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Monthly Market Report

April 2022

With commentary from David Stevenson

The average UK citizen has a take-home income of around £30,000 or £600 per week. If we are to believe the stories emerging of $200 a barrel oil and much worse, then I think it perfectly reasonable to presume that the average consumer might face extra domestic costs of at least £1000 to £3000 a year in extra energy costs. That's a material impact on the 'average' consumer and of course, excludes all the other inflationary extra expenses. In these circumstances, I think it safe to assume that the 'average' UK citizen will face a 2 to 5% squeeze on their living standards. That is a material amount of money and I suspect that it will result in a meaningful reduction in expenditure on 'less essential stuff' such as holidays, streaming services, and restaurants. Add it all up and I think it augurs strongly for an impending recession.

That's certainly what the stock markets are telling us. Last week analysts at Deutsche Bank observed that equities are now *"pricing in a significant slowing in macro growth. The S&P 500 in our reading is now in line with an ISM around 48. European and Japanese equities are also pricing in a significant slowing in growth, while EM equities have been declining in line with slowing growth. US small caps on a relative basis are pricing in a severe recession (ISM at 40)."*

How will this impact stock markets? The obvious answer is badly. One can easily imagine all those upbeat cyclicals in the travel sector suddenly feeling battered and bruised again. But investors might also start to worry that big financials could be in the firing line. My guess is the extent of the decline will be dependent on what happens to interest rates in the US. If they go up by more than we all expect, then the pain could be very real. Then again, central bankers might also be nervous of over-doing to rates rises. I'm inclined to agree with the strategist David Rosenberg who thinks that recent events might make the "situation might be too fragile for the Fed to embark on an interest rate tightening cycle, namely "the Nasdaq, S&P 500, Dow and Russell 2000 are all below their 200-day averages and if this continues, this would be the first time (data back to 1980) that the Fed would start to hike with all four composites below the 200-day trendline."

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Headline Numbers

One saving grace for investors worried about surging commodity/energy prices is that just as oil prices look like they might top $150 a barrel, we can rely on the shale gas/oil producers in the Permian and beyond to ramp up production.

According to Guinness and its specialist energy equities team, this might not be the case this time around. They've previously gone on record as forecasting that US shale production might experience moderate growth of around 0.75m b/day versus 2021. Their latest analysis form a few weeks back suggests that even this might be a stretch - *Latest data from the EIA for oil production indicates that US onshore production rose by 0.13m b/day in November, bringing the year-on-year increase to a paltry 0.54m b/day. They also report that Shale producer messaging has so far been mixed, with major producers Chevron and Hess providing production guidance for 2022 below market expectations. Their conclusion? "Noting that there will be some fraying at the edges, overall we expect capital discipline to be maintained this year among US onshore producers, with a continued emphasis on dividends, buybacks and debt paydowns."*

That's bad news for the rest of us.

