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UK STRUCTURED™ PRODUCTS ASSOCIATION

Monthly Market Report

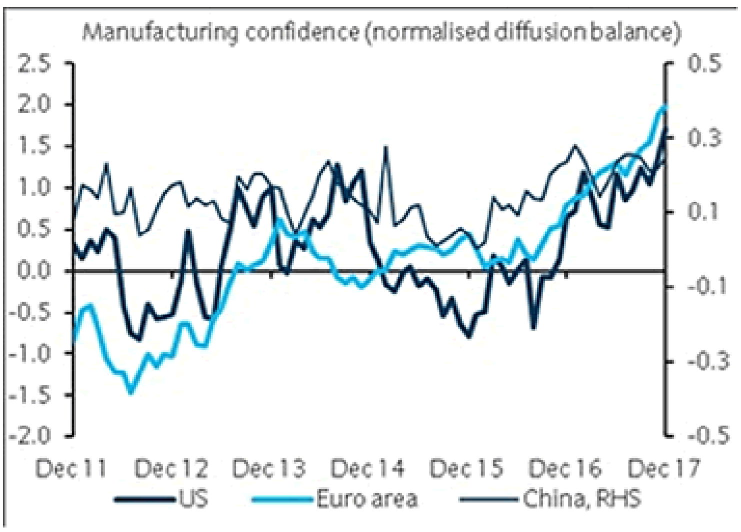
February 2018

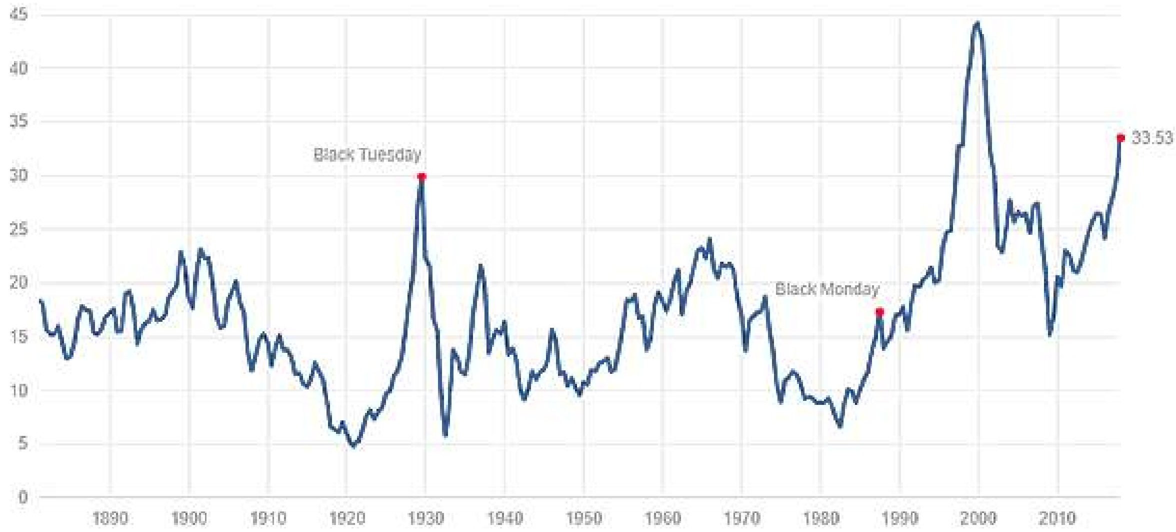
With commentary from David Stevenson

Stockmarkets have started 2018 in fine form. One measure of this optimism comes from a US investor organisation called the AAII which runs a signal called the Bulls index. This closely watched measure is currently recording its highest level since 2003. But this surge in bullishness has also pushed equities into expensive territory. Another measure, also closely watched by investors, is something called the CAPE - a yardstick on valuations using what is in effect the long-term average price to earnings ratio. This is currently registering a PE of 33.53 times corporate earnings for US stocks - the long-term average is 16.81. In fact, this CAPE measure - also called the Shiller PE after economist Robert Shiller - is nearly 20% above the same level last year and is currently at exactly the same level as the peak in 1929.

Yet the surge in equities and valuations may in part be justified, because corporate profits - earnings - are also surging at moment. This is largely because the global economy looks like its advancing in a fairly synchronised fashion. Most of the major investment banks run their own composite measures tracking the global economy but one of the best comes from our very own Barclays bank. Their most recent numbers suggested that the global manufacturing sector in particular ended 2017 on a high. The banks reading of its own global manufacturing confidence index jumped to 0.84 in December, the highest reading since March 2011. Crucially most of the key regions tracked by Barclays looked to be in good form although China's official NBS manufacturing confidence edged lower to 51.6 in December from 51.8. The good news though is that this slightly lower level for China was still in expansionary territory, with new export orders and import indices recording big increases. Crucially in the euro area, manufacturing sentiment improved further, with the PMI index reaching 60.6 — the highest since the inception of the series. If this strong global growth in manufacturing does feed through into corporate profits, there's a half decent chance that equities might continue to advance in 2018.

