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Monthly Market Report

August 2019

With commentary from David Stevenson

Its long been assumed by many investors that the central bankers, especially those in the US, watch stock markets volatility like a hawk. There are, for instance, rumours that some economists in the central bank even track the Vix - a measure of volatility - in order to build a set of measures which might help make decisions about interest rates. Thus, we've seen the emergence of an idea called the Powell Put, named after the governor of the Fed. The idea here is that the US Federal Reserve won't let stock markets s fall too much because they'd worry about contagion into the 'real economy'. Are they right to be worried? On one level cynics would argue that the stock markets isn't that important and that low interest rates and QE have made the wealthy even wealthier. The core criticism here is that most shares are owned either directly or indirectly by wealthier investors, who've disproportionately benefitted from monetary easing. But stock markets in the US are popular amongst ordinary savers and investors and there is clear evidence of what's called the wealth effect, in which ordinary investors feel more confident about spending if their stock accounts are doing well. A stable or booming stock markets is also good news for corporates who should be encouraged to spend more in capex by booming markets. I think its fair to say that the debate is fairly balanced, and I suppose one can hardly blame central bankers for being worried about instigating measures that might cause a market panic.

But the alleged Powell Put might now have turned into the Trump Put. The US President clearly watches the ups and downs of the US stock markets and that 'wealth effect' is clearly on his mind. He, probably rightly, believes that a large part of his re-election bid hangs on the current economic upturn and the S&P 500 reaching ever higher levels. Thus, he's also keen to keep the stock markets in the US in buoyant mood, lashing out at the US Fed for thinking about increasing rates. There's now considerable evidence to suggest that the USS Fed might even decrease interest rates - twice - this year.

The net effect of all this is that US investors think that President Trump and Chairman Powell will do everything in their power to keep equity markets in the black. That underpins funds flows and market confidence. Whether that confidence is misplaced depends on your view both of their willingness to keep rewarding investors as well as their ability to keep control of events not under their control (the Iranians, the Chinese, weather, the global economy).

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My guess is that President Trump can probably only deal with one war at a time, even if both the current bunch of wars (Iran and China) are primarily composed of hot air, tariffs and sanctions. News from the Osaka G20 summit that the US is pausing new tariffs and lifting some restrictions on Huawei, thus doesn't come as an enormous surprise - nor should we be too shocked by the news that China has agreed to buy more agricultural goods. They tend to be exported from the mid-West which will prove to be a key battleground in the imminent US presidential elections.

My own observation is that as with North Korea, President Trump seems to be have been rather over-generous in his compromise with China. I'm sure some people regard an initial tsunami of threats and bullying followed by obvious concessions as the art of a great deal, but for this observer, it just looks a bit silly. The initial demands were just too over the top and concessions were always required. I'd also note that even before the G20, some US suppliers to Huawei had already resumed partial shipments which suggests that the Trump administration may have eased part of the restrictions ahead of the Osaka meeting.

A team of analysts at Barclay's led by Jian Chang run a very useful update of the trade war in their frequent notes to clients and a recent one in late May was no exception. The main table below runs through the main agreements/compromises. As I said it seems to me that the American's have been very generous and have hopefully provided President Xi with enough room to make some even bigger compromises on his part.

Figure 1: Potential winners and losers from Osaka G20

Issues	Before Osaka-G20	After G20: US/Trump remarks	After G20: China statements
Tariffs	Trump threatened to impose tariffs on the remaining USD300bn of Chinese goods	Agreed not to impose new tariffs "at least for the time being"	The US will not impose new tariffs
Huawei	Huawei was placed on the US Entities List, although some US companies started to resume partial supplies	At the request of high tech firms and Xi, Trump agreed to allow US companies to sell to Huawei as long as it does not involve equipment threatening US national security; with more discussions around Huawei held this week	Chinese official said in the press it would be welcome if the US can follow through [lifting restrictions on Huawei]
China buy	China agreed at Dec G20 to purchase substantial amounts of agricultural, energy, industrial and other products from the US	Trump said China is going to buy a 'tremendous' amount of food and agricultural product, almost immediately. The US will provide a list of goods it wants China to buy	Quoting Trump that he hopes China can increase imports from the US
North Korea	US failed to reach a deal with North Korea after the Feb Trump-Kim summit; Xi visited North Korea one week before Osaka G20, first state visit in 14 years	Trump became the first sitting US president to step foot into North Korea	Trump said the US values China's important role in North Korea issues, and is willing to maintain communication and coordination with China
Taiwan	Trump administration pursued selling more than USD2bn of weapons to Taiwan	No mention	Trump said he valued China's concerns and the US will continue to pursue the One-China policy

Source: Bloomberg, Xinhua, Barclays Research

So, what's next? According to Barclay's team, a quick deal is still unlikely. They suspect that we're now into what they call a "Ceasefire scenario, in which the two sides agree to continue the discussion with additional tariffs being suspended (without specifying the duration of the truce)". The next stage in this uneasy truce will probably be in mid-November "when the two leaders potentially meet at the APEC summit in Chile (Figure 2)... In our view, it is probably in the best interest of both parties to keep the talks running as long as they can, as we do not think either side is likely to press for a better deal through further threats of re-escalation, which would also raise US recession risks ahead of the 2020 election".

