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Monthly Market Report

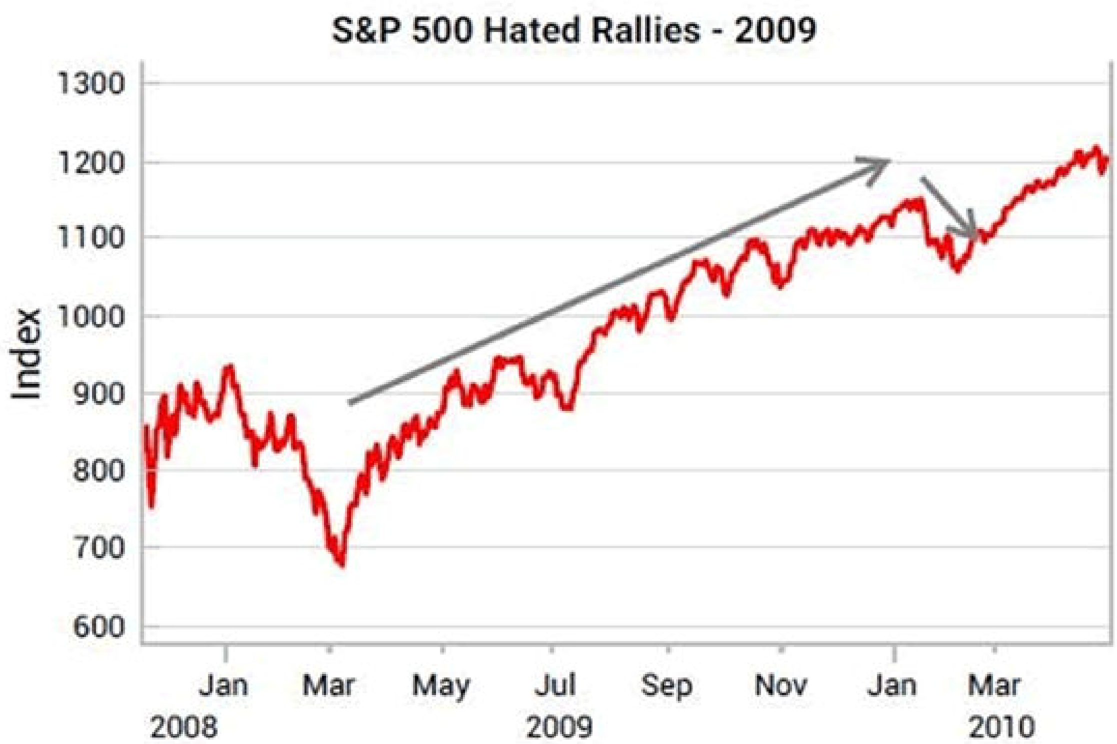
February 2021

With commentary from David Stevenson

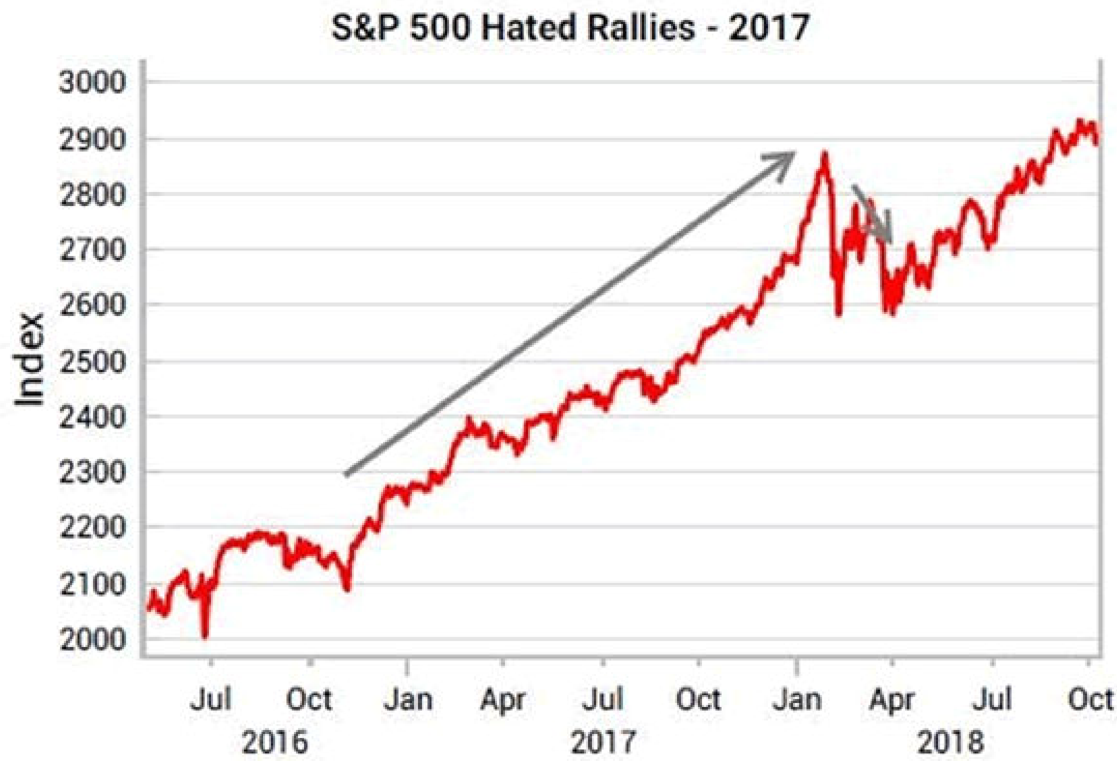
Bubble or (baby) Boom(ers)

The founder of US fund management firm Jeremy Grantham has (yet again) warned that US equities are in a bubble. He is not alone in airing considerable scepticism about equity valuations. Many professional investors and advisers I talk to grimace about valuations but argue they have no other choice - TINA as its called! This has led some to cast the recent rally as the most hated rally in stockmarket history. Yet the default consensus view amongst most big institutions - especially the investment banks - is mildly bullish. What gives? Who's right?

The excellent Variant Perception report - heavily used by hedge funds - recently provided some grist to the mill for the bears. It noted that there might be parallels with both 2009 and 2017. They remind their readers that in 2009 "equity markets rallied against a backdrop of a terrible economy, but rising leading indicators and strong policy stimulus. The rally extended until January 2010, before the S&P experienced an 8% correction in February 2010."



