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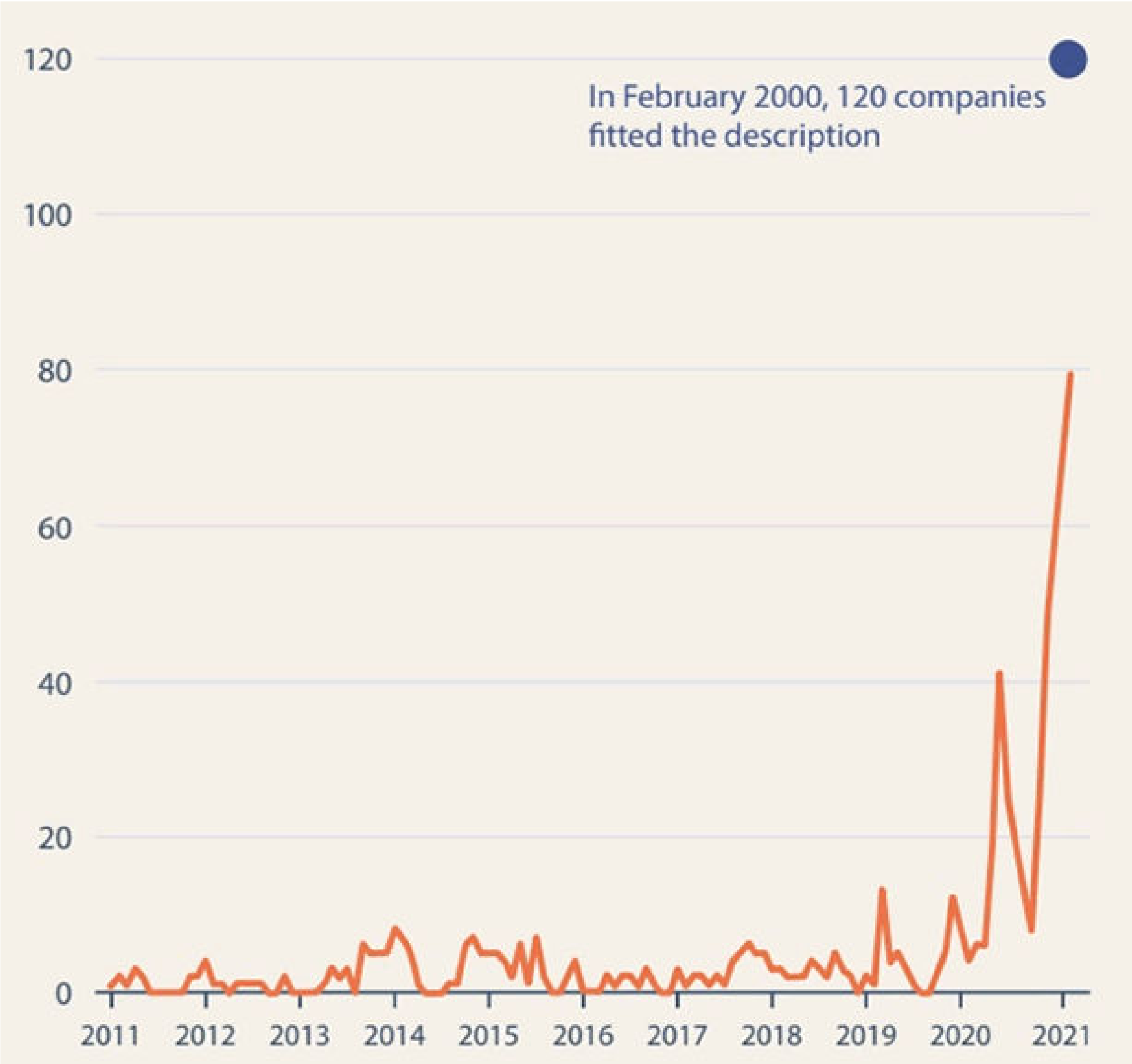
# Monthly Market Report

March 2021

*With commentary from David Stevenson*

In momentum driven markets - which we are smack bang in the middle of currently - everything is about liquidity flows (see our later section on equities) as well as businesses racing to get away IPOs before it's all too late. If you doubt that we are in such a market - which cave are you in - then look at the chart below which comes from a recent issue of the excellent Sunday Briefing intelligence publication. This chart shows firms whose shares have doubled over the past three months and whose price is more than ten times sales. Enough said.




What is powering this momentum rally. I am sure there are a whole legion of factors but as I said the easiest clues are based on the idea of following the money. And there is a lot of it about, courtesy not only of central banks but also government largesse.

