



Monthly Market Report

June 2022



With commentary from David Stevenson

This time it really wasn't that different. Professional contrarians such as yours truly had been wondering what the markets needed to jolt them back into reality. Inflation was rising, interest rates were rising, the Russians were stomping all over Ukraine and consumers were suffering and yet for much of the first quarter the stockmarkets continued to power ahead. That said the rot was already setting in for many tech stocks. I cover two particular niches within this broad spectrum very diligently - foodtech stocks and biotech firms. Both of these niches were showing signs of falling over as early as November and December last year. That malaise was spreading through the tech spectrum throughout the first quarter, but the large tech names seemed to be immune. Not anymore. We've all seen those tables showing the Netflix share price. But other big names have also been hit - chip designer Nvidia for instance has seen its share price decline 43% since the start of the year, while even boring old Microsoft is now down 22% YTD. But in early May the rot finally hit the main market - even many cyclical names in the resources sector in the US have now started heading south.

As I write, the S&P 500 has broken below the all important 4000 level, probably first making contact with 3900 but then heading back towards 3500. At 4000 the benchmark US index is down just under 18% from its peak, at 3500 its down just over 27%. But it would still be up 56% on the nadir of March 2020 - in fact it would only really have returned to levels last seen in February 2020.

The other interesting point to note is that the UK market is finally outperforming the US market. The FTSE 100 is down YTD just 2.69% versus a loss of 17.4% for the S&P 500. But that outperformance but is only because 1) sterling is falling like a stone and 2) our blue chip indices have plenty of resource led stocks. The more representative FTSE 250 index (representative of the UK economy that is) is down an eye watering 18% (worse than the S&P 500 for the record).

How much lower could markets go? If you don't think there's been a massive paradigm shift (stagflation, the end of QE and so on), then a peak to trough of somewhere between 15 and 25% would be fairly standard. For the US S&P 500 benchmark index that would imply a bottom around 3500. By contrast if we are in a proper paradigm shift with stagflation on the horizon and interest rates above 5% then I think we must be looking at a range between 25 and 45%, which would imply a bottom well below 3500 for the S&P 500. And if that is the case I can't see how the FTSE 100 will be immune from future pain.

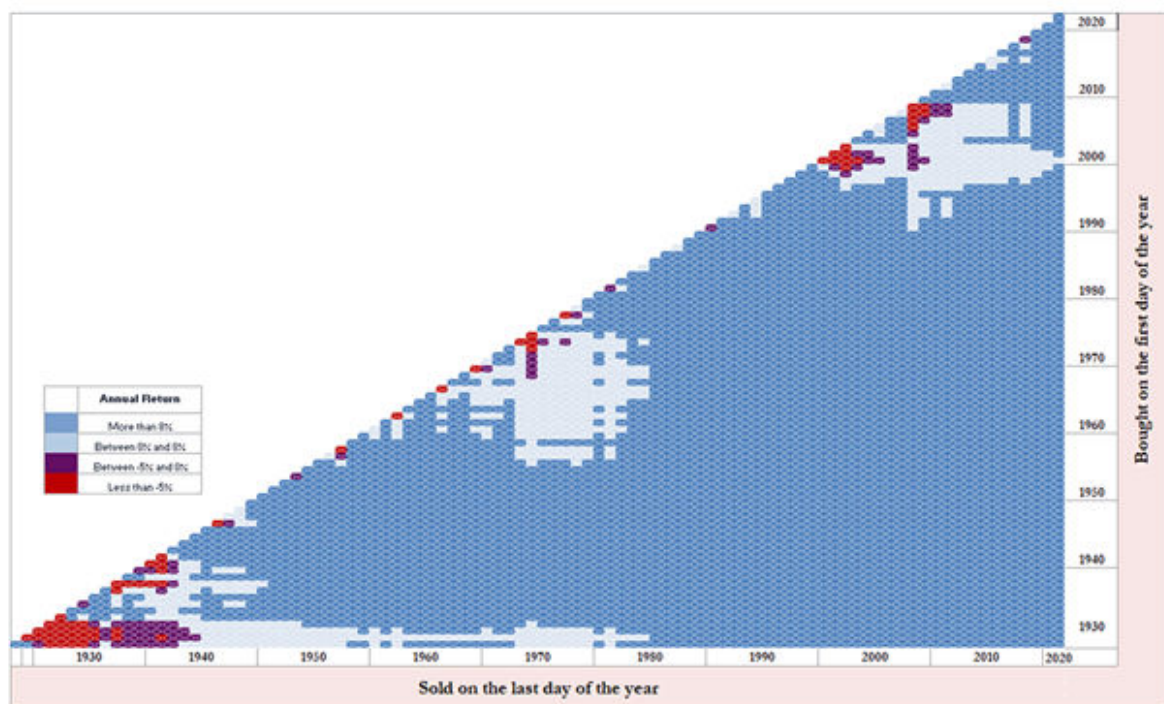
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Headline Numbers

It's easy to get carried all with the short term gloom but the message from most studies is that over the long term all this volatility does pay off. What matters is not timing the market but time in the market as the saying goes. Further proof for this comes a fascinating analysis from US firm J. Stern & Co which shows that investors who invested in the S&P 500 in January 2008, just before the global financial crisis, and who held onto their investments until the end of 2021, would have made an 11% compound annual return ('CAGR'). Over a much longer period, from 1928-2021, Stern's 'Return Triangle' analysis shows that the average CAGR over any 10-year investment period would have been 10.4% p.a., including dividends and before costs. The Return Triangle analyses the compounded returns of the S&P 500, the largest and most liquid global equity market, from 1928 to the beginning of 2022.



According to J Stern and Co, the blue blocks represent years when share prices have risen, the red blocks those in which they have fallen. Blue blocks overwhelmingly dominate, confirming that share prices rise more often than not.

"Equally significant, Stern's analysis shows that when shares suffer 'red' years - during the Great Depression, the dot-com bubble and/or Great Financial Crisis - it takes only a few years for investments to recover (and turn blue), highlighting the powerful effect of compound returns."

According to Christopher Rossbach, CIO at J. Stern & Co it's difficult to find periods over the last 94 years where an investor would have made less than 8% compound buying stocks - even if they had bought them prior to a horrible correction.

We've always understood that the stories investors tell themselves matter, if only because it helps explain investment manias. The economist Robert Shiller has taken that common sense insight and turned it into dense academic books. But this truism has always kinda lacked hard numbers. We know its true that investment narratives matter but unpicking the data is often really hard.

Liberum's strategy guru Joachim Klement has picked up on some academic research coming out of China which does pin some hard numbers on narratives impact in his latest blog [here](#).

The analysis was possible because of the coding system for Chinese listings which allows the academics to move beyond generic industry classifications and be incredibly specific i.e focus only on companies that make Covid masks for instance.

"The chart below shows the result of a strategy investing in stocks associated with narratives of rising popularity vs. stocks associated with narratives of falling popularity. The outperformance is a stunning 15% per year. While one can argue a lot about using the Chinese stock market as an example since the dynamics in that market are significantly different than in developed equity markets, the size of the outperformance is so large that it seems unlikely to be spurious. And indeed it seems likely to me that there is outperformance to be had in developed markets by investing in this kind of narrative momentum."

Performance of narrative momentum strategy in China



Measure	Values as of 12th April, 2022	Values as of 13th May, 2022
UK Government 10 year bond rate	1.80%	1.72%
GDP Growth rate YoY	6.60%	8.70%
CPI Core rate	6.20%	6.20%

RPI Inflation rate	8.20%	9%
Interest rate	0.75%	1%
Interbank rate 3 month	1%	1.24%
Government debt to GDP ratio	94.9%	94%
Manufacturing PMI	55.2%	55.8%

