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UK Structured™ Products Association

Monthly Market Report

November 2017

With commentary from David Stevenson

The Silly Season

Talk to most British investor's and there's a palpable air of foreboding. I would say sentiment is fairly grim though not quite one of panic - yet. For most investors the default position at the moment is probably to stay invested through the cycle although I would suggest that many investors also can't quite still that inner voice which suggests that the next big sell off will be the mother of all price declines. With assets very evidently inflated by QE, the turn around when it comes could be brutal. So, why not look for any signals so that one can dial down one's risk exposure? Perhaps the most powerful set of signals are based on macro considerations - that QE has inflated asset prices and thus its unwinding will cause huge pain. Analysts at Cross Border Capital watch these central bank balance sheets very carefully and although they think that policy-makers have vowed to tread slowly in reversing QE, "the facts that often-dominant cross-border flows already appear to have peaked and that Central Banks are starting out from a much less accommodative position than widely acknowledged, must heighten systematic risks. Feeding these facts into a statistical probability model that has been informed by machine-learning techniques warns that the consequence may be a bear market in World risk assets starting in 2018. This is not yet certain, but watching the upcoming direction of cross-border flows will tell us a lot more."

But for every doom-laden warning - and there are more later in this report - there's also the hard facts that the global economy seems to be in fine form. A recent note from big institutional investor Aviva even conjured up an image of the global economy entering a goldilocks period. According to Ian Pizer, head of investment strategy, " the threat of deflation has passed and inflation is slowly returning to levels close to central bank targets. Stronger growth has led to tighter labour markets, which is resulting in upward pressure on wages. Robust global growth will continue to support these trends, justifying central banks' decisions to start withdrawing stimulus or consider doing so. The global reflationary environment, alongside reduced central bank liquidity, will be supportive of risk assets but leaves global rates markets more challenged."

And before you condemn this optimistic view as unrealistic, bear in mind that most investment banks share this view. Last week for instance European analysts at Morgan Stanley (who we'll mention again later in this report) put out a note with the headline the "The Global Economy is booming" and is rude health. According to the MS analysts " the latest round of data releases suggests that the global economy is in very fine fettle indeed, and potentially even accelerating to the upside. Data from key UK macro-economic measures has been looking much more positive in recent weeks and at the global level, markets and businesses seem to be in fine form. What's the bottom line? Should we fear the Fed or is the global economy actually in fine form? Should we bias our portfolios towards domestic concerns or simply accept that the UK is a depressed outlier and that properly diversified investors should be looking externally?

Precious Metals

Despite three years of enormous political upheaval (and the threat of war in the Korean peninsula), it's a curious fact that the price of the world's premier safe haven asset - gold - has barely inched more than a few dollars higher. The shiny metal stuff seems stuck in a holding pattern between $1150 and $1350 an ounce, with no real sign of a big break out either way, although fund flows data does suggest that more and more investors are building an allocation to gold. This steady buying at the funds level seems to be running into a countervailing headwind surrounding rising interest rates - in reality gold prices might be much higher if monetary policy normalisation wasn't hogging the macro agenda. Stats suggesting a booming global economy and a strong labour market will probably do little to stop the US Federal

Reserve from increasing interest rates even more - the consensus amongst most strategists is probably an additional 25bp increase in December, followed by three more hikes in 2018. This means that the key driver is likely to be the FX markets, with the dollar/euro the key determinant. Interestingly many Wall Street and City analysts have even started scaling back their projections for the price of gold - SGs commodity team for instance recently cut their 12-month forecast for gold to $1,150/oz, "as tightening US monetary policy occurs and geopolitical tensions ease". The SG team observes that this estimate represents a "significantly bearish outlook as the 12-month forward price is higher."

