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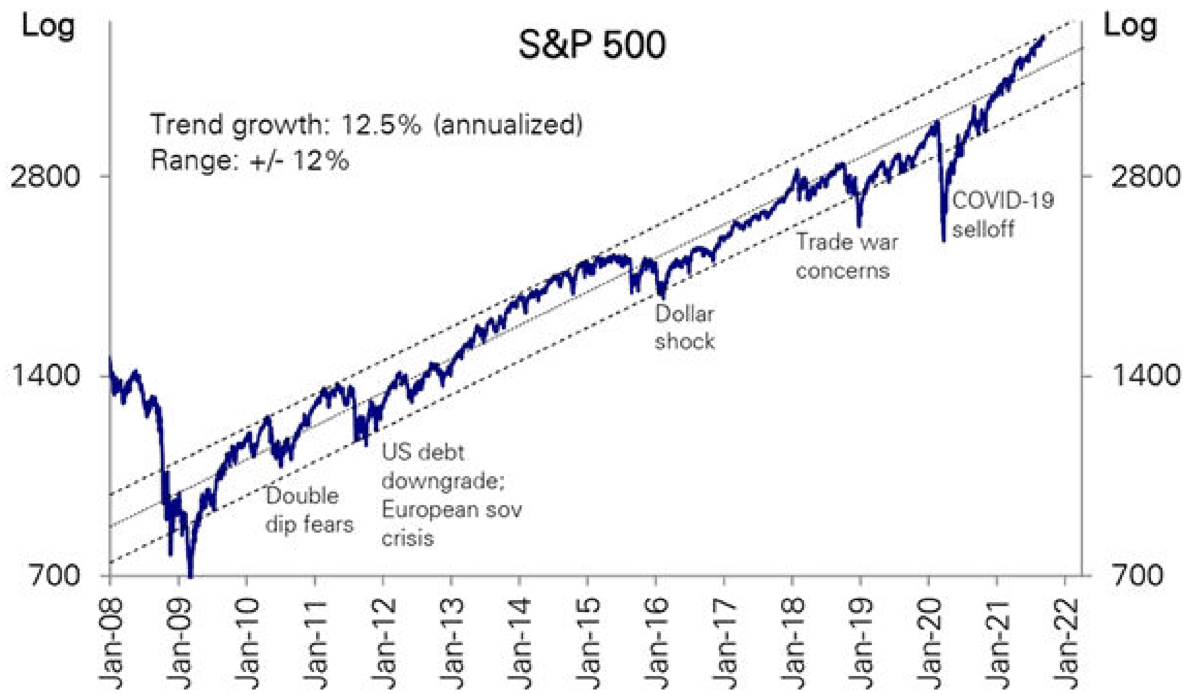
# Monthly Market Report

November 2021

*With commentary from David Stevenson*

Yet again I find myself musing about whether we are at a tipping point in the markets. I've been expecting a nasty sell off for months now and all we've had to date are some sporadic sells punctuated by equally frequent rallies. Suffice to say that I continue to think a proper correction is due - by which I mean at least a few days of negative price action, amounting to a 10 to 20% main benchmark index decline.

Which nicely brings me to the chart below and a recent report form analysts at Deutsche Bank stateside. This is an effective ‘old school' summary of why so many investors are deeply worried. The chart below makes the argument simply and figuratively. Shares are looking toppy, not only in a fundamental sense but also on technical basis.




*Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation*

The fundamentals based challenge for current share prices is ably summarised as follows by Deutsche analysts:

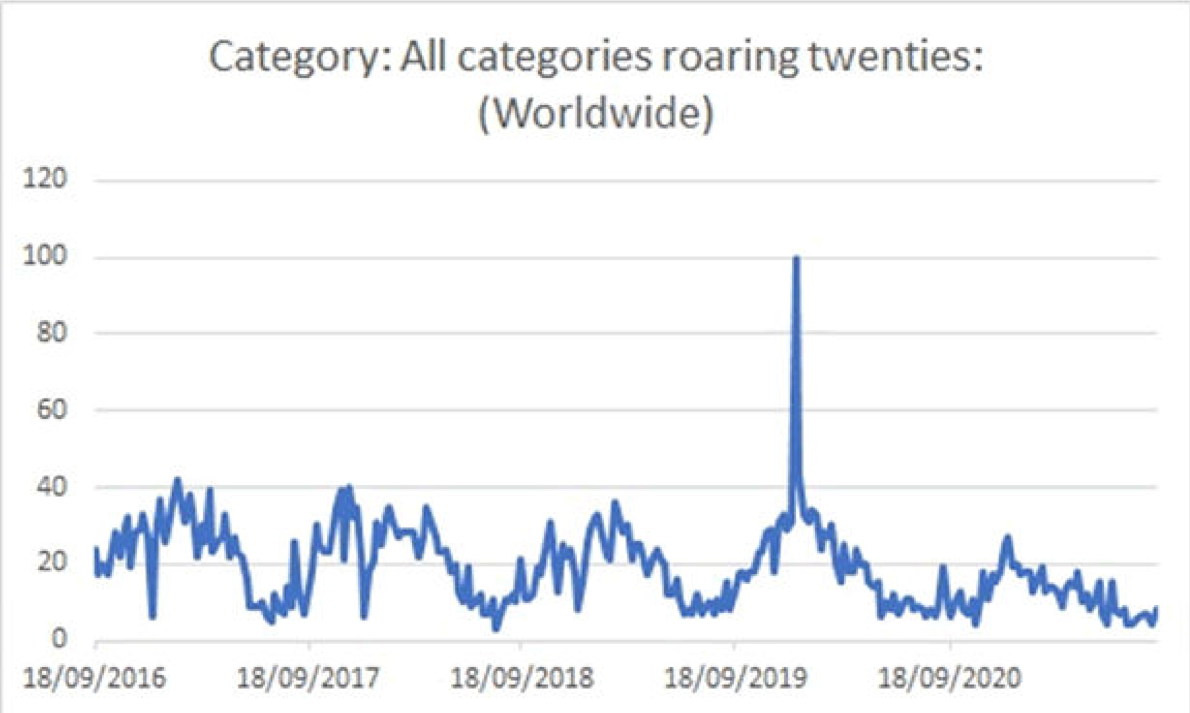
*"The traditional trailing earnings P/E, the forward P/E on consensus earnings estimates, enterprise value (EV) to EBIT, EBITDA or operating cash flow (OCF), are all in the 99-100th percentile excluding the 1990s tech bubble period. But even including it, they are well into the 90s in percentile terms. EV/FCF is at a 20-year high but the only measure that versus a longer history suggests is not particularly high, though historical data issues in measuring cash flows are significant."*

Put simply the market believes the best is still to come but the hard numbers suggest this is wishful thinking.

Cue a possible sell off as those earnings disappoint.

But at that point I would suggest that my first point about investors acting as any angry, pissed off crowd might kick in. Having seen every other sell off followed by an almost immediate rebound, the 'investor crowd' - not to be confused with the wonderful IT Crowd - kick back into action. They might argue that in fact the 'mainstream' institutions have 'got it wrong'.

Oh and one last chart from Google Trends. Looks like the Roaring Twenties thesis - which I subscribe to - has gone off the boil. All we need is for a few technological leaps to embolden the meme crowd and I think it could roar back into action!

