



Monthly Market Report

June 2021



With commentary from David Stevenson

The old idea of selling in May and coming back later in the year (September/October) hasn't worked out terribly well over the last few years. But 2021 might just be another year in which such simplistic strategies make their mark. Why my caution? Put simply there's another old adage which says that when the real economy starts to boom, investors divert their money to real world purchases such as new cars or holidays. This in turn links to what is in effect just a good old fashioned common sense idea. As money in people's pockets starts to burn a hole, consumers worry about moving quickly before PRICES START TO RISE. I put those last few words in capital letters to emphasise another increasingly obvious concern amongst investors - namely that more and more of us are beginning to focus our attention on leading inflation indicators. Now, I think its fairly obvious that given the pandemic bounceback plus Biden's reflationary stimulus, inflation is bound to tip up aggressively in the next six months simply as a result of base effects i.e prices that had been cut during the pandemic are repriced higher again. I think we are a long way from really having anything structural to worry about with inflation. But what I worry about and what the markets more generally are concerned with are two very different things. As long as enough investors think that the risks of sustained inflation are high enough, they'll worry in turn about central bankers starting to rein back in ballooning balance sheets and upping interest rates. That in turn might - just might - cause another outburst of taper tantrums. Which in turn might make the summer, with its cash leaking out into the real economy, a more challenging environment. And arguably that's what we need. For months now the markets have been 'seeing through' to a recovery, pricing that recovery in. Now that we're tiptoeing to that recovery point, the market actually needs to see those earnings and sales increases follow through. Once its banked those and stopped worrying about interest rate hikes, it might start to put its foot to pedal again. So, maybe its time to take that summer break!

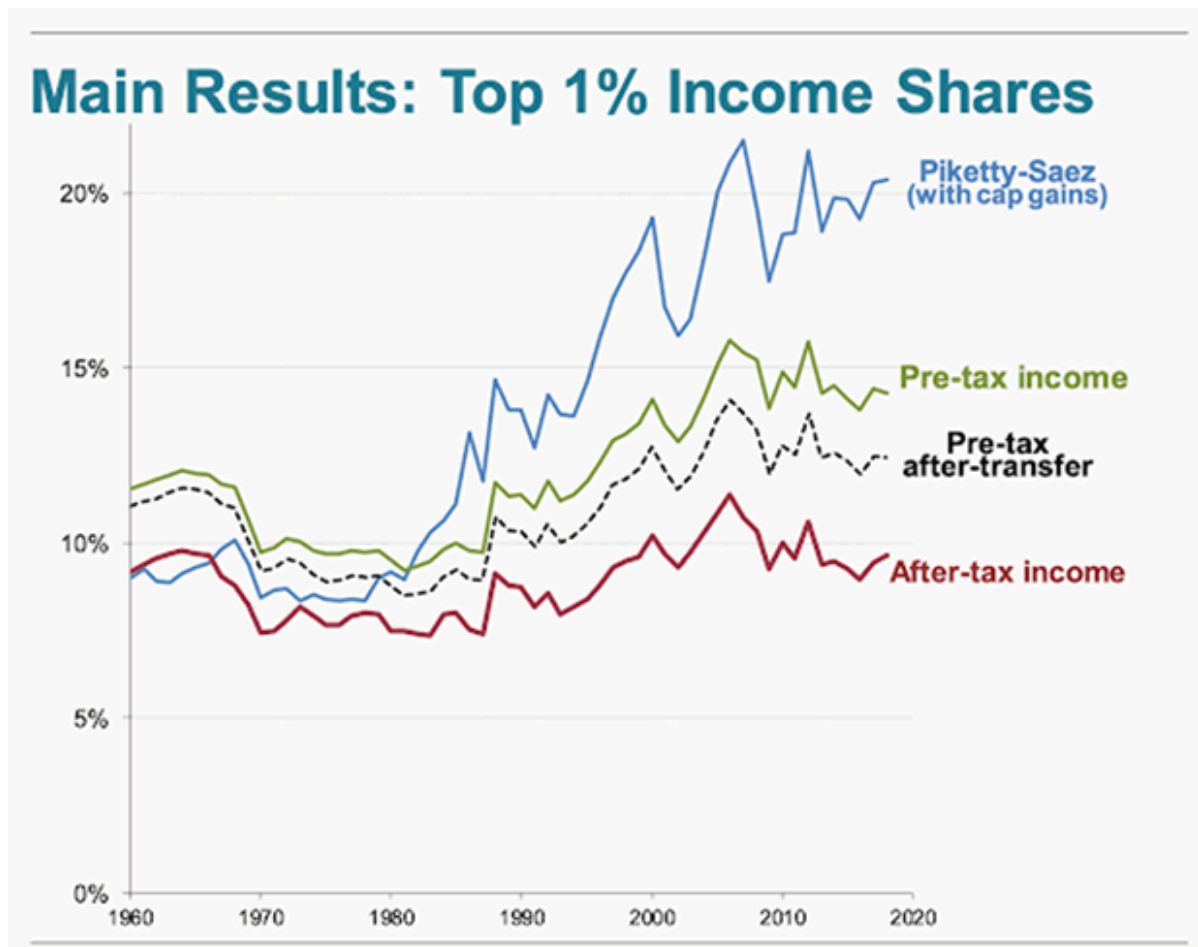
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Headline Numbers

Talk to many politicians, most of them on the left, and you'll rapidly run into the consensus view that inequality of wealth and income is the source of all our modern political scourges. I've never been entirely convinced of that view and I've also been slightly cagey about the supposedly overwhelming level of data that says we live in grossly unequal times. The conservative economist John Cochrane has just put out a detailed blog looking at inequality that is well worth reading. I recommend reading it in great detail, and Cochrane's own commentary is built on research by David Splinter and Gerald Auten. The key chart is the one below : it looks at income inequality in particular.

Cochrane's summary is as follows: *"In their careful redoing of the numbers, the top 1% share of income has barely budged since the 1970s. (And, by the way, if you think the mid 1970s economy was the great happy prosperity we should try to reestablish, you're too young to remember the 1970s.).... Piketty/Saez leave out many kinds of income. Auten Splinter attribute all national income to somebody. Before 1986 many wealthy people were incorporated. Leaving out corporate income biases the early shares down. Auten Splinter fix that. Pre-tax and transfer income! Who cares about pre-tax income! Auten Splinter calculate income after taxes at the top -- lower -- and including transfers at the bottom -- higher. Demographics. Marriage rates have fallen, so Auten Splinter calculate income by individuals. Benefits! They include benefits like employer-provided health insurance."*



There's another story lurking behind this analysis highlighted by Cochrane. Those in society who have accumulated great wealth have radically changed in recent decades. The investor Paul Graham has a very interesting take on this - you can see it on his blog called PaulGraham.com.

Here's his key insight : "In 1982, there were two dominant sources of new wealth: oil and real estate. Of the 40 new fortunes in 1982, at least 24 were due primarily to oil or real estate. Now only a small number are: of the 73 new fortunes in 2020, 4 were due to real estate and only 2 to oil. By 2020 the biggest source of new wealth was what are sometimes called "tech" companies. Of the 73 new fortunes, about 30 derive from such companies. These are particularly common among the richest of the rich: 8 of the top 10 fortunes in 2020 were new fortunes of this type."

So, should we all be worrying about the imminent arrival of surging inflation ? If these inflation numbers start rising too aggressively, markets will start to fear that the US Fed will turn hawkish, rates expectations will creep up, taper tantrums will ensue and the real economy might start to become more fragile.

This brings us nicely to a term I hadn't heard before - sticky-price indices. This was introduced earlier this month in an NYT Online column by Paul Krugman. The longish piece established that there is a big difference between "goods, notably things like oil and wheat, [which] have constantly changing prices" and other goods where changes in the base price is very rare i.e we see intermittent price adjustment. Those ordinary base goods will almost certainly increase in price in a reflationary environment but it's the sticky goods that we need to watch - if they start rising in price sharply, then we know we have a problem. There's a good summary of the economic literature on the subject of price rigidity here : [summary](#).

Unsurprisingly the US central bank watches these numbers using a measure called the "Sticky Price Consumer Price Index" which tries to sort out goods and services by how frequently their prices change. You can see the [live feed here](#).

