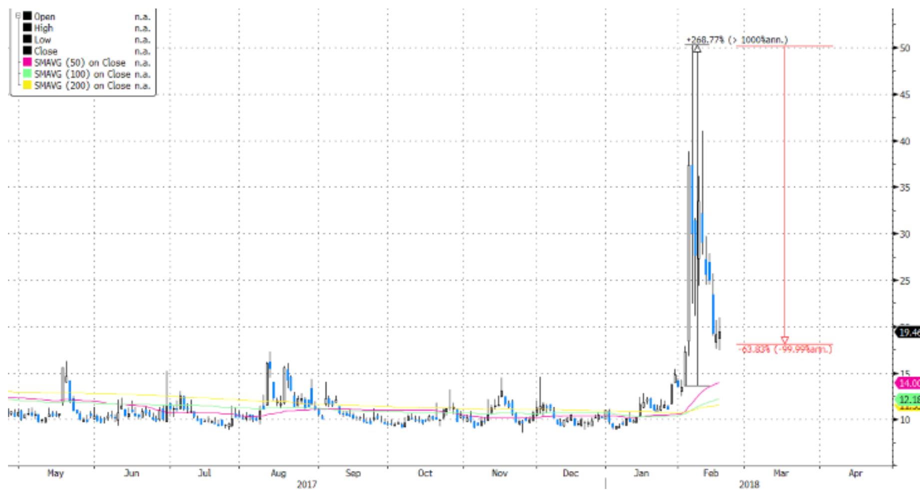
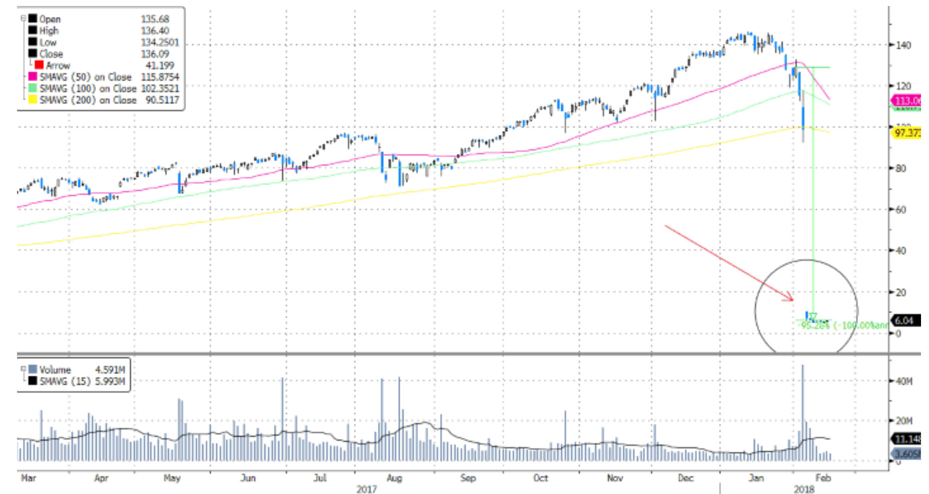
HERON
ASSET MANAGEMENT

Market Update





The VIX (weighted average of the S&P implied volatility for a wide range of strikes) has bounced 268% from our last update in just 3 days, with the largest single day move in history and since then dropped 64%... while several Inverted Volatility ETN (Exchange Traded Note) have been closed. You can see above the VIX chart on the left hand side and XIV US ETN created by Credit Suisse which has lost 95% in just 3 days (there were apparently 2.5bn$ in that ETN)

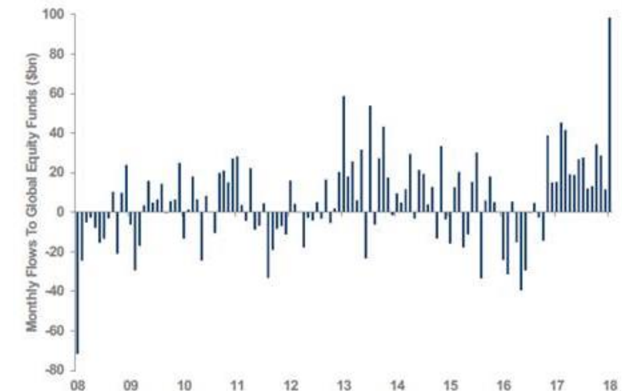
Main points

- **Excessive optimism / Volatility trap**
- Macro data / Earnings season
- Inflation / Yields
- ECB / FED
- Trades to be monitored
- Executive summary: **Volatility will be higher in 2018, we still like European Equities**
- Investment ideas

22nd of February 2018

2018 started with a very strong pace supported by positive Macro data and high expectations for the Q4 Earning Season and the Tax Reform. However the market has started to weaken as the risk appetite was too euphoric, as we rightly predicted in our last update sent on the 1st of February.

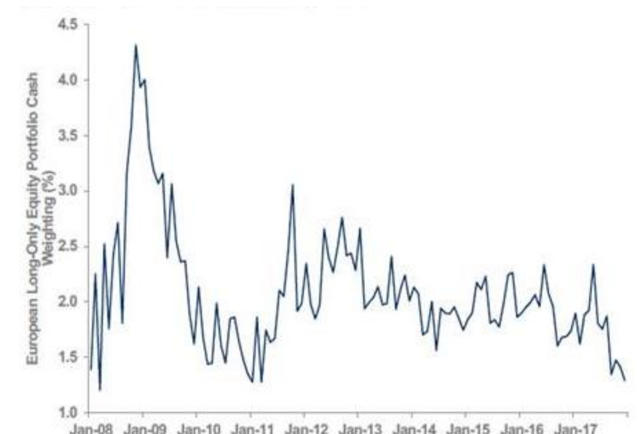
The latest rally has been lasting for an exceptionally long time. Markets have enjoyed 6 years in a very low volatility environment without any S&P drawdown of this magnitude (>4% sell-off).



With the strongest start in more than 25 years, the MSCI World has closed positive in January for the 15th consecutive month (an historical record); in Asia we had the 2nd best performing January in the last 10 years.

The total monthly global net flows towards equity funds, based on EPFR data in January, saw approx. $100bn of inflows (1st chart). This outstanding number surpassed the prior record peak of January 2013 by a factor of ⅔ and would likely rival the monthly peak of the TMT boom, even though we don't have enough data to compare with. Then ICI numbers showed that the monthly peak of inflows to US equity funds was $48bn in February 2000, at a time when US equities accounted for 45% of global market capitalization.

Retail clients were in a "all-in" mode and, as we have seen over recent updates, cash was at ultra-low values. The average cash weight was at a decade low in Long Only European equity funds (2nd chart).