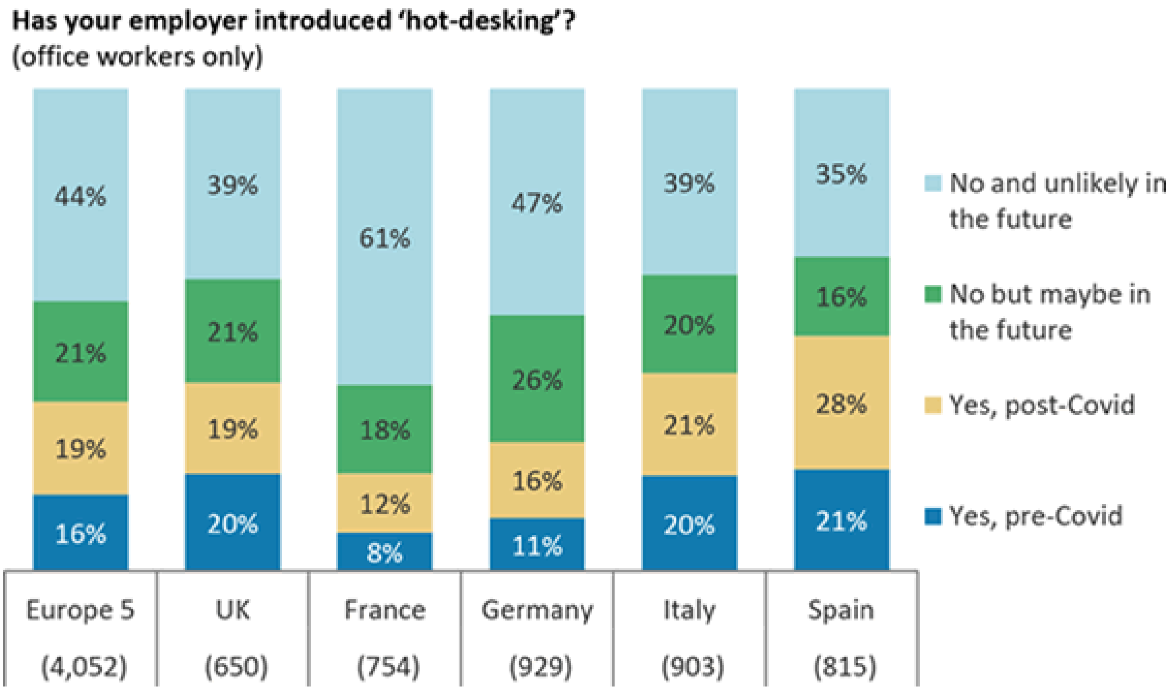
But surely the other big oil market player, Saudi Arabia, will swing into action? The chart below tells us why this confidence is misplaced. It's from Trading Economics and shows Saudi oil production. Now, if you were an optimist, you might think that our strategic allies the Saudi's might be tempted to drastically increase oil output and help curb the price rise in oil.

Think again.

Notice how gentle is the increase in output. Put simply, the Saudis are failing us and themselves. The current oil price will a) push the global economy into recession and b) accelerate the determination of more countries to ditch hydrocarbons long term and switch to other power sources. But the Saudi's and OPEC + don't seem to care. More fool them.

A large part of the capital tied up in the UK stockmarket is invested in real estate either via funds or developers. Overall, sentiment towards REITs remains bearish. And for good reason, because the great work from home is still playing out. Morgan Stanley property analysts have been running a constant series of flash reports on the work-from-home shift. Keeping track of this seems to be a crucial way of working out what might happen to quality UK commercial REITs. The latest report - the 17th survey since Covid began - argues that **desk-sharing has more than doubled since Covid started.**

"...Around one fifth of office workers said their employers have introduced 'hot-desking'/desk-sharing since the pandemic began, while 16% said they were already sharing desks pre-Covid ; another fifth think their employers may introduce it in the future. Office workers currently sharing desks work from home more on average (2.1 days/week) than those without a desk-sharing policy (1.4 days/week). And 'hybrid' workers that want to spend more days at home seem more willing to share desks at work in return... Average time in the office reduced last month, from 3.6 days/week to 3.2 on average, which in our view reflects some impact from Omicron and the holiday season, making it more difficult to extrapolate latest figures into the future: 33% of those working from home one day or more say they are doing so due to employers' decisions, up from 26% last wave. However, hybrid working continues to dominate, with over half (54%) of respondents working from home saying they now have a hybrid working policy."



Measure	Values as of 14th February, 2021	Values as of 11th March, 2021
UK Government 10 year bond rate	1.50%	1.54%
GDP Growth rate YoY	6.50%	6.50%
CPI Core rate	5.40%	5.50%
RPI Inflation rate	7.50%	7.80%
Interest rate	0.50%	0.50%
Interbank rate 3 month	0.86%	1%
Government debt to GDP ratio	94.9%	94.9%
Manufacturing PMI	57.3%	58%

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Bank CDS options

As you'd expect rates for credit default swaps moved up noticeably pretty much across the board (bar for Nomura) over the last month. The conflict in the Ukraine has obviously unnerved investors and some of the sharpest increases were in rates for European (and especially French) banks, while rate increases for US banks was rather more restrained.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	15.29	45.79	A	A2	A -
Barclays	25.93	57.38	BBB	Baa2	A
BNP Parabis	18.01	42.81	A+	Aa3	A+
Citigroup	38.03	78.33	BBB+	A3	A

Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	43.62	97.94	BBB+	Baa1	A-
Deutsche Bank	42.52	108.41	BBB+	A2	BBB+
Goldman Sachs	36.54	81.29			A
HSBC	16.61	39.46	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	35.16	66.47	A-	A2	AA-
Lloyds Banking Group	16.59	39.79	BBB+	A2	A
Morgan Stanley	40.11	79.32	BBB+	A1	A
Natixis	15.5	36	A	A1	A+
Nomura	18.06	71.4	BBB+	Baa1	A-
RBC	20.46	60.64	AA-	A2	AA-
Soc Gen	19.49	52.37	A	A1	A-
UBS	15.39	36.78	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st March 2022 www.tempo-sp.com

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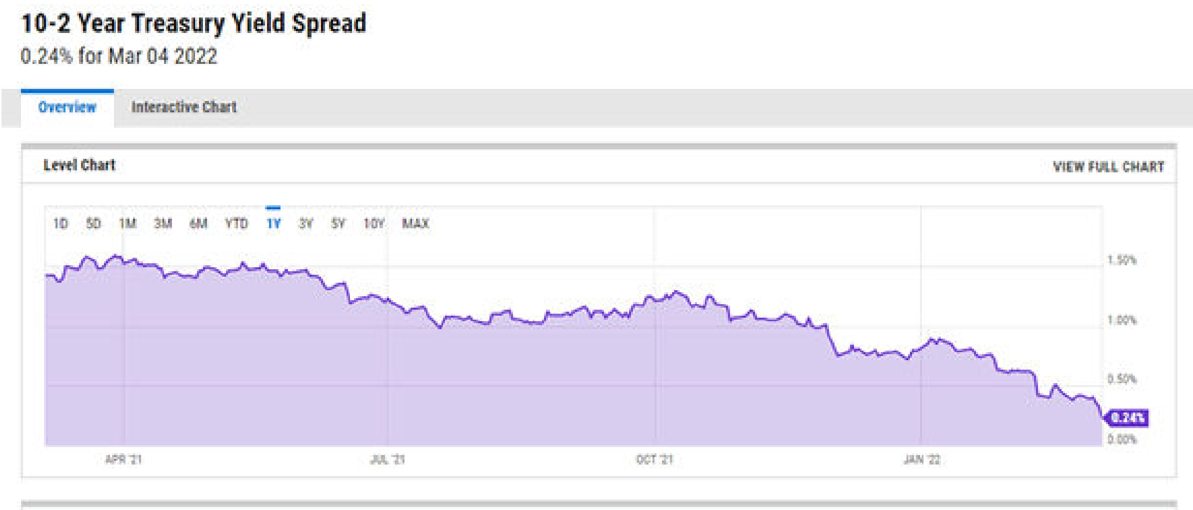
Government Bonds

