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Monthly Market Report

September 2018

With commentary from David Stevenson

My main worry at the moment is that investors are guilty of an element of cognitive dissonance when it comes to QE and its new, potentially ugly sibling quantitative tightening (QT). The consensus was that QE was a potent tailwind for equity valuations. QT by comparison is shrugged off as 'normalisation'. The always-excellent James Ferguson over at Macro Strategy has recently suggested that this consensus is just plain wrong and that QT will probably result in monetary contraction and declining asset prices. Or as James puts it "QE was inflationary and so efficacious in preventing money supply contraction, thereby pushing up risk assets and long bond yields... it would be irrational not to expect QE do the exact opposite".

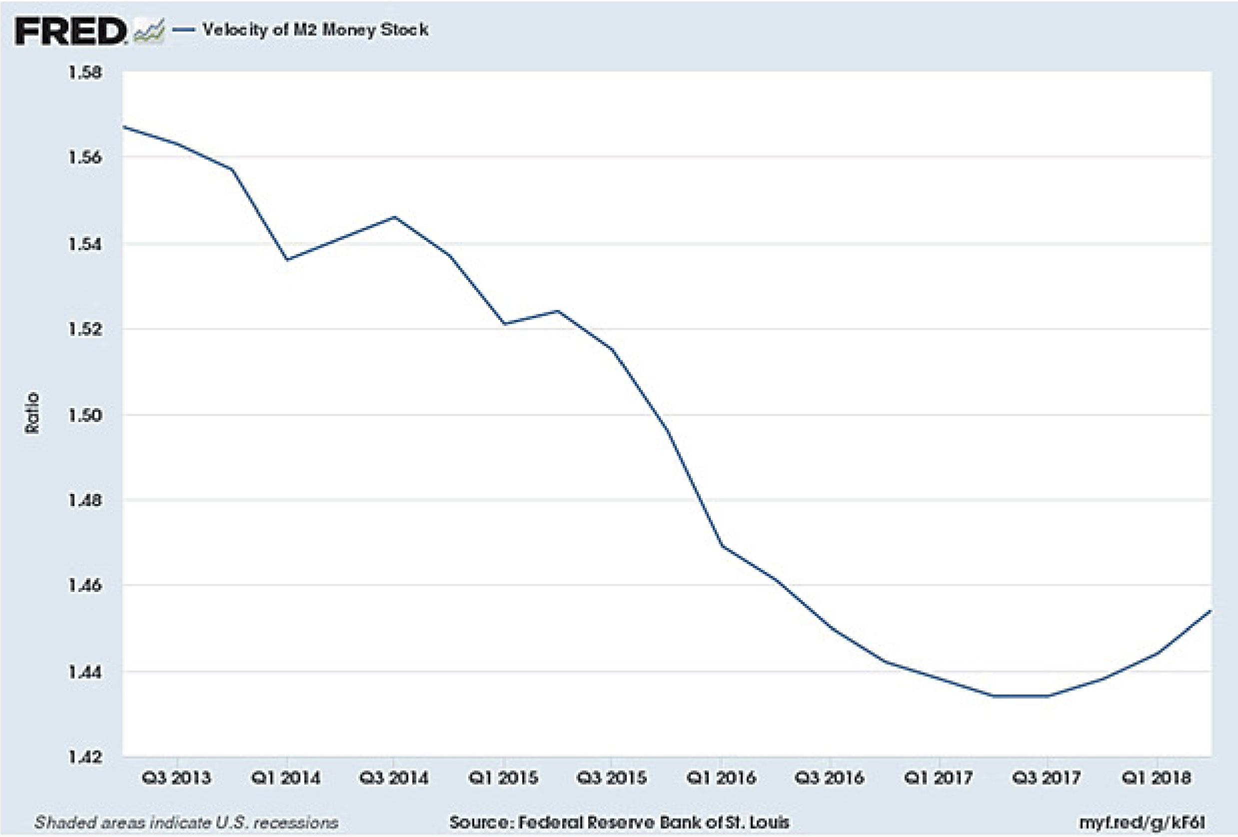
Ferguson calculates that each $100 bn of QE asset purchases "on the face of it boosted equity valuations by +5.7%. We are looking at as much as $320 bn of anti QE through the remainder of this year". On that basis, a correction of 15% is in order i.e. a massive taper tantrum spasm. Investors looking for evidence of a possible bearish turn in sentiment should monitor money supply and bank credit creation. In the absence of QE, bank deposits shrink, loan creation ebbs away and we end up with deflation, defined as a nominal contraction in broad money supply. That makes Treasuries the only sensible investment. By contrast, with QE investors dump safety, chase yield and buy risky assets. So, what's happening with current money supply numbers? Ferguson reports that US M2 money supply is now only growing at 4% per annum, while the broader M2 measure is slightly higher at 4.4% and bank loan creation at 4.2%. These are all well down from recent levels of between 5 to 8% for each measure.

Ferguson concludes that "a large proportion of US QT will feed through directly into a drain on bank deposit liabilities (aka money). Since QT began, broad M3 money supply growth has shrunk from a quarterly annualised rate of +7.1% to a sobering +1.7%". As proof of this link, Ferguson points to recent examples of balance sheet tightening by the Fed which have resulted directly in declining share prices in the last 6 to 12 months.

Stepping back from the inevitable blizzard of charts and macro numbers, an important point emerges. In its dreams, the US Fed may want to sharply increase interest rates but the US economy is now having to fight the headwind of QT. The numbers are huge and despite tax cuts and clearly strong GDP growth, the US financial system can't reach proper escape velocity if the banking and monetary system is in contraction mode because of quantitative tightening.

Sooner or later the US Fed will have to realise that its QT and proposed steady drip feed of interest rate rises is causing real damage to the monetary base of the US economy. President Trump will also be hectoring them about strangling growth and pushing them to be more accommodative. My own view is that we'll see QT stopped in early 2019 and interest rate rises will grind to a halt once they move above 2.25%.

In investment portfolio terms, until this particular penny/cent drops and investors realize that QT will be short-lived, Ferguson contends we should prepare for increased volatility. He reckons US Treasuries are a buy compared to gilts and bunds, with EM stocks also likely to be vulnerable moving forward.



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Headline Numbers

What next for China and its equity markets? It's the big question on most investor's minds as President Trump ratchets up the trade war and Chinese equities sell-off. The omens aren't good. Many economists reckon that the trade dispute could produce a hit on Chinese GDP of 1% and cost 3-4m Chinese jobs, while for the US, the drag on GDP would be more modest at just 0.1-0.2%. Given these fears it should come as no great surprise that the PBoC cut the by 50bp RRR for the largest banks to 15.5% (effective July 5) for the third time this year. Another example of this skittishness is that the People's Bank of China recently announced that it was imposing a reserve requirement of 20 percent on trading of some foreign-exchange forward contracts, effectively making it more expensive to short the yuan. The central bank used the same approach after its 2015 devaluation. Some cynics are now wondering whether the Chinese government might even consider using a Yuan depreciation as a part of its policy armoury if China slows down markedly.

Some cynics wonder.

Albert Edwards at French bank SocGen certainly seems to think so. According to the notoriously bearish SG analyst June saw the largest monthly fall in the Chinese renminbi against the US dollar on record. *"Comparisons are being made with the situation at the end of 2015 and most of 2016, when the markets were continually anxious about Chinese currency policy. Despite the reassuring words from the PBoC, it is difficult to see how, if Chinese interest rates are being slashed, the renminbi can do anything other than fall sharply. Clearly, the fear is that the Chinese authorities are using the weak renminbi as a stick to beat the US with over the trade war".*

Measure	Values as of 13th July, 2018	Values as of 8th August, 2018
UK Government 10 year bond rate	1.27%	1.32%
GDP Growth rate YoY	1.20%	1.20%
CPI Core rate	2.10%	1.90%
RPI Inflation rate	3.30%	3.40%
Interest rate	0.50%	0.75%
Interbank rate 3 month	0.72%	0.81%
Government debt to GDP ratio	85.30%	85.30%
Manufacturing PMI	54.4	54

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Bank CDS options

Pricing for swap options insuring against bank bond defaults generally declined over the last month with some banks notching up big declines - UBS and SocGen in particular saw some very noticeable declines in their swap pricing, along with Credit Suisse. Concerns about risks at German banks also ebbed this month with 1 year CDS rates for Deutsche Bank in particular falling sharply. Most UK bank pricing edged slightly lower with 1 year CDS rates for Lloyds Bank moving back into the single digits. But it wasn't all sweetness and light, with some banks experiencing a sharp increase in CDS pricing, notably Natwest Markets and Investec, both of which saw a sharp increase in their options prices.

Bank	One Year	Five Year	Monthly Change (5yr)	Annual Change (5yr)	Credit Rating (Fitch)
Banco Santander	31.37	53.71	-1.49	19.45	A -
Barclays	37.29	61.28	-5.32	42.84	A
BNP Parabis	16.01	42.25	-25.92	28.48	A
Citigroup	21.25	50.62	-11.30	0.45	A
Commerzbank	19.73	80.66	-11.46	19.86	A+
Credit Suisse	20.99	72.18	-17.88	10.33	A
Deutsche Bank	69.25	141	-20	75.7	A+
Goldman Sachs	20.83	55.5	-14.95	-15.62	A
HSBC	13.92	35.89	-4.54	40.33	AA-
Investec*	n/a	231	n/a	n/a	BBB
JP Morgan	18.42	41.06	-12.84	-12.84	A+
Lloyds Banking Group	9.91	44.26	-1.38	-1.35	A
Morgan Stanley	21.67	54.21	-12.70	-10.12	A
Natixis	17.31	43.29	2.38	26	A
Nomura	13.73	45.58	4.6	11.66	A-
Rabobank	12	37.13	-0.87	35	AA-
RBC*	n/a	65	n/a	n/a	AA
RBS/Natwest Markets	39.02	83.78	22	73	A
Soc Gen	12.98	42.91	-27	22.46	A
UBS	11.96	40.93	-12	55.18	A

Source: www.meteoram.com 3rd August 2018
*Model implied CDS rate is the 5 year model CDS from the Bloomberg Default Risk function

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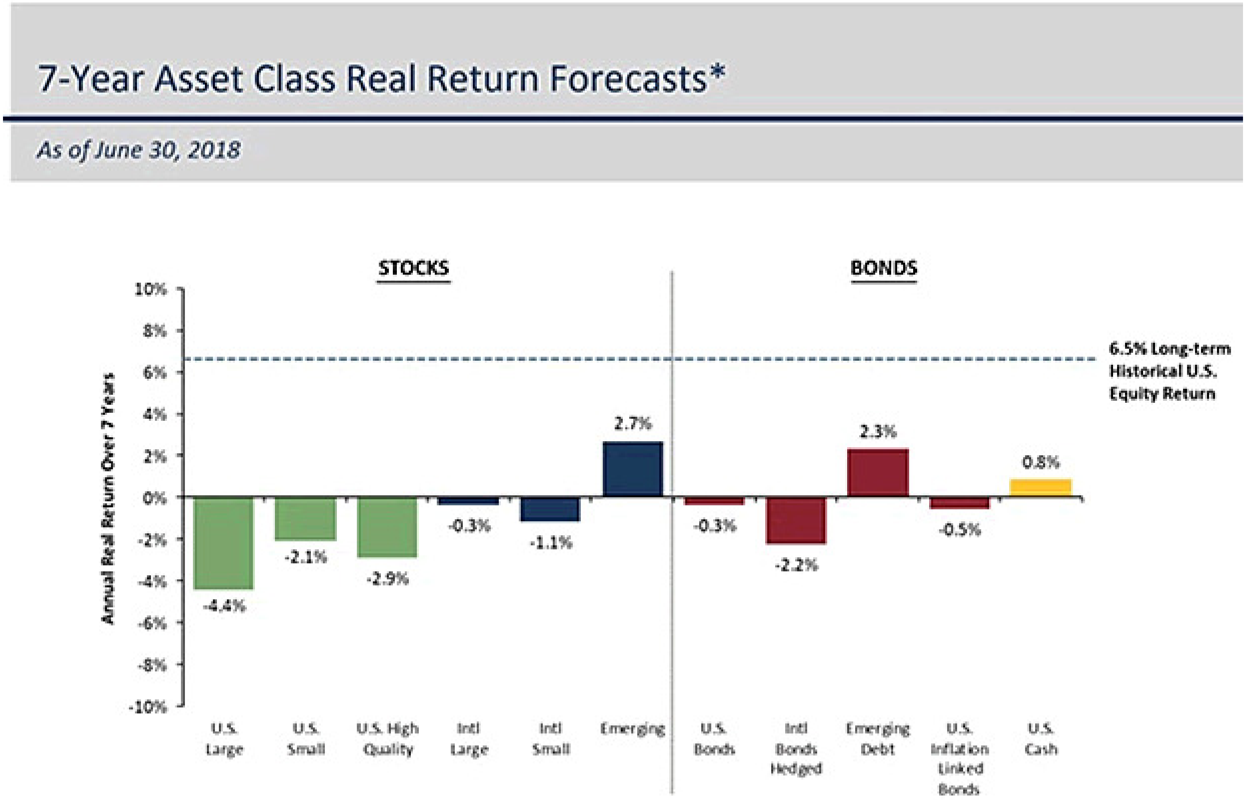
Government Bonds

One is forced to admire the sheer bravado of US fund management firm GMO. They run a fantastic forward model which forecasts asset returns over a grand total of seven years - and they even update it on a regular basis. I marvel at this sort of crystal ball gazing, although one has to caveat it by saying that it only looks at fundamentals and then projects forward likely returns. According to GMO likely returns from US equities are looking fragile (well below the long-term average) but interestingly EM equities are looking more compelling. According to GMO *"returns in the U.S. equity markets will be far below the 6.5% long-term historical average. Investors seeking higher yields should look to emerging markets, as the only asset class expected to deliver any real value over the next 7 years. GMO has revised its forecast for emerging market equities from 1.0% annual real return over the next 7 years in January 2018 to 2.7% in June 2018. It has also increased its forecast for returns on emerging debt, from 0.6% annual real return in January 2018 to 2.3% in June 2018".*



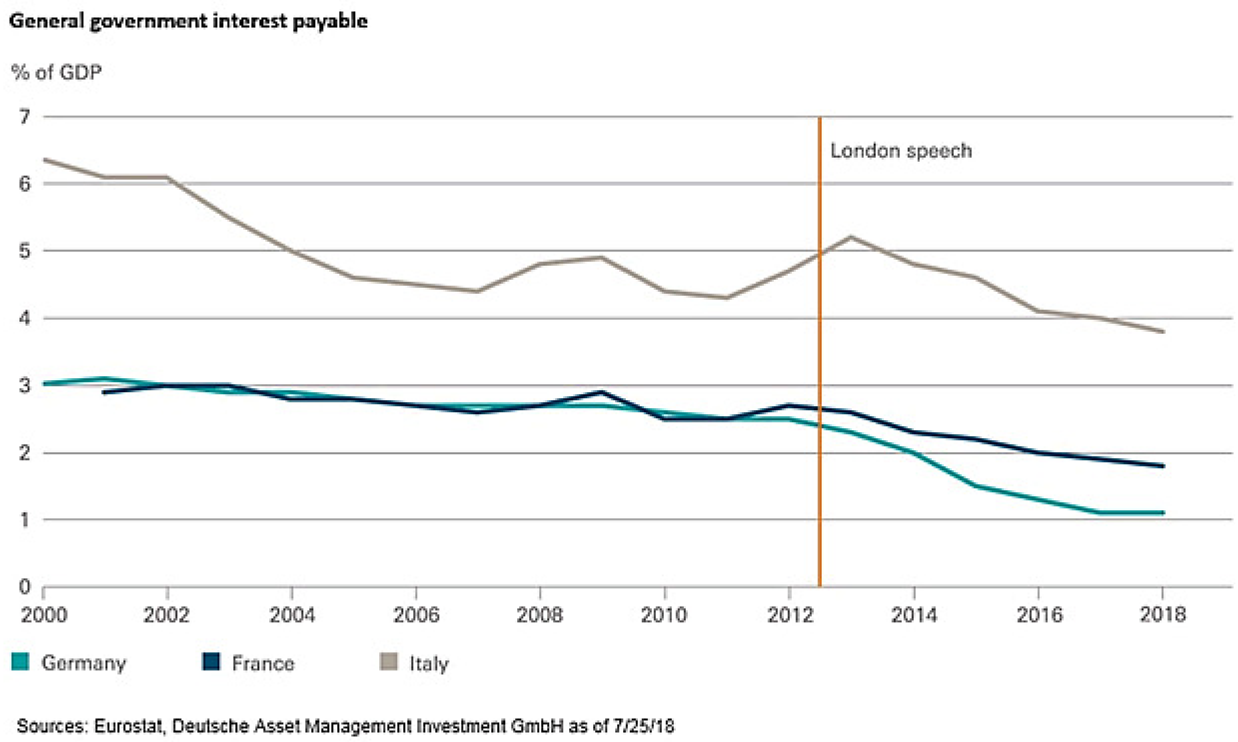
Fixed Income

Those of us worried about the hangover from the global financial crisis tend to focus our concerns on the steadily increasing global mountain of debt. In this narrative we are supposed to be only midway through a massive expansion in corporate/state balance sheets and debt levels. Or are we?

Invesco reckons there might be some good news on that ***global debt mountain***. They've crunched recent BIS numbers and they reckon that the global debt burden declined in 2017. "Having risen from 172.1% in 2001, the global nonfinancial sector debt-to-GDP ratio declined from 219.5% in 2016 to 218.3% in 2017 - the first such fall since 2010". Invesco notes in particular that there have been big declines in the Netherlands, Belgium and Spain (all with declines in the debt/GDP ratio greater than 10 percentage points). The bad news is that the US managed a slight decline, largely down to the corporate and public sectors, while China's debt barely changed during 2017. The biggest rise came in Brazil (a gain of 2.6 percentage points, moving it up the global rankings from seventeenth to sixteenth).

Those numbers from Europe suggest that some countries might have learnt their lesson after the global financial crisis. And what's generally true is that interest servicing costs have declined dramatically for what's left of the mountain of debt.

Deutsche Bank reminds is that it is now exactly six years ago that European Central Bank (ECB) President Mario Draghi made the famous pledge in London that the ECB would do "whatever it takes" to maintain the unity of the Eurozone. This speech marked an important turning point in the crisis.



Deutsche observes that since then risk premiums have declined and financing conditions have eased again. This is particularly true for public-sector debt. The chart above demonstrates this easing - Italy now spends about a third less on servicing public debt (compared to GDP) than in 2000. According to Deutsche, this is all the more remarkable given that Italian public debt has increased from 105% to 132% of GDP over the same period. The German finance minister and his French counterpart have had to allocate less money to servicing interest payments in their budgets, too."

The downside is that "the boundaries between economic, fiscal and monetary policy have become blurred to an extent we could not even have imagined 10 years ago. This further complicates fiscal and monetary policy in the already complicated post-crisis period. At some point in the future, that could well give us a headache. More progress, notably on the integration of European capital markets, would be highly welcome."

UK Government Bonds 10-year Rate 1.32%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	25.95
Germany	10.12
Japan	24.25
United Kingdom	24.05
Ireland	30.57
Italy	230
Portugal	101
Spain	65

Eurozone peripheral bond yields

Country	July 2018	August 2018	Spread over 10 year
Spain 10 year	1.26%	1.40%	100
Italy 10 year	2.56%	2.85%	245
Greece 10 year	3.85%	3.99%	359

	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

Equity markets' mood is difficult to gauge as we head into the summer. Some macro numbers suggest that profits growth is stalling - but for every negative set of numbers another positive bunch help steady investor confidence. Take the all-important subject of ***corporate profits***. We are nearly half way through Q2 European earnings season and according to analysts at HSBC they look "set to deliver another underwhelming result. Just 53% of companies so far have beaten analyst expectations for EPS, down from 56% in Q1. If maintained, this will be the lowest proportion of beats since Q4 2015. This leaves FY 8.5% EPS growth expectations vulnerable. We forecast 5%. Digging beneath the surface highlights domestic names as the main source of weakness - just 49% exceeded estimates vs 56% for more global names. We believe this trend will continue. European activity continues to disappoint, and HSBC sees just 1.9% GDP growth in 2018. Cost pressures are also rising."

Sector-wise, Consumer Staples have led the way with 89% beats, and HSBC has raised Food & Beverages to overweight, from neutral. On the macro level, the world's local bank now forecasts that the euro will "continue to weaken, reaching 1.13 by year-end, and this will provide a further boost to exporters. We are underweight Europe ex-UK, neutral UK and overweight Switzerland."

Back in the UK though there's some good news on ***UK dividends*** - Link Asset Services says that "UK dividends surged 7.1% to a record £30.7bn on an underlying basis in Q2 of 2018. Meanwhile, headline dividends dropped 2.1% year-on-year to £32.6bn owing to sharply lower special dividends than a year ago". Other key findings include:

- Underlying dividends (excluding specials) surged 7.1% to record of £30.7bn
- Headline dividends dropped 2.1% year-on-year to £32.6bn owing to sharply lower special dividends than a year ago
- Dramatically stronger mining dividends and lower-than-expected exchange-rate penalty explained the strong performance
- Underlying growth forecast raised to 6.9%, bringing a total £94.1bn for the full year
- Headline growth forecast raised to 3.2% bringing the total to £97.8bn for 2018, a new record

So, underwhelming European corporate earnings and abundant UK dividends - not a completely dire picture.

Index	July	August	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	125.8	125.9	3498	126
FTSE 100 (Dec 17)	307.3	308	7743	n/a

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	1.6	2.3	7.94	2.61	18.5	32.4	7739
S&P 500	3.57	6.98	10.7	15.5	68.4	104	2858
iShares FTSE UK All Stocks Gilt	-0.2	0.555	2.24	-0.417	15.4	8.66	13.14
VIX New Methodology	-15	-23	-66	2.83	-11.5	-26	11.27

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Volatility

In volatility terms July was another unremarkable month - we're back to the Great Moderation again. US equity risk actually declined, market volatility fell, and dispersion increased. Correlations also declined.

I find the gold markets much more interesting as a measure of market concerns. If investors are secretly worried about Trump and a Trade War, none of these concerns are showing up in the precious metals market. Gold is threatening to flatline, again. In fact, the gold market had dropped almost 8% since April, which coincided with surging momentum in the U.S. Dollar Index. Evidence of this retreat from fear is all over the place. Commerzbank for instance has reported outflows of gold from exchange-traded-fund vaults which seem to have continued into early August. "We envisage significantly higher gold prices by year's end, though for this to happen, the ETF outflows would also have to end, which has not been the case so far," Commerzbank says. "Following outflows of over 29 tonnes in July, holdings have already been reduced by more than eight tones in the first days of August."

This bearish view on gold is reflected in futures markets as well. Fund managers increased their net bearish positioning in gold futures, according to the most recent weekly data from the Commodity Futures Trading Commission. The CFTC's "disaggregated" report showed that managed-money accounts upped their net-short position in gold futures to 36,422 contracts from 26,449 the week before. Total shorts rose by 12,447 lots and outpaced the fresh buying, with the latter reflected by an increase of 2,474 gross longs.

But not everyone thinks that gold is doomed. A few analysts reckon the bearishness is overdone. One of them is Bernard Dahdah of Natixis who back in late June suggested we should expect material weakness in the U.S. dollar in September, which should support gold prices through to 2019. "We see the dollar remaining firm until September, at which point the ECB is expected to announce monetary policy normalization. The dollar could even remain stronger into 2019 if the euro is penalized by uncertainties caused by Italy or Brexit," he said in his June report. "That being said, in our central scenario we see downward pressure on the dollar by the end of 2018 as other central banks begin to normalize their monetary policy." The French bank sees gold trading in a range between $1,200 and $1,450 an ounce next year. The Natixis analyst isn't alone. Metal Bulletin precious metals analyst Boris Mikanikrezai reckons at the "present juncture, sentiment in the gold market looks excessively bearish, which is unsustainable". He reckons the bears have over stretched themselves, with a big snapback reversal imminent. "In my view, bears are playing with fire at this juncture, and some of them are on the verge to get burnt," according to Mikanikrezai.

Measure	August Level	July Level	June Level	May Level
Vstoxx Volatility	12.66	13.65	14.45	13.68
VFTSE Volatility	11.44	11.3	13.4	12.53

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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.

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