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# Monthly Market Report

August 2021

*With commentary from David Stevenson*

My overly simplistic view of cycle within stock markets is as follows. For reasonably large periods of time, equity investors behave as a herd and stampede valuations higher across the board. In these synchronised bull markets, most faintly growth-oriented assets push higher consistently, volatility subsides and correlations increase. Call this the positive momentum phase.

Then comes the next phase - the **"what next"** phase. In this more cautious phase investors are at sixes and sevens. The macro picture looks promising but confused. Investors start to worry about central bankers getting all hawkish, but the data is still relatively benign. In this phase momentum crumbles, as do correlations. In some phases small caps outperform, in others large caps.

Then, at some point, an "event" of some form emerges, and a market view crystallises. At this point then we either re-engage with a bullish forced march or we turn into a darker bearish market where investors build cash and wait for a sharp fall. Sometimes that sharp fall turns into a proper bear market (negative momentum), other times sentiment steadies and we're back in the what next phase.

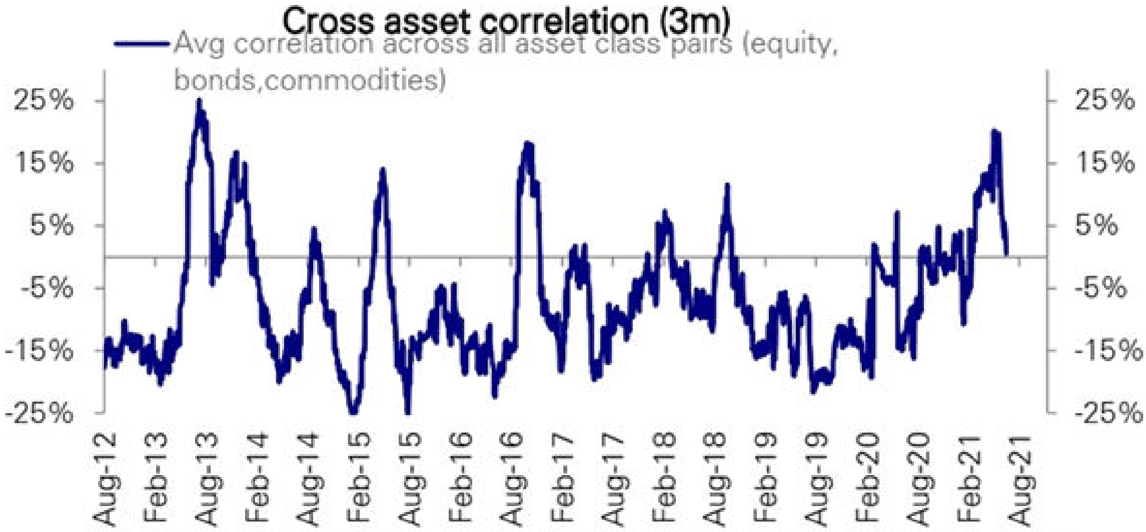
Anyway, this long and stupidly simplistic schema is background to my view that we are currently in phase two, the **what next** phase. It does not help that the virus is starting to worry investors again. And then there's the ever-present inflation challenge plus the never ending debate around what next for the dollar - see below.

Analysts at Deutsche Bank seem to be echoing my simple classification of the stockmarket with a note out this week which argues we are in a what next phase, with correlations breaking down across the board. According to the banks latest US published investor positioning report:

*"Large cap US equities have continued to edge higher, but small caps and other regional equities have been moving sideways to down and US equity breadth has also been weakening as less than half of S&P 500 stocks are trading above their 50dma; bond yields have declined most notably, while credit spreads have been going sideways; EM equities have been moving sideways while EM spreads have been widening; within commodities, while oil has continued to creep higher, others like copper have declined. Our measure of cross asset momentum breadth is now just below the middle of the band, reflecting this divergence in price action, a sharp contrast from the extremely positive levels earlier in the year when every asset class was firmly in strong risk-on territory. Cross asset correlations which had turned sharply positive from March to May have also moved back down in the last few weeks and are back to zero, pointing to divergence in returns across asset classes. Bond-equity return correlations in turn are also moving back towards zero after a surge into positive territory which was driven by the focus on inflation."*

**In these markets we should expect stock pickers to outperform the index trackers.**

Figure 8: Cross asset correlations broadly are back to zero ...




