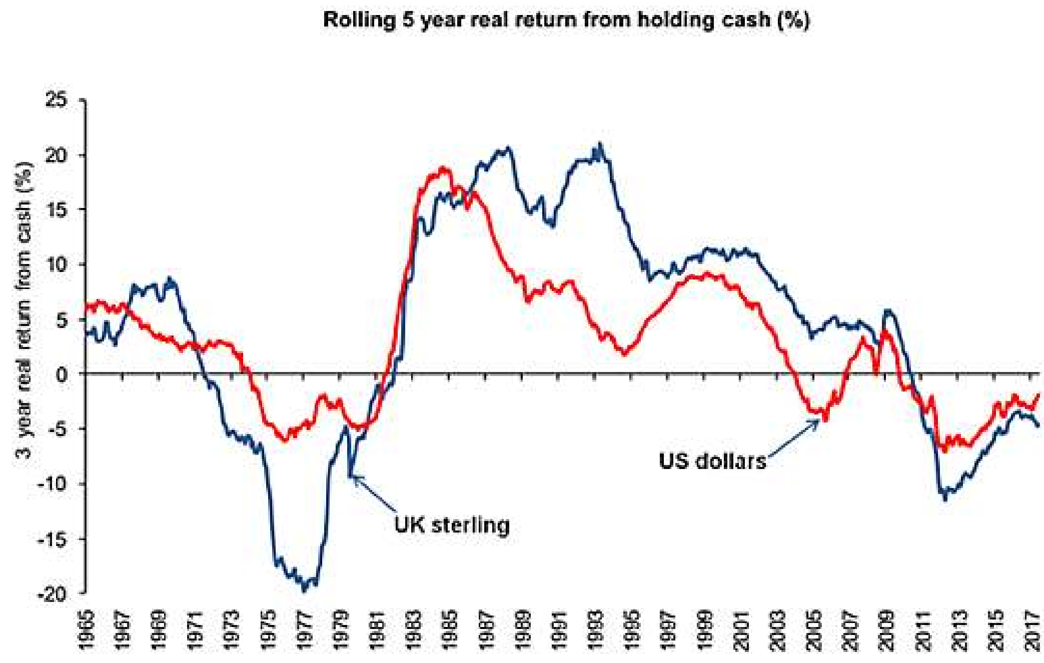
UK Structured™ Products Association

Monthly Market Report

August 2017

With commentary from David Stevenson

Talk to most investors in the big institutions at the moment and they're obsessed with one word - normalisation. As in the expectation that inflation and interest rates will "normalise to long term trends". The idea here is that we'll see reflation and interest rates back above 3 or even 4% which would have huge implications for all investors, not least those in structured products. Suddenly cash would look a good deal more appealing. The chart below is from French bank Societe Generale and shows the long term real returns from investing in cash - increasing rates might radically improve the attractiveness of cash. Increased rates would also presumably increase market volatility.



Source: SG Cross Asset Research/Equity Quant, GFD

But the problem with this normalisation thesis is that I don't buy it. Sure, inflation rates have increased in the UK and interest rates might peak at 2.5% in the US but I maintain that any push above 3% for inflation or interest rates is likely to be short lived - and followed by an almost immediate asset price fuelled slump. Here's my own take on what might happen next!

- Normalisation will mean a maximum interest rate of 2.5% before panic sets in and rates are dragged lower again. Any attempt to push rates back up to normal long term levels will be defeated by massive disinflationary pressure son the global economy
- The ECB will absolutely avoid strangling the putative Eurozone recovery. What no one wants is another example of the Bundesbank throttling any recovery in favour of continued austerity
- Governments around the world will be pushed into austerity containment i.e. attempting to unwind austerity measures. The populists on both the left and the right will demand action.

- All the current hype about unwinding globalisation and slowing down technology is complete hype and baloney. The policy makers stand no chance of doing anything other than controlling the worst side effects. The pressures affecting labour rates (technology and weak trade unions) will show no sign of abating.
- Inflation will not increase substantially. The disinflationary pressures are so huge and unending that any hope of sustaining core rates above 3% are doomed to failure.
- As central banks try desperately (and unsuccessfully) to wind back in their balance sheets - largely using rhetoric and nothing else - national government's will become much more active. Both developments risk major volatility as policy makers try and find a balance.

