UK | STRUCTURED ™ PRODUCTS ASSOCIATION

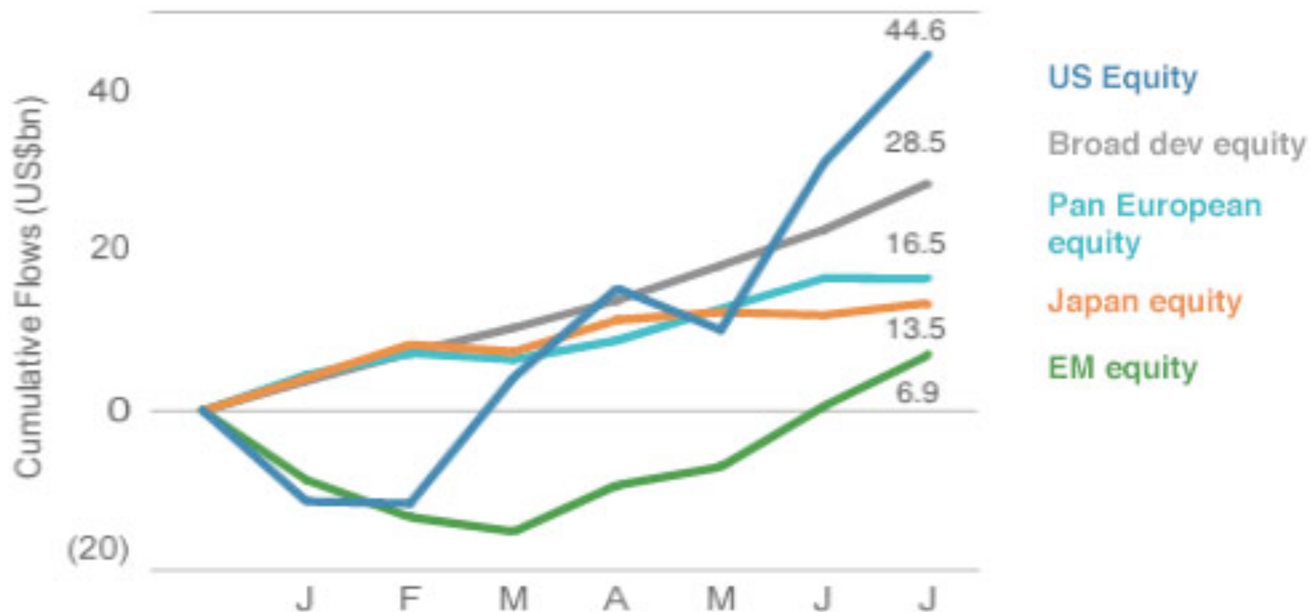
Monthly Market Report

September 2014

With commentary from David Stevenson

August has been an exceptionally quiet month - thus the brevity of this update. Overall, I think it's fair to say that investors remain cautious in attitude, yet on closer inspection most investors are actually behaving in a rather bullish manner. One indicator of this willingness to put money to work comes from tracking fund flows, especially for exchange traded funds - these numbers tell us how investors are actually allocating within their portfolios.

Last week, for instance, BlackRock put out one of their definitive reports on ETP fund flows and concluded both Emerging Market equities and Japanese stocks were trending higher while funds continued to also flow into developed world equities generally and Europe in particular. The chart below from BlackRock very succinctly demonstrates that mainstream equities continue to attract substantial inflows.



According to BlackRock "Inflows were $3.9bn and year-to-date trail only US equity among developed markets exposures. ETPs with US large cap equity exposure led all categories globally with $13.9bn even though valuations in the US are less favourable than elsewhere in the developed world". So, no bear market in sight if we are to believe

these numbers!

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Headline numbers

Measure	Value as of July 12th 2014	Value as of August 12th 2014
UK Government 10 year bond rate	2.78%	2.60%
GDP Growth rate YoY	3.00%	3.10%
CPI Core rate	2.0%	1.80%
RPI Inflation rate	2.60%	2.50%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.55%	0.55%
Government debt to GDP ratio	90.00%	90.60%
Manufacturing PMI	57.50	55.40
Sovereign Western Europe CDS	46.78	52.06
Euro Bank CDS	119.42	92.32
FTSE CDS	85.20	84.86

In terms of the UK economy, we seem to be pleasantly becalmed, with plenty of evidence of sustained growth and relatively subdued inflationary pressure. On the broad macroeconomic level, there's no fundamental change to the numbers that suggest a sustained pickup, although sooner or later the continuing deflationary concerns within the Eurozone (with German growth falling sharply in recent weeks) must have an impact on the UK and its business sector.

The only other major concern centres on the growth in real wages, which is anaemic at best. In simple terms, outside of key sought after occupations, there's no compelling evidence that wages are adjusting upwards to keep up with the pace of GDP growth. This could very quickly change of course especially if house prices were to start increasing

sharply again but for now we seem to be in a benign environment for business - increasing sales growth, low inflation for materials and services and subdued wage pressure.

Headline Thought:

Reading my initial observations on fund flows, one could very easily construct a strong bullish argument for equities - simply follow the money and invest in risky equities! But, investing is more than just a liquidity-fuelled chase for the most popular assets. Eventually old fashioned concepts like fundamental value must have an impact and on that score there's plenty of evidence to suggest that equities are beginning to look a tad 'stretched', at least in terms of key fundamental measures such as yields and price to earnings ratio. And let's be honest - most professional investors know full well that equities are beginning to look expensive!

One of the most interesting revelations of recent weeks is a report by the pointy heads at the CFA Society of the UK (CFA UK). This august body - representing all UK-based chartered financial analysts - regularly polls its professional members about valuations and their latest survey indicates that "over half of investment professionals (55%) currently view developed market equities as overvalued, up from 49% in the last quarter, and 39% at the start of the year. Meanwhile, the lowest proportion of investment professionals on record - 12% - sees value in the asset class." According to the CFA UK, "Emerging market equities remain the only asset class to be viewed as undervalued by a majority of investment professionals, but this proportion is falling: half of those investors surveyed now hold this view, compared to 57% in the previous quarter, while 22% now view them as overvalued compared to 20% previously."

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CDS Rates

There's not much to report this month on the CDS front except that prices for these insurance like options (which hedge against a bank bond default) are slowly creeping up again... but not by very much! For the last few months we've seen a steady increase in prices but from very, very low levels.

Interestingly, the dispersion between those banks viewed as (a bit) riskier and those seen as rock solid has narrowed, noticeably. Whether this indicates a growing sense of unease (unlikely given low prices) or a general feeling that nearly all big banks are fairly 'safe' (more likely) is anyone's guess!

Bank	One Year	Five Year	Monthly Change %	Annual Change %	Credit Rating
Banco Santander	38	88	0	-144	A-
Barclays	27	68	-2	-58	A
Citigroup	24	75	3	-27	A
Commerzbank	38	91	0	-58	A+
Credit Suisse	19	63	5	-31	A

Deutsche Bank	30	77	-4	-24	A+
Goldman Sachs	30	86	7	-44	A
HSBC	19	53	2	-38	AA-
JP Morgan	24	62	4	-19	A+
Lloyds TSB	15	65	5	-60	A
Morgan Stanley	28	82	7	-56	A
Nomura	22	79	-3	-59	A-
Rabobank	9	50	-1	-34	AA-
RBS	30	83	-4	-80	A
Soc Gen	27	88	2	-62	A
UBS	19	51	4	-32	A

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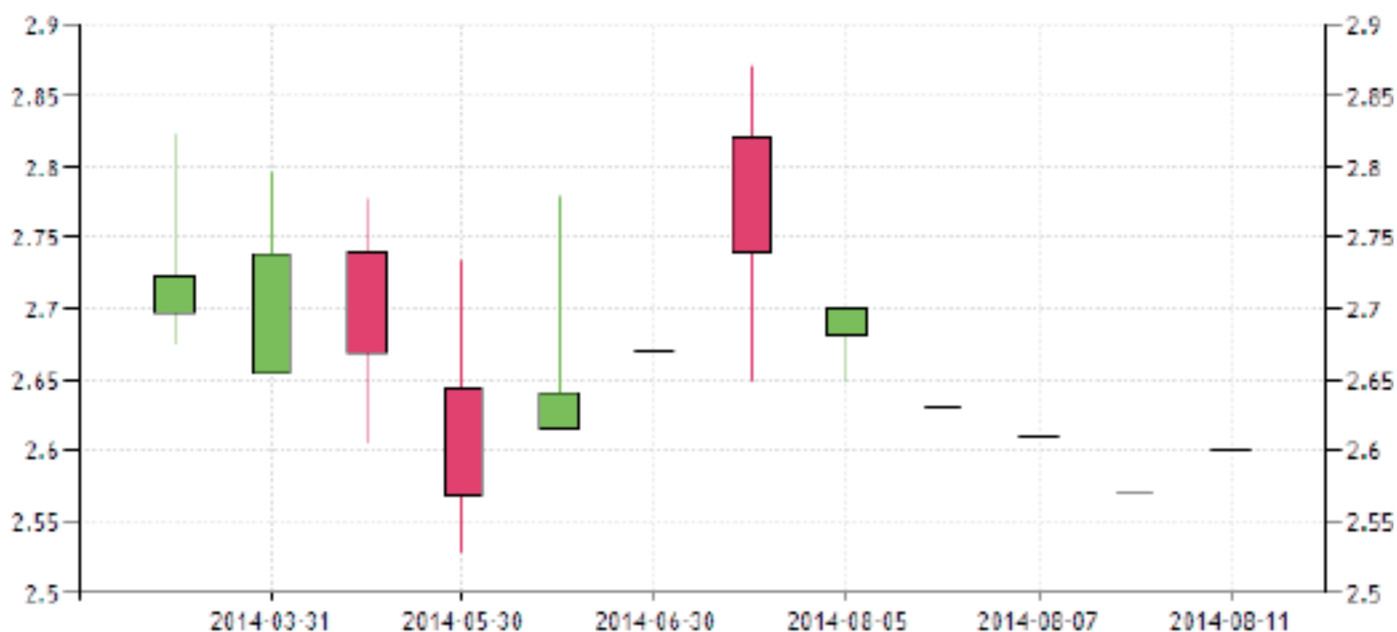
Government Bonds

Although Government Bond markets remain fairly subdued, there are some extraordinary numbers beginning to emerge from Europe, in particular, German bond yields have crashed to new lows. According to analysts at Check-Risk.com, German Bund yields have hit nearly 1% partly as a result of the ECB warning that "the Ukrainian conflict represents a serious risk to the EU economy. German 10-year yields fell 2.4 basis points to close at a yield of 1.048 having a hit a low of 1.024. Spreads between Bunds and the rest of Europe have widened as a result. The spread between Italian equivalent bonds and Germany rose to 190bps, the widest in five months. Spanish bonds rose to a three month high of 165bps".

These remarkable numbers indicate that more volatility may be on its way - Check-Risk's analysts argue there "is a risk of a broader sell off of EU periphery's and German Bunds despite the fact that the yield differential is now attractive."

UK Government Bond 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	46	-19
Germany	23	-3
Japan	41	-19
United Kingdom	21	-15
Ireland	60	-81
Italy	116	16
Portugal	212	-228
Spain	79	-149

Eurozone peripheral bond yields

Country	% in August 12th	% in July 10th	Spread over 10 year

			German bonds
Spain 10 year	2.67%	2.74%	161
Italy 10 year	2.80%	2.87%	174
Greece 10 year	6.34%	6.27%	528

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

If we were to look at the headline numbers, one could easily presume that sentiment towards equities has turned bearish, especially in the core US equity markets. Recent numbers from S&P show that over the four weeks of July US equities in aggregate fell back with small caps having been especially badly hit - the S&P 500 was down 1.51% in July whereas the Small Cap 600 fell by over 5.5%.

Yet, I also think we should be careful about using this data on recent returns to build a bearish case against risky assets such as equities. As a note accompanying the S&P data points out, July was in fact “another good month for the S&P 500—if it had ended a day earlier. Absent the last day, it was a typical month as far as the last year and a half goes, as the market opened in July with three consecutive days of closing highs (five in all for July, compared with eight new highs in June; the total is 27 YTD)."

Crucially the US numbers coming out of S&P reminds us that there's been a significant variation between different equity sectors - Energy, Industrials and Utilities may have had an especially bad month, while healthcare stocks barely moved, but stocks within the IT and Telecoms sector actually increased in value. Equally I'd also remind investors that cyclical sectors such as energy and mining stocks have still had a decent 12 months overall - both are up by more than 15% over the last year.

Index	August level	July level	Reference Index Value	Level six months ago
Euro Stoxx 50	112.6	112.6	3038	108.5
FTSE 100 (Dec 14)	232.3	232.5	6627	236

	Price change %						
Name	1 mth	3 mth	6 mth	1 yr	5 yr	6 yr	Close
FTSE 100	-0.86	-2.67	-0.6	0.75	41.99	19.69	6632.82
S&P 500	-1.56	3.11	6.44	14.51	94.79	48.39	1936.92

Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	1.66	2.51	2.60	2.06	12.09	17.70	11.635
Benchmark for volatility							
VIX New Methodology	17.80	10.14	-1.93	6.11	-45.25	-29.27	14.23

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Volatility

Measures and indicators which look at 'implied' volatility for the core US equity markets - principally measured by the VIX 'Fear Gauge' Index - have recently ticked up, very gently! After moving to 2014 highs of 16.7% in early February, volatility had dropped to multi-year lows of 5.5% through late June before climbing back towards 10. With the VIX currently at just under 15, we can see that the S&P 500 historical volatility is now in the middle of this year's range. Although still not elevated, it's clear that market volatility is ticking higher as the S&P 500 begins to make larger price swings from one day to the next.

Measure	August level	July level	June level	Acc/Dec	Direction Upwards
Vstoxx Volatility	21.23	17.60	14.15	ACC	Yes
VFtse Volatility	15.50	13.68	12.406	ACC	Yes
FTSE Put Call Ratio	0.956	1.28	0.78	ACC	No

VIX New Methodology

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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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