



# Monthly Market Report

## March 2023



*With commentary from David Stevenson*

The bulls are back and equity markets have surged ahead. The MSCI World Index is up 7.21% so far in 2023 (to Feb 14th), with the US S&P 500 up 7.76% and the FTSE 100 in buoyant mood, up 7.12%. Regular readers will know that I remain more than a tad cynical about investors and markets but there is a more than decent chance that we might have seen a trough in valuations in the second half of 2022 and thus we might be in a more bullish place. Maybe we are in the foothills of another bullish advance?

Some evidence for this comes from table below which is from index firm S&P Dow Jones. It's focused on the all-important US equity markets and shows that since 1936, of the nine prior years with double-digit losses, seven of those years experienced double-digit gains the following year, "proof that the best guess of future returns does not depend on the immediate past."

**Exhibit 4: Double-Digit Losses Were Typically Followed by Gains**

Year	S&P 500 Annual Return	Subsequent Year Return
1937	-34.7%	30.8%
1941	-11.6%	20.1%
1957	-10.7%	43.1%
1966	-10.0%	23.9%
1973	-14.7%	-26.3%
1974	-26.3%	37.1%
2001	-11.9%	-22.1%
2002	-22.1%	28.7%
2008	-37.0%	26.5%
2022 YTD	-15.0%	?
<b>Average</b>		<b>18.0%</b>

Source: S&P Dow Jones Indices LLC. Data as of Dec. 14, 2022. Index performance based on total return in USD. The S&P 500 was launched March 4, 1957. All data prior to index launch date is back-tested hypothetical data. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure linked at the end of this post for more information regarding the inherent limitations associated with back-tested performance.

If I had to summarise the bull's case, its this: sure, US corporate earnings growth is slowing down as are most developed world economies but inflation is falling rapidly and interest rates have either peaked or are close to peaking. We may in fact just about escape a recession as long as energy prices remain subdued.

There are many things that could go wrong with this scenario but for me the clear and present danger is that although inflation may indeed be falling, it could start rising again. If that is the case then interest rates might stay high, longer or could even go higher. On this score my biggest fear is that we have what one might call a 2023 Inflation redux bounce -echoing the 1970s when inflation mechanistically declined sharply only to rebound as external factors pushed rates higher again (China inflation increasing as it rebounds from Covid). On this score the second chart below from

Rob Arnott, at Research Affiliates is helpful.

Arnott predicts that "with high conviction, that US inflation will continue to tumble until mid-2023 and then re-ignite the second half of the year. Both moves will be an illusion. Why? In 2022, inflation was 6.3% in the first six months (13% per annum), and a scant 0.2% in the next six months. These months will be replaced, one month at a time, in 2023. Suppose every month in 2023 matches the average inflation of the last three years, 0.46%/month. We may see widespread applause for an illusion that inflation is tapering from 6.5% to 2.9%, followed by growing fear from an illusion that inflation is reigniting, from 2.9% to 5.7%."

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## Headline Numbers

The constant drum beat of macroeconomic always provides enough excitement for investors focused on macro themes, but the dominant concern of course is the slowdown, both here in Europe and in the US. If we are entering a recession, then most these usually result in a fall of between 10 and 20% in corporate earnings. If that does happen, then most equity markets look far from cheap. By contrast if we avoid a recession then markets look much less expensive.

So, recession or not? That's the big question on investors' minds and the big surprise of recent weeks has been the strength of the US jobs market. And the key measure here is the new net jobs numbers coming out of the US. According to Bloomberg's survey of 77 leading economists, the likely number was supposed to be 185k net new hires. In fact, "the Bureau of Labor Statistics reported that 517K new jobs were added during January, about 8.5 standard deviations from the average expectation of the survey participants. By any measure, that is a huge difference between expectations and reality" according to Morgan Stanley analysts.

