



Monthly Market Report

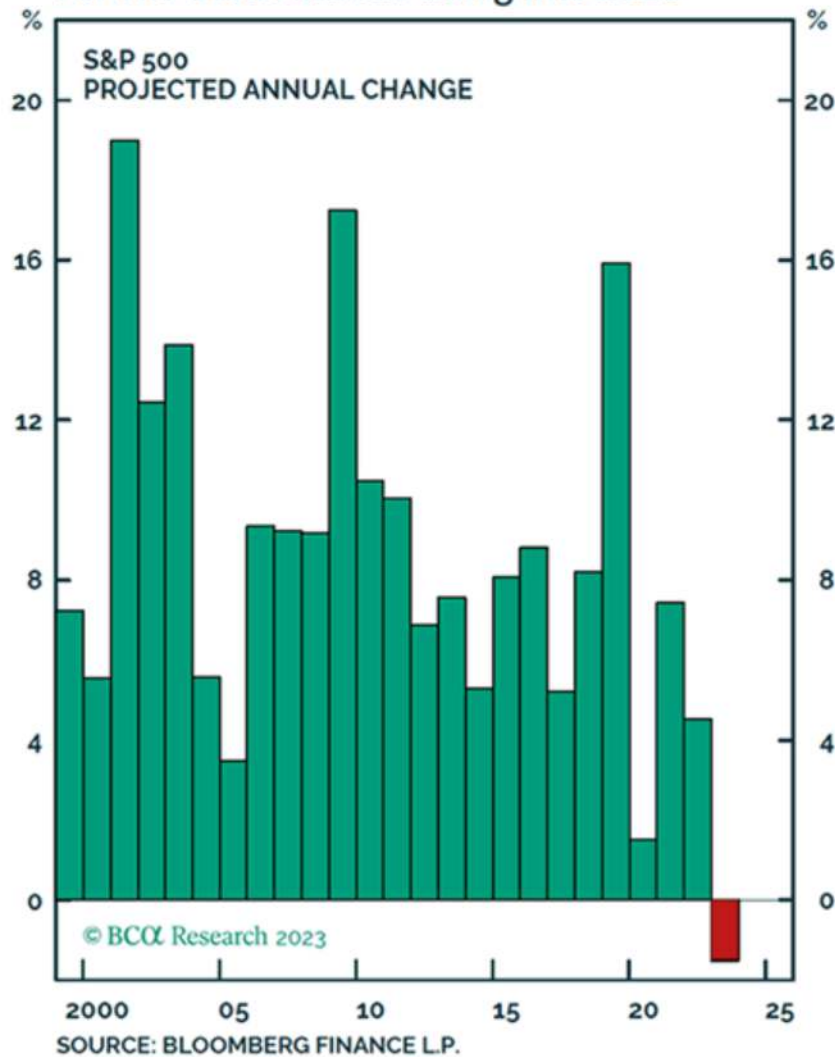
January 2024



With commentary from David Stevenson

It's that time of the year again when those crystal balls are being dusted off and every pointy-head analyst/strategy type starts to predict what might happen in 2024. Naturally, as a journalist, I love December as it involves endless column inches of earnest forecasting and I always add to the jollity - usually in January - with my own predictions. It will come as no surprise to you that in my view these predictions are about as useful as chocolate teapots, with my own predictions very definitely in the useless category. Looking back at my 2023 predictions I was struck by how consensus I was on two key calls: sagging US corporate earnings and surging China. Like many, I thought the US would lunge into recession, taking corporate earnings growth with them, and that China would rebound from zero covid with dragon-like ferocity. As we all know now, the exact opposite happened in both cases. Corporate earnings increased, largely because US consumers carried on spending. That meant the S&P 500 enjoyed another positive year. The chart below is from Peter Berezin of BCA Research using Bloomberg data (via the excellent John Authers) and shows the way in which strategists got it so wrong in 2023. They (we) all expected the S&P 500 to flunk into a funk but instead year to date the S&P 500 as I write is up 20%. Ouch!

Strategists Were Gloomy About The Prospects For The Stock Market Going Into 2023



As for China, as we discuss in the section on bonds, China is now exporting deflation not inflation - as its consumers sit on cash reserves and pass on overpriced urban apartments. Unsurprisingly this had a knock-on impact on commodity prices and all the talk of oil pushing past \$100 and then \$120 a barrel is now for the birds.

But I would make one last point. The US has been saved by its consumers and to a lesser degree its private investors, who might be one and the same. Parsing the macroeconomic data coming out of the US, it is obvious that what has been powering US consumer spending is NOT the poor benighted twentysomething consumer struggling with student debt, surging flat rents and higher energy costs. No, the real driver has been middle-aged and older, wealthier consumers who have banked all those Covid cheques and probably invested a fair stash of money in the US stock markets - or more pertinently Nvidia shares. Savings rates are, as always, highly uneven and as wealthier US consumers have opened their wallets, they have helped boost equity valuations.

Those cash piles might be winding down though and there are signs of more caution. As an example of this I would point readers in the direction of the latest survey of private investors by a venerable institution called the [American Association of Individual Investors Investor](#). They regularly run a weekly survey that tests the appetite of US private investors for equities - it's published every Thursday. The AAI sentiment survey dates back to 1987 and has now been conducted for 1,892 weeks. You can read the [latest edition here](#).

