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Monthly Market Update

Monthly focus on Financial Markets

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Contents

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Market Analysis

After correcting in August, the market bounced during the month of September with all main indexes recovering the loss and closing the quarter on their highs.

We rightly predicted the move but we got increasingly cautious at the end of September as market was once again pricing the same “perfection” we had at the end of July.

We mentioned last month “everyone is now bearish and the pain trade seems to be on the upside”. At the end of Q3, it felt very similar to last year in many ways. The S&P 500 was near its all-time high at 3000, while the MSCI EM Index and the Topix were 20% and 15% below their highs and the Eurostoxx 7% lower, leaving all these indices exactly where they traded a year ago.

But there are important differences too. Cyclical stocks have completely reversed and trade 20% lower than last September, while long-duration sovereign debt has been the best investment by far over this period, with 10-year Treasury yields 50% lower than just 12 months ago. To put this into context, over the past 50 years such a dramatic move in yields over the prior 12 months has only happened twice (during the global financial crisis in 2008 and the European sovereign debt crisis of 2011-12).

The September Equities bounce masks a much more complex situation underneath and the “pain trade” has been once again higher than what is perceived looking at index performances.

In September there has been pain in the Momentum factor trade, as evidenced in the 6-sigma move a couple weeks back (caused by the short-leg outperformance) but then, more recently, it has been the “expensive long-leg” which has caused the pain and finally, the private market with the IPOs.

P&L has been destructed in Public, Private and IPO markets, and negative flow factors.

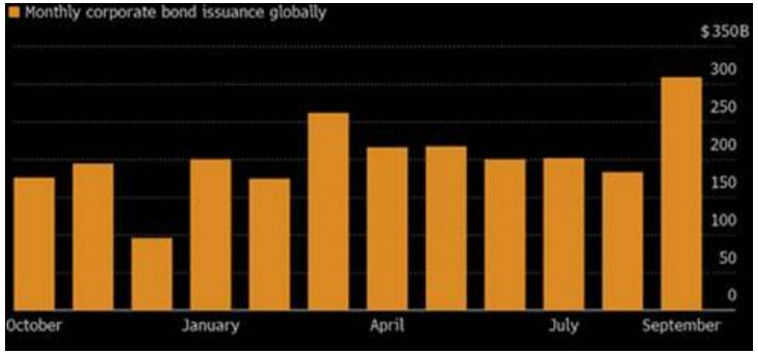
On the Bond side of investment, we had a significative bounce on Yields helped by a more hawkish than hoped message from Central Banks and fundamental repricing of growth given by more optimistic Macro data.

Market-based measures of inflation expectations, closely followed also by central banks, have somehow bounced from an all-time low reached in June but are still very depressed in absolute term.

Companies have issued more than €6.5Bln euros of new bonds in 2019 at negative yields and there has been a rush of sales of bonds taking advantage of this window of opportunity. Companies globally sold a record amount of bonds in September, the first time ever which topped $300Bln.

Interestingly global bond sales are on track to reach $2Trln this year.

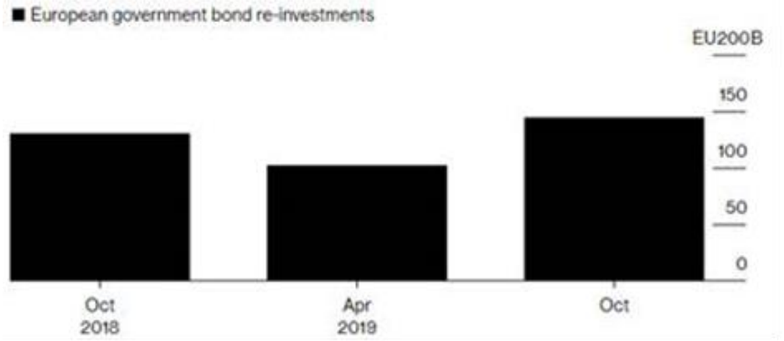
Monthly corporate bond issuance globally



Market Analysis

Investors will get a boost in October even before the QE begins. European debt market will receive cash flows of almost €150Bln this month from bond redemptions and coupon payments.This extraordinary month will exceed even the bond payouts we had in October last year. France will pay out the largest amount with €55Bln between bond redemptions and coupons.

European Government bond re-investment in Bln€



Fixed-income assets have provided much-needed portfolio protection over the past year, and both government bonds and corporate credit have performed well from a risk-adjusted return perspective. But as a result, bond yields across the fixed-income universe have now fallen significantly.

This truly is an amazing time to be alive and witness one of the biggest global bond bubbles in the making.

Ultra-low bond yields mean fixed-income assets are not uniformly secure. As we explained over the last meeting and monthly Investment Committee, corporate credit has rarely been this rich relative to equities. Corporate credit is not attractively valued relative to sovereign bonds either. The significant fall in sovereign bond yields has also been accompanied with compression in credit spreads. As a result, corporate credit is not particularly cheap relative to sovereign bonds either.

Historically such low levels of credit spreads have been followed by periods of weaker returns. Given the low level of overall corporate bond yields and credit spreads the risk-reward in corporate credit no longer looks attractive.

European HY default rate is low by historical standards but it is starting to trend higher. So far, the notional defaulted Eur-denominated debt amount to almost €3Bln of which Thomas Cook accounts for almost one third. Given the Macro scenario, it is likely we will see the European HY default rate increasing in the next few years.

12-month European HY Default rate

We have therefore started to reduce bond exposure in a multi asset portfolio as the risk-reward trade-off is no longer as favorable as it was. While maintaining government bond and linker exposure, we are reducing the corporate credit exposure in our asset allocation model.

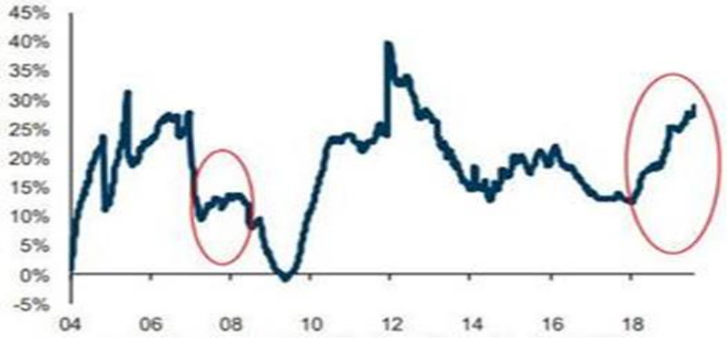
Market Analysis

Coming back to Investor's positioning, recent inflows into Bonds has been extreme.

Record 3-month inflows into bonds

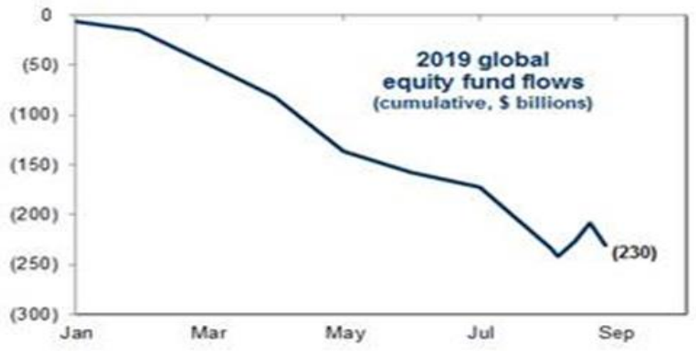
Global Government bond inflows currently amount to 16% of AuM currently vs 4% during last recession (and with current extremely low yields).

Global Govies bond inflows



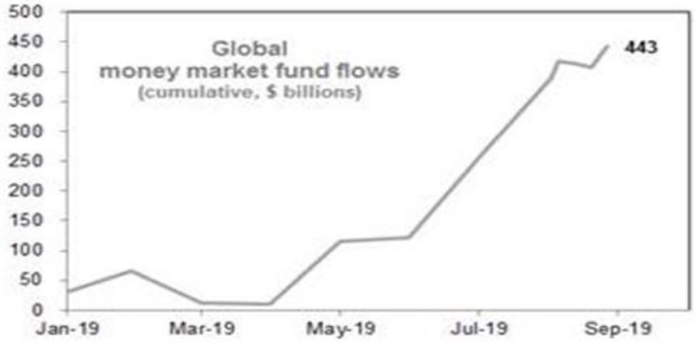
Global Equities outflows registered -$22B last week and outflows are now up to -$230B Ytd.

2019 Global Equity fund flows



Money Market Funds registered +$36B worth of weekly inflows, a massive number. Money market (fear factor) are now up to +$443bn Ytd or $550+bn annualized. Similarly, Gold funds and futures registered the largest weekly inflow in 3 years.

