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STRUCTURED ™ PRODUCTS ASSOCIATION

Monthly Market Report

July 2015

With commentary from David Stevenson

Financial markets seem to be behaving in a rather bipolar, manic manner, one part excitable, another part deeply worried and fearful. Many commentators, including yours truly, seem to be obsessed with bubble hunting, with Chinese equities top of most lists followed by government bonds, biotech stocks and possibly US equities a distant fourth. More generally, some cautious investors are beginning to worry that the scramble for yield is having unpleasant side effects especially as it ripples through those parts of the stock market based on dividend paying equity income stocks. One concrete example comes in the shape of the hugely successful Woodford Patient Capital investment trust, managed by the eponymous Neil Woodford. The last time I looked, this brand new fund was trading at 112.3p, well above its issue price of 100p. Bear in mind that this premium is based on a fund that is yet to be fully invested and will invest in a combination of dividend producing blue chip equities and risky early stage businesses not producing an income. I have no doubt that it is potentially a wonderful strategy, by a manager with a proven track record but does it really deserve a 12% premium to book assets as an investment trust? And just in case one thought that this was an isolated example, feast your eyes on Gervais Williams' new investment trust called Miton Micro Cap. This fund is also managed by an excellent manager and is also trading at a near 10% premium to book value just weeks after its listing. Not bad for a fund that is investing in riskier micro small caps.

Yet despite all this excitement, investors have also been grappling with noticeably increased volatility within the fixed income markets and the ever present risk that the Greeks may yet fall out of the Eurozone. In fact, volatility is slowly creeping up across the board, albeit in a very gentle manner. Investors are also honing in key markets such as Japan which are in turn benefitting from sharp currency depreciation. A freefalling yen might prompt an all-out currency war with everyone looking to push their rates lower, with sterling possibly the last man standing. Lurking in the background of this currency battle is China, which is being hit hard by the Yen's depreciation, struggling with its own internal slow down, and eager to push deflation out globally to its partners as its local businesses fight for market share. Obvious risks seem to be looming on the horizon yet many of the putative bubbles mentioned earlier seem to be getting bigger by the day.

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Headline Numbers

Measure	Value as of May 15, 2015	Value as of June 19, 2015
UK Government 10 year bond rate	2.01%	1.99%
GDP Growth rate YoY	2.40%	2.40%
CPI Core rate	1.0%	0.90%
RPI Inflation rate	0.90%	1.0%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.53%	0.54%
Government debt to GDP ratio	89.40%	89.40%
Manufacturing PMI	51.9	52
Sovereign Western Europe CDS	48.21	45.52
Euro Bank CDS	75.46	78.20
FTSE CDS	75	78

Headline Thought

With the UK economy continuing to motor ahead, it's worth returning to the subject of foreign exchange rates. Last month I noted just how strong sterling has become and four weeks later the pound's rally show no signs of weakening. The cable rate - the £/$ pair - has now hit $1.58 to the £1 with $1.60 the next target. Investors seem to be buying into the UK economy, with UK Retail Sales coming in above forecasts in recent days (although the previous month's figures were revised down). These numbers were preceded by positive earnings data and news that the UK Public Sector Net Borrowing came in better than expected.

My own sense looking at the chart below - which shows the cable rate since summer 2006 - is that if sterling continues to rally (especially after a Grexit) we could see the $1.60 target easily pushed aside with the next barrier at $1.70 and then possibly even $2. This would of course be absolutely terrible news for the long term health of the UK economy, making UK exports even less competitive, hollowing out what remains of our manufacturing sector.

The conventional wisdom is that emerging market equities are very vulnerable to a tightening of monetary policy in the US in 2015 and beyond. This consensus view is that as the US Federal Reserve increases interest rates and starts to cut back its balance sheet exposure, global liquidity will tighten sharply. This will in turn hit emerging market stockmarkets, largely because they are viewed as very reliant on foreign investment inflows. As US investors start to sell up, local equity markets might begin to fall in value, prompting local financial crises and even sharper currency depreciation. If this consensus view is correct, now is the time to sell EM equities in places like China and India, both of which have benefitted from a recent surge in equity prices.

