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UK | Structured ™ Products Association

Monthly Market Report

June 2018

With commentary from David Stevenson

Being a journalist forces you to be fairly cynical about big trends, especially when it comes to investment, but I freely admit that I am a paid up member of the New Interest Normal brigade. It strikes me as just plain common sense that although interest rates will rise in the short term, probably back to around 3.5% in the US, they'll average much lower rates over the long term i.e. the next few decades. My guess is that we'll see an oscillation around 0 to 4% with 2% being a very rough long-term average, although in time weighted terms I think that average will probably be closer to 1%. Why am I so confident? Debt. There's just too much of it sitting on peoples/corporates/governments balance sheets. We seem to have tripped into a default system which forces capital recycling at a global level via bonds. It's an easy to trade, liquid system which allows great pools of excess capital to be moved around the planet with ease. The proviso, of course, is that the borrower pays back the money at some stage.

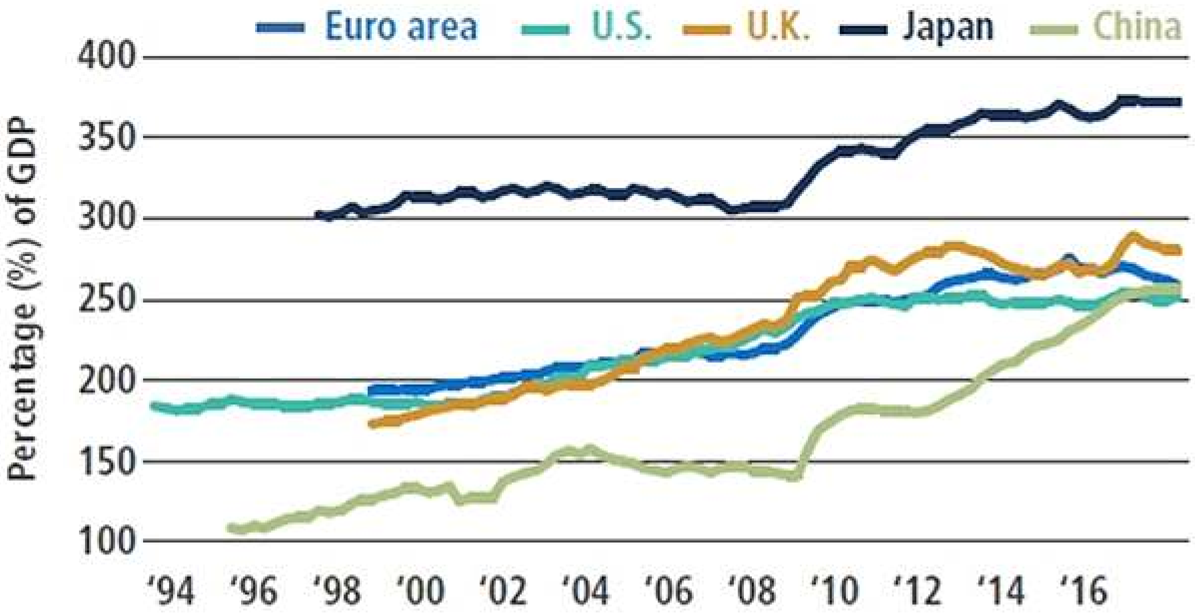
So, although it is obvious that the US Federal Reserve will win the prize for getting back to 3.5% first, it'll probably by then be staring into a new slowdown and worries about financial Armageddon. At which point it'll slam on the brakes and effect a handbrake reverse and start cutting rates - thus rescuing financial markets and especially bond investors.

None of what I say is terribly original, of course, many fixed-income investors have been making this argument for years, notably, Pimco and its New Neutral thesis. A recent paper from the bond investment firm reviewed data from the Bank for International Settlements (BIS) and analysed the growing mountain of global debt. The results are summed up in the chart below. The bottom line is that total nonfinancial debt has kept rising globally in recent years, from just over 200% of global GDP in the years preceding 2008 to over 240% currently. Debt also increased across both developed market (DM) and emerging market (EM) economies, with the increase across EM countries proving particularly steep: from around 120% of GDP in 2008 to around 190% currently. Pimco's conclusion is damning - debt levels have "arguably gotten worse." So, why do these high debt levels impact the wider economy?

According to Pimco "High debt pushes down the neutral rate by increasing economic agents' ex ante desire to save, given the focus on debt reduction; by raising the economy's sensitivity to monetary policy and in particular to interest rate increases; and by tying the hands of central banks, which need to take debt sustainability into account when setting monetary policy." And what of the investment implications? I'd suggest three stand out:

- At some point in the not too distant future bonds will be attractively priced because
- Long term bond rates will struggle to push much above 3.5% without pushing into macro economic headwinds which in turn means that
- Risky assets (such as equities) are also supported because low long term rates raises the net present value via a low long-term discount rate on cash flows. "This would suggest that valuations may be less stretched than they appear" observes Pimco.

Figure 2: Total nonfinancial (household, nonfinancial corporate and government) debt, % GDP



Source: Bank for International Settlements (BIS) as of March 2018

Headline Numbers

Oil Prices Surge: Inflation Hawks Squawk

I've just finished reading a wonderfully detailed and entirely convincing position paper by Swiss fund manager Burggraben. The report on Crude Oil is provocatively entitled "are you ready for triple digit oil prices" and it suggests that the price of oil really hinges on a unique combination of short term and long term factors, any of which could push the price of oil markedly higher (or lower). In sum, what happens at the margins, makes a huge difference.

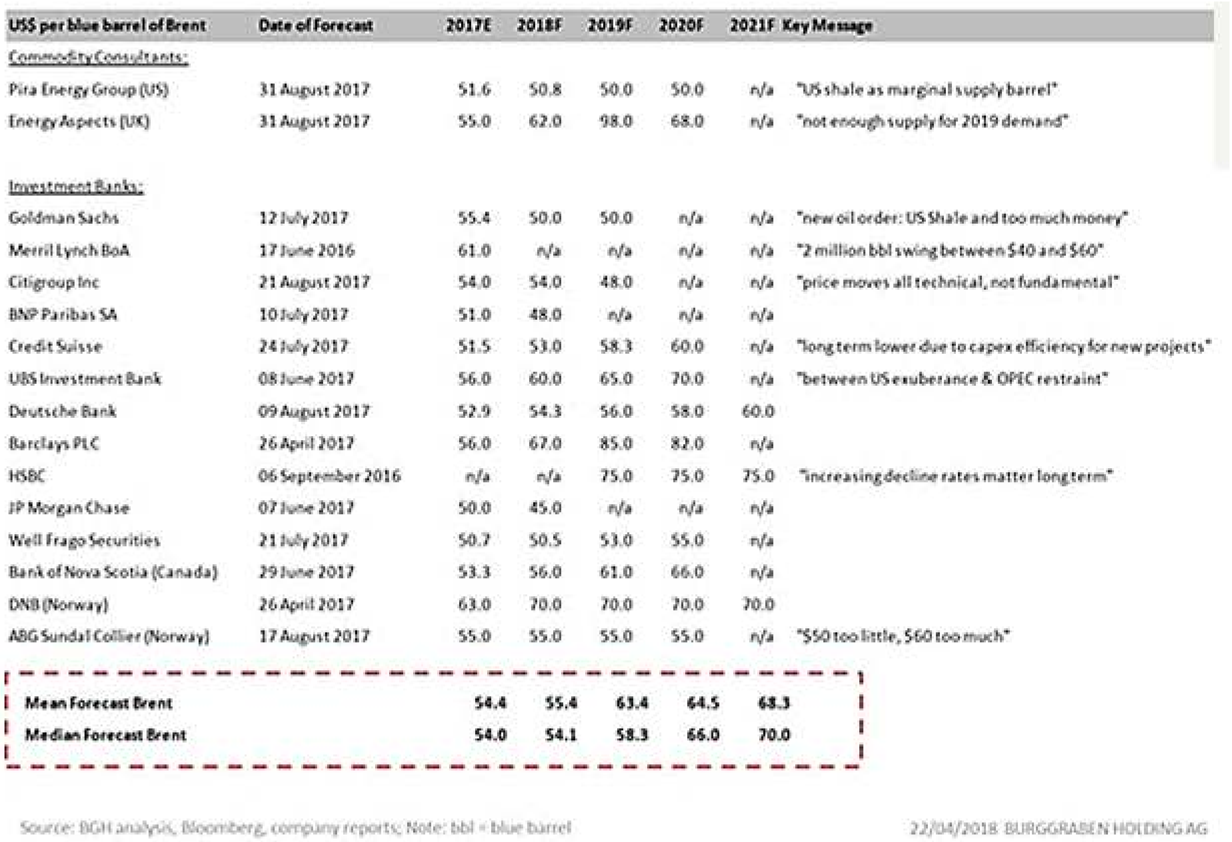
The first key point is I think the most powerful one - that although the US unconventional shale story is important, it can't really make **that** much difference to global prices. If shale is really going to move the dial at the global level and push down prices markedly we'd need to see output growth of 33% year over year growth for the Permian, the core US shale basin. That's not impossible but it is still a herculean task.

Supplies might also drop sharply from Venezuela and geopolitical tensions with Iran might curb supplies even more. Saudi Arabia could increase supply, marginally, but not by enough to cope with surging demand from the developing world. The bottom line? Within the next 24 months and barring an economic recession, Burggraben expects oil prices to increase significantly...

- as the OPEC/Non-OPEC alliance will continue tightening the supply side well into 2019 to buffer current shale growth, thus creating inventory draws throughout 2018;
- as prices will react more volatile to supply disruptions as surplus inventories are eliminated and amid wafer-thin spare capacity;
- as above-consensus demand growth will compensate for Texan oilmen's drilling frenzy;
- as the legacy project pipeline outside North American dries up, leaving a widening supply gap for the near term outlook;
- as higher decline rates of maturing fields will kick-in as a result of years of industry underinvestment;
- as cost inflation returns because the industry steadily increases capacity utilisation, thus pushing the marginal supply cost curve higher; and~
- as mid-term shale growth will disappoint from a combination of more sober drilling results, take-away capacity issues as well as labour constraints.