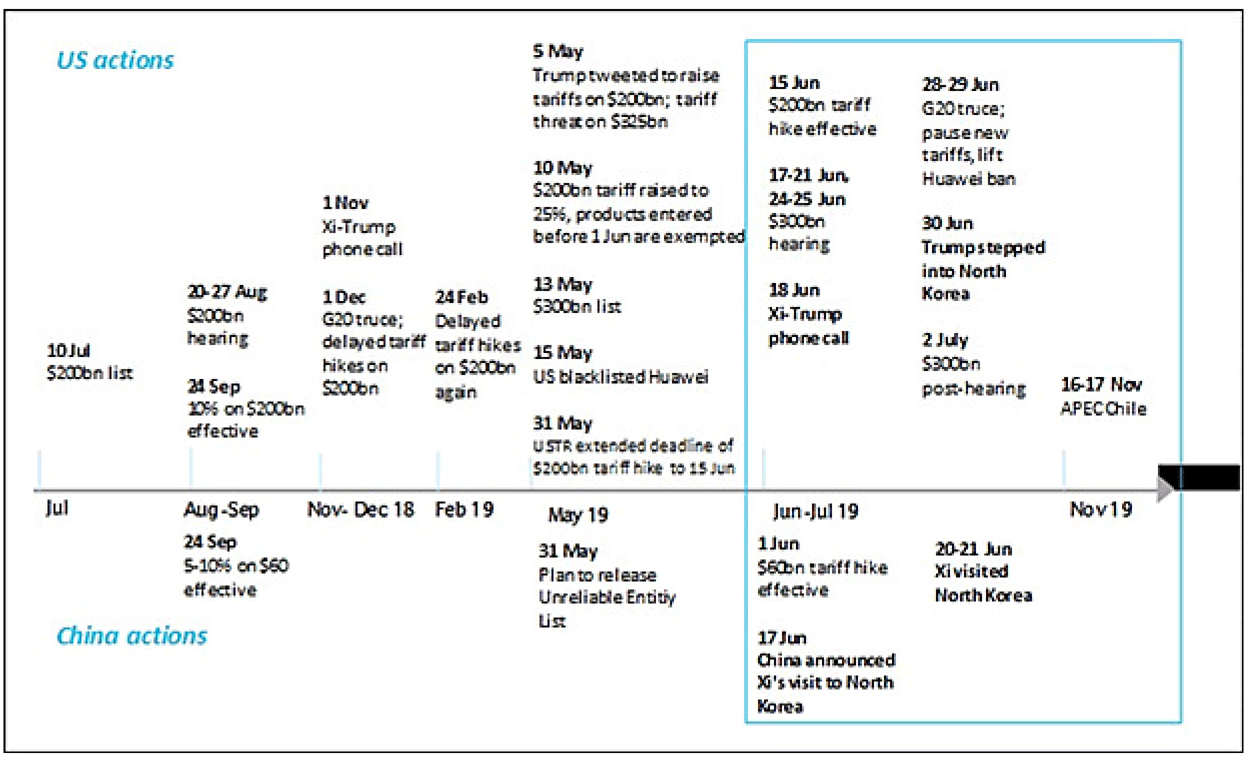
Whatever is agreed is "likely be weaker than the c.150-page 'grand deal' that Trump could have achieved before the May breakdown. Given this, we think it may be in Trump's best interest to "kick the (deal) can" down the road, while continuing his rhetoric on the trade war. In other words, no deal (but with ongoing negotiations) could be better than a weak deal for Trump, in our view. As he tweeted on Asia time Sunday, "I am in no hurry [to cut a deal], but things look very good".

The problem with this headline truce is that beneath the surface the growing stand off continues at the geopolitical level.

A few weeks ago, Barclays reports that the US Commerce Department added five Chinese companies active in supercomputing to its national security "entity list," preventing them from buying US parts and components. That comes at the same time as three Chinese banks face the risk of losing access to the US financial system due to alleged violations of North Korean sanctions ("Chinese bank involved in probe on North Korean sanctions and money laundering faces financial 'death penalty'," Washington Post, 24 Jun).

