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UK Structured™ Products Association

Monthly Market Report

June 2019

With commentary from David Stevenson

Despite the odd tantrum related to Trump's tariff utterances, the markets seem to be in a fairly chipper mood again. Most market observers seem to be betting that the worries about the slowdown were just another of those 'pause for breath' episodes and that the USF Federal Reserve will probably loosen up on the interest rate charge. This mood of confidence has been helped along by more than decent earnings numbers coming out of the US (again!) - the numbers are coming in thick and fast and so far 45% have reported.. According to Deutsche of the 230 S&P 500 companies (55% of market cap) that have announced so far 77% reported better-than-expected Q1 earnings, a sharp recovery from Q4 when the beat rate (68%) dipped to its lowest level in 7 years while the earnings beats are running at 6.4% (4.7% median), vs 3.4% historically. In sum earnings look to have grown 2.4% in the aggregate. Not spectacular but not disastrous either. At this point the cynic would shrug their shoulders, remind us that earnings estimates are only being revised up over the course of reporting, because they've been cut in the run-up. Even so, we are still looking at US earnings barely posting any growth at all in Q1. The hope is that US earnings growth will recover later in the year. In the meantime we have a potential meltup on our hands and volatility has crashed back down again. Not unsurprisingly according to Deutsche we are seeing US equity futures positioning increasing for the third consecutive week and is near the top of its historical range. Deutsche also reports that short interest in stocks and ETFs is at multi-year lows.

The fly in the ointment might be inflation, from one of two potential sources. The first is age pressure in the US. There are more and more reports coming out now that skilled workers especially are demanding - and getting - much better wage increases. That's good for the US consumer but potentially bad for corporates if they can't pass these pricing pressures on because of intense price competition.

The other source of potential pain is oil, which has rallied strongly of late (as has the dollar, a pairs trade that usually operates in the opposite direction). In oil long positioning in futures has continued to rise and according to Deutsche has "become more stretched. The large divergence in both performance and positioning from the historical relationship suggests the current dislocations are likely to revert."

Or possibly not. I note with interest a note to investors last week from Jean Louis Le Mee, a specialist energy investor at Westbeck Capital. Now they run a fund that invests in this space (long and short) so of course they'll talk up their book but what struck me was the sheer conviction of their latest update. The big catalyst - for a more bullish position - is the sanctions on Iran which they reckon is as hawkish a surprise as possible. They now expect Iranian oil exports to drop to around 600kbd. They believe the risks for an oil price "spike to $100+ this summer are increasing." Needless to say, that if Westbeck are right, then if oil prices do rise sharply, we could see those much predicted but largely dormant inflationary pressures emerge. If these coincide with margins pressure from increasing wages, we could see a nasty shock in the equity markets.

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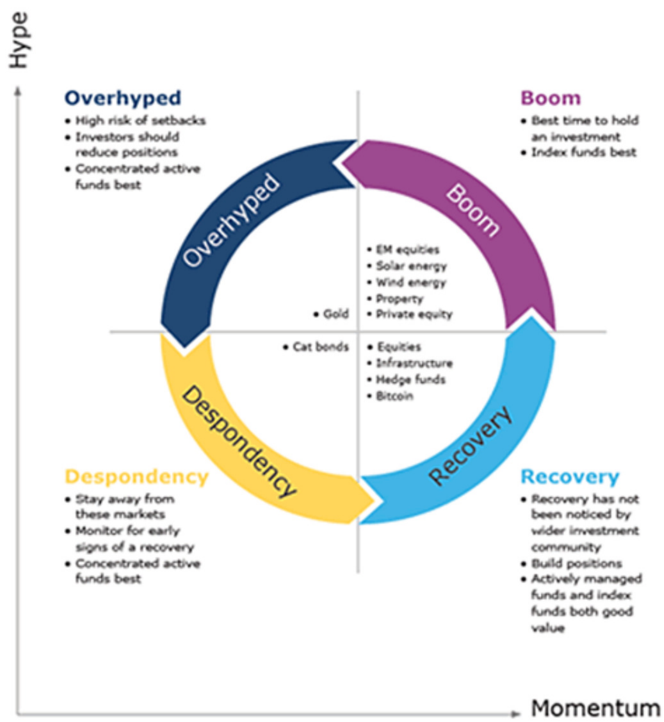
Headline Numbers

Stepping back from these debates about short term movement's I think it is nevertheless useful to ponder where we are in the cycle of markets. I think virtually everyone agrees we are late in a cycle, we're just not sure which cycle. There is a pervasive sense of a euphoric high before the inevitable cold turkey - a moral narrative that appeals intuitively to us all. Analysts at Fidante have a nice and simple way of divining where we are in the stockmarket cycle - see the diagram below. By their reckoning we are in the BOOM bit of the cycle. Most assets should do well in this scenario, bar one. Gold. According to Joachim Klement, Head of Investment Research at Fidante Partners, "sentiment for gold is too optimistic, in our view, and investors are not following through on this positive sentiment by investing into physical gold ETFs and funds. Given the seasonal decline in demand for physical gold in the second quarter, we expect gold prices to decline in the coming months."

