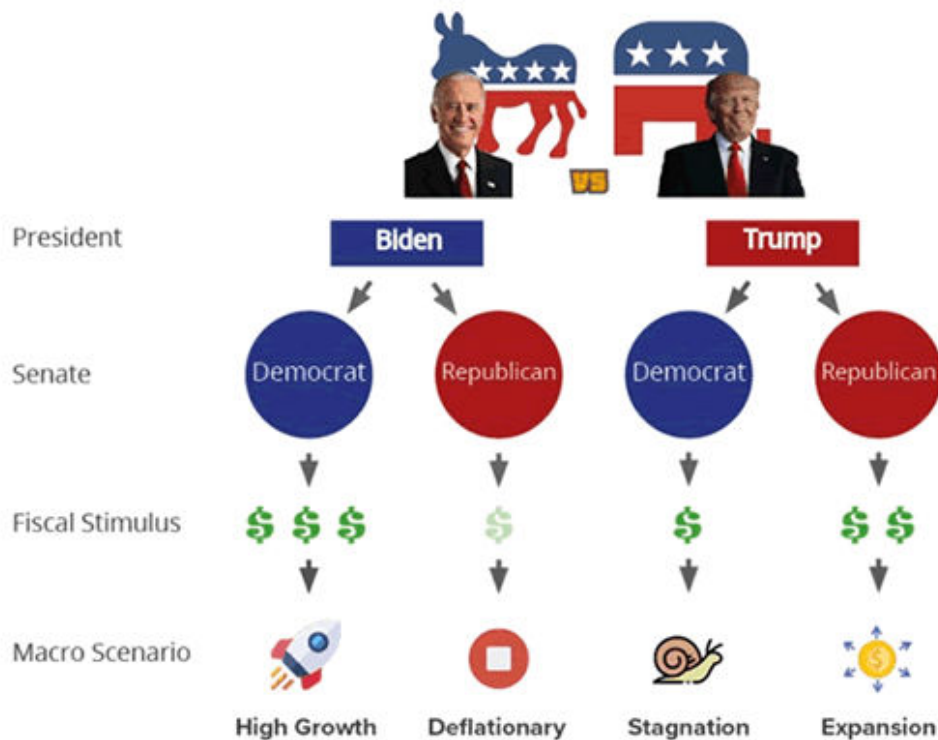




With commentary from David Stevenson

My favourite new golden rule is simple to understand - "don't get too hung up on politics as an investor". Precisely because we all have our own biases, we then tend to project them on to geopolitics and elections. Take the US presidential election which Democratic candidate Joe Biden now seems to have won. Many investors had been hoping for a blue (Democrat) sweep of the senate and the presidency. Fat chance. We now look like we're into legislative gridlock. The chart below is from a note before the election results were known by Bath based investment risk consulting service CheckRisk.

US Election Scenarios



Many analysts echo this CheckRisk prognosis and worry that we are now facing gridlock, again. The excellent Felix Salmon has a [piece](#) on the US news service Axios which suggests a dismal outcome. His argument is that in effect the Republicans will hang the Biden presidency out to dry and fight back against job measures to deal with Covid at the state level. Not that investors seem to have noticed as stock markets have bounced up aggressively, helped along by news that a vaccine from Pfizer might be close.

Rob Arnott a legendary markets analyst and founder of Research Affiliates provides some necessary balm, reminding us with a close, contentious election, market rallies are the usual

outcome, no matter who wins. *"Why? Before yesterday, 40% of the population dreaded a Trump win and 40% dreaded a Biden win. This week, one of those cohorts will no longer be fearful and happy to invest more into risk assets like stocks, while the other will have their fears realized, but likely are already risk-off. The net effect is a rally in risk assets, like stocks."* Crucially Arnott - echoing my own mantra - argues that we over estimate the importance of politics and elections in particular. According to Arnott, *"Long-term, the election outcome makes shockingly little difference, for a surprising reason. We did a global study in 2017 looking at the relative impact of conservative versus liberal election outcomes around the world. Average outcomes are surprisingly similar. The narrative that Dems are better for stocks than Republicans is dominated by two years, 1932 and 2008. In other countries, there is no similar bias in the results."*

The table below is from a 2017 research paper by Arnott and colleagues and shows the market reaction from a wide variety of left- and right-wing governments around the world. The bottom line? There isn't one - its almost random.

