

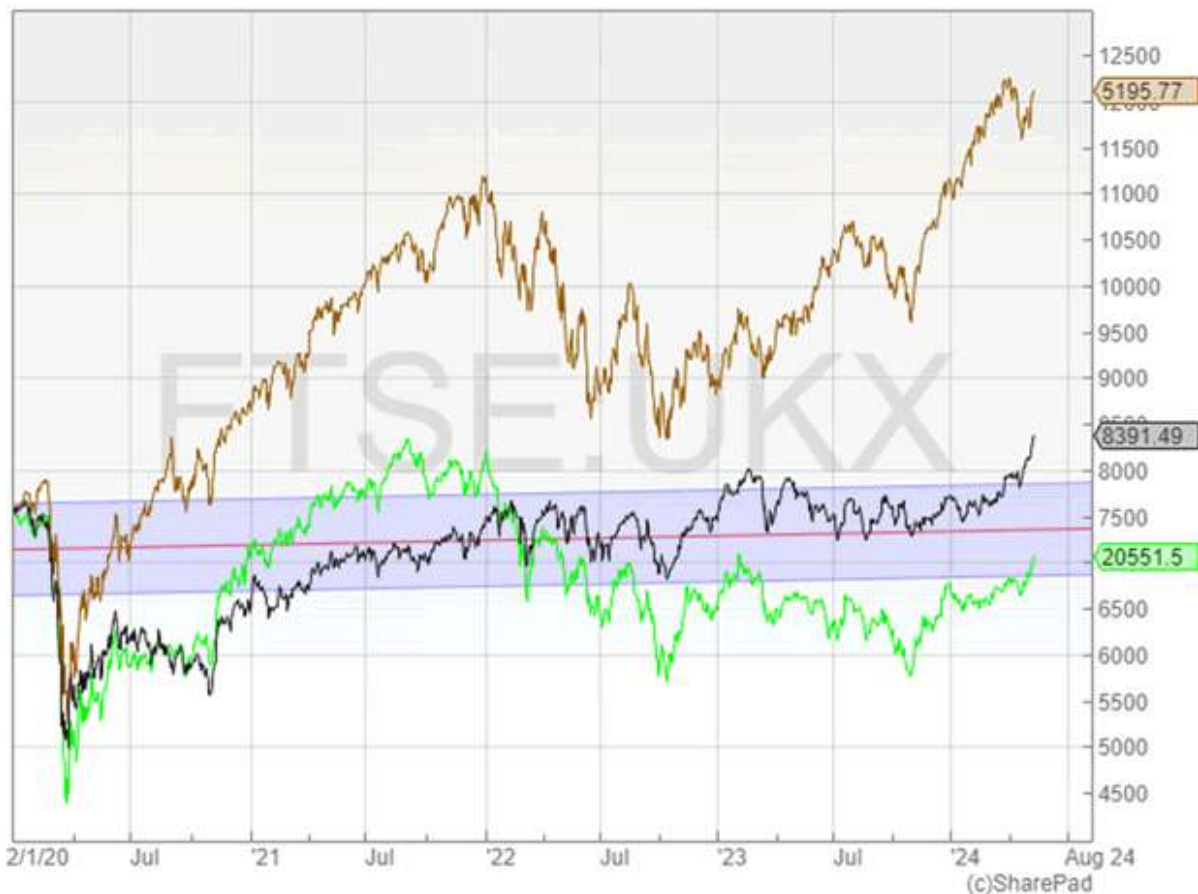


With commentary from David Stevenson

The UK perks up

At long last, there's some good news about the UK economy. Apparently, we are no longer in a recession. And it gets even better. After much gnashing of teeth, even our local, bedraggled, forsaken stock market might be in for some good news. No, I'm not talking about the imminent IPO of a Chinese e-commerce brand but the local benchmark indices.

The first chart below shows the scale of the problem - it shows the FTSE 100 in black, the FTSE 250 in green and the S&P 500 in brown. The trend line is surrounded either side by confidence levels. Essentially, the medium-term trend suggests stagnation and a huge gap with US equities.



The next chart, though, is more positive. It shows the same three indices since the beginning of 2024. Notice how the FTSE 100 has almost caught up with the S&P 500 while the FTSE 250 has fallen further behind.



It's also worth checking on some country-level valuation metrics - all of which indicate that the UK is undervalued and could potentially experience a 20 to 40% rally, still remaining below the world average. While UK corporate earnings growth may seem modest, there's a positive development. The 2025 earnings per share growth estimate for the UK market, excluding energy stocks and banks, is a promising 10.9%. It's noteworthy that the Earnings consensus for 2025 has recently turned positive, with analysts revising their estimates upwards for UK companies' earnings growth.

All May 1st Numbers

- UK CAPE is 14.1
- UK PE 2023 12.50
- UP PE 2024e 12.06
- UK PE 2025e 11.02 (World 16.82)
- 2024e EPS Growth 3.65%
- 2025e EPS Growth 9.42%
- UK Market exc Financials and Energy 2023e 15.5
- UK Market exc Financials and Energy 2024e 14.9
- UK Market exc Financials and Energy 2025e 13.5
- UK Market exc Financials and Energy 2025e EPS Growth 10.9%.

Stepping back from this accumulation of data, I think we can make the following claims:

- 1 In the aggregate, UK equities are cheap by developed world standards and also cheap against their 5-year average valuations (by around 20%). A 10 to 20% rally is entirely possible
- 2 Most big UK equities are highly profitable and benefit from high ROCE and high operating margins. Their problem is that they aren't growing earnings by as much as their US peers

- 3 The UK economy has been doing much better since the beginning of the year
 - 4 There's a huge dispersion within the two indices (the FTSE 100 and FTSE 350)
 - 5 The FTSE 250 is still lagging behind virtually every major developed world index, largely because of the poor returns from investment trusts.
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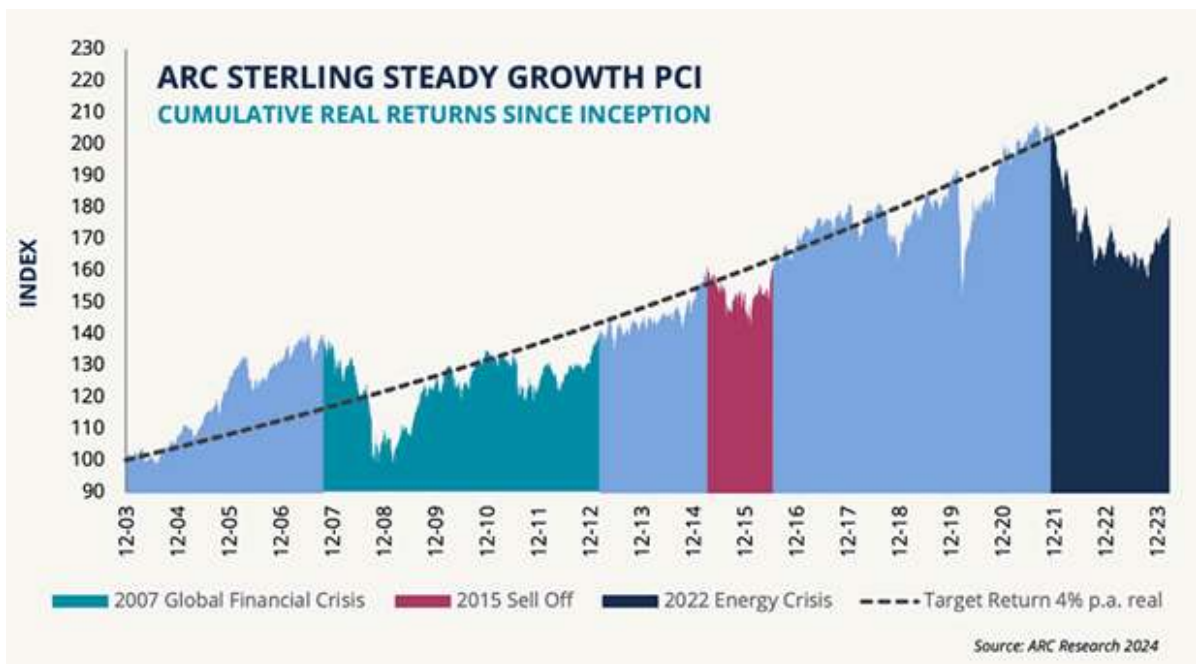
Headline Numbers

How's your portfolio doing?

A new analysis from Asset Risk Consultants (ARC) reveals that inflation has dented the 'real' value of private client portfolios, which are worth no more than they were in 2016. Adjusting for inflation, most private client portfolios* are back to 2016 levels. In fact, according to ARC the typical sterling private client investor's real wealth has fallen by 15 per cent from 2021 peak, which implies that real returns need to average 7.3 per cent over next 10 years for real wealth to be restored.

The re-adjustment of bond yields in 2022 has resulted in a one-time downward shift in investors' wealth. A rapid recovery in real wealth will require a sustained strong performance by both bond and equity markets. For real performance to revert to its historical norm of 4 per cent per annum requires a decade of 'real' returns averaging 7.3 per cent per annum.

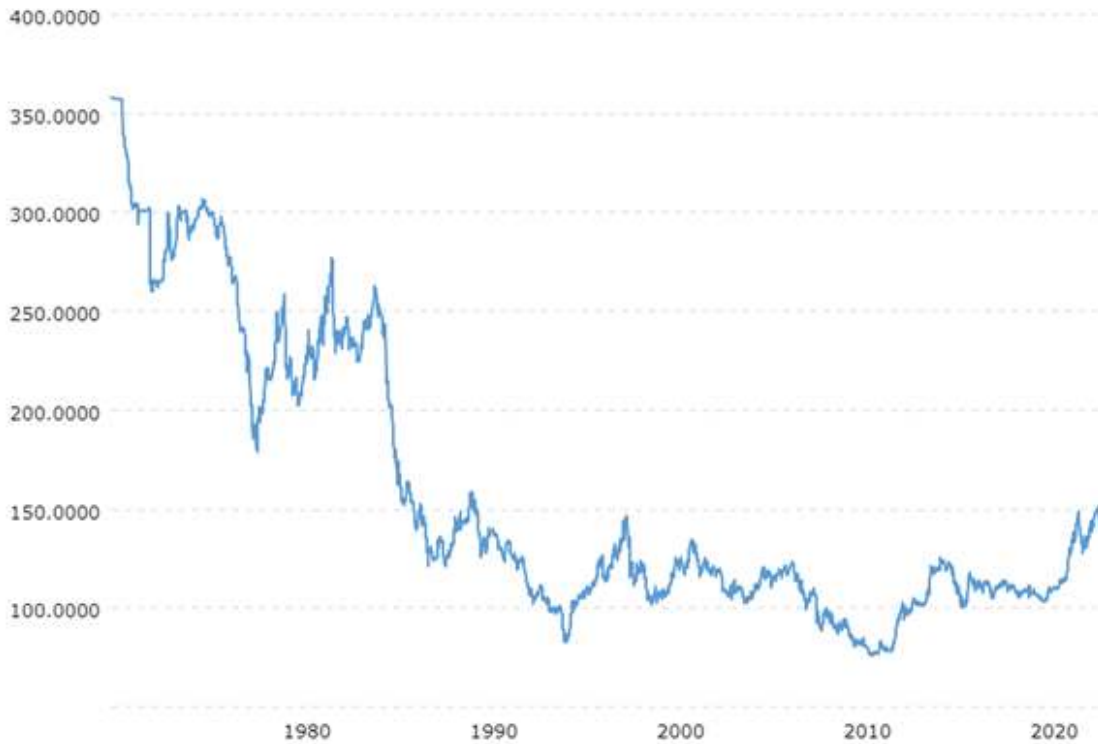
The chart below plots the ARC Sterling Steady Growth Private Client Index (based on the most common risk profile run by discretionary investment managers) since inception against a trend line of inflation plus 4 percentage points per annum. That target is a common expectation for a multi-asset class portfolio and suggests that an investor in such a strategy should be able to sustain a withdrawal rate of up to 4 per cent per annum over the long term.



The light blue shaded periods are punctuated by three market drawdown events: the 2008 financial crisis, the 2015 sell-off, and the 2022 energy crisis. Up until 2021, the ARC Sterling Steady Growth PCI delivered real returns of around 4 percent per annum. However, the most recent drawdown has caused a very significant gap to appear.

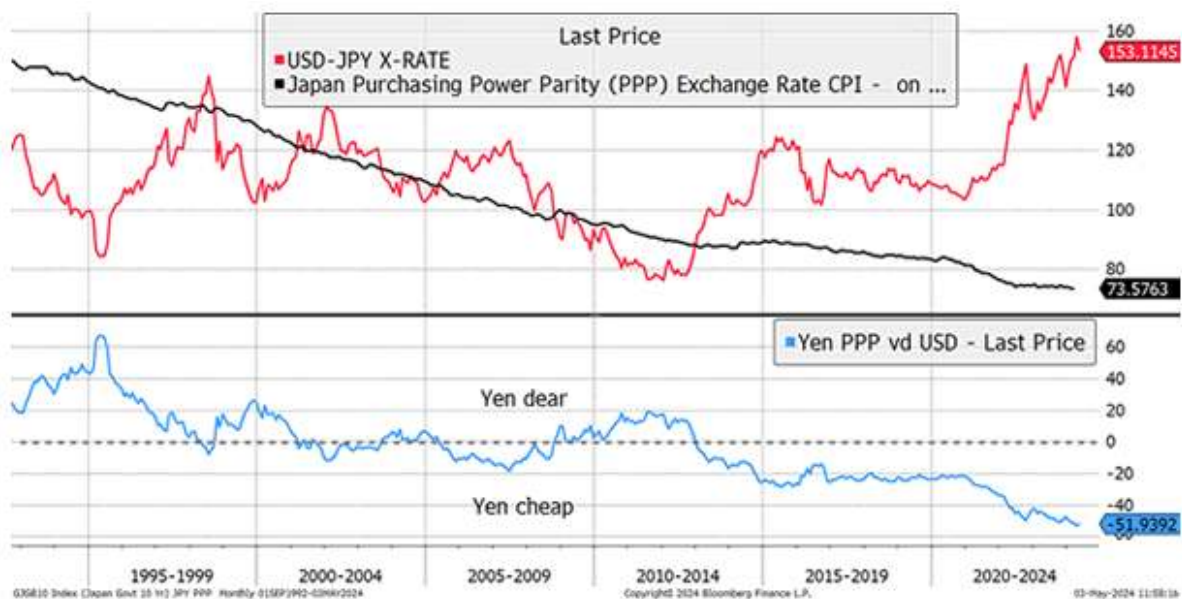
What's going on with the Yen!

