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UK | STRUCTURED™ PRODUCTS ASSOCIATION

Monthly Market Report

August 2018

With commentary from David Stevenson

Trump takes on the Financial Swamp

A few weeks ago, I visited an excellent investment event - the Amundi World Investment Forum. Headline speakers always tend to include the great and the good of economics, politics and central banking. This years line up was especially strong, featuring a headline interview with a certain Janet Yellen, ex boss of the US Federal Reserve. There were no great revelations from her chat but it did get me thinking that in the great tsunami of Trump tweets, the US Federal Reserve has got off lightly. This very radical president is clearly determined to upend many hallowed conventions, not least on trade. What happens if he turns his fire on boring, technocratic central bankers? In fact, let's be very specific here. What happens if the Fed over reacts and pushes up rates too aggressively in the next year or so - to prove its hawkish, independent credentials. This could cause a scare which could slow down Making America Great Again.

Imagine the Fox headlines. Financial elite kill US jobs just as Trump delivers. One thing we do know is that in a fight between saving his reputation and attacking established institutions, Trump will always choose the former. His whole reason for existence is to unsettle the established order and the US Fed could become his next target. He could aggressively seek to emulate his role model Erdogan in Turkey and nobble the 'unaccountable' central bankers. My guess is that the Fed would probably end up giving ground which in turn would be met with real relief by Wall Street and bullish equity investors. But if this happens the message is that central bankers are not so independent after all. Arguably central bank monetary policy has increasingly acted as a substitute for fiscal policy and thus cannot remain detached from politics. You don't have to be a leftist to think that the mantra of central bank neutrality might not work in a populist era. But if this mantra does crumble, expect fiscal incontinence and surging inflation - followed by eventual crisis. And possibly even war, which is the handy get out of jail card for any populist looking to shore up their shredded credibility.

And just in case you thought I was being a tiny bit paranoid, I'd simply observe that in a closed press conference after the first day of the event, featuring three of the biggest beasts of economics - Joe Stieglitz, Ben Rogoff and Nouriel Roubini - all three agreed that they thought the risk of a confrontation with the Fed was very real and that we should be counting down the days. Time for Trump to drain the financial swamp and push equity markets even higher?

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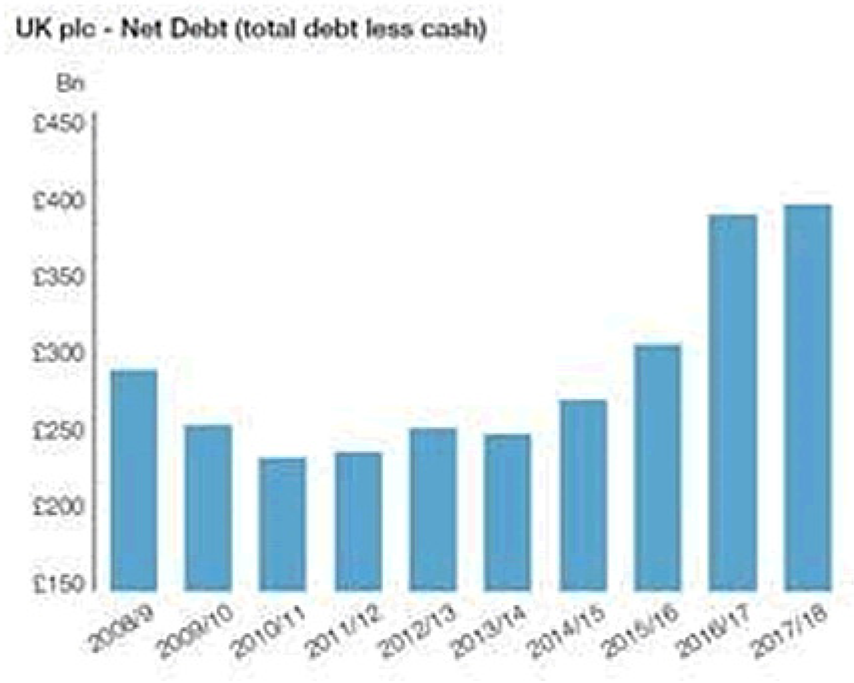
Headline Numbers

