Strategy Chartbook

OCTOBER 2018 CHARTBOOK

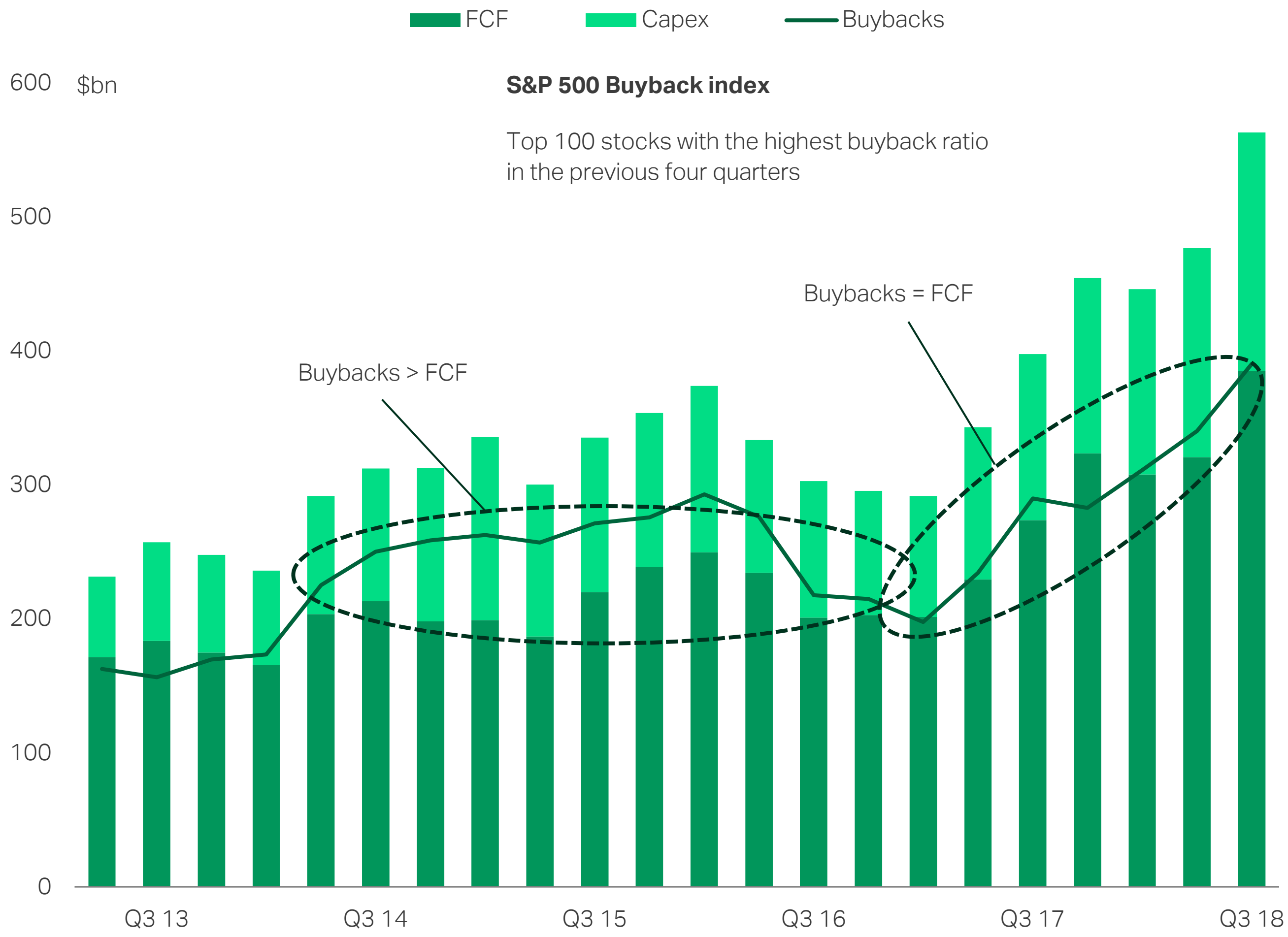
Andrea Cicione / Oliver Brennan

HIGHLIGHTS

- **Macro Drivers.** Trade war becoming material, EM headwinds unlikely to fade
- **Multi Asset.** US equities tend to outperform when the dollar strengthens – but will it?
- **Fixed Income.** The importance of global QE as a factor driving fixed income markets is already fading
- **Currencies.** USD picture against DMs mixed; EUR supported by changing EA balance of payments
- **Equities.** US capex continues to accelerate, and the outlook remains rosy
- **Commodities.** Both technicals and fundamentals suggest the Brent-WTI spread should narrow