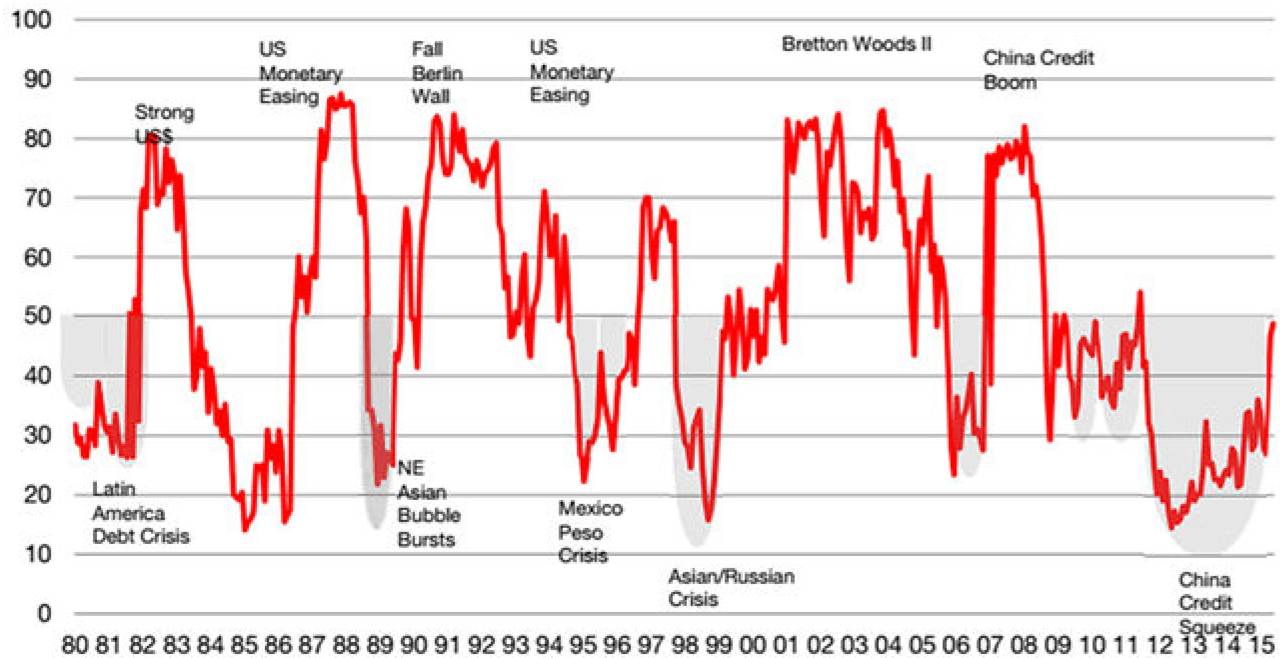
But not every market observer shares this bearish view of EM equities. Cross Border Capital is a widely followed London-based research outfit used by many hedge funds. Its analysts closely follow global liquidity flows, both in developed world markets and in emerging markets. Crucially, their research looks at both private sector, corporate cash flows AND central bank lending.

According to Cross Border Capital, emerging markets are in fact likely to benefit from IMPROVED liquidity over the next few months. The chart below sums up the long cycles of liquidity within emerging markets - an upswing in liquidity usually implies higher EM equity valuations and according to Cross Border, we are now mid-way through a recovery in EM liquidity.

According to Cross Border Capital "May 2015 proved another positive month for Emerging Market Liquidity with the EM component of our GLI™ (Global Liquidity Index) hitting 48.8 ('normal' range 0-100) from 46.7 at end-April and 21.9 a year ago. Although the index lies a tad below the neutral threshold of 50, the EM Liquidity trend is plainly upwards... Greater liquidity boosts the attractions of risk assets and underpins the business cycle. Poor liquidity over the past four years explains the disappointing economic performance of EM. This now looks to be changing... our view is that any prospective falls in US Liquidity will be more than offset, in both size and impact on the Emerging Markets, by further Chinese monetary easing."

If Cross Border Capital's analysis is right, investors might want to increase their exposure to emerging markets whilst also taking profits on their existing US equities.

Emerging Markets Liquidity Cycle Rises to 48.8 from 46.7



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CDS Rates

Yet again, we've not seen a huge change in the CDS rates offered this month. These CDS contracts are used by investors looking to insure against any losses on their holding of bank bonds. Overall these CDS rates remain at very low levels though there are some interesting bank specific stories. We've already noted how CDS rates on HSBC have edged slightly higher in recent months as have those for Dutch bank Rabobank - although it is worth noting that both banks are still regarded as very low risk by the vast majority of investors.

Meanwhile rates for insuring bank bonds issued by Lloyds Bank have dropped sharply, suggesting that the bank's core focus on its UK retail banking franchise is probably helping assuage many investors concerns about any possibility of bank failure. Investors have also notched rates down sharply for Japanese bank Nomura. Much of this is probably related to the Japanese central banks own aggressive programme of reflation and the improving economic situation for Japan's largest export orientated corporates especially as the yen weakens.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	20	73	-1.36	-3.33	A -
Barclays	33	64	2.4	1.73	A
Citigroup	26	76	2.13	11.07	A
Commerzbank	38	86	6.29	7.5	A+
Credit Suisse	41	77	12.74	31	A
Deutsche Bank	38	77	5.19	19.38	A+
Goldman Sachs	34	1.23	7.52	5	A
HSBC	30	62	-1.42	30	AA-