The table below rounds up the aggregate estimates for oil prices from a range of investment banks and consultancies with the mean forecast solidly in the $50 to $70 price range. Burggraben by contrasts reckons these numbers could be way off the mark. They reckon that OPEC spare capacity could be down to zero by 2020, with demand in that year running at 102 million barrels a day compared to 98m currently. This, they argue, could put oil prices in the 3rd quarter of 2019 above $100 for Brent. If they are right, expect the inflation hawks to start squawking loudly about the risk of surging consumer prices -

necessitating a sharp increase in interest rates.



US$ per blue barrel of Brent	Date of Forecast	2017E	2018F	2019F	2020F	2021F	Key Message
Commodity Consultants:							
Pira Energy Group (US)	31 August 2017	51.6	50.8	50.0	50.0	n/a	"US shale as marginal supply barrel"
Energy Aspects (UK)	31 August 2017	55.0	62.0	98.0	68.0	n/a	"not enough supply for 2019 demand"
Investment Banks:							
Goldman Sachs	12 July 2017	55.4	50.0	50.0	n/a	n/a	"new oil order: US Shale and too much money"
Merril Lynch BoA	17 June 2016	61.0	n/a	n/a	n/a	n/a	"2 million bbl swing between $40 and $60"
Citigroup Inc	21 August 2017	54.0	54.0	48.0	n/a	n/a	"price moves all technical, not fundamental"
BNP Paribas SA	10 July 2017	51.0	48.0	n/a	n/a	n/a	
Credit Suisse	24 July 2017	51.5	53.0	58.3	60.0	n/a	"long term lower due to capex efficiency for new projects"
UBS Investment Bank	08 June 2017	56.0	60.0	65.0	70.0	n/a	"between US exuberance & OPEC restraint"
Deutsche Bank	09 August 2017	52.9	54.3	56.0	58.0	60.0	
Barclays PLC	26 April 2017	56.0	67.0	85.0	82.0	n/a	
HSBC	06 September 2016	n/a	n/a	75.0	75.0	75.0	"increasing decline rates matter long term"
JP Morgan Chase	07 June 2017	50.0	45.0	n/a	n/a	n/a	
Well Frago Securities	21 July 2017	50.7	50.5	53.0	55.0	n/a	
Bank of Nova Scotia (Canada)	29 June 2017	53.3	56.0	61.0	66.0	n/a	
DNB (Norway)	26 April 2017	63.0	70.0	70.0	70.0	70.0	
ABG Sundal Collier (Norway)	17 August 2017	55.0	55.0	55.0	55.0	n/a	"$50 too little, $60 too much"
Mean Forecast Brent		54.4	55.4	63.4	64.5	68.3	
Median Forecast Brent		54.0	54.1	58.3	66.0	70.0	

Source: BGH analysis, Bloomberg, company reports; Note: bbl = blue barrel

22/04/2018 BURGGRABEN HOLDING AG

Measure	Value as of 6th April, 2018	Value as of 21st May, 2018
UK Government 10 year bond rate	1.40%	1.48%
GDP Growth rate YoY	1.40%	1.20%
CPI Core rate	2.70%	2.50%
RPI Inflation rate	3.60%	3.30%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.74%	0.62%
Government debt to GDP ratio	88%	85.30%

Manufacturing PMI	55.1	53.9

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Bank CDS options

The pricing of most big bank credit default swaps drifted marginally lower over the last month although a few banks stood out. Lloyds Bank continues to see its pricing for CDS at very low levels - below those of HSBC. But the renamed NatWest Capital Markets (formerly RBS) have started to catch up, with a big decline this month. Looking at one year CDS rates Dutch giant Rabobank continues to offer the lowest rates followed closely by Lloyds while at the 5 year level HSBC just pips Rabobank.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	26.28	45.43	-5.00	-31	A -
Barclays	26.5	48.44	-10.35	-18.35	A
BNP Parabis	14.26	31.6	-11	-41.88	A
Citigroup	19.37	48.25	-9.5	-8.62	A
Commerzbank	17.88	67.09	-3.88	-15.66	A+
Credit Suisse	21.17	64.37	-2.71	-15	A
Deutsche Bank	64.42	112.9	-4.5	15	A+
Goldman Sachs	21.24	58.94	-9	-15.56	A
HSBC	10.28	23.90	-5.7	-49.81	AA-
Investec*	n/a	187	n/a	n/a	BBB
JP Morgan	18.87	43.66	-10	-7.72	A+
Lloyds Banking Group	9.62	43.73	-4.75	-20	A
Morgan Stanley	21	57.13	-8.28	-11.96	A
Natixis	15.7	31.14	-4.65	-47	A

Nomura	14.04	44.29	3.92	5.04	A-
Rabobank	8.02	24.52	-12.8	-46	AA-
RBC*	n/a	77	n/a	n/a	AA
RBS/Natwest Markets	23.88	40.44	-20.0	-44	A
Soc Gen	17.62	37.76	0.43	-31	A
UBS	14.52	34.12	20.53	-20	A