I've always thought that central banks should be careful about drawing metaphorical lines in the sand regarding foreign exchange markets. Most participants in said markets have strong alpha male tendencies, which involve getting angry at said central bank tinkering, which is then followed by throwing sand in the face of the central bank by betting against the policy move. The UK and ERM fiasco is one prominent case in point, but I suspect we could also extend this analysis to Japan. The Bank of Japan hasn't explicitly said, "Cross the 150 yen to the dollar line, and we'll...[fill in central bank policy move]." But it's implied by market rumour. Not that it did much good as the yen sailed past 150 yen to the dollar. The rumour on the street is that 160 is next. Cue much discussion of the BoJ raising interest rates. Talk to some even more excitable market participants and they say that 200 yen to the dollar might be next! That's obviously a laughable idea until you look at the chart below, which shows the Yen Dollar exchange rate in a recent historical context. 200 doesn't look entirely crazy. And when one considers the very sizeable interest rate differential between the two economic superpowers, then 200 doesn't seem too crazy at all!



<https://www.macrotrends.net/2550/dollar-yen-exchange-rate-historical-chart>

Yet, on another level, 200 would actually be a crazy level for the yen to the dollar. Currencies do, eventually, tend to revert to their long-term fundamental basis, with the best measure, the PPP methodology, i.e. purchasing power parity or the Big Mac index as it is more popularly known. On this basis, the Yen is insanely cheap, a point made recently by Charlie Morris of investment research service [ByteTree](#). He reminds us that "since 1990, Japanese inflation has averaged 0.5% compared to 2.7% in the USA. That difference drives purchasing power parity (PPP), which has driven the fundamental value of the yen much higher (which is lower on the chart). According to PPP, the yen is worth 73.5 when it trades at 153."



Measure	Values as of 12th April 2024	Values as of 16th May 2024
UK Government 10 year bond rate	4.30%	4.07%
GDP Growth rate YoY	-0.20%	0.20%

CPI Core rate	3.40%	3.20%
RPI Inflation rate	4.50%	4.30%
Interest rate	5.25%	5.25%
Interbank rate 3 month	5.30%	5.30%
Government debt to GDP ratio	97.10%	97.60%
Manufacturing PMI	50.3	49.1

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Bank CDS options

After a few months where we've seen rates on credit default swaps on the major global banks decline steadily, this month there's a much more varied series of moves. Most banks saw their pricing decline marginally in the last few weeks, but many US banks saw their rates increase, although not hugely. Even some European banks saw their pricing increase, notably Natixis and HSBC. Only German mega-bank Deutsche Bank saw marked declines in their, admittedly, already high rates.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	45.62	16.68	A+	A2	A -
Barclays	59.52	27.94	BBB	BAA1	A
BNP Paribas	35.64	13.36	A+	Aa3	A+
Citigroup	58.7	24.61	BBB+	A3	A
Deutsche Bank	98.01	40.56	A-	A1	BBB+
Goldman Sachs	63.17	28.95	BBB+	A2	A
HSBC	34.31	15.34	A+	A1	AA-
JP Morgan	47.63	25.65	A-	A1	AA-
Lloyds Banking Group	38.41	13.54	BBB+	A3	A
Morgan Stanley	60.67	28.26	A-	A1	A+
Natixis	38	16.5	A	A1	A+
Nomura	70.54	20.2	BBB+	BAA1	A-
RBC	51.59	33.4	AA-	A1	AA-
Soc Gen	44.26	18.5	A	A1	A-
UBS	40.13	23.9	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st May 2024 www.tempo-sp.com

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Government Bonds

The great guessing game

In the earlier section in this report on the Yen, we looked at why some think that the Yen might go to 200 yen to the dollar. As usual, there's lots of pointy head explaining going on in the markets but the Ockham's Razor principle should be deployed. If one country pays you 0.1% interest whilst the other pays 5% plus, which one do you think will be in demand? This same Ockham Razor approach can also be applied to the great guessing game about if and when the US Federal Reserve will cut interest rates. If you are a central banker and you're worried that US citizens are griping about core inflation, you'll probably play safe and keep rates high, especially if you see the US economy running at close to full capacity, with a massive fiscal deficit. The downside risk is career ending - the central banker who let inflation run too high.

