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# Monthly Market Report

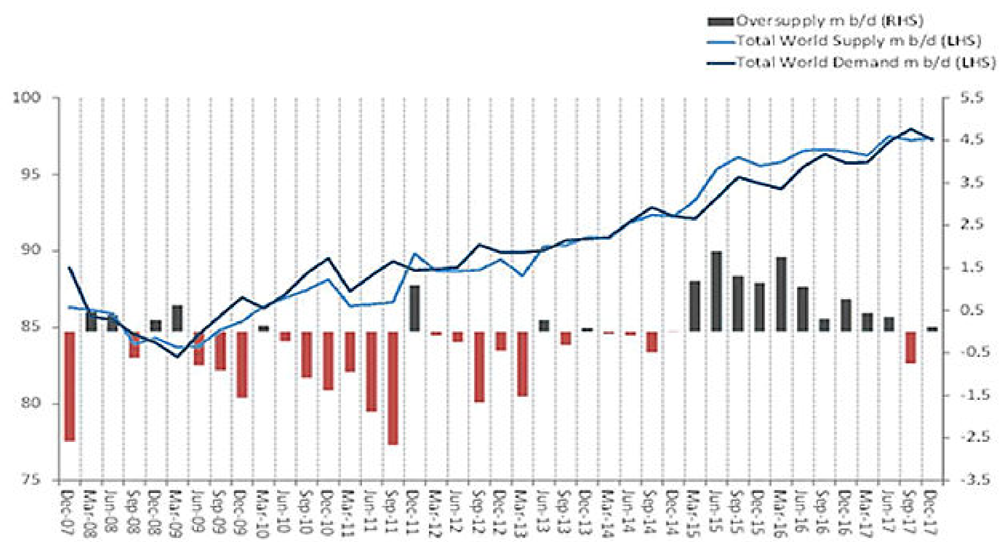
July 2016

UK Structured Products Association™

*With commentary from David Stevenson*

I have no intention of boring readers senseless with any more observations on the Brexit vote (my recent FT Weekend article looked at most investment angles relating to this increasingly depressing debate) but the dreaded day draws ever closer. And the bad news is that the once constant stream of email alerts and surveys about what might happen next is turning into a veritable tsunami. Every day now comes with at least five to ten unrevealing (not that that is a word) revelations or analysis about what investors should do - and how they'll be impacted. Thank god it'll all be over soon. Or will it? Talk that pro-Remain MPs might block exit from the common market if we leave, or that Brexit MPs might demand a rerun if there are any more substantive EU treaty changes will cause many international investor's to shudder. Markets abhor uncertainty and if there is even a whiff of post June 23rd creative anarchy, markets might take a hit.

Turning away from matters European, for this observer the biggest story has been energy. It looks increasingly like we may have turned a decisive corner when it comes to oil prices. With Brent moving above $50 a barrel, we would appear to have retreated a long way from the dark days of the winter when bears (me included) were muttering about oil at $20 a barrel. What's noticeable is that in the past few months, there has been some incremental improvement in the fundamentals, but I'd suggest that the world remains oversupplied by 1-2 million barrels per day (b/d). U.S. production has begun to decline and is now nearly 500,000 b/d below the peak levels of last year, after the dramatic reductions in capital spending since the beginning of 2015. OPEC and the International Energy Agency (IEA) both indicated in their most recent monthly reports that they expect demand to grow this year by about 1.2m b/d. This, combined with expected declines in non-OPEC production of approximately 700,000 b/d, should bring the crude oil market into a healthier balance by year-end. See the chart below for a graphical representation of this big shift in market dynamics.




