To view this email in your browser, please click here

Monthly Market Report

February 2020

With commentary from David Stevenson

There's a general tendency amongst investors - and investment commentators - to be cautious about prospects for the new year. I, like most people, tend to invoke words like late cycle or fully valued which tends to signify a high level of caution. But what happens if we're all too cautious? Maybe 2020 might be another great year for investors despite 2019 also being a great year?

This duality echoes what one might call the static vs dynamic explanation for markets. The static explanation looks backward, at backward looking measures such as valuation. In recent years, these measures have tended to always look a bit high. One current example - currently, 61% of S&P 500 stocks are trading above their respective 100-day average. The natural next thought is that what goes up, must eventually come down.

But maybe that will happen in 2021 or 2022? Cue the dynamic view which says that although valuations matter, investors should follow the flow (or flood) of money. More pertinently they should follow the flood of money coming from central banks. This more dynamic way of looking at markets as giant momentum machines tends to support a more bullish view.

And here's my central challenge for investors and their advisors as they approach 2020. My guess is that we of course late cycle and that valuations, especially in US equities, are looking stretched. It's also impossible to deny that the global economy has slowed in the last few years and that the tariff war has had an impact. Logic suggest caution. But what happens if economic growth does pick up globally? And central banks resume pumping ever more cash into the global economy? And Trump looks like he'll cruise to a win over Warren/Sanders? It's easy to imagine a scenario in which we have what's been called a melt up and markets become even MORE expensive as momentum picks up speed. Personally, I'm more cautious than that and think that we're in for very nasty bumps in 2020, but my challenge is for investors to at least consider the thought that 2020 could be another solid year of bull market gains? Stranger things have been known to happen.

Contents

- Headline numbers
- CDS Rates
- Government Bonds
- Equity Markets and Dividend Futures
- Volatility
- Summary of Pricing Impact on Structured Products
- Explanation of Terms

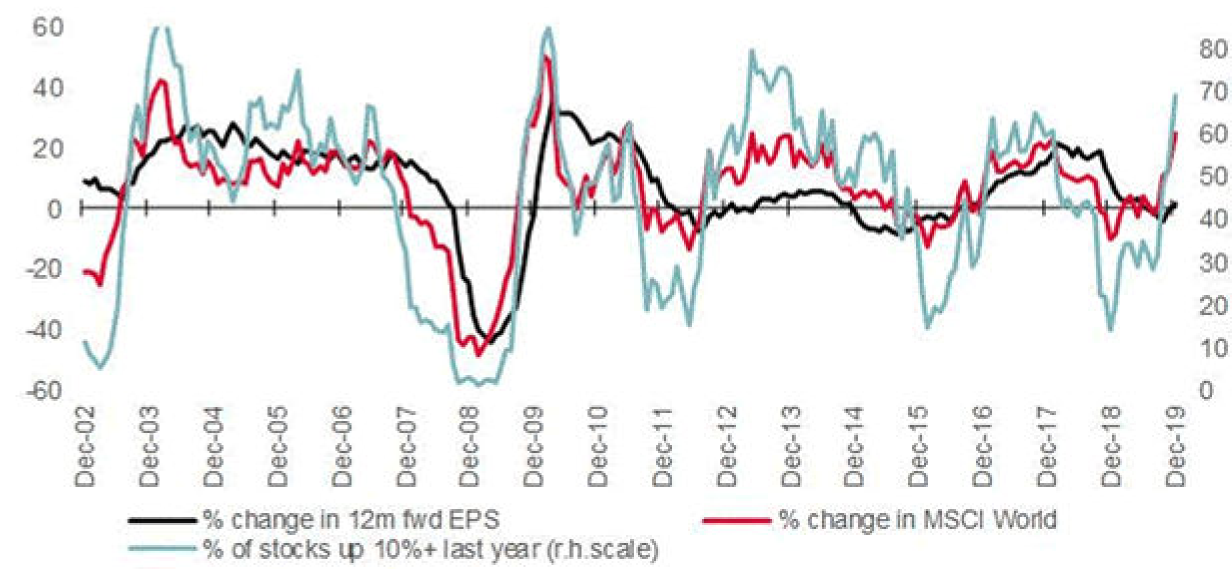
Headline Numbers

The threat from slower profits growth
One of the reasons why so many investors - and commentators - are cautious about the new year is that in the real world outside of stockmarkets, growth is looking subdued. This feeds through into anaemic profits growth or even profit squeezes. The first chart below from the SG quant team reminds us that although stocks have advanced in 2019, earnings expectations are still firmly anchored in low growth or a decline in profits. The second chart below, also from SG, repeats that point by looking at profit margins.

