Macro Strategy

PREPARING FOR 2020 ACTION ... IN H2

Oliver Brennan

- **We are bullish risk in the near term, but see clouds on the horizon**
- **We buy forward vol in equities and FX to position for 2020 H2 risks**
- **Portfolio review of 2019: a strong finish, and we sell more EUR/USD calls**

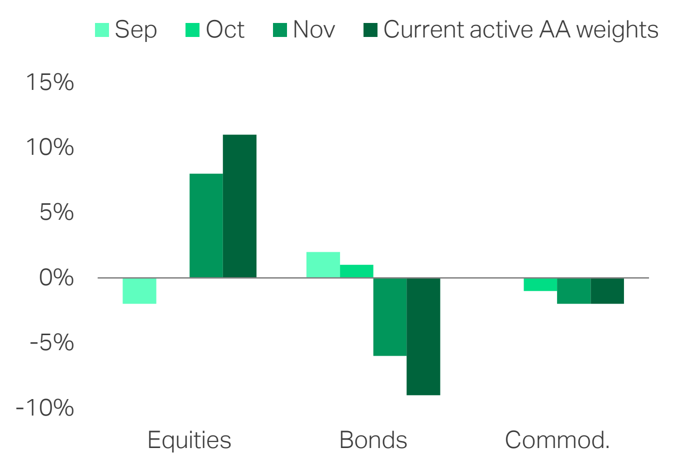
Our year-ahead outlook is a case of jam today. Last week's event risks – the Fed and ECB policy meetings, the UK election and US-China trade deadlines – passed with market-friendly outcomes and there is currently sufficient central bank liquidity support that market dips should be bought. In this month's Asset Allocation we laid out why we see the next few months as a positive period for risky assets and further increased our risk exposure to 11% overweight global equities.

But the jam will not last forever. We reckon the trade war is now on the back burner until after November's US presidential election. But as the race to be the Democratic nominee hots up ahead of the party's convention in July, election risks will mount in Q2. And if Trump were to win a second term, he may find himself at the head of a divided government – a situation which would encourage him to focus on foreign policy and restart his trade battles.

Central bank liquidity support is here for now but may weaken later. While the Fed is likely to continue buying T-Bills "at least into the second quarter of next year", our calculations below suggest that after five more months of purchases bank reserves may once again be plentiful.

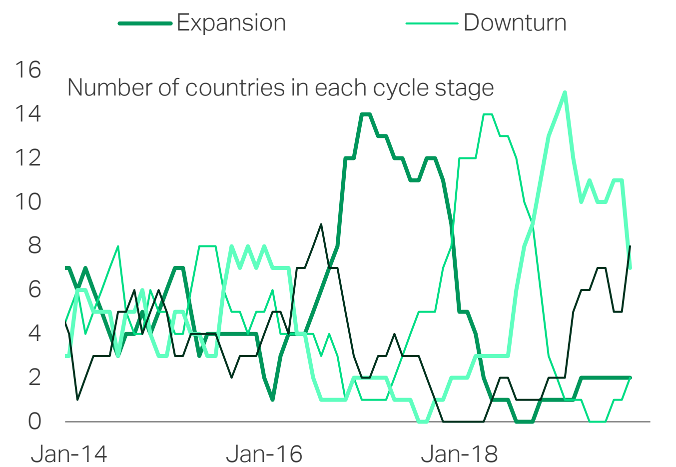
Long forward vol. Putting these pieces together, we have a framework that makes us want to be long risk now and long vol later. In today's note we buy forward VIX and forward NZD/USD vol.

