



*With commentary from David Stevenson*

As we draw towards the end of the year it's worth contemplating why the UK equity market is so thoroughly miserable. The UK economy is looking to be in good shape but UK equities have consistently underperformed their US peers - a subject we examine in another section.

Part of this relative under performance can be attributed to the UK market's focus on cyclical resource stocks, with the dropping oil price a major driver of share price declines. Again we examine this theme below.

But I also think that many foreign investors have held back from investing in UK stocks - probably decent value when compared to US equities - because they are worried about political risk. Put simply the UK General Election in May 2015 has the potential to create significant uncertainty, which may last for many years all the way through to an EU referendum in 2017.

This potential politically-induced uncertainty isn't reflected though in FTSE 100 volatility measures. A recent note from options analysts at SG observed that UK equities weren't pricing in this risk. The French bank's analysts observe that: "Volatility stands only slightly above its long-term lows (6-month ATM volatility at 13.2% is on its 21% tile over five years) and skew is mid-range (6M 90%-110% at 6.1pt vs 6.9pt on average over 5 years), lower than on the S&P 500 but still steeper than for many other markets. Moreover, term structure shows no abnormal spike between March 2015 and June 2015 that could indicate that election risk is taken into account."

Cut through all the derivatives based jargon, and I think there's a very explicit warning here for investors - UK equities may be cheap relative to US shares but collectively we're too complacent about the risks of coalition haggling, yawning public sector deficits and the possibility of the UK leaving the EU.

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## Headline Numbers

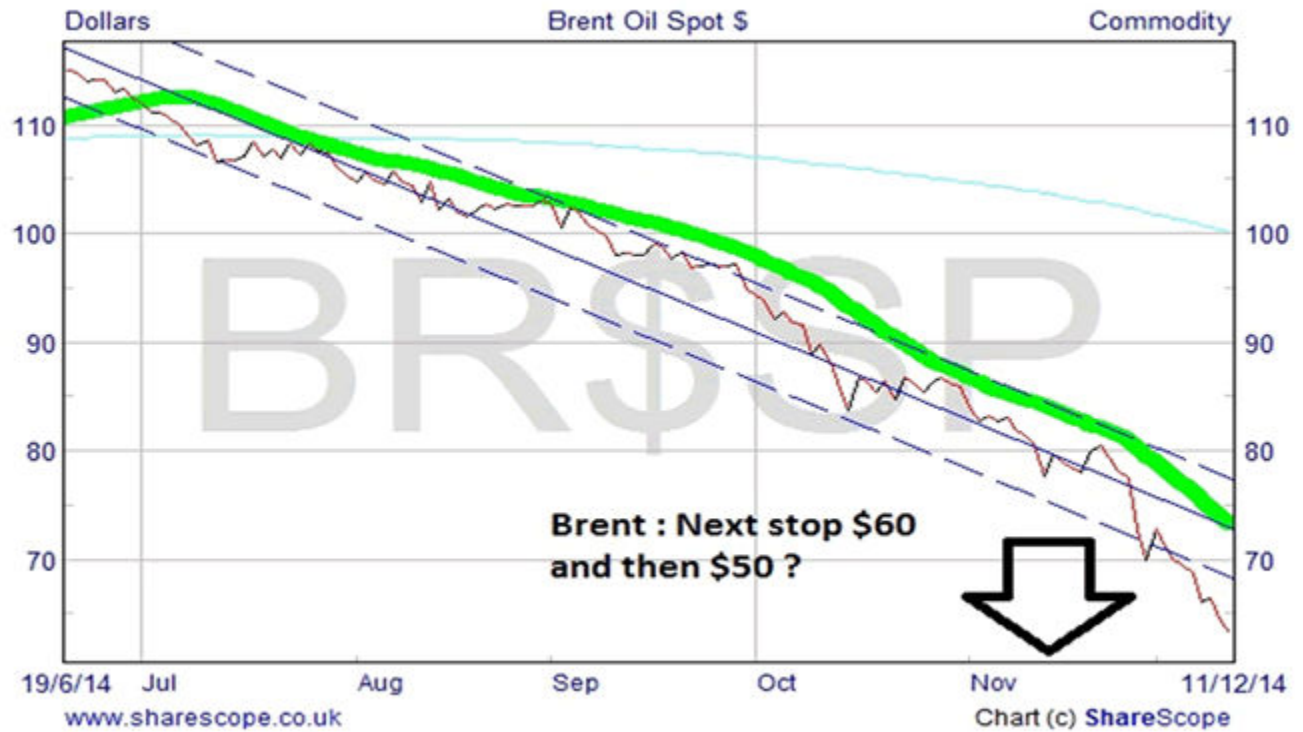
Measure	Value as of November 13, 2014	Value as of December 12, 2014
UK Government 10 year bond rate	2.18%	1.90%
GDP Growth rate YoY	3.00%	3.00%
CPI Core rate	1.50%	1.20%
RPI Inflation rate	2.30%	2.00%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.54%	0.53%
Government debt to GDP ratio	90.60%	90.60%
Manufacturing PMI	53.20	53.50
Sovereign Western Europe CDS	33.89	48.19
Euro Bank CDS	102.92	195.37
FTSE CDS	98.00	68.54