Joachim Fels, at Pimco has an alternative take on the cyclical nature of financial markets, outlined in a blog entitled A Tale of Three Cycles. He argues that there are three main macro factors for markets - "the business cycle, the liquidity cycle, and the political cycle. These days, each of these cycles is global. The three interact and influence each other, but each has its own key driver." Markets move very directionally when all three of these cycles align, either up or down. In 2018 we had a clear alignment of all three pointing downwards. Tariff wars with China, slowing global growth in trade and stockmarkets looking expensive.

But Fels reckons we've now seen these three cycles decouple, with at least two moving in the right direction. "China's purchasing manager indices (PMIs) ticked up in March, the European PMIs have been bumping along the bottom in recent months, and advance estimates of first-quarter U.S. GDP came in higher, year-over-year. With China's credit and fiscal stimulus likely to find more traction in the coming months and global financial conditions having eased substantially since the start of 2019, a moderate recovery in global growth in the second half of the year appears to be in the cards". The other big headwind is the pivot on monetary policy which is clearly moving back into an expansionary phase.

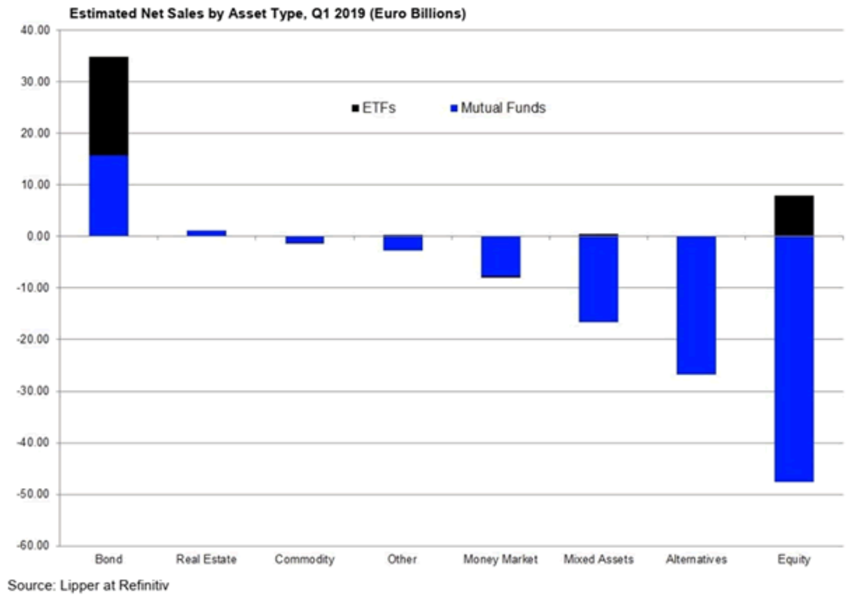
The one headwind? The political cycle, which is moving in the opposite direction, especially in Europe which not only faces an outbreak of tariff wars but also lots of political uncertainty (although personally I think this is a little overdone). "Taken together, with markets now fully priced for the Fed's triple dovish pivot, the global business cycle having bottomed but unlikely to produce fireworks in the remainder of the year, and populism likely to reveal more of its ugly face in the coming months, global risk assets will most likely lack a clear direction this year and could become more volatile again".



Fund flows tell us bull rally on weak foundations

It's always worth scanning the data on fund flows, if only because they give us an accurate record of what bets institutional investors are currently taking with their clients money. The big story at the fund level is one of mismatch between two clashing narratives. One narrative is that equity markets have bounced back aggressively and that we are potentially facing a lesser spotted melt up.

The contrasting narrative is that at the funds level, investors have been withdrawing money from equity funds and reinvesting in bond funds. Latest numbers from the Lipper team at Refinitiv reinforce the latter narrative - March for instance was the eleventh consecutive month with net outflows from long-term mutual funds after 16 consecutive months with net inflows. The Lipper team reports that Bond funds (+€16.4 bn) were the bestselling individual asset type overall for March, with the Bond Global USD hedged (+€3.5 bn) sector, the bestselling sector among long-term funds that month.



