



With commentary from David Stevenson

The last few weeks has brought a slew of good news. Equity markets have romped ever higher. Oil prices have stabilised (good news, really?). UK dividends have bounced back up after Brexit and interest rate rises have been delayed yet again (and are in fact declining in the UK). What could possibly go wrong? Any number of things of course but perhaps most importantly we should begin to fear the possibility that Donald Trump might just possibly win in early November. The polls were wrong during the Brexit debate and they might be wrong again this time.

Perhaps the most puzzling financial narrative though centres on volatility levels, as measured by indices such as the VIX. These are at near all-time lows even though there are some fairly obvious headwinds lurking. This calm is also reflected in the bond markets as well as for CDS options against bank bonds. Vol levels are usually this low when the raging bulls are charging ahead and profits are growing. We're now at the end of the second quarter earnings reporting season and overall big story is that in terms of upgrade/downgrade ratios we are seeing significant improvement, with the UK in particular benefitting from the collapse in sterling. UK stocks have also benefitted from higher commodity prices - earnings momentum is now almost positive and 2017 could be the year where EPS starts to grow again for the FTSE 100. The bad news is that in aggregate terms we are seeing weakening net income growth and in China, Japan and Germany forward EPS growth, based on this measure is now negative. According to Andy Laphorne at SG, in the US it is as weak as it has been at any time over the last five years. Overall the consensus expects no growth in aggregate. So, why the almost eerie stock market calm?

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Headline Numbers

We've traditionally looked on emerging market assets, especially equities, as a very risky asset class, liable to shoot up and down along with the economic cycle. The simple mental equation is that the developed world represents safety, with an emphasis on secular growth stories such as tech stocks, while EM equities tend to be very influenced by commodity prices and the fortunes of the US economy.

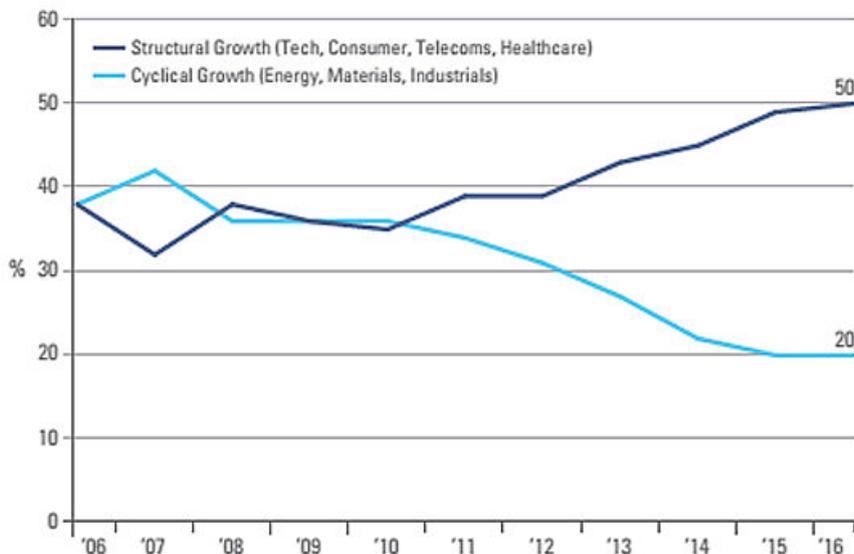
But analysts at Ashmore - specialists in emerging markets - reckon this view of EM equities is, in their own words, out-dated and wrong. Their analysis suggests that growth drivers now constitutes more than 50% of the MSCI EM equity index, while the cyclical share is down to 20%. The commodity component has fallen to just 14%, which is less than half of its share a decade ago according to Ashmore. Moreover, the tech share of the MSCI EM now constitutes 23%, which is greater than the tech share of the S&P 500. Seven of the largest ten companies in the MSCI EM Equity Index are tech companies, including Samsung, TSMC, Tencent, Alibaba, Naspers, Baidu and Hon Hai. According to Ashmore, the ability to skip entire stages of development by adopting the most up-to-date technology allows EM countries to accelerate their convergence with wealthier countries.

