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Monthly Market Report

April 2021

With commentary from David Stevenson

I suspect that most sane investors are currently engaged in an exercise of mental pass the parcel. We will all happily engage in the bullish enthusiasm but we're all wondering when it might end - and which suckers will get left the overpriced parcel. The chief mechanism for a retreat has already been discussed on these pages - which is that the real-world economy is powering ahead, diverting ready cash from investors pockets to spend on real-world goods, services and cruise trips. And we will also see central banks begin to moderate their cash infusions, whilst also prompting investors to worry about rate rises at some point. One useful way of gauging this potential turning point is to look at news flow indicators. SocGen's strategists have their own proprietary indicators which are currently flashing... well... amber if not quite red. According to SG *"Our global economic newsflow indicator (ECNI) has reached its highest level in seven years, supporting an optimistic growth outlook. Meanwhile, with the indicator only 7% below its all-time high in May 2013 (just before the taper tantrum), we can rightfully ask the question if the best part of the recovery is already behind us?" The SG strategists don't quite answer in the affirmative but its clear they are starting to get more cautious, although, like me, they think we could still see more bullish euphoria. "Currently, our global economic newsflow is only 7% below its all-time high, a point that was reached just before Bernanke triggered a taper tantrum in 2013. Meanwhile, the global policy mix remains super expansionary. In this context, we continue to believe that our economic newsflow indicators can potentially reach levels similar to previous highs. But even then, 93% of the global newsflow recovery would already be behind us."*

SG Global Economic Newsflow Indicator (ECNI) is only 7% below its previous peak

Source: Datastream, Dow Jones, SG Cross Asset Research/Global Asset Allocation

But we cautious types also need to be a tad careful. It's all good and well us saying that we are worried but what might actually happen as a catalyst to stop the positive momentum? Charlie Robertson, chief economist at Renaissance very rationally asks *"why will this stop? Central banks are not going to raise the cost of borrowing from zero in 2021-22 so for the next two years at least, where do you get income/yield? Maybe markets just have to drive prices until they get to unjustifiable levels that force a correction (like oil did at $147 in 2008). Even with US stocks at a p/e of 36 and people citing Buffett's market cap to GDP ratios (equalling the highest ever in recent decades) this looks like it has further to run - especially as the Austrian minded bears who post this stuff .. clearly haven't capitulated yet."*

