Monthly Market Update

Monthly focus on the financial markets

13th November 2018

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Market Analysis

Only more than a month ago US Equities were at all-time highs and now, 5 weeks later, many are increasingly comfortable with the view that the latest correction can't be salvaged, as global growth and US earnings are seen to be on a slippery slope to a long overdue recession.

Like it happened in February when consensus was too long, the October sell-off was initially triggered by a confluence of negative technical forces (rising yields, significant systematic selling, hedging of short gamma positions, buyback blackout, and record low market depth).

A perfect storm of worries ranging from jitters about global growth, concerns of peak earnings, rising interest rates and uncertainty about Mid-term elections unnerved investors.

There has been no place to hide in the equity space and the correction we were forecasting in US has happened very quickly. We saw too much overcrowding in US growth stocks and we knew the market would have deleveraged.

Most indices had the steepest monthly declines of this record-long 10 years bull market. In just the last month, the Nasdaq fell ~9% and the S&P fell ~7% in the worst month since 2011. US stocks lost nearly $2 trillion in value, led by well-owned names within the FANG complex.

Euro Stoxx 600 declined 5.6%, its biggest drop in more than two years. Major indexes in Asia also felt the pain, with Hong Kong's Hang Seng suffering its biggest percentage decline since January 2016.

The Chinese Hang Seng Index 10% slump in October puts it on course for a 6-months losing streak, the longest since 1982.

Overall, global Equities lost about $8 trillion in value, the biggest wipeout since the height of the financial crisis a decade ago (chart showing market value of global stocks).

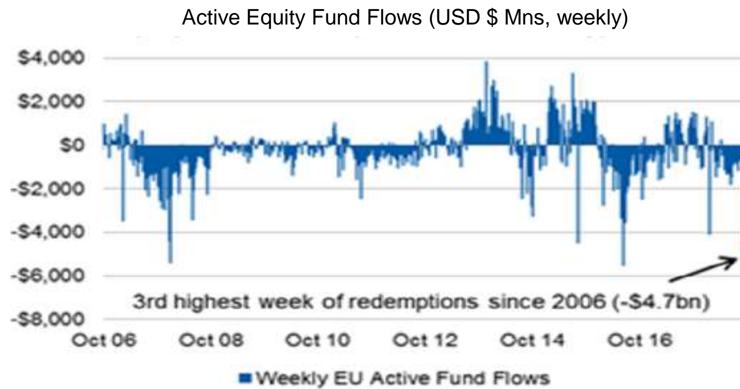
Market value of global stocks

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

Market Analysis

The sell-off generated by Algo and Passive funds has quickly turned into a redemptions/deleveraging sell-off. HF have de-netted and de-levered (risk appetite collapsed after the drawdown), Real Money feels the effects of poor performance ($4.7bn of redemptions two weeks ago for Actively Managed Funds after 8bn$ in September) and the rate of portfolio deletions of EU single names is at 6-year highs (investor base thinning).

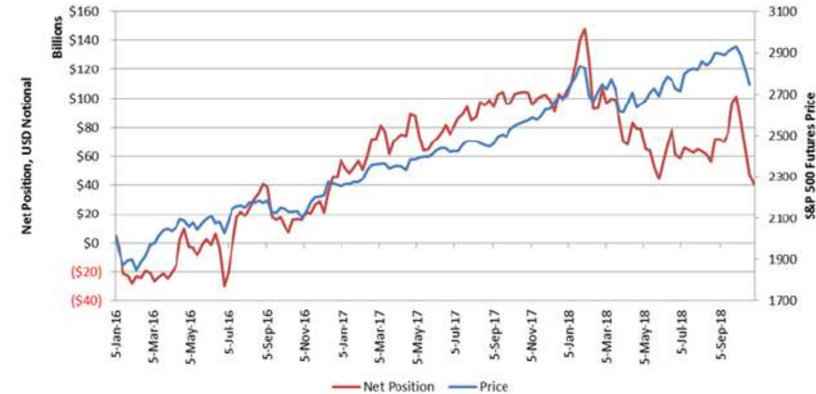
Active Equity Fund Flows (USD $ Mns, weekly)



Since the beginning of October, Asset Managers have sold 87bn$ of US equity index futures, reducing their net long position by 17% of total open interest. This is the most selling by AM over a 4-week period (in terms of # contracts, % of open interest, or USD notional) since we have got CFTC data in June 2006.

The buy-side's net long position in US Equity Index futures is now ~$40 billion notional, down $108 billion from its high at the end of January (chart).

US Equity Index Futures
Buy-Side Net Long Position vs. Price



The ratio of Long/Short Hedge Funds participating in European Equities is the lowest in the last 8 years as shown on chart.

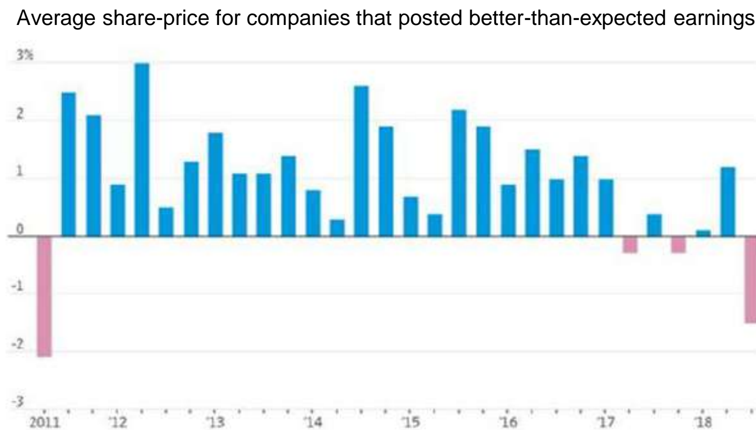
HF L/S Ratio in EU Equities

Earnings

81% of companies have now reported Q3 earnings in the US, 76% in Europe and 60% in Japan.

Results have improved meaningfully since the start of the quarter (2/3 weeks ago). Investors have sold the shares of firms that hit quarterly earnings expectations at the highest rate since 2011, a sign of concern over how long the good times can last.

Average share-price for companies that posted better-than-expected earnings



In **US**, 82% of of S&P companies have beaten EPS estimates, with EPS growth running at an 8 year high of +28% YoY.

In **Europe**, 52% of Stoxx600 companies beat EPS estimates, delivering +11% YoY growth. While earnings are surprising positively by 2% vs latest expectations, they are still 2% below the projections that were in place at the time of Q3 Preview.

