



Monthly Market Report

November 2020



With commentary from David Stevenson

Don't get too carried away with the gloom...follow the money

Much as we stock market observers love to babble on about valuations, I've long been aware that this is largely a futile exercise. My favourite trick is to go to Robert Shiller's stockmarkets data website, and call up the CAPE data for US equities. Hey presto - a complete train wreck! US equities are horribly overpriced. Sell! And if we're selling the US, we may as well sell everything else.

But this valuation driven perspective ignores a much more obvious truth. Many, arguably most, investors don't give a damn about valuation. What they care about are expectations and money to burn in their pocket. In other words what drives markets are funds flow (available liquidity) and a yoyo between fear and greed.

This is why I spend a great deal of time staring at fund flows data and why we all collectively display extreme neurosis about what central bankers may or may not do ! Which brings me nicely to current juncture.

It's very easy to construct an argument which says we are all on the brink of a stockmarket meltdown as the Covid data turns nasty again and all those momentum driven US private investors head for the hills on line. I'm not entirely sure that is the case. Sure, US equities do look more than a tad over priced but that's a long way from saying that equities overall, as an asset class, are massively over bought.

The most articulate guide I can find through this maze of expectations and liquidity is Cross Border Capital and their latest Global View report is an excellent primer for all investors. The report quite rightly tells us that at the macro level, all the talk about Price to earnings ratios are guff. Better to focus on the power of liquidity and how that translates through to the portfolio level. According to Cross Border "fixed income and forex markets are 80% determined by economic factors (including liquidity) and 20% behavioural factors, such as investors' risk appetite, whereas for equities this holds vice versa. In short, some four-fifths of what matters in the stock market is investors' risk appetite". Which feels about right to me.

The next logical step is to build risk appetite indices and see whether they have any predictive power for subsequent market returns, cross referencing back to uncertainty measures - and the answer is that they do ! According to Cross Border their "risk appetite indexes precede these uncertainty indexes by 2-3 months and again they are statistically Granger causal... each one standard deviation downward shift of investors' portfolios below their 'normal' risk settings

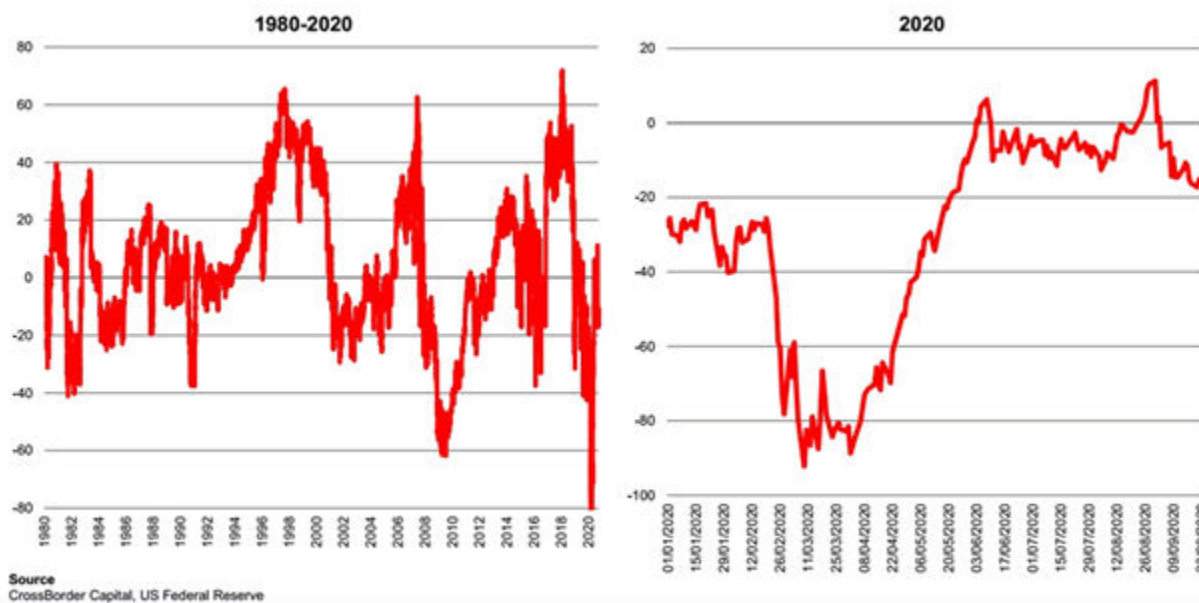
generates an average 13.7% two-year return for World Equities (equally-weighted)".