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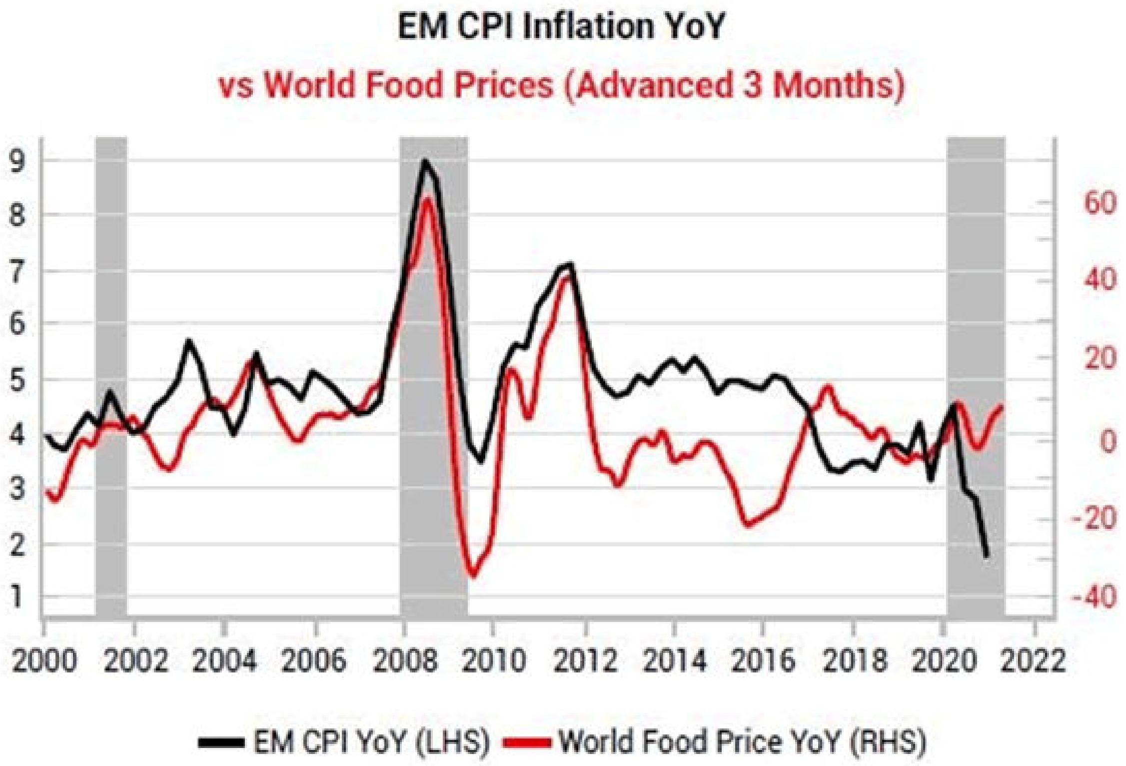
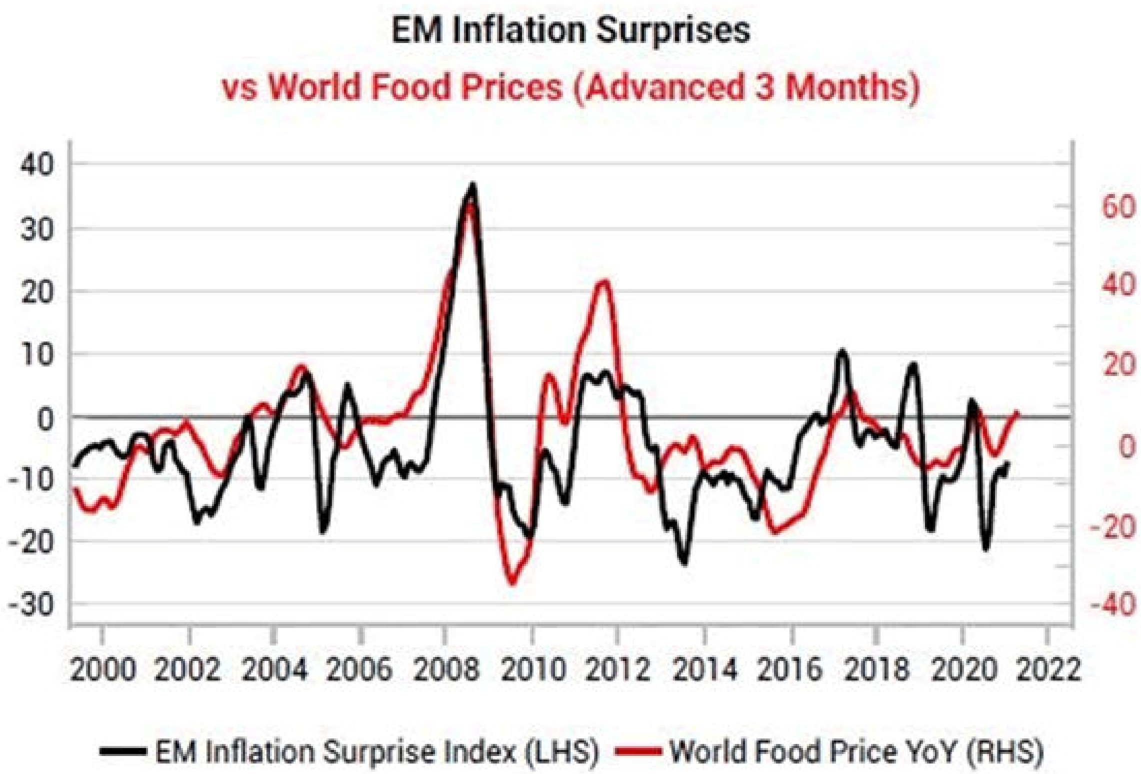
Headline Numbers

Another month and another sign that inflation is starting to re-appear in the global economic system (unsurprisingly it must be said given the likely pace of recovery). The latest report comes courtesy of the excellent Variant Perception newsletter HERE and its focus is on food inflation. In the US, food, and beverage directly account for about one-sixth of the CPI basket by weight, but in many EM countries, the weighting is in the range of 30-50%.