For me, China is key. If the "communist" superpower can push on with stoking up growth, everyone will be happy. But at some point, this credit fuelled binge must finish - and the painful restructuring stuff start to happen. **The next shock will come from China and Asia.** This month we explore this theme in a little more depth on these pages!

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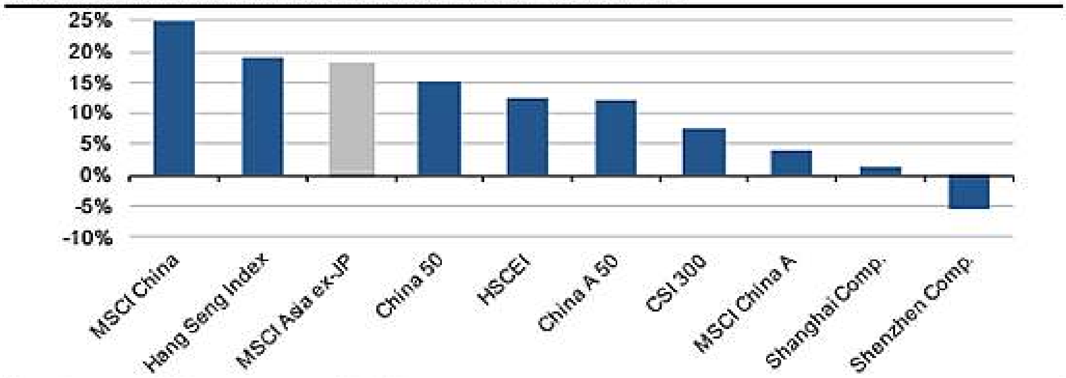
Headline Numbers

Investors are being dragged - arguably kicking and screaming - towards a better understanding of the internal dynamics of China and its local markets. If China has a problem in the next few years, so will we all. China is now integral to the global capital markets and investor's will need to work out where they stand on key market developments.

A few weeks ago, for instance, Chinese investors enthused over the news that the index firm MSCI was going to include China A-shares in the widely followed MSCI EM index for the first time. According to David Raper, Asia ex Japan portfolio manager over at fund manager Comgest "including China A-shares in the MSCI EM Index is pivotal for the future of the emerging markets asset class and is a much needed acknowledgement of China's efforts to open its domestic equity market to foreign investors. Today China is a dwarf in international equity indices. The MSCI index decision has the power to change that position and the decision is not a question of if, but when".

Chinese equities have had a decent start to the year, so any decision to include A shares in the index might help push local shares higher. Overall, depending on your benchmark (MSCI China and beyond) one could argue that China equities have either underperformed or outperformed other Asian equity markets. According to Societe Generale analysts over the year to date, the Shenzhen composite index is down 6%, Shanghai composite up 1%, CSI 300 up 8%, HSCEI up 12% and MSCI China up 25% while MSCI Asia has risen by 18%. This divergence in returns almost completely depends on which index you choose - and how that index captures flows of money into and out of China. See the first chart below for more details on recent returns from Chinese equities.

China equity indices performance (Total return) – year to date



Source: Datastream, SG Cross Asset Research/Equity Strategy

On shore equities are, arguably, much more influenced by domestic individual investors. These markets are much more likely to be influenced by government concerns about debt, over trading and tighter regulation. By contrast offshore equities tend to benefit from southbound flows, which currently represent 10% of the traded value of HK-listed stocks. These varying pools of capital are reflected in the individual indices and their composition.

According to SG analysts "unlike the HSCEI, MSCI China includes more than just H shares but also 'high growth' consumer-related stocks, consumer discretionary and technology names which together constitute close to half of the Index currently. While more representative of the Chinese economy, valuation is becoming demanding. MSCI China trades at 14.7x trailing earnings, a 90%+ premium to the more SOE-oriented HSCEI index. On average consumer, discretionary and technology trade at 35x trailing earnings". The next table below spells out the various individual indices and their underlying composition.