Average of 3m rolling correlation of daily returns between asset pairs: S&P 500 TR index, Barclays US Treasury TR index and CoreCommodity CRB Index

*Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation*

## Contents

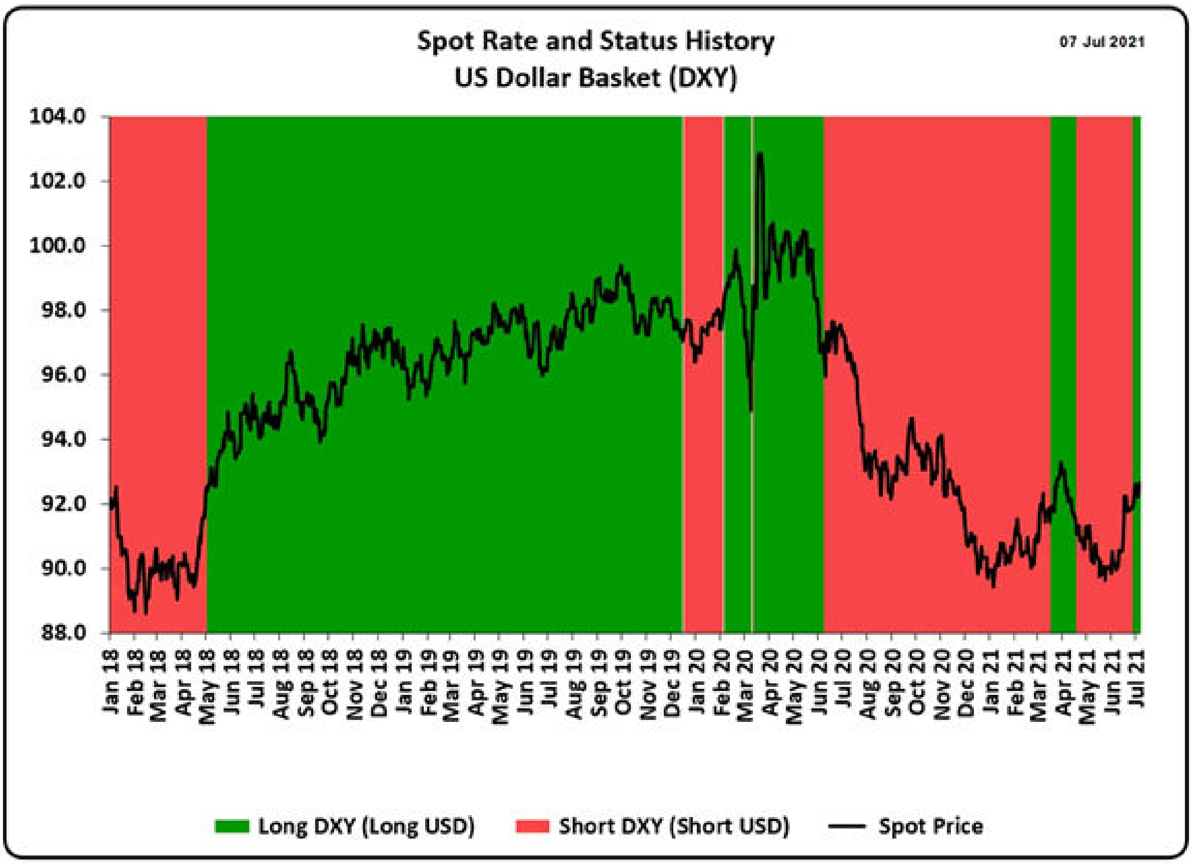


## Headline Numbers

One of the biggest questions in financial markets over the last year has been the strength - or otherwise - of the US Dollar. As Covid hit peak uncertainty and the economy tumbled, the dollar strengthened. A massive reflationary stimulus has also helped pump the dollar up, hurting some emerging markets. But a weaker dollar might also be useful to the Biden administration, so the direction of travel is closely watched - with the consensus being that the dollar will weaken. Now Charles Ekin of multi asset manager Ekins Guiness claims he has spotted a new signal, basing his analysis on the US Dollar Index (DXY*) which is a keenly followed index of the USD versus a basket of currencies.

