Monthly Market Update

Monthly focus on the financial markets

12th June 2018

Contents

- Market Analysis
- European Periphery
- Macroeconomics
- Inflation/ Interest Rates term structure
- Currencies
- Commodities
- Executive summary
- Current investment ideas
- New investment ideas
- Ideas closed

Alberto Tocchio - CIO
atocchio@heron.ch

Market Analysis

Strong earning seasons and thawing diplomacy between US and North Korea are old dreams. Q118 results were slightly better than Q417 with earnings 3.1% ahead of consensus, 3% more beats than misses. Financials, Telecom and Utilities delivered the strongest EPS beats and the worst MoM performance, down ~12%, ~5% and ~5% respectively.

We have seen a two-speed game in May with a resilient US equity market, SP500 c.+2% Nasdaq c.+5%, against a faltering European landscape with the Italian FTSEMIB (c. -9%) and the Eurostoxx Bank (c.-15%).

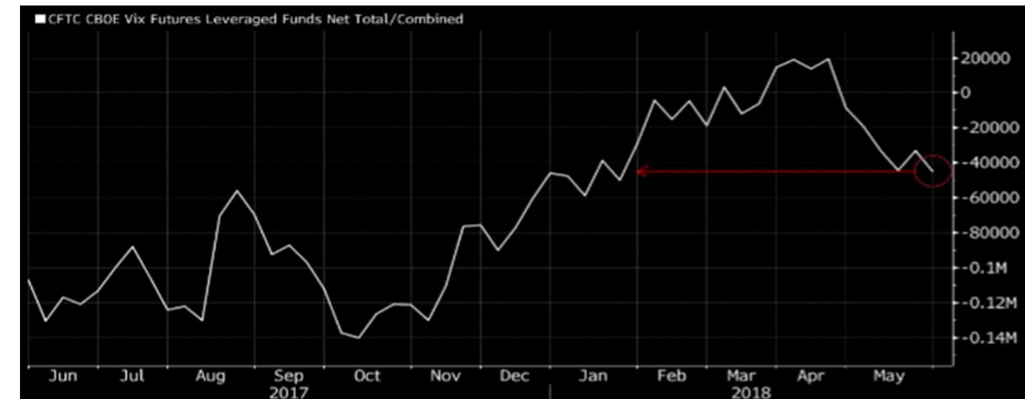
The European periphery dragged the market down. The Italian and Spanish political turmoil have weakened the confidence in Europe, with populism and anti-establishment parties threatening the Euro's survival. Some spread widening (BTPs/Bonos vs. Bunds) and curve steeping (2s10s) provoked a brutal market reaction catching many investors offside. Cross-asset volatility was really impressive this time as the market tends to severely punish the bad news now.

Despite a strong January, investors struggled to make money this year: strong gains in January vs. losses in February and March vs. flattish performance in April. Some relief in May, though hedge funds were only up by 1.4% year-to-date. Quant funds suffered the most this year due to missing market trends. CTAs down 4.5% year-to-date along with flattish Risk Parity funds (small gain of as much as 40bps). In addition, Artificial Intelligence (AI) funds down by almost 3% year-to-date.

EM funds were the main laggards this year after the April and May correction.

The short-volatility bet is back. Hedge funds are currently holding the highest number of short positions on the CBOE Volatility Index since late January (before the record spike in volatility wiped-out over $5 TRILLION in global stock valuations).

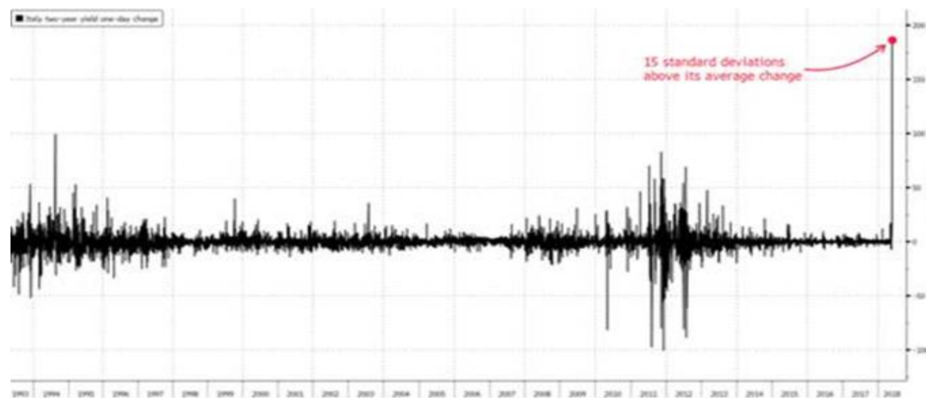
CBOE Vix futures Leveraged Funds Net Total /Combined (chart)



European Periphery

The **Italian equity index** dropped 11.5% in 4 weeks, delivering a negative performance year-to-date (FTSEMIB was the best Developed Market as of early May). High quality stocks such as Intesa San Paolo lost c.20% along with defensive stocks. Fixed income was even worse. For the first time ever, the spread Btp-Bund increased 15X standard deviation against its daily average (chart below). The 9-month Italian yield increased more than the Greek comparable (Greece seen safer than Italy in the short run). € 38 Bln of Italian debt were sold in May.

Btp-Bund Spread yield one-day change (chart)



The FTSEMIB index weight 3.9% on the Eurostoxx 600, the Italian aggregate credit represents 1.9% of the European aggregate credit, while the Italian sovereign debt accounts for 13% of the European Sovereign debt. Approximately 80/85% of the Italian debt is owned by Italian institutions (banks, insurance, pension funds) and private investors (families) along with the ECB as the sole main foreign shareholder.