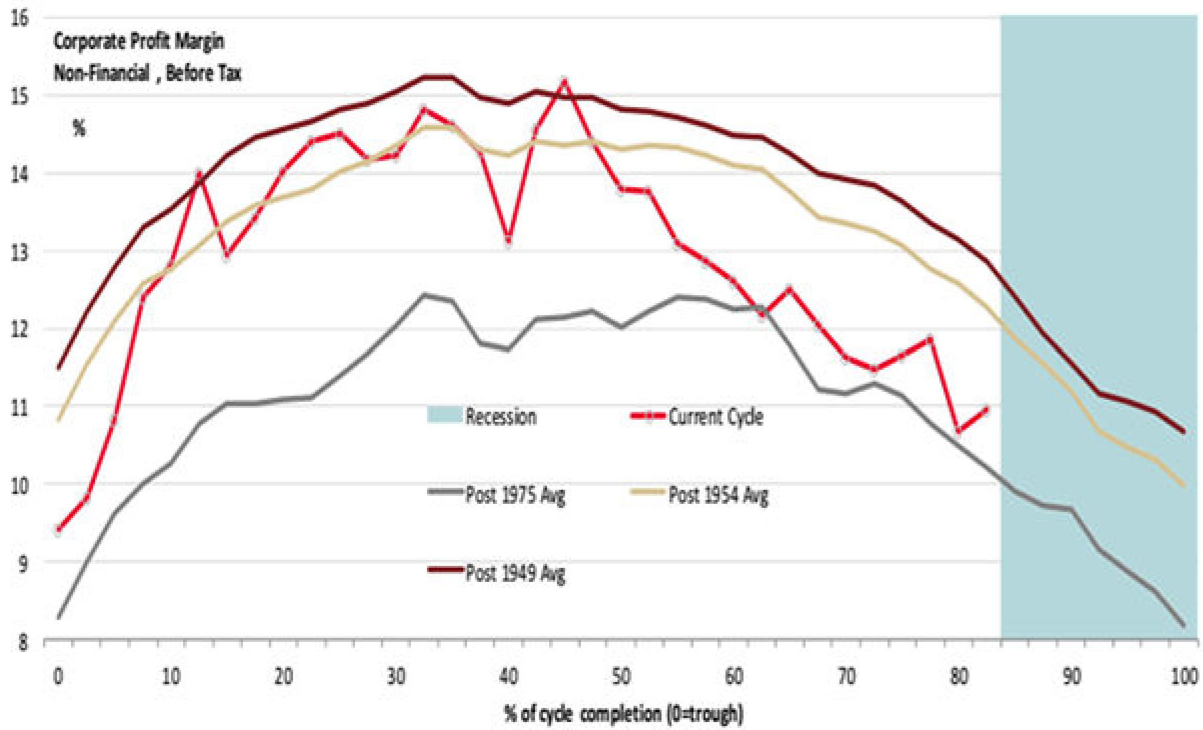
According to the bank's US economist Steve Gallagher, there's a real possibility of a profits squeeze. The Sg analysts also suggest that "given limited scope for fiscal support due to this year being an election year, US corporate profit margins are all the more under scrutiny. Focusing on National Income and Product Accounts (NIPA) profit margins, we expect the profit now in its fourth year to continue. With labour productivity continuing to rise at a sub-average rate of around 1.7% and wage growth gradually picking up, unit labour cost growth has jumped to its highest pace in five years."

This squeeze contrasts sharply with what investors have baked into their valuations for 2020 - 70% of stocks in MSCI World posted gains of 10% or more last year. Overall the MSCI World index delivered a total return of over 28%, with almost all of that coming from P/E expansion, and the decade ended with the index trading at 17x forward EPS, close to its highest forward valuation outside of the tech bubble. All of this might make sense IF profits growth picks up in 2020, but that's a big IF.

Most stocks up, NSCI World up, expectations are down



Source: SG Cross Asset Research



Tech stocks power ahead
When we talk about 'markets' moving forward or upwards, we frequently neglect an important truth - that big index advances are frequently powered by a small number of sectors and stocks. Analysts at index firm S&P Dow Jones have been crunching the numbers for last year and reckon that the IT (tech) sector accounted for 31.3% of the YTD 2019 total return, with just two stocks, Apple and Microsoft accounting for 14.8% of that gain (17.8% for MTD December 2019).

