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Monthly Market Report

April 2020

With commentary from David Stevenson

Last month was a tad bruising for equity investors - and I say that with a considerable degree of understatement.

My guess - and it is only a guess - is that the next few months will be a rather torrid, with excessive volatility. The real challenge is whether this morphs from a specific, time linked crisis - prompted by external events (the virus) - into a credit crisis. If the latter happens then we could be in for an even bigger blow out than the global financial crisis. My hunch is that the central banks and governments will do as much as they feasibly can to stop that credit crisis breaking out.

The other big question for structured product investors in particular is whether the current stockmarket volatility turns even nastier and we see first 40 and then 50% barriers breached. This reminds us of the importance of those barriers and whether they are observed at the end of maturity or during the products lifespan. Most tend to be former structure which could be a huge life saver. There must be a reasonable chance that within the next 6 to 12 months - if we avoid a credit crisis - markets might bounce back aggressively. At that point many structured products will be back in the game.

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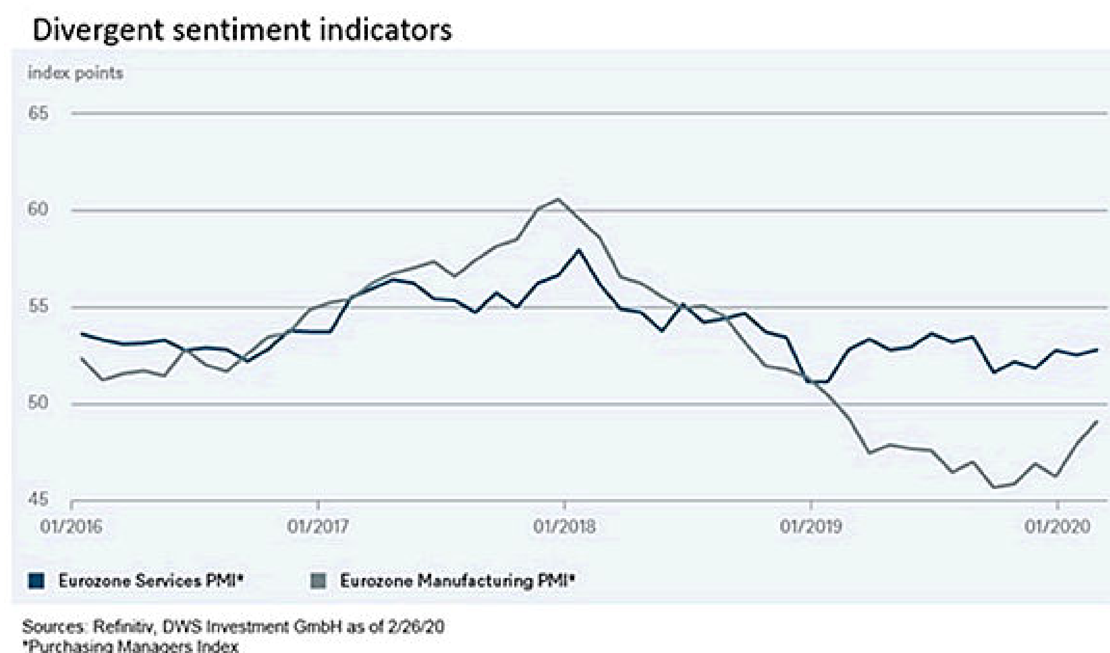
Headline Numbers

Watch out for services in Europe

You may just have noticed that continental European markets have been having a torrid time in

recent years, at least in relative terms. Investors remain concerned that the Euro zone is still mired in low growth, with serious deflationary trends. Added on to this underlying unease, is a more short term concern that more prosperous economies such as Germany might be hit by the obvious difficulties in China.

