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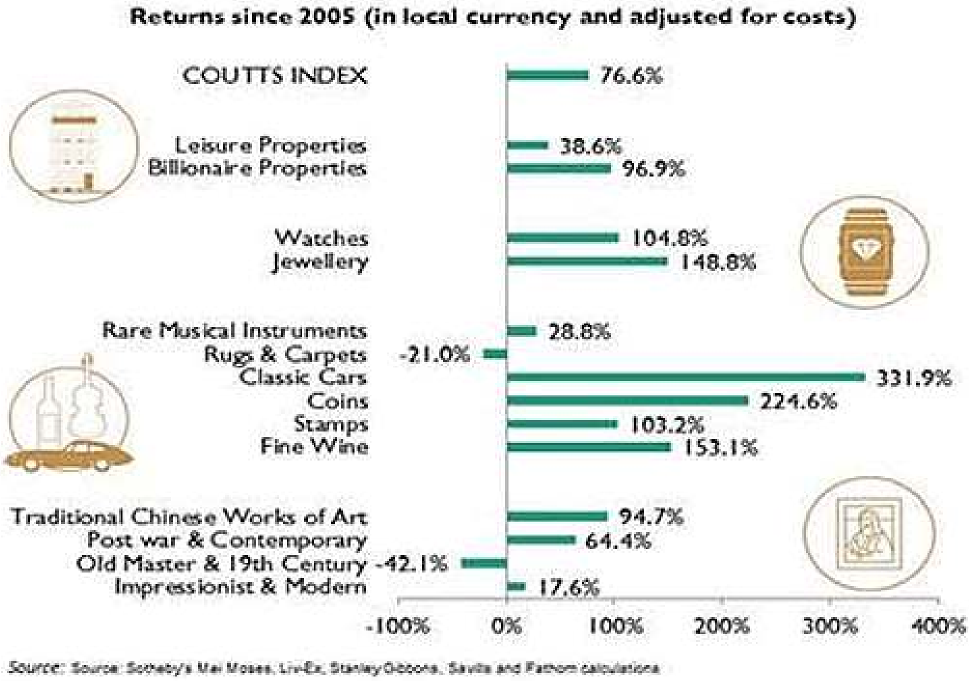
UK Structured™ Products Association

Monthly Market Report

October 2017

With commentary from David Stevenson

My hunch is that most investors have grown rather blasé about the increase in asset prices following quantitative easing and the recovery from the global financial crisis. We're all collectively rather good at post-hoc justifying the increased value of shares by pointing to surging corporate earnings, hiked dividends and abundant cashflows - barely conceding that surging share prices might have more to do with central banks unleashing a torrent of new money into the system. A cleaner measure is to look at assets favored by the rich and wealthy - in these specialist niches we can directly see the huge impact that ample liquidity has had on the value of everything from emotional assets (such as rare cars) through to second homes in the best locations. Private bank Coutts has been tracking via a proprietary index this range of desirable items for much of the last 12 years - see the chart below for the latest numbers.



The overall narrative has been unprecedented increases in value, although over the last year there have been signs that this remarkable rally has started to level off (surely a warning sign if ever there was one). According to Coutts, what are called 'passion' assets increased by 1.2% through 2016 but have risen by nearly 77% since the beginning of 2005. Intriguingly the sharpest declines in the last year have been for classic cars which experienced a short term drop of 10.4% in 2016, although they are still the top performing asset overall, up over 330% in the 12 years captured by the report. Over the last year Billionaire properties rose 1.8% in value while leisure properties nudged ahead by 1.5% in value. Coins showed steady and incremental increases of 11% per annum since 2005. On a quirkier note the price of rugs and carpets was volatile, with 2016 prices lower than in 2005 - Rare musical instruments showed the largest overall gain in 2016 of 16%, though this follows an 11% drop in 2015, demonstrating high short-term volatility.

