FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

A deep dive on the Japan SPs: Sifting through the rice to find the Sashimi

Warren Buffett once stated that it's only when the tide goes out that you learn who has been swimming naked. We at Fortem aren't advocates of a trunk-less swim so this week's FNL focuses on an in-depth performance review of a structure we launched last year and whether the product is performing as expected. For existing holders of the note, we believe it will be of interest and for those that are looking at it with fresh eyes, we hope it makes for a passably informative look at something a little more unusual – namely how the various components of a product can affect its performance. The structures in question represented an important asset allocation decision for our clients, to either move from unhedged Japanese positions or to strategically increase their weightings to Japanese equities, and as such it was noted that this has been treated much more like a fund allocation than standard structures.

Briefly, as it isn't our strong 'swim suit', do the economics still stack up?

Taking research from our partner banks, there look to be several consistent points:

- The Topix still looks cheap vs US and UK equity markets – ratings for Japanese companies are still at a discount of circa 14% to the developed world average, with P/E ratios trading at historic lows – moreover it is heavily exposed to growth through cyclical earnings. *Did you know, the Japanese stock market has a much greater exposure to cyclical constituents than any other developed index? (61% compared with a mere 26% in the UK for example).*
- The Yen still looks expensive and so for larger international exporting businesses, a weaker currency will naturally lead to more profitable companies.
- The economy is continuing to grow; mostly unrelated to Fortem's love of Sushi. Growth for 2016 was recorded at 1.6% vs 1.2% in 2015 (with greater numbers expected through 2017/18).

"I REALLY LOVE THIS STUFF, BUT I STILL HAVE A LOT OF TROUBLE WITH SUSHI."

- Japanese companies still have very low operating margins compared to the rest of the world (on average circa 5% vs 7% in Europe and 10% in the US), so there is scope for considerable improvement.
- Japanese equities have a very strong positive correlation to rising US treasury yields – something most investors consider likely to continue. And finally, corporate earnings growth is predicted to significantly outperform other developed economies – expected to be 16% for the year, making a strong case for the Japanese equity bulls.

19th May 2017

Recent Launches:

Product	Participation
6yr Morgan Stanley FTSE Supertracker 50% EKIP EIS	261%
6yr Morgan Stanley FTSE Stepdown Autocall 60% EKIP EIS	6.77%

Rates (bps)		
	Current	Week Chge
GBP 1yr	48.30	0.50
GBP 3yr	63.20	1.00
GBP 5yr	79.60	0.50

Equity Indices (%)		
FTSE 100	7472.92	0.50%
S&P 500	2,345.96	-1.88%
Nikkei 225	19445.7	-2.20%
Eurostoxx 50	3580.82	-1.56%

Currencies (%)		
GBPUSD	1.301	0.93%

5yr Credit Spreads (bps)		
Citigroup	58.49	2.38
Credit Suisse	77.43	0.45
Deutsche	100.50	0.45
GS	73.13	2.35
HSBC	51.52	0.68
JPM	49.28	1.77
MS	68.30	2.08

Commodities (%)		
Gold	1252.37	1.95%
Oil (CLA)	49.90	4.31%

3m Implied (vol pts)		
FTSE 100	11.41%	1.41%
S&P 500	11.73%	1.33%
Nikkei 225	15.59%	0.53%
Eurostoxx 50	14.95%	1.11%

5yr Implied (vol pts)		
FTSE 100	17.74%	0.55%
S&P 500	19.67%	0.42%
Nikkei 225	18.19%	-0.57%
Eurostoxx 50	19.83%	0.53%

Source Bloomberg / Partner Banks
Data as at 19th May, 11.00am

Upcoming events	
20th - 23rd May	EU Finance Ministers meet in Brussels
22nd May	Fed's Harker speaks in Philadelphia
24th May	Japanese Cabinet's May Economic Report
25th May	UK GDP % y/y
26th May	G7 Summit

