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UK | Structured ™ Products Association

Monthly Market Report

February 2017

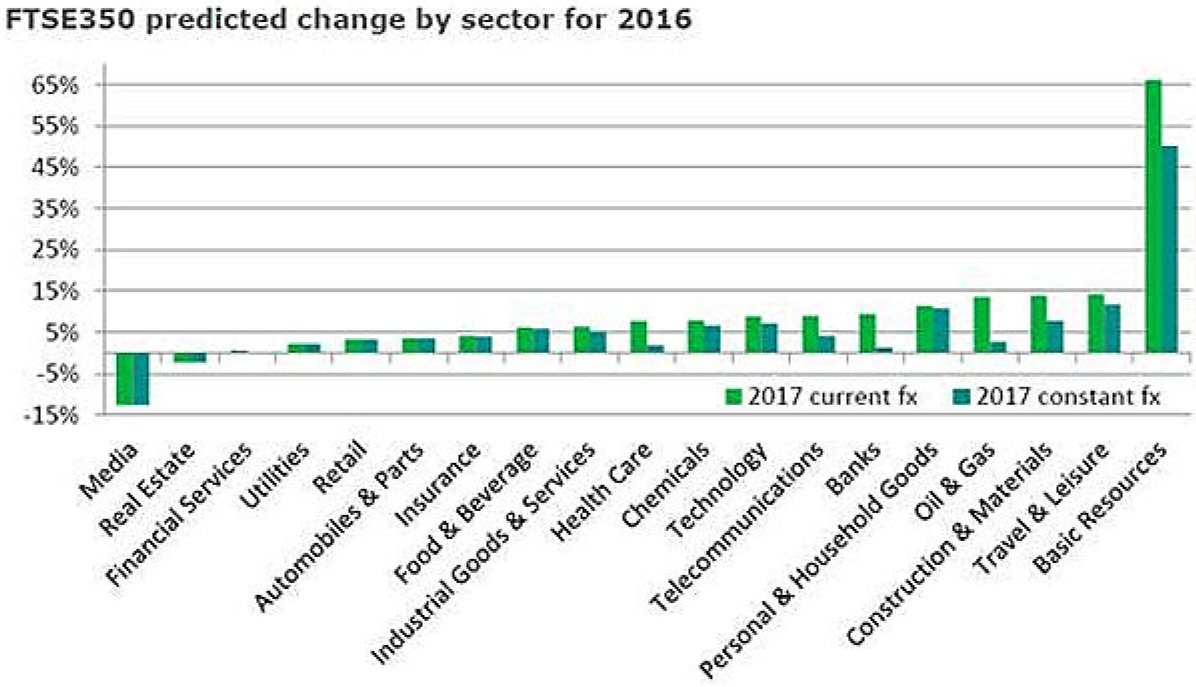
With commentary from David Stevenson

Despite the pervasive and corrosive cynicism about the style and manner of US President Elect Trump, maybe we've all got him wrong. Maybe we should call him Santa Trump, if only because a weird combination of his recent election and the regular Santa effect has helped to turbo charge developed world stockmarkets. The FTSE has bashed through first 7000 and then 7200 and the S&P 500 now looks like it might be charging towards 2500.

But in truth there's more to the bounce than just a feel good factor brought on by the festive break and the US election. There's growing evidence that lots of "things" are picking up : earnings growth, inflation, employment numbers, and the inevitable debt levels.

If I were cynical I'd suggest that much of the recent bounce was simply due to one boring factor - that dividend payouts are likely to increase in 2017. Recent projections from data firm MarkIt remind us that the global dividend picture for the coming year is looking rosier than 12 months previously, "as the calming commodities markets means that energy and materials firms are set to resume dividend growth after slashing payments across the world. This positive trend is further improved by the rising dollar which underpins many commodities related dividend policies."

Markit reckons that this dividend surge will be strongest in the UK with a 10% increase forecast, driven by pound slump and commodities rebound. The £92bn of payments expected by Markit Dividend Forecasting (see chart below) are led by oil majors BP and Royal Dutch Shell, forecast to contribute 22% of the total. But dividends are also increasing in other geographies as well. Payments by European (ex UK) and North American firms predicted to grow by over 6.5% - the only black spot is in Asia where Asian payments expected to fall by 2.2% in dollar terms although only two countries, South Korea and Hong Kong, register falls in local currencies.