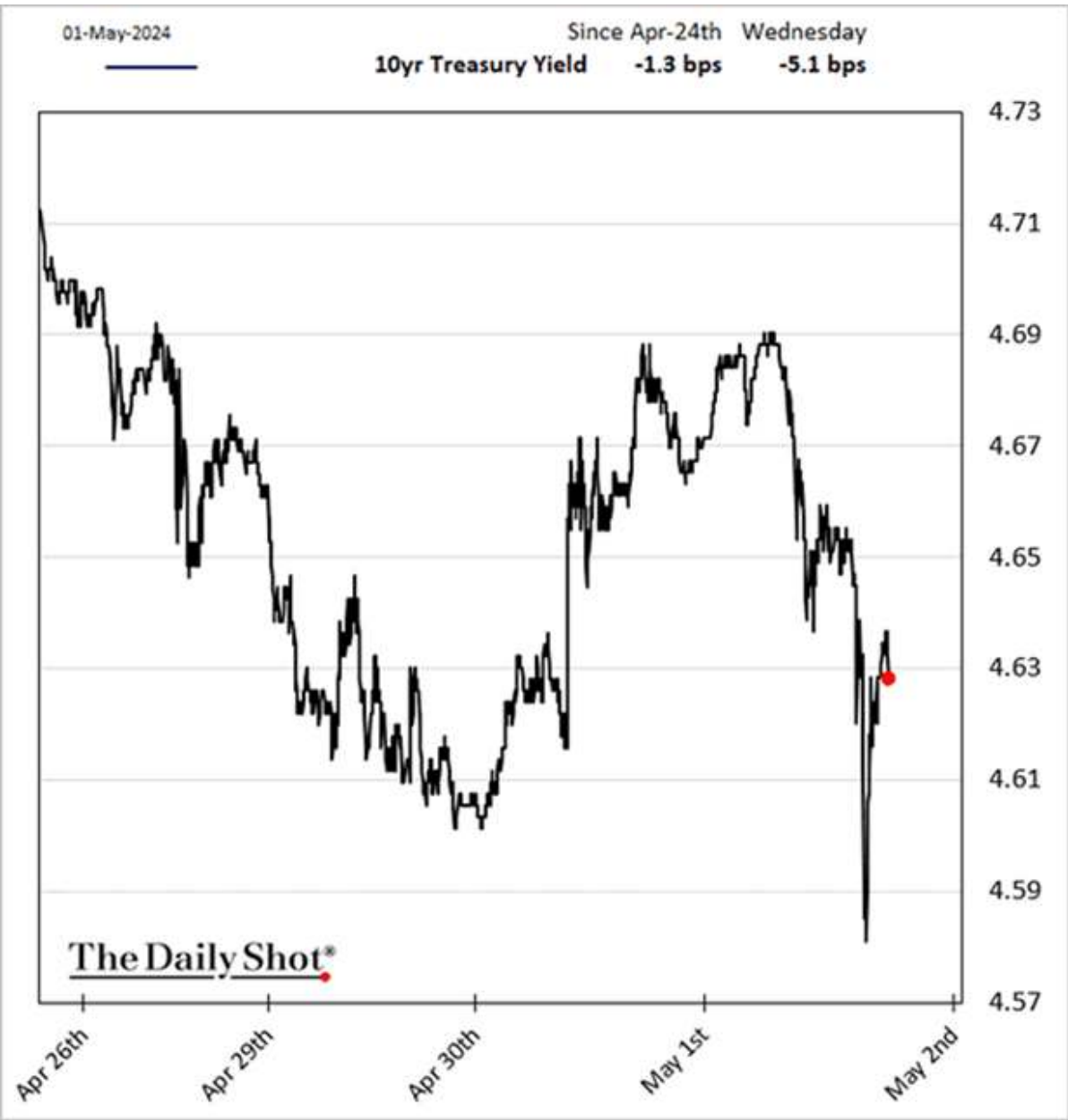
The UK is, of course, in a very different space. Our economy is not so strong, and thus high interest rates for longer will, sooner rather than later, become more painful in terms of growth. Thus, interest rates might fall sooner and quicker. Most analysts expect UK interest rates to hit 4.25% by mid-2025 or even lower, whereas most analysts only expect one interest rate cut in the US this year. That helps explain why Treasury yields in the US, though a little lower in recent weeks, have stayed elevated and the US dollar remains above its long term trend line (which has been rising).

