Monthly Market Report
March 2022

With commentary from David Stevenson

As usual there's lots of known unknowns swirling around the markets, impacting fragile sentiment at the moment. Inflation tops the list but there's also the worry about Russia and the Ukraine. These known unknowns are difficult for investors to process because they can't really second guess the players and processes. When it comes to the central banks, there's more confidence that investors can at least get some sense of what might happen next. And I think this opens up the biggest risk currently - the element of surprise when markets think they worked something out in their minds. Investors wouldn't be surprised by lots of developments, but they think they probably have a handle on the likely next steps for the US Federal Reserve - as discussed later in the bond section. In simple terms, US interest rates will go up 2 to 4 times. BUT what could really derail the markets is if there is a surprise and the US Fed doesn't behave as expected. For instance, what happens if the US Fed only raises once? Or alternatively five or six times, with the latter implying interest rates past 2%? It's the surprise that could derail the markets fragile confidence, not the actual increase.

To a lesser degree that's also true for the inflation numbers. The market is sort of poised to see inflation go higher but if those inflation rates were to suddenly, unexpectedly, jump much higher or much lower, that might completely derail market sentiment. So, in simple terms, I think we all know we're in a fragile, uncertain, more volatile market - lots of potentially bad news is priced in. What could really scare investors are the nasty 'surprises' when they thought they had something worked out.

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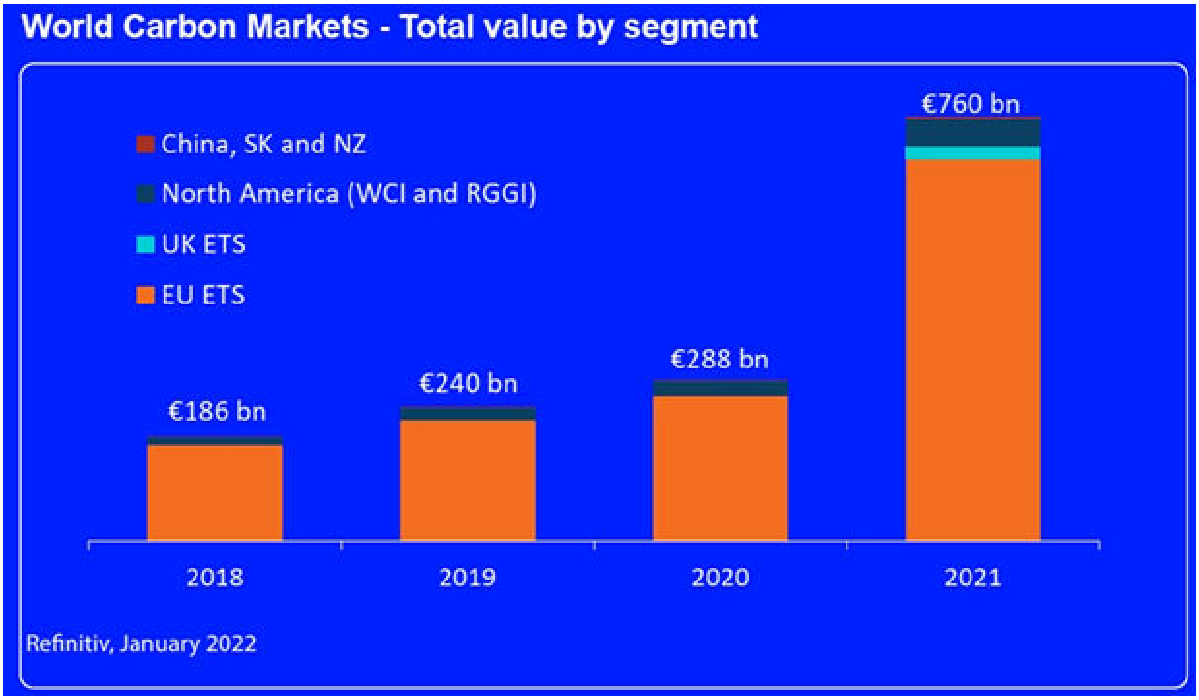
Headline Numbers

If you get a chance, head over to Refinitiv and download their latest Annual Review and 2022 outlook for carbon markets. I think the most interesting story of the next decade is rising carbon prices, easily investable via the European Union emissions trading scheme. Put simply, carbon prices need to rise, and the EU is doing everything in its power to make industrial and power emissions much more expensive. I think this is a long term one way trade, up. In the short term prices certainly have increased - the Refinitiv report reminds us that the cost of emitting greenhouse gases rose sharply in 2021 in all major emission trading systems (ETS).

