Monthly Market Update

Monthly focus on the financial markets

16th October 2018

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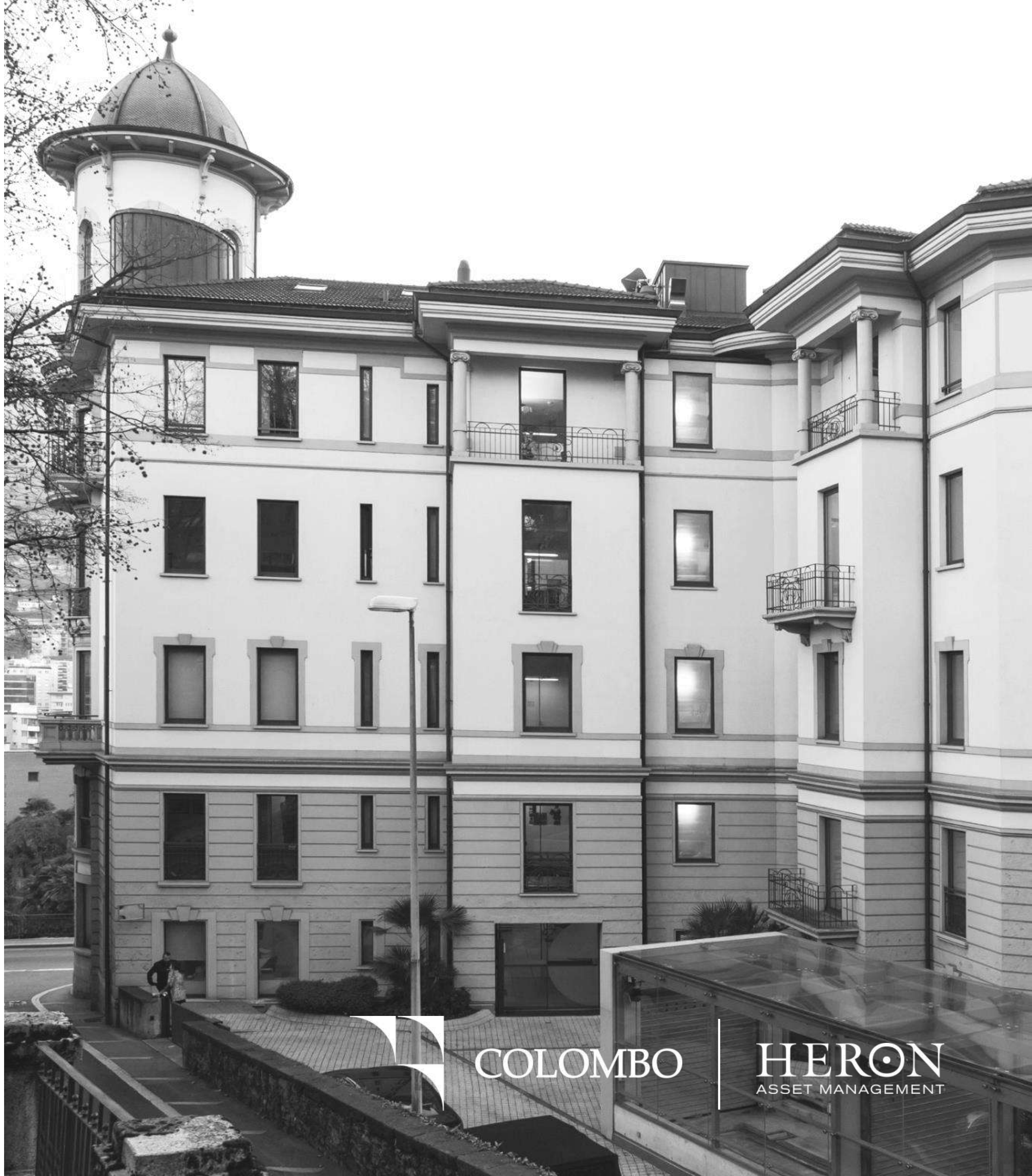
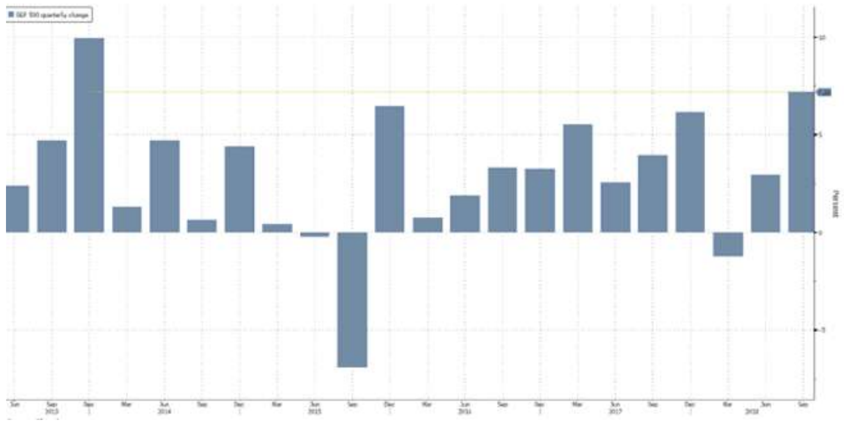


Market Analysis

It's only a few days into Q4 and it has been already a rollercoaster with a market difficult to digest.

The S&P had the strongest quarterly gain since 2013 (+7.3%) but it hasn't been an easy sailing, being a prelude to what we have seen in the month of October. The Equity bull market has reached an astounding 10-year in length making it the **longest bull market** run in all of modern history.

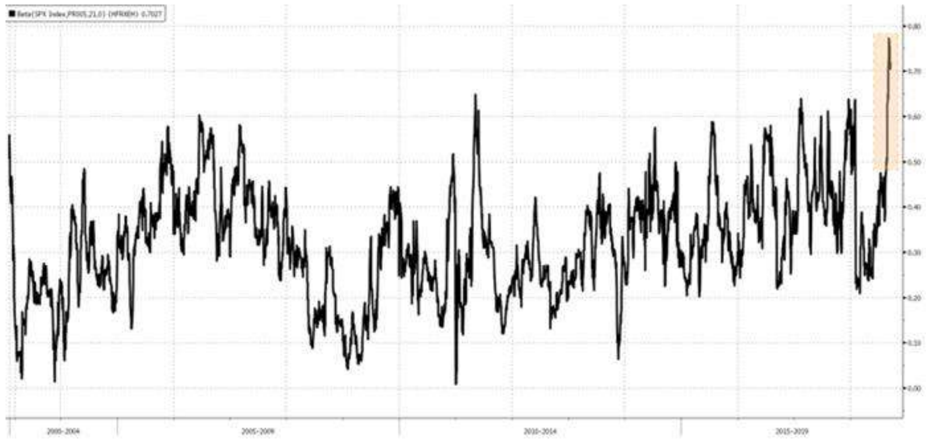
S&P500 Index quarterly change



Hedge Funds have been buying over the second part of September, but importantly it was mostly coming from short covering rather than adding new longs.

Hedge funds at the end of September had record exposure to the S&P 500 Index (chart showing HF beta on S&P) and returns posted by risk-parity and statistical-arbitrage funds (two types of quantitative investors) were ever-more linked to US shares and near levels notched on the eve of the February correction.

HF Beta S&P500 Index



The **correction** we have seen over the last few days has been once again sudden and deep. The S&P logged 5 consecutive declines (longest streak since 2016, half of year's gains lost in just 1 session), Nasdaq had its worst sell off since 2011, Russell 2000 (Small caps) posted the worst underperformance vs the S&P in 7 years. The MSCI Asia was negative for 10 straight sessions for the first time in 16 years! (not even in worst of financial crisis).

Market Analysis

If market performance is not scary enough, you don't get the real feel of the disaster if you don't look at the underlying **themes / sector rotation**.

There has been a clear **tilt towards defensives** and away from previously popular, crowded trades such as growth/momentum. In US we have seen some of the largest moves in recent history in US baskets driven by algorithms!

Momentum retraced nearly all of its YTD gains (-9% Mtd) and names with high active ownership are underperforming names with high passive ownership by 3 standard deviations.

Prime Brokerage data show net exposure has gone down to 47% from 50% just a few days ago, and back to levels last since 12 months ago, but gross exposure still quite elevated, suggesting more unwind might occur in the medium term.

Thus far the move has been more rotational in nature with **cross sector dispersion** in historical norms but within sectors stocks trading together. In US that is most obvious in **Tech**, in EU perhaps best exemplified by **Luxury**.

This indicates that for now the pain is more at stock level than at index level. The concern makes sense given where the volatility is: growth, momentum, Tech, small caps, etc. versus the broader market.

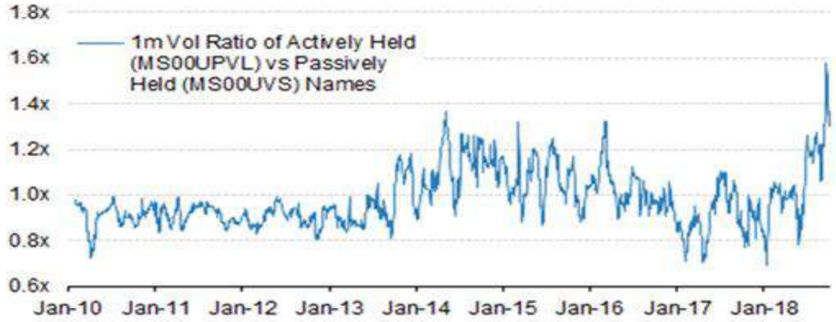
If we dig even more we can also understand that the market move has been so far all about stocks and not about futures which represents something new in the recent sell-off. Moreover, if we look at volumes traded at bid vs. offer across factors/themes/sectors/indices, we can see the 'at risk' quant factors are having an enormous unwind confirming that sell decisions have been taken by those kinds of products.

The chart shows the cumulative Eurostoxx cash market (blue line) vs Eurostoxx futures (red).

Cumulative SX5E value traded at Offer vs. Bid (Cash vs. Futures)

Another measure of this factor trading is to be seen in the volatility of actively held names relative passively held as shown on the next chart.

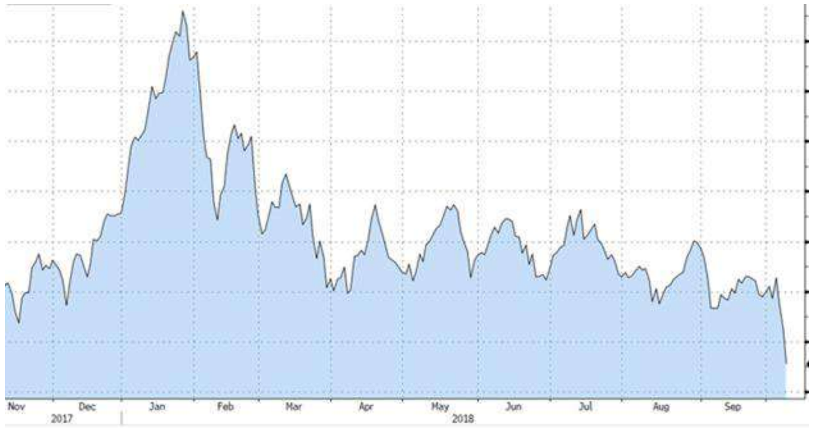
Volatility ratio active vs. passive positions



Market Analysis

<u>**Global Hedge Funds** are now not only **negative** Ytd (-2.5%, chart) but on **2018 lows** with a **massive deleveraging** (closing long and covering shorts) ahead of Q4 “performance anxiety” phenomenon.</u>

Global Hedge Funds performance



<u>So far, we have seen three **massive US-based Hedge Funds shutting down** in less than one week</u>; respectively Highfields Capital, $ 12Bln AUM formed in 1998 (it survived Lehman crisis!), Tourbillon Capital Partners, $ 4Bln AUM, and Criterion Capital, $ 2Bln AUM, a specialist in Tech, Media and Telecom closing after 16 years of activity.

<u>We have also seen many **IPOs withdrawals** due to market conditions.</u> Without any doubt, the most exclusive one is the $ 2Trillion Saudi state oil-giant Aramco, called off for domestic and international listing and postponed indefinitely.

Over the last couple of newsletters, we warned about the possibility of rising yields, increased tail risk to global growth <u>suggesting to have a greater caution</u>.

<u>We were spot-on as we also understood that Tech was too stretched and we warned of a possible rotation that could have been bad for market leaders</u>.

Let’s now better analyze what was the <u>**sell-off sparkle**</u> in order to understand what could happen from now on.

<u>**Yields** have been breaking out in US since the beginning of the month</u> and it has been a move that couldn’t be un-noticed, as <u>10-Year broke the downward channel we had from 1987! (chart). **5Y Real-Yield has broken 1%**, the highest level since 2009.</u>

10Y US Treasury yield

<u>Why focus so much on the correlation between stocks and bonds</u>? Historically, rising yields (and rising real yields) tend to mean better risk asset performance. The rationale is straightforward: <u>yields go up when economic confidence goes up</u>, and history suggests that positive often outweighs the negatives of a higher discount rate.

Market Analysis

But this time the environment is more challenging for 3 reasons:

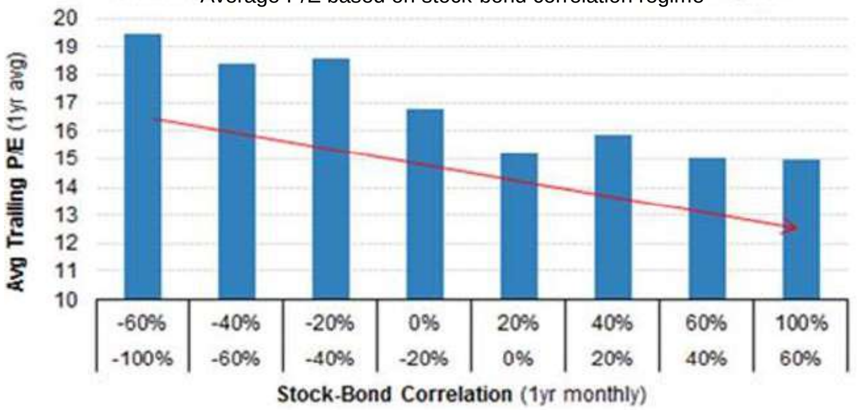
- Rise **driven by 10Y real rates**, where a wider band of uncertainty for rates is a cause for investor caution. Further more we have broken some important multi-year ranges, increasing uncertainty.

- Low rates have underpinned equity multiples at high levels and a further rise would push **equity premiums from average to rich in the US**.

- Higher US real yields usually **strengthen the dollar**, which exacerbates the developing headwinds for US earnings. Solid economic data and Fed tightening policies, are pushing nominal and real yields higher in the US bringing the end of cycle risks into focus, capping equity market valuations and leading to intra-market rotations on sector and style basis.

Because higher stock-bond correlation typically means lower equity multiples, and technically there are risks given high leverage in systematic strategies and risk parity funds. Higher yields would lower the average Price/Earning valuations of equity as shown on the chart below. Stocks are now dealing with the highest level of rates in the last few years, which means that there should be **some re-pricing**.

Average P/E based on stock-bond correlation regime



Margin pressure building with interest rates, wages, commodities & freight rising is not good for equities.

We think several factors conspired to push the recent rise in yields further, notably:

- **Long end rates** broke out and the **yield curve steepened**

- A strong **upside surprise** in the ISM non-manufacturing number, giving us the **highest print since 1997**;

- Chair Powell's comments that we are still a long way from neutral, indicating a belief that we still have **ample room for hikes ahead**;

- **3.7% unemployment rate**, combined with continued **strength in average hourly earnings** on a tough comp and a jobs number that looked quite strong considering prior month revisions.

In addition to the above we suspect that **politics** may have also contributed to the move higher in yields. If the market begins to believe that a **Republican** sweep is likely to occur in the midterms, the likelihood of a tax cut extension, infrastructure spending and continued focus on trade protectionism all rise. We view these **potential policy paths as inflationary and likely to add to the deficit, providing upward pressure on rates**.

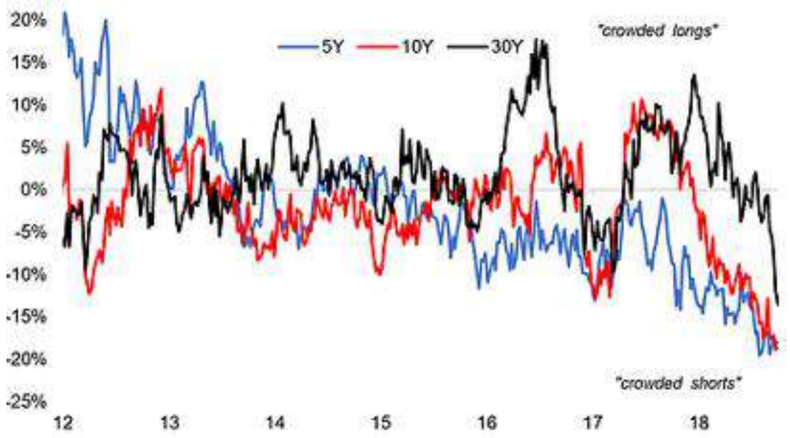
If we are entering an environment where rising rates portend slowing growth and a cycle nearing its end, typically large caps offer better defensiveness than small caps. Over last year, this dynamic was distorted as small caps outperformed due to better earnings growth and a perceived insulation from trade related pressures.

