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UK | STRUCTURED™ PRODUCTS ASSOCIATION

Monthly Market Report

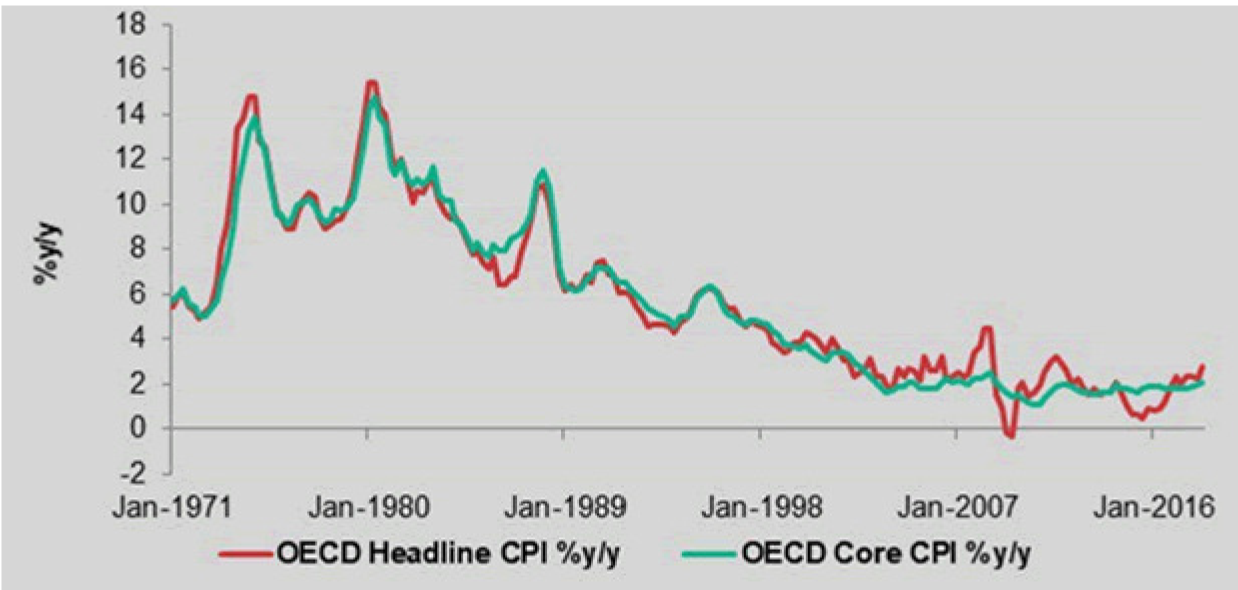
December 2018

With commentary from David Stevenson

End of World Delayed

At a recent investor event I was accosted by a fund director who claimed that I was another member of the bearish liberal journalist elite, always trying to talk down the "real" economy. I put my hands up on three of those four counts - a liberal, a journalist and thus by definition a tad elitist - but I slightly beg to differ on the bearish tag. I am concerned that we are late cycle and that gains will be much harder to find in these more expensive markets. I also don't think its remotely controversial to suggest that we are due a good recession sometime soon. But I also don't think that we are on the edge of a financial precipice. In fact, I think it entirely possible that the current bull market might 'stagger on' for quite some time yet, although my choice of the words "stagger" and "on" does betray a certain cynicism I suppose.

Evidence for a more positive take on prospects for equities is abundant, if not entirely conclusive. I'd cite two key bits of data. The first is the current market reaction to rising interest rates might subside if there's clear evidence that inflation isn't romping ahead. This might in turn mean that the US Federal Reserve starts to slow down the pace of its rate increases. And the good news here is that on the current inflation numbers it's clear that the numbers are 'under control', for the moment at least. As the chart below shows, inflation remains a world away from the double-digit levels last endured in the 1970s. Crucially these numbers are consistent with central bank plans for low and stable levels. The chart below looking at OECD core and headline CPI backs up this message. The inflation bears will be sorely disappointed.



