



Monthly Market Report

May 2020



With commentary from David Stevenson

I think my teenage son summed it up well. Looking down his list of shares (on an online trading platform), he recently muttered to me "well, dad that was different. Do stockmarkets normally behave like that?". To which my measured answer was "Nope although every once in a while, it does go a bit bonkers". What was more revealing was his subsequent admission that after massive drops in the price of his US tech shares "they are roughly back to where they were at the end of last year"? Killik and Co, a stockbroker, also recently noted that although the key benchmark, the MSCI World index, was down just under 20% from its peak, it had now moved out of a bear market into I suppose what constitutes a rather normal sell off. And all this after news that we are about to suffer the worst global recession since the Great depression, with unemployment rising by the tens of millions in the US and GDP drops of more than 20% in just one quarter possible. This manic market activity - with many large cap stocks suffering falls of more than 50% while others barely registered any decline at all - has left many investors utterly confused. We've also seen a profusion of narratives based around a V, U, L and W shaped recovery. For the record my hunch is that we are probably in the W scenario with further falls likely in the next few weeks, but what do I know. Maybe we could see a massive stock market melt up as all that funny money floods into the system from central banks. Or maybe the remarkable rally of the last few weeks was the melt up. I think risk analysts at Bath based firm CheckRisk are probably right when they suggest that Covid-19 is a news-based event risk. Markets have become persuaded that social distancing works and a vaccine or medical treatment is just around the corner.

I'm sure there's a very strong possibility that a vaccine will be found but probably not before 2021. In the meantime, as CheckRisk argue, "attempts by governments to lift lock down restrictions and social distancing will most likely result in a new wave of sick people burdening national health systems leading to further lock downs. Most likely we will have a stop start economy that regains confidence over an extended and slow period of time. This means that severe contractions in economic activity are likely to continue for longer than the IMF is predicting in its recent World Economic Outlook".

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Headline Numbers

If I had to wager some money on one big risk I'd put it on an emerging markets crisis that is even bigger than the one we've seen. The first wave of infection might have started in the emerging markets but for now the markets are focused on the impact on developed world markets. Over the next few months this might change, especially as the virus works its way through South Asia, the Middle East and Africa. On this subject I've been leaning heavily for numbers and analysis on the excellent regular missives from Renaissance's Chief Economist Charlie Robertson. His latest looks at Africa and MENA.

The health data in the table below makes for very grim reading, although the caveat is that much of the data is either very old or not entirely trustworthy. But it is at least a stab at estimating the public health capability of many states. Robertson's message is simple - if you want to avoid a calamity, lock down very early on so you can minimise the loss of life. His conclusion? The countries best positioned to cobble together a sensible response are South Africa and Russia *"while Turkey is an unfolding disaster. Nigeria and Kenya still have at least a week (if their testing data are reliable) to decide when or whether to do a lockdown, and partial lockdowns in Lagos and Abuja should help in the former."* Fingers crossed and let's start sending money and help to as many organisations as possible in this space.