Market Analysis

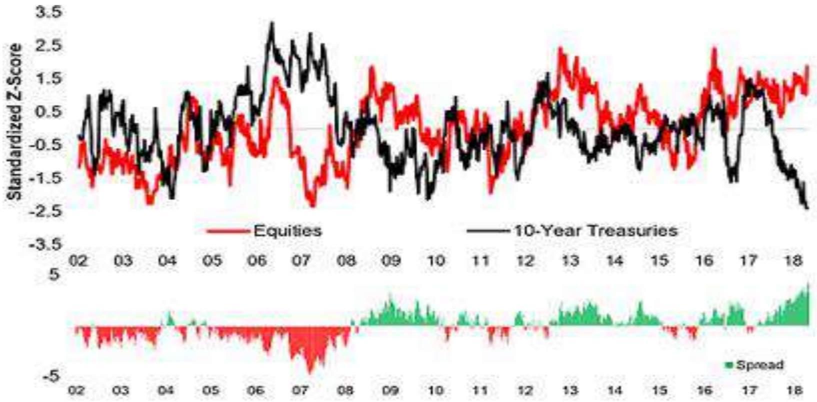
While the medium-term trajectory seems clear, in the short-term we might still se a reversal as **sentiment in bond market is extreme** now and we would pay attention at the following:

- Total capitulation on positioning: Speculative positions on Treasuries have gone in a relative short time from neutral to extreme short!
- Stocks vs Bonds futures positioning: This one shows were equity vs bond market futures positioning lies right now, notice how the gap is at a record high. Traders are doubling down on growth/inflation here.
- Bond mutual fund flows: Massive lurch in bond fund flows, with net-outflows the most extreme since the taper tantrum.

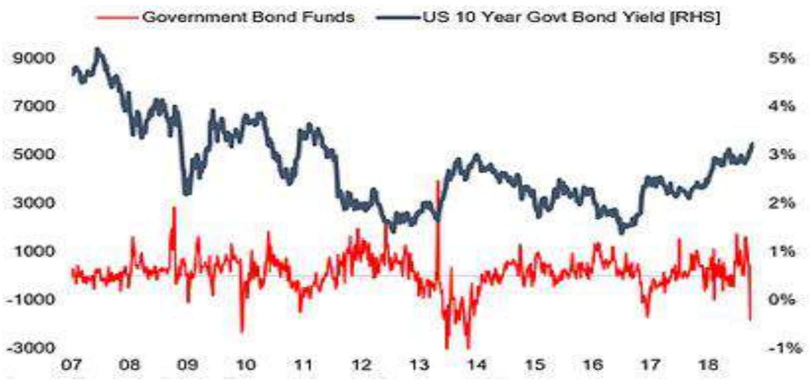
Treasuries: Speculative futures positioning (Net positioning, standardized vs. Open Interest)



Speculative Futures Positioning: Stocks vs. Bonds



US Treasuries – Mutual Fund Flows



Geopolitics

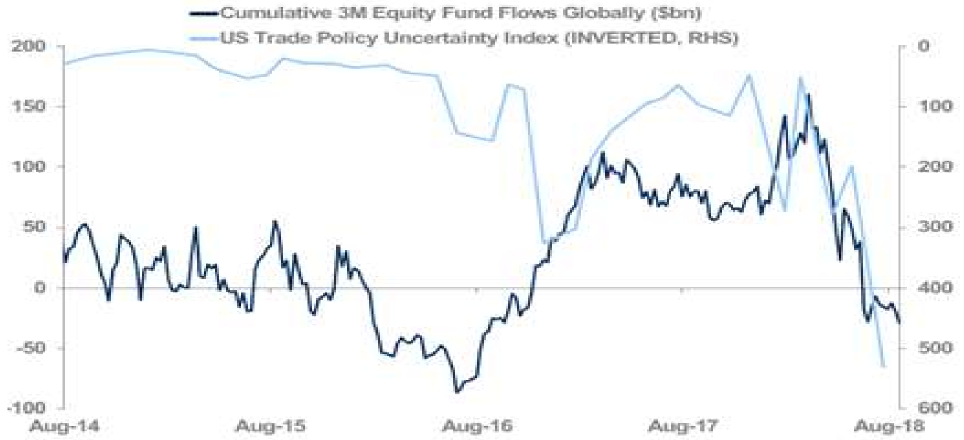
The US, Canada and Mexico **reached a deal** on a successor to the 24-year-old NAFTA capping more than 13 months of negotiations and overcoming major sticking points from Canadian dairy market access to minimum wage requirements for automobile production. The market was skeptical about reaching a deal and it is basically a victory for Trump, despite the fact that the essence of the deal is not significantly changed.

Focus is now on **China**; the question is whether trade tensions escalate further or if the new NAFTA deal helps China cave in.

The WTO has cut the outlook for global commerce throughout 2019 and warned that tension between major trading partners increasingly threatens economic growth.

Rising US trade policy uncertainty has already weighed on global equity fund flows this year (chart).

Cumulative 3M Global Equity Fund flows (dark blue) vs. Uncertainty Index (light blue)



MSCI World's 12M Price/Earning has tracked the US trade policy uncertainty index pretty well year-to-date.

MSCI World Forward PE (dark blue) vs. Uncertainty Index (light blue)

China will cut import tariffs on 1,585 tax items of goods from the 1st of November involving textile, building material, paper products and electromechanical device. Overall tariff rate will be lowered to 7.5% from 9.8% last year.

A slew of stimulus measures in China and market expectations for further monetary easing policies amid a trade spat pushed down one-year interest-rate swaps to 2.66%, the lowest level in more than 21 months. That's below the cost of its US counterpart, which is at 2.68%, for the first time in nine years, as rates in the world's largest economy rise as the Federal Reserve tightens. 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**.

Geopolitics

On the 6th of November we will have the long-awaited **US Mid-term elections**. The consensus view in financial markets appears to be a Democratic majority in the House and a Republican majority in the Senate.

Continued Republican control of the House and Senate would be slightly more growth-friendly in the near-term than divided government or Democratic control, however, under any of the scenarios, the boost to growth from recent tax cuts and spending increases should fade by 2020.

In **Germany**, Chancellor Angela Merkel's political staying power is on the line this fall, culminating with a Christian Democratic Union party convention in December that's likely to test her authority.

State elections in Bavaria resulted in huge losses for the parties of the national grand coalition. The CSU lost its absolute majority, gave up 10.5pp to 37.2% and just marginally escaped a complete disaster (their polls were as low as 33%). The SPD ended up at 9.7% and thus slipping from the second largest party of the State to position n.5.

The AfD received 10.2% (they did not compete at the last elections. As none of the established parties will work with the AfD, this means the CSU will be the majority partner of the next government with the option of forming a coalition with the Greens, Freie Wähler (most of their representatives are former CSU parties members) or the SPD.

Political volatility in Germany now is about the worst possible scenario for the European Union. Merkel is the *de facto* head of the EU and it is dealing with revolts both internal and external, **all of which revolve around fundamental questions of sovereignty of member states.**

In **Italy**, opposition to the European Union's **budget rules** is stiffening and it is getting hit by a credibility issue.

The Italian budget has been presented to the EC with the commission releasing an **opinion by the 30th of November**. Before that the market will be focused on **rating agencies' reviews**: S&P is due on the 26th of October while Moody's can be any day (19th or 26th) -> a **one-notch downgrade is likely and already priced**, should the outlook be kept negative, investors would start fearing that a further notch from both agencies could take Italy out of Investment Grade bond benchmarks and trigger a forced-selling.

Brexit talks reached a dramatic stand-off in Brussels last Sunday, after Theresa May warned that a draft treaty to take Britain out of the EU was a "non-starter" and risked tearing her government apart ahead of the European Council meeting on Wednesday.

As far as UK Macro, a wide range of Brexit outcome is now possible. Similar to the EU referendum run-up in 2016, policy makers argued that **BOE policy response** to Brexit might go either way, even in the event of a no deal scenario, with the adoption of tightening or loosening unconventional measures to protect the national economy.

Britain's decision to leave the European Union has cost the government 500 million pounds a week, wiping out for the moment any future savings from stopping payments to the bloc. The Centre for European Reform, a research group that focuses on the European Union, said the British economy is about 2.5% smaller than it would have been if the public have voted to remain in the bloc in June 2016.

Earnings

Q3 earnings have kicked off amidst heightened market volatility (VIX > 20), continued trade tensions and political uncertainty ahead of the US mid-term elections.

If beats translate into positive price actions and corporates coming out of buyback blackout period can provide a support for equities, this earning season may act as a positive catalyst for stocks.

However, the market will be more keenly focused on the forward outlook.

Ahead of Q3 reporting, analysts have steadily **cut earning estimates**. A Citigroup gauge of earning revisions, which measures the difference between the number of analyst upgrades and downgrades, has currently fallen to the lowest since July 2016!

The chart shows the Citigroup Earning Revision (dark line) vs MSCI World.

Citigroup earning revision index (dark) vs. Msci World index (light)

US valuations are at the second highest level in history. Despite the massive surge in earnings due to tax cuts, inflation and interest rates, revenue growth is weak as consumers, government, and corporations are fully leveraged, and households are *"all in"* the equity pool. This is an important point which should not be overlooked.

As Fed Chair Powell stated in his speech to the National Association for Business Economics (NABE), the outlook is "remarkably positive." In fact, the unemployment rate fell to 3.7%, the lowest level in 50 years. The National Federation of Independent Businesses (NFIB) survey stands at 108.8, the highest reading since the survey began 44 years ago. ISM non-manufacturing survey hit 61.6, the highest level since the measure started in 1997.

And yet, as we gradually anniversary the **base effect of tax cuts** by the end of the year at which point they will provide no new upside to earnings growth, a trio of new threats is emerging, all of which threaten to pull down profit margins in the coming year.

Investor concerns going forward relates to **downward pressure on profit margins from three sources:**

- **Tariffs**: will have minimal impact on Q3 results for most companies given the bulk of the levies were not imposed until late in the quarter. If a 25% tariff is placed on all imports from China, the estimate of 2019 S&P 500 EPS currently $170, could fall as low as $159, eliminating all of expected earnings growth.

- **Wage inflation**: Wage Survey Leading Indicator currently stands at 3.3%, the highest level this cycle. Meanwhile, AMZN's announcement of a $15 minimum wage for all US employees has spurred discussion of economy-wide wage inflation. While this change will not impact the 3Q results of the S&P 500's 2nd largest employer, investors will be observing the responses from other firms.

- **Interest rates**: rising yields will weigh on firms with the heaviest debt load, as higher rates flow through to higher interest costs.

Macro

In **US** we had:

- Lowest **unemployment rate** in 49 years (3.7%)
- **US consumer confidence** close to a 50-year high with Weekly Initial Claims close to 50-year lows (chart)

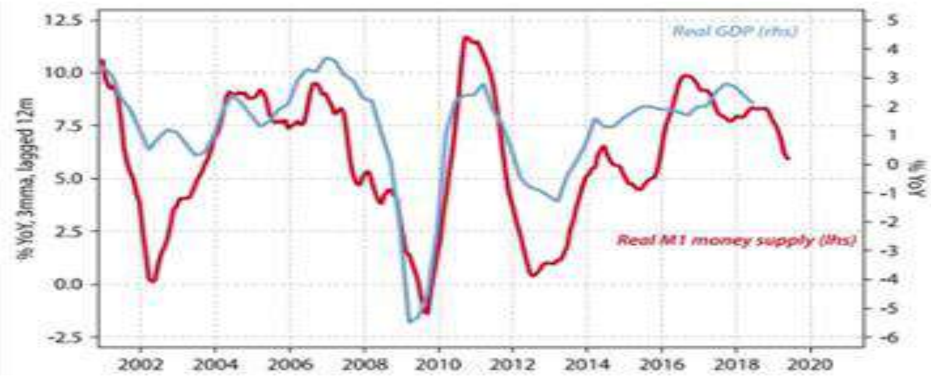
US Consumer Confidence (dark) vs. Weekly Initial Claims (light)

- Annual spending growth outpaced annual income growth for the 7th month in a row in August but month-over-month, incomes rose less than expected as The Fed's favorite inflation indicator modestly disappointed MoM. This is the 7th straight month that spending growth has been at or above income growth...
- **Home price** growth slowest in 11 months with sales of existing single-family homes have dropped each month for the last six months and are now at the level of July 2016.

In **Europe**:

- **GDP** growth looks to have peaked. M1 money supply growth slowing to 5.9% from 8.3%, points to weakening Eurozone GDP growth as M1 tends to lead real GDP by 12 months(chart).

M1 Real Money supply (red) vs. Real GDP (light blue)



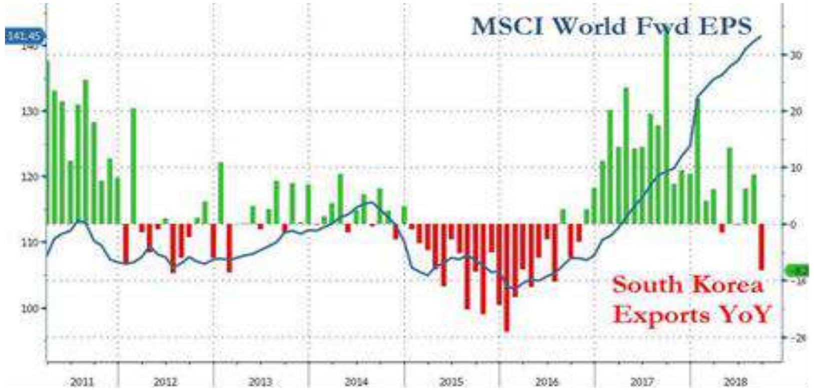
- **German PMI** data show a marked contrast between services & manufacturing in recent months, with new manufacturing orders falling sharply (the export portion is now in contractionary territory). However, the main signal for the economy is in the composite PMI which has managed to stabilize in recent months on the back of strong services.

Macro

On aggregate, Services data and continued strength in US labor market somewhat overshadowed the weakness we saw across several manufacturing PMIs globally in the last 2 weeks. Post the latest round of releases, the **aggregate global manufacturing PMI is now down to 52.2**, the **lowest** level in nearly 2 years. The YoY change in this series has been a good guide to annual returns in global equities and is a further warning sign for Equities.

Another interesting indicator is given by the **South Korean export growth**, a notorious global cyclical indicator has recently collapsed flashing a warning signal for global profits and economic growth. The September print came in at -8.2% YoY with export to US plunging 12% YoY and -6.5% to China

MSCI World Forward EPS (blue) vs. South Korea exports (red)



The last time South Korean export growth turned negative *in the downward direction* was just around the time of China's devaluation in the summer of 2015, when global markets were on the verge of a 20% bear market. We will need to monitor closely the data for October.

Central Banks

The **FED** raised the target range for the policy rate to 2.25% at its September meeting. Chairman Powell reiterated the case for gradual rate hikes as an intermediate path that balances the twin risks of unnecessarily ending the recovery and overheating. While the FOMC removed the description of the policy stance as “accommodative,” Powell downplayed the significance of the change.

We continue to expect **4 rate hikes** in total in 2018 and up to **4 more in 2019** for a **terminal rate of 3.25-3.5%**

Powell's view on risks to a faster pace of rate hikes suggests that, for Treasuries to break to new yield highs, US CPI inflation needs to surprise to the upside.

The minutes from the September **ECB** meeting have reiterated that external risks to growth have become more prominent, but the overall balance of risks around growth remains “broadly balanced” thanks to resilient domestic fundamentals.

Last week, ECB’s Knot said that Central Bank officials may consider speeding up the process of removing their extraordinary stimulus if the euro-area economy evolves in line with projections.

Foreign Exchange

The **USD** is still seen as a "**safe**" currency towards the Trade War theme (CNY dangerously depreciating to a value close to 7 again) and European Periphery troubles (even if it has been in a range between 1.15/1.18 since the end of May).

The **DXY Dollar Index** is unchanged since our last update but **long net speculative positioning** is continuing to growth and has reached the **highest level this year** and the **highest since January 2017**.

USD net short/long positions (light dashed) vs. Dollar Spot Index (black)

We don't expect some USD strengthening in the short-term, unless further trade tension.

Interestingly, the IMF has recently released the Currency Composition of Official Foreign Exchange Reserves (COFER) data for Q2 and the news is the continued run-up in CNY reserves portfolios, even in a quarter when CNY depreciated sharply. **This suggests increasing demand among reserves managers for CNY in their portfolios.** Most likely this reflects the importance of CNY in trade and initiatives taken by the Chinese government to internationalize CNY.

Global reserve managers have now a stronger appetite for CNY and **CNY in reserves is now roughly at the levels of AUD and CAD**, and about 40% of GBP and JPY holdings, so there is **room for a lot more buying**.

Commodities

The Blomberg commodity Index has bounced 3.5% since our last update and is still 5.5% below the highs made at the end of May.

Since August lows, **crude oil** has gained 8.4%, **copper** 7.7% and **iron ore** 6.3%. This should lead to a raft of earnings upgrades for commodity producers across oil majors, oil services, miners and chemicals, vs downgrades for companies consuming those commodities (or derivatives thereof) across transport, freight, retail and food and beverages.

