Monthly Market Update

Monthly focus on the financial markets

8th May 2019

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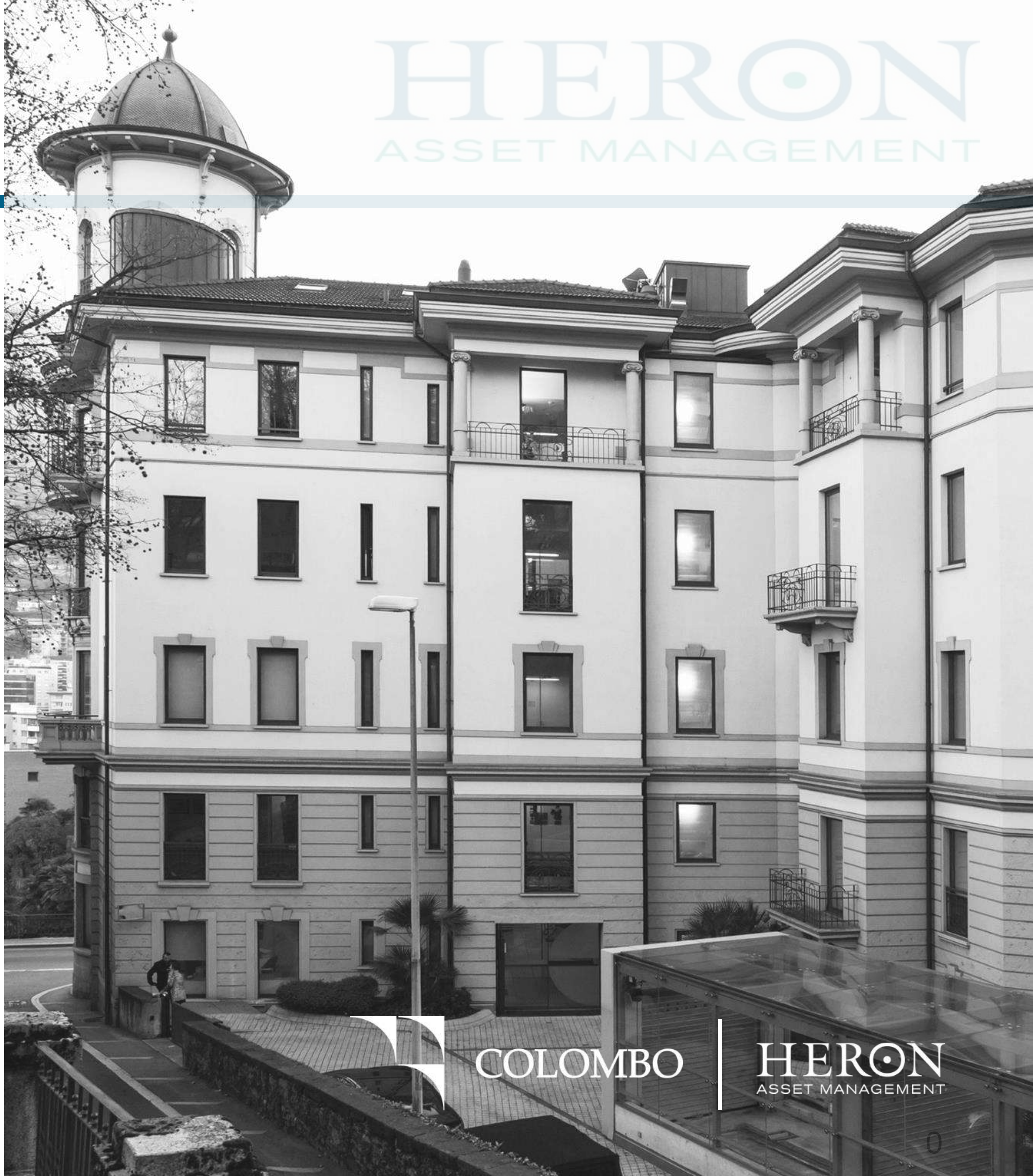


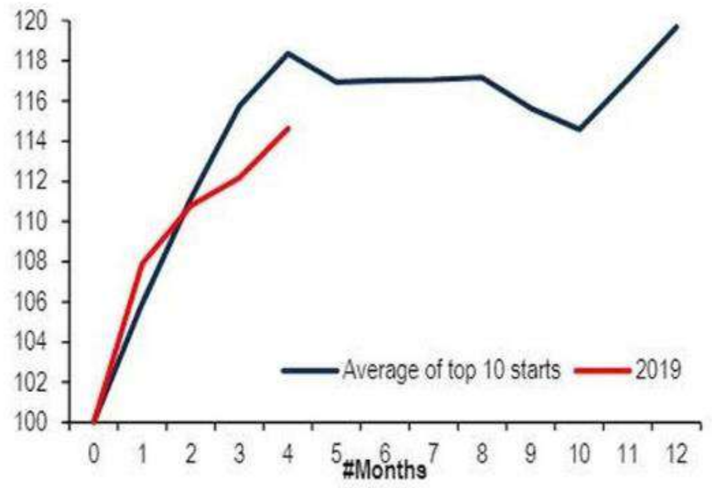
Market Analysis

The 15% rally in global equities over the last four months represents not only the best start to a calendar year since the late 1980s but also illustrates the continued power of policy to drive asset markets.

Equities drifted higher Globally boosted by a better-than-expected earnings season and Quant Investors buying with a general sentiment of FOMO (Fear of missing out) among investors.

Cyclicals outperformed and the yield curve steepened, suggesting that recession fears sparked by the prior week's inversion were overblown.

Avg top ten SPX starts vs 2019

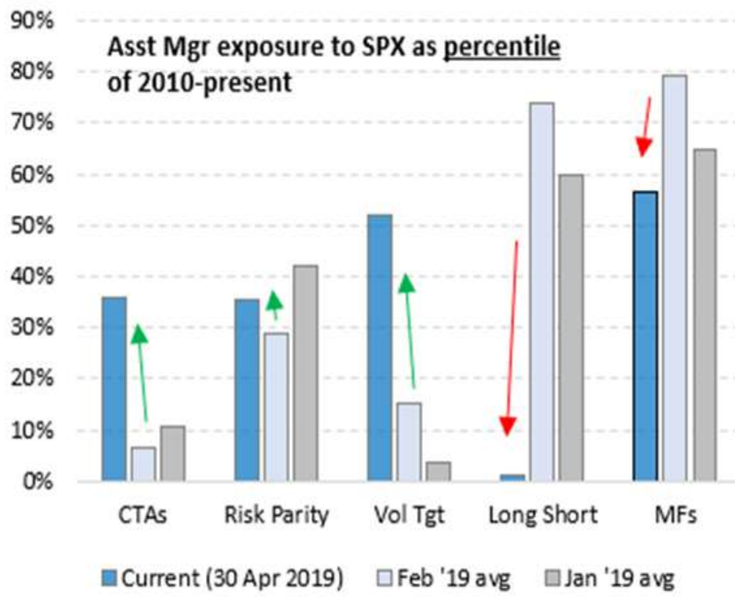


Markets have reached last week in US new all-time highs with Nasdaq that was up 33% from the lows made on the 24th of December '18 being negative on only just 1 week of the last 18.

Quant funds have been buying Equities during the month of April as we rightly predicted (https://bloom.bg/2Imrtd6) and now Volatility Target and Risk Parity funds have reached their longest positions in the last 7 years.

VT have bought back roughly 75% of what was sold during Q418 now meaning that the risk/reward is starting to skew more negatively and if volatility will start to raise (as it is happening since the beginning of this week) they could quickly turn to sellers.

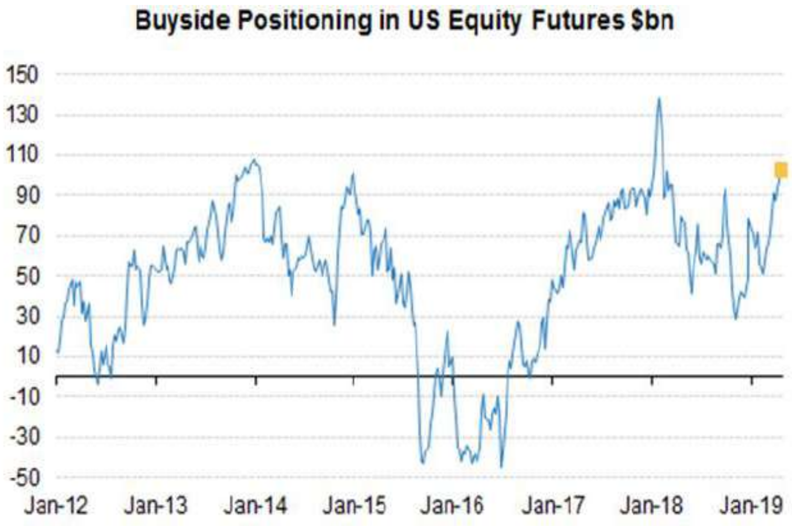
Likewise, RP funds leverage has approached the levels last seen in Q318.



Long/Short exposure is instead very low as fundamental investors have been selling into the rally and this is particularly true for Europe where, since the beginning of 2019, investors have withdrawn nearly $46Bln from European Equity Funds, taking the 12-month toll to nearly $140Bn (outflows during 59 of the past 61 weeks).

Market Analysis

That is an important factor of course but most of the buying from Retailers and HFs YtD has likely come via futures, where dollar exposures were at the end of last week higher than September 2018 levels and just short of January 2018 peaks.



The Fed and the latest tweets from Trump had a great impact on markets but in reality, we believe that <u>what is different is market positioning</u>.

