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UK | STRUCTURED™ PRODUCTS ASSOCIATION

Monthly Market Report

May 2018

With commentary from David Stevenson

Over the last few years, we've experienced what one could describe as a Goldilocks scenario, with fairly synchronised returns from most assets including individual national stockmarkets. In this 'regime' we see that most sectors move upwards and there isn't much differentiation in terms of returns between different types of stocks. Now that we're entering a new world of rising interest rates, one of the few things that we can say with some certainty is that this 'regime' is probably at death's door and we're entering into a new dynamic, a new "regime". Put simply different financial assets - and different parts of a stock market - might move in different ways. Bhanu Baweja, Deputy Head of Macro Strategy at investment bank UBS has nicely summed up some of these divergent trends and indicators. He notes that "Stocks globally have weakened, but small caps are outperforming large caps. LIBOR-OIS is widening, as are IG spreads, but high yield credit has remained largely unscathed. The USD has failed to strengthen. EM stocks have outperformed, EM currencies are only modestly weaker, while EM fixed income is rallying hard."

How might these varying trends resolve themselves? The optimists suggest that sooner rather than later we'll reach the top of the current interest rate cycle and then as interest rate rises stop, we'll probably head back into slightly more synchronised global markets. Their argument - one which I largely agree with - is that interest rates can't go too much higher for one very simple reason...there's too much debt swirling around the global system. One stat sums it all up very nicely - there has been a 45% increase in global indebtedness since 2008. Some $75tn (75,000,000,000,000) of new debt has been created and much of this might default if interest rates were to rise too sharply.

More pessimistic inclined observers think they might be seeing the first inklings of a slowdown, mostly focused on credit markets. In this monthly report, we've already observed that some analysts think they've seen the first signs of this 'turn' - last month we looked at early warning signs from investment bank Liberum.

Analysts at risk consulting firm CheckRisk think that these signals are quietly proliferating. They point to an increase in US Treasury issuance, a decline in Bank Credit and the fact that the cost of $ hedging is rising, all early-stage warning indicators. Their concern - "The message is that market risk is rising but NOT to levels of major concern BUT we are starting to see the impact of so-called liquidity flattening or the removal of dollar liquidity".

Arguably the biggest risk though centres on those central banks trying to raise interest rates. The average recession requires at least 350bps of interest rate declines to offset the effect of the economic downturn. The current Fed Base Rate is 1.75% and so rates have to double from here to provide a margin of safety. For outfits such as CheckRisk this introduces the most dangerous dynamic - Central Bank Policy Error. Namely central banks tightening their balance sheets too quickly, sparking a recession. Over at CheckRisk their Early Warning Risk System (EWRS) is picking up, especially in the USA. It observes that currently the risk spike is more centred on the LIBOR-OIS which may be indicating that banks are becoming more risk-averse.

What should the rest of us watch out for? Most analysts are concerned about the mispricing of credit risk i.e that lenders are underestimating the possibility of a sharp increase in defaults following interest rate rises. According to Check Risk "the liquidity in bond markets is not sufficient to support that kind of price discovery. Examples of credit mispricing may be seen in the UK, Canadian and Chinese housing markets, and more importantly in the Government Bond market".

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One of the great unanswerable questions of our modern age is what to do about the steady increase in global debt levels, especially for consumers. Take car loans. Anecdotally I've been picking up indications of a complete burn out in this specialised lending segment, with many PCP loan providers running up high levels of defaults. Put simply consumers have borrowed too much and the assets they've invested in are simply not worth what they thought they would be - partly as a result of plunging 2nd hand diesel prices. What's true for car loans is doubly true for consumer lending where there's a long series of banks (and online lenders) pumping out loans at single digit interest rates. For fun I recently checked out what £10,000 would cost me on the Marks and Spencers financial services website - the interest rate was 2.8% and I worked out that I could borrow incredibly cheaply and then reinvest the proceeds back in (risky) investments that yielded 5% at the very least. Needless to say, common sense kicked in at that point.