One way of understanding this is to make the following statement - **many, many consumers in the West have never had it so good and are now flushed with unprecedented levels of spare cash.**

Some of the younger ones are flushing those stimulus cheques into Robinhood accounts but most oldies are happy to let the cash sit in their bank account - ready to spend at some point in the future. Take this remarkable factoid noticed by the New York Times excellent Neil Irwin - from their Upshot publication. You can read his piece HERE. Here is the relevant nugget of information:

> *"Here's a number that came out Friday you might have missed: JPMorgan Chase said its total deposits were 37 percent higher in the fourth quarter than a year before, a rise of $582 billion.*
>
> *It's a little shocking for what was already the United States' biggest bank to experience such a vast rise in deposits, but not exactly surprising if you've been following the economic data. From March through November, Americans saved $1.56 trillion more than they did in the same period of 2019, reflecting a pullback in spending combined with federal spending that, in the aggregate at least, offset the loss of income from job losses.*
>
> *And that's before the $900 billion pandemic aid package Congress passed at the end of 2020, which includes $600 per-person checks to most Americans, and before whatever emerges from President-elect Biden's plan to spend an additional $1.9 trillion, including a further $1,400 per person.*
>
> *That is an enormous amount of money sitting in savings - whether in an account at JPMorgan, physical cash or invested in stocks and other riskier investments. So what happens if everybody starts spending at once?"*

Another perspective comes from US fund managers at the Collaborative Fund in THIS excellent post.

This eminently sensible piece points out that personal income in the US is currently ABOVE where it was January 2020. Household debt servicing payments as a share of income are also at near RECORD lows. And the personal savings rate is at near-record highs. All probably due to massive government fiscal stimulus - and that inequality I mentioned earlier.

Again, here is the key part of this narrative, in terms of income.

> *"Last year was the best year for income in American history. By far. It's not even close. A lot of the surge came from stimulus payments and unemployment benefits. But private wages and salaries are back at a new high. So are average hourly earnings. And weekly earnings. These are not small numbers: Americans made $1 trillion more from March to November of 2020 than they did from March to November of 2019."*

And another insight... on credit cards.

> *"Credit card balances declined by more than $100 billion over the last year. Americans have less credit card debt today than they did in 2007, despite an economy that's 48% larger and*

*has 30 million more people. There is no precedent for balances falling more than 10% in one year. But it just happened... In aggregate, mortgage payments as a percent of household income have declined from 7% of income in 2007 to less than 4% today, now a new generational low".*

Now the fly in the ointment here is that these consumers might not spend their money very quickly if China is anything is to go by. There, although the local economy has picked up sharply, local consumers are still holding back. My sense is that the vaccine will be the key catalyst to kick off the spending spree. In the meantime, expect more of that spare cash to find its way into the stockmarkets, chasing the next Gamestop.

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## Headline Numbers

Regular readers will know that I keep a beady eye on data suggesting that inflation rates might start picking up aggressively. For the avoidance of doubt, I think the chance of hyper inflation is very low, while the chances of inflation in the UK picking up consistently above 5% are not much higher. But I do worry that if inflation rates start rising above 3% and then stay there for a prolonged period of time, central banks might be tempted to tighten policy, and increase rates. That could cause a strong allergic reaction from investors - Taper Tantrum Redux.

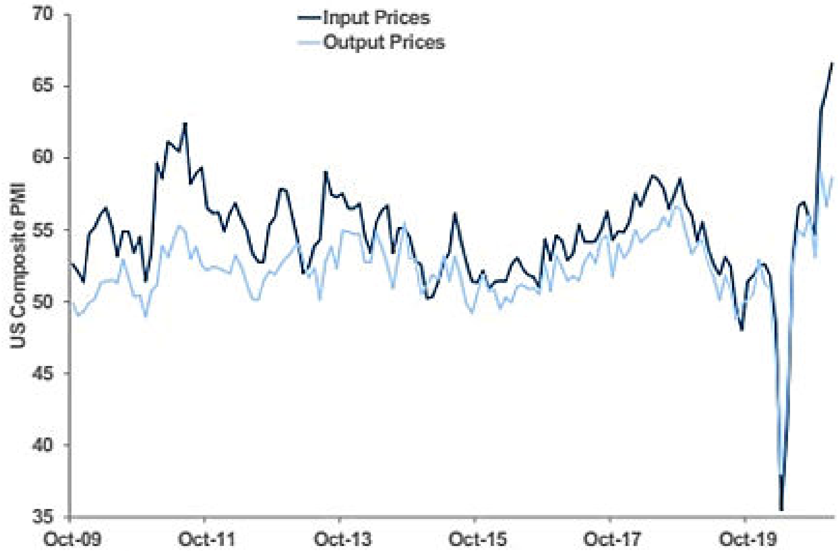
Analysts on Morgan Stanley European equity team keep an eye on this kind of data and its worth reporting back on their latest estimates. First off their US colleagues recently increased their 2021 GDP growth forecast up from 5.9% to 6.5%. And of course stronger growth might also result in higher inflation - the US Morgan Stanley analysts now reckon that core PCE inflation will hit 2.2% in December 2021. Nothing so far to worry about!

