UK | STRUCTURED™ PRODUCTS ASSOCIATION

Monthly Market Report

August 2014

With commentary from David Stevenson

As we head into the long grass of the summer holidays, the markets are becoming even quieter than normal, bar the odd panic about Portuguese banks - volumes have crashed back and even M&A activity is beginning to dry up! I tend not to take too much notice of market moves in July and early August - with the exception of the Q2 reporting round - and use the time instead to focus on more off the beaten track statistics.

On that theme, I find that numbers looking at fund flows are especially useful - they tell us how retail investors are reacting to the ebb and flow of markets. Recent numbers from the IMA (the main body over seeing unit trusts) is, I think, particularly revealing. In general terms, I think it confirms that investors are still bullish about equities, and that they've not turned overly bearish.

Inflows into retail funds are down a tad after the hype of the ISA season, but the IMA numbers suggest that inflows are holding up at the £2bn plus level on a monthly basis. But dig a little deeper into the numbers and we discover some interesting trends - demand for property funds (with their juicy income) is strong as is buying of multi asset funds. Global equity funds are also holding up well although there has been fading of interest in UK equity funds, with small caps especially badly hit.

But perhaps the most interesting numbers come from bond funds where outflows have now reversed and money is flowing back into strategic bond funds and emerging markets bond funds. In terms of structured products I'd suggest this hints at a more defensive quality to investors' outlook, with many clients still fundamentally optimistic about the markets but also looking for some 'insurance' in case markets do take a tumble.

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Headline numbers

Measure	Value as of June 12th 2014	Value as of July 12th 2014
UK Government 10 year bond rate	2.72%	2.78%
GDP Growth Rate YoY	3.10%	3.00%
CPI Core rate	2.0%	1.60%
RPI Inflation Rate	2.50%	1.70%
Interest Rate	0.50%	0.50%
Interbank rate 3 month	0.53%	0.55%
Government debt to GDP ratio	90.60%	90.00%
Manufacturing PMI	57.0	57.50
Sovereign Western Europe CDS	54.57	46.78
Euro Bank CDS	142.00	119.42
FTSE CDS	85.60	85.2

The overall big picture emerging from the UK macro-economic numbers hasn't changed much - the economy is picking up speed and we're in a mini boom! This is bound to increase pressure on the BoE decision makers to push up interest rates and my money is on the first actual move higher (albeit a small one) at some point in or around November.

One key marker though will be the August inflation report - if this signals slowing prices we could see a move up in rates delayed into 2015. The bank's core concern is the amount of 'spare capacity' in the economy i.e. the amount of slack that will allow growth without an inflationary pickup. Many bank decision makers are growing uncomfortable with the consensus view that there's loads of excess capacity and are wary of housing bubbles as well as increased wage demands.

Yet there is some evidence that the economy is far from being in a boom - recent numbers showed that industrial production actually fell 0.7% last month and there was also a backward revision to the April figure, now showing growth of 0.3% rather than 0.4%. The year on year rate of growth declined to 2.3%, from a revised 2.9% in April. Manufacturing showed the greatest weakness and these poor numbers are bound to have some impact on the Q2 GDP numbers, giving some ammunition to those in the BoE who want to keep interest rates low.

Headline Thought:

