UK Structured Products Association™

Monthly Market Report

October 2014

With commentary from David Stevenson

As the S&P 500 benchmark index pushes through the psychologically important 2000 barrier, investors have restarted a debate that started earlier in the year - are markets turning into a bubble or is there even better news to come?

If the bears are wrong - and the bulls make a persuasive case - we could see sentiment improve to the one asset class that has had a very tough few years indeed, namely emerging markets. Although we've had a small rally in the last few months, most equities from places like India and China are still way off their peaks. In China for instance although the Shanghai A share market is up 12.5% year to date, it is still down 60% from its 2007 high. It is also the cheapest market in Asia, at an average price/earnings ratio of 9.6 (half of its 10-year average).

Are investors about to take advantage of this 'value' opportunity?

One interesting way of potentially addressing this question is to accept that emerging markets equities are different - rather than exclusively focus on questions of value, we should maybe accept that sentiment is important as is the flow of liquid funds between different nations.

This line of analysis is taken by an excellent research firm called Cross Border Capital. Their analysis of global liquidity trends is hugely compelling as a possible indicator for future asset class returns - much of their most recent work has been focused on emerging markets. This firm argues that emerging market equities appear to have been stuck in a downward turbulent phase for much of the last few years - private sector liquidity "is stuck near rock-bottom levels, both in absolute terms and relative to the US. This weak liquidity data also implies that EM profits may still suffer a significant near-term recession". Lurking behind this difficult macro environment is China - "Chinese Liquidity is noticeably sub-par with no indication yet that the PBoC (Central Bank) is altering its moderately tight stance (48.9). The Chinese Liquidity level is consistent with sub-5% real GDP growth. This could be a ‘hard economic landing’".

Yet Cross Border Capital has recently observed that emerging markets may be near a key turning point - with some of their key indicators implying a bottoming out of key liquidity measures.

So, given these positive numbers, what's Cross Border Capital's current prognosis? "We still have some issues with EM. Foremost is the quality of liquidity inflows. Behind the rise in our EM sub-index is expanding Central Bank liquidity. Private sector liquidity remains weak and there are no signs of any pick-up in cross-border inflows. Moreover, forex reserve growth (ex-China) is modest and, in our view, EM currencies still look vulnerable, notably when the US Fed begins to tighten more aggressively...Overall, we feel it is still too early for aggressive EM investment.

Liquidity remains tight, the Chinese economy is uncertain and EM currencies look vulnerable to further weakness on a 6-12 month view".

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Headline numbers

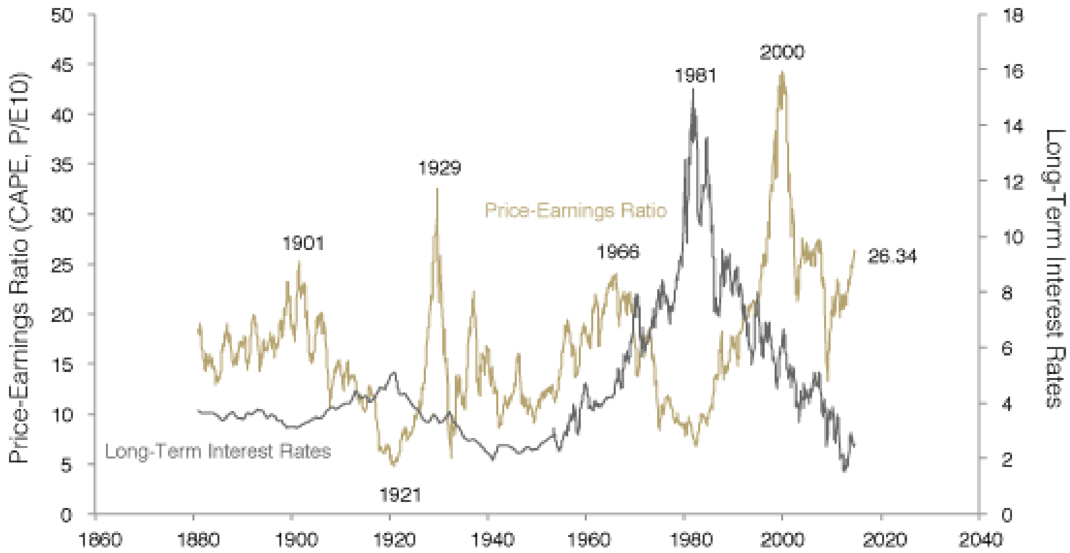
Measure	Value as of August 12th 2014	Value as of September 11th 2014
UK Government 10 year bond rate	2.60%	2.60%
GDP Growth rate YoY	3.10%	3.20%
CPI Core rate	1.80%	1.90%
RPI Inflation rate	2.50%	2.40%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.55%	0.54%
Government debt to GDP ratio	90.60%	90.60%
Manufacturing PMI	55.40	52.50
Sovereign Western Europe CDS	52.06	60.1
Euro Bank CDS	92.32	96.0
FTSE CDS	84.86	88.2

