



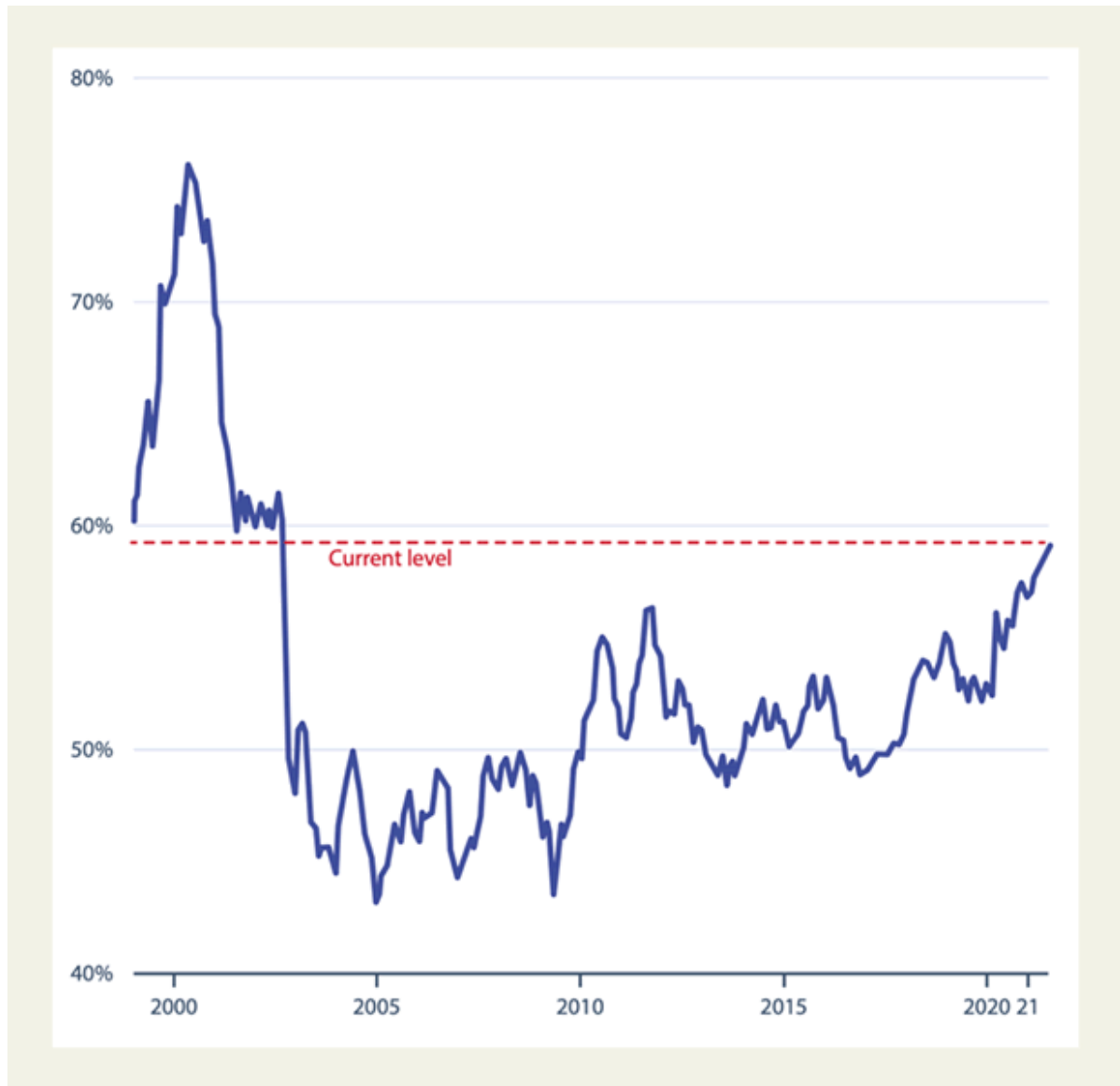
Monthly Market Report

September 2021

With commentary from David Stevenson



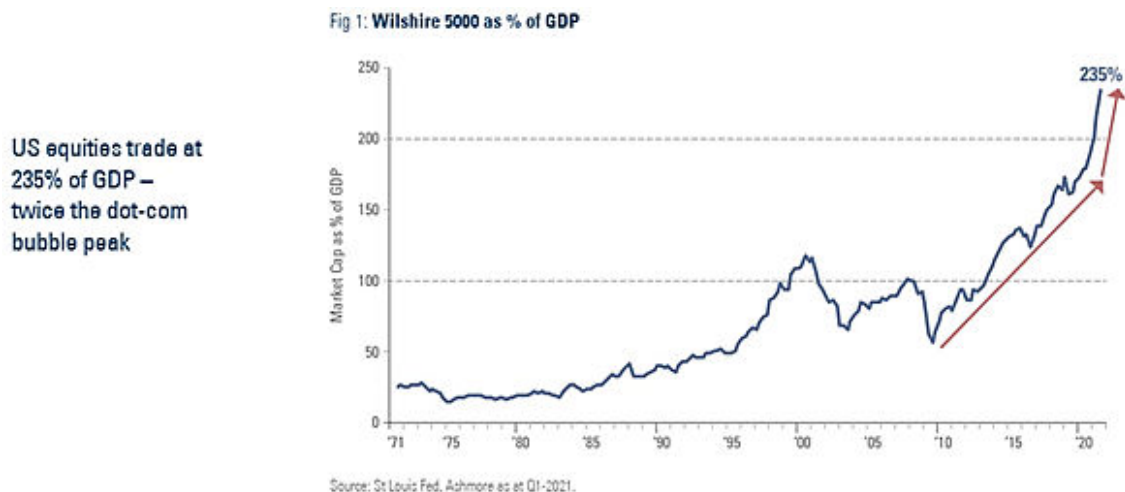
I want to start this month's report with two, contrasting, charts which speak to the bull and bear impulses pulsing through the market at the moment. For all the bulls out there, we'll start with the first chart below from a recent edition of the Sunday Briefing. It shows the percentage of buy recommendations on the 1000 largest US stocks. If this isn't a strong buy indicator, I'm not sure what is!



Now for the bears rejoinder. London based emerging markets focused firm Ashmore reminded investors this month that back in 2011 Warren Buffett declared that the ratio of stock market capitalisation to nominal gross domestic product (GDP) was "probably the best single measure of

where valuations stand at any given moment". Currently the ratio of the broad Wilshire 5000 stock market index to US GDP, stands at 235%. According to Ashmore "this is the highest level in 50 years and more than twice the peaks achieved in Q1 2000 and Q1 2007. In other words, market participants are trading US companies at close to 2.5x the size of the US economy". In fact, Buffett himself described the recent spike in the ratio above the 200% mark as a "very strong warning signal of a future market crash".

Now this is just one of many signals flashing red but many of these have been flashing red for quite some time and investors don't seem to care. I actually think equity markets in the US will have a strong last quarter and may even push higher in 2022 but even the most hardened optimist must begin to concede that the probability of a major bump is growing all the time.