https://www.researchaffiliates.com/en_us/publications/articles/614-presidential-politics-and-stock-returns-is-the-relation-real-or-spurious.html

Table 3. Average Stock Market Return Difference in First Year of Power of Left and Right Political Parties, Jan 1950–Feb 2017 (Jan 1988–Feb 2017, France and Germany)

	Left Party	Right Party	Difference (Left–Right Gap)	Transitions
France	31.68%	7.14%	24.54%	2
Germany	12.86	18.42	–5.56	2
United Kingdom	11.85	5.85	6.01	7
Canada	12.14	1.80	10.34	9
Australia	–16.44	5.53	–21.97	6
Average	10.82	5.44	5.28	26

Source: Source: Research Affiliates, LLC, using data from Global Financial Data (GFD). Note: The stock market return is in local currency. We use the S&P/ASX Index in Australia, Canada S&P/TSX Index in Canada, CAC 40 Index in France, DAX 30 Index in Germany, and FTSE All Shares in the United Kingdom. For periods prior to the launch of these indices, in some cases GFD uses alternative data sources to estimate the local market return. For all countries, we use the three-month Treasury bill as the risk-free rate of return.

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Back in the US my own sense is that the deflationary scenario is not pre-determined and that the Senate can probably be persuaded to pass a stimulus bill of some sort. And if that happens, and 2021 sees a bigger recovery from the pandemic, we could experience a reflationary new year. Again according to Arnott *"there's a little-known but very direct link between deficit spending and subsequent corporate earnings. This means that unprecedented deficit spending may lead to an unprecedented surge in profits for surviving companies in 2021-22. The market may be taken by surprise. This would be the one bullish shock that could justify today's lofty valuations."*

Contents

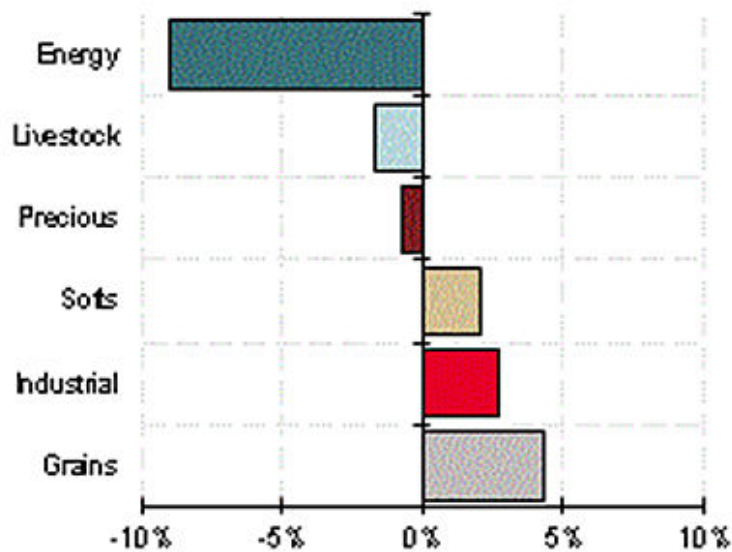
- Headline numbers

- CDS Rates
- Government Bonds
- Equity Markets and Dividend Futures
- Volatility
- Summary of Pricing Impact on Structured Products
- Explanation of Terms

Headline Numbers

Commodities hint at a more prosperous 2021

As markets bounced up following news of a vaccine, equity investors have begun to see light at the tunnel. Commodity investors are also perhaps signalling that developed world economies might be due a pronounced rebound after a truly terrible year to date. Looking at indices tracking the commodities spectrum (using the S&P GSCI (ER) index) total returns are now -36% for the year to date and 3.5% for October - the high or should we say low light is the energy complex which is down 58% year to date. Intriguingly one of the best performing sectors was the industrial metals sector which advanced 2.76% last month, bringing its year to date performance to +3.26%.



These tentative signs of a rebound in industrial metals might be a signal of a much broader economic recovery. The second chart below shows the (complex) interrelationship between US 10 year bond yields and the ratio of copper relative to gold. The obvious mini cycles have been a recurring feature of the US economy over the last decade and we seem to be at the bottom of one now. But it's worth noting that prices for copper have been particularly strong since the depths of the pandemic lockdown and based on past evidence this could be a reasonable indicator for the direction of the global economy.