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

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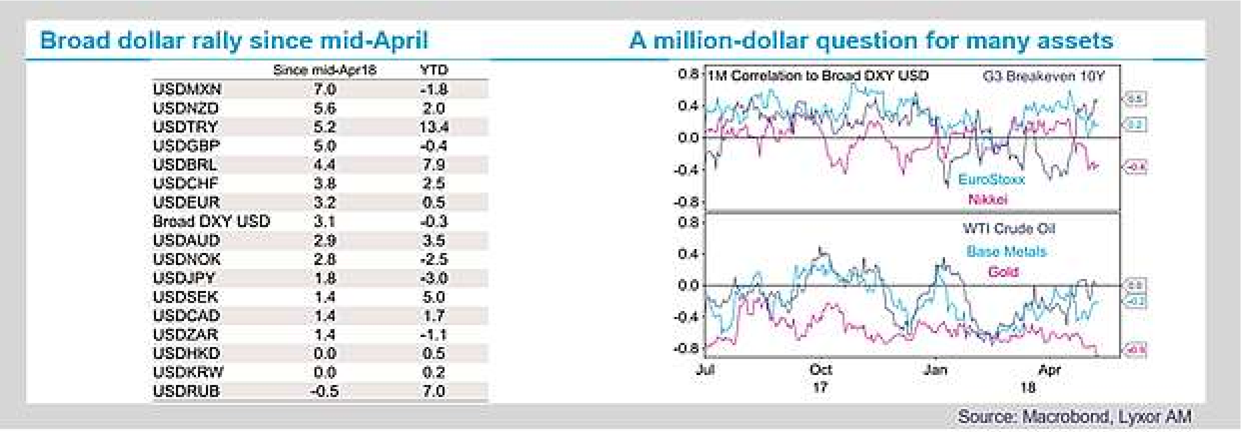
Government Bonds

What's going on with the dollar

One of the most crowded investment ideas of the last year has been the Dollar bear trade. In simple terms, with President Trump at the helm in the US, the dollar seems to be overvalued. The arguments supporting this view seem strong on first impressions - the US is further along its economic recovery whereas Europe and Japan are much earlier stage. Markets have also largely priced in rising US interest rates and US equities also seem fully valued. Arguably more to the point the America First ideology requires trade tariffs and an expansionary fiscal deficit - all bad news for the dollar. It's also worth noting as an aside that dollar hedging is becoming increasingly expensive - hedging US dollar risk has increased meaningfully since the last quarter of 2017, which makes investments in US treasuries by European or Japanese investors costly.

So much for the consensus! Despite these solid arguments for a weaker dollar, the greenback has surprised everyone, with predictable knock on effects on emerging markets such as Argentina. Since mid-April, the broad DXY dollar has rallied +3.5%. The table below shows the broad range of this rally against a variety of currencies, with obvious knock on effects on a range of asset classes. It seems that worries about inflation and growth differentials as well as the dollar's safe-haven status now matter more than capital flows and national accounts prospects. And there's more bad news for many emerging markets - worse may be to come!

A recent analysis from asset management firm Lyxor shows that hedge funds have turned aggressively bullish on the dollar - its turning into their big 'conviction trade' of the year. Lyxor reports that trend following hedge funds (CTAs) have "turned net long U.S. dollar since mid-April. Their exposures are polarized. They are net long EUR, GBP and JPY. They are short CHF, AUD and CAD." The Lyxor report also reveals that Macro funds have "neutralized most of their dollar exposures back in mid-March. Like CTAs, they reinstated long dollar positions since mid-April. They are short EUR and GBP, they are long CAD and AUD commodity currencies, and they are neutral on CHF and JPY.



Broad dollar rally since mid-April

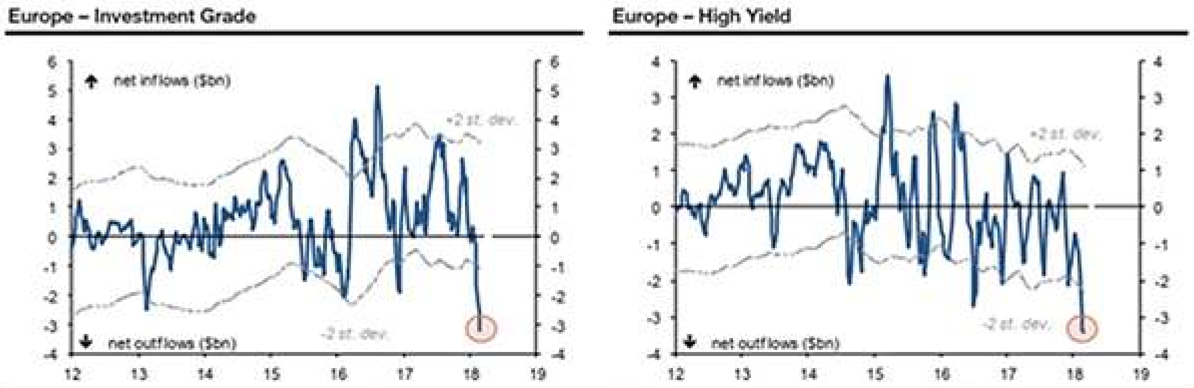
	Since mid-Apr18	YTD
USDMXN	7.0	-1.8
USDNZD	5.6	2.0
USDTRY	5.2	13.4
USDGBP	5.0	-0.4
USDBRL	4.4	7.9
USDCHF	3.8	2.5
USDEUR	3.2	0.5
Broad DXY USD	3.1	-0.3
USDAUD	2.9	3.5
USDNOK	2.8	-2.5
USDJPY	1.8	-3.0
USDSEK	1.4	5.0
USDCAD	1.4	1.7
USDZAR	1.4	-1.1
USDHKD	0.0	0.5
USDKRW	0.0	0.2
USDRUB	-0.5	7.0