The investment implications of this shift are potentially huge. On one level, it's a simple reflection that key economies such as South Korea, Taiwan and even China are maturing fast and that means there's more room for growth orientated businesses.

But if this really is the case, then why not give a much higher rating to EM assets? Ashmore maintains that as "a structural growth story EM equities ought to trade at a premium to their historical (cyclical) valuations, while the gap in valuations versus developed market equities ought to narrow or even invert. A higher valuation due to the greater share of structural growth drivers is justified because price to earnings (P/E) ought to be a function of long-term growth. Structural growth companies have superior

earnings visibility for multiple years compared to cyclical ones, so investors should be willing to pay a higher multiple. Yet the MSCI EM P/E is still trading in-line with its historical average and far below the P/E of developed markets (MSCI World). This suggests that there is considerable value in EM equities going forward."

MSCI EM Index Composition (%): Now mainly a structural growth story - source Ashmore

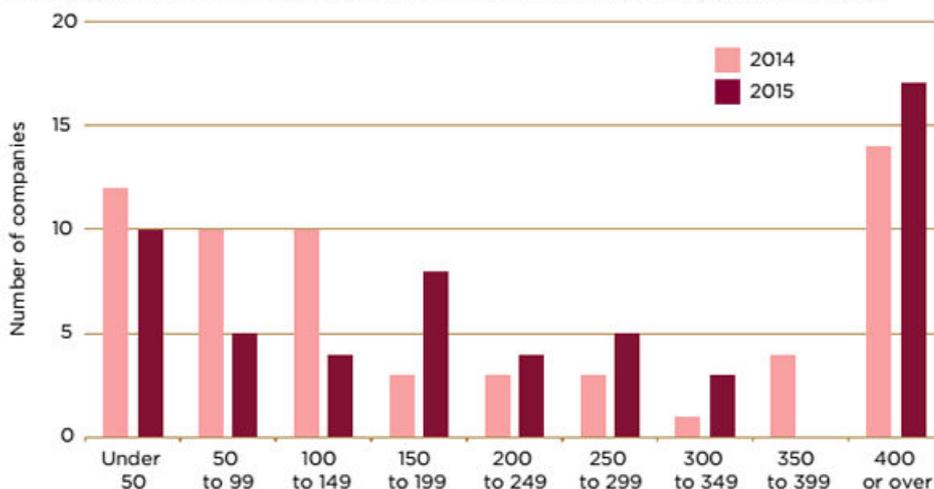


Source: Source: MSCI, Bloomberg, Ashmore as at July 2016.

Equity market investors are getting increasingly skittish about ever burgeoning pension fund deficits. Every month there seems to be yet another story about the huge sums of money owed by leading FTSE 100 businesses. For those businesses that actually declare their pensions numbers there's currently a 34% accumulated liability as a percentage of total market cap. But for some businesses such as BAe that number is closer to 180%. And the recent move by plastics firm Carlco to cut its dividend to help make up a short fall from its pension fund is a stark reminder about what could happen next. "Dividends cut back to pay for increased pensions contributions".

The chart below is from consultants at LCP and shows how pension deficits compare to dividends paid. According to LCP, "Of the 56 FTSE 100 companies that disclosed a pension deficit in 2015, 15 disclosed a deficit that was greater than or equal to the dividends paid to their shareholders in 2015. However, in 29 cases, the 2015 dividend was more than double the deficit at the 2015 financial year-end, suggesting that these companies could pay off their pension scheme deficit relatively easily if they wanted to. The total deficit for these 56 companies was £42.3bn, around 20% lower than the total dividends paid of £53.0 billion".

