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Monthly Market Report

February 2023

With commentary from David Stevenson

Regular readers will know that I ever so slightly obsess about the state of US corporate earnings. I do this because the US is THE market that sets the investment mood and is also the deepest, most liquid and dominant in market terms. Where the S&P 500 goes, everything else, at some stage, follows. And despite all the chatter about big picture stuff (inflation, interest rates) what really, really matters is the flow of corporate earnings which can be simply expressed as earnings per share for the S&P 500 (from memory, currently at around $220 per index share).

As the US is likely to experience a slowdown at best and possibly a nasty recession, it is reasonable to presume that US corporate earnings will also decline, despite fairly buoyant consumer spending and low unemployment. I've recently changed my mind on the US economy and reckon that it may, just may, avoid a prolonged recession and only have a quarter or two of negative growth. But if we're honest, if we exclude energy companies, US corporate profits were already declining in the last quarter of 2022. I think they will continue to decline and thus put pressure on the level of the S&P 500.

Enough of what I think - what's the wider market consensus? To add some context, I thought it useful to highlight some predictions form the major investment banks about the S&P 500 and its likely highs and lows:

- SocGen : S&P 500 target is 3800, EPS growth of 0% in 2023, if hard landing 3500, soft landing 4200
- Morgan Stanley: : our chief investment officer Mike Wilson expects US equity markets to sell off in 1Q23, reaching levels as low as 3,000-3,300 for the S&P 500 before ending the year about flat at 3,900
- Wells Fargo: end of year prediction: S&P 500 at 4300 to 4500 with EPS at 205 by end of year. In terms of sectors remain IT, healthcare and Energy

Another interesting temperature check comes in the shape of Morgan Stanley's annual European survey of institutional investor sentiment. This has just been released and shows that 46% of respondents are currently running a lower-than-normal level of risk, a reading last seen in 2011. By contrast, just 17% of the survey respondents are currently running above-average level of risk. 45% expect the S&P to end 2023 below 3800, with only 25% expecting a positive return of 8% or more (>4200). China and Europe are the preferred regions for 2023 while most investors reckon that Bond yields and US core CPI will be at 3-4% by Dec-23.

