# *Monthly Market Update*

Monthly focus on the financial markets

**11th September 2018**

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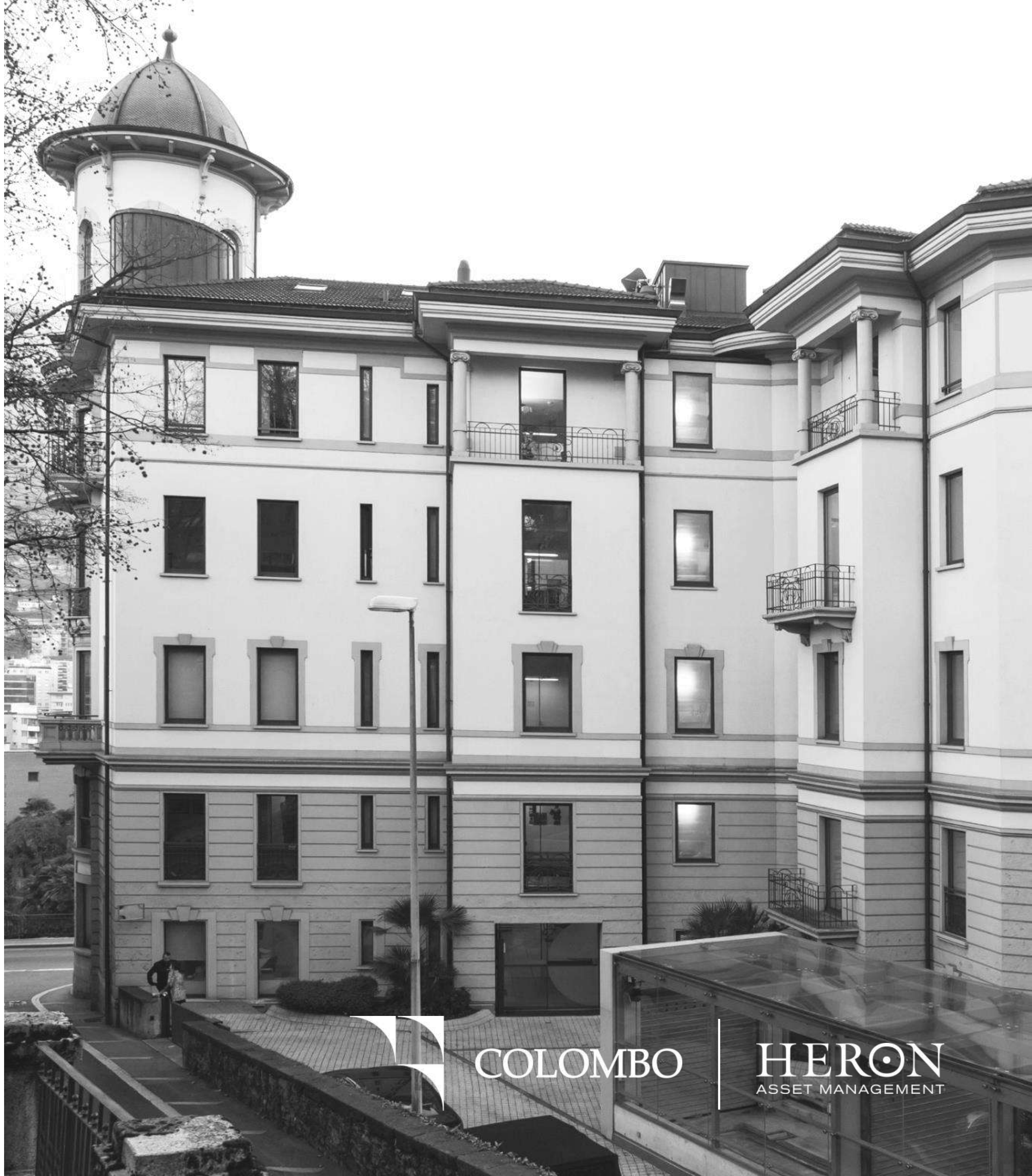


# Market Analysis

Global trade tensions, Emerging Markets crisis and a mixed Q2 reporting season have further increased the tail risk to global growth just when we are approaching the 10th anniversary of Lehman's bankruptcy (15/9).

Over last update (11th of July) we warned having a greater caution and since then Eurostoxx 50 is down 4.8%, Hong Kong down 7.2% (Shenzen -10.6%) while the US market decoupled substantially from the rest of the world with the S&P up 3.1% and Dow +3.9%.

In US, we just went through the less volatile August since 1967, with the lowest volumes (cash+futures) YTD since March 2017, as the SP500 is trading range-bound 0-1%. The US expansion is the longest-ever, currently in its 111th month (approaching twice the 58-month average length of post 1945 expansions). S&P total return is 415% since the through set, as of 9th of March 2009.

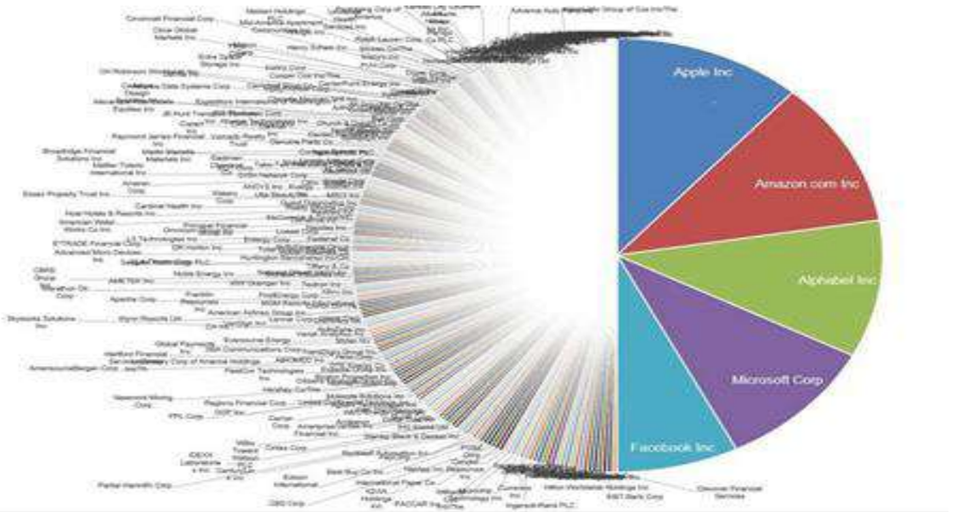
Tech is still the leading sector in US (Amazon and Apple accounted for 61% of Nasdaq gains in August, the highest monthly performance since 1929!). Despite a stronger dollar +3.5%, the difference in performance between US and EM Tech is widening to multi-year levels.

As already discussed, the narrowness of S&P500 has reached the highest level in this latest move, beating January's previous highs.

SPX Index performance vs. SPX Index performance without Apple/Amazon/Microsoft


The market cap of the top 5 S&P companies is above 4trn$ (Apple + Amazon are above 2trln$) which is the equivalent weight of the bottom 290 S&P500 companies.

SP500 companies by market capitalization

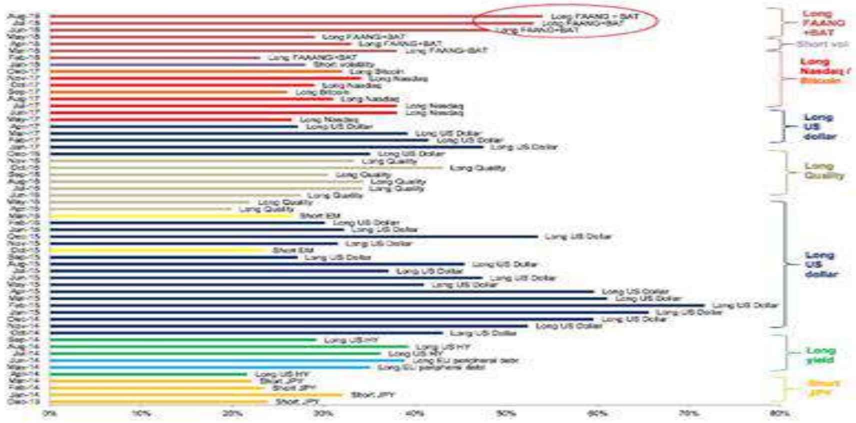



The feeble % of stocks above its 200-day moving average, confirms the market breadth deterioration as well as the performance of equal weighted indices vs. their weighted market cap.

# Market Analysis

The long FAANG + BAT (Facebook, Amazon, Apple, Netflix, Google + Baidu, Alibaba, Tencent) represents the most crowded trade for the 7th straight month in the Merrill's Fund Manager survey and the most crowded trade since Long USD in December 2015.

Long FAANG + BAT positioning (red circle)

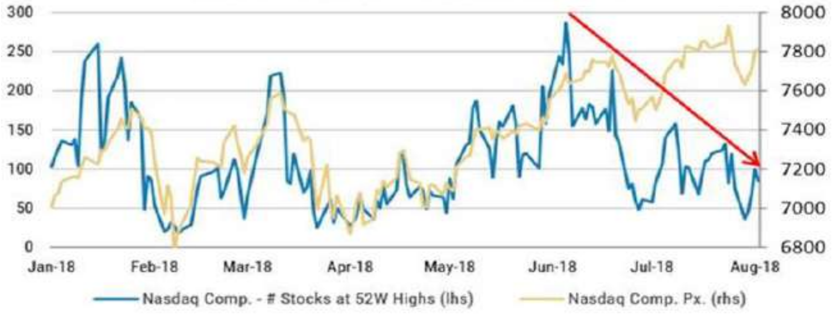


Soon to become the forth (Xiaomi is fastly growing), Apple is the third largest smartphone producer worlwide, after being overtaken by Huawei, as Apple's market share fell from 23% to 12.1% in five years only.

