UK Structured ™ Products Association

Monthly Market Report

April 2018

With commentary from David Stevenson

So it was a bump afterall

So, where are we with the global developed world stock markets - was the turbulence of the last few months a bump or something more ominous? The evidence so far firmly points to the former, the curious case of the bump. A nasty one but not unexpected. The good news is that the markets have now mostly recovered strongly from the correction in the first half of February. But as analysts at SocGen now observe, we need to focus on the FX markets moving forwards - the French bank's analysts observe that *"US dollar weakness remains centre stage, and the positive effect it has had on what are US dollar-denominated indices should not be overlooked. For the euro investor, for example, MSCI World is down in price terms over the past year and the DAX peaked in May last year, and while US earnings momentum has surged ahead on the back of both the weak USD and tax cuts, European EPS momentum is heading the other way."*

FX markets do cloud the picture, but after a few weeks of turbulence, fundamentals have started to re-assert themselves - providing a useful tailwind. Charles Stanley for instance recently brought out another issue of its earnings tracker. Its headlines? Profits are booming. According to the UK investment house *"FTSE 100 reported earnings growth now stands at 44% year-on-year for 2017 with all sectors seeing positive growth. However, this is heavily skewed by Energy's strong performance where earnings are up 99%.... Looking ahead, consensus expectations are for the FTSE 100 to see earnings growth of 9% in 2018 with Energy, Tech and Telecoms considered as having the biggest growth potential."*

And just in case you hadn't got the (positive) message, the surge in global dividends was also highlighted by a note from Janus Henderson. They reported that: *"A strengthening world economy and rising corporate confidence pushed global dividends to a new high in 2017, according to the Janus Henderson Global Dividend Index. Global dividends rose 7.7% on a headline basis, the fastest rate of growth since*

2014, and reached a total of $1.252 trillion. Every region of the world and almost every industry saw an increase. Moreover, records were broken in 11 of the index's 41 countries, among them the United States, Japan, Switzerland, Hong Kong, Taiwan, and the Netherlands."

So, what initial conclusions can we draw from these obviously very limited observations? My guess is that the nasty volatility of the last few weeks has in effect amounted to a re-pricing of Central Bank policy normalization as well as an accompanying re-pricing of inflation prospects amid firming wage pressures. The bad news I'm afraid is that if I were a central banker I'd take away one obvious conclusion - that the markets have started to adapt to a new rates environment. This might encourage the Fed to more aggressively increase interest rates, thinking it can get away with a more marked increase. If that is the case, there is much worse to come!

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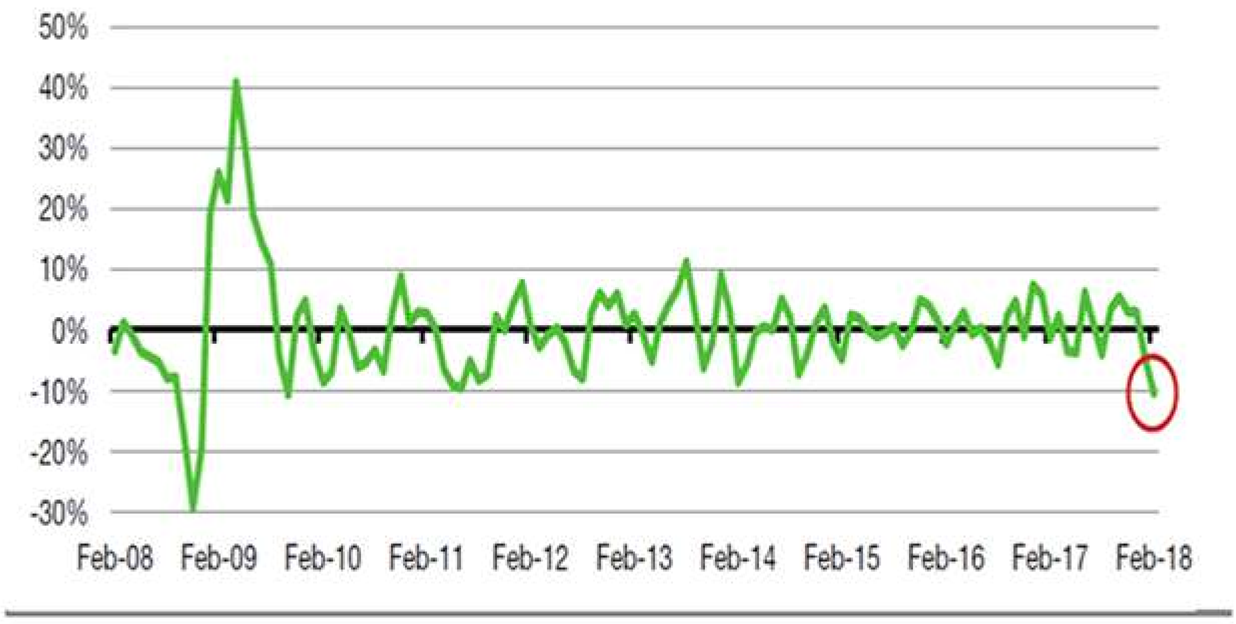
Headline Numbers