Turning to more market specific measures, it's also hard to argue with the simple fact that equity dividends are still increasing - which in turn acts as a great under pinning for equity market valuations. And what's generally true for developed markets, is especially true for UK equities. In fact, the latest Link Asset Services report suggests that UK dividends are booming. According to Link "UK dividends rose 4.1% to £32.3bn in Q3, breaking a third-quarter record. Underlying pay-outs, which exclude special dividends, reached £31.6bn, a rise of 6.9% year-on-year."

Again, it's hard to argue with investors taking these large dividend pay-outs and then reinvesting them back into equities - thus driving up equities to even higher levels.

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Headline Numbers

European Profits

Over the last few years much of the heavy lifting in terms of earnings has been by US listed firms. Europe has lagged by contrast, although in the last few years we've seen some hopeful signs that European corporates are at last catching up in terms of increasing profits.

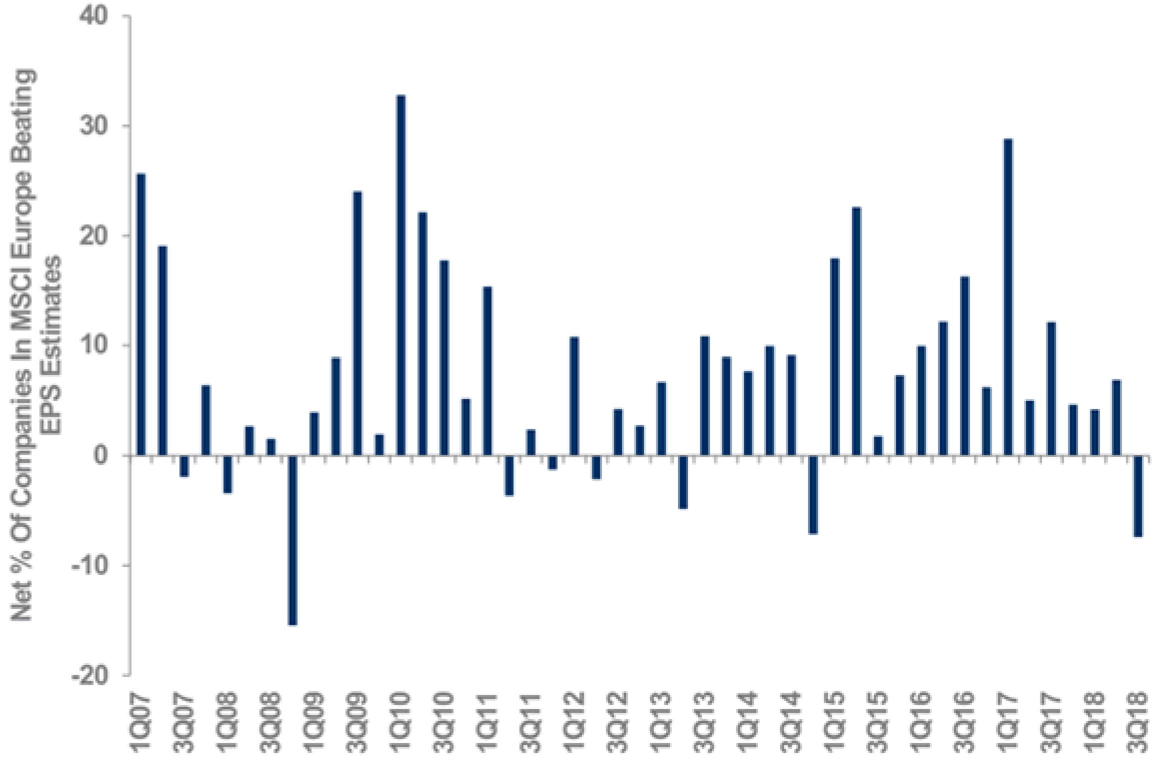
Until now that is!

