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UK Structured™ Products Association

Monthly Market Report
September 2015

With commentary from David Stevenson

Events in China may be drawing a huge amount of attention amongst investors but back in the developed world a rather old debate has recently started again - the battle between inflationists and deflationists. This argument hinges on a close reading of measures such as the CPI and RPI but it also has a huge impact on the pricing of varying assets. If the inflationists are right and we're about to see sharply rising prices, all bets are off bonds, while gold suddenly looks much shinier. By contrast if the deflationists are right - and they have been for the last few years - the global economy is still struggling with anaemic global demand, and declining prices powered in part by falling commodity prices.

We'll examine this debate a little later but for now most attention is focused on the energy markets - and the price of oil. After a buoyant few months of rising prices, oil prices have started falling again with the $45 and $50 a barrel barriers breached for West Texas and Brent respectively. Are we about to see any lunge downwards, helped along by that recent Chinese devaluation of the remnimbi? One key dynamic could be that seminal deal with Iran. The oil bears reckon we'll see a huge wave of oil output unleashed following the deal while oil bulls caution that the devil is very much in the detail. Analysts at Goldman Sachs for instance suspect that the Iran deal is indeed important but that any surge in supplies is likely to be delayed. According to a note to their investors on July 14th Goldman's analysts observed that "Once inspectors verify compliance, the sanctions relief would be wide ranging: the EU oil embargo and other nuclear-related EU economic and financial sanctions would be lifted and Iran would also be allowed to use SWIFT for international banking. The nuclear-related secondary sanctions imposed by the US, which are generally aimed at trade between non-US companies and Iran, would also be lifted once the IAEA verifies compliance.....the above timeline suggests that the sanctions relief under the agreement would take effect most likely in early 2016 assuming no additional delays."

Unfortunately that's where the good news ends reckons Goldman's. The bank's analysts reckon that eventually Iranian energy supplies will find their way on to the global markets over the next few months, depressing prices in the short term pushing oil prices sharply lower. Goldman's, once notorious for its bullish projections for oil, has now turned decisively bearish - and it's not alone. Another recent note from an investment bank, this time Societe Generale, observes that "$59 Brent is $5 lower than its range bound June average of $64, and $53 WTI is $7 lower than its June average of $60. China, Greece, and Iran have clearly caused an upswing in risk aversion, which has been bearish for crude." But the SG analysts aren't completely bearish. They reckon that measures focused on refinery output offers some hope. As the SG analysts note "Strong product demand, refining margins, and crude demand should drive a recovery. It's still summer, and gasoline is key. The most likely catalyst, in our opinion, will be gasoline."

Yet despite this slightly more optimistic tone, most energy analysts have turned bearish again, with many now predicting a big test at $40 a barrel for West Texas crude. If that happens, expect even more carnage in the commodity markets with industrial metals first in line for a sharp fall in prices.

Plunging commodity prices will of course be grist to the mill for the deflationist side of the debate - although it's also fair to say that plunging oil prices must be great news for consumers in the West. And surely as their demand for shiny new goods and services begins to pick up again, we'll see inflation start to rise again?

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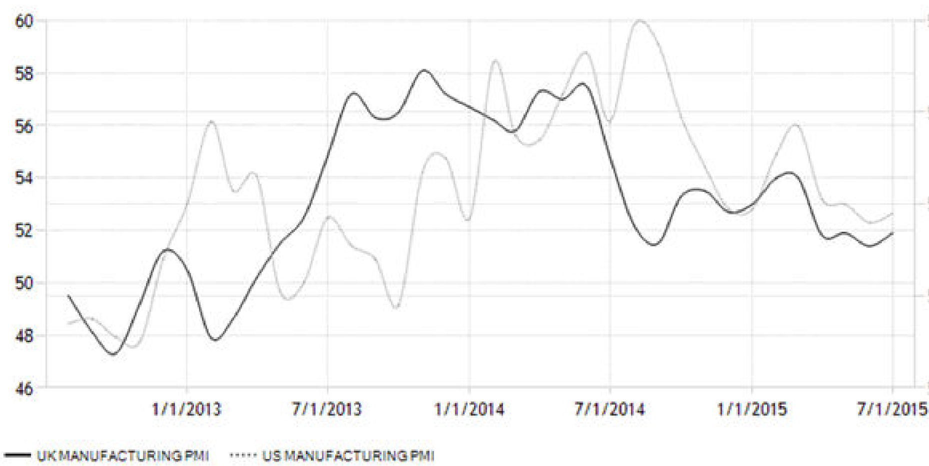
Headline Numbers

