



With commentary from David Stevenson

The thought of printing presses feverishly rolling off crisp new euro notes through the long spring nights evokes a wonderful set of images. Sadly back in the real world, the actions of the European Central Bank this month are rather less glamorous and picturesque. Imagine lots of smart but dour looking men and women staring intently at screens on the ECB's main dealing floor - accompanied by much mouse clicking and telephone jabbering as they buy every available bond.

Yes, the ECB has finally joined the modern world of central banking, cranking up the size of its balance sheet as EuroQE finally kicks into action. The desired objective is to kick start the Eurozone economy - more on that in this newsletter - but there is evidence that European economy is already slowly picking itself up off the floor. The massive bond buying programme will have another more direct impact namely to push up bond prices (especially sovereign bonds) and push down yields - to even lower levels. The frantic bond buying might also obscure the fact that Greece is once again slowly sliding over an abyss as its government flounders about looking for an excuse for a cash handout.

Lurking in the background of this manic bank activity is a more unsettling thought, namely currency wars. If everyone bar the yanks is happy to depreciate the value of their currency, surely that means sooner or later the US economy must feel the pressure as those US exporters see the price of their goods and services increase? Won't corporate earnings start to fall, dragging down US equities? And if the world's most resilient economy starts to stutter, won't we all be threatened by what seems like a zero sum game where FX rates are used as the blunt weapon for rebooting individual national economies? Follow this line of reasoning, and one can't help but expect another big jump in market volatility in the not too distant future.

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

Measure	Value as of February 12, 2015	Value as of March 12, 2015
UK Government 10 year bond rate	1.67%	1.84%
GDP Growth rate YoY	2.70%	2.70%
CPI Core rate	1.30%	1.40%
RPI Inflation rate	1.10%	1.10%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.53%	0.53%
Government debt to GDP ratio	90.60%	90.60%
Manufacturing PMI	53	54.1
Sovereign Western Europe CDS	46.20	36
Euro Bank CDS	198	59.83
FTSE CDS	72.5	61.55

The ECB has had a very busy few weeks. Boss Mario Draghi has pressed the button on QE and even gone on record to tell investors that the ECB will buy when yields are negative (up to a limit of -0.2%). Draghi has also been updating markets on the banks latest economic forecasts. GDP growth projections were more optimistic than many expected (the 1.5% and 1.9% for this year and next compare with Bloomberg consensus expectations of 1.2% and 1.6%).

My own suspicion is that these numbers may in fact be over cautious. There's already evidence BEFORE QE even started that the Eurozone economy was bobbing back into life again. Growth in the fourth quarter of 2014 for instance was a relatively good 0.3 per cent gain over the previous quarter. That good news hasn't though had any impact on the relentless decline in the value of the Euro - and the strengthening of both the dollar and sterling. The chart opposite shows the GBP/EURO rate since the beginning of 2014. It's a truly remarkable story - a proper medium term bear run on the euro. The rate has now crashed past the trend lines (the thin blue lines), pushing up over the 1.40 barrier.

This chart is a warning signal for the UK economy. A strengthening pound is horrible news for the UK's besieged exporters - their goods and services are now that much more expensive? And that must be bad news for the UK economy? How long will it take for UK manufacturing growth numbers to react sharply to the downside? My guess is that June and July will be tough months as a host of less positive UK macro-economic numbers start to emerge post-election! Good luck to the winners!

