Monthly Market Report

December 2022

With commentary from David Stevenson

I think the single biggest challenge facing anyone running money for clients - or their own money - is to work out whether we have fundamentally moved to a new economic order. If the old model was QE and low rates, the new order currently appears to be about higher rates and tapering QE or even QT. If this regime shift is upon us, the asset allocation implications are legion. A few weeks back Steve Hou at Bloomberg put together a very detailed report looking at how to build a portfolio for these uncertain times - with a focus on these regime shifts and dynamic asset allocation. He observes that it is likely that we are currently collectively stuck smack bang in the middle of the Stagflation column in the graphic table below with inflation linked securities (TIPs and Linkers) the best option along with volatile commodities, value stocks and energy and healthcare sectors. If and it's a big if we do pivot into a recession, especially a deep one, then that regime shifts again and suddenly bonds look much more attractive.

So far, so conventional. But I'm not entirely that this time it really is that different. I'd simply observe that for the US, the UK and Europe, to tighten monetary policy at a rapid rate whilst also tightening fiscal policy (at an rapid rate in the US) all at the same time is a recipe for economic chaos. History teaches us that eventually something has to give as liquidity tightens and social disorder grows. That something will either be more relaxed fiscal policy - which is stimulative and will help boost corporate earnings - or relaxed monetary policy. That latter option has already made a fleeting appearance here in the UK, with the short lived gilts purchase programme. I would argue that if we get a liquidity crisis in unrelated but systemically important submarkets, especially in the US, we'll see more 'quiet' QE emerge. Some argue that will take the shape of long duration government bond management programmes, as the Japanese are doing. I don't know what will happen next but what I would argue is that reports of the death of QE might be a tad too early. Watch this space.

	Inflationary Growth	Stagflation	Recession
Asset Class	Equities, TIPS, Commodities	TIPS, Commodities	Nominal Treasuries, Gold
Style Factor (L/S)	Value, Momentum/ Trend	Value, Momentum/ Trend	Trend
Equity Sectors	Energy, Tech, Industrials, Materials, Real Estate	Energy, HealthCare, Utilities, Consumer Staples,	HealthCare, Consumer Staples

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

Just when technology investors thought that it couldn't get much worse, it did. A few weeks we saw some quite extra ordinary moves, headlined by Meta Platforms' shares falling by 24% in value on just one day. But it wasn't alone. Amazon shocked with its announcement that it might not even make a profit, while Apple also confirmed weak sales growth for their iPhones. And even Google admitted that surprise, surprise, a slowing economy might just mean slowing advertising sales growth. Quite why tech investors thought that the sector could somehow avoid the generalised slowdown in corporate earnings growth was beyond this cynical observer. To repeat, every recession or slowdown since the 2nd world war has usually resulted in a fall of between 5 and 15% in aggregate corporate earnings for the S&P 500. Maybe the investors had been smoking a bit too much of that brand called Technology Disruption and thus they needed to be brought back down to earth. Since the beginning of the year the stocks comprising what I call the FAANNMs (Meta, Apple, Alphabet, Netflix, Nvidia and Microsoft) have lost an average 42% in value which represents a combined $400 billion decline in market capitalisation.

Then again, it could have been much worse. In the table below I've listed some other notable casualties of the great Growth Stock sell off, so far. As I write this Cathie Woods Ark Innovation ETf is down a smidgeon under 60%. Given this huge loss one can entirely understand why she's planning the launch of a new private VC fund which will be accessible to investors - whether private investors should be accessing these stocks given the still sky high valuations for many early stage private tech companies is another question. But if we're looking for the poster child of the great Growth Sell Off or perhaps more accurately the Disruptors Disrupted I'd alight on Beyond Meat, the star in the foodtech firmament which has suffered declining fast food sales, departing senior executives accused of violent assault and a share price decline of just 77% this year.

Carnage dispersed

Sector/ index / stock	YTD	2 yr. returns
S&P IT sector	-24%	+6%
S&P 500	-16.5%	+12%
FAANNGMs	-42%	-9%
ARK Innovation	-58%	11%
S&P Biotech	-23.8%	-31%

NASDAQ Biotech	-9.54%	-3.67%
SOX Philadelphia Semiconductor Index	-30%	+9.81%
S&P Small Cap IT	-19.1%	20.7%
Beyond Meat	-77%	-60%

Liquidity measures are dipping worryingly worldwide because the markets have woken up to the dope withdrawal warning. They now realize that the liquidity is draining from the system and that is a problem.

