



Monthly Market Report

January 2023



With commentary from David Stevenson

At the moment there from what I can see there is really only one debate worth having - how high will inflation go and whether that rate will stay high for many months and years. If your answer is that inflation has perhaps got further to go and might stay high for many years, then your view of asset allocation would be fundamentally cautious, avoiding most equities and bonds. If by contrast you thought inflation might start to cool and then fall sharply - presumably followed by interest rates, then your view might be very different. In this latter scenario you might be much more bullish equities, and bonds.

Obviously, there are nuances within these two views. Some of the inflation hawks might be worried about escalating inflation bleeding through into wage spirals in which case you'd presumably be more bullish gold while amongst the inflation doves there might be a school of thought that says, sure, inflation will fall back but not by very much. This line of thinking might suggest that we are stuck with a new normal of say 4 to 6% inflation with interest rates likely, though not definitely, staying above 3% for an extended period of time.

If I were a betting man I'd bet against much higher, or even hyper, inflation and probably favour the near term 4 to 6% inflation regime, but frankly I have about as much idea about what might happen next to inflation as my aged mother, who hasn't thought about macro-economics since ABBA topped the charts.

Which is why I found the table below from Charles Schwab very useful. It shows the relationship between inflation and equity valuations, specifically the forward PE ratio for the all important US market. If we're in the 4 to 6% band, then the average long term forward PE is around 15. We're currently just under 20 times forward earnings. If this scenario does play out, we'd be looking at another 20 to 25% decline in the S&P 500. The more likely scenario, at least by historical averages is we might end up in a 2 to 4% inflation range, in which case that average PE moves back to around 17. Again, to repeat we're currently at 20.

Chart: Charles Schwab on the relationship between inflation and valuations

Inflation vs. valuation				
CPI (y/y % change)	S&P 500 forward P/E			% of time
	Average	Lowest	Highest	
-2 to 0%	16.4	13.5	17.8	1%
0 to 2%	17.8	11.9	27.2	27%
2 to 4%	16.9	10.0	26.4	39%
4 to 6%	15.1	9.0	24.4	16%
6 to 8%	11.8	7.2	22.7	7%
8 to 10%	11.4	6.6	20.1	3%
10 to 12%	8.8	6.7	11.0	3%
Above 12%	8.0	6.8	9.4	2%

Source: Charles Schwab, Bloomberg, Standard & Poor's. 1958-10/31/2022. Numbers may not add up to 100% due to rounding.

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Headline Numbers

US corporate earnings

To repeat, most equity markets tend to follow the lead - and the momentum (or otherwise) - of the US markets. And the US stockmarkets are largely motivated to follow the flow of US corporate earnings.

Aggregate S&P 500 earnings in Q3 weren't actually that depressing. The S&P 500 earned \$44.79 per share last quarter, down 9.7% from \$49.59 in 3Q21. Yet that number was 4.8% higher than in 2Q22 and 31.8% higher than in 3Q19. Economists and strategists seem to be worrying about a slowdown in the US but most consumers still seem to be spending and employment levels are still fairly high.

If we dig deeper into the US corporate earnings numbers courtesy of Factset we do find some interesting narratives. So, while overall in the last quarter US corporates did report increased earnings, in fact the Energy sector was the largest contributor to earnings growth for the S&P 500 for the third quarter. If energy stocks were excluded, the index would be reporting a decline in earnings of 5.3% rather than growth in earnings of 2.2%. The Energy sector reported the highest (year-over-year) earnings growth of all eleven sectors at 137.3.

And what about the next few quarters? Bottom up estimates by analysts suggest that US corporate

earnings are now expected to report a year-over-year decline in earnings for Q4 2022 (-2.1%) for the first time since Q3 2020 (-5.7%). For Q4 2022, only 55 S&P 500 companies have issued negative EPS guidance and 27 S&P 500 companies have issued positive EPS guidance.

