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Monthly Market Report

November 2022

With commentary from David Stevenson

Without wanting to sound like a broken record player, we need to keep focused on US corporate earnings - and any likely reversal in EPS growth. It's easy to get carried away with all the talk about macro drivers like inflation rates, interest rates and bond vigilantes and so on but when it comes to equity markets, investors act like one giant earnings weighing machine - if corporate earnings are gushing in, investors will worry less about the macro factors and salivate more about the buybacks and dividends. And in this battle, the real test is whether the bottom-up analysis of US corporate earnings - by stock specific analysts - catches up with the top down estimates for the US economy coming down from strategists. And here's the nub of the issue. From a bottom up perspective, most analysts think corporate earnings for the businesses in the S&P 500 will still increase by around 7 to 9% in 2023. But this doesn't feel right especially when the top down strategists say that the US is at the very least heading into a slowdown with corporates battling cost pressures.

At the very least aggregate EPS for the S&P 500 might stay steady or, more probably, decline. If that is the case then the current level for the S&P 500 is unsustainable - and if the US market is weak, most other developed world markets will be weak as well. The game now is to watch those bottom-up estimates for corporate earnings play catch up and the numbers to get marked down. And that exercise needs to start with the big investment banks. I think a useful sign of what's to come is in a recent note from analysts at Deutsche Bank which observed "that Q3 bottom-up consensus earnings estimates continue to be downgraded, with the drop of -7% (-8% ex-Energy) since the beginning of the Q2 earnings season".

Here's the key bit for me: "In line with our house economics forecast of a recession in the second half of next year, we cut our estimates for 2022 to $222 (previously $227), falling in 2023 to $195 (previously $234). Our forecasts imply an EPS decline of -12% next year, not far from that in an average recession (-15% or EPS of $190). Our forecasts for 2023 are now well below the top-down ($232) as well as bottom-up consensus ($240), which look to be aligned with a soft landing or a continuation of the cycle."

I think if you accept the logic of S&P 500 earnings coming in at below 200 points, then the S&P 500 needs to fall to below 3300 i.e another 10% to 15% decline from where we are. And that number only makes sense if you think we are due an 'ordinary' recession - which we may not.

