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Monthly Market Report

May 2023

With commentary from David Stevenson

We live in turbulent times, right? Not if you invest in equities! I usually write this opening introduction just before the middle of the month (usually around the 13th or 14th), and over the last month the FTSE 100 is actually up 1.17%, while at the year to date level its up 5.11%. As for the benchmark US index, the S&P 500, over the last month its up 6.47% and 6.92% YTD. And these positive numbers are despite the fact that we've had.

1) A bank run or two
2) Increasing interest rates
3) Evidence that major economies are slipping into a recession
4) Massive bond losses (by said banks)

As icing on the cake, over those two time periods I mentioned above - 1 month and YTD - the Vix measure of market turbulence (in the US), is down 28% (1 month) and -11.9% (YTD). Arguably for me though the following numbers tell you everything you need to know : shares in giant graphics chip designer Nvidia, with a forecast PE of just 58, are up 80% year to date and 14.8% over the last month. Go figure. What I think we can say, is that clearly equity investors don't think we are in a financial crisis and they also don't think that more big bank runs are likely. Another way of looking at this is that equity investors have taken a giant bet on the imminent direction of interest rates. I think S&P Dow Jones veteran market commentator Silverblatt is spot on when he says the following:

"I'm not belittling the event or the damage, but the market has, and it has moved back to its issues —consumer spending, inflation, the Fed and profits. This is not the 2008-2009 banking situation and the market impact going forward at this point is expected to be tighter loan requirements, new regulations for regionals, lower margins for all deposit-related issues and an increased chance of a recession."

On a higher level, as Powell admitted, the current bank stress will tighten credit with the result being *"the equivalent of a rate hike or perhaps more than that."* So, while the run was and is bad, it has slowed the economy directly and through additional concern. Absent more banking issues (runs), it appears to have reduced the need for prolonged Fed increases - so here we are talking about when the Fed will start its cuts.

One last numerical observation. The table below shows current US equity market valuations. One explanation for the upswing in share prices could be that valuations are low - thus investors are buying into cheap stocks. Yet the table below shows that valuations though not excessive are only just about average - so what we have experienced is very definitely not a bargain basement rally!

S&P Dow Jones Indices			
S&P 500 HISTORICAL AVERAGE PRICE-TO-EARNINGS RATIO			
March 31, 20232: historical data for Q4 2022 and prior, forward based on Street estimates			
	OPERATING	AS REPORTED	
2024 Estimate, current price	16.75	18.16	
2023 Estimate, current price	18.82	20.48	
2022 Estimate, current price	20.86	23.79	
12 Mo Dec'22 (Dec,'22 price)	19.49	23.79	
Average 5-Years	21.49	24.78	
Average 10-Years	20.26	23.00	
Average from 1988	19.23	24.32	
Average from 1936		17.57	

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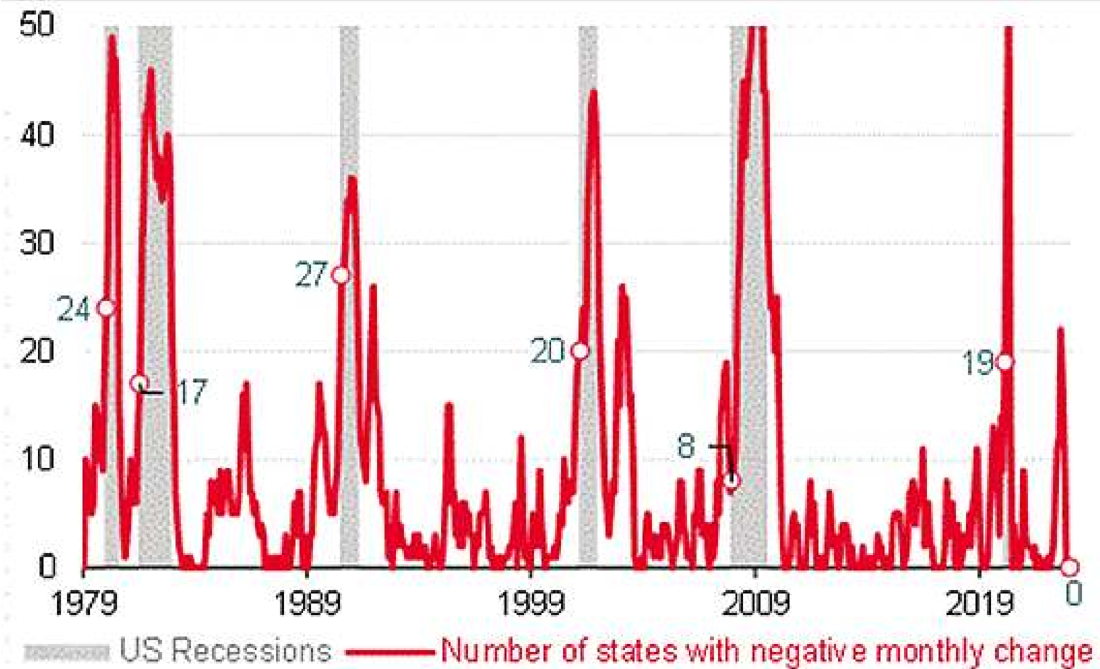
Headline Numbers