Euro Stoxx EPS growth YoY vs Sales growth YoY

Even more than usual, this earnings season has largely been about the market looking to future rather than reacting to current results. Fears about trade tensions, rising input costs (in the form of rising wages, transportation/logistics costs, and energy) and rising rates have weighed heavily on investors. Year over year S&P earnings growth is now definitively peaking, these concerns haven't been rewarding companies that are beating on earnings. In the last few weeks, we are seeing increasing evidence of rising cost inflation becoming a headwind for corporate margins/earnings globally. Rising US wage inflation has been an important theme so far during this earnings season post several high profile profit warnings. Cost pressures are on the rise due to higher wage/labor cost growth in Europe too, along with higher input prices, transport costs and raw materials prices. All of these cost related headwinds are regularly being flagged in company commentary in recent weeks.

Earnings (cont.)

We also see a greater risk on Q4, the comparison will be very tough since Q417 included hurricane relief as well as a boost to consumer spending when it became clear that the tax reform bill would have passed.

Year Over Year Earnings Growth is In the Process of Peaking

Executive Summary

Over the last two newsletters, we have predicted some market volatility during October and the US started unfolding on Growth / Tech sectors as forecast. Last month we also believed that there could have been a nice market entry point before the end of October and this worked as well.

We entered the year with a non-consensus cautious view, worries over the potential Yields rally and hawkish Fed. Now, most are bearish EM, bullish USD and hawkish on the Fed. We think one should be again contrarian with respect to all of these. Specifically, the increasingly held view is that Fed will keep hiking “until something breaks”. In our view, the Fed is likely to offer equities a put option in case of continued volatility.

Having been cautious on equities for much of this year we now have some upside to our index target and hence the risk-reward for European stocks is looking a bit better than it has for a while.

From a valuation perspective, MSCI Europe has de-rated by over two P/E points Ytd. It now trades below its long-run average on both P/E and dividend yield, with the latter up to 3.7%. However, with the macro backdrop for stocks in 2019 unlikely to be wildly different to this year, we would view any rebound from here as primarily correcting an overshoot to the downside rather than the start of a sustained and durable uptrend.

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.

Executive Summary

This has been one of the most painful periods for global equity investors in many years, not so much because of the size of the correction (although any 10% decline hurts) but rather because of the significant impact it has had on a wide range of investor portfolios. For example, two weeks ago we saw the top 10 crowded longs underperform the S&P by nearly 3%, the worst day on record since 2010.

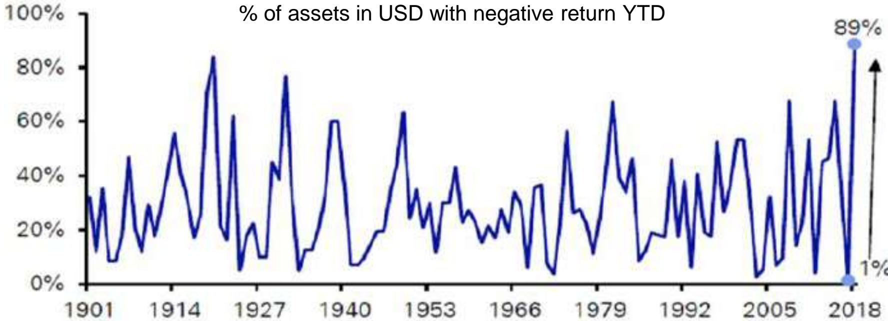
While the start of this downturn may have been prompted initially by the rise in US bond yields, or higher inflation, or concerns over trade and tariffs or rising margin pressure, we are now in the phase when markets typically start to question the growth outlook. Despite some weak economic data out of China and signs of slower data from Europe, we think the main fear in markets now is more around a slowdown in earnings (especially margins) than economic growth.

For global allocators the diversification (and performance) problem is real.. of the 17 asset class benchmarks, only 1 (S&P 500) is beating inflation Ytd.

Ranked asset class returns by year (green beats inflation)

Ranking	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	US 10Yr	MSCI EM	REITS	US 10Yr	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	S&P 500
2	US 2Yr	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	US HY
3	US Agg. Bond	Global HY	Commodities	EM $ Sov Credit	Global HY	MSCI Japan	US 10Yr	US 10Yr	US HY	MSCI Europe	US 2Yr
4	EM Local Debt	US HY	MSCI EM	US IG	REITS	MSCI Europe	MSCI China	EM $ Sov Credit	Global HY	MSCI Japan	Russell 2000
5	US IG	Commodities	MSCI Japan	US Agg. Bond	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	REITS
6	Inflation Bonds	MSCI Europe	US HY	REITS	EM $ Sov Credit	Global HY	EM $ Sov Credit	US 2Yr	MSCI EM	Russell 2000	US Agg. Bond
7	EM $ Sov Credit	EM $ Sov Credit	S&P 500	US HY	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM $ Sov Credit	EM Local Debt	Global HY
8	US HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	US 10Yr
9	Global HY	Russell 2000	EM Local Debt	S&P 500	US HY	US 2Yr	Inflation Bonds	MSCI Europe	US IG	EM $ Sov Credit	Commodities
10	Commodities	S&P 500	EM $ Sov Credit	US 2Yr	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	US IG
11	MSCI Japan	US IG	US 10Yr	EM Local Debt	US IG	US Agg. Bond	US 2Yr	Russell 2000	Inflation Bonds	Inflation Bonds	Inflation Bonds
12	Russell 2000	EM Local Debt	US IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	EM $ Sov Credit
13	S&P 500	Inflation Bonds	US Agg. Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	MSCI Japan
14	REITS	MSCI Japan	MSCI China	MSCI Europe	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	EM Local Debt
15	MSCI Europe	US Agg. Bond	MSCI Europe	MSCI Japan	US 10Yr	EM $ Sov Credit	MSCI Japan	EM Local Debt	US 10Yr	US Agg. Bond	MSCI Europe
16	MSCI China	US 2Yr	Inflation Bonds	MSCI EM	Commodities	US 10Yr	MSCI Europe	MSCI EM	US 2Yr	US 10Yr	MSCI EM
17	MSCI EM	US 10Yr	US 2Yr	MSCI China	US 2Yr	Commodities	Commodities	Commodities	MSCI Europe	US 2Yr	MSCI China

Even so important is the unprecedented number of assets (in USD) which had negative return Ytd!



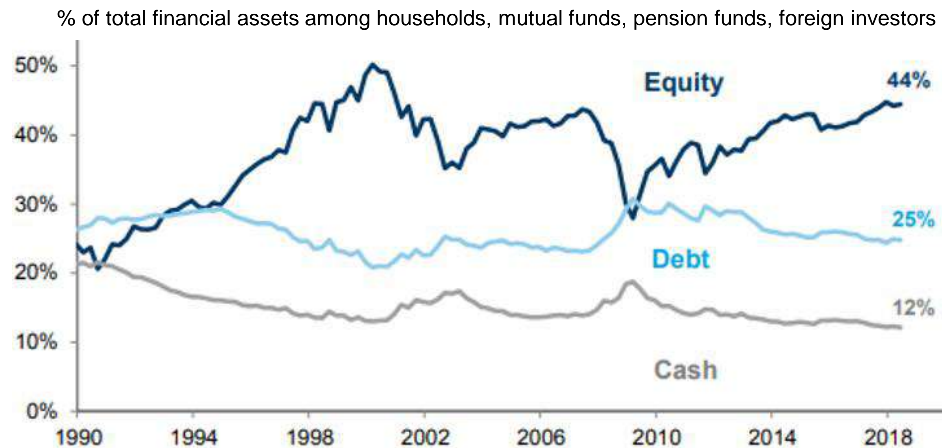
Over the last two years bond investors have lost more money than at any point since the early 1980s. Despite this move, asset allocators are still facing a highly challenging environment - e.g. a 'traditional' 60:40 portfolio split between equities and bonds is currently facing a valuation level at its 87th percentile since 1900.

Executive Summary

Two thirds of economists in the US expect a recession to begin by the end of 2020 with trade policy as the greatest risk to the expansion. The National Association for Business Economics published that "about 10% see the next contraction starting in 2019, 56% say 2020 and 33% said 2021 or later". Normally equity markets tend to anticipate the contraction by 6/12 months. Even the FED has recently raised their 2018 growth estimate to 3.1% from 2.8% in prior forecasts and 2019 to 2.5% from 2.4%. The 2020 real GDP forecast is 2.0%, which is a pretty big fall from the 2018 -3.1%.Equities account for 44% of total direct and indirect financial assets owned by households, mutual funds, pension funds, and foreign investors. In contrast, the share of their portfolios held in cash (12%) is at an all-time low and allocation to debt (25%) is below average.

We expect investors will continue to reduce portfolio risk in 2019. Pension funds drove an overall rotation towards debt – particularly Treasuries – during 1H 2018. Investor rotation to equities from cash was also diminished. A flattening yield curve, modest equity market outperformance vs. bonds and cash, and low current cash balances should continue to support risk-averse asset rotations next year.

% of total financial assets among households, mutual funds, pension funds, foreign investors



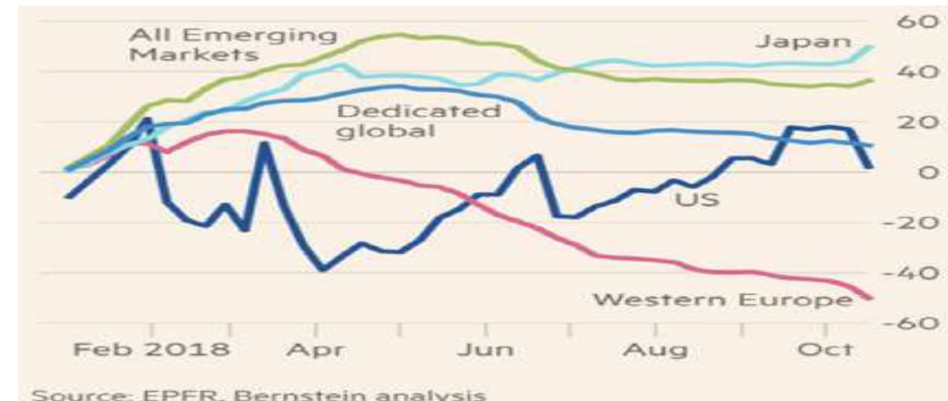
Let's now analyze the current positive and negative factors for the market:

Positive factors:

- Market could surprise on the upside as positioning is light compared to the beginning of the year. The case for a Q4 performance chase is still there. This is especially true for Europe where investor positioning on Eurostoxx futures is the most negative since the European crisis in 2012.

  In Europe we have already seen some deleveraging as around 50bn$ have left the continent and the difference vs other Geographical areas is striking.

Equity market positioning: Europe as the most delevered region

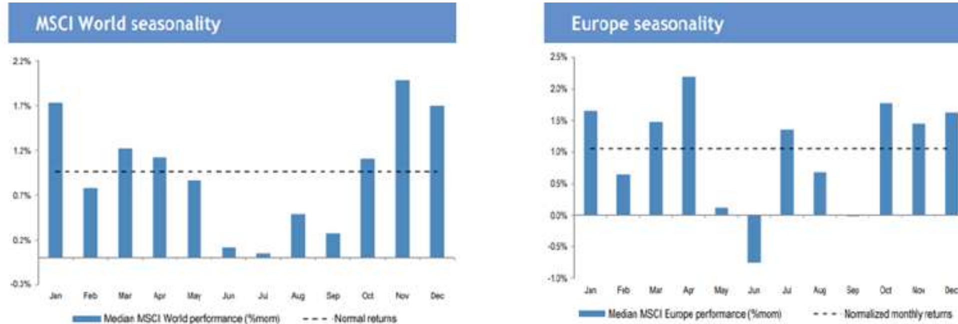


Executive Summary

- Seasonality: 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.

  If the history of midterm election years is any guide, since 1950, the S&P Index has risen by an average of 10.7% from its October low through year-end.

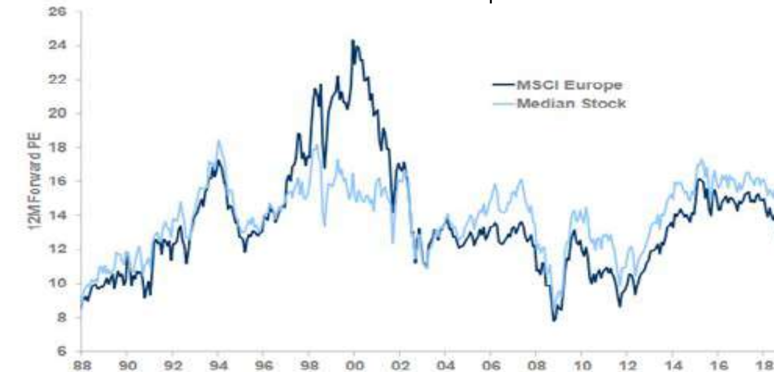
MSCI World seasonality vs. Europe seasonality



- European valuations look really compelling now and the gap between Europe's dividend yield and Government bond yields has only been higher 1.6% of the time in the last 95 years.