Here is the summary from the AAll of the current attitude of most US private investors: *"Optimism among individual investors about the short-term outlook for stocks fell for the first time in five weeks in the latest AAll Sentiment Survey. Meanwhile, pessimism rebounded from its lowest level in almost six years. Both readings have returned to their respective typical ranges. Bullish sentiment, expectations that stock prices will rise over the next six months, decreased 1.4 percentage points to 47.3%. Optimism is above its historical average of 37.5% for the fifth consecutive week and the sixth time in nine weeks. Bearish sentiment, expectations that stock prices will fall over the next six months, increased 7.9 percentage points to 27.4%."*

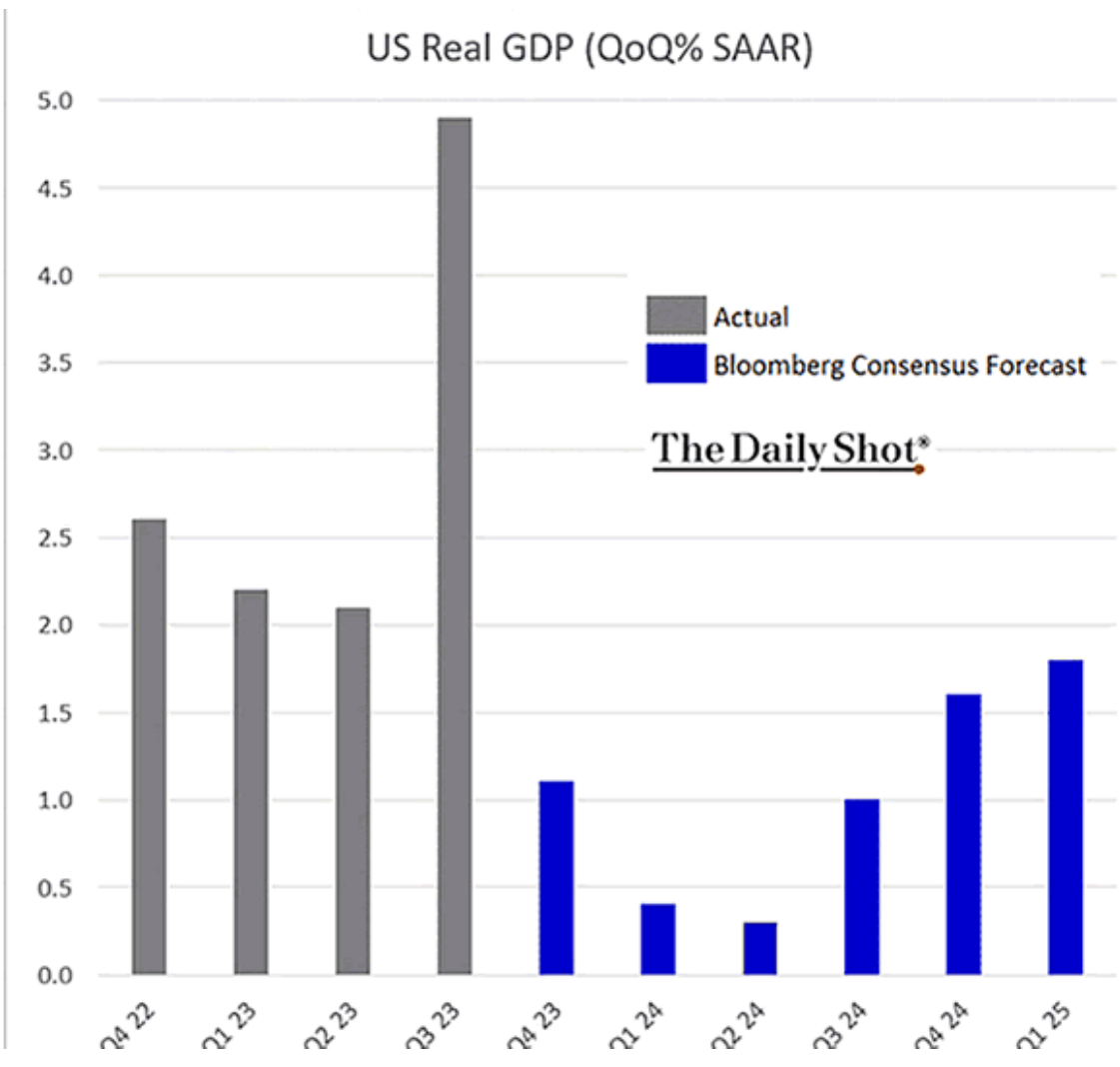
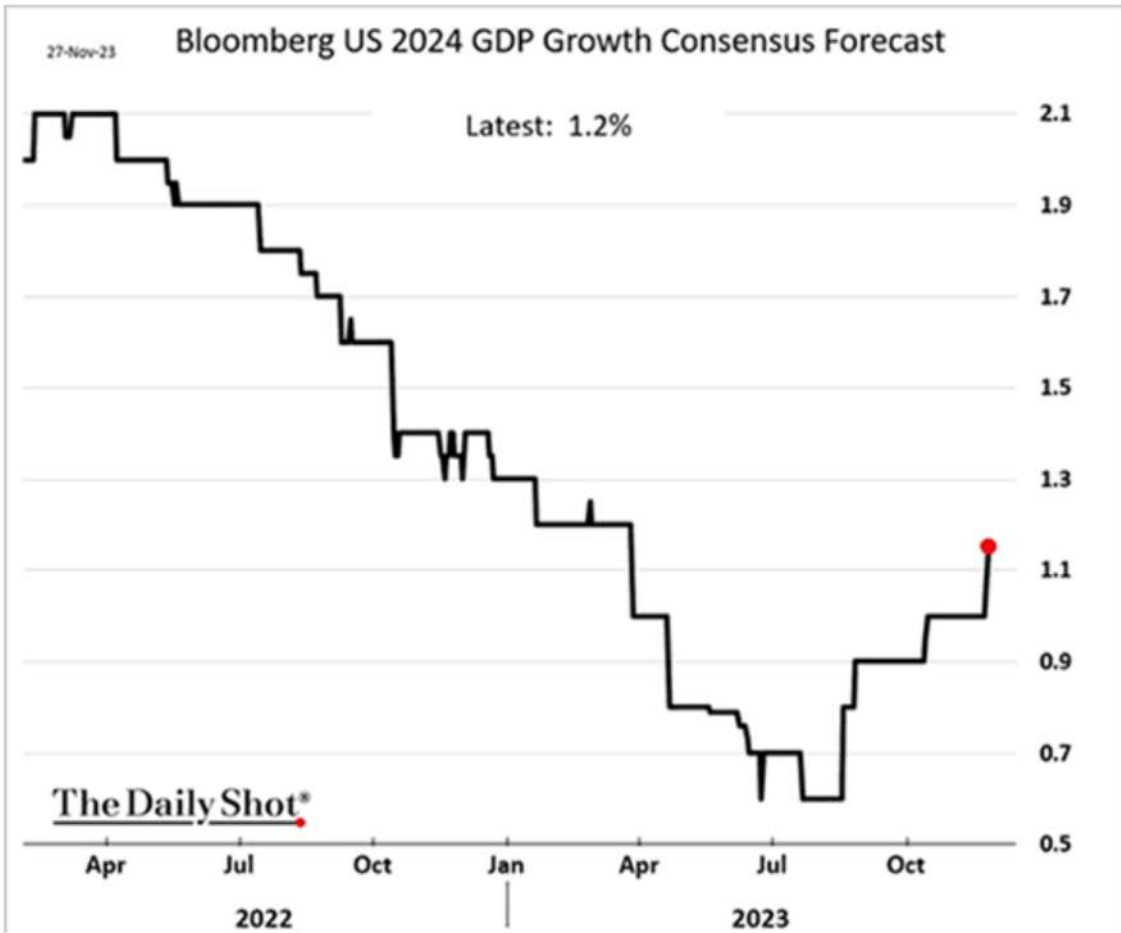
One reading of this could be positive - US investors are still largely a bullish bunch. But I am slightly cautious about that increase in bearish sentiment. The shift in sentiment is not seismic but it indicates that there is nervousness out there and that investors are getting cautious about market volatility. If that is the message, then perhaps 2024 might be the year that US equities don't outperform.

