Monthly Market Update

Monthly focus on the financial markets

6th June 2019

Contents

- Market Analysis
- Trade War
- European Elections
- Geopolitics
- Executive Summary
- Macro
- Central Banks
- Commodities
- FX
- Current Investment Idea

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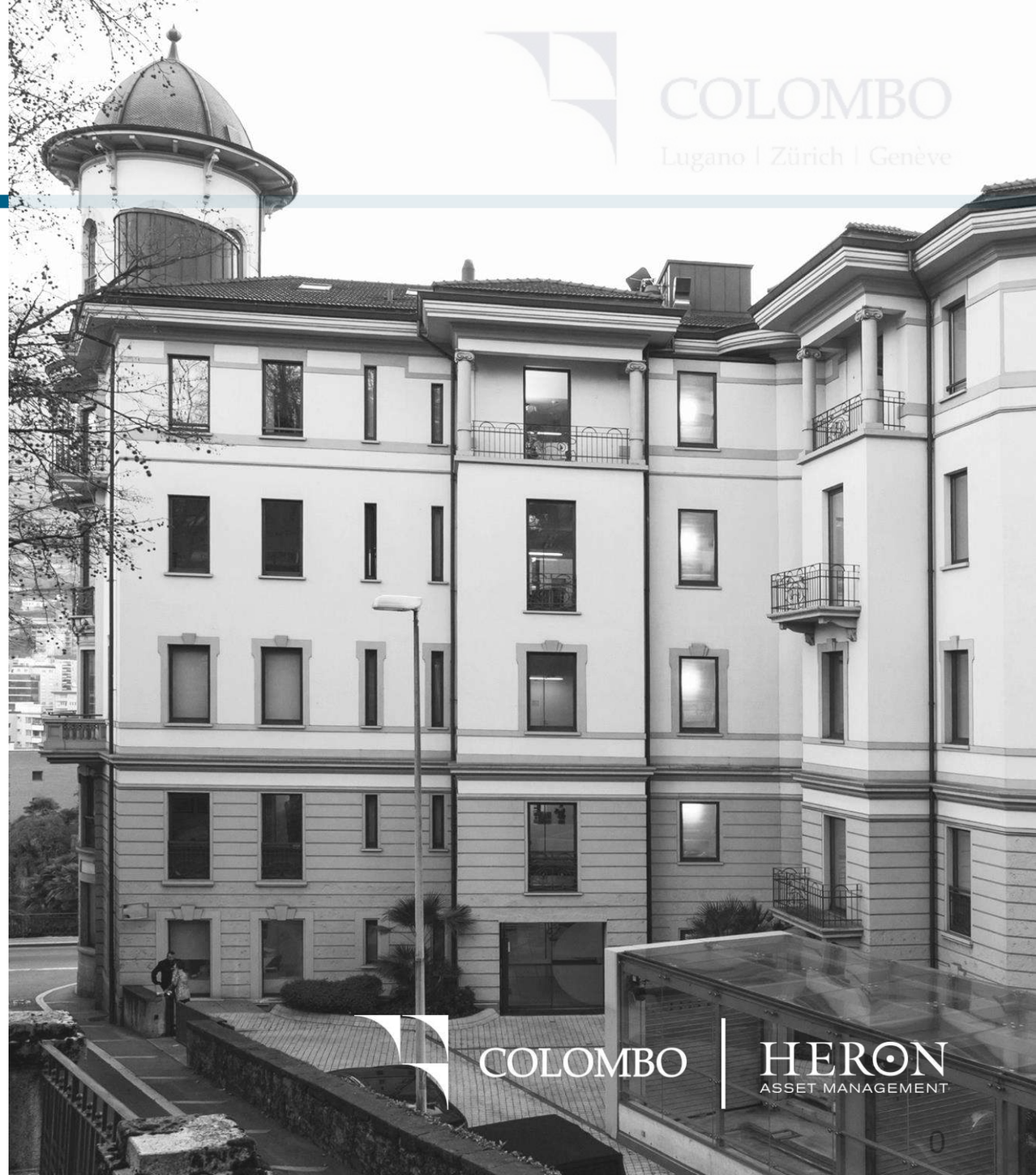


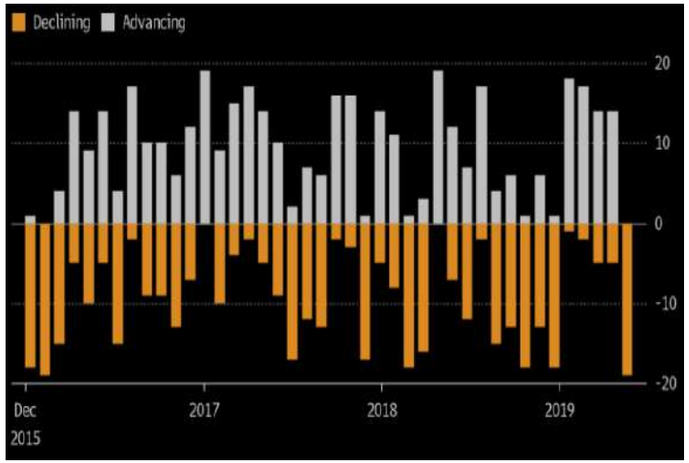
Market Analysis

The month of May has been the first negative month YtD and as we rightly predicted, valuations, high positioning from Quant funds and of course news on Trade War has caused the market to take a deep breath.

We have expressly mentioned the unfavourable profile of risk-reward and suggested that is was a great opportunity to lighten the exposure as we had witnessed the easiest part of the year with many hurdles coming over the following weeks/months.

The S&P lost 6.6% in May, Nasdaq -10.2%, Nikkei -8.3%, Hang Seng -11%, Eurostoxx 50 -6.7%.

Advance / Decline STOXX600 Sectors



While the S&P had its second-worst month of May since 1962, in Europe, the Eurostoxx 600 had the worst month since 2016 but what it matters the most is the very high correlation among stocks. All 19 industry groups of the Eurostoxx 600 have declined, a degree of wipe-out not commonly seen over the last years. Cyclical sectors such as carmakers, banks and miners suffered the most.

The risk-off market moves through May, amid trade headlines, weaker global PMIs, and political turbulence in Europe, Italy and the UK. Alongside lower equities (led by cyclicals), tighter bond yields and wider credit spreads, the most striking theme has been the sell-off of the FAANG factor (Facebook, Amazon, Apple, Netflix and Google).

FAANG stocks fell by 4.5% last Monday on the news that US antitrust enforcers were preparing sweeping investigations into some of their business practices.

Our long-term readers might remember how we were already arguing last year that such high single sector concentration on Indexes would have been dangerous. Now we are experiencing these effects as Tech continues to make up more than 50% of top 50 longs and FAANG (just 5 stocks) make up of 35% of Nasdaq ETF and 12% of S&P weighting.

NYSE Faang Index (black) vs S&P Index

The S&P equal-weighted index posted its biggest one-day outperformance over the cap-weighted since August 2009 and the FAANG weakness kicked off a massive 3.5 standard deviation in Growth vs Value.

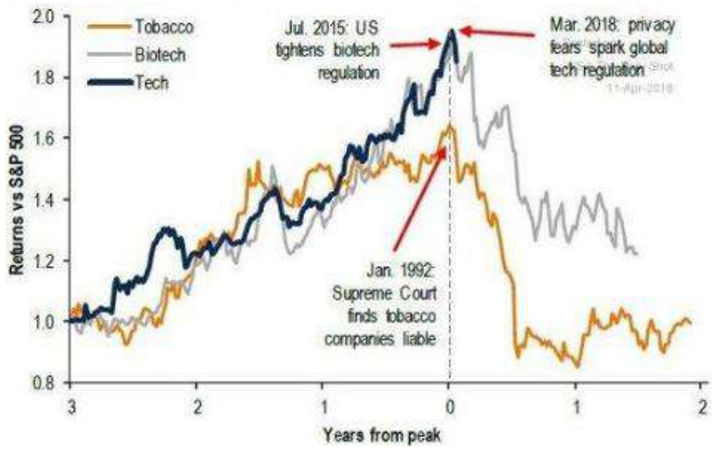
Interestingly, taking the NYSE Fang+ index, which adds Chinese names like Alibaba and Baidu to the standard list of dominant Internet companies, we can see that the group lost its leadership already last summer and has now erased its entire outperformance since the beginning of last year.

Market Analysis

It is also important to note that the last time we saw a growth underperformance of this magnitude was on the 19th of November 2018 and the S&P ended up falling 13% over the coming 5 weeks.

Another situation that doesn't bode well for FAANG is given by the past situations when Regulators have intervened on specific sectors like Tobacco or Biotech. The chart is clearly showing that a similar situation on Tech could still generate up to another 20% downside potential.

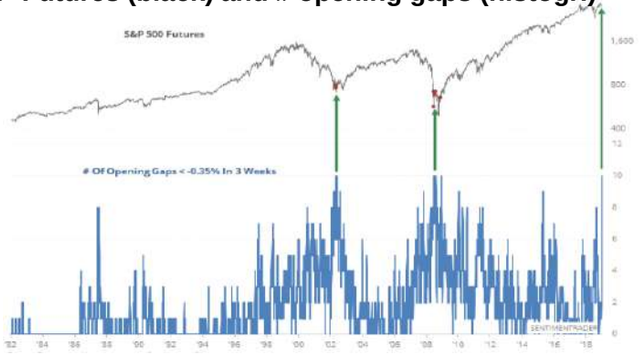
Tobacco (yellow), Tech (blue), Biotech (grey)



Let's now have a look at other patterns which are explaining better the current market condition:

- Intraday moves: Markets are in better shape than they were in 2002 and 2008, but the magnitude of swings between the close and open underscores the pressure traders confront as they're bombarded with headlines. The S&P had 10 consecutive days where the intraday drop was at least 35bps over a 3-week period. This is a clear pattern that happens in times of panic and increased uncertainty.