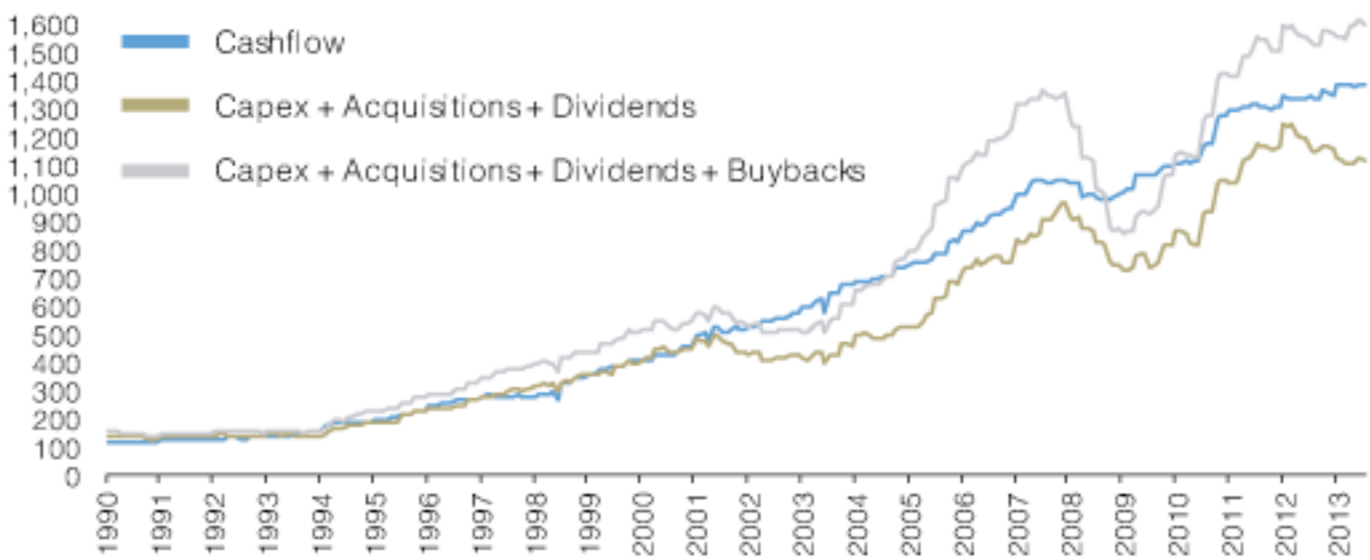
The Q2 US reporting season is nearly upon us and surprise, surprise... most guidance from businesses and analysts suggests a cautious outlook with numbers revised downwards.

This regular charade - guidance is inextricably pushed lower before actual numbers end up overshooting - is crucial, as it gives the markets a fairly constant bullish drum beat.

Many analysts though are beginning to worry about the next quarter - Andy Lapthorne at SG for instance says his data suggests that US corporate balance sheets are beginning to buckle under the weight of buying back $500bn shares every year, especially as cash flows are now under pressure. The SG analyst estimates that "non-financial S&P 1500 companies need to raise around $250bn per annum to make up the difference, which is what they are indeed doing". For Lapthorne, leverage (debt) is beginning to become an issue again.

Morgan Stanley's US analysts are also growing more and more cagey although they do note that US businesses reporting BEFORE the current round have been putting numbers slightly above estimates with outfits as varied as Adobe and FedEx shooting past their estimates. But the MS analysts do also note that "the market is rewarding companies that beat consensus earnings and revenue estimates and is punishing misses. Over the last three months, Q2 2014 consensus estimates were cut in nine of the ten sectors (healthcare being the exception) while S&P 500 earnings estimates fell by 2% led by materials and consumer discretionary. We continue to believe estimates are high as analysts are embedding 8% earnings growth in 2014... We are starting to get slightly worried that the consensus expectations are too high for 2015 at this point".

For both Morgan Stanley and Societe Generale capital spending is the key issue moving forward - will big US businesses spend some of their cash on extra productive capacity (likely to dampen share prices in the short term) or continue to plough money into share buybacks? If it's the latter, share prices might move higher but debt issues will begin to worry investors, whereas the former is better long term news for the economy and consumers.



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CDS Rates

CDS rates haven't moved much in the last month but there has been a noticeable, though small, tick upwards in prices, reversing a very long bull market in which Bank Bond CDS prices have carried on falling virtually every month for the last few years. The move upwards isn't great but it is a small sign that the markets are beginning to worry about greater risk lurking within the system.

For me, the stand out number though is that of Lloyds TSB which has a one year CDS rate that is only marginally above that of market favourite HSBC. The transformation of this once troubled UK bank has been remarkable and these CDS numbers confirm that investors think the bank is now on a solid footing.

Bank	One Year	Five Year	Monthly Change %	Annual Change %	Credit Rating
Banco Santander	27	87	11	-212	A-
Barclays	21	66	15	-84	A
Citigroup	21	68	11	-53	A
Commerzbank	25	83	17	-85	A+
Credit Suisse	17	57	5	-55	A
Deutsche Bank	24	76	18	-37	A+
Goldman Sachs	26	75	12	-78	A
HSBC	13	48	9	-61	AA-
JP Morgan	21	56	9	-38	A+
Lloyds TSB	15	56	6	-98	A
Morgan Stanley	24	72	14	-91	A
Nomura	23	81	-4	-64	A-
Rabobank	9	49	7	-47	AA-
RBS	25	82	13	-137	A
Soc Gen	27	78	16	-102	A
UBS	16	46	8	-86	A

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Government Bonds

The last year has seen a remarkable bull run in government debt issued by troubled Eurozone governments - prices have shot up while yields have crashed down. In the last few weeks that bull run has seemingly ended with many Eurozone bond prices falling and yields increasing.