The current chart is below - my amateur reading of it suggests that there are some warning signs but that there is currently zero evidence of a bigger problem. Maybe all that exuberance in the stockmarket is warranted!



Measure	Values as of 7th April, 2021	Values as of 11th May, 2021
UK Government 10 year bond rate	0.79%	0.83%
GDP Growth rate YoY	-7.30%	-7.30%
CPI Core rate	0.40%	0.70%
RPI Inflation rate	1.40%	1.50%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.09%	0.08%

Government debt to GDP ratio	100%	100%
Manufacturing PMI	58.9	60.9

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Bank CDS options

Most pricing for bank credit default swaps edged lower last month with Credit Suisse and Deutsche Bank experiencing the biggest declines - pricing for Credit Suisse is now close to its near term average while Deutsche Bank's return to more normal pricing for a global investment bank continues to grind on. Otherwise pricing for most other banks fell back marginally with Lloyds Bank regaining the lead as the bank in our table with lowest pricing for 1 year swaps at 8.93 basis points, marginally ahead of Santander. By contrast for 5 year swaps UBS is marginally the cheapest at 28.9 basis points.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.96	31.58	A	A2	A -
Barclays	15.67	45.63	BBB	Baa3	A
BNP Parabis	9.19	31.5	A+	Aa3	A+
Citigroup	24.59	50.47	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	22.24	51.84	BBB+	Baa2	A-
Deutsche Bank	34.29	86.12	BBB+	A3	BBB
Goldman Sachs	24.67	52.47	BBB+	A3	A
HSBC	9.23	30.12	A+	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	23.53	43.48	A-	A2	AA-
Lloyds Banking Group	8.93	29.95	BBB+	A3	A+
Morgan Stanley	27.45	50.45	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	17.52	54	BBB+	Baa1	A-
RBC	18.4	54.54	AA-	Aa3	AA-
Soc Gen	10.62	33.35	A	A1	A
UBS	9.69	28.9	A-	Aa3	A+

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

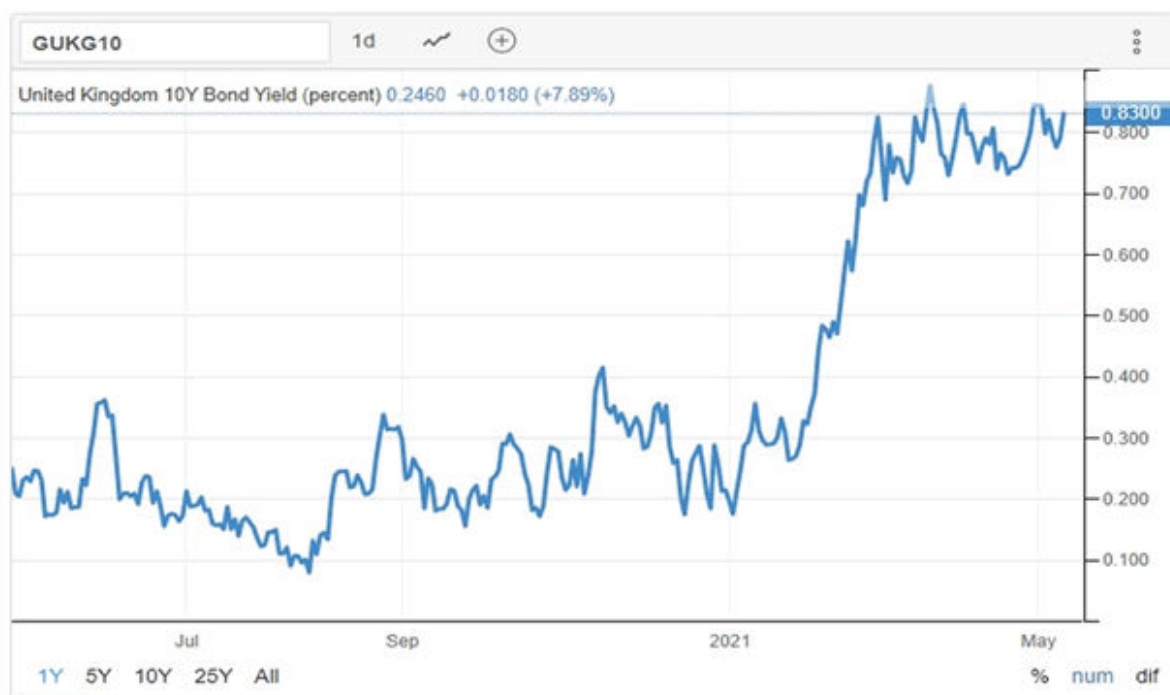
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Government Bonds

