UK Structured Products Association

Monthly Market Report
June 2020

With commentary from David Stevenson

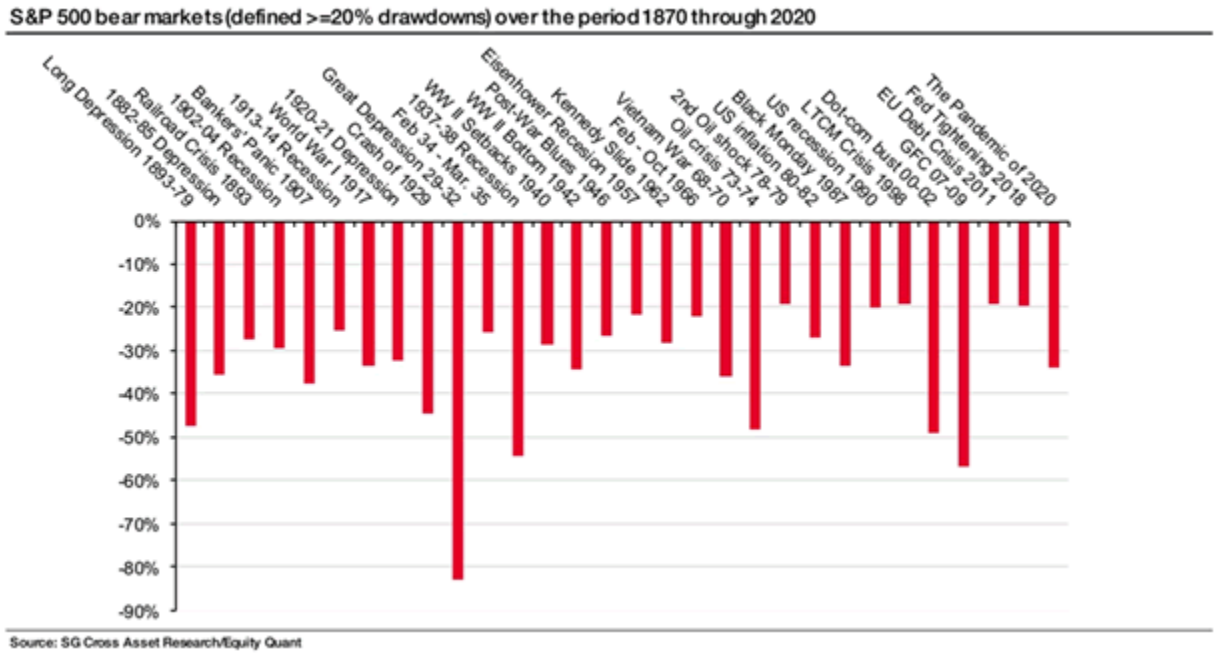
Bear markets over the last 150 years

As we head into May, more than a few investors I speak to are growing a tad nervous. They sense that markets might have got slightly ahead of themselves and are worried that once some of the more sordid realities of the Covid emergency become obvious - maybe no vaccine for years - sentiment might turn bearish again.

Alternatively the absolutely terrible news about GDP declines and galloping increase in the unemployment rate, might just do it for the bullish rally. No prizes for guessing that for my part, I'm supremely cautious. All of which raises the next obvious question. If the market does turn bearish again, how much lower might stocks go?

SocGen quant analyst Solomon Tadesse a few weeks ago put out a great little paper entitled "Beware of the oddity in this bear rally: lessons from 150 years of markets". This has done the work that many of us have wanted to do for the last month. He has delved deep into the annals of market history and looked at 150 years of bear markets. His main observation is that *"a recovery from a bear market bottom, both cyclical downturns and sudden market crashes, has often been gradual, with frequent adjustments along the way, reflecting the weight of uncertainty surrounding economic recovery out of the ashes of crises. In that respect, the ongoing surge in global markets strikes as an oddity, even after factoring in the massive bridges of support from monetary and fiscal stimulus. Based on an exhaustive analysis of bear markets of the last century and half, under the most conservative scenario - that the market has indeed reached cyclical bottom in the March sell-off - the S&P 500 would finish at about 2715 by year-end, a 7-8% cumulative correction from the current level of 2,939."*

More to the point, the chart below confirms what most of us have long suspected - that the peak to trough decline in most extreme bear markets needs to be between 40 and 60%, with 50% about right. The March correction does not even get remotely close to those levels.



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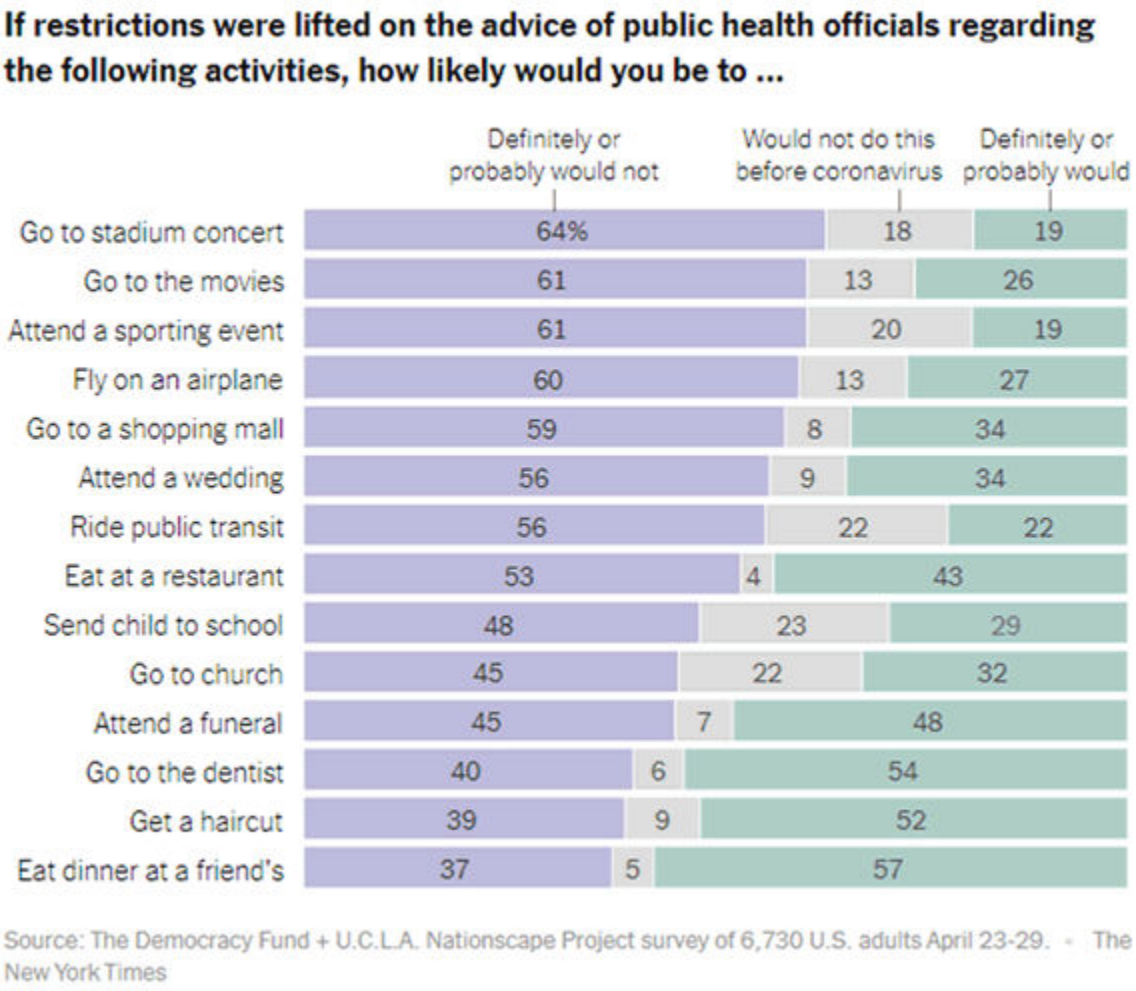
What might normal look like

Many investors are trying desperately to understand what the new normal might look like. Top of the list of questions is how will consumers react to this emergency ? Obviously we know that cruise businesses and airlines might be in for a rough few weeks, but what about broader consumer shifts in spending? As the days in lockdown go by, more and more studies are beginning to emerge that hint at this new normal. The chart below is from researchers writing a column for the New York Times. Its based on deep sampling of US consumer preferences and looks at how consumers might spend their time once they are released from lockdown, partially at least. The diagnosis for Hollywood, sports, airlines, as well as the owners of shopping malls, and restaurants is grim - even if released from captivity, consumers don't seem terribly interested in spending their money on these products. You can see the article that paints the broader picture here.



The age of the mega large cap

For the last few years there's been an idea doing the rounds in free market circles that capitalism is faltering, but not for the reasons that many on the left would have you believe. Variant Perceptions Jonathan Tepper has been especially cogent in arguing that capitalism has become too concentrated in a few big firms, verging into crony capitalism as these leviathans use their superior scale to buy regulatory influence. I think it's a very powerful argument and one that cuts to the heart of the current thinking of regulatory policy - rather than using a narrow test of consumer impediment, we should adopt a more expansive interpretation that looks at sheer market power. Tepper's Myth of Capitalism book makes this argument eloquently - his book is available here.

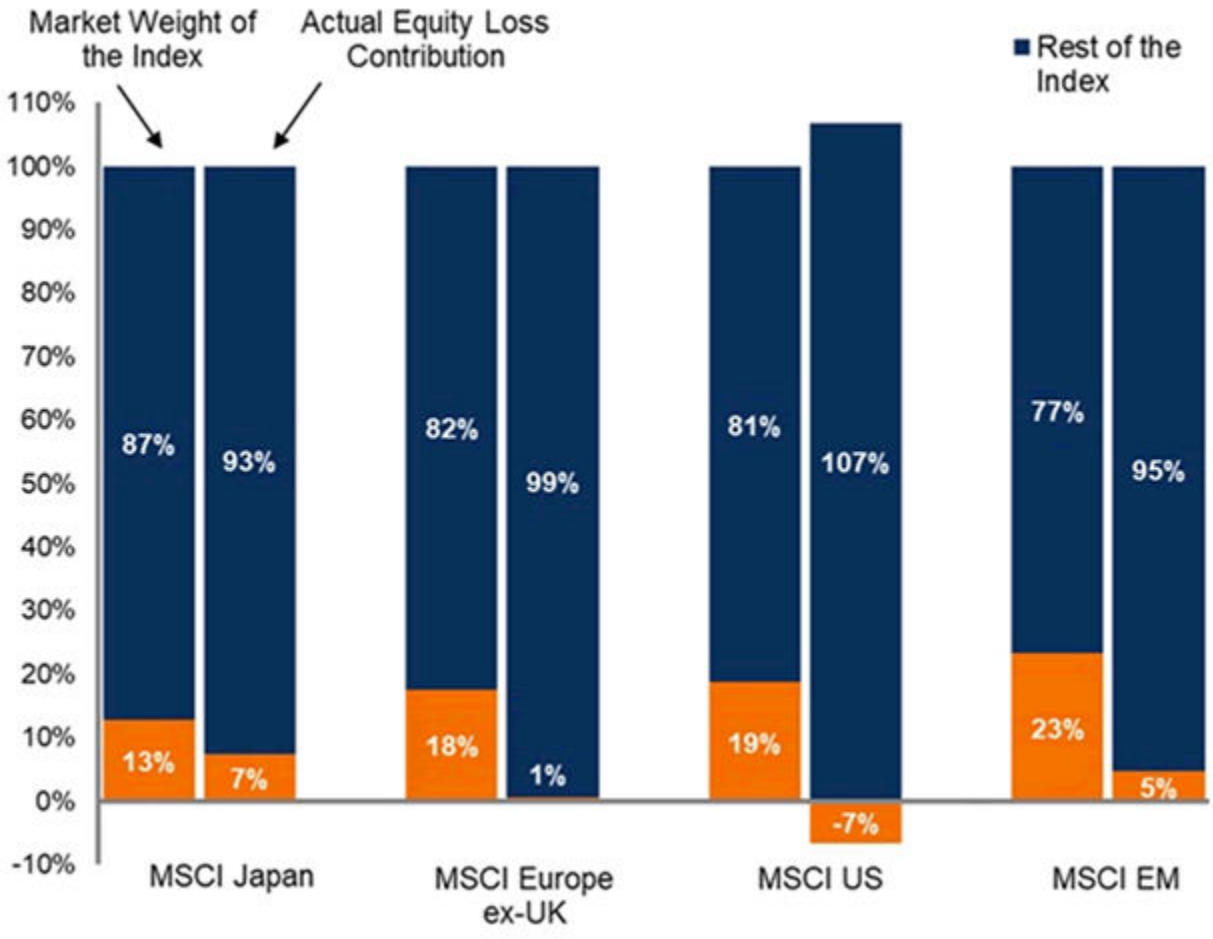
My suspicion is that the Covid 19 crisis will only make this problem much, much worse. Leviathan, mega cap businesses, especially those listed in the stockmarket have long had much easier access to wholesale markets where lending rates were already low. The viral crisis has simply intensified this scale advantage. In addition many, though not all, mega large caps have more available cash on their balance sheet which would allow them to survive longer in the coming crunch as the first phase of the virus mutates into a longer battle to keep infection rates down. It's also a sad truth that its very easy for the boss of a mega cap to pick up the phone to the BoE or the Fed and ask about a line of credit while the boss of a small or mid cap probably wouldn't even get past the switchboard, assuming they could find the right telephone number. Last but by no means least, its also obvious that leviathan mega caps will be busy using their lobbying power with big government

to protect their interests. Smaller businesses will be left scrapping for help form industry associations.

Another argument in favour of concentrated capitalism emerged in a comment this week from Ben Luk, senior multi-asset strategist at State Street Global Markets. Stockmarkets are increasingly rewarding the very biggest businesses with better share prices. His observation is that although the markets overall are still down 17% year to date, once you dig around in the numbers you discover that the losses have varied markedly between constituents, with mega-cap stocks (what he defines as the top five stocks across key markets, which makes up to 20 percent of the index) "showing little impact from Covid-19".

"In fact, the top five emerging market companies contributed less than five percent of the index's loss, relative to its 23 percent weight within the index. This number becomes more extreme for European corporates at one percent and even more staggering for the US, in which the top five actually recorded a gain but the rest of the index was responsible for 100 percent of the entire loss. Whilst most have suffered due to the virus, the virus has also solidified the mega caps!"

Is COVID-19 Solidifying the Mega Caps?



Measure	Values as of 20th April, 2020	Values as of 19th May, 2020
UK Government 10 year bond rate	0.32%	0.26%

GDP Growth rate YoY	1.10%	1.10%
CPI Core rate	1.70%	1.50%
RPI Inflation rate	2.50%	2.60%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.66%	0.37%
Government debt to GDP ratio	80.80%	80.80%
Manufacturing PMI	47.8	32.6

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Bank CDS options

Rates on credit default swaps fell pretty much across the board the last month with only bank experiencing a small increase on their 1 year swap rates - Deutsche. These declining swap rates for nearly every major systemic bank probably indicates that investors have, for now, been re-assured by comprehensive central bank intervention. That said rates are still at elevated levels compared to a year ago, which is entirely to be expected given the rising likely level of defaults in the coming 12 months.

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	46	95	BBB	Baa3	A
BNP Parabis	23	55	A+	Aa3	A+
Citigroup	58	82	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	46	95	BBB+	Baa2	A-
Deutsche Bank	199	228	BBB+	A3	BBB
Goldman Sachs	58	85	BBB+	A3	A
HSBC	22	51	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	39	61	A-	A2	AA-
Lloyds Banking Group	20	46	BBB+	A3	A+
Morgan Stanley	54	81	BBB+	A3	A
Natixis	34	46	A+	A1	A+
Nomura	40	95	BBB+	Baa1	A-
RBC	23	69	AA-	Aa3	AA

Soc Gen	24	57	A	A1	A
UBS	23	50	A-	Aa3	A+

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

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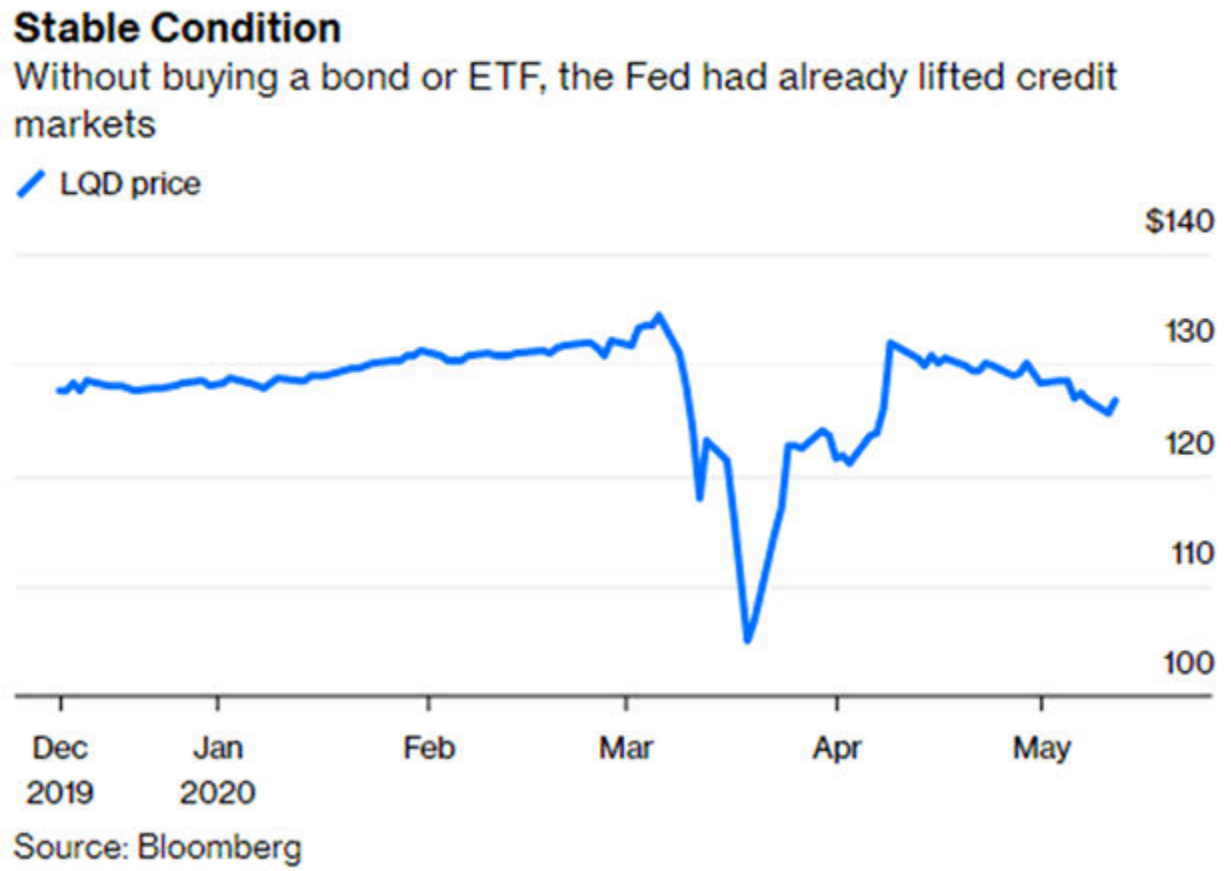
Government Bonds

