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UK Structured™ Products Association

Monthly Market Report

December 2014

With commentary from David Stevenson

Global stockmarkets seem to have recovered their poise and fears of an impending global meltdown have abated - for now at least! The bull's case is that the US economy is - if anything - strengthening, Japan is now betting the bank on massive monetary intervention and even the Eurozone might start to slowly recover some confidence. Analysts at Morgan Stanley in particular have looked at the reams of economic data coming out of the Eurozone and argue that their "economic surprise index has bounced off its lows in the last two weeks, and our economists expect the macro data to get modestly better from here. Bank lending to SMEs is also now positive again for the first time since 2008, and the Q3 results season has been encouraging, with the highest proportion of companies beating estimates since Q1 2011." If I had to bet on the consensus view amongst equity investors, I'd wager that we've probably seen the worst of the bad news but that confidence is fragile and could easily be knocked by bad news out of China, the US or even Latin America.

The other big story of the last few weeks has been lower energy prices - I'd wager that crude oil (WTI) prices could smash past $60 barrel. Bizarrely, the current pessimism has somehow translated this good news story into a token of fear - that deflation is rampant, that the emerging markets won't have the money to spend because of lower resource revenues and that the oil economies could be fragile and cause systemic collapse. By contrast, I suspect that lower oil prices is great news for investors in leading US and UK corporates - and their equities - and is another reason to stay cautiously bullish on shares for the long term.

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Headline Numbers

Measure	Value as of October 16, 2014	Value as of November 14, 2014
UK Government 10 year bond rate	1.98%	2.18%
GDP Growth rate YoY	3.20%	3.00%

CPI Core rate	1.50%	1.50%
RPI Inflation rate	2.30%	2.30%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.54%	0.54%
Government debt to GDP ratio	90.60%	90.60%
Manufacturing PMI	51.60	53.20
Sovereign Western Europe CDS	45.49	33.89
Euro Bank CDS	97.10	102.92
FTSE CDS	98.00	98.00

There's not much news to report on the economic home front for UK investors. The UK economy continues to push ahead, outpacing its Eurozone peers, helped along by low interest rates and resurgent consumer demand - although one wonders how much of that spending by consumers is fuelled by bingeing on cheap debt? The only other nagging doubt is about those inflation figures, which suggest that even the UK could be facing a deflationary blast. On paper, those low CPI numbers should bring some relief to UK consumers, and possibly even result in sustained real income growth - but many investors worry that the Eurozone's troubles might be infecting the UK as well, with export orientated manufacturers the most vulnerable.

Headline Thought

The autumn hasn't been especially kind for UK-based equity investors with a big sell off in the last two months, but how have emerging stocks performed by comparison? Index firm Russell recently released some numbers for the last few months through to November 6th, which show that their version of a broad global emerging markets equity index has returned 13.1% in 2014 year-to-date outperforming developed markets in the U.S. and Europe (based on the Russell Developed Europe Index which was up 3.1% while the US based Russell 3000® Index returned 10%). Top performing markets in the developing world were India (+49.7%), Thailand (+39.1%) and the Philippines (+35.8%) while Russia (-18.9%) and Greece (-19.2%) headed up the list of big losers. Yet even though EM stocks have outperformed their developed world peers, equity valuations are still cheap especially when compared to US stocks. Big EM funds have started seeing noticeable inflows and most measures of investor sentiment suggest that EM equities have at long last turned the corner in terms of sentiment.

Russell Index / Country Constituent	Q4 Performance (as of 6th November, 2014)	2014 YTD Performance (as of 6th November, 2014)
Russell Emerging Markets Index	0.30%	13.10%
Russell Developed Europe Index	**-1.50%**	3.10%
Russell 3000® Index	3.40%	10.60%
Russell Emerging Markets Index - India	5.90%	49.70%
Russell Emerging Markets Index - Thailand	**-0.10%**	39.10%
Russell Emerging Markets Index - Philippines	0.90%	35.80%
Russell Emerging Markets Index - Indonesia	0.20%	35.60%
Russell Emerging Markets Index - UAE	**-9.20%**	31.00%
Russell Emerging Markets Index - Turkey	6.10%	22.00%