*"Our model has been short USD for most of the last year, but recently our currency model has moved overweight the USD (green shading below) against this basket of currencies. A similar bullish USD trend first emerged in April this year as reflationary fears fed into markets. This was accompanied by a rise in US Treasury yields and a move higher in USD. However whereas 10 year*

*US Treasury yields have moved lower again recently (from a March high of 1.74% down to 1.37% now), USD strength has re-emerged."*

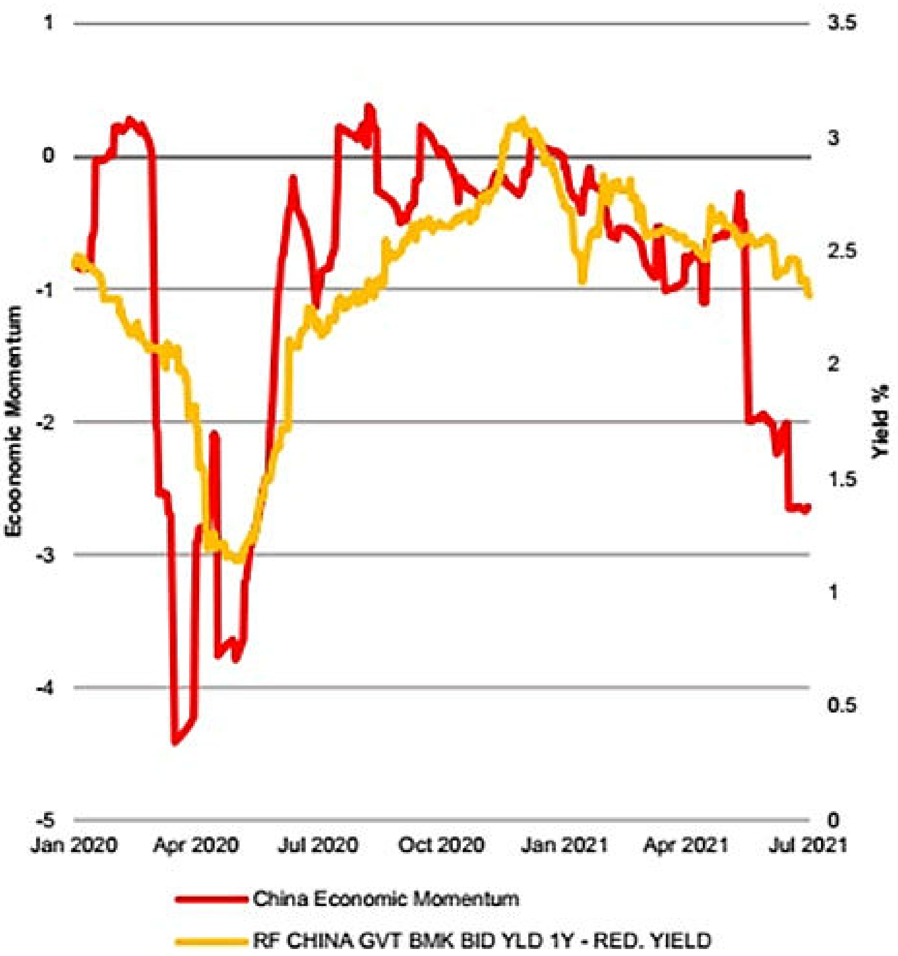



China

The big story for me this month is that more and more analysts think we are in for a nasty, surprising slowdown in Chinese growth, which in turn could spark a wider Asian slowdown. If that is the case, it'll sit awkwardly with the chatter of inflation hawks and worries about sharply rising bond yields. If Asia and China do slow down, that might actually push US Treasury yields which would undermine those central banks attempting to taper.