Investor's haven't entirely ignored the continent though. Three factors have tended to work in the favour of Eurozone markets. The first is that the European Central Bank seems ready to combat deflation, whilst also pumping into the Eurozone economy. The second is that in relative terms, local equities are good value compared to expensive US (tech) stocks. The third tailwind is that the Eurozone service sector seems to much more resilient than manufacturers. This strength in service sector revenues has helped keep recession at bay in many countries, not least Germany. But even this enormous engine of growth might be starting to falter now, according to analysts at asset manager DWS. They suspect that the Eurozone service economy might now be slowing down alongside the coronavirus. According to DWS analysts *"many service providers have been severely afflicted. Airlines, tourism, gastronomy, cultural and sports organizers are only the most obvious victims. The economic data published so far already showed the first signs of a slowdown in the Far East. The first week of March is likely to be particularly revealing for the rest of the world. The business-confidence surveys that will be published then, should give a better sense of the extent to which the service providers are initially pacing the global economy. In any case, the industry is not expected to maintain the momentum of its recent acceleration."*



Viral Numbers

Charlie Robertson, Global Chief Economist at Renaissance Capital has been busily compiling data on the spread of Covid 19, aka the coronavirus. This outfit has an excellent handle on emerging and frontier markets data, so worth listening to. The Renaissance Capital economist offers up one ray of hope in the shape of a detailed analysis of the first 1,000 fatalities, almost all in the disaster zone that was Hubei. These suggest that 99% under the age of 60 recovered and all young children under the age of 10. See the table below. Obviously, this remains concerning for those with parents in the 70+ age bracket, but 85% of over 80 year olds survived in China too.

Baseline characteristics	Confirmed cases, N (%)	Deaths, N (%)	Case fatality rate, %	Observed time, PD	Mortality, per 10 PD
Overall	44,672	1,023	2.3	661,609	0.015
Age, years					
0–9	416 (0.9)	–	–	4,383	–
10–19	549 (1.2)	1 (0.1)	0.2	6,625	0.002
20–29	3,619 (8.1)	7 (0.7)	0.2	53,953	0.001
30–39	7,600 (17.0)	18 (1.8)	0.2	114,550	0.002
40–49	8,571 (19.2)	38 (3.7)	0.4	128,448	0.003
50–59	10,008 (22.4)	130 (12.7)	1.3	151,059	0.009
60–69	8,583 (19.2)	309 (30.2)	3.6	128,088	0.024
70–79	3,918 (8.8)	312 (30.5)	8.0	55,832	0.056
≥80	1,408 (3.2)	208 (20.3)	14.8	18,671	0.111
Sex					
Male	22,981 (51.4)	653 (63.8)	2.8	342,063	0.019
Female	21,691 (48.6)	370 (36.2)	1.7	319,546	0.012
Occupation					
Service industry	3,449 (7.7)	23 (2.2)	0.7	54,484	0.004
Farmer/laborer	9,811 (22.0)	139 (13.6)	1.4	137,992	0.010
Health worker	1,716 (3.8)	5 (0.5)	0.3	28,069	0.002
Retiree	9,193 (20.6)	472 (46.1)	5.1	137,118	0.034
Other/none	20,503 (45.9)	384 (37.5)	1.9	303,946	0.013
Province					
Hubei	33,367 (74.7)	979 (95.7)	2.9	496,523	0.020
Other	11,305 (25.3)	44 (4.3)	0.4	165,086	0.003
Wuhan-related exposure*					
Yes	31,974 (85.8)	853 (92.8)	2.7	486,612	0.018
No	5,295 (14.2)	66 (7.2)	1.2	71,201	0.009
Missing	7,403	104	2.8	103,796	0.010
Comorbid condition†					
Hypertension	2,683 (12.8)	161 (39.7)	6.0	42,603	0.038
Diabetes	1,102 (5.3)	80 (19.7)	7.3	17,940	0.045
Cardiovascular disease	873 (4.2)	92 (22.7)	10.5	13,533	0.068
Chronic respiratory disease	511 (2.4)	32 (7.9)	6.3	8,083	0.040
Cancer (any)	107 (0.5)	6 (1.5)	5.6	1,690	0.036
None	15,536 (74.0)	133 (32.8)	0.9	242,948	0.005
Missing	23,690 (53.0)	617 (60.3)	2.6	331,843	0.019
Case severity§					
Mild	36,160 (80.9)	–	–	–	–
Severe	6,168 (13.8)	–	–	–	–
Critical	2,087 (4.7)	1,023 (100)	49.0	31,456	0.325
Missing	257 (0.6)	–	–	–	–

Abreviation: PD, person-days. -, not applicable.

