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UK Structured™ Products Association

Monthly Market Report

October 2019

With commentary from David Stevenson

Equity investors have turned skittish, with bond investors the main culprits for this troubling turn. Bond markets are signalling that a recession - a bad one at that - is imminent and that the bull party is well truly over. The growing profusion of negative yields speaks volumes to the scary talk coming out of bond vigilantes at the moment.

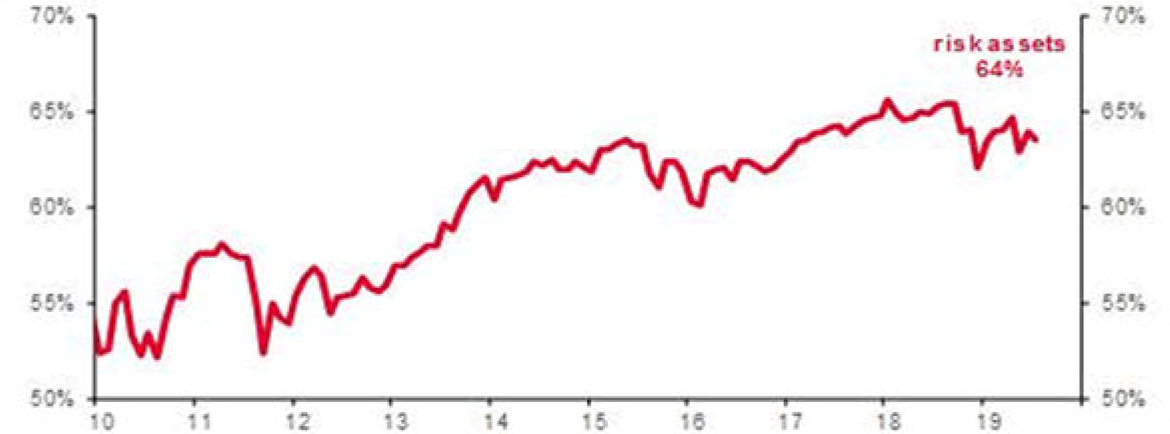
And there's certainly good reason to think that equity investors did get a little too over excited in the spring and summer. The global trade economy is definitely slowing down and the tariffs war is clearly not helping. That in turn is having a knock on impact on German exports which is helping slow down the pace of growth in the Eurozone.

All things considered some notching down in equity exposure does seem to make sense. Sadly, that doesn't seem to be the case for most investors. Equity exposures remain unusually high. That at least is the conclusion of a note from late August by the strategy team at SocGen who track fund flows. They think that despite recent equity fund outflows, portfolio allocations towards equities are too high. They observe that *"risk assets (equity and credit) account for 64% of the $32.6tn asset pool managed by mutual funds and ETFs tracked by EPFR. Despite volatility earlier in the year, the weight of risk assets is again close to the peak (66%) in this cycle. Such high risk content strikes us as excessive, especially in the context of rapidly rising recession threats and trade war skirmishes. In comparison, our own allocation to risk assets is only 47%"*.

There is though a slightly more optimistic narrative, consisting of two interrelated narratives. The first is that the bond markets aren't necessarily signalling a severe recession just a realisation that we ate mid way through a deepening of the decade long deflation cycle. The second narrative is that we are not entering a recession, just another slow down, one of at least two since the global financial crisis in 2008/9. Some equity investors like to call these slowdowns a 'pause for breath', as the world's markets take stock, and then waits for central banks and state Treasuries to act.

My own gut tells me that the slightly more optimistic narrative is probably more likely though I wouldn't rule out a much nastier recession. If my slightly more optimistic take is right we could see the positive animal spirits bubbling back up again as we enter the last quarter.

Ahead of a recession, 64% of portfolios are in risk assets, which seems excessively high



Weight of risk assets (equities and credit) in mutual funds and ETFs. Not shown: other assets (bonds and money market funds). Total = 100%
Source: EPFR Global, SG cross Asset Research / Global Asset Allocation