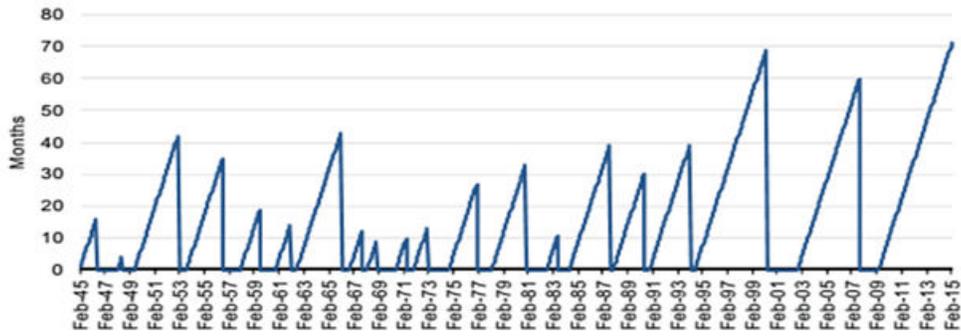


Headline Thought

Developed world stockmarkets have been on a roll! Only a few weeks ago analysts at Societe Generale observed that the S&P 500 index had just notched up the best **six-year performance in the S&P500 since 1929 and 1999. The first chart entitled The Longest Post War Bull Market maps out this remarkable recovery in US shares.** Over the last six years, the S&P Composite index gained over 200%, making it the third-strongest six-year run since 1900. The SG analysis also observes that "such a strong six year run up in US equities has only been seen twice since 1900, i.e., back in 1929 and 1999", both bad years for equity investors.

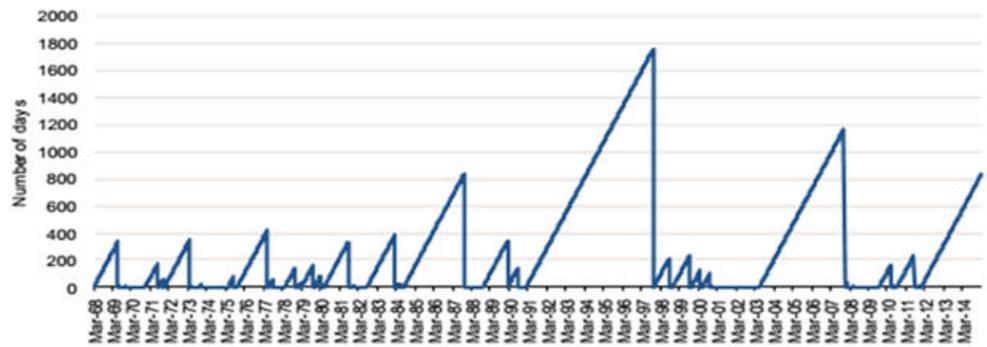
SG's highly rated stock market analyst Andrew Laphorne crunches the numbers in even more detail, and observes that such a massive rally is usually followed by short term volatility - we're now 800 days into a market where we've not had a bear sell off involving markets falling by more than 10%. He suggests that the current 800 trading day bull run "was only exceeded in 1999 and 2007, two periods that ended very badly indeed (see chart below)!"

The longest post-war bull market - Length of S&P 500 bull markets in months



Source: SG Quant, "Two centuries of Bull and Bear market cycles", Gonzalez, Powell and Shi, *International Review of Economics and Finance* (2005).

Number of trading days since a 10% correction for the S&P 500



Source: SG Cross Asset Research, Thomson Reuters Datastream

[Back to menu](#)

CDS Rates

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	37	83	-5	-45	A -
Barclays	15	53	0	-42	A
Citigroup	24	75	-3	-5	A
Commerzbank	25	78	2	-31	A+
Credit Suisse	20	58	3	-13	A
Deutsche Bank	25	69	1	-15	A+
Goldman Sachs	31	84	-2	-11	A
HSBC	14	54	3	-18	AA-
JP Morgan	24	64	-2	2	A+
Lloyds Banking Group	15	52	1	-29	A
Morgan Stanley	26	75	-2	-17	A
Nomura	23	80	-13	-15	A-
Rabobank	12	48	2	-21	AA-
RBS	15	63	7	-52	A
Soc Gen	29	75	-9	-19	A
UBS	17	46	0	-18	A

