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UK Structured™ Products Association

Monthly Market Report

July 2017

With commentary from David Stevenson

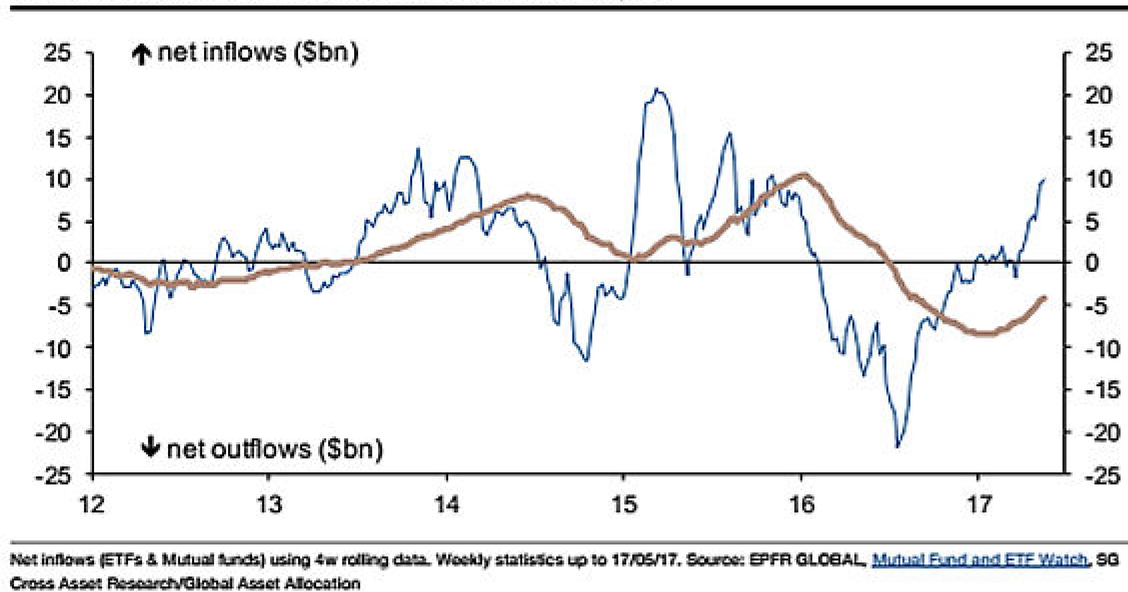
If I'd have asked most readers which region they'd suggest would constitute a 'safe haven' by mid 2017, my guess is that most wouldn't have plumped for the Eurozone. For months now we've been worrying ourselves senseless about the collapsing Euro, the revolting Greeks, the restless French/Dutch and their love of populists and the growing sense of boredom with the steady Chancellor Merkel.

Now though everything has changed. Macron has won the election; the Dutch have rejected the populists and Merkel looks like she's cruising to a victory in Germany. Crucially European stock markets have powered ahead. In fact, the European market overall is close to the multi-year peaks it last reached in 2000, 2007 and 2015 - and in all three instances corrected shortly afterwards. But there's good reason to think that it is 'different this time' (!).

A recent note by analysts at French bank SocGen observes that European equity mutual funds and ETFs have posted $15bn in inflows year to date - see the chart below. However, the bank's analysts observe that this does not come anywhere close to the $100bn of outflows recorded in 2016. "Thus, many global international investors are still underweight European equities".

Crucially, compared to US equity valuations, European stocks look fair value. According to SG, although US equities are not cheap (P/E of 18x, P/BV of 3.1x), eurozone equities are, despite the recent rally (15x 12m earnings and 1.7x book value).

I'd also argue that the political and economic environment is improving in the Eurozone. Brexit doesn't really seem to be centre stage on the continent. Macron's reform agenda has boosted sentiment, and Merkel is clearly in a strong position to dictate big structural changes - helped along by her new, optimistic French peer. If we buy this analysis - and I'm sure many diehard EU critics will still scorn all this optimism - there are some obvious investment implications. According to SG again, five key trades become obvious. First off you'd play a Eurozone upsurge and reflation, which will in turn help Eurozone equities (especially anything consumer related). This should also follow through into a renewed bout of M and A activity. Defence spending might also increase, helped along by some Trump hectoring. And last but by no means least, might we even be surprised by the French and their equities, as President Macron embarks on a supply side reform programme?