  In Europe, for the first time in 5 years the 12-Month P/E of the European market (at 12.5) and its median stock (at 13.7) are below their long-term median. (chart right above)

12M Forward P/E MSCI Europe vs. Median stock



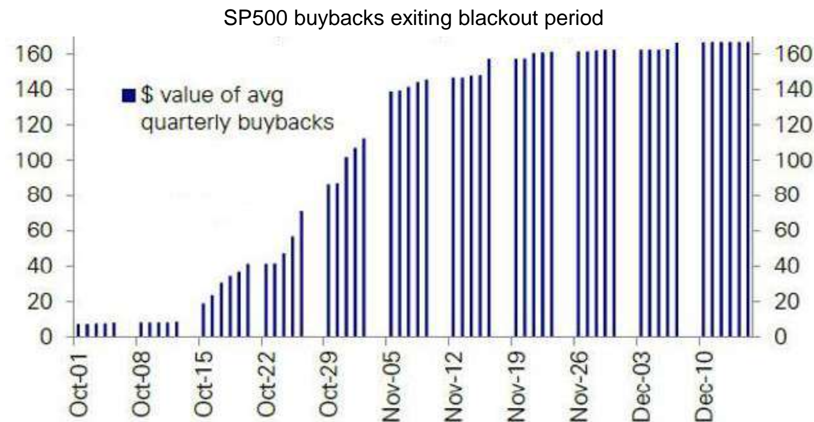
- Central Banks (positive view): We believe equities can tolerate rising yields as long as key central banks are still accommodative, with US real policy rates near zero. None of the last eight downturns started with real rates lower than 2%. Classic end-of-cycle indicators do not appear to be flashing warnings signs, yet. 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. These are worsening only marginally of late, but loan officer surveys are staying supportive.

- Volatility is expected to decline into year-end which should prompt systematic investors to re-build equity positions for up to 100bn$.

Executive Summary

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

SP500 buybacks exiting blackout period



- We have the G20 in Argentina on the 30th of November, any progress on trade-war could result in some short covering and a bounce on China/EM helping the year-end performance chase.

Negative factors:

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

  Despite the sell-off we had in October, the situation on crowded names is still not much different and these are the 1st names to be bought in a bounce especially for Year's end. As the SPX rose 10.5% in the first 9 months of the year, the Technology sector contributed 60% of returns. What's even more impressive is that just 3 stocks (AMZN/AAPL/MSFT) accounted for over 35% of the rally in the SPX and 62% of the rally in the NDX. In some heavy day losses in October, just 5 stocks (AMZN/MSFT/AAPL/GOOGL/FB) contributed to 85% of the SPX and NDX declines.

- 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 increased uncertainty around trade and tariffs will start to weigh on activity going forward.

- Central Banks (negative view): 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. Credit spreads should slowly be widening as ECB QE winds down, unhelpful for equity valuations.

Executive Summary

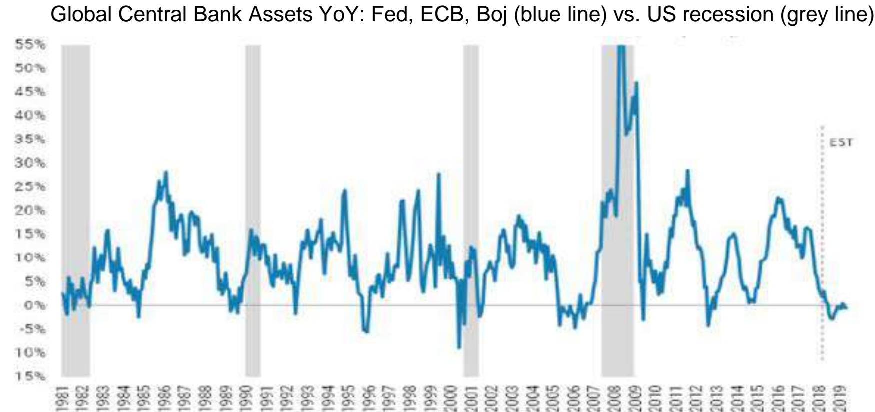
- Central Banks (cont.): From January's very healthy 15% YoY rate, CB's balance sheets growth has been plummeting and will go negative by January if the Fed, ECB and BOJ do not change course. Historically, whenever this has happened, we ended up with a financial crisis, a recession or both.

  We are also witnessing a sharp slowdown in the growth rate of M1 in US and narrow money supply growth rates in the Euro area and China are a concern for "risky assets" like Stocks and Corporate Bonds.

  "There is no longer enough liquidity to keep all the plates in the air".

  BIG 3 global central bank Balance Sheet growth is falling fast and should be negative by January

Global Central Bank Assets YoY: Fed, ECB, Boj (blue line) vs. US recession (grey line)



- Margin pressures are beginning 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. Input prices are rising more rapidly than output prices, negotiated wages are now rising sharply even in Europe.

  Margin environment is less favorable now.

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

- 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.

  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.

  Most of these IPOs were on Tech and Biotech sectors… the lesson we got from 2000 is not to be chasing what everyone else is.

  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. Not a great sign as it seems that the market cannot absorb any further paper.

Executive Summary

- IPOs / Secondary/ Placing: (cont.)

% US listed IPOs negative in the first 12 months since listing

- Cash Repatriation: the repatriation flow slowed considerably in Q2 to 105bn$, less than half of the Q1 amount. Given that 330bn$ 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 boost that US repatriation provided to US equity and bond market via share buybacks and corporate bond redemptions is likely to slow considerably now as just 5% of the repatriated cash has been used for Capex.

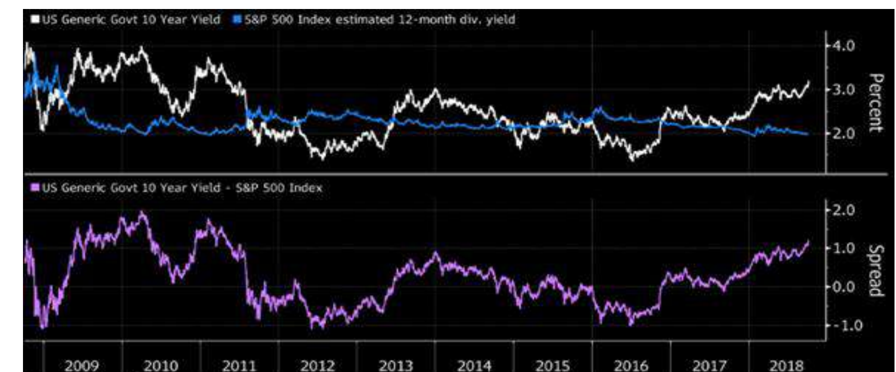
- Poor liquidity: we have been warning about this factor since the beginning of the year, liquidity is poor on every asset class except for FX. Liquidity on S&P futures has dropped considerably, the most traded in the world… not really reassuring if you are forced to sell in a short time-frame.

  Lack of market liquidity has the potential to exacerbate market moves for a given change in fundamentals. In the sell-off last month, top-of-book depth dropped quickly and its recovery has been slow even on days when the S&P was up. In past cycles**, fundamental investors monitored leverage as a key warning signal for corrections.**

  Even on Bond Markets liquidity is poor as prices remain distorted by the long-term effects of the QE era. Anyone prepared to buy at current levels is making an implicit bet central banks will step back into distorting the market again by keeping rates artificially low…

- In US the relative appeal of stocks is waning compared to fixed income. Yields on 10-year Treasuries breached 3.2% while US equities are estimated to yield about 2% in 12 months, the widest gap in eight years.

US Generic Govt 10-year yield (white line) vs. SP500 estimated 12m dividend yield vs. US Generic Govt. 10-year yield – SP500 index



Executive Summary

- US government's borrowing is at its highest level since 2008 recession. During a recession, it's *permissible* (thanks to Keynes's economic theories) for the government to pile on tons of debt, but once the recession's over, budget deficits need to contract again. And that's the farthest thing from what's happening 10 years after 2008. With the fiscal year just finished, the US budget deficit is just shy of $900 billion which means a 40% increase since last year.

  The US department expects to issue $425 billion in net marketable debt from October through December. From July through September, the Treasury said it issued $353 billion in net marketable debt, compared with its earlier prediction of $329 billion in borrowing.

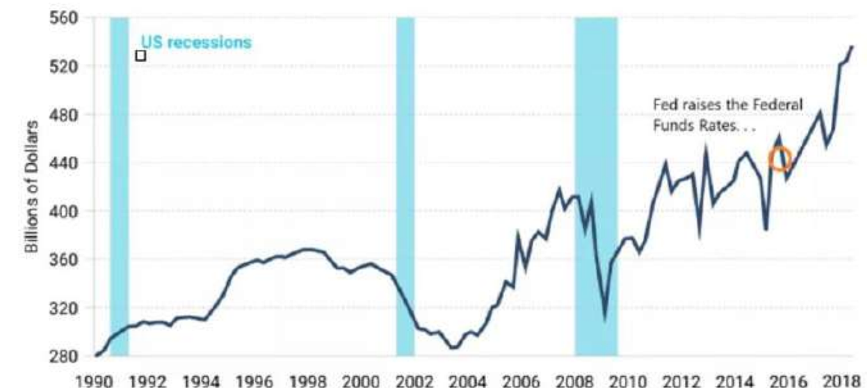
  President Trump's tax cut plan and increased spending is causing deficits to swell and the Congressional Budget Office (CBO) has significantly raised their deficit projections over the 2018 – 2025 period. The scary part is that they don't even expect a single recession or slow down between now and then. These projections are assuming steady growth and a healthy economy and are not accounting for any margin of error here.

  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 three reasons: higher inflation, Fed tightening, and increasing government's financing need.

  Jay Powell, said that fiscal policy is on an "unsustainable path," but such warnings are audible but unnoticed wallpaper. A recent IMF analysis noted that among advanced economies "only the United States expects an increase in the debt-to-GDP ratio over the next five years." For the anniversary of Lehman, never forget the toll of too much debt and rising interest rates.

Federal government current expenditures: Interest payments



Executive Summary (cont.)

- Junk Bonds: They crashed really hard just before the financial crisis of 2008, and they are starting to slip 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…

  In total, indebtedness of consumers, corporations, and all governments **has grown by $2.04 trillion over the past four quarters.** And they're going to be paying higher interest rates on this ballooning debt. In other words, debt service costs are going to rise substantially. 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.

- The complacency and relatively low equity hedging relative to years ago is concerning. 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.

  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. 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.

  Whether you believe we are on the brink of a crash is irrelevant, what is more important, from our perspective, is that no one is prepared for it. **The seed of the next crisis has been planted and the wounds will be much deeper.**

Macro

In **US** we had:

- Q2 GDP revisions saw consumer spending revised lower.. will the cracks in GDP appear in 2019?

- Consumer Confidence spending rose in August at the slowest pace in 6 months. This sent the savings rate down to its lowest since December last year.

- Employment costs surging more than expected in Q3% (+0.8% QoQ, biggest annual jump since Q3 2008). Private wages and salaries accelerated, perhaps signaling that workers are gaining leverage in a tightening labor market.This strong data, directly affecting margins follow the lowest unemployment rate in 49 years marked last month.

- Housing issues: recent data are showing a very alarming situation on Housing. The latest **Case-Shiller home price data plunged to its weakest annual growth since Dec 2016**, dramatically missing expectations.

  With purchase applications tumbling alongside the collapse in refinancing, the headline mortgage application data slumped to its lowest level since September 2000 last week.

  What these numbers reveal, **is that the average US consumer can barely afford to take out a new mortgage at a time when rates continued to rise, if not that much higher from recent all-time lows.** Judging by mortgage rates, it's about to get a whole lot worse as they lead the market for 6 months.

  What is the biggest drag on most people's disposal income? the old mortgage... US 30 Year Fixed Mortgage Rate National Average has gone from 3.70% at the start of the year to 4.66%.

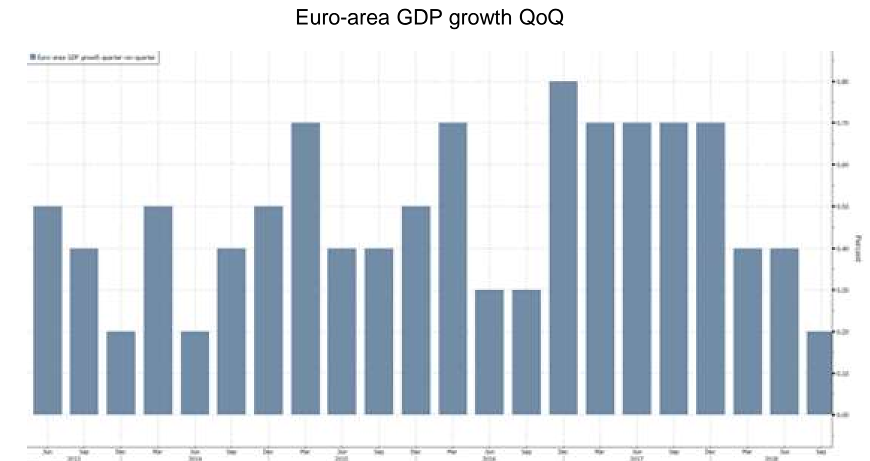
Macro

Case-Shiller Home Price YoY vs. 30Y Mortgage Rate inverted

In **Europe**:

- The euro-area economy unexpectedly grew at its weakest in more than four years and a measure of confidence hinted at a more protracted slowdown. Gross domestic product increased 0.2% in the third quarter, half the pace of the previous three months and the rate that was forecast. Growth in two of the bloc's four largest economies, Germany and Italy, ground to a halt, while sentiment among consumers and businesses in the region fell in October to the lowest in 17 months.

Euro-area GDP growth QoQ



- PMI were below estimates and at 5/7-month lows. What is more striking is Italian PMI which has gone below 50 (59-month low) paving the way for a technical recession.

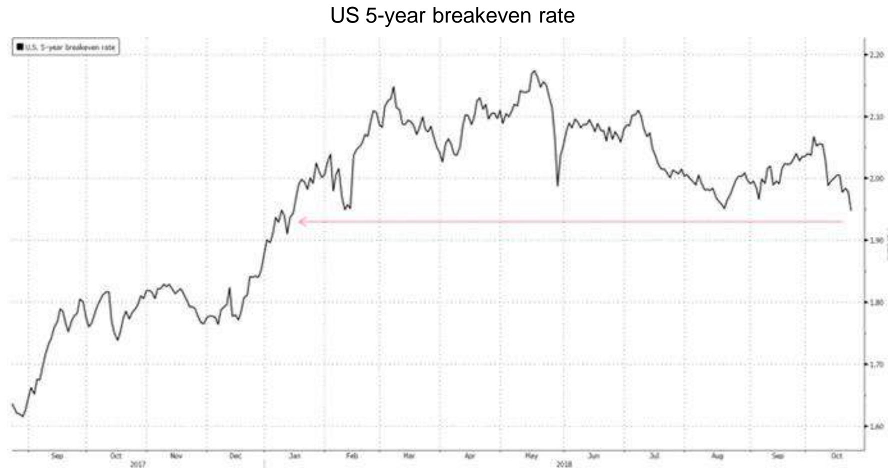
  Aggregate PMI fell to 52.7 in October down from 54.1 in September the lowest figure for 25 months and is consistent with just 1.6% annualized Eurozone GDP growth.

Central Banks

Last week, the **Fed** left rates unchanged but remained on track to keep gradually tightening borrowing costs. Basically, a non-event and market is fully expecting an hike at the December meeting and three more in 2019 according to the dots.

We are heading into a new year with the 2-year about to eclipse 3% for the first time in over a decade.

There is however a trend, beneath the surface, that should give traders pause about the Federal Reserve's capacity to maintain its gradual rate hikes. The 5-year US break-even rate, which is the market's measure of inflation expectations over the next half-decade, tumbled and is set to close at the lowest level since January. At less than 1.91%, below the targeted 2% for stable price growth.



The **ECB** in its latest meeting continued to paint the growth risk skew as symmetric. No extra details on 'operation twist' have been revealed. They will be discussed in December.

Even though the PMI undershoot points to some cyclical moderation, the ECB hasn't shifted its growth risk assessment to the downside just yet, as it moves towards ending QE at year-end and hiking the depo rate in late 2019.

The central bank is giving more weight to rising inflationary pressures, including wage growth.

The forward curve is now pricing the ECB hiking almost 17bps by Q42019 and 35bps by mid-2020 and a total of 90bps by end-2021.

Forex

The **USD** continues to be seen as a "safe" currency against the trade War theme (USDCNY dangerously depreciating close to 7 again) and European Periphery troubles (even if it has been in a range between 1.13/1.18 since the end of May).

The **DXY Dollar Index** is up 2.5% since our last update and net speculative positioning is continuing to growth, reaching 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 increased long positioning (bars).

US dollar net long – short positions on 11/06/18 (blue bars) vs. Bloomberg dollar spot (black)

Optimism on the USD has reached an alarming consensus level. Of course, reasons for USD bullishness seem compelling.

- Merkel deciding to give up the leadership of her party in reaction to repeated disappointing election results.
- Italian debt issues ongoing.
- in Sweden, the formation of a government has now fallen into the hands of the President of the Parliament.
- Brexit-related uncertainties have not gone away.
- China seems to be standing aside allowing its currency to weaken.

This backdrop leaves the impression that there is no alternative asset currency to the USD. However, there are also some USD weakness valid points:

- US growth peaked in Q2 an annualized rate of 4.2% and is likely slowing down from here (funding costs' sensitive sectors, 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 with recent comments by former Fed Yellen putting this 1.3trn$ market into the focus of market participants.
- Friedrich Merz succeeding Merkel as leader of the Christian Democratic Union. While Merz, head of BlackRock German asset management unit, would mark a shift to the political right, he is seen as being more in favor of euro-area integration.

We remain confident that we should see only very limited USD upside from here. With risky assets looking set to stabilize going into November/December.

Commodities

The Blomberg commodity Index has dropped 4.3% since our last update and is now 9% below the highs made at the end of May.

The 40-day rolling correlations between the Yuan, MSCI World Index of Developed-market stocks and the Bloomberg Commodity Index are at highs since the currency began floating in 2005.

This would probably mean that without some CNY appreciation it would be difficult to see a further strength on the commodity space.

Commodity prices fell to an all-time low relative to stock prices (chart relative to S&P).

S&P GSCI Total Return / S&P500 Index

Oil prices have dropped 15% since last update and 20% from the highs made at the beginning of last month.

We have called the profit taking at the beginning of October and we would now start to get back into the sector selectively.

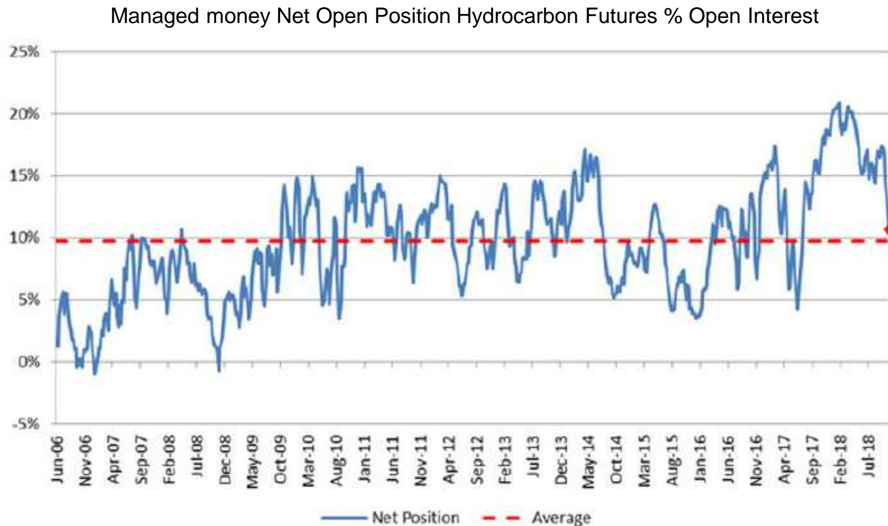
Despite US sanctions on Iran, Trump granted eight jurisdictions special exceptions to continue importing oil from Iran (Trump wants to keep oil prices low). OPEC has announced over the weekend that is considering 2019 oil production cuts in yet another U-turn (after having cut production in late 2016, OPEC boosted output in 2018). Saudi should tighten the oil market with a pre-emptive (informal) 500k bpd cut. This sets up for a potential 1mbpd cut at the Dec 6th OPEC meeting (bullish for oil). Recent November EIA crude oil inventory report shows total stocks of crude and products resuming their upward march to 1.25Bln barrels and are now just 4Mln below a year ago (bearish for oil). The great destocking of late 2017/2018 seems to have reversed itself.