So, what's going on? I reckon there's a two-step process at work that might help explain those fund flows. The first is that institutional investors pump money into longer duration bond funds as they chase the yield down (courtesy of the Fed capping interest rate rises) and then take profits and switch back into equities as the global economy slows picks up speed again, post a possible China US tariff deal at some point this summer. So, run with profits on equities but also make money from chasing that long-term yield down.

This makes short term tactical sense, but what's going on inside most big institutions long term asset allocation strategies? We can get some hints of an answer via Natixis which has just run a deeper dive on institutional fund preferences amongst 200 global fund buyers - responsible for selecting funds included on private bank, insurance, fund-of-fund and other retail platforms.

Their conclusions? The big one is that active fund management is back in business. "Three-quarters of respondents agree that alpha is becoming increasingly difficult to obtain as markets become more efficient, and they are willing to pay higher fees for potential outperformance and agree that the 2019 market environment is likely to be favourable for active portfolio management."

I'm not sure that bet on active fund management is a sensible one but I'll park that argument for another day.

Another interesting observation is that amongst the survey respondents, the long-term rate of return assumptions for diversified portfolios has declined to an average of 7.7%, down from 8.4% in 2018. Given how long bond yields are, this would suggest that most institutions will need to buy back into equities to hit their returns assumptions - confirmed by the Natixis report which observes that there is a bias "towards risk assets prevailing", although fund buyers intend to trim their overall equity allocation by 1.2 percentage points to 43% (down from 44% in 2018). Digging down into equity asset classes, U.S. equity allocations are likely to be fall, while emerging market exposure is likely to increase. " Just under half (44%) of fund buyers say they plan to decrease their allocation to U.S equities, with opinions evenly balanced towards European equities. A significant portion (39%) of fund buyers indicated that they plan to increase their allocation to emerging market equities in 2019".

Measure	Values as of 9th April, 2019	Values as of 9th May, 2019
UK Government 10 year bond rate	1.11%	1.12%
GDP Growth rate YoY	1.40%	1.80%
CPI Core rate	1.90%	1.90%
RPI Inflation rate	2.50%	2.40%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.82%	0.81%
Government debt to GDP ratio	84.70%	84.70%
Manufacturing PMI	55.1	53.1

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Bank CDS options

Government Bonds

Fixed Income

We mentioned earlier in this report that a fair bit of institutional cash has been flowing into big bond funds. This is mostly a US phenomenon - where interest rates are at least positive in real terms - but we've also experienced big inflows into money market and government bond funds in Europe. German funds in particular are doing well. Clearly though these inflows aren't being helped by the less than generous yields on offer. Ten-year German bonds - as shown in the first chart below from DWS - are now cruising around zero in yield terms. Buying such a bond today and holding it until maturity will deliver no return for 10 years, even in nominal terms. One will simply get back the principal amount. Then again this is just a snapshot of current returns, if you bought now. Looking at past returns, in 2018, 10-year Bunds managed to deliver a positive performance of 2.7% and Treasuries returned 0.9%. In 2019, so far, Bunds have produced a performance of 1.8%, and Treasuries 1.9%. In nearly all cases, they have beaten expectations handsomely according to DWS. Nevertheless, on a forward view basis its hard to work out where the future returns might come from. Then again maybe these bonds are viewed simply as a form of diversified cash holding.

Not all bonds are yielding such a miserly amount. The one part of the bonds spectrum that hasn't seen big inflows consists of emerging market bonds - yet these are providing much more attractive yields, with yields of well above 5% not uncommon. Obviously, there are all the usual caveats about the difference between local currency and hard currency loans and the strength of the dollar but I can't help but think this asset class looks slightly more appealing than some of its peers. That view is shared by analysts at US firm GMO who think that EM bonds look to be on the "cusp of neutral to cheap. This is also how we would currently describe local market emerging debt" according GMOs Carl Ross in a quarterly report titled "Valuation Metrics in Emerging Debt." The chart below puts some hard numbers to this conclusion with valuation metrics below long-term historical averages, but still well off historical lows.