Measure	Values as of 6th February, 2020	Values as of 5th March, 2020
UK Government 10 year bond rate	0.59%	0.34%
GDP Growth rate YoY	1.10%	1.10%
CPI Core rate	1.30%	1.80%
RPI Inflation rate	2.20%	2.70%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.70%	0.64%
Government debt to GDP ratio	80.80%	80.80%
Manufacturing PMI	50	51.7

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Bank CDS options

With equity investors worrying about the onset of a global recession, you might have expected credit default swaps to shoot up in price as markets worry about the growing likelihood of defaults. In reality most swap rates haven't moved much although a few have seen slightly above average increases, such as Credit Suisse, UBS and Banco Santander. The largest increase was seen at Deutsche Bank. A few banks even saw their swap rates decline slightly, such as Goldman Sachs and RBC. At the moment the CDS markets seem calm - might March and April bring big changes?

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	7.13	28.01	A	A2	A -
Barclays	15.03	36.82	BBB	Baa3	A
BNP Parabis	7.478	22.26	A+	Aa3	A+
Citigroup	16.95	43.82	BBB+	A3	A
Commerzbank	14.41	57.21	A-	A1	BBB+
Credit Suisse	8.78	39.5	BBB+	Baa2	A-
Deutsche Bank	43.28	114	BBB+	A3	BBB
Goldman Sachs	18.47	49.95	BBB+	A3	A
HSBC	7.63	27.59	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	16.15	34.8	A-	A2	AA-
Lloyds Banking Group	8.71	29.06	BBB+	A3	A+
Morgan Stanley	19.65	48.36	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	19.15	48.75	BBB+	Baa1	A-
RBC	15.44	45.67	AA-	Aa3	AA
Soc Gen	7.11	23.64	A	A1	A
UBS	6.45	20.33	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 3rd February 2020 www.tempo-sp.com

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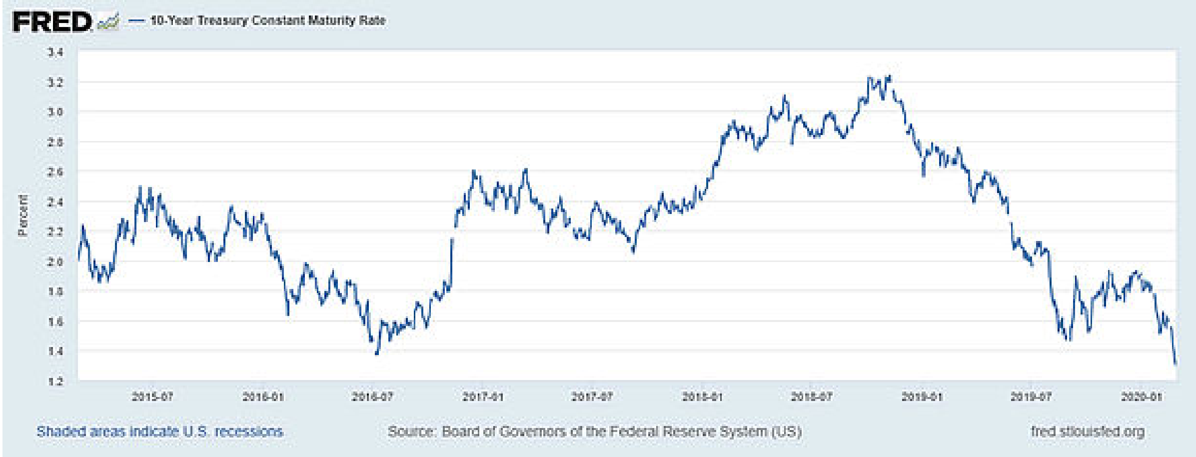
Government Bonds