So, I think we can safely describe the situation is a hot ceasefire - both main players will try to ratchet down the tension but behind the scenes we'll see more low level skirmishing aimed at disrupting trade ties and financial ecosystems. This all gives Trump a little more breathing space to take on the new prime villain in the Axis of Evil - Iran. It also gives him enough cover to boost US stock markets and help raise money for his re-election battle.

Figure 2: US-China Timeline



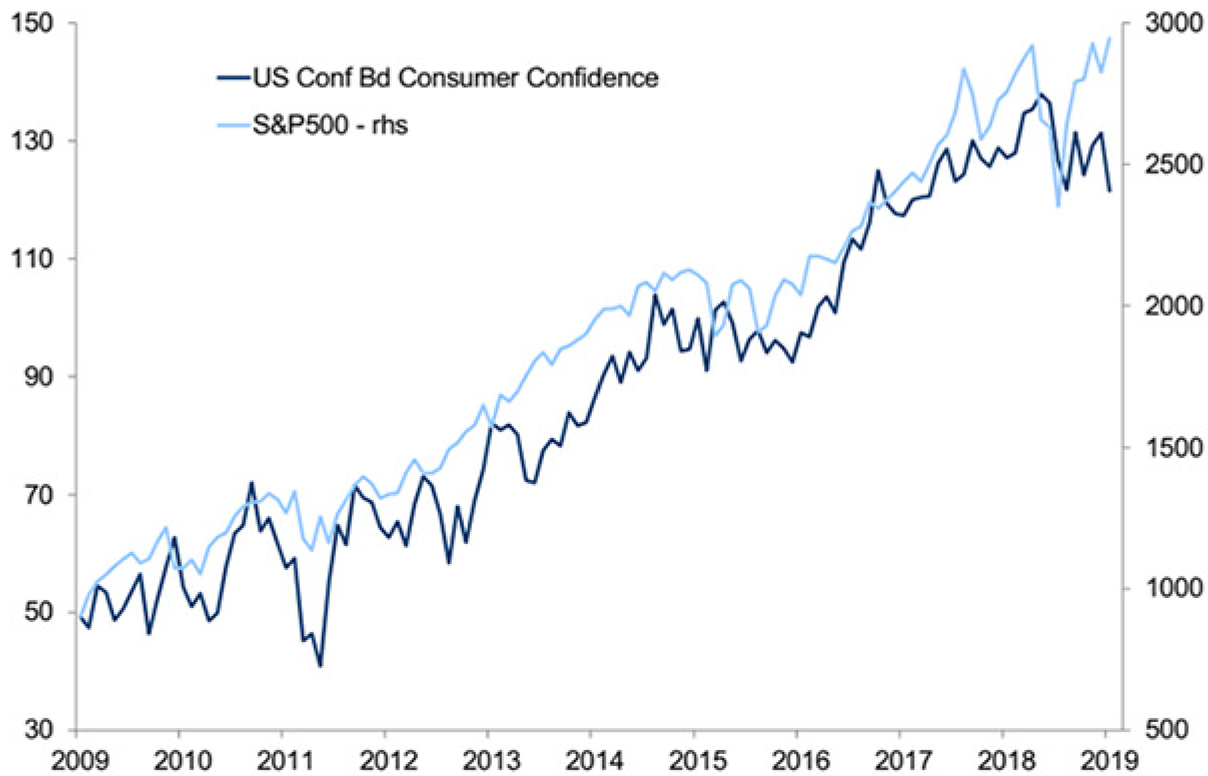
MS on US consumers starting to flag

I think we've all been collectively a bit guilty of under-estimating President Trump. I certainly assumed that as a populist, all he was concerned about was opinion polls and sentiment in his heartland. But

Trump is clearly watching key economic measures like a hawk and as a businessman he probably understands better than most how important economic sentiment measures are to political campaigns. I've already suggested that he closely watches not just interest rates but also the state of the S&P 500. I'm guessing inflation measures might also be the subject of some focus as should measures of consumer confidence.

European equity analysts at investment bank Morgan Stanley certainly think he should be watching these latter numbers. Only a few weeks ago for instance their preferred Consumer Confidence number disappointed - this measure has historically proved a leading indicator for the economy. Morgan Stanley also reports that they've seen a sharp drop in the Philly Fed survey and CRB RIND commodity index recently, which are also important indicators to track. Why does this measure matter so much? "Over the last 50 years, US Consumer Confidence has also proved to be a leading indicator for the S&P with our work in the above report highlighting that the average time lag between a peak in consumer confidence" according to the MS analysts " and a top in equity markets has averaged 8 months over this period. Interestingly we are now 9m past the Oct-18 peak in the Conference Board Consumer Confidence series".