Highest contributions for YTD 2019				
COMPANY	**TR**	**CONTRIB.**	**SECTOR**	**TICKER**
Apple Inc.	86.49%	**8.19%**	Information Technology	AAPL
Microsoft Corporation	58.83%	**6.59%**	Information Technology	MSFT
Facebook, Inc. Class A	58.75%	**2.84%**	Communication Services	FB
Amazon.com, Inc.	24.49%	**2.43%**	Consumer Discretionary	AMZN
JPMorgan Chase & Co.	46.99%	**2.08%**	Financials	JPM
Mastercard Incorporated Class A	60.31%	**1.56%**	Information Technology	MA
Visa Inc. Class A	44.46%	**1.55%**	Information Technology	V
Bank of America Corp	46.70%	**1.48%**	Financials	BAC
AT&T Inc.	46.21%	**1.42%**	Communication Services	T
Alphabet Inc. Class C	30.54%	**1.40%**	Communication Services	GOOG
Procter & Gamble Company	41.03%	**1.38%**	Consumer Staples	PG
Alphabet Inc. Class A	29.64%	**1.33%**	Communication Services	GOOGL
Citigroup Inc.	57.35%	**1.09%**	Financials	C
Home Depot, Inc.	31.49%	**0.97%**	Consumer Discretionary	HD
Walt Disney Company	34.55%	**0.96%**	Communication Services	DIS

If we take these numbers back ten years, to 2009, S&P Dow Jones suggests that those two stocks, Apple and Microsoft accounted for 8.45% of the total return. Or to put it another way, just three stocks - Amazon, Apple and Microsoft - accounted for more of the total returns than the next ten fastest growing stocks.

S&P Dow Jones Indices		12/27/2019		
Highest contributions for the decade-to-date				
COMPANY	**TR**	**CONTRIB.**	**SECTOR**	**TICKER**
Apple Inc.	1006.48%	**5.77%**	Information Technology	AAPL
Microsoft Corporation	562.54%	**2.68%**	Information Technology	MSFT
Amazon.com, Inc.	1289.98%	**2.10%**	Consumer Discretionary	AMZN
Exxon Mobil Corporation	41.81%	**1.57%**	Energy	XOM
Johnson & Johnson	205.72%	**1.35%**	Health Care	JNJ
Home Depot, Inc.	862.91%	**1.31%**	Consumer Discretionary	HD
Pfizer Inc.	212.51%	**1.23%**	Health Care	PFE
JPMorgan Chase & Co.	324.72%	**1.21%**	Financials	JPM
Chevron Corporation	126.80%	**1.21%**	Energy	CVX
Berkshire Hathaway Inc. Class B	194.07%	**1.20%**	Financials	BRK.B

Measure	Values as of 6th December, 2019	Values as of 13th January, 2019
UK Government 10 year bond rate	0.77%	0.77%
GDP Growth rate YoY	1.00%	1.10%
CPI Core rate	1.50%	1.50%
RPI Inflation rate	2.10%	2.20%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.78%	0.80%
Government debt to GDP ratio	81.70%	80.80%
Manufacturing PMI	48.9	47.5

Back to menu

Bank CDS options

Rates of credit default swaps for the major banks mostly ticked up over the month to January 6th although a few banks such as JPMorgan Chase saw their rates decline. That said pretty much all the major E~UK banks increase which shouldn't come as a great surprise given the worries about the UK economy in 2019 - and the likely knock on impact on loan defaults.

	5Y CDS Rate Rank	ΔCDS%
1	Cooperatieve Rabobank UA	↑
2	UBS AG	↓
3	BNP Paribas SA	↑
4	Societe Generale SA	↑
5	Credit Suisse AG	↑
6	HSBC Bank PLC	↑
7	JPMorgan Chase & Co	↓
8	Commerzbank AG	↑
9	Bank of America Corp	↑
10	Banco Bilbao Vizcaya Argentaria SA	↑
11	Danske Bank A/S	↓
12	Natixis SA	↓
13	Credit Suisse Group AG	↓
14	Citigroup Inc	↑
15	Lloyds Bank PLC	↑
16	UBS Group AG	↑
17	Morgan Stanley	↑
18	HSBC Holdings PLC	↑
19	Lloyds Banking Group PLC	↑
20	Goldman Sachs Group Inc/The	↑
21	Royal Bank of Canada	↑

Average Issuer Credit Rating Rank	
1	Cooperatieve Rabobank UA
	HSBC Bank PLC
	Royal Bank of Canada
	UBS AG
2	BNP Paribas SA
3	Lloyds Bank PLC
	Morgan Stanley & Co International PLC
	Natixis SA
4	Citigroup Global Markets Ltd
	Credit Suisse AG
	Goldman Sachs International
5	HSBC Holdings PLC
6	JPMorgan Chase & Co
	Societe Generale SA
7	Bank of America Corp
	UBS Group AG
8	Danske Bank A/S
9	Lloyds Banking Group PLC
10	Commerzbank AG
11	Banco Bilbao Vizcaya Argentaria SA
	Citigroup Inc
	Goldman Sachs Group Inc/The
	Morgan Stanley
12	Credit Suisse Group AG