JP Morgan	24	65	0.48	14.4	A+
Lloyds Banking Group	25	58	-2.89	-4.68	A
Morgan Stanley	30	78	2.52	8.18	A
Nomura	18	63	-2	-30	A-
Rabobank	18	60	12.21	20.87	AA-
RBS	38	73	1.45	-10.47	A
Soc Gen	35	79	5.9	5.9	A
UBS	27	56	2.95	13.97	A

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Government Bonds

It's been another volatile few weeks on Europe's bonds markets with ten year yields shooting up again as investors realise just how daft they've been to invest in long duration bonds that yield next to nothing. Spreads between still ultra-safe German bunds and more peripheral sovereign debt (from the likes of Spain, Italy and Portugal) have shot up even as German bund yields have increased. French bonds represent an especially interesting example. The chart below shows how French ten year bond yields have pushed aggressively towards 1.4%, well in excess of German rates.

UK Government Bonds 10-year Rates

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

CDS Rates for Sovereign Debt

Country	Five Year
France	35.93
Germany	14.75
Japan	42
United Kingdom	18.98
Ireland	56.15
Italy	133
Portugal	199
Spain	108

Eurozone peripheral bond yields

Country	% in June 19th, 2015	% in May 16th, 2015	Spread over 10 year German bonds
Spain 10 year	225	113	146.3
Italy 10 year	234	115	155.3
Greece 10 year	11181	10000	11102.3

	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

European equities have become hugely popular over the last 12 months. Exchange traded fund (ETF) issuers for instance have seen huge inflows of money into trackers that follow indices such as the EURO STOXX 50 Index. The chart to the side explains why so many investors are enthusiastic. It shows that the ECBs monetary bazooka is having an impact not just on corporate liquidity but also economic growth. And remember that as growth rates accelerate, we'd normally expect corporate profits to also increase sharply.

But has the rally in Eurozone equities already priced in all of this recovery? A recent note from the highly rated European equities team at Morgan Stanley suggests that investors might want to exercise more caution in the next 12 months. They argue that the case for buying European equities remains intact, for six reasons:

i) Europe's economic surprise index has turned positive for the first time in five months;
ii) The earnings upgrade cycle is still on track as financial conditions continue to ease;
iii) Investor interest in Europe is returning as mutual fund flows have started rising again;
iv) Corporate activity continues to pick up;
v) Normalised valuations are still low vs history; and
vi) Their Market Timing Indicator is close to a 'buy signal'.

But sharply higher equity valuations mean that Eurozone equities aren't cheap anymore. The Morgan Stanley team observe that the "gap between Europe vs US dividend yield and credit yield has now closed and the relative 12-month forward P/E is now trading above its historical average. Relative earnings revisions have also turned negative recently. From a tactical perspective, we see less scope for further outperformance". Their view is that the big asset class rally in Eurozone equities is probably now over, but that continued economic momentum will probably encourage more "bottom-up stock picking".

Money supply growth is accelerating - positive for GDP growth

Source: Eurostat, Haver Analytics, Morgan Stanley Research

Index	June Level	May Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	**114.7**	**114.6**	**3489**	111
FTSE 100 (Dec 14)	**246**	**248.1**	**6744**	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	-3.75	-3.42	-3.74	-1.04	27.75	56.69	6707.88
S&P 500	-0.37	1.04	2.91	8.39	89.82	130.98	2121.24
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-1.04	-4.17	-1.77	6.33	14.97	17.67	12.055
Benchmark for volatility							
VIX New Methodology	13.9	3.79	-13.74	36.66	-39.462	-51.71	14.5