Exhibit 2: Weaker US consumer confidence a cautionary signal for the S&P



Source: Conference Board, Datastream, Morgan Stanley Research

Measure	Values as of 4th June, 2019	Values as of 5th July, 2019
UK Government 10 year bond rate	0.87%	0.67%
GDP Growth rate YoY	1.80%	1.80%
CPI Core rate	2.10%	2.00%
RPI Inflation rate	3.00%	3.00%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.80%	0.78%

Government debt to GDP ratio	84.70%	84.70%
Manufacturing PMI	49.4	48

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Bank CDS options

A fairly remarkable month in June. Pretty much across the board, rates on credit default swaps have fallen drastically in price with nearly every bank seeing a decline of between 20 and 30% in the price of their 5-year swaps. The biggest falls were in Deutsche which saw the price of its 5 years swaps fall by nearly 40%. The message here is that investors have become very relaxed about the risk of bank defaults, with most investors probably assuming that central banks will ride to the rescue again as QE4 looms into view. The challenge here for investors is that swap rates are useful in helping fund structured product plans, and with rates so low that means many plans will offer even lower returns.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	7.26	32.17	-33.00	-63.00	A -
Barclays	22.63	55	-23.00	-14	A
BNP Parabis	8.97	32.38	-29.13	54	A
Citigroup	14.17	51.38	-29.76	-12	A
Commerzbank	10.68	42.8	-30.59	-54.57	A+
Credit Suisse	12.99	48.01	-39.27	45	A
Deutsche Bank	31.14	66.52	-38.37	-23	A+
Goldman Sachs	24.43	60.40	-27	-9.7	A
HSBC	9.38	30.08	-22.09	-19	AA-
Investec*	n/a	63	n/a	n/a	BBB
JP Morgan	16.11	37.17	-31.19	-22	A+
Lloyds Banking Group	17.83	78.1	-27.66	-21.9	A
Morgan Stanley	22.9	55.67	-29.60	-12.27	A
Natixis	17.7	73.14	-1.05	69	A
Natwest Capital Markets	6.58	20.54	-33.91	-43.57	A-
Nomura	n/a	61	n/a	n/a	AA
Rabobank	n/a	56	n/a	n/a	AA
RBC*	19.9	77.48	-27.46	16.23	A
Soc Gen	8.09	32.86	-31.76	-51.33	A
UBS	6.56	20.66	-28.59	-57	A