Percentage of IAS19 deficit that could be paid off with one year's declared dividends (%)



Source LCP Accounting for Pensions survey 2016

Measure	Value as of August 10th, 2016	Value as of Sept 9th, 2016
UK Government 10 year bond rate	0.54%	0.86%
GDP Growth rate YoY	2.20%	2.20%

CPI Core rate	1.40%	1.30%
RPI Inflation rate	1.60%	1.90%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.40%	0.38%
Government debt to GDP ratio	89.20%	89.20%
Manufacturing PMI	48.2	53.3

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Bank CDS options

CDS rates fell pretty much across the board last month although Deutsche Bank was the exception yet again, with the German bank registering a very small increase in swap rates of just under 3% over the last four weeks. The biggest falls were for British banks including HSBC, Lloyds, Barclays and RBS - all of which saw their 5-year CDS rates fall by more than 10% over the month. It's worth noting that HSBC rates in particular have fallen very sharply in recent months, indicating perhaps that investors now regard it as a safe proposition again. Rabobank's rates are now only marginally below those of HSBC, below 20 basis points for 1 year CDS swaps at 19.45. The Dutch bank joins an elite group of global banks whose swap rates are below 20 basis points including Danske Bank, MacQuarie Bank and Natixis.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	42.77	86.8	-2	28.7	A -
Barclays	32.95	83	-15	13	A
Citigroup	28.73	74.5	-8	-16	A
Commerzbank	48	113	-6.5	8.44	A+
Credit Suisse	63	119	9	49.72	A
Deutsche Bank	146	210	-3	3	A+
Goldman Sachs	31	93	-7	-5	A
HSBC	20	63	-16	-24.71	AA-
JP Morgan	23	58.89	-5.55	-26	A+
Lloyds Banking Group	33.75	72.72	-10	15.42	A
Morgan Stanley	33	89.5	-7	0	A
Nomura	20.68	81.24	-5.8	31	A-
Rabobank	19.45	5	-5.79	-17.7	AA-
RBS	51.91	98	-13	17	A
Soc Gen	22.72	67	-7.85	-25	A
UBS	25.58	59.6	-6	-7	A

Source: Meteoram.com, 9th September 2016

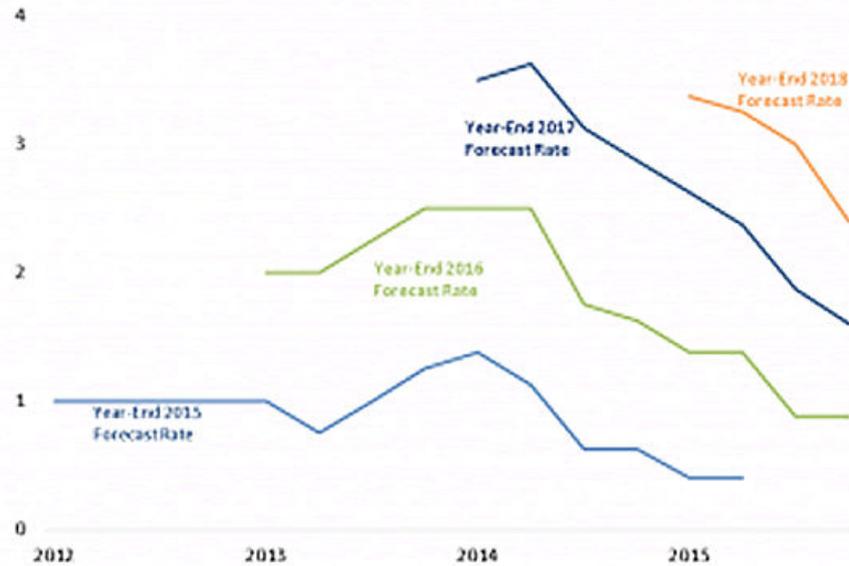
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Government Bonds

A couple of weeks back many of the world's central bankers gathered for their regular Jackson Hole symposium organised by the US Federal Reserve policy makers. Top of their agenda in the beautiful Rocky Mountains of Wyoming? The likely trajectory of interest rates in the US in the next 12 months. Most investors seem reconciled to an increase of at least 25 basis points in the next few months, whilst some believing that an increase of 50 basis points is possible by the end of the year. But many critics reckon they've heard this hawkish talk before - and the Fed has serially failed to deliver.

A recent blog post by influential US economist Larry Summers put's this cynicism into graphical perspective. Figure 1 shows the Fed's forecasts of its future monetary policies since they began releasing them. According to Summers "the Fed has always believed that rate increases and normalization were around the corner but never been able to deliver.