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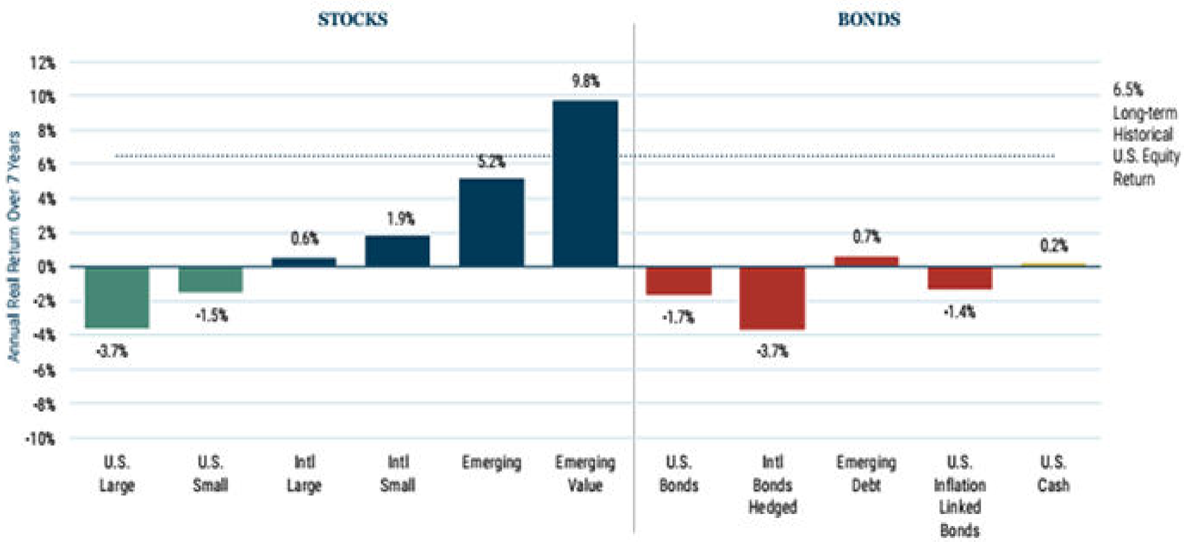
Headline Numbers

Long term forecasts for investment returns are always a tricky exercise in crystal ball gazing but the exercise isn't entirely futile. Pension fund managers for instance need some anchors to base their long-term projections around and ordinary private investors also require estimates for long term returns to plug into their models. For most, the magic number for equities is around 6 to 7% pa real returns over the very long term - bonds are likely to pay out less.

But what happens if those guestimates are wildly out of line? What happens if in our Low Rates for Longer new world, equity investment returns have also been dragged lower? That's the slightly discomforting scenario suggested by analysts at US asset management house GMO. The chart below shows their seven-year anticipated returns for a number of core asset classes. Their numbers look slightly scary for virtually every major asset class except emerging markets and cash. Then again, GMO has long had a more cautious, value driven view of the world, and perhaps their estimates are too bearish. But if they are right and returns for many key asset classes turn negative in real terms over the next seven years, we'll soon be facing the mother of all underfunding crises.

7-YEAR ASSET CLASS REAL RETURN FORECASTS*

As of July 31, 2019



Source: GMO

*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

The trade war between the US and virtually everyone else doesn't look like its winding down any time soon. In fact, if anything it looks like it is intensifying and there's no respite in sight. Most attention has focused on the impact of this spat on the stockmarkets (and economies) of the two main protagonists, China and the USA. But what about the wider global implications? Commodities are a good place to start. Grains and many agricultural commodities have been badly hit but the biggest damage has been to copper - according to one investment bank there have been massive outflows from copper positions. Short positions by contrast have massively increased, hitting levels not seen since 2006!

Back in the world of equities, emerging markets are thought to be the obvious weak spot but according to analysts from Renaissance Capital (a big emerging banks investor), the impact varies dramatically by geography. They've looked at data from the last few decades - and especially the last few years - to see how different national stock markets and sectors in the developing world cope with the tariffs flying back and forth. Their analysis suggests that the most strongly sensitive to trade war escalation are the BRICS generally, China and South Africa along with Estonia, Kenya and Vietnam in frontier markets. In terms of sectors, its mainly IT businesses that are most vulnerable.

And what about the most strongly defensive markets? Step forward Latin America, Taiwan, Brazil, Colombia, Poland and UAE. Some markets don't seem to be much affected either way by previous trade tariff spats - in this last category there's Pakistan, Frontier markets and Jordan and Slovenia. In terms of sectors, energy, industrials, consumer staples, telecoms and utilities among EM sectors.