Chart of the month

Record buybacks not impeding capex



In recent years large stock repurchase programmes have triggered a debate as to whether buybacks are just a cheap trick by corporate executives to artificially inflate earnings – on a per-share basis – and the share price. Critics say that companies should be spending extra cash to pursue growth opportunities instead, especially now that specific tax incentives have been put in place to boost capex.

The firms most active in repurchasing their own shares deserve more credit. Since 2017 record-high buybacks have been entirely funded by free cash flows – yet all the while capex at these firms outpaced the market. This behaviour contrasts with the 2013-2015 period, when buybacks were larger than FCF and companies had to leverage up to finance them.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* Trade war is already having a material impact on the real economy.
- *Fixed Income.* The influence of QE on global FI markets is fading.
- *Currencies.* EA broad basic balance of payments heading into surplus positive for EUR.
- *Equities.* US capex continues to gather pace, and the outlook remains bullish.
- *Commodities.* Brent-WTI spread likely to fall as OPEC output picks up, US exports more so.

In this month's Chartbook

Summary – key points

Macro Drivers

- Most bilateral US-China trade is now subject to extra tariffs, affecting the real economy and posing material risks to growth
- Chinese imports have recently risen but have decoupled from exports, suggesting an inventory build-up ahead of tariffs
- EMs exposed to political and liquidity risks too – headwinds that are unlikely to fade even if trade war escalation is delayed

Multi-Asset

- US equities tend to outperform on dollar strength, but in the near term stretched positioning limits further USD advance
- US IG credit spreads have begun reconnecting with equities, helped by normalisation in equity volatility
- HY has shrugged off rising bond yields and equity vol thanks to strong macro and corporate fundamentals

Fixed Income

- The importance of global QE in explaining fixed income returns has fallen in recent weeks, and will likely diminish further
- One market where demand may fade is in the UK: as the ECB ends QE in December, earlier inflows into Gilts may reverse
- Supply and demand still matter for US Treasuries, even if Chinese holdings have become less important

Currencies

- Speculative investors have built large short positions in DM currencies, making USD vulnerable to a squeeze
- The rise in the USD has been hindered by a relatively weak run in US macro data until recently
- The euro area's broad basic balance of payments is about to turn positive: when this happens, EUR tends to rally

Equities

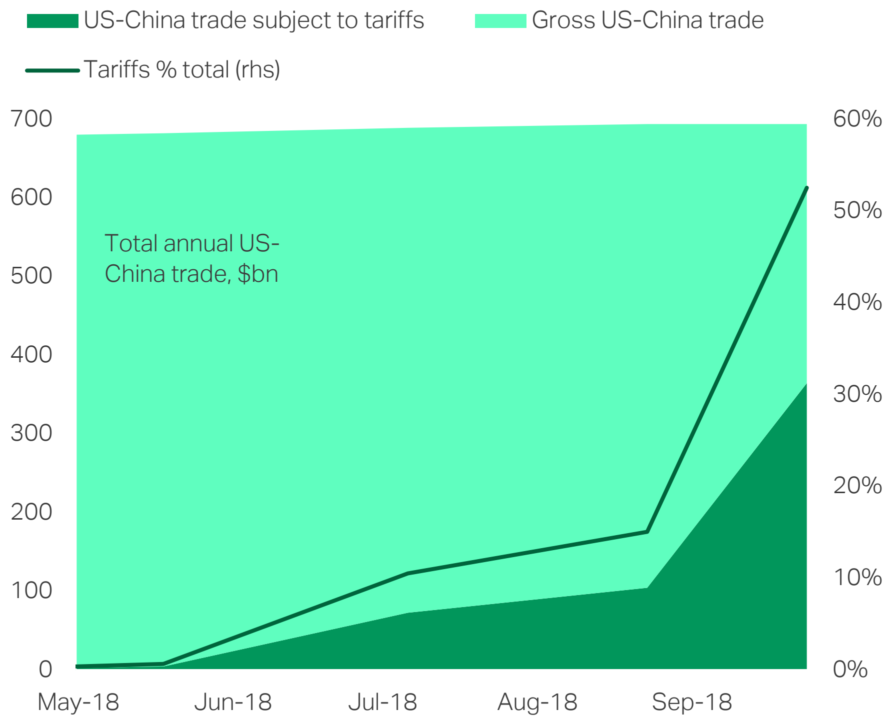
- US capex has accelerated further in the past quarter, with Tech and Energy contributing an even larger share of total growth
- Buyback 'titans' have stopped outperforming the market, as repurchases have been entirely funded by free cash flows
- The companies that have engaged in the most buybacks are also the ones investing the most

