Monthly Market Update

Monthly focus on the financial markets
9 May 2018

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Alberto Tocchio - CIO
atocchio@heron.ch

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Market Analysis

Since the end of March, the trading idea Long Europe / Short US is working well: S&P500 Index down 1.5% vs. EuroStoxx 600 up 3.6%. One of the crucial factors helping this outperformance, which we called quite well, has been the depreciation of the Euro which has lost 3%.

The market was expecting a **strong EPS season**, though so far it hasn't been a smooth sailing, as we are more than halfway through in US and Europe with both regions recording positive surprises. Despite EPS beats and misses being penalized on the earnings day, European stocks are being rewarded for beats in line with historical levels.

In **US** we had 80% of companies beating earnings, better beat than the historical trend of 67% beat rate. We had an EPS growth at 23% YoY, surprising estimates at 6% thanks to a combination of weaker dollar and tax cuts that has boosted US delivery.

In **Europe** we had 53% of the companies beating earnings estimates, delivering EPS growth of+11% YoY. European corporates have noted the FX headwinds impacting their revenues delivery in Q1, though we believe the worst is behind us as Euro depreciation in H2 will strengthen companies' revenues.

Price reaction has been exceedingly weak, stocks delivering EPS beats haven't outperformed the market on the day of results, and in the 5 days post results have actually underperformed on average. The skew in performance has been similarly negative for sales.

Sector- wise IT and Materials had EPS beats, Real Estate, Energy and Consumer Staples missed consensus. Despite these positive numbers, the consensus of global analysts' appears less optimistic on the profit outlook than a few months ago.

Market consensus seems to be less optimistic on earnings than a few months ago. In addition stocks are not rallying on results as the market was already long into numbers. Prime Brokerage data shows that the Asset Managers exposure remains elevated. Importantly, EPS upgrades continue to outnumber EPS downgrades but the trend suggests EPS revisions may have just peaked. The net 3-month EPS upgrades have fallen to +2.5% in April from a recent peak of +15.7% in January. There is a high probability that global EPS downgrades return over coming months and the market is not yet positioned for this scenario.

Market Analysis

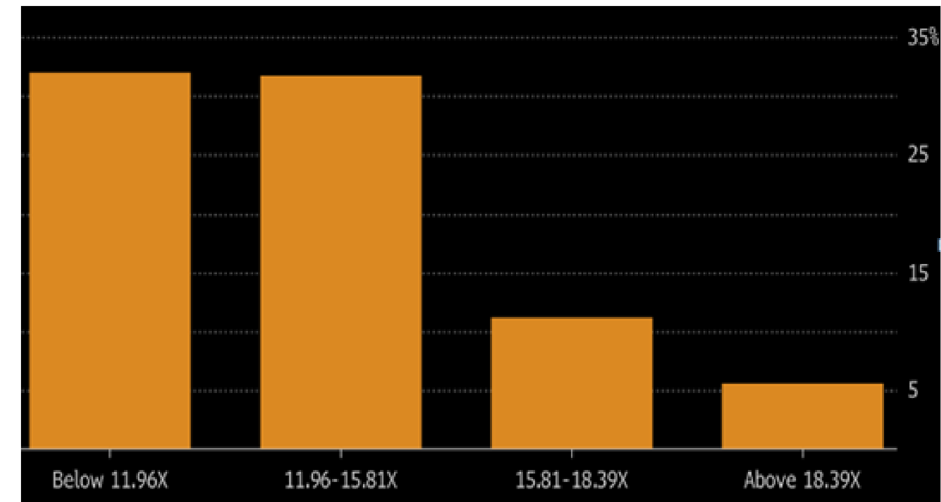
We are also increasingly nervous that the global earnings outlook will deteriorate further over the coming months, following an increasing focus on EPS growth (which lags EPS revisions), a potential pickup in inventories versus a slowing order book as inflation expectations moderate, and a continued deterioration in money supply growth across the region (these trends lead the profit cycle usually).

The table shows the S&P performance in months when earnings per share rose faster than the average for 1950 through 2018. At price-earnings ratios of 18.4x or more, the S&P 500's average annualized gain in those months was 5.5%. The S&P current P/E is 20.5x.

As we look through the global sector EPS revisions, it seems that cyclical sectors have a peak in their EPS expectations, while defensive sectors show early signs of downgrades bottoming.

Q1 has proven to be more difficult than expected. US returns are flattish Ytd, cross assets volatility has strongly increased and the market leadership is in transition. All these factors have weighed on portfolio performance.

