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UK Structured Products Association ™

Monthly Market Report

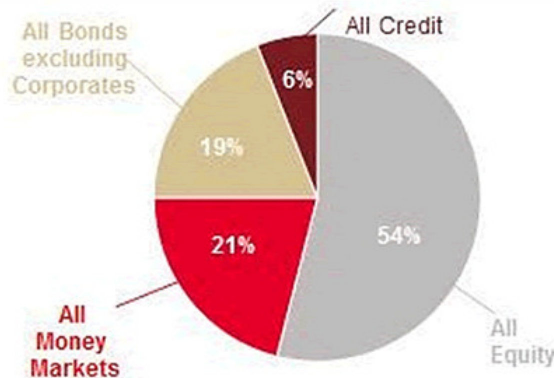
April 2019

With commentary from David Stevenson

So far, so good. 2019 is shaping up nicely. The FTSE All-Share index is up 7.2% year to date, with the MSCI World up 7.1%. Over the last 12 months, the equivalent numbers 2.9% and 6% respectively and it's only when we get to the 3-month mark that we see a small loss of 0.7% for the MSCI World. What's really interesting is that most of the excitement so far has been purely about price - investors don't seem to be putting much new money to work in the equities space.

Most flows are subdued according to SocGen's Arthur Van Slooten - he reckons that net inflows have hardly mattered. According to the SG analyst since the trough in December, total assets managed by the universe of funds that report on a weekly basis have increased by just 8% (from $18.8tn to $20.3tn) with only 4.2% of that increase in assets explained by the result of inflows and outflows. "Said differently, overall performance heavily depends on having selected an appropriate asset allocation."

And what does that asset allocation currently look like? The chart below from SG nicely sums up the global positioning.



Breakdown of asset under management (AuM) as a % of all funds. Combined data for mutual funds and ETFs, weekly statistics to 20/02/2019. Source: EPFR GLOBAL, SG Cross Asset Research/GAA

We may have had a big sell off in the last quarter of last year but equities still look to be the biggest part of most portfolios, and its worth noting that despite the recent sell off the current equity weight is higher than its average weight since 2010. Within the equity space despite all the worries about FAANGs and tech stocks, they are still heavily over owned as are US equities. And the unloved? It's still energy stocks, EM and Europe. But there is one interesting additional overweight - in cash and money market accounts, which is running at around 21%. Is this huge lump of money looking for a new home?

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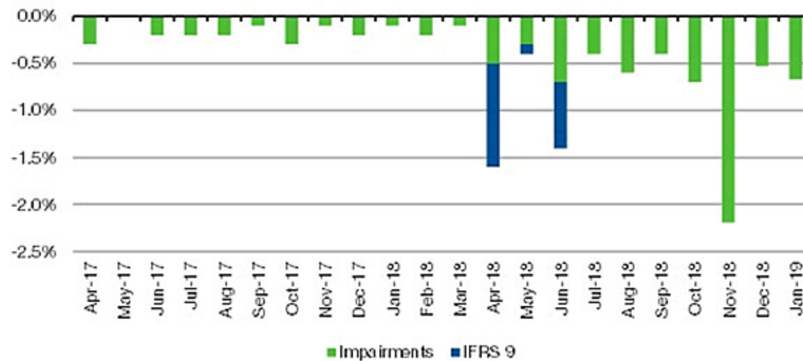
Headline Numbers

I'm always on the look out for small signals that might indicate trouble is on its way in the UK and one is flashing amber, if not red at the moment - SME lending. One of the big advantages of disruption within financial services is that intensified competition tends to result in lower interest rates charged to borrowers as capital providers swarm into markets opened up by technology. This seems to be the case in SME lending where great outfits like Funding Circle have worked wonders in advancing capital to borrowers.

The downside of this is that during some years, that pricing of the interest rate is just plain wrong i.e the interest rate charged is too low compared to the level of arrears and defaults, all revealed after a year or two. We can see a glimpse of this in reporting from Finding Circle's SME Income fund which is now one of the biggest, most liquid ways of accessing SME lending.