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Bank CDS options

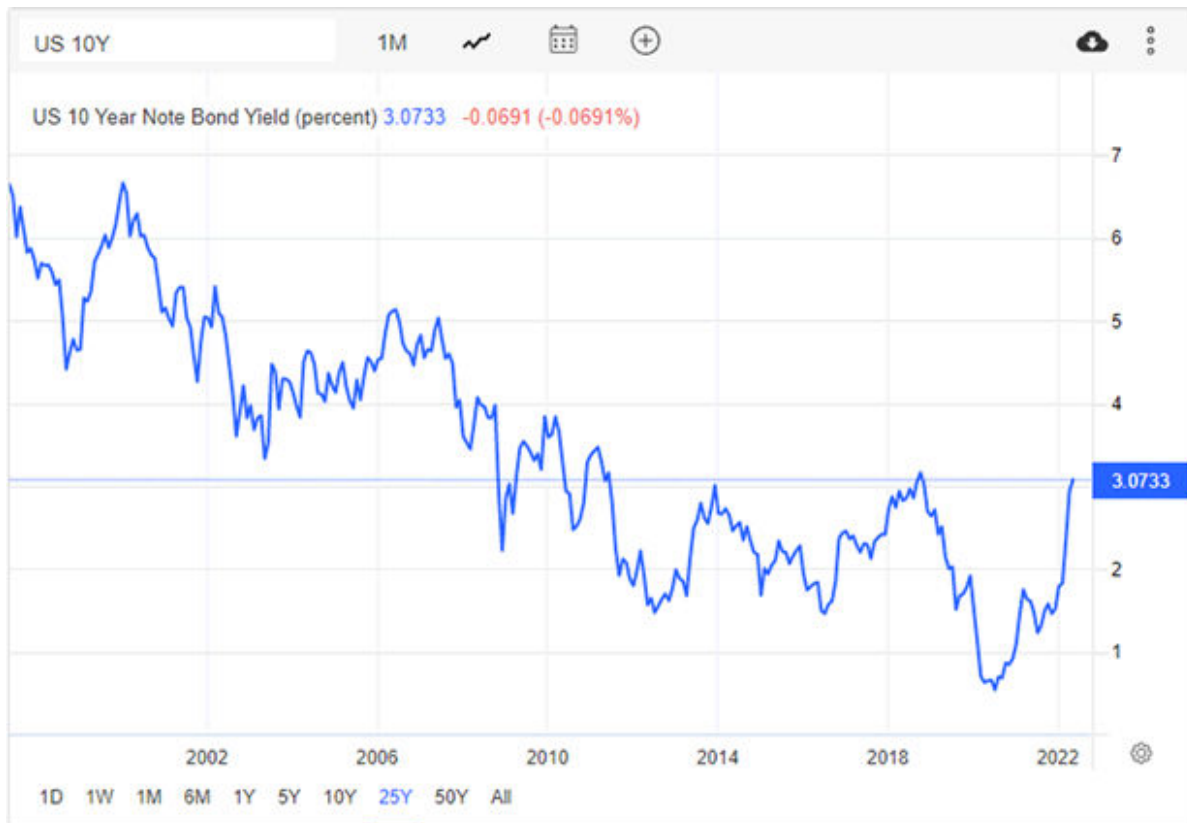
As you might expect pricing for credit default swaps for the major global systemic banks increased markedly over the last four weeks. The biggest increases were, again unsurprisingly, in the five year products which simply reflects growing uncertainty about the medium term. That said all bar two banks saw pricing on their 1 year swaps increase, fairly noticeably, across the board. The biggest increases were seen in pricing for Deutsche Bank - its one year swaps are back above 75 basis points (50 last month) and 5 year rates are above 150 basis points.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	21.44	52.59	A+	A2	A -
Barclays	37.94	74.15	BBB	Baa2	A
BNP Parabis	22.63	51.75	A+	Aa3	A+
Citigroup	54.53	107.94	BBB+	A3	A
Credit Suisse	64.85	125.52	BBB+	Baa1	A-
Deutsche Bank	75.6	151	A-	A2	BBB+
Goldman Sachs	53.4	108.92	BBB+	A2	A
HSBC	21.55	47.07	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	47.93	87.07	A-	A2	AA-
Lloyds Banking Group	16.8	42.34	BBB+	A2	A
Morgan Stanley	53.6	104.86	BBB+	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	22.33	75.69	BBB+	Baa1	A-
RBC	23.04	68.19	AA-	A1	AA-
Soc Gen	25.16	61.63	A	A1	A-
UBS	21.36	55.4	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st May 2022 www.tempo-sp.com