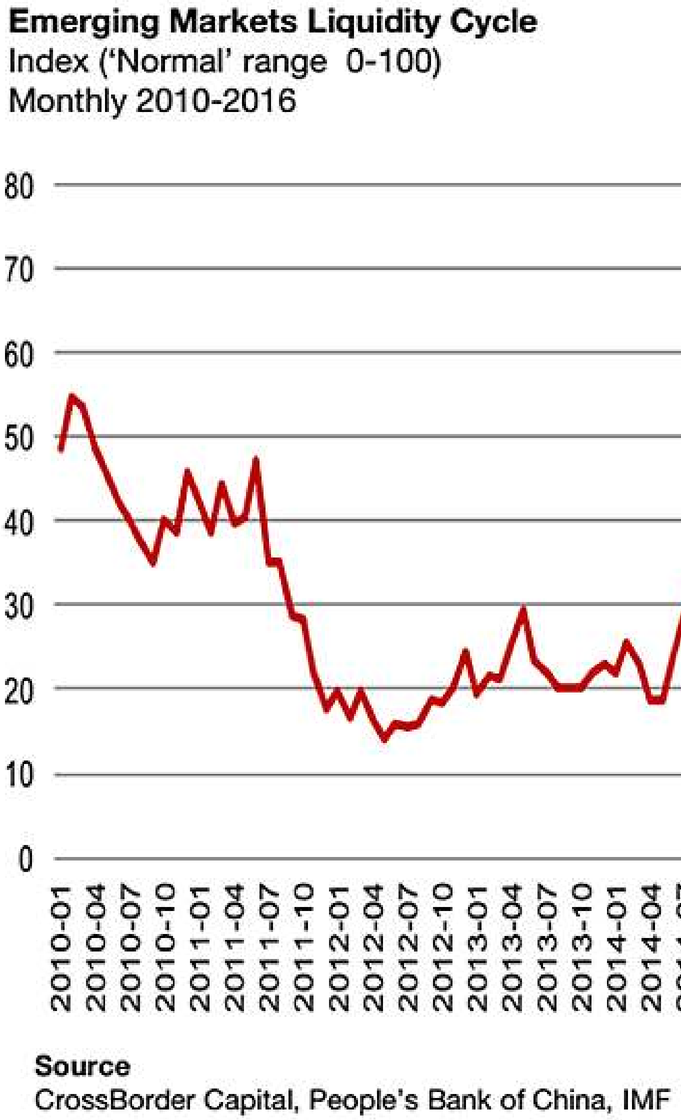
Barclays Manufacturing Confidence Index





Most investors looking to understand the surge in equities have focused on the role played by the central banks of the west. Massive QE and low interest rates have, of course, helped support equity prices. But China and its central bank have also played a crucial role in supporting the current global economic cycle. In many respects the current phase of growth is largely a story of two countries - a strong US and an equally strong China. The key switch in China seems to have happened back in January 2016 when the local central bank, the PBOC, changed direction and decided to increase the local growth rate. According to London based research firm Cross Border Capital the current driver of confidence in emerging markets is "PBoC liquidity and the conduit is increasingly China's policy banks, as money is channelling into schemes to support the massive pan-Asian Belt and Road Initiative (BRI). China's continued policy expansion owes much to this grand geo-political vision: it is likely to persist. Indeed, the recent strength of Chinese liquidity suggests that the Chinese economy is entering 2018 at a faster clip than the downbeat consensus believes".

If this reading of the stats on global capital flows is right we should a clear knock (positive) effect on shipping rates, commodity markets and emerging market equities. The picture gets cloudier though when this push for EM liquidity impacts developed markets and especially the US and its dollar. According to Cross Border the greatest potential threat in 2018 is whether the on-going capital outflows from the US dollar become a rout. "The reversal of US$3 trillion from US markets seems to be reassuringly occurring, so far, in a measured way" says the firm. "Crossborder capital is steadily flowing into faster-growth regions such as Asia, which alongside a still active Chinese PBoC points to a further boost to the Asian business cycle in 2018". These developments could push Chinese equities much higher which might in turn "spook World bond markets" already worried about rising interest rates and increasing commodity prices.



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Headline Numbers

Bond investors are increasingly on alert for inflationary pressures. The strength of the global economy has fed into an existing narrative focused on surging commodity prices and its impact on key inflation measures - in December for instance Oil prices were up 4%, Copper up 6% and Iron Ore up 7%. Copper is now 30% higher than this time last year and Brent Oil is up 50% in just six months. Even the CRB RIND index, which is often less volatile, has bounced sharply back towards its highs. According to analysts at Morgan Stanley in Europe, inflation expectations are now close to three year highs, especially when measured through something called breakeven rates. Analysts at Barclays have not unsurprisingly started raising their inflation estimates for 2018. They now project global headline inflation to be 1.7% in both 2018 and 2019 (up from 1.5% and 1.6%, respectively) and reach 1.8% by 2019-year end.

