



Monthly Market Report January 2022



With commentary from David Stevenson

Now that Omicron is upon (!), I think I have no other choice than to start this month with a discussion of the impact of the virus. This time though its not on us, the West or even Africa. Instead, I want to focus on China and what I believe is the single biggest unrecognised threat to the global economy, namely China and its Zero Covid mistake.

Precisely because we've now realized that the Covid emergency is constantly evolving, I think every nation (bar one or two) has come to the conclusion that the only way to dig ourselves out of the Covid hole is a combination of 1) vaccines and boosters, 2) better drug treatments and c) limited public health measures that stop well short of lockdowns.

The key point here is that Zero Covid as an explicit policy option is not on the table anymore. **Except in China.** The CCP has staked a huge amount of its legitimacy on trumpeting its zero covid policy. And it shows no signs of changing course. But my core concern is that it is precisely what it will have to do at some stage - change course and admit that complete suppression cannot work. And when that happens the economic hit will be HUGE because the domestic population has been lulled into a false sense of security. And the one lesson we have all learned is that when citizens realize the full nature of the challenge they stop spending and hunker down. At which point the domestic consumer market craters. Which in turn impacts the rest of us in the global economy.

So it's with this analysis in mind that I always like reading an excellent blog called [Pekingology](#) by a Chinese journalist called Zichen Wang. It's an excellent way of understanding what official China is thinking without any of that rampant nationalist guff that normally accompanies any commentary.

Last week Wang cited a paper by the Chinese Center for Disease Control and Prevention Weekly by Peking University researchers to "evaluate the corresponding potential consequences if pandemic response strategies in the aforementioned countries (the United States, the United Kingdom, Israel, Spain, and France) were to be adopted in China."

Here's Wang's pithy summary

- *"If you copy and paste the United States to China, there will be 637,155 cases and 22,364 severe cases a day here."*
- *"If you copy and paste Britain to China, there will be 275,793 cases and 9,680 severe cases a day here."*

The chart below maps out these scary numbers.

My point here is that these are precisely the numbers we can expect at some point when China is forced to ditch its zero covid policy. And when it does the impact on the domestic Chinese consumer market could be devastating, vaccinated or not. Domestic spending might well slump aggressively and that will have a knock on impact on the global economy and financial markets.

Watch this space in 2022.

TABLE 3. Estimates on the lower bound of daily severe cases in China under strategies in the reference countries.

Reference country	Estimated lower bound of daily severe cases in China
US	22,364
UK	9,680
Israel	15,522
Spain	11,231
France	15,942

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Headline Numbers

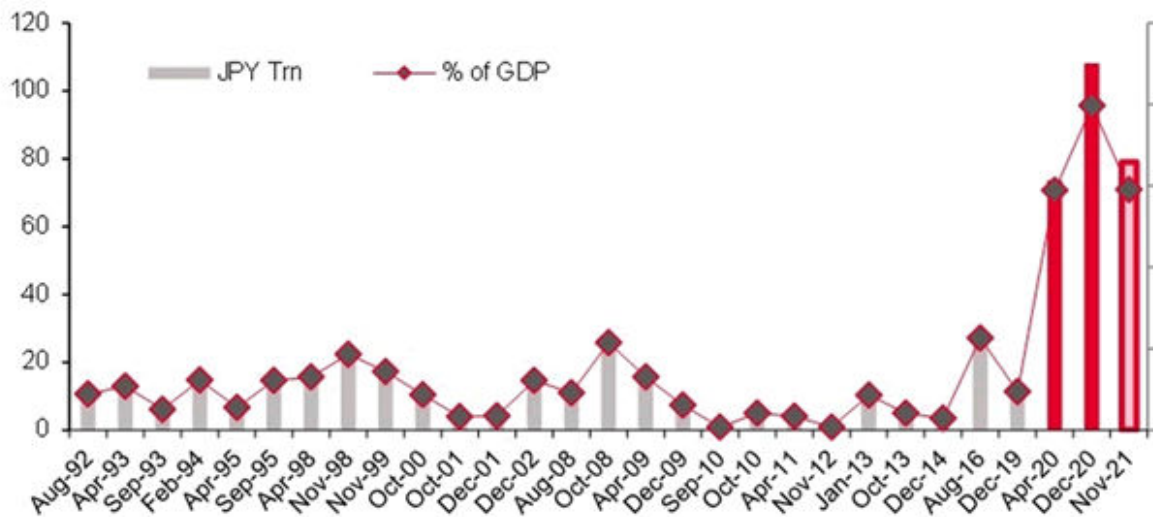
Investment bank Morgan Stanley has been running some excellent research into the new work from home transition. Their latest report - the 16th since the pandemic started - makes for fascinating reading. Here's the highlights:

- *Except in Germany, where Covid cases are increasing, average time in the office continues to increase, with office workers in the office 3.6 days a week, and half of office workers back 5 days a week.*
- *44% of those working from home at least some of the time say they are doing so because a hybrid working policy was introduced since Covid started.*
- *A further 16% saying they already had a flexible policy.*
- *And hot desking? On average, 26% of office workers said their employers had introduced hotdesking pre-Covid, with the UK at c.40%.*
- *Most (57%) office workers without a hot-desking policy pre-pandemic would not mind.*
- *There are more responses actively against (43%) than in actively in favour (27%) of hot desking.*
- *Broadly though, hybrid workers that want to spend more days at home seem more willing to share desks at work in return.*

We have another new prime minister in Japan and usually this results in big spending initiatives. According to Soc Gens Frank Benzmira, fiscal stimulus, infrastructure plans, and supplementary budgets have been a fixture of the Japan economy and policymakers (from Miyazawa during the property bust (1992) to Kishida [the new PM] facing another negative quarter of growth today) have all resorted to the fiscal tool to boost growth.

Since the Abe Administration stocks have tended to rise (the median return is shown) 1, 3, and 6 months after the announcement. Curiously the 21 plans before the second Abe Administration, had limited impact post-launch. This was largely because they didn't spend enough! This time could be different though. The recently announced plans have "the potential to lift markets in the next couple of quarters: it is large, nearly JPY 80tr in total, and it happens at time of US equities in a bull market despite upward pressure on 10y UST. The resumption of the Go To campaign, effective during the Suga Administration to boost domestic consumption, supports domestic tourism stocks."

From Miyazawa to Kishida: a short history of fiscal stimulus



Source: Media reports, SG Cross Asset Research/Equity Strategy

Measure	Values as of 12th November, 2021	Values as of 6th December, 2021
UK Government 10 year bond rate	0.90%	0.75%
GDP Growth rate YoY	1.30%	6.60%
CPI Core rate	3.10%	4.20%
RPI Inflation rate	4.90%	6.00%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.11%	0.09%
Government debt to GDP ratio	94.9%	94.9%
Manufacturing PMI	57.8%	58.1%

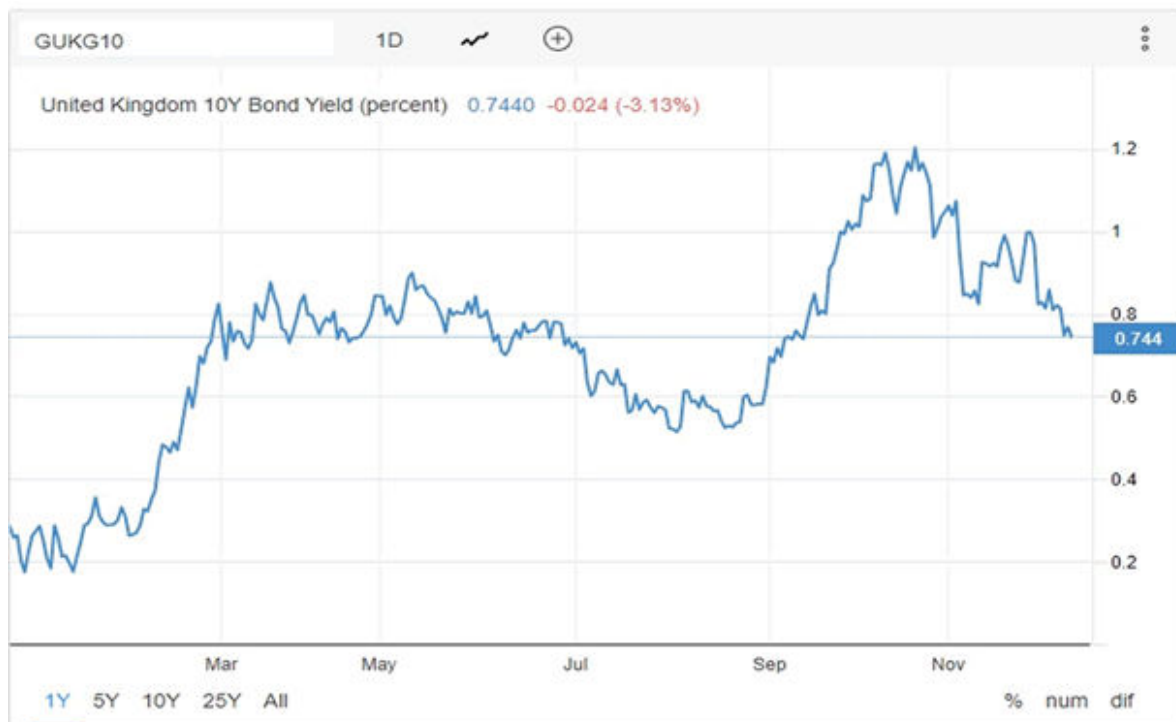
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Government Bonds

Perhaps unsurprisingly bonds as an asset class shone as equity investors retreated in December. European fixed income indices rose across the board, pulled up by strong performances in sovereign bonds as investors sought safe harbour. Inflation-linked bonds in the U.K. performed particularly well. Looking at the S&P UK inflation Linked gilt index, over 12 months this is now up

an impressive 13.04% while over the quarter to date (the 4th quarter) its up 11.63%.

UK Government Bonds 10-year Rate 0.75%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	21.4
Germany	8.8
Japan	18.1
United Kingdom	10.1
Ireland	15
Italy	88.9
Portugal	2.4
Spain	34.8

Eurozone peripheral bond yields

Country	November 2021	December 2021	Spread over 10 year
Spain 10 year	0.48%	0.33%	71
Italy 10 year	0.96%	0.87%	125
Greece 10 year	1.23%	1.26%	164

	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA

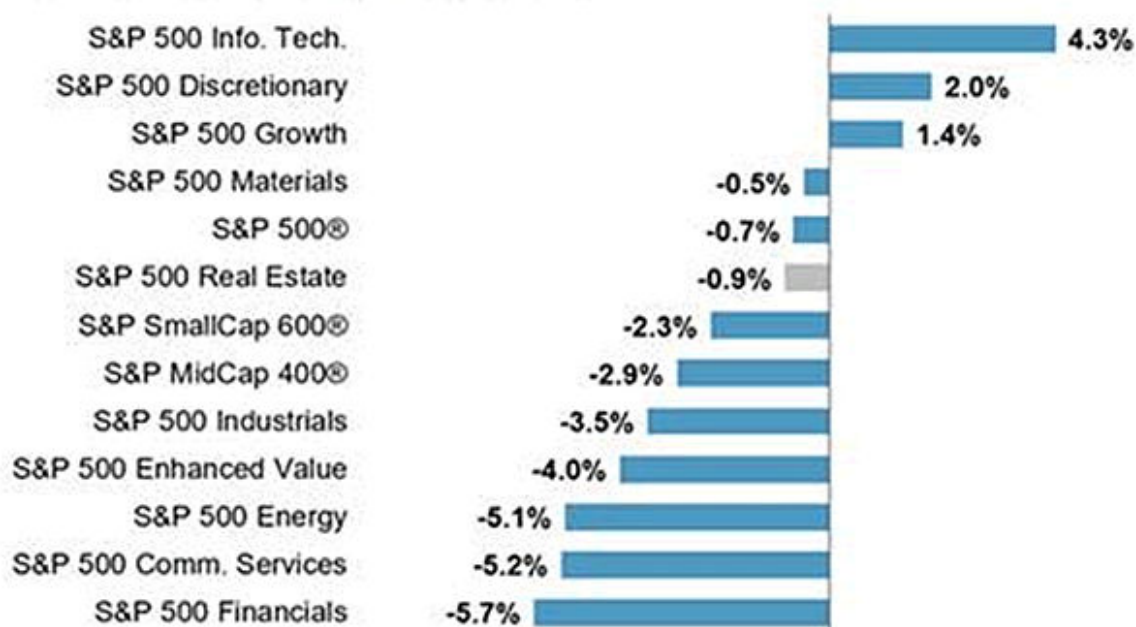
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

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Equity Markets and Dividend Futures

Overall November was a disappointing month for equity investors with U.S. equities large, mid and small broadly declining with only a handful of sectors and countries bucking the trend. In terms of styles or factors of investing only growth stocks outperformed (again). In the US, according to S&P Dow Jones, the S&P 500® posted a loss of 1%, outperforming mid (down 3%) and small caps (2%). Among sectors, IT led, followed by Consumer Discretionary, while Financials lagged. In Europe, nearly every country and nearly every sector contributed to the declines; Switzerland and Communication Services, respectively, were the exceptions.

November Leaders & Laggards: U.S. Indices



Source: S&P Dow Jones Indices. Data as of Nov. 30, 2021. Total return indices in U.S. dollars. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.

Index	November 2021	December 2021	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	100.5	100.5	4137	97.9
FTSE 100 Dividend Dec 2021	242.7	243.8	7239	235

Note changed to Dec 2021 contracts in January 2021

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.928	0.682	2.36	10.5	6.73	16	7236.19

S&P 500	-2.54	0.944	8.24	23.8	107	119	4578.26
iShares FTSE UK All Stocks Gilt	1.48	1.19	4.43	-0.639	11.4	17.5	1437.75
VIX New Methodology	86.1	86.8	86.8	47.5	160	107	30.67

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Volatility

I couldn't resist starting with that global champion of volatility - crypto currencies. The beginning of the month (the weekend of Dec 4/5th to be precise) saw an almighty spike in volatility. According to [GlobalBlock](#) the crypto markets took a nosedive in the early hours of Saturday the 4th of December. The cause? Apparently there was a wave of selling from crypto 'whales' "who have been moving Bitcoin from the wallets and depositing to exchanges at a staggering rate (as shown below)." GlobalBlock also reports that the crash was also down to a cascade in liquidations, as over \$2 billion of leveraged positions was wiped out on Saturday.



Back in the sedate (by comparison) world of equity volatility (!) the Vix finally stirred into action ending the month at 29. How does that compare with previous waves of turbulence? Since inception the average for the Vix is just a shade under 19 (18.90 to be exact), with the lowest quartile upto 13.19 and the third quartile at 21.56. One standard deviation represents 9 index points. So we've finally got a first / top quartile volatility reading consistent with one standard deviation above the average - which is probably what we should expect for a market that is looking a tad over bought and nervous about Covid variants.

The Vix during 2021



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

Measure	December Level	November Level	October Level	September Level
Vstox Volatility	30.06	16.59	21.98	18.13
VFTSE Volatility	30.67	17.66	19.54	16.41

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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.

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