Recent numbers from the current earnings reporting season suggest that profits aren't growing by anywhere near as much as analysts had expected. Notwithstanding all the usual caveats about trusting too much in these 'earnings beats' - see our later article on equities - these recent numbers paint a worrying trend.

Analysts at Morgan Stanley recently put out a flash note looking at numbers from the beginning of the third quarter of European corporate reporting. The top line is looking negative - "early indications suggest a weak earnings season with more EPS misses than beats for the first time since 4Q14." The most likely culprit?

A continuation of margin pressure as EPS has been weaker than in-line sales results. The Morgan Stanley analysts reckon that we're starting to see increased cost pressures eat into margins, with sales growth failing to keep up. Clearly, weak earnings growth is not a helpful signal and if the current season carries on in the same vein, we could see a pronounced sell-off in European stocks, even as US stocks recover some of their mojo again.

Exhibit 2: We've seen more EPS misses than beats for the first time since 4Q14



Source: MSCI, Bloomberg, Morgan Stanley Research
Note: EPS beat / miss defined as +/-5% from consensus estimates

Oil

Oil markets are notoriously volatile but over the last six months, we've seen some big moves in both directions. Back in August for instance, Brent looked like it would smash through the $70 barrier, then sharply reversed course and hit a peak of $86 a barrel as investors started to realise that the new sanctions on Iran really would have an impact. In recent days that surge has lost momentum again and the price of oil is back around $70-$75.

Fears about Iran are clearly providing a tail wind for oil prices. Most experts reckon that exports will be reduced by - 1.7mbd, falling below 1mbd for November & December. Nevertheless, there are also are some equally powerful headwinds at work. Crude stocks in particular are building and last week they grew by 6.3 mb against a consensus expectation of 3 mb.

What's next? Westbeck Capital, for one, produces some highly informative monthly reports to investors, and although they're obviously a tad biased to the buy side, they do contain some really rather insights into market dynamics and market gossip. In terms of headwinds dampening down the price of oil, Westbeck lists the following short term factors that have helped drive prices lower:

- "October is typically the time for peak refinery maintenance and petroleum stocks normally rebuild over this period."
- "Tanker rates have shot up close to +40% on certain routes... This steep rise in tanker rates has temporarily closed the export arb from US to Asia as well as Europe to Asia.
- "Iran exports [are] surprising to the upside in the first 2 weeks of October"

But it's not all doom and gloom for oil prices. The core structural driver is still very much in place - global demand for oil is strong. Westbeck's own internal market models still assume [modest] demand growth globally next year of +1.2mbd next year, and no supply disruption from Libya or Nigeria, yet they still forecast a shortfall of around -400kbd in 2019.

Westbeck also expects a "sharp tightening in the global crude markets in November and December [which] will coincide, post midterms, with significantly less tweeting from President Trump, however sharp the crude rally might be. OPEC+ countries led by Russia appear on the verge of formalising their arrangement this December, which collectively would encompass over 50% of global production".

A sudden uptick in demand, coinciding with a sudden fall in inventories, could thus have an immediate impact on the oil price - the last rally in late summer put $16 on the price of oil.

Measure	Values as of 12th October, 2018	Values as of 9th November, 2018
UK Government 10 year bond rate	1.66%	1.57%
GDP Growth rate YoY	1.20%	1.20%
CPI Core rate	2.10%	1.90%
RPI Inflation rate	3.50%	3.30%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.80%	0.85%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	53.8	51.1

