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UK | STRUCTURED ™ PRODUCTS ASSOCIATION

Monthly Market Report

February 2015

With commentary from David Stevenson

The New Year hasn't started well. Investors are in a sour mood, unsettled by plummeting oil prices and worried about what the European Central Bank will do next. Volatility is trending upwards and CDS rates on bank bonds are also slowly inching upwards. By contrast yields on longer duration government bonds are tumbling again, as everyone (and their dog) bets that the global economy is slowing down - and edging ever nearer the abyss of a recession.

In amongst all this top down macroeconomic worrying, it might be worth pausing to consider whether investors are missing some other key trends, not least evidence here in the UK that dividend payouts are likely to improve, albeit slowly in 2015.

Recent numbers from Capita Asset Services UK Dividend Monitor from early January suggest that although 2014 wasn't a great year, dividends did actually grow, just - and should carry on increasing in 2015 once exceptional factors are ignored.

According to Capita by the end of the year, dividend payouts will have fallen in real terms, up just 1.7% year on year to £79.3bn on an underlying basis. FX rates were a big factor in holding back this growth - sterling's gyrations probably knocked at least £3.5 billion off the payout in 2014. According to Justin Cooper, CEO of Shareholder Solutions at Capita Asset Services "looking ahead to next year, the strength of sterling is unlikely to be quite such an issue. The dollar is growing in strength, which bodes well for those reporting in the US currency. A return to significant growth for the US economy is also leading a global recovery, which, when combined with ongoing resilience in the UK economy, will help improve dividend payouts."

Obviously there could be some surprises along the way, not least from the long list of resources stocks in the FTSE All Share. Capita observes that "commodities companies, and specifically oil and gas giants, are traditionally dividend heavyweights in the UK, accounting for almost 13% of payouts across the market, so if their profits take a battering, they will find it harder to grow their dividends. We would not expect them to cut payouts in dollar terms however. Consumer services saw the best performance in 2014, with a host of special dividends boosting the total, but big retailers such as supermarkets continue to face threats from fresh competition, and dividends from the likes of Tesco certainly have much further to fall."

One specific stock is also likely to have an outsized impact - Vodafone. In 2014 its special dividend of £15.9 billion had a major impact on the £97.1bn headline figure for 2014. According to Capita, that payout won't be matched in 2015, "so we forecast total headline dividends in 2015 will be £85.8bn, a decline of 11.7% from the 2014 total. However, if we look beyond this one-off payout, the underlying picture is much better. We expect dividends to grow by 5.5% in 2015, to a total of £83.7bn."

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Headline Numbers

Measure	Value as of December 12, 2014	Value as of January 15, 2015
UK Government 10 year bond rate	1.90%	1.51%
GDP Growth rate YoY	3.00%	2.60%
CPI Core rate	1.50%	1.30%
RPI Inflation rate	2.00%	1.60%
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	53.50%	52.50%
Sovereign Western Europe CDS	48.19%	53.35%
Euro Bank CDS	195.37%	205.58%
FTSE CDS	68.54%	78.30%

The UK economy continues to chug along at a decent pace, with inflation rates continuing to fall as those lower energy prices finally have an impact. Debate also continues about whether the Bank of England will at long last increase interest rates in 2015. Determined action by the European Central Bank to arrest deflationary trends may be an important shot in the arm for the UK economy as will continued signs of robust growth in the US. But if we're all honest, the only really important story for 2015 is THAT election, the general election. Yes we are but mere months way from the dreaded day and a great chart - reproduced below from the excellent electoralcalculus.co.uk website - might go some way towards explaining why so many investors are fearful. It shows the 12 possible permutations of the election result ranging from an outright Labour majority through to no overall control. The key concern has to be the structural instability inherent within the system, fuelled by the rise of minority parties and the increasingly vitriolic debate about what to do about the public sector deficit and government spending.