Fixed Income

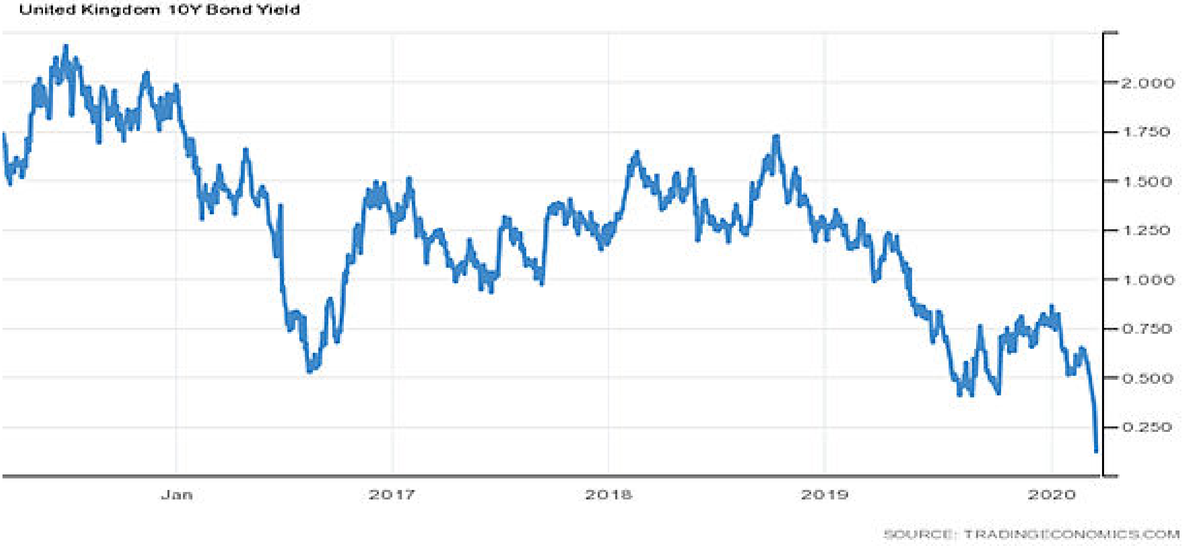
At the end of February, the 10-year U.S. Treasury closed at 1.15% (trading at a 62-year low), down

from last month's 1.51% (1.92% at year-end 2019, 2.69% at year-end 2018, and 2.41% at year-end 2017). The 30-year U.S. Treasury closed at 1.68% (trading at a 43-year low), down from last month's 2.00% (2.30%, 3.02%, 3.05%).

Since then of course yields have continued to head lower and the chart below shows the yield on ten-year US government bonds over the medium term. The key signal will be when US 10-year yields head below 1% - which it did just a few days later on March 4th - and then stay below these levels.



UK Government Bonds 10-year Rate 0.34%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	18.38
Germany	9.86
Japan	23.28

United Kingdom	20.53
Ireland	22.383
Italy	147
Portugal	45.89
Spain	46.94

Eurozone peripheral bond yields

Country	February 2020	March 2020	Spread over 10 year
Spain 10 year	0.30%	0.22%	67
Italy 10 year	0.96%	1.06%	133
Greece 10 year	1.14%	1.28%	151

	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

Index	February 2020	March 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	123.3	122.2	3232	122
FTSE 100 (Dec 19)	333	330	6462	n/a

Cast your mind back to the days and weeks before the coronavirus forced its way into our current affairs. In these heady days, there was a real sense that the global slowdown might have started bottoming out.

