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UK Structured™ Products Association

Monthly Market Report

July 2018

With commentary from David Stevenson

The great genius that is President Trump may or may not have cracked the Asiatic puzzle that is Korea, but what we do know is that he's deadly serious about kicking off a trade war. The real Trump is finally to be unleashed on a stockmarket that has lazily assumed he'd never live up to his twitter tirade. The hugely regrettable fallout from the G7 (or 8 if we include, or even maybe 10 if we include new best friends such as China and North Korea) should underline the basic fact that a multilateral trade framework is now under sustained attack from the country that was its chief author. This has huge implications for globalisation which will take many months and years to filter through to equity valuations. In the box below, I've included a very concise summary by analysts at Barclays of the implications of the current trade dispute. Personally, I think they are much too sanguine/complacent but maybe I'm too cynical.

What I do think is important is that a trade war will only hasten the inevitable - the next global downturn. We are, by common consent, late in the business cycle and any responsible investor - and adviser - must be wondering when we'll hit the 'wall'. I don't think a slow down is imminent but it must be, by definition, inevitable within the next few years. On this I note a fairly weighty recent note from an investment summit at Pimco. They observe, again rather complacently in my view, that "a U.S. recession is part of our baseline outlook for the next three to five years, and we would expect significant global economic and market spillovers in that event." An expression involving horse manure and Sherlock comes to mind. When that slowdown comes they surmise that it will be a "shallower and longer" one - they call it a wok- or saucer-shaped, recession rather than a deeper but shorter V-shaped recession:

Shallower, because there are so far no signs of corporate or housing overinvestment or overconsumption in the U.S. economy, and the global financial sector looks steadier than in the past few cycles. The main risk to this view is elevated levels of non-financial corporate leverage, which raises the risk of a major default cycle even in an initially shallow recession.

Longer, because relatively low interest rates, bloated central bank balance sheets and (in the U.S.) larger fiscal deficits limit the policy space to fight a global recession. Moreover, given the widespread trend toward economic nationalism and protectionism, a recession could fuel trade deglobulisation and currency wars, thus shrinking the pie further.

In addition, the next recession could be *riskier* than a standard post-war recession, for a few reasons: Inflation expectations are very low at the outset almost everywhere, the structural weaknesses in the eurozone could be exposed, and a recession would raise the risk of populism aimed at wealth redistribution and confiscation."

To which I'd add that a trade war certainly won't help, especially if all those wok's cost a great deal more after the inevitable trade showdown with China!

Tomasz Wieladek over at Barclays has outlined what he thinks will be the knock on effects from the trade war, all contained within a snappy Friday Thinking Macro note, entitled 'Trade War' in perspective. Wieladek uses a VAR framework to study the effect of US tariffs on global growth and CPI. He reckons that:

- US tariffs act as a negative supply shock to the world economy. Our estimates for the first year after the tariff are large, but uncertain. We illustrate the effect of a 1% US tariff as a share of imports with second-year estimates. As a result, global growth falls by 0.3pp, inflation rises by

0.4pp. With tit-for-tat retaliation, the effects double.

- US steel tariffs represent only 0.33% of US imports, even excluding exemptions. The Intellectual Property tariff of 25% on $50bn of Chinese goods is 0.5% of US imports. The threat of a 25% tariff on $100bn of Chinese goods would be double.
- Based on these numbers, the steel tariff could reduce global growth by 0.1pp and raise inflation by 0.1pp in the second year. If $50bn of IP tariffs are added and retaliated tit-for-tat, growth would fall by 0.6pp and inflation rise by 0.7pp. With $100bn and tit-for-tat retaliation, growth falls 0.9pp and inflation rises 1.1pp.
- The impact on EM is larger than on DM. A 1% tariff leads EM GDP to fall by 1.1pp and inflation to rise 1.1pp. DM growth falls only by 0.5pp, while inflation rises 0.2pp.
- Our approach may underestimate the impact of a rapid tariff rise. We likely omit second-round price and confidence effects. Global value chains could be captured by our model, as they emerged when tariffs were reduced in the 1990s. Even if the 'true' impact is twice our estimate, large effects still require large tariffs.
- There are several mitigating factors. While the US used tariffs in the 19th century, large retaliations were rare. A 70% success rate in WTO trade disputes will likely encourage the US and EU to keep this resolution mechanism. Services trade could rise with US business deregulation. But likely not enough to offset the EM impact.

