



Monthly Market Report

September 2020

With commentary from David Stevenson

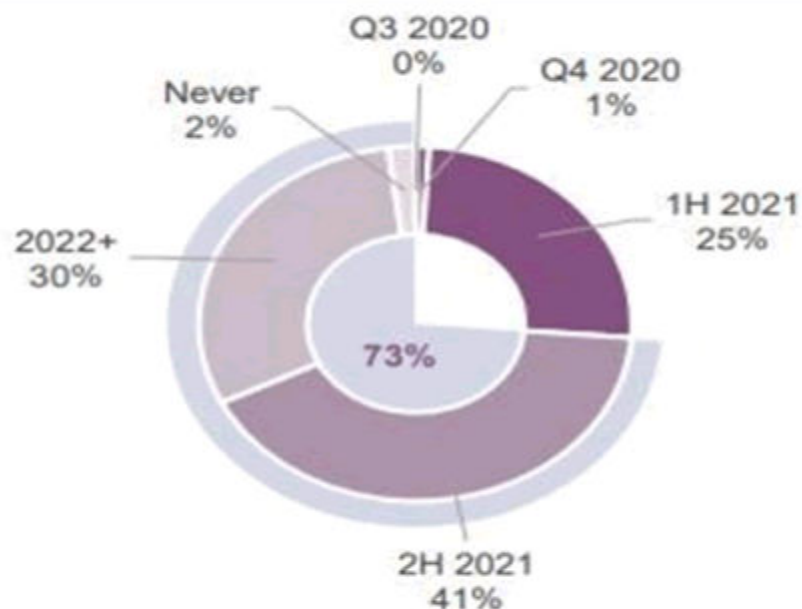


As it's summer time and frankly most of us are past worrying about whether we're in a V, U, or W (swoosh is the alternative designation for W) scenario, I thought it worth touching on two hard nosed charts that I think should make all of us a tad cautious as we head into the autumn. They're both from quant analysts at French investment bank SocGen and they emerged in a publication called the SG Practical Quant Investor.

The first addresses the \$64 billion question. Vaccines. For the record I'm deeply sceptical we'll have a working vaccine much before summer next year. My money is on incrementally better treatment of the virus to the point where the number of hospitalisations drops and those who die in hospital drops even further. That said a vaccine would be the preferable option, which brings us back to that Sg report which looks at research in the healthcare industry about the pandemic revealing that "two-thirds of the respondents of these 184 C-level health care executives expect the pandemic to continue into the second half of 2021 or beyond."

The first chart below maps out these views. I have seen similar charts from a range of experts including successful super forecasters as well as hospital doctors. All seem to carry the same message. We possibly/probably have at least another 12 more months of viral mayhem ahead of us.

Likelihood of vaccine availability, survey of health care industry leaders, June 2020



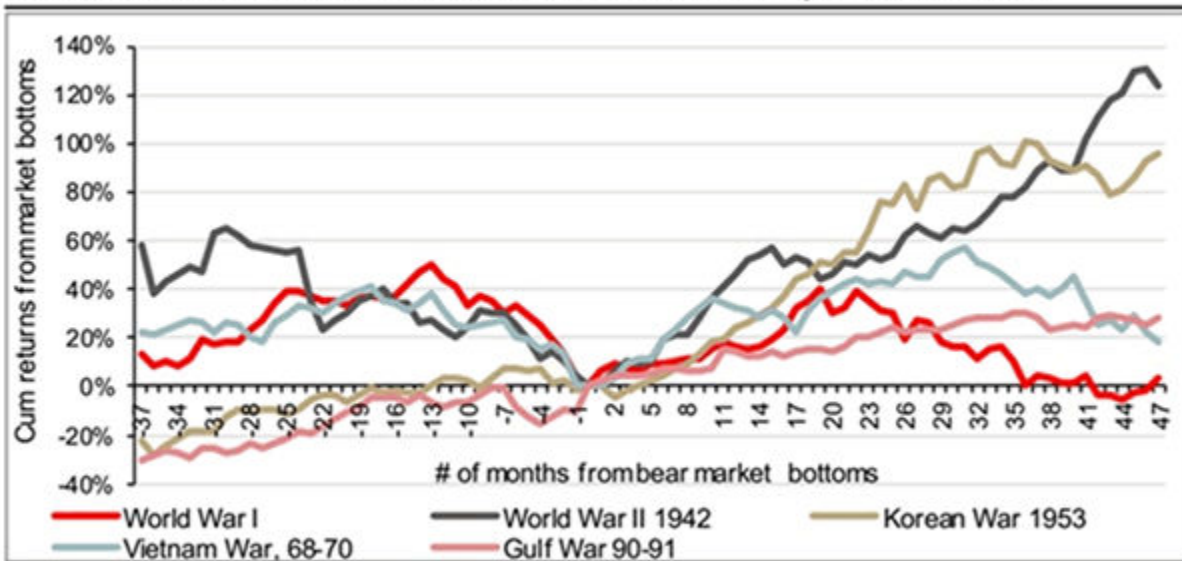
R Healthcare industry leader responses to the question:
When is this vaccine likely to be widely available?

