To view this email in your browser, please click here

UK Structured ™ Products Association

Monthly Market Report

March 2015

With commentary from David Stevenson

Well the Greeks went and did it! Syriza is now firmly in power and the world's global financial markets seem to have survived an electoral snub by local voters against austerity in Europe and pro-creditor policies. Quite how the negotiations will unfold is frankly anyone's guess and the rise in yields on Greek debt highlighted in this note suggest that many investors think that a Grexit (a short hand term for a Greek exit from the Euro) has become much more likely. Yet it's also true that most investors think that a deal on debt is likely though not necessarily probable at this stage but I find myself drawn to two very contrasting measures when looking at the Greek situation. The first is from the World Bank and looks at interest payments on the huge weight of Greek debt versus the government's revenue base. The idea here is that although Greece may be sagging under debts that amount to more than 150% of their GDP (ours is around 90%), the interest payments on those debts are actually perfectly manageable. These World Bank numbers are a bit out of date (from 2012) but they suggest that the Greek interest tab is running at 11.5% of revenues compared to 13.5% in the US and 8% here in the UK. I'd hazard a guess that the interest servicing bill is likely to fall even further, suggesting that Greece can in fact afford its payments.

The other scarier statistic is that if you look at a country's debt level versus its total tax revenue, Greece is currently the world's second worst offender - total debts are running at 475% of total revenues, with only Japan in a worse position at a mind boggling 900%. The obvious answer to Greece's problems may be just to collect more taxes but let's leave that point alone! The bigger conclusion is that Greece will survive, will stay in the Eurozone and won't drag the entire financial system into a pit of despair!

Contents

Headline Numbers

Measure	Value as of January 15, 2015	Value as of February 12, 2015
UK Government 10 year bond rate	1.51%	1.67%
GDP Growth rate YoY	2.60%	2.70%

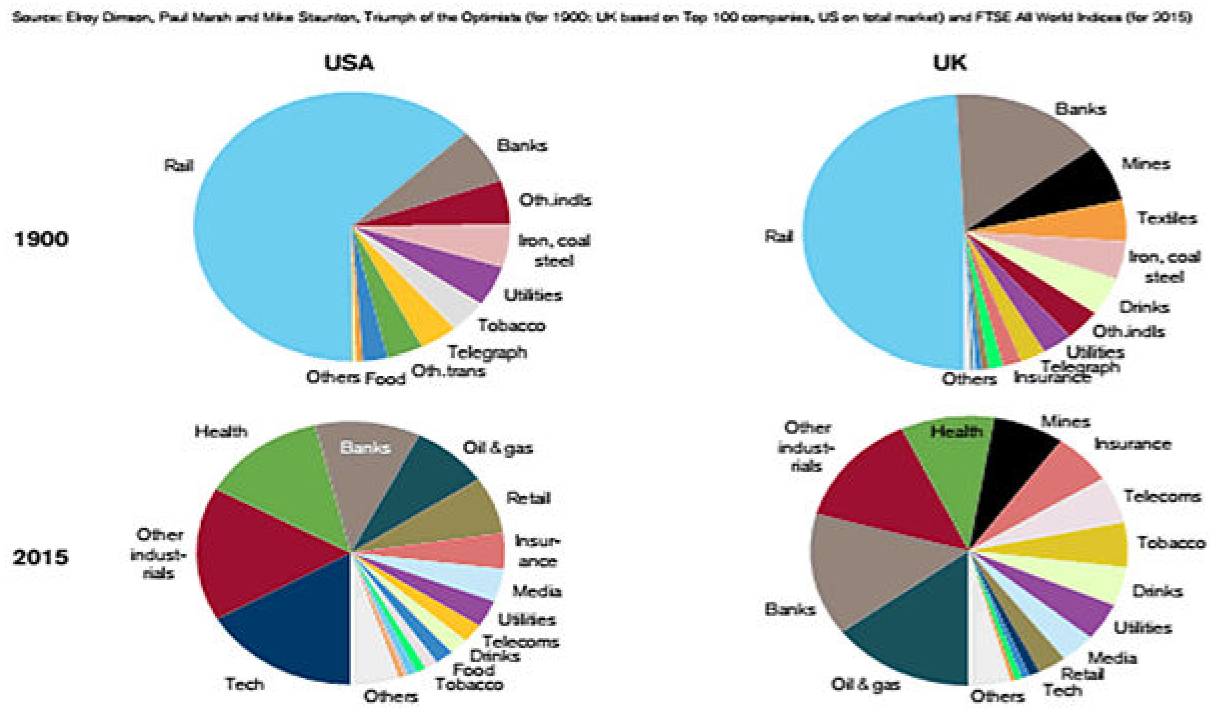
CPI Core rate	1.30%	1.30%
RPI Inflation rate	1.60%	1.10%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.53%	0.53%
Government debt to GDP ratio	90.60%	90.60%
Manufacturing PMI	52.50	53
Sovereign Western Europe CDS	53.35	46.20
Euro Bank CDS	205.58	198
FTSE CDS	78.30	72.50

