To view this email in your browser, please click here

UK Structured Products Association

Monthly Market Report

January 2019

With commentary from David Stevenson

As we head into the festive break again, it's tempting to think (again) that we've had another exceptional year. In truth we haven't. As we'll examine in this report, market volatility has simply returned to something approaching an average. We also haven't seen a proper sell off in either equities or bonds. This reflects the basic truth that the global economy is in reasonably good shape, with a small slowdown in Europe and a catching of breath in China. As we knew this time last year, the central banks - and especially the US Federal Reserve - are still keen to increase interest rates and normalise balance sheets. And Brexit is still chugging along towards a mysterious destination. So, in sum, I would say 2018 has been a fairly ordinary year.

But I would go further in my refusal to succumb to the prevalent gloomy consensus about the near term. I believe it is more than remotely possible - in fact possible, bordering on probable - that we may have a lesser spotted 'melt up' (a return of bullishness) before the inevitable 'Big One' - when markets properly lunge into crisis. My gentle near term optimism is based on the fact that the US Fed will want to slow down the pace of rate rises and that politicians the world over will want to keep up the positive momentum in the global economy. Lower oil prices might even help the developing world. To be sure, this melt up will probably be followed by a much bigger meltdown - a proper sell off. Nevertheless, overall though I think there is a strong chance that we could be in for one last hurrah.

The alternative view - equally credible - is that markets are now entering a new volatility regime, in which case they might track sideways for a year or more. In this scenario, demand for structured products could take off as investors look for alternative sources of market return. So, in sum, no need to despair about markets. But I would add one important caveat. Trump. He is essentially unknowable and unpredictable. I am, like many, genuinely worried about the possibility that relations with China could turn really nasty. Equally Trump could turn up the heat in his battle with the US Federal Reserve and threaten monetary stability. Or maybe it will all just prove hot air - as appears to be the case with North Korean relations, which don't appear to have advanced by very much after their lovein in Singapore. So, watch the US President. He really is the elephant in the room, a Republican one in stars and stripes.

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

Gold prices have ticked up over the last few months, as market volatility has returned to its long-term average but gold hasn't fully recovered from its recent bear market. Every time prices look like they might be heading above $1250, physical sellers emerge and prices push down again. But one precious metal is dazzling investors: palladium. Last week one bullion expert reported that for the first time in nearly 20 years, palladium has overtaken to become the most valuable precious investment metal on the market. Demand for palladium has been strong from the automotive industry, even despite slowing sales figures globally, and a lack of supply has helped prices grow rapidly this year. Forget gold, focus on palladium.