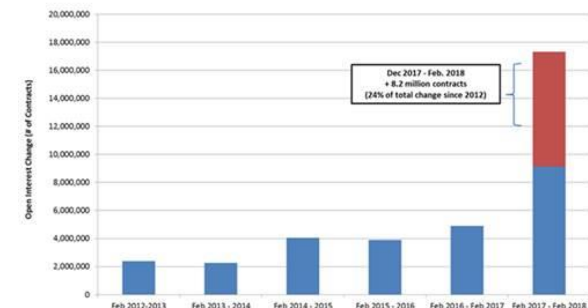


In China, investors bought a net 87.3 billion yuan ($13.9 billion) of Hong Kong stocks in January via the two trading links, the most since the Shanghai tie-up opened in November 2014 (3rd dark chart).

Even on futures the positioning was extreme as the Buy-side added a 50.4bn$ record amount in S&P futures during the first 3 weeks of the year, equivalent to 11% of total open interest.

In the last 6 years of bull market, the open interest has grown more than 70% and more than half of it has been bought in the last year. It is even more outstanding to note that half of this half has been bought in the 1st month of 2018!

The 4th chart on the side shows how the open interest has grown on the US market alone (quite alarming!).



A massive $50bn or 1.5% of total AUM has been poured into Equity ETFs alone in January. This flow is 50% higher than the previous year when equity fund buying activity was already very strong with an estimated $541bn injected into equity mutual funds and ETFs.

Prime Brokerage net exposure reached 65% at the end of January, a number that was ~ 10% above the 2015 peak.

As we warned in our last update, the picture of the market was already *very long*.

Under the technical point of view we have noted at the end of January that we were trading at record high levels of overbought on S&P (RSI above 89, seen only 3 times in history) and we also mentioned that the relative total return of US stocks versus US bonds breached 2000's prior peak and the S&P's Shiller PE moved up to 33, which was comparable to the peak reading seen in 1929.

Investor sentiment played another important role as it touched the 60% reading on the AAII 'bulls' index (the highest since 2003) and this optimism has put upward pressure on both equity prices and bond yields such that the total return on US stocks has exceeded that on US bonds by 10% in just three month above the prior peak seen in 2000 (1st chart).

The S&P more than tripled since the ‘09 lows and the cycle-adjusted P/E was at 32x as of the end of last month, 93% above the long-term average. Historically, from these P/E levels, real capital returns have tended to be minimal over the next ten years.

We wrote last time: “Investors have been selling volatility and basically betting that tomorrow will be as calm as today. We estimate that there are over 2 trillion $ in these kind of short volatility strategies. Putting this number into a context, you have 20 trillion $ in central bank balance sheets. Then you have 8 trillions worth of negative yielding bonds and 5 to 6 trillion non-investment grade bonds that trade at a yield of close to 2% and then you have the 2 trillion in short volatility strategies. These strategies are just the top of the pyramid of what could be a big issue for the market” and we were unfortunately spot-on.

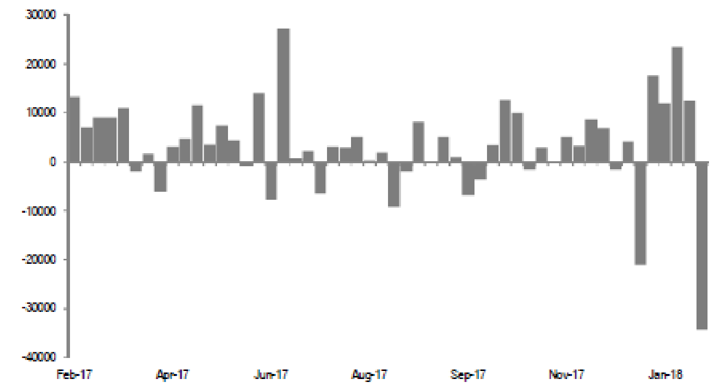
The trigger for the sell-off was a sharp rise in US Bond Yields following the data that showed US wages increasing at the fastest pace since 2009, raising the alarm about higher inflation along with potentially higher interest rates.
The move as we know, has been very sharp and very quick and this was due to a sudden spike in volatility (VIX had the largest one-day move in history) creating a negative overhang around similar products and curtailing volatility supply.

A reversal of vol from exceptionally low levels also posed a challenge to strategies that have an explicit or implicit vol target. Both rates and equities were at risk from deleveraging of risk parity portfolios, but equities were more exposed to a renormalisation of volatility on this move.

In only 2 weeks, S&P lost 10%, Eurostoxx -8%, Dax -9.5%, Nikkei -11.4%, Shangai Comp -11.2%, Shenzen -15%.. all in very high volumes on futures and ETFs.

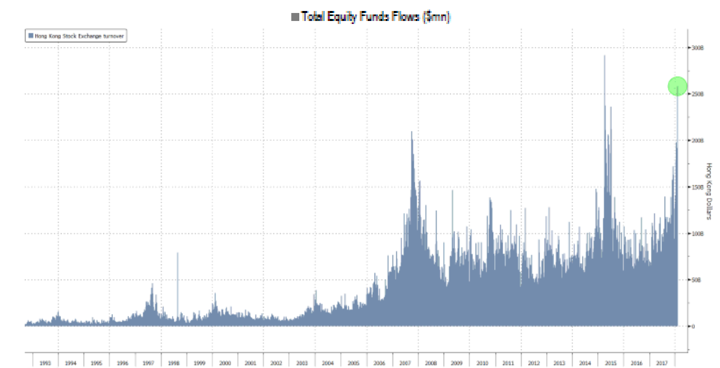
In aggregate, the buy-side sold $38 billion notional across S&P, NDX, RTY, Dow futures and the last time the buy-side saw such a big weekly drop in its net long positions (as a % of total open interest) was over the week following Brexit and prior to that the two weeks following the China-driven sell-off of August 2015.

<u>However, flows suggest that CTAs and Risk Parity funds were at the core of the correction vs. the buy-side</u><u>, with CTAs losing 6.9% and Risk Parity funds underperforming 3.7% in the first 4 trading days of February</u>. Hedge funds equities beta declined to approx. historical lows. US equity ETFs witnessed record equity outflows and inverse VIX ETPs were wiped out.



In 2017 balanced 60% stocks/40% bond portfolio had one of the strongest risk-adjusted returns since the 1960s as bonds and equities went up together with very low volatility. So far this year, US balanced portfolio have been hit hard: US 60/40 portfolio fell 7.3%, Europe 60/40 portfolio fell 6%, Japan 60/40 portfolio fell 7.2%, Risk Parity and CTAs down 4.4% and an impressive 9.7%.

<u>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, at about $34bn according to ICI data from last week</u> (1st chart).



<u>On the Hang Seng</u> the 5.1% slump recorded on the 6th was extremely hectic and <u>the value of shares traded topped 33bln$, behind only two sessions in April 2015, as the highest turnover on record</u> (2nd chart).

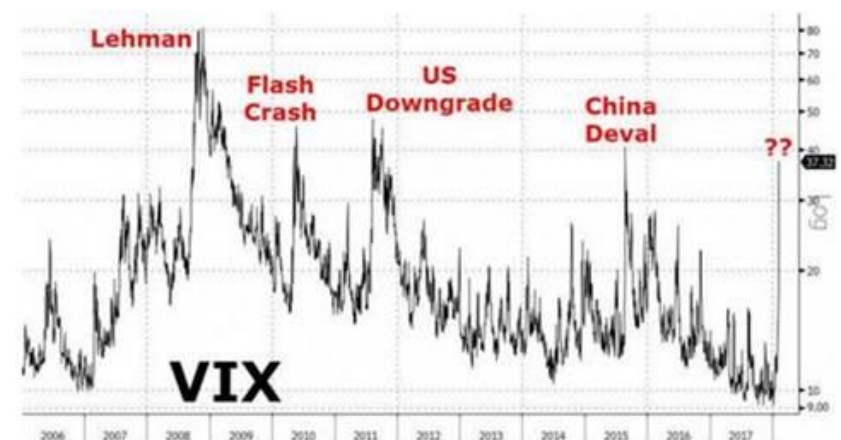
<u>3 out of 7 highest volume's days in the history of CME (Chicago Mercantile Exchange) have occurred over 3 trading days of the 2nd week of February.</u>

In VIX futures, we had the largest volumes seen in the entire history of the contract.

<u>ETFs were 33% of notional volume (normally are around 20%) of the whole turnover and single stock volumes were 20% below the average indicating there hasn't been any client capitulation yet</u>. In single stock, there have been very large relative volumes in buybacks instead.

<u>The market has been suddenly weakened up by this storm and the re-positioning has been extremely quick…in only 2 weeks the Eurostoxx has traded back to the levels where it was at the end of February 2017…1 year of performance "wasted" in just 2 weeks with many long futures and cash position caught "off-side"!</u>
<u>We warned that volatility was not simply an external measure of the market but rather an implicit factor that could disrupt markets risk and this is exactly what happened.</u>

<u>Contrary to other spikes in volatility, this time the cause was inside the product itself (3rd chart) and these were the actors involved</u>:



- **Levered long VIX / short VIX ETPs (AUM of ~7bn$ gross notional):** when volatility spikes, these funds need to buy large amounts of VIX (vega) creating a negative feedback loop (buy VIX + sell SPX futures to hedge + buy more VIX …).

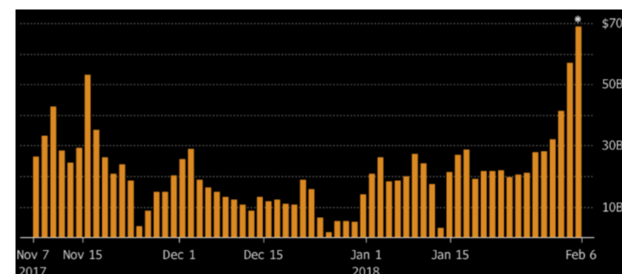
- **Volatility targeting funds (VTFs, AUM of ~400bn$):** As realized volatility breaches specific targets (8%, 10%, 12% …), VTFs reduce equity allocations. In the summer of 2015 (China de-peg), a VTF strategy would have been forced to sell ~60% of its equity holdings and led to a $250bn sell-off in 2 weeks with the assumption of $400bn VTFs AUM across the street.
- **CTAs (AUM of ~350bn$):** these funds are typical trend-followers selling as soon as momentum signals turn negative (eg. The 20 vs 120 daily average). As short-term trend signals turned sharply negative, CTAs were likely forced to unwind their record long equity positions and sell 100bn$ of equity futures assuming a conservative 30% risk-weighted allocation on equities. If the medium-term momentum had deteriorated, they would have been forced to sell an additional 100bn$. These funds have lost between 6% and 8% MTD!
- **Risk Parity Funds (AUM ~500bn$):** they use medium to long term realized volatility and correlation measures (6m/1y realized), unlike VTFs who use shorter term (1m/2m). They are therefore the last movers between all those funds. Assuming a model portfolio of (5% vol target, 12m lookback, 70% UST / 30% US Equity risk), they have sold 30bn$ in equities in summer 2015 and they should have sold ~60bn$ in equities so far. This is because the RPFs have increased leverage dramatically and equities comprise a large proportion of their portfolios. Risk parity leverage was very high at the end of 2017 due to low rates and equity vol.

Investors did not own puts and were under-protected, our recommended strategy of buying put spreads would have worked well as it would have benefitted from higher volatility and lower markets.

China has found its way of "avoiding the issue" as today has stopped updating its home-grown version of the VIX Index and has recently increased curbs on option traders in part because they were alarmed by a gain of as much as 2,250% in the price of one bearish contract on the SSE 50 ETF, also known as the China 50 ETF. The fund is China's only equity-linked product with options.

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

During the equity market sell-off on the 6th of February, more than 69bn$ of CDS (Credit Default Swap), tied to benchmark indexes (used to wager on corporate creditworthiness), have been traded in just few hours and the 1st chart on the side shows how volumes have picked up.



In Europe, the High Yield credit is down 0.2% and the Investment Grade credit index remains down in one of its worst total return year-to-date ever. Last week we had the biggest outflows in 15-years within the IG ETF.

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.

The surge in Bond Yields pushed the VIX's bond-market cousin to the highest level since April and while equity volatility has started to normalize, this measure of risk is still 40% higher year-to-date (TYVIX Index on Bloomberg).

The Merrill option volatility estimate (MOVE Index) which is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options is now still 34% higher than when it was at the beginning of January (chart)

And finally the DBank FX volatility (CVIX Index) is still 30% higher than the lows made in January.

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 latest correction has created an opportunity, on the assumption that most of the technical supply risk from volatility targeted funds (on which we are now all experts) has been cleared out. We now face a market which has partially reset valuations, moderated the 'euphoria' while we still have good macro data/ growth and earnings visibility.

We view this correction as a technical rather than a fundamental sell-off with low bear market risk, as a strong Macro environment should support stock markets worldwide, preventing the worst outcome.