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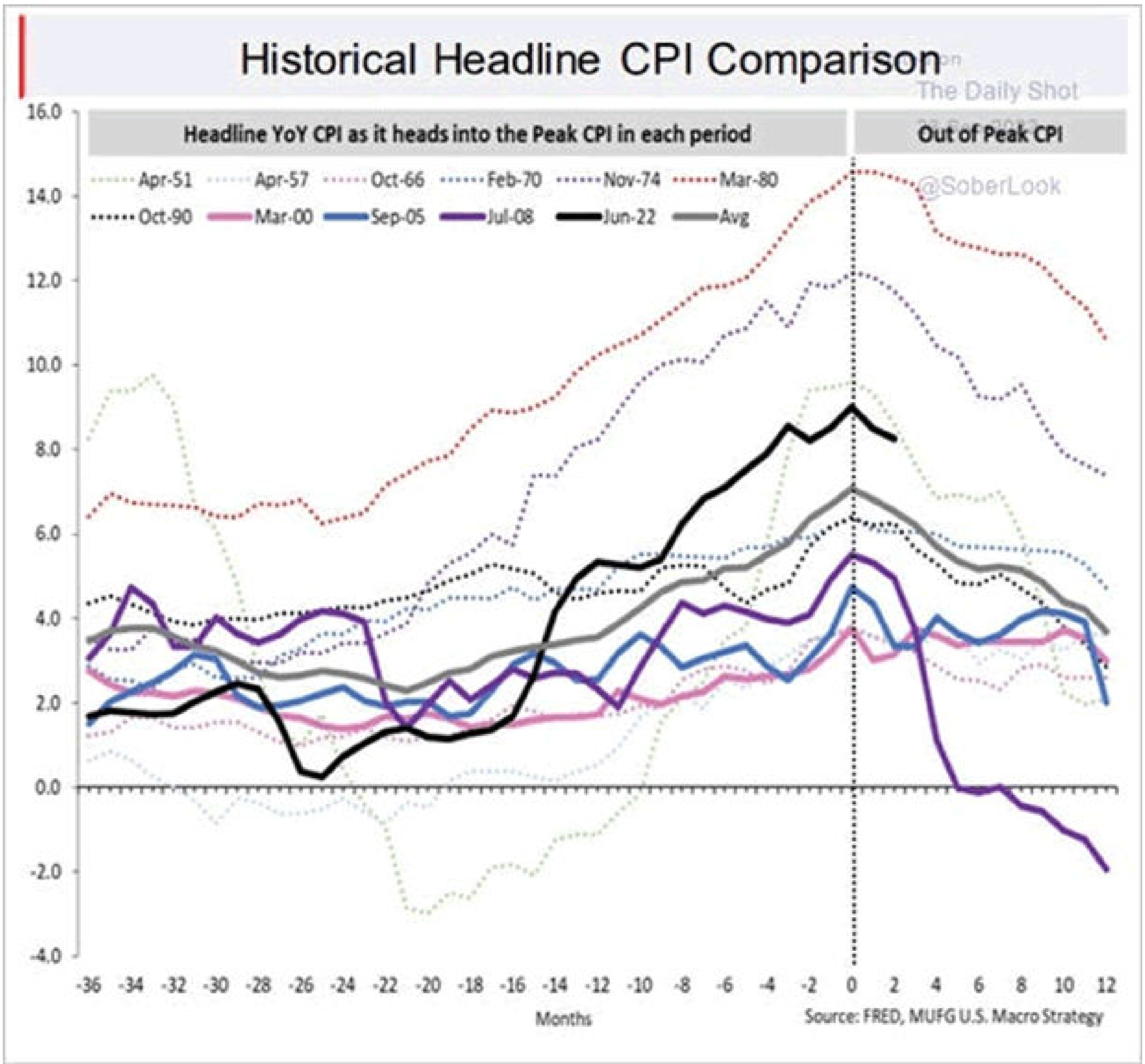
Headline Numbers

The chart below from MUFG Securities via The Daily Shot is a useful graphic demonstration of what might happen if inflation trends do start to moderate back down to historically average levels. It shows various other headline CPI high watermarks since the end of the second world war. The current explosion in prices is very noticeable and deeply worrying but not unprecedented. Notice how in every case those CPI rates fall back sharply (usually because of a recession). And notice the background average CPI rate which hovers around the 4% mark, which is a possible/likely landing spot for US inflation.



Source: MUFG Securities

In my introduction I talked about the pivotal importance of US corporate earnings. Back in Europe, that process of realisation about EPS downgrades is only just beginning. As analysts from Morgan Stanley note in Europe "we may be nearing an end to this year's PE de-rating but have not yet started the EPS downgrade cycle that is (surely) coming. At its low in late September, MSCI Europe's N12M PE fell to 10.5, which is approaching the 10x level we have been targeting since the summer. Without trying to be too precise around specific valuation levels, we think we are now 'entering the right ballpark 'and note that PE ratios usually move inversely with both inflation and base rates. Bottom line, we suspect the PE can fall a bit further in the short term, but we believe EPS trends will increasingly dictate equity performance over the medium term".

On this score I think the chart below is fascinating. It comes from the analysts at French bank SocGen. It shows the relative valuations of the big companies in the Stoxx 600 index based on forward PE. You can see how European stocks have moved up and down based on these numbers since the late 1990s. According to analysts Kevin Redureau, Roland Kaloyan, Charles De Boissezon. The STOXX 600 is currently trading at a 12-month forward price-to-earnings of 11.1x, and rapidly moving into deep-value territory to now stand at two standard deviations below trend (a shift previously only observed during the great financial crisis). And I suspect that that under valuation could deepen - I'd wager that by the middle of winter this will be at three standard deviations from the 20 year average.

