Strategy Chartbook

APRIL 2019 CHARTBOOK

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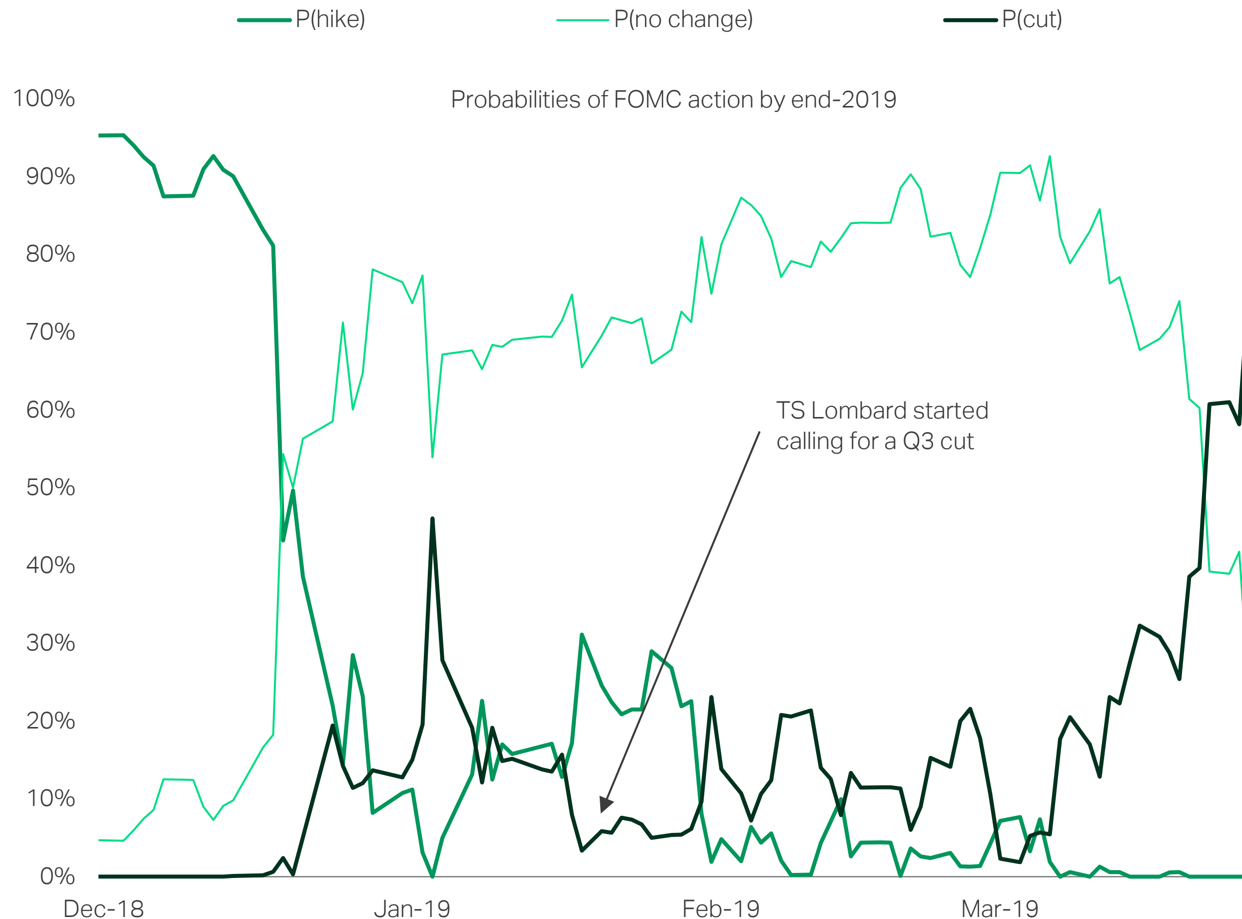
HIGHLIGHTS

- **Macro Drivers.** Central bank easing has boosted Chinese activity, but global growth still slowing
- **Multi Asset.** The UST yield-stock price divergence makes perfect sense, but can it last?
- **Fixed Income.** US yield curve indicating recession risk, but Fed eases Treasury funding needs
- **Currencies.** Lack of yield support for USD/JPY; TRY weakness always a risk given external position
- **Equities.** Despite weak data, bullish EM investors keep pouring into China, particularly Cyclicals
- **Commodities.** China new business supporting copper for now, but size of stimulus will disappoint

Chart of the month

Fed policy stance now "easy"



Since the FOMC formally softened its monetary stance at this month's meeting – removing 25bp of hikes from the dot plot for 2019 and taking out 50bp of hikes in total – investors have rushed to discount a fed funds rate cut as the most likely outcome this year.

Monetary policy works with long and variable lags, of course, so this move does not necessarily mean economic data will immediately pick up in the US. Indeed, we still expect a rate cut in Q3.

But policy easing in the US, and in China, is likely to support sentiment and boost growth. Evidence of a pick-up in Chinese activity is already starting to come through.

Elsewhere in this month's Chartbook:

- *Multi Asset.* Yield-stocks divergence: neither is wrong, but it may not last for much longer.
- *Fixed Income.* Tapering and ending QT will reduce pressure on Treasury issuance.
- *Currencies.* USD yield support is eroding, which should mean JPY rallies.
- *Equities.* EM investors rotating into Cyclicals despite persistent weakness in Chinese data.
- *Commodities.* Copper's recent support set to fade. Gold long positioning up on rising market risks.

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Summary – key points

Macro Drivers

- Fed and Chinese authorities are easing policy, evidence of improving Chinese sentiment starting to filter through
- But we expect Chinese exports to fall further before recovering, and global manufacturing PMI remains subdued
- Our leading indicators for the US and EA remain low; the recovery won't start until economic data starts to beat expectations

Multi-Asset

- The divergence between Treasury yields and stocks seen in Q1 reflects weaker economic growth, easier monetary policy
- But earnings expectations, following a small dip in Dec-Jan, have resumed climbing
- An inverted yield curve doesn't bode well for risk assets; credit remains expensive given ageing cycle, rising asset volatility

Fixed Income

- Fed policy shift pushed the universe of negative-yielding assets through $10trn and has further flattened the US yield curve
- The average time between inversion and recession in the US is no more than two years; 1.4 years for the 3m-10y curve
- But the end of QT, along with introducing QE-by-stealth by reinvesting MBS into UST, will help absorb record Treasury issuance

Currencies

- USD performed better against DM than EM currencies in 2019, but with yield support eroding the risk of a USD fall is mounting
- We did not expect the TRY sell-off to occur now, but Turkey's very weak external position means it is always at risk of a run
- Investors are losing interest in GBP – speculators are flat and options suggest investors expect GBP to remain range-bound

Equities

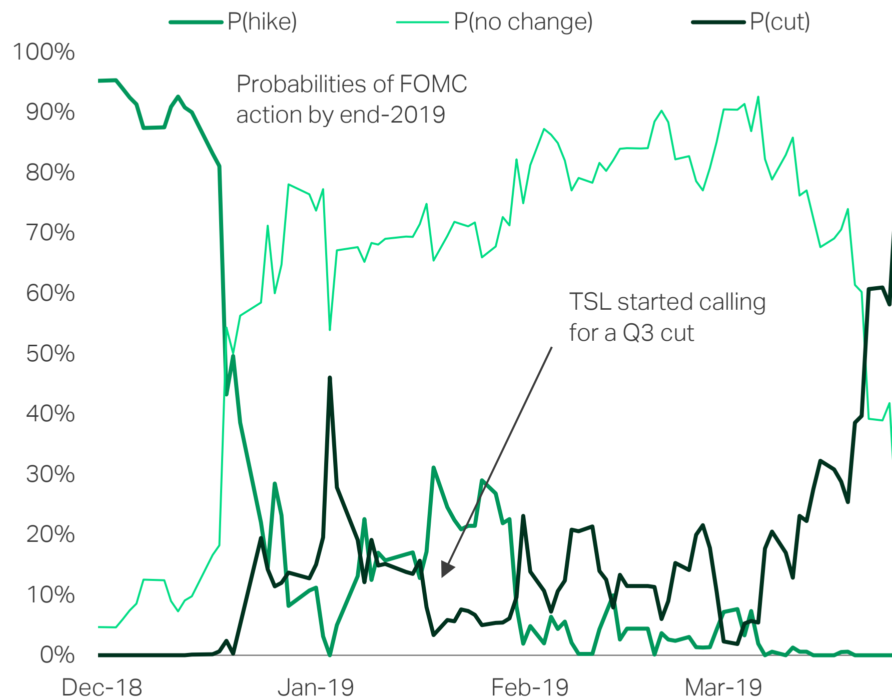
- China's outperformance of EMs in 2019 is likely to fade as margins are peaky and stocks are above their target prices
- The vast majority of inflows in the past six months has gone into Cyclicals, reversing the previous rotation into Defensives
- The continued disappointment from Chinese data doesn't seem to support investor bullishness, making a relapse is likely