One of my favourite pursuits is to hunt around the internet in search of graphs, tables and data sets that backs up my core contention that we're likely to head into a slowdown, at best, and a recession, at worst. I'm slightly obsessed by this because of what I suppose one could call cognitive dissonance. It's obvious to me at least that central bankers would absolutely love it if the US and European economies cooled down quite a bit. They are almost willing it on - though they also want to avoid a deep recession. But as we discuss below, corporate earnings aren't wilting, and job markets seem to be in rude health. Thus, my quixotic search for evidence of what I see as obvious. I'm obviously not alone in my recession quest as plenty of big bank economics teams are employed in the same search - I'd highlight numbers coming out of the respected macro economics team at French bank SocGen. They have a dozen key indicators and half of them are flashing red (recession coming), with two as amber and the other four green (we're not doomed). On balance they think it backs the central contention of their US chief economist Stephen Gallagher that the *"US will find it difficult to escape a material slowdown by the end of this year. SG's house view has a recession pencilled in for early 2024, and no recession in the other major regions. Perhaps the most interesting chart in this note is the one exploring the links between state coincident indices (published by the Philadelphia Fed) and a nationwide recession. While back in October, 22 states were experiencing a slowdown, the subsequent three months have seen exactly zero states experiencing negative month-on-month growth."*

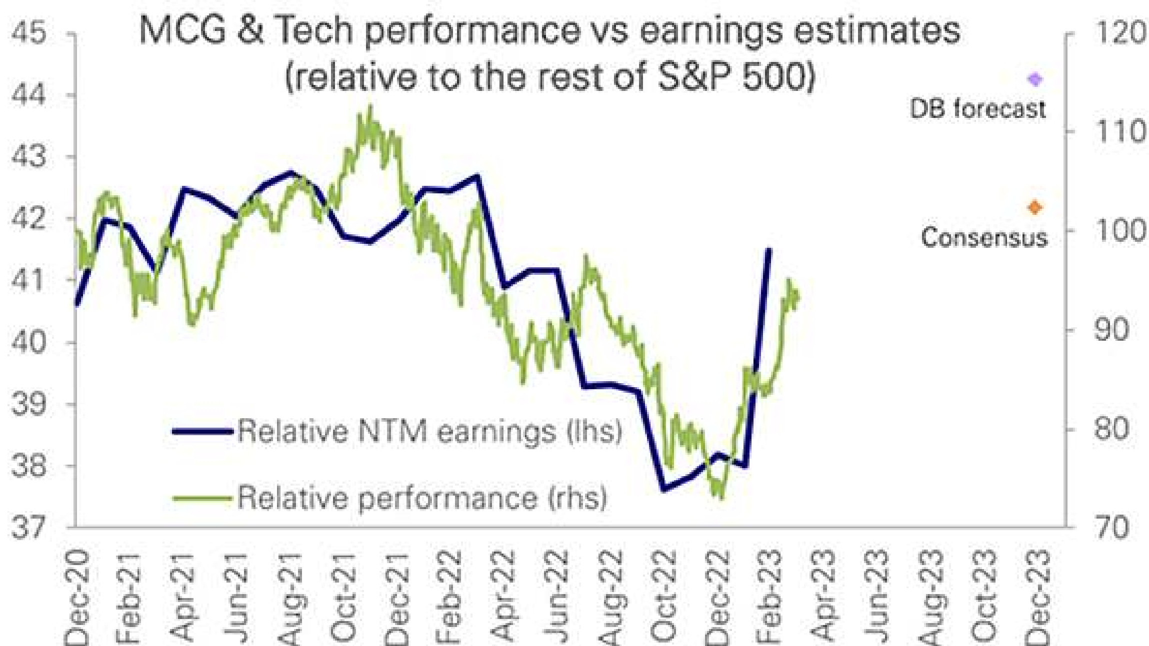


The old Tech Rout narrative was that the large tech giants were in trouble as their margins started to fall. The world wasn't quite turning out as they expected and the Covid bounce was exceptional. Except that it wasn't, was it, as tech stocks have bumped up again! Cue a fascinating snippet of research from Deutsche analysts who back in December last year argued that:

"...that a Q1 rally in mega-cap growth & Tech was likely, driven by a positioning squeeze. This squeeze has now largely played out. What next? MCG & Tech earnings rose massively through the pandemic boom and have fallen sharply through the bust, but the underlying uptrend looks to be intact. The large cycle has remained closely tied to global growth and the dollar, both of which now point to a rebound in MCG & Tech earnings off the bottom of their trend channel. We look for beats and upgrades, breaking last year's run of falling forward earnings, and stay with our tactical long through the Q1 season as the baton passes from positioning to earnings."

The bottom line - it's not an entirely crazy strategy to buy into mega-cap tech giants boasting market position, pricing power, fat margins, and upwards earnings momentum. Maybe tech leviathans are the new safe haven! Again, go figure!!

Tracking earnings estimate changes



Measure	Values as of 14th March, 2023	Values as of 14th April 2023
UK Government 10 year bond rate	3.40%	3.56%
GDP Growth rate YoY	0.40%	0.60%
CPI Core rate	5.80%	6.20%
RPI Inflation rate	13.40%	13.80%
Interest rate	4.00%	4.25%
Interbank rate 3 month	4.34%	4.48%
Government debt to GDP ratio	97.40%	101%
Manufacturing PMI	49.3	47.9

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Bank CDS options

Unsurprisingly rates for credit default swaps for major global banks increased very substantially over the last month - with just two recording no change. Rates for Credit Suisse fell - as you'd expect post deal - but rates for UBS surged higher, as did rates for Deutsche swaps. By and large North American banks plus Lloyds saw the smallest increases but in truth the markets are signalling a clear concern that the risk of default - though still low by historic levels - has increased very substantially.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	24.01	57.37	A+	A2	A -
Barclays	93.8	117	BBB	BAA1	A
BNP Parabis	31.86	59.22	A+	Aa3	A+

Citigroup	58.57	85.04	BBB+	A3	A
Credit Suisse	203	178	BBB-	BAA2	BBB
Deutsche Bank	226	200	A-	A1	BBB+
Goldman Sachs	65.38	98	BBB+	A2	A
HSBC	32.7	54.99	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	45.01	74.19	A-	A1	AA-
Lloyds Banking Group	30.53	49.71	BBB+	A3	A
Morgan Stanley	62.06	95.04	A-	A1	A+
Natixis	19.5	45	A	A1	A+
Nomura	39.78	107	BBB+	BAA1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	41.85	76.47	A	A1	A-
UBS	88.68	107.7	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st April 2023 www.tempo-sp.com

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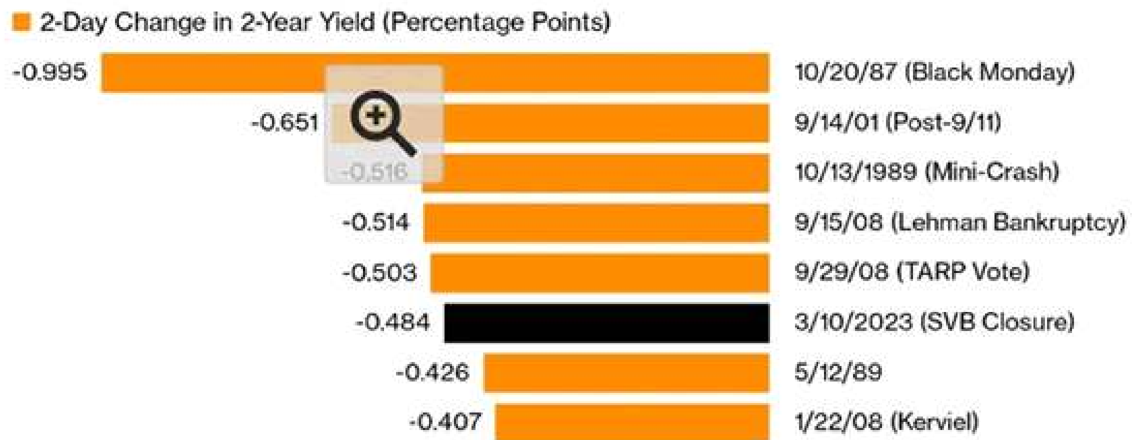
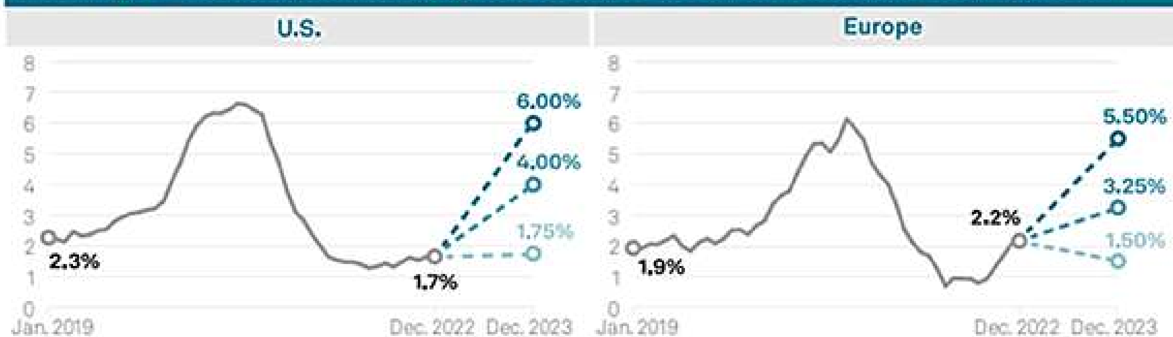
Government Bonds

Remember all those presentations from bond managers over the last decade which suggested that bonds, and especially corporate bonds, were a less volatile asset than equities. I can still picture the charts in my mind which showed historic small drawdowns and subdued volatility. Back in the real world, cynics always acknowledged the real truth - bond investing can be a highly risky enterprise. Take this chart below which showed what happened to 2 year yields after SVB closed. Yields crashed as prices shot up.



