



With commentary from David Stevenson

As we slowly drift into the summer the markets are in a fickle mood, closely watching the direction of the oil price - and awaiting the outcome of the Brexit vote in the UK. The sense of unease is palpable although that hasn't stopped more speculative investors from taking lots of very big directional plays. I'm always fascinated to see the flow of ETFs, especially as traded on the IG Index platform - its new stockbroking service - is making a big play for the speculative passive investor and ETFs are a great way of tracking market sentiment.

A couple of weeks back the dealing released data on the most traded ISA-eligible ETFs on its stockbroking platform during the period of 1 March 2016 - 30 April 2016.

It's a fascinating snapshot of what retail 'punters' are speculating on. The top ten are as follows:

1. Boost WTI Oil 3x Short Daily ETP (USD)
2. ETFS Brent Crude
3. ETFS WTI Crude Oil
4. Boost WTI Oil 3x Leverage Daily ETP (USD)
5. Boost US S&P500 3x Short Daily ETP
6. Boost FTSE 100 3x Leverage Daily ETP
7. Boost WTI Oil 3x Short Daily ETP (GBP)
8. Boost FTSE 100 3x Short Daily ETP
9. Boost WTI Oil 3x Leverage Daily ETP (GBP)
10. ETFX DAX 2x Short Fund

(*Based on the notional value of trades in pounds)

So, let's take this in. Out of the ten most traded funds on this particular platform, an astonishing six are bets on the price of oil, and just four on mainstream equities. I've long had fairly strong views about the direction of oil prices, but I wouldn't be so sure of my opinions to trade on them. Evidently many investors are much more certain!

For those investors with a slightly longer term view - especially those interested in structured products - the most news worthy item this month came from Ian Lowes up in the North East. Lowes Financial Management has been closely monitoring the success - or otherwise - of structured product plans over the last few years. According to the website StructuredProductReview - run by Lowes - all the IFA distributed products "linked solely to the FTSE 100 maturing in the first quarter of this year made a gain or returned capital for investors".

To be precise 60 of the IFA-distributed structured products linked solely to this index of the UK's largest companies made a gain for investors, while two returned capital only. None gave rise to a loss. The FTSE 100 linked maturities on average made annualised gains of 4.92% over an average term of five years. The analysis also reports that "looking beyond just the FTSE 100 linked products to all 82 products maturing in the quarter, 68 delivered a gain for investors, 10 returned capital only and 4 made a loss. Three of these were impacted by the weakness in commodities and the fourth by falls in emerging markets."

Across all the 82 products maturing in the first quarter of this year the annualised gain was 3.67% over an average term of five years with the top 25% making average annualised gains of 7.49% over an average term of 4.66 years.

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Headline Numbers

Measure	Value as of April 14th, 2016	Value as of May 13th, 2016
UK Government 10 year bond rate	1.46%	1.40%
GDP Growth rate YoY	2.10%	2.10%
CPI Core rate	1.50%	1.50%
RPI Inflation rate	1.60%	1.60%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.59%	0.59%
Government debt to GDP ratio	88.60%	89.20%
Manufacturing PMI	51	49.2