And of course, what's true for consumer lending is doubly true for mortgages. My twentysomething relatives and in-laws are all now pushing affordability levels and borrowing vast sums of money. At the moment that debt is cheap - fixed rates of 2 to 4% seem common - but we all know it could change. But the general point still stands. Credit is cheap and consumers are binging on it again. For many young people, this splurge is manageable as they'll have decades to pay back the loans and hopefully inflation of 2 to 3% per annum will help erode the true liability.

But for many older people that promise of longevity isn't realistic. A growing number of people in their fifties, sixties and even seventies are now racking up very high levels of debt - or failing to pay back existing debts. A good summary of this troubling situation can be found in a report released to coincide with Key Retirement's launch of the Managing Debt In Retirement guide with independent financial expert Alvin Hall. This reveals that...

"Credit card and loan debt is preventing more than one in five over-65s from enjoying retirement as they struggle to maintain their standard of living with one in seven (14%) relying on credit cards to boost their income in retirement, new research from leading over-55s financial specialist Key Retirement shows. The research found 26% of over-70s are juggling three or more credit cards and one in 10 have had a balance they've not cleared for more than a year. The worry of debt in retirement is only going to get worse, with levels of both secured and unsecured debt held by over-65s on the rise. Since 2016 it has increased from £70bn to an estimated £85bn in 2018**. Secured debt such as mortgages accounts for £73bn and nearly 40% of 65-74-year olds with an interest only mortgage will struggle when the capital repayment is due**."*

Measure	Value as of 8th March, 2018	Value as of 6th April, 2018
UK Government 10 year bond rate	1.46%	1.40%
GDP Growth rate YoY	1.40%	1.40%

CPI Core rate	2.70%	2.70%
RPI Inflation rate	4%	3.60%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.60%	0.84%
Government debt to GDP ratio	88%	88%
Manufacturing PMI	55.2	55.1

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Bank CDS options

All the major banks saw an increase in the cost of their credit default swaps over the last month. The increase was fairly uniform - in the range of between 20 and 30% for 5 year swaps with some much bigger increases recorded for 1 year products. Some of the biggest increases were seen with Deutsche Bank (up 34% over the month) and UBS (up 35%, from much lower levels than Deutsche). The smallest increases were recorded by Rabobank and Morgan Stanley. Interestingly Lloyds Bank 1 year credit default swap rates - at 9.41 basis points - are now the lowest of all the banks in the list and well below those offered for banks regarded as traditional safe havens such as HSBC and UBS.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	27.79	47.88	1.39	22.95	A -
Barclays	33	57.79	24	-23	A
BNP Parabis	14.49	35.37	31.61	-57	A
Citigroup	21.87	56.64	20	-12.24	A
Commerzbank	26.75	73.08	26.89	-33	A+
Credit Suisse	27.1	72.43	28.97	-28	A
Deutsche Bank	66.64	122.21	34	-1.83	A+

Goldman Sachs	24.36	68.26	16.9	-18.37	A
HSBC	12.5	29.38	29	-52	AA-
Investec*	n/a	191	n/a	n/a	BBB
JP Morgan	22.22	51.78	16.82	-7.72	A+
Lloyds Banking Group	9.41	46.23	17	-25	A
Morgan Stanley	24.35	65.24	14.58	-18.58	A
Natixis	14.69	35.21	31.39	-56	A
Nomura	15.8	48.9	18	-4.79	A-
Rabobank	10.78	14.85	14.85	-47	AA-
RBC*	n/a	83	n/a	n/a	AA
RBS	30.67	53.96	22.34	-40	A
Soc Gen	15.81	36.47	29.51	-57	A
UBS	12	32.8	35.87	-37.87	A