The UK economy continues to push ahead, powered in a large part by resurgent consumer demand. The manufacturing sector looks to be the weakest link in recent months, largely because of subdued demand in emerging markets and the Eurozone. But there is a possibility that the Eurozone will now pick up speed - Russia permitting - and there's even a possibility that key emerging markets might surprise to the upside. One can also take a cynical attitude towards the electoral cycle which is that with an election just a year away, the government will be keen to lubricate any pump that helps prime the UK economy ahead of the election. The only potential fly in the ointment? Constitutional matters, notably the Scotland question and the inevitable federal/separation issues that will be raised regardless of the direction of the vote. And of course there's another great unknown that will erode confidence - the UK's relationship with Europe. Whichever way that debate goes, uncertainty will be on the rise again.

Headline Thought:

As equities continue to move ahead, the bears are circling. These cynics are increasingly worried about high prices for large cap equities, rising house prices and loose monetary policy - they argue that financial markets are tipping over into yet another bubble.

The main parts of the bears case are well rehearsed, with valuation a key linking theme i.e. shares are expensive. Respected economist Robert Shiller has plunged into this debate by re-examining one of his most important contributions to modern investing, the CAPE measure - this acronym stands for the cyclically adjusted price to earnings ratio and its evolution over time is detailed in the chart below. It’s a crucial measure as it looks at how expensive shares using the Price to earnings ratio, adjusted over a ten year frame to ride out recessions and booms.



According to Shiller CAPE is now at "above 25, a level that has been surpassed since 1881 in only three previous periods: the years clustered around 1929, 1999 and 2007. Major market drops followed those peaks."

Yet even Shiller accepts that the CAPE measure is a very imperfect forecasting tool for future stock market behaviour - US markets have been expensive for many years according to the CAPE indicator and yet have continued to move higher and higher. Why aren't US equities mean reverting? Shiller reckons psychology provides some insight into investing behaviour.

"Perhaps today’s prices have something to do with anxiety about the future" says Shiller. "I suspect that after the financial crisis, working people are much more worried about their future pay. Many are concerned that they might lose their jobs to cost-cutting, or that they might eventually be replaced by a computer or robot or website. Such anxiety might push them to try to make up for these potential shortfalls by investing in stocks and bonds — even if they worry that these assets are overvalued."

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CDS Rates

The move by the European Central Bank to help improve liquidity across the continent has already had an impressive impact - the rates for Eurozone bank CDS options (a form of insurance against a bank defaulting on its bonds) have continued to fall, although the bank traditionally regarded as the 'safest' by this very specialist market - Rabobank - has paradoxically seen its CDS rate marginally increase over the last few weeks. US banks have also been left behind in this rally, with few seeing any major change in their CDS rates. The bigger picture? European Banks are viewed as even safer than they already were by investors who are being re-assured by the proactive intervention of the European Central Bank.

