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Monthly Market Report

September 2023

With commentary from David Stevenson

While most pointy heads in investment land are focused on what they think is the next big debate - inflation redux with rates moving up again towards the end of the year - the markets aren't taking a great deal of notice. Sure, the valuation of AI darlings like Nvidia at over 200 times earnings might have got a bit out of hand but overall, most investors, especially those in the structurally important US market, seem in relatively buoyant mood. On that US point it's worth noting that the US now accounts for 62% of the global market cap in the MSCI All Country World Index. As always, the US really, really matters if you are an equity investor.

One way of divining investor mood is to look at investor positioning, the subject of regular investment bank briefings. A recent one from analysts at Deutsche Bank traced out some of the reasons for optimism, including optimism on AI, avoiding the debit ceiling standoff, avoiding the liquidity trap that developed after the bank runs, strong macro data and the downward surprise in CPI data in many nations. If you want to build an even more bullish case for US equities, it's also worth listening to the equity strategists back at SocGen who reckon that there have been a host of additional positive bottom-up signals since the start of the year. They point other tailwinds such as surging corporate earnings, and the non residential construction boom in the US(which includes the reshoring boomlet). They reckon there is an outside chance that of a big positive momentum breakout at some point in the remainder of 2023, pointing to the example of the mid 1990s when the Fed rate cuts coincided with a productivity driven disinflation cycle. If that was to happen they reckon the US benchmark S&P 500 index could reach as much as reach 5,500 "if the AI boom trades similar to the TMT boom (25x PE)". Personally I wouldn't say it's a low probability event myself, just a LOWER probability event - say 20%. That said, I'll throw one last stat at you - 45.5% of stocks in the Russell 2000 are unprofitable based on pro-forma EPS. Any broad valuation surge might be built on weak foundations.

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Headline Numbers

Every few weeks I read a story that is centred on the collectibles markets which says that wine/whiskey/art/anything collectible has hit a recent high and that investors are chasing emotional assets. I say that it raises a smile because if there is any niche market that is likely to have been impacted by the end of near zero rates, its collectibles. The argument is as follows - easy money made many businesspeople very rich. That left them with lots of spare money, much of which they ploughed into art or even farmland. Now that interest rates are back closer to historic norm, there is some evidence that the rich aren't getting even richer quite as quickly - except if they work in AI - which means that demand for collectibles might begin to tail off. Evidence for my hunch isn't plentiful but I do note a recent article in the Wall Street Journal which observes that *"Christie's blamed a supply shortage for the drop in its overall sales during the first half of the year, which fell 23% to $3.2 billion compared to a year ago, the privately held London house said Wednesday. Christie's said its total included $2.7 billion in auction sales, down 23%, and $484 million in privately brokered art sales, down 19% compared to the first half of 2022. A recent report from auction research firm ArtTactic said it found the house had auctioned roughly $2.8 billion in the first half, down 7.8% compared to the same period last year. Sotheby's total doesn't reflect any additional private sales"*, ArtTactic said. The moral of the story - We're now seeing one consequence of the decline in personal wealth from volatile markets and declining IPOs. We're also seeing a third or fourth-order impact of tightening liquidity.

One of the possible side effects of the era of low interest rates, low inflation and easy money was that nearly all securities - bonds and equities - were quite closely correlated. Easy money flooded into everything offering yield and return. Now that we are in a potentially new era of tighter money maybe that relationship will break down and we might retreat to an either/or world? By this I mean in an easy money era, investors could afford to invest in both bonds and equities, although equities were probably more attractive. But tighter money might force on investors a choice either bonds or equities in order to produce a total return including a yield.

This either/or world tends to produce binary choices. At the moment, one possible explanation for bullish equities is that the main rival asset class, bonds, still look terrible value on most measures, especially as interest rates might not have peaked. The positive arguments for buy long duration bonds are rather thin on the ground whereas by contrast equities, while not cheap don't look expensive. The chart below is from the JPMorgan Asset Management mid year chart book. It shows the all important S&P 500 index and current valuations. As you see at roughly 19 times forward earnings US equities aren't cheap, but they are not quite, yet, expensive.

S&P 500 valuation measures

GTM | U.S. | 5

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since June 1998 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $233. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
Guide to the Markets – U.S. Data are as of June 30, 2023.

But at some point in this either/or world, bonds might start to look attractive again at which point equities might start to encounter a headwind or two. Quantitative analyst Chales Ekins of Ekins Guiness keeps a close eye on both valuation metrics AND momentum numbers for all assets classes and although he thinks there is still a bear market in bonds, the point at which bonds become more attractive in valuation terms is fast approaching.

