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UK Structured™ Products Association

Monthly Market Report

December 2015

With commentary from David Stevenson

Time for a confession. I'm finding it very hard not to feel too smug about falling oil prices. I've been boring investors and advisers at various events over the last six months about my bearish views on oil. Put simply, I've long felt that the Saudi's job wasn't anywhere near finished. The idea that they'd be happy with oil at $40 has always struck me as laughable. We need a proper push down to an extreme low of $20 before the real pain is felt in US Shale. Sure enough we are now seeing the latest push down in oil prices - entirely predictably. International benchmark Brent crude has fallen back below $45 a barrel - below the temporary bottom it hit in January and the lowest level since its upward climb from $42 in late August. US benchmark West Texas Intermediate is also back below $42 a barrel. I think this is hugely significant as it indicates that we are now approaching the capitulation phase where all those suckers/optimists who thought we'd seen the worst are forced to sell, pushing prices sharply lower, triggering mass defaults and wholesale industry restructuring.

I should also say that I think its fantastic news for the global economy, as we'll eventually see sharply lower energy prices revitalise consumer demand in early to mid-2016, but not before we see big volatile swings in the UK stock market.

If all this wasn't bad enough in the short term for equity investors I'd also draw attention to another significant trend - weakening dividend growth in Europe. Andrew Lapthorne at Societe Generale reports that although the US and Japan have been boosting dividends (from what are admittedly miserable levels), UK and Eurozone dividends have gone nowhere. Dividend downgrades are also common and cuts are on the rise. Hardly what you'd expect if corporates were seeing a profit recovery. My sense is that these declining energy prices and worries about dividend growth will weigh on the mind of equity investors in the last quarter of 2015.

One last small observation. An accompanying article about property reminds us that ordinary investor's don't need many excuses to avoid seeking financial advice about investment. If property remains a one-way bet (!) why invest in the volatile option? So how do we get investor's collectively engaged with their financial future? A recent report from Pershing Ltd gave one answer - stop talking about opportunity for investment growth and focus on specific life events. According to their survey the "vast majority of the 1,002 mass affluent and high net worth UK individuals surveyed for the report sought financial advice correlating to a specific life change. The most popular reasons are a career move (13% of respondents), location change (13%), marriage (9%), retirement (8%) or financing a property (8%). Most of the key life events that prompt individuals to seek advice take place between the ages of 38 and 50 with those 40 and under experiencing twice as many high-value life events than the older client groups." It seems that those advisers who've long argued for a focus on financial planning rather than investment opportunities were spot on after all!

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Headline Numbers

Measure	Value as of October 12th, 2015	Value as of November 13th, 2015
UK Government 10 year bond rate	1.86%	1.97%

GDP Growth rate YoY	2.40%	2.30%
CPI Core rate	1%	1%
RPI Inflation rate	1.1%	0.8%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.57%	0.57%
Government debt to GDP ratio	89.4%	89.4%
Manufacturing PMI	51.5	55.5

A couple of stories caught my eye this month, both of which talked to some peculiarly British obsessions about our economy. The first, I suppose, is what still conscripts bad news, which is that although the UK economy looks to be in decent shape we are still suffering from a weak export sector. Hopes that we'd see a rise of the 'makers' and the rebirth of British industry perhaps look a tad optimistic. The key driver has been the muted performance of industries producing visible goods. Net trade in services increased by £8.1 billion in 2014, but this was more than offset by a widening deficit in the balance of trade in goods. The most recent ONS report by the government's statisticians reported a £10.8 billion fall in the export of goods over the same period, leading to the UK's goods deficit increasing by £8.4 billion. More recent data highlights concerns for both the exports of goods and services. A British Chambers of Commerce survey reports that the balance of exports in both services and goods has slumped between Q2 2015 and Q3 2015, highlighting major concerns for the Government's export ambition target of £1 trillion by 2020.

But there is some good news - or maybe it might actually constitute bad news depending on your opinion of the UK property market. It is of course always wonderful news to hear that our houses are worth more than ever but maybe it's also terrible news - for UK exporters, for our kids and for potential future bad debts?

