UK Structured ™ Products Association

Monthly Market Report

November 2015

With commentary from David Stevenson

It's been another strange month on the markets. After worrying that a global recession was just over the horizon, markets have bounced back and stopped worrying about the end of the world. One excellent marker for resurgent bullishness centres on the gap in performance between the benchmark UK index, the FTSE 100 and its US counterpart, the S&P 500. US equities have in recent years generally outperformed their British peers but in recent weeks the FTSE 100 has started to close that gap. Over the one month to Monday 12th November, the FTSE 100 index was up over 4% while the S&P 500 was only up 2.75%.

But I reckon it would be wrong to think that the bears have completely exited the frame. Let's take each of the 'challenges' worrying the bears in turn. China obviously tops any list of imminent disasters and although the consensus is that a hard landing has, just, been averted, worries persist. One telling example is that French bank Societe Generale recently put out a paper which suggested that the possibility of a lost decade of subpar economic performance for the 'communist' super power was a real possibility - the bank's analysts suggested a 40% probability. That has helped deepen anxiety about commodities where more and more investors are arguing that we've not actually seen the worst of this multi-year bear market. In this context Glencore's recent travails may just be the beginning of a real rout. My own related concern is that we've not seen the bottom for oil, with no serious sustained breach yet of the $40 barrier. And then there's inflation of course which last month slipped back into negative territory in the UK although yearly rates are still positive. Lower oil prices help explain much of this number but the bears are convinced that these numbers tell us that the global economy is slowing down. That nervousness is reflected in turn in continuing market volatility - the widely watched fear gauge, the VIX index (which tracks the turbulence of the S&P 500), has fallen back markedly in recent weeks but at a headline rate of 17 it's still above near term averages. One last observation on this continued caution - bank CDS prices have continued to rise pretty much across the board.

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Headline Numbers

Measure	Value as of September 18th, 2015	Value as of October 12th, 2015
UK Government 10 year bond rate	1.96%	1.86%
GDP Growth rate YoY	2.60%	2.40%
CPI Core rate	1%	1%
RPI Inflation rate	1.1%	1.1%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.57%	0.57%
Government debt to GDP ratio	89.4%	89.4%
Manufacturing PMI	51.5	51.5

In these reports we tend to focus on the top line macro-economic and market stats but every once in a while it's worth taking a deeper dive into the world of attitudes - specifically those of investors. What happens next in the UK economy - and thus its equity markets to some degree - depends on how consumers react to not only the economic recovery but also longer term structural forces including inter-generational wealth.

Put simply, if consumers fear the worst, especially for their children and grandchildren, they might cut back spending. And at the other end of the generational divide, younger consumers might feel that they are so indebted after university and buying a house that they forgo immediate consumption and save.

Increased saving might be a good behaviour to encourage but at the macroeconomic level, too much saving and caution might be bad news for the economy - and equities. Luckily that generational divide might end up being helpful in that older parents might choose to transfer some of their wealth to their kids, boosting consumption.

Two recent surveys point to some fascinating trends in this inter-generational wealth game. The first is from online investment form Orbis Access which recently talked to a thousand parents and discovered that:

- three quarters of parents of children under 18 recognise this inter-generational issue and although 98% of them expect at least one of their offspring to pursue further education, only two-thirds expect to either pay for tuition fees and/or living expenses.
- Whilst 84% of parents that expect to provide their children with some form of financial support have made financial provisions to support their children, many appear to be overly reliant on cash savings to fund these major outgoings.
- Parents who are saving for their children appear overly reliant on cash savings to fund these major outgoings

Maybe this last group of parents might be the idea target market for next generation ISAs and long-term savings plans? Over at Investec Wealth & Investment the research focuses on what parents and grandparents plan do with their accumulated wealth that is the subject of research that matters. They discover that:

- 32% of parents and grandparents aged over 55 currently or plan to gift money to their children and grandchildren at an average of £5,026 a year.
- Of these, 18% plan to take advantage of the new pension freedoms by gifting money from their newly cashedin pension pots
- 8% think they're giving away too much and 11% admit to having had to cut back on their lifestyle in order to afford their generosity.