Cross Border Capital is amongst those research firms that are warning of a slowdown. It runs internal economic surprise measures which show that the "scale of the decline in the Asian data is worryingly fast" and is "significant". What's causing the slowdown? According to Cross Border "Figure 3 highlights that China seems to be largely behind this fall, with the drop in her economic surprise index beginning from May 17th 2021, or a full month before the now-infamous US FOMC meeting that spooked investors. What's more, the chart shows how 1-year Chinese interest rates have largely followed this declining economic surprise index lower."

**Figure 3**
**China Daily Economic Surprise Index and 1-Year Interest Rates**
2020-2021




**Source**
CrossBorder Capital, People's Bank of China, Bloomberg

Cross Border isn't alone in worrying about these numbers. But it's also useful to listen to alternative voices, notably Beijing based Michael Pettis and his Global Source Partners newsletter. He's entirely sanguine about the 'slowdown' worries.

*"I don't think anything substantial has changed in the past month or two. Consumption has returned a little slower than I expected because of this year's disappointing Spring Festival, but aside from that - and it is already reversing - the Chinese economy is developing so far this year pretty much as I have been expecting."*

But many analysts are declaring a real sense of surprise but Pettis has a simple explanation: too many analysts had "unrealistically high expectations of how the Chinese economy would evolve this year (the consensus is for GDP growth of 8.5 percent). Already analysts are starting to lower their growth estimates for the year."

That said, Pettis accepts that there has been a credit slowdown but that it is not nearly as dramatic as the year-on-year numbers seem to suggest.

*"9.3 percent [credit growth], I would argue, is a reasonable credit growth rate for this year. It is much lower than that of previous years (2017: 14.1 percent; 2018: 10.2 percent; 2019:10.6 percent; and 2020: 13.3 percent), but this is because I expect real GDP growth in 2021 to be somewhere between 6 percent and 8 percent - probably closer to 6 percent than 8 percent - in which case 9.3*

*percent growth in TSF would be roughly in line with expected nominal GDP growth for 2021. If credit and nominal GDP both grow at roughly the same rate in 2021, there would be no significant change in China's debt-to-GDP ratio, which is what I have been expecting since the beginning of the year and what Beijing has promised."*

Put simply, the Chinese economy and credit growth *"is slowing from the late surge last year and earlier this year exactly as we should have expected"* making it *"very unlikely that China will reverse its concern about debt any time soon, although because political concerns always trump economic and financial concerns we can never be sure that Beijing will not change its mind. For now, it is best to assume that Beijing will continue trying to restrain credit growth this year to 9.0-9.5 percent and allowing nominal GDP growth to come it at roughly the same level."*

| Measure | Values as of 8th June, 2021 | Values as of 13th July, 2021 |
|---|---|---|
| UK Government 10 year bond rate | 0.79% | 0.63% |
| GDP Growth rate YoY | -6.10% | -6.10% |
| CPI Core rate | 1.50% | 2.10% |
| RPI Inflation rate | 2.90% | 3.30% |
| Interest rate | 0.10% | 0.10% |
| Interbank rate 3 month | 0.08% | 0.08% |
| Government debt to GDP ratio | 100% | 97.40% |
| Manufacturing PMI | 65.6 | 63.9 |

Back to menu

## Bank CDS options

All's quiet again in the markets for insuring against big bank bond defaults. Swap rates haven't moved around much with most banks experiencing a small decrease in rates for both 1 year and 5-year products. Yet again rates for Lloyds Bank grind ever lower - they remain, by a considerable distance, the lowest in peer group. At the other end of the risk curve, rates for Deutsche Bank also grind lower, as that risk premium slowly but surely evaporates.

| Bank | One Year | Five Year | Credit Rating (S&P) | Credit Rating (Moody's) | Credit Rating (Fitch) |
|---|---|---|---|---|---|
| Banco Santander | 8.29 | 29.64 | A | A2 | A - |
| Barclays | 12.64 | 40.84 | BBB | Baa2 | A |
| BNP Parabis | 7.36 | 28.9 | A+ | Aa3 | A+ |
| Citigroup | 26.02 | 49.47 | BBB+ | A3 | A |
| Credit Suisse | 22.76 | 56.37 | BBB+ | Baa1 | A- |
| Deutsche Bank | 27.55 | 71.51 | BBB+ | A3 | BBB |
| Goldman Sachs | 26.1 | 53.46 | BBB+ | A2 | A |
| HSBC | 10.03 | 30.57 | A+ | A1 | A- |
| Investec | n/a | n/a | n/a | A1 | BBB+ |

| | | | | | |
|---|---|---|---|---|---|
| JP Morgan | 24.2 | 42.48 | A- | A2 | AA- |
| Lloyds Banking Group | 7.42 | 27.67 | BBB+ | A3 | A |
| Morgan Stanley | 27.43 | 50.44 | BBB+ | A1 | A |
| Natixis | 34.08 | 46.43 | A+ | A1 | A+ |
| Nomura | 17.54 | 54.62 | BBB+ | Baa1 | A- |
| RBC | 17.71 | 52.53 | AA- | A2 | AA |
| Soc Gen | 9.03 | 30.48 | A | A1 | A- |
| UBS | 8.91 | 28.16 | A- | Aa3 | A+ |

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

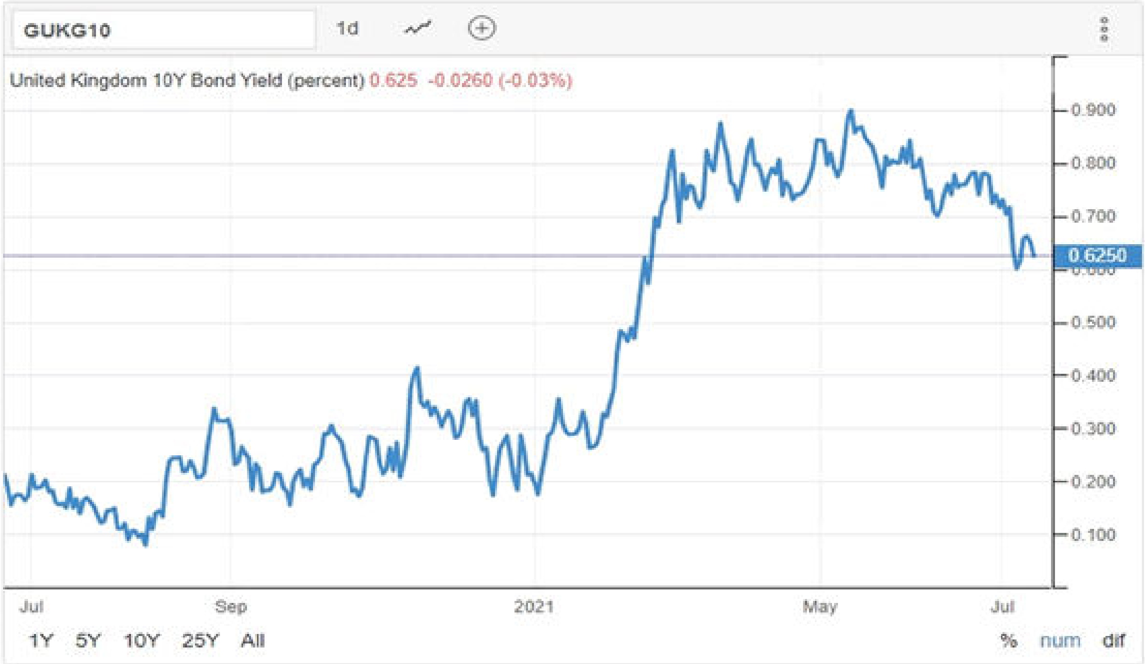
Back to menu

## Government Bonds

This month its worth paying attention to the sovereign bond market. 10 year bond yields on key European issues has started falling again with Spanish 10 year rates down 0.30% and the German rate to -30% (again). Crucially the spread between German and southern European bonds has tightened appreciably again and the Italian/German spread is just a shade over 100 basis points. Interestingly Greek rates are only a smidgeon above Italian levels. Over in the sovereign CDS markets, UK swaps have now fallen below 10 basis points - lower than German rates. In fact in our table, UK rates are now the lowest amongst developed world peers.

In terms of key UK bond market data, the 10-yr. Gilt yield dipped over the last month and there is real risk that pressure back to 0.55% and then 0.38% and even 0.20% and lower could build. According to Gerry Celaya of Tricio Advisors "this is not expected, but curve flattening and ignoring inflation risk seems to be dominating activity. If the 0.38% area holds then a pullback to 0.9% again should follow, setting up 1.5% further out. The Bank of England will be relatively happy with consolidating yields, taking the view that inflation expectations are anchored. The BoE is still suggesting that rate hikes will be a 2024 event, but traders are looking for hikes well ahead of this."

UK Government Bonds 10-year Rate 0.63%




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

## CDS Rates for Sovereign Debt

| Country | Five Year |
|---|---|
| France | 20.9 |
| Germany | 10.15 |
| Japan | 16.54 |
| United Kingdom | 9.16 |
| Ireland | 15.37 |
| Italy | 73.2 |
| Portugal | 28.39 |
| Spain | 29.27 |

## Eurozone peripheral bond yields

| Country | June 2021 | July 2021 | Spread over 10 year |
|---|---|---|---|
| Spain 10 year | 0.47% | 0.32% | 62 |
| Italy 10 year | 0.92% | 0.71% | 101 |
| Greece 10 year | 0.83% | 0.73% | 103 |

| | 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 |

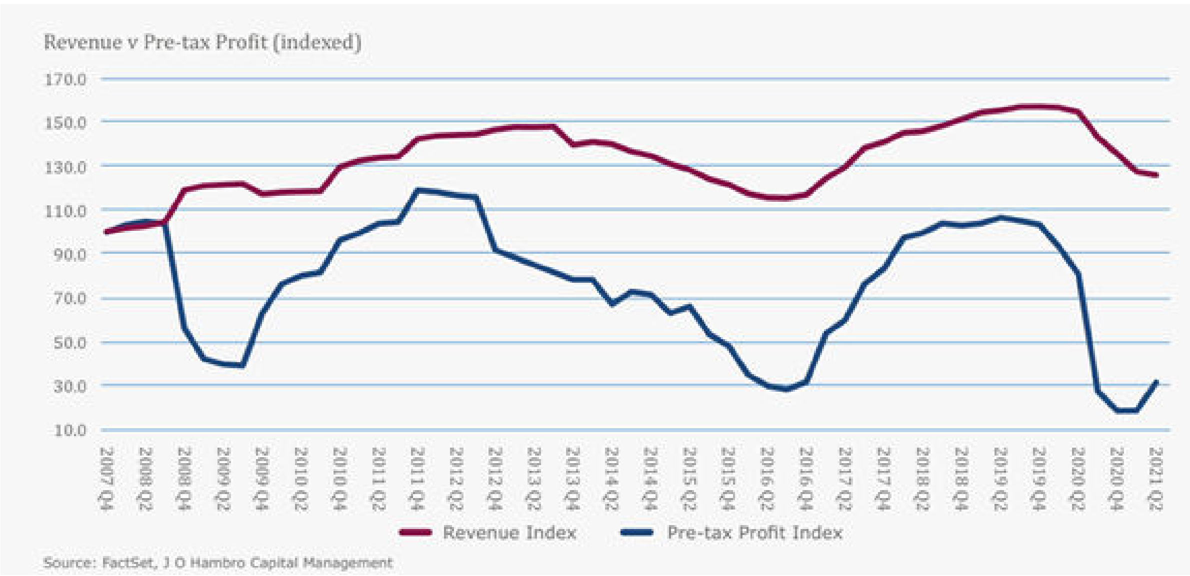
Back to menu

## Equity Markets and Dividend Futures

One of the reasons advanced for the underweighting of UK equities in most global portfolios is that Corporate UK PLC has suffered from anaemic profits growth compared to the tech heavy US index. But how accurate is this analysis ? Fund management firm The J O Hambro have just launched a useful new indicator which looks at the trend of profits for UK PLC. The UK Profit Index analyses the latest quarterly and half-yearly results published by all the UK companies listed on the UK main market, excluding investment funds and Real Estate Investment Trusts (REITs).

A bit of background first on the index itself : the index looks at the latest quarterly results, and then compares them to numbers from the last 12 months on a rolling basis. They then aggregate the results to "consider the collective performance of UK plc, and to look at sector and industry trends. In addition, we analyse consensus analyst forecasts for each company (where available) and produce forecasts for profit growth". The first release looks at company results announced between April and June, that almost all cover trading up to 31 March. The headlines for Q2 2021 are as follows:

- The pandemic caused a record decline in UK plc revenues, down £349bn or 19% in the first 12 months covering the outbreak (April 2020 to March 2021)
- Lower sales meant a substantial fall in profits - down 61% in the first 12 months of the pandemic
- J O Hambro Capital Management now expects UK plc earnings to roughly double to around £110bn in the 12 months to March 2022, and they should regain their pre-pandemic levels within another year




| Index | June 2021 | July 2021 | Reference Index Value | Level 6 Months Ago |
|---|---|---|---|---|
| Stoxx 50 Dec 21 contract# | 97.9 | 98.1 | 4085 | 85.4 |
| FTSE 100 (Dec 19) | 235.2 | 238.5 | 7120 | 207 |

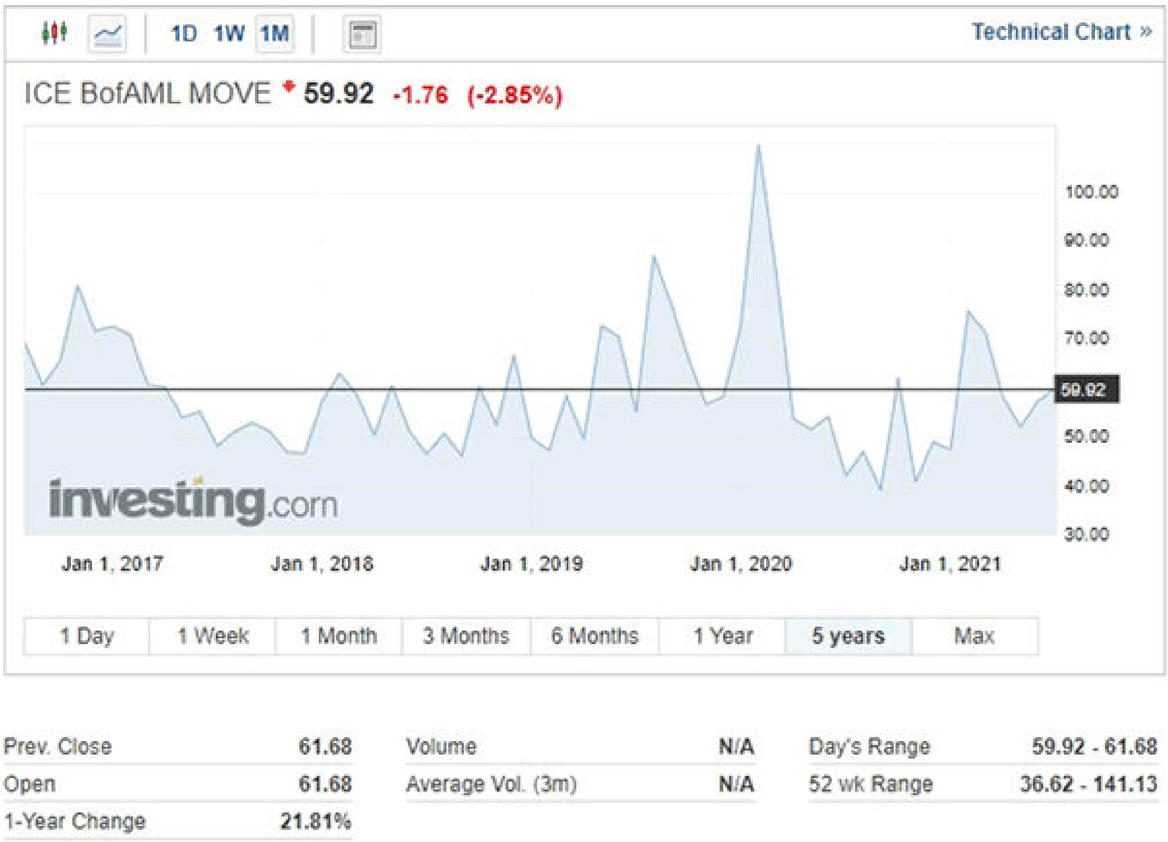
Note changed to Dec 2021 contracts in January 2021