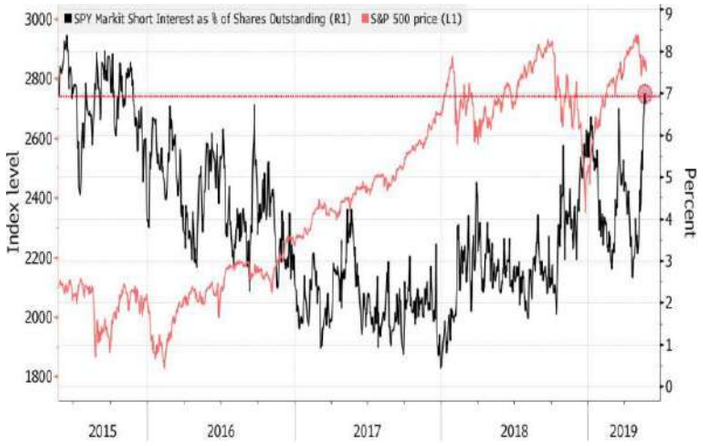
S&P Futures (black) and # opening gaps (histogr.)



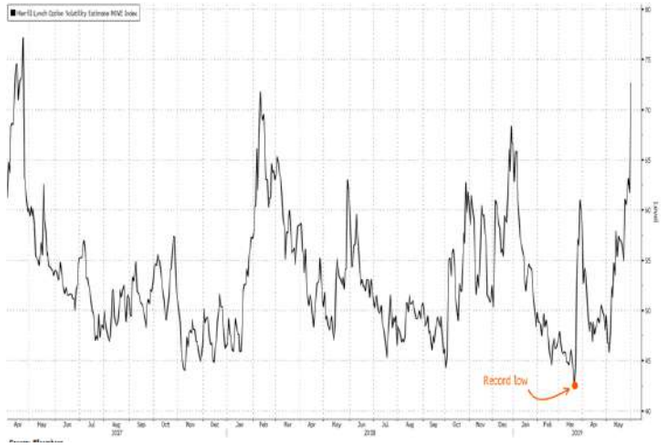
- Short interest:
  Investors haven't been this keen to short the US stock market since the Federal Reserve started raising interest rates in 2015. Short interest as a percentage of shares outstanding on the SPDR S&P 500 ETF Trust, climbed as high as 7% this week.

- Increased volatility:
  Last month we were convinced that the market would have soon stopped to be complacent and the record low volatility on every asset class (Equity, Bonds, FX and Gold) would have spiked. This is exactly what has happened with a new massive short covering on VIX (volatility on S&P up 45%) and volatility on Bonds reached a more than

S&P Index (red) vs short int. as % shrs outstanding (black)



MOVE – Merrill Lynch Opt. Volatility Estimate Index



Market Analysis

two-year high, two months after hitting a record low in March.

- Volumes: The 20-day moving average of the NYSE's advancing volume is among the lightest of the last two years, while declining volume is no higher than it was in March. When viewed that way, investors seem to be sitting on their hands.

  Chart showing on the top side the NYSE advancing securities 20-day average while on the bottom the NYSE declining securities 20-day average. This sell-off has happened with relatively low volumes.

Advancing (black) vs Declining (blue) 20day mov.avg. NYSE

- Flows: AMG data showed this week $19bn of equity mutual fund outflows (15th week of consecutive outflows) and $3.2bn of ETF outflows confirming the trend we have seen since the beginning of the year with market underweight equities as an asset class.

Fund Flows: Bond (orange), International Equity (green), US Equity (blue)

Credit investors yanked cash from investment-grade bond funds for the 3rd straight week in the biggest withdrawal since December 2015. Outflows from HY at $2.73bn, the highest level since December when the market had some serious liquidity concerns.
Year-to-date, there have been a combined $62bn in domestic equity fund outflows, $12bn in international equity fund redemptions, and $152bn in bond fund inflows.

- Technicals: most of the Indexes have managed to defend their 200-day moving average and the bounce we have seen this week has helped to defend this support. However, there are two medium-long term charts which are clearly bearish if you believe in this pattern. The "head and shoulder" figure which has been verified on most of the indexes and the first bearish key monthly reversal on S&P since 2007 when ironically also developed at a double top vs the 200 peak like it happened in May this year vs the highs made in 2018.

Technicals S&P

Market Analysis

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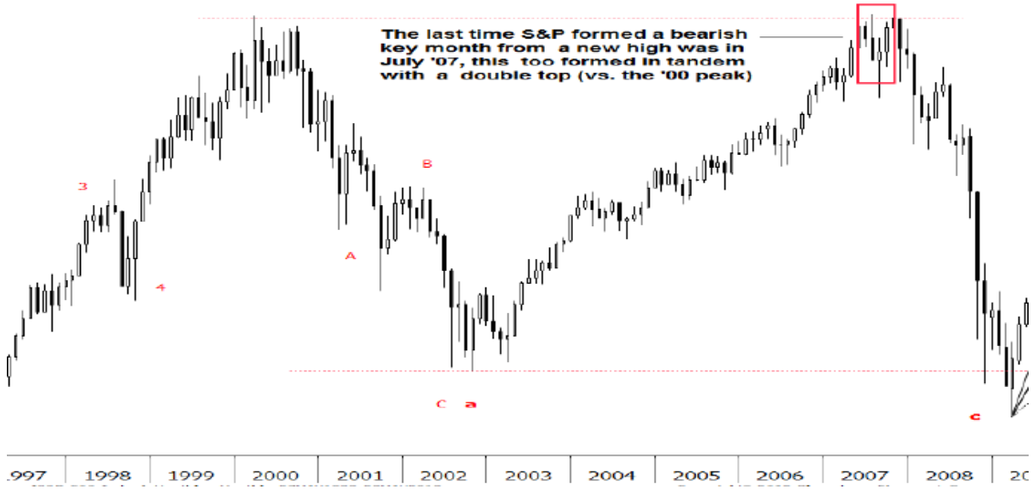
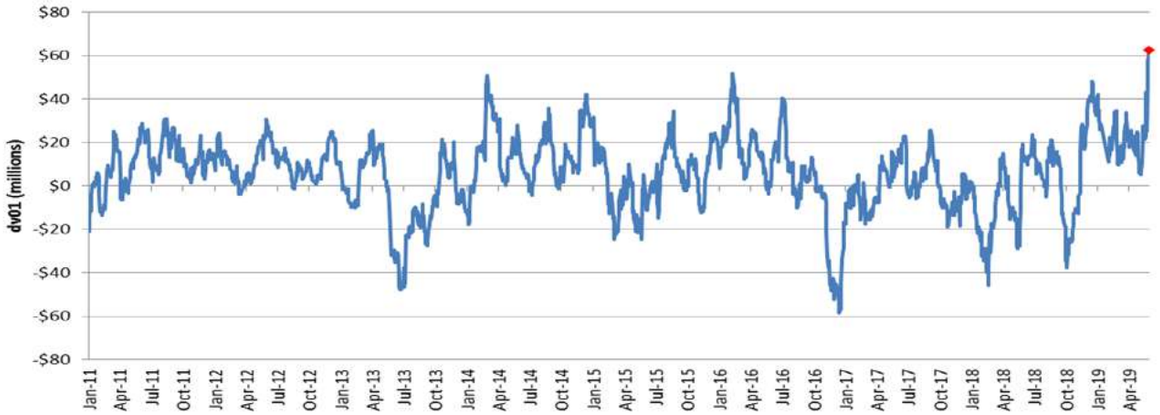
Technicals S&P



30-Day Build in Net Longs (+) or Shorts (-)
UST Futures (TU, FV, TY, UXY, US, WN)



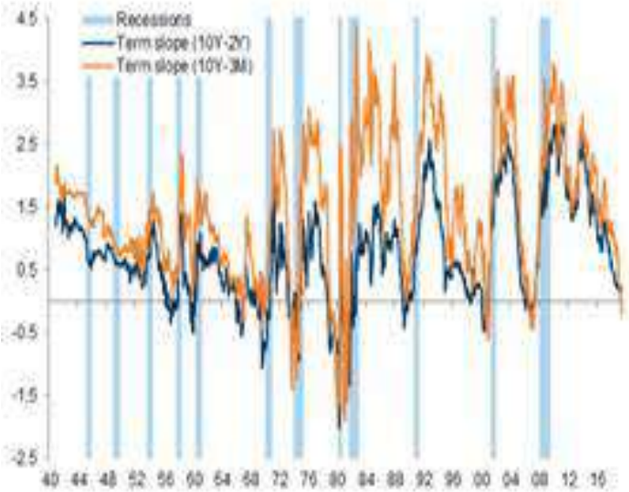
Another important event we have witnessed over the last weeks is once again the recession fear given by the 3-month/10-year inversion of the curve in US.

Last week, US 2-year yields fell 24bps (4 standard deviation event), this is the largest move in 3 years and the same magnitude as the ~55bps risk-off yield move in the 20% SPX correction during November/December '18. Crude has also fallen 18% in 2 weeks (almost 3 standard deviation decline). These extreme moves in rates and commodities speak to the market having real concerns over future Global growth and a possible US recession.

Another way to look at how stretched the rate move has been is looking at how oversold is the 14-day RSI, a level reached only for the 3rd time since 1998. Positioning on UST future also clearly show the extreme reading.

As we mentioned in our previous newsletters, a key slice of the Fed yield curve inverted in late 2018. The proportion of the yield curve has increased further, with the longer-end of the yield curve remaining upward sloping and only shorter-term maturities displaying an inversion, i.e. the US 3-month/10-year yield spread has dropped to its lowest level since 2007.
Interestingly, the 2-year rates minus the Fed fund rate is now close to -40bps and historically, the Fed became more dovish in the following months.

Term slope 10Y-2Y (blue line) vs. Term slope 10Y-3m (orange)



Market Analysis/Trade War

Fed funds are currently pointing the odds of a rate cut by the July meeting at 55% with odds at 19% a week ago and 12% a month ago.

