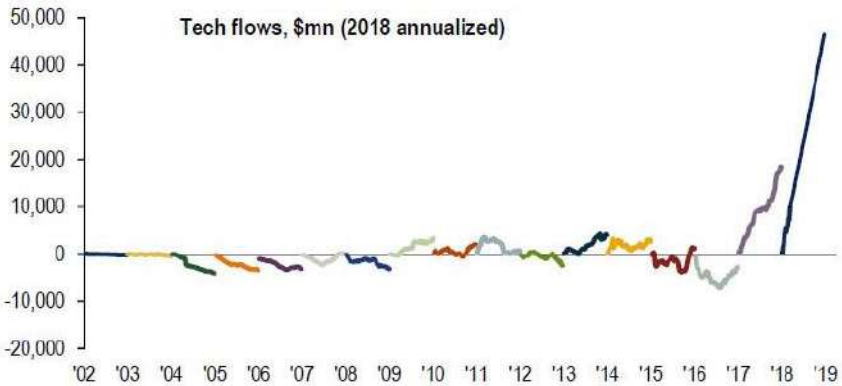
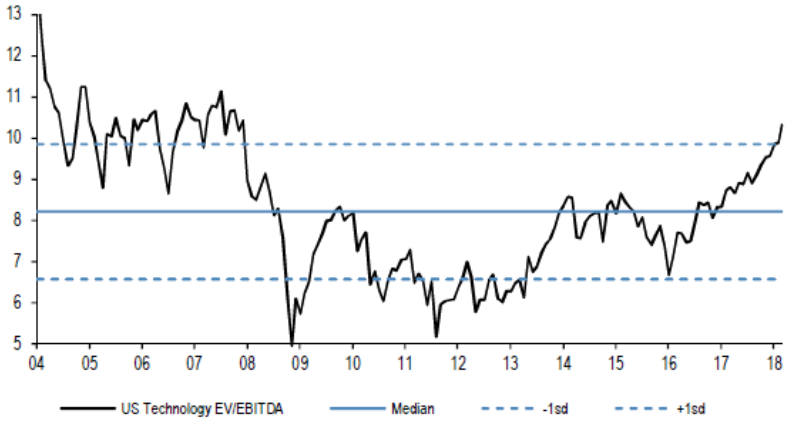
HERON
ASSET MANAGEMENT

Market Update





Positioning on Tech in US shows us that net longs in IT are back at 100 percentile since 2010 with a long /short ratio of 2.49. Inflows have been extreme in relative terms (1st chart). Tech is starting to show few signs of slowing. The sell-off we had on Monday was due to Tech weakness with FB contributing 30bps of the move for Nasdaq. The last standing positive sector Ytd was Tech which makes up nearly 50% of the "top 50 longs", up from a smaller 30% a year ago. The outlook for Tech remains constructive, but the valuations are starting to reflect this. US Tech is now outright expensive on EV/EBITDA metric in absolute terms, and vs. the broader market (2nd chart).

Main points

- Markets back to Normalization?
- Macro data / Protectionism / Earnings season
- Inflation / Yields
- ECB / FED
- Trades to be monitored
- Executive summary: **Volatility will be higher in 2018, we still like relatively European Equities. Over positioning on Tech?**
- Investment ideas

20th of March 2018

Since our last update sent at the end of February, the market has been quite shaky testing again the lows in Europe made in the middle of the month and marking the classical "W" shape recovery.

Since then we have seen some signs of normalization. Fundamentals (job growth, corporate profits expansion, corporate and consumer confidence) remain very strong globally, even if manufacturing is downshifting. A trade war could break the positive feedback loop between growth and markets, but this outcome remains a risk for the moment rather than a base case.

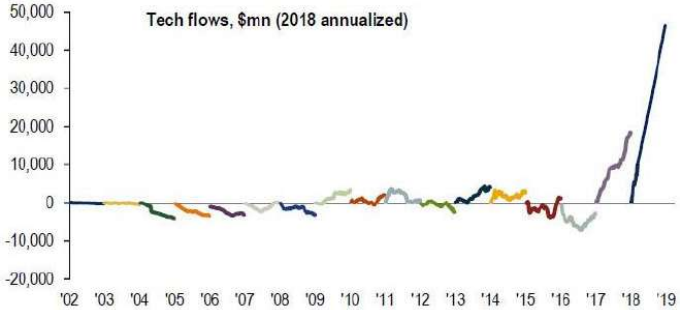
Now the market seems to tell us that we will have a very strong upcoming EPS season along with subdued inflation, especially wage inflation. The FED sees growth, but not too much of it and Real 10Y rates are off the highs as we correctly predicted… the UST 10yr yield is 2.86%... the VIX is back around 18, fears are eased, **this is what we would call Normalization**.

A month ago only we were in a global risk-off mode with rates moving higher, volatility spiking, quick portfolios deleveraging…

Even the situation in North Korea seems to be developing in an unexpected positive way.

We now have 5 weeks before companies reporting EPS, it seems smooth sailing, is it true? We will analyse below the main factors helping us to understand the market behaviour for the next weeks.

In US, Amazon's market cap is up $211bln Ytd, Apple's is up $62bln Ytd, Alphabet's is up $81bln Ytd, Microsoft's is up $86bln Ytd and FB's is up $26bln Ytd. NFLX with $15bln in revenues and 5,400 employees has a larger market cap ($139bln) than GE with $120bln in revenues and 330,000 employees.
One could argue this is simply a sign of the times, where exuberance or growth has become quite stretched. Or it could be more of a fundamental shift, evidence of how business models have evolved to lead the market today. These numbers just keep amazing us and are key to understand the future market behaviour.



Positioning on Tech in US, according to PB data, shows us that net longs in IT are back at 100 percentile since 2010 with a long /short ratio of 2.49. Inflows have been extreme in relative terms (chart 1). **Tech is starting to show few signs of slowing**, for example: i) post its largest 1-Month outperformance versus the S&P since 2012, the Nasdaq is now 2.7 Standard Deviation above its 12-Month relative average; ii) 80% of constituents of MSCI ACWI's IT index outperformed the market over the last month, the highest breadth reading since 2003. Amid all this euphoria, we should keep a close eye on EPS trends as the latest burst of price outperformance has not been accompanied by EPS outperformance.

The sell-off we had on Monday was due to Tech weakness with FB contributing 30bps of the move for Nasdaq. The last one standing positive sector Ytd was Tech which makes up nearly 50% of the "top 50 longs" up from a smaller 30% a year ago. Oracle made a profit warning after market and it dropped 7%..

The trigger for the sell-off in February was a sharp rise in US Bond Yields, following the data that showed US wages increasing at the fastest pace since 2009, raising the alarm about higher inflation along with potentially higher interest rates.

Investors have quickly de-risked and sentiment has turned cautious, contrasting with the euphoria that prevailed at the start of the year. Global equities suffered their biggest weekly outflows in more than a year.

In February Artificial Intelligence funds lost an unprecedented 7.3%, even surpassing the losses borne by CTAs. It is thus likely that AI funds, along with CTAs, played a big role in February's correction. Volatility hedge funds disappointed by their performance in February and likely also de-risked over the past month.

Now The real problem you have is given by the breakdown of the correlation between govies and equities (before it was positive, ie. higher yields / positive equities), with all risk parity funds looking to any macro data about inflation to see if this breakdown will be closed.

Obviously there is an increasing debate on multi-asset funds, in a context where govies are returning (especially in the US) to attractive levels. The outflow from HY into IG is continuing. Another debate regards the allocation between govies vs equities: with UST 10y at 3%, the earning yield and dividend yield offered by the market becomes much less attractive.

One of the structural changes in equity markets over the past decade has been the dominance of algorithmic or high frequency traders in market making. These agency traders tend to show lower commitment and withdraw from market making more quickly than principal traders once order flow imbalances emerge and uncertainty along with volatility rise. The more frequent occurrence of the so called "flash crashes" in equity markets is often blamed on the opportunistic behaviours of these market makers.

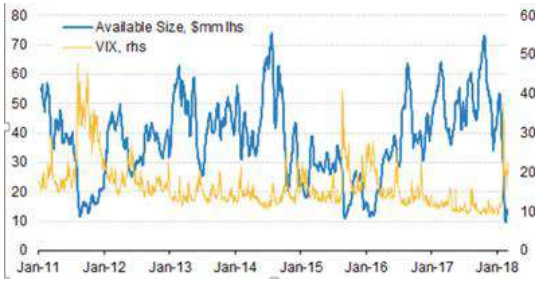
The potential withdrawal of retail investors as the equities marginal buyers (after buying an unprecedented $100bn of equity ETFs in only one month during January) could create clear downside risk for equity markets in the near term, especially if one takes into account the deterioration in equity market's liquidity. The unwillingness of institutional investors to add risk can be seen in their betas to the equity market. Both Discretionary Macro hedge funds and Equity Long/Short hedge funds have been reluctant to raise their betas in recent weeks.

There is a high likelihood that a more defensive behaviour by market makers has worsened market liquidity, exacerbating market movements over the past weeks.

Buyers are currently more selective and less willing to blindly buy dips. It is a new paradigm. We need to understand that we are in a late cycle, possibly getting closer to its end, and markets will be more volatile with dips lasting longer.
We are not seeing buyers of weakness, as we are so accustomed to, despite getting risk-positive economic data in a process of Normalization.

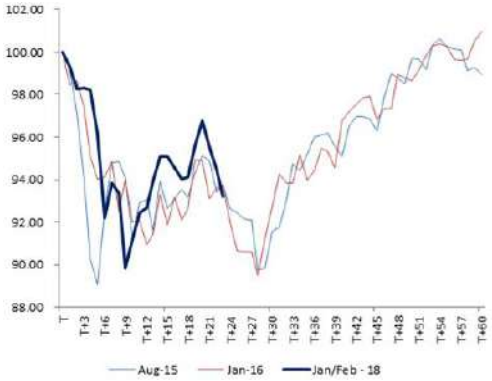
Now the move is no longer driven by systematic funds / vol target strategies, as many are indicating, but selling has come from more fundamental /discretionary investors exacerbated by a lack of liquidity.