The key is to look at actual portfolio holdings which is possible for 20 of the major markets on a daily basis. This data reveals that, on average, through most of the period, World investors held a near steady average of 27% in stocks, with a standard deviation of only around 4%, alongside an average of 56% in government bonds and liquid assets, or so-called 'safe' assets. From this you then build a simple ratio between aggregate World equity holdings and Global Liquidity.

According to Cross Border "the current ratio is 0.51 times, or roughly in line with its long-term average. However, importantly the latest reading lies well-below previous peaks of 0.85 times in 2000 and 0.7 times ahead of the 2008/09 GFC. In other words, the data show no evidence of an asset price bubble (my emphasis added)".

Looking forward this data suggests that "World equities can still deliver an moderate above-average return over the next two years, with the US likely to provide less support and European and emerging Markets rather more."

US Investors' Risk Appetite / Index 'normal' range -50 to +50



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Headline Numbers

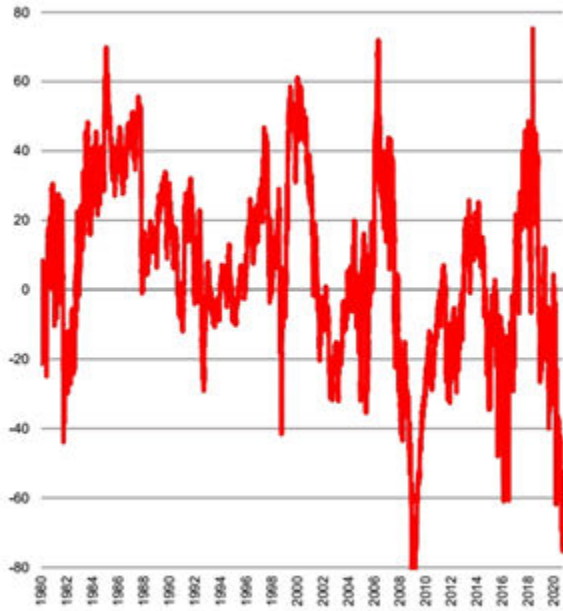
The UK real economy

Back here in the UK some of our comrades on the left are rubbing their hands with gloom and despair as Brexit rears its ugly head again - and CoVid rates spike upwards. Some have even suggested that our economic decline is terminal, and we will soon be an emerging market if we carry on this way. The spectre of Argentina (ruined by Peronista socialists) looms large. But even if we accept this gloomy logic, sooner or later the pain must surely start to lessen? If Covid does spike up in those next few months, we should be able to look forward to a much better 2021, unless of course we are mid-way through an Argentinian style slow decay!

Which is all a way of saying that you can't have your cake and eat it. If you believe that UK assets deserved a discount for uncertainty - Brexit and Covid - once these have started sliding down the agenda, you can't then ignore the potential for a rebound. I personally happen to think that Brexit has been painful, and that the government hasn't handled Covid well, but I also think that the UK is cheap relative to all other DM assets.

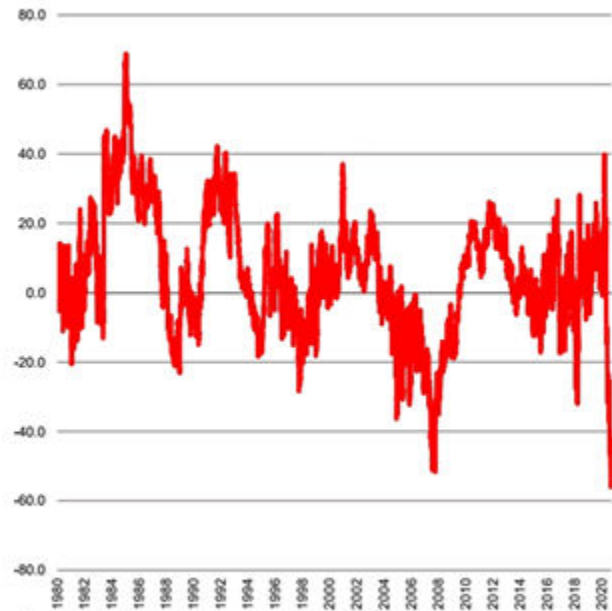
Back to that Cross Border analysis I mentioned at the beginning of this report. They reckon, like many of us, that UK equities are cheap, remarkably so based on some very obvious uncertainties! The current reading from their index is a low of minus 74 *"which has only been once bested by the lows of the 2008/09 GFC. According to historical experience, UK equities deliver an average two-year ahead returns of 35.5% when risk appetite is at just minus two-standard deviations below normal - each additional standard deviation, in theory, adds another 12% to returns. Figure 10 puts this into context and compares the UK with the World investor average. The differential of minus 45 index points is virtually unprecedented. UK equities are both relatively and absolutely out-of-fashion. Where is Warren Buffett when you need him?"*