Measure	Values as of 12th August, 2019	Values as of 3rd September, 2019
UK Government 10 year bond rate	0.49%	0.35%
GDP Growth rate YoY	1.20%	1.20%

CPI Core rate	2.00%	2.10%
RPI Inflation rate	2.90%	2.80%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.76%	0.76%
Government debt to GDP ratio	84.70%	84.70%
Manufacturing PMI	48	47.4

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Bank CDS options

Not many changes this month to report in pricing for credit default swaps on bank bonds - most prices have drifted lower for major European banks though there have been some notable individual price moves. Some key US banks such as Morgan Stanley and JPMorgan saw the price of their 1 year swaps increase but that is from very low levels.

So far, so boring but these swaps have made a few (esoteric) financial headlines over the last few weeks. In particular German bank Commerzbank has been on the receiving end of some very negative stories, with many worried about declining profitability. For instance, Bath based risk consulting firm CheckRisk recently put out a note to its institutional clients warning on Commerzbank - they called it a distance to distress alert as they reckon the big German bank is now in the red sector of their model.

Here's CheckRisk on Commerzbank:

> *"It is the first time we have seen two systemically important banks in Germany having an alert attached to them since the 2008 crisis. Although we have seen this kind of pattern occur in the past in other EU zone countries such as Italy, Greece, Spain and Portugal. We are also seeing stress connectivity in the Turkish Banking System. How severe is the level of distress at Commerzbank? The year to date plot shows that bank has been drifting towards distress throughout 2019, having started the year in a relatively healthy position. The distance-to-distress has fallen from around 2.5 at the start of the year to 1.47 today. Over the year the equivalent odds of the bank experiencing distress on a daily basis have been reduced by a factor of three from about 1 in 12000 in January to about 1 in 3900 today, meaning entering distress is three times as likely. To add context, Deutsche Banks distance-to-distress was at similar levels just before it announced it's restructuring on July*

7th 2019. Banks that fall below 1.5 Dtd have a tendency to continue to deteriorate as other market players begin to review and withdraw credit lines to the troubled party. The recent decline in Commerzbank's Dtd is precipitous and noteworthy".

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	6.37	30.02	-6.00	-54	A -
Barclays	29.44	62.5	1.99	0	A
BNP Parabis	8.59	27.3	-5.6	-38	A
Citigroup	14.91	57.62	21.88	10.79	A
Commerzbank	6.55	39.9	5.21	n/a	A+
Credit Suisse	12	48.1	-2.78	-1.42	A
Deutsche Bank	34.26	75.8	-4	10.46	A+
Goldman Sachs	26.3	66.97	-4.2	20.38	A
HSBC	10.8	33.85	10.83	-5.36	AA-
Investec*	n/a	61	n/a	n/a	BBB
JP Morgan	18.64	42.24	21.61	1.54	A+
Lloyds Banking Group	18.92	83.07	-2.34	-15.88	A
Morgan Stanley	24.89	62.69	20.97	6.03	A
Natixis	n/a	46	n/a	n/a	A
Natwest Capital Markets	27.82	79.54	4.99	-8.59	A
Nomura	19.81	76.44	7.21	76	A-
Rabobank	6.53	20.49	0.01	-45	AA-
RBC	n/a	61	n/a	n/a	AA
Soc Gen	8.04	29.14	-11.84	-32	A
UBS	5.96	20.64	0.8	-47	A

Source: www.meteoram.com 28th August 2019
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