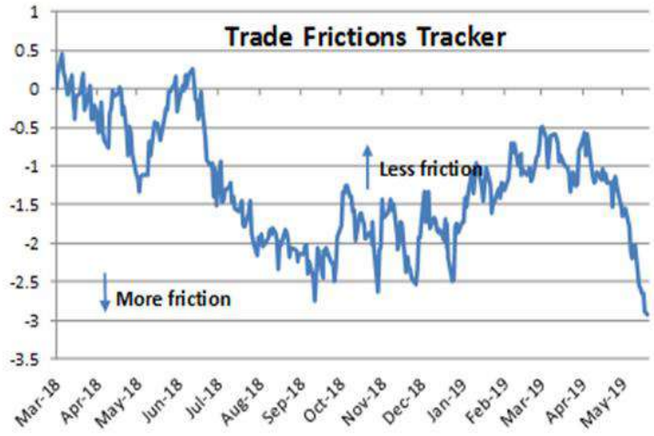
Not only does this market pricing at the front end of the US curve raise the hurdle for the Fed to satisfy market expectations but it may create more fears of either a Fed policy mistake or trade conflicts that are causing larger negative shocks, spooking bond markets both at the longer end and outside the US. The universe of negatively yielding bonds across global bond markets has expanded further as a result, reinforcing the rally at the longer end as bond investors try to escape negative yields.

A final interesting point is about the correlation between the Yield curve and VIX (volatility on S&P) is high. The curve leads by 3 years and generally does a good job of telling us what to expect for the VIX.
Recession or not, we believe US equity market volatility is likely to pick up significantly over the next 6 months.

Yield curve is predicting the VIX 3 years in advance

Trade War

New tariffs on Mexico (5%) are a fresh chapter in the US's trader war with the world. A worsening trade war between the U.S. and China is driving the steepest sell-off in Chinese shares traded on American exchanges since the global financial crisis.



The second direct consequence of the trade war is likely to become increasingly visible in the inflation numbers. The latest estimates show that if all proposed tariffs are implemented, there would be a peak core inflation boost in US of 1.25%! Companies may not be able to fully pass on higher tariffs which will erode profitability.

Corporates with global footprints will face additional downward pressure on growth and profitability from their international operations.
Investors are generally of the view that the trade dispute could drag on for longer, but they appear to be overlooking its potential impact on the global macro outlook.

Last week, AP Moller-Maersk, the world's largest container line, said it had a good start of the year but warned that it faces "considerable uncertainties" as global trade tensions continue to escalate.
Should US tariff measures announced last month and the Chinese retaliation stay in place for two years, global GDP could be 0.3% lower by mid-2021, according to the latest estimates. In an all-out trade war, global GDP would be lower by 0.6%.
Goldman has estimated that S&P firms will need to raise prices by 1% to offset tariffs

Trade War/European Elections

and a 25% tariff on all China imports could lower current consensus EPS down to 6%.

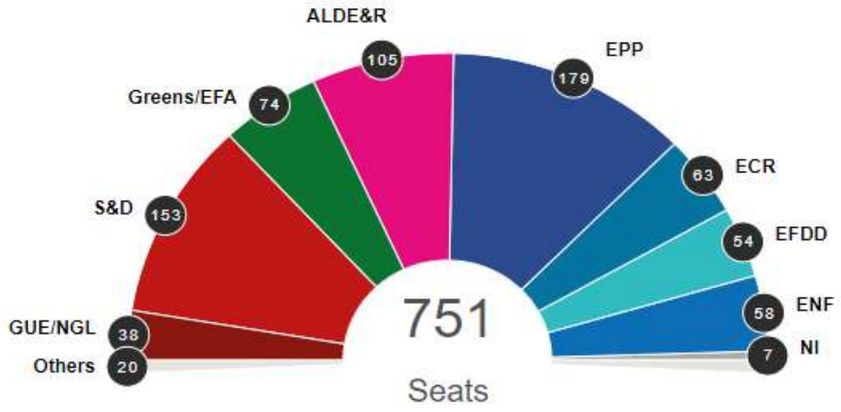
This is a 2-way issue as 7 of the 10 biggest ports in the World are in China and the US lost an estimated 70,000 factories after China went into the WTO.
China's portfolio of US bond continues to slide. Its share of all foreign-held US debt fell for the 9th straight month to the lowest level since 2006 and despite the decline it still remains the biggest creditor with holdings of 1.12tln$ (17% of the total).

Investors are right to expect a stronger policy response in the event of continuing escalation but the reality is that such policy easing will only be reactive, triggered by escalation and its effects on financial conditions and growth outlook.
Unfortunately, trade tensions have emerged at a critical moment in the global cycle with weak corporate confidence. It would be remiss to underestimate this impact when the risks of tensions persisting for longer have increased. The duration and severity of the escalation will determine how it affects global growth.

European Elections

The incumbent traditional European parties held their ground against the assault from populists in the EU parliament elections. Although populists gained consensus in France, Italy and England, the European People's Party (EPP, Christian Democrats) remains the largest party with 179 seats or 23.8%, followed by S&D (Socialists and Democrats) with 153 seats or 20% and ALDE&R (Liberal and Democrats) with 105 seats or 14%. Overall, the results signal that the European Union is likely to broadly continue current policies, no major breakthrough. It's important to underline that the mainstream center-right and center-left, respectively EPP and S&D, lost the majority of seats for the first time ever with 44%, down from 56% in 2014. The pro-business Liberals and the Greens look like the big winners with 14% and 9% respectively, up from 9% and 7% while the Eurosceptic parties look set to achieve 28% of seats.

Traditional Political Group and Coalition Majority

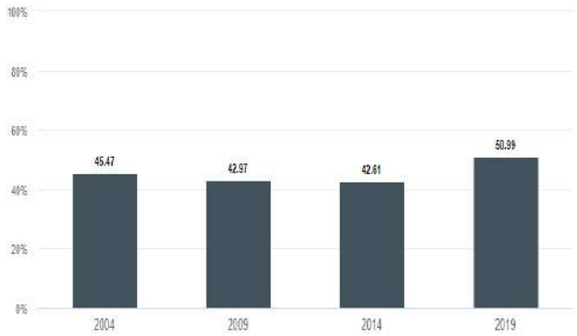


Voter turnout at the European Parliament elections averaged 51% across European Union countries. That's the highest number in 20 years, reversing a 35-year decline since the first direct elections to the EU assembly in 1979. Turnout in 2014 was 42.6%.

In Germany, the CDU/CSU remains the largest party with 28%. the Social Democrats (SPD) picks up just 15% of the vote, down 12% from the last vote in 2014 while the Green party is expected to come in second with 21%, an increase of 11%.

In France, the right-wing National Rally party, Marine Le Pen, gains with around 24% of the vote,

European Parliament election's Turnout by year



European Elections/Geopolitics

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followed closely by President Macron's La Republique En Marche (LREM) with around 22% of the vote.

In Italy, Lega becomes the first party with 34%, up almost as much as the double since the latest elections, while Five Star Movement M5S achieves 18%, down as much as the half since last year. Among the opposition political parties, the centre-left Partito Democratico is at 22% and the centre-right Forza Italia at 9.6%. Salvini was able to gain consensus mainly on immigration, security and fiscal reforms.

In the UK, the Brexit party is the winner with almost 32% of the vote. While the Brexit party came first, as expected, the aggregate support for the parties who support Remain was higher, implying no clear political message. Both main parties performed poorly, particularly the Conservatives, which could indicate limited support for a compromise Brexit. European elections are often a poor guide to general elections, given a lower turnout and voters more willing to vote for parties apart from Labour and Conservative.

In Spain, Portugal and Netherlands socialist parties won the elections.

In Greece, the Tsipras party is defeated, snap elections are called and the vote will most likely be held at the end of June or early July.

Geopolitics

Brexit: Theresa May to resign tomorrow after repeatedly failing to get her Brexit plan through Parliament. That's a big news, although quite expected, which triggers a new contest that will bring a new leader to power in the UK and Conservative party. Among all the runners, Boris Johnson is the clear favorite, the face of the Brexit campaign, who resigned as foreign minister in July in protest at May's handling of Brexit and who recently stated that "Britain would leave the EU on October 31, deal or no deal," and "a second referendum on EU membership would be a very bad idea and divisive". Considering the recent success of the Brexit Party in the European Parliament elections, the Street increased the odds of a "No deal/disorderly departure" Brexit at 15/20%, while a variant of the current deal at 45/50% and "No Brexit" 30/40%.

Italy: the European Union has triggered the "Italy Disciplinary Process", paving the way for an initial penalty of as much as € 3.5Bln and stating that Italy has failed to reduce its debt burden in line with the European Union's fiscal rules. Clearly this is a message to Lega Nord, Mr. Salvini, who recently won 34% consensus at the European elections. If enacted the procedure entails a tighter monitoring, financial penalties, requests for extra belt-tightening and even no disbursement of the EU structural funds. Please find below the next steps:

- June 12 Efc (Fin Min staff) technical opinion on EDD
- June 14 Eurogroup on EDD
- June 15 To July 1st EU commission recommendation
- July 9 Ecofin final decision on EDD

Executive Summary

Last month we have warned investors to don't get too complacent and to reduce weight on Equities with the aim to buy them back at lower prices and switch into defensive names/sectors. We also suggested to increase the positions on Gold as a protection of the whole portfolio along with a buy on Put spread on Indexes and CDS & Btp/Bund spread.

It was a great call, if an investor could move the portfolio correctly 2/3 times a year it's a done job.

The big question is **what do we do now? We are short-term more constructive while medium to long term worried about a further move downwards.**

Short-term, as the market move towards the Osaka G20 (28/29th of June), an excessive amount of cash has poured into money markets (5 consecutive weeks, +107bn$) and Government-related bonds. Risk aversion has also been seen with the Yen carry trade unwinding and the bounce of Gold and CDS.

It is therefore not too surprising to have seen a heavy day of short-covering last Tuesday. It is likely that the perception of a recession has created additional outflows reinforcing the trend. Without any precedent, investors have certainly found it difficult to price the escalating Trade-war.

However, in the **medium/long term**, we expect global equity markets to navigate a high volatility regime during the next 12 months. Expect further downside potential to global equity indices on the back of the US recession forecast for the middle of next year with a further potential correction. Investors should prepare and reshape their portfolios accordingly.

We would therefore try to play the short-term bounce with some Cyclical sectors (Auto, Basic Resources, Banks) **and use the recent weakness on Oil Sector to increase further** (as it guarantees high dividend yield and buyback on top of solid business)**. We would, at the same time, wait for the volatility to normalize back down before buying new Put spreads on Indexes and keep Gold as one of the potential best asset classes for 2019.**

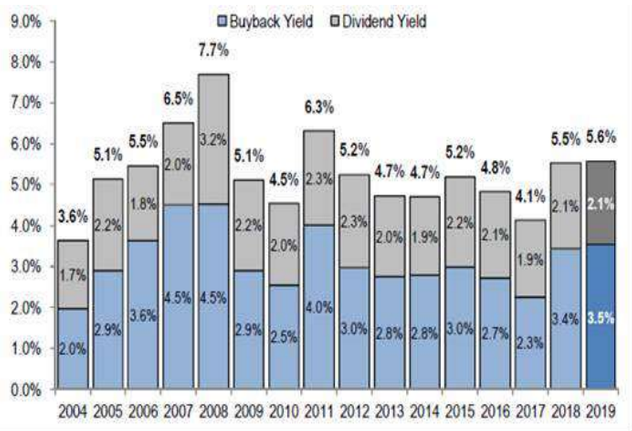
This is not a long-term buying opportunity but we think it is correct to try capitalizing from every market move and it is worth to remember that the most violent upturns are generated in a bear market with quick short-covering like we have seen this week.

Let's now analyze the current positive and negative factors for the market (please note that these factors are not all comparable in terms of timing, some factors are short term oriented while others may work in the medium to long-term):

POSITIVE FACTORS (5):

- **Attractiveness of Equities**: while equity multiple has been hovering around historical average of ~16.5x in US, the collapse in 10-year nominal and real bond rates to 2.08% and 0.34% respectively, render equity valuation more compelling. The spread between total equity yield (buyback + dividend) and bond yield has widened to 3%, with current total equity yield of 5.6% at the most attractive level since 2011.

Buyback yield (blue) vs. Dividend yield (grey)



Executive Summary

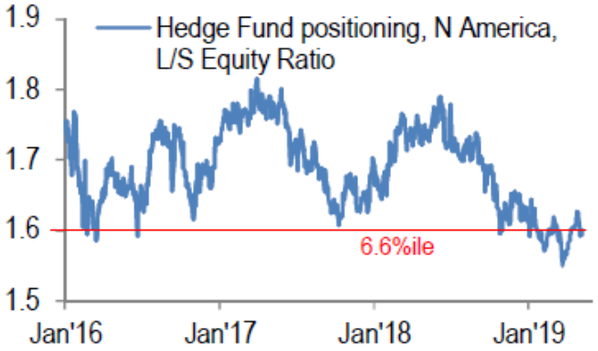
If history serves as any guide, lower rates should justify above-average equity multiple especially in an environment where there is a lack of alternatives.
Equity / bond relative valuations have approached December levels.

MSCI US earnings yield minus 10 Year US bond yield

- **Positioning / Flows**:

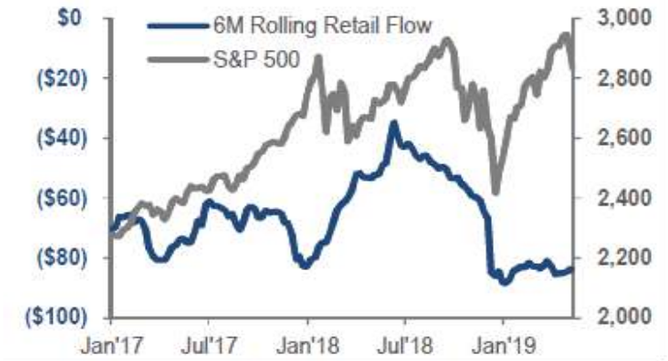
  Aggregate investor positioning remains low at 35th percentile, posing lower risk of forced de-leveraging and amplified selling (excluding Quant investors).

Hedge Fund positioning at lows



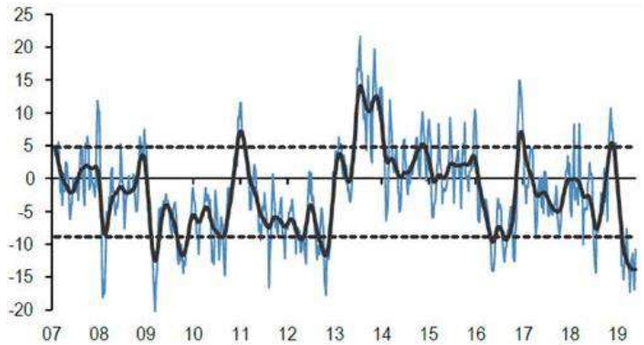
Both Hedge Funds and Retailers are invested substantially below the average of the last few years.

Retail investors remained on sideline



Also visible in the difference between flows into Equity and Bonds. The chart shows US domiciled Mutual Funds flows and Globally domiciled ETF flows. The thin blue line shows the 4-week average of difference between Equity and Bond fund flows while the black line shows a smoothed version of the same series.

4-week average difference Equity vs. Bond fund flows



- **Macro numbers getting better from very deep levels**: We might see a stabilization of the current macro numbers over the next weeks (short-term) as the base effect for many activity indicators are now favourable. As an example, Eurozone manufacturing

Executive Summary

new orders PMIs was only weaker than current level in 2008.

- **Buyback should continue to support markets in 2019**: Buybacks have been a key theme through this cycle with S&P 500 companies returning ~$5 trillion to shareholders since 2009 and contributing ~2% to annual EPS growth and we are out of the blackout period now.

  New buybacks are up 22% in Q1 led by Tech and Industrials and the existing cumulative buyback authorizations that have not been realized yet have grown to ~700bn$, higher than the record year 2018.
  US corporates have announced for 2019 an amount of buybacks equivalent to 4% of S&P market cap.

  Since 2000, stocks with higher buybacks outperformed sector peers by 150bps during corrections and 200bps during recessions.

  Irony of 2019 is that the threat of populist policies in 2020s to reduce buybacks and inequality will actually likely increase the activity for the current year.

- **Global M&A:** It is notable that Global M&A volumes have been very strong year-to-date, reaching their highest level since 2007. However, European activity has been far more muted, with M&A volumes so far tracking at their lowest levels in 8 years.

NEGATIVE FACTORS (11): *still largely outpacing the positive factors.*

- **Dangerous reporting seasons:** we think that Q119 will mark the beginning of the earning recession and full year 2019 earning estimates will possibly need to fall by 5/10%. A lot of the growth that is still expected for 2019 is being packed into Q4 and that looks unrealistic to us, especially without a trade deal. Earnings growth was negative for 5 of 11 sectors and no sectors are expected to have remarkable growth like we saw in 2018.

There has been a **significant inventory buildup** over the past year (some due to overheating economy) and **technology capital expenditures** experienced a boom last year thanks the extra earnings and cash put in the pockets of corporate America from the tax cuts and repatriation of overseas cash. During 1Q, we saw the payback begin with the big cloud computing leaders (Amazon, Google, Facebook and Microsoft) missing their capex spending plans by over 30%.
Labour is the other excess from last year's fiscal stimulus boom and where costs are eating into margins, especially for Small Caps.
Finally, **inflation** message from corporates is much less benign than bond markets currently price.
The chart shows inflation expectations plotted against the frequency of mentions of "cost inflation" in European company transcripts, which has moderated a bit from last years' highs, but remains far higher than we saw in 2016 when inflation expectations were last this low.

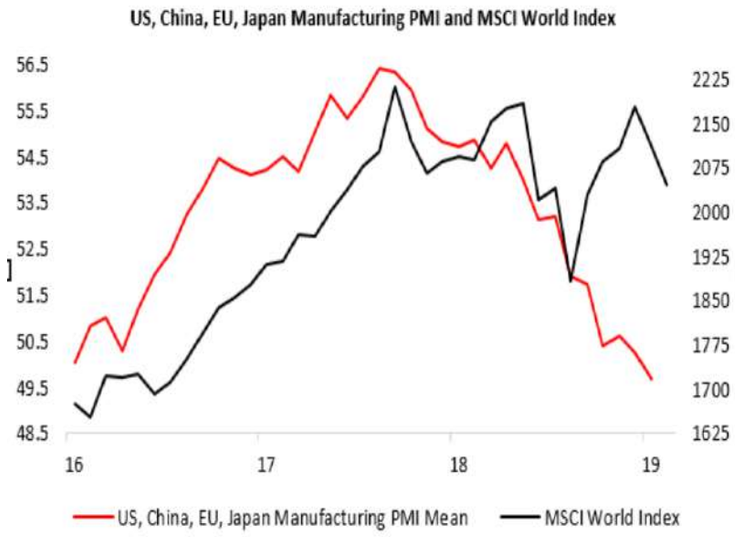
Unfortunately, the re-escalation of US/China trade tension increases the likelihood of this bad outcome, in the event that it can't be resolved in a few months.

"Cost inflation" (blue) vs EU Inflation expectations

Executive Summary

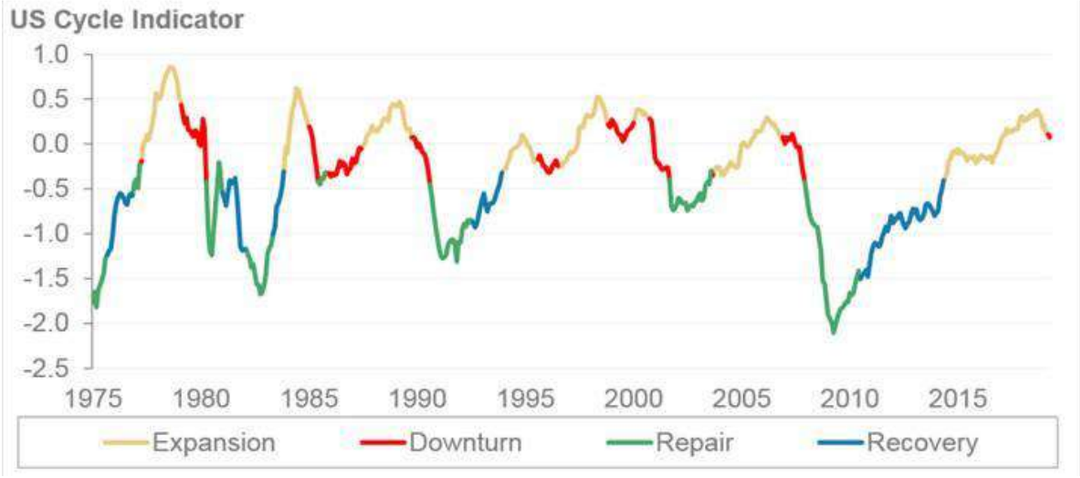
- **Economic momentum**: We see limited risk that global economic momentum will re-accelerate here. Different Brokers are now predicting that global growth will stay stagnant at current levels, rather than recovering, for the rest of 2019. With global growth expected to average 3.2%Y in 2019, this will bring us back to the sub-par global growth environment that prevailed between 2012 and 2016. Risks remain decidedly skewed to the downside.

