



*With commentary from David Stevenson*

Is this the really big one? Is the US bull market finally at an end? As I write these words early in October the S&P 500 is now down 3.54% over the last month, at 2785. Crucially, for all you technically minded investors, the US benchmark index has crashed both its 20 and 200 moving average, which pushes us into technical bear territory.

But I would also suggest some perspective. On a one-year basis the index is still up 9% and even on a six-month basis its up 5%. In sum, the index has simply paused for breath. We are still a long way from a full throttle market sell off. Crucially I'm not entirely what new pieces of information the market is reacting to. Yes, US interest rates are rising and yes, the yield on US Treasury 10 year bonds has risen above 3%. Yes, the threat of trade war is growing, and Turkey is a mess. But these are hardly new bits of information. Commentators like me have been worrying about rates tantrums and EM squeezes for ages but the markets has chosen to ignore these concerns, until now. Another argument is that the tech bubble has finally burst. One core story doing the rounds is that as regulatory pressure intensifies, costs are increasing and thus profits falling. Maybe this is true for Facebook but I'm not so sure that this is the case for most of the other FAANGs.

Another argument is that valuations have simply become too rich - and thus we are at almost a gag point where investors think that stocks are just too damned expensive. At which point of course the good old long term cyclically adjusted price to earnings ratio is trotted out, even though it has the predictive accuracy of a bowl of jelly. And if rich valuations really were the driver, why is it that some equity markets such as the FTSE 100 are getting harder hit compared to the S&P 500. Currently the FTSE 100 is down 6.8% over the year and over 7% for the last three months. On my set of measures the UK now looks very cheap especially if our government was able to miraculously produce some Brexit fudge.

So, in sum I'm not convinced this 'is it' - the big sell off. The market is simply recalibrating likely expected returns, which will be burdened by increased levels of volatility. That said - as I have recently observed in my FT column - I am much more bearish for the medium term and have been taking risk off the table for many weeks now. But I wouldn't be racing out to suddenly sell everything in anticipation of a proper 10 to 20% blow up. This is now a tactical investors market. You can buy quality on the dips and then sell out before the next volatility squall comes along. But what has vanished is the steady 10% per annum expectation of gains - the brave new world is all about scratching around for a few per cent a year of gains. Every year for the last ten years we've been told that 'this market is finally going to be an active stockpickers market' and the sages were wrong. Passive funds have destroyed everything in their wake. Now, I think, the tide really is turning. This will be a market for stock pickers - many passive funds might struggle.

Then again, perhaps I am far too cynical. Quite a few respected asset managers go to great lengths to produce forward looking estimates for financial assets - and most of these suggest that equities might still be a half decent bet. Some, such as GMO, tend to err on the side of considerable caution. Others such as those from Robeco - another respected house with a strong quant bias - err more towards a middle of the road view. A few weeks ago, they brought out their 2019-2023 estimates, with the headline that 'patience is a virtue', which is probably a sensible forecast, though a tiny bit motherhood and applie-ish. And what do they think will happen to asset class returns: see the table below for the hard numbers. Their bottom line message: most bond investors will struggle, look to emerging markets and commodities for upside.

## Expected annual returns 2019-2023\*

Developed market equities	4.00%
Emerging market equities	4.50%
German government bonds	-1.25%
Developed global government bonds	-0.25%
Emerging government debt (local)	3.75%
Investment grade credits	1.00%
High yield	1.50%
Listed real estate	3.25%
Commodities	4.00
Cash	0.50%

