UK Structured™ Products Association

Monthly Market Report

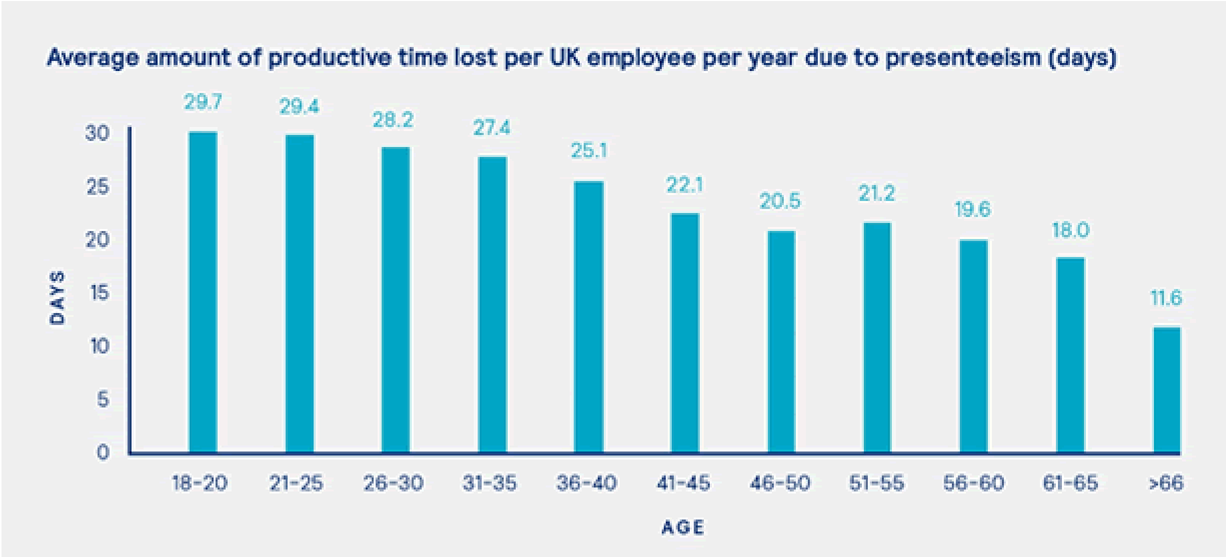
April 2017

With commentary from David Stevenson

One obvious clue to a full throttle bull stockmarket is heightened M and A activity. One can almost sense the eager anticipation of dealmakers at big investment banks to get mega deals in the bag before the inevitable market slowdown. The deal between Standard Life and Aberdeen feels very late cycle. It's no secret that Aberdeen has been hunting around for a partner for some time now and its alighted upon a close (geographically speaking) peer. The deal, to me, makes sense, but the bigger story is what the combined entity (assuming it goes ahead) will focus on: multi and mixed asset funds. Both groups are big players in this market (SLI's GARS in absolute returns for example) and historic fund flow data suggests that the only major growth market for active asset managers is currently mixed asset funds. Obviously, Aberdeen will be able to sell it emerging markets funds to Standard Life's extensive customer base but the big story will be how both sell all in one complete solutions to end investors. Standard Life's MyFolio model is an example of what could emerge: simple, low cost multi asset portfolios mixing passive and active funds in one solution, sold direct or through IFAs. Therein lies the opportunity for structured product providers. How can they build an alternative to this funds based approach? The real battle won't be around who's got the best 'investment' structure for accessing growth in UK equities via the FTSE 100. Rather the battle will be about risk grades, maturity date funds and mixed asset solutions.

Talk to most UK based economists and it's a fair bet they'll very quickly touch upon two crucial issues: poor productivity growth and the inter-generational divide. Most probably won't make the linkage between the two but a recent report does make this bold claim. A report entitled Britain's Healthiest Workplace (BHW) argues that employees aged 35 years old and under have the most financial concerns and are also the least physically active. BHW surveys more than 34,000 workers across all UK industries and was developed in partnership with VitalityHealth, Mercer, the University of Cambridge, and RAND Europe.