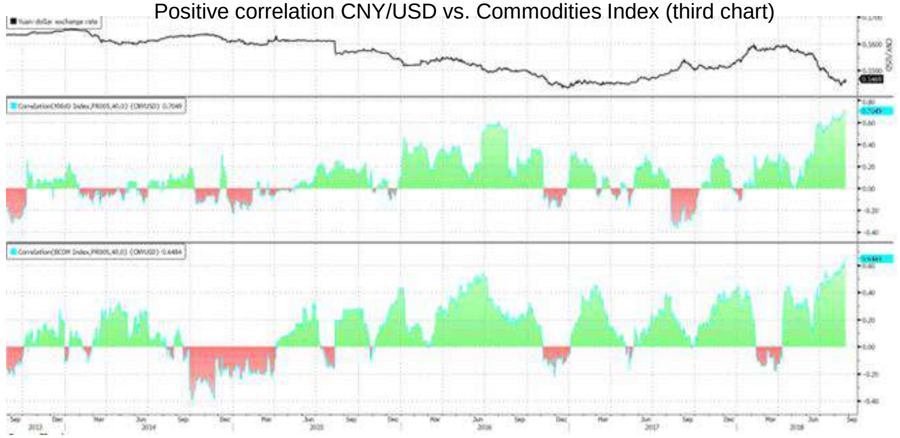
We warned that Managed Money's net specs open positions across the major commodities (ex-energy) were the shortest since 2006 and the re-positioning we have seen over last month was mainly due to this technical factor.

The 40-day rolling correlations between the Yuan, MSCI World Index of Developed-market stocks and the Bloomberg Commodity Index are at highs since the currency began to float in 2005. This would probably mean that without some CNY appreciation it would be difficult to see a further strength on the commodity space.

CNY/USD (black)

Positive correlation CNY/USD vs. MSCI World (second chart)

Positive correlation CNY/USD vs. Commodities Index (third chart)



Commodities

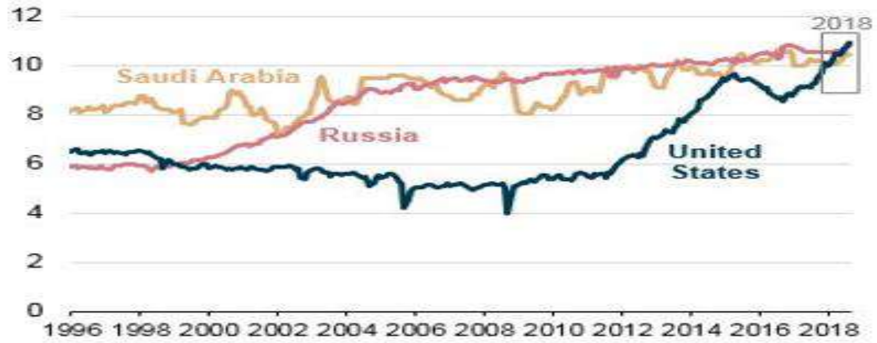
Oil prices are unchanged since last update after being dropping 6.5% from the highs made at the beginning of the month.

Positioning has started to change with some outflows, it is still a pretty much consensus long trade but over the last 2 weeks less so.

We have called for some profit taking at the beginning of October and we would eventually get back in at around 65/67$ on Crude.

Interesting to note that US is now the largest producer of Crude oil in the World

Monthly crude oil production (Jan 1994-Aug 2018) million barrels per day



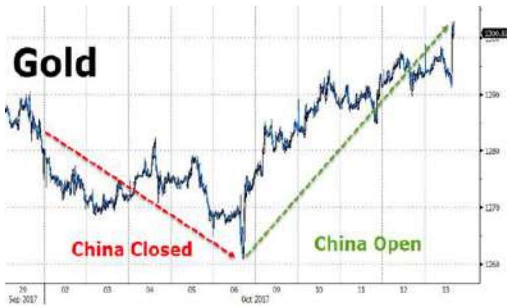
Gold has bounced 3% since our latest newsletter where we suggested to start having or increasing positions on both Gold and Silver (+4.5% since the message).

Short positioning on gold has continued to increase despite being already at record levels. Managed money (mostly hedge funds) have sold a record 109.5K gold contracts, up 37% in just 1-week. Holdings in bullion-backed ETFs tracked by Bloomberg have fallen 15 weeks straight, the longest run since August 2013.

A short-squeeze is getting very likely and it is worth to remind that at gold's mid-2016 top, these speculators had a very high positioning before the quick-correction of 15%.

We are also approaching the period of seasonal strength and another interesting data-point is given by Chinese Golden Week which has had a very predictable pattern in the precious metals markets (have a look at what happened since 2013 on the charts…)

Gold price vs.China holidays



In terms of newsflow, Russia added about 26 tonnes of gold, worth about $1 billion, as it sold Treasuries, in response to the first new US sanctions.

Correlation Gold price vs.Golden week China

Executive Summary

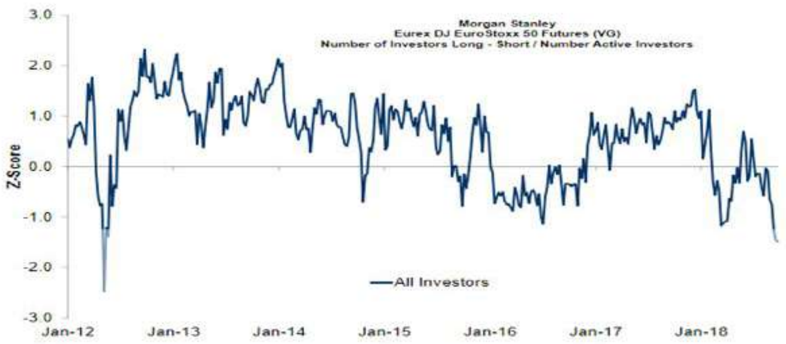
We were predicting for some market volatility during the month of October and the US has started to unfold on Growth / Tech sectors as we were anticipating.

Now it's a matter of understanding how far it could go… we believe that there could be a nice market entry point before the end of the month for the classical year-end rally.

We also believe that if we are right, this could be an interesting opportunity to offload some exposure for 2019.

The US growth outlook is less compelling than it was in early 2018, when fiscal tailwinds were aiding the outlook for corporate revenues and consumer spending. 2019 growth is likely to be far closer to trend and benefits from tax reform enter into base effects.

Eurostoxx 50 Futures – number of positions Long/Short



Positive factors:

- Market could surprise on the upside as **positioning is light** compared to the beginning of the year. The case for a Q4 performance chase is still there. This is especially true for Europe where investor positioning on Eurostoxx futures is the most negative since the European crisis in 2012.
- **Seasonality**: Q4 tended to be strong both in US and Europe with the months of November & December positive for 70% of the time in the last 50 years. It is also interesting to note that October has been a stellar performer for the US market in mid-term years being the top month of mid-term years since 1950!.
- **European valuations look really compelling now** and 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.
- **Q3 Earning Season**: EPS growth is projected to be above 20% in US and will likely end up higher if beats are delivered as frequently as has been the case historically. Revenue growth is also tracking at a solid 7%, similar to last quarter pre-season. If beats translate into positive price actions and corporates coming out of buyback blackout period can provide a support for equities, this earnings season may act as a positive catalyst to stocks. However, the first quarter of this year taught US earnings beats aren't enough to rally the market sometimes, forward outlook will matter. Any negative message regarding margins, tariffs, and Q4 guides will be received poorly by the market.
- **Technical analysis**: not yet a positive factor but if the market will continue to fall at current pace it could soon start to create some positive signals for a "bear-bounce". Please bear in mind that last week we had a record sell of futures in US (20-25% of total open interest) and a record number of Put bought.

Executive Summary

Negative factors:

- **<u>In September we mentioned</u> as 1st point: "The main bear case is that a <u>crowded trade unwind</u> spreads to an already weak broader market".** This has unfolded correctly. <u>We also mentioned that volatility was set to spike</u> as a contrarian trade (VIX (Volatility on S&P) +100% Mtd, V2X (Volatility on Eurostoxx) +60%). We also said "<u>The largest positioning risk continue to be under the surface in crowded names, sectors and factors rather than overall Index level positioning</u>".

- <u>We see **limited risk that global economic momentum will re-accelerate here**</u>, as the year-on-year comparisons get slightly tougher in the coming months and <u>increased uncertainty around trade and tariffs may start to weigh on activity going forward</u>.

- **<u>Global monetary policy is set to (gradually) tighten further</u>** as the Fed continues to lift rates 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>.