"EU emission allowances ended the year above €80/t - more than double their price at the end of 2020. UK allowances fetched an even higher price, following the launch of the new stand-alone UK ETS. In both North American markets (WCI and RGGI) permit prices rose 70 percent over the year. "

As prices have risen, we've seen an influx of financial investors in carbon markets, boosting volume and liquidity. Again, from the Refinitiv report: *"In Europe, home to the largest carbon market by traded volume, the skyrocketing permit prices were due to increased climate change mitigation ambition that will lead to a tighter market balance. In addition, soaring natural gas prices led to more coal power generation, which spurred demand for allowances and made them more expensive."*

The standout number is this: surging prices combined with a modest rise in volume led to a record high turnover of €760 billion. That represents a 164 percent increase from the €289 billion realised in 2020.



Equal weight vs market cap

Gerry Celaya, Tricio's excellent investment strategist, makes an interesting observation - the equal weight version of the S&P 500 has recently been outperforming the market cap weighted S&P 500. This slightly flies in the face of conventional received wisdom. Equal weight indices are supposed to be more volatile than market cap weights because they are overweight smaller cap socks. Not this time though.

The chart below compares the S&P 500 with the equal weight S&P 500 index tracker from Invesco, ticker RSP in the UK. The RSP ETF allocates the same weighting to all of the 500 member of the S&P 500. As Celaya observes:

"The risk in the market cap ETF is that the top holdings (Apple, MSFT, AMZN, Google (Alphabet), Tesla and Facebook (Meta)) comprise around 25% of SPY. 6 out of 500 shares make up a quarter of the index. For the record, the SPY ETF is down around -6.95% so far this year, the RSP ETF is down -5.82%. SPY is up around 19.4% over the last 12-months, up 93% over the last 5 years and up 541% from March 2009. RSP is up 21.1% over the last 12- months, up 72.7% over the last 5-years and up 639% from March 2009."

Chart below - black line S&P 500, red line, RSP Equal weight S&P 500

Measure	Values as of 11th January, 2021	Values as of 14th February, 2021
UK Government 10 year bond rate	1.17%	1.50%
GDP Growth rate YoY	6.80%	6.50%
CPI Core rate	5.10%	5.40%
RPI Inflation rate	5.50%	7.50%
Interest rate	0.25%	0.50%
Interbank rate 3 month	0.49%	0.86%
Government debt to GDP ratio	94.9%	94.9%
Manufacturing PMI	57.9%	57.3%

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Bank CDS options

After many months of becalmed markets for banking credit default swaps, virtually every contract has moved as one in the last month - upwards in price, indicating a consistent worry about increasing financial market volatility. Virtually every bank in our watchlist bar Nomura, saw a substantial increase in the pricing of their swaps - no one bank stood out in terms of their price movement. Looking at one year swaps the cheapest rates are on BNP Paribas paper followed by UBS. While on five year swaps, its Natixis and BNP Paribas. It's also worth noting that European banks are seen generally as lower risk than American banks, although that's been a persistent trend for the last year or so.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	12.3	36.91	A	A2	A -
Barclays	21.74	50.75	BBB	Baa2	A
BNP Parabis	11.47	33.75	A+	Aa3	A+
Citigroup	34.81	66.36	BBB+	A3	A
Credit Suisse	27.75	64.1	BBB+	Baa1	A-
Deutsche Bank	33.59	85.61	BBB+	A2	BBB+
Goldman Sachs	34.6	74.29	BBB+	A2	A
HSBC	13.1	34.63	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	32.03	58.41	A-	A2	AA-
Lloyds Banking Group	12.87	34.02	BBB+	A2	A
Morgan Stanley	35.8	68.33	BBB+	A1	A
Natixis	12.5	29.5	A	A1	A+
Nomura	18.06	71.4	BBB+	Baa1	A-
RBC	18.05	53.53	AA-	A2	AA-
Soc Gen	14.47	38.54	A	A1	A-
UBS	12.04	36.78	A-	Aa3	A+