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14th Annual
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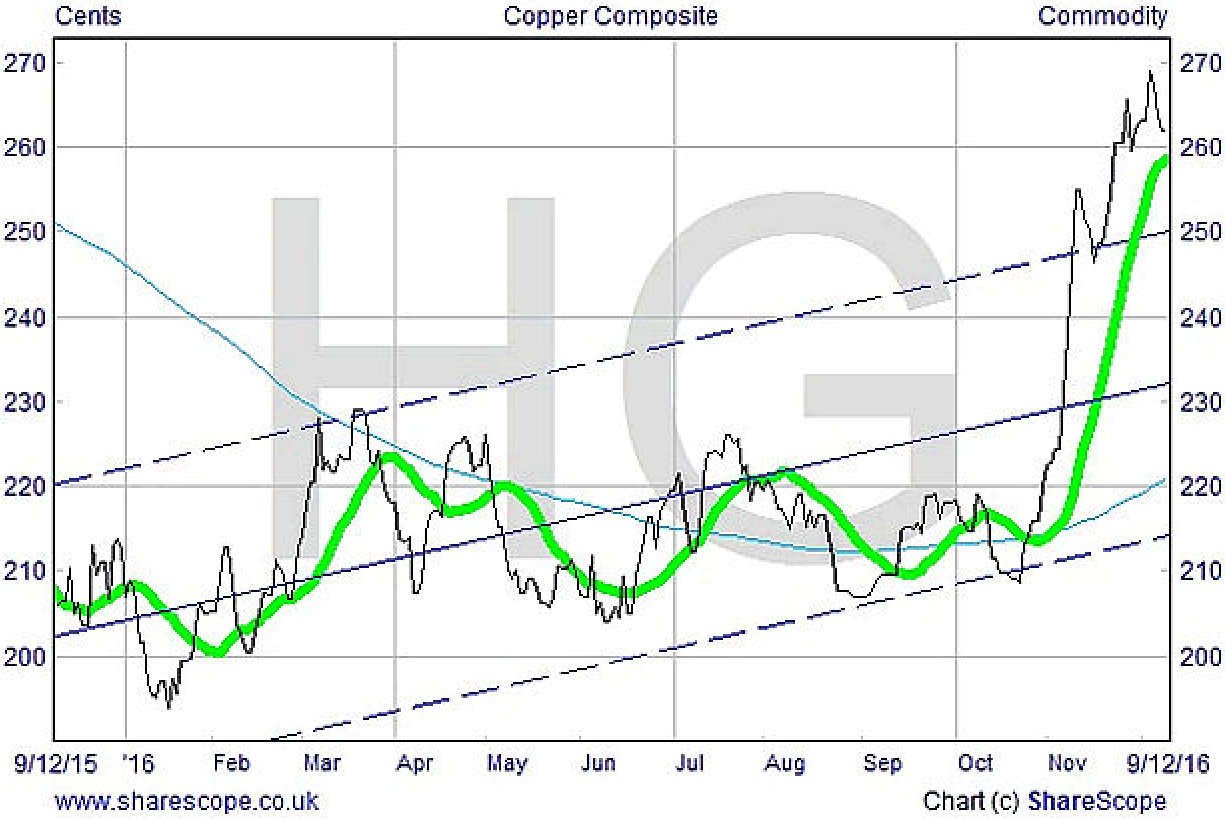
& Derivatives Conference
London | 1 & 2 February 2017

Headline Numbers

The Santa rally not only benefitted equities - some commodities have also shot up in value not least the classic industrial metal, Copper. The chart below shows composite copper futures index prices over the last year, with the current price levels well above 20 and 200 day moving averages. What's behind this strong positive momentum? China and Trump.



Source: www.sharescope.co.uk

Commodity analysts at US bank Goldman Sachs have been notoriously bearish about prospects for copper prices, but even they've been forced to increase their price estimates for the industrial metal, which they think will increase in price to $6,200/t over the next six months, 6% upside to spot, c.20% above 2Q17 consensus.

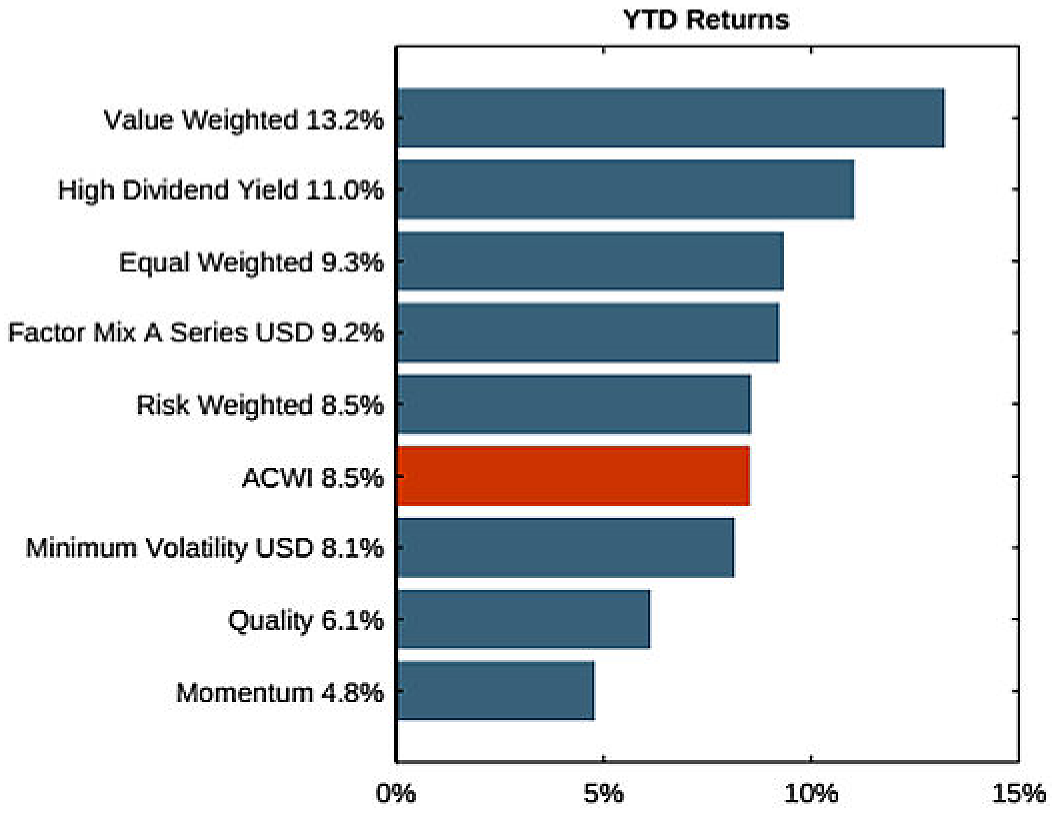
According to the bank's commodity analysts "over a very short period of 6 weeks we have seen data releases pointing to a surge in global industrial activity, most notably in China where the manufacturing PMI jumped to its equal highest level in 4 years. The improvement in demand growth was much stronger than we had anticipated and appears likely to absorb much of the 'wall of supply' that we had expected would drive prices lower during 2H16 and early 2017. Alongside the recent pick up in industrial activity, the 2017 outlook for each of the fundamental drivers of copper pricing - supply, demand and cost structure - have, on balance, become more bullish in our view".

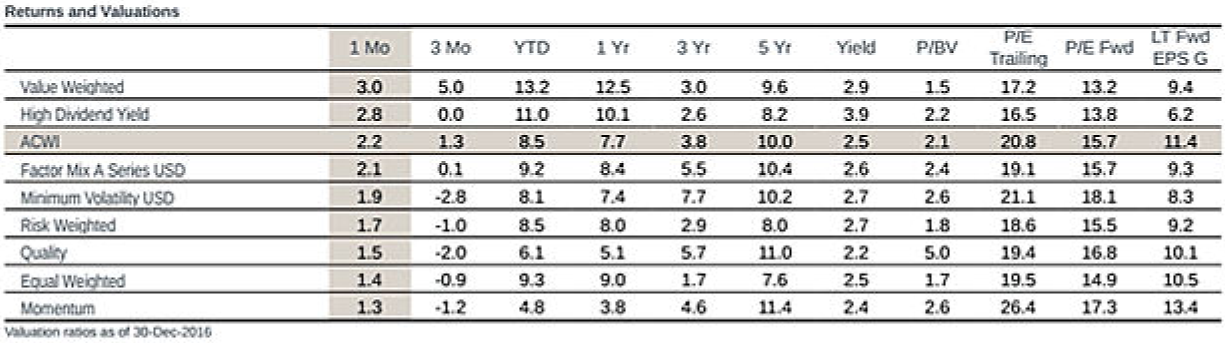
The GS analysts also observe that mine supply might fall in 2017, prompted in part by labour strikes, heightened potential for Zambian power and tax related supply issues, as well as an increased likelihood of Indonesian export permitting delays.

A Trump inspired infrastructure boom - aided by tax cuts - might also contribute towards increased demand for copper. According to GS "this underscores a very important point about the relationship between metals prices and metals demand in later stages of the business cycle, where it is not the growth rate that matters as much as the demand level. This is because a higher demand level tests the ability of supply to adequately meet demand even at lower growth rates, particularly in copper where supply is relatively inelastic to price".

The remorseless rise of 'smart beta' should be treated with some considerable caution but in truth this new form of passive investing has served a valuable purpose, reminding investors that different types or styles of stock within the global markets move in very different ways. Some of the flavours of smart beta are well known, including momentum stocks and high dividend yield, others less so such as risk weighted and equal weighted.

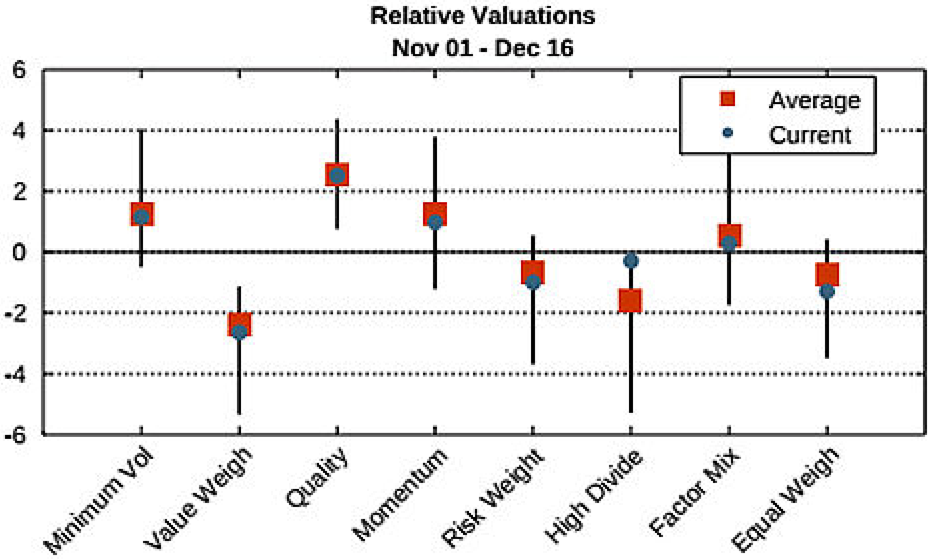
Last year, 2016, was the year of the value stock. According to index firm MSCI value weighted stocks romped ahead globally with a 13.2% return compared to 8.5% for the main benchmark MSCI ACW index. High dividend yield stocks came a close second with an 11% return followed by equal weighted stocks on a 9.3% return. Minimum volatility stocks underperformed with an 8.1% return but the wooden spoon prize belongs to quality stocks on a 6.1% return and momentum stocks on a measly 4.8% return. Using the forward P/E (see second table below), the most expensive factor is now Minimum Volatility USD with a forward P/E of 18.1 and the cheapest, Value Weighted with a forward P/E of 13.2, while the overall market (ACWI) forward P/E is 15.7. Given that value stocks are trading at just 13 times their average expected earnings, its quite possible that this recent value outperformance might continue through into 2017.




Returns and Valuations

	1 Mo	3 Mo	YTD	1 Yr	3 Yr	5 Yr	Yield	P/BV	P/E Trailing	P/E Fwd	LT Fwd EPS G
Value Weighted	3.0	5.0	13.2	12.5	3.0	9.6	2.9	1.5	17.2	13.2	9.4
High Dividend Yield	2.8	0.0	11.0	10.1	2.6	8.2	3.9	2.2	16.5	13.8	6.2
ACWI	2.2	1.3	8.5	7.7	3.8	10.0	2.5	2.1	20.8	15.7	11.4
Factor Mix A Series USD	2.1	0.1	9.2	8.4	5.5	10.4	2.6	2.4	19.1	15.7	9.3
Minimum Volatility USD	1.9	-2.8	8.1	7.4	7.7	10.2	2.7	2.6	21.1	18.1	8.3
Risk Weighted	1.7	-1.0	8.5	8.0	2.9	8.0	2.7	1.8	18.6	15.5	9.2
Quality	1.5	-2.0	6.1	5.1	5.7	11.0	2.2	5.0	19.4	16.8	10.1
Equal Weighted	1.4	-0.9	9.3	9.0	1.7	7.6	2.5	1.7	19.5	14.9	10.5
Momentum	1.3	-1.2	4.8	3.8	4.6	11.4	2.4	2.6	26.4	17.3	13.4

Valuation ratios as of 30-Dec-2016



Based on price to earnings, price to book value, price to cash earnings and price to sales at month end dates. Values below 0 indicate the factor is cheaper than the parent. A current value below average indicates that the factor is cheap relative to its own history. The line endpoints indicate historical minima and maxima.

Measure	Value as of Dec 12th, 2016	Value as of Jan 13th, 2017
UK Government 10 year bond rate	1.47%	1.37%
GDP Growth rate YoY	2.30%	2.20%
CPI Core rate	1.20%	1.40%
RPI Inflation rate	2.00%	2.20%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.40%	0.40%
Government debt to GDP ratio	89.20%	89.20%
Manufacturing PMI	53.4	56.1

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Bank CDS options

Another month and ever lower CDS products which insure against the default of big investment bank bonds. Every single product tracked in this table fell in price over the last month with the biggest falls experienced with Deutsche Bank whose CDS spreads are now moving back into line with its peers. SG also saw a big fall in pricing as did Credit Suisse.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	39.55	118.61	-7.30	-20.26	A -
Barclays	35.06	80.41	-2.53	29.77	A
BNP Parabis	41.44	87.70	2.65	32.46	A+

Citigroup	26.00	74.22	-2.68	-21.34	A
Commerzbank	46.08	118.33	-3.06	25.78	BBB+
Credit Suisse	53.76	120.11	-5.57	34.89	A
Deutsche Bank	82.26	165.82	-15.29	67.23	A-
Goldman Sachs	37.00	93.18	5.28	-4.76	A
HSBC	24.76	71.33	2.10	-11.53	AA-
Investec	n/a	n/a	n/a	201.00*	
JP Morgan	32.00	64.80	3.23	-19.15	A+
Lloyds Banking Group	34.22	71.15	1.72	32.06	A+
Morgan Stanley	32.00	87.10	-0.46	-9.11	A
Natixis	25.78	81.88	11.01	23.12	A
Nomura	22.42	80.46	-1.83	8.83	AA-
RBC	n/a	n/a	n/a	66.00*	AA
RBS	58.63	118.11	2.26	79.97	BBB+
Soc Gen	36.34	87.08	3.19	31.94	A
UBS	26.36	63.29	2.66	24.21	A+

Source: www.meteoram.com 13th January 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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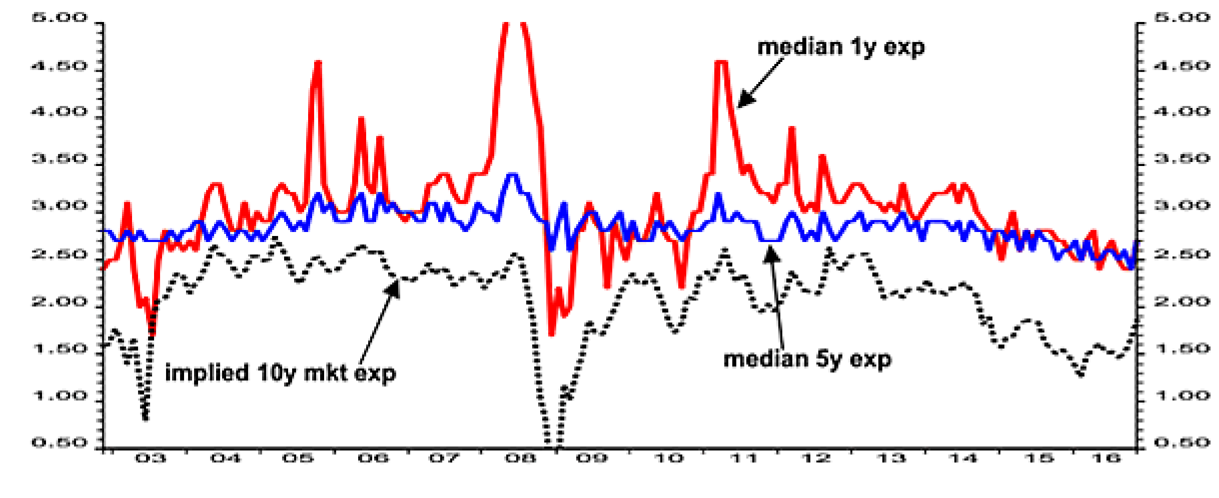
Government Bonds

The $64 trillion question bothering most bond investors is whether we're one step away from a bonds rout? A huge sell off been much prophesised but to date there's not been much evidence of a massive rotation out of bonds into equities and cash. This time it may be different, courtesy of stronger growth trends and the promise of President Trump. My guess is that we could see bond investors force the US Fed into not one but two rates rises in the next few months followed by a string of small 0.25% or 25 basis point moves over the next 18 months. If President Trump wants us to pay for all this extra spending, the bond vigilantes might chant, then pay us more in terms of bond yields and interest rates. The yield of US government 10 year bonds is currently around 2.37% but I can easily see that rate going upto 3% or maybe even 3.5% with interest rates not far under 2% by the end of 2017. But this slow turn in rates could turn into something much more deadly in the next year or so for bonds. What happens if President Trump does actually massively cut taxes and starts spending more. Bond yields rise to pay for the bill, but we also see the price of key commodities used in the industrial complex increase. That feeds through into increased wages. Albert Edwards a widely followed strategist at French investment bank Societe Generale observes that one key measure of inflationary expectations (Michigan University surveys household expectations of 5 year inflation rates) has in fact just blipped up (see blue line in chart below).

Michigan 1y and 5y median inflation expectations and 10y implied expectations



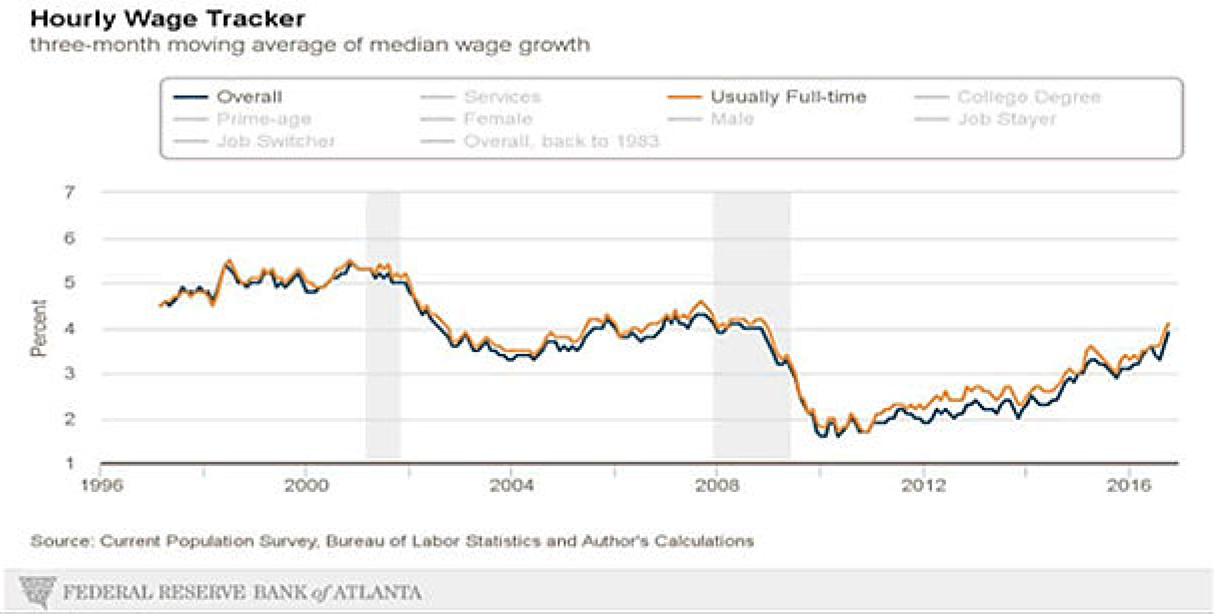
Source: Datastream

Source: Datastream

Edwards also adds that another researcher (Graham Summers of Phoenix Capital Research) has reminded him that increased inflation is "almost baked into the cake... headline CPI inflation is set to surge in the next few months as the energy component of the CPI is set to rise on the order of 20% yoy".

The next chart below also from SG suggests that we could be at a crucial turning point in terms of wage inflation - with more confident workers demanding higher rates according to the US Atlanta Fed measure of wage inflation.

US Atlanta Fed measure of wage inflation is already close to previous cycle peaks!

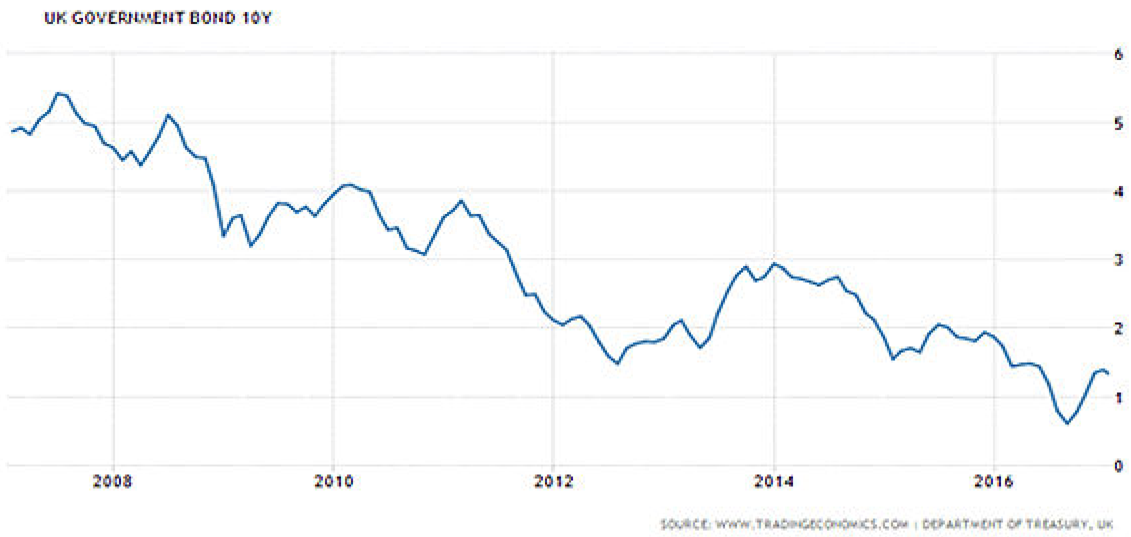


Source: Atlanta Fed

Source: Atlanta Fed

In the nightmare scenario we end up with a nasty form of stagflation - efforts to boost growth inevitably take time to work through, GDP growth slowly ticks up, but wages increase sharply as do inflation rates, forcing up interest rates even faster. The net effect on bond prices - a huge sell off?

UK Government Bonds 10-year Rates



SOURCE: WWW.TRADINGECONOMICS.COM | DEPARTMENT OF TREASURY, UK

CDS Rates for Sovereign Debt

Country	Five Year
France	41.56
Germany	21.13
Japan	30
United Kingdom	28.44
Ireland	64
Italy	159
Portugal	285
Spain	77.85

Eurozone peripheral bond yields

Country	Dec 11th 2016	Jan 11th 2017	Spread over 10 year
Spain 10 year	1.49%	1.45%	110
Italy 10 year	1.99%	1.92%	157
Greece 10 year	6.70%	6.94%	659

	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

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Equity Markets and Dividend Futures

One could be forgiven for thinking that investors in the developed world are enjoying a new bull market. But is this true of the rest of the world outside of the Anglo Saxon heartlands of the US and the UK ? Recent year end numbers from one major index firm suggests otherwise. The table below is from S&P Dow Jones and details full year returns for its major index sets through to December 31st 2016.

According to Howard Silverblatt, the firm's senior index analyst, "the telling stat is that since the {US Presidential] election, the global market is up 2.97%, but absent the 5.46% from the U.S., it is up 0.36%. The impact was seen and felt for 2016, as the S&P Global BMI posted a 6.10% yearly gain, a significant improvement from its 3.89% loss in 2015; however, absent the U.S. return of 10.30% for 2016 and relatively lower loss of 1.49% in 2015, the S&P Global BMI was up 1.79% in 2016 and off 6.30% in 2015. At this point, it would appear that the world is investing in the U.S., as domestic spending is expected to increase, along with potentially lower tax rates, with polices from Washington being more geared to U.S. economic growth. [emphasis added] ".

It's also worth noting how in 2016 S&P's broad collection of European top 350 businesses is down 0.36% while Japanese shares (the Topix) have fallen 2.6%. By contrast other markets on the American continent have shot up in value - Canadian shares (TSX 60) are up 17% while Latin American shares shot up 29%. Overall the global 1200 stocks tracked by S&P have increased just 5.99% over the year.

	2016	2015	2014	2013	2012
S&P 500	9.54%	-0.73%	11.39%	29.60%	13.41%
Consumer Discretionary	4.32%	8.43%	8.05%	40.96%	21.87%
Consumer Staples	2.58%	3.77%	12.87%	22.68%	7.52%
Energy	23.65%	-23.55%	-9.99%	22.27%	2.33%
Financials (incl RE pre-9/19/16)	20.14%	-3.48%	13.10%	33.21%	26.26%
Health Care	-4.36%	5.21%	23.30%	38.74%	15.19%
Industrials	16.08%	-4.72%	7.52%	37.63%	12.46%
Information Technology	11.98%	4.27%	18.18%	26.23%	13.15%
Materials	14.08%	-10.36%	4.68%	22.73%	12.24%
Real Estate (proforma pre-9/9/16)	0.01%	1.24%	26.14%	-1.53%	16.22%
Telecommunication Svc	17.81%	-1.73%	-1.91%	6.49%	12.50%
Utilities	12.19%	-8.39%	24.29%	8.75%	-2.91%
S&P Asia 50	9.74%	-8.73%	-0.67%	0.58%	20.67%
S&P Europe 350	-0.36%	5.18%	4.70%	17.12%	13.75%
S&P Global 1200	5.99%	-3.32%	2.84%	22.68%	13.57%
S&P LAC 40 (US$)	29.18%	-32.87%	-13.51%	-14.74%	3.30%
S&P TOPIX YEN	-2.65%	8.35%	6.65%	51.48%	20.34%
S&P/TSX 60	17.72%	-10.56%	9.07%	9.81%	4.82%
S&P/ASX 50	5.88%	-3.88%	0.66%	16.78%	16.10%

