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UK Structured Products Association

# Monthly Market Report
July 2020

*With commentary from David Stevenson*

Strange days indeed. The next wave of the crisis is happening as the virus slams into Latin America - with the awful death toll rising in Brazil - and yet the US market until recently had been scaling new heights. The first chart below - from Sharepad - shows that until recently the S&P 500 was trading above the 20 (red) and 200 (blue) day moving average super imposed along with the trend line. Any break above 3500 overt the summer would put this benchmark US index firmly in epically bullish territory, helped along by significant increases in market turnover (the bar charts at the bottom). In essence, US equities are now roughly back where they were mid summer 2019.

The S&P 500


But not every market has bounced back so aggressively. The second chart below is for the FTSE 250 and shows that the UK mid cap index is only just getting back to levels last seen in 2016 and at

the end of 2018. Crucially it is still trading well below the 200 day MA and my guess is that we won't see this level until we move above 18500, which implies another 5 to 10% uplift from here.

The FTSE 250


Overall, my guess is that the US market in particular has now - despite the recent wobbles - in effect priced in a V shaped recovery whereas the UK market is valued closer to a U-shaped recovery. One of those may be right but my money is still on a W shaped recovery.

My stab in the dark at working out the shape of the US equity rebound is echoed in a short piece out this week called Four COVID-19 Scenarios: What Might Happen Next? by MSCI analysts *Thomas Verbraken* and *Juan Sampieri*. They've used their own proprietary model to extrapolate four potential market outcomes using IMF scenarios, all done using May 19th macro economic data. The various modelled rebounds consist of ones that are V shaped, U shaped, swoosh (closest to my W) and L. The MSCI analysts reckon a V shaped scenario assumes an annualized 2.15-percentage-point contraction in the U.S. economy over the next two years but no persistent impact. These macro numbers are then fed back into an MSCI macro economic model which throws out equity losses that vary between -13% and -45% compared to the pre crisis peak.

Macroeconomic and market scenario assumptions

| Scenario<br>(shocks relative to Feb. 19, 2020) | V-shaped | U-shaped | Swoosh-shaped | L-shaped |
|---|---|---|---|---|
| Annualized two-year growth shock [4] | -2.15% | -3.15% | -4.55% | -6.25% |

| | | | | |
|---|---|---|---|---|
| Annualized long-term growth shock [5] | +0.00% | -0.40% | -1.00% | -1.60% |
| ERP shock | +0.75% | +1.25% | +2.00% | +3.00% |
| 10-year Treasury real rate (level) | -0.15% | -0.20% | -0.30% | -0.40% |
| *Implied equity returns (%)* | *-13%* | *-22%* | *-33%* | *-45%* |
| *10-year Treasury yield (level)* | *1.20%* | *0.90%* | *0.70%* | *0.50%* |
| *10-year Bund yield (level)* | *-0.30%* | *-0.50%* | *-0.70%* | *-0.90%* |
| *10-year Italian sovereign yield (level)* | *1.40%* | *1.70%* | *2.30%* | *3.50%* |
| *US IG bond spread shock (bps)* | *+120bps* | *+200bps* | *+310bps* | *+420bps* |
| *US HY bond spread shock (bps)* | *+255bps* | *+440bps* | *+685bps* | *+925bps* |
| *Oil Price (level)* | *$45* | *$35* | *$25* | *$20* |
| *EUR-USD (level)* | *1.12* | *1.09* | *1.05* | *1.00* |
| Implied inflation (level) | 1.35% | 1.10% | 1.00% | 0.85% |

Using this model, the MSCI analysts reckon the current market level almost exactly mirrors the V shaped scenario whereas the original market low in March hinted at a swoosh shaped scenario. Let's hope the markets are right!