Commodities

- A glut in the Permian basin and the threat of sanctions on Iran have caused the Brent-WTI spread to widen to nearly $10
- The premium is likely to fall as OPEC supply has picked up, as have US crude exports in response to higher Brent prices
- Bullish positioning on the spread is also starting to look stretched, something that should limit further upside in the near term

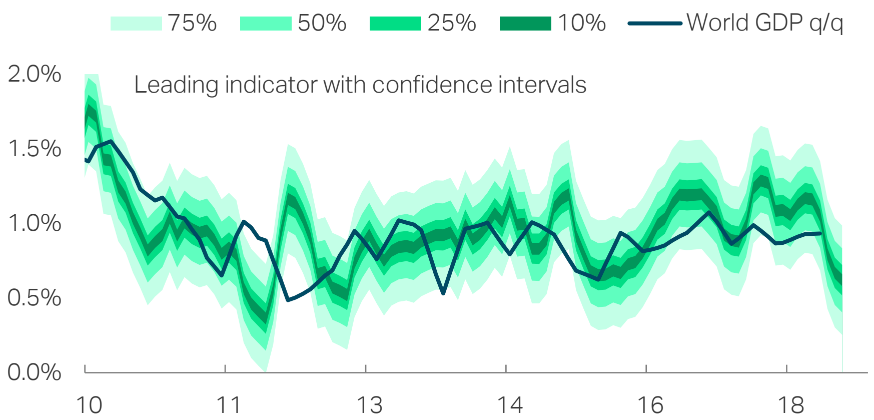
Macro Drivers Trade war becoming material

Most bilateral US-China trade now subject to extra tariffs

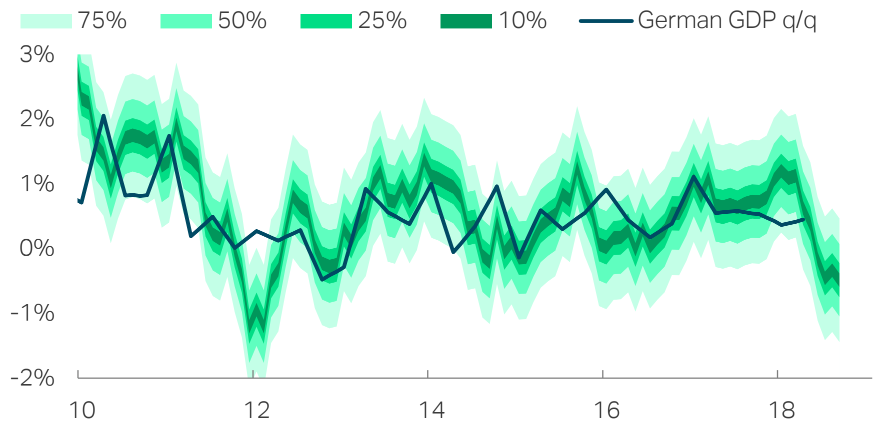


Following the recent tit-for-tat tariff escalation, more than half of total bilateral trade is now subject to extra duties imposed since June. US tariffs apply to half of all imports, and we expect them to be ratcheted up to cover almost all Chinese goods next year. China already has duties on 72% of imports from the US. We expect retaliation to spread to non-tariff barriers as the conflict continues to intensify.

GLI indicates risks to world growth…



…particularly in Germany, where external demand has slowed

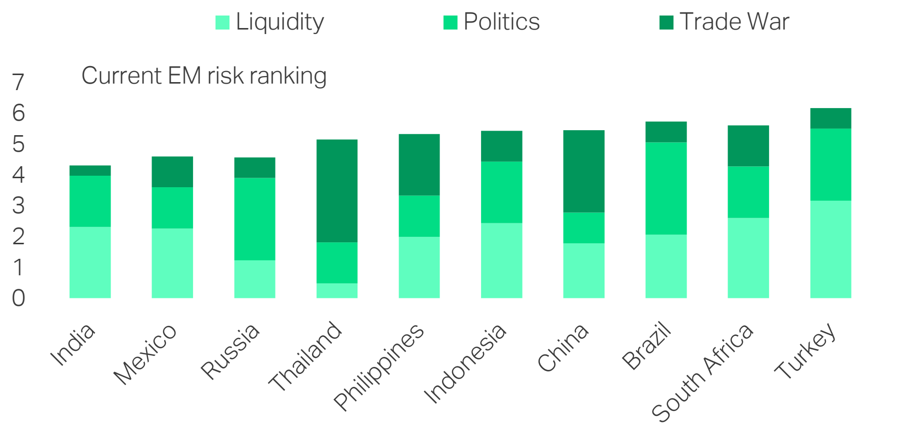


Macro Drivers EM headwinds unlikely to fade

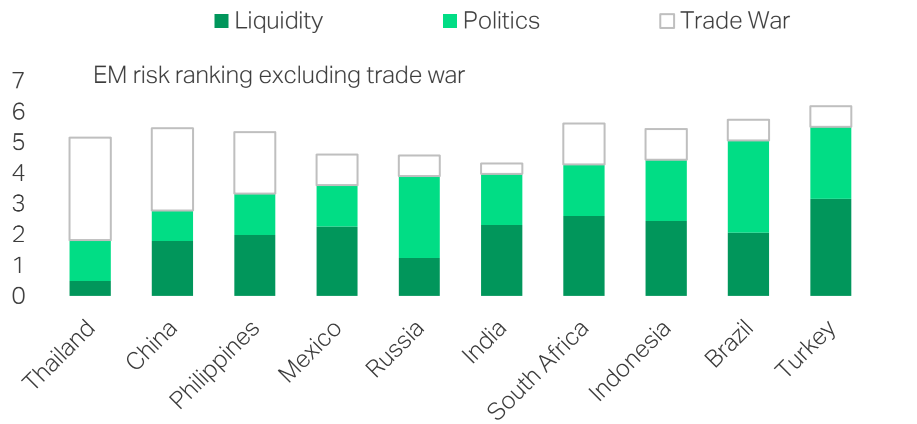
EM export decline likely shows the way for China

Chinese import growth has recently risen, but EM exports have decoupled from it. The likely reason is that China has been building up inventories ahead of the imposition of tariffs. Import growth is likely to fall from here on. As the trade war escalates, EM economies are likely to feel the heat. But trade war is not the only risk facing EMs: tightening liquidity and politics are also headwinds.