Source: SocGen

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Headline Numbers

It's far too easy to be cynical about the current rally in developed world equities, blaming it all on some peculiar Trump bounce helped along by the prospects of much lower US taxes. There are other forces at work not least surging profits and dividends.

If we look at measures tracking global earnings momentum for instance, especially those based on the percentage of analyst's upgrades, both the US and the Eurozone have seen remarkably strong growth, surging towards a 60% increase in estimates.

Surging profits also appear to be having a knock-on effect on dividends. The latest global dividend survey from fund management firm Janus Henderson has upgraded dividends payout for the current year and now expects 3.9% underlying growth and 1.5% headline growth, taking its global forecast to $1.176 trillion.

And once we dig down into the real-world economy, and manufacturing in particular we also see signs of strong growth. Analyst at UK investment bank Barclays report global manufacturing confidence

recovered noticeably in May. Their reading of the bank's own global manufacturing confidence improved to 0.19 in May from 0.10 in April. According to Barclays "this was driven by stabilization in manufacturing confidence in US and China and a marked improvement in euro area. Manufacturing sentiment in parts of emerging Europe and Asia also improved, which supported the gain in our index". Looking at the various sub components of this widely followed sentiment metric, global new orders gauge increased to 0.22 in May. Also the banks forward-looking measure of new orders less finished goods inventories strengthened to 0.19, driven by both global inventory de-stocking and rising new orders. One other factor to watch - cost inflation is moderating. According to Barclays, a common trend across most PMI reports was the easing in cost pressures, which is captured in their global input prices gauge that fell sharply to -0.31 from 0.25. "In conclusion, global manufacturing confidence has regained some of its momentum in Q2 following the weak showing in April, and we view these levels as sustainable."

Euro Area Manufacturing PMI

Source: https://tradingeconomics.com/euro-area/manufacturing-pmi

One of the mega-stories of investing over the next two decades will be pensions. How they impact on society, funding them and working out how to prioritize scheme payouts over other stakeholders such as investors looking for their dividends. Oh and to what degree government's will raid, and misdirect, pension pots to serve their policy objectives. The immediate short term story centres on the DB deficit, which looks a bit like the government's fiscal deficit, in that sometimes it gets a bit better and then most of the time simply looks horrid. The longer-term story is how we can collectively figure out ways to properly fund pensions, using a combination of more payments in to the schemes and better investment returns. A clue as to the outcomes of both challenges come in reports this month from consulting firm Mercer. So, to the short-term challenge - how big are the DB scheme black holes? The good news from the first Mercer report is that they're looking a bit better.