No news is probably good news in the case of the UK economy. Recent numbers from the macro-economic frontline indicate that the recovery is still intact with some policy makers even talking up the possibility of an increase in living standards as energy costs subside. There's even some early indications that UK manufacturing might be starting to pick itself up off the floor after a difficult year, made worse by a strong pound.

Exporters might be hoping that political concerns around 2015 will help to depress sterling again, but I'd keep a beady eye on the pound. If the European Central Bank does cave in to pressure and initiate an extensive programme of quantitative easing, the Euro could plummet, pushing sterling to even higher levels.

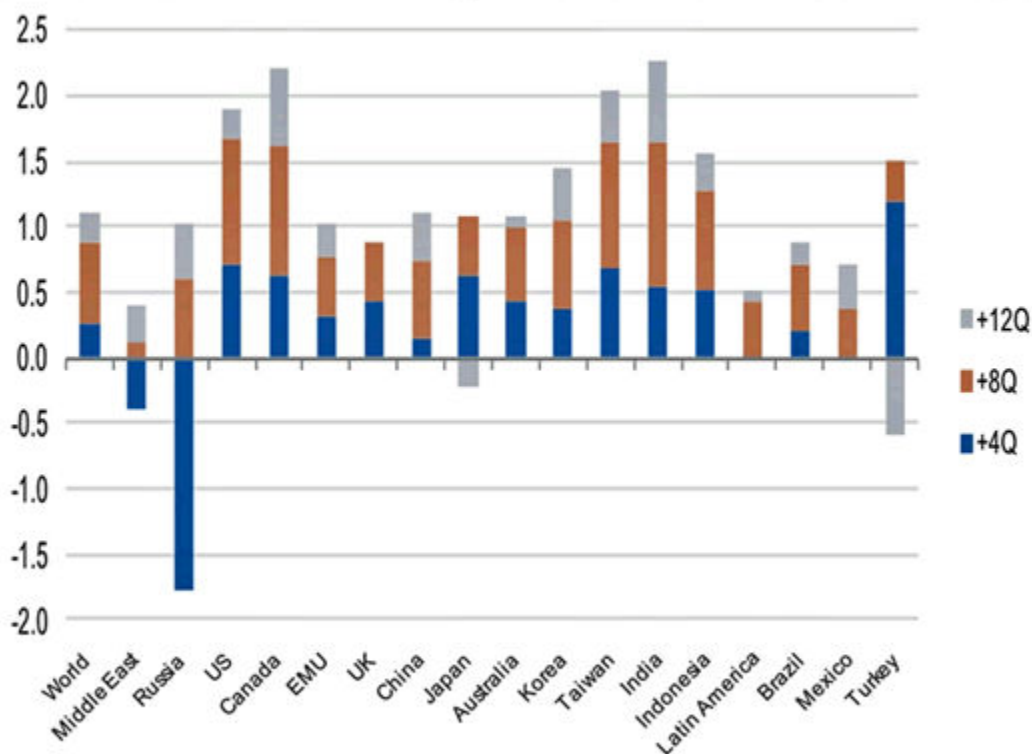
### Headline Thought

You might just have noticed that oil prices are declining - a tiny bit at the petrol pumps but very substantially on the global markets. The first chart shows the price decline since the summer for the benchmark Brent Crude oil spot price in dollars. I think this is about as negative an image as you could possibly imagine - I can't see any sign of a rebound, with the spot price (the dotted red/black line) crashing through its moving averages (20 and 200 day, thick blue and thick green lines respectively) and all its trend lines (the straight blue lines). My sense is that Brent prices probably need to crash past first a \$60 a barrel mark and then a \$50 a barrel level before we'll see any rebound.



Many investors worry that these price declines represent something approaching an investment canary in the mine, indicating declining global growth and the onset of deflation in the Eurozone. I'm not that negative and I would simply point to the next chart which shows the cumulative impact from \$20 declines in the price of a barrel of oil. Lots of the emerging world and plenty of nations in the first world will be net beneficiaries 1 year and then 3 to 4 years out.

**Cumulated impact on GDP from a \$20/b decline in oil prices**



Source: SG Cross Asset Research/Economics