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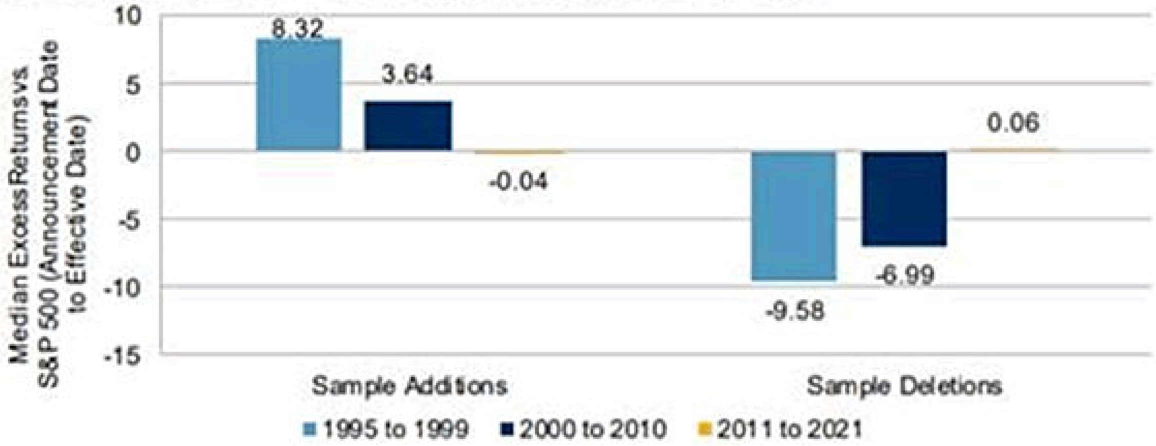
## Headline Numbers

For many years investors have been obsessed with the idea of the index effect i.e when a stock moves into a major, tracked index, the share price starts to appreciate because of heavy passive buying. Will this index effect become more pronounced as passive funds become more powerful or will the impact be slowly arbitraged away? Analysts from S&P Dow Jones have dug around and come up with a surprising conclusion. It's not as powerful as it sued to be.

This conclusion comes in a research paper, "What Happened to the Index Effect? A Look at Three Decades of S&P 500 Adds and Drops". S&P Dow Jones analyzes the additions and deletions to the S&P 500 from 1995 through June 2021 to determine the full extent of the supposed index effect. The analysis confirms that the S&P 500 index effect seems to be in a structural decline.

**Exhibit 1: The S&P 500 Index Effect Declined over Time**




Source: S&P Dow Jones Indices LLC, FactSet. Chart based on median excess returns of sample additions and sample deletions between January 1995 and June 2021. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

China

My guess is that the $64 trillion question on every globally diversified investors lips is, China - what to do? You won't need me to rehearse all the arguments but all I would say is that like many things in our messy world, two things might just be true at the same time. That is that Chinese shares are now cheap but that's for a very good reason which is that policy environment is terrible.