The AAII (American Association of Individual Investors) is reporting that the allocation on Equities is at 67.8% (highest since October when it was at 69.5%) while Cash is at 15.1% (lowest in a year, was at 14.7% in March 18). Historical averages are respectively at 61% and 23%.

<u>It is therefore no longer possible to say that positioning in US equities is still light</u> while on Emerging Markets is extreme as EM ETFs have seen nearly 18bn$ of inflows YtD and net positioning is in the 80th percentile over the trailing 1 year.

SPX Technical Indicators

Technical analysis has shown some “overheat” signals over the last few weeks but as we said over the last newsletter, the <u>worst signals are the so called “breath indicators”.</u>

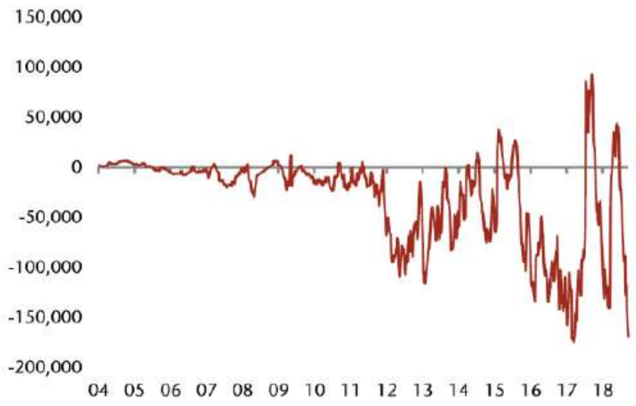
While the S&P was rising, the Advance /Decline %, New highs/New lows and stocks above 200 day moving averages were giving some bearish signals.

We consider this divergence as important as it signals underlying weakness and narrowing of leadership.

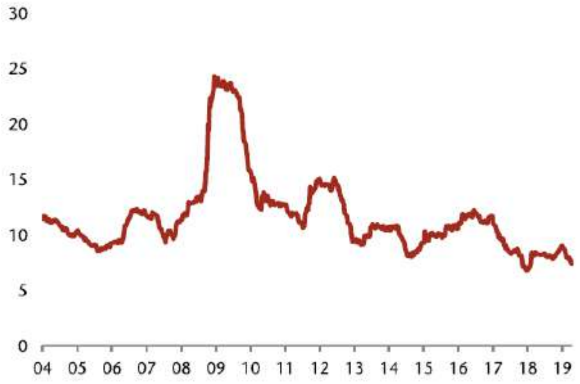
Market Analysis

Another important factor to watch is given by the market's complacency which could be measured by the VIX (Volatility on S&P) and by other indicators.
On VIX, we were at the end of the last week at the highest short positioning ever while both the Jefferies cross-asset volatility index and Citigroup global risk aversion index have reached very low levels.

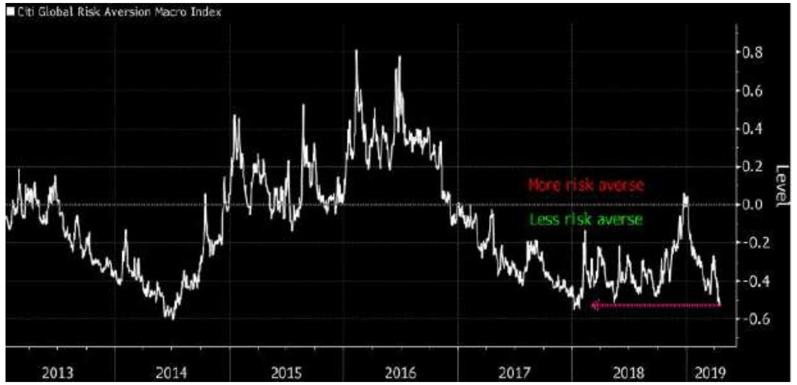
CFTC CBOE VIX Futures Non-Comm Net Total



Jefferies cross asset average volatility index

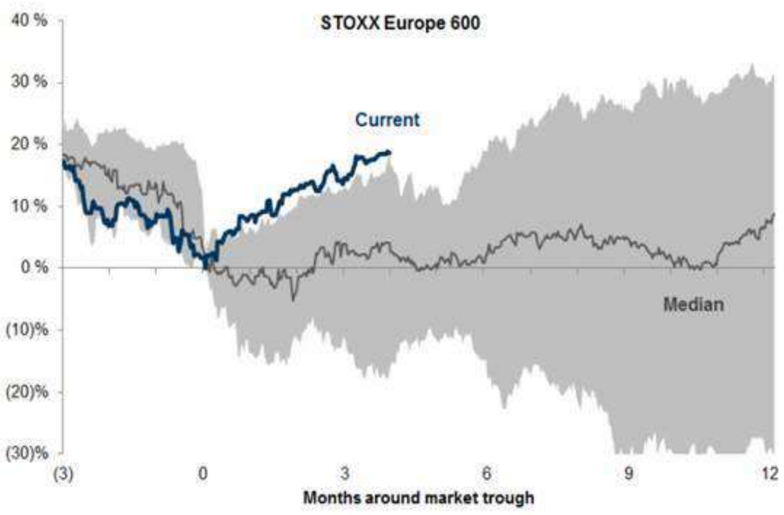


Citigroup Global risk-aversion Index



If we look at the past 10 episodes when equity markets fell as much as they did in Q4 2018 (20%+ in the US and 15%+ in Europe), we find that we are already exceeding the upper bands of the typical rebound experience. In Europe the rebound in the stock market year to date has already priced in a strong rebound in PMIs from current levels, leaving little room for upside if this improvement starts to become visible.

STOXX Europe 600 (blue) vs previous upper/lower bands (grey)



The strong rally in equity, credit and commodity markets since the beginning of the year has significantly reduced their cushion against growth risks.

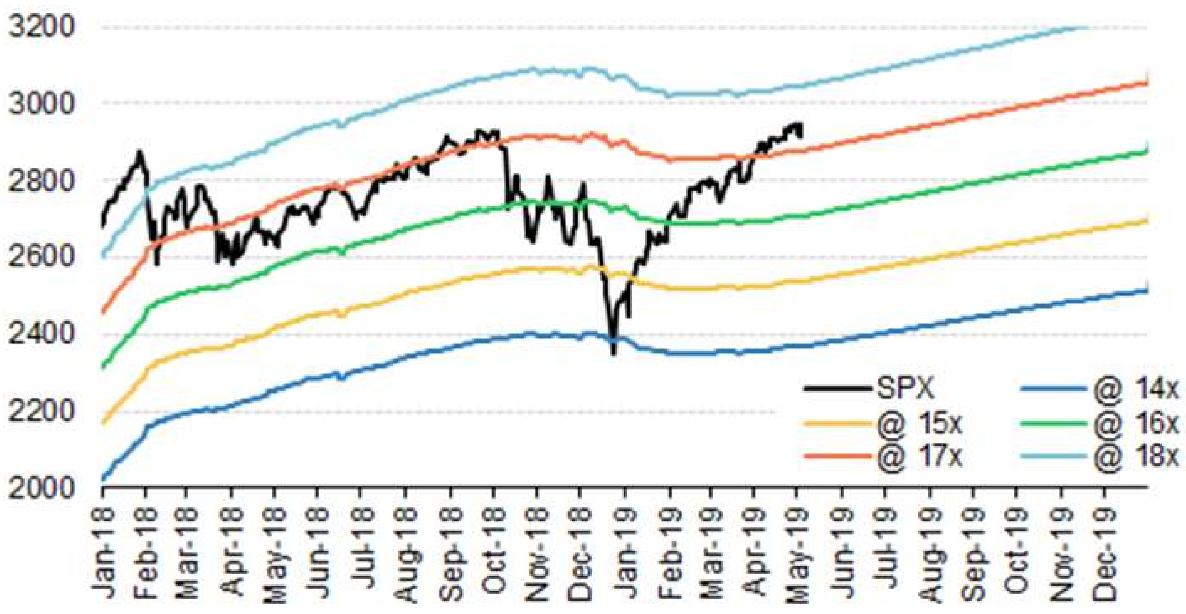
As a result, it seems that rates and risky assets are inversely related at the moment with rates signalling more elevated growth and recessions risks, and equity, credit and commodity markets pricing in more optimistic scenarios.
US equity markets appear to be currently pricing in only 15% chance of a typical US recession and discount only 3% decline in earnings. This compares to a 66% chance at the start of the year.

We believe that the conditions for a market top are beginning to brew. Extreme levels of FOMO (Bloomberg reported 3-week sum of the appearance of FOMO in news articles has hit a new all-time high), VIX shorts, Quant length and market getting optimistic on growth prospects after a double-digit rally. The last inning of a rally can be powerful but as mentioned previously the price of convexity is low while the risks become more asymmetric from here.

Market Analysis

The S&P is trading at a forward Price/Earnings multiple of 17x and has expanded by nearly 3 point since the December lows (the most since 2009) while the yield curve has flattened considerably.

SPX P/E Multiples



It is finally worth noting that the US market last year started to fall in September when the 10% on 200bn$ tariffs took effect on China and since then the market has been very careful of trade policy changes. We had since then many tweets touting a “great” deal timed to offset weakness in stock market.
Last weekend Trump has threatened China with a new increased tariff rate of 25% (vs current 10%) effective Friday and a potential new round of tariffs for 325bn$ of imports representing a shift from the optimistic statements for US officials over the last few weeks.