Figure 9
UK Investors' Risk Appetite
Index 'normal' range -50 to +50 Daily 1980-2020



Source
CrossBorder Capital, Bank of England

Figure 10
UK Investors' Risk Appetite Less World Average
Daily Index 1980-2020



Source
CrossBorder Capital, US Federal Reserve, People's Bank of China, ECB, Bank of Japan, Bank of England, IMF

It would be foolish of course though to ignore the imminent pain in the UK economy. But even that needn't be quite as bad as some maintain. Take the labour market which was the focus of a report a few weeks ago from Tosca funds' chief economist Dr Savvas Savouri.

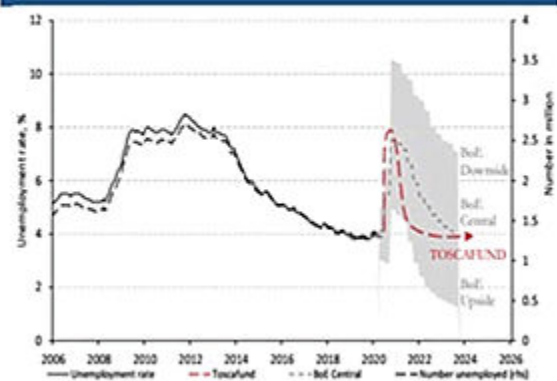
His main point is that all the talk about a K shaped recovery might be very wide of the mark! According to Dr Savouri, *"Yes, parts of the UK labour market's private side will suffer job losses, not however its - admittedly smaller - public sector. Far from it in fact, with large parts of the latter set to see their headcount grow, and do so by popular demand as it were. Moreover, whilst elements of the private sector will indeed suffer permanent job losses, far from all of it will."* The first set of charts below spell out what I think is a perfectly defensible argument - that after the late Autumn spike, employment will recover sharply.

Chart 1: UK jobless rate & number, Toscafund V-fcst vs OBR



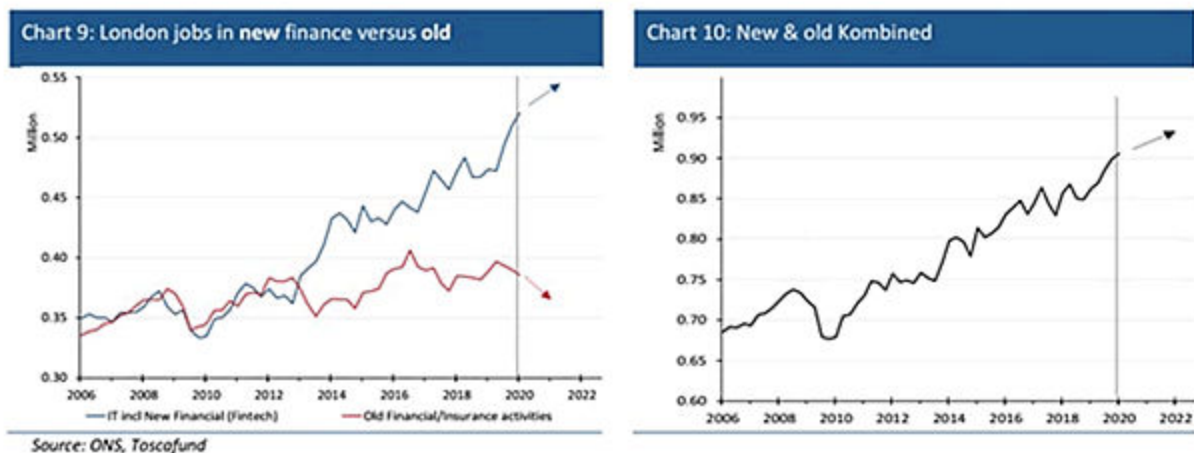
Source: ONS, Toscafund, OBR forecasts from Fiscal Sustainability report July 14th 2020, Updated Coronavirus analysis