Since the start of the year, the available size at the top of the book on futures has deteriorated sharply, with similar signs of reduced size/wider spreads in cash and option markets as well. Part of the decline is a natural function of higher volatility (spreads usually widen and available size drops when volatility increases). However the recent decline is sharper than what we have observed in similar situations. The chart shows the S&P futures available size in February vs VIX.



We should explain the lack of liquidity with the fact that market makers had high losses covering long vol positions and have pulled back now. In addition, markets have become more structurally fragmented and more volume has shifted to closing auctions with less natural liquidity during the day.

Overall the key concern is still the looming presence and supply from systematic investors which are continuing the deleveraging. Comparing the current situation (dark blue line on the chart) with the past corrections (August 2015 & January 2016), the time-frame looks very similar and we are not there yet.



While on the surface it feels like global equity markets have returned to the same trajectory they were on back in January, we think that there has been an investment regime shift and continue to see growing caution around the move in global rates (and real yields), as well as the increasing number of 'flashing red' signals within credit. Volatility is clearly back in the picture and, as we rightly predicted, volatility is now an implicit factor that could disrupt market risk.

Let's now analyse the recent Macro Data, still positive but starting to show some inflection points.

The percentage of world economies with positive data surprises has fallen to 44%, which has been a leading indicator for actual data changes. In terms of actual data, the percentage of economies beating their average has also fallen from over 90% to 67%. A break below 50% would mean that "concerted economic growth", or synchronised growth, should no longer be proclaimed.

US Core CPI rose 0.2%MoM (0.182% unrounded) in February, keeping the YoY rate at 1.8%. With food flat and energy up 0.1%, headline CPI rose 0.2% MoM, raising the YoY rate to 2.2% from 2.1%.

As expected, monthly core CPI inflation decelerated in February. But while many components slowed, a third consecutive pickup in the core services gauge points to steady momentum in underlying domestic price pressures.

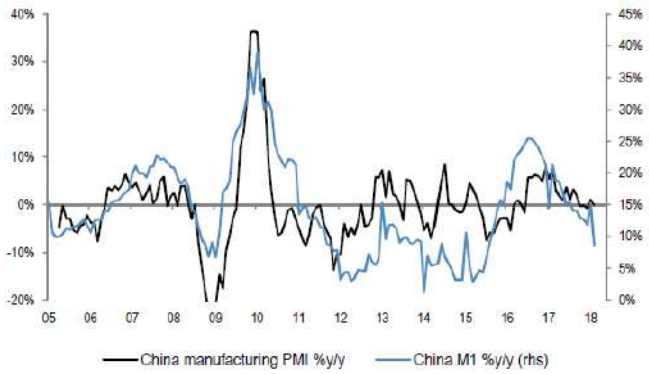
Importantly, China's 'export' prices appear to have bottomed which means China is now sparking an inflationary (albeit very modest) push to the world... (chart)

We had in US a much stronger than expected result on **Payrolls** (+313,000) but hourly earnings surprised to the downside (+0.149%) erasing much of the spike seen in January and settling back to +2.6% on a YoY basis. The market had a small relief on these numbers as they were the trigger for the sell-off generated in February.

Following a disappointing tumble in January, **US Industrial Production** spiked 1.1% MoM in February (well above all analyst expectations). This is the 2nd biggest MoM spike in production in 8 years. **US Consumer sentiment** in March unexpectedly jumped to a 14-year high after tax cuts boosted disposable incomes.

European macro data have disappointed markedly since the highs of January. The February EC composite PMI fell 1.7% to 57.1, German IFO expectations fell 3.0% to 105.4. Absolute growth is still decent but no longer supportive of an outright pro-cyclical view.

Chinese PMI had an outsized fall most recently, the biggest monthly drop since May 2012 (Chart).



In contrast with above, **US consumer confidence** jumped to the highest level since November 2000. In the last 50 years, it's only been higher twice: 1968-69, just before the 1969-70 recession; and 1998-2000, just before the dot-com crash and subsequent recession....

An important factor that has recently weighted on the performance of the markets was the **starting of Protectionism** and market pricing as "deflationary" (yields down, stocks down..).

Trump announced hefty tariffs on metal imports to protect U.S.A. from foreign competition (25% on steel imports and 10% on aluminium). As steel and aluminium represent 0.2% of US GDP only (domestic US steel prices were already up 20% since the beginning of the year in anticipation of possible rumoured tariffs), the impact on US growth and inflation is likely to be limited. However, if tariffs were to be extended to areas such as cars, or other categories of commodities, or capital / consumer goods, this could become a more significant threat.
He is now also studying a hike in tariffs and investment restrictions on China, with a package of tariffs on Chinese imports worth $30 billion a year. A formal announcement would apparently come within weeks.
The obvious counter from the news wires is that China can retaliate by halting its purchase of Treasuries, but as this would also mean halting its exports to the US, it would hurt both economies just as badly. In fact, U.S. is the least exposed as trade is just 26.6% of GDP compared with the world as a whole 56.4% and Germany 84.3%.

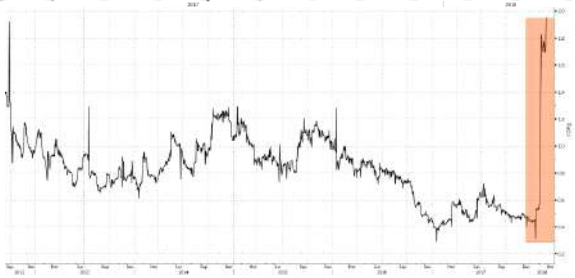
Trump is an economic nationalist, and his goal is to put US industry and domestic employment first. Every policy from immigration to regulation to taxation reflects this philosophy. By raising tariffs on select products, he is picking the domestic winners who should be able to expand production against international competition, hiring more local workers.

However, the EU seems to firmly react to Trump's tariffs imposing their own tariffs on goods. The move by President Trump may also further complicate trade talks between the United States, Canada and Mexico over renegotiating NAFTA, where rules that would affect the auto industry are already a major sticking point (declining sales as interest rates rise).

Signs of protectionism could shift focus towards US inflation and long-term growth risk. This would undercut the reflationary, pro-cyclical market trends we have seen, and also increase uncertainty, engendering volatility, which may weigh on multiples. Such conditions would favour defensives (Health Care, REITs, Telecom and Utilities), particularly those with low foreign revenues exposure over cyclicals and sectors/companies with high foreign-revenues.

Now let's have an update on volatility as Investors have been pulling money from exchange-traded notes, tracking VIX futures, like never before. The iPath S&P 500 VIX Short-Term Futures ETN posted a seventh week of withdrawals, the longest streak since its inception in 2009 (chart).

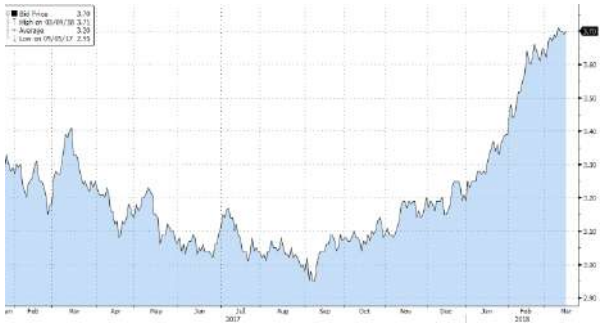
Options traders have been boosting bullish bets on an exchange-traded fund that gains when VIX futures fall. The number of calls on the security known by its ticker SVXY has jumped to a record, while outstanding puts have plunged, taking the ratio between the two near a peak (chart). Following the demise of its cousin XIV in February, SVXY's provider said it would reduce its target leverage this week, which would protect investors from getting wiped out with a one-day spike in its underlying index.



Despite having now a more normalized level of volatility, we ultimately believe that market volatility will ultimately weigh on valuations in 2018. The chart is showing the correlation between the VIX (volatility on S&P) and MSCI world inverted Price/Earnings.

Another interesting deleveraging and measure of anxiety needs to be found in Credit and Volatility of other asset classes.

Investment Grade bonds in US have had their worst start to a year in decades. The Bloomberg Barclays US aggregate credit Yield (chart) has reached a new high and S&P said the number of defaults by heavily indebted corporates could rise significantly amid tightening liquidity and credit conditions. The proportion of highly leveraged corporates (those whose debt to earnings exceed 5 times) stood at 37% in 2017 vs 32% in 2007 before the global financial crisis.



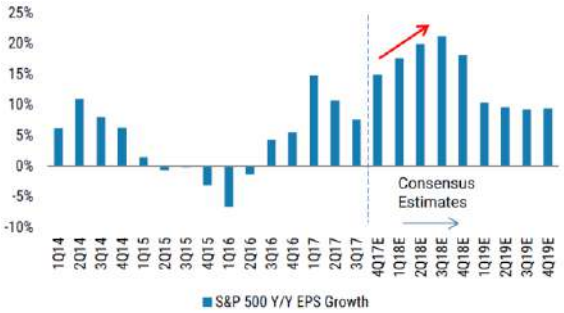
In Europe, IG and HY have also seen a relatively weak start to the year in total return terms, but not nearly as weak as in the US. This puts 2018 as the 4th weakest start for EUR IG (since 1999) and 3rd weakest start for EUR HY (since 2003).

What sort of narrative could be developed in credit? Credit market sell-offs begin slowly. Technical selloffs can beget liquidity issues, creating outflows which slowly, then all at once, force real money selling. From there, technical concern morphs into fundamental concern, credit markets and access to capital tighten, and companies begin playing defence.

We should therefore be wary of these factors as we are scared when the credit cycle becomes business cycle.

Now that the Vix/Inverted Vix issue seems absorbed by the market we should focus more attention to Credit and other asset classes' volatility.

The **Earnings season** is 4 to 5 weeks away and we should still expect good numbers. The S&P YoY earning growth should continue to accelerate up to the 3rd quarter with an expected big deceleration in 2019 (chart).



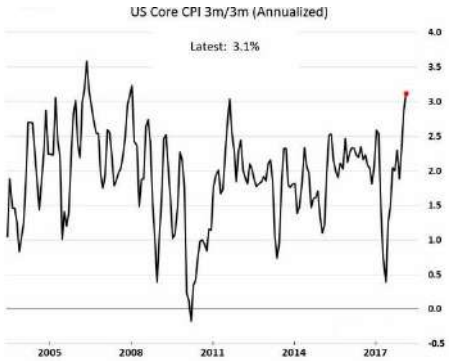
As a reminder, in US companies have beaten Q4 estimates, with bigger margins vs history, earnings and sales growth rates are the highest in recent history, and earnings day reactions were relatively mild. We should therefore expect the trend to continue at least over the next two quarters.

In US the estimate for Q1 earnings has risen by 5.6% since December and in a typical quarter, analysts usually reduce earnings estimates. Over the past five years (20 quarters), earnings expectations have fallen by 3.9% on average during a quarter S&P 500 is 17.1. This P/E ratio is bow above the 5-year average (16.1) and above the 10-year average (14.3).
However, it needs to be also considered that valuations will eventually contract once investors appreciate the lower *quality* of the revisions from tax cuts and the fact that it sets up very difficult comparisons for 2019 especially in US. At some point in 2018 we think the lower quality and difficult comparisons will challenge the valuations investors should pay.

Let's now analyse some new data about **Inflation** as the pressures building over the last month have been lower and bond yields have stabilized as we rightly predicted over last update.

Consumer prices in the 19-country EU bloc rose just 1.1% in February from a year earlier, according the European Union's statistical office. That's the weakest rate since late 2016 and falls short of an initial reading of 1.2%.

However, if we look at the 3-month annualized core CPI, we have now broken above 3%, the highest level in a decade (chart).

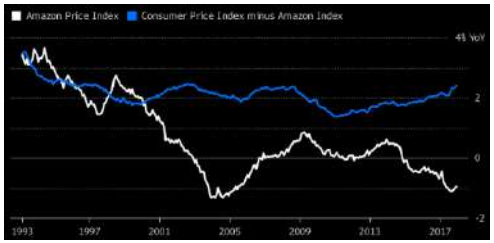


It is therefore a mixed picture this month and we believe that inflation is typically a lagging variable of the cycle. In the US, the correlation between core CPI and real GDP growth is very strong, with GDP leading inflation by six quarters, on average.

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

It needs to be note that the USD weakness is also putting some upward pressure on US inflation, the chart shows the high correlation between the US CPI and the inverted Dollar Index (DXY).

We continue to think that both headline and core inflation will likely trend higher from end-Q1. Strong and above-potential growth is such that the output gap should turn positive this year and the unemployment rate fall below NAIRU (non-accelerating inflation rate of unemployment). On top of this, wage and pipeline price pressures are starting to emerge.

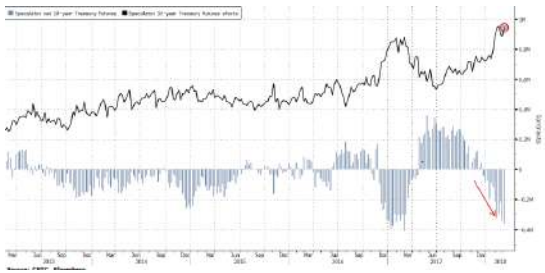


Interestingly, despite one the fastest and broadly synchronized runs of economic growth since 2011, worldwide inflation has remained relatively subdued. The depressive impact on prices as shoppers trawl for bargains online may be a key figure to understand for policy makers. The Amazon Inflation Index shows a widening gap between price growth for goods sold on Amazon.com and its peers in the US versus items in the US consumer price index that aren't available online. In just the past 2 weeks, there have been 4,240 stores closure announcements in the US from Toys R Us, Claire's, Ann Taylor, Best Buy, Foot Locker, Mattress Firm & The Walking Co alone.

Yields are now reflecting the picture amid concern about faster inflation and a government deleveraging campaign. Investors should not expect any relief this year as tougher financial regulations and tighter monetary policy reduce the lure of bonds.

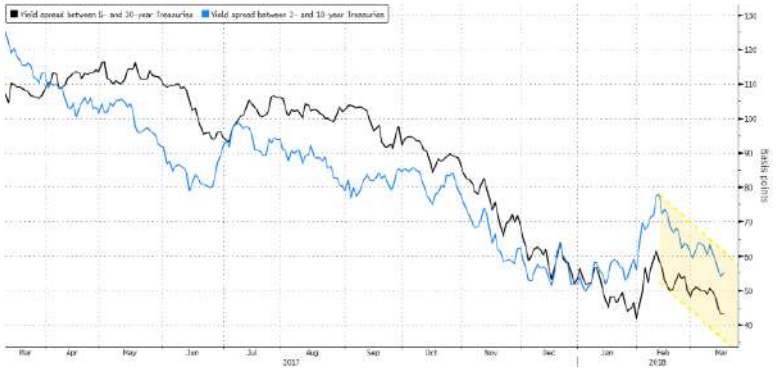
In US, the benchmark 10-year Treasury yield closed yesterday at 2.86% dropping as expected from the highs made in the middle of February.

The chart on the US 5Y it is very clear as we have both broken the downtrend that was lasting since 1988 and for the 1st time in 30 years we have broken the important resistance of 200 monthly moving average (arrow on the chart). While the 5Y has small corrected over the last month, the US 2Y jumped to 2.31%, highest since 2008!
In Europe, the German 10-year dropped from 0.77% in the middle of the last month to the current 0.58%



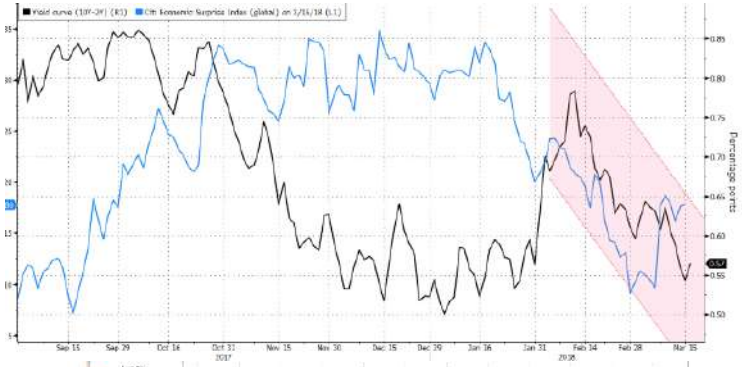
We are still bullish Yields as we were since last December but we continue to think that the move is stretched short-term.
In terms of positioning, the total short on the 10-year has reached new all-time highs as shown on the chart

The market had a correction last week as traders were nervous about the flattening of the curve if not marginally inverting… the spread between 5 and 10Y Treasury yields touched the lowest since February (blue line) while the black line shows the spread of 5 and 30Y.



It is more apparent that the everything-is-awesome environment that permeated markets in January may not be coming back anytime soon. While the gap between 10-year and 2-year Treasury yields steepened from about 50 basis points at the start of the year to 78 last month, it has resumed narrowing and is back below 57 as the worldwide economy suffers some missteps. Citigroup's global Economic Surprise Index (measuring data surprise vs. data miss) has just bounced from the lowest level since September.

The chart show how the US Yield curve 10Y-2Y (black) vs. the CESI Index (blue) are correlated.



Importantly, after the risk-off event into early February, we see so far a relatively weak bounce in SPX high yield bonds, which explains/confirms the widening high yield spreads that we also see in Europe and in other regions.

We are in a similar situation as we were in Q2 2015, where the S&P (black line) was not following the trend given by the High Yield (amber)

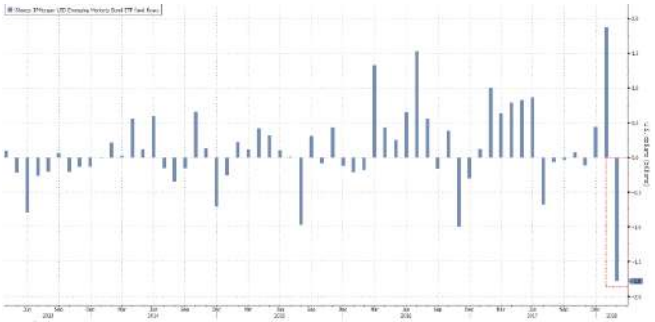
The main question is at what point inflation fears will take over and rising bond yields be bad for stocks. The difficult answer might be that is when yields reach the point where they anticipate the Fed actively trying to slow the economy. If we do an average of what is the level mentioned by the sell-side we get a 3.5% on 10Y yield; further rises above this level will progressively lower stocks valuations.

The gap between the yield on 10-year notes and the dividend yield on the S&P 500 Index topped one percentage point last month for the first time since January 2014. The potential for the spread to widen further "will serve as a headwind for stocks" (chart).

In the meantime, Exchange-traded fund investors are cutting their exposure to emerging-market bonds by the most ever. The main fund for the asset class (the iShares JPMorgan USD Emerging Markets Bond ETF) saw a record $1.8 billion pulled in February (chart).

We continue to reiterate that Equities remain substantially cheaper than bonds. The gap between equity and bond valuation still favours equities, particularly in Europe, where bond yields remain low and 80% of companies offer a better dividend yield than the yield on corporate debt.

The yield gap between the two is near historical highs, which should provide some cushion to equities in the case of a further increase of yields.



The market is now discounting 88% probability of rate hike in March, 77% probability of a hike in May and the odds for the 4th hike are ticking down at circa 25%.

