Strategy Chartbook

JANUARY 2020 CHARTBOOK

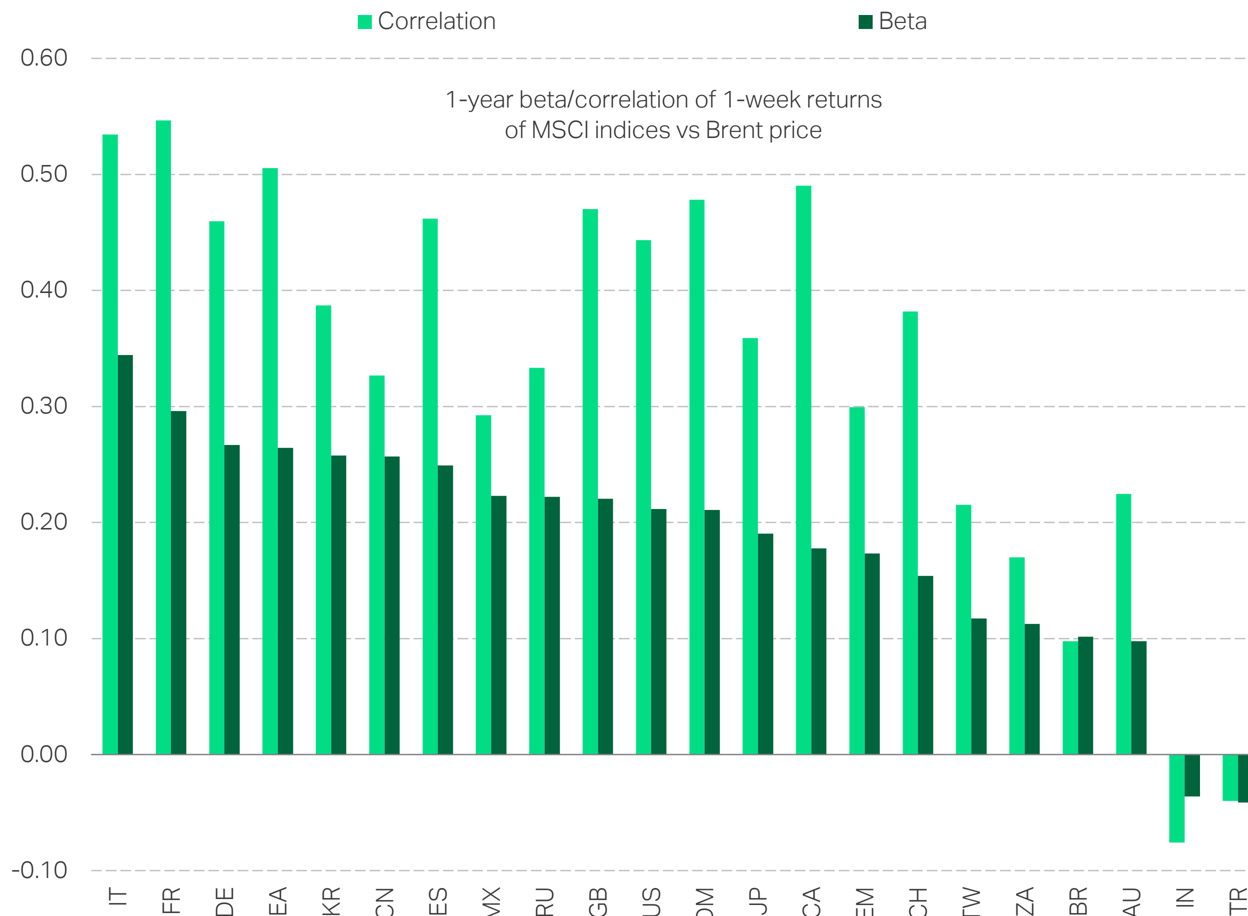
Andrea Cicione / Oliver Brennan

HIGHLIGHTS

- **Macro Drivers.** Evidence of a cyclical recovery, but global trade likely to lag
- **Multi Asset.** Markets impervious to Iran tensions, but what if oil prices were to surge?
- **Fixed Income.** Central bank QE suggests markets could trade like 2016-18 again
- **Currencies.** Reserve managers continue to buy EUR
- **Equities.** Stocks vs Oil – a nuanced relationship
- **Commodities.** Crude backwardation is not just about Middle East tensions

Chart of the month

EA stocks have benefited from higher oil – unlike India, Turkey



Tensions between the US and Iran have resulted in higher oil prices, which, if sustained, could weigh on economic activity. The good news is that so far the rise in energy prices has been temporary. Should oil start climbing again, a mitigating factor would be that, unlike in 2018, this is not being accompanied by rising interest rates, which would be an additional drag on corporate profits and the economy.

Regime changes can alter correlations and betas over time, but generally speaking European equities have benefited from higher oil prices in the past two years. On the other hand, dearer crude has been a headwind for India and Turkey, both major oil importers. (Energy's weight in the indices sometimes skews the results). Similar dynamics are visible in currencies and bond yields.

Elsewhere in this month's Chartbook:

- *Macro drivers*. German IP ex-construction belies nascent recovery
- *Fixed income*. Fed liquidity provision has stabilised funding markets
- *Currencies*. H2 risk not in the price in NZD/USD
- *Equities*. Lunar New Year is the strongest period for Chinese stocks
- *Commodities*. The risk-reward in gold remains unappealing despite Middle East tensions

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Summary – key points

Macro Drivers

- CFO confidence in Duke Uni survey is rising, suggesting the global PMI will do too
- But global trade growth is lagging, and German car manufacturing is in a crisis
- Front-loaded Chinese loan growth points to a Q1 boost for China activity

Multi-Asset

- Markets have so far been impervious to Iran tensions, but a sustained increase in oil prices would impact economic growth
- The effect of higher oil tends to be positive for all but a handful of countries and assets
- Regime changes, however, are not uncommon and can be sizeable, causing betas and correlations to swap signs

Fixed Income

- Central bank QE will be a strong pillar of support for fixed income in Q1
- The Fed's balance sheet has expanded by $400bn since August, unwinding most of its earlier QT
- There is still more to go – bank reserves may need to rise by another $200bn before money market liquidity is sufficient

Currencies

- Reserve managers bought over $40bn of EUR/USD in Q3, according to the IMF COFER report
- EUR/USD continues to be bid up in Asia, and relative economic surprises support EUR strength
- FX vols imply H2 event risk is in the price for USD/JPY and EUR/USD, but not NZD/USD

Equities

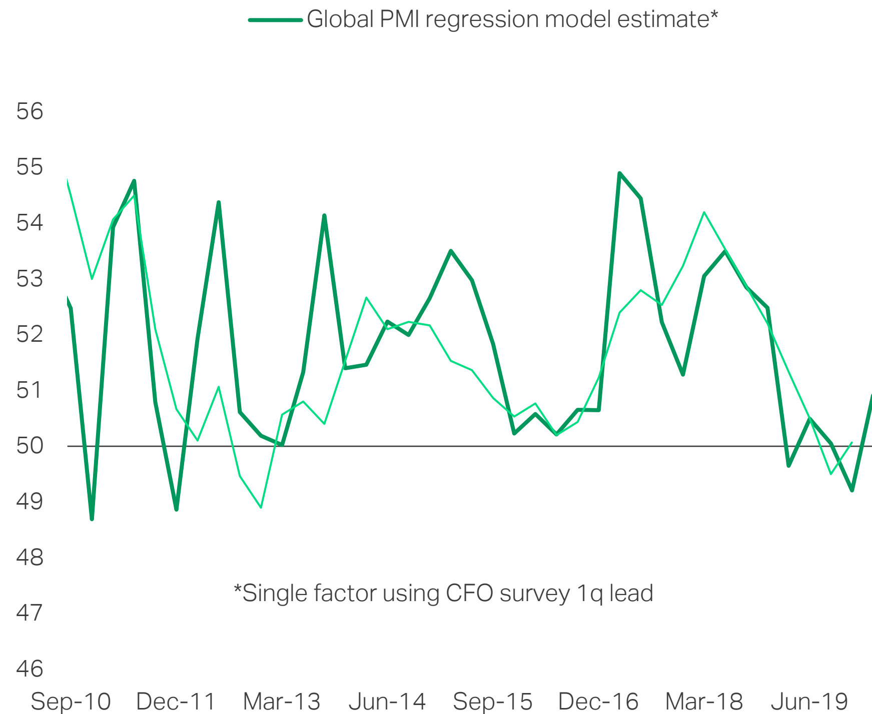
- For country indices what matters is both whether a nation is an oil importer/exporter and Energy's weight in the indices
- Italy has a positive beta to oil despite being a net importer; Mexico has too, despite the absence of Energy firms in the index
- Chinese and other Asian equity markets exhibit strong (and statistically significant) seasonality around the Lunar New Year