And valuations? The S&P 500's current multiple is 21.4x trailing 12-month earnings, equivalent to a 4.2% earnings yield, compared to a 3.7% 10-year treasury yield and mid-7 % annualized inflation rate. If equities were to follow inflation rates, then we'd have a 7% earnings yield which would imply a P/E multiple of 14.3x, which would be a 33% decline from current levels.

The dollar

Just in case you haven't noticed, over the last year the US dollar has been king of the castle. The chart below from the US Federal Reserve shows that using a broad basket of crucial currency rates on a real basis - the Real Broad Dollar Index - the US dollar is near multi decade highs, even after allowing for recent weakening (especially against the pound). The drivers of this strength aren't difficult to figure out: if nothing else, the dollar is a safe haven currency which benefits from increases in market volatility and concerns about economic growth.

But there must be a decent chance that the sharp increases in US interest rates might begin to level off in 2023 and that US policy makers might begin to worry more about financial stability which in turn demands balance sheet capacity and likely puts a floor under further significant QT (quantitative tightening). If that is the case then the stage may be set for continued weakening in the value of dollar, which might also benefit gold prices if investors think that the Fed will tolerate higher inflation rates.



<https://fred.stlouisfed.org/series/RTWEXBGS#>

Measure	Values as of 14th November, 2022	Values as of 9th December, 2022
UK Government 10 year bond rate	3.36%	3.10%
GDP Growth rate YoY	2.40%	2.40%
CPI Core rate	6.50%	6.50%
RPI Inflation rate	12.60%	14.20%
Interest rate	3.00%	3.00%
Interbank rate 3 month	3.47%	3.73%
Government debt to GDP ratio	95.90%	97.40%
Manufacturing PMI	46.2	46.5

Bank CDS options

Rates for credit default swaps to insure against bank bond default fell across the board last month - with one exception. Rates for Credit Suisse jumped yet again, to what must be crisis levels. To insure against a credit default over the next 12 months will now cost 514 basis points or 5.14%. That's more than double the rate in November. Aside from Credit Suisse rates for most other banks fell substantially last month, with BNP Paribas, Citi, HSBC and Lloyds leading the way. In terms of pricing for 1 year swaps, Natixis still leads this sub set of big banks with a rate of 19.5 basis points for insuring against a credit default over the next 12 months.

One side note in reference to credit default swaps, this time on sovereign debt. A few months ago during Liz Truss's short lived ministry, rates shot up but have now crashed back down to earth. The cost of insuring against a credit default on UK sovereign debt in the next five years has now hit a low of just 6.82 basis points. That is the lowest rate for any major sovereign issuer. What a difference just a few months make.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	27.33	60.8	A+	A2	A -
Barclays	65.93	96.07	BBB	Baa2	A
BNP Parabis	25.04	52.62	A+	Aa3	A+
Citigroup	46.92	90	BBB+	A3	A
Credit Suisse	514	402	BBB-	Baa2	BBB
Deutsche Bank	90.25	156	A-	A2	BBB
Goldman Sachs	46.37	96.03	BBB+	A2	A
HSBC	26.07	54.41	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	40.23	72	A-	A2	AA-
Lloyds Banking Group	27.46	51	BBB+	A2	A
Morgan Stanley	47.12	91.07	BBB+	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	32.73	98.04	BBB+	Baa1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	26.22	58.91	A	A1	A-
UBS	39.84	74.33	A-	Aa3	A+

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

Government Bonds

Fixed Income

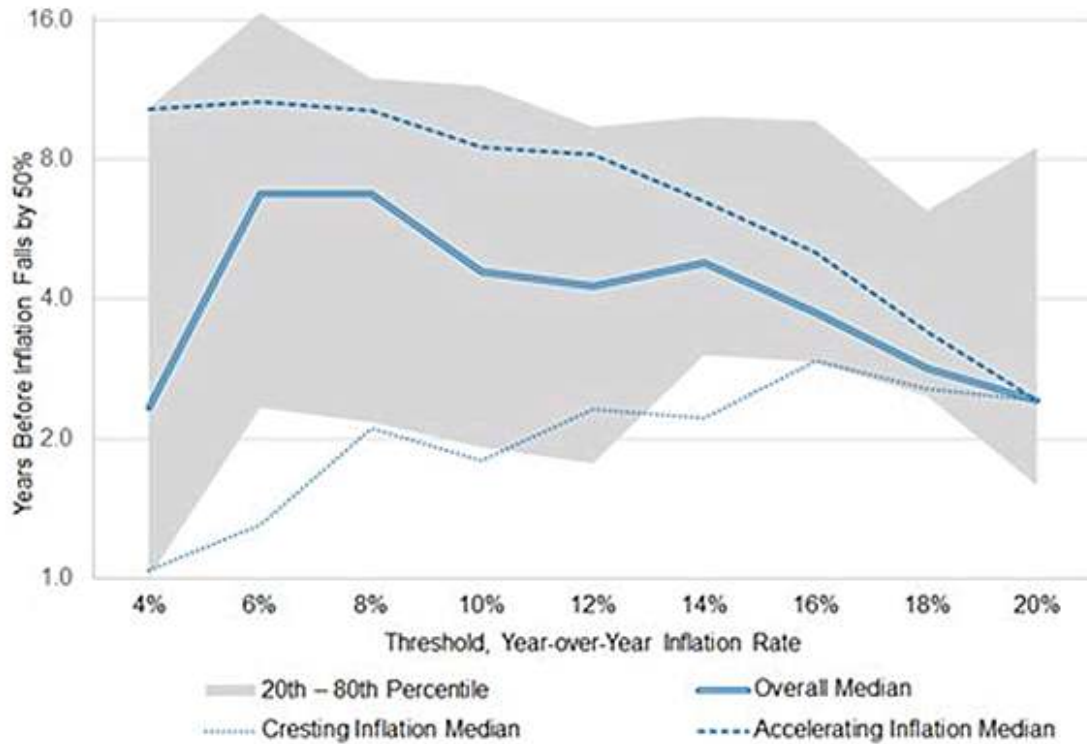
Going back to my initial comments, it seems to me that if you are a bond investor, all your decisions about how much to allocate to the fixed income asset class revolve around what you think might happen next to inflation rates and thus inflation rates. If you think they've peaked, then you might start turning bullish whereas if you think we've not hit peak levels or that inflation might not subside very much, then you'd be much more cautious.

For me the big question for bond investors is how long will it take for the current levels to fall back? Research Affiliates Rob Arnott has been crunching the numbers and his numbers don't look very comforting for those of us who think we'll be in a much better position inflation-wise by the end of 2023. His conclusions? First, he reckons that an inflation jump to 4% is often temporary, but when inflation crosses 8%, it proceeds to higher levels over 70% of the time. Next up, if inflation is cresting, inflation levels of 4 or 6% revert by half in about a year. By contrast if inflation is accelerating, 6% inflation reverts to 3% in a median of about seven years, threatening an extended period of high inflation. Reverting to 3% inflation, is easy from 4%, hard from 6%, and very hard from 8% or more. Above 8%, reverting to 3% usually takes 6 to 20 years, with a median of over 10 years.

Scenario 1

If inflation is cresting, 4% and 6% inflation revert by half (to 2% and 3%) in about a year.
 If inflation is accelerating, 6% inflation reverts to 3% in a median of about seven years, threatening an extended period of high inflation.

Number of Years for Inflation to Fall by 50%, since January 1970



Note: For 7 of the 52 cases when inflation rose above 4%, inflation did not revert to 2% before sweeping past 4%. Therefore, this graph is based on 45, not 52, cases. The gray band represents the middle three quintiles (excluding the top and bottom 20% of outcomes), which measure the passage of time until inflation is cut in half. Because of a limited number of cases, when we bifurcate between accelerating and cresting inflation, we smooth these two lines by consolidating the data for 4%, 6%, and 8% inflation for the 6% plot point, and do the same for all but the endpoints (4% and 20% inflation) of the graph.
 Source: ResearchAffiliates, LLC, based on data from Bloomberg.

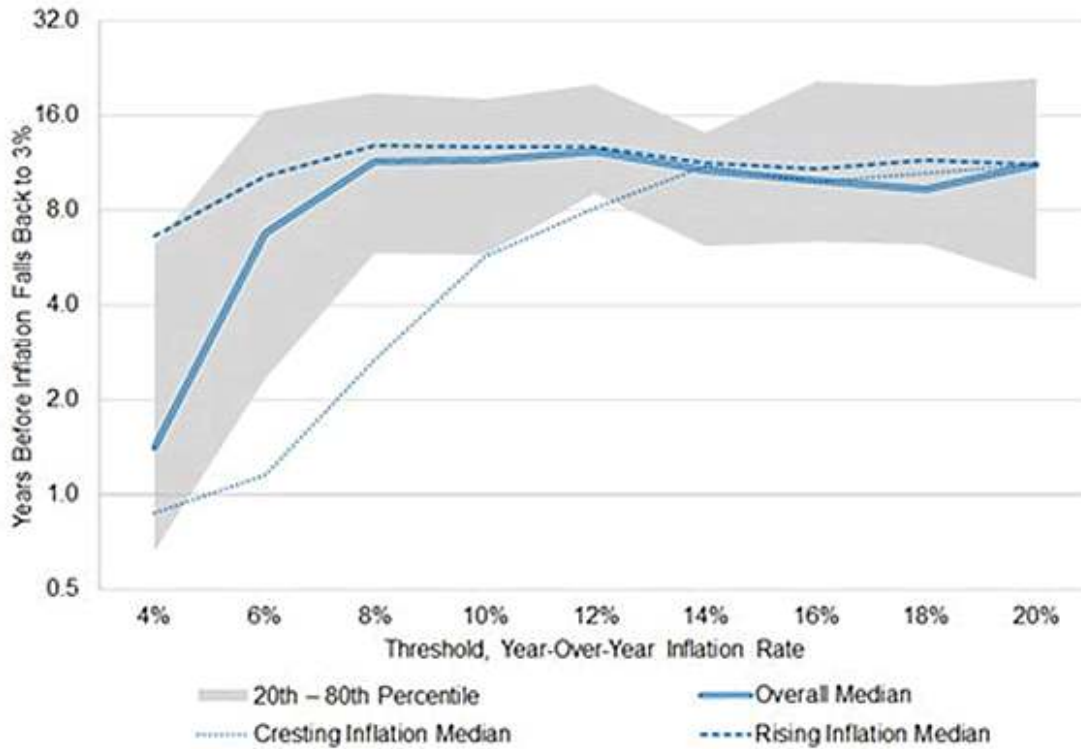
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Scenario 2

Reverting to 3% inflation, which we view as the upper bound for benign sustained inflation, is easy from 4%, hard from 6%, and very hard from 8% or more. Above 8%, reverting to 3% usually takes 6 to 20 years, with a median of over 10 years.

Number of Years Until Inflation Reverts Below 3%, since January 1970



Source: ResearchAffiliates, LLC, based on data from Bloomberg.