Cutbacks made by overgenerous parents and grandparents include travel (50%); meals out (42%); home improvement plans (39%); clothes (24%); hobbies (21%); and food shopping (11%). A worrying 3% of respondents have even had to delay retirement to help finance the younger generation.

These worrying statistics remind us that inter-generational wealth is an important factor now in any top down, macro view of markets and nations. Growing inequality not only between classes but also between generations might have profound long term effects.

Type of "life expense"	Percentage of parents with children under the age of 18 expecting to provide some level of financial support to their child(ren)
University living expenses	55%
Wedding	46%
University tuition fees	45%
House deposit	38%
Living expenses after education (including rent)	31%
Post graduate study costs (tuition fees and/or living expenses)	22%
Travelling e.g. gap year	17%
Won't be able to provide financial support for any of these	*13%*
Don't want to provide financial support for any of these	*2%*

Source: Orbis Access

As China's economic woes start to look slightly less horrible than some had predicted, the commodity bulls have slowly been banging the drum for the emergence of a mythical creature - the market phoenix!

If China has avoided a hard landing - not a certainty by any stretch of the imagination - then surely demand will pick up for a wide swathe of the commodity complex?

The argument goes something like this. Looking at past trends, it's now obvious to all and sundry that strong EM commodity demand bid prices up during the last decade. Ultimately this resulted in capacity buildout and technological innovation. This in turn resulted in today's oversupply, where prices have been searching for a new lower equilibrium.

Now those decade long trends are reversing, wilting under what analysts at Goldman Sach's - a big US investment bank - have called the "3D's of macro", namely deflation in input costs, divergence of US growth and the US$, and deleveraging of EM debt. These 3Ds have kept commodity prices locked in a downward trajectory since mid-2014.

But hard data coming out of China suggests that the rebalancing of its economy is slowly having an impact and other countries in the developing world might now begin to pick up the slack. Unfortunately a recent deep dive into the 'hard data' of emerging markets demand by Goldman Sachs reveals a very different picture, one where some 'hard' commodities might be facing yet more pain.

The banks analysts have dug into "the guts" of the commodity demand data and found rising demand for what the bank calls "opex" commodities (energy and consumption-based metals such as aluminium) and declining demand for "capex" commodities (steel, cement, iron ore).

The key transformation here is a focus on consumption in China - a major economic transformation or pivot with global consequences. According to the US banks analysts that change "now appears to have started. Furthermore, our historical analysis of the typical growth path that economies take tells us that this change is both expected around China's current income level, and is permanent. This means that peak metals demand growth is very likely in the past for China – raising a bearish question for long-term capex metals demand: which country will be the "next China", rapidly scaling up capex to building out productive capacity, and driving future metals demand growth."

If this view is right, maybe we haven't seen the bottom yet for demand for hard commodities such as iron ore and copper? And if that is the case, what's the prognosis for UK listed mining giants such as Glencore, Anglo and Rio?

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Bank CDS options

If investors are looking for signals of impending global trouble in the debt markets, maybe they should start looking at bank CDS option prices?

Over the last month these rates have increased pretty much across the board. The most notable jump has been at Banco Santander which has seen a sudden increase in its five year CDS rates but pretty much all its rival global peers have seen CDS rates tick up between 10 and 30 basis points. At the moment these numbers aren't terribly conclusive but they might be an early stress indicator telling us that investors are starting to worry about bank defaults again after a possible recession in 2016.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	67	159	47	84	A -
Barclays	30	81	10	16	A
Citigroup	33	1010	10	22	A
Commerzbank	54	115	16	27	A+
Credit Suisse	41	92	18	37	A
Deutsche Bank	49	106	13	35	A+
Goldman Sachs	40	103	4	9	A
HSBC	40	96	17	46	AA-
JP Morgan	35	89	9	20	A+
Lloyds Banking Group	27	70	10	4	A
Morgan Stanley	36	100	11	8	A
Nomura	23	68	7	-9	A-
Rabobank	22	74	10	25	AA-
RBS	37	94	14	19	A

