



Monthly Market Report

November 2023



With commentary from David Stevenson

Whenever I talk to investors at the moment they're obsessed with the idea of regime change - not of political regimes via coups or revolutions but of financial markets. Put simply, nearly every investment imaginable is influenced by the likely future direction of inflation and interest rates. When that changes, expectations change, as do the products offered.

Within the structured products space for instance that's already visible - there's been a seismic shift from growth oriented structured products to structured deposits. The latter class of products is helped by higher interest rates which feed through into higher bank bond rates.

The \$64 trillion question everyone is now struggling to answer is what happens next - and I include central banks in that uncertainty as they seem as powerless to predict what might happen to inflation rates as the rest of us!

One way of summing up this regime shift is to map out what I think are three central scenarios pre-occupying investors.

Scenario 1: Equity markets are still signalling Lower Sooner

The presumption here is that interest rates will start to fall in 2024 at the latest and that we'll see rates pull back to a 'safeish' range of around 3 to 4%. The underlying assumption here is that central banks will get increasingly spooked by signs of a slowdown in the wider economy, put rates rises on hold, and then ease them off in the next 18 months. In this analysis, lower interest rates signal a shallow recession risk followed by a rebound as consumers start spending again. If that is the case, then lower interest rates should stimulate demand and facilitate business financing and expansion. That would be positive initially for bonds as the rates start to fall - locking in capital gains - and then much more positive for equities once investors see through that risk of a recession.

Scenario 2: Bond markets are signalling Higher for Longer

By contrast, if you look at bond markets you can see another signal. This is telling you that bond investors think that real rates need to stay higher for longer, perhaps because of fears about a second upsurge in inflation or just because there's too much government debt to finance (assuming the central banks don't pick up the debt that is). See the bonds section for a deeper discussion.

Scenario 3. The return of the stop-start

There is another scenario that is becoming more possible - and it follows from that criticism of the second scenario. Real rates may move higher but eventually, they run into the hard laws of economics and the real economy is impacted. A slowdown results. At this point faced with significant domestic pressure, governments open the taps on spending again, central banks also loosen and the economy picks up speed again.

I have no real idea which scenario is likely - though I'd still wager more money on scenario 1 against the second and third variant. But each scenario has very different outcomes in terms of investment decisions. Scenario 1 favours equities. Scenario 2 probably favours cash, near cash and liquid alternatives and then, at some stage bonds while Scenario 3 probably favours some - quality - equities and some alternative strategies. Get the scenario wrong and you could lose a great deal of money.

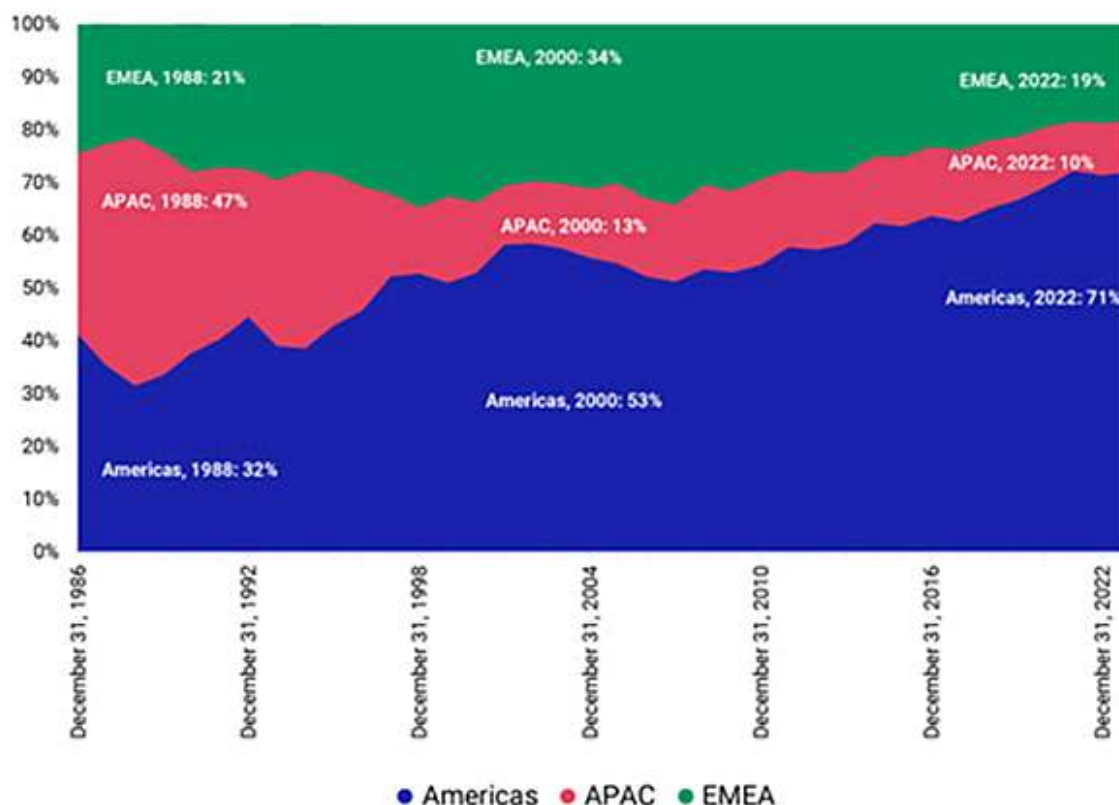
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Headline Numbers