Government Bonds

The ECB's decision to start QE really only matters for two simple and obvious reasons. The first is that it will considerably weaken the value of the Euro. The second big impact will be on government bond prices as the ECB starts to bulk up its balance sheet by buying all manner of fixed income securities. We can see the effect of this massive purchase programme in the ten-year yield for German government bonds, which has now dropped to an astonishing 21 basis points - or 0.21%. The chart below shows the declining yield on the German government bund over the last few decades - from levels of above 10% in the 1980s to near zero many decades later. Yet what is even more remarkable is that the German government is determined to reign in its borrowing just as these interest rates crash to all-time lows. One doesn't have to be a hard core Keynesian to ponder whether NOW might be the best time for the German government to INCREASE borrowing so that it can invest in much needed new infrastructure? Why not take up the chance to borrow for ten years at rates vastly below 0.5%? Surely the return on that capital employed especially in terms of extra productivity will be much greater than the puny borrowing rate?



Of course this won't happen, given the German government's much repeated economic orthodoxy, and we must begin to contemplate a world where German bund yields could actually drop to just a few basis points above zero. That would drag Spanish ten-year bond yields below 1% and make our current yield of 1.84% seem huge!

What a strange world we all live in! Sadly it's also a world, which is unlikely to provide much comfort in the form of extra yield for the issuers of structured products.

UK Government Bonds 10-year Rates



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

CDS Rates for Sovereign Debt

Country	Five Year
France	39.81
Germany	16.4
Japan	44
United Kingdom	18.94
Ireland	47.45
Italy	101.52
Portugal	118
Spain	81.5

Eurozone peripheral bond yields

Country	% in March 12th, 2015	% in February 15th, 2015	Spread over 10 year German bonds
Spain 10 year	1.15%	1.61%	227
Italy 10 year	1.12%	1.65%	226
Greece 10 year	10.34%	9.71%	693

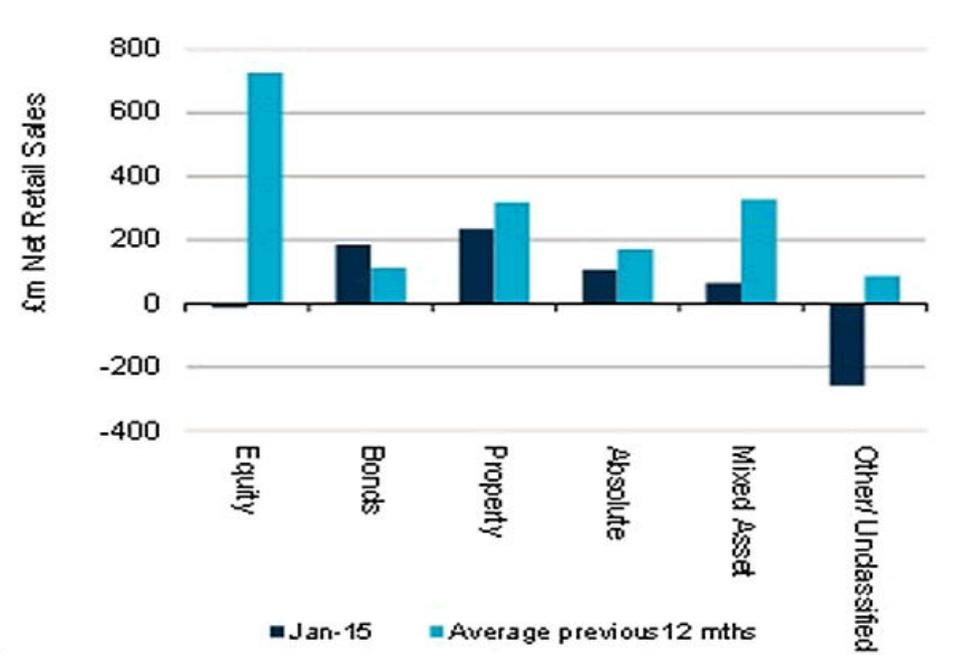
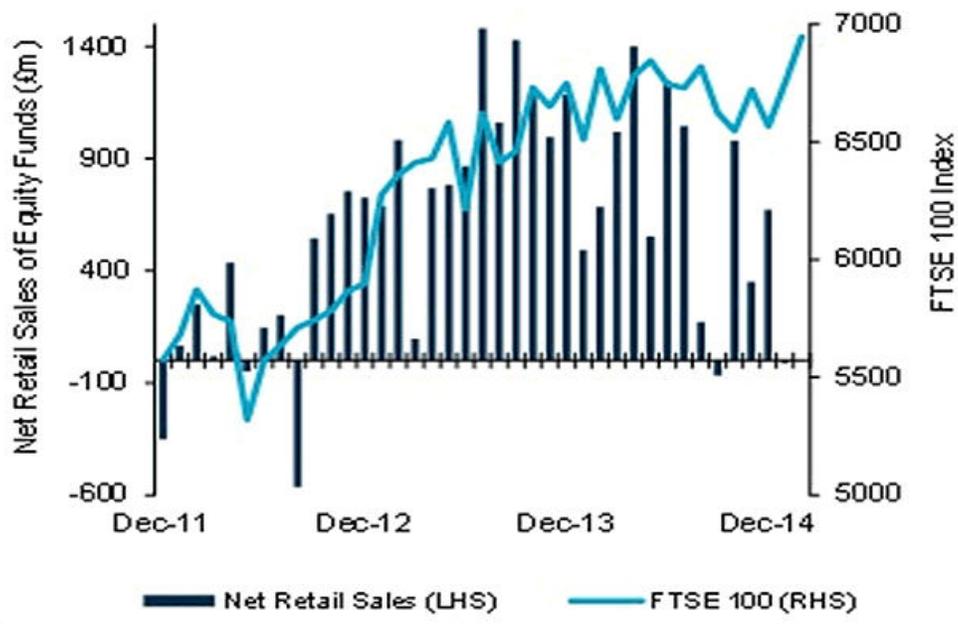
	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