Source: Lazard Global Health Care Leaders Study 2020; SG Cross Asset Research/Equity Quant

The next chart from SG tries to place the pandemic and the extreme economic damage that results from it within a wider historical context, comparing stock market outcomes with recent wars. The overall message is that the bounce back seems most pronounced at the roughly 24 months stage, not the first few months.

But the chart also reminds us that markets can then drift sharply lower again. And here one example stands out - the 'forgotten' depression of 1920-21. The SG analysts report that the "post-pandemic 1920-21 depression was as severe a calamity to the American economy as the Great Depression of the 1930s, with a deeper recession in a shorter time span. It was a massive deflationary descent with unemployment skyrocketing to an estimated 8.7% to 11.7% percent and real GDP contracting by 7%. It recorded the largest one-year decline in price levels (-18%), while destroying about a quarter of the nation's output in nominal terms." Stock markets swooned in the wake of this economic reversal. Be warned. The next wave of economic disruption could be even worse than what we've seen so far.

Peace dividend, cumulative returns of S&P 500 around end of major wars, 1915-2020



Source: SG Cross Asset Research/Equity Quant

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Headline Numbers

Back in the real world

In my experience investors have become rather blasé about the virus and its impact. We collectively transpose our largely upper middle class world view on to the wider population and then wonder why everyone else is so miserable. All that anchors us back to this real world are the small hints of wider economic fear and devastation contained in various surveys. Two stand out. The first is from Markit and looks at household spending over the long term. The drop in Q2 was truly catastrophic and although there has been a rebound we are still a LONG, LONG way from regaining a sensible level of consumer confidence. Thus, the government's increasingly panicked invocations to SPEND, SPEND, SPEND. According to HIS Markit, their index registered 41.6 in July, up slightly from 37.8 in June "but still much lower than at any time in 11 years of survey data prior to the coronavirus disease 2019 (COVID-19) pandemic."

