



Monthly Market Report

October 2023



With commentary from David Stevenson

The big story for equity investors in recent months has been the alleged "success" of a handful of US based tech leviathans called the Magnificent Seven, led by GPU giant Nvidia. But that success is not quite what it seems. Five of the seven (worth a total of \$11.2 trillion) have experienced YTD price declines. But even after these price declines, the cynical investor might want to look at some of the other metrics in the table below.

The average PE for this gang of seven is 89.5 though that is of course inflated by Nvidia's numbers - its forward PE of 44.8 is actually lower than Tesla's forward PE of 71 times prospective earnings. That's tempered by the fact that average forecast EPS growth for this Magnificent Seven is likely to average 101% (again inflated by Nvidia) though I think the 34% growth for Meta is not bad all things considered. One last point - the average return on capital employed is a rather impressive 25%.

TIDM	Name	price %		Market Cap	PE	fc PE	fc EPS	Price to	ROCE
		YTD	10 years				%chg	Free cash flow %	
GOOGL	Alphabet Inc	-6.35	523	1,715,917.00	27.4	24.3	12.9	29.7	26.1
AMZN	Amazon.com Inc	-17.2	841	1,425,087.70	200.8	64	213.9	-83.3	4.3
AAPL	Apple Inc	6.7	964	2,962,061.50	31	31.3	-0.8	27.8	52.9
META	Meta Platforms Ir	-11.9	609	762,633.60	34.4	22.2	54.8	42.1	19
MSFT	Microsoft Corp	-2.28	954	2,441,866.20	33.5	29.9	12.2	41.3	31.2
NVDA	NVIDIA Corp	64.9	12900	1,198,172.30	235	44.8	424.2	319.4	15.2
TSLA	Tesla Inc	-30.4	2050	777,660.40	66.8	71.1	-6	112.7	27.6
	total/average			11283398.7	89.8	41.1	101.6	70.0	25.2

All this talk of a Magnificent Seven shouldn't blind us to a wider context - on an historical basis for instance, these stocks could easily spend the next 12 months under performing. SocGen's chief quantitative strategist Andrew Laphorne recently reminded his clients that in 2022 the 'Magnificent Seven' was responsible for almost half of last year's 20% decline in the S&P 500.

A wider context also reminds us that there's life beyond the Magnificent Seven and US equities more generally. This lens reveals that valuations aren't entirely out of kilter in the broader market. The tale below shows data from Laphorne's team at SocGen and looks at regional earnings growth expectations and resulting PE ratios for this year and next for the major regions. Global equities overall are expected to grow 2023 earnings by a lacklustre 1.71% but that might expand to 12% in 2024. On a backward looking 12 months basis Global equities trade at 16 times earnings which drops to just 12.69 times earnings if we exclude the US. And even more notable is the PE for UK equities overall - at 10.65 times earnings, the lowest in the table and below even out of favour emerging markets. Then again, maybe that lowly rating is deserved because of those poor earnings growth numbers. Overall though these regional numbers don't suggest egregiously over valued equity markets.

Market P/E ratio aggregates

Region	2022e P/E	2023e P/E	2024e P/E	12m P/E	2023e EPS growth	2024e EPS growth
World	17.60	17.30	15.44	16.05	1.71	12.05
World excl. US	13.81	13.61	12.25	12.69	1.37	11.03
US	21.26	20.85	18.45	19.23	2.03	13.02
Europe	13.28	12.91	12.03	12.32	2.54	7.30
Eurozone	12.86	12.31	11.43	11.71	4.41	7.66
UK	10.55	11.03	10.42	10.65	-4.31	5.85
Japan	16.57	15.09	13.81	14.19	10.54	9.24
Pacific excl. Japan	13.66	15.10	12.47	13.36	-9.60	21.05
Emerging	13.83	13.43	11.67	12.21	3.02	14.95

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

As we discuss in the section on market volatility, the all important US market has been fairly subdued in recent months, helped along by buoyant corporate profits. But as we head into the autumn there are some looming potential hazards, most of them to be found in the US. Vicent Deluard, global strategist at StoneX has helpfully listed the imminent challenges that could derail the US consumer, the lynchpin of the current upturn:

- The (widely-abused) Employee Retention Credit allows businesses to claim a refundable tax credit for qualified wages paid between March 2020 and December 2021. The credit can be used to offset the employer's share of payroll taxes and can be refunded to the business if the credit exceeds the amount of taxes owed. These expire September 15th.
- Interest payments on federal student loans were deferred during COVID and will resume on October 1st. Based on a balance of \$1 trillion of federal loan in forbearance and an average interest rate of 5%, the extra cost should be about \$50 billion, which is more meaningful.
- The IRS extended the deadline to file taxes in California, Alabama, and Georgia to October 16, 2023 due to weather events in these states. The payment of these delayed tax payments should squeeze disposable income and reduce the stealth stimulus of the wider-than expected deficit.
- Only 40% of the office CMBS loans that matured this year have been paid off and that 70% of office loans that were set to mature in June have entered maturity default.
- The combination of Saudi cuts, Russian sanctions, and resilient US demand sent Brent prices to a nine-month high of \$90. Unfortunately, the strategic petroleum reserve is at a 40-year low of 350 million barrels and the US rig count keeps falling, as the most productive shale fields have been exhausted.

One of the least widely used, but most useful measures of long term value is something called the equity risk premium or ERP. This measures the extra return you get from stocks compared to bonds in return for taking the extra risk. The higher the premium, the more attractive stocks will be, and vice versa. If ERP falls to sub 3% levels, equities are likely to deliver sub-average return and underperform bonds, while the long-term average seems to hover around the 4% level, give or take a % either way. Its quite difficult to get a quick, current fix on the ERP in real time but one way of glimpsing a current derivative snapshot of the ERP is by comparing the current real cost of debt and equity for companies, and subtracting the current real interest rate. On this basis the ERP for US equities has fallen sharply, as you can see in the chart below from SocGen analysts. They reckon that if it does pass the 3% level, US equity tends to struggle and delivers weak returns in the following 12 months. "The last time we crossed the 3% threshold and subsequently the 2% was during the late-90s, a period of irrational exuberance".

US equity risk premium naturally falls when GDP growth surprises on the upside



Measure	Values as of 17th August 2023	Values as of 14th September 2023
UK Government 10 year bond rate	4.70%	4.31%
GDP Growth rate YoY	0.40%	0.40%
CPI Core rate	6.80%	6.80%
RPI Inflation rate	9%	9%
Interest rate	5.25%	5.25%
Interbank rate 3 month	5.53%	5.57%
Government debt to GDP ratio	101%	101%
Manufacturing PMI	45.3	43

[Back to menu](#)

Bank CDS options

Another quiet month for the pricing of credit default swaps, or CDS. Pricing for most of the big banks stayed fairly stable with the majority showing small decreases though a few banks such as the US giants Goldmans, Citi and Morgan Stanley did see very marginal increases in the pricing of their 1 year swaps. One last observation - Fitch Ratings (which lowered the U.S.'s rating to "AA+" from "AAA" on Aug. 2, 2023), has recently warned that it may downgrade dozens of banks, including JPMorgan Chase (JPM; currently with a "AA-" rating, while S&P Global Ratings has an "A+"). Watch this space.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	24.17	52.45	A+	A2	A -
Barclays	57.6	93.57	BBB	BAA1	A
BNP Parabis	20.49	42.91	A+	Aa3	A+
Citigroup	32.13	68.69	BBB+	A3	A
Credit Suisse	52.22	83.73	BBB-	BAA2	BBB
Deutsche Bank	80.1	142.41	A-	A1	BBB+
Goldman Sachs	39.99	78.14	BBB+	A2	A
HSBC	25.2	48.39	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	28.35	55.22	A-	A1	AA-
Lloyds Banking Group	27	52.44	BBB+	A3	A
Morgan Stanley	35.26	70.18	A-	A1	A+
Natixis	20	46.5	A	A1	A+
Nomura	35.32	96.07	BBB+	BAA1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	28.24	53.77	A	A1	A-
UBS	32.41	55.11	A-	Aa3	A+

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

[Back to menu](#)

Government Bonds

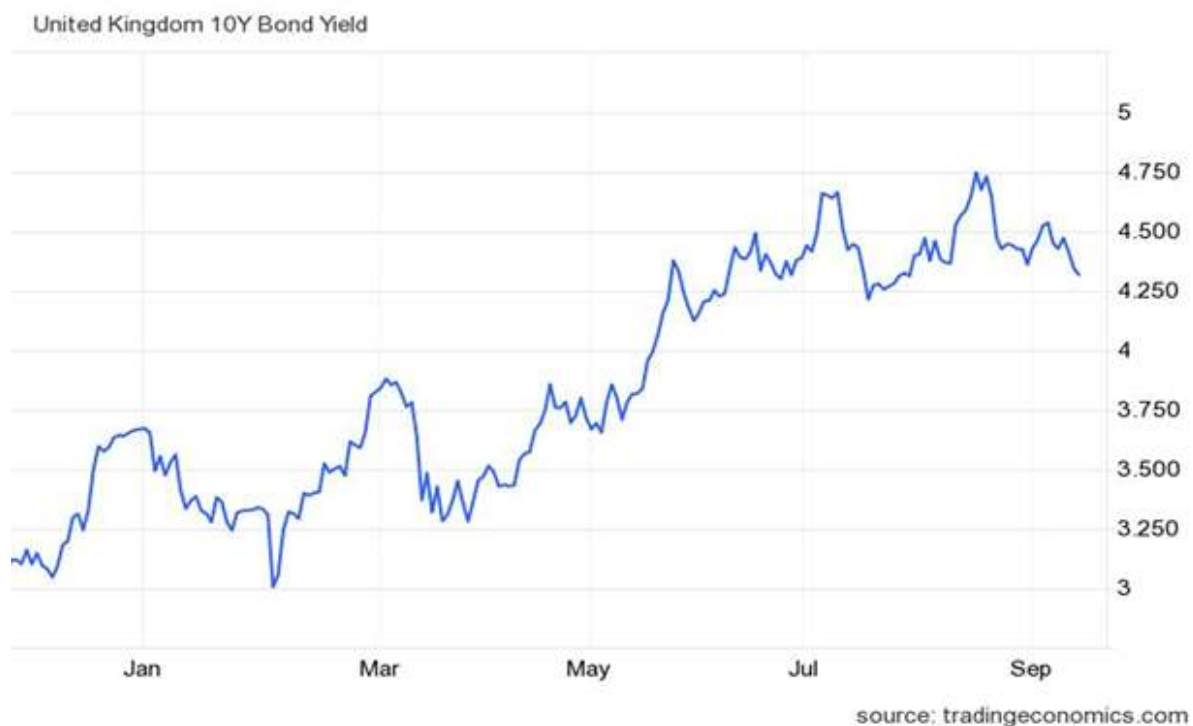
I think there is a reasonable chance we are reaching an interesting juncture with rates. Everyone and their dog now believe that inflation rates will stay higher than expected and that central banks and the BoE especially will continue to raise rates and then keep them there. As I write the 2-year bond yield is now at around 5% and if UK interest rates hit 5.5% (and even 6%) I think it's possible we could see 2-year gilt rates crest at 5.5%. What happens next? I think we need to keep some perspective. The BoE has been forced to overdo its rate-raising because it was caught with its head in the sand in the run-up to the current inflationary spasm. It refused to move quickly and now needs to be over-aggressive. But scratch away the bluster and it knows damned well that the UK economy is still weak, has deep structural flaws, and that the longer the high rates scenario

continues, the deeper the structural damage. Its professional staff is filled with doveish types who think - probably correctly - that an aggressive stance in the medium term is dangerous. So, internally, the pressure will soon start to build to call it a day and start to lower rates.

And then there's the simple hard reality that although there is a logic to pushing rates up aggressively there may also be an equally compelling logic to nudge them down as the corporate pain intensifies. Another way of saying the same thing is that we can confuse Higher rates for longer - an extra six months - with higher Rates forever (which is unlikely). Or even Higher Rates for Many Years (not as catchy). My best guess is that by mid 2024, the push for rates to move back towards 3.5% will be intense, especially if the UK slides into a slowdown/recession ahead of the impending general election. Again, to repeat my point, better for the BoE to be bold and aggressive now and then be generous next summer. There is an asymmetric pain ratio to delaying the nasty stuff.

I'd also argue that there is a perfectly respectable case for saying that there are deflationary pressures building within the system. We've all heard about the pain coming out of China and it is very real - China is yet again acting as a deflationary vortex. Maybe China might be the catalyst that makes real every bear's worst nightmare - a liquidity crunch. Just because we have avoided one to date - including after bank runs - doesn't mean it can't happen in the near future.

UK Government Bonds 10-year Rate 4.69%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	25
Germany	16.77
Japan	21.52

United Kingdom	28.17
Ireland	22.26
Italy	86.13
Portugal	44.83
Spain	47.73

Eurozone peripheral bond yields

Country	September 2023	August 2023	Spread over 10 year
Spain 10 year	3.70%	3.74%	107
Italy 10 year	4.42%	4.39%	179
Greece 10 year	4.06%	3.98%	143

	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

One of the reasons why investors are relatively enthused about holding equities is that corporate earnings are holding up reasonably well - not shooting ahead but certainly still growing. The second quarter numbers are nearly all in ow across different geographies and of the 500 stocks in the S&P500 index, 376 have beat their earnings estimates (75.8%) and while 63% have beaten their sales forecasts. According to analysts at S&P Dow Jones, across the whole of the S&P 500 index, Q2 2023 earnings per share are expected to increase 4.5% over Q1 2023 and have increased 17.2% over Q2 2022; sales are expected to increase 2.4%, and up 7.1% from Q2 2022, as they potentially set a new record, at USD 3.96 trillion (by a tick from the Q4 2022 record). Its also worth noting that operating margins for Q2 2023 are expected to increase to 11.88% from 11.64% in Q1 2023 (the average since 1993 is 8.34%, and the record is 13.54% in Q2 2021).

European corporates are also doing well. In the current 2Q 2023 numbers for Europe - the STOXX 600 index - we've seen nearly all the major corporates report and according to analysts at Morgan Stanley nearly half have published EPS above consensus estimates, while 35% surprised negatively, with most of those showing declines focused in commodity-linked sectors. Excluding Energy and Materials, earnings have grown by almost 3% (versus 2Q22). It's a similar story with global emerging markets: according to HSBC analysts, with 35% of EM companies having reported, the early results from the Q2-23 EM earnings season show that 44% of companies have beaten estimates (vs 37% last 4Q average) while 41% have missed. Reported Q2-23 earnings have grown 3.7% YoY, supported by robust top-line growth of 8% and offset by modest net margin headwinds. EMEA has delivered the strongest proportion of beats at 47%, led by Turkey, UAE, and Greece.

Index	August 2023	September 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	143	143.1	4241	140.2
FTSE 100 Dividend Dec 2022	297.4	298	7614	294.4

Note changed to Dec 2023 contracts

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	1.49	0.216	-0.235	4.7	4.31	4.44	7619.15
S&P 500	-0.496	2.17	14	13.2	53.8	79	4467.44
Gold Composite (Most Traded)	-0.592	-1.85	1.13	13.1	61.3	44.4	193520¢
iShares FTSE UK All Stocks Gilt	2.07	1.24	-5.48	-8.3	-22.5	-23.3	1006.37p
VIX New Methodology	-9.04	-2.88	-43.2	-48.5	11.7	29.1	13.48

[Back to menu](#)

Volatility

Turbulence in US large cap equities remained fairly subdued over the last month, with the Vix index ticking up a bit off recent lows but still well below historic averages. In the middle of August the Vix did spike for a few days but since then we seem to be back into a fairly subdued market, under 15 points and well below the long term average of around 19 to 20. That said S&P 500 index dispersion held steady at 20% in August, but volatility levels actually declined for small and mid caps in the US. Elsewhere, it was largely business as usual for global equities this month, with volatility and dispersion registering close-to-average levels across most major markets.



Black Line - Vix since December 2020

Red line - 20 day moving average

Blue line - 200 day moving average

Measure	September Level	August Level	July Level	June Level
Vstox Volatility	15.47	18.98	14.95	13.68
VFTSE Volatility	14.23	16.46	13.54	13.88

[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.

[Back to menu](#)

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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