Index	December	January	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	118.5	115.8	3318	112
FTSE 100 (Dec 14)	257.2	276.3	7327	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	5.83	3.82	9.16	22.99	28.79	20.52	7292.37
S&P 500	0.60	6.14	5.5	17.11	75.26	76.56	2270.44
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	1.91	-2.87	-3.73	5.14	10.32	25.81	13.04
Benchmark for volatility							
VIX New Methodology	-8.7	-27.47	-14.83	-48.64	-43.62	-28.94	11.54

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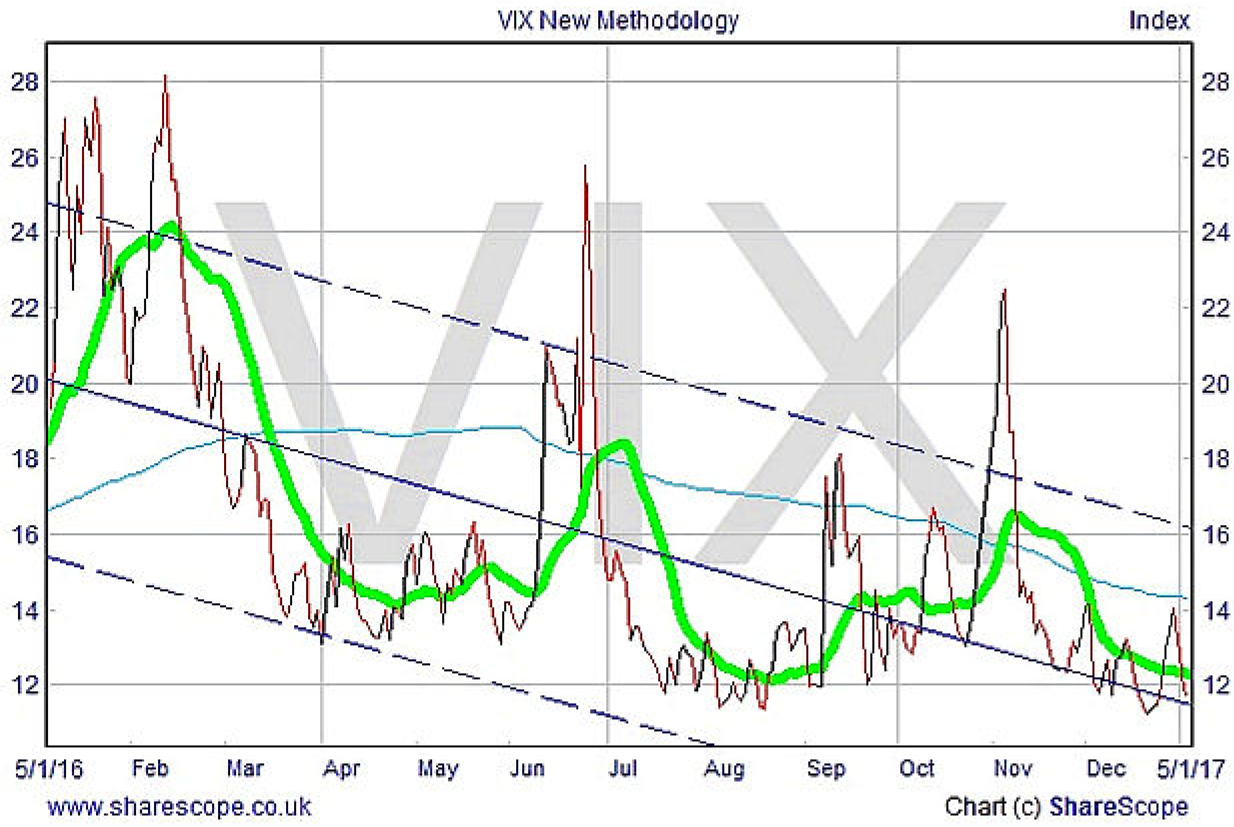
Volatility

Last month we observed that although there have been some recent spikes in stockmarket volatility (as measured by the Vix index, which tracks the turbulence of the S&P 500), the overall trend has been lower... much lower! The chart below reinforces this analysis. In recent weeks, the Vix index has recorded levels below 12, with the prospect of the index tracking below 10 if the current calm continues. Single digits for this index were last recorded back in 2007... and we all know what happened next !

Yet despite evidence that equity markets are less volatile than ever, trading in volatility related products and investments has shot up. According to a recent report in Bloomberg investors are 'piling' into securities that track volatility both in the US and Europe. The volume of VIX futures has climbed to more than 212,000 contracts on average each day this year, surpassing the previous record of about 190,000 in 2014. Popular exchange traded notes tracking volatility have as a consequence seem volumes massively increase.