Trades to be monitored

The Eur/Usd has bounced 2.1% since the beginning of the year breaking the highs made last September to levels seen only in 2014 but has struggled twice to break the 1.25 level in January/February and 1.24 in March.

As we flagged before, the long positioning on EUR/USD is extremely consensual and is where most Macro/CTA funds are having good performance Ytd (together with the long Oil position). If the USD would start to bounce it would be a real disaster for these funds.

The net long speculative positions on Eur are now the highest ever and as you can spot from the 1st chart, the positioning (yellow line) has increasingly diverged from the performance of the Eur.

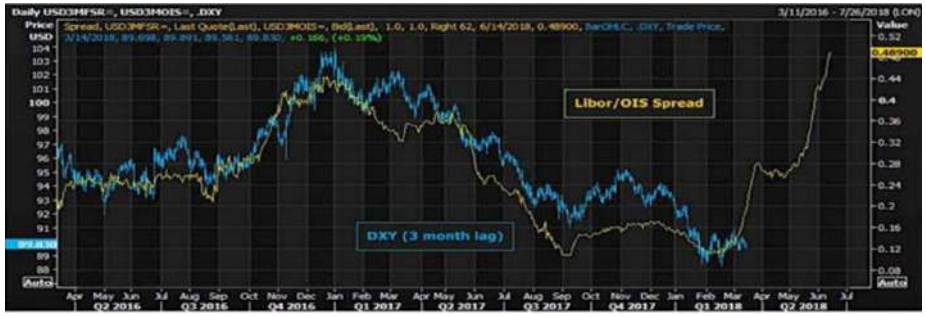
The move of the € is stretched, as we signalled over last newsletter, we would now start playing a contrarian trade long USD.

As you might have read recently, **the USD liquidity squeeze is deepening**. LIBOR (London Interbank Offered Rate) OIS (Overnight Indexed Swap) spread jumped to 52bps, the highest since Eurozone crisis (2009). The LIBOR/OIS spread is considered a key measure of credit risk within the banking sector.

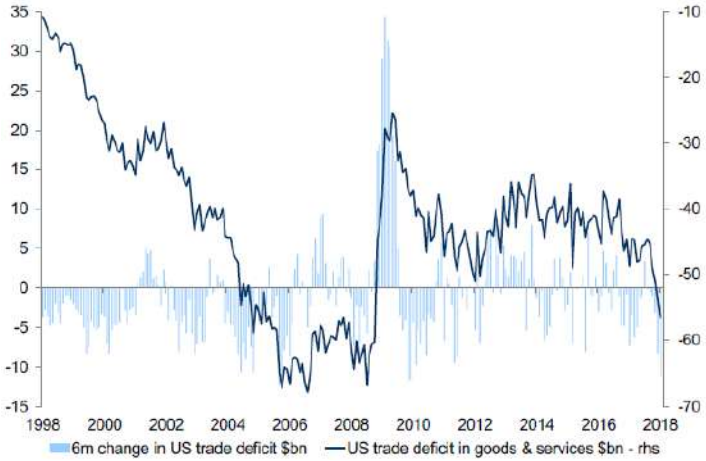
The LIBOR is the average interest rate that banks charge each other for short-term unsecured loans while the OIS represents a given country's central bank rate over the course of certain period (in the U.S., that's the Fed Funds rate).

So far, rising funding costs unnoticed by the FX markets, **could set the stage for a violent reversal in the dollar as short positions get increasingly more expensive to hold**.

The chart shows the correlation between the Dollar Index (DXY) and Libor/OIS spread applying a 3-month lag on the DXY, the picture seems even too clear....



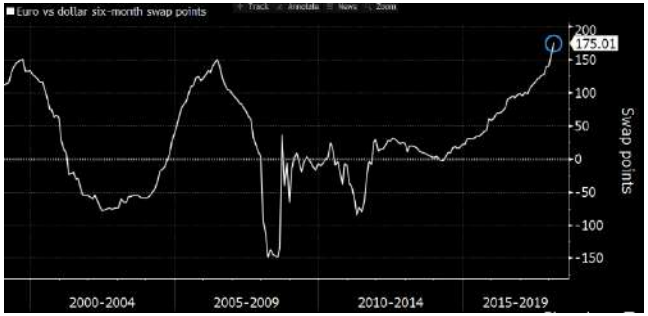
Another important factor, which is to be considered pro-USD-weakness, is given by the **US Trade Deficit which is accelerating to the downside**. Given the US administration's focus on trades is not particularly helpful for markets, the latest data on the US trade deficit in goods & services fall to -$57bn in January. Further, the pace of the deficit widening has accelerated with the $11.2bn drop over the last six months at a level that has only been exceeded for three months since 1992.



With the adoption of the Tax Bill last December, the US Deficit is only set to increase materially putting further pressure on the USD. Assuming 2% inflation and 2% real GDP growth, the annual cost of the planned US rate hikes is a real USD36bn in 2018, rising to an annual USD649bn by 2027. The real debt, increased from higher interests, amounts to USD3.018trn by 2027, and the real budget deficit blows out to USD1.472trn.

In contrast, the Eurozone current account surplus has increased materially over the last few years, driven by Germany. This, coupled with the upcoming unwinding of QE by the ECB, is acting as a support for a rising Euro over time.

In standard models, **Tariff increases** would suggest exchange rate appreciation of the USD. In the real world however, this may not be the case due to retaliation from abroad and effects on the perceived attractiveness of US assets. Indeed, similar tariffs in US history have actually been associated with subsequent currency weakness.



The latest factor we are monitoring is given by the **yield differentials. 6-month Euro forward points**, the additional premium over the spot rate that sellers of the common currency receive to compensate for the US yield advantage, are near an all-time high. This move could represent a windfall to American companies looking to hedge repatriations in 2018 and US investors looking for a measure of safety as financial markets become more volatile (chart of EUR vs USD 6-M swap points).

Additionally, China's appetite for currency strength is being tested as the yuan is trading beyond the symbolically key level of 6.4 per dollar for the first time since December 2015. The market is divided on whether the authorities will intervene to slow the pace of gains. While the currency has climbed more than 3% against the greenback in the past four months, it's little changed against the euro, suggesting dollar weakness is the driving factor behind the yuan's strength.

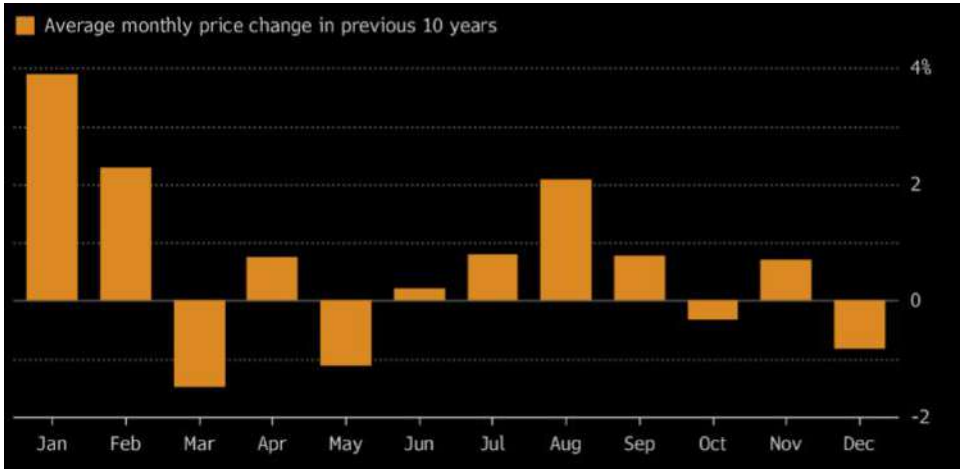
We have therefore seen that under the Macro point of view it's a mixed picture but the technicals are getting some very interesting reversing signals on the EURUSD and DXY monthly charts, please check the Monthly chart of the EURUSD (resistance of downtrend started in 2008, negative divergence RSI and many other indicators).

On a separate note, as you might remember over the update sent in January we said that **Japan's currency** was ready to gain momentum after moving within a 10 yen range against the greenback for the past 12 months. **The break-out from the triangle pattern is now clear and it's accelerating.**

On **Gold**, after rightly calling the reversal point in the support area at 1250$ in the middle of December, we suggested last month to start reducing the positions and we have been right so far.

Once again, positioning has been helpful along with the chart for calling these reversals, as in December, Managed Money added a 3.3 standard deviation amount of shorts in Gold futures ($2.9 billion notional) and a 6.8 standard-deviation amount of shorts in Silver futures ($1.8 billion notional).

The situation now is dramatically changed as Managed Money are again net long after being covering all shorts and since the beginning of the year there were very high inflows with the best run since mid-2011. Since mid-December, Managed Money have bought nearly 25bn$ of Gold futures and even if, the positioning is not reaching yet an extreme we are getting closer and closer.



January and February are traditionally the best months for Gold (as the chart shows), we should now expect some consolidation (especially if the $ start to strengthen).

Keep in mind that the Gold / Interest Rates correlation should be negative in the long term (as Gold does not yield any interest and so increasing rates on other assets should push investors away from it).

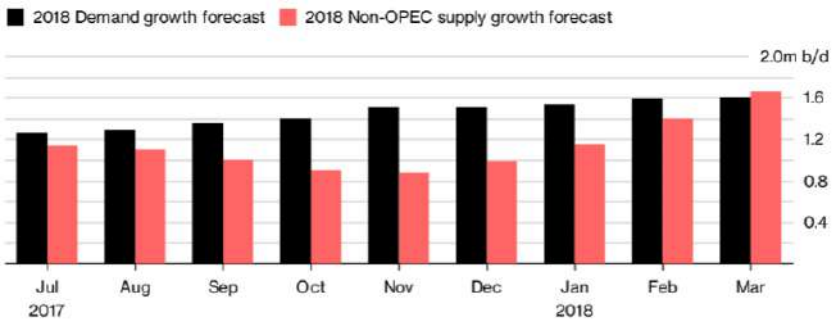
This rally can mainly be attributed to the current weakness of the dollar. Indeed, if the dollar depreciates, it becomes cheaper to buy gold in other currencies and demand increases. If you look at the Gold Performance in EUR, the rally is not so pronounced anymore.

