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Monthly Market Report

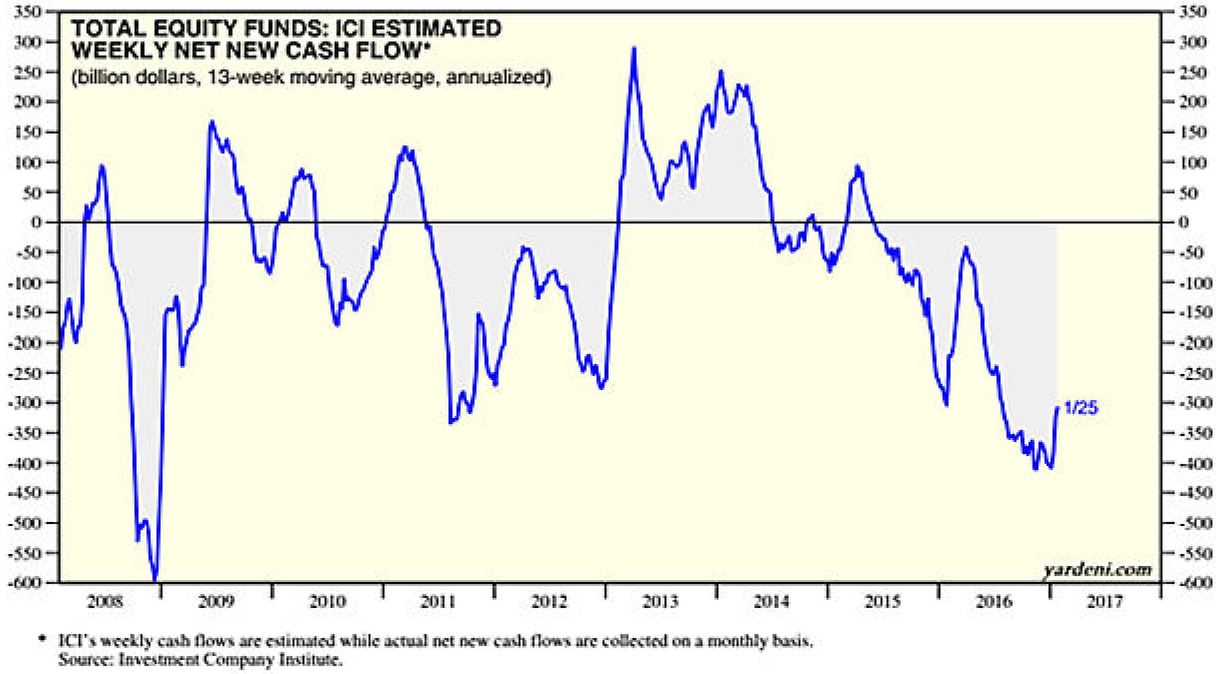
March 2017

With commentary from David Stevenson

I think it's fair to say that the mood amongst many institutional investors is moderately bullish at present. The Wall Street consensus is that the real-world economy is in fairly decent shape which should be good for corporate profits. Only a few weeks ago, for instance the US ISM Manufacturing survey for January (components such as production and new orders are fairly predictive) produced a strong set numbers whilst equivalent numbers in Europe for manufacturing new orders were close to a five-and-a-half-year high. The US labour market remains in good and still improving shape, with the behaviour of wages paying increasing testament to the fact that most of the people who want work, have work - employee bargaining power is rising correspondingly. Even global trade seems to be picking up based on new numbers. Crucially for investors, the earnings season on both sides of the pond is showing the corporate sector in decent and improving health, something that the survey data above suggests we can expect more of.

So, given this positive backdrop it seems churlish, arguably even curmudgeonly, to bring up two contrasting sets of numbers. The first warns us of the constant risk of over confidence. Transatlantic research house Investors Intelligence runs a long standing indicator called the Advisors Sentiment Report. This is closely watched by many hedge funds and tends to act as a contra indicator. It's currently "showing dangerously high levels of bullishness among financial advisors - which means it may be time to start protecting your portfolio". You have been warned !

