



Monthly Market Report

September 2022



With commentary from David Stevenson

Who knows what goes through the minds of investors when they decide on whether to be bullish or bearish about stocks and shares but I reckon the key consideration for benchmark indices such as the S&P 500 has to be what happens to earnings in the final two quarters of 2022. If you think, like most bottom-up analysts, that corporate earnings will be strong, then the current level of the S&P 500 looks about right (give or take 5 to 10%). If, on the other hand, you believe like I do that a recession (in the UK)/ slowdown (in the US) is imminent and corporate earnings will fall sharply (by as much as 15%), then the current level of the S&P 500 isn't realistic. So, corporate earnings are crucial.

Now its important to say that the data on Q2 earnings so far is looking pretty good - at least according to data from Factset. Their earnings Scorecard points to the fact that 60% of S&P 500 companies have reported a positive EPS surprise and 60% of S&P 500 companies have reported a positive revenue surprise. For the full year 2022, analysts are projecting earnings growth of 9.9% and revenue growth of 10.7% with a bottom-up target price for the S&P 500 of 4847.85, well above where we are. The last point - the target price at 4847 for the S&P 500 - strikes me as essentially ludicrous and exposes the real gap between top-down analysts worried about recession and bottom-up analysts fixated on their models.

More recently, analysts at Deutsche Bank have weighed in with even more up to date numbers which show that in the current quarter earnings growth is still "strong at the headline level but is down sharply below the surface". But these numbers are flattered by a massive increase in Energy earnings (+10.5pp boost to S&P 500 growth) as well as the return to profitability for the pandemic-impacted companies (+2pp). Excluding the impact of these three items, underlying earnings growth for the rest of the S&P 500 is only at a modest 1.2% yoy. On a sequential basis qoq, underlying earnings adjusted for seasonality are on track to fall sharply by -4.5% qoq, one of the steepest declines over the last decade, reckon the Deutsche analysts, comparable to those seen in the early stages of the pandemic [my emphasis in bold]. Overall these Deutsche numbers confirm my own worst fears - we are probably experiencing a sharp slowdown in earnings growth, and if that Q-on-Q number holds I think we could test a 10% decline in earnings in the next 12 months.



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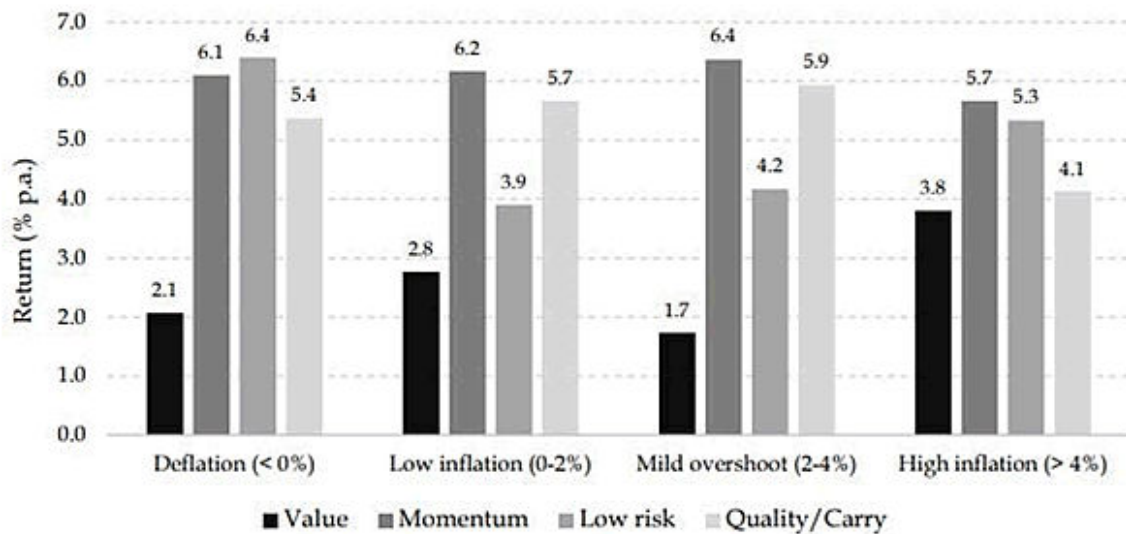
Headline Numbers