A million-dollar question for many assets

Source: Macrobond, Lyxor AM

Fixed Income

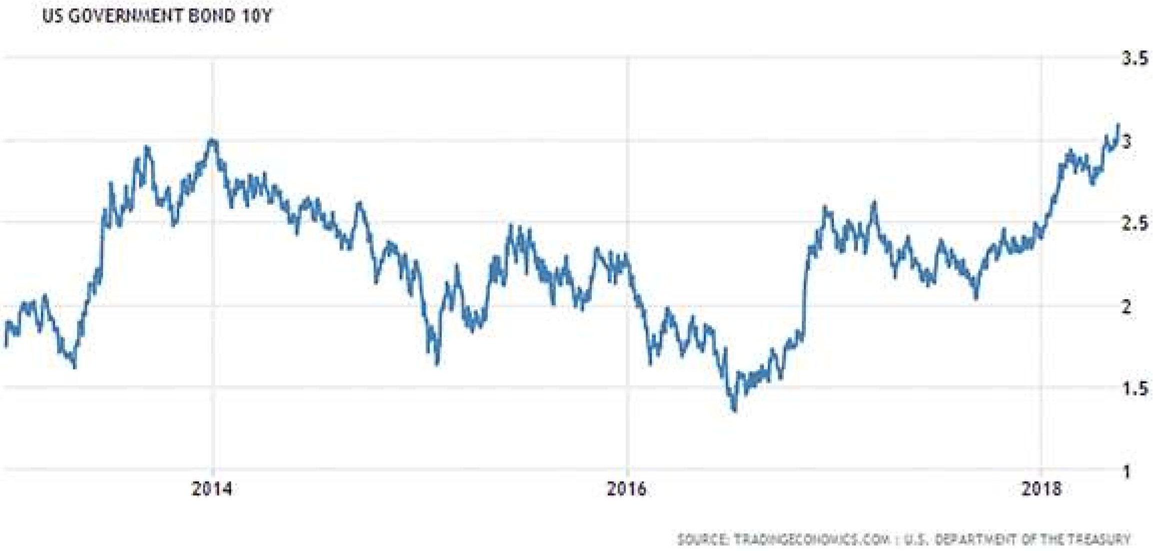
Have the global bond markets finally reached a crucial tipping point? Bond bears have been warning about a sell off for some time so these cynics have been wide of the mark - bonds have not sold off violently. Now though a small number of indicators suggest that we could be moving into a more volatile new 'normal' with uncertain impact on bond prices. The first two charts certainly suggest that bond investors are starting to worry. They look at flows of money into and out of - bond funds, in Europe. Investors are pulling money out of bond funds at an alarming clip. What do these institutional investors know that the rest of us don't?



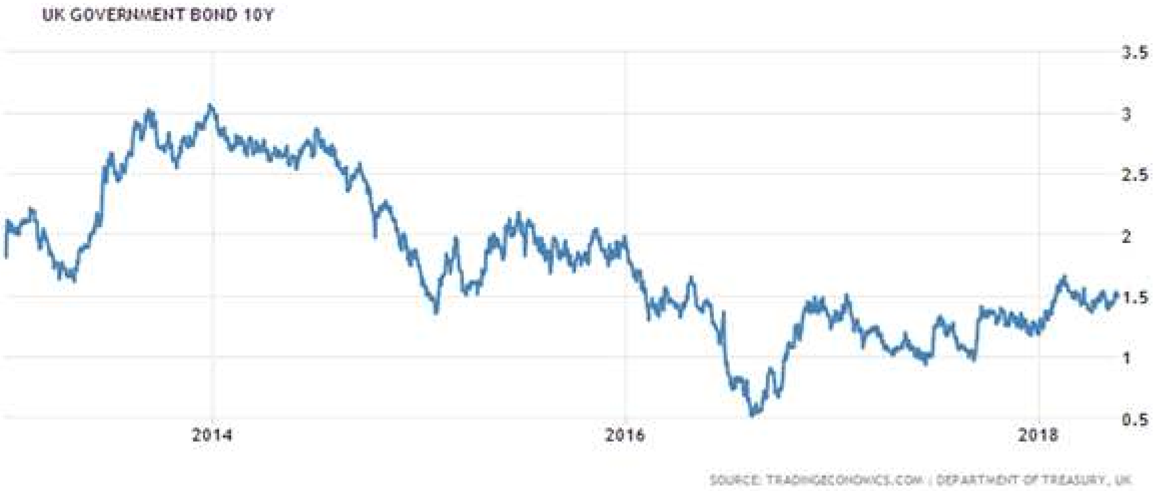
Net inflows (outflows), 4-week rolling data. Bands: long-term average plus and minus 2 standard deviations. Source: EPFR GLOBAL, SG Cross Asset Research/Global Asset Allocation

As we've observed before in these articles the simple answer is that to a man and woman, bond investors are obsessed with one key number - the yield on 10-year US Treasury bonds. The next chart below shows this yield as a percentage over the last ten years.

After a long wait, the 3% barrier has at long last been breached and the 10 year Treasury yield currently sits at around 3.10%. For most bond investors, that breach of the 3% yield barrier is usually very bad news. Traditionally rising yields - powered by expectations of increased interest rates - are an indicator of an imminent slow down. Crucially as bond yields rise, the price of bonds fall. As these bond yields grind higher, all things being equal, we might expect more uncertainty in stock markets - higher yields imply that the risk-free rate from cash is becoming more attractive. That in turn could start to eat into equity market bullishness. So, if you have to watch anything in the news - watch that 10-year bond yield rate and see if it'll test 3.5% in the next few months.



UK Government Bonds 10-year Rate 1.50%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	19.2
Germany	10.82
Japan	22.96
United Kingdom	19.17
Ireland	25.97
Italy	124.72
Portugal	84
Spain	51.68

Eurozone peripheral bond yields

Country	April 2018	May 2018	Spread over 10 year
Spain 10 year	1.23%	1.49%	95
Italy 10 year	1.79%	2.35%	181
Greece 10 year	4.02%	4.52%	398

	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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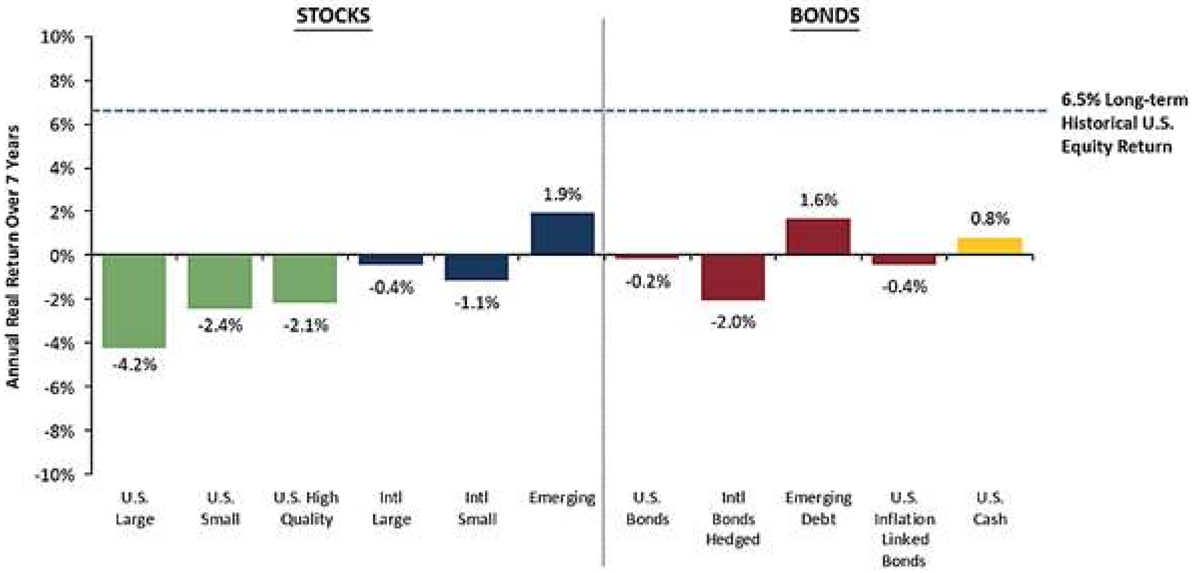
Equity Markets and Dividend Futures

Investors in both bonds AND equities have had a terrific last few years. As interest rates have hit close to zero, the price of most risk based financial assets (bonds and equities) has shot up, with correlations tightening across the board. Now that US interest rates are rising again, investors might reasonably expect the price of some risk assets (bonds and maybe even equities?) to fall and correlations to increase. But what do these trends tell us about potential future returns?

Crystal ball gazing is always a fraught exercise in investment, but some brave investors do persevere and try to build a model of future returns using past measures - and valuations - as a guide. One such firm is called GMO, led by veteran British investor Jeremy Grantham, with $71 billion in AuM. GMO tends to subscribe to a slightly more value driven, more cautious approach to investment and it's just released its own projections for future returns from a wide range of asset classes. It's bottom line? "Not one asset class is expected to provide even a 2% return over 7-years, says GMO. Nothing is cheap, so investors are asking "Are we in Purgatory or Hell?" when contemplating whether valuations will revert back to the mean quickly or slowly."

