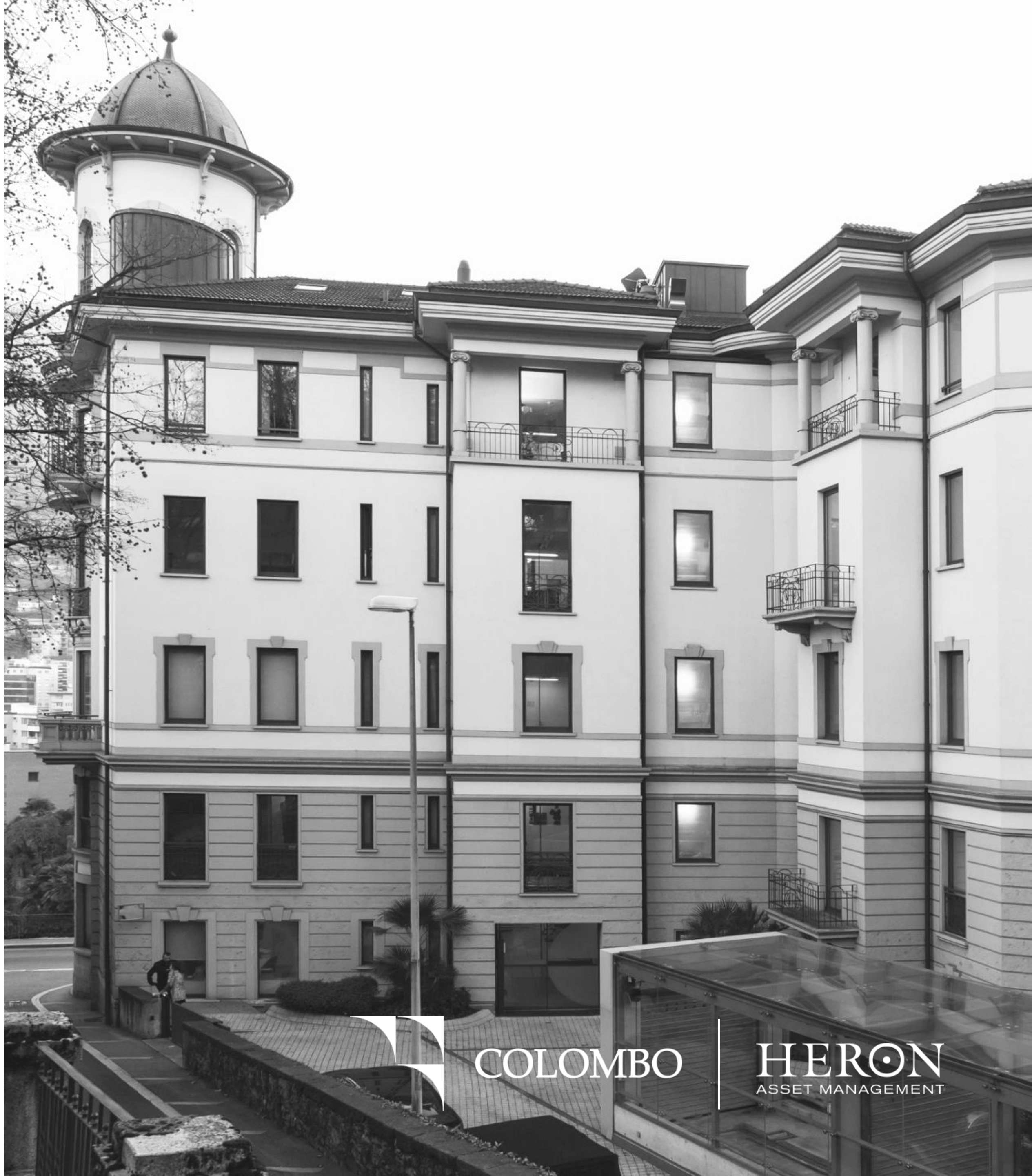
Monthly Market Update

Monthly focus on the financial markets

12th December 2018

Contents

Alberto Tocchio - CIO
atocchio@heron.ch



Market Analysis

The recent behavior of markets has been highly volatile and unpredictable.

A bit more than two months ago US Equities were at all-time highs and now most of investors are consensually bearish after we witnessed an aggressive and quick sell-off across the globe. The S&P and Nasdaq are having the worst quarterly performance in 7 years.

Not even the “safe” US FAANG Index (Facebook, Apple, Amazon, Netflix, Google) has been able to withstand the correction and Apple has now wiped more than ¼ of its market cap from the beginning of October.

From the highs just a few months ago, FAANG have lost a staggering 1trln$ in market capitalization, an incredible number relative to the fact that the entire HF industry has just ~3trn$ in assets.

Realized volatility in the “White Knights” (Amazon, Apple, Microsoft) is up 290% in the past 3 months and is at the highest level since March 2009.

As you might remember these stocks have consistently helped the US market to outperform the world over the last few years and we have constantly warned over the last few newsletters of a potential overcrowding risk on these names.

What is more worrying is that there hasn’t been any place where to hide and Stocks, Bonds and Commodities from copper to crude oil to burlap are staging a rare simultaneous retreat, putting global markets on track for one of their worst years on record. **Data are showing global stocks and bonds could both finish the year in red for the first time in at least a quarter-century**.

Within the major 17 different asset classes, none is currently beating inflation Ytd in the recent history’s worst yearly performance, not even in 2008 crisis!

No asset class is beating inflation

Ranking	2004	2005	2006	2007	2008	2009	2010	2011
1	REITS	MSCI EM	MSCI China	MSCI China	US 10Yr	MSCI EM	REITS	US 10Yr
2	MSCI EM	Commodities	REITS	MSCI EM	US 2Yr	MSCI China	Russell 2000	Inflation Bonds
3	MSCI Europe	MSCI Japan	MSCI Europe	Commodities	US Agg. Bond	Global HY	Commodities	EM$Sov Credit
4	Russell 2000	MSCI China	MSCI EM	MSCI Europe	EM Local Debt	US HY	MSCI EM	US IG
5	MSCI Japan	EM$Sov Credit	Russell 2000	Inflation Bonds	US IG	Commodities	MSCI Japan	US Agg. Bond
6	Inflation Bonds	REITS	S&P 500	US 10Yr	Inflation Bonds	MSCI Europe	US HY	REITS
7	Global HY	MSCI Europe	Commodities	US 2Yr	EM$Sov Credit	EM$Sov Credit	S&P 500	US HY
8	Commodities	S&P 500	Global HY	US Agg. Bond	US HY	REITS	Global HY	Global HY
9	EM$Sov Credit	Russell 2000	US HY	EM$Sov Credit	Global HY	Russell 2000	EM Local Debt	S&P 500
10	US HY	Global HY	EM$Sov Credit	S&P 500	Commodities	S&P 500	EM$Sov Credit	US 2Yr
11	S&P 500	EM Local Debt	Inflation Bonds	US IG	MSCI Japan	US IG	US 10Yr	EM Local Debt
12	US IG	US HY	MSCI Japan	EM Local Debt	Russell 2000	EM Local Debt	US IG	Russell 2000
13	US 10Yr	US Agg. Bond	US Agg. Bond	Global HY	S&P 500	Inflation Bonds	US Agg. Bond	Commodities
14	US Agg. Bond	US 10Yr	US IG	US HY	REITS	MSCI Japan	MSCI China	MSCI Europe
15	EM Local Debt	US IG	US 2Yr	Russell 2000	MSCI Europe	US Agg. Bond	MSCI Europe	MSCI Japan
16	MSCI China	US 2Yr	US 10Yr	MSCI Japan	MSCI China	US 2Yr	Inflation Bonds	MSCI EM
17	US 2Yr	Inflation Bonds	EM Local Debt	REITS	MSCI EM	US 10Yr	US 2Yr	MSCI China

Ranking	2012	2013	2014	2015	2016	2017	2018
1	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	REITS
2	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	S&P 500
3	Global HY	MSCI Japan	US 10Yr	US 10Yr	US HY	MSCI Europe	US 2Yr
4	REITS	MSCI Europe	MSCI China	EM$Sov Credit	Global HY	MSCI Japan	US HY
5	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	US Agg. Bond
6	EM$Sov Credit	Global HY	EM$Sov Credit	US 2Yr	MSCI EM	Russell 2000	Russell 2000
7	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM$Sov Credit	EM Local Debt	Commodities
8	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	US 10Yr
9	US HY	US 2Yr	Inflation Bonds	MSCI Europe	US IG	EM$Sov Credit	Global HY
10	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	US IG
11	US IG	US Agg. Bond	US 2Yr	Russell 2000	Inflation Bonds	Inflation Bonds	Inflation Bonds
12	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	EM Local Debt
13	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	EM$Sov Credit
14	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	MSCI Japan
15	US 10Yr	EM$Sov Credit	MSCI Japan	EM Local Debt	US 10Yr	US Agg. Bond	MSCI Europe
16	Commodities	US 10Yr	MSCI Europe	MSCI EM	US 2Yr	US 10Yr	MSCI EM
17	US 2Yr	Commodities	Commodities	Commodities	MSCI Europe	US 2Yr	MSCI China

This is what we already called the “beginning of a bear market”, there is not enough demand to support sustained rallies because there has been too much profit/loss destruction this year and the volatility of people’s portfolios is too high.

