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UK Structured™ Products Association

Monthly Market Report

March 2020

With commentary from David Stevenson

Viral Blues

Always expect the unexpected. President Xi of China must have been hoping that the new year might signal a break from his legion troubles. Those pesky tariff issues look like they might calm down and Hong Kong is looking less volatile than it did at the end of last year. And then along comes the corona virus.

Some days, it scares the living daylights out of investors. The next, everyone is soothed. My own finger in the air guess is that the virus itself might prove less damaging than the surrounding panic. One small indicator. I recently subscribed to a crowdfunding campaign for a new tech gadget (air filter). Like many of these gadgets though designed in Israel, it is actually made in China. Delivery was due in March, but a recent email said all the plants making components had shut down, transport was blocked and we wouldn't see our gadgets until May. Hours later, another announcement - of exactly the same news from another gadget supplier.

I'm also reminded of a great line from a fantastic US tv series called the Hot Zone which looked at an earlier outbreak of a strain in Ebola in the Washington DC area. The man from the CDC - the US disease control authority - warned that more people would die from a panic than from the virus. And more businesses would go under, he could have added.

So, the good news is **if the number of cases is as high as 200,000 then the mortality rate (provided Chinese fatality statistics can be relied upon) is much lower than the 2% figure currently out in the open. This is not the end of the world as we know it, yet.**

The bad news is that the economic impact on the manufacturing powerhouse of the planet will be severe if short lived. West country-based risk consultants at CheckRisk (who work with many pension funds) have put together a nice summary of what they think investors need to worry about - and the list is long.

- Coronavirus is spreading and the numbers coming from China may well underestimate the true spread and mortality rate of the disease. Currently there have been 400+ deaths and 20,000 confirmed infections.
- Current stats show the mortality rate at about 2% - 2.5%. However, the numbers of those infected could be as high as 200,000 (not the 20,000 or so declared by the Chinese) If this is the case then the mortality rate would be lower but the infection rate much greater, unless the mortality rate is also not accurate.
- The disease is more infectious than SARS, MERS or Asian Bird Flu but at present looks less of a killer. It is less infectious than smallpox or rubella.

- The virus is highly mutagenic, that is to say changes rapidly. In terms of its evolution this can be good or bad depending on how it mutates. It can mutate to become more or less deadly.
- The incubation period is 3 to 14 days. There is human to human transference and those infected, but not showing symptoms yet, can be infectious to others. This is a major issue in terms of the infection rate.

Economic and Business impacts

- SARS cost the global economy $35-$40bn. This figure is clearly manageable but the Coronavirus, because it is much more infectious, will cost a lot more. China has set aside $175bn so far in liquidity to manage the crisis, protect the yuan etc.
- As a result, and if the estimates and spread so far is over 100,000 people then the Coronavirus could cost 10x this figure, i.e. $400bn for China alone.
- China/ Asia is the powerhouse of global GDP at present. Global GDP in Q1 could fall to 0.5% as a result of Coronavirus, and Chinese GDP could go negative in Q1. We feel the potential economic impact on financial markets is being underestimated.

My own sense is that with a tailwind, the virus will blow away in the next few weeks and then we'll be back to yet more monetary stimulus. The other good bit of news is that there are still plenty of medium-term drivers pushing equities much higher. These include central banks stuffing ever more debt into the pipes; stabilizing global economy; trade talks; Europe slowly recovering. And there's one other tailwind. Dividends. Throughout the developed world, corporate cashflows are still surging, and dividend payouts are still increasing.