Russell Emerging Markets Index - South Africa	5.70%	19.00%
Russell Emerging Markets Index - Taiwan	0.90%	15.80%
Russell Emerging Markets Index - China	4.70%	15.30%
Russell Emerging Markets Index - Mexico	0.20%	13.70%
Russell Emerging Markets Index - Colombia	**-2.50%**	10.60%
Russell Emerging Markets Index - Malaysia	**-1.10%**	9.90%
Russell Emerging Markets Index - Poland	**-3.70%**	4.80%
Russell Emerging Markets Index - Chile	1.50%	4.60%
Russell Emerging Markets Index - Korea	**-4.90%**	2.60%
Russell Emerging Markets Index - Brazil	**-5.10%**	2.50%
Russell Emerging Markets Index - Russia	**-8.20%**	**-18.90%**
Russell Emerging Markets Index - Greece	**-11.40%**	**-19.20%**

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CDS Rates

It's been a quiet few weeks for CDS products based on bank bonds, with no real big moves in terms of pricing. The only noticeable trend is that the cost of insuring bonds issued by key UK banking institutions has continued to fall pretty much across the board, especially for outfits such as RBS - although it's also worth noting that Lloyds is increasingly seen as a very safe bank (assuming we believe that these CDS prices give out any meaningful messages), even when compared to the likes of HSBC and Rabobank.

Bank	One Year	Five Year	Monthly Change	Annual Change	Credit Rating
Banco Santander	30	74	0	-87	A -
Barclays	18	61	-1	-45	A
Citigroup	23	67	-9	-28	A
Commerzbank	29	81	-6	-47	A+
Credit Suisse	18	55	1	-25	A
Deutsche Bank	33	75	3	-15	A+
Goldman Sachs	33	82	-5	-31	A
HSBC	14	48	2	-27	AA-
JP Morgan	21	61	-3	-22	A+
Lloyds TSB	19	58	-5	-45	A
Morgan Stanley	29	78	-9	-32	A
Nomura	23	83	5	-12	A-
Rabobank	12	43	-4	-33	AA-
RBS	22	64	-12	-71	A
Soc Gen	19	78	4	-32	A
UBS	18	47	-1	-28	A

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Government Bonds

Over the last few weeks the great switch into supposedly 'safe' bonds has slowed down a little, with yields on long dated UK gilts nudging back to around 2.20% (for 10 years) whilst even German bunds have seen yields creep back above 0.80% (again for 10 year issues). But look beneath the surface and an even more interesting story emerges - the spread between 'uber-safe' German bonds and 'riskier' Spanish and Italian bonds has tightened dramatically and yet again we find ourselves in a topsy-turvy world where Spanish bond yields are lower than UK gilt yields, while Italian yields are only a smidgeon above our own rates - not bad for a government facing huge structural challenges and no control over its own currency. Oddly though, if we look at the market for sovereign bond CDS products, UK gilts cost less to insure over a five-year period than German bunds!

UK Government Bonds 10-year Rates

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

CDS Rates for Sovereign Debt

Country	Five Year	Annual Change %
France	51	2
Germany	20	1
Japan	49	**-4**
United Kingdom	19	**-6**
Ireland	57	-67
Italy	123	-70
Portugal	207	-150
Spain	95	-69