EM countries face three distinct risks in the current environment

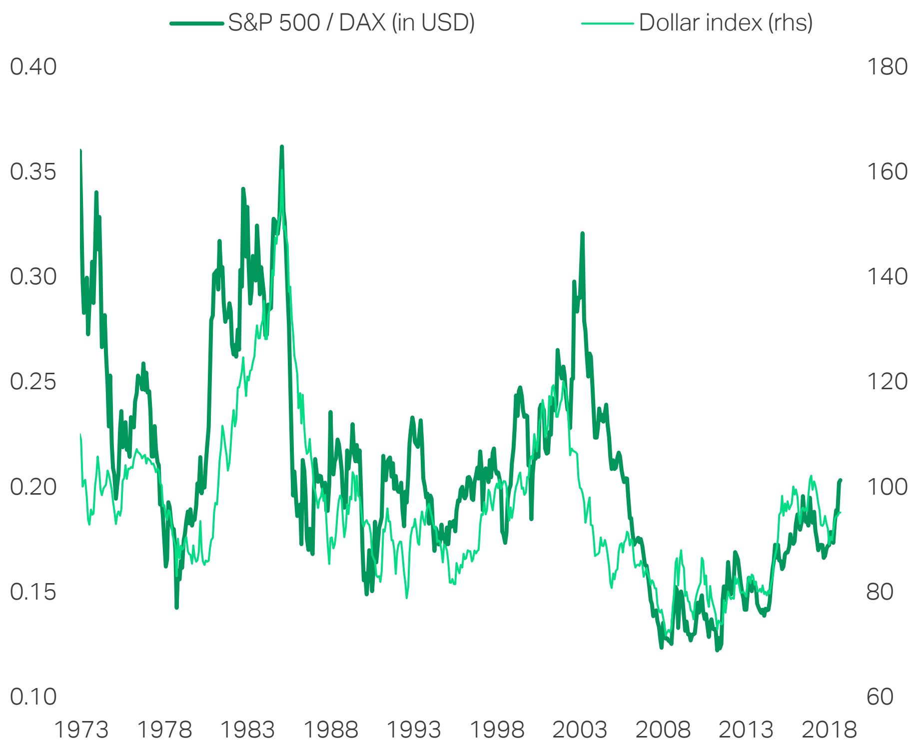


Even excluding trade wars, S. Africa, Brazil and Turkey stand out



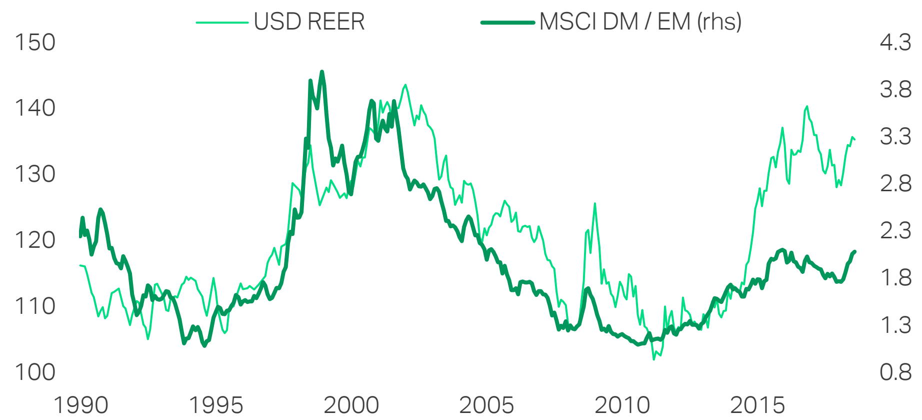
Multi-Asset US equities benefit from strong dollar

US stocks outperform at times of stronger dollar

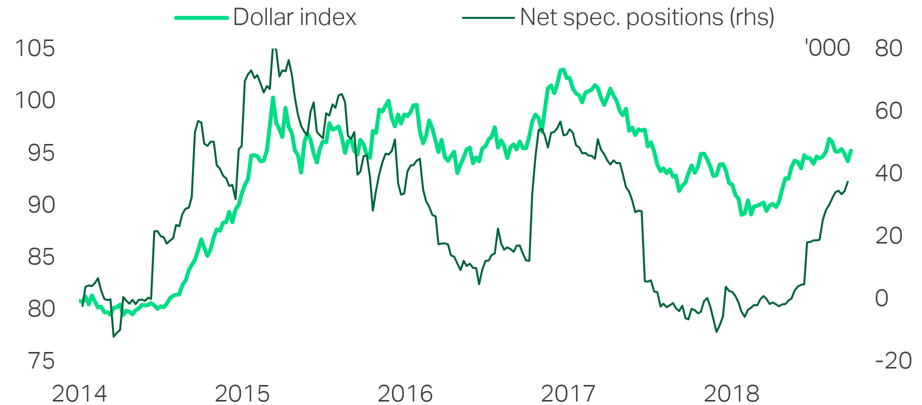


The outperformance of US equities over other markets at times of dollar strength has a long and consistent history. Both the DAX (a proxy for DMs) and EMs lag US stocks, in USD terms, during periods of dollar appreciation. So it's not just trade war risk that's helping the US beat other markets. Near term, however, investors are already heavily positioned for dollar strength, which may impede the currency's further advance.