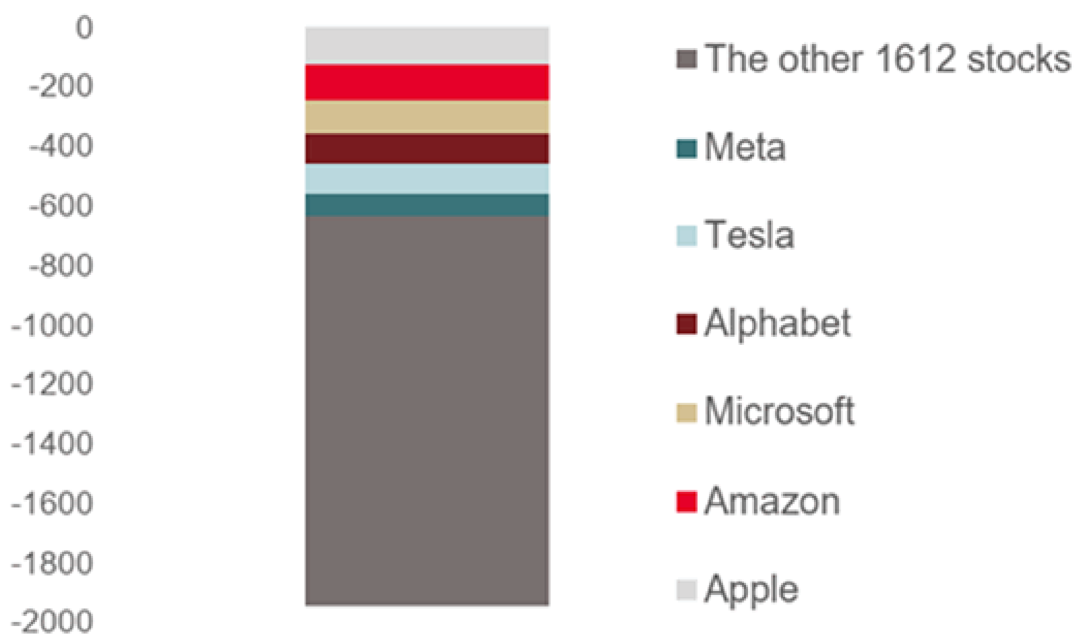
Contents

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

Headline Numbers

One of the most interesting points of agreement amongst most new year predictions I've seen is that the RoW is back i.e., the rest of the world bar the US might outperform in 2023. That scepticism about the US is perhaps influenced by the US markets aggressive growth and tech bias. On this score SG analysts highlight a remarkable statistic, captured in the graphic below - the sheer dominance over the last few years of the US based and listed FAANGs. According to the SG analysts at "one point towards the end of 2020, they contributed 10% points to annual S&P 500 index performance. Last year, they gave a lot back, deducting almost 800bp from the S&P 500, compared to 1,100bp for the rest of the index. Being so big and volatile presents problems for investors trying to outperform the index with tracking error constraints."

Graphic: US tech stocks really did dominate

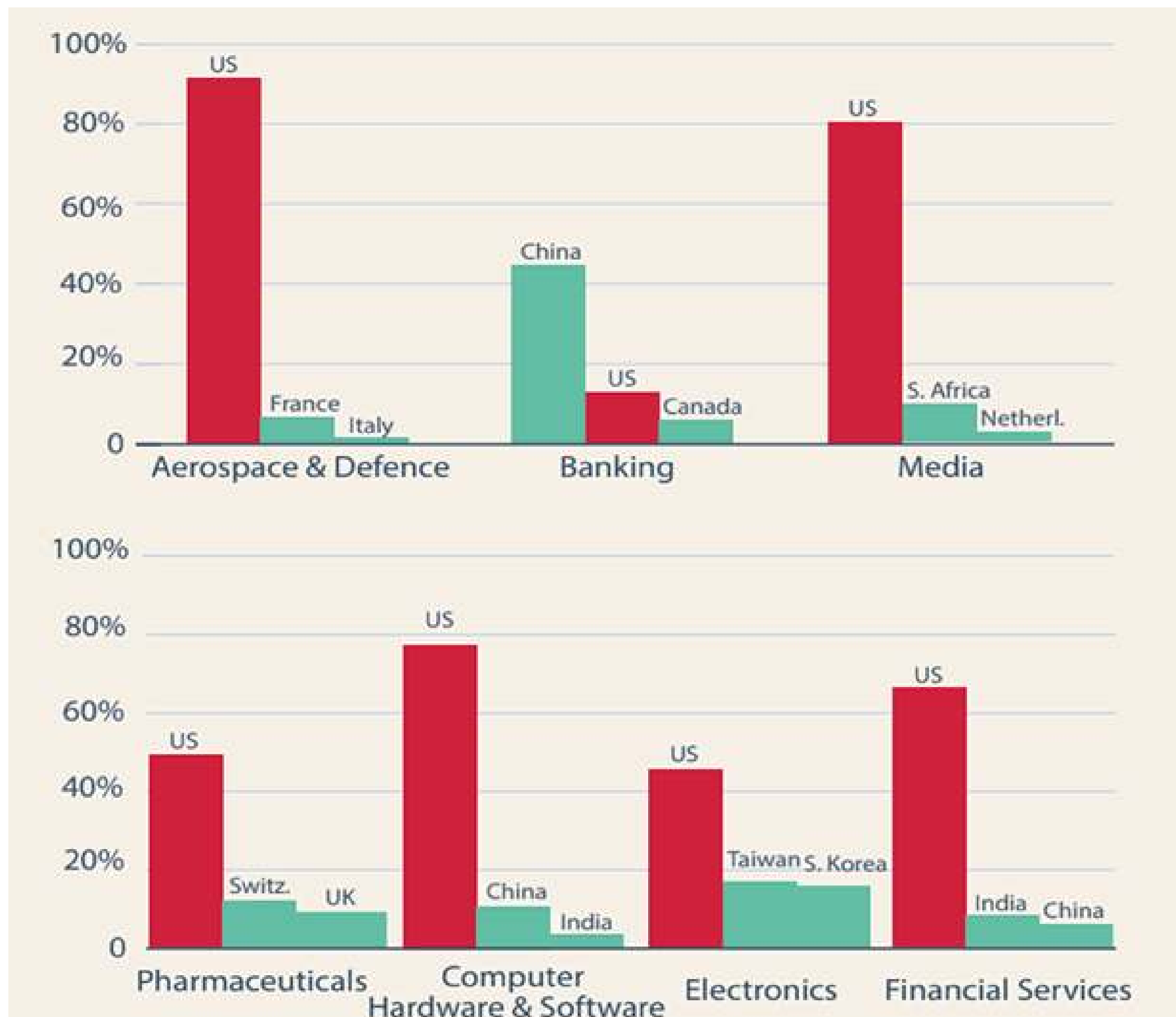


That tech bubble has clearly now burst and suddenly all those boring 'old world' stocks look a great deal more interesting. The slight hitch is that it is the US markets that determine the mood of most developed world markets - Japan excepted. So, it's great news that European markets are closing

the gap but the gap in long term returns remains immense.

And the next graphic below gives us some context as to why US equities have been such a success. Its from the excellent subscription only Sunday Briefing publication and it shows that across most major industries, "most of the world's profits end up in the USA". The extraordinary graphic shows the top three countries' share of profits by sector - given that the US markets represent 'only' between 60 and 70% of the developed world stockmarkets market cap, one could make the case that US equities still under weight the real economic power of the US.

Graphic: The vast majority of profits flow back to the US



Another point of agreement between most big institutional investors in 2023 is that emerging markets and especially China might outperform in 2023. To be fair, many emerging markets such as the main Latin American nations and India had an excellent 2022 but that rally could be broader in 2023. It certainly seems like sentiment is improving after a few years of overall underperformance. Take the latest version of HSBCs Emerging Markets (EM) Sentiment Survey which reveals a distinct improvement in EM investor sentiment. The survey was conducted last year between 2 November 2022 and 9 December 2022 among 118 investors from 118 institutions representing USD497bn of EM assets under management. The key findings? Investors who are now "bullish" on EM prospects over the next three months have nearly doubled to 29% from 15% in the previous survey in September1, while those who are "bearish" are much reduced to 18% from 41%. This brings the net of bullish versus bearish sentiment to a positive level for the first time since the July 2021 survey. - In line with an improving tone, the "risk appetite" score has also rebounded to 6.1 from 5.3, where "0" is "no risk" and "10" is "highest risk in EM" on our gauge.

Crucially mainland China's net score has picked up to 24% from 14%.

Measure	Values as of 9th December, 2022	Values as of 16th January, 2023
UK Government 10 year bond rate	3.10%	3.38%
GDP Growth rate YoY	2.40%	1.90%
CPI Core rate	6.50%	6.30%
RPI Inflation rate	14.20%	14.0%
Interest rate	3.00%	3.50%
Interbank rate 3 month	3.73%	3.98%
Government debt to GDP ratio	97.40%	97.40%
Manufacturing PMI	46.5	45.3

Back to menu

Bank CDS options

Those banks that saw a change in the pricing for their credit default swaps mostly experienced a small, marginal increase in rates for 1 year and 5 year swaps over the last month. This, one suspects, reflects a background increase in concern about an economic slowdown but in truth the rate of increase wasn't very substantial for any bank. That said 5 year rates for Lloyds and SG did increase noticeably. The only bank to see decrease in its rates was Credit Suisse - rates pulled back from very elevated levels but are still very much out of line with its peers. At the one year swap level, French bank Natixis retains the title for lowest rates - to insure against default on its 1 year swaps the cost is just under 20 basis points.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	30.25	61.29	A+	A2	A -
Barclays	67.88	93.71	BBB	Baa2	A
BNP Parabis	27.56	55.44	A+	Aa3	A+
Citigroup	50.09	96.03	BBB+	A3	A
Credit Suisse	477.48	360.16	BBB-	Baa2	BBB
Deutsche Bank	103	158	A-	A1	BBB+
Goldman Sachs	48.34	100	BBB+	A2	A
HSBC	31.68	55.4	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	43.62	78.14	A-	A1	AA-
Lloyds Banking Group	29.46	83.15	BBB+	A3	A
Morgan Stanley	49.55	98.01	A-	A1	A+
Natixis	19.5	45	A	A1	A+
Nomura	32.72	98.04	BBB+	Baa1	A-

RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	28.47	82.58	A	A1	A-
UBS	43.07	71.44	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st January 2023 www.tempo-sp.com

Back to menu

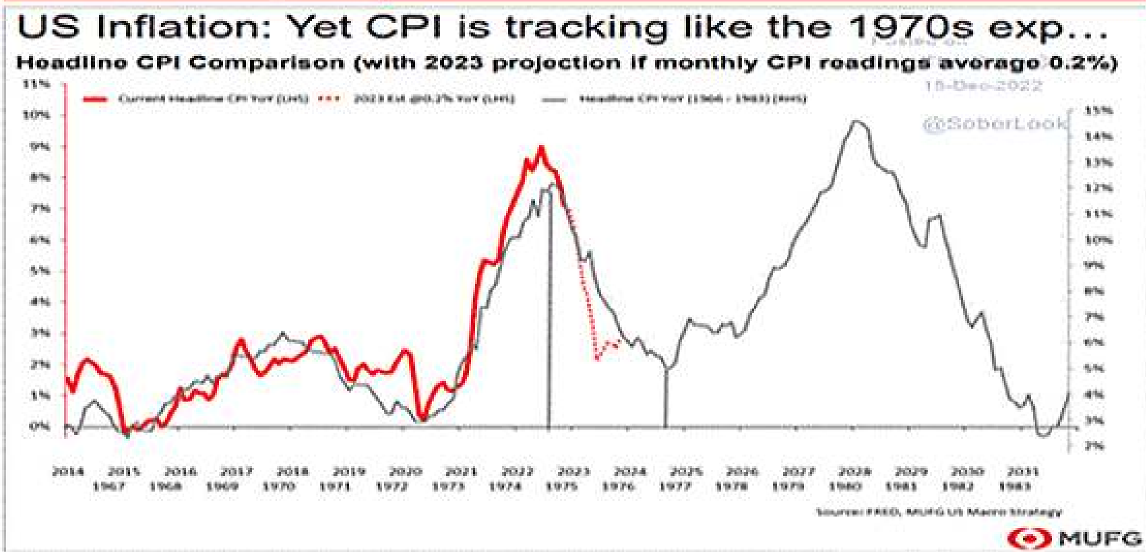
Government Bonds

Any decision about whether to invest less or more in bonds is heavily influenced by the outlook on inflation. I think there's a fair chance that 2023 could be a volatile year for inflation, with rates zig zagging all over the place. First off, it seems perfectly plausible that inflation rates could fall sharply in H1 as all the existing processes work their way through to deflate demand. One classic canary in the coal mine is the cost of housing - in the US house price deflation which is a dominant component of the shelter component of CPI (and some 40% of core CPI) is likely to be heading close to zero at some point in 2023. Unfortunately, there's an equally good chance that inflationary respite might prove short-lived as all the extra central bank liquidity, extra Chinese demand post zero Covid, and even a possibly rebounding US economy in Q4 push energy and foodstuff prices higher.