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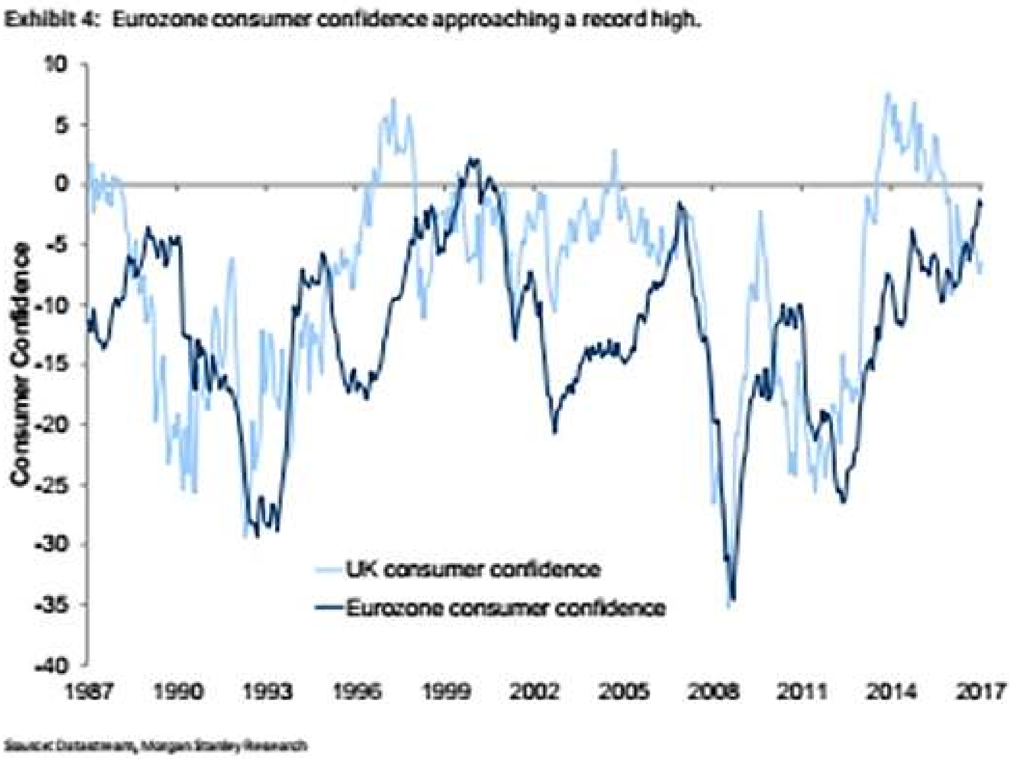
I've been arguing for most of the last 12 months that the Eurozone is the place to 'be' in asset allocation terms - along with emerging markets. All the breathless predictions about the end of the EU and a populist tsunami washing across the continent were always way off the mark in my view. The continent is largely powered by a bunch of fairly predictable factors not least FX rates, Chinese demand for expensive Eurozone industrial products and domestic consumer demand. China seems to be ticking along very nicely which helps the big German brands while the Euro has, until recently, shown signs of weakness against the dollar. Equally any trip to a Northern European city would have confirmed anecdotal evidence that those Eurozone consumers with a higher mix of citizens with blonde hair (!) are feeling confident right now.

This last observation received some backing last month from a note by European equity analysts at Morgan Stanley. In a mid-summer note to investors, the team observed that Eurozone consumers have rarely felt so good. "Five years after the depths of the Eurozone crisis in 2012 we now find that consumers across the region have rarely been as optimistic as they are today. The European Commission's consumer confidence survey is at its highest level since 2001 and at a level that has only been exceeded 5% of the time since 1987. [see chart below]".



Source: Morgan Stanley

The weak Euro has, up to now, helped boost confidence in the Eurozone. Now that the currency is increasing in value against the dollar, what happens next to local consumer confidence? "In this context", the analysts argue "it is important to note that the main driver of the Euro-zone GDP rebound in this cycle has been domestic demand and not exports (in fact net trade has been a modest drag in for much of the last 18 months. Consequently, the economy should be fairly resilient to currency strength for now unless the Euro moved materially and quickly higher." To stress test this assumption the bank's analysts have spent "not inconsiderable time looking for a chart showing a link between a stronger Euro and absolute or relative weakness in economic activity such as PMI readings or exports. We have found no consistent link... as a general rule of thumb we have always argued that FX is a much more important consideration when growth is weak than when it is strong".