Commodities

- Industrial metals have ticked up YTD on the back of increased new business from China as Beijing's stimulus feeds through
- Underwhelming stimulus size, increased supply mean that the recent move is unlikely to continue for much longer
- A build-up in gold long positioning – and higher prices – is the result of heightened risks in financial markets

Macro Drivers Policy easing: long and variable lags?

FOMC's dovish shift complete



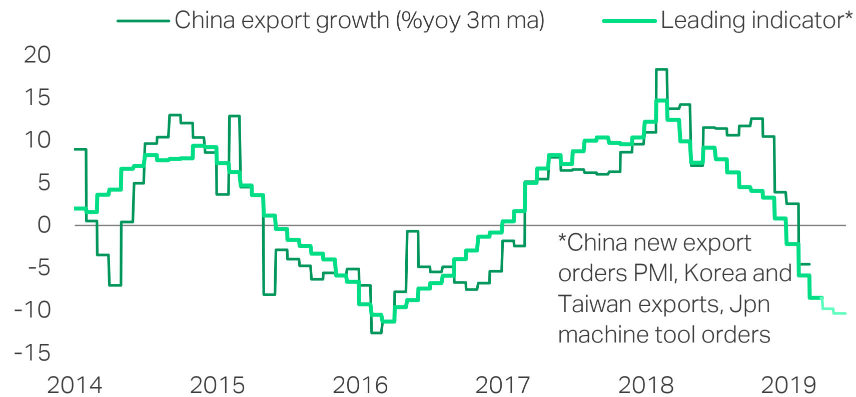
At its March FOMC meeting, the Fed confirmed its 'patient' stance and eased its balance sheet normalisation policy (see the Fixed Income section). The market's response has been to bet on a rate cut within the next 12 months. We reckon there is a chance of a cut in Q3, or earlier if data deteriorates, and the market is coming round to this view. The policy easing put in place should begin to support sentiment.

