Monthly Market Update

Monthly focus on the financial markets

11th July 2018

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Market Analysis

Rising inflation levels and global trade tensions increase the tail risks to global economic growth. Macro slow-down fears, late cycle dynamics and potential EU retaliation for Trump's tariffs, prompt greater caution from investors. Thankfully, earnings are around the corner, with the season kicking off on Friday in US. We expect SP500 earnings to growth at 20% YoY, less than the previous quarter, but still decent considering the latest events.

Since our last update (12th of June), European Equities (Dax worst performer at -3.0%) were in line with Dow Jones Industrial (-2.5%) outperforming Asian Equities (Nikkei -4.1%, Shenzhen -9%), with China suffering from the seventh straight week of losses and the longest falling streak since the start of 2012.

The "short trade" was painful for Hedge Funds in June as Long/Short Hedge Funds underperformed against High Short interest names, currently up 15% since early May and 7% MoM (short squeezing).

Despite a significant decrease in SP500 futures volume, at its lowest level year-to-date, the future to cash ratio increased by 12X in June vs. the 3X rolling average. Since our last update, we are still concerned about rising correlations and shrinking liquidity across asset-classes.

SP500 Futures Composite Volume Index

Market Analysis

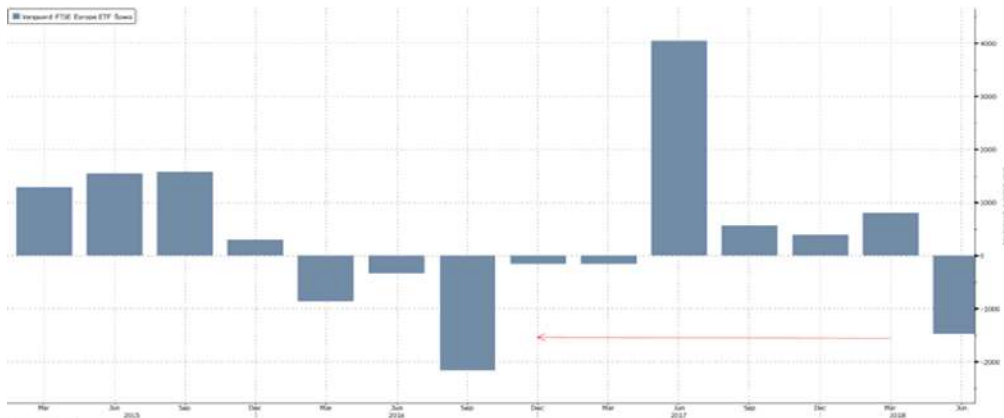
Risk-off mood overcomes financial markets in June; US Equity ETFs and Mutual Funds suffered the harshest withdrawals ($36 Bln outflows) since the peak of the 2008 Great Financial Crisis while both Europe, 17th straight week of Equity outflows with $24 Bln, and Emerging Markets, 7th straight week of Equity outflows with $13 Bln, continued to struggle. We saw a massive de-risking in Asian Equities, the 3rd largest since 2002, after the 2008 crisis and the 2015 China-led sell-off, and twice as big as the 2013 taper-tantrum. As momentum-chasing money largely exited the market, fund managers remain under-exposed to Asia.

As far as Fixed Income is concerned, we saw significant redemptions from High Yield funds, 34th consecutive negative week with the strongest intensity within 4 months, and EM debt (10th straight week of outflows with the largest magnitude since 2016 US elections).

In US, FAANG (Facebook, Apple, Amazon, Netflix and Google), 50% contribution of 3% year-to-date SP500 return, have a large exposure to the global trade war; China accounts for the 21% of Q2 Apple's revenues. As we approach the Q218 earning season, several risks arise from this sector such as high valuations, lack of material earning upside and high sector positioning. As a reminder, the Tech trade is strong enough to drag the market down.

US volatility index dropped from 20 to 12 points in Q218. Hedge funds are holding the most number of short positions on the CBOE Volatility index since late January, just before the VIX record-spike wiped almost $5 trillion in market cap. In addition, we saw more Gamma sellers than in the whole 2017. As mentioned in our last update, volatility calls for caution as we believe a new flash crash might be around the corner.

Vanguard FTSE Europe ETF flows



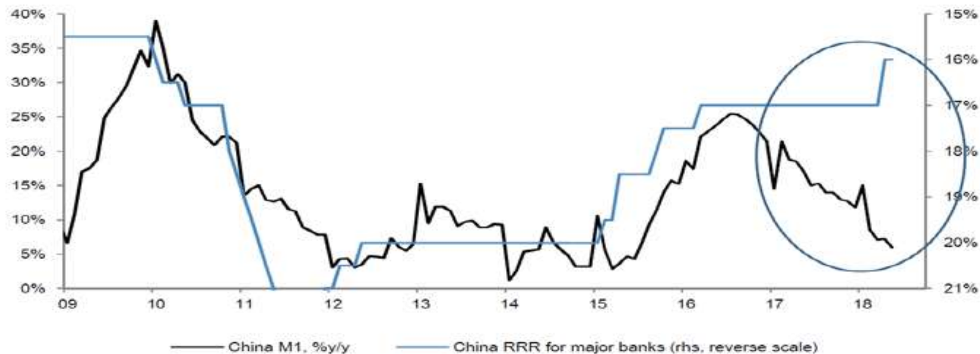
Net non-commercial positions CBOE VIX futures

Geopolitics/ Macro

Trump's controversial **trade tariffs on Chinese goods** have come into effect. The 25% levy on 818 Chinese products, worth a total of $34 Bln, kicked in on the 6th of July. China has retaliated by imposing a similar 25% tariff on 545 US products, also worth a total of $34 Bln, just before US threatening a second tranche of tariffs worth $16 Bln, on 284 Chinese goods, which would bring the grand total at $50 Bln. As of yesterday night, US listed up to $200bn worth of additional products it plans to place tariffs on as soon as September. As China is set to further retaliate, Trump is threatening to ratchet tariffs up onto a total of up to $650 Bln of Chinese goods. **Trade risk is real now.**

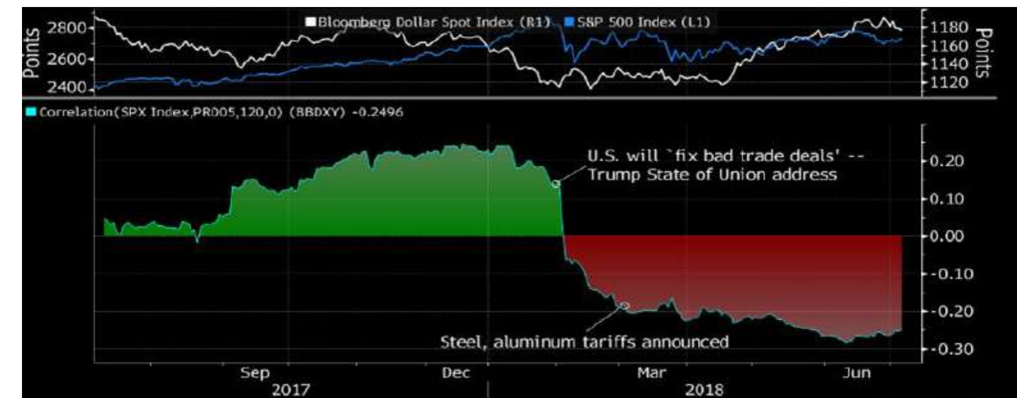
Chinese Equities are down 15% year-to-date, one of the worst-performing markets in the world. Similar to the 2015 crash, currency depreciation seems to intensify the sell-off. Renminbi continues to depreciate against the dollar despite PBOC officials' efforts to stabilize it. We believe the recent CNY depreciation is not used as a countermeasure against trade measures. Actual policy easing should ignite growth in the short run (chart shows the breaking correlation between Chinese M1 and inverted RRR).

Correlation China M1 vs. Inverted RRR (chart)



The correlation between the USD and the S&P500 has become negative as soon as steel and aluminum tariffs were announced.

Correlation USD spot index vs. SP500 index



Brussels is currently dealing with the world's leading auto exporters, such as US, South Korea and Japan, to prevent a global trade war. We expect an escalatory cycle of protectionist actions, not just rhetoric. Thus, even a minor trade event or statement is likely to weigh on markets.

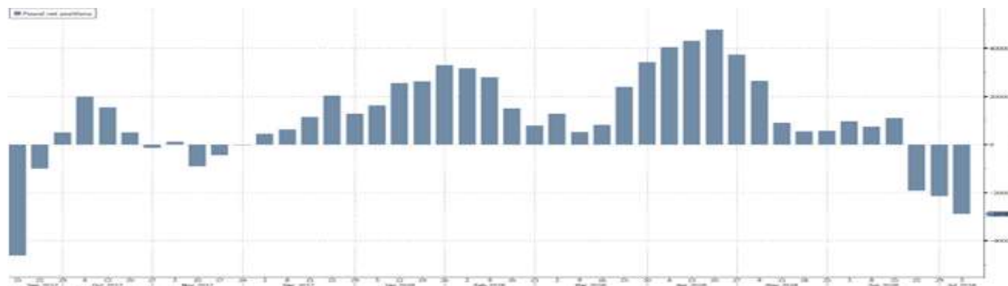
Geopolitics/ Macro

In **Europe**, populist movements continue to increase consensus due to immigration issues. While extra-EU immigration is in focus now, both Brexit and EU labor mobility disputes suggest the distinction between intra- and extra-EU immigration is definitely less clear than assumed.

We believe EU populations composition changes through cohort effects ,notably in Germany and Italy, have the potential to further exacerbate these concerns. European elections, due in 2019, are the next significant event in this contentious political debate.

In UK, Brexit Secretary Davis, responsible for divorce talks with EU, and Foreign minister Johnson have resigned last Monday after the government decision to push for a softer Brexit (the 1st time two Cabinet Ministers have resigned within 24 hours since 1982). May's cabinet is currently working on a UK-EU free trade area agreement, which establishes a common rulebook for industrial goods and agricultural products. Financial services should have limited access to the EU single market in exchange for more regulatory freedom. In the end we expect agreement on a mixed Brexit deal, since it is better for both parties than a no deal and reflects a divided UK public opinion. But the road to the deal will be bumpy with further UK concessions likely needed to close the deal. Hedge funds managers have turned more bearish on sterling.

Sterling Net short positions



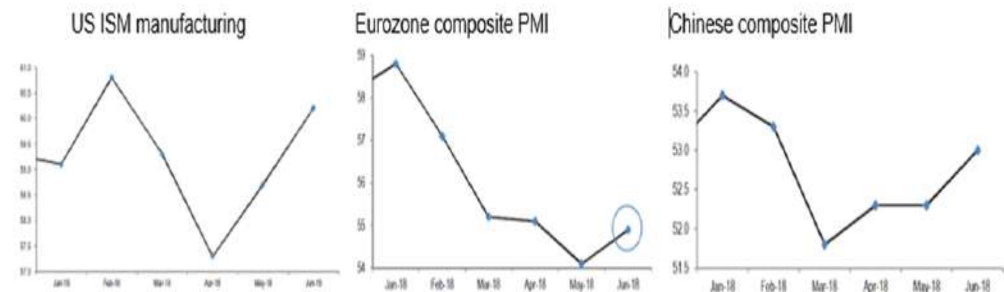
In **Italy**, we had a poll this week showing that 74% of Italians wants to stay in the Eurozone and the electorate of Lega and M5S wants to stay in the Euro is 63% and 68% respectively. Probably the scare on the bond market at the end of May played out.

As far as **Macro** is concerned, the global economy has exhibited its strongest two years growth since 2011, with extremely accommodative monetary policies bearing fruits. Despite a deceleration in consumer spending activity, we believe that strong fundamentals point to a rebound into H2.

Trade concerns have overshadowed the latest improvements in economic growth. Along with better US and Chinese data, Eurozone PMIs are inflecting higher.

European PMIs have stabilized in June, following 4x sequential monthly declines through February to May. The Eurozone composite gained 0.8pts (to 54.9), driven by services (+1.4pts to 55.2) and strength across Germany (+1.4pts), Italy (+1.0pts) and France (+0.8pts). This level of PMI is consistent with c.2.3% Euro area GDP growth.

Leading Macro Indicators



Geopolitics/ Macro

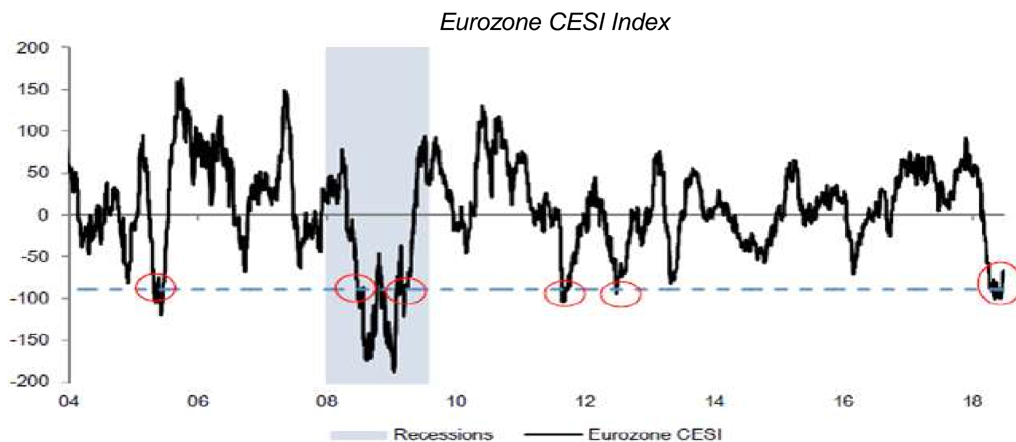
In US, corporates are producing high levels of cash flows, supported by fiscal expansionary policies. Capex and depreciation ratios are closer to the start rather than to the end of the cycle levels.

Consumers are seeing strong labor markets, increasing wages, rising house prices and record high consumer confidence. Inflationary fears has subsided as suggested by the latest mixed US Payroll data. In addition, the economy is less geared now.

There are signs of a bounce in retail sales and capex orders, as well as in Eurozone PMIs and Euro CESI, which recovered by 40 points.

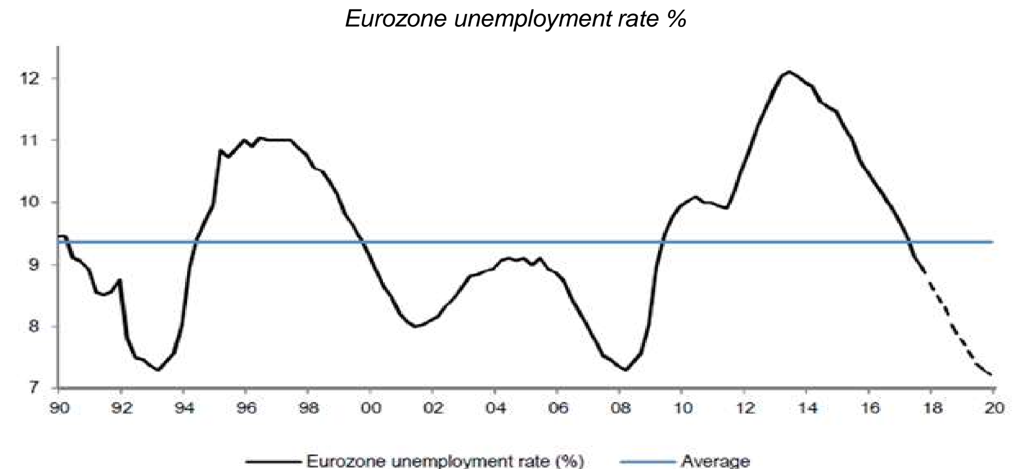
The Eurozone CESI index is recovering from its lowest levels since 2008.

Eurozone CESI Index



The Eurozone labor market is tightening, there is less slack in the economy and the unemployment rate is well-below the multi-year average.

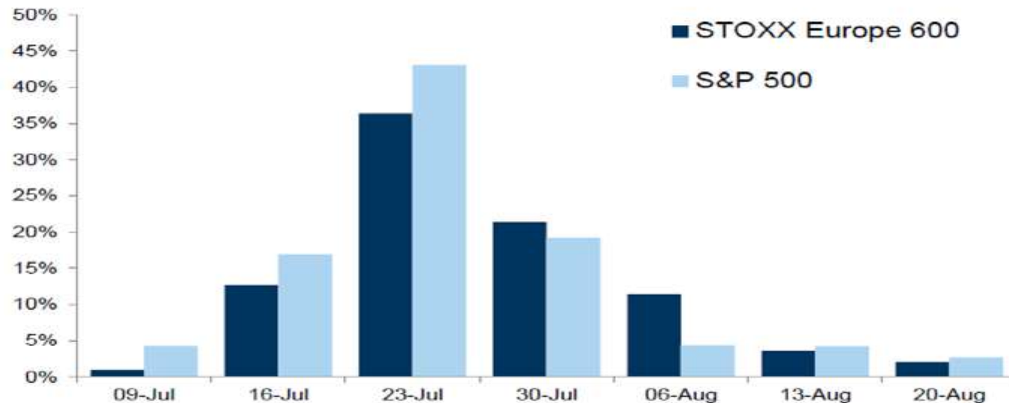
Eurozone unemployment rate %



Earning Season

In US, the earning season kicks off on Friday with Europe following the week after. 472 companies of the EuroStoxx 600 are set to report by mid-August (roughly 85% of market cap).

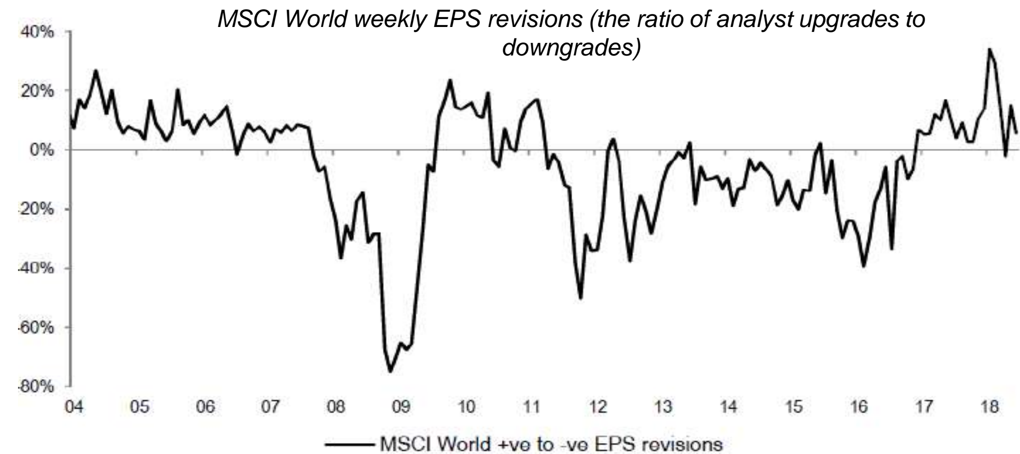
Market Cap weighted earning release distribution in Europe vs.US



After two strong quarters, earning expectations are less bullish with no consensual positioning to create further positive surprises during the current season.

We expect positive EPS revisions in US and Europe.

MSCI World weekly EPS revisions (the ratio of analyst upgrades to downgrades)



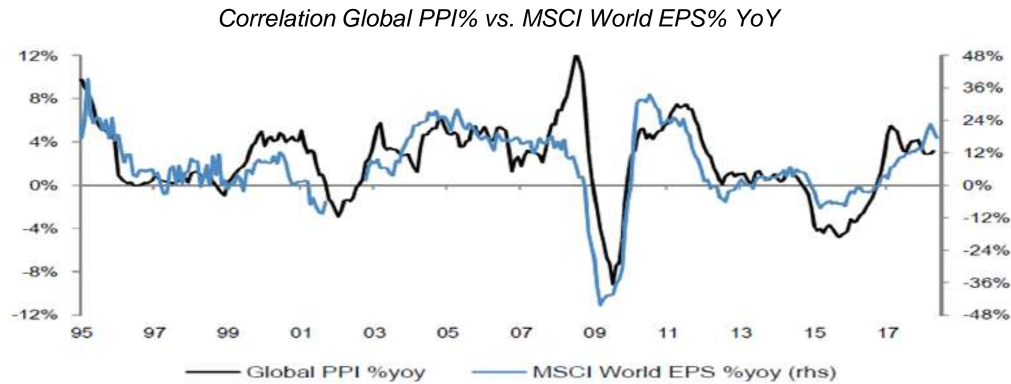
In Europe, consensus expects earnings to increase by 11% YoY and sales 3% YoY, with large contributions from Oil&Gas, Consumer Goods and Basic Materials, tough nearly all sectors are forecast to grow YoY.

EUR and GBP depreciation versus USD, should provide some FX tailwinds to earnings, even if the move has been lower in trade-weighted terms. Higher oil prices, along with structural changes in the industry, should strongly support oil-sector earnings.

Earning Season

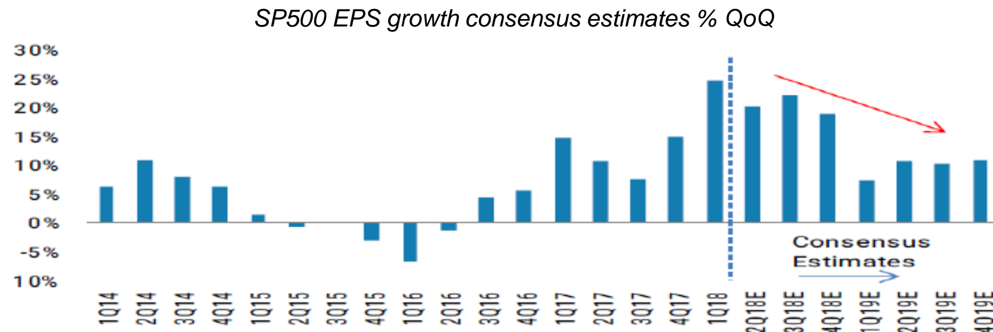
Rising inflation should offset any pressure from rising wages at corporate level.

Correlation Global PPI% vs. MSCI World EPS% YoY



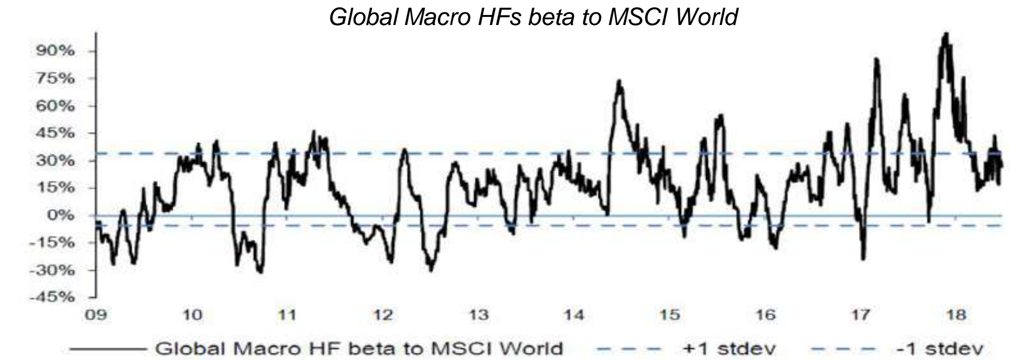
As earning expectations continue to increase, there is room for downward revisions, earnings are likely to be strong in Q218 but the general trend is decreasing, especially in US.

SP500 EPS growth consensus estimates % QoQ



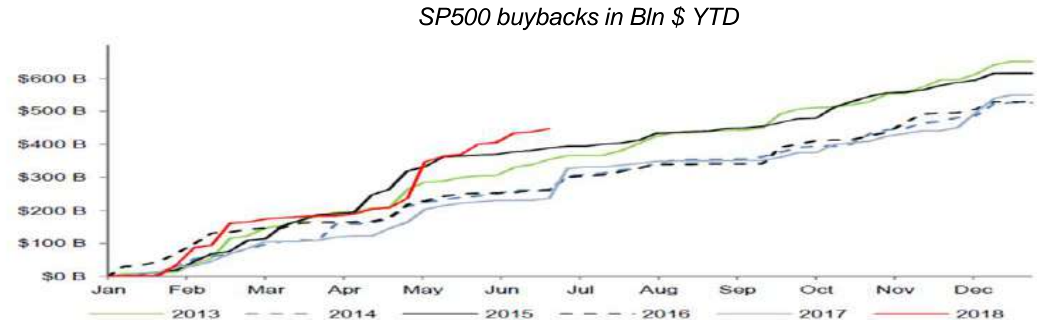
<u>In terms of positioning, investors have further cut positions</u>. Hedge Funds beta, not stretched anymore vs. end of January, has moved lower since the beginning of the year.

Global Macro HFs beta to MSCI World



US record corporate buybacks in 2018 year-to-date, supported by strenght in Tech and Energy. We are on track to beat the previous 5 years.

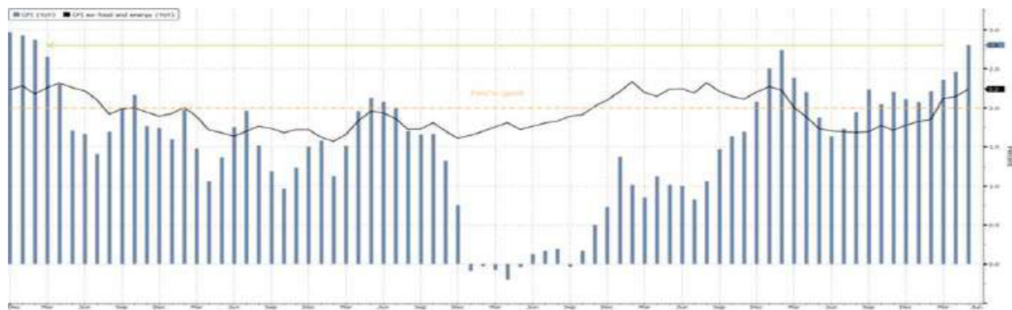
SP500 buybacks in Bln $ YTD



Inflation/ Yields

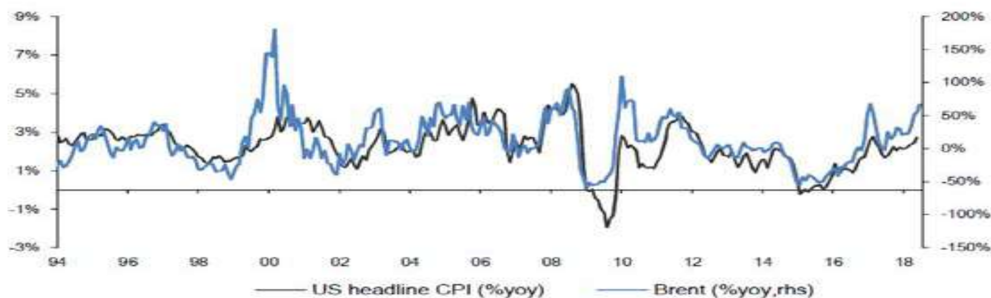
Inflationary pressure continues to intensify in June with input cost accelerating due to higher raw materials and interest rates and rising energy prices (Crude up 64% YoY). In US, the producer's general price level is rising at the fastest pace since 2012, supporting the FED's outlook for a gradual increase in rates.

US CPI YoY (blue line), US CPI ex food/energy YoY (black line), FED's target (amber line)



In US, the strong correlation between oil prices and CPI suggests further upside.

Correlation US headline CPI vs. Brent YoY



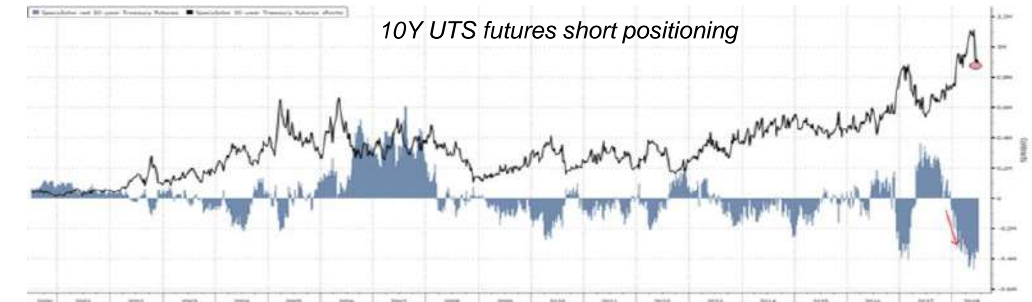
In Europe, inflation is rising at a slower pace, CPI at 1.1% YoY, below the levels seen during the 2008-13 patch. We expect to see inflation convergence to the 1.4% long term average.

Eurozone core CPI YoY

US interest rates reversal is almost done, (correctly predicted), as in Feb/March.

In terms of positioning, net 10Y Treasury futures (blue histograms) and Treasury futures shorts (black line) have reached a new all-time record high!

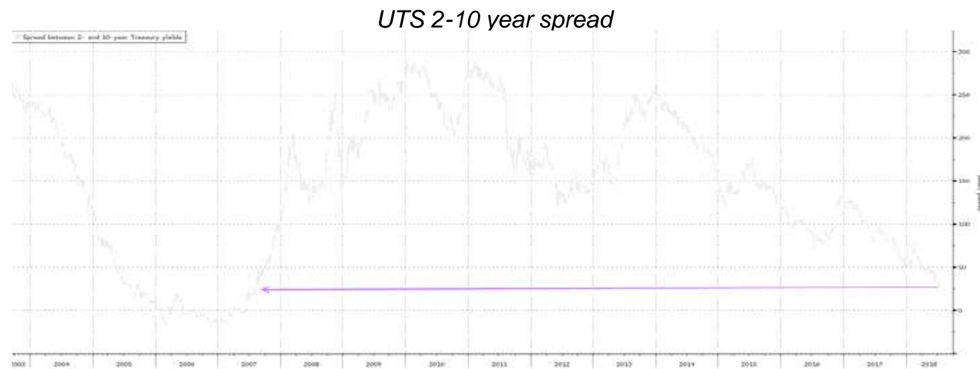
10Y UTS futures short positioning



Yields/Central banks

Since the market expects the **Fed** to hike four times in 2018, an extreme 2-10year curve flattening, currently at 30bps the tightest since July 2007, is likely to occur, ending largely flat by year-end. As a reminder, an inverted curve usually leads to a recessionary period. The combination of a geopolitical shock along with a flat yield curve makes the contraction in economic output even worse.

UTS 2-10 year spread



As far as Central banks are concerned, the Fed was more confident in June about near term growth and inflation, providing hawkish economic projections. As largely priced in, the federal fund rate was raised by 25 bps, swinging now between 1.75-2% range. As mentioned trade risk has risen. However, most partecipants believe the fiscal expansionary policy might offset the global trade threat. We then expect a slighty faster pace of normalization in 2018/19 with the next two hikes expected for September and December.

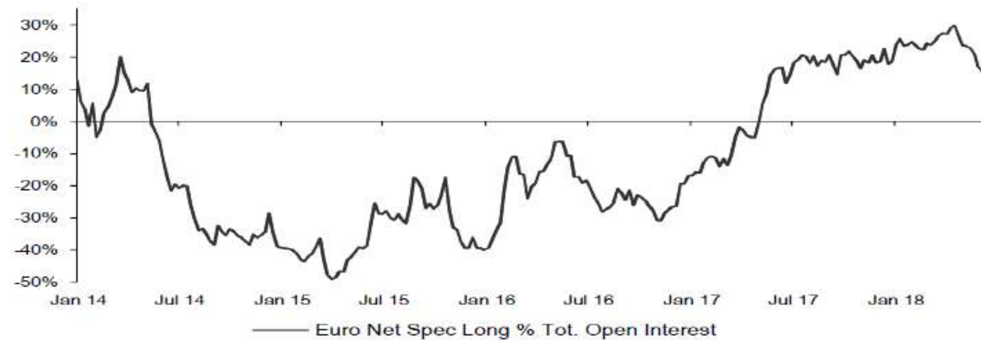
Some **ECB** news suggesting a December 2019 interest rate increase might be too late pushed the September 2019 hike probability up to 80% from 70%. Draghi mandate terminates in October 2019. Notwithstanding, the policy should remain accomodative for a prolonged period of time, due to mixed economic data, in order to facilitate a more self-sustained uptrend in inflation. QE is set to terminate at the end of the current year with the ECB mantaining an ample degree of optionality.

Brexit is real. The **BOE** has several difficult tasks to deal with, and both some hawkish comments from Carney and improving economic data, suggest we might see an early interest rate hike in August.

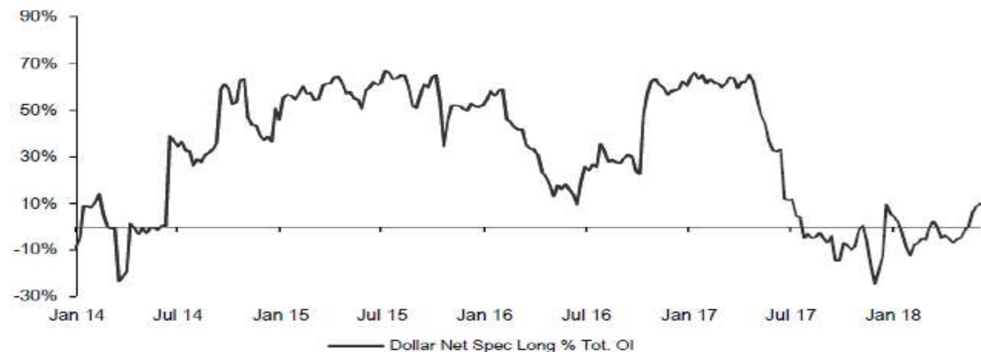
EUR/USD

DXY, dollar index, slightly appreciated since our latest update, trading sideways in a narrow range. Given an overwhelming Euro currency bullish consensus at the start of 2018, we saw a significant, still ongoing, Euro positions unwinding.

Euro currency net long positions % open interest



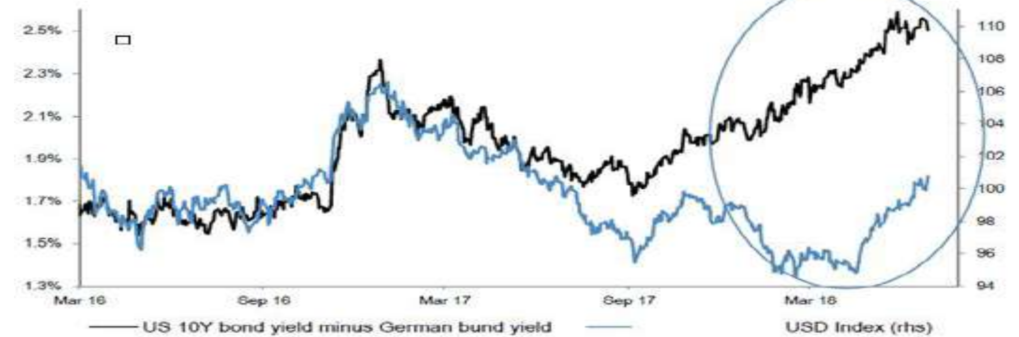
USD currency net long positions % open interest



We expect the USD to strenghten in the short-term.

The US-German 10-year interest rate differential points to further upside for USD.

US10y bond yield minus German bund yield vs. USD index



The German-led improving Eurozone current account surplus, along with the QE tapering are set to increase Euro currency over the long-run. In addition, a rising US budget deficit, following the adoption of the latest tax bill, might put further pressure on the dollar index.

China has a strong interest in a weaker dollar due to the currency effect on its growth and Emerging market. Now as the USD turns around, China might moderate CNY currency strength somewhat. Hower the resilience of China economy to tighter monetary conditions has been striking with corporate cash reserves acting as a buffer.

Commodities

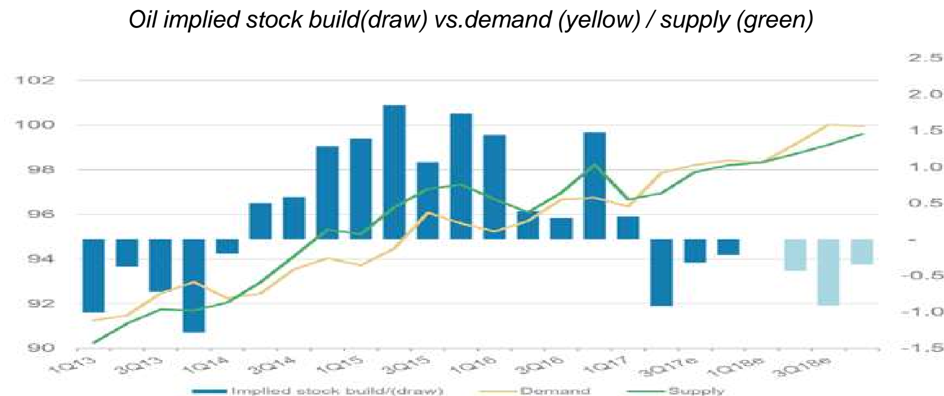
Commodities are the most performing asset class year-to-date. SXPP, Eurostoxx Basic Resources index, lost approx. 4% in June due to EM demand weakness and trade war concerns. However, it seems the asset class has been oversold. Oil momentum has recently turned on, following Iran sanctions and additional supply disruptions. In addition, the recent metals' weakness, driven by concerns about China domestic credit availability, might reverse given the latest policy shifts.

Crude price has bounced more than 12% since the last update, hitting the new highs of the year.

Supply/demand dynamics are one of the leading catalysts: a) stockpiles decline with OECD inventories below the 5-year average b) Oil demand has been particularly dynamic at +1.7 Mln bpd vs. projected +1.5Mln bpd in 2018 (IEA).

OECD inventories are 1Mln barrels below the 5-year average now. The chart shows the difference between stock draws, (which is going to be tight in H2) and demand/supply.

Oil implied stock build(draw) vs.demand (yellow) / supply (green)

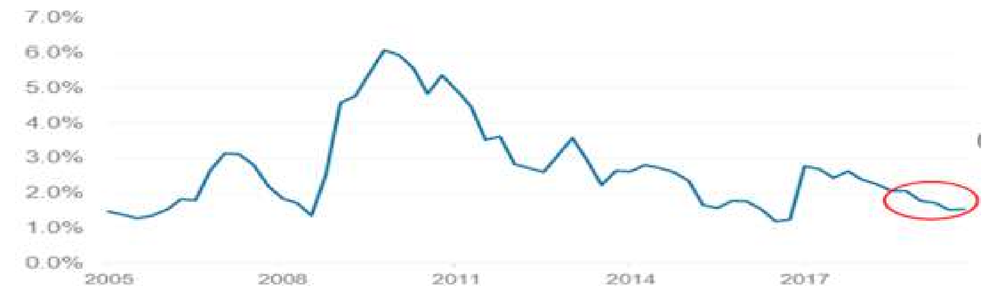


OPEC announced 6 months ahead of schedule the end of "tapering" along with a daily increase in output of 600K bpd. Yet, investors remain undeterred with prompt WTI firmly into backwardation, and still below projections.

Despite Trump urging to stop oil price manipulation and increase production, the oil market is much tighter than before with the reduced output from Iran, Libya and Angola offsetting the potential increase from the Saudis. Venezuela's production has fallen significantly over the last 2 years and OPEC spare capacity might end up at very low levels.

After the longest stretch of declines since November 2016, HFs positioning turned strongly bullish with 10bln$ notional on WTI futures, in a 3.8 standard deviation event, being bought over the last two weeks (3rd largest weekly buying since 2006).

OPEC spare capacity as % world production



Commodities

Since our last update, **Gold** price dropped by 4% after hovering around 1280/1300$ area for more than a month. This was a surprise move for the market in terms of both correlation and positioning.

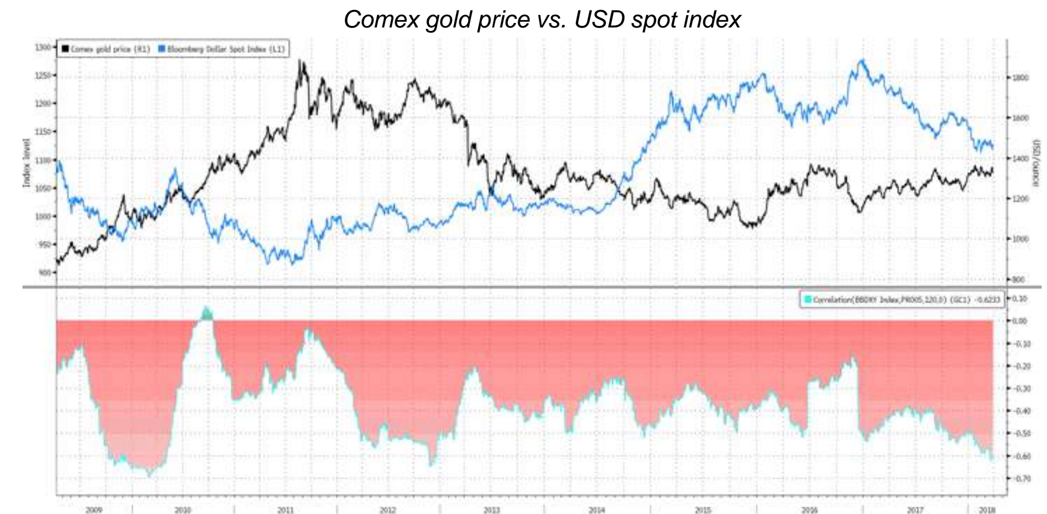
Gold price is trading at the lowest level since last December and the correlation with the USD has reached the lowest level since 2010 / 2012 (chart).

In terms of positioning, the current week is the largest weekly increase in gold short futures recorded, after short volumes have increased by 83% in the last 3 weeks for the 1st time since January, Managed Money's positioning is net short now.

We believe the current level consensus might be dangerous and expect to see some covering over the next days as we are approaching the period of seasonal strength.

As far as **Silver**, approx. all longs, built over the last 6 months , 2.3bn$ 12% of open interest, are caught "offside". Speculators are strongly bearish now.

Comex gold price vs. USD spot index



Executive Summary

Value and Momentum stocks underperformed in June with the exception of less momentum-driven Australia and Europe.

We have witnessed the first month in over 2 years that exhibited such broad defensive sector / stock leadership. We think this is likely to continue and could portend a more difficult market environment overall as we enter the seasonally worst time of the year.

Historically, S&P500 is underperforming in July, August and September, during mid-term elections, before reverting back in the last quarter. We suspect this year might be worse due to the uncertain election outcome.

At the beginning of this week, we saw a decent bounce in Equities across the globe which is probably more the result of very light volumes/positioning, poor sentiment and re-positioning ahead of Q218 numbers than proper buying flows.

Investor outlook has turned from positive to neutral since the start of the year. As a reminder of the current tail risks: trade war, yield curve flattening, quantitative Tightening, EPS disappointment, growth slow-down, geopolitical risks, Emerging market volatility, European periphery etc.

We should also consider the positive drivers such as resilient global growth, accommodative policies, and selective attractive valuations.

Given the uncertain scenario, we warn to invest with caution, being selective into single names with strong fundamentals, investing in defensive sectors with the proper timing, taking advantage of low volatility to build Put spread structures to protect portfolios. As a reminder, we have already called for de-risking in June from cyclicals to defensive.

Equities are still cheaper and more attractive than Credit. The average Eurozone spread dividend yield vs. credit yield is at 280 bps, among which defensive sectors exhibit the highest spread.

Spread dividend yield vs. credit yield

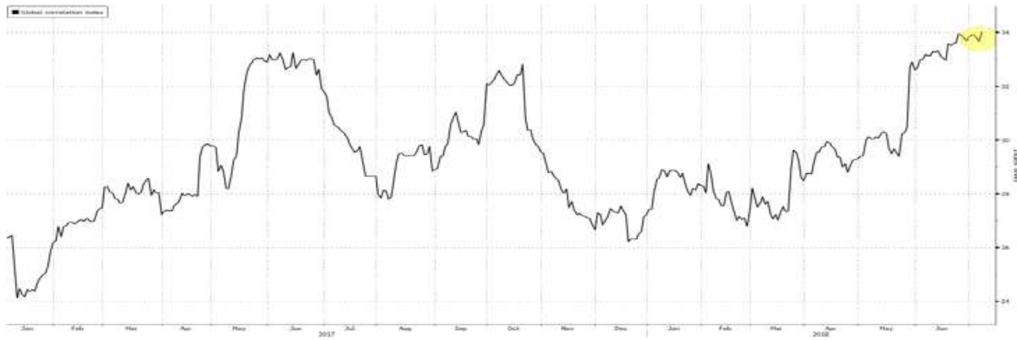
Financials	4.7%	1.0%	3.7%
Telecoms	4.7%	1.3%	3.4%
Energy	4.6%	1.2%	3.5%
Utilities	4.5%	1.1%	3.5%
Real Estate	4.2%	1.3%	2.9%
Media	3.8%	1.0%	2.7%
Autos	3.7%	1.0%	2.7%
Transport	3.5%	1.0%	2.5%
Eurozone	**3.2%**	**0.9%**	**2.4%**
Discretionary	2.8%	0.9%	1.9%
Chemicals	2.8%	0.4%	2.4%
Staples	2.7%	0.9%	1.8%
Materials	2.6%	0.7%	1.9%
Capital Goods	2.6%	0.9%	1.7%
Const Materials	2.4%	0.8%	1.6%
Technology	1.2%	0.8%	0.5%

In US, SP500 cycle-adjusted P/E is currently at 32.1X, as much as 85% above the long term average. Historically, real capital returns tend to be minimal for the ten years after.

Executive Summary

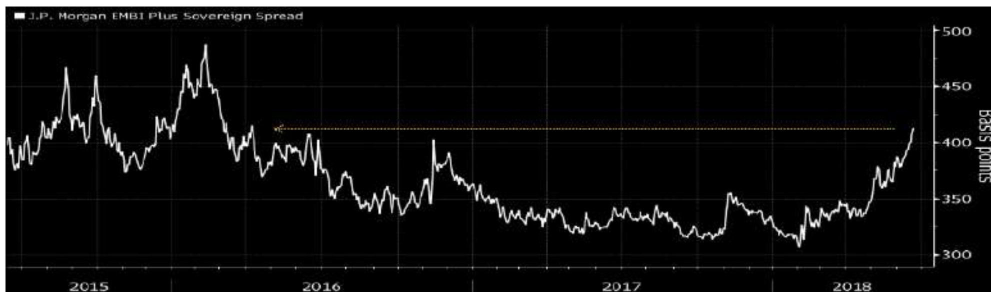
As cross-market and cross-asset correlations increase, defensive sectors might outperform the broader market.

MS Global correlation index



We are concerned about Equities and Fixed Income on **Emerging markets**; among the main tail risks a) global flight to safety, b) EM leverage c) strong USD d) higher short term US yields as a competitor e) tighter liquidity. The spread between EM bond yields and US Treasuries is at 413 bps, the highest since 2016.

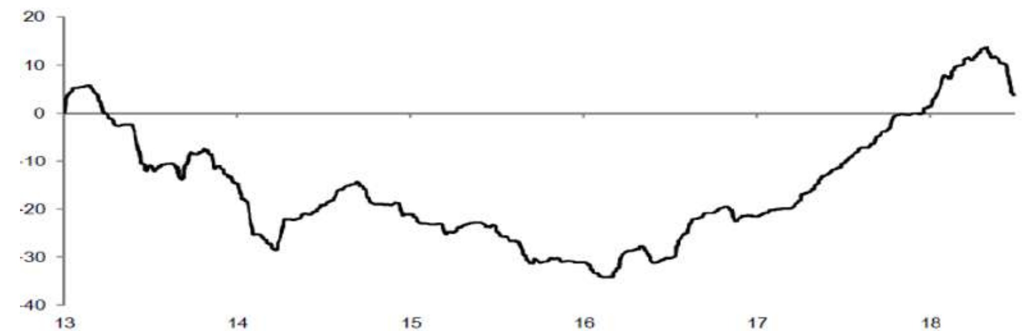
JPM EMBI plus Sovereign spread



Emerging markets were a consensus Buy at the start of 2018 and investors were heavily positioned on Equities and Fixed Income. ETFs Equities inflows might have peaked, though we haven't seen a meaningful reversal vs. the multi-year average.

Despite some EMs appear to be oversold, we prefer to be waiting for a cheaper entry point for a long-term investment.

Cumulative flows into EM Equity ETFs, $Bln



Executive Summary

In US, a "Fed Mistake" might prompt a market correction in the second half of the year. How would the market respond if Powell admitted concerns about the economy and slowed the pace of rate hikes? We don't see an upcoming recession in 2019, though we expect the topic to be raised in the mid-term.

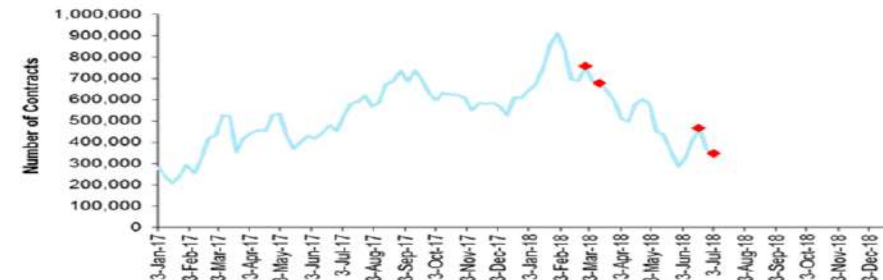
Rising cross-asset volatility and shrinking market liquidity represent potential threats to market stability. As HFs hold the highest number of short positions on the CBOE Volatility Index since January, a spike in volatility might occur ahead of some negative news with liquidity also being a font of concern.

As a reminder, the market structure has been changing as algorithms are replacing people, and speed is replacing capital and as a result, the market has the potential for extreme price movements in response to only modest fundamental news (or perhaps no news at all). Large operational losses, during adverse market conditions, could lead to liquidity supply's collapse and adverse price movements.

Interestingly the S&P futures yesterday have reached key resistance levels that have failed to break through (on the close) in the previous three times (26th of February, 12th of March, 13th of June) and once again it failed to close above even yesterday. There is however a major difference this time, positioning on S&P futures is much lower now. From the peak on the 30th of March until the end of last week, the buy-side has sold a total of 82bn$ notional of futures. It looks amazing, when you look at this chart, how many longs piled into the late January top in price. The red dots represents the previous failed breakouts (2nd chart).

In Asia the current net positioning in Hang Seng, H-Shares, Kospi 2000, MSCI Taiwan and China A50 futures is the shortest since January 2017…worth a though…

S&P500 Futures resistance tested for the 4th time YTD



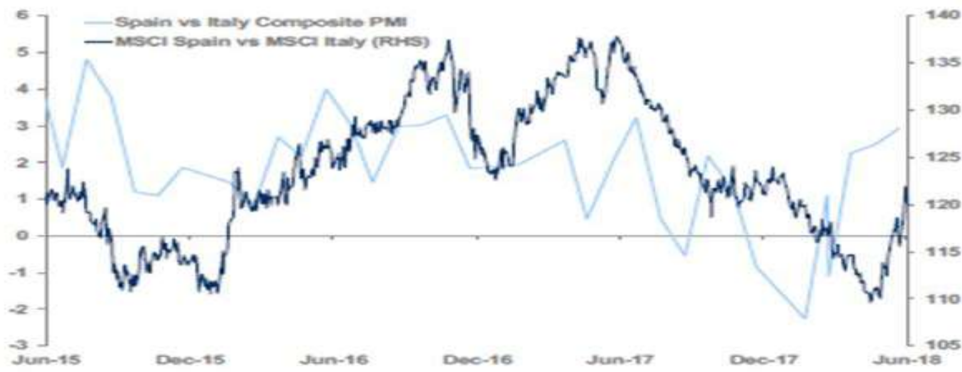
Current Investment Ideas

Long Spain / Short Italy: we keep this relative trade, +7% gain since our call. Spain outperformed Italy over the last couple of months, but relative performance remains below the 12-month average. Spain vs Italy's relative performance is catching up with improving PMI trends. The chart shows the relative composite PMI of Spain vs Italy (light blue line) vs the relative price performance of MSCI Spain vs Italy.

Spain and Italy might outperform in a global trade war scenario as only 10% of Ibex35 and 12% of Ftsemib Equities are exposed to US. Both markets have a greater than average share of their revenues in their domestic markets.

In addition, the sector composition of Italian and Spanish equity markets is relatively defensive ie. Utilities accounts for more than 15% of both MSCI Spain and MSCI Italy Index.

Correlation Spain/Italy Composite PMI vs. MSCI Spain/MSCI Italy



Long Value trade:“Factor” trade. Growth outperformed value by 18% in US and by a similar percentage in Europe. Investors commonly associate “growth” with “momentum” and this relationship is currently high: 57% of stocks with the highest momentum are growth (when typically are 44%).

Notably in US, Momentum sold off -8.4% from March through the end of April but have rallied right back up since, now back to the peak level seen in March 2018. Realized Vol factor has returned an impressive +17% since the end of March, heavily driven by Energy outperformance during this time. Growth has generally trended higher while **Value** continued its poor performance, continuing to be the worst performing factor Ytd (chart).

Value had a tough performance for much of this year, continuing the downward trend that began at the end of 2016. Following a -16% sell-off Ytd and -27.8% since its peak in December 2016, the Morgan Stanley Value EU basket MSZZVAL, built on the pair trade Value Long – Short, is at the lowest price since 2008-2009.

In 2018 YTD, the most negatively contributing sectors in Value have been Tech, Consumer Discretionary, and Health Care (Tech is a grow sector; The higher the Tech, the lower the Value.)

European Factors

New Investment Ideas

<u>Long Put spread on US market</u>: we are keen to hedge our investments through the purchase of a cheap protection either on the S&P, Russell or Nasdaq as volatility is cheap and there is a risk of a sudden correction in the next 2/3 months.

A Put spread on the S&P expiring on the 21st of September strikes 2730 (out 2.25%) / 2575 (out 7.8%) would cost 0.72bps for evert 1mln$ covered (delta 20%).

It is a bit more expensive on Russell and Nasdaq as the implied volatility of those two Indexes is higher.

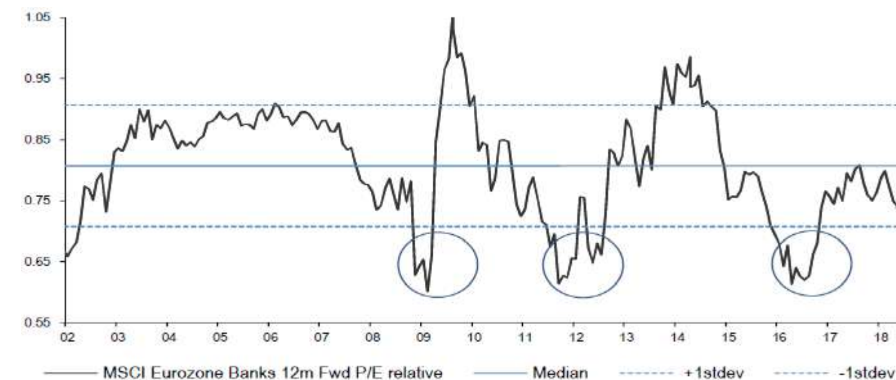
Investment on Hold

<u>Long EU Financials</u>: since the Italian political crisis volatility on the sector has been excessive. With Yields not rising anymore (for the moment) and ahead of difficult Q2 numbers we would step aside from the sector with the idea of entering again at lower prices.

We still like the following points: 1) credit recovery, 2) decreasing NPLs, the bank's 3-month breadth has fallen to a 15-year low and no European financial has outperformed the market over the last three months. Never happened since data starts in 2003.

Banks are oversold, trading at 3 standard deviation vs. 12M avg. The sector has only been more oversold three times in the last decade - during the crisis in 2008-09, January 15 and February 16.

Eurozone Banks P/E relative remains on the cheap side of fair value



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