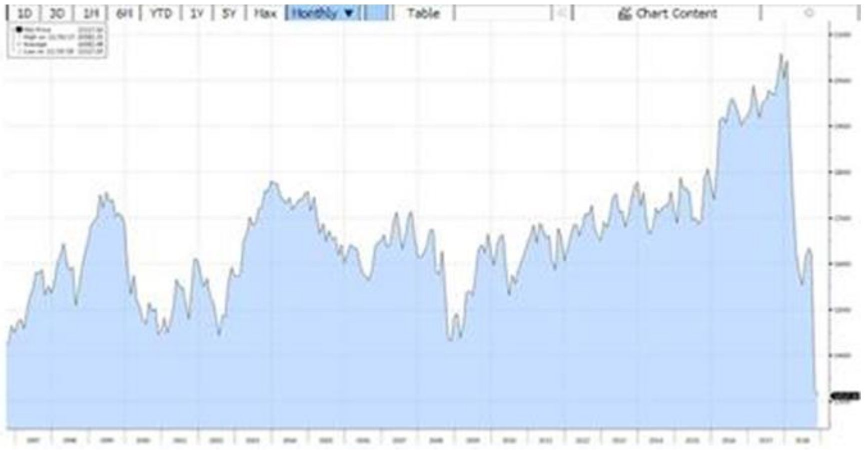
The trade-deal confusion is just the “cherry on the cake”, the reality is that the “buy the dip” strategy is already not working and the entire market is worried about the growth scare for next year.

Market Analysis

While the Dow Jones is back to the lows made in October, the gauge called “Smart Money” has now fallen to the lowest in 22 years! It is calculated by taking the action of the Dow in two time periods: the first 30 minutes and the close. The first 30 minutes represent emotional buying, driven by greed and fear of the crowd based on good and bad news.

This is self-explanatory, there has been a huge request to get out of the equity market in a very short time!

Smart Money Index



The deleveraging has been massive and quick, no wonder about who was behind this selling pressure as we have been flagging in recent months the vulnerabilities emanating from Equity Long/Short hedge funds and multi asset funds such as Risk Parity and Balanced mutual funds.

The weekly fund flows on Tech sector clearly show the damage made to the market.

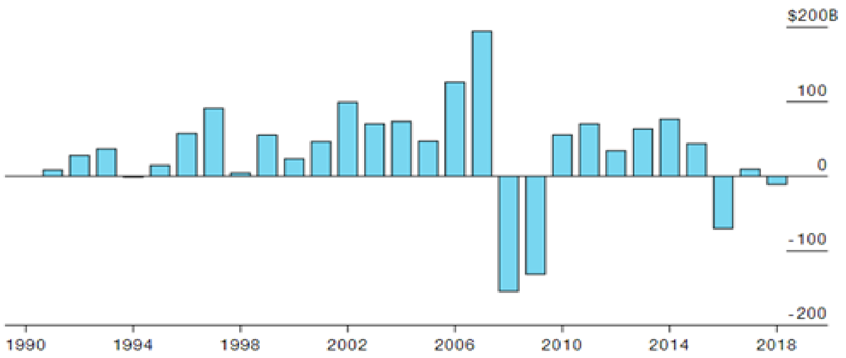
Weekly Tech fund flows ($Bln)

Global Hedge Funds saw one of the largest and fastest declines on record with beta falling from 95th percentile in September to only 10th percentile.

Market Analysis

<u>Money is leaving the industry</u>. So far this year, clients pulled a net $11.1 billion from Hedge Funds, more than erasing last year's inflows.

Hedge Fund flows ($ Bln)



<u>The Passive "overdose" is even more striking to be understood</u>. Since 1993, capital shifting into passive asset management is up 161x, this compares to only 7x for active management. Nearly $7tln is now positioned in passive asset management, over $2trln of this money has arrived in the last five years.

<u>Passive investing wasn't a big driver of equity returns in the last recessions</u>. Back in 2007, the strategy's overall size amounted to about 26% of actively managed large and all-cap funds' assets under management (AUM) in the US and about 15% outside of the US. Eleven years later, those figures have jumped to 83% and 53%, respectively.

As more and more capital flows into passive index funds, more and more FAANG shares must be owned, <u>it's a toxic, self-fulfilling cycle.</u> According to an analysis conducted by the Wall Street Journal, <u>in 1978 the percentage of profits coming from America's 100 largest companies was near 46%, today we're approaching 85%!</u>

There are currently 605 ETFs which hold FAANG equities as the top 15% position in the fund (compared to 501 in 2017, 430 in 2016 and 300 in 2015)! **<u>This has to be the most crowded trade in the history of financial markets, just five stocks are making up most of the ETF universe!</u>**

<u>Even the Cryptocurrency industry has now lost more than 700bn$ in value from a January peak</u> with most currencies down at least 80% in 1 year and 80% of the top cryptos losing at least 25% over the past few days<u>. The pain so far has been greater at the stock level more than at the Index and because of the poor liquidity, Small Cap have suffered the most.</u>

As we also mentioned over last newsletter, the depth of the book on S&P futures is declining every time the volatility spikes, implying that for a given level of volatility, market makers are providing less liquidity exacerbating market moves.

Liquidity is scarce even for Bond markets as prices are distorted by the long-term effects of the QE era. Liquidity is also stalled by technical reasons, like market making being regulated out of existence. The smart buyers aren't going to buy bonds at these levels, investors prepared to buy at current levels are betting central banks will step back into distorting the market again by keeping rates artificially low…

<u>**It is however not everything gloom and doom** and we have to be the most objective as possible as we were at the beginning of 2018 calling for a very difficult year and to avoid consensual trades (namely long EM markets, long EurUsd, short Volatility and long US FAANG names).</u>

Executive Summary

We have been calling for some market volatility during the month of October and the US started to unfold on Growth / Tech sectors as we were anticipating.

We entered the year with a non-consensus cautious view and worries over the potential Yields rally and hawkish Fed. Now, most are bearish EM, bullish USD and hawkish on the Fed. Last month we said that the Fed was likely to offer equities a put option in case of continued volatility and this has partly happened.

The rightly predicted rotation into Value over the last couple of months has come primarily at the expense of Growth, which is now the worst performing group of 'quant' factors year-to-date.

This has been one of the most painful periods for global equity investors in many years, not only because of the size of the correction but also because of the significant impact it has had on a wide range of investor portfolios.

Having been cautious on equities for much of this year we are now cautiously optimistic. This year's correction was excessive in our opinion, at current valuation levels and barring a brutal deterioration in the fundamentals, equity indices still have some rebound potential.

Commodities (first and foremost crude oil) is the other asset class susceptible of outperforming $ cash in 2019.

Although the macro backdrop for 2019 looks challenging, a reasonable degree of bad news is now in the price and valuations are looking more attractive and investor sentiment decidedly bearish.

MSCI World P/E multiple is now trading at an outright discount to historical. Relative to this, bond yields are still much lower than historical averages. Unless the earnings disappoint substantially, this suggests that P/E multiples do not need to de-rate further, and that equities are unlikely to underperform bonds in 2019.

