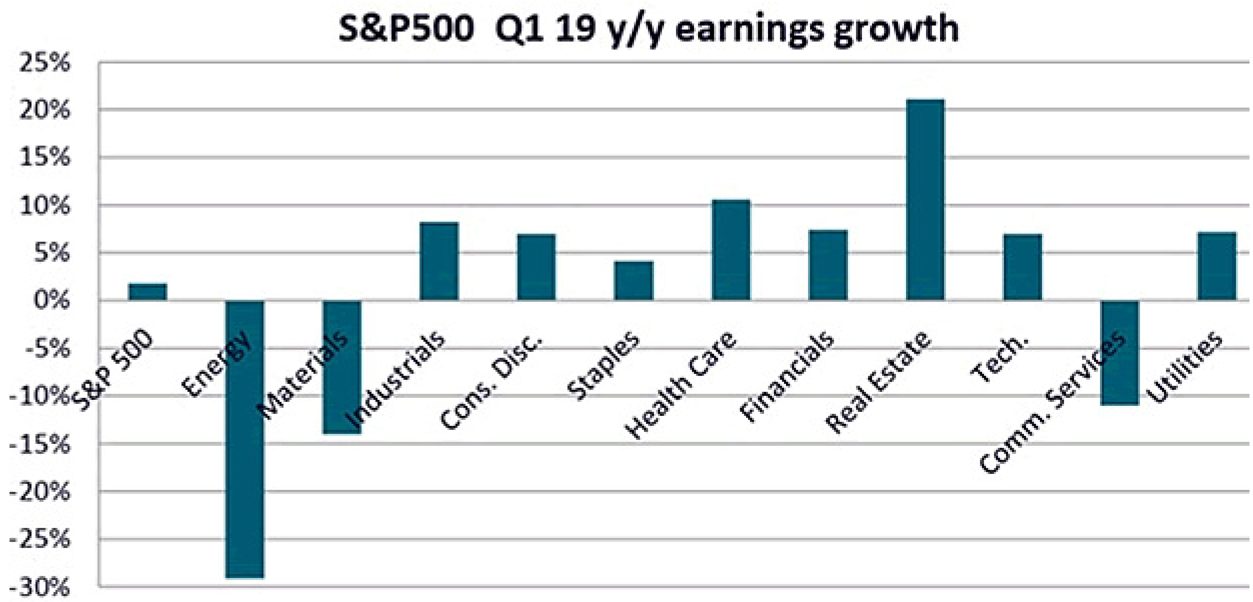
*With commentary from David Stevenson*

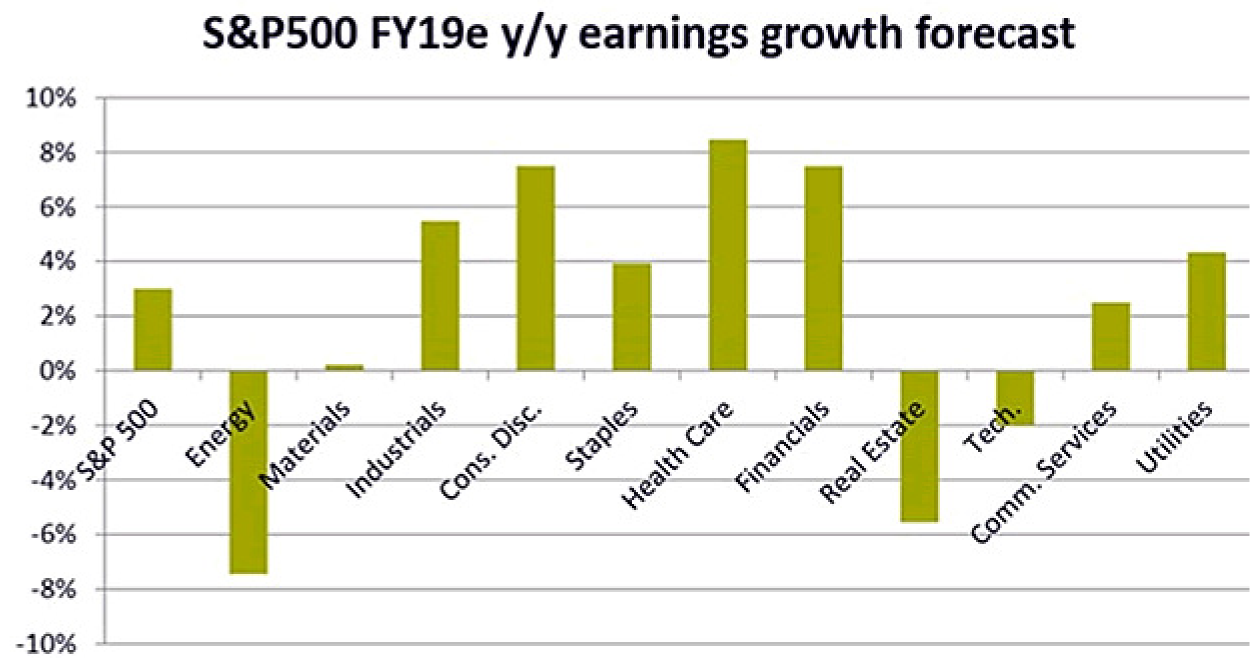
**Lets not panic quite yet**

Markets seem to have taken a turn for the worst over the last few weeks. Blame Trump and his talk of tariffs. As we'll discover in this report, bond investors are clearly signalling that there's real trouble ahead. Despite this though my hunch is that these worries are over done largely because the key fundamental numbers for global stocks still look positive. Take dividends for instance, close to most structured product investors hearts. According to Janus Henderson and their global dividend index, global divis advanced 7.8% on a headline basis in the first quarter, reaching a first-quarter record of US$263.3bn. Underlying growth was 7.5% with the impact of large special dividend payments offset by exchange rate moves while the Janus Henderson Global Dividend Index rose to a record 190.1. Looking at forward numbers, Janus Henderson expects no change to its 2019 forecast as higher special dividends are offset by the strength of the US dollar, with a likely record of US$1.43 trillion in payments this year, up 4.2% in headline terms or 5.2% on an underlying basis. One interesting side note - Asia is becoming a hotspot for dividend payouts. According to Janus Henderson, "Asia Pacific ex-Japan has seen the world's strongest dividend growth since 2009, thanks to rising profits and expanding payout ratios. The Q1 total of US$18.1bn was up 14.7% year-on-year on a headline basis, breaking the record for first-quarter payouts".