Chinese credit easing has started…

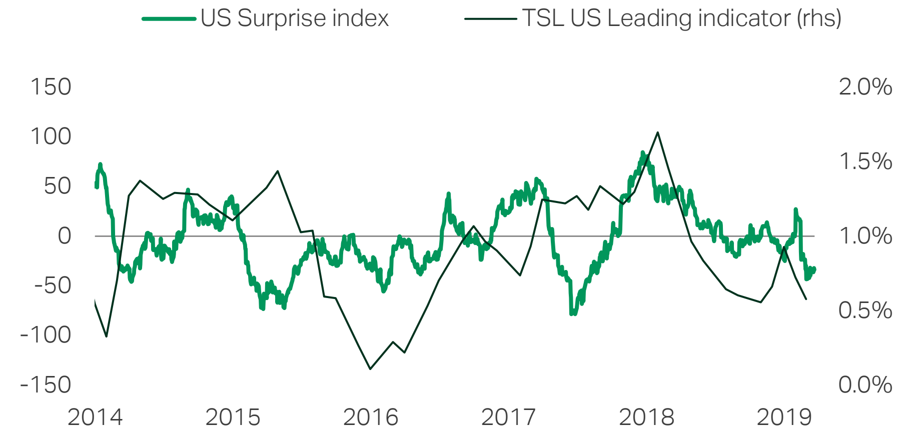
… and HK PMI data has already responded

Macro Drivers But econ activity remains in doldrums

Our leading indicator suggests Chinese exports will fall further



Our leading indicators for the US and EA continue to decline

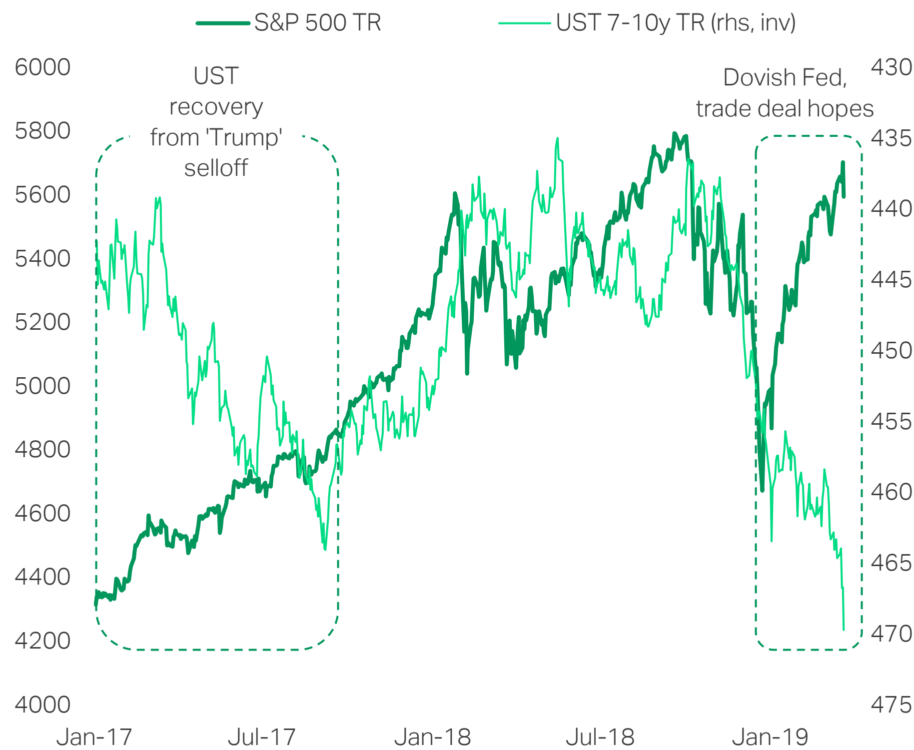


Global growth still on the back foot

And economic surprises are also underwhelming

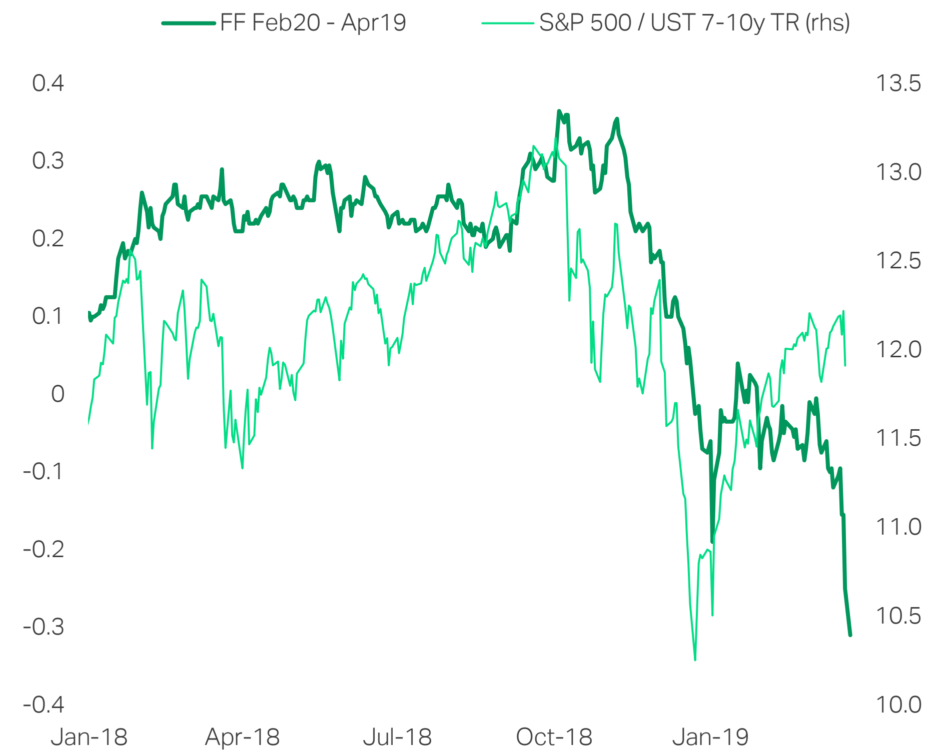
Multi-Asset   Making sense of UST-stocks divergence

Bond-stocks divergence: what's causing it?



The divergence between USTs and stocks in early 2017 was due to bonds recovering from a sell-off induced by Trump's election. The recent episode is different: 10y yields reflect a slowing US economy, worsened by weakness in Europe and China, while stocks bounced on a potential easing of the US-China trade war, Powell's soothing words and prospects of QT ending. The stocks/bonds divergence in Q1 makes sense.

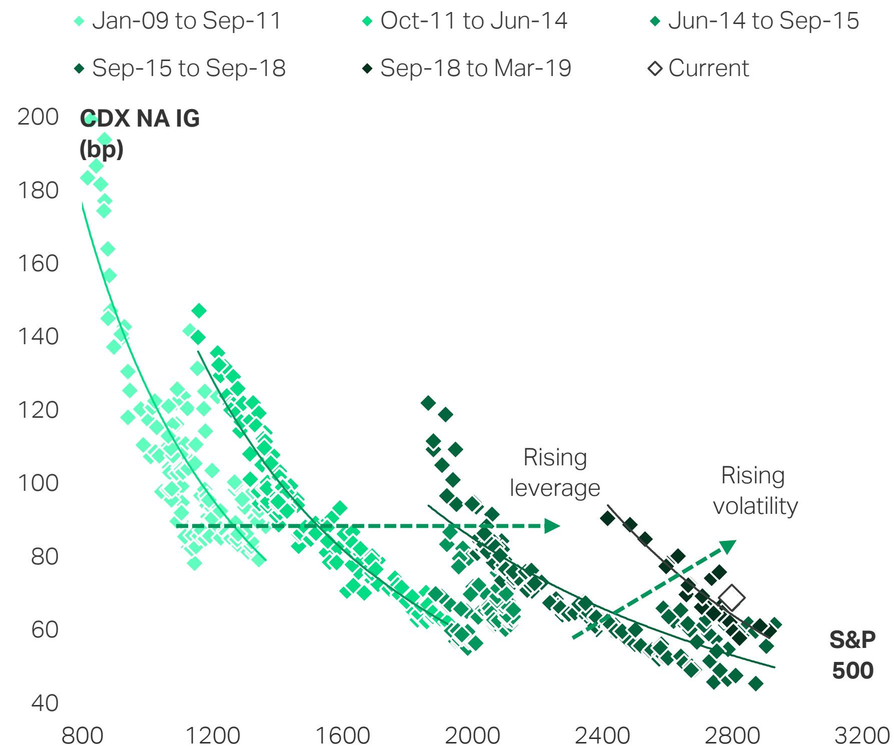
From 1½ hikes to 1½ cuts – but earnings expectations buoyant



How long the outperformance of stocks lasts is an entirely different matter. As a dovish Fed prompted investor expectations to swivel from more hikes in 2019 to cuts, continued bond resilience is to be expected. However, earnings expectations, after a brief decline in December-January, have started climbing again. With the yield curve now fully inverted, we believe that a relapse in stocks looks increasingly likely.

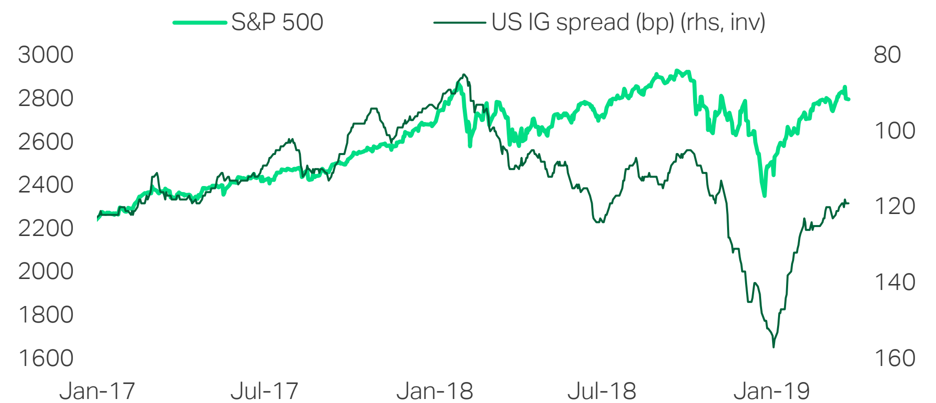
Multi-Asset Credit to continue lagging stocks

Higher leverage, vol => wider spreads for same equity prices

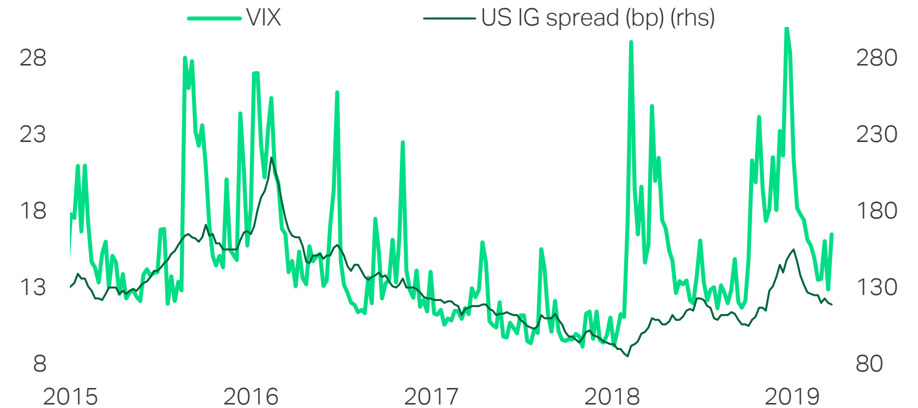


Since 2009 the tightening in credit spreads has lagged gains in stock prices as rising US corporate leverage has attracted a gradually higher credit risk premium. However, the main reason for the increase in the risk premium is not higher leverage (which is about the same as 2015), but higher asset volatility, which transfers value from bondholders to equity holders.

