



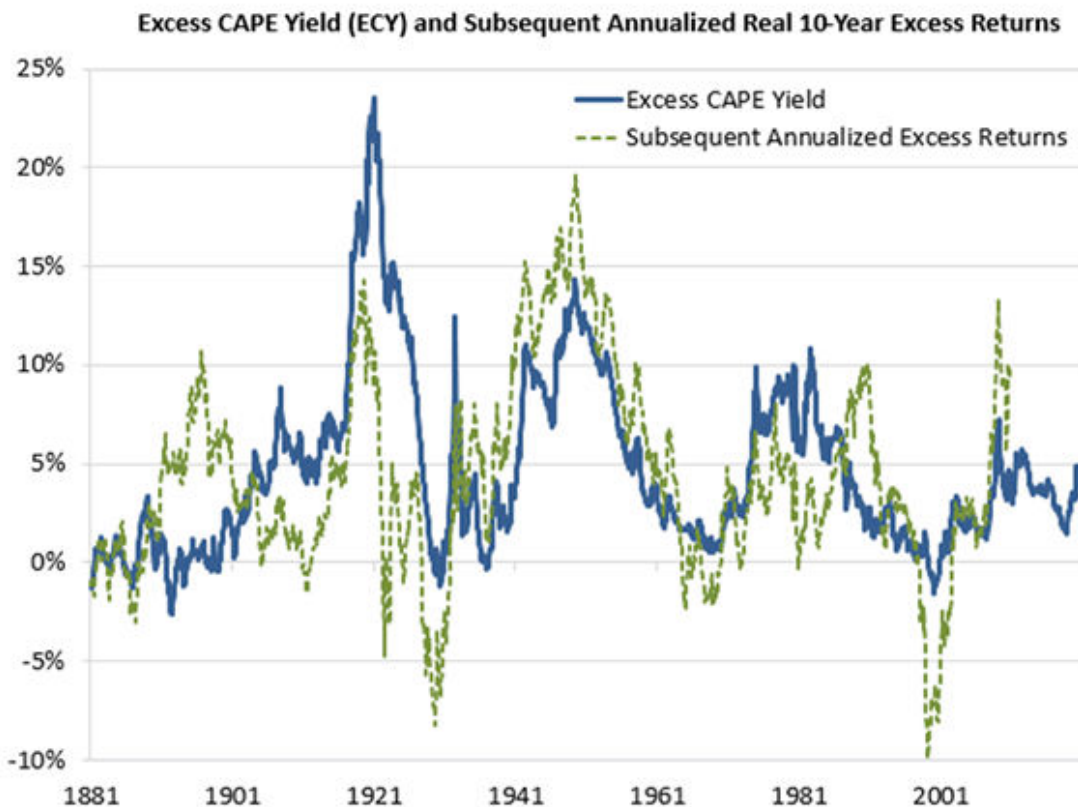
Monthly Market Report January 2021



With commentary from David Stevenson

Over the last few weeks, I have heard more and more market observers and investment bank strategists talking about the possibility of a Roaring Twenties for developed world stockmarkets once Covid begins to fade from view. I've even tried to detail a likely scenario about this optimistic scenario in my own online columns at Citywire. In virtually all the narratives I have seen - echoed in my own scenario building exercise - there is one constant: central bank monetary innovation. The consensus view is that central banks will continue to use all sorts of new tools to fight any future downturns, possibly even deploying digital (helicopter?) money which is being trialled in China as we speak.

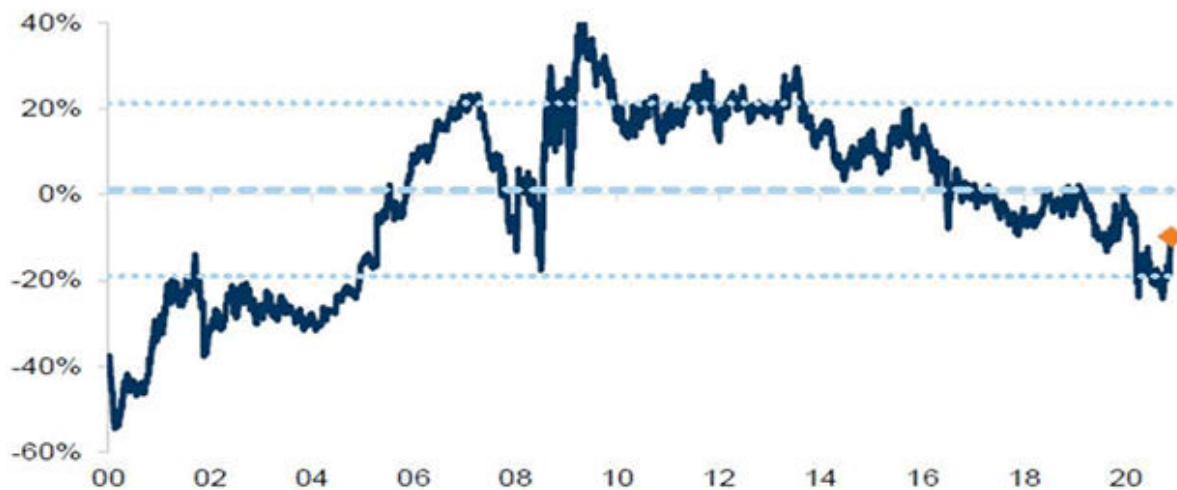
Though there are some notable sceptics who think all this central bank activism will sooner or later self-implode, loose money would seem to be an obvious underpinning for stock market valuations - and might even fire up a wider economic (inflationary?) boom later this decade. And loose money provided by central banks is also clearly underwriting exorbitant stock market valuations in a very obvious fashion first by driving down discount rates and then secondly by making cash so unattractive. Even sceptical types such as Robert Shiller, the Yale economist who - amongst many other innovations - popularised the idea of the CAPE measure (this is the long term cyclically adjusted price to earnings ratio for equities) has conceded that cheap (or free) money has had an obvious impact on valuations. Bloomberg's John Authers recently noted that Shiller along with colleagues Laurence Black and Farouk Jivraj has developed a new way of binding together the CAPE measure and near zero interest rates. This measure looks at the gap between the CAPE and interest rates using something called the "Excess Cape Yield", or ECY. This is a simple spread and expresses the CAPE as an earnings yield, rather than a multiple, and then subtracts the 10-year interest rates. "This measure has usually done a great job of predicting subsequent returns over the following 10 years" according to Authers. "And on the face of it, this measure suggests that the U.S. market should be in line for average real annual returns of about 5% per year for the next decade. ". The first chart below shows some clear correlation between this excess CAPE yield and the equity returns.



But Shiller also goes on to observe that this ECY measure looks compellingly cheap in many other places: "The ECY is close to its highs across all regions and is at all-time highs for both the UK and Japan. The ECY for the UK is almost 10%, and around 6% for Europe and Japan".

Yes, UK equities are still, post the recent rally, dirt cheap. Analysts in Morgan Stanley's European equities team have been banging this same drum for weeks now. In their latest note they say that they still expect the UK to outperform Europe next year, with the FTSE 100 set to grow 17% next year versus 10% for the MSCI Europe index. "This reflects stronger EPS growth, more helpful FX trends, cheap valuations and a rebound in Value which favours UK outperformance. Recent vaccine news flow cements our faith in a strong recovery next year and helps the Value rotation, while a Brexit deal, if and when approved, should also provide some support to UK assets.... UK cyclicals trade at a sizeable discount to European cyclicals".

The following chart is from another investment bank, this time Goldman Sachs, and shows the discount at which UK stocks trade on a 24-month forward PE basis when comparing a basket of UK stocks to Stoxx Europe. UK domestic stocks have re-rated but remain on a 10-15% PE discount to the broad European market. From an EV/EBITDA perspective the FTSE 100 is on 7.8x current year vs 12.1x for EuroStoxx50.



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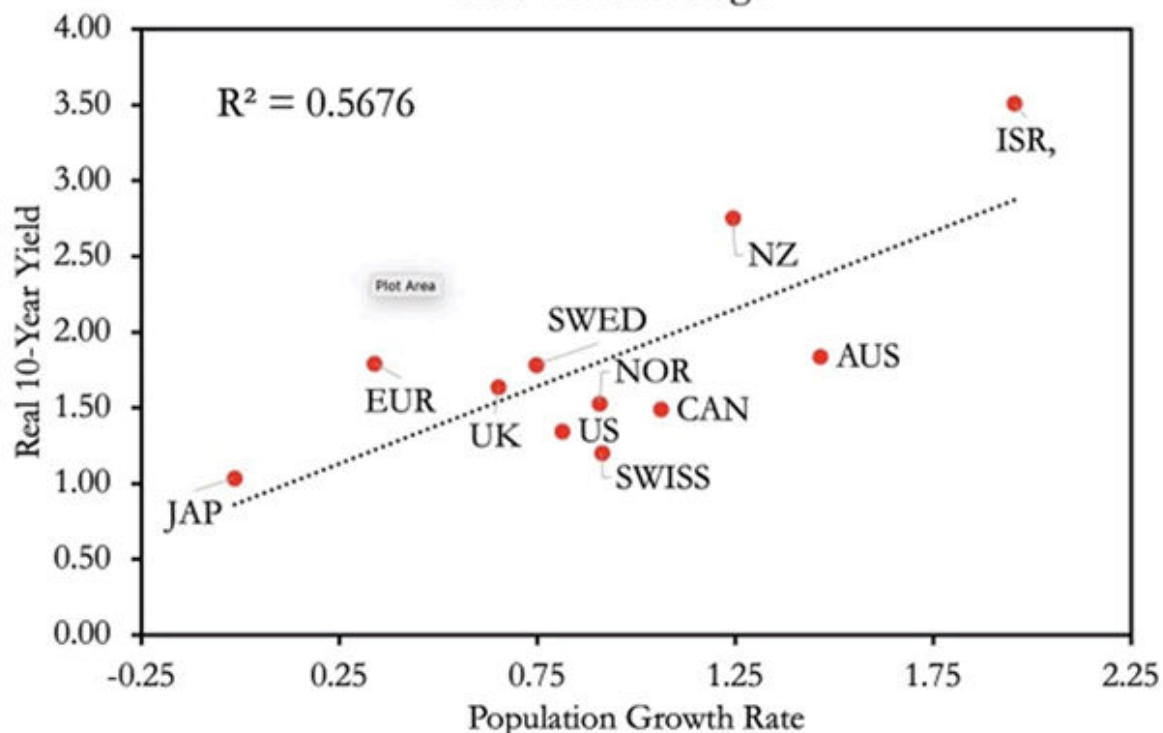
Headline Numbers

Why interest rates are low

One of the most interesting debates in modern economics is why interest rates in the developed world are so low. Many explanations have been offered, not least that central banks have flooded the financial system with cash. Some, such as Ben Bernanke reckon that there is some form of savings glut although a recent Economist magazine Free Exchange [column](#) comprehensively knocked out this theory. An alternative explanation has been advanced by US policy commentator Matt Yglesias on his Slow Boring [blog](#) on Substack. He points to what I think is an increasingly obvious suspect - **low population growth**. His big argument is that we need more people, not less to live in the UK (and the US). Slow population growth by contrast might produce low-interest rates, possibly via the related aging process. One fascinating indicator Yglesias quotes is from a tweet by David Beckworth (Senior Research Fellow at Mercatus and former U.S. Treasury Economist). The graphic below shows what I think is a clear relationship between low yields and population growth rate. Correlation isn't causation but it is a striking relationship, nonetheless.

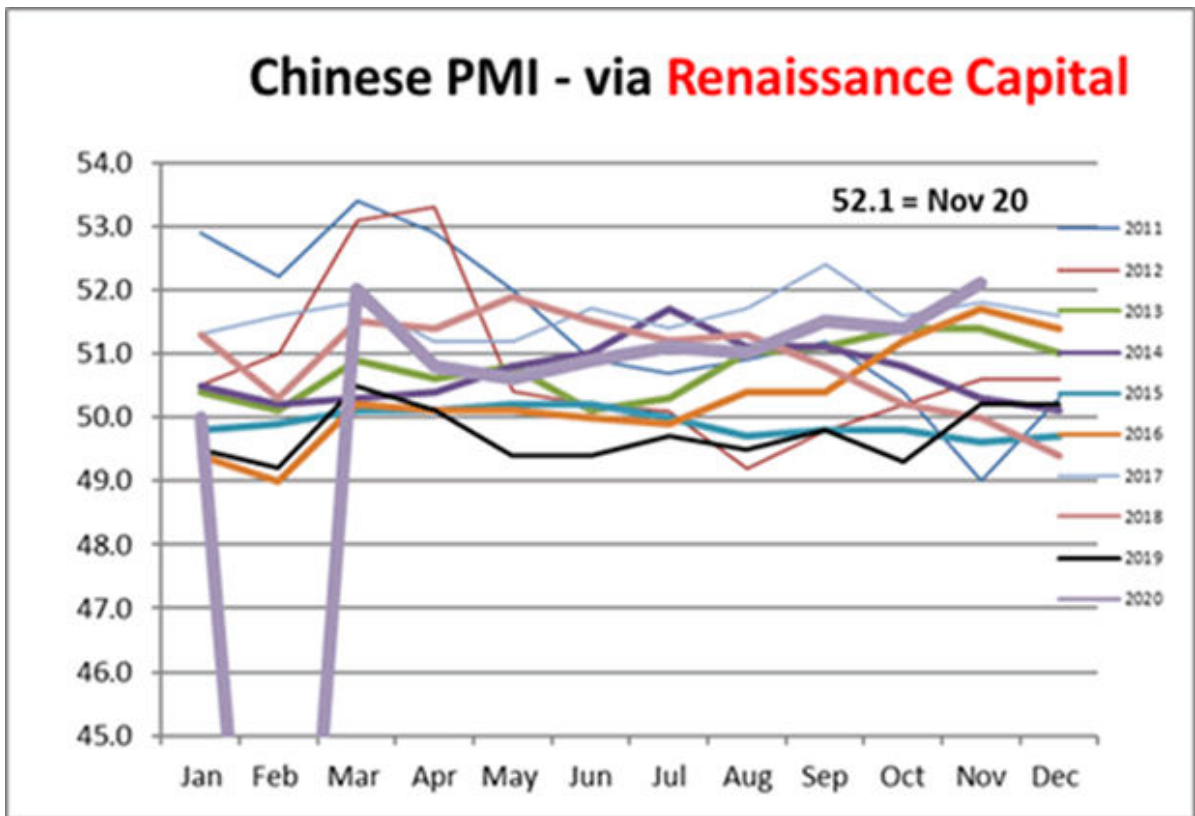
Population Growth and Real 10-Year Yield

2000-2019 Average



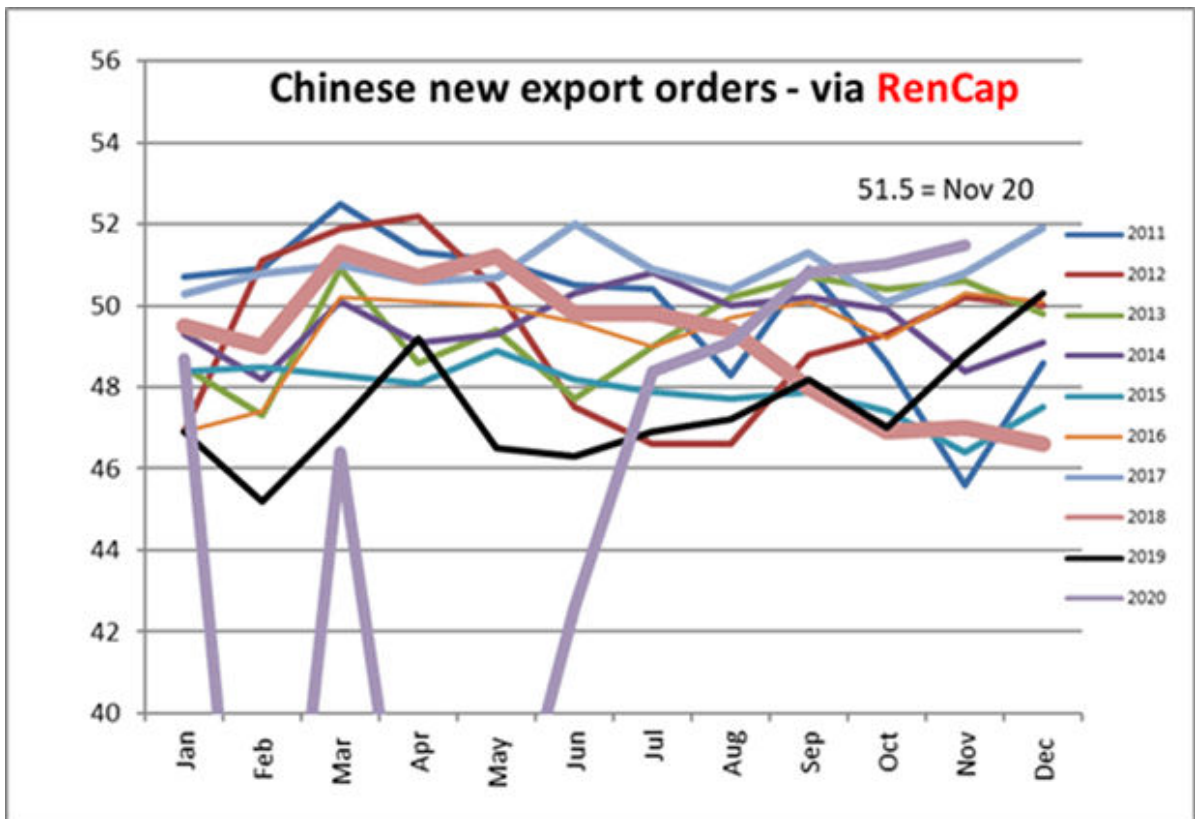
China Booms

As we probably all expected, it looks like numbers coming out of China are surprising to the upside. In fact, analysts are beginning to project a very strong recovery for Chinese growth next year based on their models for consumption growth. Charles Robertson, Global Chief Economist at emerging markets specialist Renaissance Capital reckons its not only consumption that is likely to shoot up next year - recent PMI and export numbers are also looking very positive. In a recent note entitled another "Best figure in 10 years from China" he looks at very recent China PMI figures and declares that *"with the headline PMI again (like last month) being the best figure in a decade .. and beating 51.5 expectations."*



Source: Bloomberg

"And new export orders too are also, again, the highest for a November in a decade (same story a month ago)".



Source: Bloomberg

Charlie's conclusion? "Aside from confirming that the world's second largest economy is going gang-busters, the new export orders are also encouraging as they suggest that the November lockdowns in Europe and increased restrictions in part of the US, are not impacting on global

demand. Good news".

Beijing-based American economist Michael Pettis takes a suitably more restrained view in his latest Global Source update. He suggests that next year's GDP numbers for China won't be determined by consumer data or export numbers but by "the persisting debate between those in Beijing more worried about rising debt and those more worried about slowing growth. Depending on who is in the ascendance, I expect GDP growth next year to be either in the 6-7 percent range or in the 7-8 percent range. Given the deterioration this year in every measure of debt sustainability, I suspect it will be the former, especially if the current bond market turmoil persists."

One last chart nicely sums up why we might all be surprised by **bad** news coming out of China, especially around the rising level of bad debts internally. This last chart compares the Chinese inflation level with long term bond yields - currently the net real cost of debt in China is at a recent high, forcing many big businesses to delay payments or even default on their debts.



Measure	Values as of 10th November, 2020	Values as of 4th December, 2020
UK Government 10 year bond rate	0.40%	0.35%
GDP Growth rate YoY	-21.50%	-9.6%
CPI Core rate	0.50%	0.70%
RPI Inflation rate	1.10%	1.30%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.04%	0.04%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	53.7	55.6

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Bank CDS options

Rates for bank credit default swaps have fallen sharply in price terms over the last few weeks, perhaps indicating that investors are growing less worried about a wave of defaults. Most of the big European based banks saw very substantial declines in pricing especially for their 1 year swaps - US banks by contrast saw a more gentle decline in prices. Only one bank bucked the trend, at the margins - HSBC saw the pricing for its 1 year swaps increase very marginally (from a low level) while its 5 year swaps fell back in line with its European peers. Two banks stood out for this observer - the first is that UBS saw a decline in pricing for its 1 year swaps in the last month from an already low 9.5 to 6.22 basis points. The most striking number though was for Lloyds Bank. Its one year swaps are now priced at less than those for HSBC - at 9.73 bps - while its five year swaps also trade below those for HSBC (23.6 vs 31.46). That's a remarkable testament to Lloyds' transformation.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.49	31.06	A	A2	A -
Barclays	16.94	49.58	BBB	Baa3	A
BNP Parabis	9.93	29.65	A+	Aa3	A+
Citigroup	30.47	50.34	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	11.25	41.11	BBB+	Baa2	A-
Deutsche Bank	40.11	101	BBB+	A3	BBB
Goldman Sachs	30.79	52.23	BBB+	A3	A
HSBC	10.97	31.46	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	24.36	41.41	A-	A2	AA-
Lloyds Banking Group	9.73	31.15	BBB+	A3	A+
Morgan Stanley	27.17	46.6	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	40.85	95.11	BBB+	Baa1	A-
RBC	19.11	56.52	AA-	Aa3	AA-
Soc Gen	10.68	31.46	A	A1	A
UBS	6.22	23.6	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 2nd December 2020 www.tempo-sp.com

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Government Bonds

Bonds - a tale of two charts

Two fascinating bond charts to finish off the year! The first is from SocGen strategist Albert Edwards. It shows the divergence between yields for Austria's 100-year bond which has declined from 1% to just under 0.5% while the 10-year UST yield has now started creeping towards 1%. So, let us get this right. You lend money for 100 years to a small, fiscally sound country for a mere 40 basis points but you lend to the world's military superpower - and default currency - and you pay more.

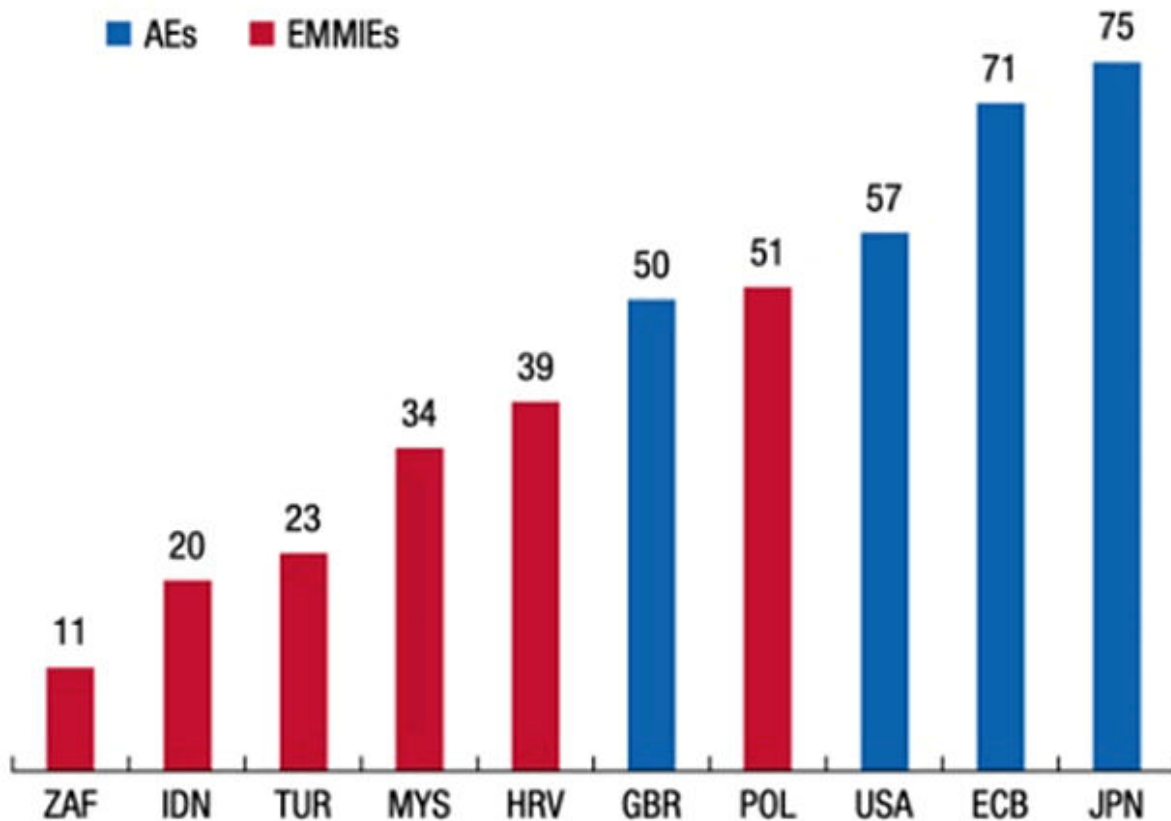
K-shaped recovery? Or King Kong 'K'olossal mispricing?



Source: Datastream

The second chart is courtesy of economic historian Adam Tooze who observes that QE-style interventions by central banks are now a spectrum running across DM and EM rather than a distinguishing mark of DM. He concludes by observing that "Purchases of central gov debt by Polish CB matches that by BofE!".

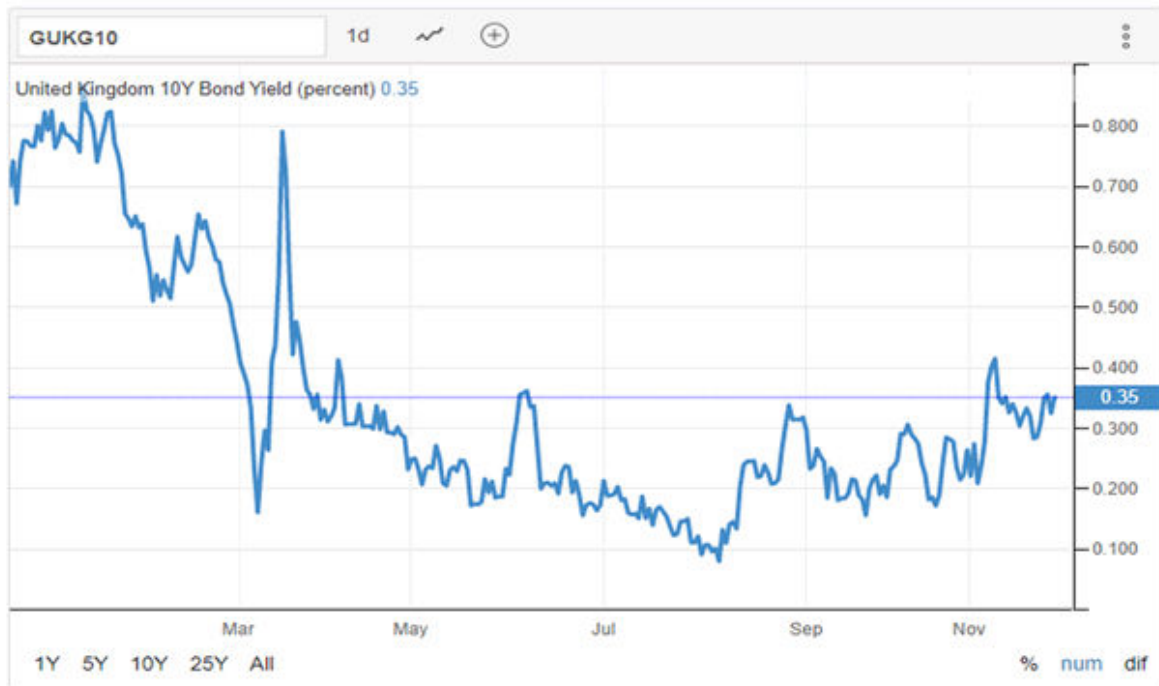
Figure 1.3. Central Bank Purchases of Government Debt
(Percent of central government marketable securities or debt issued since February 2020)



Sources: Country authorities; US Federal Reserve Economic Data; Haver Analytics; and IMF staff calculations.

Note: Data labels use International Organization for Standardization country codes. AEs = advanced economies; EMMIEs = emerging market and middle-income economies.

UK Government Bonds 10-year Rate 0.35%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	17.19
Germany	11.19
Japan	15.65
United Kingdom	18.66
Ireland	18.4
Italy	103
Portugal	40
Spain	46.7

Eurozone peripheral bond yields

Country	November 2020	December 2020	Spread over 10 year
Spain 10 year	0.15%	0.08%	62
Italy 10 year	0.72%	0.62%	116
Greece 10 year	0.80%	0.64%	118

	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

Equity Markets and Dividend Futures

Dividend futures too bearish?

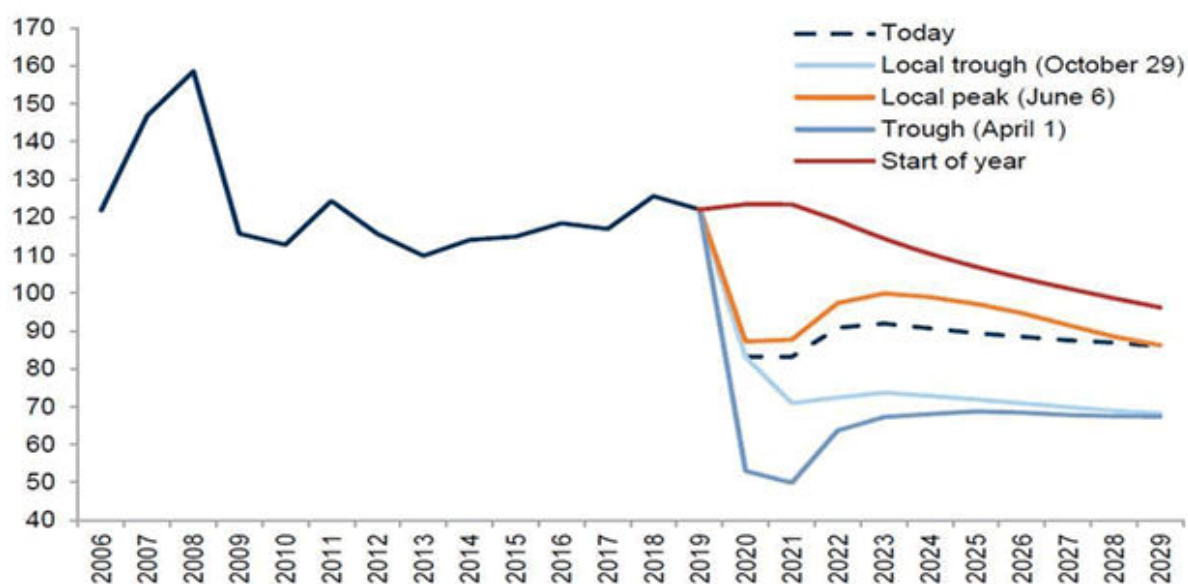
Readers might just have noticed that there was a mass rush to cut dividends earlier this year as companies became desperate to conserve cash in the face of the impending pandemic.

Unsurprisingly this had an impact on dividend futures markets - pricing for near term contracts crashed 60% in value for European contracts.

According to Ocean Wall, a specialist in alternative assets that work closely with many hedge funds and family offices, there has subsequently been a rebound driven by a view "that dividend pricing had become excessively bearish".

As a result there are, according to Ocean Wall, some opportunities further up the curve.

They observe that "dividend cuts this year do not mean they will continue to be cut 3-4 years into the future. JPMorgan believe the dividend situation will normalise by 2022. In 2019 there were 121pts of Euro Stoxx dividends. The Dec' 2020 contract is trading at 83.3pts. Analysis from 2008/9 shows that dividends have a naturally recycling and stabilising effect as time progresses from time of shock. The Dec29 Euro Stoxx 50 contract is trading at 86.9pts. The chart below from Goldman Sachs show the Euro Stoxx 50 dividend term structure. The consensus forecast for 2029 is 143.8 so a 65.8% upside or an annualised 7.4%."



Index	November 2020	December 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	83.3	83.4	3535	83
FTSE 100 (Dec 19)	212.1	215	6550	208

Name	Price % change							Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr		
FTSE 100	11.4	13	3.32	3.32	5.02	-1.91	6551.73	

S&P 500	7.22	7.73	18.6	18.6	76.5	78.2	3691.92
iShares FTSE UK All Stocks Gilt	-2.3	-1.38	-1.83	-1.83	18.2	19.3	1447p
VIX New Methodology	-28	-30.8	-30.8	-17.6	43.7	71.9	21.28

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Volatility

Bitcoin melt sup

Bitcoin is back! As gold has started to lose its allure, digital currencies have suddenly become hot again, led by the eponymous Bitcoin. But might this bubble in digital currency prices also be sowing the seeds of its own possible demise - Bitcoin prices have been rising but volatility has also been hitting new highs, under cutting the digital currencies' claim to be a future, tech led safe haven alternative to the shiny precious metal.

Data from US based digital currencies specialist Blockforce Capital revealed that the price volatility of Bitcoin surged to levels not witnessed since early June — with price fluctuating aggressively in the last month. Bitcoin's 30-day annualised price volatility reached 68.64% as November came to an end.

According to data from CoinDesk, volatility climbed to this level around the same time Bitcoin's price jumped to \$19,354.98. This price level was just 5% shy of the previous all-time high of \$19,783.21 posted in December 2017 — almost three years ago.

Interestingly, there's not a big difference between this five-month high figure and the average volatility over the long term. The annualised 30-day volatility stands at 68.64%, which is roughly 8.6% higher than the historical average 30-day volatility of 63.22%. The chart below shows Bitcoins ascent in price over the last few years, with volatility tracked in the second lower chart.

<https://www.tradingview.com/chart/Bdolo593/>



Measure	December Level	November Level	October Level	September Level
Vstox Volatility	20.82	24.8	22.32	27.87
VFTSE Volatility	21.28	23.19	25	30.76

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

Kind Regards,



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