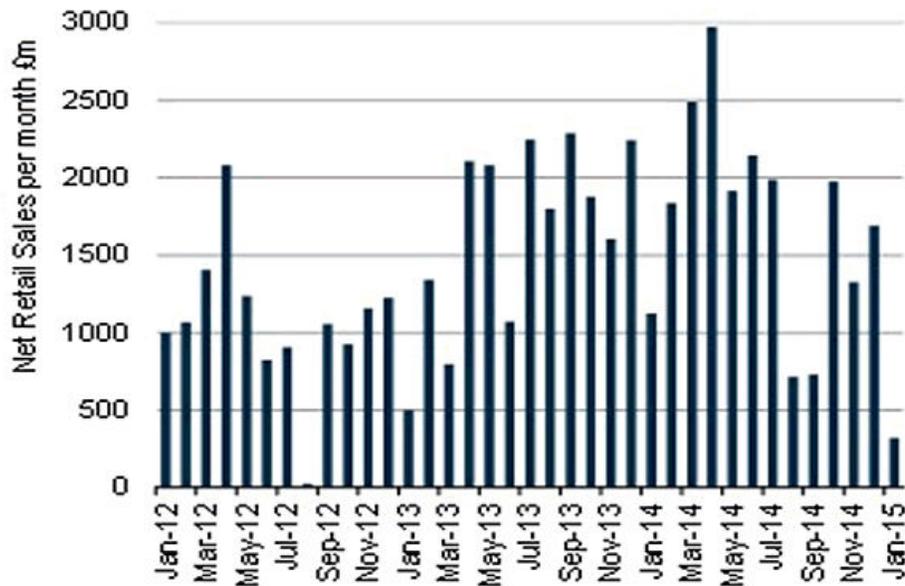
[Back to menu](#)

Equity Markets and Dividend Futures

Developed world equity markets may be powering ahead, but private investors in the UK remain a cautious bunch. Researchers at investment bank Numis recently reported on fund flows data from the asset management trade body, the IMA - these numbers give us a brilliant snapshot of what private investors are actually buying at the moment and how bullish they feel.

