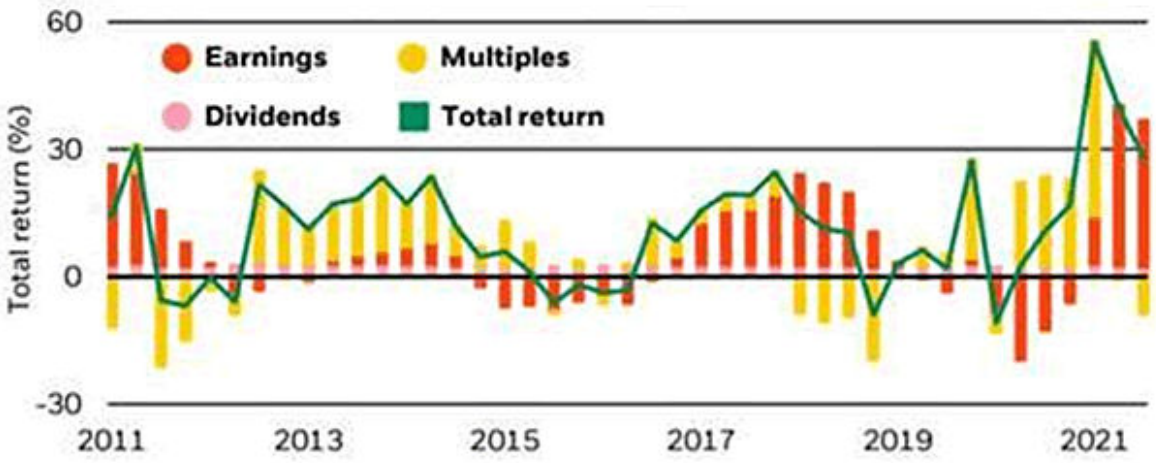
Monthly Market Report
December 2021

With commentary from David Stevenson

By and large I've turned more bearish in recent months but it's completely possible that I'm entirely wrong about my grim warnings. I've been scaling back my equities position marginally but if I'm honest I've not sold too much - its mainly just not investing fresh cash. I certainly haven't started putting on log volatility positions, yet. Perhaps this is a classic case of cognitive dissonance. I would like to think I am more bearish but in reality I've seen no hard evidence to justify scaling back risk?

One reason why I've maybe not gone full bear is that corporate earnings are still charging ahead. According to BlackRock, the US corporates are still reporting impressive numbers.

"Companies representing more than half of the S&P 500 Index market value have reported third-quarter earnings. Over 80% of them have beaten expectations on profit and more than three quarters have exceeded revenue estimates. These beat rates are slightly below the elevated levels of the past few quarters but well above long-term averages. Multiples surged last year as investors eyed the strong rebound from the Covid-19 shutdowns - and earnings growth has delivered in the powerful economic restart. Multiples have since declined slightly, but that only reflects that markets had priced in this earnings strength and would be less responsive to the actual outcome compared with a typical business cycle recovery, in our view."



Even European corporates are in decent shape. According to analysts at Morgan Stanley:

"3Q results tracked so far point to: (1) an improved net beat rate with +36% of stocks beating EPS estimates; (2) a strong breadth of sales beats at +39%; (3) weighted earnings tracking 10% ahead of expectations".

So far, very convincing but I can't resist thinking that the current mood is a product of Central bank designed easy money swishing through system based on FOMO (fear of missing out). On that

score, we shouldn't be focussed overly on corporate earnings but on liquidity drivers. On this score analysts at Cross Border Capital - who focus on liquidity measures - have turned notably bearish.

They reckon that both US private sector liquidity and US cross-border capital inflows have:

"...already turned lower from exceptionally high levels, whereas US Fed liquidity remains unusually elevated. Yet, this latter extension is down to one-off factors, namely the addition of the latest IMF SDR allocation to Fed assets and the liquidity boost that derives from the US debt ceiling and the forced run-down in the Treasury General Account. For comparison, elsewhere, 41% of Central Banks in the Advanced Economies are now running 'tight' liquidity policies compared to zero in January. Our analysis confirms what we already know that the Fed and other Central Banks have recently been the dominant drivers of higher asset prices. This suggests that the upcoming Fed taper could prove risky for Wall Street. Time will tell, but history unambiguously shows that liquidity moves markets, with its presence vital for financial stability. But Global Liquidity is now falling...".

The graphic below, also from Cross Border, offers one explanation about why we should care - many of the previous US Stockmarket corrections have been the product of previous liquidity squeezes.

Figure 1
Drivers of Past US Market Corrections
1973-2021

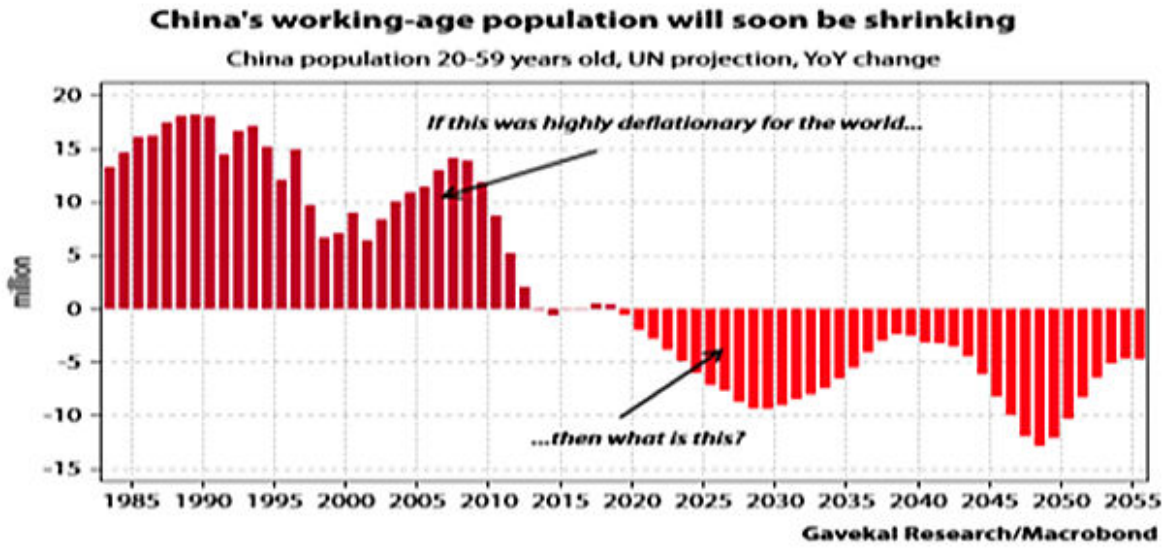
Changes in:	Federal Reserve Liquidity	Private Sector Liquidity	Foreign Capital Flows	Risk Exposure
Major Corrections:				
1973/74		•		
1979/80		•		
1987	•		•	•
2000/01	•		•	•
2008	•	•	•	
2020				•
Now	•	•	•	

Source
CrossBorder Capital

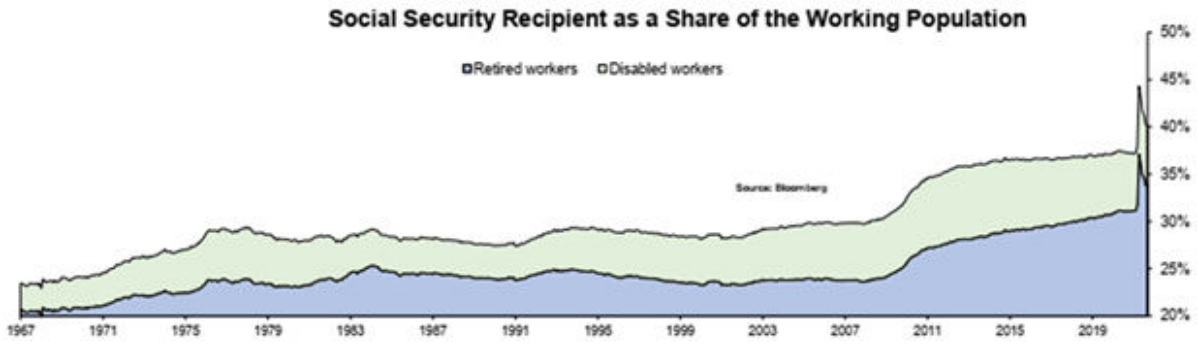
Contents

Headline Numbers

My pet theory is that over the long term, all investment is about demographics. The wrong demographics spells economic turmoil. And the chart below from a recent report by Stone X's Vincent Deluard certainly suggests future challenges. It shows a big trend that is oft quoted but not always visualised - China's population is about to decline sharply. Whether this is deflationary or inflationary s up for debate but the transformation is astonishing.



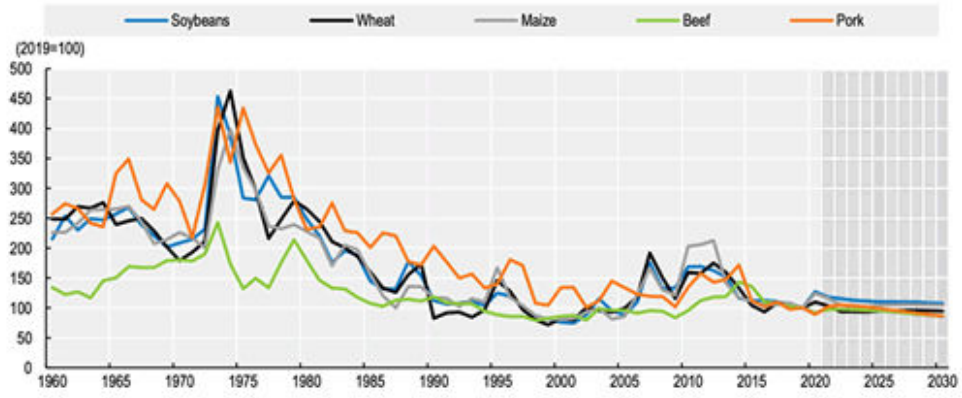
Then again as demographic transformations go, the next chart below is equally startling. The equivalent of 40% of the US working age population is now in receipt of either pension payments or disability benefits. Deluard's key observation is that this group of welfare beneficiaries is insulated from inflationary trends. " Social Security payments are indexed on the CPI-W index and the 2022 Cost-of-Living Adjustment (COLA) of 5.9% will be the largest in 40 years. Many economists argue that a return to the 70s-style wage-price spirals is impossible because of the deunionization of the US workforce. Granted, few workers have built-in inflation adjustments in their labor contracts, but social security recipients represent 41% of the U.S. workforce, a bigger share than union membership at its peak of 34% in the 60s." If we're looking for an inflationary spiral, this one is hiding in plain sight.



Economic historian and commentator Adam Tooze has a fantastic chart below that is worth a closer look for all readers following the inflation debate. The background is higher food price inflation. This is undoubtedly a challenge for many poor countries but I've been a tad sceptical myself that we are about to head back in to 1970s stagflationary territory. The numbers just don't seem to add up.

Which is also what Tooze suspects, though he's not entirely sure how the numbers pan out. The OECD-FAO graph below shows the price of soybeans, wheat, maize, beef and pork separately. Together they make up a substantial part of the FAO food price index and according to the OECD-FAO calculations, in real terms they are up slightly relative to 2020, but they remain very far below their 1970s peaks.

Figure 1.32. Long-term evolution of commodity prices, in real terms



Note: Historical data for soybeans, maize and beef from World Bank, "World Commodity Price Data" (1960-1989). Historical data for pork from USDA QuickStats (1960-1989).
Source: OECD/FAO (2021), "OECD-FAO Agricultural Outlook", OECD Agriculture statistics (database), http://dx.doi.org/10.1787/agr-outl-data-en.

Tooze has been trying to reconcile this long term data with short term staple food price inflation - to no avail so far. But I think he's spot on when he warns about taking too much of the 1970s Redux Stagflation argument at face value.

"Right now, amidst all the talk of stagflation and energy crisis, I'm worried that we have the story about food wrong too. Not only is the link to energy being seriously overplayed and for bad reasons. But the idea that we are back to 1970s in real terms, may be quite misleading."

Measure	Values as of 11th October, 2021	Values as of 12th November, 2021
UK Government 10 year bond rate	1.21%	0.90%
GDP Growth rate YoY	5.50%	1.30%
CPI Core rate	3.20%	3.10%

RPI Inflation rate	3.80%	4.90%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.09%	0.11%
Government debt to GDP ratio	97.2%	94.9%
Manufacturing PMI	57.1	57.8%

Back to menu

Bank CDS options

The market for big bank credit swaps aren't giving off many obvious signals at the moment. A small majority of banks saw the pricing on their swaps decline over the last month but there were no big moves - as was the case for the smaller number of banks that experienced equally small increases. Of note, the pricing for Deutsche swaps continued to decline and now the 1 year rates for the giant German bank are lower than for Goldman Sachs. Also of note - Lloyds 1 year swaps continue to lead the pack with pricing at just 7.77 basis points.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	9.42	33.65	A	A2	A -
Barclays	14.65	42.48	BBB	Baa2	A
BNP Parabis	8.82	31.63	A+	Aa3	A+
Citigroup	28.1	54.48	BBB+	A3	A
Credit Suisse	19.5	53.63	BBB+	Baa1	A-
Deutsche Bank	26.73	73.34	BBB+	A2	BBB+
Goldman Sachs	30.11	60.45	BBB+	A2	A
HSBC	13.21	34.31	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	25.3	46.51	A-	A2	AA-
Lloyds Banking Group	7.77	28.54	BBB+	A2	A
Morgan Stanley	28.7	55.56	BBB+	A1	A
Natixis	34.08	46.43	A	A1	A+
Nomura	18.13	71.57	BBB+	Baa1	A-
RBC	18.08	53.57	AA-	A2	AA-
Soc Gen	13.01	33.83	A	A1	A-
UBS	9.63	29.63	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st November 2021 www.tempo-sp.com

Back to menu

Government Bonds

Fixed Income

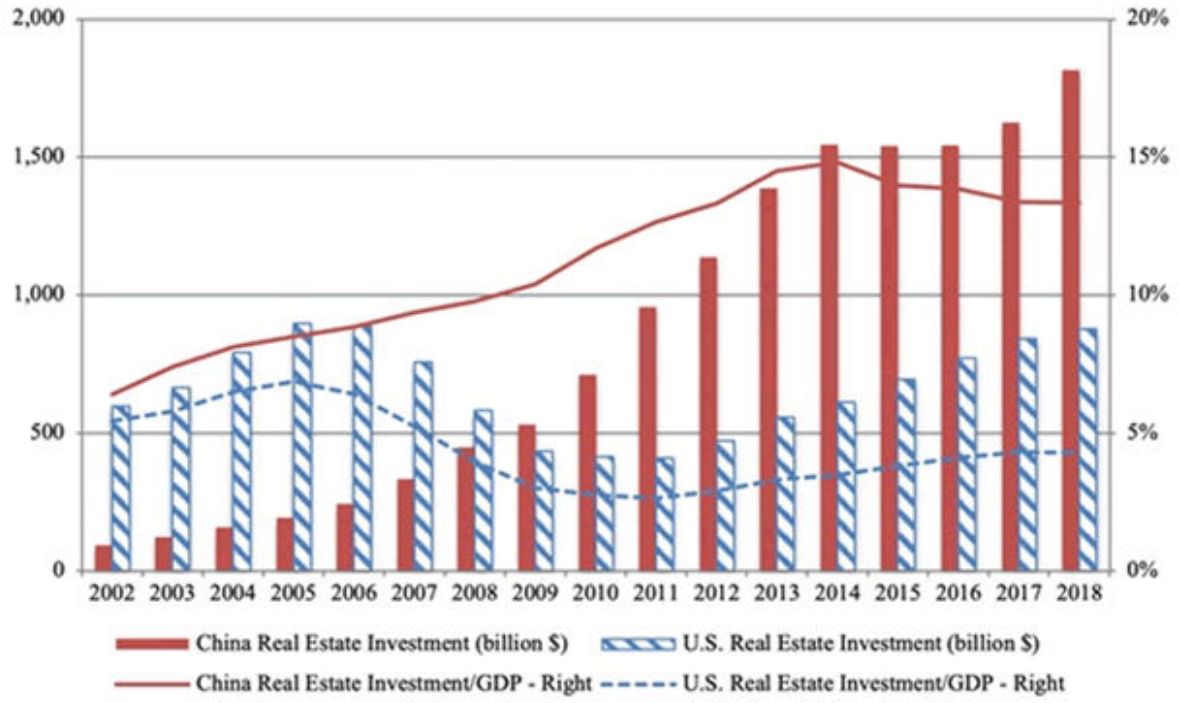
Global bond markets were spooked recently as China's largest real estate company Evergrande teetered on the edge. Even though markets outside of Asian HY seem to have suffered no contagion as yet, it is worth noting that Evergrande's liabilities are almost 2% of Chinese GDP. To put this into context, Apple's current liabilities are 0.5% of US GDP ($107.7bn current liabilities vs 21.4trn US GDP). Thus far the year-to-date fall in the Asia Real Estate HY index is 30%.

Economist and NYT commentator Paul Krugman has been worrying about China and its debts for ages - even before Evergrande- but he thinks the bond showdown might finally have arrived. He cites the chart below which comes from a 2020 paper by Kenneth Rogoff and Yuanchen Yang that shows that Chinese investment in real estate now greatly exceeds U.S. levels at the height of the 2000s housing bubble, both in dollar terms and as a share of G.D.P.:

"Rogoff and Yang also show both that housing prices in China are extremely high relative to incomes and that the real estate sector has become an incredibly large share of China's economy. None of this looks sustainable, which is why many observers worry that the debt problems of the giant property developer Evergrande are just the leading edge of a broader economic crisis."

Figure 5. China and U.S. Real Estate Investment

This figure shows annual real estate investment in China and the United States from 2002 to 2018. Real estate investment is placed on the left axis, and the ratio of real estate investment to GDP is placed on the right axis.



The market for inflation linked assets certainly seems to be taking the inflationary pulse seriously. One way of seeing this is via options linked to the UK's RPI rate. The chart below which shows the BBG chart of the UK RPI Inflation rate for Mar21-22 as traded in the inflation swaps market. Notice how it has risen in the last 6 months. It peaked at 6.72% this week.

Now, it's important to say that these prices do not represent expectations as such but demand / supply interactions but as one expert in this space observes "given that the first 6 months of this period is already known (price increases from Mar 21- Sep 21) it's a fairly robust data point...the Mar 22 point is not unique, almost all the prices/ inflation rates for next year (Apr 21-22, Sep 21-22

etc) are over 6%". Why does these rates matter?

With your politics hat think about a rate that is linked to the RPI. Bingo.

The answer is student loans !

At the moment student debt piles up and interest is charged at "Retail Price Index (RPI) plus up to 3%". You can see the calculations here. So, as a point of interest, the annual March 2022 fix (ie when the inflation for March 21-22 is known) will determine student loans starting in Sep 22. Rates could hit 10%.

UK Government Bonds 10-year Rate 0.9%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	21.2
Germany	8.5
Japan	18.2
United Kingdom	8.57
Ireland	15.2
Italy	79.1
Portugal	30
Spain	31.6

Eurozone peripheral bond yields

Country	October 2021	November 2021	Spread over 10 year
Spain 10 year	0.52%	0.48%	73
Italy 10 year	0.93%	0.96%	121
Greece 10 year	0.93%	1.23%	148

	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

Back to menu

Equity Markets and Dividend Futures

The chart below is from at HSBC. It shows that relationship between the S&P 500 and global commodities is "pretty significant", according to Stuart Kirk, Global Head of Research & Responsible Investments . "Indeed, the current five-year correlation is about 90 per cent, based on Bloomberg data, the highest in 70-odd years. Versus global indices is similar". Kirk also reminds is that the dollar plays a crucial role in the commodity complex, reminding us that it " based on a negative historic correlation of 60 per cent, to be bullish on the greenback and commodity prices. ". One has to choose: bullish on commodities OR the dollar. But not both.

Index	October 2021	November 2021	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	101	100.5	4366	96.8
FTSE 100 Dividend Dec 2021	243.3	424.7	7340	232

Note changed to Dec 2021 contracts in January 2021

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	3.03	2.13	4.88	15.9	9.15	18.9	7346.5
S&P 500	7.03	4.39	14.6	31.7	115	128	4656.5
iShares FTSE UK All Stocks Gilt	3.55	-2.04	2.38	-3.15	8.32	15.4	1399
VIX New Methodology	-11	13.3	-36	-30.3	24.6	-3.86	17.66

Back to menu

Volatility

Investment research firm Collidr have been doing some fascinating work on how asset classes perform during varying volatility regimes. They argue that there are three different market regimes : low, medium and high volatility. Rather than use an off the peg vol measure they crunch data for a wide range of markets and thousands of different stocks and then combine this into a single regime measure. Their core concern is to spot a move from a low vol market where the dispersion of returns from individual stocks is muted to a high vol regime.

Currently Collidr reckons we are in what they call a moderate volatility regime which feels instinctively about right - in these regimes investors tend to experience higher absolute returns, but at the expense of increased volatility. If that 'regime' switches into a high volatility regime they observe that in past periods of high market volatility (since 2005 that is) , "the FTSE100 has

underperformed US equity indices, returning an annualised -22% in comparison with the S&P500 which returned an annualised -19%. Perhaps surprisingly, the FTSE100 even underperformed the Nasdaq composite, which returned an annualised -14% in high-volatility periods."

Turning to the FTSE All-Share index, stocks in this index have performed "even more poorly during high-volatility periods, returning an annualised -23%". The Collidr analysis also shows that emerging markets equities have fared the worst among all major equity asset classes during periods of high market volatility, with the MSCI Emerging Markets index returning an annualised -31%.

Red line - 20 day moving average Green Line - 200 day moving average

Measure	November Level	October Level	September Level	August Level
Vstoxx Volatility	16.59	21.98	18.13	17.4
VFTSE Volatility	17.66	19.54	16.41	16.72

Back to menu

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.

Back to menu

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.

Back to menu

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

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