We suspect that the market is currently pricing too much comfort around the Trade deal resolving peacefully.
If there is a breakup in Trade talks, it will lead markets down potentially to 10/15% with China down up to 20% and UsdCny breaking above 7.0.

We also think that the US administration will become impatient with the EU's refusal to negotiate on agricultural issues and see tariffs as an opportunity to move things in its direction. The US intention to impose tariffs on the EU to address a WTO ruling on subsidies to Airbus, while not part of the auto process, underscores the willingness and the intent of the US administration to use tariffs as a negotiating tool.

Trump could therefore start threatening Europe as we are approaching the end of the 90-day period within which the US president is expected to respond to the February 17th section 232 report on auto tariffs.

We mentioned last month that it was a great opportunity to lighten the exposure as the risk/reward was much less attractive and we still think that we have already seen the easiest part of the year and numerous hurdles will still be confronting investors.

Since 1929, on average the market gives you an intra-year drawdown of around 13% and this is currently not priced in current “complacency market”.

Q1 Earning Season

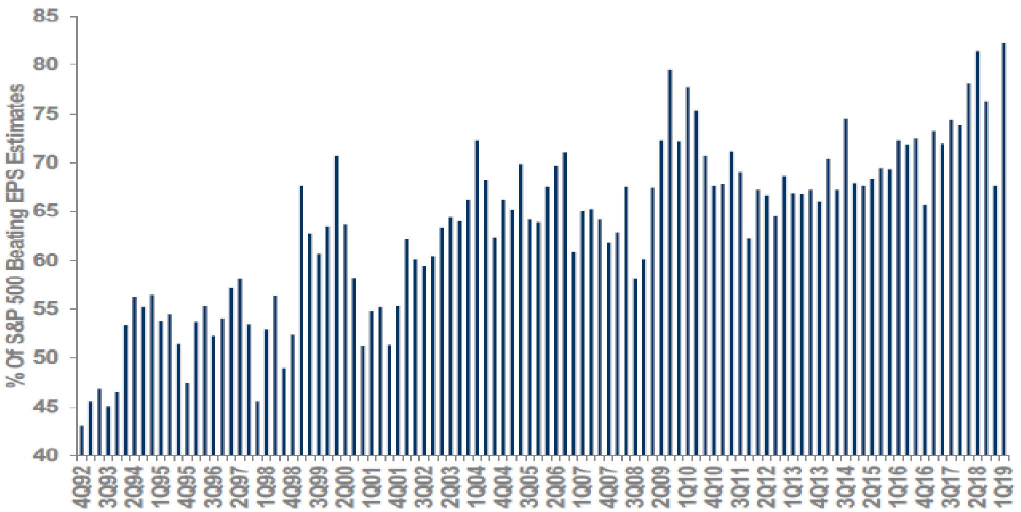
The Q1 earning season is nearly over in US and we are at about ¾ in Europe and Asia; all regions have shown positive EPS surprises vs a very low consensus expectation.

In **US**, 76% of S&P500 companies have beaten EPS estimates with a 3% growth YoY. However, companies who beat on earnings are being modestly rewarded (up 1.1%) while those who miss receive a sharper punishment (down 2.2%). The bar was lowered so much into earnings that misses of a lowered bar are seeing quite negative market reactions.

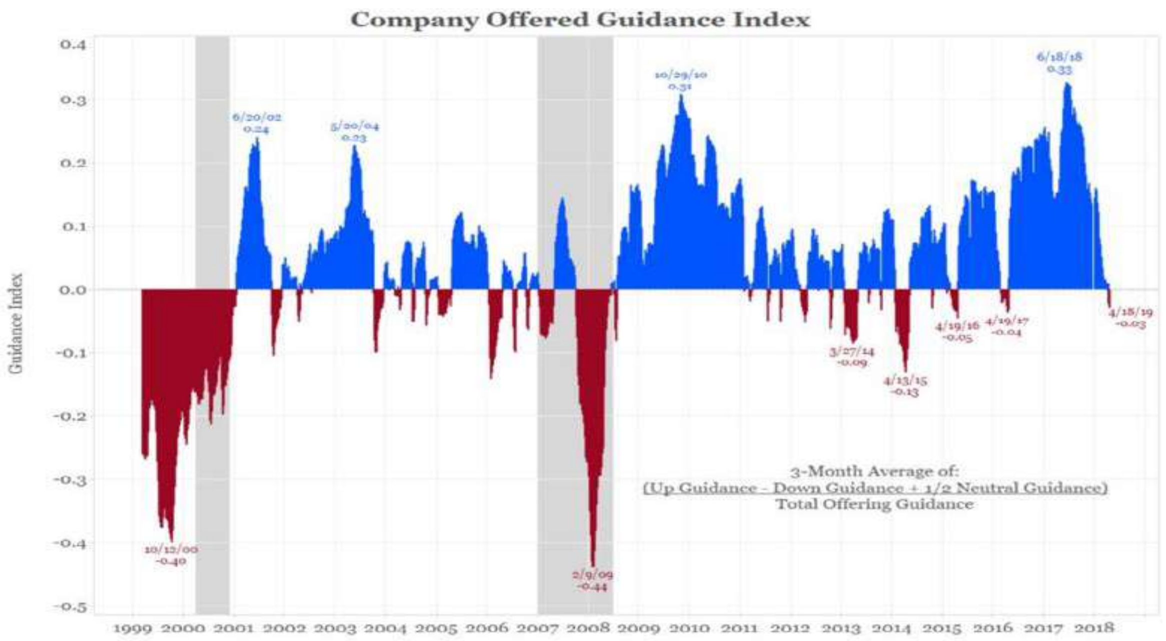
In **Europe** 53% of the Eurostoxx600 companies have beaten EPS estimates, the strongest result since Q117, but sales growth was weaker than what seen in US given the weaker macro momentum in the region.

While there is a general positive mood given by these EPS beats, we should also have a deeper look and there are some issues on profit margins and guidance. With the labour market tightening, margins are coming in narrower than they did over last year while company's earning guidance about future has been falling for 9 months and has just turned negative for the 1st time in 2 years, suggesting headwinds to earnings are not over yet.

% of S&P beating EPS estimates



3-month average of the guidance given by companies

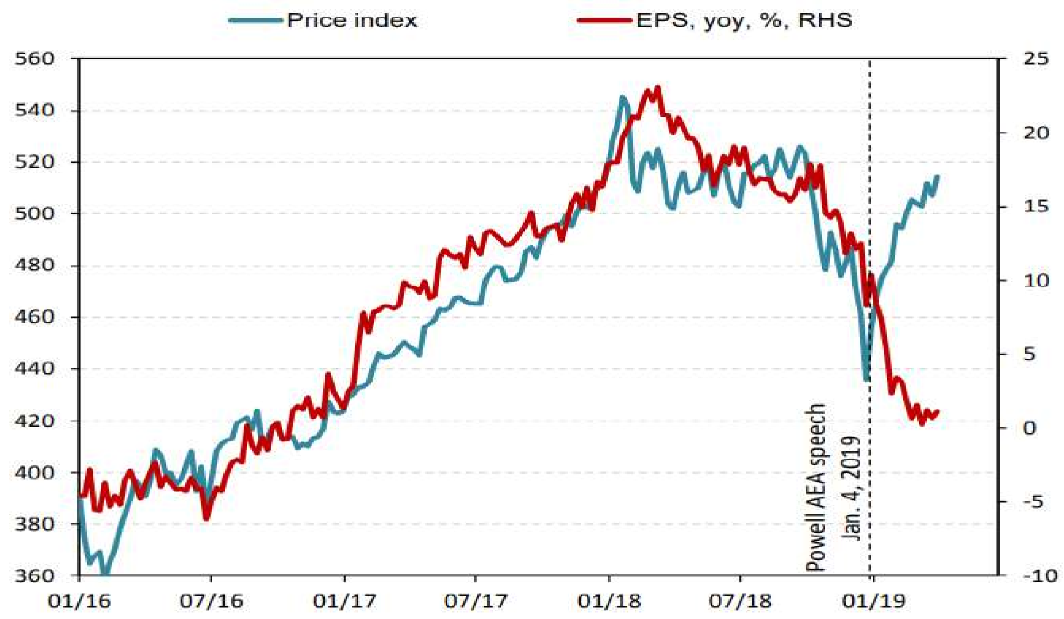


Earnings / European Elections

The bottom line is that the Fed has fixed the tight financial conditions which were largely responsible for December's overshoot to the downside. However, it can't roll back the corporate cost pressures created by the fiscal stimulus. These pressures now have to play out in what we've been calling for since last fall, a profits recession.

We think it's misguided to assume that the profits recession has magically ended and we see an increasing chance that it turns into an economic one if companies decide to protect profits by cutting labour, capex and inventories.

MSCI World: price and earnings growth



European Elections.

European elections will be held between 23 and 25 May and it is going to be an important even for the market.

This Election will not be like any other EU elections, mainly because European Parliament has gained additional power over the years and new majority will elect the next Commission President.

Based on the latest polls, we continue to expect a fragmented parliament with mainstream parties forming a coalition and continuing to drive the agenda, albeit with more pronounced populist influences. We expect a significant uptick in the number of Eurosceptic MEPs in the European elections later this month, from around 15% currently to 20-25%. The ensuing fragmentation will make majorities more difficult to build and the parliament less predictable as a result.

We should however also consider that EU populists are diverse in their ideologies, setting a high bar for them to achieve close coordination at the EU-wide level.

A negative surprise from a market point of view has the potential to affect sentiment, especially if it's perceived to obstruct further euro area integration. An extra risk is that national politics may become more volatile if the unconventional parties do very well in the European vote.

