UK Structured Products Association

Monthly Market Report

October 2020

With commentary from David Stevenson

It had to happen. At the very beginning of this month (September) the US equity markets finally wobbled after a long summer of positive price momentum. The chart below shows the S&P 500 for the last couple of years with the red line the 20 day moving average, the blue line the 200 day moving average. The wobble downwards has already threatened to break through the 20 day MA point but we'd probably need another 10 to 15% decline - pushing below 3100 for the S&P 500 - before we enter a proper bear market, implying a dynamic where the S&P 500 is pushing below both the 20 and 200 day moving average.

That said, I'm not entirely convinced we'll get that scale of bear market sell off but stranger things have been known to happen.

But this wobble does raise an interesting question. Should we be worried about deploying cash into the market at what were peak market valuations? The conventional wisdom of course is that market timing is a terrible idea but still if we are honest no one can quite resist the idea of avoiding peaks i.e markets that even your grandparents think are a bit over optimistic. Or put it another way, we may not think we can make much money from timing but we do think we can avoid big losses by avoiding peak mania. But is that really true? I'm not so sure.

One boring afternoon in August - no vacations to the continent for the Stevensons! - I looked at data for the S&P 500 and the FTSE 100 since 1987 and in addition prices for the FTSE All World index since 2003. In each case I threw up a chart and then picked a peak level (the tip of a chart within that year) and then looked at returns ten years after that interim peak. In the case of the FTSE All World I shortened that to five years after the interim peak. For the S&P 500 I counted 16 peaks - where the index had hit an interim high before falling back sharply - while in the FTSE 100 I counted 12. For the FTSE ALL World I counted 17. In each of these cases, you'd have been timing your equity investment disastrously - picking the exact wrong moment to invest. But in my scenario, you were patient and sat tight for five to ten years.

The result? With the S&P 500 in 13 out of 16 examples, you'd still have made a net gain, in most cases a very substantial gain. In the example of the FTSE All World, you'd have been ahead in 14 out of 17 cases, down in just two, and basically unchanged in one example. But there's the rub. In the example of the FTSE 100 you'd have made a loss in 8 out of 12 cases and a gain in just 4. This dismal data reminds us why the London index is such an outlier in terms of returns and value. Its cheap and has been for many years.

I'm in the process of running a similar analysis for a few other benchmark indices and so far, the data tells a similar story. If you'd have been patient, you'd be making a profit even after having picked a terrible few weeks when markets peaked. But you needed to be diversified i.e. not just investing in UK stocks.

As I have said until I am blue in the face in these articles, global diversification is hugely important. Don't just slink back into your UK focused perspective and think the world revolves around Blighty - it doesn't. Diversify, be patient, cut fund costs and in most circumstances an equity investment makes sense - whereas cash is a guaranteed to lose its value after inflation.

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Headline Numbers

I'm not sure about you but most senior (in rank and age) I talk to seem to be still working from home, either full time or part time. By contrast nearly every sub 35 year old I talk to is absolutely desperate to get back into to an office. That demographic has been royally screwed by the Covid emergency.

Back in the world of investment, the continuing WFH push by more experienced professionals must - I believe - have some real world consequences for listed property businesses. Most investors seem to have shrugged off these concerns, but I wouldn't be so confident. It seems to me that we won't be past the worst until spring next year.