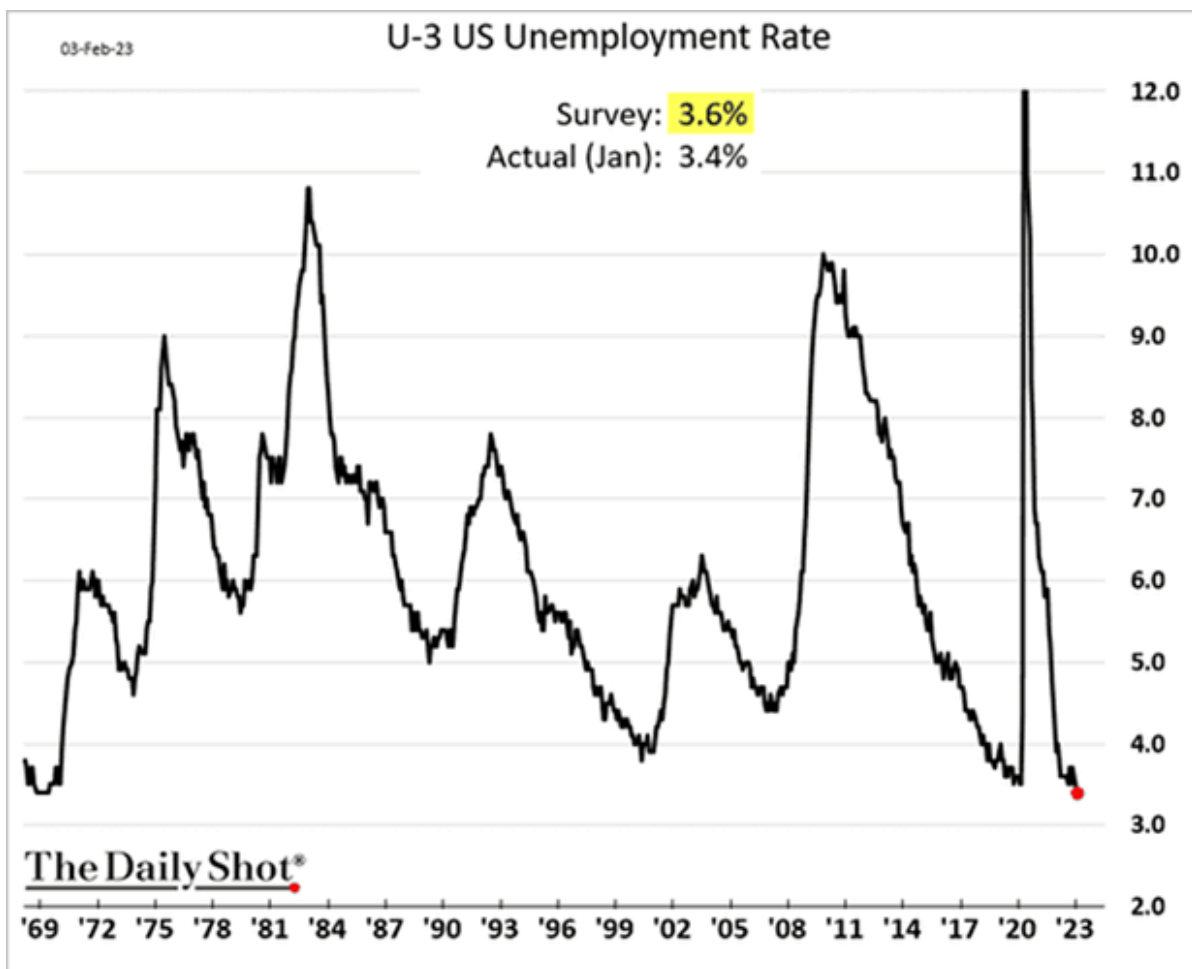
Vincent Deluard, strategist at StoneX, draws attention in particular to the construction sector. "Construction is a surprising area of strength, with 25,000 new positions added in January and 294,000 in the past twelve months. The resilience of construction jobs is a all the more shocking as new home sales fell by 60% since their 2020 peak and investment in residential and nonresidential structures fell by \$150 billion in the past six months. The resilience of construction jobs suggests that employers are hoarding workers because they believe the housing market is about to rebound. Homebuilders have indeed gained almost 60% since their June low and the Mortgage Bankers Association applications survey index rose by 81% in January."

Albert Edwards over at French investment bank SocGen was also surprised by these numbers,

observing that "Even with my own fairly optimistic view of the employment situation (relative to previous downturns), at first sight the 517,000 surge in January payrolls was frankly unbelievable. On a second take, maybe a January surge is plausible for seasonal reasons. For as the venerable David Rosenberg points out, "Something is happening to the data here in January. Since 2020, it has consistently lined up as a huge month for the payroll data: +334k in 2020, +494k in 2021, and +364k in 2022. And now +517k in 2023. The month of January has somehow managed to line up as 6x stronger than the average for all the months over the past three years."

Edwards also notes that just one exceptional monthly number shouldn't be the end of the debate - other data is pointing firmly to an impending recession. Take for instance, the latest Senior Loan Officer Opinion Survey on Bank Lending Practices' from the Federal Reserve showed yet more severe tightening of credit conditions for almost all categories of lending. According to Edwards "this extreme of tightening of US bank lending standards to the corporate sector has ALWAYS coincided with recession".

For me though the stand out chart is below, from the Daily Shot publication, which shows that the US unemployment rate hit its lowest level since 1969.

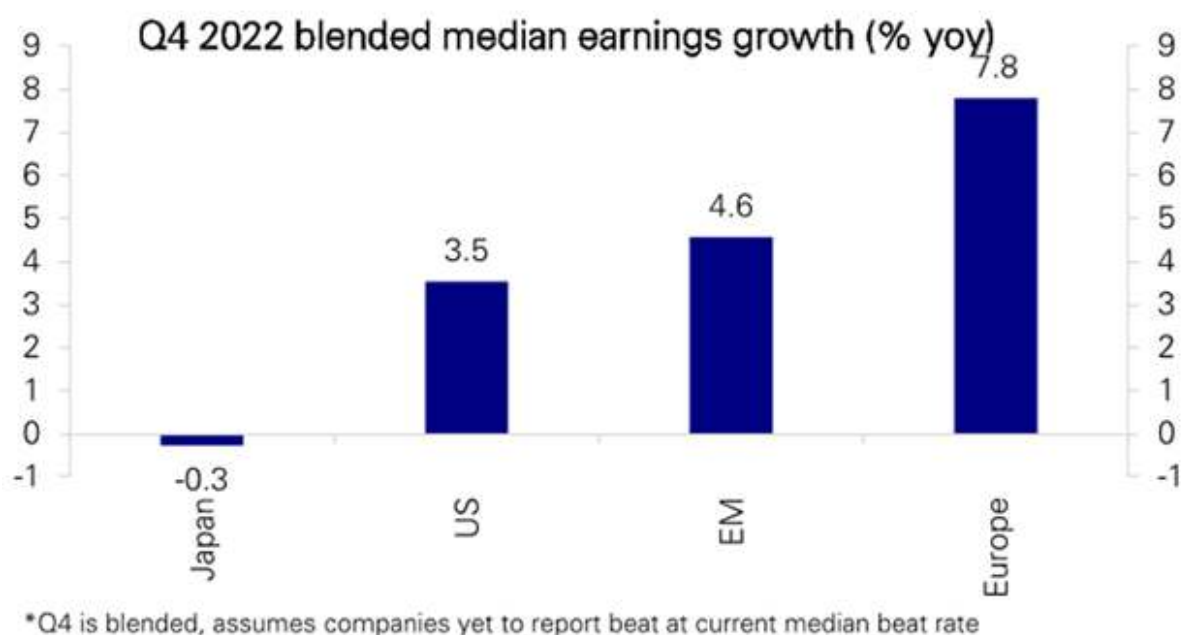


### Corporate earnings

How are corporate earnings holding up? We are currently mid way through the Q4 earnings reporting season and to date around half of the S&P 500 index members have reported so far: about 70% beat earnings expectations (which had been aggressively lowered) and 60% reported positive earnings growth. Total earnings dropped by 3.1% and 7.0% ex. Energy. Clearly, investors think that the worst is over: according to the consensus forecasts if we exclude energy stocks, earnings should start growing again in the second quarter and accelerate to 15% by this time next year. For reference, S&P 500 earnings dropped by an average of 17% during the past 24

recessions.

Dig a little deeper and a more nuanced picture emerges though, with the US the laggard. In fact, according to analysts at Morgan Stanley aggregate earnings growth has declined across most regions, turning outright negative in the US, EM and Japan but still in the mid-single digits in Europe.



Overall the US is experiencing the biggest earnings downgrades versus the Rest of the world, while emerging markets have eked out small upgrades driven by China, with estimates for the rest of EM flat. 2023 consensus growth expectations are now around 8% in EM and Japan and just 0-1% in the US and in Europe.

And what about earnings numbers coming out of **European corporates**? Morgan Stanley analysts again report, this time from Graham Secker's team in London. Their summary: 4Q results so far point to: (1) +32% breadth of sales beats - still good but lower than previously; (2) a healthy 20% net beat on EPS; (3) positive EPS trends from Large-cap Value stocks, especially Financials; (4) mild negative skew to price action around beats/misses.

Measure	Values as of 16th January, 2023	Values as of 14th February, 2023
UK Government 10 year bond rate	3.38%	3.44%
GDP Growth rate YoY	1.90%	0.40%
CPI Core rate	6.30%	6.30%
RPI Inflation rate	14.0%	13.40%
Interest rate	3.50%	4.00%
Interbank rate 3 month	3.98%	4.18%
Government debt to GDP ratio	97.40%	97.40%
Manufacturing PMI	45.3	47

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## Bank CDS options

Over the last four weeks, we've seen some pretty big declines in the pricing of credit default swaps. The biggest falls have been with Credit Suisse whose pricing is beginning to come off crisis levels, but Deutsche Bank has also seen its pricing for both 1 and 5 year swaps come off sharply. But most major international banks have seen declines in pricing either for their five year swaps (SocGen for example) or 5 and 1 year swaps). Only Santander saw a marginal increase in its swap pricing.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	33.82	61	A+	A2	A -
Barclays	64.2	89.21	BBB	Baa2	A
BNP Parabis	22.24	48.22	A+	Aa3	A+
Citigroup	36.17	77.18	BBB+	A3	A
Credit Suisse	203.2	267.98	BBB-	Baa2	BBB
Deutsche Bank	75.99	131	A-	A1	BBB
Goldman Sachs	39.69	84.14	BBB+	A2	A
HSBC	20.87	42.3	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	31.6	65.23	A-	A1	AA-
Lloyds Banking Group	25.51	48.97	BBB+	A3	A
Morgan Stanley	36.14	80.15	A-	A1	A+
Natixis	19.5	45	A	A1	A+
Nomura	29.42	88.23	BBB+	Baa1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	30.93	57.61	A	A1	A-
UBS	67.49	61.56	A-	Aa3	A+

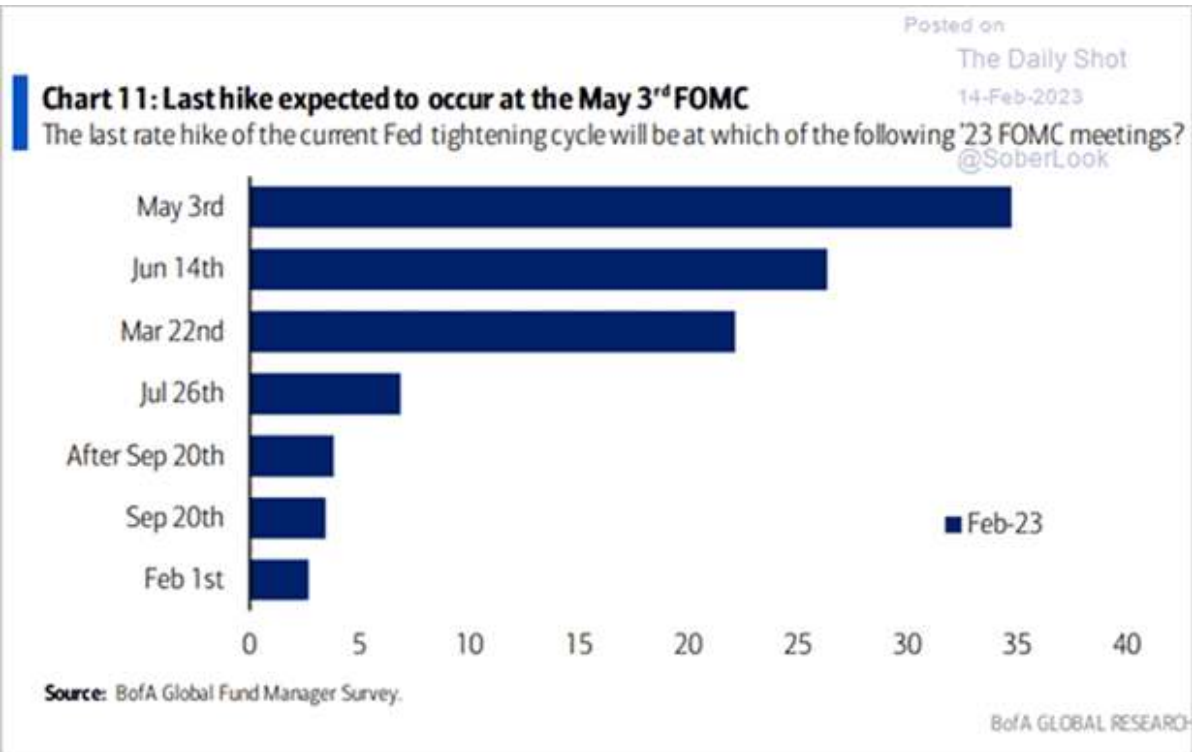
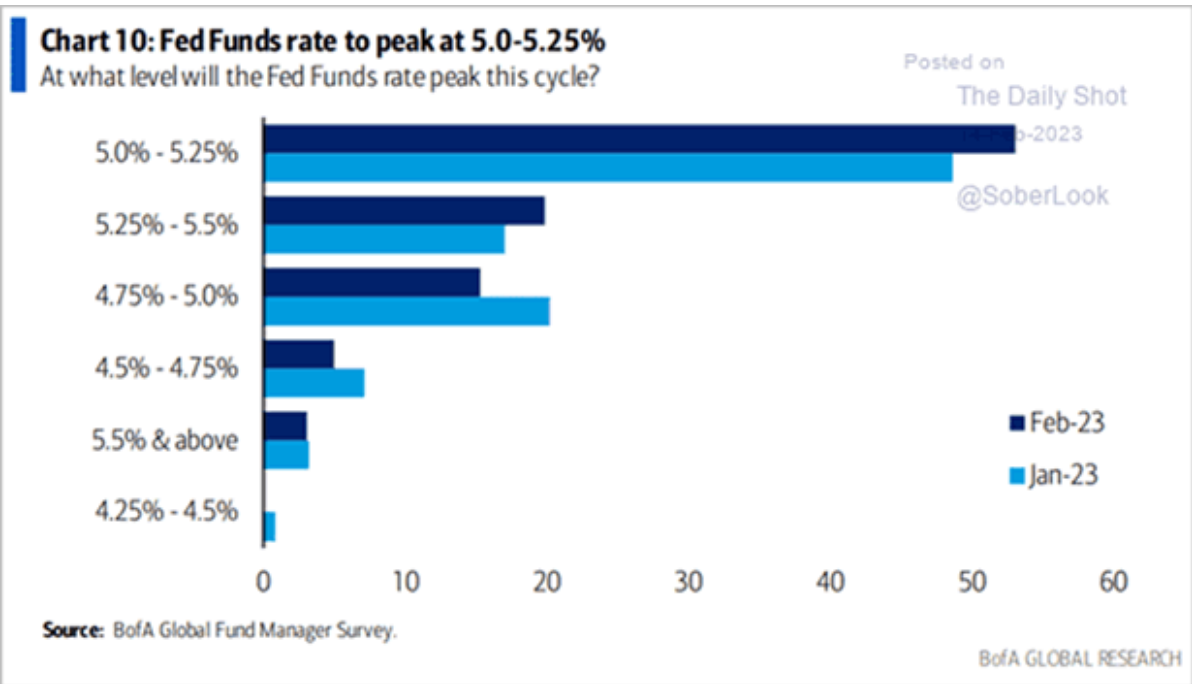
Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st February 2023 [www.tempo-sp.com](http://www.tempo-sp.com)

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## Government Bonds

One of the reasons why equity investors are in such a good mood is that they believe we are close to the peak in terms of interest rates. In both the UK, and more importantly, the US there's a sense that we are close to the peak.

The two charts below nicely sum up this consensus - they are both from BoA via their widely read fund manager survey - the first shows that most investors think the peak is above 5% but not too far from current levels. The second chart shows that investors seem to think we'll hit the peak in US rates within the next six months.



Source: [BofA Global Research](#)

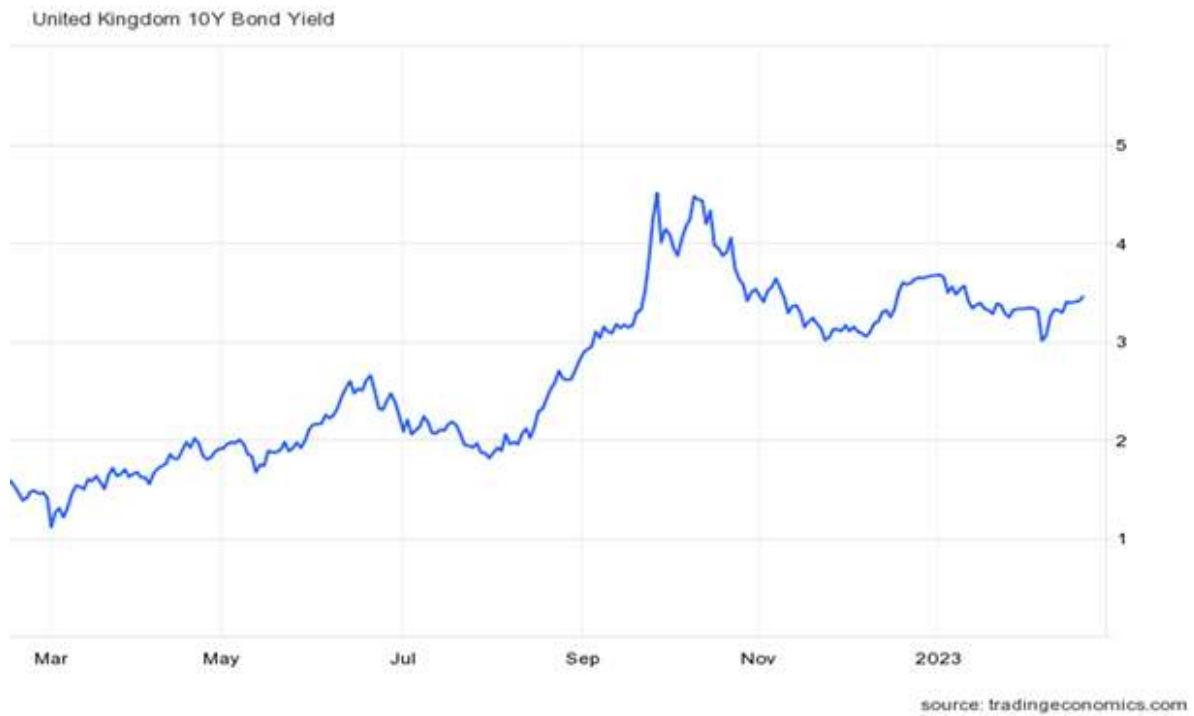
Of course, this consensus is based on the idea that inflation rates are coming down (which they are) and that they stay subdued (which they may not).

On a largely unrelated note, I'd direct readers attention to the Sovereign CDS Spreads table. This looks at the spreads for buying country specific, sovereign 5 year credit default swaps. It's a useful finger in the air estimate for the riskiness of a government and its bonds based on the 'wisdom' of the market. Note the astonishing variation in pricing for UK swaps - in the last 12 months we've moved from middle of the pack around 10 to 15 basis points) to outlier at 47 basis points (guess who was PM) to leader of the pack at rates of just 6.82.

Two other numbers stand out for me on the bonds section of this report. Note how the spread for Greek bonds over German bonds has tightened from 236 basis points to 184 basis points since the

summer of last year. I'd also note that returning to those credit default swaps on sovereigns, Italy's pricing has fallen sharply in the last few months - from a peak of over 145 basis points to the current 90 basis points.

### UK Government Bonds 10-year Rate 3.44%



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

### CDS Rates for Sovereign Debt

Country	Five Year
France	22.5
Germany	7.58
Japan	17.12
United Kingdom	6.82
Ireland	14.85
Italy	90.1
Portugal	38.61
Spain	42.81

### Eurozone peripheral bond yields

Country	January 2023	February 2023	Spread over 10 year
Spain 10 year	3.16%	3.29%	93
Italy 10 year	4.00%	4.14%	178
Greece 10 year	4.14%	4.20%	184

	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

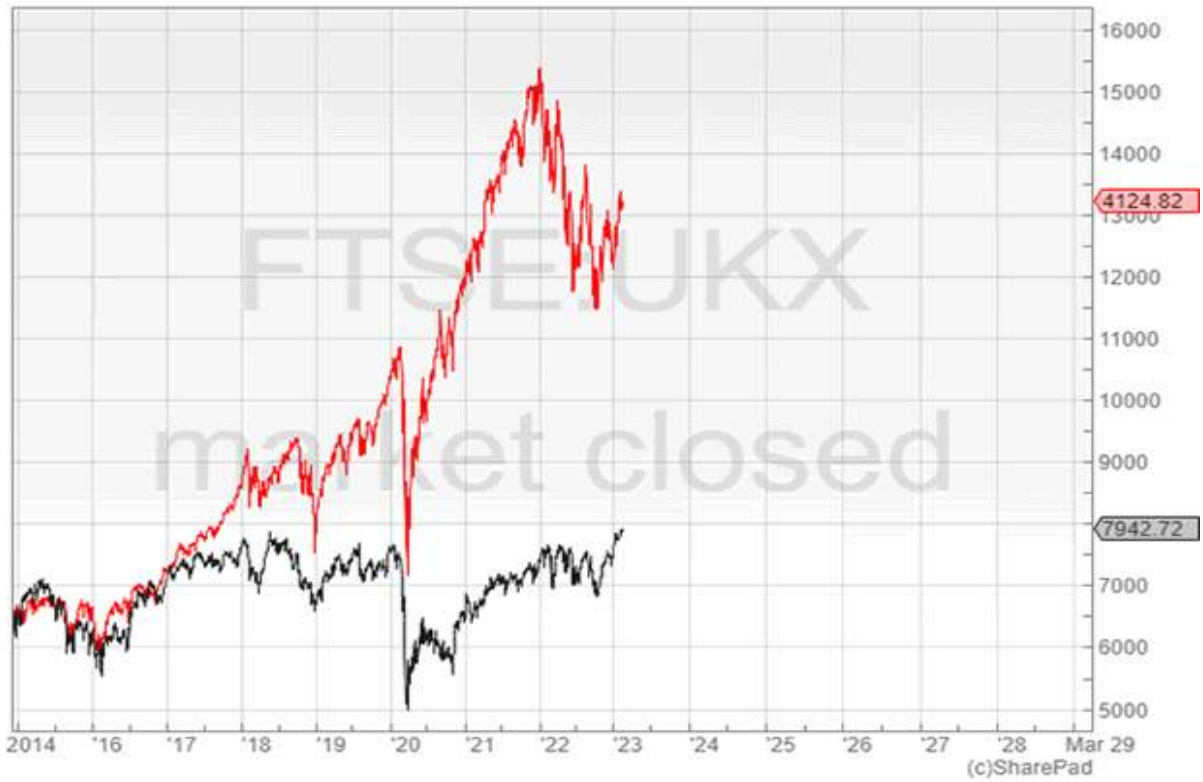
It's been a long time since UK equity investors had anything to cheer about but 2023 so far has been a pleasant surprise for what many investors regard as one of the cheapest markets in the developed world. Gerry Celaya, chief strategist at Tricio Investment Advisors reports that the FTSE is "... up over 5% so far this year and posted a new all-time high last week. The total return index, of course, has been posting new all-time highs since November 2022. This should not be a surprise given the make-up of the index. However, the table below shows that the big gains so far in 2023 are single company events and a bit of 'opening up' trades. "

*Key movers in the FTSE 100 index :*

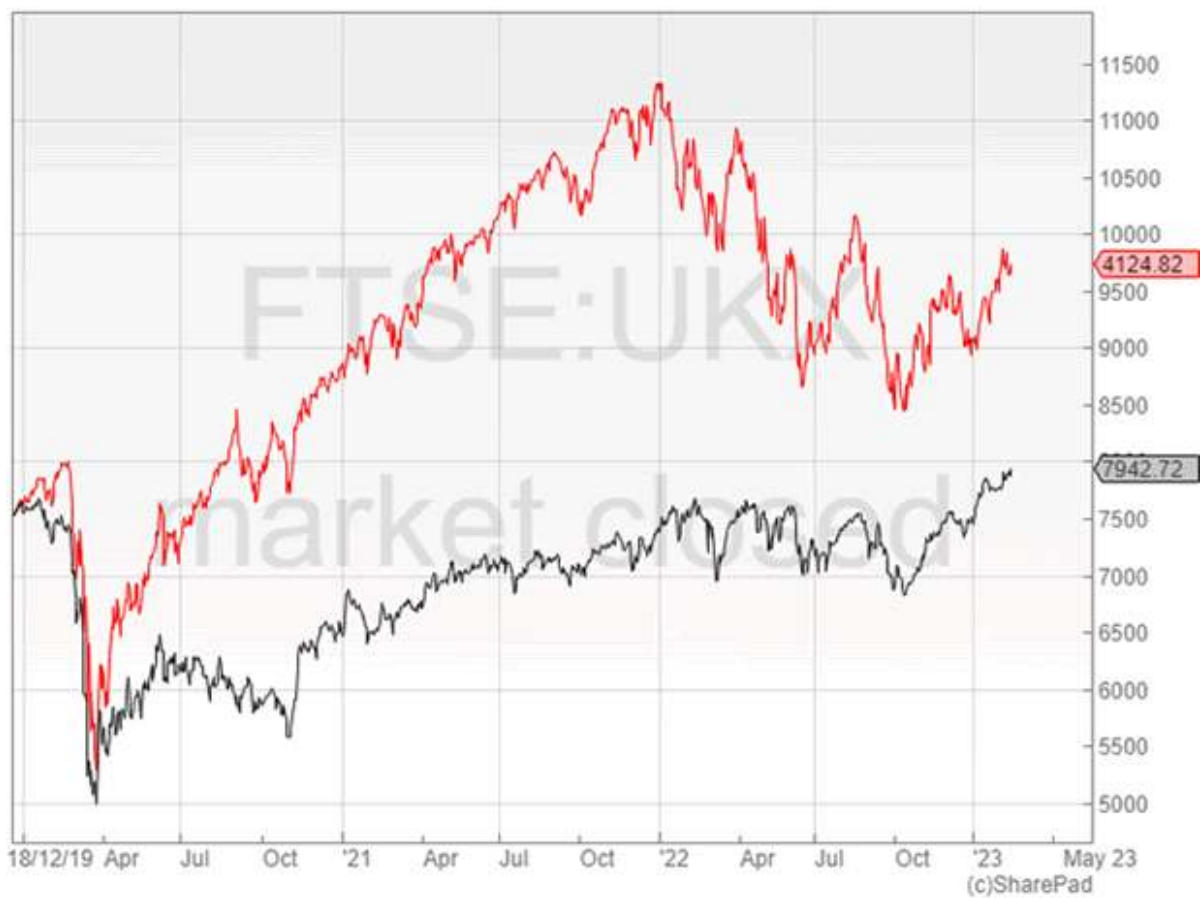
Company	YTD return
JD Sports International	41%
Consolidated Airlines	29%
Persimmon	22%
3i	21%
BT	21%
WPP	20%
B&M	20%
Taylor Wimpey	19%
Associated British Foods	19%
J Sainsbury	19%
Barratt Developments	19%

We shouldn't get too carried away with these numbers though. I've pulled together a number of charts which compare the main UK indices, the FTSE 100 and FTSE 250 with the benchmark US index the S&P 500 over a series of different time frames. The US index is always in red below.