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	6.17	26.23	A	A2	A -
Barclays	12.03	35.67	BBB	Baa3	A
BNP Parabis	8.15	24.12	A+	Aa3	A+
Citigroup	19.12	58.29	BBB+	A3	A
Commerzbank	15.80	62.66	A-	A1	BBB+
Credit Suisse	7.29	40.00	BBB+	Baa2	A-
Deutsche Bank	76.49	145.52	BBB+	A3	BBB
Goldman Sachs	21.96	57.22	BBB+	A3	A
HSBC	6.51	26.18	AA-	Aa3	AA-
Investec	n/a	n/a	NULL	A1	BBB+
JP Morgan	15.82	34.81	A-	A2	AA-
Lloyds Banking Group	8.94	29.24	BBB+	A3	A+
Morgan Stanley	20.99	52.66	BBB+	A3	A

Natixis	34.08	46.43	A1	A1	A+
Nomura	20.01	50.77	BBB+	Baa1	A-
RBC	17.17	50.62	AA-	A2	AA
Soc Gen	7.99	26.40	A	A1	A
UBS	6.97	21.09	A-	Aa3	A+

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

Back to menu

Government Bonds

Fixed Income

Bond investors have made bumper profits over the last decade of modest from steady economic growth. Economies may not have grown fast enough to push wages up by as much, but we've largely avoided deadly recessions which can result in big losses for investors in corporate credit/bonds. According to one of the world's largest bond investors, Pimco, this relatively benign environment might continue into 2020. The asset manager reckons that the current window of weakness in global growth will give way to moderate recovery during 2020. They accept that the current slowdown might carry on for a few more months but using forward looking measures such as their World Financial Conditions, their global numbers suggest that " output growth has been easing (rising) in recent months pointing to a moderate cyclical growth recovery in the course of this year". The table below maps out Pimco's estimates for economic growth in key economies with the UK expected to show GDP growth of between 0.75% - 1.25%, though personally I sense those estimates may surprise to the upside in the UK.

	REAL GDP GROWTH (% YOY)			CPI INFLATION (% YOY)		
	2018	2019 estimate	2020 forecast	2018	2019 estimate	2020 forecast
DM[1]	2.2	1.7	1.00-1.50	2.1	1.4	1.25-1.75
U.S.	2.9	2.3	1.50-2.00	2.5	1.8	1.75-2.25
Euro area	1.9	1.2	0.75-1.25	1.8	1.2	0.75-1.25
U.K.	1.4	1.3	0.75-1.25	2.5	1.8	1.25-1.75
Japan	0.8	0.9	0.25-0.75	1.0	0.5	0.25-0.75
EM[2]	5.6	4.8	4.25-5.25	2.7	3.2	3.00-4.00
China	6.6	6.1	5.00-6.00	2.1	2.9	3.00-4.00
Brazil	1.1	0.9	1.00-2.00	3.7	3.7	3.50-4.50
Russia	2.3	1.2	1.50-2.50	2.9	4.5	2.75-3.75
India	7.4	5.2	5.50-6.50	3.9	3.4	3.50-4.50
Mexico	2.0	0.5	0.50-1.50	4.9	3.7	3.50-4.50
World[3]	3.3	2.7	2.25-2.75	2.3	2.0	1.75-2.25

What's helped stabilise what looked like a dangerous situation is massive central bank intervention. In the US a debate has been raging between those who think the US Federal Reserve is merely tweaking money market policy and those (the majority) who reckon we are witnessing QE4. Sitting very much in the latter camp is London based research house Cross Border. They focus on global liquidity flows and the impact that extra pump priming has on stockmarkets.