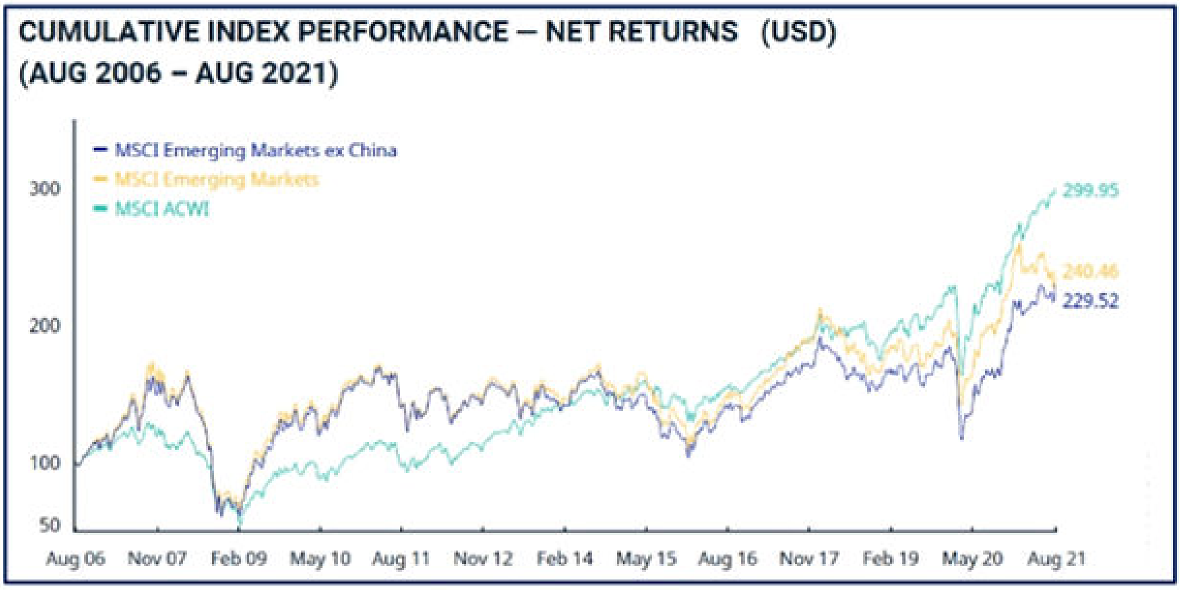
Perhaps a more pertinent question for emerging markets investors is whether to carry on including China within the broad EM indices. I think not but what do I know. Anyway the chart below from Tricio shows the returns of the MSCI Emerging Markets ex-China index (dark blue) vs. the MSCI Emerging Markets (yellow) and MSCI ACWI (All Country World Index, light blue). For investors, as China accounts for over 30% of the MSCI EM index, does the removal of this heavyweight change the returns in a material fashion for the ex-China EM index? The chart below suggests not but as Tricio's strategist Gerry Celaya observes "if the returns of an index with such a big weight is not materially affected when you take that weight out in a new index, what is the point of running the risk of holding that weighting given government actions and policies that pretty much run roughshod over any ESG or SRI considerations? "

Unfortunately, my guess is that most institutional investors don't share this sceptical view. Or at least that's the conclusion of a recent note by Invesco called China position available HERE. This suggests that many big institutions are actually keen to INCREASE their exposure to China. Anyway amongst the highlights of the Invesco report, I'd focus on the following:

- 86% of respondents say they've either maintained or grown their China exposure over the past year, with 64% expecting further increases over the coming year. Only 12% reported a reduction in their China exposure.
- Covid-19 has increased the risk appetite of more than half of survey respondents with regards to their China exposure in the past year.

- Approximately one third of survey respondents plan increases to each asset class, with the highest numbers in real estate 40%, direct ownership of companies 39% and alternatives 38%.

Do these big institutional investors know something the rest of us don't?




Source: MSCI

| Measure | Values as of 7th September, 2021 | Values as of 11th October, 2021 |
|---|---|---|
| UK Government 10 year bond rate | 0.73% | 1.21% |
| GDP Growth rate YoY | 22% | 5.50% |
| CPI Core rate | 2% | 3.20% |
| RPI Inflation rate | 3.80% | 3.80% |
| Interest rate | 0.10% | 0.10% |
| Interbank rate 3 month | 0.06% | 0.09% |
| Government debt to GDP ratio | 97.4% | 97.2% |
| Manufacturing PMI | 60.3 | 57.1 |

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# Bank CDS options

Prices for credit default swaps for the major banks increased across the board over the last few weeks with only one bank registering a small decrease, Deutsche Bank, whose pricing is now back squarely in the middle of the pack. Lloyds Bank's swaps at both the 1 and 5 year level remain the cheapest in the market.