The second observation is based on the chart below. This comes from the excellent (and free) American website Yardeni Economics and tracks US equity fund flows. You'll notice that fund flows have in fact picked up in recent months but you might also observe that equity fund flows are still running at negative levels over the medium term. These fund flows tell us that the current bull market rally might be built on weak foundations, with lowish volumes and overall bias against equities amongst most private investors. Cash levels remain high and one senses that this sense of caution amongst private investors could result in heavy selling if the current bull rally falters.



Source: Investment Company Institute

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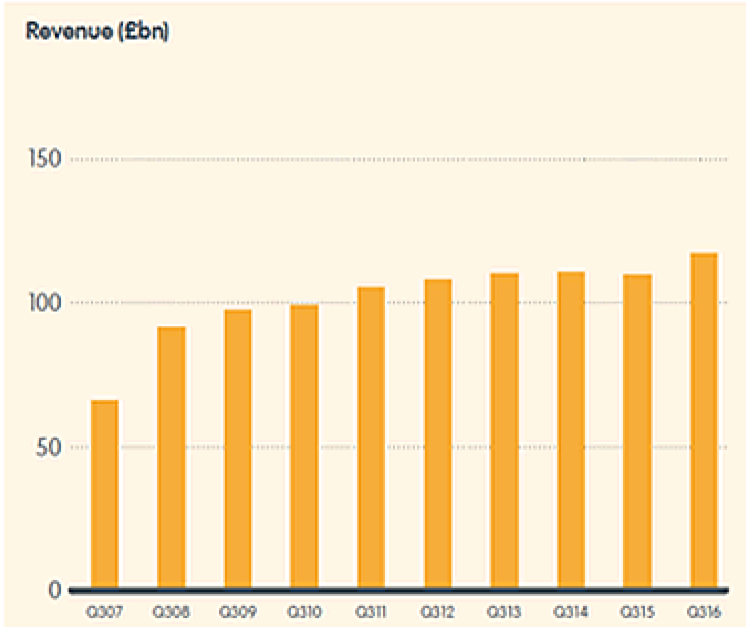
Headline Numbers

UK stockmarkets continue to set recent highs. On a technical reading the FTSE 100 index could easily shoot past 7500 based on recent trends (the blue chip index is trading above both its 20 and 200 day moving average, usually a very positive signal) while the more domestically focused FTSE 250 index also looks like it could test the 19000 level before the year is out (with 20,000 ever more likely). Some of this positive price action is down to momentum but UK equities are also benefitting from a tailwind of increasing profits. The latest Profit Watch report from The Share Centre looks at the P&Ls of the full FTSE 350, and finds that despite the obvious political and economic turbulence, UK listed companies have posted record-breaking performances in the final quarter of the year: with a 5.5% climb to £116bn - helped along by the weaker pound and a resilient UK economy. The chart below from The Share Centre shows this upward trend over the last few years. Operating profits climbed at fastest rate for three years, rising 5.6% to £10.5bn, and crucially this growth seems broad based with two thirds of companies increasing operating profits. Overall pre-tax profit fall of 2.6% seems disappointing, but due to just three very large companies. This should all be good news for dividends as well - see later in this report.