The big story in the UK at the moment is inflation - or should we say the lack of it! For many baby boomers who grew up in the stagflationary seventies, the idea that inflation has somehow been vanquished is remarkable but maybe we shouldn't not be too surprised by the current spate of low numbers. We have been here before - the chart below is from a web site called Trading Economics and looks at UK core inflation rates since the middle of the nineteen nineties. It shows clearly that core rates (running at 1.3%) have in fact been even lower in recent years, hitting negative rates (yes deflation) in 2000. A recent paper by Source ETFs strategist Paul Jackson went even further back in time and looked at Swedish inflation rates since the thirteenth century. He found many, many incidences of substantial deflation (prices falls) even within a regime of gold backed money. Yet Sweden never descended into anarchy and continued to progress and develop a sophisticated society over the last few centuries. His bottom line - Falling prices are not necessarily a bad thing and we should focus on what is causing the low rates not on the numbers alone.

Headline Thought

The charts below tell a remarkable story about stock markets. The underlying data is taken from this year's Credit Suisse yearbook compiled in collaboration with economists at the London Business School, chiefly Professors Paul Marsh and Elroy Dimson.

These colourful looking charts show how the sector composition of the main US and UK stock markets has changed over the last 115 years. In itself the fact that there has been change shouldn't be remotely surprising but take some time to consider the transformation. Whole industries have quite literally vanished - who's to say that our current obsession with tech titans won't go the same way?



According to the report "of the US firms listed in 1900, more than 80% of their value was in industries that are today small or extinct; the UK figure is 65%. Besides railroads, other industries to have declined precipitously are textiles and iron, coal and steel. These industries still exist, but have moved to lower cost locations in the emerging world."

One could argue that we live in a very different world and that these numbers are slightly irrelevant but the authors beg to differ. They observe that though much has changed, similarities between 1900 and 2015 are "apparent. The banking and insurance industries have continued to be important. Similarly, industries such as food, beverages (including alcohol), tobacco and utilities were present in 1900, just as they are today. And in the UK, quoted mining companies were important in 1900, just as they are in London today."

Perhaps the most interesting comments come in the authors musings about what investors can do about these huge sector shifts - should we go with the flow and buy the hot sectors or ignore the consensus and become contrarian by focusing on value stocks? The LBS academics conclude that "One way of leaning against any tendency to overvalue the new and undervalue the old is to follow an industry value rotation strategy. This has historically generated a premium. But momentum appears to be an even more effective rotation strategy. Buying last years' best performing industries while shorting the quintile of worst performers would, since 1900, have generated an annualised winner-minus-loser premium of 6.1% in the USA and 5.3% in the UK. Before costs, US investors would have grown 870 times richer from buying winning industries rather than losers."

Back to menu

CDS Rates

The price paid to buy options that 'insure' against a bank bond defaulting drifted lower again this month, with some banks (notably Commerzbank, Goldmans, JPMorgan and Morgan Stanley) seeing marked declines in one-year rates. A few banks, such as HSBC and Banco Santander, experienced small increases but overall the impression is that most investors have become less worried about the risk of bank defaults. That in turn will mean that banks will probably be able to borrow at lower yields which in turn might have a negative knock on effect on new structured products - remember that higher bank yields give more 'juice' for issuers when constructing a payout structure.

Equity Markets and Dividend Futures

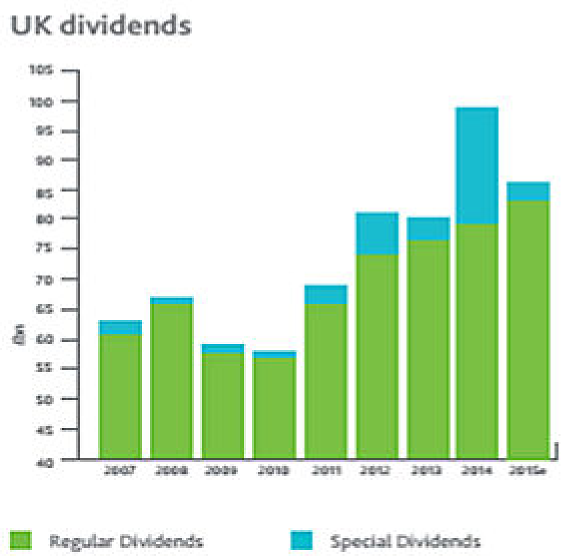
Equity markets have had another solid few weeks with the FTSE 100 Index advancing just under 5%, comfortably out pacing the UK indices' US peers which have moved ahead by between 1 and 2% over the last few weeks. Dig beneath these numbers though and we see much more change underway at the level of equity income or dividends - a key set of payments which have an inordinate influence on the pricing of structured products in the retail market. The best way of observing these payments is through data tracked by shareholder services firm, Capita based around payouts by the businesses in the FTSE 100 index.