Populism is likely to be a continued feature of the European political landscape, with potential medium-term implications for trade policy, immigration and further EU reform. But we believe that the immediate risk of a populist-driven repatriation of EU powers is now still limited.

Executive Summary

After the best start of the year in three decades, Investors were getting more confident, global equity markets didn't miss a beat and got off to a strong Q2 start with FOMO in play.

While we have been "contrarian" and positive at the beginning of the year, we got progressively more cautious even though we understood that low positioning and some technical factors (like Quant Investors) would have sustained the market for longer than what you would have expected in the past.

We now think that despite a greater sense of normalcy coming back into the picture, investors cannot allow themselves to get too complacent (VIX below 15, short interest on S&P at the lowest level since 2007 and the AAII US investor bullish sentiment back to the levels seen in the middle of 2018).

<u>The benign liquidity conditions of Q1 will likely change into tighter global liquidity conditions in H219</u>. A dovish Fed and stabilizing data have supported markets, leaving investors hopeful for a continued rally in US equities but policy is already very easy relative to prices, valuations are rich, and earnings pressure remains.

We now know that the Fed is not going to deliver an "insurance cut" unless things get much worse from here.

<u>We would therefore reiterate the message of reducing some weight on Equities with the aim to buy them back at lower prices and switch into defensive names/sectors.</u>
<u>We still prefer strong versus weak balance sheets and focus on quality and use the recent weakness on Gold to increase it as a protection of the whole portfolio.</u>

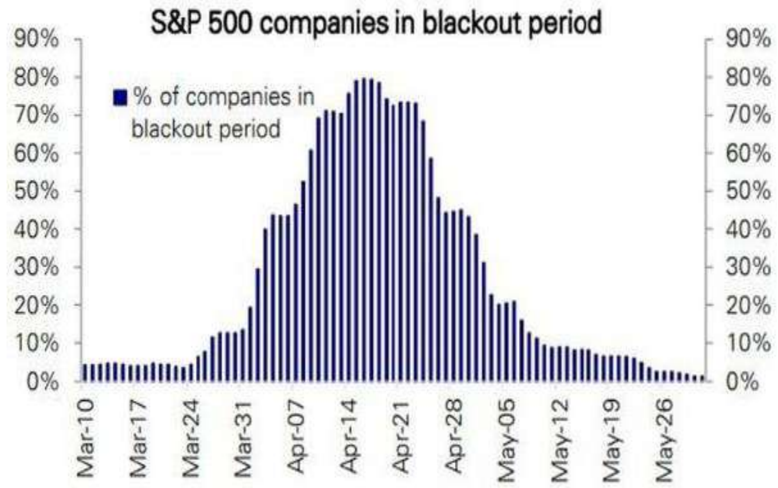
<u>Let's now analyse the current positive and negative factors for the market</u> (please note that these factors are not all comparable in terms of timing, some factors are short term oriented while others may work in the medium to long-term):

<u>POSITIVE FACTORS (3)</u>: *since the last newsletter we have removed the "lower volatility and Quant effect", "structurally low inflation and positive Fed (at least temporarily)", "positive statistic for the month of April".*

- **<u>Buyback should continue to support markets in 2019</u>:** Buybacks have been a key theme through this cycle with S&P 500 companies returning ~$5 trillion to shareholders since 2009 and contributing ~2% to annual EPS growth and <u>we are out of the blackout period now</u>.
  <u>New buyback is up 22% in Q1</u> led by Tech and Industrials and the existing cumulative buyback authorizations that have not been realized yet have grown to ~700bn$, higher than the record year 2018.

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

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



Executive Summary

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

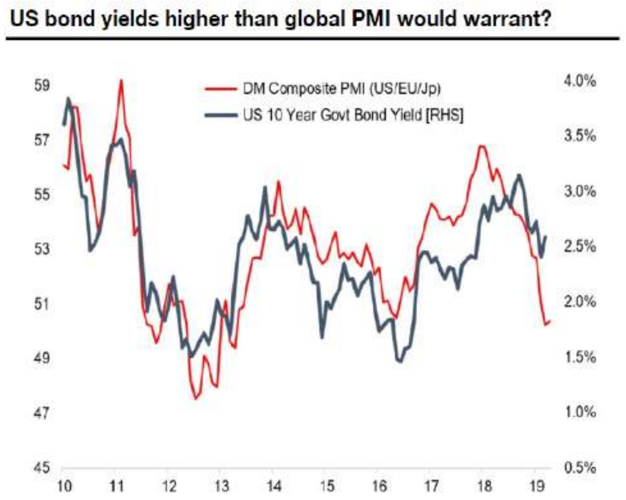
- **<u>Some investors still underweight Market:</u>** we have already seen above how Quant and CTA funds have increased their weight during the month of April. It is however still true that there has been very little participation from Retailers and some traditional Institutional.

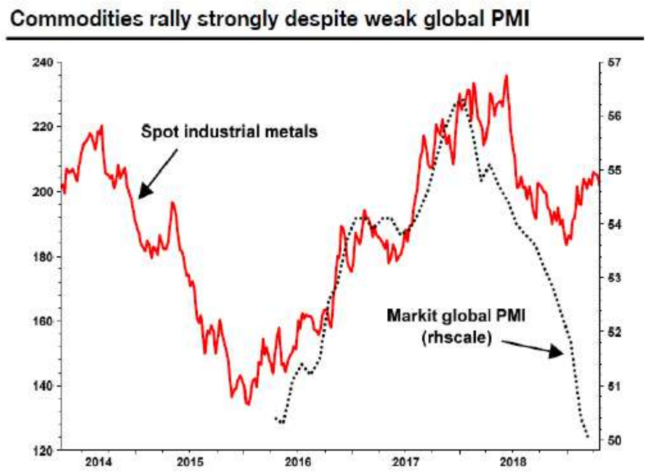
- A recent UBS survey on US investors with at least 1mln$ in investable assets is showing that they are now getting confident on the market but are still sitting on piles of cash. The recent data shows that up to 23% of these investors are planning to enter into the market within the next 6 months.

Continuous weak PMI data are in contrast to trend we recently had on Yields and Commodities

<u>NEGATIVE FACTORS (10):</u> *still largely outpacing the positive factors.*

- **<u>Economic momentum:</u>** We see limited risk that global economic momentum will re-accelerate here. During the first 15 months of Fed tightening, the S&P and Citi's Economic Surprise Index moved largely in tandem but during the past 15 months they have been moving in opposite directions.





Executive Summary

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

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

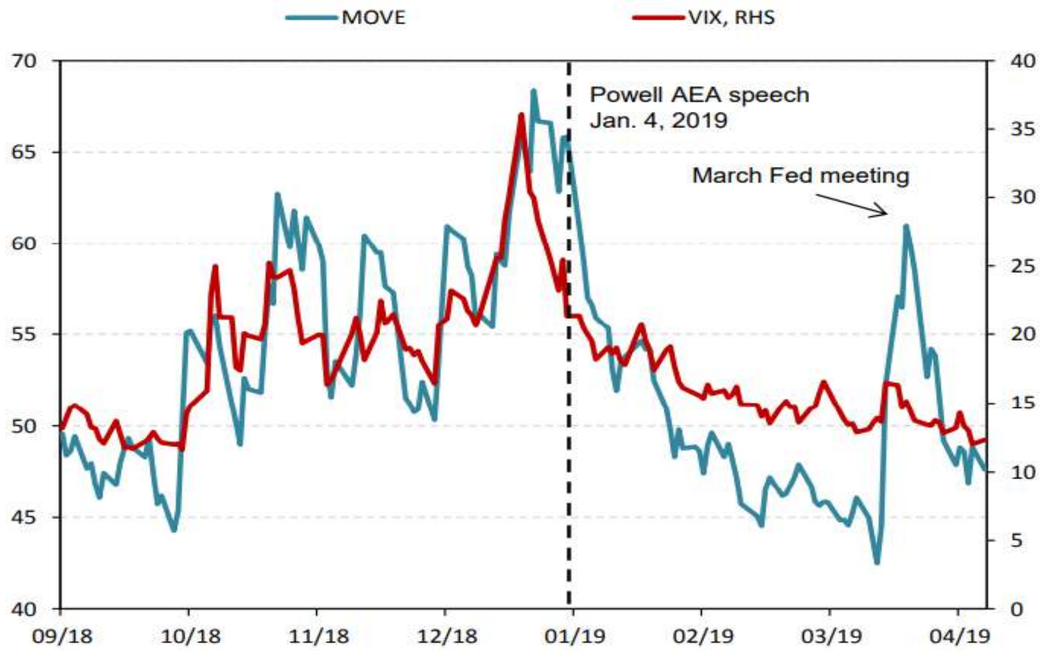
  The trend towards looser fiscal policy led by the US is potentially the greatest change in economic policy making for a generation!

- **Excessively low volatility:** Volatility has dropped over the last 3 months across all asset classes as complacency among investors is back to a dangerous level.

Short VIX punters are back in force, worthless to say that the correction in February 2018 was enhanced by these short volatility products.
Volatility is also low on Bonds (BAML Move Index), FX (JPMorgan FX Volatility Index) and even on Gold.

Central Banks and their unprecedented period of monetary interventionism are firmly behind the low-volatility trend that we are witnessing.
The reduction in the size of the Fed's balance sheet (QT) has been a structural factor in raising volatility.