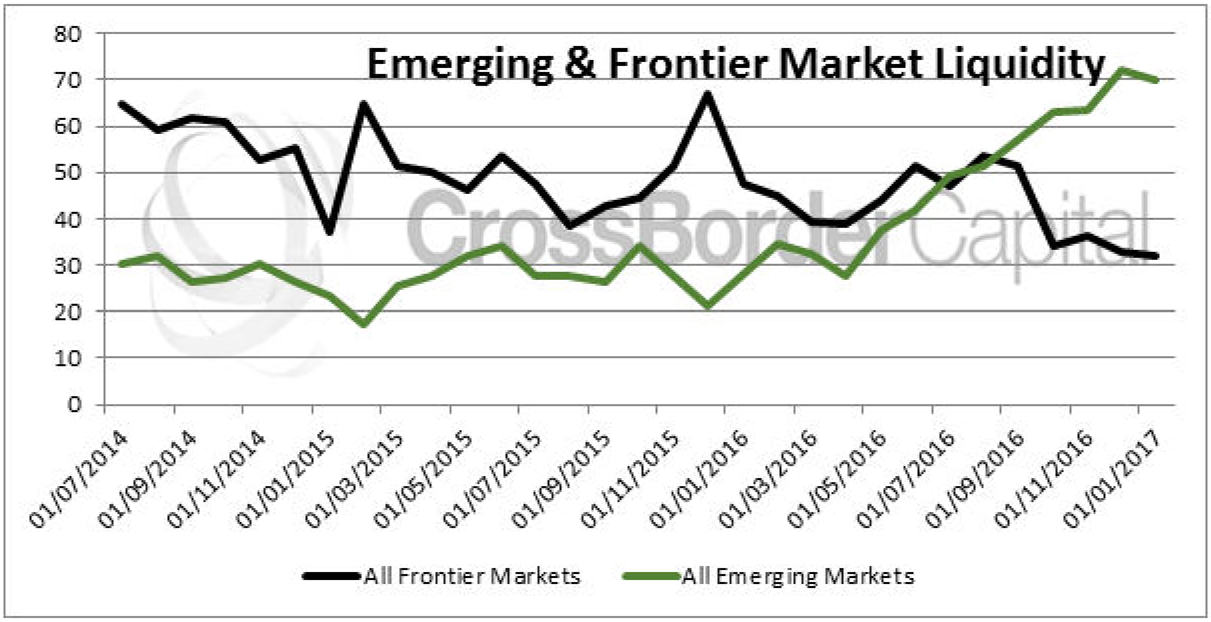


Source: The Share Centre

On paper a Trump presidency should be bad news for emerging markets. He's no great fan of cheap imports from China and his attitude towards Mexico doesn't need any restating. Crucially his presidency has also signalled renewed confidence in the dollar - partly powered by the prospect of increased interest rates but also hope that a deal on repatriating corporate profits can be agreed. The surge in Wall Street is also boosting the dollar on world exchanges. A stronger dollar by contrast is usually terrible news for emerging markets, largely because many local corporates have borrowed in dollars and now face potential financial ruin.

The irony though is that over the last year emerging markets equities have significantly outperformed their developed world peers. Over the year to date (for 13th February) the broad MSCI EM index is up a whopping 50%, while over the last three months this closely followed index is up 9% against 6% for the S&P 500. Obviously confident global markets will translate through to relative strength for all growth orientated stocks. But the potentially more significant tailwind is that China has avoided an economic hard landing. The Chinese government - and its banking system - are also new key players in terms of global liquidity, pumping up money flows to keep the economy ticking over at 6% plus growth per annum.

The chart below from analysts at Cross Border Capital shows that, over the last six months, the biggest increases in global capital liquidity have been in China, Taiwan and Emerging Markets, with the largest falls in Korea, Mexico and the smaller Frontier Markets. The London based firm observes that "China is seeing its biggest jump in liquidity since the Beijing Olympics boom and 2007/08 policy boost. These numbers tell us that emerging markets overall are benefiting from a robust and expanding Chinese credit system, and signs that foreign investor flows are returning to India, following the ‘containment' of negative demonetization effects", according to Cross Border.



Source: Cross Border Capital

Measure	Value as of Jan 13th, 2017	Value as of Feb 16th, 2017
UK Government 10 year bond rate	1.37%	1.29%
GDP Growth rate YoY	2.20%	2.20%
CPI Core rate	1.40%	1.60%
RPI Inflation rate	2.20%	2.60%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.40%	0.40%
Government debt to GDP ratio	89.20%	89.20%
Manufacturing PMI	56.1	55.9

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Bank CDS options

It's been another quiet month on the markets that insure against bank bond defaults via CDS spreads. Most pricing on these products hasn't really moved much although we have seen some small upwards in price, implying a marginal increase in concern for some European banks - but the increases are almost negligible. One other small note - the recent steady decline in CDS pricing for Deutsche Bank has stopped and last month there was a small increase. Maybe the flagship German bank is not quite out of the woods yet!

