FORTEM CAPITAL

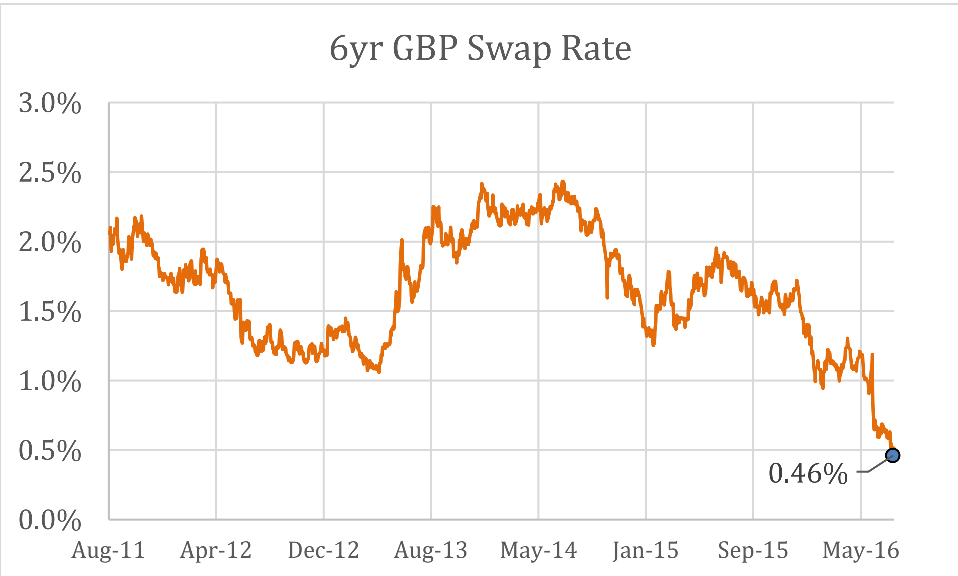
FRIDAY NIGHT 'LIGHTS

12th August 2016

Declining UK interest rates and their impact on structured investments

With the Bank of England's base rate being cut to 0.25%, which has fed through to a 7-10bps fall in the longer term 3-6 year swap market, there will certainly be changes to your structured investment portfolio, and indeed your outlook for these investments. Typically, clients have looked to consider the effect a rate change might have to the Zero Coupon bond element of their investment. The rate cut, from a primary issuance perspective will decrease the value of the ZCB element as you are being paid less to take the credit. While important, the type of investment you hold will be impacted differently depending on its makeup. As a brief summary, the forward price (from which a large part of your product's performance is derived) is far more important in participation structures, such as an Accelerator, than it is in defined return products – those that are short volatility, such as Autocalls or Digitals.

Option prices are partly derived from the forward price – the cost of owning that asset at maturity. In other words, the opportunity cost of partaking in rates and foregoing dividends. By buying a call option (going long) you are buying the right to delay a purchase. If interest rates are cut, this makes delaying the purchase less valuable as you are earning less money on the cash in the mean-time, and therefore the call is less expensive. Inversely, a put option can be looked at as the ability to delay a sale. The lower the interest you can earn on the cash received from a sale, the less desirable it is to sell said security; thereby making the put more expensive.



*Graph above showing the marked decline of 6yr GBP swap rates. Source: Bloomberg

With each product your primary issuance price is being negatively affected by the worsening terms of the ZCB and positively affected by the increase in the price of the put you are selling to generate cash for the upside. The difference in these products depends on the rest of the ingredients and the nature of their build.