The report observes that many millennials entered the workforce following the recent global financial crisis, and already suffer from social mobility challenges and tough economic conditions. These stresses are now showing up in health and wellbeing data. BHW data shows that employees under 35 years old are the least physically active in the workforce, have a high proportion of smokers and eat the least fruit and vegetables each day. In particular this BHW data shows that almost 35% of 26-30 year old employees are physically inactive, completing less than 150 minutes of exercise a week, and on top of this nearly 14% of this age group smoke. Comparatively, the same data shows that older employees have healthier habits, with 22.5% of 56-60 year olds being physically inactive and only a small proportion (6.1%) smoking. This same age group also loses up to 30 days at work due to absence and underperformance due to ill-health, also known as 'presenteeism'. This translates to workers losing more than an entire working month of productive time annually, whilst in comparison, employees aged between 56 and 60 reported up to 13% less financial concerns, losing on average just 19.6 days annually.


Average amount of productive time lost per UK employee per year due to presenteeism (days)
DAYS
30
25
20
15
10
5
0
29.7
29.4
28.2
27.4
25.1
22.1
20.5
21.2
19.6
18.0
11.6
18-20
21-25
26-30
31-35
36-40
41-45
46-50
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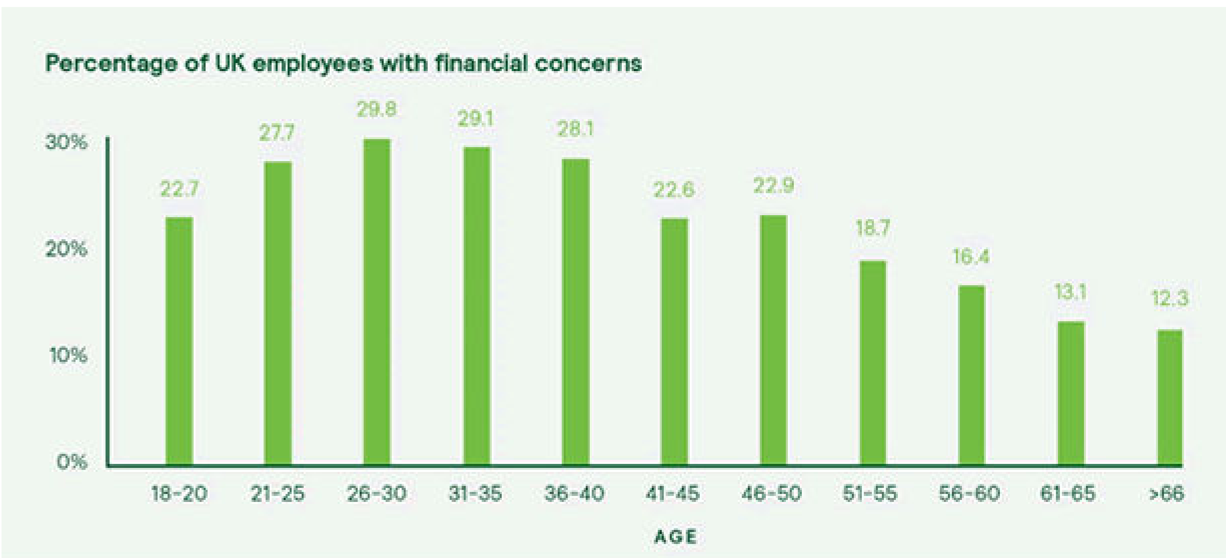
Percentage of UK employees with financial concerns
30%
20%
10%
0%
22.7
27.7
29.8
29.1
28.1
22.6
22.9
18.7
16.4
13.1
12.3
18-20
21-25
26-30
31-35
36-40
41-45
46-50
51-55
56-60
61-65
>66
AGE

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Headline Numbers

The legendary Sage of Omaha, Warren Buffett has in recent years started sounding a bit like the equally legendary financial maven Jack Bogle of Vanguard fame. Bogle has long argued that the financial services industry rips off investors with high fee funds - and poor advice. The greatest living value investor Warren Buffett agrees. He's recently taken to criticising the high fees, low returns model on offer. In fact he's become so agitated by the issue that a couple of years back he publicly offered a wager of $500,000 "that no investment pro could select a set of at least five hedge funds - wildly-popular and high-fee investing vehicles - that would over an extended period match the performance of an unmanaged [passive] S&P-500 index fund charging only token fees". Buffett suggested a ten-year bet and named a low-cost Vanguard S&P fund as my contender. The Sage expected a deluge of offers but only one investment manager took up the bet: Ted Seides a co-manager of Protégé Partners, an asset manager that had raised money from limited partners to form a fund-of-funds. Ted picked five funds-of-funds whose results were to be averaged and compared against Buffett's Vanguard S&P index fund. The results nine years later are in the table below! Buffett won the bet. Digging into the numbers Buffett estimates that over the nine-year period "roughly 60% - gulp! - of all gains achieved by the five funds-of-funds were diverted to the two levels of managers. That was their misbegotten reward for accomplishing something far short of what their many hundreds of limited partners could have effortlessly - and with virtually no cost - achieved on their own. In my opinion, the disappointing results for hedge-fund investors that this bet exposed are almost certain to recur in the future". Buffett's bottom line? "When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low-cost index funds.

Year	Fund of Funds A	Fund of Funds B	Fund of Funds C	Fund of Funds D	Fund of Funds E	S&P Index Fund
2008	-16.5%	-22.3%	-21.3%	-29.3%	-30.1%	-37.0%
2009	11.3%	14.5%	21.4%	16.5%	16.8%	26.6%
2010	5.9%	6.8%	13.3%	4.9%	11.9%	15.1%
2011	-6.3%	-1.3%	5.9%	-6.3%	-2.8%	2.1%
2012	3.4%	9.6%	5.7%	6.2%	9.1%	16.0%
2013	10.5%	15.2%	8.8%	14.2%	14.4%	32.3%
2014	4.7%	4.0%	18.9%	0.7%	-2.1%	13.6%
2015	1.6%	2.5%	5.4%	1.4%	-5.0%	1.4%
2016	-2.9%	1.7%	-1.4%	2.5%	4.4%	11.9%
Gain to Date	8.7%	28.3%	62.8%	2.9%	7.5%	85.4%

Measure	Value as of Feb 16th, 2017	Value as of Mar 10th, 2017
UK Government 10 year bond rate	1.29%	1.24%
GDP Growth rate YoY	2.20%	2%
CPI Core rate	1.60%	1.60%
RPI Inflation rate	2.60%	2.60%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.40%	0.40%
Government debt to GDP ratio	89.20%	89.20%
Manufacturing PMI	55.9	54.6

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Bank CDS options

CDS spreads by and large fell back again in price over the last months. Some of the sharpest declines were seen in US banks with Citi 1 year rates now trading below 18. Spreads for Uk banks also fell sharply. By contrast French bank SG and Dutch Rabobank saw (small) increases in their CDS options pricing, perhaps influenced by worries about impending general elections.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	35.84	72.43	-4.5	-6.5	A -
Barclays	27.31	67.89	-10	-44	A
BNP Parabis	38.65	87.25	0.13	-7.64	A
Citigroup	19.42	56	-17	-47	A
Commerzbank	41	109.83	-2.62	-14.92	A+
Credit Suisse	43.67	108.19	-2.2	-26	A
Deutsche Bank	60.17	138	-8	-35	A+
Goldman Sachs	25.83	72.73	-13	-36	A
HSBC	17.79	58	-9.41	-47	AA-
Investec*	n/a	186	n/a	n/a	BBB
JP Morgan	22.22	46.96	-18	-37	A+
Lloyds Banking Group	25	57.20	-9.91	-39	A
Morgan Stanley	23.87	69.54	-13.40	-38	A
Natixis	18.41	76.25	-0.33	-19.43	A
Nomura	18.81	73.43	-3.7	-34.84	A-
Rabobank	34.46	63.38	6.72	-13	AA-
RBC*	n/a	63	-14	n/a	AA
RBS	44.33	84.20	2.11	-36	A
Soc Gen	35.85	87.52	-5.64	-8.21	A
UBS	20.48	52.09		29.52	A

Source: www.meteoram.com 10th March 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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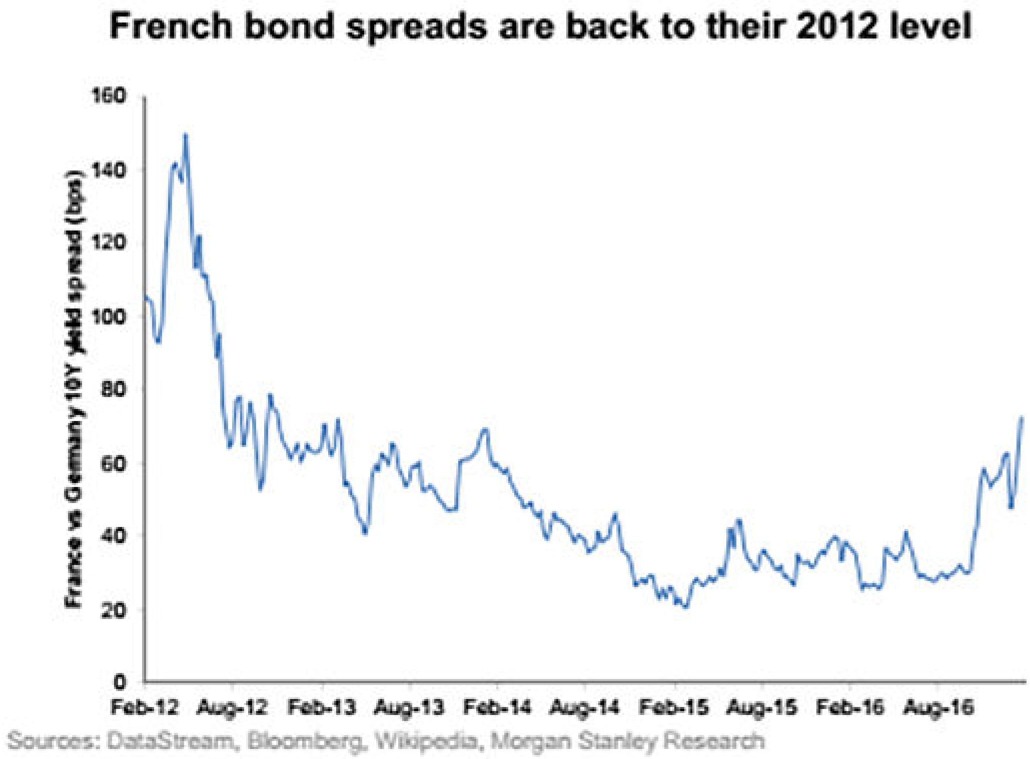
Government Bonds

Is the now time for bond investors to sell down their US holdings and reinvest in Eurozone alternatives? It appears that the European Central Bank, the ECB, is only mid-way through a powerful programme of QE. Its central banks are likely to continue aggressive buying of bonds for at least the next year, helping to support the price of bonds and cut yields, especially at the 10-year duration level. But not all Eurozone government bonds are created equally. Most investors have focused on buying bonds from reliable issuers such as the Germans - pushing down yields - and selling bonds from less reputable issuers such as the Greeks. But active fund managers in the bond space have been playing other, diversified inter-country trades.

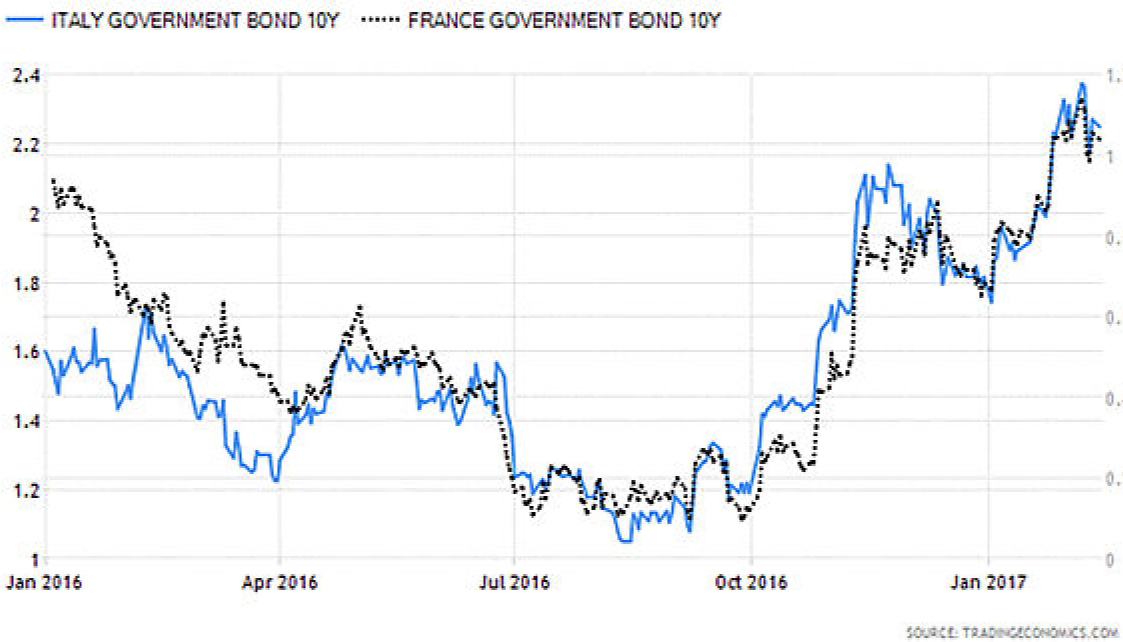
Many European bond managers are focusing on three countries: France, Italy and Germany. Both France and Italy have their fair share of political turmoil, with the election of Le Pen as President as one obvious, major risk - Germany by contrast is seen as a safer bet. The chart below is from last week's European analysts note by analysts at Morgan Stanley. It shows the spread between yields on French and German government 10 year bonds. On this measure, they are back at their 2012 level - they're currently at just under 80 basis point level. If this trend gathers speed, it's entirely possible that the spread could increase markedly to as much as 160 basis points.



The mechanism for this shift in sentiment is obvious to all but a cave dweller: the possibility of a National Front win in the up and coming French General Election is thought to be increasing and bond investors are evidently growing concerned.

Arguably though Italy has much more deep rooted challenges ahead. Italy is more likely to get a ratings downgrade by the agencies, and this means that when Italian bonds are used in the financial system as collateral, the person receiving the Italian bonds will then have to apply a higher haircut. But Italy might also be the big loser even if Le Pen does win in France. Italy's debt dynamics are in a worse state by far than France's, and in the event of an EU breakdown the market would seek out the weakest links in the system (the periphery and Italy) and focus their attentions on them. If that is the case, expect the gap between Italian and French bond yields (shown in the chart below from the Trading Economics website) to widen even further.

UK Government Bonds 10-year Rate 1.24%



CDS Rates for Sovereign Debt

Country	Five Year
France	62.18
Germany	21.305
Japan	22.55
United Kingdom	28.34
Ireland	64.29
Italy	186.765
Portugal	273
Spain	76.35

Eurozone peripheral bond yields

Country	Feb 2017	Mar 2017	Spread over 10 year
Spain 10 year	1.65%	1.89%	110
Italy 10 year	1.92%	2.37%	157
Greece 10 year	6.94%	7.19%	659

	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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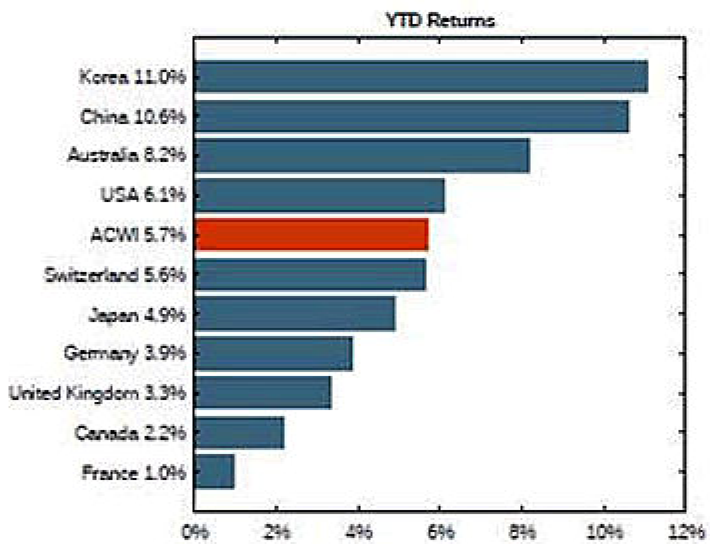
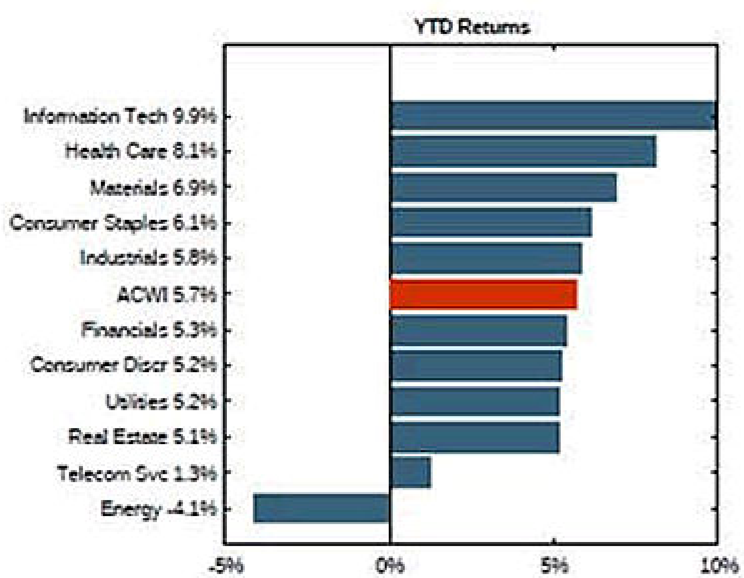
Equity Markets and Dividend Futures

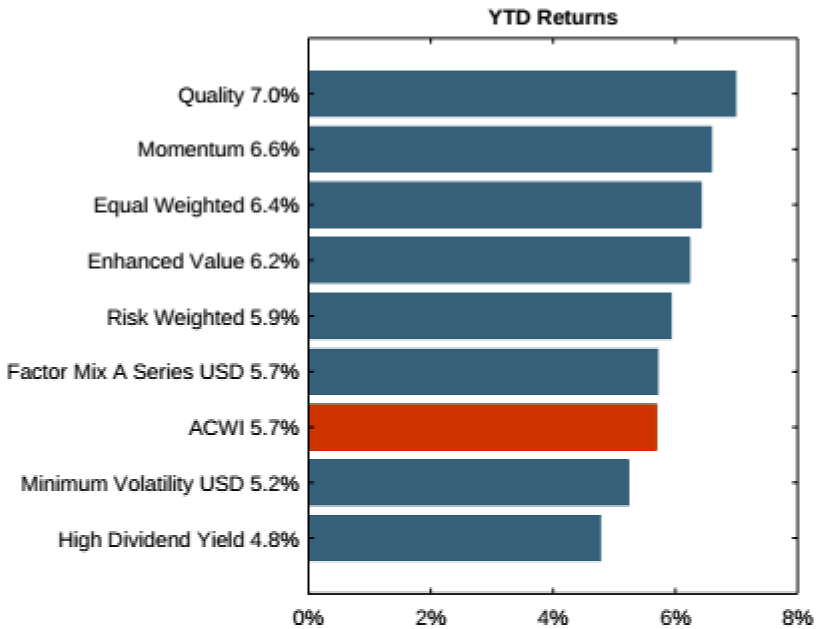
Looking back at overall returns for February, index firm MSCi has just released its monthly roundup of key market moves. In terms of single country indices, the best performing country in February was China (3.5%) and the worst, Canada (-2.1%), while the market (ACWI) returned 2.2%. According to MSCI year to date, the best performing country has been Korea (11.0%) and the worst, France (1.0%), while the market (ACWI) has returned 5.7%. Using the forward P/E, the most expensive country is USA with a forward P/E of 18.0 and the cheapest, Korea with a forward P/E of 9.3, while the market (ACWI) forward P/E is 15.9. The chart below shows year to date returns for single countries within the MSCI index family.