To be clear I think it quite possible that the US Federal Reserve can do the impossible - drain liquidity and push up interest rates to quieten down inflation - but in the absence of coordinated action that will mean an ever-stronger dollar and more liquidity flowing into the US. The rest of the world will be caught in a crunch, whether they are led by Truss or a lettuce. As long as the US Fed only thinks about the US, the rest of us are in trouble.

And if you wanted a small hint of the future liquidity issues that might be heading our way take a look at the chart below from strategists at French bank SocGen which is already warning of tough liquidity conditions in the global FX markets.

Their observations are as follows: *"The drop in trading liquidity in the FX futures market is one of the side effects of the current volatile environment. When uncertainty rises, market makers are less willing to take on risks and reduce the size on offer at the best price. Trading liquidity drops. If at the same time, traded volumes increase, prices tend to move more suddenly, and volatility increases."*

Watch out for a more generalized currency war breaking out unless the world's central banks start to coordinate more.

Measure	Values as of 13th October, 2022	Values as of 14th November, 2022
UK Government 10 year bond rate	4.27%	3.36%
GDP Growth rate YoY	4.40%	2.40%
CPI Core rate	6.30%	6.50%

RPI Inflation rate	12.30%	12.60%
Interest rate	2.25%	3.00%
Interbank rate 3 month	3.49%	3.47%
Government debt to GDP ratio	95.90%	95.90%
Manufacturing PMI	48.4	46.2

Back to menu

Bank CDS options

Pricing for 1 and 5 year credit default swaps for major bank bonds mostly declined across the board over the last month, with a few exceptions. Credit Suisse saw a substantial increase again in swap pricing as its travails continued. Pricing for Deutsche Bank's swaps by contrast decreased substantially as the big German bank starts to move back towards the average. On a side note, pricing for swaps on UK government debt has crashed back down to normal levels after the run in with the Truss administration. In our list only Germany has cheaper pricing while France's swaps are nearly three times as expensive.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	36.03	77.5	A+	A2	A -
Barclays	80.1	116.78	BBB	Baa2	A
BNP Parabis	40.99	87.7	A+	Aa3	A+
Citigroup	57.73	112	BBB+	A3	A
Credit Suisse	215	233	BBB	Baa2	BBB
Deutsche Bank	99.98	174	A-	A2	BBB+
Goldman Sachs	61.9	121.81	BBB+	A2	A
HSBC	53.57	84	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	52.54	94.03	A-	A2	AA-
Lloyds Banking Group	50.56	76	BBB+	A2	A
Morgan Stanley	57.11	112	BBB+	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	40.09	119	BBB+	Baa1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	45.91	82.83	A	A1	A-
UBS	50.4	87.3	A-	Aa3	A+

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

Back to menu

Government Bonds

Fixed Income

OK, so it looks like the (UK) Incompetence Tantrum by the Bond Vigilantes might be drawing to a close with Mr Orthodox, Rishi Sunak in charge as PM. Given that he had a Bloomberg installed in his office at the Treasury, I think we can say with some certainty he will be sensitive to 'the markets' views, whatever they might be.