This concept of inflationary zig zagging is illustrated perfectly in the chart below from Albert Edwards at SocGen. It's a warning of what might be on its way to make all of us deeply miserable: stagflation. The possible ups and downs of inflation could echo that of the 1970s. Edwards reckons that "the current recession and collapse in commodity prices will cause headline inflation to collapse. I think core inflation will abate too but stay sticky around 3% (justifying the likely change in target). But this sets us up for a second wave of inflation, as seen in the 1970s."

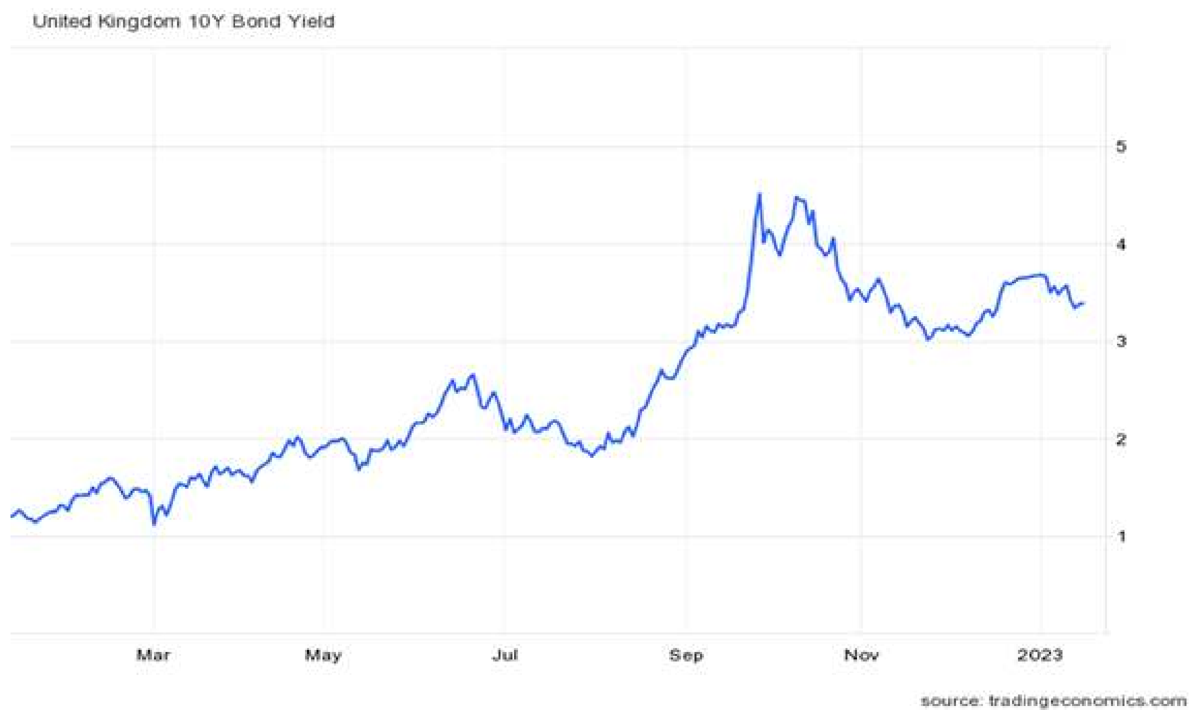
If this scenario does play out as Edwards suggests, it represents a nightmare scenario for investors. As inflation dives, bonds will seem hugely attractive again (prompting the return of the 60/40 portfolio perhaps) before possibly retreating again in subsequent years as stagflation rears its ugly head.

Inflation may fall away in the coming recession, but like the 1970s it is set to come back



Source: @SoberLook, MUFG

UK Government Bonds 10-year Rate 3.38%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	22.5
Germany	7.58
Japan	17.12
United Kingdom	6.82
Ireland	14.85

Italy	107.4
Portugal	38.61
Spain	47.88

Eurozone peripheral bond yields

Country	December 2022	January 2023	Spread over 10 year
Spain 10 year	2.93%	3.16%	99
Italy 10 year	3.81%	4.00%	183
Greece 10 year	3.98%	4.14%	197

	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

Cynical types like investment journalists love to talk up a bad news story, especially if it involves challenging rampant equity bulls, but in truth most investors should not only ignore most investment journalists they should also ignore all the excited talk about timing market bottoms. For most of the time it is an exercise in utter futility- as has been said many times before, what matters is less timing the market than time in the market. For evidence of this contention feast your eyes on the table below which is from analysts at alternative assets manager KKR. This analysis goes all the way back to the second world war and looks at US markets which suffered a 25% decline. The median number of months to a 25% decline was 11.6 months and on average it only took another 2.6 months to hit the market trough. But take a look at the performance following that 25% initial decline. The 5-year annualised return is averaging around 10%.