So, time to load up on Eurozone funds and equities? Not quite, because the MS analysts have a sting in the tail. The report notes that resurgent Eurozone confidence (especially when measured against UK consumer demand) is usually "a late cycle phenomenon and/or a cautionary sign for markets. Since 1987 the average 6m return for MSCI World has been 0.1% when Eurozone confidence was higher than in the UK versus 4.9% when UK consumers more optimistic."

I would add my own caveat at this point - of a more long-term nature. I am of course delighted that the hordes of right/left-wing populists have been beaten back in the Netherlands and France. President Macron could be an enormous success - I hope he is. If he isn't though and his reform programme crashes, we have a real problem. Every informed French voter I have talked to agrees on one point, regardless of which party they support.

If Macron fails, it's game up for the current system. We'd see a hard right or hard left-wing president in office. It might be a Le Pen or Melenchon or maybe someone entirely new, like Macron, who is catapulted into the body politic. The economic consequences will be terrible to behold and might unravel the EU. In essence, Macron has just a few years to bind France ever closer into a tight fiscal union - with liberalized domestic markets. Even if he doesn't succeed there'll be chaos and carnage.

The price of oil matters. Oil price spikes have contributed to almost all US recessions since 1950 but since the rise of unconventional oil and gas, the dynamics of the global energy markets have changed. Now investors tend to worry more about how LOW the price will go - while commentators also speculate about some 'peak demand' point in the next decade when demand for oil will tail off. The core tension, most observers now reckon, is between the ability of OPEC to manage its member's output - and the access to capital markets for shale gas and oil operators in places such as Texas.

For most of the last year we've seen prices stabilize in a $40 to $60 trading range although over the late summer prices started to edge higher again. Only a few weeks back for instance the **Financial Times** reported that crude prices had hit 11-week highs as OPEC raised "global oil demand forecasts for this year and next while lowering estimates for production outside of the cartel, even as the group's own output rose for a third consecutive month in July". The price of Brent crude oil is above $50 a barrel again - at $53 on the 11th September. Obviously, this has attracted the usual chatter. Will prices push past $55 a barrel? Is the trend range of $40 to $60 a barrel over? But maybe this consensus view is wrong?

That's certainly the view of a well-known hedgie, also featured in the Financial Times. According to the FT "hedge fund manager, Pierre Andurand's bet that oil will return to $100 a barrel has caught the attention of an industry more accustomed to energy executives warning they must prepare their companies to survive with prices less than half that level". You can see the full piece here.

Now, it's important to say that Andurand hasn't been right much this year but according to the FT his big bets have paid off in the past - he has "returned investors in his eponymous $1.1bn fund a cumulative 560 per cent since 2008". Clearly all the usual caveats apply about hedgies and their past performance but his bold bet should give us all pause for thought. We're all assuming that there's a massive over supply of the black, physical, stuff and that it's a one-way trade with US unconventional (more supply boosted by cheap interest rates). But what happens if

1. The unconventionals in the US start to run into a supply wall, helped along by increasing interest rates pushing up the cost of capital?
2. OPEC does actually get its act together and starts to curb supply more effectively?
3. We all collectively under estimate the surge in global demand from emerging markets or
4. We get a geopolitical blow out that badly impacts inventories and causes a panic?

Now I reckon that most of the above aren't **probable** but they are all **possible**. If they do have an impact, the effect on sentiment could be quite drastic and we could see a nasty short squeeze - precisely because so many investors are betting on that core 40/60 trade. Are the Western developed world economies properly prepared for a sudden increase in the price of oil? And if prices do suddenly shoot up, what impact might it have on developed world inflation stats?