While it was a consensual long position, this has now quickly changed with some outflows. For the 4th week in a row, Managed Money sold large amounts of hydrocarbon futures (totaling $33 billion notional over the last four weeks across WTI, Brent, Heating Oil, RBOB Gasoline, and Gas Oil futures).

As a percentage of open interest, Managed Money's net long position in these contracts is now back to the average since 2006. (chart next page)

Commodities

Managed money Net Open Position Hydrocarbon Futures % Open Interest



The 14-day RSI in WTI futures is now at 19, the lowest level since December 15th, 2014. There have been only 13 other days (separated by at least a week) where we've seen the 14-day RSI falling below 19, since the inception of the contract in 1983.

Gold has dropped by 1.7% since our last update and is approaching again the 1200$ level. This was function of the USD strength and a slightly more positive tone on markets.

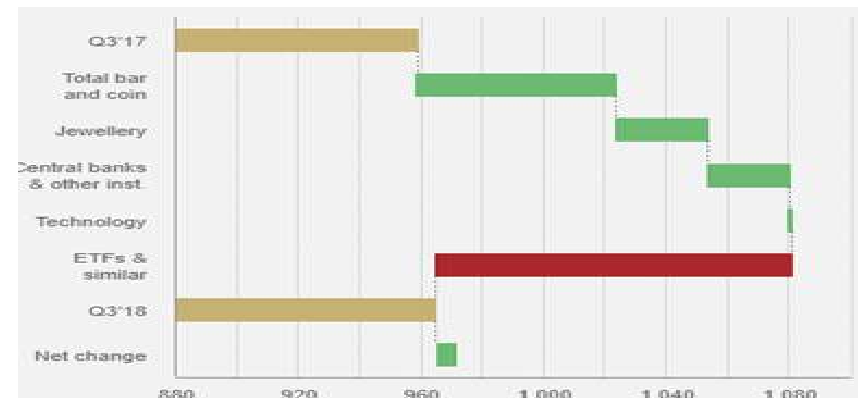
Positioning still mainly short and strong Central Bank, Governments and consumer demand has been offset by large ETFs outflows.

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 rising by 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. Last month over 70% of the gold import figures into Switzerland came from London and US.

Sharp outflows in gold-backed ETFs are offsetting growth across much of the gold market. (chart)

Gold demand by product (Physical vs Jewellery vs CB vs ETF)



Commodities (cont)

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.

We would therefore still suggest to hold the current weight in client's portfolios, increasing the allocation towards the end of December, period of seasonal strength.

A short-squeeze is getting more likely 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.

Geopolitics

In **US** Democrats laid claim to the US House in the Mid-term elections by riding a surge of voter anger and discontent with Donald Trump in suburban enclaves, even as the president's loyal supporters reaffirmed Republican control of the Senate.

Let's quickly look at the broader picture now:

- Policy path is unchanged: a fresh tax cut bill is unlikely, but trade conflict will still linger until economic and/or market impacts worsen and force Trump administration to take a more constructive stance on negotiation.
- Rates: Market had probably got ahead of itself on chance of a Red Repeat pushing yields higher, and so this will retrace. But watch carefully for any Democratic leadership comments on an unfunded infrastructure spending plan and potential impact to treasuries.
- Equities: Narrative moves away from rising rates temporarily and could alleviate pressure on equities.
- FX: given the limited scope for significant changes in government policy, the long-term forces causing a weak USD should dominate the price action.

In **Italy**, opposition to the European Union's budget rules is stiffening and it is getting hit by a credibility issue.

The European Commission will propose disciplining Italy under EU fiscal rules on November 21, unless the country's government agrees to change its draft budget plans by November 13, EU deadline. By basing its recommendation on the enormous Italian debt, € 2.3 Trillion, rather than the proposed budget deficit (2.4%), the Commission will be able to start the punitive proceeding earlier than expected.

If the Council of the EU approves it, Italy would end up facing big sanction next year, up to 0.5% of GDP, € 9Bln.

Geopolitics (cont)

In **UK** May is racing to revive her Brexit blueprint in time for a crucial cabinet meeting on Tuesday as Brussels negotiators seek to play the hardball over Britain's terms for leaving the EU. As the British prime minister battled a political crisis at home, coming under fire from both wings of her deeply divided party, she will have to face EU pushing Britain to accept stringent environmental targets and European oversight of state aid rules as part of a Brexit "backstop" plan to resolve the Irish border.

During the weekend, one senior UK government aide said he was increasingly "pessimistic" about the chances of the deal given Brussels' demands in recent days.

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New Investment Ideas

Long Dax: Germany's stock market is one of the worst 2018 performers so far, down 12% Ytd, underperforming the Eurostoxx 600 by 5%.

The DAX index hasn't been helped by a tough Q3 earning season with Deutsche Bank and Auto sector with 3 of the 4 companies issuing profit warnings (Daimler, BMW and Continental).

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

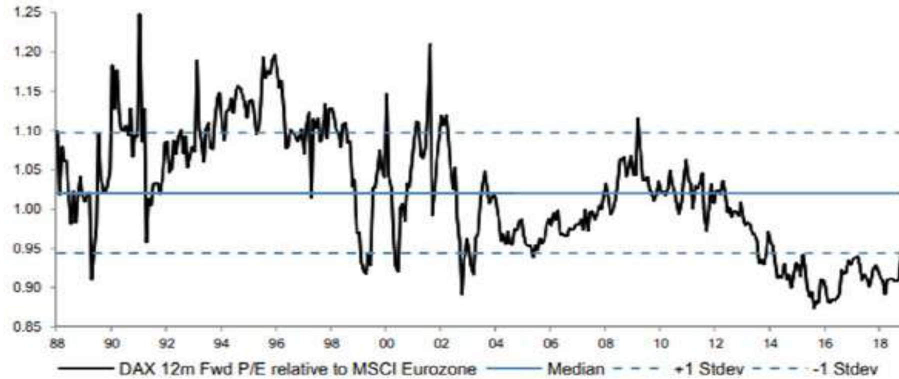
- Trade tensions: DAX is the European index with the highest beta to world trade growth and ranks just after MSCI EM and the Topix.
- EM slowdown: German companies generate about 30% of their sales from EM and Asia-Pacific.
- Regulation: The European Auto sector has taken a big, but probably temporary, 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.

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 almost as much as periphery did so far Ytd and could recover something in the short-term.

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

New Investment Ideas

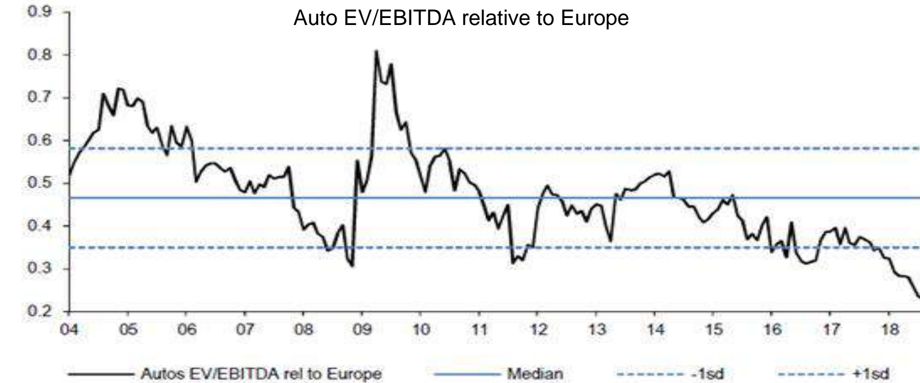
DAX 12M Forward P/E relative to MSCI Eurozone



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

DAX 12M Forward EPS (black) vs German exports (blue)

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



Even under the technical point of view, <u>our long-term proprietary signal on DAX could give us a buy at the end of this month (green bar in the middle chart, also holding the 50 monthly average) after having had two sell signals at the end of 2017.</u>

Dax Index technical chart

New Investment Ideas

<u>Long Miners (SXPP Index):</u> 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 9% Ytd, dropping more than 17% from the highs made in May.

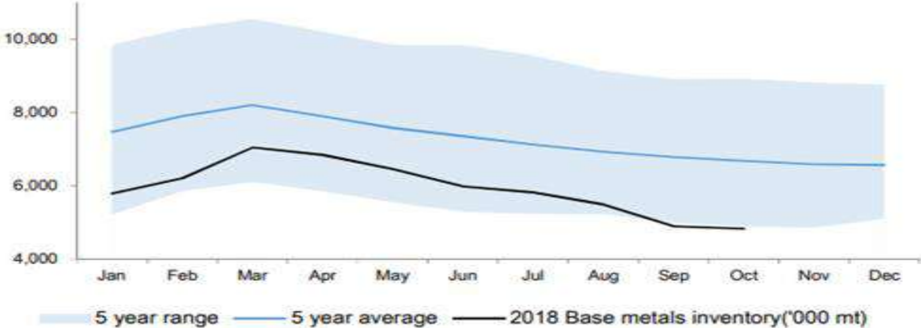
<u>The majority of this sell-off can be attributed to</u>:

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

Recent commentary on trade tensions/Chinese growth, recently, has been more positive and <u>we view recent developments as generally more favorable.</u> Miners are likely to have EPS upgrades of 10% for ‘19 and 20% for ‘20, if underlying metal prices stay at current levels. <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 (black line) pushing higher

Inventories of key metals at multi-year lows



Miners are also a good hedge on rising inflation, with the second highest positive correlation to inflation forwards, at sector level. Miners, an inflation hedge, positively related to China improving, easing trade concerns and USD peaking, offering much stronger cash flow generation and balance sheets than before. The sector is attractively valued as is trading outright cheaply relative to the overall market on EV/EBITDA metric.

Metal & Mining EV/EBITDA relative to Europe (black line)

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Current Investment Ideas

Long Value trade: 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 4% and by more than 7% Realized Volatility. As we expected, over the last month there has been some kind of normalization compared to the aggressive move we had at the beginning of October.

Value stocks have seen a strong reporting season, best ever versus Growth! The fact that prices are rising faster than real economic growth in the Euro Area should be good for our relative overweight call on Value as these stocks should be less vulnerable to a de-rating in the event that margin pressures start to bite, or maybe even benefit from the causes of inflation to some extent.

The decade long run of Growth versus Value may finally be at risk of turning on a more sustainable basis. With relative valuations having exceeded 2 standard deviations expensive in September, the recent reversal could see significant follow through before these valuations reach normal levels. We think several sectors offer particularly good value: Banks, Basic Resources and Autos.

Factors: Momentum (orange) vs. Realized Volatility (blue light) vs. Growth (grey) vs. Value (black)

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

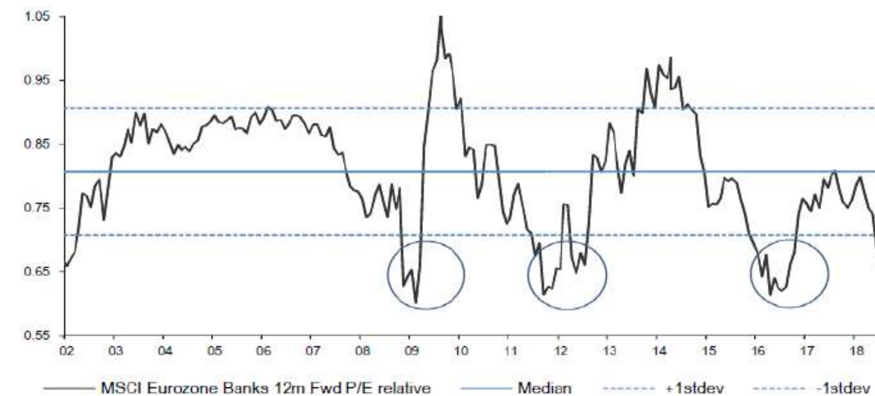
The sector as a whole has since then outperformed the market especially thanks to the Insurance because the rise in Yields is positive for them. Hedge Funds have still got a consensual short position on the sector especially on Banks.

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.

Eurozone banks look attractively valued, their 12M forward P/E is currently at levels where it has always bounced in the past.

MSCI Eurozone Banks 12M forward P/E relative



Current Investment Ideas (cont)

Even the Price to Book relative valuation is at interesting historical levels.

Eurozone Banks P/B relative

Closed Investment Ideas

Long EU Utilities (SX6E Index): the sector has outperformed since last newsletter bouncing by 6% and has significantly outperformed the market since September.

We would therefore take profit with the idea of entering back in either at lower prices or in case of lower Yields.

Keep in touch

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