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Monthly Market Report
September 2016

With commentary from David Stevenson

Who'd have guessed that just a few short weeks after the Brexit vote, equity markets would hit near term highs. Both the FTSE 100 and the S&P 500 have pushed ahead, powering past 20 and 200 day moving averages and breaking through all short-term technical trend barriers. If the current positive momentum continues to work its magic on shares we could see the FTSE 100 push past 7000 and the S&P 500 past 2250. This remarkable turnaround in confidence is mirrored in other key measures - volatility as measured by the VIX Index in the US (it tracks S&P 500 turbulence) has crashed to near all-time lows, while over in the bank CDS market, rates on what are in effect insurance contracts against bank default, have crashed to incredibly low levels. Investor's clearly believe that the chance of a major debt crisis within the banking system is increasingly unlikely. Yet these market developments seem hard to square with government bond yields crashing to all-time lows - the yield on 10-year gilts is now an incredible 0.56%. Such low yields would typically suggest that a recession is imminent although in our QE manipulated world, these low rates may simply be a factor of massive central bank bond purchase programmes.

In sum then, the optimists seem to have won out. This cheeriness and optimism has even spread to Japan, with many investors now suggesting that it represents the next frontier for equity income investors. Dividend hunters converging on Japan - how the wheel constantly turns within international finance! And yet investors might want to pause to consider the link between low gilt yields, surging equities and populism represented by Donald Trump. Our societies are aging fast which is in turn producing a savings glut. This helps to lower yields and interest rates, which in turn makes dividend producing assets more attractive. But these forces also produce low economic growth and even lower wage growth rates. Which in turn fuels the populist political agenda, built on smashing up the cosy economic and political consensus. You have been warned!

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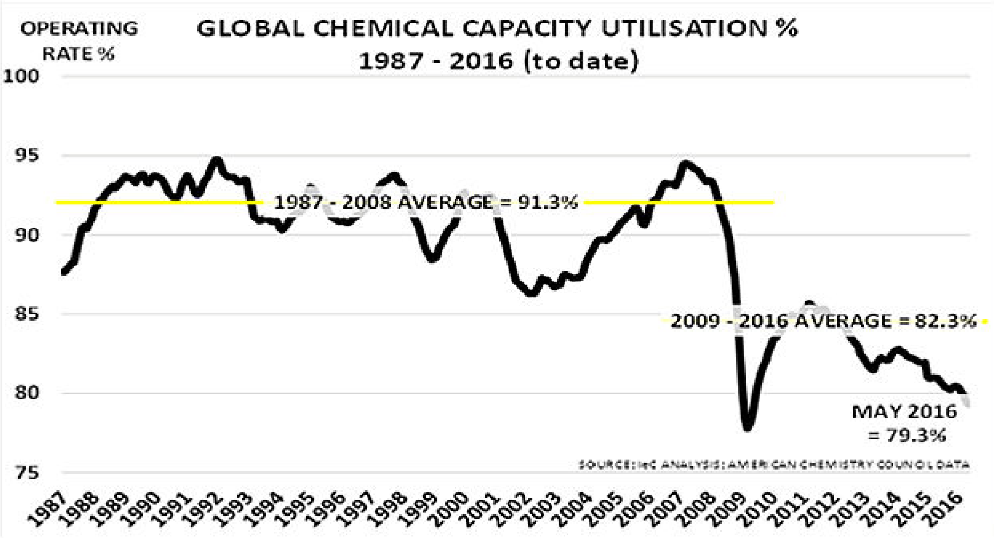
Headline Numbers

The chart below represents something of a potential warning sign for optimistic equity investors! It comes from the July-August edition of something called The pH Report, by International eChem Chairman Paul Hodges - a consultant to the petrochemical and investment industries who apparently predicted the 2008 crisis.



Source: pH Report (International eChem Chairman, Paul Hodges)

I have no way of verifying those claims but the report does identify one key fact - that what happens in the chemical market is usually a brilliant indicator for what might happen later in the wider global market. The Global chemical industry sales are currently running at around $3tn a year, close to 5% of global GDP. According to Paul Hodges "thanks to the American Chemistry Council, we have near real-time data for core trends such as capacity utilisation (CU%). This is why the industry is the best leading indicator that we have for the global economy." If this indicator does have value, then the message is clear - the global economy is in very poor shape. According to Hodges and his team, the chart above "confirms the weak picture that has developed since Q2 2011:

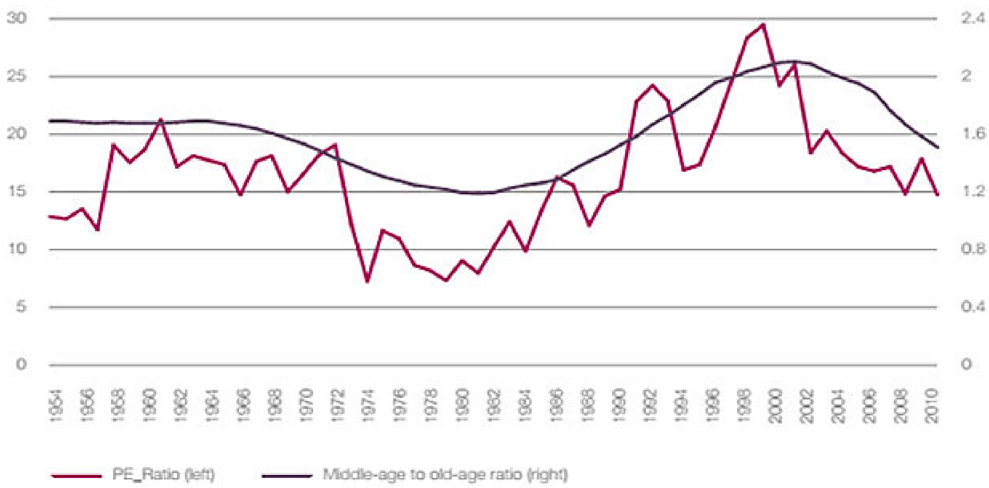
- The post-2008 Crisis recovery was relatively weak, with the CU% peaking at just 85.7% in March 2011
- This was below anything seen in the 1987 - H1 2008 period, when the lowest CU% level was 86.3% in H1 2002
- Even more worrying is that CU% has been in a new decline over the past year It is now down at 79.3% versus 81% a year ago in May 2015

According to Hodges, this recent sharp decline "is even more worrying when one remembers that the oil price rallied from January - June this year, with prices doubling to reach $50/bbl. This effectively boosted demand on a temporary basis as customers built inventory as they bought ahead of oil price-related increases. Without this support, the CU% would presumably have been even lower." If oil prices do start to fall back, we could see this CU% fall much, much lower.

The fact that most developed world countries are aging fast - with increased longevity for the old and declining birth rates - is now a common part of modern political debate. It prompts questions such as how will we pay for pensions? Will health care budgets stand the strain? The investment implications are also hotly debated. Some economists and investors think aging societies will have no direct discernible impact on shares or bonds. Others such as analysts at asset management firm Indosuez (part of Credit Agricole banking group) take a different view. The chart below suggests in fact that there is a relationship of some form between price to earnings ratios on equities and the middle age to old ratio - an indicator for the ratio between working age and retired. The wealth manager explains the relationship as follows - "more potential growth goes hand in hand with a higher return on capital, irrespective of the investment vehicle used. If an ageing population is accompanied by a decrease in potential growth, then the return on an equity investment is set to be lower. That said portfolio choices specific to each age group also influence market valuations. One noteworthy relationship between the population age structure and market valuation in the equity class is well documented. Since individuals save, notably in the form of equities, during their professional life, they tend to be buyers until retirement age and sellers thereafter. Thus, the higher the proportion of active individuals in the overall population, the higher the market price/earnings ratio. In this respect, ceteris paribus, the demographic trend is set to weigh on share prices over the coming decades. However, this relationship is strongest in the US, which suffers less from ageing, while it is weakest in countries that are ageing more rapidly such as Germany and Japan."

P/E RATIO AND MIDDLE-AGE TO OLD-AGE RATIO

Source: Liu et Spiegel



Measure	Value as of July 14th, 2016	Value as of August 10th, 2016
UK Government 10 year bond rate	0.81%	0.54%
GDP Growth rate YoY	2%	2.20%
CPI Core rate	1.20%	1.40%
RPI Inflation rate	1.40%	1.60%
Interest rate	0.50%	0.25%
Interbank rate 3 month	0.50%	0.40%
Government debt to GDP ratio	89.20%	89.20%
Manufacturing PMI	52.1	48.2

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Bank CDS options

It's been a remarkable few weeks in the bank CDS markets. Rates on 1 and 5 year CDS products have collapsed with the biggest falls seen in UK banks - both Barclays and Lloyds have seen dramatic declines in pricing, suggesting that investors have stopped worrying about Brexit and the threat of a sudden upturn in bad debts. Rates on CDS products have even fallen for German banks although they remain at elevated levels. Lastly it's worth noting that rates on blue chip Rabobank are threatening to break through the crucial 20 basis point level for one-year contracts.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	28.5	90	-10	48	A -
Barclays	53.61	100.81	-32	49	A
Citigroup	35.23	83.5	-11	6.37	A
Commerzbank	64	123	-9	40	A+
Credit Suisse	83	132	-22	87	A
Deutsche Bank	145	208	-11.45	141	A+
Goldman Sachs	34	103.5	-6	24	A
HSBC	29.85	77	24	13.37	AA-
JP Morgan	26	64.5	-4.44	-5.84	A+
Lloyds Banking Group	38	84	-33.86	40	A
Morgan Stanley	38	100.5	-9	29.68	A
Nomura	23.39	87.5	-14	41	A-
Rabobank	20.45	58.75	-29	-0.43	AA-