Measure	Value as of 11th August, 2017	Value as of 11th September, 2017
UK Government 10 year bond rate	1.05%	1.05%
GDP Growth rate YoY	1.70%	1.70%
CPI Core rate	2.40%	2.40%
RPI Inflation rate	2.60%	2.60%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.28%	0.29%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	55.1	56.9

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Bank CDS options

Yet another quiet month for CDS spreads insuring against bank bond losses. Most banks saw a small increase in the price of these options, although that is after sharp falls in the summer. A few banks did buck the trend, with Nomura and Investec experiencing fairly noticeable falls in CDS spreads pricing. UBS and Rabobank continue to fight it out as top dog i.e. the lowest 1-year CDS prices. Currently the Swiss private bank UBS is still ahead with 1-year CDS priced at 7.52 basis points. For 5-year CDS HSBC is still the cheapest, with pricing at 26.84 basis points.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	19.15	45.73	-3.29	-47	A -
Barclays	14.32	45.84	5.94	-47	A
BNP Parabis	13.82	36.23	9.21	-47	A
Citigroup	19.04	54.76	7.74	-25	A
Commerzbank	20.31	71.6	7.32	-38	A+
Credit Suisse	24.24	71.85	8.26	-41	A
Deutsche Bank	35.53	87.51	8.15	-59	A+
Goldman Sachs	24.12	68.93	5.2	-25	A
HSBC	8.57	26.84	3.87	-58	AA-
Investec*	n/a	184	n/a	n/a	BBB
JP Morgan	18.97	49.63	5.93	-14	A+
Lloyds Banking Group	10.59	40.32	10.65	-47	A
Morgan Stanley	22.06	63.72	7.28	-27	A
Natixis	17.34	37.55	9.2	-46	A

Nomura	10.75	36.51	-10.85	-55	A-
Rabobank	7.62	29.22	5.95	-47	AA-
RBC*	n/a	58	n/a	n/a	AA
RBS	15.92	51.82	5.77	-49	A
Soc Gen	11.22	37.64	7.45	-44	A
UBS	7.52	27.01	5.51	-56	A

Source: www.meteoram.com 14th September 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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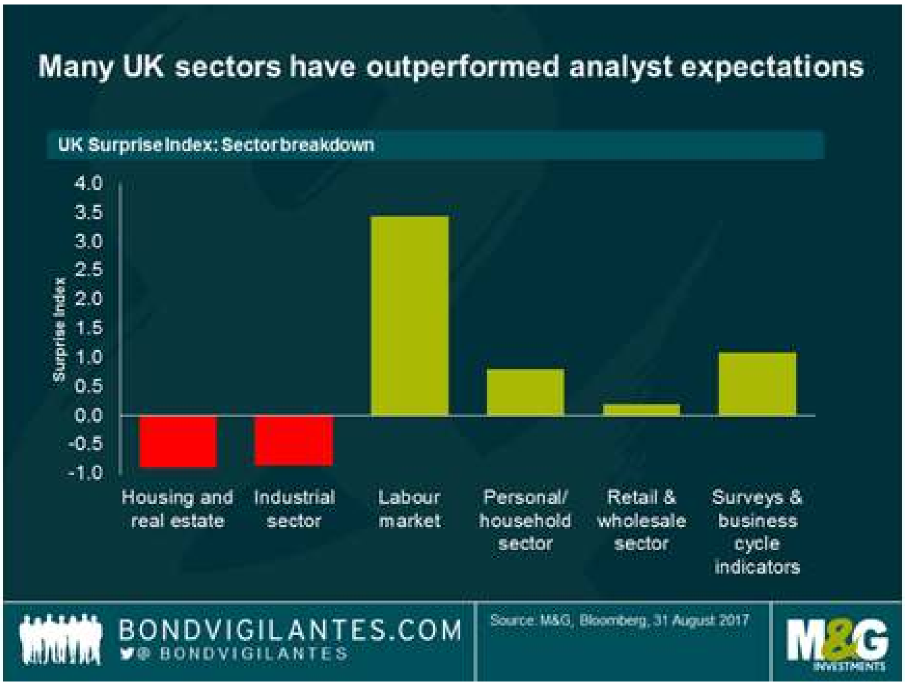
Government Bonds