Commodities

- A backwardated crude curve is typically a sign of investors worrying about short-term supply disruptions
- But increased backwardation over the past year was driven by slowing economic activity combined with OPEC+ supply cuts
- Gold remains the instrument of choice for investors looking to hedge tail risks, but the risk-reward remains uncompelling

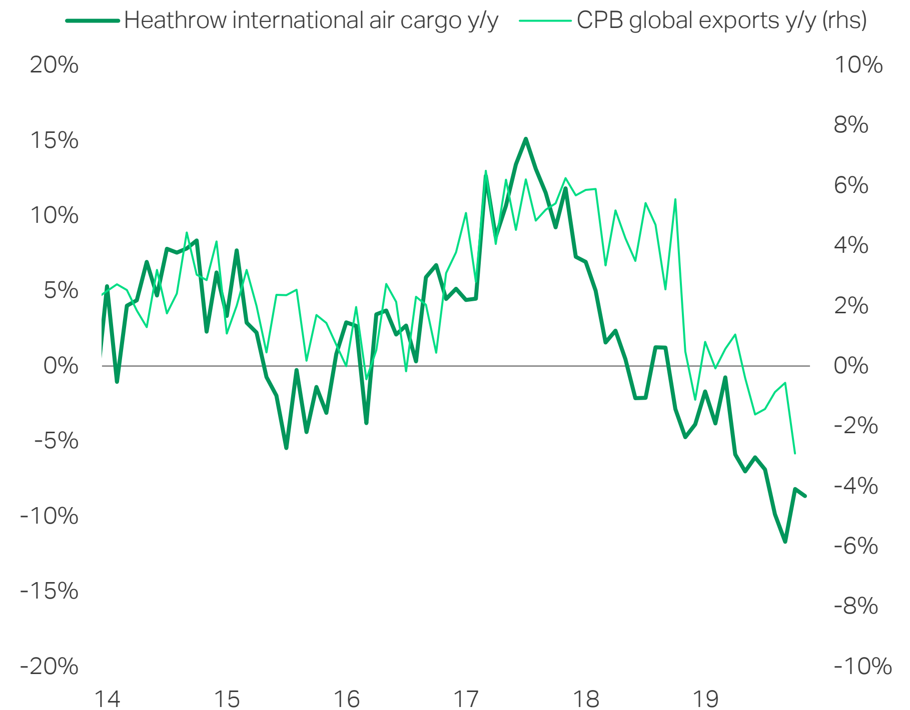
Macro Drivers Cyclical upswing not led by trade

CFO optimism improving



Duke University's quarterly survey showed CFOs were more pessimistic in Q3 than at any point since the GFC. The mood then brightened in Q4. Although respondents who were less optimistic about the US economy (33.6%) outnumbered those who were more optimistic (28.1%), the improvement supports our view of a cyclical recovery to start this year. The global PMI should continue to rise.

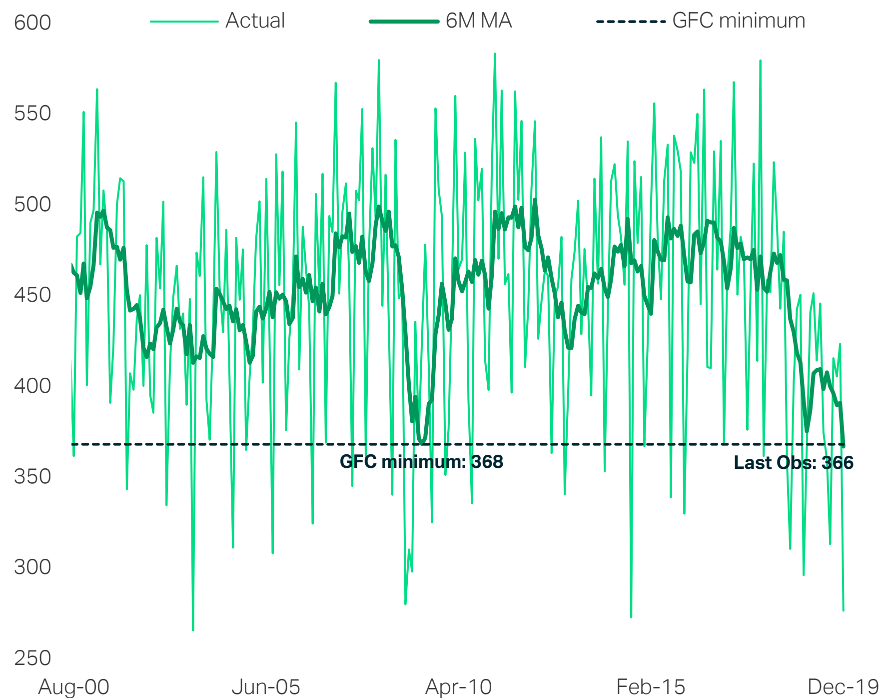
But trade is lagging



When elephants fight the grass gets trampled. Sure enough, global trade has slowed since the US-China trade war broke out. Although the Phase One deal to be signed on January 15th will trigger a rise in Chinese imports from the US, the collateral damage from higher tariffs and greater protectionism means global trade growth is likely to remain subdued.

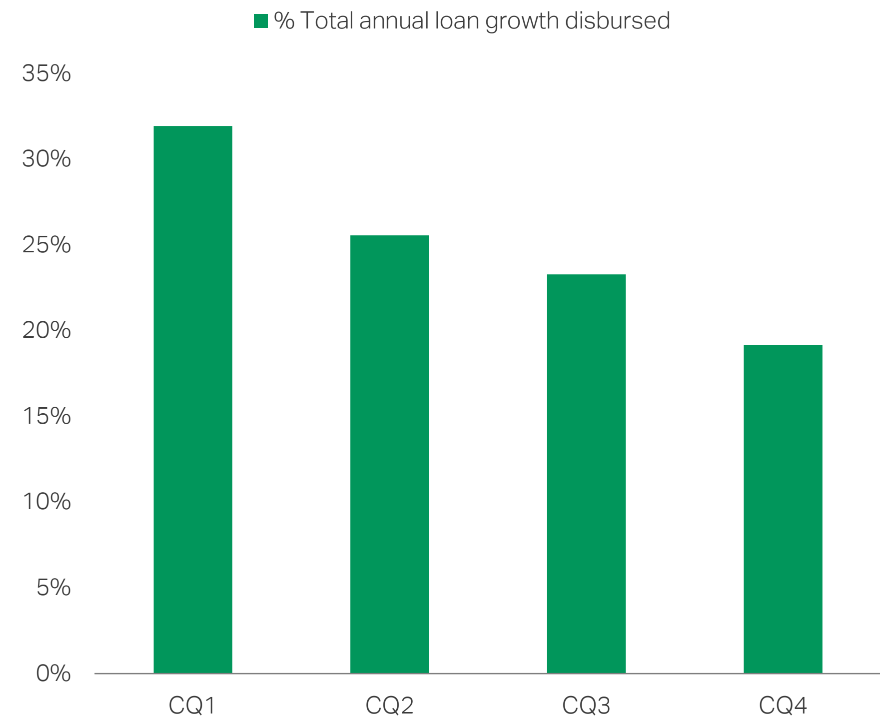
Macro Drivers Weak German auto, strong Chinese loan growth

Mid-cycle pick-up masks EA auto crisis



In this week's Europe Watch we take a closer look at data suggesting that EA growth bottomed out in Q4. But one of the engines of German growth – car manufacturing – is still grappling with its worst crisis in more than 20 years. For now, the building sector is driving this recovery. Ex-construction, German industrial production remains extremely weak.