International investors are concerned about EU compliance and fiscal consolidation, while the political turmoil is probably leading towards a prolonged period of uncertainty in Italy.

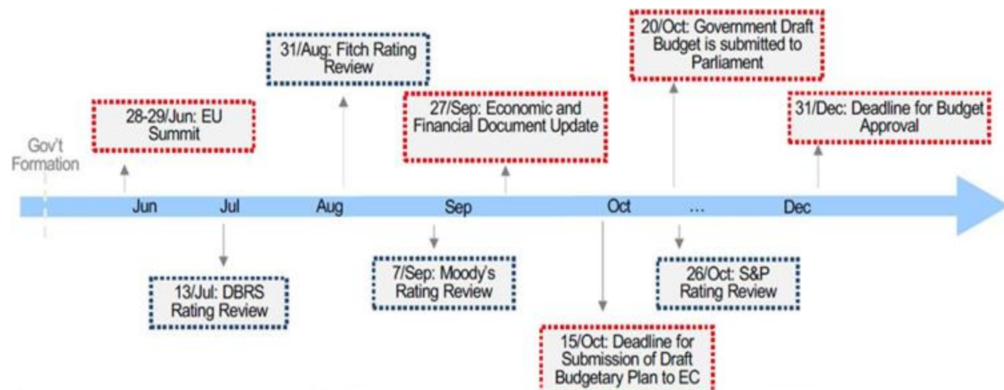
The M5S-Lega fiscal reform proposal should deteriorate the country's public finance with spending increase and uncertain revenues. An appraisal of the reform shown in the chart.

	Fiscal cost (€bn)
Flat Income tax (23%-15%)	35
Reduction of pension age	19
Citizenship income/Unemployment subsidy	17
Corporate tax cuts	13
Income tax Reduction	12
Impact as a % of GDP	**~4%**

Italian politics is likely to remain volatile over the medium term. The new coalition wants to stop fiscal austerity and budget rigor EU rules the demand. Bear in mind the ECB wants to end the QE as soon as possible.

Let's look at the timeline: European Summit on June 28-29th(banking union reform on the agenda), DBRS (June 13th)- Fitch (August 31st) and Moody's (September 7th) rating review. 2019 EU Budget approval in September-October (we could see rising tensions at several levels between Italy and the EU).

Italian Government schedule



A new technical government has been appointed in **Spain** with unknown new election dates. The new Spanish Prime Minister, Socialist Party's Pedro Sánchez, will struggle to win the parliament majority for future policy initiatives. Current polls show Ciudadanos as the leading party, with Socialist and People's Party (PP) trailing close to each other.

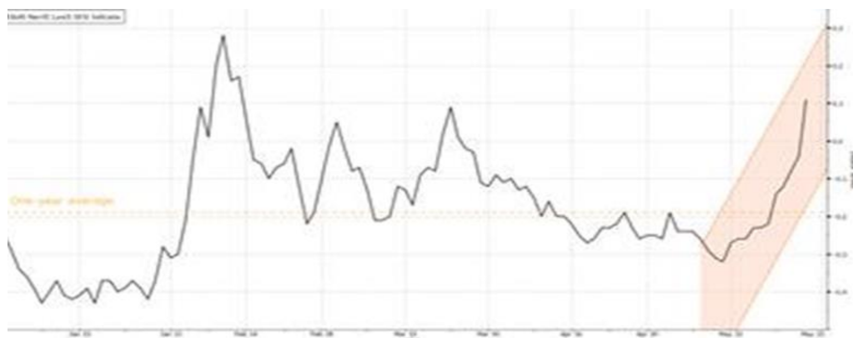
Among the political jitters in the periphery we are more concerned about Italy. The latest Eurobarometer shows 82% of the Spanish population being pro-euro, vs. Italy 60-70%. We don't expect any policy change in the short-term. Spanish fiscal budget should be approved. In addition, the labour market, the constitutional reform and Catalonia remain the most controversial points.

Macroeconomics

As far as Macro is concerned, last year, the global economy roared back to life as synchronous recovery in both developed (DM) and emerging (EM) markets propelled growth to a 3.7% annual average. However, in the first quarter of 2018, DM growth began to moderate alongside rising worries of protectionist trade policies, renewing concerns over the near-term growth outlook. **Despite slowing consumer spending, we believe that strong fundamentals point to a rebound into H218**.

As of early May, European investors were focused on corporate earnings, GDP growth and Euro depreciation. So far worries have been mounting and the **focus is just Politics**.

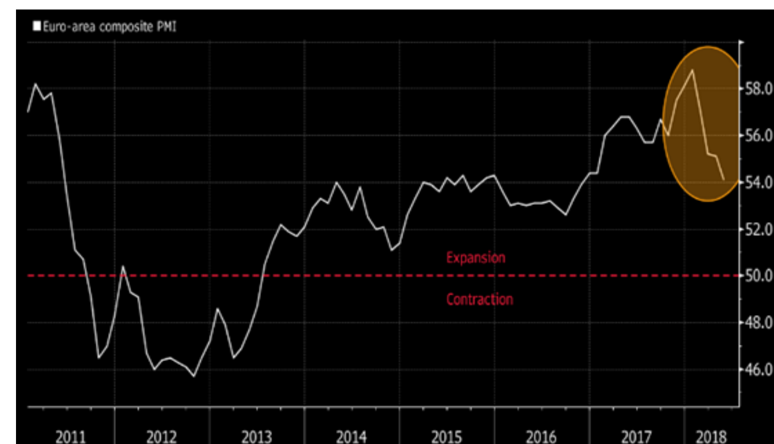
The Merrill Global Financial Stress Indicator is close to February high



In US, a strong set of data supports the growth rebound thesis in Q2 from a somewhat softer Q1, had dampened investor sentiment. The April trade report indicated a greater than expected decline in trade deficit implying a larger boost to Q2 growth from net trade. Many economists, as a result, raised Q2 GDP estimate by 0.3%. Payroll data was solid with NFP, unemployment rate and average hourly earnings better than consensus (3.755 unrounded unemployment is the lowest rate since 1969).

The ISM manufacturing index rebounded by more than expected to 58.7 in May, and the underlying composition also strengthened. Construction spending rose by more than expected in April.

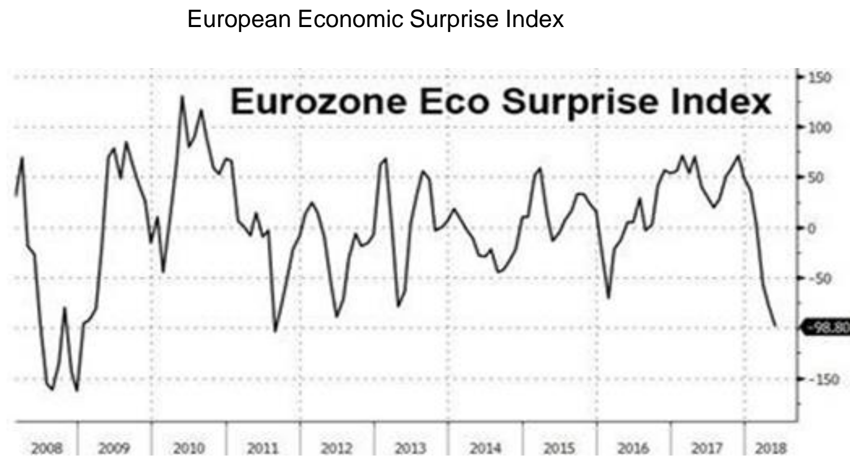
Euro-area Composite PMI



Europe is a different story. PMI decreased from 55.1 to 54.1 in April, 18-month low (chart), new orders and job growth retracted too. A composite gauge of new orders growth cooled down to a 17-month low.

The EU Economic surprise index showed a remarkable slow-down in economic activity, **with Q2 expected growth rate at 0.4%-0.5% (the worst result since 2016)**.

European Economic Surprise Index



Manufacturing in Spain and Italy doesn't provide particularly optimistic readings for the new governments. The level of activity is low in Spain (9-month low) and Italy (the weakest since 2016).

The Euro-area PMI, along with Germany and France, has been weakening since the start of 2017.

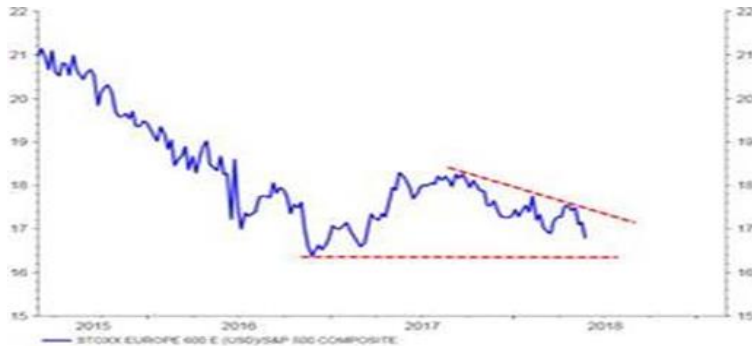
Euro-area/ Germany/ France Services PMI

The macro picture of US vs EU is therefore diverging. US is speeding up, while Europe is slowing down. The last two months marks the turnaround of the positive European trend since the end of 2016. The chart shows the US PMI (blue area) vs EU PMI.

US Composite PMI vs. Euro-zone Composite PMI

Investors are more cautious and risk-adverse on Europe. We lost another opportunity to break the downtrend since early 15 in the relative chart Eurostoxx600 vs. S&P500.

SXXP vs. SP500

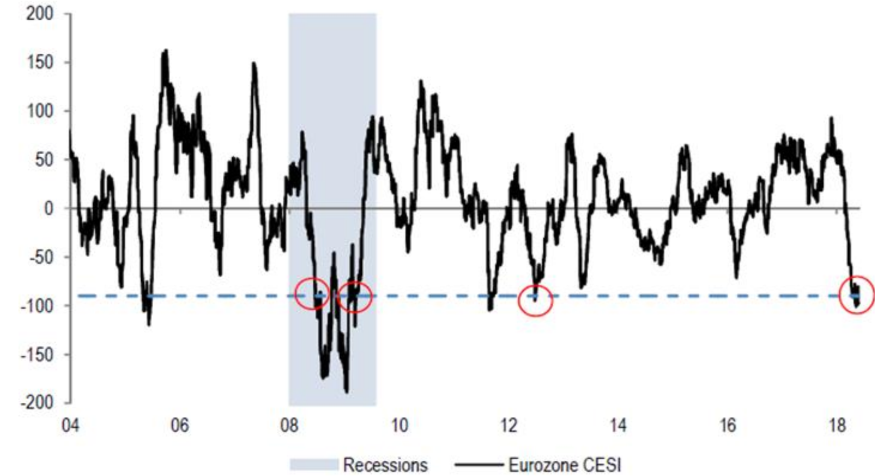


The Markit iTraxx Europe, IG European Credit Default (black line), has now crossed the Markit CDX North America Investment Grade Index (blue line) for the first time since February. It means the market is discounting a higher risk for Europe vs. US. The sovereign risk has changed, though US companies are more levered on average.

IG European CDS vs. Markit CDX US IG

The improving Euro-area labor market could reverse the negative PMI momentum in the short term. Historically, as long as CESI index reaches -90, Equities rebound (excluding the global recession in 2008).

Eurozone CESI Index. Grey area Eu recession

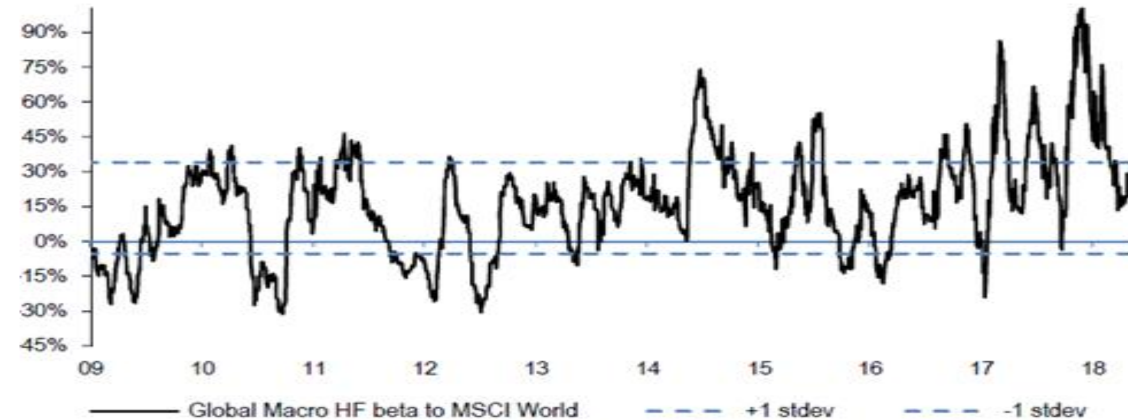


Trade War

As far as the trade war is concerned, China has reportedly offered to buy $70Bln in US farm/energy goods as long as the Trump administration does not move forward with tariffs against the country (void otherwise). Also, Mexico would retaliate, imposing tariffs on US steel, pork, bourbon, cheese, and certain other agricultural products. In the past few weeks, the US has ratified tariffs on EU steel and opened a new investigation on automobile imports (EU exporters). Tariffs and investment restrictions scheduled on June 15th and June 30th, respectively, are likely to be delayed. We do not expect trade policy risks to fade soon.

Positioning

Global Macro HFs beta vs. MSCI world



In the last week $11Bln went into US Equities reflecting the largest inflows since January. In the period Feb18-May18 the average monthly Equities ETFs and mutual funds inflows were close to $15Bln versus $43Bln Jan17-Jan18 while Fixed Income ETFs and mutual funds inflows were close to $18bn compared to $64bn.In the last week global money markets saw a massive US$55bn inflows (the second highest ever). Circa $5.2bn of shorts (cash market) were added to the SX5E in May, taking the number to +$18.2bn on a YTD basis. The total SX5E short book is now $49.8bn.

Inflation/Interest rate term structure

Inflationary pressures increased in May as input cost inflation accelerated to the fastest pace since October 2013. The latest rise in cost was due to higher material inputs, often linked to tariffs, higher interest rates and rising energy/fuel prices.

The maturing business cycle, along with the higher deficit, the return of inflation and the shrinking liquidity, are paving the way for higher yields in the short run.

We have been calling for higher inflation since the end of 2017 and we think that current level inflation is not a burden for stocks but rather a lagging variable of growth. In the US the correlation between core CPI and real GDP growth is very strong, with GDP leading inflation by six quarters on average.

The current pickup in inflation is therefore a reflection of the already strong growth environment.

Euro-area inflation hit the fastest in more than year, 1.9% in May, in line with expectations, up from 1.2% in April and above 1.6% consensus.

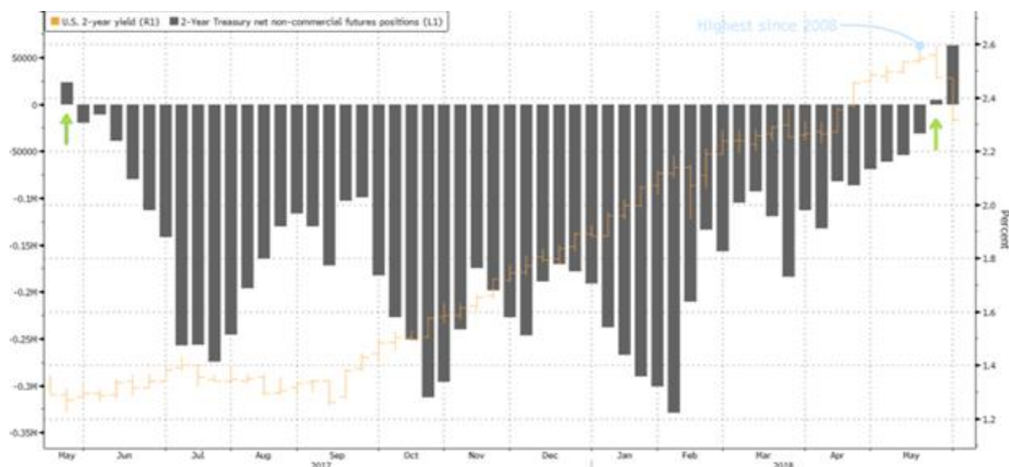
The global economic recovery is pushing interest rate yields higher.

Yields

The interest rates reversal is almost done (correctly predicted) as in Feb/March. The market positioning on Short Futures Bonds is still at record high.

Speculators have turned bullish on two-year US government bonds for the first time in 2018. Despite a record high in February, net short HFs positions are negative (investors are long bonds). The yield on two-year Treasuries retraced to c. 2.45% from a near 10-year high of 2.59% in mid-May and is currently trading at 2.52%.

2-Year Treasury net non commercial futures positions



Central Banks

The upcoming Fed meeting (today at 20 CET time) will focus on forward guidance about the economy and the rate hiking cycle as policy becomes less accommodative. The central bank should hike rates by 25bps, turn more constructive on the near-term economic outlook and indicate a slightly slower pace of tightening, once interest rates reach neutral territory.

In May, the Fed meeting confirmed policy makers support to a June rate increase and confidence in the inflation outlook. Officials would welcome an overshoot of the 2% inflation target (no rush to tighten aggressively).

The ECB ,next meeting tomorrow in Riga, prefigures the ending of the QE in 2018.

The central bank could change its forward guidance on the QE, as it currently states the asset purchases will last until September or beyond. Despite start tapering in Q4, the central bank should continue to buy securities until end-2018. A combination of higher oil prices along with FX weakness should revise up headline inflation, in 2018-19. We expect the ECB should signal end of QE in June or July.

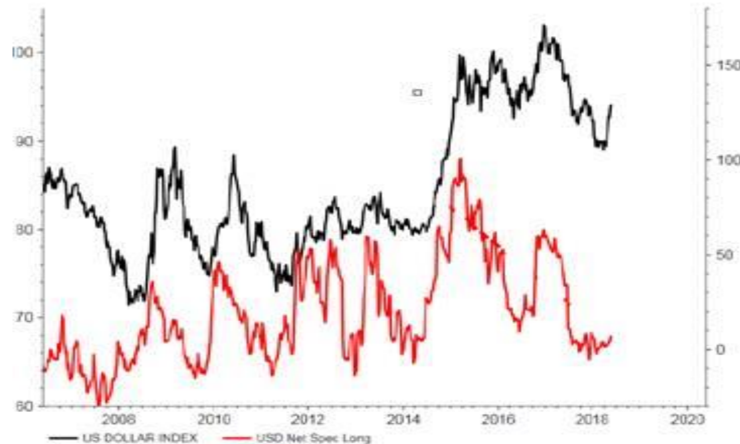
Considering the recent political turmoil in the periphery, the first 15bps depo rate hike should be pushed out further (expected on September 19).

Currencies

As correctly forecast, the DXY Index has appreciated in May before retracing in the last two weeks where we suggested some consolidation.

The Euro-area weakness facilitated this extreme movement, though the USD market positioning is still quite low (red line below) and new USD strength in the short run is expected.

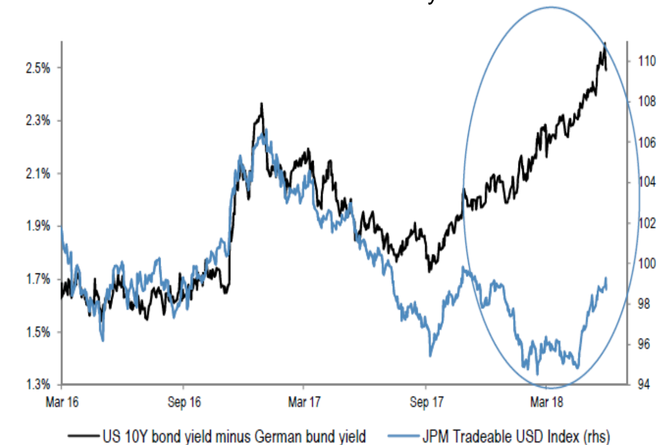
USD index vs. USD index positioning



Having significantly undershot the rate differential UTS vs. Bunds, the USD should appreciate further. The chart shows US-German 10Y bond yield differential and USD

However, China has a strong interest in having a weaker USD due to the currency effect on emerging markets and growth. As soon as the USD reverses, China would moderately strengthen its currency. The resilience of the Chinese economy against tighter RMB monetary condition has been overwhelming. Last week China's manufacturing PMI reported its highest reading since September.

USD index vs. US 10y bond yield minus German bund yield



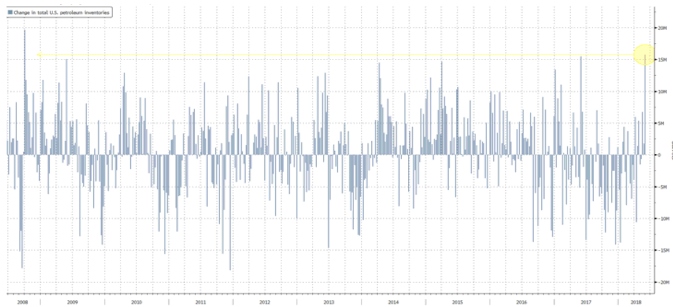
Commodities

Crude price has dropped 9% since the last update as worries about an escalating conflict between US and N.Korea have been gradually fading after the meeting held on Monday.

The OPEC meeting is scheduled on the 22nd of June. Crude oil supply from Iran/Iraq remains a threat to OPEC's plan. On one hand Saudi with a $60-80bbl oil price; on the other Russia with a $50-60bbl. A lower oil price would translate into lower taxes and higher economic activity for Russia.

Total crude and refined product inventories increased by 15.8 million barrels last week, the most since October 2008, as production marched higher and refiners ramped up.

Change in total US oil inventories



The situation is therefore still quite complex especially if we consider that around 60% of the price increase over the last year has been demand-driven, with the remaining 40% due to constraints in supply.

Increases in **oil** prices are more of a concern when caused by weaker oil supply than stronger oil demand. It is estimated that a 10% supply-driven rise in oil prices would reduce global real GDP by nearly 0.25%, with most of the effect coming after a few quarters-

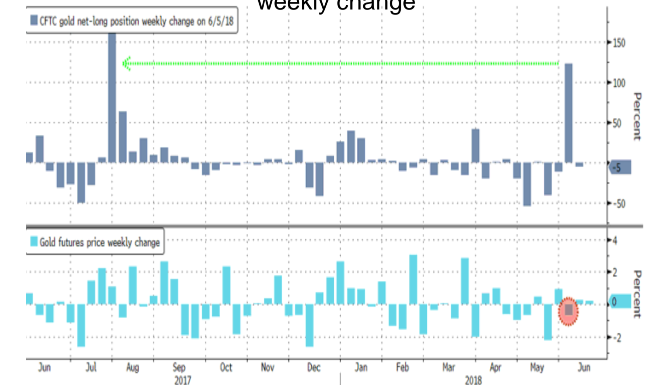
Positioning on oil is now less consensual long as Hedge Fund have decreased their long positions for the 8thconsecutive week, the longest stretch of declines since November 2016.

Brent price vs. Brent net positioning

Gold price has been hovering around 1280/1300$ area for the last 4 weeks and it seems ready to break higher anytime soon.

Wagers on gold-price gains jumped the most since July last week, just before a brief rally in the precious metal sputtered. Money managers more than doubled their net-long positions to 61,235 futures and options. Despite a stronger positioning, the price is really stable for the moment.

Gold price vs. Gold net positioning weekly change



Executive summary

After the positive momentum in the first quarter, European indices have been struggling. Sluggish growth and political turmoil (Italy/Spain) are the most dominant narrative in Europe. It is quite difficult to project the politics effect into the future. However, uncertainties and turbulences should persist prolonged period of time.

Speculation is dragging European markets lower, with 11 consecutive weeks of European equities outflows.

Growth momentum has weakened since January, with Eurozone composite PMI now down 5 points, to 54. The recent PMI trend is worrying but the absolute level at 54 is still above historical averages, and there are reasons to believe the soft patch should not extend. US PMIs are instead still very resilient, up in the last 2 months showing demand in new orders. In Europe the recent gap opened up between consumer sentiment and consumption.

Should we switch to defensives? Yes we should. It is probably a good idea to de-risk on the cyclical part of the market.

Earnings in US, Asia Pac ex Japan, and Europe have strengthened in May. At first glance, the trend in earnings appears positive for stock prices and a pro-cyclical stance. However, defensive countries (*Switzerland & UK*) and sectors (*Utilities, Telecoms, Health Care and Staples*) have mainly driven these improvements.

This week is important in order to get an updated message from both the Fed and ECB. We are now entering in the era of Quantitative Tightening (QT) as opposed to Quantitative Easing (QE). There is a direct correlation between QT and lower equity markets; not just throughout history but since the beginning of the year. Since January there have been 1 to 2 times each month where the Fed's holdings of USTs and MBS have actually increased (despite the fact that we've seen $84Bn of net sell in the first quarter) and during those 1 to 2 times each month, the equity markets went higher with the S&P 500 rising 165pts, 150pts and 105pts respectively and during the rest of the quarter we've given back all of those gains. If we consider that by H218, it is expected that net QT could be $120Bn+ (from the $84Bn we saw in Q1) we will most likely see some different kind of returns for the US equities.

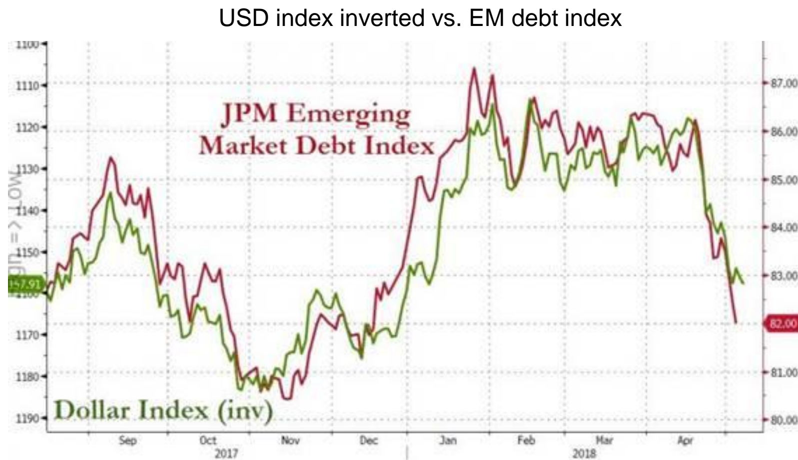
We are still worried on Emerging Markets despite the severe correction they already had from the beginning of the year. EM continues to weaken despite a peak in USD, UST yields and the recent rebound in equities. The divergence between the DXY and EM is unusual and reflects a number of factors, including country-specific issues from some large index constituents such as Brazil and more recently South Africa.

The problem is that USD denominated debt keeps growing in the EM. Therefore, a rebound in USD

could be problematic for EM given the increase in hard-currency leverage. If there is a sharp repricing of bond yields, EM might be under relative pressure as carry trades are unwound. This is especially because the EMBI index received record inflows last year, of 125bn USD. Higher EMBI yields could mean weaker EM vs DM performance.

The correlation between the inverted USD vs the JPMorgan Emerging Market debt index is self-explanatory.