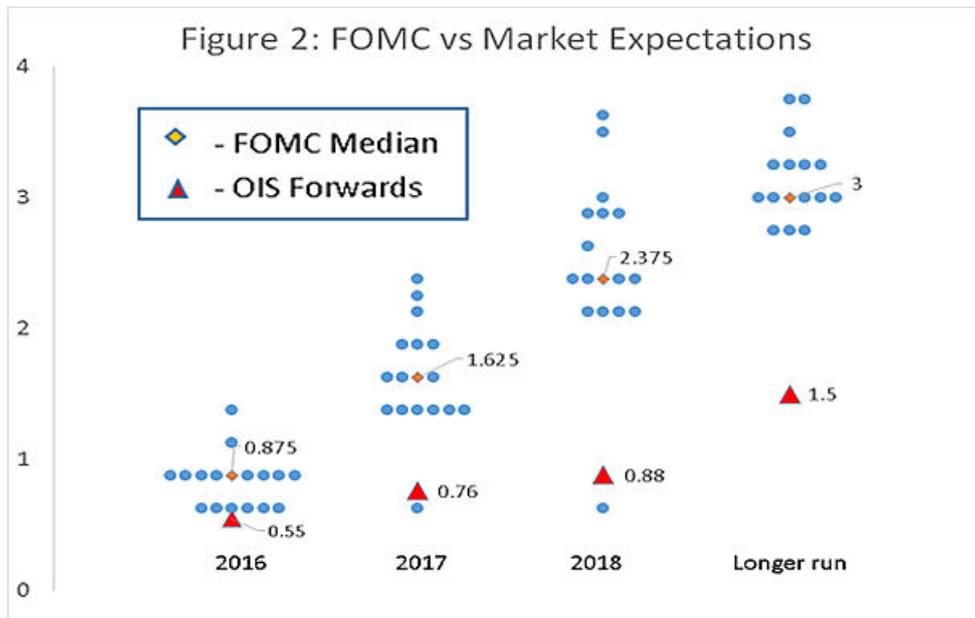
Figure 1: Fed Interest Rate Projections



Source: <http://larrysummers.com/category/blog/>

Figure 2 looks at the current situation showing the "dots" reflecting Fed forecasts and the market's prediction of future interest rates. The divergence between the market and even the dovish end of Fed forecasts is clear." Should we believe the US Fed's more hawkish tone this time? Will rates really rise by very much? Many bond investors think that we'll see at most a further 75 basis points before we reach the top of the current cycle within the next 18 months.

Figure 2: FOMC vs Market Expectations



Source: <http://larrysummers.com/category/blog/>

UK Government Bonds 10-year Rates 0.86%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	28.5
Germany	15.5
Japan	31.5
United Kingdom	32
Ireland	57.5
Italy	134
Portugal	287
Spain	75

Eurozone peripheral bond yields

Country	August 11th, 2016	Sept 11th, 2016	Spread over 10 year
Spain 10 year	0.95%	1.08%	107
Italy 10 year	1.09%	1.25%	124
Greece 10 year	8.22%	8.27%	826

	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

Who's been buying what equities?

Global equities have had a strong summer, defying the predictions that investors should sell in May and come back again in November. US markets have hit near term highs even though there's been \$128bn of outflows from equity funds since mid-March. It seems that Futures buying and short-covering have more than offset the outflows.

A recent report by analysts at Barclays investment bank digs deeper into the market mechanics to identify the main market flows.

According to Barclay's the rebalance into equities at the end of June helped drive stocks higher, fuelled by the \$2.5tr jump in the market value of bonds globally YTD (\$1tr since May). The bond-equity correlation has risen over the last month, which is a risk to equity returns according to Barclays.

Crucially foreigners have been buying US bonds (\$28bn per month) but selling US equities. Weekly data show that Japanese net buying picked up after May and spiked in mid-July, suggesting a return of the foreign buyer. Importantly, while net purchases of equities have fluctuated, gross purchases by Europe

and Japan have surged, suggesting that QE may indeed be having a sizeable impact.