The slightly worrying news here is that the fund has been suffering from a high level of defaults and arrears. According to analysts at Liberum, the fund's impairment rate has been running at 7.0% to date in FY2019 (ten months to January 2019). This compares to 2.0% in the whole of FY2018. The chart below from Liberum sums up the deteriorating situation for the fund.

Funding Circle SME Income Fund - monthly impairments (% of NAV)



Source: Liberum estimates, Company data

There are I think two possible readings of this situation. The first is that as one of the biggest SME lenders, Funding Circle (and its funds) are on the frontline of a deterioration in the credit quality of lending to SMEs - which might in turn indicate a very fragile domestic economy. The other narrative is that these lenders aren't charging enough for their risky loans, which in turn means that they need to up interest rates. Neither narrative is an optimistic one.

All roads lead to Rome

I think it is fair to say that over on the continent, Brexit is not the biggest worry amongst investors and policy makers. Their concerns are much more centred on Italy, whose populist political leasers are trying to kick start the local economy. There's much talk of a fiscal stimulus, which has now been dialled down to get EU permission, but the real headwinds centre around excessive levels of state debt and most especially weak banks. My overall impression is that the Italian banking sector is actually in fairly decent shape, with strong balance sheets, lots of tier 1 capital (13.6%) and much lower levels of nonperforming assets. But there are clearly some very localized problems, and a few weeks ago Bath-based risk consulting house Check risk brought out an excellent note which pinpointed the specific banks of concern - and lavishly lays out the hard numbers behind the potential crisis. The report identifies the following as names to worry about: Banca Monte dei Paschi, Banco BPM, Credito Valtellinese and Union di Banche Italiane. The contagion effect of these banks is also obvious - they have significant exposure to Italian sovereign bonds.

Name	DtD	Sensitivity Benign	Sensitivity Distressed	Non Perf. Asset	Trail 12M EPS	Tier 1 Cap Ratio	Loan to Deposit
Banca Mediolanum	3.8	362.0	59.9	0.3	0.35	14.61	78.6
Banca Monte dei Paschi di Siena	1.1	28.0	3.3	12.9	0.25	12.49	133.4
Banca Popolare di Sondrio	3.6	346.1	63.9	10.1	0.25	11.75	93.9
Banco BPM	1.8	85.9	12.3	7.4	-0.04	12.26	104.0
BPER Banca	2.6	204.9	29.0	10.0	0.84	14.37	114.5
Credito Emiliano	3.5	324.2	62.4	2.6	0.56	13	117.4
Credito Valtellinese	1.7	1.6	0.0	7.5	0.00	16.82	113.4
Intesa Sanpaolo	3.1	198.9	28.4	4.6	0.24	15.2	100.0
Mediobanca	3.5	247.4	42.6	3.1	0.95	14.24	202.5
UniCredit	3.0	229.6	43.7	4.6	1.73	13.64	103.9
Unione di Banche Italiane	2.4	129.2	16.9	7.8	0.37	11.7	136.3
Mean Value	*2.7*	*196.2*	*32.9*	*6.4*	*0.5*	*13.6*	*118.0*

Clearly if these banks did crash and burn, the impact on the wider banking system in Europe could be huge : the Check risk report lists the following banks as most sensitive to a 5% or worse distress event in Italian banking: Societe Generale, HSBC, Aareal, Lloyds, BBVA, ING, RBS, UBS, Standard Chartered, Bank of Ireland and Danske Bank. The table below outlines the banks most on the hook to Italy. My own sense is that the risks - even in the most catastrophic situation, are very low. But its definitely one to watch in the downturn.