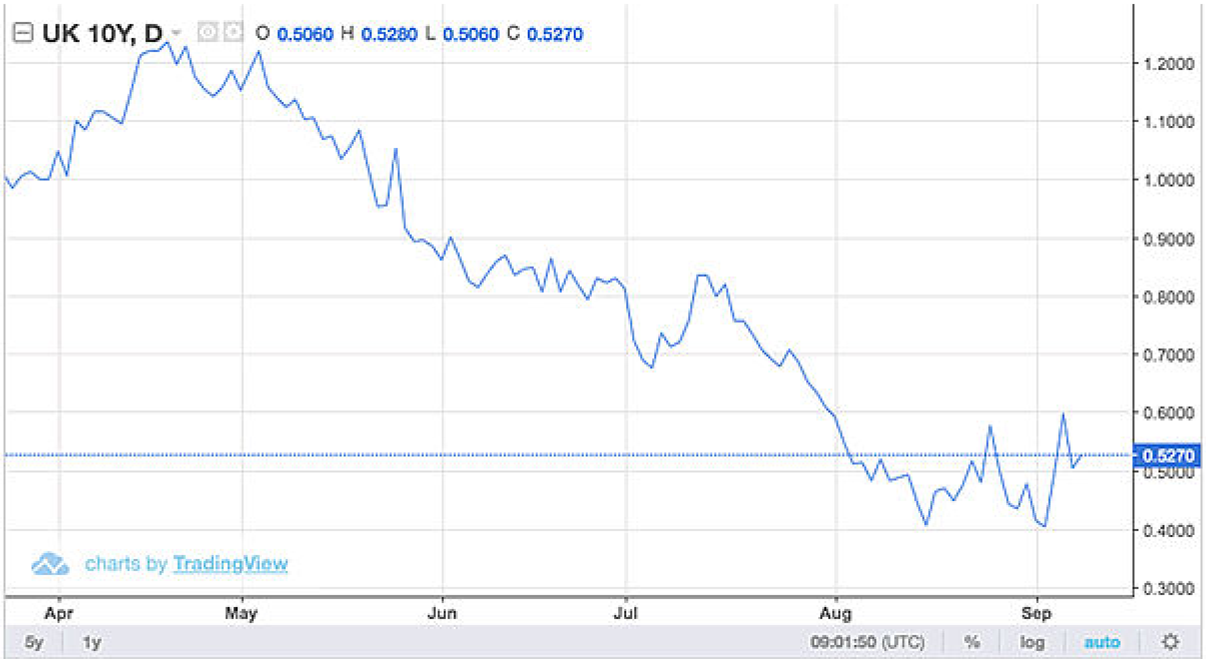
Fixed Income

The table below I think tells a remarkable story. It shows the yield of ten-year government bonds from around the developed - and developing - world. For this observer, the most remarkable number is for UK

10-year gilt yields, at just 0.35% despite all the troubles and disputes over Brexit and despite the possible threat of a Corbyn government following a snap election. But the general story is still striking. Yields have collapsed across the board. Of the 17 countries in the list, five boast negative yields for their 10-year government bonds, and another three below 0.50% positive yield - two more offer up yields of under 1%. As I have mentioned before on these pages, the US yield of 1.51% looks positively crazy by comparison - no wonder the US dollar remains so strong. Other outliers include New Zealand with a yield 1.07% and Canada at 1.16%. Both seem mispriced when one considers that Greece could now borrow for ten years at a rate of just 1.61%, only 10 basis points above that of the United States.

	Yield %	Monthly change	Yearly change
US	1.51	-0.52%	-1.40%
UK	0.35	-0.08%	-0.98%
Japan	-0.26	-0.07%	-0.38%
Germany	-0.70	-0.19%	-1.03%
Brazil	7.43	0.05%	-4.90%
France	-0.39	-0.21%	-1.09%
Greece	1.61	-0.44%	-2.83%
Australia	0.93	-0.08%	-1.59%
Italy	0.97	-0.60%	-2.22%
Canada	1.16	-0.31%	-1.06%
India	6.56	0.19%	-1.40%
Mexico	6.98	-0.53%	-0.96%
Netherlands	-0.55	-0.21%	-1.01%
New Zealand	1.07	-0.26%	-1.47%
Spain	0.13	-0.13%	-1.36%
Portugal	0.14	-0.15%	-1.76%
Switzerland	-1.00	-0.13%	-0.90%

UK Government Bonds 10-year Rate 0.49%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	21
Germany	10.51
Japan	22.56
United Kingdom	33.35
Ireland	32.94
Italy	161
Portugal	42.28
Spain	40.36

Eurozone peripheral bond yields

Country	August 2019	September 2019	Spread over 10 year
Spain 10 year	0.24%	0.08%	82
Italy 10 year	1.77%	0.90%	164
Greece 10 year	2.18%	1.61%	235