Many investors worry that the recently introduced ECB measures were perhaps over-done and that Eurozone periphery governments are cashing in on the stimulus by flooding the market with new issues at low rates. Spain, for instance, has issued 16.6 billion euros in securities in the past three weeks in auctions and via banks, taking advantage of lower borrowing costs, without having any redemptions. Increasing yields on bonds from Spain and Italy are a sign perhaps of growing caution while declining yields for rock solid German bunds (now down to 1.21% ten year issues) suggest a small move back towards caution on the part of many bond investors.

The only other story of note is that of Portuguese debt - CDS rates for government debt has shot up following recent banking crises and there is some evidence that a twin track of 'recovering countries' is starting to emerge: a fast track comprising Spain, Italy and Ireland who are seen as being 'out of trouble' and a slower track of Portugal and Greece where problems still persist!

UK Government Bond 10 Year Rates

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

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CDS Rates for Sovereign Debt

Bank	Five Year	Annual Change %
France	42	-38

Germany	21	-10
Japan	35	-35
United Kingdom	19	-29
Ireland	48	-116
Italy	95	-173
Portugal	176	-305
Spain	70	-206

Eurozone peripheral bond yields

Country	% in July 10th	% in June 12th	Spread over 10 year German bonds
Spain 10 year	2.74%	2.65%	153
Italy 10 year	2.87%	2.81%	166
Greece 10 year	6.27%	5.73%	506

Country	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

Yet another curious month on the world's equity markets - over the last four weeks US shares continued to power ahead by 1.1% while UK equities slipped back (again) by another 2%. The Anglo Saxon contrast is now looking obvious - in the six months from the end of 2013, US shares have rallied 7.33%, while UK shares have barely moved ahead at all! UK gilts have also moved up a bit in price while the main fear measure - the VIX - has also crept up (by 4%).

Which market should we look to for a signal about what might happen next? Are we in bullish markets as indicated by US equities or should we be more cautious, as suggested by UK gilts, equities and the VIX Index? A recent paper by HSBC's head of global equity research, Garry Evans, attempts to answer this all important question by first identifying the signals that can be relied upon to give us some guide to future trends!

His conclusion? "We find that bear markets usually start when long-term interest rates and volatility are rising, although these are not particularly reliable indicators. The levels of margin debt, and even economic lead indicators such as the ISM, aren't reliable either".

Other key indicators identified in the HSBC report include the shape of the yield curve, which has always inverted before a bear market (it is currently quite steep); a rise in credit spreads (they are falling now); low cash holdings by investment institutions (currently they are at the highest level in 13 years); and sell-side analysts having lots of Buy ratings (they are currently rather pessimistic).

The HSBC bottom line? "The most reliable indicators in the past for signalling an impending bear market – the yield curve, credit spreads, rising volatility, excess optimism among investors and analysts – are all absent currently".

Index	July level	June level	Reference Index Value	Level six months ago
Euro Stoxx 50	112.6	112.8	3144	108.5
FTSE 100 (Dec 14)	232.5	232.5	6655	250.40

Name	Price change % 1 mth	3 mth	6 mth	1 yr	5 yr	6 yr	Close
FTSE 100	-2.28	1.24	0.4	3.15	61.54	21.49	6718.04
S&P 500	1.1	5.38	7.33	19.4	123.5	58.5	1972.83
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	0.37	-0.35	2.08	0.11	10.82	17.08	11.3975
Benchmark for volatility							
VIX New Methodology	4.48	-20.31	-9.62	-18.82	-60.88	-53.82	11.65

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Volatility

Indices that track market turbulence (as measured by volatility via the VIX Index) finally ticked up this month....but only by a tiny amount! The recent becalming of many volatility measures has prompted some market observers to stop watching these indices, arguing that the options markets have stopped working! Yet a recent paper by Tim Edwards from S&P suggests that current VIX levels may actually be TOO HIGH!