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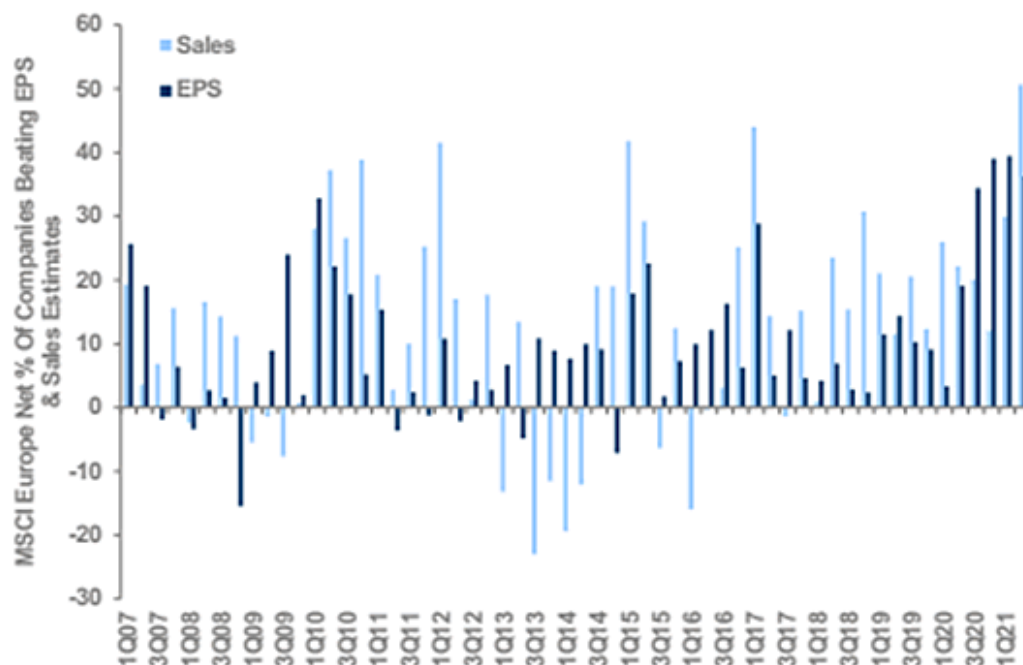
Headline Numbers

Back in Europe, the bulls will also have something to cheer about as the 2Q21 reporting season winds down. Morgan Stanley analysts have been tracking the numbers, as always, and report a strong set of numbers. "Weighted earnings are well ahead of expectations too, but price action shows a negative skew. One sweetener has been buybacks, which have been surging in Europe. "

In detailed terms, they've tracked 58% of companies beating their EPS estimates with only 22% missing, which gives a net beat of 36% of companies. "Sector/style wise, net beats have been most prominent for value stocks which have posted a record differential in the breadth of beats versus growth stocks. Elsewhere, large caps and financials have also surprised positively on EPS."

These strong numbers have had an inevitable knock on effect, with earnings being revised up fairly constantly - the Morgan Stanley analysts reckon that "European earnings revisions are close to a historic high relative to global peers".

Exhibit 2: Europe has so far delivered a strong breadth of net EPS beats at +36% with the breadth of Sales beats even higher at +51%.



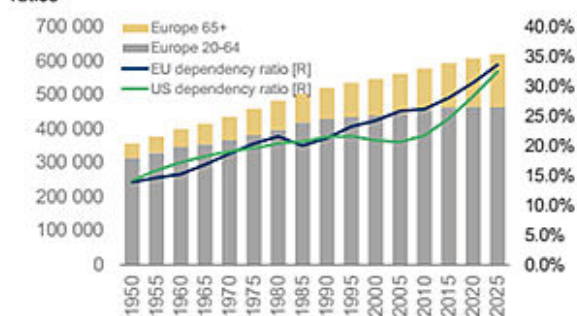
Source: MSCI, Bloomberg, Morgan Stanley Research

Note: EPS beat / miss defined as +/-5% from consensus estimates

A few weeks ago I ran a column for Citywire on the biggest thematic of them all - an aging population. It makes the point that figuring what's happening with an aging population doesn't necessarily result in a successful investment strategy. Like everything in thematic land, it's complicated. But one point is worth dwelling on - Europe and its aging population. It's become axiomatic that amongst Europe's many challenges, population decline and aging are near the top (though not quite as much as Japan). The bottom line - America is younger, Europe by contrast faces dependency ratio problems. QED invest in the US.

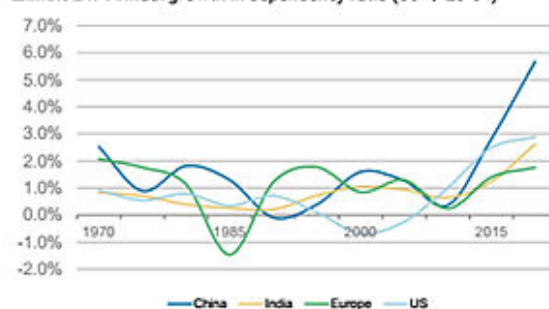
That may not be true, according to a recent Morgan Stanley thematic report on global demographics. According to *Demographics: Gradually, Then Suddenly*, the latest updated projections show that "Europe is about to enter a period of relative 'levelling up'" (Exhibit 22). From 1990 onwards, Europe was ageing about two decades ahead of the trajectory in the US and even more so relative to China. Within the space of this decade to 2030, Europe will be at parity with China and will have closed the growth and dependency gap by half with the US. While this alone cannot solve Europe's economic and innovative underperformance relative to the US and China, the levelling of the demographic playing field presents the best opportunity in over 60 years for relative growth outperformance..."