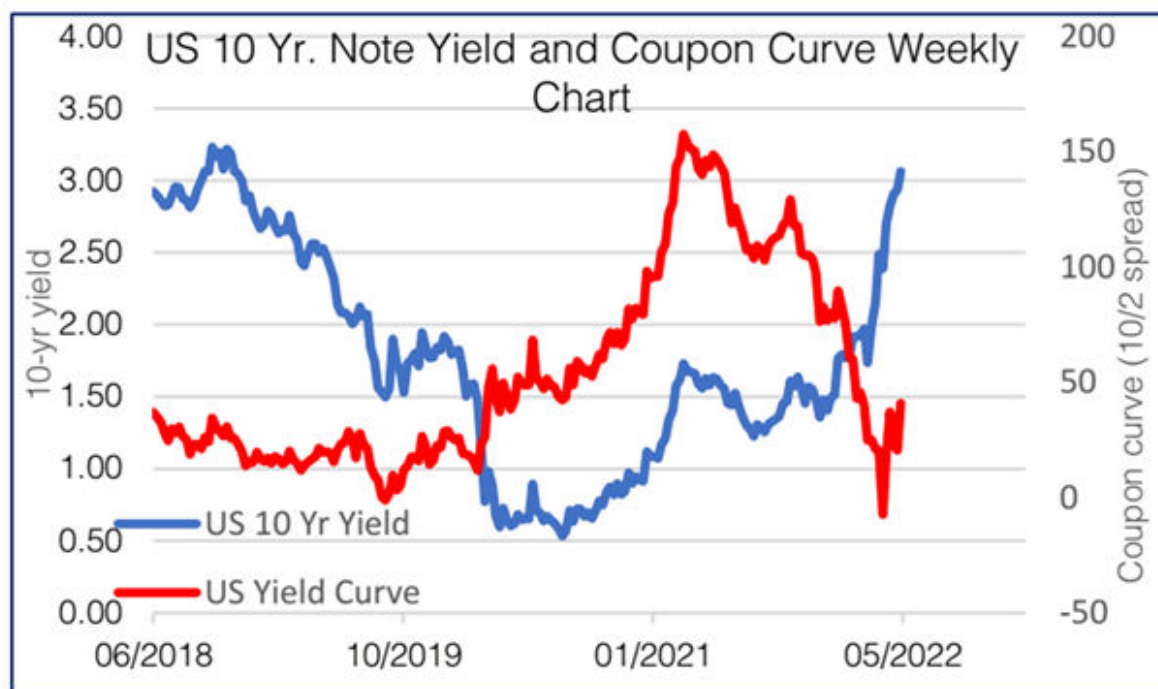
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Government Bonds



The yield of US 10-year Treasury bonds has finally pushed past 3%, as evidenced in the first chart above. It sounds a small, diminutive number, especially in historical terms but the 3% barrier is crucial. In simple terms, the next stop is 4% although many investment strategists such as Albert Edwards at SocGen think progress will probably stall above 3.5%, largely because by then we'll be in the midst of a recession.

The second chart below is from Gerry Celaya of investment research house Tricio Advisers. It shows the US 10-yr. note yield (blue line) and the coupon curve (spread over the 2-yr. note yield, red line). Celaya is much more cautious about what might happen next - he reckons the next big technical break is above 3.25% last seen in 2018. He reckons that a "break of this level would leave chartists looking for 3.75%/4.0% and then up to the 5% area as the next big areas to watch out for. On the view that the 2-yr. note yield is anchored by Fed funds expectations (to a large degree) then the curve is expected to steepen further. A push above the 50 bp area in the curve would open up 80 bp to 100 bp, and hopes of 150 bp would rise again".



UK Government Bonds 10-year Rate 1.72%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	23.5
Germany	12.9
Japan	20.7
United Kingdom	11.46

Ireland	16.4
Italy	123.4
Portugal	51
Spain	51.9

Eurozone peripheral bond yields

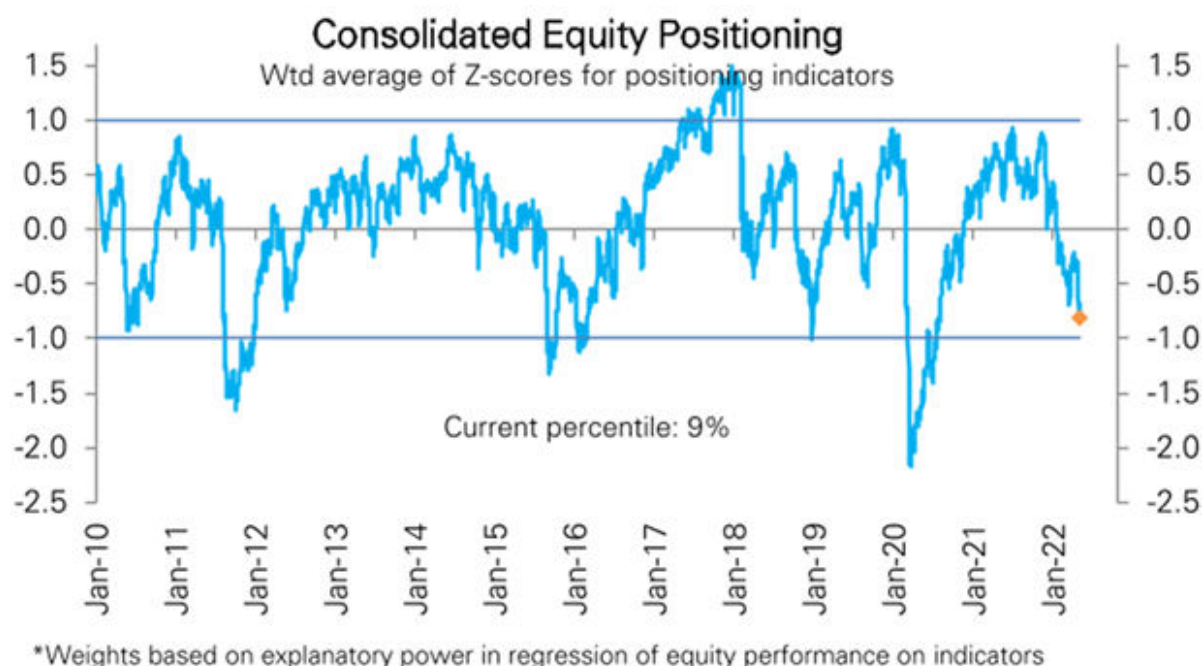
Country	April 2022	May 2022	Spread over 10 year
Spain 10 year	1.71%	1.97%	105
Italy 10 year	2.41%	2.82%	185
Greece 10 year	2.85%	3.39%	247

	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

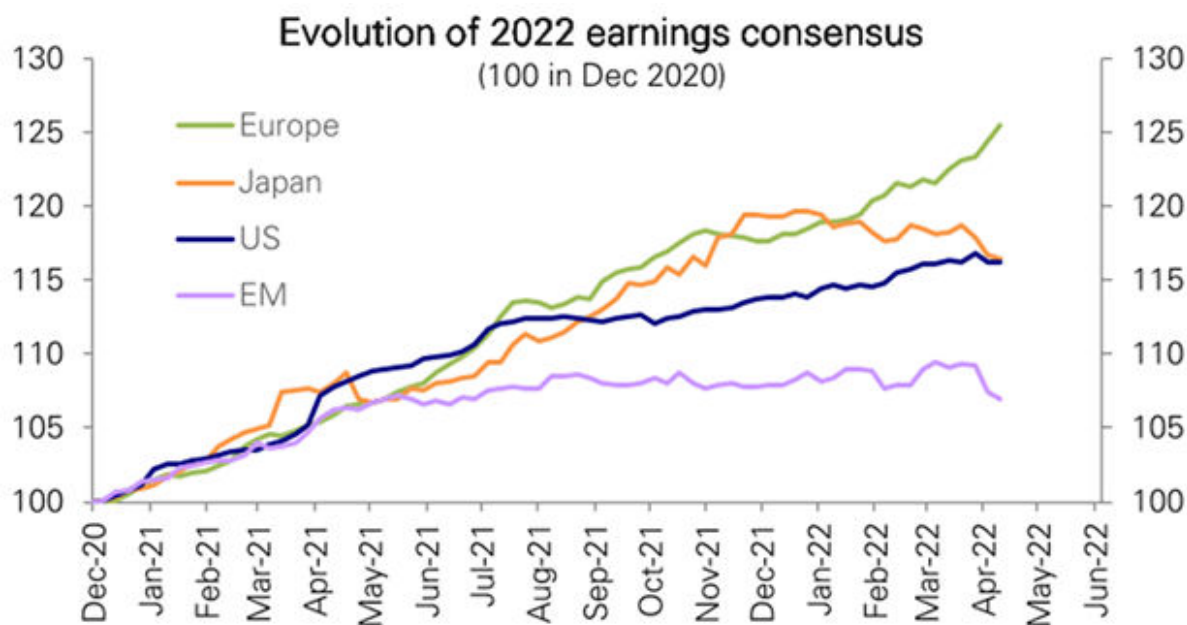
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Equity Markets and Dividend Futures

Just in case you hadn't noticed, investor sentiment is terrible, according to analysts who watch funds flows at Deutsche Bank. They report - per the first chart below - that aggregate equity positioning "in our read is nearing 1sd below average (9th percentile), a level reached only a handful of times over the last decade (June 2010 - double dip recession fear; August 2011 - US debt downgrade/European financial crisis; August 2015 - China devaluation; January 2016 - oil & dollar shock; the December 2018 selloff and the March 2020 pandemic crash)." Maybe on this basis there isn't much further to go!!



One possible source of optimism is that corporate earnings - a backward looking measure - are actually holding up surprisingly well. **Especially in Europe.** Again, Deutsche Bank analysts opine on the topic: "The earnings season is now nearly 90% of the way through in the US, three quarters in Europe, a little over half-way in EM and about 40% of the way in Japan. For the US, as we noted last week, the earnings season has been unusually noisy, but beats and growth were both solid outside of a few major outliers, and margins continued to be near record highs. Globally, for a second quarter in a row, **Europe is in the lead on almost every dimension. This quarter, it is even more remarkable given the breakout of the Russia-Ukraine war.** Across major regions, Europe has the highest beats on earnings, sales and margins, and the highest earnings and sales growth, in the aggregate as well as for the median company". So, maybe there's more hope in Europe. Perhaps.



Index	April 2022	May 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	118.5	119.2	3675	100.5
FTSE 100 Dividend Dec 2022	266.5	269.1	7361	242.7

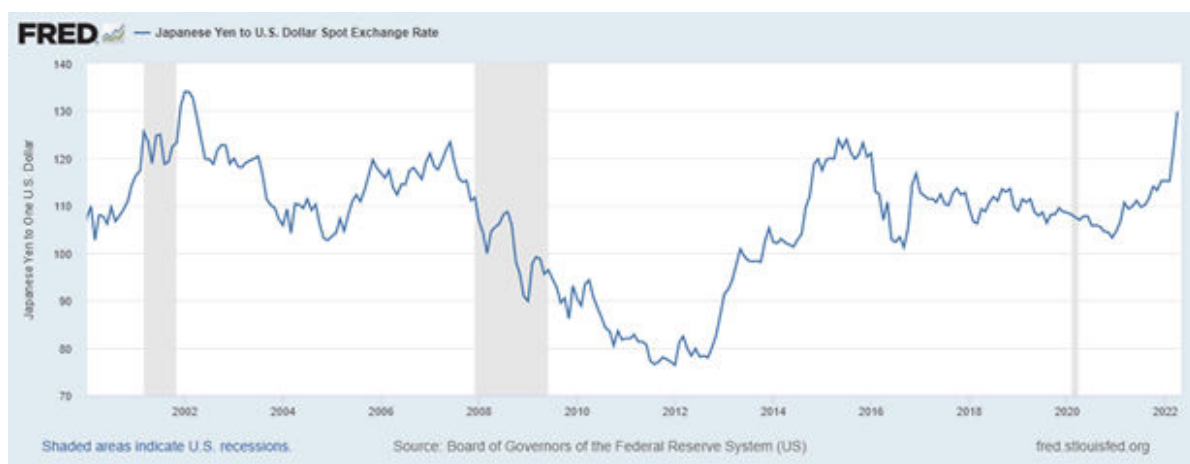
Note changed to Dec 2022 contracts in January 2022