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Headline Numbers

Seasonality is a key driver of stockmarket returns. Most investors have probably heard of the adage that investors should go away in May and stay away (until September). One possible explanation for this is that in Europe, spring and early summer brings with it a big upsurge in dividend payouts - which helps boost sentiment. An outsized share of global equity dividends are paid in April and May, which coincides with strong seasonality (especially for April). In dollar terms, April/May represents a roughly US$300 billion cashflow back to equity investors, and a helpful technical. What's that about a bird in the hand...

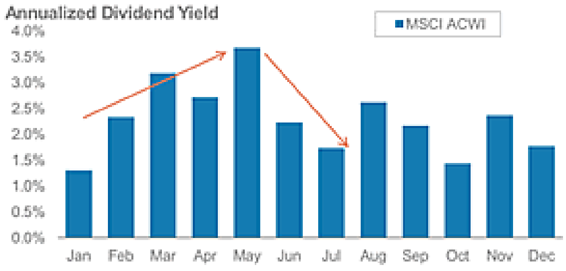
Anyway, dropping dividends after the early summer may also help explain why some investor's I talk to are particularly cagey about the fast approaching long summer days. With Trump jumping up and down, and dividends on the decline maybe we'll be in for some dismal Summer declines. According to a note out earlier this month from analysts at Morgan Stanley the dividend window "is now behind us. Dividends in most markets drop off significantly starting in June. Meanwhile, market performance from June through September tends to be weaker than average, with June seeing the lowest instances of positive returns of any month."

But there may be some good news hidden in these grim tidings - especially if you are Asian focused. According to MS "several markets in Asia are an exception, with A-shares, Hang Seng and the TAIEX paying a significant share of their dividends between June-August, and seeing better-than-average performance during these months. Our equity strategists are OW China within EM equities, and we are long A-shares versus EM equities within our top trades."

Exhibit 2: Markets had a 'normal' April/May bounce

Source: MSCI, Morgan Stanley Research

Exhibit 3: MSCI ACWI dividend seasonality



Source: Bloomberg, Morgan Stanley Research

Measure	Value as of 21st May, 2018	Value as of 18th June, 2018
UK Government 10 year bond rate	1.48%	1.31%
GDP Growth rate YoY	1.20%	1.20%
CPI Core rate	2.50%	2.40%
RPI Inflation rate	3.30%	3.30%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.62%	0.63%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	53.9	54.4

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Bank CDS options

Traders in credit default swaps seemed to have finally woken up from their collective slumbers and started pricing in much greater levels of risk - of default on bank bonds. This month pretty much every bank we monitor saw an increase in the price of their swaps with only Royal Bank of Canada and Nomura bucking the trend. Some of the biggest increases were seen in banks regarded as traditionally low risk such as RaboBank and HSBC, both of which saw some big increases on both their 1 and 5 year swaps. The French banks also saw some very substantial increases in swap prices - perhaps investors are beginning to price in the risks associated with their Italian loan books. Whatever the cause for this noticeable increase in the pricing of risk, it should represent good news for structured product investors - more expensive swaps will probably translate through to increased bond yields which will in turn allow better funding of new products.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	28.94	49.49	8.27	27	A -
Barclays	33.42	58	23.35	0.83	A
BNP Parabis	22.73	49.94	60	17.33	A
Citigroup	21.01	53.07	6.47	-6.55	A