Source: Robeco

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## Headline Numbers

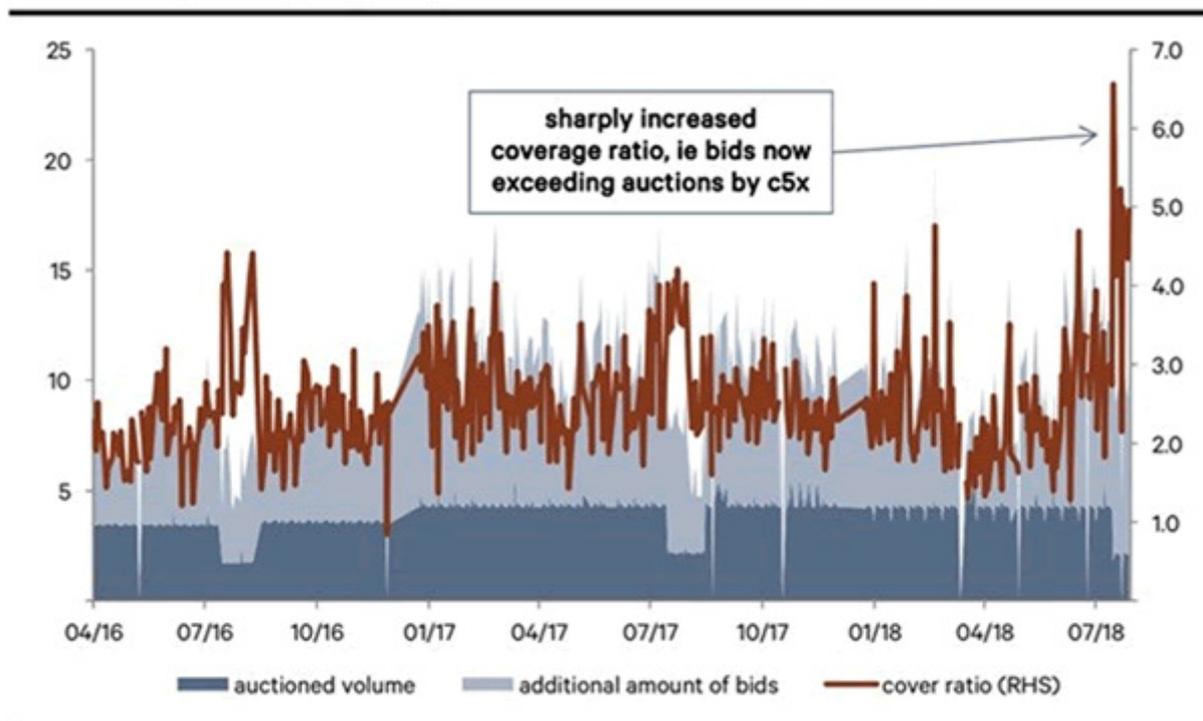
We have 12 years left to fix our global economy and contain global warming. Or at least that's the conclusion the [Guardian](#) comes to about the latest IPCC report. If that is the case I can confidently say that we are all screwed - we better work out a way to deal with temperature increases of 2 degrees or more. I don't say this with any great pleasure but there's simply no way we can get a complex range of independent actors - nation states - to agree to make the changes that are needed. But this cynicism shouldn't hide a more positive story - big changes are coming, it's just that they may come too late.

If I had a crystal ball with any predictive accuracy I'd suggest with some certainty that the price of carbon has to increase. We simply have no other choice in a global market economy. This is one of those sordid facts that state-controlled centralisation can only mask and push into other areas. Until we place a proper price on carbon emissions, we won't be able to change behaviours. Governments can ordain all sorts of nonsense, but economic actors will simply choose to ignore those directives. The only long-term solution is to price carbon appropriately. As sure as night follows day, at some point in the next few decades, carbon prices will vastly increase. The only challenge is to reduce the inefficiencies surrounding the nascent markets in emissions and carbon. At some stage, these markets will find a sensible price.

A note from Berenberg in mid-August suggests that this moment of revelation might be closer than we think. According to analysts Lawson Steele, Andrew Fisher and Oliver Brown, the 2018 carbon market already looks to be in deficit, putting upward pressure on the carbon price, power prices and generation

earnings. The key, at least in Europe, is that the existing supply of emissions permits - which have depressed prices - are about to decline sharply. That means the market for these permits for emitting carbon will move into deficit very soon. "In turn" the Berenberg analysts suggest "that could lead to an earlier, and perhaps sharper, carbon rally than we expected - we forecast €15/t for 2018, €25/t for 2019 and €30/t for 2020." The chart below shows the dynamics of the European emissions trading market - with bids and offers for emissions permits. In effect the bids for new permits will sharply exceed the available supply of credits. And carbon prices start climbing... inexorably!