What's remarkable though is that many investors are spooked by these small upwards revisions. In reality global inflation rates are still well long term levels. The chart below from the US Federal Reserve shows inflation expectations since the late 1970s. Levels of 3% would still only be at the average level experienced over the last 50 years and well below the levels seen in the late 1970s. Inflation expectations also hit 4.6% in April 2011 before falling back sharply as the global economy started to lose speed.

University of Michigan, University of Michigan: Inflation Expectation [MICH], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MICH, January 12, 2018.

Measure	Value as of 14th December, 2017	Value as of 15th January, 2018
UK Government 10 year bond rate	1.21%	1.32%
GDP Growth rate YoY	1.50%	1.70%
CPI Core rate	2.70%	2.70%
RPI Inflation rate	3.90%	3.90%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.52%	0.52%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	58.2	56.3

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Bank CDS options

Most credit default swap rates edged higher over the last few weeks, with small increases of between 2 to 7% for 5 year products fairly standard - the biggest increases (still small) were for the French banks BNP Paribas and SocGen, although it should be noted that despite these increases both boast swaps trading at prices which are well below the average for their peers. Paradoxically another French bank Natixis experienced a sharp fall in the price of its credit default swaps - as did swaps for Banco Santander, the parent business for the UK business.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	17.52	41.27	-1.75	-49	A -
Barclays	23.41	42.58	-1.45	-47	A
BNP Parabis	8.48	22.86	3.5	-73	A
Citigroup	17.49	39.92	-4.38	-46	A
Commerzbank	18.67	53.37	3.65	-55	A+
Credit Suisse	18.06	48	-4.88	-60	A
Deutsche Bank	25.18	68.14	-6	-58.9	A+
Goldman Sachs	19.32	51.19	-5.61	-45	A
HSBC	10.24	19.5	-1	-72	AA-
Investec*	n/a	186	n/a	n/a	BBB
JP Morgan	18.74	37.95	-5	-41	A+
Lloyds Banking Group	9.88	42.36	-11	-34	A
Morgan Stanley	20	50	-1	-41.91	A
Natixis	10.13	26.28	-17	-67	A
Nomura	12.57	44.92	-4.33	-49.32	A-
Rabobank	7.7	19.98	-1.09	-69	AA-
RBC*	n/a	65	n/a	n/a	AA
RBS	28.46	49.3	-0.13	-58	A
Soc Gen	9.64	23.87	6.9	-72	A
UBS	9.01	18.87	1.37	-70	A