Household spending

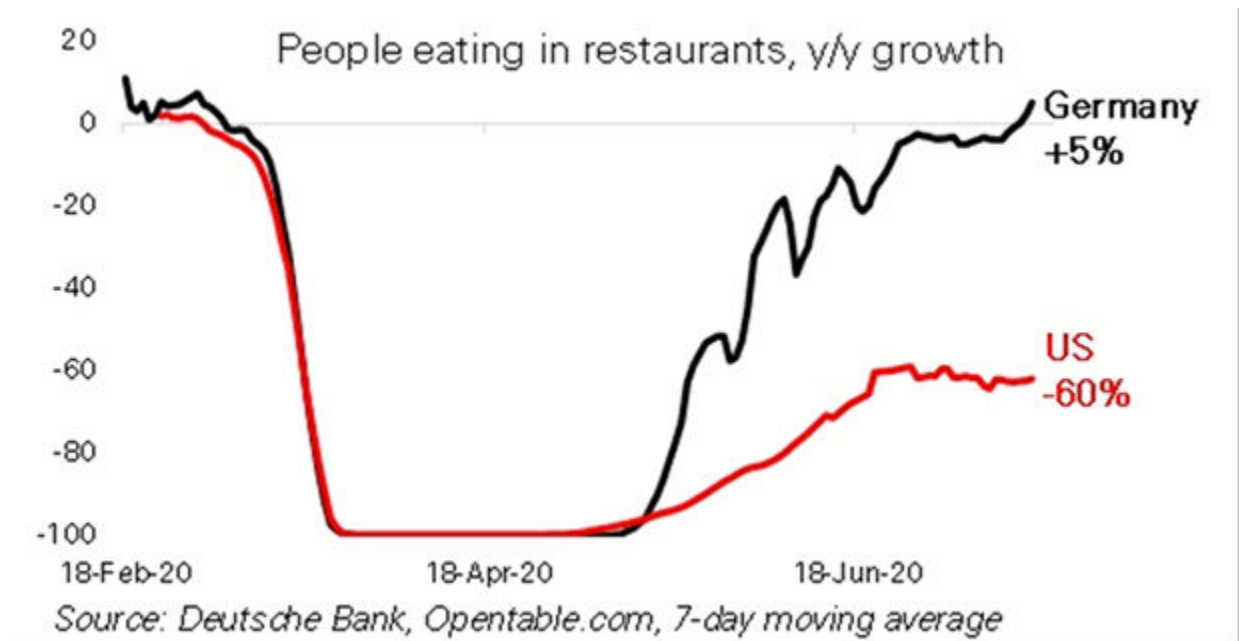
50 = no change in household spending since previous month



Source: IHS Markit.

For me though the slightly more interesting observation is this: *“Households appeared focused on reining in debt and supporting their savings where possible, according to the latest survey data. As a result, the index measuring demand for unsecured credit fell to 49.3 in July, from 50.1 in June, to signal an overall drop in households' appetite for unsecured borrowing for the first time since the survey began in February 2009.”* Economists wouldn't be surprised I am sure by this retrenchment and it absolutely backs up the argument that the government thus needs to step into the breach and deficit spend like crazy. But still this spurning of debt is fascinating. I dread to think what's happening in those economies where the fiscal activism is more restrained i.e. places like Russia.

The second chart is also from very early in August and was quoted by the excellent John Authers over at Bloomberg Opinion. Its from Deutsche and shows as close as real time as we can get for the number of people eating in restaurants.



I dread to think what the equivalent number is in the UK. Very few restaurants I pass seem to be full – in fact many seem closed. In particular I’m surprised by the country dining scene, especially gastro pubs. More than a few popular hotspots in my neck of Hampshire are still resolutely closed, despite the sheer quantity of wealthy, older local consumers. My impression is that the older, wealthier middle classes are still on a consumer strike whilst working class areas seem much more vibrant. If anyone is rescuing the UK economy, it seems to me to be ordinary working people, especially younger ones. The older affluent seem happier sitting at home complaining about the youngsters and "the masses", oblivious to the economic ruin they are creating around them.

Gold

Gold has had a good run and although in recent weeks prices have wobbled a tad, the consensus is still that gold has much further to run. The big question is how high could it go? Despite being fairly bearish myself about gold over the last few years, I tend to support that cautious optimism although trying to construct any rational, numbers influenced valuation model for gold is always tricky in the extreme. Analysts at research firm Cross Border Capital have tried to give it a go, in part as a way of explaining why they think gold might still hit \$2500 an ounce. They reckon that a 2% inflation trend and a further fall in real interest rates is still needed to justify current gold price under the alternative CPI/ real interest rate model. But that assumes that the real interest rate model is the best available?

“Not only does the statistical evidence point to liquidity rather than real interest rates as the causal factor, but, with nominal policy rates already effectively at the zero-lower bound, much higher inflation is anyway needed to justify even today’s gold price. Instead we focus on the effect of a liquidity trend on gold, with cyclical swings explained by investors’ risk appetite, Fed QE policy, and accelerations and decelerations in the rate of inflation.”

Cross Borders’ analysis is based on an internal model which looks at liquidity as a driver for the gold price rather than traditional measures focused on real interest rates (where they argue that the causation appears to run in reverse with gold the driver).