I'd also point to numbers on earnings growth, which still seem to be (slowly) moving ahead. Charles Stanley has something called an Earnings Tracker which looks at reported earnings from major markets across the globe and compares them with analysts' expectations. It covers the S&P 500, FTSE 100, FTSE 350 and the Topix and also contains forward-looking earnings forecasts. The latest numbers seem fairly decent, all things considered. Results have been slightly better-than-expected and consensus earnings estimates are being upgraded over the reporting season in response to the more positive announcements. In the US, 77% of those that have reported have beaten earnings estimates by 6%. Earnings are up 2% at the index level on the same period last year, beating current consensus expectations for Q1 for the index. Even the European Stoxx 600 is recording earnings growth of 2% on the same period last year with seven out eleven sectors reporting positive growth, although sales are up only 2%.

Obviously all these numbers could turn red if the tariff dispute turns into a full scale tariff war - aided by a new Cold War on technology between the US and China - but I'd counsel some caution on automatically assuming that all grim political news necessarily reads straight through to a dire stockmarket. In my opinion, it's still too early to call an end to this late cycle bull market run.


S&P500 Q1 19 y/y earnings growth
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
-25%
-30%
S&P 500
Energy
Materials
Industrials
Cons. Disc.
Staples
Health Care
Financials
Real Estate
Tech.
Comm. Services
Utilities


S&P500 FY19e y/y earnings growth forecast
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
-10%
S&P 500
Energy
Materials
Industrials
Cons. Disc.
Staples
Health Care
Financials
Real Estate
Tech.
Comm. Services
Utilities