Source: www.meteoram.com 15th January 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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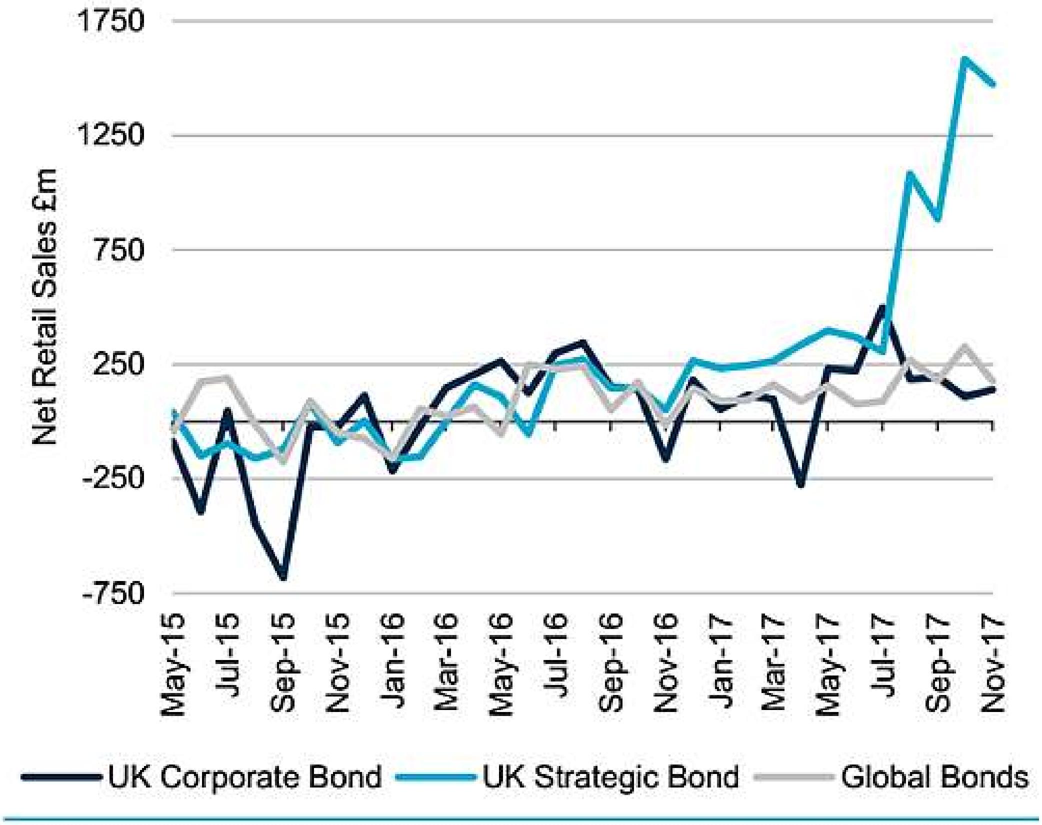
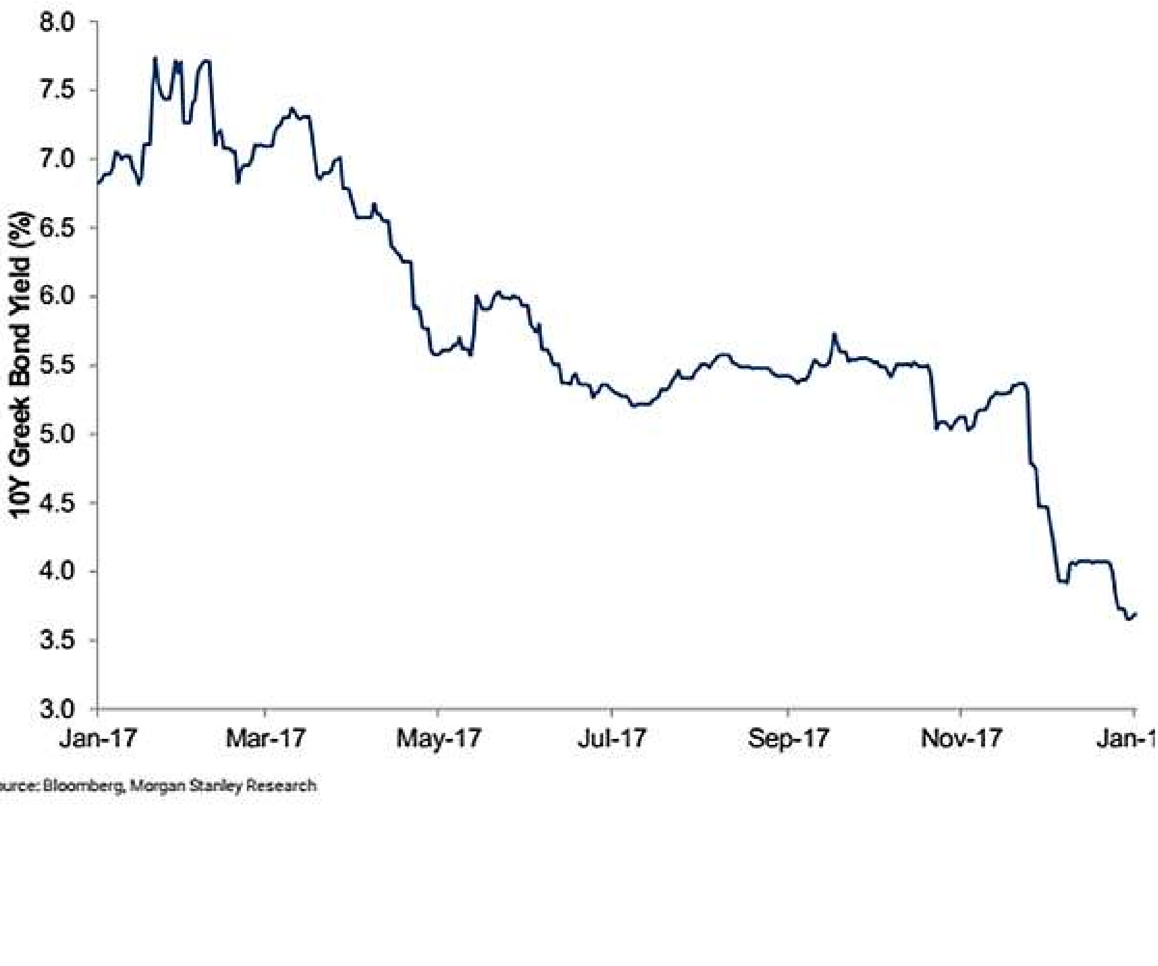
Government Bonds

