



Monthly Market Report

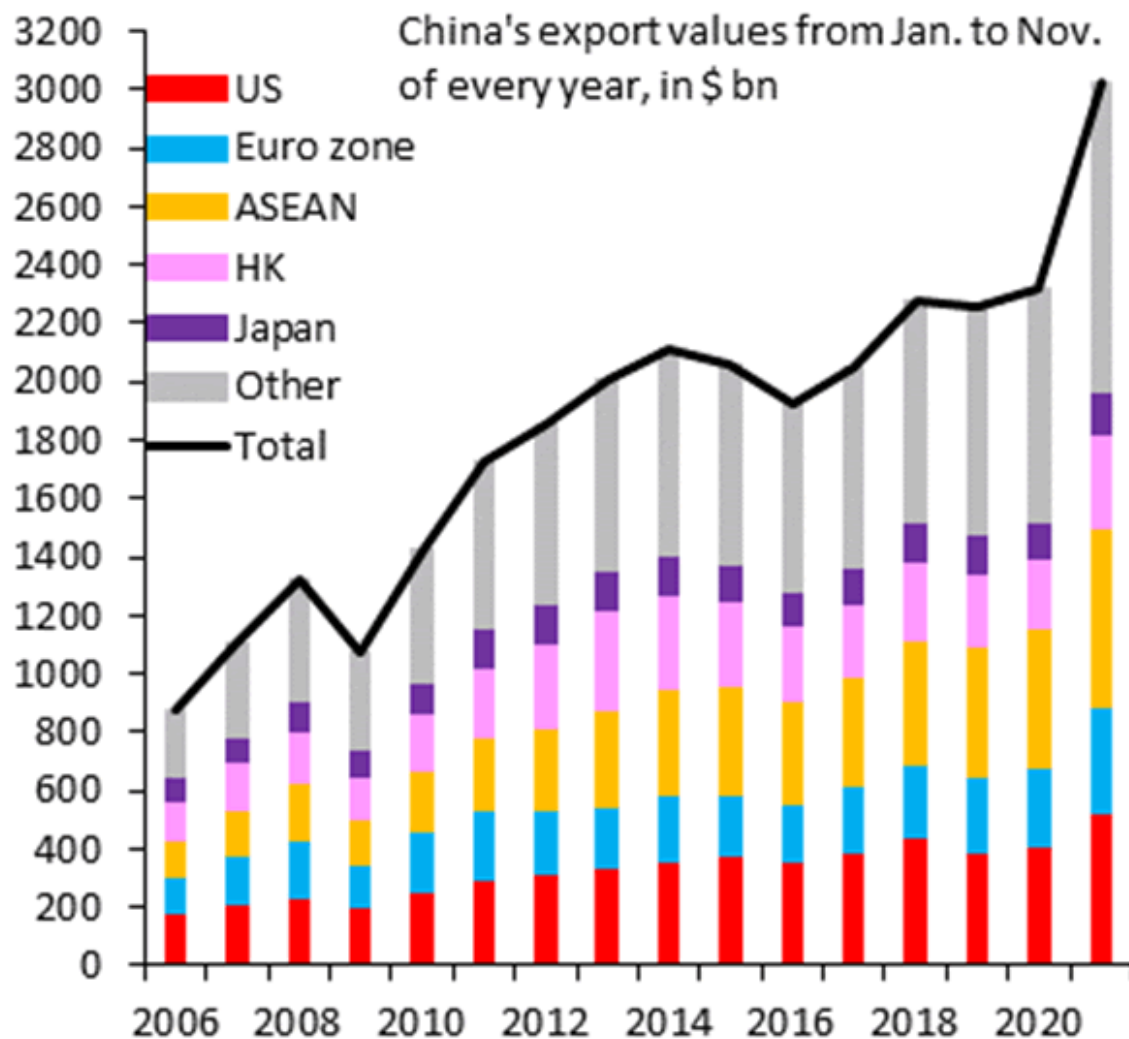
February 2022



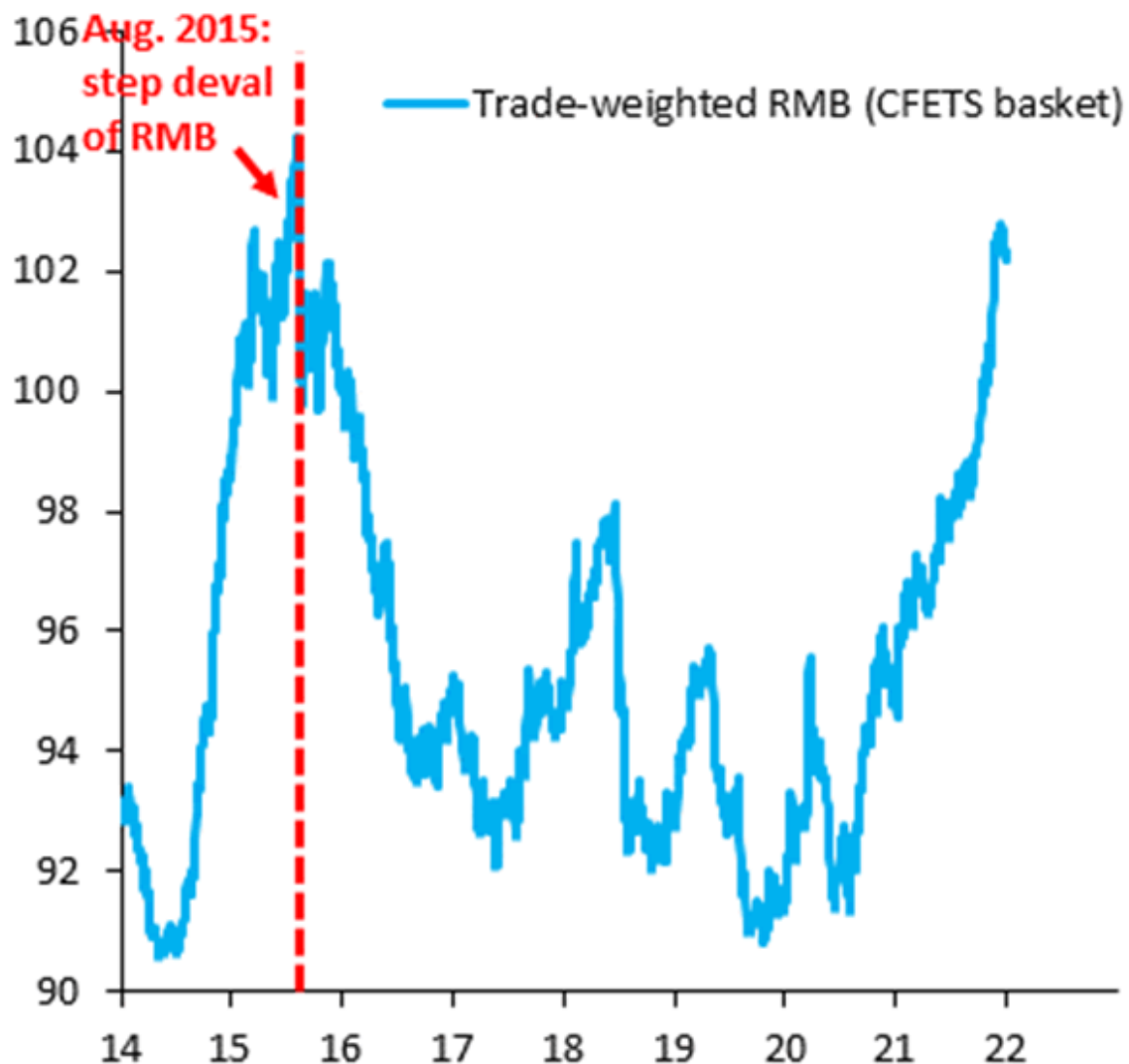
With commentary from David Stevenson

I have no idea what will happen in 2022 but of one thing I am reasonably sure - all eyes will be on China. What happens in the land of the CCP increasingly matters to all of us and frankly any macro takes on investing that avoids discussing what happens to Chinese consumers and exports is missing the point entirely. My gut tells me that China is in for big trouble in 2022 and because what happens to China matters to the rest of us, those travails will affect all of us.