Recession alert!

Over the last week or so, I've noticed a slightly worrying undertone emerging in some macro analyses - that the US might not be as strong as well think and that inventories are building. Barclays for instance last week produced a note that headlined with the following observation: the banks own proprietary global manufacturing index "oftened for the second consecutive month in February after reaching a multi-year highest level (0.81) in December 2017". The sentiment was mixed across the major economies, with the US ISM index printing significantly above expectations while euro area, the UK and China indices all demonstrated negative dynamics. Crucially Barclays noted that "at the subcomponent level, global new orders declined in February to 0.61 (-0.5 pts) while inventories strengthened further, reaching 0.66 (+0.13 pts)."

Then last week I saw this note from analysts at Liberum - their in-house early cycle indicator (ECI) has in the past flagged a major US industrial recovery in January 2016 but currently, it's showing a *"red flag for the end of the cycle or at least a mid-cycle slowdown. Bottlenecks are causing companies to buffer inventories and will lead to sales slowing and costs increasing. Liberum is not attempting to predict, nor call a recession, however, based on 50 years of data, on each of the last six occasions when US inventories increased to above 55, on average US new orders to inventories ratio's fell below 1.00 within six months - indicative of an industrial recession". In addition to this US weakness, Liberum also warns about signals coming out of China - "Over the past five months, Chinese orders have fallen at the fastest pace since the first half of 2011 and the first half of 2012, which presaged a slowdown in Chinese GDP growth from 10% and 8% respectively. Europe fell from high levels but remains robust."*

Liberums ECI indicator



Source: Liberum, Factset

So, given these slightly concerning observations, let me paint a nightmare scenario. The US must be close to late cycle and thus starts to slow down. The US Fed pushes interest rates too high, too quickly. The US also trips into a trade war with China, while the ECB also starts to pull back its bond-buying activities, so it can arrest the appreciation of the Euro. US T bond yields on 10 years go above first 3% and then 3.5%. All hell breaks out in the stockmarkets as investors start to panic. They move from worrying about inflation to the panicking about a slowdown. On balance I don't think this scenario is likely neither do I think it's completely far-fetched. On balance I'd give it a 20% probability but that number has been rising for the last few months.

Measure	Value as of 12th February, 2018	Value as of 8th March, 2018
UK Government 10 year bond rate	1.62%	1.46%
GDP Growth rate YoY	1.50%	1.40%
CPI Core rate	2.50%	2.70%
RPI Inflation rate	4.10%	4%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.54%	0.60%
Government debt to GDP ratio	89.30%	88%
Manufacturing PMI	55.3	55.2

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Bank CDS options

Not unsurprisingly given the recent spike in volatility, pricing for credit default swaps has risen pretty much consistently across the board over the last month with none of the major banks bar Natixis avoiding the price hikes. Some banks such as Rabobank some saw particularly sharp increases but that's off very low CDS rates. HSBC and UBS remain top of the table, with the lowest rates for their credit default swaps.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	25.2	41.25	10	-43	A -

