



Monthly Market Report

July 2021



With commentary from David Stevenson

For this observer the big story of the next six to 12 months is how much the US fiscal stimulus will boost top line economic growth - and the reaction of central bankers to the ensuing economic excitement and possible inflation. For the record, I think Biden's programme is astute politically and also astute economically in the short term. That said, I have my real doubts about it long-term, unless the Biden administration gets very serious about raising taxes. In my view, he needs to raise taxes at some point to prove to the markets that his big welfare state push can be financed without an ever-larger mountain of debt (a concern that also applies to previous Republican stimulus). If he doesn't and the economy tips over into sustained inflation, then we are due a nasty bout of austerity.

Which is where the latest Equity Gilt study by analysts at Barclays comes in. This huge report - a proper door stopper - was released a few weeks back and is also concerned about this eventual reckoning. For me the big point is these big bank analysts reckon that the chance of very large unexpected surprises is substantial and growing by the day.

The report believes that the "risk of disorder seems meaningful in the US, where policy responses have been especially forceful. The key variable is long-term inflation expectations: if they prove highly responsive to shorter-term price pressures, the prospect of a messy unwind could emerge for the Federal Reserve. Such a scenario would likely involve painful trade-offs between prolonged unemployment and longer-term inflation, testing the Fed's resolve to achieve its 2% inflation target... A shift in the political backdrop could force austerity, prompting a rapid fiscal consolidation that would disrupt the economy".

I'd be willing to put a date on that - quarter 4, 2022 after the next House of Representative elections when there's a good chance that the Republicans wrestle back control of the House. That's why I think what Biden is doing is smart politically. Push all the buttons now to show during that election you can make a meaningful difference to voters' lives. The risk though is that inflation wrecks that particular benefit.

The Barclays report does map out a few scenarios about how the US might pay for this fiscal and monetary bonanza. For equity investors the potential headache comes with a scenario where the Fed focuses on an "inflation focused" *approach where the Fed is determined to bring inflation and inflation expectations under control. ... doing so requires a much tighter policy, at least initially, which causes a deeper recession. The benefit of this aggressive action is that inflation and inflation expectations eventually revert to 2%, leading to better longer-term outcomes as the economy returns to full employment. Hence, even though this reaction leads to more adverse outcomes in the near-to-medium term, the overall outcome is more desirable, in our view.*

If we cut through the economist jargon, the message is simple: markets might start to look through to a slowdown or even recession in the next few years. I suspect that that isn't on most investors

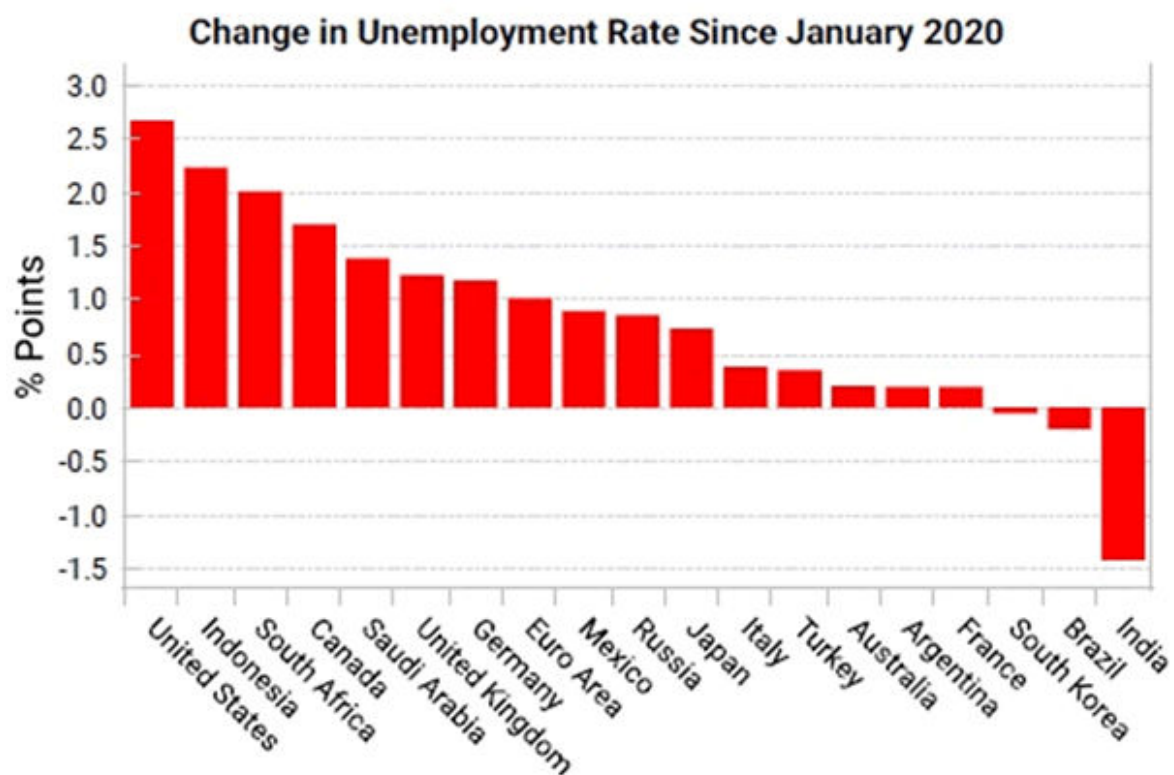
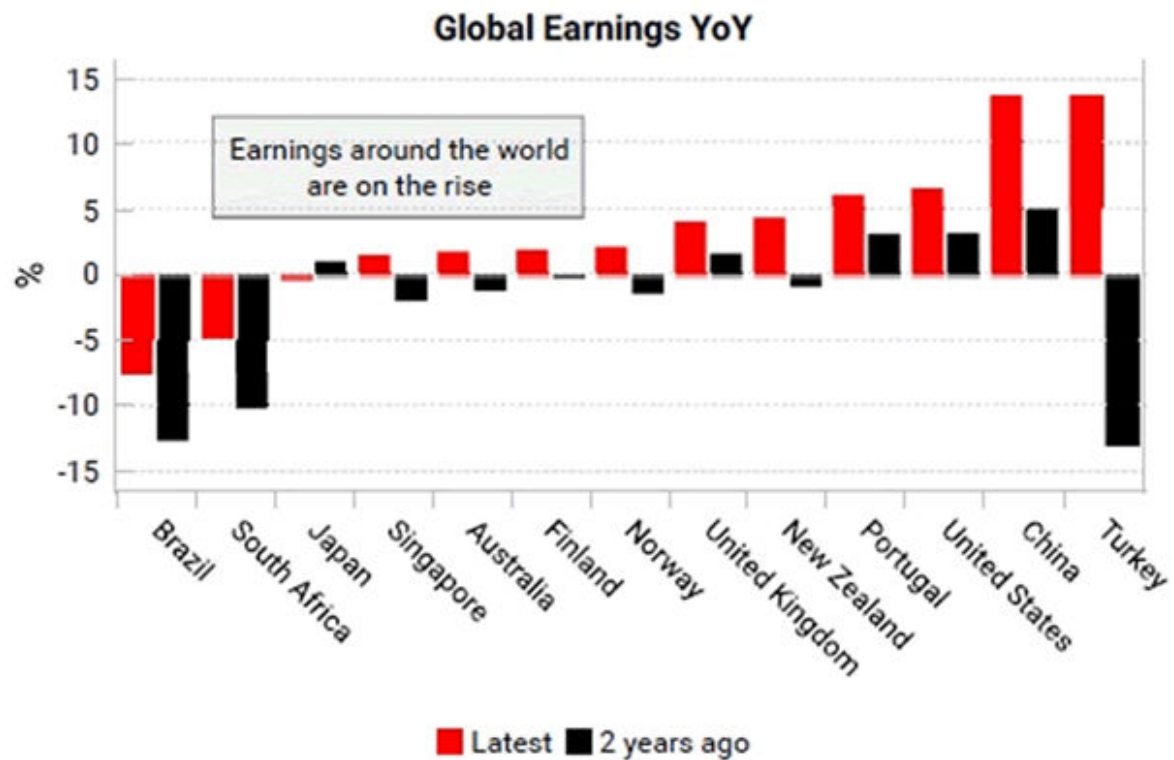
radars at the moment.