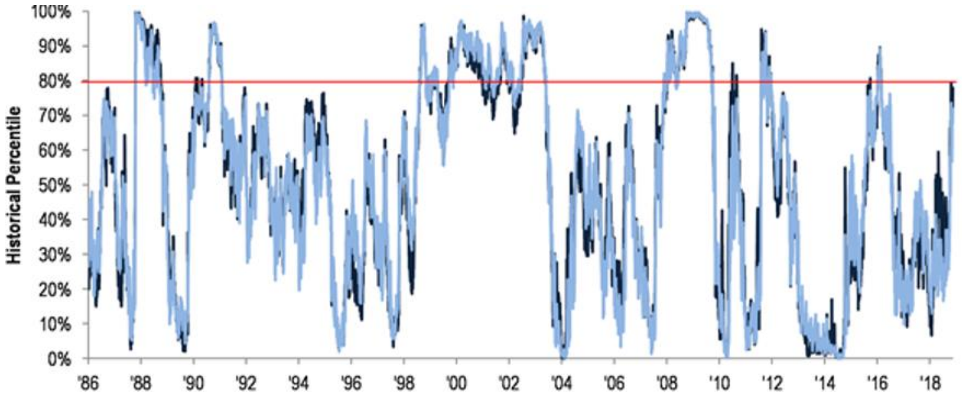
MSCI World 12m Fwd P/E (black line) vs. JP Morgan Global Govt Bond Yield (blue)

The forward 12-month P/E for the S&P has fallen 20% from its peak in December last year. At 4.1%, Europe's estimated dividend yield from equities is now the highest relative to German Bunds since 2016.

Executive Summary

<u>The level of capitulation we are witnessing is already very severe</u>, have a look at the chart showing the percentage of stocks that have lost 20% (Bear territory) and 30% (Recession)…impressive.

%SP500 Stocks in Bear (<-20%) (black line) vs. % SP500 Stocks in Recession (<-30%) (blue line)



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

<u>Positive factors (5)</u>: *unlike last year, equities are pricing in slower economic growth and Earning-Per-Share concerns*

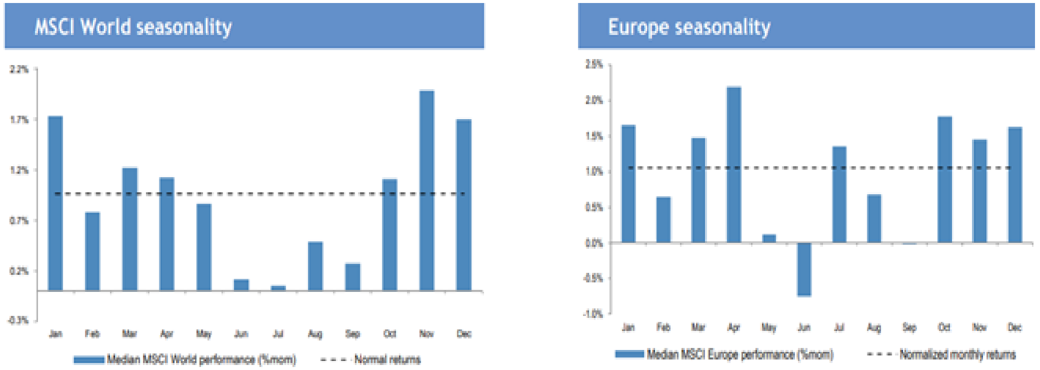
- Market could soon surprise on the upside as **<u>positioning is light compared to the beginning of the year</u>**. The case for a Q4 performance chase is still here. This is especially true for Europe where investor positioning on Eurostoxx futures is the most negative since the European crisis in 2012 and <u>we have already seen some deleveraging as around 50bn$ have left the continent and the difference vs other Geographical areas is striking.</u>

Market positioning: Global, US, WE, Japan, EM

Executive Summary

- **<u>Seasonality</u>**: Q4 tended to be strong both in US and Europe with the months of November & December positive for 70% of the time in the last 50 years.

Equity markets performance seasonality: MSCI World vs. Europe



- **<u>European valuations</u>** start to look compelling now and the <u>gap between Europe's dividend yield and Government bond yields</u> has only been higher 1.6% of the time in the last 95 years.

- **<u>Central Banks</u>** <u>(positive view)</u>: Central banks are <u>still accommodative</u>, with US real policy rates near zero. The yield curve has flattened, but crucially, stocks have never peaked before the yield curve inverted. One typically doesn't see a slowdown without HY credit spreads widening materially.

- **<u>Buyback activity is expected to increase significantly</u>** going forward after the blackout period given by the reporting season with up to 200bn$ run rate until the end of the year.

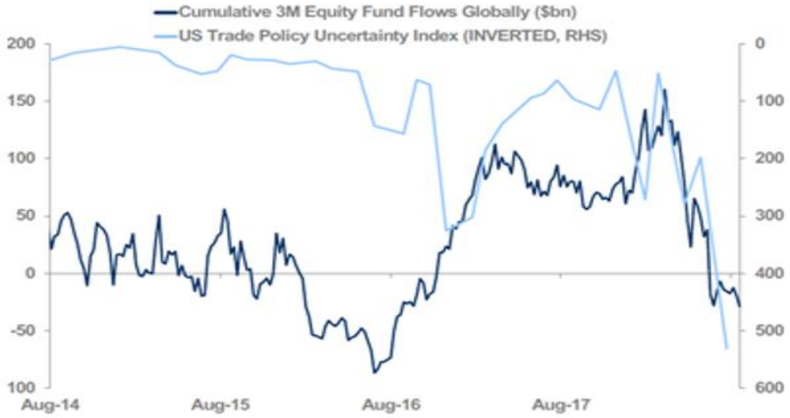
<u>Negative factors (13)</u>: *unfortunately, still largely outpacing the few positive factors*

- <u>Already in September we mentioned</u> as 1st point: "The main bear case is that a <u>crowded trade unwind</u> spreads to an already weak broader market". We also said "<u>The largest positioning risk continue to be under the surface in crowded names, sectors and factors rather than overall Index level positioning</u>".

- <u>We see limited risk that global economic momentum will re-accelerate here</u>, as the year-on-year comparisons get tougher in the coming months and <u>increased</u> **<u>uncertainty around trade and tariffs will continue to weigh on activity going forward</u>**.

  Rising US trade policy uncertainty has already weighed on global equity fund flows this year as shown on chart. <u>US cycle is 10 years old, Current expansion has reached 112 months.</u>

Correlation Equity fund flows vs. Inverted uncertainty index

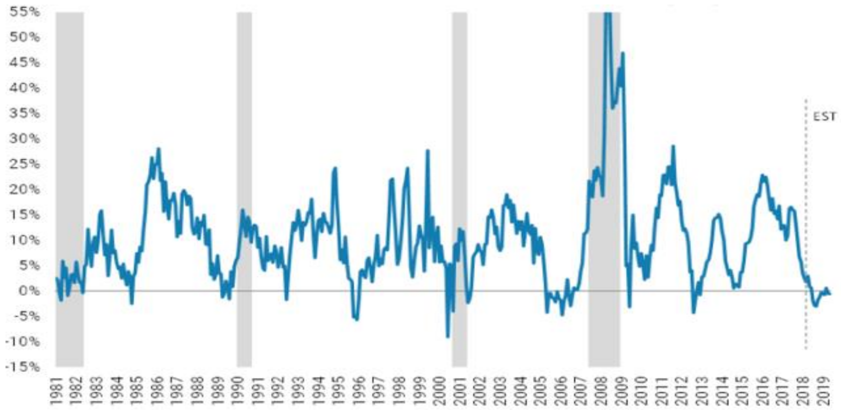


Executive Summary

- **<u>Central Banks</u>** <u>(negative view)</u>: Global monetary policy is set to (gradually) tighten further as the Fed continues to lift rates and the ECB is at the end of its bond purchase program. Tighter financial conditions in general increase the pressure on the 'weaker links in the chain' and the chance that we see higher volatility. <u>Credit spreads should slowly widen</u>, <u>unhelpful for equity valuations</u>.

  <u>BIG 3 Global Central Bank Balance Sheet Growth is Falling Fast and Should be Negative by January</u>.

  Global Central Bank Assets Y/Y: Fed, ECB, BoJ (blue line) – US Recession (grey)



- <u>US estimated **Quarterly S&P Earning Growth set to decelerate** to its long-term average of 6% to 8% in 2019</u>.

- **<u>Margin pressures are beginning to build</u>**, 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, <u>profitability concerns look set to become more of a focus for investors in the coming months</u>. Input prices are rising more rapidly than output prices (chart), negotiated wages are now rising sharply even in Europe.

  <u>Margin environment is less favorable now.</u>

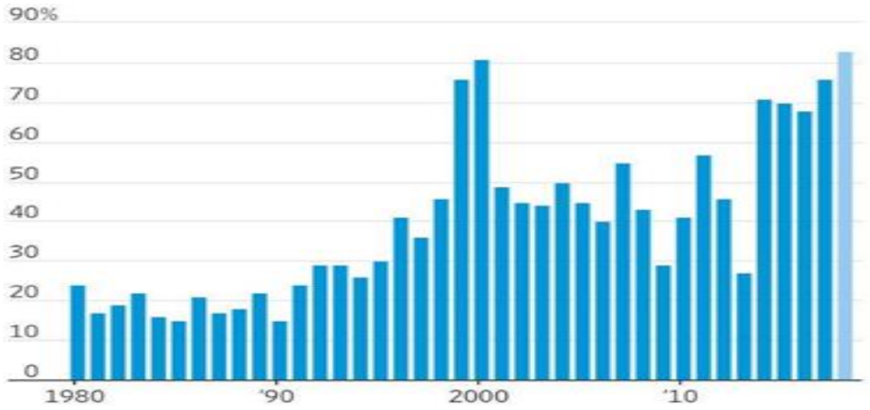
  Input Prices (black line) vs. Output Prices (blue line)

Executive Summary

- **<u>IPOs / Secondary/ Placing</u>**: 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.

  During the first three quarters of 2018, $50 billion in IPO money has been raised by more than 180 companies. This puts this year on track to be the busiest year for IPOs since 2014.Over the last couple of months a great number of IPOs has been called off and the performance of IPOs and Placings has been dreadful. <u>Not a great sign as it seems that the market cannot absorb any further paper.</u>

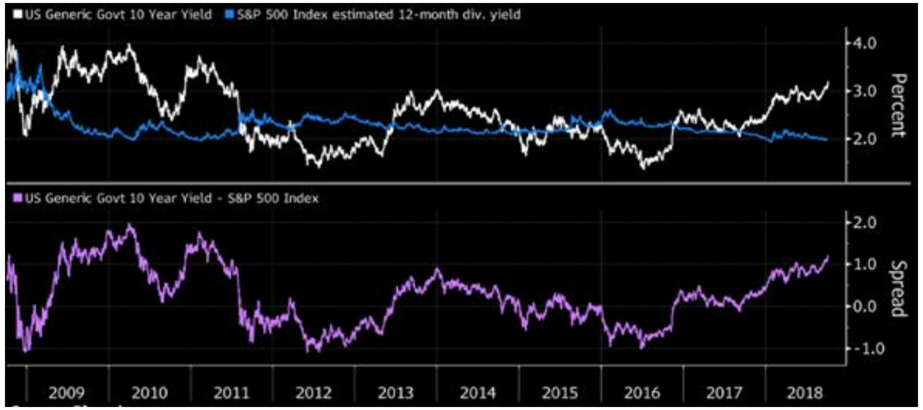
% negative IPOs after 12 months



- **<u>Cash Repatriation</u>**: the <u>repatriation flow declined to only $60bn in Q3 vs. $115bn in Q2 and $225bn in Q1.</u> Given that 330bn$ of repatriation took place already in H1 this assessment implies a significant slowing of the flow in the second part of the year. The Q3 reporting season revealed further slowing in the pace of cash holdings reduction by US companies. The <u>boost that US repatriation provided to US equity and bond market via share buybacks and corporate bond redemptions is likely to slow considerably now</u> as just 5% of the repatriated cash has been used for Capex.

- **<u>In US the relative appeal of stocks is waning compared to fixed income</u>**. Yields on 10-year Treasures are around 3% while US equities are estimated to yield about 2% in 12 months, the widest gap in eight years.

US Generic Govt 10Y yield (white) vs SP500 12m dividend yield (blue line)
Spread US Generic Govt 10Y yield vs. SP500 (purple line)



Executive Summary

- **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.

  Ignoring private consumer debt (which is greatly affected by rising rates), the US National Debt recently hit $21.3 trillion and the interest payments due on all this debt is at a record high. You can see on the chart that since the Federal Reserve began raising rates in December 2015, the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year!

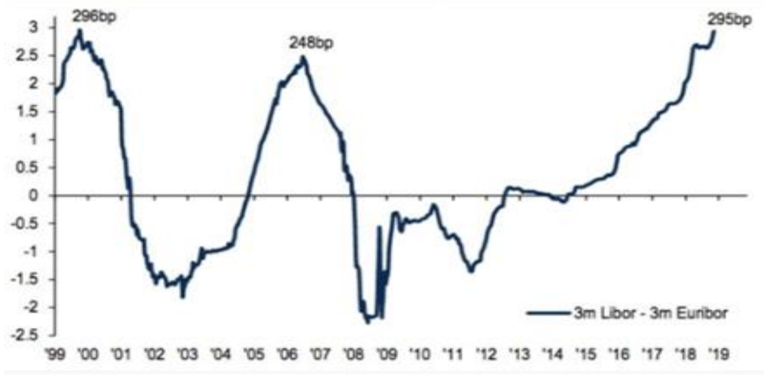
  Remember that US is taking in *less* tax revenue because of Trump's tax cuts and the Treasury will have to borrow *new* debt just to pay off maturing *old* debt and interest. Short term interest costs will continue to rise over the near-term because of 3 reasons: higher inflation, Fed tightening, and the increased amount of debt needed by the Treasury.

Federal government current expenditures: Interest payments

- **Junk Bonds**: They crashed really hard just before the financial crisis of 2008, and they started to fall again in October. A full-blown junk bond panic would definitely be a very clear sign that a major market crash is imminent. **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.

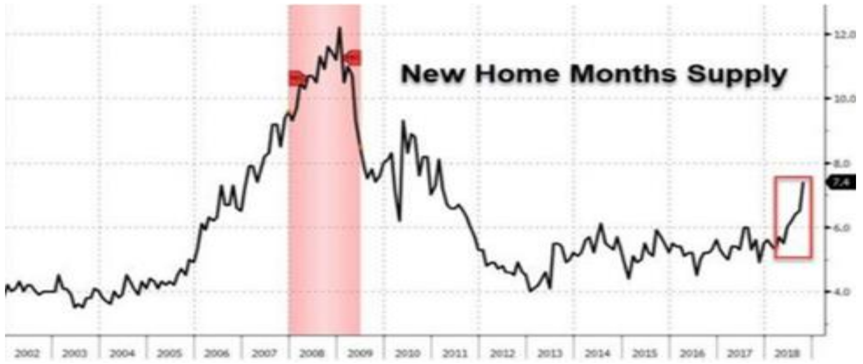
- **Abnormal Libor-Euribor spread**: London Interbank Offered Rate known as Libor is spiking to new highs. Libor reflects what banks charge to borrow dollars from each other and is used as a benchmark for trillions of dollars' worth of loans. The increase is seen as a further indicator of tightening financial conditions showing that corporate costs are experiencing a much further increase in interest rates than Fed funds.

3-month Libor vs. 3-month Euribor Spread



Executive Summary

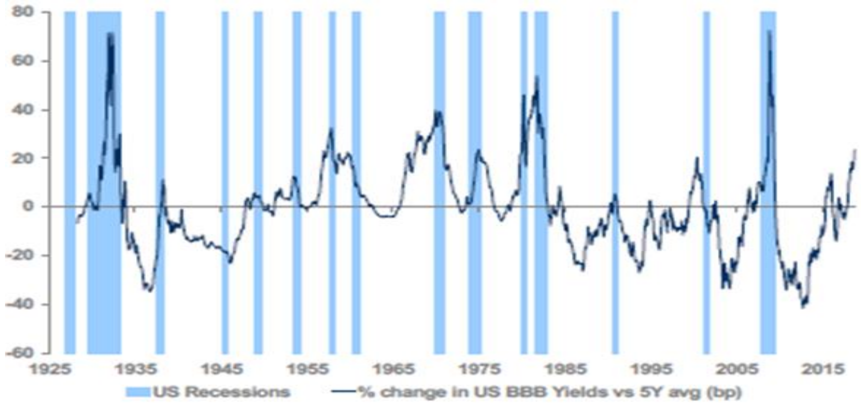
- **<u>Declining US House Prices</u>**: US new home sales plunged 13.2% YoY in November, the biggest drop since May 2011. Existing home sales tumbled 0.7% MoM marking the longest streak of declines since the taper tantrum in 2013. The <u>University of Michigan Home-buying conditions are currently the worst since Lehman</u>… <u>and supply is soaring</u>.



- **<u>The complacency and relatively low equity hedging relative to years ago is concerning</u>**. There a number of reasons you can assign to the reduced amount of derivative hedging activity, just to name a few: 1) Regulation/compliance have made it harder for funds to trade derivatives. 2) Derivatives has become a "dirty" word. 2) The investor base has changed, more computer algorithms and less humans. <u>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</u>. Furthermore, not surprising, growth in household wealth has been highly uneven for the last 10 years. Bottom income earnings have recovered a lot less relative to the top 10% of earners.

<u>The most worrying point to monitor short-term is possibly the Credit Spreads and US corporate debt</u>. Even before we see any further widening in credit spreads, corporates are <u>already facing a very hefty increase in their cost of capital</u>. 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).

% Change in US BBB Yields vs. 5Y average



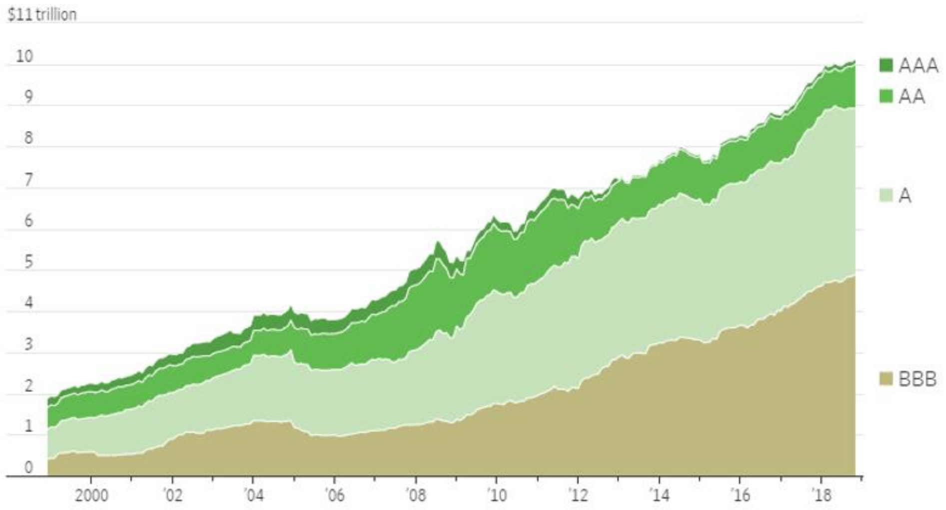
Executive Summary

As we have seen above, the cost of debt (Libor) relative to corporate earnings is on the rise and is at the highest level since 2008.

It is not a coincidence that US Investment Grade and High Yield are at their Ytd wide partly on leverage concerns. **US nonfinancial corporate debt is at its all-time high and average credit ratings of IG debt have fallen sharply.** Corporates have shown little inclination to reduce debt despite strong earnings (+25% YoY in Q3), whilst an estimated USD5.6trn debt matures by 2023.

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.

Face Value of bonds by rating



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

General Electric may be the canary in the credit market's coal mine.

The credit bear market in the US, which began in early 2018 due to weaker flows and tighter liquidity conditions, will continue in 2019 given decelerating US growth, restrictive Fed policy and weaker corporate EPS growth.

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

Oil price has been an additional unwelcome negative factor as it is clearly a component of the High Yield widening.

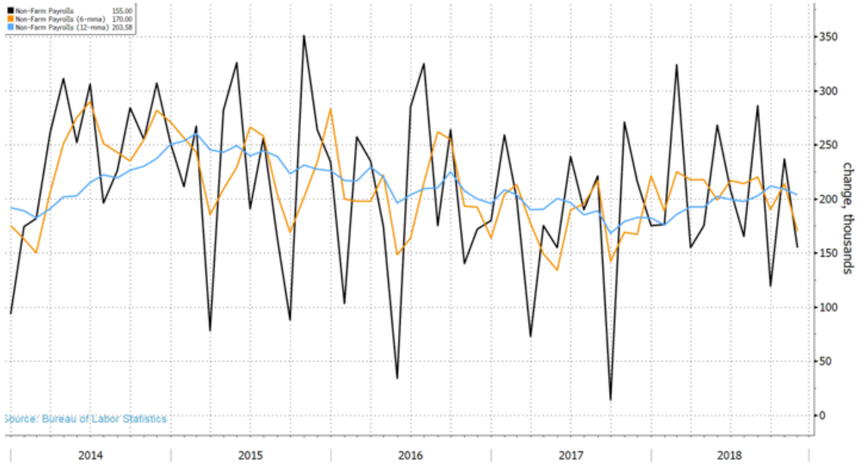
We would therefore recommend to have a close look at Credit markets also as a proxy for Equites risk-premia (Credit didn't have a single uptick despite the equity bounce we had at the end of November) **and we would start 2019 with a switch into better-rated credits.**

Macro

United States

- The Economy remained on solid footing, growing at unrevised 3.5% pace in 3Q.
- Core PCE rose 1.5% QoQ in 3Q, after rising 2.1% in prior quarter.
- In November, unemployment rate reached a new low 3.7%.
- Nonfarm payrolls missed consensus, 155k vs. 237k cons., along with lower than expected US average hourly earnings, 0.2% vs. 0.3% cons., adding to signs that economic growth is cooling a bit, following recent weakness in business equipment orders and an ebbing of consumer optimism. (slower pace of interest rate increases-dovish mood?)

December US Non-Farm Payrolls
November NFP (black) vs. 6-month NFP (amber) vs. 12-month NFP (blue)



- <u>Growth is projected to decrease in the coming two years as Macroeconomic policy become less supportive, tax stimulus and government spending fade</u>. A weaker global outlook and already introduced tariffs weigh on activity. However, the economic slack is disappearing, the labor market tightens further, and core inflation increases.

US Macro estimates

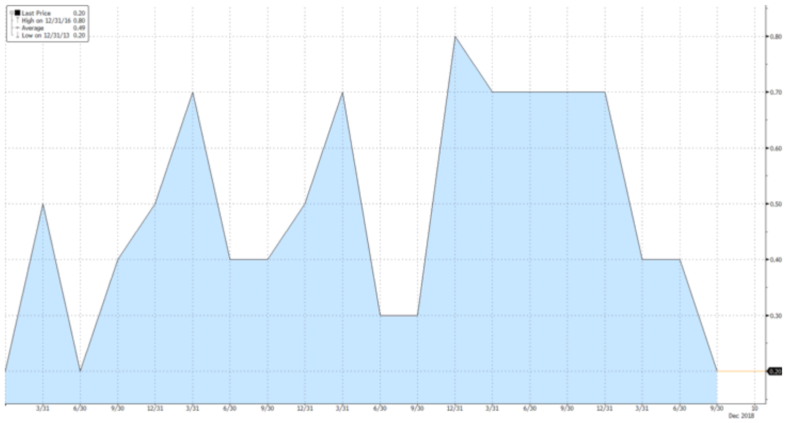
		New Forecast			Previous	
(4Q/4Q % Change)	2017	2018	2019	2020	2018	2019
Real GDP	2.5	3.1	1.7	2.3	3.0	2.0
Final Sales	2.6	2.9	1.6	2.3	2.8	1.9
Final Domestic Demand	2.8	2.9	1.8	2.3	2.6	2.3
PCE	2.7	2.5	2.0	2.4	2.3	2.1
Business Fixed Investment	6.3	6.1	1.8	3.9	5.8	3.2
Residential Fixed Investment	3.8	-2.3	-0.9	1.1	-0.2	3.1
Exports	4.7	4.5	3.6	4.9	5.3	3.5
Imports	5.4	4.4	4.1	4.8	3.3	4.2
Government	0.1	3.3	1.4	1.0	2.1	1.4
CPI	2.1	2.3	2.0	2.7	2.4	2.0
Core PCEPI	1.6	1.9	2.3	2.5	2.0	2.2
Unemployment Rate*	4.1	3.7	3.4	3.2	3.7	3.5

Europe

- The Eu Economy increased 0.2% in 3Q, <u>weakest growth in almost five years</u>, casting doubts over the economy's potential to rebound (ECB argues the slowdown is temporary), <u>due to falling exports, slowdown in spending and investment. Net trade was the biggest drag on the economy</u>.

Macro

EU GDP (weakest growth in five years)



- Euro area Core inflation fell in November from 1.07% to 0.98%, with inflation falling in Germany, France and Spain.
- The Italian Economy decreased 0.1% in 3Q, on the verge of recession as businesses see demand plunge, manufacturing contracted at the fastest pace in four years in November and services companies have seen export demand fall for five straight months.

- Euro area Growth is set to moderate to just above 1.5% in the coming years. Accommodative monetary policy and some fiscal easing will support domestic demand, in particular private consumption, and employment. Investment will remain reasonably strong, reflecting continued favorable financing conditions and a need to expand capacity. Inflation is projected to rise gradually. However, we see three main risks: a) Stubbornly weak core inflation b) An ongoing, but decelerating, economic recovery. c) A persistent populist challenge to Europe's political mainstream.

Eu Macro estimates

	2014	2015	2016	2017	2018	2019	2020	2021	2022
GDP and its components (%yoy)									
GDP	1.4	2.0	1.9	2.5	1.9	1.6	1.6	1.5	1.4
Private consumption	0.9	1.8	1.9	1.7	1.5	1.3	1.4	1.3	1.3
Govt consumption	0.7	1.3	1.8	1.2	1.1	1.5	1.3	1.3	1.4
Fixed Investment	1.7	4.6	4.0	2.9	3.0	2.0	2.9	2.6	2.0
Exports	4.7	6.3	3.0	5.4	2.0	2.8	3.5	3.2	3.0
Imports	4.8	7.4	4.2	4.0	2.5	3.1	3.6	3.4	3.3
External position (% of GDP)									
Current account	2.5	2.9	3.2	3.2	3.0	2.9	2.9	2.8	2.7
Prices (%yoy)									
Consumer prices (Harmonised)	0.4	0.0	0.2	1.5	1.76	1.34	1.24	1.38	1.41
Core consumer prices (Harmonised)	0.8	0.8	0.9	1.0	1.00	0.95	1.18	1.35	1.45
Labour market (%)									
Unemployment rate (Harmonised)	11.6	10.9	10.0	9.1	8.2	7.9	7.6	7.3	7.1

Central Banks

The **Fed** is expected to slow its rate hike next year. The decline in US Equities prices and Treasury yield looks reflective of a sharp repricing of the growth outlook. Taken together with a slight dovish shift in Fed commentary, US front-end rates have moved from pricing 2-3 rate hikes one month ago, Dec19 fed fund priced at 2.875%, to less than one full hike for all of 2019, Dec19 fed fund priced at 2.57%, conditional on a hike in Dec18 that seems already locked in (19 December).

In his recent remarks, a dovish Powell stated that a) policy rate is just below the broad range of estimates of neutral, estimated value 2.5%-3.5% b) a slow approach to normalization should be taken because it takes time to assess the effects of past tightening.

The 10Y US treasury yield is edging lower from its November highs 3.23% to 2.845%, pricing in a less hawkish Fed, a lower growth and a higher risk-off mood. The 2-10Y yield curve has further flattened from 31bps in November to 12bps (remember an inverted curve might anticipate a recession!). In addition, some part of the yield curve, respectively 2-5Y and 3-5Y yield curve, recently inverted, warning the Fed that its hiking cycle might be closed to an end.

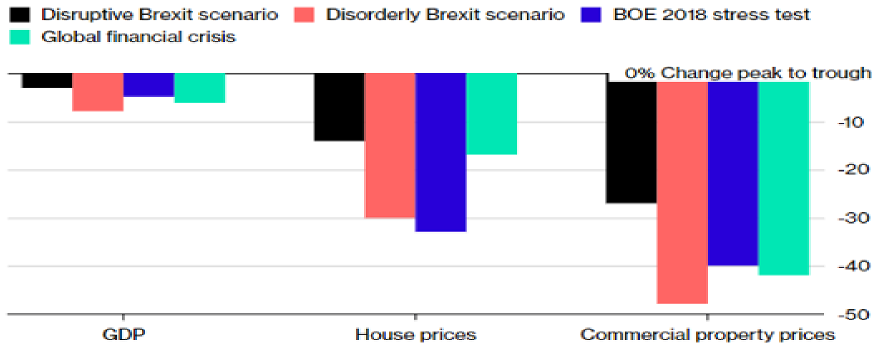
Credit sentiment remains deteriorated as late cycle dynamics, from margin pressure to slower US growth, should lead both IG and HY spreads to continue widening over the next months.

The **ECB** is likely to confirm an end to the asset purchase program this year though, the stock of asset purchased (coupons, principals) will continue to be reinvested for a long time. Unlike the Fed, the ECB is not planning to reduce its balance sheet. In its next meeting on the 13th December, projections will probably show weaker growth throughout the forecast horizon along with the inflation trajectory likely to be revised down too.

Although an ample degree of monetary policy accommodation and favorable liquidity conditions will be maintained, new TLTROs operations are not likely to be renewed. Interest rates will be left unchanged for a prolonged period of time. As far as projections are concerned depo rate should be raised by 15bps to -0.25% next October, along with two extra depo and refi rate hikes in 2020. However, the ECB policy mix toolkit will be strongly dependent on the underlying core inflation of the Euro area.

As already mentioned in our last newsletter, **BOE** policy response to Brexit might go either way, even in the event of a no deal scenario, adopting tightening or loosening unconventional measures to protect the economy and the price stability. Although the probability of a disorderly Brexit is low, Carney recently stated that the UK is not yet fully prepared for a no-deal Brexit. For the Treasury, a no-deal Brexit might cost to the economy up to 10,7% of GDP after 15 years while for BOE it gets to 10.5% within five years only, three times as fast.

Brexit Bank of England estimates



Source: Bank of England Financial Stability Report

Geopolitics

The result of **G20** was murky. Trump and Xi Jinping halted new tariffs for 90days. The US has therefore stopped new expected tariffs on 200$Bln worth of Chinese goods planned for the 1st of January 2019 while China agreed to reduce and remove tariffs on imported American-made cars (up to 40%), a claim that wasn't confirmed by Beijing until last week as the Chinese ministry of commerce statement described the meeting with the U.S. as very successful and said China is confident of implementing the results agreed upon at the talks, but didn't provide any further details on the outcome.

The situation further escalated following the arrest of the Huawei's CFO accused of violating US laws, despite risks to trade talks. China's response is yet to come and we think the trade-war negotiation will last for a long time.

Brexit: May lost three key votes in the House of Commons last week and the result is that Parliament now has the potential to decide on Britain's plan B if as expected it rejects the divorce agreement. Important catalyst: House of Commons to vote on 11th December. After the vote, an EU summit is scheduled on 13-14th December. Although May should be defeated in the House of Commons vote, the probability of a no-deal Brexit is still very low.

Italy: the government is discussing reducing budget deficit to 2-2.1% and weighing additional asset sales to cut debt raising as much as 1% GDP through privatization, after the EU threatened to start an infringement procedure that could have cost up to 0.5% of GDP, € 9Bln. Officials are concerned about the proposed reforms (income citizenship, pension reform etc.), the recent negative GDP growth rate and the massive amount of debt looming on the country. Tria is rumored to be considering to resign.

Forex

Despite new tensions on Trade War the **USD** seems to have lost the attitude of "safe" currency (CNY has also appreciated since the beginning of the month) even if it has been in a range between 1.13/1.18 since the end of May).

The **DXY Dollar Index** is basically unchanged since last update, net speculative positioning is continuing to growth and has reached the highest level this year and the highest since January 2017.

The chart shows the break-out of the USD from the tight range we had since the beginning of the summer and increasingly long positioning (bars).

US Dollar net long – short position (bars) vs. Bloomberg Dollar Spot (black line)

Forex

Optimism on the **USD** has reached an alarming consensus level.

We remain confident that we should see only very limited USD upside from here. With risky assets looking set to stabilize going into Year's end.

These should be the main factors for a potential weak USD:

- US growth peaked in Q2 an annualized rate of 4.2% and is likely slowing down from here (sectors sensitive to funding costs, such as housing and autos, have slowed). Weakening liquidity conditions, tightening, rates, weakening US data etc. Warning signals of a potential significant decline in the USD are flashing, with foreign investors no longer steering funds into long-term USD-denominated assets. It seems the trust of investing in US assets for the long-term has declined.
- Short-term fiscal stimulus running out of steam
- US corporate leverage
- Gap of input prices in US and Euro: the gap between US and Europe should continue to narrow as US inflation is more sensitive to low oil prices. The relative inflation may soon start to support a higher EurUsd.

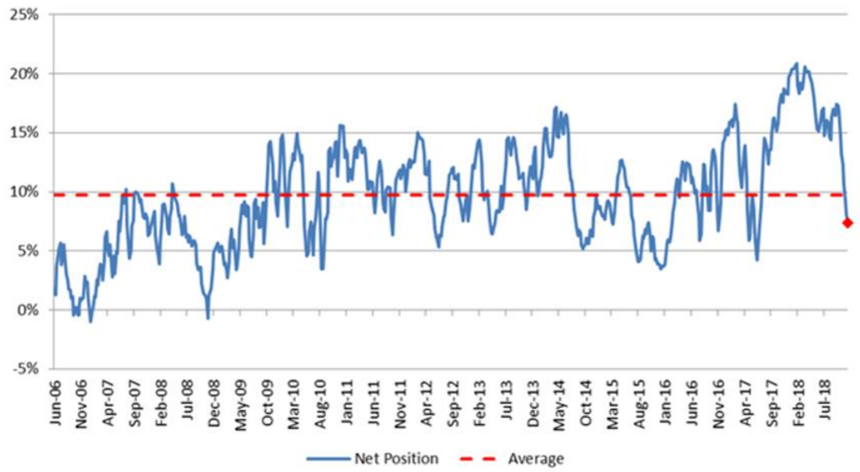
Commodities

The Blomberg commodity Index is 0.5% above our last update and still 9% below the highs made at the end of May. As we mentioned in November, the CNY appreciation would have helped to see a further strength on the commodity space.

