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UK STRUCTURED ™ PRODUCTS ASSOCIATION

Monthly Market Report

October 2018

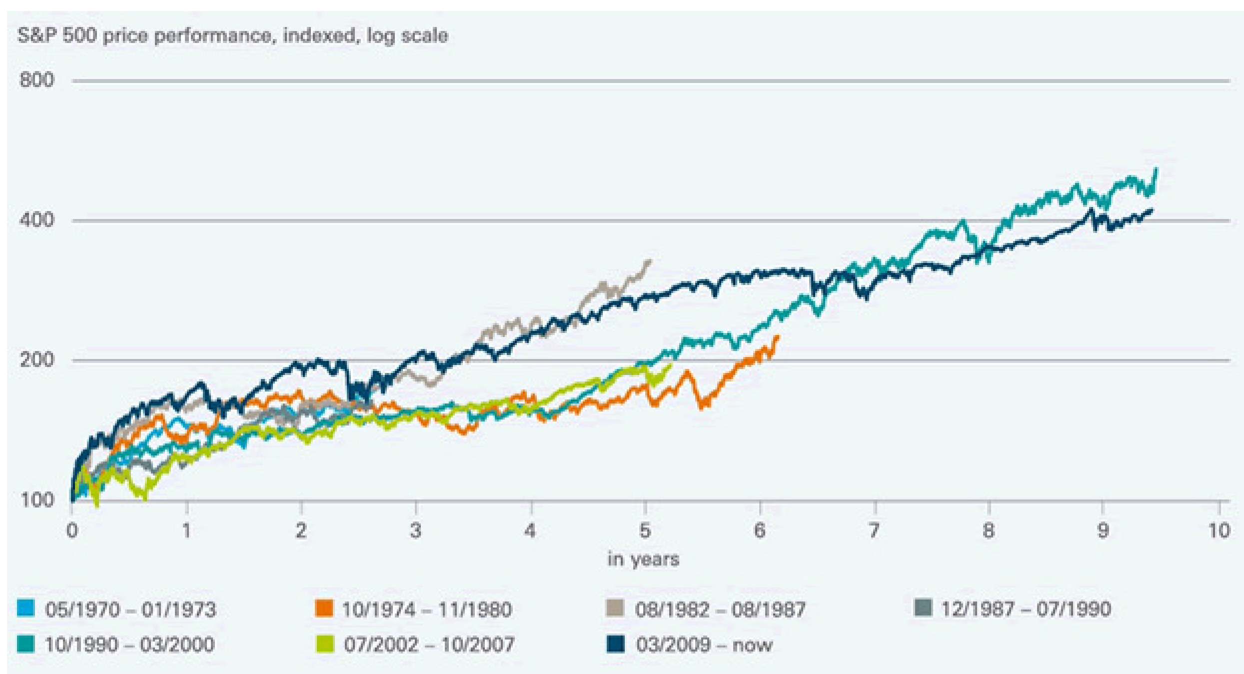
With commentary from David Stevenson

The Duracell Bounce

Regular readers will know that I tend to take a slightly cautious attitude towards investing at the moment. It strikes this observer that there's never been a better time to think about defensive strategies - be they using structured products, absolute returns strategies or just good old fashioned hedging. Nevertheless the hard numbers suggest that my caution is misplaced. The bull market rally looks to be in fine form and showing no particular signs of distress. Only a few weeks ago for instance Deutsche Asset Management released a note which suggested that since March 9, 2009, global share prices have risen without a fall of at least 20%, thus fulfilling the usual definition of a bull market. "After more than nine years, the question of the life expectancy of such a bull market naturally arises" observes Deutsche, "the current bull market is now competing with the previous record holder in terms of length".

The chart below also shows that this may not only be the longest bull market, but that it has also performed well in terms of price development compared to its predecessors. This is all the more, remarkable, says Deutsche "as economic growth in the current economic cycle, which also began in 2009, falls well short of previous cycles. However, the corporate sector has adapted better to the weak overall economic development than other sectors. Current share prices are underpinned by comparatively high corporate profits. That's unlike the situation in the late 1990s. "

What next for the bull rally? According to David Bianco, CIO Americas at DWS, the 1990 bear market was at best a small bear with a decline of just under 20% - Bianco suggests that in fact the bull market of the 1990s began after the 1987 crash. According to this definition, we would have to be patient until June 2021 until the current bull market also sets this record.



Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH as of 8/16/18

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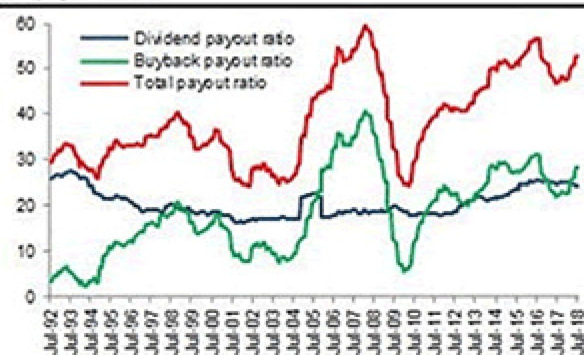
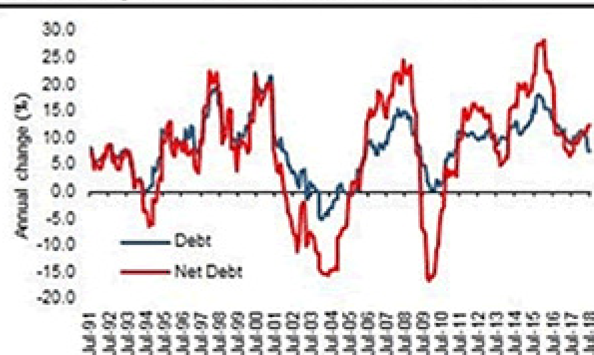
Headline Numbers

Share buybacks are all the rage at the moment, thanks to a bullish US market and generous corporate tax breaks. The good news is that many equity income managers swear by the good old share buyback. Their argument is that if a mature listed business can't find a sensible, productive use of spare capital, then it should let the investors do the decision making. Hand the capital via share buybacks and then investors can make their own mind up about what they want to invest in. This mantra of corporate capital efficiency has been extensively embraced by CEOs and boards in the US and share buybacks are now all the rage. There's even a growing number of ETFs which deliberately target listed businesses who's share base is shrinking.

But I think it's also fair to point out that there's a growing army of critics of the share buyback model. These come in two varieties - a more overtly political camp of economists who think it's a disaster for the US economy as against a more technical camp of strategists who think it distorts the market and encourages leverage. In the former camp you'll find academics such as William Lazonick, who amongst other things writes excellent pieces for the Institute for New Economic Thinking. He thinks that share buybacks ‘hurt workers and the economy' and that the US government ‘should ban them'. Excessive share buy backs result in US corporates cutting back on long term capital investment. Many stockmarket strategists are also critical of share buy backs, not least Andrew Lapthorne over at SocGen who monitors net buybacks from the US report and accounts cashflow statements. His analysis suggests that these US buybacks have risen a substantial 30% YoY following the US tax changes, with the current quarterly run rate at around $190bn gross, or a net $160bn if you measure the actual reduction in shares. "This is down from the $200bn+ in Q1, but we are now seeing estimates of $1trn+ in announced buybacks to come, which if executed would require a 50% quarterly step-up in US buybacks - an extra $100bn per quarter." Crucially he argues that a large chunk of this buyback capital is "is being funded by cash from the balance sheet and the selling of liquid investment. Net Debt is therefore on the rise. The US shareholder yield is running at around 3% on an ex-financial basis, but this compares to a European dividend yield of 3.6%. So not all that impressive. And of course, every quarter that cash pile is getting smaller."



Source: SG Cross Asset Research/Equity Quant, Factset



SG Cross Asset Research/Equity Quant, Factset

Intriguingly Lapthorne also argues that a more sensible strategy is to announce a buyback and not actually carry through the purchases - which is empirically "the best course of action for a company".

Measure	Values as of 8th August, 2018	Values as of 6th September, 2018
UK Government 10 year bond rate	1.32%	1.44%
GDP Growth rate YoY	1.20%	1.30%
CPI Core rate	1.90%	1.90%
RPI Inflation rate	3.40%	3.40%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.81%	0.80%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	54	52.8

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Bank CDS options

Just as equity market volatility has - largely - been subdued over the last month, so has the pricing of swaps against bank bonds. Although prices rose pretty much across the board last month for both 1 and year CDS products, the increases weren't especially although the big Italian banks were hit hard. Only one major bank saw a (small) decline - Japanese giant Nomura. South Africa assets have been having a tough time in recent weeks, thus it's probably no great surprise that pricing for Investec swaps has risen steadily for the last few months and currently stands at 251 basis points at the 5 year level (in market implied terms).

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	32.54	55.2	3.95	20.71	A -
Barclays	31.3	65.84	11.08	43.63	A
BNP Parabis	18.95	46.45	12.98	28.19	A
Citigroup	20.03	51.31	1.66	-6.29	A
Commerzbank	22.89	84.41	11.04	17.88	A+

Credit Suisse	16.86	69.75	1.21	-2.92	A
Deutsche Bank	72.52	144	6.6	65.04	A+
Goldman Sachs	22.93	61.51	11.75	-10.77	A
HSBC	13.54	36.36	7.11	35.47	AA-
Investec*	n/a	251	n/a	n/a	BBB
JP Morgan	18	41.29	1.88	-16.8	A+
Lloyds Banking Group	10.45	47.30	8.57	-4.19	A
Morgan Stanley	22.07	58.84	9.99	-7.66	A
Natixis	15.74	43.79	1.18	16.62	A
Nomura	14.05	43.26	-3.59	18.49	A-
Rabobank	12.86	37.57	7.56	28.58	AA-
RBC*	n/a	64	n/a	n/a	AA
RBS/Natwest Markets	37.3	87.21	5.60	68.3	A
Soc Gen	16.86	49.58	17.78	31.72	A
UBS	10.58	39.93	3.35	47.83	A

Source: www.meteoram.com 31st August 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Gold

I've quietly grown more interested in gold for three reasons in recent months. The first is that it doesn't seem to be an expensive hedge against volatility at the moment. The second cause for optimism is that volatility in the gold price has collapsed. Which could be a good contra-indicator. Lastly, although gold is seen as just one of many alternative assets and possible hedging options in the developed world, in much of the rest of the world, gold remains THE best hedge against currency collapse and unpredictable government's. All of which I think pretty much brilliantly describes the current sorry state of much of the developing world. Oh, and crypt-currencies - the supposed digital alternatives - aren't looking quite so healthy at the moment.

So, gold looks a little more interesting than usual. But perhaps the best reason to keep an eye on gold is because it's a classic hedge against inflation - which seems to be making something of a comeback at the moment. That at least is the view of Jeremy Gatto, Investment Manager on Unigestion's Multi-Asset Navigator fund and Florian Ielpo, Head of Macroeconomic Research. They've been peering into the "World Inflation Nowcaster", which is a real-time synthetic measure that tracks inflation-surprise risk. Using this metric they claim there has been an impressive pick-up since mid-2016; and this risk currently remains elevated. They also suggest that investors often associate the beginning of the 'reflationary' trade with Donald Trump's election success. The Unigestion investors suggest that inflation is much more visible in recent years, with Consumer Price Index (CPI) figures reaching higher grounds and the pricing of inflation having been revised upwards considerably by the market. Gatto and Ielpo also examined the average performance of gold across four macro regimes: recession, inflation surprises, market stress and steady growth. Looking back at the historical returns of gold between 1974 and 2017, gold delivered on average returns of 10% during periods of inflation, while during times of recession, gold returned the

same performance as bonds. They suggest that whether one is worried about recession risk or inflation shock risk, based on their findings, gold seems to offer interesting hedging capabilities.

Fixed Income

It's been another relatively quiet month in fixed income markets. Even though US interest rates are continuing their upwards crawl, yields on 10 year US bonds stayed below the all-important 3% level. The recent upward trend seems to have run out of momentum.

Over in the UK, the yield on local 10 year bonds has stayed relatively depressed for months. At around 1.44% we're not far off levels from two years ago. This despite the increase in interest rates by the Bank of England.

UK Government Bonds 10-year Rate 1.44%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	24.64
Germany	9.95
Japan	24.73
United Kingdom	28.65
Ireland	32
Italy	243
Portugal	100.345
Spain	66.3

Eurozone peripheral bond yields

Country	August 2018	September 2018	Spread over 10 year
Spain 10 year	1.40%	1.45%	110
Italy 10 year	2.85%	3.07%	272
Greece 10 year	3.99%	4.42%	407

	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

Numbers are in for August and according to David Blitzer of S&P Dow Jones, the US equity markets have yet again beat pretty much all the competition - see the big table below for returns from the S&P Dow Jones universe.

According to Blitzer "it was another Home Sweet Home for U.S. investors, as the U.S. continued to significantly outperform the rest of the world. For August, global markets posted a consolidated 0.70% gain, but absent the U.S. 3.26% gain, global markets were down 2.12% for the month. The view of the U.S. dominance is not new, as the year-to-date performance has the U.S. up 9.06% and the global markets ex the U.S. down 5.22%. Longer-term yardsticks continue the pattern, as the two-year global return is 26.00% with the U.S. and 17.42% without it, and the three-year is up 32.61%, but absent the U.S., it is up 19.09%."

Interestingly though sector variance increased within broad equity markets. Only 4 of the 11 broad global sectors increased in value last month, down from all 11 last month (6 gained the month before that). The spread between the best (information technology, up 5.17%) and worst (energy, off 3.28%) sectors for the month was 8.45%, up from last month's 4.52% and the prior month's 4.57%. Year-to-date, information technology did the best, up 13.68%, as telecommunication services did the worst, off 9.12%, resulting in a 22.80% spread.

Unsurprisingly emerging markets had the toughest month with Turkish shares down 28.52%, followed by Brazilian equities (down just under 125) and South Africa (down 10.20%). Amazingly Egyptian equities ended the month up 2.35% closely followed by Thailand and the Philippines (and Hungary) all of which recorded low single-digit increases.

One of the headwinds behind global equities has undoubtedly been dividend growth. According to the latest numbers from Janus Henderson Global dividends jumped 12.9% year-on-year in the second quarter to $497.4bn with payments rising in almost every region of the world in headline terms. Records were broken in 12 countries, including France, Japan, and the United States, some of the largest contributors to global income. The Janus Henderson Global Dividend Index ended the quarter at a new record 182.0, meaning that global dividends have risen by more than four-fifths since 2009.

S&P Global Broad Market Index(BMI) Global

US MKT	**%**	**%**	**BMI MEMBER**	**FROM 11/8/16**	**1-MONTH**
VALUE	**Of**	**of BMI**	**Global**	**27.89%**	**0.70%**
$ BILLION	**TYPE**		**Global Ex-U.S.**	**18.84%**	**-2.12%**
$55,520					
$5,294	**100.0%**	**9.54%**	**Emerging**	**15.50%**	**-3.78%**
$737	13.9%	1.33%	India	28.94%	**0.15%**
$1,725	32.6%	3.11%	China	26.54%	**-4.03%**
$219	4.1%	0.39%	Russia	15.18%	**-7.45%**
$363	6.9%	0.65%	South Africa	-0.70%	**-10.20%**
$357	6.7%	0.64%	Brazil	-11.34%	**-11.95%**
$36	272.2%	0.67%	Turkey	-43.25%	**-28.52%**
$50,226	**100.0%**	**90.46%**	**Developed**	**29.34%**	**1.19%**
$20,393	**40.6%**	**36.73%**	**Developed Ex-U.S.**	**19.75%**	**-1.68%**
$29,833	59.4%	53.73%	United States	36.74%	**3.26%**

$4,793	9.5%	8.63%	Japan	19.97%	**-0.03%**
$1,677	3.3%	3.02%	France	29.68%	**-1.88%**
$603	1.2%	1.09%	Hong Kong	13.79%	**-2.67%**
$1,528	3.0%	2.75%	Germany	22.47%	**-2.92%**
$2,898	5.8%	5.22%	United Kingdom	15.47%	**-4.40%**
$436	0.9%	0.79%	Italy	26.70%	**-8.75%**

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-4.5	-5.1	2.41	-0.478	11.8	26.7	7318
S&P 500	0.835	3.67	5.35	16.6	73.6	101	2874
iShares FTSE UK All Stocks Gilt	-0.14	0.951	1.45	-2.02	16.8	9	13.13
VIX New Methodology	23.4	19.5	-24.2	19.6	-12.2	-10.8	11.27

Index	August	September	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	125.9	125.80	3299	126
FTSE 100 (Dec 17)	308	308.30	7318	n/a

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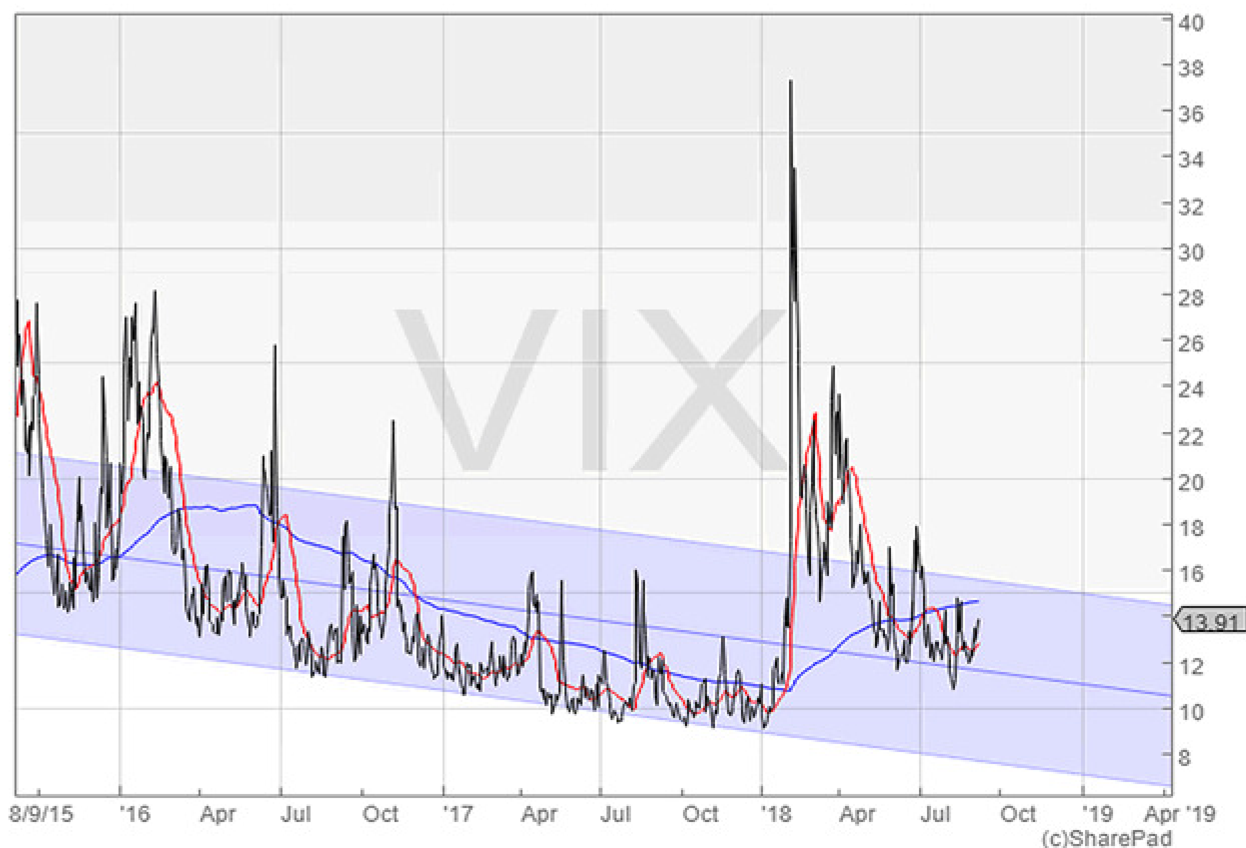
Volatility

The great moderation in terms of equity market volatility is back! According to Bloomberg "U.S. stock price swings were so muted [in August] that by some measures it was the calmest August since 1967". The Cboe Volatility Index, also known as the VIX or Wall Street's fear gauge, averaged 13.6, lower than the five-year average of 14.6. But within the broader global markets there is some evidence that volatility has ticked up marginally. S&P Dow Jones for instance reports that their volatility and correlation measures rose overall in August for the S&P Developed Ex-U.S. LargeMidCap Index. Even within US markets the index firm reported the S&P 500, S&P MidCap 400 and the S&P SmallCap 600 recorded above-average dispersion between stocks and sectors although average correlations and volatility in August were well below the average. Volatility was also weaker in the United Kingdom and Latin America benchmarks, while correlations were relatively high. Crucially there's some evidence to suggest that volatility may now start to pick up as we head into the autumn. The table below from Bloomberg based data from Macro Risk suggests that September and especially October tend to see a big pick up in market turbulence.

Measure	September Level	August Level	July Level	June Level
Vstoxx Volatility	17.08	12.66	13.65	14.45
VFTSE Volatility	13.93	11.44	11.3	13.4



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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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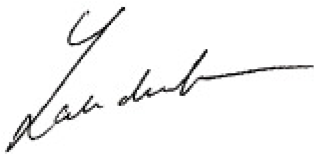

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