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Headline Numbers

If ever you're looking for hard evidence that investors are a) worried about macro policy and b) up for a good old-fashioned bubble, then look no further than crypto currencies - barely a day goes by without some new trading idea or structure emerging which allows one to access this nerd friendly alternative asset class. Only a few weeks ago for instance a European exchange traded note issuer broadened their existing crypto range by bringing out the first Ethereum tracker note - its Bitcoin sibling is already trading merrily. For me the big numbers about these rival currencies tell an astonishing story. Bitcoins

currently have a market cap in excess of $70 billion compared to Ethereum with a more modest $30 billion. The price of Bitcoin is now up 850% in the past 18 months and Ethereum a rather more bracing 2,300%. Combined all cryptocurrencies have a market value of over $125 billion.

One more amusing side fact - two of the biggest "new" cryptocurrencies are Litecoin and NEM, each with market values of roughly $2.3 billion. Obviously, we're seeing an enormous example of what many experts call FOMO (fear of missing out) - you're never too late to join the party. I think it is reasonable to say that it is a bubble, but when will it burst? I suspect Chris Beauchamp, Chief Market Analyst at IG is right when he suggests that "bitcoin is a story, one that latches on to the angst felt by people in the developed world. Over the past 500 trading days, bitcoin has gone up by over 2000%. Compare that to the tech bubble from 1994 to 2000, which took over 1500 trading days to go above 1000%, before slumping and then only surpassing this gain once 5500 days had elapsed... Bitcoin may well be a bubble, but that won't stop the price from going up."

I also think a US investor at a firm called Kopernik is equally on the money when he examines why so many investors are abandoning gold for the cryptos. Mark McKinney, a portfolio manager at Kopernik, value driven, gold friendly equities house reminds that ordinary paper money has many of the same risks associated with crypto currencies. He reminds us that "central banks increase supply every year and sometimes in massive quantities. Virtually all countries around the world overtly say they need at least 2% inflation in order to maintain economic stability, which said another way, they want to guarantee that the average citizen loses at least 2% of their purchasing power a year, combined with punishing savers by reducing interest rates to close to 0%." Maybe the rise of digital currencies are just another way of investors saying they're increasingly uncomfortable with QE?

Measure	Value as of 11th September, 2017	Value as of 12th October, 2017
UK Government 10 year bond rate	1.05%	1.37%
GDP Growth rate YoY	1.70%	1.50%
CPI Core rate	2.40%	2.70%
RPI Inflation rate	2.60%	3.90%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.29%	0.36%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	56.9	55.9

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Bank CDS options

Not much to report this month in the market for credit default swaps, with most banks experiencing a small fall in rates. The most notable moves were for global bank HSBC which saw the price for 1 year CDS fall to just 4.76 basis points, substantially lower than the rate for the UK government! Most US banks also saw a fall decline in rates while back in the UK rates for Lloyds dropped again although Barclays saw a small increase in rates for 1 year CDS to 23.36 - its rates at 1 year are now the highest of all the UK based banks.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	19.08	47.15	3.51	-47	A -
Barclays	23.36	7.69	-54	-47	A
BNP Parabis	15.51	37.3	9.05	-50.89	A

Citigroup	15.43	44.03	-20	45	A
Commerzbank	20.05	67.25	-4.36	-47.94	A+
Credit Suisse	18.29	67.87	-3.47	-51.33	A
Deutsche Bank	34.51	90.46	5.65	-59	A-
Goldman Sachs	20.19	58.21	-18	-40	A
HSBC	4.76	24.29	-8.74	-68	AA-
Investec*	n/a	181	n/a	n/a	BBB
JP Morgan	16.56	-16	-16	-35	A+
Lloyds Banking Group	9.75	42.11	-12.3	-47	A
Morgan Stanley	18.45	53.41	-17	-43	A
Natixis	15.77	37.5	2.97	-51	A
Nomura	12.62	42.66	18.12	-51	A-
Rabobank	9.05	27.12	-2.38	-57	AA-
RBC*	n/a	57	n/a	n/a	AA
RBS	16.1	51.68	3.31	-61.64	A
Soc Gen	10.14	37.11	1.92	-51	A
UBS	7.02	21.74	-14	-69.85	A