Other measures though suggest that there is growing evidence of inflationary trends starting to emerge.

*"US Composite PMI Input Prices already at record high. Even before this stimulus is enacted there are strong signs of a rising inflation environment. This week's release of the US Composite PMI showed the input prices component at a record high on data back to 2009, while output prices were within a whisker of an all-time high (Exhibit 1). Similarly the ISM Manufacturing PMI survey showed prices paid at the highest level in ten years, with 100% of*

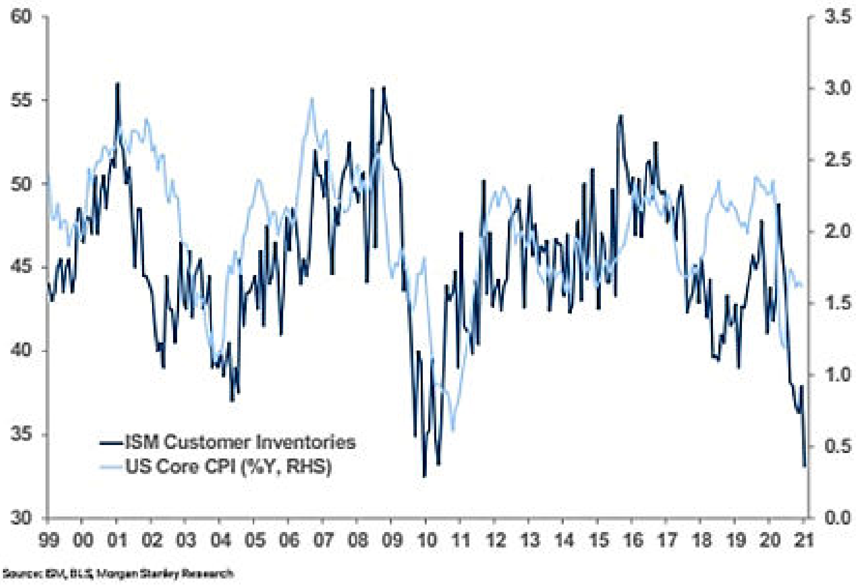
*industries surveyed facing higher prices. Another potential source of inflation pressures is the low level of inventories. Exhibit 2 shows that the customer inventories component of the ISM survey is very close to an all time low, and historically as that series has bounced, so too has inflation".*

Exhibit 1: US Composite PMI Input Prices at a record high




Source: IHS Markit, Morgan Stanley Research

Exhibit 2: ISM Customer Inventories close to a record low, and as that has rebounded historically so too has inflation




Source: ISM, BLS, Morgan Stanley Research

I, like many observers, expected the worst when the corona virus hit developing countries such as India. And indeed, at various points last year, the prognosis was grim. Panic seemed to be setting in. But as we flatten our third peak the picture from many emerging markets is very different, especially India. A few weeks ago, I sat through a lecture by Indian equity managers (India Capital Growth Trust) as they chatted through both their portfolio and the wider macro backdrop.

Over the first 30 minutes a remarkable series of charts were unfurled, all of which suggested that India had somehow - for now perhaps - avoided the second and third wave. The most compelling charts for me were those that spoke to real-time data measures of activity. The message is that India is not far off back to normal on many measures and yet the impact of the virus is drifting lower.

Now, this may all be a snapshot in time, and maybe when new variants emerge, India could be hit again. That is a distinct possibility, but I am not completely convinced and for now, many of us are left wondering what we got wrong with our initial fears. At the start of the pandemic, many wondered aloud whether there was some 'dark' matter like force at work that helps explain why some got the virus and others did not. By this, we meant whether some people had some kind of resilience to the virus which in turn helped explain why so many were cautious about models that automatically assumed between 90 and 100% of people would get the virus if it wasn't controlled. These stats on India I think tentatively re-opens this debate.

Source - India Capital Growth Fund

Chart 1 - Under control?