01-May-2024

Since Apr-24th Wednesday

2yr Treasury Yield 3.3 bps -7.5 bps



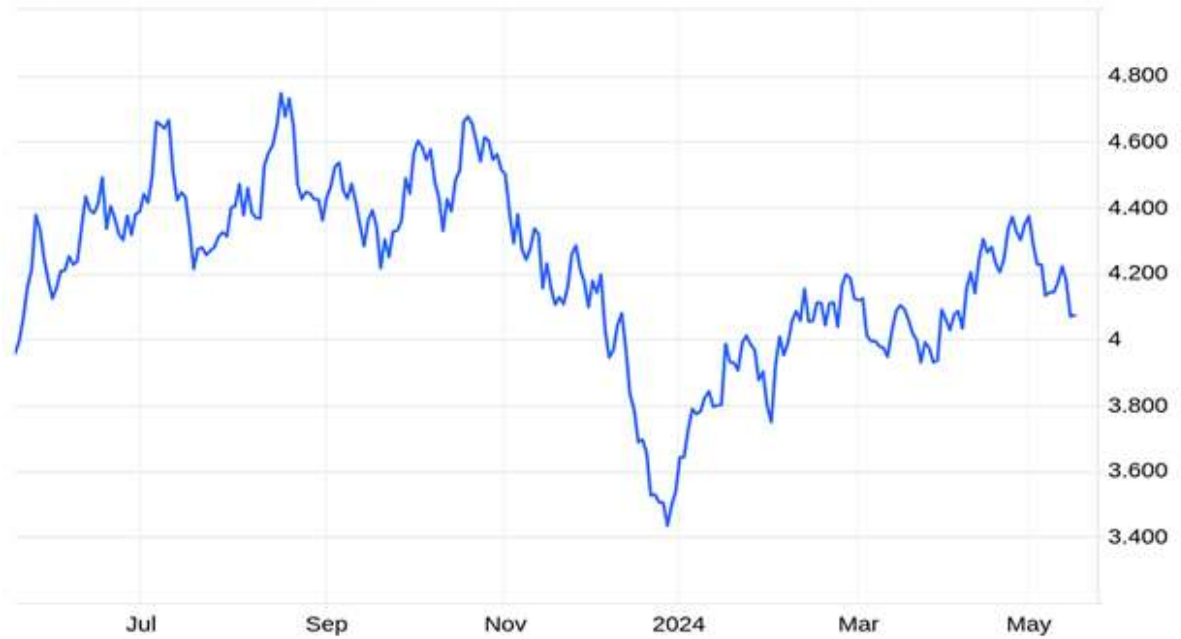


Here is the trade-weighted US dollar index.



UK Government Bonds 10-year Rate 4.07%

United Kingdom 10Y Bond Yield



source: tradingeconomics.com

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

CDS Rates for Sovereign Debt

Country	Five Year
France	25
Germany	10.07
Japan	24.18
United Kingdom	26.26
Ireland	22.45
Italy	62.35
Portugal	37.5
Spain	35.86

Eurozone peripheral bond yields

Country	May 2024	April 2024	Spread over 10 year
Spain 10 year	3.19%	3.18%	81
Italy 10 year	3.73%	3.72%	135
Greece 10 year	3.43%	3.44%	107

	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

Equity Markets and Dividend Futures

Bubble no, expensive probably

Anyone looking for a useful primer to what the heck is going on with US equities would be well advised to refer to the quarterly JP Morgan Guide to the Markets. I'd suggest that four charts stood out from the recent report at the end of March: the most interesting chart is the first one below, which suggests that overall, the S&P 500 was looking a tad expensive by the end of March if the first chart below is anything to go by.

S&P 500 Index at inflection points

GTM U.S. 4

S&P 500 Price Index



Source: Compustat, FactSet, Federal Reserve, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price-to-earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns. Guide to the Markets - U.S. Data are as of March 31, 2024.

J.P.Morgan
ASSET MANAGEMENT

That message is reinforced in the next chart, which looks at various valuation measures - note the forward PE on the S&P 500 is running at 1.34 times the 30-year average.

S&P 500 Index: Forward P/E ratio



Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since February 1994 and by FactSet since January 2022. Current next 12-month consensus earnings estimates are \$245. Average P/E and standard deviations are calculated using 30 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 30 years for each measure. *Averages and standard deviations for dividend yield and P/CF are since November 1995 due to data availability. Guide to the Markets - U.S. Data are as of March 31, 2024.



The real valuation anomaly remains the top 10 stocks, which are 40% overvalued compared to the average since 1996. By contrast, the other 490 stocks are only 17% overvalued since the 1996 average.

