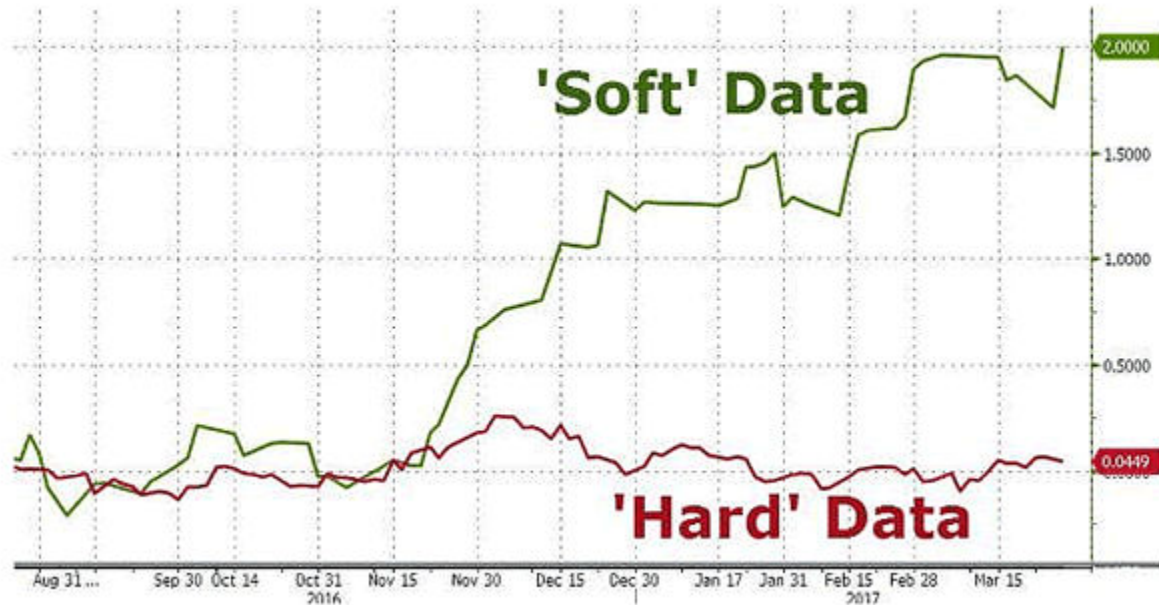


With commentary from David Stevenson



On initial inspection everything within the strange world of investment looks really rather optimistic. Most key economic indicators suggest acceleration in global growth, even in the manufacturing sector. Crucially this optimism is evenly spread about, with the Eurozone and China both looking like they might be slowly catching up with the recent pace of growth on display in the US. A good summary of this cheery world view comes via a recent note from analysts at Barclays who run their own macro measures looking at confidence levels, especially in manufacturing. It's been edging up steadily for the last three months although the very latest measure in March did edge down slightly. Overall though this index still remains at an elevated level historically, with the most recent reading the second highest since May 2011. The Barclay's analysts observe that manufacturing sentiment continues to be underpinned by "buoyant demand - both domestic and external... global manufacturing sentiment remains solid at the end of Q1" although cost concerns are beginning to build. So, all in all then a decent picture emerges from this one survey. Yet after a bullish few months stock markets have stopped bounding forward, with the FTSE 100 becalmed well below the symbolic 7500 level while the benchmark US index, the S&P 500, also appears to be stuck below the 2500 level. We are, one suspects, at one of those key inflection points in which the next move up or down will likely set the tone for markets over the next 12 months.

One strange aspect of our current inflection point is the mismatch between what's called hard data - macro economic statistics mostly collected by leading governmental organisations - and soft data based on estimates and projections. These obviously don't move in lock step but there is usually some correlation between the two, usually with a lag one way or the other. Currently though the divergence "**is stunning**", according to strategists at Morgan Stanley. The chart below, from Morgan Stanley and quoted in Zero Hedge, demonstrates this remarkable tale. You can see the original chart [here](#). The last time this gap was so great was in 2011, and that didn't end well for equity markets! The positive spin on this tale is that the hard data will eventually start to catch up with the soft data. Yet as Zero Hedge observe, "from an economist's point of view, smoothing through the volatility simply looks like the outlook for around 2% growth remains intact".