While EMs suffer



Near term, dollar upside capped by bullish positioning

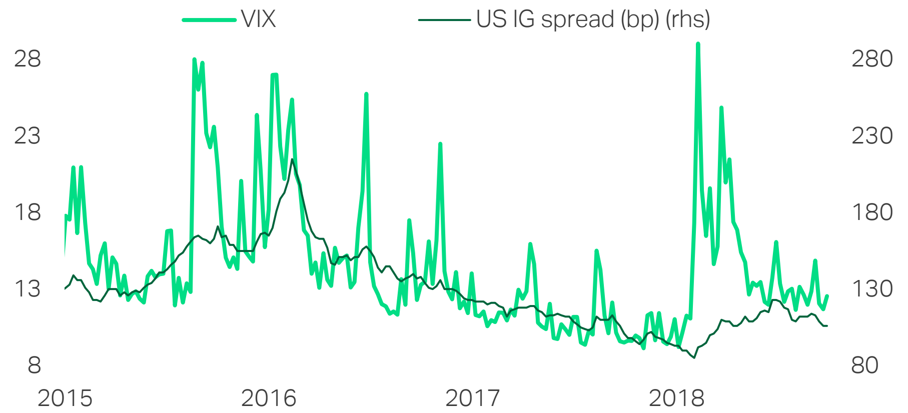


Multi-Asset Credit reconnecting with equities

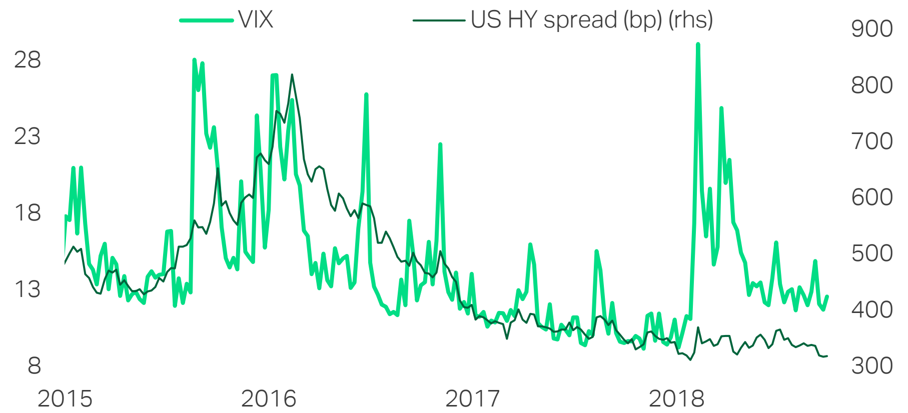
Credit catching up with stocks

After diverging from April to July, US IG credit spreads have begun reconnecting with equities, helped by normalisation in equity volatility. HY has been resilient all along, largely shrugging off rising bond yields and equity vol while benefiting from strong macro and corporate fundamentals.

