



## Monthly Market Report

July 2022



*With commentary from David Stevenson*

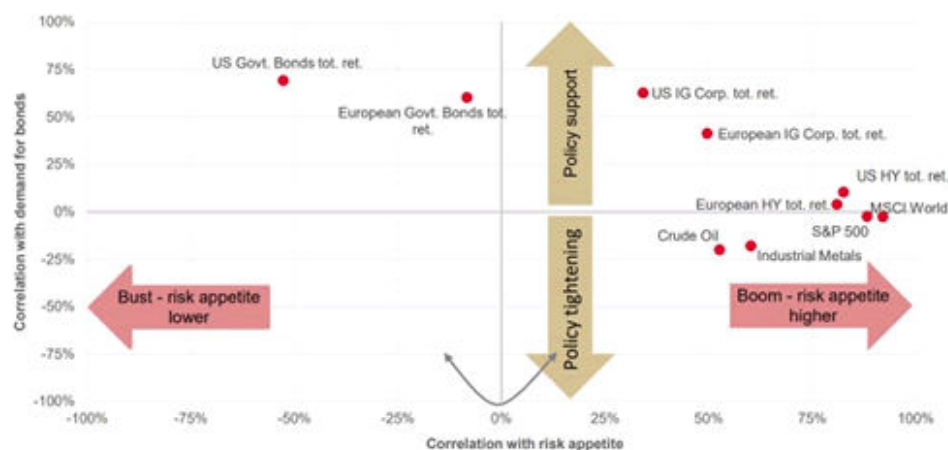
I have this working hypothesis which is that there are two sorts of bearish investor out there. The first sort is short termist and thinks that yes, interest rates are rising, and that we are a short step away from a slowdown which might turn into a recession. This group think that once we get to recession we'll see interest rates and inflation come down sharply and we'll be sort of back to a more normal macro economic regime.

The second group are much gloomier and think the paradigm is changing for the medium term. This group think globalisation is unwinding and inflation will be sticky and persistent. They also worry that the old monetary regime is dead and that we are into a new era of permanently higher interest rates, possibly above 3 to 5% for quite some time.

I have no fixed views on this difference of opinion. But the graphic below is I think a useful way of navigating the investment strategy choices. Its from a talk I ran recently with Andrew Lapthorne over at SocGen who was explaining to a select bunch of ETF buyers what were their asset allocation choices. I call it the Black Hole of Wall Street conundrum. It shows that there are things you can invest in if you think risk appetites are declining but policy support will increase. But what do you do if both the risk appetite is fading AND policy is tightening. You'll notice there is nothing in that box. Andrew suggests that various options based strategies might work, which helps explain why many investors I know think hedge funds might be a smart place. Or I suppose just plain old cash deposits.

## BEWARE OF THE BLIND SPOT OF TRADITIONAL ASSETS

A simple framework to think about macro risks



Source: Bloomberg, SG Cross Asset Research/Cross Asset Quant

Source: SG Cross Asset Research/Equity Quant, Bloomberg



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## Headline Numbers

A couple of weeks back Barcelona played host to the 23rd European Hedge Fund Forum in Barcelona. Nick Lawson from alternative investment house Ocean Wall attended - and has attended over the years - last week. His observations on the event are useful: "Despite the market backdrop the mood was upbeat as, of the 270 allocators present, over 65% are looking to increase their allocation to hedge funds for the rest of 2022". Morgan Stanley set up electronic voting throughout the conference for allocators and released some of the data afterwards. This chart below I found especially interesting: maybe the black swan event is an imminent Chinese recession?



One other noteworthy observation - "Also mentioned as a worry to investors yet to be fully appreciated was the human effects after Covid. One of the reasons for the labour shortage is people choosing not to be available as well as a de-skilling."

It's striking that as many investors pull out of the US stock market, the executives running American businesses are piling in. They are rushing to buy the dip essentially because, with their deeper knowledge of the firms they work at, they believe the company will exceed market expectations. More than 1,100 executives at S&P500 firms - such as Starbucks CEO Howard Schultz and Intel CEO Patrick Gelsinger - have bought shares in their own firms this May. The signs are this will be the first time buyers have exceeded sellers since March 2020. These corporate insiders correctly signalled the bottom of the bear market that year. The insider buy-sell ratio also jumped in August 2015 and late 2018, with the former preceding a market bottom and the latter coinciding with one.

The same applies on a corporate level. American companies have announced plans to buy back \$666bn of their own stock since January, 19% above what was intended for this stage in the year.

Current predictions are that companies in the S&P 500 will earn an aggregate \$248 per share next year. That means the index is trading at around 16 times profits - cheap by historical standards. Executives evidently believe they can deliver healthy profits despite all the large-scale downers, from the Fed raising rates to the problems with China and Russia.

## Ratio of Insiders Selling v. Buying

(Rolling 90 day lookback)  
Source: Fintel.io



Measure	Values as of 13th May, 2022	Values as of 2nd June, 2022
UK Government 10 year bond rate	1.72%	2.15%
GDP Growth rate YoY	8.70%	8.70%
CPI Core rate	6.20%	6%
RPI Inflation rate	9%	11.10%
Interest rate	1%	1%
Interbank rate 3 month	1.24%	1.42%
Government debt to GDP ratio	94%	94%
Manufacturing PMI	55.8%	54.6%

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## Bank CDS options

After a turbulent few month in the market for credit default swaps - essentially insurance against banks defaulting on their bonds - pricing steadied over the last month with most banks seeing a marginal decline in pricing for 1 and 5 year swaps. There were a few exceptions with both deutsche Bank and Lloyds experiencing very small, marginal increases in pricing although these increases were very small in size.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	19.56	48.96	A+	A2	A -
Barclays	34	73	BBB	Baa2	A
BNP Parabis	20.42	49.17	A+	Aa3	A+
Citigroup	50.47	100	BBB+	A3	A

Credit Suisse	57.1	122	BBB+	Baa1	A-
Deutsche Bank	76.76	149	A-	A2	BBB+
Goldman Sachs	51.41	104.96	BBB+	A2	A
HSBC	21.29	47.63	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	45.15	82.09	A-	A2	AA-
Lloyds Banking Group	17.84	43.54	BBB+	A2	A
Morgan Stanley	51.02	100	BBB+	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	22.35	75.7	BBB+	Baa1	A-
RBC	23.06	68.24	AA-	A1	AA-
Soc Gen	23.22	59.51	A	A1	A-
UBS	18.36	51.86	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st June 2022 [www.tempo-sp.com](http://www.tempo-sp.com)

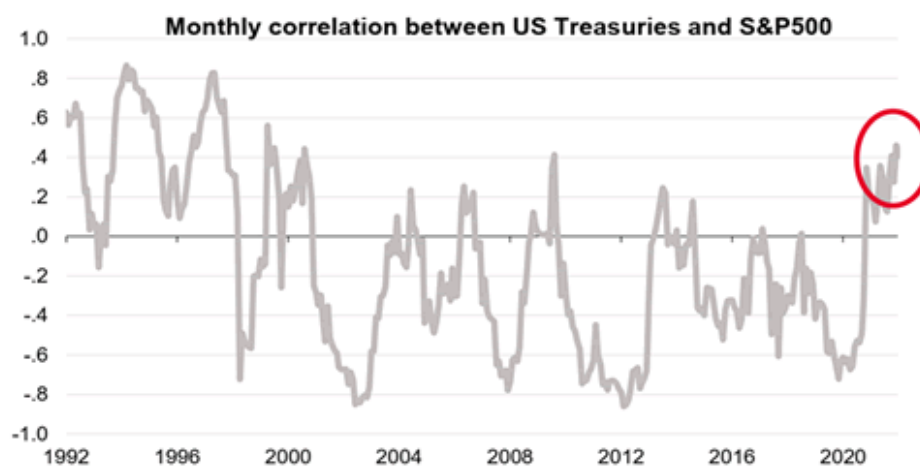
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## Government Bonds