European asset management firm Robeco has a terrific track record for its quantitative research, much of which is of the highest academic quality. So, when it comes to useful data on what kind of investments have worked during periods of high inflation, it's worth taking note. A case in point is their latest research paper entitled: *Investing in deflation, inflation, and stagflation regimes*. In this the Robeco analysts, examine asset class and factor premiums across inflationary regimes, starting as far back as 1875.

It shows that moderate inflation scenarios provide the highest returns across asset class and factor premiums. During deflationary periods, nominal returns are low, but real returns are attractive. "By contrast, real equity and bond returns are negative during a high inflation regime, and especially so during times of stagflation" observes the Robeco researchers. "During these 'bad times' factor premiums are positive, which helps to offset part of the real capital losses." These numbers have a number of implications not least that factor strategies "provide consistent value add for traditional portfolios. These premiums provide diversification, but at the same time are also not a perfect hedge against inflation, as their returns do not substantially increase during the worst times."

Figure 5: Factor premiums across inflation regimes, 1875-2021

The figure shows the historical average return on Value, Momentum, Low risk and Quality/Carry factor premiums across inflationary regimes. Factor premiums are computed as the equally weighted average of equity, government bond, and global factor premiums. The sample period is 1875-2021.



Another study worth picking up is from the Man Group which looks at what we might expect to happen to portfolios in the second half of this year. The data is in a fascinating paper called [The Road Ahead : Riddles in the Dark](#) which is based on ferreting out 222 years of monthly data for a US 60/40 portfolio, and then using this to analyse returns in the first half of the year - and then into the second half. According to Man, the first half of 2022 was the second worst first half performance for 60/40 portfolio in more than two centuries: In 79% of years a 60/40 portfolio was positive through to June. Not this time! But there was some good news though - according to the Man Group, after big historic falls, "there has tended to be a sharp H2 bounce: In the ten worst H1s (excluding 2022), average performance was -12%. For the corresponding H2s the average was 10%, and the positive hit rate was 90%". That said most of the big absolute 60/40 moves (up and down) happened a long time ago. Prior to 2022, there had not been a +20% or -10% year since 1975. Maybe the second half of 2022 will bring better news for diversified investors, though personally I think not.

Measure	Values as of 12th July, 2022	Values as of 11th August, 2022
UK Government 10 year bond rate	2.04%	1.99%
GDP Growth rate YoY	8.70%	8.70%
CPI Core rate	5.90%	5.80%
RPI Inflation rate	11.70%	11.80%
Interest rate	1.25%	1.75%
Interbank rate 3 month	1.76%	2.10%
Government debt to GDP ratio	94%	95.90%
Manufacturing PMI	52.8%	52.1%

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Bank CDS options

Rates on credit default swaps for bank debt fell across the board in the last four weeks, with many seeing very substantial declines especially at the five-year level - the drop for Deutsche Bank was particularly noticeable. That said UBS did see a small increase in pricing for its 1-year swaps. Overall Natixis boasts the cheapest rates for both 1- and 5-year swaps.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Banco Santander	29.28	70.12	A+	A2	A -
Barclays	55.39	101.3	BBB	Baa2	A
BNP Parabis	30.37	60.44	A+	Aa3	A+
Citigroup	52.96	100.99	BBB+	A3	A
Credit Suisse	121.71	179	BBB+	Baa1	A-
Deutsche Bank	99.65	170.92	A-	A2	BBB+
Goldman Sachs	52.9	107.93	BBB+	A2	A
HSBC	29.56	56.47	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	46.26	84	A-	A2	AA-
Lloyds Banking Group	30.98	58.12	BBB+	A2	A
Morgan Stanley	55.27	100.99	BBB+	A1	A
Natixis	19.5	45	A	A1	A+
Nomura	29.67	100	BBB+	Baa1	A-
RBC	23.5	70.94	AA-	A1	AA-
Soc Gen	33.32	72.14	A	A1	A-
UBS	27.28	65.21	A-	Aa3	A+