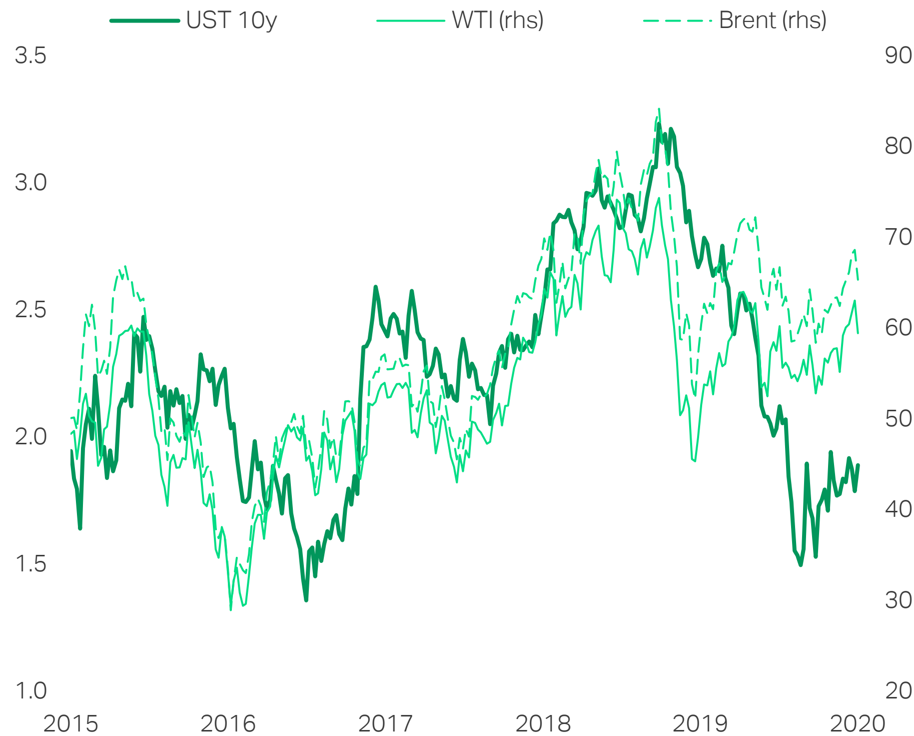
Front-loaded Chinese loan growth this quarter



After the PBoC re-sets loan quotas in Q1, there is always a mini-boom in Chines loan growth. This year will be no exception. The authorities began allocating loans to projects in Q4, so related activity could start as soon as this quarter, supporting growth in the short term. Sentiment in Beijing has turned positive, but the risk to growth this year is asymmetric – 6% official growth is the maximum, not an average.

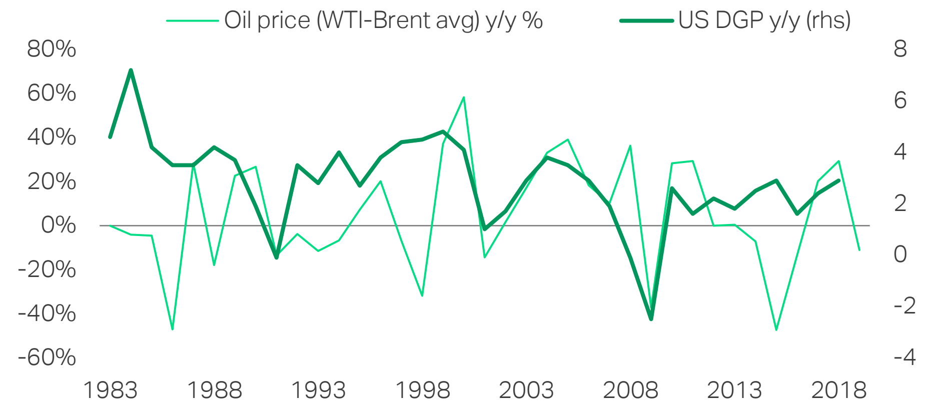
Multi-Asset Markets impervious to Iran tensions

Unlike in 2018, oil prices trending higher but rates still low

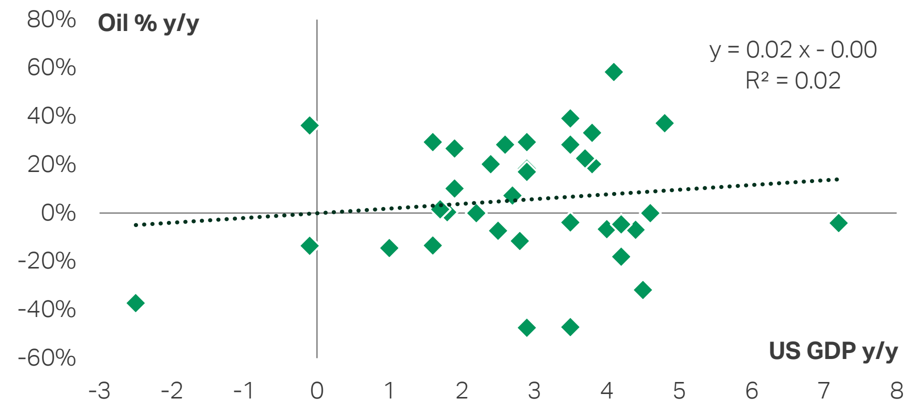


Tensions between the US and Iran have resulted in higher oil prices, which, if sustained, could weigh on activity. The good news is that so far the rise in energy prices has been temporary. Should oil start climbing again, a mitigating factor would be that, unlike in 2018, this is not being accompanied by rising interest rates, which would be an additional drag on corporate profits and the economy.

No obvious correlation between oil and US growth…

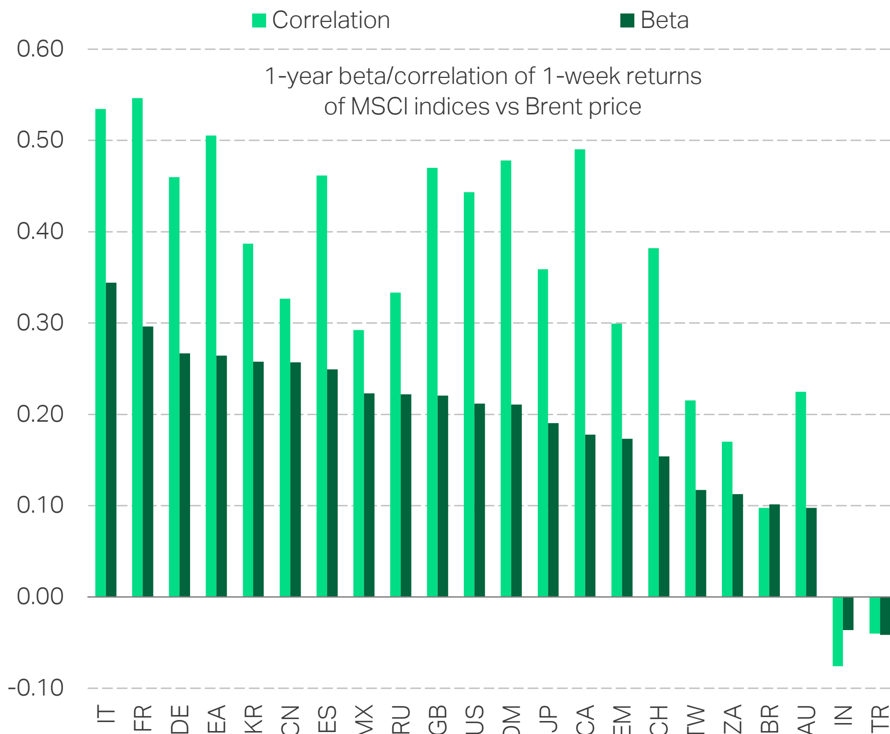


…which, if anything, is slightly positive



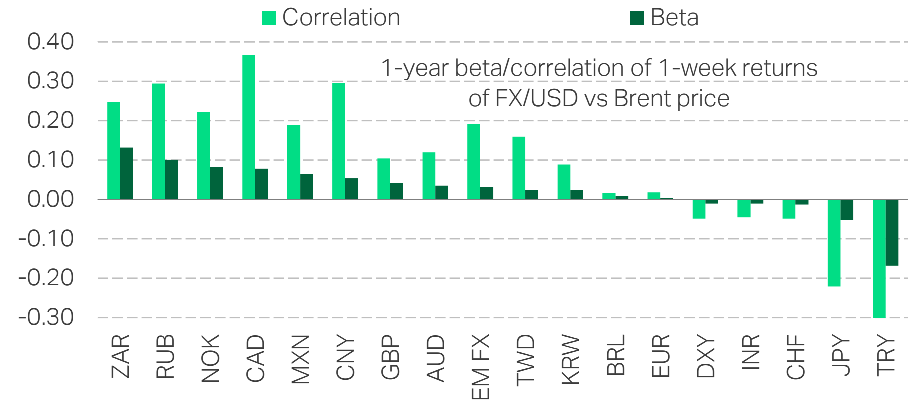
Multi-Asset But what if oil prices were to surge?