The diversification problem

The single biggest challenge facing most investors globally, even in the UK, is that we are all collectively overweight US equities. The MSCI World Index is currently running at over 70% US and Canada exposure, which is towards the top end of the recent historic range. See the chart below from MSCI for a historical perspective. I entirely understand why this exposure is so high, as the US corporate giants have amazing operating margins and easy access to deep pools of capital. Maybe that advantage will persist but I do think that it is a risk - you are increasingly reliant on the US, which is a country with its own unique (political) challenges.



Whiter ESG? Not very well...

Over the past few years, we've seen an almost never-ending series of reports and surveys extolling the benefits of ESG investing - much to the horror of this ESG sceptic! This has helped the marketing of said products no end, but I've always thought that the data suggesting ESG outperformance was deeply flawed - it was flattered by the tendency of ESG screens to favour tech stocks. Now though research is trickling out which suggests that there is in fact no alpha outperformance record for ESG strategies. Put simply ESG isn't a strategy for investment outperformance. That at least is the message of a new study from Scientific Beta, entitled "[Sustainability Alpha in the Real World: Evidence from Exchange-Traded Funds](#)", which assesses the performance of sustainable investing from a value-weighted portfolio of exchange-traded funds (ETFs) that follow systematic Environmental, Social, and Governance (ESG) investing strategies in the US equity market. *"The study finds that sustainable investing did not deliver higher returns than standard index funds. Widely commented periods of outperformance, such as the year 2020, can be explained in large part by industry effects, such as a tilt towards technology stocks. Over the past decade, such periods of outperformance are offset by corresponding periods of underperformance, leaving ESG investors with returns of -0.2% compared with the market index and -0.7% compared with a benchmark with matching industry exposure."*

Measure	Values as of 14th September 2023	Values as of 16th October 2023
UK Government 10 year bond rate	4.31%	4.35%
GDP Growth rate YoY	0.40%	0.60%
CPI Core rate	6.80%	6.70%
RPI Inflation rate	9%	9.10%
Interest rate	5.25%	5.25%
Interbank rate 3 month	5.57%	5.41%

Government debt to GDP ratio	101%	101%
Manufacturing PMI	43	44.3

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Bank CDS options

The vast majority of banks saw their rates for credit default swaps increase last month with more than average increases for the large US banks and Deutsche Bank and to a lesser degree USB post the Credit Suisse deal. The one exception is RBC which saw its rates fall substantially.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	57.4	20.37	A+	A2	A -
Barclays	99.8	62.11	BBB	BAA1	A
BNP Parabis	45.9	23.48	A+	Aa3	A+
Citigroup	85.63	40.11	BBB+	A3	A
Credit Suisse	83.73	52.22	BBB-	BAA2	BBB
Deutsche Bank	162.54	91.79	A-	A1	BBB+
Goldman Sachs	93.55	47.96	BBB+	A2	A
HSBC	51.1	29.27	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	64.73	33.29	A-	A1	AA-
Lloyds Banking Group	56.05	30.62	BBB+	A3	A
Morgan Stanley	86.11	43.35	A-	A1	A+
Natixis	51.5	22.5	A	A1	A+
Nomura	99.99	25.16	BBB+	BAA1	A-
RBC	48.79	31	AA-	A1	AA-
Soc Gen	59.62	33.78	A	A1	A-
UBS	64.96	44.57	A-	Aa3	A+

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

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Government Bonds

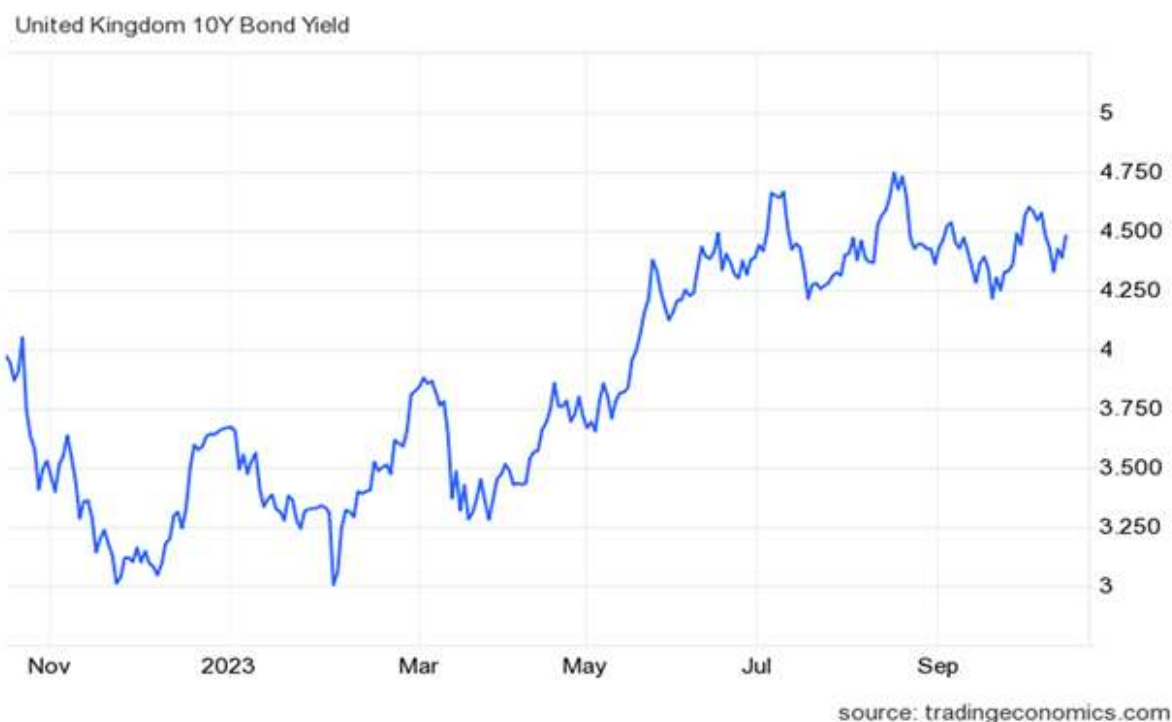
The big story of the last few days and weeks has been the sudden rise in yields on 10-year bonds, especially in the US. The US Treasury 10-year bond yield has sailed past 4.5%, a level that has traditionally acted as something a red flag. The consensus view seems to be that although US interest rates might be nearing their peak, other concerns are coming to the fore. On this Michael

Howell, at research house Cross Border Capital is particularly interesting. He reckons the surge in 10-year yields is mainly "...A duration crisis resulting from a lack of willing buyers of longer-dated debt. This crisis coincides with the downgrade of US debt by rating agency Fitch and projections by the US Congressional Budget Office (CBO) that the US public debt / GDP ratio will exceed a whopping 200% within the next quarter century... Worryingly, investors are losing their appetite for Treasuries at a time when their supply is slated to soar."

Howell at Cross Border also notes that the foreign demand for US Treasuries appears to be faltering. At US\$6.7 trillion, foreign holdings are down from their 2019 peak. A storm might be brewing and Howell at Cross Border reckons that it seems "fair to project a potential 100bp increase in term premia from the prospective growth in future net supply. Note that this increase is seemingly independent of future expected fed funds rates." That would mean the US 10-year yield is likely to test 5.5%, which equates to a 7% fall in World bond prices at the 10-year tenor.

One aside - the spread between Italian and German 10 year government bond yields have shot up over the last year. The spread hit a low of 160 basis points (1.6% in the summer of this year after having started at 183 basis points in January 23. Its now hit over 200 basis points and is rising. Its also worth noting that the cost of insuring against an Italian sovereign bond default via CDS swaps has increased sharply as well - its now at 111 basis points for a 5 year swap. Time to watch Italy again?

UK Government Bonds 10-year Rate 4.35%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	27.49
Germany	21.88

Japan	27.99
United Kingdom	33.20
Ireland	27.32
Italy	111
Portugal	50.82
Spain	54.33

Eurozone peripheral bond yields

Country	October 2023	September 2023	Spread over 10 year
Spain 10 year	3.92%	3.70%	112
Italy 10 year	4.81%	4.42%	201
Greece 10 year	4.31%	4.06%	151

	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 another underwhelming month for developed world equities. The FTSE All Share index was up a modest 1.58% as was the FTSE 100 - up 2%. By contrast the FTSE 250 was lower, falling 1.12% in September. Over in the US, the S&P 500 intensified August's decline, down 4.87% in September, as Q3 is down 3.65% and the YTD is up 11.68%. Those underwhelming numbers in the US hide a variable picture - worries of a slowdown are building momentum and consumer spending is beginning to slow down as debts rise but corporate margins are historically high (11.87% in Q2 with the 10-year average 10.32%), with earnings expected to post a slight tick up in Q3. It's also worth noting that according to S&P Dow Jones market analyst Howard Blitzer, October (up 58% of the time, average 0.54%) has a better track record than September (worst month of the year, up only 42% of the time, average -1.12%).

Two other useful US focused stats worth bearing in mind - dividends in the US are looking stable. From December 1936 through September 2023, the average quarterly yield for the S&P 500 was 3.497% vs. 3.502% at June 2023. By contrast companies broadly reduced their share buybacks in Q2 2023, as concerns over banking and a slowing economy dominated. One last stat focused on US equities to bear in mind - from January 1926 through September 2023, the annualized total return for the S&P 500 was 10.27% per year vs. 10.34% at June 2023.

S&P Dow Jones Indices		
S&P 500 HISTORICAL AVERAGE PRICE-TO-EARNINGS RATIO		
September 29, 2023: historical data for Q2 2023 and prior, forward based on Street estimates		
	OPERATING	AS
		REPORTED
2024 Estimate, current price	17.45	19.11
2023 Estimate, current price	19.49	21.40
12 Mo Jun, '23, current price	20.61	23.69
12 Mo Jun, '23 (Jun, '23 price)	21.39	24.59
Average 5-Years	21.63	24.93
Average 10-Years	20.59	23.43
Average from 1988	19.24	24.26
Average from 1936		17.62

Index	September 2023	October 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 23 contract	143.1	141.1	4156	141.1
FTSE 100 Dividend Dec 2023	298	299.4	7617	293.4

Note changed to Dec 2023 contracts

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-1.32	2.36	-3.33	10.9	7.8	1.1	7609.71
S&P 500	-2.21	-3.4	5.18	21.5	54.9	70.2	4352.03
Gold Composite (Most Traded)	-0.241	-1.17	-3.69	17.7	58.1	49.7	194150¢
iShares FTSE UK All Stocks Gilt	-1.07	-0.427	-6.31	1.43	-22.8	-24	991.25p
VIX New Methodology	21	21.3	-2.23	-47.9	-5.28	68.4	16.69

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Volatility

Volatility eased slightly in the US, after perking up a little in August. Having traded up to 17 in the prior month, VIX retreated 2 points to 15 but is now back up above 16, but that's still well below the long-term average for the Vix which is around 20. By contrast the European volatility measure the Vstoxx has ticked markedly higher and is currently at 20, around its long term average.

One key observation though is worth noting - according to analysts at Deutsche Bank correlations between several asset classes such as rates, the dollar, oil and equities have risen sharply. In fact, they reckon that the average pairwise cross asset correlation is back near record highs - in particular they observe that the correlation between oil prices and the dollar has spiked from its usual negative territory to turn extremely positive, to levels often seen around severe supply disruptions such as the onset of the Russia-Ukraine war. This in turn has raised the correlations between rates and oil and the dollar.

For a wider historical perspective on correlations, look at the graphic below from US asset manager Guggenheim which is a little out of date - it's from December 2022 - but does provide some historical context for the previous 11 years.



Black Line - Vix since December 2020
 Red line - 20 day moving average
 Blue line - 200 day moving average

Measure	October Level	September Level	August Level	July Level
Vstox Volatility	20	15.47	18.98	14.95
VFTSE Volatility	16.69	14.23	16.46	13.54

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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,



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