Charts Source: Bloomberg, Macrobond and Variant Perception



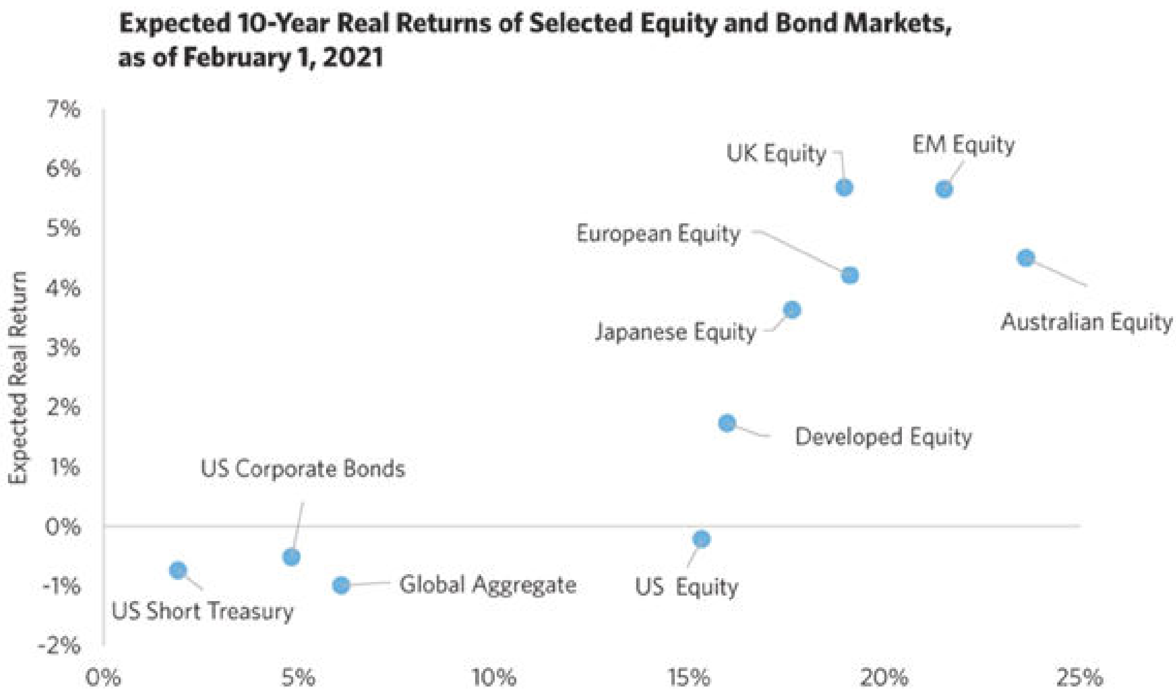
Charts Source: Bloomberg, Macrobond and Variant Perception

According to Variant Perception *"Due to the lockdown recession, the underlying resilience of food inflation is being masked, with a notable divergence between EM CPI and food prices at present. The concern is that later in 2021, as global economies recover and re-open, the EM inflation picture could change rapidly as cyclical inflation comes on top of food inflation. We are also tracking Chinese food prices closely in case food inflation there spills over into global food prices.*

Historically, China's food CPI and global food CPI have been closely correlated, but the relationship has broken down in recent years due to China's struggle to contain African Swine Flu, which has caused huge moves in pork and meat prices. The combination of coronavirus disruptions and African Swine Flu drove China's food CPI to 20% during the depths of their pandemic."

Value in the UK - "trade of the decade"

Analysts at US firm Research Affiliates have spent much of the last decade thinking through the idea of value investing. They are also usually fairly considered and cautious about their analysis but a comment from earlier this month really struck me as unequivocal. In a comparative piece looking at how economies are recovering from the pandemic - it's entitled "How COVID-19 Vaccines and Brexit Create the Trade of the 2020s" and it's by Rob Arnott, Vitali Kalesnik, and Lillian Wu HERE - they suggest that their top target is Europe and especially the UK which they think is the TRADE OF THE DECADE! *"Around the globe, value is trading at extremely deep discounts relative to growth. The discounts are wide no matter how we measure valuation. While we still like our last-named trade of the decade, emerging markets value stocks, the UK equity market, and UK value stocks in particular, are now even cheaper. With the final Brexit deal done and the rapid COVID vaccination rate in the United Kingdom, the outlook for UK value is extremely promising, enough for a "trade of the decade."*



Measure	Values as of 12th February, 2021	Values as of 4th March, 2021
UK Government 10 year bond rate	0.45%	0.73%
GDP Growth rate YoY	-8.60%	-7.80%
CPI Core rate	1.40%	0.70%
RPI Inflation rate	1.20%	1.40%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.05%	0.07%
Government debt to GDP ratio	80.70%	100%
Manufacturing PMI	54.1	55.1