MSCI also looked at sector returns to date. For February the best performing sector was Health Care (6.5%) and the worst, Energy (-3.6%), while the market (ACWI) has returned 2.2%. Year to date, the best performing sector has been Information Tech (9.9%) and the worst, Energy (-4.1%), while the market (ACWI) has returned 5.7%. Using the forward P/E, the most expensive sector is Real Estate with a forward P/E of 22.0 and the cheapest, Financials with a forward P/E of 12.3, while the market (ACWI) forward P/E is 15.9. The chart below shows year to date returns for global sectors within the MSCI family of indices.



Lastly MSCI also looked at the relative performance of different 'style factors' such as value and momentum. According to the index firm the best performing factor in February was quality stocks up 3.8% and the worst, Enhanced Value (1.5%), while the market (ACWI) has returned 2.2%. Year to date, the best performing factor has been Quality again, up 7% and the worst, High Dividend Yield (4.8%), while the market (ACWI) has returned 5.7%. In terms of valuations, using the forward P/E, the most expensive factor is currently Minimum Volatility USD with a forward P/E of 18.4 and the cheapest, Enhanced Value with a forward P/E of 10.1, while the market (ACWI) forward P/E is 15.9



Source: MSCI

Index	February	March	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	115.6	116.4	3309	114.80
FTSE 100 (Dec 17)	282.1	286.60	7263	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	-0.91	1.18	5.19	7.97	8.97	24.25	7314.96
S&P 500	-0.72	2.47	4.66	11.94	25.92	72.71	2364.87
iShares FTSE UK All Stocks Gilt	0.08	0.95	2.90	-3.49	16.66	12.83	13.235
VIX New Methodology	4.15	13.05	4.68	-29.71	-12.83	-28.11	12.30