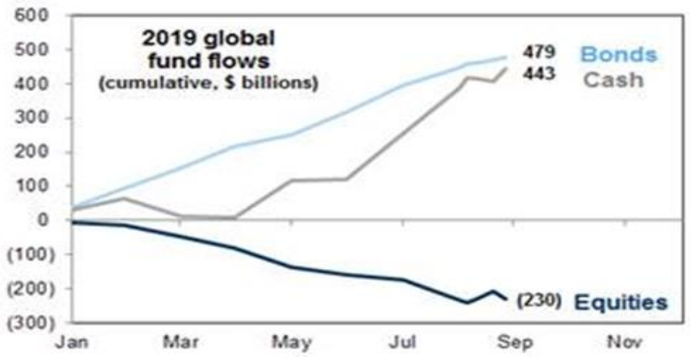
2019 Global Money market fund flows



Market Analysis

If you compare flows on Equities, Bonds and Cash (Money market), the result is that the Equity positioning is extremely light on Global Asset allocations.

2019 Global fund flows



If you isolate, European Equities, the situation is even more extreme as we have seen Equity redemptions in 72 out of the past 75 weeks (starting April 2018). Since April 2018, EU Equities have seen a -13% reduction in AUM. European Equities have seen -$106B worth of Ytd redemptions or -46% of total global equity redemptions!

Looking at **Hedge Funds exposure**, while we were reporting over last newsletter that HF 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.

The current situation is instead showing that Gross Exposure for Hedge Funds is near the 100th percentile and Net Exposure being between the 55th and 100th percentile. The breakdown we saw in the Momentum Basket (with huge short-covering confirmed that), the Short leg up 2x more than the long leg.

Gross leverage is lower than last year, reducing the need to panic de-risk and convexity on the downside.

Active Funds have lost 71bn$ of assets in redemptions Ytd and 2.2bn$ last week, which is about 8% of AuM vs the start of the year!

These numbers are quite important, think about the fact that Active Funds have lost for redemptions an amount equal to 1% of all volumes traded across EU exchanges Ytd. We are witnessing the biggest January to September Active Funds outflows of any calendar year!

Looking at the full picture we should also consider that investors are better hedged with options/futures this time around owning almost $7bn of put delta as we enter Q4 (vs. $4.5bn this time last year, or $2bn this time 2017) so less likely to hit the panic button.

And finally, there is some P&L “cushion” there to avoid major panics. L/S HFs up 8% YTD (best YTD since 2009), the most actively held Mutual Funds stocks up 19% (vs. benchmark up 16%), Multi-asset funds are +9% (best year since 2009) and all HF groups in aggregate are +6% (best year since 2009).

While we were expecting this correction (as described on our daily updates: https://colombo.swiss/), **it is not all gloom and doom on the equity space as we actually believe that by the end of this month we will have a nice opportunity to participate to the year’s end rally.**

The situation is different from last year, we will not have a 15% drop from the beginning of October to the end of December.

We are instead reducing bond exposure in a multi asset portfolio as the risk-reward trade-off is no longer as favorable as it was.

Earnings

In about 10 days will start the Q3 earning season.

Real-time indicators like the PMIs and ISM indicate that global growth is likely to decelerate in Q3.

Even with 19 out of 33 Central Banks we follow cutting interest rates today, the recent GDP growth estimates are showing a high risk of recession. If tariffs on all imports from China rose to 25% and China responded with countermeasures, the global economy would likely fall below 2.5% in 2-3 quarters.

Consensus estimates look unrealistic on S&P YoY EPS growth.

2019 S&P Earning consensus estimates

With blackout looming, several firms are speeding up to revise their guidance down. So far, it seems to us that Industrials and Chemicals, respectively Cyclicals and Value stocks, are the most exposed to the global slowdown.

During the past few days, **we saw a massive number of profit warnings flooding into the market.**

Fedex (Transportation & Logistic), which slashed its full-year profit forecast two weeks ago, British Airways (Airlines) cut its forecast and its capacity growth in a deteriorated environment. In the Steel industry, United States Steel and Salzgitter adjusted their earnings forecast while, in the Industrial segment, Corning (Tech-Telecom equipment), Kuka (machine manufacturer), Wartsila (power plant solutions), Pfeiffer Vacum Tech (pump manufacturer) announced sharp profit warnings for this year. In the Chemical industry, K+S (Agricultural) and H.B. Fuller slashed production numbers and revenues. Some interesting surprises in the Defensive Value space, after Imperial Brands (Tobacco) warned about missing revenues in the vapour category and Pearson (Publishing) cut EBIT due to structural issues.

On the semiconductor US blue chip, we had the profit warning of Micron, which lowered its guidance mainly due to global trade tension and global slowdown which could extend the memory-chip industry slump. They reported a 42% YoY increase in inventories heading into the seasonal slowdown with sales down 42.3% YoY. Gross margins guided to 25% from 60% a year ago. We believe Micron might be the the first of a series of Semis downgrade mainly due to Macro deterioration, global slowdown, lower Capex etc.

Considering the Macro deterioration, rising input-cost and margin erosion trends, we would be surprised not to see several other companies cutting final-year guidance (being smashed on announcement) as the Q3 earning season is set to kick off on the 16th of October. Will Q3 deliver the so much discussed earning recession?

Central Banks

September was the month of global Central Bank meetings. While Developed markets Economies delivered a more hawkish message than market expectation, Emerging Markets delivered a net 11 cuts last month out of 37 Developing Economies.

No surprises from the Fed which announced a 25bps cut (vs some brokers pricing 50bps cut) for a second straight meeting, current Fed Fund rate at 1.75-2%, and also lowered the interest paid on excess reserves by 30bps to 1.8%. The most important point was **the future trajectory which was somewhat hawkish** showing some dissent over the need for more easing, not just in 2019 but in coming years. Esther George and Eric Rosengren again dissented in favor of no cut, while James Bullard sought a half-point cut. It was the first decision with three dissents since 2016, under Janet Yellen. Current Fed Fund futures are pricing an **implied 25bps rate cut probability of 74% in October**, and 75bps rate cut probability of 25% in the next 3 meeting.

The **ECB** announced the following extraordinary measures: A) **Deposit rate cut** from 40bps to 50bps (the market was pricing 15bps) B) **More dovish forward guidance** with rates at present or lower levels until inflation converges on goal C) **Quantitative Easing is back**, up and running , with net purchases at a monthly pace of €20Bln, starting in November (interestingly, lower monthly purchases amount vs consensus €30/40Bln per month but no definite period of time) D) **Tiering** to ease the impact of lower interest rates on banks' balance sheet, exempting part of banks' excess liquidity from negative rates in two-tier system E) Cutting cost of its long-term loans to banks, lowering interest rates on **TLTROs** and lengthening maturities to 3 years from 2 years.

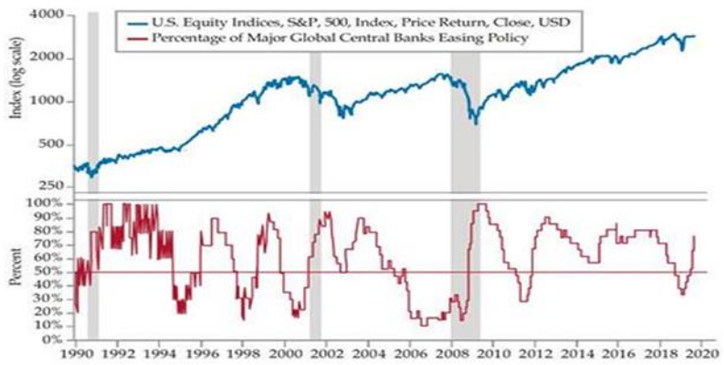
The ECB has cut rates by 10bps on 2/3 of the Eurosystem Cash (so 6.666bp of cuts) but, thanks to the newly introduced tiering system, it increased rates by 40bp on the remained 1/3 (so 13.33bp). **This means that you get a 7bps of hike and the reaction has been of rates sell-off (i.e. higher yields) and EUR appreciation vs USD**. On the other side the introduction of an open-ended QE, at face value, has the impact of flattening the whole curve. The market is pricing a 30% probability for a 10bps rate cut (to -60 depo rate) for December meeting.

Central Banks/ US Repo

A final consideration on **Central Banks as they looks prisoners of the markets**. The more stocks rise, the less Central Banks can normalize.

Central Banks are now hostages to the valuation monster they have created, as the chart below is showing.

S&P500 (blue line) vs
% Major Global Central Banks Easing (red line)

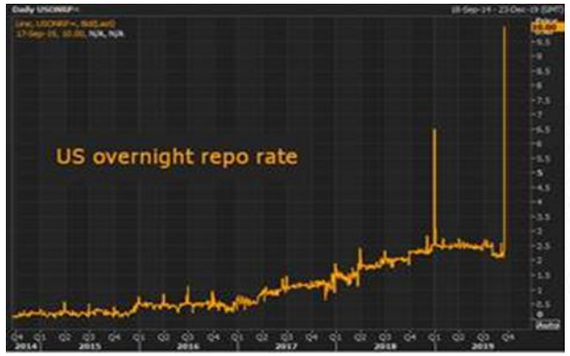


As far as US short-funding industry is concerned, the **rate on overnight general collateral repurchase agreements (REPO)** blew up to 10% in September, about four times greater than the average, for the following reasons:

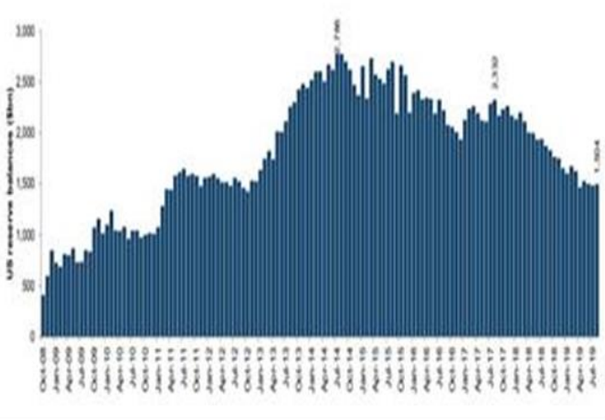
- Recent Quantitative tightening had reduced liquidity in the market
- Banking system near reserve scarcity
- Elevated US Treasury Supply (US government sold $78Bln of 10 and 30Y)
- Corporates withdrawing cash from banks/money markets to pay for quarterly taxes.

US Repo

GC US Overnight Repo Rate



US Reserve Balances fallen to 1.5Trln



The Fed managed to calm the money-market industry in the end, <u>with a program of $75Bln daily injection through October 10. The main problem here is not a potential shortage of liquidity but its maldistribution.</u> During Quantitative Easing era, from 2009 to 2015, the Fed increased its balance sheet from $870Bln to $4.5Trln, then shrinking it back, during Quantitative Tightening, to $3.8Trln. What we should focus on here, is the amount and the use of US banks' excess reserves, which increased from almost 0 in 2008 to a peak of $2.7Trln in 2014, and are currently down to $1.4Trln.

<u>The main message is that US banks do not have incentives to lend in or participate in the Repo funding segment because they are better off to put the money and get paid interest at the FED IOER rate</u> (Interest Rate on excess reserve), currently set at 1.8% (kind of a free gift). In addition, US banks are facing increased capital and liquidity charges on any short-term loan exposures (then why bother?).

So, the issue here is more structural, as the Fed should create a standing facility repo (a systematic mechanism able to prevent any rate volatility). Indeed, if you think that increasing Quantitative Easing would fix the problem you are wrong because it would just increase the US banks' balance sheet but would not change their incentives to participate in the short-term funding industry.

<u>As Fed's QT is over and market needs more liquidity to function without turbulence, Fed's balance sheet has risen by 75bn$ last week.</u>

US Fed Balance Sheet

Trade War

September was a relatively benign month for the global trade commerce.

As far as the **US-China trade war** is concerned, it seems that the situation de-escalated with several concessions on both parties. So far US has imposed tariffs on $550Bln worth of Chinese goods while China, in turn, has set tariffs on $185Bln worth of American products.

In a gesture of goodwill for the 70th Anniversary of the People's Republic of China, Trump **delayed the planned increase in tariffs** from 25% to 30% onto $250Bln worth of Chinese imports from October 1 to October 15. In return, as expected, China exempted various agricultural products from additional levies such as imports of US soybeans, pork and other farm goods. In addition, the Chinese Commission agreed to exempt 16 types of US imports from tariffs, which include products such as pesticides, animal feeds, lubricants and cancer drugs. On September 20, US released new tariff exemption lists, which excluded over 400 Chinese goods among which different types of equipment or material (chemical, mechanical etc.).

US-China high-level trade talks are scheduled to **start on October 10** in Washington. Importantly, the market has been pricing a mini-deal or, at least, a delay in the next tranche of tariffs.

China and the United States both have incentives to make a deal during next week's high-level trade negotiations in Washington, but it remains unclear whether either side will be willing to make the concessions necessary to reach an agreement.

Any potential deal during the 13th round of trade negotiations will hinge, in large part, on the true policy objectives of US President Donald Trump towards Beijing. If he wants to isolate and contain China, then he may walk away from a possible agreement, as he has done before.

China may also be unwilling to make sufficient concessions to meet US demands, having themselves walked away from the outline of a potential deal in May because it was seen as infringing on the nation's sovereignty.

As far as the **US-Japan trade war** is concerned, both countries have agreed an initial trade deal that will eliminate or lower tariffs on certain products between them. The current trade deficit between US and Japan accounts for as much as $68Bln in 2018. Duties and levies will be reduced or lowered on agricultural products, food on both sides while a special treatment will be reserved for some digital products such as videos, music, e-books etc.

As far as the **EU-US trade war** is concerned, the World Trade Organization allowed US to impose $7.5Bln worth of European exports annually in retaliation for illegal state aid (from EU) to Airbus. The USTR will impose 10% tariffs on civil aircrafts and 25% tariffs on cheese, wine, Scotch whiskies, olives, butter, yogurt, pork products and some other industrial items from European Countries with start date due on October 18. This move is likely to force the **European Union to retaliate**. We then see a strong risk that the situation might escalate, with the European Auto industry the next US target.

Geopolitics

US Impeachment

The current formal impeachment enquiry of Trump is likely to last for a very long time, have unpredictable consequences either in domestic or foreign geopolitics and add additional turbulence to market in 2020.

Without any doubt the market was not scared of the news, muted with no real strong risk-off behavior, since **the probability of Trump being convicted is currently very low**. To be impeached, Trump should be convicted in the Senate with two-thirds majority when Republicans hold 53 of 100 seats (sounds very unlikely).

It is also very unpredictable how Trump would behave in domestic and foreign policy, given an impeachment process. The optimists would argue that Trump would get on his knees to be re-approved (means rising Equity markets), seeking an intermediary solution with China. The pessimists would answer that Chinese could afford another year of below trend growth (Xi Ping is elected for life) while Trump would have to retaliate not to lose credibility to his own people.

Markets are not very much prepared for an adverse resolution.

Brexit

The tone of the EU-UK talks has become more constructive.

The UK Supreme court ruled that the recent prorogation of parliament was unlawful, void and of no effect and urged politicians to reconvene as soon as possible.

A law designed to stop a no-deal Brexit on 31 October has been passed. If a deal is not agreed between the UK and EU by 19 October, and MPs don't vote in favor of leaving with no deal, then the **prime minister will be legally obliged to ask the EU for a Brexit delay**. If there **is no new deal, and the prime minister refuses to seek an extension there is likely to be a legal battle**.

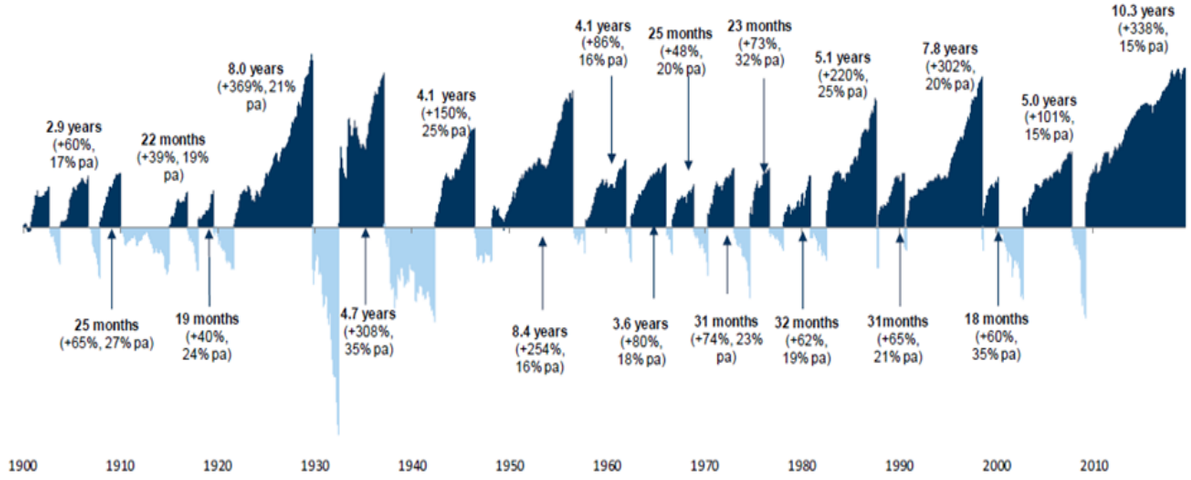
The default position is still that the UK will leave the EU on 31 October at 23:00 GMT.

In a controversial move, **Johnson is expected to set out his proposals for a Brexit deal** in Parliament later, while EU leaders also consider their response (Juncker already said that there some problems) and **probably closing the Parliament again next week**.

Executive Summary

The duration of the current US economic expansion is now the longest than any of the 13 last expansions since 1933 and the global economy looks to be close to reverting to a lackluster growth. We are in the longest bull market without a 20% drawdown on S&P.

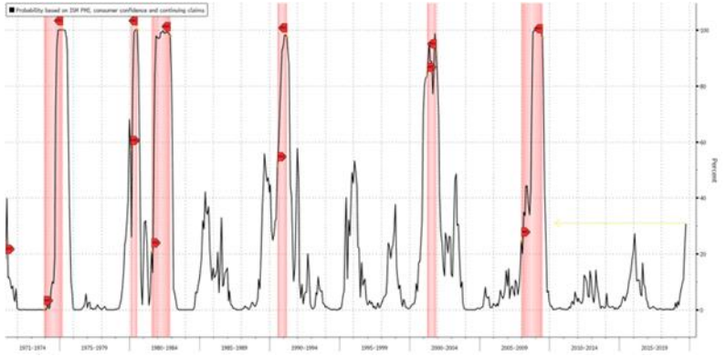
S&P500 Business Cycles



Over last newsletter we have dig down and find the first signals showing a potential recession. Now we had some bad macro data and market is increasingly pricing the recession scare for next year.

The probability of US recession given by the aggregate message given by ISM, PMI, Consumer confidence and continuing claim comes out to 31%, the highest since last recession of 2008/2009.

Probability based on ISM PMI, consumer confidence (black) vs Recession (red area)



Consumer confidence (mainly in US) was the only macro factor which was giving a positive message last month, indicating that the largest component of GDP growth remains strong and could support overall activity even if weakness continues in investment and manufacturing.

We asked ourselves if it was going to last.

<u>The answer now is that is not holding as well as hoped and is giving us the first signals of cracking.</u>

US consumer confidence slumped to a 3-month low posing a risk to the household spending that is underpinning growth and showing the <u>biggest decline in “Jobs Plentiful” component of the US Consumer confidence since 2001. This new data is starting to be a bit concerning especially considering that Equities have a very strong correlation with consumer confidence data.</u>

Executive Summary

There is also a high (inverse) correlation between the unemployment rate (still at multi-year lows) and Equities. A potential increase of unemployment would trigger a cycle peak.

MSCI World (light) vs
OECD Unemployment (blue)

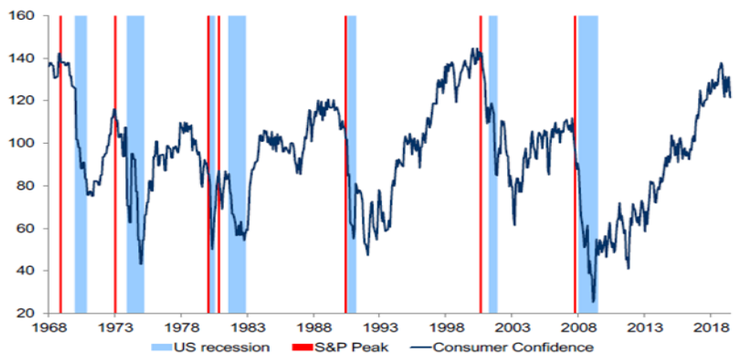
In late 2015/early 2016, the industrial side (representing about 10% of the US economy) was in recession, but the consumer was unstoppable, so the economy continued to motor along in expansion.

<u>The US consumer is roughly 70% of the economy, and the US cannot be in a recession without its participation.</u>

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 consumer confidence peak occurred 15-month ahead of US recession and 8-month ahead of S&P peak.

S&P500 peak (red) vs
US Recession (blue) vs
Consumer Confidence (black line)



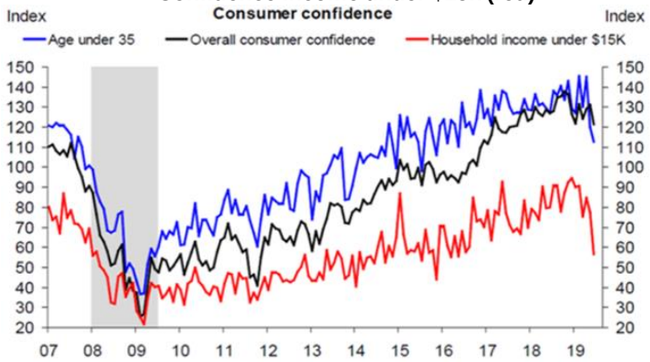
The US Ceo confidence in the economy 1 year from now vs the Consumer confidence has reached the lowest point since 2009!

Ceo Confidence vs Consumer Confidence

Executive Summary

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

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



As we wrote above, we were expecting a market correction and as usual is very short in time and sharp in performance.

We are still 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.

We are not extremely bearish on equities and we actually believe that it will be interesting to use this correction in order to increase the weight on the main liquid asset class that might provide a decent return in the medium term (if traded well reducing the volatility).

In order to reduce cyclicality, we would focus towards stocks that offer an high and resilient FCF yield, quality not expensive (trading below multiples of 25x P/E) and oversold stocks already pricing recession.

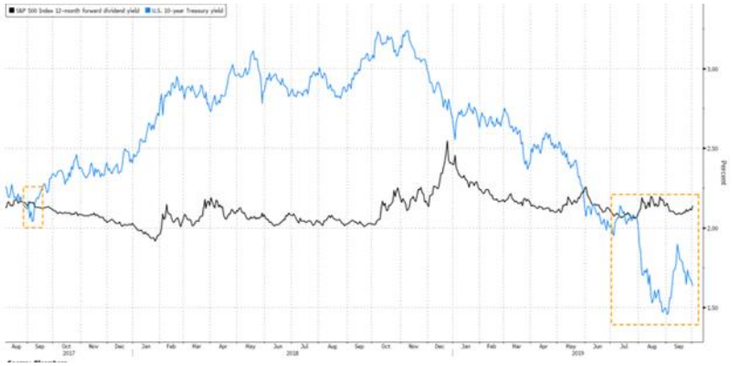
We would also use eventually part of the cash we have prepared over the month in order to selectively buy interesting names and we would use further Gold weakness to start a new position (from 1450 to below) having called very well the top.

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 (4):

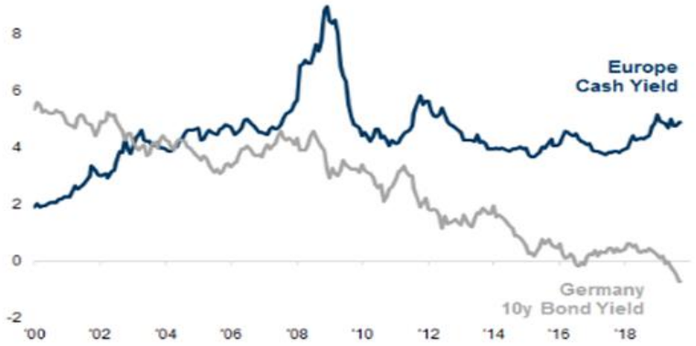
- **Attractiveness of Equities**: Negative-yielding debt makes up 30% of debt globally, with the Euro area driving the most recent rise in negative-yielding assets. In contrast, the earnings yield on SXXP is above 7% and dividend yield alone is 4% showing that there is no lack of yield in Equity. While some closure of the gap 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.

S&P 12M forward dividend yield (black) vs US 10Y yield (blue)



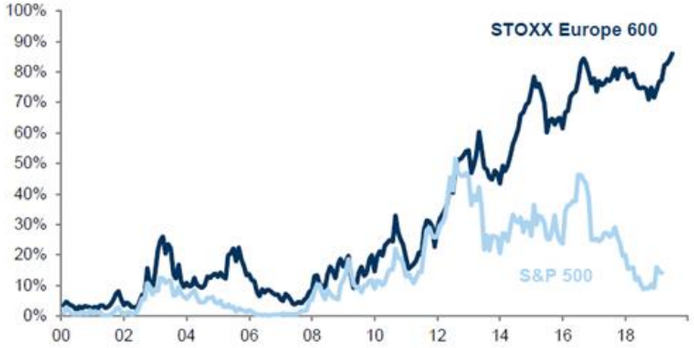
Executive Summary

European Equity Cash Yield, dividend, buyback (blue) vs German 10Y Treasury yield (grey)



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

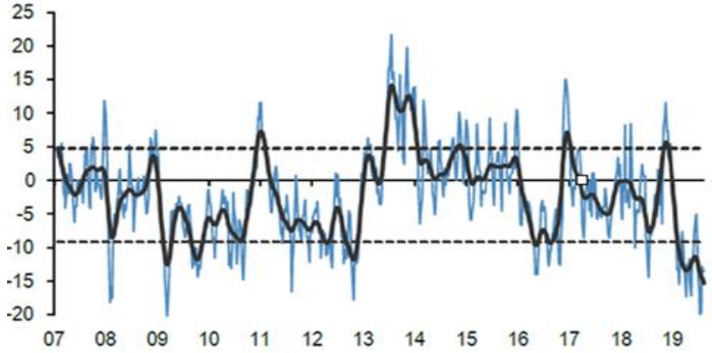
Stoxx 600 dividend yield higher than corporate yield (blue) vs S&P500 dividend yield higher than corporate yield (light)



Equities have a substantial yield cushion but are not always digestible by Fixed Income investors, that's why we believe in flexible products that can lower down the volatility and provide a decent yield.

- **<u>Positioning / Flows</u>**: as discussed, Equities have a significative potential as global investors are underweight and the difference between flows into Equity and Bonds is striking.

Difference between Equity vs Bond inflows (black)



- **<u>Macro numbers to stabilize from very deep levels</u>**: In contrast to that 2018 backdrop, there is the possibility that activity momentum will start showing signs of stabilization 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 will re-start QE.

Executive Summary

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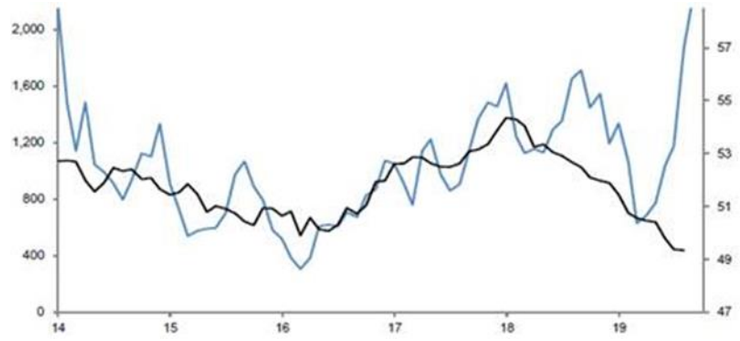
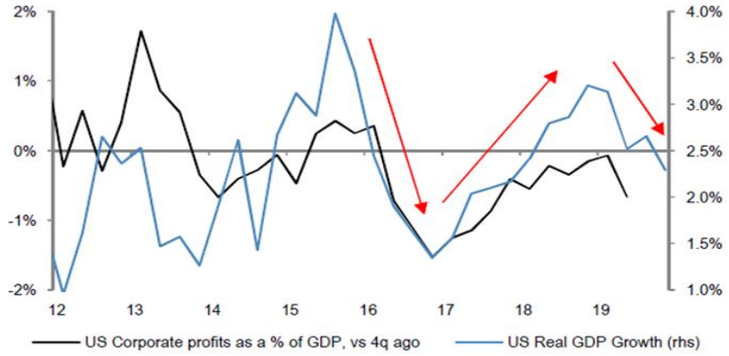
Global manufacturing PMI (black) vs Baltic Dry Index (blue)



If the activity momentum stabilizes, the recent slowing in the EPS growth rate might 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 a % of GDP (black) vs US Real GDP Growth (blue)



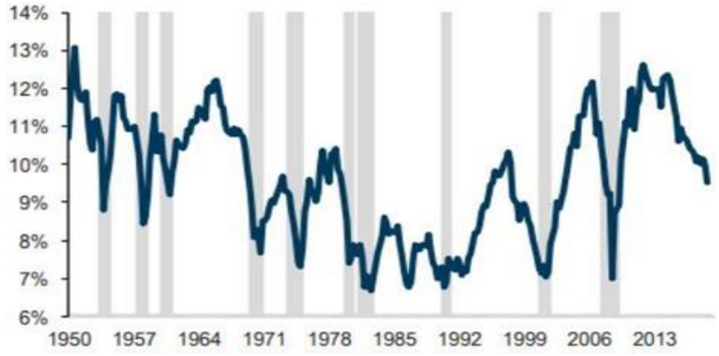
- **Global M&A**: It is notable that Global M&A volumes have been very strong year-to-date, reaching their highest level since 2007.

NEGATIVE FACTORS (7):

- **Dangerous reporting seasons**: we think that Q319 could continue **the trend of earning recession** seen last quarter and full year 2019 earnings 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 Q1 '12, which is thirty quarters ago.

Weakening Profit margins (black)



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 the extra earnings and cash put in the pockets of corporate America from the tax cuts and repatriation of overseas cash.

Executive Summary

Labor is the other excess from last year's fiscal stimulus boom and where costs are eating into margins, especially for Small Caps.

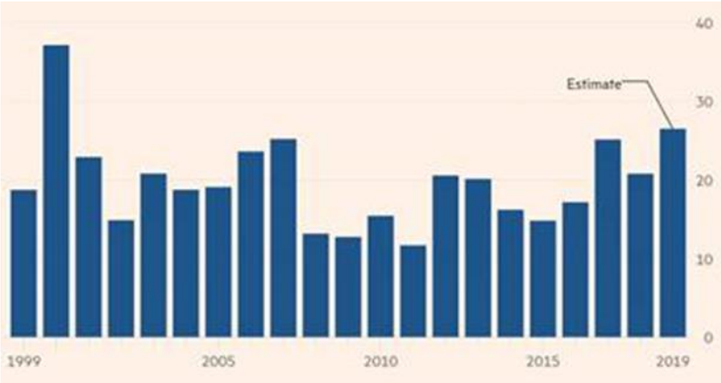
Finally, **inflation** message from corporates is much less benign than bond markets currently price.

- **Economic momentum**: Morgan Stanley widely followed proprietary US Cycle Indicator model has predicted the beginning of the downturn for the 1st 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

- **Insider Selling**. Executives across the US are selling stock in their own companies at the fastest pace in 20 years on concerns that the long-lasting bull market is reaching its final stages. They sold a combined 19bn$ of stock through to mid-September with a possible number at the end of year close to 26bn$ similar only to the number reached at the highs of the dotcom bubble in 2000.

2019 $ Value of Insider Selling



- **Buyback** should continue to support markets in 2019 but this is changing and this point has passed from "positive" to "neutral". Buybacks have been a key theme through this cycle with S&P 500 companies returning ~$5 trillion to shareholders since 2009 and contributing ~2% to annual EPS growth.We are not in the black-out period due to reporting season, the main issue is however that the pace of buybacks has slowed considerable over the last quarter and we believe that this has become from a positive factor to neutral. **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. Tech companies' buybacks were 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 that **for the 1st time in a long time, companies didn't step in to support their stock prices**. This is possible due to weakening corporate earnings and signs of a downturn in global growth.

Executive Summary

- **<u>IPOs / Secondary/ Placing</u>**. The most clear and easy way to gauge investor risk propensity is seeing how new issuances have traded. Since 7/27, the Renaissance IPO Index (IPOUSA Index) has underperformed the S&P 500 by ~13%.

  We are not talking about small numbers as 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.

  The number of IPOs that lost money is marking a new record high, <u>Peloton IPO and Smile Direct Club were the latest victim of the US IPO names trading negatively already on the first day</u>. Peloton was priced at $29 raising $1.16Bln at the top of the range price and the listing process was oversubscribed. The stock lost 27% in the first 4 days of trading. Smile Direct Club lost 27% on the 1st trading day and has since then lost a further 22%!

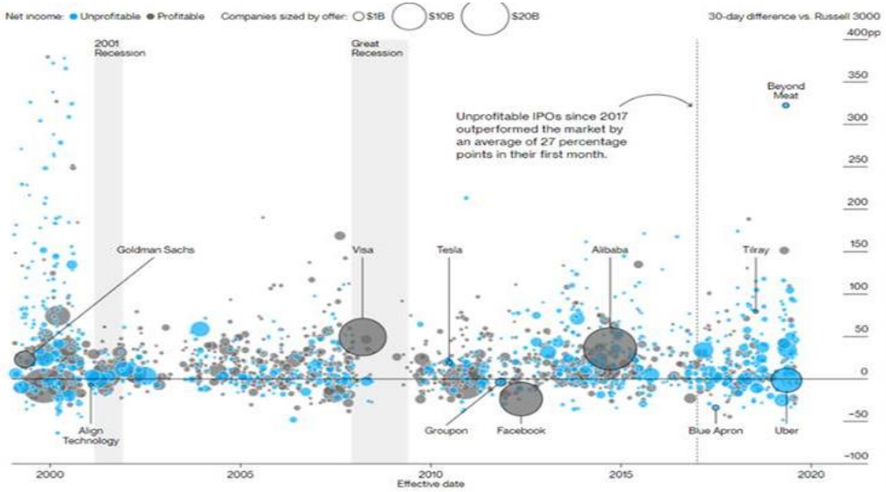
  Peloton is the eighth in the US this year to top $1 billion. The offering follows disappointing performances by several consumer-oriented companies positioning themselves as game-changing tech companies. Most notably, Uber Technologies shares have fallen more than 30% since May after its $8.1 billion IPO, the year's biggest.

  <u>WeWork decided to withdraw the IPO.</u>

  The problem lies both in the number of deals the market can absorb but also more importantly in valuation/pricing.

US IPO Index (amber) vs SPX (green), it is a 2.5 sigma adjustment since late July

<u>While still not as extreme as the dot-com bubble, the number of unprofitable company IPOs have surged to the highest levels in nearly 20 years!</u>



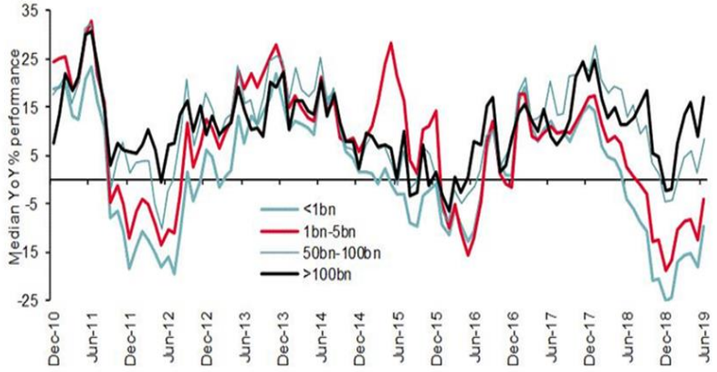
Executive Summary

- **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 USD100bn) is powering ahead whilst those in the sub-1bn market cap range are still struggling to make back last year's loss.

  The more remarkable numbers are that this 100bn portfolio represents just 77 companies but 27% of the global market cap. Meanwhile that sub USD1bn 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.

Market Cap US blue Chips > 100Bln $ (black)
Market Cap US 50-100Bln $ (green)



  The poor capacity of equity markets to absorb secondary placing and IPOs is a further evidence that liquidity might be a serious issue over the next months.

- **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 5.6trn$ 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 $200 billion 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.

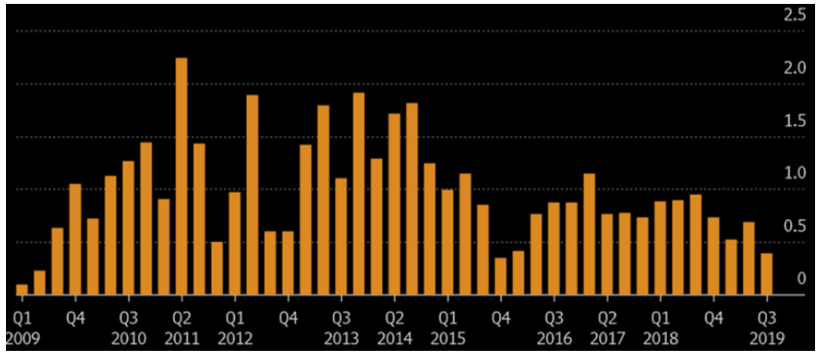
  The US equity to US credit volatility ratio is close to record highs as credit-implied vols seem to disregard cyclical risks and barely reacted to equity softness in August but it's worth noting that credit market isn't exactly sending rosy signals either. There's been an unusually high spread differential between high-beta and high-quality HY. BBs are close to their richest levels relative to Bs and CCCs since 2016.

  The fact that nearly half of CCCs are trading at distressed levels (>1000bp in spread terms) tells us that recession risks are being priced into some pockets of the credit market.

Executive Summary

As investors continue to pile into US corporate debt and issuers ramp up borrowing, S&P Global Ratings continues to warn about deteriorating credit quality. **Q3 saw the most rating downgrades for companies relative to upgrades since 2015, with the majority of those cuts being applied to the high-yield corner of the market**. The credit-rating agency lowered the bonds of 164 issuers compared to 64 upgrades, putting the upgrade-downgrade ratio at 0.39.

US Corporate upgrade to downgrade ratio



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.

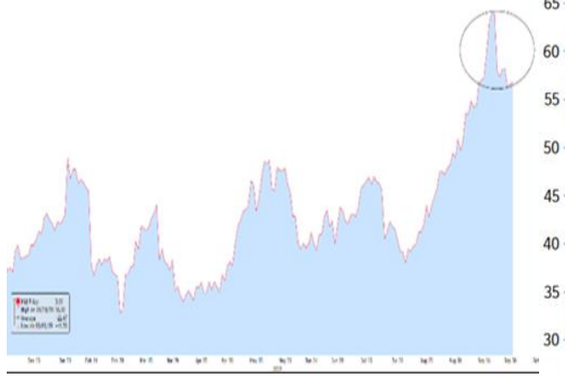
Macro

Global growth is currently tracking 2.6%, the lowest level year-to-date.

The **WTO** revised global trade forecast down for the current and future years, the lowest in a decade, respectively from 2.6% to 1.2% in 2019 and from 3% to 2.7% in 2020. In addition, **Fitch**'s world GDP growth forecasts for both 2019 and 2020 have been lowered by 20bps since June in response to the sharp escalation in the US-China trade war over the summer. Global growth is projected to fall to 2.6% this year and to 2.5% next year from 3.2% in 2018. This would be the slowest pace of expansion since 2012 when the Eurozone crisis was at its peak. Indeed, we don't have to forget that the **OECD** revised its growth forecast down too and currently see global economy's growth at 2.9% and 3% in 2020 (still below trend-growth rate).

So far, **global manufacturing PMIs** weakened further to post-credit crisis low, reaching the lowest multi-year level. It should not be surprising that global manufacturing activity is struggling. The latest **ISM Manufacturing** surprised to the downside, falling to 47.8 (recession). The latest **German Manufacturing PMI** came much worse than expectation at 41.4 vs 44 consensus (the lowest level since 2009). After a stabilization of Macro numbers in late August/early September, the global economy weakened further in the second half of September, with main culprit US and Europe (chart).

Citi G10 Economic Surprise Index



ISM Manufacturing (light) vs ISM Orders (blue)

Macro

Europe

The weakest region mainly due to the recession of the Auto industry in Germany. Leading economic institutes have lowered their growth forecast for Germany in 2019/20, respectively from 0.8% to 0.5% and from 1.8% to 1.1%. It seems that the recession among export-driven manufacturers is spreading, as France and Italy (Fitch cut growth down to 0% in 2019) are delivering weak results too.

September numbers:

- Germany Zew -19 vs -15 recession (confidence dropping)
- Germany IFO expectations 90.8 vs 92 consensus (decade low)
- Eurozone Manufacturing PMI 45.7 (in line, recession)
- Italy Manufacturing PMI 47.8 vs 48.1 (recession)
- Spain Manufacturing PMI 47.7 vs 48.2 (recession)
- UK Q2 GDP -20bps (first contraction in 7 years)
- UK Manufacturing PMI 48.3 vs 47 consensus (biggest drop since 2009)
- Euro Area Economic Confidence 101.7 vs 103 consensus (lowest in 4 years)
- Euro Area Industrial Confidence -8.8 vs -6 (lowest in 6 years)

USA

US consumer confidence slumped to a 3-month low, at 125 vs 133 consensus (135 prior month), posing a risk to household spending that is underpinning growth.We have already highlighted how important the resilience of the consumer confidence factor is within the US Macro picture. **If weakness moves from Manufacturing to Retail and Services (consumption), then a recession is more likely**.

September numbers:

- Empire Manufacturing 2 vs 4 (multi-year low)
- Markit Service PMI 50.9 vs 51.4
- Markit Composite PMI 51 (in line very low)
- Richmond Fed Manufacturing -9 vs 1
- Q2 GDP revised down by 10bps 2% vs 2.1% prior

Asia

So far, **September Chinese data better than expectation**, with Composite PMI for September at 53.1 vs 53 and stronger Manufacturing PMI at 49.8 vs 49.6. Another important measure of productivity, Caixin China PMI Manufacturing came at 51.4 vs 50.2 consensus. In **Japan, Manufacturing PMI came below 50** (recession), at the lowest level this year, while Services and Composite were both below expectations, respectively 52.8 vs 53.3 prior month and 51.5 vs 51.9. In addition, Japanese foreign tool orders came at -37% YoY. **South Korea delivered the lowest export numbers since 2009**, at -22% in September.

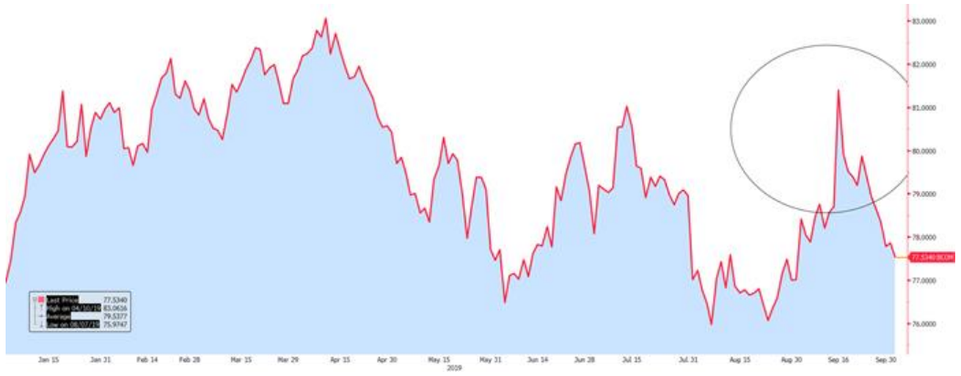
Commodities

As mentioned in our previous update, we are **still neutral-positioned in the short-mid run until global growth rebounds**. We were cautious, we were right. Imbalances between supply and demand, global growth slowdown, Geopolitical shocks and investors concerns have been increasing volatility into the Commodities market.

Since the beginning of September, the Bloomberg Commodities Index decreased almost 1.5%, after jumping circa 4%, mainly due to Geopolitics, Trade war, Macro, interest rates and oil fluctuations (note that oil weights almost as much as 20% in the index). So far, the Bloomberg Commodities Index is up 1% year-to-date, down 7% since April highs.

Have a look at the performance of its single components in September: Oil (-6%, or -18% since half September), Gold (-3%), Silver (-10%), Copper (-1%, -4% since half September), Natural Gas (-7.8%, -17% since half September), Soybean (+4%) and Corn (+7.5%).

Bloomberg Commodity Index



Oil

September will be remembered as one of the **most volatile months** in several years, Oil up 15% and down 17%, overall -1.9% month-on-month, two-months lows, after -6% in August.

One of the best asset class year-to-date with WTI up 16% and Brent +7%.

On September 14, Saudi oil facilities, Aramco, were attacked by drones allegedly launched by Houthi rebels in Yemen, **knocking off nearly half of Saudi oil production, almost 5% of global crude supply**. While Brent surged almost 12$ on the first day after the attacks, it has since given up the whole gain as **Saudis restored capacity and production in record time**, producing as many as 9.9Bln barrels a day.

In addition, further news about Saudis agreeing to impose partial cease-fire in Yemen and US offering to remove all sanctions on Iran exchange for talks contributed to the oil price slump.

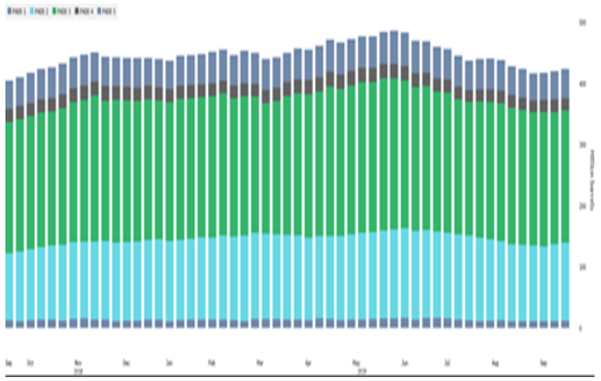
OPEC oil output fell the most in 16 years last month, mainly due to Geopolitical shocks, (ie. Ecuador instability, Venezuela recession, Saudis attack etc.).

Despite this slowdown it seems that, even if output were to remain at September's level, the **market would not be short of oil in H1 2020**. Why? The problem here is the weak demand **as demand fears are overriding supply fears**. Interestingly, OPEC + might be called to cut production in December.

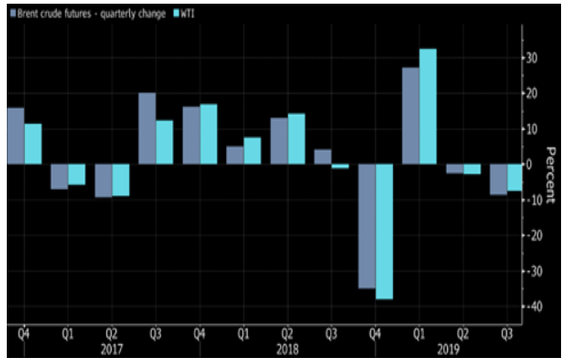
Commodities

Lastly, **massive oil stockpiles are increasing in September**, helping to take commercial inventories of crude and refined above the levels seen in September 2018 and in 2017 and pushing down WTI and Brent valuation.

EIA Stockpile increasing for the 3rd straight week (bearish)



WTI (light blue) vs Brent (gray)



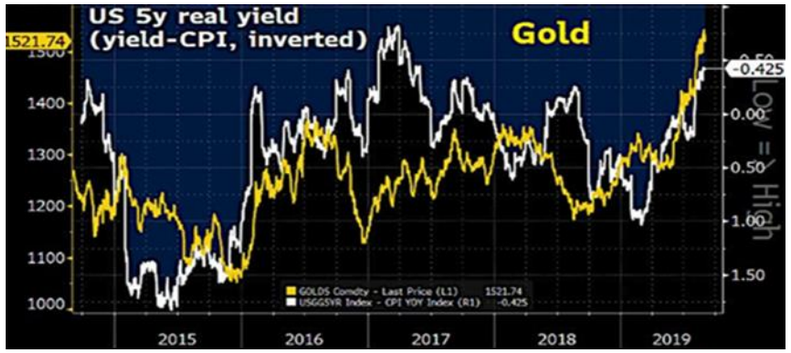
Gold

Here we called the market very well. We started a long position in October 2018 until the end of July/mid-August, achieving a positive total return of 24%. Although not invested, we are waiting for a more favorable entry point, around 1400-50$ level. Since our neutral call, gold down 3.5% and silver down 10%.

Gold is hovering around 1500$, same level of late August, probably due to very weak German CPI data (-0.1% in September) and by month-end/quarter-end flows. Interestingly Gold, is now down nearly 3.5% from September's highs. All this makes sense if you consider that 10Y US real rate was 5 bps (negative couple weeks ago) and now is 20bps (inverse correlation real rates vs gold).

Gold rally was mainly driven by lower real bond yields as Gold is a kind of a currency which has no inflation and zero interest rates.

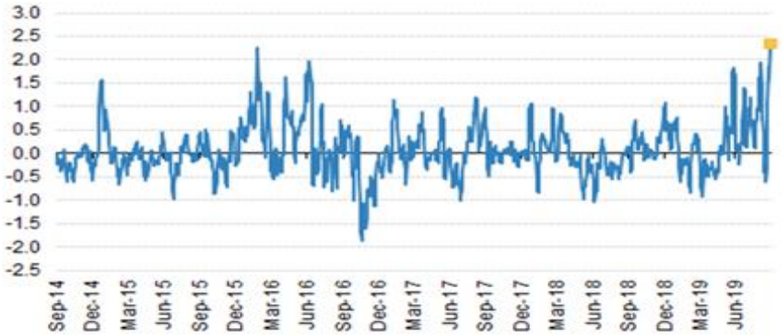
US 5Y real yields inverted (white) vs Gold (yellow)



As we warned several times, **Gold had a very good performance and was due for a correction** also because was the most consensual long among investors with little space for a marginal buyer.

Gold ETFs have seen last week 2.3bn$ inflows, the **biggest one-week flow** in nearly 10 years.

Inflows Gold ETFs



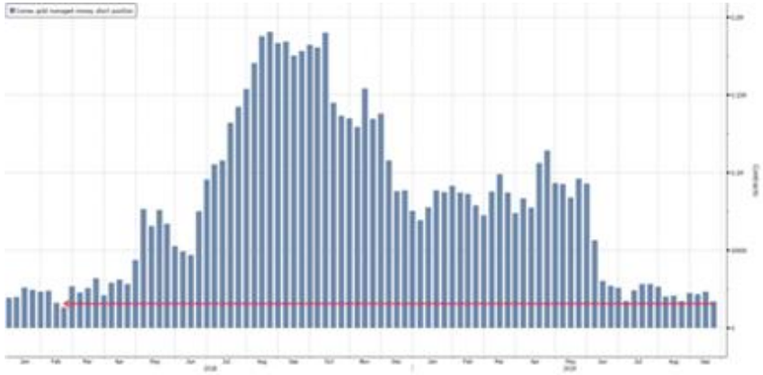
Commodities

Positioning on futures is also still extreme.

Comex Gold future Open Interest

…and **no shorts** from HFs..

Comex Gold Managed Money Short position



We would start buying back some gold progressively below 1450.

Forex

EUR

The **EURUSD** is currently hovering around 1.09, close to the lowest level of this year, down almost 12% since 2018 highs (February, 1.25) and down 4.5% YTD. As you can see the net long position on USD and the EUR short base (reverse of chart) have been increasing, massively in during the last few months.

USD Net positioning (dotted) vs USD (black)

Why is the dollar so strong? First of all, **US interest rates have been rebounding** with US 10Y real rates up to 20bps (was negative), and US 10Y nominal up to 1.75 (was lower than 1.50 end of August). Secondly, **US money market tightness** (Repo turmoil up to 10%) probably led USD strength higher in the short run. Thirdly, the **USD still remains the most preferred safe haven currency along with Swiss Franc and Yen** (Geopolitics, Trade war, Iran etc. driving investor worries). Indeed, the weaker and weaker **European Macro patch** (see Macro data above) pushes the Euro lower and lower.

Forex

Current Investment Idea

CHF

Swiss franc continues appreciating against Euro in the short and long-run. In the past two weeks, Swiss franc appreciated up to 1.7%, and is currently hovering around 1.085, while in the long-run, it gained for sixth-straight quarters, the longest run since 2015. As you might already know, a strong Swiss franc might create several problems to the Central Bank such as **deflationary pressures** (consumers defer spending in the hope of things getting cheaper in the future), currency gains **slashing exports** (higher franc vs lower Euro) and **overvaluation of the currency**, so far, the OECD's gauge of purchasing-power parity shows Swiss franc is the most overvalued G-10 currency against Euro.

However, the main point to us is that the SNB might be unable to defend the currency as it did in the past because the market condition and balance sheet are not helping. We believe the CHF is likely to appreciate further in the medium term.

Currency over/under-valuation based on Purchasing Power Parity

Call replacement on Single Names/Sectors

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

This worked well as the downside has been limited owning a Call rather than the physical underlying. If the market continued to drop we would then suggest to go back buying physical single names/sectors.

Long European oil sector, SXEP

This was either a relative call (vs Eurostoxx 600) or absolute. The EU Energy sector is flat Ytd and is cheap on most valuation metrics.

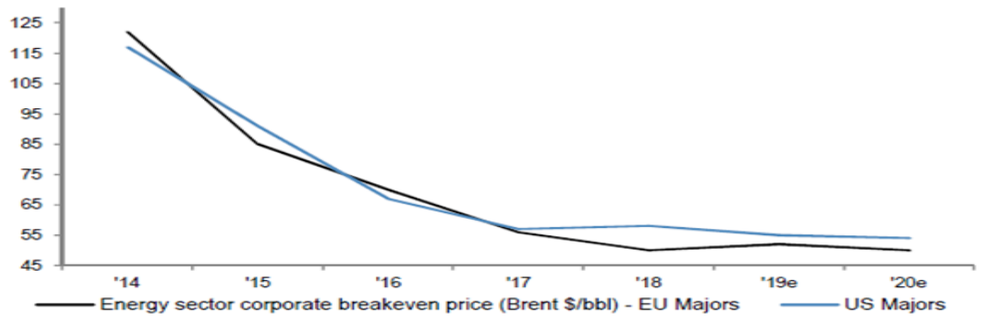
Last month we were saying that Energy wasn't so much oversold in relative terms in almost 5 years, at 3 standard deviation, a level it reached only 3 times in the past 15 years!

We had a brief bounce after the drone attack but the sector is back since it was when we launched the idea.

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.

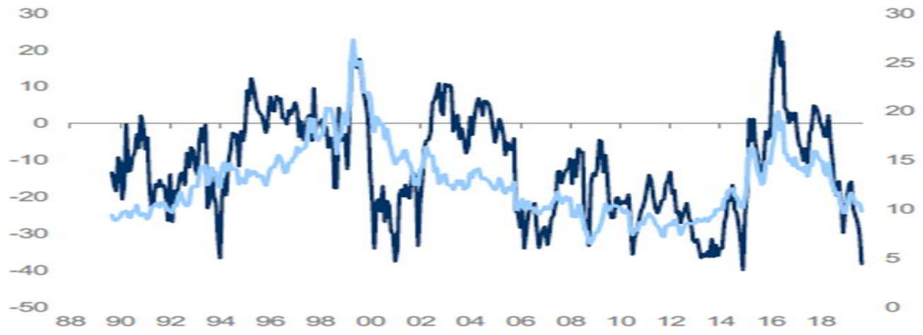
Current Investment Idea

Energy Sector Breakeven price



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 blue) and relative to MSCI 12-months P/E



The gross dividend yield for the sector is an interesting 5.5% excluding the positive effect given by buybacks 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 has possibly got the lowest exposure among all other cyclicals sectors. It is the fourth European most oversold sector (down 2 standard deviation from 12-month average).

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

Most major carmakers reported very weak growth and guided to weaker outlooks.

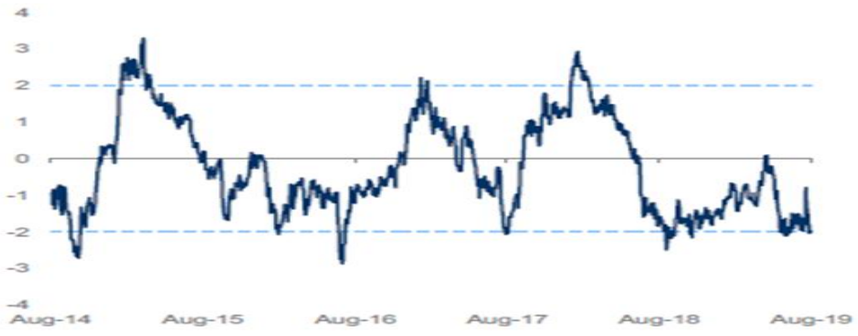
However, even if we are approaching Autumn, we are starting to see some first green shots on the sector.

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 1st time in a long period positive.

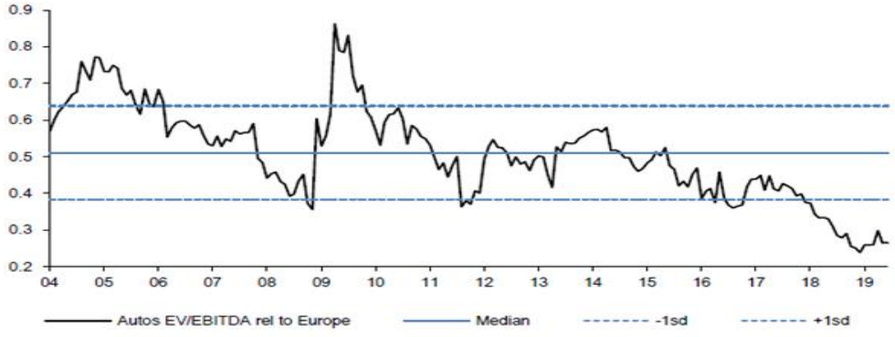
One of the issues was about the length of the process to convert into electric vehicles but now we are going to get the first electrical Porsche (Tacan) which is an important milestone and had already 20K order is few days for a car that would definitely better than a Tesla (at a higher price). This is a beginning of a revolution within European cars.

Current Investment Idea

Relative performance, standard deviation vs 12-month average



European Autos EV/Ebitda relative to MSCI Europe



Valuations are showing a forward P/E of 6.5x, less than half the one of MSCI Europe and suggesting that plenty of bad news have been priced in.

<u>Based on a 10-year valuation across P/E, DY and PBV, the sector was last cheaper in early 2001.</u>

China accounts for 30-40% of European manufactures EBIT. Given the sector's high operating leverage, any improvement in activity in China would be a support.

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

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