UK Structured Products Association

Monthly Market Report

May 2022

With commentary from David Stevenson

Like many I'm astounded by the solid stockmarket bounce back in the last few weeks. Every time something positive emerges out of the Turkish peace talks involving Russia and Ukraine investors start buying. Quite what possesses these investors is beyond me, as its obvious to me - and many millions of other sentient human beings - that the Russians are simply playing for time in order to regroup and then pulverise the cities of Eastern Ukraine. Quite what a peace deal looks like, given this grim reality is beyond me and I think it wiser to suggest this war will drag on for many months, with many more provocations and a lot more inflationary upside.

Which brings me to the other elephant in the room: Interest rates. The market consensus is that a) "the Fed has this" in hand and b) that interest rates will probably peak at about 2.5% before coming down in 2023. Again, quite what possesses supposedly smart investors to think this is beyond me.

Inflation is raging and getting worse and the entire credibility of the Federal Reserve now hinges on cracking down hard on those inflationary pressures. In those circumstances I think it entirely possible that the Fed might, just might, pull a Volcker.

A Volcker?? This term is brilliantly defined by the Bloomberg columnist and economist Noah Smith as follows: *"If the Fed raises interest rates high enough, inflation WILL go down, period. This happens for multiple reasons, but the most important one is probably that high interest rates make it hard for companies to borrow and invest, so investment dries up and people lose their jobs. When businesses aren't spending because they can't borrow and people aren't spending because they're either unemployed or afraid of becoming unemployed, then the economy goes into a recession. This is also known as "pulling a Paul Volcker". In the early 1980s, Fed Chair Paul Volcker, who had been appointed by Jimmy Carter to defeat persistent inflation, hiked rates all the way up to 19%."*

The chart below from Noah Smith nicely illustrates this potentially cataclysmic outcome, which is currently regarded by most investors as next to impossible i.e interest rates shoot well above 5% or even 10% for the next year or two.

I think this is a real risk if only because what Volcker did worked - it did defeat inflation and as Smith says "and not just for a little while. Inflation stayed low for four decades after Volcker's rate hikes, probably because it "anchored" expectations - people now knew that the Fed was highly intolerant of inflation." If the markets think a Volcker is possible, then I think it fair to say that stockmarkets might take a big tumble or two.

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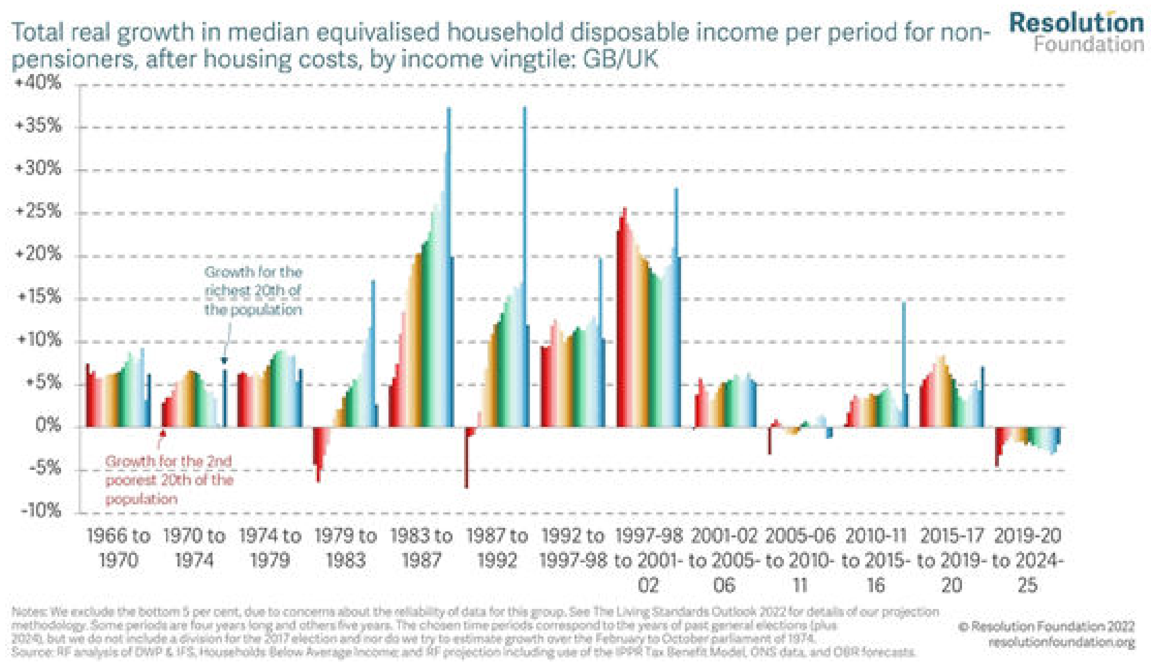
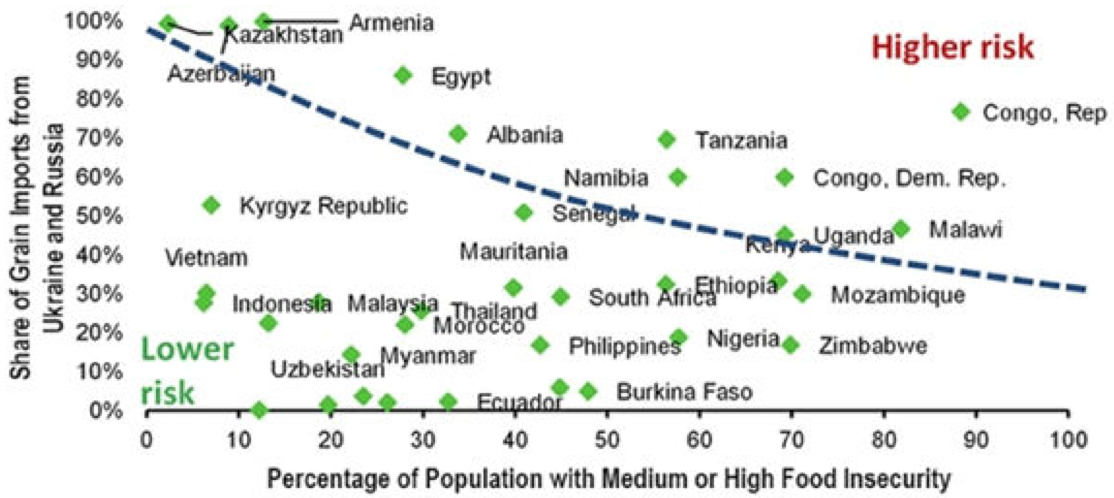
Headline Numbers

I've been expecting a recession or at least a sharp slowdown in the UK for weeks now. I fully accept that the US might avoid a slowdown - and corporate earnings over there are holding up. But the UK looks to be in a more precarious position. Recent numbers from the OBR suggested that nearly 90% of the expected growth in the economy in 2022 was likely to come from increased consumer spending. But the chart below, which is from the excellent Resolution Foundation, makes this look very unlikely. It shows 50 years of economic change based around income growth. As Duncan Weldon of the Economist observes of the chart *"The projections for 2019/20 to 2024/25 are eye-catchingly bad. But, taken together, the whole period from around 2005 onwards is miserable."* Recent macro numbers have confirmed just how depressed consumers are. Given that they were supposed to be the engines of GDP growth, how on earth is the UK going to avoid a recession?



Liberum's chief strategist Joachim Klement moonlights from his usual macro day job with some excellent geopolitical and political-economic analysis. His latest on the food crisis highlights the chart below which reminds us that the potential food crisis is of huge importance to many developing countries, especially Central and East Africa. This may help explain why so many African countries abstained at the UN on the Ukraine vote.