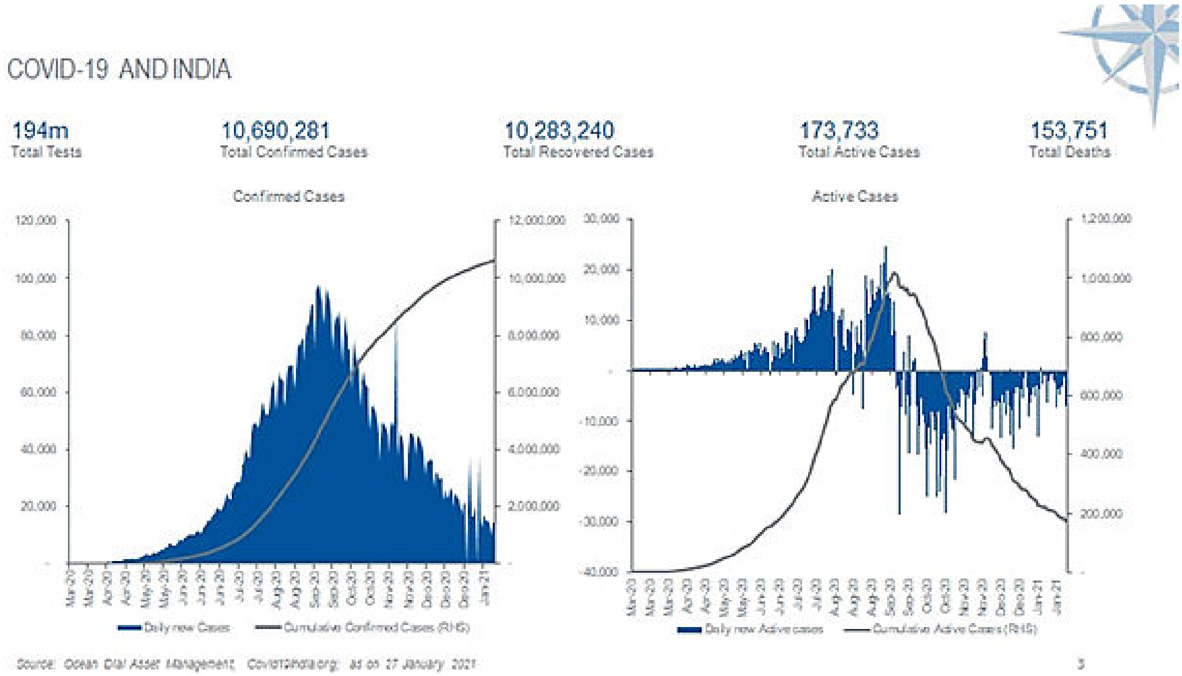
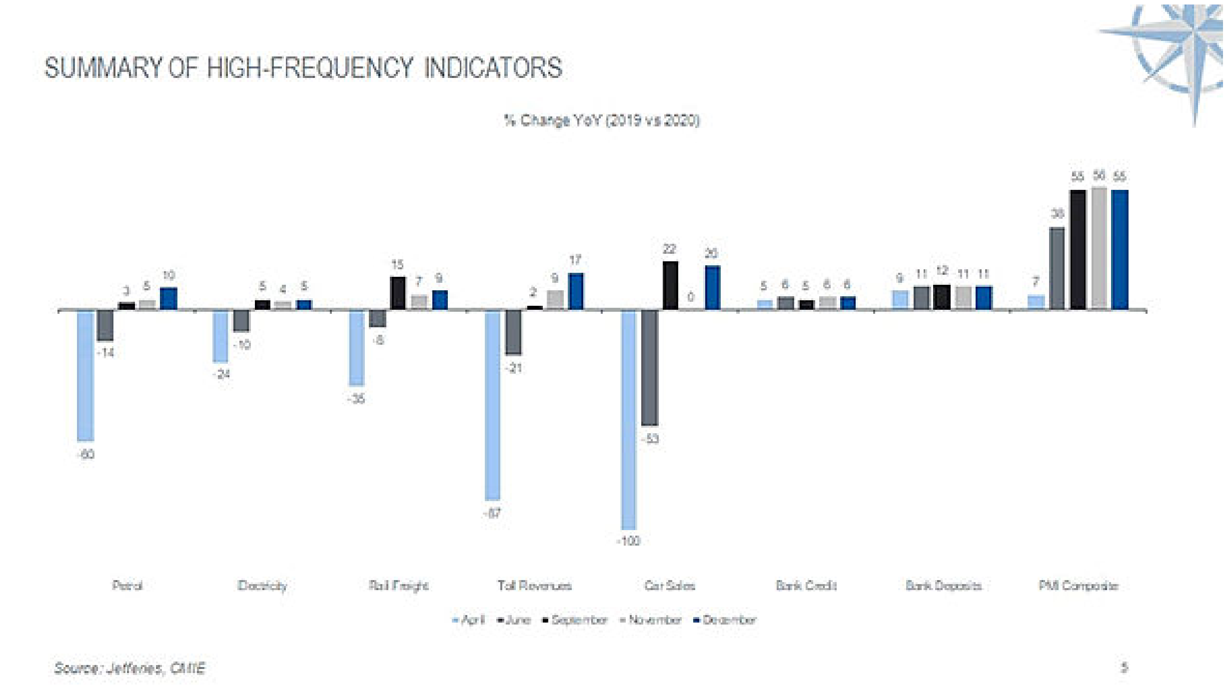