- <u>We are also witnessing a **sharp slowdown in the growth rate of M1 in US and narrow money supply growth rates in the Euro area and China**</u> are a concern for "risky assets" like Stocks and Corporate Bonds. <u>There is no longer enough liquidity to keep all the plates in the air.</u>

- **<u>Margin pressures are beginning to build</u>**, which is perhaps not surprising given that input cost inflation (PPI) has been above CPI for much of the last two years. With <u>labor costs gradually rising and tariffs</u> offering up the potential for higher input costs and supply chain disruption ahead, <u>profitability concerns look set to become more of a focus for investors in the coming months</u>. <u>Input prices are rising more rapidly than output prices, negotiated wages are now rising sharply even in Europe</u>. <u>Margin environment is less favorable now.</u>

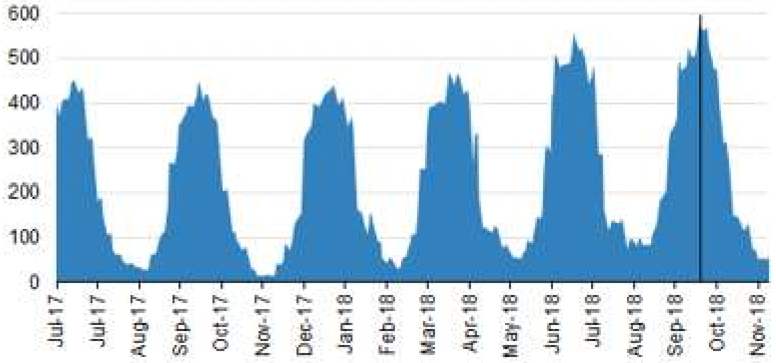
- **<u>US estimated Quarterly S&P Earning Growth set to decelerate</u>** <u>to its long-term average of 6% to 8% in 2019</u>.

S&P500 quarterly Earnings growth estimates

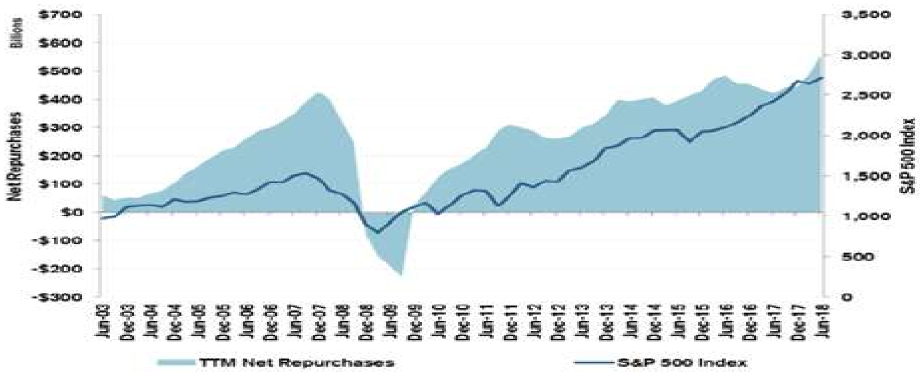
- **<u>Buybacks temporarily on halt</u>**: stock buyback announcements by U.S. public companies have already reached $827.4 billion in 2018, topping the previous record of $809.6 billion in 2007 with more than three months left in the year. According to Goldman, the final authorized buyback number will be no less than $1 trillion. <u>Now we enter into the "blackout window" for buybacks.. just to compare this effect, the current blackout period is the peak of the year vs half blackout in February.</u>

Executive Summary

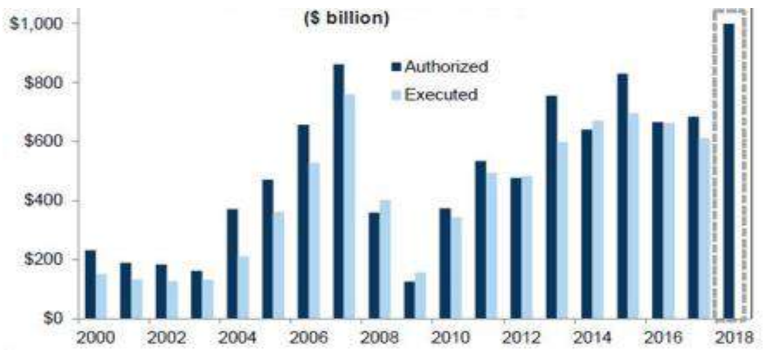
S&P500 Authorized Buybacks in «Black-out Window» in Bln $



Correlation S&P500 (dark) vs. Total Net repurchases (light)



S&P500 annual US share buyback activity



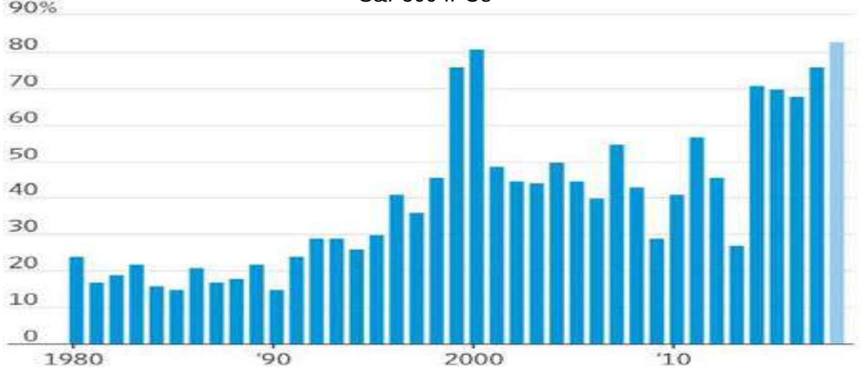
- **Insider selling**: One month ago, we reported that insider selling reached $450 million daily in August, the highest level this year; on a monthly basis, insiders sold more than $10 billion of their stock, the most of any month this year and near the most on record. As corporate buying is at least taking a breather, corporate insiders were ramping up share selling as the major US stock market averages were at or near record highs.

- **Cash Repatriation**: this week's US Flow of Funds data suggest that the repatriation flow slowed considerably in Q2 to 105bn$, less than half of the Q1 amount. Given that 330bn$ of repatriation took place already in H1 this assessment implies a significant slowing of the flow in the second part of the year. The boost that US repatriation provided to US equity and bond market via share buybacks and corporate bond redemptions is likely to slow considerably now as just 5% of the repatriated cash has been used for Capex.

Executive Summary

- **<u>IPOs / Secondary/ Placing</u>**: <u>The percentage of US listed IPOs that lost money in the last 12 months is marking a new record high (83%) exceeding the top reached in the dot bubble</u>. During the first three quarters of 2018, $50 billion in IPO money has been raised by more than 180 companies. This <u>puts this year on track to be the busiest year for IPOs since 2014. Most of these IPOs were on Tech and Biotech sectors</u>… the lesson we got from 2000 is to don't chase what everyone else is chasing. We also mentioned at the beginning of the newsletter that over the last couple of months a great number of IPOs has been called off and the performance of IPOs and Placings has been dreadful. <u>Not a great sign as it seems that the market cannot absorb any further paper.</u>

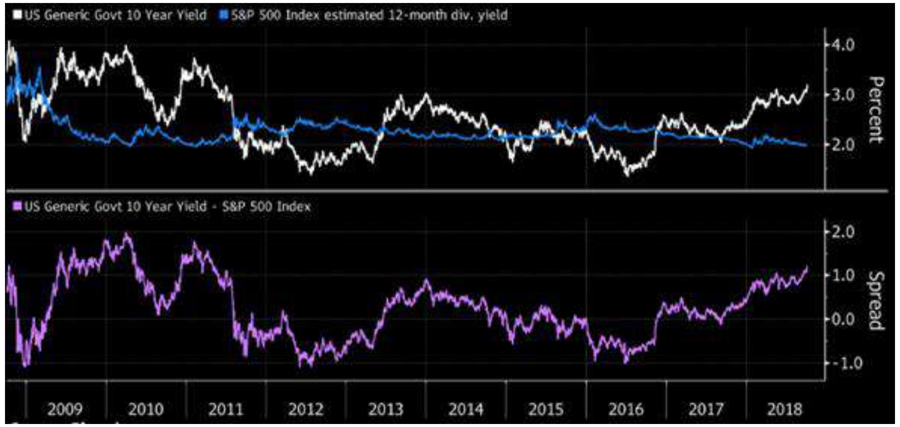
S&P500 IPOs



- **<u>In US the relative the relative appeal of stocks is waning compared to fixed income</u>**. Yields on 10-year Treasures breached 3.2% while US equities are estimated to yield about 2% in 12 months, the widest gap in eight years.