As Joachim summaries, *"Kazakhstan and Azerbaijan along with Egypt and Congo are among those at the most risk given their reliance on Russian and Ukrainian grain imports, their existing food insecurity, or combination of the two."*

Measure	Values as of 11th March, 2021	Values as of 12th April, 2021
UK Government 10 year bond rate	1.54%	1.80%
GDP Growth rate YoY	6.50%	6.60%
CPI Core rate	5.50%	6.20%
RPI Inflation rate	7.80%	8.20%
Interest rate	0.50%	0.75%
Interbank rate 3 month	1%	1%

Government debt to GDP ratio	94.9%	94.9%
Manufacturing PMI	58%	55.2%

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Bank CDS options

Rates on credit default swaps increased again in the last month with he vast majority experiencing small, marginal increases in rates. A few banks did see very small, again marginal, decreases, but the overall trend is that CDS rates are increasing again.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	16.47	46.85	A+	A2	A -
Barclays	28.89	63.33	BBB	Baa2	A
BNP Parabis	16.38	43.92	A+	Aa3	A+
Citigroup	42.63	84.23	BBB+	A3	A
Credit Suisse	50.67	111.31	BBB+	Baa1	A-
Deutsche Bank	50.67	121.52	A-	A2	BBB+
Goldman Sachs	41.81	85.21	BBB+	A2	A
HSBC	16.16	40.69	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	37.1	67.42	A-	A2	AA-
Lloyds Banking Group	14.73	39.65	BBB+	A2	A
Morgan Stanley	43.08	84.22	BBB+	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	22.33	75.69	BBB+	Baa1	A-
RBC	21.95	64.53	AA-	A1	AA-
Soc Gen	19.98	54.12	A	A1	A-
UBS	18.33	52.71	A-	Aa3	A+

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

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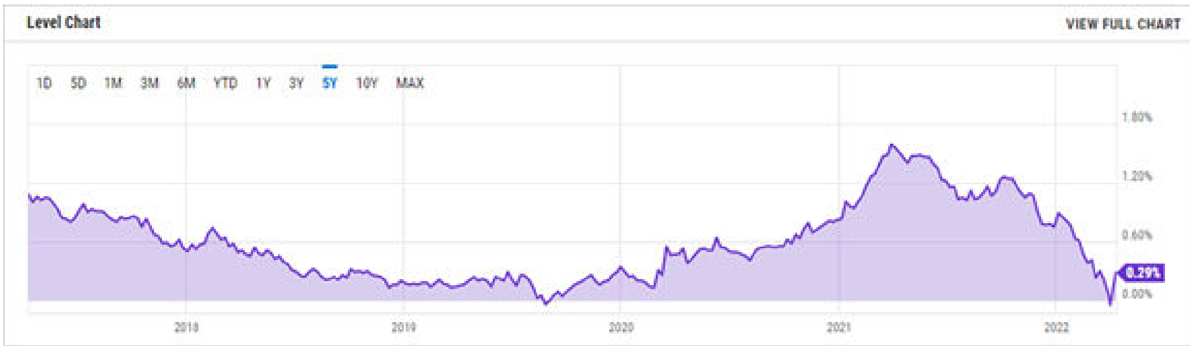
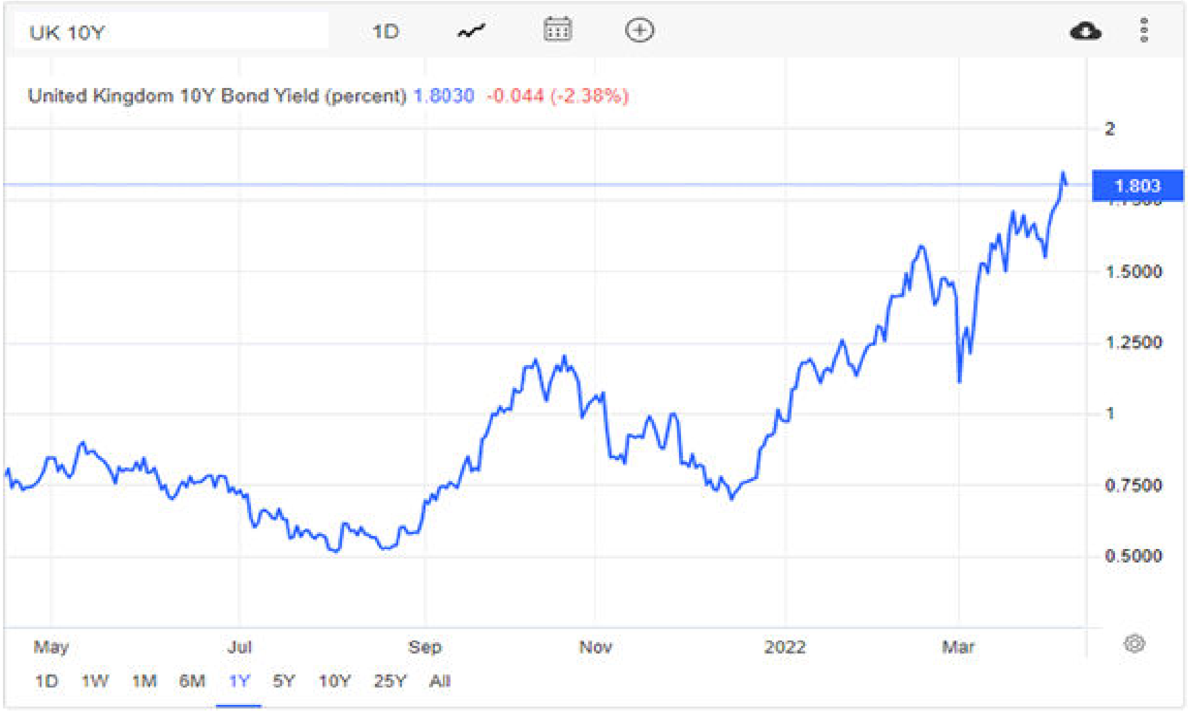
Government Bonds