| Name | | | Price % change | | | | Close |
|---|---|---|---|---|---|---|---|
| | 1 mth | 3 mths | 6 mths | 1 yr | 5 yr | 6 yr | |
| FTSE 100 | -0.237 | 3.29 | 5.51 | 15.2 | 6.7 | 5.63 | 7117.17 |
| S&P 500 | 3.23 | 5.87 | 15.1 | 39 | 104 | 109 | 4384.5 |
| | | | | | | | |
| iShares FTSE UK All Stocks Gilt | 1.4 | 1.82 | -3.31 | -5.63 | 3.09 | 17.4 | 1409p |
| | | | | | | | |
| VIX New Methodology | 3.32 | -2.88 | -27.2 | -49.8 | 24 | 16.3 | 16.17 |

Back to menu

## Volatility


Markets are in a subdued mood, despite growing concerns about inflation and higher interest rates. The chart above shows recent action for the VIX index, from mid-February 2020 through to today. The green line shows the 200-day moving average, the red line the 20-day moving average - the blue line shows the near term trend. Now, as we all know this widely watched fear index has had its share of ups and downs, reaching 37.2 on 27 January this year and dropping to 20 at the start of February. It's now back down consistently below 20, trading at around 16 points the last time I looked. The long term average for the Vix has been somewhere between 18 and 22 depending on your timescale, so in terms of equities we are definitely in a quiet lull after the pandemic storm - perhaps this is the quiet before the storm. But its not only equity markets that are becalmed. Over in the bond markets, the ICE MOVE index serves a similar purpose as the Vix, measuring bond market sentiment. Typically the index rises as concerns grow that interest rates are on the march higher. At current levels of around 60, this index seems to be flashing normal with no imminent hint of an interest rate increase, despite the protestations of the inflation hawks.




Source: https://www.investing.com/indices/ice-bofaml-move

| Measure | July Level | June Level | May Level | April Level |
|---|---|---|---|---|
| Vstoxx Volatility | 18.04 | 17.59 | 16.69 | 16.15 |
| VFTSE Volatility | 16.7 | 16.7 | 21.83 | 16.95 |


**Source:** sharepad
Red line - 20 day moving average
Green line - 200 day moving average
Red straight line - medium trend line

[Back to menu]

## 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.*

Back to menu

# 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.

Back to menu

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Kind Regards,

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

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