The biggest clues come from the earnings being reported for previous quarters. Some evidence for this comes from the latest roundup of the European Q4 earnings season from analysts at Morgan Stanley at the end of February. Their numbers reveal that earnings were surprising on the upside with 43% of companies beating EPS estimates by 5% or more, while 33% missed. "If maintained, this implied net beat of 10% would be broadly consistent with the breadth of beats we've seen through recent reporting seasons".

Crucially these earnings beats were much higher quality. According to the analysts at Morgan Stanley "recent quarters have shown a consistent pattern of large downgrades to consensus just ahead of results, followed by earnings beats. However, this quarter has shown a higher quality beat, given the downgrades to consensus numbers were much smaller than usual. In the two

months before results season, EPS estimates were in aggregate downgraded by 1.4%, but weighted earnings are currently on track to beat expectations by 5.9%, implying results are a solid beat".

Overall these numbers implied a return to EPS growth for Europe. "Results currently suggest that weighted earnings are on track to grow by 2.4% year on year in 4Q, much improved on the ~5% contraction averaged in the first three quarters of 2019. This is an impressive result in our opinion given soft comps don't really come into play for the aggregate index until 1Q20 reporting season."

But it wasn't all positive news though. Even as Morgan Stanley was reporting progress in Europe, equity analysts at SocGen were reporting more dismal US numbers. They report that *"net income barely moved, with a rise of just 0.3%. More worrying is without the Big 5 companies (Microsoft, Alphabet, Apple, Amazon and Facebook), net income fell 7.5%. In part, this is due to higher costs (SG&A) and a significant rise in both interest expense and taxes. That interest costs are rising so quickly despite low-interest rates is remarkable and a challenge to policymakers. With all this debt, higher interest rates seem no longer feasible."*

"The headline-grabbing figure is share buybacks. We measure buybacks both from the declared amount repurchased to the repurchase figure from the cashflow statement. Typically, the former is bigger than the latter. With 80% of the overall value of buybacks reported so far, buybacks are 20% lower in 2019 than 2018 - excluding the Big 5, the figure is down 32%."

Annual growth rates	Total reported	Market	Big 5	Market ex-financials	Market ex-financials ex Big 5
Net Sales	74%	5.5	13.5	5.2	4.4
Cost of Goods Sold + Depreciation	69%	4.2	11.7	3.9	3.3
Selling General & Admin Expense	72%	7.6	19.2	8.0	6.0
EBIT Operating Income	77%	1.8	10.5	1.4	-0.3
Interest Expense	76%	12.1	2.2	9.4	9.9
Pre-tax Income	82%	1.4	8.2	-0.3	-2.3
Total Income Taxes	82%	5.2	17.3	21.8	22.8
Net Income Before Extras	**82%**	**0.3**	**6.7**	**-4.7**	**-7.5**
Cash and Short -term Investments	79%	11.5	16.1	10.7	8.0
Total Debt	79%	3.1	-1.1	4.5	4.9
Net Debt	79%	0.9	Cash	1.1	3.9
Total Assets	84%	6.0	11.8	5.9	5.2
Share repurchases	**80%**	**-20.7**	**10.5**	**-23.0**	**-31.9**
Share repurchases (Cashflow)	75%	-14.3	10.2	-16.4	-24.8

Source: SG Cross Asset Research/Equity Quant, Factset Fundamentals

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-13.4	-1	-10.7	-9.71	-6.5	-3.73	6462
S&P 500	-10.7	-5.52	-0.213	8.13	43.5	58.3	2972
iShares FTSE UK All Stocks Gilt	5.3	7.58	4.04	11.9	22.5	31.7	14.94