Measure	Value as of July 15th, 2015	Value as of August 11th, 2015
UK Government 10 year bond rate	2.13%	1.92%
GDP Growth rate YoY	2.90%	2.60%
CPI Core rate	0.80%	0.80%
RPI Inflation rate	1.0%	1.0%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.55%	0.55%
Government debt to GDP ratio	89.4%	89.4%
Manufacturing PMI	51.4	51.9
Sovereign Western Europe CDS	46.32	46.94
Euro Bank CDS	69.52	165
FTSE CDS	78.14	88

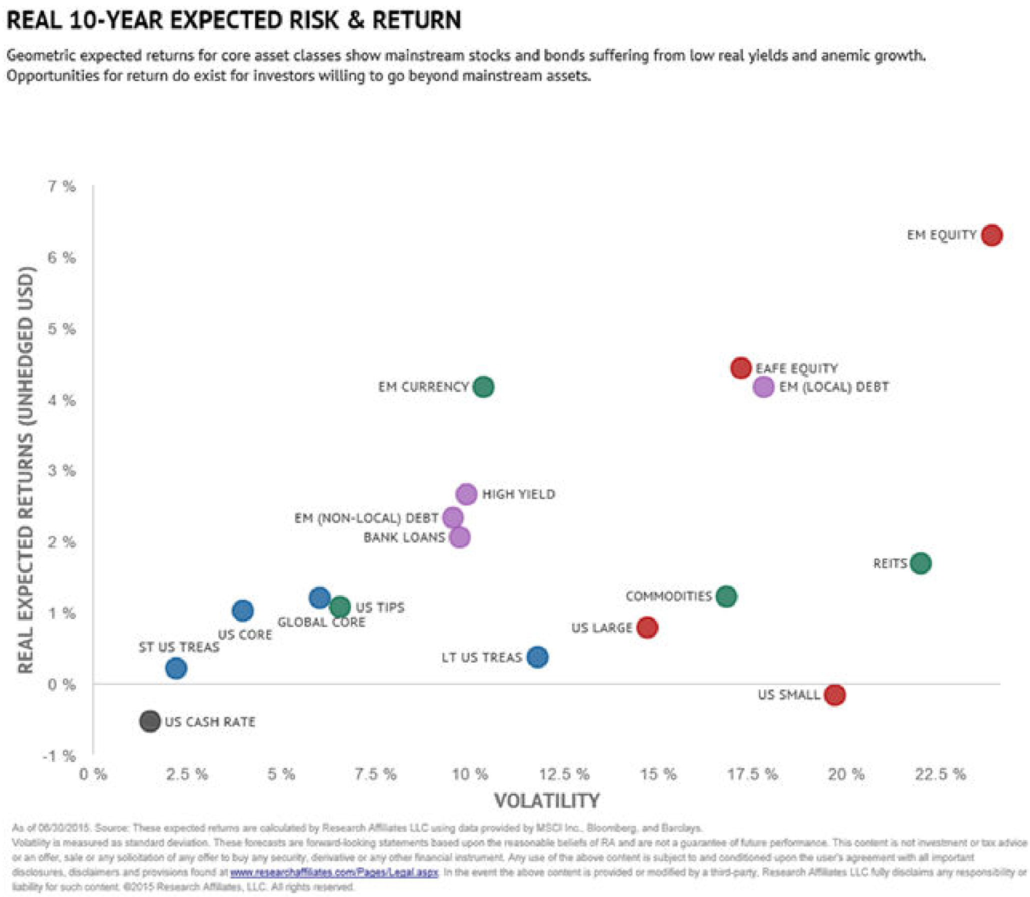
Headline Thought

One of the most persistent worries for those pointy head economist types peering into their collective crystal balls for the UK is the weakness of manufacturing output, indicated by PMI measures which gauge confidence in future sales growth for the industrial sector. The consensus narrative is that UK manufacturing is weak and that the recovery is uneven, with surging consumer demand the primary driver. But a comparison of PMI indicators for the UK and the US - see the chart below from the website Trading Economics - shows that over the last three years UK PMI measures for manufacturing are not materially diverging from their supposedly more confident cousins across the pond. The dotted line below represents US manufacturing PIM while the thick line is the UK. Both are roughly heading in the same direction although the US has had a stronger last 12 months. But this PMI chart doesn't tend to support the argument that the UK manufacturing sector is terrifically weak.



Source: Trading Economics

Even though in our heart of hearts we know that financial forecasting is largely a mugs game - especially over the long term of the next few decades - it's constantly surprising how many bright, intelligent investing types keep persisting with the chore of long term forecasting. Many value orientated, fundamentals based investors think that by using past historical data we can build predictive models that give us some indication of future returns. The idea here is to break down the various components of past returns and then use those valuation metrics to forecast through into the future based on variables such as national GDP growth rates or returns from dividends. It's an honourable pursuit and in truth probably fairly useful for financial advisers though I remain to be convinced it has much value. But if anyone is going to make a decent stab at this forecasting game, Rob Arnott and his colleagues at US firm Research Affiliates are likely to be among the most trusted. They've been constantly tracking returns from fundamentals based investing for the last decade and they've just updated their excellent 'Expected Returns' website. The chart below summarises the range of expected returns for a bunch of varying asset classes, with real expected returns compared to likely volatility.



Emerging market equities come out top in terms of potential returns with annual returns of nearly 7% (real) likely over the next decade, but that bumper potential profit comes at a likely cost, with very high levels of volatility. Investing in emerging markets currencies looks a slightly less scary trade, with returns of over 4% but much lower levels of volatility. US Small caps look a terrible idea with negative likely returns but massive volatility while the most depressing numbers concern global equities - potential real returns of not much more than 1% per annum. The site is freely available and the clever tools there allow the user to compare Research Affiliates' long-term return expectations across a variety of geographies and asset classes. Crucially the site has just been revised with updated quarterly numbers (it was first launched in Q2 this year). An absolute must see for any investor interested in the long term.

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CDS Rates

Another quiet month in the world of bank bond CDS options although there is some good news to report, at least for British based investors worried about the possibility of bond defaults by high street banks Barclays and RBS. We've already observed on these pages how Lloyds CDS rates have collapsed over the last few years, indicating that the markets are much less worried about any potential for bond defaults. Rates for RBS have traditionally been much higher with those for Barclays a little lower but it's noteworthy that both of these banks have seen their CDS rates plunge. Barclays' rates are now not that far off of those for HSBC while rates for RBS have also fallen sharply.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	53	108	5	20	A -
Barclays	33	69	-10	-1	A
Citigroup	29	79	3	6	A
Commerzbank	46	89	-9	1	A+
Credit Suisse	41	73	-6	9	A
Deutsche Bank	43	88	-7	13	A+

Goldman Sachs	35	88	-3	2	A
HSBC	33	69	-4	14	AA-
JP Morgan	29	79	1	10	A+
Lloyds Banking Group	27	61	-5	-4	A
Morgan Stanley	31	-4	-2	16	A
Nomura	21	61	-1	-17	A-
Rabobank	22	62	-4	11	AA-
RBS	38	79	-12	-4	A
Soc Gen	40	82	-4	-3	A
UBS	27	59	-7	7	A