Measure	Values as of 13th September, 2022	Values as of 13th October, 2022
UK Government 10 year bond rate	3.06%	4.27%
GDP Growth rate YoY	2.90%	4.40%
CPI Core rate	6.20%	6.30%
RPI Inflation rate	12.30%	12.30%
Interest rate	1.75%	2.25%
Interbank rate 3 month	2.67%	3.49%
Government debt to GDP ratio	95.90%	95.90%
Manufacturing PMI	47.3	48.4

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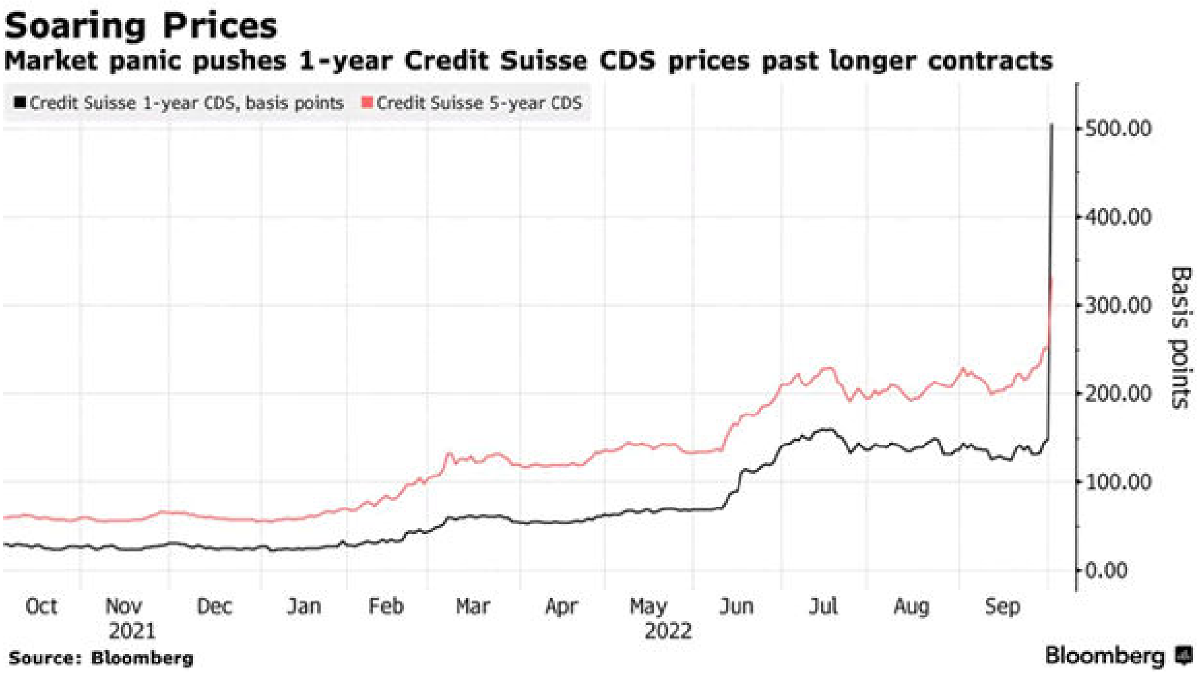
Bank CDS options

Any article about the pricing of bank credit default swaps would be remiss not to mention events at Credit Suisse. A few weeks ago Credit Suisse CEO Ulrich Koerner sent out a now legendary memo which stated the following: " No doubt there will be more noise in the markets and the press between now and the end of October. All I can tell you is to remain disciplined and stay as close as ever to your clients and colleagues. I know it's not easy to remain focused amid the many stories you read in the media - in particular, given the many factually inaccurate statements being made. That said, I trust that you are not confusing our day-to-day stock price performance with the strong capital base and liquidity position of the bank."

The chart below from Bloomberg tells you the reaction. To say that the Swiss bank has a few problems is an epic understatement. Whilst it's a long way from distress, the bank has suffered from low profitability and losses in some divisions. According to the Economist magazine, the firm had a return on equity of minus 14% last quarter, its share price has tumbled, and its market cap is now below $11 billion. That said, its funded with capital worth 14% of its risk weighted assets and its not remotely close to default. But the current CDS pricing will probably only make these challenges worse, not least because rising credit spreads will make Credit Suisse's debt more expensive to refinance. According to FT's Alphaville service over 2020-2021 "the average CDS spread for Credit Suisse's opco debt was about 57 basis points and for the holdco the average over the previous three years was 83 basis points, according to RBC." By the end of September the relevant CDS rate stood at 251 for the 1 year options and 285 for the 5 year options - according to the FT this suggests " an incremental increase in 2023 refinancing costs in the order of SFr300mn." As I write this the rates for Credit Suisse are 148.14 for 1 year and 234.38 for 5 years.

Looking at the broader market, pretty much all the banks we track saw the pricing of their swaps increase substantially over the last four weeks with only Natixis seeing no change and RBC a small, marginal increase. And its also worth noting that Credit Suisse's current rates are only marginally above those of Deutsche Bank which has suffered from high CDS pricing for over a year now.



Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	45.38	90.2	A+	A2	A -
Barclays	90.58	132.69	BBB	Baa2	A

BNP Parabis	45.75	78.66	A+	Aa3	A+
Citigroup	67.96	132.68	BBB+	A3	A
Credit Suisse	148.14	234.38	BBB	Baa2	BBB
Deutsche Bank	139.75	223.43	A-	A2	BBB+
Goldman Sachs	69.54	141.5	BBB+	A2	A
HSBC	46.09	81.42	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	60.57	109.91	A-	A1	AA-
Lloyds Banking Group	50.29	84.65	BBB+	A3	A
Morgan Stanley	65.7	129.68	A-	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	45.07	134.9	BBB+	Baa1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	49.58	91.17	A	A1	A-
UBS	55.09	97.52	A-	Aa3	A+

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

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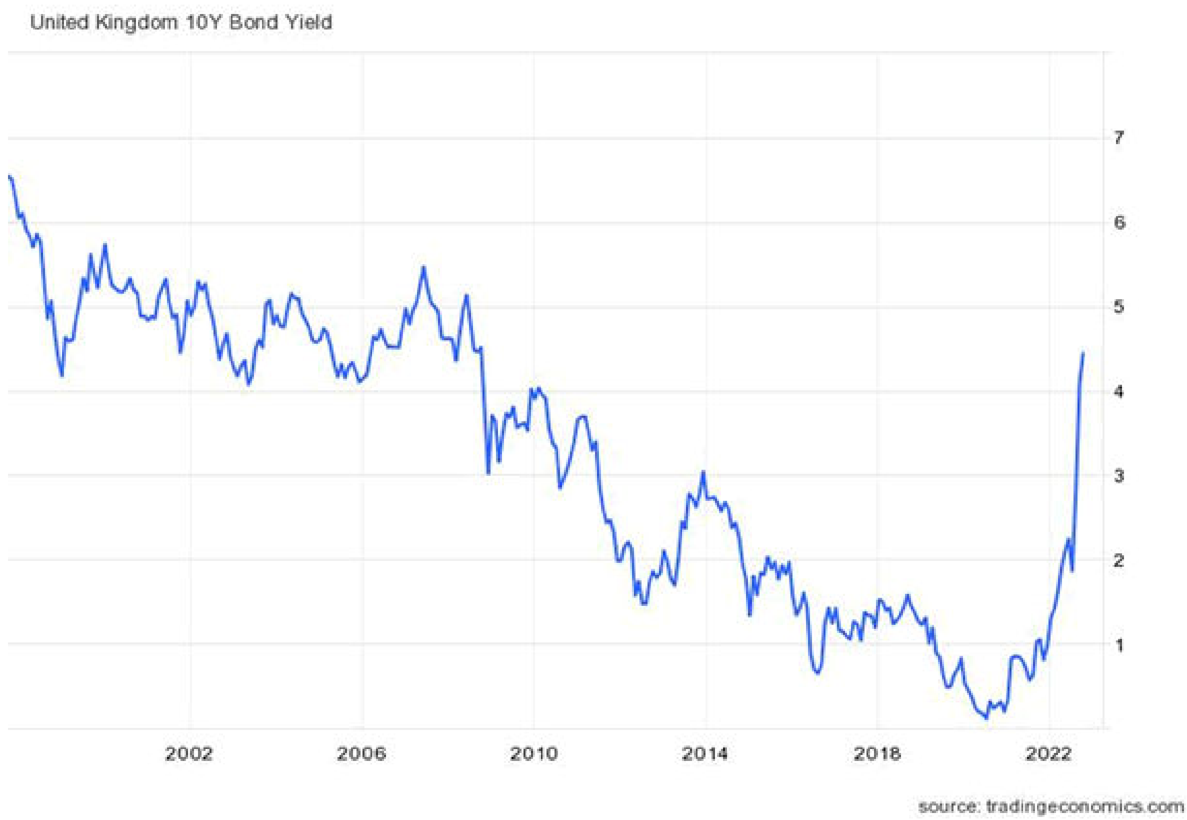
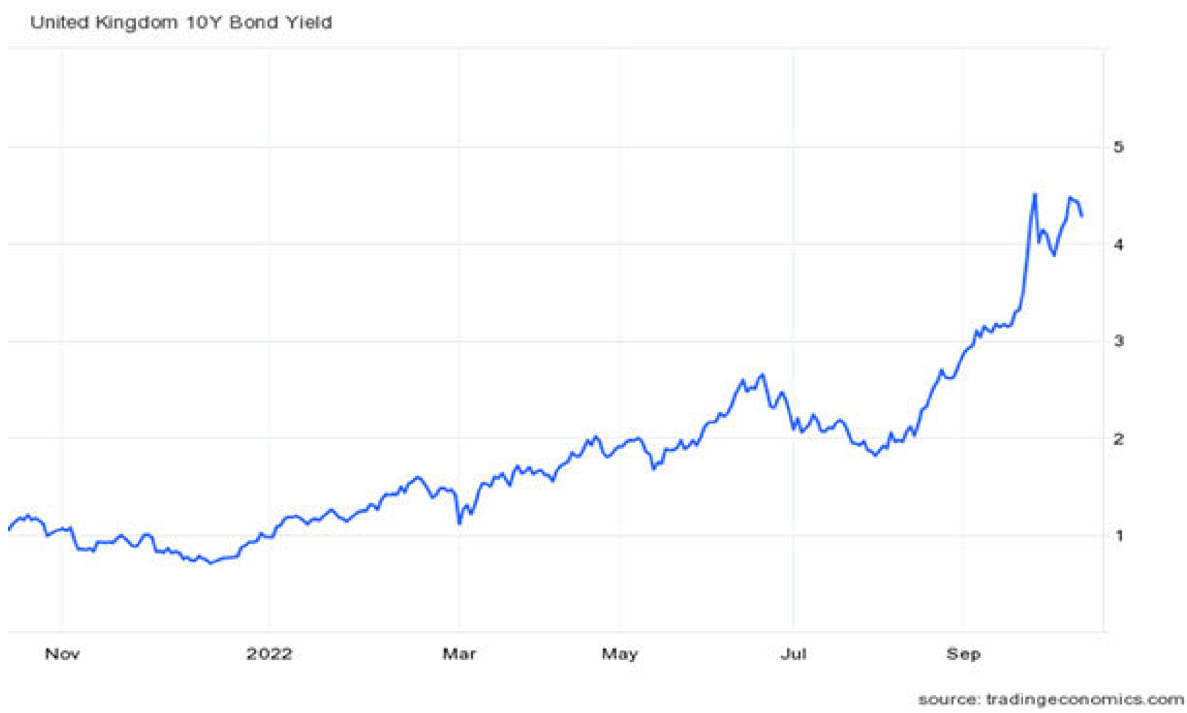
Government Bonds

Who'd have thought that the first cracks in the global wall of liquidity would happen in the UK? I'll refrain from making any comments about the mini budget and the subsequent crisis but simply note that the UK gilts market is in a dreadful place. And the chart below tells the story. It shows the yield on UK government 10 year securities. By the time you read this, the curve might have steepened even more but I think we need to retain some perspective. At current levels, that yield is not far off the levels last seen at the beginning of the millennium i.e yields of 4.5% to 6% are not even remotely unusual in historical terms. My own guess is that the yield will shoot past 4.5% and then 5% before stabilising. But who knows?



UK Government Bonds 10-year Rate 4.27%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	24.2
Germany	17

Japan	19.8
United Kingdom	47.13
Ireland	18.4
Italy	144.2
Portugal	52.1
Spain	52.6

Eurozone peripheral bond yields

Country	September 2022	October 2022	Spread over 10 year
Spain 10 year	2.77%	3.43%	115
Italy 10 year	3.89%	4.67%	239
Greece 10 year	4.16%	4.86%	258

	S&P Rating		Moody's Rating		Fitch Rating
Germany	AAA	Stable	AAA	Negative	AAA
United Kingdom	AAA	Negative	AA1	Stable	AA+
United States	AA+	Stable	AAA	Stable	AAA

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Equity Markets and Dividend Futures

September really wasn't a great month for international equities. That's confirmed by numbers from analysts at S&P Dow Jones. **Amazingly not one single national market recorded a gain in September,** with Mexico reporting the smallest loss at 0.70% whilst Turkey was not far behind at a loss of -1.40%. Even the UAE market recorded a -5% loss.

			S&P Global Broad Market Index(BMI) (		30/09/2022
US MKT	**%**	**%**	**BMI MEMBER**	**1-MONTH**	**YTD**
$146	2.18%	0.24%	Mexico	**-0.70%**	-14.19%
$48	0.71%	0.08%	Turkey	**-1.40%**	21.23%
$16	0.24%	0.03%	Peru	**-1.94%**	-10.77%
$7	0.11%	0.01%	Egypt	**-2.81%**	-35.25%
$193	2.87%	0.32%	Indonesia	**-2.89%**	1.76%
$424	6.33%	0.70%	Brazil	**-4.71%**	-2.76%
$112	1.67%	0.19%	U.A.E.	**-5.04%**	-5.81%
$86	1.28%	0.14%	Qatar	**-5.28%**	4.20%
$1,362	20.31%	2.25%	India	**-5.74%**	-10.50%

As for the year to date through to the end of September, the winner is still Turkey with a 21% gain, with Chile at 7%, and Qatar with a 4.2% gain.

			S&P Global Broad Market Index(BMI) (		30/09/2022
US MKT	%	%	BMI MEMBER	1-MONTH	YTD
$48	0.71%	0.08%	Turkey	-1.40%	21.23%
$41	0.61%	0.07%	Chile	-11.42%	7.23%
$86	1.28%	0.14%	Qatar	-5.28%	4.20%
$193	2.87%	0.32%	Indonesia	-2.89%	1.76%
$312	4.65%	0.52%	Saudi Arabia	-7.58%	-0.65%
$67	0.99%	0.11%	Kuwait	-9.58%	-1.46%
$424	6.33%	0.70%	Brazil	-4.71%	-2.76%
$112	1.67%	0.19%	U.A.E.	-5.04%	-5.81%
$1,362	20.31%	2.25%	India	-5.74%	-10.50%

Index	September 2022	October 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract	123.3	123	3346	18.5
FTSE 100 Dividend Dec 2022	271.9	272	6824	266.5

Note changed to Dec 2022 contracts in January 2022

Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-7.4	-4.43	-9.78	-4.24	-9.24	-1.98	6839.25
S&P 500	-9.04	-5.91	-19.6	-18	40.1	67.7	3577.03
Gold Composite (Most Traded)	-1.83	-2.85	-15.1	-6.06	29.1	34	168600¢
iShares FTSE UK All Stocks Gilt	-9.38	-17.6	-21.9	-27.6	-24	-26.5	989.625p
VIX New Methodology	23.3	25.4	54.1	80.4	250	101	33.63

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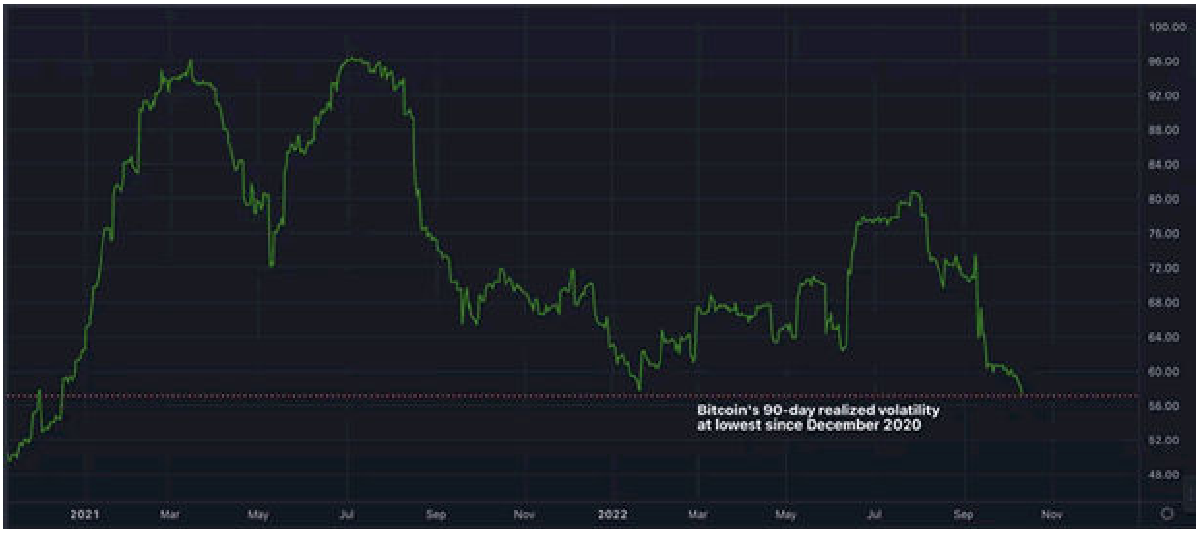
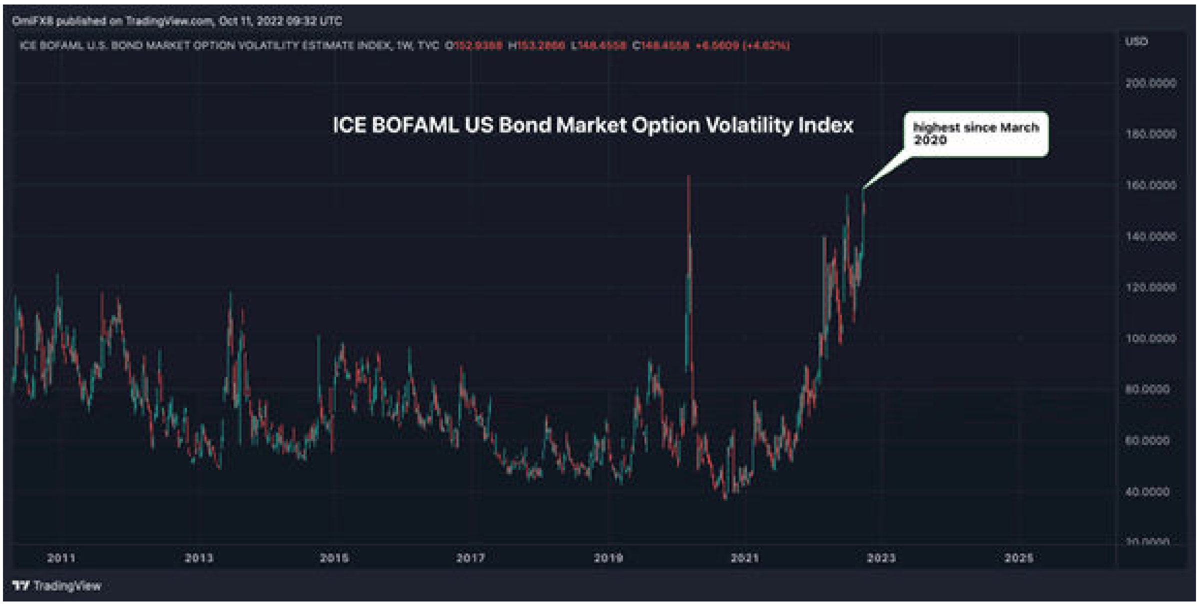
Volatility

Here's two charts I expect most readers didn't expect to see. They are both from a recent article on the Coindesk crypto website: the first one shows Bitcoin's 90 day realized volatility which is clearly trending downwards from very elevated levels over the last few years.

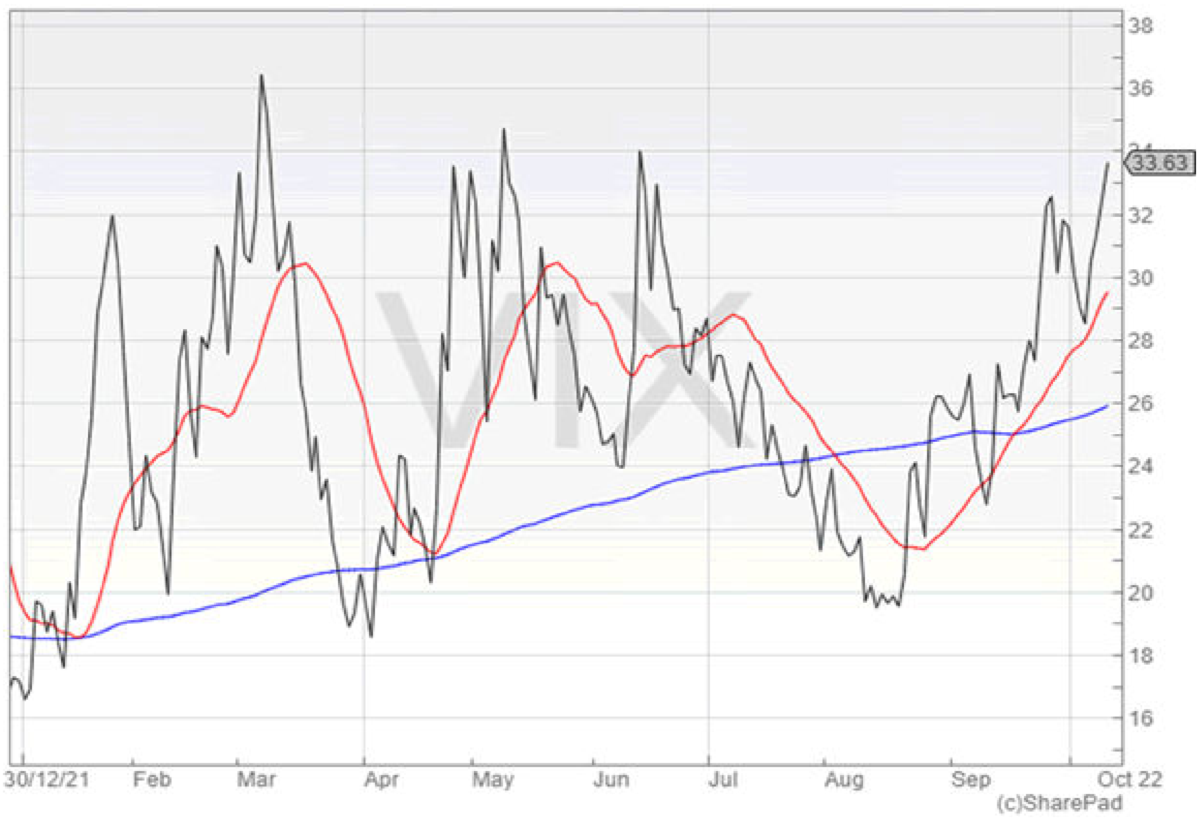


The second chart shows one of the key measures for US bond market volatility, the ICE BoAML bond market option volatility measure which is trending firmly upwards and is currently trading at levels last seen during the Covid pandemic. So, bond market volatility is currently trending upwards while Bitcoin is calming down ! Strange world.



As for Equity market volatility, as measured by the Vix index, this remains at fairly elevated levels, trading in a range between 20 and 35 since the beginning of the year.

VIX since the beginning of 2022



Black - VIX
Red - 20 day MA
Blue - 200 day MA

Measure	October Level	September Level	August Level	July Level
Vstoxx Volatility	31.82	24.4	n/a	29.63
VFTSE Volatility	33.63	22.79	21.7	26.17

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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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