Then in 2017, "the S&P rallied through the year with minimal drawdowns, against a backdrop of fiscal stimulus (Trump's tax cuts) and the Fed, under Janet Yellen, hiking rates very cautiously. The 2017 rally extended into January 2018, before a -11% correction in February 2018. Given the analysis we presented to clients recently on seasonal equity inflows in January, it seems plausible that today could see a similar pattern, where markets keep grinding higher into January 2021 and we see a correction in February."

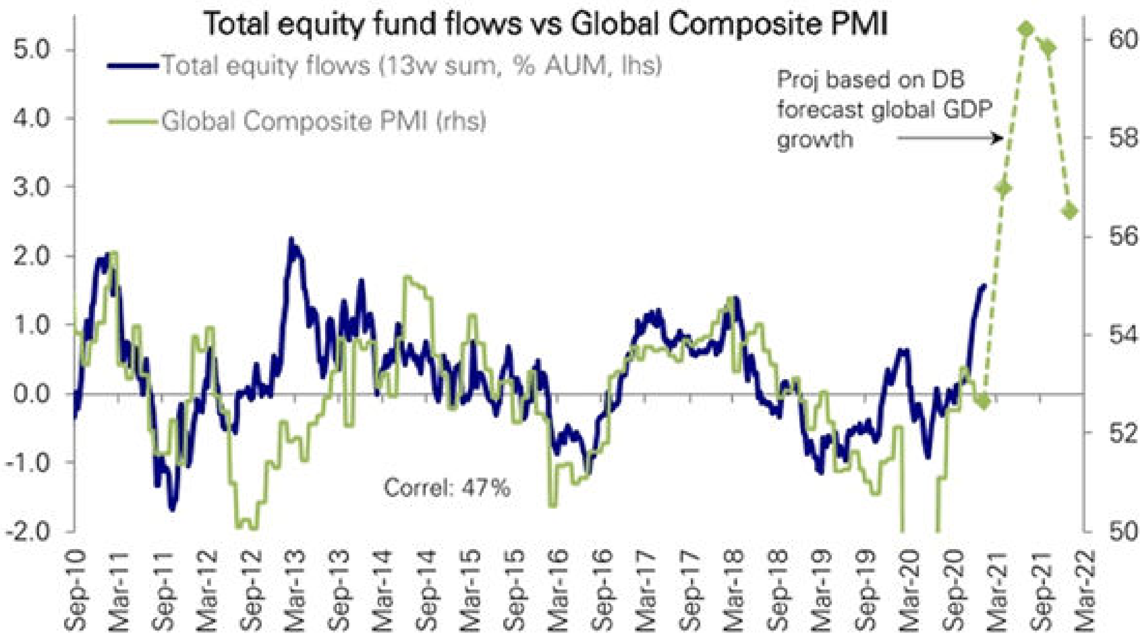


The pleasant sting in the tail of the Variant Perception analysis is that they reckon that 2021 might not repeat this miserable pattern. A retracement is "but it is not our base case, given today's underlying strong macro, and strong liquidity growth.".

This finds an echo in the torrent of research coming out of the investment banks as we head into a new year.

Let's start with Deutsche Bank. They argue in their latest Investor Positioning note that *"Global growth prospects suggest equity inflows have further to go. The pace of equity inflows has historically been closely tied to global growth (PMIs). While recent inflows have been running slightly ahead, if global growth picks up in line with DB's house view, there is significant room for inflows to rise."*

The chart below sums up this view very well.



Cross asset class analysts at SocGen, the big French investment bank, are also broadly supportive of risky equity assets although there are a few obvious strategists at said bank who probably hold a diametrically opposite view.

In SGs latest Conviction Thinking report the main cross-asset team sum up their view as follows: *"All in all, with a policy background still heavily geared towards calming financial risks (i.e. active monetary policies), supporting the real economy and distorting the credit cycle (think fiscal policy and state interventionism), we see little reason to change our (reasonably) optimistic view on risk assets; liquidity support for the credit market and accelerating M&A should help peg equities higher up the scale. Our updated equity risk premia indicators (chart 5 US, 6 Japan) still show equities heavily discounted versus the rates environment, with little prospect of monetary policy tapering any time soon in the Western world."*

The chart below nicely sums up the view that the current rally is far from entering exuberant territory.

Chart 1: SG Multi Asset Risk Indicator (SG MARI) – No exuberance in overall market positioning

SG MARI = Multi Asset Risk Indicator. It enables to qualify overall hedge fund positioning as risk on (high) or risk off (low). MARI is the weighted average of four positioning indicators, i.e. for equities (EPI), rates (RPI), currencies (FXPI) and commodities (COPI). Hedge fund positioning refers to non-commercial positioning reported to the CFTC. Dotted lines: 5y z-score of 2 and -2. Latest data as of 01/01/2021

No signs of exuberance here

After touching a low in March 2020, our Multi Asset Risk Indicator has strongly improved. Meanwhile, investor positioning in the forward markets remains far removed from levels that we would qualify as exuberant. This makes perfect sense in the current context, with the tug of war between the mutant virus and ongoing vaccination process.

Last up are the Cross Asset specialists at Morgan Stanley, who - in a note from earlier in December of last year - declared that *"while cheap valuations have generally boosted nominal expected returns, most of this boost has been offset by low inflation expectations and a low-income component versus history. However, given how much government bond yields and expected returns have fallen over the past year, equity risk premiums now look fair to attractive across all the regions."*

The chart below would seem to suggest switching some focus from US markets to my own favorite, namely emerging markets.

Equities nominal expected returns are mostly fair outside the US

Source: Bloomberg, MSCI, RIMES, Morgan Stanley Research forecasts

Obviously, these institutional views should be treated with a large dollop of caution but as we discuss in the equities section, its hard to argue with 1) the massive inflows into equities and 2) the massive central bank monetary easing. All I can say is that these are tough days to be a bear like Grantham. At some point of course, he will be proved right. The question is how soon?

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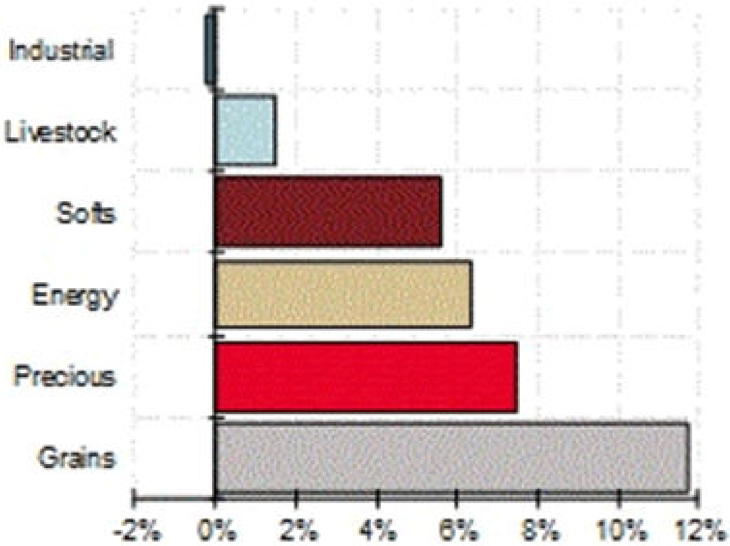
Headline Numbers

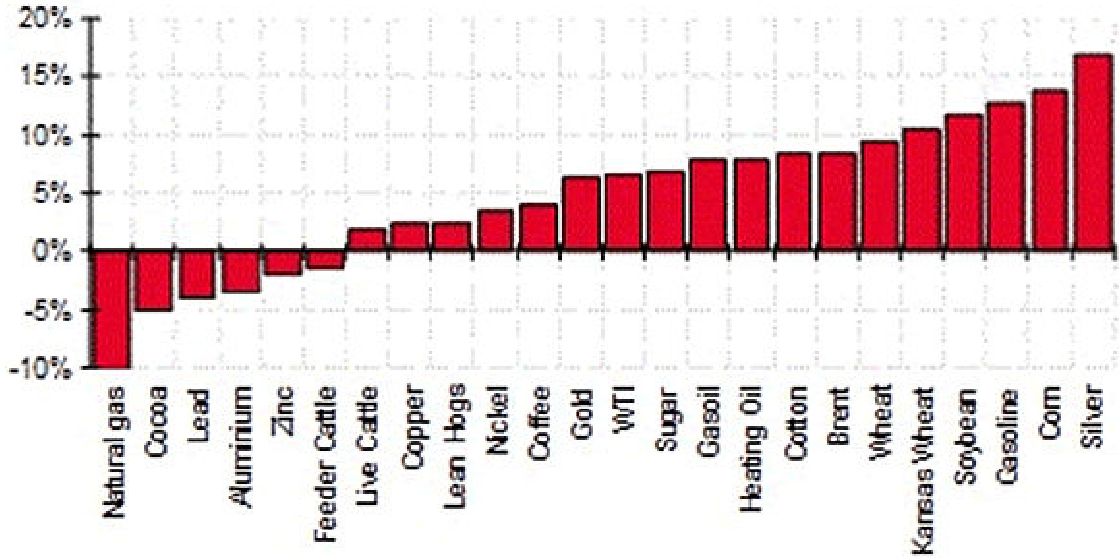
As long as I have been writing about alternative investments, experts have been predicting a new leg upwards up in the commodity cycle. Over the last few years, most though not all, commodities have had a dismal time but the first half of 2020 proved to be a real bloodbath for the sector. But by late 2020 the numbers were beginning to turn and I'm growing more receptive to the idea that we might be fast approaching a key inflection point when large bits of the commodity spectrum starts to roar ahead. I'm not remotely certain of this turn but I'd give it a 40% probability if pushed that we'll see a major bull run over two or more years in commodities. That might even impact the energy complex though I'm slightly more sceptical about the prospects for oil and gas prices.

Why my cautiously bullish stance? A number of tailwinds come to mind. First the concerns about a reflationary economy pushing into inflationary territory, which could in turn prompt speculators to pile into some parts of the commodity spectrum as inflation insurance. I also think some parts of the commodity spectrum related to the Green push will benefit from very strong multi decade secular drivers. I also think that we have seen very capacity destruction in some segments of the spectrum and although excess profits will surely drive-up supply, I'm not entirely sure there is enough elasticity in supply for some commodities. Related to this tailwind is a growing big power scramble to secure some key commodities as tensions increase. Lastly, I think we might be about to experience a weaker dollar which could be beneficial for commodity prices.

Grist to the mill of my possible commodity bull argument comes in end of year numbers on commodity markets from experts at SocGen. They report that the benchmark S&P GSCI (ER) index "saw a resilient 5.96% gain in December, building on the very significant 12.03% in November. Those brought the year-to-date decline to 24.02% as the index finished at 180.71. Five of the six sectors rose in December with the largest advance in grains, which was up 11.76% and bringing its year-to-date increase to 17.01%."

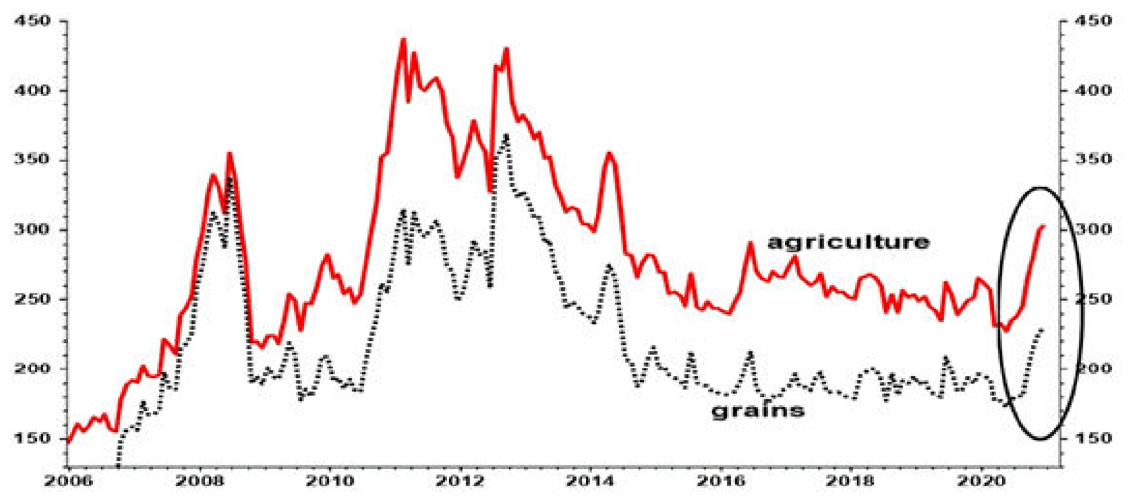


Analysis period: 1 December 2020 - 31 December 2020. Unless otherwise stated, all price returns are calculated based on S&P GSCI Excess Return Component Indices.



These numbers are far from suggesting an inflationary spike but in the food complex there are already some worrying signs as higher commodity prices feed through into higher food prices. SocGens uber bear Albert Edwards at the back end of 2020 alighted on the UN's Food and Agriculture Organization's (FAO) widely followed food price index which has *"once again - been surging over the last few months (the basket measures prices for oilseeds, dairy products, meat and sugar). Reuters reports that the FAO food index rose for a sixth month running in November, almost hitting a six-year high. Annual inflation in cereals reached 20%, the highest annual rise since mid-2011 when the Arab Spring was in full flow! (see chart below). At a time when the World Bank notes that the Covid-19 pandemic will increase extreme poverty by around 150 million (link), we all need to be very vigilant of another food price bubble."*

Food prices have begun to rise very sharply (index)



Source: Datastream, Bloomberg formally DJ-UBS Commodity series

Tesla numbers

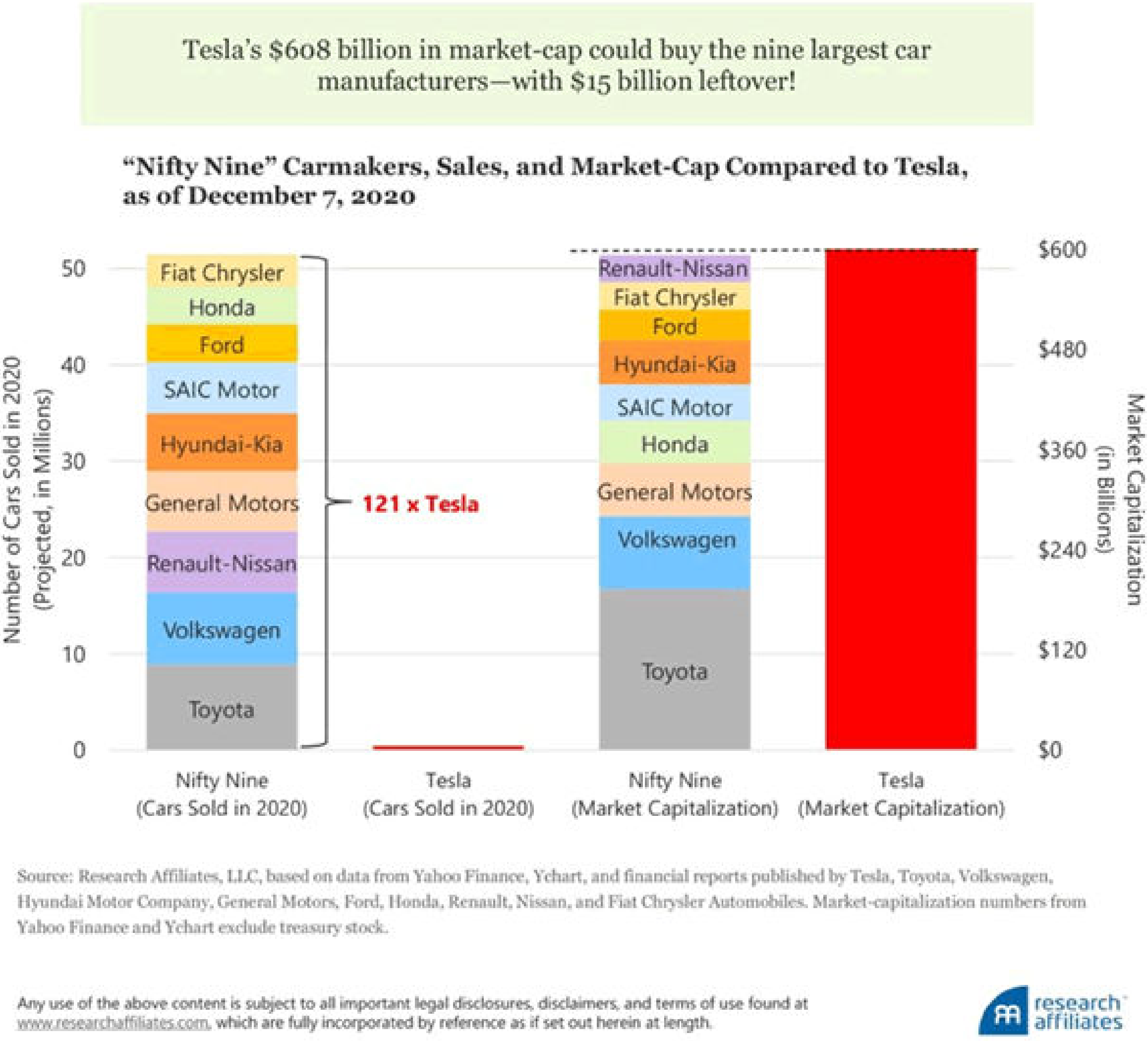
No discussion of whether we are in a bubble or the first stages of a boom without mentioning Tesla. It is every short seller's dream and every tech bull's best argument. I have no fixed view on the business beyond grimacing at its valuations. Then again, that's not an original insight on eye popping valuations and a much better analysis comes from the notorious contrarian investors at Research Affiliates who've run their slide rules over Tesla. You can see their results here.

In a paper by Rob Arnott, Vitali Kalesnik and Lillian Wu they remind their clients that Tesla is entering the S&P 500 with a stupendously high valuation and will likely be ranked sixth in the index. Their warning is that Traditional cap-weighted indices, such as the S&P 500, are structured to buy high and sell low - "and Tesla is a prime example of this maxim."

"The eightfold increase in Tesla's share price since its March low meets our two-part definition of a bubble: 1) implausible assumptions are needed to justify its valuation, and 2) buyer interest is based on a great narrative rather than being supported by a conventional valuation model.

Our research shows that a continuation of Tesla's 2020 share-price performance is vulnerable on two additional fronts: 1) as a top-dog stock (top 10 market-cap stocks), the odds are against its remaining a top-dog stock, and 2) as an addition to the S&P 500, history indicates it is likely to underperform the market (S&P 500) in the year after entry.

Our research also demonstrates that Apartment Investment and Management, the stock removed from the S&P 500 to make way for Tesla, is likely to outperform the index over the next year by as much as 20%, based on the average outperformance of all deletions from the index in the 31-year *period from October 1987 through December 2017".*



Measure	Values as of 4th December, 2020	Values as of 12th January, 2021
UK Government 10 year bond rate	0.35%	0.34%
GDP Growth rate YoY	-9.6%	-8.6%
CPI Core rate	0.70%	0.30%
RPI Inflation rate	1.30%	0.90%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.04%	0.03%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	55.6	57.5

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Bank CDS options

A quiet month for the market in credit default swaps for big global banks. There were no big moves on pricing with most banks showing a marginal increase in pricing, especially the big US banks saw a more notable upwards repricing of risk. Some banks swap rates fell, notably Lloyds Bank which is now deemed much lower risk than HSBC (who'd have thought that ten years ago).