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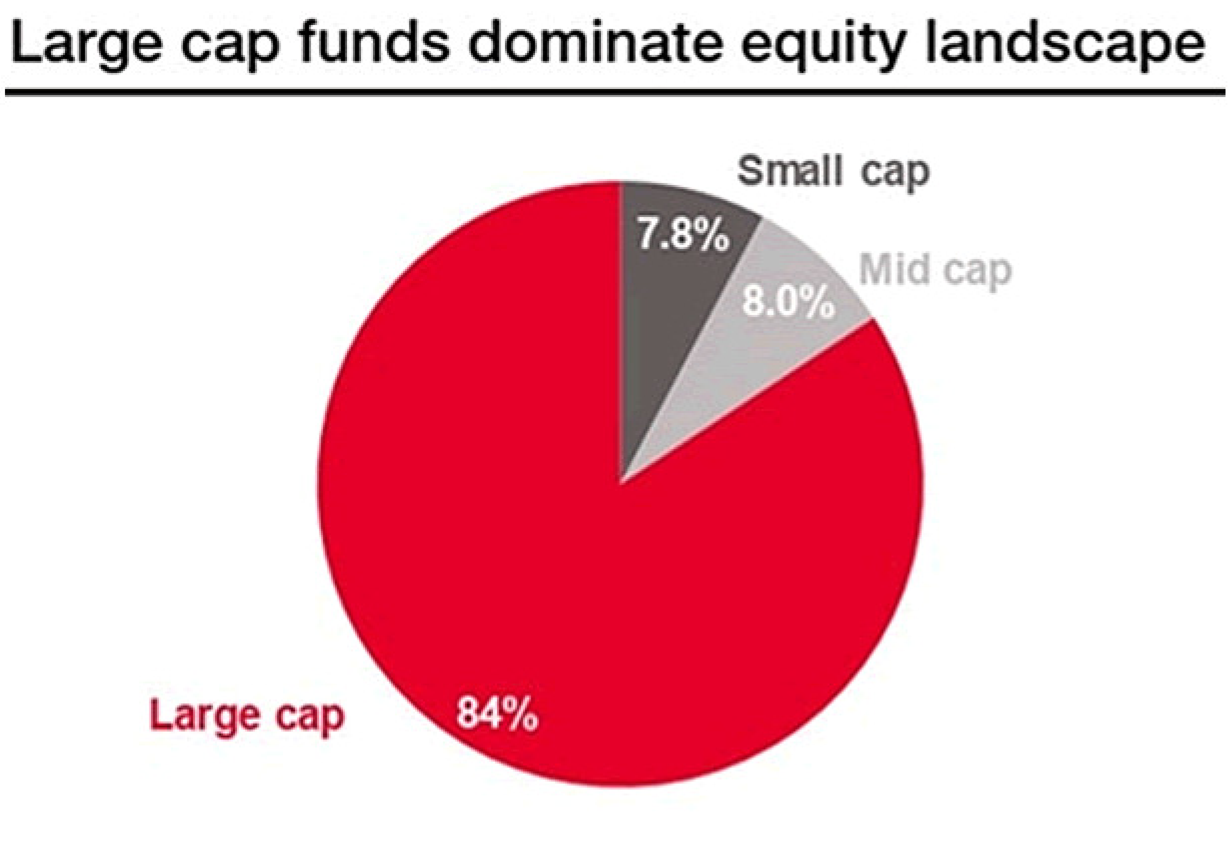
## Headline Numbers

**Obsessed with Size**

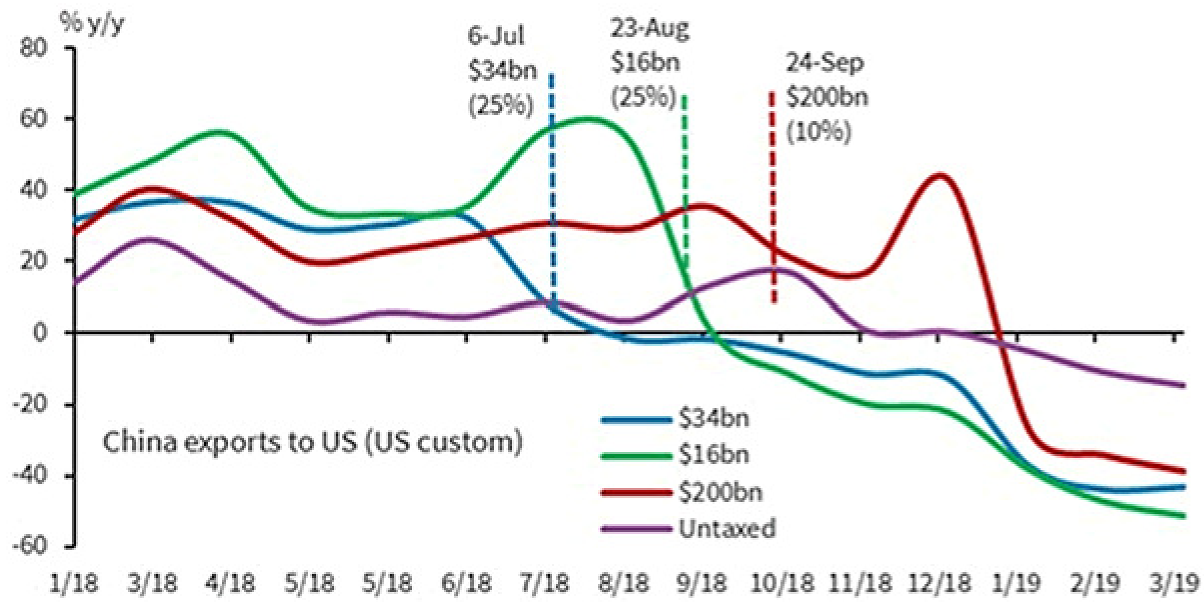
Shock horror. Journalist reads reports and accounts. Yes, this weekend I sat down to read the always fascinating annual report by the managers behind the Scottish Mortgage investment trust, run by Baillie Gifford. Hidden in the annual commentary is a fascinating insight - that getting on for half of all stockmarket returns can be accounted for by the (increased) share price of just 90 big companies. This reflects a brutal truth. That stockmarkets have placed nearly all their bets on a small elite of globalised mega caps who have taken the lions share of all new funds. By comparison funds investing in mid and small caps have been starved of capital as investors retreat into mega scale. The hard numbers for this retreat comes in a recent paper from SocGen's cross-asset team headed by Arthur Van Slooten. They've done the maths on fund flows at the global level, a global investment pool of $14.3 trillion in the US and Europe. Their view is that large caps "reign". Large-cap equity funds now represent a "crushing 84.2% of assets under management (AuM... In contrast, the share of mid-caps funds (8.0%) is near its lowest point since 2010". In asset allocation terms, compared to average weights since 2010, fund investors now appear to be strongly overweight large caps, mildly underweight small caps and strongly underweight mid-caps according to SG.