### Fixed Income

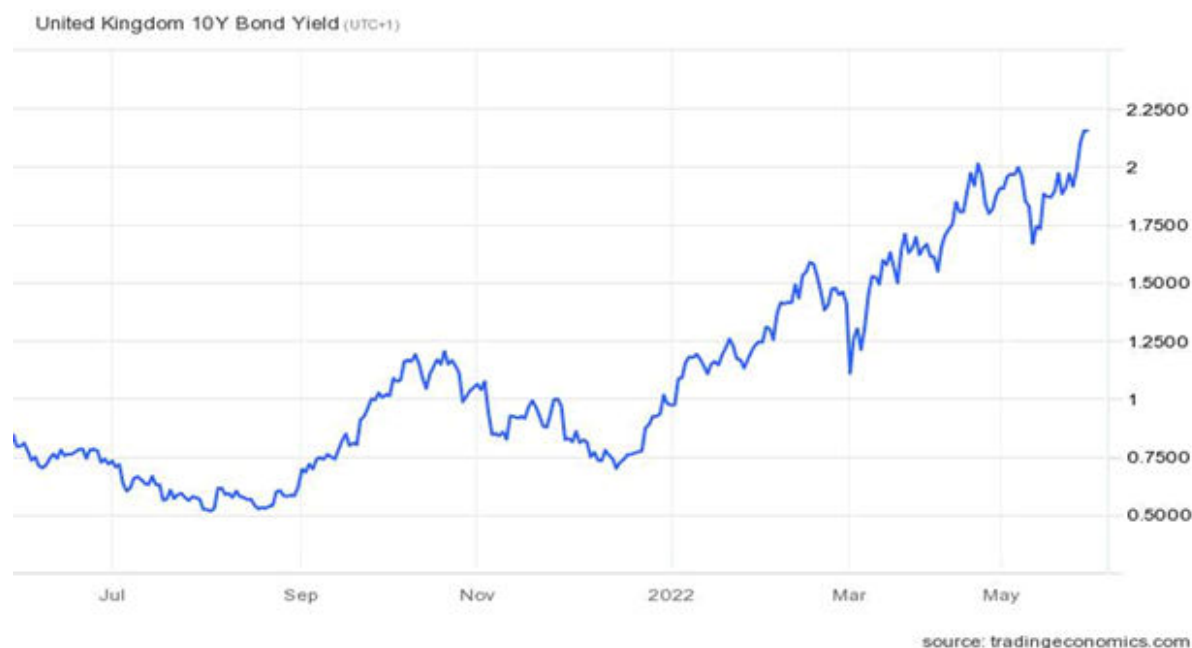
US treasury bonds are seen as the classic safe haven bet in times of bearish stress. In the 1990s particularly - and the extended New Normal of deflation - the correlation between the returns on 10 year notes and stocks hovered around minus 0.9, providing huge diversification benefits for investors. Now that relationship is switching again and as the chart below from SocGen shows, its shot back upwards - blunting any diversification benefits for equity investors. An extra twist is that this rise in correlations may also be the final undoing of the 60/40 portfolio strategy - maybe investors in a more inflationary world might switch out of Treasury notes and bonds into commodities ? One last observation. We shouldn't be surprised by the shift in correlations - the returns of long-term Treasuries were positively correlated to stocks throughout the 70s.

## Monthly correlation between US Treasuries and S&P500



Source: SG Cross Asset Research, Derivatives Strategy

## UK Government Bonds 10-year Rate 2.15%



source: tradingeconomics.com

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

## CDS Rates for Sovereign Debt

Country	Five Year
France	21.6
Germany	12.5
Japan	19.9
United Kingdom	10.94
Ireland	16.9
Italy	127
Portugal	52.3

## Eurozone peripheral bond yields

Country	May 2022	Junw 2022	Spread over 10 year
Spain 10 year	1.97%	2.33%	110
Italy 10 year	2.82%	3.23%	202
Greece 10 year	3.39%	3.70%	249

	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

I've always been very interested in Professor Andrew Lo's ideas around adaptive markets and the way that Professor Robert Shillers narratives play out. Markets and market sentiment as expressed through a consensus is enormously powerful i.e the market likes to tell itself stories about what a reasonable level for an index, and for market valuations might be.

Take the S&P 500 as a key, liquid, deep benchmark of global developed world markets. The index itself is just a composite of 500 different measures but the index itself has taken on a narrative and is trending. Investors look at it as an entity influencing individual stock level behaviour. One way this is concrete and tangible is the level of the index itself - barriers and thresholds become important.

Another way, arguably more important, is through valuation metrics. The average price to earnings level for the index helps to anchor individual stock measures and values. So currently the average PE for the market is around 20, give or take a bit. That says that anything much above that level is expensive and thus needs real growth to justify the valuation. But this individual index measure is also relative through time - when the PE gets too high (above 25/30) investors get nervous.

So, the relative valuation of the S&P 500 and its composite earnings streams matters. I've been busily crunching numbers, looking at total earnings per share for the S&P 500 since 1945 AND the composite price to earnings ratio, also since 1945. In addition, I have then extracted the years in which either measure declines i.e when earnings per share for the S&P 500 declines and years in which the PE ratio for the index declines. I could have gone further back to the 19th century but I'm not entirely sure that that is a useful exercise.

OK so what does this very simplistic data tell us?

Over the ensuing 76 years, we've had 27 years in which the S&P 500 EPS declines in value. The simple arithmetic mean is a decline of 15.4% in that year with one standard deviation at 16.7 which implies a 1 Sd event of a 32% decline. On a side note, the median decline was 11.36%.



Next moving to the years in which the PE ratio declined, we have 39 years where the PE declined - thus proving that not all S&P PE declines are caused by an earnings recession (markets just get overextended). The simple average decline in the PE ratio is 16.4%, with one standard deviation at 13.66 (implying a near 30% 1 SD outcome). The median is 12%.

So, let's translate these to the market at the end of December 2021 when earnings per share was 200 points and the PE on the S&P was 23.12.

I think it's fair to assume that a 15% decline in earnings per share is possible by the end of 2022 taking the S&P 500 earnings per share down to around 170 while the PE multiple might decline to around 19.4.

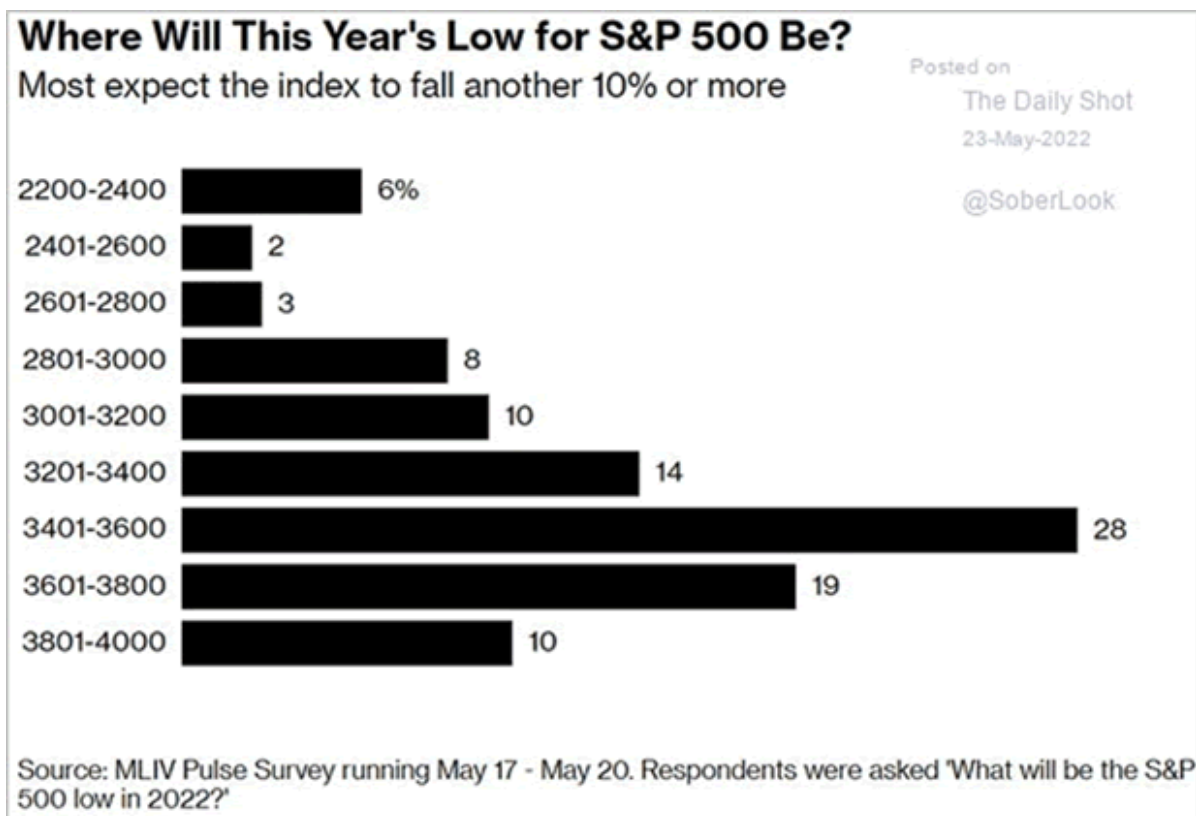
We're not that far off that PE multiple as we speak but its also reasonable to assume that earnings might fall H2.

If we take earnings per share for the S&P 500 at 170 and then times it by a trough PE of 19 we end up with a trough valuation of around 3250 for the S&P 500 compared to the current 3900. This implies a 17% decline from current levels.

This would also imply a peak to trough decline for the S&P500 of just over 30%.

These numbers feel about right for me. Obviously, this is a very simplified, nonadaptive way of looking at how markets work and I can anticipate all the obvious criticisms but it feels like we need to get PEs back around 19 on reduced earnings because of the imminent recession which will cut coming year profits growth.

And, slightly bizarrely, these numbers also accord with what the market estimates of where the S&P 500 might bottom out - as seen in the chart below from the Daily Shot. This suggests many market participants think a trough of around 3400 to 3600 is possible/likely. I'd be slightly more cautious than this but it feels about right.





Index	May 2022	June 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	119.2	120.6	3787	100.5
FTSE 100 Dividend Dec 2022	269.1	270.7	7352	243.8

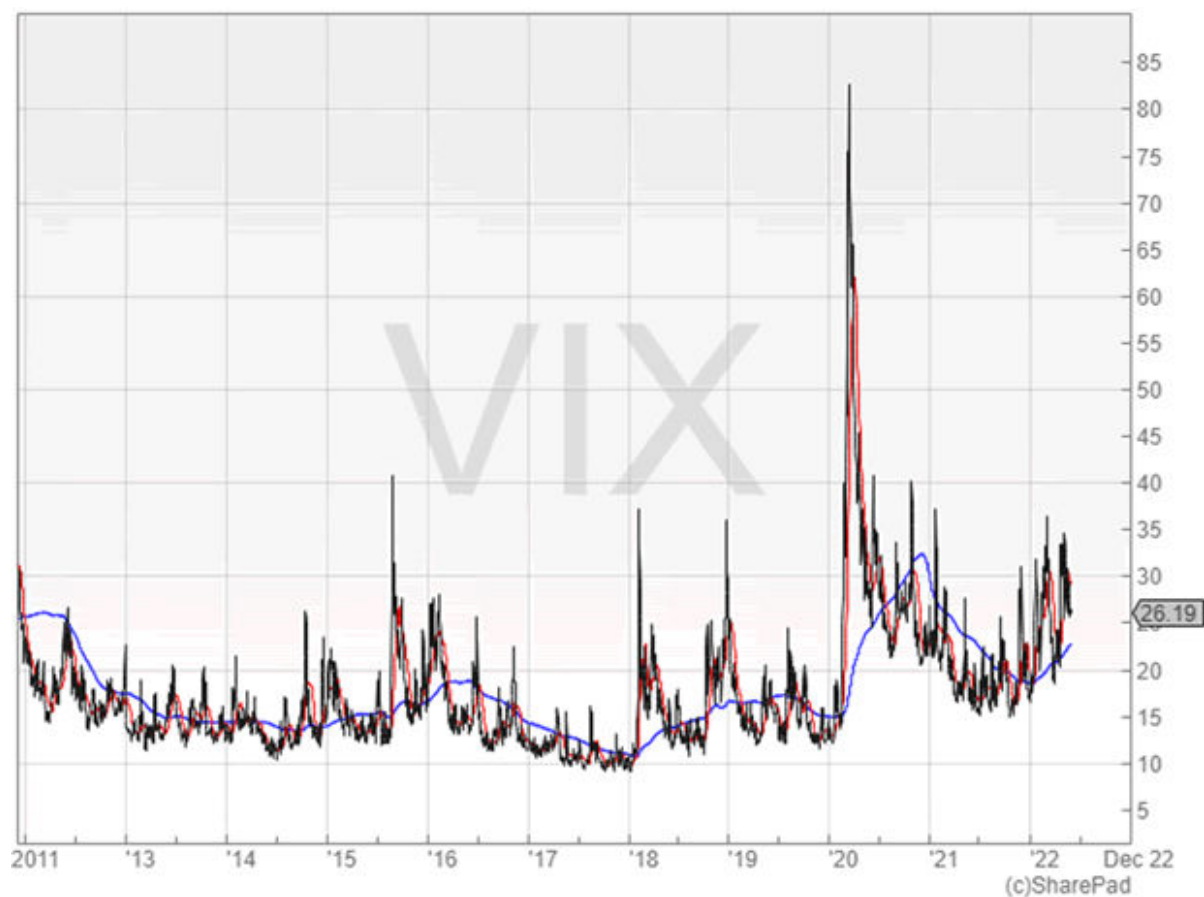
Note changed to Dec 2022 contracts in January 2022

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.154	1.39	5.66	5.98	0.194	21.8	7532.95
S&P 500	-1.3	-6.5	-10.4	-2.54	68.1	94.8	4101.23
Gold Composite (Most Traded)	-0.816	-3.84	4.86	-3.22	44.2	52.7	1848.40c
iShares FTSE UK All Stocks Gilt	-3.54	-9.69	-15.2	-12	-9.1	-5.72	1211.5p
VIX New Methodology	-19	-14.8	-6.3	49.8	169	92.1	26.19

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## Volatility

You might just have noticed that markets are in a turbulent, unsettled place. The chart below shows the benchmark US volatility index - which in turn tracks the ups and downs of the S&P 500. It shows values for the last decade, with the black line the Vix, the red line 20 day moving average and the blue line the 200 day moving average. What's very obvious here is that since 2020 we've seen a fundamental reset. Up until this point the Vix was settled into a low volatility regime - now it's a medium to high volatility regime. The Vix bottomed out at 16 on January 3rd and since then has only dipped below 20 on a few occasions in early January and in late March and April.



Black - VIX

Red - 20 day moving average

Blue - 200 day moving average

Measure	June Level	May Level	April Level	March Level
Vstox Volatility	23.92	29.61	30.01	38.91
VFTSE Volatility	26.19	31.77	24.37	30.23

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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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