Growing divergence between stocks and bonds

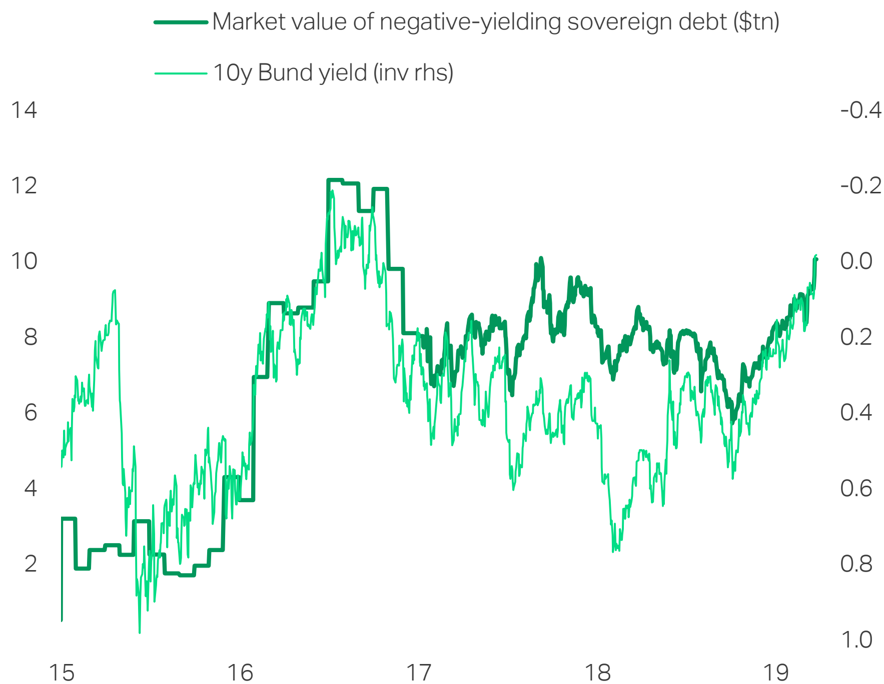


Spreads look too low compared to equity volatility



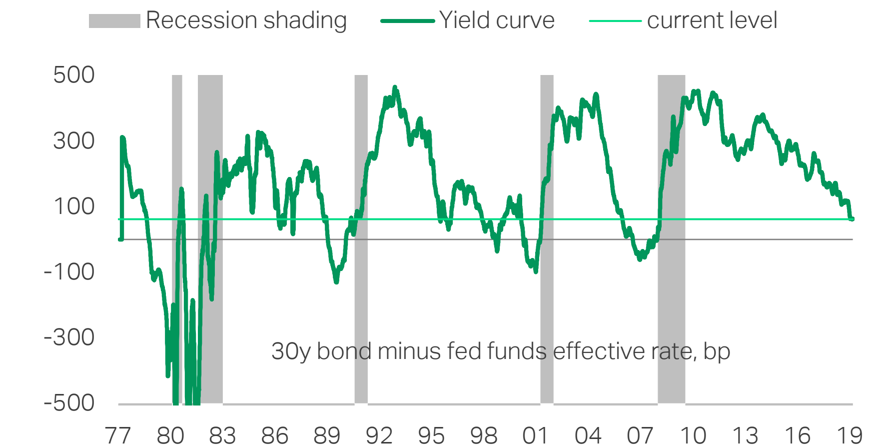
Fixed Income Fed cuts rates everywhere except fed funds

Ten trillion dollar question

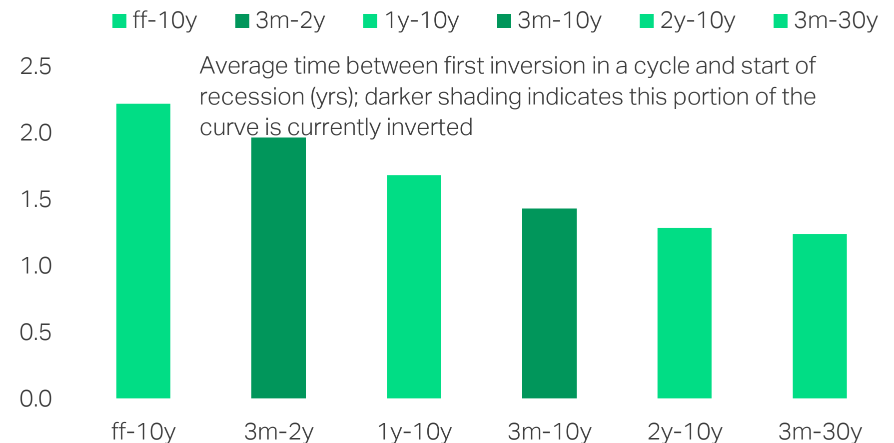


The Fed's dovish shift has sent the total value of negative-yielding global debt above $10trn. Although the Bund yield is now negative it remains much higher for a German investor than the yield on currency-hedged Treasuries (-70bp). Meanwhile, the Fed has ensured the US yield curve is extremely flat, with the front end now discounting a rate cut within the next couple of years. The question is whether this inversion will trigger a recession or whether the Fed's prompt reaction can avert such an outcome.

Like the 90s or the noughties?