Bonds

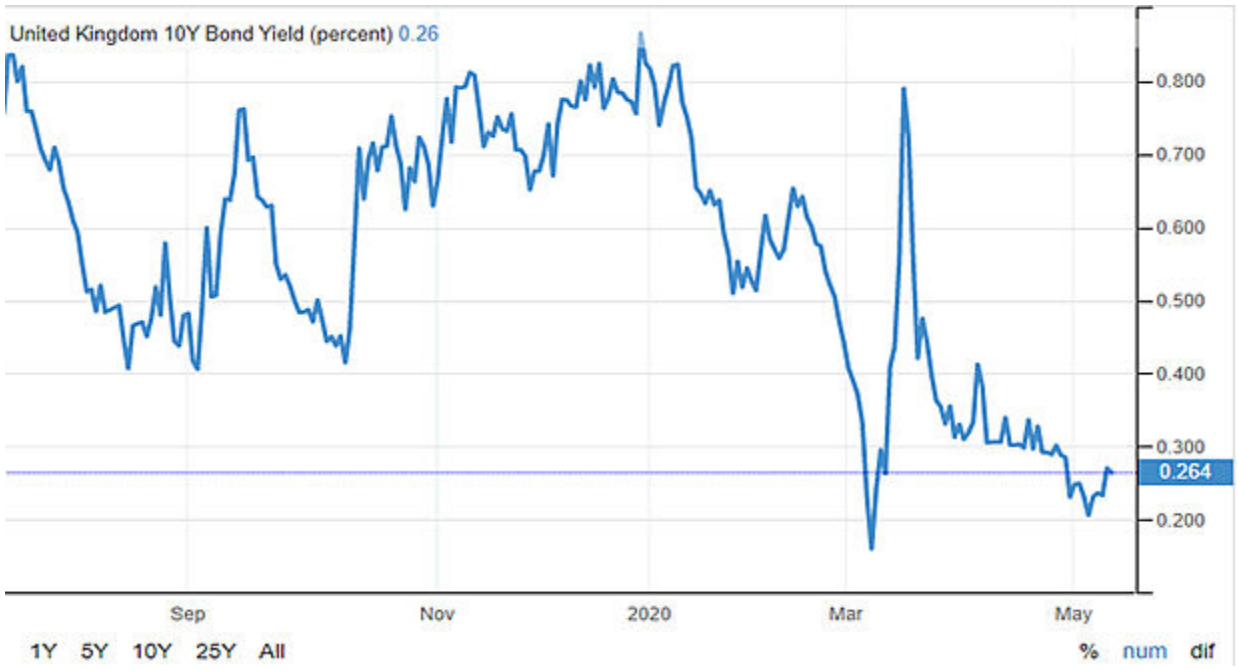
Many of us have been arguing for quite some time now that when the next crisis comes along central banks will bring new weapons to the fight, many of them based on ideas pioneered in Japan. First in the queue was the idea that central; banks would directly buy corporate bonds, and exchange traded funds - or perhaps a combination of both, namely corporate bond ETFs. Well, we didn't have to wait long. Back in in March, when faced by credit meltdown the US Federal Reserve announced that it might/would buy into corporate bond Etfs if it needed to, largely to stabilise crucial investment grade markets.

For the time being that promise of action seems to have worked. According to Bloomberg's Brian Chappatta "encouraged by the Fed's backstop, the final week of March catapulted supply to a record $260 billion, only to be topped by April's $285.6 billion onslaught. The first full week of May brought an additional $93 billion to market. Credit spreads are wider than they were before the pandemic, but on average remain 160 basis points tighter than their March 23 peak."

One way of seeing this in action is to look at the largest US exchange traded fund tracking the investment-grade market, known by its ticker LQD. The chart below shows the ETF plunged in value in March but is now in pricing terms not far off where it was before the crisis. That said the ETF is looking weak in technical terms - which is not surprising given all the macro economic certainty. Yet the truly amazing thing about this chart is that despite the promise, the US Federal Reserve has not actually bought any corporate bond ETFs (LQD included) , yet. That might change in mid-May but when the Fed opens its Secondary Market Corporate Credit Facility but so far just the promise of action has produced an astonishing bond market recovery.



UK Government Bonds 10-year Rate 0.26%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	20.14
Germany	23.6
Japan	33.68
United Kingdom	32.56
Ireland	41.2
Italy	233
Portugal	118
Spain	120

Eurozone peripheral bond yields

Country	April 2020	May 2020	Spread over 10 year
Spain 10 year	0.89%	0.79%	136
Italy 10 year	1.92%	1.88%	239
Greece 10 year	2.11%	2.11%	258

	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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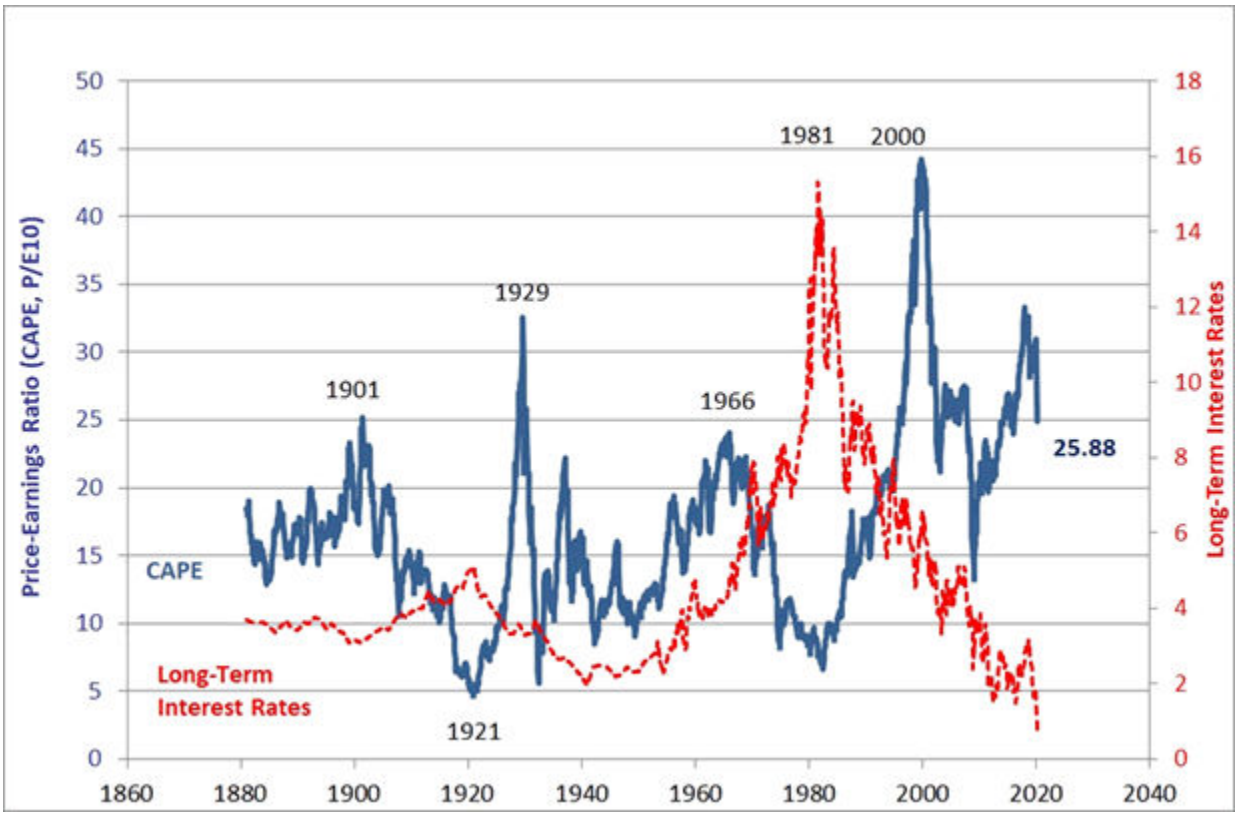
Equity Markets and Dividend Futures

Index	April 2020	May 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	68	81.7	2881	122
FTSE 100 (Dec 19)	160	177.6	5996	n/a

One of the more ironic aspects of the current market environment is that even after the correction, most analysts reckon that US equities are probably more than fairly valued - and that's being generous in the extreme. The first chart below looks at a useful long term measure of value - its produced by economist Robert Shiller and shows the long term cyclically adjusted price to earnings ratio for US equities in the S&P 500. As you'll see valuations have come down from recent levels but at 26 times long term averaged earnings, US equities are hardly cheap.