Source: Morgan Stanley

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Headline Numbers

Investors and economists may be at sixes and sevens about what happens next with the US economy - with most expecting the Eurozone economy to power ahead - but a consensus (a positive one) seems to be emerging about emerging markets. Helped along by surging credit growth in China, most investors now seem to think that emerging markets are set fair for a strong 2018. One small indicator pointing towards optimism comes in the first chart below which shows the Baltic Exchange Dry index, which tracks shipping prices for container cargo fleets. This index is a good leading indicator for overall merchandise trade activity, and has been on an uptrend pretty much since mid-February and is currently around the levels last seen in 2014, although it's still well off levels last seen in 2010 and 2012.

BALTIC EXCHANGE DRY INDEX



SOURCE: WWW.TRADINGECONOMICS.COM | OTC

| Measure | Value as of Mar 10th, 2017 | Value as of Apr 7th, 2017 |
|---------------------------------|----------------------------|---------------------------|
| UK Government 10 year bond rate | 1.24% | 1.08% |
| GDP Growth rate YoY | 2% | 1.90% |
| CPI Core rate | 1.60% | 2% |
| RPI Inflation rate | 2.60% | 3.20% |
| Interest rate | 0.25% | 0.25% |
| Interbank rate 3 month | 0.40% | 0.34% |
| Government debt to GDP ratio | 89.20% | 89.20% |
| Manufacturing PMI | 54.6 | 54.2 |

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Bank CDS options

Pricing for most credit default swaps increased, marginally, last month but this modest trend was overshadowed by declines for some continental banks such as Rabobank and Credit Suisse. German banks in particular experienced sharply lower swap pricing which might indicate improved confidence. The sharpest decline in swap pricing though as for Japanese bank Nomura whose 1 year CDS swaps now trade at just 10.13 basis points for one year and 47.22 basis points for five years - Danske bank is not far behind as is UBS.

| Bank | One Year | Five Year | Monthly Change (5yr) | Annual Change (5yr) | Credit Rating (Fitch) |
|-----------------|----------|-----------|----------------------|---------------------|-----------------------|
| Banco Santander | 35.62 | 75.65 | 1 | -8 | A - |
| Barclays | 31.8 | 77.15 | 7.47 | -42 | A |

| | | | | | |
|----------------------|-------|-------|--------|-------|-----|
| BNP Parabis | 35.53 | 87 | -5.72 | 6.27 | A |
| Citigroup | 23.66 | 62.94 | 2.32 | -36 | A |
| Commerzbank | 34.46 | 110 | -5.19 | -1.11 | A+ |
| Credit Suisse | 34.17 | 101 | -11 | -33 | A |
| Deutsche Bank | 44.48 | 127 | -12 | -33 | A+ |
| Goldman Sachs | 31.14 | 82.38 | 4.34 | -25 | A |
| HSBC | 16.26 | 63.28 | 1.02 | -40 | AA- |
| Investec* | n/a | 178 | n/a | n/a | BBB |
| JP Morgan | 27.14 | 55.79 | 8.9 | -28 | A+ |
| Lloyds Banking Group | 28.26 | 65.13 | 4.18 | -38 | A |
| Morgan Stanley | 29.82 | 81.26 | 7.18 | -24 | A |
| Natixis | 19.97 | 80.62 | -9.27 | -3.16 | A |
| Nomura | 10.13 | 47.22 | -37 | -54 | A- |
| Rabobank | 23.24 | 59.80 | -10.85 | -11 | AA- |
| RBC* | n/a | 61 | n/a | n/a | AA |
| RBS | 41.59 | 92.92 | 1.05 | -31 | A |
| Soc Gen | 33.65 | 87.76 | -5.96 | 5.1 | A |
| UBS | 16.59 | 54.35 | -3.36 | -28 | A |