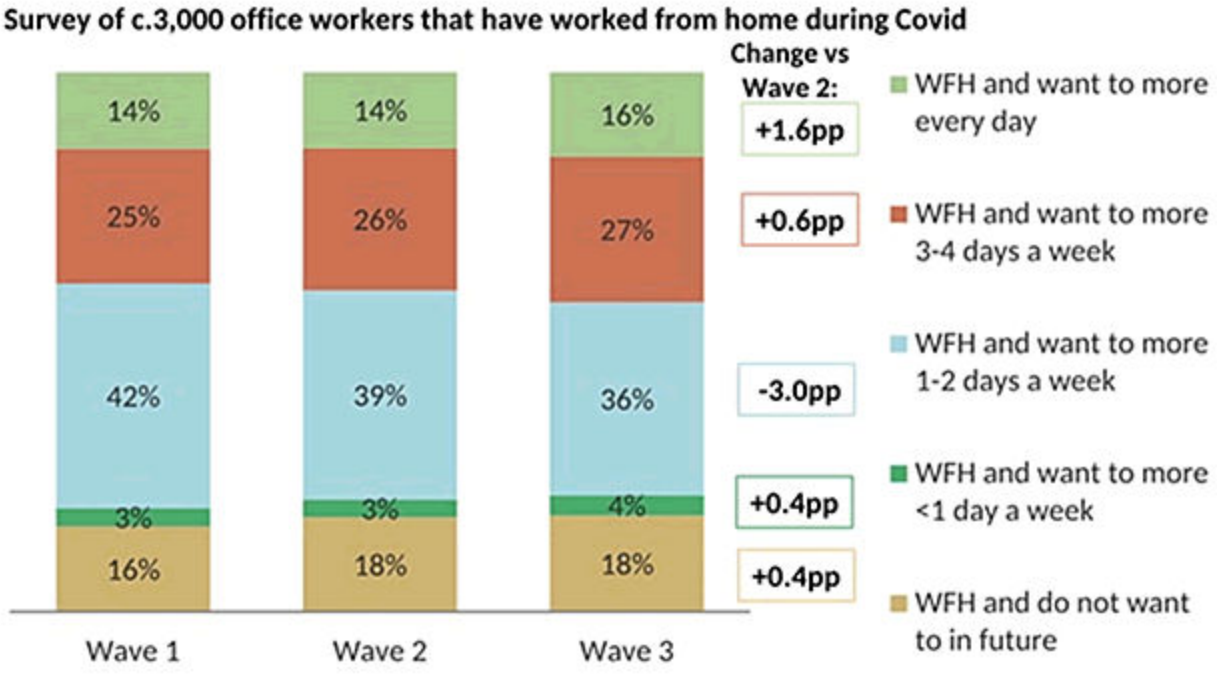
In the meantime, it's worth picking up on yet another excellent special report from Morgan Stanley analysts, this time on the WFH trends - this is I think the third iteration of their market data sets.

Their most recent report observes of office workers working from home during Covid, that 82% would like to do so more in the future (unchanged). However, the mix of demand has shifted slightly to more days at home: 36% would do this 1 to 2 days a week (last survey: 39%, first survey: 42%), 43% would do so 3-5 days a week (last survey: 40%, first survey: 39%).

"Employer policy (vs. employee demand) also more generous? 64% of office workers (last survey: 60%) believe their employers will allow 1-2 days working from home (44%, last survey: 42%) or more (20%, was 18%). Geographic differences remain minimal.

Willingness to share desks. Responses here remain inconclusive: 40% are comfortable with 'hotdesking' once Covid-related concerns have died down (last survey: 39%); 37% are uncomfortable (unchanged), with the remainder indifferent. UK workers remain most resistant. We see desk-sharing as an important component in any reduction in space demand (Exhibit 43).

New data on levels of returning to work - all countries increasing; UK still lagging. 74% of employees, and 70% of office workers (last survey: 72% and 68% respectively) have now returned to working at their normal location UK figures still lag; only 37% have returned, 3pp more than last survey."

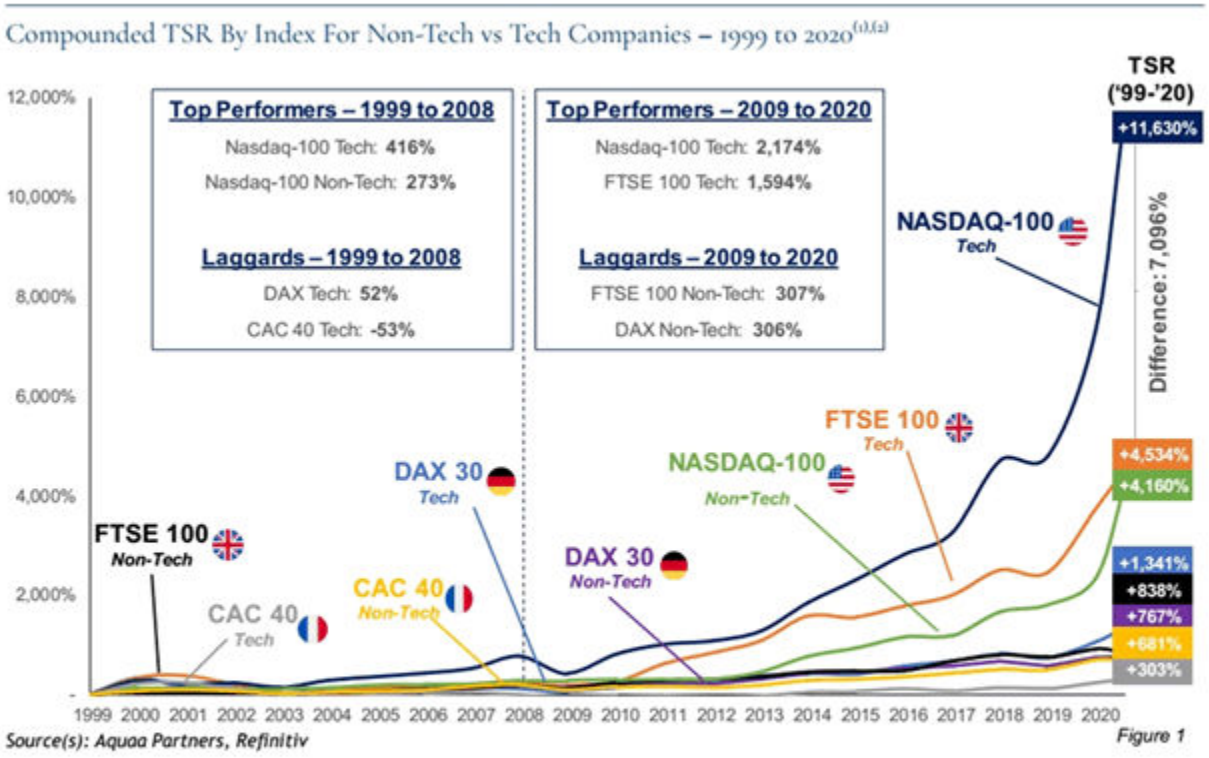


Gold

I know you've heard all those narratives about just how well growth stocks have done in the last few months but the story really is worth repeating at length, courtesy of Paul Cuatrecasas. His new venture called Aquaa Partners Investment Research has just put out a fascinating research paper entitled The Death of value investing and the dawn of a new tech driven investment paradigm. I'll pull out a few choice charts, both of which are truly extra ordinary. Figure 1 below illustrates total shareholder returns since 1999 for key tech and non-tech indices.

"In the 22 years since 1999, the Nasdaq 100 Tech index has delivered a TSR to investors of 11,630 per cent. This compares to the Nasdaq 100 non-tech index TSR of only 4,543 per cent (despite this non-tech index including Amazon and Alphabet). the TSR since 1999 of the Nasdaq 100 Tech Index was almost 13 times greater than the TSR of the FTSE 100 Non-Tech index (838 per cent). Figure 1 also illustrates how these differences have become even more pronounced since 2009 as tech began to pick up exponential speed. the TSR of the Nasdaq 100 Tech Index from 2009 to 31 July, 2020 was six times greater than that of both the FTSE 100 NonTech index and the DAX Non-Tech index."

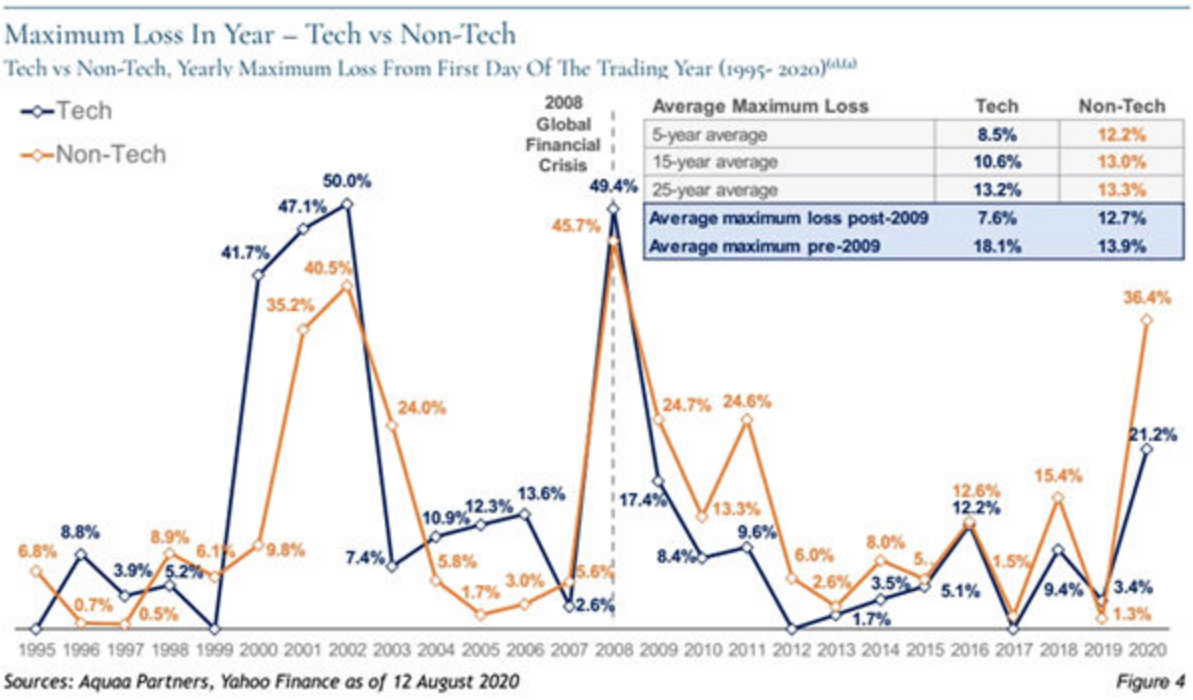
In other words, over a 22-year period technology stocks have delivered an approximate return 15 times greater than non-technology stocks, in spite of the dot-com collapse from 2000 to 2003. Even in the last five and half years, since January 2015, the Nasdaq 100 has delivered a TSR close to 3.5 times greater than that of the average of the non-tech indices.



1 - Source: Refinitiv

Ah, but surely all these amazing returns have come with much greater risk? Not so, says Aquaa. They point to the chart below. Their chosen measure of risk is based on calculating the maximum point of loss in each year since 1995 from the first day in the year of trading. Yearly averages are calculated, and the figures amalgamated. The exercise is then applied to both tech and non-tech stocks. Again, the Nasdaq 100 index is used as the source of tech sector data, while the non-tech sector is measured by the average of non-tech data for the FTSE 100, CAC 40 and DAX 30 indices.

According to the Aquaa report "in the 12 years from 2009 to 2020 (seven months to 31 July, 2020), the average of the maximum point of loss for the tech sector was only 7.6 per cent, compared to 12.7 per cent for the non-tech sector".



Sources: Aquaa Partners, Yahoo Finance as of 12 August 2020 *Figure 4*

Note(s): (1) Price index only, excluding the effects of currency, tax and dividends; (2) Tech considers the maximum loss for the Nasdaq-100 Index and Non-Tech considers the average maximum loss of the FTSE 100, DAX and CAC 40 indices for each period

So, what's the driver of this extra ordinary transformation - which the report reckons could continue for many years hence? " It's the effect of Moore's Law materialising in all industries as the world becoming more technology dependent. This force is only to going to grow, despite the inevitable market cycles."

Measure	Values as of 13th August, 2020	Values as of 11th September, 2020
UK Government 10 year bond rate	0.25%	0.25%
GDP Growth rate YoY	-21.70%	-21.70%
CPI Core rate	0.60%	1%
RPI Inflation rate	1.10%	1.60%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.07%	0.07%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	53.3	55.2

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Bank CDS options

Pricing for credit default swaps for 14 of the 18 banks offering prices continued their steady decline of recent months. The biggest fall in pricing was for two Swiss banks in particular - UBS and

Credit Suisse. No banks saw their swap pricing increase over the last four weeks.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.73	32.3	A	A2	A -
Barclays	21.23	58.86	BBB	Baa3	A
BNP Parabis	11.19	31.56	A+	Aa3	A+
Citigroup	36.37	57.67	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	8.26	43.44	BBB+	Baa2	A-
Deutsche Bank	80	142	BBB+	A3	BBB
Goldman Sachs	37.6	59.69	BBB+	A3	A
HSBC	10.62	38.47	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	27.57	47.35	A-	A2	AA-
Lloyds Banking Group	11.77	33.99	BBB+	A3	A+
Morgan Stanley	32.1	53.76	BBB+	A3	A
Natixis	34	46.43	A+	A1	A+
Nomura	40.85	95.11	BBB+	Baa1	A-
RBC	19.79	58.5	AA-	Aa3	AA-
Soc Gen	11.05	33.67	A	A1	A
UBS	8.13	28.94	A-	Aa3	A+

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

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Government Bonds

Rise of the fallen angels

It is really quite straight forward to construct a narrative which suggests that there's very little extra profit to be made out of investing in bonds, especially in a new world order of negative rates. But I am not so sure that's true - there really is still opportunity left, it's just that you need to work a bit harder! Talk to more than a few bond investors and they will start to wax lyrically about the strange nether world of the fallen angel. In simple terms, we are about to see a fountain of celestial opportunities opening up for the canny bond investor.

So, what is a fallen angel? The classic example is a globally recognisable corporate name issuing

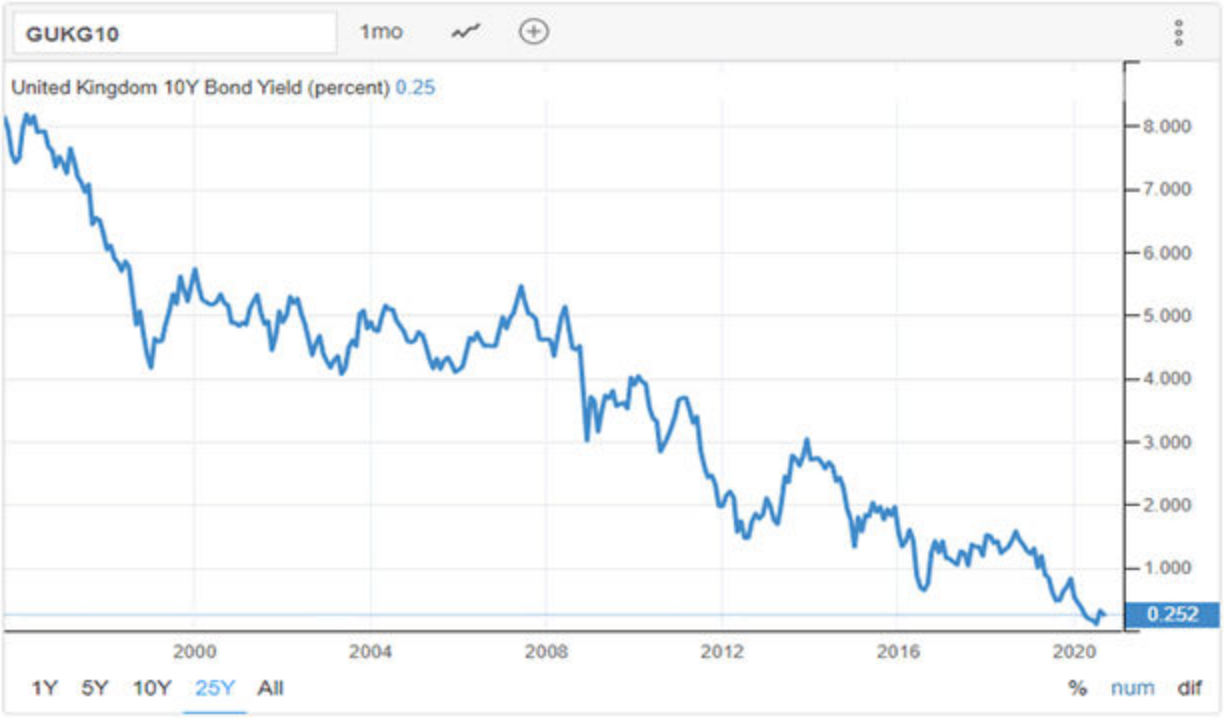
bonds which might once have boasted a very high grade rating, say Aa3 (using Moodys) or AA- (for S&P and Fitch) but then as its profit margins started to deteriorate and it starts piling on debt it might find itself downgraded subtly to say single A status and then into a much larger, riskier BBB (or Baa using the Fitch system) category. These latter ratings are still technically investment grade, but the market has suddenly turned much more cautious. In Europe for instance the BBB category - right at the bottom of the IG rating - now accounts for just under half all corporate bonds and is many times bigger than the high yield, (BB or lower) non-investment grade market. In the US, it's a similar story - the BBB rating is the largest segment of the corporate bond market.

Once a bond issuer has a BBB rating, the next downgrade in the credit rating is to BB or even single B (or Ba and B using the Moody's system) i.e. into non investment grade, higher risk. That move takes it out of the most liquid bit of the bond market into a higher risk, less liquid segment regarded as much 'riskier' - high yield or junk as it's called. Crucially many large institutions such as pension funds have strict investment criteria which specify just how many riskier, sub investment grade bonds they can hold - in some cases, none at all. It's also worth noting that a downgrade to high-yield status results in those bonds being kicked off an index that only invests in investment grade bonds - that in turn requires index funds and ETFs to divest them. Thus, a downgrade from IG to high yield - from say BBB- to say BB+ - could trigger a huge wave of almost automatic, forced selling.

And these downgrades happen with alarming regularity. Ratings agency S&P, for instance, has taken negative rating actions on 383 IG rated issuers affected by COVID-19 and oil to April 17th 2020, 'junking' 23 issuers so far this year.

Most investors focus on that incremental but monumental slide from BBB- to BB+. At one time there's probably at least one hundred billion euros of bonds (currently £107 bn) in the BBB- category on what's called a negative ratings outlook i.e. is vulnerable to a downgrade from BBB- into BB and thus out of investment grade. Many of these downgrades tend to coincide with times of economic stress. The fallen angel rate of BBB issuers hit 12.88% in 1986 and a similar rate would see €156bn of euro fallen angels and $457bn in the US market. Global Investment bank Goldman Sachs forecasts €180bn of fallen angels in the euro market over the next two quarters while US fund manager Vanguard reckons that as much as $400 billion worth of BBB bonds could be at risk of downgrade to high-yield in the United States as a result of the pandemic, depending on the path of economic recovery.

UK Government Bonds 10-year Rate 0.25%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	17.3
Germany	11.35
Japan	17.1
United Kingdom	18.1
Ireland	22.15
Italy	131
Portugal	49.05
Spain	53.69

Eurozone peripheral bond yields

Country	August 2020	September 2020	Spread over 10 year
Spain 10 year	0.37%	0.35%	81
Italy 10 year	1.01%	1.05%	151
Greece 10 year	1.11%	1.15%	161

	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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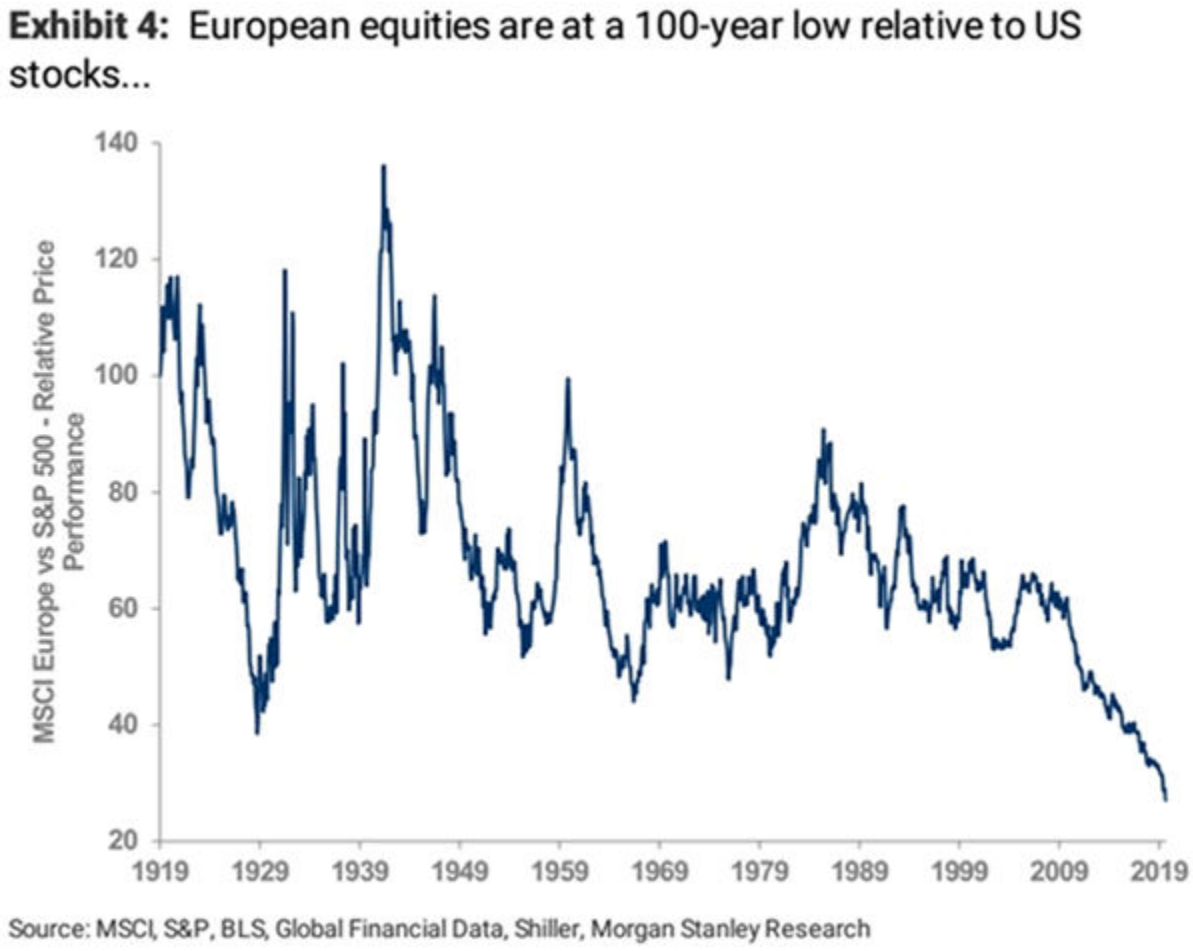
Equity Markets and Dividend Futures

Time for Europe?

As I've said on more than a few occasions in these articles, my sense is that continental Europe is an increasingly promising alternative for equity investors. So far, Europe has weathered Covid better than the Americans - though that could change. And European valuations are also relatively low, by comparison with the yanks. The chart below from European equities team at Morgan Stanley tells this story elegantly - European equities are at a 100 year low relative to US stocks (god alone knows how much worse UK stocks are).



But there's one more tailwind worth exploring - the European markets are changing, with new

sectors becoming more important to local markets. That's the focus of an excellent special report by the Morgan Stanley European Equities team called "The changing face of European Equities". Here's the ten facts form the report that may surprise all readers, using data on the MSCI Europe index and GICS classifications.

*At 16% of the index, **Healthcare** is now the largest sector in Europe, after the biggest increase in weighting of any sector in the past decade. Pharmaceuticals is also Europe's biggest overweight sector relative to ACWI.*

*Europe is no longer overweight **Banks** - its 6% weighting is exactly the same as for ACWI. Europe's exposure to Banks has more than halved from 14% in 2010, and the sector is now only modestly bigger than Insurance (5%) and Diversified Financials (4%).*

***Energy** has seen the second biggest decline in market weighting in the last decade (after Banks/Financials); it now represents just 4.3%, smaller than **Utilities** at 5.3%.*

***Consumer Staples** is the second largest sector in the market after Healthcare at 15%. At 4.4% **Household & Personal Products** is a larger driver of MSCI Europe than Energy, Telecoms or Software.*

*The largest sector in MSCI **Germany** is not Autos or Capital Goods but Technology (14%), then Healthcare (12%). Across MSCI Europe, Semis ranks above Autos (2.4% vs 2.2%).*

*MSCI **Denmark** is bigger than MSCI Italy or MSCI Spain. Denmark has been the best performing country in Europe over the last decade.*

*The largest stock in **Retailing** is Prosus, then Inditex, Delivery Hero and Just Eat Takeaway. ASML is the 5th largest stock in Europe. Both Prosus and ASML are listed in the Netherlands - MSCI Netherlands has the highest correlation of any country or sector (including Technology!) to the Nasdaq.*

*The **periphery** now accounts for just 9% of MSCI Europe, down from c.14% a decade ago. The largest sector in both Italy and Spain is Utilities (not Financials).*

***Technology** is the largest sector at 14% (using STOXX classification), followed by Personal & Household Goods and Healthcare. At <7%, index exposure to Banks is lower than it is to Chemicals.*

Index	August 2020	September 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	83.5	83	3315	112
FTSE 100 (Dec 19)	208.5	207.3	5943	333

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-16.1	-8.47	-8.16	-18.5	-2.29	-13.4	5935.26
S&P 500	-1.57	0.282	-1.73	2.24	17.5	24.8	1468.13

iShares FTSE UK All Stocks Gilt	2.26	7.3	15.3	15	78.4	70.7	3426.96
VIX New Methodology	38.5	25.4	-26.7	105	10.6	15.4	30.75

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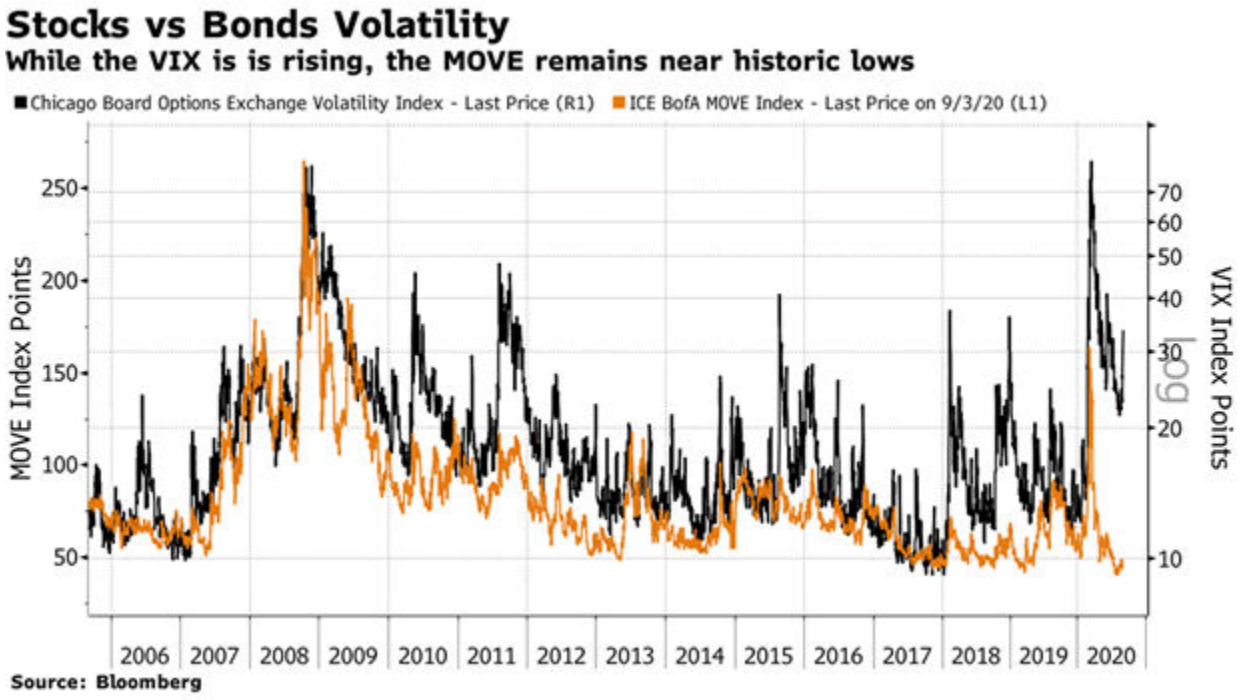
Volatility

A quick update this month on market volatility featuring a fascinating chart from John Authers at Bloomberg Opinion. It shows two key measures for financial volatility - the line in white is for the Vix, measuring equity volatility, while the line in blue is for the MOVE index which measures bond market price volatility. As the chart below shows, these two measures usually tend to move in tandem - generally stocks and bonds are regarded as substitutes for each other, and so measures of their volatility tend to rise and fall together. But as the chart below clearly shows "the Fed has put bond volatility to sleep". Sounds like job done at the moment for central bankers.



Measure	September Level	August Level	July Level	June Level
Vstoxx Volatility	27.87	22.69	27.28	30.54
VFTSE Volatility	30.76	21.69	27.29	27.57

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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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