To view this email in your browser, please click here

UK Structured™ Products Association

Monthly Market Report

May 2015

With commentary from David Stevenson

Without wanting to sound like a maven of doom and despair, it does seem that the old adage about selling in May and going away until say September seems to be visiting us early this year. As I write this article it is mid-April and various warning signs are flashing 'code red'! The key market bug bear seems to be the all too obvious softening in growth for US consumer spending plus the equally obvious slowing pace of US corporate earnings growth. Neither of these trend indicators - in the world's strongest economy - need imply that a recession is imminent. It might just mean for instance that the US economy will not grow as fast as its peers but will advance nevertheless. Prime candidate for taking up the baton of growth seems to be Europe and the Eurozone where I suspect we're under-estimating the positive momentum. But even here there's a fly in the ointment - Greece. As I will discuss elsewhere I think the chances of a Grexit are growing by the day.

Turning to China, equity investors may be in buoyant mood but the Chinese economy is I think not growing anywhere near as fast as the Communist government would like it to at the moment! I suspect we'll soon begin to realise that GDP growth is probably running at closer to 4% pa rather than the hoped for 7% pa.

Next up in the list of worries is Iran. This should be good news. A settlement over nuclear technology should help keep oil prices low and encourage Middle East trade. Unfortunately I suspect the room for geopolitical mayhem is increasing as we inch towards a settlement. There are a great many vested interests out there who would NOT like a settlement on virtually any terms bar an Iranian total surrender and now is their chance to have an impact. Another concern might be the very real possibility that oil prices will continue to slip below $50 and then $40 a barrel, especially as we head towards the OPEC summit in June. In the medium term lower energy prices are great news for the world economy but in the short term this commodity price deflation will fuel market turbulence.

Overlaying all these factors is the simple fact that many bonds are looking unappetising in terms of yields and some equity markers look a bit frothy in the absence of strong earnings growth. Add it all up and I'd be willing to bet that the US Federal Reserve will be worried enough to NOT raise interest rates in June, sparking another summer of worry and concern about the direction of the global economy.

Contents

- Headline numbers
- CDS Rates
- Government Bonds
- Equity Markets and Dividend Futures
- Volatility
- Summary of Pricing Impact on Structured Products
- Explanation of Terms

Headline Numbers

Measure	Value as of March 12, 2015	Value as of April 16, 2015
UK Government 10 year bond rate	1.84%	1.58%
GDP Growth rate YoY	2.70%	3%
CPI Core rate	1.40%	1%
RPI Inflation rate	1.10%	0.9%
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	54.1	54.4
Sovereign Western Europe CDS	36	19.8
Euro Bank CDS	59.83	119.18
FTSE CDS	61.55	63.4

For much of the last few years British based investors have looked out on the Eurozone with something bordering disdain. Austerity induced political paralysis, fears about the end of the Euro, infighting between 'spendthrift' Southerners and 'frugal' Northerners - the Eurozone affair has all the makings of a sensational farce! But now the tables look like they might be turning and it's our continental cousins who might get the chance to lament our own (self inflicted) problems.

ECB boss Mario Draghi has pressed that big red button marked QE. This has come at the same time as growth in some key states seems to be picking up speed. According to the ECB its had to notch up its expectations of growth - 1.5% and 1.9% for this year and next compared with Bloomberg consensus expectations of 1.2% and 1.6%. The Euro is also continuing to weaken which should help local exporters. But as Paul Jackson, research head at Ossiam ETFs, points out many of these big moves - especially in the value of the Euro - represent terrible news for the Brits. "A strengthening pound is horrible news for the UK's besieged exporters - their goods and services are now that much more expensive?" says Jackson. "And that must be bad news for the UK economy? How long will it take for UK manufacturing growth numbers to react sharply to the downside? My guess is that June and July will be tough months as a host of less positive UK macro-economic numbers start to emerge post-election! Good luck to the winners!" Perfectly put! Winner beware in the general elections.