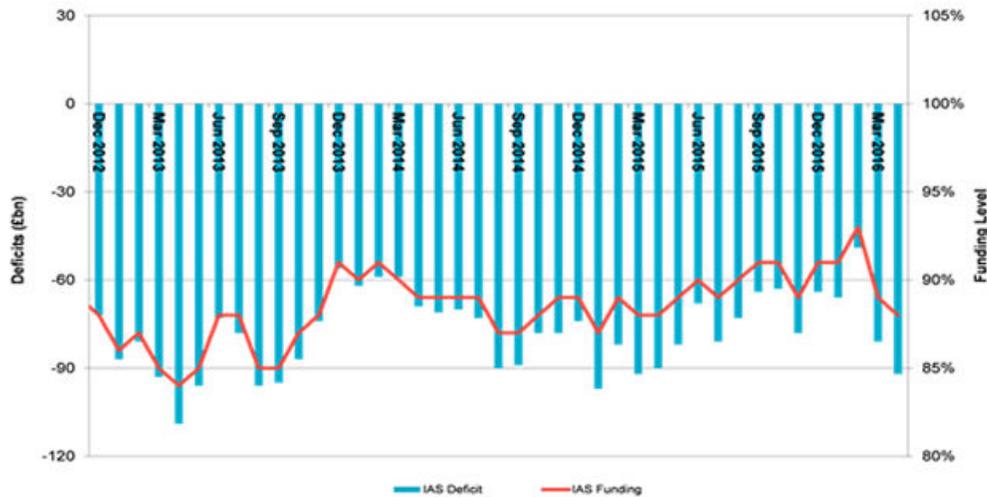
The collapse of BHS has put the pensions liability crisis back in the news. The high street retailer pension fund trustees are clearly grappling with a huge funding liability but they are not alone. Many big pension funds are in technical deficit and these funding gaps are now one of the key issues for equity market investors - how much of the future value of a listed business will be gobbled up by the pension fund? In fact, if interest rates stay at historically low levels, there's every reason to believe that these pension fund deficits could remain at elevated levels. Pension fund managers have been helped out in part by rising bond prices but many have also invested in equity markets and here returns have been much more pedestrian.

Investment consultants Mercer regularly keep a regular tab on these pension fund deficits and in its latest Risk Survey data they report that the accounting deficit of defined benefit (DB) pension schemes for the UK's 350 largest listed companies increased from £81bn on 31 March 2016 to £92bn at the end of April. At 29 April 2016, asset values were £655bn. According to Mercer this represents a fall of £2bn compared to the corresponding figure of £657bn at 31 March 2016. Liability values were £747bn, representing an increase of £9bn compared to the corresponding figure of £738bn at the end of March. "Liabilities are now at levels not seen since April last year when they stood at £750bn" reports Mercer.

One factor helping to push liabilities higher is economic and financial uncertainty - and the impact on corporate bond yields. Mercer's reckons that corporate bond yields have recently swung by 15 basis points, which they reckon is broadly equivalent to a £20bn movement in liabilities. The consultancy says that political uncertainties around Brexit have undoubtedly contributed to the volatility in corporate bond yields. The first table below shows the evolution of the corporate bond yield since 2012 with yields falling from 4.07% to 3.31%, a decline of 76 basis points - over the same period the FTSE 100 Total return index increased by a little under 20%. The second chart below shows how the current deficit (with funding levels just below 90%) is back at near term highs - the biggest deficits were seen back in April 2013 when they smashed past £100 bn.

Date	High Quality Corporate Bond Yield	FTSE100 Total Return index
31 December 2012	4.07 %	4,146.40
31 December 2013	4.42 %	4,920.23
31 December 2014	3.41 %	4,956.47
31 March 2015	3.10 %	5,166.30
30 June 2015	3.68 %	5,023.82
30 September 2015	3.63 %	4,715.95
31 December 2015	3.68 %	4,890.97
29 January 2016	3.55 %	4,769.44
29 February 2016	3.64 %	4,808.71
31 March 2016	3.36 %	4,894.50
29 April 2016	3.31 %	4,964.16