Average annualized gain in months when S&P 500 EPS growth was above average



Global Equities Positioning

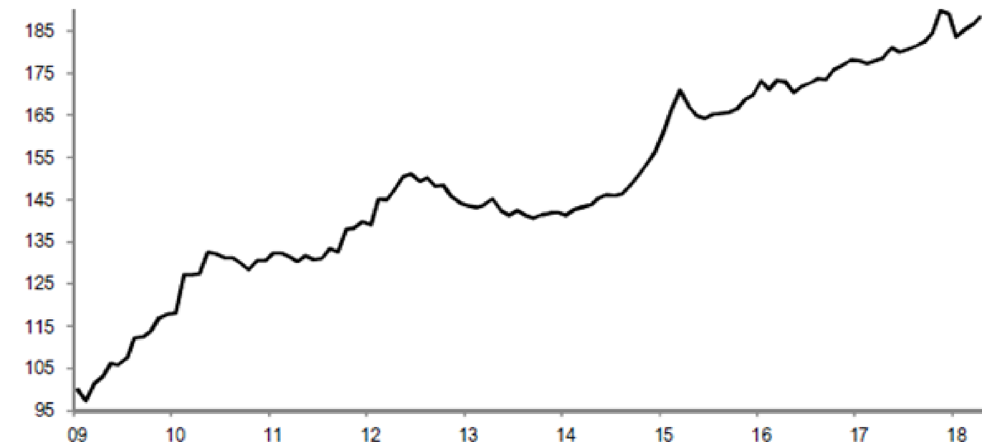
In terms of **positioning**, the gross leverage of US Long/Short is still high, at about 166% (the 98th percentile since 2005) while the gross leverage of HFs is near the highest level we had in recent time. Tough, performance is not necessarily following. In 2017, average HF performance was positive every single month. In 2018, a very strong January was followed by two negative months. Globally, HFs are up only +0.9% in Q1 18 and only about 0.8% through late April '18. Last year HFs were up 2.9% in Q1 17 and +3.5% through April '17.

As already discussed, the market will likely be driven by Tech (Tech and Retail Tech longs account for nearly 60% of the names in the Top 50 Longs, accounting for nearly 75% of the exposure). 7 out of 500 companies accounted for the 60% of the S&P total return in Q1.

Historically this kind of narrow markets end badly such as the crash of 1929, as well as 1972 and 1999. So whatever the darling of that narrowness it needs to be avoided.

Technology earnings have strongly outgrown other sectors' during this cycle. It is getting more challenging to deliver significant EPS growth rates in Tech due to the substantial EPS base and expectations as well as a mounting regulatory uncertainty.

MSCI World Technology 12-month forward EPS vs. MSCI World



Global Equities Flows

Hedge Funds have held their trading book steady over the last few months thanks to a positive "performance cushion". However recent returns of momentum stocks suggests performance is struggling.

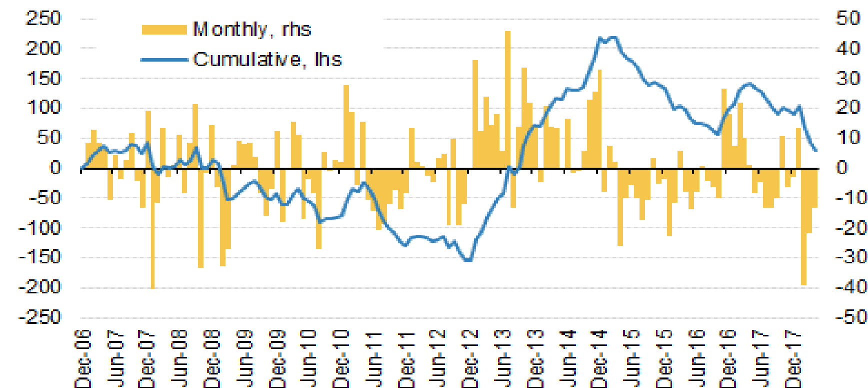
Corporates will start to re-enter the market as earnings season draws to a close, but these flows argue more for less downside than explosive upside as buybacks are a drip not a flood.

Asset managers and Macro investors could provide some demand but their flows have been choppy (sold in Feb/March to moderately buying in April).

Retailers have reduced beta risk (passive funds saw the biggest outflows since 2009 over the last 3 months, see charts below) and likely remain on the side-line due to higher volatility. It seems that the February equity market correction have caused a structural break in the behaviour of retailers as the bidding activity of equity and bond funds have shrunk with little signs of a recovery. Contrary-wise we have seen a rather different behaviour in January. (Investors bought 100bn$ of ETFs in January to sell back ¾ of them)

Systematic investors are currently unlikely to buy this market too, given high cross-assets volatility.

Global ETFs Retailer Inflows



Macroeconomics

As far as **Macro** is concerned, the global economy has exhibited its strongest two years growth since 2011, with extremely accommodative monetary policies finally bearing fruits. Despite a deceleration in consumer spending activity, we believe that strong fundamentals point to a rebound into H2. The latest data indicate consumer spending perked up in March, while last week's flash April PMI readings in the US, Euro area, and Japan support the call that the Q1 momentum loss has been arrested and that global industry will maintain solid growth consistent with a reacceleration in global GDP.

Having remained in positive territory for a record 16 months, the Eurozone economic surprise index fell sharply in recent months to the lowest level since 2012. However, in the last couple of weeks there has been a modest improvement in the Citigroup ESI, and also a more noticeable improvement in the Westpac equivalent index.

US hiring rebounded in April and the unemployment rate dropped below 4% for the first time since 2000, while wage gains unexpectedly cooled, suggesting the labour market still has slack to absorb. The central bank is on track to raise interest rates in June for the second time this year. In addition, these results also reinforce forecasts for a rebound in economic activity in Q2, after a slowdown in the first three months of the year, with the labour market supporting gains in consumer spending.