EA stocks have benefited from higher oil – unlike India, Turkey

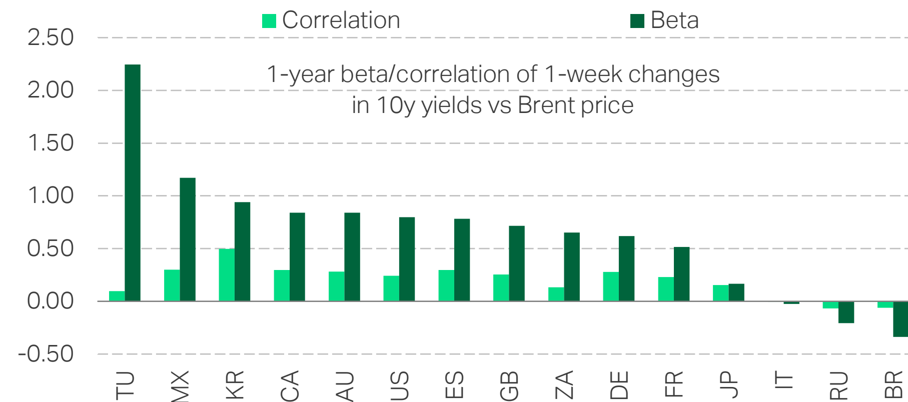


Regime changes can alter correlations and betas over time, but generally speaking European equities have benefited from higher oil prices in the past two years. On the other hand, dearer crude has been a headwind for India and Turkey, both major oil importers. (Energy's weight in the indices sometimes skews the results – more in the *Equities* section). Similar dynamics are visible in currencies and bond yields.

In EMs, higher oil good for ZAR, RUB, MXN, bad for INR, TRY

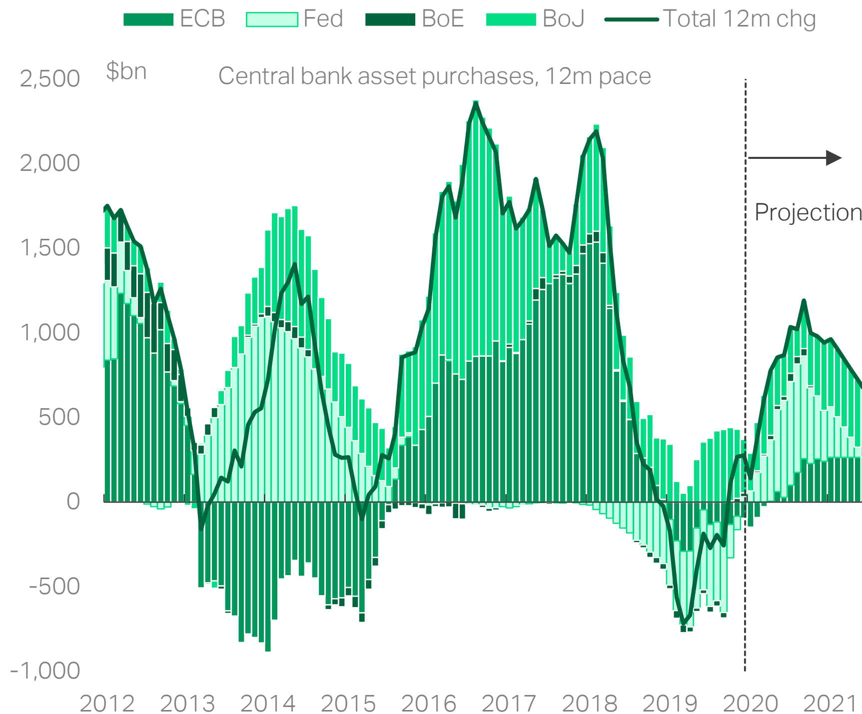


USD/BRL not too affected by oil, but Brazilian bonds are



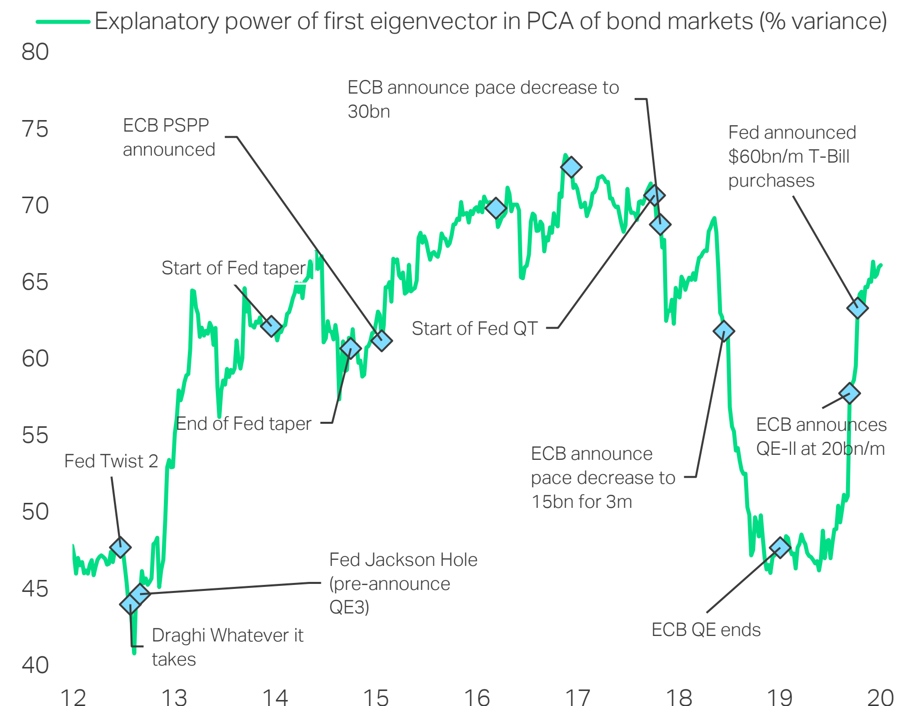
Fixed Income Remember 2016-18?

Central bank QE momentum in H1



The resumption of asset purchases by the Fed and the ECB helped arrest fears of a market meltdown last year. Their buying is unlikely to be as aggressive as in 2016-18, but fixed income markets are displaying similarities to that period. The right-hand chart plots the explanatory power of the first eigenvector from principal component analysis of DM fixed income markets.