Source: www.meteoram.com 4th July 2019
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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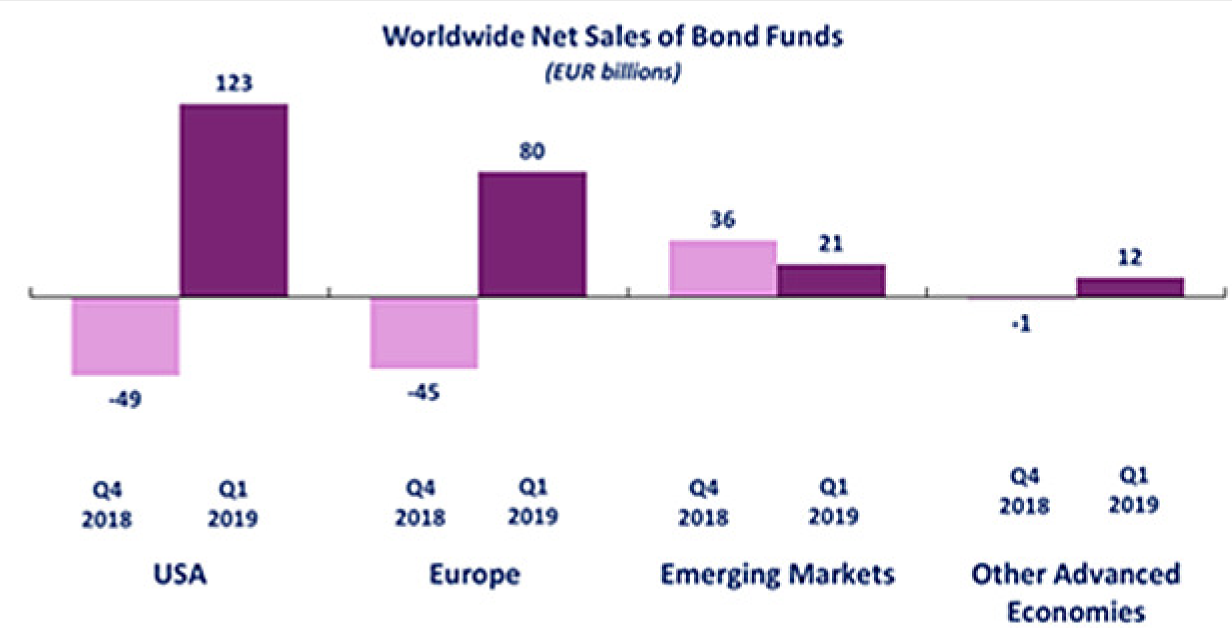
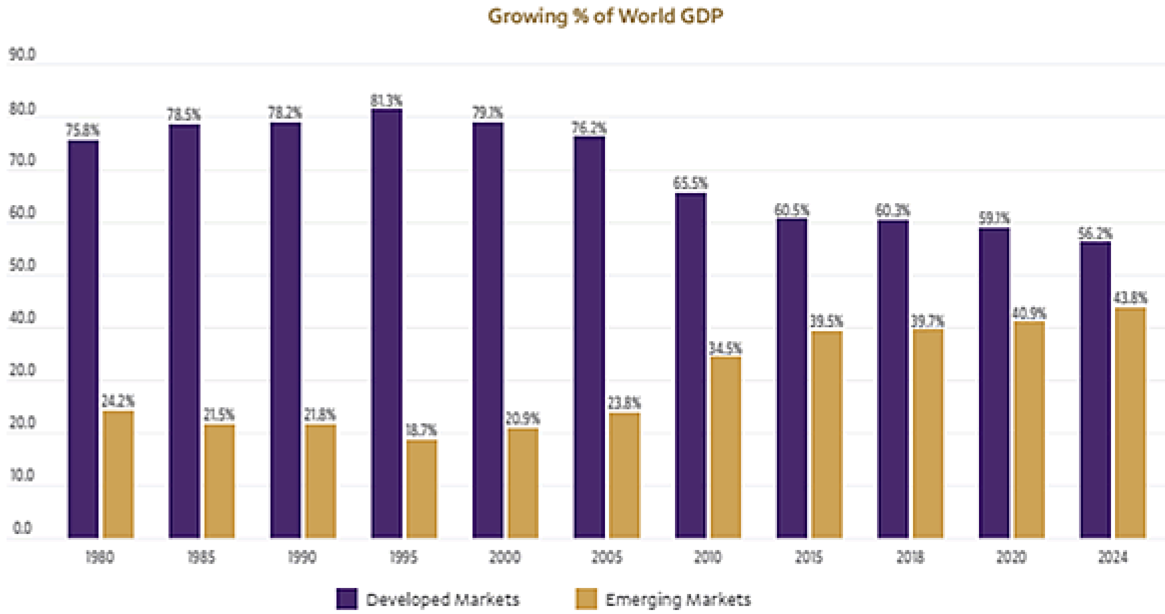
Government Bonds

Fixed Income

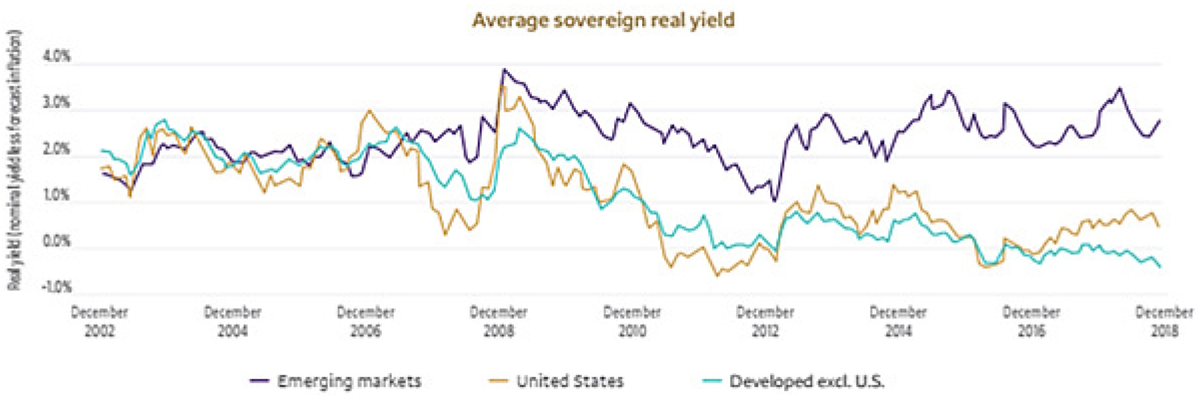
Equity investors may have recovered some of their confidence, but the hard numbers keep telling us a very different story - which is that investors are worried and are pumping more and more money into bond funds. The first chart below is from the European Fund and Asset Management Association (EFAMA) and shows just how pronounced these inflows are to bond funds. US investors in particular seem to have become aggressively much more cautious. But for me the interesting sub story is that investor interest in emerging market bonds is steadily increasing, admittedly from a low base.