Key features

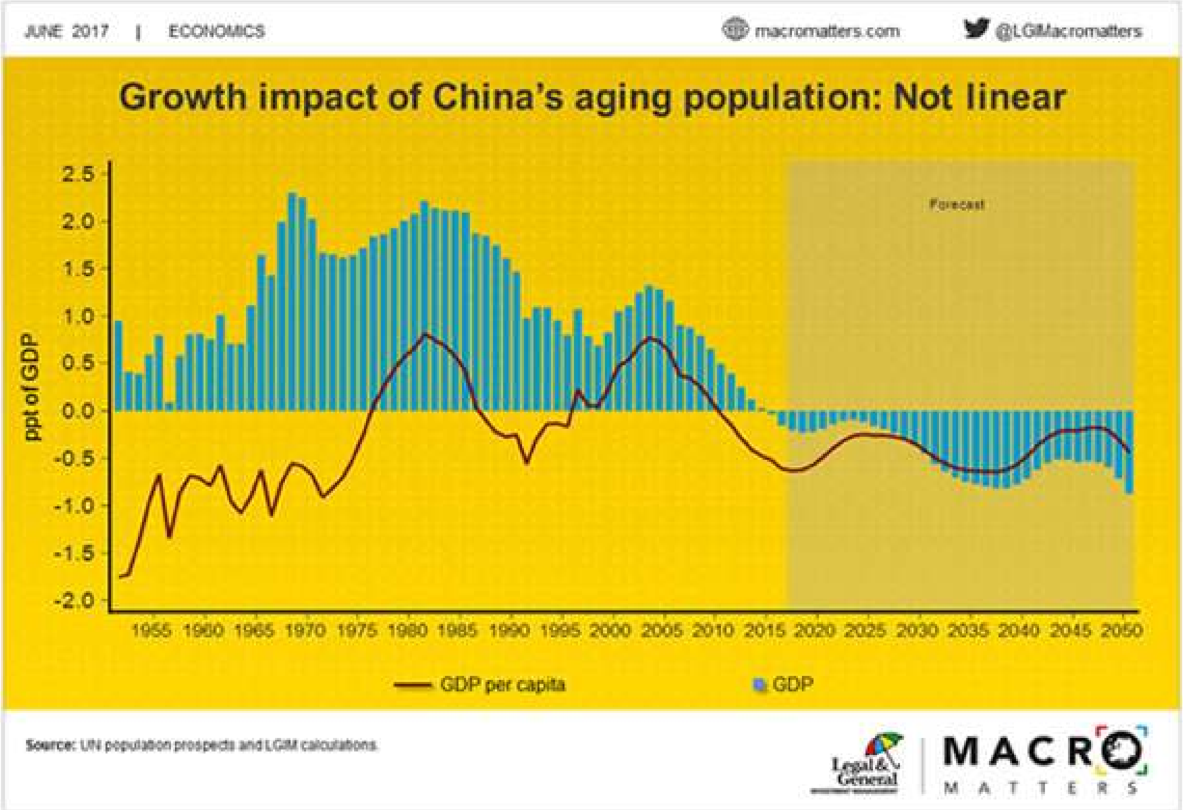
	Bloomberg Ticker	Shares	Listing	Fin & Tech Weighting		Currency	No. of stocks	FF Market Cap
				Financials	Technology			(USDbn)
HSCEI	HSCEI	H-shares	Hong Kong	71%	0%	HKD	40	428
MSCI China	MXCN	H, Red, P	Hong Kong and NY	25%	35%	HKD	149	1496
Hang Seng Index	HSI	HK, H, Red, P	Hong Kong	47%	13%	HKD	50	1173
China 50	XIN0I	H, Red, P	Hong Kong	49%	10%	HKD	50	746
CSI 300	SHSZ300	A, B	Shanghai and Shenzhen	35%	9%	CNY	300	1184
Shanghai Comp.	SHCOMP	A, B	Shanghai	28%	4%	CNY	1315	1421
Shenzhen Comp.	SZCOMP	A, B	Shenzhen	4%	19%	CNY	2009	1333
Chinext	SZ399006	A, B	Shenzhen	0%	44%	CNY	356	139
China A 50	XIN9I	A	Shanghai and Shenzhen	65%	1%	CNY	50	548
MSCI China A	MXCN1A	A	Shanghai and Shenzhen	24%	10%	CNY	865	1713

Source: Datastream, Bloomberg, SG Cross Asset Research/Equity Strategy

Deciding which index to use for tracking developments in Chinese equities is one thing, but the more important task is to keep track on the big macro stories coming out of the country which will dominate investor news flow over the next few years.