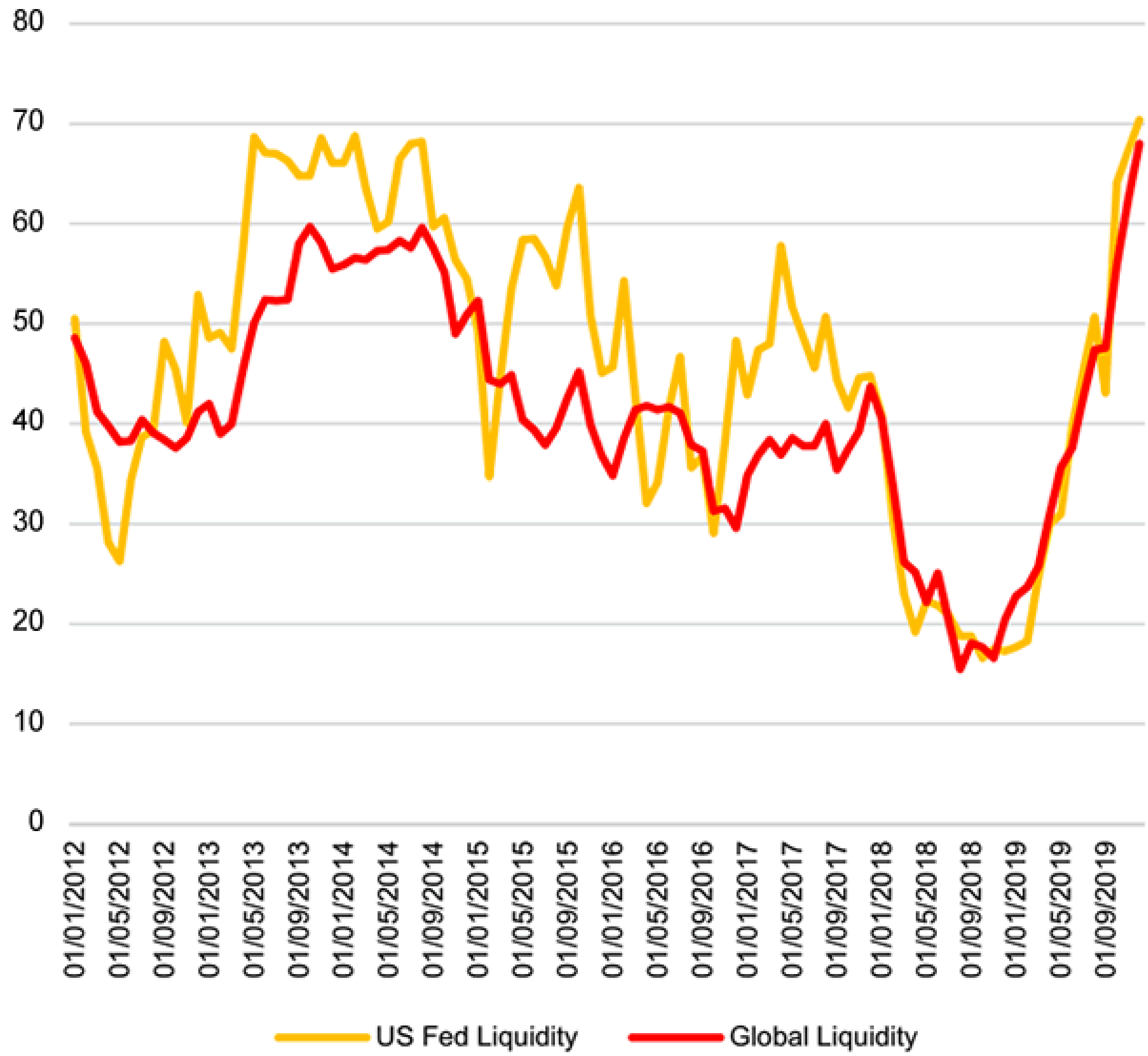
In a recent note to clients they observed the current monetary easing has "delivered the greatest liquidity boost to the US economy since the immediate aftermath of the 2008 GFC and the 9/11 terrorist attacks in 2001. Measured over a 12-month period and put into standard form, this is arguably the biggest boost ever!". Cue the second chart below which shows a dramatic easing in liquidity. All of this might feed through into better than expected sales and earnings growth - and above trend GDP growth which could kick through into surging earnings, and thus even more bullish stockmarkets.

But there's a sting in the tail for bond investors, according to Cross Border. They think it possible that as the economy picks up speed, "US 10-year Treasury yields could test 3%, which is equivalent to a **10-15% fall** from current levels. Bond market selloffs typically precede stock market falls. Consequently, although we remain invested in equities, we shall be closely watching both the liquidity data and the response of the bond markets to time our exit from stocks". Bond investors beware!

Figure 2

US Federal Reserve Liquidity and Global Liquidity Indexes

'Normal' Range 0-100   2012-2019



Source

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

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	18.37
Germany	8.56
Japan	21.1
United Kingdom	18.94
Ireland	22.76
Italy	124
Portugal	36.99
Spain	4.49

Eurozone peripheral bond yields

Country	December 2019	January 2020	Spread over 10 year
Spain 10 year	0.49%	0.43%	63
Italy 10 year	1.35%	1.32%	151
Greece 10 year	1.51%	1.36%	156

	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

Index	December 2019	January 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	122	12.9	3791	123
FTSE 100 (Dec 17)	326.3	327.2	7758	n/a

Continuing with my theme of reviewing 2019 in the rear-view mirror, I've pulled together a bunch of useful equity market stats for the last year.

