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UK Structured™ Products Association

Monthly Market Report

September 2017

With commentary from David Stevenson

Although global stockmarkets have had a strong run of late my suspicion is that is that equities might take a breather fairly soon, not least because global growth doesn't look like it's going to pick up any more speed until President Trump decides what to do about government spending and taxes.

It's also likely that the central banks are preparing for a winding down of some monetary stimulus measures. As one fund manager recently put it to me "the onus is now on equities to justify their strong performance after a spectacular run, with suitably strong earnings numbers". Needless to say, market expectations are running a tad high, especially in the US - with a real possibility of disappointment. The consensus view on US earnings implies real GDP growth is in excess of 3 per cent - well over levels not seen over the last decade. On balance, this suggests room for some caution, but certainly not panic.

Yet it is worth quoting at length from a recent note to investors by the Ruffer Investment Company. It's a widely followed listed investment fund within the wealth space and the current managers Hamish Baillie and Steve Russell have always taken a more cautious view of current financial exuberance.

The latest note though takes this caution to a much higher level. Here's what they say: " Once again we have eaten tomorrow's cake today but this time at a moment when we were still trying to atone for yesterday's binge. At this crucial juncture the stakes are now higher and the options more limited. On top of this (and to some extent because of it) there has been another important development in the last 12 months; the political winds have changed. Austerity is a vote loser and is off the table and the have-nots are voting for change. This means more spending to try to boost growth and more borrowing to fund that spending. The inflationary risks were already high and they are about to get higher. What this boils down to is a transfer of wealth from the world's savers to the world's borrowers and now the political wind is firmly behind this movement. The mechanism for this change is financial repression; keep interest rates below the rate of inflation. This has been happening for some time in the UK, US and Europe and is likely to become more extreme."

I'm not sure that a sustained bout of inflation is that necessarily that likely or that a transfer of wealth is actually such a bad thing per se, but the message from Ruffer is stark - and likely to be repeated on a daily basis throughout the UK in conversations with clients from many different firms. Watch out, your wealth is under attack! This month we go "full on" 'defensive' and investigate what investors might need to worry about next?

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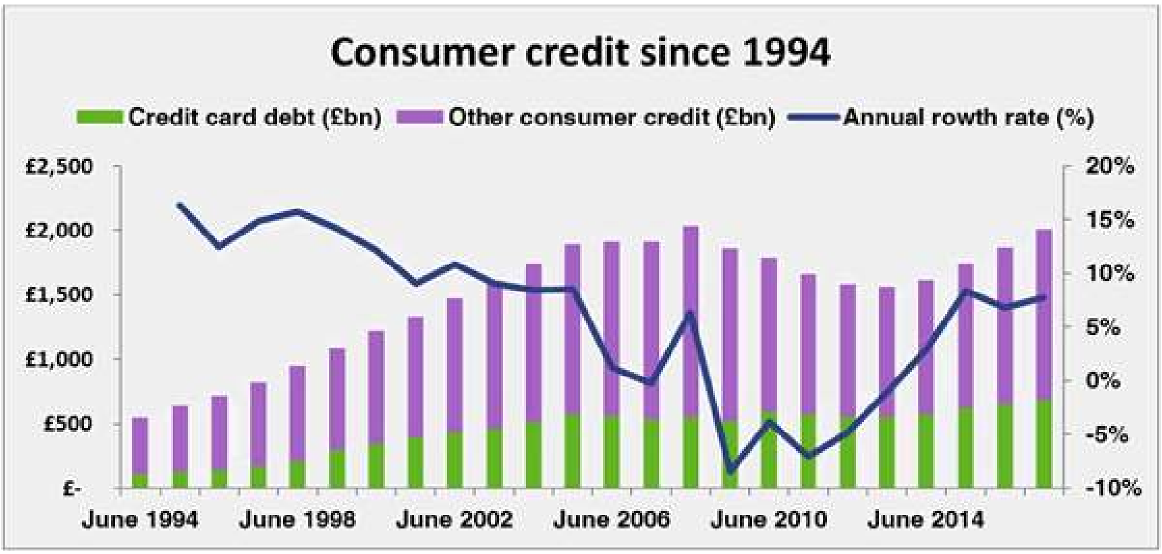
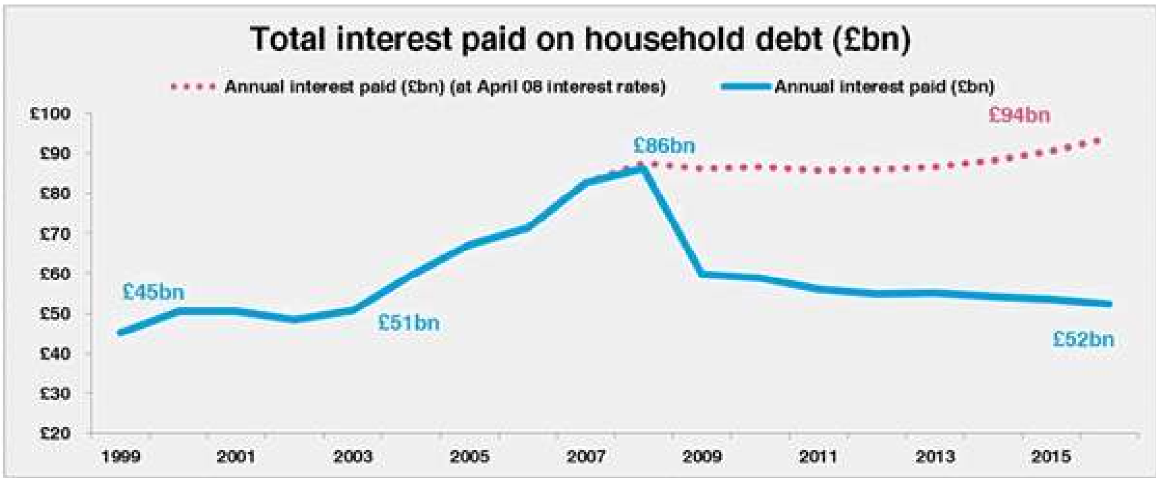
Headline Numbers

Everybody and their dog certainly seems to be worrying about consumer debt - and the parallel, low, savings rate. The regulators are clearly concerned about increasing levels of unsecured consumer debt - and have asked lenders to tighten up. Latest figures from June showed that unsecured loans debt grew to more than **£200 billion** for the first time since 2008. Mortgage debt is another concern (especially around buy to let mortgages) as are car loans - a particular focus of much media attention. Leading financial charities are also muscling in on this generalised sense of gloom. The Money Charity for instance has been digging into these numbers and discovered that the average household owes **£7,413** in unsecured debt, **£530** more than a year ago. Debt is growing at the same rate it was back in the mid 2000s, expanding at around **7%** for the last three years. The first two charts below map out this growing mountain of debt - and examine the parallels with the Great Financial Crisis. The one big difference, it argues, is that interest rates are low. A decade ago, Britons paid back **£86bn** and today that is just over **£50bn**.If rates had not changed at all since then, we would be paying **81% more** than we pay today according to the Money Charity - that's £94bn, £1,810 for every adult in the UK or **7% of average earnings**.

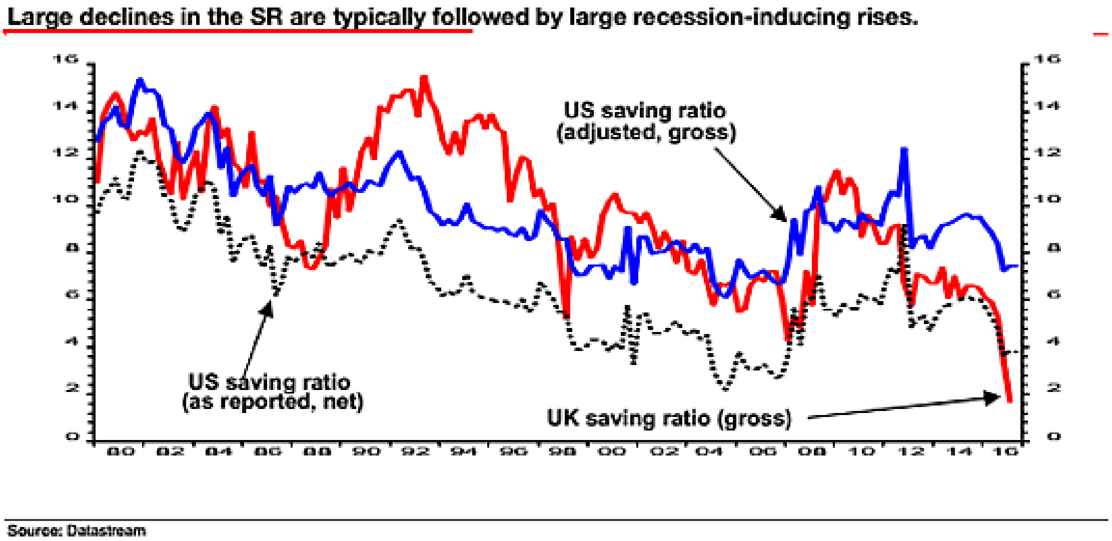




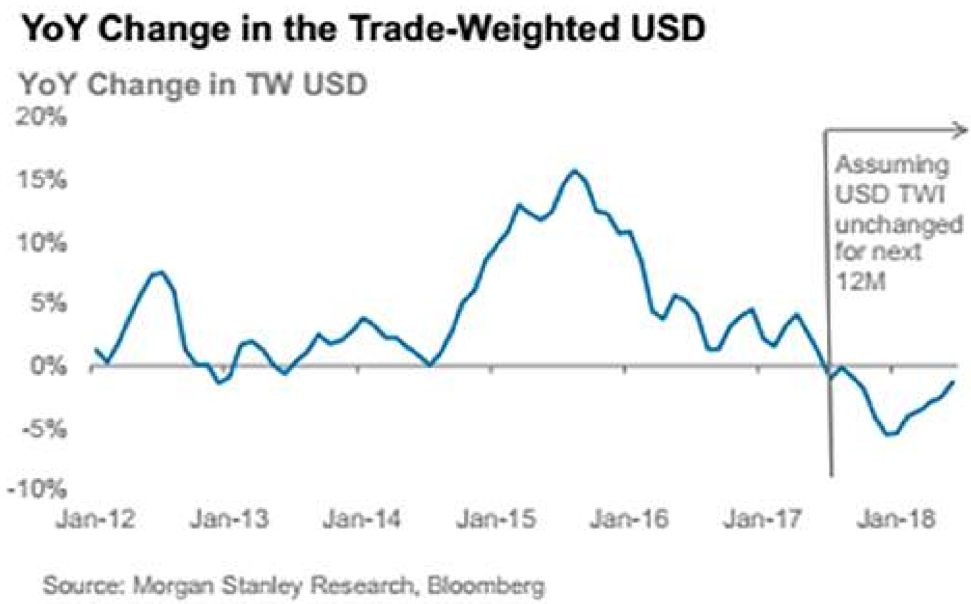
Source: Bank of England

According to permabear Albert Edwards, a strategist at French bank SocGen, these numbers on debt reflect a much bigger, more systemically important story - the remarkable decline in the savings rate (SR). He observes in a recent note that the US authorities have been revising downwards their numbers for saving, but the UK is in an even worse position, with recent data showing a slump in Q1 to only 1.9% (see chart below). According to Edwards "the UK has also only sustained moderate GDP growth via a total collapse in the Savings Rate to unprecedented historical lows, but also relative to the levels of the credit crazy US. The BoE recently warned of spiral of complacency about mounting consumer debt. But, of course, there is no acknowledgement of its own pernicious role in this unfolding disaster."

Edwards observes that most large declines in the savings rate are "typically followed by large recession inducing rises".



How does one measure the vitality of an economic super power? On one level - its stockmarkets - the US is fine form with the benchmark Dow Jones cruising past the 22,000 level. Yet on another measure - the value of the dollar - confidence is slipping. At the beginning of August, the dollar tumbled to a 15-month low against its rival currencies. Two simple statistics sum up the story: the aggregate dollar index is down 8% so far this year (see chart below) while the S&P 500 index is up 10.3 percent.



On paper, a lower dollar should be good news overall - many analysts have certainly been expecting the planet's reserve currency of choice to weaken for some time. Analysts say the companies most likely to feel the impact of a weaker dollar are those with the most exposure overseas. Foreign sales accounted for 42.3 percent of 2016 revenues of S&P 500 companies, down from 44.3 percent the year earlier and the lowest percentage since 2003, according to Standard & Poor's. Morgan Stanley analysts reckon that for every 1 percent drop in the dollar, S&P 500 earnings could gain a half percentage point - with most of the impact showing up in the second half.

Yet what's good news for US exporters is also

1) Bad news for US importers and consumers (look out for inflation concerns to mushroom) and
2) Bad news for Eurozone exporters and investors.

In fact if the S&P 500 is priced in euros, then it has actually fallen 8% since reaching a peak back in February. It's a similar picture for the Dow Jones, which is down 7.8% in euro terms since peaking at the start of March. This trend could reduce the attractiveness of US stocks for Europeans, and may eventually limit inflows into the US indices.

Measure	Value as of 14th July, 2017	Value as of 11thAugust, 2017
UK Government 10 year bond rate	1.29%	1.05%
GDP Growth rate YoY	2%	1.70%
CPI Core rate	2.60%	2.40%
RPI Inflation rate	3.70%	2.60%
Interest rate	0.25%	0.25%
Interbank rate 3 month	0.29%	0.28%
Government debt to GDP ratio	89.30%	89.30%
Manufacturing PMI	54.3	55.1

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Bank CDS options

After the dramatic price moves of the last few months (downwards, in terms of pricing), the market for credit default swaps (CDS) went very quiet over the last four weeks, leading up to August. Most options carried on falling in price, marginally, although a few issuers such as SG experienced very small increases. For this observer the biggest story of 2017 so far has been the dramatic repricing of HSBC swaps, which have crashed in price implying that the market has very few concerns about its continuing viability. Currently the market is pricing in 1 year CDS options for the worlds local bank at just 7.7% basis points although pricing for rival bank UBS is slightly lower (at 7.13 basis points).

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	18.68	44.96	-5.58	-50	A -
Barclays	16.01	42.9	2	-57	A
BNP Parabis	12.33	32.88	-4.45	-56	A
Citigroup	18.34	50.39	-1.12	-39	A
Commerzbank	19.75	67	-3	-45	A+
Credit Suisse	25.69	65.42	-1.88	-50	A
Deutsche Bank	32.11	80.52	1.93	-61	A+
Goldman Sachs	24.17	65.77	-0.72	-36	A
HSBC	7.7	25.58	-9.85	-66	AA-
Investec*	n/a	194	n/a	n/a	BBB
JP Morgan	19.19	47.11	4.53	-22.96	A+
Lloyds Banking Group	9.88	36.66	-2.51	-56	A
Morgan Stanley	21.83	60.32	-1.28	-40	A
Natixis	15.68	34.35	-14	-52	A

Nomura	12.74	40.82	0.77	-53	A-
Rabobank	7.82	27.51	-7.52	-53	AA-
RBC*	n/a	54	n/a	n/a	AA
RBS	16.87	48.23	-0.48	-58	A
Soc Gen	10.01	35.04	-2.12	-52	A
UBS	7.13	26.38	-1	-59	A

Source: www.meteoram.com 4th August 2017
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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Government Bonds

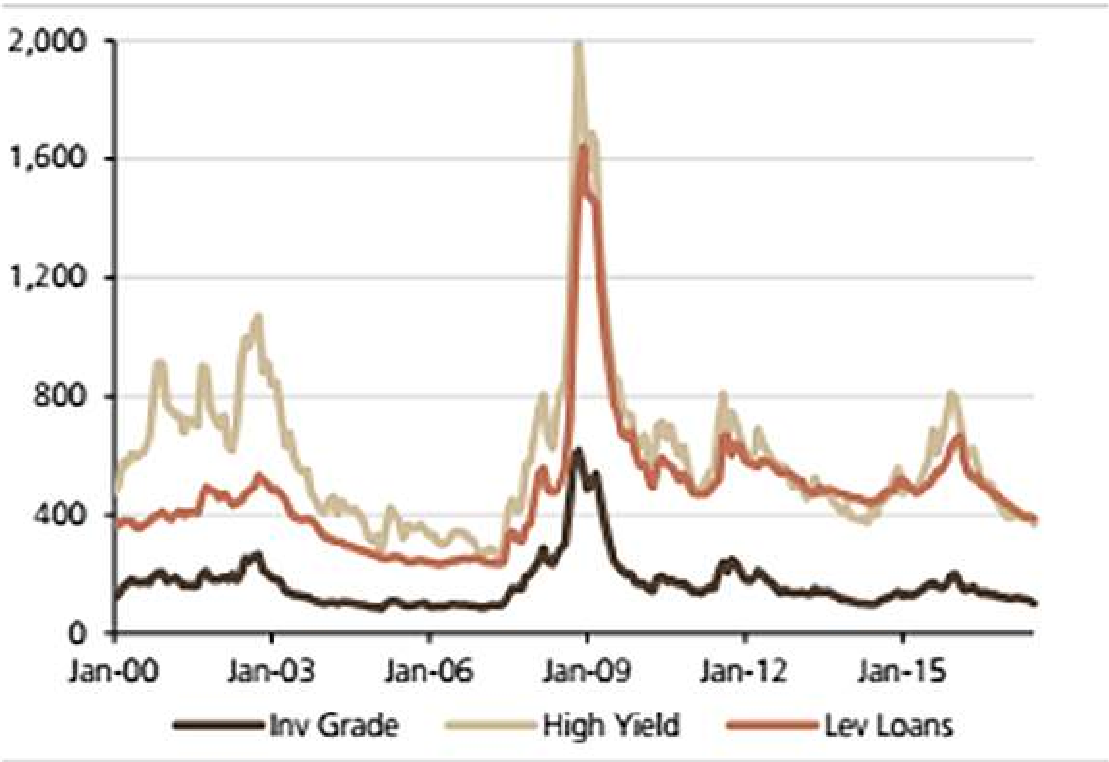
One increasingly worried line of investment thinking is that demand for global equities is being fed in part by strong demand for corporate bonds. As central banks vie with ETFs and sovereign wealth funds to snap up the most liquid bonds, prices rise and yields fall. This encourages corporates to issue more debt, some of which is then recycled back into share purchase programmes. The plunging yield on corporate bonds also encourages investors to buy higher yielding equities. Equities sharply increase in value as a result.

In this scenario, any future stress within global stock markets might emerge initially in the corporate bond space. Two specific concerns have come to the fore in recent months. The first is that the boom in bonds is being fuelled by a very different kind of investor i.e. more fickle investors who could sell out in a future panic. In addition, liquidity in the trading of these bonds might not be strong enough to allow for a sudden sell off, sparking market volatility, which could impact on stock markets.

A recent paper looking at the micro dynamics of the corporate bond markets by analysts at Swiss bank UBS, finds some evidence for these concerns. Called "Macro keys - US Corporate debt", the paper revisits some of the banks earlier analysis and finds that "US corporate credit spreads are near or at post-crisis lows, yields are within 30-50bp of all-time lows and credit market sentiment feels very firm. However, it is precisely these conditions that have raised financial stability questions and the potential risks lurking in US corporate sector".

The UBS analysts specifically worry about the supply of long dated investment grade corporate bonds - they observe that there "has been a material rise in the number of lowest rated companies, with triple C rated issuers doubling to over 1,400. This phenomenon risks material credit losses for markets dominated by smaller issuers (e.g., middle market, private credit) if and when the cycle turns... Historically, strong debt growth has often foreshadowed rising industry stress".

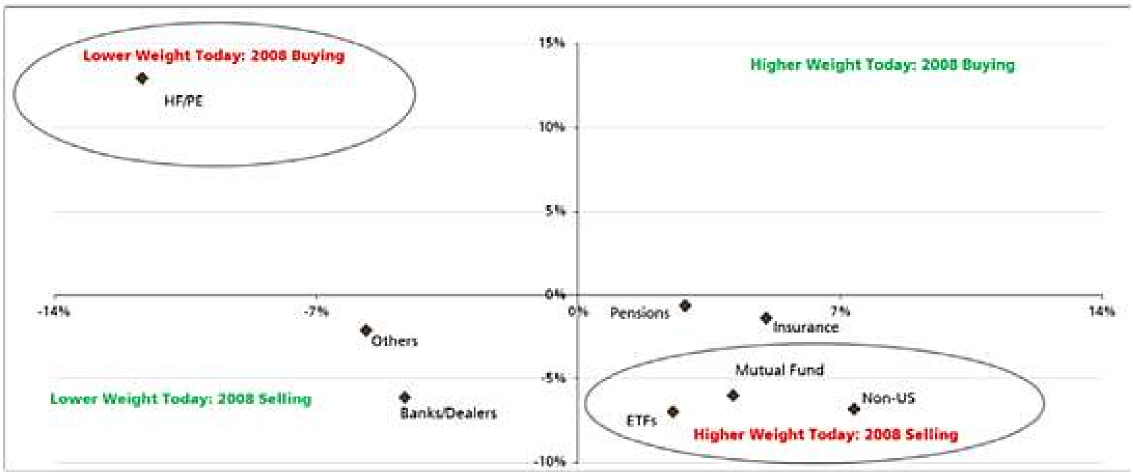
US investment grade, high yield and leveraged loan spreads (bp)



Source: UBS, Yieldbook, S&P LCD

On the demand side, the UBS analysts find that the key marginal buyers are "non-US investors, accounting for about 40% of total flows since 2014. These flows are likely to weaken, not exit - likely compelled by less attractive valuations, hedging costs and rising supply of other assets. Key risks include a material rise in credit risk. Today's ownership structure is not as fragile as the financial crisis, but the accumulation of debt has been concentrated in hands that sold materially during the financial crisis (rest of world, funds, ETFs). And regulation has compromised market-making capacity to handle risk transfer, resulting in illiquidity in stress periods near levels seen in the financial crisis."

Corporate debt accumulation post-crisis has accrued to those who sold most in the financial crisis



Source: UBS, Flow of Funds

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	19.47
Germany	13.38
Japan	27.41
United Kingdom	17.77
Ireland	31.63
Italy	140
Portugal	187
Spain	69.89

Eurozone peripheral bond yields

Country	July 2017	August 2017	Spread over 10 year
Spain 10 year	1.63%	1.44%	106
Italy 10 year	2.26%	2.04%	166
Greece 10 year	5.33%	5.56%	518

	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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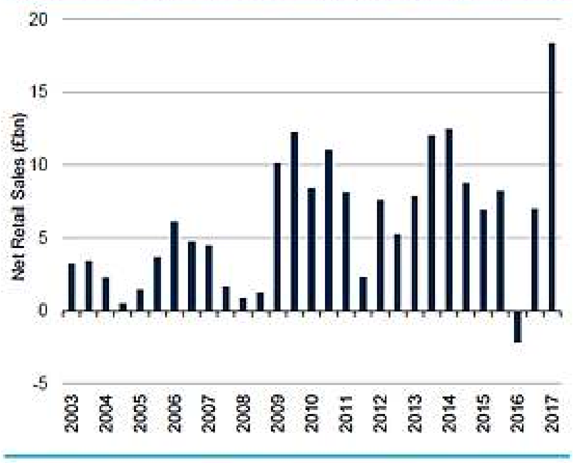
Equity Markets and Dividend Futures

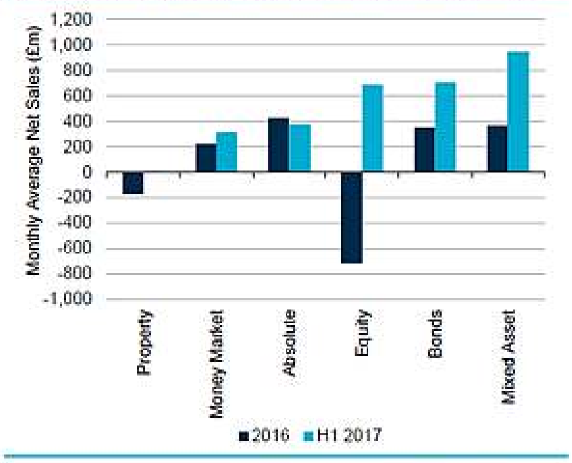
Global equities had another good month in July, leaving the MSCI World index up 2.3% in July, its eighth monthly price rise in a row, its best run since the 2003 recovery and the fourth-longest monthly winning run on record. Not unsurprisingly these strong returns are encouraging private investors to put more money to work in the funds space. According to analysts at Numis there was a record £18.4bn net inflow into open-ended funds from UK retail investors in H1 2017, using figures released by the Investment Association (IA). Net flows were positive into all asset classes with the most significant flows into Mixed Asset (£5.7bn) funds, which experienced a record half for net inflows, whilst Bond (£4.2bn) funds saw the second largest net inflow on record, behind only H1 2009 in the midst of the global financial crisis. Demand for Equity funds recovered in H1, with net retail inflows of £4.1bn following net outflows of £8.6bn during 2016.

Figure 1: Net Retail Sales of Open-ended Funds by Half Year



Note: bars represent half years. Source: Investment Association & Numis Securities Research

Figure 2: Average Monthly Net Retail Sales by Asset Class



Source: Investment Association & Numis Securities Research

Overall, UK investors seem to be favouring global equities in asset class terms - these saw the largest net inflows of £1,875m in H1, followed by North American (£851m) and Japanese (£746m) funds. Sentiment towards European funds has experienced a turnaround, with a net inflow of £571m in H1 2017, after outflows of £3.6bn in 2016. Investor uncertainty about prospects for the UK was reflected by net retail outflows from UK Equity funds of £1.4bn in H1 2017, including UK Equity Income funds, which suffered their largest ever half-yearly net outflow of £389m.

Most contrarians tend to regard this level of fund inflows into risky equities as a strong sell signal - many recent peaks in fund flows have been followed by sharp reversals in key indices. Also, a strong run of positive numbers for the major indices over the summer months is regarded with some suspicion by many contrarians. But according to analysts at French bank SG long positive runs are not necessarily harbingers of impending doom; "of the five winning runs over seven months or more for MSCI World since 1969, returns were still positive a year later. So there is little to fear from a run of gains per se."

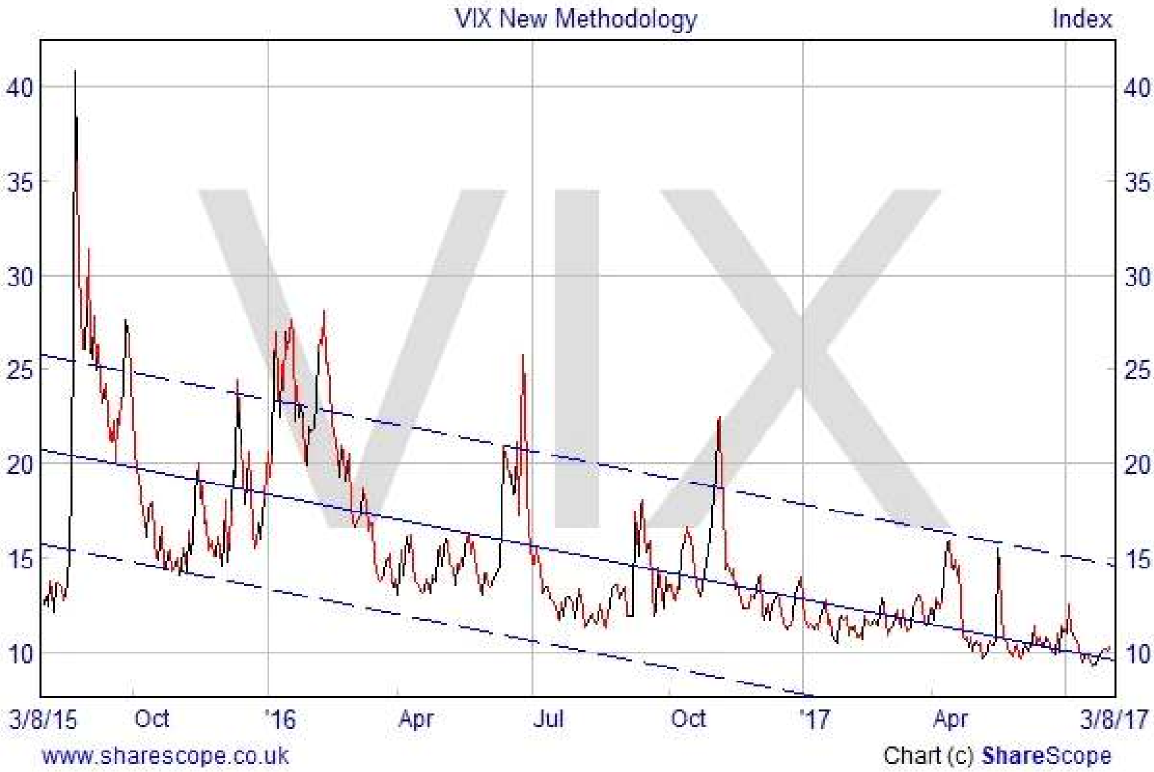
Index	July	August	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	116.8	116.7	3404	115.7
FTSE 100 (Dec 17)	285.8	287.9	7311	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.27	-1.04	0.71	5.72	25.02	41.59	7309.96
S&P 500	0.31	5.1	13.72	13.72	80.41	85.76	2447.83
iShares FTSE UK All Stocks Gilt	2.11	1.18	-5.83	-5.83	9.68	19.84	13.3175
VIX New Methodology	42.42	46.32	32.79	32.79	5.22	-60.23	15.51

Volatility

Regular readers will know that we keep a close watch on measures of equity market volatility, and especially the Vix index - this popular index tracks turbulence for the benchmark S&P 500 index.

Here are some basic facts on the VIX index in recent months: the average level of VIX for this year sits in the lowest 5% in history (since 1991) with the current level being in the lowest 1%. Furthermore, the low of 9.75 this year was the 5th lowest in history, a level last achieved in late 1993. The chart below from Sharescope puts it all in grisly detail. It shows the last two years VIX levels, with trend lines either side. Again, I don't think you need me to repeat the general direction of these trend lines.



On one level, of course, there is no great mystery. Equities markets have been relatively quiet but also buoyant. Thus, Vix has been low. Problem solved. But this rather ignores the underlying reality. Something else 'must be going on' ? One explanation relates to the specifics of the market in Vix options itself. The best explanation here comes from ETF Securities Head of Research James Butterfill. Here's his recent take, in a blog, on what's going on in the market for Vix options. *"Since 2013 a worrying trend has arisen amongst a group of investors who are shorting the VIX. The subdued level of the VIX has likely been driven by investors, on the hunt for yield, motivated by years of loose monetary policy. The steep term structure gives these investors who are short the VIX a yield. According to the CFTC investors are holding record short positions - over 3x standard deviation from its historical range relative to long positions - suggesting shorting the VIX is an increasingly crowded trade.*

"We question how long this can last given the VIX is so low. We also remain concerned that an unwind of this trade will hurt, potentially prompting a VIX short squeeze and the resultant higher volatility prompting a risk asset sell-off. Timing a potential shift in sentiment is difficult although shorting the VIX will become increasingly less attractive every time the US Federal Reserve (FED) increases interest rates. The short VIX yield will therefore look increasingly less attractive as yields in other assets increase with rising interest rates. Conversely, an unexpected sharp move in equities or a significant political event could also precipitate an unwind in short VIX positioning."

Butterfill suspects that investors are becoming much too complacent, especially given how high valuations have become in US equities. An alternative explanation looks to much deeper structural factors. It's a view that I have sympathy with. Might volatility levels be low because investors believe that interest rates will remain low? Another factor could be that central banks are watching the vix as a warning signal. In this alternative explanation, market volatility - or lack of it - is a simple function of central bank balance sheet expansion. Banks buy corporate bonds. This buying helps steady equity investor nerves. Vix remains low. Banks also watch VIX, so that if it pops, they buy more bonds. Problem solved. Research analysts at London based house Cross Border tend to echo this line of reasoning. They also observe that the VIX is not the only volatility measure. Equivalent indexes track bond market volatility along the US yield curve (e.g. the MOVE index) and major currency-crosses (e.g. the CVIX index). Cross Border dubs these, for convenience, respectively, the BIX and FIX. According to Cross Border:

"The BIX, FIX and VIX indexes are: (1) persistent (i.e. they trend for long periods) and (2) they are highly correlated together. Their interaction is complex, but it can be uncovered from a simple Vector Auto-regression model (VAR). This shows Granger causality running from bond market shocks (BIX) to forex shocks (FIX) and to equity shocks (VIX). The VAR also confirms high autocorrelation or persistence for the BIX (e.g. parameter on the previous lagged value 0.852); the FIX (0.904) and the VIX (0.856). This is consistent with regime shifts from periods of high to low volatility." The table below maps out these complex relationships in some simple correlation numbers.

Correlation Between Volatility Measures and Autocorrelation
Monthly 1988-2017

	BIX	FIX	VIX	Autocorrelation
BIX	1.00	0.64	0.78	0.852
FIX	0.64	1.00	0.76	0.904
VIX	0.78	0.76	1.00	0.856

I can't say I'm any expert on auto regression models but I am inclined to agree with Cross Border's bottom line:

"We conclude that a World characterised by: (1) Central Bank 'Forward Guidance' and (2) low credit growth, possibly induced by tighter regulation of banks, there is likely to be low volatility across most asset classes. This backdrop has characterised the last few years and slow policy rate movers and tightly regulated banks were also features of the 1950s and 1960s, when both the MOVE (74.6 vs. 97.3) and VIX (12.2 vs. 16.9) stood well below their entire period averages. For this backdrop to change, we must either see private sector credit growth jump higher and/or Central Bank policy actions deviate significantly away from prevailing market expectations. Such 'shocks' will trigger heightened market volatility. They will come, but until then, expect low volatility to continue."

If you believe - as I do - that we are in a for multi decade low rates environment, then volatility could remain at subdued levels for a very long period of time indeed. As I've said on these pages before, I fully expect US interest rates to get above 2% - and then come crashing down again. Overall, if one believes we are in a sub 2.5% rates environment for the next few decades, then the Vix as an index becomes increasingly irrelevant as a fear gauge.

Measure	August Level	July Level	June Level	May Level
Vstoxx Volatility	21.41	12.84	13.33	14.45
VFTSE Volatility	15.97	9.9	11.6	10.33

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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.

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

Kind Regards,

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