Exhibit 23: Europe population structure and EU/US dependency ratios



Source: UN Population projections, Morgan Stanley Research

Exhibit 24: Annual growth in dependency ratio (65+ / 20-64)



Source: UN Population projections, Morgan Stanley Research

"While Europe's dependency ratio is still likely to worsen than improve, its relative positioning is the most attractive it has been since 1985. This could in turn support relatively superior economic growth outlooks and the comparative attractiveness of Europe to global investors. Given the speed at which demographic and behavioural changes are now occurring, we believe investors should consider this relative demographic outlook in their portfolio construction."

Measure	Values as of 13th July, 2021	Values as of 11th August, 2021
UK Government 10 year bond rate	0.63%	0.61%
GDP Growth rate YoY	-6.10%	-6.10%
CPI Core rate	2.10%	2.50%
RPI Inflation rate	3.30%	3.90%
Interest rate	0.10%	0.10%
Interbank rate 3 month	0.08%	0.07%
Government debt to GDP ratio	97.40%	97.40%
Manufacturing PMI	63.9	60.4

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Bank CDS options

Some marked moves in the market for bank swaps this month. Many of the European banks have seen their rates for 1 year swaps plunge to near time all lows (especially Lloyds and BNP). In fact rates for most European banks bar Deutsche have slipped over the last four weeks whereas rates for most American banks have started to edge higher, perhaps reflecting concerns about the rapid rise of Delta variant infections and a possible slowing of growth.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	8.17	29.32	A	A2	A -
Barclays	8.03	41.35	BBB	Baa2	A
BNP Parabis	5.52	27.47	A+	Aa3	A+
Citigroup	28.12	53.44	BBB+	A3	A

Credit Suisse	19.01	53.26	BBB+	Baa1	A-
Deutsche Bank	28.14	70.19	BBB+	A3	BBB
Goldman Sachs	28.56	57.43	BBB+	A2	A
HSBC	8.53	29.87	A+	A1	A-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	25.25	46.47	A-	A2	AA-
Lloyds Banking Group	5.5	29.39	BBB+	A2	A
Morgan Stanley	28.14	54.43	BBB+	A1	A
Natixis	34.08	46.43	A	A1	A+
Nomura	17.52	54.61	BBB+	Baa1	A-
RBC	15.37	36.25	AA-	A2	AA-
Soc Gen	5.57	28.62	A	A1	A-
UBS	7.52	26.37	A-	Aa3	A+

Source: Tempo Issuer & Counterparty Scorecards ('TICS') 1st August 2021 www.tempo-sp.com