Correlation SP500 E12m dvd yield vs. 10Y US yield (blue vs. white)

Spread: 10Y US yield – S&P500 (purple)



- **<u>Fewer asset classes are beating inflation than in 2008</u>**: <u>fewer asset classes are beating inflation in 2018 than they did in 2008</u>. Granted, the magnitude of the losers is much, much different. <u>But it's still extraordinary and speaks to the risk that investors are crowding into the narrow set of things that are working. Investors frequently like to complain that "it's a hard market". But this year we think they really have a point.</u>

Executive Summary

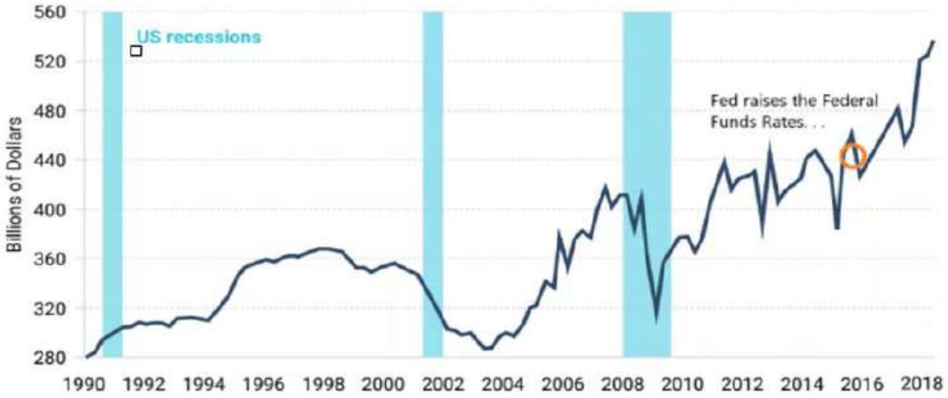
Asset classes beating vs. missing inflation

Ranking	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	REITS	MSCI EM	MSCI China	MSCI China	US 10Yr	MSCI EM	REITS	US 10Yr	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	Russell 2000
2	MSCI EM	Commodities	REITS	MSCI EM	US 2Yr	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	S&P 500
3	MSCI Europe	MSCI Japan	MSCI Europe	Commodities	US Agg. Bond	Global HY	Commodities	EM $ Sov Credit	Global HY	MSCI Japan	US 10Yr	US 10Yr	US HY	MSCI Europe	REITS
4	Russell 2000	MSCI China	MSCI EM	MSCI Europe	EM Local Debt	US HY	MSCI EM	US IG	REITS	MSCI Europe	MSCI China	EM $ Sov Credit	Global HY	MSCI Japan	US HY
5	MSCI Japan	EM $ Sov Credit	Russell 2000	Inflation Bonds	US IG	Commodities	MSCI Japan	US Agg. Bond	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	US 2Yr
6	Inflation Bonds	REITS	S&P 500	US 10Yr	Inflation Bonds	MSCI Europe	US HY	REITS	EM $ Sov Credit	Global HY	EM $ Sov Credit	US 2Yr	MSCI EM	Russell 2000	US Agg. Bond
7	Global HY	MSCI Europe	Commodities	US 2Yr	EM $ Sov Credit	EM $ Sov Credit	S&P 500	US HY	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM $ Sov Credit	EM Local Debt	MSCI Japan
8	Commodities	S&P 500	Global HY	US Agg. Bond	US HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	US 10Yr
9	EM $ Sov Credit	Russell 2000	US HY	EM $ Sov Credit	Global HY	Russell 2000	EM Local Debt	S&P 500	US HY	US 2Yr	Inflation Bonds	MSCI Europe	US IG	EM $ Sov Credit	Global HY
10	US HY	Global HY	EM $ Sov Credit	S&P 500	Commodities	S&P 500	EM $ Sov Credit	US 2Yr	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	US IG
11	S&P 500	EM Local Debt	Inflation Bonds	US IG	MSCI Japan	US IG	US 10Yr	EM Local Debt	US IG	US Agg. Bond	US 2Yr	Russell 2000	Inflation Bonds	Inflation Bonds	MSCI Europe
12	US IG	US HY	MSCI Japan	EM Local Debt	Russell 2000	EM Local Debt	US IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	Inflation Bonds
13	US 10Yr	US Agg. Bond	US Agg. Bond	Global HY	S&P 500	Inflation Bonds	US Agg. Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	Commodities
14	US Agg. Bond	US 10Yr	US IG	US HY	REITS	MSCI Japan	MSCI China	MSCI Europe	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	EM $ Sov Credit
15	EM Local Debt	US IG	US 2Yr	Russell 2000	MSCI Europe	US Agg. Bond	MSCI Europe	MSCI Japan	US 10Yr	EM $ Sov Credit	MSCI Japan	EM Local Debt	US 10Yr	US Agg. Bond	MSCI EM
16	MSCI China	US 2Yr	US 10Yr	MSCI Japan	MSCI China	US 2Yr	Inflation Bonds	MSCI EM	Commodities	US 10Yr	MSCI Europe	MSCI EM	US 2Yr	US 10Yr	EM Local Debt
17	US 2Yr	Inflation Bonds	EM Local Debt	REITS	MSCI EM	US 10Yr	US 2Yr	MSCI China	US 2Yr	Commodities	Commodities	Commodities	MSCI Europe	US 2Yr	MSCI China

- **<u>The US government's borrowing has increased to amounts that it hasn't since the 2008 recession.</u>** During a recession, it's *permissible* (thanks to Keynes's economic theories) for the government to pile on tons of debt, but once the recession's over, budget deficits need to contract again. And that's the farthest thing from what's happening 10 years after 2008. <u>The fiscal year isn't even finished yet (few weeks to go) and the US budget deficit is just shy of $900 billion which means a 40% increase since last year</u>. President Trump's tax cut plan and increased spending is causing deficits to swell and <u>the Congressional Budget Office (CBO) has significantly raised their deficit projections over the 2018 – 2025 period. The scary part is that they don't even expect a single recession or slow down between now and then</u>. These projections are assuming steady growth and a healthy economy and are not accounting for any margin of error here.

- <u>Ignoring</u> private consumer debt (which is greatly affected by rising rates), **<u>the US National Debt recently hit $21.3 trillion and the interest payments due on all this debt is at a record high</u>**. You can see on the chart that <u>since the Federal Reserve began raising rates in December 2015, the cost of interest payments on the national debt has soared hitting an all-time high of 538bn$ per year!</u> Remember that US is taking in *less* tax revenue because of Trump's tax cuts and the Treasury will have to borrow *new* debt just to pay off maturing *old* debt and interest. <u>Short term interest costs will continue to rise over the near-term because of 3 reasons: higher inflation, Fed tightening, and the increased amount of debt needed by the Treasury</u>. Jay <u>Powell, said that fiscal policy is on an "unsustainable path</u>," but such warnings are audible wallpaper, there but not noticed. A recent <u>IMF analysis noted that among advanced economies "only the United States expects an increase in the debt-to-GDP ratio over the next five years.</u>" For the anniversary of Lehman, **<u>never forget the toll of too much debt and rising interest rates.</u>**

US Federal Government current expenditures: Interest payments

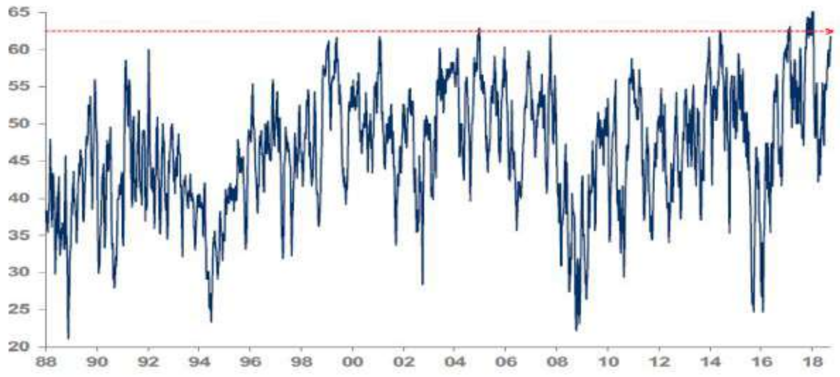


Executive Summary

- **Junk Bonds:** They crashed really hard just before the financial crisis of 2008, and they are starting to slip here in October 2018. A full-blown junk bond panic would definitely be a very clear sign that a major market crash is imminent. We are in the terminal phase of the biggest debt bubble in human history. In fact, total indebtedness in the United States has increased by more than 2 trillion dollars over the past 12 months…In total, indebtedness of consumers, corporations, and all governments has grown by $2.04 trillion over the past four quarters. And they're going to be paying higher interest rates on this ballooning debt. In other words, debt service costs are going to rise substantially. All of this debt has fueled a short-term bubble of relative "prosperity" but meanwhile all of our long-term problems just continue to get worse.

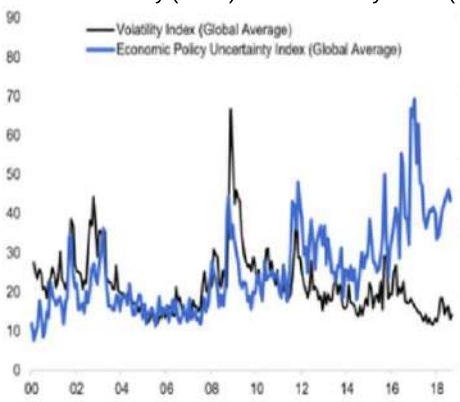
- **US advisors survey suggesting extreme level of bullishness.** The US Advisors bullishness survey rose to 62% this week, a level that has only been exceeded 1% of the time since 1988.