The first chart to the right demonstrates a big contrast - the thin blue line shows the rising FTSE 100 index while the bar charts clearly show that UK fund inflows have actually been DECLINING over the same period. According to Numis net retail flows into UK open-ended funds were £320m in January - "this represents the lowest net inflow since August 2012, and compares to an average monthly net inflow of £1.74bn over the previous 12 months. **Equity** funds saw the most significant drop-off in demand, with net retail outflows of £14m, compared to net inflows of £814m in the previous month. Demand remained robust for **Property** (+£235m), **Bonds** (£185m) and **Absolute Return** funds (+£106m). Despite a decline in net sales compared to December, UK Equity Income funds were the most popular equity sector (+£280m).By Geography, **Global** funds saw the strongest net inflows (+£329m), whereas **UK** funds saw significant net outflows of £515m, compared to an average net inflow of £425m over the previous 12 months. There was a small pickup in demand **Europe** (net inflows of £95m vs £18m average over previous 12 months) and **North America** (£75m vs -£27m) “.





Index	March Level	February Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	113.2	109.4	3648	110
FTSE 100 (Dec 14)	248	247	6790	N/a

Name	Price % change						Close
	1 month	3 months	6 months	1 year	5 year	6 year	
FTSE 100	-1.42	4.02	-1.15	0.54	19.66	81.97	6721.51
S&P 500	-1.37	0.24	2.14	9.24	77.38	182.83	2040.24
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-1.71	0.82	5.28	8.45	20.96	13.92	12.32
Benchmark for volatility							
VIX New Methodology	-0.53	-15.99	31.8	13.99	-6.59	-31.32	16.87

[Back to menu](#)

Volatility

As I mentioned in this article last month, it's increasingly obvious that central bankers are looking at measures of market volatility as a way of judging whether their initiatives are working or not. Increased equity market volatility usually spells fear, which in turn prompts much soothing talk by central bankers. Once that fear subsides we have more hawkish talk about increasing interest rates.

If this (cynical) take on measuring market volatility is right, what's do the key market measures tell us about Mr Market's mood at the present? The VIX itself closed 2014 in a more aggressive position, finishing the year at around 19.20. The New Year and especially the start of spring has brought a big pull back, with volatility falling away sharply. Over the past month, the main measure of US equity market volatility - the VIX - has posted its biggest drop ever after equities advanced toward new highs on the more optimistic outlook, following the Greek bailout deal, stabilization in oil prices, and dovish Federal Reserve stance. Bloomberg reports that the VIX plummeted 36% over February as the S&P 500 index increased 5.5%. In fact the CBOE Volatility Index (VIX) has had its worst calendar month ever in February!

Many investors think this means that equity buyers are complacent - these speculative types are betting on a few months of steady price action before a big pick up in market turbulence in the early summer. That consensus that volatility will eventually pick up is reflected via fund flows into volatility trackers -

the same Bloomberg article announced, that "investors added \$514 million in February to the iPath S&P 500 VIX Short-Term Futures ETN, known by its ticker symbol VXX, for its biggest monthly inflows since July 2013. The note appreciates as futures on the Chicago Board Options Exchange Volatility Index climb."

If past market cycles are anything to go by, these big inflows into volatility trackers are usually an indicator of subsequent spikes in equity volatility i.e. its bad news for US shares in the summer!

Yet it's also worth noting that these volatility measures only measure implied future volatility - actual volatility has indeed crashed! Markets just aren't turbulent anymore. Current measures of volatility may just be telling us that we're probably still in a low-volatility regime - the VIX median in 2014 was 14, while the current median price level is around 15. Crucially we've spent most of the last five years under 20! So volatility is about where we'd expect to be over a long-term average and maybe the markets aren't complacent after all! If this is the case, the pricing environment for most structured products is likely to remain very tight for the foreseeable future, with the potential for lower pay-outs.



Measure	February Level	January Level	December Level	Acc/Dec	Direction Upwards
Vstox Volatility	18.41	24.2	28.78	ACC	Yes
VFtse Volatility	11.8	14.68	18.52	ACC	Yes
FTSE Put Call Ratio	1.02	2.00	1.02	DEC	No

[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)

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.

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 fix 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.

[Back to menu](#)

To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,



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