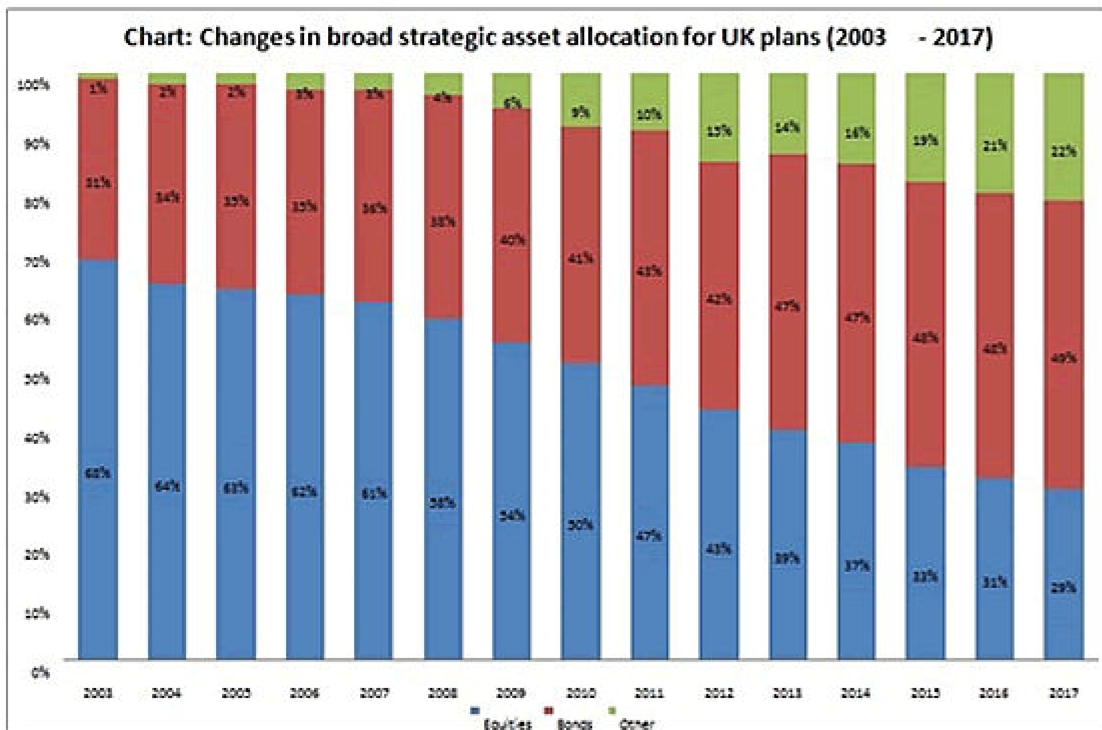
"Mercer's Pensions Risk Survey data shows that the accounting deficit of defined benefit (DB) pension schemes for the UK's 350 largest listed companies fell from £145bn at the end of April to £134bn on 31 May 2017. At 31 May 2017, asset values were £749bn (an increase of £10bn compared to the corresponding figure of £739bn at the end of April 2017), and liability values fell by £1bn to £883bn compared to £884bn at the end of April.

"The improvement in the funding level over May was predominantly due to an increase in asset values which reached another new high. Liability values remained substantially unchanged with a reduction in long dated corporate bond yields being offset by a reduction in the market's expectation for long-term inflation," said Ali Tayyebi, Senior Partner at Mercer. "With stock markets around the world at all-time highs, trustees and companies should consider the merits of putting in place some downside protection

for such assets." continued Mr Tayyebi.

Mercer's European Asset Allocation survey is another publication. It dives deep into the detailed portfolios to see what's happening at the cashflow mechanics level of funds. The latest version of this report suggests that "55% of the UK's defined benefit (DB) pension schemes are now cashflow negative (up from 42% in 2016) with 85% of the remainder expecting to be cashflow negative by 2027. Cashflow negative schemes lack sufficient income from investments and contributions to pay member pensions, so typically need to sell assets to meet their liabilities. Consequently, they are more vulnerable to market corrections since they may be forced to disinvest during a period of market stress". So, given these trends, what would you as a pension fund manager or trustee do if you felt you didn't have enough cash coming? One tactic might be to goose up returns by taking a bit more risk. And where would you look for those extra returns? According to Mercer "pension schemes are investing in alternative assets that offer some additional return in exchange for reduced liquidity and greater complexity as well as providing a regular income stream. The average allocation to alternatives increased in 2017 to 22% compared to 21% in 2016 (up from 4% in 2008)."

In parallel, pension funds are also dumping what are in effect conventional 'alternative ' assets with deep liquidity - shares to you and I - and investing in much less liquid stuff such as private debt finance for smaller companies. According to Mercer's "in terms of asset allocation (See Chart 1 below) since 2008, UK plan equity allocations have halved from 58% to 29%. Report participants see this continuing, expressing their intention to further cut equity allocations in the years ahead. Indeed, in 2016, equity allocations fell as some schemes took opportunities to de-risk in the latter part of the year as equity markets and bond yields rose. Equity allocations averaged 29% in 2017 - compared to 31% in 2016 - while allocation to bonds rose from 48% to 49%".