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.53	31.64	A	A2	A -
Barclays	20.04	51.81	BBB	Baa2	A
BNP Parabis	8.7	27.8	A+	Aa3	A+
Citigroup	31.7	53.37	BBB+	A3	A
Credit Suisse	13.49	43.35	BBB+	Baa1	A-
Deutsche Bank	41.1	98.24	BBB+	A3	BBB
Goldman Sachs	34.49	55.36	BBB+	A3	A
HSBC	10.09	30.73	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	26.37	45.39	A-	A2	AA-
Lloyds Banking Group	8.68	30.42	BBB+	A3	A+
Morgan Stanley	28.56	50.41	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	11.07	38.66	BBB+	Baa1	A-
RBC	19.1	56.48	AA-	A2	AA
Soc Gen	8.71	28.71	A	A1	A-
UBS	7.6	26.03	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 4th January 2021 www.tempo-sp.com

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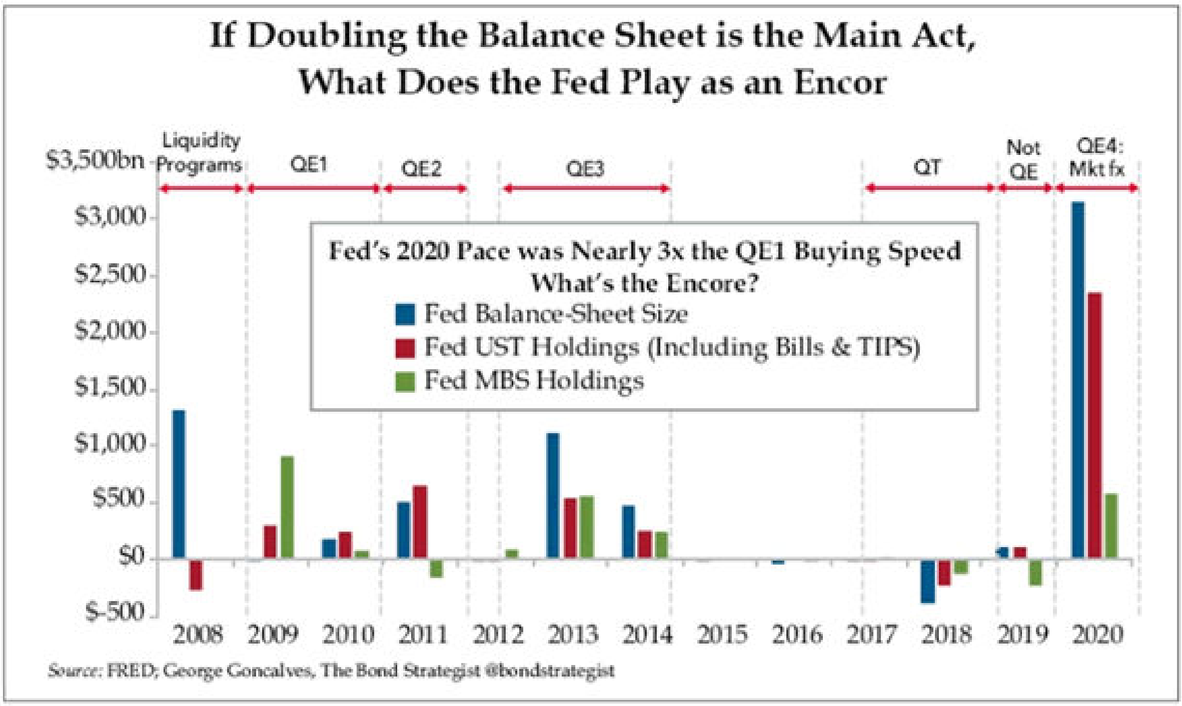
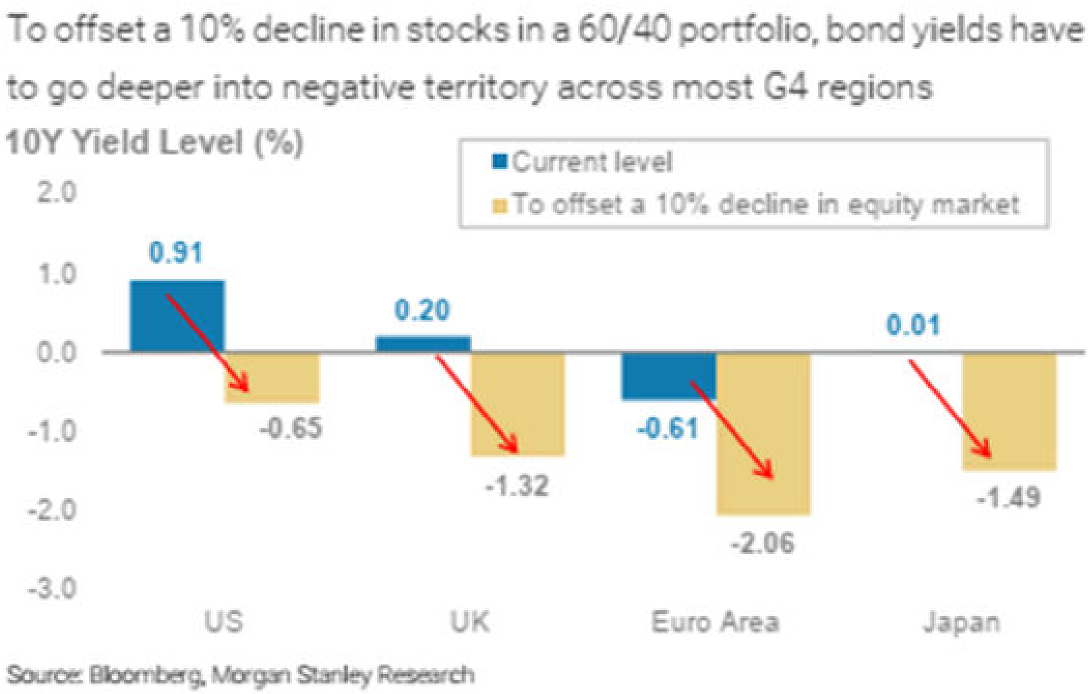
Government Bonds