VIX New Methodology	156	191	164	139	161	181	39.62

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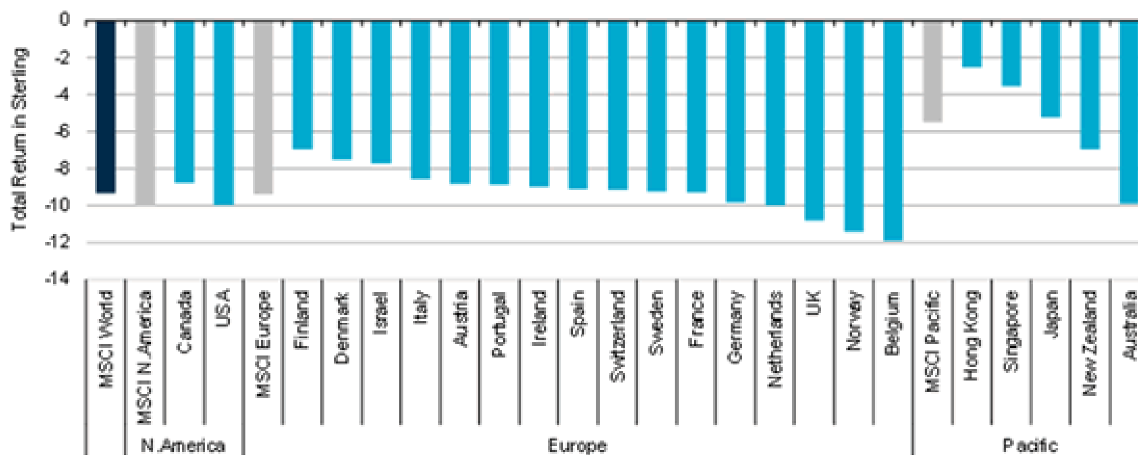
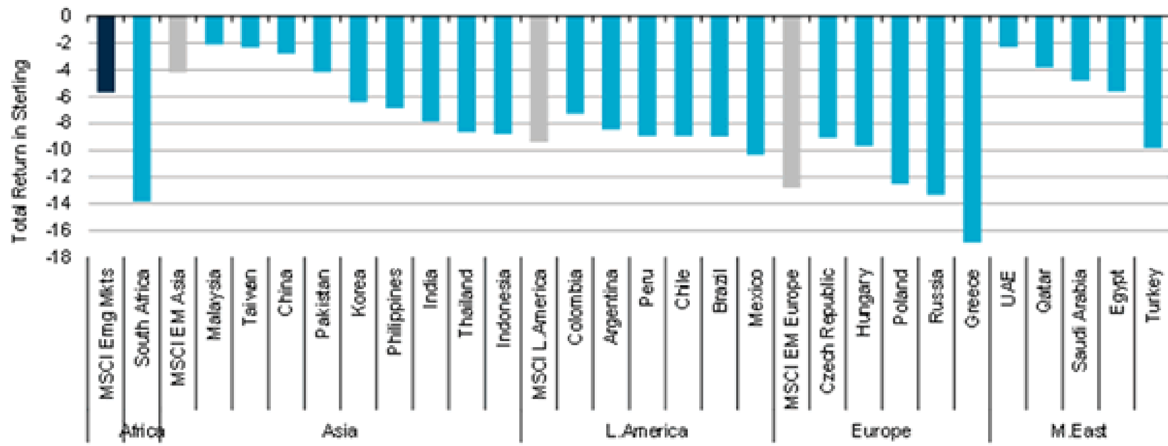
Volatility