Bank	One Year	Five Year	Monthly Change %	Annual Change %	Credit Rating
Banco Santander	18	63	-25	-174	A-
Barclays	17	57	-12	-65	A
Citigroup	21	69	-3	-28	A
Commerzbank	25	75	-14	-81	A+
Credit Suisse	15.77	51	-12	-46	A
Deutsche Bank	20	62	-13	-24	A+
Goldman Sachs	29	80	-6	-44	A
HSBC	14	45	-9	-49	AA-
JP Morgan	20	56	-4	-29	A+
Lloyds TSB	20	62	-3	-64	A
Morgan Stanley	27	78	-3	-57	A
Nomura	21	70	-7	-64	A-
Rabobank	14	43	-8	-46	AA-
RBS	30	86	3	-70	A
Soc Gen	19	64	-21	-82	A
UBS	16.67	42	-10	-45	A

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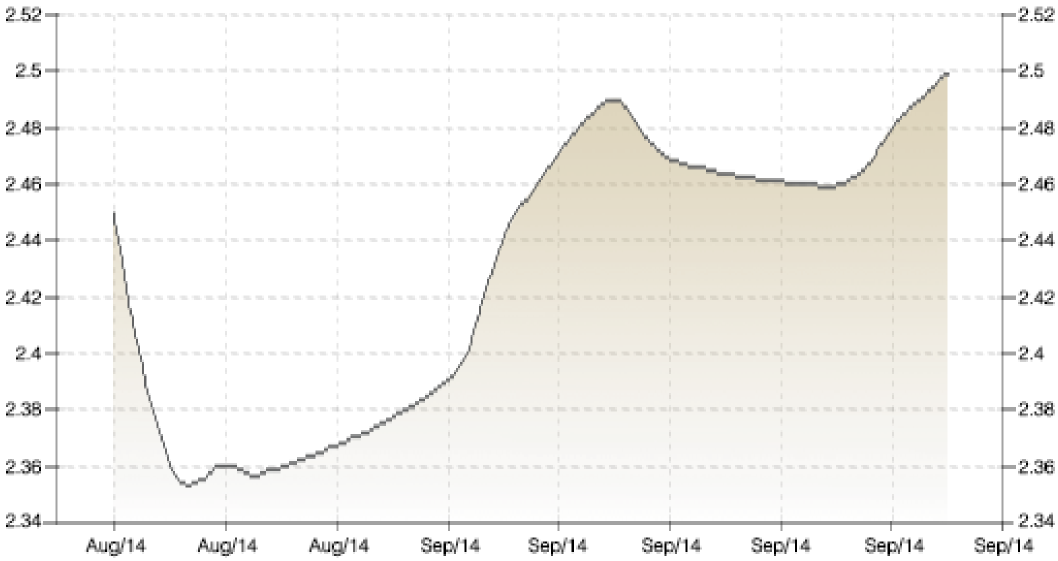
Government Bonds

European government bonds continue to increase in price, and yields on longer duration issues continue to fall to rock bottom lows. German Bund yields have held near their record lows in recent weeks as investors increasingly bet that the ECB will ease monetary policy further to lift a stagnating economy. This market reaction is in part powered by fears of deflation in Europe, which are in turn exacerbated by nervousness over Russia and the Ukraine. Most investors seem to think that by the time the ECB is finished German 10 year Bund (bonds) will be consistently yielding less than 1%. Even Spanish and Portuguese bonds have increased in price - and yields have fallen - and the spread between riskier, Southern European debt and German bunds has continued to narrow.

Some of this bullishness directed to bonds has even crept over the English Channel, with investors buying up our own 10 year gilts, pushing the yield down to 2.60%.