Fixed Income

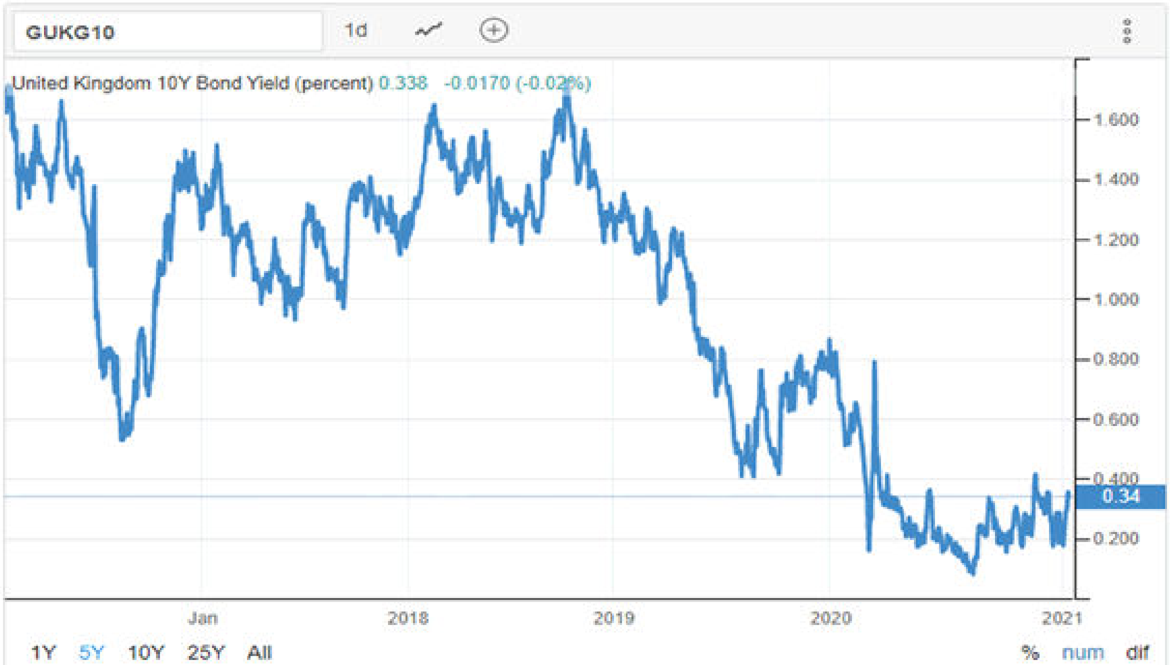
One of the central planks of the equity bears argument is that stock prices are under pinned by not only by low interest rates but also low bond yields. This in turn makes equities seem much more attractively valued. But what happens if those bond yields start to edge upwards again? Equity valuations could suddenly start to seem a bit stretched, causing the bubble to burst. But this prompts the inevitable reply - would central banks really be willing to see bond yields spike? Surely, they'll roar back into action and start buying up yet more bonds, pushing down yields. Again, the bears have an answer - the central banks are beginning to run out of road for new policies. The first chart below nicely sums up this view, putting in easy to understand graphic terms the sheer scale of central bank intervention. What more could they do?



The second chart below is from a cross asset class research note from December by Morgan Stanley strategists. It hints at what might come next. It looks at what needs to happen in 'normal' 60/40 portfolios to arrest a 10% decline in stocks following jitters about higher bond yields. The answer? Ever lower bond yields and a blitz of negative interest rates. In the Euro area we'd end up seeing vast swathes of the bond spectrum pushed into negative territory, assuring half decent profits for bond investors in this eventuality.



UK Government Bonds 10-year Rate 0.34%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	15.94
Germany	11
Japan	14.95
United Kingdom	17.34
Ireland	16.96
Italy	97.04
Portugal	36.76
Spain	40.87

Eurozone peripheral bond yields

Country	December 2020	January 2021	Spread over 10 year
Spain 10 year	0.08%	0.09%	58
Italy 10 year	0.62%	0.64%	113
Greece 10 year	0.64%	0.67%	116

	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

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Equity Markets and Dividend Futures

The 2020 winners

The large, scary looking table below shows returns in 2020 from S&P Dow Jones massive equity markets database for 2020. I have merged country by country returns from developed markets into emerging markets and then rank-ordered each national market for the full year 2020 numbers. Some surprising results emerge when we look at this table in some depth. Who would have thought that Korea and Denmark would emerge at the top, followed not too far behind by Sweden, and the Netherlands (both of which have been more lockdown sceptic in their virus containment policies)? Also, an overall a 14% return in 2020 for all markets isn't half bad!!

Turning to the classroom dunces, I'm surprised by the following factoid - Irish stocks advanced 10% but UK stocks in the S&P Dow Jones BMI index fell nearly 12%. Given that both countries are both closely tied to each other and share large parts of the same economy, this 22% discrepancy looks mighty revealing. Greece has done a great job of containing the virus, but its markets are still down 13%. Then again, the virus wasn't the only story of 202 for investors. The other revealing anomaly is the near 10% decline in Indonesian stocks.

			S&P Global Broad	31/12/2020			
US MKT	**%**	**%**	**BMI MEMBER**	**1-MONTH**	**1-YEAR**	**2-YEAR**	**3-YEAR**
VALUE	**Of**	**of BMI**	**Global**	**4.86%**	**14.34%**	**41.38%**	**24.64%**
$1,367	2.23%	1.96%	Korea	**14.57%**	44.14%	54.55%	20.71%
$452	0.73%	0.65%	Denmark	**7.00%**	40.91%	76.61%	48.81%
$1,199	14.60%	1.72%	Taiwan	**8.82%**	31.70%	69.42%	47.08%
$773	1.26%	1.11%	Sweden	**5.55%**	31.47%	61.88%	37.16%
$3,524	42.93%	5.06%	China	**2.96%**	27.87%	52.50%	21.22%
$709	1.15%	1.02%	Netherlands	**6.98%**	26.91%	65.68%	40.22%
$94	0.15%	0.13%	New Zealand	**5.16%**	25.54%	64.07%	57.33%
$38,432	62.55%	55.18%	United States	**4.35%**	18.68%	52.42%	41.71%
$257	0.42%	0.37%	Finland	**2.70%**	18.16%	27.60%	13.17%
$173	0.28%	0.25%	Israel	**8.12%**	17.38%	39.00%	33.69%
$1,002	12.20%	1.44%	India	**9.01%**	15.77%	22.82%	8.86%
$61,445	**100.00%**	**88.22%**	**Developed**	**4.71%**	**14.54%**	**42.60%**	**26.38%**
$46	0.07%	0.07%	Luxembourg	**12.88%**	13.40%	1.06%	-20.71%
$8,208	**100.0%**	**11.82%**	**Emerging**	**5.99%**	12.68%	31.17%	10.32%
$1,670	2.72%	2.40%	Germany	**6.33%**	10.52%	31.08%	-0.51%
$1,714	2.79%	2.46%	Switzerland	**5.10%**	10.43%	42.63%	25.57%
$158	0.26%	0.23%	Ireland	**3.65%**	10.40%	43.48%	12.14%
$5,381	8.76%	7.73%	Japan	**3.97%**	10.38%	28.72%	9.39%
$1,428	2.32%	2.05%	Australia	**6.12%**	9.71%	29.79%	9.22%
$23,014	**37.45%**	**33.04%**	**Developed Ex-U.S.**	**5.31%**	**8.26%**	**28.73%**	**6.87%**
$37	0.06%	0.05%	Portugal	**11.26%**	5.98%	20.19%	2.62%
$315	0.51%	0.45%	Singapore	**4.41%**	5.36%	19.63%	2.44%
$610	0.99%	0.88%	Hong Kong	**4.69%**	5.10%	10.45%	-2.20%
$1,906	3.10%	2.74%	Canada	**3.50%**	4.48%	30.94%	5.57%
$180	2.19%	0.26%	Malaysia	**4.71%**	4.18%	3.15%	-9.90%
$168	0.27%	0.24%	Norway	**8.55%**	2.98%	13.24%	1.05%
$214	2.60%	0.31%	Saudi Arabia	**0.11%**	2.97%	9.78%	21.26%
$488	0.79%	0.70%	Italy	**3.52%**	2.68%	27.88%	1.09%
$1,820	2.96%	2.61%	France	**2.94%**	1.77%	25.12%	5.69%
$54	0.66%	0.08%	Turkey	**20.15%**	-0.59%	11.37%	-37.48%
$75	0.91%	0.11%	Philippines	**5.18%**	-3.34%	4.15%	-13.52%
$153	1.87%	0.22%	Mexico	**6.90%**	-3.56%	5.97%	-11.13%
$63	0.77%	0.09%	Qatar	**1.26%**	-4.04%	-5.86%	15.06%
$9	0.10%	0.01%	Czech Republic	**11.49%**	-4.10%	-4.83%	-12.63%
$62	0.75%	0.09%	Poland	**8.61%**	-5.09%	-10.45%	-25.54%
$65	0.10%	0.09%	Austria	**8.03%**	-5.42%	9.33%	-18.68%
$322	3.92%	0.46%	South Africa	**9.89%**	-7.02%	0.93%	-25.21%
$204	0.33%	0.29%	Belgium	**2.45%**	-7.43%	13.96%	-17.11%
$448	0.73%	0.64%	Spain	**2.46%**	-7.51%	0.43%	-18.30%
$8	0.09%	0.01%	Pakistan	**4.28%**	-7.52%	-13.61%	24.39%
$48	0.59%	0.07%	Chile	**11.51%**	-8.85%	-25.68%	-40.84%
$171	2.08%	0.25%	Thailand	**3.82%**	-9.27%	1.54%	-10.80%
$135	1.64%	0.19%	Indonesia	**7.22%**	-9.67%	-3.26%	-12.49%
$51	0.62%	0.07%	U.A.E.	**2.44%**	-10.01%	-9.25%	-16.49%
$2,732	4.45%	3.92%	United Kingdom	**5.94%**	-11.54%	4.43%	-14.36%
$18	0.22%	0.03%	Hungary	**10.78%**	-12.33%	-0.23%	-8.68%
$22	0.27%	0.03%	Peru	**7.56%**	-12.47%	-10.59%	-12.13%
$49	0.59%	0.07%	Kuwait	**2.18%**	-12.68%	10.78%	20.92%
$274	3.34%	0.39%	Russia	**9.05%**	-13.03%	23.34%	11.77%
$24	0.29%	0.03%	Greece	**11.11%**	-13.54%	26.53%	-14.36%
$26	0.32%	0.04%	Colombia	**21.58%**	-17.95%	4.36%	-15.79%

Index	December 2020	January 2021	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	83.4	85.4	3608	83.5
FTSE 100 (Dec 19)	215	207.2	6756	205.5

Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	3.23	13.2	9.42	-11.3	13.4	3.3	6758.18
S&P 500	3.76	8.24	20.5	15.6	101	87.9	3801.19
iShares FTSE UK All Stocks Gilt	-2.14	-1.44	-2.76	4.24	17	14.9	1451.75
VIX New Methodology	0.0858	-10.5	-27.5	89.4	-7.49	13.5	23.33

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Volatility

Equity market volatility has, unsurprisingly, been relatively subdued in recent months. That said if we are only mid-way through a bubble/boom, then you would expect relatively low intraday and inter day price volatility.

But I would also observe that the Vix itself is still trading fairly consistently above the important 20 index points level, which would suggest that there is still a fair bit of market turbulence kicking around on US exchanges.

But that volatility looks to be under control largely because equity inflows are so resilient. In the second week of January US analysts at Deutsche Bank released data which showed that the *last 2 months of 2020 saw the strongest inflows (+$190bn) into equity funds (ETFs and mutual funds) on record.*

"As a proportion of assets under management (+1.1%), these flows were the second largest in the last 10 years, eclipsed only slightly by those at the beginning of 2013. The first week of 2021 has seen strong equity inflows continue (+$11bn)....Equity inflows follow enormous outflows for over two years. Recent inflows represent only a small turn around after huge persistent outflows which began in 2018 (-$725bn cumulative) and are also dwarfed by the inflows into bonds (+$1 trillion) and MM funds (+$2 trillion) over the last 2½ years."

The first chart below is a fantastic graphic of that huge surge in funds.