Oil prices have dropped a further 4% since last update and more than 30% from the highs made on the 3rd of October. We have called the profit taking at the beginning of October and last time we suggested to start getting back into the sector. Last Friday the OPEC concluded its meeting with an accord to remove 1.2 million barrels a day of crude from the market, with non-OPEC allies including Russia taking a 400,000 barrel-a-day share.

Oil was a consensual long position in October and after losing for 8 weeks in a row, Managed Money's net long position (as a % of open interest) across the hydrocarbon futures complex is now just 7% of total open interest**! We would now definitely invest back in the Oil/Energy sector.**

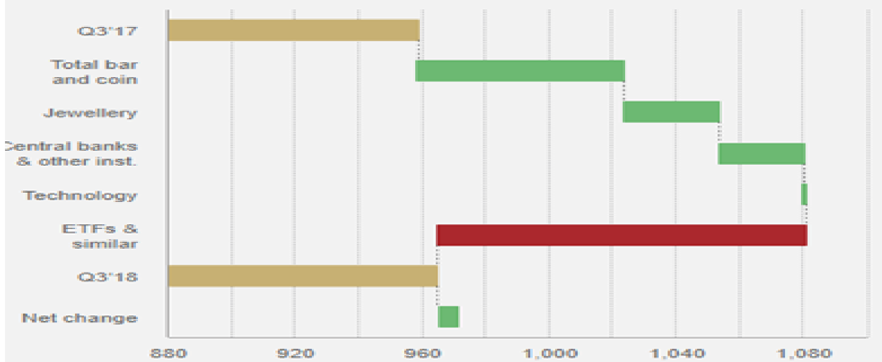
Managed Money Net Open Position Oil Futures % Open Interest



Commodities

Gold has bounced 3.7% since last update and is approaching again the 1250$ level. This was function of the risk-off mode on markets. Positioning is still mainly short and strong Central Bank, Governments and consumer demand has been offset by large ETFs outflows. Gold demand was 964.3t in Q3, 6.2t higher YoY. Jewellery demand rose 6% in Q3 and a growing number of Central Banks buyers saw demand rise 22% YoY to 148.4t, the highest level of quarterly net purchases since 2015! Iran's demand for gold bars and coins climbed to a 5-year high, China is still heavily buying physical gold and last month over 70% of the gold import figures into Switzerland came from London and US. As the picture is showing, sharp outflows in gold-backed ETFs offset growth across much of gold market.

Gold positioning



Gold is the only real money that has survived throughout history. Currently, economic, financial and geopolitical risk is unprecedented. **Physical gold is the ultimate insurance against these risks and should form the solid foundation of investors' wealth pyramid**. **Short-squeezing is getting more likely especially if it manages to break 1250$** and it is worth to remind that at gold's mid-2016 top , these speculators had a very high positioning before the quick sell-off.

Current Investment Ideas

Long Dax: Germany's stock market is one of the worst performers so far in 2018 being down 18% Ytd, underperforming the Eurostoxx 600 by 4%.

German companies have been hit by a combination of the following factors:

- Trade tensions: DAX is the European index with the highest beta to world trade growth and ranks just after MSCI EM and the Topix.

- EM slowdown: German companies generate about 30% of their sales from EM and Asia-Pacific.

- Regulation: The European Auto sector has taken a big, but probably temporary, hit from changes in environmental rules. Since July, car registrations in the Euro area have fallen 25%, and the auto dependent German manufacturing PMI has dropped by nearly 5 points, underperforming its peers significantly.

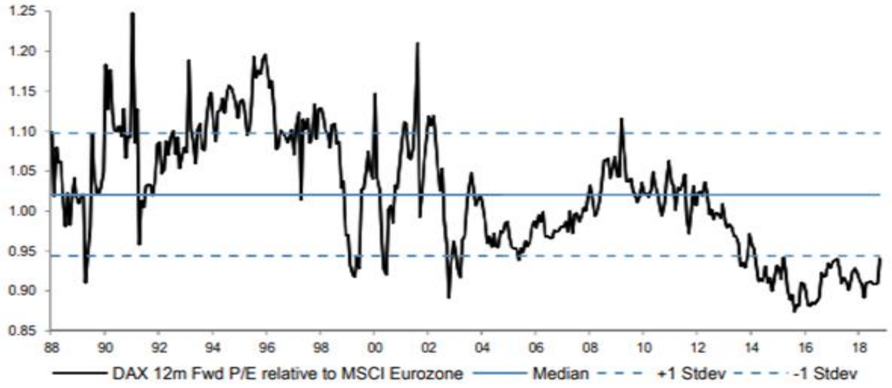
- Politics: Chancellor Merkel announced her intention to step down in 2021 after serving as Chancellor since 2005 and leader of the CDU since 2000. Over the weekend we had the election of the new CDU leader Karrenbauer.

While these factors are not going to change in the short-term, we believe that the market is discounting some degree of the above uncertainties as has fallen more than periphery did so far Ytd and could recover something in the short-term.

DAX has lagged, and it is getting attractive, especially as euro is weaker, DAX valuations are near the lows of the range.

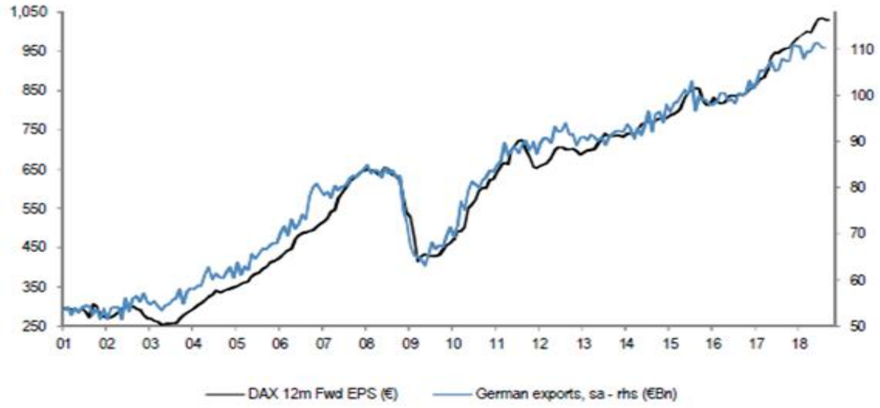
Current Investment Ideas

Dax 12-month Forward P/E relative to MSCI Eurozone



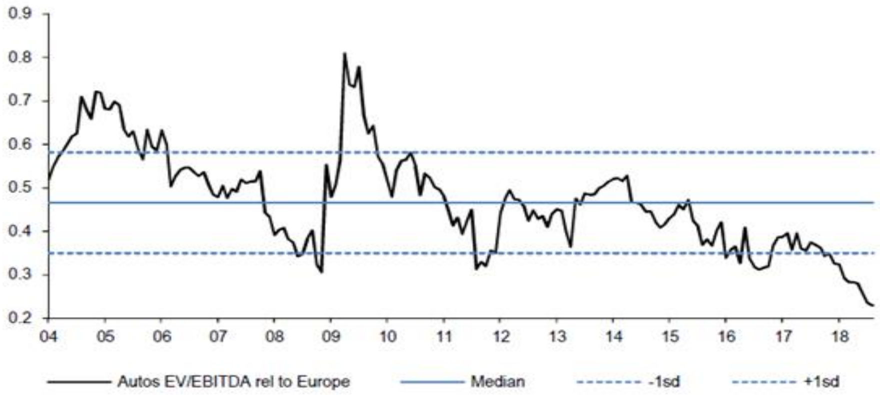
Interesting to see how 12-month Forward EPS is correlated to growing German exports.

Dax 12-month Forward EPS relative to German exports



The Auto sector is the most oversold in recent years in relative to Europe. (EV/EBITDA)

Autos EV/EBITDA relative to Europe



Current Investment Ideas

<u>Long Miners</u> (SXPP Index): The European SXPP Miner Sector has sold off over the last 3-4 months, on trade concerns, global growth slowdown and disappointing China data.

Having risen 8% over the first six months of 2018, the SXPP has fallen materially and is now down 19% Ytd dropping nearly 30% from the highs made in May when the street was consensually positive.

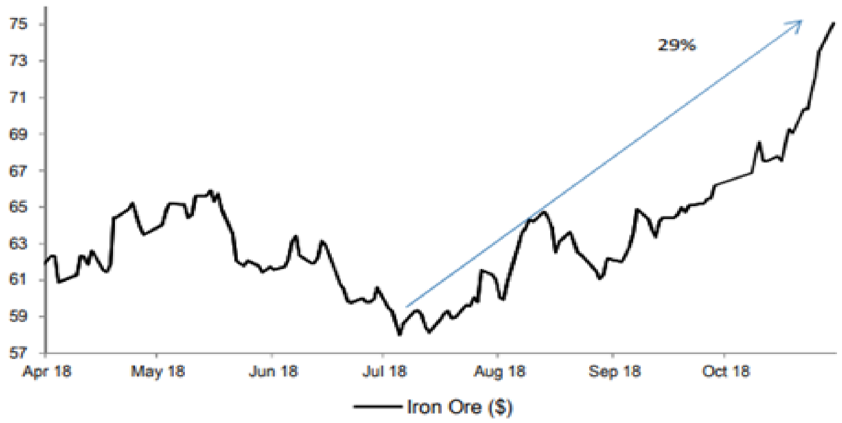
<u>The majority of this sell-off can be attributed to</u>:

- trade tensions between the US and China;
- a weakening of the growth narrative, which has seen global growth decline;
- disappointing data from China, as policymakers have resisted a broad stimulus.

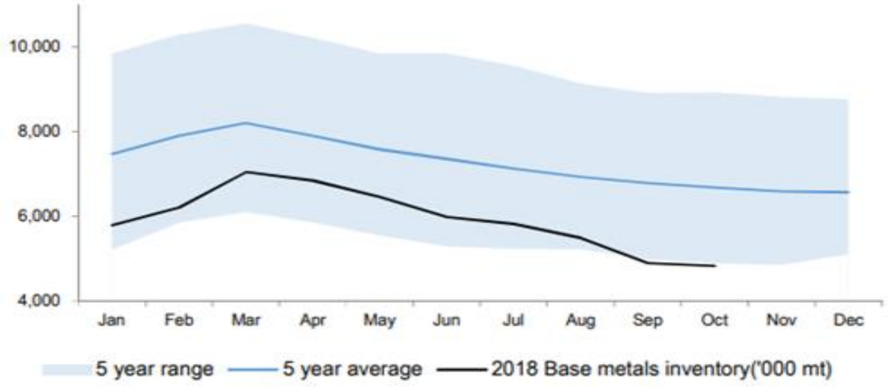
Recent commentary on trade tensions/Chinese growth at G20 has been more positive but unfortunately there is some noise every day and we will need to see what happens in these 90-days pause.

Miners are likely to have EPS upgrades of 10% for ‘19 and 20% for ‘20, if underlying metal prices stay at current levels. Encouragingly, <u>metal prices such as iron ore have been moving up recently, and the inventories of a number of metals are near multiyear lows.</u>

Iron ore pushing higher



Inventories of key metals are at multiyear lows



Current Investment Ideas

Miners are also a good hedge on rising inflation, with the second highest positive correlation to inflation forwards, at the sector level.

Miners are a play on China improving, easing trade concerns, USD peaking, are an inflation hedge and offer much stronger cash flow generation and balance sheets than before.

The sector is attractively valued as is trading outright cheap relative to the overall market on EV/EBITDA metric.

Mining EV/EBITDA relative to Europe

<u>Long EU Financials</u>: we entered into this theme in September as expectations/sentiment /positioning and prices were attractive.

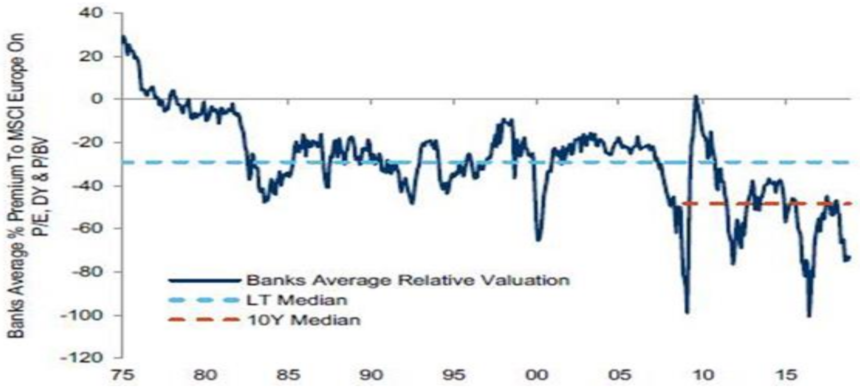
The sector as a whole has since then outperformed the market especially thanks to the Insurance because of the good dividend yield and buybacks.

<u>Hedge Funds have still got a consensual short position on the sector especially on Banks and global net exposure currently sits at the 5th %-tile since 2010..ie, extremely low exposure</u>.

We still like the following points: 1) credit recovery/ loan growth, 2) decreasing NPLs, the bank's 3-month breadth has fallen to a 15-year low and no European financial has outperformed the market over the last 12 months.

The median European bank stock now trades below tangible book for the 1st time in almost 2 years. Relative valuations of banks remains well below 10-Year average levels vs MSCI Europe.

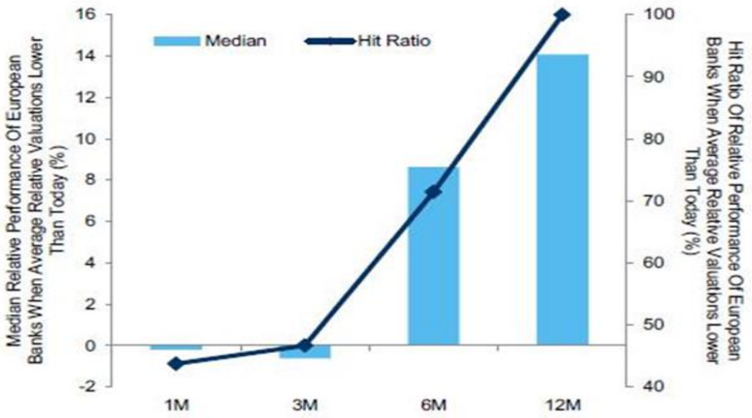
Banks average relative valuation vs. LT Median vs. 10Y median



Current Investment Ideas

Whenever banks have been cheaper than the market, they have always outperformed on a 12-Month view.

Median relative performance of Eu banks when average relative valuation lower than today (blue light)
Hit Ratio of relative performance of Eu banks when average relative valuation lower than today (dark blue)



Closed Investment Ideas

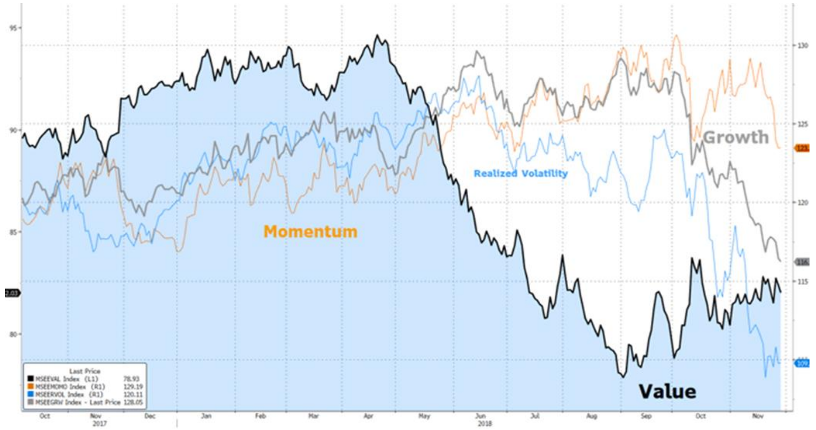
<u>Relative Factor trade: Long Value /Short Growth</u>: Growth has outperformed value by 25% in the last 12-months in US and by a similar percentage in Europe.

The rise in Yields has coincided with a clear and sharp rotation within Equities and since we pushed the idea of the relative trade Value in the middle of June, Value has outperformed Growth by more than 6.5% and by more than 10% Realized Volatility.

Since last newsletter European value is flat while Growth has lost a further 3% and as you can spot on the chart below the values of the 4 factors have more than converged.

<u>We think several sectors offer particularly good value: Banks, Basic Resources and Autos but we **would take profit on this relative factor trade as we wouldn't like to be short growth after such a massive deleveraging.**</u>

European Investment styles: Momentum, Value, Realized Volatility, Growth



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