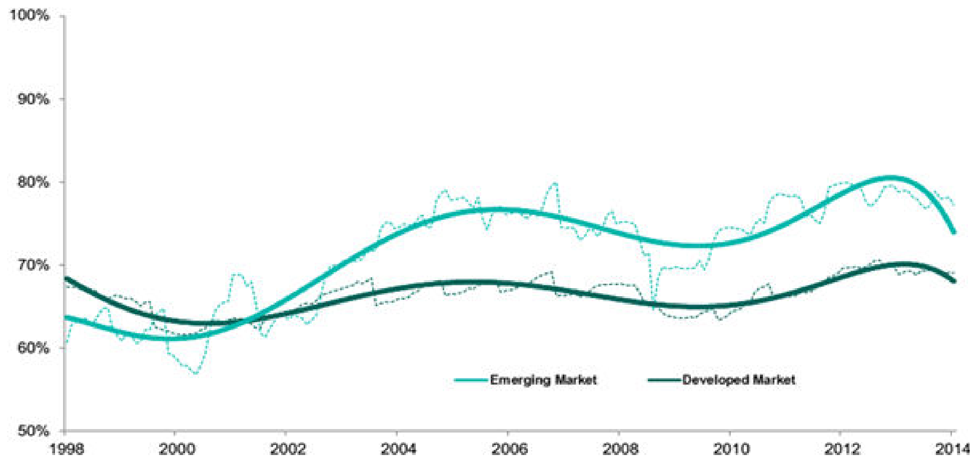
Headline Thought

One of the most interesting developments within global investing over the last few decades has been the inexorable rise of emerging markets. This growth orientated asset class has come from virtually nowhere in the 1980s to become a major focus for many investors - some structured products have even be devised to take advantage of the possibility for huge capital gains. But this relentless increase in prominence has masked another fascinating trend, which is that more and more emerging market businesses are relatively mature. That has meant that they are happy to pay out a dividend to their shareholders. According to a recent report by Aye Soe, Senior Director, Global Research and Design at S&P Dow Jones Indices, over the past 16 years the percentage of companies paying dividends has increased at a faster rate in emerging markets than in developed markets.

S&P reckons that the percentage of dividend-paying companies in developed markets varies between 60% and 70% yet for emerging markets, while the percentage of companies paying dividends has steadily increased from 60% in 1998 to 70% - 80% in 2014, surpassing the levels observed in developed markets. According to Soe from S&P the Czech Republic, Poland and South Africa have made the biggest impact in terms of dividend growth. The aggregate annual dividend payout ratio has been climbing steadily in EMs although the S&P analysts also point out that " the dividend payout ratio, which indicates the percentage of earnings that is being returned to shareholders, has been declining in developed markets.

Crucially investors who'd put money to work in emerging markets stocks would have discovered that dividend payers in EMs have outperformed non-payers, with much lower volatility. The S&P research shows "that over the past 16 years ending Dec. 31, 2014, emerging market dividend payers delivered significantly higher returns with lower risk compared with the non-payers and the overall market. In addition to better risk-adjusted returns, dividend-paying stocks had lower systematic risk and were less sensitive to market changes". Bottom line? Expect to see more structured products emerge that are designed to capture this trend towards increased dividends paid out in emerging markets.