Commerzbank	21.82	79.58	21.35	11.93	A+
Credit Suisse	30.76	78.92	26.31	14	A
Deutsche Bank	96.23	145.38	29.6	56	A+
Goldman Sachs	24.21	63.78	6.09	-11	A
HSBC	13.17	32.45	38.86	-21	AA+
Investec*	n/a	201	n/a	n/a	A
JP Morgan	18.82	43	-2.82	12.62	A
Lloyds Banking Group	11.24	45.95	5.84	-12	A
Morgan Stanley	24.33	58.99	1.22	-11.88	A+
Natixis	19.21	41.84	75	-16.5	A
Nomura	11.23	39.24	-2.42	-5.87	A-
Rabobank	9.83	30.65	31.21	-19	AA-
RBC*	n/a	62	n/a	n/a	AA
RBS/Natwest Markets	62	55.27	37.8	-19.87	A
Soc Gen	23.68	53.17	46	19.53	A
UBS	16.92	42.01	23.65	10.35	A

Source: www.meteoram.com 18th June 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

I'm no fan of gold but I do find myself watching the price of the shiny stuff more carefully these days, especially if we are looking for the proverbial canary in the gold/coal mine which indicates an impending slowdown. If gold prices started to break out of their recent trend and head towards $1350, we might be in for more volatility. In the meantime, many contrarian reckon that gold - and related gold stocks - might represent the ultimate contrarian play. Analysts at fund management firm - and ETF specialists Van Eck - certainly seem to agree, which shouldn't come as a surprise as they have a gold miners ETF. According to Joe Foster, Portfolio Manager and Strategist at Van Eck gold mining stocks currently out of fashion. Foster says that "due to a lack of demand, the gold mining sector missed its performance expectations last year. The market has shown a muted response to earnings, and this lack of interest has caused them to fall short of performance expectations. The sustainability of gains from earnings has declined in the last two years. Meanwhile, losses on earnings misses have become much worse in the last few years and these losses have been sustained over a longer period. We are currently seeing a lack of buying interest and absent are those momentum players that follow the winners who beat earnings and the value seekers who invest in those companies which disappoint."

This slightly optimistic take on gold doesn't really chime with recent numbers from BullionVault which suggested that selling of physical gold had intensified in recent weeks. The online gold trading platform reports that it's users are actually selling gold as a group, liquidating 75 kilos worth £2.3 million from their total holdings. From end-March's all-time record high, clients have now liquidated almost 0.5% of their total holding, selling it down to 38.7 tonnes worth £1.2 billion.

Crucially "what began as a Trump slump for US gold coin sales in 2017 has now spread to retail gold bar investing demand in UK and Europe. And globally, Google search volumes for the phrase 'buy gold' have sunk to 2007 lows, back before the global financial crisis got started. Existing gold coin and bullion bar owners have meantime turned seller, steadily exiting the stockpile they began building ahead of the financial crisis."

BullionVault suggests that "this might seem natural with the stock market setting new all-time highs. Longer-term investors wanting to defend their profits in the stock market might take the lack of interest in gold as a contrarian signal to buy."

But logic suggests that gold is being caught up within the US interest rates/dollar debate. Conventional wisdom has it that increasing interest rates and a stronger dollar is BAD news for gold - and thus gold miners. According to Van Eck's Foster "while $1,365 per ounce has been the ceiling for the gold price, the floor has been rising consistently since 2015. Ahead of a potential rate hike, gold could test its bottom line trend threshold this month. Given the resilience of the gold price as a result of geopolitical risks, trade tensions and inflation, we would be surprised to see gold fall below this level. However, in the second half of 2018, the gold price could again run against this latest cap of $1,365. A spark that moves the gold price through its $1,365 ceiling may rekindle interest in the miners."

Maybe. Maybe not. I think gold is becoming more interesting as we move into what could be a more volatile period but I think we're still some way from that point. My own sense is that we'll see gold prices move ahead once we get closer to 3.5% US Treasury yields - at which point I'd expect signs of a slowdown in the all-important US economy.

