UK Structured Products Association

Monthly Market Report
August 2016

With commentary from David Stevenson

So much for the financial betting markets and Brexit. We've been told for ages that experienced financial speculators tend to make a better job of guessing political results. Brexit yet again proved them wrong although this time to be fair the opinion polls were a tad more accurate than on previous occasions. Personally I'm still amazed that there were enough fools and simpletons out there globally who believed on polling night that sterling would rebound - and pushed the cable rate (how many dollars to the pound) up to $1.50 before it came crashing down within a few hours. It was always obvious that it would be a close run affair and in truth the win by Leave was indeed a close run thing. A majority of under 4% is hardly a landslide. But it is a decisive result nevertheless and the financial markets have been left to figure out what to do next. The most predictable financial turmoil has been in the FX markets, with much excited talk of the cable rate pushing first past $1.30, then $1.20 and maybe even ending up at parity. Given that over the last 15 years the cable rate has barely pushed much out of a range between $1.40 and $2, I personally can't quite see why sterling would collapse to parity. I even think any rate below $1.30 is probably a little excessive over the medium term.

Equity markets seem to have taken a much calmer view with the benchmark FTSE 100 Index pushing ahead to recent highs although - as we discuss in this report - there have been some much more worrying trends lurking beneath the surface. The sudden run on commercial property funds was also, in retrospect perhaps, entirely predictable. If the core concern is foreign capital leaving the country, why not start first with prime London commercial property? But here again there's some evidence that the panic was over played. Prices might slip a bit in key markets but we don't seem to be anywhere near a 2008 style meltdown. Some even expected severe selling pressure on gilts, but yet again events surprised - investor's in fact swarmed into gilts pushing yields to all-time lows. So as Supertramp once famously declared, crisis, what crisis? Nevertheless, I'd be cautious about reading too much into the last few weeks. We need to see the sustained impact of Brexit over a period of months, if not years. That means focusing on inflation rates, dividend pay-outs, and earnings growth. It's still far too early to predict anything meaningful on these metrics but I'd suggest that caution might be the watchword for the rest of 2016.

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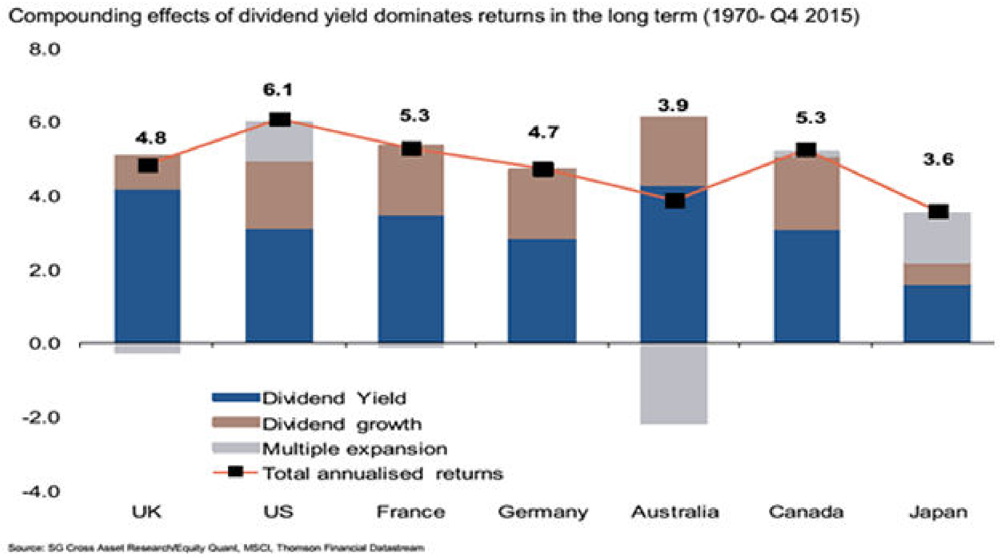
Headline Numbers

There's been so much noise about Brexit in the last few weeks that its rather obscured the underlying economic reality in Europe, which was that until very recently most corporates were expecting a decent 2016, with hard evidence of earnings upgrades. This message comes through loud and clear in the latest edition of Liberum's respected Early Cycle Indicator, run internally by Daniel Cunliffe. In a note from July 6th Cunliffe observes that for the first time since 2011, their ECI indicator posted a fourth consecutive month above 1.1. Using their stock universe of leading cyclical European corporates, they project ">10% organic sales growth (2011) for early cyclicals vs 4% growth forecast by our ECI from 2H16. Consensus remains too low at 2.5% FY17. Europe's order/inventory ratio reached a high for the year, due to both the UK and German strength. The UK ratio hit at a 2 year high, supported in particular by de-stocking into Brexit; German orders reached a 30 month high."