Equity size universe (EPFR): large, mid and small cap funds in the US, Europe and in Global funds. Breakdown of Asset under Management (%). Latest data as of 30/04/2019.

**Buckle up for a trade war**

Regular readers will know that I've become increasingly cautious about linking geopolitical developments with stockmarket returns. There isn't always a straight linear read through to markets from populist stuff but even I would have to concede that the recent ructions around China and Tariffs can't be ignored. I've been looking for a good summary and last week I got a brilliant one from a team of analysts at Barclays, who to date have been spot on. The team is led by Jian Chang and their key takeaway is that they think it is "unlikely [China will] make further concessions unless the US offers compromises". This means that their Standoff scenario is "materializing and the Escalation scenario is becoming increasingly likely". The Barclays authors think the Chinese position is best summarised by quotes from Hu Xijin, editor-in-chief of China's Global Times who in late May concluded that "China is now reassured and ready for a protracted trade war. The political goal of not yielding to the US has been placed above the economic goal of minimizing losses." So, what might the next steps be for China? According to the Barclays analysts, the official rhetoric has hinted that some non-tariff retaliation could be imposed, which could include "intensifying shipping inspections and prolonging customs checks, applying greater scrutiny or delaying approvals of licenses and permissions for doing business in China, and tightening regulatory discretion of investment by US companies. Citing a recent survey, the American Chamber of Commerce of China said this week that nearly half of its members are seeing non-tariff barrier retaliation in China as a result of the increasingly bitter trade war ("U.S. business group says retaliation rising in China amid trade war," Reuters, 22 May). The survey also suggested that 40.7% of respondents were considering or had relocated manufacturing facilities outside China, which increased from 19% from the survey before the latest tariff hikes". The impact on Chinese exports is already apparent and substantial - as evidenced in the dramatic chart below. China is hurting.




| Measure | Values as of 9th May, 2019 | Values as of 4th June, 2019 |
|---|---|---|
| UK Government 10 year bond rate | 1.12% | 0.87% |
| GDP Growth rate YoY | 1.80% | 1.80% |
| CPI Core rate | 1.90% | 2.10% |
| RPI Inflation rate | 2.40% | 3.00% |
| Interest rate | 0.75% | 0.75% |
| Interbank rate 3 month | 0.81% | 0.80% |
| Government debt to GDP ratio | 84.70% | 84.70% |
| Manufacturing PMI | 53.1 | 49.4 |

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## Bank CDS options

Rates for investment bank Credit Default Swaps mostly ticked higher over the last month, probably because of more general concerns about a deterioration in the global economy and trade. There were though some stand out increases in rates with HSBC, Credit Suisse, Barclays, Lloyds and Natwest all registering increases of 25% or more for their 5 year swaps. By contrast Commerzbank and Deutsche both saw a marked decline in their 5 year swap rates. At the 1 year swaps level, Swiss Bank UBS still remains the bank with the lowest risk rating, with Rabobank not far off and Credit Agricole catching up.

| Bank | One Year | Five Year | Monthly Change (5yr) | Annual Change (5yr) | Credit Rating (Fitch) |
|---|---|---|---|---|---|
| Banco Santander | 9.78 | 47.18 | 6.67 | -47 | A - |
| Barclays | 25.85 | 75.86 | 28.97 | 45 | A |
| BNP Parabis | 14.54 | 44.18 | 18.96 | -5.9 | A |
| Citigroup | 16.96 | 66.10 | 17.7 | 22 | A |
| Commerzbank | 16.43 | 65.73 | -16 | -30 | A+ |
| Credit Suisse | 27.99 | 78.36 | 25 | -8.57 | A |
| Deutsche Bank | 63.3 | 113.57 | -33 | -23 | A+ |
| Goldman Sachs | 28.76 | 76.68 | 0.09 | 20.18 | A |
| HSBC | 13.3 | 42.63 | 28.15 | 39.59 | AA- |
| Investec* | n/a | 68 | n/a | n/a | BBB |
| JP Morgan | 20.62 | 49.37 | 7.59 | 4.14 | A+ |
| Lloyds Banking Group | 27.13 | 118 | 46 | 21 | A |
| Morgan Stanley | 28.15 | 72.69 | 11.95 | 20.13 | A |
| Natixis | n/a | 60 | n/a | n/a | A |
| Natwest Capital Markets | 17.97 | 73.94 | 3.91 | 71 | A- |
| Nomura | 9.8 | 30.57 | 9.01 | -11.77 | AA- |
| Rabobank | n/a | 61 | n/a | n/a | AA |
| RBC* | 28.55 | 121 | 42 | 138 | A |
| Soc Gen | 12.48 | 48.86 | 19.2 | -9 | A |
| UBS | 9.32 | 29.96 | 9.14 | -36.1 | A |