First of all though, lets disabuse readers of one thing: that globalisation is over and everyone is re shoring. It isn't and very few are. The first chart below is from the excellent [Robin Brooks at the IIF](#), the global association of the financial industry and a former strategist and economist with Goldman Sachs and the IMF. The chart below shows China's export values from Jan to Nov each year by key regional market. As you can see the US and European exports have steadily increased but the real quantum of increase has been in exports to the ASEAN countries and beyond. China is still an export powerhouse. That chart below gives me no confidence that China will not dominate global exports for the rest of this decade.



Now, that exporting strength might have one immediate consequence. Cue the second chart from Robin Brooks which shows how the trade weighted value of RMB has been steadily strengthening over time. Put simply China needs to devalue, as it has done in the past, and aggressively so. If that happens we can expect a wave of turbulence in the global markets as investors work out what that means for other emerging markets - especially South Korea, and Vietnam.



If this particular dog doesn't bark, then I think we can identify another possible source of disorder and concern: Covid. I've been sounding like a broken record player on the subject of Zero Covid for months now, but it seems to me all but impossible to keep Covid out of China in the medium term. Sure dramatic local lockdowns will dampen down the impact but until 80 to 90% of the population is triple vaccinated with mRNA vaccines, then at some stage the dreaded virus will sneak back in unless China intends to shut down for the next decade. The winter Olympics could be the turning point but hey, the virus is essentially unpredictable when it comes to where it might appear (or mutate) next.

When Covid makes contact with the domestic population, the carnage will be spectacular and inevitably crush local consumer demand and knock the global economy off balance. But don't just take my word for it. The political consultancy Eurasia has just released its annual Top Risks for 2022 Overview and up at number one is [No Zero Covid](#). Here's their basic summary which I agree wholeheartedly with:

"China is in the most difficult situation because of a zero-Covid policy that looked incredibly successful in 2020, but now has become a fight against a much more transmissible variant with broader lockdowns and vaccines with limited effectiveness. And the population has virtually no antibodies against Omicron. Keeping the country locked down for two years has now made it more risky to open it back up. It's the opposite of where Xi wants his country to be in the run-up to his third term, but there's nothing he can do about it: The initial success of zero Covid and Xi's personal attachment to it makes it impossible to change course."

To repeat: when Covid rips through China, Chinese consumer demand will crater, and that will have a knock on impact on the rest of the world, dulling down inflationary pressures.

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Headline Numbers

Tis the time for enormous annual financial data dumps. Analysts at S&P Dow Jones last week released their annual dump of underlying data on their array of major benchmark indices - the data set on long term returns by sector is fascinating. Let's start with the first table below which looks at returns over the 31 years to Dec 2021 for key sectors listed on the US market.

I'd make a number of observations. First that annualised return for the S&P 500 is impressive at 10.76% per annum. Compound that out over many decades and the return is a staggering 2532 % in total return terms over 31 years.

I also think the contribution to those total returns by dividends is also fascinating. We're told that the US market is one predominantly driven by multiples increase i.e. an increase in the price to earnings ratio. And that is largely true but note that the annualised return for the index increased by 27% when factoring back in dividends while the return increased from 1248% on a share price basis to a total return of 2532% on a total (inc dividends) return basis.

And that impact from dividends is even more pronounced on a sectoral basis. Utilities, energy and communication services sectors returned annualised 4%, 4.89% and 3.13% per annum in share price terms but total returns were 8.59%, 8% and 6.95% respectively i.e. dividends increased returns by between 63% (energy) and 122% (comms services). By contrast Its total return was increased by only 8.93%.

Next up I'd observe that as you'd expect the IT sector produced the biggest gains, with annualised returns of 13.94% (TR) closely followed by healthcare (12.3% pa) and consumer discretionary (11.83% pa). Comms services produced the weakest returns of just under 7% per annum - though that in itself wasn't a terrible return!

S&P Long term numbers by sector since 1990

LONG TERM

S&P 500 SECTOR	31/12/2021	29/12/1989
RETURNS RANGE:		

	ANNUALIZED STOCK	ANNUALIZED TOTAL RETURN	% DIVIDENDS INCREASED RETURN	STOCK RETURN	TOTAL RETURN
Energy	4.89%	8.00%	63.49%	361.38%	1074.28%
Materials	6.41%	8.89%	38.84%	629.61%	1428.82%
Industrials	8.05%	10.33%	28.31%	1092.74%	2226.72%
Consumer Discretionary	10.24%	11.83%	15.62%	2162.09%	3486.28%
Consumer Staples	8.32%	11.04%	32.71%	1190.73%	2755.72%
Health Care	10.24%	12.31%	20.19%	2165.61%	4006.02%
Financials (incl RE pre-9/19/16)	6.93%	9.46%	36.47%	753.78%	1703.23%
Information Technology	12.79%	13.94%	8.93%	4615.67%	6410.77%
Communication Services	3.13%	6.95%	122.42%	167.76%	759.19%
Utilities	4.00%	8.59%	114.82%	250.53%	1296.11%
S&P 500	8.47%	10.76%	27.04%	1248.67%	2532.17%

The next table below, also from S&P Dow Jones, looks at long term returns (up to 25 years) through a different lens - size. Let's start with the 25 year mark and note that both mid cap and small cap stocks produced a bigger total return compared to large caps (the S&P 500) 11.65% (mid caps) & 10.72% (small caps) vs 9.76%. BUT once we switch to the last five years, that story changes. At the five year mark (2016 to 2021), large caps in the S&P 500 outperform with an annualised return of 18.47% vs 13% for mid caps and 12.42% for small caps. I'd also make the obvious observation that annualised returns of 18.47% for the last five years is an astonishing number and well above any historic average.

S&P Dow Jones Indices

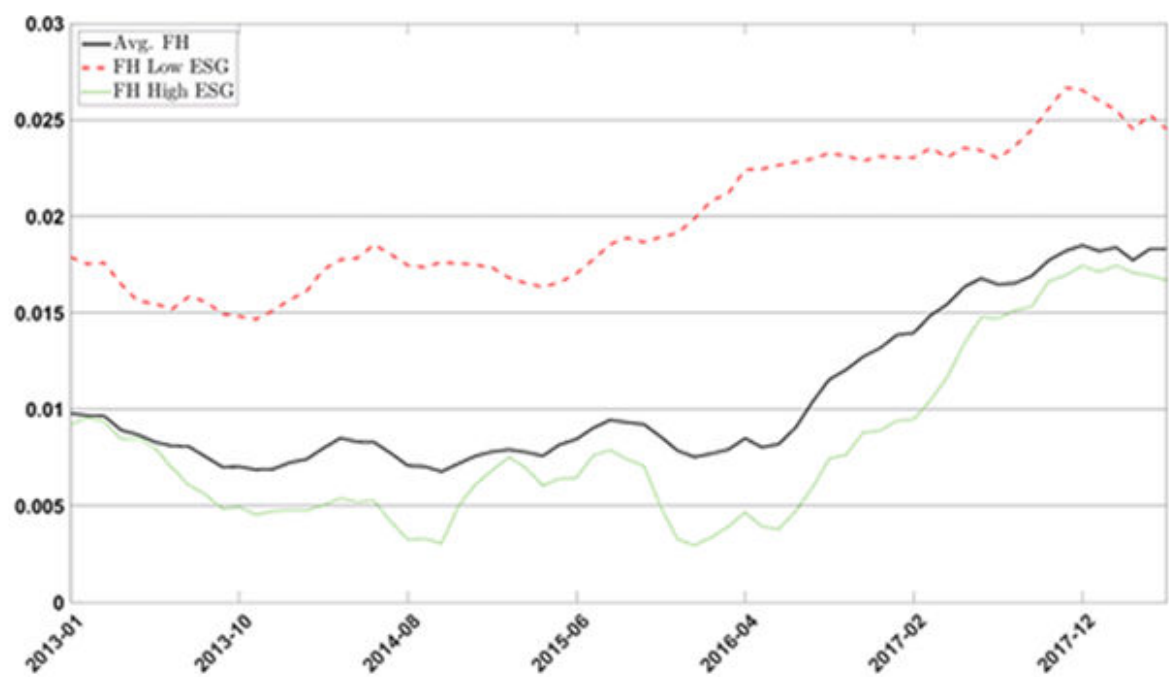
	S&P 500	S&P MidCap 400	S&P SmallCap 600	S&P Composite 1500	DJIA
S&P TOTAL RETURNS, ANNUALIZED					
12 Months	28.71%	24.76%	26.82%	28.45%	20.95%
3 Years	26.07%	21.41%	20.11%	25.63%	18.49%
5 Years	18.47%	13.09%	12.42%	17.95%	15.51%
10 Years	16.55%	14.20%	14.50%	16.35%	14.21%
15 Years	10.66%	10.45%	10.15%	10.66%	10.12%
20 Years	9.52%	10.56%	10.73%	9.68%	9.28%
25 Years	9.76%	11.65%	10.72%	9.93%	9.63%

I'm on record as being something of an ESG sceptic. I think the whole movement is a giant marketing invention and I think most ESG indices measure the wrong set of metrics. More to the point I tend to think that ESG investing has become a surrogate for investing in tech and quality stocks, already overcrowded trades.

But maybe my scepticism is unwarranted. Liberum's UK based strategist [Joachim Klement](#)

highlights a **recent study** which investigated how much fund managers exhibit that herding behaviour. "They looked not just at the average fund manager but also at fund managers sorted by the ESG ratings of their funds". The chart below shows the degree of herding amongst fund managers of more than 10,000 funds across the globe between 2012 and 2018. According to Klement "it seems that the fund managers with top quartile ESG credentials herd quite a bit less than fund managers with bottom quartile ESG credentials or the average fund manager. This is good news for pension funds because it shows that they can reduce systematic risks in their portfolios by handing mandates to fund managers with strong ESG credentials (which in this study meant a high ESG rating from Morningstar) where the likelihood of having large overlaps in portfolio holdings is reduced."

Herding amongst fund managers



Source: Ciciretti et al. (2021)

Measure	Values as of 6th December, 2021	Values as of 6th December, 2021
UK Government 10 year bond rate	0.75%	1.17%
GDP Growth rate YoY	6.60%	6.80%
CPI Core rate	4.20%	5.10%
RPI Inflation rate	6.00%	5.50%
Interest rate	0.10%	0.25%
Interbank rate 3 month	0.09%	0.49%
Government debt to GDP ratio	94.9%	94.9%
Manufacturing PMI	58.1%	57.9%

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Bank CDS options

It's been an incredibly quiet end to 21 and beginning to 22 on the market for bank credit default swaps. Pricing hardly changed for the vast majority of banks with a few experiencing small increases in pricing - notably Lloyd's bank (from a low level) and Barclays - while an equal sized handful saw their pricing decrease. Of note in the latter category (declining prices) was HSBC and Natixis. In terms of one year pricing on swaps BNP Paribas has the cheapest rates in our sample with UBS not far behind.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	10.32	31.68	A	A2	A -
Barclays	21.3	42.48	BBB	Baa2	A
BNP Parabis	8.87	30.25	A+	Aa3	A+
Citigroup	28.5	54.38	BBB+	A3	A
Credit Suisse	20.51	52.32	BBB+	Baa1	A-
Deutsche Bank	27.45	71.92	A-	A2	BBB+
Goldman Sachs	31.07	61.33	BBB+	A2	A
HSBC	10.24	30.89	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	25.43	46.4	A-	A2	AA-
Lloyds Banking Group	9.68	29.68	BBB+	A2	A
Morgan Stanley	30.55	58.35	BBB+	A1	A
Natixis	13	30	A	A1	A+
Nomura	18.06	71.4	BBB+	Baa1	A-
RBC	17.04	50.49	AA-	A2	AA-
Soc Gen	12.75	34.01	A	A1	A-
UBS	9.56	30.3	A-	Aa3	A+