For me the standout statistic is that at the end-2019, 61% of S&P 500 stocks were trading above their respective 100-day average (which is very bullish), with this percentage having gradually increased throughout the year– 58% for defensive stocks, versus 63% for cyclical stocks.

These numbers also tell us that the current bull market is very much powered by US equities - on most measures the US indices have continued to outperform. American equities now comprise 53.5% of global markets, up from 41.1% in 2009.

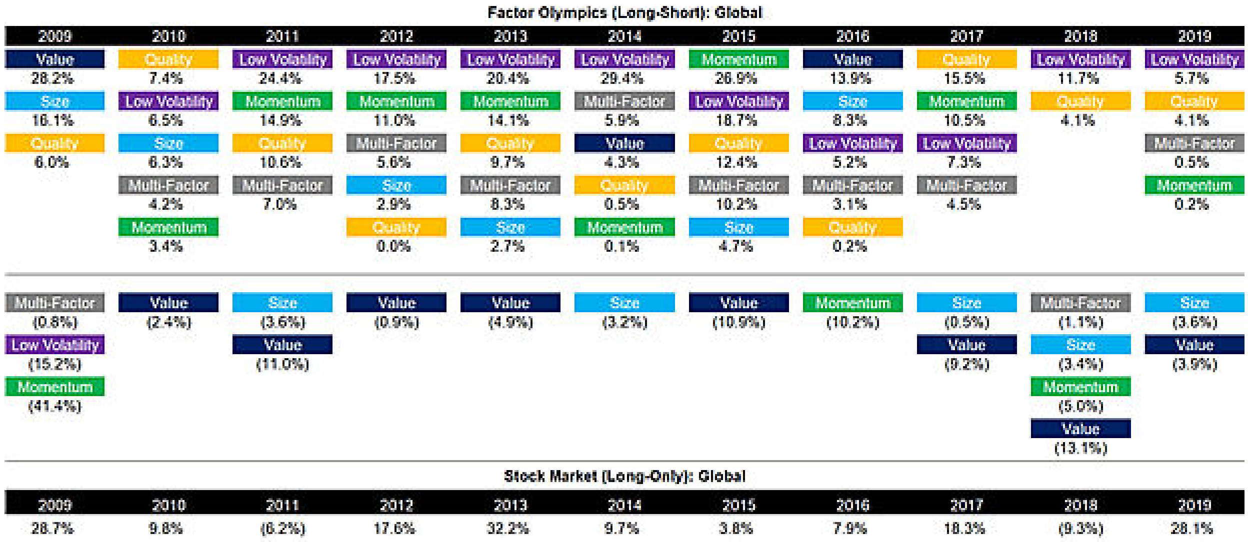
S&P Global Broad Market Index(BMI) Global						12/27/2019
BMI MEMBER	FROM 11/8/16	MTD	YTD	QTD	FR 12/17	FR 12/16
Global	37.02%	3.63%	23.92%	8.89%	9.25%	33.07%
Global Ex-U.S.	23.82%	4.40%	18.60%	9.00%	-1.25%	23.37%
Emerging	24.28%	6.74%	16.59%	10.93%	-1.94%	29.63%
Developed	38.53%	3.25%	24.78%	8.64%	10.59%	33.51%
Developed Ex-U.S.	23.66%	3.67%	19.13%	8.40%	-1.10%	21.80%
United States	50.13%	2.98%	28.77%	8.80%	19.73%	42.36%

But what kind of stocks have done well within this broad US-led equity rally?

Nicholas Rabener at Factor Research has crunched the global stats to find out which types or styles of shares outperformed in 2019. He reckons the big story has been the inverse relationship between unloved value stocks and low volatility equities. In 2019 these two styles "behaved liked polar opposites, which was especially apparent from May onward, where Low Volatility generated strongly positive and Value significantly negative returns."

Otherwise Rabener observes that there was a significant rotation from Momentum, Quality, and Low Volatility into Value in September 2019, "but this was short-lived and no structural shift in the trend of the Value factor performance seems to have occurred."

The bottom line? Value stocks remain unloved.



Last but by no means least investment platform Willis Owen have looked at how these big picture numbers impacted returns in the UK at the funds level. First up in the box below, the top performing fund sectors in the UK, followed by the second table which highlights the inevitable pack of dog funds that have underperformed.