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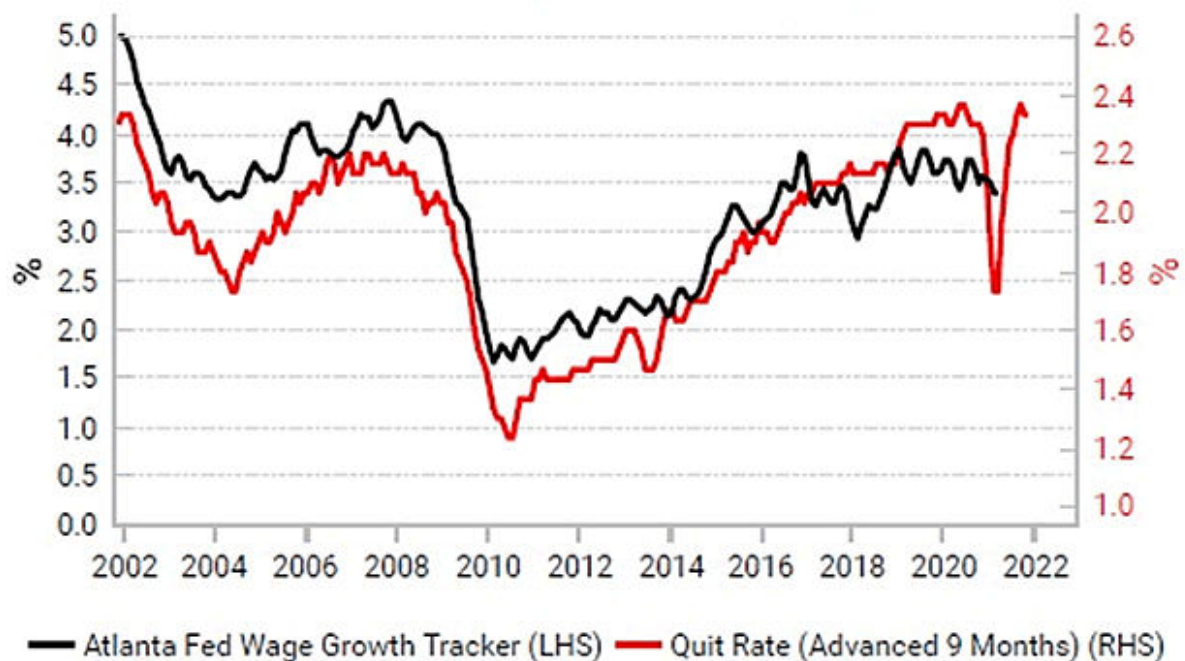
Headline Numbers

The threat of inflation is on all investors minds at the moment which means focusing on price rises for consumer goods and services. Arguably though we should be more focused on wage rates. On this score, its interesting to see research firm Variant Perception warning that wages are rising sharply. According to the research firm - widely used by hedge funds - their leading US indicators are currently pointing towards *"higher wage growth as employers pay up for better quality labour in the wake of the pandemic. A nascent rise in trade-union density suggests the wind is changing and that we may see more structural inflation risks coming from the labour market...Labour costs and rising wages are becoming a growing concern, with earnings rising in many countries across the world. The pandemic and the policy responses to it - including direct fiscal support for earnings - have led to the dynamic of wages continuing to be biased higher, even while in many cases unemployment rates remain well above their pre-pandemic levels."*



"Leading indicators for US wages agree. The rising Quit Rate suggests workers are confident enough of finding a new role if they quit, and this often leads to rising wages."

Atlanta Fed Wage Growth Tracker vs Quit Rate (Advanced 9 Months)



I think the juries still very much out about a more systemic inflationary surge but I do think that the developed world stock markets will be watching these wage numbers like a hawk.

The Barclays Equity Gilt study is an invaluable resource on long term returns from holding varying assets. The three charts below shine a light on those historical returns - with the first one below looking at real investment returns. The surprising number for me is the real return for UK equities over the last 20 years - just 1.7%!

FIGURE 1. Real investment returns by asset class (% pa)

	2020	10 years	20 years	50 years	121 years*
Equities	-10.5	2.9	1.7	5.3	4.9
Gilts	7.2	3.8	3.1	3.6	1.4
Corporate Bonds	7.8	4.3	3.2		
Index-Linked	6.3	4.2	3.3		
Cash	-1.0	-2.2	-0.5	1.0	0.7

Note: * Entire sample.
Source: Barclays Research

The next table digs a little deeper into those returns decade by decade. The standout reveal for me is that there were six decades where the real return per annum on UK equities was below 4%, with three below 1% per annum. The 1910-1920 decade produced real investment returns per annum of -7.9%.

FIGURE 2. Real investment returns (% pa)

	Equities	Gilts	Index-linked	Cash
1910-1920	-7.9	-10.8		-6.3
1920-1930	12.8	13.1		9.8
1930-1940	2.3	4.0		-1.2
1940-1950	6.3	0.3		-1.1
1950-1960	12.1	-4.1		-0.6
1960-1970	3.3	-1.4		1.6
1970-1980	0.4	-3.2		-3.1
1980-1990	11.7	6.0		5.2
1990-2000	11.8	9.4	6.2	4.2
2000-2010	0.6	2.4	2.4	1.1
2010-2020	2.9	3.8	4.2	-2.2

Source: Barclays Research

Last but by no means least, the last table illustrates the performance of equities against gilts and cash for various holding periods. The first column shows that over a holding period of two years, equities outperformed cash in 83 out of 120 years; thus, the sample-based probability of equity outperformance is 69%. Extending the holding period to ten years, this rises to 91%.

FIGURE 8. Equity performance

	Number of consecutive years				
	2	3	4	5	10
Outperform cash	83	84	87	89	102
Underperform cash	37	35	31	28	10
Total number of years	120	119	118	117	112
Probability of Equity Outperformance	69%	71%	74%	76%	91%
Outperform Gilts	80	88	88	84	86
Underperform Gilts	40	31	30	33	26
Total number of years	120	119	118	117	112
Probability of Equity Outperformance	67%	74%	75%	72%	77%

Source: Barclays Research

Measure	Values as of 11th May, 2021	Values as of 8th June, 2021
UK Government 10 year bond rate	0.83%	0.79%
GDP Growth rate YoY	-7.30%	-6.10%
CPI Core rate	0.70%	1.50%
RPI Inflation rate	1.50%	2.90%
Interest rate	0.10%	0.10%

Interbank rate 3 month	0.08%	0.08%
Government debt to GDP ratio	100%	100%
Manufacturing PMI	60.9	65.6

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Bank CDS options

A much more mixed picture this month with some banks experiencing marginally increased rates - mainly US banks - while most European banks saw small falls in swap pricing. Pricing for Deutsche's swaps continue to fall substantially while Lloyds Bank saw its pricing for one year swaps fall to a low of 7.47 basis points.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.94	31.51	A	A2	A -
Barclays	12	54.22	BBB	Baa2	A
BNP Parabis	8.04	29.9	A+	Aa3	A+
Citigroup	25.06	51.38	BBB+	A3	A
Credit Suisse	21.49	55.66	BBB+	Baa1	A-
Deutsche Bank	31.74	79.11	BBB+	A3	BBB
Goldman Sachs	27.57	56.38	BBB+	A2	A
HSBC	8	29.56	A+	A1	A-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	25.15	46.39	A-	A2	AA-
Lloyds Banking Group	7.47	31.26	BBB+	A3	A
Morgan Stanley	29.61	54.36	BBB+	A1	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	17.7	52.47	BBB+	Baa1	A-
RBC	18.4	54.54	AA-	A2	AA
Soc Gen	8.97	31.92	A	A1	A-
UBS	9.49	28.22	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st June 2021 www.tempo-sp.com

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Government Bonds

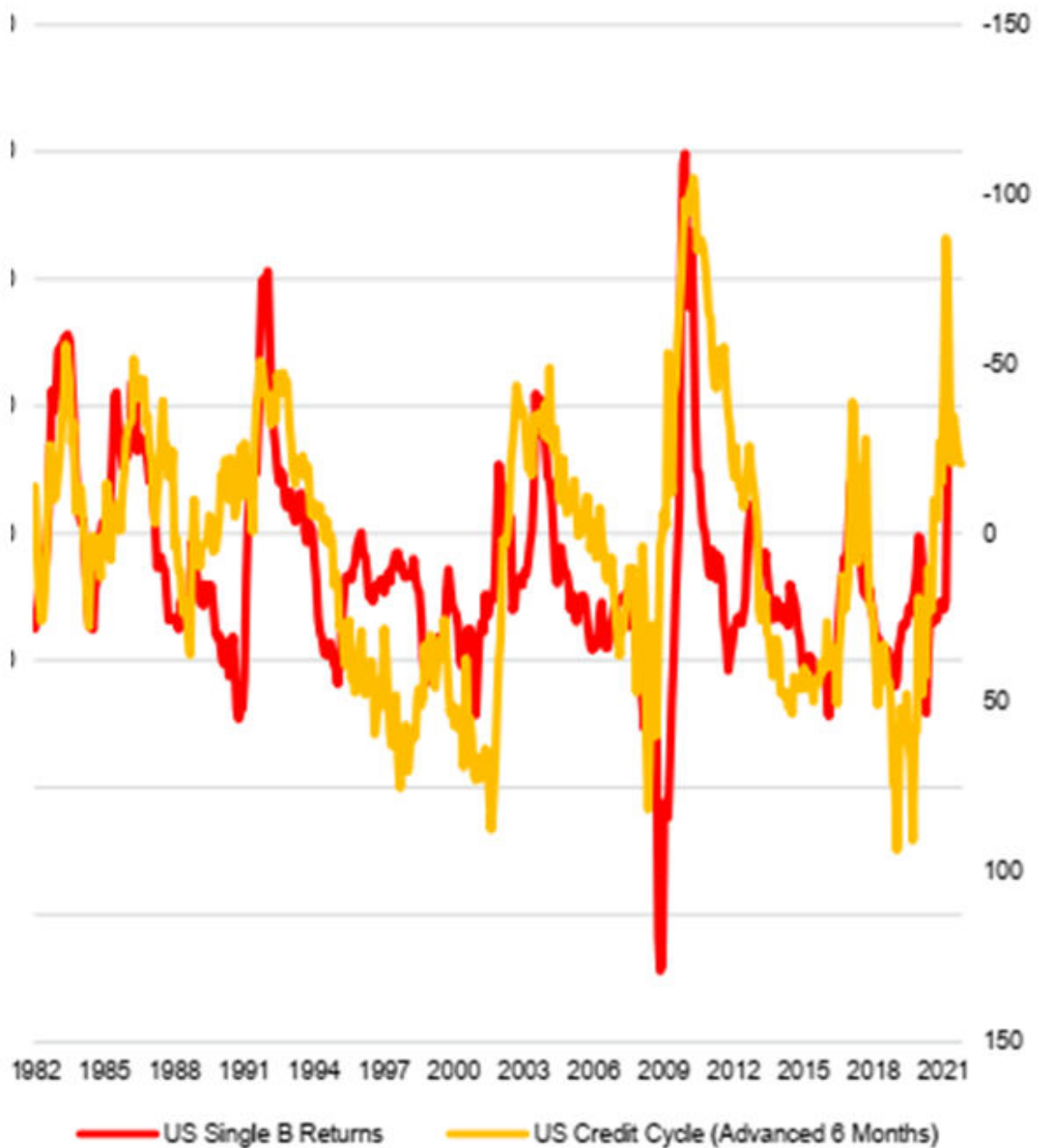
Fixed Income

Analysts at London based research firm have been peering into their fixed income models and think they've spotted a peak credit signal. Their *"Global Credit Cycle measures the riskiness of investing in the corporate credit markets. It is partly a derivative of the broader Global Liquidity Cycle and partly determined by investor positioning. We extract this data and show how it consistently leads the returns from both US and non-US high yield credit markets. Our research [currently] suggests:*

- (a) the US credit cycle is running around 3 months ahead of other economies, and*
- (b) the Global Credit Cycle is around its peak.*

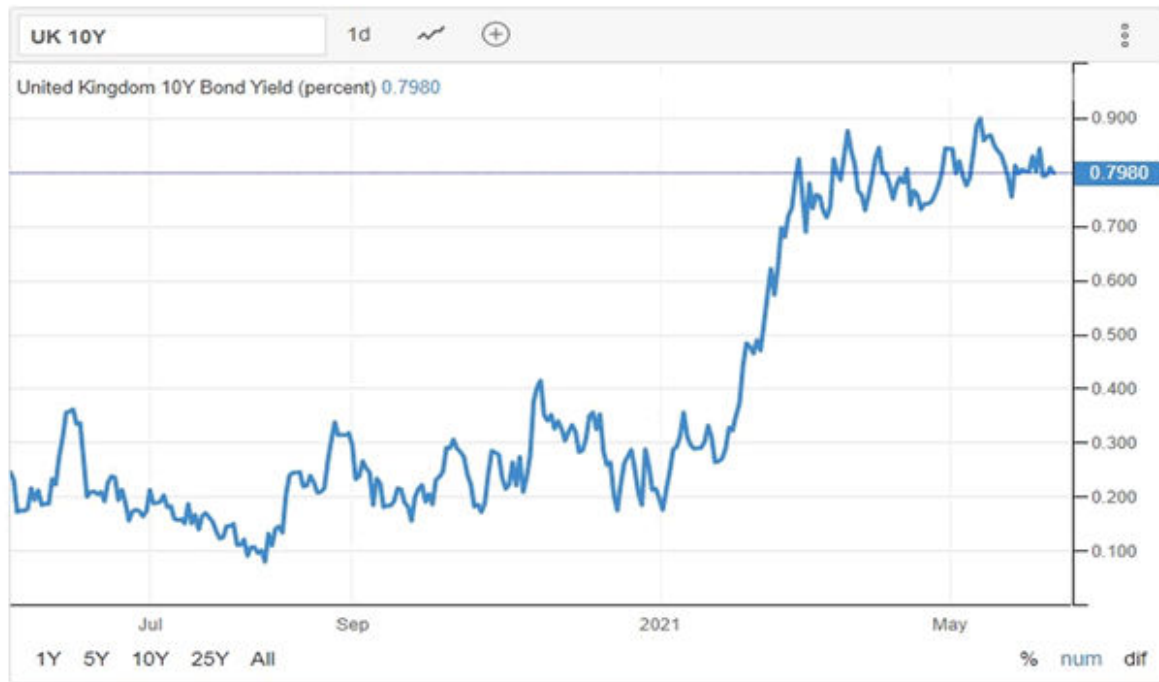
This is not yet a signal to exit credit markets, rather a warning that conditions don't get much better than this."

Figure 4
US Credit Cycle Index (Advanced 6 Months) and US Single B
Corporate Credit Returns %YoY 1982-2021



Source
CrossBorder Capital, US Federal Reserve

UK Government Bonds 10-year Rate 0.79%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	22.74
Germany	10.6
Japan	16.9
United Kingdom	12.01
Ireland	15.7
Italy	78.3
Portugal	31.36
Spain	34.4

Eurozone peripheral bond yields

Country	May 2021	June 2021	Spread over 10 year
Spain 10 year	0.51%	0.47%	68
Italy 10 year	1.99%	0.92%	115
Greece 10 year	1.00%	0.83%	116

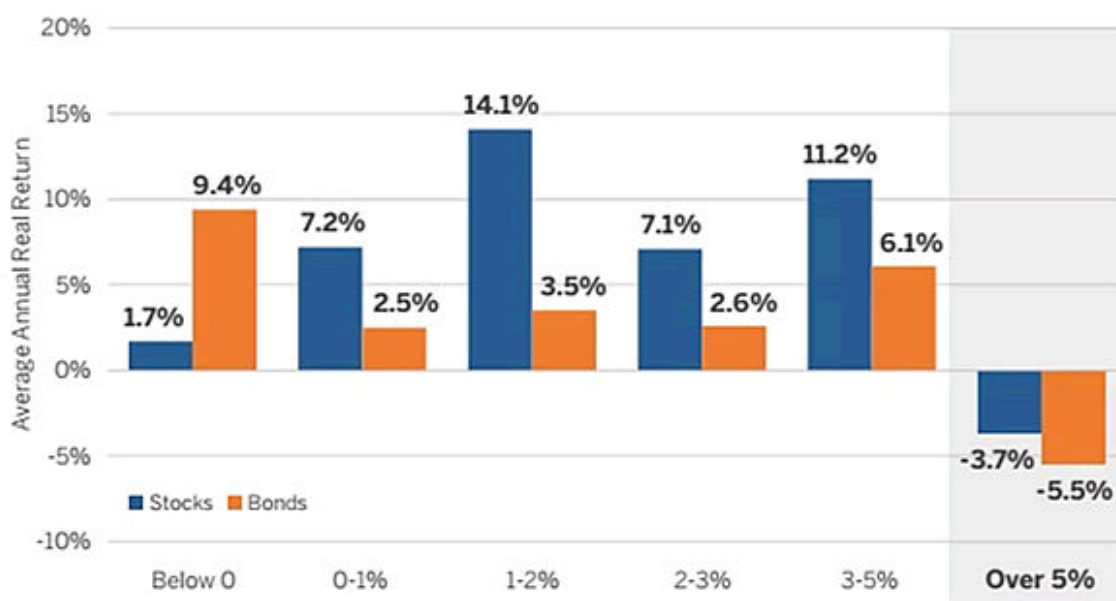
	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

Equity Markets and Dividend Futures

US investment firm Brown Advisory has just released a useful primer called "Inflation in the US Economy". It provides a very clear overview of how inflation and investments interact. One chart stands out - it shows how returns on equities and bonds varies depending on the inflation rate. It confirms three essential relationships: equities do very well in the 1 to 2% regime but returns from 3 to 5% are also pretty impressive. Interestingly bonds also do well in the 3 to 5% scenario. I would add one additional coda - as discussed before on this blog two other variables matter. Markets don't like inflation surprises (when rates go up more than expected) and markets also keep a watchful eye on what are called sticky prices (where prices don't ebb and flow with the business cycle).

How Hot Is Too Hot? Returns over Last 100 Years

Stocks and bonds have historically performed well as long as inflation remained below 5%. Inflation below zero also poses risks to stock returns.



As of 3/31/21. Source: Bloomberg

Index	May 2021	June 2021	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	96.8	97.9	4100	83.4
FTSE 100 (Dec 19)	232	235.2	7097	215

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	-0.551	5.53	8.1	9.55	12.5	4.42	7090.4
S&P 500	-0.144	10.6	14.2	30.8	99.4	103	4226.5
iShares FTSE UK All Stocks Gilt	-0.802	-0.865	-6.25	-6.5	6.37	13.7	1374.88
VIX New Methodology	-1.62	-35.5	-20.6	-36.4	16.6	7.39	16.42

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Volatility

Just a few months ago, excitable crypto types were suggesting that digital currencies such as bitcoin might at some stage replace traditional safe haven assets such as gold. Jump forward a few weeks and I tend to hear much less of this excitable chatter.

Bitcoin prices are moving around like a yo-yo on speed while gold prices seem remarkably stable. According to John Reade, Chief Market Strategist at the World Gold Council gold prices seem to be forming a steady upwards pattern –the chart below could easily be cited as evidence. The green lines represent the 200-day moving average, the red line the 20 day moving average.

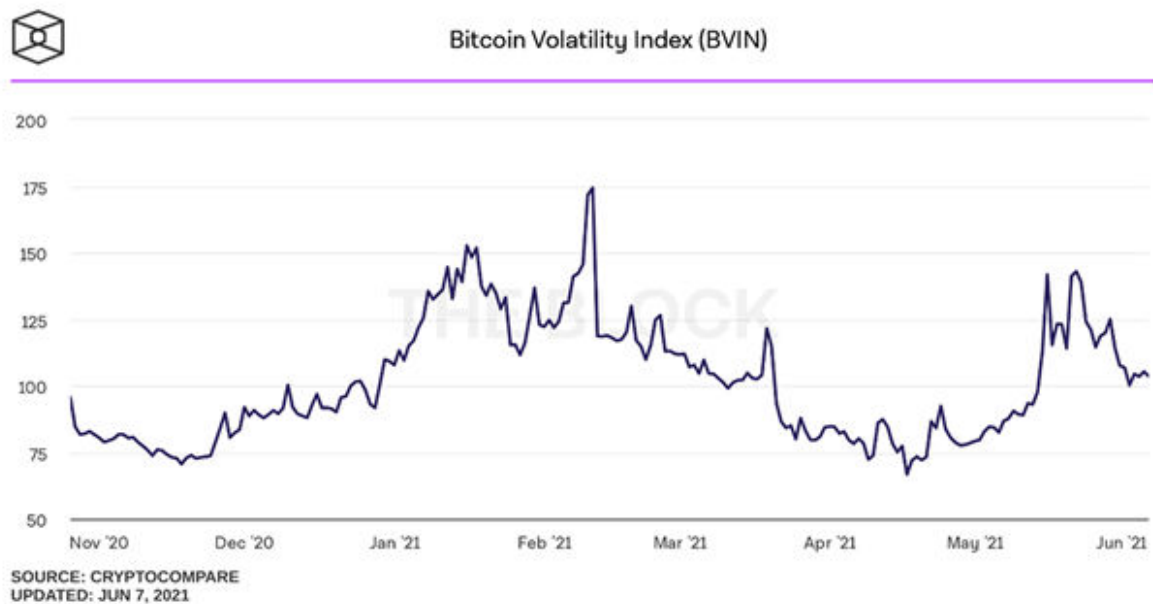


Reade notes that gold has moved higher and is now above its 200-day moving average for the first time since early February. According to Reade "Buyers have returned to physically-backed

Exchange Traded Funds - a key barometer of investor sentiment - and Net Managed money positions held on the Comex futures market jumped We believe investors started to cut gold holdings in November last year following signs that vaccines would soon start to end the COVID-19 pandemic. This profit taking, as investors moved to increase riskier assets, weighed upon gold but this may have run its course....With breakeven inflation expectations near the highs of this century while real Treasury yields sink to further negative territory gold is gaining traction from investors looking again to hedge against "interesting times."

By contrast over at Bitcoin, volatility levels are only now starting to die down after the recent blow out where plunges by more than 30% in just one day. The chart below shows Bitcoin vol index levels.

Let's just say that to my untrained eyes there's only one obvious *low vol safe haven asset* - and its not bitcoin.



Measure	June Level	May Level	April Level	March Level
Vstox Volatility	17.59	16.69	16.15	22.1
VFTSE Volatility	16.7	21.83	16.95	26.16



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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 its 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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