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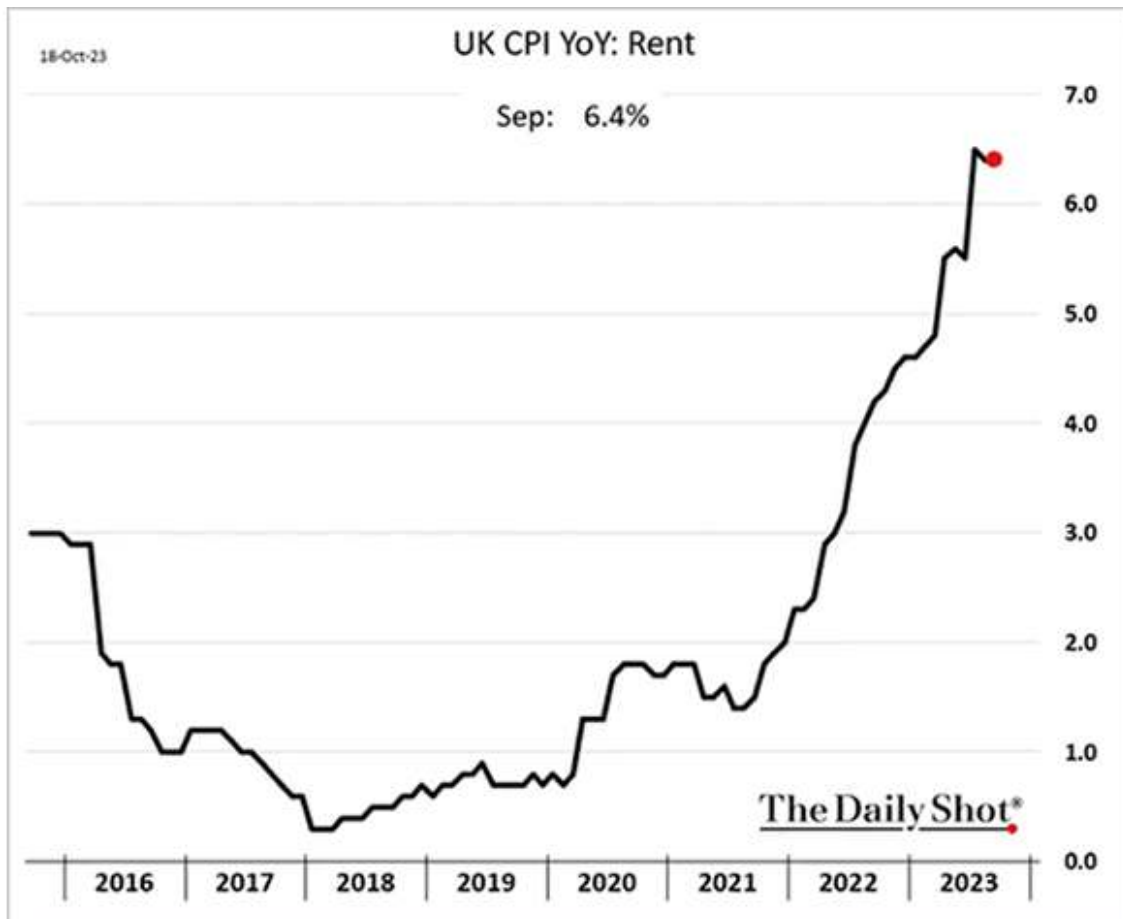
Headline Numbers

The two charts below from The Daily Shot letter sum up why I think investors got SO excited in November - see the equity section later. The first shows that economists upgraded their forecasts for next year's GDP growth in the US. The second shows consensus estimates which indicate that most analysts think the US economy will accelerate its growth rate in the second half of next year, 2024. The slowdown might bottom out in the second quarter of 2024 and then pick up speed.