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

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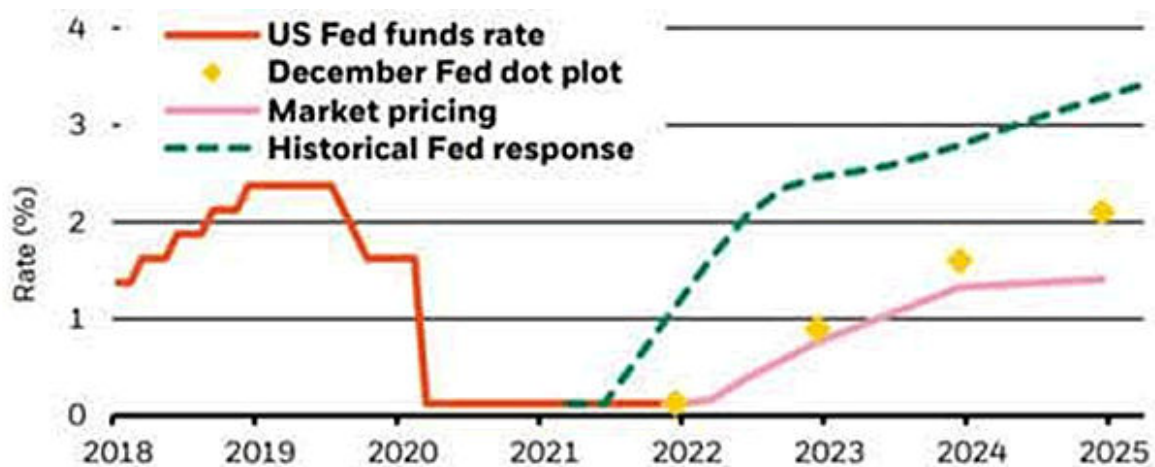
Government Bonds

The outlook for bonds as an asset class depends mightily upon what happens next to US interest rates. Those rates anchor a whole set of expectations about implied value throughout the financial system. In simple terms the higher the end point, the more dramatic (and negative) the impact. My own (cold) finger in the air suggests that US interest rates will end up around 1.5 to 2.25% with a likely 2% peak. But the risk is that I'm wrong and on this score its worth taking note of the comments below from [BlackRock](#) which come from their Global Outlook for 2022.

"Central banks could revert to previous policy responses in the face of persistent inflation

pressures. The Bank of England (BoE) - which in December became the first major DM central bank to raise rates since the pandemic struck - has made the most noise about responding more aggressively to inflation, leading markets to expect repeated rate hikes. The BoE may serve as a test case of a DM central bank coming closer to hitting the brakes, prompting the market to price in a risk of a policy reversal on rates by 2024. And inflation expectations could become unanchored from policy targets in the post-Covid confusion, forcing central banks to react **aggressively**." [my emphasis added]

This signals, correctly in my view, that one major risk is that central banks are too aggressive in their rates policy which negative implications for equity investors. On which score I thought I'd also include the chart that goes with the BlackRock prediction. The markets are pricing 1.5%, the Fed's December dot plotting says 2% but if central banks conform to historical precedents, then it could be closer to 3%... OR MORE. Needless to say if the stock market thinks 3% or more is on its way, we can expect very significant market volatility.



UK Government Bonds 10-year Rate 1.17%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	20.2
Germany	8.8
Japan	17.1
United Kingdom	10.01
Ireland	14.4
Italy	89.9
Portugal	29.8
Spain	31

Eurozone peripheral bond yields

Country	December 2021	January 2022	Spread over 10 year
Spain 10 year	0.33%	0.65%	68
Italy 10 year	0.87%	1.30%	133
Greece 10 year	1.26%	1.56%	159

	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

Sticking with that huge S&P Dow Jones financial returns data dump, the table below looks at national stock market returns in 2021. It's full of surprises. I have to say I wasn't surprised that the petro states such as the UAE and Saudi did well but how did the Czech Republic manage to score a 43.7% gain? Also, that's an epic 84% gain since the pandemic first broke in 2020!!!

And what's with India and its number four slot on a 30% gain. And the Dutch at number six with a 26% gain. At least the US is in the top ten (best not mention the UK).

