To view this email in your browser, please click here

UK | STRUCTURED ™ PRODUCTS ASSOCIATION

Monthly Market Report

May 2019

With commentary from David Stevenson

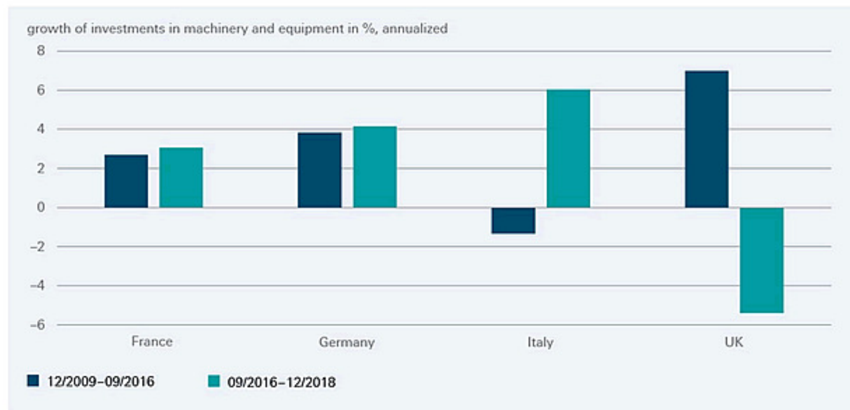
If I was a betting man - which I'm not - I'd wager that we are mid-way through one of the frequent pauses for breath, after which the global economy picks up speed a tad. As has happened so often in the years since the global financial crisis, I would hazard a guess that the central bankers will stop their balance sheet tightening, pause (for breath) and then watch and listen. In particular, they'll be focusing attention on two key numbers - corporate earnings growth for further evidence of a slow down in growth rates and China/US trade for indications that the dispute over tariffs is having a substantial material impact. Sitting in the 'pausing for breath' lounge will be many equity investors. As we discuss later in this report stockmarkets have strongly rallied in the first quarter, but I'd argue that this bullish reaction to last years travails is built on weak foundations. Why my caution? If we look at fund flows, a distinct pattern has emerged - outflows from equities, inflows into bonds. Sure, stockmarket indices have ticked up aggressively, but this hasn't prompted any big switch into risky assets. My evidence? Analysts at Deutsche Bank in the US track these flows and a few weeks note ago they noted bond funds are experiencing big inflows across almost "every category, while large equity outflows persist. Year-to-date [early April], bond funds have seen almost $150bn in inflows while -$50bn has moved out of equity funds". My guestimate is that once we've seen long term bond yields head down another 1%, those inflows into bonds will moderate and then we'll all collectively wait and watch for evidence of a rebound in global trade, and corporate earnings. If these numbers impress, expect another big equity bull rally.

Contents

- Headline numbers
- CDS Rates
- Government Bonds
- Equity Markets and Dividend Futures
- Volatility
- Summary of Pricing Impact on Structured Products
- Explanation of Terms

Headline Numbers

I have tried valiantly to keep talk of Brexit to a minimum but one chart from asset management firm DWS did catch my eye. It speaks to what I think is the main concern for business folk and economists - we're all collectively delaying key decisions while we wait for the never-ending series of votes. This delay is causing real damage, which could be easily reversed if we had some form of resolution (please dear god let there be some resolution). DWS in particular has focused on investment spending and then compared our (dismal) numbers with those across the channel. According to DWS "adjusted for inflation, British investments in machinery and equipment have been shrinking by a 5.4% annualized rate since the referendum, down from a growth rate of 7% before. Other European countries in the meanwhile keep accelerating, in the case of Italy catching up for the drop during the crisis". This delay in investing has a real impact on tomorrow's jobs and productivity and must surely have a knock on impact on the country's medium term growth potential. Time for some form of resolution, me thinks even if it is a hard Brexit



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 4/3/19

Analysts at Morgan Stanley in Europe put out a great chart a few weeks ago which ranks asset class returns over the last ten years, with green indicating that returns beat inflation. In 2018 everything lagged inflation as growth slowed and the Fed tightened policy. There was nowhere to hide in 2018, observes the MS team. So far, 2019 has been the exact opposite. Almost everything is beating inflation to start the year. The big question is whether it will continue?