Only 5 other trading days in the last 50 years have seen an S&P sell-off of this magnitude or greater when PMIs were at 60 or above (all episodes in 1987 and 1988).

This S&P 500 correction has been faster and harder to diversify than the previous ones. Risk appetite has now normalised to more neutral levels due to the spike in VIX.

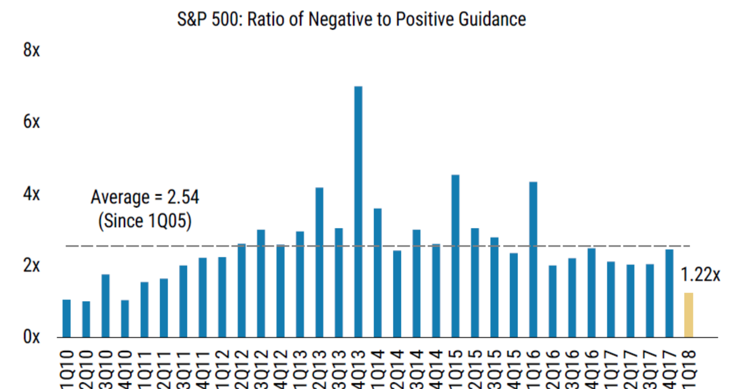
The risk of a sudden ETP-fuelled spike is now behind us, the VIX ETP community (now net long vega) can still contribute to vol-of-vol, but at a significantly reduced scale relative to the VIX futures market size.

The futures to cash ratio was extreme on the S&P (on average 7x over the last 3 weeks, 5 standard deviation above normal) and less extreme on the Eurostoxx (5x). This is to be considered as a measure of the systematic nature of sell-off and now futures are trading back to the average.

It has also to be considered that systematic funds have dispersion across strategies (more than any small set of models will capture), can also exercise discretion, and the marketplace is much broader than systematic alone. Global equity market cap is $84 trillion, dropping from $87tn less than 3 weeks ago, and still comfortably higher than the $75tn six months prior.

We also tend to believe that if the interest rate increase is too fast and/or the equities markets fall too fast, the central banks will suspend their policy of curbing the stimulus and will try to stabilize the markets.

The **Earnings season** is nearly complete now, even if then major catalyst of the last 3 weeks was the market turmoil. Unsurprisingly, Q4 numbers had a very high beat rate across most sectors and confirmed the recently risen earnings estimates.



In US, the biggest earnings surprises were in Materials, Discretionary, and Telecom Companies have also provided a rosy outlook on the next quarter; the ratio of negative to positive guidance stands at 1.22x, the lowest it has been since Q4 2010 (chart).

In Europe, results have been robust with 77% company's beating at the topline and 54% beating at EPS. Sales growth is tracking at +8% yoy and EPS growth at +17% yoy (+10% ex energy). Financials, Discretionary, Energy & Materials have seen the greatest EPS surprises, while Real Estate, Telecom & Industrials have seen greatest misses.

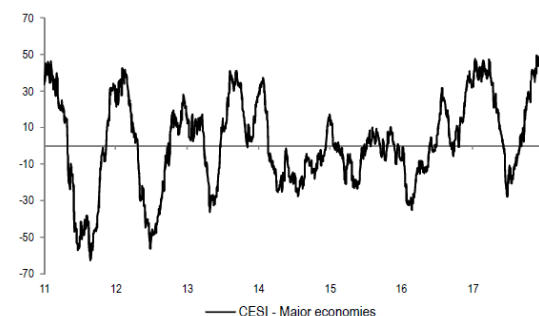
Weighted earnings growth in Europe currently stands at 44% YoY in 4Q, but this is heavily distorted by base effects in Financials. More representative is the growth in the median stock, where earnings are up 8.5% yoy.

It is however to be noted that Europe's earnings revisions ratio has weakened in recent weeks with all major sector groupings having seen earnings revisions ratios drop in the last month or so. Commodities are the only area of the market still seeing a strong pace of earnings upgrades, albeit at a slower pace, while Defensives continue to be the laggard. We assume that the FX revision has had an impact.

Interestingly, with the surge in earning growth expectations coupled with the market correction, valuations have moved down more sharply than the market and are the "cheapest" in 2 years (chart).

Global CESI (Citigroup Economic Surprise Index) is strongly positive correlated to earning and currently at its best levels in more than 6 years (2nd chart).

Commodity prices rallied strongly last quarter, which we see as another positive development for earnings.
The positive relationship between commodity prices and top-line growth works in US and in Europe.
Global PPI, which is a good proxy for corporate pricing, inflected higher over the last few quarters, providing a significant boost to earnings. This should play out favourably again in Q4.



However, it need 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.

Both in Europe and US there been a sharp increase in labour shortages recently, which could be prelude to a rebound in wages. In US, the labour market is at a more advanced stage of improvement and employment cost index could grow at the fastest pace in 10 years.

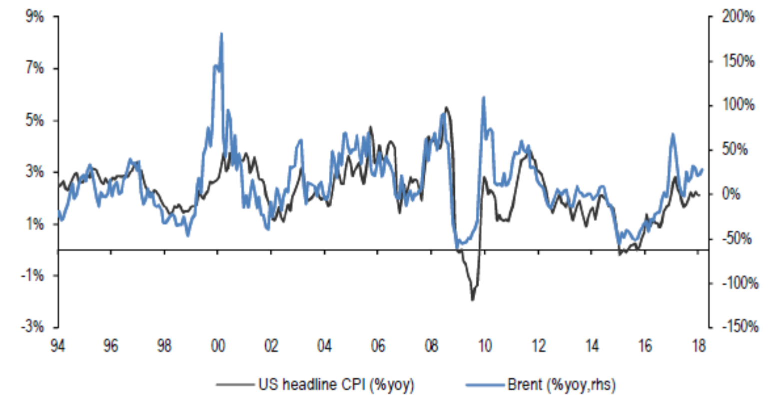
Let's now analyse some new data about **Inflation** as the pressures are building and bond yields have risen as we rightly predicted over the last few updates.

The continued run of good economic newsflow was also corroborated by an incredible resilience of the commodity prices since the beginning of the year, even the CRB RIND index, which is often less volatile, is now back to Ytd highs and is not far away from the highs made in 2014.

Industrial surveys in US and Europe indicate that both input and output prices are rising at the strongest pace since the beginning of the decade.

G3 January CPI readings show a broad pickup in goods price inflation and US CPI had the largest increase in 12 years.