Barclays	27.14	49.55	12.4	-27	A
BNP Parabis	9.88	27.03	12.95	-69	A
Citigroup	19.7	48.82	20.4	-13.2	A
Commerzbank	21.57	59.52	16.1	-45	A+
Credit Suisse	22.32	58.26	29.77	-46	A
Deutsche Bank	49.37	94.6	35.51	-31	A+
Goldman Sachs	21.79	60.19	18.97	-17	A
HSBC	10.42	24.02	12.88	-59	AA-
Investec*	n/a	188	n/a	n/a	BBB
JP Morgan	19.27	45.11	23	-4	A+
Lloyds Banking Group	9.33	40.31	10.83	-33	A
Morgan Stanley	21.74	57.79	17	-16	A
Natixis	9.77	26.8	-1.07	-64	A
Nomura	13.63	42.03	1.53	-42	A-
Rabobank	9.84	28.09	16.5	-14.04	AA-
RBC*	n/a	78	n/a	n/a	AA
RBS	27.33	46.57	9.46	-44.7	A
Soc Gen	10.47	28.19	12.38	-67	A
UBS	10.6	25.18	23	51	A

Source: www.meteoram.com 2nd March 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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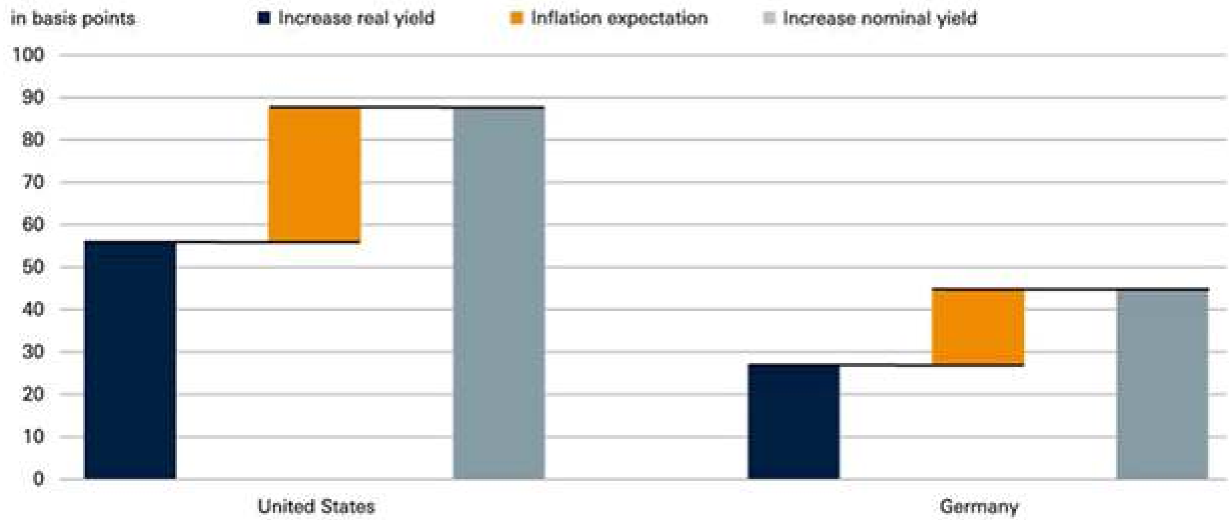
Government Bonds

Bond investors, stay calm, don't panic... yet

Investors shouldn't be remotely surprised by the fact equity and bond markets are closely intertwined, with interest and inflation rates as some of the primary drivers of both risk and returns. In fact, in equity markets there's a whole school of investors who believe that the direction of interest rates drives equity market returns - this coalesces around something called the Fed Model. We'll look at the relationship between bonds and equities later in this report. In the meantime, it's also worth observing the close relationship between inflation rates and bond yields. Nominal yields for bonds increase for a number of reasons of which two stand out - increases in the real yield (because of an expected increase in interest rates as the economy strengthens) as well as inflation expectations (derived from the pricing of inflation linked securities). Analysts from Deutsche Bank recently looked to break out the impact of these two, inter-related, drivers on bond prices. Their challenge? What's driving bond prices higher - the increase in real yields or worries about inflation. The answer is in the chart below.