The key positive driver has been stabilisation in China. According to Liberum, export-led German orders picked up sharply to a 30-month high, and Italy remained strong largely due to stability within China. "It remains to be seen whether China's continued stability, can offset the impact of Brexit instability in terms of Europe's recovery prospects". Talking of Brexit, there's even hints that the UK may rebound strongly. According to Cunliffe and his team their core early cyclical corporates have "a solid near term cushion given the sharp de-stocking into Brexit, with orders 22% higher than inventories, the widest gap in 2 years".

One area where investors might see a direct impact of Brexit on their portfolio returns is on dividends. Regular pay-outs from big FTSE 350 names make a huge difference to long term returns from investing in equities. The first chart below (from SG) shows the total shareholder returns from investing in a number of key markets including UK equities. Returns are broken down into varying components including the dividend yield itself, growth in the dividend pay-out and multiple (price to earnings expansion). Notice how in the UK dividends are far and away the most important bit of total equity returns. If dividends take a hit, we might expect that equity returns could fall substantially.



Worryingly many market commentators reckon that dividends could now fall markedly following Brexit. One of those is market information business Markit. In the week following the UK's vote to leave the European Union this London based research firm lowered its dividend estimates for 55 large and mid-cap UK companies. According to Markit "due to the significant change in the value of the sterling following the EU vote, we used the FX rate as of June 23rd. On this basis, we have reduced our forecast for FTSE 350 companies by £205m in 2016 and £851m in 2017. At those rates, the total pay-out from UK large and mid-cap companies is expected to increase by just 1% to £82.6bn for 2016, and to fall by 2% to £80.9bn for 2017". The second table below spells out some of the company-by-company changes in projected dividends.

Top ten 2017 payout revisions since the EU referendum vote

2017 Payout in GBP million at constant fx rate	Pre-Brexit	Post-Brexit	Change (£m)
Lloyds Banking Group	2,284	1,998	-285
International Consolidated Airlines	489	375	-114
Aviva	958	905	-53
Easyjet	330	282	-48
Legal & General	898	863	-36
TUI AG	347	316	-32
Barratt Developments	380	356	-24
Thomas Cook	46	34	-12
St.James's Place	173	164	-9
CYBG	35	26	-9

Source: FactSet, Markit

Markit's concerns are echoed in another recent report by the Share Centre, which has been focusing its attention on a crucial measure called the dividend cover - the amount of cash earnings available to cover the regular dividend pay-out. The stockbrokers regular Profit Watch UK report produced alongside the Capita Asset Services UK Dividend Monitor, reckons that dividend cover has fallen by 38% in the past year, dropping to 0.98x from 1.63x. According to the online broker "this means companies paid out more in dividends than they made in profit. Based on profits of £76.4bn made by the UK's top 350 listed firms in the year to the end of December 2015 and reported by the end of March 2016, dividend cover is now at its lowest level since the third quarter of 2009, when it stood at just 0.73x. It has fallen for four consecutive quarters." The Share Centre reckons that "Income investors should tread carefully if judging a stock on high yield yet low cover". According to the Share Centre, dividend cover is a ratio defined by profit after tax divided by dividends paid. The higher the ratio, the greater the comfort that a company can afford, and can sustain, its dividend pay-outs. A lower ratio means a cut in the dividend is more likely if profits fall. One small detail on the report - apparently Banks, miners, and oil and gas companies had the largest impact on dwindling dividend cover in the top 350.

Yet despite these rather obvious concerns, not everyone in the market is buying into a negative agenda, with many believing that sterling's devaluation may make a huge positive difference. That's certainly the view Capita Asset Services via their latest Dividend Monitor. Sterling's precipitous drop could deliver an extra £4.3 billion in UK dividends this year. Capita reckons that two fifths of the dividends paid by UK-listed companies are declared in dollars or euros, reflecting the international nature of the UK stock market. According to Capita "as the pound fell in the wake of the EU referendum, these payments are being converted at a much weaker exchange rate, bringing a huge boost to income investors based in the UK. In the second half of the year alone, Capita expects exchange rate gains of just over £2.8bn, adding to the £1.4bn already booked in the first half".