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Bank CDS options

The last four weeks have been much quieter in the world of credit default swaps on major investment banks - these are, in effect, insurance policies on a bank defaulting on its bonds. A few banks, mostly American, saw their credit default swaps increase in price whereas many continental banks experienced a small decline in pricing. Arguably one of the biggest movers of the month was HSBC which saw a big decline in the price of its credit default swaps although its 1 year swaps are still trading in the double digit basis points - until recently it had been in the high single digits.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	31.02	60.74	4.95	34.26	A -
Barclays	34.31	70.95	-4.59	56.55	A
BNP Parabis	20.26	49.71	1.52	60.26	A
Citigroup	21.41	55.32	5.52	15.93	A
Commerzbank	23.35	84.17	-6.52	53.57	A+
Credit Suisse	23.02	70.13	-0.21	16.46	A
Deutsche Bank	74.36	143.63	5.15	76.7	A+
Goldman Sachs	26.22	69.99	12.94	17.07	A
HSBC	12.14	33	-11.86	72.48	AA-
Investec*	n/a	75	n/a	n/a	BBB
JP Morgan	19.24	44.84	10.15	-1.39	A+
Lloyds Banking Group	33.13	104.16	-2.3	80.81	A

Morgan Stanley	23.45	60.52	7.77	9.14	A
Natixis	20.65	47.69	1.9	36.84	A
Nomura	15.17	47.1	0.21	4.67	A-
Rabobank	10.35	31.25	-5.16	34.53	AA-
RBC*	n/a	60	n/a	n/a	AA
RBS/Natwest Markets	34.87	96.16	15.95	86.07	A
Soc Gen	22.43	52.12	4.28	63.77	A
UBS	17.33	59.62	-1.81	41.37	A

Source: www.meteoram.com 4th November 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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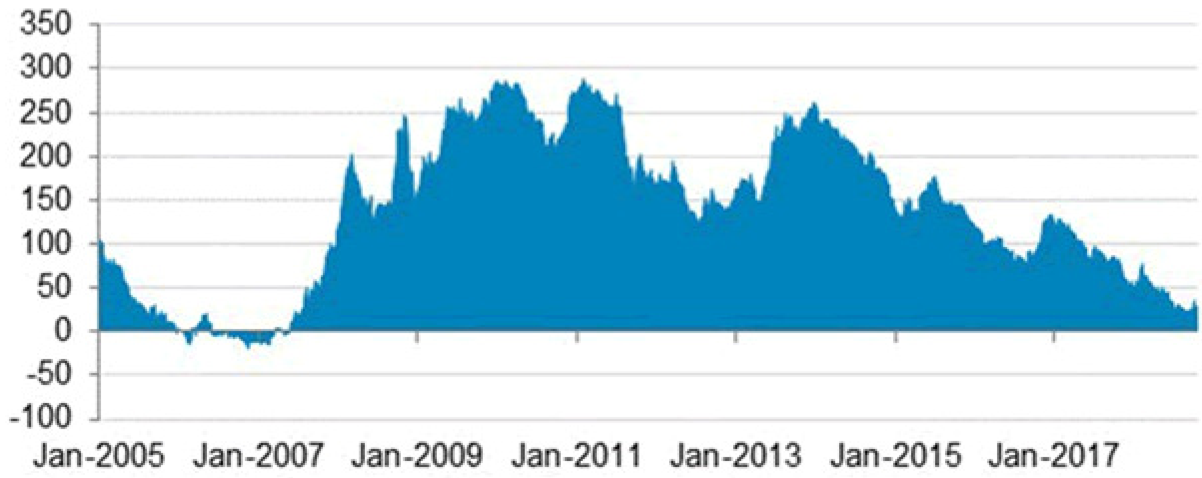
Government Bonds