The table below details GMOs predictions for 7-Year Asset Class Real Returns. US large caps are expected to produce negative real annual returns of 4.2% while International equities might return -0.4% per annum. By contrast emerging markets equities are forecast to return 1.9% in real terms. Over in bonds land, US bonds will produce negative real returns of 0.2% with international bonds lagging a long way behind with a return of -2%. US cash by contrast will produce a net real return of 0.8% pa. The key point though is that all these investment classes will produce negligible returns (or losses) when compared to the long term historical return of 6.5% for equities - widely used as a benchmark for US pension fund returns. The investment implications? A variant on the barbell approach - invest in cash and emerging markets equities & debt.

Obviously, this GMO forecast is based on the firm's own internal valuation metrics - and not every investor will necessarily buy into their pessimistic world view and analysis. Nevertheless, it's hard to argue with the common-sense observation that equity markets are closer to being expensive than cheap, with the long term law of averages suggesting that the days of easy returns must be drawing to a close.

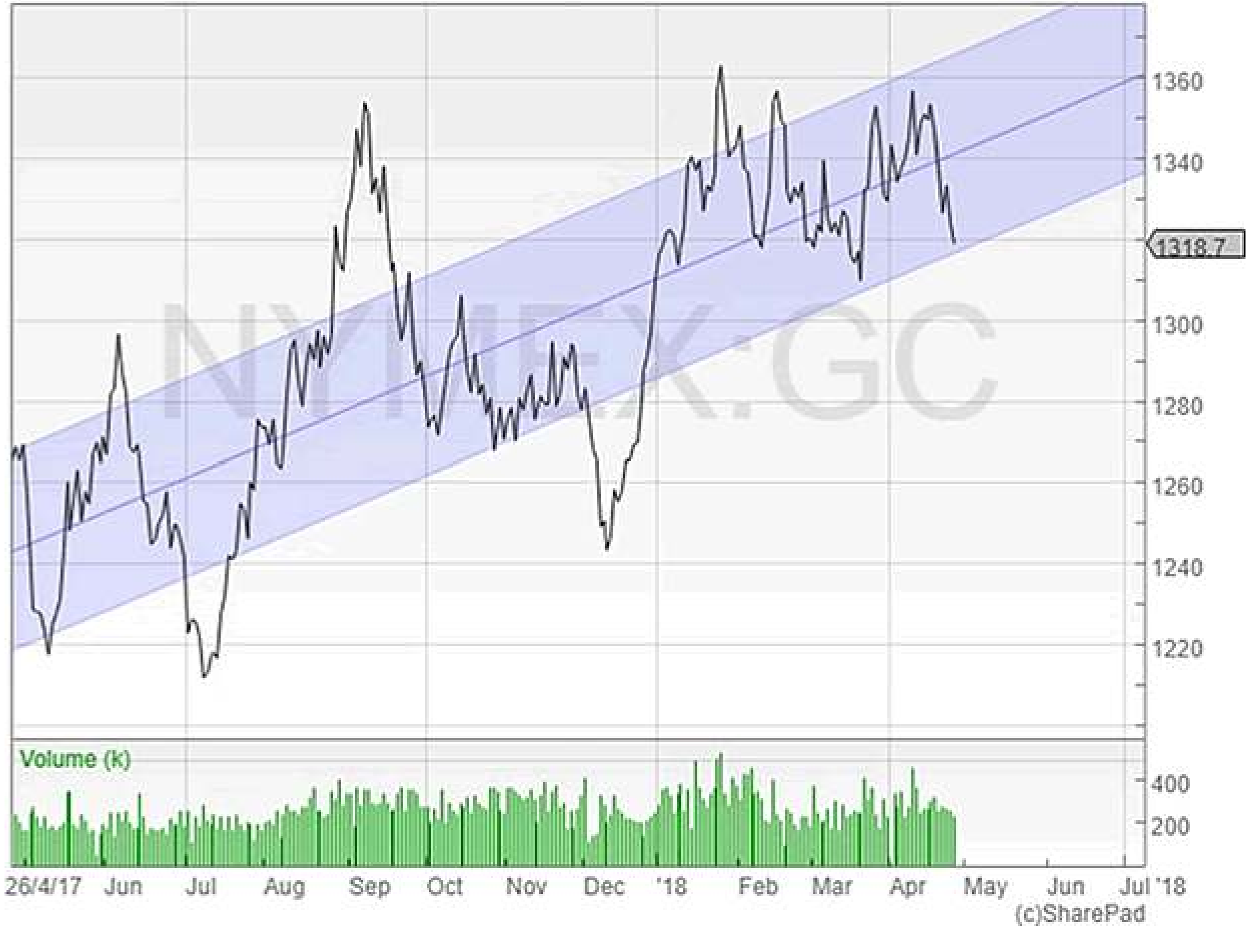


Index	April	May	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	126.2	126.2	3474	125
FTSE 100 (Dec 17)	303	306	7853	n/a