Source: www.meteoram.com 12th October 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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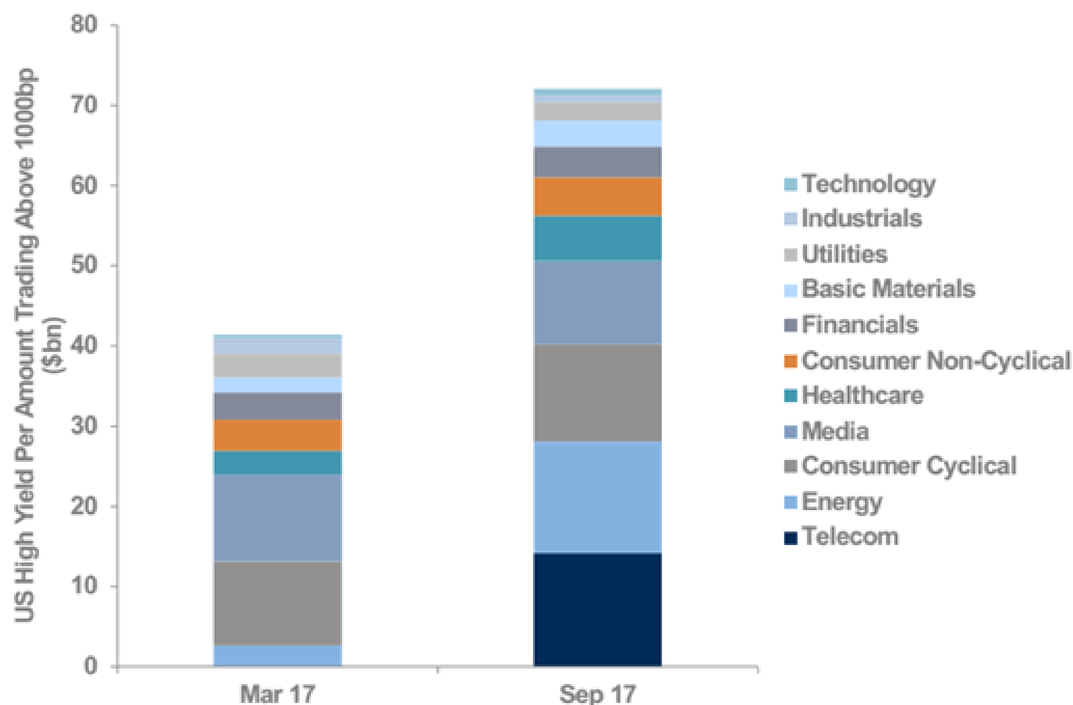
Government Bonds

Fixed income investors have long worried about a bonds rout, prompted by a sudden reversal in central bank monetary policies. Now equity investors are starting to catch the bearish bug, with many worrying what might happen to stocks if bonds do start to sell off. European equity analysts at US bank Morgan Stanley joined this chorus last week in a weekly note to investors.

Their short analysis highlights US high yield bonds - a popular asset class for many yield hungry investors. In particular they draw attention to the fact that loans and bonds in distress has now increased by 74% in the last six months. According to the Morgan Stanley analysts "in contrast to two years ago when Energy was far and away the largest driver of the upturn distressed debt, the sector composition of distressed US high yield debt is reasonably broad", as can be seen from the graphic below.



Worryingly the London based analysts also suggest that credit quality has been deteriorating in Europe as well. "There hasn't been the same degree of distress in European credit markets, and in general leverage has been declining for European corporates, in contrast to the US. However, there have been some signs of a deterioration in credit quality in Europe. The proportion of BBB debt in EUR non-financial IG markets has now reached 59%, a record high, while duration risk has also increased as companies have pushed out the maturity of issuance. Similarly, in the proportion of covenant-lite loans in the European Leverage Loan Index has reached a record high of 67% year-to-date."