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

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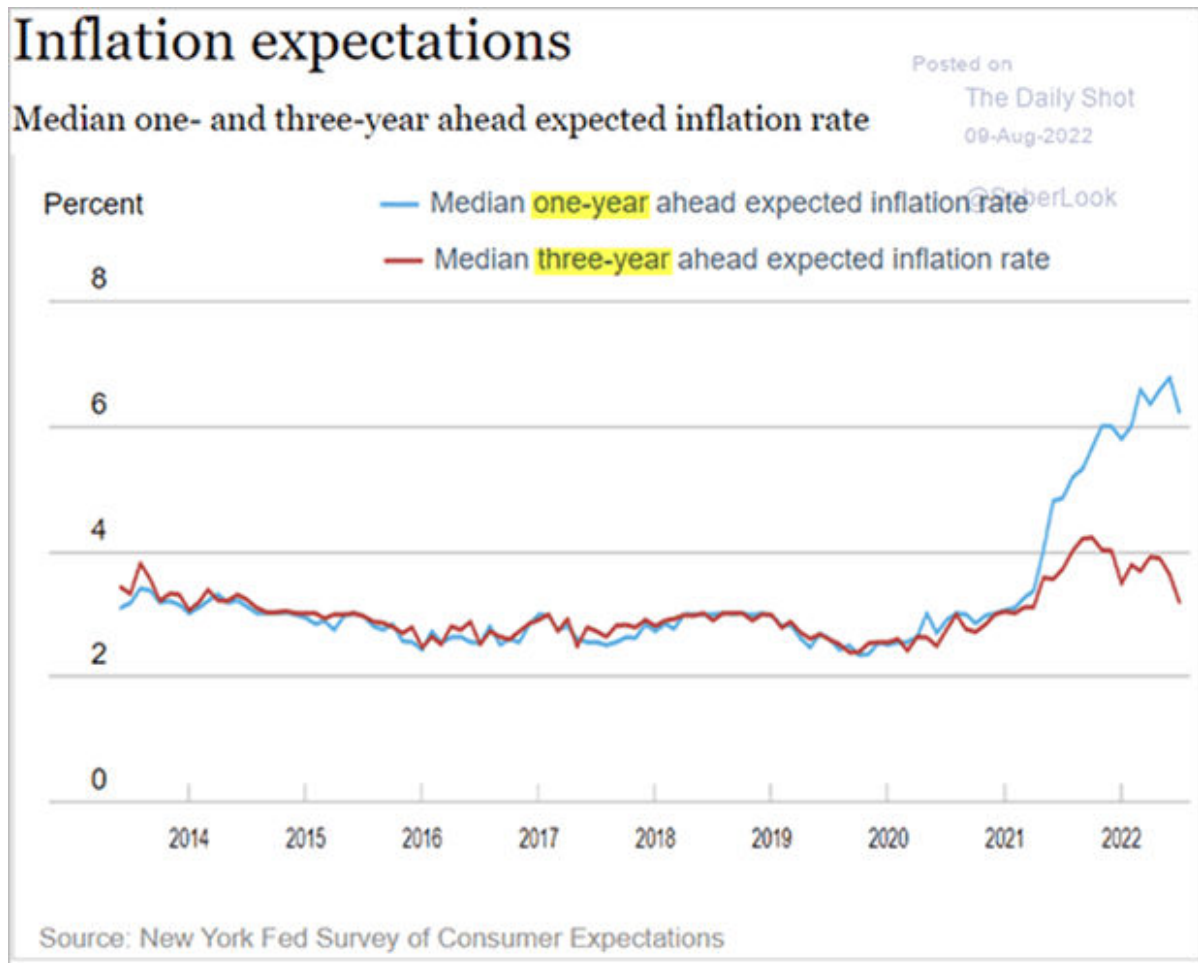
Government Bonds

There's a strange disconnect emerging. If you look at the actions of the US Federal Reserve and the words of the governor of the Bank of England, we are entering an inflationary dystopia. This powerful argument is being used to justify sharply increased interest rates - the markets are already assuming interest rates above 3.5% but maybe 4.5% could be the next target ? But if we look at other measures of inflation, especially those based on market expectations, then the picture is much less dramatic. Two charts should suffice to make the point, both from the excellent Daily Shot website.