Source: www.meteoram.com 10th April 2017

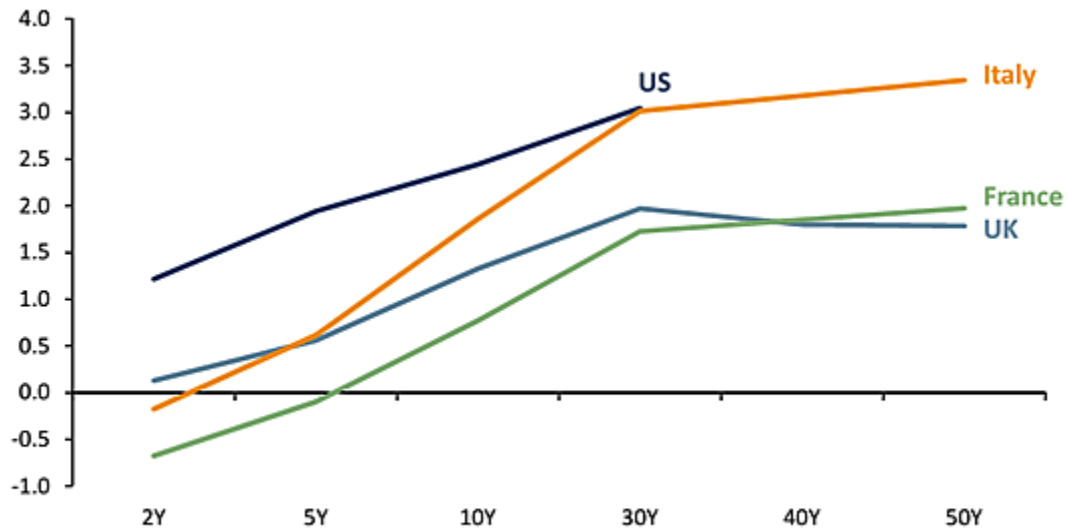
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

The last decade has proved to be a wonderful era for bond investors. Prices have steadily risen while yields have fallen back close to zero in some cases. This benign environment has also been a boon for most government's issuing debt. The cost of debt has fallen to historically low levels, helping in turn to contain the cost of burgeoning public sector deficits. The first chart below shows rate curves for different durations of government debt in the US, Italy, France and the UK. In each of the four developed nations, the cost of servicing 30 to 50 year debt has fallen below 3.5% per annum.

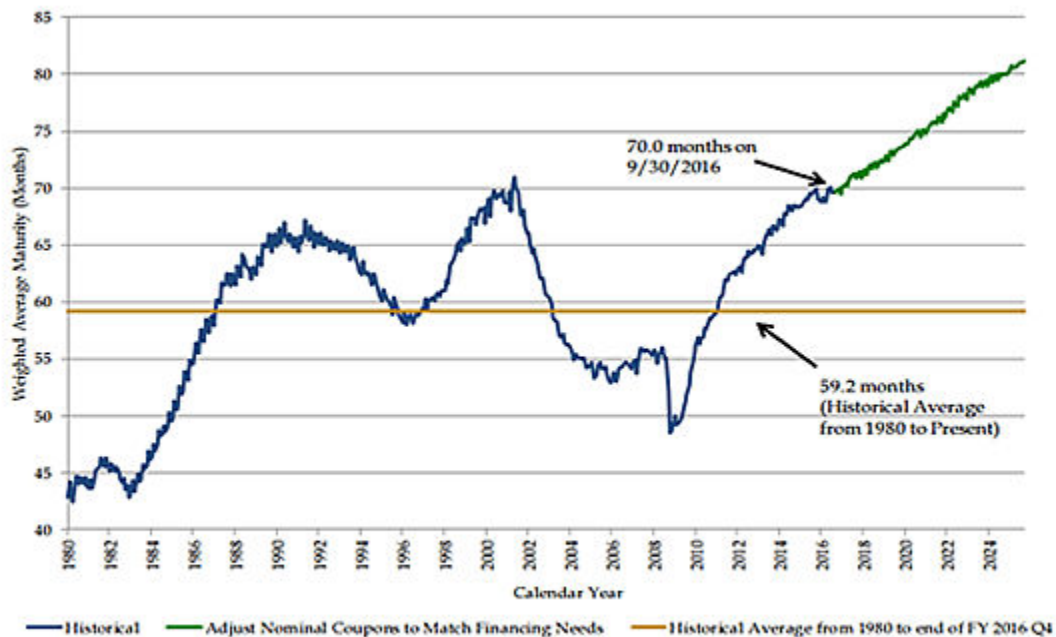
Nominal Rate Curves



Source: Bloomberg

But astute management of the duration profile of government securities could help push costs even lower. The second chart below from asset management firm GMO shows the average maturity of US government debt outstanding. Back in the 1980s the average maturity was under 45 months. By the end of September 2016 that was above the 36 average (59 months) at 70 months and is currently projected to head over 80 months by the middle of the next decade.