Unsurprisingly growth equity funds seemed to be in the ascendant with absolute returns funds trailing a very long way behind… again!

Is it time maybe for all those poor absolute returns investors to at least consider using structured products as an alternative?

10 best-performing sectors

Investment Association Sector	Percentage Return
Technology & Telecommunications	310.88
North American Smaller Companies	279.55
North America	248.61
Japanese Smaller Companies	246.59
UK Smaller Companies	245.71
European Smaller Companies	179.07
Global	149.15
Global Equity Income	143.71
Japan	141.40
UK All Companies	129.78

Source: FE Analytics, performance from 31st December 2009 to 31st December 2019 in pounds sterling on a total return basis.

10 worst-performing sectors

Investment Association Sector	Percentage Return
Targeted Absolute Return	26.45
Global Bonds	50.98

Mixed Investment 0-35% Shares	52.14
Global Emerging Markets Bonds	58.68
Specialist	59.21
UK Gilts	64.74
Sterling Strategic Bond	64.96
UK Direct Property	66.88
Mixed Investment 20-60% Shares	67.23
Global Emerging Markets	68.23

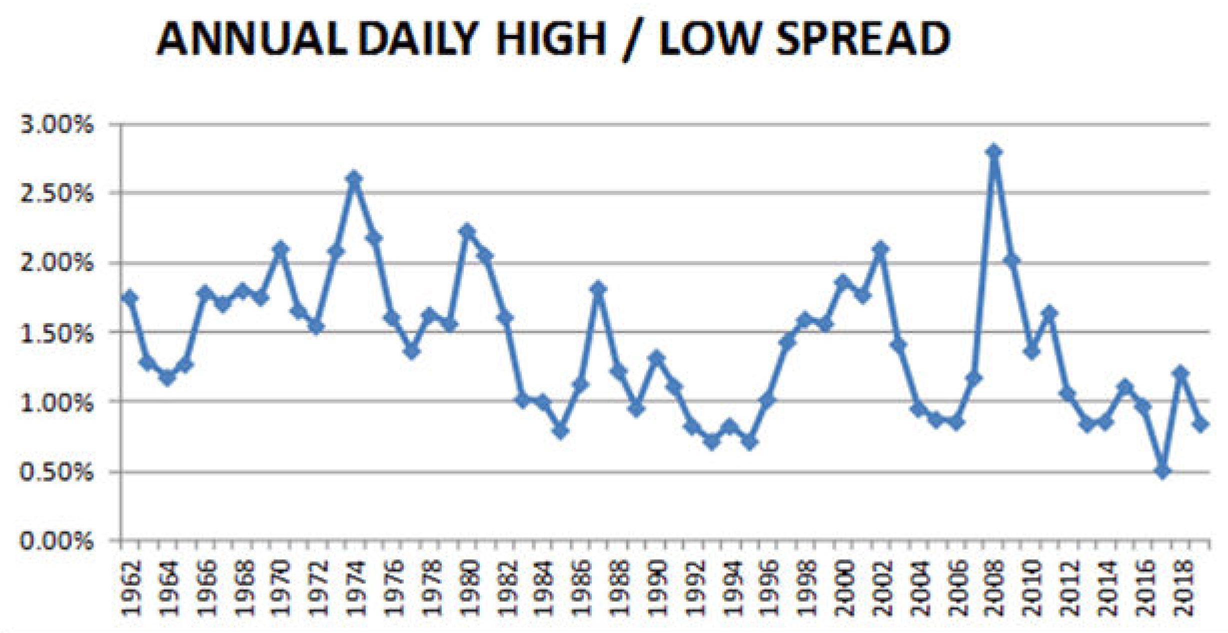
Source: FE Analytics, performance from 31st December 2009 to 31st December 2019 in pounds sterling on a total return basis.

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	5.19	5.59	0.75	9.29	16.7	12.6	7587
S&P 500	4.52	11.4	9.39	26.1	60.1	77.7	3274
iShares FTSE UK All Stocks Gilt	0.487	-2.76	1.05	5.74	10.4	23.8	13.91
VIX New Methodology	-20	-28.6	-3.76	-35.7	-28.5	3.29	12.54