		% Support					Predicted seats						
	Scenario Type	CON	LAB	LIB	UKIP	SNP (Scot)	CON	LAB	LIB	UKIP	NAT	MIN	Comment
1	Labour majority	29.0	35.0	8.1	17.2	43.5	227	336	21	0	47	19	Labour majority of 22
2	Lab choice of Lib/Nat	30.6	33.4	8.1	17.2	43.5	243	319	19	0	50	19	Labour need six seats - could be LibDem, SNP, or DUP
3	Lab/Nat coalition	32.0	32.0	8.1	17.2	43.5	267	297	18	0	49	19	Labour need 29 seats - only SNP have enough
4	Nat choice of Con/Lab	33.0	31.0	8.1	17.2	43.5	280	286	16	0	49	19	Labour need 40 seats, Conservatives need 46 seats. SNP have enough for either
5	Con/Nat coalition	34.4	29.6	8.1	17.2	43.5	302	267	14	0	48	19	Conservatives need 24 - only SNP have enough
6	Conservative majority	37.0	27.0	8.1	17.2	43.5	340	231	11	0	49	19	Conservative majority of 30
7	Con choice of Lib/Nat	35.4	28.6	8.1	17.2	43.5	318	253	12	0	48	19	Conservatives need 8 seats - could be LibDem or SNP
8	Con/Lib coalition	27.0	21.2	23.9	17.2	43.5	262	214	97	0	57	20	Conservatives need 64 seats - only LibDems have enough
9	Lib choice of Con/Lab	25.6	22.6	23.9	17.2	43.5	236	241	97	0	56	20	Labour need 85 seats, Conservatives need 90 seats. LibDems have enough for either
10	LibDem majority	19.0	19.0	34.1	17.2	43.5	82	158	339	0	50	21	Lib Dem majority of 28
11	Lab/Lib coalition	24.6	23.6	23.9	17.2	43.5	218	255	102	0	55	20	Labour need 71 seats - only LibDems have enough
12	No overall control	29.0	26.2	16.9	17.2	43.5	260	267	48	0	55	20	Labour need 59 seats. Conservatives need 66 seats. No other single party has enough.

