Monthly Market Update

Monthly focus on the financial markets

11th March 2019

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Market Analysis

After the worst December for stocks since the Great Depression, the market enjoyed the best January return since 1987 and a further rally in the month of February / beginning of March with US Indexes up for the 11th straight week.

MSCI World is now up 11% Ytd, the best start of the year since 1991.

If you decided to take a vacation for all of December and ignored the markets until now, you probably wouldn't think much has changed: investors still generally own what they have owned, just with lower exposures. The speed and magnitude of the collapse and recovery in stocks since early December has been highly exceptional.

On December 24, only 1% of stocks in the S&P closed above their 50-day moving average, one of the most extreme oversold levels in history. Now, after a broad rally over the last weeks, that number now stands at 94%, one of the most extreme overbought levels in history.

In Europe, at the end of 2018 we had only 5% of the names of Eurostoxx 600 above their 63-day average, now we are at 78%. When it reaches 80% it has been always a relative top for markets.

Stoxx Europe 600 Index (blue)
% above moving average Stoxx Europe 600 Index (red)

The Shanghai Composite had record flows recently (multiple Chinese brokerages seeing system crashes) and has bounced 24% Ytd thanks to the new important Monetary and Fiscal policies. Now, 98% of its members are trading above their 50-day moving average, the highest since the latest top made in 2015. US 60/40 balanced portfolio had the strongest Ytd return since 1991, but the same portfolio would have been now small down or close to flat since early 2018.

The recovery in risk appetite was triggered by a combination of dovish Fed shift in January coupled with better US data, a sharp recovery in oil prices and optimism on a US-China trade deal. A combined rally of bonds and equities is quite common when the Fed stops hiking: at the end of the past four Fed hiking cycles (1989, 1995, 2000 and 2006), the S&P 500 did well on average and bonds rallied in every case. This has been a big contrast to 2018, when no assets managed to outperform cash.

This year's rally has rested on pricing out recession fears rather than pricing in improvement, but such is the nature of retracements after indiscriminate sell-offs. What is more interesting however is to check the latest data in terms of positioning and flows as you will find that the market's recovery hasn't been as easy as it might seem.

In US, the correlation of weekly S&P returns and weekly US equity futures flows, is negative for the first time in 8 years!

Correlation SPX Index returns vs. US future flows (blue)

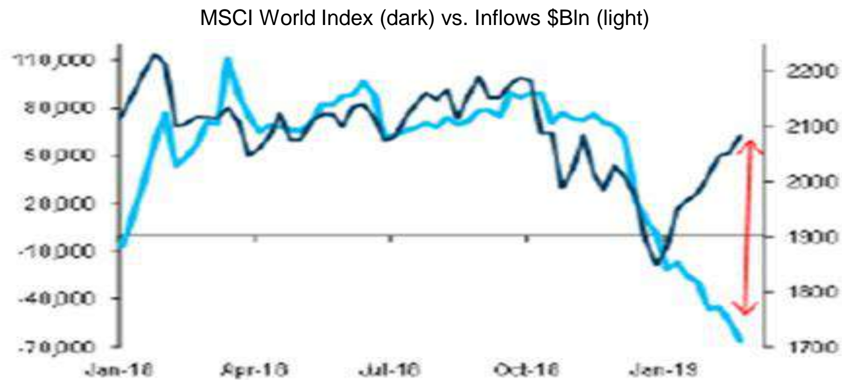
Market Analysis

The divergence between S&P future positioning and the SPX is striking.

SPX Index (light) vs. US Index futures $Bln (dark)

The MSCI World, up 11% Ytd, is still having negative flows as Mutual Funds are selling equities and relocate into Bonds and Cash.

MSCI World Index (dark) vs. Inflows $Bln (light)



In Europe, January 2019 posted the second lowest volumes since August 2017.

Equity positioning is still relatively light even across discretionary and systematic portfolios (~30th percentile) while retail saw outflows until late February.

This implies most investors have not participated in this V-shaped recovery other than corporates and insiders who were accelerating purchases into the sell-off.

This week we saw positive macro data out of Europe with the Composite PMI surprising to the upside, the first sequential rise in six months and yet, European Hedge Fund net exposure has barely moved, having risen from a low of 21% to just 25% today.

If the market hasn't bounced through some flows, the same can be said about the fact that the market wasn't driven by fundamentals (chart) or earnings.

Consensus GDP growth Q119 (blue) vs. SPX Index (red)

Market Analysis

Most of the initial rally (roughly 10% of performance) was generated by short-covering, the next leg was a mix of more short-covering and real increases in exposure by Risk Parity, Long Only, HFs and Macro accounts.

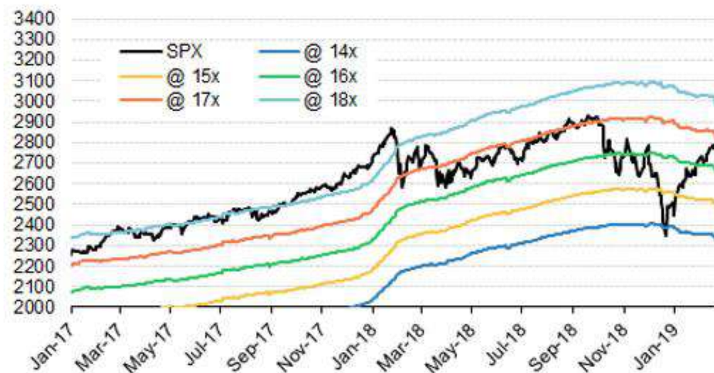
In Europe the short-covering is still substantial as in the past two weeks, 25bn$ of shorts have been covered on Eurostoxx 600, the largest covering volumes we have seen to start a year in the last 7 years. The last leg and the "overshoot" could be generated by the only investors yet to "re-risk": Retailers, CTA and Volatility Target funds which all together have roughly ~300bn$ of AuM.

There is simply too much cash to put to work, central banks seem to be more accommodating and sovereign bond yields don't seem to be going up by much any time soon. So investors need to put to work the large cash positions they built last year and they have been doing so.

With the 3-month volatility likely to drop further (as December will be soon not considered) we might see some further "forced" buying interest from VT funds helping the market to overshoot.

Equity valuations are less compelling than it was at the beginning of the year with the S&P trading at #17 Forward P/E, the same level it traded for most of 2018 when growth expectations were higher.

SPX Index Forward P/E Multiple

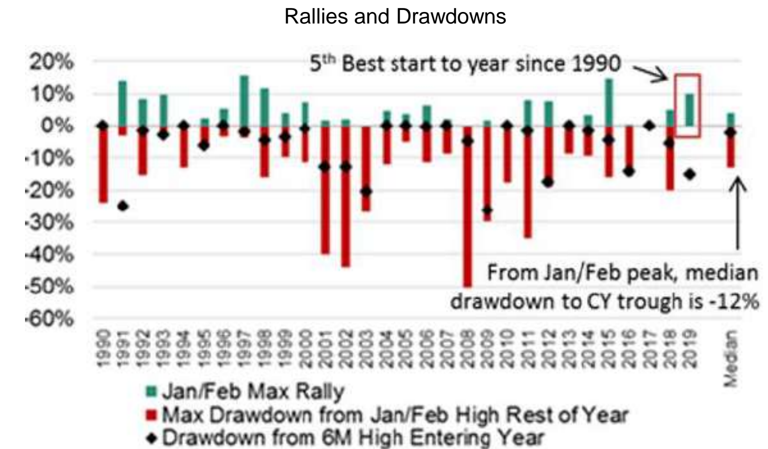


While the Fed is giving investors comfort there won't be much downside in the market, it's also true that Powell can't get much more dovish from here, and the risks over each 'Fed speak' event are growing more skewed to the downside.

This is a great opportunity to lighten the exposure as the risk/reward is much less attractive at this point given the numerous hurdles still confronting equity investors.

In Europe, the last 8 times we had Ytd rallies similar to the one we've just seen, the median correction trough from here was -12%. Given how late cycle we are, deteriorating growth and potential 0% EPS growth for 19 we don't see a -15% drop as unreasonable.

Rallies and Drawdowns



Earnings

The earning season is proving to be a tough one, even though better than feared, with the lowest percentage of US companies beating EPS estimates since Q416 and the highest percentage of US companies missing estimates since Q416. Earning growth and breadth are deteriorating.

The most worrying aspect is for us the declining margins and more properly onto shrinking profit margins due to higher input costs (that's explained by revenue much better than earnings with 33% more sales beats than misses). We continue to think the margin environment is deteriorating and will cause further earning downgrades over the next months.

In **US**, the breadth and magnitude of earnings beats and surprises was lower this quarter vs. recent history. Only 53% of S&P 500 companies beat on revenues (vs. 70% seen during last four quarters) and 60% beat on net income (vs. average of 76%).

Revisions and guidance have also been poor. Revisions breadth has been negative for all of 2019, but has inflected higher the last 2 weeks and 17 out of 72 companies have provided positive Guidance for Q119 with Negative to Positive ratio being 3.18X.

SPX Index earnings revisions breadth (blue)

SPX Index quarterly EPS YoY growth

The growing divergence between the performance of S&P and Forward EPS data is striking.

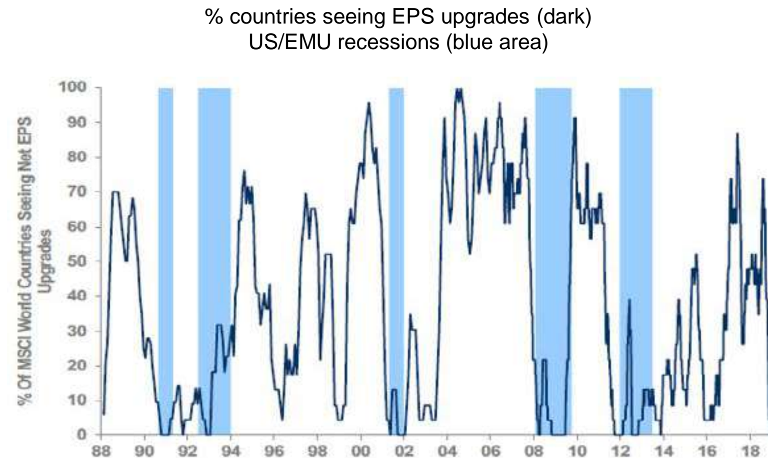
SPX Index (green) vs. SPX forward EPS (red)

Earnings

In **Europe**, Q4 results delivered mixed results with more beats than misses but with weighted EPS missing for the 3rd quarter in a row and lagging behind sales results.

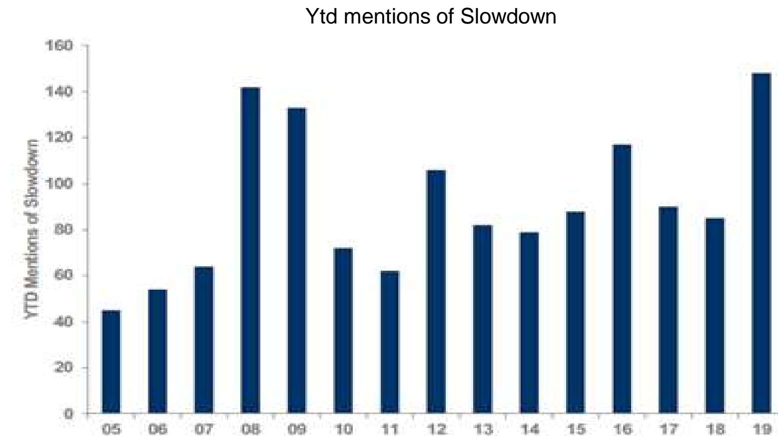
Looking at the **MSCI World**, for the first time since May-2013, no countries are seeing net upgrades presently, having been as high as 73% just six months ago. Disconcertingly, there have been five broad periods since the 1980s where this has been true, and all of them have been around either US or Eurozone recessions.

% countries seeing EPS upgrades (dark)
US/EMU recessions (blue area)



The mention of the word "slowdown" in company transcripts spiked during Q418, and that this historically suggested further downside risks to consensus estimates. This trend has continued year-to-date, with the highest mentions ever at this stage of the year on data back to 2005, higher even than 2008.

Ytd mentions of Slowdown



Executive Summary

After one of the strongest ever starts to a year across global equity markets, a number of technical indicators are starting to look somewhat stretched but investor sentiment still seems to be relatively subdued, especially in Europe where outflows remain stubbornly persistent and Hedge Fund net exposure is stuck towards the bottom-end of its range.

In the 1st newsletter for 2019 we started saying that although the macro backdrop for 2019 was very challenging, a reasonable degree of bad news was in the price and valuations were looking more attractive and investor sentiment decidedly bearish. We expected a big bounce in equity prices.

Now markets had a record bounce and with earning season behind us, investors are left to refocus on the macro/geopolitical backdrop and therein we can find something for both Bulls and Bears.

The Bears continue to point to weaker macro data in the US and Europe and risks to FY estimates, as well as the ongoing Brexit saga and a disappointing, “no-deal” outcome in North Korea last week, while Bulls point to some signs of sequential improvement in Asia, a clearer path to resolution on US/China trade and some management commentary highlighting prospective recoveries in H2.

Despite a greater sense of “normalcy” coming back into the picture, investors cannot allow themselves to get too complacent. Risks certainly still persist, and ghosts could reappear, particularly on the credit side, as the credit cycle is ever so slowly starting to turn. While a year ago we had strong growth in the US and defaults looked rather benign, the environment has become more challenged as the year progressed and worries over global growth escalated.
We don’t believe that the “bear market” might have lasted only 3 months, the shortest on record?

The market has possibly got too complacent with volatility back to subnormal levels (VIX below 15), the short interest on S&P at the lowest level since 2007 and the AAII US investor bullish sentiment back to the levels seen in the middle of 2018.

If there is one thing the events over the past two months have proven beyond a reasonable doubt, it is that when it comes to risk prices, one thing matters, not fundamentals, not political risks, not earnings forecasts, not squiggly lines on charts, not opinions about the economy or even inflation and interest rate forecasts. The only thing that *truly* matters is **how much liquidity is being generated or drained by the Fed and other Central Banks at any given moment.**

The recovery in global equity markets has now priced the shift in US monetary policy stance and positive anticipations about a provisional trade agreement between the US and China. After a 30bp drop in US real bond yields which boosted US equity valuation, we expect a period of consolidation, amplified by the recent weakness of US manufacturing data. Many investors have not participated in the Q1 2019 equity rally and are likely to buy future pullbacks.

We would therefore opportunistically reduce some weight on Equities with the aim to buy them back at lower prices and switch into defensive names/sectors.

We still prefer strong versus weak balance sheets and focus on quality and use the recent weakness on Gold to increase it as a protection of the whole portfolio.

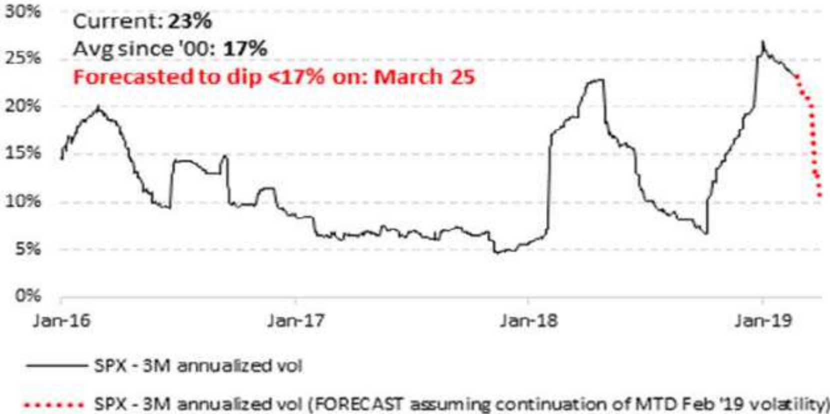
Let’s now analyze the current positive and negative factors for the market:

Executive Summary

POSITIVE FACTORS (5): *unlike at the beginning of last year, equities are still pricing in slower economic growth and Earning Per Share concerns. Compared to last newsletter we have removed the positive effect given by equity valuations and added the "low vol" potential effect and M&A.*

- **Low volatility**: positioning is still low, 3-month realized volatility is continuing to drop being now at 14%, lower than the average since 2000 at 18%. This provides a risk-on equity for Risk Parity, Vol Target and Macro investors. The market could "overshoot" on this specific factor.

Current 3-Month volatility & expectations



- **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.

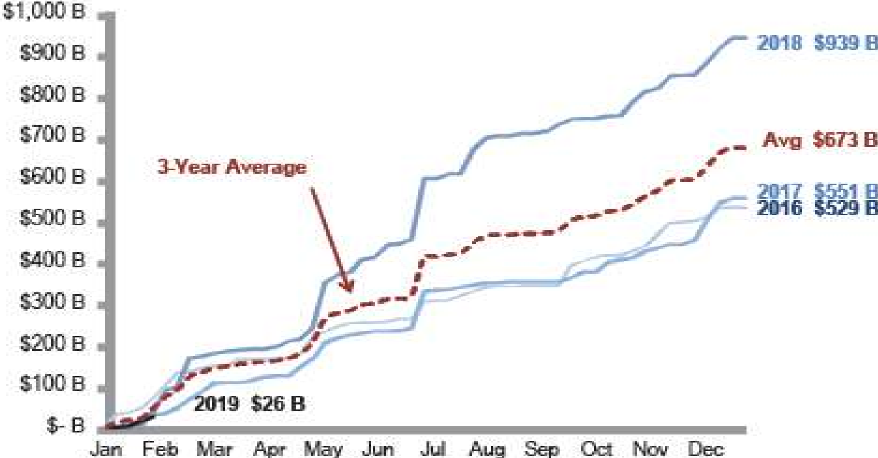
New buyback announcements remain strong YTD at $187b (in-line with 2018, which was a record year) and we expect another $600b+ of buybacks for remainder of 2019 considering the record~$700bn$ available to execute under existing authorizations.

In 2019 we also expect an additional ~500bn$ via dividends which is in-line with 2018 shareholder return.

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

The chart shows US buyback average per year. Since the Tax Reform it has been higher.

US buyback average per year



Executive Summary

- **Insider activity**: The recent insider activity implies that corporates are still optimistic about the current cycle.

  In fact, the current near record level of insider bullishness is similar to the prior two intra-cycle resets (i.e. 2011 and 2015-16) in which insiders sold fewer shares and stepped up purchases on lower valuation.

  Chart showing 6-month rolling (number of insiders buying less selling).

- **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.

Global M&A Volumes

- **Central Banks** (positive view): Central banks are still accommodative, with US real policy rates near zero. Just three months ago the market was pointing to a quarter-point hike in 2019 and is now factoring a 0% possibility of hike for this year and 22% possibility of a cut in 2020.

  A lot of talk of late (Reuters and FT) noting that the Fed may allow inflation to deliberately 'overshoot' (so that the average of long-run inflation would be 2%, instead of an outright target) and commentary from the Fed's Williams on the dangers of permitting inflation to persistently undershoot their 2% target.

  Encouragingly the US Yield curve might have stopped flattening and as Fed has paused, the chance of "policy mistake" reduces.

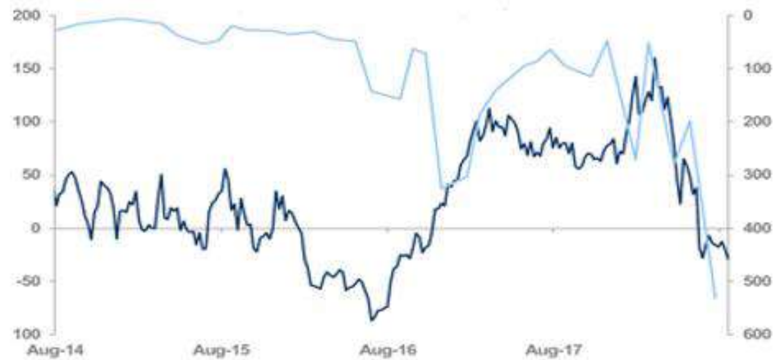
Executive Summary

- **NEGATIVE FACTORS (14)**: *still largely outpacing the positive factors. In January we had 13 negative factors, in February 15. The new addition is the increase issuance for Credit markets while the 2 deletions are the excessive Libor-Euribor spread and reduced appeal of Stocks vs Fixed income.*

- We see limited risk that global economic momentum will re-accelerate here, as the year-on-year comparisons get tougher in the coming months and **the uncertainty around trade and tariffs is continuing to weigh on activity.**

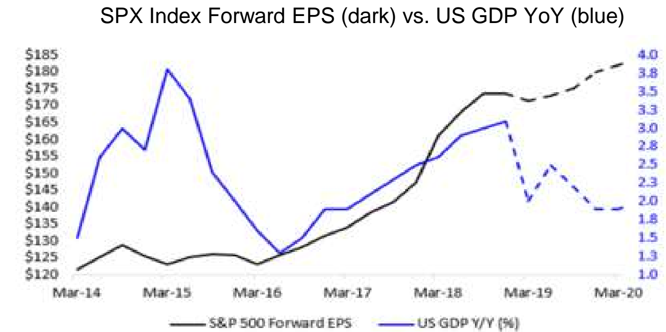
  Rising US trade policy uncertainty has already weighed on global equity fund flows over the last year as shown on chart.

Cumulative 3M Equity fund flows globally (dark)
US Trade policy uncertainty Index inverted (light)

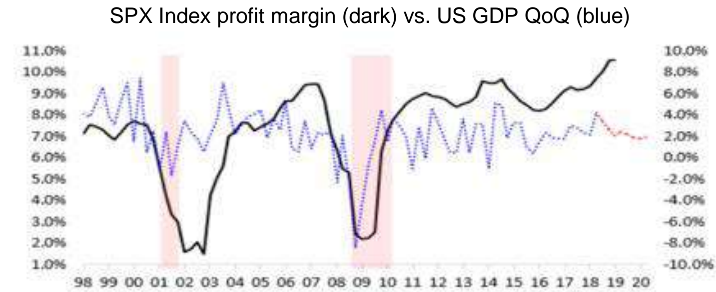


The correlation between some important economical indicators and the S&P are diverging too much, one of the two is going into the wrong direction.

SPX Index Forward EPS (dark) vs. US GDP YoY (blue)



SPX Index profit margin (dark) vs. US GDP QoQ (blue)



- **Central Banks** (negative view): 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.

Executive Summary

- When “the world was ending” back in late December, there was a 72% chance of a rate cut being priced in out to January 2020. Recently that has changed, to about 22%. The chance of a rate hike has stayed flat with the probability of “no change” going much higher, “rate cut” going much lower. Next month’s FED meeting could be a catalyst for expectations, expressed through Fed Fund Futures, to become more hawkish. That would in turn have bond yields rise. The 50-day correlation between the US 10yr Yield and the SPX is near at 5-year high!

Correlation UST 10Y yield and SPX Index (green)
Slope UST 10Y yield to SPX Index (purple)

- **Margin pressures** are continuing to build, which is perhaps not surprising given that input cost inflation (PPI) has been above CPI for much of the last two years. With labor costs gradually rising and tariffs offering up the potential for higher input costs and supply chain disruption ahead, profitability concerns look set to become more of a focus for investors in the coming months. Margin environment is less favorable now.

- **US estimated Quarterly S&P Earning Growth** set to decelerate to its long-term average of 6% in 2019. Guidance of Q1 numbers has been very conservative.

- **IPOs / Secondary/ Placing**: The percentage of US listed IPOs that lost money in the last 12 months is marking a new record high (83%) exceeding the top reached in the dot bubble, the highest proportion since 1980 when record started. Over the last Quarter, a great number of IPOs has been called off and the performance of IPOs and Placings has been dreadful. Not a great sign as it seems that the market cannot absorb any further paper.

- **Increase issuance on Credit Markets**. Similarly to the point above, we are expecting an 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.

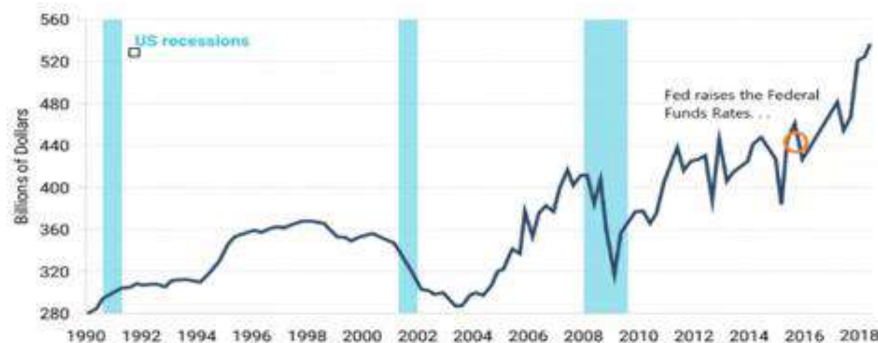
- **Cash Repatriation**: the repatriation flow slowed considerably in the last 3 Quarters. Given that 330bn$ of repatriation took place already in H1 this assessment implies a significant slowing of the flow in the second part of the year. The Q4 reporting season is revealing further slowing in the pace of cash holdings reduction by US companies. The boost that US repatriation provided to US equity and bond market via share buybacks and corporate bond redemptions is likely to slow during 2019.

Executive Summary

- **<u>Fund's redemptions</u>**: This year we are likely to see more redemptions following the bad performance and high volatility of most of the funds. Depending on the type of fund, if you assume the notice period being from 1 to 3 months, <u>investors will start some redemptions soon</u> also helped by the recent better performance Ytd.

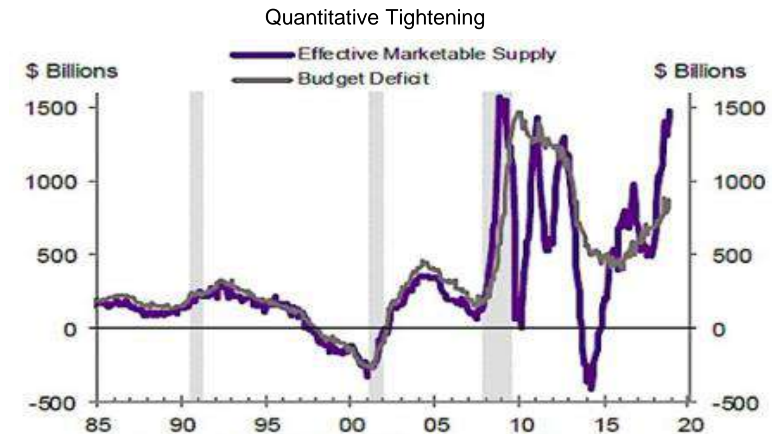
- <u>**US government's borrowing** has increased to amounts that it hasn't since the 2008 recession.</u> <u>The US budget deficit is just shy of $900 billion which means a 40% increase since last year</u>. Ignoring private consumer debt (which is greatly affected by rising rates), <u>the US National Debt recently hit $22 trillion (from 21.3trn last month) and the interest payments due on all this debt is at a record high</u>. You can see on the chart that since the Federal Reserve began raising rates in December 2015, <u>the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year!</u>

Federal Government current expenditures: Interest payments



<u>The ratio between the US budget deficit (grey on chart) and the Treasury issuance (purple) poses substantial risks as they are going to issue 1.3trn$ this year and the unbalance has never been that great!</u>

Quantitative Tightening



The US's financial burden is growing despite a strong economy. The country's obligations are mounting as President Donald Trump debates members of Congress over funds for a wall along the southern border and fiscal experts including former Federal Reserve Chair Alan Greenspan warn about the dangers of rising budget deficits.

Remember that <u>US is taking in *less* tax revenue because of Trump's tax cuts and the Treasury will have to borrow *new* debt just to pay off maturing *old* debt and interest</u>.

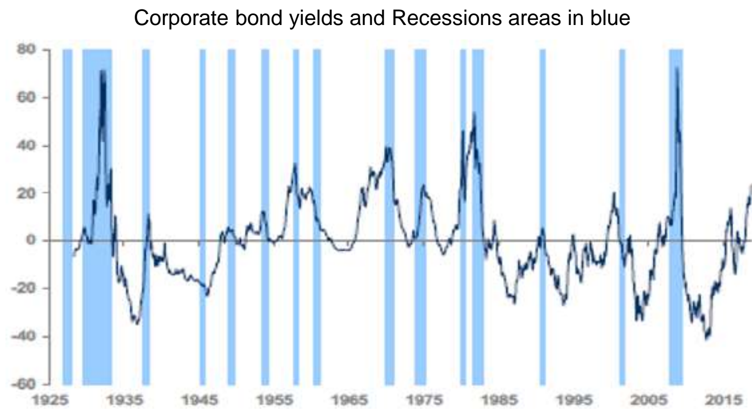
Executive Summary

- **Junk Bonds**: They crashed really hard just before the financial crisis of 2008, and they started to fall again at the end of last year. **We are in the terminal phase of the biggest debt bubble in human history. In fact, total indebtedness in the United States has increased by more than 2 trillion dollars over the past 12 months.**

  All of this debt has fueled a short-term bubble of relative "prosperity" but meanwhile all of our long-term problems just continue to get worse.
  Moody's has recently affirmed that "Leveraged loan are in unchartered territory and that's a big risk"

- **Corporate Debt**: even before we see any further widening in credit spreads, corporates are already facing a very hefty increase in their cost of capital. The chart shows that the increase in US corporate bond yields relative to their trailing 5-year average is at its highest level since the early 1980s (if we exclude late 2008, when default rates were spiking).

Corporate bond yields and Recessions areas in blue



The cost of debt relative to corporate earnings is at the highest level since 2008.

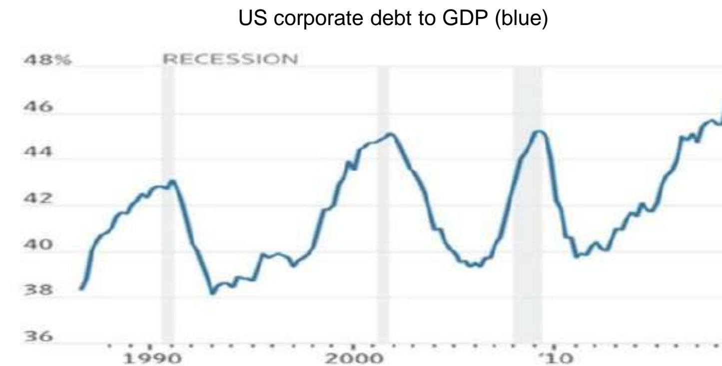
US nonfinancial corporate debt is at its all-time high and average credit ratings of IG debt have fallen sharply.

Over the last few years, yields on bonds with triple-B credit ratings (the lowest score, still considered investment-grade), have risen faster than those on safer debt.

The Q4 pace of downgrades from A into BBB territory is the largest since the late 2015 wave of commodity related fallen angels. S&P has recently put $140 billion in investment grade bonds on downward watch, about $11 billion of which is due in the year ahead.

The ratio of US corporate debt to Gdp is on new all-time highs as shown on the chart. The grey areas are the previous recession levels.

US corporate debt to GDP (blue)



Executive Summary

<u>Even European credit markets are likely to see further spread widening in 2019 as growth moderates and ECB QE ends</u>. BBB ratings represents more than 50% of IG volumes in Europe and the largest 25 BBB names account for 26% of IG Index.

<u>The risk really lies more in what will happen from a market structure perspective if a large swatch of BBB "Investment Grade" is downgraded to Junk.</u>

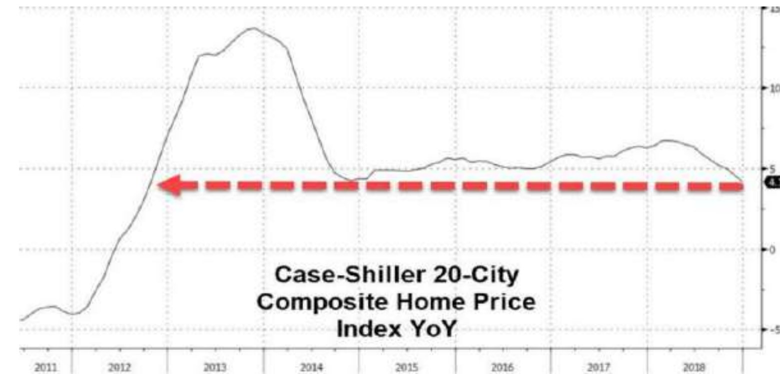
Moreover, the increasingly covenant-lite, leveraged loan market (which, at 1.2tn$, has surprised the size of the high yield market) not only has meaningful credit risk given leverage/ covenants but also (and more importantly) a toxic liquidity structure.