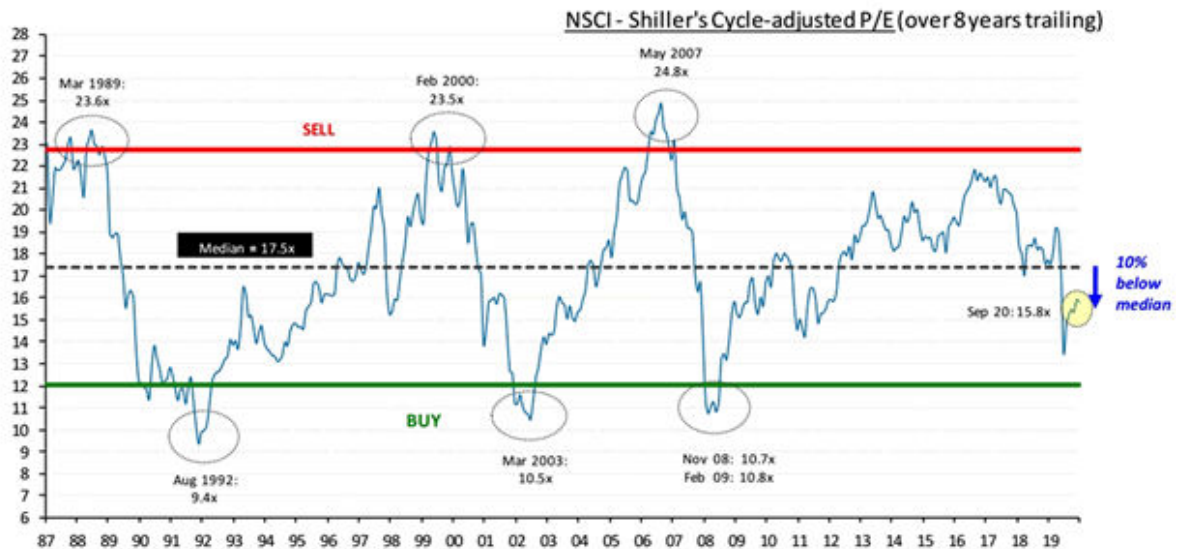


Here is a simple statement of fact. UK equities are on average some of the cheapest when compared to other developed world markets. According to investment bank SocGen's quant team led by Andrew Laphorne *"Over the last three years, the total return in USD terms on MSCI World is around 29% meanwhile for the UK it is a shocking -15.5%, a relative underperformance that is as bad as when the UK was in recession and suffering rampant inflation back in 1972-74. Back then, UK equities fell 70% in just over two years despite profits almost doubling, resulting in a P/E of just 3.0x, i.e., performance was entirely driven by a de-rating in the wake of significant macro issues."*

One other statistic stands out for me - over the last three years, of the 12 countries in the developed MSCI index that have seen market cap fall, the UK is responsible for 56% of that decline, i.e. more than the other countries put together. Yet when one looks at earnings by contrast the UK has actually beaten everyone else including, up until recently, the US.

And what's true for the mostly large caps inside the FTSE 100 index is also true - to a lesser extent - for small to mid caps. The chart below is from specialist fund cap managers at Montanaro in the UK. They've been tracking their version of CAPE price to earnings metric for a few years now and by the autumn of this year it was still 10% below the long term median.

The 8-year Shiller P/E for UK SmallCap is 10% below median



Source: Internal, Bloomberg, Numis.

Note: the SELL line (red) shows 1.5 Standard Deviations above Average. The BUY (green) line shows 1.5 Standard Deviations below Average.

34

Measure	Values as of 11th October, 2020	Values as of 10th November, 2020
UK Government 10 year bond rate	0.28%	0.40%
GDP Growth rate YoY	-21.50%	-21.50%
CPI Core rate	0.20%	0.50%
RPI Inflation rate	0.50%	1.10%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.05%	0.04%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	54.1	53.7

[Back to menu](#)

Bank CDS options

The market for credit default swaps for major global banks was a tad subdued over the last month with most European banks experiencing a small increase in their rates whilst most US banks saw a small decrease. That said we did see some more noticeable price changes with Deutsche Bank, UBS and HSBC all benefitting from substantial declines in swap pricing with HSBC 1 year swaps now in single figures again at 9.99 (versus 9.5 for UBS 1 year swaps).