This internal model also boasts some overlays, notably inflation and policy choices. In terms of inflation, “each 1%-point rise in the future inflation trend over the coming year adds 2% to the level of gold. Thus, a permanent rise in the US inflation rate from 2% to 3% would add around US\$50 to the current price of gold. Although this may not sound much of an impact, it does come on top of the impact from faster liquidity growth”. In policy terms the key factors are the US Federal Reserve and (Emerging Market and Chinese flight capital. “Again, using our normalised indexes (range 0-100) of the size of the Fed balance sheet and the outflow of EM and specific Chinese capital, each 10 index point increase, respectively, adds 3% and 8% to the level of gold prices.”

Using this model, they project that gold is currently ‘fair-value’ at US\$2,100/oz. and could even test US\$3,000/oz. by late-2021. But we also need to add some caution here – this time from the unlikely quarter of the World Gold Council, the industry trade association. Top of any warning list has to be physical gold markets: according to the world Gold Council bar and coin investment declined sharply in Q2 driven by Asian weakness and leading to a 17% decline to 397t in H1. With global markets in lockdown and consumers deterred by high gold prices and a squeeze on disposable income, the WGC also reported that jewellery demand fell by 46% to 572t and gold used in technology dropped 13% to 140t in H1. Investment in gold coins and small bars also slowed sharply in H1 2020, down by 17% to 397t while Central banks bought 233t of gold during H1, 39% below 2019’s record level. Buying has become more concentrated, with fewer banks adding to reserves so far in 2020. That said some of these bearish signals coming from the physical markets were offset by the that Gold supply was impacted by the pandemic: total H1 supply declined 6% to 2,192t as both mine production and recycling were affected by lockdown restrictions.

Measure	Values as of 10th July, 2020	Values as of 13th August, 2020
UK Government 10 year bond rate	0.18%	0.25%
GDP Growth rate YoY	-2.20%	-21.70%
CPI Core rate	0.50%	0.60%
RPI Inflation rate	1.00%	1.10%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.09%	0.07%
Government debt to GDP ratio	80.70%	80.70%
Manufacturing PMI	50.1	53.3

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Bank CDS options

Pricing for credit default swaps for 12 of the 18 banks offering prices continued their steady decline of recent months. The biggest fall in pricing was for three banks in particular – Santander, Morgan Stanley and Goldman Sachs. Curiously two banks saw their CDS pricing increase – HSBC

and Lloyds. One suspects that troubles in China may have had some impact on the former while worries about the domestic UK economy seem to be weighing on the UK's largest bank.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.91	32.64	A	A2	A -
Barclays	26.15	64.78	BBB	Baa3	A
BNP Parabis	17	39.67	A+	Aa3	A+
Citigroup	43	64	BBB+	A3	A
Commerzbank	n/a	n/a	A-	A1	BBB+
Credit Suisse	21	60	BBB+	Baa2	A-
Deutsche Bank	94	158	BBB+	A3	BBB
Goldman Sachs	43	67	BBB+	A3	A
HSBC	13	40	AA-	Aa3	A+
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	33.89	54	A-	A2	AA-
Lloyds Banking Group	12.75	35.21	BBB+	A3	A+
Morgan Stanley	36	59	BBB+	A3	A
Natixis	34	46.43	A+	A1	A+
Nomura	40.85	95.11	BBB+	Baa1	A-
RBC	20.16	59.52	AA-	Aa3	AA-
Soc Gen	12.13	41.98	A	A1	A
UBS	14	36	A-	Aa3	A+

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

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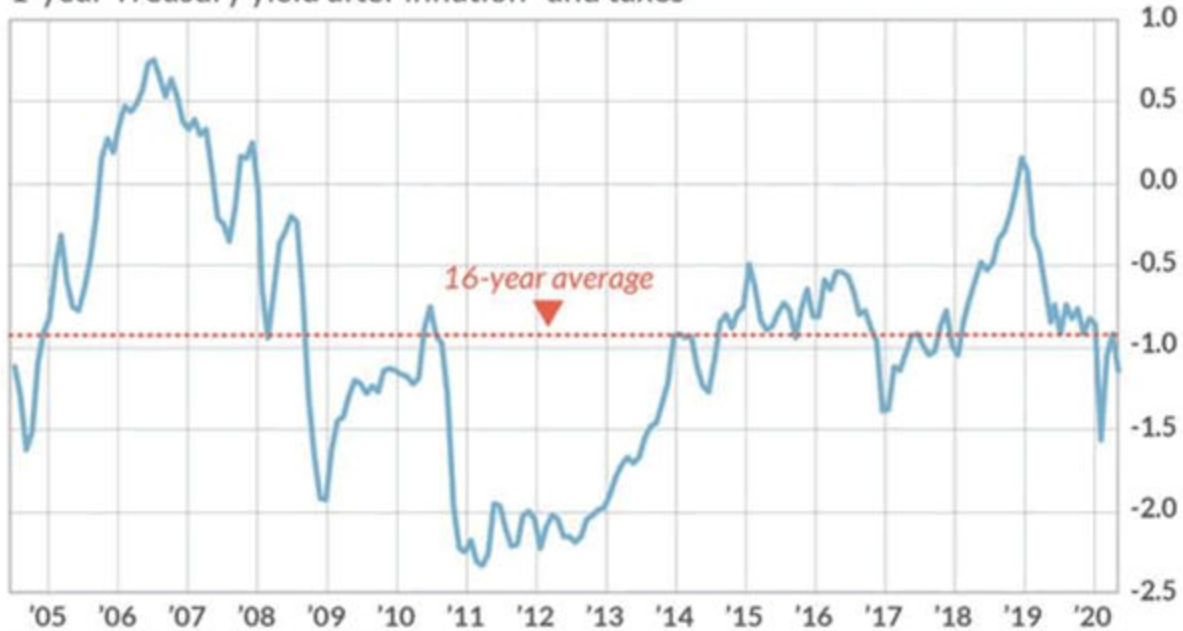
Government Bonds

This month I have just one very straight forward chart to share on the subject of bond valuations. It comes via a LinkedIn post by a fixed income portfolio manager at Asian manager GaoTeng Global Asset Management. In very simple terms, it restates what is I think still a rational, bullish view for bond valuations. It argues that “even with yields close to zero. Counting for inflation and taxes, interest rates aren't particularly low. Interest rates have just as much a chance of declining as rising. Many of you will have difficulty accepting this. The almost-universal narrative these days is that, because U.S. rates are at record lows — close to zero, in fact — their path is undoubtedly up. Bonds in turn will suffer. But this widely-held narrative fails to take into account both inflation and

taxes. Once you do, it becomes clear that interest rates now are not even close to being at all-time lows..."

Who said rates are at record lows?