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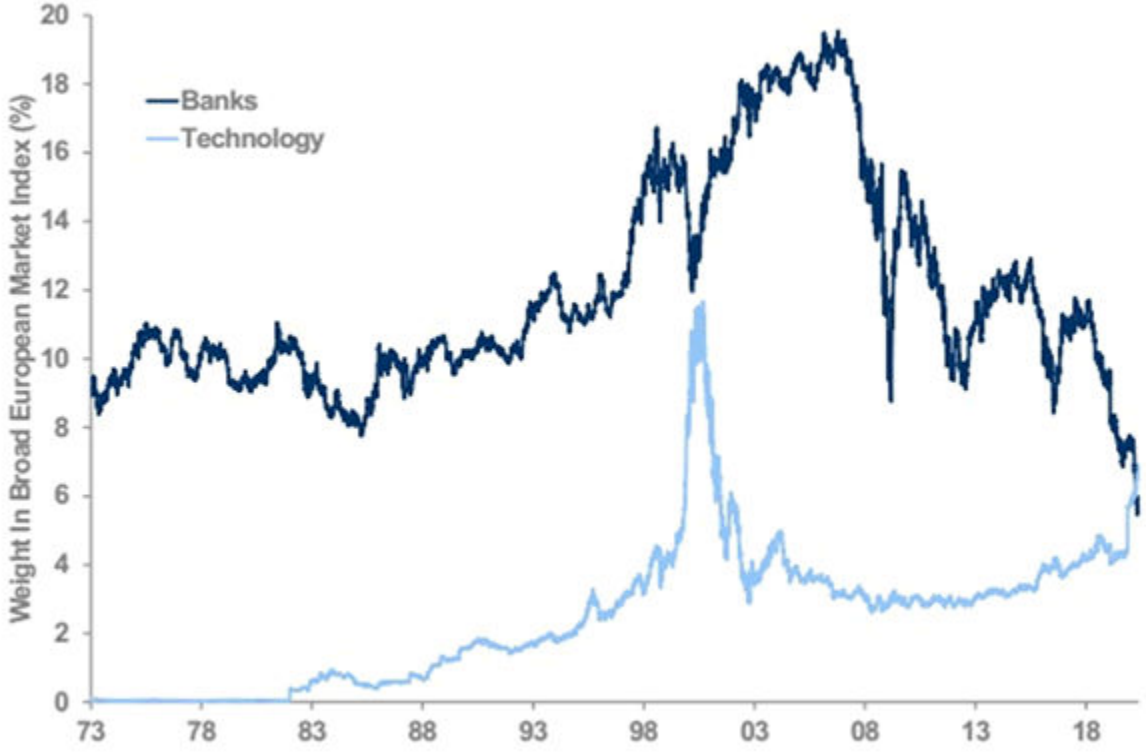
## Headline Numbers

**Euro Tech is big, better than Euro Banks!**

Next up we have a simple observation from the European equities team at Morgan Stanley. The simple punchline is that Euro Tech is now worth more than Euro Banks. The chart below is from the Morgan Stanley team and "shows the weight of Banks in a broad European index over the last ~50Y. Before the financial crisis, Banks accounted for 20% of the European market, but this has now fallen to just 5.6%. Perhaps more surprising is the fact that Technology (7%) now accounts for a greater share of European equities than Banks for the first time ever." How the mighty have fallen!

**Exhibit 6:** Technology now accounts for a larger part of the European index than Banks

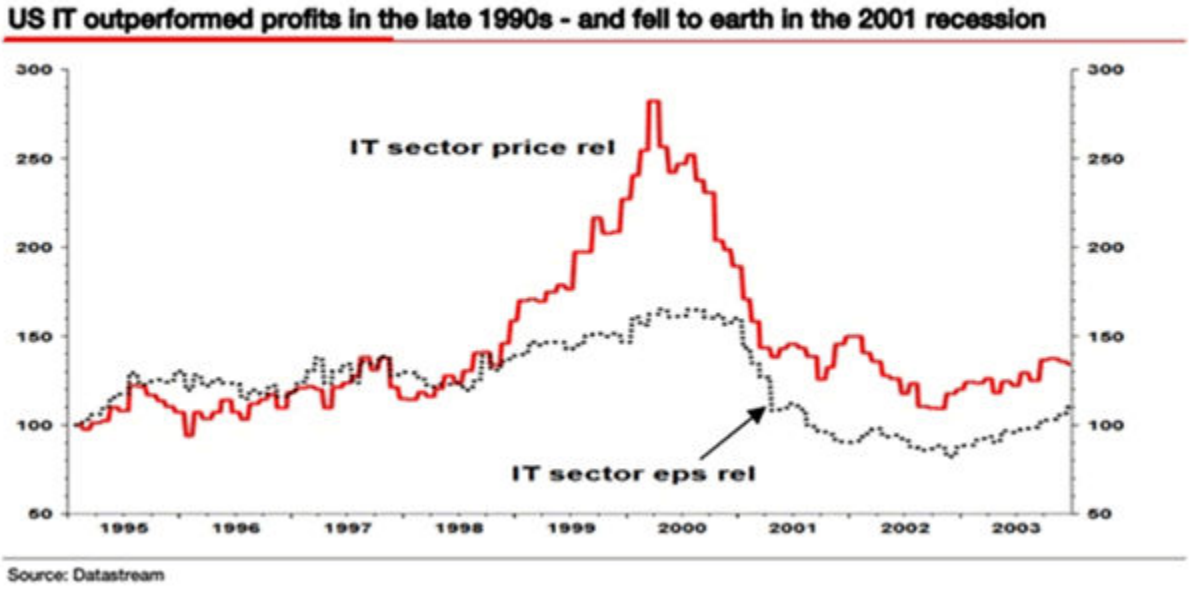



Source: Refinitiv, Morgan Stanley Research.