I think its fair to say that most investors now roll their eyes when they keep hearing how important emerging markets are to the world economy. They've heard the story a million times before. But the second chart below from Wells Fargo reminds us that just because we keep hearing the same story, doesn't mean it's not true. Quite the opposite in fact - emerging markets are a constantly growing proportion of world GDP. Given this undeniable fact, it's hard to understand the narrative behind the third chart, also from Wells Fargo. It shows average sovereign debt yields for EM nations as well as developed countries. Real yields haven't much moved in the developing world and are still well above 2% per annum. In the developed world those real yields are cruising close to zero and in some countries clearly negative. Most emerging market sovereigns are still growing fast, feature younger demographics and have lower debt levels yet the yield they pay on their debts hasn't budged much. EM bond managers keep muttering about this strange state of affairs, but bond investors don't seem overly concerned - as they keep buying into safe haven developed world sovereign bonds.





Source: International Monetary Fund (IMF) as of May 2019



Source: Consensus. Economics, Bloomberg, 31-May-19. Developed market real yield is a simple average of Germany, Norway, U.K., Switzerland, Australia, New Zealand, Japan, Korea, Singapore and Canada. Emerging markets consist of constituents of the JP Morgan GBI-EM Global Diversified, weighted using index weights. Opinions are subject to change, provided for informational purposes only and should not be relied upon. Past performance is not indicative of future results.

UK Government Bonds 10-year Rate 0.67%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	23.03
Germany	11.02
Japan	20.04
United Kingdom	29.77
Ireland	27.29
Italy	167
Portugal	37.91
Spain	35.29

Eurozone peripheral bond yields

Country	June 2019	July 2019	Spread over 10 year
Spain 10 year	0.65%	0.25%	87
Italy 10 year	2.51%	1.67%	273
Greece 10 year	2.93%	2.00%	315

	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

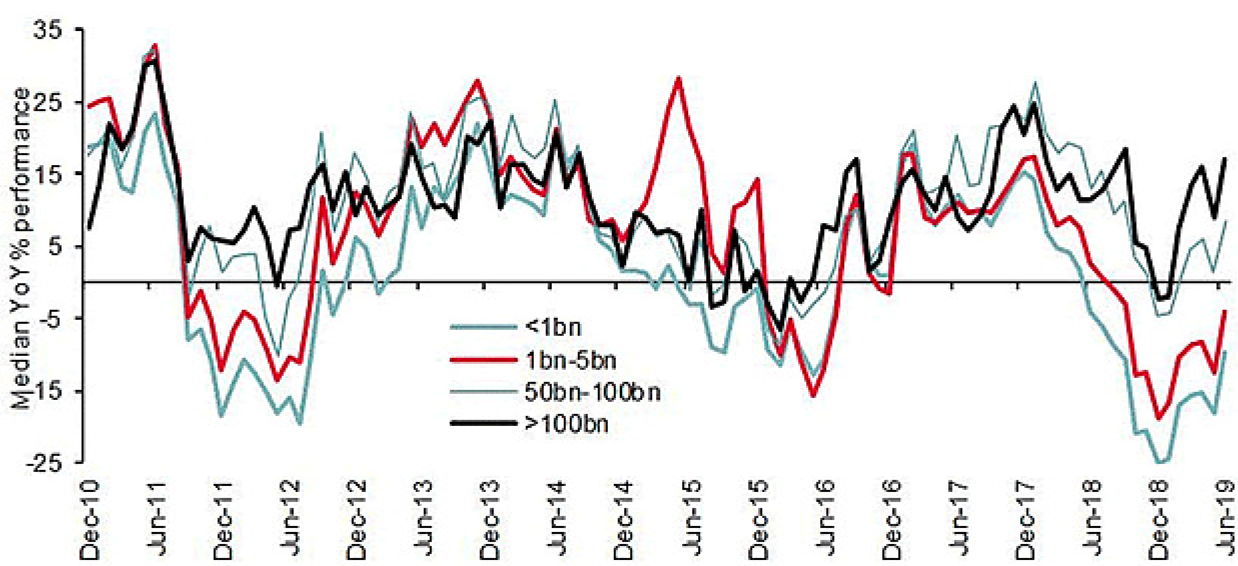
Equity Markets and Dividend Futures

June was another good month for equity markets as global markets uniformly turned around from last month. According to S&P Dow Jones, June posted a broad gain of 6.20% after Mays broad decline of 6.20%, which was after April's broad gain of 3.11% (March was up 0.78%). Over the one-year period, global markets were up 2.42%, and absent the U.S.'s 6.85% gain, they were off 2.34%. Longer-term yardsticks continued to show the U.S. outperformance pattern, as the two-year global return was 11.69% with the U.S. (20.40%) and 2.86% without it, and the three-year return was up 30.57%, and absent the U.S. (39.90%) it was up 20.99%.