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

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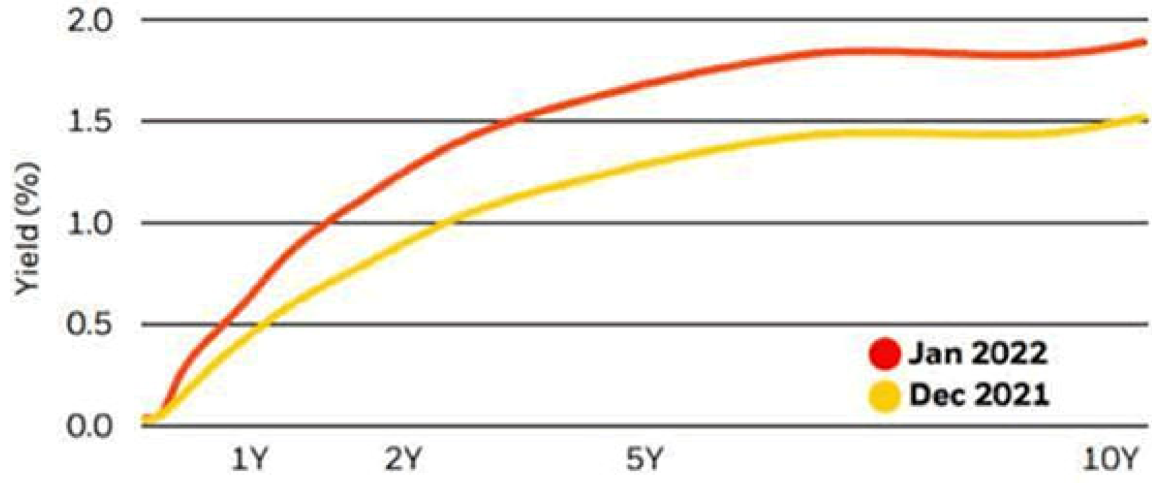
Government Bonds

If you want a decent proxy for what the market consensus on rates might be, its probably worth starting with the biggest fund manager of all - BlackRock. They publish some excellent market overviews which nicely sum up where they think US interest rates are heading - and thus whether bonds are attractive as an asset class. It comes as no surprise that they believe that there'll be a sharp rise in rise in government bond yields this year, largely because investors want greater compensation for the risk of holding government bonds.

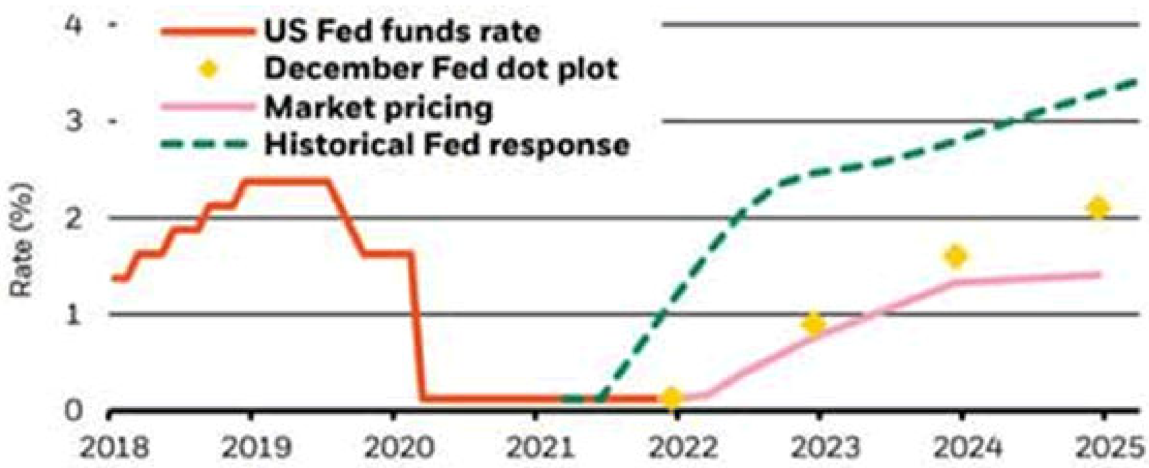
Shift in the U.S. yield curve, Dec 2021-Jan 2022