Physical Holdings linked to ETP inflows represent a significant part of worldwide demand and could quickly turn into a major source of supply if investment flows suddenly disappear (as was the case in 2013, when 18% of the world total supply got sold on the back of ETP outflows)

We would take profit as we believe that the main upside on Gold from this level could only be given by the weakness of the equity markets. 1300$ is an important support level, it is estimated that only last week (Gold -0.68%) 10% of open interest have been currently caught "off-side."

Crude oil is up 4.9% Ytd, +46% from the lows made last June but -4.5% from the highs at the end of January. As you might remember **we mentioned over last update that we were expecting some consolidation and that we were reaching some important technical and political resistance levels, positioning was also too stretched**.

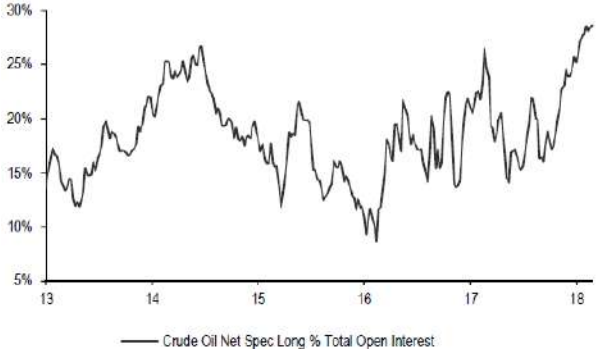
OPEC compliance is still very strong and at the highest level since the organization began curbing output over a year ago. For the 1st time is forecasting that new oil supplies from its rivals will exceed growth in demand this year as the US industry thrives.



While global oil demand will climb by 1.6 million barrels a day this year, more than previously thought, that can be covered by an increase of 1.66 million barrels a day of supplies from outside OPEC.

As a result, OPEC's ongoing cuts won't be as effective in clearing the rest of the inventory surplus. The cartel will be required to supply about 200,000 barrels a day less than anticipated in last month's report.

The US will dominate global oil markets for years to come, satisfying 80% of global demand growth to 2020, the International Energy Agency said. That means the shale boom will keep OPEC under pressure, giving the cartel little scope to expand output even after its production cuts expire this year.



However, in January, most of the best drilling locations in North Dakota and south Texas have already been tapped and issues like the shortage of sand for fracking indicate there's more trouble to come, meaning that US production isn't going to go up as fast as most people think it will.

It is therefore still a mixed situation where the underlying dynamics are quite complex and is not easy to predict where the Crude price could move, we use positioning as a help.
Long positioning on Crude oil has continued to rise and we are at the highest open interest since these data were collected. CTA funds are still very long Crude and they will comfortable keep these positions having had a positive return of around 20%.

We warned over the last two updates that we were reaching some technical resistances and the 200 monthly moving average has worked perfectly so far (chart), **we have already retraced something, we should probably trade sideways from now on.**

The **BCOM index** (Bloomberg Commodity Index) is now down 1.75% Ytd and has fallen 4% from the 3-year highs it reached at the end of January. Once again, positioning was extreme as we have seen more than 120bln$ of Commodity Open Interest initiated Ytd an all-time high for this time of year. Previous record for a like number of days in January (since 1996) was $69 Bil in 2013.

The majority of open interest change were on Crude (more than 20% of total open interest from the beginning of the year) and Gold (roughly 30% of total interest built since the beginning of the year).

Under the **Geopolitcal point of view** since last update, **Merkel** was elected to her fourth term last week, finally bringing to an end the political uncertainty Europe's largest economy was thrust into by inconclusive elections last September.

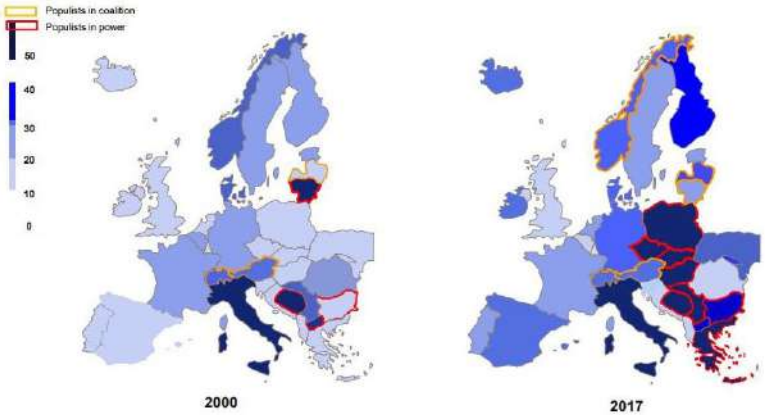
In **Italy**, election resulted in a huge shift in the direction of non-mainstream/populist parties. The polls largely underestimated this drift as they were portraying a roughly 50-50 split between moderate and non-mainstream forces. The centre (as measured by PD, FI and connected smaller parties) has instead shrunk to 40% with M5S and NL as real winners of the election.

There is not much visibility about the future. What seems safe to say is that it will take a long time before some clarity emerges about the options to form a government. Given the dominant share of non-mainstream vote, none of them looks constructive, even though it is possible that extreme worst case scenarios will be avoided. With M5S reaching about 1/3 of the seats, there is no possibility to build a large grand coalition without it.

The Italian economy, with its longstanding weaknesses on the growth, fiscal, structural and institutional sides, remains vulnerable, probably more so than before the election, given the likely lack of commitment to reform from any new government that emerges from the election.

It is interesting to note that in Europe in 2000 an average of 8.5% of the vote went to populist parties, in 2017 that number was 24.1%...and this is not considering the current Italian situation.

It is also worth to mention the sudden unexecpected positive development in **North Korea**. US President Trump said he was prepared to meet North Korean leader Kim Jong Un for the first US North Korea summit, marking a potentially dramatic breakthrough in nuclear tensions with Pyongyang.



The FED tomorrow is likely to hike rates by 25bp, taking the target range to 1.50-1.75%. Market focus will be on the statement and content of the press conference which are likely to lean towards hawkishness.

The odds of four or more rate hikes have gone up to 35% from 11% at the beginning of the year. So what are the signposts this month?

However, it will not only be the Fed taking the liquidity punch bowl away, weekend comments from the **ECB** have been hawkish too.

The Bundesbank's Weidmann confirmed that the ECB had not decided when and how to end QE, but that positive economic developments and inflation forecasts could allow the ECB to quickly end its bond purchases.

The ECB at last meeting while leaving its key rates and the QE programme unchanged as expected, has modified the forward guidance by dropping any reference to buying in bigger sizes or for longer if needed…a surprise to the consensus. The next step, perhaps in June, is to set an end date for QE.

In our view, the ECB will manage the communication regarding the hiking path after the end of QE very carefully.

The **Bank of Japan** has resumed buying corporate bonds at yields below zero in February and analysts suggested this may prompt investors to hunt for more risky assets to maintain returns. The central bank bought corporate notes from the market at a minus 0.049 percent yield last month, the first negative-rate purchase in 11 months.

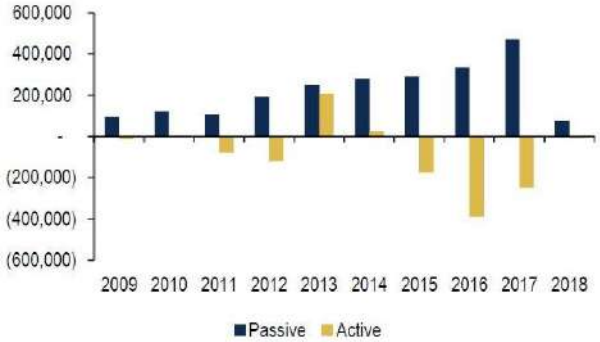
Executive summary

The start of the year has been impressive with a "melt-up" phase and we think that January marked the top for sentiment, if not prices, for the year.

Tax cuts were the event to capture investors' imagination, but the reality is that the market had been pricing tax legislation in for months, if not quarters. S&P500 EPS expectations for '18 currently stand at $158, up from $146 at the beginning of September (1st chart).

All the growing sentiment factors that we have mentioned over last updates have contributed to the "**capitulation in caution**" and the market has taken on a more defensive posture in this correction/recovery, having a **continuing breadth deterioration**.

2018 is likely to be a trickier year for equities despite a good macro backdrop. A combination of an overbought momentum and a polarised market makes crowded trades looking increasingly precarious. We reiterate that 2018 will be about alpha not beta. Active funds are starting to get the first flows after 9 years of outflows (2nd chart).



If we look at the current US Hedge Fund Gross Leverage, the shift we had from January (all-time highs) was extraordinary and this high was 2 years in the making aligning with the conclusion that the "melt up" was almost done by the time it was being widely called for. This top was also right before the volatility shock which is what forced clients to reduce the total risk they are holding to a more tolerable level. With volatility moving higher from the cycle low in January, we think it will be very difficult for gross leverage to approach the old highs anytime soon.

Higher inflation and higher rates simply means higher volatility and this is undermining the "carry trade" which has been tentacles across multiple investment strategies.

From an asset allocation perspective we continue to believe that an extended economic cycle, with low risk of recession, is **consistent with equities outperforming other asset classes, even though absolute returns are lower** than they have been during the 'goldilocks' phase. In terms of country allocation we continue to believe that non-US equities will deliver a higher total return than US equities over the balance of this year in US dollar terms.

MSCI World is now at 16.5x, the same level that it held in 2004, when bond yields were more than double their current level.
The gap between the dividend yields on a stock vs the high grade yield that these stocks borrow at is as much as 260bp, on average in Eurozone.
HY credit does not offer much upside, but equally we do not believe there will be a significant widening in spreads, too. This should keep supporting equities.