Chart 2: UK jobless rate & number, Toscafund V-fcst vs BoE



A key part of this positive argument is that we're all victims of a composition fallacy argument. We

see whole sectors laying off employees like crazy and we forget a) that most of the economy hasn't been hugely impacted in employment terms and b) some have drastically increased employment. The Tosca economist points to a good example - jobs in old London finance may have flatlined or even be heading down but new jobs in the new finance sector have increased. Yes, a few high profile fintechs have laid off staff but they are a minority. Net net, once we combine the sectors, employment in London has INCREASED.



Inflation redux

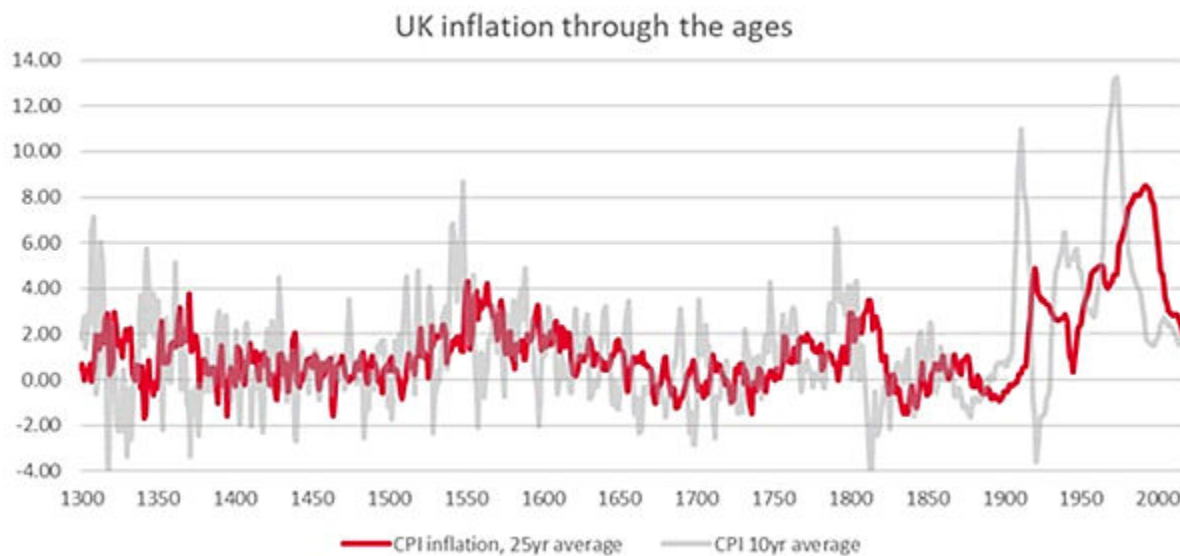
Like many market observers I tend to worry about things that most people would dream about. Take inflation. Most ordinary folks are currently grappling with the side effects of a deflationary economy - all those job losses are crushing demand in much of the consumer economy. But talk to many institutional investors and they say they more worried that inflation might re appear aggressively later in 2022 and 2023. Upside surprises might prompt ruthless central bank action, curtailing loose monetary policy and prompting a massive taper tantrum, redux! Then again we may not have to wait until a few years time to see the first signs. One possible pointer is that for the first time since 1995, U.S. durable consumer-goods prices are rising! Prices for household appliances (gained 10% since February 2020) and used motor vehicles (gained 17%) were the main drivers. Put simply once the fight against the virus is won, the odds are that services will likely face capacity shortages too.

Then again, we should also keep some perspective, by looking at hundreds of years data and try and work out if history teaches us any important lessons, particularly once politics becomes involved. That is what SocGens' Kit Jukes has been doing in the chart below via his recent macro blog entitled "Inflation is a genie held in a monetary lamp". Jukes has been crunching BoE data showing UK inflation since 1300. Once one cleans out the noise we notice five distinct spikes in the 25-year average inflation rate, starting with a rate just under 4% in the mid-14th century. Inflation in the second half of the 18th century "came at a time when the UK was fighting wars and all over the world, much of it financed by credit". But for Jukes the standout period is the 6 1/2% average inflation rate between 1945 and 1980.

