STRUCTURED ™ PRODUCTS ASSOCIATION

Monthly Market Report

March 2018

With commentary from David Stevenson

At long last. I think it is fair to say that we've all been collectively waiting for some kind of nasty market correction for what has seemed like an age. The trail of breadcrumbs was always clearly on display. One of the primary supports for equities over the last decade has been accommodative monetary policy and low interest rates. This has allowed debt levels to carry on increasing - in fact there has been $72tn ($72,000,000,000,000) of new debt created since 2008 taking global debt to over 327% of GDP. But that extra liquidity has also supported share prices. So, when interest rates started to increase - helped along by worries about resurgent inflation - it wasn't any surprise that we saw market volatility. The only surprise was why anyone thought it wouldn't happen. A good summary of where we had got to come from risk analysts at CheckRisk who observed that "In January equity markets globally had become extremely overbought, both on a valuation basis and also from a technical perspective with relative strength indicators (RSI) of greater than 90 recorded. These are at the absolute upper bounds of what we have seen."

So, a bump or even a correction was arguably inevitable. Now we must deal with consequences. Will the market volatility persist, or will we see a more robust bounce back? It's certainly worth watching so-called Volatility Control and Risk Parity funds which target a specific level of volatility. According to Bloomberg, this could unleash some $225bn of equity market sales. Also, some $500bn of global funds are attached to such strategies and in many cases are driven by algorithms. Such a wave of sell-offs could keep market volatility high at best and could cause a crash if volatility continues to rise.

My own sense is that we are probably experiencing another variant of taper tantrum. The markets know that interest rates will rise but they're signalling that they think rates shouldn't rise too aggressively. Maybe they've under-estimated the steely resolve of the central bankers to crawl back towards monetary 'normality'. On the other hand perhaps too much volatility will scare the central bankers back into a more cautious stance. Who knows! My own guess is that if the FTSE 100 finds itself under 7000 - and the S&P 500 under 2400 - I'd probably think about venturing back into the markets. Whatever target level you have, I'd observe that a consensus view is beginning to crystallise - long emerging markets versus some developed markets, caution on the US, short bonds and long some commodity trades.

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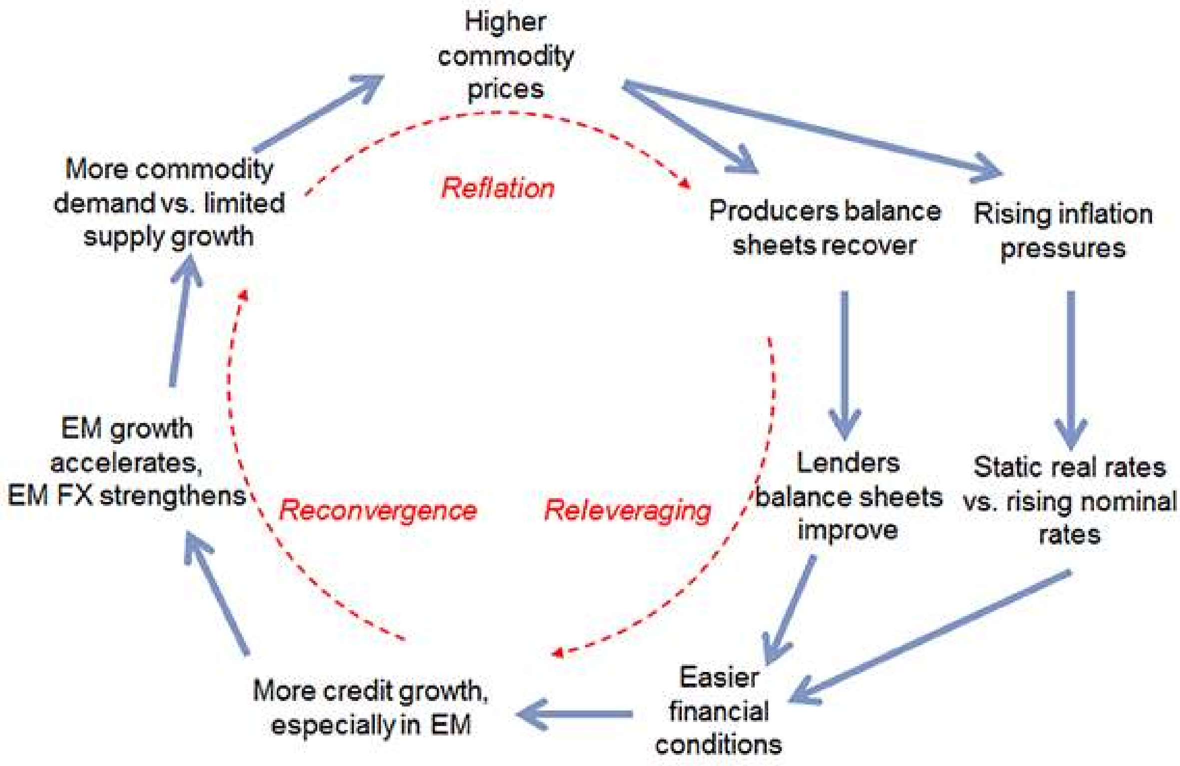
Headline Numbers