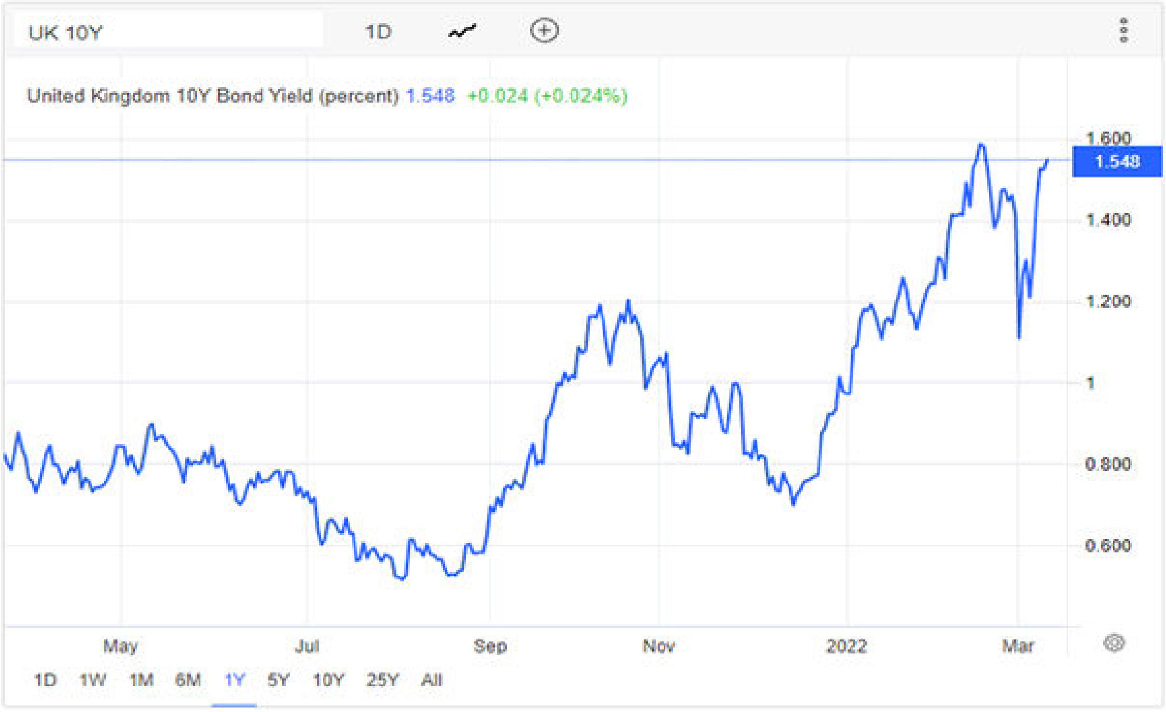
Ominous signs from the bond markets about a possible impending recession. The chart below shows the govie spread, which as of today, has dropped sharply to 0.24%. As long as we're above 0 we're probably not actually in a recession but by god, we are moving aggressively closer to that point. By now the lights are flashing red for recession. And if that is the case then I think we can expect another 5 to 5% off the global developed world stock markets with even bigger declines for emerging markets.

The Govie spread



I'd also draw attention to some harp moves in the German government bond market. For much of the last few years German bunds were trading with a negative yield but that has now reversed sharply and German ten year bonds are now trading with a 0.30% yield. That's also mean that the spread between Italian, Spanish and Greek bonds and the German bond market has tightened very considerably. Lastly I would also note that the cost of insuring German government debt via CDS products has nearly doubled in the last few weeks.

UK Government Bonds 10-year Rate 1.54%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	26.1
Germany	17.4
Japan	18.9
United Kingdom	15.84
Ireland	21
Italy	100.9
Portugal	42.8
Spain	43.8

Eurozone peripheral bond yields

Country	February 2022	March 2022	Spread over 10 year
Spain 10 year	1.15%	1.30%	99
Italy 10 year	1.90%	1.92%	161