Measure	Value as of June 9th, 2016	Value as of July 14th, 2016
UK Government 10 year bond rate	1.23%	0.81%
GDP Growth rate YoY	2%	2%
CPI Core rate	1.20%	1.20%
RPI Inflation rate	1.30%	1.40%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.58%	0.50%
Government debt to GDP ratio	89.20%	89.20%
Manufacturing PMI	50.1	52.1

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Bank CDS options

It's been a dramatic four weeks in the world of CDS options. Rates have shot up pretty much across the board over the month as investor's have worried incessantly about the consequences of Brexit - and an accompanying melt down in the Eurozone. The big US banks have experienced the smallest rise in CDS rates - as you'd expect given the strength of their domestic economy - while the big UK and German banks have been hit by very significant increase in rates with Commerzbank, Deutsche, Lloyds, Barclays and RBS experiencing the biggest rises over the month.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	39	125	10	75	A -
Barclays	99	156	43	75	A
Citigroup	37	89	10	5	A
Commerzbank	74	137	22	22	A+
Credit Suisse	132	177	35	100	A
Deutsche Bank	185	254	45	136	A+
Goldman Sachs	43	108	13	17	A
HSBC	51	103	12	24	AA-
JP Morgan	29	64	33	116	A+
Lloyds Banking Group	67	139	51	75	A
Morgan Stanley	43	107	15	26	A
Nomura	30	102	13	65	A-
Rabobank	28	82	14	2	AA-
RBS	112	170	40	60	A
Soc Gen	46	92	13	-9	A
UBS	51	76	6.4	2.35	A

Source: Meteoram.com, 14th July 2016

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Government Bonds

Before the referendum, a few contrarian types rather excitedly imagined one particular form of financial meltdown - a gilt buyers strike. In this scenario, a vote to leave the EU would result in a sudden exodus of capital from the UK (which has to a degree occurred in equity markets). This would in turn result in a shortage of buyers for UK government securities, or gilts.

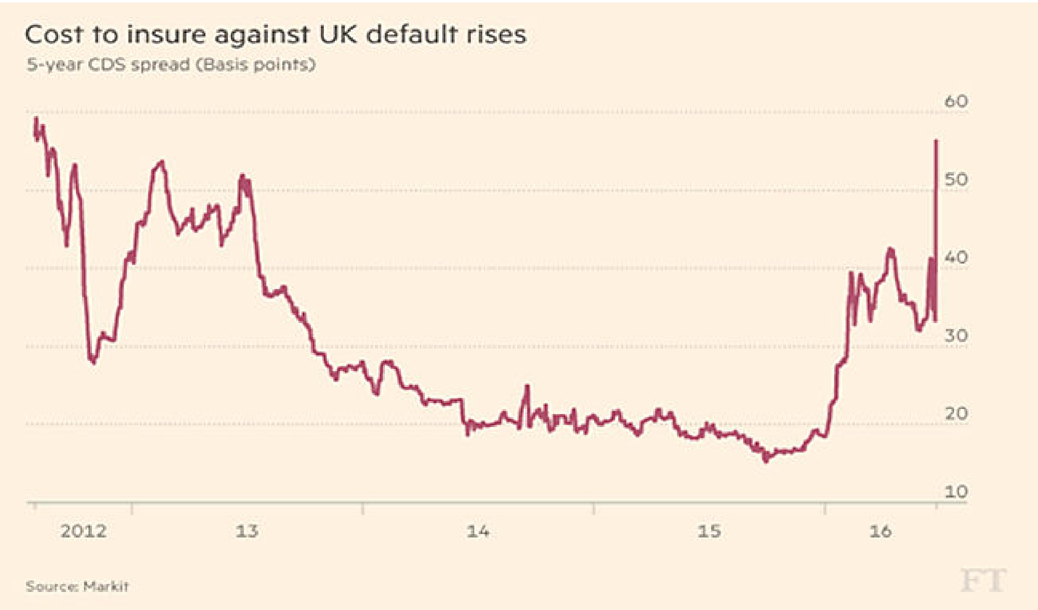
Thankfully, none of this came to pass. In fact, quite the opposite seems to have happened. The first chart below shows the relentless decline in the yield of ten-year gilts - currently standing at an astonishing rate of just 0.76%. Last week, the UK held its first government bond sale since voting to leave the EU, issuing £2.5bn of debt, which attracted lots of demand from investors around the world. Bids exceeded the amount on sale by 1.8 times according to Reuters data, enabling the five year bonds to be sold at a record low yield of 0.38 per cent.