RBS	72	115	-27	50.48	A
Soc Gen	26.54	73.41	-20	-9.93	A
UBS	29.18	64.50	-18	15.18	A

Source: Meteoram.com, 3rd August 2016

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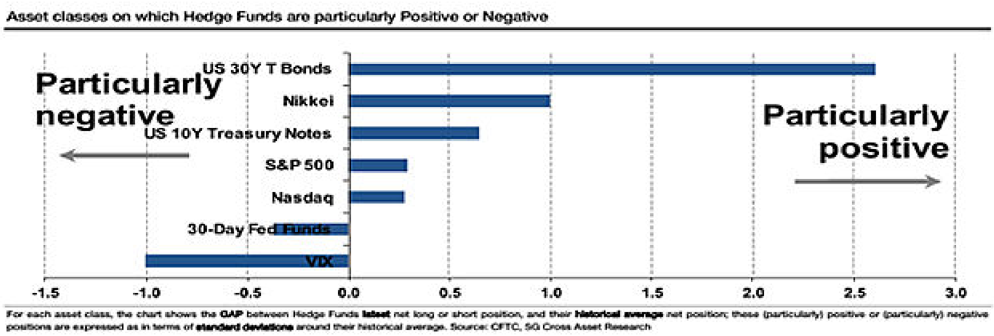
Government Bonds

The yield on UK government bond yields continues to push ever lower - the rate on ten-year bonds is now 0.56%, well below the 2% levels seen last summer. With yields this low, it's increasingly easy to see why so many hedge funds are betting so big on long dated US Treasuries.

UK Government Bonds 10-year Rates 0.56%

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

According to a survey of hedge funds by French bank SG, the single biggest net positive position for most hedge funds is now the 30-year Treasury Bond, with the US 10 year notes not far away. Given that US 10 year bonds now yield a whole 1% more than their peers in the UK and not far off 2% more than negative yielding German bund bonds, it's not hard to see why investors are so attracted to US bonds. A decent yield, a relatively strong economy, and the real prospect of rising interest rates.



Source: Societe Generale

CDS Rates for Sovereign Debt

Country	Five Year
France	30
Germany	17
Japan	33.2
United Kingdom	20.5
Ireland	70
Italy	130
Portugal	267.5
Spain	82.5

Eurozone peripheral bond yields

Country	July 11th, 2016	August 11th, 2016	Spread over 10 year
Spain 10 year	1.17%	0.95%	105
Italy 10 year	1.21%	1.09%	119
Greece 10 year	7.90%	8.22%	833

	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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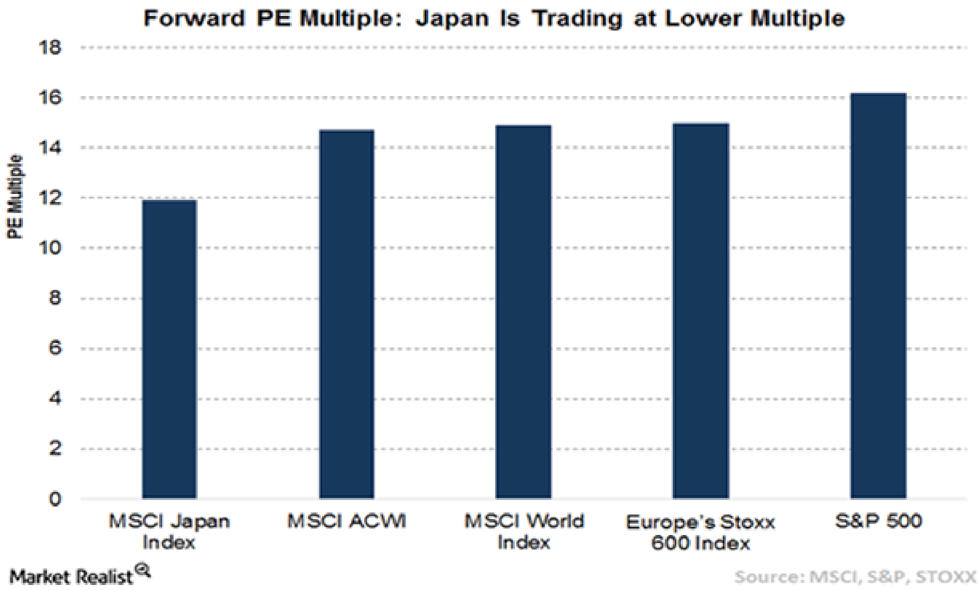
Equity Markets and Dividend Futures