Name	DtD	Sensitivity Benign	Sensitivity Distressed	Tier 1 Cap Ratio	Sensitivity to Italian Banks	Criticality to Banking System
Societe Generale	4.5	312.6	46.6	13.7	13.9	6
HSBC	5.4	413.8	71.2	17.3	13.1	17
Aareal Bank	4.4	399.3	66.5	23.8	12.6	20
Lloyds Banking	5.6	352.1	56.6	17.6	12.2	2
Banco Bilbao Vizcaya Argentaria	4.2	399.6	75.6	13.2	12.1	18
ING Groep	4.4	326.1	46.4	16.2	10.9	5
Royal Bank of Scotland	3.9	224.0	31.2	20.6	10.6	1
UBS	4.3	327.4	62.7	17.7	10.3	10
Standard Chartered	4.3	293.8	43.3	16.6	9.9	19
Bank of Ireland	3.4	176.6	22.4	16.9	9.8	9
Danske Bank	3.3	197.5	35.3	20.1	6.6	11

Measure	Values as of 7th February, 2019	Values as of 8th March, 2019
UK Government 10 year bond rate	1.18%	1.19%
GDP Growth rate YoY	1.50%	1.30%
CPI Core rate	1.90%	1.90%
RPI Inflation rate	2.50%	2.50%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.85%	0.84%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	52.8	52

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Bank CDS options

The pricing of credit default swaps has declined sharply again this month, with nearly all the major European banks experiencing a sharp decline in pricing for their 1 and 5 year swaps - with only Natixis and Credit Suisse resisting with slight increases in rates. The US banks by and large didn't experience quite the same big declines although swap rates also edged back. One interesting stat - rates on one- and five-year credit default swaps for Rabobank, HSBC Bank and UBS are now below those on offer for the UK government. Who said that investing with the UK Treasury was 'risk free'? The markets are suggesting that (some) banks might actually be safer.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	18.92	76.43	-5.51	83.90	A -
Barclays	24.16	65.6	-15.42	32	A
BNP Parabis	12.52	47.5	-12.31	75.83	A
Citigroup	25.68	61.07	-2.17	24	A
Commerzbank	27.53	92.66	-13.58	61.91	A+
Credit Suisse	23.73	74	-5.9	26.53	A
Deutsche Bank	66.24	159	-11.37	75	A+
Goldman Sachs	32.31	82	-0.22	38	A
HSBC	11.06	31.18	-17	32.86	AA-
Investec*	n/a	76	n/a	n/a	BBB
JP Morgan	21.54	50.74	-3.21	-3.21	A+
Lloyds Banking Group	18.43	-15.89	-15.89	29.44	A
Morgan Stanley	27.47	-4.23	-4.23	19.32	A
Natixis	33.82	0.07	0.07	126	A
Nomura	16.12	-5.21	-5.21	11.57	A-
Rabobank	8.34	-13.50	-13.50	8.37	AA-
RBC*	15.44	-8.32	-8.32	n/a	AA
RBS/Natwest Markets	30.03	-18.75	-18.75	19.8	AA
Soc Gen	17.16	-13.0	-13.0	77	A
UBS	24.31	-3.19	-3.19	47.68	A

Source: www.meteoram.com 11th February 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

When are we going to talk about what's going on in mainstream Europe ? The British are understandably paranoid about how the world perceives us, post Brexit but in truth the global financial system has pretty much discounted our local political 'challenges' - it's mostly factored into sterling. The Eurozone is a much bigger economic block and continues to chug along at a subpar growth rates. Over the last few years, its looked like the Northern powerhouses like Germany would pull the region up but recent numbers are far from encouraging. The bad news is that European banks may already be beginning to react to this monetary tightening. Analysts at Barclays Bank have just launched their own Barclays Augmented Credit Impulse (ACI), which is a compact gauge of lending and securities issuance data.

And the really bad news? Europe is in trouble. Bank lending has decelerated while credit demand "seems relatively less buoyant recently... Econometric analysis confirms credit impulse shocks materially affect real activity... With the exception of Germany, narrow credit impulse indicators in the big four concur with euro area overall developments, dipping further into negative territory."