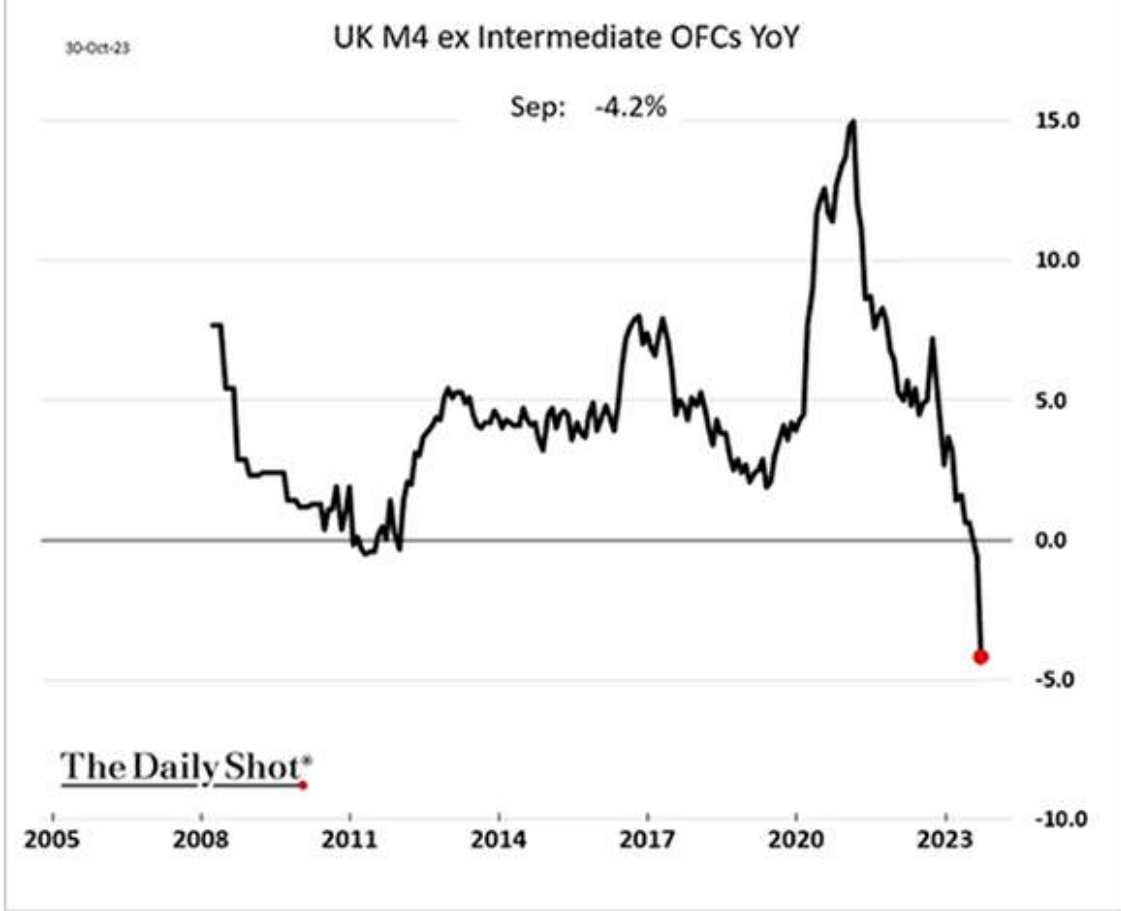
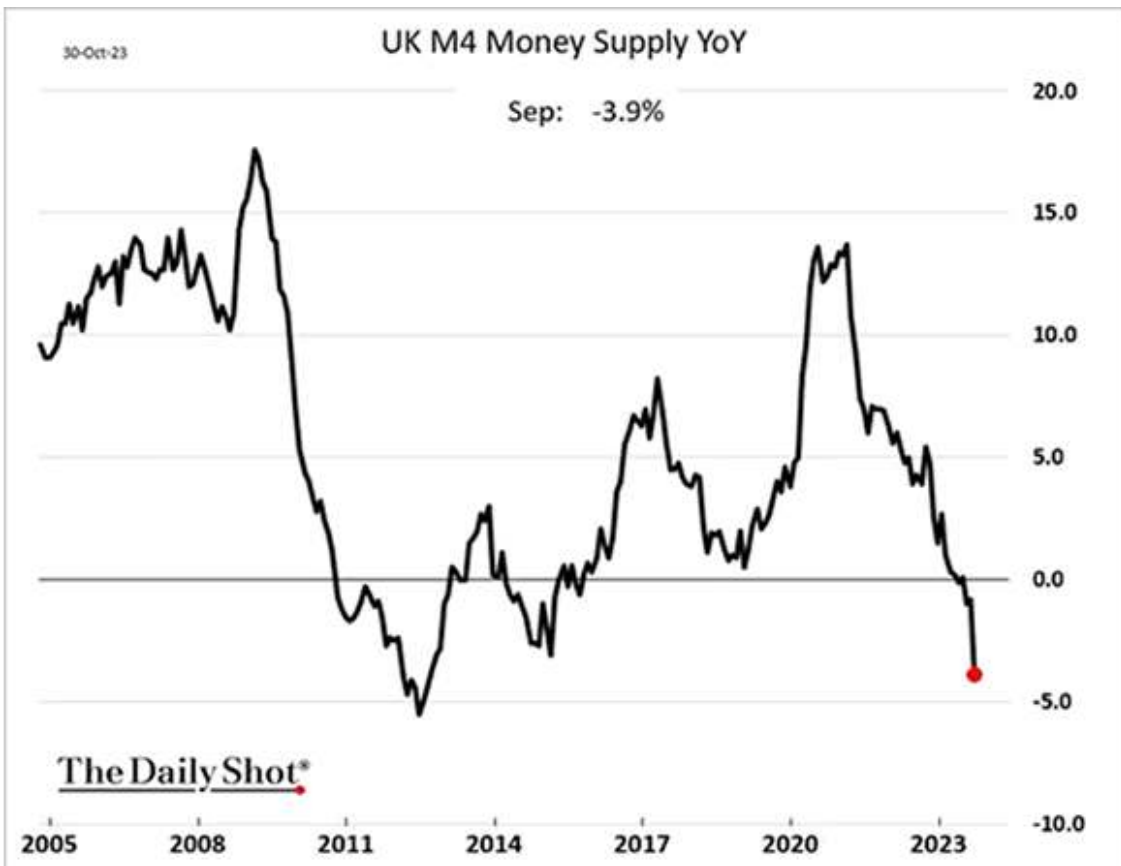