According to Ekins, one measure - the size of the gap between Bond Value Yield and its trend level, measured in standard deviations - is now at 3.3 standard deviations which is the third highest since the early 1980s in valuation terms. The key driver is that "1 year inflation has fallen sharply down towards the nominal level of 10 Yr Treasuries, so real yields are now zero instead of deeply negative". To repeat, Ekins is not saying that bonds are quite ready to break out of their bear market funk but he does suggest that an "opportunity for bond markets may be coming and, if it materialises, it poses a risk for Equity markets", especially if US inflation numbers remain subdued. That said, many are betting that US inflation numbers don't stay subdued. More on that later.

Measure	Values as of 14th July 2023	Values as of 17th August 2023
UK Government 10 year bond rate	4.42%	4.70%
GDP Growth rate YoY	0.20%	0.40%
CPI Core rate	7.10%	6.80%
RPI Inflation rate	11.30%	9%
Interest rate	5%	5.25%
Interbank rate 3 month	5.50%	5.53%
Government debt to GDP ratio	101%	101%
Manufacturing PMI	46.5	45.3

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Bank CDS options

Credit default swap rates on the big systemic banks fell substantially across the board over the last month. The only bank to show an increase was UBS, for its 1 year rates, from relatively low levels. Many of its peers saw very substantial declines in rates at both the 1 year and 5 year mark, especially Deutsche, Goldmans and Morgan Stanley. For 1 year rates, the lowest rates are still those for Natixis although Santander and BNP Paribas aren't far behind. For 5 year rates BNP Paribas is in front, followed by Natixis and with HSBC not that far off.

Bank	One Year	Five Year	Credit Rating (S&P)	Credit Rating (Moody's)	Credit Rating (Fitch)
Santander	24.63	51.9	A+	A2	A -
Barclays	89.72	63.8	BBB	BAA1	A
BNP Parabis	23.17	44.8	A+	Aa3	A+
Citigroup	29.8	63.7	BBB+	A3	A
Credit Suisse	52.22	83.73	BBB-	BAA2	BBB
Deutsche Bank	85.14	136	A-	A1	BBB+
Goldman Sachs	38.56	70.66	BBB+	A2	A
HSBC	26.26	45.09	A+	A1	AA-
Investec	n/a	n/a	n/a	A1	BBB+
JP Morgan	26.37	51.22	A-	A1	AA-
Lloyds Banking Group	31.8	52.38	BBB+	A3	A
Morgan Stanley	33.07	75.69	A-	A1	A+
Natixis	21	48	A	A1	A+
Nomura	35.32	96.07	BBB+	BAA1	A-
RBC	25.75	76.15	AA-	A1	AA-
Soc Gen	30.38	54.83	A	A1	A-
UBS	42.78	66.55	A-	Aa3	A+

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

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Government Bonds

In recent months investors in most developed world markets have raced ahead to one inevitable conclusion which is that high-growth equities are the place to be because we are clearly approaching peak interest rates. Next up comes a widely anticipated economic slowdown (though

maybe not a recession) and then another pick up in demand and equities start to soar away again. There's also, obviously, the whole AI thing playing out but in essence, the story of the last six months has been where all the 'smart' money has gone on equities.

But it strikes me that now we're at another turning point. There are obvious risks to the bulls scenario, not least that the Fed seems in a combative mood and might not be happy with the current level of inflation, although it is falling sharply in the US. There's a large number of commentators who keep saying something along the lines of 'job done', or 'inflation back in the box'. This helps power the equity market bulls.

Yet there's a decent chance that the job is not done and that inflation could come surging back. A classic inflationista argument is currently being made by Vincent Deluard, a strategist at US firm Stone X. In a recently released paper The Inflation Miracle Will Not Last he echoes the points made by others including Research Affiliates Rob Arnott - watch for the second surge in prices. Amongst Delaurd's observations, he suggests that the long-term drivers of inflation, shelter and labour-intensive services, remain stuck at about 5% confirming the view of many that inflation has reset at a durably higher plateau. He also looks at his favourite indicator of the price of wages and rent, haircut inflation, which was unchanged at 5%. Last but by no means least, a reversal of healthcare inflation to its long-term trend of 4% would add about 40 basis points to the CPI.

In sum, this is the Inflation Redux argument i.e. inflation pops back up again like an unwanted guest. If that happens then it's reasonable to presume that interest rates will stay high (compared to the last decade) for longer - say through 2024 and possibly even beyond. The other awful possibility is that interest rates could even increase from the current pencilled-in peaks of between 5.5 and 6% in the US and the UK. I think that unlikely though not impossible.