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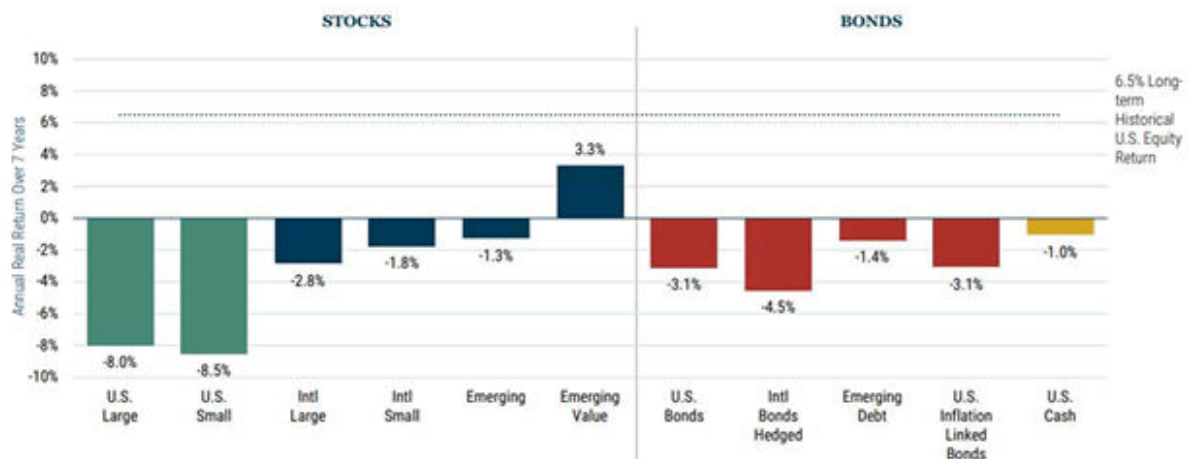
Government Bonds

Fixed Income

My sense is that one of the most important untold stories in investment is the remorseless decline of the 60/40 portfolio. We all know the drill: diversify sensibly, invest 60% in equities, 40% in lower volatility bonds. Combine the two and hey presto you have sensible diversification on the cheap. Except that that isn't true anymore. US fund manager is the latest in a long list of managers who have abandoned this thinking, as is obvious from the chart below which shows the firms' 7 year forecast returns from various asset classes. As GMO admits "we are loath to recommend a traditional 60/40 mix. There will come a day when global equities and government bonds are fairly valued and should deliver a "normal" real rate of return. On that day, GMO will be the first in line to tell you to own that traditional mix. Today, however, is still not that day.". And its easy to understand why if bonds are likely to provide an annualised real negative return of between 1 and 55 per annum for the next seven years. Now, for context, GMO is a notoriously bearish shop and so its 'forecasts' should be treated with some cation but its hard to argue with their core logic - that the 60/40 portfolio doesn't work at the moment.