Percentage of Dividend-Paying Companies in Developed and Emerging Markets



Back to menu

CDS Rates

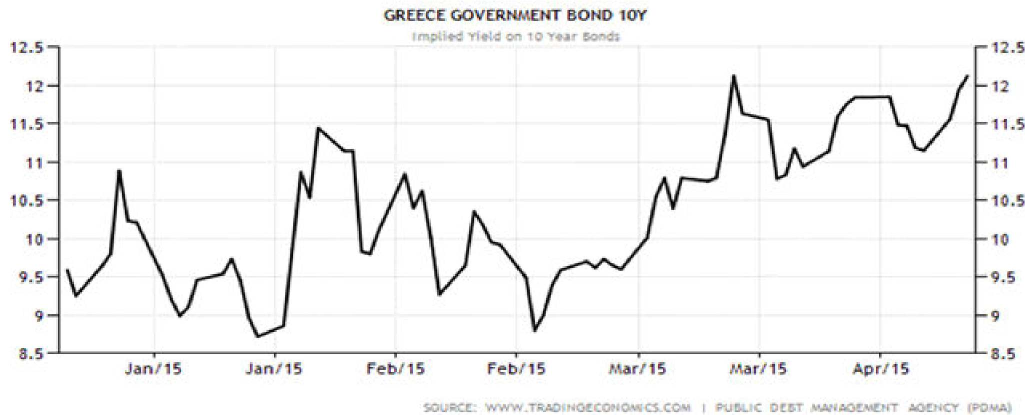
Rates on CDS options - products that are in effect a way of insuring against default for bank bonds - have continued to remain fairly steady over the last few months, although we have seen some small movement at the individual bank level. European bank CDS rates have continued to fall but the most remarkable story focuses on the dynamic between two banks, namely HSBC and Nomura. Until very recently the London based global bank was regarded as one of the very safest banks in the world with rock bottom 1-year CDS rates. Nomura by contrast was perceived to be rather 'riskier' - though not massively so - and belonged to a bigger group of banks where investors did have some concerns focused on macro-economic worries at the political level. Yet in recent weeks HSBCs' 1 year CDS rates have nudged steadily upwards while Nomura's have fallen relentlessly - the cost of insuring 1-year bank bonds for Nomura are now cheaper than for HSBC. All this said and done we shouldn't read too much into this pair especially as HSBC's CDS rates at the five year level are still very low (although it is worth noting that Lloyds has even lower rates!).

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	41	84	10	-23	A -
Barclays	24	56	7	-20	A
Citigroup	25	73	-3	1	A
Commerzbank	33	79	7	-17	A+
Credit Suisse	26	62	10	-3	A
Deutsche Bank	31	69	8	-5	A+
Goldman Sachs	29	81	-5	83	A
HSBC	25	56	7	-4	AA-
JP Morgan	23	60	-6	2	A+
Lloyds Banking Group	24	55	8	-15	A
Morgan Stanley	28	73	-3	-5	A
Nomura	23	70	-18	-29	A-
Rabobank	12	49	5	-11	AA-
RBS	27	65	6	-40	A
Soc Gen	34	74	1	-13	A
UBS	25	51	7	-6	A