Bloomberg reports that the "number of shares outstanding on the ProShares Ultra VIX Short-Term Futures and the VelocityShares Daily 2x VIX Short Term ETN -- which generate twice the daily return of a gauge tracking CBOE Volatility Index futures -- has soared by more than 1,000 percent this year, with trading surging more than sevenfold". This rush into volatility related products isn't confined just to the US. In Europe, a record volume of VStoxx Index futures in December pushed the number of annual trades to a daily average of 40,000, almost 40 percent more than last year according to Bloomberg.

Do these speculators know something the rest of the market doesn't? Are they simply hedging their full equity exposure or is there a real concern that a financial blow out is just around the corner, courtesy of Trump or a possible President Le Pen?



Source: www.sharescope.co.uk

Measure	January Level	December Level	November Level	October Level
Vstoxx Volatility	15.21	16.94	21.96	21.52
VFTSE Volatility	11.62	12.04	16.69	16.82

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Summary of Pricing Impact on Structured Products

Pricing Parameter	Change	Impact on Structured Product Price
Interest Rates	Up	Down
Underlying Level	Up	Up (unless product offers inverse exposure to the underlying)
Underlying Volatility	Up	Down for capped return/fixed return/capital at risk products. Up for uncapped return/capital protected products.
Investment Term	Up	Down
Issuer Funding Spread	Up	Down
Dividend Yield of Underlying	Up	Down

Correlation (if multiple underlyings)	Up	Up (unless product offers exposure to the best performing underlyings only)

Source: UK Structured Products Association, January 2014

This information is provided for information purposes only, and the impact on a structured product price assumes all other pricing parameters remain constant.

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Explanation of Terms

CDS Spreads and Credit Ratings

A CDS effectively acts like an option insuring at a cost in basis points a bank or government bond in case of default. The higher the basis points, the riskier the market perceives that security. Crucially CDS options are dynamic and change in price all the time. A credit rating is issued by a credit rating firm and tells us how risky the issuer is viewed based on the concept that AAA (triple A) is the least risky and ratings at C and below are regarded as much riskier. CDS and ratings are useful for structured product buyers because they give us an indication of how financial risk is viewed by the market. Crucially a high CDS rate indicates that an issuer of a bond will probably have to pay a higher yield or coupon, which could be good for structured product buyers as bonds are usually a prime source of funding for a structured product. G8 government bonds issued by the likes of the UK and US Treasury are also sometimes used as collateral in some form of investments largely because they are viewed as being low risk. One last small note on credit ratings and CDS rates. A is clearly a good rating for a bond (and much better than B) but AA will be viewed as even "safer" with triple AAA the least risky. Terms of CDS rates anything much above 100 basis points (1%) would warrant some attention (implying the market has some, small, concern about the possibility of default) while anything above 250 would indicate that the market has major concerns on that day about default.

Why does the yield matter on a bond?

As we have already explained bonds are usually used as part of a structured product. The bonds yield or coupon helps fund the payout. All things being equal a higher bond yield means more funding for the payout. But rising bond yields, especially for benchmark US and UK Treasury 10 year bonds also indicate that the markets expect interest rates to rise in the future. Rising interest rates are not usually a good sign for risky financial assets such as equities.

Volatility measures

Share prices move up and down, as do the indices (the S&P 500 and FTSE100) that track them. This movement up and down in price is both regular and measurable and is called volatility. It is measured by stand alone indices such as the Vix (tracking the volatility of the S&P 500), VStoxx (the Eurozone Dow Jones Eurostoxx 50 index) and VFtse (our own FTSE index). These indices in turn allow the wider market to price options such as puts and calls that pay out as markets become more volatile. In simple terms more volatility implies higher premiums for issuers of options. That can be useful to structured product issuers as these options are usually built into an investment, especially around the barrier level which is usually only ever broken after a spike in volatility. Again all things being equal an increase in volatility (implying something like the Vix moving above 20 in index terms) usually implies higher funding levels for issuers of structured products.

Dividend Futures

These options based contracts measure the likely total dividend payout from a major index such as the FTSE 100 or the Eurozone DJ Eurostoxx 50 index. In simple terms the contract looks at a specific year (say 2015) then examines the total dividend payout from all the companies in the index, adds up the likely payout, and then fixes it as a futures price usually in basis points. Structured product issuers make extensive use of dividend futures largely because they've based payouts on a benchmark index. That means the bank that is hedging the payout will want to be 'long' the index (in order to balance it's own book of risks) but will not want the dividends that come from investing in that benchmark index. They'll look to sell those future possible dividends via these options and then use the premium income generated to help fund their hedging position. In general terms the longer dated a dividend future (say more than a few years out) the lower the likely payout on the dividend future as the market cannot know dividends will keep on increasing in an uncertain future and must his price in some level of uncertainty.

Equity benchmarks

Most structured products use a mainstream well known index such as the FTSE 100 or S&P 500 as a reference for the payout. For investors the key returns periods are 1 year (for most auto calls) and 5 and six years for most 'growth' products. During most though not all five and six year periods it is reasonable to expect an index to increase in value although there have been many periods where this hasn't been the case especially as we lurch into a recession. Risk measures such as the sharpe ratio effectively measure how much risk was taken for a return over a certain period (in our case the last five years using annualised returns). The higher the number the better the risk adjusted return with any value over 1 seen as very good.

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

Kind Regards,

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