Fixed Income

I freely admit that I have a behavioural weakness based on affirmation bias, especially when it comes to my big investment themes. In simple terms, I tend to hunt out those research and strategy views that affirm my core view, especially when it comes to a New Normal for interest rates. This view argues that although we'll see increasing interest rates in the US, they'll hit a maximum of no more than 3 to 4% and then promptly come down again.

Having got that admission out of the way I can now report on the latest research note from Cross Border Capital - which handily backs up my core conviction that interest rates will be back around zero in the US within the next few years.

Cross Border has been busy crunching the bond market dynamics and concluded that US Treasury yields are rising and that the yield curve is currently seeing a "bearish flattening, with short rates increasing faster than long rates.... The recently flatter yield curve has resulted from four drivers: (1) rising US policy rates; (2) falling yield volatility; (3) tighter US domestic liquidity, and (4) net international demand for US Treasuries."

What follows is a frankly complex unpicking of the components of bond returns - focusing very much on term premia and tenor. Without going into phenomenal detail (and there's plenty of that), Cross Border observes that we need to unpick term premia by their distribution by the tenor. "The pattern of buying and selling along different parts of the yield curve reflects the risk-seeking and risk-avoiding behaviour of investors. This may be affected by liquidity, but it could also be influenced by other factors too".

Using this analysis Cross Border suggests that the bulk of the movements in the US yield curve are dominated by term premia and these derive from liquidity factors - and that periods of rising Treasury yields and flattening yield curves "often end badly for the real economy".

The bottom line?

> *"The FOMC's 'dot plot' diagram projects two further US rate hikes this year, three in 2019 and two more in 2020, taking Fed Funds to around 3¼-3½%. A weaker US economy in coming months would likely cap future rate increases to perhaps only another 50-75bp, so taking Fed Funds to a local peak of 2½%. We maintain a view that the US Treasury market should test 3½% yields at the 10-year tenor in the short term but set against this backdrop of prospective economic deterioration and lower-than-expected policy rates, US bonds could begin to rally thereafter."*

Which handily accords with my own view: that interest rates in the US will peak somewhere between 3 and 4%, and that 10 year Fed yields will go above 3.5%; but that a slowdown will then heave into view; the direction of interest rates will then be down; sparking a move back into bonds again.

What's powering this slightly cynical view of long term interest rates is that the world is still addicted to debt, which brings us nicely to the graphic below which is from West Country based risk consulting firm CheckRisk, founded by Nick Bullman. This snappy little image should remind us that the global mountain of debt is a real systemic risk which isn't going away. Economists need to have a long, hard think about we design a better global economic system that doesn't rely so excessively on leverage.

UK Government Bonds 10-year Rate 1.31%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	26.37
Germany	11.305

Japan	22.77
United Kingdom	23.86
Ireland	31.71
Italy	204.63
Portugal	96.23
Spain	63.69

Eurozone peripheral bond yields

Country	May 2018	June 2018	Spread over 10 year
Spain 10 year	1.49%	1.28%	88
Italy 10 year	2.35%	2.58%	218
Greece 10 year	4.52%	4.47%	407

	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

Guessing when the next recession is likely to hit - or the likely direction of stockmarkets - is of course largely a mugs game. For every bearish argument about financial exuberance, there's a perfectly strong argument to suggest that corporates are enjoying bumper profits. And crucially those bumper profits are feeding through into bumper dividend payouts. According to the most recent report of the Janus Henderson Global Dividend index, dividends pushed 10.2% higher on a headline basis to $244.7bn in the first quarter. The total was a record for the first quarter.