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Headline Numbers

One of my core bets for 2020 is that UK assets, especially equities, are one of the least bad places to be at the moment. Now that we have some political stability, businesses should be able to expand. But this optimism needs to tempered by a brutal fact - UK corporate profits are sagging. That's the backward-looking message from the Share Centre's latest Profit Watch UK. Their analysis suggests that UK Plc's earnings recession intensified in Q4 as profits fell at fastest pace for over three years. The key messages? Profits fell 10.4%, the third quarter in a row in which more than half of companies have reported lower profits. UK profits have grown only 5.8% since 2007. Looking forward, the market consensus for 2020 profit growth has moderated in recent months; median profit growth of 7.5% is expected, down from

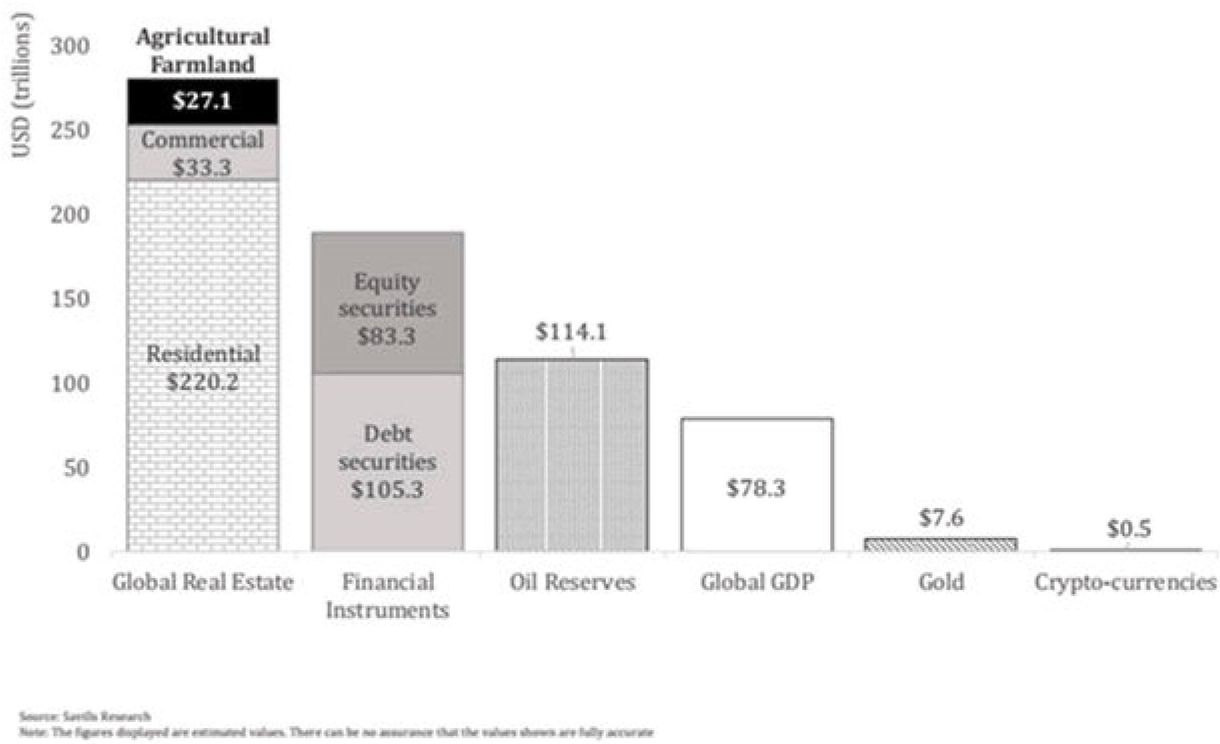
8.6% three months ago, but still looks too high. One last interesting stat - for companies outside the top 40 superleague, the largest 40 companies in the UK, this was the seventh consecutive quarter of lower profits, the worst run since 2008-2009.

It's hard to feel optimistic about these numbers but I would add two caveats. The first is that these are backward-looking numbers and that things might change for the better in 2020 (we hope). The second is that although developed markets are trading on a cyclically adjusted price/earnings ratio of 25.7x, the UK market is currently trading at 16.5x. The yield on UK shares for the year ahead is 4.1%, well above the 3.5% long-run average according to the Share Centre.