Clearly if these banks did crash and burn, the impact on the wider banking system in Europe could be huge : the Check risk report lists the following banks as most sensitive to a 5% or worse distress event in Italian banking: Societe Generale, HSBC, Aareal, Lloyds, BBVA, ING, RBS, UBS, Standard Chartered, Bank of Ireland and Danske Bank. The table below outlines the banks most on the hook to Italy. My own sense is that the risks - even in the most catastrophic situation, are very low. But its definitely one to watch in the downturn.

Ranked Asset Class Return by Year. Green Means You're Beating Inflation

Ranking	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 YTD
1	US 10yr	MSCI EM	REITS	US 10yr	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	US 2yr	MSCI China
2	US 2yr	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	US 10yr	REITS
3	US Agg. Bond	Global HY	Commodities	EM$Sov Credit	Global HY	MSCI Japan	US 10yr	US 10yr	US HY	MSCI Europe	US Agg. Bond	Russell 2000
4	US IG	US HY	MSCI EM	US IG	REITS	MSCI Europe	MSCI China	EM$Sov Credit	Global HY	MSCI Japan	US HY	S&P 500
5	Inflation Bonds	Commodities	MSCI Japan	US Agg. Bond	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	US IG	MSCI Europe
6	EM$Sov Credit	MSCI Europe	US HY	REITS	EM$Sov Credit	Global HY	EM$Sov Credit	US 2yr	MSCI EM	Russell 2000	EM Local Debt	MSCI EM
7	US HY	EM$Sov Credit	S&P 500	US HY	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM$Sov Credit	EM Local Debt	Global HY	Commodities
8	Global HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	REITS	MSCI Japan
9	Commodities	Russell 2000	EM Local Debt	S&P 500	US HY	US 2yr	Inflation Bonds	MSCI Europe	US IG	EM$Sov Credit	Inflation Bonds	US HY
10	MSCI Japan	S&P 500	EM$Sov Credit	US 2yr	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	EM$Sov Credit	Global HY
11	Russell 2000	US IG	US 10yr	EM Local Debt	US IG	US Agg. Bond	US 2yr	Russell 2000	Inflation Bonds	Inflation Bonds	S&P 500	EM$Sov Credit
12	S&P 500	EM Local Debt	US IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	Commodities	US IG
13	REITS	Inflation Bonds	US Agg. Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	Russell 2000	Inflation Bonds
14	MSCI Europe	MSCI Japan	MSCI China	MSCI Europe	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	MSCI Japan	EM Local Debt
15	MSCI China	US Agg. Bond	MSCI Europe	MSCI Japan	US 10yr	US 10yr	MSCI Japan	EM Local Debt	US 2yr	US Agg. Bond	MSCI EM	US Agg. Bond
16	MSCI EM	US 2yr	Inflation Bonds	MSCI EM	Commodities	EM$Sov Credit	MSCI Europe	MSCI EM	US 10yr	US 10yr	MSCI Europe	US 10yr
17		US 10yr	US 2yr	MSCI China	US 2yr	Commodities	Commodities	Commodities	MSCI Europe	US 2yr	MSCI China	US 2yr

Source: Bloomberg, Morgan Stanley Research;
Note We compute annual returns minus US headline inflation. Green means returns (in USD) beat inflation, and red means returns trailed inflation. 2019 data are year-to-date returns as of April 4 close.

Measure	Values as of 8th March, 2019	Values as of 9th April, 2019
UK Government 10 year bond rate	1.19%	1.11%
GDP Growth rate YoY	1.30%	1.40%
CPI Core rate	1.90%	1.90%
RPI Inflation rate	2.50%	2.50%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.84%	0.82%
Government debt to GDP ratio	85.30%	84.70%
Manufacturing PMI	52	55.1