Fixed Income

Bonds continue to sit in the dog house for asset allocators but if we look at sovereign bonds in Europe, there are some interesting moves. Take Spain's 10 year bond yield - at the end of 2020 the yield was down to single digit base points but now its back up to 0.51%. The rise in Italian bond yields is even more stark. Ten-year yields are now a fraction under 1% up from 0.48% in February of this year. At 1% by the way, these bonds are now yielding the same as Greece, which readers will remember was formerly an economic basket case and close to default. But for me the most interesting 10 year yield is for German bonds which is now -0.16%, up from -0.54% in October last year. That's still a negative yield for sure but its edging closer to the symbolic 0.01% rate. Over in CDS spreads for sovereign risk I'd also observe that French rates have moved markedly higher, to 23.85 basis points while UK rates are moving markedly lower - too within spitting distance of German rates. To be fair, none of these moves in either 10 year rates or CDS rates is actually that seismic but they do suggest that investors view the continental European monetary and fiscal system with greater caution and wariness.

UK Government Bonds 10-year Rate 0.83%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	23.85
Germany	10.81
Japan	16.94
United Kingdom	11.34
Ireland	14.75

Italy	84.89
Portugal	31.2
Spain	34.28

Eurozone peripheral bond yields

Country	April 2021	May 2021	Spread over 10 year
Spain 10 year	0.33%	0.51%	67
Italy 10 year	0.66%	1.99%	115
Greece 10 year	0.85%	1.00%	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

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Equity Markets and Dividend Futures

April was, by and large, another good month for stockmarkets around the world. S&P Dow Jones reports that overall global markets gained 4.15% (after last month's 2.27% gain), as the YTD was up 9.10%. For the month, 40 of the 50 markets gained (with all developed markets up), up from 33 last month and up from 36 the month before that. The U.S. outperformed for the month, up 5.09% versus 2.95% for non-U.S. markets.

By contrast emerging markets posted a 2.76% gain for the month, after last month's 1.75% decline and the prior month's 1.45% gain, as the three-month gain was 2.43%, the YTD return was 5.33%, and the one-year return was 44.57%. The two-year return was 23.10% and the three-year return was 16.01%.

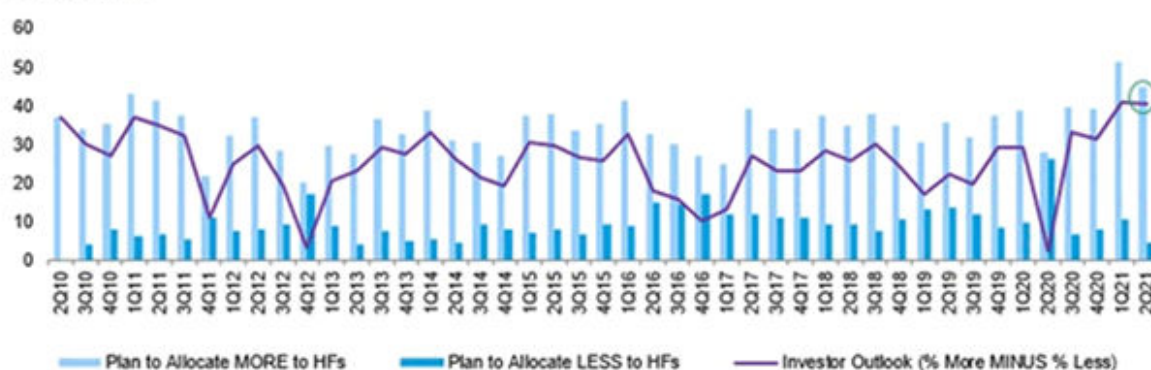
For April, 16 of the 25 markets gained, up from March's 11 and February's 15. **Poland** did the best, gaining 9.83% for the month, up 5.13% YTD and up 40.16% for the one-year period. **Greece** was next, up 9.04% for the month, up 14.73% YTD, and up 61.08% for the one-year period, followed by **Taiwan**, up 8.95% for the month, up 20.84% YTD, and 72.76% for the one-year period. Chile did the worst, falling 8.62%, up 5.62% YTD, and up 17.37% for the one-year period.