The first shows inflationary expectations for US inflation rates 1 and 3 years out. The one year chart looks scary enough but is trending down already while the 3 year chart looks anchored to

long term rates around the 2 to 3.5% range. These numbers suggest we are not about to enter into an inflationary inferno, at least not in the US that is.

The one year chart looks like this:



The second chart below, also sourced originally from the US Federal Reserve echoes the broad point - it shows plummeting inflation expectations for a range of key goods and services. These numbers help inform any debate about why the US 10 year yield is still anchored below 3% - its currently at 2.80%. The rate has peaked above 3% in recent months but is a long way from where many bears thought it might be - I myself think a rate of 3.5% or more is sensible and would act as a key trigger for buying US government bonds. Evidently the markets still think inflation has peaked and is under control. Needless to say, the bears think this is obviously complacent.

One-year ahead commodity price change expectations

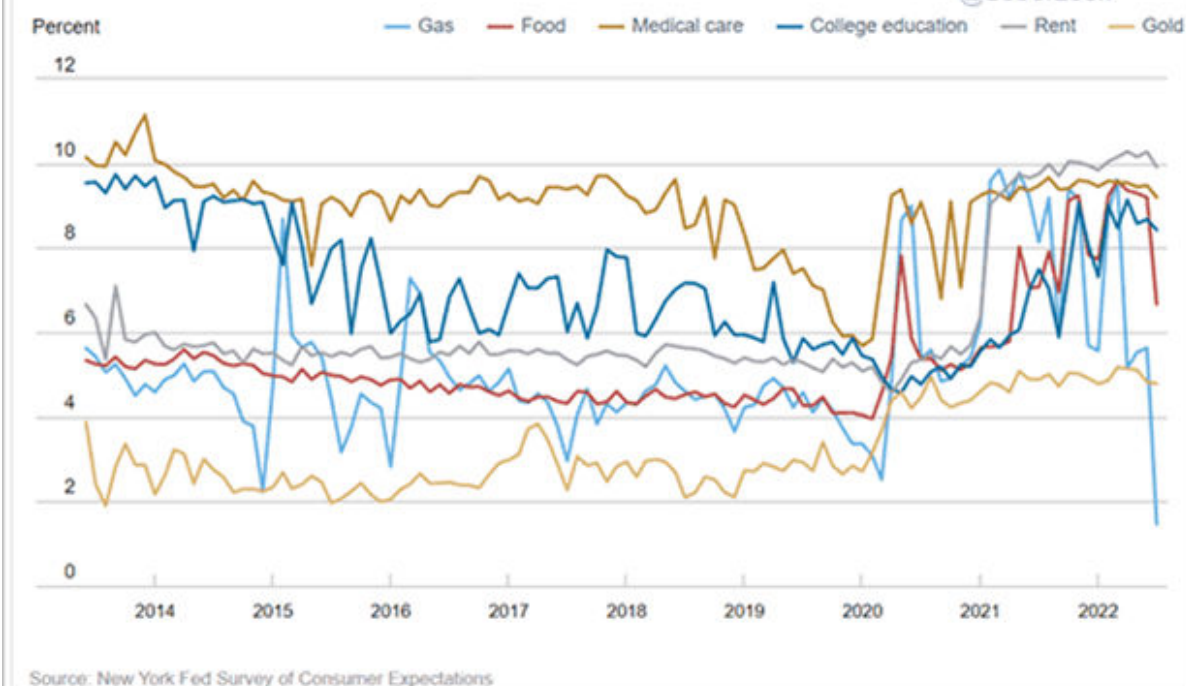
Median point prediction

Posted on

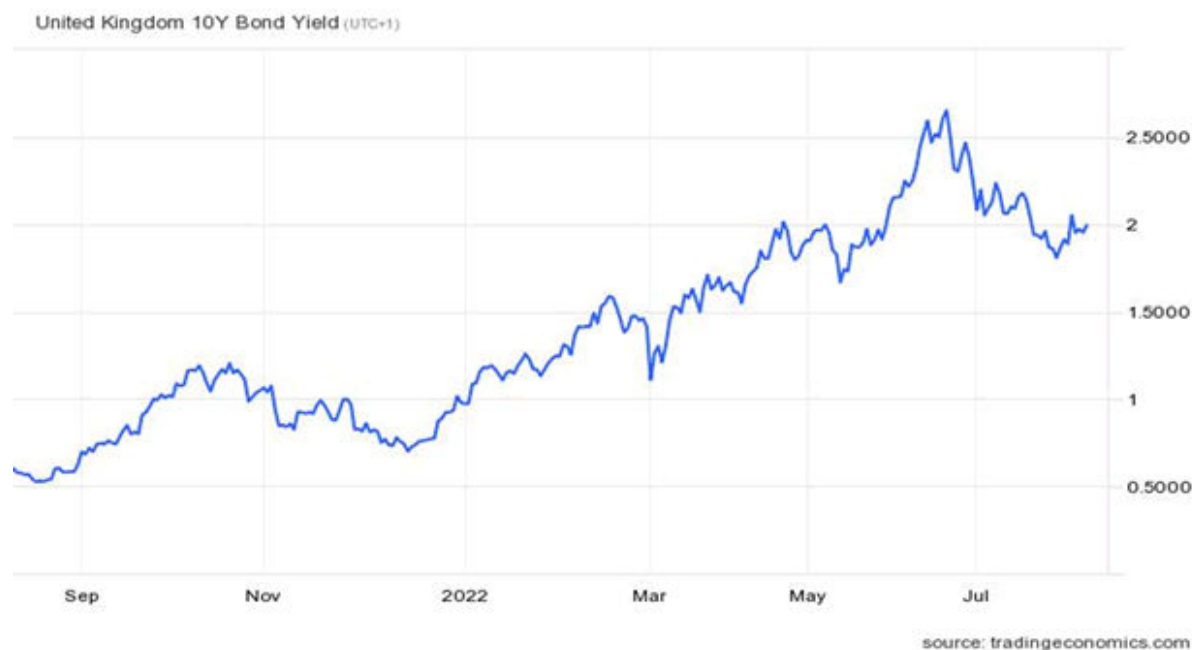
The Daily Shot

09-Aug-2022

@SoberLook



UK Government Bonds 10-year Rate 1.99%



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

CDS Rates for Sovereign Debt

Country	Five Year
France	26.4
Germany	15.5

Japan	22.3
United Kingdom	16.31
Ireland	18.3
Italy	141.9
Portugal	51.2
Spain	51.3

Eurozone peripheral bond yields

Country	July 2022	August 2022	Spread over 10 year
Spain 10 year	2.22	1.99%	108
Italy 10 year	3.10%	2.98%	207
Greece 10 year	3.48%	3.19%	228

	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

Back on the subject of how portfolios have fared in the first half of this year (see the earlier analysis by the Man Group) Asset Risk Consultants (ARC) has pulled together performance data on 300,000 portfolios managed by 100+ managers. It's key message is a classic one - the importance of diversification.

Overall, the majority of investors saw a decline in value of 10% in their portfolios in the first half of 2022 - average private client portfolios were also down 7.3% in the second quarter of 2022* (YTD -11.1%). But greater diversification would have capped losses to less than 10% ARC reckons, especially as value stocks outperformed growth stocks in 2022 by an average of 16 percentage points (-12% v -28%**). ARC also notes that the past six months' losses "are amongst the worst recorded for nine of the 16 asset classes Asset Risk Consultants have been monitoring for its indices since they began in 2003".