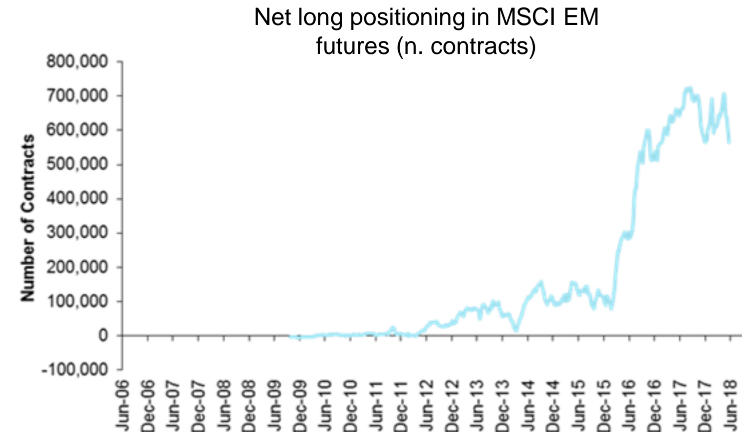
USD index inverted vs. EM debt index



Unfortunately, Long EM was a consensus call. Many investors drew liquidity (several bulge-bracket IBs were long Equities, Fixed Income EM just on month ago). We expect the situation on EM to deteriorate in the short run.

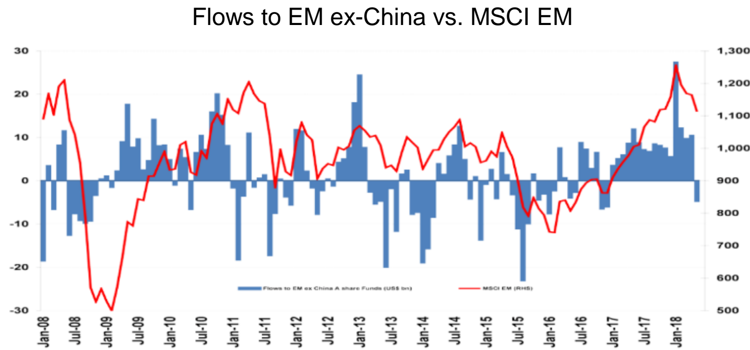
Since Q116 there have been 600bn$ of inflows into EM stocks and 200bn$ into EM debt almost doubling the size. Since the beginning of January 2016, the buy-side increased their net long positions in MSCI EM futures by a total of 451k contracts ($19 billion notional).

Net long positioning in MSCI EM futures (n. contracts)



With the recent sell-off in EM, we are looking for signs of further unwinds from the buy-side. The chart clearly shows how the longs have been built since the beginning of 2016.

It shouldn't sound a surprise that EM funds reported last week the largest outflows since December 2016 (2.4bn$).



We saw very large trades going up in **EMLC** and **EBND** (biggest ETFs on EM)… sells on EM local currency bonds. There is not only a lack of buyers for EM Debt, but, there are sellers too. This will continue to weigh on sentiment and will continue to force inventors to look for further safe haven assets.

Brazil's equity index lost 16% in less than a month. The market was bullish on the country outlook. However, the situation quickly deteriorated with two quarters of disappointing growth, a government with very little political capital to push measures through congress, and market-friendly candidates struggling to gain traction in polls. The eventful truck drivers, helped accelerate that change in mood especially by providing a platform for radical candidates to push populist agendas. Central banks have intervened in FX/bond markets with no success. The market is now pressuring the CB to hike rates, next meeting June 20th(an inappropriate move given the country's low growth). There has been a big pressure on the fixed income side where the country was a big overweight.

Argentina's peso lost 40% Ytd with a strong acceleration from the beginning of May. Soaring inflation, exploding capital outflows and a central bank that was far behind the curve (as in "13% of rate hikes in a week" behind) deteriorated the country's outlook. The IMF has now officially bailed out the country (again) this time with a $50 billion, 36-month stand-by loan, and coming in about $10 billion more than rumored earlier in the week, it was the largest ever bailout loan in IMF history, meant to help restore investor confidence in the nation.

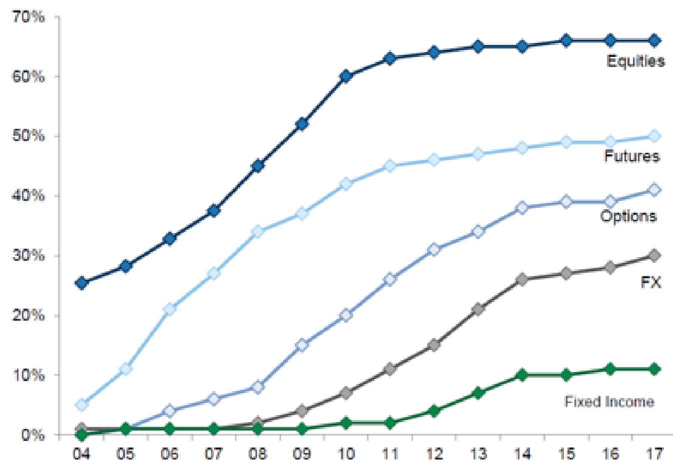
Rising cross-asset volatility and shrinking market liquidity represent serious potential threats to market stability. As HFs hold the highest number of short positions on the CBOE Volatility Index since late January, we could see a spike in volatility ahead of one of the potentially most volatile weeks of the year (CBs, Trump-Kim etc.). After the VIX shoot up in February 2018, we mentioned the frequent "flash crashes" across markets might be a wake-up call that something is not quite right with the current state of trading liquidity.

Liquidity may nonetheless pose a potential systemic risk. The past 10 years have seen fairly dramatic changes in the regulatory environment, industry composition, and the trading technologies by which liquidity is supplied to markets. The resulting market evolution is one in which algorithms are replacing people, and speed is replacing capital.