Current Asset Allocation stance: o/w equities



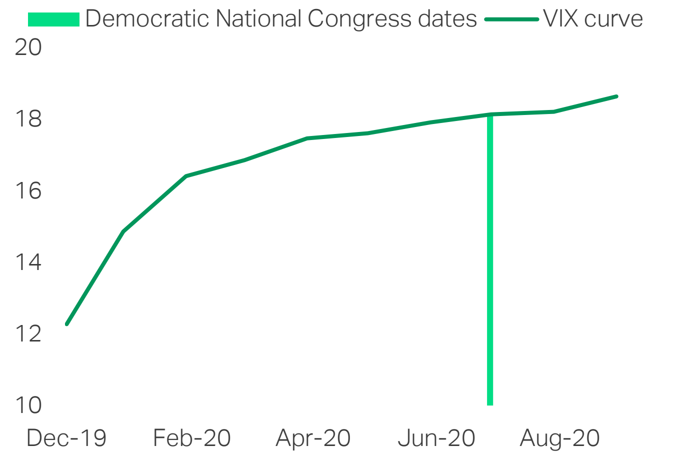
Source: TS Lombard

OECD leading indicator looking more optimistic



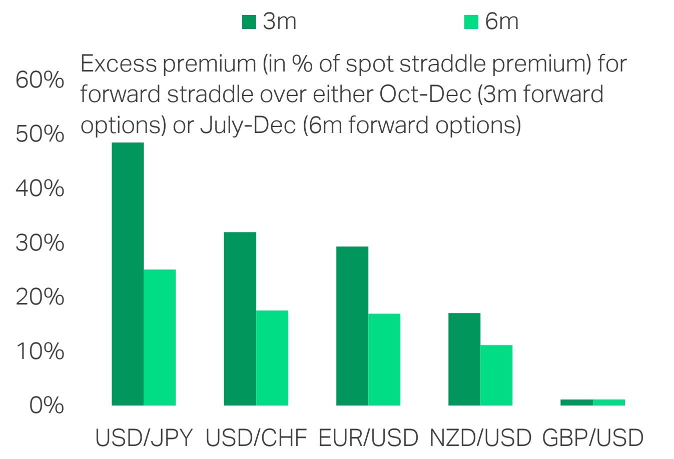
Source: OECD, TS Lombard

VIX futures are flat around the DNC



Source: Bloomberg, TS Lombard

FX forward vol not in the price for NZD/USD



Source: Bloomberg, TS Lombard

Positive market environment for the next few months. The generous provision of liquidity is not only brightening the outlook for markets. There are also some signs of an economic recovery. The OECD's leading indicators, which, it must be pointed out, tend to lag, are improving; 10 of the countries we follow boast a rising LI, denoting recovery or expansion, while nine have a falling LI, indicating a downturn or slowdown.

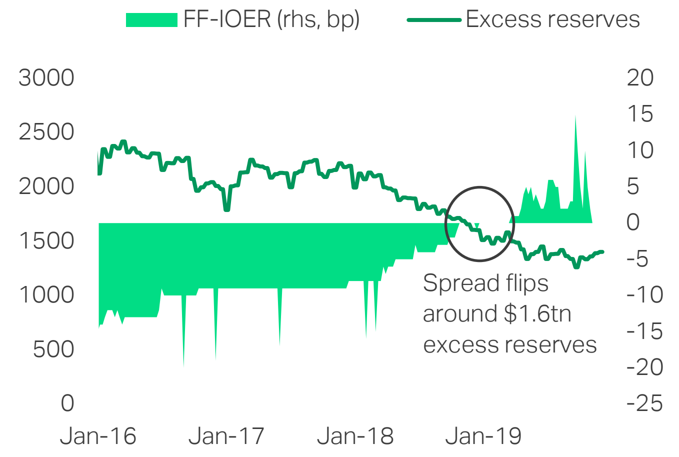
Flat forward vol curves. Owning forward vol is worthwhile only when event risk is not sufficiently discounted already – we want to find the flattest vol curves over the relevant period. At the moment, forward vol is obliging.

In equities, the front end of the VIX forward curve is actually steep. We looked at this in "Over-exuberant equities" and pointed out that a steep VIX curve was not historically good for stocks. Since the Fed has backstopped the market with its liquidity injections and the US and China have reached an interim trade deal, the next few months may prove an exception to this rule. But the back end is still flat (at a high level) and this is the area that interests us. The Democratic National Convention (DNC) is on July 13th-16th, where we expect a close race for the nomination. And as some candidates proposals are potentially negative for the equity market, this means the DNC could be the first of the risk events in H2. **We sell one unit of June VIX futures and buy one unit of August for a net cost of 0.4** vol points to own event risk over the DNC (listed futures do not yet cover the presidential election on November 3rd).

In FX, implied options curves are already beginning to price in H2 event risk with EUR/USD, USD/JPY and USD/CHF steepness around one standard deviation above average. For example, forward USD/CHF 3m vol starting in September is around 8%, a hefty premium over current 3m vol at 5.5%. Among the major pairs, only the GBP/USD and NZD/USD vol curves are below their long-term averages. NZD/USD looks the pick of the bunch. Why not cable? The answer is lingering H1 Brexit-related risks, plus the vol base is high compared to other pairs.