According to Jukes this "is the period when the state become more important in the economy, when much more money was spent on health, education and welfare". And that is the core insight - that its not really monetary policy that drives inflation, but real-world hard politics and especially

decisions about government spending (and wars). As Jukes reminds us the 1970s spike was all about politics the growth of the public sector and workers rights, all of which combined to produce higher inflation. There is an echo of these policies today in the "political refocus towards fighting inequality and injustice, rebuilding welfare and health systems, and a huge increase in public sector spending, are similarities with the post-war period" according to Jukes. "But with asset prices bloated by years of low rates, there is clearly a danger that getting inflation back under control if we do get it back, will, be even more painful this time than it was in the 1980s. At that point, countries with a history of hard money and a cultural acceptance that an inflation/devaluation spiral is fool's gold, will be the winners in the FX market and probably in the global economy, too."

I completely agree. Those policy makers who think that huge government borrowing, and record state spending are an entirely risk-free lunch over the medium term (by which I mean 5 to 20 years) are deluding themselves. Everything comes at a price, eventually.



Measure	Values as of 11th September, 2020	Values as of 11th October, 2020
UK Government 10 year bond rate	0.25%	0.28%
GDP Growth rate YoY	-21.70%	-21.50%
CPI Core rate	1%	0.20%
RPI Inflation rate	1.60%	0.50%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.07%	0.05%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	55.2	54.1

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Bank CDS options

Pricing for credit default swaps for major global banks rose pretty much across the board over the last month with nearly all the banks experiencing small but noticeable increases in pricing. The biggest proportional increases came with HSBC, Credit Suisse and BNP Paribas although they all still trade towards the lower end of their historic averages. Only one bank experienced a sustained decrease in pricing - Deutsche Bank whose swaps might be starting a long normalisation process after years of worries about systemic risk.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	12.96	40.16	A	A2	A -
Barclays	23.4	62.34	BBB	Baa3	A
BNP Parabis	17.21	38.52	A+	Aa3	A+
Citigroup	38.75	64.22	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	18.26	52.36	BBB+	Baa2	A-
Deutsche Bank	65.26	138	BBB+	A3	BBB
Goldman Sachs	41.68	67.81	BBB+	A3	A
HSBC	16.38	45.23	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	31.07	52.93	A-	A2	AA-
Lloyds Banking Group	15.79	40.13	BBB+	A3	A+
Morgan Stanley	33.4	58.34	BBB+	A3	A
Natixis	34.08	46.43	A+	A1	A+
Nomura	40.85	95.11	BBB+	Baa1	A-
RBC	20.5	60.53	AA-	Aa3	AA-
Soc Gen	15.65	40.62	A	A1	A
UBS	11.1	33.33	A-	Aa3	A+

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

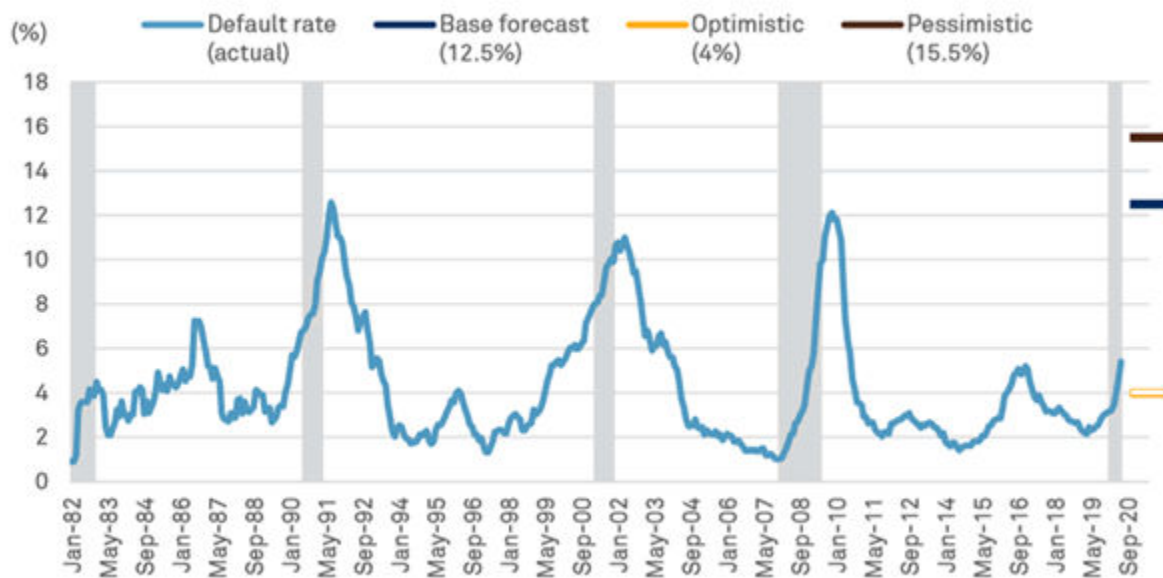
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Government Bonds