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	18.37	49	A	A2	A -
Barclays	25.52	65.62	BBB	Baa3	A
BNP Parabis	17.76	38.29	A+	Aa3	A+

Citigroup	34.69	58.41	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	19.99	51.69	BBB+	Baa2	A-
Deutsche Bank	50.99	122	BBB+	A3	BBB
Goldman Sachs	36.54	62.4	BBB+	A3	A
HSBC	9.99	39.25	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	27.92	47.46	A-	A2	AA-
Lloyds Banking Group	16.48	41.74	BBB+	A3	A+
Morgan Stanley	31.42	55.45	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	40.85	95.11	BBB+	Baa1	A-
RBC	20.47	60.52	AA-	Aa3	AA-
Soc Gen	17.09	39.56	A	A1	A
UBS	9.5	27.73	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 2nd November 2020 www.tempo-sp.com

[Back to menu](#)

Government Bonds

Fixed Income

I have always assumed that the Covid pandemic would unleash a potent double whammy from policy makers. The first wave would attempt to control and mitigate the economic impact of the first and second wave and would be centred on fiscal policy i.e. furloughs and such like. Central banks would merely play along with this first wave of policy, making sure there was no systemic damage to the global economy and helping at the margins. The second wave of policy would be launched once everyone started to believe that the virus was either under control or imminently under assault from a vaccine. In this second stage, the focus would be on kick starting the global economy and revving up speed. The emphasis here would be on monetary policy, to lubricate the engine of growth - and would presumably wait until some point in 2021 to properly kick off.

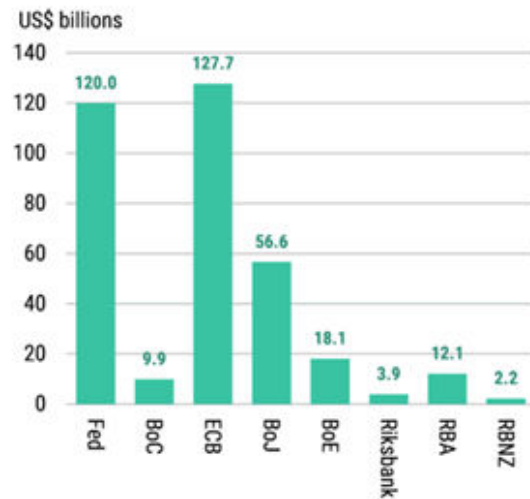
A good primer on this second wave comes in a global strategy overview out last week from analysts at Morgan Stanley. Entitled "Let It Flow, Let It Flow, Can't Hold It Back Anymore" it outlines my double whammy above, with a focus on that monetary boost. The investment bank analysts expect a tidal wave of additional liquidity in 2021 with 8 central banks combining together "to remove US\$350bn of securities, on average, from private markets every month in 2021. Unsurprisingly, the Fed, ECB, and BoJ will remove the most securities each month, in US dollar terms". This will help push corporate bond prices even higher. But as the two charts below show, the next phase will be even more audacious for fixed income investor - "these central banks will be adding liquidity worth 0.76% of annual nominal GDP, on average, every month in 2021. That is a rapid pace of global liquidity injection, the likes of which we haven't seen outside of 2020."

Exhibit 4: G10 central bank expected average monthly QE pace in 2021

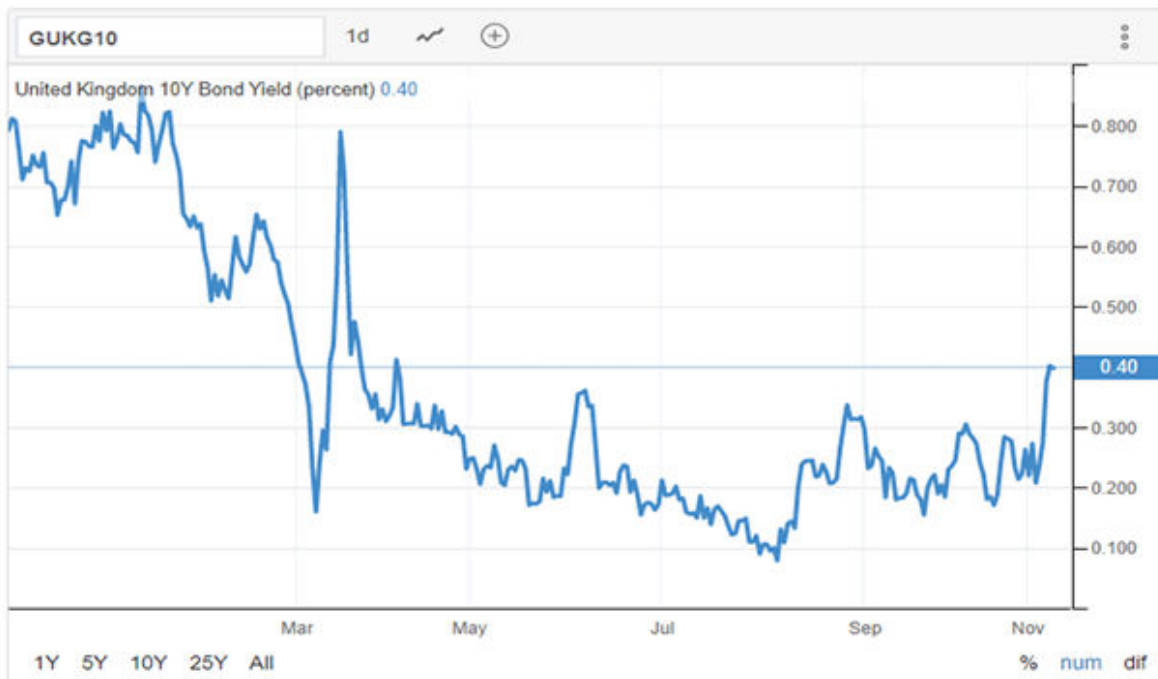
	Local CCY (bn)	USD (bn)	GDP (USD bn)	% GDP	CB BS (LCL bn)	% CB Balance Sheet
Fed*	120.0	120.0	20,856	0.58	7,157	1.7
BoC	12.9	9.9	1,642	0.60	531	2.4
ECB	107.5	127.7	13,440	0.95	6,776	1.6
BoJ**	5,850.0	56.6	5,093	1.11	698,231	0.8
BoE	13.8	18.1	2,681	0.67	992	1.4
Riksbank	34.0	3.9	570	0.69	1,356	2.5
RBA	16.7	12.1	1,395	0.87	295	5.6
RBNZ	3.3	2.2	200	1.12	62	5.3

Source: Morgan Stanley Research, National central banks, Bloomberg
 *Net Purchases of Treasuries and Agency MBS
 **Monthly JGB Purchases (excludes t-bill purchases)

Exhibit 5: G10 central bank expected average monthly QE pace in 2021, in USD



UK Government Bonds 10-year Rate 0.40%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	18.06
Germany	11.25
Japan	16.39
United Kingdom	20.21
Ireland	19.4
Italy	110
Portugal	43

Eurozone peripheral bond yields

Country	October 2020	November 2020	Spread over 10 year
Spain 10 year	0.15%	0.15%	66
Italy 10 year	0.68%	0.72%	123
Greece 10 year	0.80%	0.80%	131

	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](#)