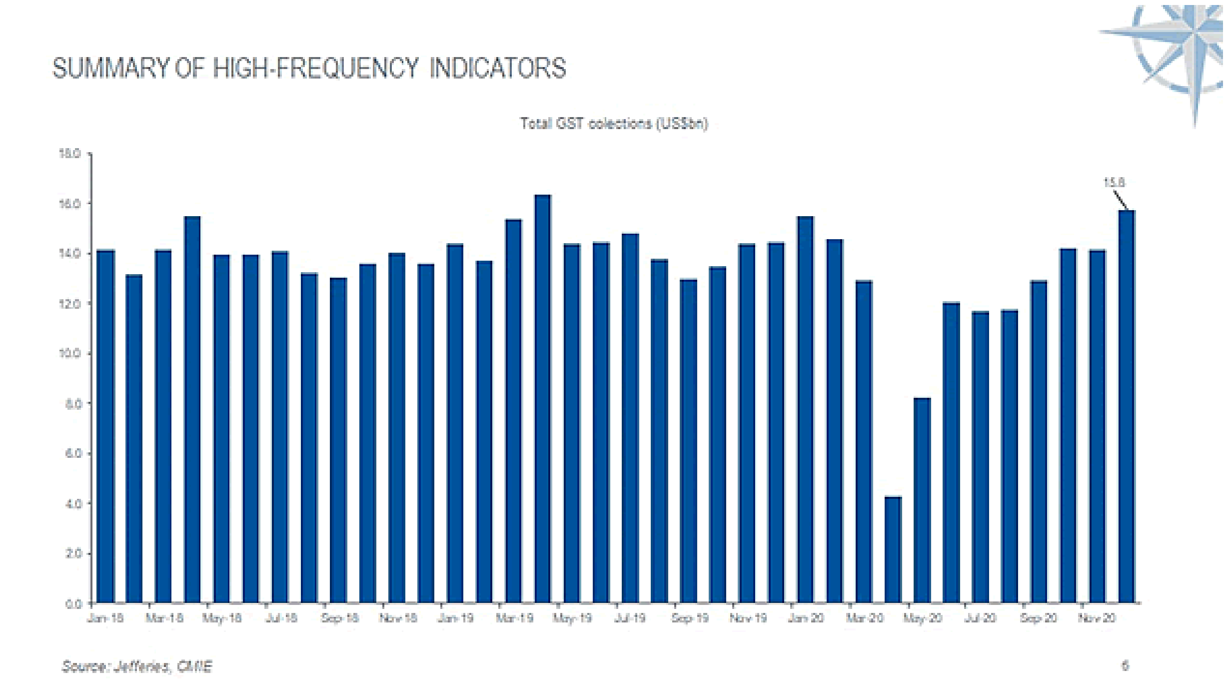