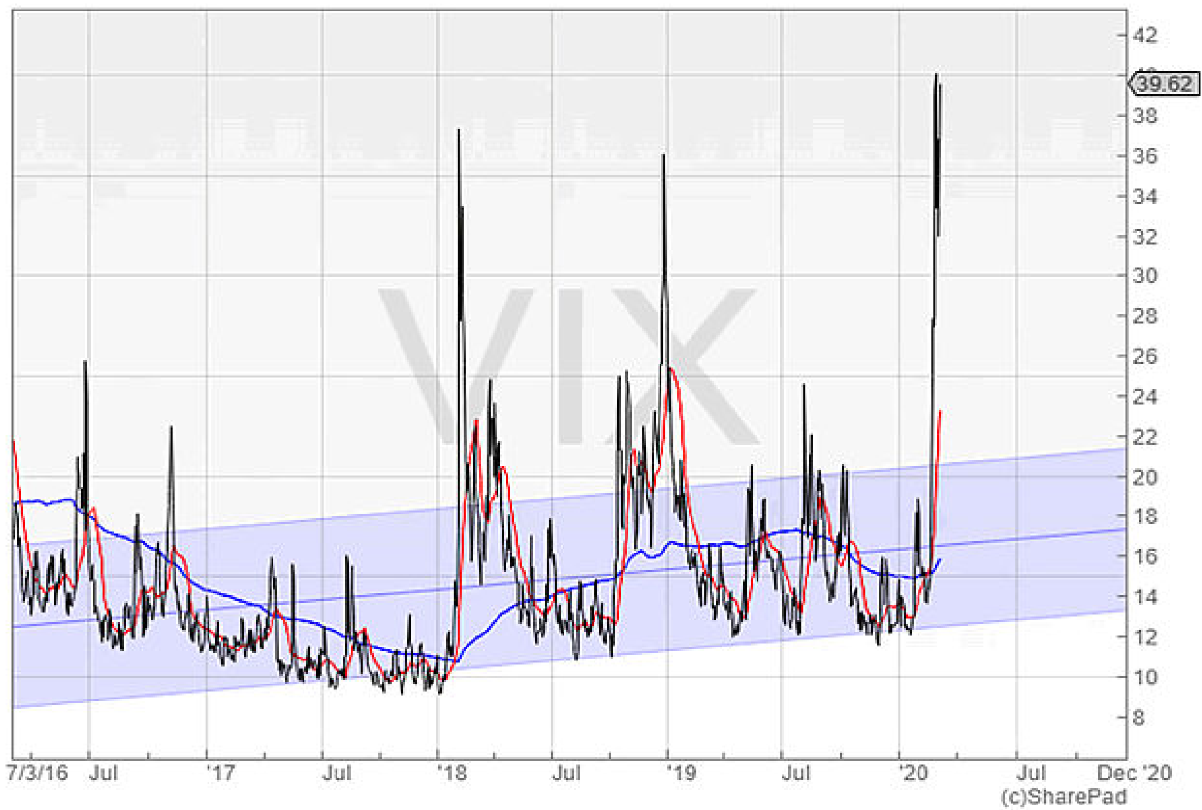
February was a terrible month for investors. We've just had the latest S&P Dow Jones analysis in and it doesn't look good.

According to Howard Silverblatt from the index firm, in February the U.S. *"had turned a 3.67% gain into an 8.36% decline, as the composite global market turned a 2.40% gain into an 8.29% decline. For the month, only one of the 49 markets gained, down from last month's 11 and almost a complete opposite from the prior month's sweep, where all 49 countries gained. February posted an 8.29% decline, after January's 1.42% decline and December's broad 3.40% gain. Absent the U.S.'s 8.36% fall, the global non-U.S. market was down a tick less, at -8.20% for the month".*

The table below from funds analysts at Numis nicely locates this turbulent market within a geographical context. Interesting to see how places such as Belgium, Norway (all that oil) and Germany were particularly badly hit while Finland, Israel and Denmark experienced much smaller declines. In the second chart we see the impact on emerging markets - pity poor Greece (and South Africa) and wonder how Taiwan emerged relatively unscathed.







Measure	March Level	February Level	January Level	December Level
Vstoxx Volatility	33.35	13.4	12.7	13.4
VFTSE Volatility	n/a	n/a	n/a	n/a

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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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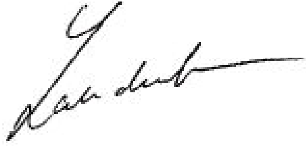
To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,



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