| Bank | One Year | Five Year | Credit Rating (S&P) | Credit Rating (Moody's) | Credit Rating (Fitch) |
|---|---|---|---|---|---|
| Banco Santander | 8.66 | 30.96 | A | A2 | A - |
| Barclays | 14.82 | 42.46 | BBB | Baa2 | A |

| | | | | | |
|---|---|---|---|---|---|
| BNP Parabis | 8.91 | 31.07 | A+ | Aa3 | A+ |
| Citigroup | 27.57 | 53.49 | BBB+ | A3 | A |
| Commerzbank | n/a | n/a | A- | A1 | BBB+ |
| Credit Suisse | 22.51 | 55.14 | BBB+ | Baa1 | A- |
| Deutsche Bank | 28.42 | 73.58 | BBB+ | A2 | BBB+ |
| Goldman Sachs | 28.6 | 57.47 | BBB+ | A2 | A |
| HSBC | 11.31 | 33.22 | A+ | A1 | AA- |
| Investec | n/a | n/a | n/a | A1 | BBB+ |
| JP Morgan | 29.21 | 56.46 | A- | A2 | AA- |
| Lloyds Banking Group | 8.25 | 28.74 | BBB+ | A2 | A |
| Morgan Stanley | 26.05 | 50.43 | BBB+ | A1 | A |
| Natixis | 34.08 | 46.43 | A | A1 | A+ |
| Nomura | 21.64 | 57.17 | BBB+ | Baa1 | A- |
| RBC | 18.07 | 53.58 | AA- | A2 | AA- |
| Soc Gen | 12.61 | 32.78 | A | A1 | A- |
| UBS | 9.97 | 29.15 | A- | Aa3 | A+ |

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st October 2021 www.tempo-sp.com

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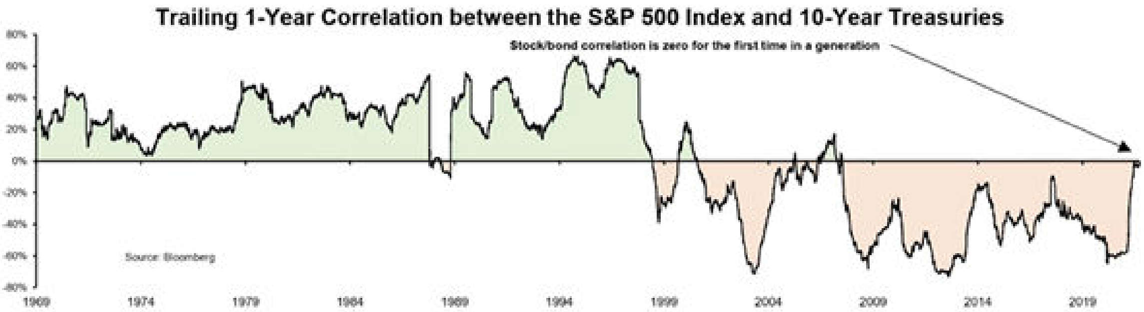
# Government Bonds