Back to menu

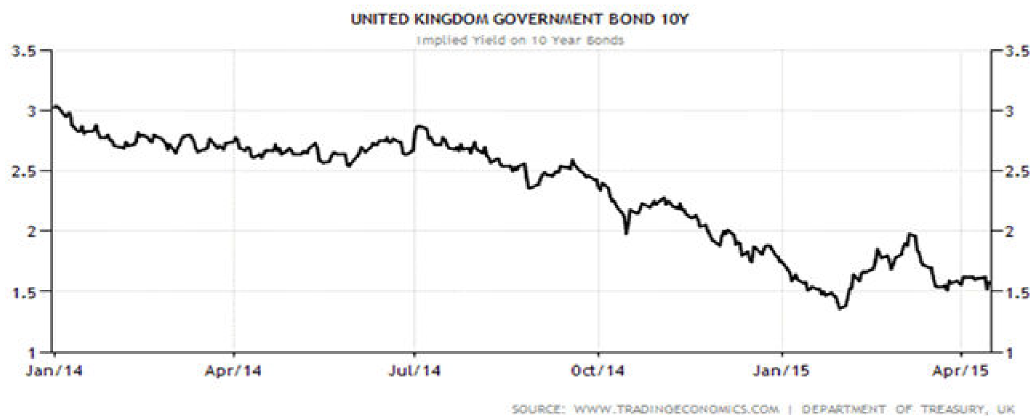
Government Bonds

Beware! Many bond investors I talk to look on the short term pricing environment with some trepidation with Greece and its fate within the Eurozone the focus of much nervousness. The chart below shows the yield on Greek government ten-year bonds. Since the beginning of 2015 it's crept steadily higher from lows of under 9% to the current 12% plus level. These yields tell us that concerns about the trustworthiness of the Greek government are mounting by the week but they also tell us that fear of outright default and non-payment is still fairly subdued, for now at least - if we were in a panic situation yields would be above 20 or even 30%. My own sense is that the possibility of a Greek default has moved from a small chance (under 20%) to a 50/50 outcome. A great many hedge funds are now actively preparing for a default of some sort and word on the street is that even the central bankers think a default is now a distinct possibility. If that does happen, expect massive short term market turbulence, with German bund yields possibly moving even closer to zero and many equity investors selling Eurozone equities.



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

UK Government Bonds 10-year Rates



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

CDS Rates for Sovereign Debt

Country	Five Year
France	37.915
Germany	16.96
Japan	36
United Kingdom	20.93
Ireland	49.31
Italy	113.92

Portugal	141
Spain	89.9

Eurozone peripheral bond yields

Country	% in April 16th, 2015	% in March 12th, 2015	Spread over 10 year German bonds
Spain 10 year	1.29%	1.15%	227
Italy 10 year	1.30%	1.12%	226
Greece 10 year	11.19%	10.34%	693

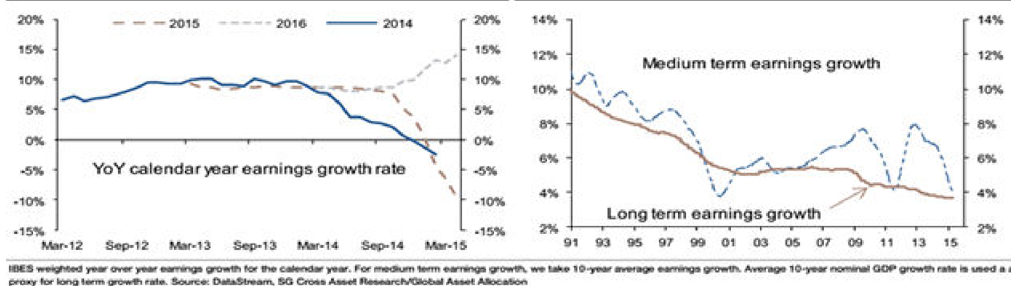
	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

Back to menu

Equity Markets and Dividend Futures

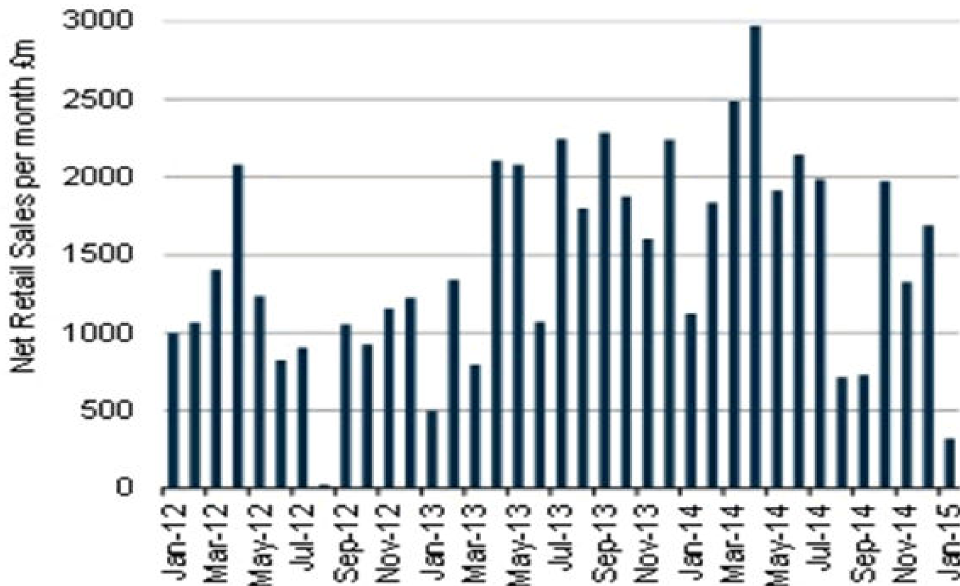
It's become something of a consensus idea here in the UK that our equities are undervalued. The chart below shows the relationship between the mainstream Eurozone, DJ Eurostoxx 50 Index and the FTSE 100 - the UK market has very clearly underperformed.