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	38.91	76	-4.57	-2	A -
Barclays	36.41	78.63	-0.86	-43	A
BNP Parabis	41.40	88.76	6.19	-24	A

Citigroup	23.14	67.87	-6.93	-52	A
Commerzbank	50.33	118	0.64	-27.49	A+
Credit Suisse	46.04	116	-2	-27	A
Deutsche Bank	81.63	157	-2.89	-33	A+
Goldman Sachs	33.89	89.97	-5	-40	A
HSBC	22.28	66.51	-4.39	-52	AA-
Investec*	n/a	194	n/a	n/a	BBB
JP Morgan	28.68	57.48	-10	-43	A+
Lloyds Banking Group	32.19	66.95	-3.57	-36	A
Morgan Stanley	29.58	81.61	-5	-43	A
Natixis	24.98	84.30	6.87	-31	A
Nomura	20.71	78.26	-1.64	-23	A-
Rabobank	32.94	64.65	0.54	-22.73	AA-
RBC*	n/a	66	n/a	n/a	AA
RBS	53.72	102.78	-11.78	-24	A
Soc Gen	36.67	88.21	6.82	-27.50	A
UBS	21.36	57.19	-8.35	-35	A

Source: www.meteoram.com 13th January 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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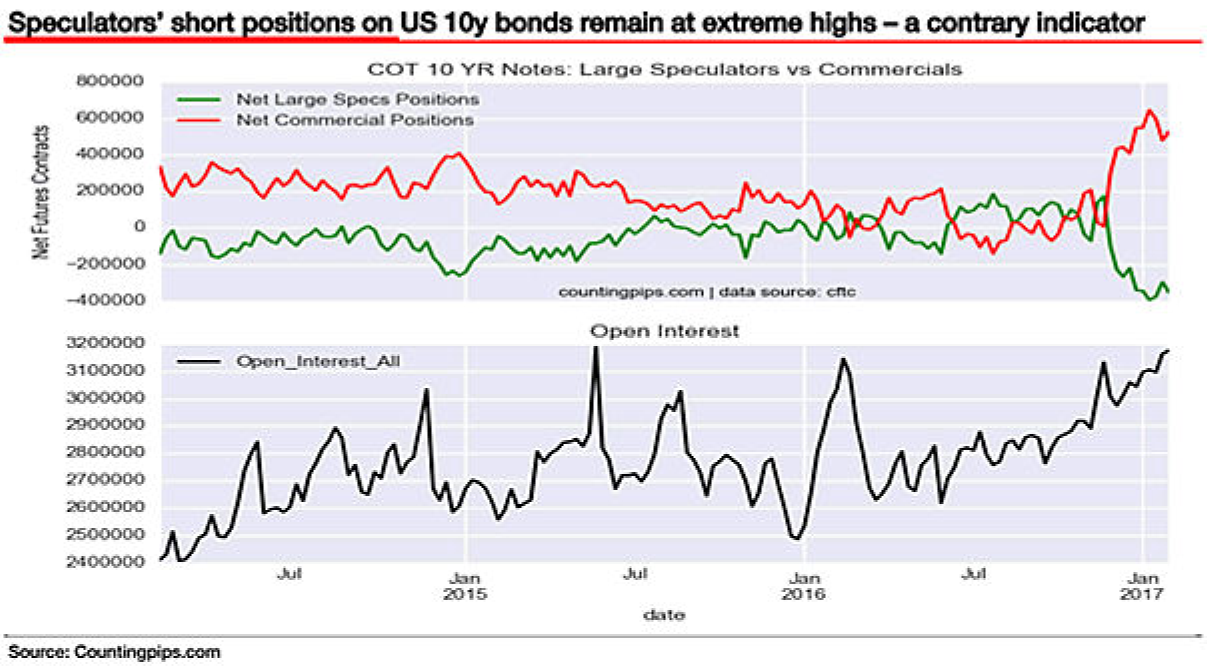
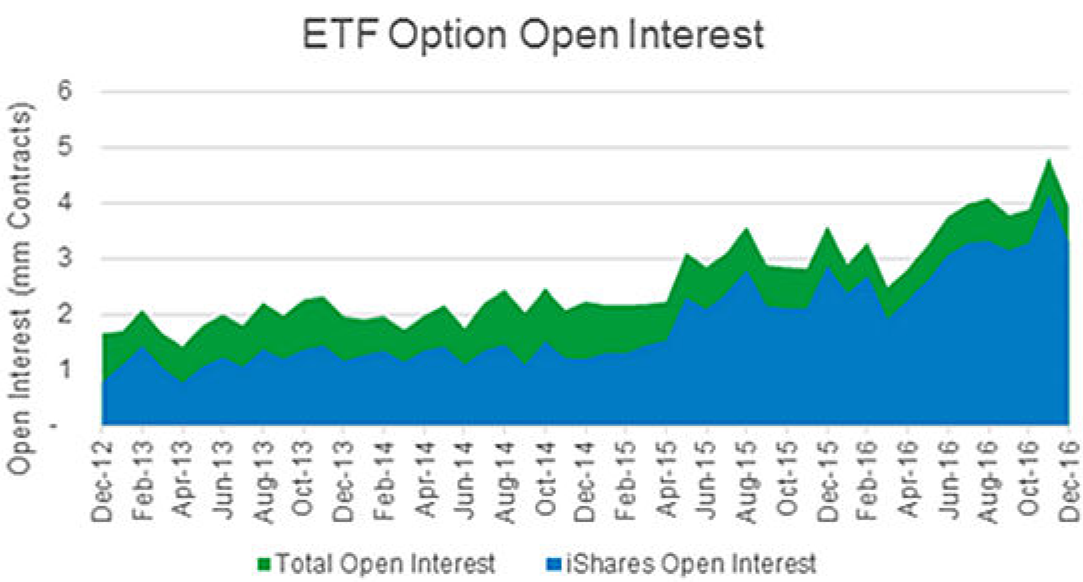
Government Bonds

2017 was supposed to be the year that the bond market stumbled into a crisis, prompting the much-prophesised bonds rout. The logic behind a big sell off seems impeccable: with rising interest rates on their way in the US and the threat of more inflation to come, most institutional investors will be tempted to sell conventional government securities, pushing up the yield and lowering the price. Investors are also betting that the US Federal Reserve will start to aggressively unwind its quantitative easing programme, thus under cutting buying for US government bonds.

The chart below is from a paper last week from SocGen's Albert Edwards and shows the sheer weight of speculators positions on US Treasury 10 year notes - it also shows the net open interest. Notice the very substantial growth in short positions. Data out this week from BlackRock echoes this message. The asset management firm has looked at the markets for Bond ETF options via this open interest market - many investor's use these products to hedge against any downside risk. Blackrock reckons that this has now grown to a notional value of $50bn (as of 16/12/16) in the US with the largest ETF option markets in high yield and government bonds. The second chart below - from BlackRock - shows the growth of the ETF Option open interest positions over time, with a clear upward trend.