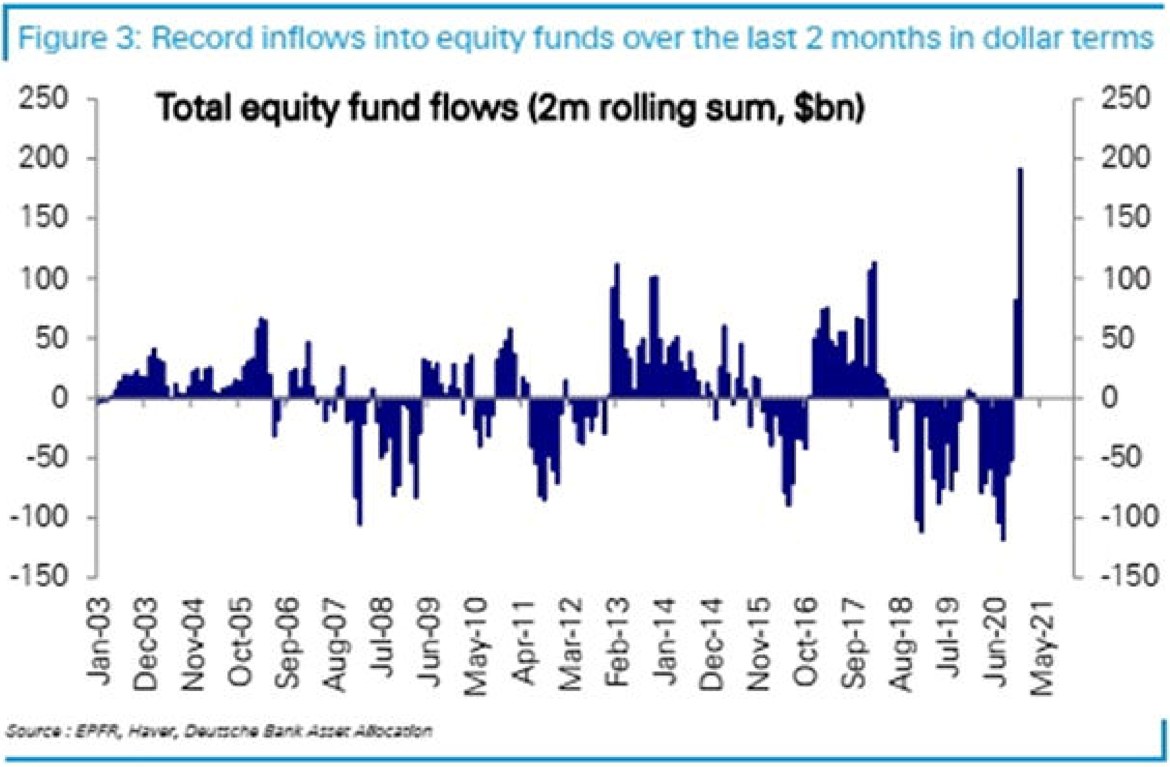
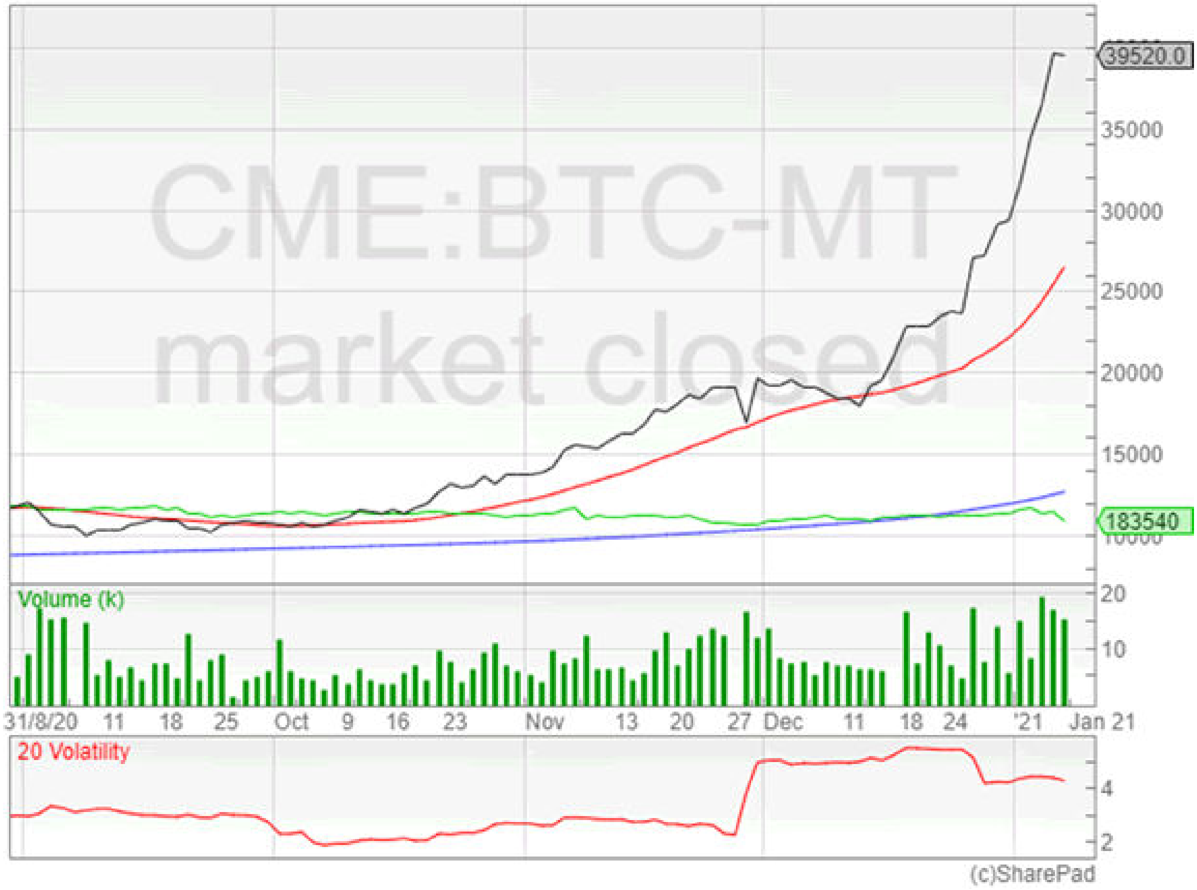


Figure 3: Record inflows into equity funds over the last 2 months in dollar terms

Source : EPFR, Haver, Deutsche Bank Asset Allocation

If you are really looking for a momentum driven surge, in part driven by fund inflows, check out the second chart below. The black line shows the price of.... Bitcoin! The red line is the 20-day moving average, the blue line the 200-day moving average - I've started the period at the beginning of Autumn 2020. Finally, the dour green line at the bottom is the spot price of gold. Talk about a 'gap' forming! The bottom chart shows inter day price volatility for bitcoin, which has also been 'relatively' modest given this huge momentum surge.

Bitcoin volatility versus gold volatility
Black line - Bitcoin
Red line - 200 day moving average
Blue Line - 200 day moving average
Green line - gold price



Measure	January Level	December Level	November Level	October Level
Vstoxx Volatility	24.41	20.82	24.8	22.32
VFTSE Volatility	23.33	21.28	23.19	25

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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 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.

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

Kind Regards,

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