HERON
ASSET MANAGEMENT

Monthly Market Update

Monthly focus on the financial markets

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Contents

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Market Analysis

We had a very good Q119, especially if compared with Q418, and the worst December for stocks since the Great Depression. Q1 has seen the best quarterly gain since 2009 in US.

European Equity market gains made in January and February continued in March, albeit at a slower pace, with the Eurostoxx 600 finishing the quarter up +12.27% (marking a full recovery from a terrible Q4).

Sentiment has swung back on the bullish side, tensions have largely abated and investors appear to be getting back to single stock picking.

Statistically, a good start to the year has been favourable to bulls. In nine of the past 10 instances when the equity benchmark closed up at least 10% in the first quarter, the rest of the year was also in the green, by an average of 5.8%.

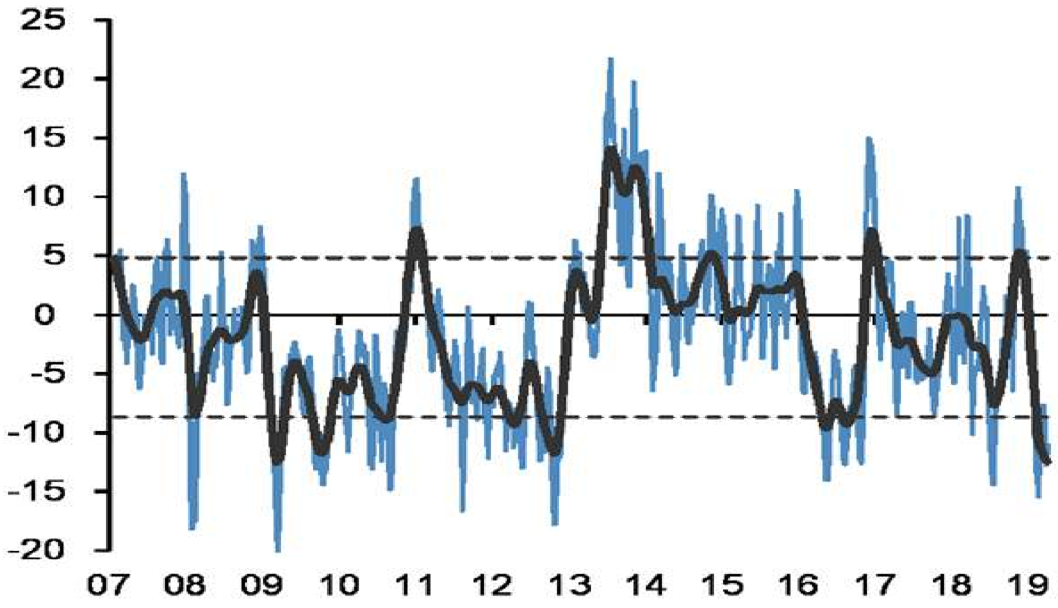
It is also true that the current number of bulls on major World Indexes is now at an extreme (S&P 91%, Nasdaq 89, Nikkei 93%, Eurostoxx 85%, Ftse100 88%, Dax 85%) and the risk-reward for equity markets is poor.

Technicals are deteriorating and the <u>new highs on S&P are not coming along with a good market breadth</u> (chart showing 3-day new highs of the combined Nyse + Nasd).

Positioning and liquidity are crucial to understand the reason behind the quick move we had over the last two quarters.

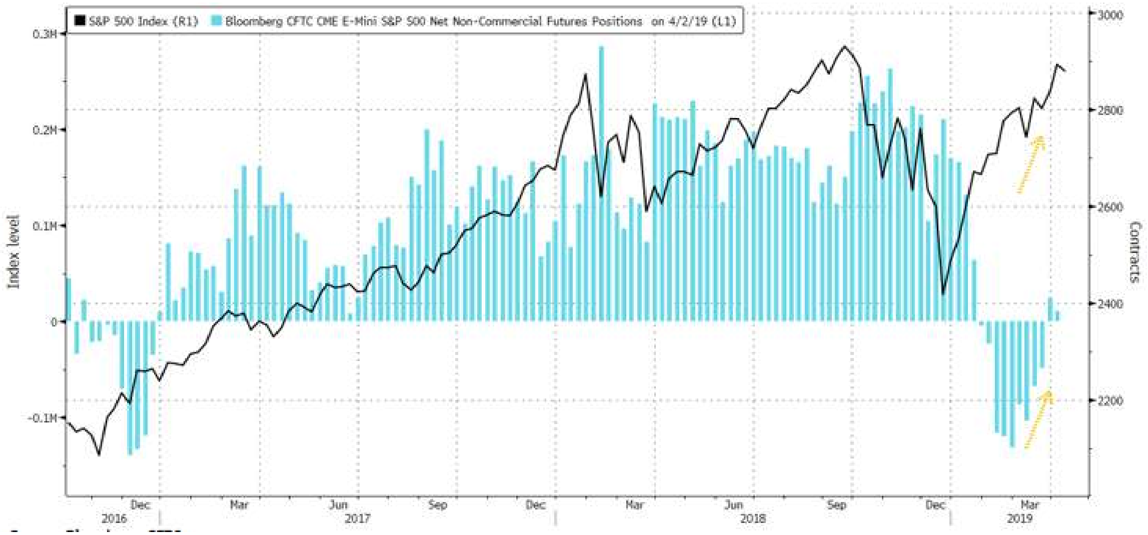
As we mentioned over last newsletter, despite a very strong equity market, we have mainly seen outflows from equities (EU and US) into bonds and the chart is clearly showing that we currently stand at the lowest level since the Euro depth crisis in 2012.

Difference between flows into Equity and Bond funds: $bn per week.



Market Analysis

The same could be seen on the positioning of S&P futures vs the S&P Index performance.



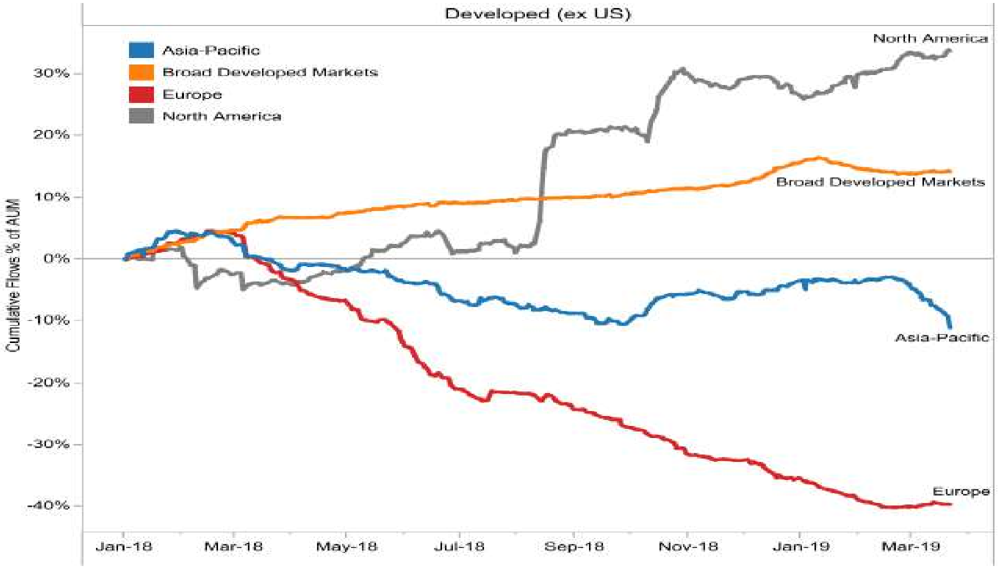
After 13 weeks of near constant selling by Institutionals and Retail investors, which resulted in the worst start to a year for equity flows since 2008, we have started to seen some form of capitulation or FOMO (Fear of missing out).

Investors are at the same time back to betting on more calm and according to the latest data they hold the most short VIX futures positions since November 2017!

With every asset category now looking inflated, we've noticed the rally taking on a more speculative nature in the past month. Bitcoin, which was the first asset to top in the rolling bear market back in December 2017, has come back strongly with a 30% rally in just a few weeks.

Market Analysis

Regionally European flows are still massively lagging.



Why was the Q4 2018 selloff and subsequent rally so violent? How could these moves have happened without a large shift in positioning? Is the current rally sustainable? The answer to all of these questions lies in market liquidity.

What is drastically different with the Q4 selloff relative to other selloffs in the past decade is the market liquidity (market depth).

Specifically, the average liquidity during the last selloff and recovery was less than 1/3 of the liquidity in previous episodes (and about half of the worst liquidity drawdowns of the last decade).

So, if liquidity was only a half or a third, it is reasonable to expect two or three times the speed of market moves for a particular level of flows. Liquidity thus explains how the market could go down and up so much on a relatively small change in positioning, and we would argue a small change in fundamentals since December.

Given liquidity, it is plausible that just short covering, buybacks, dealers' gamma hedging, and some limited re-leveraging drove the entire recovery. This, in turn, opens the possibility that the current rally could possibly continue during the spring.

It is however also true that the strong rally in equity, credit and commodity markets over the past quarter has significantly reduced their cushion against growth downside risks.

As a result, there appears to be a disconnect between rates and risky markets at the moment with rate markets 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 (vs 66% chance at the start of the year), US credit markets are currently pricing a chance between 10% and 25% (vs 30% and 55%).

In contrast, the 85bp fall in 5-year US Treasury yields from their early November peak points to 80% chance of a US recession.

Another very interesting tool which historically has predicted well the recession is, as we know, the US curve inversion.

Market Analysis

This suggests that this bad omen for risky markets is resurfacing, and it appears that the hurdle to reverse this inversion has been raised after the FOMC meeting. In other words, an even bigger dovish shift in Fed policy, or evidence of a sustained recovery in economic data, could be needed going forward for the yield curve inversion to improve.

The lesson from previous cycles is that equity markets are unlikely to see a sustained recovery with the inversion at the front end of the US yield curve worsening.

The spread between the US 10Y and 3-month treasury yields dipped below zero for the first time since 2007 while the spread between the 10Y and 2Y also declined to the lowest levels of the current cycle.

US 10Y / 2Y Treasury Yield curve

Statistically, the US (10Y-3M) yield curve inverts 12 months before the onset of a US recession (brown bar on chart) since 1960 and inverted 17 months ahead of the 2008 recession.

It is also true that current that this time current real rates are near zero when they averaged 3% at the point of the past 6 inversions and while the 10Y-3M curve has inverted, the 10Y-2Y is not far but hasn't inverted yet.

We shouldn't however ignore the large gap between stock and bond pricing. The S&P is up 23% since the December lows while the US 10Y is down 33bps. Historical betas would have suggested that the S&P should be down about 1% over that time frame.

The market is pricing a new QE and this could be clearly seen on two charts, the inverse correlation between the S&P and real yields
which has reached a stunning -92% (levels last seen during QE1) and the recent jump in 1Y breakevens
while the market prices odds of a full 2020 rate cut.

Market Analysis / Earnings

Unlike in January, we doubt that fundamental news will be good for stocks any more, given that <u>equity valuations are less compelling than it was at the beginning of the year</u> with the S&P trading at 16.5 Forward P/E and the fact that the Fed can't pivot any further at this point without signalling rate cuts.

EARNINGS

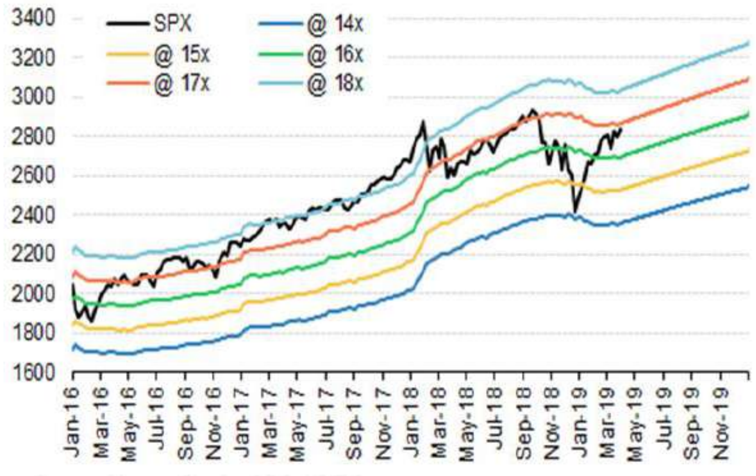
US and European stocks continue to rally in the face of steadily falling earning estimates leading some market commentators to draw comparison to 2016, when equity markets rose amid a corporate earning recession.

Q1 earnings season will start tomorrow and in US the great bulk of numbers will be out over the next 3 weeks. It will offer a gut check for a market looking for some evidence that the worst is truly behind us.

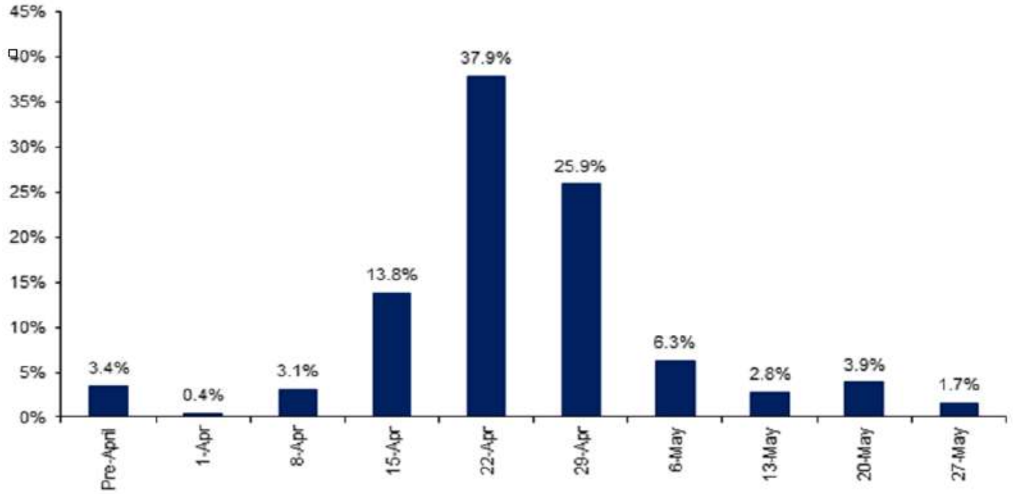
The S&P P/E multiple has expanded by nearly 3 point since the December lows (the most since 2009) while the yield curve has flattened considerably.

Historically, the first rate cut is a red flag for stocks because it portends even weaker growth.

S&P Price/Earning multiples



Q1 percentage of market cap of S&P reporting each week



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

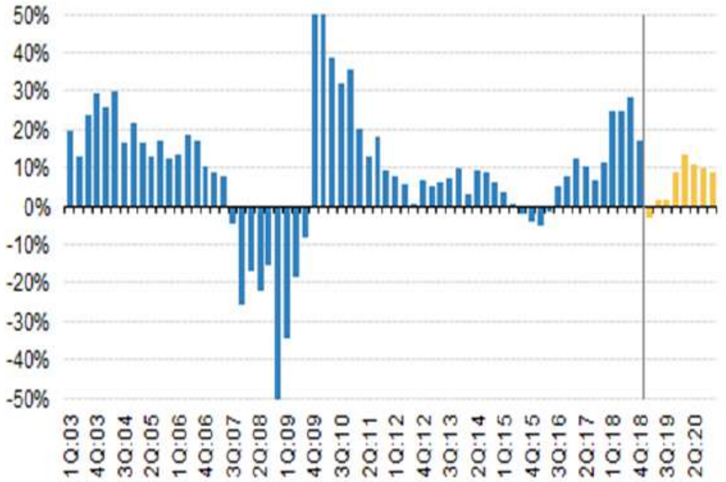
Earnings

<u>Q1 it is likely to be the first negative YoY growth quarter in three years</u>. While S&P companies are likely to beat the significantly lowered bar for Q1, we think it will still end up in negative YoY growth territory when all is said and done.

According to Factset, out of 105 companies in the S&P500 that issued earning guidance for this quarter, 77 have issued negative EPS guidance and 28 issued positive. The 5-year averages are: negative EPS = 74 and positive EPS = 32. The US technology sector, which is approximately 21% of the S&P500, relative to the 5-year average, has recorded a high number of revenue warnings.

Actual/Estimated Quarterly S&P Earnings growth

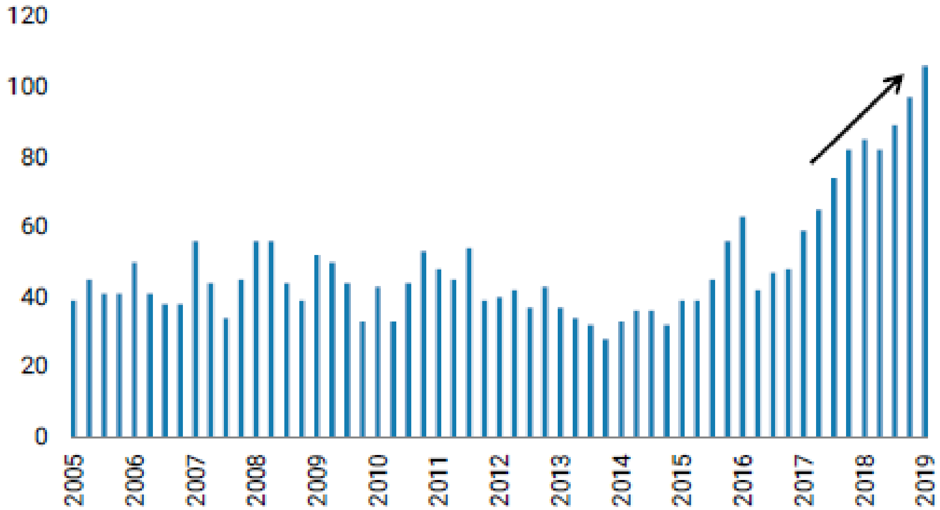
Consensus is priced for one of the fastest reductions in earnings growth in Q1 in the last ~15 years, but then starting in 4Q19 estimates embed a return to robust growth. Earnings revisions breadth has rebounded back to flat- i.e. analysts have stopped cutting estimates.



As we mentioned over the past letters, <u>we believe that labour cost will be one of the key pressures sending margins lower in 2019.</u>

Last quarter, the number of mentions of labour costs during earnings calls was the highest it has been since 2005.

Mentions of Labor Costs on Earning calls is at an extreme level



Even in Europe earning revisions continue to fall with Stoxx600 FY1 estimates down 90bps this month and down 320bps over 3 months. Downgrades have continued to be led by cyclicals across semis, autos, media, banks, logistics, electricals and chemicals.

Q1 consensus earnings growth estimates now stand at -3.1%, having fallen by 10% since last July.
If those expectations for Q1 come to fruition, it would be the lowest YoY quarterly EPS growth since Q1.

<u>Unfortunately, a lowered bar doesn’t necessary mean a big beat is coming</u>.

Executive Summary

EXECUTIVE SUMMARY

Earlier this year, it was virtually a consensus that the rally was not sustainable and that a retest of Q4 lows was possible.
After the best first quarter in a decade, Investors are getting more confident, global equity markets didn't miss a beat and got off to a strong Q2 start.

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.
On March, risk-asset returns slowed and Treasuries outperformed Stocks. Several cycle indicators are suggesting an increased likelihood of a cycle turn and we would anticipate more reversals in cross-asset performance.

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).

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

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

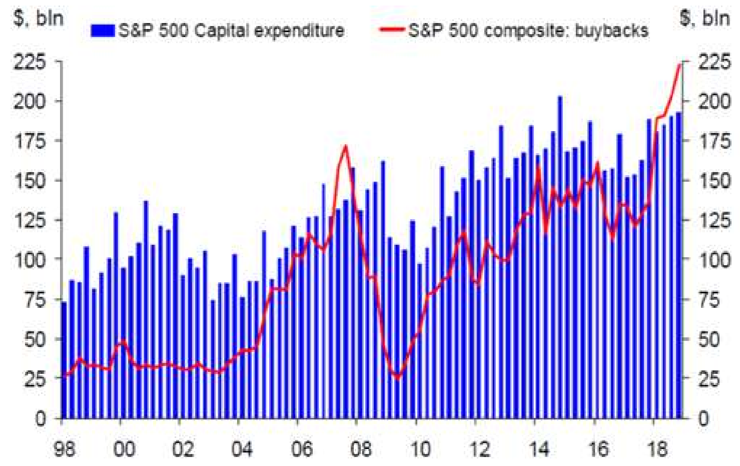
Let's now analyse the current positive and negative factors for the market (please note that these factors are not all comparable in terms of timing, some factors are short term oriented while others may work in the medium to long-term):

POSITIVE FACTORS (6): *unlike at the beginning of last year, equities are still pricing in slower economic growth and Earning Per Share concerns. Since last newsletter we have added the "Stats for the month of April" point.*

- **Lower volatility & Investors still underweight**: Macro investors. positioning is still low, 3-month realized volatility is continuing to drop, lower than the average since 2000 at 18%. This still provides a risk-on equity for Risk Parity, Vol Target and
  The market could "overshoot" on this specific factor and it will be an opportunity to reduce the weight (as also seen on Bloomberg interview out this week: **https://bloom.bg/2Imrtd6**).

- **Buyback should continue to support markets in 2019**: Buybacks have been a key theme through this cycle with S&P 500 companies returning ~$5 trillion to shareholders since 2009 and contributing ~2% to annual EPS growth.

S&P Capex (blue) vs S&P Buybacks



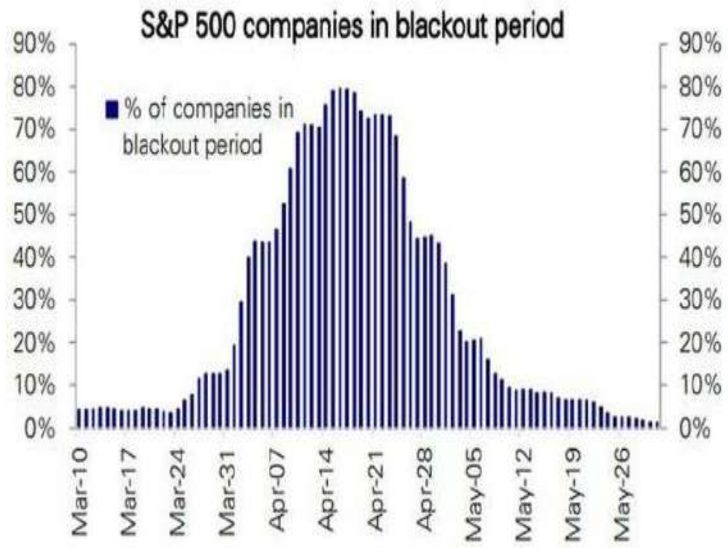
Executive Summary

New buyback announcements remain strong YTD at $250b (30% higher Ytd than 2018, which was a record year) and we expect another $600b+ of buybacks for remainder of 2019 considering the record~$700bn$ available to execute under existing authorizations.

In 2019 we also expect an additional ~500bn$ via dividends which is in-line with 2018 shareholder return.
Since 2000, stocks with higher buybacks outperformed sector peers by 150bps during corrections and 200bps during recessions.

The Tax Reform was used for stock buybacks, not capital expenditure, pants and jobs as shown on the chart. Weak growth is the predictable result.

Interesting to note that number of companies getting into the buyback blackout period will grow considerably over the next days and could be a temporary negative factor especially for the US equity market.



- **Structurally low inflation and (very) risk-asset-friendly Central Banks:** Inflation is going to stay lower for the foreseeable future and Central Banks have shown an incredible positive attitude, the Fed has been intervening on every market correction since 2009.

Just three months ago the market was pointing to a quarter-point hike in 2019 and is now factoring a 0% possibility of hike for this year and 60% possibility of a cut in 2020.

Executive Summary

- **<u>Insider activity</u>**: The recent insider activity implies that corporates are still optimistic about the current cycle. In fact, the current near record level of insider bullishness is similar to the prior two intra-cycle resets (i.e. 2011 and 2015-16) in which insiders sold fewer shares and stepped up purchases on lower valuation.

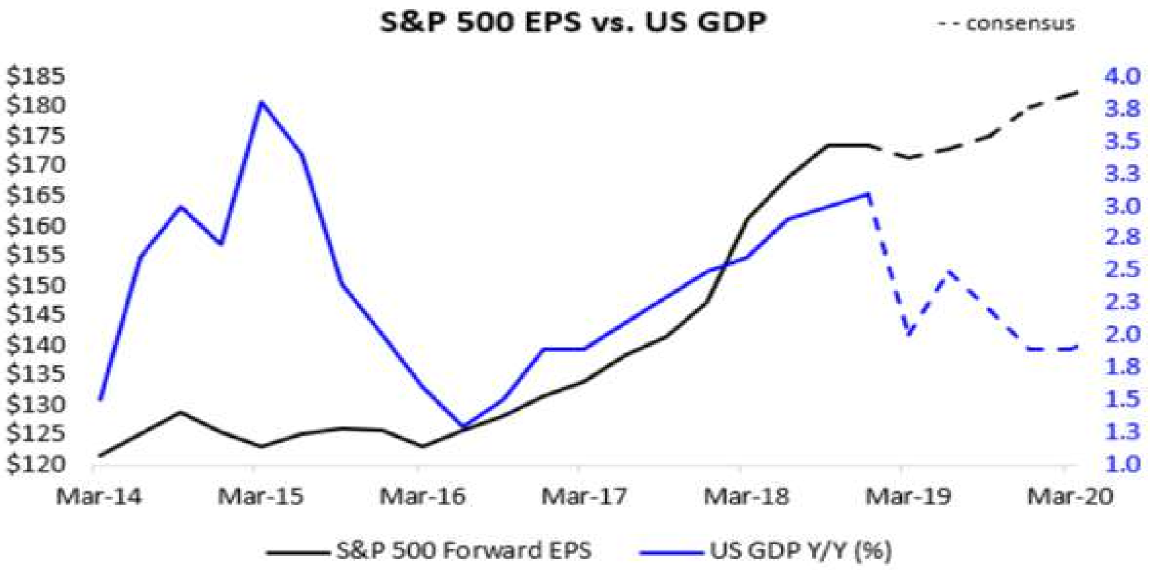
6-Month # of insider buying less selling

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

- **<u>Statistics for April:</u>** April marks the end of the best 6 months for Global equity markets. Typical pre-election year strength does bolster April's performance since 1950. April is Dow's best month in pre-election years (+4.0%), second best for S&P (+3.5%) and third best for Nasdaq (+3.5%).
  <u>The S&P has only closed down once in April over the past 14 years!</u>

<u>NEGATIVE FACTORS (14):</u> *still largely outpacing the positive factors. In January we had 13 negative factors, now the number is 14. The new addition is the "excessively low volatility".*

- **<u>Economic momentum:</u>** We see limited risk that global economic momentum will re-accelerate here. The correlation between some important economical indicators and the S&P are diverging too much, one of the two is going into the wrong direction.



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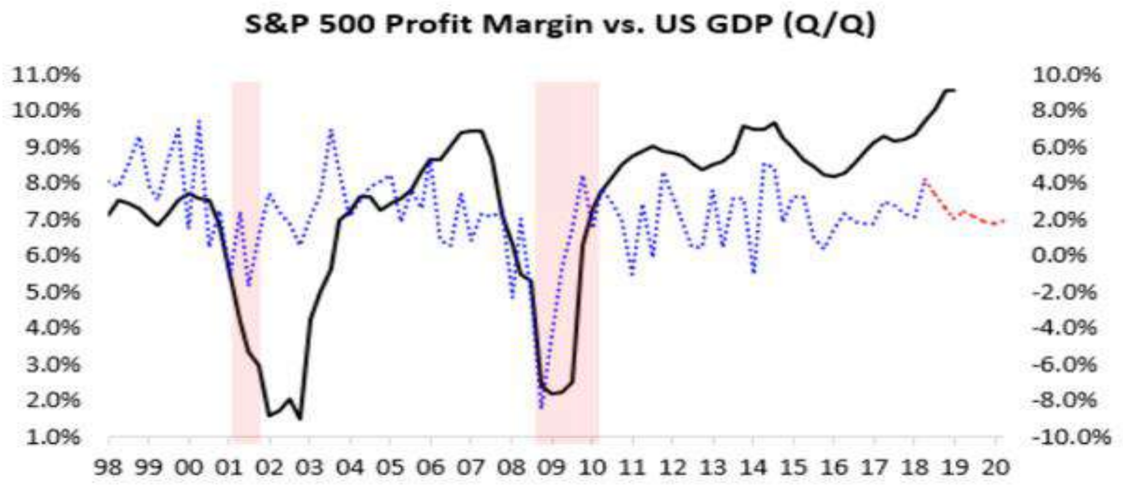


- **<u>Central Banks:</u>** Global monetary policy is set to (gradually) tighten further, this will increase the pressure on the 'weaker links in the chain' and the chance that we see higher volatility. <u>Credit spreads should slowly widen, unhelpful for equity valuations</u>.

  ECB's balance sheet has shrank last month by another 10.7bn€, total balance sheet is however still near record highs for an equivalent to 40.5% of Eurozone Gdp vs Fed's balance sheet that has shrank to 19% of US Gdp.

  Last month, Fed President Williams said that the Fed would consider negative interest rates to combat an economic downturn in the future.

Powell's predecessor Yellen recently said that it would be an attractive option it the Fed could have an expanded QE program to include the buying of stocks and corporate bonds (currently prohibited).

<u>With 74trillion$ of money supply globally and widespread low rates, more than 15 countries with inverted yield curves and 10trln$ of negative bond yields, Central Bankers believe that the solution for the poor macro is.. more liquidity and lower rates.</u>

The <u>BOJ</u> said that it held at the end of December 43% of all JGBs and 77.5% of all Japanese ETFs, is the market for JGBs still a free market? Kuroda a couple of weeks ago mentioned that future easing options will include increasing bond purchases.

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

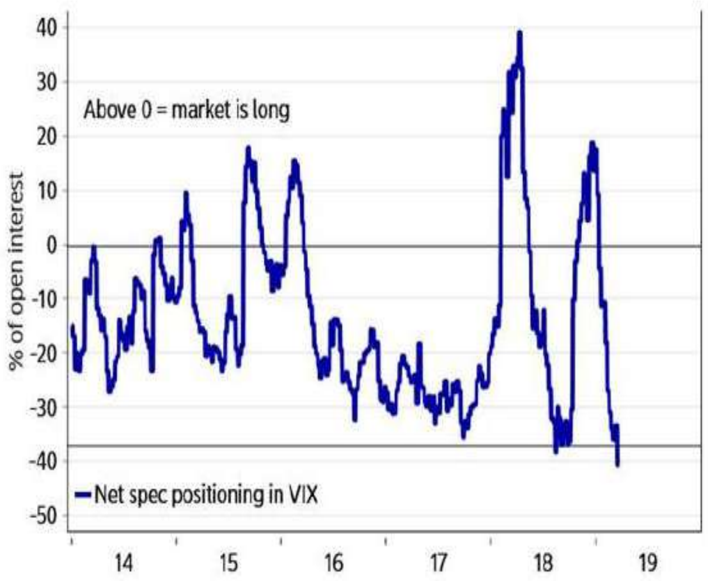
  <u>Short VIX punters are back in force</u>, short positioning is back to the lowest levels seen in May 2017 (heavier than prior to the February and October sell-offs) worthless to say that the correction in February 2018 was enhanced by these short volatility products.

Executive Summary

On Bonds, the Baml MOVE Index, a gauge of implied volatility for US government bonds, fell below it previous all-time low in 2017.

Volatility is low even on FXs, the JPMorgan Fx volatility Index has dropped to the lowest level since September 2014 as the world’s largest economies show signs of slowing and central banks signal caution in terms of their future monetary policy.

Net Speculative positioning in VIX index



Even the volatility on Gold has reached the lowest in several years.

- **Q1 potentially difficult reporting season /margin pressures are continuing to build:** which is perhaps not surprising given that input cost inflation (PPI) has been above CPI for much of the last two years. With labour costs gradually rising and tariffs offering up the potential for higher input costs and supply chain disruption ahead, profitability concerns look set to become more of a focus for investors in the coming months.

  Margin environment is less favourable now.

- **IPOs / Secondary/ Placing:** The percentage of US listed IPOs that lost money in the last 12 months is marking a new record high (83%) exceeding the top reached in the dot bubble, the highest proportion since 1980 when record started.
  Over the last Quarter, a great number of IPOs has been called off and the performance of IPOs and Placings has been dreadful. Not a great sign as it seems that the market cannot absorb any further paper.
  In US, 2019 could prove to be one of the biggest years in record for the amount of money raised in IPOs, the total could possibly reach 80bn$ this year, double the yearly average since 1999.
  As an example, Lyft Ipo opened up 25% on the day of listing (was 20x oversubscribed), the stock was already below the issue price on the following day.

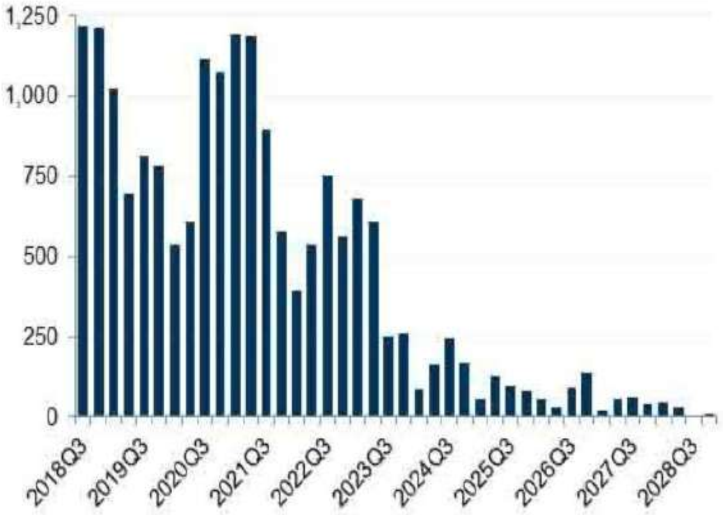
- **Increase issuance on Credit Markets.** Similarly, to the point above, we are expecting a rapid increase in issuance volumes and it will likely put some strains on Credit spreads.

  Overall issuance is already running 22% ahead of last year, and the numbers are particularly strong in the IG market, which is running at over 50% more than last year’s figures, while senior financials are running around 10% higher than a year ago.

Executive Summary

Making matters worse, the <u>bond maturity schedule is staggering with trillions in corporate bonds set to mature in coming quarter</u>, you can see below the situation in China.
Onshore corporate bond maturity schedule in the next 10 years (RMB bn).

Net US Repatriation flow QoQ



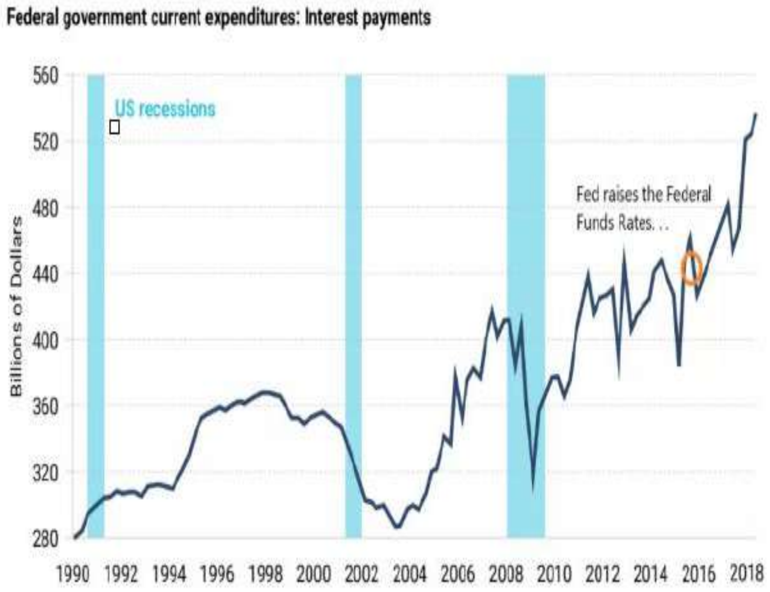
- **Cash Repatriation**: the release of US Flow of Funds for the fourth quarter confirmed our previous assessment that the <u>US repatriation flow practically ended by last summer</u> and that the amounts repatriated during the second half of the year were rather small. Practically speaking. the 2018 US repatriation episode is largely behind us with the cumulative amount repatriated by the US non-financial sector having reached around $430bn, or 21% of the estimated $2.1tr stock of offshore cash.

  <u>The boost that US repatriation provided to US equity and bond market via share buybacks and corporate bond redemptions is going to be absent during 2019.</u>

- <u>**Fund's redemptions:**</u> This year we are likely to see more redemptions following the recent bad performance and high volatility of most of the funds. Considering that markets have now recovered the loss made in Q4, investors will continue the redemption process started in Autumn last year.

- <u>**US government's borrowing**</u> has increased to amounts that it hasn't since the 2008 recession. The <u>US budget deficit is just shy of $700 billion which means a 20% increase since last year.</u>

  Ignoring private consumer debt (which is greatly affected by rising rates), the US National Debt recently hit $22 trillion and the interest payments due on all this debt is at a record high.
  You can see on the chart that since the Federal Reserve began raising rates in December 2015, <u>the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year!</u>



Executive Summary

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!

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.

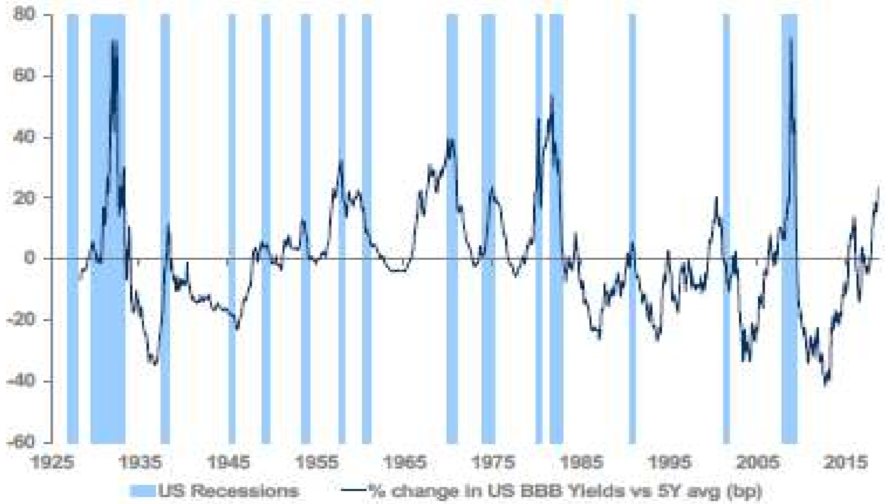
Global debt is not only an US issue, have a look at the chart showing how it has increased in only 10 years around the Globe.

Sovereign Debt in USD

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

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

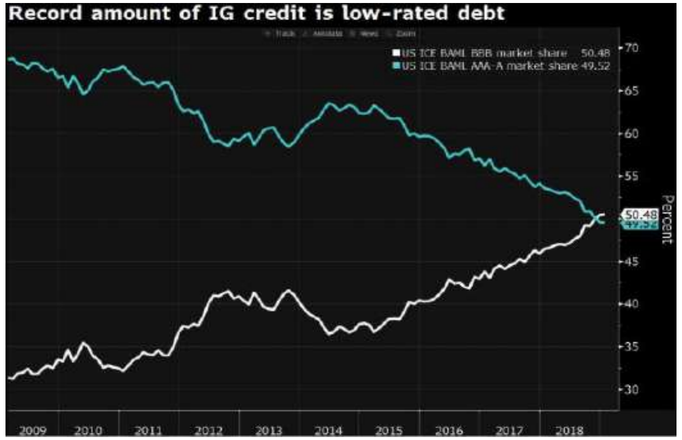
Change in US BBB yields vs 5Y avg (bps)



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

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

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

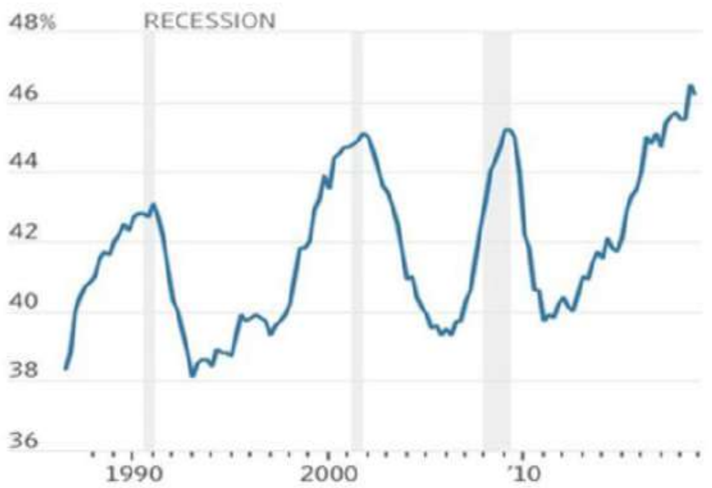


Executive Summary

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

US Corporate Debt vs GDP

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



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.

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

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

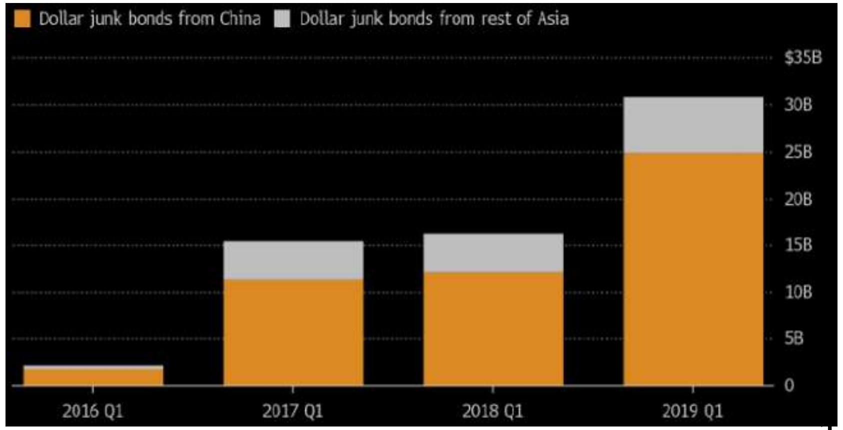
Mutual funds/ETFs have become over 20% of the market and daily liquidity in the event of panic selling will very likely prove theoretical. It is also worth noting that Main Street is increasingly exposed to leveraged loans via mutual fund/ETFs, something that was not the case before the Financial Crisis.

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

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

- **Junk Bonds:** Junk-rated bond issuance has had a solid start to the year, making up close to 40% of all dollar bonds sold in Asia. The proportion is the highest in nine years and indicates investors hunting for higher yields amid a dovish stance by the FED

Dollar Junk Bonds from China (orange)
vs
Dollar Junk Bonds from Asia ex-China (white)



Executive Summary

In Asia, sales of speculative-grade Asian dollar bonds in the first quarter hit a record of $31 billion, almost double the year-earlier period but investors are now "struggling to absorb a veritable avalanche of new issuances.

Chinese companies have missed payments on 26.2 billion yuan ($3.9 billion) of local bonds in the first quarter, almost quadruple the same period in 2018. It was also the third highest quarter for bond delinquencies in China's history

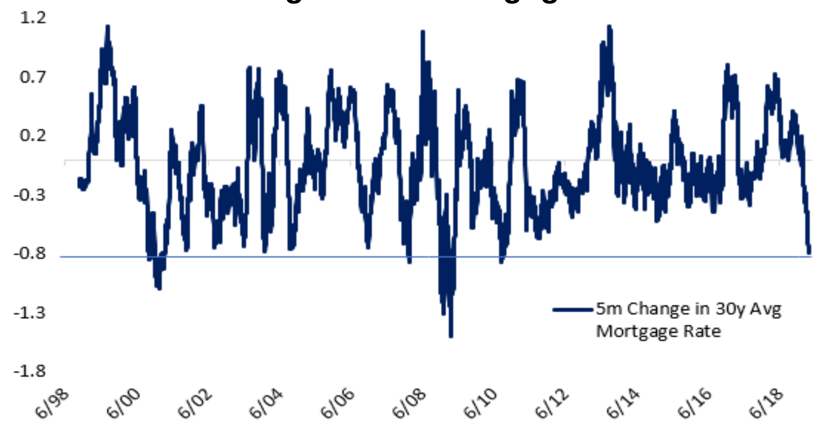
We are in the terminal phase of the biggest debt bubble in human history. In fact, total indebtedness in the United States has increased by more than 2 trillion dollars over the past 12 months.

All of this debt has fuelled a short-term bubble of relative "prosperity" but meanwhile all of our long-term problems just continue to get worse.

Moody's has recently affirmed that "Leveraged loan are in unchartered territory and that's a big risk".

- **Declining US House Prices:** US Housing data are continuing to surprise on the negative side.

5M Change in 30Y Mortgage Rate



Very few regions escaped a significant deceleration with some prominent regions like San Jose (-45%) and San Francisco (-19%) even getting crushed on a year-over-year absolute basis.

Manhattan real estate's sales have been falling for the 6th straight quarter, the longest losing streak in 30 years.

The national average is now down 8.2% YoY.

Pending US home sales tumbled in February, 14th straight month of declines, US housing starts fell 8.7% MoM in March, the biggest drop in 8 months.

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.

It is possibly also because of these data that the Fed stopped the hiking process as we have already a similar housing deceleration and it was in 2007.

Executive Summary

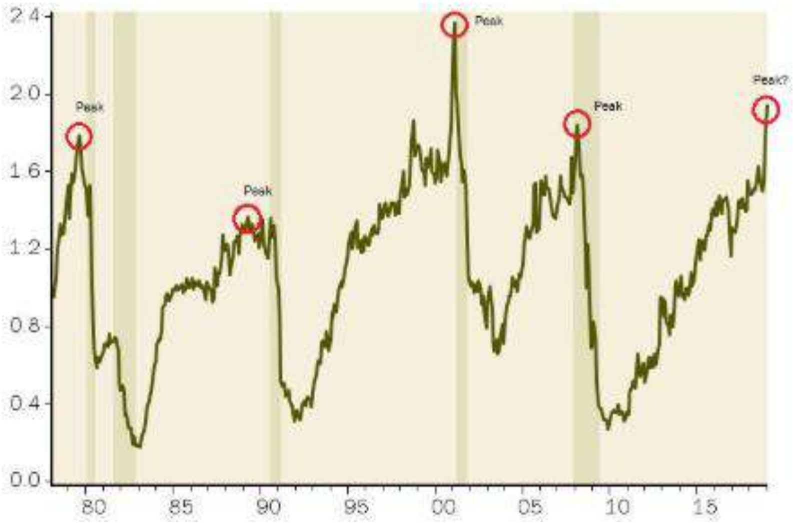
- **Consumer sentiment very downbeat**

Consumer confidence dropped in March for a fifth consecutive month. If you look the chart showing the ratio of "present situation" to "expectations" is a great leading indicator at turning points because it either coincides with the recession or occurs a few months prior.

US Consumer Sentiment

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

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



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

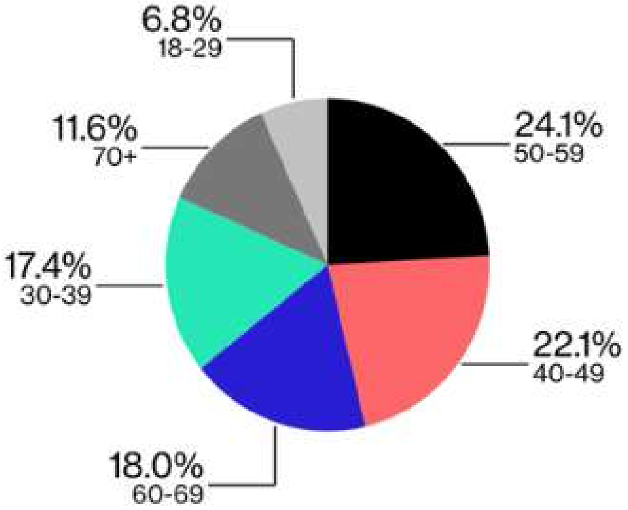
Total US household indebtedness was at a staggering $13.54 trillion in December, $32 billion higher than Q318. Overall household debt is now 21.4% above the Q2 2013 trough, according to the latest quarterly data from the Fed.

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.

Credit card debt by age group

More troubling is that according to the Fed, 37 million Americans had a 90-day delinquent strike added to their credit report last quarter, an increase of 2million from Q4 2017. These 37 million delinquent accounts held roughly $68 billion in debt.

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



Executive Summary

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

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

At the same time, the average car loan payment just hit a decade high at 545$ per month.

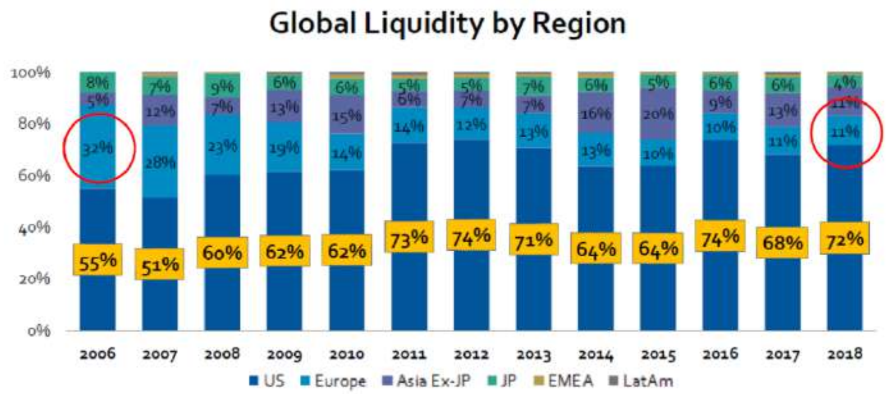
Delinquent US student loans reached a record $166 billion in Q4. But since "delinquency rates for student loans are likely to understate effective delinquency rates" by about half, according to the Fed, the figure is probably a far cry from reality. Factoring for understatement would imply that about $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+ day delinquencies for implied debt in arrears.

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

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

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



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

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

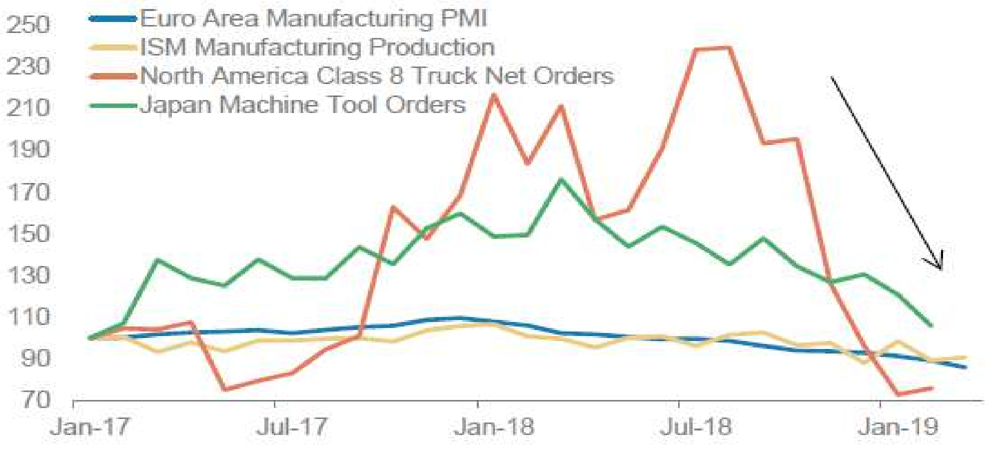
Macro

MACRO

Global growth is now tracking lower at 3.2%Y in Q119, and decelerating from 3.3%Y in Q418. The main drivers of a lower tracking estimate for global growth is because of A) US, impact of the government shutdown and weaker growth data B) India, due to weaker than anticipated growth in Q418, and softer data points in both consumption and exports. Recently <u>IMF cut 2019 global outlook to the lowest since the great financial crisis.</u>

Over the past month, we had mixed data in Developed Markets (Japan continued to surprise to the downside), improving indicators in Emerging Markets (China surprised to the upside with further room for growth). Global growth momentum starts to recover following the H2 slowdown: higher PMIs in all three major regions, China, the US and the Euro area, are leading the global PMI to increase by around 1 point, the first improvement since August. The rise was particularly strong in China, where the manufacturing PMI rebounded by 3 points, the largest monthly gain since 2013.

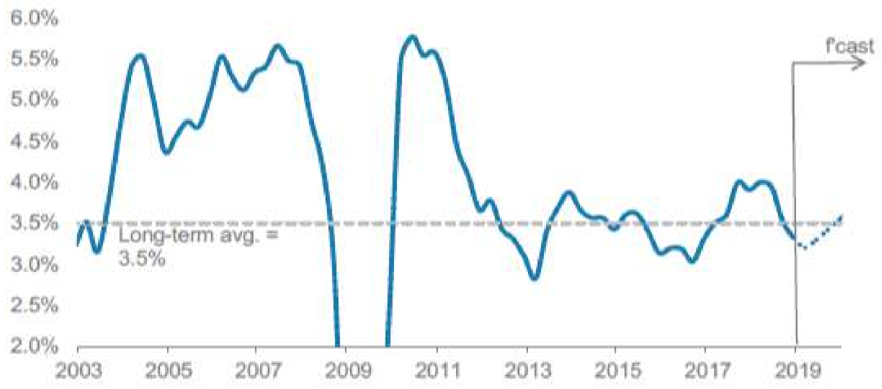
Global data weakness across a wide variety of metrics



Asia volume exports %YoY (blue) vs. Korea volume exports (yellow)

Trade data have weakened sharply

Global Real GDP growth % annualized



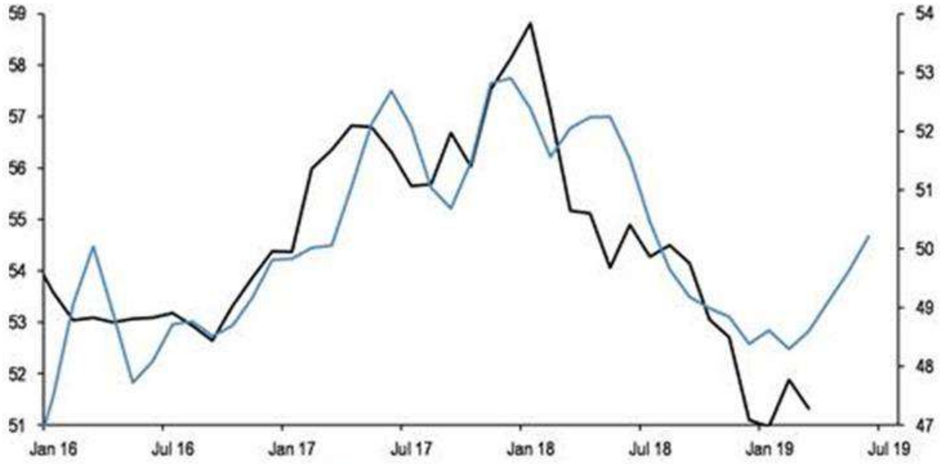
Macro

China

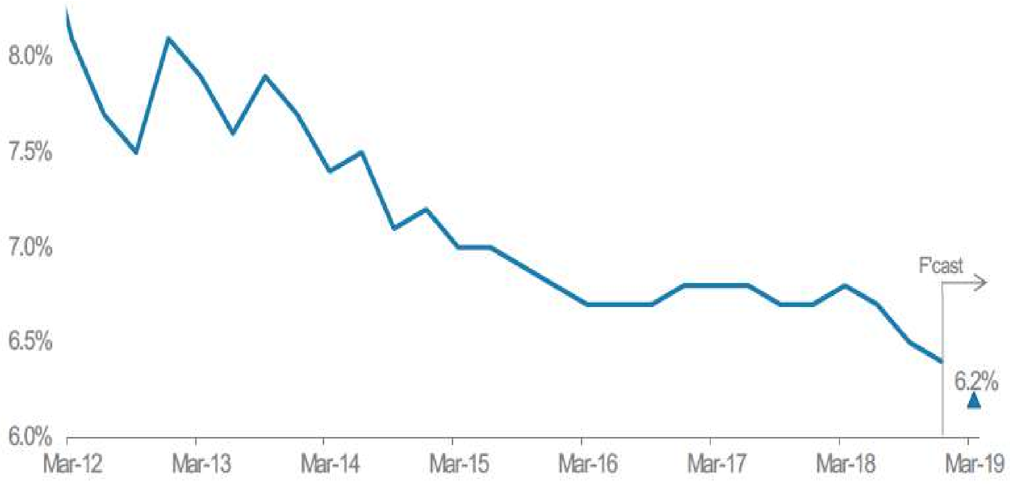
Some improvements in high-frequency indicators from the December lows (infrastructure investments, real imports, fiscal spending etc.) as earlier easing measures start to filter through. The combined January-February broad credit growth marked the strongest rebound in 18 months, expected to reach 12.5% by the end of 2019.

Stronger-than-seasonal rebound in March PMIs, above the 50-threshold in expansionary territory and biggest gain since 2012, leading global markets higher. The key driver was a sharp rebound in production while new orders continued to rise. The street expects April PMI to stay above 50 with fiscal easing kicking in.

Euro area PMI (black) vs. China PMI (light blue)



China real GDP growth (%Y)



Fiscal easing measures have come to fruition as the government announced a reduction in pension contribution ratio and VAT cut, starting on April 1 and May 1 respectively. Augmented deficit should increase by 1.5% of GDP.

Overall the countercyclical fiscal easing effects should support a strong recovery from Q219 onwards, creating some positive spillover effects for the global economy. So far, PMIs for Emerging Markets excluding China improved further after a recovery in 2019. On China, downside risks would materialize if private sentiment does not recover fully and hence the tax cuts do not transmit into higher spending. While the government is increasing spending, via bonds issuance, to boost infrastructure, a sizeable part of the easing manoeuvre is aimed at reducing the burden on the private/corporate sector.

Macro

US

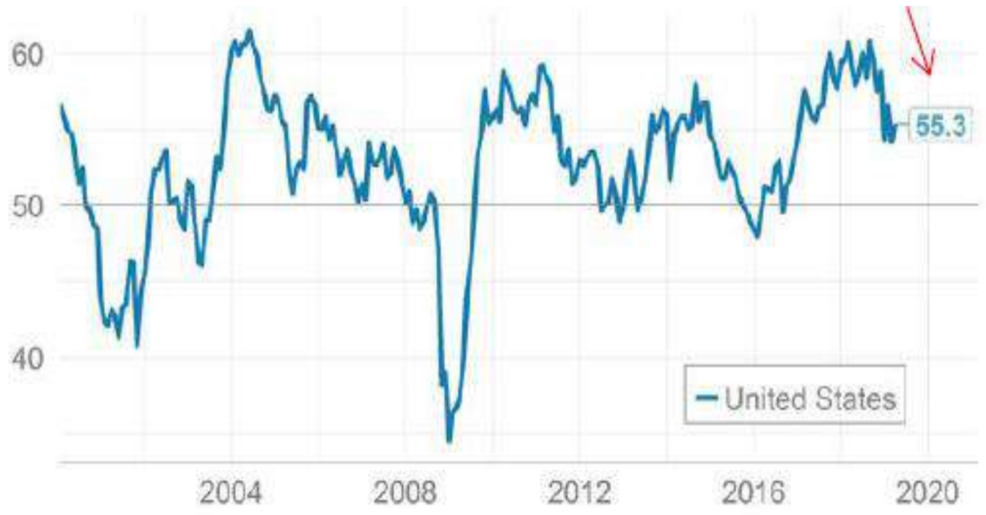
Challenging outlook ahead with a mixed set of data in February and March. Q119 GDP is still tracking weak (street consensus between 0.7-1.3%).

Q418 GDP growth was revised down to 2.2% in the third estimates, largely reflecting downward revisions to personal consumption along with downward revisions to residential investment, business fixed investment and government spending.

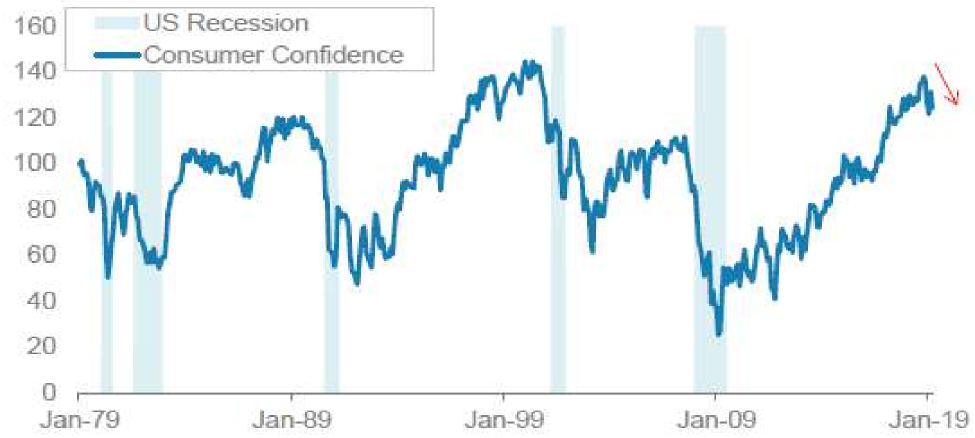
We saw a bunch of weak data in March:

- Empire manufacturing (3.7 vs. 10 consensus)
- Industrial production (0.1% vs. 0.4% consensus)
- Factory orders (0.1% vs. 0.3% consensus)
- Durable Goods ex Transportation (-0.2% vs. -0.1% consensus)
- Manufacturing PMI (52.5 vs. 53.5 consensus)
- Manufacturing Services PMI (54.8 vs. 55.5 consensus)
- Housing starts MoM (-8.7% vs. -1.6% consensus)
- Personal Income/Spending (0.2% vs. 0.3% consensus, 0.1% vs. 0.3% consensus)
- Personal consumption (2.5% vs. 2.6% consensus)
- Retail Sales (-0.2% vs. 0.2% consensus)

US ISM Manufacturing PMI declining



US Consumer confidence shows sign of peaking



Macro

Europe

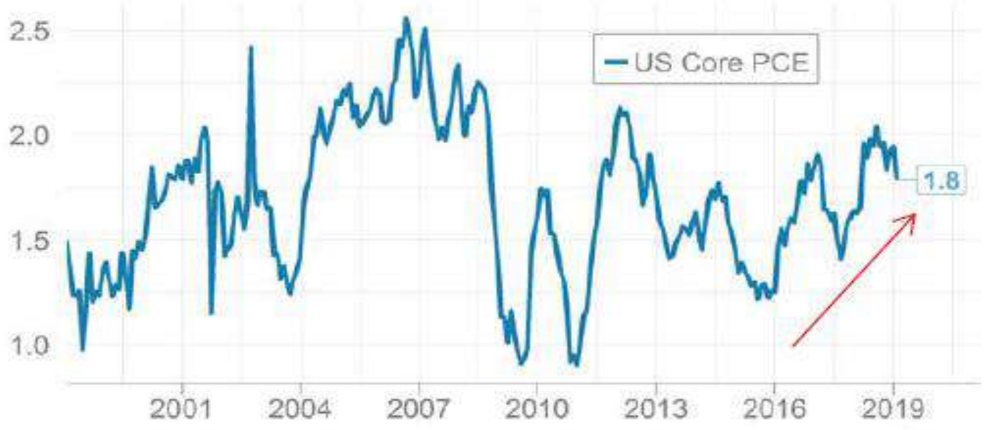
Still worrisome numbers with a very fragile outlook.

SP500 index (blue) vs. US Macro surprises (red)

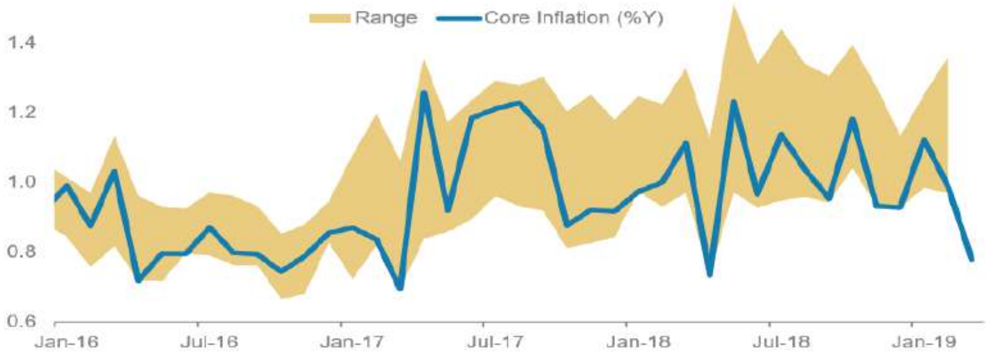
Euro Area Real GDP growth (%Q)

The weak prints in the March Euro area flash manufacturing PMIs, finally revised down, were mainly driven by a meaningful decline in export orders, which investors took as a sign of further weakness in global demand, particularly in China.

US Core PCE still rising on 2-3 year basis



Euro Area Core Inflation (% Y) (blue line)



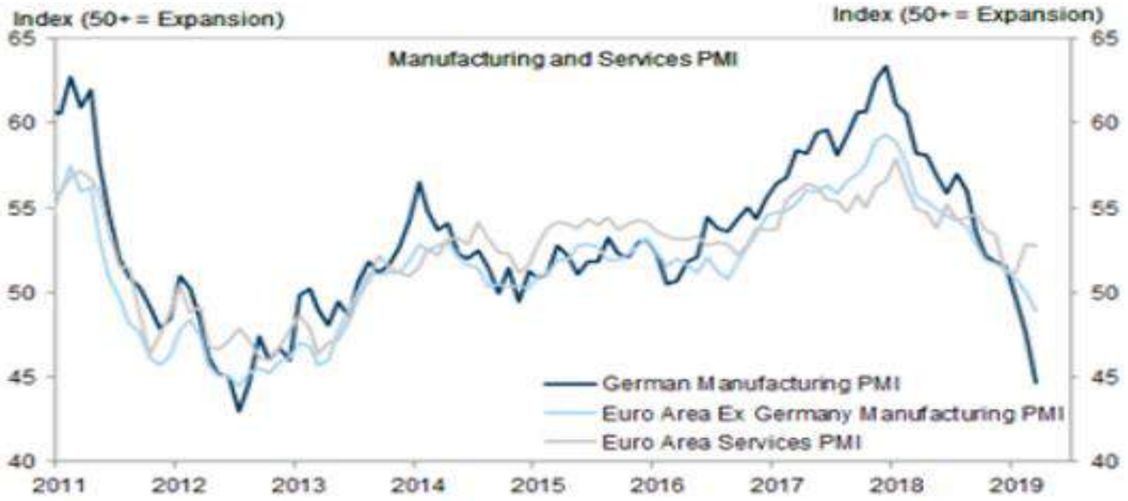
Macro

Key PMIs Numbers:

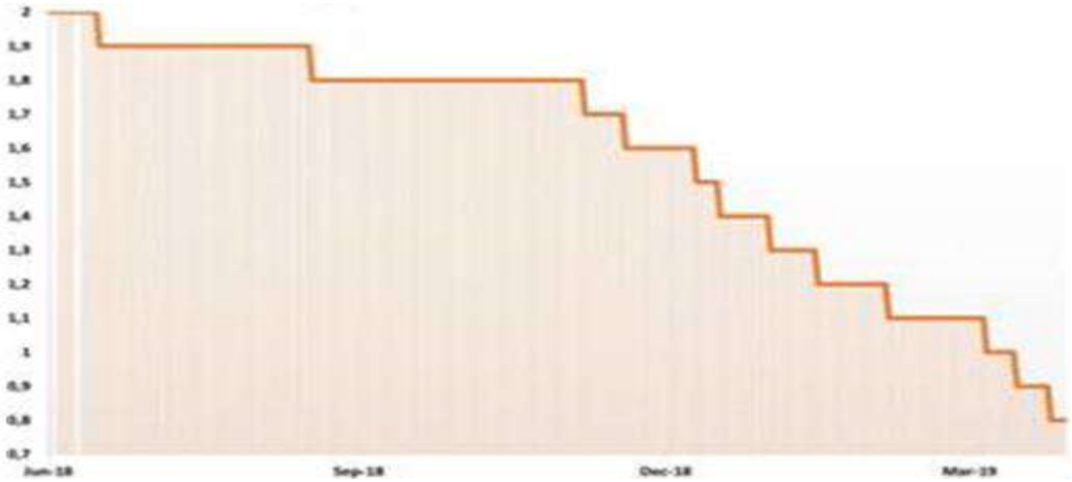
- Euro area Manufacturing PMI (47.5 vs. previous 49.3)
- Germany Manufacturing PMI (44.1 vs. previous 47.6)
- France Manufacturing PMI (49.7 vs. previous 51.5)
- Italy Manufacturing PMI (47.4 vs. previous: 47.7)

German manufacturing PMI was the lowest since 2012, down for the third month in a row. The downturn in demand for German goods continued to be largely driven by a slump in new export orders, which fell for the seventh month in a row and at the quickest rate since 2012. Interestingly, after the German manufacturing PMI collapsed from May to July 2012 to 43, the Dax corrected 10% in the next few months.

German Manufacturing PMI (blue) vs. Euro Area ex Germany PMI (light)



Germany Consensus GDP forecast 2019



Geopolitics / Commodities

GEOPOLITICS

Trade War: US-vs-China talks have yielded some progress, and an epic agreement on some of the toughest point is expected in the next four weeks. Although a partial deal would be critical for the economy/markets ($360Bln total tariffs imposed so far), we believe that an agreement on Technology and IP rights is not likely to be found soon. On the other side, US-vs-Europe relationships have deteriorated after the US is considering imposing tariffs on about $11Bln worth of goods from the EU in response to subsidies that support Airbus. The move would mark a retaliation.

Brexit: As a reminder, the parliament rejected the withdrawal agreement three times so far. Last night the EU has proposed a further extension for the UK to stay in the bloc until the 31st of October. British Prime Minister Theresa May accepted the offer and must now sell it to skeptical members of Parliament in London.

Italy: Budget deficit projection has been increased to 2.4% vs. previous 2%, while growth has been decreased to 0.1% vs. previous 1% this year, according to the Def (Documento Economia Finanza). The markets didn't react negatively to this announcement. But, further out, the risk is that Italy's fiscal weaknesses become a focal point once again. This could happen in the context of the negotiations for next year's budget, which will have to be sent to Brussels by mid-October.

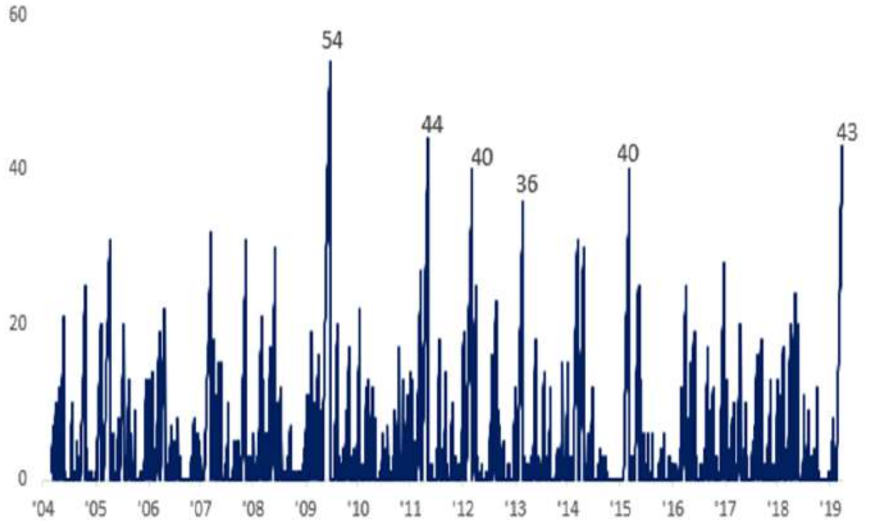
COMMODITIES

Commodities, (S&P GSCI index), are now up 20% year-to-date on a Goldilocks rally, up almost 7% since early March, mainly buoyed by the outperformance of WTI crude and Iron ore. As already discussed in our previous newsletter, we think that commodities have reached a level where they are no longer significantly undervalued against fundamentals. This is the reason why we would have a neutral stance now on commodities as the risk-reward of being long commodities is less compelling than at the end of 2018. It is very important to stress that the next potential upside will have to be supported by better macro and fundamental data, contingent with geopolitics and idiosyncratic risks.

Oil

Oil is still one of the best asset class in 2019 with WTI up 41% YTD and Brent up 32% YTD, its best quarterly performance since the 2009 great financial crisis. In March, WTI and Brent rose as much as 11% and 7%, respectively, after the latest fighting in Libya elevated the risk of new supply outages.

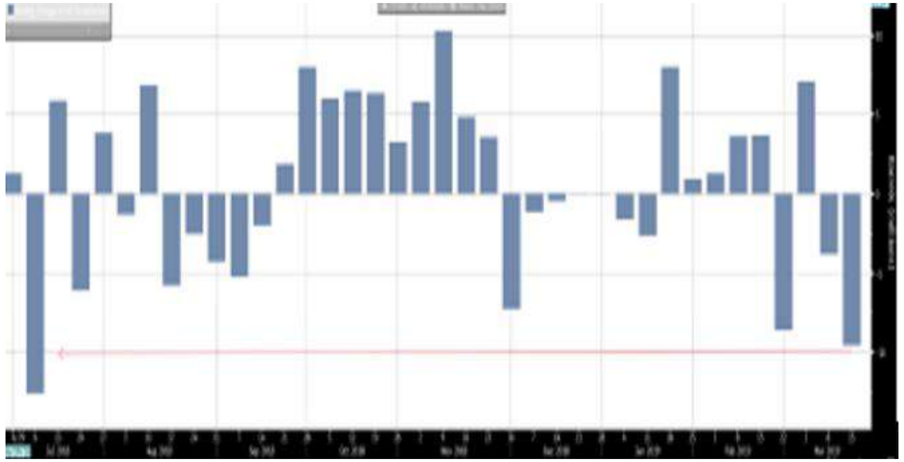
National average price of gasoline: streaks without a decline



Commodities

It is striking to see the number of days without a decline in gasoline prices, moving closer to the second longest since at least 2004. US crude stockpiles unexpectedly fell two weeks ago in one of the biggest drawdowns.

US crude stockpile weekly

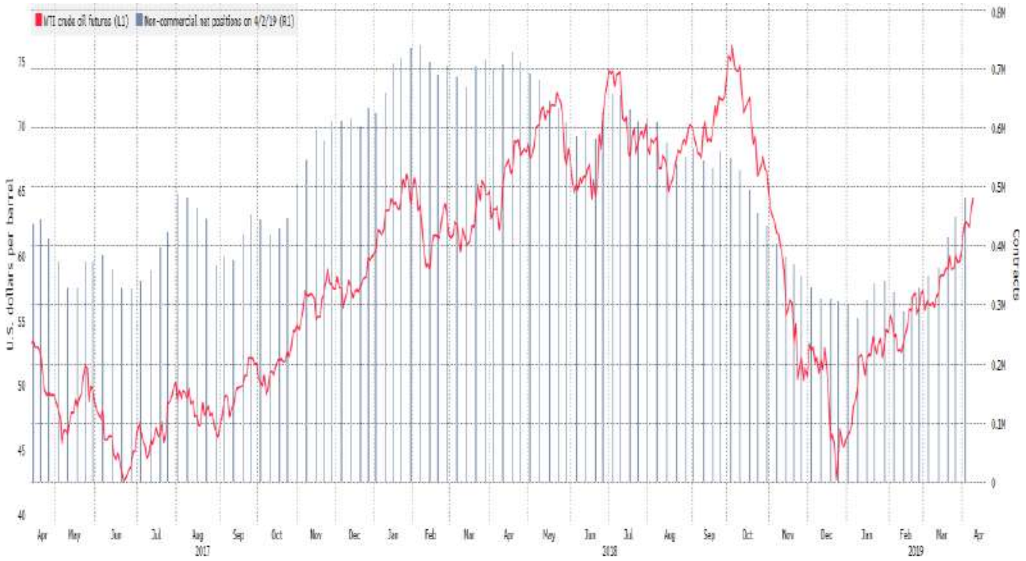


The street in increasingly getting more and more bullish on the asset class for the following reasons:

- Robust demand (EM growth to drive global growth)
- Supportive Fed
- OPEC+ overcutting (Saudi overcutting to continue, seeking to protect a floor of 60$ per barrel for Brent)
- Slowing US shale growth (this is a crucial point, as already mentioned shale gas is a big driver of oil valuations. US shale growth should slow in 2019 to 1.5mbd and further again in 2020 to 1mbd)
- weakening Venezuelan output
- Geopolitics tension

As far as positioning is concerned, Hedge funds are getting more and more bullish on oil. Net speculative long positions in West Texas crude oil futures rose for a seventh straight week, to the highest since October.

WTI crude oil futures (red) vs. oil net positions (histogram)



We are currently neutral on the asset class for two main reasons: A) we still see a mix set of data in Developed Markets in the next few months. B) current momentum is manly driven by sentiment and supply volatility, due to supply losses in Venezuela and Iran while OPEC+ and Canada are curtailing output, rather than fundamentals in demand.

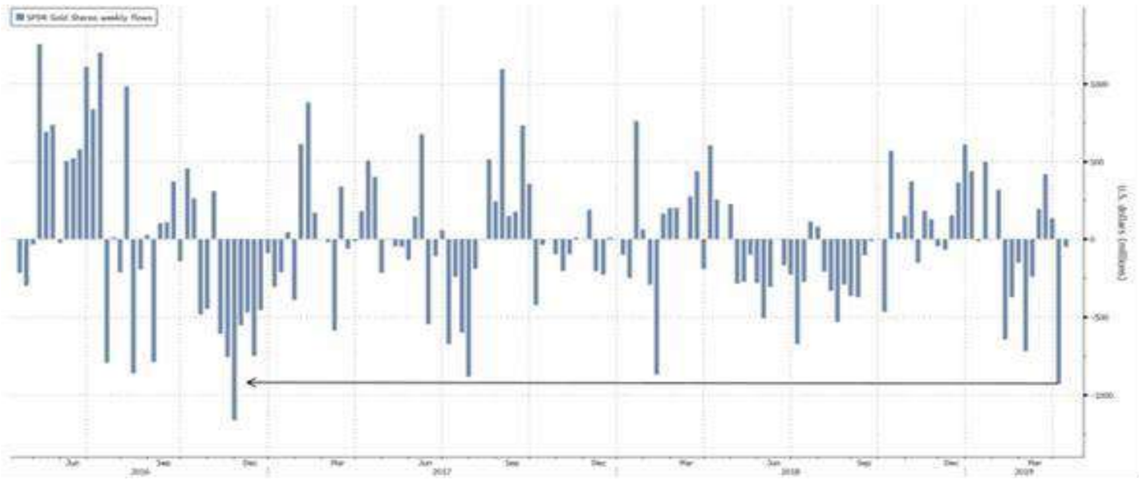
Commodities

Gold

As already mentioned in our previous newsletter, gold is one of our most preferred asset class and a need-to-own in 2019, currently up 1.5% year-to-date, down more than 3% since its February highs.

In its recent downside, a 2.2 z-score number of gold future longs were liquidated while 1.2 z-score number of new shorts were added. In addition, investors recently pulled $927Mln from the SPDR Gold Shares, the biggest outflow from the exchange traded fund since 2016.

SPDR Gold Shares weekly flows



We are currently bullish on the long-term appreciation of the asset class for the following reasons: A) dovish Fed B) global Central-Banks buying C) ETFs build to resume D) seasonality E) demand-supply imbalances.

In a money printing environment, it is crucial to be invested in assets that will retain their value. We think that gold will really start to bounce when the Fed starts cutting its fed funds rates as it happened in 2001 and 2007. It is interesting to see that, historically, the gold allocation is highest when the US yield curve inverts (some part of the US yield curve are already negative).

Central Banks are buying at the highest pace in the last 50 years. The two main players, respectively China and Russia, are relentlessly switching their reserves from dollar and US Treasuries to physical gold holdings.

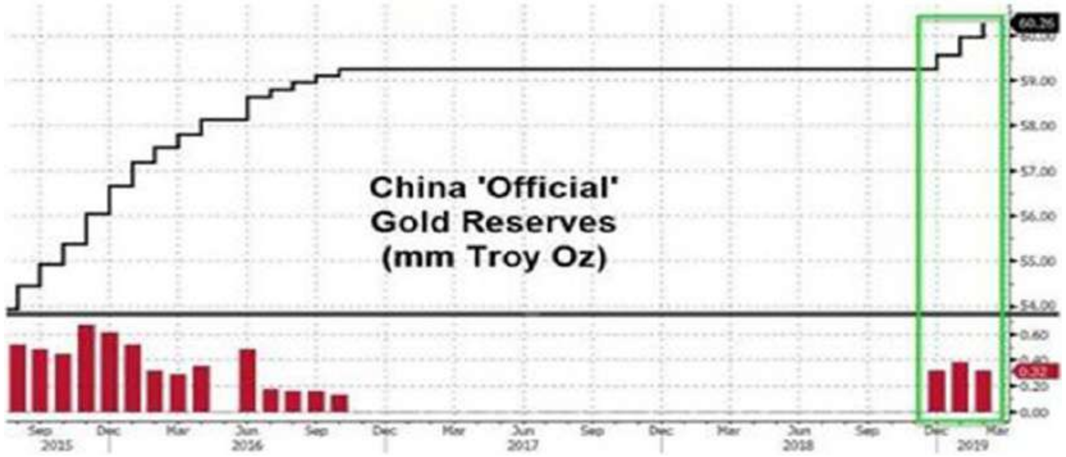
2018 marked the most ambitious year for Russia gold-buying, which coincided with its Central-Bank mass-dumping of US Treasuries, liquidating $ 81Bln in April and May, nearly its entire holdings. This voracious gold-buying behaviour is setting an example for other countries. Interestingly, gold-buying outstripped production in Russia, with gold now accounting for the 20% of the foreign exchange reserves.

Russia gold reserve (brown) vs. US Treasury holders Russia

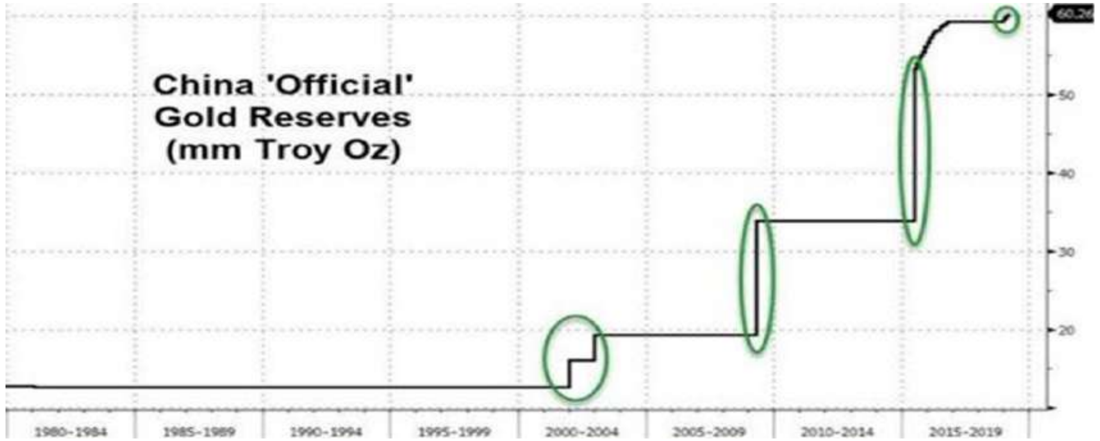
Commodities

After China's official gold reserves rose for the first time in around two years (since Oct 2016) in December, Beijing appears to have joined the global gold rush, increasing its gold reserves for the third month in a row in February to 60.26Mln ounces. The value of the precious metal Country holdings reached US$79.5Bln, increasing by more than $3Bln compared to the end of last year.

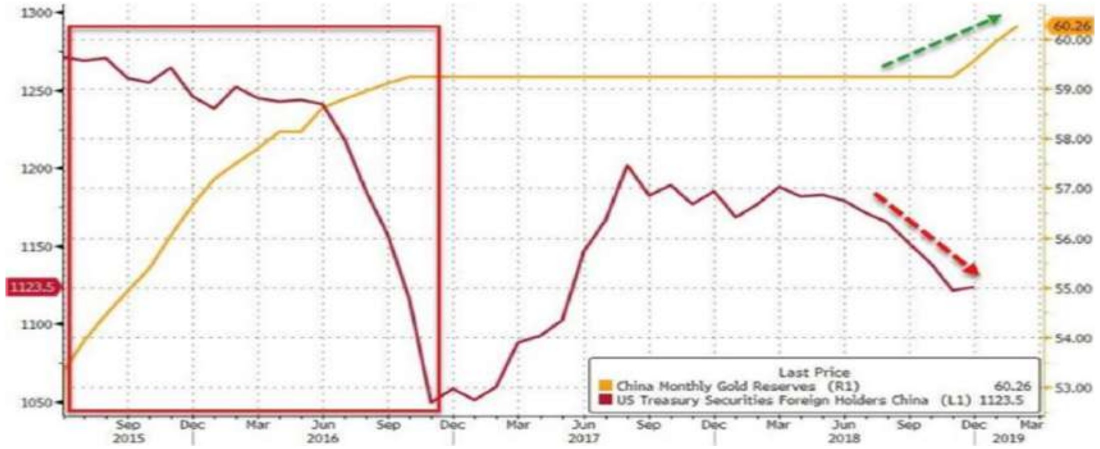
China gold reserve (mm Troy Oz)



Historic China gold reserve (mm Troy Oz



China gold reserve (yellow) vs. US Treasury holders China (red)



Forex

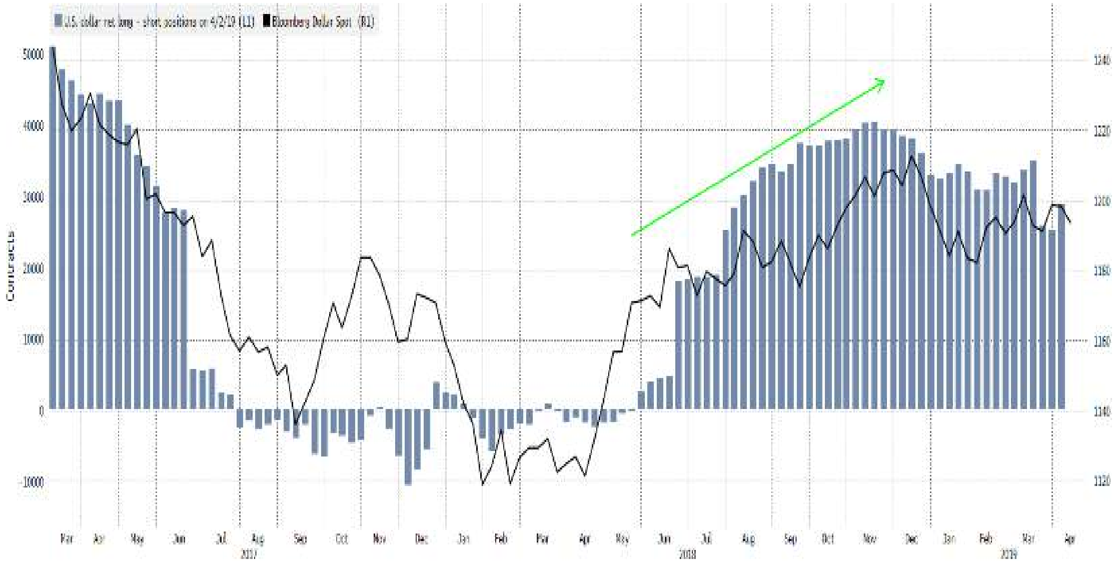
FOREX

<u>The USD dollar index is still trading in a bullish upward channel,</u> swinging range-bound since our last update. As long as it does not break the 1191.61 level, the bullish trend remains confirmed.

Bloomberg Dollar Spot Index (black)

<u>USD positioning consensus is still long USD</u>. The dollar is the highest yielding currency in the G10 with the 3-month LIBOR yielding more than 200bp above the average 3-month rate for other G10 currencies outside the US. This positive carry makes investors reluctant to abandon their long USD positions for more than short period of time. And this backdrop appears unlikely to change in the near term until either the Fed starts cutting rates or markets see a prospect of other DM central banks raising rates, eroding the dollar’s carry advantage.

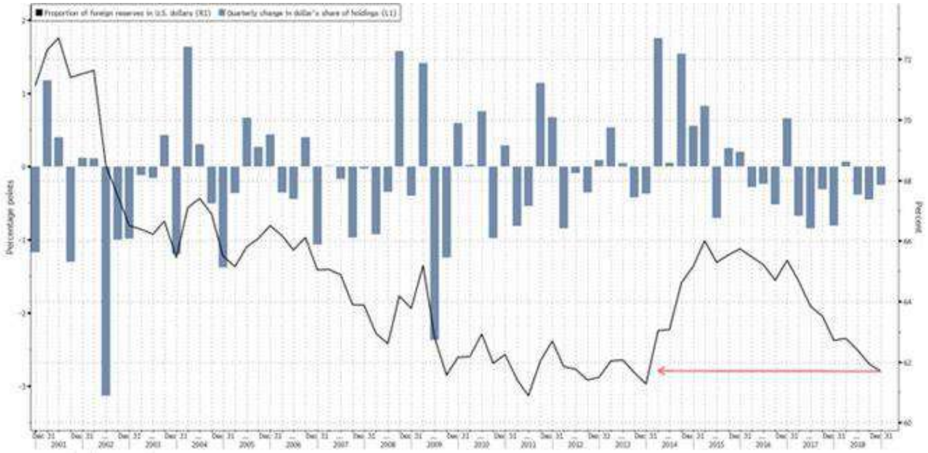
US dollar net long-short positions (histogram) vs. USD index (black)



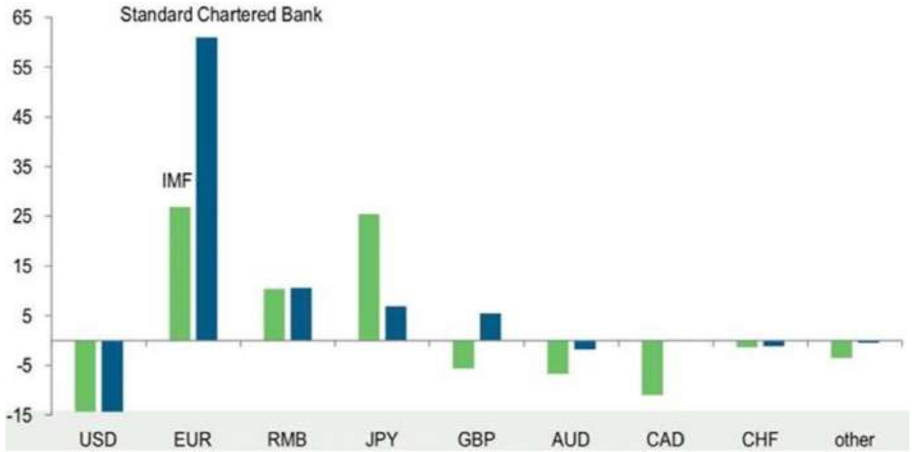
Interestingly, Central Banks are slowly dropping the USD as a reserve currency, with 62% of their allocated currency reserves in the greenback at the end of the last quarter, a declining trend, close to a five-year low.

Forex / Current Ideas

US dollar foreign reserves (black) vs. US dollar holdings change (histogram)



Q418 changes composition currency reserves



CURRENT INVESTMENT IDEAS

Call replacement on single names/sectors

We would advise trying to get advantage of the low volatility and replace some of the single names with Calls.

Long Put spread on Indexes

It has never been this cheap over the last 2 years to protect the portfolio through some Put spreads on Indexes.

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.

A similar idea would be achieved through the long spread of Bund vs BPT in Italy. The spread has tightened considerably since the beginning of the year but unfortunately the Economic and Political news are not having a great momentum on Italy.

We believe there could be a new widening of the Italian spread vs German Bund.