7-YEAR ASSET CLASS REAL RETURN FORECASTS*

As of June 30, 2021



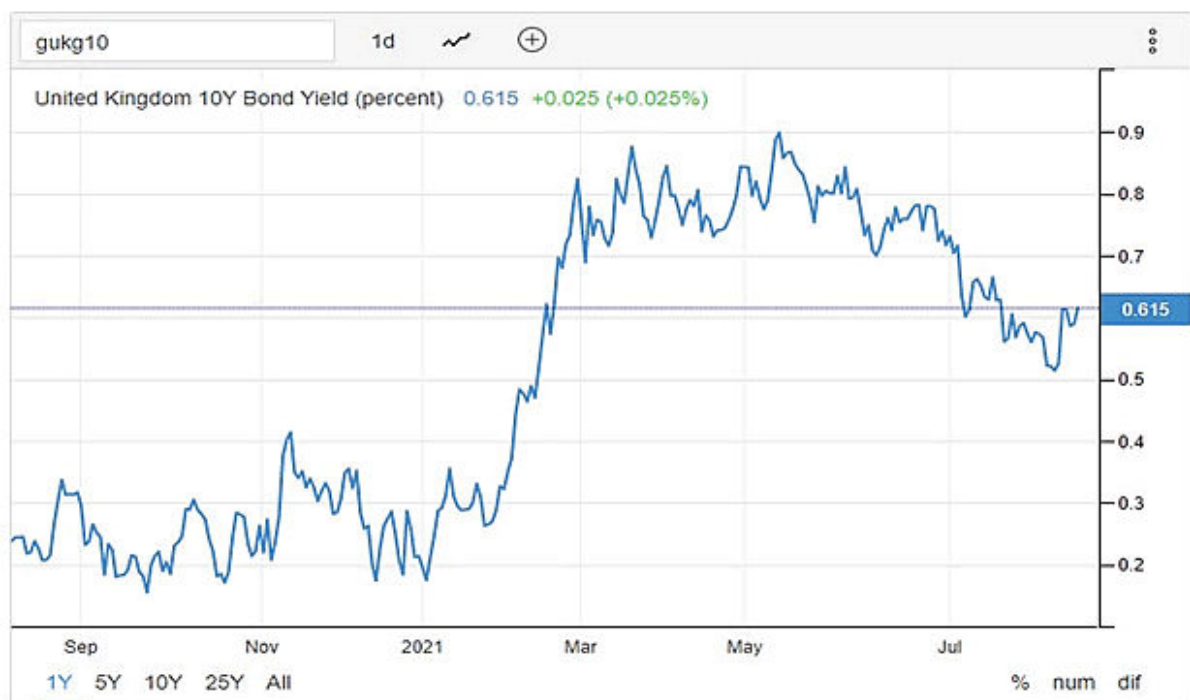
Source: GMO

*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

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GMO

UK Government Bonds 10-year Rate 0.61%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	19.79

Germany	9.61
Japan	17
United Kingdom	9.1
Ireland	16.4
Italy	71.2
Portugal	28.54
Spain	29.2

Eurozone peripheral bond yields

Country	July 2021	August 2021	Spread over 10 year
Spain 10 year	0.32%	0.26%	70
Italy 10 year	0.71%	0.60%	104
Greece 10 year	0.73%	0.55%	99

	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

July wasn't a that bad a month for equities again, according to analysts at S&P Dow Jones. Developed world equities advanced 1.19%, while global equities only nudged higher, with a 0.32% gain. Yet again the US markets outperformed - up 1.68% against the UKs 1.13% gain.

That said, for July, according to S&P Dow Jones 15 of the 25 markets gained, up from last month's 6 and down from May's 22. Luxembourg did the best, adding 8.41% for the month, 11.43% for the three-month period, and 21.12% YTD. Finland was next, adding 5.59% for the month, 8.81% for the three-month period, and 18.03% YTD, followed by Sweden, which was up 5.05% for the month, 6.14% for the three-month period, and 18.05% YTD.

Global market returns for July from S&P Dow Jones

S&P Global Broad Market Index(BMI) Global				
US MKT	BMI MEMBER	FROM 11/3/2020	1-MONTH	YTD
\$273	Saudi Arabia	38.91%	0.29%	27.36%
\$72	U.A.E.	43.34%	3.50%	26.91%
\$877	Netherlands	45.23%	4.55%	23.45%
\$51	Luxembourg	60.30%	8.41%	21.12%
\$59	Kuwait	22.45%	3.93%	19.78%

\$2,287	Canada	34.46%	-0.35%	19.00%
\$918	Sweden	39.77%	5.05%	18.05%
\$304	Finland	33.50%	5.59%	18.03%
\$10	Czech Republic	51.13%	-0.32%	17.82%
\$1,188	India	41.92%	1.41%	17.79%
\$1,410	Taiwan	38.34%	-2.16%	17.55%
\$75	Austria	52.25%	1.60%	17.15%
\$44,919	United States	31.96%	1.68%	16.48%
\$318	Russia	45.75%	-1.86%	15.71%
\$174	Mexico	44.66%	1.74%	15.40%
\$21	Hungary	49.59%	0.79%	14.79%
\$366	Singapore	35.10%	0.85%	14.78%
\$2,056	France	37.01%	1.37%	13.79%
\$75	Poland	44.72%	0.45%	13.77%
\$69,994	Developed	30.17%	1.19%	13.55%
\$512	Denmark	30.07%	4.32%	13.47%
\$187	Ireland	26.30%	3.40%	12.80%
	Global	28.34%	0.32%	12.06%
\$3,057	United Kingdom	32.07%	1.13%	11.76%

Of note, the U.K. was up 1.13% for the month, up 1.80% for the three-month period, and up 11.76% YTD. I would also add that since the market lows of early March 2020, UK equities have now advanced 32.07% versus 31.96% for the US. Finally, the UK closes the gap, a bit.