**Bids have significantly stepped up above auction volumes in recent weeks (mt)**



Source: Berenberg estimates, ICE and EEX

Measure	Values as of 6th September, 2018	Values as of 12th October, 2018
UK Government 10 year bond rate	1.44%	1.66%
GDP Growth rate YoY	1.30%	1.20%
CPI Core rate	1.90%	2.10%
RPI Inflation rate	3.40%	3.50%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.80%	0.80%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	52.8	53.8

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## Bank CDS options

The pricing for credit default swaps on global banking groups continued to edge higher in general terms, with some UK banks such as Lloyds and Barclay's seeing small but noticeable increases in their rates - by contrast some US banks such as Goldman's and JPM saw their rates fall back marginally. In terms of standout moves, Deutsche Bank continues to see a sharp reduction in CDS pricing whilst the price of Investec's credit default swaps continues to increase.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	29.38	57.52	4.20	22	A -
Barclays	38.53	74.06	17.83	59.95	A
BNP Parabis	16	46	3.43	23.34	A
Citigroup	19.83	51.06	-2.31	15.96	A
Commerzbank	24.3	86.43	6.51	28.52	A+
Credit Suisse	21.17	68.11	0.74	0.41	A
Deutsche Bank	63.17	130.95	-6.33	44	A+
Goldman Sachs	22.48	60.92	-4.27	4.49	A
HSBC	14.94	39.16	3.76	51.66	AA-
Investec*	n/a	274	n/a	n/a	BBB
JP Morgan	16.83	39.16	-6.6	-7.74	A+
Lloyds Banking Group	13.78	50.28	1.32	19.39	A
Morgan Stanley	21.15	54.03	-9.75	1.16	A
Natixis	18.34	46.81	5.61	24.83	A
Nomura	13.73	45.06	5.32	5.61	A-
Rabobank	10.47	31.78	-7.38	17.19	AA-
RBC*	n/a	60	n/a	n/a	AA
RBS/Natwest Markets	34.87	96.16	15.95	86.07	A
Soc Gen	19.27	46.94	-0.51	26.49	A
UBS	15.39	38.13	0.12	75	A

Source: [www.meteoram.com](http://www.meteoram.com) 4th October 2018

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

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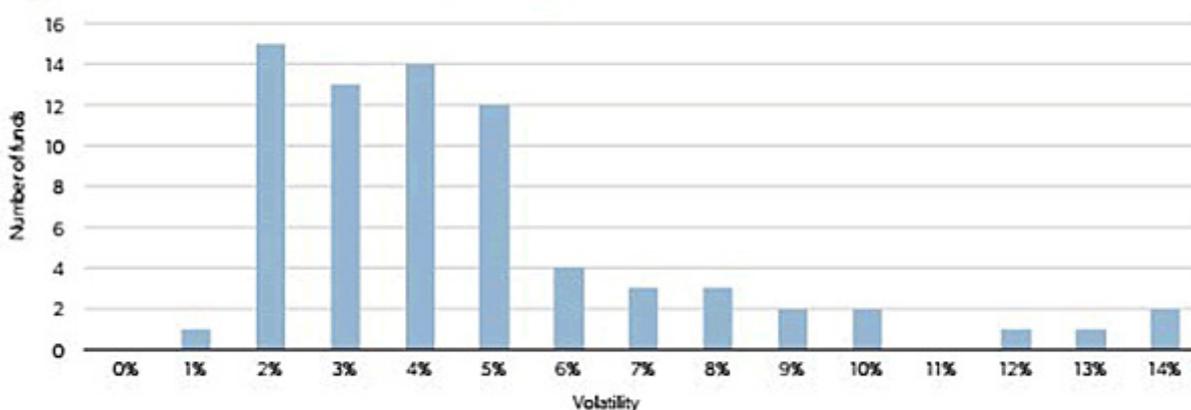
## Government Bonds

It's easy to see why absolute returns funds have become so insanely popular in recent years. We've seen a necessary move towards solutions-based investing, and who wouldn't want the solution on offer from absolute returns managers - positive returns in all markets. The problem of course with all grand promises is that they usually fail to deliver. Academics have rightly taught us to be careful about the claims made by active managers, which is why the extravagant claims made by absolute returns specialists need to be treated with Hazchem gloves.

This month structured product provider Tempo released the latest research into absolute returns - with fairly damning conclusions. The report is called "Targeted Absolute Returns Funds: Mind the Gap", and it won't come as a great surprise to professional cynics that most of the claims to absolute returns investing are disproved in the paper. What most investors want out of these funds is clear: low volatility, regular positive returns and reasonable fees. What they actually get is very different. Looking at its sample of AR funds the report observes that 15% of Targeted Absolute Return funds have produced negative returns. Over three years, the percentage is higher still: 30% have failed to produce a positive return. In particular the report looked at returns 49 monthly rolling one year periods - to see what proportion of those periods resulted in: a) positive returns and b) returns in excess of the benchmark. In total the report analyses 73 funds with 49 rolling one-year performance period histories. The results?