United States Weighted Average Maturity of Marketable Debt Outstanding



Source: US Treasury

But the US might be about to push out durations even further. Rumours abound that Steven Mnuchin (the US Secretary of Finance) and Gary Cohn (head of the main council of economic advisers) are warming to the idea of the US government issuing much longer duration securities, possibly even 100-year bonds. Ultra long duration or even permanent government securities are certainly familiar in other parts of the developed world - our very own Treasury issued perpetual debt called consols during the Napoleonic war and only recently retired them.

According to GMO countries as diverse as "Mexico, Ireland, Belgium, and the UK have issued these so-called ultra longs. Certain corporates and private issuers have also tapped the long end of the curve, with names as disparate as Disney, Coca-Cola, and Petrobras. Non-profits such as Cal Tech, the Cleveland Clinic, DC Water and Sewer, Tufts, MIT, and New York Presbyterian have also taken part in this market." What price then 100 year US government bonds? With 30 years already yielding less than 3%, 50 and 100 year issues probably wouldn't yield much more than 3.5% - or even less if big pension funds start snapping them up to manage long term liabilities.

UK Government Bonds 10-year Rate 1.09%



CDS Rates for Sovereign Debt

| Country | Five Year |
|----------------|-----------|
| France | 53.62 |
| Germany | 18.395 |
| Japan | 25.35 |
| United Kingdom | 28.41 |
| Ireland | 54.75 |
| Italy | 181 |
| Portugal | 267 |
| Spain | 81.91 |

Eurozone peripheral bond yields

| Country | Mar 2017 | Apr 2017 | Spread over 10 year |
|----------------|----------|----------|---------------------|
| Spain 10 year | 1.89% | 1.61% | 138 |
| Italy 10 year | 2.37% | 2.21% | 198 |
| Greece 10 year | 7.19% | 6.88% | 665 |

| | 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 |

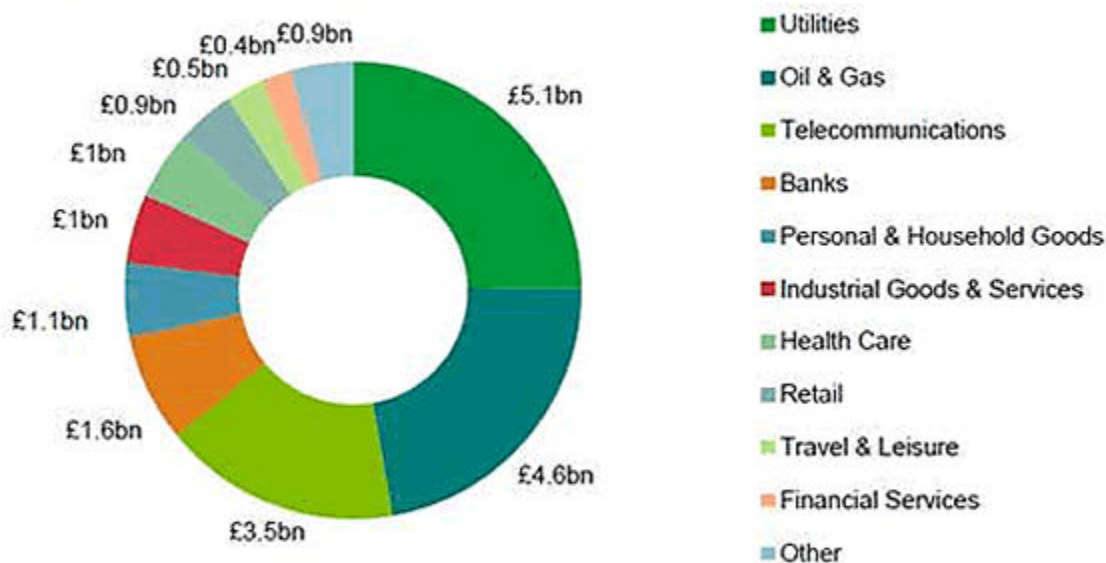
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Equity Markets and Dividend Futures