Investors focused on dividend are certainly sitting pretty. That's the message coming through from another report, this time from the Link group which regularly updates on the current state of UK PLC dividends which hit a new record in 2019. Link observes that UK dividends jumped 10.7% to a record £110.5bn in 2019, boosted by an exceptionally large £12.0bn of special dividends. But underlying dividends (which exclude specials) rose just 2.8% to £98.5bn, the slowest increase since 2014 while on a constant-currency basis, underlying growth was just 0.8%, once FX gains were excluded, the slowest since 2016. Looking forward to 2020, Link reckons that the big engines of dividend growth over the last three years - miners and banks - are less likely to propel dividends in 2020 plus the stronger pound and likely lower special dividends will also depress growth. Overall Link forecasts headline dividends to fall 7.1% to £102.7bn in 2020 and underlying payouts (i.e. excluding specials) to fall 0.7% to £97.9bn, equivalent to an increase of 1.1% on a constant-currency basis which means that UK shares are set to yield 4.1% in 2020. The top 100 will yield 4.2% and the mid-caps 3.0%.

The chart below is, I think, fascinating. It reminds us that all the stuff we as investors care about (equities and bonds) are actually dwarfed in value by another asset class, property and land. So, total debt securities globally are worth $105 trillion compared to only $83 billion for equities. Admittedly those numbers are much bigger than total, annual, global GDP which is just $73 trillion. As for the rest, gold is just $7.6 trillion and all digital currencies under $1 trillion.

But residential property is worth a mammoth $220 trillion, commercial property $33 trillion (a little under half the total value of global equities) and farmland a staggering $27 trillion. I say the last figure is staggering because I would wager than virtually no one reading this note would have any exposure to farmland in their portfolios, yet as a specialised asset class it's worth around a third of all equities at the global level - and not that much less than the value of all global commercial property. Yet outside of big institutional structures, there's almost no way of accessing this most alternative of assets.



Measure	Values as of 13th January, 2020	Values as of 6th February, 2020
UK Government 10 year bond rate	0.77%	0.59%
GDP Growth rate YoY	1.10%	1.10%
CPI Core rate	1.50%	1.30%
RPI Inflation rate	2.20%	2.20%
Interest rate	0.75%	0.75%
Interbank rate 3 month	0.80%	0.70%
Government debt to GDP ratio	80.80%	80.80%
Manufacturing PMI	47.5	50

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Bank CDS options

Overall rates of credit default swaps rose by a small amount over the last month although a few banks did see the price of their swaps decline marginally such as HSBC.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	5.59	24.09	A	A2	A -
Barclays	13.72	35.88	BBB	Baa3	A

BNP Parabis	7.32	21.77	A+	Aa3	A+
Citigroup	16.57	42.01	BBB+	A3	A
Commerzbank	14.41	57.21	A-	A1	BBB+
Credit Suisse	5.79	37.03	BBB+	Baa2	A-
Deutsche Bank	8.97	33.05	BBB+	A3	BBB
Goldman Sachs	19.26	50.72	BBB+	A3	A
HSBC	5.94	24.99	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	15.32	32.60	A-	A2	AA-
Lloyds Banking Group	8.26	28.18	BBB+	A3	A+
Morgan Stanley	19.63	48.11	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	19.15	48.74	BBB+	Baa1	A-
RBC	15.82	46.66	AA-	Aa3	AA
Soc Gen	7.14	23.54	A	A1	A
UBS	6.06	19.69	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 2nd January 2020 www.tempo-sp.com

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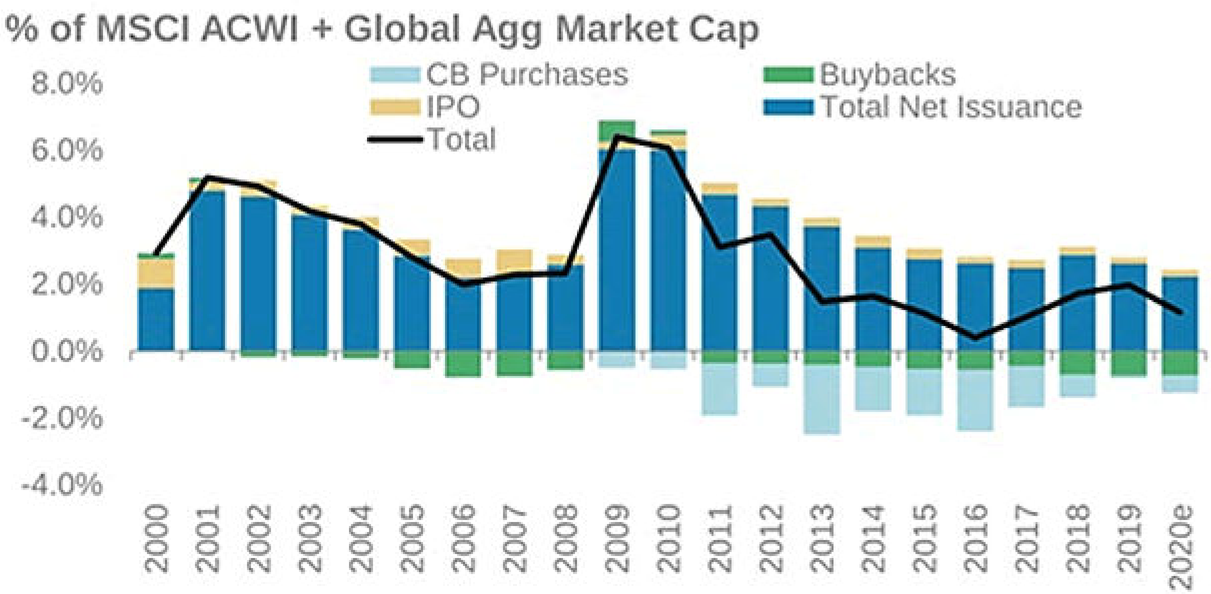
Government Bonds

Fixed Income

One of the most interesting stories of the last decade has been the pool of available bonds and equities. As our economies have continued to grow, admittedly at below average rates, one would expect this global pool of bonds and equities to be constantly replenished and growing in size.

But quantitative easing has had a material impact and there's some evidence that as the central banks market activities ramp up again, the pool of liquid assets might become ever shallower. And there's also the continuing program of share buybacks being executed by large-cap businesses in the US, diminishing the size of the equity pool.

The evidence for this comes in a paper released in February by cross asset strategists at Morgan Stanley. They reckon that US sovereign net issuance, net of central bank purchases, is expected to fall by US$332bn in 2020 while their credit strategists expect a total of US$648bn of corporate credit net issuance in 2020, a decline by US$302bn from 2019. This brings corporate credit net issuance down to post-crisis lows. Over in equities global net buybacks have spiked in 2019 while the total value of announced IPO deals globally has remained flat. The graphic below nicely sums up this big picture.



The obvious question that follows is whether this declining pool of liquid assets might support asset prices? My guess is that yes it will - as ever more money flows into the global markets, especially in the US, it needs to find a home. Cue higher prices supported by ample global liquidity and not enough investable opportunities.

UK Government Bonds 10-year Rate 0.77%

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

CDS Rates for Sovereign Debt

Country	Five Year
France	17.01
Germany	8.36
Japan	16.7

United Kingdom	18.31
Ireland	21.67
Italy	98.35
Portugal	32.5
Spain	35.31

Eurozone peripheral bond yields

Country	January 2020	February 2020	Spread over 10 year
Spain 10 year	0.43%	0.30%	67
Italy 10 year	1.32%	0.96%	133
Greece 10 year	1.36%	1.14%	151

	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	January 2020	February 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50	12.9	123.3	3791	123
FTSE 100 (Dec 17)	327.2	333	7424	n/a