Strategists at French bank Societe Generale are also warning that the debt markets might be moving into a dangerous phase. Well known uber bear Albert Edwards' latest weekly strategy update "BoE leads the way in monetary schizophrenia" warns that the "US Fed and BoE are once again presiding over a credit bubble, with the BoE in particular suffering a painful episode of cognitive dissonance in an effort to shift the blame elsewhere. The credit bubble is everyone's fault but theirs". Edward argues that the current biggest problem lies in unsecured credit, the growth of which has exploded above 10% in both the US and the UK... we are in a QE, zero interest rate world, where central banks are effectively force-feeding debt down borrowers' throats. They did it in 2003-2007 and they are doing it again. Most of the liquidity merely swirls around financial markets, but there is certainly compelling evidence now of a consumer credit bubble in both the UK and US (as well as a corporate credit bubble in the US). ...The simple fact is monetary policy is way too loose in the UK as well as in the US, and let us not forget the BoE cut rates in the immediate aftermath of last July's Brexit vote. Bubbles are appearing in areas like consumer credit because interest rates are far too low and need to be raised. And yes, when interest rates are excessively low, both borrowers and lenders do stupid things. But to ignore their own role in creating debt misery for millions, the BoE can only deal with its own cognitive dissonance by blaming someone else. When this debt bubble blows, I suspect citizens' rage will be directed where it belongs."

UK Government Bonds 10-year Rate 1.37%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	20.62
Germany	12.11
Japan	37.21
United Kingdom	24.78
Ireland	31.74
Italy	139.99
Portugal	135.7
Spain	67

Eurozone peripheral bond yields

Country	August 2017	September 2017	Spread over 10 year
Spain 10 year	1.56%	1.62%	118
Italy 10 year	1.96%	2.11%	167
Greece 10 year	5.46%	5.57%	513

	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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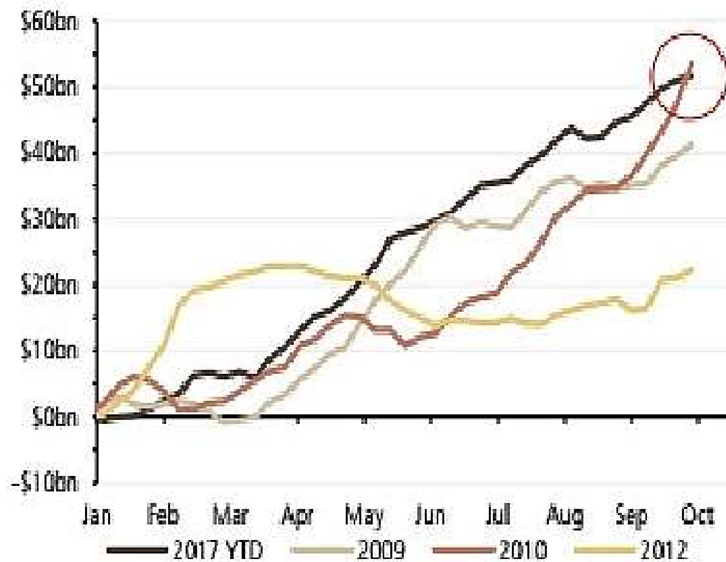
Equity Markets and Dividend Futures

Global equity markets are in confident form, with emerging markets equities are leading the way. The MSCI World index added 0.7% last week, driven by a renewed enthusiasm for high beta stocks. Emerging Markets were particularly strong, gaining 2.0%, leaving EM up a remarkable 27.9% this year. This enthusiasm for emerging market stocks is partly analysts who reckon that corporate earnings will increase markedly this year - according to analysts at French Bank Societe Generale, earnings growth in emerging markets is likely to hit 18% in 2017 before falling back to 11% in 2018. And this bump in growth is no aberration. According to analysts at Deutsche Asset Management, since 2000, emerging-market countries have recorded substantially higher economic growth rates than their "developed" peers: Between 2000 and 2009, the average growth differential amounted to a whopping 4.3 percentage points per annum. A recent report from Deutsche observes that "starting in 2009 however, the difference started to shrink, touching a low point of 2% in 2015. Since then, we are witnessing a global re-acceleration, and emerging economies are gaining ground again. The relative performance of emerging-market equities (measured by the MSCI Emerging Markets Index) versus their global peers (MSCI World Index) has been tracking the changing growth differentials quite well. Going forward, the International Monetary Fund (IMF) projects emerging economies to outgrow developed countries again". According to Deutsche this performance gap bodes well for emerging-market assets as well.

That confidence is certainly reflected in fund flows INTO emerging market funds - which have been booming this year. But analysts at rival investment bank UBS warn that these inflows are now beginning to slow down. Citing EPFR data the UBS analysts observe that "GEM funds saw inflows of $625mm last week, less than half the prior week's print and the smallest inflow in six weeks. This sharp deceleration in inflows, despite the 2% week-over-week gain in the MSCI EM Index, was likely a delayed investor reaction to the 3.6% EM pullback in late-September, in line with our view that fund flows follow the markets, not lead them. EMEA funds saw inflows of $169m - above Asia ex-JP ($78m) and LatAm ($69m) combined - which is a 33-week high in USD terms for the region. Dedicated GEM funds ($309m) absorbed just 50% of the weekly inflow. Across countries, China, Korea, Russia and India saw the biggest inflows, while only Taiwan had outflows (-$71m)."

Sources: Bloomberg Finance L.P., International Monetary Fund, Deutsche Asset Management Investment GmbH; as of 9/27/17
*) International Monetary Fund (IMF) forecast for 2017-2020



Source: EPFR Global, UBS

YTD flows during the years of net inflows
source : UBS

Index	September	October	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	116.8	116.8	3605	116.5
FTSE 100 (Dec 17)	287.4	287	7553	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	1.62	2.78	2.29	6.55	29.23	39.63	7533.81
S&P 500	2.7	5.35	8.56	19.59	78.33	113.73	2555.25
iShares FTSE UK All Stocks Gilt	-3.07	-0.69	-3.68	-4.23	8.1	13.25	12.9525
VIX New Methodology	-8.2	-9.55	-34.64	-35.87	-36.82	-70.02	9.85

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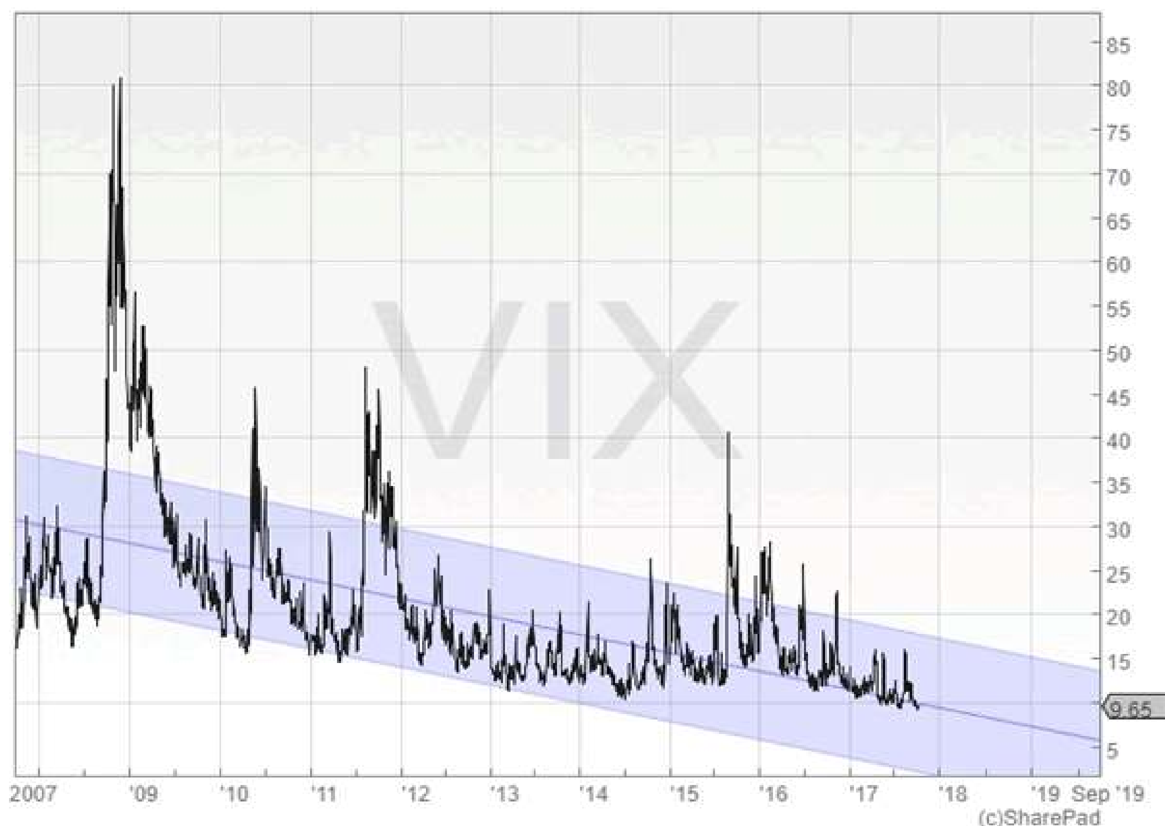
Volatility