Source: www.meteoram.com 29th May 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 - What bond investors are shouting at the moment.**

I quite like keeping a close eye on fund flows as an indicator of sentiment and the big story of 2019 so far has been a simple one. Equity prices might have rebounded (and subsequently stumbled) but investors are voting with their feet - selling down equity funds and reinvesting the proceeds into bond funds. The most recent evidence of this comes via data from the European Fund and Asset Management Association (EFAMA) which has just published its European wide survey for numbers through to the end of the first quarter of this year. This looks at 29 different investment associations, representing 98 percent of total UCITS and AIF assets. The stand out number - the Net sales of bond funds increased to EUR 43 billion, from EUR 14 billion in February whilst UCITS money market funds recorded net outflows of EUR 2 billion, compared to net inflows of EUR 4 billion in February.

The obvious message here is that investors are turning to bonds, preferably government securities. This can be seen very clearly in the next bunch of charts, with the first one for a key UK gilt issue. This first chart is from www.sharepad.co.uk and shows the price of the UK gilt ticker TG28 - a relatively recently issued security paying 1 and 5/8th coupon through to October 2028. The yield to maturity on this popular security is now a tad under 0.80% per annum, for just under nine years.


Looking more broadly at an adjusted basket of ten-year gilts, the overall yield to maturity is now running at 0.88%. The chart below shows this yield over the last ten years. My guess is that we'll see most longer dated gilts trade at well under 1% for the next few weeks, with a possible push below 0.7 if we get more bad news.

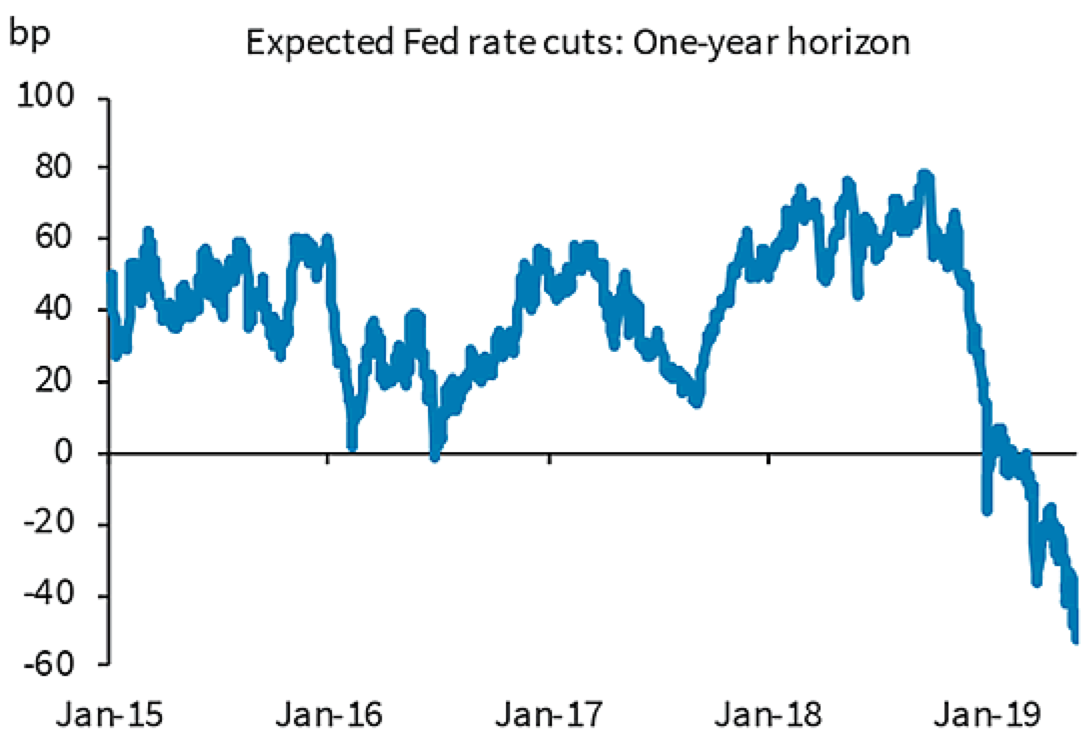

The next chart suggests more bad news - it shows the spread between US Treasury 3 month securities and 10 year securities. The current spread according to this Bloomberg grab is close to levels last seen in 2007.