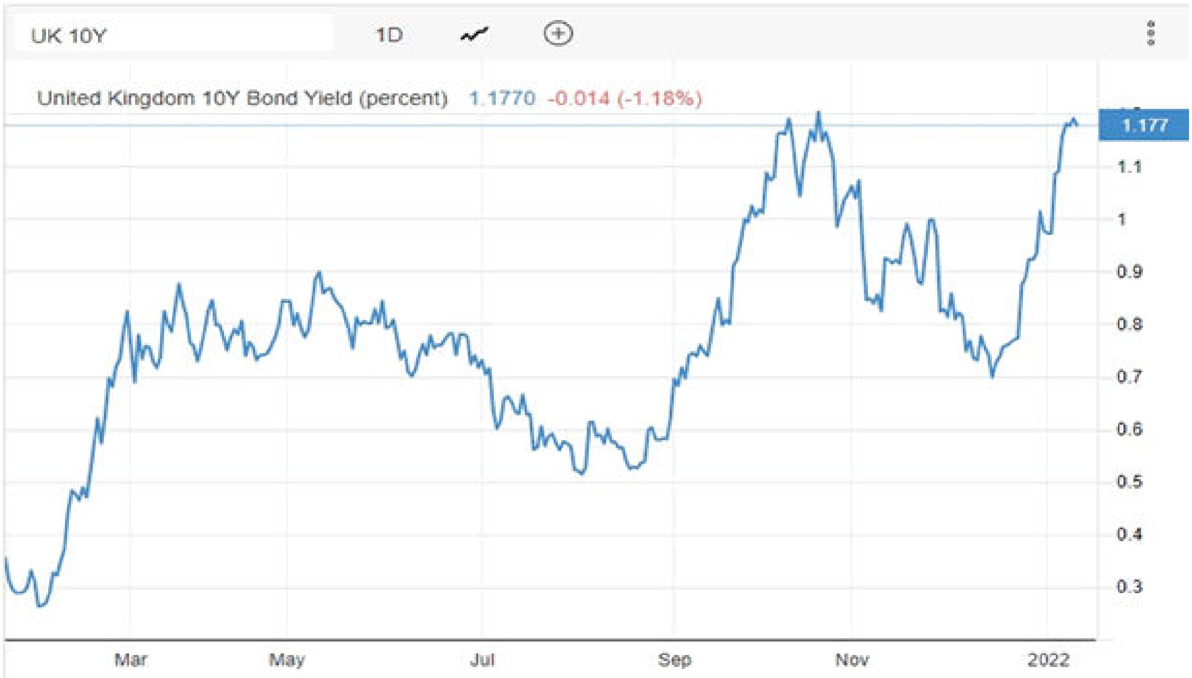
Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, January 2022. Notes: The chart shows the number of 25 basis point rate to the end of 2024 across selected DM economies priced in currently vs. the number that were priced in November 2021. The hikes are calculated by comparing the average forward rate priced by the market in 2024 and comparing it to the current rate. We use the Secured Overnight Financing Rate in the U.S. and overnight index swaps for the rest.

BlackRock observes that the rise in 10-year yields has largely been driven by a resurgence of the term premium, but what's really surprising is the speed of the yield spike. The Fed has effectively abandoned its prior guidance by suggesting it's ready to start raising rates before achieving its "broad and inclusive" employment mandate... we see a further resurgence of the term premium pushing yields higher, especially as the Fed prepares to shrink its balance sheet.

But there's a deeper concern - that the Fed and other central banks are behind the curve in dealing with inflation. To use a metaphor, central banks are only taking their collective foot off the monetary accelerator, rather than hitting the brakes. Or as BlackRock puts it - "We don't see [central banks] responding aggressively to persistent inflation. The Fed's indicated policy response (yellow dots in the second chart below) is very mild compared with how it would deal with inflation in the past: a series of rapid-fire rate hikes that would have already begun and would hoist the fed funds rate to near 4% over time (dotted green line).