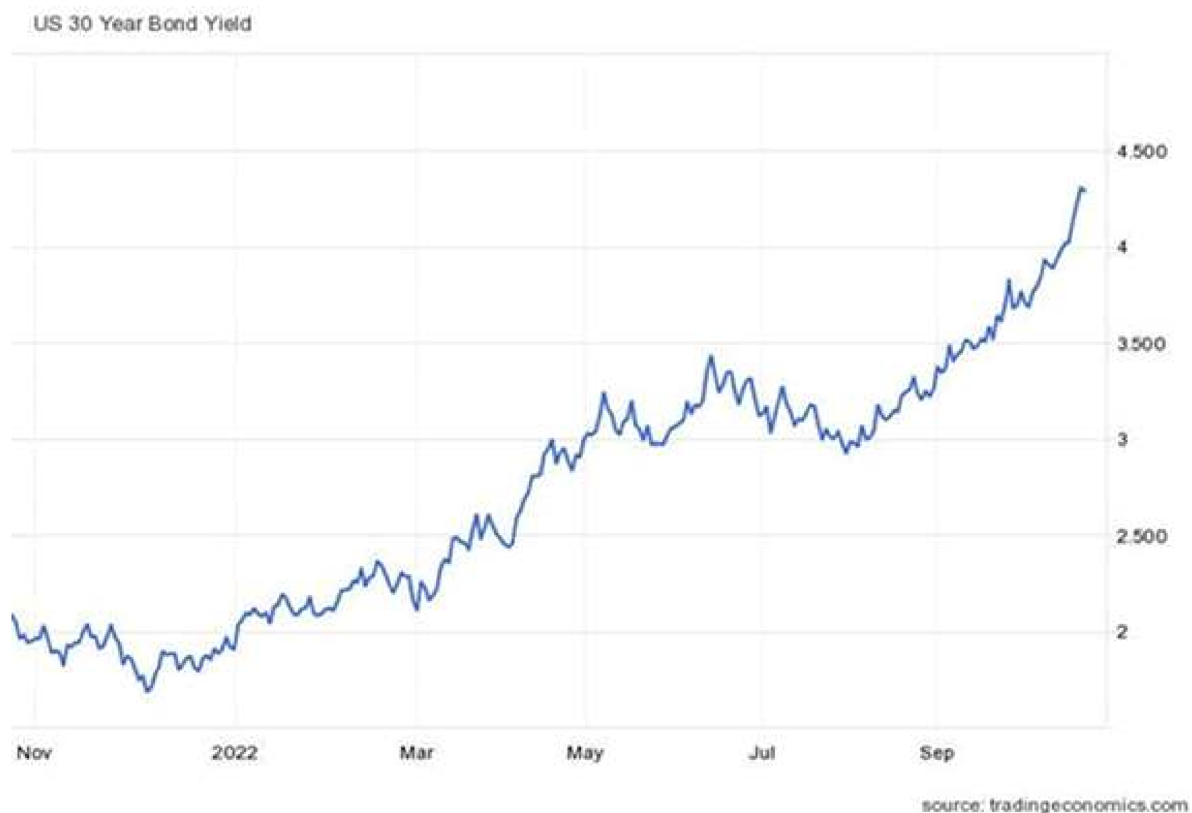
So where might the next tantrum appear?

Maybe we should look across the pond in the US. The chart below shows the yield on the US 30 year Treasury. These T bonds were running at a 2% yield at the beginning of the year, but are now at just over 4%. The steepness of the curve looks rather worrying don't you think, though we shouldn't be remotely surprised by this? The bond markets are beginning to realize that an awful dilemma awaits.

The US Federal Reserve can do one of two things.

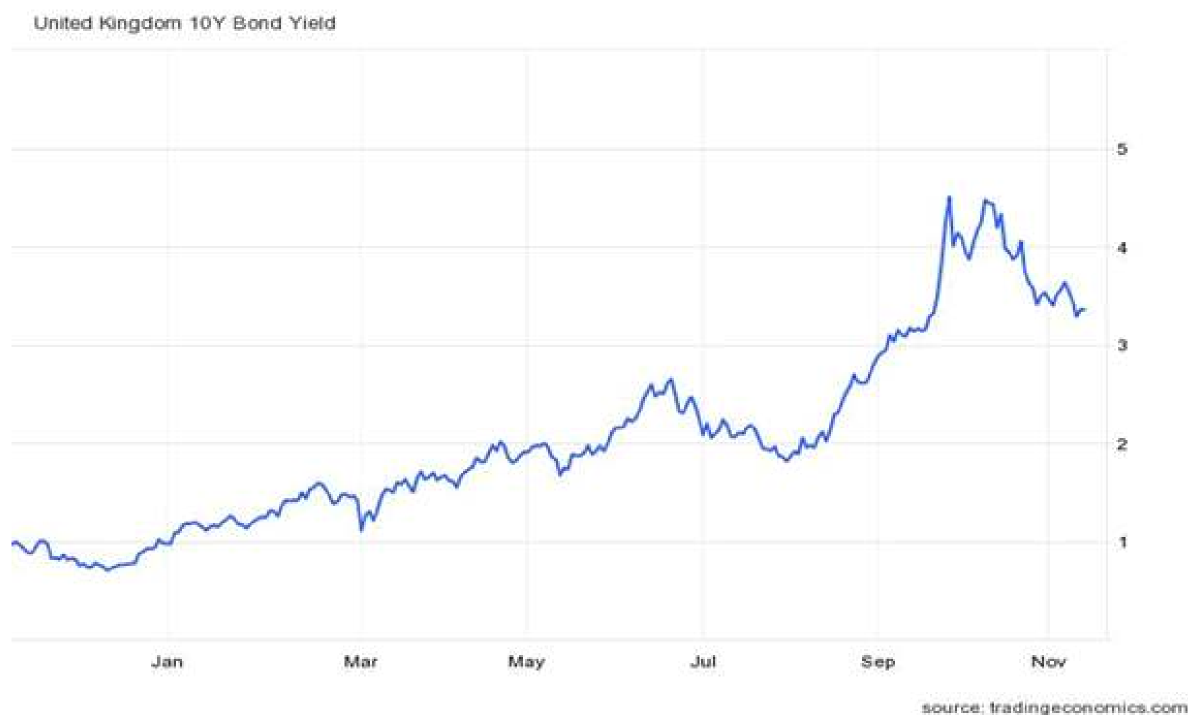
The first is it can continue with QT (quantitative tightening) and sharp interest rate increases which could push the US into a sudden recession, collapsing inflation OR it could slow down a little and tolerate higher-than-expected inflation. Until very recently all bets were on the former scenario but doubt is creeping in. Perhaps the Fed is mindful after all of the global impact of its moves? Perhaps the Fed is worried it might overshoot on the way up in terms of interest rates?

If this view does become more dominant there is a nasty consequence - it assumes that the Fed will be willing to let inflation stay above its target range for longer. In other words, instead of zealously pushing rates back down into the 1 to 4% range, it might be happy to let inflation rates stay above 5% for longer.



For the record, think this scenario is unlikely, both as a policy choice or as an inflation outcome, but I might very well be wrong on both counts. If the logical consequence of this line of thought is followed through, then we are indeed in choppy waters and the 30-year yields might be the first pointer to future trouble. Equities do pretty well when inflation stays in a 2 to 5% range but returns fall sharply once inflation goes above that level - and head past 5% - and maybe these long duration bond yields are warning us that there might be a longer-term inflation problem. If so we could be into a multi year beat market for equities.

UK Government Bonds 10-year Rate 3.359%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	29.45
Germany	7.58
Japan	17.12
United Kingdom	10.05
Ireland	14.85
Italy	105
Portugal	38.61
Spain	39.26

Eurozone peripheral bond yields

Country	October 2022	November 2022	Spread over 10 year
Spain 10 year	3.43%	3.19%	104

Italy 10 year	4.67%	4.19%	204
Greece 10 year	4.86%	4.33%	218

	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

We're all so fixated on US and to a lesser degree UK stockmarkets that we sometimes forget there are dozens of other markets, exchanges and indices out there. Sometimes, on some months, this vast universe of markets merits comment, as places like Turkey and Chile shoot ahead while well established markets stagger on with mediocre returns, or losses. But what we rarely see is how different markets compare on valuation terms, and not just current PE ratios but long term measures of 'value'. A US website called the Idea Farm produces a quarterly estimate for long term valuations which is fascinating reading - you can read it here.

They reckon across all global markets - developed and emerging - the median cyclically adjusted earnings ratio (the long-term PE using Robert Shiller's measure) is running at 15, with the lowest quartile of national markets boasting a PE of just 10, and the top quartile a PE of 24. The average for foreign developed markets is now running at 19 which compares to just 13 times earnings for the average emerging market.

The bottom line? US markets might still be overpriced but most other national equity markets are now looking historically cheap and getting cheaper.

	CAPE	CAPD	CAPCF	CAPB	Real Drawdov %
Poland	6.5	16.3	2.8	0.6	-66.68
Egypt	6.8	19	4	0.8	-79.3
Colombia	9.5	19	5.3	0.8	-48.03
Czech Republic	11.7	14.2	5	1.3	-33.97
Spain	12.8	17.4	5.7	1	-39.35
Austria	10.8	29.7	4.9	0.9	-51.21
Hungary	8.2	38.8	3.2	0.9	-47.47
Singapore	11.1	19.3	8.7	0.9	-24.76
Italy	15.9	25.7	4.8	0.9	-46.45
Hong Kong	11.4	25.6	8.1	0.9	-33.62
Chile	12.7	23.5	6.9	1.2	-46.4
Turkey	8.6	31.6	6.8	1.2	-46.18
Germany	12.5	27.1	5.9	1.2	-36.35
China	9.3	30.9	7.3	1.1	-54.77
Malaysia	12.8	23.7	8	1.2	-19.72
U.K.	13.7	22.6	7.4	1.5	-14.3
Brazil	13	22.2	7.5	1.5	-23.73
Korea	11.2	54.5	5.8	1	-38.85
Portugal	21.7	21.4	5.6	1.4	-53.46
Greece	-3.2	32.5	4.6	0.5	-96.75
Peru	11.5	26.1	10.8	1.4	-50.16
Belgium	15.2	25.7	9.3	1.4	-32.99

Index	October 2022	November 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	123	123.4	3886	119

FTSE 100 Dividend Dec 2022	272	272	7387	269

Note changed to Dec 2022 contracts in January 2022

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	7.6	-1.62	-0.518	0.433	-0.468	9.28	7379.75
S&P 500	10.9	-7.12	-1.21	-15.1	54.1	83.7	3975.3
Gold Composite (Most Traded)	7.31	-2.54	-2.15	-5.3	38.1	44.6	176940¢
iShares FTSE UK All Stocks Gilt	11.5	-9.23	-13.8	-22	-16.6	-15.3	1089.75p
VIX New Methodology	-29.7	15.3	-22	38.2	94.3	55.5	22.52

Back to menu

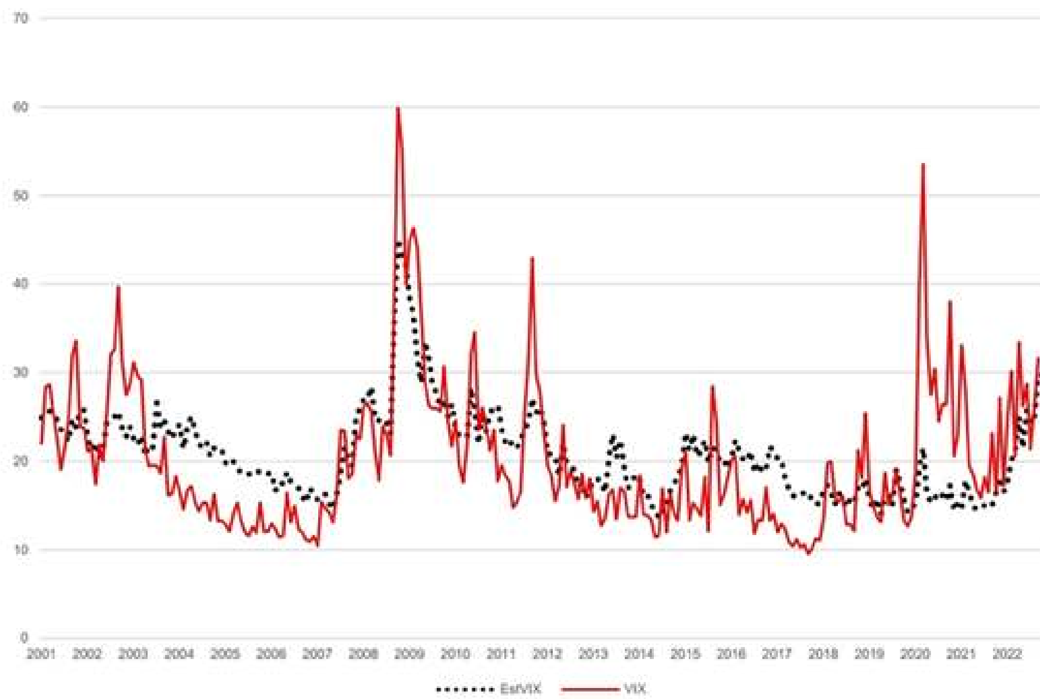
Volatility

Equity market bulls have been emerging out of the shadows in recent weeks but the bears haven't gone away. The bears are still lurking, largely because they think that equity markets are ignoring worrying signs appearing in other financial markets. Or at least that's the argument being made by macro strategist Michael Howell at Cross Border Capital. His argument is based on the undeniable fact that global liquidity is drying up, which is spawning all sorts of volatility blow-ups, especially in the fixed income and FX markets where they are happening more regularly and vol measures are elevated.