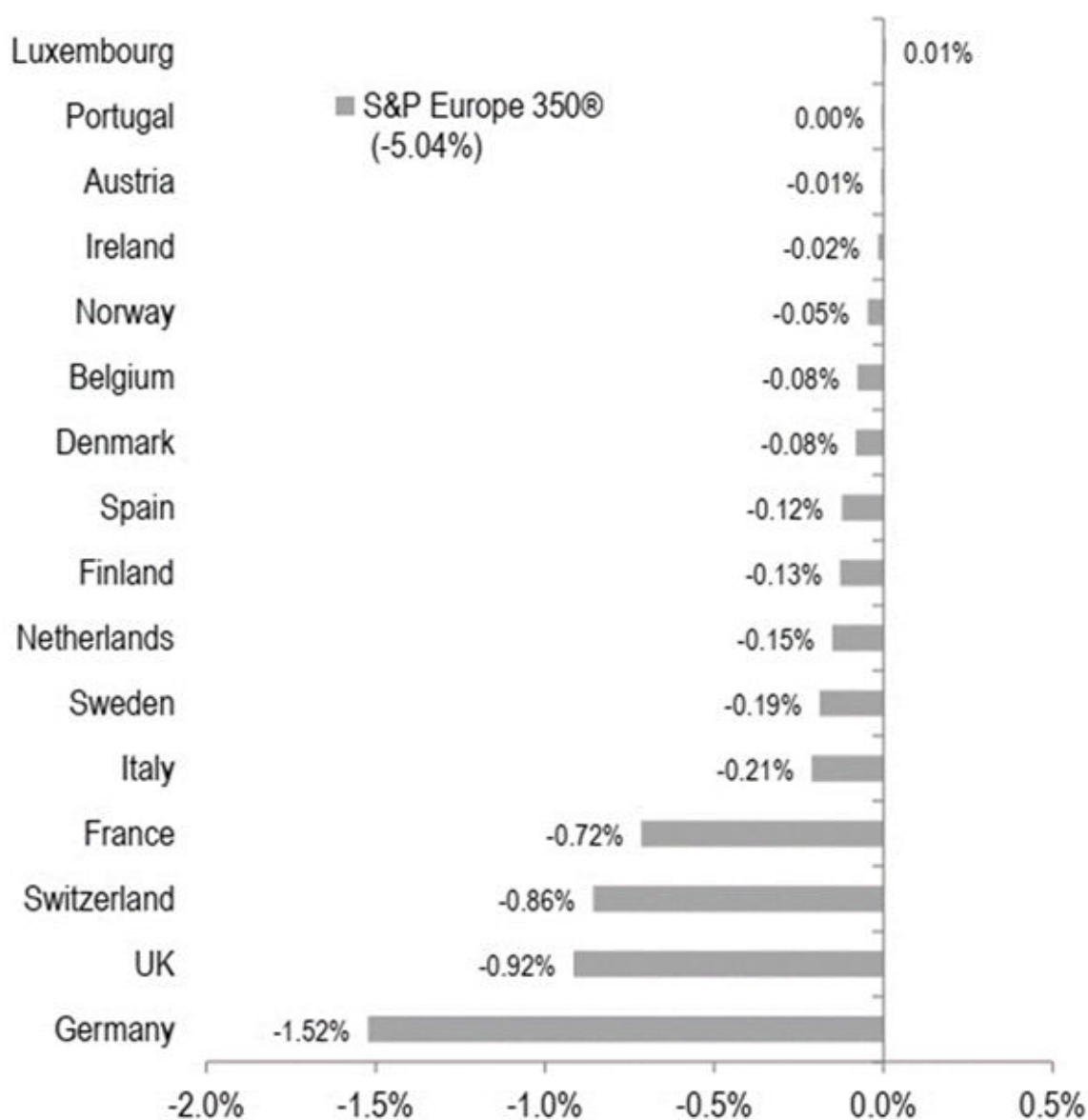
Equity Markets and Dividend Futures

November looks like it might be one of the better months this year but October provided with some dismal numbers, according to data from index firm S&P Dow Jones. For the month, 12 of the 50 markets gained, up from 11 gainers for the prior month (and down from 42 the month before that), while the U.S. performance was on par with global markets for the month. According to the index firm, sector variance decreased, as two of the 11 sectors gained for the month, compared to last month when all 11 sectors declined; there were 10 gainers the month before that. The spread between the best (Communication Services, 1.52%) and worst (Energy, -5.55%) sectors for the month was 7.07% (the one-year average was 10.54%), down from last month's 11.35% and down from the prior month's 13.39%.

Intriguingly Emerging markets outperformed, posting a 1.94% gain for the month, after last month's 2.36% decline and the prior month's 2.53% - the year-to-date return is -2.28%. "Indonesia did the best, adding 8.98% for the month, though it remained down 26.99% year-to-date and down 25.07% for the one-year period. The Philippines were next, up 7.93%, down 15.58% year-to-date, and down 17.46% for the one-year period, followed by China, up 4.80%, up 20.08% year-to-date, and up 31.63% for the one-year-period. Poland did the worst, as it declined 14.74%, bringing it down 32.35% year-to-date and down 32.63% for the one-year period."

Sticking to Europe, UK and Germany were the laggards. The S&P Europe 350 dropped 5% on the month, breaking out of a narrow trading range which had held since May. **The S&P United Kingdom declined every day in the final week of October to finish the month with a loss of 5%, the worst monthly performance for U.K. equities since March [my emphasis added].** By contrast, the star performer was boring old Luxembourg. Who'd have thought...

S&P Europe 350 Country Contributions October 2020



Index	October 2020	November 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	83.5	83.3	3464	81.7
FTSE 100 (Dec 19)	210	212.1	6359	160

Name	Price % change							Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr		
FTSE 100	5.74	3.38	7.11	-13.2	1.03	-4	6362.24	
S&P 500	1.97	6.35	21	14.9	70.9	73.8	3545.53	
iShares FTSE UK All Stocks Gilt	-1.76	-2.62	-4.58	3.77	18	21.5	1440.38	

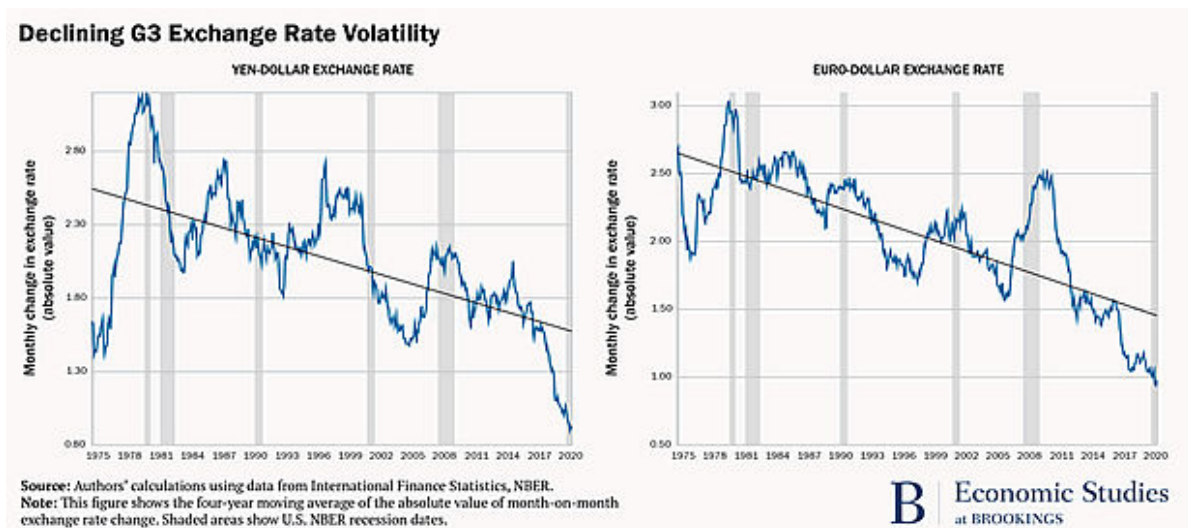
[Back to menu](#)

Volatility

We've observed before in these articles that there seems to be something of a paradox when it comes to foreign exchange markets. We tend to think of these FX markets as very volatile and the urban myth is that FX traders tend to nearly always lose money because currencies are so damned unpredictable ! But the stats suggest otherwise. Volatility amongst core currencies - dollar, euro and yen - has in fact trended downwards through the 21st century. In fact we are now at a point where by some measures global exchange rates are more stable than during the halcyon Bretton Woods era of the 1960s, when rates among major economies were fixed.

These startling conclusions come in a recent paper by economist Ken Rogoff for the Brookings Institute. He reveals that during this crisis, the euro rate has risen 7% against the dollar, but during the 2008 crash, the dollar swung between \$1.58 and \$1.07 against the euro, while the yen-dollar, which this time has hardly moved, swung between \$0.90 and \$1.23. Why are FX rates so stable ? According to Rogoff, all major economies now have very similar, very low rates of interest and inflation. With little to distinguish between them, there's less reason for exchange rates to move (the big exception is sterling and Brexit). The trend towards stability accelerated sharply in 2014, when the ECB introduced negative interest rates. And nearly all high-income countries have an inflation rate of between zero and 2.5%. The past two decades have had the lowest differentials on inflation rates since the war.

<https://www.brookings.edu/bpea-articles/will-the-secular-decline-in-exchange-rate-and-inflation-volatility-survive-covid-19/>





Measure	November Level	October Level	September Level	August Level
Vstoxx Volatility	24.8	22.32	27.87	22.69
VFTSE Volatility	23.19	25	30.76	21.69

[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.

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.

[Back to menu](#)

To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,



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