UK Government Bonds 10-year Rate 1.17%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	20.1
Germany	7.3
Japan	17.7
United Kingdom	9.96
Ireland	15.1
Italy	103.1
Portugal	40
Spain	40.6

Eurozone peripheral bond yields

Country	January 2022	February 2022	Spread over 10 year
Spain 10 year	0.65%	1.15%	137
Italy 10 year	1.30%	1.90%	212
Greece 10 year	1.56%	2.59%	281

	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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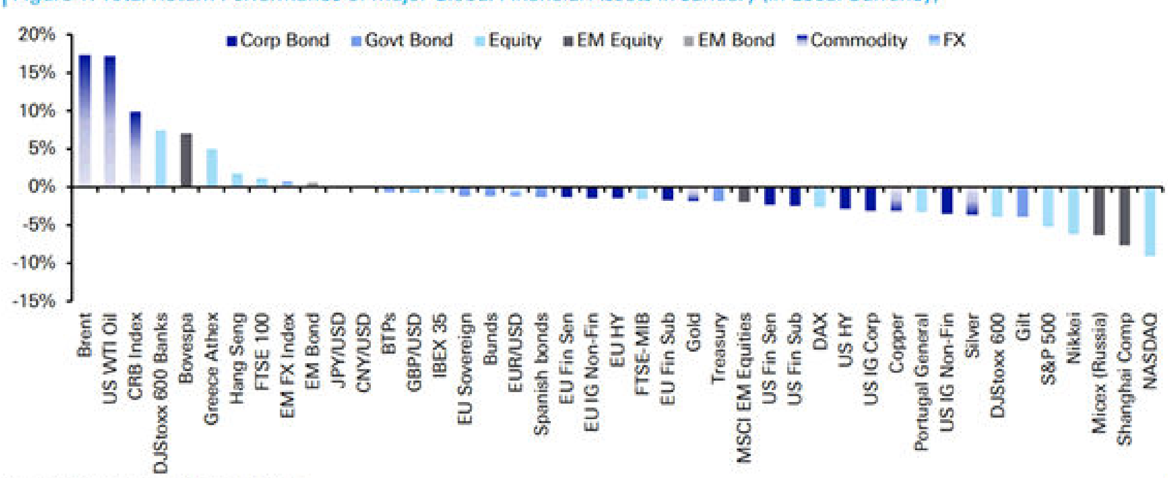
Equity Markets and Dividend Futures

So, as the headline says, the Jan 2022 numbers are in and they don't look pretty. By my reckoning, the peak to trough in this sell off has been around 10% which compares to about 13 to 15% for most sell offs that don't involve a recession. So, its not a BIG sell off but it was painful enough. According to analysts at S&P Dow Jones, the "S&P 500® made its worst start to a year since 2008, finishing with a January loss of 5% including dividends. The S&P MidCap 400® and S&P SmallCap 600® fared worse, both retreating 7%..... Growth and Real Estate shed 9%, and Consumer Discretionary gave up 10%."Analysts at Deutsche Bank have also been collecting the stats and here's their roll call of damage...

- *S&P 500 -5.26% (-11.40% at the intra-day lows on 24th). NASDAQ -8.98% (-16.30% at lows). Euro Stoxx 600 -3.81% (-6.82% at lows). All in price terms. Full document link below has total returns.*
- *10yr US treasuries +26.7bps (+39.1bps intra-day on 19th).*
- *2yr US Treasuries +44.6bp (+49.2bps on 28th).*
- *Fed hikes for 2022 up from 2.96 to 4.94 (5.06 high on last day of month).*
- *10yr Bunds +18.8bps (closed month at the highs).*
- *Brent Crude (+17.3%) and WTI (+17.2%) both seeing their strongest gains in 11 months. Former above $90 for first time since 2014.*
- *Dollar was strongest G10 FX (+0.9% gain) after +6.4% in 2021. 18-month highs on 28th.*
- *CDS: EU XO +40bps (+51bps at 28th wides). EU IG +11.1bps (+13.7bps at wides).*
- *CDS: HY CDS +46.5bps (+57.5bps at 28th wides). US IG +10.5bps (+14.9bps at wides)*
- *Bitcoin (-17.0%) fell for third month, joined by XRP (-26.5%), Ethereum (-27.3%) and Litecoin (-25.3%).*
- *Covid: Up from 9.2m weekly global cases to 23.1m in January. Weekly global fatalities up from 44.1k to 66.6k. However, peak weekly number in pandemic before Omicron was a relatively low c.6m weekly cases but over 100k (confirmed) fatalities. So a huge swing.*