S&P Global Broad Market Index(BMI) Global				30/04/2021			
US \$ MKT Cap	Country/Region	FROM 11/3/2020	1-MONTH	YTD	1-YEAR	2-YEAR	3-YEAR
\$70	Poland	33.74%	9.83%	5.13%	40.16%	-7.15%	-15.60%
\$27	Greece	64.65%	9.04%	14.73%	61.08%	19.15%	-7.01%
\$1,450	Taiwan	42.22%	8.95%	20.84%	72.76%	80.73%	77.78%
\$471	Denmark	18.59%	6.90%	3.46%	50.16%	62.69%	58.51%
\$279	Finland	22.69%	6.56%	8.47%	49.72%	31.67%	14.71%

\$495	Brazil	28.06%	6.38%	-5.42%	46.54%	-9.35%	-12.76%
\$215	Belgium	26.69%	6.31%	4.75%	29.97%	-0.14%	-10.16%
\$2,000	France	33.16%	6.07%	10.59%	50.24%	19.86%	12.04%
\$190	Israel	27.14%	5.70%	6.73%	38.47%	28.59%	48.22%
\$262	Saudi Arabia	32.91%	5.49%	21.85%	49.58%	11.92%	28.58%
\$9	Czech Republic	41.45%	5.47%	10.28%	49.82%	5.92%	-6.75%
\$1,532	Australia	26.00%	5.38%	7.17%	52.50%	24.11%	22.87%
\$362	Singapore	34.82%	5.31%	14.54%	51.69%	21.77%	10.62%
\$89	New Zealand	11.15%	5.11%	-5.12%	38.67%	37.83%	50.91%
\$42,970	United States	26.30%	5.09%	11.49%	48.68%	44.16%	59.27%
\$55	Kuwait	13.60%	5.09%	11.12%	29.01%	10.83%	32.13%
\$489	Spain	32.31%	5.05%	6.53%	38.03%	-2.87%	-13.18%
\$863	Sweden	31.68%	4.94%	11.22%	71.66%	60.58%	60.49%
\$823	Netherlands	36.83%	4.93%	16.31%	71.75%	61.39%	61.15%
\$2,184	Canada	28.64%	4.43%	13.85%	47.65%	26.66%	27.53%
\$67,525	Developed	25.64%	4.33%	9.61%	46.03%	35.41%	39.46%
\$2,985	United Kingdom	29.73%	4.23%	9.79%	32.00%	0.92%	-5.42%
	Global	24.95%	4.15%	9.10%	45.85%	34.02%	36.78%

This growing market confidence is also obvious from the latest Morgan Stanley Prime Brokerage 1Q21 Global Investor Survey which was published earlier this month. This observes that investor sentiment remains near highs over the past decade. With regards to strategies, interest levels for Global Macro, Commodities, and Event Driven funds increased to recent highs, while interest for Credit and Quant Equity funds declined to multi-year lows. With SPACs in focus in early 2021, ~3/4 investors noted that they currently have exposure to SPACs, but interestingly, less than 20% of those with SPAC exposure plan to increase their allocations to SPACs in the next 6-12 months.

Investor Outlook: 2Q21 Outlook Remains Near Highs Since 2010; % Who Plan to Allocate More to HFs Falls QoQ
% of Respondents



Source: Morgan Stanley Prime Brokerage Investor Surveys

Note: Investor Outlook is measured as the difference between investors with a Better and Worse Outlook

And what about earnings? Deutsche Bank analysts report that S&P 500 earnings are on track for a fourth consecutive quarter of large beats. Breadth (86%) is running at the upper end of the range of the prior 3 quarters; and despite the record upgrade coming in, so is the size (20%). While the headline is boosted by Financials loan loss releases, even excluding them the beat has been big

(11.5%). Earnings beats have been broad based across sectors, while sales beats are at a new record.