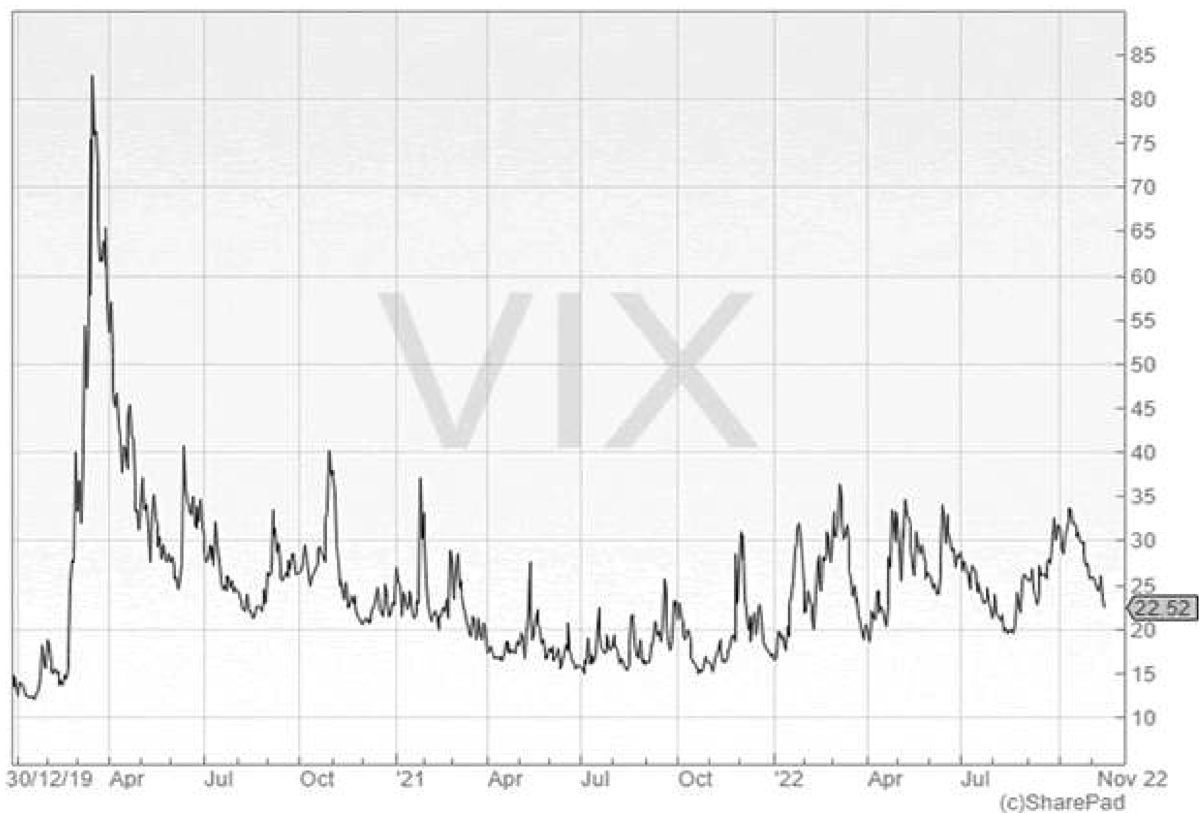
"The MOVE index of bond volatility recently exceeded 150, compared to under 40 in late-2020. Similarly, the CVIX index of forex volatility is twice its reading of six months ago. These are bad omens for stocks, which have lagged these jumps. Financial history shows that volatility, like London buses, comes in clusters. What's more, there is a clear sequential pattern to volatility, evidenced in statistical tests: it often starts in the forex markets, quickly migrates to the fixed income markets and ends up in the stock and credit markets. In other words, the VIX (stocks) follows the previous turbulence in FIX, or CVIX (currency) and BIX, or MOVE indexes (bonds), i.e., FIX, BIX, VIX!"

So, if these volatility tremors do move over into the equity markets, how bad could it get? According to Howell it could get really, really bad:

"...we can estimate the expected volatility in stocks, based solely on what has previously occurred in forex and fixed income markets. In other words, the baseline for the VIX has moved up to around 30 or close to current levels, even without any equity specific shocks that might come on top. These equity shocks are typically associated with negative reactions to the business cycle, such as the effect of deteriorating earnings growth. In fact, already at end-September 2022 World earnings growth is now falling at a 6.2% rate (annualised) since end-March. This could deteriorate further. Indeed, we have argued elsewhere that the prevailing low US Treasury term premia reading itself implies a coming 25% collapse in S&P500 earnings".



VIX since the beginning of 2020



Black - VIX

Measure	November Level	October Level	September Level	August Level
Vstoxx Volatility	20.82	31.82	24.4	n/a
VFTSE Volatility	23.15	33.63	22.79	21.7

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

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

Kind Regards,

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