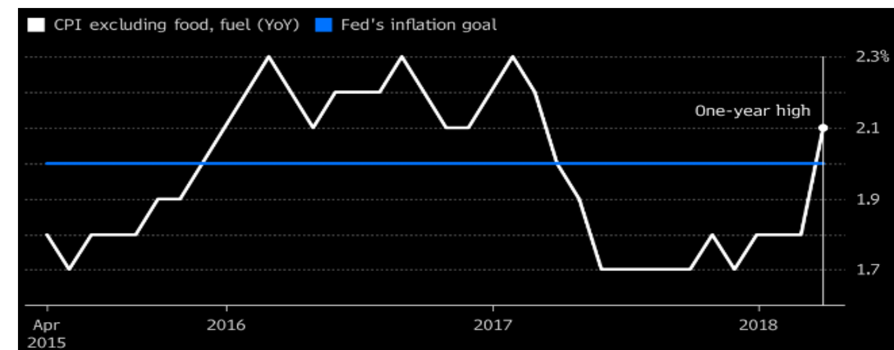
Let's now analyse the important **inflation** effect and the Yield curve.

Euro zone April headline CPI last week slowed to 1.2%, down from a 12-month average of 1.4%. Core CPI slowed to 0.7%, down from a 12-month average of 1.0%. These data increase the likelihood that the ECB will have to lower both growth and core inflation projection in June.

In US, one measure of underlying inflation is back above the Federal Reserve's goal once again. The core consumer-price index, which excludes volatile food and fuel components, increased 2.1% in March from a year ago.

We continue to forecast a more rapid acceleration in inflation than markets discount. Breakeven inflation expectations have been rising fairly steadily since last summer and, in both Europe and US, recently moved close to 3Y highs.

US Core CPI YoY (ex-food/fuel) vs FED inflation goal



Inflation

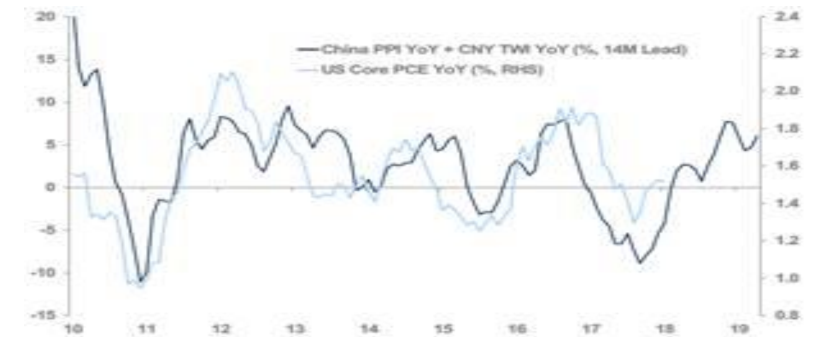
The main underlying dynamics are the following:

- Labour market suggests higher inflation. OECD unemployment is now at a record low and is finally translating into higher wage inflation in US and more modestly in Europe. The labour markets tightness and rising wage growth are likely to contribute to higher inflation from here.
- China is now exporting inflation rather than deflation. The 1st chart combines changes in China's PPI inflation and the CNY currency to provide a measure of China's influence on global inflation. Having provided a big disinflationary shock in 2015-16, China now appears to be exporting inflation rather than deflation.
- Commodity prices are on the rise. Headline inflation is likely to be supported by the rise in commodity prices over the last few quarters.
- USD weakness likely to filter into higher US inflation. The 2nd chart illustrates that there is a close link between US inflation and moves in the dollar, the weakness in the USD in the last year or so is likely to contribute to a pick-up in US inflation in coming quarters. The chart shows the correlation between the DXY Dollar Index and US CPI.
- Trade tensions could add to inflationary pressures. While the outcome of the recent flare-up of trade tensions is unclear, an escalation of trade protectionism could add to inflation pressures.
- Consumer inflation expectations have been rising. The last chart shows that inflation expectations of both European and US consumers have been on the rise for the last year at least (chart).

The result of higher inflation simply translates into higher volatility.

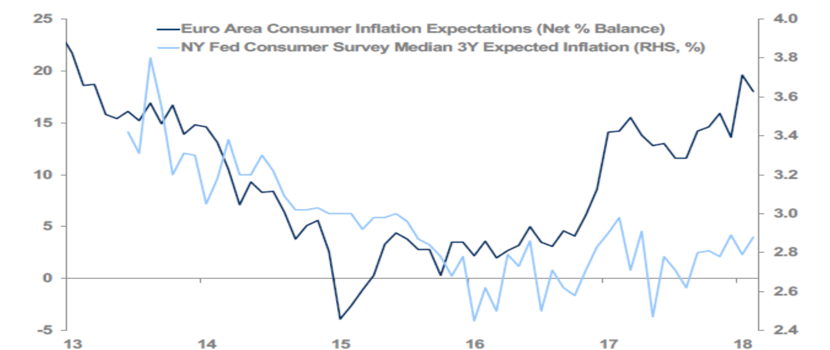
PEs have been lower and volatility higher in the Q118.

US Core PCE (core inflation) vs. China PPI (producer price index) YoY



Inverted DXY Index vs. US CPI

Eu expected inflation vs. US expected inflation



Inflation / US Yields

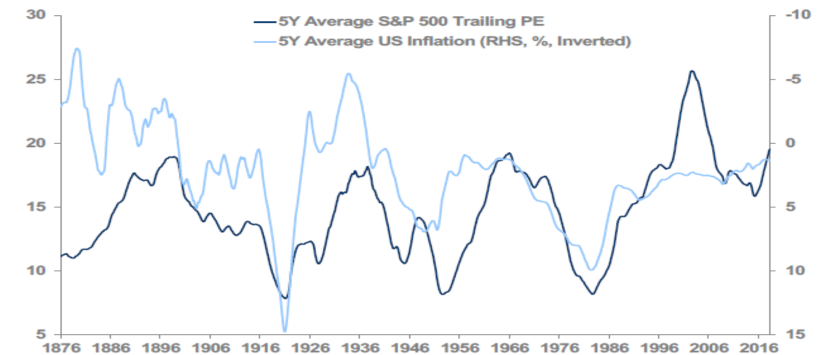
The US market in particular has shown a consistent negative correlation between PEs and inflation over the long-run. The chart shows the 5-year average P/E on S&P and the inverted 5Y inflation.

We also had a further evidence of inflation into Q1 numbers.

Sales growth at Nestle, Procter & Gamble and Unilever was driven almost entirely by shifting more goods, in a stark illustration of how difficult is to raise prices. Pressures are also building up between manufacturers and retailers as the former are getting squeezed by rising transport costs. Caterpillar is struggling to preserve its pricing power due to rising material costs. Australian miner Fortescue Metals has also reported a 2% drop in fiscal Q3 iron ores shipments on reduced demand from China, while also flagging an increase in costs, mostly due to the stronger Australian dollar and rising fuel costs.

The **Yield curve** has been flattening further with 2s/10s touching the lowest since 2007. Bullard (Fed member) said recently that there might be a curve inversion within 6 months.

SP500 PE vs.inverted US Inflation (positive correlation)



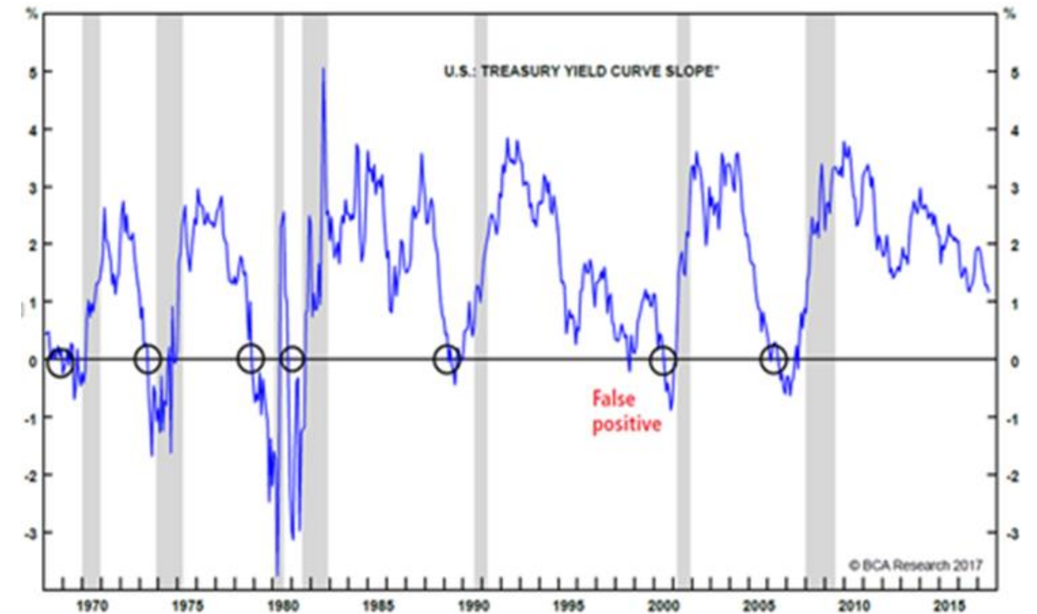
Spread between 2 and 10-year Treasury yields

Yields Positioning

Positioning on US10 Treasuries has hit a new record level and is potentially prompting some short covering (bottom left chart). Over the past 50 years, there have been 8 instances of yields curve inversions where 7 were followed by recessions (blue chart highlighted by shaded zones) with only 1 'false positive' in September of 1998.

Market positioning on 10-year Treasury futures

US Treasury yield curve slope. UST 3m/10y curve

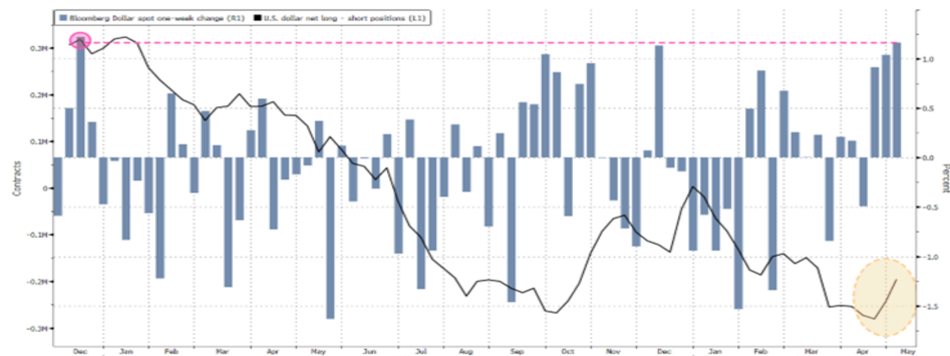


Central Banks / EUR-USD

The **FED** left the funds rate target range unchanged at 1.50-1.75% in May. The key change in the post-meeting statement was the recognition that headline and core inflation have “moved close to 2%”. The market odds of a June hike are unchanged at 90%. Most participants who have recently been on the dovish end have made comments hinting at a shift toward the centre. The FED is likely to accelerate the pace of rate hikes only if inflation seems poised to accelerate meaningfully from here.