The current equity surge has largely - though not exclusively - been powered by a relatively narrow slug of stocks, mainly in the US tech sector. Gerard Minack, who writes the Down-under Daily strategy note uses a new acronym which combines the FAANGs (calling Google by its correct name Alphabet) with Microsoft to form the FAAANMs (Facebook, Apple, Alphabet, Amazon, Netflix & Microsoft). Minack also notes the massive out performance of the S&P versus the MSCI rest of the world (RoW) is almost entirely attributable to the FAAANM, top 6 stocks.

The chart below echo's that message and was recently published by analysts at DWS, a European asset manager. It demonstrates that the rally of the past three months has mainly been driven by those sectors already deemed to be pricey by conservative standards (when looking at price-to-earnings (P/E) ratios ), while the cheap ones continued to be avoided.


What might make this euphoria turn into despair? A likely bubble-burster in my book could be a nasty turn in tech sector profits. According to notable equity bear Albert Edwards the recent tech rally might turn into cyclical sand - in the late 1990s *tech stocks had also enjoyed a period of massive outperformance. This surge pushed tech stocks to peak valuations, helped along by ample US Fed liquidity. But Edwards reminds us that "the 2001 recession exposed the tech sector as heavy with cyclical stocks masquerading as growth stocks... Hence when the 2001 recession unfolded, many tech stocks suffered a totally unexpected fall in profits. These were not growth stocks at all and shouldn't have been on 40x+ PEs. These were in reality cyclical stocks trading on peak multiples on peak cyclical earnings, when they should have been trading on top of the cycle, single-digit PEs".*



| Measure | Values as of 19th May, 2020 | Values as of 10th June, 2020 |
|---|---|---|
| UK Government 10 year bond rate | 0.26% | 0.29% |
| GDP Growth rate YoY | 1.10% | -1.60% |
| CPI Core rate | 1.50% | 0.80% |
| RPI Inflation rate | 2.60% | 1.50% |
| Interest rate | 0.10% | 0.10% |
| Interbank rate 3 month | 0.37% | 0.22% |
| Government debt to GDP ratio | 80.80% | 80.70% |
| Manufacturing PMI | 32.6 | 40.7 |

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## Bank CDS options

Rates for bank credit default swaps have largely fallen back in recent weeks, as aggressive efforts by central banks to reassure markets has had the desired effect. Its worth noting that in particular UBS and SocGen have seen sizeable moves down in their 1 year rates, as has Deutsche (from elevated levels). Almost no banks saw their pricing increase, bar a tiny, marginal increase at RBC.

| Bank | One Year | Five Year | Credit Rating (S&P) | Credit Rating (Moody's) | Credit Rating (Fitch) |
|---|---|---|---|---|---|
| Banco Santander | 18.4 | 41.87 | A | A2 | A - |
| Barclays | 35.67 | 85.62 | BBB | Baa3 | A |
| BNP Parabis | 14.98 | 44.83 | A+ | Aa3 | A+ |
| Citigroup | 51 | 75 | BBB+ | A3 | A |
| Commerzbank | n/a | n/a | A- | A1 | BBB+ |
| Credit Suisse | 21.69 | 73.77 | BBB+ | Baa2 | A- |
| Deutsche Bank | 150 | 195 | BBB+ | A3 | BBB |
| Goldman Sachs | 55 | 86 | BBB+ | A3 | A |
| HSBC | 20.66 | 49.89 | AA- | Aa3 | A+ |
| Investec | n/a | n/a | n/a | A1 | BBB+ |
| JP Morgan | 38.96 | 62.4 | A- | A2 | AA- |
| Lloyds Banking Group | 12.7 | 43 | BBB+ | A3 | A+ |
| Morgan Stanley | 46.8 | 72 | BBB+ | A3 | A |
| Natixis | 34.08 | 46 | A+ | A1 | A+ |
| Nomura | 40 | 95 | BBB+ | Baa1 | A- |

| | | | | | |
|---|---|---|---|---|---|
| RBC | 24.69 | 72 | AA- | Aa3 | AA |
| Soc Gen | 14.7 | 46.99 | A | A1 | A |
| UBS | 12.69 | 38 | A- | Aa3 | A+ |