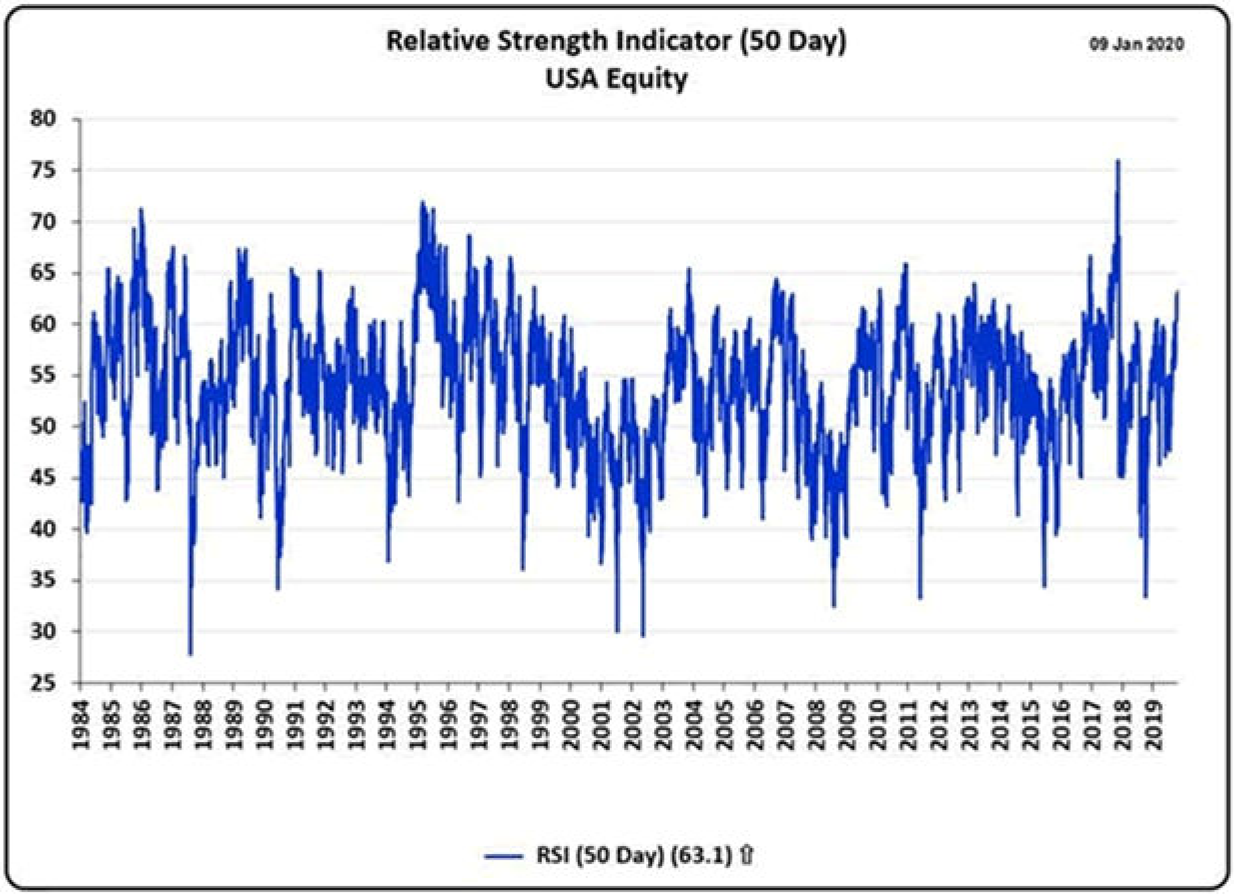
Even before the coronavirus stoked global fears, there was strong evidence that developed world stock markets were in danger of getting too excited in the very short term.

Analysts at investment bank Deutsche closely watch money and fund flows and even at the start of February they were expecting an outbreak of market volatility, with falls of 3 to 5% highly likely. Their numbers on equity and fund flows suggests that *equity positioning had become very stretched and was close to January 2018 peaks.*

"Over the last 3 months," the Deutsche analysts observed at the end of January that "equity funds have also seen inflows of $75bn, the strongest since early 2018, with cyclical sectors being big beneficiaries, especially Tech, Financials and Industrials."

In terms of time scales for a bull rally, the team reckon that at over 3 1/2 months, the duration of the current rally is already well above average (86th percentile). Rallies longer than 3 1/2 months become *increasingly rare.*

That said, its also worth adding the chart below which is from Charles Ekins, of Ekins Guinness - a smart quant strategist who also runs his own multi-asset class fund of ETFs. Charles was the former CIO at hedge fund Valutrac and is usually a perceptive follower of both technical and fundamental trends. He reckons that US equities are (not yet) overbought. One possible clue is that according to Ekins the 50 Day Relative Strength Indicator for the S&P 500 benchmark is at 63, which is not currently showing the market to be especially overbought (unlike in January 2018) - the chart below fleshes this out.



Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-3.88	0.94	3.65	2.18	6.94	8.54	7376
S&P 500	1.52	8.27	17	21	61	83.6	3380
iShares FTSE UK All Stocks Gilt	0.46	2.05	1.15	6.48	14.9	25	14.16
VIX New Methodology	13.1	9.79	-25.9	-8.25	-11.5	1.37	13.68

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Volatility

Something terribly important happened with the Woodford affair. Ordinary retail investors lost a great deal of money because of poor investment decision making, illiquid underlying assets and a wave of negative publicity. And this all happened at a time when ordinary shares were performing fairly impressively, and other star managers were busily making huge profits.

Clearly the circumstances are unique to Woodford but a more general point to observe is that volatility is everywhere and anywhere. There's market volatility and then there is manager volatility. Not all funds rise with a bullish market. Some fund managers make bad decisions and destroy the capital of their investors. Some funds go even further in their claims. They promise absolute returns through the cycle and then actually deliver negative returns whereas the wider market average delivers positive returns.

The point here is that just because someone is famous or says they'll produce a steady income or an absolute return, doesn't mean they actually will do as they say. We all make mistakes.

But there are investments - structured products - which have a contractual, legal, structure built into them which requires them (except in certain circumstances) to make a positive return even in volatile markets.

Again, that doesn't mean that every structured product will make a positive return or that a provider won't build a badly constructed product. But the numbers suggest that by and large, those contractual returns are being met - again, even in volatile markets. The evidence for this comes from Ian Lowes, up in the North East who has persevered with structured products through thick and thin. He keeps crunching the numbers and only a few weeks ago brought out his latest round up on SP returns - it's called the Lowes Financial Management Structured Products Annual Performance Review and it reveals "yet another great year for the sector" according to Ian. His top line numbers are impressive.