Two narratives dominate at the moment. The first is the upcoming autumn CCP meeting at which President Xi is likely to consolidate his control of the party and the country. Part of the logic behind this centralization is that the Communist Party leadership are trying to develop new policies to keep growth rates up whilst also clamping down on credit bubbles - the second narrative obsessing foreign investors.

According to Erik Lueth, Global Emerging Market Economist at Legal & General Investment Management that means investors are likely to encounter three myths about China's growth slowdown: "The first myth maintains that China's growth will slow significantly on the back of its ageing population. This is correct, if you take a long-term view, but not over the next five years or so. China's labour force is shrinking which should subtract ¼-½ percentage point from growth in 2017. But, as shown in the chart below, between 2018 and 2023 population ageing will subtract slightly less from growth, thereby actually providing a demographic tailwind in the short term."



"The second myth is that productivity growth will slow as China rebalances from the high-productivity industrial sector to the low-productivity services sector. But, if the experience of China's Asian peers, such as Japan, Korea, or Taiwan, is anything to go by, the share of industry will remain stable around current levels. Most labour will move from the low-productivity agricultural sector to the higher-productivity services sector, thereby boosting productivity."

"The third myth is that the growth of China's Asian peers slowed when they were at China's level of development, as measured by GDP per capita. This is true for Japan and Singapore, but not Taiwan and Korea. It is also questionable whether GDP per capita is an appropriate measure for China's level of development. In terms of urbanization, for example, China is today where Japan was in 1953, which would imply higher growth rates in the future."

"Despite the three myths, we also believe that China's growth will slow from here, but for a very different reason. The key headwind is a credit bubble of historic proportions, which could weigh on growth as the economy deleverages. The distinction isn't merely semantic. Credit cycles are very long, but they are still cycles, while the three myths refer to trend growth. However, the fact that China still has a lot of underlying catch-up growth should help when it eventually goes through its tough deleveraging process."

Measure	Value as of 5th June, 2017	Value as of 14th July, 2017
UK Government 10 year bond rate	1.04%	1.29%
GDP Growth rate YoY	2%	2%
CPI Core rate	2.40%	2.60%
RPI Inflation rate	3.50%	3.70%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.29%	0.29%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	56.7	54.3

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Bank CDS options

Something quite remarkable seems to be happening in the bank CDS spreads market. Pricing has quite literally fallen off a cliff, and rates are near all-time lows for many European institutions. Over the last month we've seen huge price falls for banks as varied as HSBC, Natixis, Santander and UBS. Only two institutions registered an increase in prices - Commerzbank and Investec. Every other bank has seen a fall in pricing. In fact, looking at 1 year CDS spreads, we now have single digit rates for UBS, HSBC, Rabobank, BNP Paribas, SG and Lloyds Bank.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	18.95	45.97	-34	-61	A -
Barclays	13.52	45.9	-23	-66	A
BNP Parabis	8.67	36.6	-19	-56	A
Citigroup	18.96	51	-12	-36	A
Commerzbank	17.09	73.56	2.81	-42.23	A+
Credit Suisse	16	69	-2.34	-57	A
Deutsche Bank	24.92	82	-13.77	-64	A+
Goldman Sachs	23.07	65.42	-12	-32	A
HSBC	6.31	29.49	-12	-32	AA-
Investec*	n/a	190	n/a	n/a	BBB
JP Morgan	18.04	45	-12	-20.98	A+
Lloyds Banking Group	-9.06	40.23	-19.75	-65	A
Morgan Stanley	22.15	60.95	-12	-36	A
Natixis	14.40	38.73	-29	-56	A
Nomura	12.28	41.05	-1.84	-58	A-
Rabobank	6.77	32.47	-14.55	-55	AA-
RBC*	n/a	55	n/a	n/a	AA
RBS	14.09	54	-23	-63	A
Soc Gen	8.55	38	-17	-53	A
UBS	7.76	27.86	-29	-60	A

Source: www.meteoram.com 14th July 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

The decision by the US Federal Reserve to raise interest rates again has inevitably kicked off an increasingly lively debate about what happens next to monetary policy and by default financial markets. Two weeks ago, the US central bank voted to raise its key rate target to a range of 1% to 1.25%, the highest level since 2008.

How many more increases are on the way and what does this shift in tone mean for the banks related but separate quantitative easing programme?

According to analysts this week at Morgan Stanley, they don't think the Fed is done yet. "Financial conditions have eased since late last year despite three rate hikes - see chart below. Our economists think the Fed now pauses before hiking in December, and then hikes four more times in 2018. While this path is far more aggressive than market pricing, we think it's consistent with the (far less radical) idea that conditions should be tightening in a tightening cycle".

The MS economists think that these big increases in 2018 will coincide with what they see as the bigger challenge for markets - a shrinking balance sheet. "The Fed will start slowly (in October), but by early 2018 will be reducing securities by up to US$50 billion/month. This reduction will be a steady drumbeat in the background of markets, and coupled with ECB tapering, and the BoJ exiting YCC, it will mean quite a bit of tightening that converges in (early) 2018. We think it is too soon to be defensive, but believe our US rates strategists are right to forecast a flatter yield curve; challenges are coming."

Over in Europe, analysts at asset management house Lyxor reckon that their central bank is at least two steps behind, with the Bank of Japan also watching carefully. Their central view is that the ECB is in no rush remove any monetary accommodation. According to Lyxor "the ECB and BoJ actions seem to have helped rekindling domestic activity pulses and tightening labour markets. However, inflation pulses are far from assured on a recovery trajectory yet. As was true in the US, wage growth looks to have suffered globally from deep labour market wounds, and could take time to recover."

This caution, the Lyxor analysts reckon, means that the ECB will want to keep yields low. They argue that investors need to be cautious. "First, the ECB's rhetoric looks now tuned on dovish/hawkish gyrations to keep a lid on rates. Second, with the improving political landscape, risk premia have further tightening potential...we believe that the reflating ECB and BoJ would see no point in sapping the progress achieved at arm's length over the past three years. We think that both central banks will adjust their tapering to maintain currency competitiveness. The ECB may announce in December the initiation of a slow tapering (which could run throughout 2018), one step behind the Fed's balance sheet reduction. The BoJ could remain two steps back, and taper its QQE only in 2019."

In this scenario - with central banks keeping tabs on each other's moves - monetary normalisation will proceed step by step according to Lyxor, with currency competition to the fore, forcing the US to "export its growth". In these circumstances, the USD should stay strong.

UK Government Bonds 10-year Rate 1.29%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	21
Germany	14.65
Japan	26.85
United Kingdom	21.48
Ireland	38.93
Italy	148
Portugal	194
Spain	69

Eurozone peripheral bond yields

Country	June 2017	July 2017	Spread over 10 year
Spain 10 year	1.57%	1.63%	105
Italy 10 year	2.27%	2.26%	168
Greece 10 year	6.04%	5.33%	475

	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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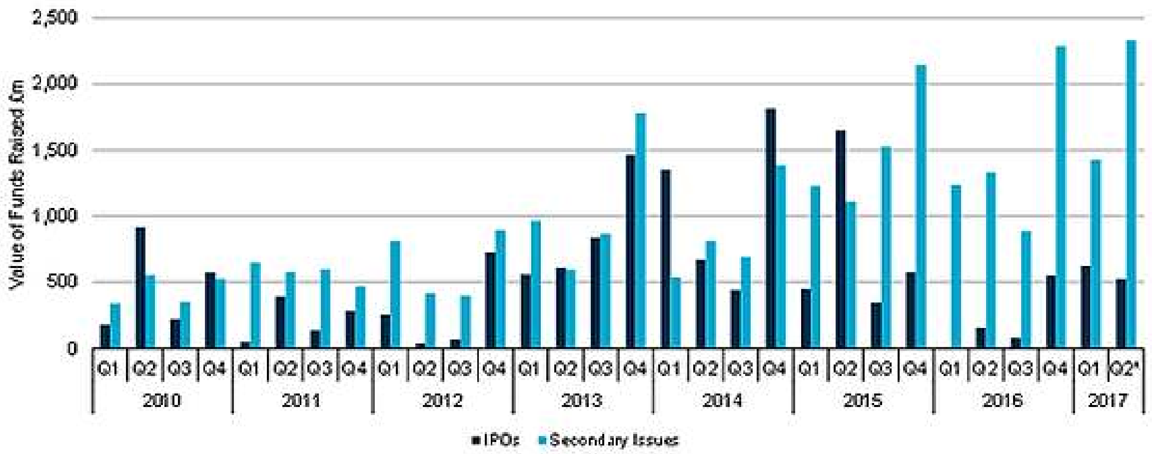
Equity Markets and Dividend Futures

A few weeks back French fund management firm Amundi held its annual investment congress in Paris. It's a useful exercise to listen in on this slightly rarefied debate because it sheds light on what the big institutional investors (plus some big sovereign wealth funds) are thinking about at the moment. Unsurprisingly for such an elite audience, populism dominated the debate. Key note speakers observed that interest rates are likely to increase to fund extra government spending. Inflation expectations might also rise, making bonds less attractive. As volatility in equity markets increased, investor's might be tempted to invest money in more alternative ideas.

But two big sovereign wealth funds at the event were very strident about their fears for illiquid assets. One investor from Singapore warned that investors are increasingly not being paid enough for taking on illiquidity risk. He suggested that the fund was "finding it increasingly difficult "to find good value investments with many of the best opportunities "bid away". This message was echoed by a manager from Abu Dhabi who warned that anyone contemplating investing in illiquid assets afresh would "find it very difficult to get involved. Be careful of doing it now...valuations looks stretched".

My own view is that this sensible caution should be broadcast to London based investors and their advisers, who've been pumping billions of pounds into new listed equity funds on the London stockmarket. My own sense is that we might be reaching the point of 'Peak alternatives'. As more and more niches find their way into the public markets - arguably less well equipped to deal with the volatility of underlying illiquid assets than long term sovereign wealth funds - the chances of a nasty surprise increase by the day. The chart below, from fund analysts at Numis, backs up my worry. Investors are flooding the equity markets with new money for funds - both existing funds via placings and new funds via IPOs. According to Numis "£1.448bn has been raised by IPOs YtD, with a further £3.762bn via secondary issues." For H1 2016 the numbers were £159m IPO and £2,573m secondary (IPOs tough due to Brexit vote) and 2016 as a whole was IPOs £787m (6 by number) and £5,746m secondary.



Source: Numis

Index	June	July	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	116.5	116.8	3528	115.7
FTSE 100 (Dec 17)	285.3	285.8	7393	n/a

Name	Price % change						Close
	1 month	3 months	6 months	1 year	5 year	6 year	
FTSE 100	-1.16	1.17	1.03	11.14	30.84	25.51	7413.44
S&P 500	0.31	5.1	7.61	13.72	80.41	85.76	2447.83

iShares FTSE UK All Stocks Gilt	-2	-3.34	0.44	-4.81	7.59	21.28	13.01
VIX New Methodology	-4.99	-37.97	-11.84	-24.08	-40.86	-50.28	9.9