UK Government Bonds 10-year Rates 0.76%

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

Yet as a report from economists at the Centre for Policy Studies points out (Apocalypse Soon? The Danger of Further Loosening Monetary Policy by Daniel Mahoney and Co) not everything is quite as rosy as these numbers make out. They observe that sovereign credit defaults based on gilts have jumped to the highest level since the Eurozone crisis of 2012 as investors attempt to protect themselves from further turmoil (see FT chart below).

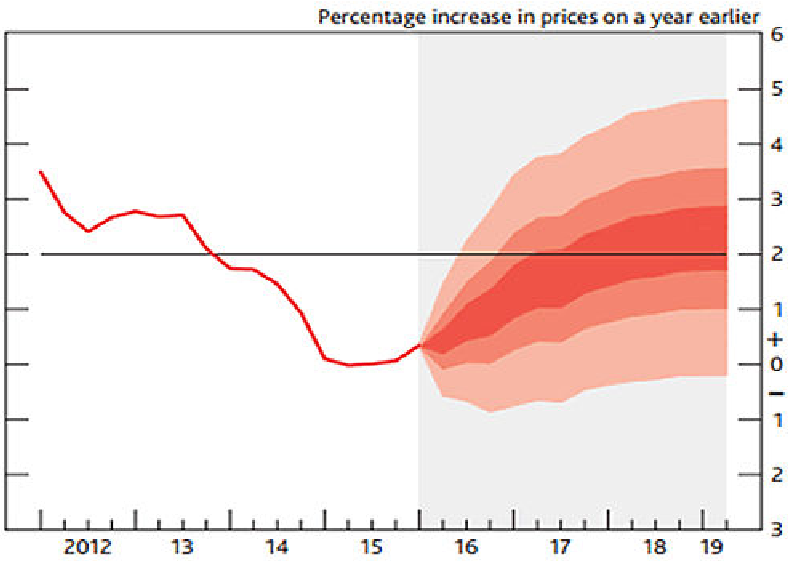
Costs to insure against UK Government



Source: Financial Times

In particular inflation could make a very unwelcome appearance as a result of Brexit. The CPS economists observe that using data from the below chart "CPI inflation is projected to pick up over the next year or so. In the Bank of England's central projection, under the path implied by market interest rates, domestic cost pressures are projected to return inflation to the 2% target by 2018. There is therefore a very high likelihood of the Bank of England overshooting its inflation target over the next couple of years. If monetary policy is further loosened, the risk of inflation overshooting the Bank of England's target becomes even more likely. Furthermore, given the sharp rise in the cost of imported goods following Sterling's relative weakness after the Brexit vote, these Bank of England estimates will likely be revised upwards".

Chart 5.13 CPI inflation projection based on constant nominal interest rates at 0.5% and £375 billion purchased assets



Source: CPS / Bank of England

So is Brexit bad news for bond investors? Absolutely not in the short term but looking further out trouble potentially looms. Government bond yields could rise substantially in the near future at a time when inflation looks like it might pick up. If inflation rates do start moving above 2 or even 3%, those sub 1% rates on long-term government debt may start to look hugely unappetising.

CDS Rates for Sovereign Debt

Country	Five Year
France	37.3
Germany	18.3
Japan	32
United Kingdom	38.5
Ireland	74
Italy	135
Portugal	297
Spain	95

Eurozone peripheral bond yields

Country	June 9th, 2016	July 11th, 2016	Spread over 10 year
Spain 10 year	1.40%	1.17%	136
Italy 10 year	1.36%	1.21%	140
Greece 10 year	7.37%	7.90%	809