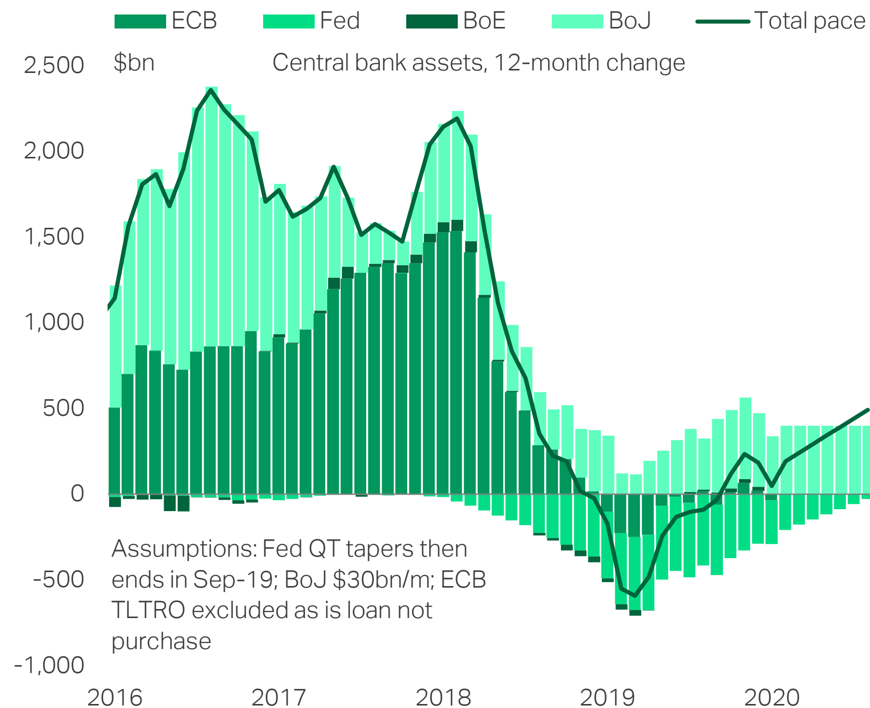


Time from curve inversion to recession is, on average, two years

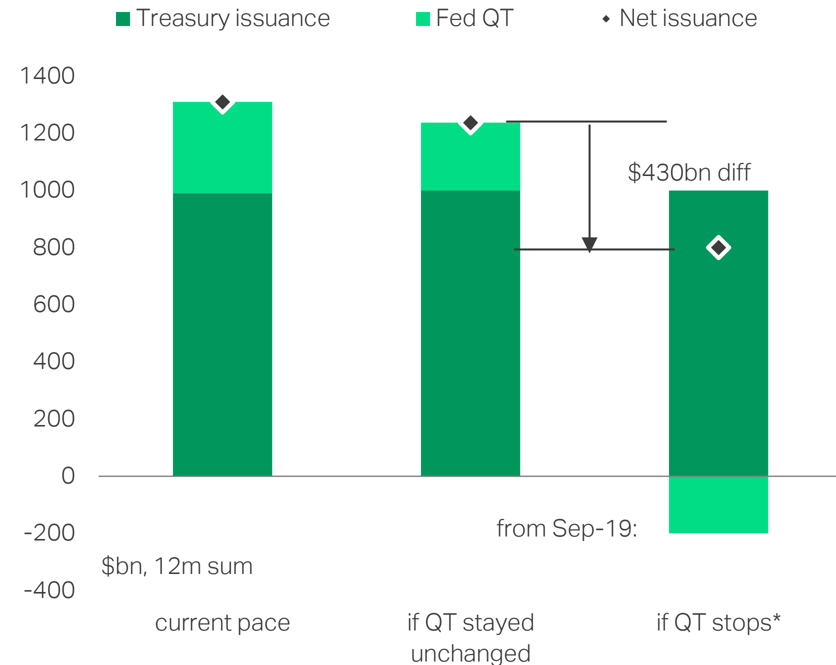


Fixed Income QE by stealth

QT to slow in May and end in September



End of QT means a 30% fall in net issuance next year

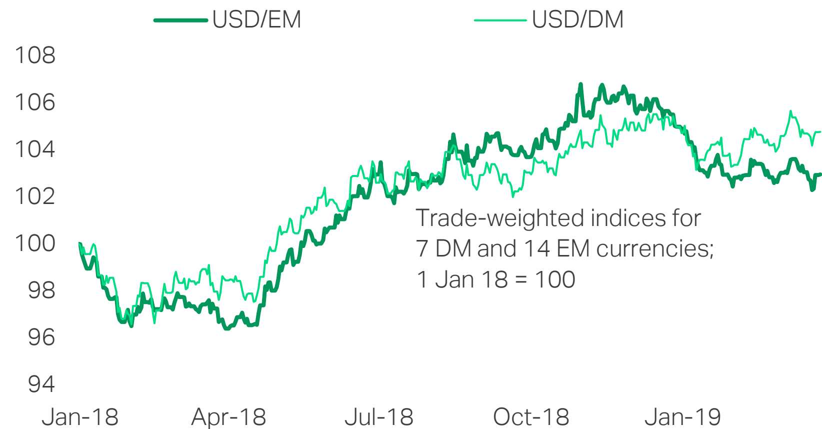


As we showed last month, the Fed's balance sheet will soon reach Chairman Powell's target of 16-17% of GDP. After halving the rate of Treasury QT to $15bn a month in May, the Fed will cease Treasury roll-offs in September. Thereafter, the Fed will use the proceeds of maturing MBS to buy Treasuries – QE by stealth (see chart, right). It also means that global CB liquidity provision will turn positive in Oct, thanks to BoJ's QQE.

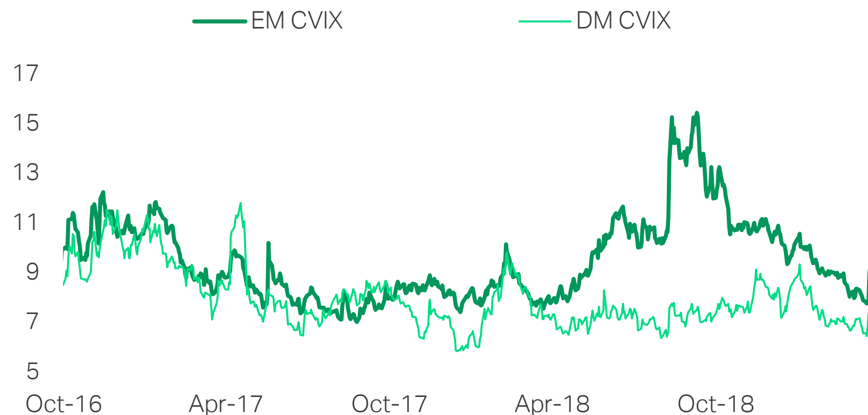
Adding estimated US Treasury debt sales of $1trn to the Fed's roll-offs, net Treasury issuance this year will be $1.3trn. Next year, if QT were unchanged, it would be around $1.25trn. But ending Treasury QT and switching MBS into Treasuries as they mature (at the current rate of $15bn/m) will lower net sales of new debt to $800bn in 2020. Still high, but this stealth QE is set to reduce net issuance by around 30%.

Currencies USD high despite yield fall

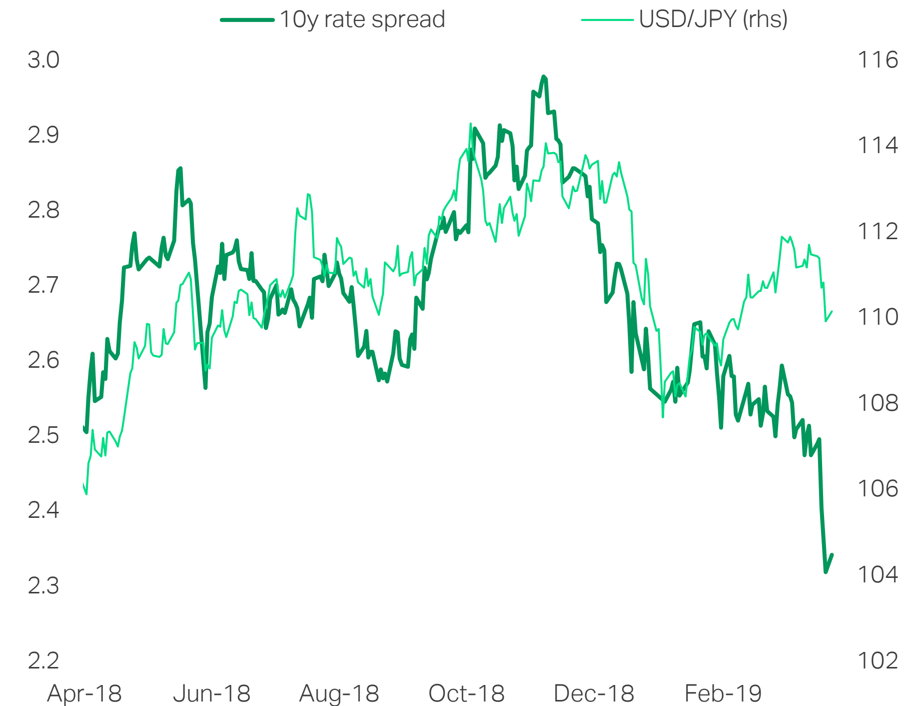
USD has outperformed vs DM so far this year



Which makes relative vol back to front: EM vol premium is too



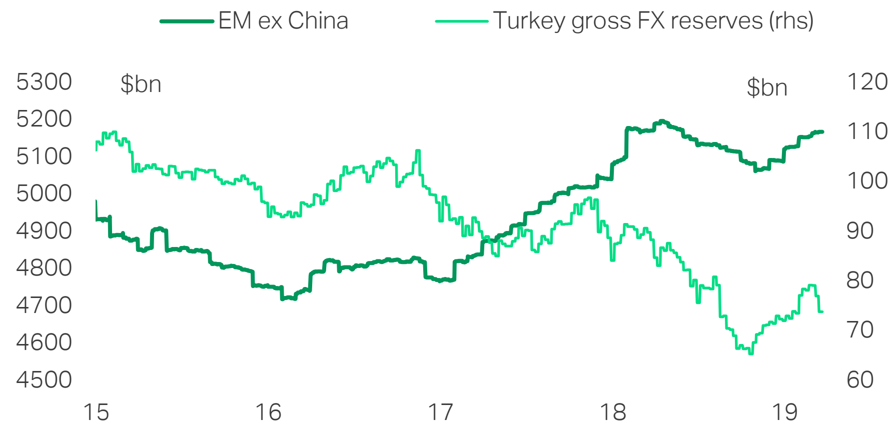
USD strength against JPY undermined by yields



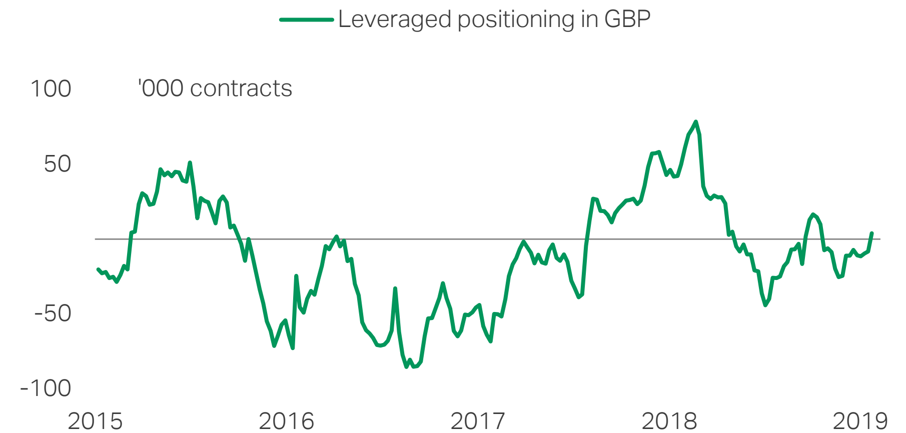
USD/JPY closely tracked the relative 10y rate spread over the 12 months to February. The rise in USD/JPY since then is out of line with the fall in US yields (and therefore the spread over JGBs). We are overweight JPY in our Asset Allocation portfolio, in part because of yield support and in part due to risk reduction across the board. USD remains rich overall, as we noted last month, and we do not expect to see a material USD rally this year.

Currencies EM FX reserves and GBP FX reverse

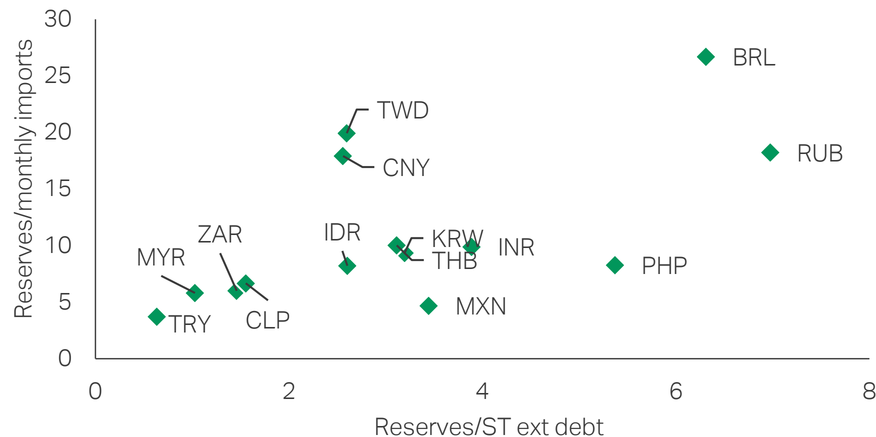
EM (ex China) FX reserves are rising, except in Turkey



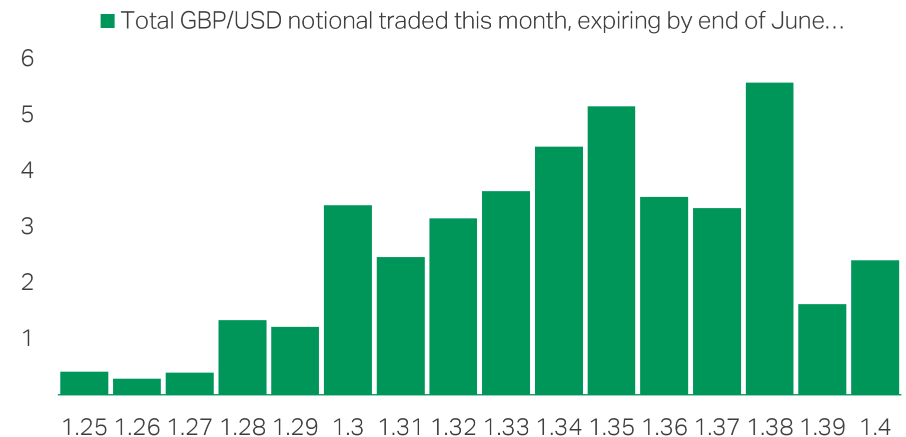
Spot FX market has no position in GBP



Turkey's weakest FX reserve position in EM justifies last week's



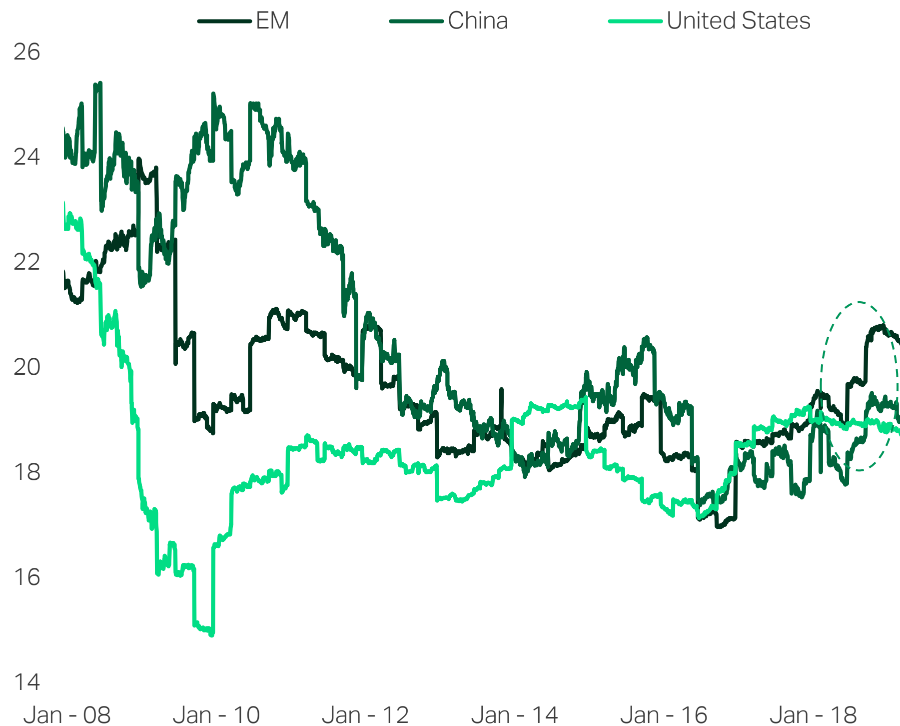
But based on options flow, GBP likely to remain in its Brexit range



Equities

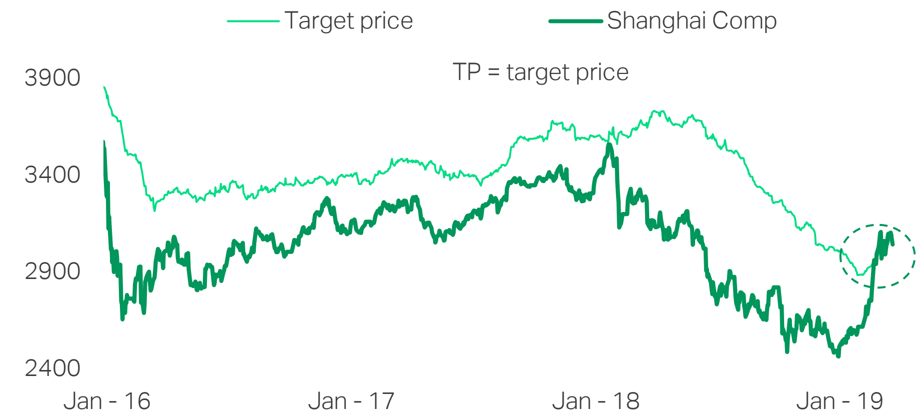
Chinese outperformance to fade

Chinese EBITDA margins at a peak

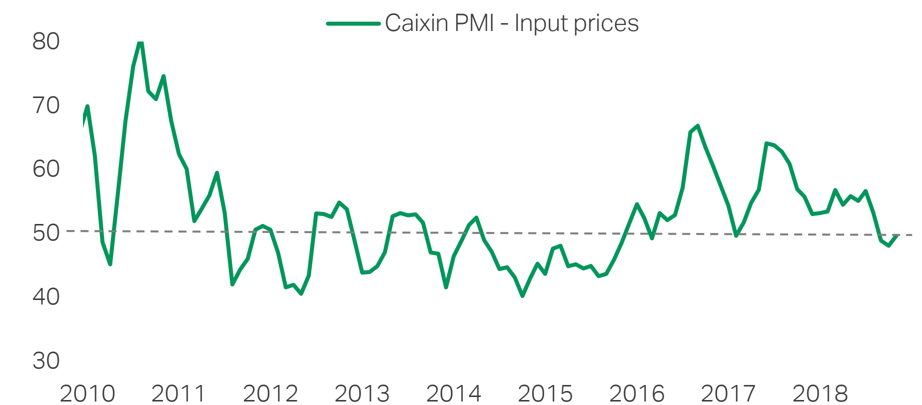


The outperformance of EMs relative to the rest of the world over the last six months has been spearheaded by a rally in Chinese assets. About 70% of total equity inflows YTD ($59bn) have been into EM and China-specific ETFs, supporting the EM rally. EBITDA margins in China have started to surpass those in developed markets due to supply-side reforms and a reduction in leverage.