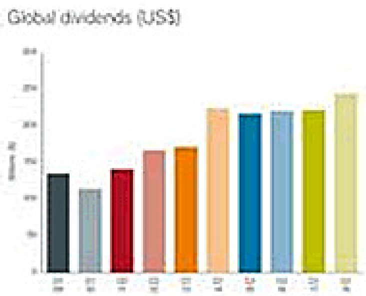
Janus Henderson also reports that all-time quarterly records were broken in Canada and the US, while first-quarter records were broken in one in four of the countries in the index. Asia Pacific ex Japan was the only region not to see an increase, owing to sharply lower special dividends in Hong Kong, and dividend cuts in Australia.

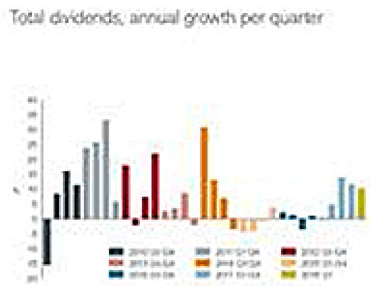
The Janus Henderson Global Dividend Index ended the quarter at a record 174.2, meaning that global payouts last year were almost three-quarters higher than in 2009. Key highlights included:

- 2018 set to see global dividend growth of 6.0% in underlying terms
- Headline growth upgraded to 8.5%, helped by a weaker dollar, with payments expected to reach a record $1.358 trillion.
- Q1 headline growth was ahead of Janus Henderson's forecast, mainly because the US dollar weakened steadily over the course of the quarter, meaning that payments denominated in other currencies were translated at more favourable exchange rates.

- On an underlying basis, growth was exactly in line with Janus Henderson's expectations, up 5.9% year-on-year and continuing the pace set in 2017.
- Seasonal patterns in dividend payments give North America a greater share of global payouts in Q1, as almost every company makes regular quarterly distributions to investors. US underlying growth was 7.6%, with the total paid reaching an all-time quarterly record of $113.0bn.
- Overall, almost eight in ten US companies paid out more in dividends year-on-year, with technology, financials and healthcare doing best. Canada saw underlying growth of 13.8%, the fastest in the developed world. The $10.1bn total there was also an all-time record, and every company in the dividend index raised or held payouts.

Janus Henderson has maintained its forecast for underlying dividend growth of 6.0% this year, with expansion expected to come from every region of the world. The dollar decline in recent months has added to the headline growth forecast and Janus Henderson now expect dividends to rise 8.5% in headline terms for the full year, reaching a total of $1.358 trillion, $10bn more than its initial expectations in January.





Index	May	June	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	126.2	126	3472	126.2
FTSE 100 (Dec 17)	306	307	7606	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-2.2	6.2	0.94	1.94	19.4	38.6	7607
S&P 500	2.45	1	3.32	14.2	68.3	107	2779
iShares FTSE UK All Stocks Gilt	158	0	-1.16	-1.34	13.5	9.89	13.12
VIX New Methodology	-9.69	-23.3	27.2	16.8	-27	-33.8	12.12