Back to menu

Bank CDS options

Another quiet month for the markets in credit default swaps (CDS). By and large, most of the European banks saw a small increase in their rates but nothing noteworthy - most crept up a few single digit basis points at most. The big French banks, notably SG and BNP, did see the price of their swaps fall significantly (between 7 and 9%) while the big German bank Deutsche experienced another steady increase in the price of its swaps. Rates for 5-year swaps are now around 160 basis points. Swap rates on Royal Bank of Canada also crept up over the month by 10%.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	20.26	78.96	-0.53	65	A -
Barclays	28.84	66.88	2.52	19.54	A
BNP Parabis	13.26	41.60	-9.19	16.09	A
Citigroup	25.47	60.41	-0.02	6.73	A
Commerzbank	29.64	98.69	8.64	36.05	A+
Credit Suisse	24.53	73.49	1.48	3.36	A
Deutsche Bank	81.22	160.94	3.2	31	A+
Goldman Sachs	30.08	82.20	0.79	20.87	A
HSBC	12.85	32.50	5.06	13.84	AA-
Investec*	n/a	72	n/a	n/a	BBB
JP Morgan	21.22	49.33	-1.8	-3.4	A+
Lloyds Banking Group	20.24	53.91	4.44	23.99	A
Morgan Stanley	25.60	66.73	-1.23	2.98	A
Natixis	17.84	53.50	6.32	17.92	A-
Nomura	31.68	63.77	4.87	90.46	A
Rabobank	10.46	31.42	9.46	1.7	AA-
RBC*	18	54.70	10	n/a	AA
RBS/Natwest Markets	30.33	110	3.51	11.73	A
Soc Gen	14.83	44.78	-7	22.42	A
UBS	21.04	64.68	1.5	19.32	A

Source: www.meteoram.com 3rd April 2019
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

Back to menu

Government Bonds

Fixed Income

March saw the sharpest decline in global government bond yields since the aftermath of the Brexit referendum in June 2016 but note that although global bond yields are once again plummeting, there is still some way to go before they hit the 2016 lows. German ten-year bond yields are now down at 0% but this optimism has even reached Greek shores - their ten year bond yields are now down at 3.46% compared to 4.42% autumn last year (September). UK ten-year gilt rates also fell back noticeably hitting a recent low of around 1.1%. The next test for the UK will be if these yields push below 1%.

What's curious about this strong rebound is the way that both bonds AND equities have risen so strongly. Arguably bonds should be providing some diversification for investors - in the past bonds have frequently increased while equities have fallen. But as analysts at SocGen point out, this isn't always the case. They suggest that the hard numbers tell us that quarterly periods in which global bond and equity markets both rally are quite common - "44% of quarters fit the description since 1988, or 34% since 2000 even though it is widely accepted that the bond/equity correlation turned negative again since that marker. Less common are periods in which both bond and equities lose money at the same time at around 10%".

UK Government Bonds 10-year Rate 1.11%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	28.9
Germany	11.47
Japan	21.15
United Kingdom	31.22
Ireland	35.65
Italy	201
Portugal	69.66
Spain	61.64

Eurozone peripheral bond yields

Country	March 2019	April 2019	Spread over 10 year
Spain 10 year	1.05%	1.08%	108
Italy 10 year	2.51%	2.47%	247
Greece 10 year	3.80%	3.46%	346

	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

The first quarter has provided bumper returns for investors, both in equities and bonds. Global equity markets rose 12.6% in total return terms and global 10+ year bonds were up 3.7%, delivering the best-combined bond + equity return since 3Q10. Emerging markets posted a 1.56% gain, after last month's 0.60% gain (and January's 7.72% gain), as the three-month year-to-date gain was 10.06%. This rally isn't an aggressive one though, as I report in the introduction to this report. Equity funds are still experiencing heavy OUTFLOWS and looking at specific sectors its clear to see that defensive stocks have hogged the limelight, which is exactly what we'd expect from investors worried about a slowdown but relieved that the interest rate hike cycle has paused (for breath). Over the last couple of weeks sectors such as Tobacco, Personal Goods and Beverages have led the way, along with growth sectors such as Technology and Software Services. According to SocGen the "laggards included cyclicals such as Autos and Chemicals, and interest rate reliant sectors such as Banks and Life Insurance - all lost value in March."

Index	March 2019	April 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.5	121.6	3442	125.50
FTSE 100 (Dec 17)	319.7	320.4	7454	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	4.92	7.92	2.99	3.6	12.3	18.1	7453
S&P 500	5.57	12	0.53	10.8	54.7	84.6	2895
iShares FTSE UK All Stocks Gilt	0.92	1.54	5	1.85	17	11.3	13.38
VIX New Methodology	-17.9	-34	-17.4	-39.5	-9.85	187	13.18

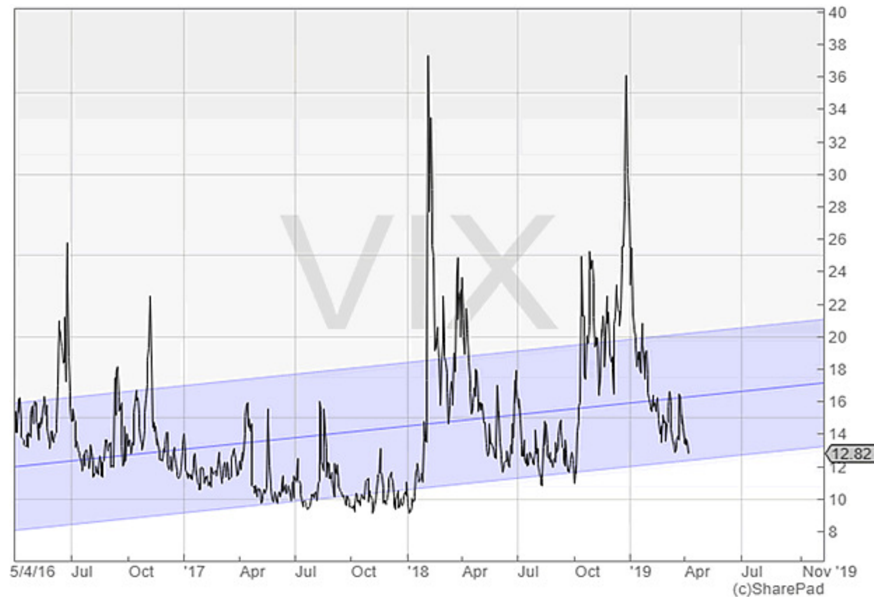
Back to menu

Volatility

As you'd expect equity market volatility has fallen sharply in the last few weeks, with the Vix back below 15 and heading towards 13. Over in Europe both the VFSTE and the VStoxx are close to short term lows. This sense of calm isn't unique to just risky assets such as stocks though. As analysts at ING note even FX markets look becalmed. They observe that "in the FX market we're now looking at the lowest levels in five years. Clearly, the Federal Reserve's pause and what it means for interest rate volatility is helping, with the Fed having recently been joined by the European Central Bank in a long path for unchanged policy rates".

The hard evidence for this surprising decline in FX volatility comes in a table published by Peter Wells of FastFT. The chart is from Credit Suisse and it shows that if we exclude "a skittish British pound", the average one-month implied volatility of G7 currencies is now sitting around a level of 6, "and less than 1 volatility point away from the all-time low set in the summer of 2014," according to Mandy Xu at Credit Suisse. The JPMorgan global FX volatility index also recently (March) fell to its lowest level since September 2014, and is down by about one-quarter so far this year. A similar index tracked by Deutsche Bank is also at its lowest level since the same month, reports Wells from the FT.

Source: Credit Suisse Derivatives Strategy



Measure	April Level	March Level	February Level	January Level
Vstoxx Volatility	14.07	14.58	16.2	18.43
VFTSE Volatility	11.89	13.09	13.72	17.52

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.

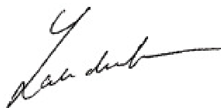
Equity benchmarks

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

THIS COMMUNICATION IS FOR FINANCIAL ADVISERS IN THE UK ONLY

This email is sent from The UK Structured Products Association (UKSPA) and is intended for UK financial advisers only. UKSPA has taken every step to ensure the accuracy of the information in this email but cannot accept liability for errors. Copyright of the contents of this email belongs to UKSPA. This email and its contents are only intended for the recipient. If you no longer wish to receive emails from UKSPA please click here to unsubscribe

UK Structured Products Association, 1A All Saints Passage, London, SW18 1EP