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Bank CDS options

An exceptionally quiet month in the market for insuring against bank defaults. Looking at the major systemic banks in the list, there were a few very marginal increases almost matched by equally marginal increases. No particular pricing on any bank stood out except that pricing for 1 year credit default swaps on Lloyds Bank increased notably, though from a very low level.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.89	32.29	A	A2	A -
Barclays	13.46	42.71	BBB	Baa2	A
BNP Parabis	6.92	26.63	A+	Aa3	A+
Citigroup	25.54	52.43	BBB+	A3	A
Credit Suisse	14.74	44.59	BBB+	Baa1	A-
Deutsche Bank	37.16	92.53	BBB+	A3	BBB
Goldman Sachs	26.63	56.42	BBB+	A2	A
HSBC	10.23	29.14	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	24.6	45.46	A-	A2	AA-
Lloyds Banking Group	7.66	27.77	BBB+	A3	A+
Morgan Stanley	30.21	53.42	BBB+	A1	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	11.04	38.62	BBB+	Baa1	A-
RBC	18.03	53.52	AA-	A2	AA-
Soc Gen	8.43	27.53	A	A1	A-
UBS	7.63	25.79	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st March 2021 www.tempo-sp.com

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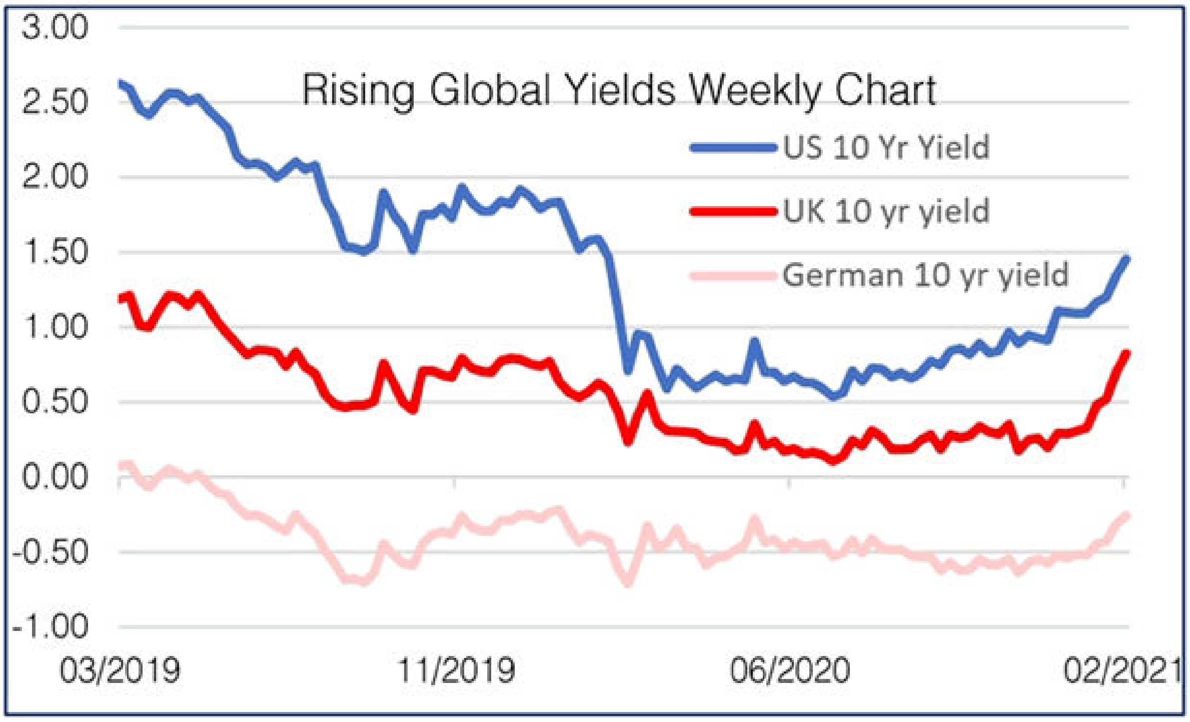
Government Bonds