Apple's market cap is 3X as big as the other names combined since the Cupertino firm is  still sweeping up circa 86% of the global smartphone profits (Apple has just under 8% of Chinese market vs. +35% for Huawei and Xiaomi combined)…Does anyone remember previous market leaders as Nokia, Ericsson, Motorola and Blackberry? Some high excess memory semiconductor inventory pileup seen over the last few days might already be a worrying sign.

The number of Nasdaq stocks making new highs has been in a clear downward channel, with lower lows and lower highs while the index price level has pushed to near new highs. In other words, fewer and fewer stocks are carrying the burden of lifting the market, a sign of exhaustion and, in our view, a bad signal for further price gains.

Nasdaq number of stocks at 52 weeks high (blue line) vs. Nasdaq price Index (yellow line)




Some drivers of the two recent declines make us cautious in this latest uptrend. The former decrease in June led by defensives outperforming (performance laggards and short leg of the index), while the latter led by some weakness in Tech and growth stocks (the performance leaders and the long side of the index).

Long Top 200/ Short Bottom 200 of Russell 3000 index (two recent declines explained above)

# Market Analysis (US decoupling vs rest)

Given the exposure of discretionary and quant investors to the momentum factor, <u>lingering weakness here could feed on itself and invite further rotations</u>, which will not be good for price momentum leaders (i.e. Tech and growth stocks with strong price momentum on a trailing 12-month basis).

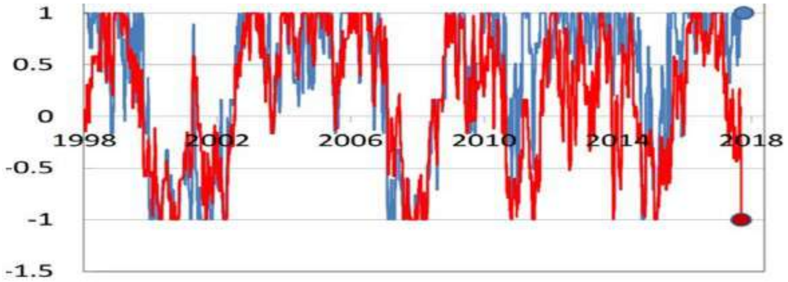
While the US market is back to January highs, the Buy-side (AM and Leveraged Funds) net long positioning is still subdued (80bn$ notional smaller).

SP500 futures buy-side net long position vs. price


<u>US has been outperforming the market worldwide, Europe and Asia.</u>

US vs. European/Asian momentum divergence is the widest ever nowadays (chart right above). <u>Inverted relations happened only twice in the last 20 years</u> and the <u>current momentum split it's the widest it's ever been.</u>

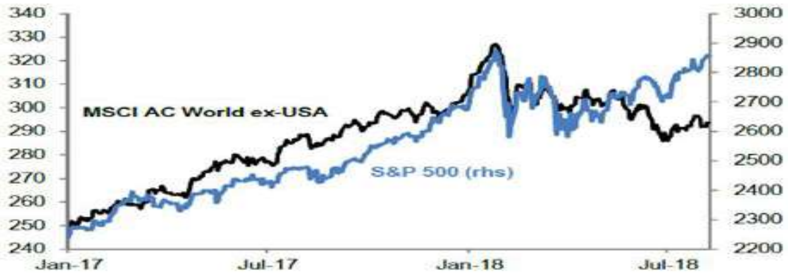
US momentum (blu line) vs. Europe/Asia momentum (red line)




Since its lows as of March 2009, S&P index outperformed the rest by circa as much as 150%; <u>1/3 of this move occurred in the past 4 months</u> and, surprisingly, the $ index was up 8% in the same period. With global debt 70% higher vs.10 years ago, risk of Emerging-Market stress is likely.

The MSCI World-ex US index stands 10% below its January peak and 4% below its levels at the beginning of the year, even with S&P500 index on record highs.

MSCI AC World ex-US index (black line) vs. S&P500 index (blue line)



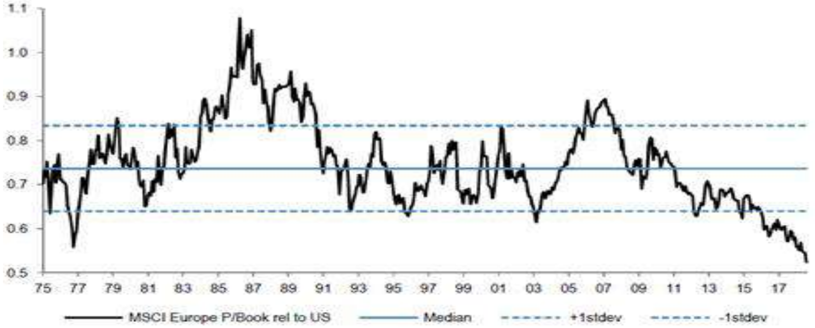
# Market Analysis (US decoupling vs rest)

The US market resilience is also due to the strong US share buyback activity in July and August, and CTAs and momentum traders buying US vs. non-US Equities.

As far as Microstructure is concerned, US vs. Europe/Asia divergence is further explained by low liquidity, (which creates bigger asset moves), and price-insensitive systematic flows of investors, long US stocks and short Europe along with EM.

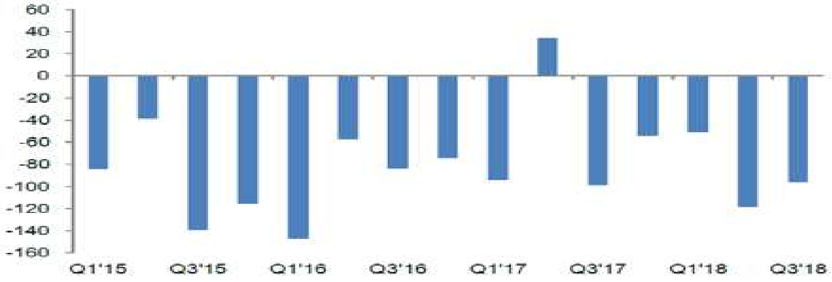
The US relative price index extends to 2.5X standard deviation above its 12-month moving average. The relative valuation of MSCI US vs. MSCI Developed + EMs (P/Es, P/Bs and Dividend Yield) reached circa 23%, the highest premium in the last 30 years.

MSCI Europe P/B ratio vs. US



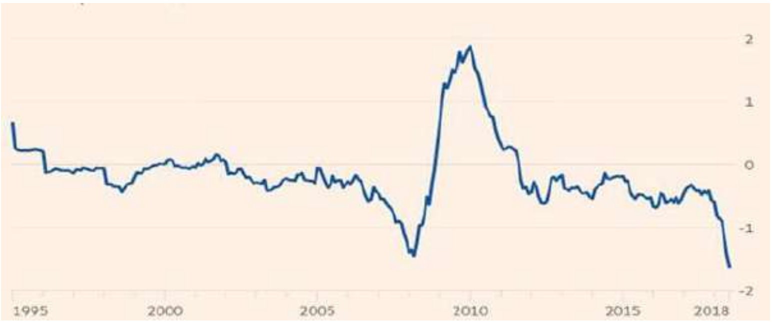

After spiking in Q2, US buyback activity seems to be even stronger in Q3. As of Q3 start, the net share count reduction is tracking as much as $100bn pace QTD vs. $120bn in Q2 and $50bn in Q1. See chart right above for a graphic interpretation.

Average net share count reduction across four major US equity indices in Bln $




UK, Europe and Japan corporates are also aggressively repurchasing their shares; so far, we have seen more buybacks than IPOs along with secondary share issues. The FT reports total value of buybacks in Western Europe, Canada, Japan and Asia DMs up to $248bn by the end of July, as much as double YoY.

12-month trailing value of equity issuance vs. buybacks as a % of global market capitalization

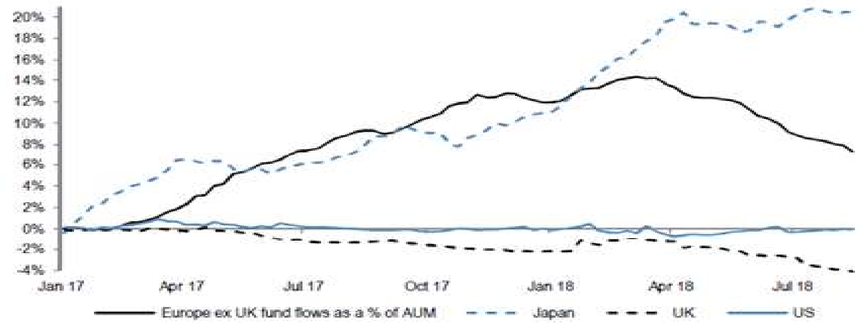


# Market Analysis

<u>The global equity market is shrinking at the fastest pace in at least two decades</u> Overall volume of US buybacks expected to reach a record-breaking 1trn$ in 2018 (GS source).

<u>The recent slowdown in EU growth, political turmoil and a weakening Euro currency spurred outlows from Europe since March</u>. The chart below shows cumulative fund flows into regional funds, with European ex-UK outflows (black line) vs. US inflows (blue line).

Fund flows as % of AUM, Europe (black line), US blue line

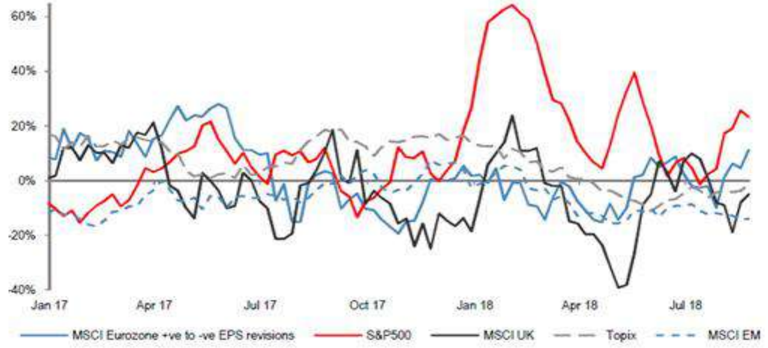



<u>The less appealing ex-US equities becomes, the more the market is betting into relatively safe US assets.</u>

CTAs and momentum investors overweighed US equities and underweighted ex-US equities over the past months. Therefore, <u>we see a potential momentum reversal in US, along with a more alarming threat in Europe as CTAs are already short there.</u>

<u>**Earnings** remain a tailwind. US and Eurozone weekly EPS revisions are positive with improving trends in US and Eurozone</u>. Japan, UK and EM are on the weaker end of the spectrum. The chart below shows how positive US trend (red line) had been so far vs. Europe (blue line) and EM (dotted line).

Positive to Negative EPS revisions: US (red line), Europe (blue line), Japan (grey line)




<u>Overall corporate results are strong</u>, with double-digit EPS growth in US/Europe, and high single-digit EPS growth in Japan. Surprises are positive for the 3 regions combined. <u>The % of earnings surprises in the US at 84%, the highest since 2009</u>.

US profits are up 7.7% YoY, though tax burden is down 33% YoY in Q2, with 16.1% YoY increase in after-tax profits. <u>The current tax rate is 10% of corporate profits, the lowest ever (50% tax rate in 1953)</u>. More than 2/3rd of companies revised EPS guidance higher in US.

# Market Analysis

In Europe however, we have seen some signs of margin pressure as whilst sales numbers have come in strong, EPS trends have been much more modest this quarter. The chart is comparing the Sales to Earning revisions ratio in Europe.

MSCI Europe Sales Revisions ratio vs. Earnings Revisions Ratio


**Drivers of US Equities outperformance:**

- Robust economic indicators with sizzling Q2 GDP growth, an ISM manufacturing gauge at 14-year highs, unemployment close to the lows touched in 2000 and no negative externalities from confrontations with China, Canada, Mexico, Europe and Turkey.
- Supportive equities fundamentals, strong earnings growth and high P/E ratios.
- Trumponomics creating a virtuous cycle for $ index, whose appreciation is damaging EM markets.
- Corporate tax cuts spurred capital repatriation and inflows to US.
- The boost to growth and underlying inflation concerns, validates a tightening path for the Fed, widening the US's rate premium.
- Trade-war news spark haven inflows into US assets. EM volatility reinforces the attractiveness of US.
- US as the global leader; US stocks and bonds account for as much as 40% of global markets, with US GDP still 50% greater than China and Europe.

The more Trump insists on putting his country first, the more you see why that can feed a strong premium for US assets

However, highlighted above, some of the reasons for being rather more careful on US markets and concerned about Tech leadership and resilience.

Consistent to our understanding, the market is concerned about slowing growth in 2018 and 2019. In addition, we see further looming threats: high comparisons, Fed tightening, mounting cost pressures and chronical trade tension risk.

# Market Analysis

<u>Q3 earnings consensus represents a difficult hurdle to beat</u> with analysts already lowering estimates for next quarters as shown in chart below.

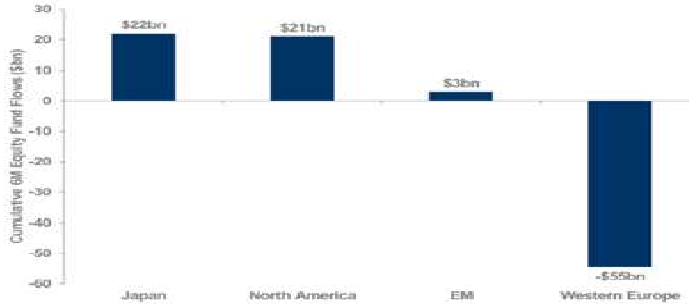
SP500 YoY EPS growth estimates


<u>As the rolling bear market began in January is threatening US growth and small cap valuation, we would call for a rotation to defensive and value in portfolios.</u>

<u>European valuations look increasingly attractive</u>.

After months of continued and heavy outflows, the <u>Euro-area now appears unloved and undervalued</u>. Italian politics remains the main risk here, though already largely priced-in. The chart right above shows some staggering European outflows within the last six months.

Cumulative 6-month fund flows by region in Bln $




<u>European HF net exposure close to 31%,the bottom of the range</u>, considerably lower than circa 50% in US and Asia.

European HF net positioning is at the bottom end of its 5-year range.

<u>The Eurostoxx50 trades at 12.5x 12-month forward EPS</u>, below the 2015/16 post-sovereign crisis and the long term average of 13.2x since the 90s.

Eurostoxx 50 index valuation EPS

# Market Analysis (Valuations)

In Europe, price performance has been dislocated from the improving earnings picture for several months. Given the historic link between 12M EPS and performance, recent underperformance might be overdone.

MSCI Italy currently trades at a 19% discount to EMU on 12M PE, a difference only greater at the height of the sovereign debt crisis in 2012 (24% discount) as Italian bond spreads neared 500bps and 10-year yields as much as 6%.

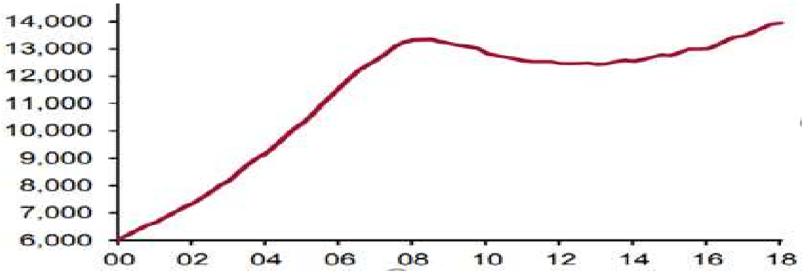
Italy to EMU P/E vs. BTP-Bund 10Y spread inverted


The background is different in US.

The S&P median Price to Free Cash Flow close to 6.4, in other words, investors buying US stocks at current levels are valuing large-caps at almost as much as 35 years worth of free cash flow.

Household debt reaching all-time highs increases concerns about household sector's financial vulnerability. As already mentioned, recession risks are related to balance sheets. Further, Uni of Michigan home-buying condition current sentiment is the worst since the Lehman crash.

US Household Debt in Bln $




Consumer credit is at more than 28% of US total spending and the ratio of total consumer loans outstanding to consumer spending is the highest ever. There are several signs of excessive lending and the delinquency rate on auto loans is rapidly increasing.

Ratio consumer loans outstanding to consumer spending in Bln $
(Grey areas US recession patches)

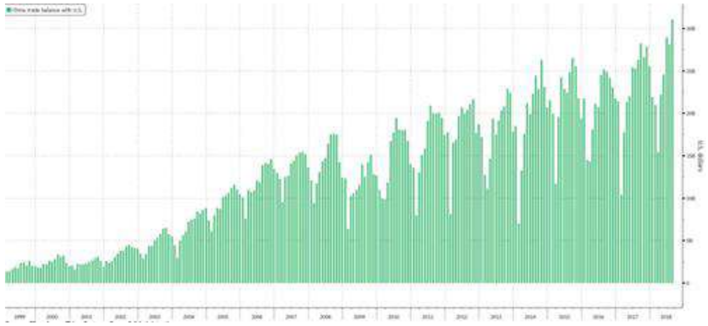
# Geopolitics

Rumors US is considering tariffs on an additional 267bn$ of imports from China confirms the trade conflict remains in an escalatory cycle, with Trump responding to China's announced $60bn retaliation, after having already imposed up to 25% tariffs on $200bn of China exports.

We think the duration of this conflict has to be measured in quarters, not weeks and could be eventually generate an erosion of earnings growth and fiscal stimulus gains. In Equities, US tech, US small caps, and Asia EM are the most vulnerable.

China's surplus vs. US widened to a record 31.1bn $ in August, paving the way to further actions from Trump admin.

China trade balance versus US in Bln $



In terms of timing, the latest decision on potential new Chinese tariffs could be implemented at the next G20 (30th of November). Next steps for Chinese retaliation could be announced at the Communist Party meeting in October/November and the first-ever International Import Expo in Shanghai (5/10 November).

It is clear to us, China needs to move from an export-growth to an internal consumption model, strengthening rather than weakening FX, cleaning up regional debt issues, restructuring financial markets and privatizing the economy.

Chinese monetary easing expectations pushed 1-year interest rate swap below the US 1-year interest rate swap for the first time in 9 years. With divergent monetary policies likely to remain in place, the narrowing rate differentials between the two nations point to bearish implications for the yuan against the dollar.

US and Canada are working on **NAFTA**, after the former posting its biggest July trade surplus vs. the latter in a decade. Trump wants to renegotiate NAFTA due to Canada's surplus.

Last week Trump announced **Japan** might be the next rival. The US deficit vs. Japan was 63bn$ Bn in 2017, the 5th largest country deficit, but relatively modest vs. the 351bn$ China deficit last year.

**Europe** still "untouched" but the weakest link in the chain, being the most internationally exposed stock market as 53% of European revenues are produced abroad compared to 27% for US, 46% for Japan and 28% for EM companies.

US sanctions vs. **Iran** aimed at blocking the purchase of $ and preventing gold and other precious/industrial metals trading.

# Geopolitics

US trade war policy affects investors behavior. MSCI World's 12-month PE Index is strongly related to US trade policy uncertainty index since the start of 2018.

MSCI World 12M PE vs. US Trade Policy Uncertainty Index


The preliminary result of Sunday's **general elections** points to an uncertain period in Swedish politics. The overall result is close to the polls in recent days.

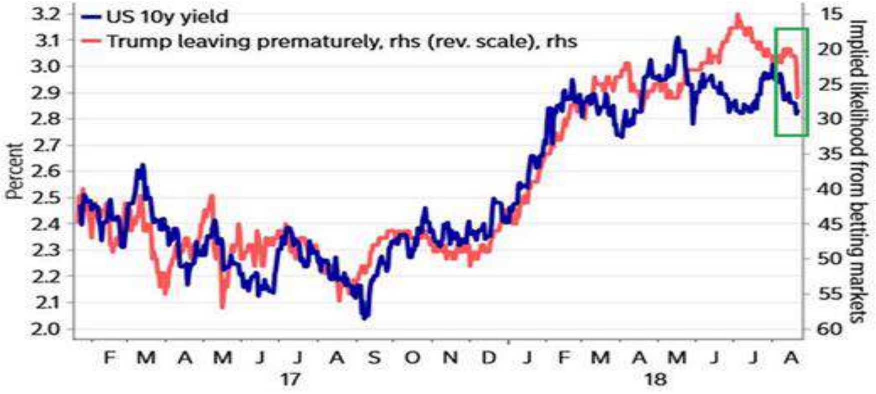
The two main blocks' vote share is within a half percent of each other and with a very close seat count. At the current count, the center-left is one or two seats ahead of the center-right. The populist anti-immigration and EU-sceptic Sweden Democrats are just below 18%; the low end of its exit-polls range ahead of the election. The final result may not be known until later in the week.

The **US midterm elections** are held on the 6th of November. 435 seats in the House of Representatives and 35 out of 100 seats in the Senate will be contested. Exit-polls imply the most likely outcome of the midterm election is a Democratic House and Republican Senate majority. Today's numbers suggest a fairly tight contest. In particular, generic ballot polling and district-level approval ratings suggest Democrats are expected to win with a narrow majority. Last week Trump attacked Montana Republicans, claiming a potential impeachment would be the result of their abstention.

A divided Congress could incrementally raise the probability of disruptive outcomes on trade policies and sanctions. With little prospect for legislative action, the White House might become even more focused on issues where it can act unilaterally, like tariffs. Trump's approval rating remains high by his Administration's standards, and about midway between Nixon's 25% and Clinton's 60% ratings when their impeachment sagas began in February 1974 and December 1998, respectively.

The probability Trump leaves prematurely has jumped from 22% to 27% as shown in chart below.

Probability Trump leaving prematurely vs. UTS 10y yield



# Macroeconomics

In US we continue to get robust data, with a recently strong ISM and jobs numbers (the yearly rate of pay increases climbed to 2.9%, the highest level since 2009), pushing up GDP but increasing Fed hawkishness. August ISM Manufacturing PMI hit 61.3 such that manufactures have not felt this strong since the Reagan Era in 1984 (except for 1 reading in 2004!).

In Europe the situation is mixed with PMIs being stabilized since June, after 4x sequential declines from February until May and August composite printing at 54.4 supported by Germany and France activity.

German IFO expectations have moved up to the highest since March, implying a German GDP growth rate at 3%.

On aggregate level we note however that economic surprises in the US vs Eurozone are not far from going negative. US CESI (Citigroup Economic Surprise Index) has clearly peaked versus Eurozone and has been rolling over for a few months now.

US minus Euro Cesi Index


The big misses in European PMIs we had in the past months were among the worst in several years. July was only the 2nd time in the history of the ISM Services report (1997+) where Business Activity, New Orders, and Backlog Orders dropped 5 or more points MoM, almost as bad as the print following 9-11.

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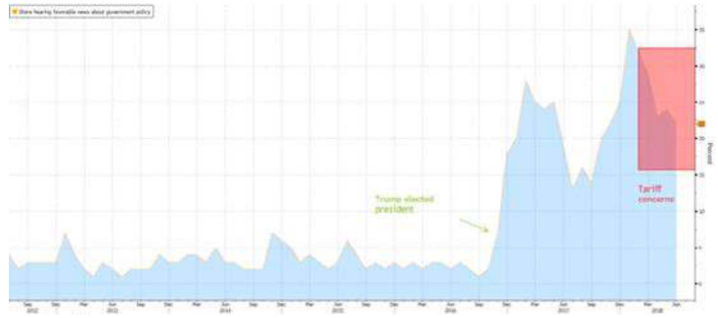
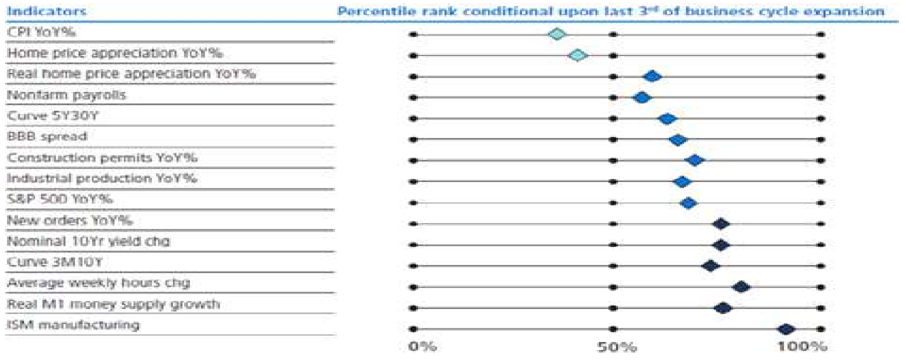
In US, rising global trade war's threats makes Americans more unsettled. Fewer and fewer US citizens, 18% the smallest share since Sept., heard favorable news on business conditions with respect to governmental policies. After reaching a record 35% in January in the wake of tax cuts, this share has declined, wiping out almost as much as half consensus since President Donald Trump was elected (chart).

Decreasing US citizien share hearing favourable news about Trump's policies



In addition, several economic indicators are eventually running too hot in US as shown below.

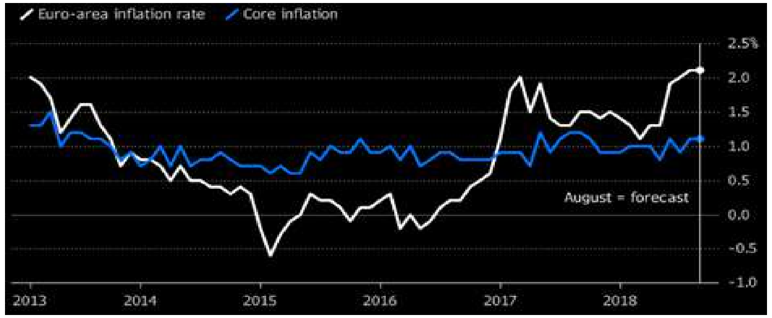
US Macro indicators overheating the Economy



# Inflation/ Yields

Euro-area inflation remains on a very slow upward path, though the ECB expects to see stronger numbers emerging towards year end. Unemployment is falling ,now at the lowest in almost a decade, and there are signs of wage growth strengthening.

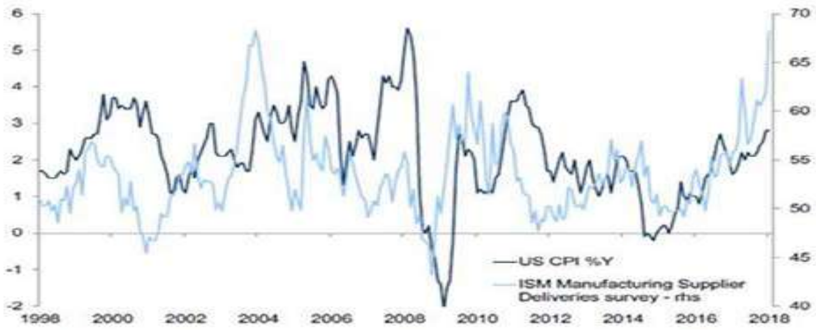
Euro-area headline inflation rate (white line) vs. Core inflation rate (blue line)




In recent months questions about inflation, and 'inflation expectations' from bond markets have been subdued, in contrast to some inflation data coming through, especially in the US, where the latest headline and core PPI inflation skyrocketed since 2011 at 3.4%Y and 2.8%Y respectively. With increasing cost-push inflation, headline CPI is already at 2.9%Y target.

The “supplier deliveries” component of the latest ISM manufacturing, at the highest since 1979, has been a reasonable indicator of subsequent inflation trends over the last 20 years, suggesting US CPI is likely to move higher over coming months.

US CPI % YoY vs. ISM Manufacturing Supplier Deliveries survey




Despite strong bond issuance, the market value of the global bond universe failed to increase so far this year as the rise in bond yields and the resulted capital losses offset issuance. The yield on the Barcap Global Aggregate index increased from 1.66% at the end of last year to 2.00% and an increase of 34bp implies a capital loss of close to 2%, or more than $1tr, for the global bond universe. In addition, the strength of the US dollar has inflicted a further decline in the dollar value of the global bond universe as it reduces the dollar value of non-USD denominated bonds.

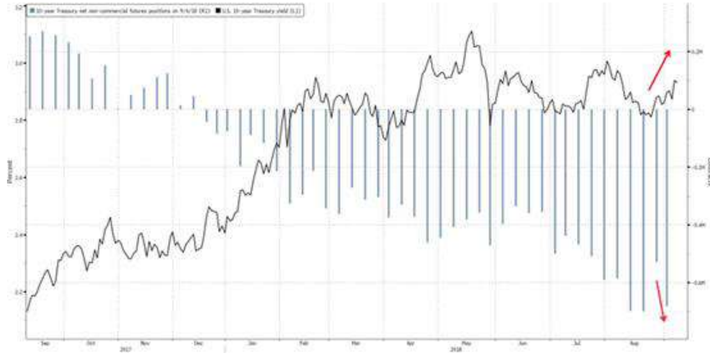
German and US bond yields are moving higher again, with US 10 year yield not far from 3% level and German 10Y above 0.4%.

# Inflation/ Yields

A week after what seemed to be signs of capitulation, hedge funds have re-extended their bearish positions toward record levels. Speculative net short positions on 10-year notes rose by nearly 30%, almost paring the previous week's decline, according to the latest Commodity Futures Trading Commission data.

<u>The chart shows the net positioning (bars) vs US 10Y yield</u>. <u>It is an unprecedented consensual call and therefore as we warned in the past, very dangerous!</u>

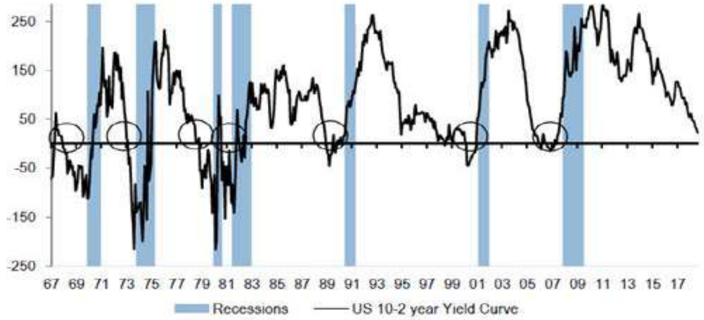
US CPI % YoY vs. ISM Manufacturing Supplier Deliveries survey



<u>Our expectation is that the 2year-10year curve is likely to flatten further from here</u>, in essence ending largely flat by year-end. Curve flattening is nothing unusual while the Fed is tightening. In the last six episodes, the yield curve was flattening every single time that the Fed was tightening.

This will however get us closer to a potential inversion of the curve with the highlighted risk of recession (highlighted on top-right chart in blue areas).

US 10-2 year Yield Curve (black line), US Recession (blue patches)




<u>The US curve has tumbled back below the Japanese yield curve</u> for the 1st time since November 2007.

<u>The yield premium on 10Y Treasuries over German bunds may have peaked</u>. The spread hit record highs in recent months, with the Federal Reserve pushing ahead with interest-rate increases even as the European Central Bank signaled it will keep borrowing costs low well into 2019. Over the next 12 to 18 months, the yield gap may narrow amid a potential reversal of monetary policy cycles on both sides of the Atlantic and a likely cutback in expansionary fiscal measures in the US

US 10Y yield minus German 10Y yield

# Central Banks

In his closely watched speech at the **Fed**'s annual Jackson Hole, Powell expressed confidence in the economy and said he does not see inflation getting out of hand.

He expects a slow but steady diet of interest rate increases to continue as the central bank looks to find the right recipe between promoting growth and controlling excesses. The current trajectory the Fed has been following since December 2015 is unlikely to change so long as there aren't any significant changes to economic trends.

The Fed also has been in the news lately as Trump has leveled criticism against it for continuing to raise rates. Powell did not mention the president's remarks in his speech, though a few other Fed officials have said they are committed to maintaining independence from political pressures.

After a certain rate hike on the 26th of September and a likely one on the 19th of December, all bets are off until there's clarity on the trade wars. But the big Fed story of the summer is the looming feud between Powell and Trump, who wants a lap-dog Fed, he won't get it.

On Thursday we will have the Central Bank of Turkey, the ECB and BoE all delivering policy decisions.

**Turkey** will undoubtedly be the most watched post the recent currency crisis and the market expects up to 500bps of interest rate hikes believing that regaining policy credibility will require the CBRT leadership to demonstrate commitment to bringing down inflation and the current account deficit (despite a significant cost to near term growth).

The **ECB** has been less of a market "event" recently but now QE will be tapered to 15bln€, and Draghi should continue to signal QE to end in December and for the first rate hike to take place next September. Unlike the start of the year when the market was hugely bulled up on rate hikes the opposite is now true. The 3 month Euribor breakeven is now May 2020 and we believe that inflation should pick faster than what ECB has in mind and therefore ECB will have to become more hawkish at some point.

The ECB balance sheet in the meantime has hit a new life-time high (chart) with total assets held by the ECB equivalent to 41.3% of Eurozone Gdp, exactly twice the Fed's at 20.7%.

ECB Balance sheet Assets: Last Quote 4,619M Euro

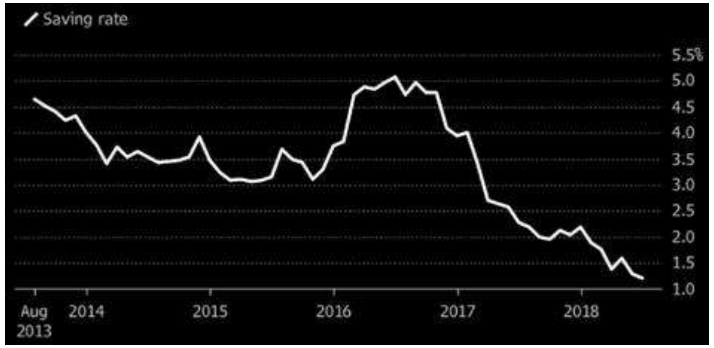
# Central Banks

The **BoE** is going to stay on hold, what is more interesting though are the recent developments on Brexit as the EU is providing some comfort and is preparing to give its Brexit negotiator (Barnier) new instructions to help close a deal with Britain, in a conciliatory move. It seems that both from the UK and EU side there is willingness to finalize divorce terms by the middle of November.

We will hear more comments on Brexit at the upcoming Party conferences (Labour 23rd-26th September, Conservative 30th September – 3rd October).

In the meantime, macro data on UK are still sluggish and UK consumer's savings rate fell to the lowest on record as they eat into more of their pay to cover shopping, rent and mortgages (chart) and we continue to suggest an underweight positioning on UK.

UK Consumer Saving Rate %



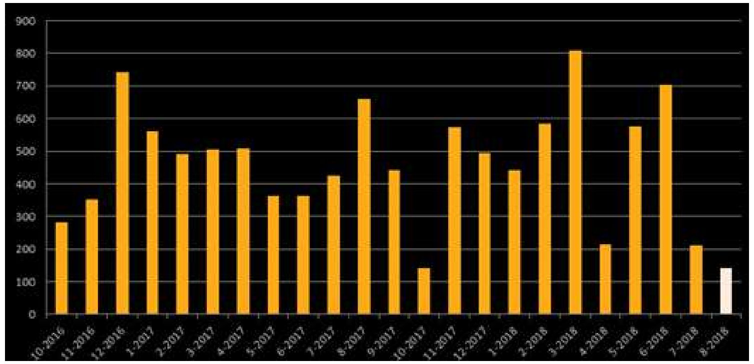

A recent poll has affirmed that as many as 59% said they would vote Remain in another referendum while only 41% indicated they would still back Leave. This is by far the highest level of support for Remain we have seen since the Brexit vote.

The **BoJ** has started to slow down the pace at which it buys exchange-traded funds, apparently following a policy shift in July to make the 6 trillion yen (54bn$) target of its stock-buying program more flexible.

So far this month, the BOJ has not reacted to certain market signals that in the past seem to have prompted ETF purchases. For the first seven months of this year, every time the index fell 0.4% or more in the morning, the bank has bought 70 billion yen worth of ETFs later in the day. In August and September however, it refrained from making a purchase despite the threshold being breached.

The chart shows the BOJ's buying in Japanese shares (Blns Yen).

BOJ's buying in Japanese shares (Bln Yen).



# FX

FX markets continue to provide a range of narratives more linked to country-specific developments than a general theme. The closest thing to the latter is the ongoing “trade wars” topic, with the US and China implementing fresh tariffs and again exchanging barbs. But even this theme is not all encompassing; for example, markets have been positioned for NAFTA talks to go well this month in spite of the backdrop of global trade tensions. Even in the case of China, PBOC measures to increase the cost of holding forward positions and hints at further action to slow CNH weakness are making FX trading related to the trade wars theme choppier.

The real value of currencies likely must be the release valve whenever there is another crisis someday.

**DXY**, dollar index, is up 0.7% since out latest update, trading sideways and being driven by factors including strong domestic growth coupled with a deceleration in global economic growth data, continued Fed tightening and widening interest rate differentials, and escalating trade tensions.

Net speculative positioning on USD is the longest it has been this year (shortest on Euro as seen on chart), form here a convergence is more likely.

Euro net positions vs. EurUsd FX (black line)

A weaker Euro might be good for European corporates’ overseas earnings, but it’s no good for their shares these days. The usually negative correlation between the euro-area currency and stocks has turned positive, as both become increasingly dominated by political fears such as Italy’s potential conflict with the European Union. On the chart below you can spot the Dollar Index (black line) vs the ratio between S&P and MSCI World Index, the positive correlation started after the “Tax Day” last year.

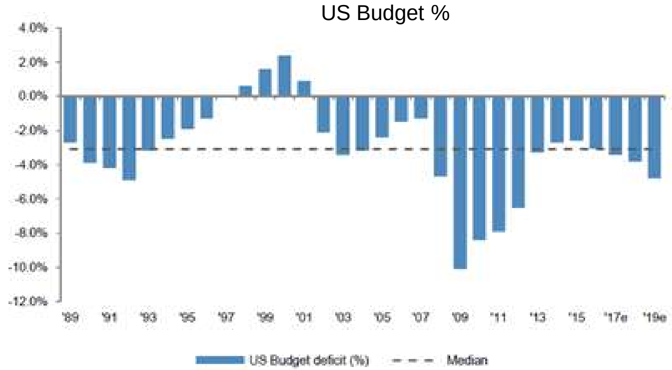
USD spot index (black line) vs. SPX to MSCI World index (blue line)

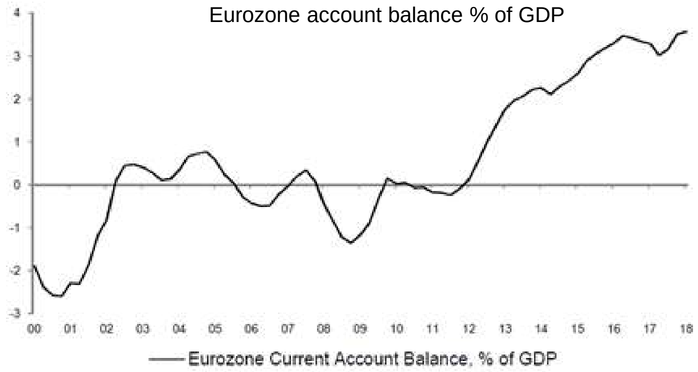
# FX

The **<u>Eurozone current account surplus</u>** <u>has increased materially over the last few years, driven by Germany. This, coupled with the upcoming unwinding of QE by the ECB, will likely support a rising euro over time</u>.

On the other hand, <u>US funding needs remain material</u> (the chart shows the US vs Germany yield spread).


The massive difference between the Eurozone current account as % of Gdp (courtesy of Germany) vs the US budget balance is massive and is <u>likely to put some pressure on the currency in the long term.</u>




The record German budget surplus triggers calls for tax cuts and more public investments<u>. Germany had a surplus of 48.1bn€ in H1 2018 equivalent to 2.9% of Gdp, the highest level since German reunification in 1990 and the world's largest trade surplus for a 3rd consecutive year</u>. Last week, <u>German Foreign Minister Maas said that they are working in an independent payment system in light of row with US over Iran</u>. This is a good example of how US sanctions will ultimately undermine the USD's role as an international payment currency and could encourage the use of Eur by European corporates even when trading commodities that are traditionally USD-denominated. <u>We think that the USD is ready for a new leg lower and our "best friend" is Trump as he clearly wants it weaker mainly because it will help reducing the trade deficit through a loose monetary policy and higher inflationary expectations</u>. The great irony in this narrative is that Trump had the most dovish Fed Chair ever, Janet Yellen, who was fired. Now Trump has a Chairman who's slightly more hawkish and the markets have to brace for the unprecedented spectacle of a president in open warfare with his central bank.

# Commodities

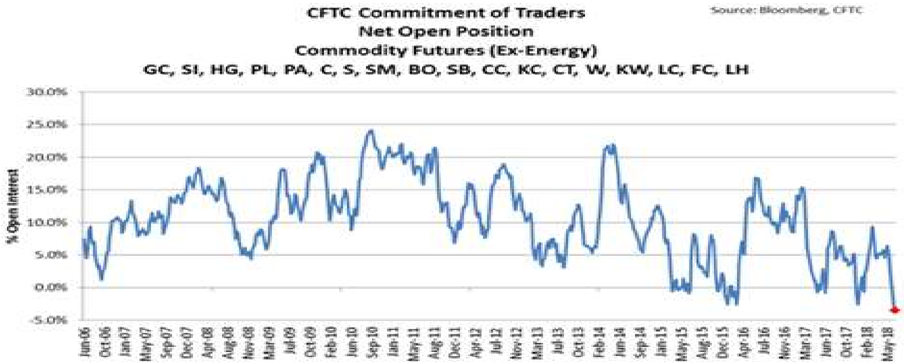
The Blomberg commodity Index has nearly lost 10% from the highs at the end of May and is down a bit more than 1% since our last update.

The strong correlation with the CNYUSD exchange rate explains why there has been such a move on commodities.

BBG Commodity Index (yellow line) vs. CNYUSD currency (white line)

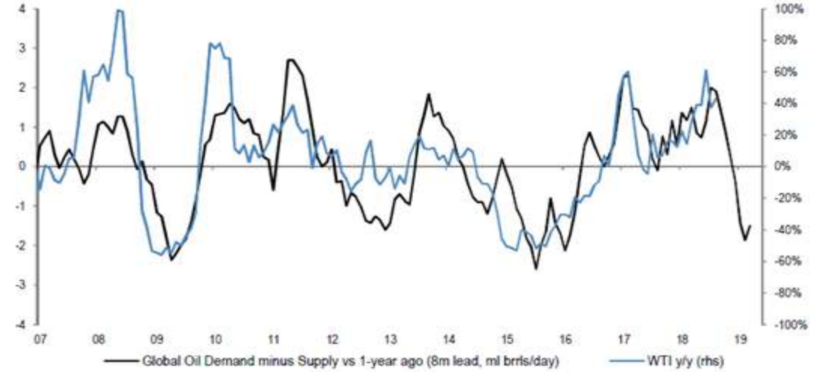

Managed Money's net open position across the major commodities (ex-energy) is now the shortest it has been since the data were first reported in 2006 (chart).

Net Open position Commodity Futures (ex-energy)




**Oil** prices are on their longest weekly losing run since 2015 and the demand-supply outlook calls for caution, chart vs WTI (Crude price). Crude oil seems to be stacked in a range between 64$ and 74$, we are now close to the bottom of this range.

Global Oil demand minus supply 1 year ago (black line) vs. WTI YoY (blue line)



# Commodities

Since our last update **Gold** lost a further 4% (-11.5% since the middle of April) touching a low at 1175$ and since then stabilizing around 1200$.

Investors have continued to build-up short positions to a record pace both vs Gold (chart) and Silver


Short positioning is therefore the highest is has ever been since data were collected by CFTC in 1993, it is basically the biggest bearish position in 25 years!

Weakness on strong dollar, higher yields, weak physical demand, rising shorts… everything that could possibly go wrong it went wrong but it is an anti-consensus trade which could eventually work if only one of the following hypothesis would happen:

- US data undershooting expectations sparking a reassessment of how fast and far the Fed can hike rates;
- Economic data of the rest of the world improves weighing on the USD;
- Equity market correction, risk-off sentiment;
- China stimulates its economy and re-values the yuan higher to ease trade tensions;
- India reduce gold import duties.

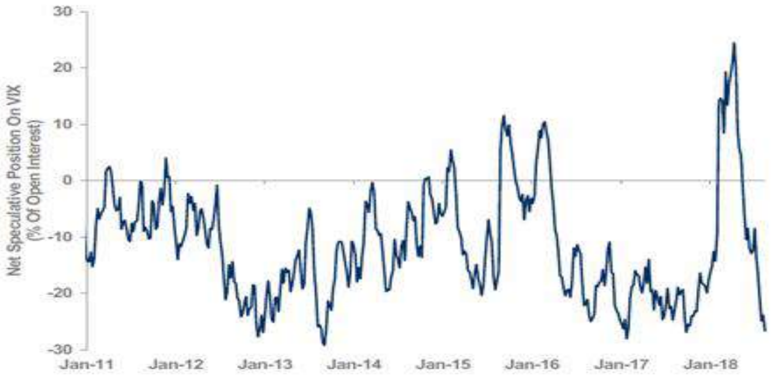
We would therefore suggest to start having or increasing the positions on both Gold and Silver with a long-term view. We are approaching the period of seasonal strength.

# Volatility

After reaching a post-Feb low of 10.85 at the beginning of August, the Vix has been squeezing higher to 15.

VIX position indicators such as the net spec position in VIX futures is back to the very negative territory of last January also pointing to bullish rather than cautious investor positioning.

Net Speculative position on VIX (% of Open Interest)

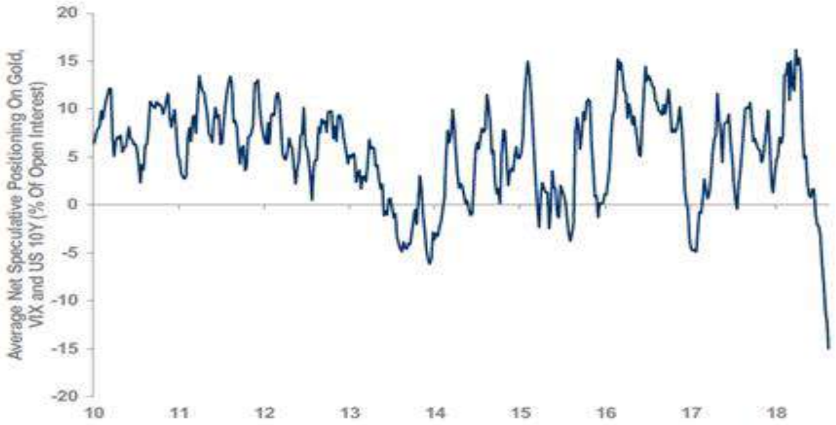



We don't think that the situation is similar and we shouldn't expect a huge spike as in February the spike was boosted by the inverse ETPs delivering as their rules forced them to do, and those products are not an issue today.

However, we should still be cautious as large speculators are betting the equity calm will persist, even though September tends to bring market storms.

The net positioning on "safe assets" is self-explaining the current extreme situation (chart showing the aggregate positioning of Vix + Gold + US 10Y)

Average Net Speculative position on Gold, VIX, US 10Y (% of Open Interest)



# Executive Summary

It's "back to school" again, with the same debates and challenges facing the markets as when summer started.

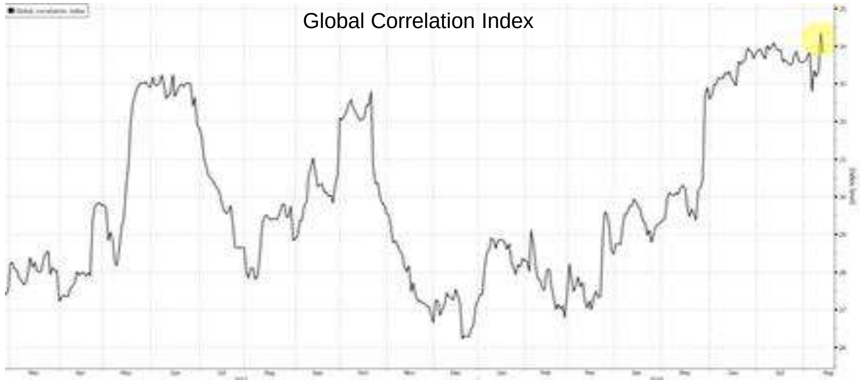
The bears will say that EPS is slowing, margins are contracting, higher rates are dampening growth, EM "contagion" will proliferate, and the continued tariff and trade drama to damage corporate profits and behavior. From a bearish perspective, many argue that this could inevitably lead to the US markets rolling over. Such a view is all focused around the economy and market being late cycle.

The few bulls still standing will argue that global markets (especially the US) have seen multiple contractions already, discounting many challenges, while EPS globally (particularly in the US) has been buoyant. Some bulls may even think that trade uncertainty will be solved eventually, while the worst is already discounted.

The events we had since the beginning of September have given both sides much to think about.

We are leaning towards the bears as we have been warning of a difficult market since the top made in January, this has not worked yet in US but we have been right on the other Geographies and asset classes.

What is important to note first is the performance of the different funds YTD, considering the doing stock picking in a falling market with the highest correlation in recent years (chart) is a very difficult task.




The weakness in active manager performance stands in contrast to the continued resiliency of the overall index this factor is seen in the dispersion which is high in the 76th historical percentile. The largest positioning risks continue to be under the surface in crowded names, sectors, and factors rather than overall index level positioning.

On top of this already difficult situation it is also worth to mention that volatility of actively held names relative to passively held names is at new multi-year highs.

European funds have been suffering particularly also because of the relative extreme underperformance vs US peers.

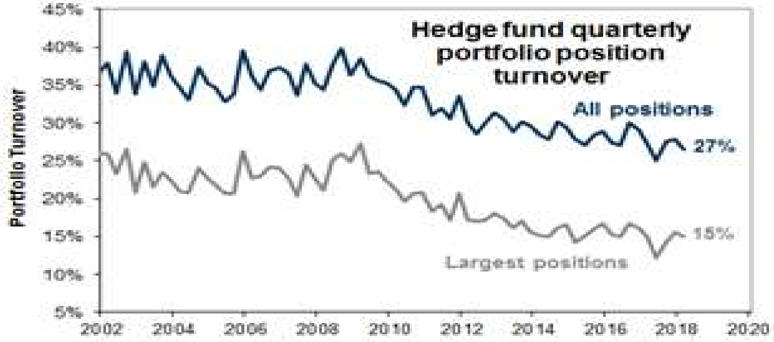
US Hedge Funds are now negative Ytd despite the positive performance of their Indices as they have lowered down the exposure further during the summer with the lowest net exposure in few years (chart comparing Goldman Sachs HF net exposure vs S&P).

SPX index (light blue line) vs. HF net exposure (blue line)

# Executive Summary

Not surprisingly, portfolio turnover remained low being now down to 15% for the largest positions (chart).

HF Largest positions (grey line) vs. HF All positions (blue line)



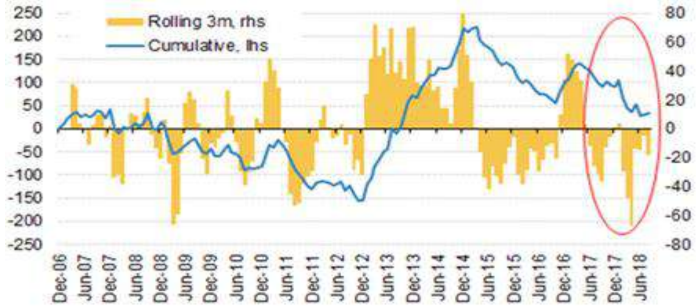

Global Macro HF are negative Ytd and they have done a further deleveraging lowering down their beta to multi-year lows (chart vs beta of MSCI World).

Ratio global Macro HF beta to MSCI World Index


Quant funds have performed really poorly Ytd while they were supposed to perform better in bear markets. Risk Parity funds have still a high leverage and are likely to reduce further if volatility will rise again.

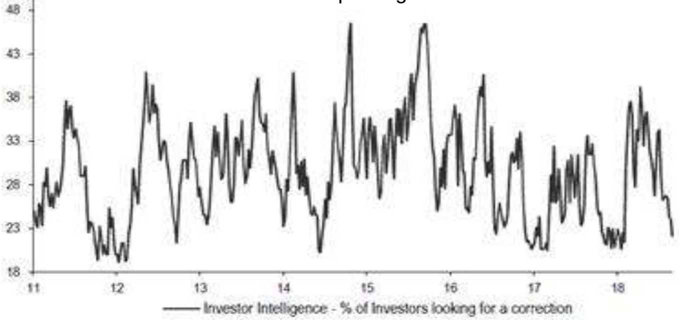
The result is that positioning in European and US equities is now light and significantly below January's highs, see chart below.

Cumulative US Equity mutual funds + ETF flows (blue line)




Despite the massive deleveraging done YTD, the current expectations for a correction are low (chart showing the data from Investor Intelligence showing the number of investors looking for a correction), the same concept is to be seen in the volatility

% of investors expecting a market correction



# Executive Summary

**Positive factors**

- Macro, strong US data potentially offsetting some signs of moderation in China and EM more generally. European economic indicators appear to have stabilized post their drop earlier in H1;
- From a yield perspective, equities remain attractive relative to other asset classes. The yield gap between equities and other asset classes remains close to historical wides. While we don't think this is necessarily a reason why equities in aggregate should perform strongly, we recognize the argument regarding the lack of viable alternatives to equities' yield especially in Europe as the yield on inflation-linked German 10Y bonds is currently -1.3%, close to an all-time low.
- In the US, for investors wishing to position more defensively while also capturing an income, there are viable options outside of equities. The US 10Y bond offers a yield of 2.9%, the US 2Y yields 2.6%.
- US real yields remain close to the top of their 7Y range, while in Germany they remain close to all-time lows. The gap between Europe's dividend yield and government bond yields has only been higher 1.6% of the time in the last 95 years! (chart showing the MSCI EU dividend yield vs 10Y yield).

Ratio MSCI EU dividend yield vs. EU 10Y bond yield


- European valuations are compelling now. The Eurostoxx trades at 12.8x 12-month forward EPS, below the last 5-year average at 13.5x and the long-term average of 13.2x since the 90s. The S&P is trading at 20.9x.
- Global equity positioning not extreme as it was in January.

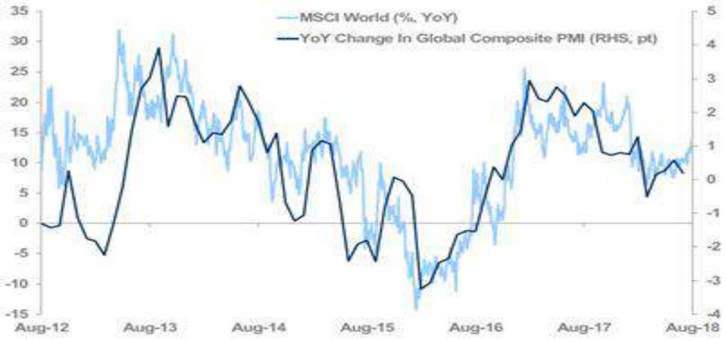
**Negative factors**

- The main bear case is that a crowded trade unwind spreads to an already weak broader market. Any such move likely won't be as violent as February, but if it materializes could actually be more negative for many managers than that event was (at least relative to the broader equity market).
- We see limited risk that global economic momentum will re-accelerate here, as the year-on-year comparisons get slightly tougher in the coming months and increased uncertainty around trade and tariffs may start to weigh on activity going forward.
- In addition**,** margin pressures are beginning to build, which is perhaps not surprising given that input cost inflation (PPI) has been above CPI for much of the last two years. With labor costs gradually rising and tariffs offering up the potential for higher input costs and supply chain disruption ahead, profitability concerns look set to become more of a focus for investors in the coming months.

# Executive Summary

- <u>The annual change in global PMI likely to turn negative in the coming months</u> and we know how correlated it is (chart)

MSCI World % YoY (light blue line) vs. Global PMI YoY (dark blue line)



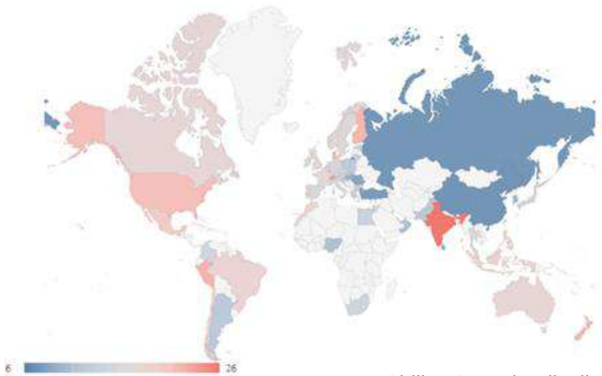

- <u>Input prices rising more rapidly than output prices</u> (chart), <u>negotiated wages are now rising sharply even in Europe.</u>

Output prices (light blue line) vs. Input prices (dark blue line)

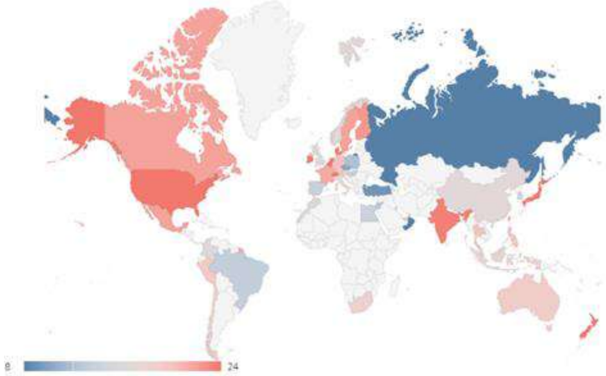

- Over the last few years, a key driver of Europe's EPS recovery has been a sharp rise in margins which, excluding commodity sectors, rebounded to record highs. However, we've already started to see signs that the <u>margin environment is becoming less favorable</u>, this might be an ongoing theme.

These two pictures clearly explains how “hot” are the current valuations along the globe with two indicators:

P/E by Country



Shiller-Cape (cyclically-adjusted P/E ratio) by Country



# Executive Summary

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

MSCI World % YoY (light blue line) vs. Global PMI YoY (dark blue line)

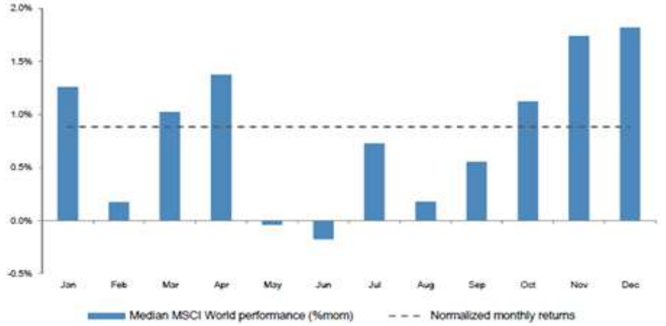

- <u>Global monetary policy is set to (gradually) tighten further</u> as the Fed continues to liftrates and the ECB nears the end of its only bond purchase program. Tighter financial conditions in general increase the pressure on the 'weaker links in the chain' and the chance that we see higher volatility. <u>Credit spreads should slowly widen</u> as ECB QE winds down, <u>unhelpful for equity valuations</u>. Chart showing the MSCI EU P/E valuation and inverted EU High Yield credit spreads.

MSCI EU 12M PE (dark blue line) vs. EU HY Credit spreads (dark blue line)


- <u>Volatility is set to spike</u>, contrarian trade. The <u>largest positioning risk continue to be under the surface in crowded names, sectors and factors rather than overall Index level positioning</u>.

- <u>Seasonals are weak for the remaining of the month.</u> MSCI World seasonality (data since 1970). Since its inception in 1928, the S&P 500 S&P, has finished lower in September more than any other month.

Median MSCI World performance MoM (dark blue line) vs. Normalized Monthly returns (dotted line)




We've been making the case that a <u>rotation towards defensives</u> already last time and we still think it is not too early to start shifting out of some of the extreme cyclicals and picking up a few more defensively oriented names.

<u>Timing the next 20% bear market is difficult due to policy distortion but it seems quite likely to have a correction within the next 6 to 12 months</u>.

# Current Investment Ideas

**Long Value trade:** Growth has outperformed value by 25% in the last 12-months in US and by a similar percentage in Europe.

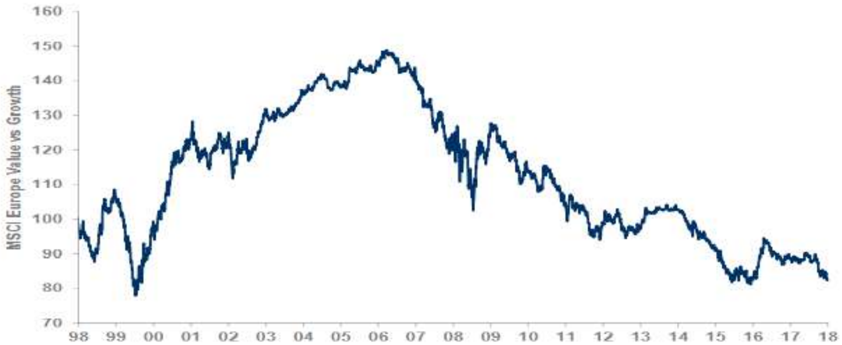
Value factor lost a further 7.1% since our last update but it is starting to give some signal of stabilization.

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%).

EU Factors:Growth vs. Momentum vs. Value vs. Realized Volatility


The relative performance of MSCI Europe Value vs Growth is closing in on its 20Y lows.

MSCI Europe Value vs. Growth




Value now trades at a 49% discount to growth when measured across MSCI indices, a level which effectively represents a 40Y low, excluding the 12 months of 2000. Interestingly, this Growth index now yields less than half that of the Value index.

The current Value universe is heavily overweight Financials, Commodities (especially Energy), Utilities and Telecoms.

Value had a tough performance since the beginning of 2017, the Morgan Stanley EU basket on Value MSZZVAL, built on the pair trade Value Long – Short is at the lowest price since 2008-2009 and down 22% Ytd.

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

The catalysts that could accelerate the appreciation of Value factor are: Higher Bund Yields, stronger EUR, Risk-off markets, slowing EPS trends for Growth.

# Current Investment Ideas (cont)

**Long Put spread on US / EU markets:** we are keen to hedge our investments through the purchase of a cheap protection in US (low volatility) but even in Europe through a put spread.

A Put spread on the S&P expiring on the 21st of December '18 strikes 2800 (out 2.5%) / 2675 (out 7%) selling a Call 3000 (out 4.5%) would cost only 0.16bps for every 1mln$ covered (delta 36%).

It is a bit more expensive on Russell / Nasdaq and European markets as the implied volatility of these Indexes is higher.

# New Investment Ideas

**Long EU Utilities (SX6E Index)**: after being long US Utilities we took profit over the last 3 weeks and we would now be long EU peers.

The Utilities sector has seen negative earnings revisions since 2012, and over the past 10 years it has only outperformed once, in 2014, on the removal of regulatory uncertainty, cost cutting and lower yields. With market earnings revisions expected to turn negative (as we have seen above), Utilities should look relatively more attractive offering better EPS momentum, growth and inexpensive valuations.

Going into winter, the risks for power prices are tilted to the upside and the sector should outperform in a further market correction.

**Long EU Financials (from trade "on hold" to live, SX7E Index)**: we stepped out of the trade because of Geopolitical issues (mainly Italy and EM) and ahead of Q2 difficult numbers with the idea of entering again at lower prices.

We now think that it is worth to enter again as expectations/sentiments and prices are attractive.

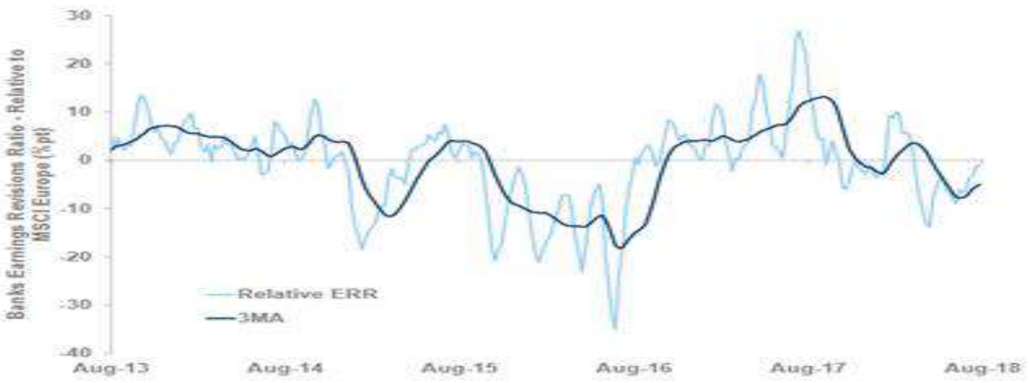
In Italy the spread is considerably tightening as the announcement to be done on the 27th of September is likely to show EU deficit threshold around 2%, Hedge Funds have a consensual short position on the sector… there is a general risk-off mood on the market which would induce some to quickly reduce some shorts where the performance has been positive.

The underperformance and undervaluation of Banks has reached extreme levels despite a stronger EUR and better domestic macro data which are positive factors.

# New Investment Ideas (cont)

We still like the following points: 1) credit recovery/ loan growth, 2) decreasing NPLs, the bank's 3-month breadth has fallen to a 15-year low and no European financial has outperformed the market over the last 12 months.

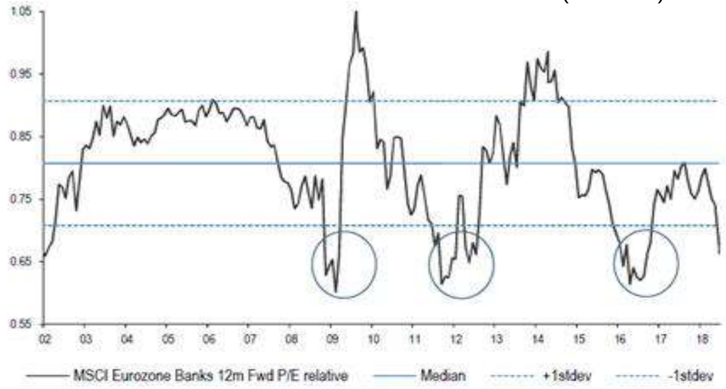
MSCI Europe, Banks Earning Revisions Ratio %




Banks relative earning revisions are showing some signs of troughing as seen on the chart. The median bank stock now trades below tangible book for the 1st time in almost 2 years.

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

MSCI Eurozone Banks 12M Forward P/E relative (black line)




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

MSCI Eurozone Banks P/B relative (black line)

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# Closed Investment Ideas

**<u>Long Spain / Short Italy</u>**: we had this relative trade since May producing a 10% gain before we <u>sold it in August</u>.

We have decided to close the trade as the performance of the Italian market has reached an extreme and it was a consensus global trade.

The relative performance of Italy it is actually helping us producing the new two ideas above: Financials and Utilities (Utilities weight for more than 15% of MSCI Italy).

Italy is trading at 2.5 Standard Deviation oversold levels having underperformed since May's government formation (chart).

FTSEMIB oversold, trading at 2.5X Std. Deviation


The long-term view remains cautious on Italy as the debt trajectory remains vulnerable to shocks, also in the context of political uncertainty but the high degree of uncertainty seems to be already in the price and a relative stable global market plus the absence of further bad news would be sufficient to drive a relative relief rally.

<u>The situation is likely to become tense again from the middle of October with the different deadlines for the submission of Draft Budget to the European Commission and S&P / Moody's reviews</u>.

# Keep in touch

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