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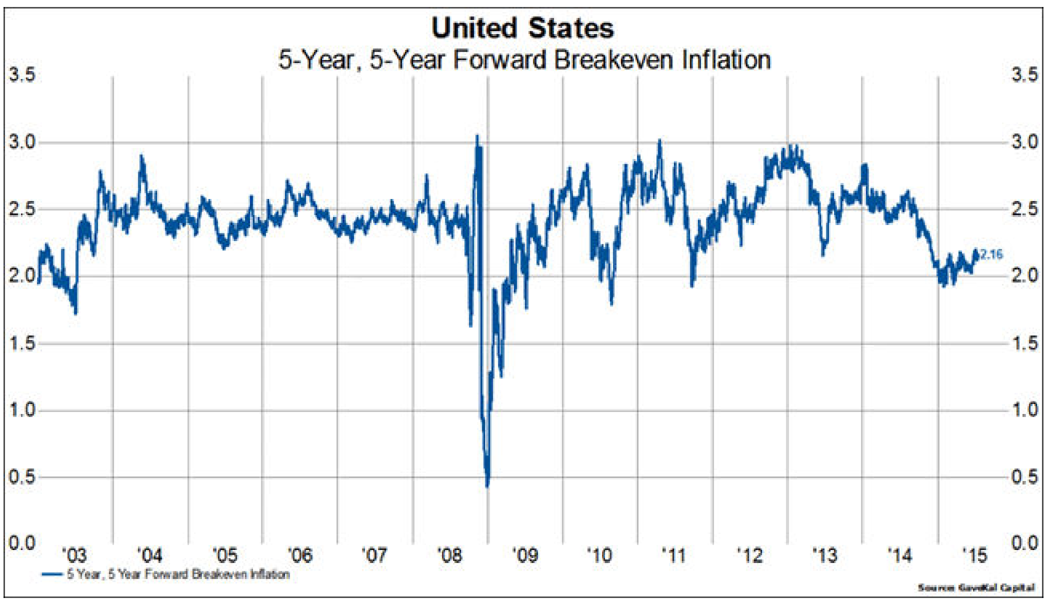
Government Bonds

Is inflation dead? A large number of bond investors certainly seem to think so, with many arguing that we're now stuck in a deflationary rut, helped along by collapsing commodity prices. This deflationary world view has in turn helped fuel insatiable demand for bonds, pushing yields down to all-time lows, which has in turn forced central banks to snap up huge quantities of quality issues in the open market, further fuelling an extra ordinary bull run in equities.

Yet maybe these deflationists are missing the bigger picture? Are the missing signs that inflation is starting to rear its (ugly) head again. The chart below shows that in fact US expectations for inflation in the future - as measured by 5 year breakeven rates - have never really changed that much over the last few years. US Breakeven rates are roughly back where they were over a decade ago.



Source: http://www.valuewalk.com/2015/07/us-inflation-expectations-have-rolled-over-charts/

Looking forward there's also some signs that inflationary pressures are beginning to build. Take one classic 'canary in the coal mine' for the global economy - shipping. Global shipping volumes may have contracted by 3.4% in the first two-quarters of this year, and the Baltic Dry Index collapsed in value but in recent months this measure has posted a strong recovery. Various world trade indices are now turning higher with high rates of change. It's also worth noting that global money supply growth has been above expectations. The Telegraph newspaper for instance recently quoted Gabriel Stein from Oxford Economics saying that the growth rate of real M3 money supply for the world rose to a six-year high of 6.2% in June. According to consultants at investment firm Check Risk, in Bath, the M3 world aggregate is for US, China, EMU, UK, Japan and Canada and is the broadest measure of money supply that is easily monitored. Global M3 usually precedes economic growth by some 12 months or so. They also observe that cheap oil is the same as a tax cut releasing consumer spending power in advanced economies. Crucially though it's worth watching the pace of change of prices and the impact of previous big trends dropping out of the system over time. Year on year comparisons of inflation are going to start to look very positive given that commodity indices have fallen upwards of 50% since last October.

UK Government Bonds 10-year Rates 2.13%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	34
Germany	14
Japan	41
United Kingdom	20
Ireland	45
Italy	112
Portugal	169
Spain	96

Eurozone peripheral bond yields

Country	July 15th, 2015	August 11th, 2015	Spread over 10 year German bonds
Spain 10 year	2.02%	1.94%	128
Italy 10 year	2.01%	1.80%	114
Greece 10 year	12.50%	10.37%	971

	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

The inexorable rise of exchange traded funds in recent years has been powered by a number of factors including low charges and transparency. But many investors have switched to tracker funds because of concerns about the alleged prowess of rival active fund managers in producing that elusive alpha. Looking at the sheer weight of historical data the simple fact is that most active fund managers have - in the past at least - singularly failed to outperform their benchmarks (which are in turn tracked by those lower cost ETFs). But recent numbers from UK firm F&C suggests that active fund managers in the UK might be beginning to get their act together - and produce above average returns.