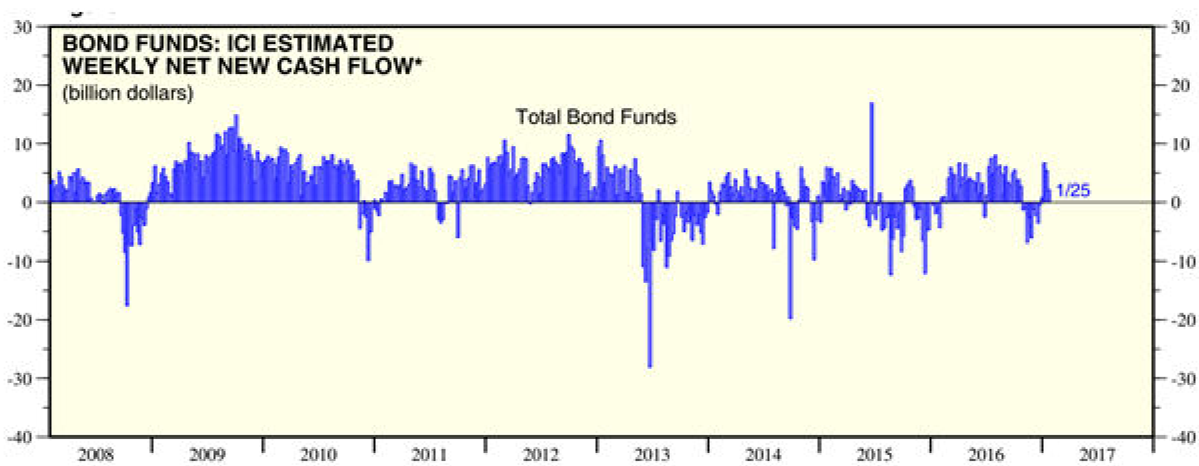




Source: BlackRock iShares

But this BlackRock data also reminds us of an essential fact– that investors are not selling their bond positions in any great scale. Analysts at investment bank Barclays back up this contrarian observation, noting that bond funds have had $27bn of INFLOWS during the first few weeks of trading in 2017. According to the bank's analysts " after bond allocations fell so much in Q4, fears of massive bond fund redemptions have not materialized, suggesting that uncertainty may be keeping risk sentiment in check. A closer look, though, shows that flows are going to TIPs and floating-rate loan funds. Investors may be looking for more safety, but they are still concerned about an upward move in rates."

The final chart below puts these bond fund inflows into a wider context. The chart is from Yardeni Economics' website and tracks US fund flows for bonds. Notice how inflows have remained consistently positive in the last year or so. In fact if anything we've seen INFLOWs into bond funds over the last few weeks - a complete inversion of the market consensus view.



Source: Yardeni

UK Government Bonds 10-year Rate 1.29%

CDS Rates for Sovereign Debt

Country	Five Year
France	56.63
Germany	24.28
Japan	26.36
United Kingdom	26
Ireland	44
Italy	99.95
Portugal	291
Spain	77.88

Eurozone peripheral bond yields

Country	Jan 2017	Feb 2017	Spread over 10 year
Spain 10 year	1.45%	1.65%	110
Italy 10 year	1.92%	1.92%	157
Greece 10 year	6.94%	6.94%	659