Graphic : KKR on market troughs and rebounds

Following Large Market Drawdowns, Longer-Term Investors Are Generally Rewarded Over the Next 3-5 Years for Leaning Into Dislocations

Date of			No. of Months From		Decline	Performance Following 25% Drawdown						
Market Peak	25% Decline	Market Trough	Market Peak to 25% Decline	25% Decline to Market Trough	Peak-to-Trough	+3m	+6m	1yr	+3yr	+5yr	3yr Annual-ized	5yr Annual-ized
Nov-40	Dec-41	Apr-42	13.2	4.3	(34%)	(3.3%)	(1.2%)	14.0%	56.3%	78.8%	16.1%	12.3%
May-46	Oct-46	Oct-46	4.3	0.0	(27%)	6.3%	4.5%	4.3%	9.1%	63.7%	2.9%	10.4%
Dec-61	Jun-62	Jun-62	6.3	0.2	(28%)	10.0%	15.8%	31.1%	59.2%	72.6%	16.8%	11.5%
Nov-68	Apr-70	May-70	16.9	1.0	(36%)	(4.5%)	2.8%	28.1%	33.7%	6.3%	10.2%	1.2%
Jan-73	Aug-74	Oct-74	19.1	1.6	(48%)	(4.0%)	2.1%	11.6%	27.6%	40.0%	8.5%	7.0%
Nov-80	Aug-82	Aug-82	20.2	0.2	(27%)	35.9%	35.9%	53.8%	82.1%	200.7%	22.1%	24.6%
Aug-87	Oct-87	Oct-87	1.8	0.0	(33%)	12.1%	15.5%	24.3%	36.0%	83.1%	10.8%	12.9%
Mar-00	Mar-01	Jul-02	11.9	16.1	(48%)	5.8%	(4.4%)	0.8%	(2.9%)	14.4%	(1.0%)	2.7%
Oct-07	Sep-08	Nov-08	11.3	2.1	(52%)	(21.0%)	(34.8%)	(7.9%)	5.2%	46.8%	1.7%	8.0%
Feb-20	Mar-20	Mar-20	0.7	0.4	(34%)	28.6%	34.3%	59.0%				
Jan-22	Oct-22	-	9.2	-	(25%)							
Avg.			**10.6**	**2.6**	**(37%)**	**5.4%**	**5.1%**	**20.2%**	**31.4%**	**60.2%**	**9.5%**	**9.9%**
Median			**11.6**	**0.7**	**(34%)**	**6.0%**	**3.7%**	**19.1%**	**33.7%**	**63.7%**	**10.2%**	**10.4%**
Memo: Median Return Across All Comparable Periods								*9.7%*			*7.4%*	*7.3%*

Data as at November 30, 2022. Source: Bloomberg.

Index	December 2022	January 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	123.4	133.2	4161	120.4
FTSE 100 Dividend Dec 2022	272.50	290.6	7860	273.1