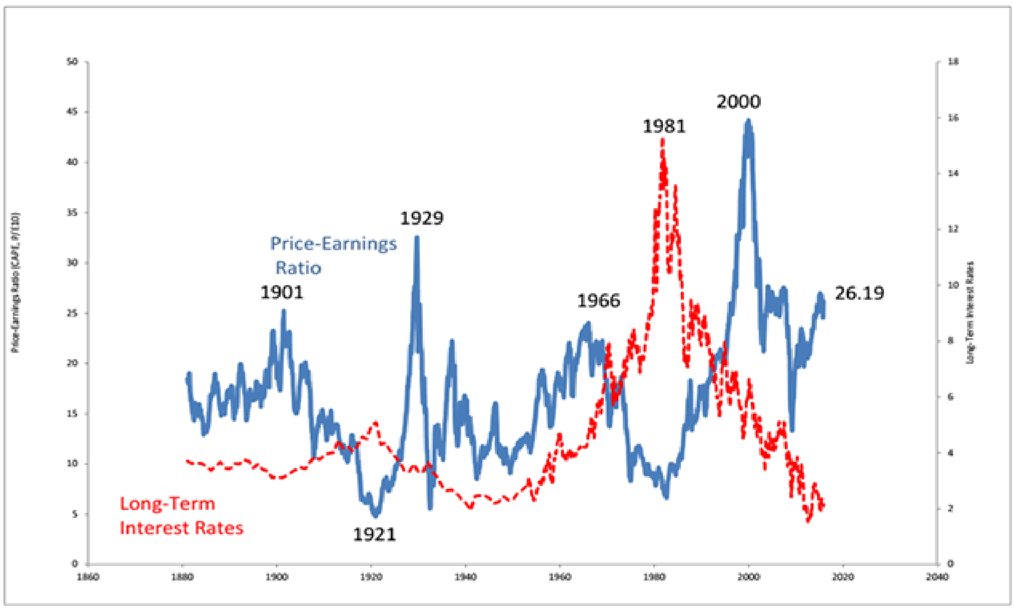
Anyway, whatever your take, a survey by Bank of Ireland UK this month revealed that recent stock market volatility "appears only to be fuelling confidence in the UK's buy-to-let market". Yep it does actually say that! There are many things that I have long assumed are powering the British obsession with property but I had naively assumed that worry about stock market volatility wasn't one of them. This quarterly survey by the Irish bank revealed that almost 30% of British landlords are more likely to invest in buy-to-let properties as a result of concerns about growth in China and the Eurozone. I was slightly relieved to see that 2/3rds of those surveyed said that the recent turmoil would make no difference to their investment attitude with only 8% less likely to invest in buy to let. Overall the survey revealed that most buy to let landlords are fairly positive about the state of the market - there is currently a positive view of the market at 61.4, "remaining above 60 for the third quarter in a row and up from 58.7 in the first wave of research in June 2014. Scores in excess of 50 out of 100 indicate a positive outlook for the UK's buy-to-let market."

Trebles all around. Our exports may be stagnating but our housing investments are booming in value.

Stock markets in the developed world have been edging higher again after the dark days of the early autumn, with the US taking the lead. As we discuss elsewhere in this update, sentiment indicators suggest that the bulls are firmly back in the saddle. But the bad news is that these indicators of sentiment and momentum are diametrically at odds with another bunch of measures, namely fundamental valuation based metrics with the most widely used focusing on the price to earnings ratio.

As the first chart below shows, the price-earnings ratio for the Standard & Poor's 500 Index is close to a five-year high at the end of October the S&P 500 was valued at 18.8 times earnings according to data compiled by Bloomberg. The ratio peaked at 18.9 times on July 20 and dropped to 16.6 times on Aug. 25, when the index set this year's low.

These numbers are troubling enough - indicating as they do that US equities are fully valued - but the next chart tells a much more worrying story. It looks at the PE ratio in an historical context, using 10 year trailing earnings to establish what's called a cyclically adjusted PE ratio. In simple layman's terms this measure, popularised by economist Robert Shiller, strips out the ebb and flow of business cycles and gives us an historic measure for the PE ratio. As you can see from the chart, the current CAPE for the S&P 500 index is a chunky 26.19 times earnings - well above the historic average (and even above peak levels in the 1960s).



Source: Bloomberg

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Bank CDS options

Something very interesting is happening on the markets that trade bank CDS contracts. Over the last month the price of a huge swathe of these options has tumbled markedly. Take one small example, Lloyds Bank. Last month their contracts against 5-year bank bonds were trading at 70 basis points - now we're at 50 basis points, a remarkable drop in just a few weeks. But these price falls have been across maturities and include one, three and five year structures. HSBC contracts for example for one year have fallen markedly from 40 to 27 basis points. But for this observer the most remarkable story now centres on RBS. Until a year ago, it's CDS rates were abnormally high though not unsurprising given its troubled past. Now its CDS contracts trade at nearly the same level as HSBC. What a remarkable turnaround. So, given these sharp price falls, are there any wider implications? I find the changes curious as we're seeing some high yield bond yields move up sharply, indicating that investors are worried about a global slow down. But if we were just a few steps away from a recession why push CDS rates on bank bonds to such low levels? Maybe we should stop worrying about market risk and embrace our bullish side?