Source: Mercer

Measure	Value as of 8th May, 2017	Value as of 5th June, 2017
UK Government 10 year bond rate	1.10%	1.04%
GDP Growth rate YoY	2.10%	2%

CPI Core rate	1.80%	2.40%
RPI Inflation rate	2.30%	3.50%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.32%	0.29%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	57.3	56.7

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Bank CDS options

Quite a few major price changes for Bank CDS spreads in the last month. Many continental banks have seen a sudden and dramatic decline in the cost of their 1 year CDS spreads, with French and German banks leading the way. CDS pricing for Deutsche Bank in particular is now close to its peer's level in France and Italy. This favourable pricing has also impacted UK banks, where pricing has also fallen sharply. Banks such as HSBC UK and Lloyds seem to have been particular beneficiaries of their benign pricing environment.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	28.93	71.23	-12	-38	A -
Barclays	22.96	64	6.24	-41	A
BNP Parabis	12.56	51.26	-10.74	-38	A
Citigroup	20.85	58.31	-0.54	-30	A
Commerzbank	22.39	78.8	-3	-29	A+
Credit Suisse	21.04	75.2	-5.91	-42	A
Deutsche Bank	30.39	98.58	-2	-42	A+
Goldman Sachs	30.2	73.93	3.98	-23.92	A
HSBC	14.26	51.46	7.77	-44	AA-
Investec*	n/a	182	n/a	n/a	BBB
JP Morgan	21.12	52.06	7.87	-19	A+
Lloyds Banking Group	17.96	54.4	7.8	-41	A
Morgan Stanley	25.52	69.7	3.97	-26	A
Natixis	17.7	53.28	-12	-36	A
Nomura	12.53	42.25	-4.37	-53	A-
Rabobank	11	43.33	-8.46	-40	AA-
RBC*	n/a	58	n/a	n/a	AA
RBS	28	75.8	4.49	-37	A

Soc Gen	13.04	51.27	-11.38	36.48	A
UBS	9379	43.05	0.12	-40.67	A

Source: www.meteoram.com 6th June 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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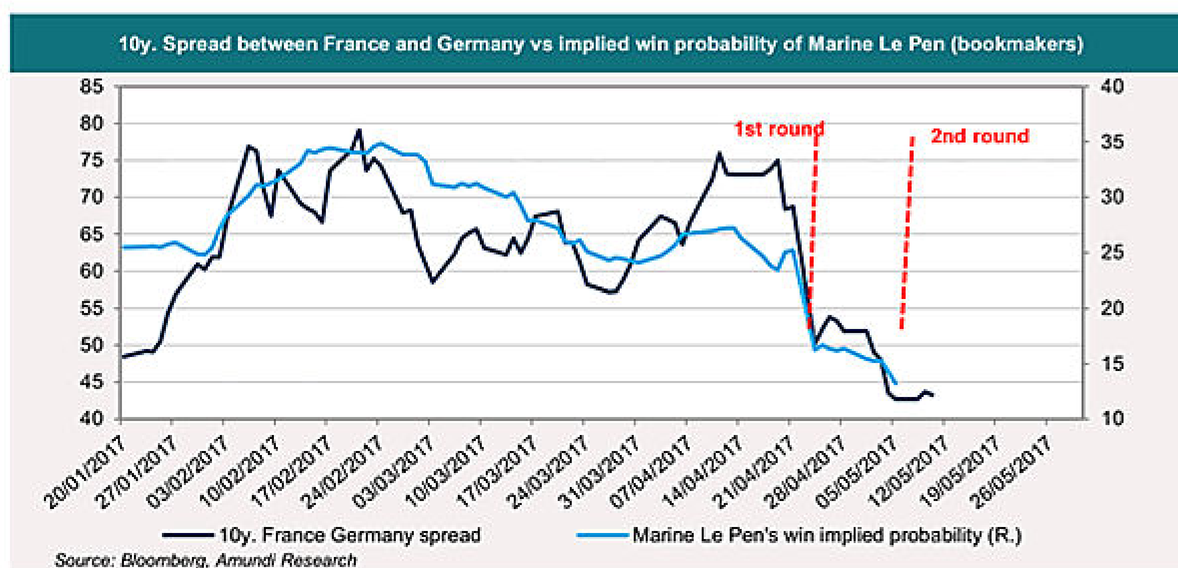
Government Bonds