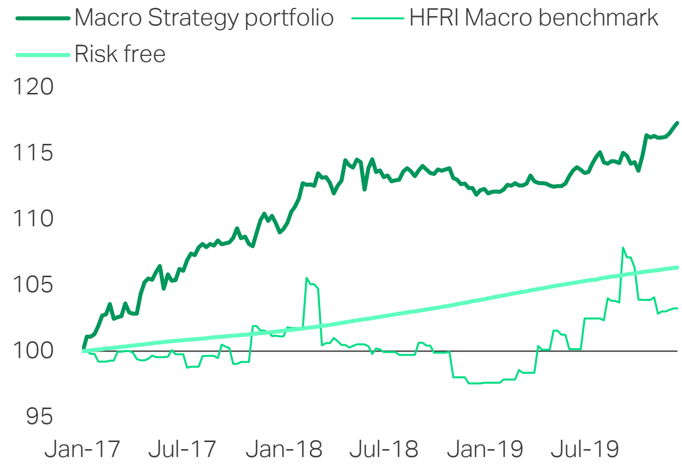
Forward 6m NZD/USD vol is 8%, a premium over the current 7.2%. But this period spans the US vote *and* the NZ general election, due before the end of November. We take the risk that NZ will go to the polls in Q3 at the earliest (the last five elections have been held no earlier than September; a snap election is unlikely since the incumbent Labour party is trailing in the opinion polls) and we **buy a 6m6m NZD/USD vol swap for 0.3 points** (sell 6m at 7.4; buy 1y at 7.7), betting 6m implied vol will rise above 8% for 2020 H2.

Fed T-Bill buying to continue in H1



Source: Federal Reserve, Bloomberg, TS Lombard

Model portfolio up 17% over last 3 years



Source: TS Lombard

Fixed income vol should remain suppressed. With the Fed buying $60bn of T-Bills a month, it may take another four to five months before excess reserves are back above $1.6trn, the level below which fed funds started trading above IOER (see our May note "Five bps: when a little means a lot"). And even once this point is reached, we reckon the Fed will continue to err on the side of caution. In his 2020 outlook, our US economist, Steve Blitz, expects the Fed to continue feeding liquidity into the market after Q2. As such, although the fair value of yields should rise (see the Cross Asset section of Asset Allocation) as economic data improve, we do not anticipate large fixed income moves in H1. Fixed income also offers a good forward vol opportunity for H2, but in our model portfolio here we stick with VIX and NZD/USD for now.

Portfolio update: a strong finish

Year to date, our model portfolio has returned 4.4%, half of which has come in Q4. The most profitable trades were our healthcare/pharma and transportation/aerospace RV trades; our short CNH trades also made gains. The hit rate (share of profitable recommendations) was over 55%. Although we have so far underperformed our HFRI Macro benchmark this year (4.4% vs 5.8%), our **three-year average performance is well ahead of the Hedge Fund Macro universe (5.6% ann vs 1.5% ann).** Moreover, the portfolio remains uncorrelated to the benchmark and other major indices, making it a truly different source of alpha.

The market reaction to the UK election result was almost precisely as we expected. But our choice of a 1.3450 topside barrier in cable proved to be too aggressive as cable rose just above 1.35 and the GBP/USD DKO was knocked out. Our EUR/GBP DKO remains in the money, and we hold onto this position as well as our long UK vs EMU equities trade.

We sell another EUR/USD short-term call to fund the long EUR/USD spot position: we sell half a unit of 6w 1.1300 to earn 20bp; this means our EUR/USD spot position is again fully hedged with a half-unit short call at 1.1250 expiring on New Year's Day and with this new option expiring at the end of January.

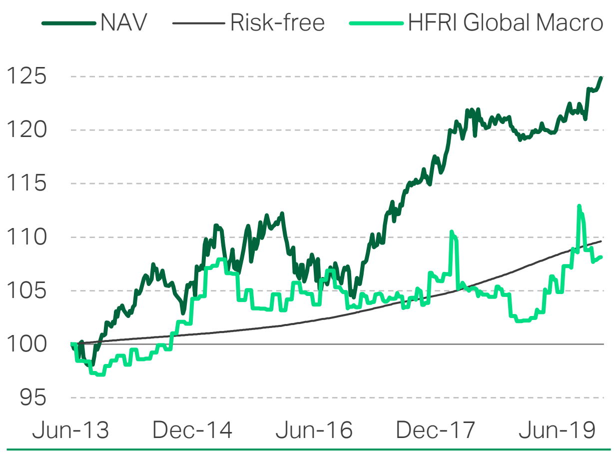
Elsewhere, we **raise the stop on our AT1 CoCos (+4.5%) position to 106.90**, locking in over 2% profit. We also **raise the stop on our long NOK/JPY (+2.5%) position to 11.90**, cementing a small gain, but we keep some risk for the Norges Bank policy meeting tomorrow. And finally we **close our long AUD/CAD position** after today's Canadian CPI. Spot volatility is greater than any directional trend at the moment, so the risk can be put to better use elsewhere.

Current trade recommendations

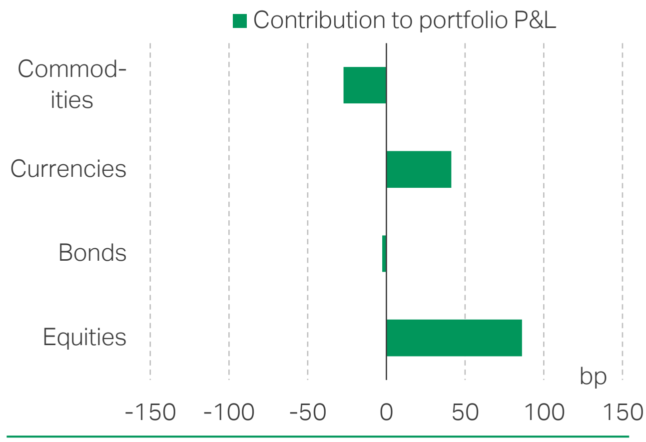
Theme / Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
2020 H2 risks							
Long Aug VIX vs June VIX	18-Dec-19	0.4					Forward vol for end of H1, including DNC
Long NZD/USD 6m6m vol	18-Dec-19	8					Forward vol for H2, including US and NZ elections
Growth to underperform Value							
Long IVE vs IVW	11-Sep-19	0.661	0.677	2.48%		0.661	High valuation and signs of slowing momentum risk growth rerating lower
EA banks to benefit from tiering							
Long AT1 CoCos (COCB LN)	18-Sep-19	104.7	109.4	4.5%		**106.9**	Tiering saves banks money; if policy ease further banks will be shielded
Relative value FX							
Long AUD/CAD*	9-Oct-19	0.8970	0.8998	0.3%		0.8930	CA economic cycle in slowdown; AU cycle improving
Long NOK/JPY	23-Oct-19	11.83	12.149	2.7%		**11.90**	NOK is cheap and Norges should remain hawkish
Fundamentals to drive next leg of equity gains							
Long US Financials vs Materials	6-Nov-19	1.3850	1.4244	2.7%		1.3950	Relative earnings trends and valuations support FN vs MT
Long Italy vs Germany	6-Nov-19	1.0150	1.004	-0.9%		0.9850	Relative fundamentals and valuations support IT vs GE
EUR set for positive consolidation							
Long EUR/USD	20-Nov-19	1.1060	1.1121	0.6%			Positive seasonals, growth, Fed b/s expansion support EUR/USD
Short short-term EUR/USD calls**	20-Nov-19	0.21%	0.03%	18bp			...but negative carry and slow growth limit potential gains
Trading the UK election							
Long MSCI UK vs MSCI EMU	4-Sep-19	0.769	0.807	0.5%			UK discount includes no-deal and nationalisation risks; both overstated
Long EUR/GBP 6w DKO put***	27-Nov-19	38bp	76bp	26bp			
China-US spread							
Long China 10y vs US 10y	11-Dec-19	138bp	134bp	5bp	100bp	160bp	Slower growth and falling inflation to narrow spread
Portfolio hedge							
Long VIX January 17-21 call sp	13-Nov-19	1.0	0.4	-0.6			Market is becoming overexuberant

Bold indicates new trades or changes made this week. *Closing today **Adding another short-call this week ***GBP/USD hit barrier post-election

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	24.87%	8.12%
Annualized Return	**3.45%**	**1.20%**
2016	-4.89%	0.14%
2017	9.67%	2.47%
2018	2.98%	-3.48%
YTD	4.46%	5.81%
MTD	0.91%	
Volatility (ann.)	4.18%	4.13%
Sharpe ratio	**0.48**	**-0.04**
Sortino ratio	**1.49**	**0.50**
Alpha (12m, vs HFRI)	-0.11%	
Beta (12m, vs HFRI)	-0.17	
Corr (12m, vs HFRI)	-0.23	
Corr (12m,vs MSCI World)	-0.06	
Corr (12m, vs JPM GBI)	-0.26	
Max drawdown (12m)	-4.16%	-1.13%

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long Healthcare Equipment/short Pharma (22-May-19)	118
Long US Transportation/short Aerospace (21-Aug-19)	61
US 2s10s steepener (07-Nov-18)	40
Long Eurostoxx banks/Short Eurostoxx (18-Sep-19)	32
Fed Funds Futures Oct19 (23-Jan-19)	29
Worst	**Contrib. (bp)**
Long EM / Short US (24-Apr-19)	-37
Long EM ETF (03-Dec-18)	-36
Long Comms/short Tech (07-Aug-2019)	-30
Short Brent /WTI spread (19-Sep-18)	-27
US Consumer Discretionary (06-Dec-18)	-22

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