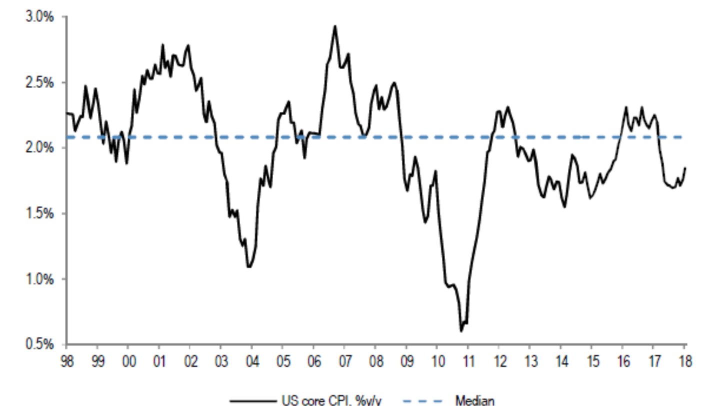
The inflation rebound should not come as a surprise. First, oil prices are up 35% from their June '17 level and up 65% from their trough level of two years ago. As the 1st chart shows, there is indeed a strong positive correlation between the oil price and headline CPI historically.



Inflation was 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. Basically,the current pickup in inflation is just a reflection of the already strong growth environment.

But while inflation is moving higher, it is still not elevated in the historical context. At 1.8% currently, US core CPI is still below the latest 20-year average (the 2nd chart shows the US core CPI since '98)

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 and the rise in oil prices is more than offsetting FX strength.



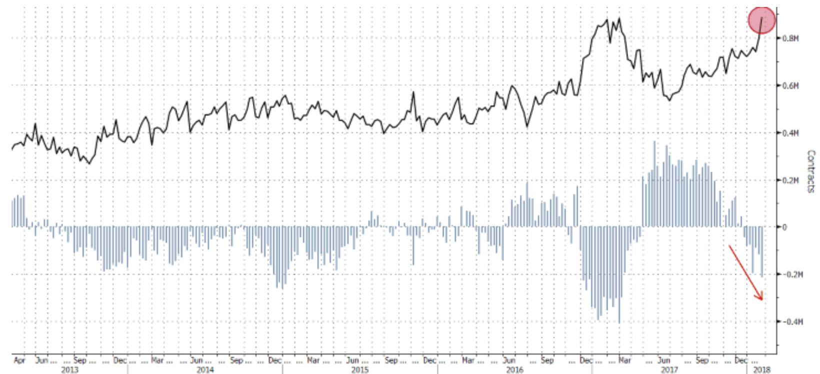
We believed that bond yields were just catching up with the resilient activity dataflows. We have highlighted many times that a significant gap opened up between the two in '17 and is now closing. The last time global PMI was at the current levels (in February '11) US bond yields were at 3.6%, 75bp above the current rate.
Yields are now finally starting to reflect 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 reduces the lure of bonds.

In US, the benchmark 10-year Treasury yield closed yesterday at 2.94% attempting the breach of the highest level since 2013 and getting closer to the first resistance at 3%.

In the middle of December **we mentioned that technicals were pointing to a potential turning point in US real rates** (so called "flag or triangle"), **we have now clearly broken this important level and what is more important is that we have broken several multi-year downtrends**

The chart on the US 5Y it is pretty amazing 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 1st chart). The US 2Y jumped to 2.26%, highest since 2008!
In Europe, the German 5-year yield broke above 0% for the first time since December 2015 and is quickly reaching the 0.1% threshold.

While we have been bullish Yields since the middle of December, we now think that we have started to reach some important resistances and the move looks stretched short-term. The monthly RSI on US 10Y is at an extreme matching the levels touched in January 2000 and November 1994 where it consolidated.
It now yields 1% more than the S&P dividend index.
The market has traded around current levels for nearly 3 weeks and in terms of positioning, the total short on the 10-year have reached a new record as shown on the chart.



We would therefore expect the market to stabilize around current levels and even retrace a bit over the next few days/weeks.

We continue to reiterate that Equities remain substantially cheaper than bonds. 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.

As we have mentioned over the first part of the letter, it is important to consider that Central banks tightening is still in early stages, with US real policy rates outright negative. None of the last 8 downturns started with real rates lower than 2%. Classic end of cycle indicators are not flashing warnings signs yet. The yield curve is flattening, but it is unlikely to get inverted until at least 2H '18. Crucially, **stocks never peaked before the yield curve inverted**.

The **minutes of the Fed** released on Wednesday were indeed hawkish citing the weak USD, potentially greater effects to come from tax cuts (good as it's pro-growth, bad that it could put upward pressure on prices and inflation).
The hawkish interpretation has given the stage for more interest-rate increases in 2018 than previously forecast, the key point was the word "FURTHER "gradual increases in the policy rates would be needed…if this means faster and more (the probability for 4 rate hikes moved from 25% to 29%) or if it echoes what stated in December and acknowledges what priced in the market.

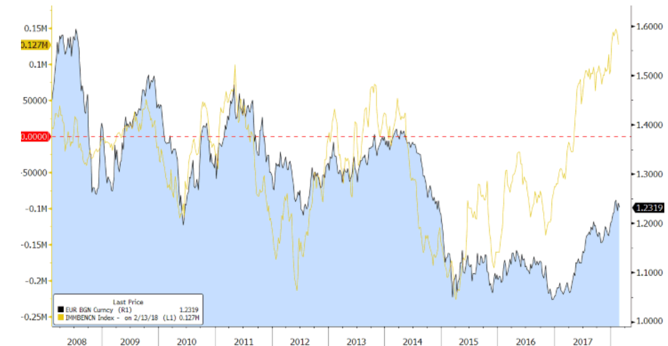
Fed's Kashkari (dove, non-voter) said Fed statement's inclusion of word "further" signalled we're continuing the path we are on, we debate each word change in the statement. Fed's Kaplan (non-voter, dove) sees inflation making progress toward 2% over 2018, there is a risk to waiting too long to remove accommodation.
The market is now discounting an 88% probability of rate hike in March and 80% probability of a hike in May.

Trades to be monitored

<u>**The Eur/Usd**</u> has bounced 2.4% since the beginning of the year breaking the highs made last September to levels seen only in 2014 but has <u>struggled twice to break the 1.25 level.</u>

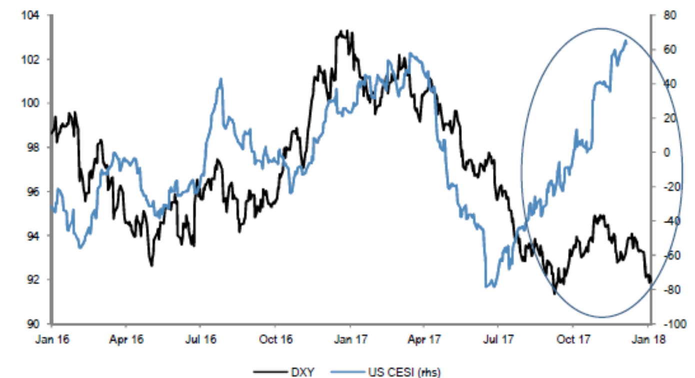
As we flagged before, <u>the long positioning on EUR/USD is getting increasingly very consensual and is where most Macro/CTA funds are having good performance Ytd (together with the long Oil).</u> If the USD would start to bounce it would be a real disaster for these funds.

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.



<u>**The move of the € is stretched, we would now start playing a contrarian trade long USD.**</u>

As we have seen above, <u>US activity is continuing to pick up</u>. <u>CESI (Citigroup Economic Surprise Index), which turned deeply negative in April, is now strongly positive and appears to be overlooked by USD so far, but might change soon (2nd chart).</u>



Eurodollar credit growth is at near record highs and the level of market risk bridging the gap between the local and dollar value of world money supply, is also near a record high.
Whilst there is potential for the Eurodollar credit growth to extend further, any such move is limited, and with U.S. and European monetary policy likely to remove the pillars of its support, the risks it represents in asset prices and the economy are likely to unwind.
<u>If the Eurodollar market blows up, the US dollar will soar as people repatriate dollars back home, the base money on which the Eurodollar is built</u>.
Additionally, <u>China's appetite for currency strength is being put to the test as the yuan rallies beyond the symbolically key level of 6.4 per dollar for the first time since December 2015.</u> 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 three months, it's little changed against the euro, suggesting dollar weakness is the driving factor behind the yuan's strength.

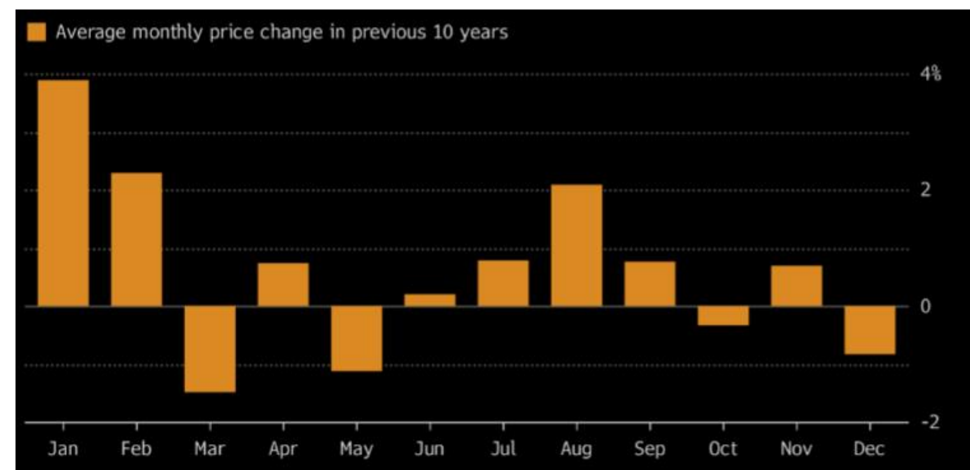
<u>**Under the technical point of view we are now getting some very interesting reversing signals on the EURUSD and DXY monthly charts**</u>, please check the Monthly chart of the EURUSD (resistance of downtrend started in 2008, negative divergence RSI and many other indicators), please let us know if you want to go more in deep on this analysis.

On a separate note, as you might remember over last update 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** as you can spot on the 1st chart on the right.

On **Gold**, after rightly calling the reversal point in the support area at 1250$ in the middle of December **we are now thinking that it should start to consolidate or at best continue in a lateral phase.**

Once again, positioning has been helpful along 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).

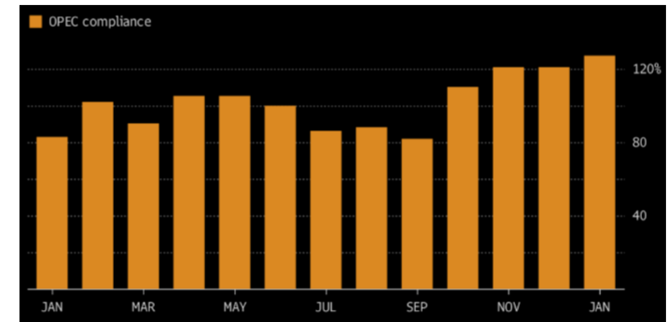
This rally can mainly be also attributed to the current weakness of the dollar. Indeed, if the dollar depreciates, it becomes cheaper to buy gold in other currencies and demand increases. If you look at the Gold Performance in EUR, the rally is not so pronounced anymore.

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.

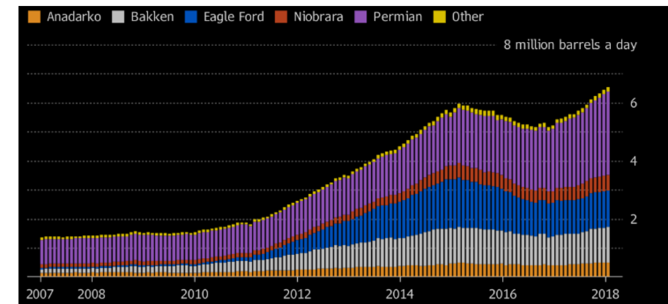
Crude oil is up 2.3% Ytd, +44% from the lows made last June but -7% from the highs at the end of January. As you might remember **we mentioned over last update that we were expecting some consolidation and that we werereaching some important technical and political resistance levels and positioning was also too stretched**.

OPEC compliance with production cuts that started last year rose by 6% points MoM to 127% in January, that's the highest level since the organization began curbing output over a year ago. Part of the reason for the over-compliance lies with Venezuela, where a chronic recession and underinvestment have seen its output fall by 30,000 barrels a day to 1.67 million b/d last month, the lowest since 1989 (chart on the side).



At the same time, US oil production rose 14.2% yoy to 10.251m bpd, the biggest increase since May 2015 and Chinese oil imports rose 20% yoy to 9.57m bpd, a new record high.

Total crude production from major U.S. shale plays is forecast to rise by 111,000 barrels a day month-on-month to 6.55 million barrels a day in February (2nd chart).