US Advisors Investor Intelligence % Bullishness

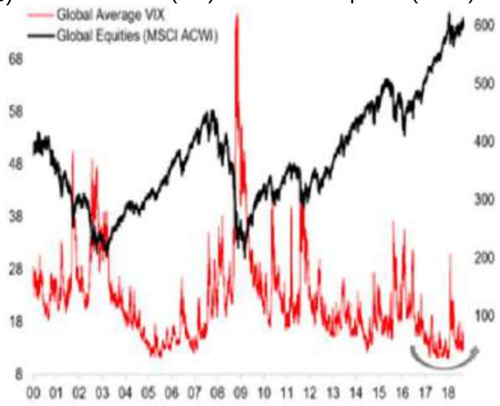


- **Volatility tends to be higher in H2.** Two interesting charts, the 1st shows the correlation between the Volatility Index (black line) vs. the Economic Policy Uncertainty index (blue line). The 2nd chart shows the correlation between Global Volatility (red line) vs. Global Equity (black line). Global Volatility has bottomed.

Global Volatility (black) vs. Uncertainty Index (blue)



Global VIX (red) vs. Global Equities (black)



We believe there is a possibility of a bounce on technicals/positioning but the general picture is getting quite dim, this is something that we need to bear in mind for 2019.

Executive Summary

Let's now analyze, what could stop the market's fall?

Having correctly spotted the usual suspects behind the latest rout, we think the following three things could make a short-term difference:

- **The Fed could provide some comfort to markets.** They could acknowledge the deterioration in financial conditions and soften their hawkish tone. The Fed's recent rhetoric suggests this is unlikely, but a combination of the scale of the moves and even President Trump's vocal criticism's may influence them. Trump is warning them quite publicly.

- **De-escalate the US-China trade/investment/tech war.** There has been a notable ramping up of US rhetoric against China which has clearly spooked markets just as the threat of limiting Chinese investment in US tech did earlier this year. Given the energy the US administration has devoted to this in recent weeks, a de-escalation seems unlikely. A positive news will definitely help the markets.

- **Stock buybacks return.** We are currently in the "black-out" period for US corporate stock buybacks ahead of earnings seasons. Remember, one of the biggest buyers of US stocks since 2009 have been corporates themselves. With earnings season starting last Friday and market prices falling, we will see a return of buybacks over the next month or so.

Current Investment Ideas

Long Value trade: in US and Europe, Growth stocks outperformed Value by 25% during the last 12-months.

Factors: Value (black), Momentum (orange), Growth (gray), Realized Volatility (light blue)

The rise in Yields has coincided with a clear and sharp rotation within Equities and since our last update Value har risen more than 6% while both Growth (-4.4%) and Realized Volatility (-4.2%) had a significative underperformance.

This has been one of our best calls this year as we realized that the 50% discount to growth was excessive and was representing a 40-year low with the Growth Index yielding less that half that of Value.

It was an extremely painful rotation for the markets as Investors were very long growth and momentum. The current Value universe is heavily overweight Financials, Commodities (mainly Energy), Utilities and Telecoms while the universe for Growth is Tech, Consumer Discretionary and Healthcare.

Current Investment Ideas

While we don't expect this unwind to be as aggressive as what we have seen over the last 2 to 3 weeks, we still think that Value is interesting.

Global value vs growth average valuations are at the lowest level since the TMT bubble.

MSCI World Value vs.Growth (% Avg. % Premium P/E, PBV & PD))

The decade long run of Growth versus Value may finally be at risk of turning on a more sustainable basis. With relative valuations having exceeded 2 standard deviations expensive in September, the recent reversal could see significant follow through before these valuations reach normal levels. Asset allocators tend to be slow to make these shifts but once they do, they tend to be persistent. This has the potential to frustrate bottom-up growth stock managers with good earnings results faded.

We think several sectors offer particularly good value: Banks, Basic Resources and Autos.

Long EU Utilities (SX6E Index): we started the idea last month as we were thinking to get more defensive but the breakout on Yields haven't helped the sector so far which has returned a negative performance despite the outperformance vs most of the other sectors.

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, 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: we entered into this theme last month as expectations/sentiment /positioning and prices were attractive.

The sector has since then clearly outperformed the market because the rise in Yields is positive for them.

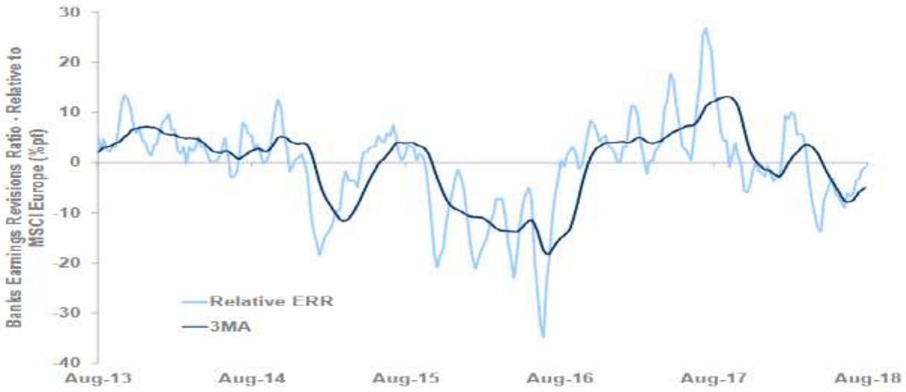
Hedge Funds have still got a consensual short position on the sector… the market deleveraging over the last weeks is positive because there would be further short-covering.

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.

Current Investment Ideas

<u>Banks relative earning revisions are showing some signs of troughing and the first US Banks which have reported since last Friday are showing some decent set of numbers</u>.

Banks Earning Revision Ratio vs. MSCI Europe

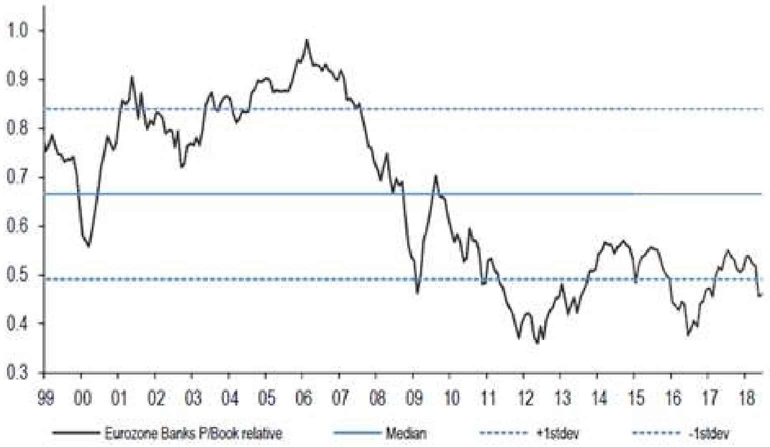


The median European bank stock now trades below tangible book for the 1st time in almost 2 years.

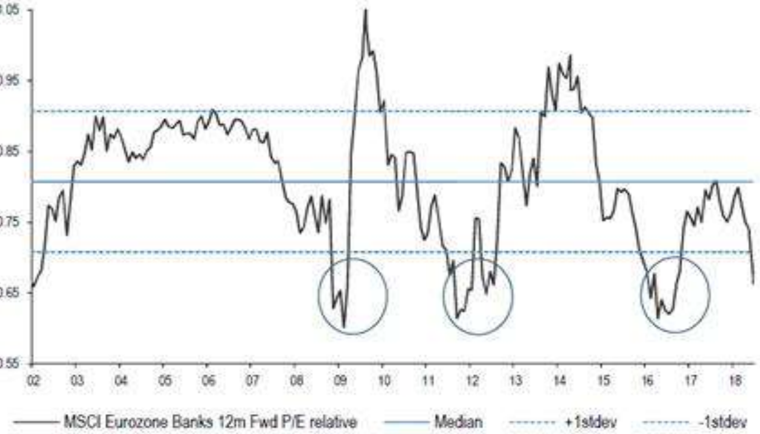
<u>Eurozone banks look attractively valued</u>, their 12M forward P/E is currently at levels where it has always bounced in the past.

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

Eurozone Bank P/B relative



Eurozone Bank 12m Forward P/E relative



Ideas closed

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

Even this call worked very well as Markets have dropped and Volatility has spiked higher!

We thought that was interesting the 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%) spending only 0.16bps for evert 1mln$ covered (delta 36%).

Now this structure would be comfortably in the money with a value of 1.5% of Nav (from a cost of just 16bps)… we would **suggest to take profit ahead of a potential market stabilization (volatility decreasing).**

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Keep in touch

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