Rates (bps)	Current	Week Chge
GBP 1yr	44.00	-1.00
GBP 3yr	39.90	-1.80
GBP 5yr	45.10	-3.10

Equity Indices (%)		
FTSE 100	6909.51	1.76%
S&P 500	2185.41	0.52%
Nikkei 225	16919.92	4.09%
Eurostoxx 50	3044.58	2.94%

Currencies (%)		
GBPUSD	1.296	-0.54%

5yr Credit Spreads (bps)		
Citigroup	79.98	-4.63
Credit Suisse	128.56	-5.11
Deutsche	200.23	-11.48
GS	98.67	-2.18
HSBC	74.78	-5.40
JPM	62.84	-0.95
MS	95.70	-3.06

Commodities (%)		
Gold	1351.88	0.56%
Oil	43.83	4.83%

3m Implied (vol pts)		
FTSE 100	12.33%	-1.79%
S&P 500	12.04%	-0.24%
Nikkei 225	19.76%	-4.08%
Eurostoxx 50	18.25%	-3.10%

5yr Implied (vol pts)		
FTSE 100	19.34%	-0.09%
S&P 500	21.08%	-0.45%
Nikkei 225	19.39%	-0.67%
Eurostoxx 50	19.27%	-0.58%

Source Bloomberg / Partner Banks
Data as at 12th Aug, 2.30pm

Indicative Levels – 6yr	
FTSE/S&P Digital, 65%	47.0%
Topix Supertracker, 65% EKIP	177.0%
FTSE 5% step, 60% EKIP	7.10%

Call us for more details – see below

Upcoming Events	
16th Aug	UK CPI % YoY
18th Aug	ECB minutes released

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Taking an Accelerator (a geared long product), you are able to buy more calls because of their worsening value, thereby increasing your gearing. This effect (along with the increase in the put) outweighs your ZCB and therefore benefits from a cut in rates. Naturally, from a secondary market perspective, your terms are worse. The inverse is true for the defined return type investments such as digitals, synthetics and autocalls. Similar to the supertracker, the value you derive from the put goes up, the cost of the ZCB goes up but in addition the cost of the digital options that derive your defined return element cost more as the present value of the coupons also goes up. The impact on the fixed duration higher coupon digitals is greater given you have a longer period and higher coupon, compared to, for example, the autocall structure which will have a lower expected maturity. Therefore the impact on the ZCB is less and also the size of the coupons you are present valuing is less.

So in summary, a rate cut helps primary pricing for participation structures and hurts pricing for defined return; the greatest effect being on digital type structures with autocalls being somewhere in the middle (albeit we are making sweeping simplifications here as it does depend on the exact structure of each). Of course the converse is true for the secondary market price of already issued product. A rate cut hurts the mark to market of participation structures and helps the defined return structures.

With the BoE cutting rates and therefore net returns on cash being eroded to very minimal levels, the search for income continues – on that note we have worked on putting together a number of defensive investments, that are at least partially uncorrelated to short term performance of equity indices that we believe could be considered as either cash alternatives or defensive equity; whether that be a reverse convertible bond on Constant Maturity Swaps, geared dividend products on the FTSE or highly defensive autocalls.

	Cash Alternatives, Defensive Equity and RCB Products
FTSE Geared Dividend Income	1% coupon paid Dec 2016 Then 1.45x realised FTSE Dividends to Dec 2021 paid each year FTSE Knock-in Put at 65% of strike
Cash Alternative Highly Defensive Autocall	FTSE/ S&P 3 Year, Fixed Coupon of **3.0**% paid out as income each year if both Indices are above 48.25% of strike Worst-of Knock-in Put at 48.25% of strike
USD RCB Vanilla	1 Year, Fixed Coupon of **6.5%** paid at maturity Redemption at maturity of: 100%, if 10y USD Swap Rate > Barrier Otherwise Redemption Amount of: 10y USD Swap Rate / Barrier * spot Barrier at 55% of current 10y USD Swap Rate (ref spot: 1.434%)
USD RCB Digital	1 Year, Fixed Coupon of **8.2%** paid at maturity Redemption at maturity of: 100%, if 10y USD Swap Rate > Barrier Otherwise Redemption Amount of: 10y USD Swap Rate / Spot Barrier at 55% of current 10y USD Swap Rate (ref spot: 1.434%)

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