One theme I keep returning to in these reports is global indebtedness. In simple terms, its only heading one way - upwards. Andrew Lapthorne for instance over at SocGen has been banging on for an age about fast-rising US corporate debt levels. And, of course, US investors have taken no notice. Share prices have headed onwards and upwards. I'd presumed rather innocently that UK corporates were more immune to this debt binge but a report out recently from Link Asset Services suggests otherwise. Their UK plc Debt Monitor report reveals that:

- UK plc debts hit an all-time high of £390.7bn
- This is up 69% since the debt low point in 2010/11, an increase of £159.6bn
- Most of this increase (£122.6bn) has been in the last three years, helping fund dividends of £263bn at a time of low profitability for UK plc
- Oil borrowings have risen fastest, though the debt burden of oil companies is relatively low
- BAT is the UK's most indebted company; Persimmon has the most cash
- A high value of debt need not mean the debt burden is high - the debt/equity ratio helps solve the puzzle
- UK plc's debt burden is in decline after a post-crisis peak in 2015/16

Here's Link's summary - *"after years of rock-bottom interest rates, the debts of the UK's listed companies have soared to a record high of £390.7bn, easily surpassing pre-crisis levels, according to the new annual Link Asset Services UK plc Debt Monitor. In the vice of the credit crunch, companies had cut their borrowings by a fifth in just two years. But since the low point in 2010/11 net debt has jumped by a staggering £159.6bn. Moreover, most of this increase (£122.6bn) has been in the last three years alone. Over the same three-year period UK companies have paid their shareholders £263bn in dividends, despite profitability being squeezed and dividend cover levels (the relationship between profits and dividends) falling to record lows in 2016/17, before recovering this year. Faced with the demand from shareholders to continue their pay-outs and needing also to invest in new assets and acquisitions, companies had to increase their borrowings significantly."*



Who said that share buybacks were a positive idea? Drowning in debt, corporates are taking on more loans to increase dividend pay-outs. What could possibly go wrong?

Measure	Value as of 18th June, 2018	Value as of 13th July, 2018
UK Government 10 year bond rate	1.31%	1.27%
GDP Growth rate YoY	1.20%	1.20%
CPI Core rate	2.40%	2.10%
RPI Inflation rate	3.30%	3.30%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.63%	0.72%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	54.4	54.4

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Bank CDS options

A quiet last few weeks in the market for credit default swaps for big banks. Most 1 year and 5 year swaps increased marginally in price, probably reflecting more cautious global outlook. A few banks saw their pricing decline, notably Lloyds Bank whose 1 year swaps fell markedly in price. By contrast Deustche Bank's woes continued with its swaps increasing markedly in price - the 1-year swaps are back above 100 basis points and the 5 year swaps look like they might be heading back towards 200 basis points. Overall, it's also worth noting that 1 year swap rates for HSBC and Rabobank continued to increase - these are still seen as ultra-reliable, but they are now being challenged by UBS, Lloyds and Natixis who all boast markedly lower swap rates.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	30.97	52.77	7.63	13.24	A -
Barclays	34.87	63.65	20.76	40	A
BNP Parabis	24.1	55.44	0.27	53.58	A
Citigroup	22.04	56.96	2.31	10.69	A
Commerzbank	23.84	86	3	21.5	A+
Credit Suisse	29.26	85.21	2.39	24.31	A
Deutsche Bank	110.66	166.03	0.91	106	A+
Goldman Sachs	23.97	64.09	-4	-2.84	A
HSBC	13.92	35.07	20	20	AA-
Investec*	n/a	211	n/a	n/a	BBB
JP Morgan	19.66	46.99	-1	2.49	A+
Lloyds Banking Group	10.64	45.97	4.29	-16.37	A
Morgan Stanley	23.97	61.96	-0.46	1.54	A
Natixis	15.57	42.26	29.51	9.1	A
Nomura	12.19	42.76	3.32	4.85	A-

Rabobank	11.65	36.44	17.55	20.81	AA-
RBC*	n/a	63	n/a	n/a	AA
RBS/Natwest Markets	33.42	71.99	16.29	61.87	A
Soc Gen	24.69	56.67	-2.25	-7.43	A
UBS	17.74	43.85	6.55	59.37	A

Source: www.meteoram.com 6th July 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

As we head into the long summer months, volatility is on the slide and most investors are now focusing on the impending holiday. But one market continues to bob up and down violently. Energy and more precisely the price of oil. Every week brings some new big announcement that either rekindles fears of $100 a barrel oil - or warns of an imminent price meltdown. President Trump has taken to twitter to demand cheaper oil, but OPEC is doing its best to manage supply. Last month saw the latest meeting of its globetrotting energy bureaucrats - determined to keep bumper revenues flowing into state Treasuries. The big news was that the oil cartel agreed to add around 0.6m b/day of production from OPEC to the market. In country terms, most of that increase will probably come from Saudi, Kuwait, Iraq and the UAE. Against that it's worth noting there are significant OPEC supply risks in the second half of 2018 with further supply disruptions from Venezuela, Iran and Libya each capable of offsetting today's OPEC production increase. Overall OPEC remains committed to delivering a reasonable oil price to satisfy their own economies but also to incentivise investment in long-term projects.

What should we make of these gnomic prognostications from an investor point of view? I tend to defer to the experts at Guinness (who have a very successful global energy fund) who've been watching this space for aeons. Here's their take....

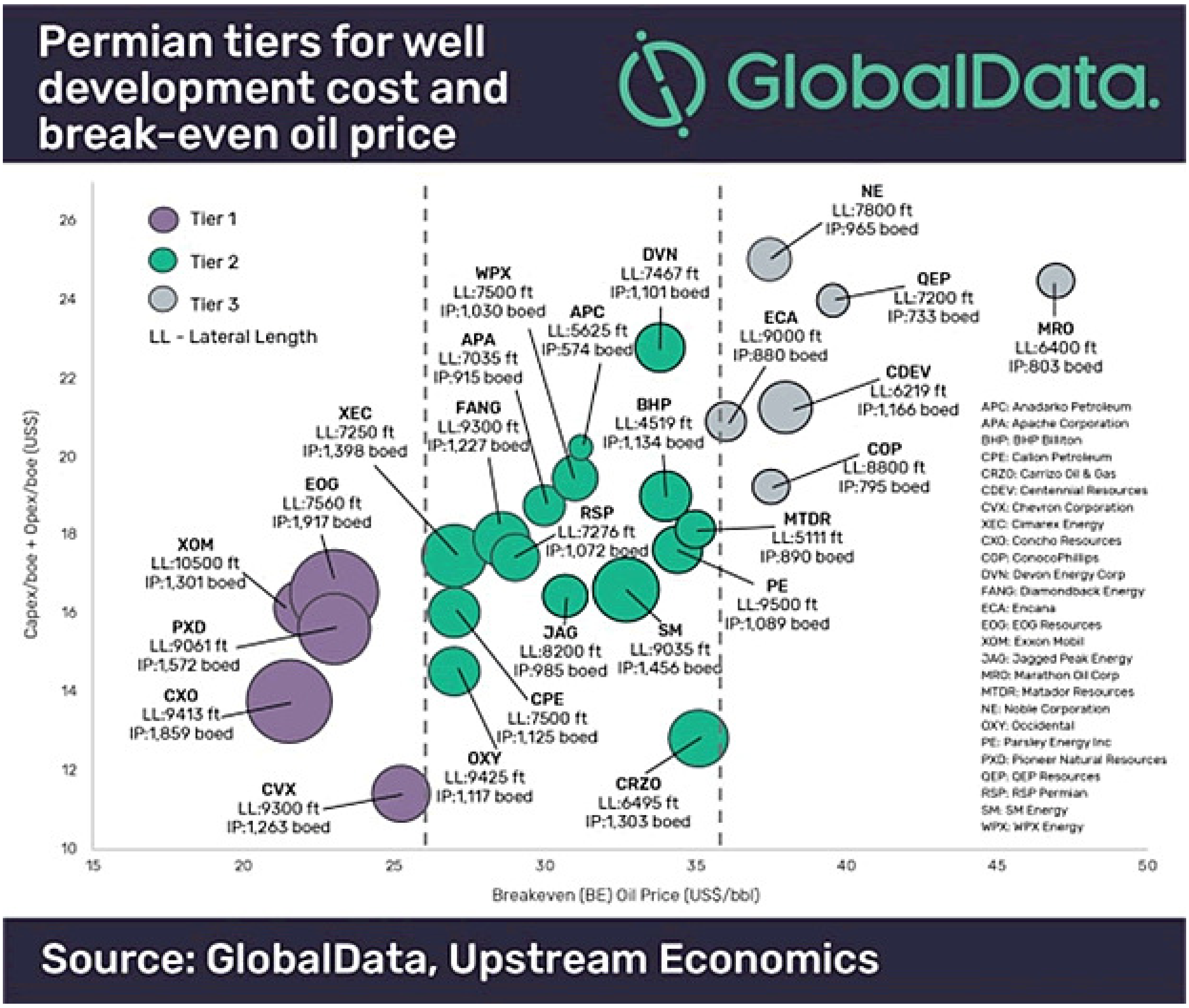
"We continue to think that Saudi are managing the oil price in a rational fashion. On the one hand, the IMF still forecasting Saudi requiring oil price of $70+ /bl in 2018 in order to close their fiscal deficit to zero. An IPO or private sale of 5% of Saudi Aramco is also still planned: we estimate that the targeted $100bn proceeds can only be achieved at an assumed long-term oil price of $70. These factors underpin Saudi's efforts over the last twelve months to bring Brent back above $70/bl...".

I also tend to take notice of the energy team at Westbeck who've been running an energy fund for the last few years. Like Guinness they are obviously bullish energy and energy equities but their analysis is usually very objective and informed. In their latest note to investors they think that oil could now hit $100 - echoing the views of a number of well informed market players.

- *"We expect oil prices to resume their move higher over the summer forcing President Trump to release SPR in September ahead of the mid-terms.*
- *The President has some flexibility to establish the needs for a 'limited drawdown'. However, we see this as limited to 30mb for no more than 60 days. In other words, in our view it is unlikely SPR would be released before September and would have to be bought back right after the elections. SPR can be released as fast as 4mbd, i.e. 30mb could be released in ~8 days.*
- *Timing, however, would coincide with fall maintenance season for US refiners. This in turn could max out US crude oil exports. Meaning a crude oil release in the US might remain landlocked, affecting WTI pricing but doing nothing to appease international prices and hence US domestic*

gasoline prices."

But I'm going to finish with a sting in the tail. A note out earlier in June from Global Data contained a standout number that I think is worth repeating again and again. OPEC may want oil prices to stay high to pay for their welfare programmes but over in America, high oil prices might translate into bumper profits - especially in the super-lucrative Permian basin. The researchers looked at recent wells for 26 operators in the Permian basin: this indicates a break-even oil price range from US$21 to US$48 per barrel with lateral lengths ranging from 4,500 ft to 10,500 ft." The chart below fleshes out the story. The bottom line? Bumper profits beckon for the US shale industry as OPEC keeps prices too high.



Fixed Income

The price of many financial assets including equities but notably also bonds are buoyed by the New Normal interest rate thesis. This suggests that we live in a new era of permanently lower interest rates, powered by demography (excess savings), excessive debt and global capital imbalances. It's a thesis I agree with.

One part of the New Normal school lays the blame for these permanently lower interest rates at the door of central banks. But at the Amundi World Investment Forum, Ken Rogoff, the US economist, offered an alternative suggestion.

He thought that real global interest rates were low because of secular drivers and that central banks were simply playing catch up - the key driver being low productivity rates. Thus, if central banks did aggressively raise rates they'd simply kill any economic growth stone dead. Thus, the consensus in the financial markets is for lower rates, longer. US rates almost certainly will rise over the next 18 months but they are unlikely to go much above 3.5% at which point they'd head straight back to zero again. As for the ECB and BoE - well, they are so far behind the curve they'll never get anywhere close to 3.5% before the next recession.