I can't say I was terribly surprised by the resounding victory of Macron in the French Presidential elections. Opinion polls have been the subject of much criticism following Brexit and Trump but to be fair these polls did consistently say that both elections were too close to call - with differences of just a few per cent. They weren't entirely wrong judging by the closeness of the results in both cases! In France by contrast though the polls had been consistently saying that Macron would win, decisively - and he did with more than 65% of the vote. Betting markets may have been suggesting that the odds were much closer but yet again those professional betting markets have been proved wrong!

Curiously though the high likelihood of a Macron win had been discounted by some investors, especially those in the bond markets - one easy way of explaining this was to look at the sovereign bond markets where many investors seriously believed that a Le Pen was likely. That helped push the spread up between French and German sovereign bonds to absurdly high levels.

A paper out a few weeks back by Bastien Drut, strategy and economic research analyst at fund management Group Amundi Asset Management, maps out that evolving spread in the chart below.



The recent plunge in the spread is thus to be entirely expected. But what happens next? The Amundi analyst rightly reminds investors that these spreads are usually influenced by a complex range of factors over the medium term to long term, not least political risk and macro-economic considerations. As evidence, he points to a recent Bank of Italy working paper (« Recent Estimates of Sovereign Risk Premia for Euro Area Countries », 2012) which looks at the full range of factors. Using this analysis, he then

builds his own "Eurozone sovereign spread model".

According to Drut if his model is right "the fair values of 10-year sovereign spreads would be as follows:

• 80 bps for France,
• 180 bps for Italy,
• 150 bps for Spain,
• 200 bps for Portugal,
• 120 bps for Belgium

UK Government Bonds 10-year Rate 1.04%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	28.4
Germany	15.66
Japan	26.37
United Kingdom	24.48
Ireland	43.14
Italy	175
Portugal	212
Spain	78.14

Eurozone peripheral bond yields

Country	Apr 2017	June 2017	Spread over 10 year
Spain 10 year	1.61%	1.57%	117
Italy 10 year	2.21%	2.27%	178

Greece 10 year	6.88%	6.04%	533

	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

Emerging market equities are on a roll. On a 12-month basis, the MSCI EM index is now up just under 40% compared to 16% for US equities - South African equities are up 32% and Chinese equities up 19%.

European equities have also had a good few months, regaining their composure after worries about the rise of populism. The German DAX index is up 26% over the last 12 months, the French CAC 40 up just over 20%.

A paper from global bank HSBC suggests that European and EM equities might be even more closely linked than we first thought. In a flash note from May 24th entitled "Why Europe Matters a lot", HSBC's Murat Ulgen, Bertrand Delgado, Ali Cakiroglu and Paul Blower probe the close connection between continental Europe and emerging markets.

The table below probably best sums up this linkage based on exports. The European Union has been and still is the biggest export market for emerging markets, constituting 22.3% of the total (Table 1), despite a decline after the global financial crisis. As such, the improvement in economic activity in the region should support the recovery in EM exports. In effect, a recovery in the Eurozone is good news for EM equities - and vice versa.

Table 1. Europe is still the leading trading partner and a more important capital provider for EM on an aggregate basis

	Export exposure as % total			Total claims % of total			
EM	EU	US	Japan	EU	EU exc. UK	US	Japan
2007	27.6%	19.7%	7.1%	57.3%	40.8%	13.1%	5.1%
2016	22.3%	18.5%	5.4%	53.1%	37.6%	15.1%	11.7%
Asia							
2007	19.5%	19.1%	8.9%	43.8%	18.8%	22.2%	12.5%
2016	15.0%	18.2%	6.8%	32.6%	10.9%	32.6%	37.9%
EEMEA							
2007	49.1%	9.4%	6.0%	62.4%	48.4%	10.2%	4.6%
2016	47.2%	6.0%	3.7%	75.1%	60.1%	12.9%	7.3%
LatAm							
2007	15.9%	43.9%	3.0%	65.1%	54.5%	18.3%	2.7%
2016	10.5%	44.1%	2.5%	60.9%	55.2%	23.5%	7.8%

Source: BIS, IMF, Thomson Reuters DataStream, HSBC

According to the HSBC analysts "with world trade already showing some signs of a turnaround, stronger eurozone activity should offer further respite to EM exports, in particular for those that trade predominantly with the eurozone. There is clearly good news here for CEE countries...specifically, the Czech Republic, Poland, Hungary, and Romania. Also, Turkey, Russia and South Africa should benefit,

followed by India, China and some Latin American (LatAm) economies". The European Union also has close financial links to emerging markets. According to the HSBC report "thanks to ECB's QE programme that helped European banks to restore their balance sheets, total claims of European banks have remained at elevated levels, at around 53.1% (37.6% when excluding the UK) of the total claims on EM at end 2016, particularly towards the CEE countries".

Last but by no means least the EU is also one of the major sources of foreign direct investments (FDI) within emerging markets. "Outward FDI flows from the EU to emerging markets have accelerated over recent years, reaching almost USD100bn annually and at a level more than three times higher than a decade earlier. The largest recipients during recent years have been China, Brazil, Mexico, South Africa, and Chile, each averaging over USD5bn a year. The EU invests three times more than the US invests in EM through FDI, and therefore a far greater proportion of GDP. Germany, the Netherlands, Spain, and Belgium are the largest providers of FDI outflows to EM".

These close links between emerging markets and the Eurozone suggest that the remainder of 2017 should be positive. The Eurozone recovery is gathering pace and emerging markets - and especially China - look to be on a stable footing. Crucially political risk has diminished greatly in the Eurozone and there's now a greater emphasis at the regional level to carve out a more internationalist trade and diplomatic policy, partly in opposition to the perceived Trump agenda of America First. If this analysis is right then we could see even more capital inflows into emerging markets from the Eurozone. On the downside, the HSBC analysts warn that "aggressive US anti-trade and fiscal policies and geopolitical miscalculations, as well as a more hawkish Fed, ECB and PBoC are all risks to this positive EM view".

Index	May	June	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	116.3	116.5	3580	114.7
FTSE 100 (Dec 17)	282.4	285.3	7525	n/a

Name	Price % change						Close
	1 month	3 months	6 months	1 year	5 year	6 year	
FTSE 100	4.1	2.24	12.14	22.02	43.49	29.07	7547.63
S&P 500	2	2.4	11.27	15.86	90.84	85.77	2439.07
iShares FTSE UK All Stocks Gilt	-0.43	0.78	3.01	3.72	9.92	24.88	13.3275
VIX New Methodology	-7.93	-17.44	-30.95	-28.47	-63.43	-46.1	9.75