If rates go even higher in the Inflation Redux scenario, then the table below I think is instructive. It shows US bond yields. As you would expect at the short end of the curve yields have caught up with historic (well, since 2007) highs. But at the long end of the range, there's still a lot further to go. The 30-year for instance topped out at 5.35% whereas it's currently at 3.91%. As for 10-year rates they hit 5.26% but are currently at 3.84%.

Yields and the Fed Funds Rate Since January 2007

Instrument	High	Low	Current	Basis Points From Low
30 Year	5.35%	0.99%	3.91%	292
20 Year	5.44%	0.87%	4.10%	323
10 Year	5.26%	0.52%	3.84%	332
5 Year	5.18%	0.19%	4.09%	390
2 Year	5.10%	0.09%	4.82%	473
3 Month	5.55%	0.00%	5.50%	550
FFR	5.41%	0.04%	5.08%	504

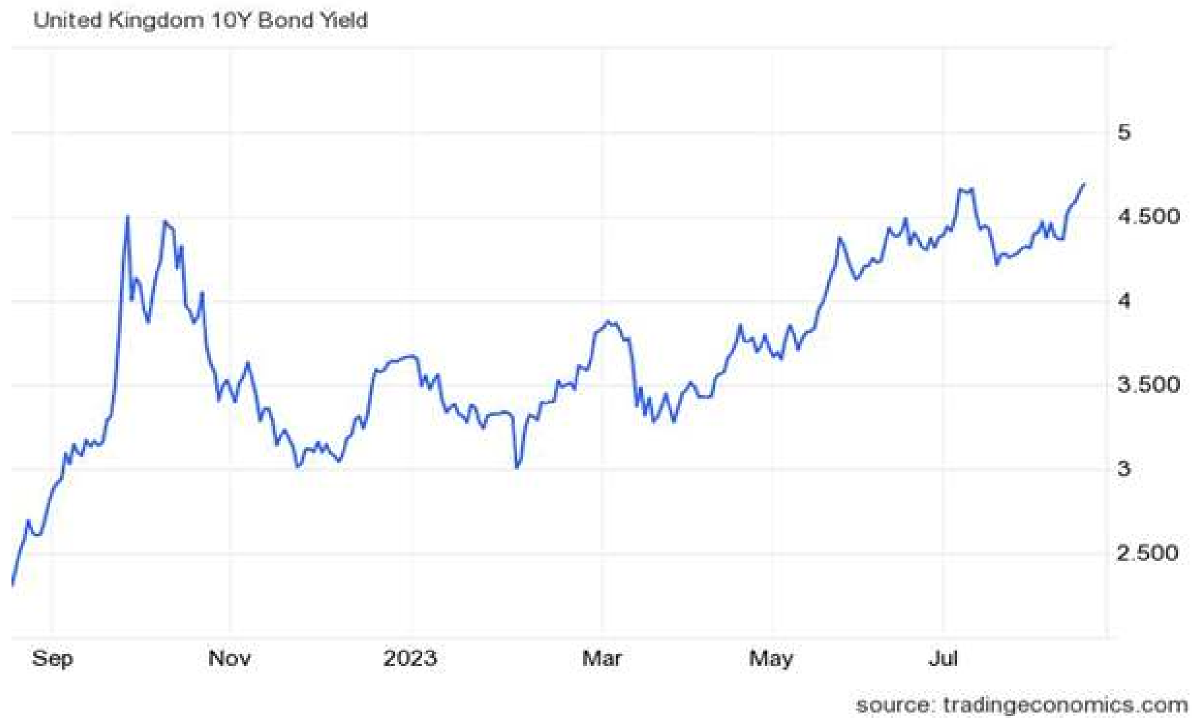
As of July 21, 2023

Source: https://etfdb.com/fixed-income-channel/treasury-yields-snapshot-july-21-2023/

The danger scenario here is that too many investors reckon Inflation is under control, pile in at the current yields and then see their longer-duration assets sour as investors start to focus on the

inflation-redux argument.

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	14.74
Japan	18
United Kingdom	27.73
Ireland	24.09
Italy	88.12
Portugal	45.78
Spain	47.8

Eurozone peripheral bond yields

Country	August 2023	July 2023	Spread over 10 year
Spain 10 year	3.74%	3.51%	105
Italy 10 year	4.39%	4.14%	170
Greece 10 year	3.98%	3.91%	129

	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

Over the boring summer weeks I've been playing around with data on regional stockmarkets, looking to see just how much variation there is in terms of valuations and earnings growth for some of the most well known equity markets. The two tables below, courtesy of data from SocGen, are the fruits of that labour. The first table groups together the nations and puts them into regional (and global) categories and then compares their valuations (PE) and EPS growth rates. Observers like me whinge all the time about crazy sky-high valuations for US equities but if we are honest those metrics simply reflect cold hard facts i.e. the US corporates are producing bumper profits.