### Fixed Income

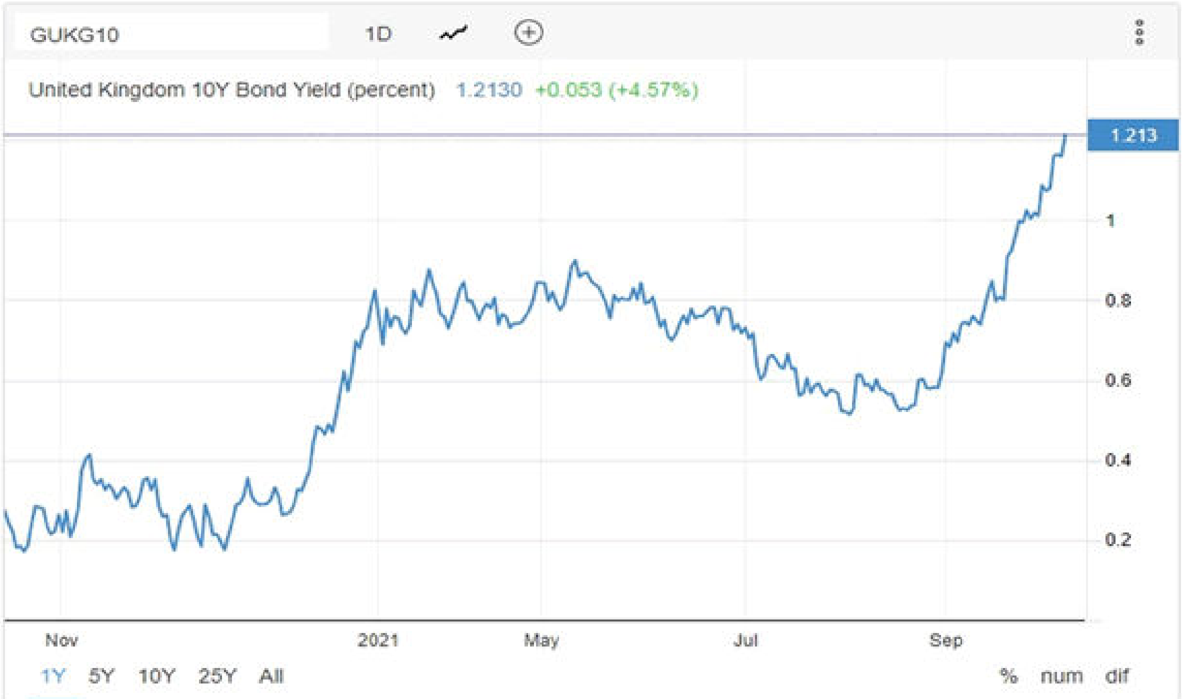
It's almost investment 101. Looking for an excellent long term diversifier of returns within a portfolio? Step forward US Treasuries. It is almost the classic definition of a safe haven contra indicator asset class. Or is it ? Stone X's iconoclastic strategist Vincent Deluard isn't quite as convinced as I am that this does represent such a great diversification bet. In a paper to clients earlier this month Deluard measures a range of asset class correlations - 93 in all with a gold medal awarded to the asset with the lowest correlation, silver to the second, and bronze to the third. According to Deluard "the medal tally is even more unbalanced than that of the Tokyo Olympics: short-term U.S. Treasuries are the most diversifying option for 67 assets. Long term Treasuries got 12 gold and 64 silver medals. Uranium, natural gas, and the Yen were distant thirds".

But the hold of UST on the top prize looks like it might be slipping. Deluard observes that "...the trailing one-year correlation between the returns of long-term Treasuries and those of the S&P 500 index is close to zero. Long-term Treasuries have lost a cumulative 1.7% on down days for the S&P 500 index since March 2020 and they have lost an average 20 basis points on large equity selloffs days in 2021 "

If UST isn't such a great diversifier anymore, what is left???




UK Government Bonds 10-year Rate 0.73%




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

## CDS Rates for Sovereign Debt

| Country | Five Year |
|---|---|
| France | 21.3 |
| Germany | 9.3 |
| Japan | 18.8 |
| United Kingdom | 9.11 |
| Ireland | 14.8 |
| Italy | 72.9 |
| Portugal | 27 |
| Spain | 30.4 |

## Eurozone peripheral bond yields

| Country | September 2021 | October 2021 | Spread over 10 year |
|---|---|---|---|
| Spain 10 year | 0.329% | 0.52% | 63 |
| Italy 10 year | 0.69% | 0.93% | 104 |
| Greece 10 year | 0.767% | 0.93% | 104 |

| | 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

September was something of a disappointment again for equity investors, although I think it could have been much, much worse. According to analysts at S&P Dow Jones, their aggregate measure of major markets posted its first decline (-4.08%) since January 2021 (-0.21%), and its worst month since March 2020 (-14.61%).

Interestingly, for the first time in ages, the US markets underperformed with global breadth strongly negative. For the month, global markets declined 4.08% and without the U.S.'s -4.63%, the decline was -3.34%, after August's 2.35% gain and 1.84% without the U.S.'s 2.73% gain. For September, 19 of the 50 markets gained, down from August's 44, July's 25, June's 20, and May's 36.

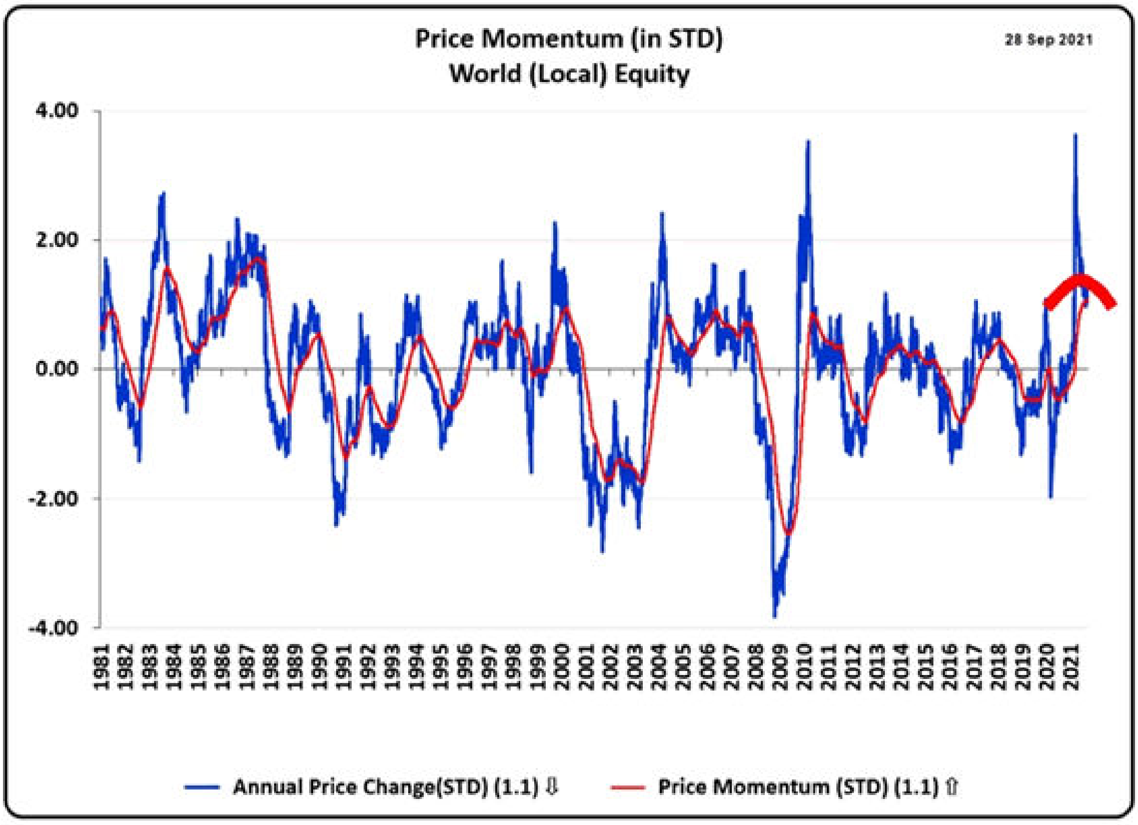
The table below shows some of the out performers - led by Russian equities. Who'd have guessed, followed by the Czech Republic and Qatar. Where's the natural gas in the Czech Republic? As for laggards, I'd draw attention to the two populist hotspots, Turkey and Brazil. The former is now down nearly 20% this year (all those gas imports) and the latter is down over 15% (lots of natural gas!).

S&P Global Broad Market Index(BMI) Global 30/09/2021

| Market size | Country | From 11/3/2020 | 1 Month | YTD | 6 month | 1 year | 2 year | 3 year |
|---|---|---|---|---|---|---|---|---|
| $353 | Russia | 60.37% | 5.93% | 27.32% | 19.71% | 50.81% | 27.22% | 39.75% |
| $11 | Czech Republic | 66.66% | 3.01% | 29.93% | 24.26% | 72.06% | 35.00% | 13.38% |
| $71 | Qatar | 15.76% | 2.91% | 9.88% | 9.84% | 12.51% | 7.60% | 10.58% |
| Laggards | | | | | | | | |
| $3,015 | United Kingdom | 28.67% | -3.20% | 8.88% | 3.37% | 28.53% | 6.46% | -1.13% |
| $8,668 | Emerging | 13.95% | -3.42% | 0.17% | -2.28% | 17.74% | 25.01% | 23.23% |
| | Global | 25.99% | -4.08% | 10.01% | 5.02% | 27.06% | 36.67% | 34.46% |
| $69,583 | Developed Markets | 27.62% | -4.17% | 11.33% | 5.97% | 28.30% | 38.23% | 36.03% |
| $46 | Turkey | 16.00% | -10.47% | -19.56% | -4.97% | 6.34% | -18.30% | -7.59% |
| $467 | Brazil | 14.65% | -13.95% | -15.32% | -4.75% | 15.03% | -21.68% | -1.82% |

But as sell offs go, this isn't the real thing. Its more a bump. As I mentioned in the introduction I've been expecting a much more determined sell off. And I'm not alone. My own thinking is summed up nicely by Charles Ekins of Guinness Ekins which runs a multi asset portfolio using ETFs based on technical and fundamental measures. Only a few weeks ago he warned that "Equities are on the Cusp of Danger, based on the simple fact that valuations look 'very stretched'. Crucially, looking at the chart below, equity markets "are now losing momentum...Equity Markets are still in a bull phase but downside risks are becoming a major concern. Our model is waiting for confirmatory signals, but is very close to reducing Equity allocations due to value risks and loss of momentum".

Maybe the bulls really are running out of energy.




| Index | September 2021 | October 2021 | Reference Index Value | Level 6 Months Ago |
|---|---|---|---|---|
| Stoxx 50 Dec 21 contract# | 101.2 | 101 | 4051 | 95.9 |
| FTSE 100 Dividend Dec 2021 | 243.5 | 243.3 | 7119 | 226 |

Note changed to Dec 2021 contracts in January 2021

| Name | | | Price % change | | | | Close |
|---|---|---|---|---|---|---|---|
| | 1 mth | 3 mths | 6 mths | 1 yr | 5 yr | 6 yr | |
| FTSE 100 | 1.14 | -0.178 | 2.8 | 18.2 | 0.542 | 10.8 | 7109.2 |
| S&P 500 | -1.51 | 0.499 | 6.36 | 26.3 | 106 | 118 | 4391.3 |
| | | | | | | | |
| iShares FTSE UK All Stocks Gilt | -5.44 | -4.48 | -3.32 | -8.77 | -1.1 | 8.19 | 1337.62 |
| | | | | | | | |
| VIX New Methodology | -6.73 | 20.8 | 17.1 | -21.8 | 27.2 | 14.4 | 19.54 |

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## Volatility

Equities may be running out of positive momentum, but measures of market volatility aren't exactly shooting up at the moment. The chart below shows the fear gauge, the Vix. The Green line shows the 200 day moving average, the red line the 20 day moving average.

The Vix has been increasing gently over the last few weeks but within a trading range which doesn't suggest a massive sell off. But this relatively calm out turn belies two facts. First long positioning on Vix futures has shot up. Secondly the 200/20 day moving averages have crossed over which in technical terms is usually a bad sign (or good if you are long vol).


Red line - 20 day moving average Green Line - 200 day moving average

| Measure | October Level | September Level | August Level | July Level |
|---|---|---|---|---|
| Vstoxx Volatility | 21.98 | 18.13 | 17.4 | 18.04 |
| VFTSE Volatility | 19.54 | 16.41 | 16.72 | 16.7 |

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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.<br>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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Kind Regards,

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