Low levels of market volatility have been worrying investors for most of 2017 - at varying points over the last ten months, market turbulence as measured by the VIX index (which tracks the variance of S&P 500 equities) has hit all time levels, with single digits for the index recorded on many days this year. The chart below, from www.sharepad.co.uk, shows end of day Vix levels for the last ten years - notice the steady decline with just a few peaks in volatility.



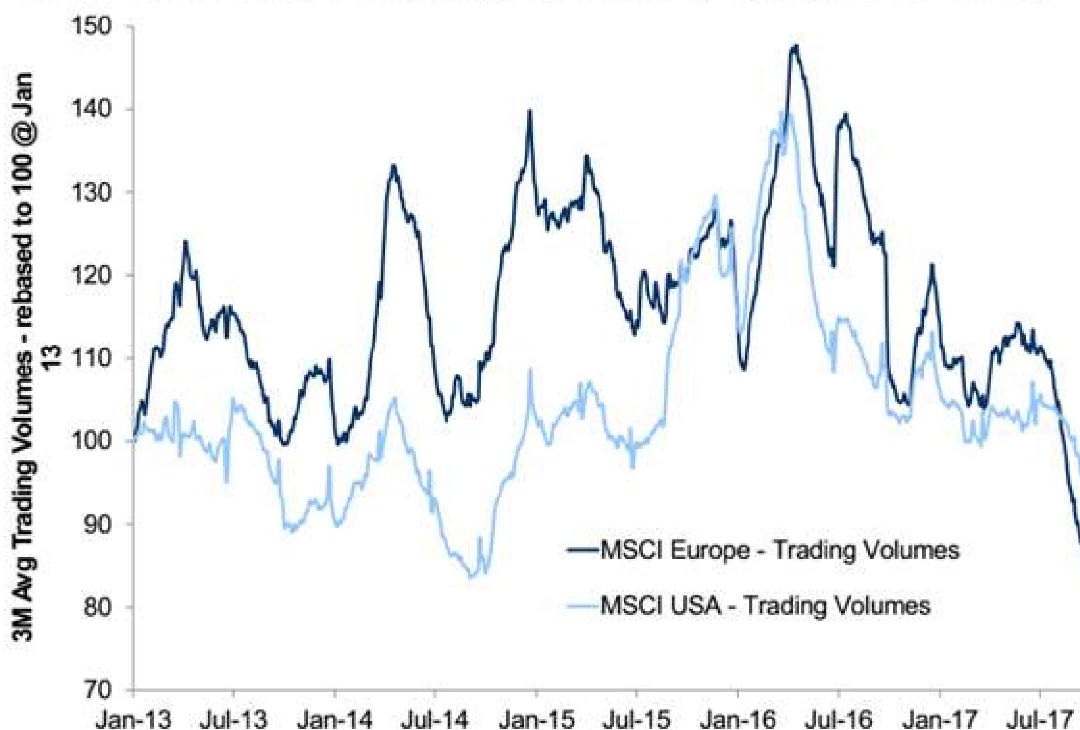
This week a report from Europe based equity analysts at American bank Morgan Stanley suggests that this isn't the only 'strange' market development based on technical measures. The analysis by Graham Secker and Matthew Garman observes that intra-day volatility is also extremely "depressed. Over the last 5Y the average (10-day) max-to-min intraday spread in the STOXX 600 has been 1.06%, however this same metric has been below 1 continually all year and is currently down to just 0.38%. This level is the lowest we've seen in over a decade."