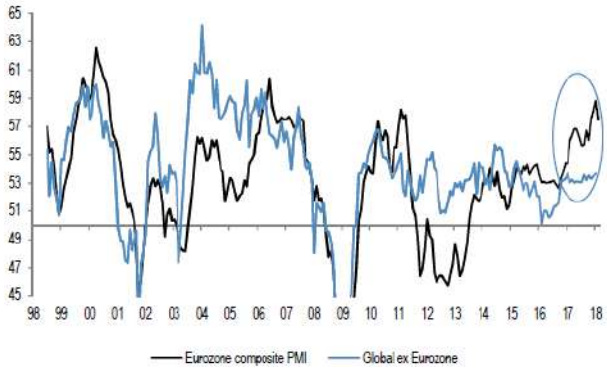
The following are the potential positive and negative catalysts and will be followed through the course of the year.

POSITIVES:

1) **Growth** momentum might have peaked, but activity is still likely to remain above trend. 2018 might be the second year in a row without EPS disappointments.

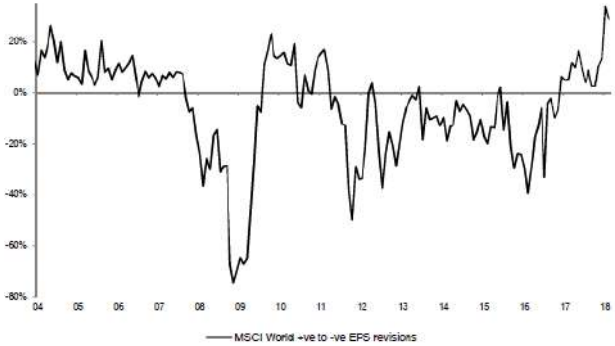
While the best of the acceleration in growth momentum is likely behind us, we expect global activity to remain well supported in '18. All the key regions are expected to grow above trend, even though the pace of growth is unlikely to accelerate further.

Eurozone is actually outperforming the global activity, have a look at the chart of Eurozone PMI (black line) and Global ex-Eurozone.



2) **Earnings look set to continue growing.** Inflation has typically been positively correlated to corporate topline and to the pricing power. Q4 reporting season has delivered the best results in years in the US, and is also strong in Europe. This trend is likely to continue in Q1. We note though that the bulk of the EPS upgrades on the back of the US tax cuts are by now behind us. **Earnings should still act as a positive catalyst for the market.**

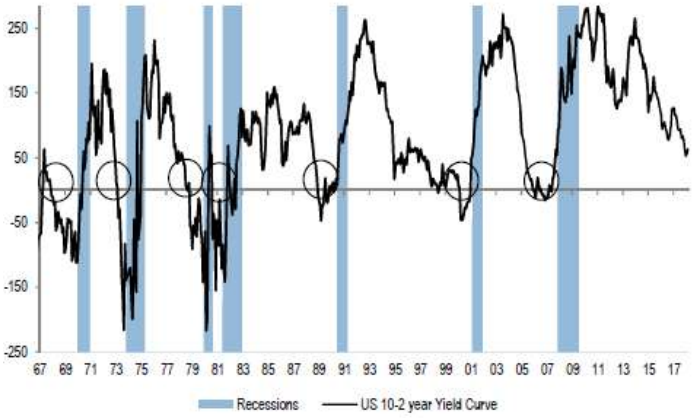
Global weekly EPS revisions (the ratio of analyst upgrades to downgrades) were recently the most positive in 14 years.



The levels of PMIs so far in Q1 suggest that earnings should again grow at double digit pace this quarter. The chart plots the Regional quarterly EPS growth vs. Global PMI. Importantly, the improving pricing power should help to offset any pressure from rising wages.

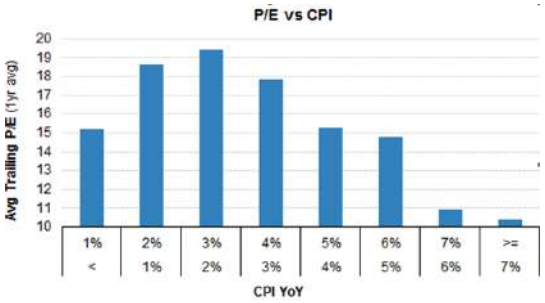
3) **Central banks** tightening is still in early stages. None of the last 8 downturns started with real rates below 2%. Any inflation pickup would act to reduce real rates further. Yield curve is unlikely to invert until at least until 2H, and crucially, stocks never peaked before the yield curve would be outright inverted.

The liquidity withdrawal will be gradual and that Fed will remain very sensitive to the conditions within risky assets at least in the first stage. It seems highly unlikely that the Fed will persevere with hikes in the case equity markets deliver a meaningful correction.
The latest market expectation is that the 2year-10year curve is likely to flatten much further from here, in essence ending largely flat by year-end. The 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.
We also know that the inverted yield curve was a good predictor of slowdowns. Looking at the last seven US recessions, the US yield curve would invert ahead of every single one but **crucially equities did not tend to peak before the signal was reached, before the curve inverts, they peaked only afterwards**.



Inflation has a long way to go to be clearly equity negative. The economy has indeed moved from reflation to inflation, but that doesn't mean CPI is high enough to be a drag on multiples. And while it is true equity markets are forward looking, it's also important to consider that the bar is generally high for investors to price in a change of regime. Since 1998 stocks have generally moved in the opposite direction as bonds, and after 20 years investors would likely need to see ample evidence before pricing in the opposite.

The table on the side shows how the Price/Earnings is changing with a growing CPI.

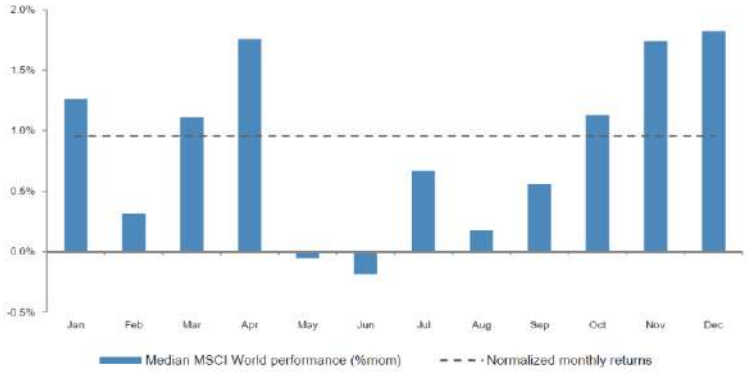


4) **Equity multiples** do not look cheap in absolute terms, but relative to both bonds and to credit, we find that equities continue to offer a valuation gap. Compared to equities, which show a small P/E premium to historical, bond yields are significantly below their averages, trading close to the 30-year lows. Relative to credit too, equities keep trading favourably.

5) **US corporates announced record buybacks** so far Ytd. This should act to provide a floor to the market. A record $800bn in US buybacks plus profits growth is a more important driver than bond yields or trade conflict this year.

6) **Certain Equity technicals are better than they were in January**. Investor sentiment is not stretched and complacent as it was in January, Gross Leverage has decreased substantially. Seasonally was typically supportive during March-April and weakening again afterwards (average fata since 1970)

During a mid-election year, March has been down only once in eight instances since the mid-'80s (1994) and over the past 10 and 20 years, **March has ranked as the second best month on average**, at 2.4% and 2.1%, respectively. Also, April has historically been even stronger in two of the three periods.

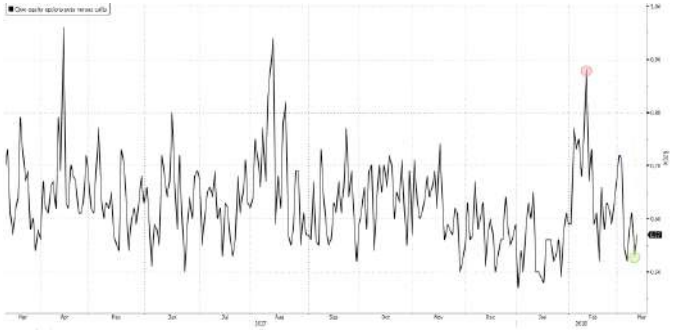


NEGATIVES:

1) **US Cycle is 9 years old**. The longevity of the current US upcycle is a concern, as it is approaching the longest on record since WW2.
We have reached at the end of January 103 months of expansion. The S&P 500 Index's price-sales ratio has approached a bull-market peak of 2.25 dating from March 2000. Other gauges in a similar position are the 10-year Treasury note's yield, wage and price inflation, unemployment, oil prices and the dollar. Another reliable indicator of US recession risk is given by the jobless claims. If **weekly claims** move up by 10% or more qoq, the bearish signal would be reached. Every single time that claims moved up by this or greater amount, we had a recession, and we did not have any false signals.

2) **Pace of global monetary policy tightening to pick up**. Although central banks are likely to continue moving slowly and carefully in 2018, we should nevertheless see a pick-up in the pace of monetary tightening. The market expects 3 to 4 Fed rate hikes over the next 12m, while 2H18 is also likely to see the conclusion of the ECB's tapering program and the BOJ continues to stealthily reduce its QE purchases via its Yurve Curve Control program, none of which bodes well for financial conditions.

3) **Credit spreads set to widen**. A combination of tighter monetary policy, record spread valuations and high leverage (especially on US corporate balance sheets) looks set to weigh on credit markets going forward. We forecast spread widening in all regions with the biggest move projected in the US. As shown in the chart, there has been a tight link between credit spreads and the PE ratio for global equities. Equity valuations have been negatively correlated to credit spreads in this cycle, the chart shows the correlation between US BAA spreads and the inverted curve of MSCI World 12Months Price/Earnings. It should be also added that High Yield spreads are in complacent territory and is not compensating one much for holding risk. If the spreads start to widen, equities will not ignore that.



4) **Higher volatility**. Volatility has already bottomed out and is here to stay. Investors still do not own enough puts and are under-protected. The CBOE Equity Put/Call Ratio is nearing pre-meltdown levels (chart).

5) **A flat US yield curve**. Markets may react more cautiously to a flat curve in this cycle, given the very low level of policy rates and the potential signal from the curve that the next downturn could occur with very little scope for central banks to react by easing monetary policy. The yield curve is among the best market signals for a recession. Since the 1950s, there has not been a US recession without the yield curve inverting. Historically, the front end has driven the majority of the flattening during slowdowns, the US 10-year yield has been flat to slightly up, on average. But this time, most of the bear-flattening has been driven by US 10-year yields, which might distort the signal.
Also, Rising US HY credit spreads late cycle have also signalled rising recession risk historically, although there have been a few false signals (in 2015). Given the search for yield and lower liquidity in credit markets, the signal from credit for recession risk might be less reliable. However, as mentioned above, we think credit spreads would likely need to rise from here to signal concern more broadly for risky assets.

Another important factor that could potentially gain the attention is that at 2.9% the US 10Y yield is exceeding the dividend yield on the S&P which is roughly at 1.8%....

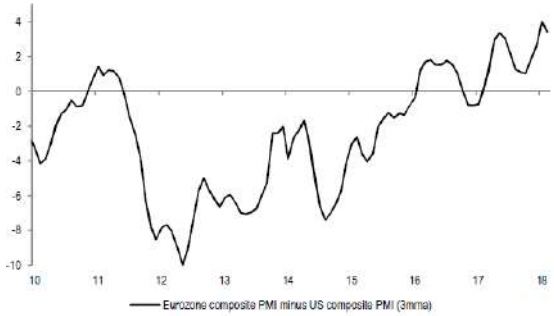
As you could perceive from the points above, the result is that if we have to choose the Asset Class where to be invested we prefer Equities and we are particularly positive on European equities.

We still believe that the correlation between bond and equity prices remains firmly inverse meaning that equities will tolerate higher yields. This is consistent with equities bouncing last week despite bond yields making clear new highs.

Inflation is primarily a lagging indicator of growth and should not come as a surprise. Signs of a move up in inflation are building, but it is important to note that the actual inflation rates are still subdued in the historical context. The latest US core CPI print of 1.8% YoY is still below last 20-year average and, in fact, as much as 50bp below what was already seen a few times in the current upcycle.

Equities should be a natural inflation hedge as their earnings are strongly correlated to PPIs, they could benefit from improving pricing power, better top line growth and a reallocation of investor flows. Even if equity valuations are not cheap in absolute terms, in the past 15 years, the correlation between P/E multiples and bond yields was positive rather than negative and the same could be told for the correlation between PPI and EPS (chart).

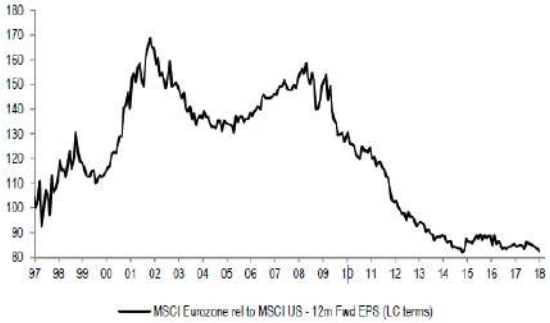
Why do we like Europe?



1) **Attractive macro outlook and earnings.** All Brokers have upgraded GDP forecasts for the Euro Area again and see 2018 as a second year of >2% growth followed by 1.9% in 2019. Despite strong above-trend growth, the ECB looks set to maintain an extremely easy monetary policy setting, while fiscal policy may also ease further at the margin.
The key drivers of the Eurozone domestic recovery appear to be well aligned. The unemployment rate has already moved below its long-term average and it is expected to continue falling in '18 (positive for the consumers).

The Euro area equity market underperformance is even starker than the rather encouraging relative PMI momentum that the region enjoyed since 2013. The 2nd chart shows the Eurozone vs US composite PMI.

Eurozone valuations are attractive, both in absolute and in relative terms. The region has seen inflows in 2017, but this has not translated into higher multiples. Eurozone P/E has barely moved over the last two years, contrasting with the re-rating seen in all the other regions. The 3rd chart shows the 12-month forwards EPS of MSCI Eurozone vs MSCI US.

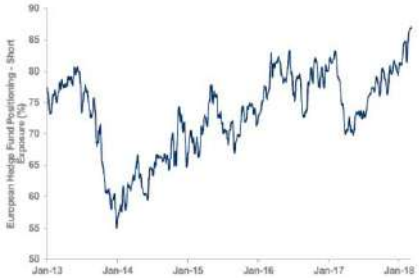


2) **Eur strength to moderate**. The relative performance of European equities has been highly negatively correlated to moves in Eur this year, so a potential Eur depreciation is helpful and the drag on European earnings from FX should now mostly be behind us. Some of the disappointing numbers we got on Q4 were due to the currency.

3) **European credit supported by the ECB**. European credit markets should be less vulnerable to any wider global sell-off in credit markets, given continued purchases as part of the ECB's QE program. In addition, European companies are less levered than their US peers and Europe's relative equity valuation has been badly lagging its relative credit valuation.
Investment Grade here is yielding around 0.8%... so, whereas in the US folks are trying to figure out where and when that magic percent yield is, which would cause an 'out of equities, into credit' move… we are nowhere near that in Europe.
Credit conditions appear favourable in Europe, with rising loans growth, easier Banks' lending standards and still subdued interest rates.

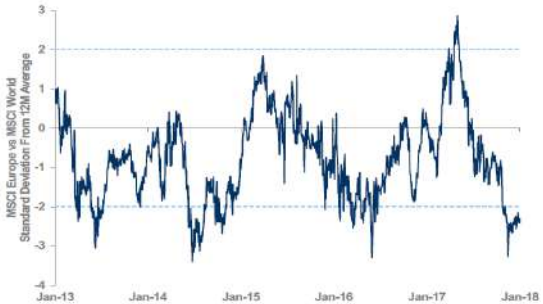
4) **No flattening in the Euro Area yield curve**. The region's relative performance has been positively correlated with bond yields in this cycle. The market forecasts lower yields and a flatter curve in the US, whereas also expects higher yields and a steeper curve across European bond markets.
In addition, the relative performance of Europe was typically strongly linked to the direction of bond yields, being the region Value heavy. If higher yields materializes next year, Europe will likely be supported.
Given the single point of focus for the ECB (inflation), versus the dual focus for our FOMC it will be much easier for the ECB to keep a "Dovish Stance".

5) **Investor sentiment is more downbeat in Europe versus elsewhere** and there has been a reduction in hedge fund net exposure down to 18-months lows (1st chart).
According to PB data, positioning of European hedge funds shows a 33% net exposure close to a 5-year low (6th percentile), driven particularly by a steady rise in Short Exposure which is now up to its highest level in at least five years (2nd chart).



6) **Europe has lagged the rise in bond yields and inflation expectations**. Europe should be a relative beneficiary of 'reflation' (i.e. stronger nominal growth) and, in this context, its recent underperformance versus both bond yields and inflation expectations looks overdone.

7) **Europe is relatively oversold**. The relative performance of the MSCI Europe vs MSCI World is striking; We have now reached the 2nd standard deviation (chart).
After hitting post-French election "peak optimism" in May, Europe has been underperforming the US consistently over the last 6 months as Tech pushed US valuations up to new all-time highs whilst EUR strength and relatively negative earnings revisions have been weighing on Europe's relative performance.



Being at 12 month relative performance lows, Europe looks set to outperform into 2018 led by banks and oils.
MSCI Europe is now close to its lowest-ever relative levels vs. MSCI AC World.

European equities have held up relatively well in this global market correction, ie. High beta indices such as MIB and IBEX. Historically Europe has underperformed US equities.

Taking into consideration that the trigger to market sell-off has not been related to European political or economic risks, **a lack of positioning and a relatively inexpensive valuation** has sustained the valuations of the Old Continent.

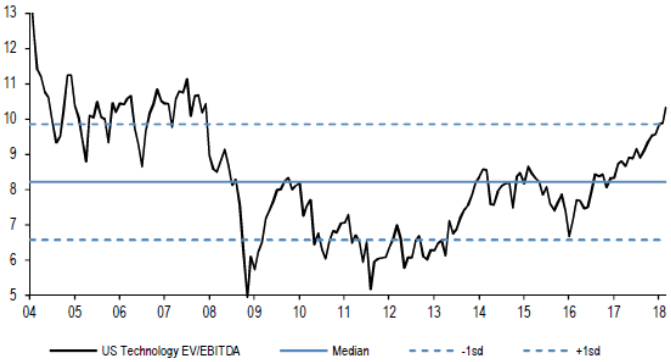
Why we are more negative US?

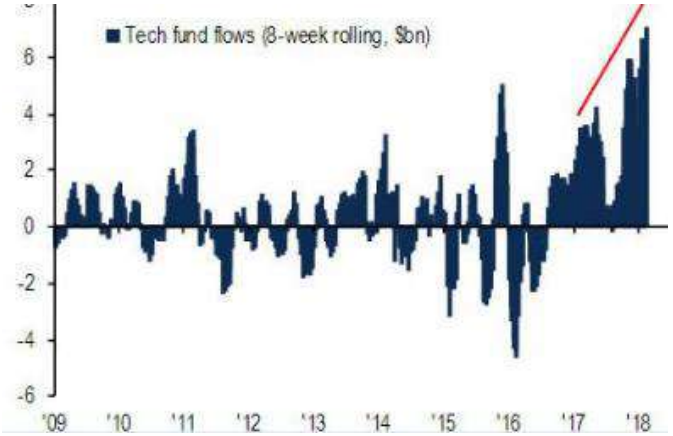
2017 has been one of the best years for equity investors in recent memory with high overwhelming absolute returns. Each sector has contributed to the positive performance with the exception of Energy and Telecom Services which represent less than 10% of the index.
While we are not calling for the end of the cyclical bull market yet, as we mentioned over last few updates, we think the odds of that happening during 2018 are higher than a typical year and much higher than it was during 2017.

US equities are currently trading on 18x 12m forward P/E, the highest in almost 14 years.
Beyond this, the US re-rating could be structural as the share of Internet and Tech stocks in the overall US equity market has grown materially, from 15% 10 years ago to 30% at present.
The strong rally in Tech YTD has been a big headwind for the relative performance of European equities, given that IT accounts for just 8% of MSCI Europe market cap, compared to 18% for MSCI ACWI and 25% for MSCI US.

Technology is again this year by far, the best performing sector in the S&P500. Ex Tech/FANG, Eurozone equities are outperforming the US ytd by 140bp, in USD terms. The outlook for Tech remains constructive, but the valuations are starting to reflect this. US Tech is now outright expensive on EV/EBITDA metric in absolute terms, and vs the broader market (1st chart).

It is also quite dramatic to spot the inflows into the sector (2nd chart), as it will be difficult to beat this growing pace.





The relative weight of the Tech growth category within the US equity space has become so considerable that leading large cap market indices are dominated by its performance. Without strength in large cap growth the leading indices of US equity cannot go far.

We reiterate the 3 things we believe investors can do to equip portfolios for whatever 2018 brings:

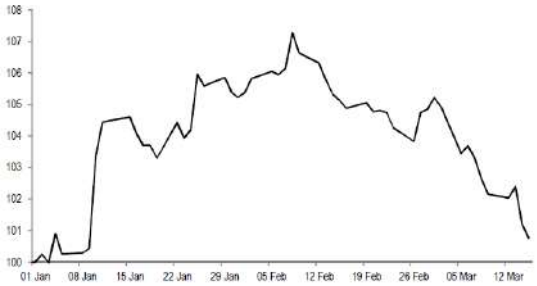
1) **Buy some portfolio insurance through derivatives** (Put-spread is still our favourite vehicle and it's now cheap again with volatility dropping to interesting levels)
2) **Buy anything you can find with less cyclicality than the overall market and trading at discount**;
3) **Continue to invest in those regions with the best economic momentum. The cyclical growth universe within developed equity has entered the territory of relative over-valuation**.

Investment ideas

- **Long EU Banks, SX7E Index (-0.6% Ytd, they have been largely outperforming the market), we would now get back into the sector after the recent underperformance.** Banks one of the few sectors to offer upside to both valuation and profitability going forward. Valuations are at the 10-year 'crisis' average and could continue to re-rate given lower risk profile and better growth.

  We suggested over last update to take some profit or hedge it as the sector had a strong run in a short time and Yields could have dropped. We have been right as they have rolled over after a strong start of the year.

  Now if we look at the **Eu Banks in relative terms we are basically back to the same levels of the beginning of the year** (chart).

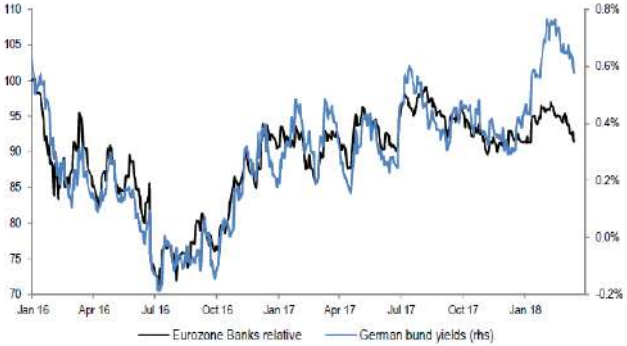


  We see their earnings benefiting from a potential further increase in bond yields as ECB starts tapering in '18, from the ongoing recovery in credit growth and the fall in NPLs.

  The recovery in private loan growth is gathering pace across Eurozone, which is driving the rebound in Banks' profitability. **60% of Eurozone Financials index constituents are seeing outright earnings upgrades Ytd**.

  Banks have seen positive and stronger EPS revisions compared to the Eurozone market. Likewise, Banks' P/Book relative is still below the historical median. As balance sheet repair comes to an end and earnings grow sustainably again, we believe that the sector could continue to re-rate.

  We like the banks sector as a value cyclical over 'early stage cyclicals'. Historically, when PMIs are as good as it gets then many investors tend to take profits on growth cyclicals, but you still tend to see the overall index rally.



  The gap with Yields has opened up recently. Banks would need to outperform by almost 10% to recouple with the current level of bond yields.

  Importantly, there is almost no paper to absorb. In H1 2017 we had the Unicredit capital increase, the CS capital increase, a Deutsche capital increase, a BCP capital increase, a Santander capital increase (to buy Popular) and the IPO of AIB. The only meaningful IPO Ytd is in asset management, and looking down the large cap banks it's not clear that any have a capital hole.

  In terms of newsflow, the ECB last week provided the final guidance on provisioning for new Non Performing Exposures (NPEs), applicable to all loans that become Non Performing from 1 April 2018. The new ECB guidance is broadly in line with the initial draft published in Oct 2017, i.e. banks have to cover 100% of new NPEs after two years for unsecured and seven years for secured loans. As expected, the ECB approach is tougher than the European Commission's, however there are two significant improvements: 1) the increase in coverage for secured NPEs is slightly more progressive than the linear approach initially

proposed, and 2) the new ECB guidance on NPE provisioning will only be accounted in banks' SREP process from 2021, which leaves plenty of time for banks to adjust, this is positive for all NPL outliers in the periphery.

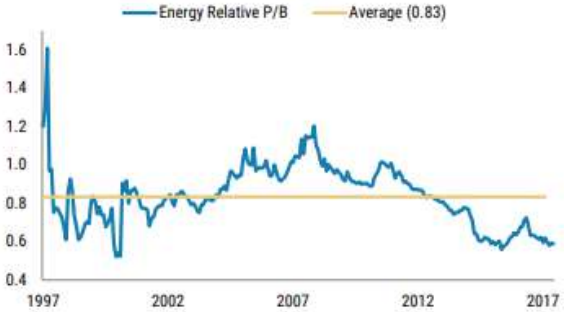
- **Long Energy Sector, SXEP Index (-5.3% Ytd and +1.2% from our buy signal).** The energy sector has lost 10% high to bottom in the recent correction and has seen in Q3 and Q4 more EPS upgrades since 2008 when oil was at 146$. The sector has actually seen the strongest rise in next 12 months earnings of any other sector.
  Oil demand growth outpacing supply is what drives the outperformance of Energy equities late in the cycle. Global oil demand looks to be growing above its historical trend rate now for the third year in a row.

We expect European Big Oils to generate the strongest FCF in over a decade in 2018 allowing for full cash coverage of capex and dividends. We think the sector is entering a positive cycle of earnings revision, with 16% median upside to 2018 consensus EPS, supported by the end of scrip dividends and the start of a buyback cycle.

Profitability should start to recover from depressed levels (1st chart on ROE).

EU Big Oils have shown over 10 years a tendency to deliver the strongest earnings (+15% above Bloomberg consensus) in Q1, while missing expectations on average by -10% in Q4. **We believe that Q118 is building up to be a record quarter for Big Oils, with supporting seasonality, and macro and micro forces, providing a strong catalyst for the sector to perform.** On the **macro side**, the sector is enjoying higher oil prices (driven by strong oil demand and OPEC action), a stronger LNG market (driven by the shift in the Chinese environmental policy towards gas-fired power generation), and healthy global downstream margins (both refining and petrochemicals) recovering from the 4Q17 lows.

On the **micro side**, the sector offers strong volume growth and a large backlog of cost recovery providing strong oil price leverage. We expect this will allow the sector not only to fully cover a 5.4% dividend yield, but execute incremental buybacks and return to dividend growth.



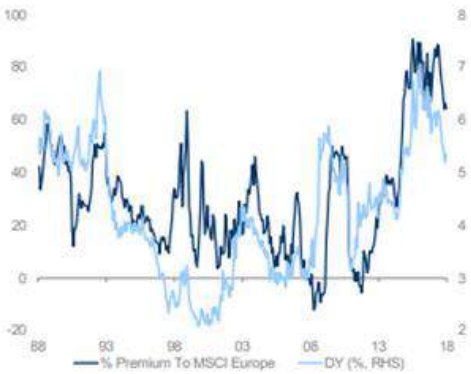
Energy equities have lagged the upward move in the commodity (2nd chart), and the relative P/B of the sector still sits near 20-year trough levels. With the positive backdrop we outlined above, we suspect that this low relative valuation is untenable.

The Sector is very cheap relative to the market on Price to Book (3rd chart)
In addition to the relatively valuation lows in the sector, investor positioning in Energy equities still looks exceptionally light especially after the recent sell-off.

Energy's relative RSI recently hit oversold territory, despite the sector continuing to see the strongest earnings revisions in Europe and is underowned (4th chart).

The sector still has a dividend yield 64% higher than the wider market even as Energy's dividend revisions ratio has spiked to a 12 year high.

The chart shows the absolute and relative dividend yield (chart).



- **Buy Put-spreads on US Indexes**: **we would again take advantage of the relatively low volatility (more than 50% lower from the spike made in February) in order to spend few bps and protect the portfolios from a new potential downturn of US equities as it's the cheapest way to protect the portfolio.**

  A Put spread on S&P strikes 2700 (out 0.9%) / 2575 (out 5.5%) selling the Call 2875 (out 5.5%) with a cost of 0.6bps for every 1% notional covered. The current delta position would be of 36%. We have highlighted the different strikes on the chart on the side.

- **Gold**: we would take profit

- **USD:** we would go long $ vs the EUR and other major currencies