Note changed to Dec 2023 contracts

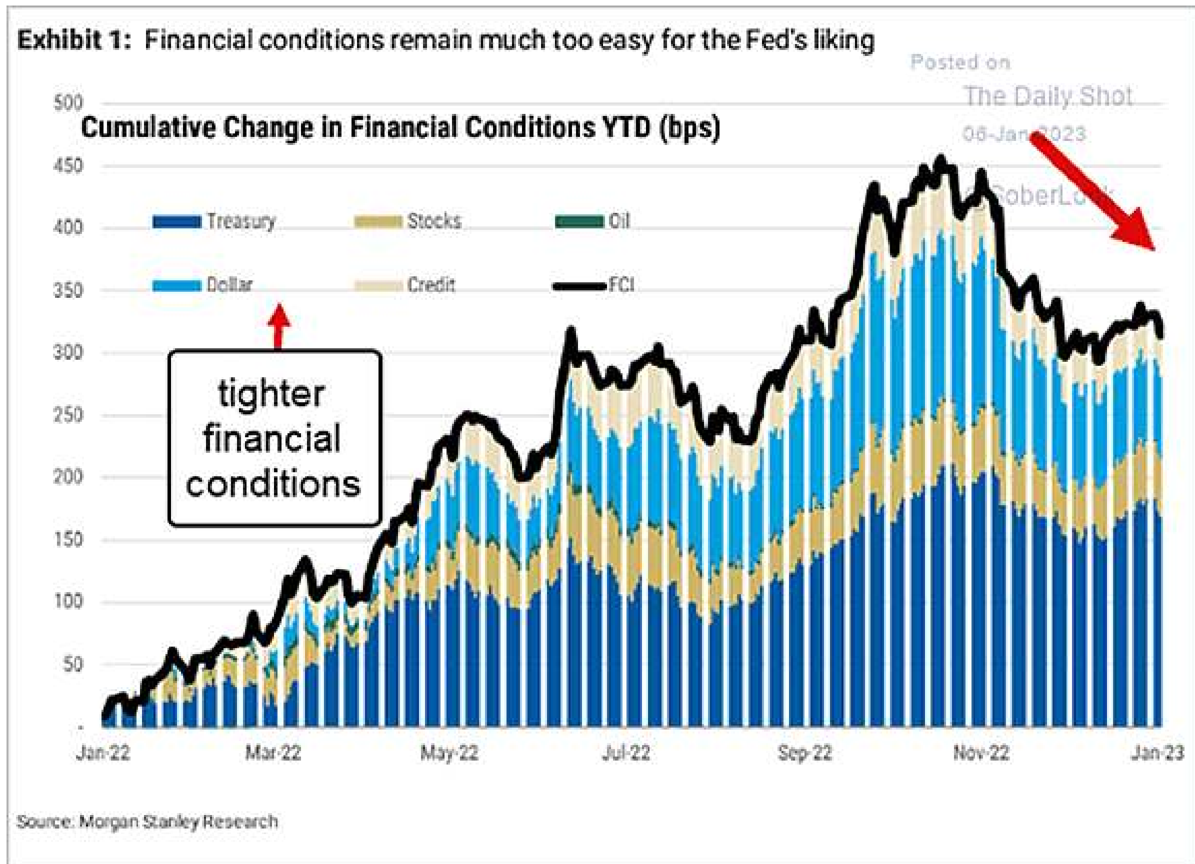
Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	7.2	14.6	9.79	4.2	1.34	7.27	7859.67
S&P 500	3.81	11.6	3.52	-14.2	44	75.8	3999.09
Gold Composite (Most Traded)	6.75	16.5	12.8	5.79	43.7	59.8	192170¢
iShares FTSE UK All Stocks Gilt	0.129	9.68	-10.3	-21.7	-18.3	-17.6	1071.88p
VIX New Methodology	-18.9	-42.7	-24.3	-4.38	57.4	63.4	18.35

Back to menu

Volatility

One of the more curious features of many of the 2023 forecasts pouring out on the wires at the moment is the catch all caveat being issued by most crystal ball gazers. Whatever sector, geography or asset class captures the imagination there's always the subsequent weasel words along the lines of "everything above is of course assuming that we don't see any liquidity crunches