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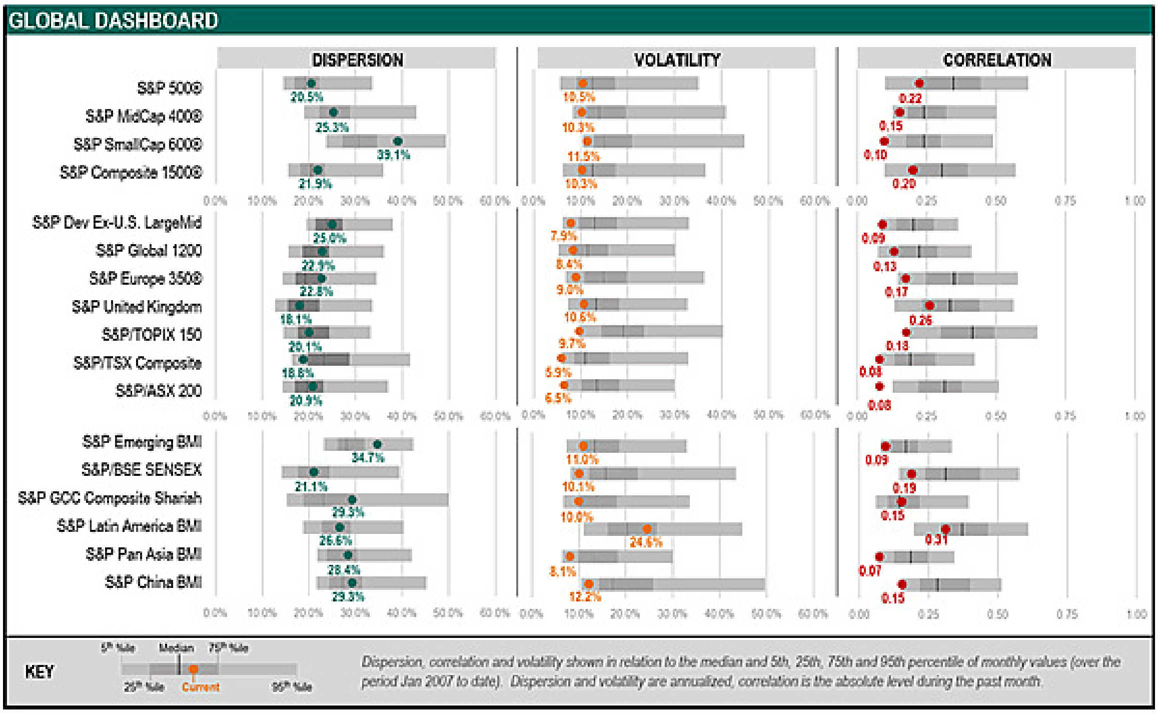
Volatility

Measures of stockmarket volatility are heading sharply lower again, despite all the talk of trade wars and diplomatic blustering. Investors are also clearly not panicking - yet - about increasing US interest rates and a stronger dollar. At the moment the prevailing view seems to be that rates will slowly head north and US Treasury Bond yields won't shoot past 3.5%. That'll in turn help flows into the dollar which might continue it's recent strengthening. But this recent dollar strength does suggest an alternative narrative which is that investors aren't fooled by the low levels of volatility and are quietly moving into the dollar because it's a safe haven asset. In this more bearish narrative, the dollar might continue to strengthen as big global institutional investors slowly start buying back into US Treasury bonds as their yields start to exceed 3.5%.

The story of the next 12 months will be framed by these two narratives - gentle increases in US interest rates and in the value of the dollar indicating a strong global recovery versus the dollar as a safe haven asset. In the meantime, recent numbers for May, from S&P dow Jones, suggests that markets are buying into the first narrative. Measures of index volatility have crashed to low levels across the board although the index firm notes that "dispersion continues higher than would otherwise be typical; correlations are subdued. The spread between the S&P SmallCap 600 dispersion and index volatility was the second-highest since the early 2000s. Only November 2016 - the month of the Presidential election - displayed a higher spread. Dispersion in the S&P Emerging BMI reached its highest level in two years; rising energy prices acted to boost many of the OPEC nations' bourses, but triggered crippling strikes in Brazil and weighed on the energy-importing nations more generally. Evolving U.S. trade relations with China, on-off Korean peace negotiations, Middle Eastern tensions and volatility in the Turkish Lira also played a part in producing a noisy month."

In sum, if you're going to bet on stockpickers focus on US Small caps and emerging stocks.



Measure	June Level	May Level	April Level	March Level
Vstoxx Volatility	14.45	13.68	17	16.75
VFTSE Volatility	13.4	12.53	13.84	13.59

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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.

Explanation of Terms

CDS Spreads and Credit Ratings

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

Why does the yield matter on a bond?

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

Volatility measures

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

Dividend Futures

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

Equity benchmarks

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

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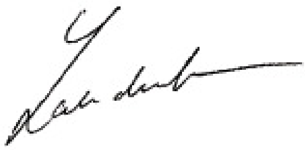
Kind Regards,



Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk