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UK | STRUCTURED™ PRODUCTS ASSOCIATION

Monthly Market Report

June 2015

With commentary from David Stevenson

One of the more amusing perks of the job being a journalist is that I get to be on the receiving end of a remorseless tide of information during pivotal events such as general elections. Two sets of PR distributed survey information stand out for me. The first is from financial betting firms who in my experience have a pretty good handle on what the financial speculators think will actually happen next (or at least better at least than the opinion polls). The second stream of reports is the legion of notes by top down, big picture macro analysts and strategists, predicting the likely direction of a big clump of assets like UK equities after a big political move. Curiously both groups were united before the election in their unswerving conviction that we were facing a) another minority/coalition government and b) economic turmoil. I must admit I was minded to agree with both at the time nevertheless also felt that everyone and their dog was under estimating a likely Conservative late surge. Flash forward just a few days and the City is jubilant, markets are buoyant and the prevailing view is that stability has been resumed.

Yet I would wager that the General Election only solved one relatively small challenge - who governs. What the result hasn't done is resolve the economic uncertainties that have always been lurking in the wings. These include how to deal with Europe. The effect of even more austerity on consumer demand. The UKs poor productivity levels and chronic balance of payments issues. The long term strength of sterling, undermining UK exporters. None of these issues were really the subject of the election campaign and none are any closer to being solved after that big date with destiny. All of which makes the current consensus in favour of stability curious. The global economy has probably just about avoided a nasty brush with recession and both the Eurozone and China will probably surprise to the upside in 2015 but the sudden run on Eurozone bonds - and subsequent strains on liquidity - speaks to a huge structural issue. What will happen when global liquidity (powered in large part by the US) starts to tighten? Maybe the becalmed markets, displaying their current low levels of volatility, will finally kick back into a more frenzied mode.

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Headline Numbers

Measure	Value as of April 16, 2015	Value as of May 15, 2015
UK Government 10 year bond rate	1.58%	2.01%
GDP Growth rate YoY	3%	2.40%
CPI Core rate	1%	1%
RPI Inflation rate	0.9%	0.9%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.53%	0.53%
Government debt to GDP ratio	90.60%	89.40%
Manufacturing PMI	54.4	51.9
Sovereign Western Europe CDS	19.8	48.21
Euro Bank CDS	119.18	75.46
FTSE CDS	63.4	75

Much the most curious aspect of the general election was the relative silence about what's happening in the UK economy and especially the recent sharp appreciation in the value of sterling. I can think of not one politician or economic analysts who asked what effect a strong pound has on the UK economy. The answer would have been simple - devastating, especially if you are an exporter. Consumers may like the lower import prices and cheap travel but the UK's rump industrial base is looking becalmed and beleaguered. The two charts below tell a fascinating story. The first shows the sterling/euro pair. Sterling weakened noticeably up until 2009 and since then we've seen strong appreciation in sterling. The second chart shows a more recent pairing between sterling and the dollar since the beginning of 2015. Again we can see a resurgent £ pushing ahead against what is already a fairly robust dollar. These numbers are terrible for the UK economy and we can see a direct impact on manufacturing PMI numbers which have fallen sharply in the UK. This sterling strengthening may also be weighing on the minds of policy makers at the Bank of England. The new UK government may be keen to 'kitchen sink' all the tough decisions to its first year in office - Heathrow airport, spending cuts, increased interest rates - but the Bank of England may have other things on its mind like a strong pound hitting the recovery. It may be looking at sterling as the victim of a global attempt to weaken currencies to help local exporters... with the UK the last man standing in a new currency war.

GBP/EUR - Euros per £
Exchange Rate
GBPEUR
1.7
1.6
1.5
1.4
1.3
1.2
1.1
4/1/00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
'11
'12
'13
'14
14/5/15
www.sharescope.co.uk
Chart (c) ShareScope

GBP/USD - US $ per £
Exchange Rate
GBPUSD
1.58
1.56
1.54
1.52
1.50
1.48
1.46
1/1/15
12
19
26
Feb
16
23
Mar
16
23
30
Apr
13
20
27
May
14/5/15
www.sharescope.co.uk
Chart (c) ShareScope

Headline Thought

Over the many years following the global financial crisis, investors have worried about all manner of balance sheet and Chas flow related themes. Debt levels may have peaked before the crisis for instance but many still worry about chronically high levels of consumer debt. Other investor's - and policy makers - worry about businesses hoarding too much cash, slowing down monetary velocity and generally hobbling the recovery of national economies. In the strange world that is modern finance, high levels of excess debt can coexist quite happily with mountains of cash sitting on and offshore.