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st June 2020 www.tempo-sp.com

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## Government Bonds

### Fixed Income

Talk to most bond investor's and they'll tell you that apart from corporate defaults, the one thing they fear more than anything else is inflation - unless of course they are invested in index linked bonds! But what kind of inflation do they fear? All forms, even mild inflation levels of around 4%? This question has become more urgent over the recent weeks as central banks have flooded the market with extra liquidity, and bought up ever more bonds, including slugs of corporate bond ETFs. Lurking in the background of this unprecedented monetary drama is the threat of future inflation. Until recently most investors in developed markets tended to think of inflation as the annual change in prices that is typically around 2%, which is roughly the average in the US since 1990. However, even the US had significantly higher levels in the not too distant history. Inflation peaked at 14% in the US in 1980, which seems as unreal from today's perspective as negative oil prices at the beginning of 2020.

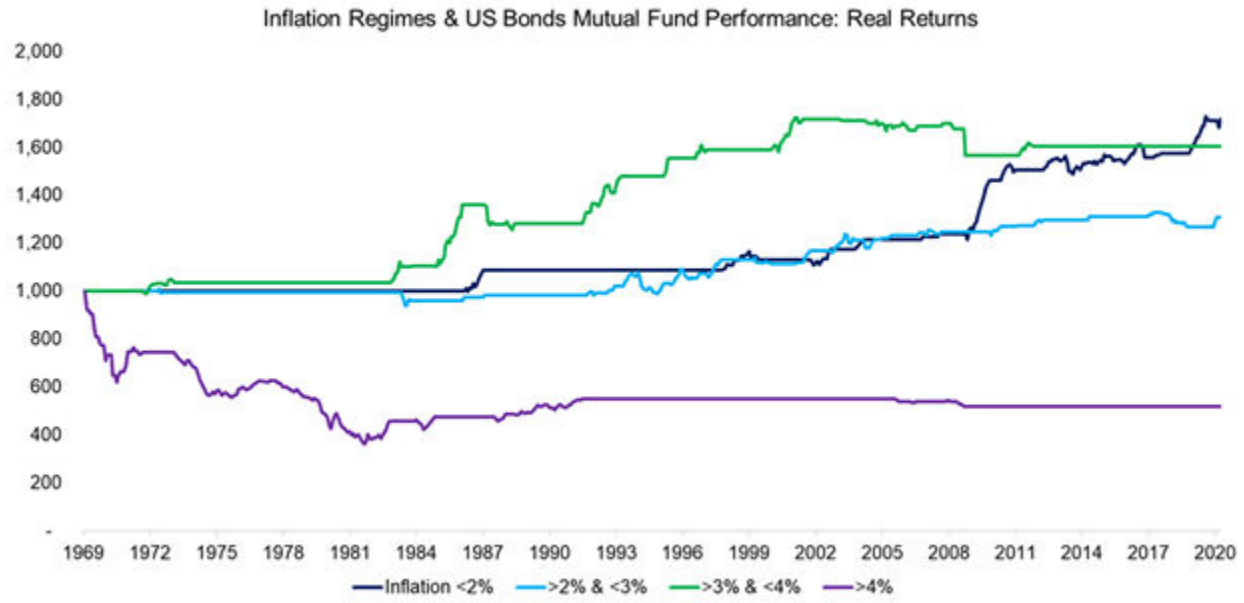
Source: OECD, FactorResearch


So although most investors think a return to double digit inflation rates is unlikely, a substantial uptick in inflation in say 2021 or 2022 is not a complete impossibility especially if we do have a V

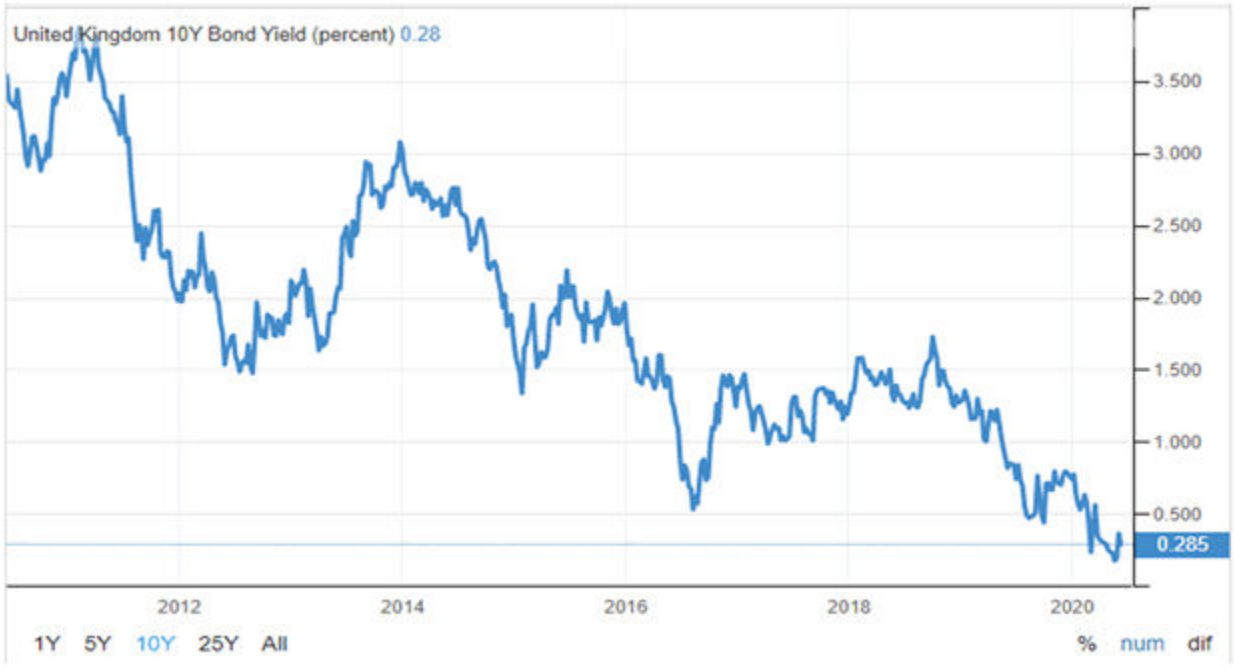
shaped recovery as many equity investors seem to be betting on.

Given these concerns, what impact will a change in the inflation regime have on bonds and the accompanying range of bond funds? A recent note by Nicholas Rabener of research firm FactorResearch digs around inside the historical data on inflation regimes and comes to some bracing conclusions. Rabener reminds us that when inflation hit unprecedented levels in the Seventies, US bond mutual funds experienced a 60% drawdown in real returns.

But not all higher inflation regimes are the same - in fact according to Rabener, real returns were in fact positive on average in all other inflation regimes. According to the head of FactorResearch "a lot of this behaviour has to do with the impact of expected versus unexpected inflation. Many articles have been written documenting their different impacts on real returns, where unexpected inflation is more damaging. In the US, most episodes of high inflation in the 1970s were unexpected and for that reason the nominal yields were incapable of matching the realized inflation, making real returns negative. Furthermore, high inflation tends to have negative effects on consumers and businesses, which ultimately reflects in higher default rates on corporate bonds, rising the required rate of return, and reducing the price of bonds."




UK Government Bonds 10-year Rate 0.29%




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

## CDS Rates for Sovereign Debt

| Country | Five Year |
|---|---|
| France | 26.95 |
| Germany | 16.3 |
| Japan | 19.54 |
| United Kingdom | 28.62 |
| Ireland | 31.47 |
| Italy | 161 |
| Portugal | 63.77 |
| Spain | 71.68 |

## Eurozone peripheral bond yields

| Country | May 2020 | June 2020 | Spread over 10 year |
|---|---|---|---|
| Spain 10 year | 0.79% | 0.66% | 98 |
| Italy 10 year | 1.88% | 1.51% | 183 |
| Greece 10 year | 2.11% | 1.37% | 169 |

| | 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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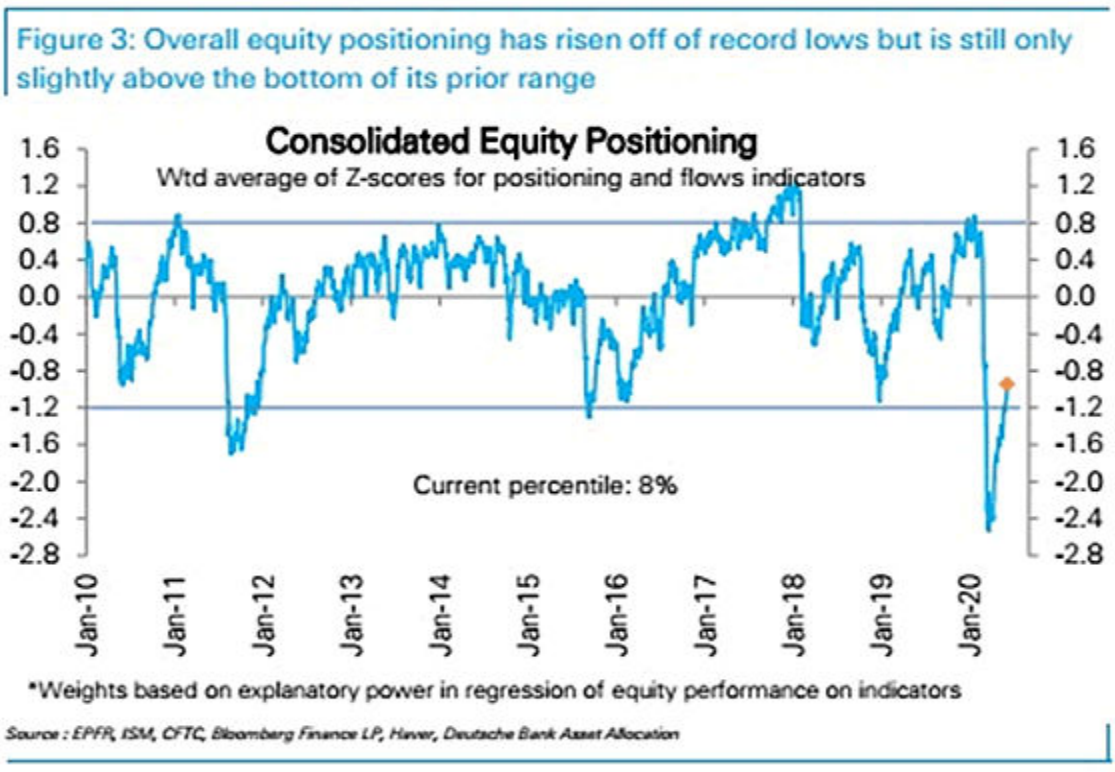
## Equity Markets and Dividend Futures

| Index | May 2020 | June 2020 | Reference Index Value | Level 6 Months Ago |
|---|---|---|---|---|
| Eurostoxx 50 (Dec 19) | 81.7 | 85.6 | 3291 | 122 |
| FTSE 100 (Dec 19) | 177.6 | 191 | 6234 | 326 |

Many commentators have called the recent surge in equities, especially US equities, the most hated/despised rally in history. The constant daily increases through the thick and thin of corona (and street protests) has left many investors scratching their head. What's propelling stocks to ever higher valuations given this dreary, fearful backdrop? US analysts following fund flows at Deutsche Bank reckon they have a simple and concise explanation for this bullishness. Follow the money. Lurking behind this is the inescapable point that a huge wall of cash is still sitting on the side lines and currently outside of equities (and I suppose) TINA: there is no alternative. Crucially the Deutsche analysts point out that equity positioning is actually still very, very low. Thus, the chart below.



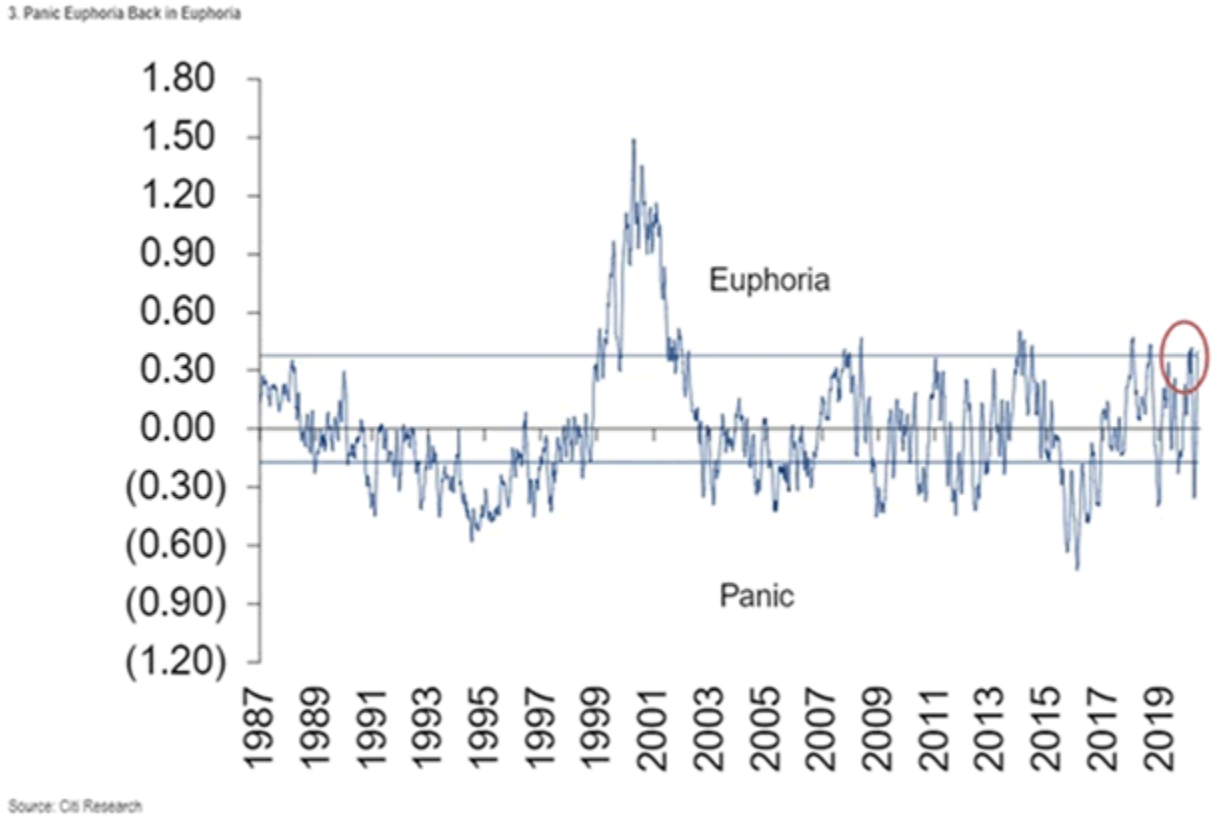

The Deutsche analysts also observe that *"large swathes of the equity market in the US as well as*

*globally, are only one week into a break out of a 7 week range, and for this group, positioning is still extremely low. There is also plenty of evidence that new retail investors raised exposure through the selloff and the rally, unexpectedly so, and institutional money across the systematic as well as discretionary spaces is now chasing."*

*Crucially this potential surge could be fuelled by the cash mountain currently sitting in money market funds which remains enormous. According to Deutsche, after $1.2 trillion went in since March and almost none moving out so far, money market assets ($5 trillion, 25% of GDP) are still at financial crisis highs and any re-allocation away should be beneficial across risk assets.*

*One last factor to consider is the flow of cash from buybacks. Currently in the US these are falling drastically - within the S&P 500 they are likely to fall from $175bn in Q4 2019 to $70bn in Q2, in line with levels implied by the sharp decline in Q2 earnings. However, the Deutsche analysts remind us that the cyclicality of buybacks works both ways and, as earnings rise in Q3, "we expect buybacks to bounce back as well, although the extent is likely to be tempered in an election year to the benefit of M&A."*

*Thus, we one way of looking at recent events is not to see it as the end of a bull cycle but the possible beginning of something even more aggressively bullish. Arguably one could argue the markets are now increasingly euphoric.* John Authers in his regular column for Bloomberg, Points of Return, looked at a note by Citi strategists and particularly Tobias Levkovich, the bank's chief U.S. equity strategist, who has been keeping a "Panic/Euphoria" index. *"This is based on rigorously quantitative and unchanging criteria all of which are rooted in market prices (the NYSE short interest ratio, margin debt, Nasdaq daily volume as a percentage of NYSE volume, a composite average of Investors Intelligence and the American Association of Individual Investors bullishness data, retail money funds, the put/call ratio, CRB futures index, gasoline prices and the ratio of price premiums in puts versus calls). It is a contrarian indicator. When the market is in panic, you should buy. In euphoria, you should sell."*




| Name | Price % change | | | | | | Close |
|---|---|---|---|---|---|---|---|
| | 1 mth | 3 mths | 6 mths | 1 yr | 5 yr | 6 yr | |
| FTSE 100 | 4.21 | 12.6 | -17.8 | -17.7 | -9.92 | -10.8 | 6043 |
| S&P 500 | 6.2 | 12.2 | -4.02 | 5.35 | 45.9 | 57.1 | 3041 |
| | | | | | | | |
| iShares FTSE UK All Stocks Gilt | 0.2 | 3.02 | 8.15 | 9.73 | 23.9 | 32.5 | 15 |
| | | | | | | | |
| VIX New Methodology | 27.9 | -29.5 | 223 | 167 | 165 | 235 | 40.79 |