These concerns find an echo even in Germany. Another note, this time from DWS, suggests that the financial markets are signalling a major problem: falling yields on German government bonds. According to the European asset manager yields are falling both for nominal yields on German government bonds and to the yields on inflation-indexed longer-dated German government bonds, as the chart below shows. "The difference between real and nominal yields, the so-called inflation break-even rate and an indicator of inflation expectations, has also fallen - in the ten-year maturity range even to a new two-year

low. All of these are hardly signs of economic dynamism. Since January of this year, the European Central Bank (ECB) has also stopped net new purchases of securities as part of its purchasing program. That should actually have pushed yields upwards." My guess is that the ECB will be watching these numbers with caution - with a reversal of quantitative tightening or QT on the cards within the next few months.

UK Government Bonds 10-year Rate 1.19%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	31.2
Germany	11.7
Japan	19.71
United Kingdom	31.49
Ireland	35.65
Italy	193
Portugal	69.55
Spain	59.98

Eurozone peripheral bond yields

Country	February 2019	March 2019	Spread over 10 year
Spain 10 year	1.24%	1.05%	99
Italy 10 year	2.95%	2.51%	245
Greece 10 year	4%	3.80%	374

	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

As I've already noted, equity markets look to have regained some of their mojo. And yet again, it looks like the Americans are leading the way. My guess is that its reasonable to presume that rising bond yields might prompt some rotation away from bonds into equities. Buybacks also remain a strong source of support. The pace of announcements has picked up over the last 3 months and according to US analysts at Deutsche Bank their buyback baskets of stocks is out performing strongly since the beginning of the year. The Deutsche analysts also suggest that equity positioning is still in "the middle of its historical range" with many hedge funds - especially CTAs - still adding to long equity positions. And valuations? The Deutsche analysts reckon the S&P 500 is now back in line with current growth, with positioning "in the middle of its historical range (see chart below), while vol has fallen sharply".

Index	February 2019	March 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.4	121.5	3065	125.90
FTSE 100 (Dec 17)	320	319.7	6773	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	0.24	4.58	-2.6	-1.59	5.6	9.33	7089
S&P 500	1.52	4.4	-4.27	0.364	46.4	77.2	2748.93
iShares FTSE UK All Stocks Gilt	-0.459	1.33	1.4	2.18	17	13.9	13.27
VIX New Methodology	5.53	-28.6	11.5	0.302	17.6	31.8	16.59

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Volatility

Measures of stockmarket volatility have crashed back to more normal levels after the excitement of the last few months. The VIX, which tracks the turbulence of options on the S&P 500 index, is back around the 15 level as I speak - which is where markets were back in the early autumn of last year. There are other signs of normality returning to risky assets with gold prices in particular looking like they've hit a

plateau. My own gut instinct had been that the precious metal was slightly cheap at its previous floor of around $1100 an ounce whereas the current levels of nearer $1300 look a tad expensive. But then again gold prices have been helped along by positive comments from some in the investment banking community. Morgan Stanley, for instance, had a buy note on gold for many months, but it now looks like they are having second thoughts. They've closed their September call on the shiny precious metal - and think that commodity investors might want to look elsewhere. Cynics might wonder why MS has taken its profits and run especially as the bank's analysts think that 2019 might be the year of a weaker USD dollar and lower US real rates (conditions that should otherwise be good for gold). According to Morgan Stanley, "Gold has rallied significantly over the last five months, moving close to a $1350 level that it has repeatedly failed to break. Sentiment has also risen sharply as the market has embraced a 'Goldilocks' narrative (no pun intended). Gold has been boosted by hopes of a dovish Fed. But with markets now priced for cuts through the end of 2020, we question how much further this catalyst can help".

Is the Goldilocks scenario back in business, again>> Which would of course be terrible news for gold investors.

Measure	March Level	February Level	January Level	December Level
Vstoxx Volatility	14.58	16.2	18.43	19.16
VFTSE Volatility	13.09	13.72	17.52	17.30

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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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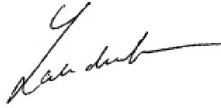

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