	Risk Relative to World Equities	Returns for 3 months to June 2022		
		GBP	USD	EUR
ARC Cautious PCI	0% - 40%	(4.7)	(6.2)	(6.0)
ARC Balanced Asset PCI	40% - 60%	(6.2)	(9.7)	(7.8)
ARC Steady Growth PCI	60% - 80%	(7.3)	(11.9)	(9.4)
ARC Equity Risk PCI	80% - 110%	(8.4)	(14.3)	(10.5)

	Risk Relative to World Equities	Returns for 12 months to June 2022		
		GBP	USD	EUR
ARC Cautious PCI	0% - 40%	(5.5)	(9.9)	(8.0)
ARC Balanced Asset PCI	40% - 60%	(6.5)	(13.1)	(9.1)
ARC Steady Growth PCI	60% - 80%	(7.5)	(14.6)	(9.1)
ARC Equity Risk PCI	80% - 110%	(9.1)	(18.1)	(9.2)

Index	July 2022	August 2022	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 21 contract	120.4	121.6	3751	120.7
FTSE 100 Dividend Dec 2022	273.1	271.4	7488	270.2

Note changed to Dec 2022 contracts in January 2022

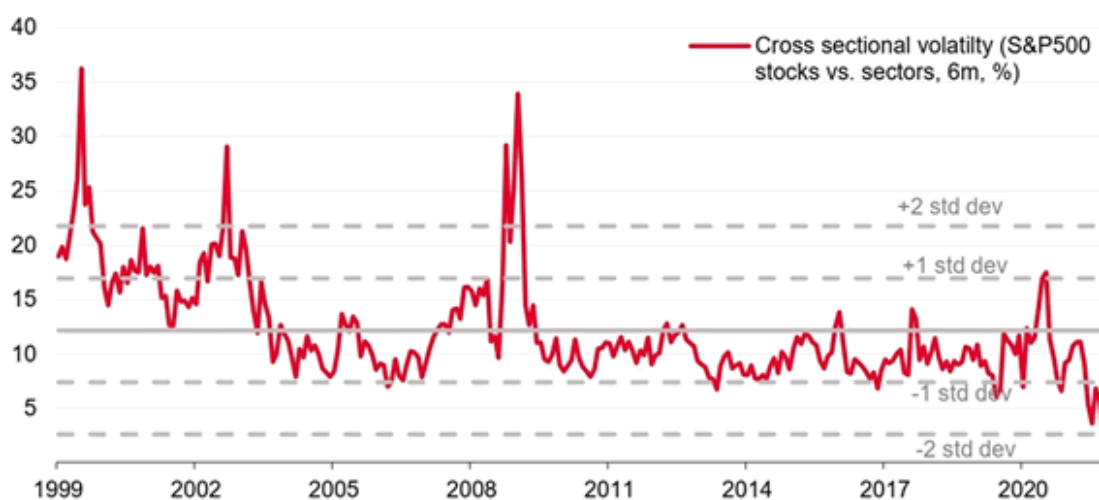
Name	Price % change						Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	4.03	1.89	-2.28	3.69	2.41	8.25	7486.42
S&P 500	9.23	6.99	-4.72	-5.34	72.5	92.6	4210.24
Gold Composite (Most Traded)	4.65	-2.23	-1.62	3.37	39.9	34.7	1812.30¢
iShares FTSE UK All Stocks Gilt	2.2	-2.97	-6.91	-15.1	-8.64	-14	1216.75p
VIX New Methodology	-16.8	-33.1	-20.4	35.6	40.4	86.4	21.77