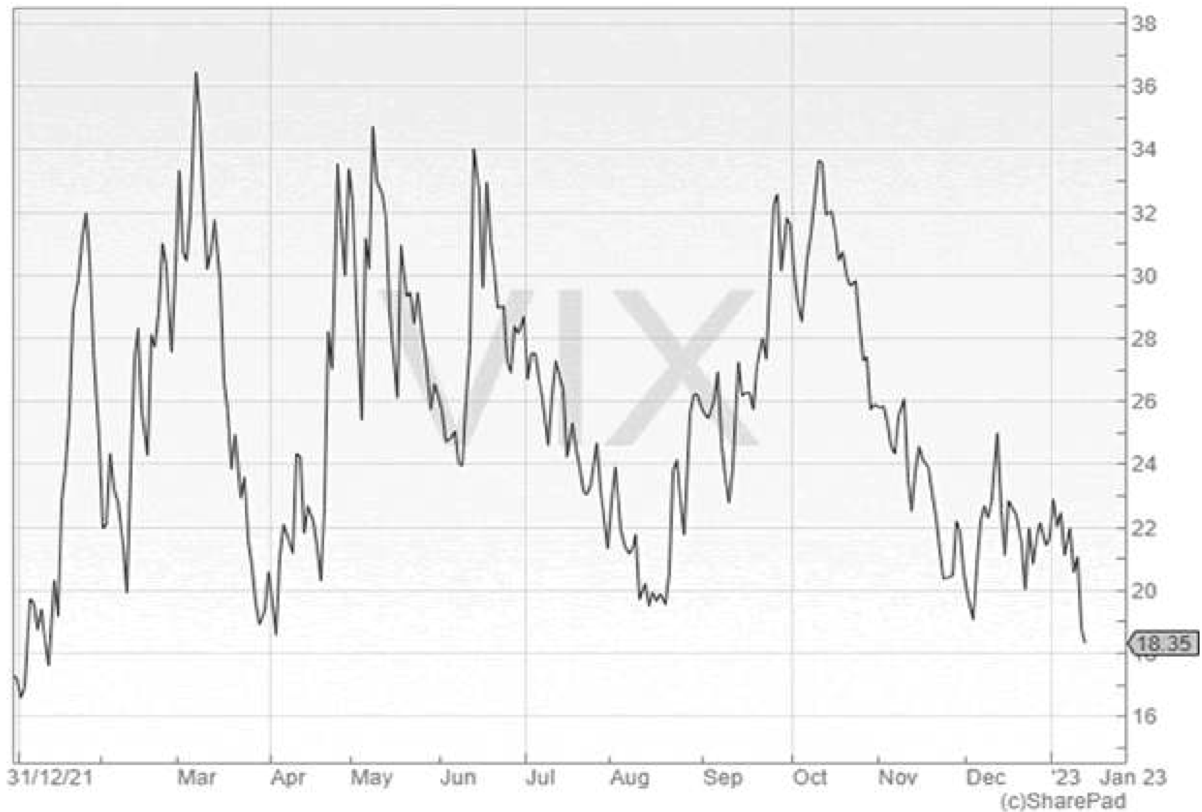
and evidence of market stress". That caution is warranted because it would appear to be obvious that a combination of an economic slowdown combined with central bank balance sheet tightening is likely to result in liquidity issues at some stage, somewhere. And of course, the golden rule of all investment theories is that liquidity stress usually results in asset price volatility. On this score though there is some good news, which is nicely summed up in the chart below from Morgan Stanley which suggests that financial stress is declining at the moment.



Source: Morgan Stanley Research

That message is backed up by analysis this week from Cross Border Capital which observes that "net liquidity provision, in other words the increase in the Fed's 'effective' balance sheet, has remarkably risen in eight of these weeks. In fact, the Fed added an impressive net US$60 billion to US money markets, even though her headline balance sheet fell by US$288 billion over the same period. There may be more cash coming into markets in 2023, if the Fed continues adding liquidity."

So much for the new dawn of Quantitative Tightening.



Measure	January Level	December Level	November Level	October Level
Vstoxx Volatility	18.25	21.24	20.82	31.82
VFTSE Volatility	18.35	22.48	23.15	33.63

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.

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