The cause of all this angst is obvious - trade wars. If President Trump wants to avoid a recession before elections next year, I'd cordially suggest he's going the wrong about it. Markets are clearly signalling recession risks. My guess is that tensions will escalate first before some kind of deal is done but markets aren't in a patient mood. Which brings me to my last chart. Its from the macro economics team at Barclays and shows what they think is the consensus expectation for Fed rates in the remainder of this year. According to Barclays, they "expect the Fed to cut its policy rate by 75bp this year beginning in September. Earlier action is not out of the question if financial conditions deteriorate rapidly". So much for the great Interest Hike narrative, battling with surging inflation and a return to 'normal' long term interest rates. The markets clearly believe that we are stuck in the Low(er) Rates for Longer Model.

Which brings me nicely to one last titbit, relating to the CLO market. This little tale clearly shows how once we dig beneath the big macro trends we discover lots of interesting sub narratives. This concerns Japanese buyers of highly rated CLO paper and the story comes from a specialist manager in this space, Fair Oaks. They've long been worrying about "the potential risk to the primary CLO market from a concentrated AAA investor base as a small number of Japanese banks are a key source of financing for the CLO market. Market sources estimate that Japanese banks have purchased over 30% of primary CLO AAAs over the last few years. In Europe, it is estimated that Japanese buyers accounted for two thirds of primary CLO AAAs in the first quarter of 2019". CLO AAAs have underperformed in 2019. While investment grade corporate spreads have tightened significantly (19 and 23 bps in Europe and the US respectively), CLO AAA spreads have widened slightly.

FIGURE 2

...and investors are expecting the Fed to cut its policy rate to support the outlook




Note: Difference between the expected federal funds rate 1y ahead and the expected average federal funds rate in the current month. Source: Bloomberg, Barclays Research

**UK Government Bonds 10-year Rate 0.88%**


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

## CDS Rates for Sovereign Debt

| Country | Five Year |
|---|---|
| France | 30.05 |
| Germany | 11.45 |
| Japan | 24.32 |
| United Kingdom | 30.44 |
| Ireland | 31.28 |
| Italy | 229 |
| Portugal | 59.33 |
| Spain | 53.2 |

## Eurozone peripheral bond yields

| Country | May 2019 | June 2019 | Spread over 10 year |
|---|---|---|---|
| Spain 10 year | 0.98% | 0.65% | 87 |
| Italy 10 year | 2.72% | 2.51% | 273 |
| Greece 10 year | 3.58% | 2.93% | 315 |

| | 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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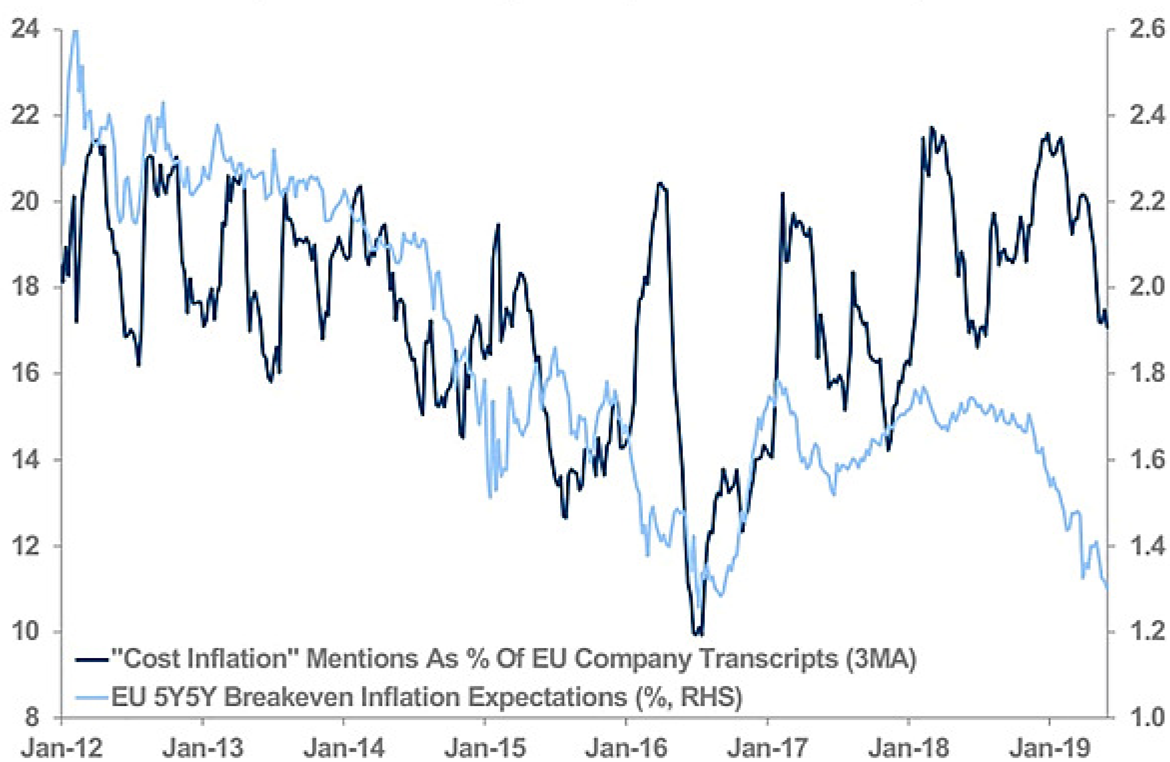
## Equity Markets and Dividend Futures

Two interesting recent charts from the cross-asset research team at Morgan Stanley stand out this month for equity investors. The first reminds us that although inflation expectations have fallen sharply globally, the really big moves have been in Europe where these rates have "fallen 30 basis points year-to-date to within 5 basis points of their all-time low" according to the MS analysts. Now what's odd about this is that most European corporates are telling us a very different story - the chart below also shows those inflation expectations plotted against the frequency of mentions of "cost inflation" in European company transcripts, which has moderated a bit from last years' highs but remains far higher than we saw in 2016 when inflation expectations were last this low.

**Exhibit 5:** ... even though the inflation message from corporates is much less benign




Source: Bloomberg, Alphasense, Morgan Stanley Research

I think this might hint at a potential challenge for many European corporates. They probably are seeing increased cost pressures, but the disinflationary environment means that their ability to pass on these cost pressures is very limited. European consumers just don't have enough spare cash kicking around. Thus corporate profit margins might get squeezed in the next year or so.

The plunging inflation rate is also a contributor to the rock bottom - or should we say negative - yields on German bonds at the moment. These have crashed as investors have sought protection in German bonds. This, in turn, could have a knock-on effect on investors desperately searching for any/some nominal positive yield. Equities might seem rather appealing. But what kind of equities? The Morgan Stanley analysts reckon that European high yield equities with robust balance sheets might be a good place to look. " Exhibit 7 shows that historically the relative performance of the MSCI Europe High Dividend Yield index has been closely tied with moves in bond yields. The German 10Y is now 2.4 standard deviations below its 12M average, yet the relative performance of high yielding stocks is merely in-line with the 1Y average." Might we be about to see a wave of disgruntled German investors slowly siphon money away from their low yielding bunds and into German dividend payers?

**Exhibit 7:** There has been an unusual gap between the relative performance of High Dividend Yield stocks and the move in bond yields


Source: MSCI, Thomson Reuters, Morgan Stanley Research

| Name | Price % change | | | | | | Close |
|---|---|---|---|---|---|---|---|
| | 1 mth | 3 mths | 6 mths | 1 yr | 5 yr | 6 yr | |
| FTSE 100 | -2.52 | 0.84 | 2.45 | -7 | 5.52 | 9.7 | 7194 |
| S&P 500 | -6.83 | -1.73 | 1.64 | -0.08 | 42.4 | 68.2 | 2744 |
| | | | | | | | |
| iShares FTSE UK All Stocks Gilt | 2.96 | 3.45 | 5.02 | 3.82 | 20.2 | 17.5 | 13.64 |
| | | | | | | | |
| VIX New Methodology | 45.4 | 27.9 | -9.79 | 46.9 | 54.9 | 15 | 18.81 |

| Index | May 2019 | June 2019 | Reference Index Value | Level 6 Months Ago |
|---|---|---|---|---|
| Eurostoxx 50 | 121.5 | 121.8 | 3314 | 120 |

| | | | | |
|---|---|---|---|---|
| FTSE 100 (Dec 17) | 325.1 | 320 | 7197 | n/a |

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## Volatility

**Come on in, the water's lovely.**

One of my favourite arguments advanced by crypto currency enthusiasts is that the various digital money systems, and most notably bitcoin, are a great future potential store of value. Clearly the crypto enthusiasts have in mind usurping the age-old store of value, namely gold. Optimism towards bitcoin has been lifted in the last few months as prices started to creep back upwards. But I'm not entirely convinced that comparing gold with bitcoin 9or any digital currency) makes much sense. Why? Volatility. Bitcoin prices might have stabilised a bit and started creeping up but most conventional measures of price volatility suggest that cryptos are insanely volatile. Bloomberg for instance reported recently bitcoin volatility has grown significantly and averaged 4.5% in May as compared to 3.5% in April and 1.1% in March. This is the highest level on record since December 2018, when volatility hit 4.2%. Bloomberg also confirmed that volatility has increased within the trading bands - the spread between upper and lower price range levels. "When volatility gets high it should be indicative of extremes in price. The market is getting a bit stretched here from a trader's standpoint," Bloomberg Intelligence analyst Mike McGlone reported.