In this report we've already observed how more and more bond investors are beginning to worry about rising inflation rates. Traditionally this spells bad news for most bonds, which in turn rather implies that investors should be rotating out of fixed income securities into inflation linkers and equities. Yet funds flow data, especially here in the UK, suggests the exact opposite effect. Recent numbers from the retail orientated Investment Association show that although investors are putting record amounts of money into investment funds overall - 2017 YtD, net retail inflows totalled £43.1bn, already surpassing the largest net inflow in any calendar year since 2009 - the biggest inflows have been into bond funds. According to the IA, November saw very high inflows of £4.4bn, albeit down from £5.1bn in October and a record breaking £5.6bn in September. In particular demand remained focused on **UK Strategic Bond** funds which according to analysts at Numis "saw net inflows of £1.5bn, resulting in net retail inflows totalling £7.4bn in the last 12 months. We understand that this has been focused on inflows into M&G Optimal Income which yields 1.9% and has assets of c. £21.9bn." All in all, this represents a peculiar state of affairs. If inflation is about to increase sharply and the global economy is advancing steadily, interest rates could increase sharply which would be terrible news for bond investors. Alternatively, bond investors might know something everyone doesn't - that inflation rates will fall, and that the global economic recovery is temporary. In effect these bond inflows suggest that many retail investors are betting on a repeat of 2011, when economic growth lost momentum. One last side note - on Greek bonds, where yields have been falling sharply in recent months. Greek 10Y bond yields have now fallen from 5.25% to just 3.6% since the beginning of December and currently stand at their lowest level since 2006. Their 110bps spread over US Treasuries is the lowest since 2008.

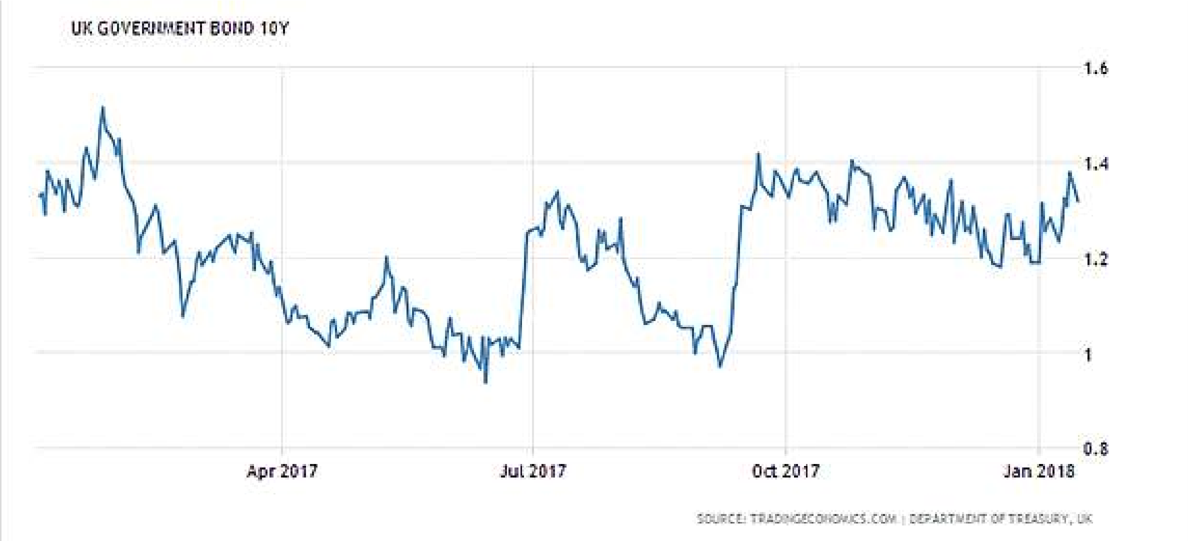


Source: Investment Association, Numis Securities Research



Source: Bloomberg, Morgan Stanley Research

UK Government Bonds 10-year Rate 1.32%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	16.1
Germany	7.81
Japan	22.5
United Kingdom	17.38
Ireland	24.79
Italy	107.81
Portugal	80.95
Spain	45.61

Eurozone peripheral bond yields

Country	December 2017	January 2018	Spread over 10 year
Spain 10 year	1.49%	1.51%	94
Italy 10 year	1.79%	1.99%	142
Greece 10 year	4.17%	3.89%	332