But maybe that under performance represents a brutal reality - that, prospective profits growth in the Eurozone is likely to surprise to the upside while UK blue chips are likely to struggle to maintain positive momentum? Analysts at French bank Societe Generale certainly take this view - in the charts below they plot short term, medium and long term earnings growth expectation for UK equity market.



In their view "consensus expects earnings to deteriorate further in 2015. Medium and long term earnings growth expectations for UK remain near historical lows." The French bank’s analysts maintain that UK equities are in fact over valued and they reckon that from an asset allocation perspective, UK government bonds "offer better value. Our proprietary risk premium model indicates that UK equity market is expensive on an absolute basis as well as relative to government bonds. While UK government bond yields are low in historical context, they offer better value relative to UK equities." At the moment I'd observe that this is probably still a minority view but I think that as the political risks become more obvious at the national level after the general election, UK equities might be seen to be the weak link within the developed world markets.

FTSE 100 performance in GBP relative to the Stoxx 600 performance in euro. Both indices in total return. Sources: FTSE, DataStream, SG Cross Asset Research/Equity Strategy



Index	April Level	March Level	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	**114.6**	**113.2**	**3758**	110
FTSE 100 (Dec 14)	**248**	**248**	**7067**	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	5.28	9.2	14.25	8.49	21.83	78.83	7096.78
S&P 500	2.59	5.72	13.11	14.31	73.86	147.24	2106.63
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	2.06	.11	3.8	10.3	23.19	19.82	12.695
Benchmark for volatility							
VIX New Methodology	12.84	-19.75	-42.65	-51.09	-34.32	-19.19	12.84

Back to menu

Volatility

In the last few months its becomes obvious that more and more fund managers have been taking advantage of relatively subdued market volatility to top up on downside market protection. Only a few weeks back for instance trade newspaper Investment Week revealed that a number of well-known managers were buying put options on the UK market to protect them against any downward future move in UK equities. Alex Breese, Head of UK Equities at Neptune, observed in Investment Week that a measure called the Relative Strength Indicator, used to measure momentum in the FTSE 100, hit a high of 84 back in January but has since fallen back, indicating the start of a consolidation period. "Data from Merrill Lynch showed that in the fourth week of [2015], $18.8bn flowed into equities - that is the third largest sum since 1992 and has triggered a sell signal at Merrill Lynch. The flows are above 10% of AUM - the last time that happened was in January 2011 and it did result in an 8% correction a few weeks later."

Bearish investors in the US have also focused on another contra-indicator - an index of three-month volatility called the VXV. The relationship between this index and the more widely followed VIX index (measuring one month volatility) is seen by many investors as a key indicator of looming trouble. The VIX measures expected volatility over the next 30 days, while the VXV measures expected volatility over the next 93 days. A recent note from Bank of America Merrill Lynch technician MacNeil Curry reported that this ratio has now moved above 1.2, which is of " significant concern. Historically, the market has struggled to hold its gains when this ratio closes above 1.2". Curry says that a VXV/VIX ratio below 1 is a buy sign for the S&P 500.

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

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

Back to menu

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.

Back to menu

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

THIS COMMUNICATION IS FOR FINANCIAL ADVISERS IN THE UK ONLY

This email is sent from The UK Structured Products Association (UKSPA) and is intended for UK financial advisers only. UKSPA has taken every step to ensure the accuracy of the information in this email but cannot accept liability for errors. Copyright of the contents of this email belongs to UKSPA. This email and its contents are only intended for the recipient. If you no longer wish to receive emails from UKSPA please click here to unsubscribe