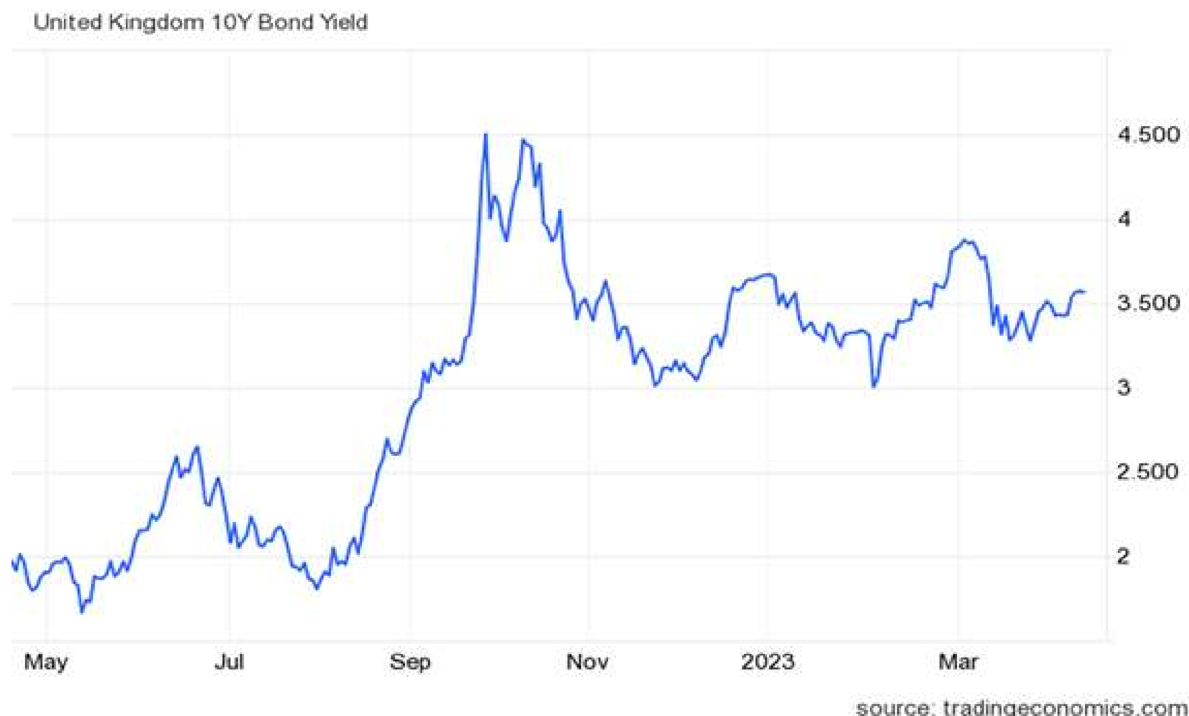
Here are analysts from Deutsche Bank on the latest bond market moves: *"Normalizing the moves in the form of standard deviations (ten-year window), it is striking that since the banking shock, the biggest moves by far have been in short-dated government bond yields with the decline in US and German 2y yields clocking in at a massive -12sd. US and German 10y yields also fell by about -5sd. This compares to US regional banks, the epicenter of the crisis, which fell by about -5.5sd over the same period, and S&P 500 Financials which fell by -3.5sd. Credit spreads widened about 2.5-3.5sd. Moves elsewhere were relatively muted in comparison. Bonds, volatile? Surely not!"*

But bond investors don't only need to worry about price moves in turbulent markets. They also need to worry about default risk. On this subject its worth focusing on global credit market metrics. Liquidity is tightening and credit quality is now declining. Here's Alexandra Dimitrijevic, Global Head of Analytical Research, S&P Global Ratings, who reckons that *"Global credit quality continues to erode. S&P Global Ratings noted that economic resilience has somewhat limited the pace of downgrades so far this year, but slowing economic growth, sticky inflation, and tighter financing conditions are expected to weigh on credit, as reflected in a negative bias close to 15%. Credits in consumer goods, retail, media, real estate, and more generally at the lower end of the ratings scale are most at risk. Our base-case scenario assumes default rates double this year to more than 4% in the U.S. and to 3.25% in Europe."*



Trend lines point to our optimistic-, base-, and worse-case scenarios. Negative bias as of March 24, 2023, calculated as the percentage of ratings with negative outlooks or CreditWatches. Downgrade ratio refers to proportion of downgrades, to the total of upgrades and downgrades. Other chart data is as of Mar. 29, 2023. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

UK Government Bonds 10-year Rate 3.56%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	26.99
Germany	14.9
Japan	26.0
United Kingdom	19.56
Ireland	26.37
Italy	109.87
Portugal	48.65
Spain	47.85