Foreigners aren't the only buyers driving the market higher. According to Barclay's "with \$1tr of annual dividends paid out globally and S&P 500 firms buying back over \$500bn of stock on net, corporates remain the primary driver of equities. Strong Q1 buybacks likely primed the pump for the rally, but S&P 500 gross buybacks declined by \$22bn in Q2 and 12m announcements are down \$115bn YTD". Across other regions, Europe equity outflows YTD (-\$85bn) reversed two-thirds of the post QE inflows. Across sectors, short-covering has been the primary driver of performance, but recent fund flows have gone to cyclical sector funds as defensives have had outflows.

On a stock specific level, the table below is hugely revealing. It's from research firm eVestment and examines institutional buying in the core US market. The table below looks at the US Large Cap Growth Equity Universe and tracks a collection of US equity funds that invest primarily in large capitalization stocks. One side note - Peer weight is the weight of an individual stock in its universe. The sum of all peer weights total to 100%.

Rank	Stocks	Peer Weight - 2Q 2016	Change in Peer Weight - 2Q 2016	Institutional Fund Ownership
1	Alphabet	4.16%	-0.55%	90.00%
2	Amazon.com	2.94%	0.49%	71.43%
3	Facebook	2.92%	-0.19%	78.21%
4	Apple	2.82%	-0.82%	77.50%
5	Visa	2.13%	-0.14%	68.93%
6	Microsoft	1.83%	-0.13%	62.14%
7	Home Depot	1.43%	-0.03%	55.00%
8	Starbucks	1.22%	-0.18%	59.64%
9	MasterCard	1.15%	-0.13%	47.14%
10	Celgene	1.13%	-0.04%	54.29%
11	Bristol-Myers Squibb	1.02%	0.23%	45.71%
12	Priceline Group	1.01%	-0.03%	43.57%
13	Salesforce.com	0.99%	0.06%	44.29%
14	Gilead Sciences	0.93%	-0.27%	49.29%
15	UnitedHealth Group	0.93%	0.14%	41.07%
16	CVS Health	0.86%	-0.17%	41.07%
17	PepsiCo	0.85%	0.09%	37.86%
18	Allergan	0.84%	-0.05%	38.57%
19	Adobe Systems	0.84%	0.05%	40.36%
20	Nike	0.81%	-0.21%	44.29%

Source: Institutional Quarterly Ownership Report, eVestment - Q2 2016

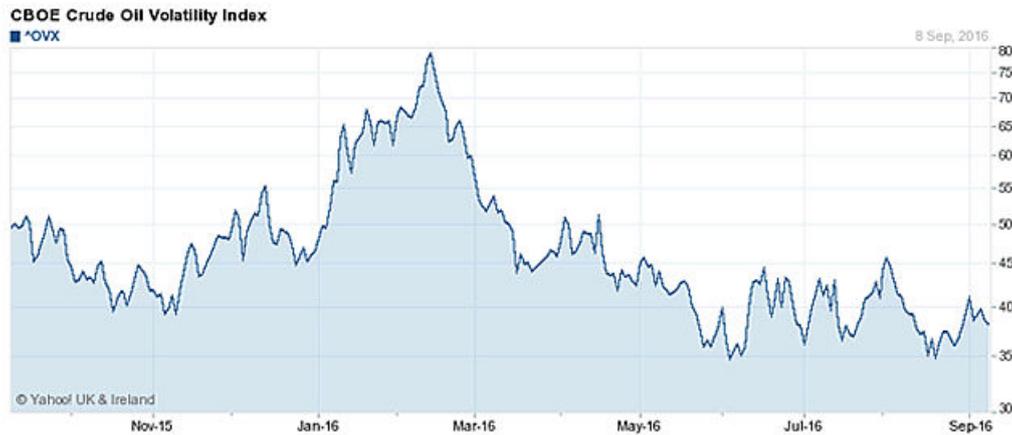
Index	September	August	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	118.7	118.3	3051	114.8
FTSE 100 (Dec 14)	252	249.7	6768	N/a