At the end of 2014 Capita had pencilled in headline dividends of £85.8bn, down on 2014 largely because Vodafone won't be repeating its special dividend. At the time underlying dividends were estimated to be around £83.7bn.

But in January Capita revised its numbers, citing a number of contrasting dynamics. "There is much greater pessimism about the world economy, the oil price is much lower, the US dollar is much stronger, and Tesco has cancelled its 2015 final dividend. We do not think the weaker oil price will lead to a cut in pay-outs from Shell and BP, two of the powerhouses of UK dividends."

"In 2009, when the oil price was last at this level, Shell continued to increase its US dollar denominated pay out, while BP held its one flat. Unless the oil prices crashes a lot further, we expect them to at least hold their US dollar pay-outs steady. Lower oil prices will be a positive for many other firms. A weaker world economy will drag on the ability of the UK market's highly international list of firms to deliver strong earnings growth. The impact on dividends is always more muted than the impact on profits, and we expect that to be the same this year."

Some changes will of course have a positive impact on UK dividends, notably FX rates. 40% of UK dividends are from companies that report in US dollars and currently the dollar is just under 10% stronger against the pound than its average for the whole of 2014. All other things being equal, Capita estimates that if the current level of the dollar is sustained, it will at least add 3 percentage points to the UK's dividend growth rate for 2015.



Overall Capita has decided to RAISE its forecast for headline dividends to £86.1bn (with a slightly higher run rate of special dividends), "but the Tesco effect means our underlying forecast is slightly lower, at £83.6bn, an increase of 5.7% compared to 2014. This allows for the fact that Vodafone, formerly a top 3 UK payer is now a much smaller company and is likely to drop to fifth place in the rankings in 2015, and for the £900m cost of the Tesco final dividend cancellation; we had expected Tesco to pay £220m. Stripping out these two factors, we think growth can top 7% in 2015."

Index	February Level	January Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	**109.4**	**107.4**	**3138**	112.5
FTSE 100 (Dec 14)	**247**	**247**	**6444**	232.5

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	4088	2.88	2.79	2.18	32.1	61.02	6818.17
S&P 500	1.16	1.41	6.79	13.67	97.8	148.1	2068.53
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-0.57	5.73	7.72	10.53	22.58	19.08	12.53
Benchmark for volatility							
VIX New Methodology	-3.36	31.27	19.18	16.88	-29.22	-61.91	16.96

Back to menu

Volatility

Here's a curious idea - are central banks deliberately targeting measures that look at stock market volatility as they decide what to do next about interest rates and QE? Amongst macro investor's within the hedge fund this idea has been gaining a fair amount of traction in recent months i.e. many now believe that policy makers look very closely at indices such as the VIX volatility index in order to help shape their next policy moves.

On one level this idea seems absurd as central banks should actually be focusing on good old fashioned measures like inflation and jobs growth. But maybe what is actually happening is that central bankers are now formally looking at volatility measures and thus when indices like the VIX shoot up, these economic policy makers deliberately crank up the money printing presses.

Lurking beneath this controversial argument - put ably by commentators such as Richard Duncan of website MacroWatch - is that QE is specifically designed to boost stock markets. Rising share prices feed through into consumer spending and thus increased corporate profits. This in turn pushes the economy forward.

But when stock markets stutter and droop, volatility shoots up, confidence ebbs away again, and the central bankers have to step up the gas on QE again. If all this makes sense then I think we can begin to see why QE4 may be on its way - the chart below looks at the classic Vix fear gauge measure and shows that market turbulence has started trending upwards again, with more big spikes above the crucial 20 index level. This might mean that if volatility in the US markets intensifies, helped by a strong dollar crushing US corporate profits, we could see the Federal Reserve stepping back into the breach again with another bout of QE. The bottom line? Betting on equities rising is a decent bet because central bankers want to engineer rising equity prices. If volatility spikes, maybe the smart thing to do is to dip back into the market and look for sensibly priced structured products to harvest this increased risk premium?

Measure	February Level	January Level	December Level	Acc/Dec	Direction Upwards
Vstoxx Volatility	24.2	28.78	16.33	DEC	Yes
VFtse Volatility	14.68	18.52	10.69	DEC	Yes
FTSE Put Call Ratio	2.00	1.02	1.02	ACC	No

Back to menu

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.

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.

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

Kind Regards,

Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk