To view this email in your browser, please click here

Monthly Market Report

June 2023

With commentary from David Stevenson

Corporates are OK

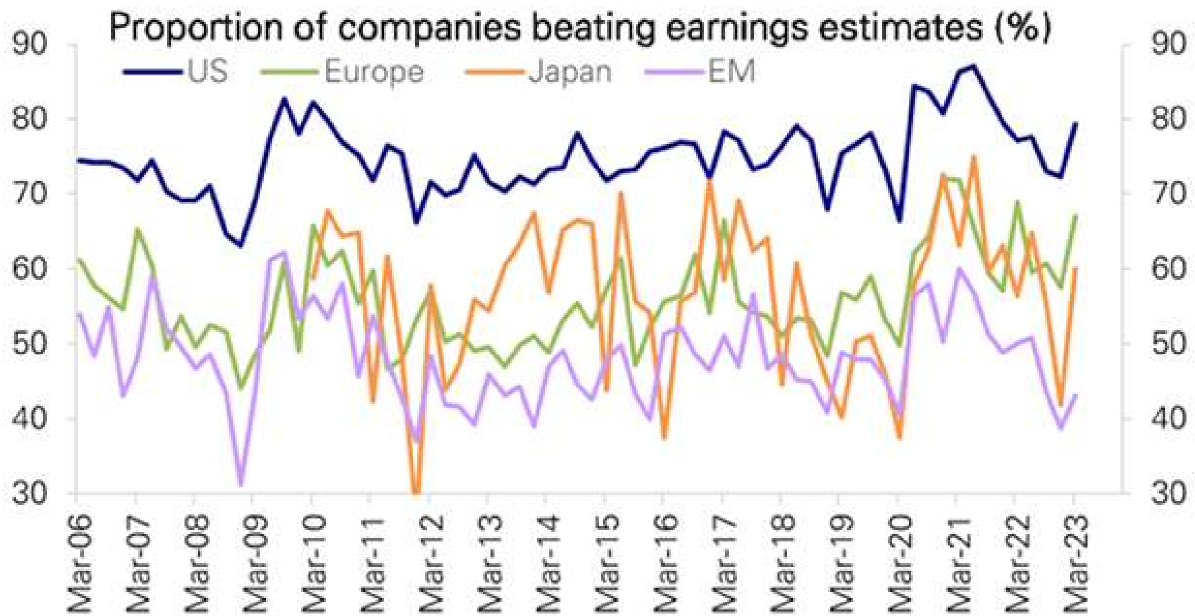
Here's a paradox. Look to indicators of sentiment - from investor positioning surveys and short positions through to social media aggregators such as Google Trends - and you won't be surprised to discover that the mood is bearish. There's copious talk of recession, cost of living crises, increasing interest rates and so on. Yet stockmarkets seem to be at the very least holding steady, in a sideways pattern, while some sectors such as tech are surging again. The bears are scratching their heads - me included - trying to work out why everyone seems so calm.

Yet the key weakness in the bear's case is that corporate earnings are actually holding up fairly well, both in the US and in Europe.

Let's start with the US first. As you'd imagine the big investment banks are keeping a beady eye on earnings from the big S&P 500 corporates, especially now that 60% of US equities have reported to date. Overall, the message from outfits such as Deutsche Bank is that although earnings growth remains weak on a year-on-year basis earnings are rising sequentially - we are seeing the strongest EPS beats in six-quarters with 82% of firms beating EPS (on lowered estimates).

In fact, there's evidence that US earnings are now rebounding fairly strongly from Q4 2022 to Q1 2023. None of this means that earnings estimates for the coming quarters aren't still being marked down but the pace of those downwards revisions is slowing. In fact, 2023 estimates in the US and Europe have ticked slightly higher as the Q1 beats have more than offset cuts to the forward quarters.

The consensus for 2023 growth remains near zero for the US and is slightly negative for Europe. In terms of sectors, the past four weeks have seen the most positive change on 12m Fwd EPS for Consumers (Disc and Staples), Industrials, and Tech - for energy and financials the earnings growth is negative. As for major listed corporates in Europe, the numbers also seem to be surprising on the upside. According to the highly regarded Graham Secker at the European equities team at Morgan Stanley in London, with 62% of corporates reporting so far, first quarter "numbers are currently posting their biggest beat in over 15 years. Crucially of those reporting 41% boast sales beat, moderating through the season. To be precise a net 41% of companies have beaten consensus expectations at the top line now, an outcome that is still above the previous quarter (25%) but below the first three quarters of 2022 (average 59%). The bottom line? Investors care most about profits and most large listed corporates seem to be in decent shape.



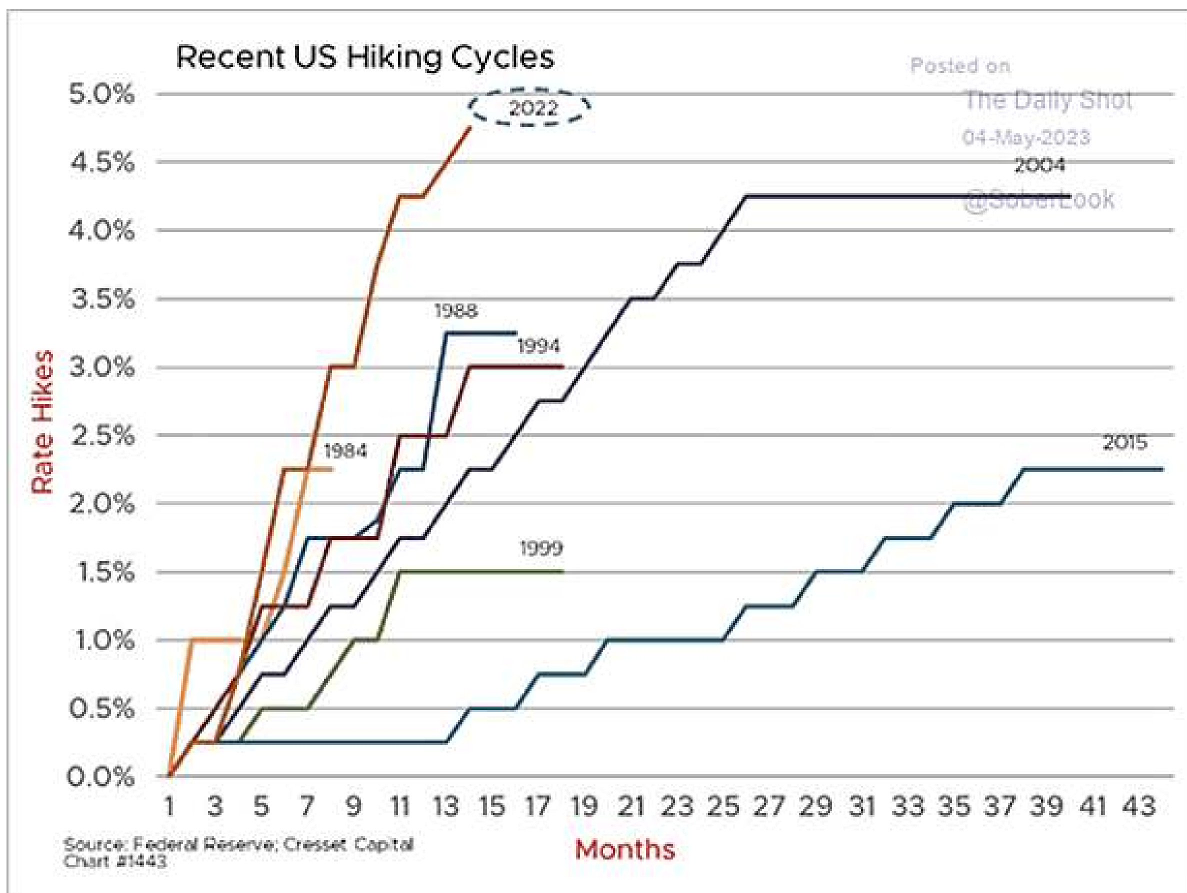
Contents

- Headline numbers
- CDS Rates
- Government Bonds
- Equity Markets and Dividend Futures
- Volatility
- Summary of Pricing Impact on Structured Products
- Explanation of Terms

Headline Numbers

One very steep curve

I find the chart below (from the Daily Shot website) absolutely fascinating. It shows the sheer quantum of interest rate rises in a historical context. Thus, when people shout that we live in turbulent times, as regards rates, they're spot on. We really are living through an enormous experiment. In fact, its hard not to look at this chart below and think a) my gosh that's steep and b) surely, it'll peak very soon and then come down rapidly. This is probably why equities have had a decent few months although it's also true that global equity markets are currently struggling to find direction. The slight fly in the ointment with this Panglossian way of looking at markets is that in no other era were interest rates so low, for so long. So the exponential increase is a mathematical necessity and tells us nothing about what might happen next.



The dollar is still King

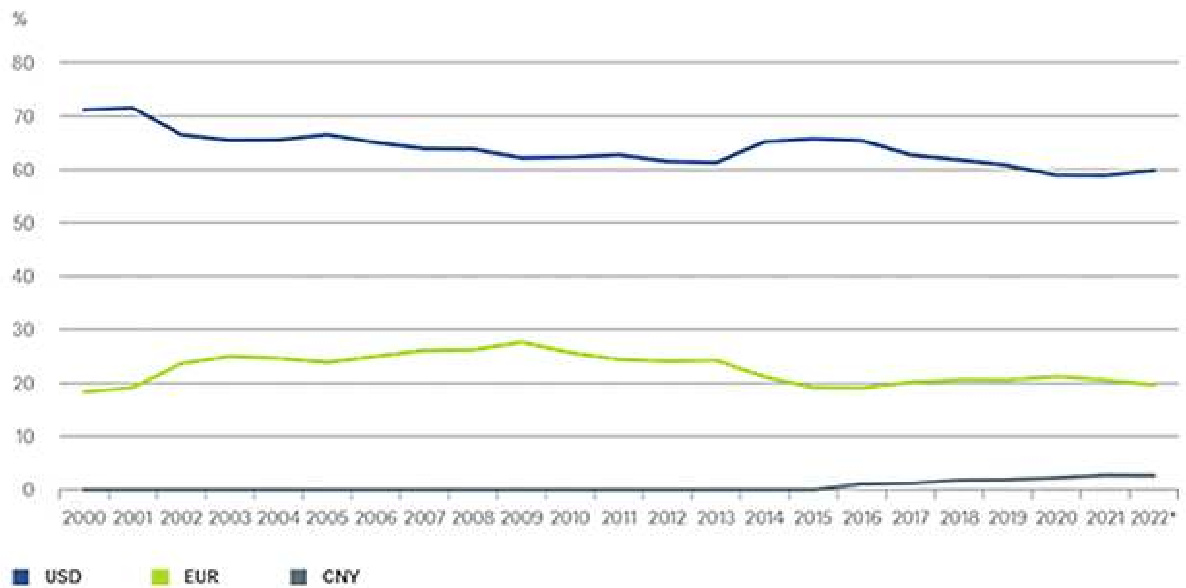
One of the central debates of our time is the focus on US assets amongst financial investors. Put simply, we're all a little bit too US-centric although that's only a function of 'following the money' i.e., US equity markets dominate developed world equities as do US bonds and dollar trade flows.

Thus, the endless debate about the slow demise of the dollar is in fact just a proxy for a much deeper concern with this US-centric worldview. If the dollar starts to fall from its hegemonic position, then maybe US equities and US bonds might follow. And of course, there's a geopolitical element to this - if the US is relegated from a dominant hegemon to a muti-polar world, then there are myriad political and economic consequences.

My guess is that multi-polarity is real and that the US dollar is not as hegemonic as it was, but it's also clear that the dollar is still pretty damned dominant on most common-sense measures. For instance take the dollar's role as a global reserve currency, where the dollar's share has declined once adjusted for price changes. But as analysts at DWS point out once we look at this in nominal terms, the decline doesn't look very significant at all! The chart below from DWS shows the currency reserves of central banks worldwide, as far as they are reported and can be assigned to a currency.

"It's a picture of stability, but depending on which starting year is used, it can certainly be used to tell stories about the dollar's decline. Questions such as "Will there be a dollar crisis?" and "What would be the macroeconomic scenario of a sudden collapse of the greenback value?" have not only been the subject of market chatter in recent decades but also of profound economic debates]. "We expect steady de-dollarization to continue in the coming years, reflecting in part the growth and increasing financial literacy in the rest of the world," argues Dr. Xueming Song, currency strategist at DWS."

Graphic: A reassuringly boring picture of the dollar holdings of the world's central banks



Measure	Values as of 14th April, 2023	Values as of 15th May 2023
UK Government 10 year bond rate	3.56%	3.80%
GDP Growth rate YoY	0.60%	0.20%
CPI Core rate	6.20%	6.30%
RPI Inflation rate	13.80%	13.50%
Interest rate	4.25%	4.50%
Interbank rate 3 month	4.48%	4.69%
Government debt to GDP ratio	101%	101%
Manufacturing PMI	47.9	47.8

Back to menu

Bank CDS options

After the excitement of the last few months, pricing for credit default swaps calmed down over the last month - pricing for most bank default swaps increased in the last four weeks, although the pace of the increase has slowed sharply. That said, pricing for UBS swaps declined markedly as the deal with Credit Suisse bedded in while both Deutsche and Barclays saw pricing for their 1 year swaps also marginally decrease.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	28.59	60.5	A+	A2	A -
Barclays	91.37	104.58	BBB	BAA1	A
BNP Parabis	34.29	63.09	A+	Aa3	A+
Citigroup	56.27	92.02	BBB+	A3	A
Credit Suisse	195	195	BBB-	BAA2	BBB

Deutsche Bank	215	185	A-	A1	BBB+
Goldman Sachs	68.04	101.99	BBB+	A2	A
HSBC	32.3	54.62	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	45.61	75.06	A-	A1	AA-
Lloyds Banking Group	35.4	56.91	BBB+	A3	A
Morgan Stanley	64.01	98	A-	A1	A+
Natixis	24.5	65.5	A	A1	A+
Nomura	44.17	119	BBB+	BAA1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	43.68	80.16	A	A1	A-
UBS	62.9	87	A-	Aa3	A+

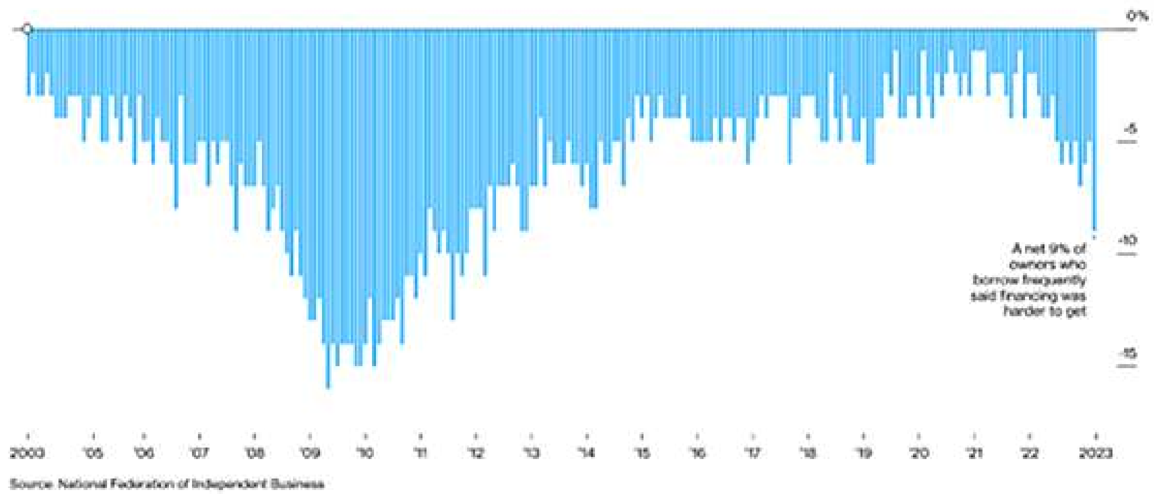
Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st May 2023 www.tempo-sp.com

Back to menu

Government Bonds

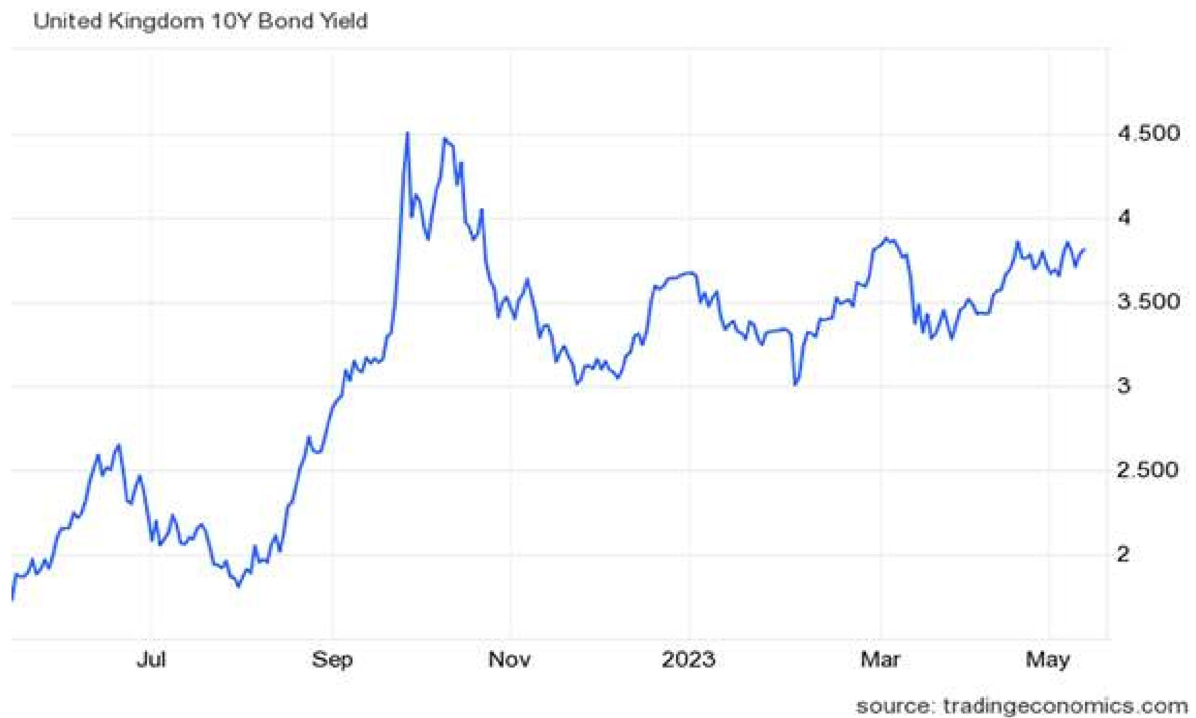
Bond markets are in fickle mood. Surging interest rates in the developed world are unnerving many investors - that earlier chart showing the steep curve of interest rate increases has crashed many bond portfolio valuations. Yet bond investors are also - like equity investors - starting to look beyond the current phase to a world where interest rates at the very least plateau or even start falling. A falling rates environment might be good news (at last) for bond investors. But there's a catch. Interest rates only tend to fall back if economies are slowing down or already mired in recession. And what happens in recessions ? Defaults amongst corporates start rising.

The chart below shows that the volume of US corporate debt trading at distressed levels — a risk premium of at least 10 percentage points over the benchmark for bonds, or a price of fewer than 80 cents on the dollar for loans — has surged some 28% since last month's banking crisis to around $300 billion, according to data compiled by Bloomberg. That figure stood at up from about $74 billion a year ago. This is probably a grim warning to all those tempted to buy into private credit and debt funds - defaults are rising fast.



Source: Bloomberg

UK Government Bonds 10-year Rate 3.80%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	27.49
Germany	13.29
Japan	22.46
United Kingdom	19.05
Ireland	25.09

Italy	112.84
Portugal	51.12
Spain	54.4

Eurozone peripheral bond yields

Country	May 2023	April 2023	Spread over 10 year
Spain 10 year	3.38%	3.41%	107
Italy 10 year	4.19%	4.22%	188
Greece 10 year	4.01%	4.23%	170

	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

Back to menu

Equity Markets and Dividend Futures

So, the numbers are in for April for major stockmarkets. In the key US benchmark, the S&P 500, we've experienced a sideways market, which has edged a bit higher off the back of decent earnings numbers. Here is a very useful summary from analysts at S&P Dow Jones:

- *For April, the S&P 500 posted a 1.46% gain, after March's 3.51% gain and February's 2.61% decline. Year-to-date, the index was up 8.59% (after 2022's 19.44% decline, 2021's 26.89% gain and 2020's 16.26% gain).*
- *Breadth for the month ticked up, as 266 issues were up (263 last month), with 22 (32) issues up at least 10% and 1 (7) up at least 20%, while 235 (240) declined, with 28 (53) declining at least 10% and 4 (14) down at least 20%. Year-to-date, breadth increased, with 291 issues up (47 up at least 20%) and 212 down (19 down at least 20%).*
- *The market moved higher as earnings beat the lowered estimates, with an expected small gain (1.3%) over Q4 2022, but they were weaker than previously expected, with forward guidance cautious. Inflation continued to decline, but slowly, as the Fed May 2-3 meeting was expected (85% based on futures) to end with another 0.25% increase, as the market was betting it would be the last for now (with 23% expecting another 0.25% increase in June).*
- *Volatility significantly decreased for April, as the market posted a 1.46% gain on positive breadth, as the YTD was up 7.71%.*
- *The average daily high/low spread declined to 0.92% from last month's 1.51%.*
- *3 of the 19 days had an intraday high/low spread of at least 1%, compared to 11 last month.*
- *Trading declined 24% for the month.*

As for **investor positioning** overall, analysts at Deutsche Bank confirm that sideways, cautious optimism positioning - they see "Flat overall positioning" as equities "go sideways through the first

two weeks of the Q1 earnings season despite a big spike up in beats and earnings tracking the first sequential rebound in this cycle". In sum, nothing much to write home about!

Index	April 2023	May 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	141.1	142.3	4304	123.4
FTSE 100 Dividend Dec 2022	3.5	294.4	7792	272.5

Note changed to Dec 2023 contracts

Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-1.01	-2.57	5.74	5.05	0.9	4.54	7792.52
S&P 500	-0.328	0.567	3.32	2.49	52.1	71.7	4124.08
Gold Composite (Most Traded)	0.233	9.49	13.7	11.7	56.4	64.1	202050¢
iShares FTSE UK All Stocks Gilt	-1.36	-1.45	-4.65	-17.5	-19.7	-20.8	1043.63p
VIX New Methodology	-0.82	-7.13	-31	-41.4	15.7	62.5	16.93

Back to menu

Volatility

The chart below shows the Vix index over the last 12 months. It tells a remarkable story which is that currently the Vix is the **most bullish benchmark tracked by investors.** The long term average level for the US based Fear Gauge is around 19 to 20 (depending on the date range) - the Vix is, as

of writing, below 17. And all this during a series of bank runs and a period of unprecedented interest rate rises, and very high (though trending lower) inflation. But its not just volatility measures which are looking slightly unusual. S&P Dow Jones also reports that in April S&P 500 correlations fell to an 18-month low. Accompanying diversification effects helped reduce index volatility to below average levels. Diversification effects were even stronger in broad European equities: at an average pairwise level of 0.07 in April, S&P Europe 350 correlations reached their lowest monthly reading in at least 15 years, while realized index volatility was a thoroughly sleepy 6% annualized.

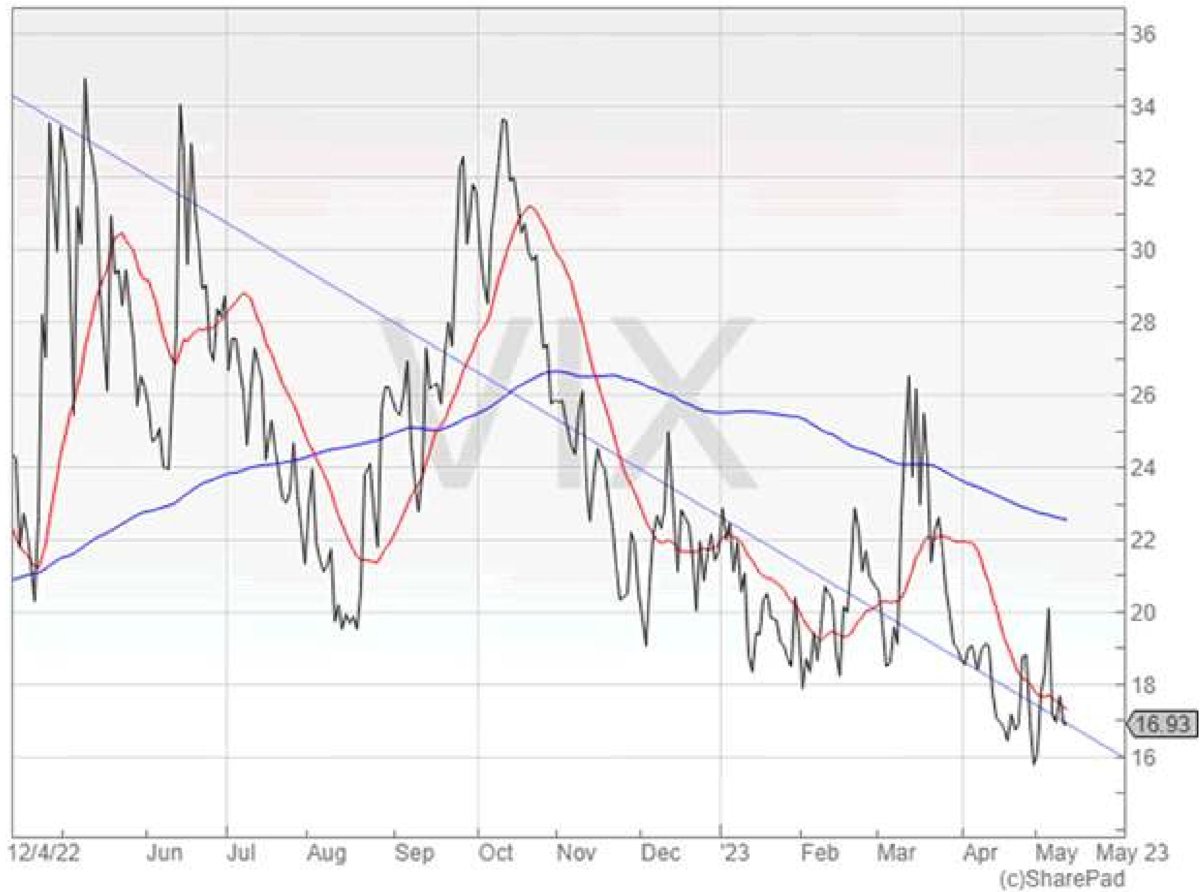
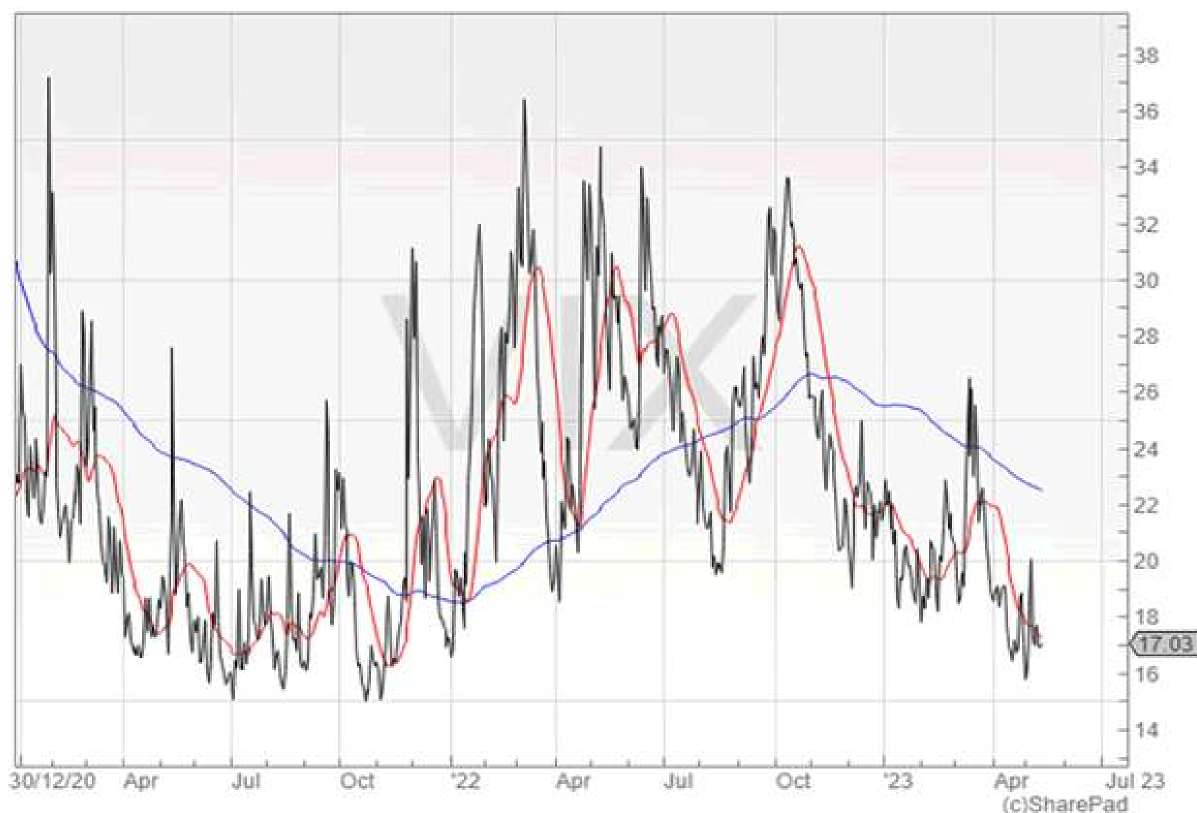


Chart above - Vix in Black
Dark blue line - 200 day moving average
Red line - 20 day moving average
Straight light blue line - trend line



Black Line - Vix since January 2021
Red line - 20 day moving average
Blue line - 200 day moving average

Measure	May Level	April Level	March Level	February Level
Vstoxx Volatility	17.73	17.34	27.97	18.91
VFTSE Volatility	16.93	19.09	24.8	20.34

Back to menu

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.

Back to menu

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.

Back to menu

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

Kind Regards,

Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk

THIS COMMUNICATION IS FOR FINANCIAL ADVISERS IN THE UK ONLY. IT SHOULD NOT BE CONSIDERED AS INVESTMENT ADVICE OR ANY FORM OF PERSONAL RECOMMENDATION TO PURCHASE THE PRODUCTS DESCRIBED.
This email is sent from the UK Structured Products Association (UKSPA) and is intended for UK financial advisers only. If you have received this communication in error, please destroy all electronic and paper copies and contact the sender immediately. UKSPA has taken every step to ensure the accuracy of the information in this email but cannot accept liability for errors. None of the information contained in this email constitutes an offer by UKSPA or any of the product providers to buy or sell the products listed, or to participate in any other investment strategy. The information available on this email is provided for information purposes only. Copyright of the contents of this email belongs to UKSPA. This email and its contents are only intended for the recipient. If you no longer wish to receive emails from UKSPA, please click here to unsubscribe

UK Structured Products Association, 1A All Saints Passage, London, SW18 1EP