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	59	126	-4	48	A -

Barclays	19	62	-8	1	A
Citigroup	28	82	-20	22	A
Commerzbank	39	89	-8	27	A+
Credit Suisse	41	81	6	24	A
Deutsche Bank	40	92	1	14	A+
Goldman Sachs	33	82	-17	1	A
HSBC	27	69	-11	20	AA-
JP Morgan	33	73	-15	11	A+
Lloyds Banking Group	27	50	-7	-8	A
Morgan Stanley	32	82	-17	3	A
Nomura	21	65	-4	-16	A-
Rabobank	22	55	-10	9	AA-
RBS	28	69	-10	4	A
Soc Gen	40	75	-13	0	A
UBS	27	52	-7	4	A

Source: Meteoram.com, 7th November, 2015.

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Government Bonds

Inflation is bad news for investors in bonds. The conventional wisdom is that as retail prices start to rise, central bankers start to yank on the interest rate levers, pushing up interest rates. Inflation also eats into the nominal capital value of conventional bonds.

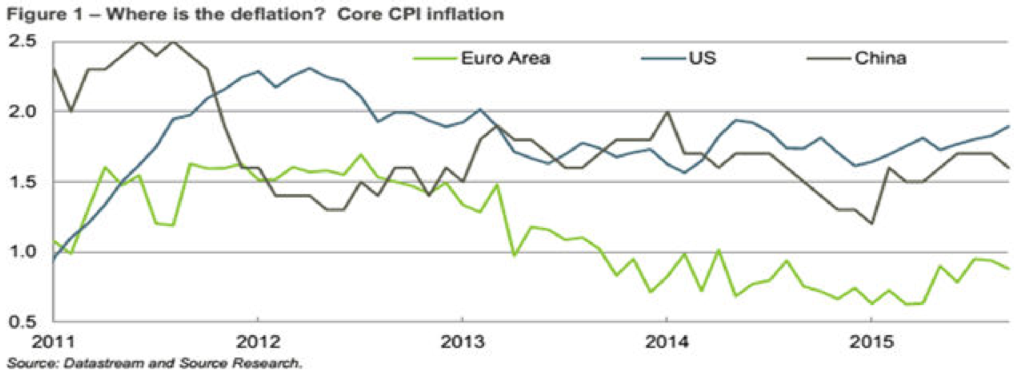
The good news is that inflation at the moment seems to be very distant concern for most investors, which has cheered up those investing in bonds. With collapsing oil prices, deflationary forces are ripping through the global economy. Just last month for instance I noticed the following core inflation rates: - US 0.0%, Eurozone -0.1%, UK -0.1%, China 1.6%. But notice that I used the term core inflation - shouldn't we actually be looking at headline inflation? Before we answer that question let's first have a quick primer about the difference between these two measures. Core inflation ignores food and energy while headline inflation includes everything, including food and energy. Talk to central bankers and they'll say they prefer core inflation for a number of reasons:

1. Headline inflation is more volatile than core inflation.
2. The core predicts headline inflation.
3. The 'relative price' argument. This says household budgets are fixed, so more money spent on one good must lower the amount spend on another good.
4. Households may prefer that we focus on a subset of prices.

This distinction matters because the core and headline inflation numbers have been telling a very different story in recent months. Or at least that's the view of Paul Jackson at ETF specialist Source. He suggests that fears of deflation are greatly exaggerated; if anything, core inflation has been creeping up during 2015 as the chart below shows.

According to Jackson, "why core CPI is not following headline inflation lower is not clear (it often does with a lag), especially since commodity prices have been falling for some time. Maybe tightening labour markets and excessively loose central bank policies are working their magic on underlying inflation trends (Sweden's measure of core inflation is called underlying inflation and has risen from 0.5% at the start of the year to 1.0% in September). Price movements over the last few weeks in the stockmarket indicate that investors are more focused on headline, rather than on core, inflation - bond yields are down (the 5y/5y forward inflation rate is down around 10bps in the last week to 2.07%)."