	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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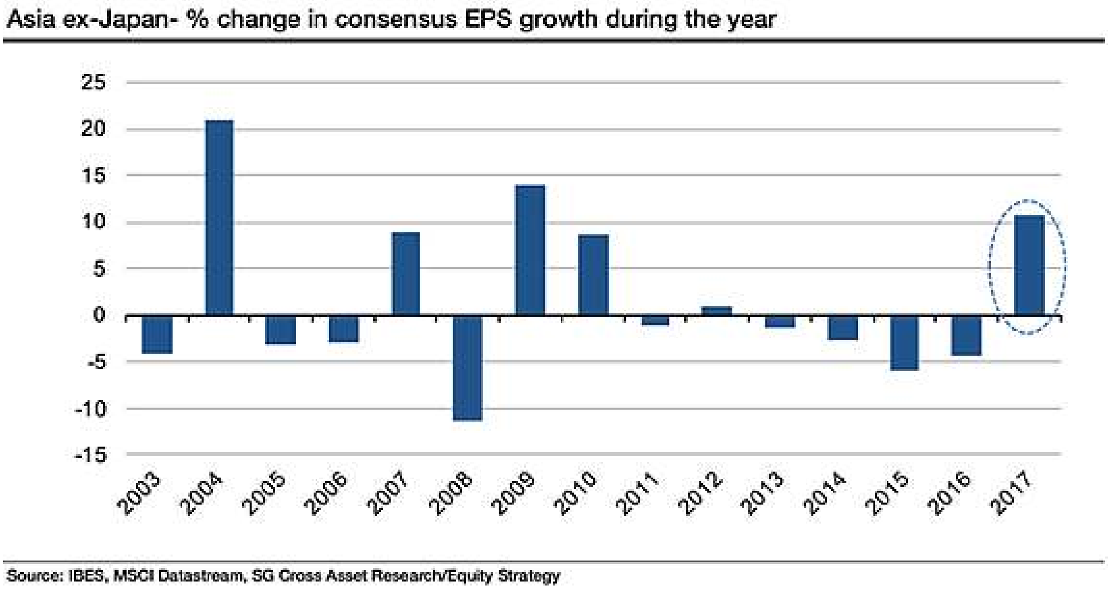
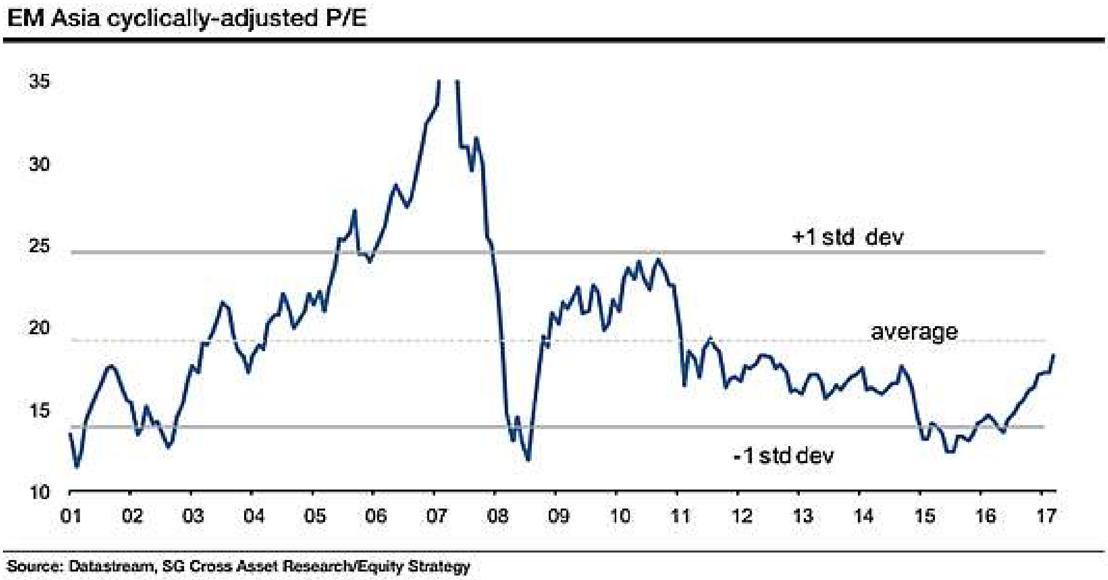
Equity Markets and Dividend Futures

If analysts such as Cross Border - see our earlier article on emerging markets capital flows - are right, equity investors might want to think about increasing their exposure to Asian equities in 2018. China is an obvious driver for the developing world and there seems to be no let up in the Chinese central bank's efforts to generate moderate, sustainable GDP growth. Analysts from French bank SocGen are certainly in the bullish camp when it comes to Asian equities. They think this ample liquidity emerging out of China helps but there are other drivers at work that might support local stockmarkets, not least relatively low valuations and surging earnings. They reckon that Asian equity markets currently trade at 18.3x on 10-year average earnings, well below levels in the US and Europe. Looking at profits, the banks analysts observe that with a few exceptions, "the latest earnings season confirmed the three trends we have observed over the last four quarters. Firstly, earnings growth has been revised upwards. A weaker dollar, the reacceleration of China growth since March 2016 and the recovery in global trade have triggered a new earnings cycle. Secondly, they have become less cyclical thanks to a lower weighting of resources sectors and a higher weighting of technology. Thirdly, domestic earnings are improving. The domestic sector and notably financials became positive contributors to earnings growth in 2017 and we expect this to continue in 2018."