But within this broad positive trend, there's a worrying pattern emerging. Sure, global equity markets look to be in reasonable shape as we head into what must be a late part of the cycle. But these gains are not being evenly distributed. Quite the opposite in fact. More money than ever is flooding into large cap funds, and that in turn is pushing up mega cap valuations. But this uneven distribution of flows - and gains - is arguably even more extreme than it first appears. There is growing evidence that just a handful of global businesses - dozens, or at most hundreds - are capturing the vast majority of the gains.

One way of seeing this in action is to watch the returns from equal-weighted versus market cap-weighted performance. The idea here is that it is clearly healthier for the majority to be outperforming the more concentrated large cap-tilted index and of course passive and associated top-down flows favour market cap rather than equal-weighted ones. According to equity analysts at French bank SocGen, these indices are telling a very different story. In 2018 and again this year, the MSCI World equal-weighted index has slumped versus the more closely watch market cap index. "In other words, a majority of companies are struggling", according to SG. The chart below splits a very large global universe of 17000 stocks into market-cap grouped portfolios and measures their median annual performance over the last 12 months.

According to SG "the mega-cap group (i.e. those above USD100bn) is powering ahead whilst those in the sub-1bn market cap range are still struggling to make back last year's loss. The more remarkable numbers are that this 100bn portfolio represents just 77 companies but 27% of the global market cap..... our increasing focus on a few large cap indices populated by just a fraction of the world's companies is giving investors a false impression. Corporates are struggling!"



Source: SG Cross Asset Research

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	5.37	2.71	11.2	0.39	10.7	18.4	7601
S&P 500	6.87	4.04	18.3	10.4	50.09	85.5	2995
iShares FTSE UK All Stocks Gilt	2.11	3.5	5.85	5.33	22.5	21.6	13.88
VIX New Methodology	-25.9	-7.44	-41.20	-22.1	21.8	-22.4	12.57

Index	June 2019	July 2019	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	121.8	121.9	3544	120
FTSE 100 (Dec 17)	320	324.5	7602	n/a

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Volatility

Readers will know that we keep a close eye on the price of gold on these pages. Although most investors think that measures such as the Vix give you a snapshot of market turbulence, I think it's the price of gold that gives you a much richer insight into the true level of fear amongst global equity investors. In June the price of a troy ounce of gold broke through the $1,400 mark for the first time since September 2013. Gold long futures positions are also at their highest in over a year while Gold funds have benefited from strong inflows in recent weeks, including $1.4bn last week alone.

For the first time in many years it's possible to construct a very strong bull case for gold. At the very top geopolitical level, I won't dwell on obvious matters such as Iran and the politics of the Gulf, but just observe that politics worldwide has become so much more unpredictable - and that should be good news for gold. It also helps that the world's leading central banks themselves have been large net gold buyers since 2010. Crucially some of those relationships I mentioned at the beginning look like they might be turning more positive. QE 4 doesn't look too far away as monetary policy is eased by central bankers worried about slowing global trade. Maybe the dollar might start to weaken. Even if it doesn't the old relationship with real US interest rates, a synced one, looks like it might be about to reboot itself. The yield on 5-year inflation-linked U.S. government bonds (which is considered a proxy for the real U.S. interest rate) has fallen from 1.15% to 0.17% over the past year. As a result, the opportunity cost of owning gold has fallen significantly.