Sticking with aggregate market data, here's an stand out fact on UK equities from Nick Lawson at investment house Ocean Wall : "Over the past decade, UK equities have consistently underperformed other major developed markets in terms of total shareholder returns; between 2010 and 1H 2021, S&P 500 delivered 379% return, DAX delivered 111% whilst the FTSE 100 delivered only 69% (and only 9% excluding dividends) in dollar terms. Currently, the S&P 500 trades at a 2022 P/E multiple of c. 20.5x vs FTSE100 2022 P/E of c.12.6x and FTSE250 2022 P/E of c. 16.0x.".

If like me, you think UK equities are still undervalued, I'd argue we have more to go for the UK equities revival.

Index	July 2021	August 2021	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract#	98.1	100.5	4193	94
FTSE 100 (Dec 19)	238.5	243.9	7193	228.5

Note changed to Dec 2021 contracts in January 2021

Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	

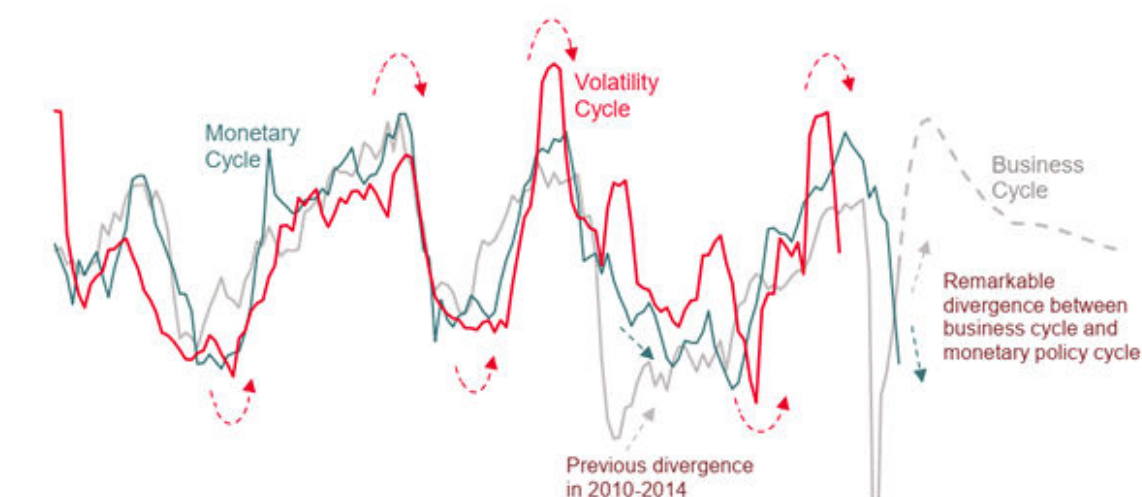
FTSE 100	0.942	3.47	10.1	16.8	3.97	7.87	7189
S&P 500	1.54	6.86	13.3	33.1	103	113	4436.75
iShares FTSE UK All Stocks Gilt	2.12	4.09	0.236	-3.32	1.11	15.3	1430
VIX New Methodology	3.34	-23.4	-21.3	-30.4	43.2	22	16.72

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Volatility

I couldn't resist featuring this chart below from derivatives analysts at French bank SocGen. It's a follow up on a paper from a colleague, Albert Edwards, who observed that there were some signs that "the current recovery may not be a new economic cycle but rather the old one briefly interrupted by the pandemic". This prompted the derivatives analysts to update their own models which tend to track two key signals as an indicator for future market volatility - the monetary and business cycle which tend to be 'closely aligned'. But, during the last cycle it became abundantly "clear that in the event of a divergence between the two, it's monetary policy that seems to drive equity volatility. At least that was the case the last time the monetary-policy cycle and business cycles diverged (2010-2014)". Cue the fascinating chart below which begs the same debate - which signal will impact volatility. Overall their base case remains that volatility will "test newer lows for the next couple of years, given extremely easy monetary policy, and for the two- to three- year lag to feed into equity volatility".

Divergence between the monetary-policy cycle and business cycle in the US – Which one will drive volatility?



Source: SG Cross Asset Research/Derivatives

Measure	August Level	July Level	June Level	May Level
Vstox Volatility	17.4	18.04	17.59	16.69
VFTSE Volatility	16.72	16.7	16.7	21.83



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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 its 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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