The two charts below put some graphic flesh on the bones of this unsettling month

Figure 1: Total Return Performance of Major Global Financial Assets in January (in Local Currency)



Source : Deutsche Bank, Bloomberg Finance LP, Mark-it

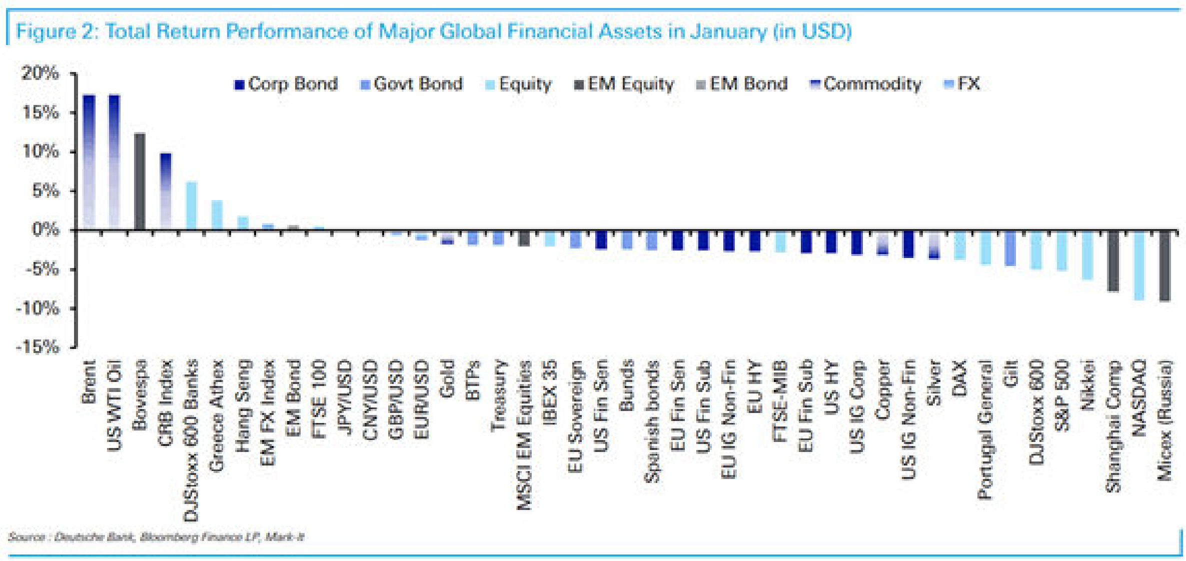


Figure 2: Total Return Performance of Major Global Financial Assets in January (in USD)

Source : Deutsche Bank, Bloomberg Finance LP, Mark-It

Index	January 2022	February 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	116.3	10.7	4014	100.5
FTSE 100 Dividend Dec 2021	269.1	270.2	7517	243.9

Note changed to Dec 2022 contracts in January 2022

Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.307	2.34	4.17	14.1	3.46	31.7	7519.8
S&P 500	-5.24	-5.64	-1.1	12.3	89	137	4418.6
iShares FTSE UK All Stocks Gilt	-3.83	-5.82	-8.01	-7.23	1.1	3.16	1316.63
VIX New Methodology	42.6	68	77.1	37	155	7.72	27.36