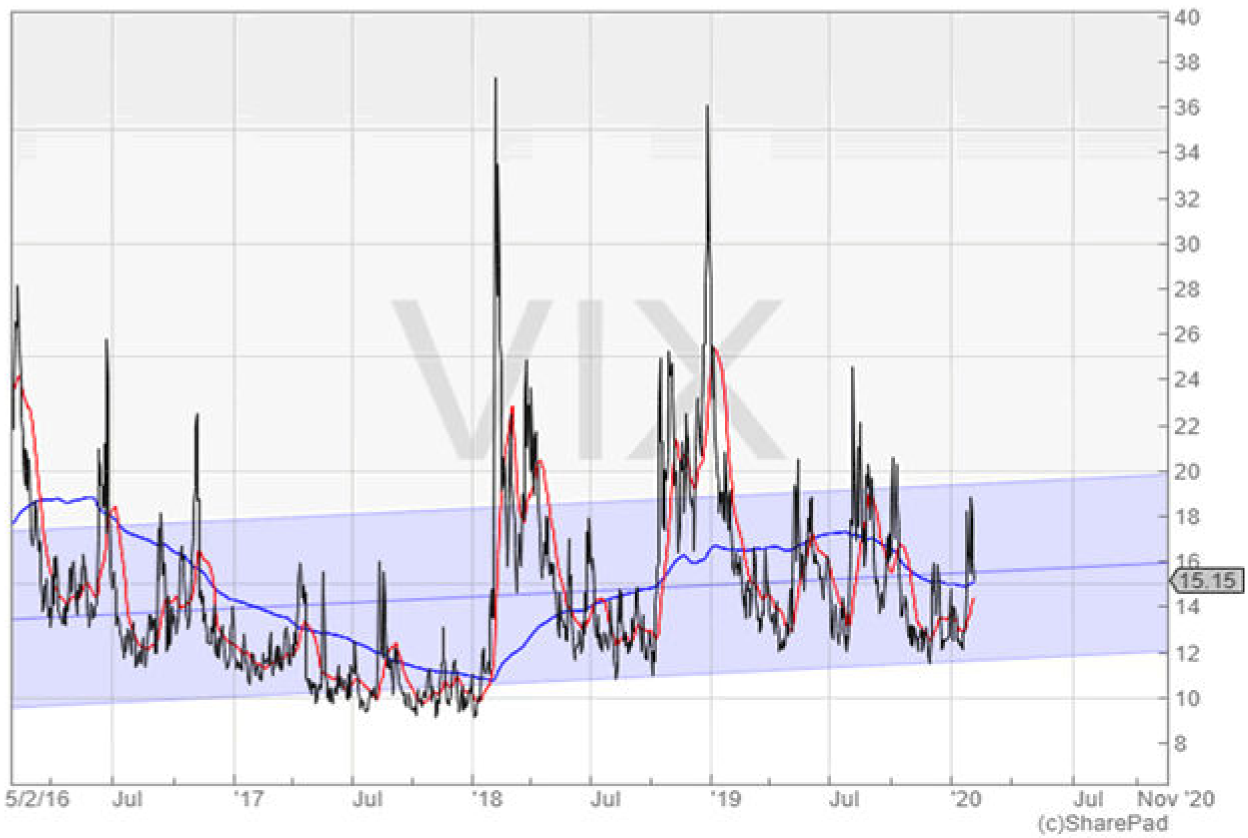
He reckons that a total of 334 plans matured in 2019 of which 80 were structured deposits. Amongst this sample, Capital-at-risk maturities returned an average of 6.74% per annum whilst deposit-based maturities returned 3.01% per annum. More than half of all maturities (179) were auto-calls / kick-outs while 66% of all maturities were linked to the FTSE 100 Index Only.

Here are the two numbers that stand out for me.

The first is for returns, which average just over 7.4% per annum for the most prevalent "product shape" (for capital-at-risk, FTSE 100 linked auto-calls) while 94.31% of maturing products produced positive results for investors. Only 4 maturities gave rise to a loss.

None of this tells us anything about the future and I'm sure there will be plenty of bad years in the future, but the point here is predictability. Structured products have, to a very large degree, delivered on what they promised - admittedly in a bullish market. You could have done better with some other asset classes and you could also have done a great deal worse. The point though is that predictability and relatively low levels of product return volatility. By and large, with the vast majority of structured products, in recent years you got what you were promised.

All Products	Structured Product Maturities 2019	Lowes 'Preferred' Plans
334	Number of Product Maturities	71
315	Number that Generated Positive Returns	71
15	Number that Returned Capital Only	0
4	Number that Lost Capital	0
3.81	Average Duration / Term (Years)	3.68
	Average Annualised Returns	
6.74%	All Capital at Risk Products	7.80%
9.38%	Upper Quartile	9.82%
3.81%	Lower Quartile	6.03%
3.01%	All Deposit Products	4.38%
5.05%	Upper Quartile	5.64%
0.37%	Lower Quartile	2.44%
5.73%	All Products	7.22%
8.95%	Upper Quartile	9.60%
1.81%	Lower Quartile	4.77%



Measure	February Level	January Level	December Level	November Level
Vstoxx Volatility	13.4	12.7	13.4	13.09
VFTSE Volatility	n/a	n/a	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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