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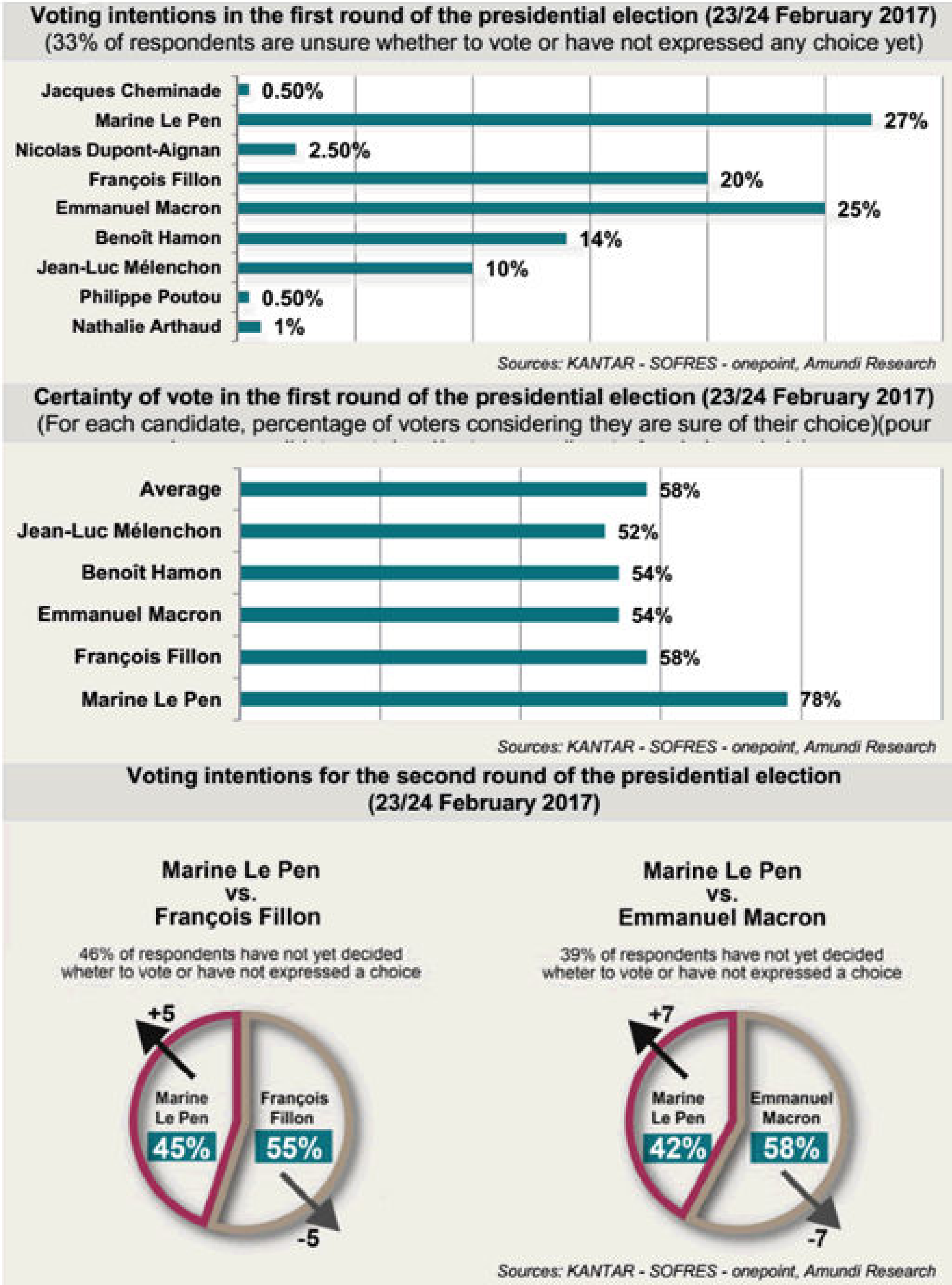
Volatility

Volatility levels across the global financial markets remain at historically very low levels. In this relative calm many investor's inevitably tend to focus on potential political 'upsets' i.e a potential repeat of the Brexit and Trump scenario.

Top of the list is France, where all bets seem to be off. Conservative Republican candidate Francois Fillon's evident familial 'difficulties' look like they might prove fatal and the rise of former Socialist minister Emmanuel Macron sets the scene for an epic Le Pen/ Macron face off. Personally, I would wager that Macron would sail to a victory in these circumstances but the National Front has gone on record as saying that its favourite challenger would be the 'liberal' Macron, hardly a comforting conclusion for the young ex minister's supporters. It's also true that betting markets have increased the probability of a Le Pen win from around 25% to 34% in recent weeks. The big table below from asset management firm Amundi sums up the most recent trends in France.

Their numbers suggest that Le Pen looks doomed, again. Their analysts suggest that although the French elections revive fears about the euro zone [Le Pen is obviously no great fan] "these fears seem largely exaggerated" They argue that investors might want to bet on an improvement in spreads against bund (and in particular the spread OAT-Bund) and sovereign CDS after the elections. In the meantime, they suggest adopting a "wait-and-see attitude (with a negative bias to France and other peripheral countries) which still seems to be the best strategy".



Measure	March Level	February Level	January Level	December Level	November Level
Vstoxx Volatility	15.36	15.05	15.21	16.94	21.96
VFTSE Volatility	6.19	11.44	11.62	12.04	16.69

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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,

Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk

UK Structured Products Association, c/o 1 - 9 Hardwick's Square, London, SW18 4AW