	S&P Global Broad Market Index (BMI) Global			31/12/2021
\$ market cap billion	BMI MEMBER	FROM 11/3/2020	1-MONTH	YTD
\$81	U.A.E.	63.79%	0.77%	45.01%
\$12	Czech Republic	84.32%	11.99%	43.70%
\$291	Saudi Arabia	43.16%	4.81%	31.25%
\$1,397	India	56.76%	3.84%	30.11%

\$66	Kuwait	30.40%	3.68%	27.54%
\$970	Netherlands	48.92%	3.16%	26.58%
\$1,535	Taiwan	48.62%	5.29%	26.28%
\$48,478	United States	40.73%	3.74%	24.22%
\$2,418	Canada	38.63%	4.15%	22.68%
\$80	Austria	58.69%	5.97%	22.11%
\$240	Israel	42.74%	4.10%	19.83%
\$73,984	Developed	35.69%	4.08%	18.37%

Index	December 2021	January 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	100.5	116.3	4290	98.1
FTSE 100 Dividend Dec 2021	243.8	269.1	7487	238.5

Note changed to Dec 2022 contracts in January 2022

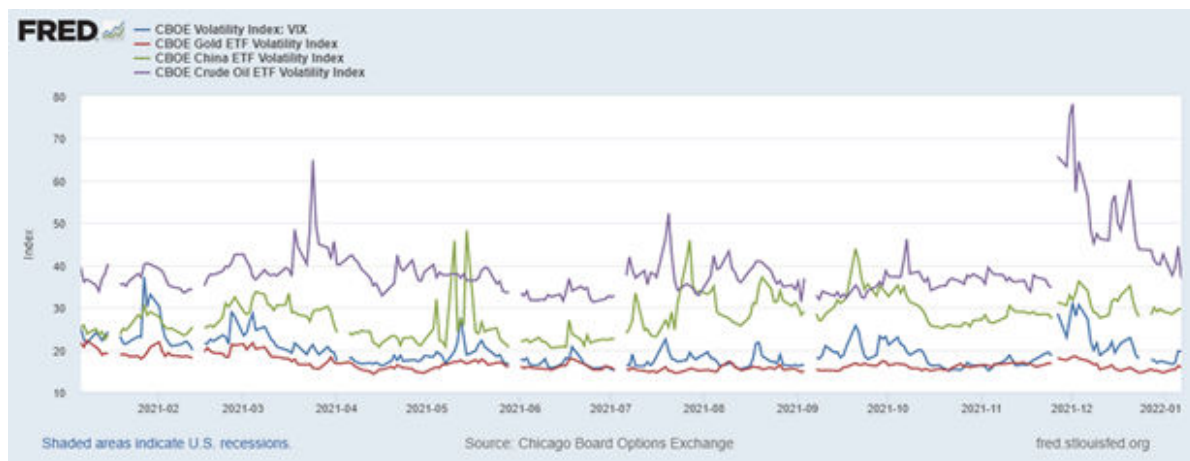
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	2.72	4.8	5.17	10.2	2.74	27.6	7489.98
S&P 500	-0.886	7.09	6.88	22.9	105	143	4670.29
iShares FTSE UK All Stocks Gilt	-5.32	1.52	-2.71	-6.27	4.78	10.2	1362.38
VIX New Methodology	3.8	-3	19.9	-19.4	72.3	-20.2	19.4

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Volatility

So, how volatile were key types of investment in 2021? The table below looks at volatility for a bunch of asset classes during 2021, as measured by the US Federal Reserve St Louis. You can see the chart [online here](#).

The dominant purple line at the top is the volatility of the oil price, which, as you'd expect, was all over the place during 2021. But what I find astonishing is that sometimes the volatility of China ETF's (the green line) was greater than that of the oil price - I counted four times where the China ETF vol exceeded oil. If that doesn't put off most long-term investors in China, I don't know what will. Another interesting observation is that the blue line - S&P 500 volatility - largely kept track with gold price volatility. Sure, equities were more volatile, as you would expect, but not by THAT much. And again there were numerous times when equity market volatility dipped BELOW gold volatility for days on end. One doesn't have to be a cynic to wonder whether this market behaviour is a tad strange.



Red line - 20 day moving average Green Line - 200 day moving average

Measure	January Level	December Level	November Level	October Level
Vstox Volatility	20.27	30.06	16.59	21.98
VFTSE Volatility	19.4	30.67	17.66	19.54

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Summary of Pricing Impact on Structured Products

Pricing Parameter	Change	Impact on Structured Product Price
Interest Rates	Up	Down
Underlying Level	Up	Up (unless product offers inverse exposure to the underlying)

Underlying Volatility	Up	Down for capped return/fixed return/capital at risk products. Up for uncapped return/capital protected products.
Investment Term	Up	Down
Issuer Funding Spread	Up	Down
Dividend Yield of Underlying	Up	Down
Correlation (if multiple underlyings)	Up	Up (unless product offers exposure to the best performing underlyings only)

Source: UK Structured Products Association, January 2014

This information is provided for information purposes only, and the impact on a structured product price assumes all other pricing parameters remain constant.