The overall message is very bullish: Blended earnings growth is on track for a very strong 46% yoy, while sequential seasonally adjusted growth is on track for 20% qoq sa. All five of the groups of stocks and sectors in our earnings framework are on track for double digit sequential growth.



Index	April 2021	May 2021	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	95.9	96.8	3939	83.3
FTSE 100 (Dec 19)	226.5	232	6971	212

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	0.759	6.73	9.18	17.3	13.1	-0.877	6968.22
S&P 500	1.44	6.95	17.2	42.9	103	98.9	4188.43
iShares FTSE UK All Stocks Gilt	-0.56	-3.57	-4.31	-8.86	7.12	12.5	1375.75
VIX New Methodology		-21.5	-28.8	-39.5	13.6	20.5	16.69

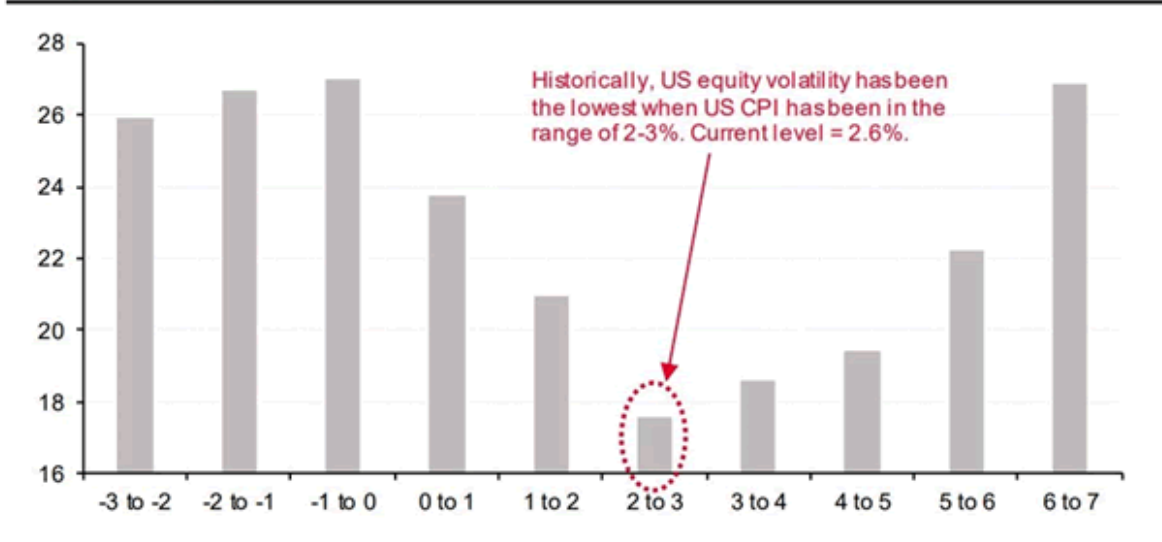
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Volatility

Analysts at French investment bank socGen have been looking at the link between varying inflation levels and stockmarket volatility. Calculating the average level of S&P500 equity volatility (VIX) for various ranges of US YoY CPI inflation, they find that the current level of US inflation (2.6%) is consistent with equity volatility at the lowest average level (around 17.5). Most analysts think that inflation rates are likely to head significantly higher in coming months, possibly above 3.5% and then 4%. What impact might higher inflation have on stockmarkets ? Nothing much, according to the SG analysts who've looked at historical data.

"When CPI moves from the 2-3% range to 3-4%, the level of VIX on average changes from 17.6 to 18.6. Even when CPI rises to the 4-5% range, VIX on average has stayed below 20. Au contraire, volatility markets are much more skittish when inflation moves below 2% or above 5%. In short, higher inflation is much less of a problem for volatility than lower inflation, and the bar for volatility to increase is quite high in a reflationary environment. We therefore believe that the ongoing normalization in volatility markets has further to run, and should not be truncated by higher inflation prints in the very near term."

Average monthly VIX distribution as a function of US CPI yoy



Source: SG Cross Asset Research/Derivatives, Bloomberg

Measure	May Level	April Level	March Level	February Level
Vstox Volatility	16.69	16.15	22.1	21.21
VFTSE Volatility	21.83	16.95	26.16	21



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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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To find out more about UKSPA, please visit www.ukspassociation.co.uk.

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