

With commentary from David Stevenson



Let's be honest - 2019 has been something of a surprise. I like many thought that this year would be the year the markets 'turned' in anticipation of the always impending slowdown. In reality 2019 proved to be a fairly positive year for both equities and bonds. Major equity indices are up 15-25% year-to-date, an impressive move even after factoring in last December's risk-off. Meanwhile, global bond yields are down sharply, despite a mild sell-off in recent months. Even better as we look forward to 2020, the economic outlook has improved. I stick with my view, off expressed on these pages, that the recent turbulence was another pause for breath in a long, seemingly relentless bull market, egged on by central bankers.

That said I think we need to be aware of some challenges as we head into the new year. By any definition the US recovery is late cycle and due a slowdown although the impending Presidential election complicates matters mightily.

The euro area still has enormous challenges as we discuss below, (with savings and negative interest rates) and China, crucially, seems to be trying to engineer a slower, more sustainable growth rate in the face of trade wars. I think analysts at Barclays sum it up very well when they suggest that "all of this makes for a rather unexciting macro outlook".

In investment terms stock markets seem fully priced, and much of the recent rally in equities seems due mainly to multiples expanding, not earnings growth. That last point - earnings - is crucial. For the bull market to run even stronger in 2020 we need to see some evidence of earnings growth, especially in the US. To date the evidence for this has been patchy at best and until we see firm data on a bounce in corporate earnings, my sense is the current bull rally will struggle as it heads into 2020.

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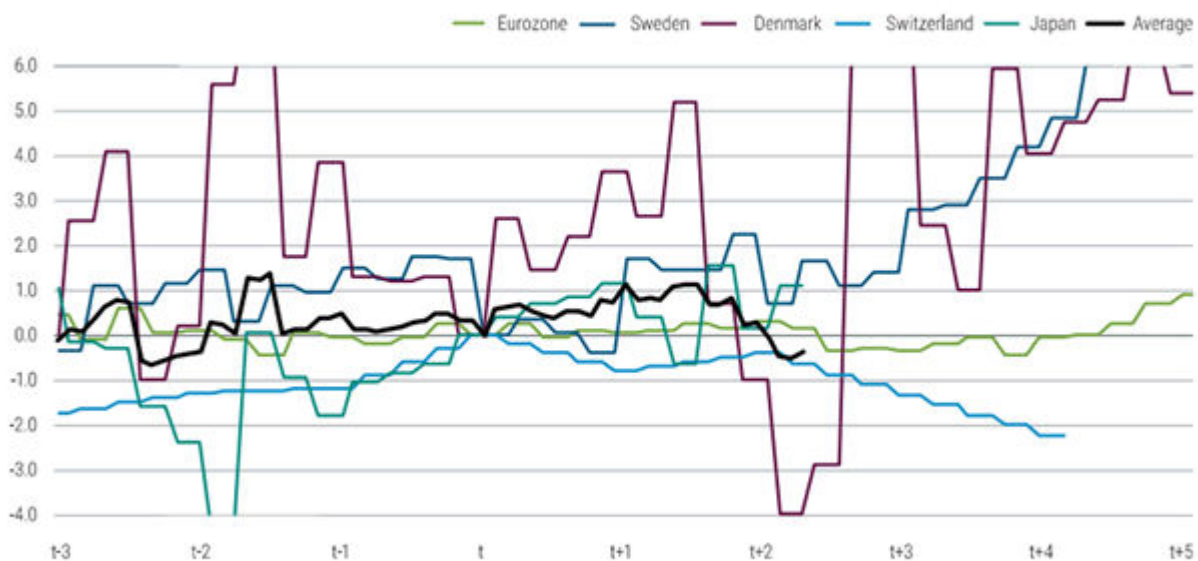
Headline Numbers

A few years back former US Federal bank chair Ben Bernanke advanced what seemed like a radical idea - the world was suffering from a savings glut. This was roundly ridiculed in some quarters; especially as global debt levels were also at the same time rising inexorably. But over a decade later, those words seem spookily prescient, at least as far as Europe as concerned.

While much of the European bond markets trades in negative yielding territory (see section on fixed income) evidence is mounting that European savers are responding by INCREASING their money hoard of spare cash and paper wealth.

According to Oliver Eichmann, Head Fixed Income Rates EMEA at DWS the Eurozone now runs a savings surplus of more than 300 billion euros per year. What makes this even more difficult as a policy challenge is that there is evidence that this mountain of savings is actually growing as a result of negative interest rates. The first chart below is from Pimco and shows that the household savings rate in many countries experiencing negative interest rates is growing over time. This poses a real dilemma for the European central Bank. If negative interest rates don't discourage increased savings, what's the next weapon to increase consumption?

Figure 7: Household saving rate, % gross disposable income

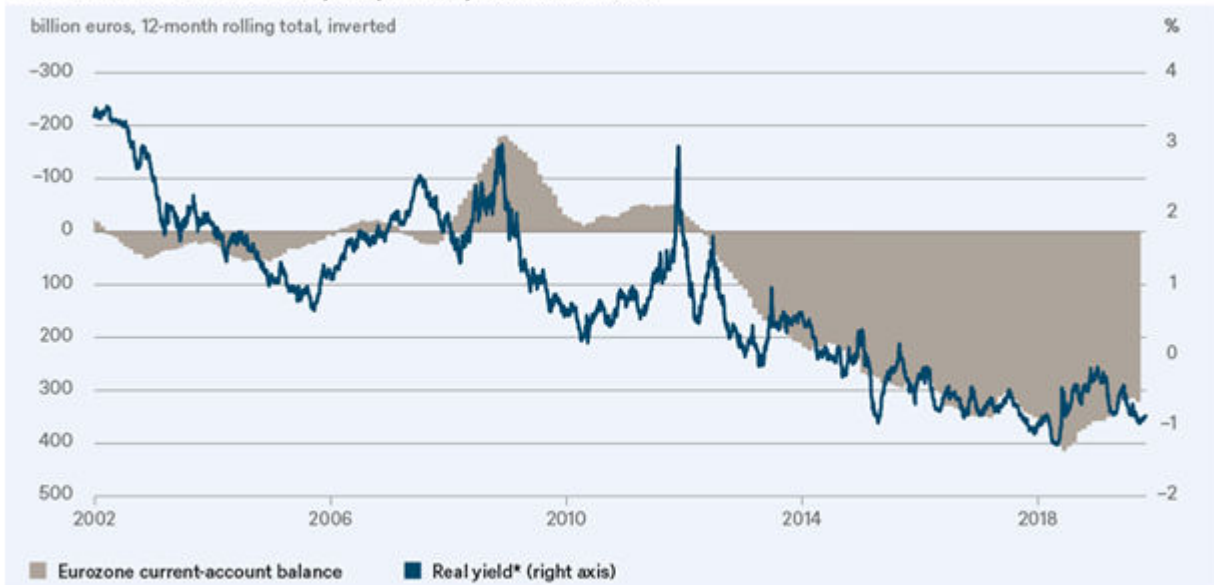


Sources: PIMCO, Statistics offices and central banks of the various jurisdictions. As of November 2019.

The flip side of this glut of savings is that Europe is also running a massive trade surplus. The second chart below shows the lock step between negative yields. From this perspective, the question analysts at DWS observe "is not whether the ECB will hike rates again, but how to create an environment where the corporate sector is willing to invest, thus achieving a return, and passing on part of this return to creditors. That is something monetary policy cannot achieve on its own." European savers and consumers need to find some confidence in their economies - and start spending. Equally European corporates also need to boost confidence and start investing in order to grow productivity.

If President Trump really wants to close that trade gap maybe he should be encouraging European's to stop being frightened about spending those savings.

How a current-account surplus pushes yields downward



* Yield of ICE BofAML 1-10 Year Euro Inflation-Linked Government Index
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 12/2019

ESG investing is hot. Barely a day goes by without some new survey suggesting that we should be investing more ethically. As an example, a recent survey by Bank of America showed that 78% of Millennials review their investment portfolios from an ESG perspective, compared to only 63% from Generation X. Modern investment firms such as robo-advisors like Wealthfront or Betterment, which target Millennials, have therefore integrated ESG in their core product offering.

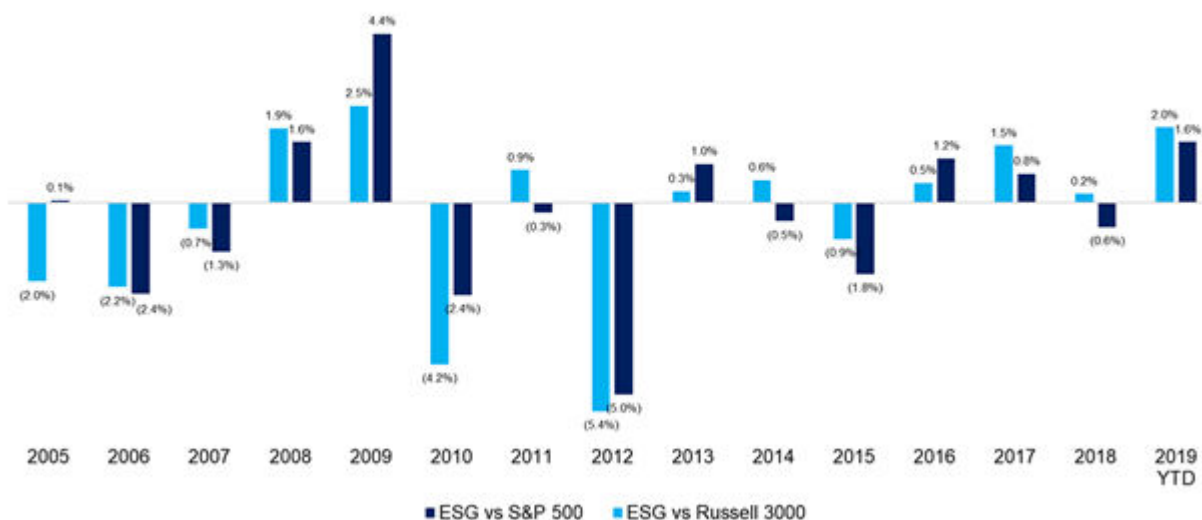
But does ESG makes sense from investment perspective? The evidence from various academic studies is at best mixed with very little evidence for outperformance.

Quantitative researcher Nicholas Rabener runs a firm called FactorResearch and has crunched the data on ESG returns from a gaggle of relatively well-established exchange traded funds in the US which boast ethical credentials. The chart below shows the resulting under and over performance for ESG ETFs versus the plain vanilla (evil) benchmarks.

What do the results tell us? The numbers point to an almost random in distribution i.e. no noticeable out performance or under performance. Given that most investors are worried about not saving enough for their retirement in the US and the UK (if not on the European continent), maybe it might be better to focus less on ESG factors and more on boosting long term capital growth?

<https://www.factorresearch.com/research-why-pension-funds-millennials-should-avoid-esg>

ESG Over- and Underperformance in the US



Measure	Values as of 11th November, 2019	Values as of 6th December, 2019
UK Government 10 year bond rate	0.80%	0.77%
GDP Growth rate YoY	1.00%	1.00%
CPI Core rate	1.70%	1.50%
RPI Inflation rate	2.40%	2.10%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.79%	0.78%
Government debt to GDP ratio	81.70%	81.70%
Manufacturing PMI	49.6	48.9

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Bank CDS options

Rates for bank credit default swaps universally edged up last month, which on initial inspection is odd given that risk assets have rallied in the last weeks. Either investors are right to be worried about the increasing risk of debt delinquencies (thus rising CDS rates) or the economy is looking relatively smooth and thus delinquencies are likely to stabilise. In reality of course what's probably going on is that rates on these swaps were arguably a little too low and prices are just re-adjusting.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.31	32.08	A	A2	A -
Barclays	10.84	37.7	BBB	Baa3	A
BNP Parabis	9.55	28.04	A+	Aa3	A+

Citigroup	20.23	50.50	BBB+	A3	A
Commerzbank	14.99	59.39	A-	A1	BBB+
Credit Suisse	11.05	43.73	BBB	Baa2	A-
Deutsche Bank	78.49	147.47	BBB+	A3	BBB
Goldman Sachs	22.58	58.90	BBB+	A3	A
HSBC	5.67	25.13	AA-	Aa3	AA-
Investec	n/a	n/a	NULL	A1	BBB+
JP Morgan	15.23	34.83	A-	A2	AA-
Lloyds Banking Group	7.24	30.70	BBB+	A3	A+
Morgan Stanley	22.37	55.82	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	21.49	54.49	BBB+	Baa1	A-
RBC	17.21	50.59	AA-	A2	AA
Soc Gen	9.01	29.59	A	A1	A
UBS	6.15	20.20	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st November 2019 www.tempo-sp.com

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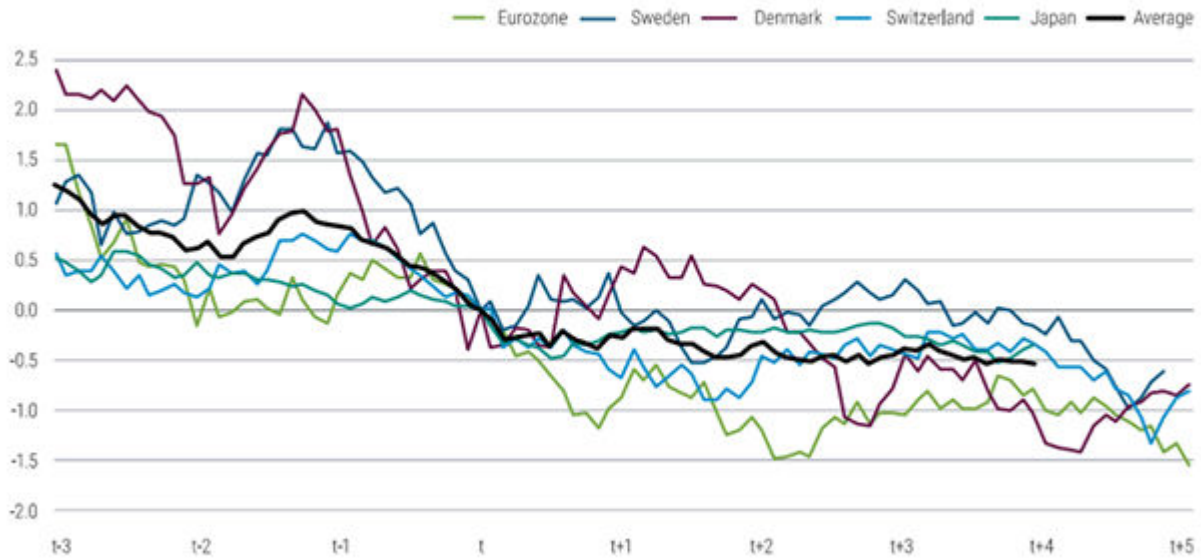
Government Bonds

Fixed Income

A short note this month on fixed income, which has, overall, enjoyed another excellent year in 2019, with prices up and yields generally down.

If anything, 2019 will be known as the year of the negative yielding bond. A recent fixed income event hosted by Reuters suggested that this epidemic of bonds with negative yields might be coming to an end, but the chart below from analysts at Pimco suggests that plenty of nations still suffer from the curse of negative yields.

Figure 2: 10 year sovereign bond rates, %



But how big is the total aggregate global pool of negative yielding bonds in issue?

The last number I've seen quoted at the beginning of September (by Bloomberg) suggested that this pool totals a mighty \$17 trillion. That's a big number especially when compared to measures of the total aggregate bond universe which usually come in at between \$50 and \$60 trillion, suggesting that going on for between a third and a quarter of the entire value of bonds issued is currently negative yielding.

UK Government Bonds 10-year Rate 0.77%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	17.94

Germany	8.79
Japan	21.57
United Kingdom	19.66
Ireland	25.37
Italy	138
Portugal	38.5
Spain	41

Eurozone peripheral bond yields

Country	November 2019	December 2019	Spread over 10 year
Spain 10 year	0.43%	0.49%	78
Italy 10 year	1.26%	1.35%	164
Greece 10 year	1.37%	1.51%	180

	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	November 2019	December 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	122	122	3636	121.6
FTSE 100 (Dec 17)	328	326.3	7329	n/a

November was yet another half decent month for equity markets, although the numbers do suggest that the extent of the bull rally is narrowing as the months go by with US equities (as always) leading the charge. According to analysts at S&P Dow Jones, amongst the 49 main stockmarkets globally 27 were up, down from 43 gainers in October, and 36 in September (3 in the fun month of August).

Overall, developed markets did better than emerging markets, as the U.S. (54.0% of the global equity market) outperformed for November, after two months of underperforming. November posted a 2.31% gain, after October's 2.70% gain and September's 1.88% gain (August posted -2.68%). For the three-month period, global markets posted a 7.05% gain - year-to-date, global markets were up 19.58%, and absent the U.S.'s 25.04% gain, they were up 13.60%.

According to S&P Dow Jones over the longer term, the U.S. dominated as we've come to expect - for the one-year period, global markets were up 10.78%, and absent the U.S.'s 13.19% gain, they were up 8.08%. The two-year global return was 7.04% with the U.S. gain of 17.28% and -3.30% without it, and the three-year return was up 31.03% with the U.S. gain of 40.70%, and absent the U.S., it was up 20.94%.

These numbers suggest those of us who've stayed invested in risky equities have done fairly well over the last few months - as indeed they have for much of the last ten years.

But if we look at investment sentiment through a different lens, a much more cautious picture emerges. Analysts at Cross Border Capital have looked at the share of US investors' portfolios devoted to so-called 'safe' assets (i.e. government bonds and cash). They reckon this currently stands at a relatively high 37%. According to Cross Border "this is consistent both with reports of persistent outflows from equity funds throughout this year and the further evidence cited in Figure 2 that World Investor Confidence (as sampled by State Street) remains depressed, despite the obvious up-turn in Global Liquidity conditions shown alongside".

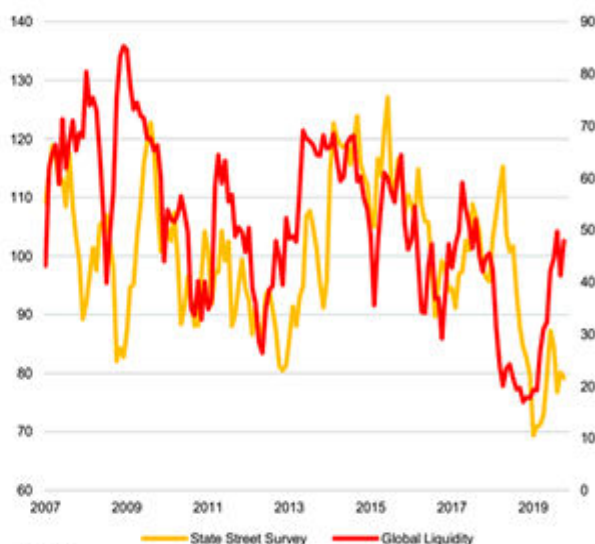
So, though the numbers tell a confident equity market, sentiment suggests very high levels of caution. Which set of indicators is right as we enter into 2020?

Figure 1
Share of 'Safe' Assets in US Investment Portfolios (All Investors)
Per Cent 1980-2019



Source
CrossBorder Capital, US Federal Reserve, BIS

Figure 2
State Street World Investor Confidence Survey and Global Liquidity
Indexes 2007-2019



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

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-2.12	-0.5	-0.278	7.99	7.37	10.5	7239
S&P 500	2.37	5.74	10.8	16.8	51.8	74.5	3149
iShares FTSE UK All Stocks Gilt	-0.804	-3.29	1.33	6.3	14.7	23.8	13.88
VIX New Methodology	15.1	-3.2	-8.85	-31.5	22.8	5.29	14.52

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Volatility

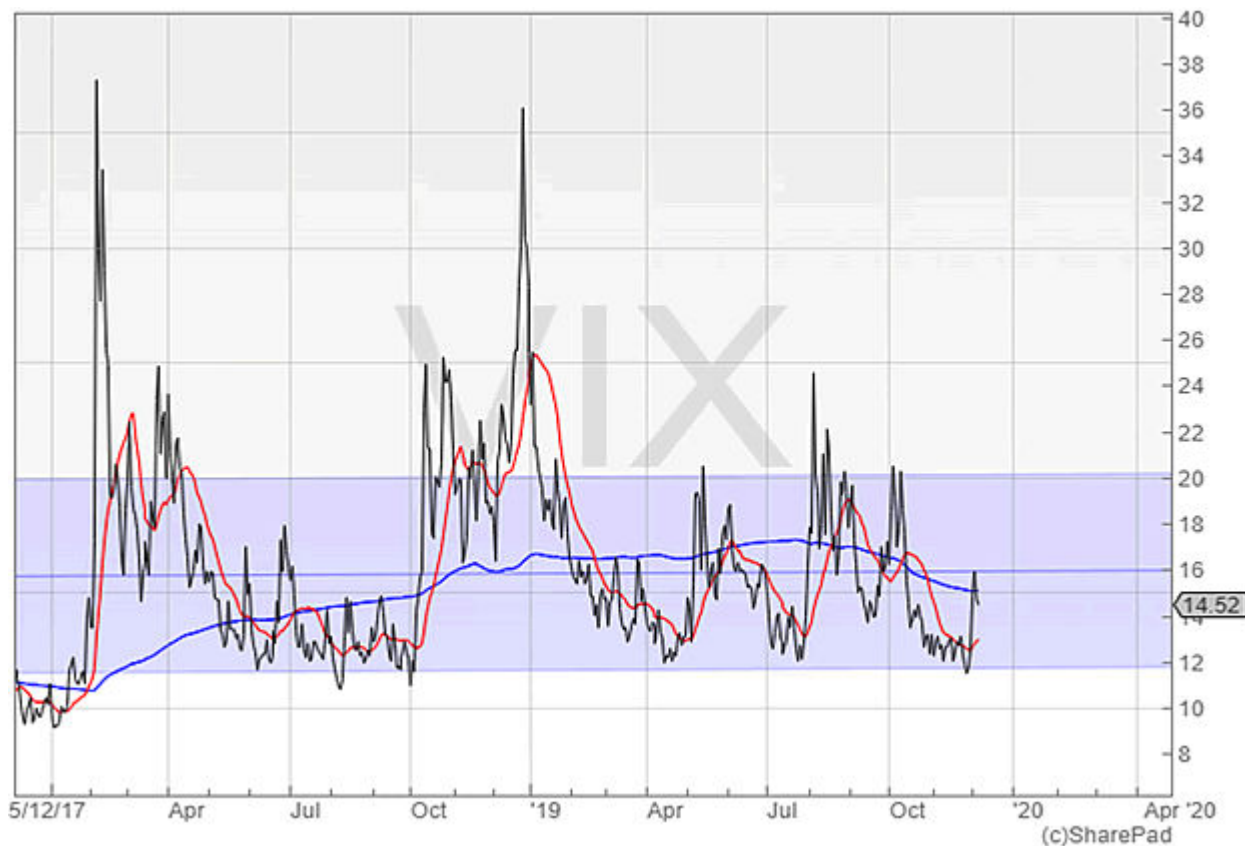
As we finish off 2019, I thought it might be worth highlighting one sector which has clearly demonstrated relatively low levels of volatility in terms of returns, not only over the last year but the last decade - structured products.

Ian Lowes and his colleagues at StructuredProductreview.com have run the numbers again on their survey of UK issued products and found that of the 1500 maturities between April 2009 and September 2019, the average annualised returns was 8.52% over an average term length of 2.09 years. 28 of the 1500 simply returned capital only with no gain and 23 plans matured with a loss - according to StructuredProductReview "that leaves 1449 produced which matured with gains - 96.6% of all maturities!".

Capital at risk autocall plan maturities

1500	900	600
8.52%	8.13%	9.10%
12.21%	10.83%	13.72%
5.03%	6.05%	3.79%
23	0	23
28	9	19

Source: StructuredProductReview.com



Measure	December Level	November Level	October Level	September Level
Vstox Volatility	13.4	13.09	18.3	18.15
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 fix 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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