P/E ratio of the top 10 and remaining stocks in the S&P 500

Next 12 months, 1996 - present

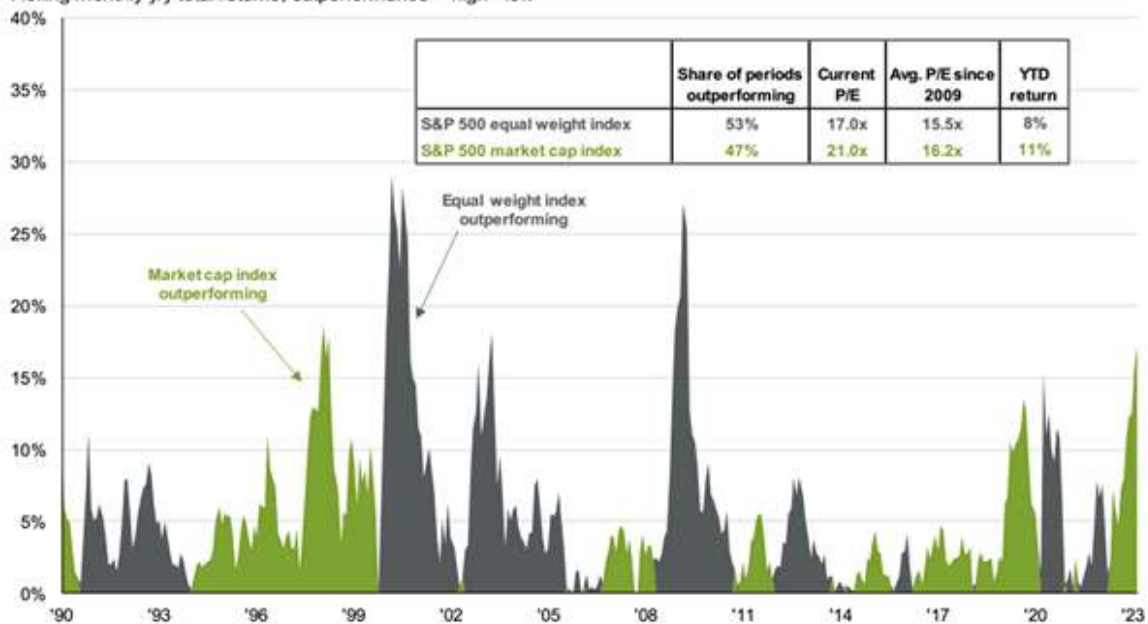


The final chart underlines that valuation discrepancy, which compares the market cap (standard) version of the S&P 500 to the equal-weight version. The equal-weight version (in grey) frequently outperforms its market cap version. Its average PE is currently 17 times earnings versus the long-term average of 15.5 times earnings, a much smaller premium than the market cap version.

S&P 500 market cap vs. equal weight performance

S&P 500 market cap and equal weight relative performance

Rolling monthly y/y total returns, outperformance = high - low



Source: FactSet, J.P. Morgan Asset Management, Guide to the Markets - U.S. Data are as of March 31, 2024.

Index	April 2024	May 2024	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 23 contract	160.6	160.9	5083	143.3
FTSE 100 Dividend Dec 2023	300	303.5	8418	299.3

Note changed to Dec 2024 contracts

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	7.62	9.13	13.6	8.58	14.4	8.81	8415.92
S&P 500	5.08	6.04	17.7	29.2	84.5	95	5308.15
Gold Composite (Most Traded)	-0.536	18.3	20.5	20.2	86.2	85.5	239490¢
iShares FTSE UK All Stocks Gilt	0.74	0.492	1.06	-1.78	-23.6	-21.5	1021.5p
VIX New Methodology	-27.1	-5.76	-6.28	-25.4	-12.2	0	13.42

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Volatility

The VIX equivalent for the bond market is called the Merrill Option Volatility Estimate, or MOVE, index. This widely followed index measures U.S. interest rate volatility, tracking the movement in U.S. Treasury yield volatility implied by current prices of 1-month OTC options.

According to Ned Davis Research's chief global macro strategist, Joseph Kalish - as reported in the US investor publication Barrons - in recent years, the MOVE index has been highly correlated with an index tracking volatility in bonds. Thus high levels of bond volatility relative to the trend have been bullish for Treasuries, while subdued levels have been bearish, Kalish argues. Lower volatility is positive for riskier high-yield debt: That market segment usually outperforms when volatility is falling and underperforms when it is on the rise. And Kalish also warns that equity markets should watch this measure, as there does appear to be some linkage between the MOVE and Vix. Kalish argues that equity investors feel more comfortable when markets are subdued and volatility declines relative to its 2-year average. By contrast when stocks struggle when bond volatility spikes. So, in simple terms, a spike in both VIX and MOVE reflects turmoil in the financial markets. On the other hand, low readings of both these indexes are a sign of normal market conditions. The good news is that looking at the chart below - from Google Finance - the MOVE index has been trending lower over the last 12 months although there was a recent spike!