UK equities have had a strong run over the last year. The FTSE 100 blue chip index is up over 18% over the last year while the mid cap FTSE 250 index is up 12.53%. The S&P 500, the key US benchmark index, by comparison is up 13.80% over the last year. British equities have benefitted from a number of tailwinds not least the sharp fall in the value of the pound and the pronounced recovery in commodity prices globally.

Moving forward sentiment to UK equities might be helped along by two other factors: pensions and rising dividends. The first bit of potential good news is that according to HIS Markit FTSE 350 companies are expected to raise dividends by 25% to £20.7bn in Q2, boosted by National Grid and a stronger dollar. Their most recent survey suggests that ordinary dividends from FTSE 350 companies will reach £17.4bn, up 9% - although at constant exchange rates, the increase is only 1.7% to £16.3bn. Utility stocks are to expected account for 25% of the total payout, largely due to a £3bn special dividend from National Grid. Following this, the company is expected to lower its regular payout by 10%. At constant exchange rates, the top three forecast sector increases are Media (+76%), Technology (+12%) and Financial Services (+10%) while the retail and Travel & Leisure sector is expected to decline by 8% due to one-offs.

FTSE 350 predicted dividend declarations by sector in Q2 2017 - GBP billion



Source: FactSet, IHS Markit

The other bit of good news is that the aggregate UK pension fund deficit looks like it's falling. According to PwCs Skyval index it had fallen to £500bn at the end of March 2017, a £20bn decrease since last month. PwC's Skyval Index, based on the Skyval platform used by pension funds, provides an aggregate health check of the UK's c.5,800 DB pension funds. According to PwC this decline was mainly due to a decrease in assumed inflation, reflecting movement in the published yields. The current Skyval Index figures are detailed below:

Lastly MSCI also looked at the relative performance of different 'style factors' such as value and momentum. According to the index firm the best performing factor in February was quality stocks up 3.8% and the worst, Enhanced Value (1.5%), while the market (ACWI) has returned 2.2%. Year to date, the best performing factor has been Quality again, up 7% and the worst, High Dividend Yield (4.8%), while the market (ACWI) has returned 5.7%. In terms of valuations, using the forward P/E, the most expensive factor is currently Minimum Volatility USD with a forward P/E of 18.4 and the cheapest, Enhanced Value with a forward P/E of 10.1, while the market (ACWI) forward P/E is 15.9.