	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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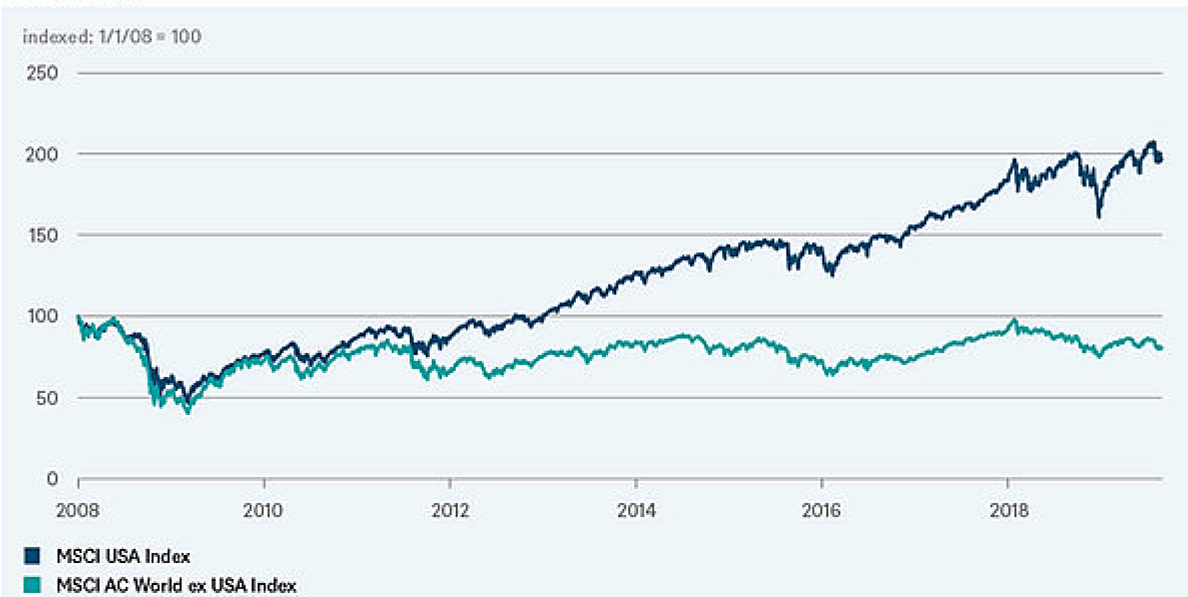
Equity Markets and Dividend Futures

Index	August 2019	September 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.6	121.2	3414	121.8
FTSE 100 (Dec 17)	325.3	327.5	7261	n/a

America first



Appendix: Performance over the past 5 years (12-month periods)

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 8/28/19

One of the most interesting stories of the current long bull cycle has been the relative outperformance of US equities versus the rest of the world. The chart above shows that U.S. equities have made up for all their losses since 2008/9 and have then gone on to double in value.

According to fund management firm DWS, calculated in U.S. dollars non-U.S. equities by contrast are still trading below the January 2008 level. Thomas Bucher, equity strategist at DWS, explains this discrepancy with the significantly stronger earnings growth of U.S. companies as well as their greater focus on shareholder value. Industry composition also helped the U.S. market: Within U.S. indices, the service sector and especially companies with a heavy focus on digital technology are more strongly represented than, for example, in European indices.

These numbers of course use the dollar as the standard currency for reporting. But the dollar has appreciated by more than 30% against the euro since the beginning of 2008. Calculated in euros, non-U.S. shares have also done 30% better and that doesn't include more generous dividend payments. The bad news though is that the performance gap doesn't entirely disappear. US equities have vastly outperformed and Europe is still one decade on playing catch up.

Volatility

Reuters carried a cracking little chart just a few days ago (August 29th) which shows the sterling volatility index as measured by implied volatility. According to this measure the price of the three-month contract has jumped hugely in August and is now back to levels last seen at the end of 2018. My bet is this is only the beginning of the roller coaster ride in 2019. Sterling and more generally FX rates are likely to be the main transmission mechanism for political uncertainty over the remaining months of the year. Most UK focused equities are already on their back while UK gilts continue to soar away in price - generating ever lower yields. So, all eyes then on sterling. My guess - and it is only that - is that if we go for no deal, we could see Sterling Euro parity and the cable rate (US$ vs £) touch a low of 1.10. That's great news for all those of us with substantial foreign equity and bond positions, but terrible news for UK consumers as domestic import prices continue increasing. But there could be another twist in the tail. If - and it's a big if - Boris Johnson and the Conservatives do call a general election, leave on Oct 31st and then win the resulting election, we could see a major relief rally - sterling could rise sharply (its hugely undervalued on any sane long term measure), FTSE 100 shares could slump, and domestic equities bounce back. Internationally diversified UK investors might find themselves caught in the ensuing whiplash.

Measure	September Level	August Level	July Level	June Level
Vstoxx Volatility	18.15	18.1	12.9	16.6
VFTSE Volatility	n/a	n/a	10.96	13.54

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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.

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