Eurozone peripheral bond yields

	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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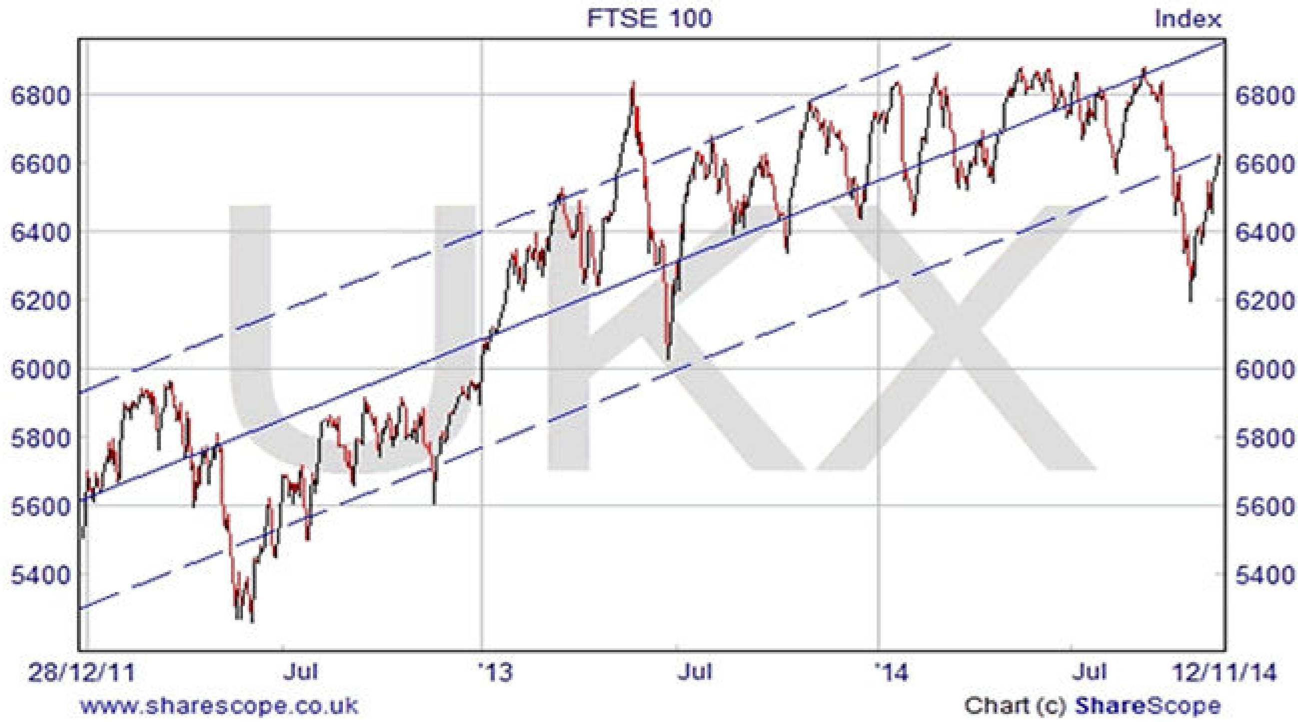
Equity Markets and Dividend Futures

A few weeks back, the research team at Morgan Stanley brought out a paper that looked at the losers and winners in the big sell off between September 18 and October 31. According to the MS analysts, over this period the market sold off by over 7% through October 15, then recovered all losses (and slightly more) over the remainder of October. "Mega-caps outperformed large-caps by 2.1% [beta-adjusted] through October 11, before reversing and finishing the period flat". That game of two halves was also true for growth stocks versus value - growth initially outperformed beta then under performed in October.

Overall quality stocks beat most other stocks over the whole period while "dividend yield [stocks were] strong during the sell-off and remained positive throughout." Many hedge funds had a tough few weeks with event driven funds suffering particularly steep losses. Traditional equity long/short funds also had a bad few weeks. Overall, October was a good month for small-cap stocks while mega-caps underperformed modestly, although it's also worth noting that small-cap stocks have still underperformed by over 8% in the last 12 months.

Back in the UK, the FTSE 100 Index has recovered most of its losses for the last two months with recent gains in the last few days breaking through the lower support levels for this benchmark index. If trend lines are to be believed – our chart shows trend dating from the end of 2011 - the next target for the FTSE 100 should be above 6900.



Index	November Level	October Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	**114**	**112.8**	**3066**	112
FTSE 100 (Dec 14)	**233**	**233**	**6642.75**	233

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	4.28	-0.32	-3.51	-1.72	25.29	58.08	6611.04
S&P 500	6.93	5.4	7.47	15.31	87.47	139.15	2038.25
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	0.45	-0.68	2.42	5.28	5.98	15.05	11.8962
Benchmark for volatility							
VIX New Methodology	-8.12	-38.7	-7.86	6.46	1.56	-46.29	13.02