Source: www.meteoram.com 29th March 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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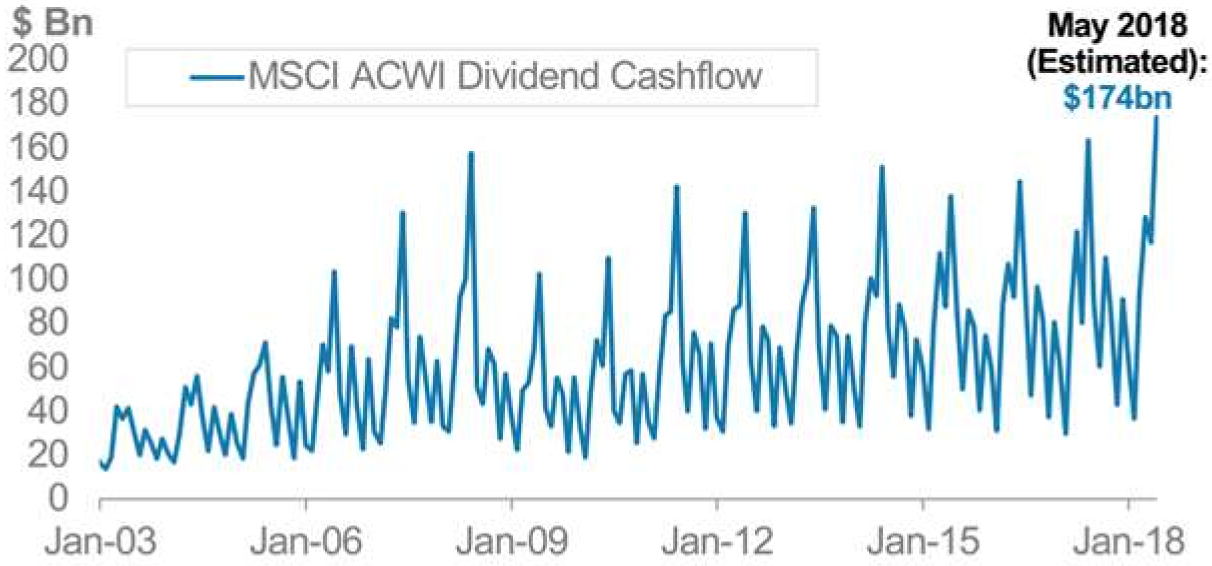
Government Bonds

One of the more curious aspects of the current increase in stockmarket volatility has been that although share prices have become much more turbulent - the VIX, a measure of stockmarket volatility for the US based S&P 500 index, has risen sharply in recent months - many other (backward looking) indicators indicate a surprising lack of volatility when it comes to corporate cashflows. Corporate earnings have been rising steadily over the last few months and that's fed through into bumper dividend pay-outs. Back in February for instance analysts at fund management firm Janus Henderson observed that global dividends have hit record levels. Global dividends rose 7.7% on a headline basis, the fastest rate of growth since 2014, and reached a total of $1.252 trillion. Every region of the world and almost every industry saw an increase. Moreover, records were broken in 11 of the 41 countries tracked by Janus Henderson, among them the United States, Japan, Switzerland, Hong Kong, Taiwan, and the Netherlands. Volatility hasn't declined markedly over the last few weeks - blame that Trump and his trade war - but there's growing evidence that those dividend flows could carry on increasing.

Analysts at Morgan Stanley note that an outsize share of annual global dividends are paid out between March and May. In fact, they estimate that roughly US$400 billion is set to be paid into investor accounts over these next few months which may be why risk assets in general, tend to outperform statistically in April. The US banks' analysts observe that amongst "higher volatility and a dragging risk-free 'anchor', this could provide some welcome (temporary) relief' in the coming months. In particular spring is very much the high season for European dividends, with Stockholm OMX, AEX (Netherlands), FTSEMIB (Italy), SMI (Switzerland) and FTSE 100 (UK) all showing high carry over the next 4-6 weeks. Morgan Stanley reckons "this cash flow could provide tactical support to Europe, an equity region we also like strategically within global equities".

Exhibit 1: MSCI ACWI dividend cashflow could be as much as US$400 billion from March-May 2018