That said I would make two other observations. The first is that the UK metrics are well deserved - our corporates are anaemic in terms of profits and thus, arguably, deserve their lowly rating. By contrast Japanese equities still look good value with steady earnings growth and a slightly above average PE rating though not egregiously so.

Region	PE 22e	PE 23e	PE 24e	PE 12 mth	23e EPS growth	2024e EPS growth
world	17.18	16.9	15.11	15.95	1.61	11.89
wolrd exc US	13.52	13.26	11.95	11.95	1.85	10.93
US	20.75	20.47	18.15	19.23	1.38	12.82
Europe	13	12.62	11.71	12.15	2.58	7.75
Eurozone	12.61	12.21	11.25	11.7	3.24	8.55
UK	10.3	10.59	10.02	10.33	-2.77	5.67
Japan	16.08	14.87	13.64	14.21	9.02	8.97
Pacific excl Japan	13.41	14.51	12.13	13.26	-7.85	19.6
Emerging	13.63	13.07	11.41	12.15	4.29	14.5

Source: SocGen

Next up we have recent returns - 12 mths and YTD to end of July - for a collection of developed world national markets. There are also two columns showing valuations (price to earnings again) and EPS growth which are based not on individual national indices but broader aggregate national numbers derived by the SocGen team.

Country (index)	12 mth return	YTD return	2023 PE estimate	2023 EPS growth
Austria (ATX)	10.6	-0.4	6.87	-6.83
Belgium (Bel20)	-7	-5.4	15.68	0.16
Denmark (QMX Copenhagen)	8.9	4.8	23.17	4.91
Finland (OMX Helsinki)	-5.1	-9.5	11.8	-2.14
France (CAC 40)	18.4	9.9	13.2	0.15
Germany (DAX)	21.5	12.1	11.49	0.59
Greece (FTSE ASE 20)	62.1	36.8	8.44	8.05
Ireland (ISEQ)	32.6	19.2	10.74	34
Italy (FTSE MIB)	28.9	17.2	8.37	9.13
Netherlands (AEX)	12.2	9.4	18.99	17.29
Norway (Oslo All Share)	0.6	0.4	9.97	-19.7
Portugal (PSI)	-1.3	2.9	13.78	14.85
Spain (IBEX 35)	14.9	9.9	10.29	4.32
Sweden (OMX Stockholm)	14.9	9.9	14.93	47
Switzerland	-0.6	1.4	16.92	6.72
S&P 500	12.7	14.6	20.47	1.38
Nikkei 225	22.3	24.1	14.87	9.02
Australia	5.9	0.1	14.86	-4.4
FTSE All Share	0	-2.9	10.59	-2.77
Canada (S&P TSX Composite)	4	2.3	13.44	-7.25
Note1 - source SocGen				
Note 2: The 23 PE estimate and 23 EPS Growth numbers bove				
are for whole nationl not just idnex (ie aggegate national)				

Source: SocGen

Again, I would make several observations, namely that the sheer variation in returns is extraordinary. A clear group of leaders emerges, including many European markets (especially Northern European), Greece, and Spain. Ireland and Italy are also outpacing US equities. The laggards are also clear - the UK, Norway, Belgium, Portugal, and Switzerland. Also Japan looks good again on these measures while the UK looks terrible although Australia and Canada don't look much better.

Index	July 2023	August 2023	Reference Index Value	Level 6 Months Ago
Stoxx 50 Dec 22 contract	143	143	4272	138.8
FTSE 100 Dividend Dec 2022	298	297.4	7350	295

Note changed to Dec 2023 contracts

Name			Price % change				Close
	1 mth	3 mths	6 mths	1 yr	5 yr	6 yr	
FTSE 100	-0.783	-4.85	-8.19	-2.23	-2.78	-0.534	7348.4
S&P 500	-2.62	5.9	7.97	3.05	54.5	81.2	4404.3
Gold Composite (Most Traded)	-1.08	-2.5	4.59	8.92	62.4	49.5	193520¢

iShares FTSE UK All Stocks Gilt	-1.7	-6.02	-7.29	-17.6	-26.1	-26.3	977.375p
VIX New Methodology	22.6	-2.43	-17.8	-17.3	30.2	5.85	16.46

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Volatility

Everyone loves reading bad news - its hard, evidence based, social scientific fact that purveyors of bad news tend to get more airtime than those proffering good news. That's especially true of markets - German strategist Joachim Klement who works at investment bank Liberum calls this the Casandra complex i.e. a fear of impending disaster.