Most investment banks and their teams of analysts have settled on a new consensus view - if we do avoid a recession, commodities might move much higher which might in turn provide a tailwind for emerging markets. Not that that should come as any great surprise based on past returns - during the second half of 2017, commodities were the best performing asset class, posting a solid 18% return.

According to analysts at Goldman Sachs energy prices are the classic 'canaries in the coal mine' i.e. a good indicator of the health of the global economy. The foresee what could be called a virtuous "3Rs" scenario, with many emerging markets the biggest beneficiaries. "Strong demand growth against limited supply growth due to OPEC and Chinese supply curtailments created significant **reflation** in commodity prices last year" say the Goldman analysts. "Given the high level of debt held by commodity producers, not only do higher commodity prices reduce the number of bad loans and free up capacity on bank balance sheets, higher commodity prices also help strengthen EM currencies and weaken the dollar via the accumulation and recycling of rising excess savings. On net, this in turn lowers EM funding costs and leads to EM **releveraging**. More EM leverage leads to more EM growth **reconvergence**, reinforcing even more synchronized global growth and, ultimately, reflation pressures - creating a feedback loop".

According to the GS analysts their current global Activity Indicator (CAI) is currently on target to hit 5.1% annualized real GDP growth in the US, which is the "best ever recorded in the history" of that particular signal. Unsurprisingly, given these numbers the bank's analysts have been hiking their estimates for commodity prices across the board - they now expect returns of +15% and +10% over the next 6 and 12 months, respectively.

Goldman Sachs 3Rs feedback loop



Measure	Value as of 15th January, 2018	Value as of 12th February, 2018
UK Government 10 year bond rate	1.32%	1.62%
GDP Growth rate YoY	1.70%	1.50%
CPI Core rate	2.70%	2.50%
RPI Inflation rate	3.90%	4.10%
Interest rate	0.50%	0.50%

Interbank rate 3 month	0.52%	0.54%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	56.3	55.3

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Bank CDS options

It won't come as a great surprise to learn that rates on credit default swaps jumped pretty much across the board over the last month. Deutsche Bank in particular experienced sharp increases in its swap rates although Banco Santander wasn't too far behind. CDS rates for UK banks also ticked up over the last month although the increases were marginal at best. Investors in Credit default swaps are likely to anticipate an increase in bank bad debts as a result of the recent increase in stockmarket volatility. If markets quieten down, expect to see these rates slip back again.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	22.31	38.92	4.06	-7.36	A -
Barclays	8.97	24.83	3.76	4.61	A
BNP Parabis	22.81	47.59	8	-39	A
Citigroup	18.27	45.8	12.96	17.47	A
Commerzbank	20.81	58.5	14.11	7.4	A+
Credit Suisse	18.02	51.26	14.17	5.25	A
Deutsche Bank	41.88	88.71	27.08	26	A+
Goldman Sachs	21.51	58.45	15.54	17.5	A
HSBC	10.01	23.05	8.34	16.86	AA-
Investec*	n/a	191	n/a	n/a	BBB
JP Morgan	18.3	42.13	15	14.49	A+
Lloyds Banking Group	9.68	39.62	8.94	-2.46	A
Morgan Stanley	21.03	54.52	11.03	12.23	A
Natixis	10.61	27.15	0.22	3.31	A
Nomura	12.09	41.31	-0.22	-8.67	A-
Rabobank	8.39	23.23	16.5	14.04	AA-
RBC*	n/a	49	n/a	n/a	AA
RBS	24.75	44.51	4.62	-9.22	A
Soc Gen	9.78	25.87	3.15	5.1	A
UBS	9.05	22.96	12.39	17.45	A