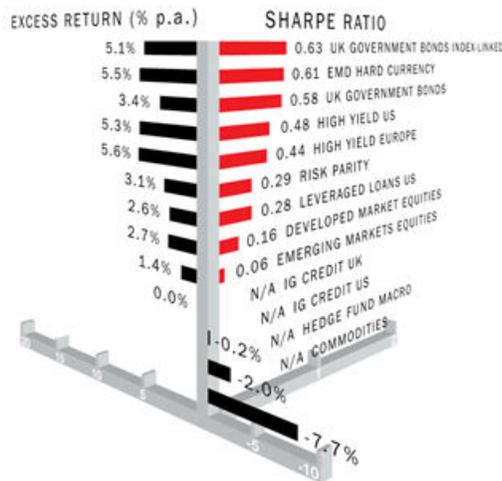
Source: Mercer, May 2016



Source: Mercer, May 2016

What's been the best investment in asset class terms over the last decade? Bonds? Equities? Commodities? The table below comes from pensions consultants Redington. Its fascinating historical statement as it shows the returns from a wide variety of pension fund orientated assets over the ten years from 31/03/2006 to 31/03/2016. Crucially it shows not just the excess return but also the sharpe ratio - a measure of risk-adjusted returns. A positive Sharpe ratio is usually a good sign and anything approaching 1 is regarded as excellent.

Risk - Adjusted Return (Q1 2016) - 10 Year - 31/03/2006 - 31/03/2016



Source: Redington

Asset Class	Excess Return % Pa 10 years	Sharpe Ratio
UK Govt Bond Index Linked	5.1	0.63
EMD Hard Currency	5.5	0.61
UK Govt Bonds	3.4	0.58
High Yield Bonds US	5.3	0.48
High Yield Bonds Europe	5.6	0.44
Leveraged Loans	2.6	0.28
Developed Market Equities	1.4	0.06

Source: Redington

The big message from this data is obvious - bonds have absolutely trounced equities over the last decade, with developed market equities producing an excess return of just 1.4% against 5.3% for high yield US bonds.

According to Redington over the 10-year period, UK Index-Linked Government Bonds were the top performer on a risk-adjusted basis with a Sharpe ratio of 0.63. European High Yield and Emerging

Market Debt posted the highest excess returns of 5.6% p.a. and 5.5% p.a. respectively, however the returns attributable to these asset classes were more volatile, and therefore had moderate Sharpe ratios.

On the downside, Commodities and Macro Hedge Funds produced negative excess returns of -7.7% p.a. and -2.0% p.a. respectively. According to Redington these two asset classes have continued to produce negative returns over a 10-year period for the past eight quarters.

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Bank CDS options

There's not much to report this month from the regular update on bank CDS options. Some of the key rates have declined marginally, with the biggest falls seen in contracts for Citigroup (it's catching up fast with its American peers JPMorgan and Goldman Sachs), Deutsche (whose CDS rates spiked massively in recent months) and UBS. Overall outfits such as JPMorgan and Rabobank remain the winners, with very low CDS rates, implying low cost of funding.

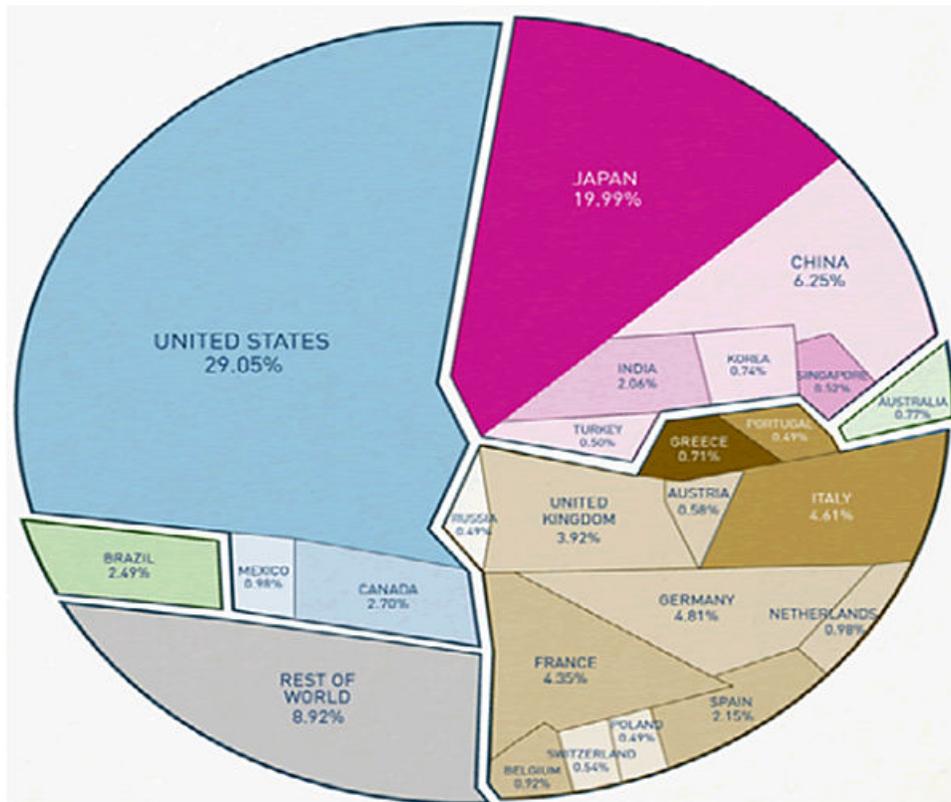
Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	59	140	0.8	42	A -
Barclays	86	131	-6	98	A
Citigroup	39	91	-10	16	A
Commerzbank	56	118	3	38	A+
Credit Suisse	98	140	-10	93	A
Deutsche Bank	129	177	-10	133	A+
Goldman Sachs	39	106	-2.5	18.56	A
HSBC	61	104	-7	62	AA-
JP Morgan	29	-0.68	7.8	28	A+
Lloyds Banking Group	52	107	-4	68	A
Morgan Stanley	38	104	-5	26	A
Nomura	30	100	3.4	52	A-
Rabobank	23	70	1.42	23	AA-
RBS	79	135	-2	81	A
Soc Gen	28	83	-5	4	A
UBS	32.45	70.83	-10.69	20	A

Source: [Meteoram.com](#), 13th May 2016

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Government Bonds

The chart below, from the BIS via risk consulting firm CheckRisk - is a brilliant snapshot of the global sovereign debt markets. It tells a very simple story. Who owes what, in relative terms on the global debt markets.



Source: BIS

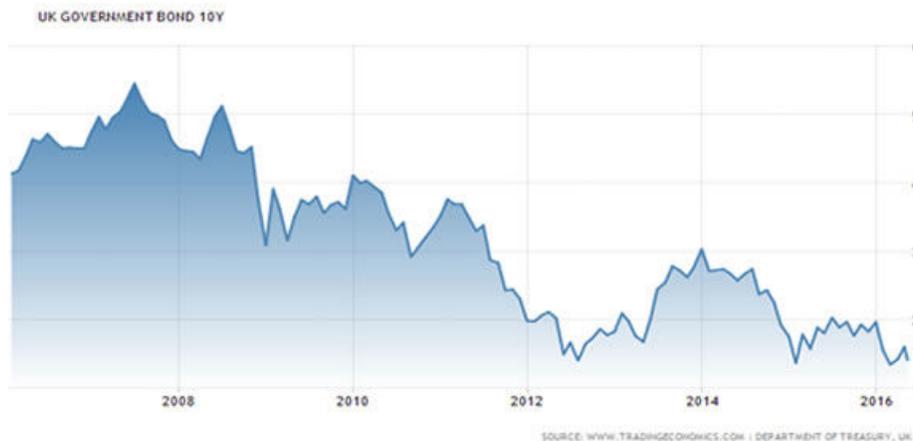
Unsurprisingly the US dominates the market with 29% of total outstanding debt but notice how Japan now comprises 20% of total accumulated debt - and growing by the day. China is now not an inconsiderable 6% of total debt with Italy, France and Germany not far behind.

This chart has numerous real world implications, not least that the flows of any sovereign bond products (be they ETFs, ETPS or just funds) will be dominated by available 'stock' i.e. those nations with the most accumulated debt are likely to offer the most liquid markets. So, in effect what happens in the pricing of Japanese debts increasingly makes a huge difference to the pricing of all fixed income securities.

This chart also prompts another fascinating idea. In very simplistic terms, the weight of debt is accumulating very fast in key nations such as Japan where the stock of government debt is now above 240% of its annual GDP. This huge mountain of bonds might become unserviceable at some point if interest rates increased which could in turn prompt a solvency crisis.

What can government's do to deal with this huge mountain of debt? Three options stand out. First, ignore the problem and borrow more - hoping that no one worries about the scale of leverage. Secondly they could also cancel this debt especially if most of the bonds are held by their own central banks. Lastly, governments could also look to inflate their economies pushing down the real value of these bonds. Or, possibly, governments could consider deploying all three tactics in the hope that economic growth can be boosted thus diminishing the economic burden.

UK Government Bonds 10-year Rates 1.40%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	38
Germany	18
Japan	37
United Kingdom	35
Ireland	66
Italy	129
Portugal	269
Spain	94

Eurozone peripheral bond yields

Country	April 15th, 2016	May 13th, 2016	Spread over 10 year
Spain 10 year	1.49%	1.61%	148
Italy 10 year	1.34%	1.50%	37
Greece 10 year	9.37%	7.40%	727

	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

Baby Boomers are looking to downsize. Millennials are choosing style over square footage. The net-net? The new American home is shrinking in size for the first time in 40 years. That's the big message from Stephen Kim of Barclays Capital whose latest report called 'The New American Home' examines how the US housing market has picked itself up off the floor after the global financial crisis of 2008 and is now changing in a very profound way. The bottom line? The average new American home is shrinking in size - reversing a 40-year trend.

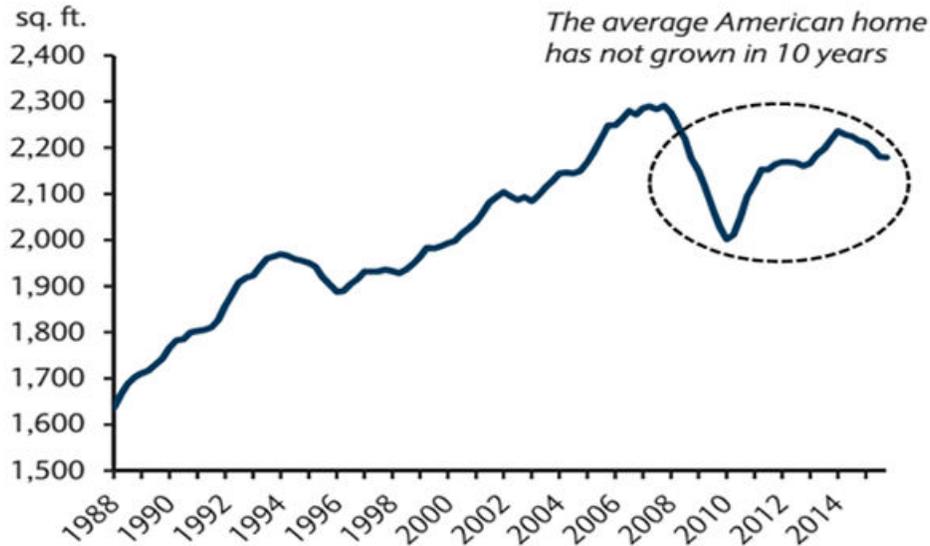
According to Kim, at one end of the spectrum, millions of Baby-Boomers-turned-empty-nesters are seeking to downsize. At the other end, Millennials are buying pricier homes than typical first-timers, choosing style over footage. The net result according to the Barclay's analyst is that the nation's two

largest demographic groups now desire smaller, but well-appointed houses, termed "jewel boxes". The other big trend is that Barclay's reckons it's seeing a big rise in discretionary renting. Overall, Kim reckons that today's buyers prefer more density and less lawn, more upgrades but less footage, and have an increased willingness to rent rather than own their own home.