Source: electoralcalculus.co.uk

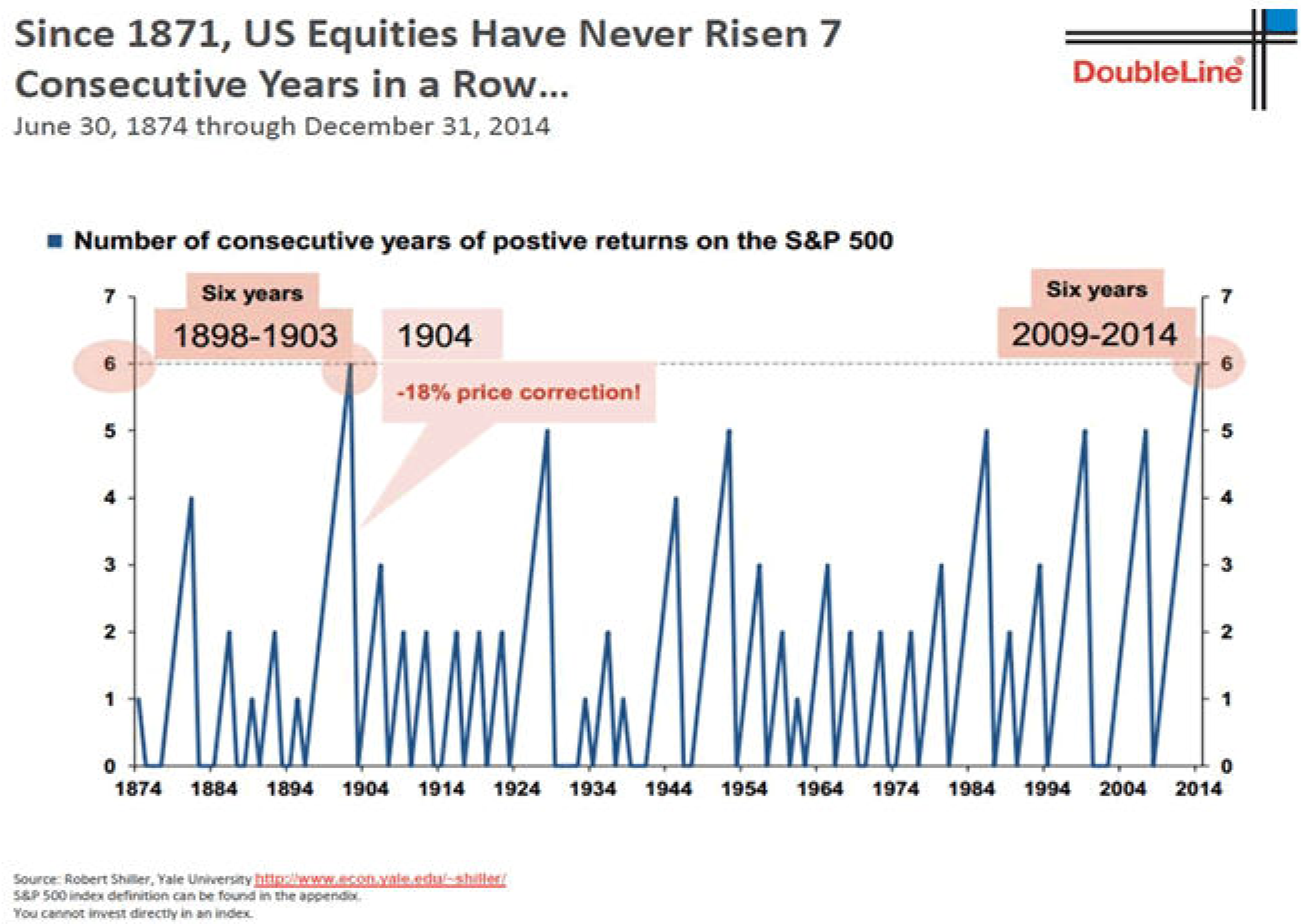
Headline Thought

This month I'm going to very briefly dwell on one simple observation, mapped out in the chart below courtesy of DoubleLine in the US - that it's about time the US stock market started falling in value! It charts US shares since not long after their own Civil War and suggests that we've never had a US market that has risen for seven consecutive years in a row.

The curious fact here of course is that the US equity markets have had a terrific ride since 2009, rising every year since the Global Financial Crisis.

An equally fascinating observation is that the last time US investors basked in a six-year lucky run back in 1903, equities subsequently tumbled 18%.

The logic behind the 'six year itch' is of course something called the business cycle - these familiar creatures tend to fairly predictably ebb and flow pulling stock markets along with them in their wake. But these business cycles have also steadily lengthened in the past few decades, which has, in turn, meant that equity bull markets have also increased in duration. As one hedge fund blogger noted "the increased frequency of 5 consecutive up years since the 1980's is not a fluke, but an artefact of lower business cycle volatility". Seven years lucky for US shares??



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CDS Rates

This month we have one major development to report on - pretty much across the board, CDS rates on bank bonds have increased. It's not unusual for an individual bank's CDS rates to move up or down over a month but for nearly all CDS rates to inch up is of note. Does it matter? Arguably not. The increase in these rates is still very small although I would observe that we have seen at least four double-digit basis point increases in the banks we follow. My own take would be that investors are beginning to price in higher levels of risk, with the possibility of losses (marginally) increasing. This increased options pricing is arguably good news for structured product investors - higher CDS rates might force up bank bond yields (marginally) higher, providing more fire power for structurers, i.e. the extra yield can be used to increase payout rates for investors buying products.

Bank	One Year	Five Year	Monthly Change	Annual Change	Credit Rating
Banco Santander	36	82	15	-34	A -
Barclays	16	54	7	-31	A
Citigroup	25	77	11	5	A
Commerzbank	31	83	12	-21	A+
Credit Suisse	20	58	9	-7	A
Deutsche Bank	35	78	8	-4	A+
Goldman Sachs	34	88	7	-4	A
HSBC	14	45	6	-14	AA-
JP Morgan	24	66	9	-1	A+
Lloyds TSB	19	53	7	-25	A
Morgan Stanley	31	84	8	-4	A
Nomura	24	94	8	21	A-
Rabobank	12	48	8	-14	AA-
RBS	12	43	5	-50	A
Soc Gen	19	96	26	4	A
UBS	18	45	6	-15	A

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Government Bonds

Oh how wrong the bond market bears were in 2014! A dark cloud comprising the threat of increasing interest rates was supposed to be the cue for a bond market rout i.e. increased interest rates usually end up lowering the price of conventional bonds and increasing yields.