Chinese equity euphoria



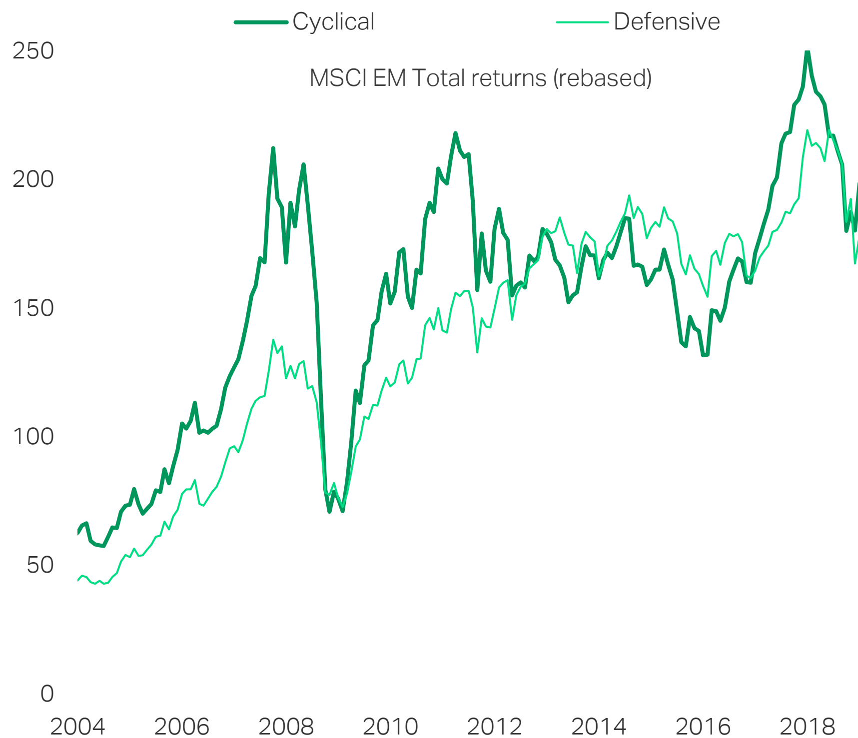
Chinese PMI prices hint at PPI deflation ahead



Equities

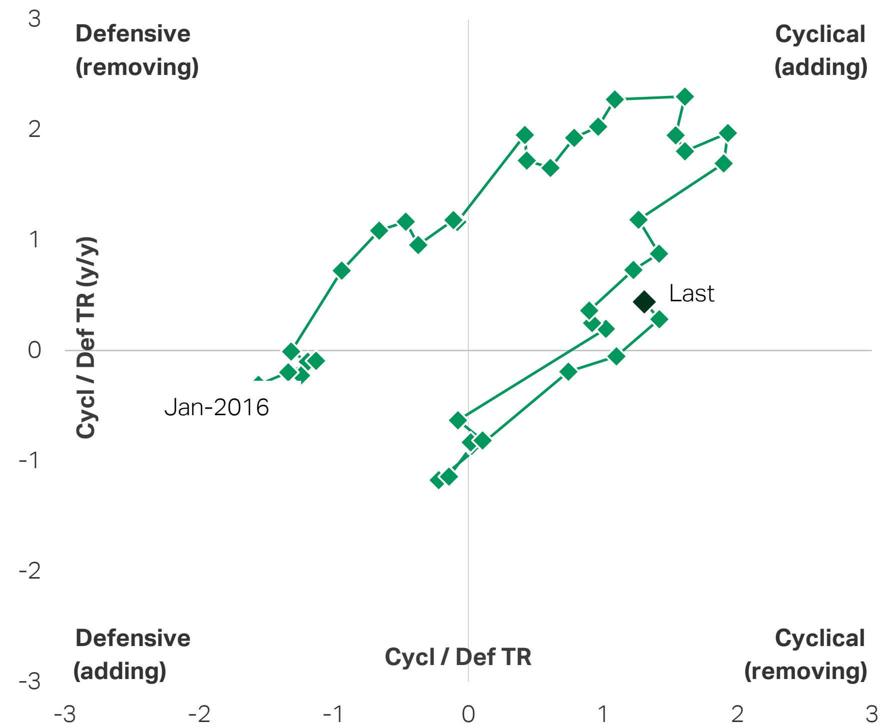
Markets get ahead of EM fundamentals

Recent EM Cyclical outperformance



The rotation into EMs (Chinese) stocks has been about adding to Cyclicals rather than a Defensives vs Cyclicals switch – i.e. holding Cyclicals or not holding EMs at all. The nature of this rally in EMs has been spurred by heightened EM inflows and sentiment, with clear elements of euphoria. Analysts have joined in the euphoria, upgrading their price targets and fuelling the surge in EM stocks.

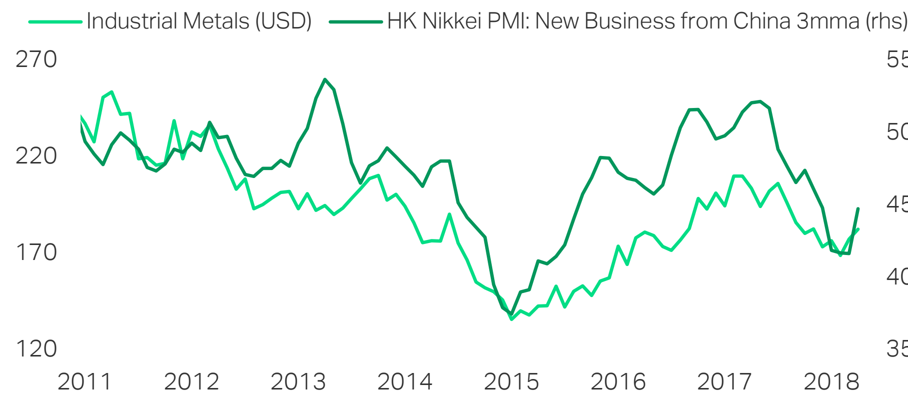
EM rotation in and out of EM cyclicals



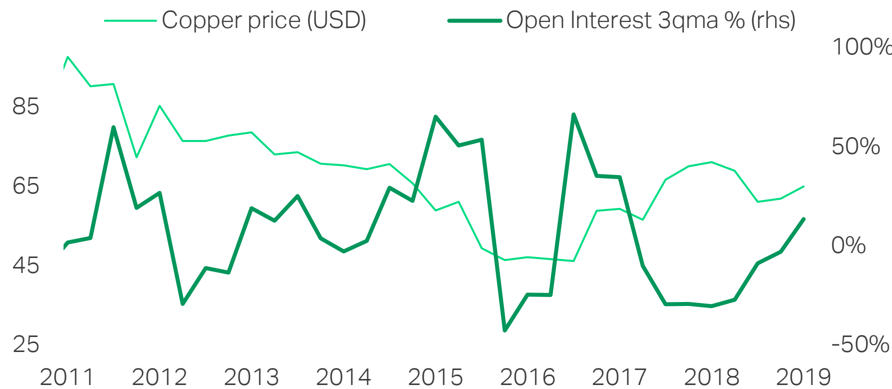
Worse-than-expected China data amid weakening growth fundamentals does not seem to support this reaction. We feel a phase of consolidation is in order. We do not see margin strength persisting since China is likely to experience producer price deflation. There could be a sharp sell-off or a period of stagnation as markets catch up to weakened fundamentals.