	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

One of the more curious aspects of the whole Brexit saga has been the absence of the much anticipated collapse in British equities. Slightly annoyingly for the alarmist brigade, the benchmark FTSE 100 Index actually moved up in the weeks following the vote to leave the EU. But it's best not to be too complacent - beneath the headline numbers there have been some very significant moves. According to analysts at SG assets under management (AuM) at UK funds supplying data to EPFR Global fell by 9.1%, to $450bn. Losses were concentrated in equity (-11%) and money market funds (-9%), whereas bond fund AuM were more or less flat. The SG analysts caution that the data "should be viewed with caution and as only a partial estimate of the damage to the fund industry. A number of funds report only on a monthly basis, hence we will have to wait for the full picture. Also, these numbers do not capture the consequences of recent property fund suspensions or assets held by institutional investors that are beyond the scope of the EPFR dataset." The SG analysts also observe that in the two weeks between the referendum and 6 July (latest available data), UK equity mutual funds and ETFs (data until 6 July) saw $4.7bn net outflows, the highest level since at least 2007. Annualised, this works out at $122bn!

Little surprise then that last week Andrew Lapthorne of SG - he's their chief equity quant strategist - noted that the equal-weighted FTSE All Share was down 7.5% post the Brexit result and is down 6.5% in June. The MSCI Eurozone index lost 6.3% in euro terms with Ireland, Spain and Italy taking the biggest hits. Meanwhile, Japan also experienced big losses, losing 4.1% over the month courtesy of an ever-strengthening yen. The big table to the side is from analysts at S&P Dow Jones and shows the full list of developed world equity indices including the UK, which was down nearly 7% in June. Other markets fared even worse. Austrian and Portuguese stocks both fell by more than 10% in June while Italian equities collapsed in value by 22.79%.

Index	July	June	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	118.1	118.5	2967	115.3
FTSE 100 (Dec 14)	247.6	247	6671	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	10.35	4.83	11.9	-1	12.93	26.55	6670.40
S&P 500	3.53	3.36	13.87	2.52	63.35	96.51	2152.43
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	5.22	6.9	10.18	13.87	27.41	29.49	13.6675
Benchmark for volatility							
VIX New Methodology	-37.82	-5.78	-48.3	-6.19	-34.51	-46.91	13.04

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Volatility

Investor's looking for future global market volatility might do well to watch China very carefully. One key signal is flashing red - its exchange rate, and more particularly the currency pair between the Chinese yuan and the dollar. The chart shows this currency pair over the last year - what's immediately obvious is that remnimbi has steadily fallen back from 6.20 to its current trading level just below 6.70. This weakening for the RMB is in effect a new normal, clearly engineered in part by the Chinese central bank (the PBoC). Curiously there does seem to be a clear historical pattern at work - since the USD-CNY bottomed out in early 2014, there have been five waves of depreciation and each has followed a predictable pattern: three to five months of USD-CNY increasing (+3.5% on average), followed by modest gains (+1%) spanning an equivalent time span, before another round of depreciation ensues. The clear depreciation of the RMB is now sparking vigorous debate amongst Asia watchers. Should we move near term targets for the rate up from the current consensus level of 6.80 CNY/USD to a near term target at around 7.10? According to the optimists this steady depreciation is a sign that the Chinese central bank's measures are working, built around new capital control measures and a defines of the countries FX reserves. But this steady depreciation could very easily turn into a much more dangerous phenomenon if capital outflows start to pick up speed. Widely read hedge fund site Zero Hedge recently ran a story quoting research from American bank Goldman Sachs which argued that local Chinese investors have intensified their push to get capital out of the country.

According to Goldman's analyst MK Tang since October total net FX outflow has been about $500 billion, which is 50% above $330b implied by SAFE's onshore FX settlement data. Tang's analysis suggests "net capital outflows at $123bn in Q1 (vs. $504bn in Q3-Q4 combined last year). Of the Q1 net outflows, about 70% was due to Chinese residents' accumulation of foreign assets; 40% to repayment of FX liabilities; and -10% to foreigners' demand for RMB assets (i.e., foreigners were a source of net inflows in Q1)".

These capital outflows matter. If they start to pick up speed again, the Chinese central bank might start worrying again. Local market volatility could pick up as a consequence and we could see a sharp depreciation in the value of the local currency. This could in turn revive existing concerns about global deflation and currency wars. The net result? A sudden spike in market volatility in the second half of 2016.

Measure	July Level	June Level	May Level	April Level
Vstoxx Volatility	21.69	25.57	23.58	20.64
VFTSE Volatility	14.66	21.83	15.75	14.84

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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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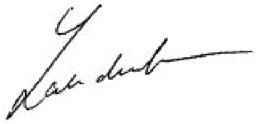
Kind Regards,



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