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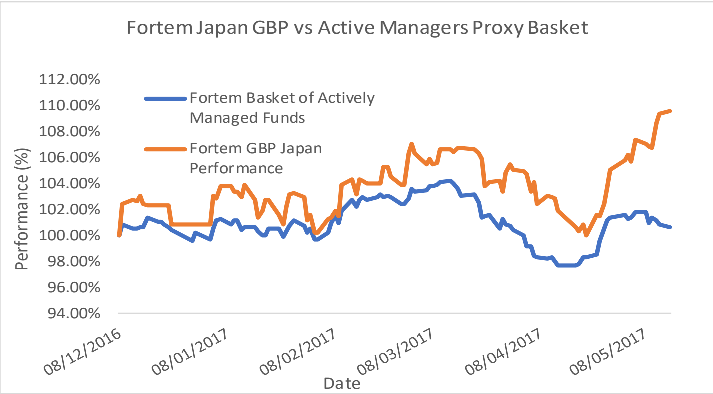
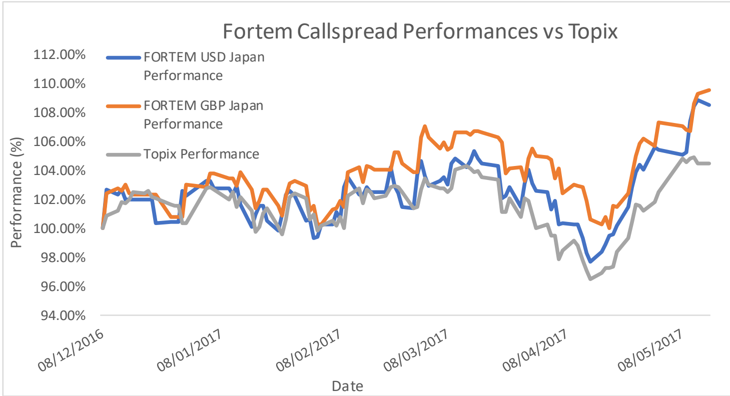
"Know what you own, and why you own it"– *Peter Lynch*

And now, the deep dive on the products…





When we launched these Callspreads, we put together some analysis around how regularly active managers underperformed the underlying index and how inefficient their currency hedges were, and this has certainly held true for the first few months of our structures. To avoid single manager bias, we then constructed a weighted average basket of 7 mainstream Japanese active managers and compared their performance to our products since launch (8th Dec 2016). As you can no doubt see from the above graph, our structures have consistently out-performed both the Topix and active managers to date. Based on our scenario analysis when these products were launched, all other things being equal and only considering market moves, the GBP product should be trading at circa 105%, so why is it up almost 10%, and in fact outperforming the higher geared USD version?

Let's look under the hood! Barring the positive performance of the Topix, what else makes up your structure? Firstly, this product benefits from weakening GBP and USD rates (USD rates have moved partially against you, whilst 6yr sterling swap rates have narrowed since launch – this is the predominant reason for the difference in performance to date). Moreover, these products (because of the forwards built into the options) are also short longer term Japanese equity market volatility and JPY rates – more so for the GBP structure because of the lower gearing. As you can see from the table on the right, 5yr Japanese equity implied volatility is off nearly half a percent and JPY 6yr swap rates have widened, which makes a marked difference. Finally, these investments are also naturally exposed to any depreciation in Citi's funding, which using their 5yr CDS as a proxy, we can see has narrowed significantly – again aiding the M2M of your structure. It is important to note that the delta on these products takes more time to kick in than your standard Supertrackers and as such, will not see the effects of the higher gearing (and in a bull market, outperformance) until roughly their 3rd year.

Key Underlying Product Changes from Strike

Products	Participation	Offer
6yr Citigroup Daily Hedged USD 100/140 CS with 60%EKIP	425%	108.9
6yr Citigroup Daily Hedged GBP 100/140 CS with 60%EKIP	325%	109.7

Rates (bps)			
	Initial	Current	Change
GBP 6yr	1.028	0.898	-0.13
USD 6yr	1.966	2.003	+0.037
JPY 6yr	0.1025	0.1188	+0.0163

Equity Index (%)			
	Initial	Current	Change
Topix	1512.69	1584.23	4.73%

Currencies (%)			
	Initial	Current	Change
GBPJPY	143.55	146.33	1.94%
USDJPY	114.04	113.54	0.44%

5yr Credit Spread (bps)			
	Initial	Current	Change
Citigroup	79.87	55.43	-24.44

5yr Implied (vol pts)			
	Initial	Current	Change
Nikkei 225	19.17%	18.76%	-0.41%

Source Bloomberg / Partner Banks
Data as of close on 8th Dec 2016 to 16th May 2017, 11.00am

For more details on anything referenced in this week's FNL, or to find out more about the products described above, do please get in touch via the usual means or see the factsheets: GBP and USD.

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