



Monthly Market Report

April 2023



With commentary from David Stevenson

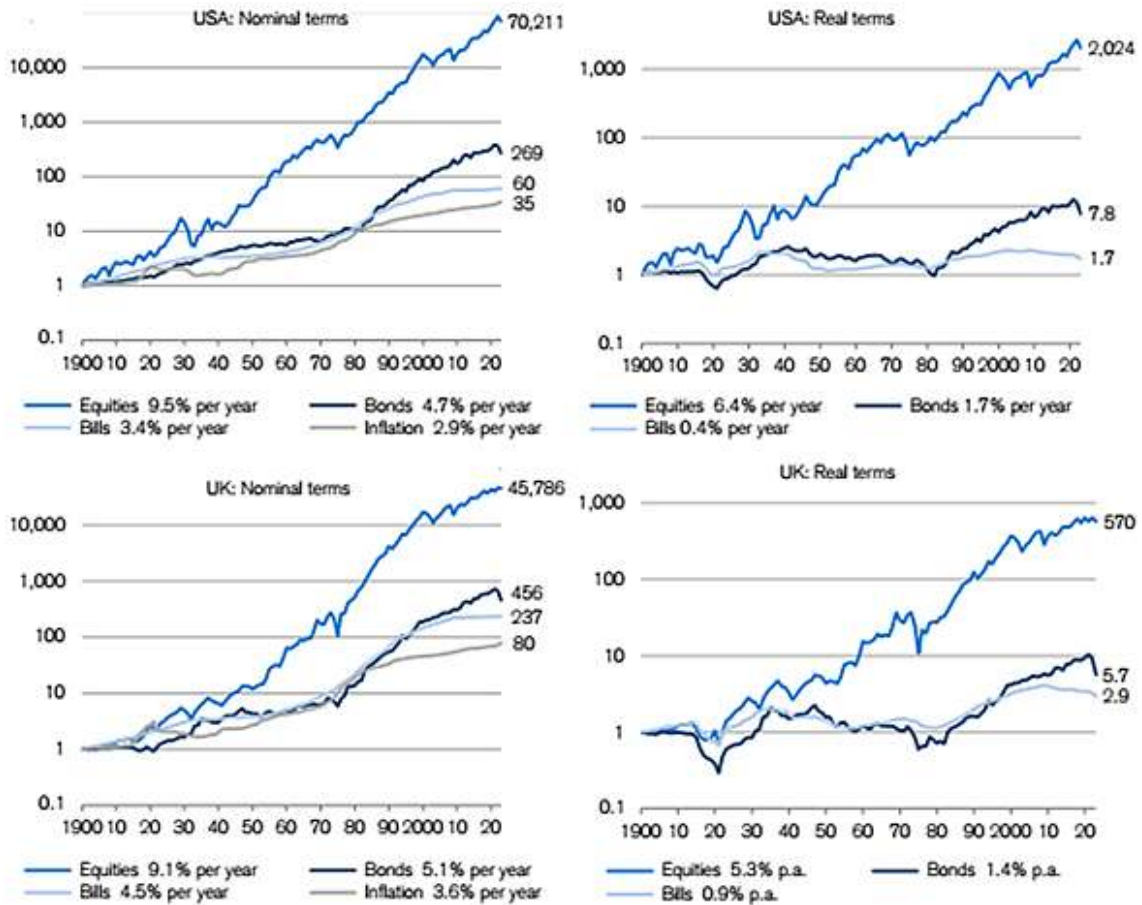
Long term returns

For those of us sad dismal types who like pouring over long term historical studies of investing and economics (!), the end of February is something of an exciting time. It's when the latest Credit Suisse Global Investment Returns Handbook is released, based on data from a bunch of academics led by Elroy Dimson and Paul Marsh. The message is nearly always the same - that over the long term (many decades), equities provide superior returns. Or to be more precise that over the last 123 years, global equities have provided an annualized real USD return of 5.0% versus 1.7% for bonds and 0.4% for bills. In fact, equities have outperformed bonds, bills and inflation in all 35 markets studied by the academics.

Since 1900, world equities outperformed bills by 4.6% per year and bonds by 3.3% per year. All this mining of the financial data produces one key conclusion : that prospectively, the equity risk premium might/will be around 3.5%, a little below the historical figure of 4.6%. That said 3.5% isn't all bad : with a 3.5% premium, equity investors would expect to double their money relative to short-term government bills in 20 years.

The other fascinating insight is into individual national markets, with more than a few (Russia and China spring to mind) providing proof that investors can in some circumstances lose everything. As for the winners? Since 1900, Australia has been the best performing stock market in real USD terms with an annualized real return of 6.43%, very closely followed by the USA, at 6.38%. Currently though the US stock market accounts for 58% of total world value (on a free-float, investible basis), which is over nine times as large as Japan, its closest rival. The USA also has the world's largest bond market.

Cumulative returns on US and UK asset classes in nominal terms (left); real terms (right), 1900–2022.

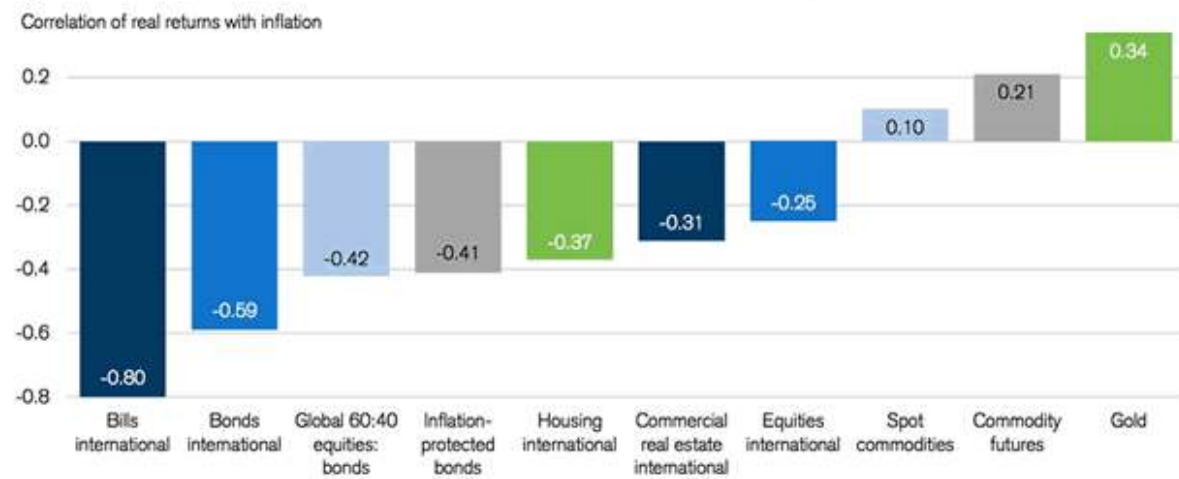


Sources: Ekroy Dimson, Paul Marsh and Mike Staunton, DMS Database 2023, Morningstar. Not to be reproduced without express written permission from the authors.

This year's report also contains an in depth analysis of another key topic - inflation and the returns from various financial assets. The chart below shows the correlation between annual inflation and real asset returns from 1900 to 2022 (note inflation-protected bonds, commercial real estate & gold have later start dates). Unsurprisingly, the major asset classes - bonds, stocks, and real estate - tend to fall when inflation rises, while commodities have shown the ability to hedge against higher inflation.

I would add one caution - this kind of analysis isn't great when we face a wildly turbulent inflation landscape i.e., where rates swing from double digits down to single digits within a year. The analysis is more useful for sustained bursts of inflation.

Figure 78: Correlations between inflation and real asset returns for a range of asset classes, 1900–2022



Source: Analysis by Elroy Dimson, Paul Marsh, and Mike Staunton; the data is for the period 1900–2022 except for inflation-protected bonds, commercial real estate and gold. For equities, bonds, bills, inflation and the 60:40 global portfolio the data are from DMS Database 2022, Morningstar; the inflation-protected bond returns are for UK index-linked gilts from 1981–2022 computed by Elroy Dimson, Paul Marsh, and Mike Staunton; housing returns are the average correlation across 11 countries using updated series from Elroy Dimson, Paul Marsh, and Mike Staunton, Global Investment Returns Yearbook 2018 (for full sources, see Box 4, page 75 of that volume); commercial property data is for 17 countries, with the UK data taken from the MSCI (formerly IPD) UK Annual Property Index from 1971–2022, the USA data from the NCREIF indices (averaged across categories) for 1978–1998, linked into the FTSE EPRA NAREIT US index from 1989–2022, while the data for the other 15 countries are from the FTSE EPRA NAREIT indices, mostly starting in 1989; the spot commodities correlation relates to the equally weighted portfolio of spot commodities constructed from 29 individual commodities with the data taken mostly from Global Financial Data (see Table 15 above); the correlation for commodity futures relates to the equally weighted index constructed by Bhardwaj, Janardanan and Rouwenhorst (2019) and updated by SummerHaven Investment Management as described above; the gold data is for spot gold over the post-Bretton Woods period from 1972–2022 and is from the World Gold Council. Not to be reproduced without express written permission from the authors.

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Headline Numbers

Although most investors seem to be obsessing about bank runs and what the US Federal Reserve might do next to interest rates, I find a more interesting and rewarding exercise is to keep tabs on how corporate earnings are evolving. The \$64 trillion question in this regard is whether US corporates in particular are starting to see profits - and sales - fall away. In this pursuit for insight one can throw around all sorts of data points but sometimes the most interesting revelations come via anecdotes. On this score analysts at Deutsche Bank have usefully pulled together a summary of management commentary from over 130 earnings calls in the Q4 reporting season. Here's their summary:

"There is still a wide spectrum of views on growth and demand trends. While several companies mentioned weakening demand, these largely fall into now familiar buckets: those suffering a reversal of the pandemic boom; those seeing inventory destocking as goods spending as well as supply-chains normalize; and those hurt directly by higher interest rates such as in housing. However, most companies fall into the camp of being constructive but nervous, and even as they

see robust demand, they are wary of macroeconomic uncertainties and pencilled in a modest recession into their planning. Concerns about European growth linger despite the recession reprieve, but companies look forward to reopening tailwinds in China. The dollar remained a massive headwind in Q4. Contrary to the message from the US payrolls report, companies broadly report that the labour market has become significantly easier for them to navigate, if not yet easy. The number of companies which continue to raise prices is now smaller than in recent quarters as cost pressures have eased. Capex plans vary but most companies remain committed to returning capital to shareholders."

"Demand slowing within now familiar buckets. There is still a wide spectrum of views on growth and demand trends. While several companies mentioned weakening demand, these largely fall into now familiar buckets: those suffering a reversal of the pandemic boom; those seeing inventory destocking as goods spending and supply-chains normalize; and those hurt directly by higher interest rates such as in housing. Microsoft captured it as "Just as we saw customers accelerate their digital spend during the pandemic, we are now seeing them optimize that spend" while FedEx argued that "the main macro issue in the United States is really the ecommerce reset." Destocking has been deeper and longer than many expected, but some companies said that they expect demand to improve once inventories normalized. JB Hunt for example said that "demand and volume were unusually soft during what is normally considered peak season" but also that "The freight recession that we see right now is largely inventory driven. We don't see anything else from our customers in total."

What's the signal here? It's muddled and mixed, but it suggests that there is a very decent chance that in aggregate US listed corporates might avoid an earnings recession of more than 1 to 5% on the downside.

Here's one, crucial bit of good news that should cheer up equity bulls - corporates are still eager to buy back their shares. In fact, if anything we are mid-way through a buyback boom with S&P 500 companies announcing over \$342bn in the last 3 months, which represents more than 1% of S&P 500 market cap, and close to the highest on record. According to analysts at Deutsche Bank in the US "Actual buybacks typically follow." In practical terms, this surge translates through to 4 billion USD worth of corporate demand/day estimate according to Goldman Sachs analysts.

Now not everyone sees this as good news - plenty of Democrat Party politicians hate share buybacks, and they're not entirely wrong to be cynical. Share buybacks are a tacit admission that as a corporate leader you can't find a better way to deploy your capital. Plus, buybacks tend to be poor value over the long term i.e. corporates. Nevertheless this level of buyback activity could be a strong driver for US equities to stay stubbornly high, even in a more inflationary environment. If you are a large scale corporate player and you have pricing power, which many S&P 500 companies do have, you can ride this volatile environment and increase your market power.

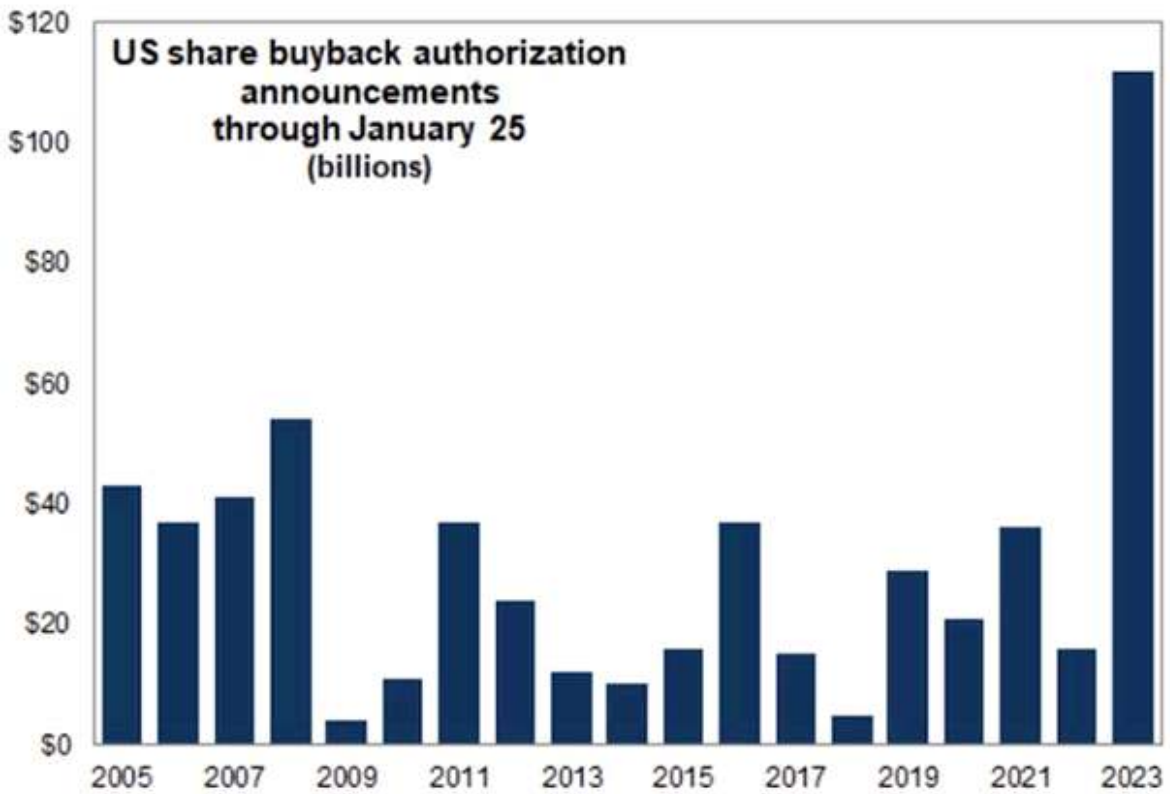
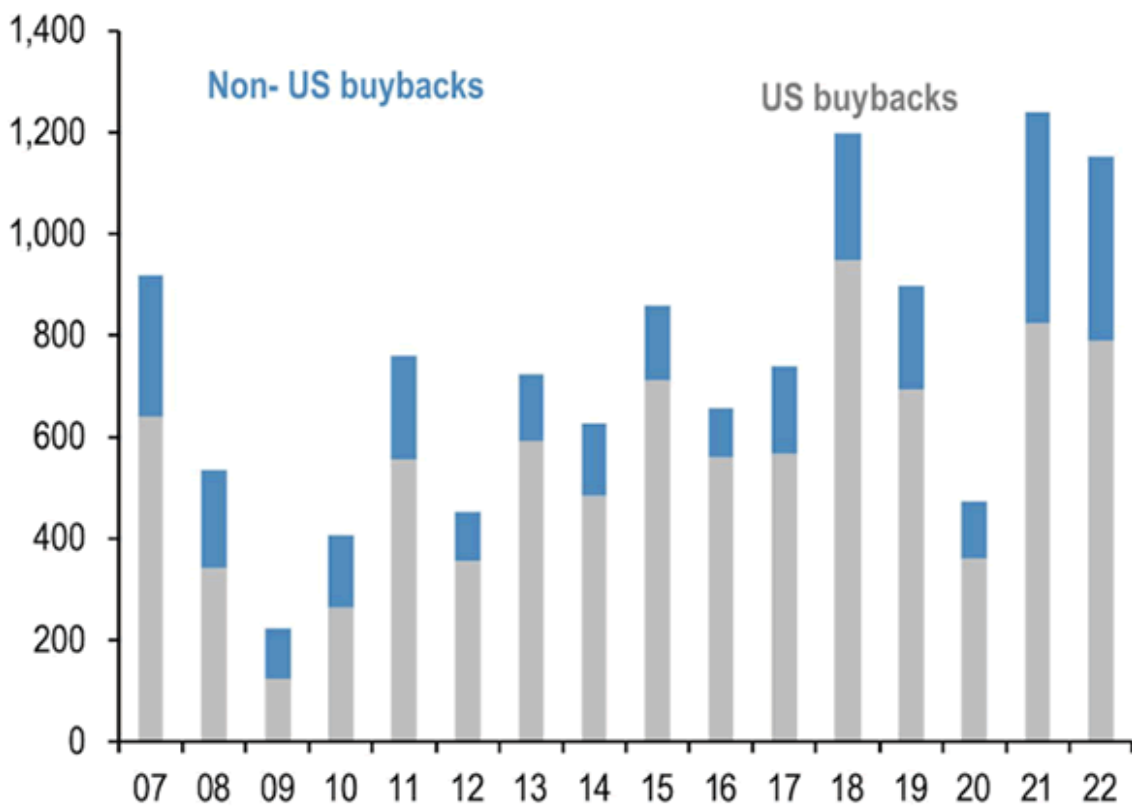


Chart A27: US and non-US share buyback

\$bn, 2022 are as of Dec'22. Buybacks are announced.



Source: Bloomberg Finance L.P., Thomson Reuters, J.P. Morgan

Measure	Values as of 14th February, 2023	Values as of 14th March, 2023
UK Government 10 year bond rate	3.44%	3.40%
GDP Growth rate YoY	0.40%	0.40%
CPI Core rate	6.30%	5.80%
RPI Inflation rate	13.40%	13.40%
Interest rate	4.00%	4.00%
Interbank rate 3 month	4.18%	4.34%
Government debt to GDP ratio	97.40%	97.40%
Manufacturing PMI	47	49.3

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Bank CDS options

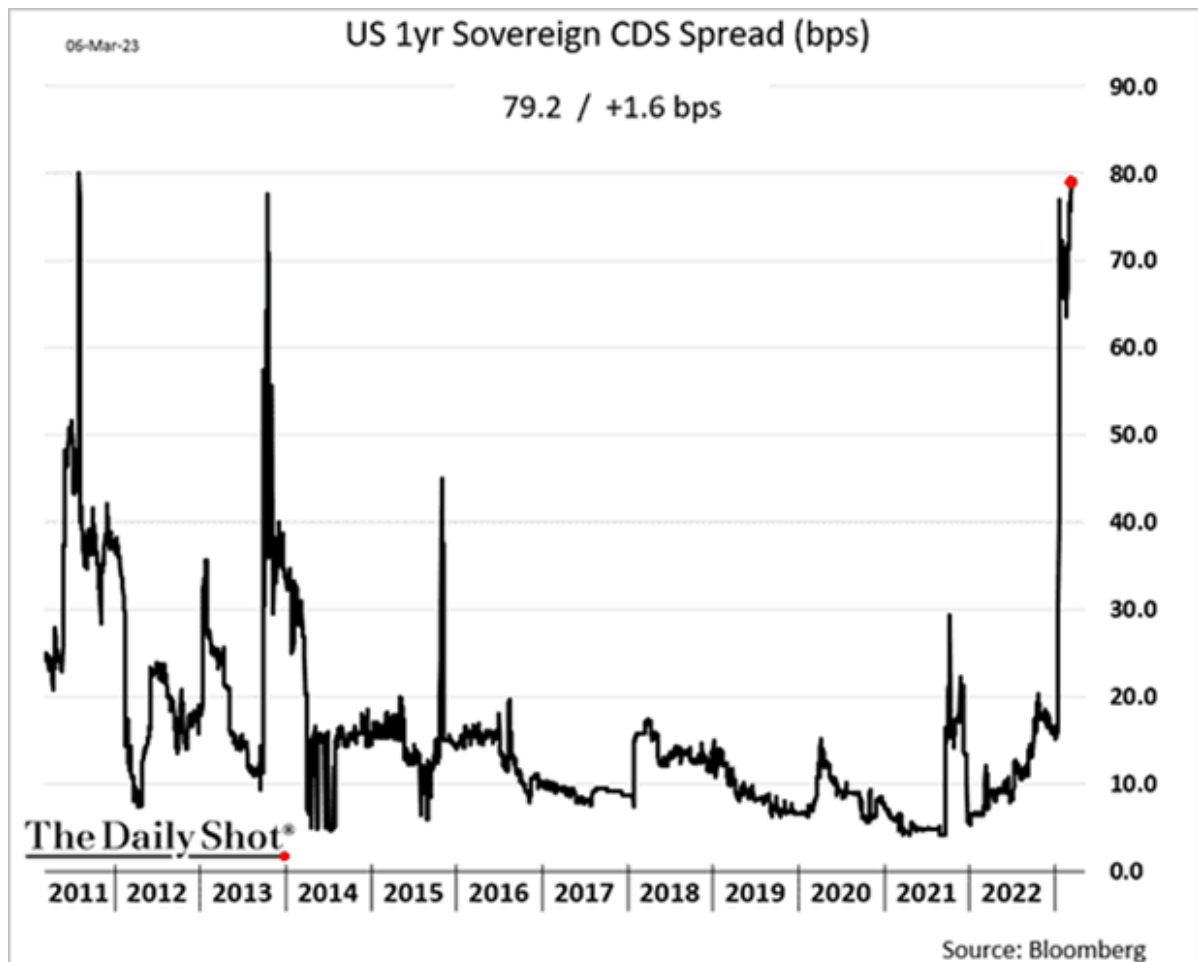
You'll have seen from virtually every financial media source that banking is in crisis, what with SVB shut down and UBS agreeing to buy it's troubled Swiss rival, Credit Suisse. The table below shows CDS spreads across the banks as of the end of February - and we know that much can change in a short period of time. At that snapshot in time, the table shows prices for credit default swaps for the major globally important systemic banks largely declining (obviously pricing for Credit Suisse swaps has increased markedly). We're not yet in a crisis but that could change overnight!

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	24.01	50.81	A+	A2	A -
Barclays	54.81	79.46	BBB	Baa2	A
BNP Parabis	23.57	43.77	A+	Aa3	A+
Citigroup	34.61	78.14	BBB+	A3	A
Credit Suisse	2526	325	BBB-	Baa2	BBB
Deutsche Bank	63.44	127	A-	A1	BBB+
Goldman Sachs	34.2	84	BBB+	A2	A
HSBC	22.7	41.9	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	30.9	67.16	A-	A1	AA-
Lloyds Banking Group	22.59	41.65	BBB+	A3	A
Morgan Stanley	33.97	80.15	A-	A1	A+
Natixis	19.5	45	A	A1	A+
Nomura	26.75	80.37	BBB+	Baa1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	28.21	53.3	A	A1	A-
UBS	32.79	58.5	A-	Aa3	A+

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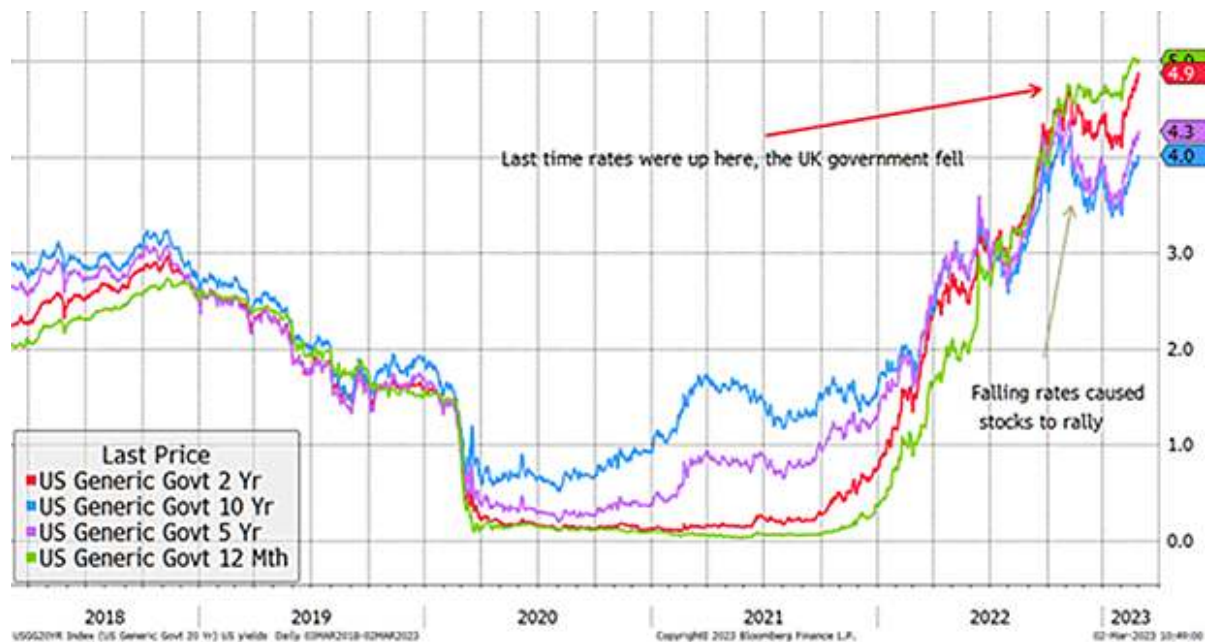
Government Bonds

This month I thought it worth drawing attention to two fascinating charts. The first shows that the one-year sovereign credit default swap spread has hit its highest level since 2011 when the debt ceiling impasse resulted in a US debt downgrade. The worry here is obvious - that the US defaults on its debt after negotiations in the US congress breaks down. Pricing for 5 year swaps is much lower at 37.55 basis points - five times higher than the equivalent rate for UK 5 years swaps.



The second chart is from stockmarket commentator Charlie Morris of [Byte Tree Premium](#): its warning is stark - Bond Yields of above 4% Break Things. As Charlie notes that "US 10-year yield has just risen back above 4%. It's not making the headlines, but this is what it did for 18 painful days last October. In that time, the UK government came crashing down as it tried to introduce policies the bond market couldn't stomach."

High Bond Yields Will Cause Havoc



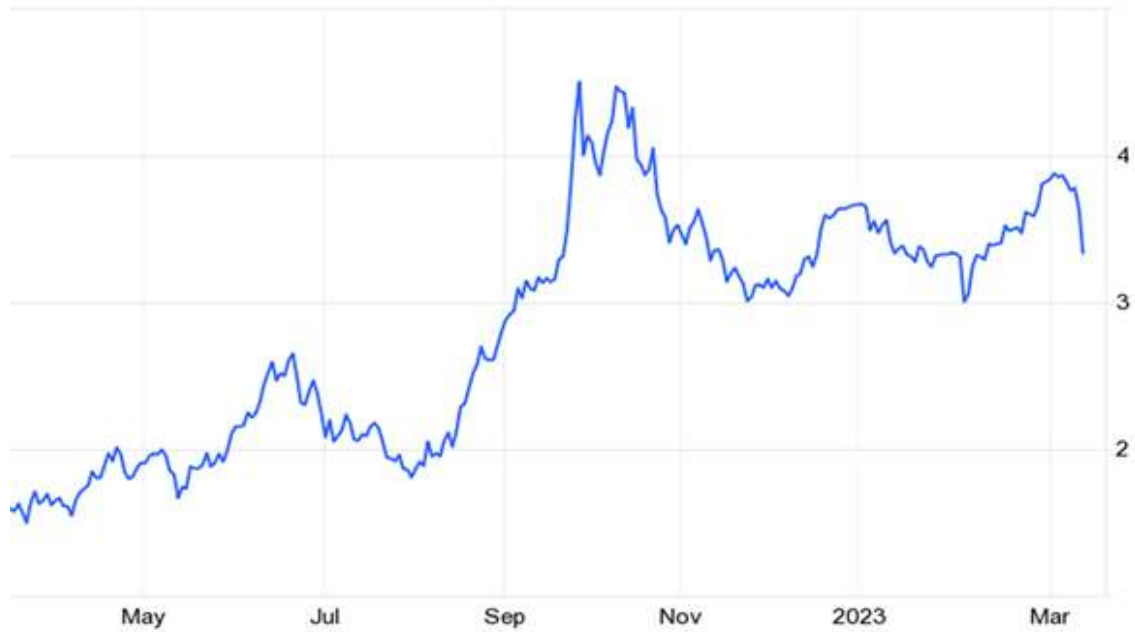
Of course, this consensus is based on the idea that inflation rates are coming down (which they are) and that they stay subdued (which they may not).

On a largely unrelated note, I'd direct readers attention to the Sovereign CDS Spreads table. This looks at the spreads for buying country specific, sovereign 5 year credit default swaps. It's a useful finger in the air estimate for the riskiness of a government and its bonds based on the 'wisdom' of the market. Note the astonishing variation in pricing for UK swaps - in the last 12 months we've moved from middle of the pack around 10 to 15 basis points) to outlier at 47 basis points (guess who was PM) to leader of the pack at rates of just 6.82.

Two other numbers stand out for me on the bonds section of this report. Note how the spread for Greek bonds over German bonds has tightened from 236 basis points to 184 basis points since the summer of last year. I'd also note that returning to those credit default swaps on sovereigns, Italy's pricing has fallen sharply in the last few months - from a peak of over 145 basis points to the current 90 basis points.

UK Government Bonds 10-year Rate 3.40%

United Kingdom 10Y Bond Yield



source: tradingeconomics.com

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

CDS Rates for Sovereign Debt

Country	Five Year
France	22.5
Germany	7.258
Japan	17.12
United Kingdom	6.82
Ireland	14.85
Italy	90.1
Portugal	38.61
Spain	42.81

Eurozone peripheral bond yields

Country	February 2023	March 2023	Spread over 10 year
Spain 10 year	3.29%	3.31%	93
Italy 10 year	4.14%	4.13%	178
Greece 10 year	4.20%	4.19%	184

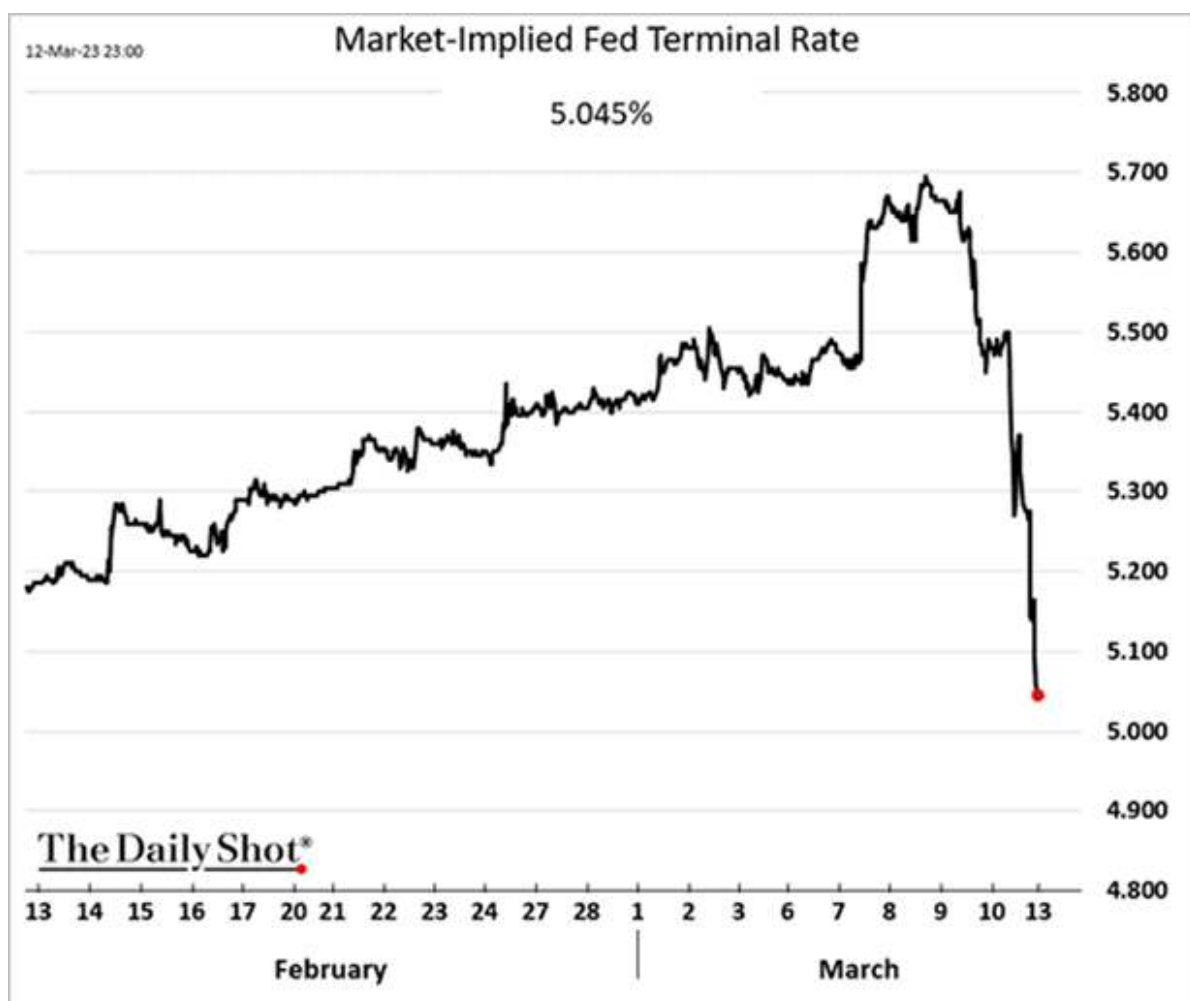
	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

Equity Markets and Dividend Futures

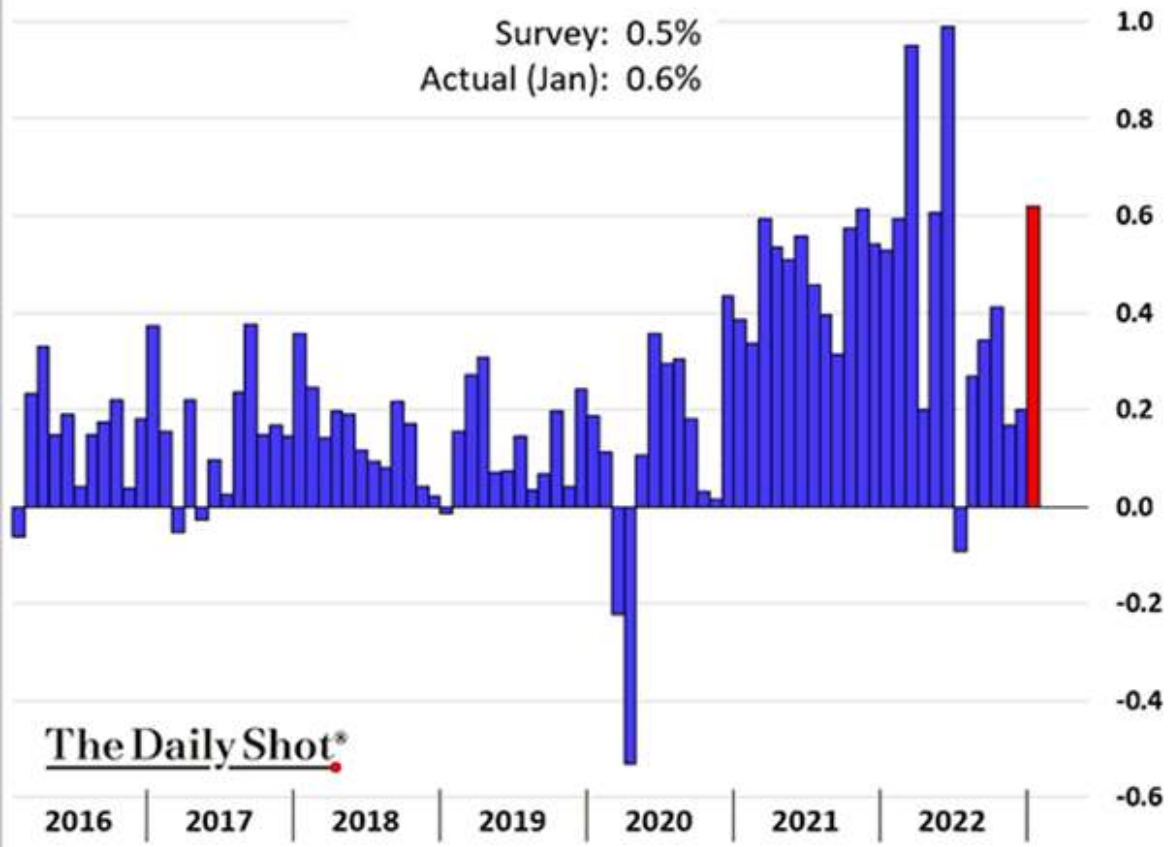
The three charts below graphically speak to a huge debate amongst equity investors at the moment. The first chart gives us an estimate for where 'the market' thinks US interest rates will peak. Until SVB blew up, everyone and their dog thinks that US interest rates won't stop at 5% but possibly head over 5.5%, or even, god forbid, hit 6%. Then SVB came along and the chart shifted dramatically. Whether you choose to believe the market consensus that Chair Powell will suddenly pivot is your decision - I think he'll pause and then slam his foot down on the accelerator again.

That hawkish central bank rhetoric is partly inspired by the message from the second chart which shows core US inflation rates. The good news that rates have fallen sharply from recent highs. The bad news is that they are rising again as wage claims and food prices start to rise.

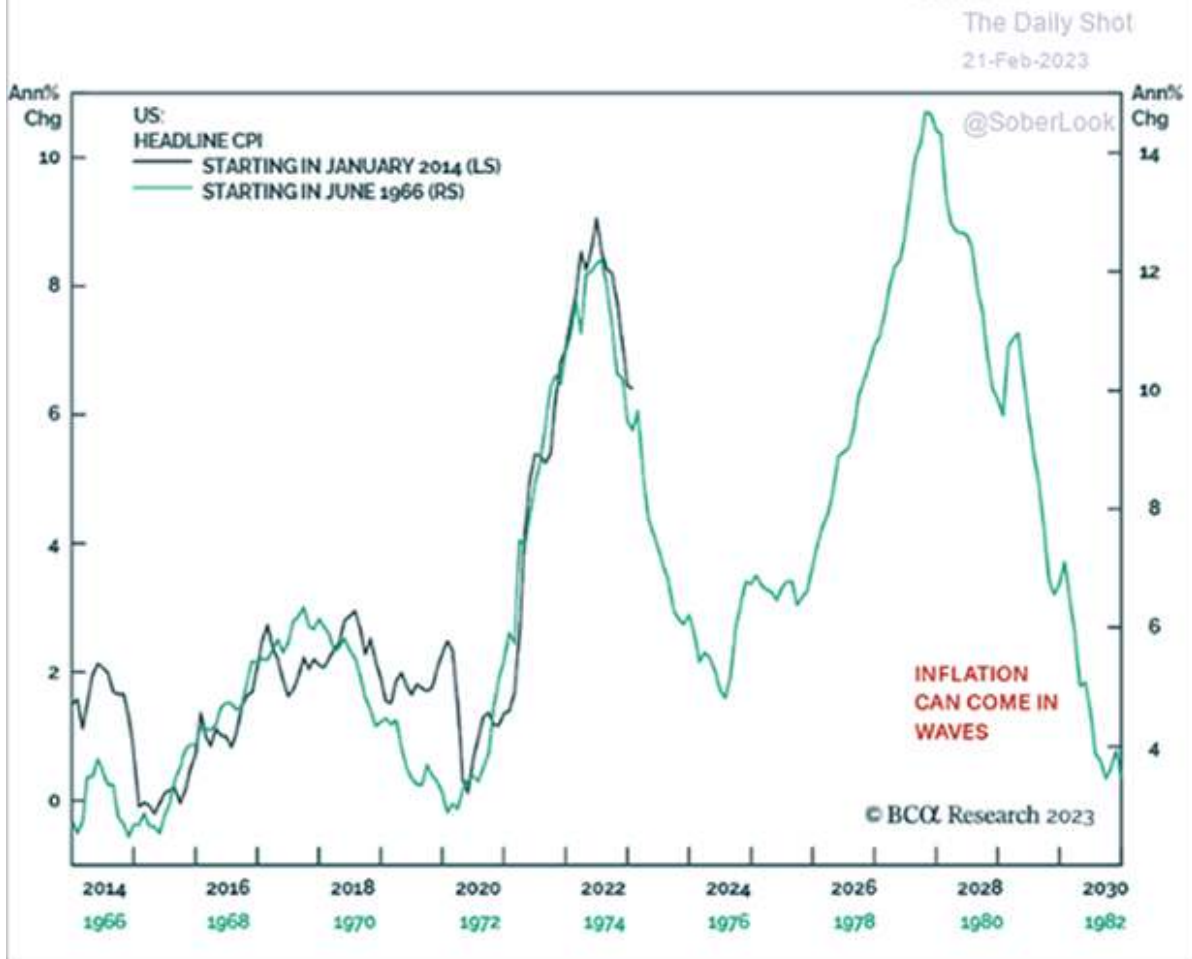
All of which brings us to the third chart which shows what happened to inflation rates in the 1970s mapped against current trends. Call it the 1970s Redux story. Arguably the US Fed is sounding hawkish to precisely avoid a repeat of this situation.



US PCE Inflation MoM



The Risk of a Second Inflation Wave: If Not Now, Later?



These charts have prompted a lively debate about what life will be like in a new economic normal nicknamed 'Higher for Longer' - a world where interest rates stay above 5% for a number of years. The challenge here is something I have discussed before - macro economic regime change. These big shifts make a huge difference to investors and they impact long term returns. I would argue that we are now at a cross roads where four different scenarios are on offer, all with greatly different implications for risk assets.

SCENARIO 1. The current consensus is that inflation is back under control, interest rates will come down at some point in 2024, inflation will fall below 5% and then 4%. This is fundamentally bullish for most risk assets.

SCENARIO 2. The Higher for Longer scenario outlined above by Smith. This sees interest rates stay above 5% for a few years, if not the rest of the decade. Logically this scenario only really works if you assume that we don't have a sudden hard recession (see next scenario) that inflation continues to drift in the 4 to 7% scenario.

SCENARIO 3. The Volcker moment scenario we have discussed before, where the US Fed whacks up interest rates hard ! The US Fed in particular gets deeply annoyed with strong employment numbers, and robust consumer demand and decides to hit the brakes hard to push the economy into a hard stop. This scenario MUST imply very sharp earnings contractions probably in the 10 to 20% range which would make risk assets very expensive. Debt would also be hit by a tsunami of corporate failures.

SCENARIO 4. The return of QE Vs 2. After the Volcker moment central bankers realise they have hit the brakes too hard and they so badly stalled the system that they have caused multiple liquidity crises which ripple through the system. This threatens a deep depression. Central bankers panic and restart a diluted form of QE. Again, this is excellent news long term for risk assets as interest rates eventually tumble sharply.

Now in all these scenarios there is the ever-present risk of geopolitics playing a role. Two obvious wild cards are first Taiwan and secondly an energy crisis which could push us from Scenario 3 into a scenario (call it 5) which I haven't outlined - robust stagflation with inflation rates pushing back towards 10%. I haven't outlined this scenario because I think if there was any danger of that happening, we'd be straight to the Volcker moment and interest rates would be heading north of 8% as quick as anything.

Index	February 2023	March 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	138.8	140.2	4106	123.3
FTSE 100 Dividend Dec 2022	295	294.4	7596	271.9

Note changed to Dec 2023 contracts

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-4.71	0.937	2.54	5.83	6.08	2.8	7573.16
S&P 500	-6.79	-4.06	-1.94	-8.28	39.5	62.5	3856.29
Gold Composite (Most Traded)	0.199	2.28	8.72	-5.93	40.7	55.4	186720¢

iShares FTSE UK All Stocks Gilt	1.02	0.596	-1.38	-17.2	-17.2	-18.3	1076.88p
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VIX New Methodology	21.9	9.98	-9.06	51.7	51.7	119	24.8
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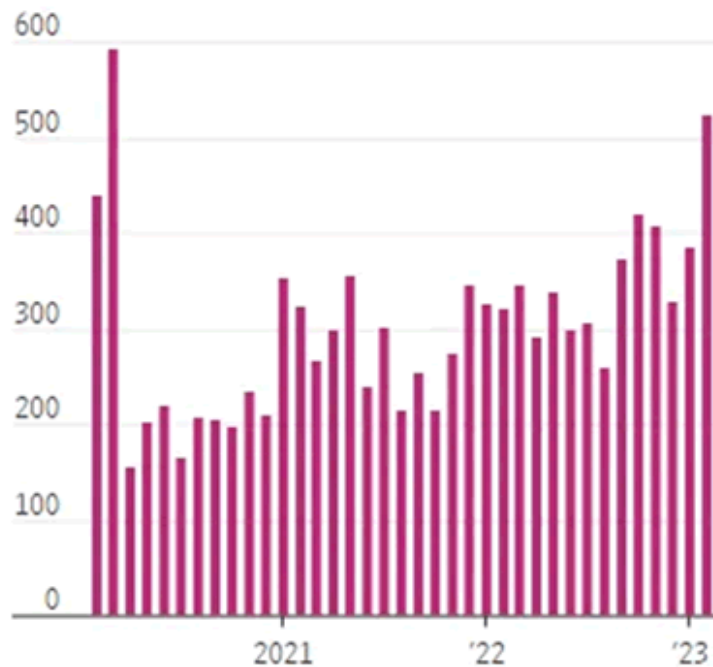
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Volatility

The volatility of equity markets as measured by the Vix index - which tracks the ups and downs of the S&P 500 - has been at subdued levels in recent months. The Vix has been trending downwards and is currently at around the 19 to 20 level depending on the day. The long term average for the Vix is around 20. But these subdued levels hide a growing sense of caution. The Wall Street Journal recently ran an article which observed that *"Fear is creeping back into the stock market. To protect against a potential downturn, traders are scooping up hedges at the fastest clip since the onset of the Covid-19 pandemic. More call options betting that the Cboe Volatility Index, or VIX, will rise have changed hands on an average day in February than at any time since March 2020, Cboe data shows."* See the chart from the WSJ below.

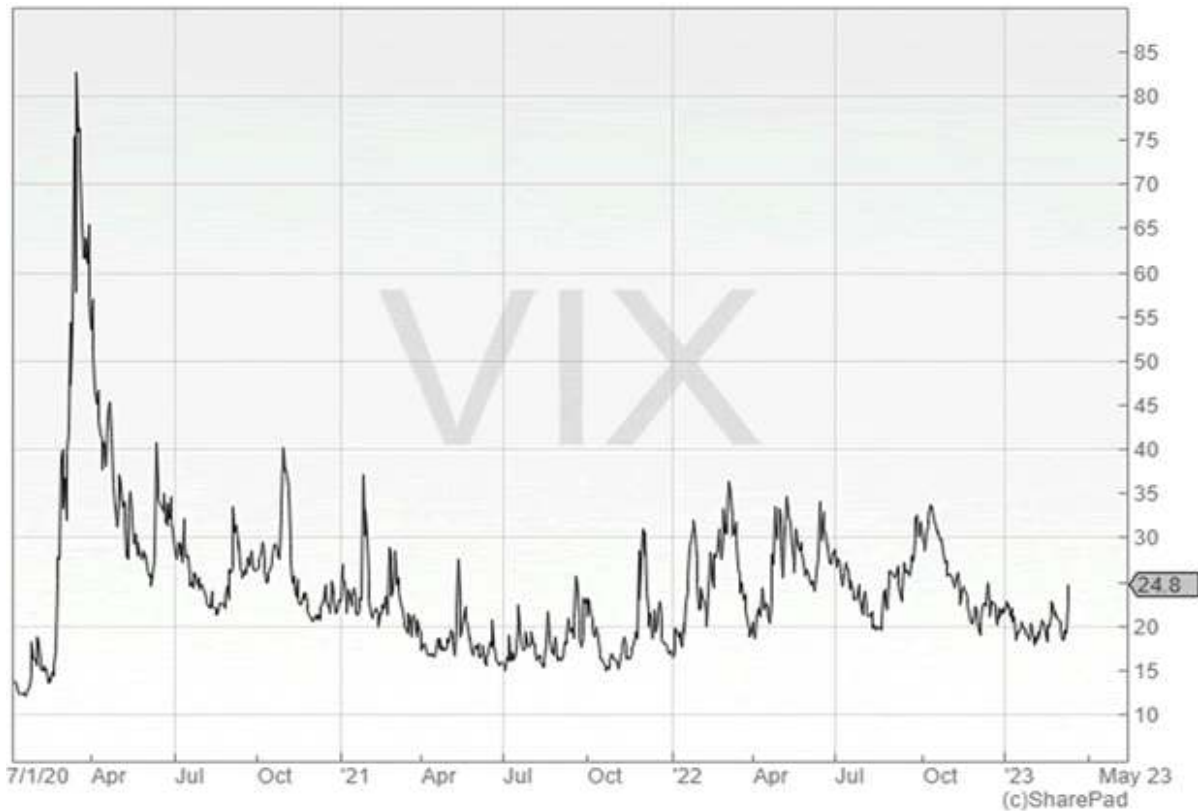
VIX average daily call options volume

700 thousand contracts



Note: monthly

Source: Cboe Global Markets



Measure	March Level	February Level	January Level	December Level
Vstox Volatility	27.97	18.91	18.25	21.24
VFTSE Volatility	24.8	20.34	18.35	22.48

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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.

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 fix its 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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