There's been much anguished debate about whether the narrowing govie spread is supposed to signify an impending recession. The chart below shows that this has trended sharply lower in recent weeks though moved into positive territory in recent days. Personally I'd be astonished if the narrowing spread wasn't shouting at us that a recession is coming but who knows.



What I think is much more interesting is the second chart below which shows the yield on US Ten year government bonds. I've included a ten year timeframe for perspective. Notice just how sharp that upwards curve currently looks but really given previous peaks, none of us should be surprised if it heads past 3.5% - which implies yet more pain ahead for government bond owners.

UK Government Bonds 10-year Rate 1.80%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	26.7
Germany	13.9
Japan	18.9
United Kingdom	12.12
Ireland	16.6
Italy	100.3
Portugal	40.6
Spain	41.9

Eurozone peripheral bond yields

Country	March 2022	April 2022	Spread over 10 year
Spain 10 year	1.30%	1.71%	91
Italy 10 year	1.92%	2.41%	162
Greece 10 year	2.60%	2.85%	206

	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

Global equities posted a decent March, all things considered. According to data from analysts at S&P Dow Jones, their Global BMI index posted a 1.70% gain in March, with the help of the U.S. 3.11% gain, - excluding the U.S., developed markets were down 0.25% with UK equities falling by just under 1%. Other notable numbers for March?

- YTD three-month period, global markets were down 6.00% and down 6.45% without the U.S.'s 5.69% decline, as the one-year return was up 4.11% and down 3.84% without the U.S.'s 10.43% gain.
- Longer term, the U.S. also dominated, as the two-year global return was 61.53% with the U.S.'s gain of 76.74% and 43.59% without it, while the three-year return was up 38.13% with the U.S.'s gain of 57.36% and 17.16% without it.
- Sector variance decreased, as 9 of the 11 sectors gained, compared to 2 last month and only 1 gaining the month before that (January; all 11 were up in December).
- Emerging markets posted a third consecutive month of declines, as they fell 2.55% in March, after February's 3.49% decline and January's 0.98% decline (December was up 1.41%), as the YTD three-month period posted a 6.88% loss. The one-year period was down 10.23%, the two-year return was up 38.09%, and the three-year return was 9.66%.
- Developed markets performed significantly better (again) than emerging (and better excluding the U.S, again), as they posted a 2.21% gain, after last month's 2.25% decline

Yet again, the US has pulled ahead of its European and especially UK peers! Sticking with national-level data, not all emerging markets suffered in March. Winners included Brazil (oil), Colombia (presumably oil) and Chile (metals). Intriguingly Turkish equities advanced by 9% and Mexican stocks also advanced by over 8%. As for developed markets Australia was the winner - as you'd expect - with a near 10% rally, with the Czech Republic and Portugal a long way behind at 6.5%.

In terms of losers, Egypt stood out (all those missing wheat supplies) with a 14% loss followed by China (see next article) on an 8% decline. Italy stood out with a 2.7% loss with Germany and Japan not far behind with losses of over 2%. The United Kingdom lost just under 1%.

		S&P Global Broad Market Index(BMI) Global				
US MKT	**%**	**BMI MEMBER**	**1-MONTH**	**3-MONTH**	**6-MONTH**	**1-YEAR**
$548	6.80%	Brazil	**13.59%**	29.86%	14.51%	9.06%
$27	0.33%	Colombia	**11.15%**	29.79%	26.86%	29.58%
$48	0.60%	Chile	**10.88%**	26.46%	16.85%	-10.18%
$1,700	2.44%	Australia	**9.97%**	3.47%	5.93%	10.42%
$24	0.29%	Peru	**9.67%**	31.08%	47.48%	15.75%
$44	0.55%	Turkey	**9.06%**	8.72%	-5.26%	-9.96%
$188	2.33%	Mexico	**8.34%**	8.49%	12.65%	21.44%
$77	0.96%	Kuwait	**7.76%**	16.59%	19.65%	40.64%
$118	1.46%	U.A.E.	**7.73%**	17.17%	29.79%	51.07%
$364	4.52%	South Africa	**7.66%**	18.20%	17.60%	11.58%
$72	0.89%	Poland	**6.67%**	-10.45%	-12.22%	5.10%
$12	0.15%	Czech Republic	**6.55%**	3.11%	14.04%	41.70%
$41	0.06%	Portugal	**6.50%**	2.29%	3.73%	6.60%
$211	0.30%	Norway	**5.52%**	5.92%	6.85%	12.22%
$2,513	3.61%	Canada	**5.19%**	4.19%	10.21%	17.26%
$343	4.26%	Saudi Arabia	**4.15%**	15.49%	12.91%	31.23%
$84	1.05%	Qatar	**4.03%**	14.35%	16.80%	28.29%
$1,363	16.92%	India	**3.75%**	-2.87%	-2.72%	18.12%
$168	2.09%	Indonesia	**3.39%**	7.11%	12.20%	13.37%
$77	0.11%	New Zealand	**3.25%**	-9.73%	-12.14%	-11.93%
$45,664	65.66%	United States	**3.11%**	-5.69%	2.66%	10.43%
$327	0.47%	Singapore	**2.69%**	-4.12%	-11.00%	-3.75%
$490	0.70%	Denmark	**2.65%**	-8.14%	-4.06%	9.86%
$788	1.13%	Sweden	**2.63%**	-17.40%	-12.08%	-9.66%
$69,550	**100.00%**	**Developed**	**2.21%**	**-5.90%**	**0.05%**	**6.02%**
$2,988	4.30%	United Kingdom	**-0.99%**	-2.27%	1.76%	5.19%
$545	0.78%	Hong Kong	**-1.24%**	-4.12%	-7.50%	-18.67%
$194	2.41%	Thailand	**-1.50%**	2.11%	7.18%	-0.71%
$1,436	17.83%	Taiwan	**-1.83%**	-6.57%	2.26%	6.36%
$247	0.36%	Finland	**-1.95%**	-14.75%	-13.23%	-6.47%
$4,951	7.12%	Japan	**-2.02%**	-7.66%	-12.20%	-9.64%
$1,535	2.21%	Germany	**-2.42%**	-13.08%	-12.76%	-13.60%
$8,054	**100.0%**	**Emerging**	**-2.55%**	-6.88%	-8.14%	-10.23%
$77	0.96%	Philippines	**-2.64%**	-0.64%	2.18%	6.76%
$517	0.74%	Italy	**-2.72%**	-10.91%	-7.01%	-3.96%
$67	0.10%	Austria	**-3.08%**	-15.60%	-13.43%	-3.99%
$7	0.09%	Pakistan	**-4.89%**	-5.08%	-10.26%	-22.88%
$152	0.22%	Ireland	**-7.55%**	-17.69%	-16.23%	-11.60%
$2,626	32.60%	China	**-8.35%**	-14.23%	-19.05%	-31.65%
$11	0.13%	Egypt	**-14.31%**	-20.00%	-7.77%	-6.92%

Index	March 2022	April 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	117	118.5	3831	101
FTSE 100 Dividend Dec 2022	260.3	266.5	7576	243.5

Note changed to Dec 2022 contracts in January 2022

Name	Price % change						Volatility	Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	20 day observations	
FTSE 100	5.88	0.33	6.26	9.98	3.1	21.4	0.699	7576.66
S&P 500	5.86	-5.83	2.3	7.82	89.8	116	1.12	4450.82
Gold Composite (Most Traded)	-1.85	6.62	10.7	12.4	51.1	55.1	0.998	1948.20¢
iShares FTSE UK All Stocks Gilt	-2.83	-7.34	-6.14	-8.31	-5.78	-0.451	0.641	1265.5p
VIX New Methodology	-20.7	38.3	22.8	44.1	54.5	64.1	6.94	24.37

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Volatility

Bloomberg's excellent John Authers recently discussed in his Long View column why complacent investors have become about events in the Ukraine. Again, it's another subject I've been banging on about. We are potentially just at the beginning of a sustained period of heightened volatility and everyone seems to have suddenly lost interest. More fool them! **This is just the first act of a terrible, long tragedy.** Anyway, Authers quotes Eric Robertsen of Standard Chartered PLC who offers up the graphic below which shows that the VIX volatility index has returned to its pre-invasion norm, "while emerging market stocks, which stand to be most directly affected by the conflict, have recovered almost completely: Everyone knows that you should "buy when there's blood in the streets," but it seems dangerous that so many are comfortable that the worst is known and risk assets are ready to recover."

Figure 1: Has the decline in risk premia gone too far and too fast?
VIX volatility index, % (LHS) vs MSCI EM, inverted (RHS)

Source: Bloomberg, Standard Chartered Research

Other indicators are looking a bit ominous again. The next chart below uses the SG X Sentiment indicator. Notice how the measure has dropped again sharply and is now trending lower. Beware.

Variable	Value	Score	1d var	1w var	1m var	1y high	1y low
VIX	21.16	21	0.0%	13.9%	-31.2%	36.45	15.01
FX vols	8.20	11	0.2%	1.7%	-3.8%	9.25	5.44
Rates vol (normal)	82.81	11	0.3%	2.7%	2.8%	88.66	25.85
Gold to silver ratio	78.59	6	0.0%	-0.3%	2.6%	81.91	66.18
Peripheral spreads	1	3	0.0%	6.5%	0.5%	1.34	0.70
Credit spreads	77.06	15	0.0%	9.0%	-4.3%	86.64	44.48
Variable	**Value**		**1d var**	**1w var**	**1m var**	**1y high**	**1y low**
Sentiment Indicator	0.35		-0.01 (-1.6%)	0.2 (-36.45%	0.03 (8.95%)	0.96	0.02

Measure	April Level	March Level	February Level	January Level
Vstoxx Volatility	30.01	38.91	32.85	20.27
VFTSE Volatility	24.37	30.23	27.36	19.4

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Summary of Pricing Impact on Structured Products

Pricing Parameter	Change	Impact on Structured Product Price
Interest Rates	Up	Down
Underlying Level	Up	Up (unless product offers inverse exposure to the underlying)
Underlying Volatility	Up	Down for capped return/fixed return/capital at risk products. Up for uncapped return/capital protected products.
Investment Term	Up	Down
Issuer Funding Spread	Up	Down
Dividend Yield of Underlying	Up	Down
Correlation (if multiple underlyings)	Up	Up (unless product offers exposure to the best performing underlyings only)

Source: UK Structured Products Association, January 2014

This information is provided for information purposes only, and the impact on a structured product price assumes all other pricing parameters remain constant.

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Explanation of Terms

CDS Spreads and Credit Ratings

A CDS effectively acts like an option insuring at a cost in basis points a bank or government bond in case of default. The higher the basis points, the riskier the market perceives that security. Crucially CDS options are dynamic and change in price all the time. A credit rating is issued by a credit rating firm and tells us how risky the issuer is viewed based on the concept that AAA (triple A) is the least risky and ratings at C and below are regarded as much riskier. CDS and ratings are useful for structured product buyers because they give us an indication of how financial risk is viewed by the market. Crucially a high CDS rate indicates that an issuer of a bond will probably have to pay a higher yield or coupon, which could be good for structured product buyers as bonds are usually a prime source of funding for a structured product. G8 government bonds issued by the likes of the UK and US Treasury are also sometimes used as collateral in some form of investments largely because they are viewed as being low risk. One last small note on credit ratings and CDS rates. A is clearly a good rating for a bond (and much better than B) but AA will be viewed as even safer with triple AAA the least risky. Terms of CDS rates anything much above 100 basis points (1%) would warrant some attention (implying the market has some, small, concern about the possibility of default) while anything above 250 would indicate that the market has major concerns on that day about default.

Why does the yield matter on a bond?

As we have already explained bonds are usually used as part of a structured product. The bonds yield or coupon helps fund the payout. All things being equal a higher bond yield means more funding for the payout. But rising bond yields, especially for benchmark US and UK Treasury 10 year bonds also indicate that the markets expect interest rates to rise in the future. Rising interest rates are not usually a good sign for risky financial assets such as equities.

Volatility measures

Share prices move up and down, as do the indices (the 500 and FTSE100) that track them. This movement up and down in price is both regular and measurable and is called volatility. It is measured by stand alone indices such as the Vix (tracking the volatility of the 500), VStoxx (the Eurozone Dow Jones Eurostoxx 50 index) and VFtse (our own FTSE index). These indices in turn allow the wider market to price options such as puts and calls that pay out as markets become more volatile. In simple terms more volatility implies higher premiums for issuers of options. That can be useful to structured product issuers as these options are usually built into an investment, especially around the barrier level which is usually only ever broken after a spike in volatility. Again all things being equal an increase in volatility (implying something like the Vix moving above 20 in index terms) usually implies higher funding levels for issuers of structured products.

Dividend Futures

These options based contracts measure the likely total dividend payout from a major index such as the FTSE 100 or the Eurozone DJ Eurostoxx 50 index. In simple terms the contract looks at a specific year (say 2015) then examines the total dividend payout from all the companies in the index, adds up the likely payout, and then fixes it as a futures price usually in basis points. Structured product issuers make extensive use of dividend futures largely because they've based payouts on a benchmark index. That means the bank that is hedging the payout will want to be 'long' the index (in order to balance it's own book of risks) but will not want the dividends that come from investing in that benchmark index. They'll look to sell those future possible dividends via these options and then use the premium income generated to help fund their hedging position. In general terms the longer dated a dividend future (say more than a few years out) the lower the likely payout on the dividend future as the market cannot know dividends will keep on increasing in an uncertain future and must his price in some level of uncertainty.

Equity benchmarks

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

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

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