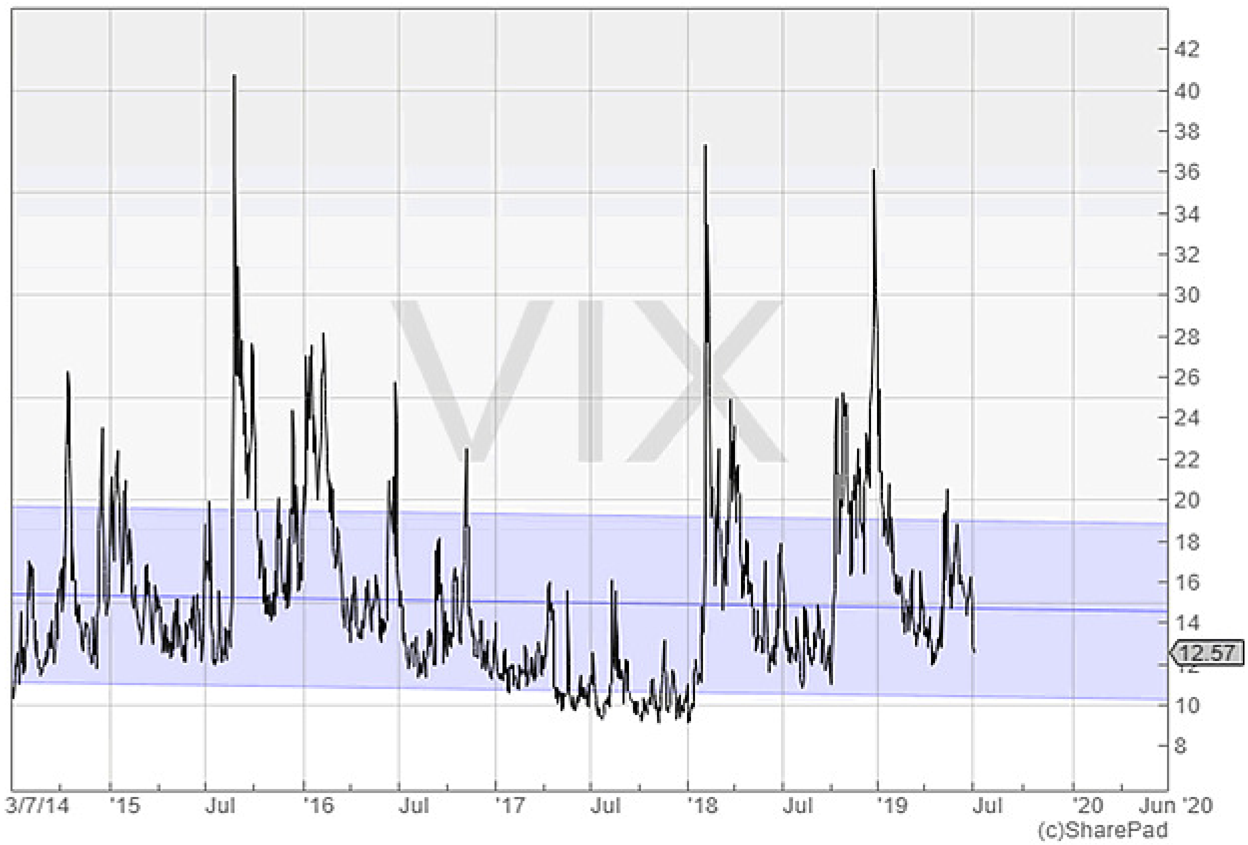
Arguably a more interesting long-term story is that the price of gold has become much less volatile. If we compare equities with the shiny precious metal, we discover that the two asset classes do not differ much from each other in the long run in terms of volatility. On a more specific level spot gold prices over the last ten years have been less volatile than the top 10 largest S&P 500 stocks, lower than the MSCI Emerging markets index and much lower than oil, silver and a broad basket of commodities (the S&P GS Commodity Index). Bitcoin can only dream of these low levels of volatility. Arguably the real world uses of gold have helped to sustain demand and dampen down volatility. According to the World Gold

Council, over the last ten years jewellery demand has accounted for 51% of global demand, with bars and coins coming in at 27%. Central banks are next up, accounting for 10% of demand while ETFs account for a measly 3%. Demand for gold from China, India and SouthEast Asia generally accounts for 58% of total demand.

So, as an alternative asset gold ticks many boxes, bar one - positive returns over the long term. The honest to god truth is that gold hasn't been very volatile because positive returns have been relatively meagre. A recent note by analysts at asset management DWS observed that the price of gold is "still more than a fourth down from its 2011 peak. And what's more, exactly ten years ago gold and U.S. stocks had met at the same level: at the beginning of July 2009, a troy ounce of gold was worth $927 and the S&P 500 stood at 923 index points... U.S. equities have risen by 220% - excluding dividends - to reach almost 3000 index points. "Gold, on the other hand, has risen by only 50% to currently a little over $1,400. The chart below nicely sums up this relationship.

On par ten years ago: gold and the S&P 500

Sources: Refinitv, DWS Investment GmbH as of 6/26/19



Measure	July Level	June Level	May Level	April Level
Vstoxx Volatility	12.9	16.6	18.63	14.07
VFTSE Volatility	10.96	13.54	16.41	11.89

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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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