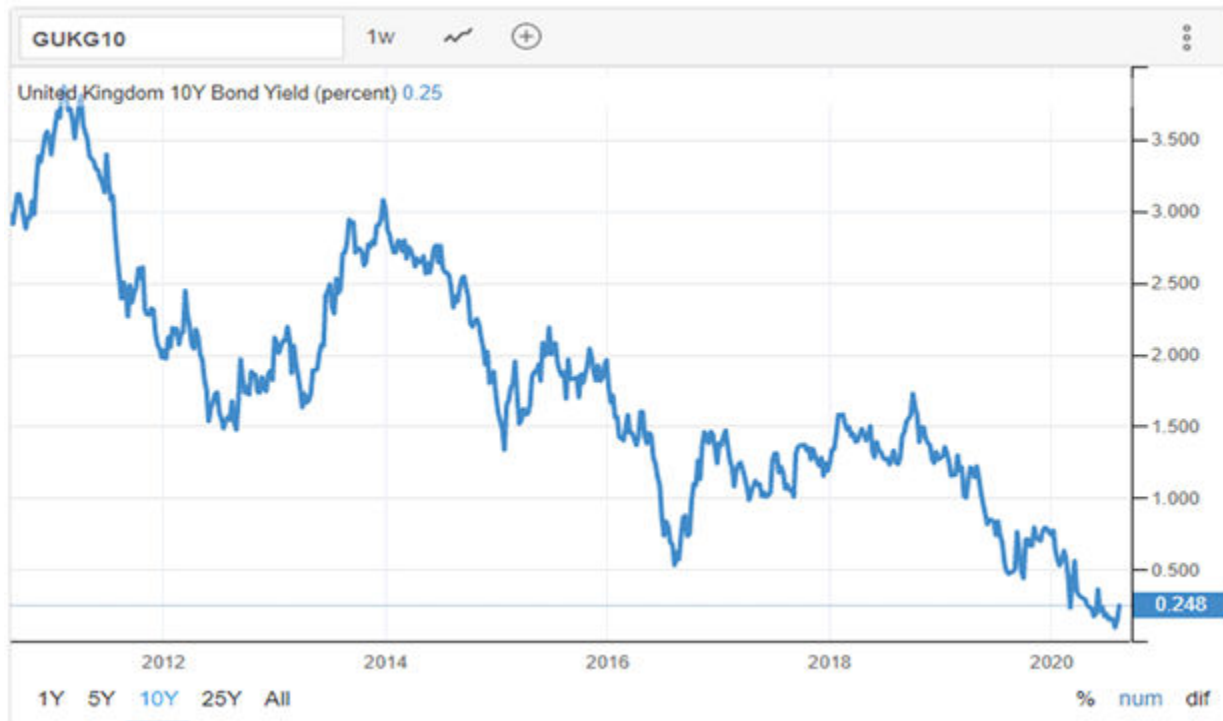
1-year Treasury yield after inflation* and taxes



*As measured by % change in CPI over trailing 24 months

Source: Ivo Welch, Clinton Tepper, Daniel Feenberg, St. Louis Federal Reserve, www.HulbertRatings.com

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	18.4
Germany	11.69
Japan	17.31
United Kingdom	23.35
Ireland	22.63
Italy	142
Portugal	54.38
Spain	59.84

Eurozone peripheral bond yields

Country	July 2020	August 2020	Spread over 10 year
Spain 10 year	0.44%	0.37%	78
Italy 10 year	1.24%	1.01%	142
Greece 10 year	1.08%	1.11%	152

	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

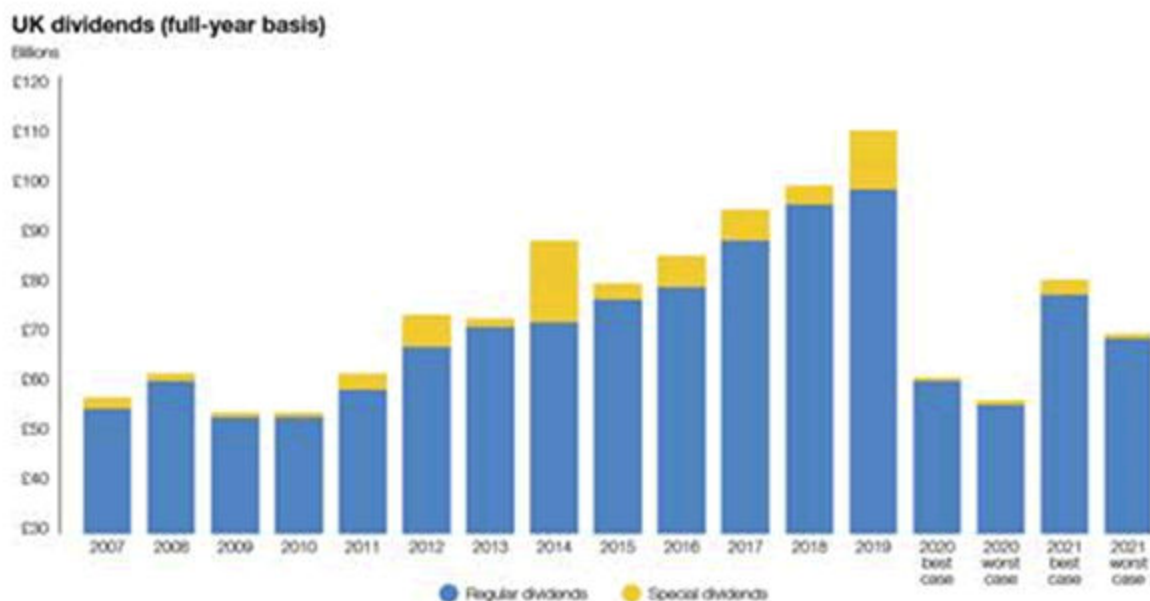
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Equity Markets and Dividend Futures

Most investors knew that the Dividends Massacre was on its way but over the last few weeks we've finally received confirmation by a series of dividend surveys. Link has been producing a regular dividend monitor for many years now and its latest quarterly report mapped out the full horror of the dividends bloodbath. For me the interesting number is the dividend yield in future years. According to LINK, their best case scenario is a yield of 3.6% in the next twelve months or 3.3% in their worst case. Some perspective here : the long term UK dividend is probably hovering around the 3.5% to 4.5% range but still I think a best case of 3.6% is still terrible. One could use that number to imply that the UK market is arguably at least 10 to 20% over valued if we use dividends as a signalling device for equity value.

Here's the headlines from the LINK Dividend monitor:

- Covid-19 caused unprecedented cuts in dividends in Q2 2020, down £22bn on a headline basis; they fell £16.4bn on an underlying basis (i.e. if special dividends are excluded)
- 176 companies cancelled payouts and 30 more cut them, together representing three quarters of Q2 payers
- In the aftermath of the Global Financial Crisis (GFC), just two fifths of companies cut or cancelled payouts
- Dividends fell 57.2% to £16.1bn on a headline basis, or 50.2% to £16.0bn if special dividends are excluded Top 100 payouts fell 45% in Q2 compared to 76% for the mid-caps
- 2020 will see payouts fall at best 39% to £60.5bn on an underlying basis, or 45% in headline terms (which includes special dividends). At worst they will fall off 43% to £56.3bn on an underlying basis, or 49% on a headline basis case scenario (in line with the long run average of 3.5%) or 3.3% on a worst-case scenario.



Before we get too carried away with the pessimism it is worth dwelling on one positive. Earnings in Europe, which are likely slightly more positive than we first thought. We're mid way through the Q2 numbers now and according to analysts at Morgan Stanley the numbers are looking better than expected. According to MS 52% of companies have beaten EPS estimates by 5% or more, while 30% have missed, giving a strong 'net beat' of 22% of companies. IT and Consumer Staples stocks have posted the strongest breadth of beats vs consensus so far.

Index	July 2020	August 2020	Reference Index Value	Level 6 Months Ago
Eurostoxx 50 (Dec 19)	85	83.5	3348	120

FTSE 100 (Dec 19)	178	208.5	6185	333			
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	0.153	4.77	-17	-14.7	-5.83	-7.08	6185.62
S&P 500	-1.49	-2.66	4.2	3.76	18.9	26.4	1470.75
iShares FTSE UK All Stocks Gilt	7.24	20	0.291	15.6	62.4	73.8	3383.75
VIX New Methodology	-30.8	-36.8	57.5	27.2	65.2	72.7	22.28