With the yield on ten-year government bonds only a smidgeon over 1%, bond markets in the UK seem to be signaling an imminent recession for the domestic economy. Traditionally bond yields decline sharply as prices go up ahead of an imminent slowdown in economic growth. This fits in nicely with a wider perception in the financial media that the Brexit slowdown has finally arrived - in fact barely a day goes by without some story of impending consumer gloom. But the hard-economic numbers aren't anywhere near as conclusive - in fact if anything most reports coming from the macro economic frontline are fairly positive. Analysts at Barclays for instance recently posted an analysis of UK consumer spending patterns which suggested that spending growth was 2.9% y/y in August, according to the latest Barclaycard data, in-line with the three-month average of 3.0%, but below the 12-month average of 4.1%. The data covers the period from 23 July to 19 August 2017. This same report also confirmed that whereas in-store growth remains negative, it was much stronger online. According to Barclays in-store spending decelerated again in August at -1.3% - a further worsening from July (-0.6%) and below the three-month average (-0.7%). Online growth stayed strong at 15.7%, above the three-month average (13.9%). Online channels accounted for a 27.3% share of spending, in line with the three-month average.

Analysts at the fixed income team at fund manager M&G have also been tracking a similar set of numbers - and then matched them to consensus expectations. Their analysis suggests that most UK sectors are actually surprising to the upside. Eurozone economic growth is also exceeding estimates whereas the US has consistently produced numbers below most estimates.



According to Anjulie Rusius, investment director at M&G Investments, most economists have been "too bearish on the UK and Euro area, but too bullish on the US. This does not bode particularly well for those advocating an aggressive rate hiking path from the FOMC. Indeed, the underwhelming data in the US has been reflected in market expectations for Fed rate hikes, with 60 basis points of rate hikes priced out from the Fed Funds curve (over the next 3 years). The pessimistic view on the Euro area, however, arguably makes it a tad easier for the ECB to follow its slow and gentle plan towards policy normalisation, as forecasters are similarly reticent about being too bullish too soon. In the UK, this has made me ponder the Bank of England's policy rate. The "emergency rate cut" of August 2016 to 0.25% could be reversed should this trend continue, though this is certainly not what most economists are expecting."

UK Government Bonds 10-year Rate 1.05%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	20.96
Germany	13.35
Japan	33
United Kingdom	23.27

Ireland	32.6
Italy	142
Portugal	166
Spain	63.51

Eurozone peripheral bond yields

Country	August 2017	September 2017	Spread over 10 year
Spain 10 year	1.44%	1.56%	122
Italy 10 year	2.04%	1.96%	162
Greece 10 year	5.56%	5.46%	512

	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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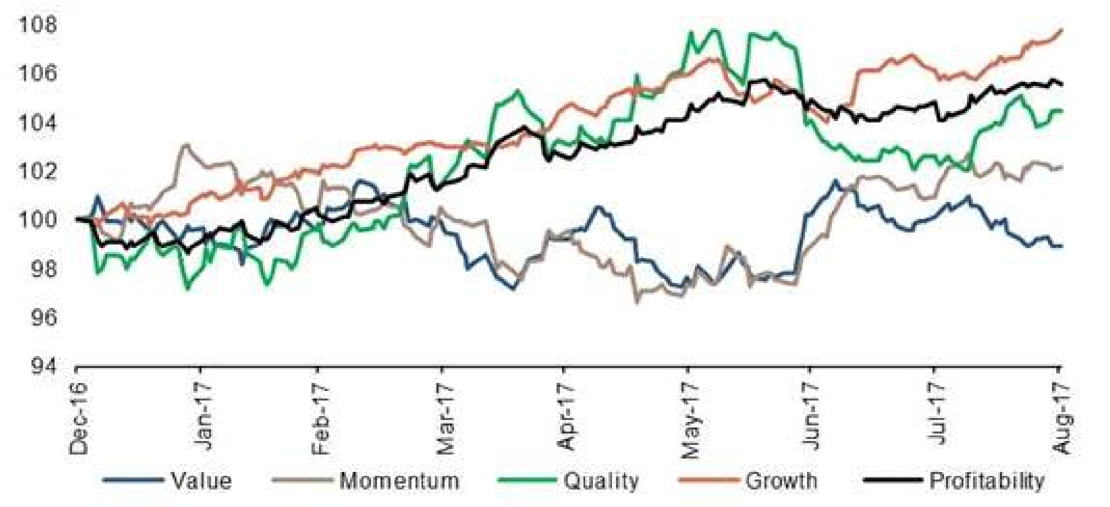
Equity Markets and Dividend Futures

One way of looking at how stockmarkets behave is to look at different styles of stocks - called factor investing. So far, this year the best performers, according to French bank SocGen, have been growth stocks. According to SGs Andrew Lapthorne "Growth is typically favoured as the economic cycle enters its twilight years. The difficulty is getting out before the downswing, as Growth tends to suffer most in down markets. And given that it is now the most expensive of all the factors, this is all the more critical". By contrast value stocks have been a disappointment this analysis suggests. According to SG the US stockmarket has been driving this rotation away from value towards growth and momentum stocks. "The underperformance of one of our favoured Value metrics has been as bad as it was in the Tech boom, perhaps worryingly indicating an equivalent willingness to ignore valuations" suggests the SG report.

Global long/short factor performance



Source: SG Cross Asset Research/Equity Quant

Emerging markets might also be playing a role, shifting money away from value stocks to growth and momentum strategies globally. According to a recent survey for investment bank UBS, EM inflows have been increasing substantially over the summer. Back at the beginning of September the banks head of GEM equity strategy, Geoff Dennis, reported that the pace of inflows has picked up again. "Eight months into 2017, cumulative YTD inflows into EM equity funds have now reached $44.7bn, which continues to be a historically high run-rate for this time of year. The gap over the second-best year for GEM fund flows (now 2010) has risen considerably in recent weeks and is now at a new high of 29%. Over 100% of this year's inflows have gone to Dedicated GEM funds". Hot countries for fund inflows include India, China and Brazil, contrasting with weak inflows into Mexico and Russia.

Index	August	September	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	116.7	116.8	3491	116.5
FTSE 100 (Dec 17)	287.9	287.4	7413	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-2.19	-0.97	0.59	7.57	27.31	38.15	7377.6
S&P 500	-0.55	1.14	4.17	12.84	71.18	107.56	2461.43
iShares FTSE UK All Stocks Gilt	1.76	1	1.53	-3.26	11.27	18.77	13.43
VIX New Methodology	10.58	19.29	2.19	1.51	-15.72	-64.69	12.12

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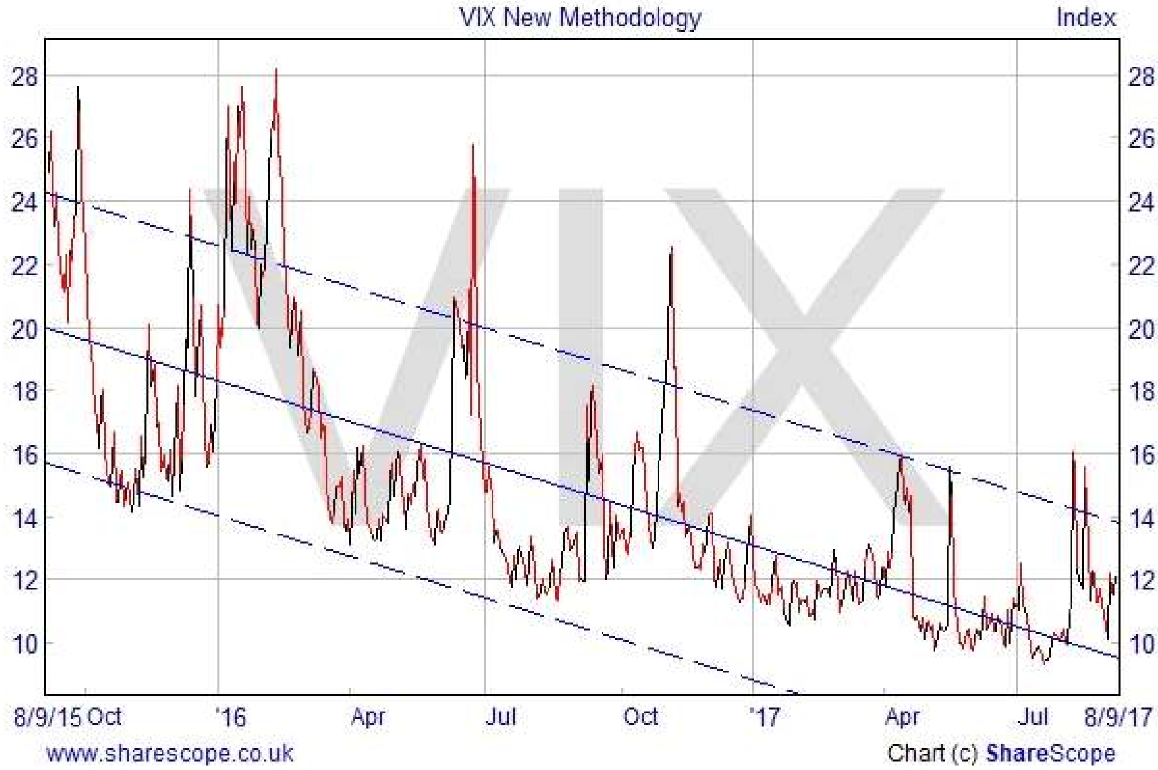
Volatility



Another month, another take on the mystery of why equity volatility indices such as the Vix are so becalmed. News and views website Business Insider recently ran an illuminating discussion with an American academic, Bob Whaley, a Vanderbilt University finance professor who had worked with colleagues to help create the immensely popular VIX index.

Was he surprised by the low levels for the VIX? "When you see VIX go up, you can know there are a bunch of people out there that are buying insurance on the stock market because they're anxious about something. When VIX goes down, it's just recognition that people aren't too worried. The average closing level is 19. If it's 11 now, that means people aren't particularly concerned. At the same time, its level was 9 a couple weeks ago, so there's clearly more anxiety now than there was a few weeks ago, but relative to its entire history it's just not that big a deal. "

According to Professor Whalley most investors don't understand the index as well as they should do. "The VIX doesn't trade. It's just a number produced from these 250 S&P 500 option prices. But what does trade are the VIX futures and the VIX options, which are related to VIX but in a strange way. Where VIX is the volatility over the next 30 days, VIX futures is the expectation of the volatility 30 days from now. Those two series don't behave like one another, in fact quite differently. VXX is incredibly actively traded. Would I have thought it would be this actively traded? No, but it is. I think the VIX futures index is particularly staggering. It probably trades more shares in a day than Microsoft. If you look at the turnover ratio, you'll find that it's a huge number. If people were just buying and holding, that number would be much lower."

Crucially Whalley sees a big distinction between institutions and retail investors trading in volatility options. "If you look at VXX and go to 13F filings, you'll see it's largely an instrument used by retail customers, not institutions. If you go over to the ownership of XIV, it's largely institutions that know that this thing will go downward through time. It only goes down a few cents a day, but if you get a volatility spike, you'll lose money, but you're not going to get that many spikes if you have a long-term investment. In fact, if you go to the prospectus of these things, it explicitly states that if you buy and hold these things, you're assured to lose most if not all of your investment. But people do still buy and hold, and its largely retail customers. Because how many retail customers look at a prospectus? Those things are 300 pages long. They don't do that. The issue I have is if you're a sophisticated investor, like an institution, they know exactly what's going on. Retail customers don't."

And does Professor Whalley himself trade in these options? "Yes I do. I buy long-term put options on VXX, because I know VXX is going to go down through time. There may be days where there's a spike in volatility, but I don't care because these options have three years to maturity, so I just let their prices go up as VXX goes down. It's worked pretty well."

The full interview is online here.

Measure	September Level	August Level	July Level	June Level
Vstoxx Volatility	13.96	21.41	12.84	13.33
VFTSE Volatility	10.71	15.97	9.9	11.6

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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,

Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk