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Monthly Market Update

Monthly focus on Financial Markets

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Contents

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Market Analysis

After witnessing a bounce over the months of June and July, we had a strong correction in August, as we rightly predicted over the last newsletter.

Bond vs. Equity performance in August was extreme, with US Treasuries vs. Equities posting one of the largest 1-month moves in the last several years.

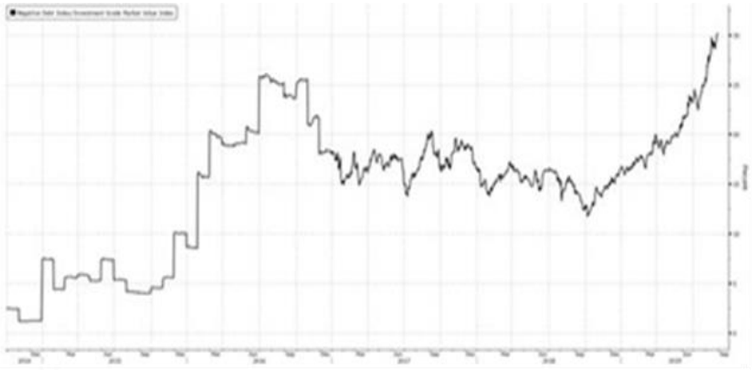
The stockpile of negative obligations across all markets hit a record $17 Trillion, and could swell further, because of expansionary monetary policies and global recession fears.

US 30Y Treasuries yields plunged to 1.93%, the lowest ever in history and below the yields of 3-month US Bills, which are trading at 1.95%.

Bloomberg Barclays Global Agreggate Negative Yielding Debt Market Value USD

Negative-yielding debt has spread to more than 30% of the world's investment-grade bonds, the most ever.

Negative Debt Investment Grade Market Value USD



Companies have issued more than €6.5Bln euros of new bonds in 2019 at negative yields. The street expects that it will soon be commonplace for European companies to stamp negative yields on new borrowings. Trading levels of companies with the same ratings as German industrial giant Siemens, single A, show they can basically borrow for free in euros. Companies are being paid to issue new debt.

Even Apple couldn't ignore cheap money. The iPhone maker, which has more than $200Bln in cash and securities on its books, is borrowing $7Bln in its first bond sale in nearly two years. The longest portion, a 30-year security, will yield 1.03% above Treasuries. It joins a slew of companies, including Disney, that have rushed to borrow last week.

Market Analysis

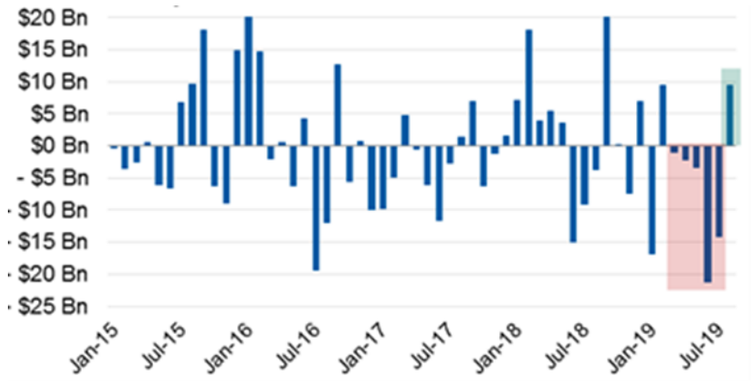
It is amazing to be witnessing one of the biggest global bond bubbles in the making. Last week, Treasury Secretary Mnuchin said that issuing ultra-long US bonds is “under very serious consideration” in the Trump administration.

Despite the correction, and unlike last year, all major asset classes have beaten inflation Ytd.

On the first page of our last newsletter, we have highlighted the massive short covering that took place after the G20 meeting (2nd biggest since 2013) which helped the market to touch new-year highs at the end of July.

After 5 months of short covering, August saw $9.5Bln of Eurostoxx 600 shorts added, the largest addition since the end of last year. It is quite rare to witness such a great swing in just two months. The current short positioning is however still low in absolute terms and mainly concentrated on Cyclicals sectors like Retailers, Basic Resources and Media.

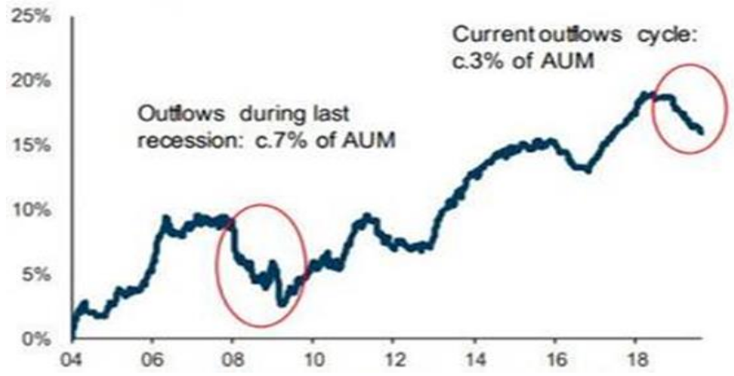
Eurostoxx 600 monthly short base additions



During the month of August, we had instead an aggressive de-risking which we would like to analyze below with the help of few charts.

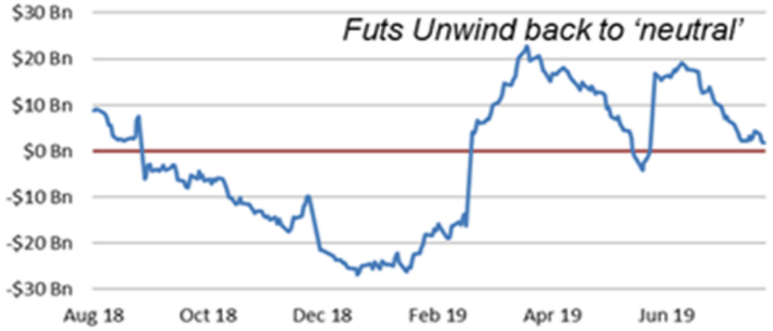
Global Equities outflows have reached 3% of AUM since December, already about half of the outflows sustained during the 2008-2009 downturn.

Global Equity outflows cycle



On Eurostoxx futures, almost $20Bln were unwounded over the last 6 weeks taking the position down to a small $1.3Bln net long. Over the same period, investors bought roughly $4.5Bln of Eurostoxx Put option delta and sold $4.1Bln of call delta.

Eurostoxx futures positioning



Market Analysis

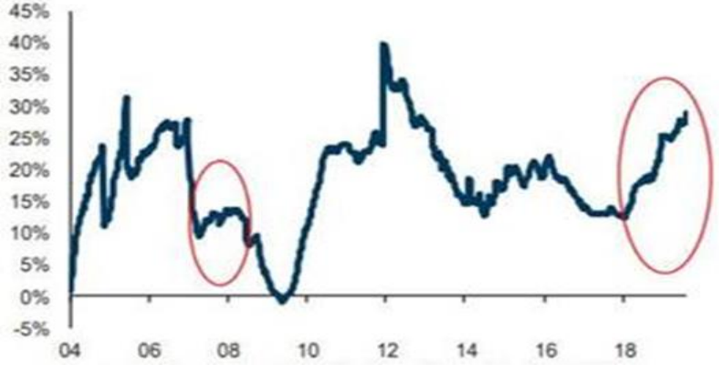
An astonishing $197Bln has departed from Equity funds this year, while $313Bln poured into Bonds, according to EPFR Global data.

The pattern over the past three months is striking: Bond funds saw record inflows of $155Bln, with corporate bonds particularly in demand.

Record 3-month inflows into bonds

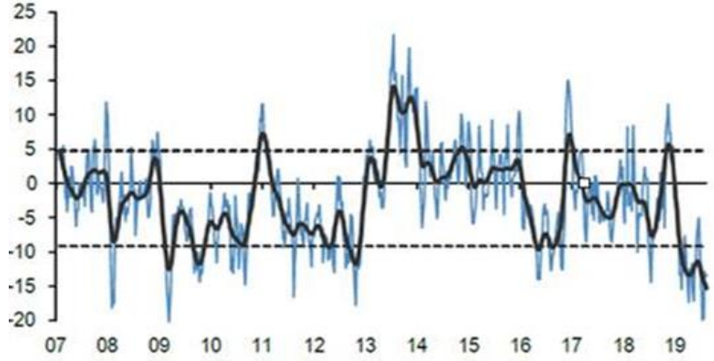
Global Government bond inflows currently amount to 16% of AUM vs 4% during last recession (and with current extremely low yields).

Global Government bond inflows



The result is that the difference between flows pouring into Equity and Bond funds has never been this low.

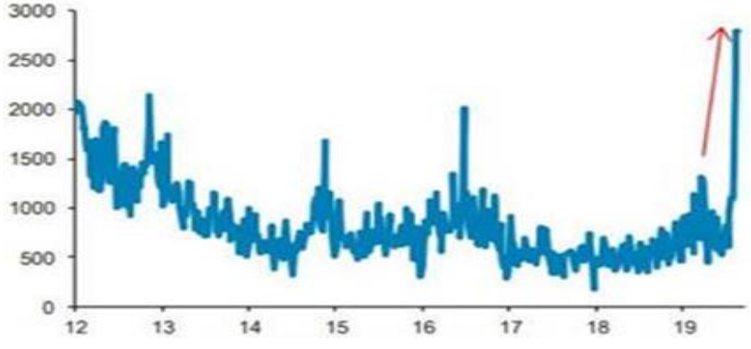
Difference Equity-Bonds inflows (black)



30Y Government bond has gained 25% YTD, twice as much as the German benchmark Dax index.

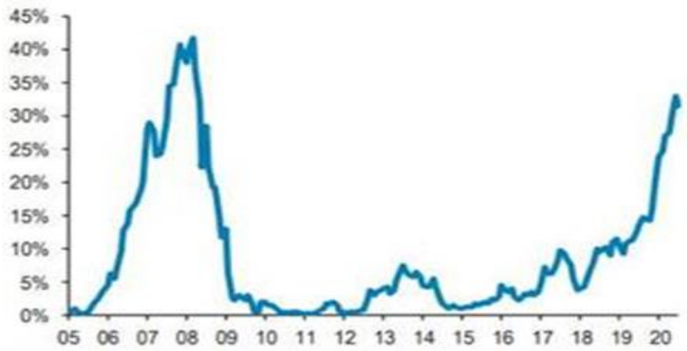
The aggressive de-risking that occurred in August shows that Equity investors are not complacent anymore and recession scare is possibly even extreme now.

Recession word in global news



Market Analysis

New York probability of US recession in 12 months is at the highest level in 10 years



Within Equities, the “flight to defensive” narrative has produced some extremes.

Cyclical stocks are trading at their lowest relative level to defensive peers in three years. Up until recently, the shares had held well despite deteriorating European Macro data but not in August.

Miners and Steelmakers have been particularly affected, dropping 11% and taking the Basic Resources sector into negative territory for the year. At the other end of the spectrum, the demand for Food & Beverage has shown no sign of abating, pushing the underlying stock to very high valuations.

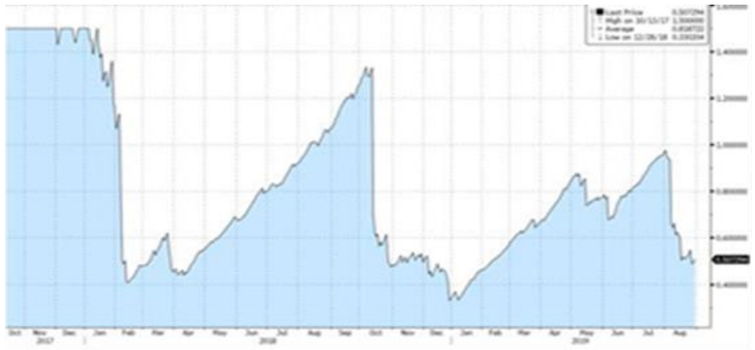
How are the Systematic, Hedge Funds and Retailers positioned?

Volatility Control, CTA and Risk Parity strategies have significantly reduced their Equity positioning, driven by the increase in realized volatility but they keep the very long exposure to Bonds.

As you can spot from the chart below, the current Systematic positioning is nearly as low as it was in December. These investors have been possibly responsible for more than half of the market move we had since the end of July.

CTAs have cut massively (short-term signals are short on main global indexes) along with Risk Parity.

Systematic funds positioning



Hedge Funds have decreased the net exposure to a 7-year low, at below 20%, which means that is near the 0th percentile on the 1/3/5-year relative basis.

Retailers have instead, in stark contrast to the flows seen above, increased their (low) exposure on market weakness while they fell during the precious corrections of February/December 2018 and May 2019.

It is actually fairly amazing to see markets bouncing despite continued Trade escalation, CNH dropping to new lows on the year, bad Macro-data and a continued breakout out of the USD. The reason behind is simply the same (on the opposite sign) of what we were mentioning over our last newsletter. Everyone is now bearish and the pain trade seems to be on the upside.

Central Banks

Markets are currently pricing in a higher probability of 50bps cut on September 18 Fed meeting, with another 50bps cut before the end of the year.

The latest message we got from Powell was at Jackson Hole where he signaled a cut and the need to act as response to significant risks. Trade-War is possibly the greatest threat they will have to face.

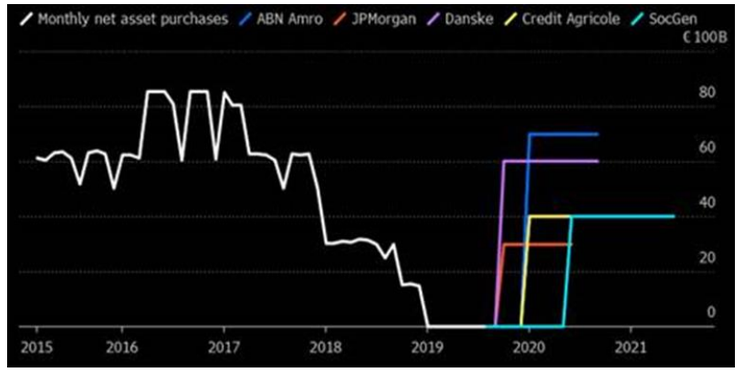
Trump has been very vocal on the need of further cuts to weaken the USD.

Fed Funds are discounting very deep cuts as shown on chart.

Implied yield on January 2021 Fed Funds futures (black)
Federal Funds effective rate (blue)

September will also be an important month as we have the ECB meeting and the market is discounting a cut of 10bps on its deposit rate (to -0.5%) with an announcement of a strong QE (see chart for different brokers expectations).

Street EU QE forecast



It will be interesting to understand their reactions to the inflation outlook, now barely above zero in the Euro-area. Commodity prices have been dropping. Cyclicals and Small-cap stocks are underperforming. All these dynamics are consistent with continuing growth risks.

It is however important to point out that given how much is priced into the policy path for both Central Banks, and the market's faith on Central Bank action will offset fundamental weakness, <u>we think these meetings could pose some risks to the market</u>.

Some are already talking about policy mistake rather than stimulus, and keeping rates in very negative territory for prolonged periods, or navigating to even deeper negative territory, could eventually unleash more united consequences than benefits.

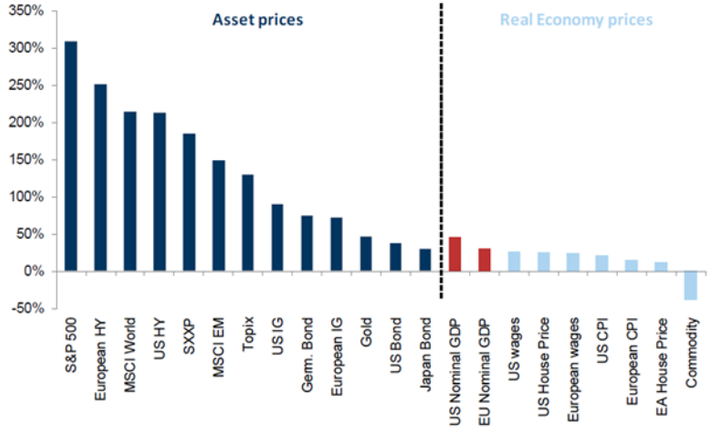
It is possibly not a coincidence that recently we had a greater number of dissenters like ECB's Muller ("no strong case to resume bond buying program") or Villeroy.

Central Banks/ Trade War

With the next Fed cut, we will reach the 730 Global Central Bank cuts since Lehman bankruptcy. A decade of deflation assets massively outperforming inflation assets, with a wide dispersion of assets price inflation and “real economy inflation”.

Deflation assets (blue) vs Inflation assets (yellow)

Asset prices (dark) vs Real Economy prices (light)



Looking at positioning, it is worth to bear in mind that Disappointing investors too much could trigger a potentially unsettling jump in bond yields. It would also push down market-based inflation expectations, which are already very low and whichever Central Bank drags its heels more will see its currency rise, which will put downward pressure on inflation and hurt exports.

TRADE WAR

Since our last newsletter, US-China relationship deteriorated further. We still remain quite skeptical on a resolution of the conflict before 2020 election, despite Trump and Xi Ping efforts to sustain the Equity market.

Trade tensions have re-emerged at a critical moment in the global cycle. Corporate confidence is weak, and the outcome of trade talks will be key to the global growth outlook.

Just to give you a quick remainder about the current situation so far, the US has imposed different levies on more than $360Bln of Chinese goods, while China has retaliated with tariffs on more than $110Bln of US products. The difference in tariffs size/amount is given by the composition of the US-China trade balance (before trade tariffs effect in 2017, US imported $505Bln from China while China imported $155Bln from US).

In August, Trump threatened a new 10% tariff on $300Bln of Chinese goods from the first of September, further to the existing $250Bln already in place. Trump decided then to split the new additional tariffs in two tranches, $110Bln on September 1 and the rest on December 15, to avoid disruption during Christmas shopping holidays. The delayed tariffs would have affected the cost of items of mass consumption, including cell phones, laptops, video game consoles, computer monitors, certain items of footwear and clothing, and certain toys, raising the purchase price for consumers.

Central Banks/ Trade War

In addition, Trump threatened to raise the existing 25% tariffs to 30% on $250Bln on October 1, and increase the new levies from 10% to 15% on $300Bln, after China applied retaliatory tariffs on $75Bln of US goods, resuming tariffs on US Auto and imposing 5% tariffs on Soy beans, US oil and further 10% tariffs on US pork. As of September 1, both US and China new tariffs, respectively $110Bln of Chinese goods and $75Bln of US goods, are in place.

Interestingly, the latest planned/imposed US tariffs will have a strong impact on consumers. As shown below, the first two rounds are hitting $45Bln of US goods only, while list 3, 4A and 4B would be hitting more than $400Bln of US goods with a real impact on consumer spending, e-commerce and retail sales.

US tariffs list tranches

Tranche	Import Volume (2018 $bn)	Current Rate	Latest Proposed	Major Categories
List 1	30	**25%, as of July 6, 2018**	*30%, as of Oct. 1, 2019*	Industrial machinery Capital goods
List 2	15	**25%, as of August 23, 2018**	*30%, as of Oct. 1, 2019*	Electrical equipment Capital goods
List 3	222	**25%, as of May 10, 2019**	*30%, as of Oct. 1, 2019*	Furniture, electronics, autos, leather goods, other int. and cap. goods
List 4A	104	**0% (current)** *10% proposed for Sept. 1, but not yet implemented*	*15%, as of Sept. 1, 2019*	Apparel, footwear, electronics, TVs/monitor screens
List 4B	156	**0% (current)** *10% proposed for Dec. 15, but not yet implemented*	*15%, as of Dec. 15, 2019*	Cell phones, computers, toys, electronics

mplemented. *Proposed.*

As already discussed in the last newsletter the US-China trade war is affecting: A) corporate profitability (unable to completely pass consumers cost-inflation) B) inflation C) consumer prices set to increase D) corporate confidence (lower Capex, several dislocations, etc.)

President Trump wants to be re-elected, but the pain inflicted by trade war appears to make that less likely.

It is a bit like a chess game, as time passes President Xi is increasingly incentivized to wait until after the election before pursuing a deal with Trump's successor. China's leaders read the polls. China is hurting, but if their calculation is a bad deal now or a much better deal in 18 months' time, they might well choose to wait.

If that's the case, Trump will probably recede at some point in the first half of next year, offering to remove tariffs in order to kick-start talks. His base won't like it, and China might in any event not respond positively given the approaching election. By next spring, though, Trump is likely to find he has no good options left.

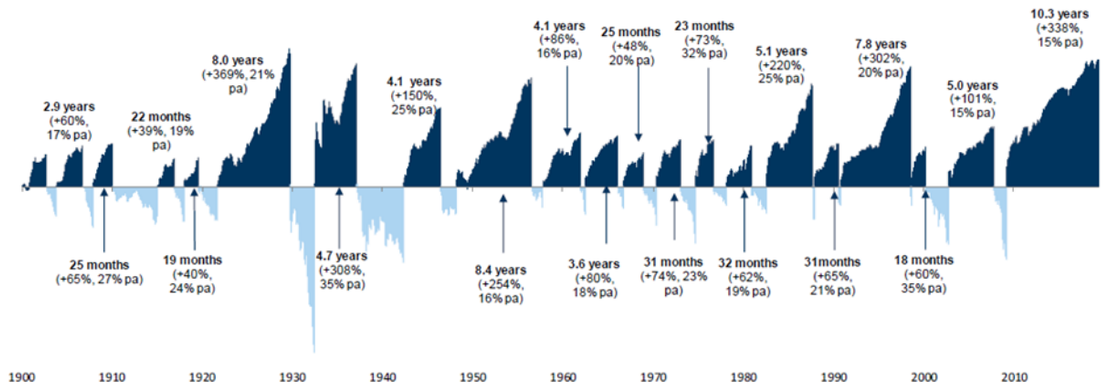
Our base case is therefore that we shouldn't see a further escalation as: half of Chinese exports to the US are electronics and clothing, and nearly all the tariffs in the final round are on products that the US does not produce (hence it is a tax on US consumers or producers).

At the same time, China does have scope to respond further (there are $200Bln of US products sold in China that are not exported from the US), China controls roughly 70% of global rare earths production, Trump's popularity is trailing his rivals in four agrarian Republican swing states in the recent election polls and China owns 5% of US Treasures.

Executive Summary

The duration of the current US economic expansion is now the longest vs the last 13 expansions since 1933. The global Economy looks to be close to reverting to a lackluster growth while the S&P is going through the longest bull run without a 20% drawdown.

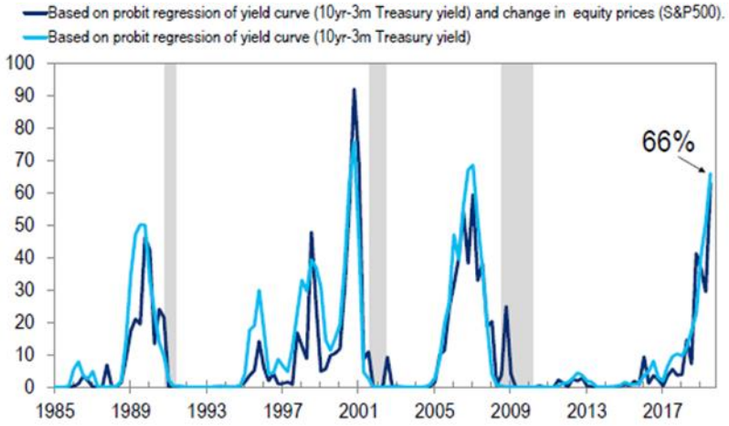
US Economic Cycles



The market, scared about recession risk, has been following these main indicators:

- US Yield 3-month/10-year curve has been inverted since May implying a 66% chance of recession over the next 12 months. Statistically, the yield curve needs to invert for 5 months prior to a recession, so far it has been 4 months (though the 2 year versus 10 year has not been inverted). In addition, the NY probability of US recession is at 10-year highs.

Probability of recession over next 12 months



- Leading economic indicators (ISM manufacturing new orders, initial jobless claims, single family building permits) suggest some cause for concern based on recent trends. We should however also consider that Non-Manufacturing in ISM are still above the 50-level indicating expansion (56) and while initial jobless claims have not continued to decline further, they remain steady at close to 50-year lows.

- Record Gap between Investors and Consumers confidence. While Investors sentiment is highly depressed, consumption data (mainly in US) continues to indicate that the largest component of GDP growth remains strong and could support overall activity even if weakness continues in investment and manufacturing. Is it going to last?

Executive Summary

Zew EU Macro expectations (dark) vs EU Consumer Confidence (light)

- Divergence between the confidence measure of the Conference Board and the University of Michigan. The gap between the two gauges grows ahead of recessions because the Conference Board emphasizes employment and is more backward-looking, while the University of Michigan is slightly more forward-looking with its emphasis on personal finances.

Conference Board minus University Michigan (black)
Recession (red area)

- McCulley indicator has been a pretty good reliable indicator in the past. It includes core Capex orders (those excluding military and aircrafts) and it has been in a downtrend since November 2017. Over the last 20 years, when the data print has crossed below zero for the three-month average of the YoY change, recessions followed in 2001 and 2007.

US capital good orders (yellow) vs moving average (pink)

As we have seen at the beginning of this newsletter, the market got itself positioned for a bearish scenario and there is an enormous amount of money flowing into money markets these days ($241Bln YTD, a record and nearly 3x the 2008 comparison).

There has also been a very quick run to Gold and precious metals and Gold is currently up 17.5% YTD and 27% since we started pushing the idea of buying Gold as of October 2018.

Since our last newsletter we have also seen the extreme Bond vs Equity move we have already described. We now think that despite all the ongoing issues and uncertainties, the only asset class that provides some yield (and volatility) is Equities.

Executive Summary

Last time, we suggested some defensive trades (which have worked well in August), now we would start offloading the defensive sectors, selling at least half of Gold positioning and prepare some cash to be used in order to selectively buying Equities.

We are surprised by the fact that investors now appear willing to buy assets where they are guaranteed to make a loss. Yes, enthusiasm for Germany's 30-year bond with no coupon appeared a bit flat, but there was no such issue with a 10-year bond in July that was sold above par!

The extreme overvaluation of Quality & Growth vs Value has reached a 25-year extreme.

While it is not obvious that this reversion will happen in the short-term, the extreme disparity in performance and valuation ownership means that, when this move will take place, it is likely to be aggressive with higher bond yields the most likely catalyst.

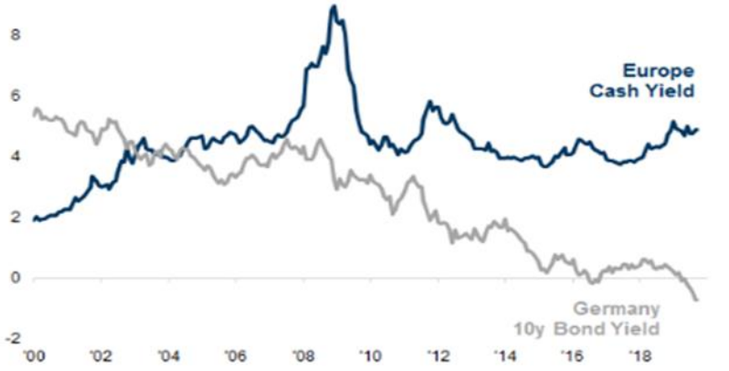
Bear in mind that September is historically a tough month for Fixed Income as usually sees supply pick up markedly, which means it also tends to be worse-than-average for credit and government bond returns. It is a bit a hazardous call but we are starting to think that we might soon see a directional move downward in Bonds which would cause investors (including Systematic money like CTAs, Risk Parity and Vol Control) to sell their Bonds and move into Equities…

Let's now analyze the current positive and negative factors for the market (please note that these factors are not all comparable in terms of timing, some factors are short term oriented while others may work in the medium to long-term):

POSITIVE FACTORS (5):

- **Attractiveness of Equities**: Negative-yielding debt makes up 30% of debt globally, with the Euro area driving the most recent rise in negative-yielding assets. In contrast, the earnings yield on SXXP (Eurostoxx 600) is above 7% and the dividend yield alone is 4%, showing that there is no lack of yield in Equities. While some gap closure between Equities and Bond yields seems possible, low growth and high uncertainty are not going to help to a radical reversal of the trend in the medium term.

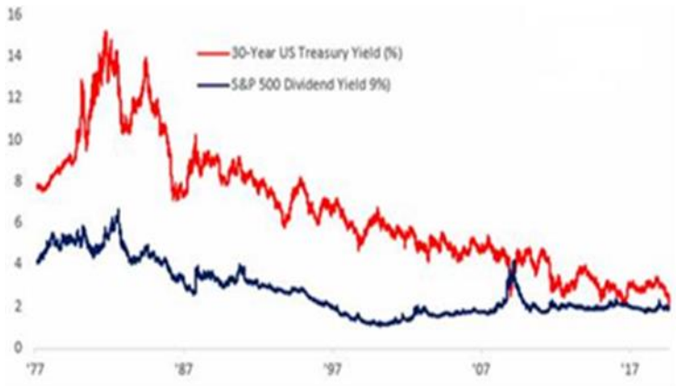
German 10Y Bond yield (grey) vs EU Equity yield (dividend + buyback)



Let's look at the next chart which compares 30Y US Treasury Yield vs S&P dividend yield. We got to these levels in few instances only, every time the S&P tended to benefit and bounce relative to bond prices. Statistically, on a daily basis, there have been 9 instances over the last 10 years and 7 out of 9 instances saw a significant move upward in the S&P in the 3, 6 and 12 months following those breaches with returns that were respectively up on average +3.5%, +8% and +19%.

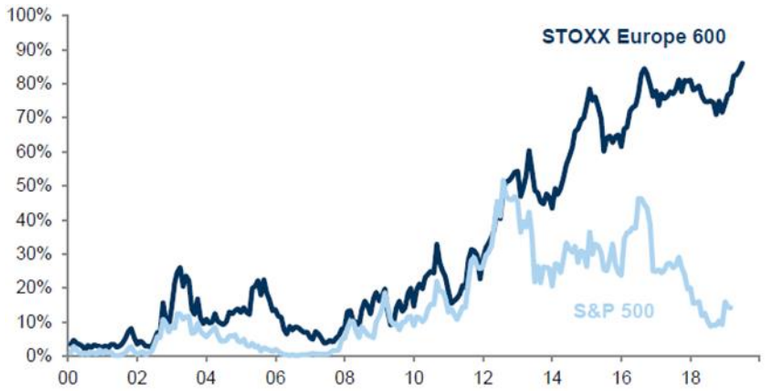
Executive Summary

30Y US Treasury yield (red) vs S&P500 Dividend yield (blue)



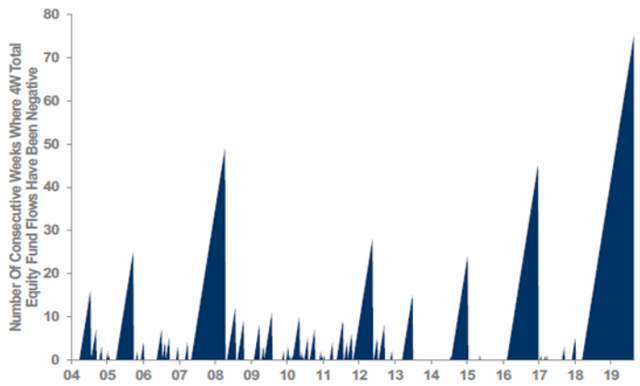
In Europe, circa 80% of European firms have a dividend yield higher than corporate bond yields.

% EU Equity Dividend yield higher Corporate Bond yield (dark)
% US Equity Dividend yield higher Corporate Bond yield (light)

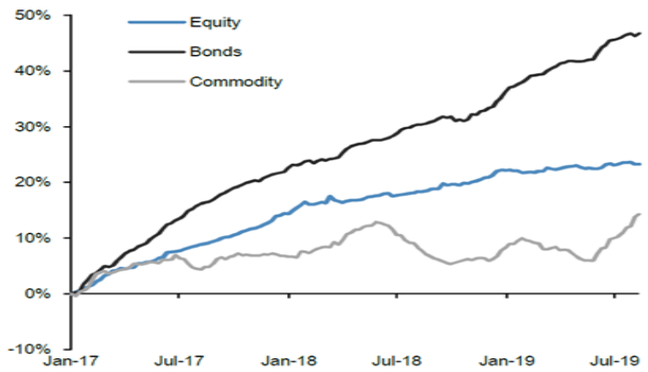


- **Positioning / Flows**: Aggregate investor positioning is the most cautious since the beginning of the year. As an additional note, European Equity funds have seen 77 consecutive weeks of outflows, the longest stretch of outflows in a decade.

Number of weeks EU Equity outflows



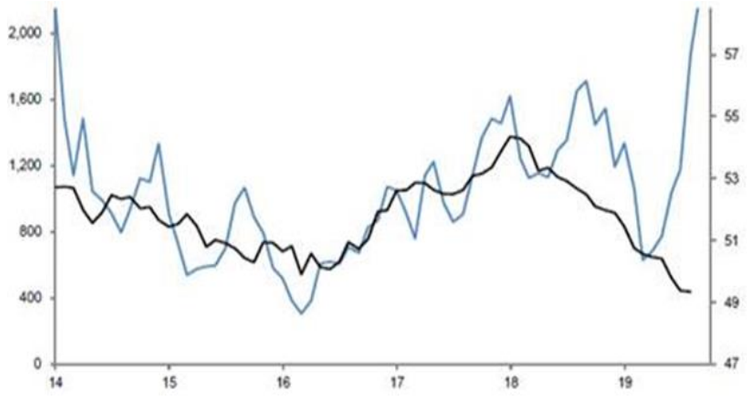
Cumulative flows into ETFs as a % of AUM
Equity (blue) vs Bonds (black) vs Commodity (grey)



Executive Summary

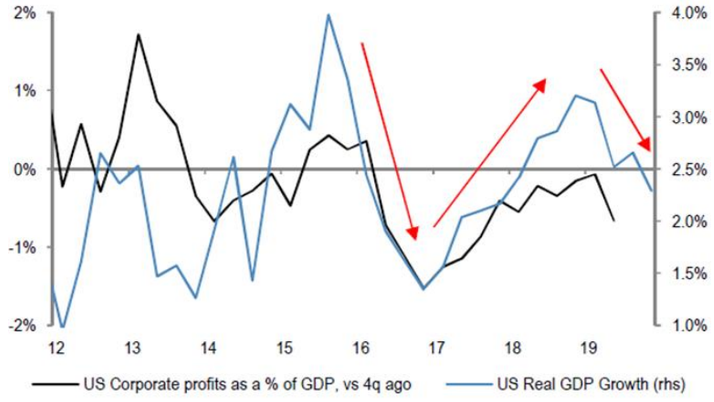
- **Macro numbers getting better from very deep levels**: In contrast to that 2018 backdrop, there is the possibility that activity momentum will start showing signs of stabilization, given favorable base effects, reduction in inventory overhang and the bottoming out in M1 in all key regions. At the same time, and in a stark contrast to last year, Fed will be cutting rates and ECB might re-start QE (Quantitative Easing).

Global Manufacturing PMI (black) vs Baltic Dry Index (blue)



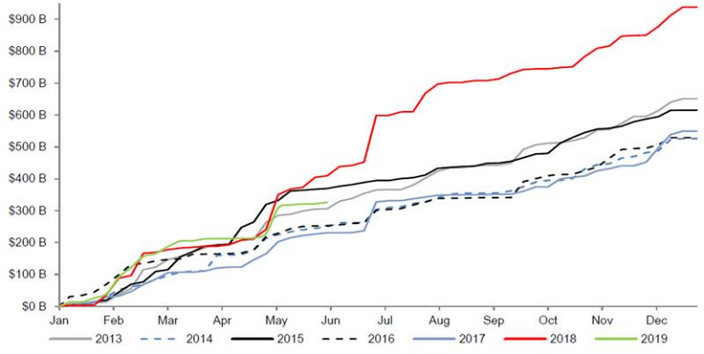
We believe if the activity momentum stabilizes, the recent slowing in the EPS growth rate will stabilize too. Profits and margins remain operationally leveraged to Economic growth. An improvement in activity momentum, driven by the Fed cuts, restart of ECB's QE and further China stimulus, should help drive better earnings and margins from here.

US Corporate profits as % GDP (dark) vs US Real GDP growth (light)



- **Buyback should support markets in 2019**: key theme through this cycle with S&P 500 companies returning ~$5 trillion to shareholders since 2009 and contributing ~2% to annual EPS growth. US corporates have announced for 2019 an amount of buybacks equivalent to 4% of S&P market cap. We will be entering the reporting season in about 3 weeks and buybacks will go into black-out period (2/3 week negative effect).

S&P500 Announced Buybacks
2019 Buybacks (green)



Executive Summary

However, please note that US companies are repurchasing their own shares at the slowest pace in 18 months, a potential sign of more volatility ahead as the buyback bonanza from the corporate tax overhaul wanes.

Companies in the S&P500 repurchased about $166Bln of their own stock in Q2, down from $205.8Bln in Q1 and $190.6Bln in Q218. This is the slowest pace since Q417 and the second consecutive quarter of contraction.

Tech companies buybacks are down 23% in Q2. Cisco Systems huge buyback program was due to massive (1-time) repatriation of cash flows, Micron's cash flow evaporated. Apple's iPhone business falling. Cash flows are not the same as before.

What is interesting to note is that companies have eased up on share repurchases even if market have dropped, suggesting that for the first time in a long time, companies didn't step in to support their stock prices. This is possible due to weakening corporate earnings, signs of a downturn in global growth and uncertainty over the FED's interest rate policy.

- **Global M&A:** It is notable that Global M&A volumes have been very strong year-to-date, reaching their highest level since 2007.

NEGATIVE FACTORS (6):

- **Dangerous reporting season**: we think Q319 could continue the trend of **earning recession** seen last quarter and full-year 2019 earning estimates will possibly need to fall further. A lot of the growth that is still expected for 2019 is being packed into Q4 and that looks unrealistic to us, especially without a trade deal.

  Profit margins are weak and a similar peak always preceded past US recessions (grey bars on chart), by seven quarters at least on average. This time around, margins appear to have peaked long back in Q112, which is thirty quarters ago.

US Profit Margins (blue) vs Recession (grey area)

There has been a **significant inventory buildup** over the past year (some due to overheating economy) and **technology capital expenditures** experienced a boom last year thanks to the extra earnings and cash put in the pockets of corporate America from the tax cuts and repatriation of overseas cash. **Labor is the other excess** from last year's fiscal stimulus boom and where costs are eating into margins, especially for Small Caps. Finally, **inflation** message from corporates is much less benign than Bond markets currently price.

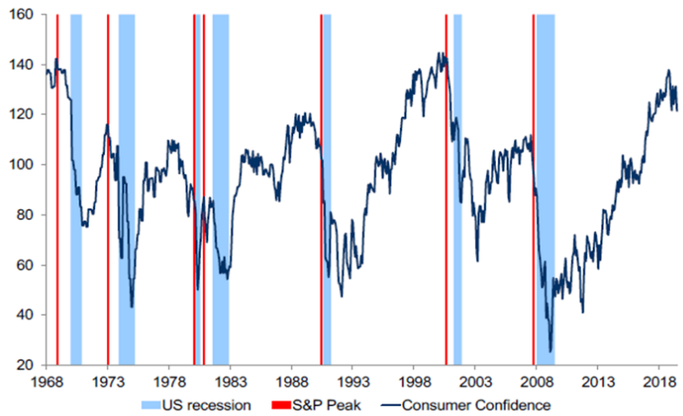
Executive Summary

- **Economic momentum**: Morgan Stanley's widely followed proprietary US Cycle Indicator model has predicted the beginning of the downturn for the first time since 2007 already two months ago. Recent softness has caused their model to switch to 'downturn', where data are 'above trend but deteriorating'. This phase-change has historically meant a worse backdrop for returns and higher chances of recession or a bear market.

US Cycle Indicator

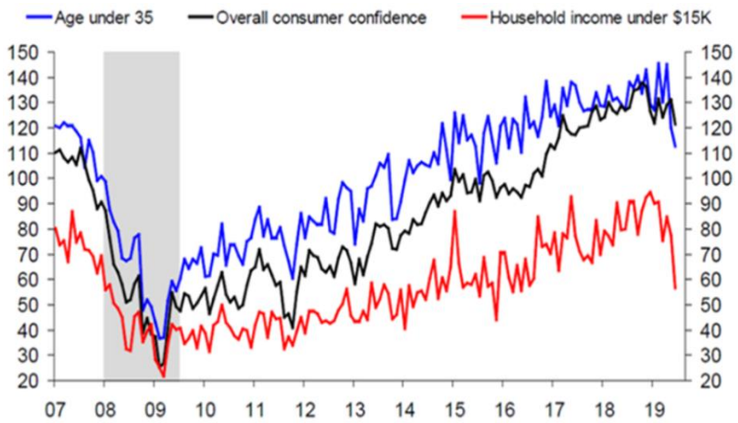
- **Consumer confidence**: it is still holding well as we have seen above, but how long for? In late 2015/early 2016, the industrial side (representing about 10% of the US economy) was in recession, but the consumer was unstoppable, so the Economy continued to motor along in expansion. The US consumer is roughly 70% of the economy, and the US cannot be in a recession without its participation. The fastest way to stunt consumer behavior is to hit them in their pocketbooks, and that comes through the labor market. More than 80% of American households rely on labor market income. On average a peak in consumer confidence has occurred 15-month ahead of US recession and 8-month ahead of S&P peak.

Consumer Confidence (blue)
S&P500 Peak (red area) vs US recession (light area)



Additionally, consumer confidence among younger & poorer Americans has deteriorates significantly in recent months.

Overall Consumer Confidence (black)
Consumer Confidence Age under 35 (blue)
Consumer Confidence Income under $15k (red)



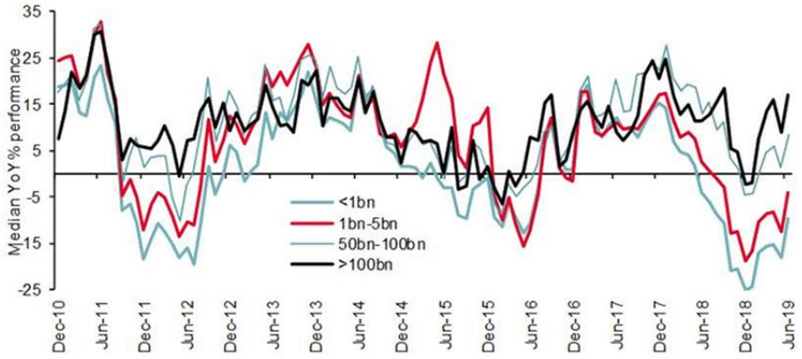
Executive Summary

- **Liquidity**: There have been quite a few headlines recently surrounding "liquidity issues", which might be surprising given the strong performance of asset markets this year. That investors flee at the first sign of a problem appears to confirm that investors are shuffling towards the exit door, in anticipation of a need to leave the party in haste.

  The chart below splits a very large global universe of 17000 stocks into market-cap grouped portfolios and measures their median annual performance over the last 12 months. The mega-cap group (above $100Bln) is powering ahead whilst those in the sub-$1Bln market cap range are still struggling to make back last year's loss.

  The more remarkable numbers, $100Bln portfolio represents just 77 companies but 27% of the global market cap. Meanwhile that sub $1Bln represents 7% of the market capitalization yet over 11,000 companies, or 65% of total numbers. And this is the problem, our increasing focus on a few large cap indices populated by just a fraction of the world's companies is giving investors a false impression.

Perfomance US stocks
Mkt cap over $100Bln (black)
Mkt Cap $50-100Bln (light)



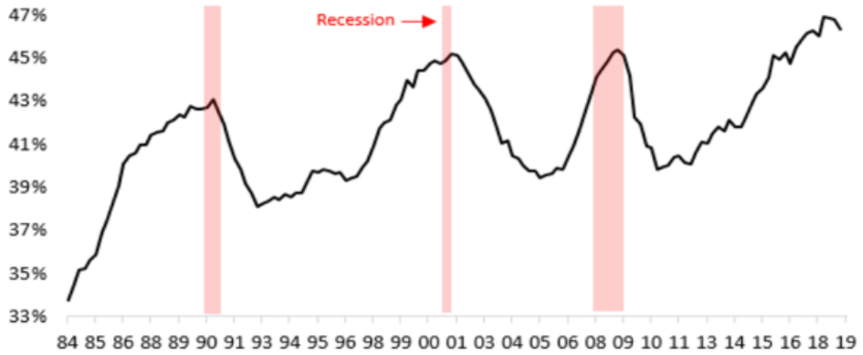
- **Increase issuance on Credit markets and quality of debt**: we are experiencing a rapid increase in issuance volumes and it will likely put some strains on Credit spreads over the next months.

  More than half of the $5.6 trillion US Investment Grade bond market is now rated in the BBB tier, the lowest rung of the grade and the gap between BB rated and BBB bonds has evaporated.

  About 6% of BBB-rated companies, or approximately $200Bln in par value, currently trade at levels closer to HY than to the BBB spread curve according to the IMF. If credit agencies effectively downgrade these firms (in case of economic downturns in 2020), the US HY could face **liquidity issues** due to fire sales of rating-sensitive investors.

  Corporates are already facing a very hefty increase in their cost of capital, their trailing 5-year average is at its highest level since the early 1980s.

Corporate debt as as percent of GDP (black)



Executive Summary

Investors need for yields was found in US credit. The demand for credit pushed yields lower, which in turn incentivized companies to issue more debt.

We find examples of problematic non-financial credit quality are widespread, for example, in the loan market, where leverage levels, covenant quality, and structures are in many cases weaker than 2007 extremes, and in IG, where leverage is already near historical peaks, before earnings growth has rolled over.

Moody's Investors Service said covenant quality for 2018's last quarter was close to a record low, and the rating company sees no signs of improvement this year. One big concern is that borrowers can now easily move more collateral out of the reach of lenders, which translates into bigger losses in a downturn.

Even in Europe, companies have used the leveraged loans market, a field usually dominated by firms owned by private equity funds.

- **IPOs / Secondary/ Placing**: US companies such as Venture Capital firms are still seeing an opportunity to cash out and they are all rushing to go public before this window of opportunity is closed from a repeat of last year's correction.

  Annualized, the value of US IPOs during the first six months of this year exceeds the previous high seen in 1999 at the peak of the dot com bubble.

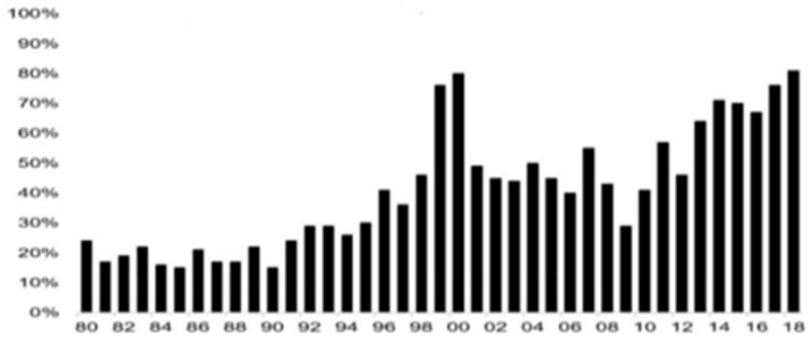
  Unfortunately, performance is not great as the number of IPOs that lost money is marking a new record high. The problem lies both in the number of deals the market can absorb but also more importantly in valuation/pricing as this chart is showing. As an example, Lyft is down 36% from the Ipo price and Uber down 28%.

The next one could be WeWork which now runs offices in 111 cities worldwide with 527,000 members paying fees for access to a shared workspace in 29 countries across the world.

In the prospectus the company warns: "We have a history of losses and, especially if we continue to grow at an accelerated rate, we may be unable to achieve profitability at a company level … for the foreseeable future."

The share sale will be the latest test of investors' appetite for fast growing companies that are making huge losses.

% IPOs with negative earnings



Macro

Global growth continued to decelerate in July and August, with Global Current Activity Indicator index, an alternative measure of GDP, tracking 2.7% (was above 3% until May, 2.5% Global recession threshold).

So far, we were proven right being pretty bearish on the Global Macro outlook. Despite the latest negative data on Global PMI, still below 50 (contraction) for the third consecutive month, Global new orders and employment (still weak), we could soon witness a stabilization of Macro numbers, after an unprecedented descent in Global PMIs. Interestingly, China and US composite PMIs are not in contraction territory, and the Global PMI has shown the first small uptick thanks to China latest positive numbers.

Number of consecutive months of falling PMIs (grey area)
World Manufacturing PMIs (red)

Correlation US Macro Surprise (red) vs S&P500 (blue)

Europe

Probably among the most worrisome region, with Germany leading the decline. On average Manufacturing PMIs are weak while Service and Composite PMIs are more resilient among EU Countries. The latest August Composite PMIs are positive and above consensus for Germany, France, Spain while Italy and UK are lagging.

Positive Germany numbers:

-Composite PMI August 51.7 vs 51.4 consensus
-Service PMI August 54.8 vs 54.4 consensus
-Retail Sales July 4.4% vs 3.3% YoY consensus

Negative Germany numbers:

-Zew Survey Expectations July -24.5 vs -22 consensus
-Zew Survey Expectations August -44.1 vs -28 consensus (consistent with GDP contracting 0.2% in Q4)
-IFO Expectations July 92.2 vs 94 consensus
-IFO Expectations August 91.3 vs 91.8 consensus
-Q219 GDP revision -0.1%
-Factory Orders July YoY -5.6% vs -4.2% consensus vs -3.6% prior
-Industrial production July YoY -4.2% vs -3.9% consensus

Macro

Usa

Mixed bag of data in July and August, with a still strong consumer spending which is the driving force behind growth in the current and latest quarters. Q3 GDP is tracking 2%, below previous growth but still above recessionary thresholds. Trade war potential escalation likely to affect growth.

Positive numbers:

-Empire Manufacturing August 4.8 vs 2 consensus
-Philadelphia Fed business August 16.8 vs 9.5 consensus
-Consumer Confidence August 135 vs 129 consensus
-Retail Sales July 0.7% vs 0.3% consensus
-Personal Consumption Q2 4.7% vs 4.3% prior/consensus
-Personal Spending July 0.6% vs 0.3% prior
-Durable Good orders July 2.1% vs 1.2% consensus
-ADP Employment change August 195k vs 148k consensus vs 156k prior
-Factory orders July 1.4% vs 1% consensus
-ISM Non-Manufacturing Index August 56.4 vs 54

Negative numbers:

-ISM Manufacturing August 49.1 vs 51.3 consensus (the lowest since 2016)
-ISM New orders 47.2 vs 50.5 consensus
-Personal Income July 0.1% vs 0.3% consensus
-University Michigan 89.8 vs 92.4 consensus
-Industrial production MoM July -0.2% vs 0.1% consensus
-New Home sales MoM July -12.8% vs 0.2% consensus

China

Weaker July followed by a firmer August, with Current Activity Indicator tracking 5.8% from 6.1% in June. Data set to improve from the current counter-cyclical fiscal easing and further extraordinary measures. Same considerations for US on trade war.

China State Council release is the strongest loosening message in 2019, to avoid a further slowdown in the Economy, or even worse a recession. Among the expected measures China should provide: A) additional banking reserve ratio cuts, (Required Reserve Ratio), to increase banking lending activity B) lower interest rates to spur growth in the real Economy, basically decreasing the Medium-term lending facility and the Loan-prime rate C) boost government spending in fixed asset investment via new issuance of special purpose bonds (railways, highways etc.).

Positive numbers:
-Composite PMI August 51.6 vs 50.9 prior
-Non-manufacturing PMI August 53.8 vs 53.7 consensus
-Industrial profits 2.6% vs -3.1% prior
-Caixin PMI Services August 52.1 vs 51.6 prior
-Caixin PMI Manufacturing August 50.4 vs 49.9 prior
-Caixin PMI Composite 51.6 vs 50.9 prior

Negative numbers:
-Manufacturing PMI August 49.5 vs 49.7 prior
-Retail Sales July YoY 7.6% vs 8.6% consensus
-Industrial Production YoY 4.8% vs 6% consensus

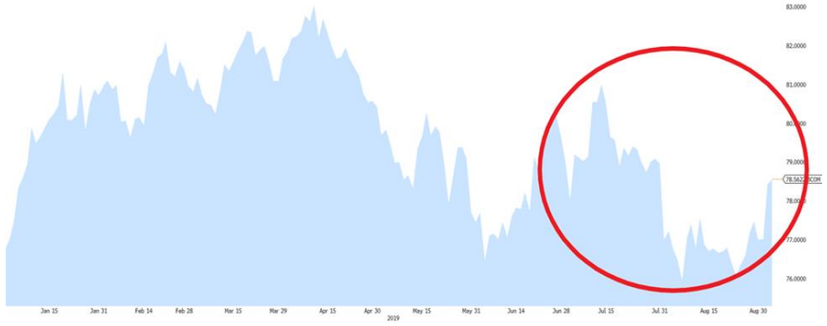
Commodities

We are currently **neutral-positioned in the short/mid-run** until global growth rebounds.

Since our last newsletter, the Bloomberg Commodities index decreased approximately 3%, although still up 2.3% year-to-date. US-China trade war escalation, uncertainties about global growth, free-falling nominal/real interest rates, multi-year low inflation expectations, Technical, seasonality and Geopolitical issues were the main reason for the recent slowdown.

Among its leading components, Gold (+10%) and Silver (+25%) delivered a staggering performance, while Oil (-7%), Natural Gas (drawdown -17%), Copper (-4%), Soybean (-6.5%) and Corn (-22%) underperformed during the last two months.

Bloomberg Commodity Index



Oil

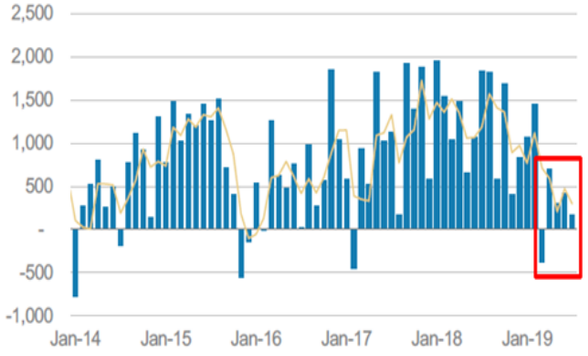
We reiterate our neutral position in the short/mid run. Fundamentals, Technicals, Macro and Geopolitical events seem to be providing conflicting signals to take meaningful actions.

Still one of the best asset class year-to-date with WTI up 25% (down 7% since last update) and Brent up 14% (down 9% since last update).

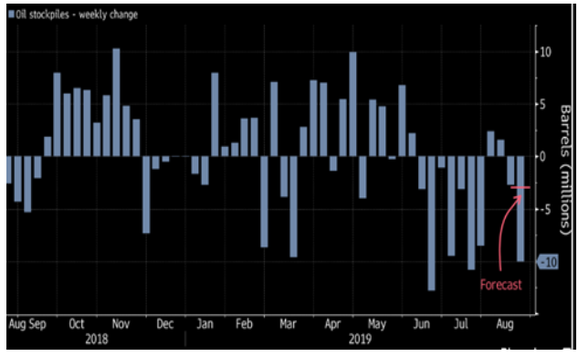
The Oil underperformance in August, after a flattish July, is mainly explained by: A) the escalation of US-China trade war (China planning to set tariffs on US Oil along with risk-off mood) B) weaker demand for Oil due to strong uncertainties on global growth (the market is currently pricing 0.85 mb/d YoY average global demand growth between Q119 and Q220, the longest stretch of weak demand since 2011-12) C) negative gamma effect (Oil prices traded through strikes of large option open interest) D) Demand/Supply imbalances (some weak data probably attributed to a collapse in exports in July/August)

As shown in chart below, world oil demand growth decelerated in July, with weakness in China and Japan partly offsetting growth in the US, India, South Korea and Brazil.

World Oil Demand Growth



US Crude inventories fell the most in August



Commodities/ Forex

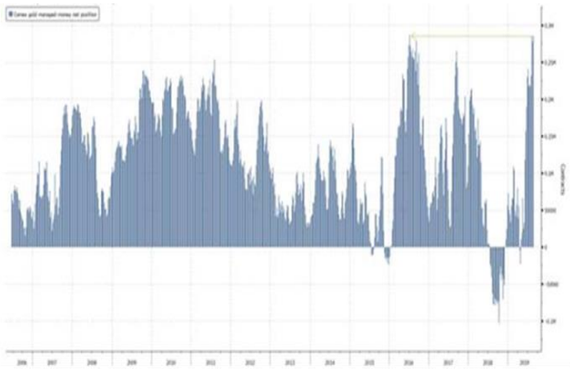
Gold

In our last newsletter, we recommended to buy or overweight Gold, (up 17.5% Ytd), because we were waiting for lower interest rates, inflation expectations and a turbulent market. Looking at the Gold performance in the last two months, +6.5%, we would believe to have called the market quite well..Since our initial call as of October 2018, Gold bounced +27%..amazing performance...Now we would recommend to decrease exposure to gold in the short run.

In the past few weeks, we started to witness some consolidation which quickly reversed with the market sell-off. As the ultimate safest asset, it is quite normal to seeing an additional squeeze on global risk-off; However, we strongly believe that the current risk-reward is not good enough to buy at current Gold levels.

Investors currently have the highest long positioning on Gold on record, matching the highest estimates since 2016.

Gold net positioning



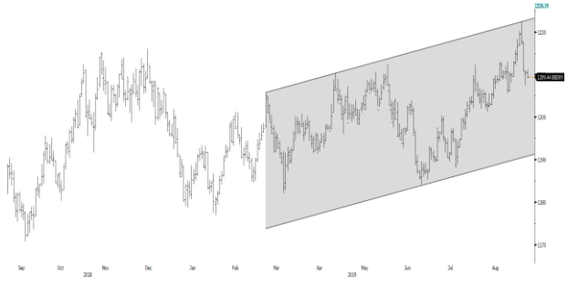
Global Negative Yielding bonds $Bln (blue) vs Gold (red)

US 5Y Real yield inverted (red) vs Gold (blue)

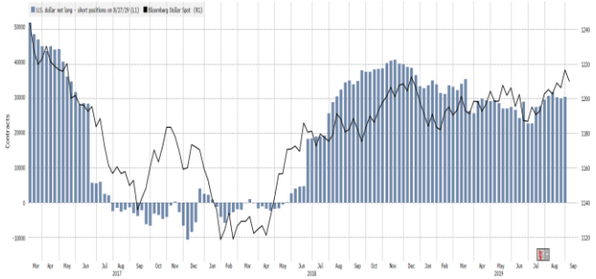
Forex

We are currently neutral in the short/mid run. Since our last update Usd gained up to 3% vs Eur to lose some 1% in the past week (Equity market melt-up, risk-on mood), since investors still perceive Usd as one of the safest safe haven currencies.

USD trend bull channel



USD positioning (blue histogram) vs USD (black)



Investment Idea

Current Investment Idea

Call replacement on single names/sectors

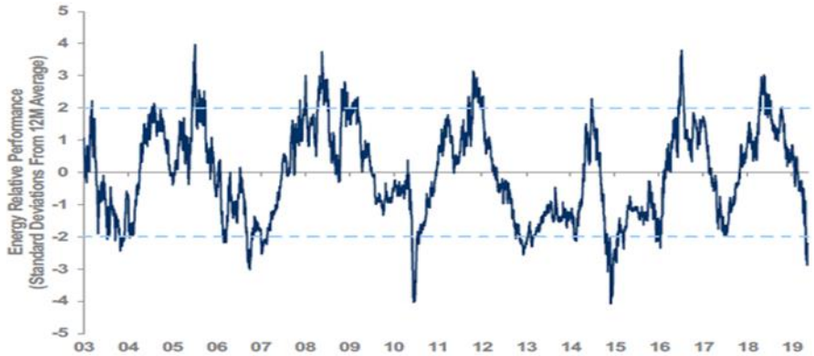
Already last month we suggested to take advantage of the low volatility, replacing some of single names with Calls in order to better protect the portfolio in a downturn phase and still being able to participate to the upside.

We would additionally suggest to increase the portfolio weight with some cheap Index Calls, as the market is very binary now and nobody can afford missing the upside with a low weight.

Long European oil sector, SXEP

Relative (vs Eurostoxx 600) or absolute market call. The EU Energy sector is up 2% Ytd only and cheap on most valuation metrics. Energy has not been so much oversold in relative terms in almost 5 years, at 3 standard deviation, a level it reached only 3 times in the past 15 years!

Energy relative performance with standard deviation from 12-months average

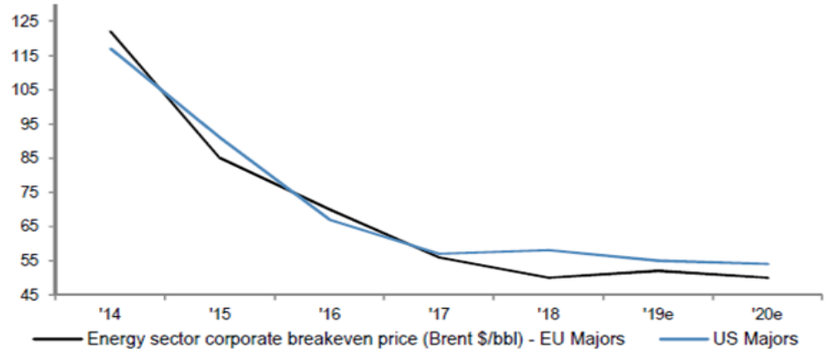


Improved Capex discipline has supported stronger cash flow generation for the sector. Past margin pressures have forced the Energy sector to undergo restructuring which resulted in lower breakeven prices, and a better ability to handle volatile commodity prices. We should therefore expect the sector to continue to deliver strong earnings.

The European energy sector has slumped faster than oil prices breaking a long-term correlation.

WTI crude futures (black) vs Stoxx 600 Oil & Gas (blue)

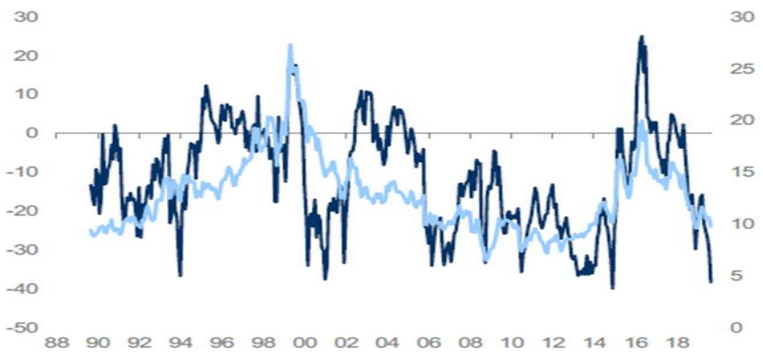
Energy sector breakeven price



Investment Idea

In terms of valuations, the current 12-month P/E is at 9.8x, down to levels vs the market that have typically represented a trough for the sector.

Absolute (light) and relative (dark) to MSCI 12-months P/E



The gross dividend yield for the sector is an interesting 5.3%, excluding the positive buyback effect which, on average, gives you another 3-4% yield. It is a rare Value sector seeing strong EPS revisions and Macro data remains favorable.

Long European Auto sector, SXAP

The Cyclical Auto sector has greatly underperformed global markets and possibly got the lowest exposure among all other cyclical sectors. It is the fourth European most oversold sector (down 2 standard deviation from 12-month average).

It underperformed since the first tariffs launched by Trump last year, but there were many negative catalysts aligning all together. To name a few: diesel gate, compliance issues with increasingly harsh Co2 emissions regulations, slowing Macro affecting demand and of course, several profit warnings.

Most major carmakers reported very weak growth, guiding to weaker outlooks.

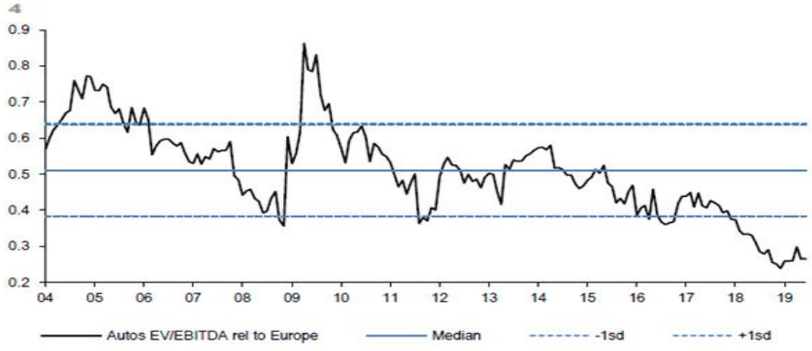
However, even if we are approaching Autumn, we are starting to see some first green shots on the sector.

This week we had good August US sales helped by low rates on credit and a stabilization (despite the negative Macro) of German car sales in Europe.

Defensive positioning is at an all-time high while Cyclicals are at an all-time low… a long Auto sector position has still some risks but we believe that the risk-reward is for the first time positive in a long period.

One of the issues is the upcoming fleet electrification but now Porsche is releasing the new Tacan, which is an important milestone, with already 20K orders in few days for a car that would definitely be better than a Tesla (at a higher price). This is the onset of a revolution within European cars.

Relative performance, standard deviation vs 12-month average



Investment Idea

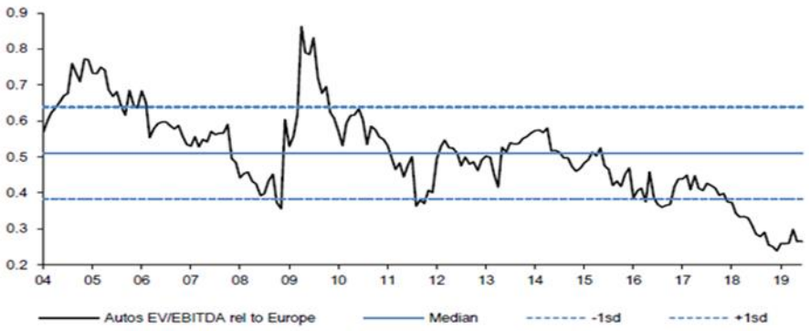
Valuation shows forward P/E of 6.5x, less than half of MSCI Europe, suggesting that bad news are already priced in.

Based on 10-year valuation across P/E, DY and PBV, the sector was only cheaper in early 2001.

China accounts for 30-40% of European manufactures EBIT. Given the sector's high operating leverage, any improvement in China activity would be supporting. In addition, China is exploring ambitious new plans for the future of its car industry, weighing a target for 60% of all automobiles sold in the country to run on electric motors by 2035.

Strong labour market and rising wage growth should keep US car sales fairly elevated in the near term.

European Autos EV/Ebitda relative to MSCI Europe



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