The big chart - from DoubleLine again in the US - tells a remarkably different story. It looks at returns for 30 year, long dated US Treasury Bonds, comparing 2014 returns [the black line] with those for the last forty years. Remarkably US long dated sovereign bonds have returned more than in any virtually any other year since the last big Global Oil Crisis (a crisis which involved a radically different market for energy). With a 29% gain in 2014, only three other years produced better gains (2011, 2008 and 1995).

Will 2015 finally be the year for a bond rout????

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	47	-3
Germany	18	-6
Japan	69	**25**
United Kingdom	20	**-5**
Ireland	47	-59
Italy	132	-14
Portugal	199	-95
Spain	96	-32

Eurozone peripheral bond yields

Country	% in January 15th, 2015	% in December 12th, 2014	Spread over 10 year German bonds
Spain 10 year	1.54%	1.87%	104
Italy 10 year	1.72%	2.05%	122
Greece 10 year	8.70%	8.71%	820

	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 two big tables below tell a fascinating story for equity investors. They detail stock market returns at the national level for the broad global equity indices in 2014 managed by research firm S&P. The second, lower table focuses on the developed world and here we can see a remarkable contrast - only the US amongst major markets plus Israel, Denmark and New Zealand produced positive gains last year for local investors. UK stocks by contrast were down a nasty 8%, bettered by an even longer list of countries including oil dependent Norway, China, focused Korea (down 10%) plus a very long list of familiar Eurozone names headed by Portugal where losses hit an astounding -33.84%.

My one takeaway? The US has largely decoupled from its developed world peers especially those nations that have chosen to be stuck with the Euro.

The first table though looks at the developing world and here the story becomes much more interesting and heterodox. India provided the most surprises with a staggering 31% gain in equities closely followed by Egypt (up 26%) and natural gas rich Qatar (up 23%). Indonesia and Thailand also produced very decent returns - one ruled by a military dictatorship (Thailand), the other by a widely respected new democratic leader who has risen from humble roots on an anti-corruption ticket (Indonesia). Countries like Turkey also notched up big gains, despite topping most investors lists of 'fragile states' most likely to implode in 2014 (it didn't and probably won't in 2015 either).

Emerging Markets

BMI Member	1-Year	2-Year	3-Year
Global	**1.96%**	**23.52%**	**40.90%**
Global Ex-US	**-5.64%**	**6.99%**	**22.03%**
Emerging	**-2.06%**	**6.00%**	**8.36%**
India	31.63%	23.29%	52.05%
Egypt	26.30%	41.56%	99.85%
Qatar	23.00%	52.48%	49.64%
Philippines	21.67%	12.06%	61.79%
Indonesia	20.48%	-8.69%	-6.12%
Thailand	15.59%	0.67%	40.55%
Turkey	14.41%	-15.64%	35.56%
U.A.E.	7.32%	95.75%	143.16%
South Africa	4.02%	-3.87%	11.27%
China	3.03%	10.51%	29.49%
Taiwan	2.84%	12.90%	28.51%
Peru	-1.17%	-28.89%	-16.52%
Morocco	-3.14%	-2.67%	-16.98%
Mexico	-9.68%	-9.47%	14.86%
Czech Republic	-10.46%	-24.51%	-26.95%
Malaysia	-11.73%	-7.89%	2.61%
Chile	-12.90%	-32.11%	-24.37%
Poland	-16.39%	-13.85%	15.55%
Brazil	-18.38%	-34.00%	-34.18%

Colombia	-19.80%	-34.11%	-14.90%
Hungary	-28.66%	-28.53%	-15.14%
Greece	-39.65%	-11.64%	10.15%
Russia	-48.98%	-49.85%	-45.99%

Developed Markets

BMI Member	1-Year	2-Year	3-Year
Developed	**2.42%**	**27.51%**	**45.24%**
Developed Ex-US	**-6.43%**	**10.48%**	**25.65%**
United States	10.38%	44.35%	64.60%
Israel	8.76%	23.57%	27.40%
New Zealand	6.56%	19.70%	51.37%
Denmark	6.49%	39.79%	80.90%
Belgium	1.32%	25.01%	66.66%
Ireland	0.81%	44.35%	72.36%
Hong Kong	0.12%	7.75%	32.13%
Switzerland	-0.48%	25.13%	47.82%
Singapore	-1.06%	-4.01%	23.72%
Canada	-2.14%	0.78%	6.82%
Netherlands	-3.28%	24.07%	45.74%
Japan	-4.77%	18.76%	25.69%
Finland	-5.63%	27.82%	44.02%
Spain	-6.65%	22.84%	24.69%
United Kingdom	-8.16%	9.46%	24.189%
Australia	-8.28%	-9.85%	3.69%
Sweden	-8.59%	13.29%	35.67%
Korea	-9.96%	-7.13%	10.41%
France	-11.16%	11.51%	31.83%
Germany	-11.61%	13.43%	43.70%
Italy	-12.02%	8.27%	20.21%
Luxembourg	-14.35%	-5.82%	-5.30%
Austria	-21.08%	-11.16%	15.36%
Norway	-24.11%	-17.98%	-4.56%
Portugal	-33.84%	-18.81%	-16.35%

