Monthly Market Update

Monthly focus on the financial markets

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Contents

Alberto Tocchio - CIO

atocchio@heron.ch

Market Analysis

After witnessing the first negative month for the year in May, we had a global strong bounce in June as we correctly predicted over the last newsletter.

US and European Indexes have closed the 1st half of the year being up 13/14%, the best performance since 1998, with most of US Indexes reaching new fresh record highs.

June is usually a bad month for Equities, but not this year, as Dax had its best June performance in 16 years and Eurostoxx 600 the best monthly performance since 2012.

We mentioned at the beginning of last month that it was not a long-term buying opportunity, but we wanted to play the bounce as the most violent upturns are generated with quick short-covering. That is what happened exactly.

In the week after the G20 meeting, we had 15bn$ of shorts covered on Eurostoxx 600 (8% of all shorts), with total covering for the month of June being the 2nd biggest since 2013. On the Italian Ftsemib (still most shorted in Europe) have been covered 5.5bn$ of shorts in the last 2 weeks, 1/3 of the total short base, which is an outstanding figure (the highest pace ever!). Because of these buying flows, the Index has outperformed the Eurostoxx 600 by 6% Ytd, the strongest outperformance since 2000 not certainly fueled by fundamentals.

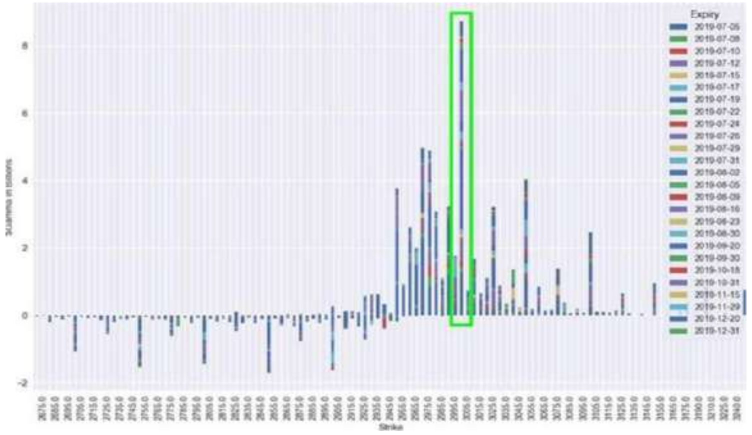
As a result of this aggressive short covering, the current short-base on Eurostoxx is the lowest in at least 5-years, just 1.1% of free-float.

We can easily say that the strong performance of June has been severely impacted by the short-covering effect, with a strong outperformance of the most shorted stocks.

This “short-pull” effect is now close to an end, but what it is still important to understand is the impressive Gamma (delta changing based on price) and Vega (reaction of options to change in volatility) we have at Index prices slightly higher from here.

Brokers are increasingly getting short upside gamma and vega as a result of the demand for call options. This is likely to pull us higher, especially if we break certain important levels. Market makers would need to both buy futures and re-hedge their delta.

SP500 Gamma by strike



Not only Equities performed well in H1, both US IG and HY credit had their best H1 excess returns since 2009. Govies such as US 10-year Treasury had the best H1 performance since 1995 and the German 30-Y bond posted the 2nd best 6-months return in 25 years.

Market Analysis

Unlike last year, all the major assets have beaten inflation Ytd.

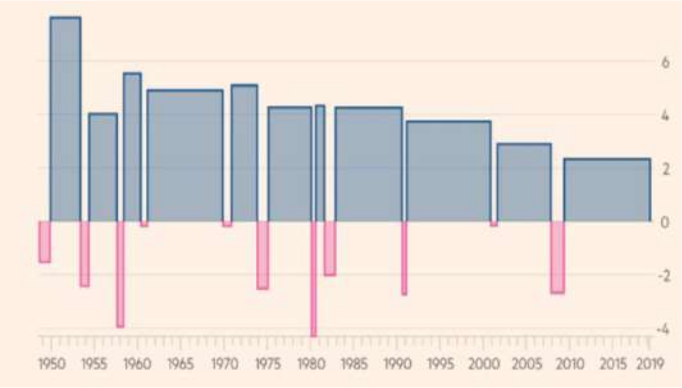
Dovish Central Banks and a slightly better news flow on Trade War have supported Bond and Equites markets which are now strongly correlated (it used to be an inverse relation).

Despite this widespread strength, some Fed members are pointing to the low rate of inflation and acknowledge the severe downturn in global trading volumes and the worldwide contraction in the PMI manufacturing indexes in over 40 countries.

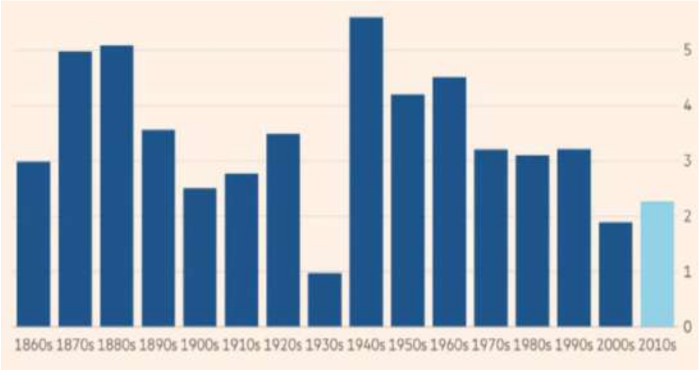
However, the lack of positive growth news during the rally Ytd helps explaining the growing gap between Equity and Bond yields.

The current US expansion is now the longest on record; growth in the current decade has been the lowest apart from the recession-hit in 1930s and 2000s and anemic in comparison with previous booms.

Average US annual growth in real GDP during US economic expansions and contractions (%)



Average annual growth in US real GDP over each decade



Once again, positioning has been the name of the game and small improvement in the news flows are matched with large upside moves while big disappointments are contained.

The investor's cautiousness is easy to see on market volumes and into fund's flows. We have experienced over the last few months the largest Equity fund outflows in years (especially in Europe) while there have been large inflows in Bonds and Money markets.

Central Banks

Markets are currently pricing in more than 25bps cut in July, with 25bps additional cuts in September and October and two more throughout the end of 2020.

The Jobs report out last Friday has lowered the likelihood of a 50bps cut at the next Fed meeting.

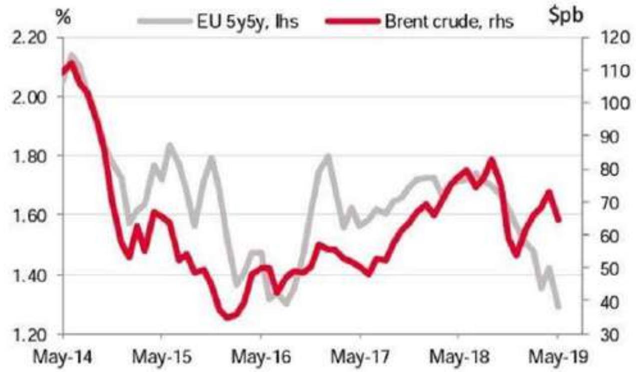
In US, the entire government bond yield curve has fallen below 2.5%, which is the upper band of the Fed target rate.

The Draghi speech at Sintra and the potential election of Lagarde as the new ECB Chair have helped the yield of German 10Y bond falling below the ECB's -0.4% deposit rate for the 1st time, on speculation for further rate cuts and quantitative easing.

One of the reasons for the new (and unexpected) dovishness is to be found in the inflation figures. Inflations expectations haven't risen despite the move of oil prices recently. While crude values have been boosted by the prospect of OPEC cuts, breakeven rates have continued to drop in the face of the economic slowdown necessitating those productions cuts.

European 5Y inflation expectations vs Brent crude price

EU 5Y5Y (grey) vs. Brent crude (red)

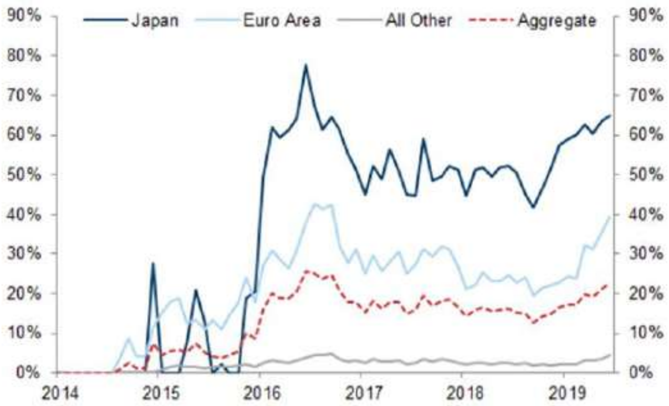


The result of this new policy action is unprecedented.

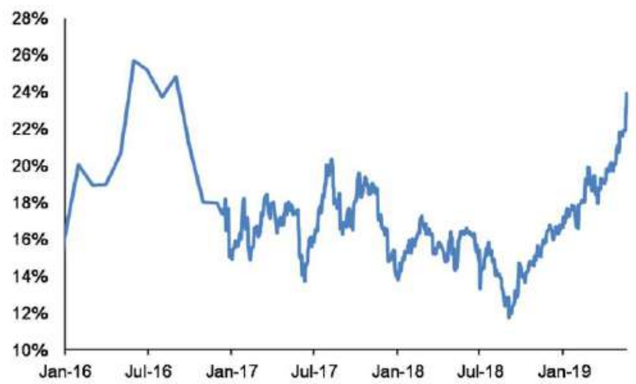
We have 13.5trln$ of negative bond yields across the world and 24.5% of world-wide Investment grade bonds have negative yields!

Even in a troubled country like Italy, the yield difference between Italian 10-year government bonds and the equivalent German securities fell to below 200bps for the first time since May 2018.

Fraction of debt trading at sub-zero yields by region



Market value of negative bond yields as percentage of total outstanding in Bloomberg Barclays Global Aggregate Index



Looking at positioning, it is worth to bear in mind that disappointing investors too much could trigger a potentially unsettling jump in bond yields. It would also push down market-based inflation expectations, which are already very low and whichever central bank drags its heels more will see its currency rise, which will put downward pressure on inflation and hurt exports.

However high the bars that markets are now setting, rate-setters will have to at least try to vault them.

Trade War

The US market has managed to bounce to new highs after the G20 as it seems that US and China agreed to restart trade talks making clear that Washington would not raise additional tariffs on China while talks are ongoing. The Huawei de-escalation was also a positive surprise.

However, we continue to think that renewed talks are for the moment unlikely to result in the broad agreement the US had sought a few months ago.

Looking at the Chinese press, we feel that the Osaka summit didn't warm the hearts of Chinese and they are highly vigilant and still prepared for the worst-case scenario. China and US need to rebuild basic trust needed for negotiations.

While we acknowledge that there is a pause on setting up new tariffs with China, global trade tensions are unlikely to ease and risks to the global outlook are still decidedly skewed to the downside.

The next US targets are: US-Mexico-Canada (USMCA) ratification, Mexican tariffs vs. immigration and the auto tariffs threat vs EU/Japan).

Trade discussion with Europe are likely to intensify over the next weeks as the WTO arbitration ruling on Airbus subsidies is expected during the summer and, if positive, it would allow the US to implement tariffs on up to 11bn$ worth of EU products.

Interestingly, after few months of pause, the US trade deficit has re-accelerated in May (deficit rose from 51.2bn$ to 55.5bn$), considerably more than expected.

The US largest single trade deficits are with: China ($30.1), European Union ($16.9), Mexico ($9.9), Japan ($6.0), Germany ($5.8) and Canada ($3.6).

With resilient US growth and 2020 elections looming, Trump may be tempted to hold a hard line with further implications for global growth.

These are the main channels where trade tensions will transmit:

- Profitability: companies may not be able to fully pass the higher tariffs impact that will spill over into domestic and global supply chain. There will also be an increasing number of profit warnings. Last month we mentioned AP Moller-Maersk, while we had last week the profit warning on Hexagon (Swedish global provider of design and visualization technologies) due to an unexpected and significant slowdown of demand in the Chinese market.

- Inflation: trade war is likely to become increasingly visible in the inflation numbers. The latest forecasts are boosting US inflation numbers up to 2.3%/2.4% in early 2020.

- Consumers: facing higher pricing and affecting an already weak demand.

- Corporate confidence: companies will pull back on Capex which will weigh on aggregate global demand. International companies are likely to face additional downward pressure on growth and profitability from the global footprint.

Trade tensions have re-emerged at a critical moment in the global cycle. Corporate confidence is weak, and the outcome of trade talks will be key to the global growth outlook.

Earnings

US Q2 season kicks off on the 15th of July and few days after in Europe.

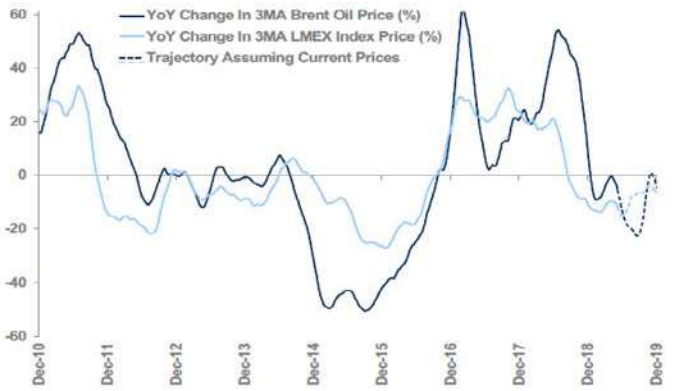
The slowdown in economic growth during Q2 is consistent with expectations for a decline in EPS growth as economic growth is the primary driver of sales and earnings growth.

Profit margins will shrink as input costs continue to weigh on profitability. Margins have started to contract in Q119, for the 1st time since 2016, as they were to an all-time high due to the boost given by the tax reform.

An already slowing economy and now evident margin pressure (Q119 saw negative operating leverage in US) tell us that companies are already struggling to take price or maintain margins. Thus, we believe an exogenous cost shock would be very hard to be absorbed.

The current level of commodity prices suggests headwinds on earnings.

Change in 3MA Brent Oil (blue) vs. Change in 3MA Lmex (light)



Even though the Fed's put has lifted Equities valuations in every sector, we believe earnings will become an increasingly important driver of returns going forward (important for long-term valuation).

With global Macro and trade related concerns weighing on global EPS trends, it is interesting to note that Europe's earnings revisions are holding up better than its regional peers. Although MSCI EMU and MSCI Europe's N12M earning revision ratios are still negative, they are the least bad of all major regions globally.

Earning revisions for Stoxx600 are down just 30bps through Q2, vs. down 260bps in Q1.

Executive Summary

Last month we were expecting a short-term bounce into the G20 as positioning and other technical were in favor of a rally, but we were and are worried about the medium-term.

We suggested to increase the allocation on Gold as a protection for the whole portfolio and this has also played correctly, thanks to the dovishness expressed by Central Banks.

The duration of the current US economic expansion is now on the cusp of being longer than any of the 13 last expansions since 1933 and the global economy seems to be reverting to a lackluster growth.

The NY Fed probability of recession in the next 12 months is hitting a 5-year high (33%), while at the same time, markets are at all-time highs with both Net and Gross positioning having shot up aggressively during the month of June (improvement of sentiment, re-risking amongst HFs and near max length from the CTA community).

Central Banks have intervened to keep the current bull market alive as trade disputes, poor Macro data and a potential earning recession become the main current risks, but are also focused on averting deflation rather than inflation. However, we believe the market is pricing in more easing than our baseline views for Fed and ECB.

Despite having the largest balance sheet on record (4.7trn€ or 40.5% of European GDP), it seems that the ECB will restart the bond-buying program, though we should expect limited effects this time. On the back of the original ECB QE announcement in January 2015, Eurozone Equities re-rated by 30%. As soon as the ECB upsized QE in March 2016 and broadened its purchases to include corporate bonds, Equities re-rated by 20%. This time we expect a maximum 5-10% re-rating, consistent with the more limited credit and peripheral spread compression. Greater upside could be unlocked if the ECB were to include bank debt and/or Equities ETFs in the purchase program.

We doubt that a further stimulus would have a considerable effect on the real economy.

Empirical evidence from Japan suggests stimulus suffers a clear case of diminishing returns (Topix 100 has not gained an inch in 20 years despite the government debt to GDP having gone from near 100% to 237% and the balance sheet of the BoJ having expanded from around 20% to 100%). Commodity prices are already near decade lows already (except oil), which means any recovery will bring pressure to consumer disposable income and corporate margins in most industries. Low rates for longer will not pull additional leverage, because most market participants believe it is too late in the cycle, as that there is more debt in the system today than at the peak of 2007 in most of the main economies in the world.

If we think that the current bull market can continue, we will need to bear in mind that returns will be lower and we recommend some defensive trades focused on preserving the positive performance Ytd.

We expect low single-digit returns for most asset classes for the remainder of the year. Valuations are less compelling now, given the strong equity and bond rallies over past month. In addition, still uncertain if consumption will be able to compensate for the weak manufacturing and Capex growth, and the deteriorated business sentiment.

The 23% underperformance of the FAANG stocks against the market and the 29% underperformance vs gold stocks since mid-2018 may be an early sign that all is not well with the Tech market leaders of the past 8 years.

It seems increasingly appropriate to hold some positions on Gold and some Cash as an insurance against policy mistakes, rising late cycle risks and a potential recession.

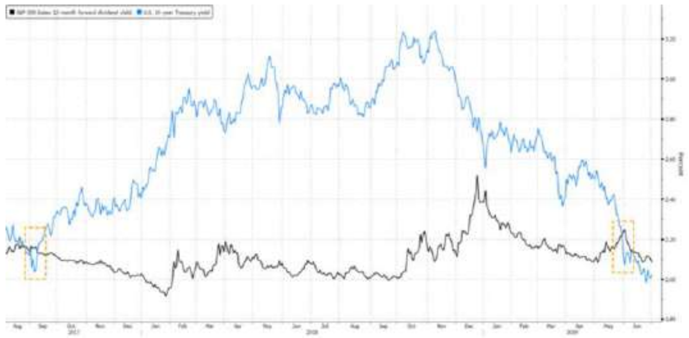
Executive Summary

Let's now analyze 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):

<u>POSITIVE FACTORS (5):</u>

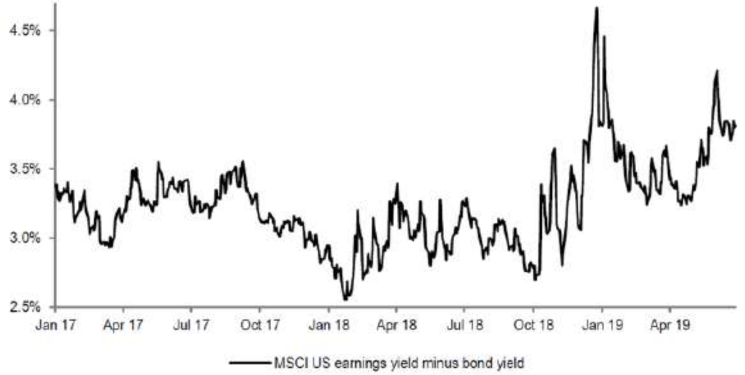
- **<u>Attractiveness of Equities</u>**: The slump in Treasury yields is making it a little easier for stock brokers to flog the income potential of US Equities. <u>The yield on the 10Y US has tracked below the forward dividend yield on the S&P Index for the 1st time in almost 2 years.</u>

S&P500 12m forward dividend yield (black) vs. US 10Y Treasury yields (blue)



<u>The same is also true in terms of earnings.</u>

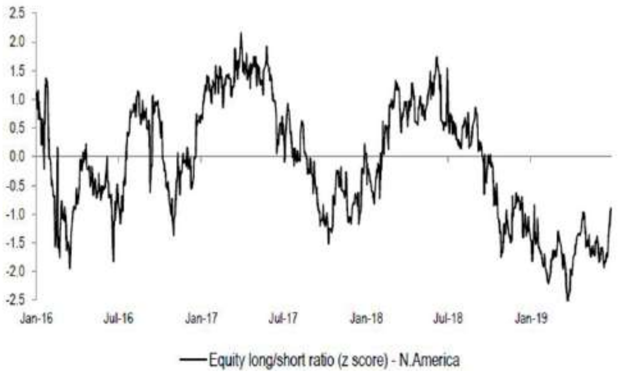
MSCI US earnings yield minus bond yield



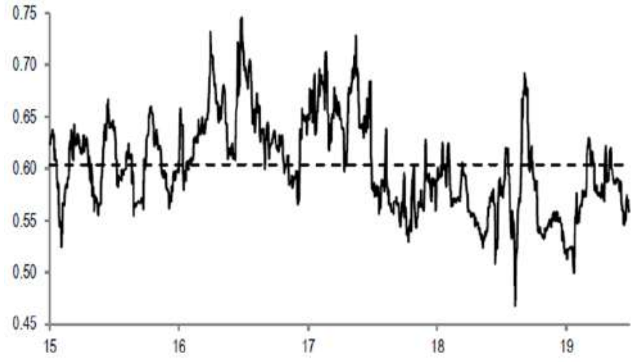
- **<u>Positioning / Flows</u>**: Aggregate investor positioning is still cautious (excluding Quant investors). Retailers are invested substantially below the average of the last few years, while Hedge Funds have aggressively covered the shorts during June.

  The significant de-risking in the US since 2H of last year has not unwound. Prime Brokerage data indicates net exposure to Equities across regions remains subdued. This should limit the downside during a correction.

Equity long/short ratio (Z score) North America



Equity beta of US mutual funds



The S&P Put/Call ratio has risen, currently in the 80th percentile on a 1-year basis, suggesting investors are well hedged (Put buyers and topside Call sellers).

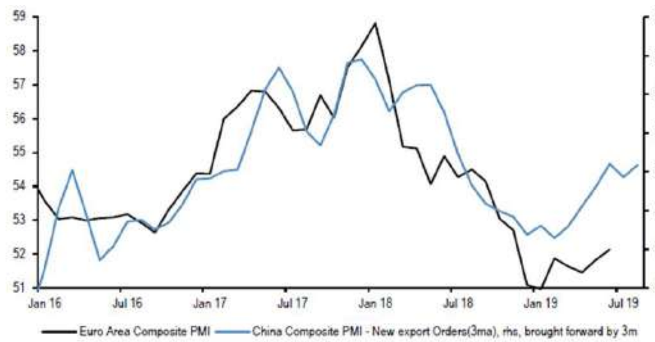
The risk that has been added on is lower-beta by nature, further upside would hurt.

Executive Summary

- **<u>Improving Macro from a very deep level</u>**: In contrast to 2018, momentum activity might start showing signs of stabilization, given favorable base effects, reduction in inventory overhang and the bottoming out in M1 in all key regions. At the same time, and in a stark contrast to last year, Fed will be cutting rates, USD is likely peaking, curve could stop flattening.

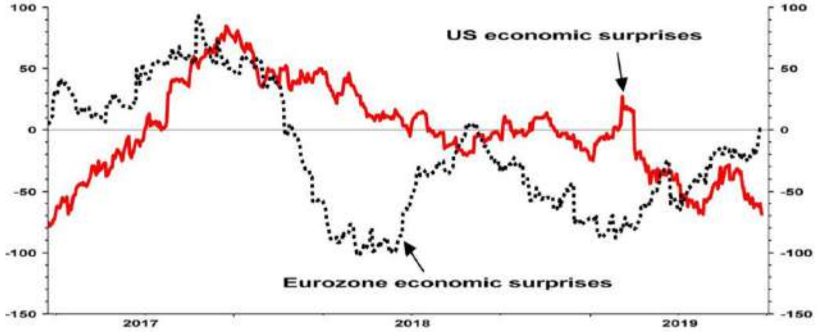
  Recent easing policy measures should stabilize the Chinese growth trajectory, with PMI stabilizing in H2 as it appears to follow the Chinese business confidence indicator, which has been strong since January.

Eurozone (black) and China (blue) composite PMI - New export orders



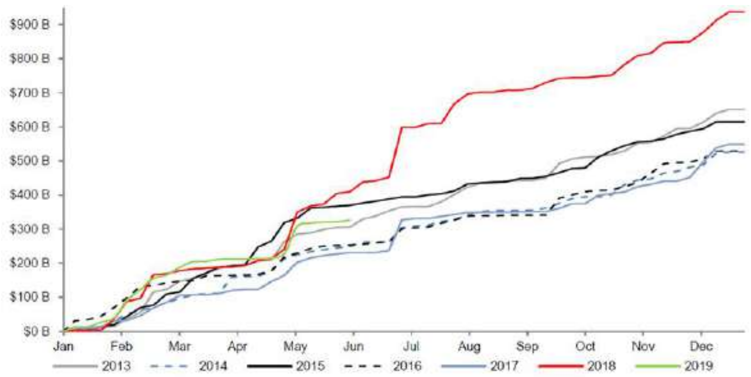
In Europe, Economic surprises are exceeding the US for the 1st time since 2017.

US (red) vs. Eurozone (blue) Economic surprise



- **<u>Buyback should continue to support markets in 2019</u>**: Buybacks have been a key theme through this cycle with S&P500 companies returning ~$5 trillion to shareholders since 2009 and contributing ~2% to annual EPS growth. <u>US corporates have announced for 2019 an amount of buybacks equivalent to 4% of the S&P500 market cap. On the eve of the reporting season, 80% of buybacks are in black-out period (2/3 week negative effect).</u>

S&P announced buybacks 2019 (green) vs. 2018 (red)



- **<u>Global M&A</u>**: <u>Global M&A volumes have been very strong year-to-date</u>, reaching their highest level since 2007. Recently, Alphabet's deal to buy Looker Data Sciences for 2.6bn$ helped 2019 to be already the biggest M&A year in recent period.

Executive Summary

- **NEGATIVE FACTORS (10):**

- **Dangerous reporting season**: we think Q219 will mark the beginning of the earning recession with full year 2019 earning estimates likely to fall by 5/10%. A lot of the 2019 expected growth is being packed into Q4 and that looks unrealistic to us, especially without a trade deal.

  Over the past year, we saw significant inventory building up (some due to economy overheating) and **technology capital expenditures** booming, driven by tax cuts and repatriation of overseas cash. During Q119, we saw the payback begin with the big cloud computing leaders (Amazon, Google, Facebook and Microsoft) missing their capex spending plans by over 30%.

  Labor is the other excess from last year's fiscal stimulus boom and where costs are eating into margins, especially for Small Caps. Finally, **inflation** message from corporates is much less benign than bond markets currently price.

- **Positioning** (negative view): Equities and Fixed Income posted a strong and almost simultaneous rally this year.

  This co-movement between Equities and Bonds is more common than thought and to a significant extent is driven by the prevalence of fixed weight allocation frameworks among investors such as 60:40 balanced funds, retail investors, pension funds and SWFs (e.g. the Norges Bank).

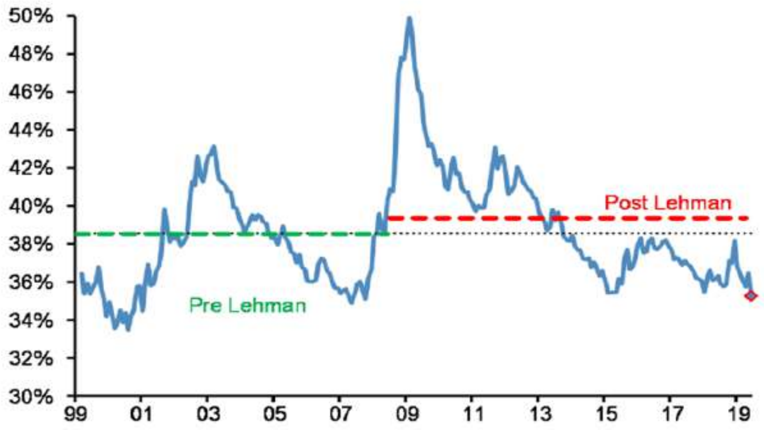
  As the Bond market expands, fixed weight allocation investors find themselves overweight bonds and underweight equities and thus need to buy equities to rebalance their portfolios in line with their rebalancing thresholds.

So, despite global Equity prices close to new highs, we note investors are not as overweight in equities as they were last September simply because bond markets rallied strongly this year making them less underweighted in bonds. Effectively, the recent Bond rally boosted Equities outperformance, creating more room for investors to increase their equity allocations.

And this, is a major risk for Equity markets going forward: if Central Banks fail to validate over the coming months market expectations of universal rate cuts, Equities could be hit not only by a potential selloff in Bonds that would mechanically make investors more overweight in equities, but also by a potential increase in cash allocations as investors cover their currently extreme cash underweight.

In a scenario where the Fed and/or other Central Banks fail to cut by as much as markets expect, perhaps because growth turns out to be better than expected, the upside for Equities from better growth news could be offset by a Bond selloff via the mechanism described above.

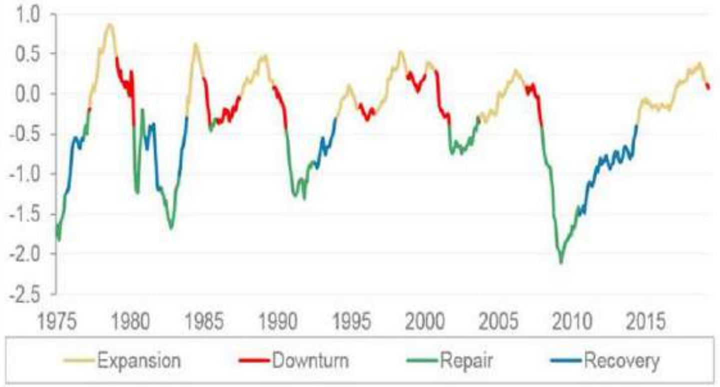
Implied cash allocation by global non-bank investor



Executive Summary

- **Economic momentum**: Morgan Stanley widely followed proprietary US Cycle Indicator model has predicted the beginning of the downturn for the 1st time since 2007 already last month. Recent softness has caused their model to switch to ‘downturn’, where data are ‘above trend but deteriorating’. This phase-change has historically meant a worse backdrop for returns and higher chances of recession or a bear market.

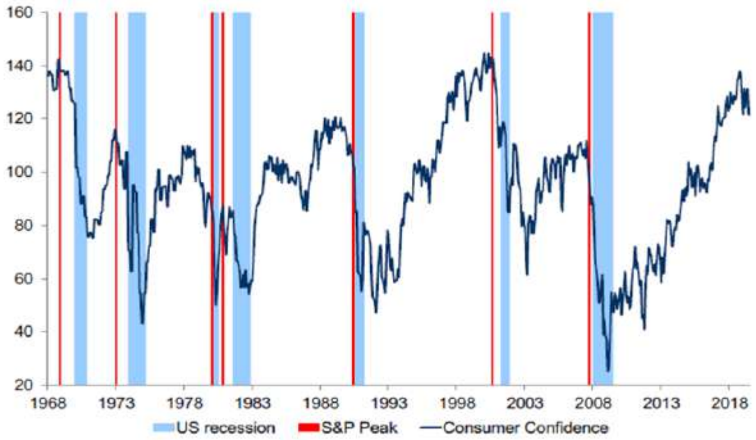
US Cycle Indicator: Downturn (red)



- **Consumer confidence**: the latest disappointing number of US consumer confidence number is particularly noteworthy as this has historically proved a leading indicator for the Economy. Over the last 50 years, US Consumer Confidence has also proved to be a leading indicator for the S&P500 with the average time lag between a peak in consumer confidence and a top in Equity markets of 8 months over this period. Interestingly we are now 9 months past the Oct-18 peak in the Conference Board Consumer Confidence series.

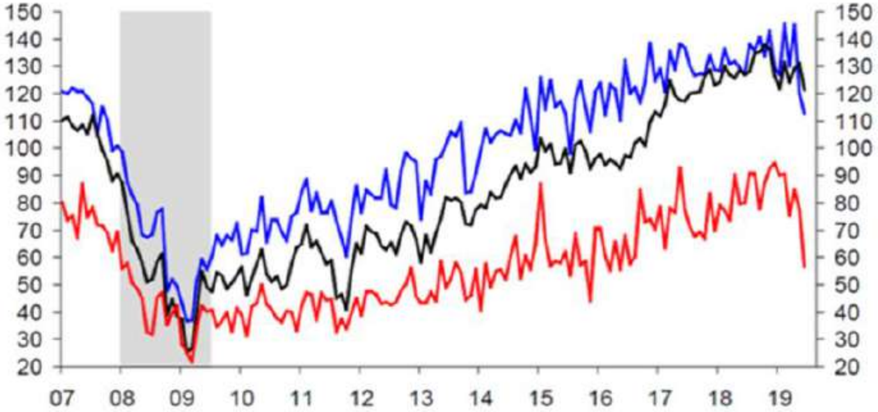
  On average a peak in consumer confidence has occurred 15-months ahead of US recession and 8-months ahead of S&P peak.

Consumer confidence (blue line) vs.
US Recession (light blue area) vs.
S&P500 peak (red line)



Additionally, consumer confidence among younger and poorer Americans has been deteriorating significantly in recent months.

CONSUMER CONFIDENCE
Age under 35 (blue) vs. Overall consumer confidence (black) vs.
Household income $15K (red)



Executive Summary

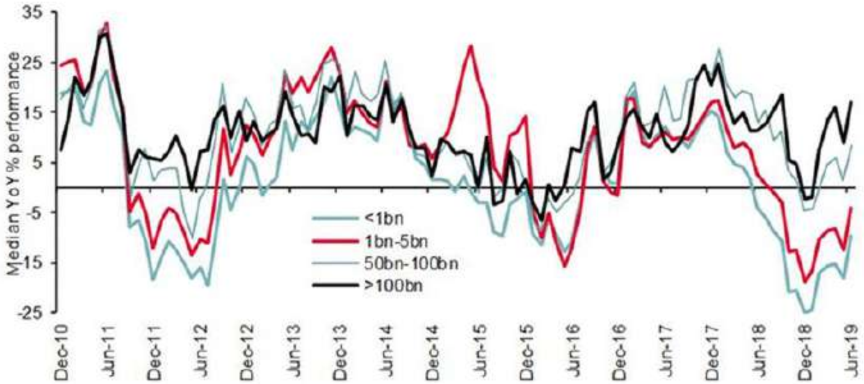
- **<u>Liquidity</u>**: There have been quite a few headlines recently surrounding "liquidity issues", which might be surprising given the strong performance of asset markets this year. That investors flee at the first sign of a problem appears to confirm that investors are shuffling towards the exit door, in anticipation of a need to leave the party in haste.

  A key barometer we watch is equal-weighted versus market cap-weighted performance. Not only as many of quant models tilted towards an equal-weighted structure, but it is clearly healthier for the majority to be outperforming the more concentrated large cap-tilted index and of course passive and associated top-down flows favor market cap rather than equal-weighted ones. Worryingly in 2018 and again this year, the MSCI World equal-weighted index has slumped versus the more closely watch market cap index. In other words, a majority of companies are struggling.

  The following chart splits a very large global universe of 17000 stocks into market-cap grouped portfolios and measures their median annual performance over the last 12 months. The mega-cap group (above USD100bn) is powering ahead whilst those in the sub-1bn market cap range are still struggling to make back last year's loss.

  <u>The more remarkable numbers are this 100bn portfolio represents just 77 companies but 27% of the global market cap.</u> Meanwhile that sub USD1bn represents 7% of the market capitalization yet over 11,000 companies, or 65% of total numbers. And this is the problem, our increasing focus on a few large cap indices populated by just a fraction of the world's companies is giving investors a false impression.

Stock Universe by mkt cap
Big cap >100Bln (black)



- **<u>Low shorts/protection and relatively low volatility</u>**: Volatility has dropped during the month of June to the multi-year lows reached in April before the correction we had in May.

  Central Banks and their unprecedented period of monetary interventionism are firmly behind the low-volatility trend that we are witnessing.

  As already discussed, we have recently seen a fast short-covering leaving the Eurostoxx50 with the lightest number of shorts in the past 5 years.

  <u>The market is still pretty complacent and not prepared for a severe downturn.</u>

Executive Summary

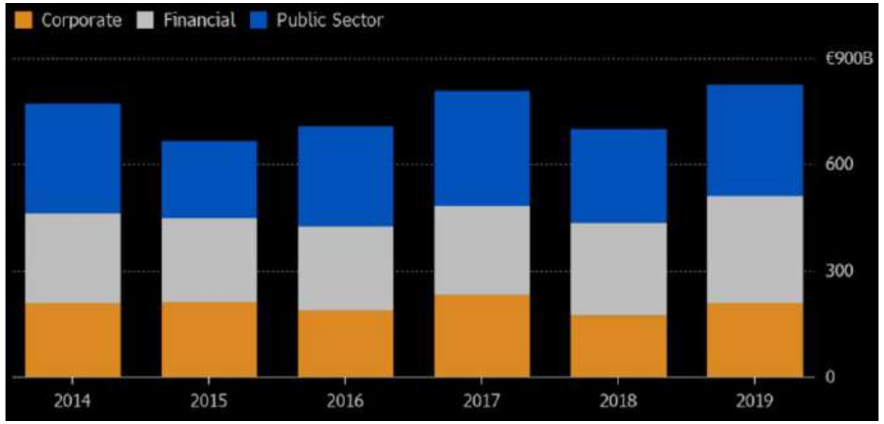
- **Increase issuance on Credit Markets and quality of debt**: we are experiencing a rapid increase in issuance volumes and it will likely put some strains on Credit spreads.

  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.

  With 500bn$ corporate bond maturities next year, average interest rates to rise despite easing monetary policy and profit growth to ease, corporates are likely to shift from returning cash to shareholders to greater deleveraging.

  In Europe, primary bond issuance in the first half topped 827 billion euros equivalent, exceeding levels achieved in the same period for the past five years. Sales also surpassed the previous high set in 2017 by more than 2%.

Europe primary bond issuance

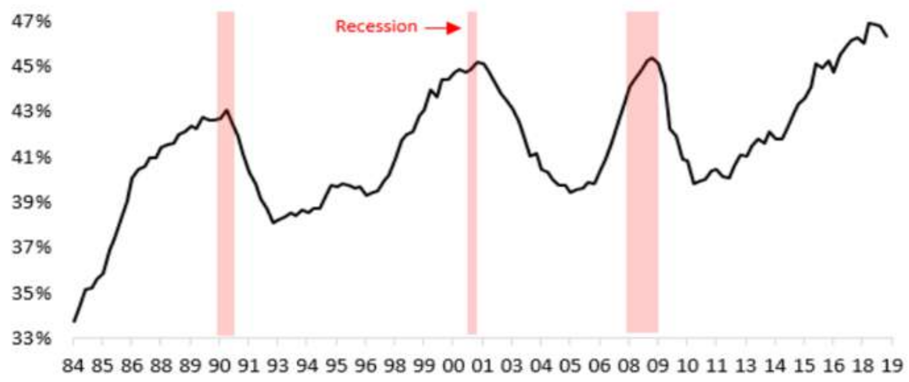


More than half of the 5.6trn$ US Investment Grade bond market is now rated in the BBB tier, the lowest rung of the grade and the gap between BB rated and BBB bonds has evaporated.

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.

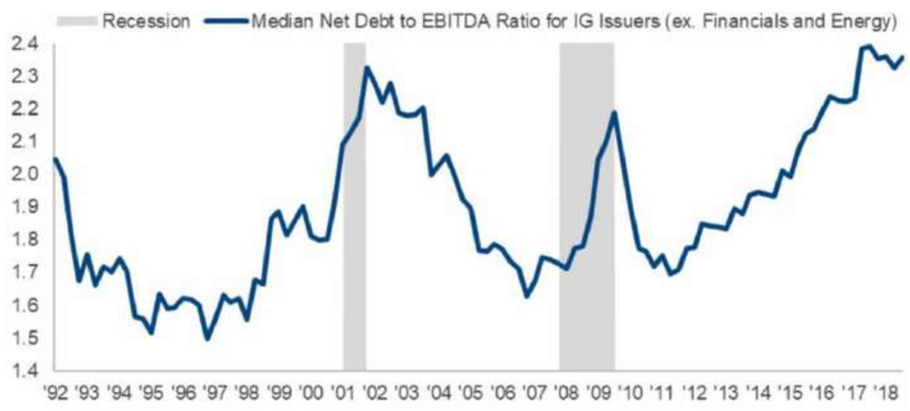
Corporate Debt as percentage of GDP



Executive Summary

During economic expansions Ebitda is usually rising faster than net debt so this ratio falls towards the lows. Then in recessions when Ebitda gets obliterated the ratio spikes. This time, net debt growth has outpaced Ebitda growth during the expansion making this the major bubble.

Investment Grade Debt/ EBITDA



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 more debt.

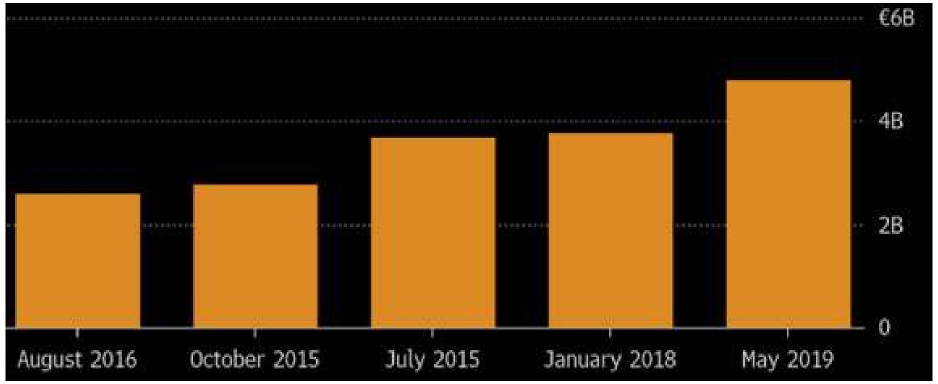
With demand for credit outstripping supply, investors were willing to accept weaker structures and the like, despite historically tight spreads.

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.

Moody's Investors Service said covenant quality for 2018's last quarter was close to a record low, and the rating company sees no signs of improvement this year. One big concern is that borrowers can now easily move more collateral out of the reach of lenders, which translates into bigger losses in a downturn.

Even in Europe, companies have used the leveraged loans market, a field usually dominated by firms owned by private equity funds. In May, these borrowers made up more than half of the loans launched in Europe. One reason for the influx is that the banks that traditionally provided liquidity are busy cleaning up their balance sheets, encouraging these companies to seek alternative sources of capital.

Leveraged corporate loan issuance



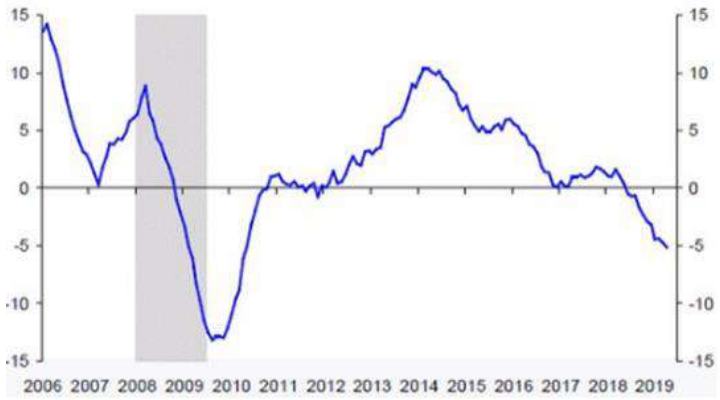
We reiterate our call for a defensive stance on HY and EM bonds.

Executive Summary

- **Consumer sentiment very downbeat**

Home sales continue to slow. Existing home sales did beat consensus expectations to the upside, but new home sales were down YoY for the first time in 2019 and housing starts continue lower YoY. Now even Manhattan home prices are falling at the fastest rate since the financial crisis.

Home price index: Manhattan

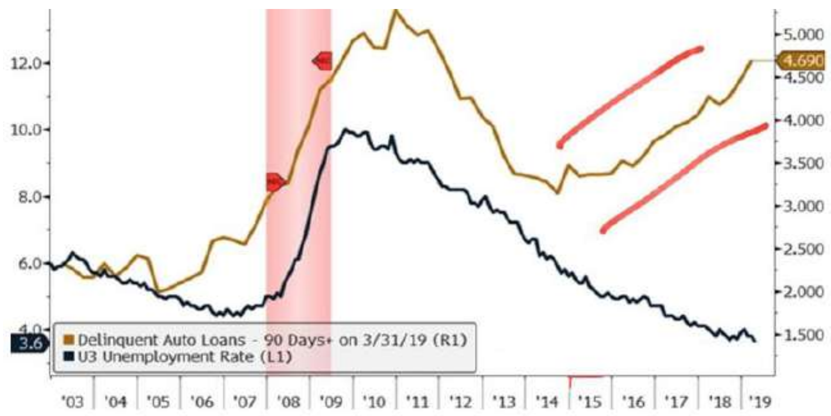


Credit card transaction volumes have decelerated sharply in recent months, supporting latest data on retail sales; while credit card interest rates are >2 decade-high. At the same time, the percentage of loans companies have decided they will never collect, rose to the highest since 2012.

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

In Q1, total outstanding balances of auto loans and leases rose by 4% from a year ago to $1.28 trillion, up 65% in 10 years! The correlation between unemployment and delinquent auto loan has worriedly broken.

Delinquent Auto Loans (brown) vs. Unemployment rate (black)



Delinquent US student loans reached a record $166 billion in Q4. Student loans constitute around 40% of the total debt balance of 90+ dat delinquencies for implied debt in arrears.

US Student Loans outstanding % GDP

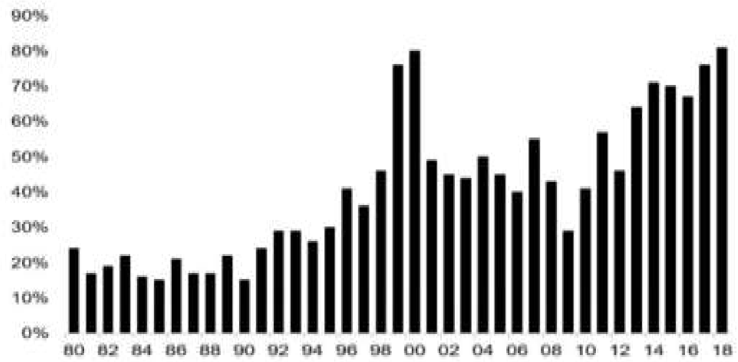
Executive Summary/Macro

- **<u>IPOs / Secondary/ Placing</u>**: US companies such as venture capital firms are still seeing an opportunity to cash out and they are all rushing to go public before this window of opportunity is closed from a repeat of last year's correction.

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

  Unfortunately, performance is not great as the number of IPOs that lost money is marking a new record high. 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.

% IPOs with negative earnings



- **<u>Weak Seasonality in summer</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%. May to October is instead the weakest.

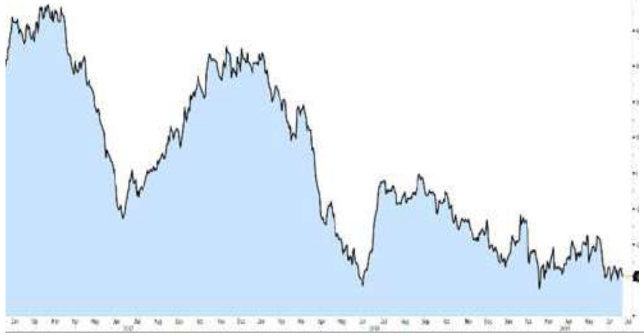
  Eurostoxx 600 and S&P have lost 300bps and 130bps on average from June through September over the last 20 years; if we condition for those indices down in May, they have historically lost 350bps and 550bps from June through September respectively.

MACRO

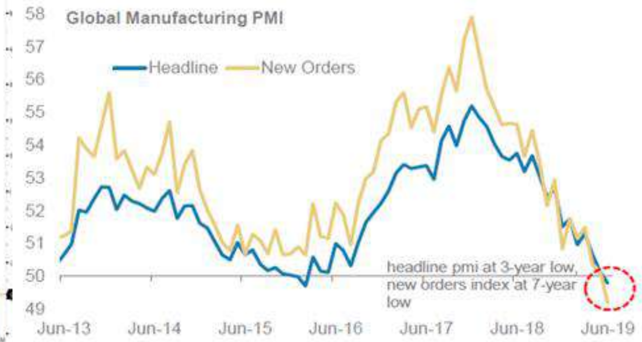
<u>Global growth has continued to soften this year. Unfortunately, we were proven right regarding our prediction of a significant slowdown.</u> The current global CAI (current activity indicator) is running at 2.5%, down from more than 3% in April. Risks to the global outlook remain firmly on the downside, along with weak data in Developed economies, subdued investments in Emerging and Frontier markets, rising global debt and looming trade tension escalation.

<u>In June, the global manufacturing PMI fell into contraction territory (below 50) for the first time in three years, along with contracting new orders, well-below 2015-16 cycle lows. Almost two thirds of the manufacturing PMIs worldwide are in contraction</u>, corporate and consumer confidence have weakened significantly. Capital goods imports, which is a proxy for capex, have been at depressed levels, tracking at -3% in May/June. All of this should translate into <u>lower consumer and investment spending and lower global GDP</u>. The Street is revising downwards its global growth forecast, even taking into account a positive trade war resolution.

Citi Economic Surprise Index



Headline PMI (blue) vs. New orders (yellow)



Macro/Commodities

Europe

The CAI (current activity indicator), an alternative GDP measure, has reached its lowest level year-to-date in June, currently tracking 0.6% in June, down from 1.4% in early January.

Within the Euro area, most of data disappointment comes from Germany and Italy while France and Spain remain robust. In line with the Street consensus seeing a significant bounce in H219 (circa 1.3%), the ECB recently adjusted its GDP growth forecast up to 1.2% in 2019 and down to 1.4% in 2020 and raised its inflation forecast for 2019 to 1.3%.

United States

Mixed bag of Macro data although growth slowed down significantly in the recent quarters. The CAI (current activity indicator) has reached its lowest measure year-to-date in June down to 0.9% from 1.7% January 2019. Continued weaker US data keep the US market cycle indicator in the downturn phase. Data deterioration remains broad-based even though there are some outliers such as a better-than-expected ISM Manufacturing Production index and stronger jobs, employment data such as Non-Farm Payroll and Average Hourly Earnings.

China

Growth weakness is significant in Asia as well, with China CAI (current activity indicator) marking its lowest level year-to-date down to 5.5% from 6% January 2019. Manufacturing PMI dropped to 49.4 in June, still contraction, slightly lower than expectation, while Non-Manufacturing PMI in line. Each Caixin China PMI, manufacturing, composite and services downshoot forecast, the second lowest readings since October 2018. In addition, weaker new export orders, employment and lower inflationary pressure in June, confirms the soft patch of the economy.

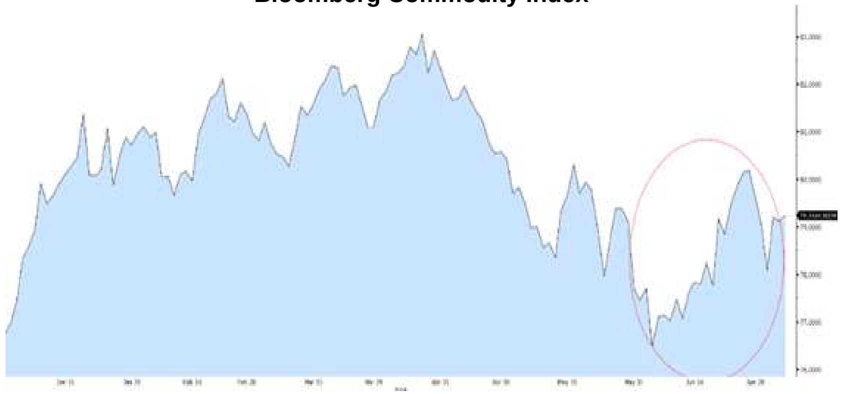
COMMODITIES

A dovish stance of global Central Banks led a rally in commodities in June. The Bloomberg Commodities Index is now up 3.5% year-to-date, recovering roughly 4% from May lows, mainly buoyed by the outperformance of oil and gold. Since our last newsletter, the former rose 14% due to Macro and Geopolitics, while the latter skyrocketed 11% after inflation expectations and yields were plummeting on Central Banks moves.

With demand conditions possibly deteriorating further as risks to global growth point to the downside, commodities performance in the quarters ahead will depend on whether supply-driven factors outweigh demand-driven factors. Low growth and inflation environments have tended to be inherently negative periods for commodities performance as a whole.

We correctly called the market in May, as we suggested to take a long position in gold and oil. First of all, we thought that oil was undervalued, down more than 20% from April level. Secondly, we were hoping for some form of Central Banks intervention due to the global slowdown and awful Macro data. Indeed, we were looking forward to seeing a gold re-bounce either on risk-off fear or on financial easing.

Bloomberg Commodity Index



Commodities

Oil

After having called its bottom in late May, we are currently neutral on fundamentals, technical and Macro.

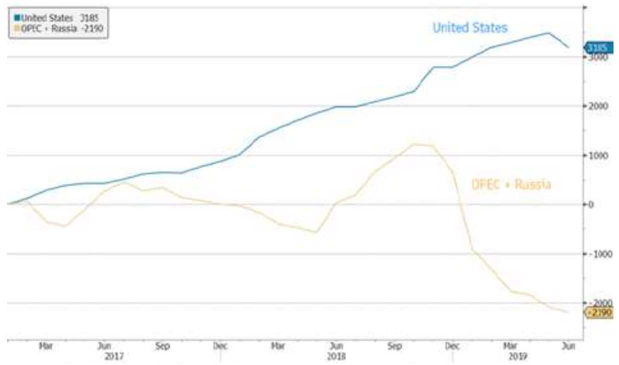
One of the best asset class year-to-date with WTI up 28% and Brent +20%.

After being up 10% in June, oil slumped in its worst decline, circa 7%, following a meeting by the OPEC (1 July) in four years. The fall was mainly due to disappointing economic data and economic growth concerns. OPEC+ member announced the roll-over of production cuts for nine months, one quarter longer than expected. In terms of a goal, the cuts continue to aim for normalized inventories, with the introduction of a very aggressive formal target of 2010-14 average OECD inventories (OPEC+ to increase the size of cuts to reach this goal). Historically, when OPEC loses market share, oil prices trend down.

The Geopolitical situation is simple here: A) Trump wants to bring down oil prices, extracting record output of shale (USA as the first oil producer world-wide), B) Russia and Saudis want to keep prices above marginal cost (oil-dependent economies) C) OPEC countries along with Saudis and Russia (OPEC+) need to stabilize the market, decreasing output to sustain prices at the expense of considerable loss of market share against US.

The structural outlook remains soft as medium-term fundamentals are not strong (slowdown in oil demand growth + slowdown in global growth). However, we might see some upside risk in the short-run due to seasonality (higher oil demand in summer period to lead to Q3 production deficit).

Change in Oil production since OPEC+ agreement (early 2017)
United States (blue) vs. OPEC+Russia (yellow)



Correlation OPEC mkt share vs. Oil price
OPEC mkt share (blue) vs. Oil price (yellow)

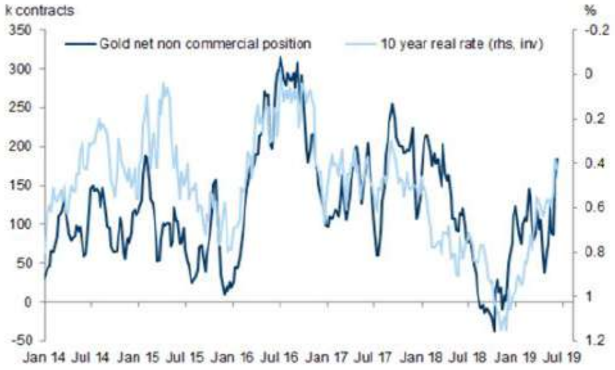
Gold

We reaffirm that gold is one of the best asset class for your portfolio in 2019 and reiterate our bullish stance mid-long term. Gold provides diversification in a portfolio and is often correlated with the stock market during risk-on periods if the bounce is due because of Central Banks intervention, while it decouples and becomes inversely correlated during period of stress. This particular relationship has been confirmed in June (Gold +8%, S&P500 +7%).

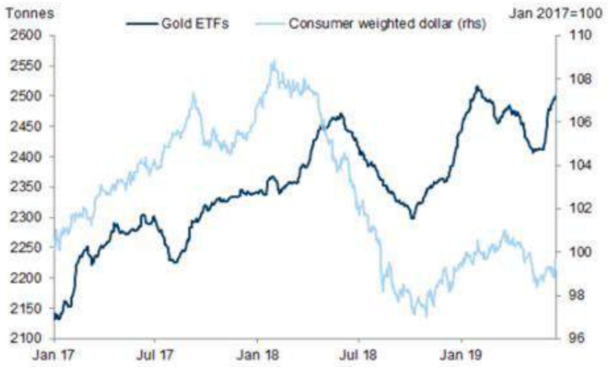
Since our last bullish call, gold bounced circa 11% driven by global growth worries, a major dovish pivot by almost every Central Banks and a long streak of negative Macro data. It's pretty clear that the strongest driver is the inverse correlation between real rates and gold, which had broken down for almost all of last year.

Commodities/Forex

Gold net non-commercial position (blue) vs. 10Y real rate inverted (blue light)

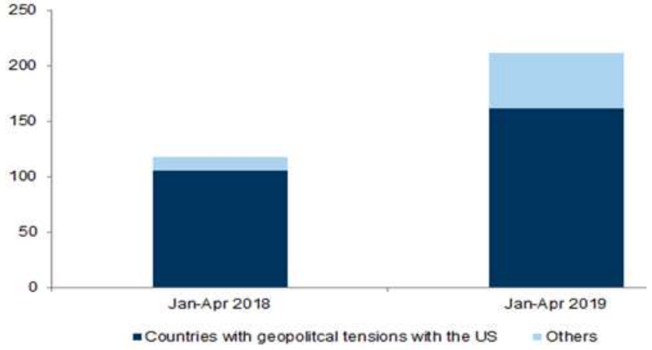


Weaker dollar supports demand in gold
Gold ETFs (blue) vs Consumer Weighted Dollar (light)



Gold-backed ETFs flows by month

Central Bank Gold purchases
Countries in the trade war (blue) vs Others (light)



<u>Interestingly, gold net speculative positions have moved in line with US 10-year real rates and their positioning is currently close to an extreme.</u>

Over the month of June, the buy-side increased their net long positions in Gold and Silver to the highest pace since 2006! It is now possibly everyone’s favorite long.

We would therefore see less tactical upside short-term and we could see an increased volatility due to a potential excessive positioning. We are still convinced about the medium/long-term call.

<u>We reaffirm that Central Banks are buying at the highest pace in the last 50 years.</u> Importantly, China raised its gold purchasing pace from 10 tonnes per month to 15 tonnes for April and May as it aims to diversify its reserve holdings.

Forex

<u>We started to get more bearish on the USD last month</u>. June has been a volatile month for the EURUSD, trading range-bound between 1.115 and 1.1410. The main drivers of EUR outperformance in the first part of June were the dovish commentaries by Fed officials, weak US data and the increasing expectation for a 50bps double rate cut in July. Then, the situation reversed with EUR underperforming, following the nomination of Christine Lagarde for the ECB presidency on rumors for an additional round of Quantitative Easing (real and nominal yields down, currency down).

<u>The widening in growth differential</u> between the US and rest of the World has driven the dollar higher since January 2018. From here, convergence is more likely.

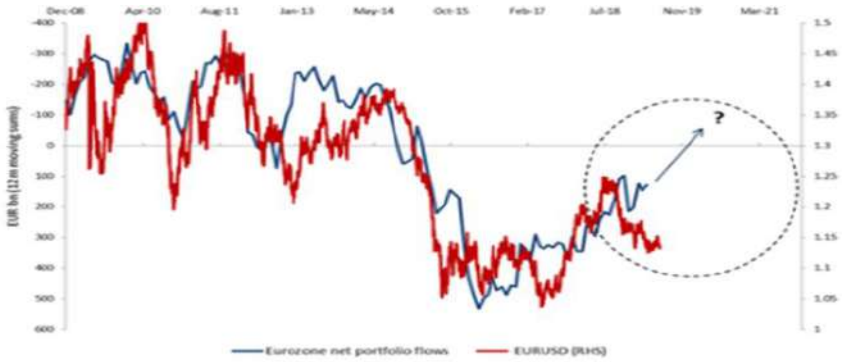
<u>USD also benefitted from the decoupling in the US-rest of the World interest rate direction</u>, the situation is now changing and the differential is at a record now.

Forex

While US funding needs remain material, the Eurozone current account surplus has increased materially over the last few years, driven by Germany.

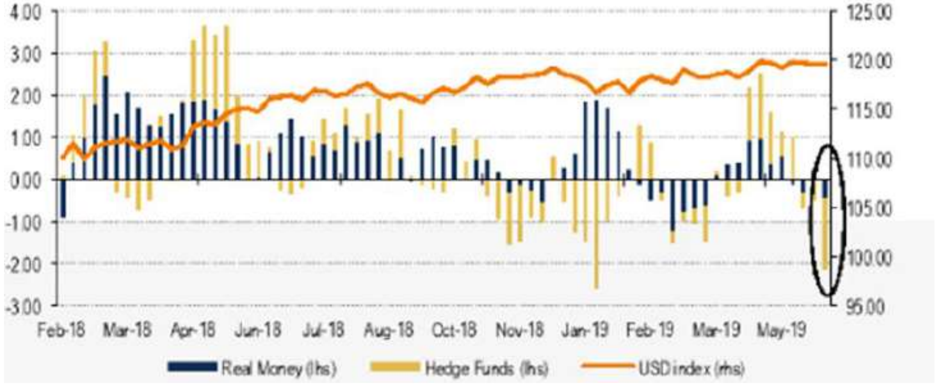
Eurozone Balance supportive for a Euro surge

Eurozone net capital outflows vs Eur/Usd



In terms of positioning, the market is still long USD but at a smaller pace and recently Hedge Funds have been selling aggressively.

USD Index (orange)
Hedge Funds (yellow) vs. Real Money (blue)



We would therefore be prepared to further USD weakness and would decisively go long EURUSD if it breaks 1.14.

Investment Idea

Current Investment Idea

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 Index

Over the last newsletter we said that we would have waited for a market bounce and volatility drop before building up new protection strategies. We think that the time has come again for this strategy.

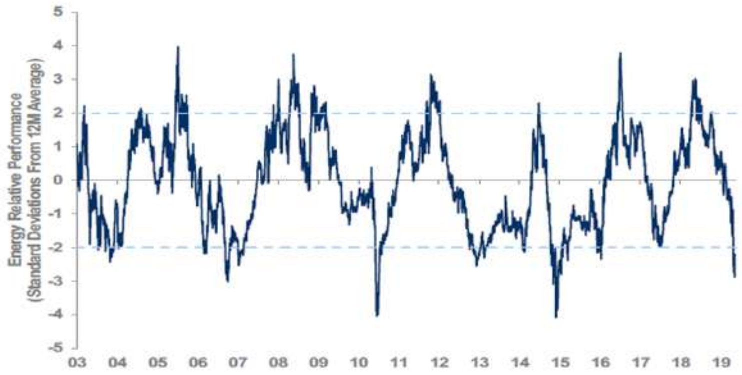
Long European oil sector, SXEP

This was either a relative call (vs Eurostoxx 600) or absolute.

The EU Energy sector (up 4% in a month) is still cheap on most valuation metrics and Q1 reporting has shown good numbers and guidance.

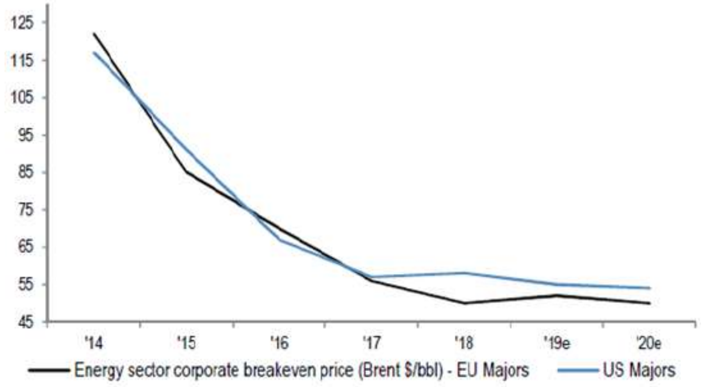
Energy hasn’t been this oversold in relative terms in almost 5 years, at 3 standard deviation, a level it reached only 3 times in the past 15 years!

Energy relative performance with standard deviation from 12-months average



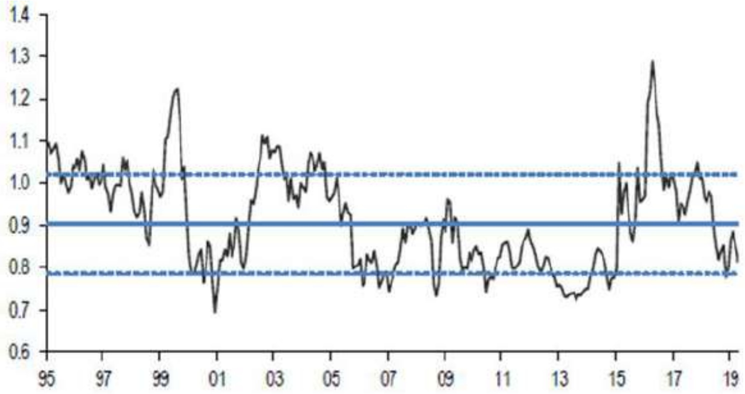
Improved capex discipline has supported stronger cash flow generation for the sector. Past margin pressures have forced the Energy sector to undergo restructuring which resulted in lower breakeven prices, and a better ability to handle volatile commodity prices. We should therefore expect the sector to continue to deliver strong earnings.

Energy sector breakeven price



Investment Idea

European Energy Sector forward Price/Earnings



The gross dividend yield for the sector is an interesting 4.9% excluding the positive effect given by the buybacks which on average gives you another 3-4% yield. <u>It is a rare Value sector seeing strong EPS revisions and macro data remains favorable.</u>

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

This is either a relative call (vs S&P500) or the start of a buildup for an absolute trade on market weakness.

Russell 2000 (US small-cap Index) has barely performed since the end of February while the S&P has bounced 7.5% and Nasdaq +11%.

Gap between Russel 2000 and S&P500 % changes in past year

While this is function of an early warning signal and in line with the breath indicators mentioned last month, we start to believe that there isn't a proper justification for such an underperformance of Small Caps vs Big Caps, especially if the Macro picture will eventually stabilize in the medium-term.

The relative chart of Russell vs. S&P500 shows how we are back to December 2018 lows, historically when there's a 6% divergence over a 2 to 3-month period, the RTY/SPX pair trade has reversed 70% of the time.

COLOMBO
Lugano | Zürich | Genève

COLOMBO WEALTH SA
Via C. Maraini 39
6902 Lugano
Switzerland

Tel. +41 (0)91 986 11 00
Fax. +41 (0)91 986 11 10

www.colombo.swiss
info@colombo.swiss