Commodities Copper's recent support to fade

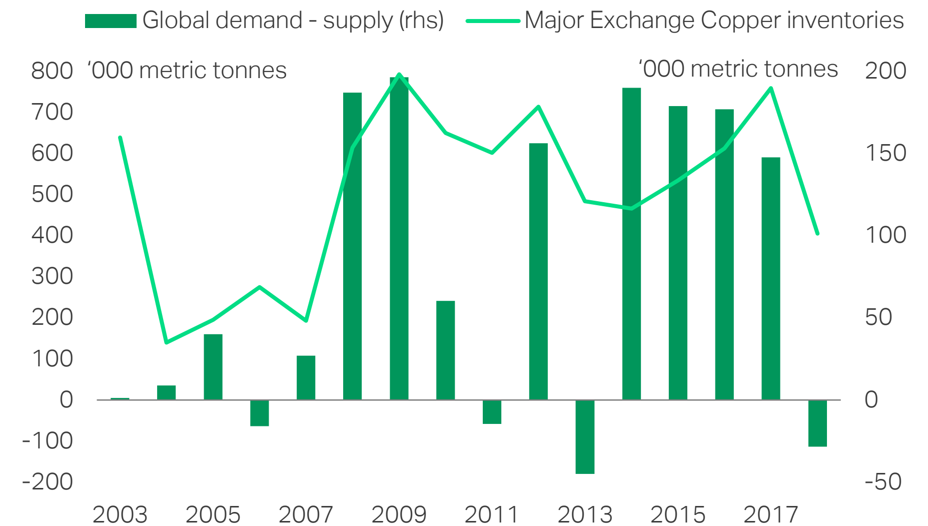
Industrial Metals supported by new business from China



Copper price bolstered by growing open interest



Copper market ended 2018 in deficit and with inventories falling

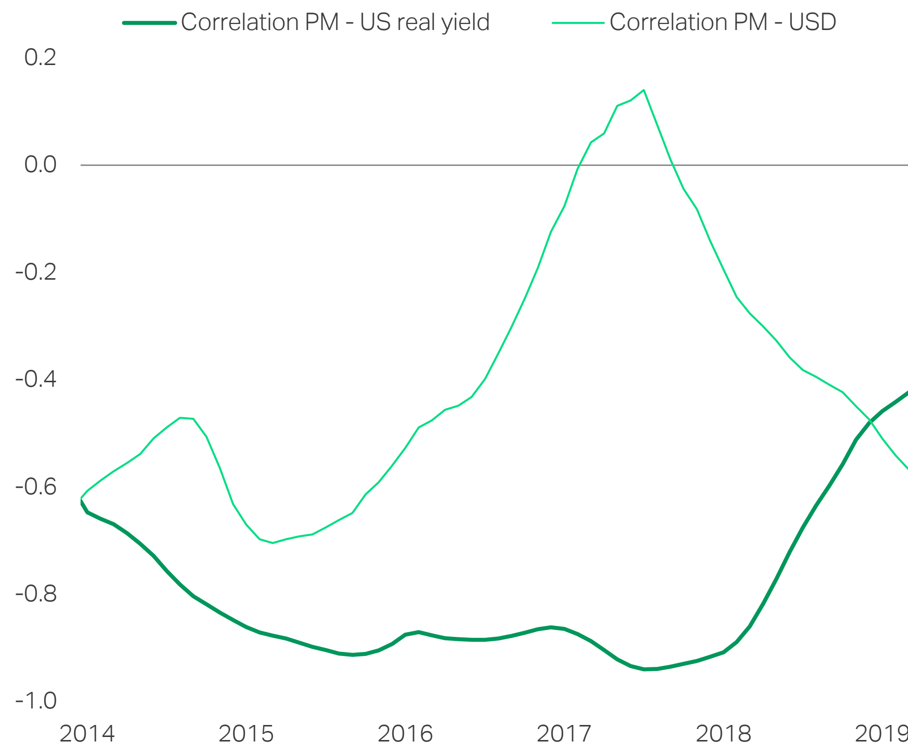


Industrial metals have ticked up YTD on the back of increased new business from China as Beijing's stimulus feeds through. Copper had already begun 2019 with demand outpacing global supply, leading to inventory drawdowns that supported the price. In keeping with its well-earned "Dr Copper" moniker, the metal has also tracked an improvement in leading indicators of new China business, prompting a rise in open interest.

Looking ahead, we are concerned about weakening growth fundamentals and believe China's stimulus will be underwhelming. Additionally, more copper mine supply is forecast to come online than in 2017 and 2018. We therefore anticipate some consolidation as Dr Copper prices in a softening of growth and market fundamentals.

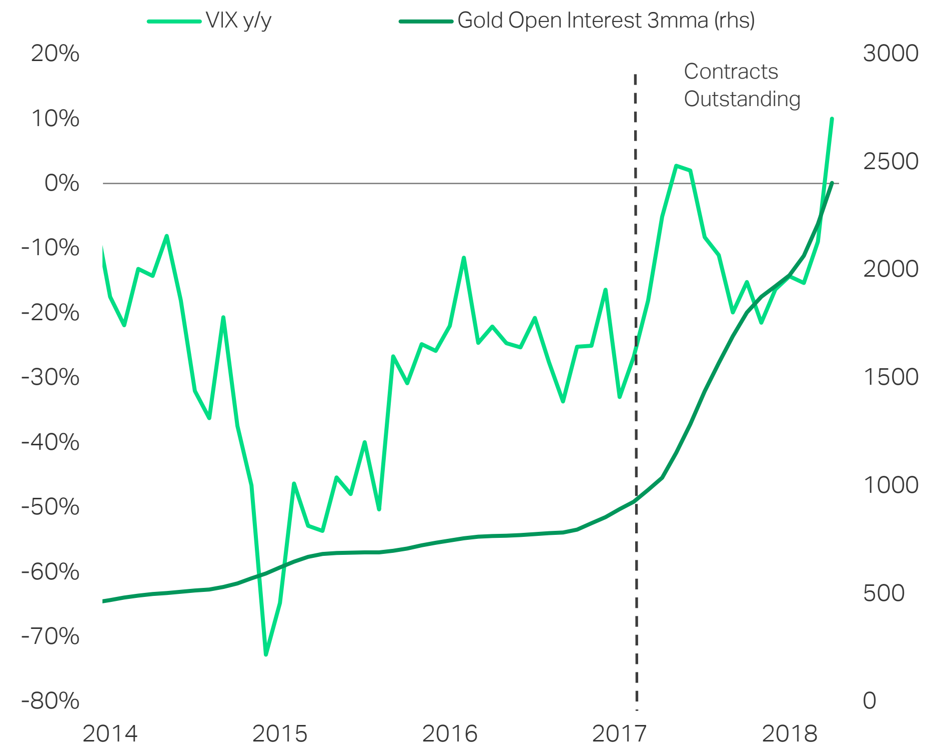
Commodities Gold reacting to heightened market risks

Precious metal correlations with real yields fading, with USD



Precious metals have historically been strongly negatively correlated with US 10y real yields, acting as an inflation hedge. However this relationship has been fading over the last year. Correlation with USD has strengthened towards -0.6 since H1 2018. However, the dollar has been relatively range bound during this period and as such is not providing much direction for PM commodities.

Positions in Gold building with VIX moves



Gold's chart shows open interest started to build up with the first spike in the VIX in February 2017 and has been growing ever since as global risks and uncertanties have mounted. Given that we expect these risks to persist in the short term, we anticipate support for gold and continued momentum in open interest positioning.

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