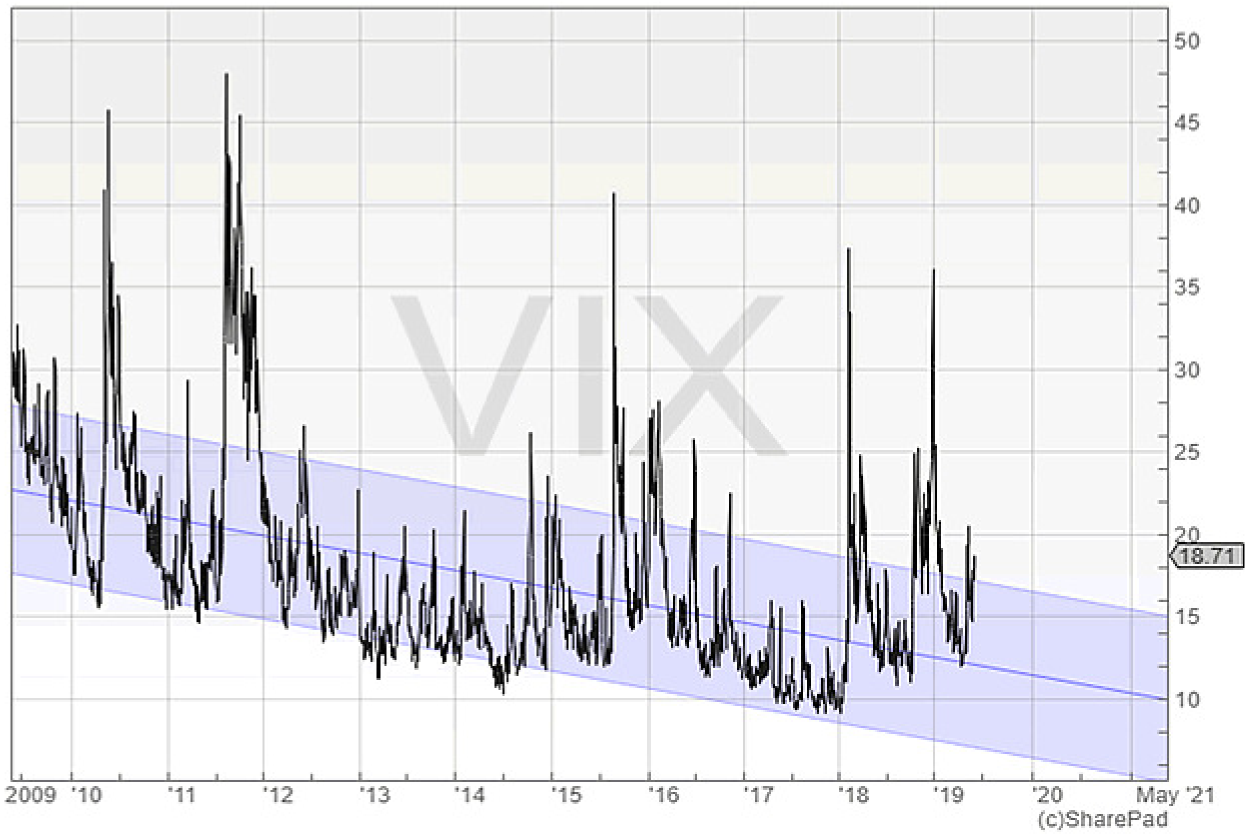
What's even more curious is that bitcoin volatility looks like it might be beginning to move in step with equities. The chart below is from Bloomberg as well and only goes to the end of March, so it's an incomplete record. But a pattern might be emerging.


If we turn to gold, an entirely different story emerges. Gold price volatility is measured by a number of futures contracts most notably the CBOE and their GVZ measure. This measures "the market's expectation of 30-day volatility of gold prices by applying the VIX methodology to options on SPDR Gold

Shares (Ticker - GLD). " Over the last five years this measure was trending between 15 and 20 but then from the spring of 2017, the volatility measure stepped down noticeably. The more recent trading range has been between 10 and 15 with the index sometimes moving into the single digits. Its currently just above 10. You can see the chart in detail here.

We can also see the subdued volatility in the last chart below which is for the Comex futures price over the last five years. Gold seems to be trading well above recent trend lines but 20 day volatility as measured in the lower part of the chart has fallen noticeably.

So, lets summarise. Bitcoin might have recovered some of its own mojo but it's become more not less volatile. Stores of value generally need to boast low volatility, which bitcoin clearly doesn't posses. Gold by contrast has become less volatile in price and thus a potentially more stable store of value. Do we honestly believe that long term gold investors will be contemplating cutting their holdings of the shiny stuff to invest in cryptos? I think not.




| Measure | June Level | May Level | April Level | March Level |
|---|---|---|---|---|
| Vstoxx Volatility | 16.6 | 18.63 | 14.07 | 14.58 |
| VFTSE Volatility | 13.54 | 16.41 | 11.89 | 13.09 |

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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.<br>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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