Eurozone peripheral bond yields

Country	April 2023	March 2023	Spread over 10 year
Spain 10 year	3.41%	3.31%	105
Italy 10 year	4.22%	4.13%	186
Greece 10 year	4.23%	4.19%	187

	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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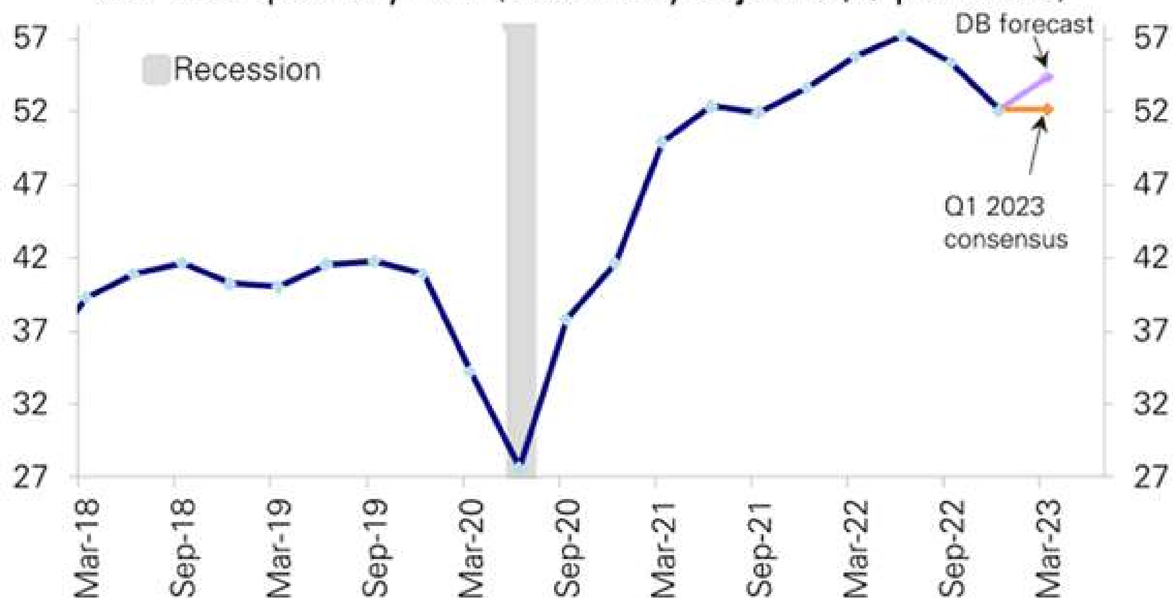
Equity Markets and Dividend Futures

I may think that a recession is imminent but clearly the thundering herd that is Wall Street has other ideas. I wouldn't go quite so far as to say that most big bulge bracket banks are bullish, but there is a palpable edge of cautious optimism i.e., the sense that the worst may be behind us. If you were a contrarian you'd immediately come to the opposite conclusion - these crazy deluded fools have no idea what's coming next with a recession. But the cautious bulls can point to a slow accumulation of data which suggests that corporate earnings, especially in the US, is holding up much better than we expected. Deutsche Bank's US teams have been running some good research into earnings trends - in fact their analysts report that several drivers of S&P 500 earnings have picked up recently, and "we continue to look for a better Q1 earnings season than we have seen in a year... using our earnings framework based on groups of stocks and sectors defined by very different trend growth and cyclical sensitivities to macro growth and the dollar, we see Q1 earnings growth turning up, albeit staying negative on a year-on-year basis. Sales growth should continue to slow but margins tick higher on the back of operating leverage to the pickup in real growth."



Bloomberg Finance LP, Deutsche Bank Asset Allocation

Index	March 2023	April 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	140.2	141.1	4373	123
FTSE 100 Dividend Dec 2022	294.4	3.5	7877	272

Note changed to Dec 2023 contracts

Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	3.06	0.338	14.8	3.34	8.34	7.41	7870.6
S&P 500	5.79	3.68	15.7	-5.61	56.1	78	4146.22
Gold Composite (Most Traded)	5.97	5.37	22.8	2.53	50.1	57	202490¢
iShares FTSE UK All Stocks Gilt	0	-0.815	8.95	-15.2	-18.8	-20.9	1064.75p
VIX New Methodology	-19.6	4.03	-40.4	-15.9	9.65	19.6	19.09

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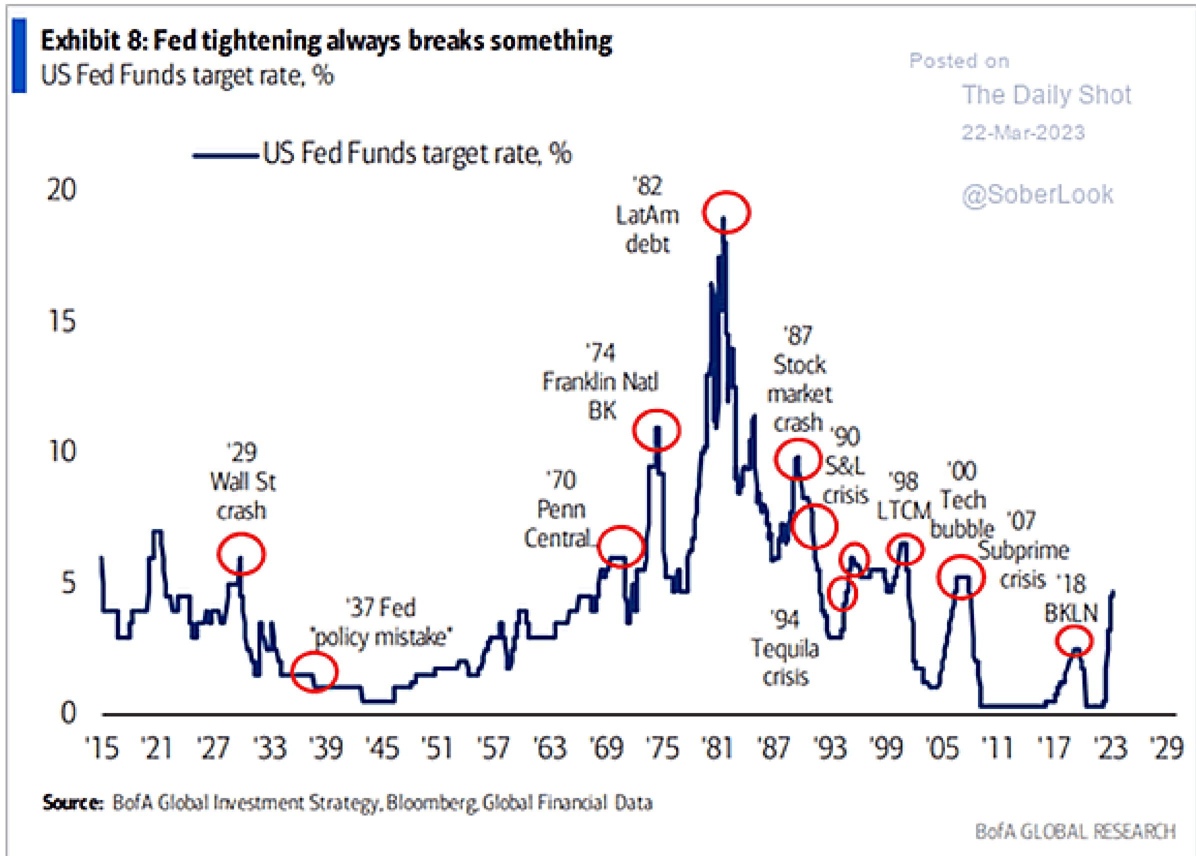
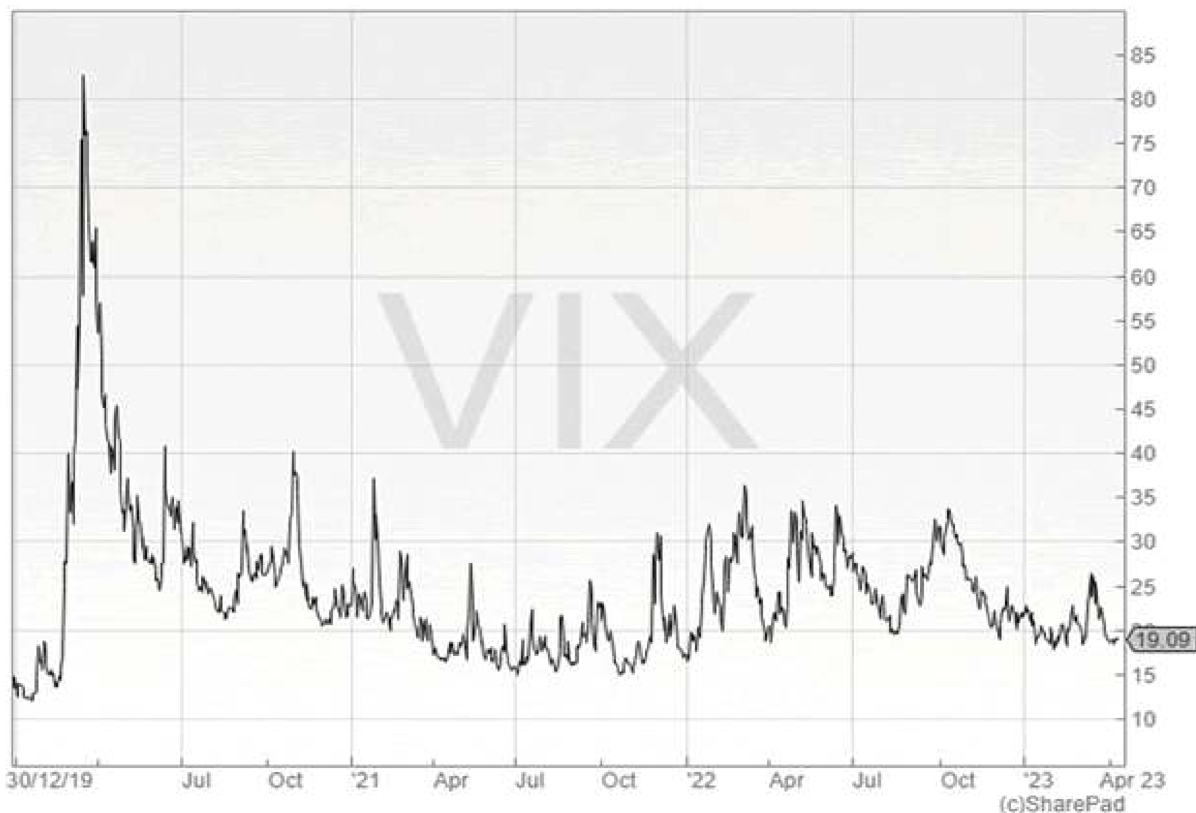
Volatility

According to S&P Dow Jones research analysts last month, February, was an unusually turbulent few weeks - correlations among S&P 500 constituent returns rose by 9 points between February and March, returning to their average level since January 2007. Confidence that contagion would be contained and brightening prospects for Big Tech helped keep S&P 500 index volatility relatively subdued. U.S. mid and small caps, on the other hand, were much more jittery. This paradoxical state of affairs - increased correlations, lower mega cap volatility, increased small/mid cap volatility

- is typical of a market trying to figure out what might happen next. Are we one step away from a recession or is the worst past us ? Cue the widely circulated chart from BoA below which shows what happens when we have interest rate tightening cycles - volatility spikes are an inevitable consequence. Or as many market observers are repeating - things tend to have a habit of breaking when US 2 year Treasury yields sike past 4%.





Measure	April Level	March Level	February Level	January Level
Vstoxx Volatility	17.34	27.97	18.91	18.25
VFTSE Volatility	19.09	24.8	20.34	18.35

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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.

Kind Regards,

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