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Explanation of Terms

CDS Spreads and Credit Ratings

A CDS effectively acts like an option insuring at a cost in basis points a bank or government bond in case of default. The higher the basis points, the riskier the market perceives that security. Crucially CDS options are dynamic and change in price all the time. A credit rating is issued by a credit rating firm and tells us how risky the issuer is viewed based on the concept that AAA (triple A) is the least risky and ratings at C and below are regarded as much riskier. CDS and ratings are useful for structured product buyers because they give us an indication of how financial risk is viewed by the market. Crucially a high CDS rate indicates that an issuer of a bond will probably have to pay a higher yield or coupon, which could be good for structured product buyers as bonds are usually a prime source of funding for a structured product. G8 government bonds issued by the likes of the UK and US Treasury are also sometimes used as collateral in some form of investments largely because they are viewed as being low risk. One last small note on credit ratings and CDS rates. A is clearly a good rating for a bond (and much better than B) but AA will be viewed as even safer with triple AAA the least risky. Terms of CDS rates anything much above 100 basis points (1%) would warrant some attention (implying the market has some, small, concern about the possibility of default) while anything above 250 would indicate that the market has major concerns on that day about default.

Why does the yield matter on a bond?

As we have already explained bonds are usually used as part of a structured product. The bonds yield or coupon helps fund the payout. All things being equal a higher bond yield means more funding for the payout. But rising bond yields, especially for benchmark US and UK Treasury 10 year bonds also indicate that the markets expect interest rates to rise in the future. Rising interest rates are not usually a good sign for risky financial assets such as equities.

Volatility measures

Share prices move up and down, as do the indices (the 500 and FTSE100) that track them. This movement up and down in price is both regular and measurable and is called volatility. It is measured by stand alone indices such as the Vix (tracking the volatility of the 500), VStoxx (the Eurozone Dow Jones Eurostoxx 50 index) and VFtse (our own FTSE index). These indices in turn allow the wider market to price options such as puts and calls that pay out as markets become more volatile. In simple terms more volatility implies higher premiums for issuers of options. That can be useful to structured product issuers as these options are usually built into an investment, especially around the barrier level which is usually only ever broken after a spike in volatility. Again all things being equal an increase in volatility (implying something like the Vix moving above 20 in index terms) usually implies higher funding levels for issuers of structured products.

Dividend Futures

These options based contracts measure the likely total dividend payout from a major index such as the FTSE 100 or the Eurozone DJ Eurostoxx 50 index. In simple terms the contract looks at a specific year (say 2015) then examines the total dividend payout from all the companies in the index, adds up the likely payout, and then fixes it as a futures price usually in basis points. Structured product issuers make extensive use of dividend futures largely because they've based payouts on a benchmark index. That means the bank that is hedging the payout will want to be 'long' the index (in order to balance it's own book of risks) but will not want the dividends that come from investing in that benchmark index. They'll look to sell those future possible dividends via these options and then use the premium income generated to help fund their hedging position. In general terms the longer dated a dividend future (say more than a few years out) the lower the likely payout on the dividend future as the market cannot know dividends will keep on increasing in an uncertain future and must fix its price in some level of uncertainty.

Equity benchmarks

Most structured products use a mainstream well known index such as the FTSE 100 or 500 as a reference for the payout. For investors the key returns periods are 1 year (for most auto calls) and 5 and six years for most 'growth' products. During most though not all five and six year periods it is reasonable to expect an index to increase in value although there have been many periods where this hasn't been the case especially as we lurch into a recession. Risk measures such as the sharpe ratio effectively measure how much risk was taken for a return over a certain period (in our case the last five years using annualised returns). The higher the number the better the risk adjusted return with any value over 1 seen as very good.


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Kind Regards,

A handwritten signature in dark ink, appearing to read 'G. Smith', is written below the text 'Kind Regards,'.

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