Fixed Income

Bond investors love their signals. As we've commented before on these pages, their favourite indicator is the yield on 10-year US government bonds. The common view is that once this goes above 3%, caution is warranted as a recession could be on the cards. Once we go above 3.5% anxiety sets in and whereas if the yield surges above 4%, equity investors should run for the hills. But the headline rate is only one measure - others are arguably just as important. One of the most widely watched is what's called the US T bond gap, measuring the spread between the yield on 2- and 10-year duration bonds. Bond investors tend to get spooked as this flattens - suggesting an imminent slowdown - but if the gap (or 'spread') between these yields actively inverts, it generally signals there is a recession ahead. Over the last few months this gap has indeed been flattening out which has undoubtedly contributed towards increased equity market volatility. But according to Graham Bishop at investment management form, Heartwood, the good news is that the US T Bond gap has stopped flattening. He suggests that the recent flattening "now appears to have eased, with yields beginning to diverge once more. This is a heartening, even if temporary, sign for the economic outlook. It is also important to remember that even an inverted yield curve should not signal an imminent doomsday - this would be a leading indicator pointing to recessionary conditions over the medium term." Bottom line - no need to panic just yet!

The yield curve is not flashing red
2-year and 10-year US Treasury spread



UK Government Bonds 10-year Rate 1.66%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	29.58
Germany	11.36
Japan	18.78
United Kingdom	28.92
Ireland	37.74
Italy	262
Portugal	91.8
Spain	77.74

Eurozone peripheral bond yields

Country	October 2018	November 2018	Spread over 10 year
Spain 10 year	1.68%	1.60%	117

Italy 10 year	3.54%	3.44%	301
Greece 10 year	4.42%	4.35%	392

	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

Mind the (Earnings) Gap

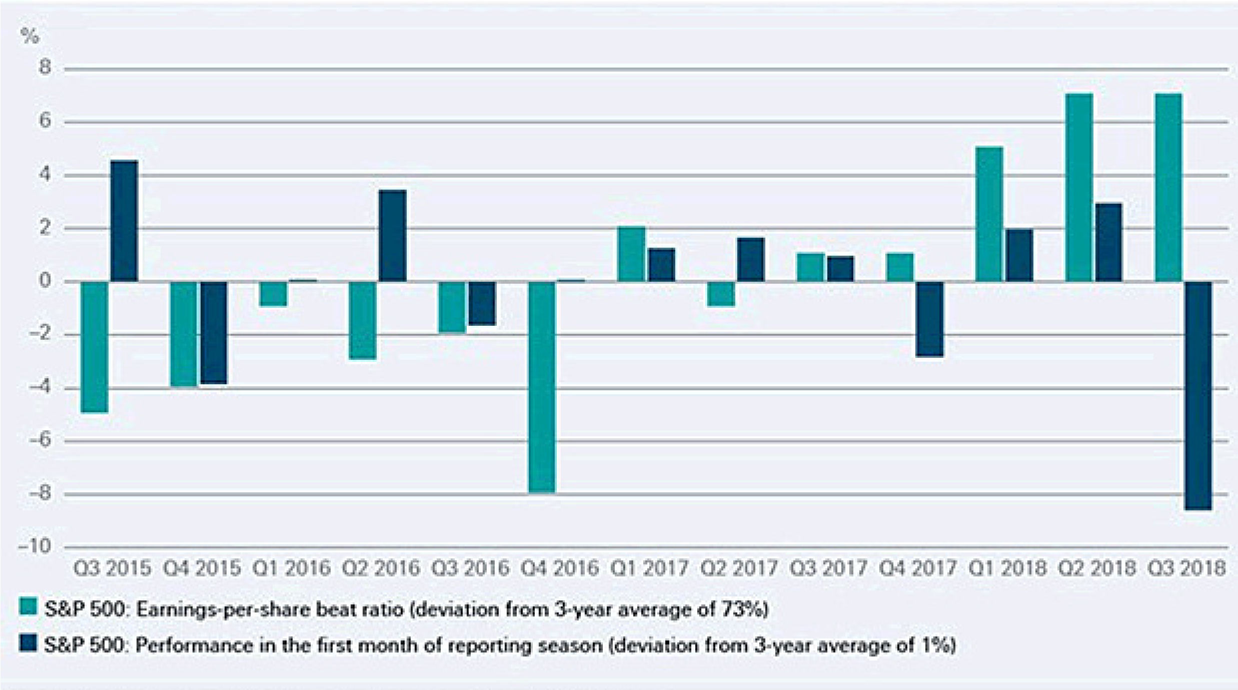
Whereas most value investors might love to focus on price metrics and balance sheets, the great majority of mainstream investors tend to prefer a rather more dynamic, forward looking approach to working out whether they should buy - or sell - shares. The key measure here is the growth in profits or earnings. Put simply, if earnings growth overall is strong, expect share prices to at least hold steady, if not increase over time. This market consensus is usually based on the steady drum beat of quarterly earnings numbers for aggregate markets represented by say the S&P 500. We're currently mid-way through a quarterly reporting patch in both US and European markets and surprise, surprise, most of the numbers don't look too bad. Crucially many businesses seem to be 'beating' the analysts estimates for earnings.