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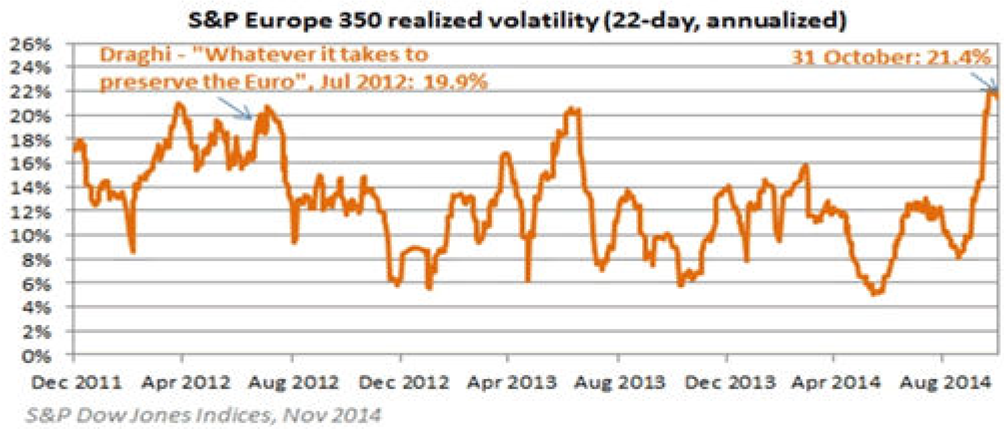
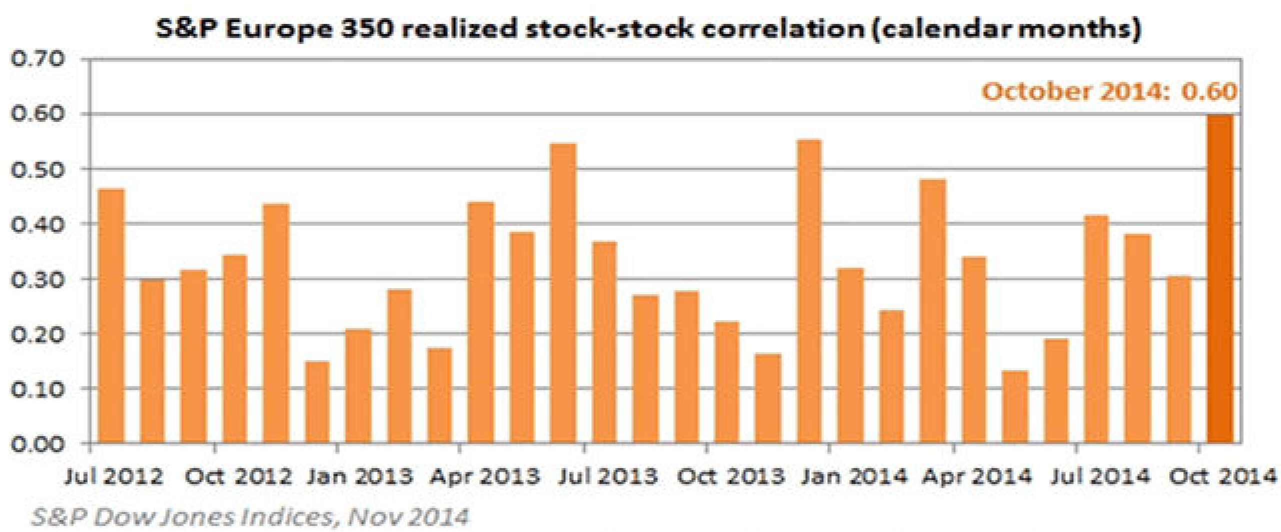
Volatility

October in particular was a difficult month for European equities. According to S&P, their Europe 350 Index fell by over 3%, "taking a day-to-day lead from Greek government bond prices, and with every sector and nearly every country posting a loss for the month. A 3% loss is not unusual, nor remarkable. But the warning lights are flashing..."

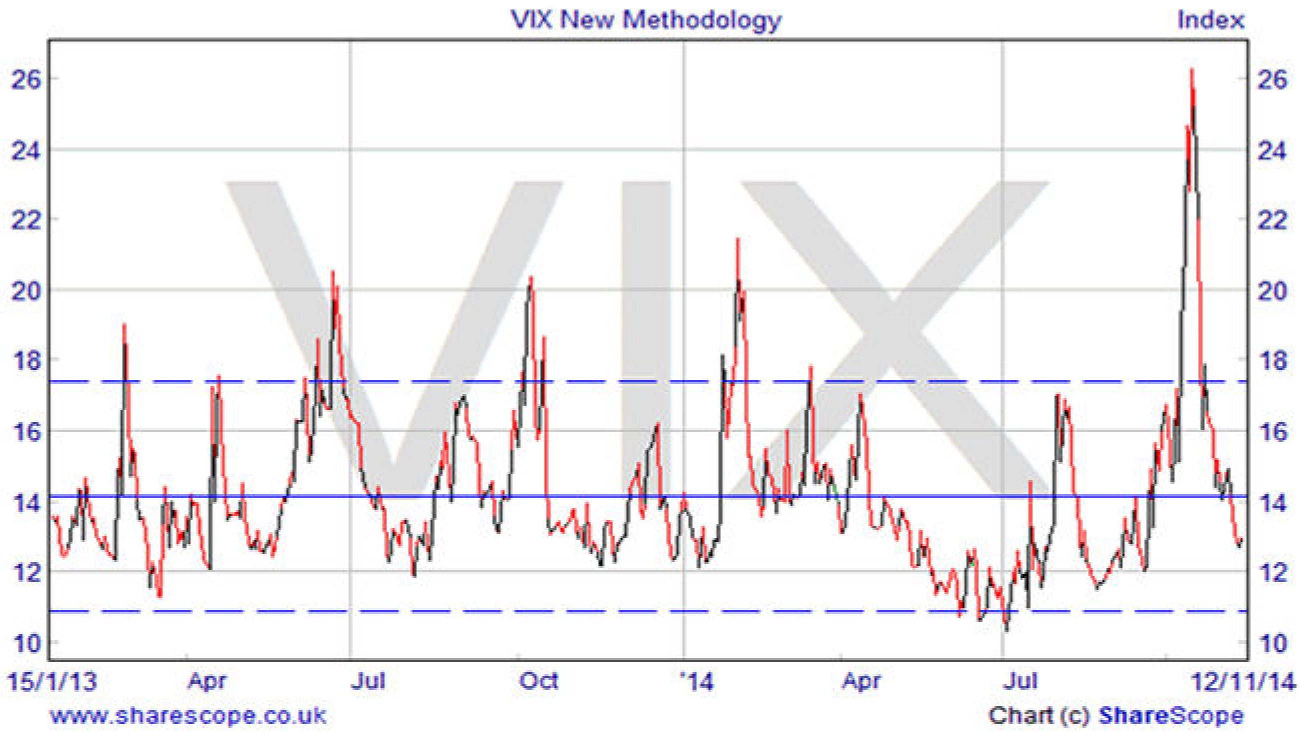
Our first volatility chart suggests that 22-day realized volatility in this mainstream European index has now nearly tripled since September, hitting a two year high.



The second volatility chart measures the degree to which stocks within this index have moved together - this has increased markedly and the correlation amongst S&P Europe 350 stocks for the month of October was also the highest for over two years. In fact, S&P reckons it's now the highest since 2007! S&P's take? "High correlations and high volatility tend to persist in the short term. And elevated levels of both lead to a highly unstable marketplace. Don't be surprised if there are some bigger bumps down the road." If this analysis is right, European investors might expect bigger stock losses in the next few months as the continent-wide crisis grapples with deep austerity.



Looking at the main US measure of volatility called the Vix - captured in the third volatility chart - we can see that market turbulence has collapsed back again and we're now back at the abnormally low level of the last two years. Is the market trying to say that the crisis in US stocks is over but there's more fear to come in European stocks? Investors in structured products who are confident that an economic meltdown can be averted, might take heart from these measures - a high perceived risk of volatility might produce better options prices which will feed through into better terms for SP issues.



Measure	November Level	October Level	September Level	Acc/Dec	Direction Upwards
Vstoxx Volatility	20.31	31.4	16.6	ACC	Yes
VFtse Volatility	14.15	25.74	15.45	ACC	Yes
FTSE Put Call Ratio	0.95	1.5	0.82	ACC	No

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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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