	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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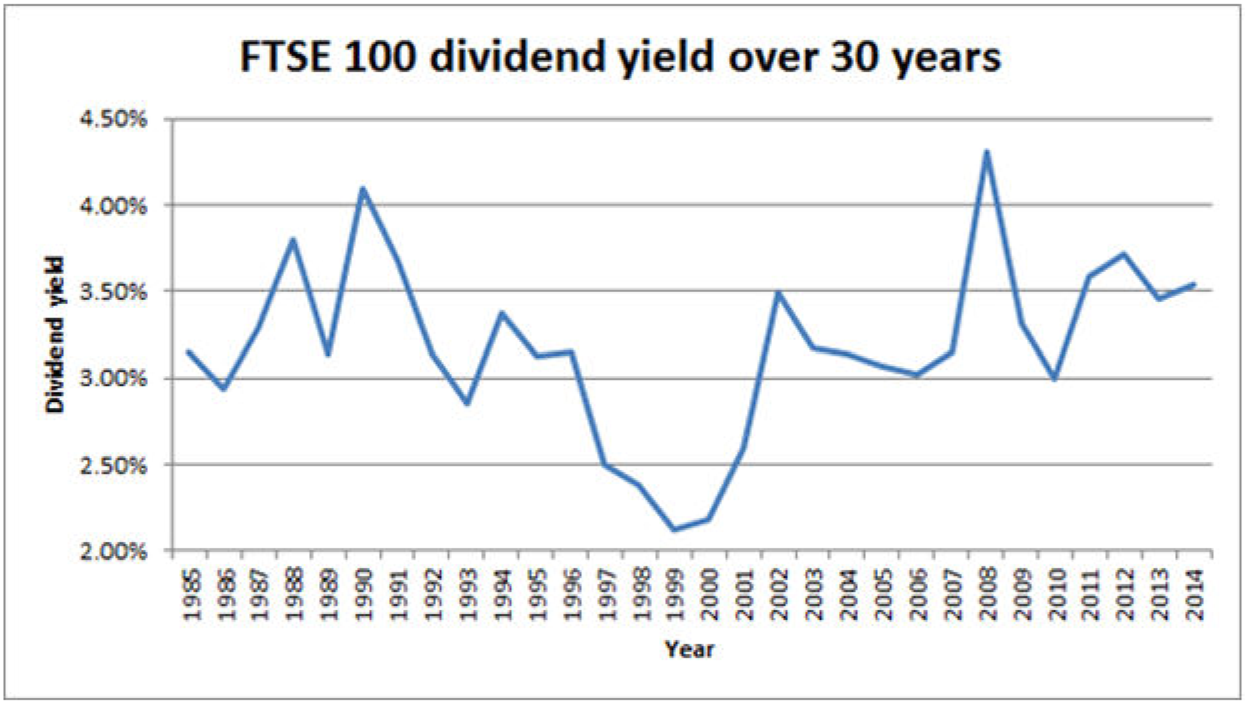
Equity Markets and Dividend Futures

UK equities have very evidently benefitted from a post Brexit bounce - or perhaps more specifically a decline in the value of sterling. The logic here is that the blue chip FTSE 100 index is jam packed full of global names whose earnings per share in pounds are likely to jump in value because of the fall in sterling. If Brexit is good for large caps, surely by contrast it should have been bad news for mid cap equities where increasing inflation rates might start to eat into margins? The fly in the ointment in this logic is that mid cap FTSE 250 stocks are now up 16% while the even more domestically focused FTSE Small Cap index is up just under 25%. Why the recent strength? One explanation could be surging dividends helped along by the weak pound - which have the effect of under pinning strong share prices. Hard numbers on this surge came this week from Capita Asset Services via its UK Dividend Monitor. According to Capita, UK listed businesses recorded a record fourth quarter with total UK dividends up at £84.7bn in 2016, an increase of 11.7% year on year to reach £16.6bn. As a result, the headline total for the full year was 6.6% higher than in 2015.

- Intriguingly Capita reports that the growth was not driven by large increases in regular dividends. Instead, payouts were buoyed by higher special dividends. Capita's key findings include:
- The Weak pound accounted for £4.8bn of £5.2bn gain in year, while special dividend payouts doubled
- At underlying level, dividends climb a slower 2.6% to £78.5bn in 2016, as companies struggle to grow profits
- 2016 marks third year top 100 saw slower underlying growth than mid-250, as global trends hampered the UK's largest companies
- Underlying dividends set to climb 7.5% to £84.4bn in 2017, buoyed by more currency gains
- Overall, 26 sectors out of 39 paid out more in 2016 than in 2015, somewhat below the average of 32 since the financial crisis.
- Dividend increases were unevenly distributed, with a disproportionate influence from the UK's largest firms. Shell was comfortably the UK's largest payer, and is now the largest payer in the world. Its total dividend was worth £11.1bn in 2016, £3.2bn more than the previous year. This alone was 12% more than the entire UK mid-cap index distributed. HSBC was the next highest payer, distributing £7.5bn, followed by GlaxoSmithKline. Between them, the top five payers accounted for 38% of UK dividends in 2016, up from one third in 2015.