Intuitively, rising global demand and years of underspending in capex suggests upside price risks, whilst the weak dollar continues to support the price. But on the negative side it seems that that the risks of increased US production is overdone as 85-90% of the Permian basin 'tight oil' production is so light that it makes it unusable in the near-term which is why there is continued pressure in the oil futures curve in terms of backwardation. This seems to have been ignored by recent IEA updates that suggest a surplus is coming on the back of US production.

The dynamics are therefore quite complex and is not easy to predict where the Crude price could move but as usual we use the positioning as a help.

Long positioning has not decreased along the price since the beginning of the month and we are having the largest open interest since these data were collected in 2006. CTA funds are still very long Crude and they will comfortable keep these positions having had a positive return of around 20%.

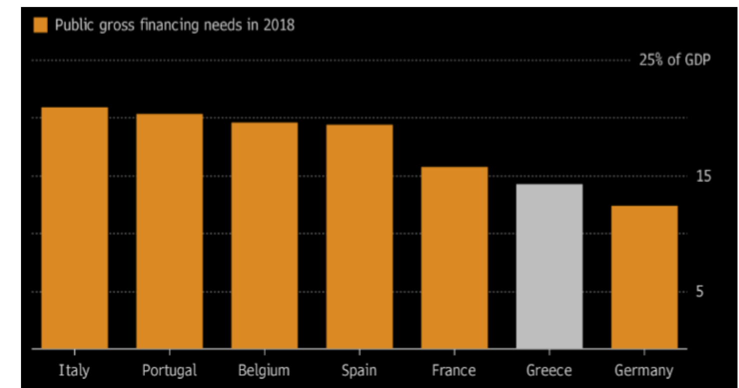
Last time we warned that we were reaching some technical resistances and the 200 monthly moving average has worked perfectly so far (3rd chart), **we have already corrected something, we should probably trade sideways from now on.**

If we look at the commodities in general we need to analyse the **BCOM index** (Bloomberg Commodity Index) which has fallen 3% from the 3-year highs it reached at the end of January and 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 (22% 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** the next important theme in Europe is the **Italian Election** which is on two weeks time.

The most likely scenario by far is still of a large grand coalition but the recent polls are saying that the center-right coalition is set to gain plurality as a whole (40% vs 37% at the beginning of February), even though Five Stars (28%) could be the single most voted party.



Despite a great deal of uncertainty, we see a very low probability to a disruptive event such as a non-mainstream government.

While there are no policy specifics yet, the centre-right's joint manifesto talks about some structural reforms and a rethink of the pension system. It also mentions a potentially quite expansionary fiscal stance, which could mean stronger cyclical growth, but also higher deficits and lesser compliance with the European fiscal rules.

It is interesting to note that Italy will have to face the higher gross financing needs in 2018 (chart) and is likely to influence the spread if the country don't get a stable and clear result from the elections.

In **Germany**, a Merkel-led coalition is still uncertain, as more than 450k Social Democratic Party (SDP) members have been asked to accept or reject the Grand Coalition deal the SPD leadership closed out with CDU earlier this month. The vote is an all or nothing affair. If the SPD members give the thumbs up, Germany gets a government. If they say no, there will be new elections or a minority government which will not be able to rule. Results are expected early March. As the vote is expected to be very tight, further political uncertainty remains.

In **UK**, negotiations on Brexit are still going in on with just over a year to go until Brexit day in 2019. The U.K. prime minister has invited her 11 most powerful colleagues to join her today at her Chequers country house residence and by the end of the night she hopes to have won enough support from her top team to be able to go away and write a speech she's expected to deliver next week, announcing the U.K.'s negotiating goals.

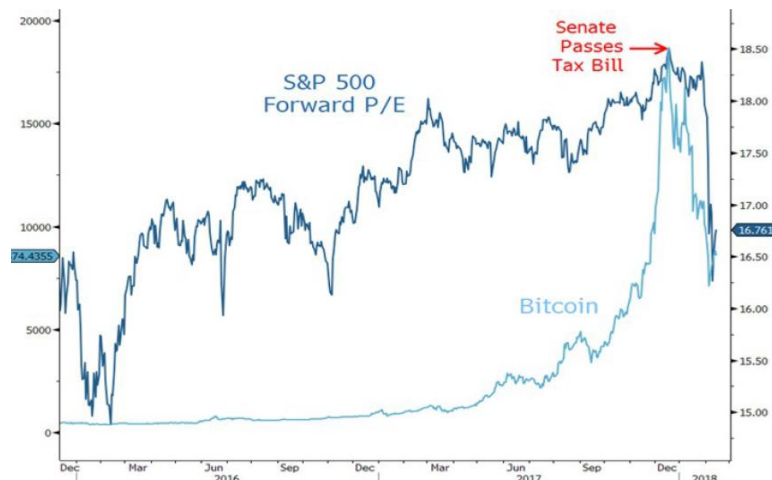
The latest labor market report caused a mild stir with a rise in the unemployment rate to 4.4%. The number of foreign nationals working in Britain continued to rise last year, but they are no longer the job-creating force they once were. Office for National Statistics figures show they accounted for a third of the 332,000 jobs created, suggesting the 2016 Brexit vote is taking a toll.

The UK economy expanded less than previously estimated in Q4 as consumers and businesses absorbed faster price increases. Brexit continues to dominate the outlook for the economy, creating uncertainty for companies and consumers that is holding back demand. The drop in the pound following the referendum is also driving prices up faster than wages.

Executive summary

The start of the year has been impressive in a "melt-up" phase but as we described above the correction has been sudden and severe.

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 and recovery and we can't help but notice the continue breadth deterioration. We reiterate that 2018 will be about alpha not beta.
Our suggestion was that avoiding a nasty drawdown at the beginning of 2018 could make all the difference in the performance to starting what is likely to be a much more difficult year to trade than 2017.
2018 is likely to prove a trickier year for equities despite a good macro backdrop. A combination of overbought momentum and a polarised market makes crowded trades look increasingly precarious.



Our strategic understanding told us that the January amplification of the most characteristic trends of 2017 would not be sustainable. The transition from January to February has brought the equity market climax. The warning signs have been accumulating and the crucial catalyst has been the behaviour of bond markets.

We are exiting the 2017 paradise of "growth without inflation". The most fundamental message of this investment year is being delivered by bond markets rather than by equity. The fixed income world has begun to anticipate the deterioration of the trade-off between growth and inflation in America that will characterise this year.

Sentiment is still a very important factor in market perception and it is maybe not a coincidence that P/Es on the S&P and Bitcoin topped the same day in December and the move they had afterwards looks indeed very similar (chart).
We also witnessed a collapse in breadth on the sell off which has not rebounded as much as the index price level over the past week. This is what we call as narrowing breadth. Using "FANG" as a more specific example, Facebook and Google have underperformed the market significantly since the correction began.

Higher inflation and higher rates simply means higher volatility and this is undermining the "carry trade" which has been tentacles across multiple investment strategies. Higher vol led to the 'Systematic Unwind' which we saw over the past few weeks.
We think that Systematic Money have de-risked enough for the moment BUT Real Money were not forces traders and have instead increased on the weakness.

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.
   Global weekly EPS revisions (the ratio of analyst upgrades to downgrades) were outright positive the whole of the year. **Earnings should still act as a positive catalyst for the market.**

2) **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.

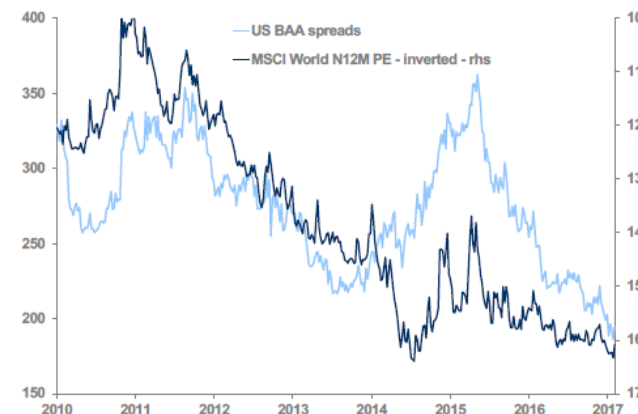
3) **Equity multiples** do not look cheap in absolute terms, but relative to both bonds and to credit, we find equities continue to offer a valuation gap. Compared to equities, which show a small P/E premium to historical, bond yields are significantly below their averages, trading close to the 30-year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

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.



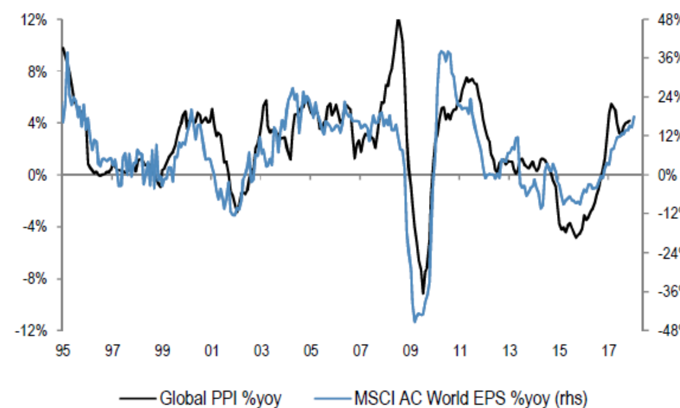
4) **Higher volatility.** Volatility has already bottomed out and is here to stay. Investors still do not own enough puts and are under-protected.

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.

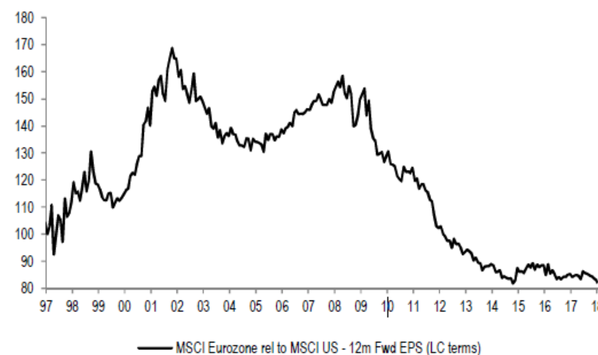
Inflation is primarily a lagging indicator of growth and should not come as a surprise. Signs of a move up in inflation are building, but it is important to note that the actual inflation rates are still subdued in the historical context. The latest US core CPI print of 1.8%yoy is still below last 20-year 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.** 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 we should expect it to continue falling in '18 and be a positive for the consumers.
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 1st 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 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 badly lagged 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 loan 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 correlated positively with bond yields in this cycle. While the market is forecasting lower yields and a flatter curve for the US, market is expecting 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, as the region is 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 them to continue their "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 (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 "peak optimism" in May post the French election, Europe has underperformed the US consistently over the last 6 months as tech has helped the US hit new all-time highs whilst EUR strength and negative relative earnings revisions have weighed on Europe's relative performance.

With Europe now at 12 month relative performance lows , it looks set to outperform into 2018, led by banks and oils. Europe is on track to underperform for the eighth time in nine years, MSCI Europe is now close to its lowest ever relative levels versus MSCI AC World.

European equities have held up relatively well in this global market correction. This is especially true of the higher-beta indices such as MIB and IBEX. In most corrections historically Europe has underperformed US equities.

A **lack of positioning and relatively inexpensive valuation** has helped insulate Europe and also, unusually for this cycle, the trigger to markets' selling off was not European political or economic risks. Data has been strong; Euro area Composite PMI was 58.8 in January, +0.7 pt vs. December.

Why are we more negative US?

2017 has been one of the best years for equity investors in recent memory. Not only have absolute returns been high, but every sector has participated 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 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 behaviour. 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);
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 (+3.1% Ytd, they have been largely outperforming the market ytd), we would now take profit with the idea of getting back in at lower prices.** 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 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.

  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 sector has had a strong run in a short-time and is now overbought in relative terms (chart). Yields might also contract a bit before they might get higher.

  Interestingly, investors are now optimistic about the trajectory of financial stocks and the cost of hedging against declines in the sector is hovering near the lowest level since at least 2015.

- **Long Energy Sector, SXEP Index (-4% Ytd and +2.5% 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 from Q4 2017. 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.

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Energy equities have lagged the upward move in the commodity, 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.

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.

- **US/ German rates:** We continue to stay bearish the long end of the yield curve and recommend to shorten duration on strength.

- **Buy Put-spreads on US Indexes**: as explained, **we would still take advantage of the relatively low volatility (up more than 50% from the average of last year) in order to spend few bps and protect the portfolios from a new potential downturn of US equities.**

  The Put spread on the S&P we suggested over last newsletter has worked perfectly as we were long strike 2775 / and short 2550 expiring on the 16th of March 2018 with a cost of only 0.6bps for ever 1% notional of the portfolio covered.

  As you can spot from the chart, the S&P has fallen through the first white line of 2775 and has bounced before the 2550 short strike covering very well the portfolio.

  A similar strategy at current prices would mean buying the Put spread on S&P strikes 2690 (out 1.7%) / 2500 (out 8.6%) with a cost of 1bps for every 1% notional covered. The current delta position would be of 28%.

- **Gold**: we would take profit

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

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