These low rates support both bond and equity valuations - bonds most obviously but equities also via the dividend and risk-free rate transmission mechanism.

So, what could possibly go wrong with this scenario?

Hard money hawks think surging inflation will sink this consensus but I'm not so sure. Sure, inflation rates have gone up a bit but not by anywhere near what we expect - with energy as the obvious exception. Crucially the other key transmission mechanism - increasing wage rates - has seemingly broken down after decades of anti-union crusading and deindustrialisation.

Rogoff offers a novel headwind in the shape of surging productivity growth rates. Like many, he concedes that technology hasn't helped push productivity rates much higher in recent decades, largely because the advances in the internet don't seem to have produced huge game changes for corporates. Advances yes, but no enormous revolution. This relative lack of change via technology has possibly contributed to low productivity growth rates.

But Rogoff thinks big changes are coming down the line courtesy of AI, big data and automation. I sense he's right. Talk to the Hard Left critics of capitalism for instance and they are dead scared that we are about to plunge into a new era of automated, roboticised societies where the residual power of labour is shredded. Libertarian tech visionaries have the same fear which is why they are rallying around ideas such as the Minimum Basic Income (a flawed idea of epic proportions).

My sense is that Rogoff, the Marxists and Libertarians are right - something big is coming, probably led by China and Japan. A massive change will rip through corporates giving the owners of capital even greater profit margins. Crucially it will spur them to invests countless billions and trillions in a tech arms race which will suddenly boost demand for capital. The knock on effect might be an increase in productivity rates even as Labour is hollowed out as a factor of production. The combined effect of

- increased technological innovation
- increased capital investment in said technology
- increased macroeconomic productivity growth

could be to INCREASE the natural long-term real rate of interest. Normally there would be a howl of collective despair about such a scenario as ordinary borrowers find themselves squeezed, but in this scenario capital(wealth) inequality would probably have vastly increased and most citizens probably wouldn't be hugely impacted - they'd be renting access to capital at this point. Owners of capital would, of course, be hit by these increased interest rates but the increased rate of return on investments might help mitigate the losses.

In this scenario, we could see a decade's long slow sell-off of fixed income assets and a painful valuation readjustment process for some equity sectors. I don't see any obvious signs of this scenario playing out at the moment but I do think we New Normal rates enthusiasts need to be on alert for a paradigm shift. We need to keep watching productivity rates and understand how China is embracing AI and machine learning. A turning point might be fast approaching as we head into the Twenties....

UK Government Bonds 10-year Rate 1.31%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	26.2
Germany	10.38
Japan	24.4
United Kingdom	24.03
Ireland	30.53
Italy	216
Portugal	102
Spain	67.9

Eurozone peripheral bond yields

Country	June 2018	July 2018	Spread over 10 year
Spain 10 year	1.28%	1.26%	92
Italy 10 year	2.58%	2.56%	222
Greece 10 year	4.52%	3.85%	351

	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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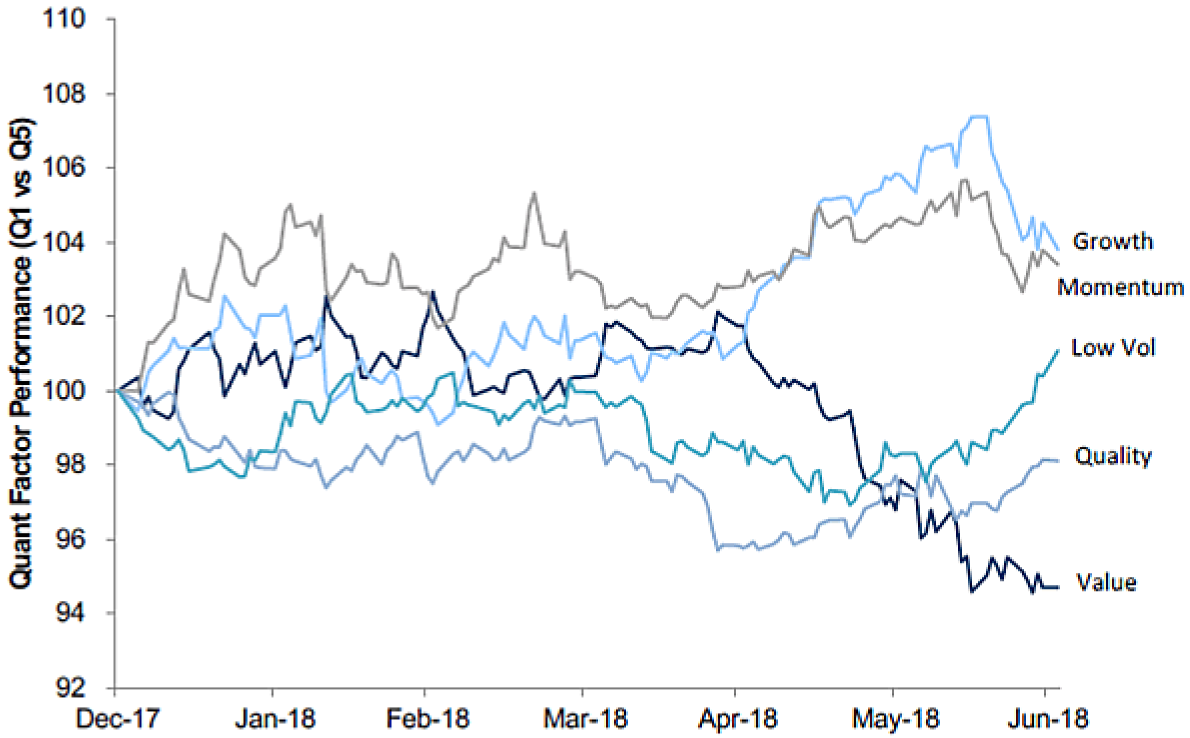
Equity Markets and Dividend Futures

European analysts at investment bank Morgan Stanley have recently been observing a strange new trend - that investors are generally having a tough few months. Crucially most of the "popular 'styles' of investing have started to underperform at the same time". Specifically, the banks quants are highlighting the fact that "Growth, Momentum and Value factors are all struggling at the expense of 'Quality' and 'Low Vol'." Much of the drift to these styles of equity investing might be do with a defensive sector rotation (utilities and pharmaceutical stocks for instance have done well, in relative terms). And the Morgan Stanley analysts also report that "investors are also looking to hide in 'Quality' as an alternative way to reduce portfolio risk. The bank's analysts now reckon that the difference in return for quality over value equities is now close to a recent high! The bottom line? Investors are crowding into quality stocks at an unprecedented rate.



Nicolas Rabener at FactorResearch has done an even more detailed deep dive into which types of equities have outperformed over the first half of 2018. You can see the full report online here.

He observes that the first half of 2018 is pretty much following directly in the path of 2017. The Size factor has "taken the lead, likely reflecting the threat of global trade wars" whereas "value has generated the most negative returns across regions". The chart below shows the performance of seven well-known factors on an annual basis for the last 10 years and the first half of 2018. The global series is comprised of all developed markets in Asia, Europe and the US. According to Rabiner "the strong performance of small caps can likely be explained by the threat of global trade wars, which are based on policy changes of the US government. Investors anticipate that smaller companies will be less negatively impacted by trade tariffs than larger companies."