Looking forward, Capita Asset Services reckons dividends will rise "£5.9bn to £84.4bn in 2017 on an underlying basis, a healthy increase of 7.5%, with two-thirds of this down to the effect of the weaker pound. Special dividends are unlikely to repeat their 2016 performance. Headline dividends, therefore, will grow more slowly. Capita expects an increase of 3.3%, bringing a total of £87.5bn."

Overall, UK equities will yield 3.7% over the next twelve months. The top 100 will yield a little over 3.8%, while the mid-caps 250 index will yield 2.5%. This forecast dividend yield is fairly above average for the FTSE 100 as the chart below shows - which rather implies that there may be more upside to valuation levels for the blue chip index.



Source of Chart: https://uk.investing.com/analysis/ftse-100-to-reach-10,000-by-end-of-this-decade-2945

Index	January	February	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	115.8	115.6	3309	114.80
FTSE 100 (Dec 14)	276.3	282.1	7263	N/a

Name	Price % change						Close
	1 month	**3 months**	**6 months**	**1 year**	**5 year**	**6 year**	
FTSE 100	-0.48	7.5	5.20	25.38	23.93	20.96	7302.40
S&P 500	3.28	7.74	7.26	25.98	74.90	76.90	2349.25
iShares FTSE UK All Stocks Gilt	0.43	0.73	-7.54	2.05	11.09	26.36	13.0088
VIX New Methodology	-4.36	-19.67	-9.06	-57.72	-49.20	-34.39	10.74

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Volatility

We've noted before in these articles that volatility measures have quite literally fallen off a cliff in recent months. The chart below (from equities website Sharepad.co.uk) paints the full picture, in all its grisly details for investors in volatility.

It shows the VIX index, which tracks the ups and downs of the blue-chip US index, the S&P 500. The chart shows one year prices for this index through to early February 2016 - the blue line is the 200-day moving average and the red line the 20-day moving average, with trend lines either side. Notice the consistent downward trend in the VIX, well below both the 20 and 200 day MA.

In recent days, this index has been trading not far off the 10 level with single digits a distinct possibility if current trends continue. Single digit measures for the VIX were last recorded back at the tail end of 2006 and the start of 2007 and we all know what happened next! Turning to Europe, the main measure of FTSE 100 volatility - the VFTSE - is also at 1 year lows, trading at a notch under 10.5 while the Eurozone version (the VSTOXX) is also at year lows (at just under 15). This calm has even extended out to the global commodity markets - the main index of oil price volatility from the CBOE (ticker OVX) is currently trading around 1 year lows at 27.40 while the index of gold price volatility (tracked by the CBOE under ticker GVZ) is also just a fraction above 1 year lows at its current index level of 14.77.

Source: www.sharescope.co.uk

Measure	February Level	January Level	December Level	November Level
Vstoxx Volatility	15.05	15.21	16.94	21.96
VFTSE Volatility	11.44	11.62	12.04	16.69

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Summary of Pricing Impact on Structured Products

Pricing Parameter	Change	Impact on Structured Product Price
Interest Rates	Up	Down
Underlying Level	Up	Up (unless product offers inverse exposure to the underlying)
Underlying Volatility	Up	Down for capped return/fixed return/capital at risk products. Up for uncapped return/capital protected products.
Investment Term	Up	Down
Issuer Funding Spread	Up	Down
Dividend Yield of Underlying	Up	Down
Correlation (if multiple underlyings)	Up	Up (unless product offers exposure to the best performing underlyings only)

Source: UK Structured Products Association, January 2014

This information is provided for information purposes only, and the impact on a structured product price assumes all other pricing parameters remain constant.

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Explanation of Terms

CDS Spreads and Credit Ratings

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

Why does the yield matter on a bond?

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

Volatility measures

Share prices move up and down, as do the indices (the 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.

Kind Regards,

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