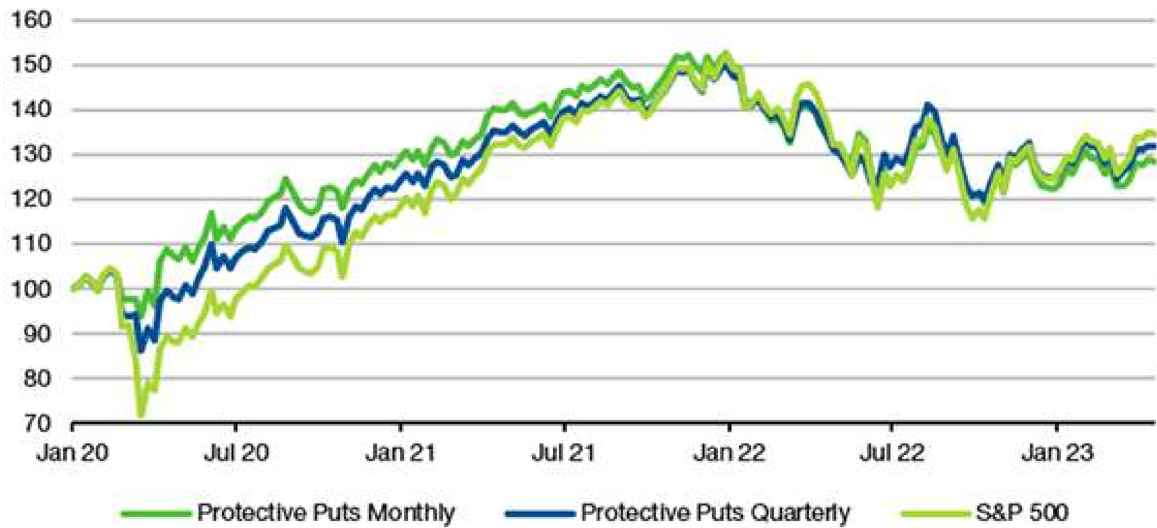
One of the consequences of this Casandra complex is the extensive use by finance professionals of systemic tail risk hedging strategies - there's certainly been an explosion of said products in ETF land in recent years. The $64 trillion question is do they work? Klement points to research by two academic economists - Roni Israelov and David Nze Ndong - who've looked at the performance of three different ways to protect a portfolio against extremely unlikely but potentially severe losses and how they performed in the years of the Covid pandemic and the bear market of 2022.

The first strategy involved using a simple put protection strategy where investors buy the S&P 500 together with out-of-the-money put options. The second strategy was to buy straddles and strangles that allow gaining long volatility exposure (something akin to what many hedge funds do to hedge tail risks). And finally, they tested a simple strategy of going long VIX futures. The long and short of it is that none of these strategies seemed to work - all underperformed a simple buy and hold strategy involving the S&P 500.

Klement went on to test another fairly easily applied strategy which was a monthly purchase of 5% out of the money puts alongside a quarterly strategy which buys 10% out of the money put options that expire every quarter. The average annual return of the S&P 500 since 2004 was 9.2% compared to 6.6% for the monthly put protection strategy and 7.0% for the quarterly put protection strategy.

According to Klement *"Even if you somehow had the genius to not hedge your portfolio until the start of 2020 and then implement the put protection and keep it in place until today, you would have lost money compared to just holding the S&P 500. And that is in a period when we had the worst pandemic in 100 years and a bear market in the S&P 500 as well as a spike in inflation to 40-year highs. In fact, the outperformance you accumulated during the pandemic year 2020 was gone by mid-2021. In order to make money, the Cassandras would have to be able to time both the start and the end of the pandemic with very high precision."* Risk aversion strategies using complex or even simple options programmes - all designed to manage tail risk - don't seem to deliver much in the way of upside against a simple buy and hold argument.

Chart: Protective put strategies since 2020



Source: Liberum, Bloomberg

Black Line - Vix since December 2020
Red line - 20 day moving average
Blue line - 200 day moving average

Measure	August Level	July Level	June Level	May Level
Vstoxx Volatility	18.98	14.95	13.68	17.73
VFTSE Volatility	16.46	13.54	13.88	16.93

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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 his 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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