Interest rate and equity volatility

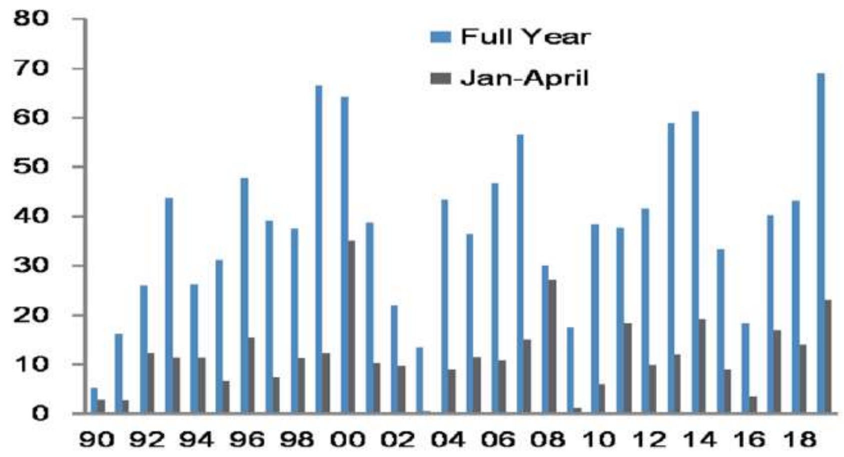


Executive Summary

- **<u>IPOs / Secondary/ Placing:</u>** Now that US equity markets have risen strongly and are back to the previous highs, the founders and private owners of these companies such as venture capital firms are seeing an opportunity to cash out. And they are all <u>rushing to go public before this window of opportunity is closed from a repeat of last year's correction.</u>

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

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



The market is therefore absorbing an enormous amount of cash, how are these IPOs doing in terms of performance?

Unfortunately, not too well as <u>the number of IPOs that lost money is marking a new record high.</u>

The problem lies both in the number of deals the market can absorb but also more importantly in valuation/pricing as this chart is showing.

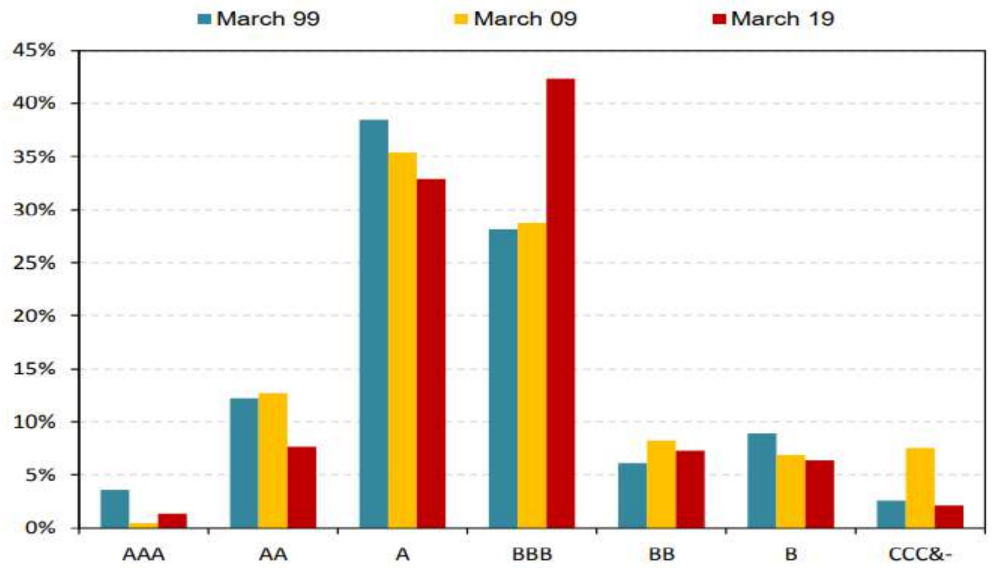
The recent filing of WeWork would be the new loss-making company which has been valued 47bn$.

- **<u>Increase issuance on Credit Markets.</u>** Similarly, to the point above, <u>we are expecting a rapid increase in issuance volumes and it will likely put some strains on Credit spreads</u>.

Overall issuance is already running 22% ahead of last year, and the numbers are particularly strong in the IG market, which is running at over 50% more than last year's figures, while senior financials are running around 10% higher than a year ago. The size of the US corporate credit market has risen from around $3,500bn (23% of GDP) in 2009 to $7,500bn (37% of GDP) in 2019.

Executive Summary

HY represents around $1,200bn today and the BBB segment almost $3,200bn (2.7 times the size of HY). These amounts demonstrate that refinancing conditions in the HY segment can deteriorate severely if fallen angels become too numerous.



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

Corporates are already facing a very hefty increase in their cost of capital, their trailing 5-year average is at its highest level since the early 1980s (if we exclude late 2008, when default rates were spiking).

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

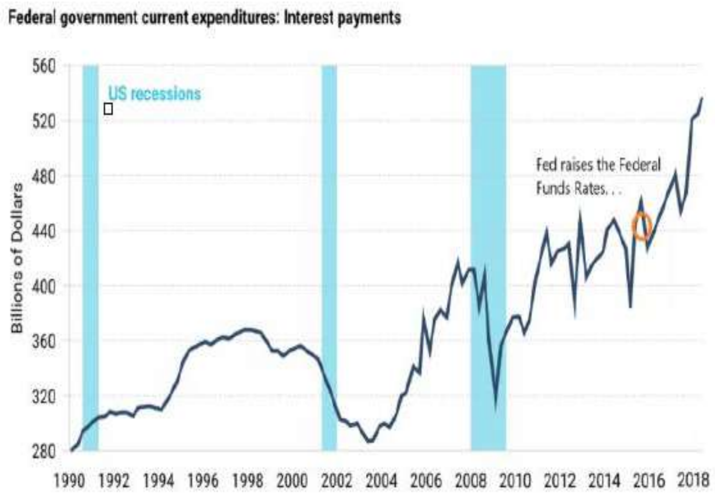
For the first time even, there is now more BBB- rated corporate debt than AAA- to A- rated debt combined!

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

With demand for credit outstripping supply, investors were willing to accept weaker structures and the like, despite historically tight spreads.
We find examples of problematic non-financial credit quality are widespread, for example, in the loan market, where leverage levels, covenant quality, and structures are in many cases weaker than 2007 extremes, and in IG, where leverage is already near historical peaks, before earnings growth has rolled over.

- **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 $22 trillion and the interest payments due on all this debt is at a record high. You can see on the chart that since the Federal Reserve began raising rates in December 2015, the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year.



Executive Summary

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

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

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

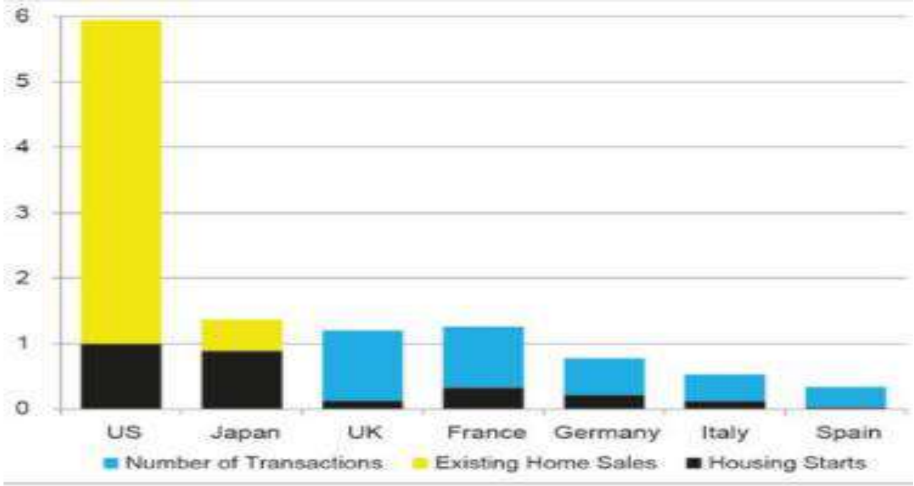
- **<u>Declining US House Prices:</u>** US Housing data are continuing to surprise on the negative side.
  While new-home are now rising, both existing and pending home sales continue to drop. New home sales account for only 10% of the market and are calculated when contracts are signed (not considered as a good barometer).

New vs Pending vs Existing home sales

Forward-looking building permits were also weaker posting the 3rd consecutive decline. It is quite worrying to see mortgage rates falling along with housing data, we are used to see an inverse relation as we just had one of the largest mortgage rate tailwinds of the past 30 years.

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

Global home sales in terms of n. transactions



- **<u>Consumer sentiment very downbeat</u>**

  <u>Consumer confidence dropped in April for a 6th consecutive month</u>.

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

Executive Summary

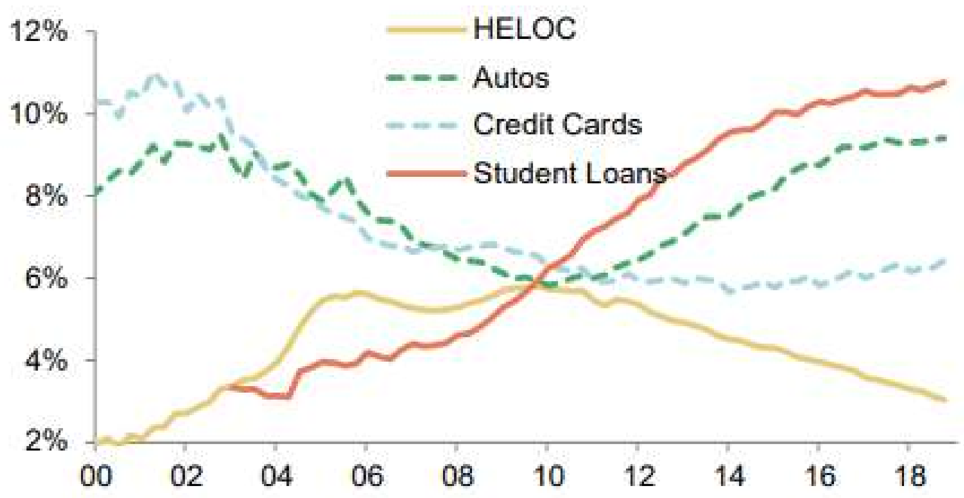
Credit card transaction volumes have decelerated sharply in recent months, supporting latest data on retail sales; while credit card interest rates are >2 decade-high.

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

There are approximately 480 million credit cards in US circulation, that is 1.47 credit cards per citizen, and up more than 100 million since the 2008 financial crisis.

Total US household indebtedness was at a staggering $13.54 trillion in December, $32 billion higher than Q318. Overall household debt is now 21.4% above the Q2 2013 trough, according to the latest quarterly data from the Fed.

Chart showing share of household debt balance. The housing mortgage debt has relatively fallen as a share of the total.



Rising delinquency levels pose a serious risk to consumer spending which accounts for more then 2/3 of economic activity.

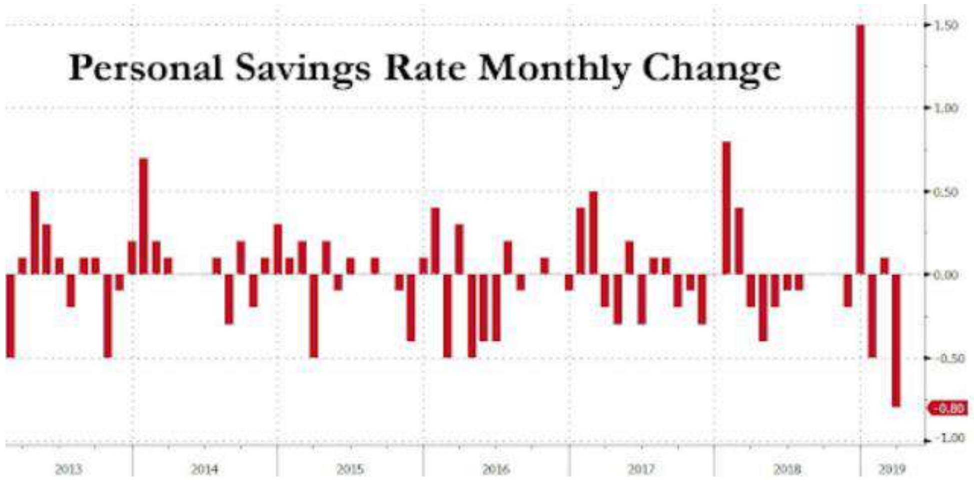
The percentage of auto loans in serious default has risen to the highest level in almost seven years, as consumers with weak credit struggle to make payments despite a strong US economy and tight labour market. Loans delinquent more than 90 days rose to 4.47% of the total in Q4. At the same time, the average car loan payment just hit a decade high at 545$ per month.

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

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

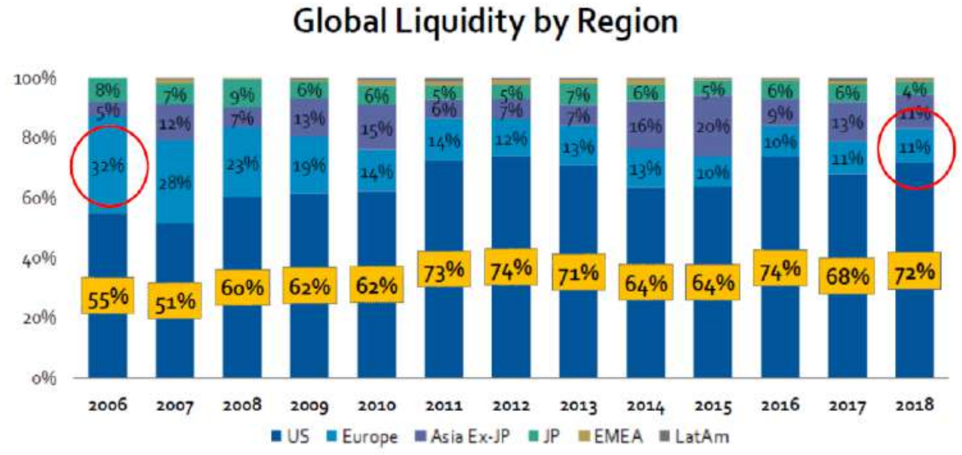
Executive Summary

<u>US saving rates had the biggest monthly drop in recent years.</u>



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

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



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

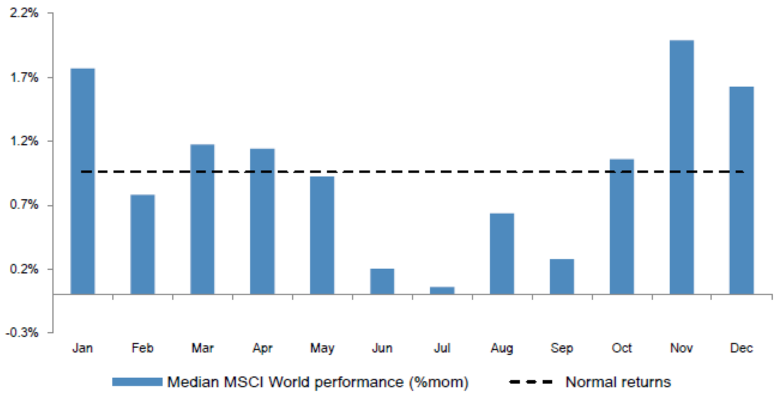
<u>**The signs are everywhere, credit exhaustion is global**</u>, and that means the global growth story could be over: revenues and profits are all sliding as lending dries up and defaults pile up.

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

- <u>**Seasonality**</u>

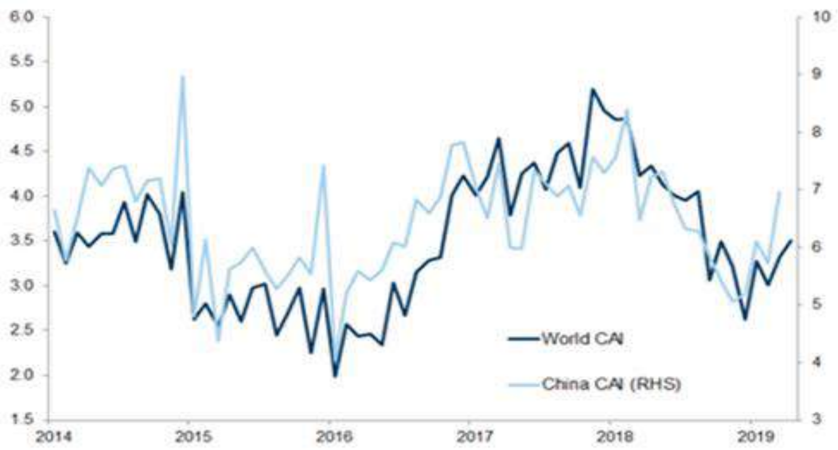
With the rally in April, we had statistically ended the best 6-month period of the year where the S&P returns an average performance of 7%. The May to October period it is instead the weakest.

Median MSCI World monthly performance.



As already mentioned in our previous newsletters, the fundamental picture had strongly deteriorated in the past few quarters. The current global CAI (current activity indicator) is now up to a preliminary 3.6% in April with most of the acceleration due to China, where strong activity data lifted the CAI to 6.9% in March (up from 5.2% as recently as December). However, excluding China, Macro fundamentals still appear to be weak in Developed Countries, mainly Europe, US and Japan, and in some important Emerging countries such as South Korea and Taiwan.

Diverging growth: China CAI vs. World CAI



Europe

Growth remains weak. The CAI has decelerated further in recent months, currently reaching 0.8% in April. The most recent estimate of Q1 Euro-area GDP was a bit stronger than expected at 1.5%, but the composition was soft, with an outsized trade contribution in Spain and continued contraction in Italian domestic demand.

In addition, Euro-area inflation developments have been weak. Although core inflation rose to 1.2% in April, strongest in 6 months, the underlying trend has been stuck to 1% along with low momentum in wage growth.

Germany is running out of steam, dragging down the Union, with the government and the European Union cutting 2019 GDP forecast to 0.5%, the weakest expansion in 6 years and the latest in a series of downward revisions from 2.1% projection a year ago.

To sum up: A) weak aggregate and country-specific PMIs, B) Euro-area economic confidence down for the 10th straight month (German confidence hits the lowest level in 3 years), C) industrial and consumer confidence both falling in April.

EU Economic Sentiment Index

Macro

HERON ASSET MANAGEMENT

The latest negative prints:

- Zew Survey current situation, 5.5 vs. 8.5 consensus
- Euro Area Flash composite PMI, 51.3 vs. 51.8 consensus
- Euro Area Services PMI, 52.5 vs. 53.1 consensus
- Euro Area Manufacturing PMI, 47.8 vs. 48 consensus (still below 50/ expansion)
- Germany Manufacturing PMI, 44.5 vs. 45 consensus
- Euro Area Consumer Confidence, -7.9 vs. -7 consensus
- Germany IFO business climate, 99.2 vs. 99.9 consensus
- Germany IFO expectations, 95.2 vs. 96.1 consensus
- Germany IFO current assessment 103.3 vs. 103.5 consensus
- Germany Factory orders 0.6% vs. 1.4% consensus

United States

The economy seems to be improving, with some mixed data in April. However, watch out for details (not as good as it seems). Q1 GDP came stronger than expected, at 3.2% annualized rate vs. 2.3% consensus. However, let's take a look under the hood (green positive, red negative components).

• **Inventories**: +65bp contribution, very solid but will this component will fade over the year.
• **Net Export**: 1% contribution, double estimates, solid.
• Federal Government: Flat, consistent with estimates (drag from a government shutdown).
• **Housing**: 5th quarterly decline.
• **Personal Consumption**: 1.2% SAAR, the lowest since Q1 of last year, and the 2nd weakest since Q213.
• **Final Sales to Domestic Purchasers**: 1.4%, the softest in over a year, and 40bps lower than estimates.

The composition of growth in Q1 suggests that headline growth will likely come in weaker next quarter, where the Street initial Q2 GDP tracking estimate points to 1.1% growth.

The latest job data suggest that the job market is tightening along with a decline in labor market slack. Nonfarm payrolls rose strongly in April 263k vs. 190k consensus and the pace of job growth over the previous two months was revised up. Average hourly earnings stable at +3.2% YoY.

The latest negative prints:

- Industrial production, -0.1% vs. 0.2% consensus
- Philadelphia Fed business outlook, 8.5 vs. 11 consensus
- Manufacturing PMI, 52.4 vs. 52.8 consensus
- Services PMI, 52.9 vs. 55 consensus
- Housing starts, -0.3% vs. 5.4% consensus
- Building permits, -1.7% vs. 0.7% consensus
- Personal Income, 0.1% vs. 0.4% consensus
- Personal Spending, 0.1% vs. 0.3% consensus
- ISM Manufacturing, 52.8 vs. 55 consensus

China

Very good results in March/April, better China data all around. Overall, the countercyclical fiscal easing seems to be working, further evidence needed in the upcoming months.

Strong GDP, industrial production much better and retail sales beat too, and remember VAT cut only came into effect early April! Although April PMI slightly missed the consensus estimate (50.1 vs. 50.5), we believe Macro momentum is getting stronger.

Macro/ Central Banks

The latest positive prints:

- GDP YoY 6.4% vs 6.3% consensus
- Industrial production YoY 8.5% vs. 5.9% consensus
- Retail Sales 8.7% vs. 8.4% consensus
- Production at 52.1 (continuing expansion)
- New orders at 51.4 (the second-highest since Sep18)
- New export orders 49.2 (improvements)
- Forward-looking production and business expectations 56.5 (strong number)

Further to the recent fiscal easing measures:

- Extra stimulus measures might be implemented to bolster consumption of cars, electronics and phones (plan is only at consultation stage).

- Required reserve ratio cut for rural commercial lenders to release 280 billion yuan (credit growth boost).

Central Banks

FED: left the funds rate unchanged, target range 2.25-2.50%, but unexpectedly realigned IOER (Interest on Required Reserve balances) by 5 bps to 2.35% and changes to the statement were dovish on net. A dovish initial reaction gave way to a hawkish response during the press conference due to the following takeaways:

- recent inflation decline attributed to “transitory factors” (inflation to come back)
- the economy is on a healthy path and supported by solid fundamentals (consumption and business investment to bounce back)
- IOER rate adjustment does not reflect any shift in intended stance of monetary policy.

The market is currently pricing a probability of 38% for a rate cut in October 2019 against a probability of 62% for a rate cut in January 2020.

ECB: assessment on the economy remains cautious. The current forward guidance says the key policy rates will stay unchanged through year-end. No extra information on TLTRO 3 whose details will probably come in the middle of the year. In addition, No meaningful progress on a hypothetical tiered depo rate system.

Commodities

Commodities, (S&P GSCI Index), are up 17% year-to-date, down almost 4% since April high. A bearish gust has blown through oil, agriculture, base and precious metals these recent weeks, which seems to be an expression of wider Macro concerns. As discussed in our previous newsletters, we keep reiterating our neutral stance on commodities as the risk-reward of being long commodities now is less attractive on current valuations (fundamentals are no longer significantly undervalued).

Oil

<u>We are currently neutral on the asset class because we expect the price to be within a tight range.</u> Still one of the best performers, with WTI up 36% YTD, +6.2% in April and Brent up 31% YTD, +6.4% in April. Despite a positive monthly performance, WTI and Brent lost $5 dollar from their recent peak, circa 6-7%.

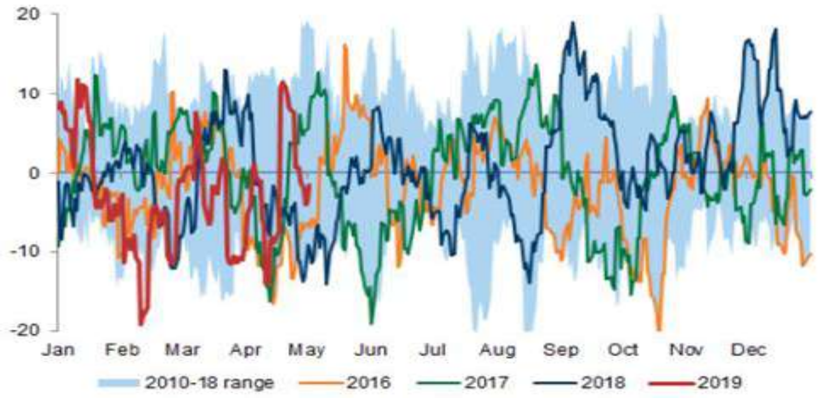
The global oil market is currently caught in a war of diverging fundamental signals: A) Bottom-up, indicators point to an oversupplied US market (market leader) B) Top-down, the timing of production losses and ramping up spare capacity remains uncertain.

4-week change in total US stocks vs 2010-18 average (mb)

US inventories have gone from drawing at the highest rate in 10 years to building near the highest rate in 10 years (chart), at over double the normal rate over the last five weeks.

However, inventories elsewhere have remained tight versus seasonality (chart).

4-week change in Global ex-US stocks vs 2010-18 average (mb)



With production risks rising, <u>we believe that supply might be the likely new dominant driver for oil prices</u>. However, there is <u>lack of clarity</u> here as well:

- Iranian waivers formally came to an end (bullish oil price)
- Venezuela still unstable (bullish)
- Recent contamination on the Russian Druzhba pipeline (bullish)
- Saudi Arabia to higher production only in response of customer demand (bullish)
- Core-OPEC and Russia, large spare capacity, to offset the falls in both Iran and Venezuela (bearish)
- Rising Permian Basin oil production (bearish)

Commodities/ Forex

Gold

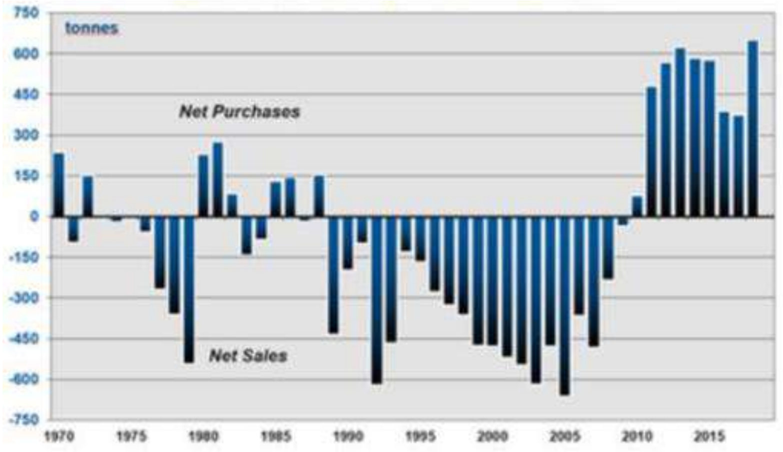
Gold has always been primarily a hedge against tail risk events and the current low volatility environment reduces investment appetite for gold. Despite a significant drop in long-term real rates (inverse relation, i.e. up rates/down gold), gold prices have remained flat year-to-date as recession fears have receded since late last year and are down 5% since their February high.

As already mentioned in our newsletter we believe gold is one of the best asset class to have for 2019.

<u>Prudent financial discipline has been abandoned, debasing of currencies and disregard for sovereign deficits should be viewed as friendly to the gold markets. We think that will start to rally when the Fed will start cutting its Fed Fund rates as it happened in 2001 and 2007.</u>

<u>Central banks are buying at the highest pace in the last 50 years.</u>

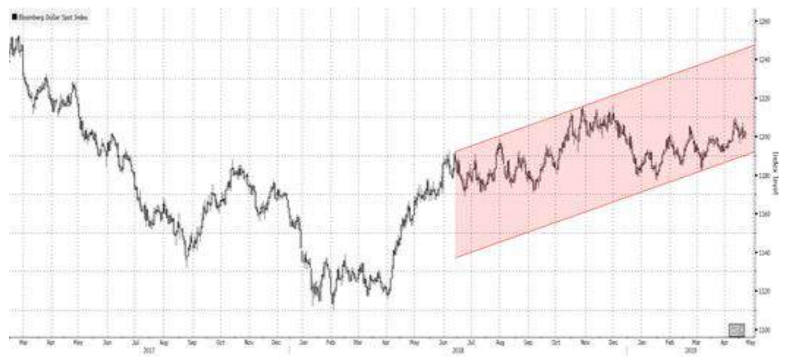
Central Banks Purchase



Forex

Implied and realized volatility have been falling this year across most currencies and FX trading volumes have been low due to the Central Banks synchronous dovish policy stance. The USD dollar index is still trading in a bullish channel. As long as it does not break the 1190 level, the bullish trend remains confirmed. <u>Positioning is still a consensus long USD</u>. EURUSD has been trading in a downtrend since the start of the year. Lack of hawkishness, which tends to push up volatility or divergence in central bank talk, leaves currencies to trade in narrow ranges.