Japanese equities might be another very strong beneficiary of this Asian rebound. For many more value orientated investors it's already the market of choice, with low leverage and consistent dividend payout ratios. Most interestingly according to SG analysts 2017 also saw a slow decoupling between the yen and the equity markets with several periods where equities rallied hard despite the yen strengthening: underscoring that Japan is not just a yen play any longer.

Looking forward into 2018, the banks ultra bearish strategist Albert Edwards, says that income growth is outstripping consumer spending by a wide margin in Japan and the savings ratio is widening. "Hence if consumer confidence in Japan remains buoyant" Edwards notes," consumer spending should contribute to even stronger GDP growth than the above trend 2% YoY rate recorded in 3Q last year". The Japanese labour market is already tight and there's even some (limited) evidence that wage rates are increasing. If that is the case an alternative (slightly worrying) scenario emerges - as Japanese profits surge because of a strong Asian market, inflation does start to edge up noticeably, and the **Bank of Japan decides to tighten early**. According to Edwards such a tightening might wrong foot the markets "prompting a massive 2008-like unwind of carry trades (CFTC data shows extreme short yen positioning). If investors are looking for the major surprise that could end this equity bull market, could this be it?"





Index	December	January	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	116.9	126.3	3608	123
FTSE 100 (Dec 17)	287.6	298.9	7766	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	3.68	3.07	5.26	5.84	27	37.8	7765
S&P 500	4.13	9.13	13.3	22.5	89.2	116	2786
iShares FTSE UK All Stocks Gilt	-1.29	0.66	0.798	1.17	12	10.3	13.1
VIX New Methodology	4.88	2.81	3.89	-12	-27	-52	9.88