Chart 2 - Getting back to normal?




| Measure | Values as of 12th January, 2021 | Values as of 12th February, 2021 |
|---|---|---|
| UK Government 10 year bond rate | 0.34% | 0.45% |
| GDP Growth rate YoY | -8.6% | -8.60% |
| CPI Core rate | 0.30% | 1.40% |
| RPI Inflation rate | 0.90% | 1.20% |
| Interest rate | 0.10% | 0.10% |
| Interbank rate 3 month | 0.03% | 0.05% |
| Government debt to GDP ratio | 80.70% | 80.70% |
| Manufacturing PMI | 57.5 | 54.1 |

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# Bank CDS options

A quiet month for the market in credit default swaps for big global banks. There were no big moves on pricing with most banks showing a marginal increase in pricing, especially the big US banks saw a more notable upwards repricing of risk. Some banks swap rates fell, notably Lloyds Bank which is now deemed much lower risk than HSBC (who'd have thought that ten years ago).

| Bank | One Year | Five Year | Credit Rating (S&P) | Credit Rating (Moody's) | Credit Rating (Fitch) |
|---|---|---|---|---|---|
| Banco Santander | 8.6 | 31.2 | A | A2 | A - |
| Barclays | 13.98 | 47.14 | BBB | Baa2 | A |
| BNP Parabis | 7.59 | 27.7 | A+ | Aa3 | A+ |
| Citigroup | 25.57 | 52.41 | BBB+ | A3 | A |
| Credit Suisse | 25.57 | 52.41 | BBB+ | Baa1 | A- |
| Deutsche Bank | 12.48 | 44.18 | BBB+ | A3 | BBB |
| Goldman Sachs | 25.62 | 54.51 | BBB+ | A2 | A |
| HSBC | 9.49 | 30.67 | A+ | A1 | AA- |
| Investec | n/a | n/a | n/a | A1 | BBB+ |
| JP Morgan | 25.53 | 43.4 | A- | A2 | AA- |
| Lloyds Banking Group | 3.97 | 27.71 | BBB+ | A3 | A+ |
| Morgan Stanley | 28.54 | 50.41 | BBB+ | A1 | A |
| Natixis | 34.08 | 44.43 | A+ | A1 | A+ |
| Nomura | 11.07 | 38.66 | BBB+ | Baa1 | A- |
| RBC | 18.4 | 54.48 | AA- | A2 | AA- |
| Soc Gen | 8.53 | 28.85 | A | A1 | A- |
| UBS | 7.47 | 25.65 | A- | Aa3 | A+ |

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 4th January 2021 www.tempo-sp.com

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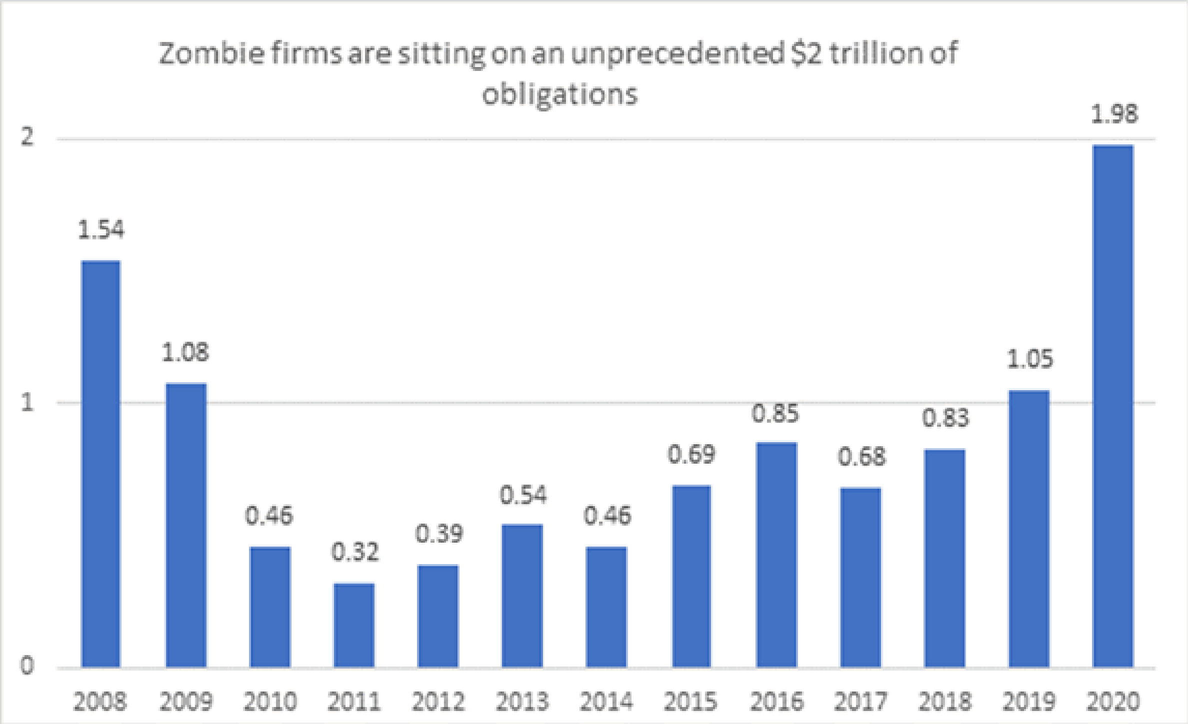
# Government Bonds

### Fixed Income Zombie Firms

Zombie loans are huge and growing by the day, artificially supported by mammoth central bank lending programmes. Looking at the subset of large cap stocks, Bloomberg recently calculated that more than 200 of these very large companies have become so-called "zombie companies", categorised as a business limping through the economy burdened by their debts and unable to earn enough to pay off their interest. Well-known names include Boeing, Carnival, Delta Air and