The **ECB** still believes that the underlying strength of the euro area economy supports the inflation convergence towards target over time. In a wait-and-see mode, but how long for? The ECB is not in a rush to announce the next policy decision. However, they think that the constraints around the QE programme, and the current forward guidance of "until September 2018 or beyond", are such that the next announcement on how and when QE will end is likely to come in June or July at the latest.

US dollar currency weekly flows



EUR/USD. As we rightly forecast, the DXY Index has appreciated 3.2% since our latest newsletter and more than 4.5% since the end of March lows. Last week, the dollar had its biggest weekly gain since December 2016 with sellers reducing their massive short positioning. Even though the DXY index is in a short-term overbought phase, we would suggest to hold a long position on the green currency.

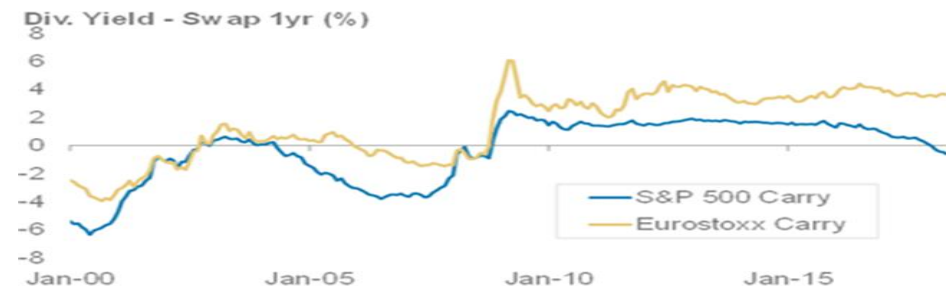
Short positioning has reached the highest level in 7 years at the end of April. The chart shows how flows are turning through the blue bars and the highlighted DXY level.

For the first time in 10 years, the S&P is now a negative carry trade for USD investors and even for most global investors, the S&P 500 index is an expensive position from a carry perspective today.

Europe is the largest market with the currencies that offer the best FX-hedging yield and most reasonable asset yields. At the moment, Europe is the country with the broadest appeal for global investors.

European equities FX-hedged yields are at or close to record highs (Swiss, Netherlands (AEX) and UK stocks (6%+ yields) stand out), Bunds offer a pick-up in carry over Treasuries and look better on a vol-adjusted basis. European credit, despite lower headline yield, is now also competitive on an FX-hedged basis vs. US credit.

SP500 Carry vs. Eurostoxx Carry



Commodities

Crude price has reached $70 for the first time since November 2014 (+16% Ytd), the reasons behind this further up move needs to be found in the strong OPEC compliance, shrinking inventories and Geopolitical tensions.

The threat of a re-imposition of U.S. sanctions against Iran risks disrupting exports from the OPEC's third-largest producer. Worries about an escalating conflict between the United States and Russia in Syria have been mounting in the past few weeks.

OPEC April compliance rate rose to 162%. Along with Venezuelan production falling, Angola is now producing 260,000 bpd less than target. According to the survey, OPEC pumped about 610,000 bpd less than its target.

Positioning on Oil is still very long and is the only asset class where CTA and Macro are making good money since the beginning of the year. Since short and long term charts are now stretched, we believe that a genuine correction might happen anytime, though difficult to forecast.

$ Silver net-short positioning

Gold/Silver. After calling the reversal point in the support area at 1250$ in the middle of December, we suggested at the end of March to start reducing risk. We have been right so far as Gold dropped 3% since our call. Positioning has turned too bullish in a short time-frame with May and March being traditionally the worst months.

The correlation between Gold and Interest rates should be negative in the long term, especially if the USD strengthen.

The 1300$ level could act as a first support now, we have started to buy Silver as positioning is now the most bearish ever on the metal (chart) and the relative value of Silver to Gold is reaching an interesting level.

As far as **Geopolitics** is concerned, no Government has been formed in **Italy** yet. However it seems that discussions are now in the latest phase with the President being ready to appoint a technocrat as PM (Italian Index up 10% since the elections… not yet a real concern for the moment).

US Treasury Secretary Mnuchin said that US and China are having "very good bilateral conversation," after a recent meeting in Beijing.

As a reminder, Trump is threatening to impose further tariffs on Chinese goods worth as much as $150 billion. Since America will punish China if bilateral talks fail, a Chinese retaliation on the same amount of US exports would be expected.

Another positive catalyst is coming from the decision of North Korea to comply with a full denuclearization process by 2020. The meeting between Kim Jong-Un and South Korea President Moon Jae-in was an historical event (last meeting took place in 2007), and paved the way for a possible summit between US and North Korea in June.

EXECUTIVE SUMMARY

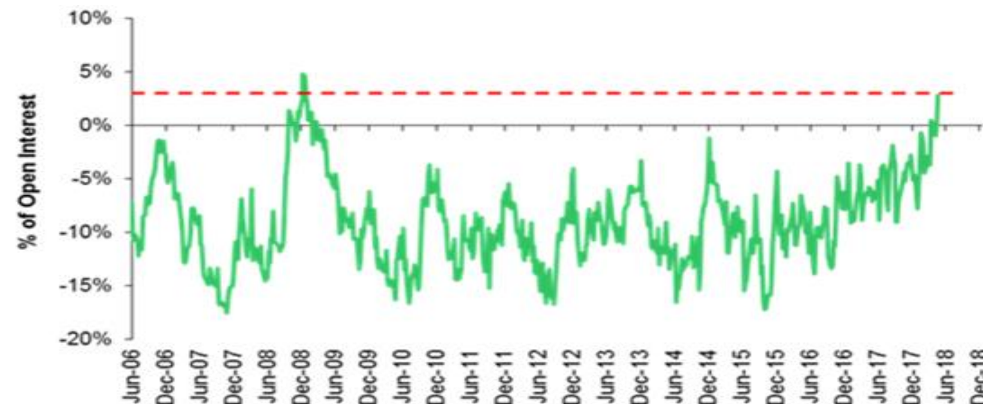
The Eurostoxx 600 index has recovered 7.0% from the lows made at the end of March while the S&P has increased 3%. Markets have also regained confidence helped by the Q1 reporting season. Volatility has dropped to March lows showing low levels of protection. Despite the market moving higher, we still see some breadth of deterioration. We are approaching what is likely to be a new turning point as we are in the classical "End Cycle" market pattern.

Sentiment has shifted, good news is frequently sold into, good EPS are sold into and we continue to highlight the very poor liquidity.

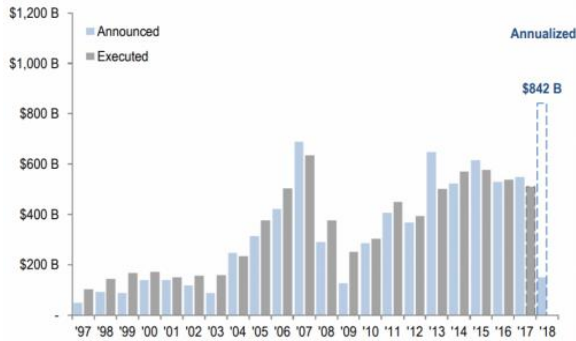
The dichotomy between the strong Q1 results so far and market's end of cycle fears does not provide an easy answer. While nonfarm payrolls provided ammunition for both bulls and bears, the trend is for continued growth in a non-inflationary manner..

Positioning is turning bullish again for Leveraged Funds, last week they covered 8.1bn$ notional and are now the longest they have been since December 2008.

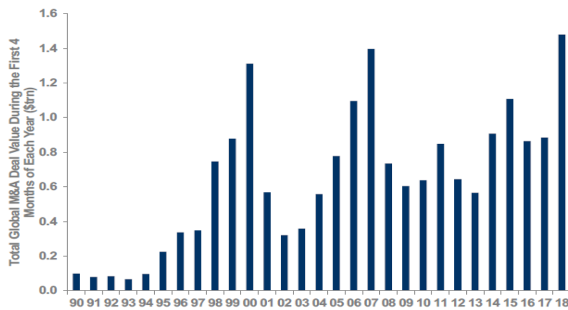
Leveraged Fund S&P long positioning



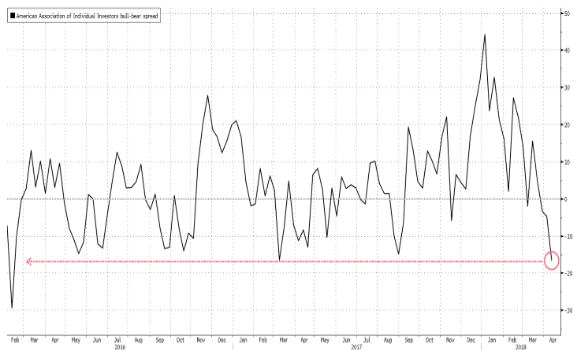
Buybacks: Announced vs Executed



Total Global M&A deal value during the first 4 months of each year



AAII US Bullish outlook vs bearish



Let's now analyse the current main positive and negative data-points:

Positive

1. **Buybacks**: recent forecasts are showing a potential of up to 800bn$ of repurchases in 2018, the strongest since 2015. No other region has planned to buy back as much as US yet. This means that every day there is roughly 3bn$ being bought on the market. While Japanese and EU buyback yield is only 0.5% US provides a 2.5% buyback yield and a +4.5%. Apple is simply the latest corporation to announce slowing sales growth and compensate for this stagnation with a massive $100 billion buyback to prop up shares at their current valuation. The chart shows the announced vs realized buybacks.

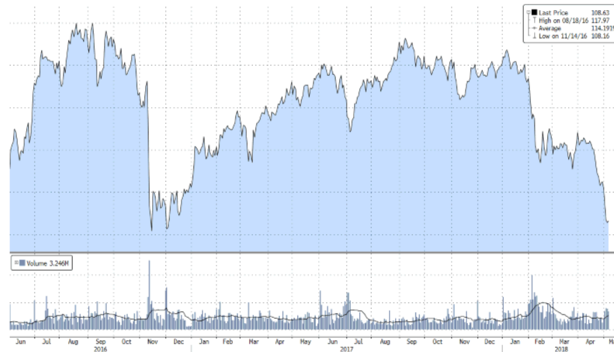
2. **IPOs**: Global IPOs are up about 25% this year compared with the same period in 2017. Companies sold $27.9 billion of stocks this year compared with $22.2 billion a year ago at this time. The number of deals rose 2.5% despite a much more difficult market.

3. **M&A**: Global M&A activity has seen the strongest year-to-date start since 1990. Volumes have totalled $1.5trn YTD, surpassing the pre global financial crisis peak of $1.4trn in 2007. At a regional level, the US has been once again the biggest driver of the surge in global M&A activity, where deal volumes have risen to a record high. Europe has seen a sharp pick-up too, and volumes in the region are at the highest level since 2007. The chart shows the total Global M&A deal value during the first 4 months of each year.

4. **Short-term sentiment**: the mood has radically changed among US retail investors who were heavily buyers in January. The gap between bullish outlook vs. bearish outlook has slumped to the lowest since February 2016 (3rd chart).

5. **Short base**: The Eurostoxx index has seen a sharp YTD increase in the short base (cash market), the biggest point-to-point increase we have seen in at least 5 years. Using a bottom-up cap weighted analysis of the Eurostoxx constituents, as a % of free float, the short base has risen from 1.1% to 1.6%. The Days-to-Cover ratio for the index is 4.6x (on 30d volumes), restrained compared to the increase in the "% of Free Float" measure as cash market volumes have picked up lately. We estimate the short community is sitting on a P&L of -2%. If they want to close half of the short base that has been built up YTD, it will equate approximately to one day's worth of volume in the cash market (about $8bn). If we look across the Hedge Fund data community from IBs Prime Brokerage, we can see that short leverage is sitting on its 5 year highs.

JPMorgan USD Emerging Markets Bond ETF



Global PPI & MSCI World EPS

<u>**Equities should be a natural inflation hedge as their earnings are strongly correlated to PPIs, they could benefit from improving pricing power, better top line growth and a reallocation of investor flows.**</u> Even if equity valuations are not cheap in absolute terms, <u>in the past 15 years, the correlation between P/E multiples and bond yields was positive rather than negative as well as the correlation between PPI and EPS (chart).</u>

Negative

1. <u>**Q1 numbers**</u>: as seen above, <u>EPS upgrades continue to outnumber EPS downgrades but the trend suggests that EPS revisions may have just peaked</u>. We are worried about global profit backdrop deteriorating further over the coming months.

2. <u>**Volatility**</u>: last year, there were only 8 days where we saw a one-day move greater than +/-1% on the S&P, the lowest level since 1965. While this year we have already seen 27 days of more than a 1% magnitude move in the S&P (the median is 42 days and the average is 53 days since the 1960s, the volatility has been really low in 2017).

3. <u>**Liquidity**</u>: we see several reasons to believe that <u>“markets themselves” are becoming a bigger source of market risk than fundamentals</u>. In particular, new regulations and new technologies have caused a dramatic evolution of the post-crisis ecosystem for providing trading liquidity. In this new market structure, machines have replaced humans, and speed has replaced capital. Regulators and researchers are increasingly warning that HFT strategies can contribute to breakdowns in market quality during periods of distress.<u>We worry that a future such a collapse in **market liquidity** could amplify the magnitude of sell-offs.</u> This could contribute to price declines and possibly prolonged periods of financial instability in ways that are reminiscent of the price declines caused by financial deleveraging. While the analogy is imperfect and our uncertainty is high, <u>we see reasons to think that “liquidity is the new leverage”, just like financial leverage during the previous cycle.</u>

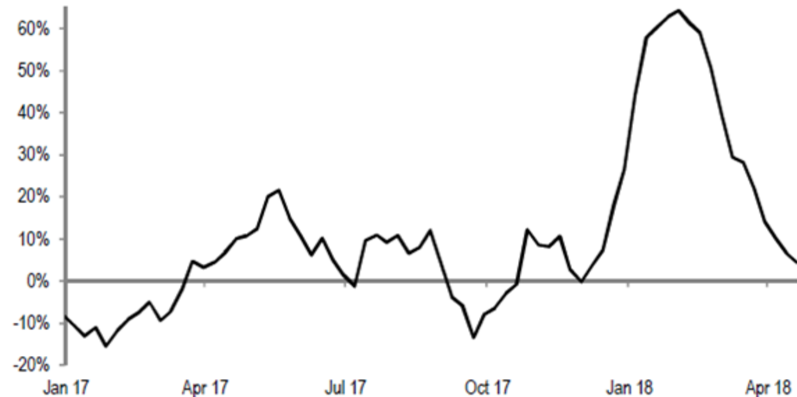
4. <u>**Yield curve**</u>: <u>Markets may react more cautiously to a flat curve in this cycle, given the very low level of policy rates</u> and the potential signal from the curve that the next downturn could occur with very little scope for central banks to react by easing monetary policy<u>. The yield curve is among the best market signals for a recession</u>. Since the 1950s, there has not been a US recession without the yield curve inverting.

5. <u>**Seasonality**</u>: From a historical trading perspective, <u>March and April are two of the most profitable months for the equity markets</u>: During a mid-election year, March has been down only once in eight instances since the mid-‘80s (1994). The best six months of the year seem to almost always include Jan-March and Nov-Dec, with April and October fighting over the final spot. The six worst months seem to reliably begin in May (sometimes April) and run through October (sometimes September)<u>. We are now about to enter in the worst statistical phase of the year.</u>

6. <u>**Emerging Markets Credit**</u>: the recent news flows on <u>Argentina and Turkey</u> (both raising rates to defend their currencies) had partially spooked the market. <u>The JPMorgan USD Emerging Markets Bond ETF is now trading at the lowest levels since 2006 and could prompt a new market correction especially considering that the Credit Market is roughly 100x bigger than Equities.</u>

Why do we prefer the trade Long Europe / Short US?

EU positive to negative EPS Revisions ratio



European stocks are now the least correlated vs US stock since 2006

We see some key drivers of the US outperformance to be gradually fading: **Earnings, Tech and FX.**

- **Macro outlook and earnings**: The key drivers of the Eurozone domestic recovery appear to be well aligned. The unemployment rate has already moved below its long-term average and is expected to continue falling in '18 (positive for consumers). The European market underperformance is even starker than the rather encouraging relative PMI momentum enjoyed since 2013.

The current hurdle rate for US stands at 20% yoy EPS growth, and the Euro area's at 7%, then positive surprises are much more likely in the latter.

Euro area is going through an earlier stage of the economic cycle than US. Its shareholder yield vs. bond yield looks significantly more attractive, at 4.4% vs 1.6%, and might be a better hedge against rising yields. It trades at 13.7x P/E, on what are still subdued earnings. In contrast, US trades at 16.8x P/E, 22% premium on what are elevated earnings.

Look at the ratio positive to negative EPS revisions in chart, which has fallen form January highs.

- **€ strength set to moderate**: a potential Eur depreciation is positive for European exporters. The negative FX effect on European earnings should mostly be behind us. Most of the disappointing results in Q4 17 and Q1 18 were due to currency headwinds.

- **ECB vs FED**: different shareholder yields vs. bond yields arise from a divergent monetary policy cycle. Eurozone has 3.8% equity yield, vs -0.6% 2Y bond yield. In US, these numbers are 4.1% and 2.5%. Net-net, Eurozone has a yield of 4.4%, vs US at 1.6% over their 2Y bond yields. The Yield curve has not been flattening in Europe as much as in US. Europe is typically correlated to the direction of bond yields being the region value-heavy.

- **Investor sentiment** is more downbeat in Europe versus elsewhere, the relative performance of MSCI Europe vs MSCI World is striking. European stocks are now the least correlated with their American peers since before the financial crisis. European equities have outperformed US stocks since the global market correction began in late January.

Investment Ideas

EUR-USD monthly chart

Spain vs Italy weekly chart

1. **Long USD / EUR**: we went long at the end of March. In the short term the USD is overbought, first target long term is 1.16 vs EUR on the 50 monthly MA (see arrow on chart).

2. **Long EU Financials**: one of the few sectors to offer upside on both valuations and profitability going forward. Earnings will benefit from a potential further increase in Bond Yields, the ongoing recovery in credit growth and the fall in NPLs. Two thirds of the Eurozone Bank index's constituents forecasts EPS upgrades in 2018 along with a pick-up in loans growth and a greater confidence in net interest margins. Banks are currently undervalued, trading at discount to the last 10-years P/E average and the historical P/B median.

3. **Long Spain / Short Italy**: Italy has been the best-performing country in Europe YTD and the best-performing country across all of Developed Markets. While such outperformance may seem at odds with Italy's uncertain election outcome, it does reflect superior earnings trends, with the country seeing the largest 3-months increase in its 12-month EPS in Europe. Spain now stands close to a 2-year relative low to MSCI EMU and has underperformed Italy by 16% over the last 12 months, a rate of decline that has rarely been seen over the last 15 years. While the outperformance of Italy over Spain has been justified by superior EPS trends so far, there are some signs that this support is now slowing. The weekly chart shows the relative underperformance of Spain vs Italy.

4. **Long Silver**: we have suggested over the last update to take profit on Gold that has now reached the 1st support at 1300$. We would start buying Silver as positioning is now the most bearish ever on the metals and the relative value of Silver to Gold is reaching an interesting level.

Ideas closed

1. **Long Energy sector (SXEP Index):** we rightly predicted good Q1 numbers, the sector is generating the strongest Free Cash Flow in a decade allowing for full cash coverage of capex and dividends. On the macro side is enjoying higher oil prices, a stronger LNG market and healthy global downstreammargins. We closed the long trade temporarily as it performed too well in a short time (+15.4% from end of March) with the aim of getting back in at lower prices.

Keep in touch

HERON Asset Management SA

Via Clemente Maraini 39, P.O. Box

CH - 6902 Lugano (Svizzera)

T +41 91 910 17 90
F +41 91 910 17 91

www.heron.ch

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