When the going gets rough

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 4/24/19

EXHIBIT 1: LONG-TERM VIEW OF THE "FAIR MARKET MULTIPLE" FOR EMERGING EXTERNAL DEBT

As of 3/31/19 | Source: GMO calculations based on Bloomberg and J.P. Morgan data
Note: Green line represents a credit multiple level above which EMBIG has subsequently delivered positive credit returns historically; red line represents a credit multiple below which EMBIG has subsequently delivered negative credit returns historically.

UK Government Bonds 10-year Rate 1.12%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	28.04
Germany	11.53
Japan	21.71
United Kingdom	28.58
Ireland	32.28
Italy	204.05
Portugal	62.44
Spain	55.34

Eurozone peripheral bond yields

Country	April 2019	May 2019	Spread over 10 year
Spain 10 year	1.08%	0.98%	104
Italy 10 year	2.47%	2.72%	278
Greece 10 year	3.46%	3.58%	352

	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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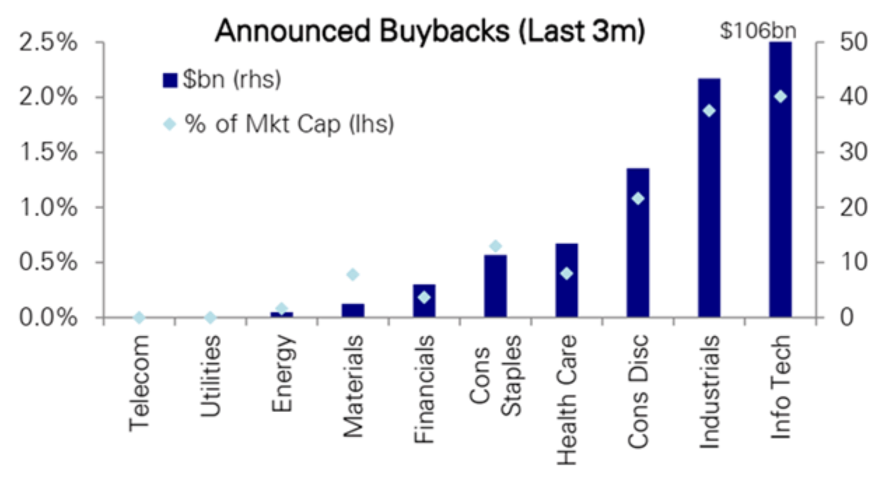
Equity Markets and Dividend Futures

Maybe don't go away in May afterall

The old expressions is sell in May and come back again in the late autumn or early winter (variously September through to November). This old investing adage has been looking a bit tired for years now and as Interactive Investor points out doesn't seem to have been true for quite a few years now. According to their reckoning if we go back to 1986, between 30 April to 15 September (typically the date closest to St Legers Day), the FTSE All Share and the FTSE 100 have fallen 15 out of 33 times (45% of cases), making the old adage inconclusive. "Last summer saw comparatively modest falls in the FTSE All Share and FTSE 100 of 2.1% and 2.7% respectively. The cruellest summers of the last decade were not surprisingly during the financial crisis in 2008, where the FTSE All Share and FTSE 100 fell 14.4% and 14.5% respectively. Yet patient investors who hung on in there would have enjoyed a 19% positive bounce the following summer. Yet the falls we saw between 30 April - 15 September 2008, during the financial crisis, are well behind those of 2001 and 2002, where the FTSE All Share fell 19.7% and 22.6% respectively. The FTSE 100, meanwhile, fell 20.3% in 2001 and 22.4% in 2002."