IG spreads tracking trend in equity volatility

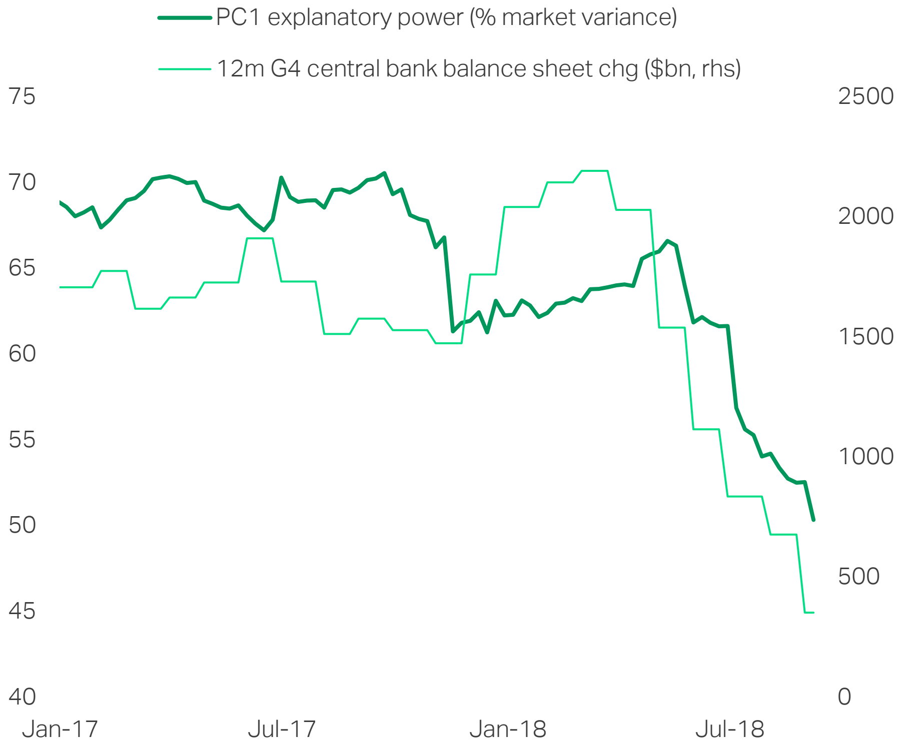


HY outperforming vol helped by strong fundamentals



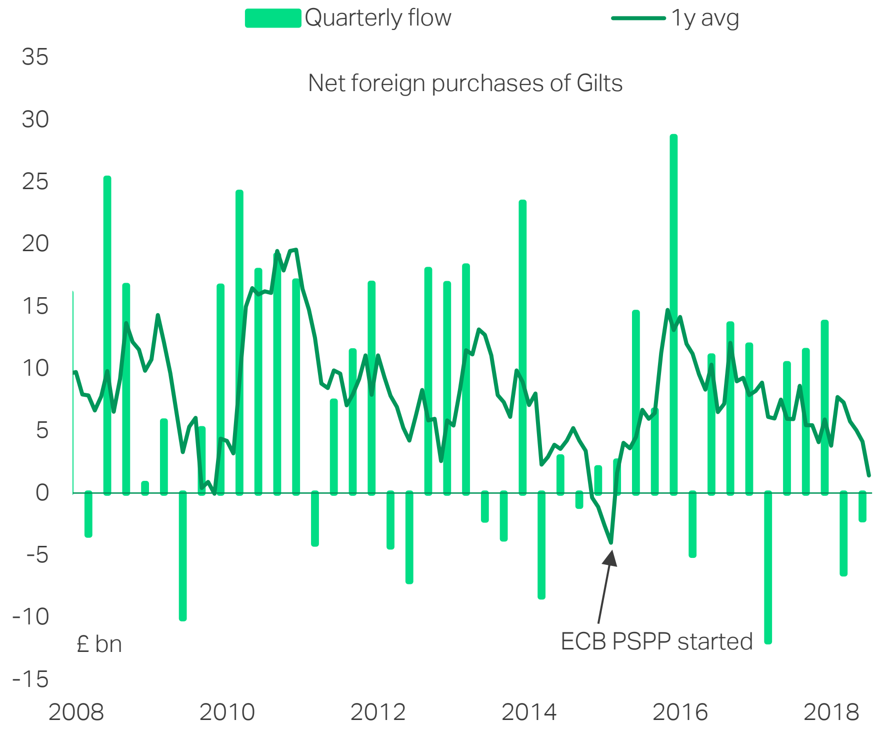
Fixed Income QE influence fading

Declining pace of QE reduces its influence on markets



We use PCA to understand the behaviour of the global fixed income market. In recent weeks, the explanatory power of the first principal component has declined sharply. This looks to be related to the slowdown in central bank balance sheet expansion – which we expect to flip to contraction by 2019. This is allowing other factors to drive fixed income returns, and means supply and demand are becoming important again.

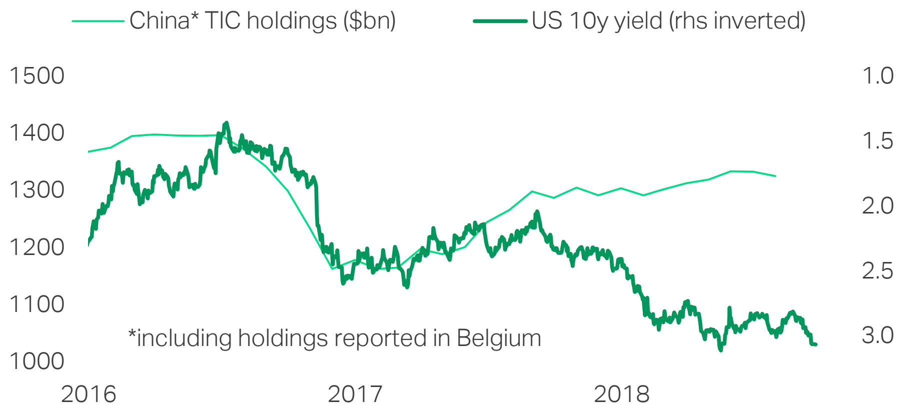
Gilt demand, spurred by ECB PSPP, is waning