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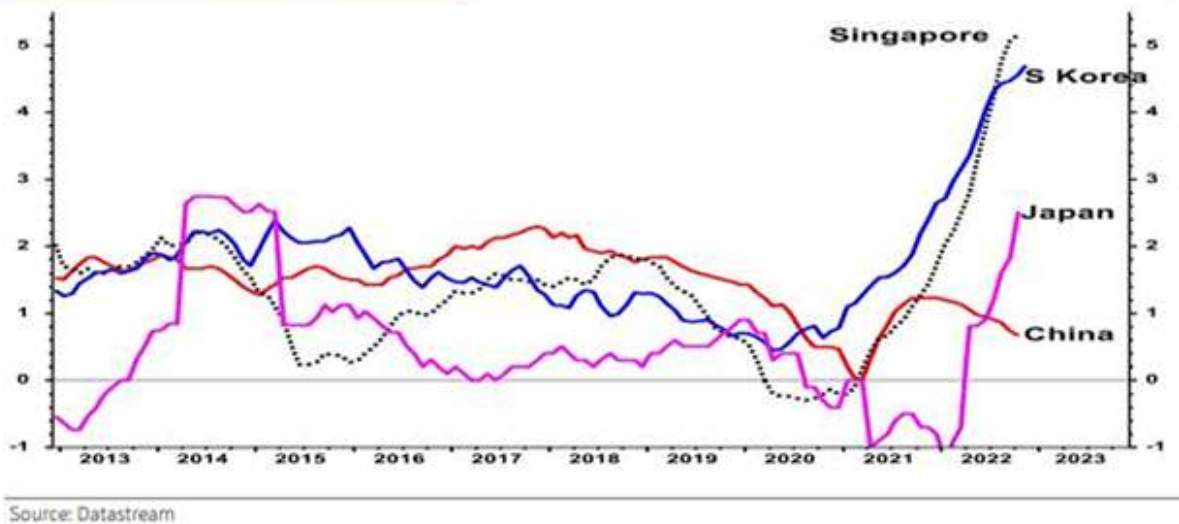
If Arnott is right, then it's reasonable to think that interest rates will remain higher for longer. On cue, many investment banks have been revising their estimates for peak US interest rates. Goldman Sachs now sees rate hikes in February, March, and May, and **no rate cuts in 2023**.

Exhibit 11: We Expect 125bp of Additional Funds Rate Hikes and No Cuts in 2023



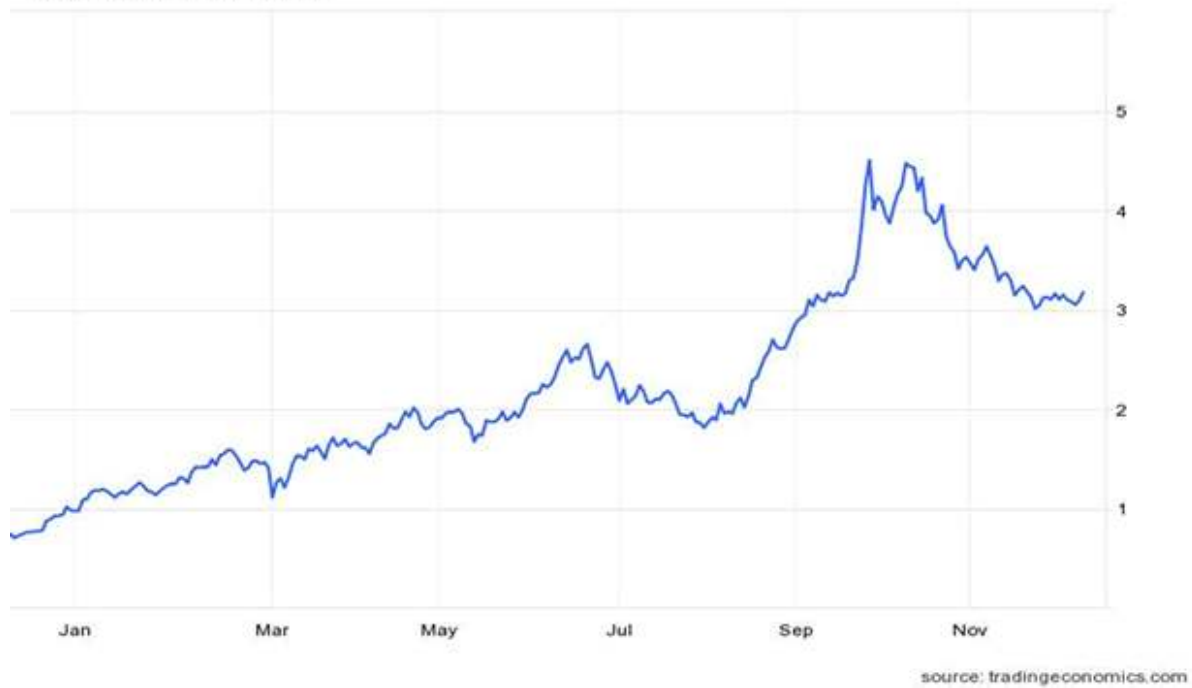
But if you're looking for an outlier view, listen to Albert Edwards over at SocGen. He reports that while “the rest of the world is grappling with core CPI inflation close to 5%, China's core CPI inflation has fallen sharply to a bare 0.6%. Even Japan has seen core (core) inflation rise to 2.5%. Like with its zero-COVID policy, China appears to be living in a parallel reality, but the implications could be that the monetary sluice gates are creaking open again. And as we have found out increasingly in recent years, “what happens in China does not stay in China”.

Core CPI inflation (% yoy) in key Asian economies - Can you spot the MASSIVE outlier?



UK Government Bonds 10-year Rate 3.10%

United Kingdom 10Y Bond Yield



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

CDS Rates for Sovereign Debt

Country	Five Year
France	27.49
Germany	7.58
Japan	17.12
United Kingdom	6.82
Ireland	14.85
Italy	124.66
Portugal	39.61
Spain	52.82

Eurozone peripheral bond yields

Country	November 2022	December 2022	Spread over 10 year
Spain 10 year	3.19%	2.93%	101
Italy 10 year	4.19%	3.81%	189
Greece 10 year	4.33%	3.98%	206

	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

Could US equities underperform?

Just as some experts think that 2023 might be a year for the dollar to weaken, many equity market observers think that 2023 might see US stockmarket underperformance relative to other developed world markets. The first chart below is a useful in that respect. It reminds us that US equities are at unprecedented levels in market cap terms compared to other developed world markets. That ratio could change in one of two ways - US stocks underperform or other developed world markets outperform.

The ratio of the S&P 500 to the rest of the world (MSCI World ex-US) finished October at its most extreme level in history



And that outperformance might be starting to happen. The table below from S&P Dow Jones shows returns in November for a series of developed and emerging markets during the month - the US was up over 5% but a whole host of countries outperformed the US, some very substantially. Note how emerging markets overall were up over 11% while Taiwanese stocks were up over 20%. Interestingly German stocks were up nearly 14% while even French stocks were up 11.4%.

S&P Global Broad Market Index(BMI) C 30/11/2022			
US MKT	BMI MEMBER	1-MONTH	YTD
\$2,376	China	27.30%	-26.45%
\$74	Turkey	24.47%	85.92%
\$463	Hong Kong	23.73%	-16.72%
\$1,140	Taiwan	20.31%	-27.05%
\$13	Hungary	18.20%	-33.77%
\$55	Poland	17.67%	-31.69%
\$288	South Africa	17.51%	-3.60%
\$702	Netherlands	17.34%	-26.15%
\$8	Egypt	16.42%	-27.63%
\$55	Austria	15.22%	-25.40%
\$1,039	Korea	15.22%	-27.27%
\$1,320	Germany	13.95%	-25.40%
\$7,312	Emerging	13.05%	-19.50%
\$452	Italy	12.86%	-19.42%
\$65	Philippines	12.53%	-14.78%
\$453	Denmark	11.84%	-13.55%
\$20	Peru	11.68%	11.53%
\$1,761	France	11.42%	-15.85%
\$ BILLION	Global Ex-U.S.	11.12%	-18.48%

Index	November 2022	December 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	123.4	123.4	3936	120.6
FTSE 100 Dividend Dec 2022	272	272.50	7477	270.7

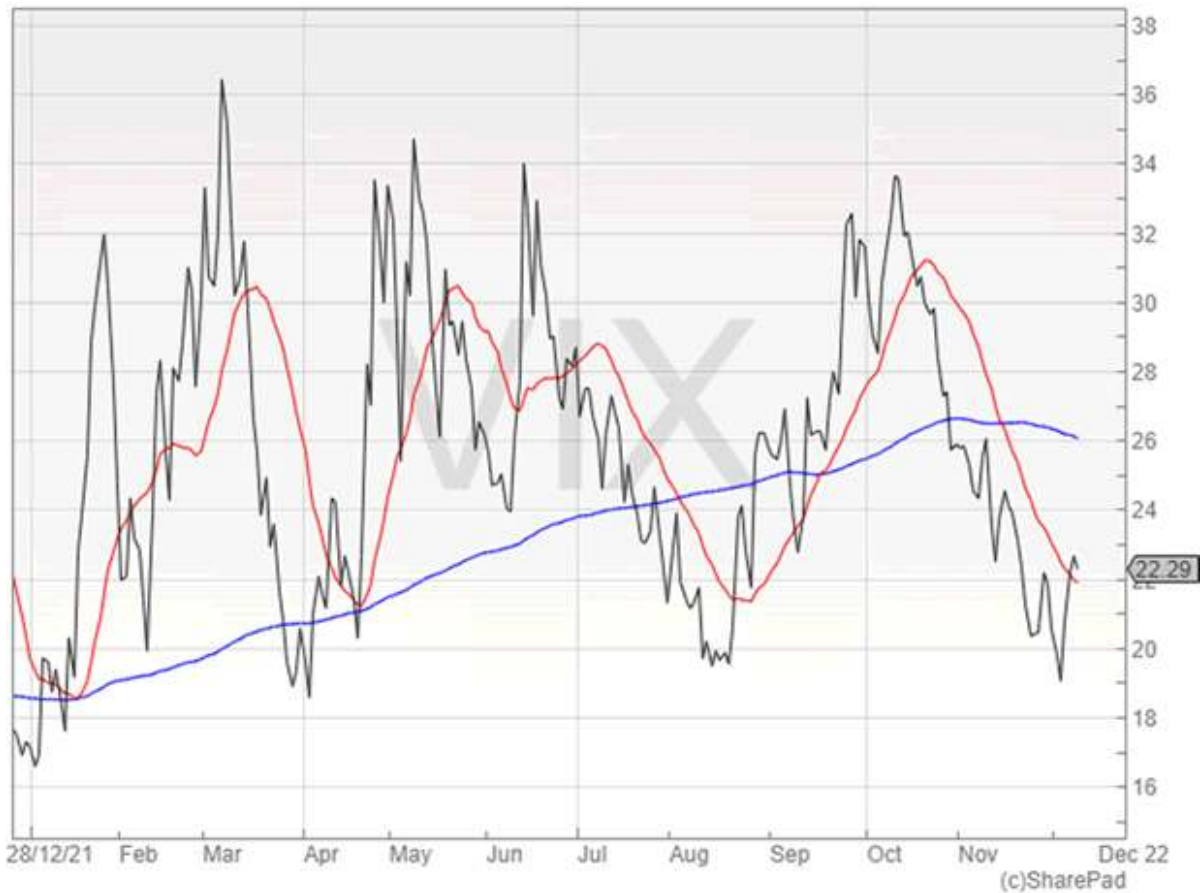
Note changed to Dec 2022 contracts in January 2022

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	2.42	1.66	-0.0439	2.07	1.07	7.46	7472.93
S&P 500	5.76	-2.53	-1.33	-15.1	49.5	75.5	3964.35
Gold Composite (Most Traded)	5.12	4.22	-2.77	1.4	44.1	55.1	180150c
iShares FTSE UK All Stocks Gilt	0.464	-0.0801	-9.48	-24.6	-17.1	-15.8	1083.5p
VIX New Methodology	-14.6	-2.19	-14.6	3.29	133	89.7	22.29

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Volatility

The year 2022 has been an unusually volatile 12 months for stock markets as evidenced in the chart below which shows lots of big troughs and terrifying peaks for the Vix index. The index has spent much of the year trading at above the 25 index points level - the long term average for the volatility index is currently running at 19.25. In the last few weeks though the index has fallen back sharply and is currently trading at just over the long term average.

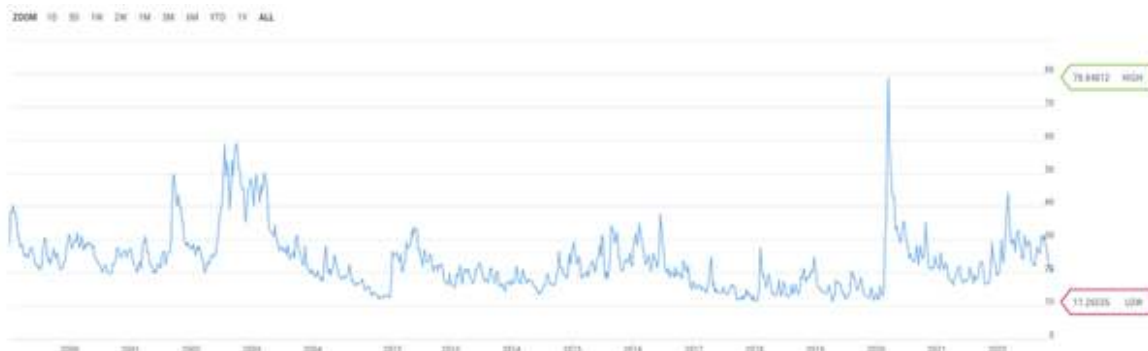


Black Line - Vix

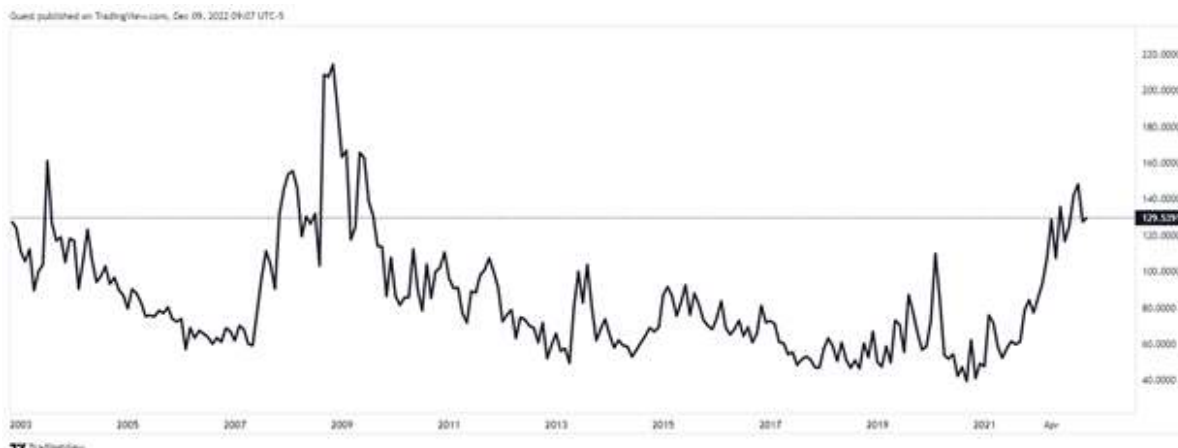
Blue line - 200 day moving average

Red line - 20 day moving average

The next chart below is for the Vstoxx index, which measures the turbulence of the Stoxx 50 index. Its current level is at 21 index points, not far off the Vix level. But this level doesn't seem terrifically high on a medium term basis as the chart below shows - its about at the long term average for this measure of European equity volatility.



By contrast one of the most widely used measures of bond market volatility - the MOVE index - is trading well above its long-term average at 129 index points. For most of its life, this index - which measures measure short dated one month volatility for widely traded US bonds - has been trading at under 100 index points.



Measure	December Level	November Level	October Level	September Level
Vstox Volatility	21.24	20.82	31.82	24.4
VFTSE Volatility	22.48	23.15	33.63	22.79

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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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