First let's look at returns since 2015 - the FTSE 100 in black has a long, long way to go to catch up with US equities.



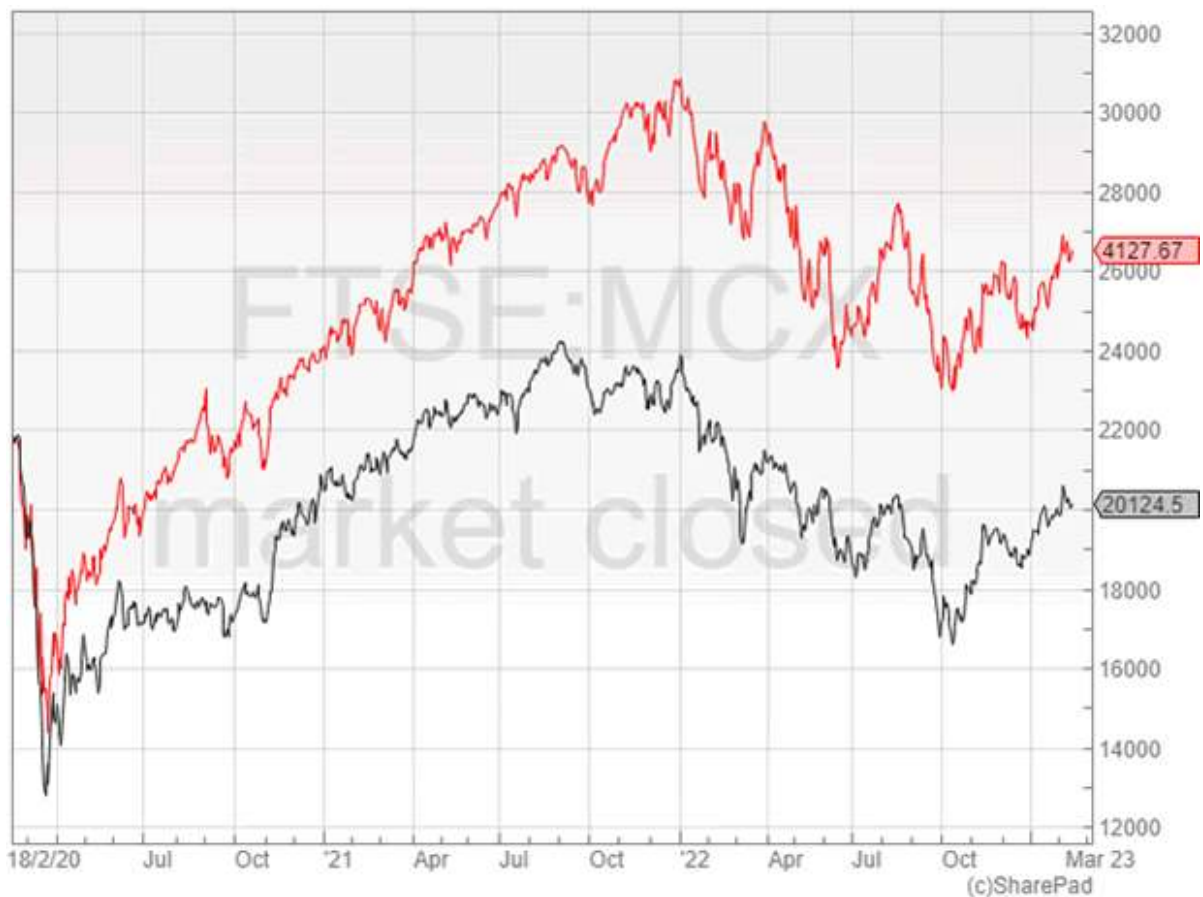
That's also true for the period starting with Covid and the subsequent recovery. Again, the FTSE 100 is in black, the S&P 500 is in red. The gap is still very substantial.



Its only when we get to the period from late 2022 - the possible recent bearish trough- that the UK market starts to pull ahead.



As for the FTSE 250 (in black, the S&P 500 in red), yet again the US markets are still very considerably ahead in the Covid and recovery period - though the more growth oriented FTSE 250 more closely tracks the US benchmark.



Since late 2022, the FTSE 250 has, like the FTSE 100, started to pull ahead of the US benchmark but

only marginally - and in my view not terribly convincingly, as shown in this last chart.



Index	January 2023	February 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	133.2	138.8	4260	121.6
FTSE 100 Dividend Dec 2022	290.6	295	7979	273.1

Note changed to Dec 2023 contracts

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	1.76	8.08	6.42	5.98	10.6	9.82	7982.17
S&P 500	3.46	4.55	-3.34	-6.01	53.3	77	4137.29
Gold Composite (Most Traded)	-3.03	4.87	2.64	-0.316	37.7	51.6	186350c
iShares FTSE UK All Stocks Gilt	-0.955	-2.23	-11.4	-18.4	-17	-18.4	1063.25p
VIX New Methodology	10.8	-14.3	4.15	-28.2	5.61	89.4	20.34

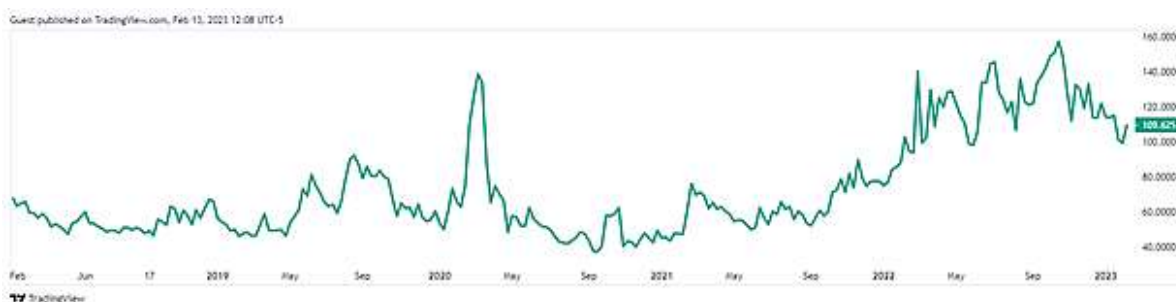
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## Volatility

Given that equity markets have had a strong start to the year, indices measuring volatility have edged back towards historical averages. The first chart below shows the range for the Vix index since the Covid crisis. We're not quite back to levels last seen in the immediate post Covid recovery phase but we're now only just above the long term average measure for the Vix at 20.53.

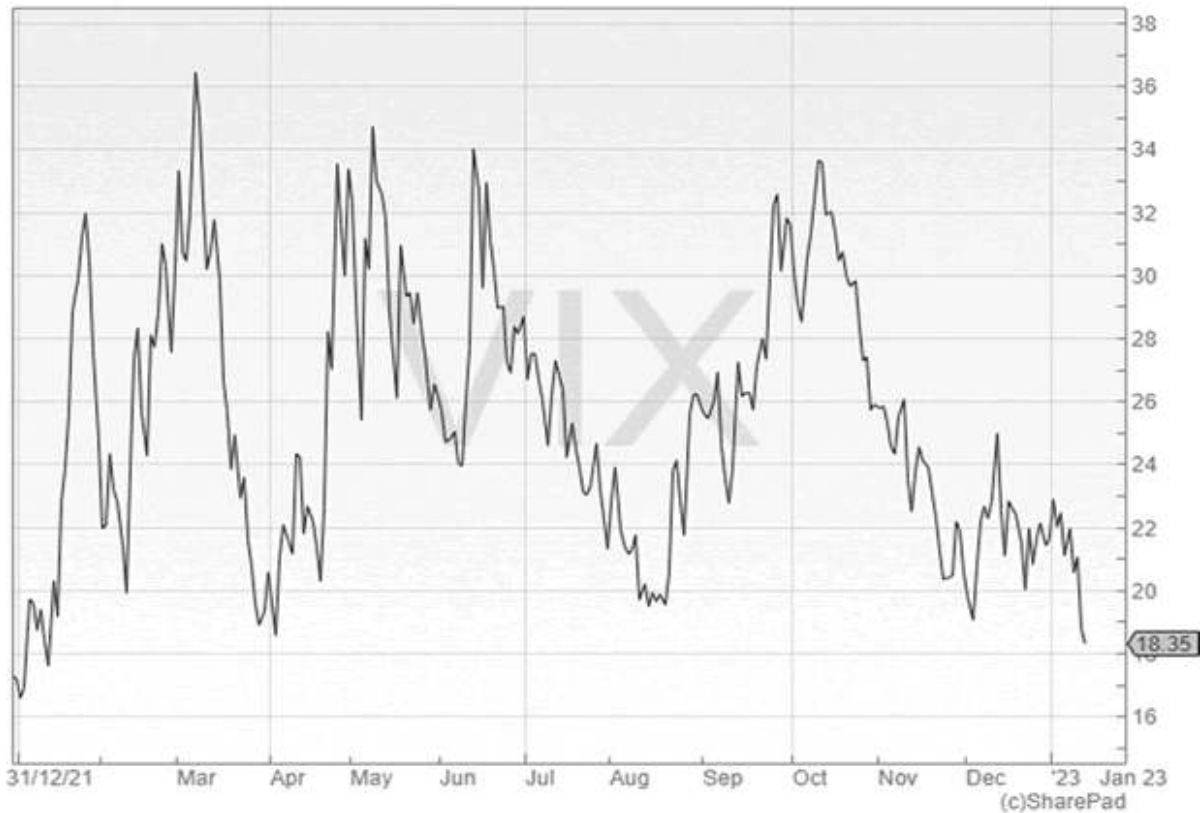


But this more subdued volatility regime is not the entire picture for asset price volatility. The MOVE index which is a close approximation to a measure of volatility in the bond markets - and shown in the second chart below - is much higher than the medium term average, indicating perhaps that investors do still have fears about the impending slow down/recession and increased defaults.



Source: [Morgan Stanley Research](#)

It's also worth making a few other observations on Vix. According to analysts at French investment bank SocGen current equity market volatility remains low compared to earnings uncertainty between 2012 and 2017. They also note that options pricing for Vix contracts remains high "driven by the lack of natural sellers of volatility post COVID. However, the recent moves suggest the return of vol sellers in the short-term space."



Measure	February Level	January Level	December Level	November Level
Vstox Volatility	18.91	18.25	21.24	20.82
VFTSE Volatility	20.34	18.35	22.48	23.15

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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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