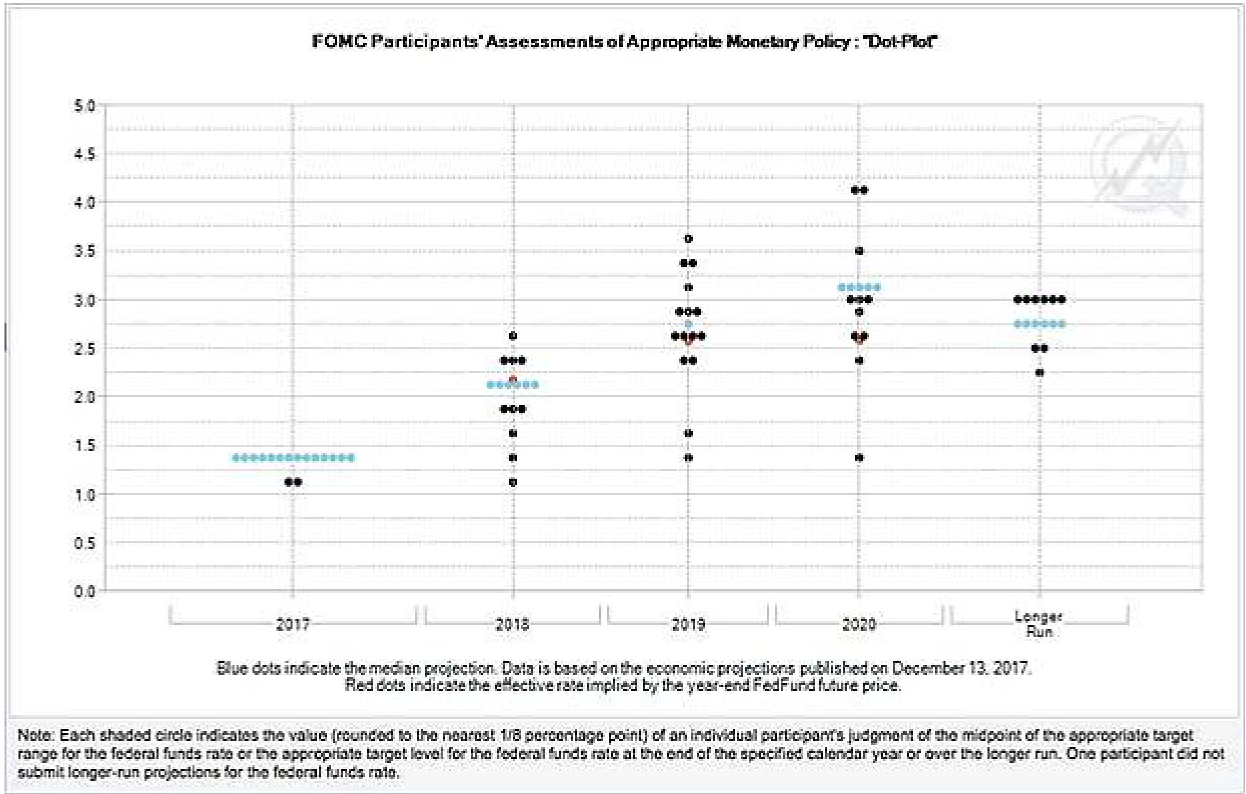
Source: MSCI, Morgan Stanley Research

Fixed Income

All eyes are on the US Federal Reserve at the moment in the fixed income markets. A few weeks back the Fed delivered another 25bp hike, which was probably priced in with 100% probability ahead of the meeting. The more interesting numbers come in the papers accompanying the fed's discussion and in particular the charts and tables which show where interest rates might go over the next few years. The chart below shows a typical graphical representation of the monetary committee's estimates of future rates or points as they're called. The median of the 2018 Fed dots was left unchanged, but 2019 and 2020 medians increased to 2.875% and 3.375% respectively, from 2.6875% and 3.0625%. The longer run rate moved higher to 2.875% from 2.75%.

Most analysts reckon this is a relatively 'hawkish' change to the estimates and increases the possibility of much sharper increases in interest rates in the next few years. Crucially though the Fed Chair in the news conference after the decision was announced seemed fairly cautious about reading too much hawkishness into these estimates - many estimates over the next three years were highly uncertain he noted, and he said that he wouldn't put too much faith into any particular reading of future estimates. In reality these comments had the effect of slightly downplaying the hawkish story told in the chart below.

Crucially in terms of inflationary expectations - usually a signal for much bigger interest rate rises - the Fed Chair noted how "we are not on the cusp of an acceleration in inflation". The bottom line? The US Federal Reserve seems to be determined to get interest rates up to between 3 and 3.5% over the next 18 months. For investor's the key to watch out for is what impact that will have on longer dated, 10 year US government bonds. If they break decisively past 3 and then 3.5% we could be in for more stockmarket volatility. It's also crucial to see how the dollar will react - by rights its should be strengthening...but isn't. If it continues to weaken, this could add to global instability.



https://www.terraseeds.com/blog/wp-content/uploads/2018/03/FOMC-dotplot-before-March2018meeting.jpg

UK Government Bonds 10-year Rate 1.40%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	16.75
Germany	9.85
Japan	24.71
United Kingdom	17.36
Ireland	22.44
Italy	100.97
Portugal	70.46
Spain	38.82

Eurozone peripheral bond yields

Country	March 2018	April 2018	Spread over 10 year

Spain 10 year	1.40%	1.23%	72
Italy 10 year	1.98%	1.79%	128
Greece 10 year	4.16%	4.02%	351

	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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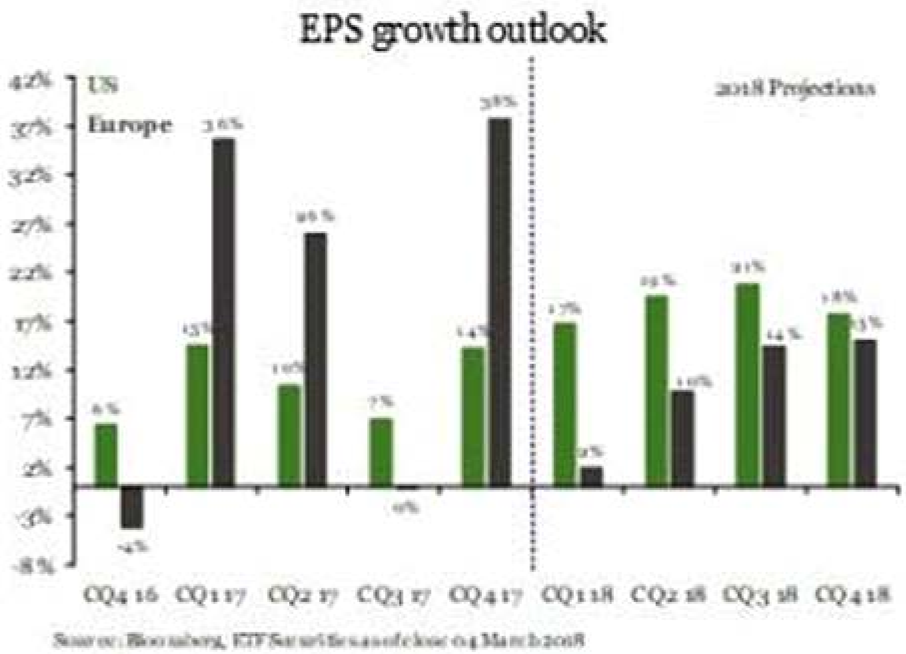
Equity Markets and Dividend Futures

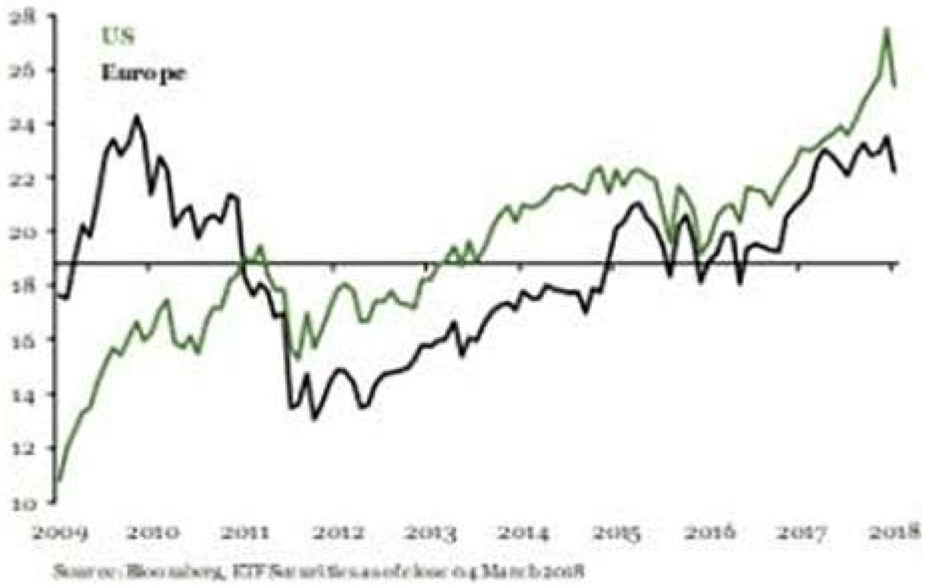
Investors have become increasingly cautious about US equities, and tech stocks in particular - valuations look high by any measure. Fakebook's woes are fairly unique but investor's have become more disillusioned about the FAANGs - and that's cutting into stockmarket optimism on the other side of the pond. Back in Europe, stocks have continued to push ahead but by nowhere near as much - especially in the UK where the FTSE 100 is still lagging behind its US blue chip peers. Eurozone markets have seen a stronger surge over the last year, helped along by huge inflows into Eurozone equity funds - and relatively relaxed central bank policy. Will this continue and have European shares become equally expensive? Analysts at London based fund management firm ETF Securities don't think so. They argue that Eurozone equities are still relatively cheap, certainly when compared to the US, and that the performance gap will narrow by the fourth quarter in 2018. Their analysts are focusing most of their attention on the positive trajectory of Eurozone Purchasing Manager's Index (PMIs), which even taking into consideration the recent pullback in February, indicate that European profit margins are set to expand further.

Crucially the ETFS analyst's projections for 2018 Earnings Per Share (EPS) growth continue to rise for both economies - by contrast the pace is slowing in the US whereas in Europe estimates are set to accelerate towards year-end. Energy and materials sector are contributing the most to the pace of revisions going forward.



What about valuations? Eurozone equities seem to be trading at a discount to US equities, a trend in place since 2011. One key long-term measure is called the Cyclically Adjusted Price to Earnings (CAPE) ratio - a widely used measure by stockmarket analysts. According to recent Bloomberg estimates, European stocks aren't cheap when they trade at 22x earnings in Europe but this is a 13% discount to US equities which trade at 25x their long term earnings. Crucially European companies have historically paid out a greater share of their earnings to shareholders in dividends than US companies. Higher dividend yields in Europe at 3.3% compared to US equities at 1.9% enhance the case for investing in European stocks say analysts at ETF Securities. "In light of the above discussion, we expect Europe to bridge the gap with US equities over the course of the year supported by higher earnings projections, an improving macro backdrop and lower valuations" argue the analysts at ETF Securities. "While political headwinds linger, evident from the success of the anti-establishment Five Star Movement in the recent Italian elections, we believe it is unlikely to derail Europe's economic expansion."

CAPE Valuations



Index	March	April	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	126.4	126.2	3407	124
FTSE 100 (Dec 17)	301.7	303	7201	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	0.52	-7	-4.51	-1.64	14.94	25.51	7183.64
S&P 500	-2.39	-2.93	4.45	12.95	71.43	90.46	2662.84
iShares FTSE UK All Stocks Gilt	1.48	-0.23	1.24	-1.76	8.35	12.45	13.14
VIX New Methodology	3.16	105.42	96.27	52.87	36.06	13.41	18.94

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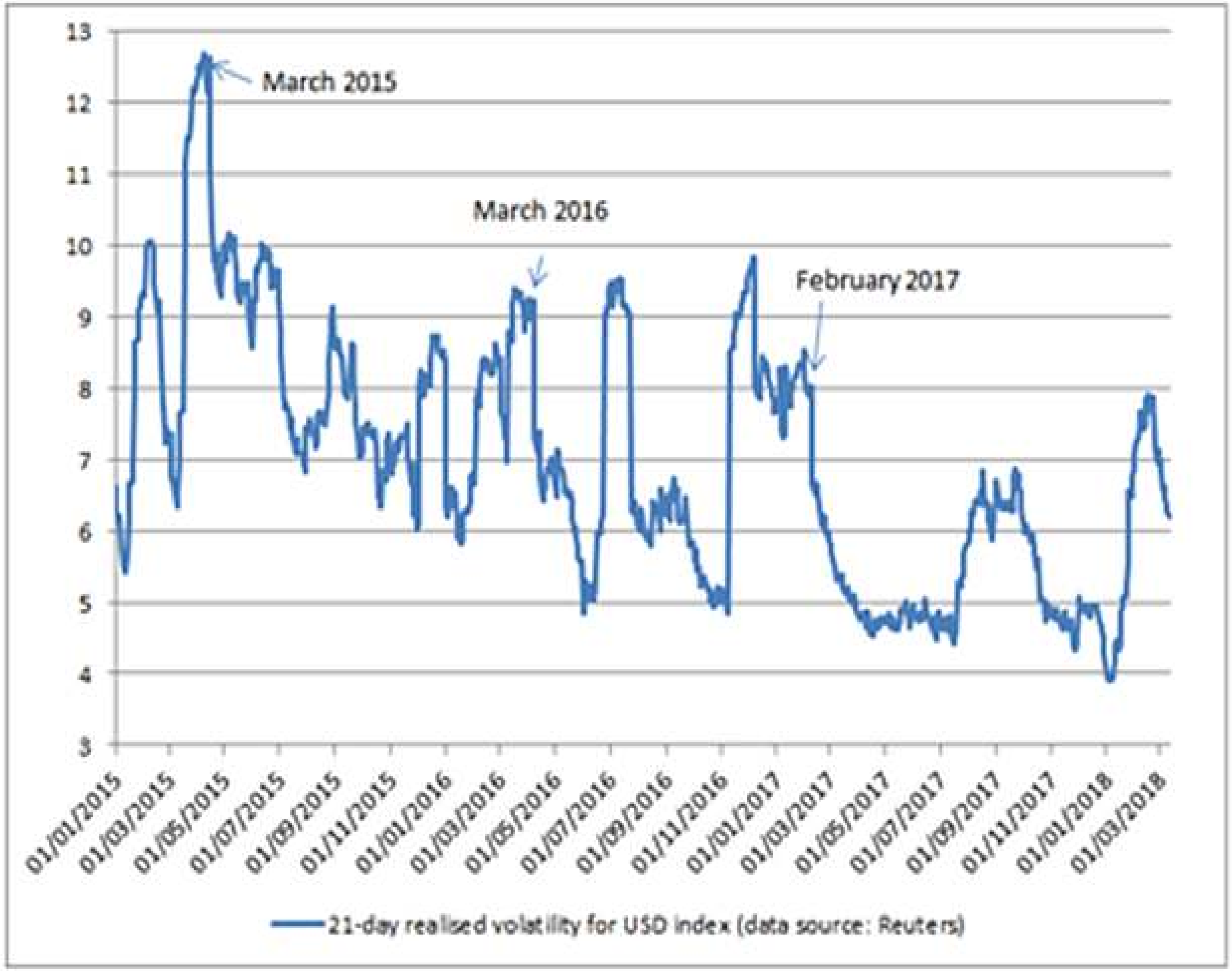
Volatility

Anyone who thought that stock market volatility was about to die down after the panic at the beginning of the year has been in for a nasty surprise over the last few weeks. President Trump's Trade War with China has distinctly unsettled investors as the spate of recent Cabinet level changes which have included the exit of Former Goldman's alumni Gary Cohn. Whereas for most of 2017, the VIX traded at just above 10 or in single digits, the first chart below shows that the VIX has rarely been below 15 in recent weeks. The one year trend is firmly upwards and if the trade war does escalate, it's reasonable to expect even more turbulence.

Stockmarket investors may be in a more volatile frame of mind but curiously since February there's been a notable decline in volatility in the foreign exchange market. One measure of this, 21-day realized volatility in the US dollar index has declined from 7.8% to below 6.2%. This broadly repeats a pattern seen over the previous three years. "While history does not necessarily provide a guide to what happens next, this pattern of a benign second quarter certainly seems to have held over the past five years," reckons Bank of New York Mellon strategist Simon Derrick.



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21-day realised volatility for USD index (data source: Reuters)

Measure	April Level	March Level	February Level	January Level

Vstoxx Volatility	17	16.75	27.52	10.97
VFTSE Volatility	13.84	13.59	21.14	9.16

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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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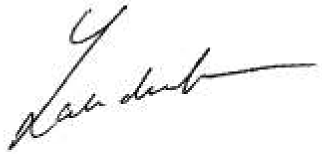
Kind Regards,



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