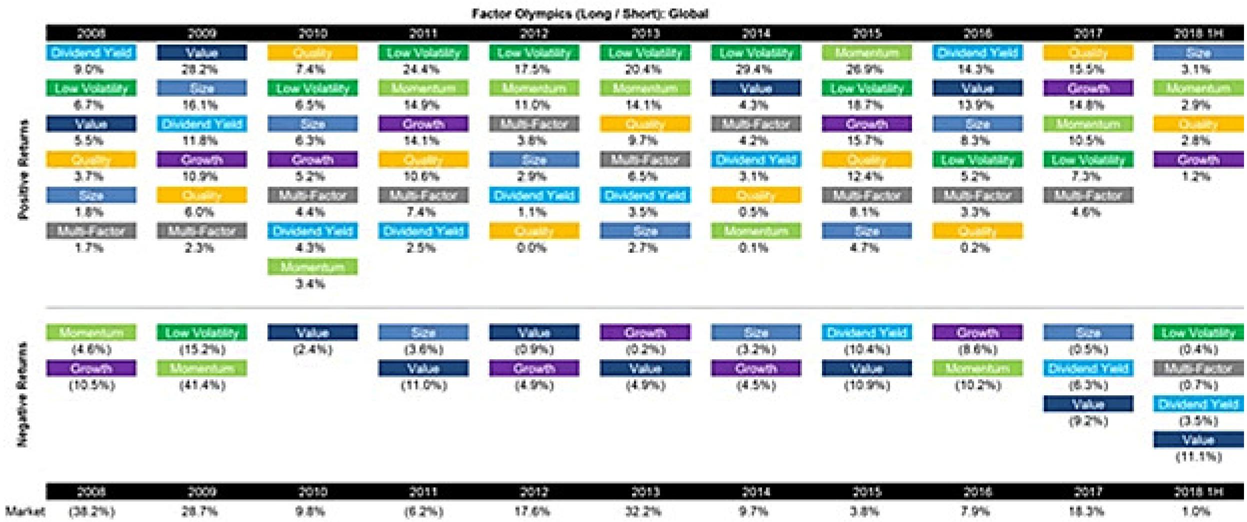


CHART showing varying returns for different factors, globally - source Factor Research

Index	June	July	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	126	125.8	3455	126.2
FTSE 100 (Dec 17)	307	307.3	7606	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	0.94	5.48	0.55	14.5	66.8	106	2802
S&P 500	-0.42	5.59	-1.39	3.47	17.2	35.4	7670
iShares FTSE UK All Stocks Gilt	0.889	0.591	0.745	1.33	14.9	9.01	13.12
VIX New Methodology	-2.78	-27.7	23.8	27.1	-9.1	-24.9	12.58

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Volatility

Without wanting to sound a bit like a broken record - especially give my comments last month on growing dispersion in returns for equities - the current stock market is looking ever more like an asset allocators and stockpickers environment. Not every sector, theme, factor or market is rising equally. It's clear for instance that global equities are struggling to make any headway, with the MSCI World hovering between +/-2% since the end of January. Emerging markets also continue to struggle.

But these headline numbers mask some interesting cross-currents or at least that's the message from a recent report by Andrew Lapthorne over at SocGen. He notes that China in particular has been particularly weak, with the CS300 down 10% so far in 2018. "This is in stark contrast to the Russell 2000, which has been among the strongest performing indices over the last three months. Indeed, if Trump's

'Trade War' is about rebalancing the prospects of US companies versus, say, China, then markets appear very much on message. The Russell has outperformed the CS300 by a remarkable 22% since the beginning of April."

This is all slightly inconvenient for Andrew as he's been worried about US Small caps for quite some time - he rightly observes that amongst these relative small caps, corporate leverage is high and profits are struggling. I suspect that Andrew is right though when he warns that if the Trade War talk fades, "then a reversal of this relationship could be on the cards".

Back in the large-cap segment Lapthorne also notes that most of the gains in US equities can be "accounted for by just a few FAANG stocks. However, such, an analysis perhaps overstates the narrowness of the US market, as for every big winner there is often a big loser as well. For example, the un-weighted average YTD performance of today's S&P 500 constituents is +3.4% and the equal-weighted index shows a total return of 3.2% versus a weighted return of 4.0%. So, while the FAANG performance is impressive - and perhaps concerning - S&P 500 strength is broader than often reported."

Measure	July Level	June Level	May Level	April Level
Vstoxx Volatility	13.65	14.45	13.68	17
VFTSE Volatility	11.3	13.4	12.53	13.84

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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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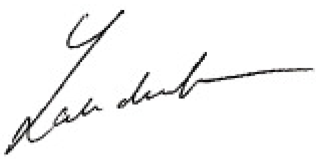
Kind Regards,



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