Given this fixation about cash and debt I couldn't help but notice two curious stories over the last month. The first is a survey by the UK Cards Association (as in credit cards) and looks at spending patterns. Given all the talk about indebtedness you may presume that we are wandering spending like crazy, running up huge levels of debt. This survey suggests otherwise. Apparently in February for instance spending on payment cards reached £49.6 billion with debit cards continuing to outstrip credit cards. According to this trade association consumers spent £35.2 billion on their debit cards in the month, up 7.7 per cent on the previous year. At the same time credit card spending also grew, but at the lower rate of 5.6 per cent to £14.4 billion. Figures show that around four-fifths of credit and charge card spending is made by cardholders who repaid the balance in full.

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CDS Rates

The market for insuring against bank bond losses is showing some small evidence of leaping back into life. For much of the last few years we've been tracking Bank Bond CDS rates on their remorseless descent downwards. These sagging rates indicate a general feeling that the risk of capital loss has been ebbing away, with big banks effectively backstopped against failure by the developed world's central banks. But in the last few weeks and months this multi-year decline looks like it might have finally stopped, and rates have started rising again. In truth rates on bank CDS contracts have always been volatile, and its noticeable how some banks have fallen out of favour (in relative terms at least) while others are now suddenly viewed as much less risky.

But last month every bank CDS rate bar one - for Nomura - increased. Admittedly these increases aren't huge but they do indicate that maybe investors are beginning to worry a tiny bit more about bank balance sheets. This might mean that bank bond yields might start to rise and that might, in turn, help push up the funding that goes into structured products.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	49	92	8	-3	A -
Barclays	34	65	8	-8	A
Citigroup	27	77	4	6	A
Commerzbank	39	83	4	-7	A+
Credit Suisse	26	62	10	-3	A
Deutsche Bank	36	75	6	2	A+
Goldman Sachs	34	87	6	5	A
HSBC	31	64	8	10	AA-
JP Morgan	23	65	5	10	A+
Lloyds Banking Group	30	61	6	-7	A

Morgan Stanley	32	81	8	8	A
Nomura	23	66	-4	-24	A-
Rabobank	12	58	9	5	AA-
RBS	37	71	6	-18	A
Soc Gen	34	79	5	-8	A
UBS	25	60	9	9	A

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Government Bonds

The last few weeks brought another big surprise apart from the UK general election, with equally important political implications - the selloff in German bunds or government securities. The chart below shows the yield on ten year German bonds. Just a few months ago this seemed to be heading close to zero, but now that yield has snapped back to close to 0.80%. This implies big capital losses for the owners of these bonds - pension funds and central banks. More generally it's a reminder that bonds are not riskless as an asset class. Paul Jackson of ETF firm Source sums up the markers reaction beautifully when he observes that "there are reasons to suspect both real and nominal yields can rise from here: first, investors are not mugs and will not accept such low yields unless all other assets promise even less (economic depression, say); second, ECB policies seem to be contributing to economic recovery which naturally drives up real yields and inflation expectations and, third, the rise in US yields that we forecast will exert an upward influence on European yields."

Bond investors beware. We may not be approaching a rout but this could be a nasty brutish summer.

German Government Bonds 10-year Rates

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

CDS Rates for Sovereign Debt

Country	Five Year
France	34
Germany	17
Japan	38
United Kingdom	20
Ireland	N/a
Italy	110
Portugal	143
Spain	84

Eurozone peripheral bond yields

Country	% in May 16th, 2015	% in April 16th, 2015	Spread over 10 year German bonds
Spain 10 year	113	119	227
Italy 10 year	115	120	226
Greece 10 year	1125	1109	693

	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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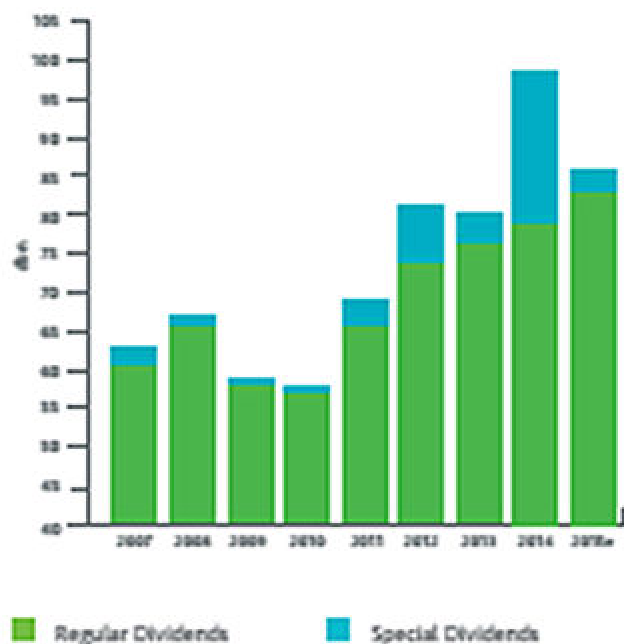
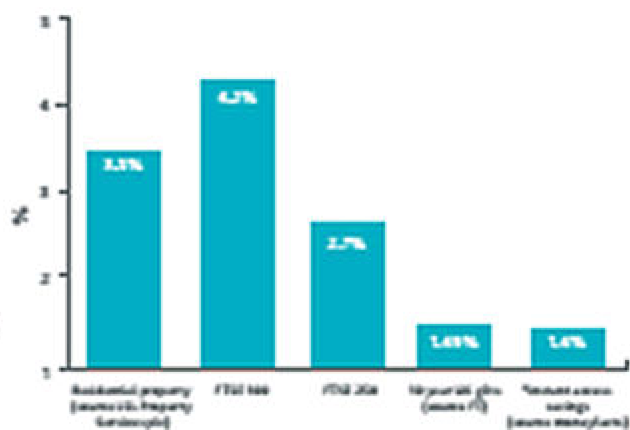
Equity Markets and Dividend Futures