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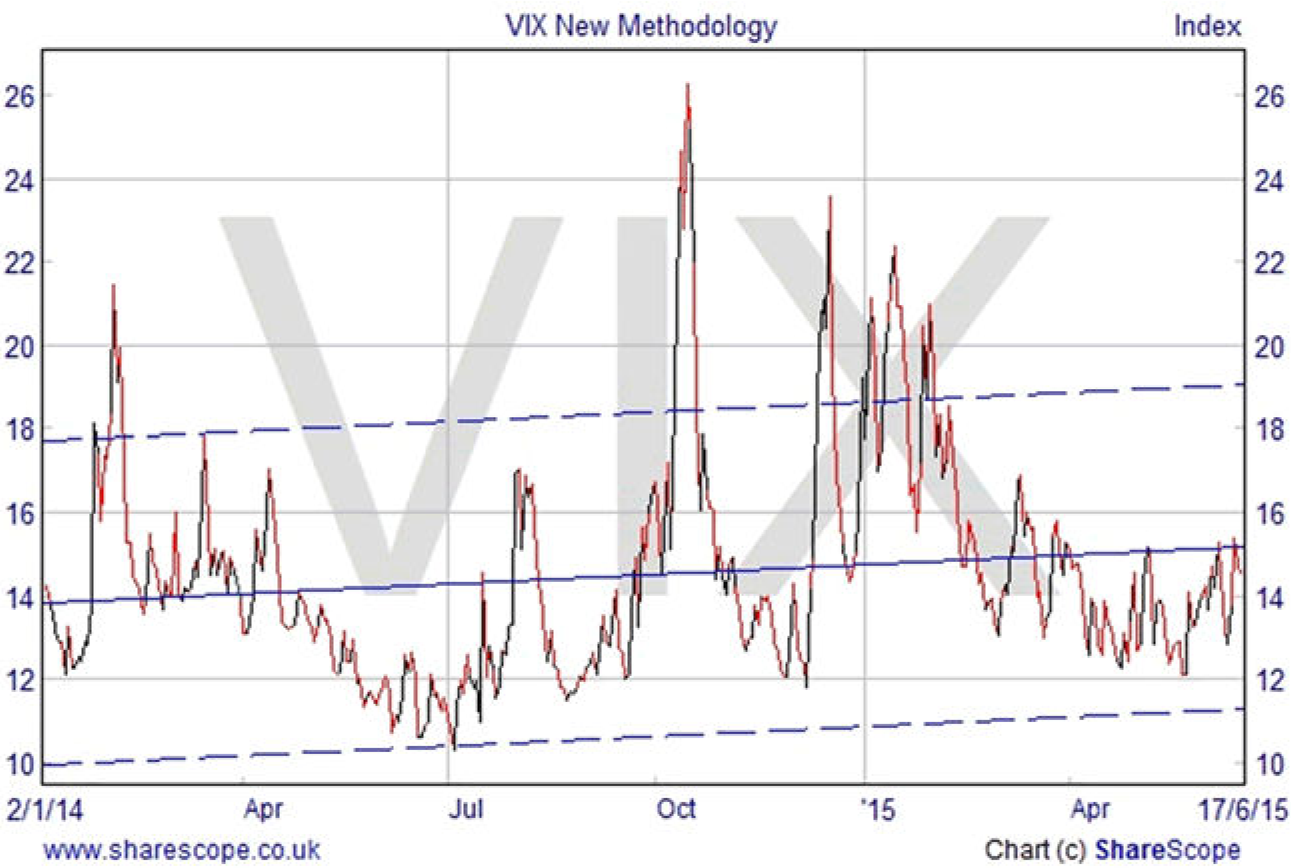
Volatility

Measures of US volatility - as seen in the chart below - remain at relatively low levels although it is worth noting volatility is gently trending upwards. Four weeks ago the VIX reached its lowest level for 2015, closing at 12.11. It's recently been trading at around 14.5 although it's also true to say that even at these slightly higher levels it remains below the indices 200 day moving average.

Tim Edwards, Senior Director of Index Investment Strategy at S&P Dow Jones Indices speaks for many when he suggests that "there is a sense that the current U.S. equity bull market has hit the buffers this year; the range-traded nature of the S&P 500 has seen it underperform the CBOE S&P 500 Buy-write by 2% year-to-date. However, despite the rise in US volatility measures, our best-performing investable volatility index was the S&P Daily Inverse Short-Term VIX Index. That an index selling VIX futures should perform so well is partly due to the high volatility levels at the turn of the year but also, and more importantly, due of the steep contango in VIX futures prevalent during the period - a sign that 2015 has not been as bad for U.S. equities as many had supposed."

US volatility measures may be low - as are those for the UK FTSE 100 Index - but Eurozone measures are beginning to tick up again, helped along by worries about Greece. According to Edwards, the government in Athens needs to make more payments this month "and with many viewing a failure in negotiations as less catastrophic than it might have been at the outset of the crisis, the political balance of pressures has changed along with the potential outcomes. A default and "Grexit" - however mitigated - would nonetheless certainly be bad news for the equity markets. European equity volatility is up considerably in consequence, recording its highest levels so far this year at time of writing."

And it's not only Eurozone equities that are experiencing an uptick in volatility - measures of bond market turbulence have also shot up. If these trends continue - subdued volatility in the US and the UK, increasing volatility in Eurozone equities and heightened colatility in the bond space - investors could see correlations between different asset classes fall sharply. That could be a great pricing environment both for new, specialists structured products and for stock picking fund managers more generally.



Source: http://eoddata.com/stockquote/INDEX/VFTSE.htm

Measure	June Level	May Level	April Level	March Level	Acc/Dec	Direction Upwards
Vstoxx Volatility	24.15	21.92	20.47	18.41	ACC	No
VFtse Volatility	14.09	16.55	14.94	11.8	DEC	No
FTSE Put Call Ratio	0.75	1.02	1.90	1.02	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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