<u>Mutual funds/ETFs have become over 20% of the market and daily liquidity in the event of panic selling will very likely prove theoretical</u>. It is also worth noting that Main Street is increasingly exposed to leveraged loans via mutual fund/ETFs, something that was not the case before the Financial Crisis.

Bottomline, while systemic risk may not be high now, the "market structure" risk may prove just as painful to asset prices.

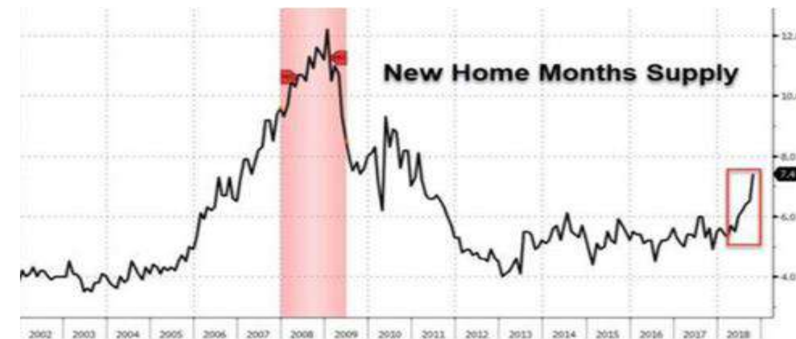
<u>Markets could therefore soon face a "tsunami of junk rated debt" as about half of 5trhn$ market for investment-grade bonds now resides in the lowest tier of ratings prone to a downgrade to junk.</u>

- **<u>Declining US House Prices</u>**: US Housing data are continuing to surprise on the negative side. <u>US home price growth has slowed for nine straight months</u>, the weakest since September 2012, according to S&P Case-Shiller's 20-City Composite index.



<u>Affordability remains a challenge despite a pullback in mortgage rates</u>.

We suspect that unless the Fed is going to start buying millions of homes, prices are going to fall to what buyers can afford. As China's debt bubble implodes, the Chinese buyers with cash (probably not even cash, just money borrowed in China's vast unregulated Shadow Banking System) who have propped up dozens of markets Internationally will vanish.



Executive Summary

- **Consumer sentiment** very downbeat.

  Consumer confidence dropped in January for a third consecutive month, likely hit by political discord in Washington, in addition to market and economic uncertainty weighing on US households.

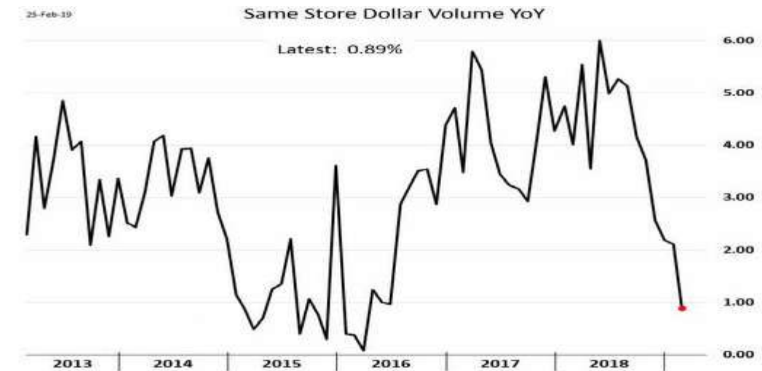
  If you look the chart showing the ratio of "present situation" to "expectations" is a great leading indicator at turning points because it either coincides with the recession or occurs a few months prior.

  US consumer outlook on labour market has inverted, generating another recession signal.

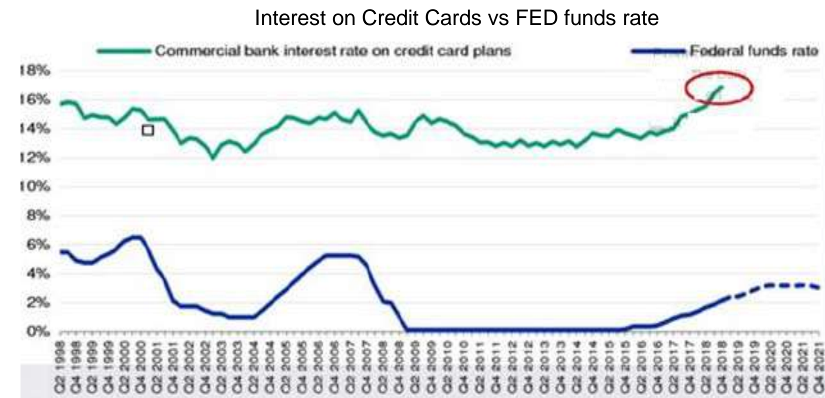
  US personal interest payments have soared to a new all-time high exposing even more the consumers to a recession.

US present situation to expectations

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.



Interest on Credit Cards vs FED funds rate



Executive Summary

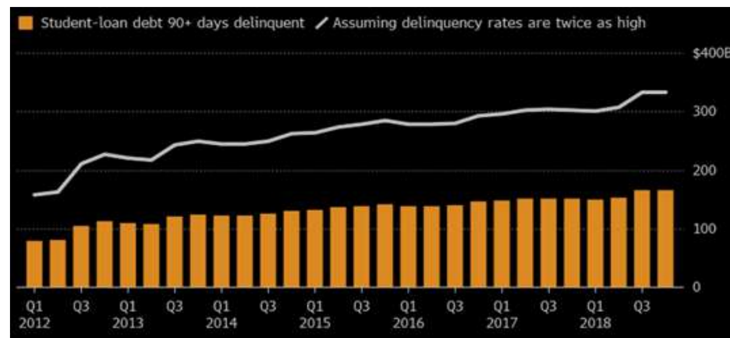
The percentage of auto loans in serious default has risen to the highest level in almost seven years, as consumers with weak credit struggle to make payments despite a strong US economy and tight labor market. Loans delinquent more than 90 days rose to 4.47% of the total in Q4.

Overall delinquencies rose even as auto lenders shifted business to more creditworthy borrowers and car loan originations reached $584bln, the highest level in the Fed's 19-year history tracking data.

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.

90+ days Student loan delinquencies & Assumptions rates



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

Debt held by Americans aged 19 to 29-years-old (so-called Millennials) exceeded $1 trillion at the end of last year. The debt load marks the highest exposure for the group since late 2007 at a time when younger adults under 35-years-old have decreased their spending compared to previous generations.

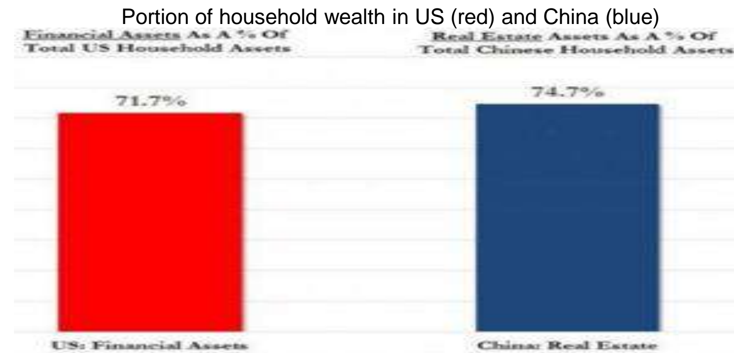
The signs are everywhere, credit exhaustion is global, and that means the global growth story could be over: revenues and profits are all sliding as lending dries up and defaults pile up.

Qualified buyers don't want to borrow more, leaving only the unqualified or speculators seeking to save a marginal bet gone bad with one more loan (which will soon be in default). Lenders are faced with a lose-lose choice**:** either stop lending to unqualified borrowers and speculators, and lose the loan-origination fees, or issue the loans and take the immense losses when the punters and gamblers default.

Executive Summary

According to the recent data in the US, stocks now make up an increasing portion of household wealth and has overtaken real estate for the first time. In China, the situation is even more worrying as roughly 3/4 of all household wealth in China is tied up in real estate, where it is effectively dead-money, earning no yield and completely illiquid.

Portion of household wealth in US (red) and China (blue)



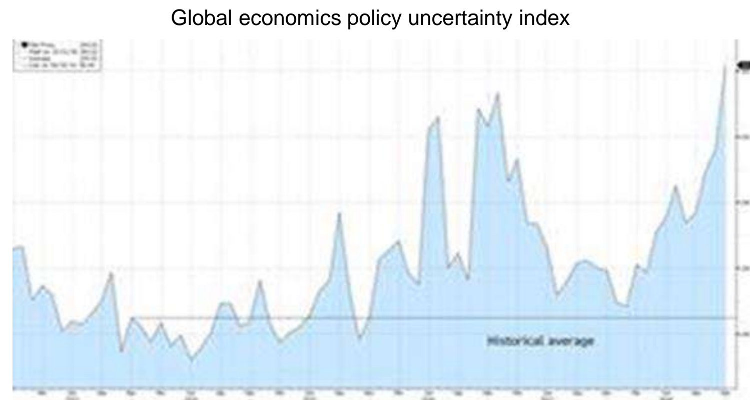
- **Market liquidity** continues to drop and we have already seen in December how can this affect markets when there is the need to sell.

  Looking at some statistics helps to understand the entity of this factor. 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.

Macro

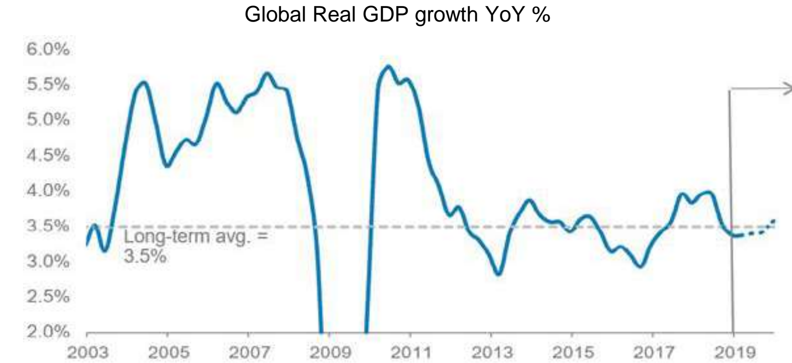
The fundamental picture has deteriorated across the globe during the last quarters. Global growth is still tracking at a below-trend pace of 3.4% YoY in Q119, the same as Q418 as DM growth remains weak. Meanwhile the macro outlook is improving in China, EMs (India, Brazil) and US, incoming data are pointing towards protracted weakness in economic growth momentum in the Euro area and Japan. Political and Economic uncertainty is still very high (chart). OECD recently cut 2019 global economic growth forecast to 3.3% vs. 3.5%.

Global economics policy uncertainty index



Three factors, respectively Fed tightening, rising trade tensions and a China slowdown, are the main reason why global growth slowed in H218. However, they are now moving in the right direction and we should see global growth to trough in Q119 in this mini-cycle.

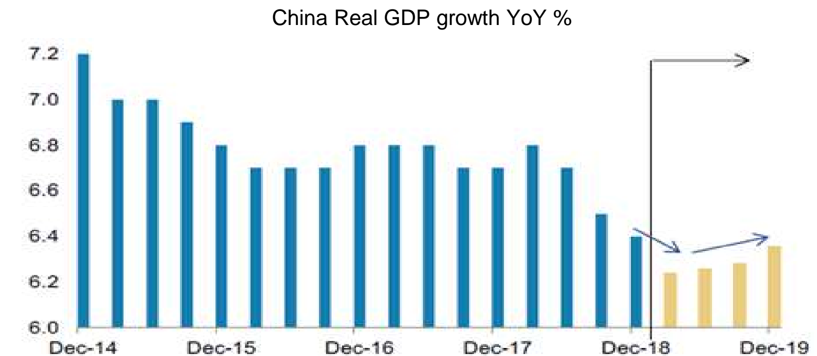
Global Real GDP growth YoY %



China

Countercyclical easing has moved into full swing to stabilize economic growth and the labor market. The National People's Congress delivered a stronger than expected fiscal stimulus package confirming a consistent pro-growth signal, emphasized that labor market is the policy priority, and vowed to prevent economic growth from dipping without compromising financial stability. After softening in Q418-Q119, real GDP growth should stabilize from Q219 (chart).

China Real GDP growth YoY %



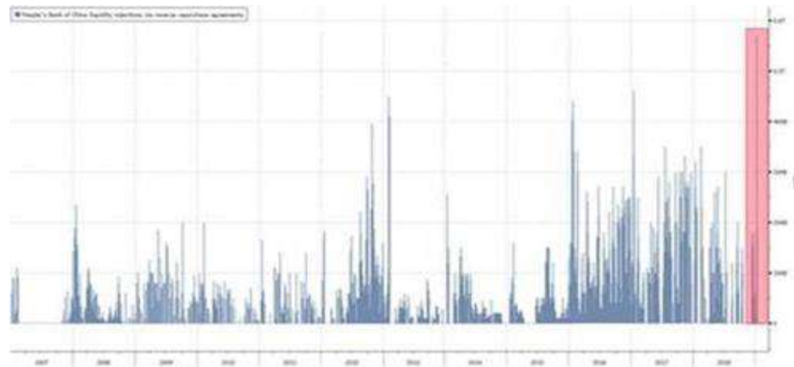
Macro

The main policy targets implemented by China were largely as expected:

- Real GDP growth target: 6-6.5% (6.1% growth in 19/20 to meet the ongoing goal of doubling GDP in the decade to 2020)
- CPI inflation target: 3% (current CPI between 1/2 %, still room for easing)
- 2.8% on budget fiscal deficit. (augmented fiscal deficit should widen by 1.5% of GDP in 2019, which means the size of the fiscal easing is not small)
- VAT cut 3% for the 16% bracket and 1% for the 10% bracket (0.6% of GDP, should boost earnings)
- Higher local government bond issuance quota (in support of infrastructure)
- Cut total taxes and social security contributions by around two trillion RMB

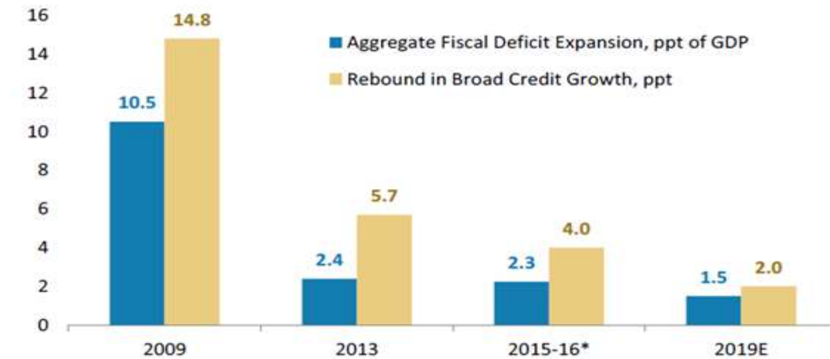
It's worth noting expansionary measures and the extraordinary liquidity injections, 560Bln yuan ($83Bln) in January the biggest one-day addition on record (chart), are bearing fruits as the latest lending data, New Yuan Loans CNY, resulted above expectations, CNY 3230Bln vs. 3000Bln consensus, the highest in the last 10 years. In addition, we should see a broad credit growth to 12.5% by year end vs. 10.6% in 2018.

PBOC liquidity injections MoM



Bear in mind that the above-mentioned measures, aggregate fiscal deficit and credit growth, are not as high as in the past, which means that are more manageable in nature than in past cycles, preserving capital efficiency and financial stability. However, **China will take any extraordinary measure to sustain the economy**.

Key drivers on GDP growth
Fiscal deficit expansion (blue) vs. Credit grow (yellow)



Macro

USA

Originally due for release on December, but delayed due to government shutdown, Q418 GDP grew by 3.1% on QoQ basis in 2018. This situation has changed dramatically in the last few months though, with a list of data confirming a weakened economic activity:

- December retail sales plunged the most in nine years
- December personal consumption had its largest monthly decline since 2009
- November/December Capital/Durable goods report down for the third consecutive month
- January industrial production contracted the most in eight months
- February Philadelphia Fed Business outlook was very weak, the lowest since 2016
- February Markit US Manufacturing PMI below consensus
- Q119 GDP is currently tracking 0.5% GDP

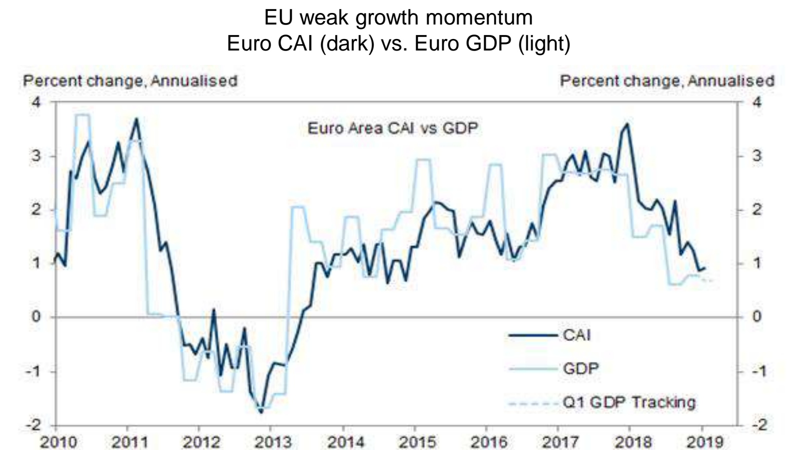
However, given the dovish stance of the Fed, we think the GDP growth rate might be close to a bottom in Q119 and should bounce back to 2.3% in Q219 and 2.1% in H219.

Europe

Although February Euro area PMIs came stronger than expected, growth remains very weak in the Union. Whilst real GDP growth is only tracking 0.7% annualized in Q1, the Euro area current activity indicator is running at 0.8% in February down from 3% in early February.

Looking across countries, Italy remains in recession (on track for a third negative GDP print in Q1), Germany narrowly avoided a technical recession at the end of last year and French momentum remained sluggish. The exception is Spain, which is tracking at an annualized pace of 2% in Q1 despite the slowdown in the other Big Four.

EU weak growth momentum
Euro CAI (dark) vs. Euro GDP (light)



Macro

At its meeting in March, the ECB cut 2019 Euro-area GDP growth rate forecast to 1.1% from previous 1.7% while the Street cut to 1.1% in 2019 on a Q4/Q4 basis, pushing down the annual average to 1% for 2019, in 2020 to 1.4% and 2021 to 1.3%. The expected downside is mainly explained by domestic demand indicators slowing, global growth decelerating and a weaker than anticipated Italian outlook as credit conditions have started to tighten. The Italian recession is likely to weigh on growth in the rest of the Euro area.

Weak data in Germany:

- Manufacturing PMI below 50
- Weak new component orders
- Weak German industrial output
- Sluggish factory orders
- Q418 GDP at 0% (after contracting in Q3)

Shocking data in Italy:

- Negative GDP (technical recession)
- Negative industrial production (-5.5% vs. -2.7% consensus YoY)
- Negative industrial sales (-7.3% vs. 0.6% gain consensus YoY, the lowest since 2008)
- Negative industrial orders (-5.3% vs. -2% consensus YoY)
- Weak new car registrations
- General low confidence
- Negative retail sales

The Union cut Italy's GDP growth forecast to 0.2% from 1.2%. Taking into account its fiscal policy and its current political situation, it is unlikely that Italy will keep a stable debt/GDP ratio, currently at 130.7%, as the cost of debt will likely increase, 20bps expected in 2019 or €3.5Bln. In addition, Italy is the only European country whose PCI (per capita income) is still below the pre-great financial crisis level (even South Korea has overtaken Italy in PCI terms), currently being in technical recession.

Japan

The likelihood of a recession is set to increase. February PMI dropped to contractionary territory at 48.5 for the first time since September 2016. The 20-year yield drop to its lowest level since 2016, following recession alert.

Japan 20-year yield

Central Banks

Fed: Dovish stance**.** At its January meeting**,** the FOMC left its policy rate unchanged at 2.25-2.50% as forecast, removed any explicit hiking bias, and confirmed a wait-and-see approach as the appropriate response to increased downside risks.

It seems Fed officials are unsure what rate adjustments needed in 2019, noting that some downside risks had increased (tighter financial conditions' impact on business and consumer sentiment, volatility, slower global growth especially in China and Europe, trade tensions). The bottom line is that the FOMC is on track to curtail the normalization of the balance sheet without providing any solid reasoning for doing so. Further information will be provided at the March 19-20 Fed meeting.

Inflationary pressures as measured by both PPI, CPI, and the Fed's preferred measure of Core PCE, continue to rise as well. The chart below is the spread between PPI and CPI, historically, when "producer price" inflation rises faster than consumer prices, it has impacted economic growth by suggesting that inflation can't be passed on to consumers.

Gap between Core PPI & CPI (orange) vs. GDP% at annual rates (blue)

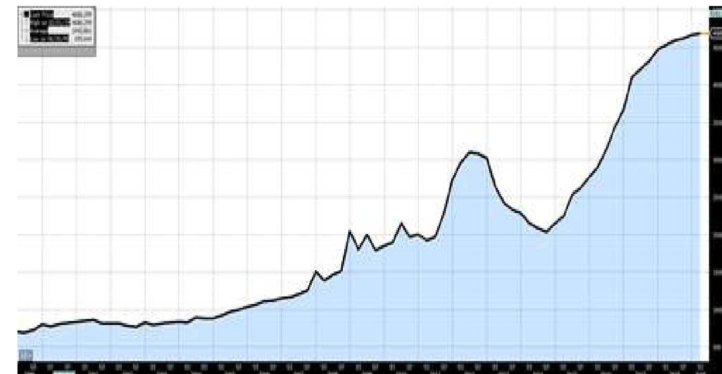
The composite inflation index is also screaming higher suggesting that if the Fed pauses they could potentially get well *"behind the curve."* Even the Federal Reserve's favorite measure of inflation, PCE, is also suggesting the Fed should be hiking rates rather than pausing. **All of this data clearly suggests that the Fed should be hiking rates currently, rather than pausing.**

The problem the Fed faces currently, as we discussed previously, is that when the last recession started the Fed Funds rate was at 4.2% not 2.2% and the Fed balance sheet was $915 billion not $4 trillion.

"If the market fell into a recession tomorrow, the Fed would be starting with roughly a $4 Trillion-dollar balance sheet with interest rates 2% lower than they were in 2009. In other words, the ability of the Fed to 'bail out' the markets today, is much more limited than it was in 2008."

ECB: Dovish stance. ECB balance sheet rose by another €6.3bn as QE reinvestments remain higher than QE redemptions. Total assets now at €4,686bn, near record high and equal to almost 42% of Eurozone GDP while the Fed's balance sheet has already shrunk to 19.5% of US GDP.

ECB Balance Sheet in 000 Mln €



Central Banks

At its March meeting, the ECB left rates unchanged but announced a news series of quarterly targeted longer-term refinancing operations (TLTRO-III), starting in September 2019 and ending in March 2021, each with a maturity of two years and surprised on the dovish side, changing the rates forward guidance, with rates staying unchanged at least through the end of 2019 (vs. previous expectation rate hike in 2019, dovish indeed). Most striking has been the downbeat language and macro projections for inflation, 2021 inflation forecast at 1.6% vs 1.8% previously.

Japan: Dovish stance. The central bank would be ready to ramp up stimulus if sharp yen rises hurt the economy and derail the path toward achieving its 2% inflation target. Kuroda told the parliament “if currency moves are having an impact on the economy and prices and if consider it necessary to achieve our price target, we will consider easing policy”.

Geopolitics

Brexit: Theresa May pre-empted defeat by setting out a three-part plan to maintain control over Parliament’s influence in Brexit negotiations. If the PM’s revised Brexit deal cannot command a Commons majority by 12 March, second meaningful vote, MPs will vote for a “no deal” Brexit. If that too is rejected, MPs will vote on an extension of Article 50. All three exit options, “no deal”, “this deal”, and “no Brexit” remain in play. The likelihood of an Article 50 extension has increased in recent weeks. The GBP has rallied more than 3% vs. USD YTD and more than 4% vs. EUR YTD.

Trade war: Trump delays the step-up in the tariff rate from 10% to 25% on $200Bln in imports from China scheduled to take effect March 2. The ongoing negotiations on specific commitments on six issues (IP, technology, transfer, service market access, agriculture, currency and non-tariff barriers) have raised expectations that a formal agreement could be reached in the next few weeks. The base case is that an agreement would leave some US tariffs in place, potentially lifting them in stages as various commitments under the agreements have been met. In addition to longer-term reforms involving IP and tech transfer, the White House also appears intent on shrinking the bilateral trade deficit with China through purchase commitments.

Commodities

Commodities are now up 12% year-to-date on a Goldilocks rally; further gains will need to be fundamentally-driven. The first two months of 2019 have seen a strong rally of commodities correlated with risk-assets after a massive 2018 sell-off. However, we now think that commodities have reached a level where they are no longer significantly undervalued against fundamentals. This is the reason why **we keep reiterating our neutral stance on commodities as the risk-reward of being long commodities is less compelling than at the end of 2018**. It is very important to stress that the next potential upside will have to be supported by better macro and fundamental data, contingent with geopolitics and idiosyncratic risks.

Oil

We reiterate our neutral position, as discussed in our previous newsletter. Oil prices are having their best start since at least 1990, with WTI currently up 25% year-to-date and Brent currently up 24% year-to-date. January and February crude positive performance hovers around 19% and 3% respectively. The US imported the least amount of crude oil since 1996 and shipments from Saudi Arabia tumbled to a record low, as shown in the following chart. The steep drop in overall imports comes amid sanctions on Venezuela and as Saudi Arabia sticks to its commitment to reduce production as part of an OPEC agreement that kicked in this year. At the same time, the data highlighted US domestic crude production that reached a fresh high.

US oil imports (red) vs. WTI price (blue)

As discussed in our previous newsletter, Brent spot prices are forecast to average $61 in 2019 and $65 in 2020 while WTI spot prices are forecast to average $8/b lower than Brent prices in Q119 before the discount gradually falls to $4/b in Q419.

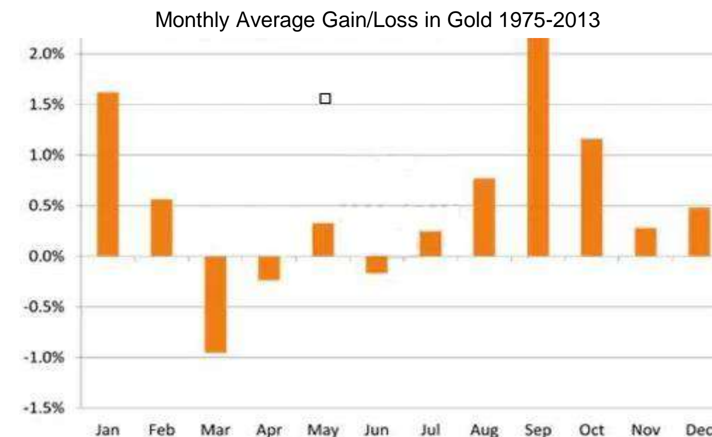
Gold

Gold is holding near a five-week low, losing approximately 5% since half February and coming back almost flat year-to-date, given a stronger dollar, higher rates and increased risk-on posture, as shown in the chart.

We were expecting some consolidation and we are therefore getting more bullish on gold after the recent correction, gradually increasing gold in our allocation due to its hedging properties and relative compelling valuation.

Gold seasonality is playing out as March is one of the weakest months statistically.

Monthly Average Gain/Loss in Gold 1975-2013

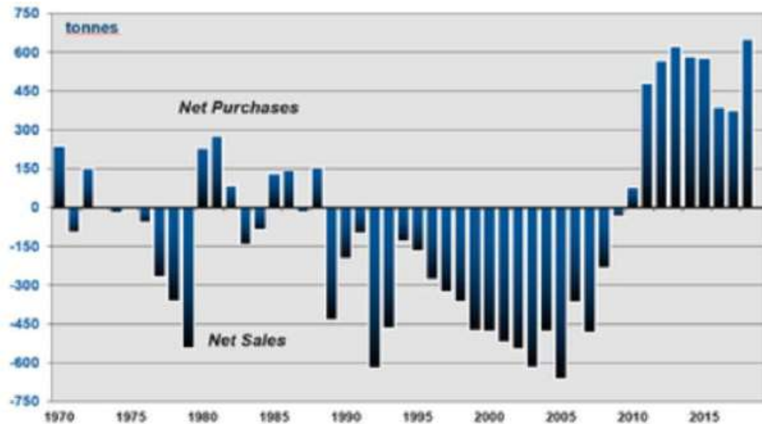


Commodities

DSI (Sentiment) has dropped from the 90% bullish reading note in February to 55%.

The Central Bank gold-buying momentum is expected to be as strong as in 2018. China increased holdings to 60.25Mln ounces in February from 59.94Mln in January. Should China continue to accumulate gold at that pace over 2019, it may end the year as the top buyer after Russia, which added 274.3 tons in 2018. Interestingly, as discussed in our previous newsletter, governments worldwide added 651.5 tons of bullion in 2018, the second highest total on record and the highest demand in 50 years. We think Central Bank buying supports the bullish stance for gold in the long run amid elevated geopolitical tensions and uncertainty.

Central Bank Gold Demand



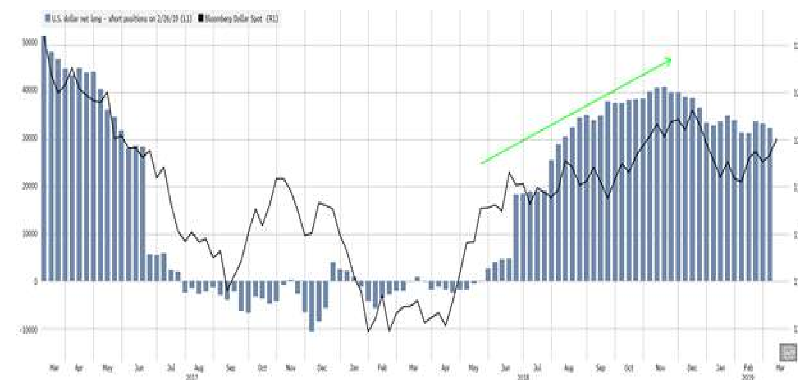
Forex

The USD Dollar index is trading in a bullish upward channel as shown in the chart, trending higher for seven consecutive session. As long as it does not break the 1185 level the bullish trend remains confirmed.

Bloomberg Dollar Spot Index (black)

Positioning is still bullish USD as speculators raised their bullish bets to the highest since January 2017.

US dollar net long- short positions (histogram) vs. USD index (black)



Current Investment Ideas

Long Put spread on Indexes

We would advise trying to get advantage of the low volatility and protect portfolios through a cheap Put spread on Indexes.

As an example, the Put Spread on S&P 2700 (OTM 2%) / 2450 (OTM 11%) April costs 100bps of performance for every 1% notional covered and has a current delta of 41%.

Long CDS and Btp/Bund spread

We would start buying some protection through ETFs that synthetically replicates the performance of the short iTraxx Crossover 5-year CDS like the XTC5 GY ISIN LU0321462870. This trade would benefit from spread widening.

A similar idea would be achieved through the spread of long Bund vs. short BTP future in Italy. The spread has tightened considerably over the past two months but unfortunately the economical and political news are not having a great momentum on Italy. We believe there could be a new widening of the Italian spread.

Keep in touch

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