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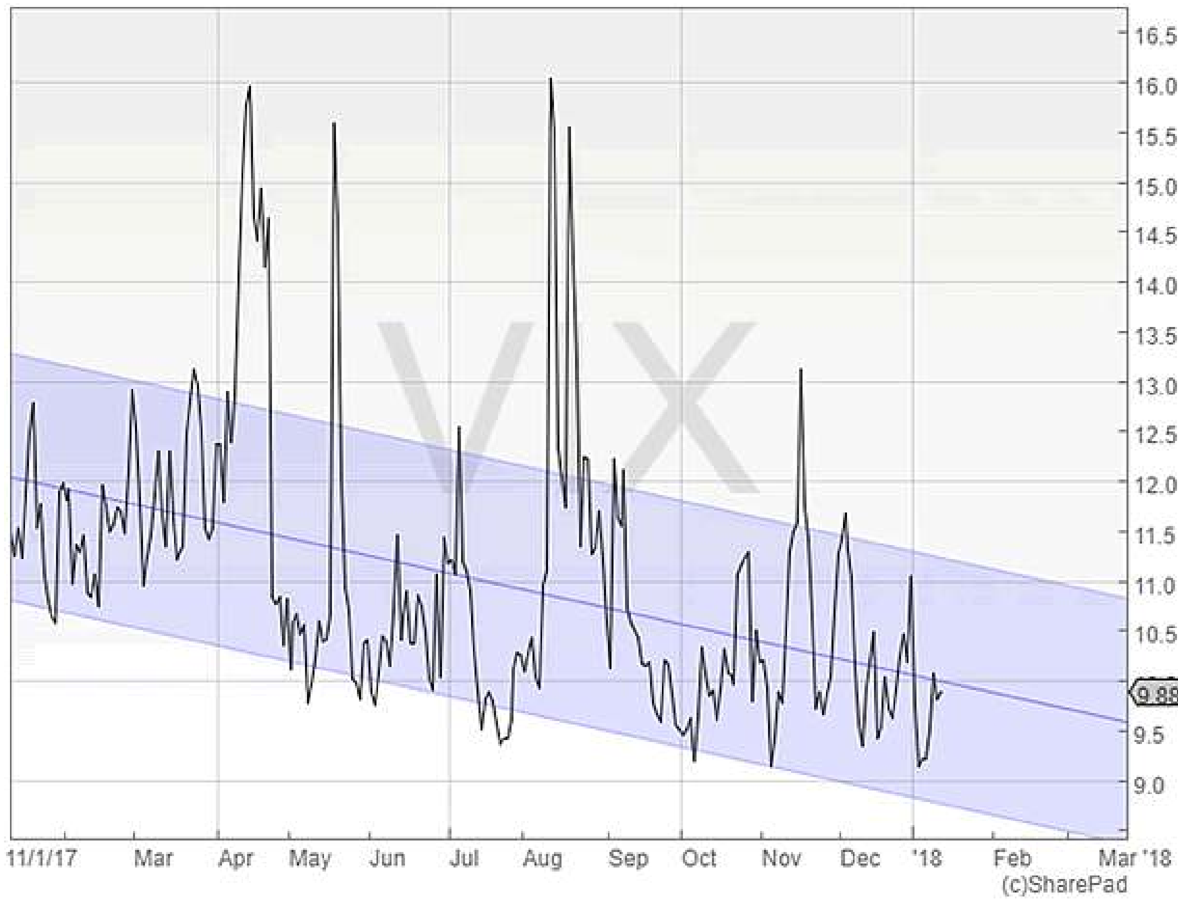
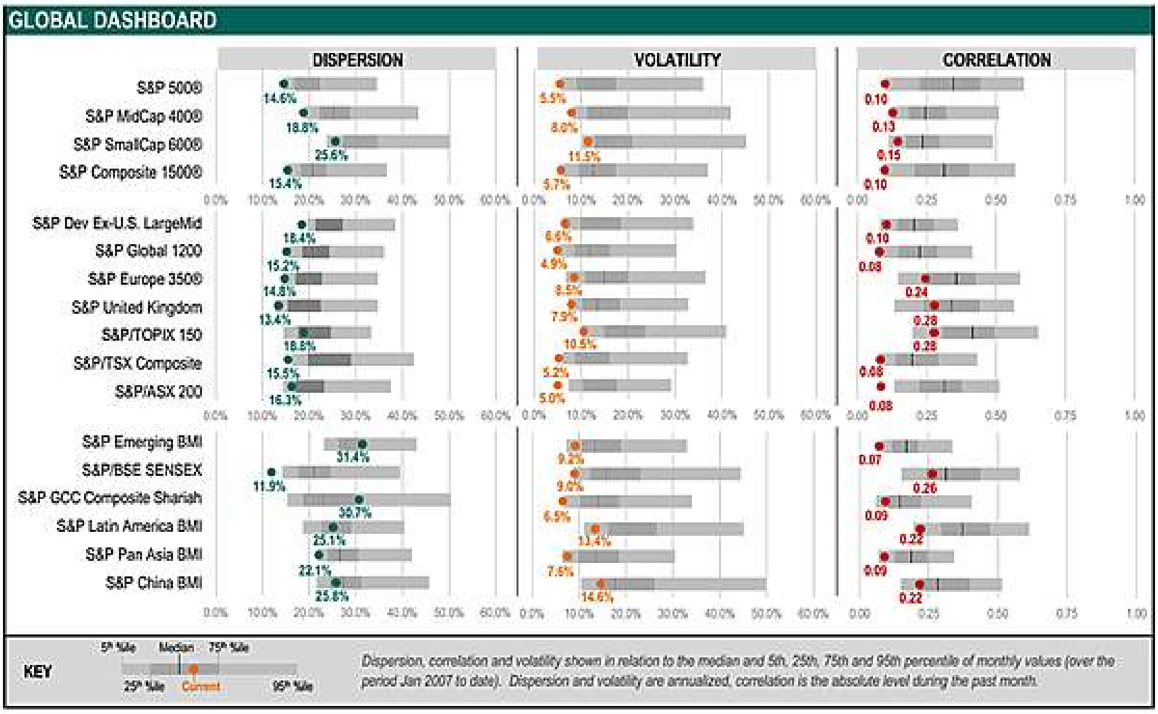
Volatility



Risk was the dog that didn't bite in 2017 - according to analysts at S&P Dow Jones, average observed 1-month volatility in the S&P 500 in 2017 was lower than in any other year since 1970. European equities were similarly becalmed - the average monthly volatility in the S&P Europe 350 was lower in 2017 than in any other year in the past decade. The MSCI World index for instance delivered a positive total return every month of the year and for 14 months in a row, realised daily MSCI World volatility over the year was less the 6%, half the usual rate, and the index experienced a maximum drawdown of only 2%. Low levels of volatility usually imply that most passive strategies win out over active stock picking - if most stocks are heading steadily upwards, there's not much extra return to be had for active managers. But the chart below – from S&P Dow Jones - shows that although volatility levels were indeed incredibly low, dispersion between returns for some markets was much higher i.e. the range of share price returns was much wider than expected. Of particular note are the returns from stocks within the US small caps universe - the S&P Small Cap 600 universe had nearly twice the level of dispersion compared to the S&P 500. Emerging markets also produced much more dispersion, especially Gulf State equities (perhaps the Qatari effect), as well as Latin American stocks and Chinese equities. In most of these more volatile markets, dispersion of returns between stocks was 'elevated' according to S&P Dow Jones - implying that stock pickers could have picked up bumper returns if they had the right strategy.



Source: S&P Dow Jones

Measure	January Level	December Level	November Level	October Level
Vstoxx Volatility	10.97	12.3	14.61	12.43
VFTSE Volatility	9.16	7.09	10	9.69

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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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