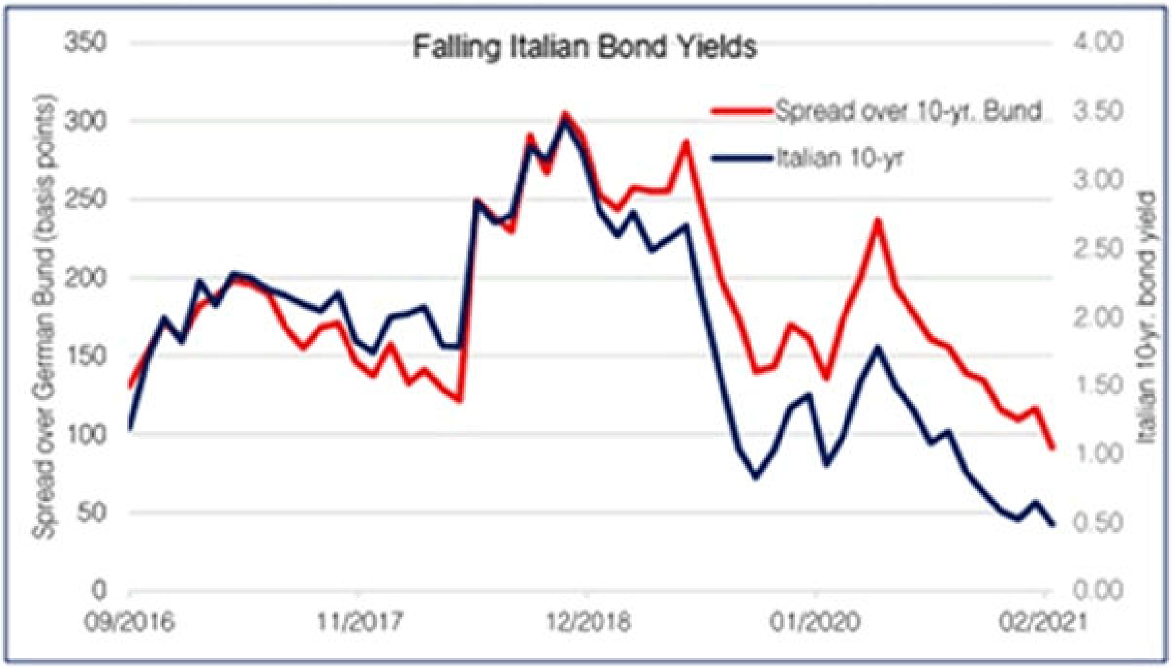
Fixed Income

In recent weeks Bond prices have fallen sharply and long-term yields have risen markedly, with the UK gilt market, in particular, leading the way.



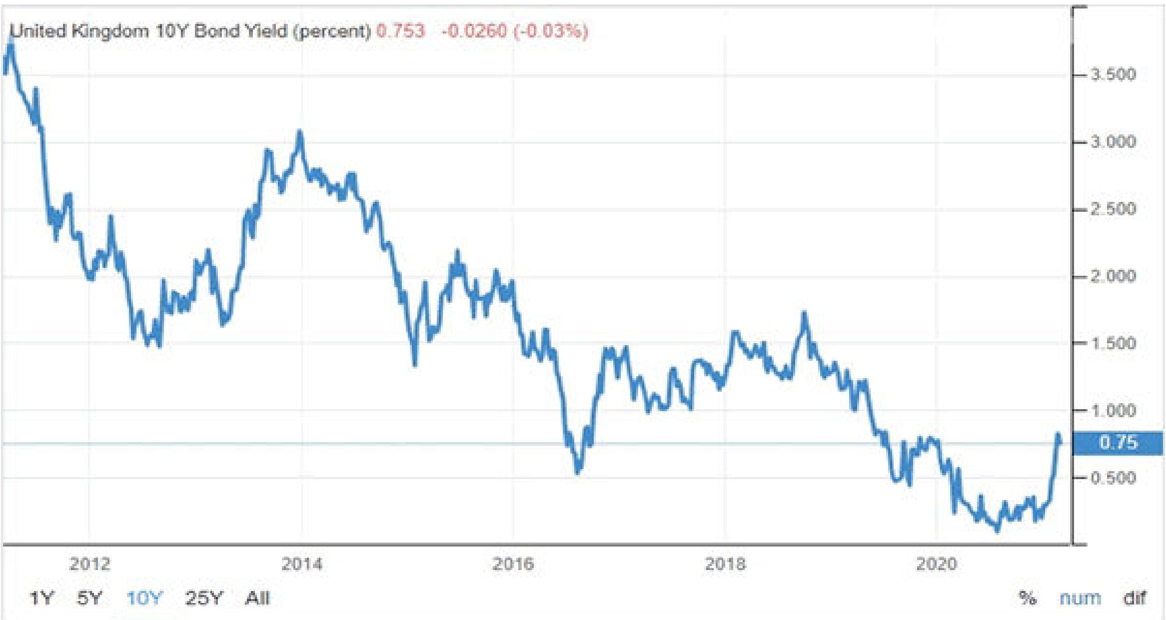
As Gerry Celaya, chief strategist at investment research firm Tricio reports these sharp moves are putting real pressure on traditional 60/40 portfolios, especially if they are jam-packed full of UK equities and gilts. He observes that the FTSE 100 12 month change is still around -8% (ex-dividends) and "if gilt holdings are taking a knock, the portfolio effect is not clever. Taking the iShares IGLT ETF as a proxy and the 7.1% tumble so far this year is wiping out much of the 2020 8.2% total return. Bond investors need to take stock and consider whether the recent bond market shakeout will consolidate over the rest of H1 2020 and beyond or if this is a trend move that will require moves along the curve (duration management) or reduction of holdings."

But one country is bucking the trend - Italy, where 10 year bond yields have been falling aggressively.



The chart shows the Italian 10-year bond yield versus its German peer. According to Gerry Celaya, "they are showing some really optimistic expectations over Italian debt risk. Italian 10-year bond yields are hitting all-time lows below 0.5% while the spread over the German bund yield is cracking below 100 bps." Berar in mind 10 years ago that Italian yield was 7.5% and the spread 500 basis points. That said, I think one can argue that In a negative-yielding world, then 0.5% isn't bad. Gerry reckons that that spread could even compress below 80 basis points which I think is completely possible, implying that the 10-year bond yield could crash closer to 0.20%.Gerry rightly in my view concludes that " this is going into 'lofty' investor sentiment territory and is worth watching as another indicator to gauge 'overdone' investor optimism. " Keep watching that Italian 10-year bond yield for hints of market volatility.

UK Government Bonds 10-year Rate 0.73%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	15.54
Germany	10.07
Japan	14.94
United Kingdom	15
Ireland	14.09
Italy	73.72
Portugal	30.74
Spain	34.32

Eurozone peripheral bond yields

Country	February 2021	March 2021	Spread over 10 year
Spain 10 year	0.13%	0.37%	68
Italy 10 year	0.48%	0.74%	105

Greece 10 year	0.76%	0.96%	127

	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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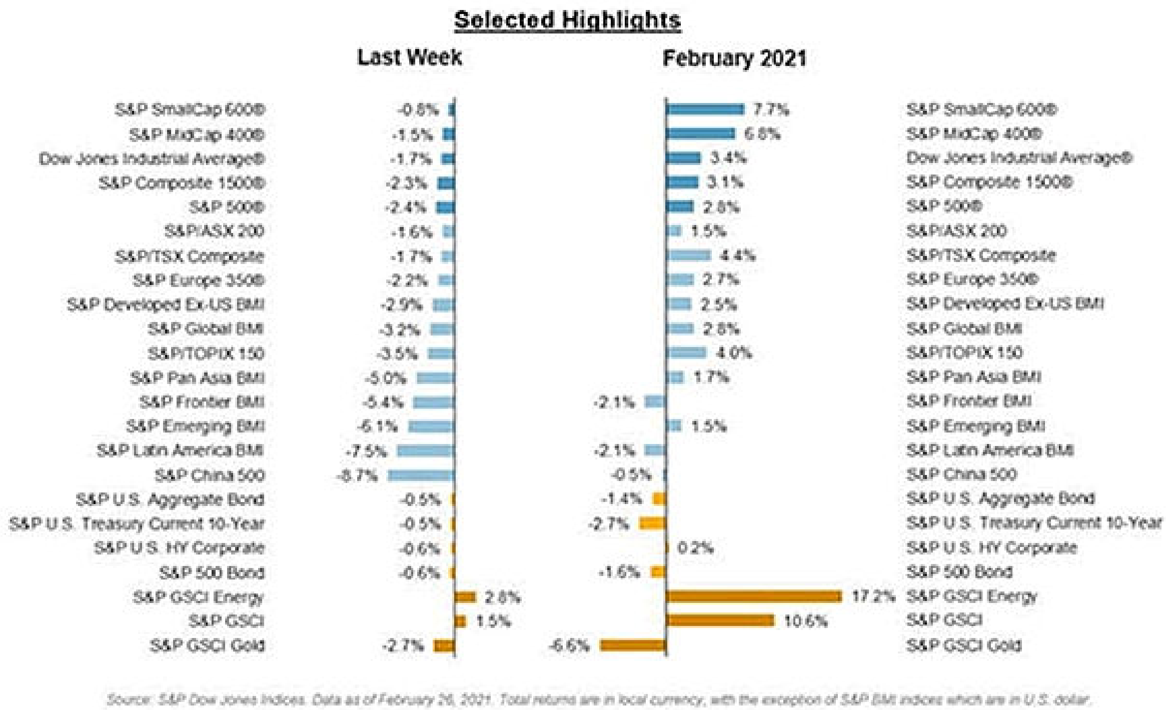
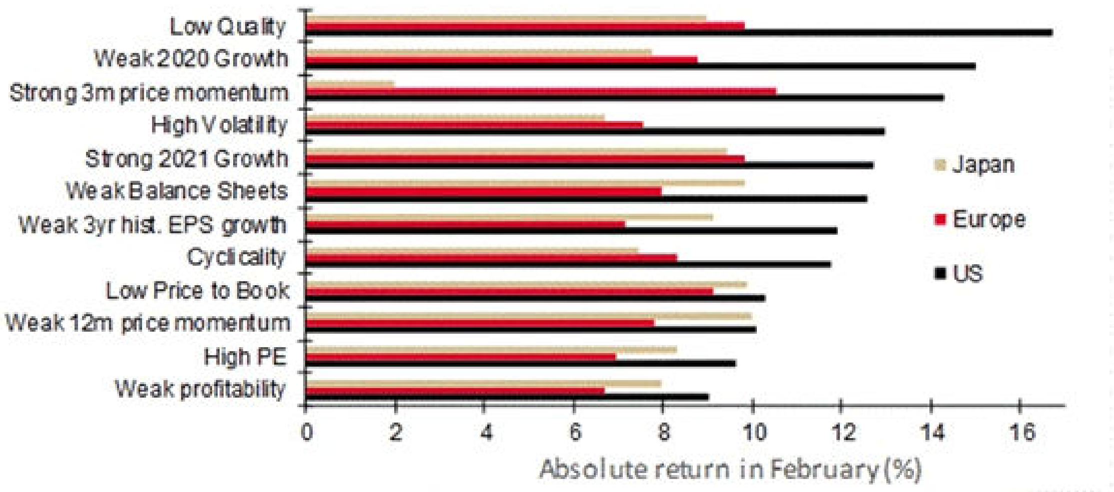
Equity Markets and Dividend Futures

February was another good month for stockmarkets. Analysts at SG report that *"Global equity markets ended February with a gain of 2.5% for MSCI Developed and a 0.7% rise in Emerging after a hefty sell-off over the last week, which saw EM give up 6.3% and Developed drop 2.8%. Nasdaq fell 4.9% over the last week but rallied to end the month slightly up 0.9%. Sector-wise the message was as clear as can be, with Industrial Metals & Mining up 12.5% in February, followed by a 7.0% gain in Oil, Gas & Coal stocks. Travel & Leisure also saw strong gains with a 12.7% gain and with bond yields up and the yield curve steepening financial sectors also put in a good showing with global banks up 9.8% and Life Insurance adding 8.3%. The biggest losers included Alternative Energy which fell 9.6%, Pharmaceuticals off 3.7% and Consumer Staples with Personal Care down 4.5% and Beverages off 2.8%. The message then is cyclical risk-on and bond risk off, which is no surprise given the moves in government bond yields so far in 2021."* According to Tim Edwards, Managing Director, Index Investment Strategy at S&P Dow Jones commodities saw the largest gains, *"with the price of oil leading the charge for S&P GSCI Energy (+17%). Meanwhile, smaller firms continued to outperform in the U.S. as the S&P SmallCap 600® and S&P MidCap 400® gained 8% and 7%, respectively, compared to the S&P 500®'s February rise of 3%."*



In terms of factor styles, SG analysts report that the clear winner was low quality stocks with the greatest returns during February, followed by those companies who had the worst profits growth during 2020. But *"value factors are not necessarily the winners on an absolute basis here. Yes, relatively they will do well as bond-proxies and growth stocks de-rate, but courtesy of the rally seen so far, many recovery names are no longer cheap, or their earnings are still depressed. So, while the low price to book factor is doing well, stocks with high PE s are also doing well, which is why the Value factor is not performing quite as strongly as you might expect."*

Best performing factors during February (absolute returns, ranked by US factor returns)



Source: SG Cross Asset Research/Equity Quant Research, Factset

Index	February 2021	March 2021	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	94	93.9	3704	83.5
FTSE 100 (Dec 19)	228.5	226	6650	208.5

Note changed to Dec 2021 contracts in January 2021

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	2.26	1.54	14.7	-2.42	7.28	-3.88	6650.88
S&P 500	-1.65	2093	11.1	21.6	90.4	81.4	3807.68
iShares FTSE UK All Stocks Gilt	-3.21	-4.16	-5.49	-4.49	9.21	12.9	1386.75
VIX New Methodology	22.5	28.3	-13.3	-16.6	58.2	87.4	26.67

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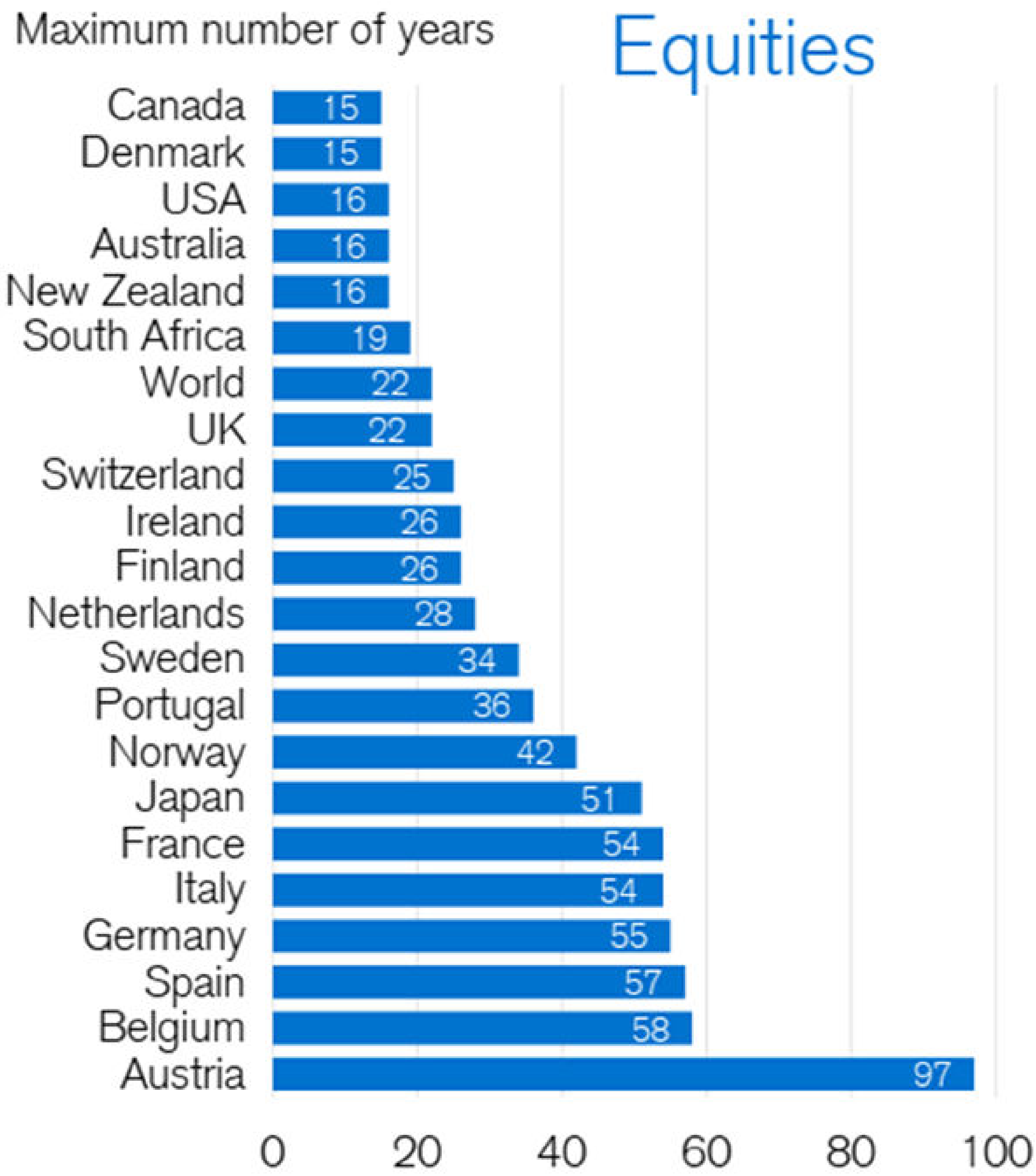
Volatility

Credit Suisse has just brought out its excellent Global Investment Returns Yearbook for 2021 by academics Elroy Dimson, Paul Marsh and Mike Staunton and as always, the weighty tome has a wealth of fascinating data on market trends. Next month I will return with some more data driven gems but for now I wanted to pull out their historical data on market volatility. Two charts stand out. The first one below looks at the longest periods of real return drawdowns between 1900 and 2020. It wouldn't surprise you to know that the US - along with Australia - has been the lucky market with a maximum of only 16 years, while the UK is closer to the middle of the pack at 22 years. But just look at the Teutonic world - Germany at 55 years and Austria at a staggering 97 years.



The second chart looks at measures of implied volatility over the period from 1986 through to 2021. The simple message is that volatility spikes appear at irregular intervals and are hard to predict. Most of the markets are usually calm, but when volatility does spike, they tend not to be too prolonged. According to the Credit Suisse report on average it takes only 88 trading days for the Vix to mean revert. Note though that the Covid 19 emergency has still not quite reverted to the mean though it's not far off.

Measure	March Level	February Level	January Level	December Level
Vstoxx Volatility	22.1	21.21	21.41	20.82
VFTSE Volatility	26.16	21	23.33	21.28

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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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Kind Regards,

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

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UK Structured Products Association, 1A All Saints Passage, London, SW18 1EP