This sharp decline in intraday volatility has also been accompanied by a sharp fall in trading volumes both in Europe and the USA. According to the MS analysts "you might think that a combination of strong

and stable economic growth, coupled with very low volatility, would encourage investors to become more active in equity markets, however the opposite seems to be occurring. As we show below, Bloomberg data suggest that trading volumes for MSCI Europe and MSCI USA have fallen materially in recent months - this is most acute in Europe where volumes are at their lowest level in over 5 years."

In sum, both inter and intraday volatility is close to all-time lows, while trading levels have fallen sharply, yet equities continue to power higher, pushing valuations close to historic highs. Has central bank QE finally tamed volatile global markets?

Exhibit 7: Trading volumes are falling sharply despite a backdrop of good growth & low volatility



Source: Bloomberg Morgan Stanley Research

Measure	October Level	September Level	August Level	July Level
Vstoxx Volatility	12.43	13.96	21.41	12.84
VFTSE Volatility	9.69	10.71	15.97	9.9

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Summary of Pricing Impact on Structured Products

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

Dividend Yield of Underlying	Up	Down
Correlation (if multiple underlyings)	Up	Up (unless product offers exposure to the best performing underlyings only)

Source: UK Structured Products Association, January 2014

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

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Explanation of Terms

CDS Spreads and Credit Ratings

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

Why does the yield matter on a bond?

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

Volatility measures

Share prices move up and down, as do the indices (the 500 and FTSE100) that track them. This movement up and down in price is both regular and measurable and is called volatility. It is measured by stand alone indices such as the Vix (tracking the volatility of the 500), VStoxx (the Eurozone Dow Jones Eurostoxx 50 index) and VFtse (our own FTSE index). These indices in turn allow the wider market to price options such as puts and calls that pay out as markets become more volatile. In simple terms more volatility implies higher premiums for issuers of options. That can be useful to structured product issuers as these options are usually built into an investment, especially around the barrier level which is usually only ever broken after a spike in volatility. Again all things being equal an increase in volatility (implying something like the Vix moving above 20 in index terms) usually implies higher funding levels for issuers of structured products.

Dividend Futures

These options based contracts measure the likely total dividend payout from a major index such as the FTSE 100 or the Eurozone DJ Eurostoxx 50 index. In simple terms the contract looks at a specific year (say 2015) then examines the total dividend payout from all the companies in the index, adds up the likely payout, and then fixes it as a futures price usually in basis points. Structured product issuers make extensive use of dividend futures largely because they've based payouts on a benchmark index. That means the bank that is hedging the payout will want to be 'long' the index (in order to balance it's own book of risks) but will not want the dividends that come from investing in that benchmark index. They'll look to sell those future possible dividends via these options and then use the premium income generated to help fund their hedging position. In general terms the longer dated a dividend future (say more than a few years out) the lower the likely payout on the dividend future as the market cannot know dividends will keep on increasing in an uncertain future and must his price in some level of uncertainty.

Equity benchmarks

Most structured products use a mainstream well known index such as the FTSE 100 or 500 as a reference for the payout. For investors the key returns periods are 1 year (for most auto calls) and 5 and six years for most 'growth' products. During most though not all five and six year periods it is reasonable to expect an index to increase in value although there have been many periods where this hasn't been the case especially as we lurch into a recession. Risk measures such as the sharpe ratio effectively measure how much risk was taken for a return over a certain period (in our case the last five years using annualised returns). The higher the number the better the risk adjusted return with any value over 1 seen as very good.

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To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,

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