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Volatility

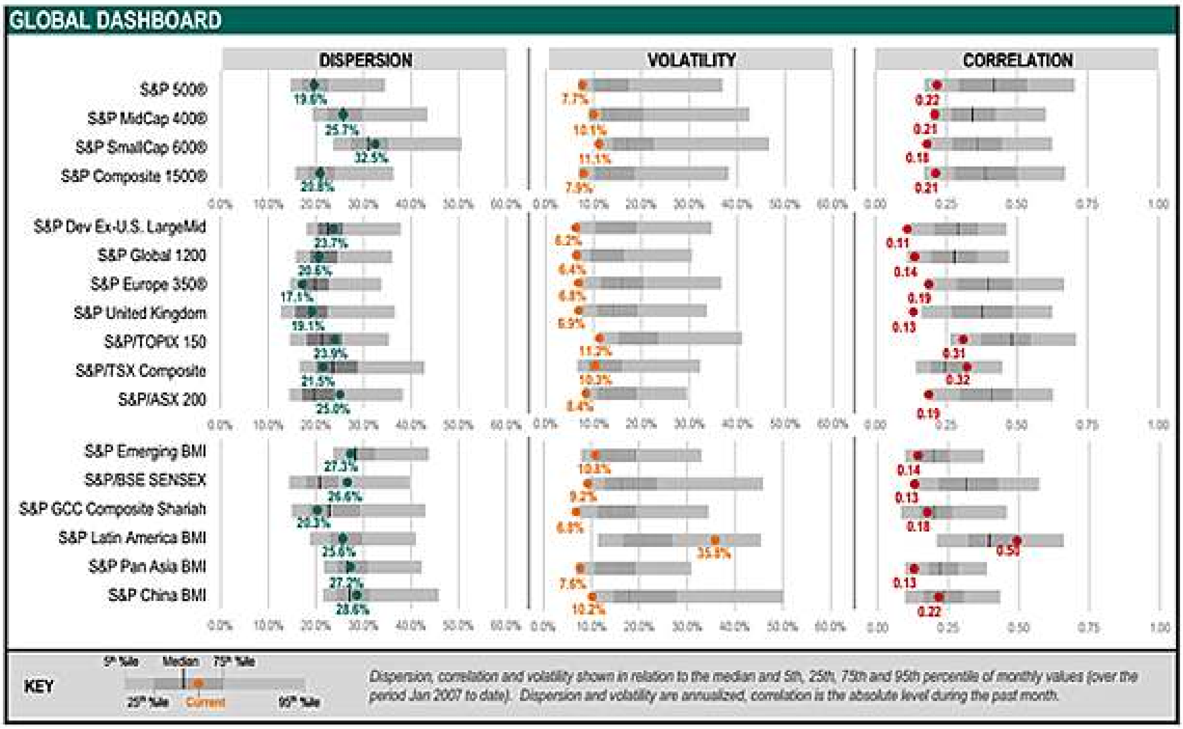
Over the last couple of months, we've seen big moves, downwards, in volatility again. Last month - June 21st to be exact - VIX, aka the market's "fear gauge" closed at its lowest level in 23 years at 10.75. Just as a side note the VIX recorded its lowest closing value in 23 years when it ended June 2nd at 9.75. One last noteworthy statistic. The VIX index has not risen above 12 for over a month.

According to Tim Edwards, Senior Director, Index Investment Strategy, S&P Dow Jones Indices these numbers indicate an "intensely relaxed" market. One of the exceptions was the British pound - the BPVIX was up closing at 8.64 as political uncertainty was generated by the start of Brexit negotiations and failure to form a majority government. The second exception was the Australian volatility measure, S&P/ASX 200 VIX which was also up, due to signs of a falling property market. The CBOE Gold ETF Volatility index also set an all-time low of 10.16 on June 16th.

Edwards also observes that "the sustained low volatility environment has provided a boon to volatility sellers; the S&P Daily Inverse Short Term VIX Futures index has tripled over the past twelve months. In signs that such outsized returns may be attracting more participants, the VIX futures curve is unusually shallow. Only 5% separates the price of the front future from that of the front-next."

This decline in volatility has presented huge opportunities for the right kind of investors. According to Edwards, the month of May might have been one of the best month's ever for stockpickers. He identifies a number of factors as headwinds for active fund managers. These alpha investors tend to do well in markets where there's a high level of 'dispersion' - the difference between winners and losers should offer significant rewards to those who make the right calls. A strong stock pickers markets also requires low correlations between different stocks and markets - according to Edwards the stock picker prefers his picks to reflect the that characteristics made them more attractive than their peers in the first place, as opposed to shared drivers. Lastly stockpickers also like markets with low market volatility - Edwards argues that "the stock picker who outperforms the market, yet is whipped around along with it, has not only a more stressful experience (or at least his clients do), but also is provided with a less clear signal of his skills".

The table below shows measures of dispersion, correlation and volatility in May for the major markets covered by S&P Dow Jones Indices. The charts place each measurement in their historical context: the level for the most recent month is the coloured dot; the light grey bars represent the middle 90% of all observations in the past decade, while the dark grey bars represent the middle 50%. A single black line represents the historical median. According to Edwards " in several of these regions, most notably in countries such as Australia and Japan, and in market segments such as U.S. small caps, as well as across the broad-based S&P Developed ex-U.S. Large/Mid BMI universe, benchmark volatility and average stock correlations stand at or near record lows, while dispersion has risen above average."



Measure	July Level	June Level	May Level	April Level
Vstoxx Volatility	12.84	13.33	14.45	19.54
VFTSE Volatility	9.9	11.6	10.33	12.7

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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.

Kind Regards,

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