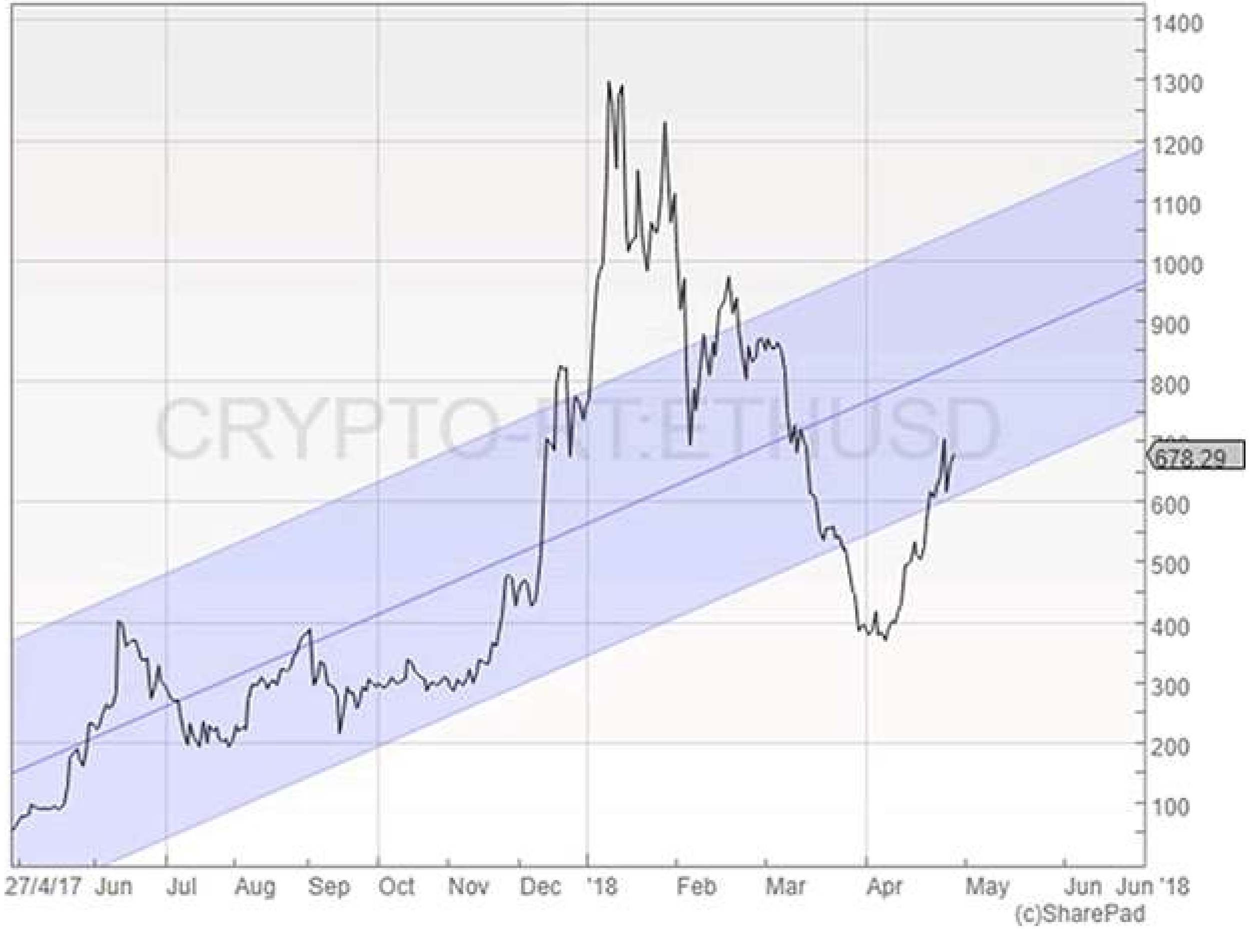
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	6.57	7.84	5.95	5.11	15.4	48	7852
S&P 500	2.57	1.4	5.39	15	64	108	2738
iShares FTSE UK All Stocks Gilt	-0.787	0	-1.51	-2.77	10.4	9.47	12.92
VIX New Methodology	-20.5	-33	37.9	11.5	0.374	-39	13.42

Volatility

I am very far from being a gold bull - I tend to share Buffett's dismissive view of the precious metal - but I think we might be close to a turning point. The chart below from Sharepad is for 1-year price returns and we can see a steady upwards trading range of $1220 to $1360 an ounce. I don't think there's any imminent (bullish) break out here but I would make three simple observations.



The first is that the gold price hasn't been enormously volatile over the last few years. Many investors, me included, have tended to shy away from this supposed 'alternative to fiat money' because the price has been much too volatile. Call me old-fashioned but if you're after a safe harbor asset, a relatively stable price is a necessity. By comparison, the chart below shows the spot price for Ethereum, the Number 2 cryptocurrency. To say that this modern alternative to money fiat is a tad volatile is the understatement of the century.



The next obvious statement is that there has to be a decent chance that after the recent dollar rally, the greenback might weaken for the rest of the year. Traditionally that's been a positive signal for gold prices - oil prices have also firmed substantially, another potential tailwind. Last but by no means least, we must be close to the peak of the current bullish cycle. Maybe we have another 12 to 18 months left. I hope we do. But the odds are a sharp slowdown must be growing by the month. If that happens, we'll see an increase in volatility and we could also see a flight to gold - although investors might also buy the dollar which could complicate matters considerably.

Measure	May Level	April Level	March Level	February Level
Vstoxx Volatility	13.68	17	16.75	27.52
VFTSE Volatility	12.53	13.84	13.59	21.14

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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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