Back to menu

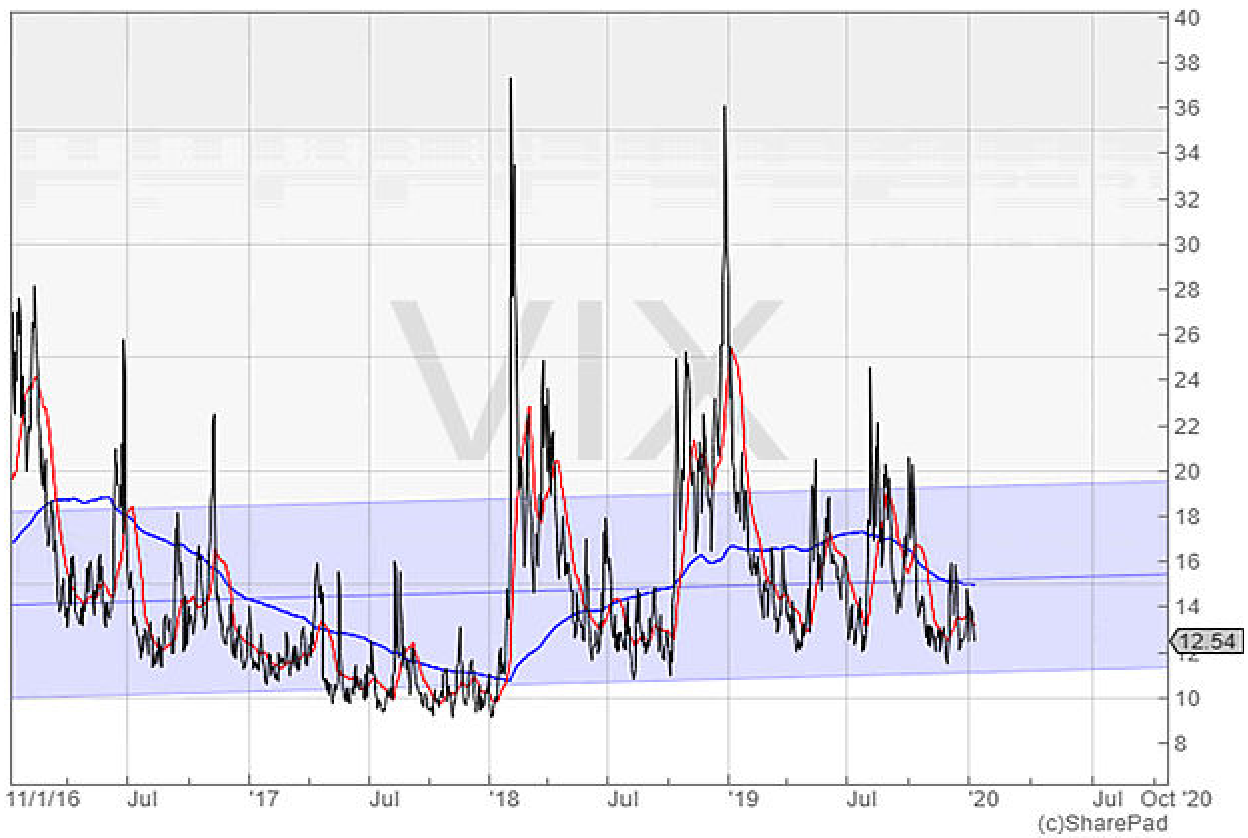
Volatility

Finishing off our observations on stock markets in 2019, an obvious point to make is that equities in the US in particular have remained fairly steady in a bullish trend, with no huge pulses of volatility. The two charts below from S&P Dow Jones tell this story succinctly. The first shows the average annual daily high/low spread, with 2019 well below the long-term average. The second chart reminds us that this relatively low level of market turbulence also boasted relatively strong market breadth i.e. most stocks remained within a bullish trading range.



Market breadth

PERIOD	UP/DOWN RATIO	UP ISSUES	UNCHANGED ISSUES	DOWN ISSUES	AVERAGE % CHANGE	TOP 10 BY MKT VAL % AVG CHG	TOP 25 BY MKT VAL % AVG CHG	TOP 50 BY MKT VAL % AVG CHG	S&P 500 % CHANGE
YTD 2019	7.47	441	5	59	27.64	39.34	29.80	29.82	29.25
2018	0.53	174	0	331	-8.48	-10.00	-16.27	-8.62	-6.24
2017	3.02	377	3	125	17.85	32.11	32.11	24.81	19.42
2016	2.50	352	2	141	11.47	15.00	11.61	9.73	9.54
2015	0.76	215	7	282	-3.73	16.52	10.53	8.40	-0.73
2014	2.98	373	4	125	12.61	11.37	10.66	12.23	11.39
2013	11.15	457	2	41	34.93	28.63	24.67	34.75	29.60



Measure	January Level	December Level	November Level	October Level
Vstoxx Volatility	12.7	13.4	13.09	18.3
VFTSE Volatility	n/a	n/a	n/a	n/a

Back to menu

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)

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