



Monthly Market Report

October 2022



With commentary from David Stevenson

Watch those earnings

So, the bears are back in business. As I write this before the US markets open, the S&P 500 - the index you need to watch - is down around 4% over the last month. Looking at the old 20 and 200 day moving averages we are sliding back into bear market territory (both below the Moving averages).

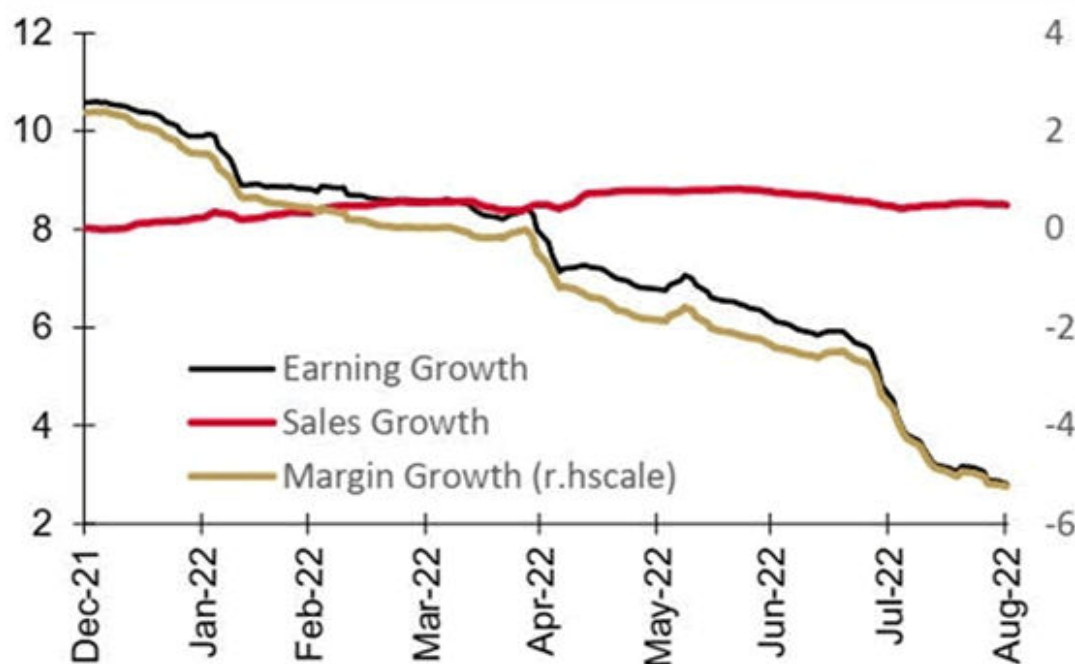
At the global level, Howard Silverblatt at S&P Dow Jones reports that August was a dismal month "as reality sank in that interest rates would continue to go until central banks were satisfied that inflation was under control. The S&P Global BMI declined 3.63%, and were down 3.19% absent the U.S.'s 3.94% decline, after last month's 6.89% gain."

It wasn't doom and gloom last month though for everyone - emerging markets posted their first gain after seven consecutive month of declines, as they increased 1.02% in August, after July's -1.05%, June's -5.80%, May's -0.31%, April's -5.63%, March's -2.55%, February's -3.49% and January's -0.98% (December 2021 was up 1.41%), and they posted a 17.51% loss YTD. Turkish shares were up 19% in August with Pakistan not far behind at a 14% gain. In developed markets only Israel notched up a gain - of 4.98% with Australia in at number 2 on a -.078% loss.

As for the key developed world markets, I repeat my own observations - I think the next point for the US benchmark index is 3600 with a possible trough around 3400. I also repeat my other core observation - investors are now waking up to declining earnings. I get all the talk about investors already factoring in a recession (or sharp slowdown in the US) but I can't for the life of me see 10 to 15% earnings declines marked in for US corporate earnings.

Analysts at SocGen echo this and report that *"the focus is ...increasingly on the profit outlook, which is deteriorating and hidden to some extent by the very strong Oil & Gas profits. Sales growth remains robust at around 8%, even ex Oil, but earnings growth is slowing down and heading towards zero. This implies pressure on the margin, which the consensus now forecasts to decline by 5% in 2022. Alongside this margin squeeze in proforma profit expectations, there is a worryingly large gap between proforma reported profits and GAAP profits, which again is symptomatic of profits coming under increasing pressure."* The first chart below nicely sums up the trend - a dismal one if we exclude energy stocks.

S&P 500 ex Oil & Financial 2022 profit margins are declining



Source: SG Cross Asset Research/Equity Quant, FactSet

Not to be outdone analysts at Morgan Stanley are echoing the same message.

"With the Fed emphatically dashing hopes for a dovish pivot, we think that asset markets may be entering fire and ice part deux. In contrast with part one, this time the decline in stocks will come mostly via a higher ERP and lower earnings rather than higher rates. Our leading earnings models are all flashing red for the S&P 500, and we have high confidence that the decline in NTM S&P 500 EPS forecasts is far from over (see Exhibits). In short, part deux will be more icy than fiery, the opposite of 1H22."

Contents

- Headline numbers
- CDS Rates
- Government Bonds
- Equity Markets and Dividend Futures
- Volatility
- Summary of Pricing Impact on Structured Products
- Explanation of Terms

Headline Numbers

In case all this bearish sentiment is getting you down, I recommend re-assuring yourself with the chart below which was circulated earlier this month by UK wealth advisers Killik and Co. It makes the important point that although timing the markets is tough, what really matters long term is

time in the market - even during dismal bearish periods.

Returns of Global Equities

£10,000 invested in global equities from 31/12/1981 to 31/12/2021



It seems to me that the only really important story in developed world markets now is the likely trajectory of corporate earnings. Investors are already alive to the inflation risk and they're actively working out how to protect themselves against rising interest rates. The obvious big unknown is whether the US is about to enter into a recession or just a slowdown (even a soft landing). This last question matters hugely.

If the US is about to stumble into recession, then corporate earnings are likely to take a pounding, thus forcing the benchmark US indices even lower. So, the \$64 trillion question is whether the US is about hit a nasty recession. One fairly detail take on the likelihood of a recession in the US comes via the excellent Liberum strategist [Joachim Klement and his newsletter - Klement on Investing](#). He cites research from economist Edward Leamer at UCLA who has looked at the development of several key macroeconomic indicators in the three years before the onset of a recession and compared it with the development of these indicators in 2021 and 2022, focusing on the progress or otherwise) of US interest rates, inflation, the unemployment rate, and the housing market. He has then estimated the probability that the US will enter recession in the next 12, 24 and 36 months. The table below shows a summary of his findings.

	Recession start date		
	July 22 - July 23	July 23 - July 24	July 24 - July 25
Steepness of yield curve	1%	66%	33%
Inflation	89%	11%	0%
Unemployment	60%	29%	11%
Housing starts	38%	26%	35%

Source: Leamer (2022)

According to Klements: "In general, the probability that a recession in the US will start in the next 12 months is very high. Inflation data would suggest that it is all but inevitable. Advocates of a soft landing claim that the job market is so strong that a recession is by no means certain and may likely never come. My response to that is and always has been that we learn in Economics 101 that the labour market is a lagging indicator. If you wait for the labour market to show you a recession, you will be 3 to 6 months late. Indeed, Leamer's analysis suggests that current strong labour market data is perfectly in line with the onset of a recession in the next 12 months. Better not believe the Fed and other economists when they point to employment data as a sign of an economy far away from recession."

Measure	Values as of 11th August, 2022	Values as of 13th September, 2022
UK Government 10 year bond rate	1.99%	3.06%
GDP Growth rate YoY	8.70%	2.90%
CPI Core rate	5.80%	6.20%
RPI Inflation rate	11.80%	12.30%
Interest rate	1.75%	1.75%
Interbank rate 3 month	2.10%	2.67%
Government debt to GDP ratio	95.90%	95.90%
Manufacturing PMI	52.1	47.3

[Back to menu](#)

Bank CDS options

Last month pricing for credit default swaps for the major banks generally increased, although at a much slower rate than in previous months. Given the increase in interest rates and the likelihood of a recession in most developed world economies, an increase in pricing of risk isn't entirely surprising.

The biggest increases were seen by the likes of Deutsche Bank, although pricing for their swaps is always fairly volatile. A few banks experienced small, almost marginal decreases in pricing - Citi, Lloyds and SocGen - while Morgan Stanley saw pricing fall more substantially. In the market for one year swaps French bank Natixis remains firmly out in front with pricing at 19.5 basis points for insuring their debt over the next year, with a second tier of banks (RBC, Nomura, BNP Paribas, HSBC and SocGen) not far behind with pricing in basis points in the mid twenties to mid thirties.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	34.7	75.72	A+	A2	A -
Barclays	66.74	103.56	BBB	Baa2	A
BNP Parabis	33.32	60.05	A+	Aa3	A+
Citigroup	51.59	100.99	BBB+	A3	A
Credit Suisse	130.38	203.24	BBB+	Baa1	A-
Deutsche Bank	115.55	185	A-	A2	BBB+
Goldman Sachs	55.81	113.89	BBB+	A2	A
HSBC	32.37	62.18	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	48.99	89.05	A-	A2	AA-
Lloyds Banking Group	30.33	56.11	BBB+	A2	A
Morgan Stanley	50.53	100	BBB+	A1	A
Natixis	19.5	45	A	A1	A+

Nomura	29.64	100	BBB+	Baa1	A-
RBC	23.5	70.04	AA-	A1	AA-
Soc Gen	32.03	70.84	A	A1	A-
UBS	31.79	69.72	A-	Aa3	A+

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

[Back to menu](#)

Government Bonds

A trinity of charts this month looking at some key bond yield benchmarks. The first looks at the all important US Treasury 10 year bond yield. We've seen a decisive break past the 3% level with the 3.5% level the next big barrier. I can't see how this upward curve can be stopped in all honesty until it moves past 4%.



And even if the US 10 year yield did break past 4%, that wouldn't be a big deal historically, as evidenced by this next chart below which shows the 10 year yield since the early 1960s. Frankly if the past is anything to go by then the next stop could be 5%!

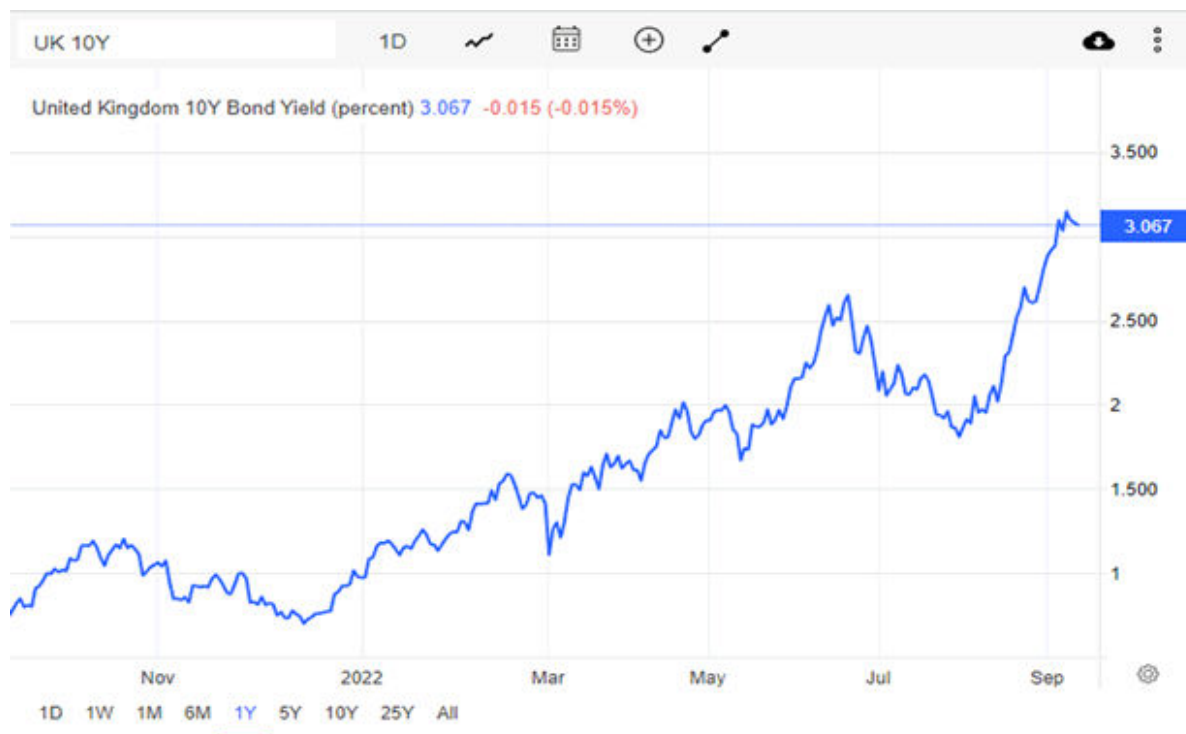


Arguably the third chart is the more consequential - it shows the yield on 2 year Treasury securities. The steepness of this curve is really quite extra-ordinary (though easily predicted). Talk to most analysts and they think 4% is the new target to beat for US 2 year yields. And be under no

illusions - what happens first in the US will happen next in the UK. The cable rate - \$/£ - is already under stress because the Bank of England is perceived as having gone soft on inflation. The BoE has to show credibility now and that means at the very least keeping up with the US, if only to avoid further sterling depreciation, or maybe even going more aggressive than the Americans (unlikely in my view). At some point not very far away in time, government bonds and cash will start to look very attractive, possibly encouraging more investors to switch out of equities into risk free assets. If so, that might set us up for another equity sell off - or , alternatively, prompt another bout of QE as central banks pedal harder to avoid a risk assets sell off.



UK Government Bonds 10-year Rate 3.06%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	24.2
Germany	16.2

Japan	20
United Kingdom	28.5
Ireland	18.4
Italy	145.7
Portugal	51.8
Spain	52.1

Eurozone peripheral bond yields

Country	August 2022	September 2022	Spread over 10 year
Spain 10 year	1.99%	2.77%	112
Italy 10 year	2.98%	3.89%	224
Greece 10 year	3.19%	4.16%	251

	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

[Back to menu](#)

Equity Markets and Dividend Futures

Talk to enough quantitative finance types and they'll say to you that over the long term - by that we mean longer than 20 years - the fundamentals of a stock price really matter. Or, to put it simply, you can't ignore that a stock is a claim on a stream of cash earnings that can either be used to pay a dividend or reinvested for yet more growth. James O'Shaughnessy of O'Shaughnessy Asset Management has been working on huge data sets for stock market returns for many years now - his book [What works On Wall Street](#) is a classic IMHO. His firm has just produced an excellent report which should remind us that over the long term, those corporate cashflows are what really matter.



Source: Robert Shiller

The first chart is I think self-explanatory and shows the impact of each component on the S&P 500 Composite's returns since 1871 (i.e., Earnings Growth drove 45% of the S&P 500 Composite's total return since 1871). The bottom line - multiple expansion doesn't really matter.

"Interestingly, from 1871 - 2021, Multiple Expansion was responsible for just 6% of the S&P 500 Composite's return. Again, Multiple Expansion simply reflects the willingness of investors to pay more for each \$1 in earnings that a company generates (in other words, buy stocks at a higher P/E multiple). Why would an investor decide to pay more money for the same amount of earnings? The answer lies in the investor's expectation that future earnings growth will justify the current (high) valuation. Unfortunately, humans have a very poor track record in predicting the future. Consequently, projections of future earnings tend to be overly optimistic. However, this also explains why companies with less robust fundamentals (i.e., earnings growth) emphasize intangible things like narrative and future disruption / innovation. Done well, these intangible items can entice enthusiastic investors into paying a higher earnings multiple for their stock."

The second chart below outlines how markets have changed - and demonstrates why multiple expansion has become a more powerful driver of returns i.e investors have chosen to value a stock more highly because of its growth potential. Over the last few decades, multiple expansion as an explanation of returns has moved from 6% to over 24%.



Now there are two ways of looking at this analysis. The first is that markets will return to a fundamentals-based approach or 'mean revert' in the jargon.

The other explanation is that 'this time it really is different' i.e that a fundamental shift has occurred and that the markets have changed. That macro driver could be say the era of low-interest rates which allows investors to more highly prize those growing corporate cashflows (growing because the returns to capital have increased partly at the expense of labor). I don't know the answer, but I have a sneaking suspicion that maybe markets really have fundamentally changed in our new normal.

Index	August 2022	September 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract	121.6	123.3	3665	117
FTSE 100 Dividend Dec 2022	271.4	271.9	7501	260.3

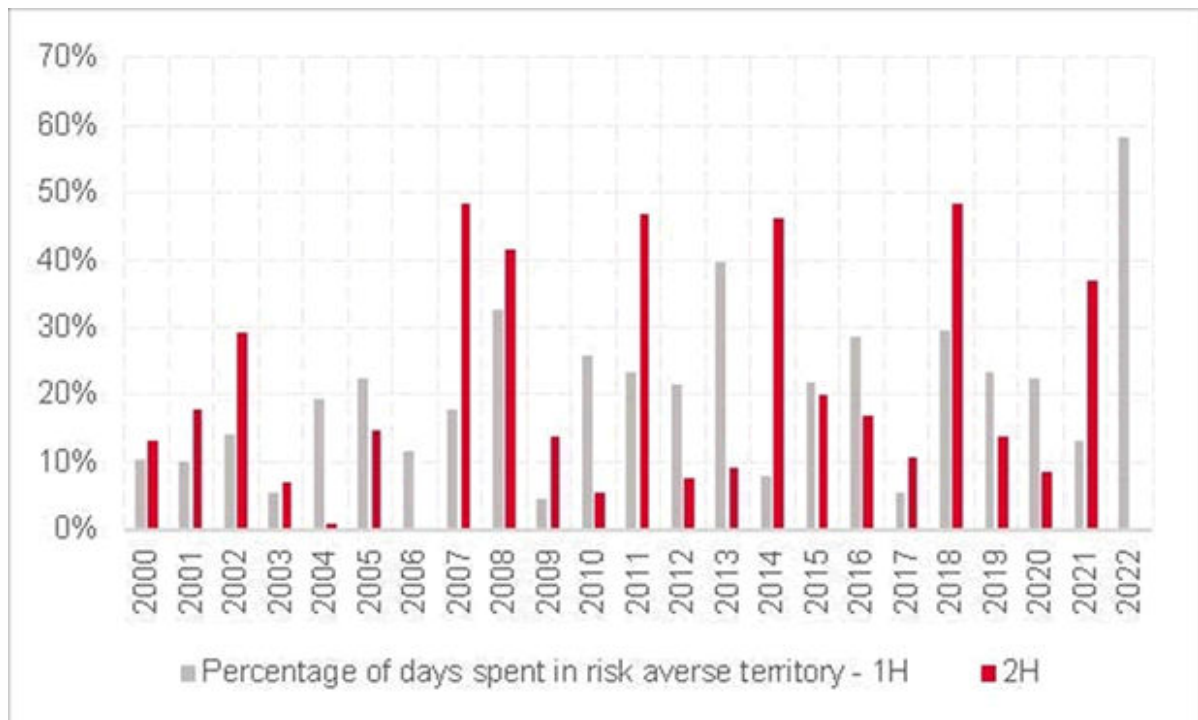
Note changed to Dec 2022 contracts in January 2022

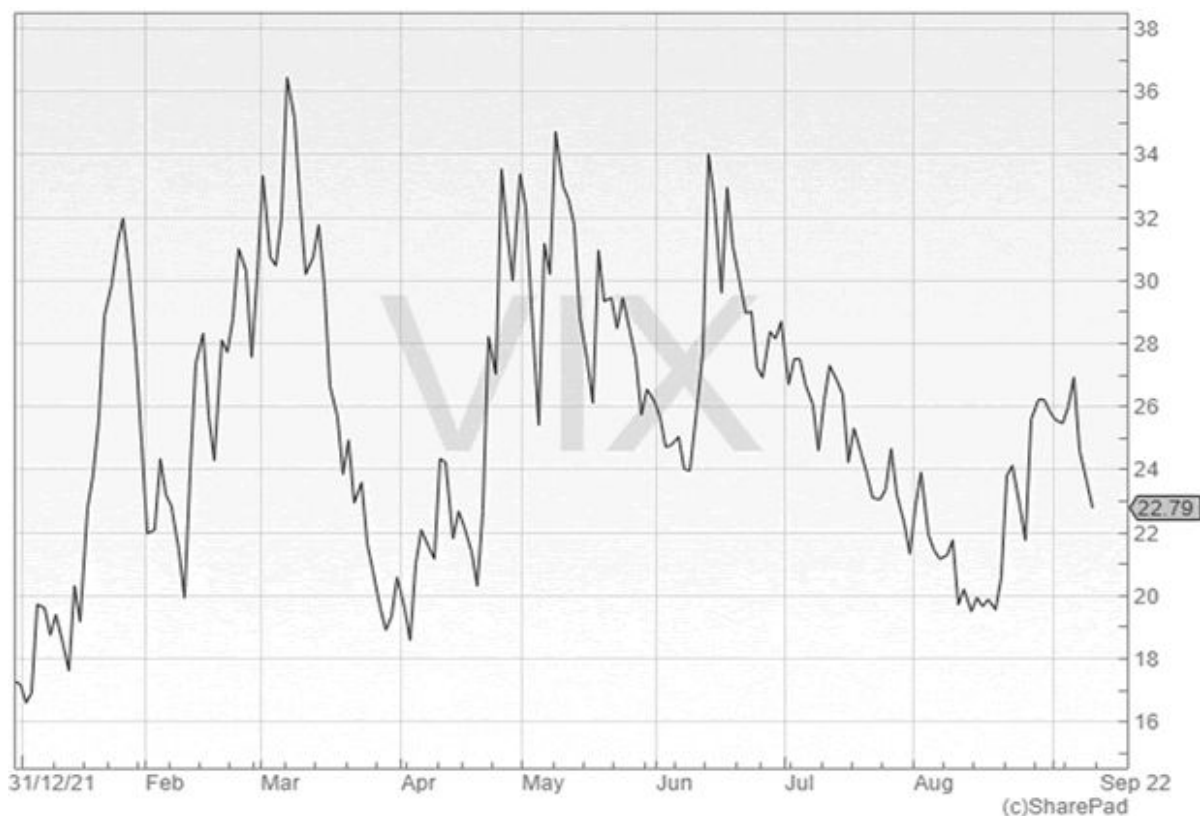
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.0091	4.09	4.82	6.11	1.63	12.5	7500.21
S&P 500	-3.97	9.62	-2.23	-8.02	64.5	93.2	4110.41
Gold Composite (Most Traded)	-4.79	-5.63	-12.9	-3.67	30.3	30.5	172860¢
iShares FTSE UK All Stocks Gilt	-8.41	-6.7	-15.8	-22.4	-16.8	-19.6	1099.5p

[Back to menu](#)

Volatility

The chart below is from the quantitative team at French investment bank SocGen and charts the evolution of their Sentiment Indicator. This is one of my favourite, aggregate investor sentiment measures and is in my view a fairly accurate gauge of how pessimistic or optimistic most investors feel at any one moment in time. The measure itself varies between 0 and 1. When its value falls below 0.35, it is generally a good time to deleverage risky assets and fly to safety. When its value falls below 0.05, extreme risk aversion has been reached and equity markets tend to rebound over the following month. The measure is currently at just 7% and according to SG "this indicator was below 0.35 on about 60% of days in 1H22, a record number by historical standards." This is I think very indicative of just how bearish equity sentiment is at the moment. We might have seen a recent rally but I sense that investors are not remotely convinced.





Black - VIX

Measure	September Level	August Level	July Level	June Level
Vstox Volatility	24.4	n/a	29.63	23.92
VFTSE Volatility	22.79	21.7	26.17	26.19

[Back to menu](#)

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.

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.

[Back to menu](#)

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