The chart shows how is the current market share of algorithmic trading within the different asset classes.

The market has the potential for extreme price movements in response to only modest fundamental news (or perhaps no news at all). Large operational losses during adverse market conditions could lead to the collapse of liquidity supply and thus cause outsized price declines. The substitution of speed for capital means that ever larger amounts of trading volume are backed by too-thin capital cushions; liquidity supply could collapse on a large operational loss.

Algorithmic trading market share



Our previous call, Long Europe / Short US, worked quite well until the surge of the political crisis in Italy.
It is difficult now to back this trade idea. We would eventually prefer to "hide" on the Dax index because we expect further volatility/ instability in Italy.

However, Europe is still the place to be now (avoiding high-volatility countries such as Spain and Italy)

After the recent sell-off, the EuroStoxx 50's dividend yield is trading close to the highest relative to the 10-year German bond yield since 2016 (chart).
The gap between stock dividend yield vs high-grade yield at which companies borrow is as much as 270bp, on average in Eurozone, still decent and very attractive (Euro-zone dividend yield at 3.1% vs High grade yield at 0.9%).

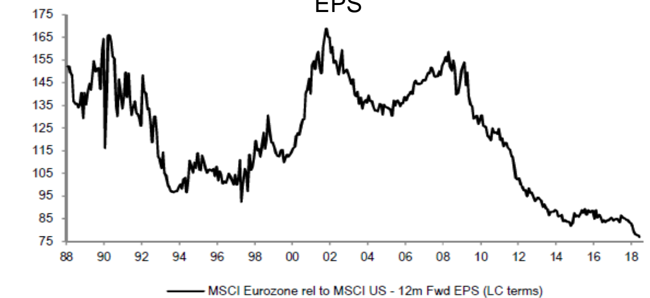
SX5E divided yield vs. 10y bund yield

Earnings trends continue to improve across both Eurozone and the US. However, the trajectory for
Eurozone is quite underwhelming when compared to the US. Eurozone earnings are still about 20% below the last cycle highs while US earnings are at fresh highs.

Compared to the US, Eurozone earnings appear extremely depressed in a historical context (chart) but we can now argue that this might stay the case for the next weeks due to the issues we have highlighted above.

In US, the S&P 500 is trading at a price-to-earnings ratio above 20X…a level exceeded in just 12 of past 120 years.
The S&P 500 is also trading at a price-to-book ratio >3X, a level exceeded in just 5 of past 70 years.

MSCI EU vs. MSCI US -12M Fwd EPS



Current investment ideas

Long Spain / Short Italy: Italy was the leading advancer in both Europe and DM. Spain was close to a 2-year relative low to MSCI EMU, underperforming Italy by 16% in a year. Now everything has changed having Italy lost 9% while Spain 3% (outperforming in relative terms by 6%) since our call.

The chart is showing the Forward price to earnings ratios of Ftsemib vs Ibex. Correction and re-pricing has been quick but we are still long the trade.

Fwd P/E FTSEMIB vs. IBEX

Long EU Financials: this idea must be traded due to sector volatility. Despite challenging market conditions, we are still positive on this trade. Why should we buy financials? In addition to the original selling points 1) rising yields, 2) credit recovery, 3) decreasing NPLs, the recent correction offers an interesting selling point, the bank's 3-month breadth has fallen to a 15-year low and no European financial has outperformed the market over the last three months. Never happened since data starts in 2003. Furthemore, banks are oversold, trading at 3 standard deviation vs. 12M avg. The sector has only been more oversold three times in the last decade - during the crisis in 2008-09, January 15 and February 16. We would therefore try to sell it a higher price keeping in mind that the sector's consensus 12m forward EPS estimates have actually risen fractionally over the last 3 months.

New investment ideas

Long Value trade: this is a “factor” trade. Growth has outperformed value by 17% in the last 12-months in US and by a similar percentage in Europe.

Investors commonly associate “growth” with “momentum” and this relationship is currently high: 57% of stocks with the highest momentum are growth (typically 44%).

Notably in US, Momentum sold off -8.4% from March through the end of April but have rallied right back up since, nearing the peak level seen in March 2018. Realized Vol factor has returned an impressive +16.9% since the end of March, heavily driven by Energy outperformance during this time. Growth has generally trended higher while Value continued its poor performance, continuing to be the worst performing factor Ytd (chart).

Equites multi-factors investment style

Value had a tough performance for much of this year, continuing the downward trend that began at the end of 2016. Following a -14.7% selloff Ytd and -25.6% since its peak in December 2016, the Morgan Stanley EU basket on Value MSZZVAL, built on the pair trade Value Long – Short is at the lowest price since 2008-2009 (chart).

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.)

MS EU basket Value Long - Short

Ideas closed

Long USD / EUR: we went long at the end of March and closed the position 3 weeks ago as in the short term the USD was overbought and the EUR was giving a trading buying signal (as shown on weekly chart). We might think about going back to long USD around the 1.20 level.

EUR vs USD weekly chart

Keep in touch

HERON Asset Management SA

Via Clemente Maraini 39, P.O. Box
CH - 6902 Lugano (Svizzera)

T +41 91 910 17 90
F +41 91 910 17 91

www.heron.ch

Disclaimer
For information purpose only by Heron Asset Management. The information herein is not intended as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. Commissions and costs have a negative impact on the prices quoted. If the currency of a product or a financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives or financial situation or tax nor to the particular needs of any specific final user. The information and opinions contained in this document are provided by Heron Asset Management with no warranty and are for personal use and information purposes only.