Source: BlackRock iShares

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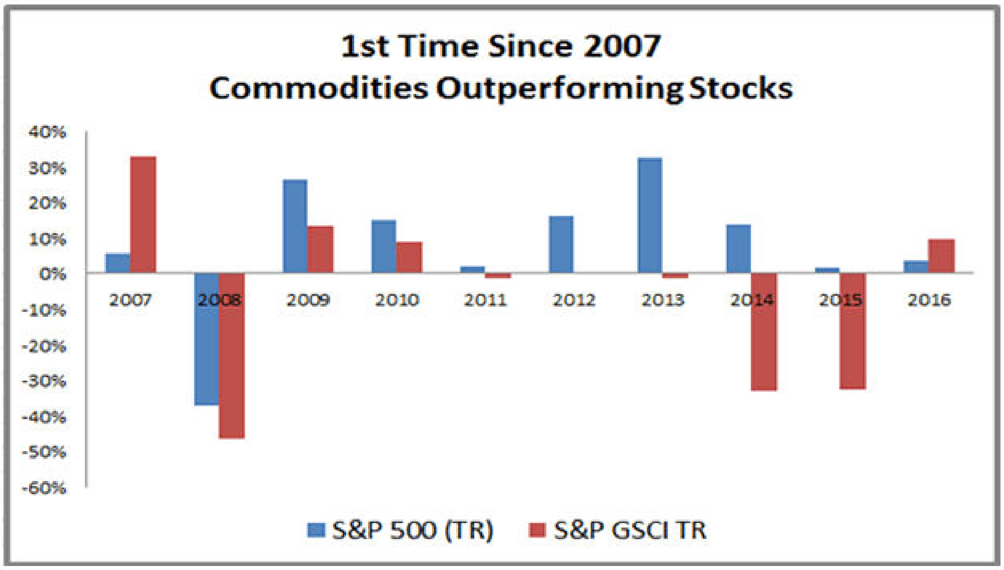
## Headline Numbers

A recent note from Jodie Gunzberg, global head of commodities and real assets at S&P Dow Jones, reminds us of the remarkable turnaround in sentiment towards the broad commodity complex in the last few months. In May the benchmark S&P GSCI Index notched up a 2.2% gain making it the third consecutive positive month for the index. This is the first time commodities have gained three months in a row since the period ending in April 2014, and this is also the biggest three-month gain, 18.1%, for commodities since the period ending in July 2009 when they returned 20.9%.

Not surprisingly the biggest gains were recorded in the energy sector (70% of this index), which gained 4.6% in May but livestock and agriculture also gained 3.2% and 1.3%, respectively in May. Gunzberg also observes that that the roll returns (measuring backwardation in the sector) turned positive in agriculture for the first time since May 2015 and has improved in energy from -5.6% in Feb. to just -1.5% in May.




Source: S&P Dow Jones Indices

According to Gunzberg "if this outperformance holds through the year's end, it will break the longest number of consecutive years that stocks outperformed commodities. Following the last time equities outperformed commodities for near as long in 1980-86, seven consecutive years, commodities returned almost 300% through 1990 when the trend reversed."

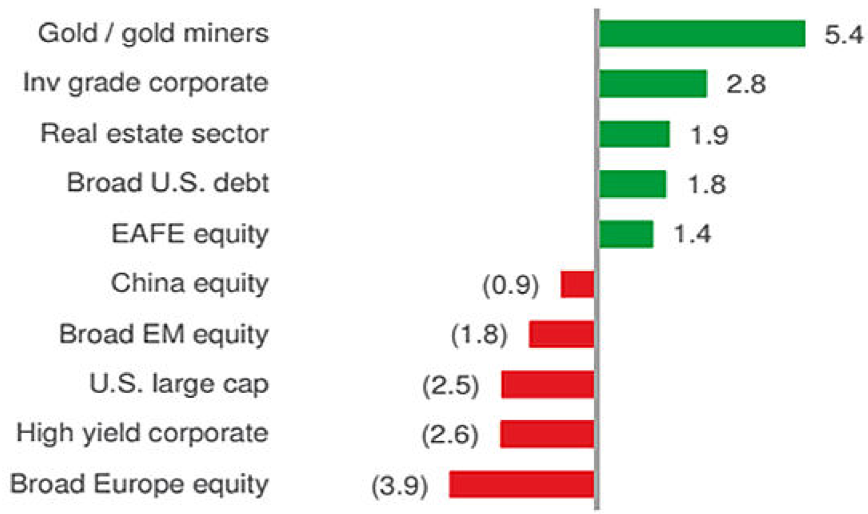
One of the most interesting stories of recent months has been the change in mood amongst multi-asset investors. Equities haven't exactly fallen out of favour but trading remains subdued. Bonds by comparison have proved very popular indeed. UK gilt rates have increased markedly in price, whilst German 10 year bund yields have collapsed to below 3 basis points. Yes, currently the German government is paying an effective yield of just 0.03% to borrow for ten years. This resurgence in demand for bonds has also helped push money into other perceived 'lower risk' asset classes, yet this is happening even as volatility measures continue to drift ever lower. So, in sum it's not exactly a risk off situation more a drift towards safety.