Change in sovereign bond yields*



Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 2/15/18
* 10-year maturity, since September 7th, 2017

According to the Deutsche analysts the recent surge in US government yields is predominantly being driven by "rising real yields, which are commonly taken as a proxy for growth expectations. A pickup in inflation expectations has contributed as well, but to a much lesser extent. It is a similar picture for German Bunds".

So what message does the German bank divine from the bond markets? "For now, the pick-up in yields reflects stronger growth and not so much rising inflation... This is consistent with our base case of a moderate acceleration. With the U.S. labor market as tight as it has now been for a while, it was unwise to ignore inflation risks before the recent market correction. Based on the data so far, it would be equally unwise to expect a swift acceleration... inflation expectations appear well anchored."

Fixed Income - what happens when yields spike upwards?

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

One of the drivers behind increased stockmarket volatility is the yield on 'risk-free' government securities, and especially the yield on ten-year US Treasury bonds. As these bond yields grind higher, all things being equal, we might expect more uncertainty in stock markets - higher yields imply that the risk-free rate from cash is becoming more attractive. But this relationship isn't a simple, binary one.

At low Treasury rates - probably below 225 basis points - there's not much impact at all from an increase of say 10 to 20 basis points. Those worries start to snowball though once key thresholds are reached - with 3% for US Treasuries a favourite marker. Looking at the chart above it becomes clear that that 3% level isn't too far away. The good news though is that according to a recent Bloomberg article the 3% barrier may hold for the time being. The news service looked at trader's speculative position on Treasury yields and found that the 3% limit might not be crucial at all. Bloomberg found that looking at open interest data there is a "large number of March puts at a 120 strike price, equivalent to a 2.95 percent yield. Another large accumulation of puts comes at a 118 strike price in April, equivalent to a 3.1 percent yield on the 10-year security... In other words, those bond bears ready to watch the Treasury market falter at 3 percent may be in for a slow grind."

But even that 3% barrier might not be end of the world according to Jonathan Golub, chief U.S. equity strategist at Credit Suisse. He thinks that the yield level to watch out for is actually 3.5% - or at least that's what he told investors in a recent note to clients. "Everybody says that rising yields are bad, but if you put aside that preconception and look at the data, you see that it's not the case... If rates rise from 3 percent, that's a good thing."

Golub's analysed returns from the S&P 500 for a period starting in 2014 to the present and estimates projected US equity returns after focusing on rising interest days - at yields of below 2% the equity markets return 62%, at between 2 and 3% they return 36%, while between 3 and 4 there's a small decline of just 3.6%.

The bad news though is that once we get to 4 to 5% bond yields, the S&P 500 could drop by as much as 40%. According to Golub what really matters is the trajectory of the yields after 3.5%. If rates stay unchanged at this level, the S&P 500 probably won't react. The further away yields rise from the 3.5 percent threshold, the bigger problem it becomes. "If yields rise from 4 percent, that's a problem," he said. "If rates rise from 5 percent, that's a bigger problem."

CDS Rates for Sovereign Debt

Country	Five Year
France	17
Germany	9.37
Japan	20.32
United Kingdom	16.72
Ireland	22.3
Italy	99.49
Portugal	70.75
Spain	41.37

Eurozone peripheral bond yields

Country	February 2018	March 2018	Spread over 10 year
Spain 10 year	1.46%	1.40%	72
Italy 10 year	2.02%	1.98%	134
Greece 10 year	4.20%	4.16%	352

	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

Energy sector under performs… as does the FTSE

Energy stocks matter for UK equity investors, especially those looking to focus on the blue-chip equity income stocks in the FTSE 100. Royal Dutch Shell is the largest listed business by market capitalisation, worth £190 billion, while BP comes in at number 5 with a market cap of £95 bn.

Both energy majors also pay out a very generous dividend yield- Shell's current yield is 6.3% while BP pays out a yield of 6.4%. Most of the other ten biggest stocks in the FTSE 100 pay out a much lower yield - the nearest (in terms of percentage yield) are Vodafone (at number 11) with a yield of 6.4%, Rio at 5.7% and GsK at 6.1%. By comparison, the exposure of the US benchmark - the S&P 500 - to energy stocks is much lower at 5% of overall market cap, and proportionately much lower dividend yields.

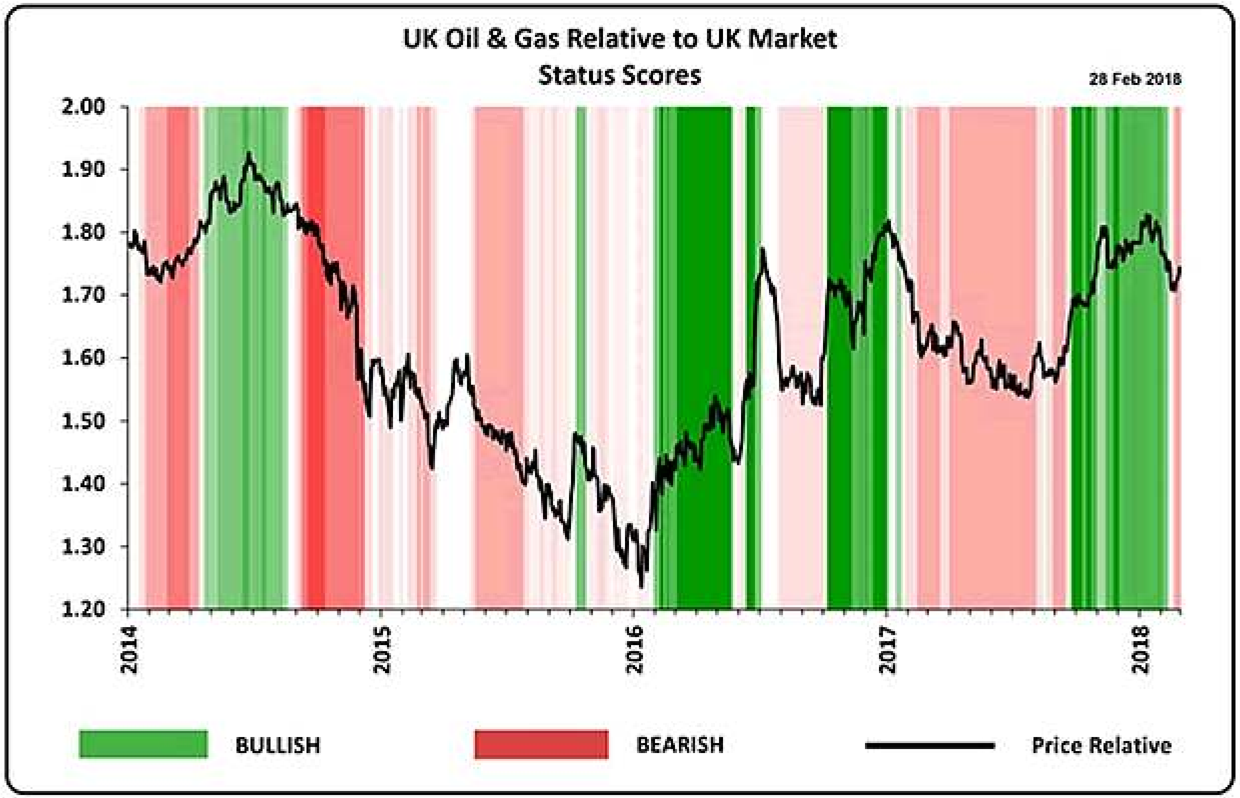
So, anyone interested in the future of UK equity income needs to keep a wary eye on the energy sector - and the price of oil. Over the last few years, I've been fairly optimistic about energy stocks but the first few months of 2018 have left me wondering whether I'm missing something. Index firm S&P Dow Jones only a few weeks ago put out a note looking at returns from its various European indices and surprise, surprise, the energy sector was in the dog house (although prize mutt was real estate). Over the 1 month to the end of February energy stocks within the S&P 350 Europe index were down -4.07%, whilst over the quarter to date that loss was slightly less at -3.53% - over the last 12 months, by contrast, energy stocks in Europe had notched up a gain of 7.86%. I find this all bit perplexing because energy businesses should be in good shape considering the chart below - it's from Sharepad and shows prices for Brent over the last two years. In recent weeks prices have certainly edged backwards - as I write they are around $63 - but this is still well above where most people in the industry thought they'd be in 2018. Most of us expected oil prices to struggle to hit the top of the $40 to $60 range, whereas in recent months some have been wondering whether the new range is between $60 and $80.

In fact, back in mid-January equity analysts at Morgan Stanley observed that "Backwardation is a strong buy signal for oil and oil equities. The oil market has recently moved into backwardation, and analysis from our oils team suggests this is positive for both oil and oil equities. Our new oil price forecast of $75bbl by 3Q18 suggests the Energy sector could enjoy a 15-20% re-rating." The chart below from Morgan Stanley (in mid-Jan) does most of the explaining required. Put simply backwardation should be good news for energy prices and thus energy stocks.

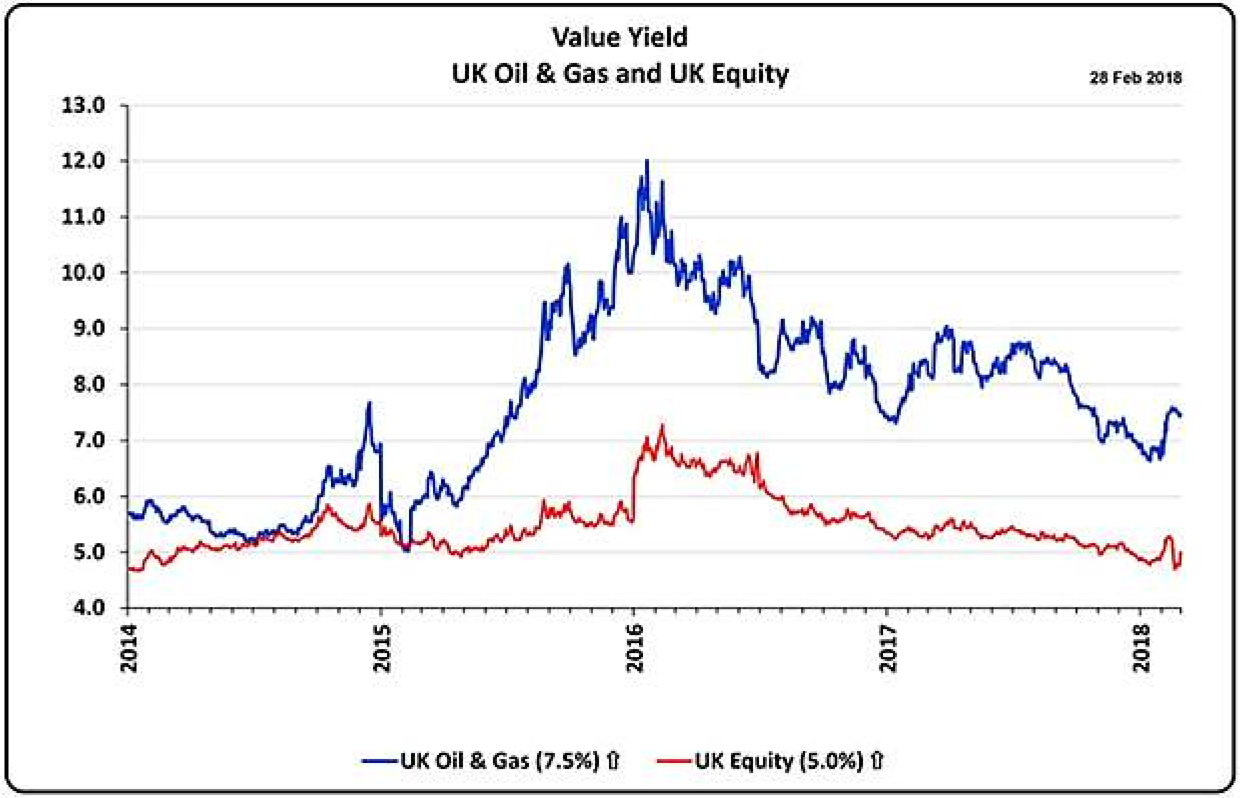
Exhibit 1: The Energy sector performs much better in periods of backwardation than contango

Source: Bloomberg, Morgan Stanley Research

So, it's against this backdrop that a note recently appeared from Charles Ekins who runs a small firm called Ekins Guinness. He runs a multi ETF fund which uses his own asset allocation model pioneered many years back when he was CIO at ValuTrac. Combining technical and fundamental measures, Charles moves back and forth between different sectors, including energy. He observes that "the Oil & Gas Sector has underperformed against the UK market since early January (black line falling). This loss of relative momentum has caused our Model to go to a modest underweight again" - see his first chart below.



But Charles warns that this underweight position "may only be temporary because relative Value Yield for the UK Oil & Gas Sector (blue line) is higher (i.e. more attractive) versus the UK market (red line), although the value premium is lower than previously. Note how the peak in early 2016 coincided with the start of major outperformance" - see his second chart below.



My own hunch is that the oil price will be supported by the following factors in the near term:

- Strong global growth
- Strengthening growth rates in the oil-hungry developing world
- Signs of success for OPEC in its negotiations with the Russians to ‘manage' the price of oil steadily higher
- US unconventional oil and gas is ramping up growth but not by quite the same quantum as in previous years.

And what might this mean for UK equity investors? With a fair wind, we could see the finances of many leading E&P and integrated energy majors strengthen, with increased dividends and cash earnings. If prices do stay above $60 a barrel it's increasingly reasonable to expect oil & gas companies to be able to grow shareholder distributions meaningfully for the first time in a decade. Some investors reckon that the super majors such as Shell and BP could even raise distributions by 40%, with mid and large cap producers aiming for a dividend increase of as much as 80%. That could be the positive news that the UK equity markets are in desperate need of.

Index	February	March	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	125.8	126.4	3400	123
FTSE 100 (Dec 17)	294.3	301.7	7200	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-1.67	-2.23	-3.23	-2.47	11.16	23.59	7157.84
S&P 500	1.68	3.41	10.62	15.13	76.58	101.59	2726.8
iShares FTSE UK All Stocks Gilt	0.49	-1.09	-3.64	-2.19	10.98	10.27	12.9675
VIX New Methodology	-35.95	74.8	53.77	55.11	35.99	-6.87	17.76

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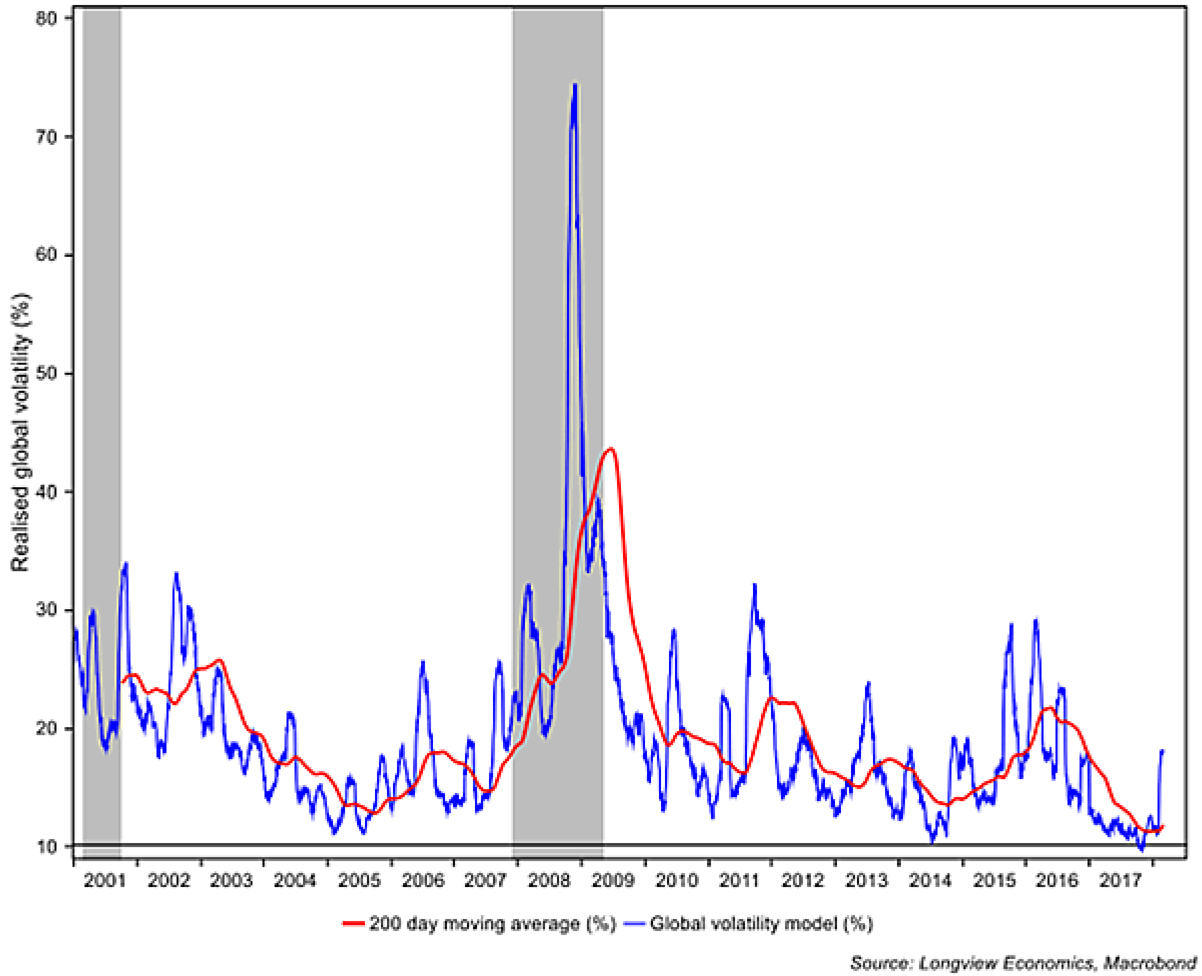
Volatility

As we've already noted in this publication last month, February represented a (not unsurprising) reversal of the recent relentless market rise and a return to normal market volatility. Thus, its' worth putting this volatility from last month in some context - which also serves the purpose of making one realise just how abnormal 2017 actually was. The chart below is from research firm Longview Economics and shows a composite of 150 global asset prices over the last 2 decades. What's clear from looking at this chart is that the outbreak of market turbulence in the first few weeks of February was just a move back towards the average levels that existed well before 2017. If that is the case we should reasonably expect further outbreaks of market fear and loathing, probably prompted by sharply increasing interest rates and T bond yield pushing back above 3%. The continued decline in the value of the dollar might also prompt fresh volatility.

But for me the $64 billion question is whether the central banks care about repeated upsurges in stockmarket volatility? If they don't worse may still be to come? There's certainly growing evidence that money market operations by both the US Fed and the ECB are beginning to slow down or even wind up, although paradoxically the Bank of England seems to currently boast the least hawkish set of policies with no real evidence of a winding down of QE. Will the central banks stop monitoring stockmarket volatility and just what they think is right - and slim their balance sheets? We're about to find out in the next six months.



Measure	March Level	February Level	January Level	December Level
Vstoxx Volatility	16.75	27.52	10.97	12.3
VFTSE Volatility	13.59	21.14	9.16	7.09

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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 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 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 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.

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