Cue signs of renewed bullishness amongst investors.

Except of course those quarterly estimate "beats" are largely an exercise in futility. According to analysts at Deutsche we need to take these numbers with a pantry sized pinch of salt. They've looked at data going back to the 1980s and found that "more than half of U.S. companies always surprise the markets - every quarter, whether the economy is in an upswing or a recession. More recently, over the past three years, 73% of U.S. companies have on average exceeded their forecasts.

"The reaction of the S&P 500 in the first four weeks after the start of the reporting season during the past five years, of which we only show three years, has been largely detached from the beat ratio (the ratio of firms that were able to beat the forecasts). The correlation of both data series is close to zero... In the current quarter, the discrepancy is particularly striking: a record 80% of U.S. companies were able to beat the forecasts, but, after Wednesday's selloff, the S&P 500 is down by 8%. "

Yet despite this slightly waspish take on 'earnings beats' the Deutsche analysts are still fairly sanguine - businesses may be manipulating the numbers but overall, the broad thrust of most recent numbers is that American firms are still experiencing an upturn in profits.



Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 10/25/18

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-1.93	-8.31	-7.36	-5.16	5.84	23.1	7098
S&P 500	-2.55	-1.64	4.04	8.6	58.5	103	2806
iShares FTSE UK All Stocks Gilt	1.34	-1.74	-1.01	-1.65	14.7	8.27	12.91
VIX New Methodology	2.57	45.2	21.9	55.8	26.8	-12.1	16.36

Index	October	November	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	125.60	125.5	3215	126
FTSE 100 (Dec 17)	308.00	308.6	7103	n/a

