



# Monthly Market Report

## February 2024



*With commentary from David Stevenson*

Last year was an extraordinary year. Everyone and their aunt expected markets to struggle, or even plunge but in reality, equities powered ahead. As did many bonds. Not unsurprisingly volatility also plunged, not just in equities but also in bonds and even currencies. Unpicking what happened in 2023 is a fascinating exercise, one which will dominate this monthly note. The big story as we all know is that information technology stocks contributed almost 50% of the MSCI World's performance last year. But it wasn't just the Magnificent Seven that did well (or did it - see next comment). The trash of equity markets in 2022 also outperformed. The worst-performing group of US stocks, which lost on average 68% during 2022, rebounded 98% in 2023 - a powerful reversal effect not replicated in the World ex US. So an everything rally, yes? No. Although the Nasdaq composite is only around 6% of its 2021 high, having been at one point down 36% in 2022, many stocks in this index remain substantially below their 2021 highs. For example, over 1,000 stocks out of around 3,400 are still down 75% from their 2021 peaks.

Step back from the ups and downs and a real problem emerges for equity investors : concentration risk. According to analysts at French investment bank SocGen, *"Stock market concentration risk is now a major headache, with 33% of the market capitalisation of the S&P 500 and 28% of MSCI World held in the top 10 stocks, both historically high levels. Yet the profit share of the biggest 10 has remained stable throughout the last couple of decades at just over 20%. Also, the type of businesses populating this top ten has narrowed to become dominated by technology companies (albeit now redistributed into other sectors), whereas 20 years ago you would have found a greater sectoral mix, including cyclical and defensive stocks."*

And outside these dominant elite valuations remain sensible: 21% of European stocks and 17% of Japanese stocks in MSCI World on a forward P/E of 10x or less. This compares to less than 9% in the US. Those valuations are also backed up gushing dividends and cash buybacks. European stocks are paying out over 40% of non-financial cash flow in either dividends or net buybacks. According to those SocGen analysts even *"Japan, never known for its shareholder return generosity, is now paying almost 30%. That said, despite the healthy distributions in the US and Japan this still results in a US total distribution yield of slightly less than 3%"*.

The obvious question looking to 2024 is whether this optimism is backed up by the earnings. The consensus bottom-up expectation for non-energy and ex-financial EPS growth in 2024 and 2025 is a slight pick-up in sales growth, a rebound in margins, and a return to double-digit profit growth. All this in an environment where inflation is still above recent averages, interest rates are coming down and central banks are getting worried about slow downs or even recessions.

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## Headline Numbers

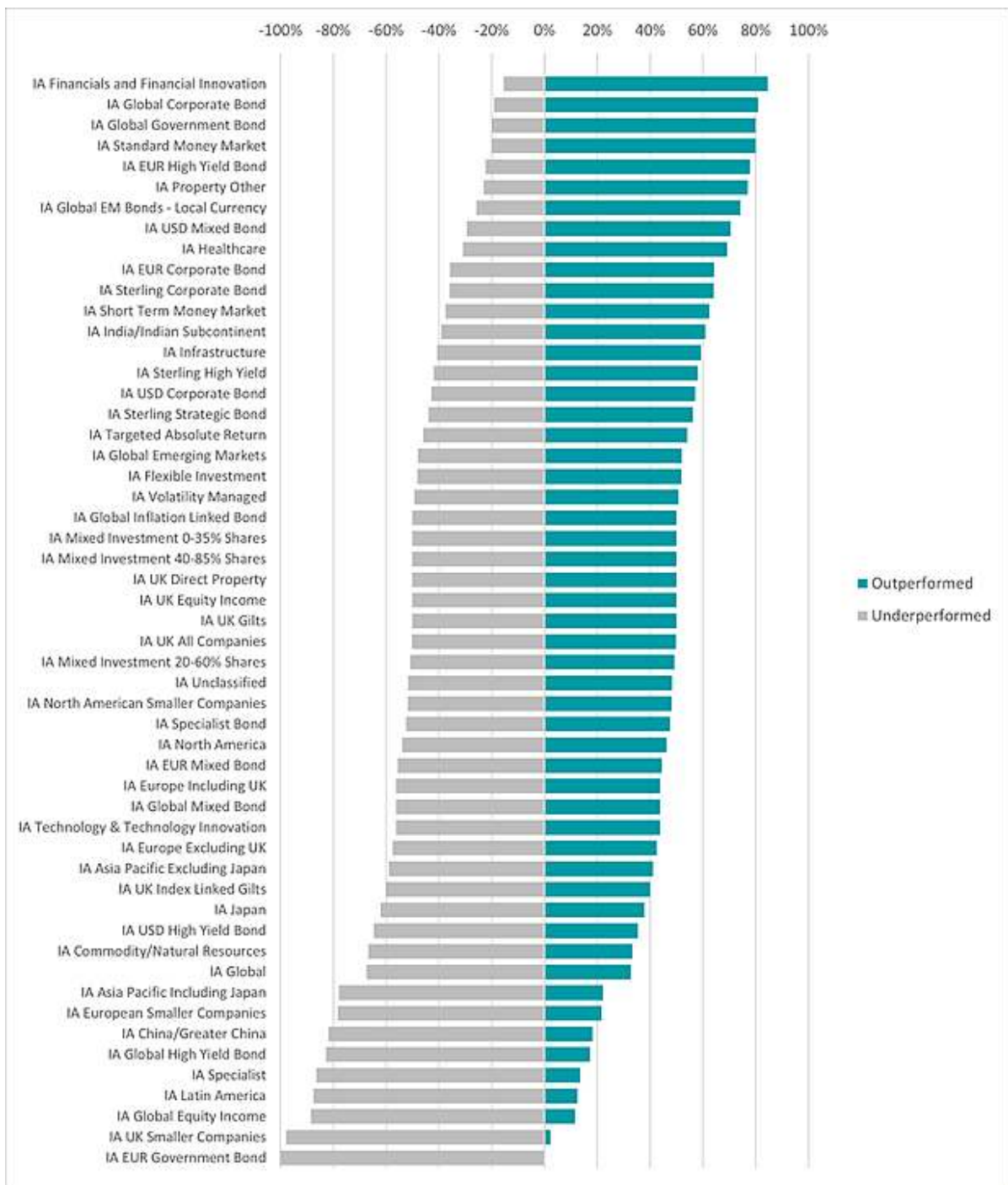
A few years back it was the rise of the FAANGs that transfixed investors. 2023 was all about the Magnificent Seven. What will 2024 bring us - maybe an investor version of the Dirty Dozen perhaps? More seriously though that term the Magnificent Seven needs some careful caveating. According to Howard Silverblatt over at S&P Dow Jones Indices the whole Magnificent 7 notion is in fact a red herring. 4 of the Magnificent 7 companies are still in the red from the close of 2021, as the Magnificent 7 for that period becomes the Magnificent 3 and the Devastating 3.

### Active vs Passive

Every year a familiar debate emerges around this time. It's the old passive vs active chestnut. For the record, I slightly tire of this debate when broad brush aggregate numbers are used. You've seen the studies I'm sure - they usually involve data points such as the SPIVA reports and have headlines like 60% of active funds underperform their benchmarks. These surveys are riddled with debates about data and so on but they also miss a more central point. Yes, in the broadest, most liquid markets that are more (not perfectly) efficient, tracker funds probably are a better bet. But there's a huge universe of niches, strategies and sectors where passive probably doesn't work as well. You can understand this more nuanced approach by looking at a recent article from Trustnet which looks at data from FinXL. It compares returns in 2023 by Investment Association sectors (this is unit trust-focused data) for actively managed funds versus index benchmarks. **Headline reveal?** Active management had the upper hand in 22 Investment Association (IA) sectors out of 54 in 2023.

As always there are some headline grabbers in here. For example, the Trustnet article says, "the chances of picking an outperforming active fund were slim - of the 343 funds that failed to beat the benchmark (the MSCI ACWI index), 289 (84%) were actively managed". But if you closely scrutinise the chart below that more nuanced analysis becomes obvious.

To understand the chart below look at the preferred actively managed portfolios (on the upper side of the chart below) versus those asset classes where cheaper, passive alternatives (on the lower side of the diagram) would have outperformed. The most successful active managers - versus their benchmark - were in niches such as the IA Financials and Financial Innovation sector, where 84.6% of active funds managed to beat the MSCI ACWI/Financials index. Of the 12 funds that did, 11 were actively managed.



Source: FinXL

The report also suggests that active funds work well in focused bond sectors as well - passive funds tend to end up buying the biggest, most liquid, most indebted issues not the safest. Also the huge increase in alternatives helps actively managed funds, especially in property, healthcare and infrastructure where having an active manager at the helm seems to have worked well. By contrast in the more mainstream, more liquid strategies and markets it was a 'coin toss' between active and passive: IA UK Equity Income, IA UK All Companies and IA North America, where the chance of active portfolios outperforming passives was approximately 50%.

The most revealing data point though are returns for tech funds, notably the IA Technology and Technology Innovation sector. Here the index funds captured nearly all the gains any active manager would have targeted.

Measure	Values as of 12th December 2023	Values as of 11th January 2024
UK Government 10 year bond rate	3.97%	3.80%
GDP Growth rate YoY	0.60%	0.30%
CPI Core rate	4.60%	3.90%
RPI Inflation rate	6.10%	5.30%
Interest rate	5.25%	5.25%
Interbank rate 3 month	5.35%	5.32%
Government debt to GDP ratio	97.10%	97.10%
Manufacturing PMI	47.2	46.2

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## Bank CDS options

CDS markets that trade in swaps insuring against bank bond default are echoing the low volatility in equity markets. Rates for nearly every bank we cover in the table fell quite substantially in the last month. Most swaps at the 5-year level now trade in a range from 40 to 55 basis points and from 20 to 35 basis points for 1 year swaps, with only a few outliers such as Deutsche Bank (that said the German banks rates have also fallen substantially). Of note is that Lloyds Bank has very low rates, the lowest for 1 year swaps in our table and second lowest for 5 year swaps - only Natixis pips it to first place at the five year level.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	47.93	18.92	A+	A2	A -
Barclays	75.68	45.02	BBB	BAA1	A
BNP Paribas	41.18	18.62	A+	Aa3	A+
Citigroup	63.71	30.46	BBB+	A3	A
Deutsche Bank	109.57	52.23	A-	A1	BBB+
Goldman Sachs	70.17	39.93	BBB+	A2	A
HSBC	41.13	22.07	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	44.22	23.76	A-	A1	AA-
Lloyds Banking Group	40.76	15.32	BBB+	A3	A
Morgan Stanley	63.71	32.03	A-	A1	A+
Natixis	39.5	17	A	A1	A+
Nomura	88.26	22.16	BBB+	BAA1	A-
RBC	50.91	24.52	AA-	A1	AA-
Soc Gen	51.5	25.07	A	A1	A-
UBS	47.39	31.53	A-	Aa3	A+

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## Government Bonds

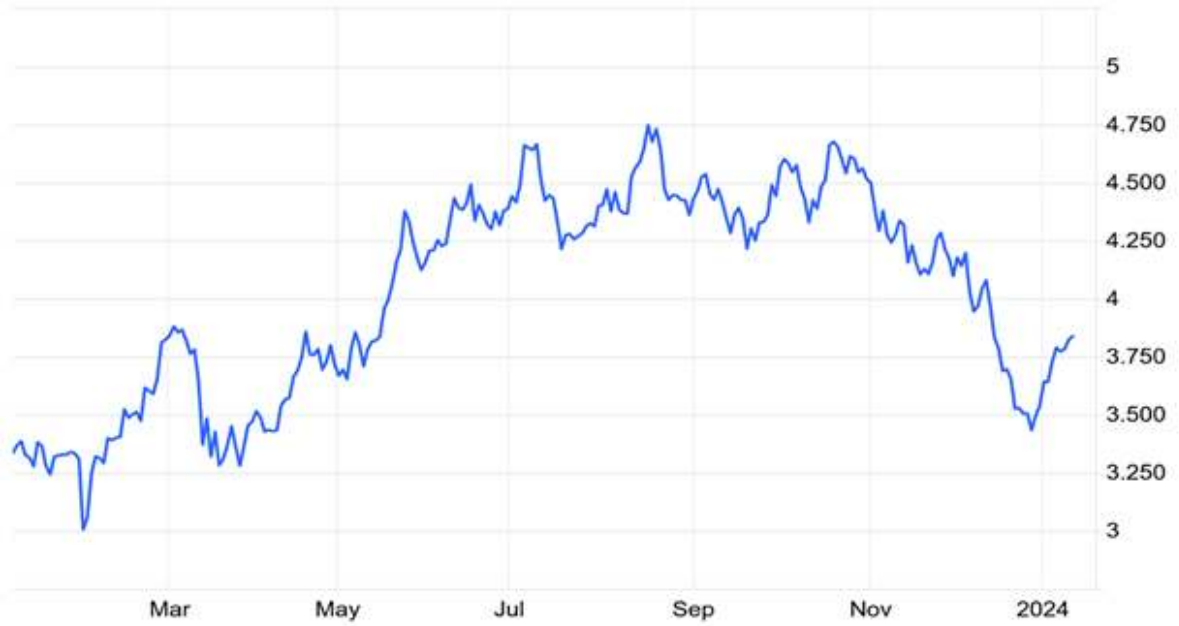
By the end of 2023 investor interest in fixed income had undergone something of a dramatic reversal. For much of the last 18 months bonds have been deeply unpopular for all the obvious reasons in a rising rate, inflationary environment. And then suddenly at the end of last year, the consensus flipped. Suddenly more money started flowing into bond funds as investors anticipated a rate cut.

But most of that money has been finding its way into government securities, not corporate bond funds. The driver here is again very obvious: default risk with gilts and Treasuries is next to nothing. By contrast as the economy slows down, corporate default risk is growing. If anything, 2025 might even be worse than 2024. In 2024, approximately \$770 billion of investment-grade rated bonds are due to mature, with over \$900 billion set to mature in 2025 according to data by Morgan Stanley. Goldman Sachs estimates that corporate debt maturities will be \$790 billion in 2024, and \$1.07 trillion in 2025. The amount of debt maturing in the 2024-2025 period has grown by about 25% to \$333 billion, raising near-term refinancing risk.

Now lower interest rates will help of course but it's not entirely unreasonable to expect defaults to increase which will in turn have a knock on impact on bank balance sheets. The total-twelve-months (TTM) defaults from corporate bond and loan issuers in the U.S. rose in 2023, from 1.6% at the end of 2022 to 3.04% for leveraged loans, and 1.35% at the end of 2022 to 2.99% for high yield as of December 20, 2023. The U.S. trailing 12-month speculative-grade corporate default rate also increased from 3.7% as of August 2023 to an expected 4.5% by June 2024. Last but by no means least, the U.S. trailing 12-month speculative-grade corporate default rate was projected to reach 5% by September 2024, up from 4.1% in September 2023.

**UK Government Bonds 10-year Rate 3.80%**

United Kingdom 10Y Bond Yield



source: tradingeconomics.com

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

### CDS Rates for Sovereign Debt

Country	Five Year
France	24.5
Germany	15
Japan	24
United Kingdom	35.24
Ireland	24.02
Italy	80.2
Portugal	42.58
Spain	45.76

### Eurozone peripheral bond yields

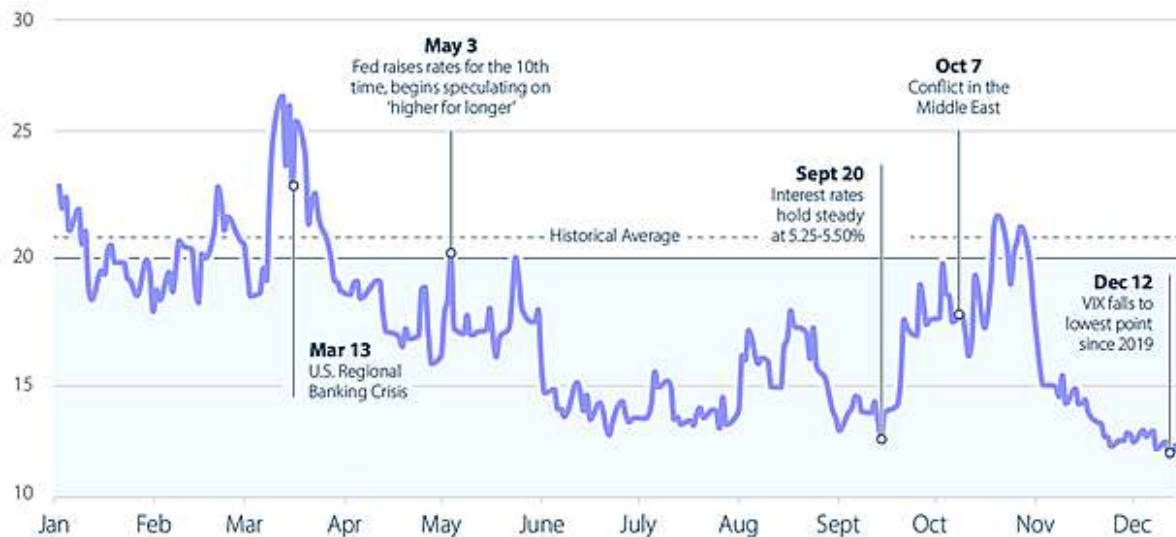
Country	January 2024	December 2023	Spread over 10 year
Spain 10 year	3.14%	3.23%	101
Italy 10 year	3.82%	3.99%	177
Greece 10 year	3.27%	3.42%	120

	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



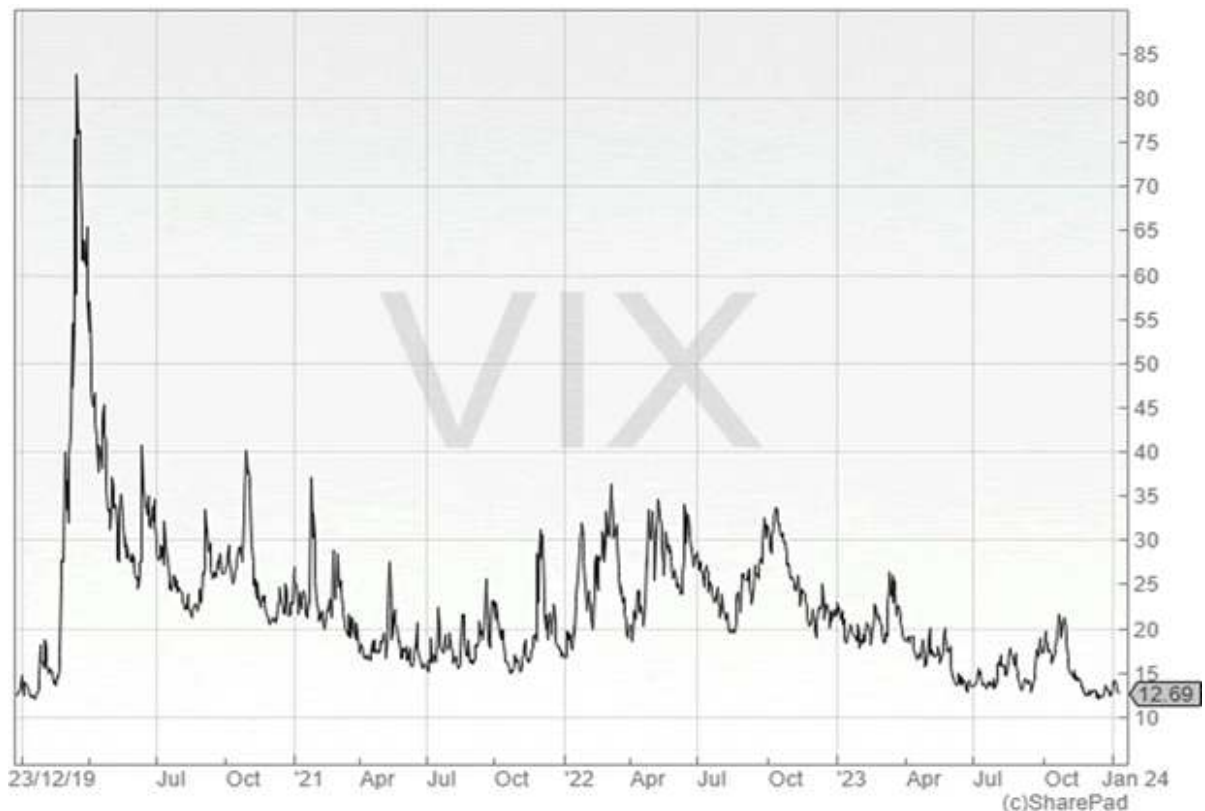


make is that when we did get surges in the VIX it was almost entirely driven by what's called macro factors outside of the equity markets i.e. Worries about rates, liquidity or the Middle East.



Source: Cboe, 12/15/2023.

What's less obvious though is that in 2023 according to S&P Dow Jones, nearly every major developed market index reported that equity implied volatility indicators declined. The Hong Kong-focused HSI Volatility Index for instance registered the largest fall, down by 4 points to 21. It's also true that in other asset classes, volatility trended lower with Japanese Government Bonds and Gold representing the exceptions. Perhaps the most fascinating trend is that according to Deutsche Bank, their measure of currency market volatility - the CVIX (.DBCXIX) - which tracks turbulence in a weighted average of implied "vol" of nine major currency pairings imploded in 2023. By the end of November - the last time I could see data points - the index was exactly half the peaks of September last year and some 1.5 points below its historic average.



Measure	January Level	December Level	November Level	October Level
Vstoxx Volatility	13.92	13.21	15.93	20
VFTSE Volatility	12.69	12.63	14.17	16.69

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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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