- "Only 2 funds produced positive returns in every period. On average, funds produced a positive return in less than 50% of the rolling one-year periods. [my emphasis]"
- "On average, funds exceeded their positive return objective in around 49% of periods, and their benchmarks in 41% of the periods."

Figure 9: Variance of annualised volatility of Targeted Absolute Return funds



Source: FE Analytics, 5 years to 30 June 2018

One last crucial statistic. I imagine that investors would be mightily unhappy if they discovered that their absolute returns fund turned into an Absolute Negative Returns Fund - the presumption is that all funds are Absolute (Positive) Returns funds. Again, according to the report "despite the promise and the allure of the sector, every fund in the sector suffered a loss as its worst-case maximum drawdown."

## Fixed Income

The yield of ten-year US government bonds is often used as a totem for the future. The conventional wisdom is that as these ten-year yields increase, the risk of a recession increases - thus increasing financial asset volatility. It isn't, of course, a linear relationship. An increase of say 30 basis points from 2.3 to 2.6% is likely to have much less significance than a move from 3.3 to 3.6%. The conventional wisdom is that a push through 3% is a trigger for closer inspection, whilst a push past 3.5% is usually a sign of trouble ahead. A push past 4% usually tends to suggest that you should sell equities as quick as you can.

Obviously, we should treat these as rough and ready guidelines - the wider context matters. The current rate is 3.23% the last time I looked. I've spent much of the last year watching that 3% level like a hawk and we now seem to have decisively broken past that point. Again, we shouldn't be completely surprised as bond yields are reacting to the steady increase in US interest rates - which is itself pushing up the dollar.

But the alarm bells are beginning to ring nevertheless. Matthew Bartolini, Head of SPDR Americas Research recently observed that the 10-year Treasury note yield has reached its highest level since 2011. Crucially the market is pricing in an 80% chance of another interest rate increase in December. The SPDR researcher has looked at the implications for ETF investors. His key findings are, I would suggest, slightly worrying:

- 9 of the 30 largest fixed income ETFs had losses in 100% of rolling one-month periods from December 31, 2012 to September 28, 2018
- 18 of the 30 ETFs had losses in 90% of the rolling one-month periods
- 24 out of 30 ETFs recorded losses in 75% or more of these periods
- Notably, losses weren't confined to any particular fixed income category

Obviously, there's a huge subset of questions surrounding fixed Income ETFs, but the more interesting debate has to focus on the broadest range of financial assets. A recent paper from the European Cross Asset research team at Morgan Stanley peers into the crystal ball and comes to some equally worrying conclusions. In a paper out this week, called *Are Rising Rates a Problem?* They largely come to the conclusion that... yes they are if rates carry on increasing. The caveat with this is that "Contrary to popular perception, rising rates are generally associated with higher equity markets, both being driven by greater optimism about the future growth backdrop."

The bad news is that the current market environment is rather more challenging - specifically

- 1) Most of the rise has been driven by US 10-year real rates, which have broken the stable five-year range of 0-85bp. A wider band of uncertainty for rates is a cause for investor caution.
- 2) Low rates have underpinned equity multiples at high levels and a further rise in rates would push equity premiums from average to rich in the US.
- 3) Higher US real yields usually strengthen the dollar, which exacerbates the developing headwinds for US earnings.



As of: 2018-10-04

**UK Government Bonds 10-year Rate 1.66%**



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

### CDS Rates for Sovereign Debt

Country	Five Year
France	29.01
Germany	11
Japan	23.91
United Kingdom	28.56
Ireland	37.3
Italy	274.33
Portugal	102.7
Spain	79.55

### Eurozone peripheral bond yields

Country	September 2018	October 2018	Spread over 10 year
Spain 10 year	1.45%	1.68%	115
Italy 10 year	3.07%	3.54%	301
Greece 10 year	4.42%	4.42%	389

	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

One of the most interesting stories of recent years has been the growth of the humble dividend in Asia. Traditionally value and income investors have tended to steer clear of Asia, largely because the yield was low and corporate governance lamentable. Too often cash inflows were seen as a sign to overpay executives and splurge on wasteful capex. The story has changed though in recent years. Value investors are swarming over Japan and dividends are on the increase in Asia.