		Hospital beds per 1,000	Implied beds	ICU beds if WHO advice followed	Active cases 30 March	30 March Cases vs beds	Hospital beds vs Italy ratio	Age vulnerability index	Vs Italy	Population in respective year	Population in 2019
China	2009	4.2	5,604,900	112,098	2,763	0%	124%	86%	Better		
Korea, Rep.	2015	11.5	586,673	11,733	4,216	1%	338%	99%	Better	Millions	Pop 2019
Italy	2012	3.4	204,571	4,091	75,528	37%	100%	100%		60	60
Egypt, Arab Re	2014	1.6	138,720	2,774	465	0%	47%	57%	Worse		
Kenya	2004	1.4	46,052	921	48	0%	41%	47%	Worse	33	49
Nigeria	2004	0.5	67,660	1,353	125	0%	15%	43%	Worse	135	201
South Africa	2005	2.8	134,008	2,680	1,292	1%	82%	64%	Better		
Ethiopia	2015	0.3	26,928	539	23	0%	9%	42%	Worse		
Senegal	2008	0.3	3,661	73	135	4%	9%	43%	Worse		
Cote d'Ivoire	2006	0.4	7,528	151	161	2%	12%	43%	Worse		
Morocco	2005	1.2	35,380	708	526	1%	35%	66%	Worse	46	59
Greece	2015	4.3	46,689	934	1,114	2%	126%	100%	Better		
Hungary	2012	7.0	69,524	1,390	439	1%	206%	100%	Better		
Pakistan	2008	0.6	98,796	1,976	1,764	2%	18%	51%	Worse	190	205
Poland	2005	6.5	248,131	4,963	2,094	1%	191%	95%	Better		
Russian Federat	2013	8.2	1,178,340	23,567	2,199	0%	241%	89%	Better	144	147
Turkey	2012	2.7	204,193	4,084	10,497	5%	79%	73%	Better	79	83
Kazakhstan	2013	6.7	114,979	2,300	312	0%	197%	68%	Better		
Vietnam	2005	2.6	214,219	4,284	150	0%	76%	76%	Same		

Clearly markets are now waking up to the awful realisation that we are in the midst of one of the

worst recessions in history - one that might even turn into a new Great depression if badly handled. But the numbers are only just coming in on this unfolding catastrophe and for now investors are still focused on tracking the progression of the virus as it moves first through Europe (after starting in China) and then, crucially, the US. On this last point - the impact on the all important US economy - some of the most realistic analysis comes from a biotech analyst at **Morgan Stanley**, called **Matthew Harrison**, who is worth quoting from at length. Harrison tries to look beyond the peak and see what might happen in the all-important US market. His core concern is that US outbreak is far from over.

"Recovering from this acute period in the outbreak is just the beginning and not the end. We believe the path to re-opening the economy is going to be long. It will require turning on and off various forms of social distancing and will only come to an end when vaccines are available, in the spring of 2021 at the earliest".

This caution is built on an exercise where Harrison and his team ran a state-level model for the US *"which suggests it is likely to face a multiphasic peak. In particular, we expect the coastal regions, led by New York, to peak - defined as a sustained decline in new daily cases - over the next 3-5 days. However, we expect the rest of the country to follow slowly, trailing the coasts by around three weeks. While this "second" peak is unlikely to be as severe as the first (~10,000-15,000 daily new cases versus 30,000-35,000 in the first peak), it means the US outbreak will have a very long tail. This much longer tail would put the US time to peak at ~4x China and 2x Italy, driven by the slow uptake of social distancing measures and lack of robust testing (New York, with the highest testing ratio in the US, is still testing at a per capita rate just half that of South Korea's most impacted city Daegu). This would put an initial US re-opening on track for mid-to-late May at the earliest".*

Harrison reminds us that come late summer or Autumn we still won't see a "normal reopening". That can't happen until we see a number of steps fulfilled:

1. adequate surge capacity in hospitals,
2. broad public health infrastructure to support testing for disease surveillance,
3. robust contact tracing to curtail "hot spots" and
4. widespread availability of serology testing (blood tests to see who is already immune to the virus) can the US confidently return to work.