Source: www.meteoram.com 8th February 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

Many years ago, I remember having coffee with a wizened old investment academic who gravely intoned that "David, always watch the FX markets. Everyone focuses on stock indices and bond yields, but the trouble usually starts with FX rates". His argument was simple. As the world globalises and becomes more inter dependent, the interplay between the main currencies - the dollar, Euro, JPY and increasingly the Chinese remnimbi - tells you everything you need to know about capital imbalances and the direction of the global economy. Eventually the widely followed rates - interest rates and inflation rates - start to give us signals about those capital imbalances. Asset classes also react accordingly with commodities especially sensitive.

So, it's with those wise words ringing in my head that we approach the elephant in the room - the weakening dollar. The chart below comes from the US Federal Reserve and shows the trade weighted value of the dollar. Notice the direction of travel since the beginning of 2017? You guessed it - since the start of 2017, the dollar has been falling again. Inflation expectations are on the rise, slightly, as are inflation rates (compared to consumer prices during the 2015-16 downturn). Commodities are up, including WTI. And again, it doesn't take a genius to work out why this might be happening - read the US President's own words. Trump last year said that while a strong dollar "sounds good", his actual view on this issue was that "our dollar is getting too strong..it is very, very hard to compete when you have a strong dollar and other countries are devaluing their currency". The titanic battle now becomes a clash between two world views - weaker dollar and be damned about inflation expectations or unleashing the inflation hawks in the central banks and sharply higher interest rates. My money is on the former, especially given the fact that the new Fed chair seems a very long way from being a Paul Volcker i.e. someone who will hike interest rates sharply to kill inflation dead. Which would also crush Trump's (and the Republicans) re-election prospects.

The chart below indicates to me at least that we could see more dollar weakening to come - with a decline of another 5 to 10% on the cards. If that was the case, the asset class implications are clear. A weak dollar is bullish for oil prices - much higher oil prices could be the big surprise in 2018. And remember that every major episode of galloping inflation since 1973 has been fuelled by a surge in oil prices. Emerging market economies are also likely to benefit from a growing influx of capital as the dollar weakens. Lastly, historically at least, there is an inverse correlation between the U.S. dollar and gold.

Fixed Income - what's in a number?