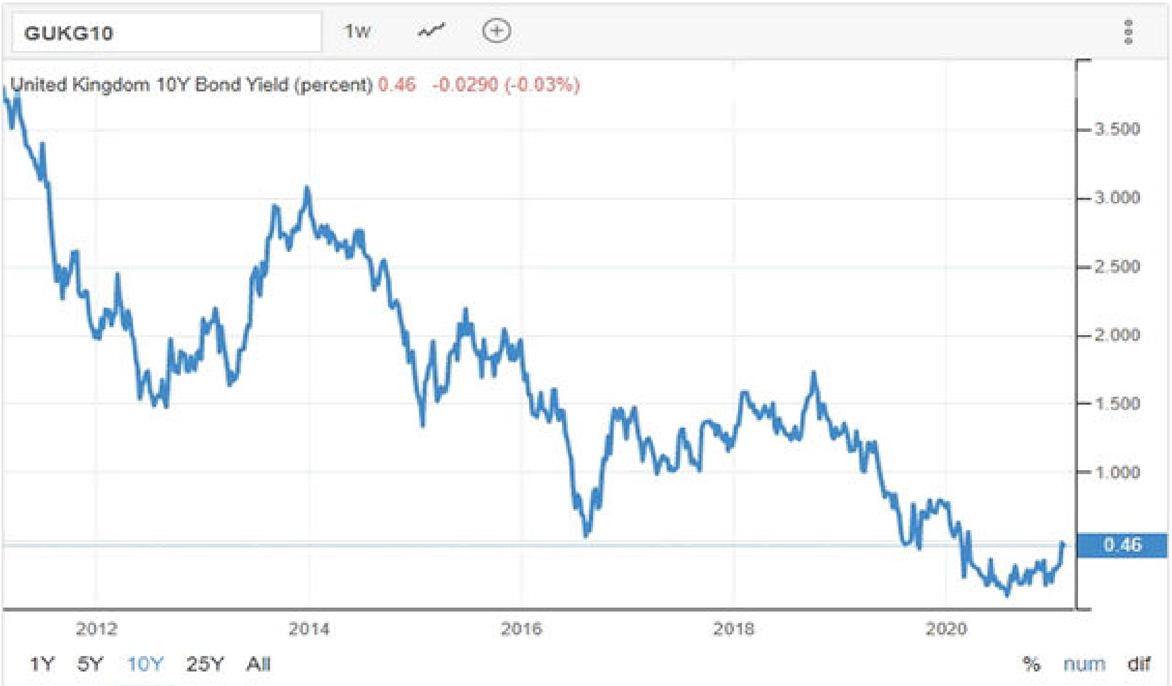
Rolls Royce.

The chart below shows the added $1trn of debt that these 200 Zombie firms have added over the pandemic. What might happen next? As one investor in this space recently asked, "when the debt holders want their money back, and the corporate relief programs end, which companies will manage to grow out of their debt and restructure to stronger more resilient businesses, and which companies will downgrade further and become fallen angels?".




Source: Bloomberg Dec 2020

UK Government Bonds 10-year Rate 0.46%




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

## CDS Rates for Sovereign Debt

| Country | Five Year |
|---|---|
| France | 15.62 |
| Germany | 11.07 |
| Japan | 15.61 |
| United Kingdom | 15.65 |
| Ireland | 14.21 |
| Italy | 78.49 |
| Portugal | 33.59 |
| Spain | 38.15 |

## Eurozone peripheral bond yields

| Country | January 2021 | February 2021 | Spread over 10 year |
|---|---|---|---|
| Spain 10 year | 0.09% | 0.13% | 59 |
| Italy 10 year | 0.64% | 0.48% | 95 |
| Greece 10 year | 0.67% | 0.76% | 112 |

| | 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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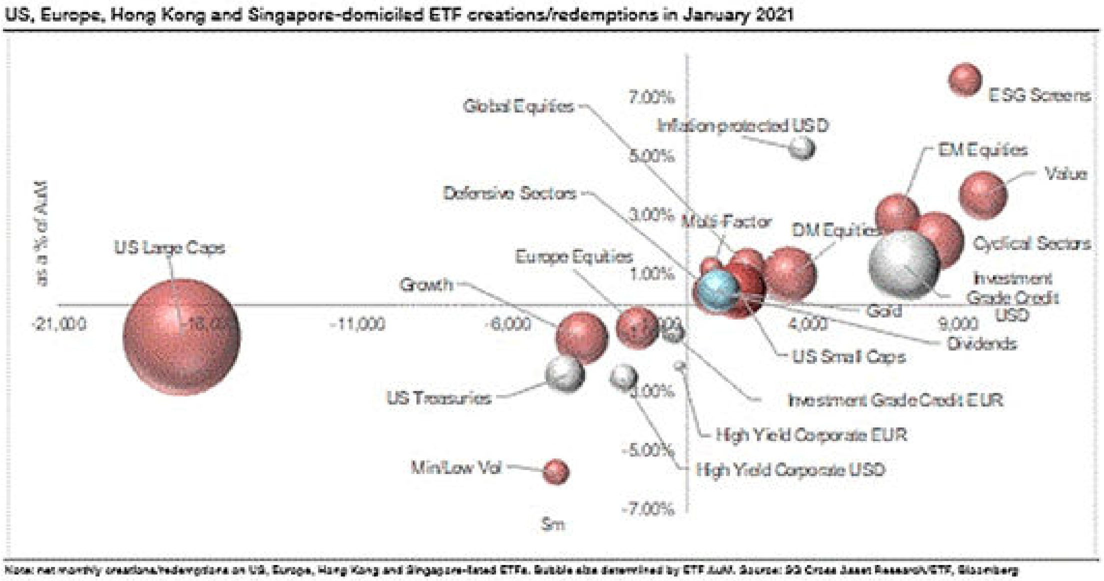
# Equity Markets and Dividend Futures

