



## Monthly Market Report

### August 2020











*With commentary from David Stevenson*

In the depths of the market panic, one of the commonly expressed anxieties was that millions of equity-based retirement plans would be blown out of the water by plunging share prices. The message was - save more!

Now that we've had a remarkable rebound and many months of surging shares, we're back to worrying about excessive interest in shares. One small sign - a recent Sunday Times business section headlined with worries that the rise of cheap share dealing (or free) was encouraging gaming\gambling like behaviour. As we'll see later in this report, removing frictions to investing is bound to encourage daft behaviour. But I tend to err on the side of caution when it comes to these scare stories. We've always had reckless behaviour in investing (many of it by very well paid hedge funds who really should know better). In the world of private investors, day traders have always been with us but they have always been a tiny bit of an equally tiny pool of people who actually 'invest' in risky stuff like equities. And the evidence is that even the small number of people who do 'invest' in equities do so sensibly. For instance I'd point to new research from eToro which seems to be based on a novel way of understanding what interests investors - it uses "Google AdWords to discover which alternative investments Brits are most frequently inquiring about online during Covid-19". First though this survey asked investors what their traditional investment options were. The first table shows bonds and ETFs seem reasonably popular. Notice the complete absence of structured products. Curiously unit trusts seem very low down the list.

### The traditional investment opportunities Brits are most inquiring about during Covid-19

TRADITIONAL INVESTMENT	ONLINE SEARCH VOLUME	% YEAR-ON-YEAR INTEREST (INCREASE OR DECREASE)
Stocks and Shares	110,000	66% 
Bonds	40,500	22% 
Exchange-Traded Fund (ETF)	27,100	124% 
Mutual Funds	8,100	50% 
Real Estate Investment Trust (REIT)	6,600	50% 
Gilts (Government Bonds)	4,400	132% 
Unit Trusts	2,400	No change 
Open Ended Investment Companies (OEIC's)	2,400	No change 

As for alternatives, the eToro research reports that property is still "the alternative investment that Brits are most looking into during Covid-19, with 9,900 online searches". Some of the search terms are not surprising, such as precious metals (where searches increased 91%) and rare coins (3600 online enquiries), but there were also the inevitable left field ideas. Whisky seemed to be popular (1600 online queries) while interest in Lego increased 53%. That last category is a new one for me - I was aware that Lego was popular in the second-hand market but not THAT popular! Note again, no structured products.

The big takeaway for me is that rather than worry about day traders, the investment community should be encouraging ordinary folk to think about alternatives to boring alternative stuff such as property. In my experience there's a huge number of people who think owning a second property is the very best alternative to cash, whereas day traders are a tiny minority. Property seems to offer many investors - alongside bonds - a defensive, long term way of building wealth. Which is precisely what most investors want from classic 'equity' strategies - and structured products.

## The alternative investment opportunities Brits are most inquiring about during Covid-19

ALTERNATIVE INVESTMENT	ONLINE SEARCH VOLUME	% YEAR-ON-YEAR INTEREST (INCREASE OR DECREASE)
Property Investment	9,900	No change ➡
Gold Investment	4,400	128% ⬆
Rare Coins Investment	3,600	177% ⬆
Whiskey Investment	1,600	23% ⬆
Silver Investment	880	126% ⬆
Art Investment	880	22% ⬆
Watches Investment	880	No change ➡
Cryptocurrency Investment	590	23% ⬆
Fine Wine Investment	390	No change ➡
Diamonds Investment	320	23% ⬆
Lego Investment	260	53% ⬆
Classic Cars Investment	210	34% ⬆
Precious Metals Investment	210	91% ⬆
Farmland Investment	170	55% ⬆

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## Headline Numbers

I recently found myself perusing a quarterly research report from Drivewealth. You've probably not heard about this service before but in simple terms this is the platform that powers most of the US free share dealing offers offered by everyone from Revolut to Stake. Crucially if anyone has the data on retail investor flows in the US, it's probably Drivewealth.

The big question is whether the supposed retail investor boom is a myth or a reality. The answer seems to be... reality. According to DriveWealth retail investors have been more active this year - trading on average 10+ times YTD. In 2019, investors traded on average 2.23 times/month while the average US brokerage account trades 2-3 times per year (Source: FDIC report). For Drivewealth

YTD the average trade size was ~\$145, however this fluctuates widely on a daily basis in the range of ~\$95-275. Crucially the big chart below shows just how much trading activity in US shares by retail has shot up in the last few months.



Dig around inside DriveWealth's data vault and you'll also find out which US stocks, UK based investors have been buying so regularly. The second table below reveals the grisly results.

I'm most interested in the Q2 numbers, with three firms dominating the middle of the list : Callon Petroleum, Oasis Petroleum and Whiting Petroleum. I can't say that I know much about these three stocks except to say that they seem obvious shale plays. My recollection is the Whiting had filed for Chapter 11. These seem like classic day trader oil volatility plays. What's also interesting is to see Hertz in at number 2. Matt Levine at Bloomberg Opinion has been recounting the cracking tale of Hertz (also bankrupt) and I have to say that you really couldn't make it up if you tried. Before the SEC stopped them, they were planning to raise fresh equity even after going bust. The fact that four out and out mega risk, day trader stocks (plus Tesla, which is highly volatile but a much more solid business) dominate the Q2 trades is ever so slightly worrying.

Q1		Q2	
1	Tesla	1	Tesla
2	Apple	2	Hertz
3	Microsoft	3	American Airlines Group
4	Advanced Micro Devices	4	Callon Petroleum
5	Virgin Galactic Holdings	5	Oasis Petroleum
6	Amazon	6	Whiting Petroleum
7	Alphabet	7	Apple
8	Beyond Meat	8	Boeing
9	Facebook	9	Delta Airlines

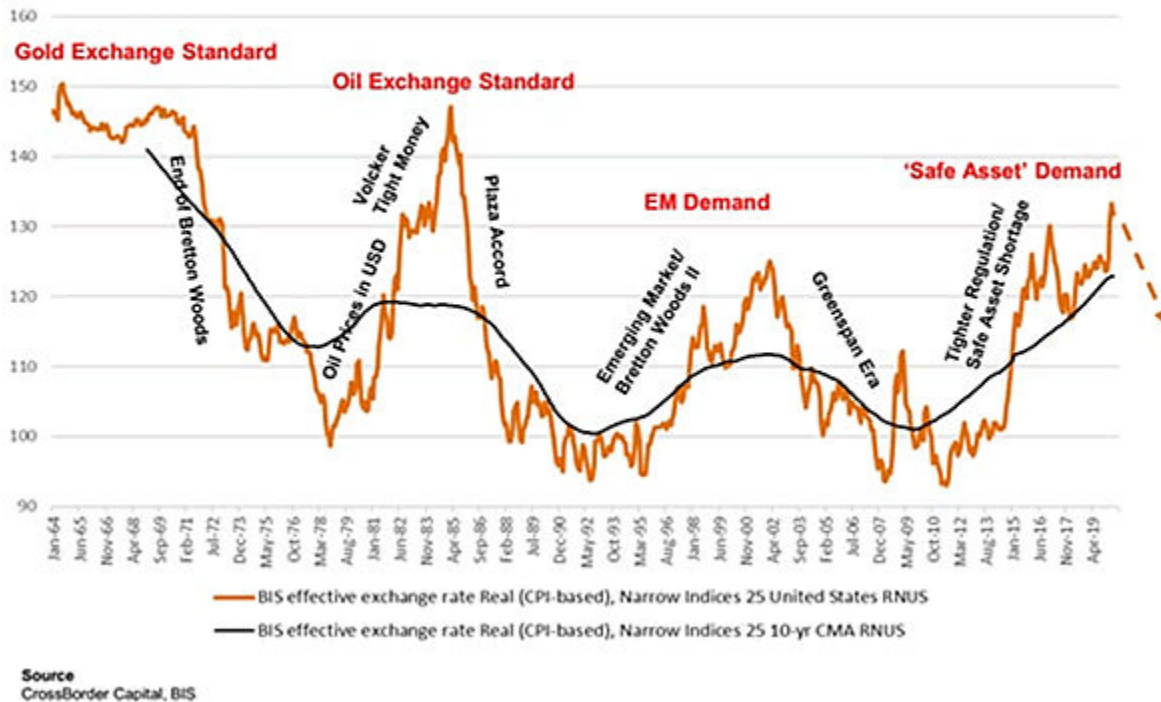
Ask most investors to list their key long term concerns, and I suspect many other headwinds (notably inflation) might hog the list but maybe UK investors should worry a bit more about a weaker dollar. Everyone and their aunt seem to have predicted a weaker dollar and it hasn't happened - yet. That doesn't mean it won't or can't happen and Cross Border Capital (who've also been predicting a weaker dollar for some considerable time) reckon they've spotted the first signs that footloose global capital might be slowly turning bearish on the greenback. Cross Border is a London based research firm, widely used by the hedge fund community. They think a weaker US dollar is on the cards for a number of reasons:

*"The prospective deterioration in US fiscal arithmetic, the speed, and size of the US Fed's monetary response to the COVID crisis and their willingness to take on serious inflation risks, suggests that a major inflexion in the US dollar may be underway? If this turns out to be a normal cycle, then investors should expect a 25% drop in the DXY effective dollar index over the next 2-3 years. In the early stages, at least, this would underpin a sizeable rally in global risk assets, boost commodity prices and Emerging Markets and bolster gold and crypto-currencies. Eurozone and the Euro could be key winners."*

Cross Border seems to have based their call on in house trading indicators - these include upcoming US forex risk which has **decisively rolled over** and the **capital-flow sensitive** Swiss Franc/ US dollar cross rate itself which " also appears to be changing direction. This background does not point to a collapse in the US unit, but downward pressures are plainly building."

The chart below is I think an excellent overview of the long-term strength of the US dollar - and a hint of why it might have reached peak levels in the last few weeks.

**Figure 2**  
**Four US Dollar Regimes**  
Real Trade-Weighted Exchange Rate Index, 2010=100      1964-2020



Measure	Values as of 10th June, 2020	Values as of 10th July, 2020
UK Government 10 year bond rate	0.29%	0.18%
GDP Growth rate YoY	-1.60%	-2.20%
CPI Core rate	0.80%	0.50%
RPI Inflation rate	1.50%	1.00%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.22%	0.09%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	40.7	50.1

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## Bank CDS options

Another fairly uneventful month in the markets for credit default swaps. Looking at 1 year swaps, Credit Suisse saw a modest uptick but HSBC saw its swaps at the one year level fall sharply in price from 20 to 11 basis points while the biggest declines were for Deutsche swaps which fell from 150 to 115 basis points. At the 5 year swaps level, most banks saw a decline in their pricing, with risk levels easing off - Deutsche also saw big falls at the 5 year level, decreasing from 195 basis points

to 171. One last observation - Lloyds Bank swap prices have come down markedly over the last few months and now trade below much bigger peers such as HSBC.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	15.48	30.59	A	A2	A -
Barclays	30.66	71.62	BBB	Baa3	A
BNP Parabis	18.14	42.88	A+	Aa3	A+
Citigroup	48.69	71.08	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	25.54	66.86	BBB+	Baa2	A-
Deutsche Bank	115	171	BBB+	A3	BBB
Goldman Sachs	52.2	79.77	BBB+	A3	A
HSBC	11.46	38.76	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	40.14	62.54	A-	A2	AA-
Lloyds Banking Group	11.32	34.43	BBB+	A3	A+
Morgan Stanley	45	65.66	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	40.85	95.11	BBB+	Baa1	A-
RBC	22.91	67.47	AA-	Aa3	AA
Soc Gen	14	44.77	A	A1	A
UBS	14	36	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st July 2020 [www.tempo-sp.com](http://www.tempo-sp.com)

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## Government Bonds

### Fixed Income

As I have consistently argued in these UKSPA reports, investors and their advisors need to think long and hard about the future risks to capital appreciation. Top of that list should, arguably, be inflation, or at the very least the threat of inflation. All we need is for the consensus of inflation expectations to move towards a surge for investors to start worrying. Again, what worries investors is not only increasing inflation rates - or the fear there of - but any surprise upwards revisions. So, to be precise we need a double whammy - increased worry about increased inflation plus actual



surprise upwards inflection in the inflation rate. Of this, market crashes are made.

Analysts at asset management firm DWS correctly remind us that current inflation rates are low and getting lower. Without taking into account the energy component, which, thanks to the oil price, fluctuated wildly in 2020, the inflation rate in the Eurozone was 1.3% in June. That is exactly the same level as at the beginning of the year, observes the note from DWS.

But the challenge is the supply curve which remain stuck to the left of its old level, even as the demand curve shifts to the right again, as consumers and businesses start to spend more. "The rising economic output would then be accompanied by a significantly higher price level" reckon the DWS analysts." Fears of such a scenario may already be reflected in the bond market."

The chart below shows, the difference in yield from nominal to real U.S. government-bond yields suggests that inflation expectations have risen quite a bit since their lows in March.



"It is quite conceivable that unlike the economy, inflation could perhaps see a V-shaped recovery", suggests the DWS report, at which point worries about inflation could intensify!

UK Government Bonds 10-year Rate 0.18%





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

## CDS Rates for Sovereign Debt

Country	Five Year
France	22.13
Germany	14.59
Japan	33.5
United Kingdom	25.5
Ireland	28.22
Italy	164
Portugal	65
Spain	77

## Eurozone peripheral bond yields

Country	May 2020	June 2020	Spread over 10 year
Spain 10 year	0.66%	0.44%	86
Italy 10 year	1.51%	1.24%	166
Greece 10 year	1.37%	1.08%	150

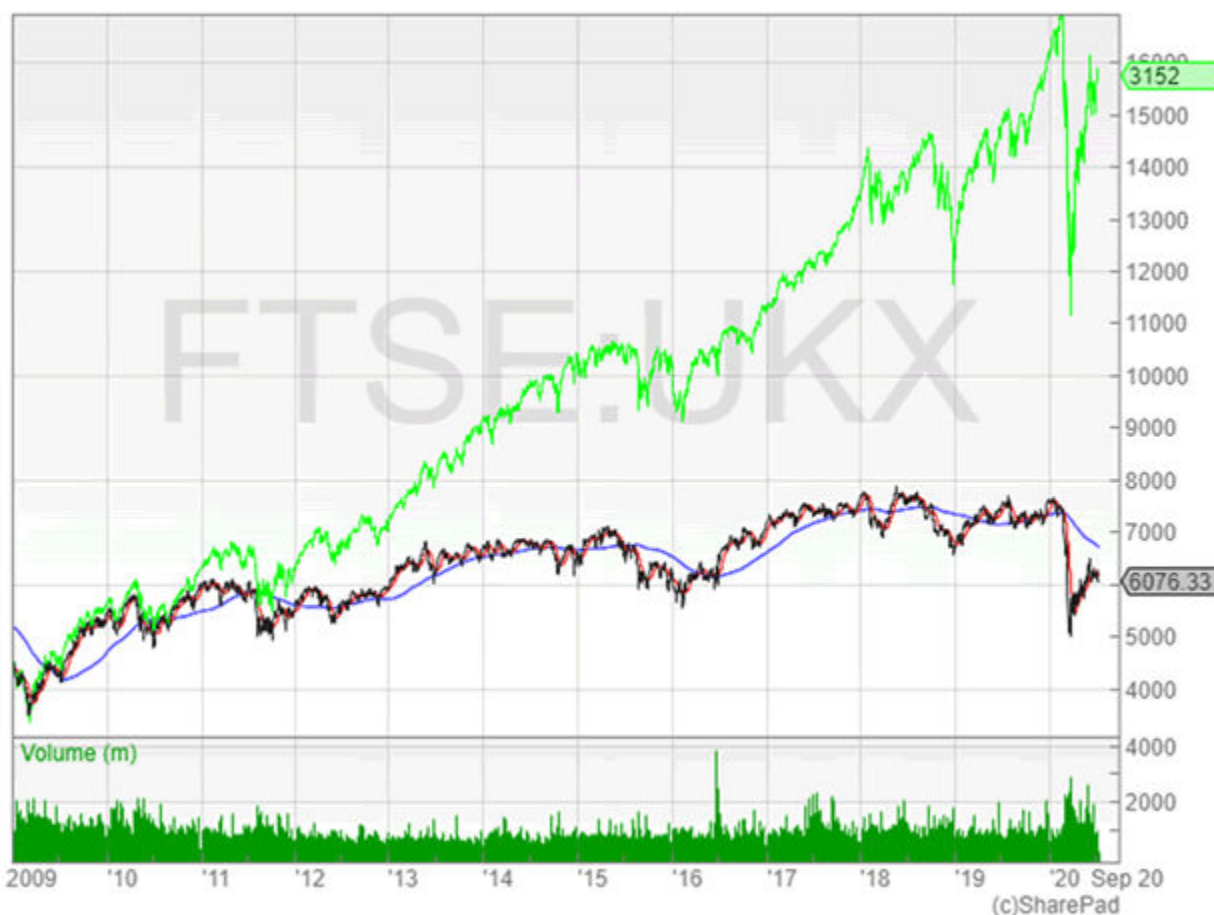
	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+

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## Equity Markets and Dividend Futures

Index	June 2020	July 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	85.6	85	3342	122
FTSE 100 (Dec 19)	191	178	6173	326

One of my favourite sleights of hands when talking to investors is to show the chart below (courtesy of Sharepad). It demonstrates the historic under performance of the UK's FTSE 100 index compared to the equivalent US benchmark, the S&P 500. In the chart below the US chart is in green, the UK index in black with the 20 day moving average in red and the 200 day MA in blue. I said sleight of hand earlier because in reality of course we are not quite comparing like for like. The FTSE 100 is not an index measuring UK PLC in any meaningful way, rather an unruly collection of sectors that have fallen out of favour. Crucially the UK market suffers from an almost complete absence of tech stocks.



The second chart below (with the same colours) shows that gap in performance over the last few months of the Covid emergency.

As you can see, all the way through to mid March the FTSE 100 was holding its own (although still under performing) but since then the gap has become cavernous, again!



Now, one of the few consolations of this exercise in national humiliation has been the abiding thought that the UK was probably in good company, with most European markets also suffering consistent under performance.

Not anymore.

A note out today from equity analysts at Morgan Stanley suggests that even our continental chums have now overtaken us. Importantly though this analysis suggests that the rot has begun to set in much further down the market cap scale here in the UK. Traditionally for instance UK mid caps have tended to keep up with their American cousins, sort of. But the curse of under performance is, according to MSCI, broadening out. They observe that the "*MSCI UK is the worst-performing major country/regional index year-to-date, having fallen by 19% versus MSCI Europe down 11% and MSCI World down 5%. Although the headline UK index has been lagging its rivals steadily for much of the last decade, the magnitude and breadth of this under performance has accelerated recently.*"

They cite two examples:

- *Severe UK under performance has now spread from the large-caps to the smaller-caps too, with the MSCI UK SMID index under performing the World SMID index by 10% over the last 6 months, its worst run-rate since 2003.*
- *Although its still early in the month, it is noteworthy that every UK sector has under performed its European peer month-to-date; if this trend persisted through the full month, it would be only the second time in five years that this has happened.*

The two charts below speak to these narratives.

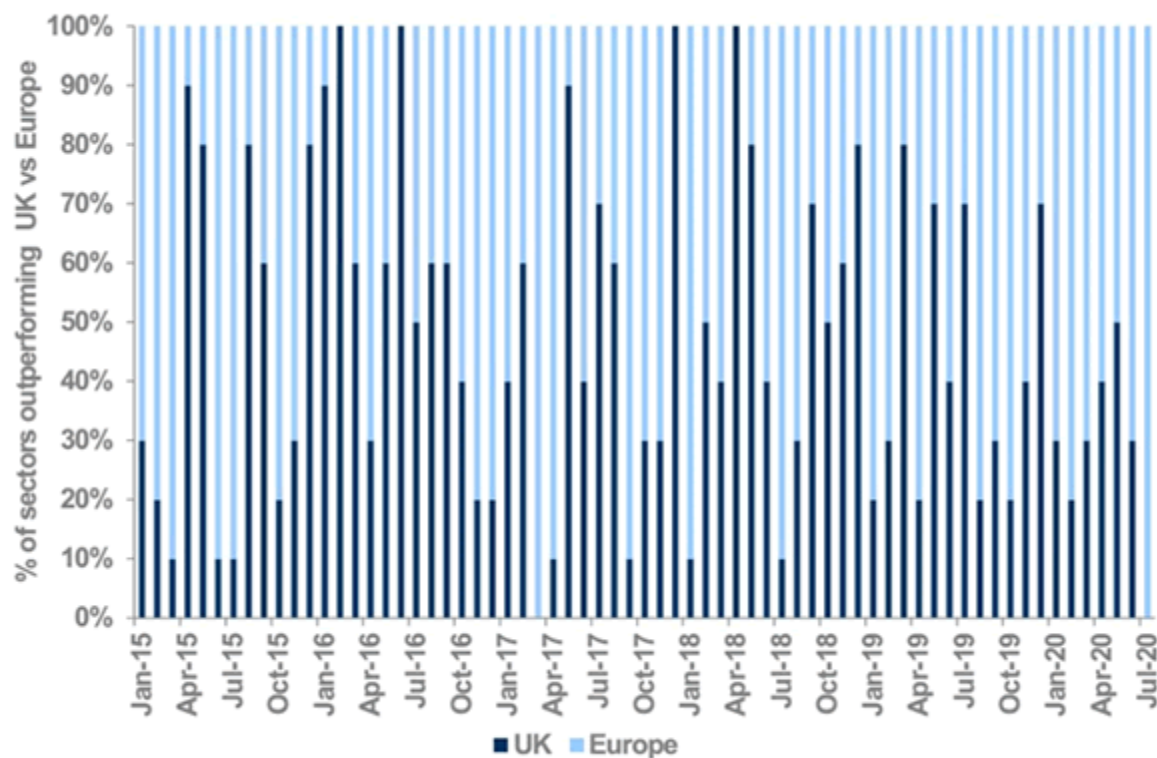
How do we explain this worrying trend?

Most investors point to this under performance - and the low weightings to UK stocks - via two narratives. The first is that sectoral explanation. But the MSCI analysis suggests that this really isn't the case as the mid and small cap indices have much lower exposure to the 'wrong' sectors.

The next handy explanation is Brexit. I'm sure that has some explanatory power but again I'm not entirely convinced. First off no one knows anything about what might happen including the main negotiators in Brexit and secondly I can't help but think that these concerns have been baked into the price for many months. Sure, a no deal hard Brexit could be a complete (avoidable in my view) pain but no one can say they'd be surprised if that happened. If markets are supposed to be forward looking prediction engines, why the hell haven't they priced that possible outcome in many, many moons ago ?

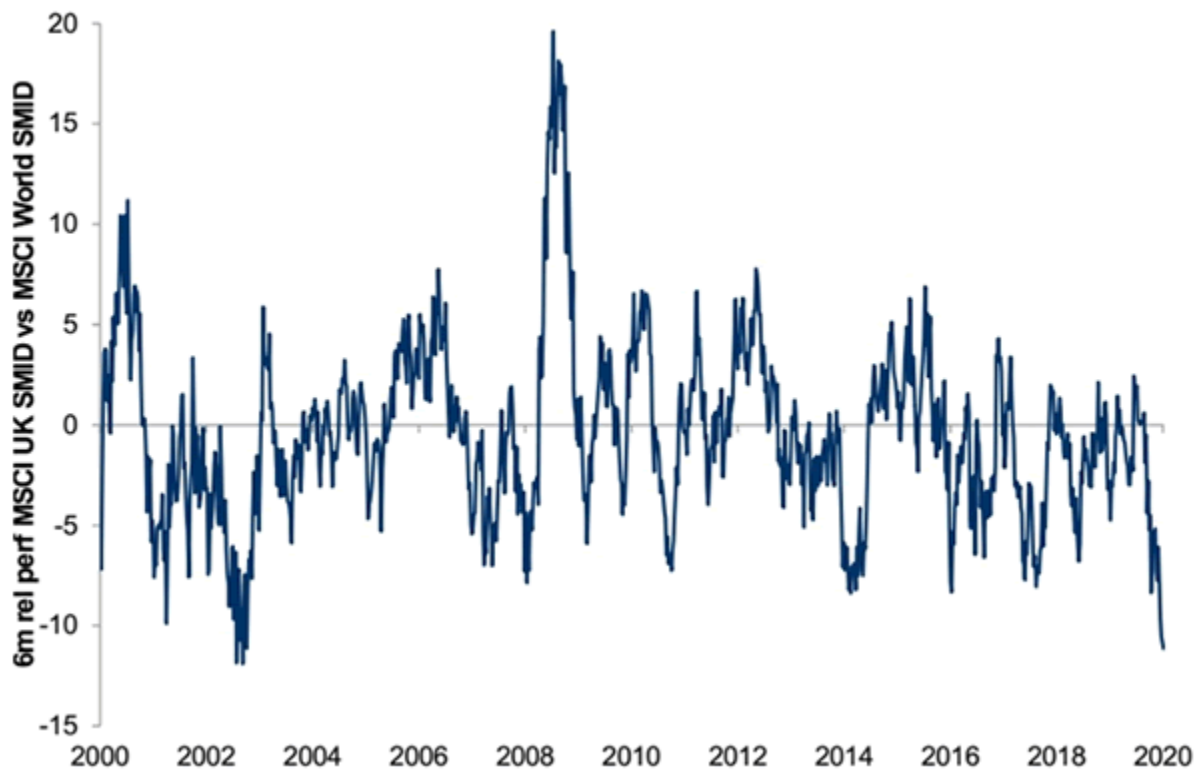
No, a more convincing narrative for me is that investors have decided that the UK hasn't had a good viral emergency. They know we've suffered an excess of deaths and they know that UK consumers know that as well. We all collectively have been scared to death (well, at least all those aged over 40) and that we're now increasingly reluctant to loosen our wallets. The Chancellor has explicitly acknowledged that challenge and all that global investors are doing is awarding a discount for poor policy outcomes in dealing with the virus. Continental Europe by contrast has had a much better crisis and so far looks like its getting a better handle on the inevitable next waves.

**Exhibit 11: So far in July every UK sector is underperforming its European equivalent**



Source: MSCI, Morgan Stanley Research

**Exhibit 10: UK Small & Mid caps have just seen their worst 6m underperformance since 2003**



Source: MSCI, Morgan Stanley Research.

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.16	4.33	-19.7	-18.8	-8.66	-8.89	6095.41
S&P 500	4.73	14.2	-2.46	5.68	53.4	61.9	3185.04
iShares FTSE UK All Stocks Gilt		0.2	7.8	9.73	24.5	31.1	1500
VIX New Methodology	-18.9	-29.8	133	136	73.9	142	29.26

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## Volatility

The first big panic about Covid 19 seems to be over. Time to stop worrying, perhaps? I am not sure the market is quite as confident as it first appears. The chart below shows the Vix measure since late February. As we've discussed in these UK SPA reports many times in recent months, the Vix spiked in mid March and has been trending downwards ever since. The chart below shows the Vix, in black, plus the 20 (red) and 200 (blue) moving average for the fear gauge. The last time I looked the Vix was still at 29.25 which is above the long term average of nearly 28. And in recent weeks we've seen plenty of spikes above 30. This suggests to me that markets are still skittish and that another major spike in the Vix is a distinct possibility.





Measure	July Level	June Level	May Level	April Level
Vstoxx Volatility	27.28	30.54	28	36.4
VFTSE Volatility	27.29	27.57	27.39	41.69

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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 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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To find out more about UKSPA, please visit [www.ukspassociation.co.uk](http://www.ukspassociation.co.uk).

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