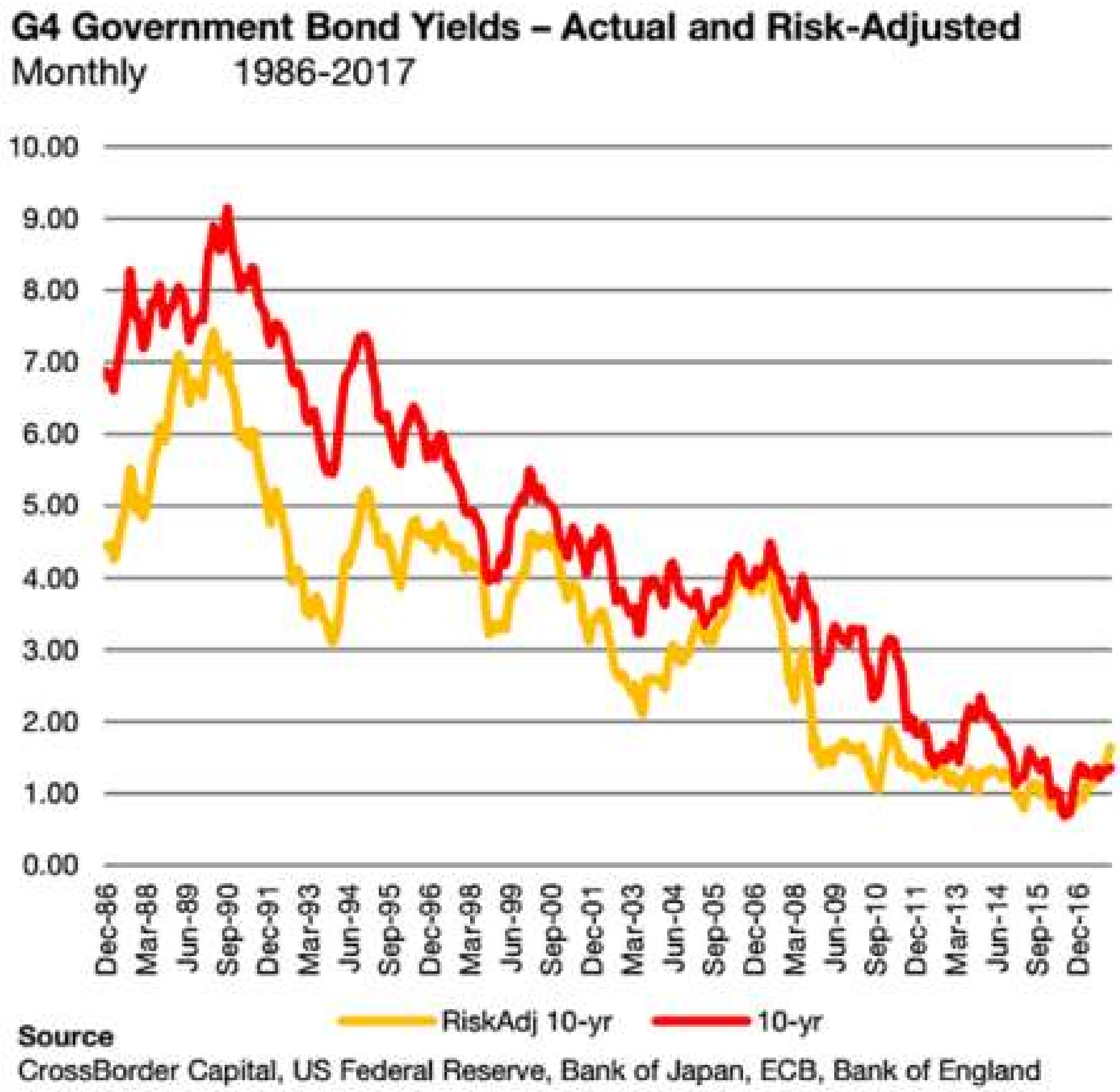
Most of us tend to fixate on round numbers. Take long term investment returns from risky assets. A huge variety of research studies have shown that most of us expect returns of around 6 to 7% per annum over the long term from investing in equities. It's a similar story for dividend yields from equities. Most of us have an instinctive understanding for what constitutes a poor yield - under 2% - and what constitutes an attractive yield - anything above 3.5%. It won't come as a great surprise to learn that bond investors also have 'magic numbers' which they think constitutes an important signalling mechanism.

The yield on US Treasury bonds is one such example. Most assume that anything above 2.5% for ten-year govies constitutes an important turning point while anything above 3% strikes most as a big flashing red light. One investment bank recently headlined an email to investors with "is there life at a US Treasury yield of 3%" - with the implication being that any yield above 3% implies that equities might steadily collapse in value. The chart below shows that those concerns are bound to grow over the next weeks and months - yields look they are set for a challenge at 3%.

UK Government Bonds 10-year Rate 1.62%

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

Nevertheless, the next chart below, from analysts at Cross Border Capital, do give us some perspective - they show G4 yields (UK, US, Japan and Eurozone) over the last thirty plus years. The current upturn barely amounts to more than a tiny uptick compared to long term averages. If bond investors are worried about rising yields, their worries only just started if history is anything to go by. Overall though the prognosis is grim for bonds. Cross Border reckons global bond markets will suffer a "tough 2018, with G4 markets losing an average 5-6%, and with losses concentrated in US Treasuries and JGBs... *We continue to expect 10- year bonds to test 3.5% yields this year*". If Cross Border is right, expect more stock market volatility as first that 3% UST yield barrier is breached and then 3.5%.



Prognosis is bad for bonds moving forward.