Which brings us to the current earnings season which is something of an oddity. Numbers reported on a backwards looking basis look more than half decent but in truth they are probably entirely irrelevant for some industries. According to SocGen's quant analysts the forward-looking numbers at the global level are falling sharply - as you'd expect. *"We are seeing almost 200bp cuts from 2020 global EPS expectations every week - and yes near-term forecasts are obviously seeing the biggest hit, with Q2 sharply down in April, but 2021 has also seen a 22% cut. At the start of this year, end 2021 EPS forecasts were expected to be 20% higher than the then end 2019 estimates; based on the latest estimates end 2021 forecasts have EPS down only a couple of percent on 2019, and that's after a rapid recovery in profits expected that year. The most remarkable number though is the valuations the market is putting put on these 2021 earnings, which at nearly 16x worldwide is a level rarely exceeded since the Tech-bubble."*

Back in Europe, the numbers look a tad more realistic. Here's the latest scorecard report from European equity analysts at Morgan Stanley - *"Current results imply a material EPS contraction of ~30% YoY at the index level, with expectations for 2Q already down to -40% YoY. At the sector level we note that Financials, Commodities & Industrials are trending down the most in YoY terms with Health Care names proving the most resilient."*

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	3.61	-21.7	-20.6	-20.5	-16.7	-15.2	5799
S&P 500	2.14	-15.9	-8.89	-0.34	33.8	51.9	2842

iShares FTSE UK All Stocks Gilt	0.30	5.57	7.7	11.2	22.2	30.5	14.97
VIX New Methodology	-20	138	171	98.4	163	148	32.61

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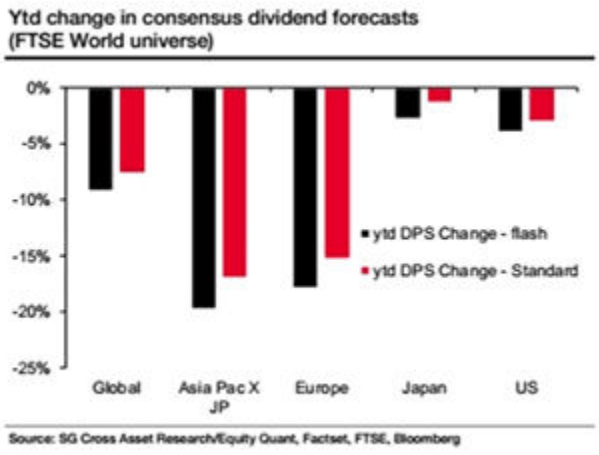
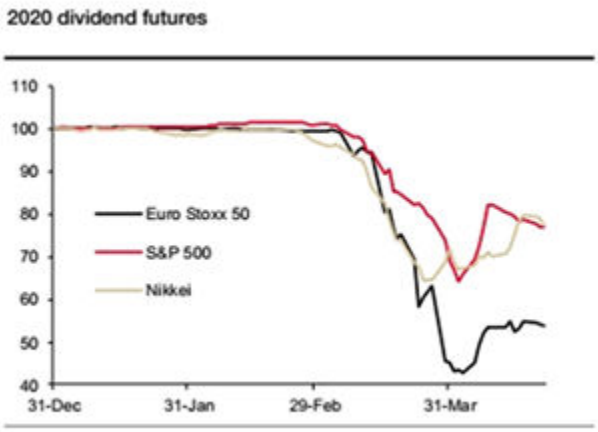
Volatility

Over the last decade, dividends have acquired a justifiable reputation for being boring. Businesses tend to be reluctant to cut dividends and by and large many focus instead on steadily, progressively, increasing the payout over time. Thus, dividends have become almost the definition of anti-volatility. Steady, solid, boring. Until now that is. Suddenly dividends have become in the Covid world arguably MORE volatile than the underlying equities.

Earnings have fallen off a cliff and taken with them dividends. Futures traders are now expecting a 50% decline in 2020 dividends in Europe versus a 20% decline in the US. 20% of Stoxx 50 and FTSE 100 businesses have already cancelled their payouts. Looking at the first four months of 2020 versus 2019 data from Bloomberg reveals that Stoxx 50 stocks have already cut their dividends by 39% FTSE 100 equivalent numbers are -17%). But looking at forward looking data comparing May 2020 with May 2021, the decline in the Eurozone expands to a stonking 57% decline, helped along with Eurozone banking dividends vanishing overnight.





Measure	May Level	April Level	March Level	February Level
Vstoxx Volatility	28	36.4	33.35	13.4
VFTSE Volatility	27.39	41.69	n/a	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. 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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