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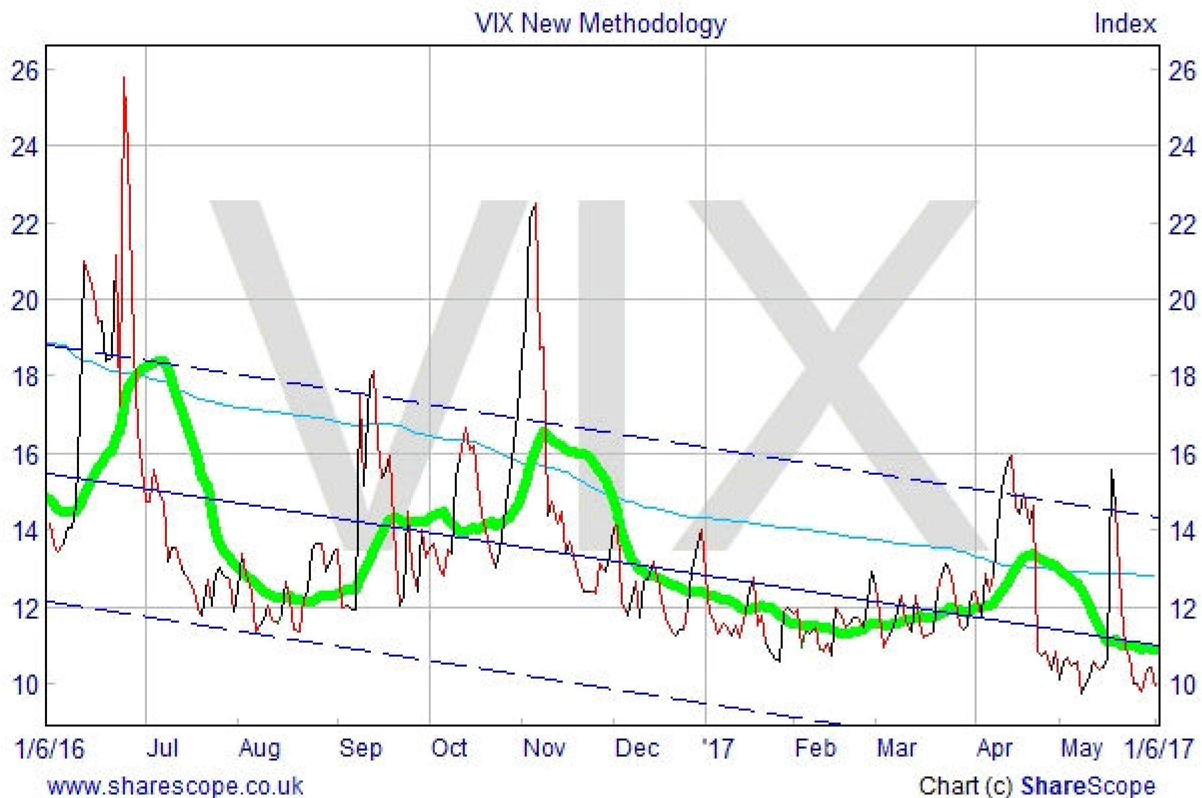
Volatility

We've commented many times before on these pages that something seems to have markedly changed with indices tracking market volatility. Only a few weeks ago market turbulence as measured by the VIX index (tracking ups and downs of the S&P 500 stocks) dipped into the single digits. In fact during the middle of May, the VIX index finished in single digits for only the tenth and eleventh time ever. These reading are at levels not seen since the run up to the 2008/9 GFC. The chart below shows this gentle deflation in the level of the VIX over the last 12 months.

But the obvious truth about the VIX - in fact any volatility measure - is that the index is inherently 'volatile' and 'unpredictable'. In the middle of May the key measure for market volatility exploded back into life, pushing above its 20 and 200 day moving average. In fact at one point in mid-May the VIX increased in value by 46% during just one session. The VIX looks to be back in business.



According to Tim Edwards, Senior Director, Index Investment Strategy, S&P Dow Jones Indices, it's worth looking more closely at the structure of the options market underlying VIX pricing in order to understand what might be moving markets.

Edwards observes that VIX term structure might be in effect " digesting a one-time repricing, as opposed to a structural change in the risk regime. The one-week VXST closed considerably higher at 20, while the first VIX future closed more than a point below VIX. Repeating the pattern observed in the immediate aftermath of the presidential election, dispersion rose while correlations remained muted: the so-called "Trump trade" was one that emphasized some sectors and business over others, instead of an overall market outlook".

There's also some evidence that this resurgence in volatility is very specific to the US markets - as suggested by the volatility dashboard from S&P Dow Jones below. According to Edwards there has been a "significant drop in European volatility that occurred after the French presidential election, with the VSTOXX dropping a whopping eight points to close at 16.14. In fact, with the European political situation looking more secure, and despite the U.S. intrigue, most of our reported volatility measures are down this month. "FX volatility has also remained relatively low, with S&Ps Yen, GBP and Euro vol measures all falling substantially over the last month".

Measure	June Level	May Level	April Level	March Level
Vstoxx Volatility	13.33	14.45	19.54	15.36
VFTSE Volatility	11.6	10.33	12.7	6.19

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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.

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

Kind Regards,

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