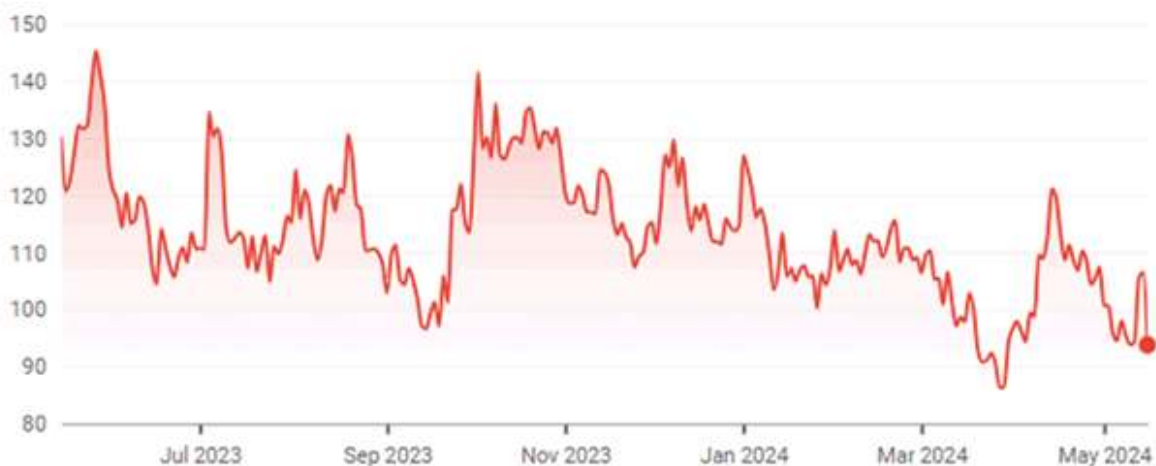
Merrill Lynch Option Volatility Estimate

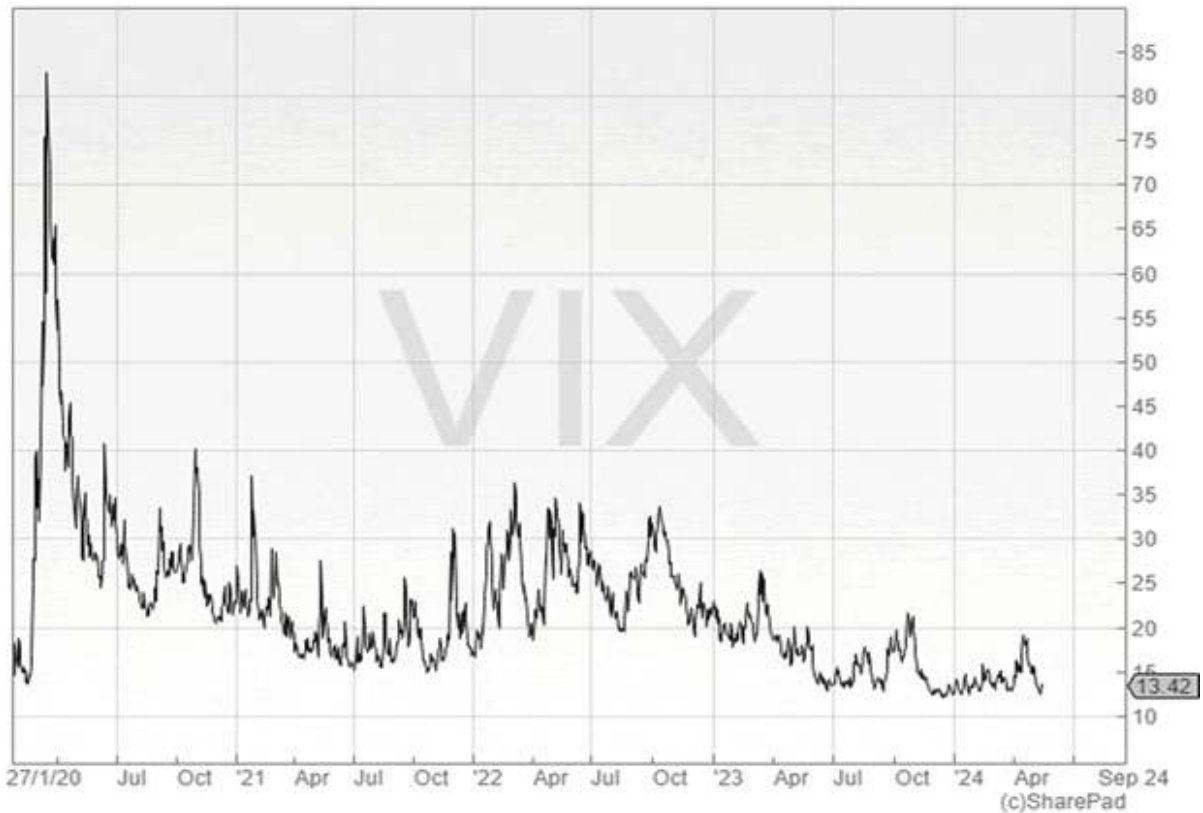
93.78

↓ 28.03% -36.52 1Y

May 15, 7:45:00 PM GMT-4 · INDEXNYSEGIS · Disclaimer

1D 5D 1M 6M YTD 1Y 5Y MAX





Measure	May Level	April Level	March Level	February Level
Vstox Volatility	12.77	16.53	13.03	13.62
VFTSE Volatility	13.42	17.31	14.40	12.93

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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.

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.

Kind Regards,



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