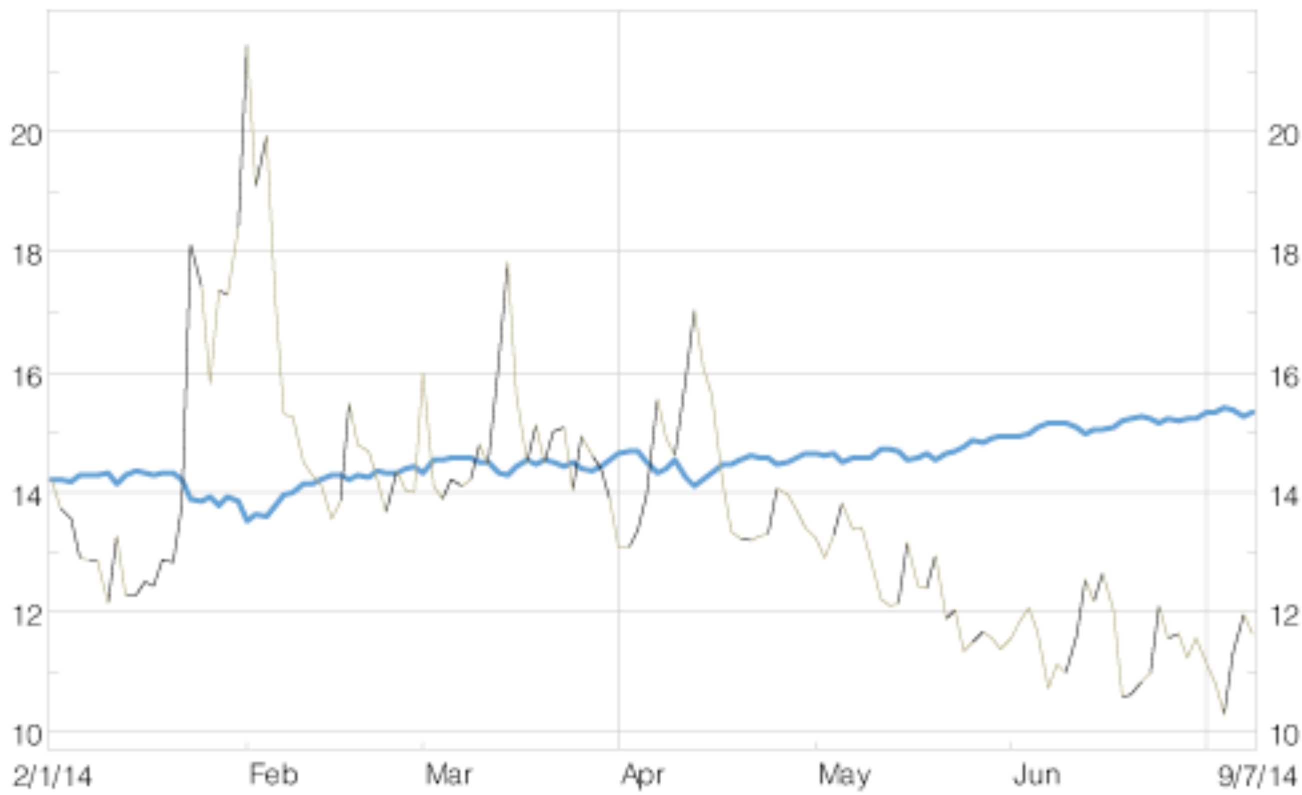
He reminds us that actual, realized volatility has been running at roughly 6%-7% annualized which is well below levels currently being suggested by indices that track 'implied' volatility. According to Edwards "VIX is currently much, much higher than realized volatility – at around 11.5 as we write. One interpretation of this is that the market “expects” next month’s volatility to be nearly double what we’ve seen recently. Moreover, the futures market is pricing in an expected gain in the VIX to around 17 by March 2015 — nearly triple the current level of realized volatility."

Edwards thinks that "a high proportion of the risk in equity markets currently is accounted for by the possibility of tail events. In other words, a VIX several points higher than realized volatility is consistent with a market expectation of continuing similar volatility unless something surprising happens. The mere possibility of tail events – invisible in current equity valuations – provides the VIX with a different perspective, evoking Michel de Montaigne: “My life has been full of terrible misfortunes most of which never happened.”

If Edwards is right, maybe investors are being much too cautious and under-estimating the chance of a continuing boom in share prices?

Measure	July level	June level	May level	Acc/Dec	Direction Upwards
Vstoxx Volatility	17.6	14.15	15.13	ACC	Yes
VFtse Volatility	13.68	12.406	11.44	ACC	Yes
FTSE Put Call Ratio	1.28	0.78	1.05	ACC	No

VIX New Methodology



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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 S&P 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 S&P 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 S&P 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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