CDS Rates for Sovereign Debt

Country	Five Year
France	16.1
Germany	8.59
Japan	17
United Kingdom	14.96
Ireland	21.42
Italy	103.20
Portugal	77
Spain	50.84

Eurozone peripheral bond yields

Country	January 2018	February 2018	Spread over 10 year
Spain 10 year	1.51%	1.46%	71

Italy 10 year	1.99%	2.02%	127
Greece 10 year	3.89%	4.20%	345

	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

The glass half empty: surging dividends and profits

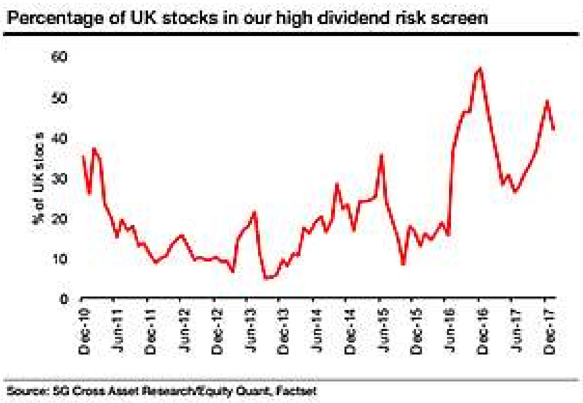
The greatest irony of the last few weeks market volatility has been that the sudden panic has happened just as evidence emerges that the global economy is fine form - and corporates are enjoying bumper profits which are in turn then being paid out in surging dividends. Suddenly markets have switched into a gloomy, half glass empty mood, with good news turning into bad. The evidence for surging profits comes from the regular earnings tracker service by Charles Stanley. They report that FTSE 100 companies have so far released earnings growth of 45% year-on-year for 2017, with all sectors seeing positive growth - although these numbers are heavily skewed by Energy's strong performance where earnings are up 99%.

Looking ahead, Charles Stanley reckons that consensus expectations are for the FTSE 100 index to see earnings growth of 9% in 2018 with Energy, Tech and Telecoms seeing the biggest growth. Over in the US, with 72% of the S&P500 having reported, full-year earnings are up a solid 20% at the index level with Energy and Materials reporting the biggest gains of 136% and 40% respectively. Notably, 82% S&P500 stocks beat fourth-quarter earnings estimates, the highest in seven years.

The earnings outlook for US companies has also turned very positive over the last three months, with analysts revising their full-year earnings estimates by 7% over the period. This leaves expectations for 2018 earnings growth at an ambitious 24%, with Energy expected to outperform. All sectors are expected to see positive earnings growth.

Given this surge in profits, it's not surprising that dividends paid out to investors has also surged. According to another survey, this time from Link Asset Services, record dividends of £94.4bn were paid in 2017, up 10.5% year-on-year, boosted by large special dividends and rebounding payouts from miners. Underlying dividends (ex specials) grew 10.4% to £87.7bn, the fastest rate of growth since 2012. Exchange rate gains of £2.1bn owing to sterling's 2016 devaluation boosted the annual total, though a stronger pound by year end meant FX losses in Q4.

But investor's also need to tread carefully with these surging dividends levels in the UK - or that at least is the view of analysts at French bank SocGen. The observe that the UK market is heavily weighted towards USD earnings but is "also seeing quite a few companies getting into trouble as profit warnings crash into weak balance sheets". They run a monthly dividend risk screen highlighting high dividend yield stocks with poor quality balance sheets - several UK names that have recently got into trouble were on this list, and of the current 50 names, 21 are UK listed, close to historical highs". SocGen's analysts reckon that UK investors should "Expect more dividend cuts in the UK." That could certainly be the case if sterling carries on increasing in value against a weak dollar. Those dividends might suddenly seem a tad vulnerable.



Index	January	February	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	126.3	125.8	3377	122
FTSE 100 (Dec 17)	298.9	294.3	7178	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-1.4	0.58	0.65	8.86	28.83	36.51	7432.99
S&P 500	1.24	5.91	7.61	19.14	87.14	108.3	2582.3
iShares FTSE UK All Stocks Gilt	0.37	-2.03	-1.83	0.71	9.26	12.27	13.035
VIX New Methodology	4.17	-34.54	2.84	-28.77	-43.58	-68	10.5