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-2.88	-3.89	0.201	5.74	0.978	19.9	7362.69
S&P 500	-11.6	-11.1	-16.1	-4.44	64.4	92	3930.08
Gold Composite (Most Traded)	-8.07	-0.95	-2.35	0.0329	48.6	43.2	1824.60¢
iShares FTSE UK All Stocks Gilt	0.0395	-3.02	-9.33	-6.7	-4.43	-0.471	1267.5p
VIX New Methodology	45.6	16.1	95	37.4	205	111	31.77

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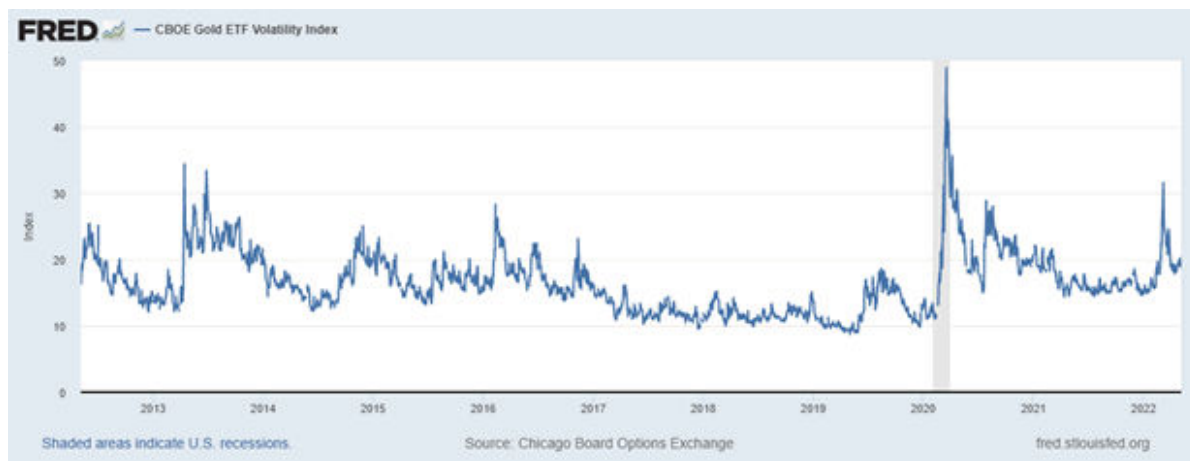
Volatility

Volatility within the foreign exchange markets is one of the best indicators of growing financial stress - and possible liquidity issues. On that score, the strength of the US dollar is drawing a great deal of attention. The first chart below from the US Federal Reserve shows the rapid appreciation in the dollar - and depreciation in the Japanese yen. The Bank of Japan's accommodative monetary policy is clearly weakening the yen, which is arguably good news for exporters, and bad news for imported inflation. And of course the Yen isn't the only foreign currency on the receiving end of selling pressure - our very own sterling is under tremendous pressure and could even push past the \$1.20 to the £ barrier.



This currency market volatility is one of many factors influencing an escalation in stockmarket volatility - the Vix has been trading in its top quartile range for much of the last few weeks and seems stuck above 20 points.

Yet gold market volatility, after a spike following the Russian invasion of Ukraine, doesn't seem to be way out of line with historic trends, as is obvious from the second chart below. Levels are elevated compared with much of the mid to late 2010s but not excessively so.



Measure	May Level	April Level	March Level	February Level
Vstox Volatility	29.61	30.01	38.91	32.85
VFTSE Volatility	31.77	24.37	30.23	27.36



Black - VIX
 Red - 20 day moving average
 Blue - 200 day moving average

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

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