If, and it's a big if, we are through the worst of the pandemic emergency, what should bond investors expect to happen to corporate bond defaults? Will the pace of growth slow down or should we expect a pickup in defaults? S&P Global Ratings head of research Alexandra Dimitrijevic has dusted down her crystal ball and pondered what the current numbers on ratings tell us about what might happen next year. Her analysis suggests that downgrades have slowed but negative outlooks are at unprecedented highs. This is the case for both nonfinancial corporates (37%) and banks (30%) globally, indicating more rating actions ahead. Crucially her analysis suggests that credit metrics are increasingly diverging between industries. Some sectors have been barely touched by the pandemic, such as tech, consumer staples, homebuilders, and retail essentials. For others, including airlines, hotels, and auto to name a few, the credit damage will go well into 2023. Negative rating actions (downgrades, negative outlooks, or negative CreditWatch placements) have affected between 60% and 80% of rated corporates globally, in sectors such as capital goods, transport, auto, media and entertainment, and energy. Crucially S&P forecasts that "the speculative-grade corporate default rate to double by June 2021 to 12.5% in the U.S. from the current 6.2%, and to 8.5% in Europe from 3.8%."

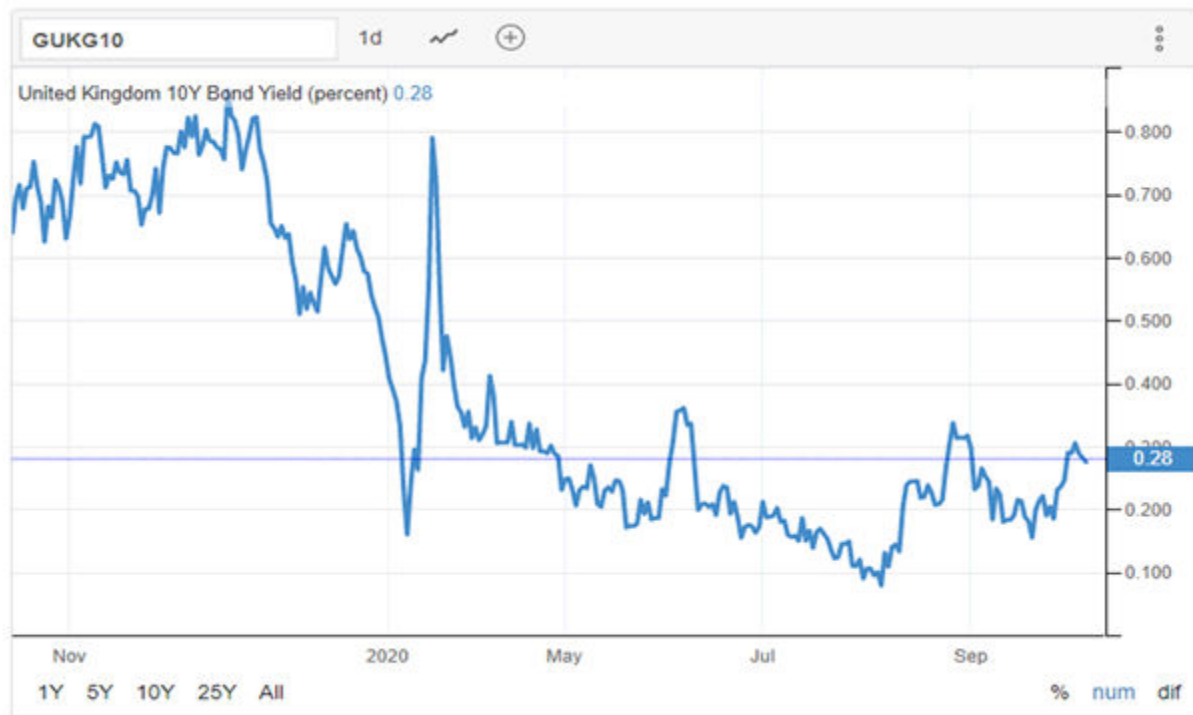
Chart 4

U.S. Default Rate Forecast Through June 2021



Note: Shaded areas are periods of recession as defined by the National Bureau of Economic Research. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

UK Government Bonds 10-year Rate 0.28%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	18.3
Germany	11.08
Japan	16.9
United Kingdom	20.7
Ireland	23.14
Italy	120
Portugal	48.7
Spain	53.4

Eurozone peripheral bond yields

Country	September 2020	October 2020	Spread over 10 year
Spain 10 year	0.35%	0.15%	69
Italy 10 year	1.05%	0.68%	122
Greece 10 year	1.15%	0.80%	134

	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

We've now got the numbers back for September as well as the last (third) quarter and we've had another good run for equities. Those of us expecting a nasty, brutish return from the summer holidays have been disappointed again, although October might yet contain some big surprise as we drive towards the US general elections.

According to analysts at index firm S&P Dow Jones, last month 42 of the 50 markets gained, the same as last month, and down from 45 the month before that. The U.S. outperformed global markets in August, as the U.S. market posted several new closing highs. Emerging markets posted a 2.53% gain after last month's 6.46% gain and the prior month's 7.11%, as the three-month gain was 18.36% and the year-to-date return was -1.83%.

At the Q3 level despite a slump in September, U.S. equities managed to end the quarter with gains. The S&P 500® gained 9%, while the S&P MidCap 400® and the S&P SmallCap 600® gained 5% and 3%, respectively. International markets also rose, with the S&P Developed Ex-U.S. BMI and S&P Emerging BMI up 6% and 9%, respectively.

British equities lagged in the third quarter - large British banks weighed down the S&P United Kingdom, which declined 2% this month and 5% this quarter. By contrast Germany contributed the most positively, thanks in part to its champions in the Discretionary and Industrials sectors.

In Europe seven sectors of the S&P Europe 350 managed to end the quarter in positive territory. Consumer Discretionary led with a gain of 8%, followed closely by Industrial and Materials, which both gained 7%. Energy declined 18% as the prospects of a return to pre-pandemic levels of demand for fossil fuels dimmed.

According to S&P Dow Jones Tim Edwards, almost all factor indices posted gains. Quality led the way, while Momentum continued its recent dominance, with both gaining 3% in the third quarter. Low Volatility also added 3%. Meanwhile, Value continued to struggle: the S&P Europe 350 Enhanced Value declined 2% this quarter, leaving the beleaguered strategy down 32% year-to-date.

One last interesting stat - according to London based researchers Lalcap, India, despite having 6.3 million Covid-19 infections (not that far behind the US' number at 7.2 million) , the local benchmark indices the SENSEX and NIFTY are only 8% and 7% down on the year.

Index	September 2020	October 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	83	83.5	3296	68
FTSE 100 (Dec 19)	207.3	210	6004	160

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.459	-1.49	2.77	-17.1	-5.76	-5.29	6004.4
S&P 500	5.35	10.5	26.2	18.5	74.5	84.7	3519.72
iShares FTSE UK All Stocks Gilt	-1.23	-2.32	-2.12	3.92	18.1	22.3	1465.25
VIX New Methodology	-6.96	-8.39	-40	60.5	54.6	17.7	25

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Volatility

Here is an odd factoid. The classic measure of stockmarket pain - volatility - has been moving in roughly the same direction as US stocks. Up. What?!? This is slightly peculiar. In most ordinary times - that is more than 95% of the time - when stockmarkets move up steadily, as they have been doing, the classic fear gauge measure, the Vix moves down. Put simply if equity investors are confident enough to keep bidding up share prices that would tend to suggest they are not fearful of market turbulence. But as the chart below from analysts at DWS shows, in recent weeks the S&P 500 and the Vix have both been trending upwards. What on earth is going on ?

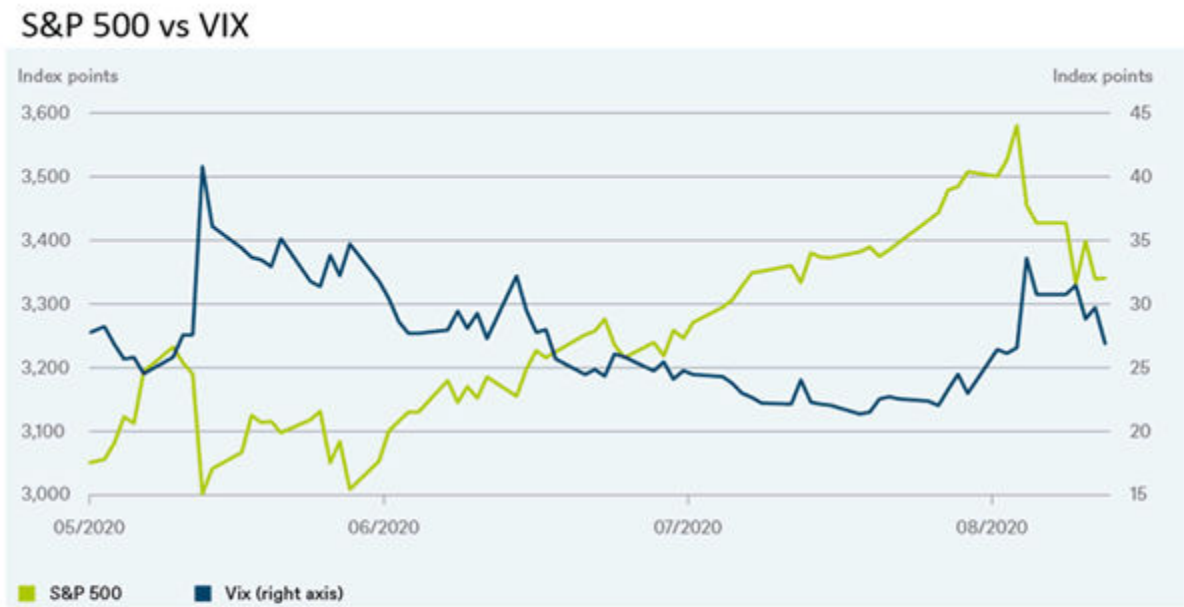
Here's the take from DWS:

" First, higher daily moves translated almost directly into higher option prices (and thus a higher Vix). Second, the demand for options increased from two sides: investors afraid to miss out on a rally tried to jump on the band wagon; and investors worried the rally was going too far too fast sought to protect their gains by buying put options. Higher demand for options means higher premiums, which means a higher Vix. There is also the potential for a self-enforcing upward spiral between the cash and options markets (while it is never clear what is the hen and what is the egg). The options market was certainly a significant driver in the recent U.S. stock-market rally."

So, those naughty new wave of retail investors are at fault, again. According to DWS, what's unusual this year is the amount of options traded on single names, above all the Tech heavyweights - trading volumes in some of these options having almost tripled compared to 2019.

If that is the case could we have an equally bizarre experience in the future where US equities start to steadily fall in price but the Vix also declines, powered in part by a situation where options

trading falls off sharply alongside falling prices and steadily deflating share prices ? Declining Vix and declining S&P 500? Who'd have thought but the chart below suggests this is a distinct possibility...



Appendix: Performance over the past 5 years (12-month periods)

	08/15 - 08/16	08/16 - 08/17	08/17 - 08/18	08/18 - 08/19	08/19 - 08/20
S&P 500	12.6%	16.2%	19.7%	2.9%	21.9%

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 9/31/20
Past performance is not indicative of future returns.



Measure	October Level	September Level	August Level	July Level
Vstox Volatility	22.32	27.87	22.69	27.28
VFTSE Volatility	25	30.76	21.69	27.29

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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.

Zak De Mariveles
UK Structured Products Association Chairman
chairman@ukspassociation.co.uk

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