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One last question is also worth exploring - which equity sectors benefit most from declining oil prices? A recent note from analysts at Morgan Stanley suggests that four sectors display noticeable crude oil price sensitivity: lower oil is obviously negative for energy and materials, while staples and the discretionary sector is positive. By contrast junk stocks (cheap businesses with poor balance sheets) and cyclical sectors "benefit by about 1% per month when crude oil has large price increases while cyclicals underperform by 80bp on average when crude oil has large price declines. Defensives outperform by an average of 60bp in months when crude oil has a large decline." Two last observations from the US based team - Metals & mining tend to overreact to crude oil price moves while airlines and retailers outperform.

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## CDS Rates

There haven't been any dramatic moves in the bank bond CDS market although I would observe that rates on Barclays debt have fallen sharply over the last month i.e. investors seem increasingly less worried about the risk of a default. It currently costs 15 basis points to insure Barclays bonds for one year, marginally below the rates for Lloyds and a smidgen above rates for outfits like HSBC and RBS, which are traditionally seen as 'rock solid' in risk terms. This reflects a shift in sentiment towards UK banks generally - they're now perceived as a fairly low risk bunch by investors.

Bank	One Year	Five Year	Monthly Change	Annual Change	Credit Rating
Banco Santander	29	76	2	-59	A -
Barclays	15	51	-10	-44	A
Citigroup	24	69	1	-13	A
Commerzbank	26	77	-4	-38	A+
Credit Suisse	20.42	52	-4	-21	A
Deutsche Bank	32	72	-3	-13	A+
Goldman Sachs	33	72	-3	-14	A
HSBC	12	42	-6	-25	AA-
JP Morgan	22	62	1	-10	A+
Lloyds TSB	19	48	-11	-40	A
Morgan Stanley	30	82	4	-14	A
Nomura	23	89	6	17	A-
Rabobank	12	43	0	-27	AA-
RBS	12	49	-15	-69	A
Soc Gen	19	83	6	-18	A
UBS	17.63	43	-3	-25	A

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## Government Bonds

European bond markets are currently sending out a very strong message, namely that investors need to beware of an impending recession. German bond yields for ten year paper have dropped to as low as 0.66% whilst Spanish ten year bond yields have sunk below the UK's current (already low level of) 1.90%. These are truly remarkable rates - who would have thought just a few years ago that German bonds would follow in the wake of Japanese bonds and hit such low yields. The only fly in the ointment is Greece of course - if a new left wing party does win power, we're likely to see a rather disorderly squabble about debts. This uncertainty helps explain why Greek bond yields have bucked the wider trend and headed back up to close to 9% p.a.