Name	Price % change						Close
	1 month	3 months	6 months	1 year	5 year	6 year	
FTSE 100	-1.09	8.75	10.26	8.8	29.96	23.35	6776.95
S&P 500	-2.47	0.58	6.96	9.57	8435	92.7	2127.81
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-1.8	5.82	7.66	10.55	20.4	26.92	13.7138
Benchmark for volatility							
VIX New Methodology	2.4	-18.44	-34.9	-54.48	-69	-47.65	11.94

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Volatility

After dominating most financial news front pages for the last year, oil markets have turned a tiny bit more boring in recent months. The chart below is from Yahoo and shows an index from the CBOE options exchange which tracks oil price volatility over the last year. Note how current levels are near 1-year lows. Oil price volatility has collapsed because oil prices have firmed up in recent weeks, pushing past the all-important \$50 a barrel level at one stage.

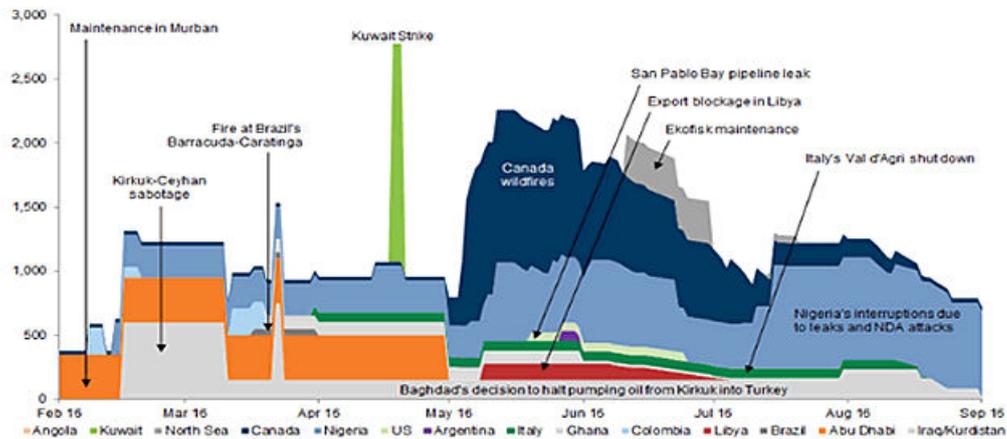


Source: Yahoo.com

One key factor has been recent supply disruptions, which have helped push Brent prices sharply higher. According to energy analysts at Goldman Sachs the three remaining large sources of oil supply disruptions - Nigeria, Iraq and Libya - "have all shown signs of increasing output in the last couple of weeks...In Iraq, flows from the Baghdad controlled northern fields resumed on Kurdistan's pipeline to Ceyhan. In Libya, a vessel started to load crude from the Zueitina port, one of the three ports slated to reopen following an agreement between the UN-backed Government of National Accord in Tripoli and the Petroleum Facilities Guard, one of Libya's armed brigades. Finally, the Niger Delta Avengers announced that they had agreed to a ceasefire".

If oil does start to flow more freely in these geopolitical hotspots, prices might start to drift lower before the OPEC meeting at the end of September, where talk of a production freeze is likely to be top of the agenda. But will Russia and the Saudi's play ball and voluntarily cut back their output? If they don't - and the betting must be against an agreement - we could see oil prices drift sharply lower, which might increase oil market volatility. That turbulence could leak into global equity markets just as the US presidential campaign heats up. The possibility of a Trump presidency, more muscle flexing in the South China sea, and lower oil prices over the next few months could be a deadly cocktail for equity markets.

Potential for another large decline in production disruptions from Nigeria, Iraq and Libya - Short term oil production disruptions (thousand barrels per day / Source: Company data, Reuters, Goldman Sachs Global Investment Research



Source: Goldman Sachs

Measure	September Level	August Level	July Level	June Level
Vstox Volatility	19.15	18.43	21.69	25.57
VFTSE Volatility	12.91	12.92	14.66	21.83

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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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