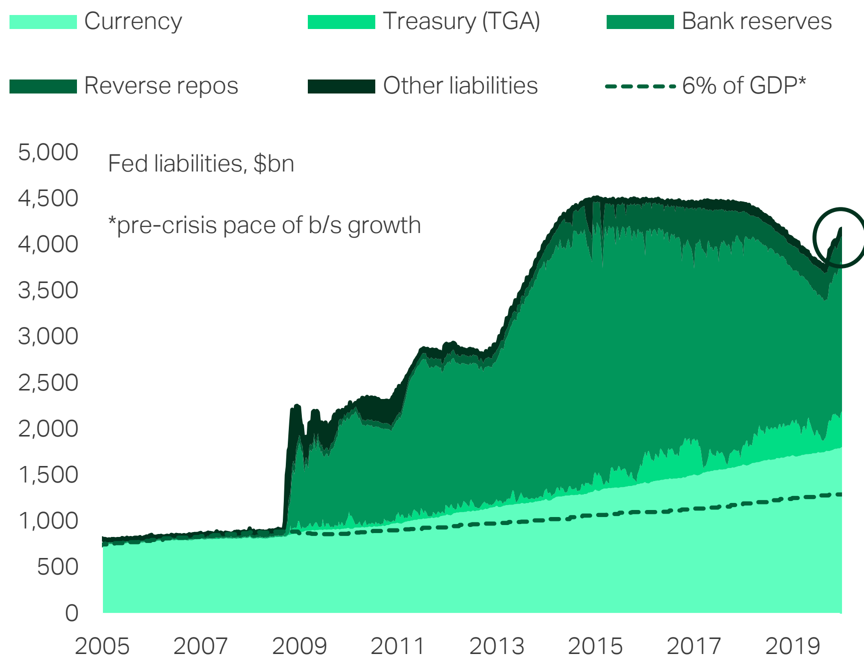
Fixed income trading like it's 2016-18



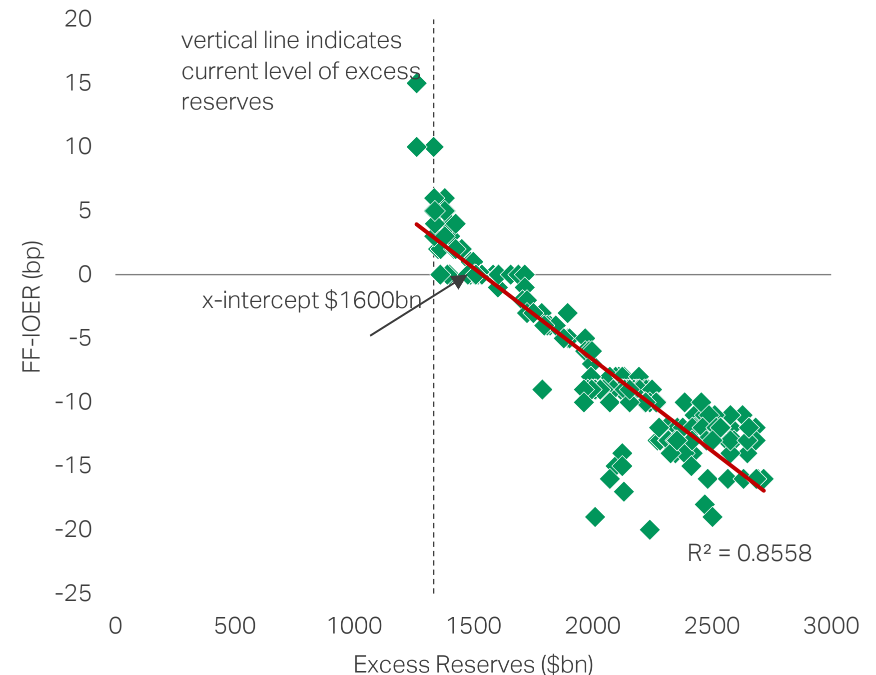
The explanatory power is as strong as it was during the previous episode of central bank QE. This is thanks in part to the resumption of asset purchases, but also to global investor demand for assets with positive yields: Japanese, Korean and Taiwanese demand for foreign bonds is similar in magnitude to ECB QE.

Fixed Income What year-end squeeze?

Balance sheet expansion eased the passage of time



But FF-IOER still has a way to go

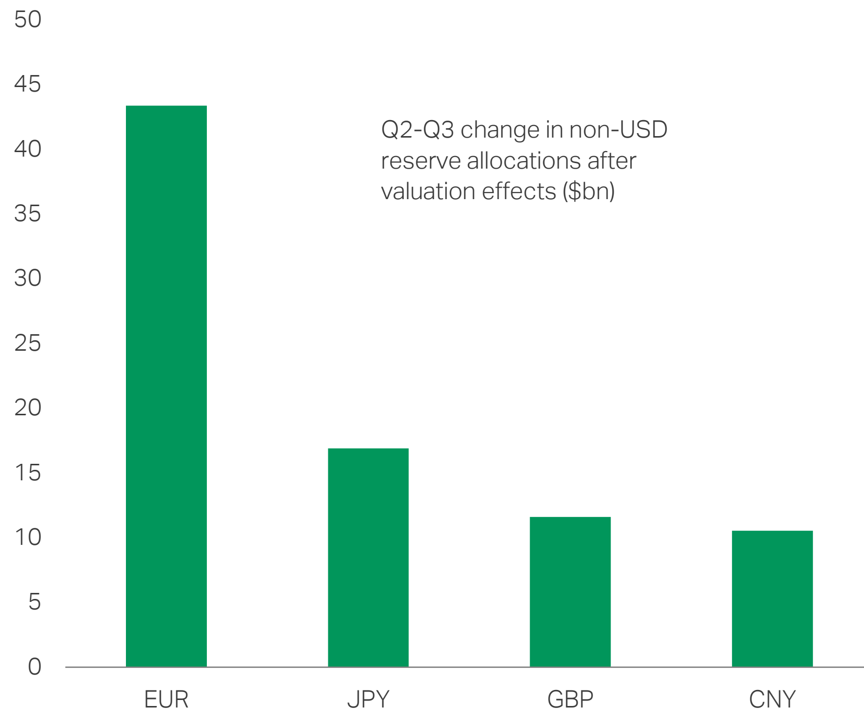


Despite warnings from the prophets of doom, the GC repo rate over year-end rose a mere 6bp (from 1.56% to 1.62%). One can dig into the weeds of money markets, TOMOs, POMOs and balance sheet composition if it is of interest, but the key macro point is that the Fed signalled unlimited support for money market liquidity, including via open market operations and renewed asset purchases.

This support means the Fed's balance sheet has expanded by $400bn since August and bank reserves have risen by over $100bn. This may still not be enough: the chart above plots the fed funds – IOER spread against the Fed's definition of banks' excess reserves. These are currently around $1.4trn, so the Fed is likely to need to keep buying $60bn of T-Bills a month for most of H1 to hoist excess reseves above $1.6trn, the threshold at which fed funds should once again trade below IOER.

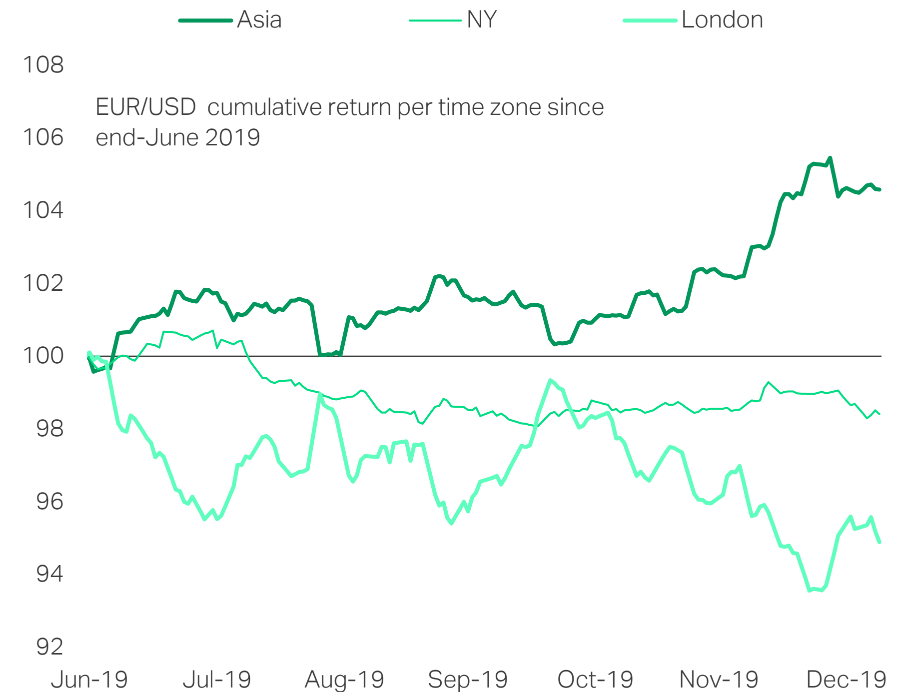
Currencies Reserve managers are buying EUR

Reserve managers bought over $40bn EUR in Q3



Global FX reserves fell slightly by $73bn between Q2 and Q3 last year. As this was the period in which USD/CNY rose towards 7.20, it should be no surprise that reserve managers spent some ammunition to stabilise their currencies. But, after accounting for valuation effects, their allocation to non-USD currencies rose: The Wall St Journal has reported that global central banks may merely be playing the $-repack trade.