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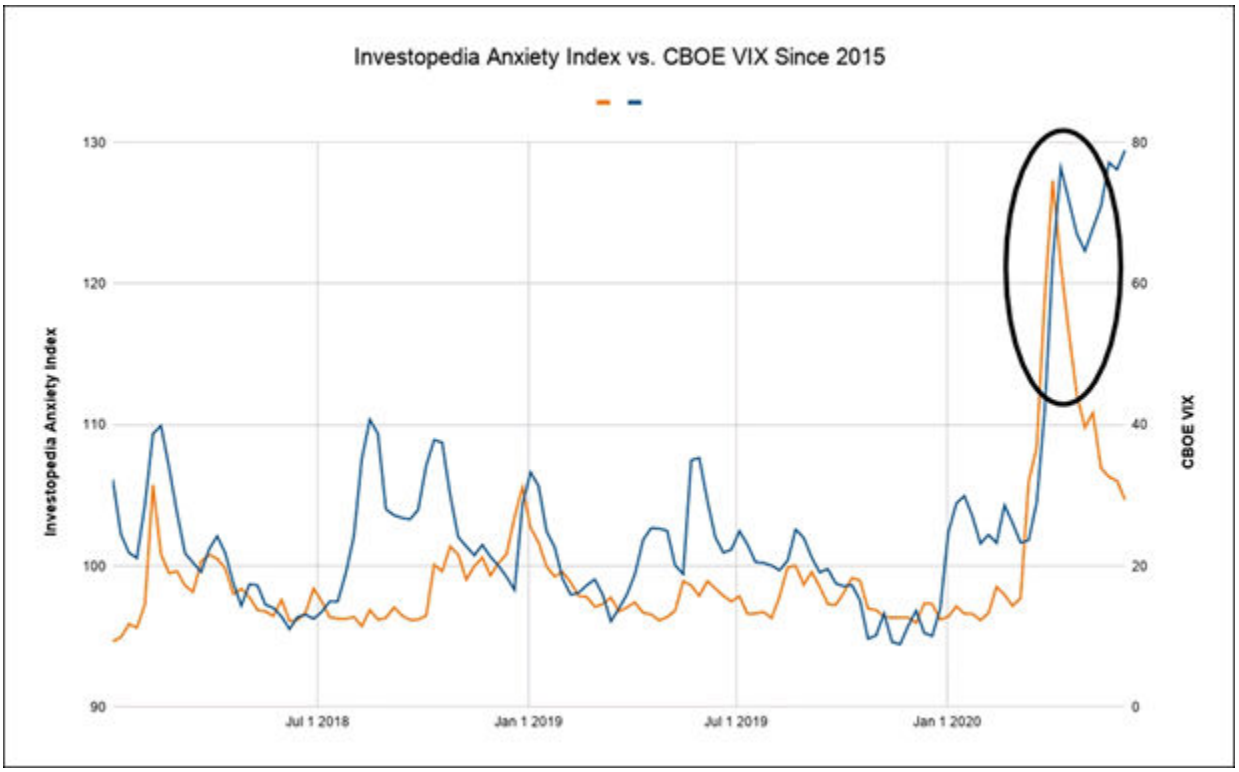
## Volatility

You may just have noticed that global stockmarkets seem to have overcome their initial panic about the Covid 19 virus and the resulting economic fallout. As we have mentioned elsewhere in this report, markets are probably edging into euphoric territory. That has meant that volatility, usually measured by an index called the Vix, has collapsed from all time highs, although current levels are still well above the long-term historic average of around 17 for the index.

But this euphoria and lower volatility slightly jars with the high levels of anxiety in the wider

population - and the huge mountains of cash sitting in money market funds and electronic cash. So, it's interesting to see a report at the end of last month from the popular Investopedia website based around their proprietary Investopedia Anxiety Index, which is 'a measure of our readers' concerns about market and economic related issues, and the CBOE Volatility Index (VIX), otherwise known as the "Fear Gauge". These two measures have historically been closely correlated - the Anxiety Index "typically increases ahead of the VIX as investors attempt to learn what is happening before they take action in their portfolios. That has been consistent since the last financial crisis, and every peak and valley in between." Not anymore though.




According to Investopedia in late May this survey has "revealed a notable divergence between the two as anxiety, especially around personal finance related issues, has spiked, just as markets-based anxiety has subsided. It's not surprising that has come on the heels of April's 14% rise in the S&P 500, while some 24 million Americans filed for unemployment.".


| Measure | June Level | May Level | April Level | March Level |
|---|---|---|---|---|
| Vstoxx Volatility | 30.54 | 28 | 36.4 | 33.35 |
| VFTSE Volatility | 27.57 | 27.39 | 41.69 | n/a |

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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.<br>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 his 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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