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Volatility

Gold Prices

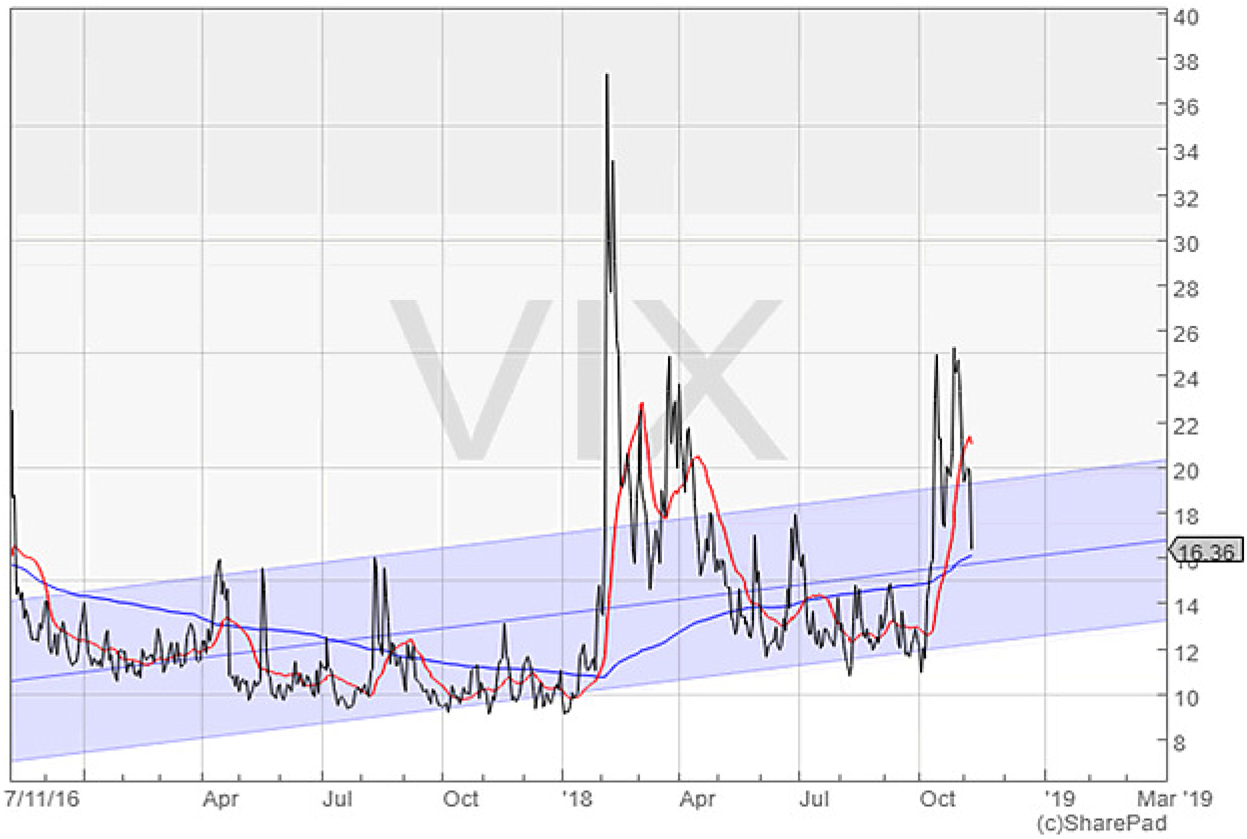
One of the more curious features of the recent increase in market volatility is that gold prices have only risen by a relatively small amount. The chart above shows the recent uptick over a two year period. Gold is traditionally seen as a safe haven for worried investors but to date we've only seen an increase of less than 5%, to a recent high of just under $1240 an ounce.

The recent strength of the dollar clearly hasn't helped as there tends to be an inverse relationship between gold prices and the greenback. Also, it's worth noting that traditional sources of demand for physical gold - India and China - have both failed to provide much of a catalyst on the upside. And I think that it's that last word that is crucial here - where's the catalyst for higher demand going to come from in the next few months?

We don't seem - quite yet - to be tumbling into a recession and the dollar seems attractive as a safe haven. Trump hasn't nuked anyone (yet) and US Treasury Bonds seem attractively priced. Again, where's the catalyst for increased demand? There's also a strong argument for suggesting that the recent decades long rally in gold prices might have come to a grinding halt.

Matthew Turner at Australian bank Macquarie suggests that in fact gold embarked on this rally in the early 2000s because of major shifts in demand. Talking to one gold news website he suggested that "Central banks started buying gold after being net sellers, investors were buying investment gold through newly launched exchange traded products, and the Chinese started to build its gold exchange... These were three major factors that fundamentally increased demand for gold. Right now, we see the supply demand outlook as a little bit soggy. We just don't know where the next big catalyst for gold is going to come from". If Turner is right, we might see gold prices becalmed in a trading range between $1200 and $1300 an ounce, until we see a decisive shift in the global economy.

Measure	November Level	October Level	September Level	August Level
Vstoxx Volatility	16.63	19.96	17.08	12.66
VFTSE Volatility	15.5	16.45	13.93	11.44



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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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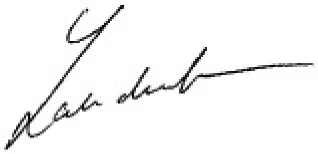
Kind Regards,



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