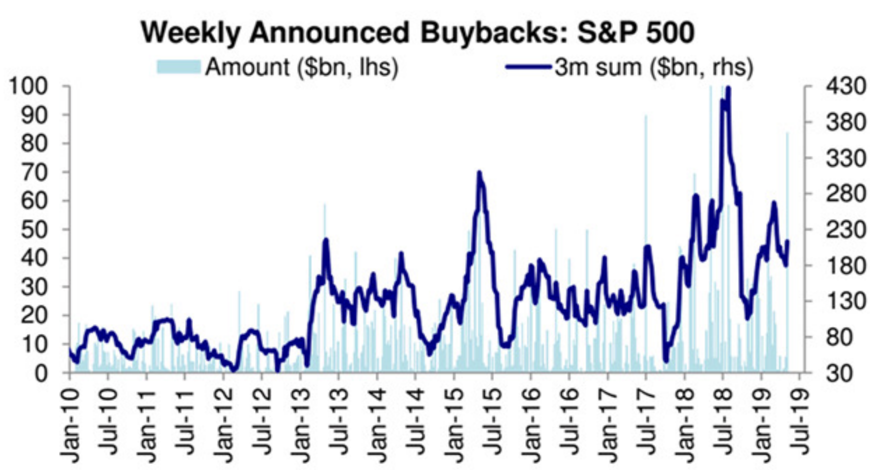
Now that doesn't mean that there aren't lots of things to worry about anyway. My own hunch is that we are just at the beginning of an especially egregious meltup where stockmarkets will bounce back aggressively. Clearly there are lots of people who think that's utter rubbish. But I would suggest that the tailwinds behind stockmarket bullishness are strong, not least the sheer amount of buyers out there. Some cynics think that the flood of money into passive, ETF funds is helping to power a massive momentum rally. Possibly although I remain to be convinced. Most institutions don't make extensive use of equity Etfs preferring options and direct holdings. A far more likely suspect for large scale buying of equities is the continuing push from corporates to buy back their own shares, especially in the US. It's a tax efficient strategy and many big corporates might be accelerating their purchases ahead of a growing political backlash about these buybacks. I have my own severe doubts about the rationality of this massive share buyback bonanza but its increasingly likely that announced buybacks may start sharply increasing again in the next few months. Digging around inside a recent report from US analysts at Deutsche and found these two stand out charts - the first showing the volatile upward trend in buybacks, the second by industry, with tech businesses very much in the lead. All those buybacks in the tech sector implies that there's plenty of tech friendly cash swilling around, ready to find a home in new tech IPOs, suitably over priced of course.

Figure 75: S&P 500 sectors announced buybacks



Source : Bloomberg Finance LP, DB US Equity Strategy

Figure 74: S&P 500 weekly announced buybacks



Source : Bloomberg Finance LP, DB US Equity Strategy

Index	April 2019	May 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.6	121.5	3333.75	120
FTSE 100 (Dec 17)	320.4	325.1	7170	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-3.49	-0.182	1.76	-7.08	4.43	8.23	7177
S&P 500	-0.895	4.66	5.85	5.63	51.9	76.4	2881

iShares FTSE UK All Stocks Gilt	0.7444	0.404	3.47	2.44	17.8	13.8	13.37
VIX New Methodology	33.6	2.49	-19.9	26.8	32.2	27.8	16.04

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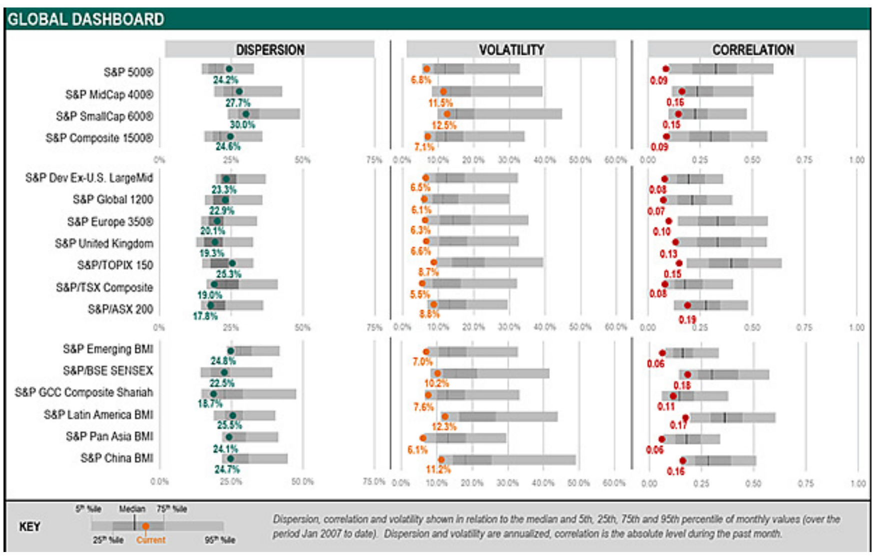
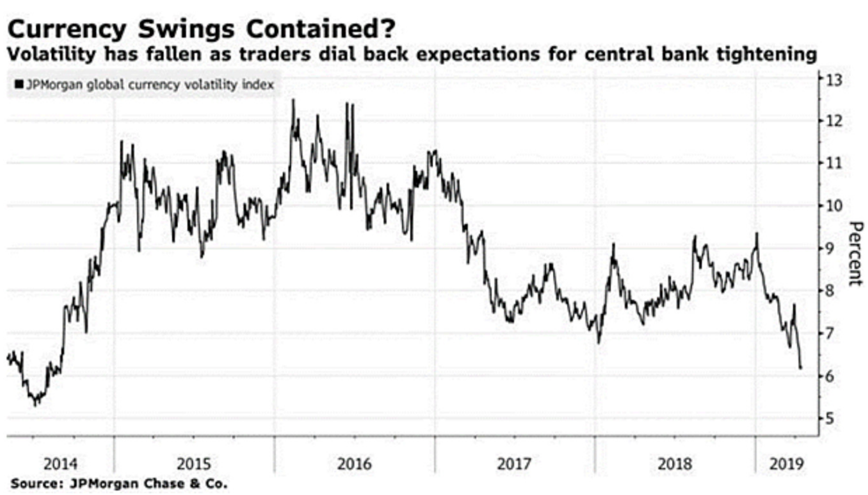
Volatility