Soc Gen	40	98	12	25	A
UBS	27	71	8	23	A

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Government Bonds

Pity the poor fixed income bond investor. After a decade or two of startling outperformance, bond investors now face a very uncertain future - which is itself something of an epic understatement. The possibility of rising interest rates is merely the icing on the cake, whereas the hard truth is that it is almost impossible to see how many bonds can increase by much more in value. Even if we aren't at the very peak of the long term bond cycle - maybe a deep recession is around the corner in 2016 - we can't be that far off!

In these circumstances it's not hard to imagine what might happen next - underperformance against equities or even absolute losses. Readers might remember that we recently looked at long term (10 year) expectations for different asset classes based on valuation metrics used by US firm Research Affiliates. This suggested that real returns might be negative for some bonds and barely above 1% for most mainstream fixed income securities. High yield and loans by contrast looked a much more alluring prospect.

This downbeat message also comes through loud and clear in a recent survey by NN Investment Partners. Using its own panel of institutional investment managers it reports that expectations for returns are fairly low - though cynics might argue that these numbers are actually still far too high. The least surprising statistic from the analysis was that only 4% of respondents believed that the environment was 'easy' for fixed income investors - who are these deranged 4% of investors!

The core assumption of most investors is of an expected 3% yield in "challenging" bond markets with expectations ranged from less than 1% to more than 6%. NN also reported that "42% of respondents believe that it is difficult for fixed income fund managers to generate positive performance throughout the interest rate cycle" while an even bigger 47% described current market conditions for fixed income as "challenging" with one in eight respondents (12%) describing it as 'very challenging'.

One suspects that fixed income bond fund managers will have to work overtime to come up with exciting new narratives and investment ideas in this environment. My bet would be for more and more managers to focus on riskier securities and loans, chasing yields of more than 4% without taking too much risk. Good luck finding them when UK ten year gilt rates are back below 1.90% and even Greek ten-year bonds are back at a yield of just over 7.5%!

UK Government Bonds 10-year Rates 1.86%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	32
Germany	14
Japan	46
United Kingdom	16

Ireland	50
Italy	124
Portugal	178
Spain	112

Eurozone peripheral bond yields

Country	September 18th, 2015	October 12th, 2015	Spread over 10 year
Spain 10 year	2.00%	1.83%	122
Italy 10 year	1.80%	1.69%	108
Greece 10 year	8.57%	7.58%	697

	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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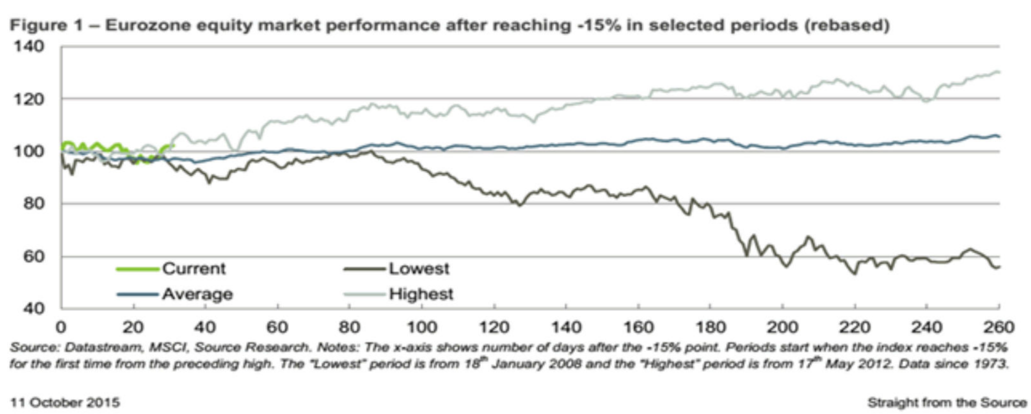
Equity Markets and Dividend Futures