The chart showing the World PMI vs MSCI Index tells you everything.



Morgan Stanley has a proprietary US Cycle Indicator model which is widely followed. What is worrying is that they are now predicting the beginning of the downturn for the 1st time since 2007.

Recent softness has caused their model to switch to 'downturn', where data are 'above trend but deteriorating'. This phase-change has historically meant a worse backdrop for returns and higher chances of recession or a bear market.



- **Central Banks**: Global monetary policy is set to (gradually) tighten further, this will increase the pressure on the 'weaker links in the chain' and the chance that we see higher volatility. Credit spreads should slowly widen, unhelpful for equity valuations.

ECB's balance sheet is near record highs for an equivalent to 40.5% of Eurozone GDP vs Fed's balance sheet that has shrank to "only" 19% of US GDP.

The trend towards looser fiscal policy led by the US is potentially the greatest change in economic policy making for a generation!

Executive Summary

- **Low shorts/protection and relatively low volatility:** Volatility has bounced during the month of May but it is a small move compared to one of the recent risk-off moves. On VIX we are still more than 50% away from the levels touched at the end of December.

  Central Banks and their unprecedented period of monetary interventionism are firmly behind the low-volatility trend that we are witnessing.

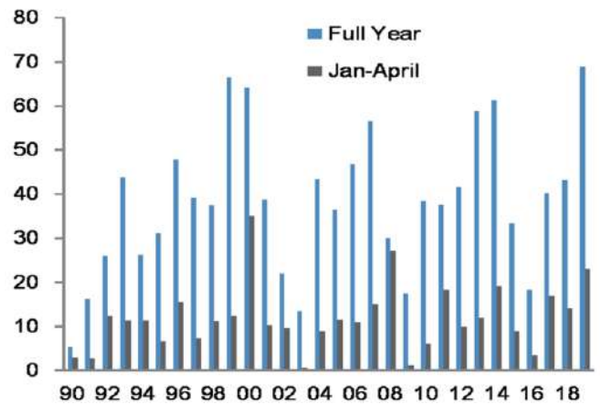
  The S&P closed down 6.6% in May and the last time we saw a comparable sell-off was on the close of the 11th of October when were sold 36bn$ of short futures over the preceding 30 days.
  We have instead seen that at the end of May were only sold 12bn$ of short futures over the previous 30 days.
  A similar statistic gives the same message looking at the number of Puts opened during May.
  The market is still pretty complacent and not prepared for a severe downturn.

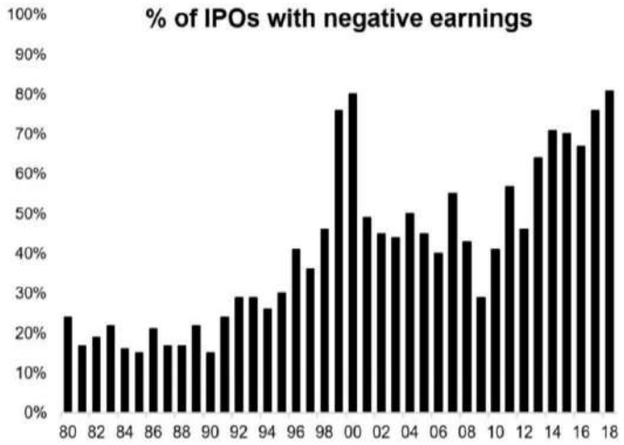
- **IPOs / Secondary/ Placing**: Despite the recent correction, US companies such as venture capital firms are still seeing an opportunity to cash out and they are all rushing to go public before this window of opportunity is closed from a repeat of last year's correction.

  Annualized, the value of US IPOs during the first four months of this year exceeds the previous high seen in 1999 at the peak of the dot com bubble.

Unfortunately, as we mentioned over the last newsletter, performance is not great as the number of IPOs that lost money is marking a new record high.
The problem lies both in the number of deals the market can absorb but also more importantly in valuation/pricing as this chart is showing..

Actual IPOs in bn$, 2019 full year estimate based on Jan-April pace annualized





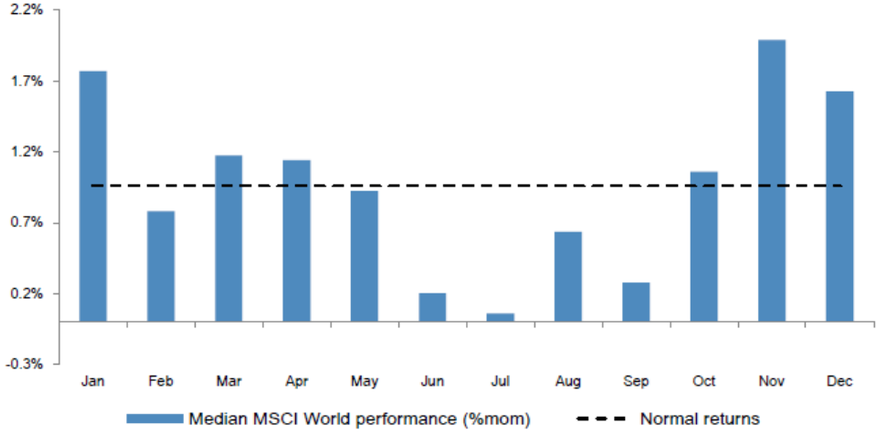
Executive Summary

- **Weak Seasonality in summer**: With the rally in April, we had statistically ended the best 6-month period of the year where the S&P returns an average performance of 7%. May to October is instead the weakest.

  Eurostoxx 600 and S&P have lost 300bps and 130bps on average from June through September over the last 20 years; if we condition for those indices down in May, they have historically lost 350bps and 550bps from June through September respectively.

  The Eurostox 600 has fallen in June in all but two of the past 10 years.

Median MSCI World monthly performance



- **Increase issuance on Credit Markets and quality of debt**: we are experiencing a rapid increase in issuance volumes and it will likely put some strains on Credit spreads.

Overall issuance is already running 22% ahead of last year, and the numbers are particularly strong in the IG market, which is running at over 50% more than last year's figures, while senior financials are running around 10% higher than a year ago.

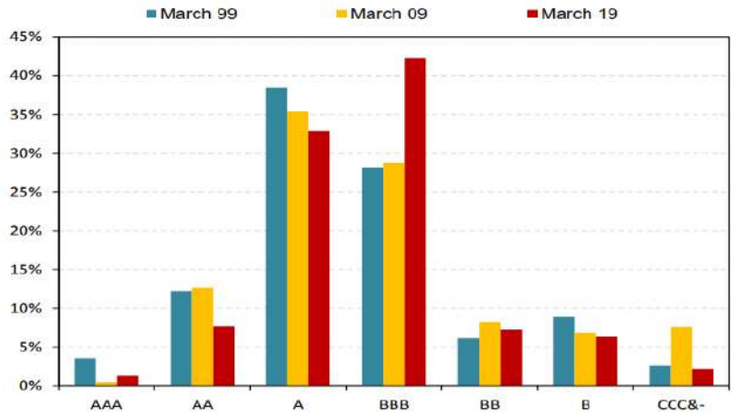
The size of the US corporate credit market has risen from around $3,500bn (23% of GDP) in 2009 to $7,500bn (37% of GDP) in 2019.

About 6% of BBB-rated companies, or approximately $200 billion in par value, currently trade at levels closer to HY than to the BBB spread curve according to the IMF. If credit agencies effectively downgrade these firms (in case of economic downturns in 2020), the US HY could face liquidity issues due to fire sales of rating-sensitive investors.

In December 2018 the HY market went halted because of lack of volumes and last week we had one of the largest weekly outflows form HY (900mln$, 6.5% of its assets).

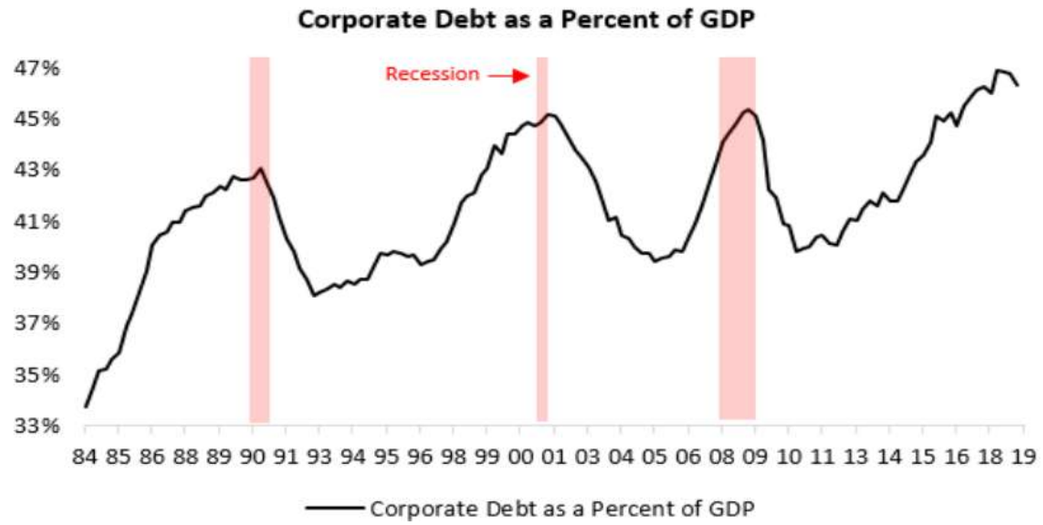
For the first time even, there is now more BBB- rated corporate debt than AAA- to A-rated debt combined!

US corporate credit market issuance



Executive Summary

Corporates are already facing a very hefty increase in their cost of capital, their trailing 5-year average is at its highest level since the early 1980s.



Investors needed yield, and US credit was one of the few places they could find it. The demand for credit pushed yields lower, which in turn incentivized companies to issue debt, and they did just that.

With demand for credit outstripping supply, investors were willing to accept weaker structures and the like, despite historically tight spreads.

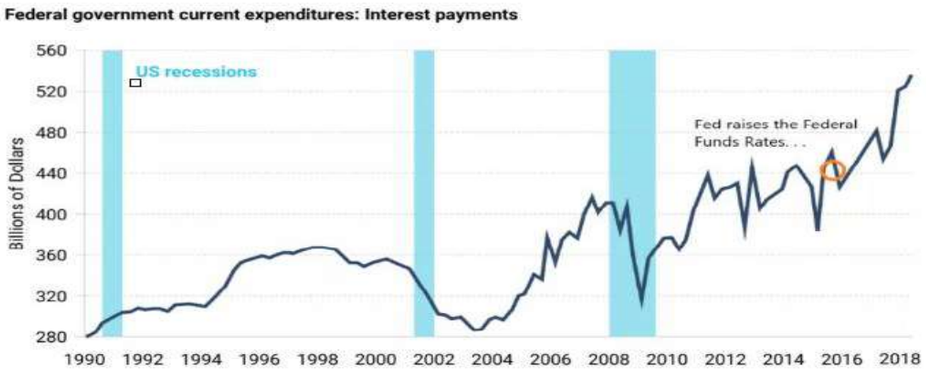
We find examples of problematic non-financial credit quality are widespread, for example, in the loan market, where leverage levels, covenant quality, and structures are in many cases weaker than 2007 extremes, and in IG, where leverage is already near historical peaks, before earnings growth has rolled over.

There were several articles recently about the danger on Leveraged-loan market. The CIO of Merrill said this week that “it’ll be ugly for those companies if the economy slows down and they can’t carry the debt and then restructure it, and then the usual carnage goes on”.

Moody’s Investors Service said covenant quality for 2018’s last quarter was close to a record low, and the rating company sees no signs of improvement this year. One big concern is that borrowers can now easily move more collateral out of the reach of lenders, which translates into bigger losses in a downturn.

We reiterate our call for a defensive stance on HY and EM bonds. We have seen 4 defaults in CDX HY so far since October 2018 and believe that the fundamental deterioration we’ve discussed for some time in credit is beginning to play out. We expect spreads wider over the next 12 months, with our base case forecast calling for HY spreads 100 wider from current levels (essentially back to the wides of last year).

- **US government’s borrowing** has increased to amounts that it hasn’t since the 2008 recession. The US budget deficit is just shy of $900 billion which means a 40% increase since last year.



Executive Summary

Ignoring private consumer debt (which is greatly affected by rising rates), the US National Debt recently hit $22 trillion and the interest payments due on all this debt is at a record high. You can see on the chart that since the Federal Reserve began raising rates in December 2015, the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year!

The ratio between the US budget deficit and the Treasury issuance poses substantial risks as they are going to issue 1.3trn$ this year and the unbalance has never been that great!

US budget has been deteriorating for 3 years despite the economy being on an expansionary phase.

Global debt is not only an US issue, have a look at the chart showing how it has increased in only 10 years around the Globe.

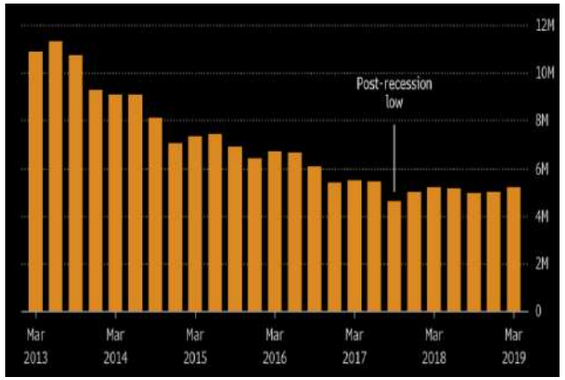
Global Debt in Trillion

- **Declining US House Prices**: US Housing data are continuing to surprise on the negative side.

The US pending home sales index fell 1.5% in April, missing expectations which looked for growth this month. Pending home sales typically lead existing home sales which are already down 4.4% YoY (dropping for the 14th consecutive month).

About a decade after the US recession ended, the number of properties that are "seriously underwater", where loans secured by the owner are 25% or higher than the property's estimated market value, is on the rise. More than 5.2 million properties are estimated to be deeply in debt, an increase of almost 600,000 from the post-recession low.

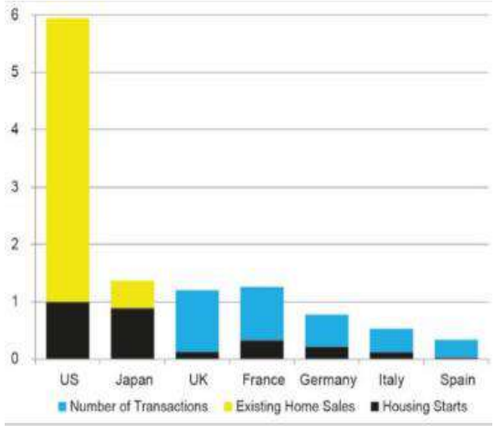
US Housing in Strong Debt



The number of US properties seriously underwater is on the rise.

If you are asking yourself why are we so focused on US home prices you should have a look at the chart showing the size of US market in terms of number of transactions (million units).

Global home sales in terms of n. transact. Existing home sales (yellow), Housing starts (black)



Executive Summary

- **Consumer sentiment very downbeat**

  Consumer confidence dropped in May for a 7th consecutive month.
  US personal interest payments have soared to a new all-time high exposing even more the consumers to a recession.

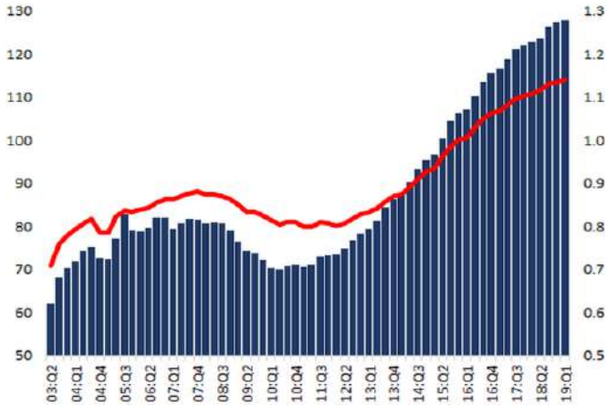
  Credit card transaction volumes have decelerated sharply in recent months, supporting latest data on retail sales; while credit card interest rates are >2 decade-high.

  At the same time, the percentage of loans companies have decided they will never collect, rose to the highest since 2012.

  The percentage of auto loans in serious default has risen to the highest level in almost seven years, as consumers with weak credit struggle to make payments despite a strong US economy and tight labor market. Loans delinquent more than 90 days rose to 4.7% of the total in Q119. At the same time, the average car loan payment just hit a decade high at 545$ per month.

In Q1, total outstanding balances of auto loans and leases rose by 4% from a year ago to $1.28 trillion, up 65% in 10 years!

Number of auto-loan accounts in tril$



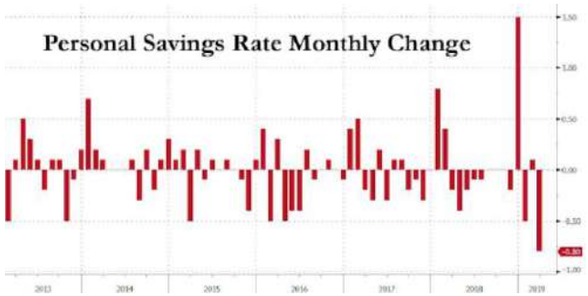
Delinquent US student loans reached a record $166 billion in Q4. But since "delinquency rates for student loans are likely to understate effective delinquency rates" by about half, according to the Fed, the figure is probably a far cry from reality. Factoring for understatement would imply that about $333 billion in student debt has not been serviced in at least three months. Putting this into perspective, $441 billion had been disbursed under Treasury's entire Troubled Asset Relief Program to provide financial stability during the recession.

Student loans constitute around 40% of the total debt balance of 90+ dat delinquencies for implied debt in arrears.

Appliance Shipments

Another example of the downbeat sentiment of US consumer is given by the statistic of major appliance shipments, collapsing 17% YoY in April..

US saving rates had the biggest monthly drop in recent years.



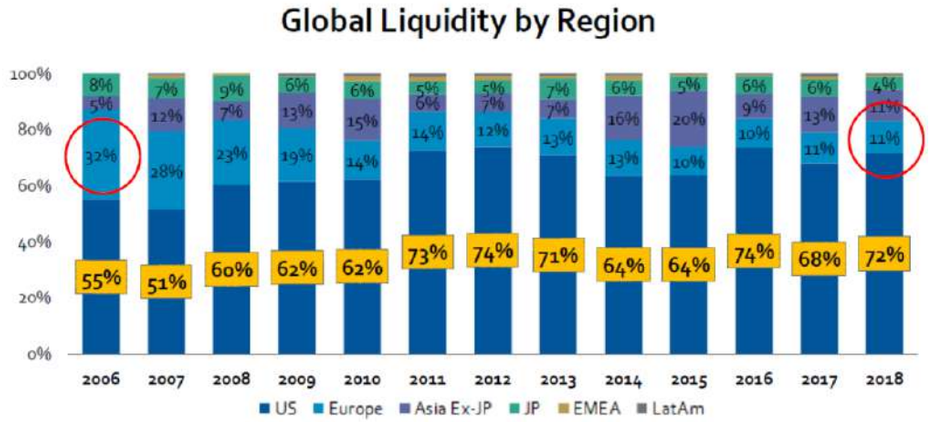
The signs are everywhere, credit exhaustion is global, and that means the global growth story could be over: revenues and profits are all sliding as lending dries up and defaults pile up.

Executive Summary / MACRO

- **Market liquidity continues to drop** and we have already seen in December how can this affect markets when there is the need to sell.

  Current average of US S&P futures is 66% below the 2018 average and 85% below the average since December 2015. US 10Y futures are trading 31% below 2018 average. WTI crude futures are trading 25% below the 2018 average and 48% below the average since March 2016.

  European equity liquidity has declined by 75% in 12 years.

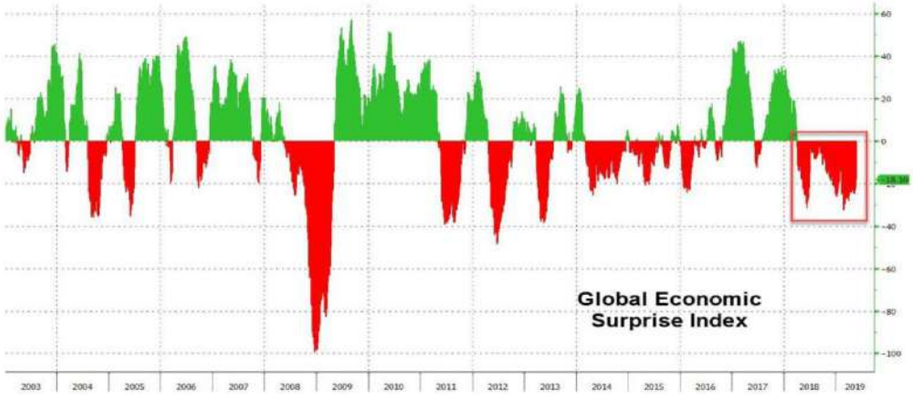


The greatest risk to quantitative strategies wouldn't be an equity bear market or a sharp increase in rates, it would be a collapse in liquidity.

MACRO

As mentioned in our previous newsletter, the fundamental picture strongly deteriorated in the last quarters. The Global Economic Surprise Index is suffering the longest negative streak, 286 days, on record.

Global Economic Surprise Index



Global economic growth is on track to be the weakest since 2016, while trade growth is set to be the weakest since the financial crisis in 2008. This week, the World Bank reduced its forecast for 2019 global trade growth to 2.6% from 3.6%, citing global trade tensions, and lowered its global GDP growth forecast to 2.6%Y from 2.9% for 2019.

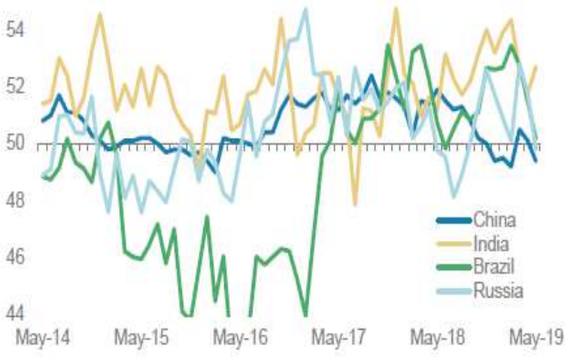
The downside risks to global growth are becoming more pronounced in May. The global manufacturing PMI fell to 50.1, a three year-low and just above the expansion threshold of 50. The decline was broad-based across Developed and Emerging markets; almost two-thirds of the manufacturing PMIs in each country fell below 50 while almost 75% of the PMIs declined vs. previous month. Escalation in trade war (China, Mexico etc.) along with waning corporate and consumer confidence are the main drivers of this weakness.

MACRO

PMIs in the US, China and Korea (leading countries) declined the most while in Europe and Japan remained weak in contractionary territory.

PMI US (yellow), PMI EU (blue), PMI Japan (light blue)

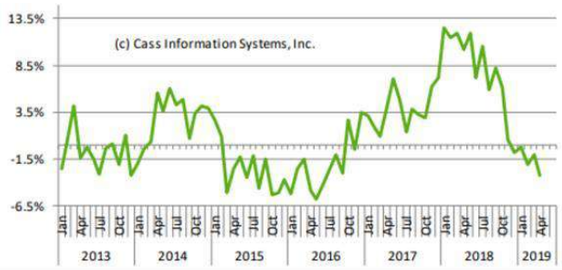
China PMI (blue) in contractionary territory



Extended trade tensions would undermine the degree to which China's fiscal stimulus spills over to the rest of Asia/Emerging markets. Exports decreased in China, Korea and Japan. In addition, the Cass Freight index was down 3.5% YoY in April, suggesting growth was slowing before the trade tensions re-escalated.

China new orders/exports declining (blue)

Cass freight Index Shipments



Europe

Focus on Germany. Growth remains sluggish. The current activity indicators have decelerated further in recent months. Aggregate and Country-specific PMIs were subdued as mentioned, with a soft Euro-area and German Q1 2019 GDP.

Germany is running out of steam, with the Government and the European Union cutting 2019 GDP forecast to 0.5%, the weakest expansion in 6 years and the latest in a series of downward revisions from 2.1% a year ago. The IFO index, Germany's business climate, decreased again in May due to weaker services and trade, along with subdued factory orders, and rising unemployment for the first time in almost two years.

Aggregate and Country-specific PMIs were stronger in June, along with rising aggregate economic confidence, suggesting that the Macro situation might be improving.

US

Data still-above average but deteriorating. The current activity indicator points to growth of 1.7% in May, strong slowdown, 50bps lower from February levels. As a result, the Street estimates a weaker headline growth in the next quarter, around 1%. The ISM index, a measure of U.S. manufacturing activity, unexpectedly fell to the lowest level since October 2016. On one hand, the consumer and industrial segment were weaker in April with negative retail sales and industrial production; on the other, the job market remains firm with shrinking economic slack and strong nonfarm payrolls. Q1 2019 GDP has been revised to 3.1% vs. 3% consensus.

MACRO/ Central Banks / Commodities

China

April and early May activity data below expectations. April Industrial Production slowed meaningfully to 5.4% YoY, from 8.5% YoY in March. Growth of cement production and automobile manufacturing slowed as well in April (sign of slow-down). Further, Retail sales surprised to the downside, 7.2% YoY in April vs. 8.7% in March, with broad-based weakness along with Fixed Investments. Caixin China PMI lower than consensus, previous month in May. Clearly, activity growth is under increasing pressure and the economy is losing steam.

CENTRAL BANKS

FED: the FOMC turned increasingly dovish as Powell is prepared to act as necessary (not mentioned how) to sustain the near-record expansion and respond if inflation remains persistently low, trade war escalates and global growth continues to weaken. The market is now discounting 95% cutting probability by September and 99% probability by November 2019, at least two quarter-point cuts by year-end, one more than the case just days ago. This is also well-explained by the bond market as the 10Y nominal Treasury yield declined approximately 30bps in the past few weeks from 2.40 to 2.10%.

ECB: In June, the main refinancing rate and the deposit facility rate are left unchanged as expected. The major surprise is the pledge to keep interest rates unchanged through the first half of next year, 2020 (this means 6 months extension vs. 3 months consensus). Further, the ECB gave more details on TLTROs: A) the interest rate in each operation is set at a level that is 10 basis points above the average rate applied in the Eurosystem's main refinancing operations over the life of the respective TLTRO B) For banks whose eligible net lending exceeds a benchmark, the rate applied in TLTRO III will be lower and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation plus 10 basis points. Basically, it means if lending criteria are reached then cost is -30bps which is bullish for peripheral banks (street consensus was between -20/25bps). Conditions of TLTRO III remain very accommodative and will allow easy refinancing of current EUR 240bn TLTRO II Italian Banks' exposure with limited impact on their funding costs.

COMMODITIES

Commodities, are small down year-to-date, down almost 8% since April highs. The Bloomberg Commodity Index, a gauge of prices for everything from copper and crude to coffee and cattle, has sunk to the lowest level since March 2016.

Bloomberg Commodity Index

Steep drawdown due to Macro, inflation and growth concerns, which seems to have increased with the escalation of Trump trade policies. As discussed in our previous newsletters, <u>we warned that commodities were not significantly undervalued against fundamentals anymore and the risk of holding commodities was too high compared to the reward. **Now the situation has changed** as Oil price dropped nearly 20% from the levels of April, the USD is weakening and we are bullish on Gold for the medium-term.</u>

Commodities

Oil

After being neutral, we are starting to get positive again but we expect price volatility to remain elevated as Quant fund are consensually short. However, we think the current valuations of oil big caps represents an interesting opportunity to build up a position on the sector.

Still one of the best performing asset class, with WTI up 17% YTD and Brent up 15% YTD. May has been a tough month for the oil market, with WTI down 16% and Brent down 12%. The magnitude and the velocity of the sell-off has been consistent with A) rising price volatility driven by rising supply and demand uncertainties B) deteriorating Macro environment (weak broad-based results in May) C) geopolitical tensions (trade war etc.) D) technical and positioning.

We would like to focus our attention on the following points:

- **Demand side**: on one hand oil demand decreased in March along with shrinking refining margins, on the other a milder winter, excess available refining capacity and April data suggest there might be upside momentum.

- **Supply side**: here the situation is a bit more uncertain. On the positive (bullish for oil price), the European market is tight, Iran exports have fallen sharply in May, Iran and Venezuela production have strongly declined this year. On the negative (bearish for oil) US inventories are rising more than seasonal, US production has risen approximately 1 mb/d year-to-date, new US infrastructure/pipelines out of the Permian, the cheapest and largest shale basis, will decrease the global cost of production, core-OPEC aims to balance the global market (Bloomberg consensus expects higher Saudi, Russia, UAE production in 2019 to offset decrease in Iran and Venezuela).

- **Technical**: the set-up of the market was in April consensus long oil, this has obviously changed. In addition, oil prices gapped lower through their moving averages, triggering additional sell-off with the help of CTA funds which are now short.

Gold

Gold provides diversification in a portfolio and is often correlated with the stock market during risk-on periods, while it decouples and becomes inversely correlated during periods of stress. This is unique amongst most hedges in the marketplace. We reiterate our mantra, that gold is one of the best asset class to have in portfolio in 2019.

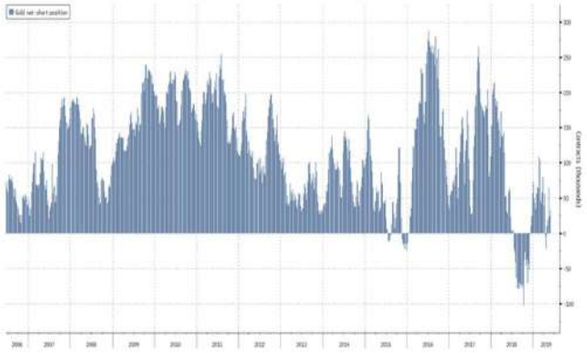
We are currently bullish medium to long-term on the asset class, moving from a previous neutral stance, after the Fed signalled an increased dovishness, along with declining real interest rates (inverse correlation real rates vs. gold) and a lower USD dollar which seems to be weakening. The technical setup and shifting macro currents place gold in possibly one of the best positions to perform since the bear market began.

After a weak March and April (gold lost 5/6% since February highs), gold rebounded approximately 5.5% in late May, early June. Over the last two weeks there has been a substantial amount of short covering, one of the largest covering since last year. There is however a decent number of shorts and the buy-side net long position on Gold futures remain 1.2 standard deviation below the average since 2006.

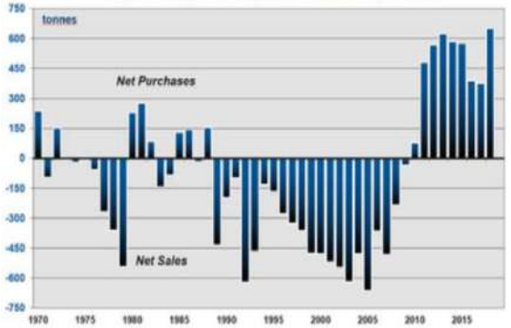
Commodities / Forex

Central banks are buying at the highest pace in the last 50 years.

Gold net short positions



Central Banks Purchase

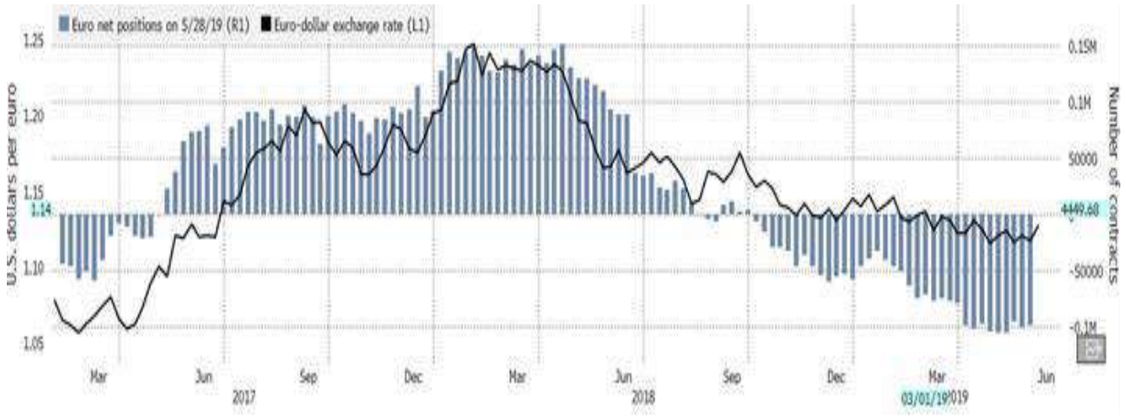


FOREX

We are starting to get more bullish EURUSD pair in the medium run. After several weeks of broad USD strength, markets seemed to take a breather over the past few sessions. Several factors have contributed to this change in pace, including Fed officials opening to potential easing and thereby validating existing market expectations, idiosyncratic strength in selected EM currencies such as TRY and BRL. We acknowledge that the Fed opening to the possibility of easing is meaningful development that can limit USD potential in the near term especially if US data were to give further reason for policy accommodation.

In terms of positioning, investors are consensual long USD (possibly the last consensual trade that hasn't derailed yet). The short EURUSD position is the funding leg of many carry trades meaning that a new potential market correction could lead to a partial unwind of the trade.

Euro net positions (histogram) vs. EURUSD (black)



Technically, we have been trading in a tight range between 1.11 and 1.14 from the end of last year, we could see a break of this trend simply only above 1.14 or below 1.11.

However, an interesting DeMark chart analysis is showing an important sell signal on the DXY (Index dollar). It is an important factor to be monitored as an EURUSD strength could possibly derail the carry trade and push Commodities, Gold and EM higher.

DEMARK Count

Current Investment Idea

Call replacement on single names/sectors

Already last month we suggested to take advantage of the low volatility, replacing some of the single names with Calls in order to better protect the portfolio in a downturn phase and still being able to participate to the upside.

Long Put spread on Indexes

Over the last newsletter, we mentioned it has never been so cheap over the last 2 years to protect the portfolio through some Put spreads on Indexes and this has worked well.

We would now wait for the volatility do drop lower, taking advantage of the market bounce, before building up new protection strategies.

Long CDS and Btp/Bund spreads

We would keep the position bought on ETFs that synthetically replicates the performance of the short iTraxx Crossover 5-year CDS like the XTC5 GY.

This trade would benefit from a widening of the spreads.

Long European oil sector, SXEP

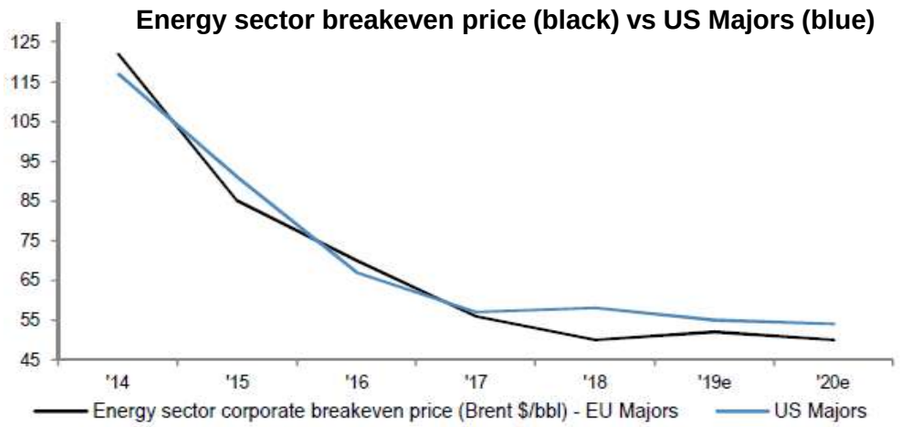
This is either a relative call (vs Eurostoxx 600) or absolute.
The EU Energy sector is still cheap on most valuation metrics and Q1 reporting has shown good numbers and guidance.

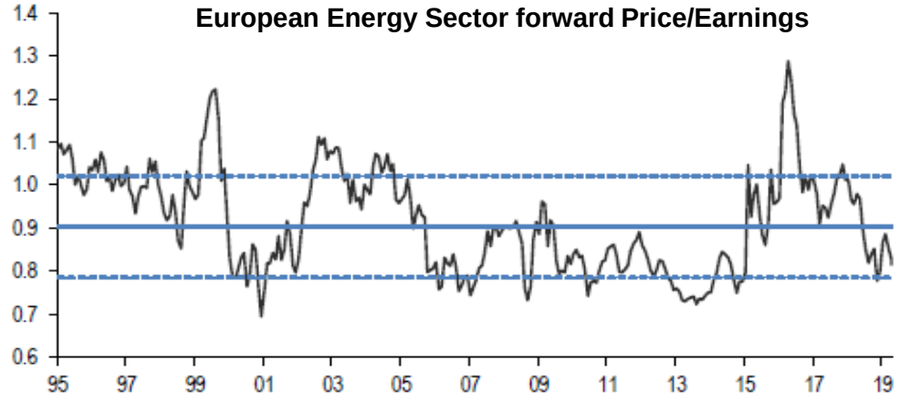
<u>Energy hasn't been this oversold in relative terms in almost 5 years, at 3 standard deviation, a level it reached only 3 times in the past 15 years!</u>

Energy relative performance with standard deviation from 12-months average

Improved capex discipline has supported stronger cash flow generation for the sector. Past margin pressures have forced the Energy sector to undergo restructuring which resulted in lower breakeven prices, and a better ability to handle volatile commodity prices. We should therefore expect the sector to continue to deliver strong earnings.

Current Investment Idea





The SXEP has lost 9% since the middle of April and has already retraced more than 50% of the upside move it had since the 27th of Dec18.
The sector is flat since our call started over last newsletter, already outperforming the market

The gross dividend yield for the sector is an interesting 5.1% excluding the positive effect given by the buybacks which on average gives you another 3-4% yield. <u>It is a rare Value sector seeing strong EPS revisions and macro data remains favourable</u>.

Long Russell in US, RTY (absolute and relative terms)

This is either a relative call (vs S&P500) or the start of a buildup for an absolute trade on market weakness.
Russell 2000 (US small-cap Index) has barely performed since the end of January while the S&P has bounced 5.5% and Nasdaq +6%.

Gap between Russel vs S&P

While this is a function of an early warning signal and in line with the breath indicators mentioned last month, we start to believe that there isn't a proper justification for such an underperformance of Small Caps vs Big Caps, especially if the macro picture will eventually stabilize in the short-term.

Current Investment Idea

The relative chart of Russell vs S&P shows how we are back to December 2018 lows, historically when there's a 6% divergence over a 2 to 3-month period, the RTY/SPX pair trade has reversed 70% of the time.

Our proprietary relative (RTY cs SPX) weekly trading signal is giving a buy recommendation