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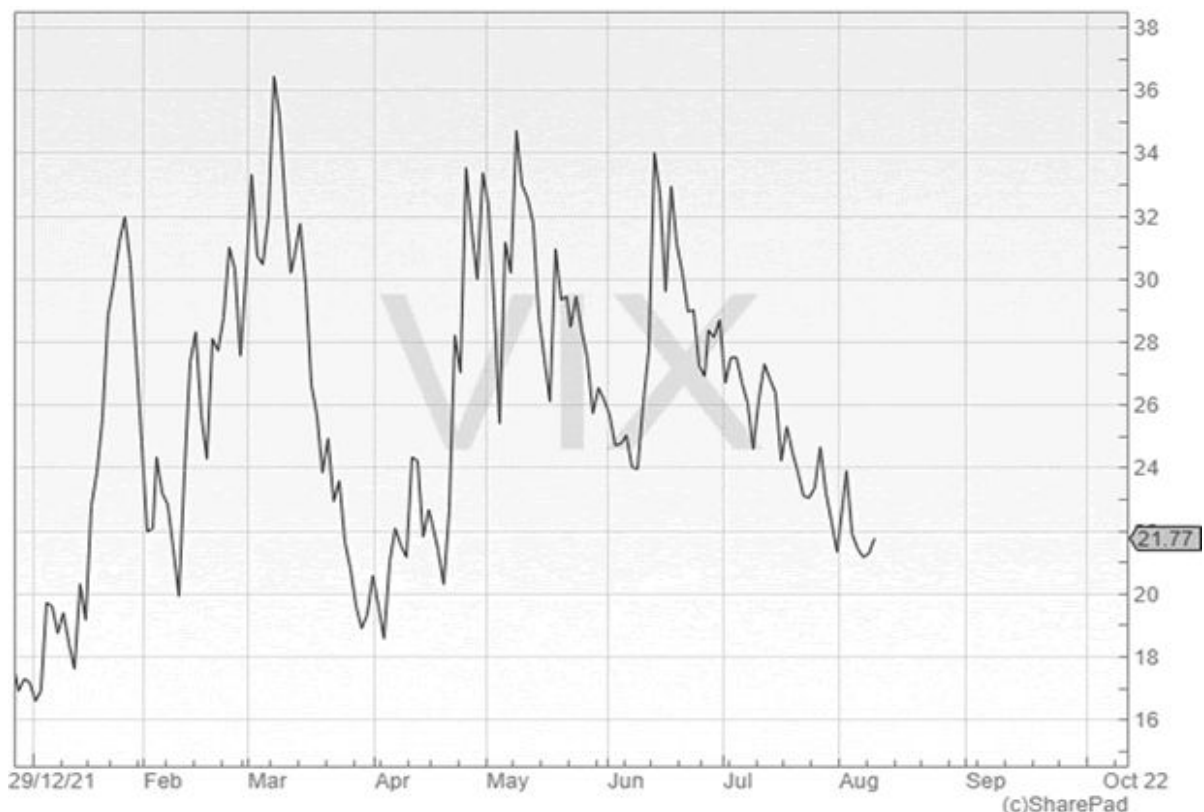
Volatility

An interesting although slightly nerdy observation - talk to most quantitative analysts and they'll say that the volatility in stockmarkets over the first half of the year has been driven not by lots of individual stock moves in different directions but by macro considerations. In a sense that is obvious, given the hysteria around stagflation, but it is worth stating. According to quants at SocGen the spectrum of stock return distributions year to date is much narrower than in previous sell offs. They reckon that the volatility we've seen so far in 2022 has in fact resulted from extreme dispersion between sectors (and not stocks), especially in the US. In sum, they, like most quant observers, conclude that "this the most macro-driven market environment of the past two-and-a-half decades". The chart below shows the unprecedented difference between the cross-sectional volatility of stocks and the cross-sectional volatility on sectors within the S&P 500.

Cross-sectional volatility (stocks/sectors) in the US at unprecedented levels



Source: SG Cross Asset Research/Derivatives, Refinitiv Eikon Datastream



Measure	August Level	July Level	June Level	May Level
Vstox Volatility	n/a	29.63	23.92	29.61
VFTSE Volatility	21.7	26.17	26.19	31.77

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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.

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