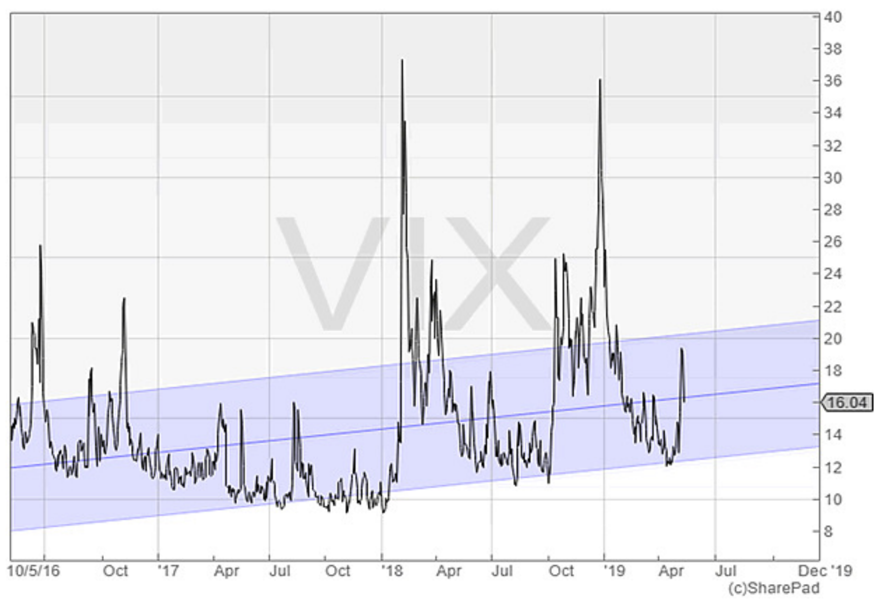
Come on in, the water's lovely.

The headline above is the alluring conclusion from a report at the end of April by S&P Dow Jones looking at equity markets and current very low levels of volatility. In April, the index firm concluded that using their family of indices "large cap stocks in the U.S., Europe and Japan, and across our Emerging Market indices, displayed moderately high dispersion and near-record low volatility and correlations. Every reported index volatility was below average; correlations were below the 5th percentile in a majority." The dashboard below gives what I think is a nice snapshot of key market metrics such as dispersion (growing), correlations (declining) and volatility (near record lows).





Given this benign outlook, its no surprise that some speculators are starting to take some outsized market positions. FTfm for instance quoted a certain Mark Spitznagel who says his Miami-based fund, Universa Investments - a "black swan" fund designed to profit from market turbulence - "is happy to scoop up increasingly cheap insurance against financial storms". This echo's market data for equity volatility related products which shows that at the end of April there had been inflows of $2.7bn YTD to long vol products whilst at the same time net short positioning in VIX futures contracts had also hit a recent high. According to analysts at Deutsche "the inverse relationship between positioning in the VIX futures market and Vol ETPs suggests that demand for long vol exposure from primarily retail investors is being recycled to institutional players, likely Hedge Funds, in the VIX futures market." Bloomberg reports that "Hedge funds are betting the calm will last, shorting the Cboe Volatility Index, or VIX, at rates not seen in at least 15 years. Large speculators, mostly hedge funds, were net short about 178,000 VIX futures contracts on April 23, the largest such position on record, weekly CFTC data that dates back to 2004 show." Société Générale estimates that the shape of the Vix curve means that investors are currently pocketing a monthly 8 per cent yield by shorting the index.



Measure	May Level	April Level	March Level	February Level
Vstoxx Volatility	18.63	14.07	14.58	16.2
VFTSE Volatility	16.41	11.89	13.09	13.72

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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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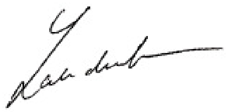
Kind Regards,



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