The equally long list of losers in the developing world featured some more familiar names such as Russia (down a terrifying 49%) followed by Greece (down 39%) and Hungary (down 28%). The bottom line? Investors in the developing world probably wouldn't have gained much advantage by trying to second guess which national stock market would power ahead in 2014. By investing in a mainstream broad market fund tracking something like the MSCI World, they'd have made money simply because US shares dominate the index. Over in emerging markets by contrast country level selection really does matter i.e. we've seen huge variations in returns, even within big important markets.

Index	January Level	December Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	**107.4**	**114**	**3138**	112.5
FTSE 100 (Dec 14)	**247**	**233**	**6444**	232.5

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	1.39	-0.07	-5.3	-5.59	16.19	52.81	6388.46
S&P 500	0.45	7.11	1.73	9.37	75.13	138.69	2011.27
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	3.2	5.25	11.21	12.79	24	19.91	12.7225
Benchmark for volatility							
VIX New Methodology	1.9	-5.75	81.73	74.92	21.84	-56.29	21.48

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Volatility

Markets that track volatility within key developed world markets have sprung back to life - at long last we have volatile volatility! The chart below shows recent price activity for the key fear gauge for equity investors - called the VIX. The last few weeks turbulent markets have seen the VIX shoot above its trend lines (the blue lines) as well as its recent moving averages (the thick green line represents the 20 day moving average while the thin light blue line represents the 200 day moving average).

The VIX is now close to a one month high after more than 10 sessions involving the S&P 500 (which it tracks) declining. The VIX usually rises when stocks fall. When stocks advance, the VIX usually declines.

This market turbulence has actually been on the increase since the autumn of 2014 - in October for instance, the VIX ranged from about 16 to 25 and then edged lower. November was dull, but in December the VIX ranged from below 12 to above 25. Just this week, the VIX ranged from about 16 to around 23.

The key motor behind this recent uptick in volatility is obvious - worries about lower global growth as well as a longer list of market specific concerns including a soaring dollar, lower crude prices, Russia's Rouble collapse, lower copper prices, and now the decision by the Swiss central bank to suspend its FX regime.

US investment newspaper Barrons reports on comments by Adam Crisafulli from J.P. Morgan's equity trading desk who told clients that U.S. stocks won't likely be able to evade the laundry list of global concerns for the time being: “This tape as seen as spike in volatility in the last few weeks and that isn't going to end soon. There are simply too many macro questions at the moment and valuation sensitivity at will keep this market from setting new highs (for now).”

Two events will now dominate investor attention in the next few weeks - what the ECB does at the end of January and the Greek election result.

But Barrons also draws attention to what I think is a much more interesting development: volatility is becoming a mainstream asset class for investors. The US newspaper reports that the VIX is now almost as popular as the Dow Jones Industrial Average and Standard & Poor's 500 index. "A Google search reveals about 28 million mentions for the VIX, 32 million for the Dow, and 37 million for the S&P 500" says the newspaper. For the fifth straight year, VIX futures set an annual trading record of about 50 million contracts in 2014, up 27% from about 40 million contracts in 2013. Overall, CBOE trading volume set a record of 1.2 billion contracts, up 11% from 2013. Total index options volume hit an all-time high of 406 million contracts, driven by record volume of 224 million contracts in S&P 500 index options and record volume of 159 million VIX options."

Measure	January Level	December Level	November Level
Vstoxx Volatility	28.78	16.33	20.31
VFtse Volatility	18.52	10.69	14.15
FTSE Put Call Ratio	1.02	1.02	0.95

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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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