Their latest quarterly Fund Watch survey from the firm's Multi-Manager team reveals that 4.2% of funds, (46 of a possible 1,104), consistently achieved top quartile returns, which is near the historic high of 5%, and significantly up from 2.8% of funds achieving this same feat in Q1.

Their Consistency ratio is a review of the 12 major Investment Association (IA) sectors, highlighting those funds that are consistently above average in each of the last three years, and those consistently top quartile. According to the F&C analysis, Japan led top quartile returns in Q2 2015, with 8.7% of funds in the IA Japan sector achieving consistently top quartile returns - double that of the last quarter. It was closely followed by the IA UK Equity Income and IA UK All Companies sectors, with 7.6% and 6.3% of funds, respectively, being the most consistent. The survey also revealed that although the IA UK Smaller Companies sector did not have any consistent funds over the quarter, the sector was the best performing as a whole. This was due to the sector benefiting from domestic recovery and a tailwind of relative cheap valuation compared to other areas of the market.

Index	August	July	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	114.8	114.8	3634	111
FTSE 100 (Dec 14)	247	247	6684	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	0.94	-4.41	-1.36	2.57	25.29	42.65	6681.15
S&P 500	1.33	-0.56	1.72	8.94	87.7	108.93	2104
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	2.22	0.22	-2.03	5.35	16.1	18.39	12.36
Benchmark for volatility							
VIX New Methodology	-27.33	-4.9	-29.02	-22.45	-45.33	-51.06	12.23

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Volatility

One of the constant themes of this section is that market turbulence, as measured by stock market based volatility indices, has been in a rut for most of the last few years. Paid up professionals whose job it is to watch this kind of stuff such as Tim Edwards at S&P Dow Jones indices do occasionally get very excited about spikes relating to Greece and China but even they're forced to admit that markets are fairly confident/complacent (depending on your view of the valuation of financial assets). A couple of weeks back for instance Edwards observed that the VIX Index bumped up to above twenty around the Greek "Oxi" at the referendum, "before rapidly declining back to close last night at an intensely relaxed 12.12... volatility everywhere is down - including notably our measures for Hong Kong and Europe. Apart from in Canada, volatility is low on an absolute basis, too; implied volatility in every equity market is below its trailing 200-day average." Edwards also notes that vol measures are down for the Japanese yen, pound sterling, euro, U.S. Treasury bond and interest rate rates vol measures.

The only spikes in vol seem to be at the margins, with gold and oil leading the way although the bears can always point to the odd warning signal such as the S&P/IDS U.S. High Yield CDS spread index which has widened by another 30 basis points over the last month "and remains high compared to recent history" according to Edwards. "The S&P/ISDA U.S. 150 CDS spread index also widened by a few basis points. "

Given all this wall of data suggesting placid trading conditions, should we stop worrying about volatility and just assume that markets will remain quietly benign for the foreseeable future?

The cynic might of course spot the obvious, missing player in this cosy arrangement - central banks. It seems increasingly obvious to this observer that the central banks are implicitly targeting equity volatility measures as one of their key signalling mechanisms. Subdued volatility encourages risk taking which might in turn feed through into an uptick in macro-economic activity via capex spending and job hiring.

If you buy this argument, what then are we to make of the growing consensus that the US Fed will raise interest rates BEFORE the end of this year? The consensus bet seems to be that we'll see very small moves up in rates (around 0.25% a quarter) but what if we're wrong? More specifically what if Paul Jackson, head of research at ETF issuer Source is on to something when he looks at the last six tightening cycles (those starting from May 1983 to June 2004)? According to his analysis the average length of these tightening was 13.7 months (ranging from 9 to 24 months), with an average total rate hike of 281bps (ranging from 137bps to 425bps), giving an average monthly increase of 20.5bps (ranging from 15.2 to 29.5). Anyone care to guess what would happen to vol indices, even for equities, if rates did find their way above 3% by 2016?

Measure	August Level	July Level	June Level	May Level	Acc/Dec	Direction Upwards
Vstoxx Volatility	18.71	18.8	24.15	21.92	DEC	No
VFtse Volatility	1.26	11.97	14.09	16.55	ACC	Yes
FTSE Put Call Ratio	1.02	1.02	0.75	1.02	DEC	No

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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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