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Volatility

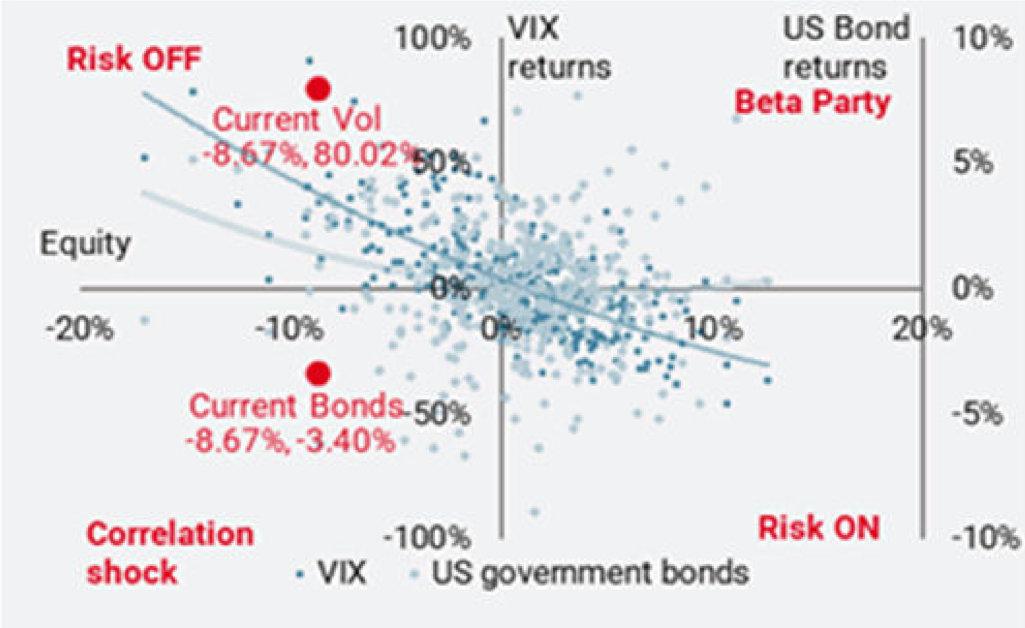
Unigestion's Senior Portfolio Manager, Olivier Marciot, from their Cross Asset Solutions team has been looking at hedging strategies over the last few weeks as QE reverses track. He suggests that the traditional binary distinction has been between risk on (where risk assets thrive and hedges, such as bonds, suffer) or Risk-off (where risk assets suffer and hedges thrive). Since the current unconventional version of QE has emerged, he suggests two additional regimes have appeared:

"'Beta parties' (where most assets thrive together with little to no distinction between them) and 'correlation shocks' (where most assets re-correlate positively to the downside). "

In these correlation shocks, traditional safe havens (hedges) behave differently. The new framework encourages investors to work out whether we're in a conventional risk-off scenario (growth shocks for example) or a correlation shock (like the one in Q4 2018).

Figure 1 illustrates the historical relationships between equity returns on the x-axis and two commonly used hedging assets on the y-axis, government bonds and volatility. It also demonstrates why all hedges are not created equal.

Figure 1: Monthly equity vs hedges performances:

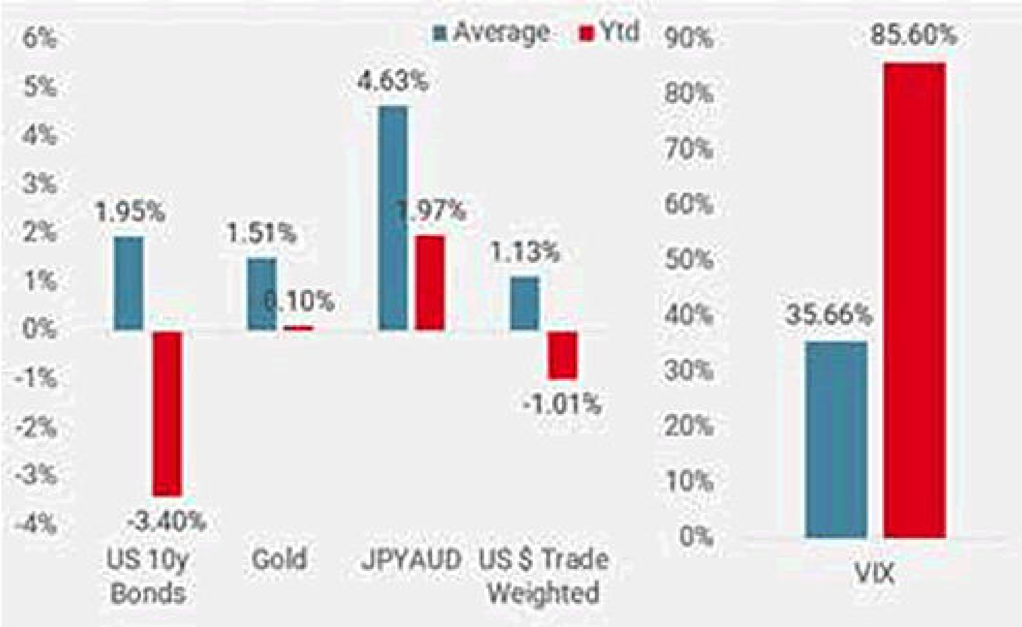


The key takeaways?

- Government bonds helped only half of the time when equities fell.
- Government bonds have an inverse relationship with equities, but mostly to the downside
- Volatility disappointed much less when equities were down

Thus as Marciot observes: *" ...choosing the right hedge (long volatility) can make a clear difference versus choosing the wrong one (government bonds). A broader spectrum of hedges in Figure 2 clearly shows that this time around, most usual safe heavens have underperformed. " All of this suggests that there "not many places to hide, apart from cash and long volatility strategies. Volatility has been the first and virtually only rampart."*

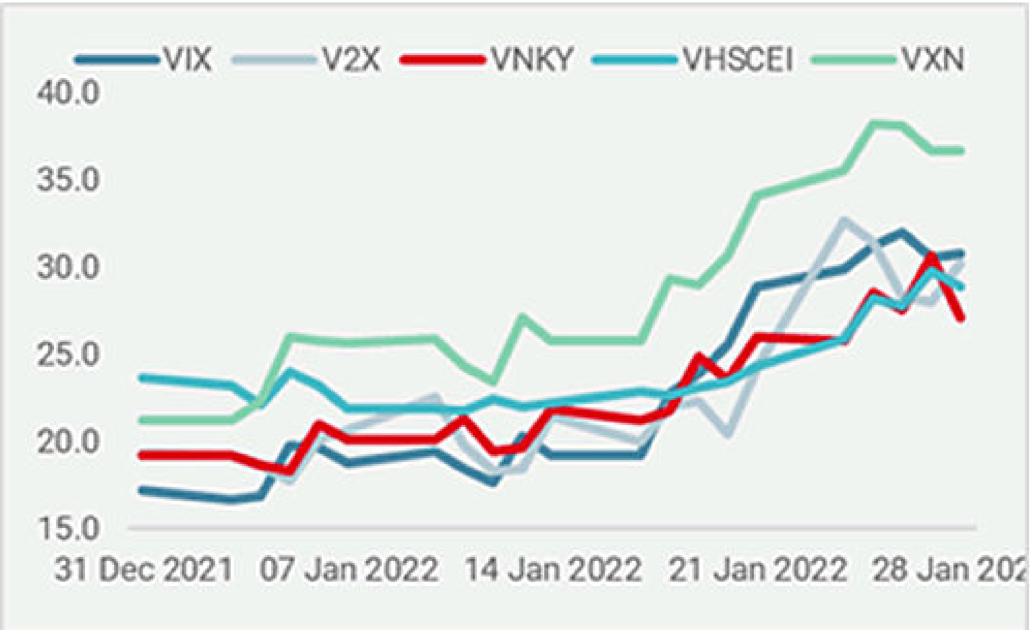
Figure 2: Monthly historical performance when equites < -5%



Source: Bloomberg, Unigestion. As of 26 Jan 2022

Crucially though within the vol category, not all options have performed equally, as shown in Figure 3.

Figure 3: Volatility indices



Source: Bloomberg, Unigestion. As of 26 Jan 2022.

Red line - 20 day moving average   Green Line - 200 day moving average

Measure	February Level	January Level	December Level	November Level
Vstoxx Volatility	32.85	20.27	30.06	16.59
VFTSE Volatility	27.36	19.4	30.67	17.66

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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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