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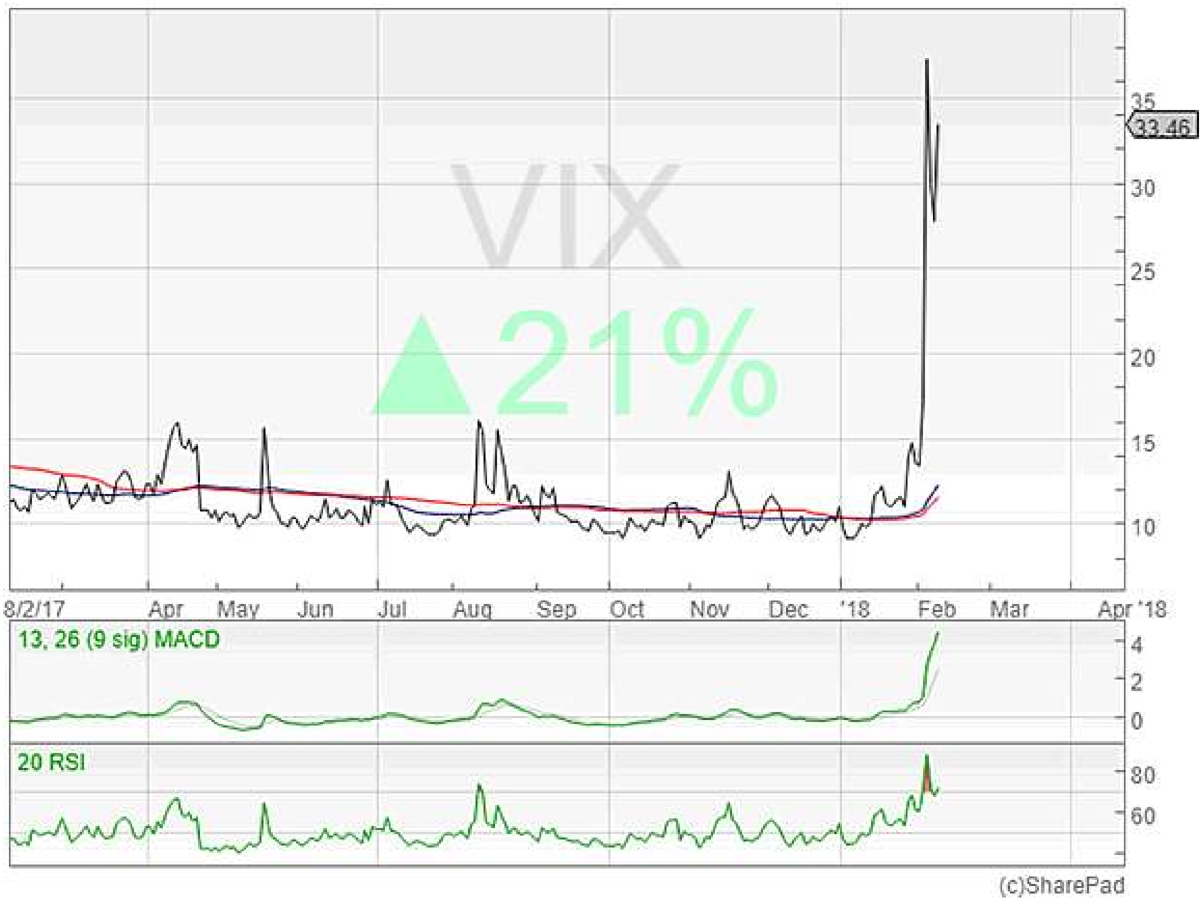
Volatility

Without wanting to sound a tiny bit smug but can anyone have been surprised that volatility measures such as the Vix shot up over the last few weeks. We have been expecting an uptick in volatility for months - if not years. On these pages we've been commenting ad nauseum about the exceptionally low levels of stockmarket volatility. The last time we saw measures for the Vix move into single digits was back in late 2006 and early 2007 - and we all know what happened next. So, in simple terms, anyone who was still short Volatility and the Vix was probably playing with fire. Cue the entirely unsurprising news that a number of US volatility products have now 'blown up'. The chart below sums up the carnage - it shows the Vix index smashing past the 30 level. The Cboe Volatility Index soared three fold in just three days as $3 trillion was wiped from equities amid signs the U.S. economy could be overheating. And what started in the US has also hit other developed world markets - the VFTSE went from under 10 to peak at over 23 while the VSTOXX also shot up to 35.4 from a low of 11 over last month.



This clearly caught many US investors on the hop - and Credit Suisse Group AG was forced announce that it would liquidate one investment product while more than a dozen others products were halted after their values sunk toward zero. Bloomberg reported that Credit Suisse will buy back its VelocityShares Daily Inverse VIX Short term ETN, ticker XIV. The news website reported that the fund's market value topped $2 billion in late January; it was down 93 percent before trading was halted. The second chart below shows price returns for this widely held Vix tracker. Clearly going short the Vix was a daft trade.

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.

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