Although the UK equity market has had its ups and downs in 2015 so far, matters finally seem to be improving for the beleaguered blue chip index. Over the last three and six months the FTSE 100 has started to close the gap with the more successful US market. This turn around may well be helped by recent numbers from dividend experts Capita who monitor the total amount of UK business dividends paid out by listed businesses. Their numbers suggest that UK equities have had a strong start in 2015, despite apparently poor headline figures masking accelerating underlying growth. As a result, Capita has now increased its 2015 forecast for headline dividends to £86.5bn, up from £86.1bn. On an underlying basis, Capita has revised its forecast up by £500m, with dividends forecast to reach £84.1bn, the highest rate of growth since 2012.





Index	May Level	April Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	**114.6**	**114.6**	**3611**	110
FTSE 100 (Dec 14)	**248.1**	**248**	**6997**	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	-1.44	1.45	4.79	1.37	32.5	59.84	6973.04
S&P 500	1.21	1.15	3.98	12.31	86.77	137.51	2121.1
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-4.79	-3.08	1.57	6.12	17.42	16.79	12.135
Benchmark for volatility							
VIX New Methodology	-6.8	-13.27	-4.28	4.68	-59.22	-59.39	12.74

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Volatility

Volatility matters for investors in structured products. Options based on volatility and big market moves are baked into many products that are structured and sold within the retail space. Put simply more volatility helps the issuers of new products as it allows them to price more upside into a product. Low volatility isn't a complete disaster for issuers, but it sure as heck doesn't help pricing.

So given this basic investment maths, what are we to make of the current low levels of market volatility? In these articles we've been constantly observing that markets are in fact becalmed, turbulence has been tamed, and volatility measures close to all-time lows. Again using simple terms, volatility may matter, but not as much as it used to!

The Wall Street Journal recently underlined this strange state of affairs by observing in an article called "volatility for stocks stays in check" that as the S&P 500 hits record highs, the benchmark US equities "hasn't had a single move, up or down, of 2% this year, compared with three such swings by this time in 2014 and two in 2013.....To be sure, the S&P has posted more 1% moves so far in 2015 than it did in the corresponding period last year."

Many investors like to think that this subdued volatility is a harbinger of nasty things to come, but the reality seems to be much more mundane - equity markets have simply become boring and may stay that way for a considerable period of time in the future.

But investors also still need to understand how market volatility can make a difference, especially by using indices such as the Vix which measures turbulence within the broad S&P 500 index. Luckily a US website called ETF Trends recently put out what I think is the best, most concise summary yet of how to understand the relationship between the VIX index and volatility.

"Here's a question for you. If the market were to expect consistent 2% daily moves in the S&P 500 over the next 30 days, what approximate VIX level would we see? I won't make you wait for the answer. VIX would increase to approximately 40. And to scale this down, expected 1% moves would translate to a VIX of about 20. In brief, that's the 'rule of thumb', the round numbers to keep in mind: VIX at 40 = 2% daily changes; VIX at 20 = 1% daily changes. This is the math behind the numbers. VIX is a monthly measure of implied volatility that has been annualized. A VIX of 40 (or 40%) equals an expectation of 30-day volatility of 11.5%. This is done by dividing the annual number, 40%, by the square root of time, in this case 12 months. To get to a daily volatility value, you have to divide by the square root of days in a year, 365. So, 40% divided by the square root of 365 is approximately 2%. And 20% divided by the square root of 365 equals about 1%."

Measure	May Level	April Level	March Level	February Level	Acc/Dec	Direction Upwards
Vstoxx Volatility	21.92	20.47	18.41	24.2	DEC	Yes
VFtse Volatility	16.55	14.94	11.8	14.68	DEC	Yes
FTSE Put Call Ratio	1.02	1.90	1.02	2.00	DEC	Yes

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

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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.

To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,

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