Yet recent central bank policy changes have emboldened the equity bulls. More monetary easing and specifically negative interest rates have all attracted investor enthusiasm. But perhaps the most direct impact has been seen via the Bank of Japan's ETF purchase programme - just doubled in size to some 6tn Yen p.a. Gregg Fisher of boutique Asian investment firm Samarang (the firm has its own deep value Japanese fund) reckons this ETF buying programme may be increased further still. According to Fisher "The catalyst [for increased share prices] is this combination of buying across Japanese public and private institutions, not to mention the companies themselves. The Topix's capitalisation is about 310tn Yen. It could be that this year, as much as 12tn will be bought up by companies and the BOJ alone, leaving aside the GPIF, other pension funds and private individuals."

The chart below gives some succour to these value orientated investors - it's from BlackRock analysts writing on the Market Realist website and shows that Japanese equities are reasonably priced, certainly when compared to their global developed market peers. And analysts from French bank SocGen have even started enthusing about the once humble Japanese dividend payer. Local companies have traditionally been very reluctant to share profits to investors via dividends - until very recently Japanese equities have tended to boast a low dividend yield by international standards. But according to SG's equity quant team "not only does Japan offer a dividend yield not seen outside of a crisis, but that dividend yield is also underpinned by better dividend cover than either the US, Europe or Asia ex Japan. We never thought we'd say it, but not only is Japan attractively valued, it is increasingly becoming an equity income pick."



Source: http://marketrealist.com/2016/03/japanese-stocks-look-attractive-valuations-cheapen/

Index	August	July	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	118.3	118.1	3020	115.3
FTSE 100 (Dec 14)	249.7	247.6	6834	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	3.96	12.04	21.65	1.98	32.65	26.63	6851.30
S&P 500	2.43	5.98	17.79	5.01	86.07	93.45	2181.74
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	2.32	8.93	9.27	12.69	27.01	31.56	13.965
Benchmark for volatility							
VIX New Methodology	-12.88	-21.07	-56.67	-14.12	-67.20	-48.06	11.50

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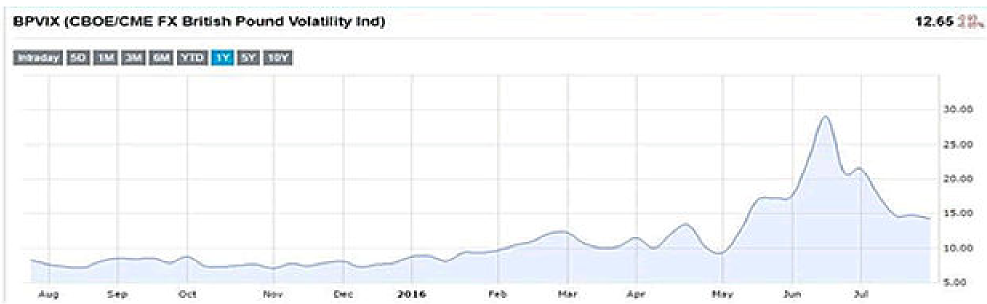
Volatility

What's happened to measures of market volatility? Over the last few weeks' indices such as the VIX - tracking turbulence in the equity benchmark index, the S&P 500 - have literally fallen off a cliff, crashing to near historic lows. As you can see from the chart below - it looks at the index over the last year - the VIX has now decisively pushed below 12 index points and is heading towards the single digit's level not seen since the last decade. But remember that VIX is not a leading indicator - as analysts at ETX Capital recently pointed out the VIX "shouldn't be used to predict market behaviour, but is rather a confirmation of the direction. When the market is falling, the VIX goes up (usually), as it is really a measure of the cost of portfolio insurance. So a low VIX reading does not necessarily mean we're in for a period of selling".

This aura of invincibility has also descended on to other financial markets. The chart below - from ETX again - shows that FOREX markets have also been a lot less volatile than immediately after the Brexit vote. According to the spread betting firm's analysts "sterling volatility, as measured by the CBOE/CME FX British Pound Volatility Index has dropped from a peak of just shy of 22 to a level between 17 and 18. That is still higher than average but a sign that some of the immediate post-Brexit nerves have gone. Euro volatility has also plunged since late June, when it flirted with a reading of 15 - a level not seen since 2012. This has now dropped back to around 9."



Source: http://www.etxcapital.co.uk/blog/what-s-happened-to-all-the-volatility

Measure	August Level	July Level	June Level	May Level
Vstoxx Volatility	18.43	21.69	25.57	23.58
VFTSE Volatility	12.92	14.66	21.83	15.74

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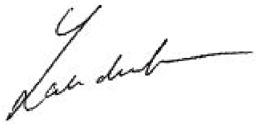
To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,



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