Back in the UK, sentiment is nowhere near as positive. I'm not one of those truly dismal types who thinks that the UK economy has gone to hell in a handcart, but I do think we face some strong headwinds, not least weak productivity growth and below peer group average business investment levels (cue the Mansion House reforms).

Those structural headwinds though seem rather puny compared to the problems which the next two charts highlight. The first shows why many 20 and 30-somethings are rattled, especially if they rent a home. The chart shows rental price inflation which back in September was up at 6.4%. And [according to Zoopla](#) in December their own proprietary UK rent inflation measure topped an astonishing 9.7%.



The second chart - also from a few months ago - tells another very different but equally disturbing story. Monetarists economists such as Roger Bootle have been warning for months now that the Bank of England have underestimated the impact of the tenfold increase in interest rates. Their worry has been that money supply measures, such as the M4 measure, would show a sharp deceleration after the central bank monetary tightening - which might point to an impending recession. The chart above screams M4 contraction although the next month (October) data points did show a small increase. Little surprise then that more and more economists worry that UK growth could flatline, at best, or fall, in 2024. The only bright side to this is that that slowdown might just help mitigate rental inflation which Zoopla reckons will 'moderate' to 'only' 5% in 2024.



Measure	Values as of 14th November 2023	Values as of 12th December 2023
UK Government 10 year bond rate	4.29%	3.97%
GDP Growth rate YoY	0.60%	0.60%
CPI Core rate	6.70%	4.60%
RPI Inflation rate	8.90%	6.10%
Interest rate	5.25%	5.25%
Interbank rate 3 month	5.36%	5.35%
Government debt to GDP ratio	101%	97.10%
Manufacturing PMI	44.8	47.2

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Bank CDS options

Rates for credit default swaps for the major international and national banks fell across the board last month. I'd go so far as to say that the decline was almost entirely uniform with relatively substantial falls in pricing (more than 20 to 25% lower was typical) with only two exceptions. Two North American banks, RBC and Citi, saw pricing for their 5-year swaps increase but one suspects this repricing was probably idiosyncratic. The big takeaway is that bar these two exceptions, traders of credit default swaps are pricing lower risk for major banks as we finish 2023.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	55.52	26.54	A+	A2	A -
Barclays	90	52.2	BBB+	BAA1	A
BNP Parabis	46.63	24.29	A+	Aa3	A+
Citigroup	74.13	35.44	BBB+	A3	A
Deutsche Bank	127	61.68	A-	A1	A-
Goldman Sachs	82.09	42.03	BBB+	A2	A
HSBC	47.41	25.64	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	51.65	27.75	A-	A1	AA-
Lloyds Banking Group	47.89	22.49	BBB+	A3	A
Morgan Stanley	74.13	37.27	A-	A1	A+
Natixis	42.5	18.5	A	A1	A
Nomura	88.26	22.16	BBB+	BAA1	A-
RBC	50.92	28.32	AA-	A1	AA-
Soc Gen	57.3	31.5	A	A1	A-
UBS	56.36	36	A-	Aa3	A