One can sense some of these big asset class shifts via statistics tracking ETF and ETP flows. Every month the major tracker fund issuers such as BlackRock iShares issue their own market over views looking at in and outflows and the two tables below sum up the big asset class shifts for this massive ETF issuer. Here's iShares summary:

## KEY INVESTMENT THEMES / ETP FLOW TRENDS


## GLOBAL ETP FLOWS BY ASSET CLASS & EXPOSURE[1]

May 2016 flows: $10.7bn




Source: iShares

- "**Fixed income** exposures posted another strong month with inflows of $9.7bn, maintaining a healthy momentum. Cumulative flows for 2016 now stand at $61.8bn - the best year-to-date rate in the history of the product.

- **Global developed market exposures** were the driver of equity ETP flows with $5.2bn recorded for the month, while flows into U.S. equity exposures were more benign at $0.9bn

- ETP investors extended their **record purchases of low/minimum volatility equity strategies**, with inflows of $2.6bn during May, across U.S. and global developed market exposures. At $14.4bn, year-to-date inflows in these strategies have already surpassed the record full-year flows of $11.6bn during 2015

- **Equity ETPs saw outflows** of -$3.7bn, reversing the course of net inflows for the past two months as risk-off sentiment took hold at the start of the month

- Commodity ETPs added $4.1bn in May on the back of s**trong demand for gold funds**."

| Measure | Value as of May 13th, 2016 | Value as of June 9th, 2016 |
|---|---|---|
| UK Government 10 year bond rate | 1.40% | 1.23% |
| GDP Growth rate YoY | 2.10% | 2% |
| CPI Core rate | 1.50% | 1.20% |
| RPI Inflation rate | 1.60% | 1.30% |
| Interest rate | 0.50% | 0.50% |
| Interbank rate 3 month | 0.59% | 0.58% |
| Government debt to GDP ratio | 89.20% | 89.20% |

| | | |
|---|---|---|
| Manufacturing PMI | 49.2 | 50.1 |

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## Bank CDS options

Yet another quiet month for markets tracking CDS options, bank bond insurance products widely used by institutions to protect against default risk (and volatility). Prices don't seem to have moved much again over the last four weeks but it is noticeable that key UK banks such as HSBC and Barclays have seen a sharp decline in the price of their one year CDS options, indicating that investors have become a little less worried about any (remote) risk of bond defaults. The other interesting story is that major French bank Societe Generale is also benefitting from lower CDS rates - this despite the general political turmoil in France at the moment.

| Bank | One Year | Five Year | Monthly Change (5yr) | Annual Change (5yr) | Credit Rating (Fitch) |
|---|---|---|---|---|---|
| Banco Santander | 60 | 140 | 6.51 | 56 | A - |
| Barclays | 58 | 108 | -13 | 69 | A |
| Citigroup | 38 | 85 | -4 | 12 | A |
| Commerzbank | 54 | 111 | -3 | 79 | A+ |
| Credit Suisse | 86 | 131 | -3 | 79 | A |
| Deutsche Bank | 107 | 170 | 0.74 | 123 | A+ |
| Goldman Sachs | 39 | 98 | -5 | 15.71 | A |
| HSBC | 42 | 94 | -5 | 54 | AA- |
| JP Morgan | 27 | 66 | -6 | 4 | A+ |
| Lloyds Banking Group | 38 | 85 | -5.69 | 30.31 | A |
| Morgan Stanley | 36 | 95 | -3 | 24.65 | A |
| Nomura | 27 | 91 | -6 | 51 | A- |
| Rabobank | 23 | 71 | 3.46 | 23 | AA- |
| RBS | 79 | 135 | -3.46 | 23 | A |
| Soc Gen | 30 | 79 | -2.9 | 3.44 | A |
| UBS | 33 | 71 | 3.97 | 30.11 | A |

Source: Meteoram.com, 3rd June 2016

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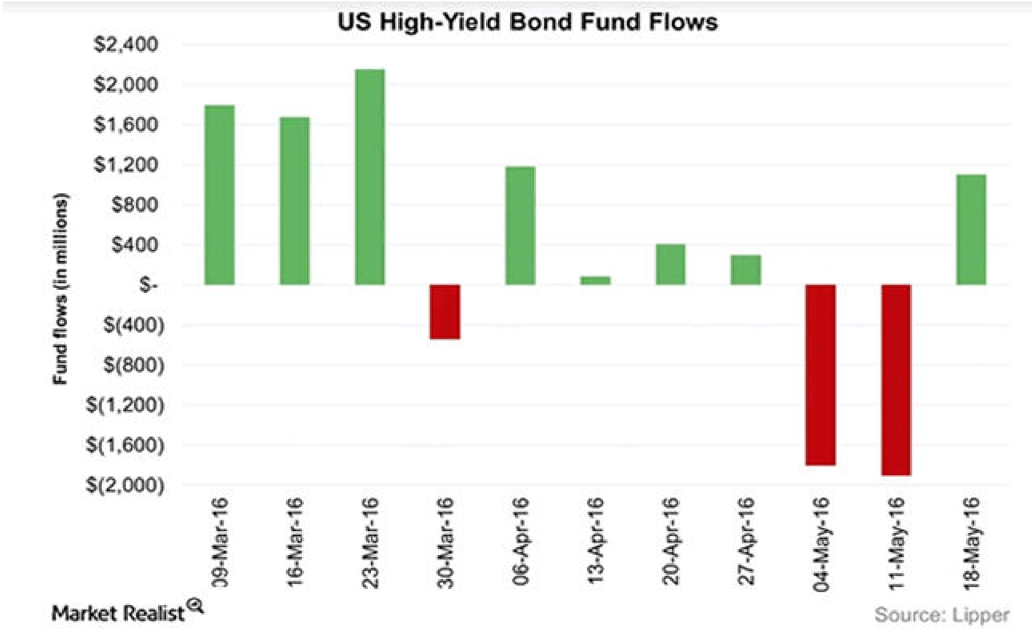
## Government Bonds

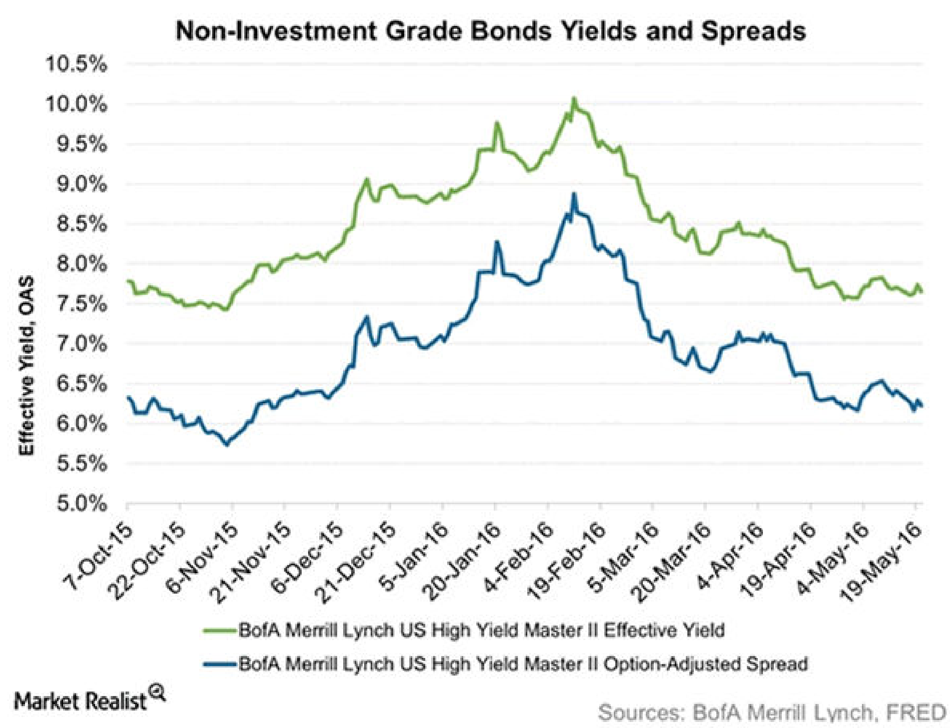
As we observed at the beginning of this report, investor's haven't exactly fallen out of love with equities (in fact, some markets have risen over the month) but they have re-engaged their long term romance with all instruments bond related. Again we'd observe that the 10-year UK government bond yield has declined again and now stands at a remarkable 1.23%. German bond yields are at just under 3 basis points. Even Greek bond yields have fallen back marginally. But investors have also been pumping additional cash into other, riskier bonds such as high yield corporate credit. In recent months high yield corporate credit funds - especially ETFs - have suffered big outflows but according to a report last week by Market Realist's Lynn Noah (available online at http://finance.yahoo.com/news/high-yield-bond-funds-saw-130730975.html) investors have now decided to put more money to work in high yield bonds, reversing the negative trends of the previous two weeks. According to Lipper, net inflows from high yield bond funds totalled $1.1 billion in the week ended May 18, 2016. Noah reckons that including last week's inflows, high yield bond funds have witnessed year-to-date (or YTD) inflows of $7.1 billion.

As money has poured in, yields have obviously fallen - as prices pick up again. According to Noah both yields on high yield debt and spreads between high yield debt and Treasuries fell in the week ended May

20, 2016. High yield debt yields as represented by the BofA Merrill Lynch U.S. High Yield Master II Effective Yield fell five basis points from a week prior, ending up at 7.7% on May 20, 2016. Like yields, the option-adjusted spread also fell last week. The BofA Merrill Lynch U.S. High Yield Master II Option-Adjusted Spread fell by 19 basis points from the previous week to end at 6.2% on May 20.

With yields falling, returns on high yield debt rose in the week ended May 20, 2016. The BofA Merrill Lynch U.S. High Yield Master II Index rose 0.2% in the week. Returns in 2016 were positive, with the index up by 7.5% YTD.




What might happen next? If equity investors remain in optimistic mood, there's every reason to think that US High Yield bond prices could continue to rally, pushing yields even lower - and tightening spreads over ultra-safe Treasury bills. This confidence might even seep through into global markets, with emerging market bonds the most likely beneficiaries in the short term.

**UK Government Bonds 10-year Rates 1.23%**


Source: [http://www.tradingeconomics.com/united-kingdom/government-bond-yield](http://www.tradingeconomics.com/united-kingdom/government-bond-yield)

### CDS Rates for Sovereign Debt

| Country | Five Year |
|---|---|
| France | 36.8 |
| Germany | 18 |
| Japan | 37 |
| United Kingdom | 33 |
| Ireland | 64 |
| Italy | 133 |
| Portugal | 281 |
| Spain | 98.93 |

### Eurozone peripheral bond yields

| Country | May 13th, 2016 | June 9th, 2016 | Spread over 10 year |
|---|---|---|---|
| Spain 10 year | 1.61 | 1.40 | 137 |
| Italy 10 year | 1.50 | 1.36 | 133 |
| Greece 10 year | 7.40 | 7.37 | 734 |

| | 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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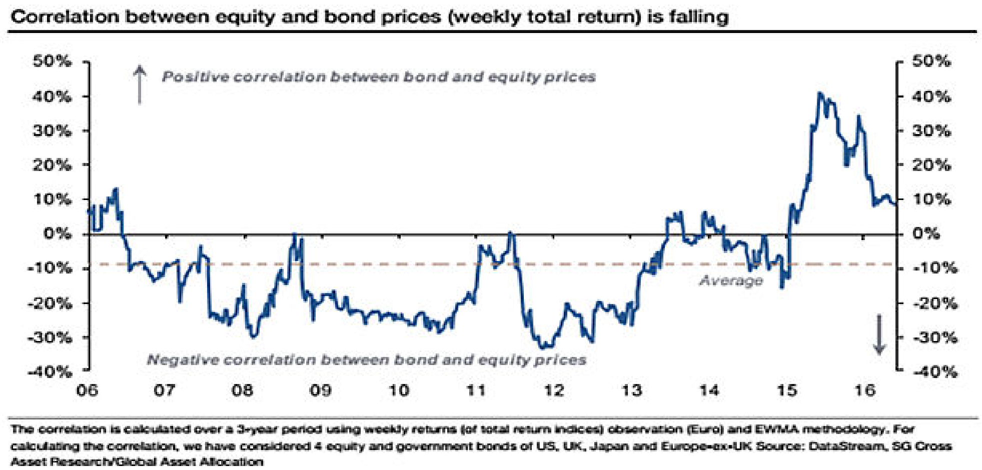
## Equity Markets and Dividend Futures

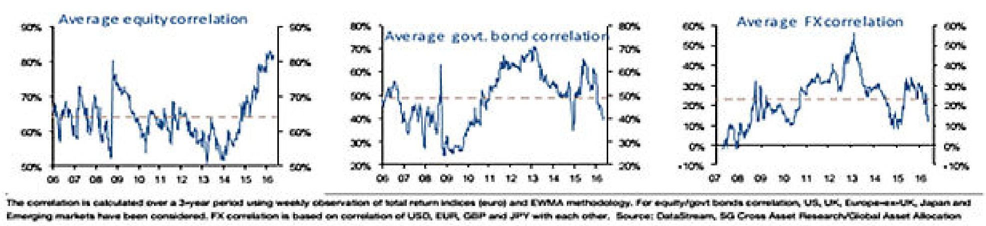
The gaggle of charts below tells a fascinating story. They are from a recent Societe Generale Cross Asset class research report and they show the correlation between different asset classes. The overall message from the analysts at SG is as follows: cross-asset correlations have been declining and "this has been mainly driven by a falling correlation between: i) FX, ii) bonds, iii) equities and bonds."

The first chart tells this story succinctly - correlations between asset classes are almost back to normal levels, indicating that we might reasonably expect different markets to behave in a very different fashion over the next few months. The good news in these numbers is that high correlation implies tough times for portfolio allocators whereas low correlations indicate much room for manoeuvre.




Source: Societe Generale

The bad news comes in the second set of charts, which show that the correlation between equity markets remains high, "indicating limited diversification opportunities among equities." In other words, equity investors haven't benefitted greatly from a very diverse range of equity markets.




Source: Societe Generale

| Index | June | May | Reference Index Value | Level 6 Months Ago |
|---|---|---|---|---|
| Eurostoxx 50 | 118.5 | 118.5 | 2997 | 116.5 |
| FTSE 100 (Dec 14) | 247 | 245.5 | 6238 | N/a |

| Name | Price % change | | | | | | Close |
|---|---|---|---|---|---|---|---|
| | **1 month** | **3 months** | **6 months** | **1 year** | **5 year** | **6 year** | |
| FTSE 100 | 2.87 | 2.87 | 2.71 | -7.19 | 8.48 | 25.32 | 6301.52 |
| S&P 500 | 3.01 | 7.07 | 2.69 | 1.92 | 65.61 | 99.54 | 2119.12 |
| Benchmark for gilt | | | | | | | |
| iShares FTSE UK All Stocks Gilt | 0.7 | 0.66 | 4.3 | 6.91 | 21.48 | 22.69 | 12.925 |
| Benchmark for volatility | | | | | | | |
| VIX New Methodology | -4.35 | -24.58 | -20 | -7.91 | -25.07 | -58.22 | 14.08 |

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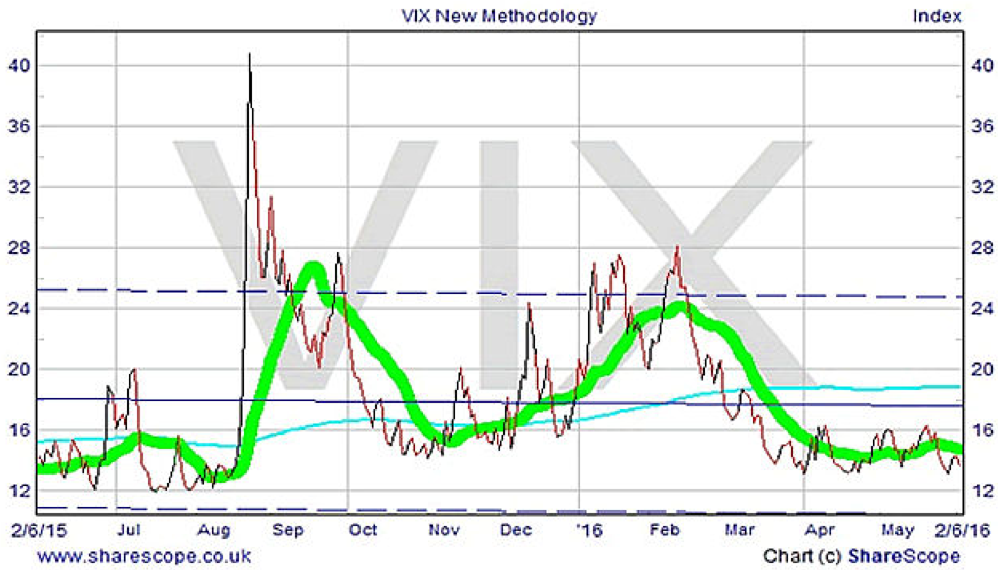
## Volatility

The chart below tells yet another remarkable story. It shows the one-year price for the VIX Index, the US fear gauge measuring turbulence in the benchmark S&P 500 Index. You'll see lots of other lines including trend lines (straight blue lines) and 20 (thick green) and 200 (thin pale blue line) day moving averages. The story over the last year is obvious. Although volatility has picked up slightly in recent weeks, we're now in a bear market for vol i.e. you'll lose money betting on more volatility.




But volatility hasn't fallen off a cliff absolutely everywhere. Measures of turbulence in European equity markets has trended much higher, especially in recent days. The VSTOXX measure of Eurozone equity volatility for instance has started to move ever closer to the 25 level (back in April it was below 20) while the UK focused VFTSE Index (tracking volatility in the blue chip UK index) also edged higher at 18.90, against 18.71 from the week before and well above spring levels of around 15.

| Measure | June Level | May Level | April Level | March Level |
|---|---|---|---|---|
| VoxOx Volatility | 25.57 | 23.58 | 20.64 | 24.11 |
| Vets Volatility | 21.83 | 15.74 | 14.84 | 17.71 |

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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.<br>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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