But maybe just maybe bond investors are looking at the wrong measure? What happens when oil prices stop falling and start pushing up again? Will workers in the US and the UK start demanding big wage increases, fuelling domestic inflationary pressures? Could we see inflation emerge again, with dramatic consequences for bond investors?



UK Government Bonds 10-year Rates 1.97%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	28
Germany	13
Japan	44
United Kingdom	17
Ireland	46
Italy	98
Portugal	213
Spain	90

Eurozone peripheral bond yields

Country	October 12th, 2015	November 13th, 2015	Spread over 10 year
Spain 10 year	1.83%	1.78%	122
Italy 10 year	1.69%	1.56%	100
Greece 10 year	7.58%	7.19%	663

	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

The bulls seem to have retaken control of the US stock market, again. The US benchmark index, the S&P 500, has more than tripled since March 2009, with investors' search for yield, added to an investment boom in oil and gas, a housing market bounce back, technology-related productivity gains and a broader recovery underpinning companies' performance. That outperformance has continued in recent weeks and months. Equity markets performed well globally in October: the Dow was up 9%, the S&P 500 was 8%, with all 10 sectors of the S&P 500 were up for the month.

This optimism about US equities can be seen clearly from technical market based indicators, especially for the S&P 500 benchmark index. The chart below shows one year returns for the S&P 500 with the thin lines representing the 20, 50 and 200 day moving averages. At around 2,100 the S&P 500 is firmly in bullish territory, with current prices well above all key technical measures for momentum.

But these technical measures are only one part of a wider jigsaw of sentiment indicators that are nearly all flashing green - optimism and confidence seem to abound. The widely followed CNN Fear and Greed index, which picks up on a wide range of sentiment based measures, is one excellent way of summarising market views. This excellent summary of measures demonstrates that bar one or two categories, US investors are firmly in the extreme greed phase i.e. excessively bullish:

CNN Fear and Greed Index - updated November 6th

Stock Price Breadth:
Extreme Greed
The McClellan Volume Summation Index measures advancing and declining volume on the NYSE. During the last month, approximately 1.83% more of each day's volume has traded in advancing issues than in declining issues, pushing this indicator towards the upper end of its range for the last two years.

Stock Price Strength:
Extreme Greed
The number of stocks hitting 52-week highs exceeds the number hitting lows and is at the upper end of its range, indicating extreme greed.

Safe Haven Demand:
Extreme Greed
Stocks have outperformed bonds by 6.09 percentage points during the last 20 trading days. This is close to the strongest performance for stocks relative to bonds in the past two years and indicates investors are rotating into stocks from the relative safety of bonds.

Put and Call Options:
Extreme Greed
During the last five trading days, volume in put options has lagged volume in call options by 37.34% as investors make bullish bets in their portfolios. This is among the lowest levels of put buying seen during the last two years, indicating extreme greed on the part of investors.

Market Volatility:
Neutral
The CBOE Volatility Index (VIX) is at 14.33. This is a neutral reading and indicates that market risks appear low.

Market Momentum:
Fear
The S&P 500 is 2.33% above its 125-day average. During the last two years, the S&P 500 has typically been further above this average than it is now, indicating that investors are committing capital to the market at a slower rate than they had been previously.

Junk Bond Demand:
Extreme Fear
Investors in low quality junk bonds are accepting 2.15 percentage points in additional yield over safer investment grade corporate bonds. This spread is higher than recent levels and suggests that investors are becoming more risk averse.

Index	November	October	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	115.2	114.2	3356	110
FTSE 100 (Dec 14)	248.5	248.2	6118.28	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	-3.53	-6.85	-11.96	-7.79	5.54	15.52	6118
S&P 500	2.11	-1.8	-2.5	0.33	70.61	87.0	2039
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-1.82	-1.64	0.21	2.18	15.34	17.97	12.16
Benchmark for volatility							
VIX New Methodology	3.96	36.17	33.5	33.21	10.33	-10.87	17.08