The latest evidence for this income trend comes from Janus Henderson who keeps a track of global dividend payouts more generally. Their latest report observes that dividends from companies across the Asia Pacific region, excluding Japan, "soared 15.9% to a record £222.6bn in the twelve months to the end of July 2018... this was more than twice the estimated 5.5% growth in dividends seen across the rest of the world... Between 2009 and the end of July 2018, companies paid their shareholders £1.3 trillion, and on an annual basis, dividends have more than tripled in value (+210%). Meanwhile, dividends from the rest of the world have doubled (+103%)... Over the same period, UK dividends have grown by 76.5%, impressive for a mature economy, but behind the faster-developing regions of the world."

Over the next twelve months, Janus Henderson expects dividends in the region to rise 10.9% on an underlying basis to break a new record of around £239bn, equivalent to a headline growth rate of 7.5%. So, if equity income is your game, maybe you need to head East for the fastest growth rates?



Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-3.52	-7.8	-2.81	-6.64	8.74	21.8	7055
S&P 500	-5.56	-2.5	2.42	6.96	60.2	91	2728
iShares FTSE UK All Stocks Gilt	-2	-3.28	-2.5	-1.68	11.9	5.95	12.77
VIX New Methodology	90.1	98.6	35.1	152	58.9	54.8	24.98
Index	September	October	Reference Index Value		Level 6 Months Ago		
Eurostoxx 50	125.80	125.60	3219		126		

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## Volatility

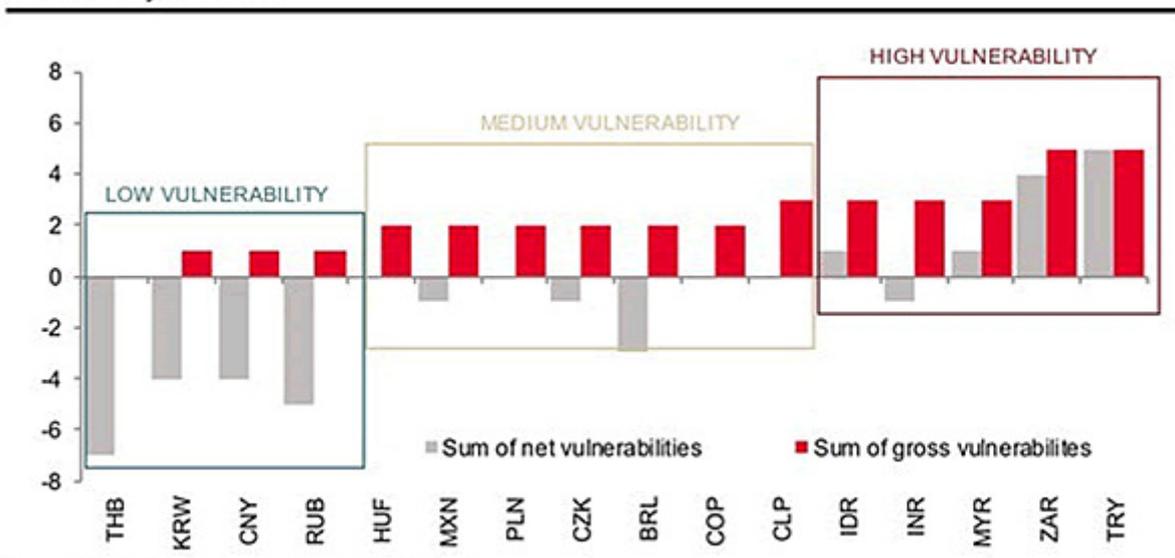
If the bull market in (largely US) equities really is over - and as I say I'm not entirely convinced - then one of the smoking guns will probably prove to be emerging markets. Investors have increasingly got themselves convinced that a new global liquidity pump is at work. Higher US interest rates makes dollar assets more attractive which in turn deprives emerging markets of spare capital. This causes local volatility in emerging markets which seeps through into the main markets usually via bank balance sheets. So, if we are looking for any clues or signals for future market volatility, maybe a good place to start is look at the most vulnerable emerging markets. Last month SocGen analyst Jason Daw helpfully provided a useful quick summary of the countries to watch. In a note entitled *EM Looking Glass - Who's Naked*, Daw observes how the tide (of cheap dollar funding) is receding and aims to identify those countries which have been, or will be, caught "naked". Daw and his team have looked at a number of measures to identify vulnerabilities including: short-term external debt, foreign currency-denominated debt, fiscal and debt positions, reserve adequacy, and foreign bond ownership. The final scorecard looks a bit like this:

**High vulnerability: Turkey, South Africa, Malaysia, India, Indonesia.**

**Medium vulnerability: Mexico, Chile, Brazil, Colombia, Czech Republic, Hungary, Poland.**

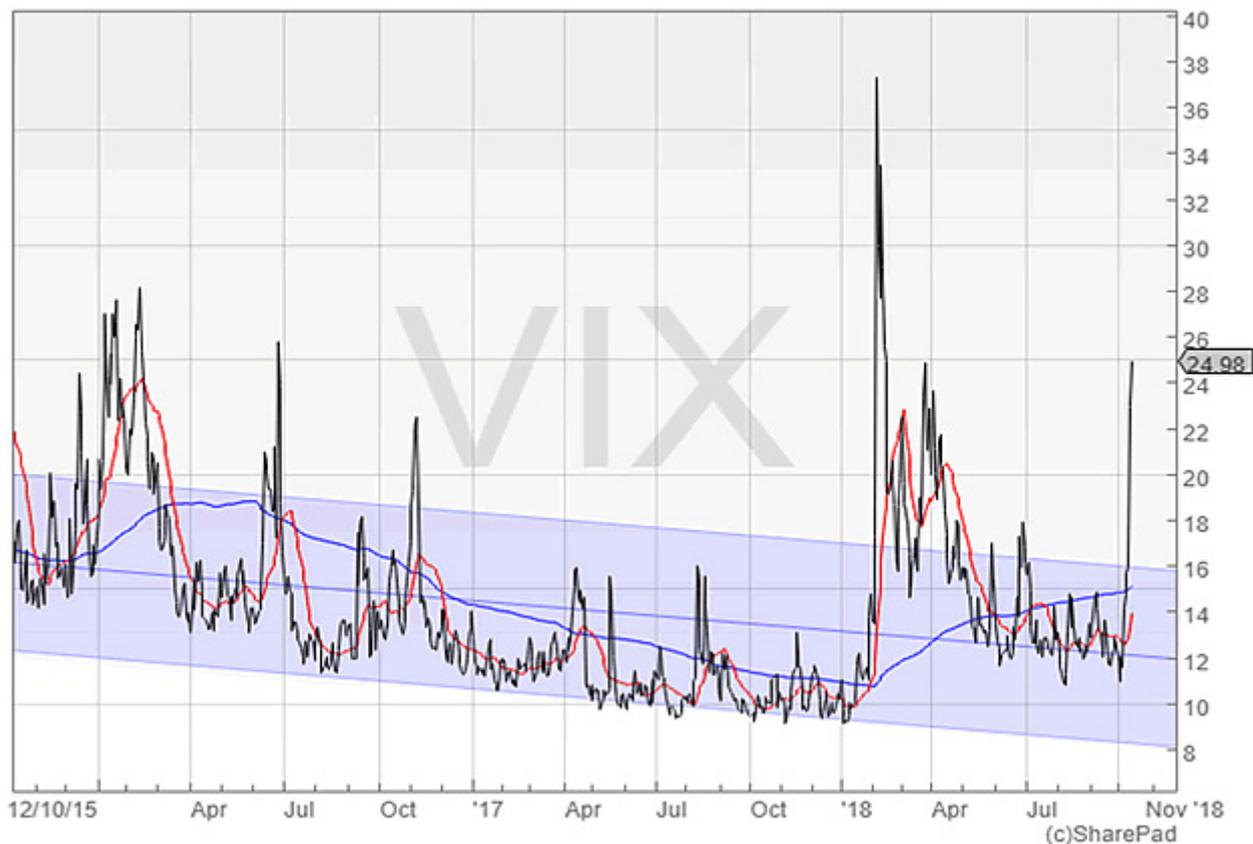
**Low vulnerability: Korea, China, Thailand, Russia**

Vulnerability scorecard



Source: SG Cross Asset Research, Haver, IMF, World Bank.

Measure	October Level	September Level	August Level	July Level
Vstox Volatility	19.96	17.08	12.66	13.65
VFTSE Volatility	16.45	13.93	11.44	11.3



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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 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 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](http://www.ukspassociation.co.uk).

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