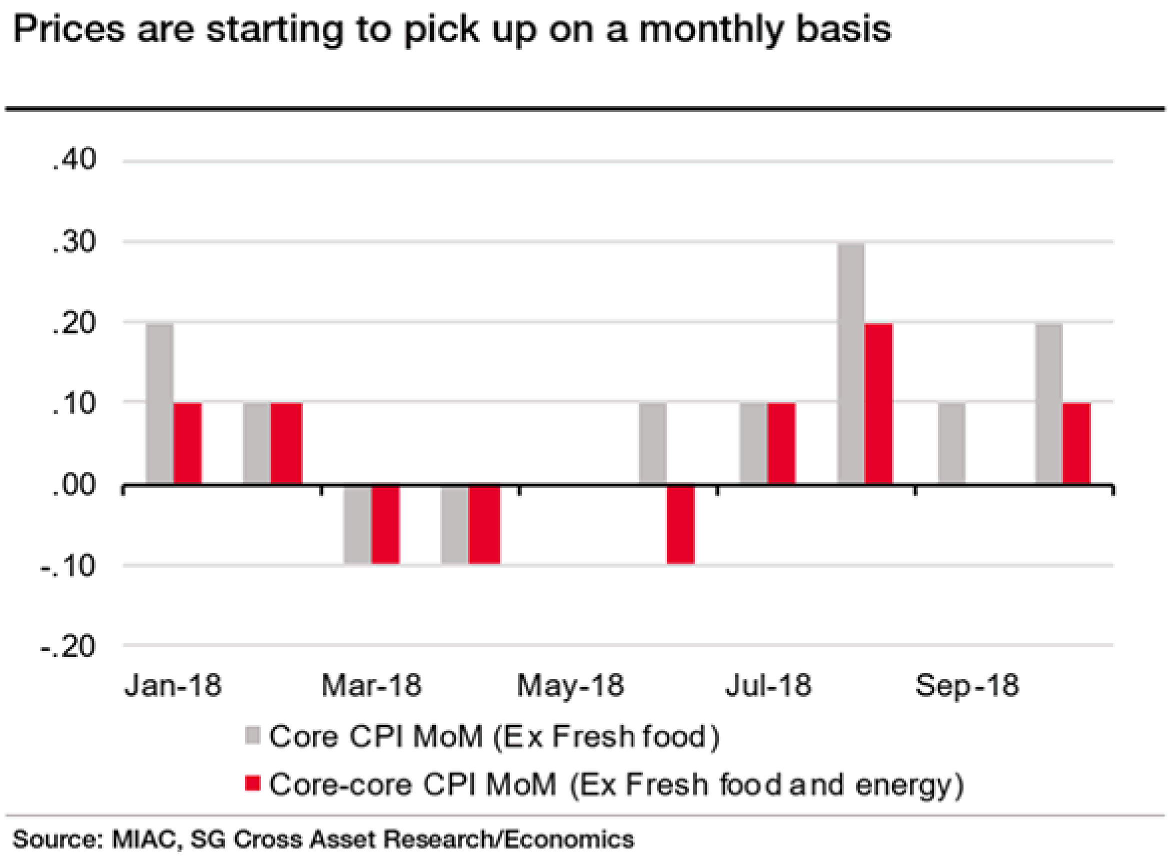
Keep an eye on Japan

If investors are looking for a real surprise over the coming year, my suggestion is to focus on events in Japan. The Asian economic powerhouse has been battling not only deflation for a decade but also a host of natural disasters in recent months, all of which have sapped domestic demand. Crucially the government is also valiantly trying to steady government finances and has recently passed a supplementary budget and is expected to pass another in January to support the economy ahead of the next consumption tax hike in 2019. At the same time, the government is (courageously) pushing legislation through the Diet to ease restrictions on foreign workers. And this barrage of policies seems to be having an impact.

According to a recent report from Asia analysts at French bank SocGen the first round of 4Q data indicates "that economic activity is rebounding after the series of natural disasters that hit Japan over the summer. At the same time, risk-off sentiment is strengthening in the financial markets, stemming mostly from external factors. Newsflow on Japan remains positive as domestic conditions remain strong, despite the ongoing uncertainties in the global economy".

The chart below - from SG - shows that there's even some, limited, evidence that the long deflationary funk is possibly coming to an end. Prices are starting to steadily pick up as the labour force shrinks and wages slowly start to rise. Yet despite all this relatively positive news local equity markets have consistently underperformed the Asia and US markets generally, despite a weakening JPY.

One final positive to contemplate. Most other central banks are now starting to tighten aggressively, yet Japan is still the exception. With inflation still well below the 2% target, and bond yields remaining suppressed, the BoJ policy board will probably maintain its monetary easing over the next few months. Might Japanese equities start to stir again?