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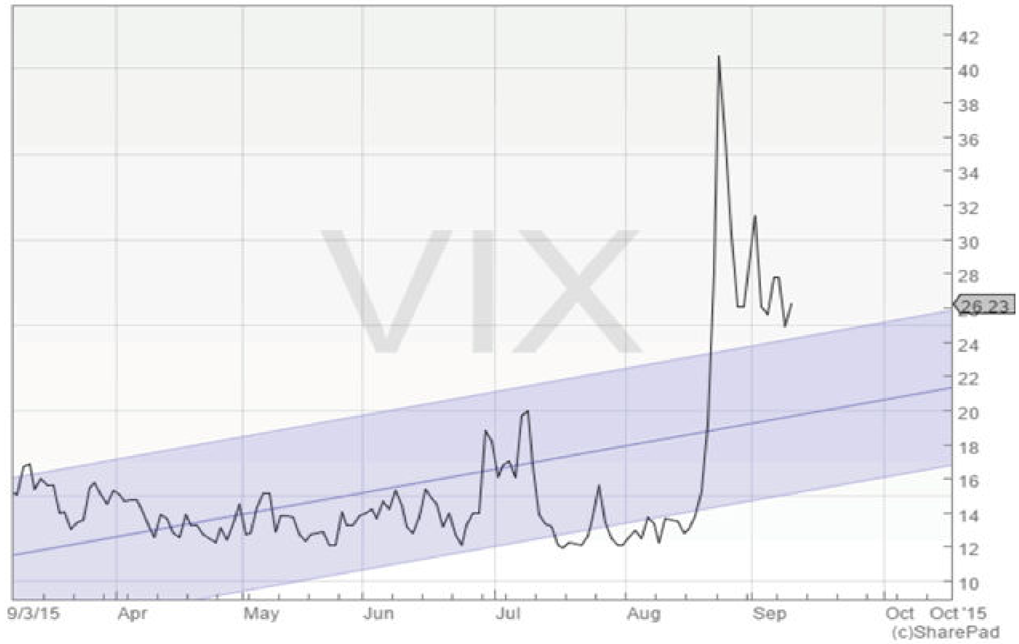
Volatility

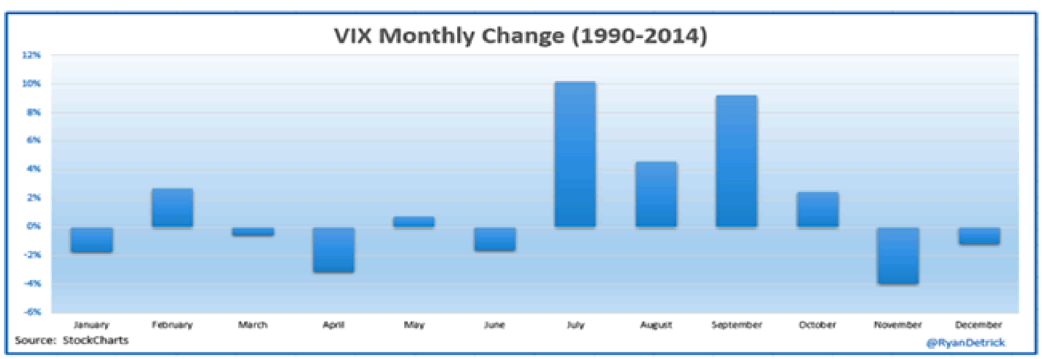
Over the last few weeks we've seen isolated surges in the measure of US stockmarket volatility, called the VIX index. The so called fear gauge - which measures expected volatility from the price of US stock options - has recently been posting big one day jumps. In fact during the week before last the VIX registered an 18% increase to just under 17 before dropping back again. Yet it's also true that the VIX remains below its long-term average of 20 and well below the intraday high of 53.29 seen in August.



Source: SharePad

Just how frightened should equity investors be about stock market volatility? An excellent online blog by Ryan Detrick called Seeitmarket has some clues to long-term behaviour. You can view the blog online here.

According to Detrick, we should stop worrying about volatility - markets are still in relatively calm waters. The first chart below from the blog looks at seasonal adjusted vol. According to Detrick "seasonality-wise, the next two months tend to see a muted move in market volatility." The second chart looks at VIX averages per year - according to Detrick the average yearly value since 1990 has been 19.84. He reckons that "even after the big swings in equity prices and market volatility we've seen since late August, it is worth noting the VIX has averaged just 16.53 in 2015. This is the fourth straight year beneath the long-term average of about 20. For years we've been hearing about higher market volatility coming. It hasn't happened yet."



Source: http://www.seeitmarket.com/is-market-volatility-set-to-rise-again-vix-fear-gauge-14957/

Measure	November Level	October Level	September Level	August Level
Vstoxx Volatility	25.1	24.1	27.76	18.71
VFtse Volatility	19.56	16.6	21.07	1.26
FTSE Put Call Ratio	0.99	1.01	1.01	1.02

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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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