### 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	9
Germany	18	-7
Japan	67	<b>20</b>
United Kingdom	19	-7
Ireland	54	-70
Italy	140	-29
Portugal	207	-150
Spain	103	-48

### Eurozone peripheral bond yields

Country	% in December 12th	% in November 13th	Spread over 10 year German bonds
Spain 10 year	1.87%	2.11%	134
Italy 10 year	2.05%	2.37%	164
Greece 10 year	8.71%	8.02%	707

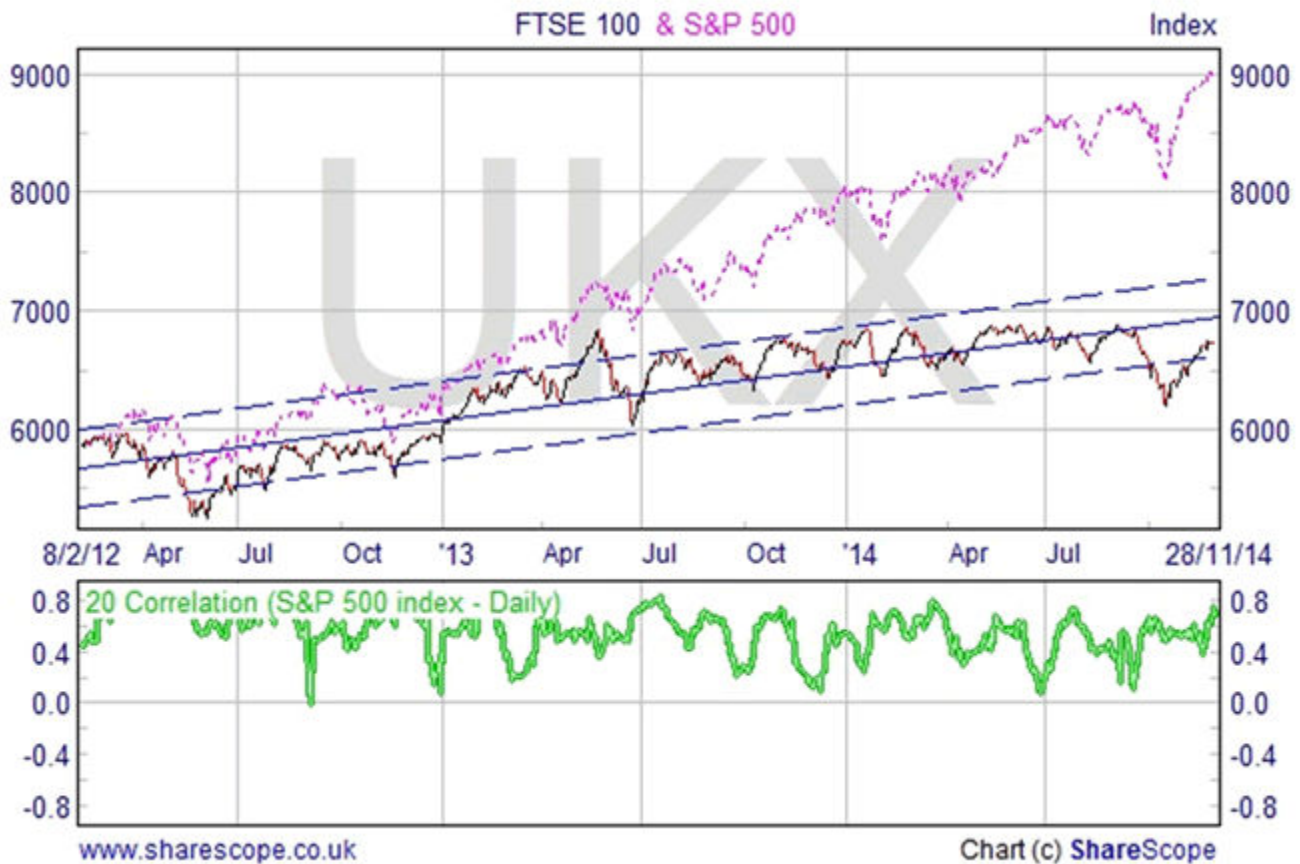
	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