Measure	Values as of 9th November, 2018	Values as of 17th December, 2018
UK Government 10 year bond rate	1.57%	1.24%
GDP Growth rate YoY	1.20%	1.55%
CPI Core rate	1.90%	1.90%
RPI Inflation rate	3.30%	3.30%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.85%	0.85%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	51.1	53.1

Back to menu

Bank CDS options

The normally boring world of big bank credit default swaps is beginning to show signs of life. For much of the last few years these insurance-based options against bond defaults have barely moved, with rock bottom pricing. This in turn indicated that investors were mightily relaxed about default risk. Literally in the last month this seems to have changed. Using the latest December 12th numbers from Meteor

Structured Products, we can see that pretty much across the board 1 year and 5 year CDS prices have jumped very substantially. Most of the big banks have seen a 20% increase in pricing with a few such as Deutsche and Credit Suisse experiencing an increase of over 35% over the month to mid-December. By contrast just one entity, Santander UK saw a decline in the pricing of its 5 year swaps while Royal Bank of Canada and Natixis chalked up very small single digit increases. For many years HSBC Bank PLC has offered the lowest CDS pricing for 1 year swaps, usually in the single digits. Now that title belongs to Dutch bank Rabobank, whose 1 year swaps are currently priced around 12 basis points - HSBC is up at 20. It's also worth noting that over the one year timescale, 5 year swaps have shown big increases with most more than doubling in price. Quite what any of us should make about these recent increases is tricky. I'd suggest that investors were too complacent and that current pricing is probably just returning to realistic levels. But the bears could mount an argument for saying that this is another canary in the coalmine of default risk ahead of a slowdown. Whatever your forward view, these rising CDS rates represent good news for structured product buyers - these increased rates will probably result in more generous funding for new products.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	19.12	59.30	-2.38	41.00	A -
Barclays	52.49	94.83	20	119	A
BNP Parabis	26.34	70.55	34.87	219	A
Citigroup	26.38	68.48	33.75	64	A
Commerzbank	38.39	106.81	21.89	107	A+
Credit Suisse	45.95	100.99	35	100	A
Deutsche Bank	148	208	41.68	187	A+
Goldman Sachs	33.18	90.85	31.18	67.51	A
HSBC	20.43	46.40	4	22.93	AA-
Investec*	n/a	79	n/a	n/a	BBB
JP Morgan	25.61	58.8	31	47	A+
Lloyds Banking Group	59.18	148.47	23.57	163	A
Morgan Stanley	31.67	79.34	37	55.48	A
Natixis	23.94	47.74	4.46	49.36	A
Nomura	14.06	59.67	26.78	41.96	A-
Rabobank	12.22	38.14	19.21	88.79	AA-
RBC*	19.99	56.47	2.29	n/a	AA
RBS/Natwest Markets	53.87	125.46	29.71	154	A
Soc Gen	28.30	71.81	32.66	221	A
UBS	33.65	81.38	29.73	122	A

Source: www.meteoram.com 12th December 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

Back to menu

Government Bonds

Fixed Income - Italy and inflows into bonds

The great bonds rout hasn't happened yet. Despite an almost universal consensus that bonds are an increasingly expensive asset class, and thus due a proper sell off, we haven't seen any strong evidence of a massive sell off - especially if we look at funds data which suggests the exact opposite. Deutsche Bank's US based ETF team for instance put out a note a few weeks back which suggested that fixed income flows had in fact rebounded in November, recording the second largest monthly inflow YTD. Investors increased flows by +$14bn last month ($80bn YTD). Fixed income flows remained US-centric with the majority of inflows to US exposure. Investors added $13bn to US bond funds last month. Followed by global ($769mn) and emerging market ($470mn) fixed income funds. Within international focused funds, sovereign debt and aggregate funds recorded notable inflows.

But this positive investor momentum shouldn't hide an important fact: central banks around the world (with the exception of Japan) are tightening the screws, slimming balance sheets and increasing interest rates (especially in the US). London based research firm Cross Border Capital is widely used by hedge funds (macro ones in particular) looking for clues about central bank liquidity. They have a measure called the Global Liquidity Index which hit a low of 18.5 at end-November 2018 ('normal' range 0-100), or roughly equivalent to two standard deviations below normal.

Cross Border reckons that "policy-makers are guilty of over-tightening, since four-fifths of the eighty Central Banks we monitor are now running 'tight' monetary policies. Overall, global liquidity is slumping at the fastest rate since 2008, "largely because of the unrecognised scale of Central Bank tightening, alongside the legislative assault on the off-shore Eurodollar markets". The other big trend has been the strength of the dollar - US$4 trillion of foreign capital has fled into US asset markets over the 2012-17 period in search of 'safety' and so pushed up the US dollar and pulled down bond term premia. Crucially though world liquidity cycles are now out-of-step, with Asia leading, Europe trailing and America in between. According to Cross Border this means that "we should look to Asia, and perhaps the emergence of a 'co-ordinated' pan-Asian Liquidity Cycle for recovery, whereas the Eurozone looks vulnerable to still further deflationary squeeze".

Figure 1: World Central Bank Liquidity
Weekly 3m Annualised Balance Sheet Growth of G4 and Major EM Central Banks 2010-2018

Source
CrossBorder Capital, US Federal Reserve, People's Bank of China, Bank of Japan, ECB, Bank of England, IMF

UK Government Bonds 10-year Rate 1.24%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	35.4
Germany	13.29
Japan	20.8
United Kingdom	38.36
Ireland	42.38
Italy	216
Portugal	86.39
Spain	80.4

Eurozone peripheral bond yields

Country	November 2018	December 2018	Spread over 10 year
Spain 10 year	1.60%	1.41%	116
Italy 10 year	3.44%	2.94%	269
Greece 10 year	4.35%	4.25%	400

	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

Mid caps outperforming

Traditional stock market logic has it that large caps are boring, but also more reliable in a volatile market environment. Mid-caps, by contrast, are supposed to be racier and more exciting. That means potentially bigger gains on the upside but also bigger losses on the downside. But the recent market sell off, suggests this old market adage isn't always accurate.

Index firm S&P Dow Jones has just released an interesting research piece by Jodie Gunzberg, MD of equities which showed that mid-cap stocks actually outperformed in November. During the month, the S&P 400 gained 2.9% versus 1.8% from the S&P 500 and 1.4% from the S&P SmallCap 600. In mid-caps, 9 of 11 sectors were positive, while 8 of 11 large-cap sectors gained and 6 of 11 small-cap sectors gained.

This isn't the first time that mid-caps have outperformed, of course. The S&P MidCap 400 outperformed the S&P 500 by 38% from 1991-1993, 81% from 2000-2005 and by 24.1% in 2007-2010. Not only were the premiums big, but in the latter two times, the returns of the S&P 500 were negative 15.0% and 11.3%, respectively, while the S&P MidCap 400 gained 66.0% and 12.8%, respectively. Intriguingly mid-caps also displayed lower volatility than large caps. The last November when this happened occurred in 2007.

According to Gunzberg, these numbers give us hope that equities might pull out of their recent funk. She reckons that *"Equities historically perform well on average in December with every size, style and sector gaining. But mid-caps have done best. If trading tensions ease, helping growth and pushing the dollar down, mid-caps may be best positioned to perform best based on historical sensitivity. Mid-caps gain most from a 1% dollar drop, rising on average 3.2% versus 2.6% for large-caps. Oftentimes, the falling dollar acts as a catalyst for new international growth and propels returns beyond the mature large-caps."*

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-2.68	-6.28	-11.9	-8.1	6.29	15.6	6845
S&P 500	-0.5	-3.05	-5.87	-1.24	47.5	85	2618
iShares FTSE UK All Stocks Gilt	1.82	1.14	0.07	-0.812	17	11.2	13.13
VIX New Methodology	-2.82	71.1	70.04	96.9	31	21.5	20.65

Index	November	December	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	125.5	125.6	3065	125.90
FTSE 100 (Dec 17)	308.6	308.8	6773	n/a