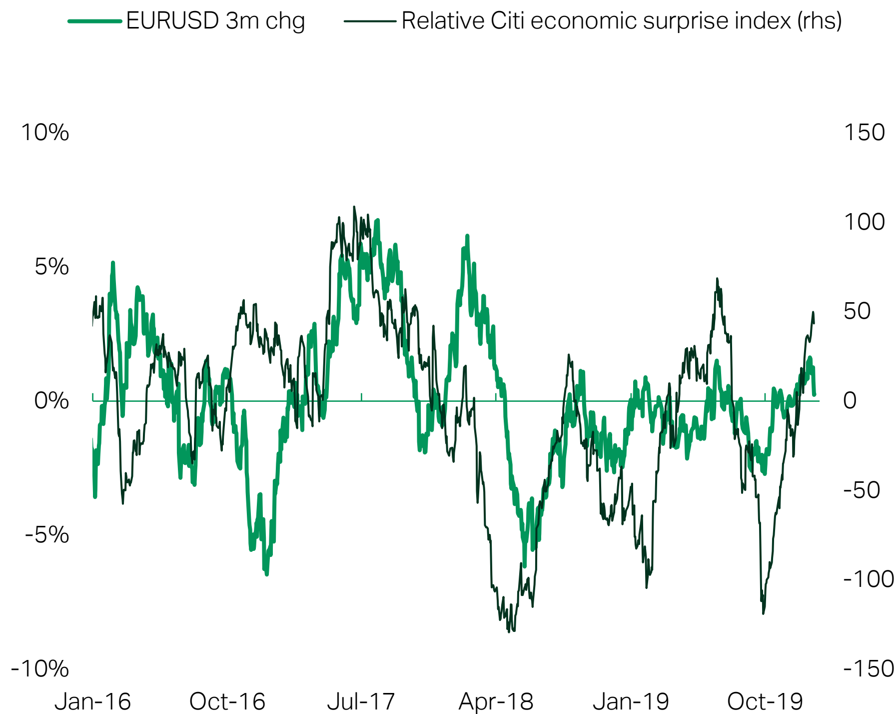
Time zone flows show Asians still buying EUR/USD



Time zone analysis shows Asian buyers continue to demand EUR, with EUR/USD rising by 5% in Asian hours over the last six months. Combined with the IMF's COFER analysis, this suggests Asian reserve managers are still diversifying their holdings. This is a supportive factor for EUR that we first mentioned in early 2019 and is a reason why we are comfortably long EUR/USD in our Macro Strategy portfolio – EUR dips will be bought by the strong hands of reserve managers.

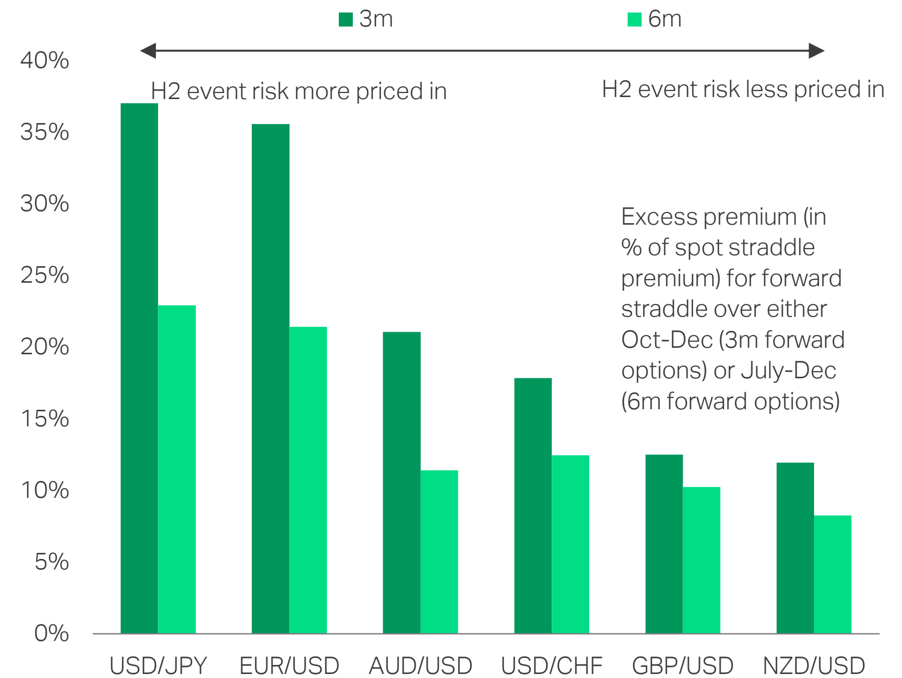
Currencies EUR up slowly; H2 risks already being priced in

Economic data also support EUR strength



In last month's Chartbook we wrote that relative data surprises were not powerful enough for EUR to break higher. Now they are, with EA economic readings on their strongest run for a year compared to the US. As we note above, we are long EUR/USD in the Macro Strategy portfolio. But, with around 2% negative carry and a determinedly dovish ECB, we do not expect a major breakout so are funding the negative carry by selling EUR calls.

H2 risk already in the price in some crosses

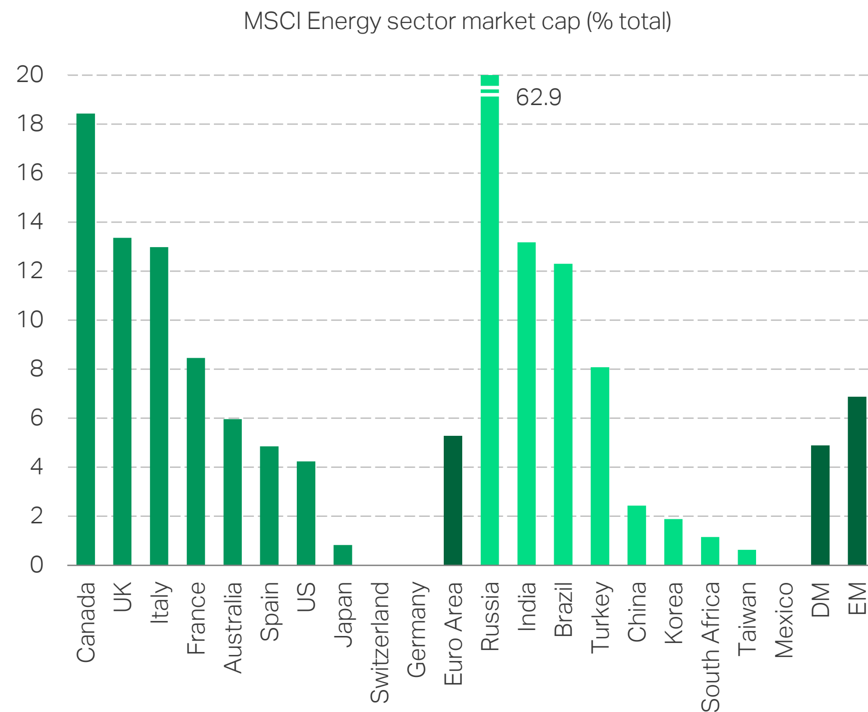


Our markets view is very much that 2020 will be a year of two halves. We see the risk of higher volatility and greater uncertainty in H2, while H1 is set to be characterised by dovish central banks and easy market liquidity. The chart above shows that H2 risks are already in the price in JPY, EUR and AUD FX options (the chart plots the excess straddle premium for forward options, i.e. forward vol premium over spot vol), but not in NZD, where a general election is on the cards. We are long NZD/USD forward vol.

Equities

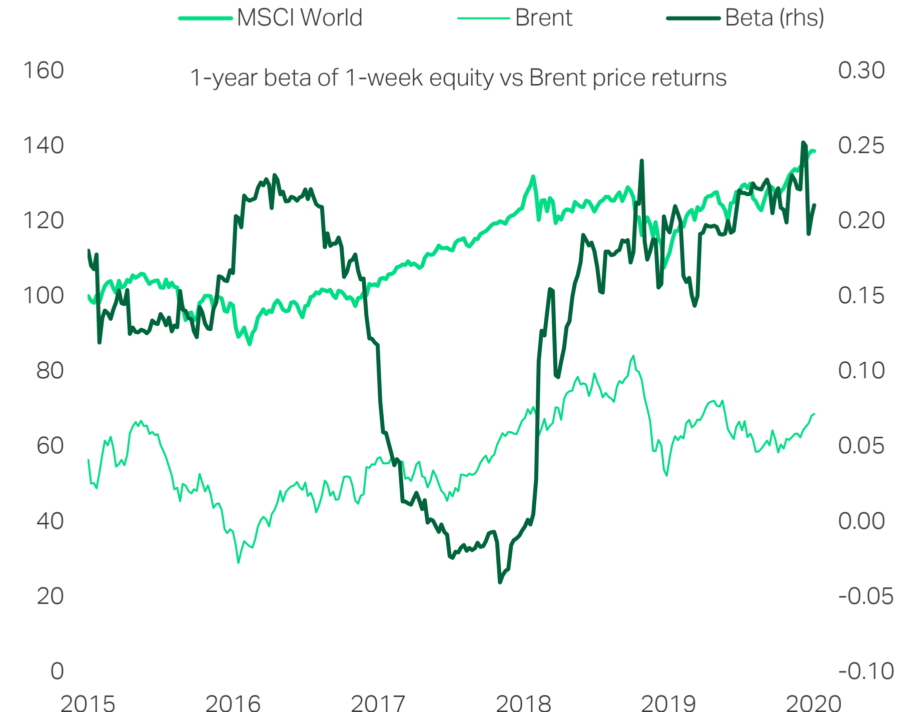
Equities vs Oil – a nuanced relationship

Energy sector weights affect equities' response to oil prices



For equity investors, understanding the relationship of stocks to oil prices is key, especially at times of geopolitical uncertainty in the Middle East. This is not always straightforward. Italy is a case in point. The country is not a major oil producer and yet the weight of Energy companies in its equity index makes it positively correlated with crude. The opposite is true for Mexico (see *Multi Asset* section).

Regime changes can be dramatic and are not uncommon

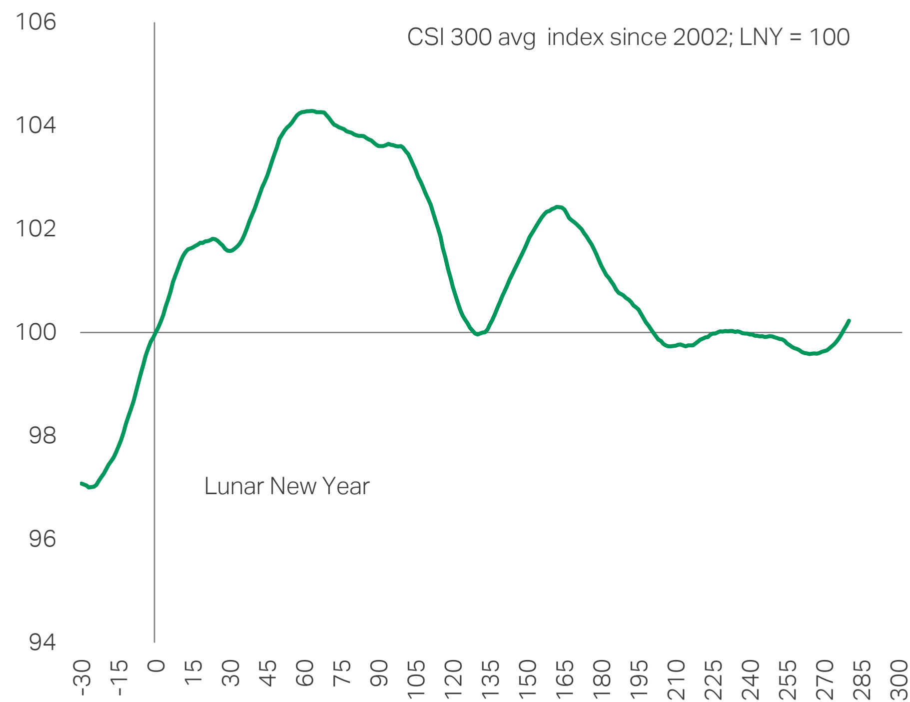


Also, regime changes are not uncommon. Looking at the MSCI World, for instance, one can clearly see that the beta dropped dramatically in 2016-17. For markets like India, regime changes cause the beta to flip from positive to negative and vice versa. In such cases understanding the direction of causality becomes particularly important.

Equities

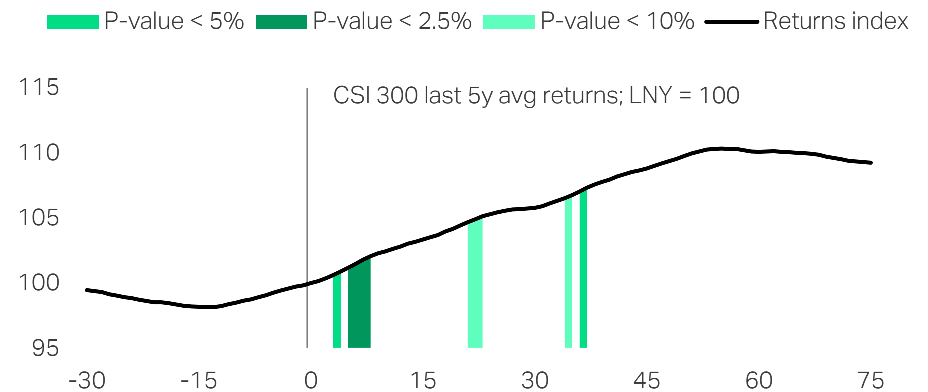
Lunar New Year and seasonality

LNY is the strongest period for Chinese stocks

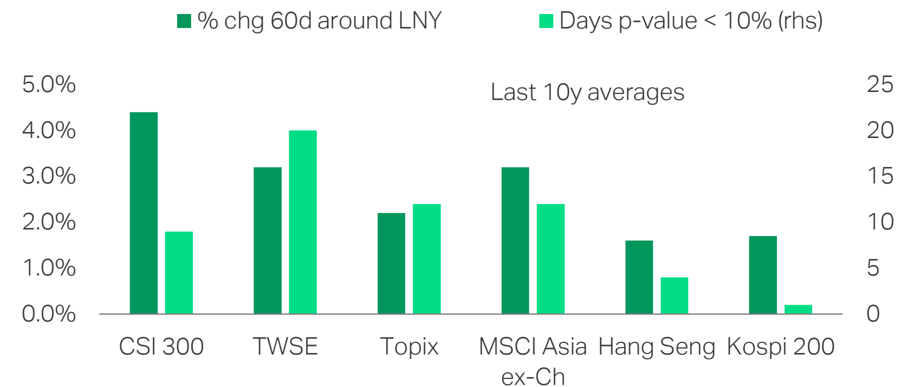


Chinese and other Asian equity markets exhibit strong seasonality around the Lunar New Year. The effect is statistically significant and has solid fundamental explanations: tens of millions of people travelling; busier-than-usual shopping; selling of shares in the lead-up to LNY to fund gifts of cash, and the subsequent repurchase of stocks; bonuses being paid and spent. In Macro Strategy we bought A-Shares and MSCI Taiwan to exploit this pattern.

Statistically significant gains

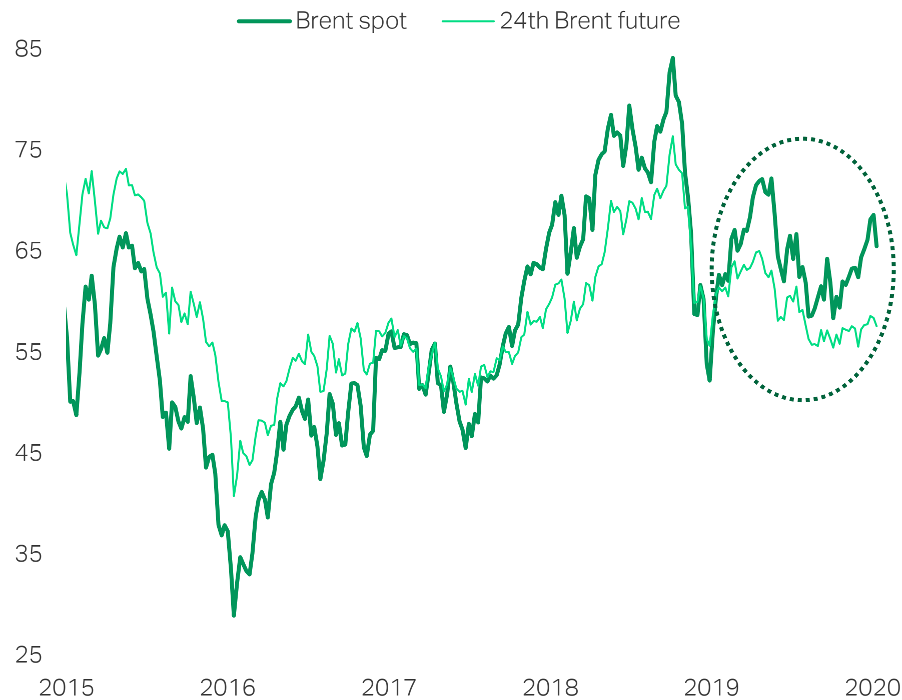


Taiwan is the other significant mover over LNY



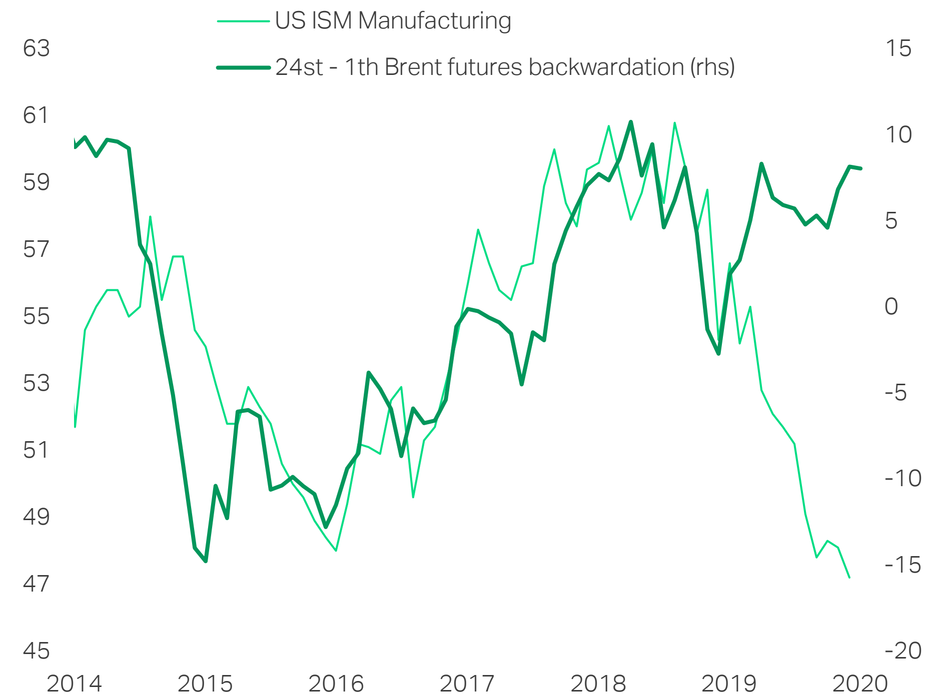
Commodities Backwardation: a double whammy

Two reasons for current crude curve backwardation



A backwardated crude curve is typically a sign of investors judging that short-term supply disruptions won't necessarily result in sustained long-term shortages. The spot price goes up, back futures less so. Middle East tensions often result in this behaviour. In the last 12 months, however, the backwardation has been caused as much by falling back futures as by rising spot.

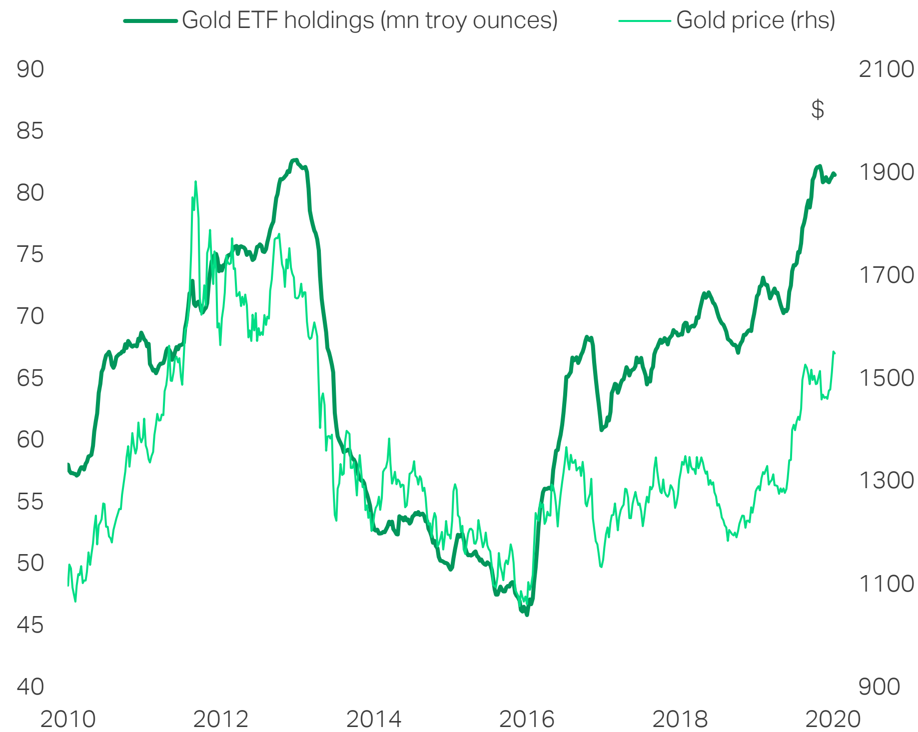
Near-term economic weakness plus OPEC+ supply restrictions



The level of industrial activity tends to correlate positively with backwardation in the oil curve. Crude supply struggles to keep up with rising demand, but oil production is expected to catch up over time, correcting the near-term imbalance. But increased backwardation over the past year has been driven more by slowing economic growth, which has dragged down back futures prices, coupled with support for spot prices from OPEC+ supply cuts.

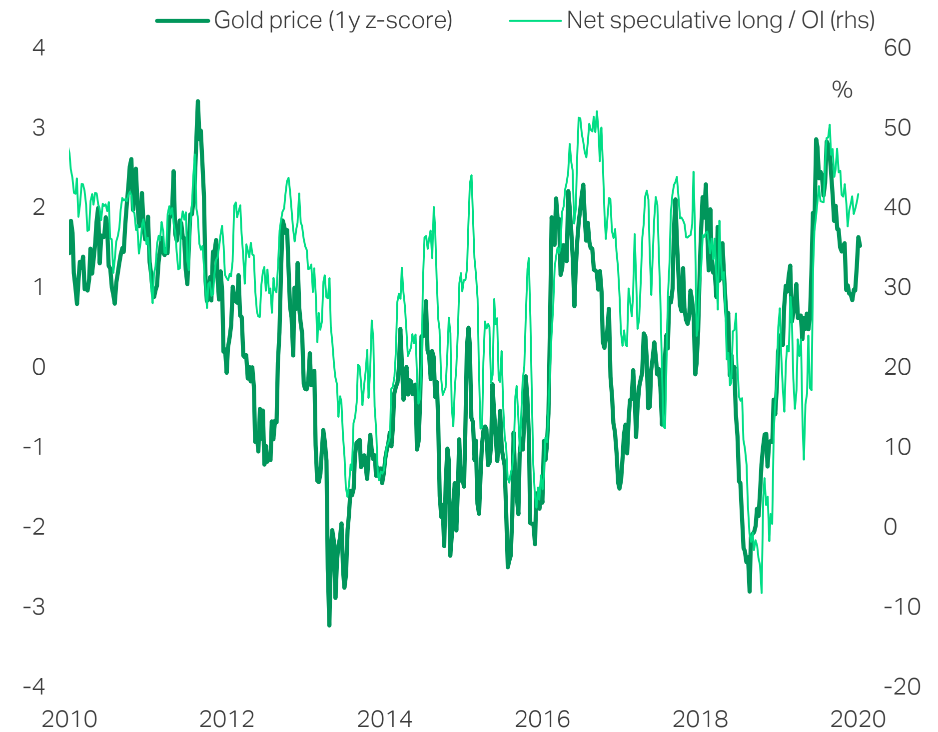
Commodities Risk-reward in gold still unappealing

Positioning in gold ETFs remains close to all-time highs



Heightened tensions between Iran and the US led to a surge in gold prices. The two countries have appeared to de-escalate the conflict, but only some of gold's gains have been undone. In other safe-haven as well as risk assets, by contrast, the initial reaction has been completely reversed.

Speculators were very long gold even before recent events



This suggests gold remains the instrument of choice for investors looking to hedge tail risks. However, we're not chasing this rally. Positioning in gold ETFs and futures looked very long even before the latest flare-up. This suggests that, absent a major escalation, the risk-reward offered by gold remains unattractive.

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