Away from the madness of Gamestop, what have mainstream investors been putting their into over the last few weeks? One of the best ways of understanding momentum flows is to look at data on exchange-traded fund (ETF) creations and redemptions. Earlier this month the SocGen ETF analysts team published their latest report, which suggests that in January their universe recorded $75bn net new money. The winners? **International stocks, cyclicals, value and... bonds** ?!? Curiously, "*Fixed Income ETFs posted the largest creations relative to total assets (1.5%). In terms of strategies the most traded included US Financials, Value, the Innovation themes, Renewable Energy and USD Bonds. By contrast ETFs tracking the Hang Seng, US Real Estate and USD High Yield Corporates reported the largest divestments.*"




**The chart above reminds us though that the one stand out star of 2020 was ESG funds.** According to another report out this month from analysts at SG at the end-2020 EPFR ESG funds' assets under management (AuM) **"reached $1.6tn, having increased tenfold since 2017 and doubled in size almost every year."** And crucially, it looks like outperformance has been driving these flows - In 2020, ESG funds outperformed the overall EPFR fund universe (+10.4% and +7.0%, respectively), continuing the trend seen since 2013".

| Index | January 2021 | February 2021 | Reference Index Value | Level 6 Months Ago |
|---|---|---|---|---|
| Eurostoxx 50 (Dec 19) | 85.4 | 85.4 | 3608 | 83.5 |
| FTSE 100 (Dec 19) | 207.2 | 207.2 | 6756 | 205.5 |

| Name | | | Price % change | | | | Close |
|---|---|---|---|---|---|---|---|
| | 1 mth | 3 mths | 6 mths | 1 yr | 5 yr | 6 yr | |
| FTSE 100 | -3.96 | 2.3 | 6.09 | -12.9 | 17.9 | -4.24 | 6529.2 |
| S&P 500 | 2.9 | 9.44 | 17.3 | 16.4 | 11.4 | 89 | 3909.88 |
| | | | | | | | |
| iShares FTSE UK All Stocks Gilt | -1.76 | -0.686 | -3.46 | 0.167 | 10.5 | 13.9 | 1427.88 |
| | | | | | | | |
| VIX New Methodology | -8.68 | -6.23 | -8.49 | 44.9 | -21.9 | 29.7 | 21.99 |

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# Volatility

This month saw the release of the latest Structured Products Annual Performance Review 2021, produced by the excellent Lowes Financial Management. This is the latest comprehensive study conducted over many years into absolute returns from the whole of market. The big story of the last decade is that the vast majority of structured products (SPs) have delivered what they said they would. This, I hope, will contribute towards a mainstreaming of these alternative investments. What happened in 2020? Well, as we could have expected, there have been some 'challenges' but nothing which remotely undermines what I think is a very interesting story of redemption and renewal for structured products generally.

Here are some of the key headline stats:

- *Market turmoil resulted in 16 among 235 structured product maturities in 2020 realising a capital loss. This compares against four loss-making maturities among 334 maturities in 2019. Average annualised returns for all 2020 maturities, including deposits were 3.52% against 5.73% in 2019 and 6.37% in 2018.*
- *Almost 70% of all products maturing last year generated positive returns for investors; fewer than 7% returned a loss. The rest simply returned investor capital, having protected it from the fall in the market."*
- *During 2020 there were 11 plans that matured realising an annual return greater than 10%. More than half the rest delivered an average annualised return of more than 4%, easily beating inflation.*
- *Half of all maturities in 2020 were linked solely to the FTSE 100 Index. Of these the deposit and capital protected structures returned an average annualised return of 1.82% over an average duration of 5.35 years and the capital at risk plans returned an average of 5.68% over an average duration of 4.24 years.*

A copy of the Annual Performance Review can be found here.

| Measure | February Level | January Level | December Level | November Level |
|---|---|---|---|---|
| Vstoxx Volatility | 21.21 | 24.41 | 20.82 | 24.8 |
| VFTSE Volatility | 21 | 23.33 | 21.28 | 23.19 |


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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.<br>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.

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