UK Government Bonds 10-year Rates



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

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CDS Rates for Sovereign Debt

Country	Five Year	Annual Change %
France	39	-19
Germany	18	-3
Japan	34	-19
United Kingdom	22	-15
Ireland	50	-81
Italy	87	16
Portugal	145	-228
Spain	61	-149

Eurozone peripheral bond yields

Country	% in September 11th	% in August 12th	Spread over 10 year German bonds
Spain 10 year	2.33%	2.67%	227
Italy 10 year	2.46%	2.80%	226

Greece 10 year	5.62%	6.34%	693

Country	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

Equity Markets and Dividend Futures

August is usually a fairly disappointing month for equity investors but the last few weeks have in reality been fairly kind to equity investors - US shares advanced 3% in August while the FTSE 100 continued to lag behind with a 2.5% uptick.

Crucially measures that look at profits growth in the core US market are looking fairly bullish for the next few months. A recent note by analysts at S&P looked at the crucial S&P 500 Index and results from companies within the index for the second quarter of 2014 - according to S&P with "487 companies now reporting for the second quarter, year-over-year profit growth for the S&P 500 is 10.3%, the index's highest growth rate since third-quarter 2011 (17.7% growth). Although our expectations for the second quarter were always more bullish than consensus estimates, this 10.3% rate is even higher than the 9.0%-10.0% we predicted at the beginning of the season. Analysts expect earnings per share (EPS) to come in at $29.69, which is a record for the index."

Results have been especially strong for retailers in the US - both online and on Main Street - and analysts now expect the overall consumer discretionary sector to continue to do well for the balance of the year.

According to S&P these 2Q numbers point towards a "corporate environment that is steadily improving. This puts to rest the worry that companies weren't actually growing."

My guess is that it would be a brave investor who bet against US equities continuing to outperform in the next three to six months, which would in turn imply that the UK market will continue to lag behind, although British stocks might well carry on increasing in value. Yet sooner or later this confidence in growth should start to feed back into cyclical sectors such as mining or even banks, which will in turn be positive for UK equities.

Index	September level	August level	Reference Index Value	Level six months ago
Euro Stoxx 50	113.1	112.6	3237.76	111.5
FTSE 100 (Dec 14)	232.0	232.3	6799	N/A

	Price change %						
Name	1 mth	3 mth	6 mth	1 yr	5 yr	6 yr	Close

FTSE 100	2.51	-0.57	1.71	3.21	35.68	27.85	6799.62
S&P 500	3.03	2.66	6.89	18.15	91.39	59.78	1995.69
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	0.58	3.13	3.01	4.58	10.14	16.5	11.7025
Benchmark for volatility							
VIX New Methodology	-9.49	11.03	-12.97	-6.8	-46.67	-47.19	12.88

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Volatility

Indices that measure volatility within the global equity markets - and especially the US via the VIX index - have been stuck in the doldrums since at least the beginning of this year. The chart below shows the trajectory of this VIX Index since January, with a fairly narrow trading range of between 11 and 15, numbers which are very low by any measure for what is traditionally regarded as the Fear gauge index.

But in recent weeks this VIX Index has started to creep up again, driven largely by worries about Russia and the Ukraine. What will happen next? A recent Barron's report reminded its US readers that "September and October are traditionally the stock market's most volatile months. The market's major corrections have tended to occur in October, which means September is usually a month of psychological dread. Options volatility tends to increase in those months, if for no other reason than dealers pay close attention to seasonal factors that tend to influence trading patterns.....One day the relative calm [surrounding volatility] will more likely fade, and volatility will assert itself."

Measure	Sep' level	Aug'ust' level	Jul' level	Acc/Dec	Direction Upwards
Vstoxx Volatility	16.6	21.23	17.6	ACC	Yes
VFtse Volatility	15.45	15.5	13.68	ACC	Yes
FTSE Put Call Ratio	0.82	0.956	1.28	ACC	No

VIX New Methodology

Source: www.sharescope.co.uk

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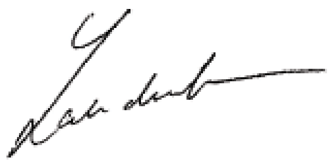
To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,



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