Bloomberg Dollar Spot Index



US Dollar Index Net Non-Commercial Futures Positions

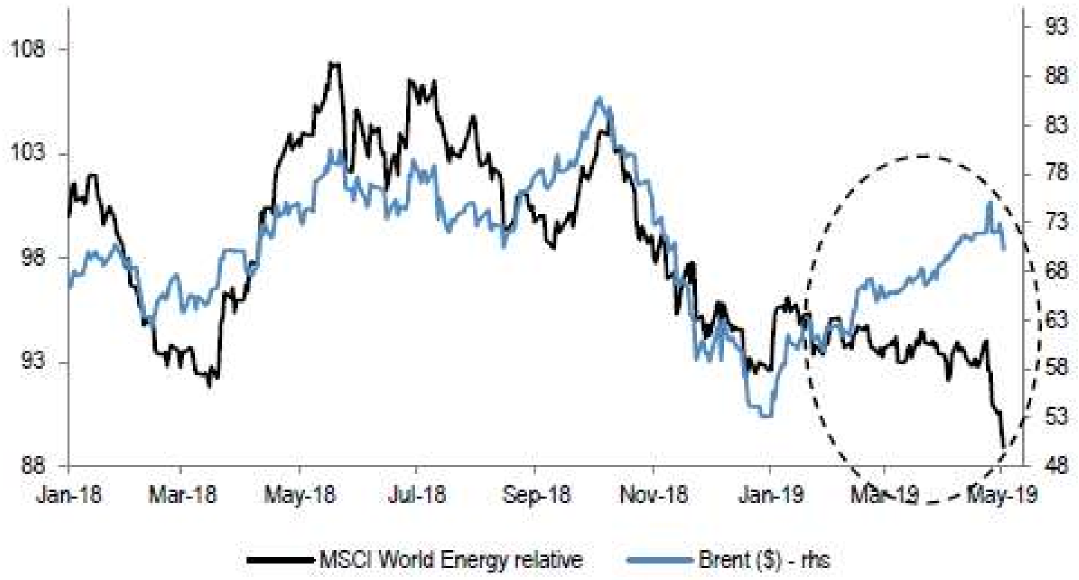
New Investment Ideas

Long European oil sector, SXEP

This is either a relative call (vs Eurostoxx 600) or absolute. Oil prices have strongly rebounded YtD but they are still down 20% from 2018 peak.

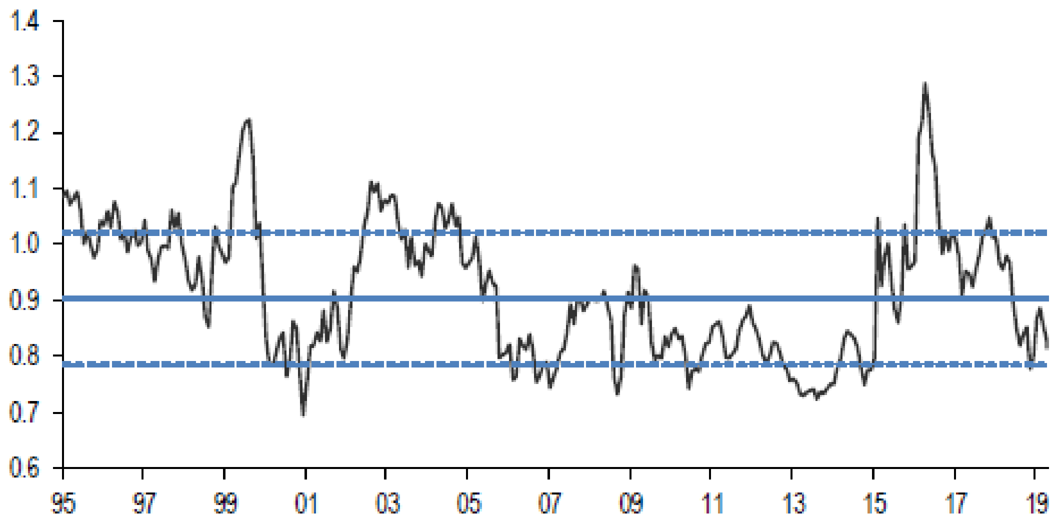
The MSCI World Energy sector relative chart clearly shows how the correlation with the underlying commodity has diverged.

Energy sector relative performance vs oil price



The EU Energy sector is still cheap on most valuation metrics and Q1 reporting is showing good numbers and guidance.

European Energy Sector forward Price/Earnings



The SXEP has lost 8% in the last 2 weeks and has already retraced 50% of the upside move it had since the 27th of Dec18.

The gross dividend yield for the sector is an interesting 5%.

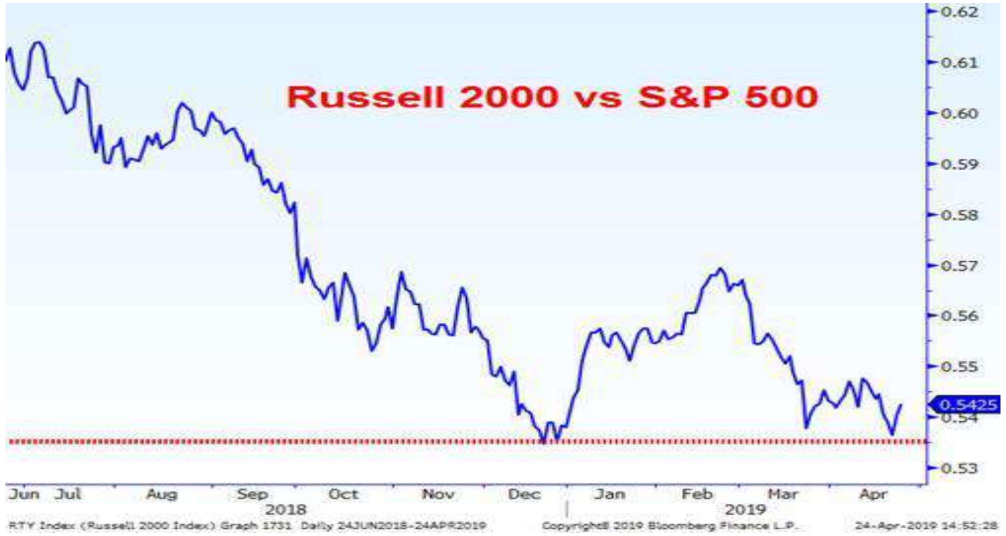
New Investment Ideas

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

This is either a relative call (vs S&P500) or the start of a build up for an absolute trade on market weakness.
Russell 2000 (US small-cap Index) has barely performed since the middle of February while the S&P has bounced 5% and Nasdaq +9%.

While this is function of an early warning signal and in line with the breath indicators mentioned above, we start to believe that as Q1 earning season is nearly finished, there isn't a proper justification for such an underperformance of Small Caps vs Big Caps especially if the macro picture will grow.

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



Our proprietary weekly trading signal is giving a buy recommendation.

Current Investment Ideas

Call replacement on single names/sectors.

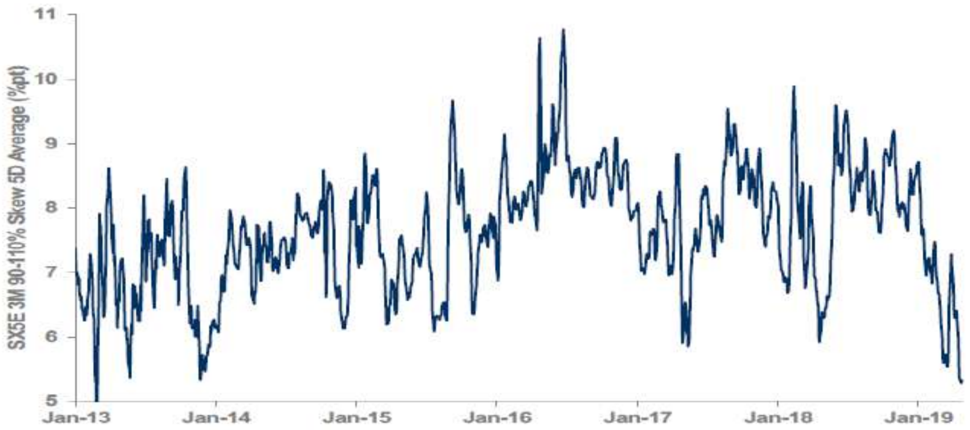
Already last month we suggested to take advantage of the low volatility and replace some of the single names with Calls in order to better protect the portfolio in a downturn phase and still being able to participate to the upside.

Long Put spread on Indexes.

Over the last newsletter we mentioned that it has never been this cheap over the last 2 years to protect the portfolio through some Put spreads on Indexes and this is still valid.

Also, the relative cost of Puts vs Calls on the Eurostoxx is now at the lowest levels since 2013. It's worth noting that the last time Bund yields were this low (2016), this same series was at a 6-year high (i.e. investors were busy buying protection then but are selling it today).

Eurostoxx 3-Month 90-110% skew 5-day average



Long CDS and Btp/Bund spread

We would start buying some protection through ETFs that synthetically replicates the performance of the short iTraxx Crossover 5-year CDS like the XTC5 GY.

This trade would benefit from a widening of the spreads.