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## Equity Markets and Dividend Futures

The gap in performance between the UK FTSE 100 Index and its US counterpart the S&P 500 Index has been constantly growing over the last few years. In part this reflects the earlier recovery from recession in the US, more aggressive quantitative easing and the perceived strength of the US economy. The chart below spells out that difference in returns since the beginning of 2012 - the thin pink line represents the S&P 500, the black/red line the FTSE 100. The UK index seems stuck in a trading range between 6000 and 7000 whereas the US index has consistently pushed past its barriers. Will this performance gap continue to increase?

In part the S&P 500 is being pushed higher by expected growth in corporate earnings in 2015 (10% in the US versus less than 5% in the UK). Sector composition is also a big issue. The UK market has 25% total weighting exposed to energy stocks and miners. But this sector bias doesn't explain everything. Its noticeable for instance than many key UK sectors trade at significantly lower price to earnings ratios - US oil businesses trade at more than 15 times earnings while UK energy businesses are at 10 times their profits. In a similar vein US financials trade at 17 times profits while UK banks trade at just 12 times profits.



Index	December Level	November Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	<b>114</b>	<b>114</b>	<b>3104</b>	112.5
FTSE 100 (Dec 14)	<b>233</b>	<b>233</b>	<b>6364</b>	232.5

Name	Price % change						Close
	<b>1 month</b>	<b>3 months</b>	<b>6 months</b>	<b>1 year</b>	<b>5 year</b>	<b>6 year</b>	
FTSE 100	-2.5	-4.97	-5.52	-0.71	22.81	47.24	6300.63



S&P 500	-0.21	1.9	4.7	14.2	83.96	132.98	2002.33
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	3.08	4.42	7.69	8.72	18.81	17.95	12.32
Benchmark for volatility							
VIX New Methodology	55.42	56.88	73.1	30.22	-6.99	-64.00	21.08

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## Volatility

The chart below paints a fascinating picture! It's for the benchmark volatility measure VIX - called The Fear Gauge because it measures the ups and downs of the S&P 500 US Index. There are lots of lines on this chart (which tracks the measure since the beginning of 2014) with the big thick green line representing the 200 day moving average while the thin blue line represents the 20 day moving average - these moving average measures are classic technical indicators with a break above/below either or both a key indicator. The horizontal lines (dotted and straight) represent the trend lines, with lower and higher barriers and a trend average in the middle.



The big story here is that the volatility of US equities has started to push well above the recent moving average as well crawling past those trend lines. We're also seeing more peaks above this line and no troughs below the line. Technically this indicates 'choppy waters' i.e. an increase in overall regime instability. In simple language - markets are becoming much more volatile.

A rather more disturbing thought is that we are now fairly regularly witnessing two to three month spikes (upwards) in volatility - if this starts to happen more often I think investors might become rather punch drunk and fearful. My own feeling is that once we have more than a few trading sessions where markets start to crash by more than 1 or even 2% in a day, investors start to slowly take cash off the table. This leads to declining investor confidence and might indicate a bear market.



Ironically it's these punch drunk reactions that sometimes represent the best buying opportunities. As long as the trend is not firmly downwards, we start to see panic sell offs for individual stocks. We also see options pricing become much more attractive, helping the buyers of structured products. My own sense is that January in particular could be a very volatile, and miserable few weeks!

Measure	December Level	November Level	October Level	Acc/Dec	Direction Upwards
Vstox Volatility	26.5	20.31	31.4	ACC	Yes
Vftse Volatility	21.32	14.15	25.74	ACC	Yes
FTSE Put Call Ratio	1.02	0.95	1.5	DEC	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 fix 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.

To find out more about UKSPA, please visit [www.ukspassociation.co.uk](http://www.ukspassociation.co.uk).

Kind Regards,

A handwritten signature in black ink, appearing to read 'Zak De Mariveles', with a stylized flourish at the end.

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