Greece 10 year	2.59%	2.60%	229

	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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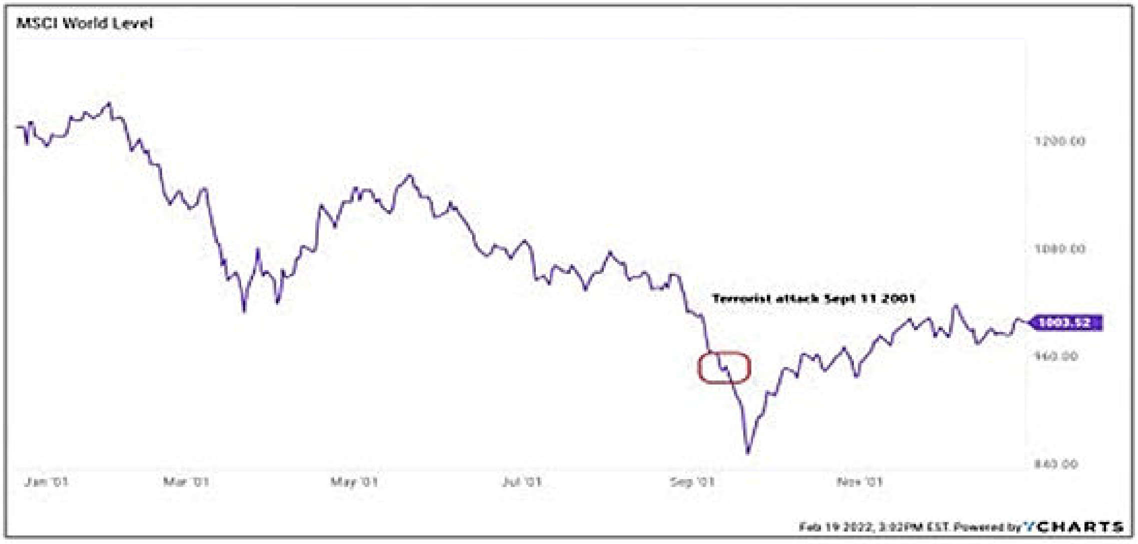
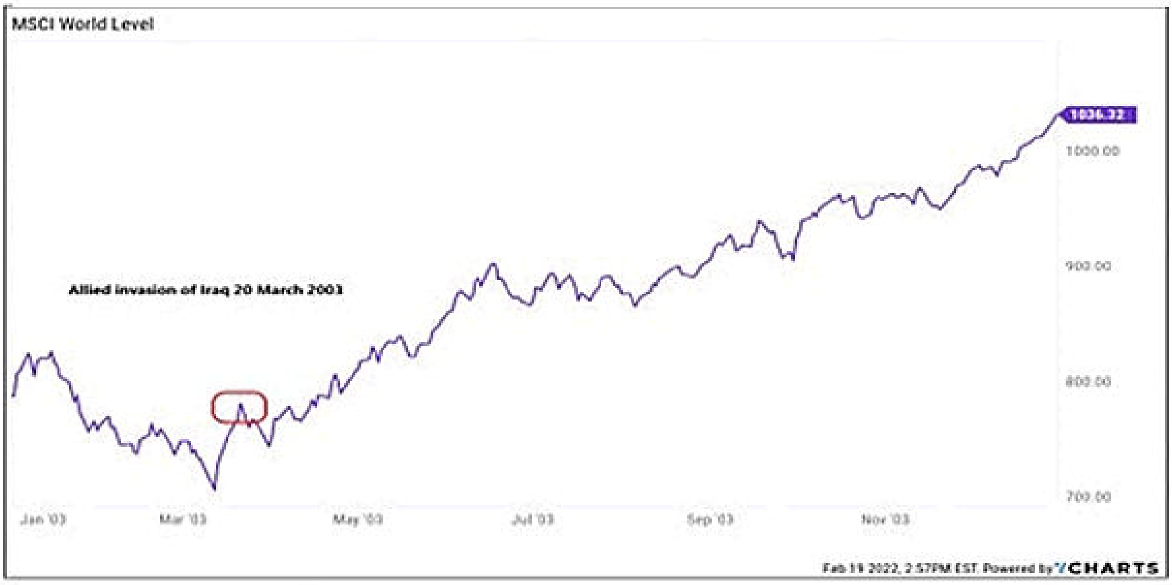
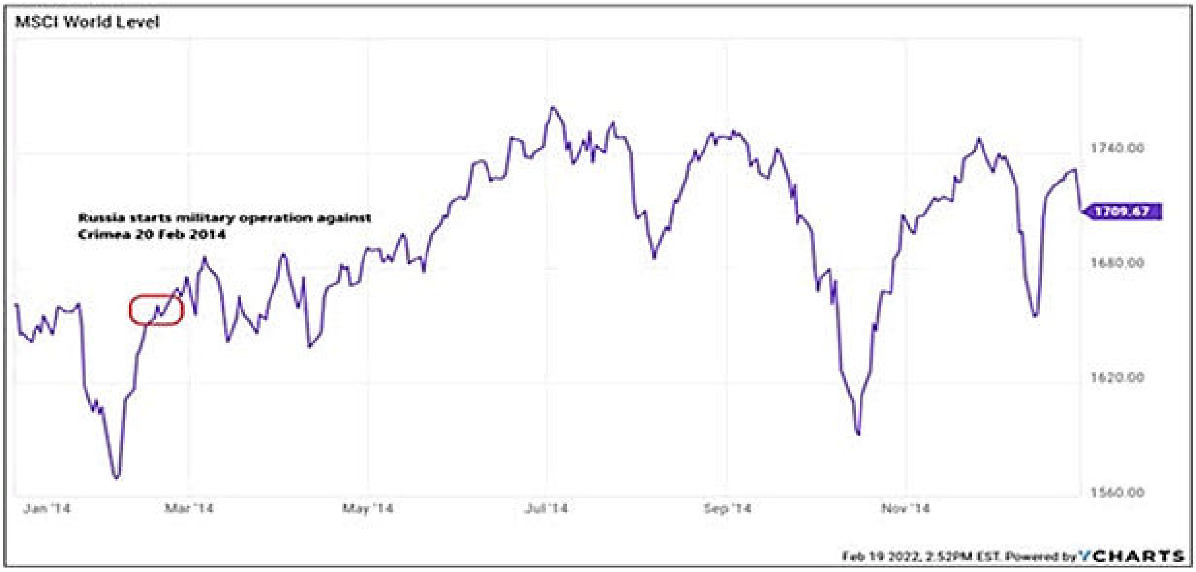
Equity Markets and Dividend Futures

Events in the Ukraine have mightily unsettled investors but most studies suggest that this turbulence is usually short term in nature. A recent note from analysts at Killik and Co nicely sums up this optimistic narrative. Their key point is that these geopolitical events have a "surprisingly short-lived" impact. By way of evidence, the three charts below show the performance of the broad-based MSCI World index following the September 11th terrorist attack, the Allied invasion of Iraq, and Russia's annexation of Crimea in 2014.







In the 9/11 incident "the market had recovered its losses in little more than a month".

The key message is that these events don't always have a longer-term impact - *"during the last 10 years the MSCI World index has corrected by at least 10% on nine previous occasions, yet as of today, it has delivered a total return of over 180% over the same period."*

Will it be different this time? I have my suspicions it will be.

Index	February 2022	March 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	120.7	117	3760	101
FTSE 100 Dividend Dec 2021	270.2	260.3	7199	243.5

Note changed to Dec 2022 contracts in January 2022

Name			Price % change				Volatility	Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	20 day observations	
FTSE 100	-5.83	-1.06	2.64	7.09	-1.75	17.5	1.95	7214.58
S&P 500	-3.6	-9.6	-4.46	8.13	79.5	111	1.56	4259.52
Gold Composite (Most Traded)	8.59	12.1	11.6	16.1	66.1	59.9	1.31	200040 ¢
iShares FTSE UK All Stocks Gilt	-0.621	-9.74	-8.17	-6.54	-1.58	2.76	1.07	1298.88p
VIX New Methodology	10.5	61.7	44.3	38	159	83.2	8.9	30.23

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Volatility

Volatility as measured by the Vix - which tracks the ups and downs of the S&P 500 - has continued to trend much higher in recent weeks. The chart below shows the Vix since summer 2021, with the blue line the 200 day moving average, the red line the 20 day moving average. Looking further back at the last ten years, the Vix has tended to top out at around the 40 index level with only a massive spike above 80 during the early days of the panic. So perhaps we've seen the worst of the US market volatility though I suspect we are still in a very unstable market which has no sense of direction, except maybe on a downwards trend.

I'd also observe that the key measure of Eurozone equity market volatility, the Vstoxx, is currently substantially above the Vix at 38 basis points. That means European stocks are seen as more volatile than US stocks which is somewhat curious given the lower valuation multiples attached to European listed businesses. Might we be seeing the start of another US versus Europe performance gap open up, again?

Measure	March Level	February Level	January Level	December Level
Vstoxx Volatility	38.91	32.85	20.27	30.06
VFTSE Volatility	30.23	27.36	19.4	30.67

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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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