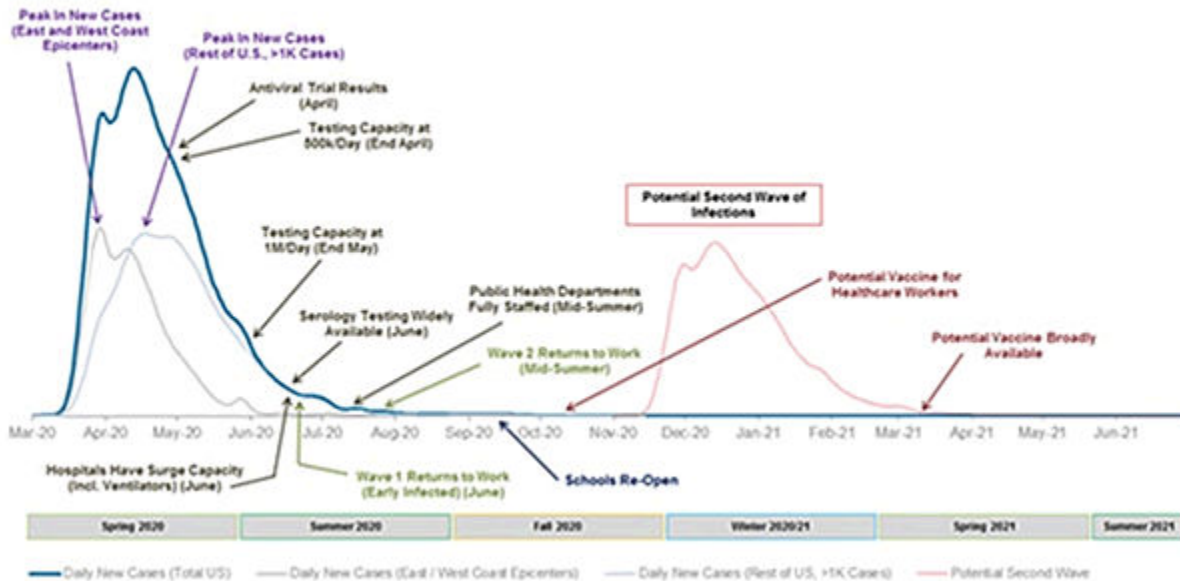
"We see this happening in waves starting in mid-summer." I'd also add that that timescale probably also fits with the UK, although we might be a month or two ahead of the US on some of these measures.

And when we re-open, what will 'normal' look like?

"Unfortunately, we think there will still be a large number of workers not able to go back to work until a vaccine is abundantly available as social distancing cannot be fully relaxed until we have herd immunity (~60% of people vaccinated). Furthermore, large venues such as sports stadiums, concert halls and theme parks are also likely to remain shut or have attendance capped at 10-25% of prior levels. This view on the delayed peak and slow return to work has led our US economists

to revise their US forecast to a return to pre-COVID-19 levels not until 4Q21".

Actual/Estimated New Case Count (United States, Non-Cumulative)



Measure	Values as of 5th March, 2020	Values as of 20th April, 2020
UK Government 10 year bond rate	0.34%	0.32%
GDP Growth rate YoY	1.10%	1.10%
CPI Core rate	1.80%	1.70%
RPI Inflation rate	2.70%	2.50%
Interest rate	0.75%	0.10%
Interbank rate 3 month	0.64%	0.66%
Government debt to GDP ratio	80.80%	80.80%
Manufacturing PMI	51.7	47.8

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Bank CDS options

Last month pricing on credit default swaps massively increased pretty much across the board. With a few exceptions, rates on most swaps (1 and 5 year) more than quadrupled - rates on Deutsche paper for instance is now approaching 200 basis points on a 1 year basis and 250 on a 5 year basis. But not every bank suffered as investors worried about a huge leap in lending defaults. Rates on French bank Natixis stayed almost stable and we saw only modest increases for Nomura and RBC. At the one-year level, rates are now lowest for Natixis and RBC with traditional low risk outfits such as HSBC and Lloyds experiencing big jumps in pricing for their swaps.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	18.40	41.87	A	A2	A -
Barclays	68.01	121.17	BBB	Baa3	A
BNP Parabis	35.56	74.53	A+	Aa3	A+
Citigroup	83.34	114.76	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	69.76	124.18	BBB+	Baa2	A-
Deutsche Bank	191.85	249.15	BBB+	A3	BBB
Goldman Sachs	87.42	124.30	BBB+	A3	A
HSBC	36.84	68.45	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	58.03	84.22	A-	A2	AA-
Lloyds Banking Group	38.99	71.14	BBB+	A3	A+
Morgan Stanley	85.60	122.41	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	40.86	95.11	BBB+	Baa1	A-
RBC	20.89	61.55	AA-	Aa3	AA
Soc Gen	33.76	69.37	A	A1	A
UBS	24.69	50.64	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st April 2020 www.tempo-sp.com

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Government Bonds

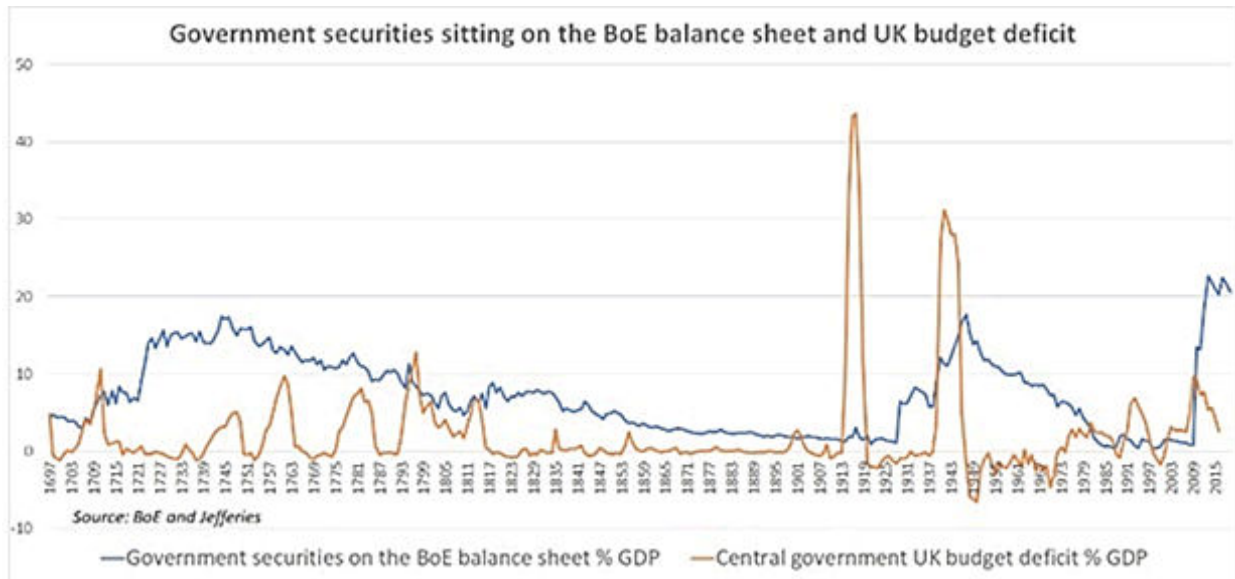
Bonds

Clearly the events of the last few months have been terrible news for equity investors. Even after the recent rally, most markets and sectors are down anything between 15 and 30%. But might the aftermath of the coronavirus spell trouble for bonds? On one level its hard to make that claim as government yields head lower along with investment grade corporate bonds. But lurking in the background is a fear that over the next 3 to 5 years we might see the re-emergence of bond's deadliest enemy - inflation. Clearly as of this moment most central bankers need to worry much more about deflation, helped along by plunging oil prices. But the central banks are also unleashing a wall of cash, sensibly, into the economies of the developed world. This might cause inflation to roar back into action. One key indicator of this risk is the use of the money printing presses by the UK government. Jefferies Chief economist David Owen, has a good summary of the

UK's controversial - short term - decision to directly fund the government's deficit.

"We still assume that the vast majority of financing will be through debt issuance, with much ending up on the BoE balance sheet, possibly as part of an ever-expanding QE programme. The chart below may help put this into long-term context showing central government borrowing alongside BoE holdings of government debt securities since 1697. As we continue to highlight, even without direct monetary financing of the UK budget deficit, the UK broad money supply M4 (currently standing at just over £2.5 trillion) could be growing by 10% or more by the end of this year."

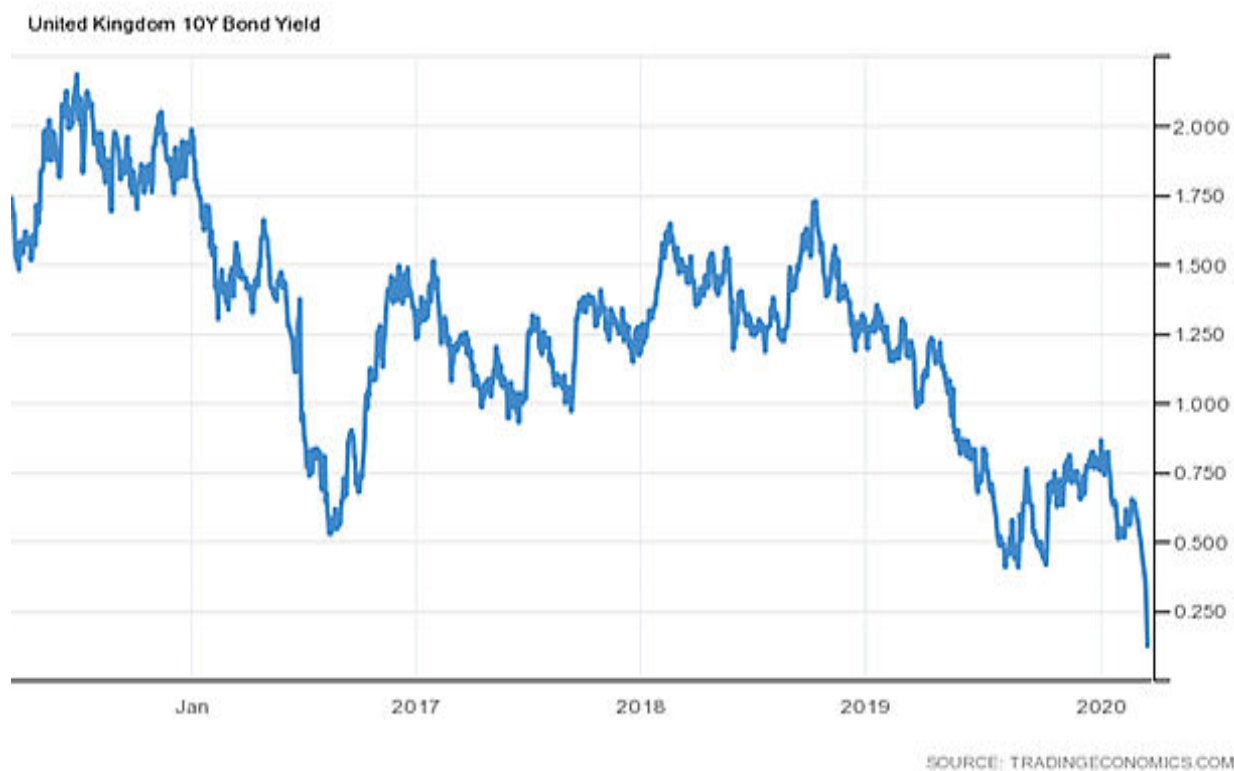
Now, one doesn't have to be a monetarist to wonder whether this substantial increase in money supply might have some impact on inflation.



London based research firm Cross Border Capital map out the next steps in what might happen.

"The huge monetization of deficits planned by Central Banks, culminating in a one-third jump in the size of their balance sheets, could lead to 15-20% monetary growth in 2020. With velocity already depressed and real GDP growth slow, this surely must lead to faster inflation of circa 5-10% in the US from 2021. Bonds beware. Gold looks great... A cyclical shift from 'low-low' inflation to 'higher-low' inflation favours equities over bonds, with some improvement in the outlook for real assets. Equities prefer low inflation regimes, but they still outperform fixed income when inflation is rising largely because earnings can keep pace with rising prices".

UK Government Bonds 10-year Rate 0.33%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	41.7
Germany	24.9
Japan	n/a
United Kingdom	37.5
Ireland	44.1
Italy	240
Portugal	124
Spain	126

Eurozone peripheral bond yields

Country	March 2020	April 2020	Spread over 10 year
Spain 10 year	0.22%	0.89%	136
Italy 10 year	1.06%	1.92%	239
Greece 10 year	1.28%	2.11%	258

	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	March 2020	April 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	122.2	68	2866	122
FTSE 100 (Dec 19)	330	160	5758	n/a

Analysts at Deutsche have been digging around in the data dumps, this time in funds flow data for the last few weeks and their findings are, I think, startling in what they tell us about the huge recent rally in sentiment. Their first point is perhaps the most obvious. Any proper rally needs a decline in volatility and the scene was set up two weeks ago for this. Daily ranges have plateaued since, while volatility, both implied and realized, has continued to decline. We'll discuss this point in the section on volatility below. That said, it's worth noting that liquidity however remains stuck at record lows despite the strong bounce in equities.

Nevertheless, funds flow data reveals big moves into equities (+18.4bn), the strongest in six months, following robust inflows in the prior week as well (+\$8.1bn) [my emphasis added]. US equities (+\$14.4bn) were the biggest beneficiary but Europe (+\$1.0bn) and Japan (+\$3.3bn) also saw inflows.

And losers? EM equities (-\$1.4bn) and Bonds (-\$1.1bn) although money has flooded into high yield funds (+\$4.1bn) and investment grade bonds. Money market funds also continued to see large inflows and scaled by GDP or personal income, assets in these funds are now approaching past recession highs [again my emphasis].

Cynics might suggest that the rally in recent weeks is just a dead cat bounce, typical of bear markets which grind ever lower after occasional, short lived rallies. But not every market expert buys this gloomy analysis. The table below is from Louis Vincent Gave, founder of Gavekal. He's careful not to add too much commentary to the numbers but I think we can probably surmise on underlying message - after a market meltdown, it's not unreasonable to expect a longer term market recovery. The table below shows the 50-day moving averages for each time the S&P 500 fell by 25% or more.

	3m	6m	12m	24m
10 October 2008	-0.99%	-4.74%	19.16%	29.57%
19 October 1987	10.78%	14.06%	23.06%	54.23%
1 June 1931	9.25%	52.95%	121.36%	113.18%
5 October 1932	-17.04%	-26.04%	-18.80%	16.65%
13 November 1929	32.02%	38.01%	-6.32%	-39.31%

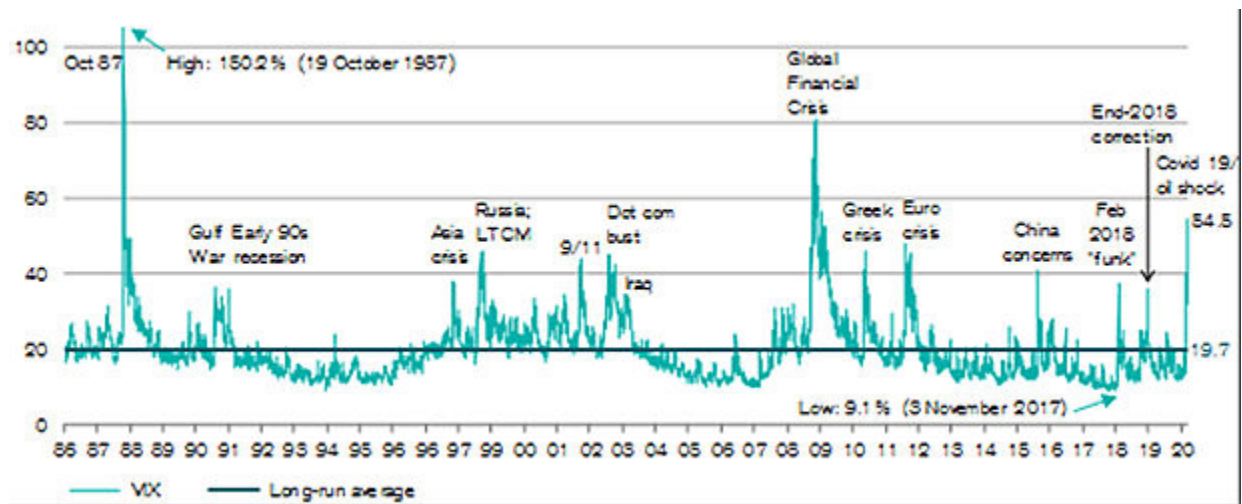
As Gave observes "For investors who were willing to project themselves out two years or more, buying the S&P 500 after such declines was almost always a good idea, the exception being in 1929 at the start of the Great Depression. Of course, back then, policymakers followed policies that were 180 degrees from the path they seem to be embracing today."

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	10.7	-24.9	-19.6	-23	-18.5	-13.3	5748
S&P 500	24.7	-13.7	-3.74	-1.05	36.9	54.1	2874
iShares FTSE UK All Stocks Gilt	3.1	6.23	5.81	12.2	17.7	31.4	14.91
VIX New Methodology	-39	2.31	181	232	202	200	40.11

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Volatility

Over the last few months, we've experienced some of the most dramatic moves in market volatility ever seen. The first chart below is from the authors of the yearly Credit Suisse Yearbook, Elroy Dimson, Paul Marsh and Mike Staunton. The data behind the chart is up to the middle of March (the 16th to be precise) and shows the vix index over the long term.



According to the academics, the market turbulence on March 12th resulted in the "all-time biggest-ever close-to-close jump. The next ten biggest close-to-close VIX jumps were as follows:

- Mon 05 Feb 2018 = +20.01 from 17.31 to 37.32
- Wed 22 Oct 2008 = +16.54 from 53.11 to 69.65
- Mon 08 Aug 2011 = +16.00 from 32.00 to 48.00
- Wed 15 Oct 2008 = +14.12 from 55.13 to 69.25
- Mon 01 Dec 2008 = +13.23 from 55.28 to 68.51
- Mon 24 Aug 2015 = +12.71 from 28.03 to 40.74
- Mon 29 Sep 2008 = +11.98 from 34.74 to 46.72
- Fri 24 Oct 2008 = +11.33 from 67.80 to 79.13
- Thu 18 Aug 2011 = +11.09 from 31.58 to 42.67
- Tue 20 Jan 2009 = +10.54 from 46.11 to 56.65

According to Professor Paul Marsh "based on the VIX history, the average reversion time from peak back to the long-run average (19.7%) for "completed" crises was 86 trading days (four months). The average half-life was just 9 days (time from peak to half-way back towards the long-run mean). This means that when we see a spike in volatility, we know that more normal times are ahead (if we can keep our heads). It also means there is no reason to expect a permanent increase in risk, or in investors' expected returns, or in the cost of capital for companies. BUT, as we point out in the Yearbook, "Caution is obviously needed in interpreting these figures since one knows only with hindsight when peak volatility has been achieved".



Measure	April Level	March Level	February Level	January Level
Vstox Volatility	36.4	33.35	13.4	12.7
VFTSE Volatility	41.69	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 fix its price in some level of uncertainty.

Equity benchmarks

Most structured products use a mainstream well known index such as the FTSE 100 or 500 as a reference for the payout. For investors the key returns periods are 1 year (for most auto calls) and 5 and six years for most 'growth' products. During most though not all five and six year periods it is reasonable to expect an index to increase in value although there have been many periods where this hasn't been the case especially as we lurch into a recession. Risk measures such as the sharpe ratio effectively measure how much risk was taken for a return over a certain period (in our case the last five years using annualised returns). The higher the number the better the risk adjusted return with any value over 1 seen as very good.


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To find out more about UKSPA, please visit www.ukspassociation.co.uk.

Kind Regards,

A handwritten signature in black ink, appearing to read 'Alan Smith', written in a cursive style.

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