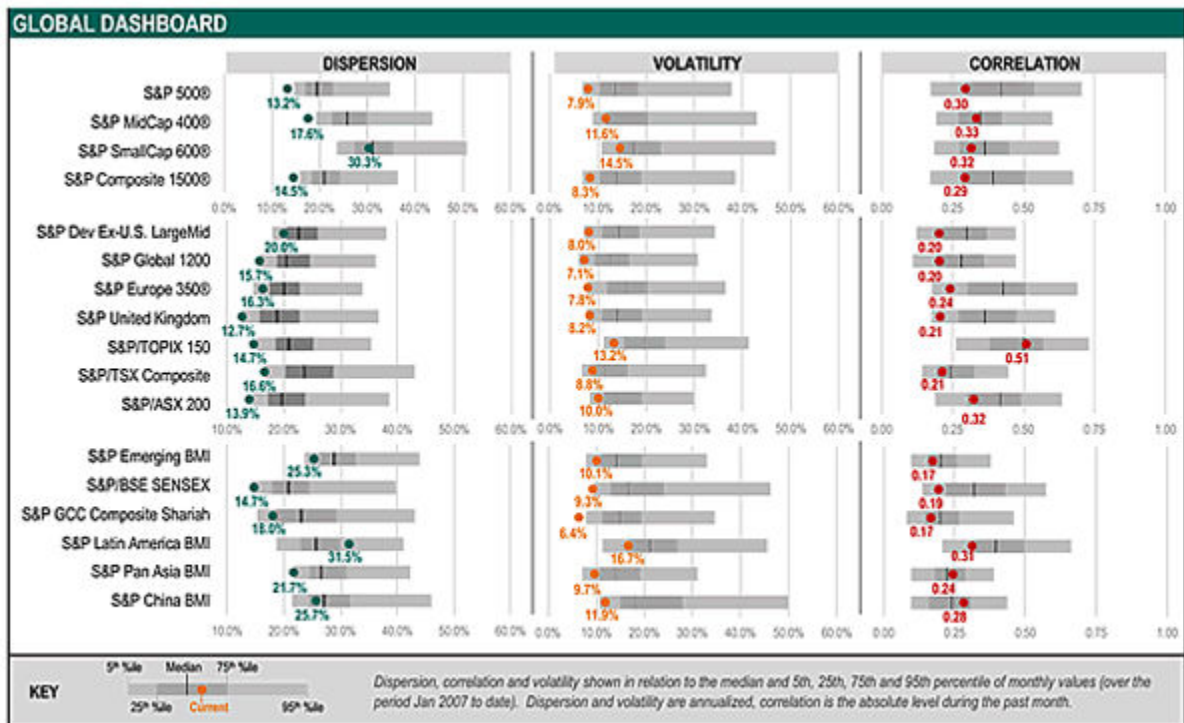
| | Assets | Liability target | Deficit | Deficit change since last month |
|--|----------|------------------|---------|---------------------------------|
| Funding measure | £1,530bn | £2,030bn | £500bn | £20bn decrease |
| Funding measure without extended allowance for future longevity improvements | £1,530bn | £1,790bn | £260bn | £20bn decrease |
| Accounting measure | £1,530bn | £1,870bn | £340bn | £30bn decrease |

| Index | March | April | Reference Index Value | Level 6 Months Ago |
|-------------------|--------|-------|-----------------------|--------------------|
| Eurostoxx 50 | 116.4 | 116.5 | 3488 | 114.20 |
| FTSE 100 (Dec 17) | 286.60 | 288 | 7343 | 7349 |

| Name | Price % change | | | | | | Close |
|---------------------------------|----------------|----------|----------|--------|--------|--------|---------|
| | 1 month | 3 months | 6 months | 1 year | 5 year | 6 year | |
| FTSE 100 | -1.24 | 1.46 | 4.28 | 18.49 | 24.74 | 21.18 | 7282.69 |
| S&P 500 | -1.02 | 4.47 | 9.14 | 13.8 | 66.89 | 77.04 | 2358.84 |
| iShares FTSE UK All Stocks Gilt | 1.6 | 3.36 | -2.6 | 5.3 | 15.51 | 28.49 | 13.4625 |
| VIX New Methodology | 12.86 | -3.74 | -8.84 | -5.57 | -21.01 | -28.91 | 12.37 |

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Volatility



Source: S&P Indices

We've commented a number of times in recent months that volatility indices, especially the VIX (which tracks turbulence in the S&P 500), have edged markedly lower in 2017. The chart above from S&P indices looks at a much wider series of measures which includes volatility but also correlation and dispersion. Marked turbulence tends to go hand in hand with a wide dispersion of returns. This in turn tends to produce low levels of correlation between indices as different sectors and themes bounce around almost independently of each other. In recent months though, we've seen a major decline in volatility, which in turn has dampened down dispersion and increased correlations. According to S&P "hopes that a rise in U.S. interest rates would presage a riotous "stock pickers' market" appear short-lived as the S&P 500 dispersion recorded its second-lowest monthly reading for a decade. The risk environment now is different to the last time dispersion was this low (July 2011); the present lows in dispersion come with lower correlation and much lower benchmark volatility". In simple terms, most US markets are not currently favouring stock pickers! And what's true for the US is also increasingly true for global markets. The only major exceptions seem to be U.S. Small Caps and Latin America where volatility and dispersion levels have picked up noticeably.

| Measure | April Level | March Level | February Level | January Level |
|------------------|-------------|-------------|----------------|---------------|
| Vstox Volatility | 19.54 | 15.36 | 15.05 | 15.21 |
| VFTSE Volatility | 12.7 | 6.19 | 11.44 | 11.62 |

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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 fix its 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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