Back to menu

Volatility

Gold Prices

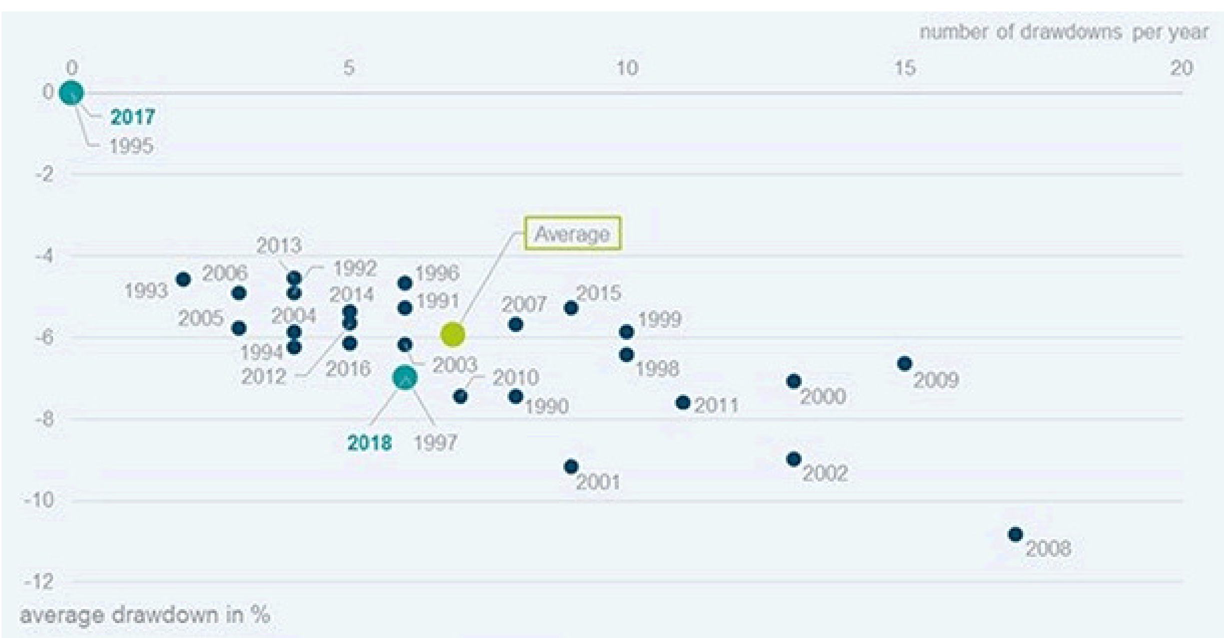
There's been much collective moaning and gnashing of teeth amongst investors over the last few, turbulent, weeks. The penny seems to have finally dropped that we are now entering a new volatility regime, where markets could trend sideways for aeons, or even slowly trend downwards interspersed by elongated bouts of peak panic. On balance though the consensus seems to be that the equity bull market has probably run its course, for now, although as I have already indicated I still think we could see one last hurrah early next year.

Anyway, the key point is that we are probably simply 'back to normal' i.e markets won't obviously trend in any direction. As evidence of this I'd cite a note out last week from DWS which reminded us that in 2018 market volatility was... wait for it... about average for the long term.

DWS compared the number of S&P 500 declines of at least 3% with the average magnitude of the decline in each calendar year.

The chart below shows *"that 2018 almost exactly matches history: in 2018, we saw six times a decline by more than 3% (average fall: 7%). Since 1990, declines of more than 3% occurred almost seven times a year (average fall: 5.9%). So from an average-volatility perspective, 2018 is just a normal stock-market year. Looking at the top left corner, 2017 was the big exception, when the S&P 500 did not drop by 3% or more even once. Dropping twice by some 10%, as the index has this year, might seem more exceptional. But it is not that uncommon, too, when looking back in history: at least two declines by 10% or more within one year have occurred seven times since 1990."*

If that is the case, don't expect the big hedge funds to reap any super returns from elevated volatility. Vol levels are simply back to where they need to be - which means that speculators will still struggle to make much money. Is it possibly time to ditch the absolute returns promises and embrace structured products perhaps???



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/22/18

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

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