It's relatively easy to get a bit blasé about the recent market volatility, labelling it a 'correction' but in truth the selling was actually very heavy and market sentiment pretty brutal. Declines of between 15 and 20% are noteworthy because there have in fact only been 11 corrections of 15% or more since 1973.

My own personal suspicion is that the selloff was possibly overdone but the $64 billion question is what does stock market history tell us about what usually comes next? Analysts at Source ETFs have attempted to put some hard numbers to this question - and the chart below gives some idea of the range of possibilities. According to Source the "episode with the weakest subsequent returns ("Lowest") was that starting in January 2008, not surprising given that the financial crisis was about to hit. That with the best returns ("Highest") came after May 2012 (just before Draghi made his "anything it takes" speech)."



Source: The Source

In aggregate Source reckons that the market was up in the next 12 months in 7 of the 11 cases with the average 12-month gain across the 11 episodes 5.6% and the median was 15.7%. "Given that we have just passed the 30 trading day point since the market dropped below the -15% mark, it is interesting to note that in the five previous occasions when the market was up after 30 days (as it is now), it was still higher at the full year mark in four of them (with an average 13% 12-month gain across the five episodes). On this basis, we should be encouraged by the rapid rebound in the market."

If this analysis is right, maybe now is the time to start dusting off plans to look again at autocall based products? Even the most hardened optimists within mainstream developed markets don't believe we'll see a massive rally from here – the perfect environment for autocalls especially considering elevated levels for volatility based options.

Index	October	September	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	114.2	114.5	3247	108
FTSE 100 (Dec 14)	248.2	247.9	6371	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	4.14	-4.53	-10.14	0.49	12.53	22.28	6371
S&P 500	2.75	-2.97	-4.15	5.71	72.25	87.22	2013
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-0.3	3.03	-1.99	3.61	13.33	15.12	12.41
Benchmark for volatility							
VIX New Methodology	-26.38	1.49	35.77	-19.59	-9.77	-25.77	17.08

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Volatility

Global stock markets have slowly started to get back on to an even keel, with the widely followed VIX Index pushing back below 20 - although this US focused index is still above recent trend levels. What's potentially much more interesting though is that professional speculators are also betting big that volatility will keep sliding. One way of measuring this is through the large number of Exchange Traded Notes and Products traded on the US exchanges which track the VIX fear gauge index.

Back in August these investors bet big that volatility would continue to climb the wall. Shares outstanding on a major US VIX ETN jumped by 13 million on Aug. 24, the biggest single-day increase since August 2011. That increase mirrored a spike in the VIX, which more than doubled in just two days after a pair of 45 percent single-sessions gains.

But by September sentiment had radically shifted again. Now investors were betting that vol would decline sharply - one major US inverse VIX note (see chart below) saw more than 55 million shares change hands on the day of the September Fed meeting, more than double its average volume over the previous year.

On balance though investor's shouldn't get too carried with this shift. Even at recent sub 20 levels, the VIX is trading above its recent average, probably closer to its historic norm of around 20. Remember that the VIX ran well below 15 for much of this year and at one point even lunged below a reading of 12 before moving back up again in recent months.

Measure	October Level	September Level	August Level	July Level
Vstoxx Volatility	24.1	27.76	18.71	18.8
VFtse Volatility	16.6	21.07	1.26	11.97

FTSE Put Call Ratio	1.01	1.02	1.02

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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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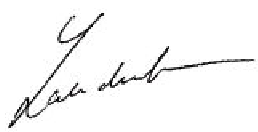
Kind Regards,



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