If we're to believe these sweeping generalisations, then it's clear that there'll be some profound equity market sector shifts. The big DIY retailers should be the most immediate beneficiaries. But the major house builders should also benefit, as shifts in buying preferences will support an elevated price premium for new homes over existing homes. According to Kim the biggest losers will be "individual owners of high-end suburban homes, luxury homebuilders with long land positions, and the furniture industry".

If the first part of this narrative does come true - that the owners of individual high-end suburban homes suffer - expect trouble in the wealth advisory space. Many investors have relied on their home as their primary source of wealth and if this asset suffers a relative decline, we could see money switched out of the equity markets to plug the unexpected gaping gaps.

Average New Home Size (LTM, Single & Multi-family)



Source: Census Bureau, Barclays Research

Index	May	April	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	118.5	118.6	2955	116.5
FTSE 100 (Dec 14)	245.5	247	6138	N/a

Name	Price % change						Close
	1 month	3 months	6 months	1 year	5 year	6 year	
FTSE 100	-2.21	6.95	-1.21	-11.96	2.68	13.39	6104.19
S&P 500	0.12	10.69	0.89	-1.67	53.05	76.17	2064.11
Benchmark for gilt							
iShares FTSE UK All Stocks Gilt	-0.37	-0.53	4.68	4.52	20.16	23.55	12.695
Benchmark for volatility							
VIX New Methodology	-2.96	-43.27	-21.56	3.97	-10.11	-43.53	14.41

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Volatility

Volatility in FX markets is markedly lower than for equity and commodity markets. All of which is not to say that we don't see big moves in key pairs - just that those moves don't tend to be very big in terms of the amplitude of price movements. So, it's against this backdrop that we must report strange goings on in the cable rate.

Two key narratives have emerged in the last 12 months. The first is that the dollar has been strengthening based on expected higher interest rates. The second is that sterling has been weakening, hurt by uncertainty about Brexit.

In recent weeks though we've seen a complete reversal of these narratives. Many investors are betting big that the dollar will actually weaken, especially as the US Federal Reserve notches down its expectations for interest rate increases. Last week the second part of that narrative also switched - sterling started to strengthen against the dollar, pushing past \$1.46 to a £1. The following two charts put this trend into perspective. The first chart is perhaps the most important. It shows the cable over the last year with trend lines and 20 (thick green line) and 200-day moving averages overlaid. Notice how the cable rate has broken through its trend lines and is building momentum.



How much higher could sterling go against the dollar? The second chart above shows the cable rate since 2010. We can clearly see that even with recent strengthening the cable rate is well below its medium term levels. If the current bullish momentum continues we could easily see sterling push past \$1.50 and then even hit \$1.55 - without so much as breaking a sweat in historical terms! But this fascinating potential shift seems slightly at odds with what another bunch of measures are telling us - the possibility that the UK electorate could vote for a Brexit. Whatever one's views on this debate, it's not really disputed by either side that a vote for Brexit would result in increased market turbulence with the cable rate one obvious cause for concern. The big move in this debate is that by virtually any measure the chances of a

Brexit are increasing. The trend is by no means irreversible but it is noticeable. More and more voters seem to be warming to the idea of snubbing Obama (and much of the rest of the global leaders who've intoned on the subject)! If that is the case and a Brexit becomes MORE likely, the current strength of sterling could be very temporary and we could see a very dramatic move past \$1.40 and maybe even towards \$1.30 in the short term.

Measure	May Level	April Level	March Level	February Level
VoxOx Volatility	23.58	20.64	24.11	36
Vets Volatility	15.74	14.84	17.71	30.38
FTSE Put Call Ratio	N/a	N/a	N/a	0.99

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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.

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