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

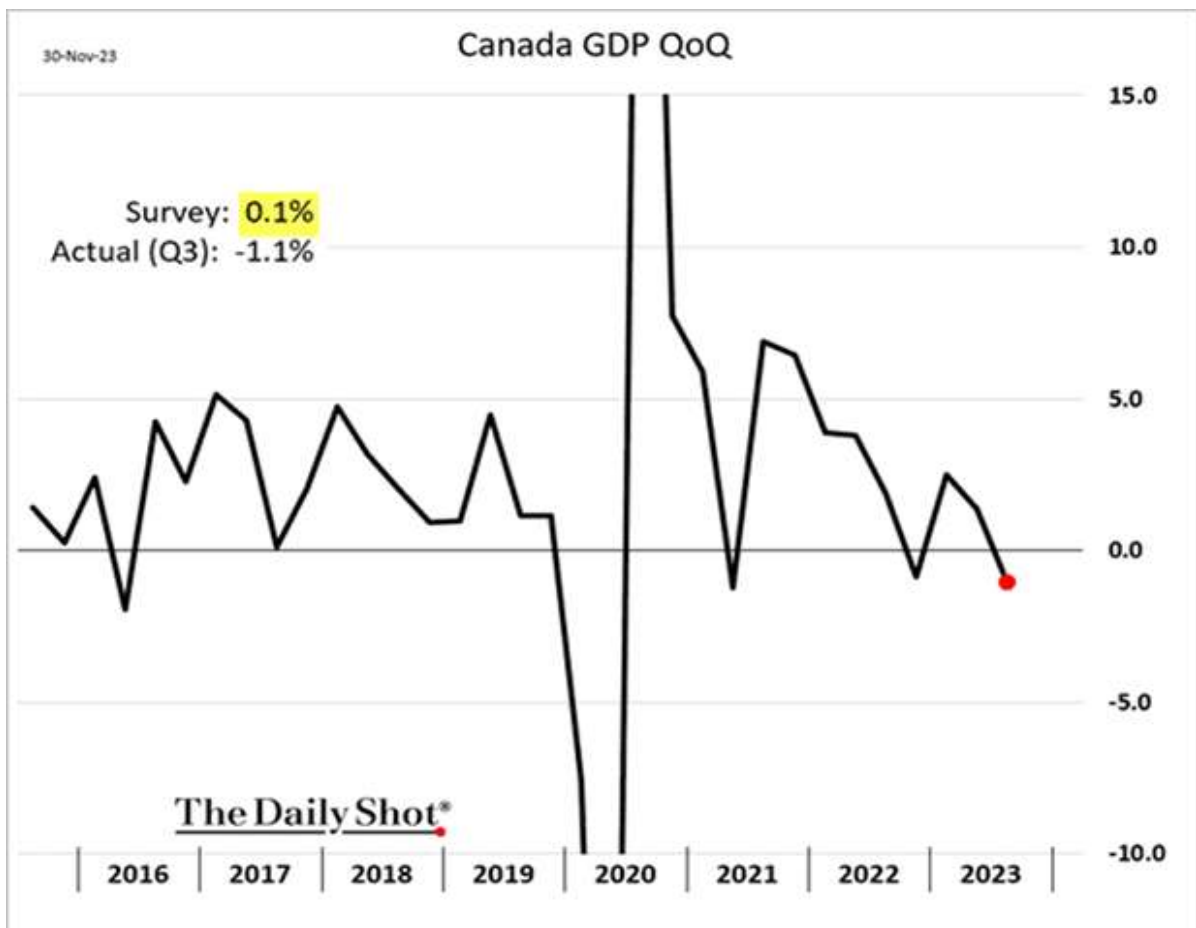
Government Bonds

Fixed Income - deflation?!?

I'll kick off this section with one left field observation. Last month I noted that the pricing of Greek government debt had declined very substantially. One key measure is the spread between German 10-year government bond yields and Greece's. That spread has come down from close to 200 points to its current 120 basis points. There is another interesting point to make though. The yield on Greek ten-year government bonds is now just 3.42% which is a full 50 basis points (0.5%) than that for the UK. To repeat, Greece can now borrow long-term for much cheaper rates than the UK.

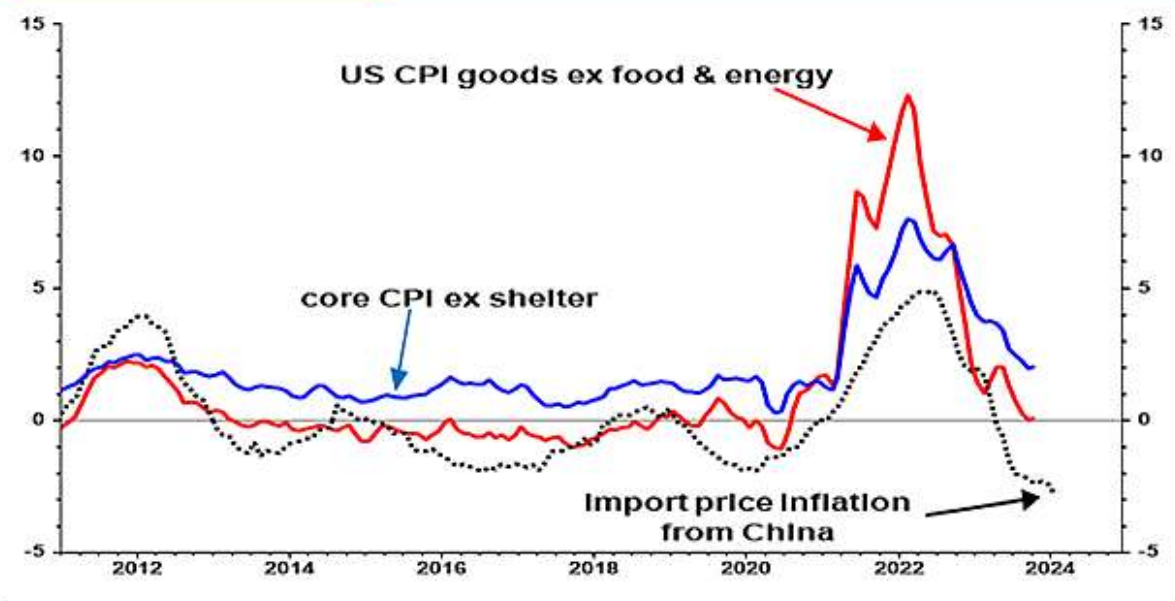
With that aside out of the way, consider this: the idea that we'll go back to a world of very low-interest rates is clearly - in a consensus world inhabited by analysts - for the birds. I'm liable to agree but I'm far from certain. That's because there is one macroeconomic pivot that is rarely discussed - the return of deflation and a nasty recession or even depression which forces interest rates below the consensus 3 to 4% rate in a few years hence. As an investor you might yawn and say that this all for pointy heads with their crystal balls, but I'd counter that if it were to happen then plenty of portfolios would be positioned in entirely the wrong place. Bonds might fly again, and tech stocks might shoot ahead along with other growth stocks. And value stocks would be given a good bashing.

To repeat I don't think that a deflationary pivot is imminent or even likely but it's not impossible. Take the chart below which focuses on Eurozone inflation it has now fallen to its lowest level in two years. This reinforces a key insight - not all the major developed world economies will necessarily move in sync in the next few years. The Bank of England might stay hawkish as it tamps down rampant wage inflation, but the Eurozone might slip closer to deflation. We might also talk a little about another major developed economy, Canada. The chart below suggests that the large North American economy has already slumped into a recession.



Other indicators are also flashing red. In the US for instance mortgage applications are holding at multi-year lows. Perhaps a more pertinent factor is China. According to SocGen's Albert Edwards, prices of Chinese imports into the US are already falling sharply, which might drag down US goods prices (red line) and core CPI with it (blue line).

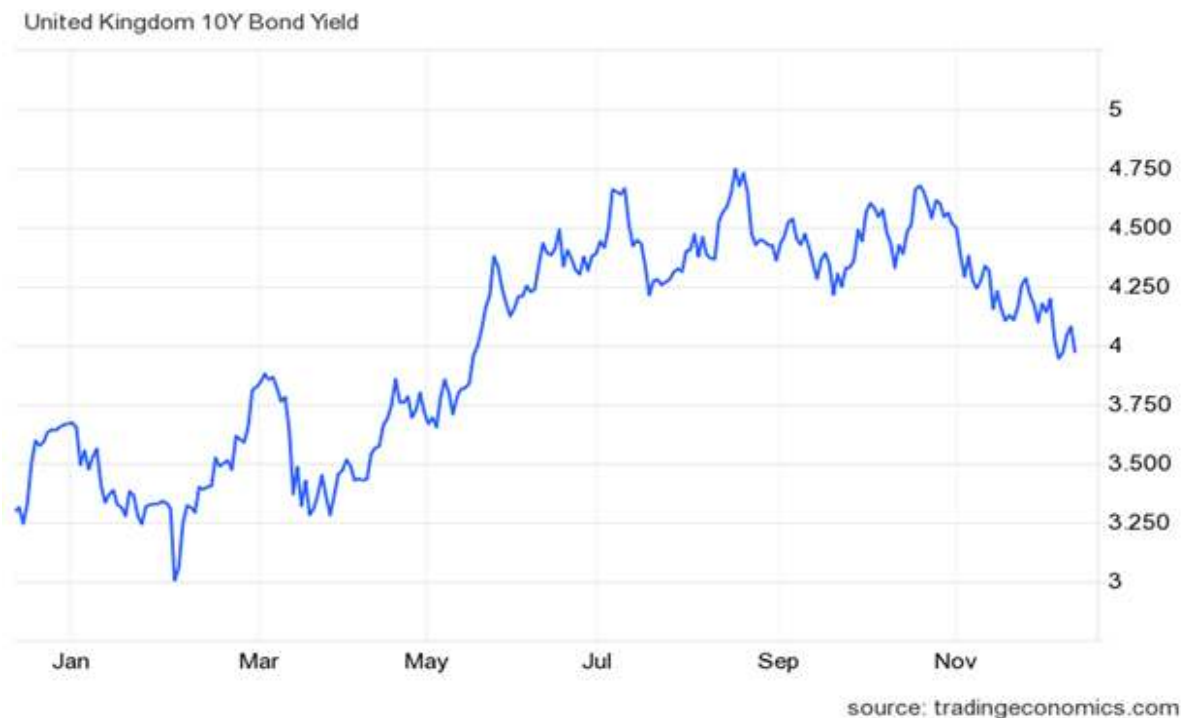
China's deflationary goods impulse will drag US CPI inflation lower



Source: Datastream

What's not to like? According to Edwards, the "fly in the ointment might well be that, if a US hard landing is imminent (reflected in weak money supply) and triggers a collapse in US domestic inflation anyway, importing an extra slug of Chinese deflation would then be extremely unwelcome and throw the Fed into a tizzy".

UK Government Bonds 10-year Rate 3.97%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	25
Germany	16.7
Japan	25.5
United Kingdom	34.99
Ireland	25.5
Italy	85.17
Portugal	45
Spain	47

Eurozone peripheral bond yields

Country	December 2023	November 2023	Spread over 10 year
Spain 10 year	3.23%	3.75%	101
Italy 10 year	3.99%	4.55%	177
Greece 10 year	3.42%	3.97%	120

	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+

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Equity Markets and Dividend Futures

November was another bumper month for equities generally, and US equities in particular. According to analysts at index firm S&P Dow Jones, the big surprise was that in November, the benchmark US equity index, the S&P 500 closed at 4,567.80, up 8.92% (9.13% with dividends), **the best month since the 9.11% of July 2022.**

For the three-month period, the index was up 1.33% (1.74%), as the YTD return was up 18.97% (20.80%) and the one-year return was 11.95% (13.82%). Historically, November has posted gains 61.1% of the time, with an average gain of 4.02% for the up months, a 4.16% average decrease for the down months, and an overall average gain of 0.88%.

More broadly the **S&P Global BMI index reversed course and posted broad gains, as November added 9.05%**, compared to October's decline of 3.44% and September's 4.29% decline. Global markets were up 8.87% without the U.S.'s 9.18% gain, compared to being down 4.41% without the U.S.'s 2.78% decline in October.

As for valuations, based on estimates for the earnings up to 30th September 2023, and using operating earnings the S&P 500 is currently valued at 18.92 times earnings which drops to 18.37 based on estimates to the end of the year. If we use as reported earnings those respective PEs increase to 21.42 times and 20.41 times earnings.

The quant team at SocGen also has a typically sanguine take on the excitement in the markets: *"November was a terrific month for most assets, with prices surging across the board. The global 60/40 portfolio as calculated by Bloomberg surged 7.64%, its best monthly performance since the announcement of the COVID vaccine in November 2020. This helped push this index into a very healthy 11.5% ytd gain."*

Index	November 2023	December 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 23 contract	143.3	143.3	4536	143.1
FTSE 100 Dividend Dec 2023	298.5	299.3	7542	297.5

Note changed to Dec 2023 contracts

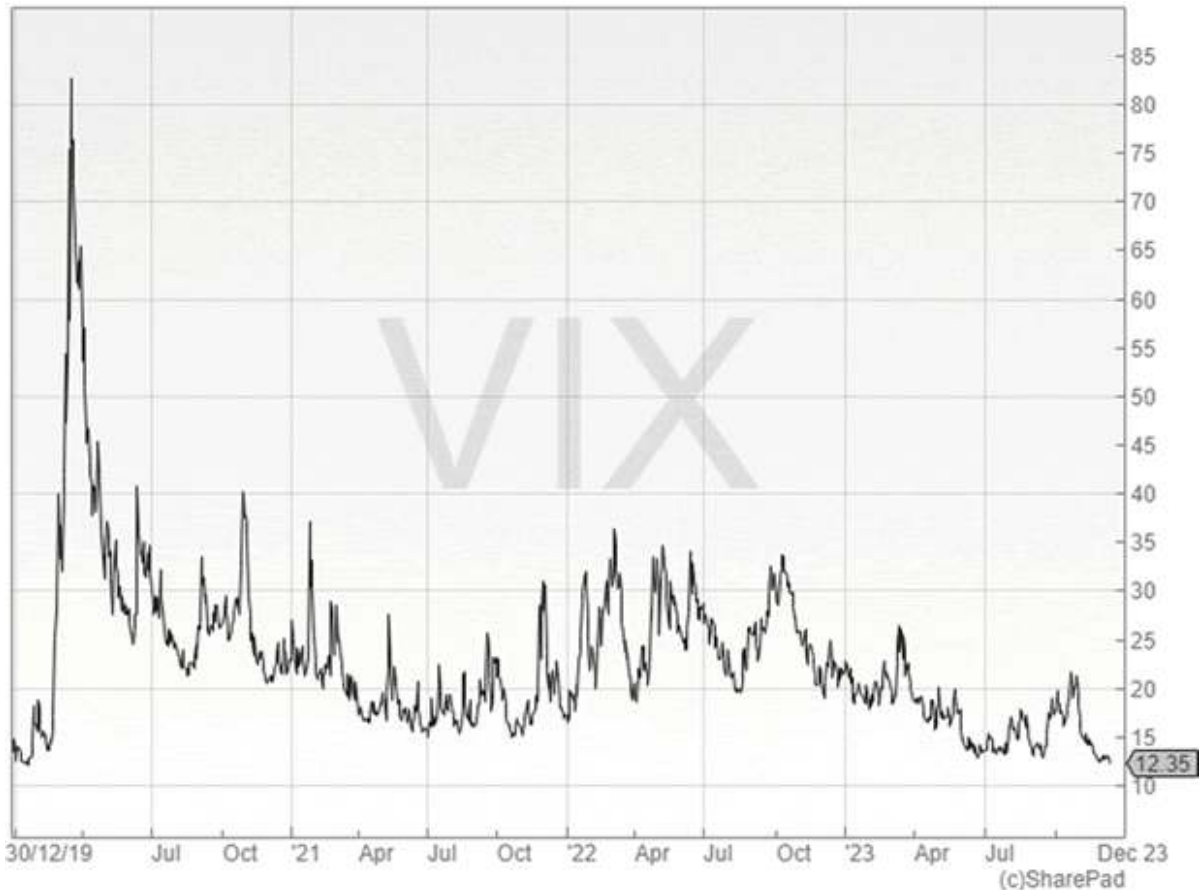
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	2.48	0.202	-0.369	1.3	9.63	0.565	7542.77
S&P 500	4.85	3.76	6.7	16	74.6	73.8	4629.54
Gold Composite (Most Traded)	2.89	3.03	1.22	11.2	59.4	60	199370c
iShares FTSE UK All Stocks Gilt	1.44	2.33	2.55	-5.29	-22.1	-22.3	1021.5p

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Volatility

The chart below shows the Vix index, which tracks turbulence in the pricing of stocks in the S&P 500. As of writing, it's stuck at around 12.5 index points, a decline which has coincided with a six-week winning streak in US stocks. To repeat notes from the previous months, this is a remarkably low level. The long-term average is around 19 to 20 depending on your yardstick. We're now back to levels last seen before Covid in January 2020. The high measure for the Vix in 2023 was in the March 13 week at 30.81 during the banking crisis (SVB went bankrupt on March 10). The high in 2022 was in January at 38.94.

Other measures of market turbulence also indicate complacency/market confidence. In November for instance S&P Dow Jones reported that for the US benchmark S&P 500 index, monthly intraday volatility (daily high/low) decreased to 0.75% from last month's 1.28% and was 1.06% YTD.



Measure	December Level	November Level	October Level	September Level
Vstox Volatility	13.21	15.93	20	15.47
VFTSE Volatility	12.63	14.17	16.69	14.23

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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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