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Volatility

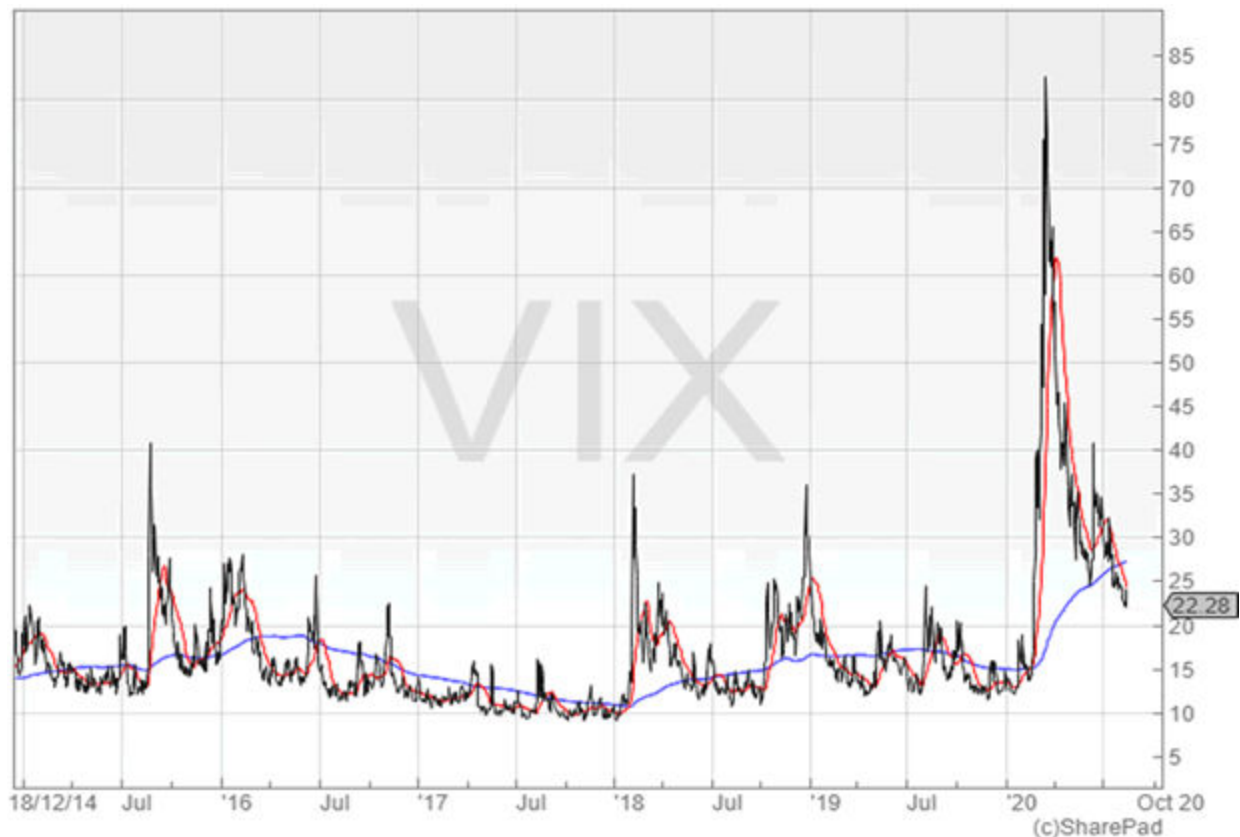
The structured products industry has quite rightly in my view been constantly repeating a message I would endorse – why bother with flaky, volatile absolute returns funds when you can invest in relatively dull, predictable, defined returns from structured products. One part of this narrative is based on the huge variability of returns from supposedly boring absolute returns funds which have, frankly, been all over the shop in recent years. Many have in fact recorded huge losses.

But the counter argument – that structured products can provide predictable returns – has long needed some long term data points. These have been steadily emerging courtesy of Ian Lowes at Lowes Financial Management. His team have been compiling data sets of all SPs on the market and his latest review – The Review of the Decade – provides what I think is definitive evidence that structured products have now become frankly a bit boring. The Lowes Structured Product Review of the Decade can be downloaded from Lowes.co.uk/spdecade.

Many of the trends are familiar to anyone who's bought into structured products. Autocalls have come to entirely dominate the sector and within this trend there's also been a wholesale transition to simple, end of term capital protection barriers. The other big shift has been to longer maximum duration autocalls which has repositioned market risk – the overall impact is that high risk plans are now extremely rare. Anyway, here's the numerical highlights from Lowes' report:

- 4,444 – structured products issued.
- 3,895 products matured.
- 2,467 maturities were capital at risk plans
- 60 (1.54%) of all maturities returned a loss
- 3 years, 9 months average investment duration

- 7.84% - average annualised return from capital at risk products
- 3.64% - average annualised return from deposit-based products
- 5.56% - average annualised return from income plans



Measure	August Level	July Level	June Level	May Level
Vstox Volatility	22.69	27.28	30.54	28
VFTSE Volatility	21.69	27.29	27.57	27.39

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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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