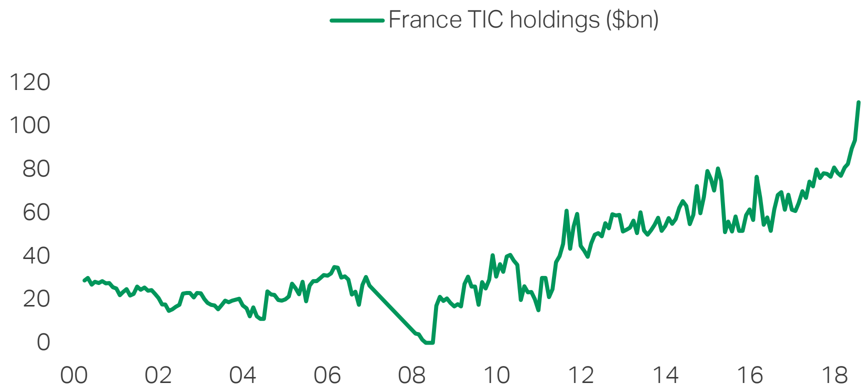
One market where demand may fade is in the UK. Gilts got a boost after the ECB started buying government bonds, crowding out EA investors who sought similarly safe debt overseas. But two consecutive months of outflows, and cumulative ytd foreign selling of £24bn of Gilts, suggests demand is waning. We are short Gilts vs Bunds in our Macro Strategy portfolio.

Fixed Income US Treasuries supply/demand matters

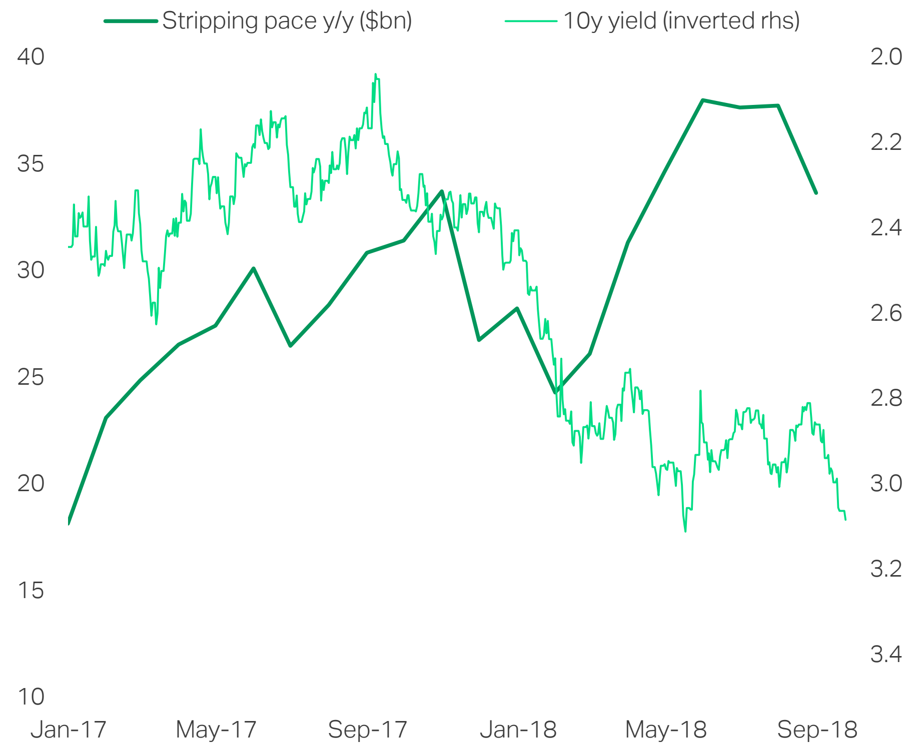
Chinese Treasury holdings have become less related to yields



French UST holdings hit a record, rising by $17bn in July



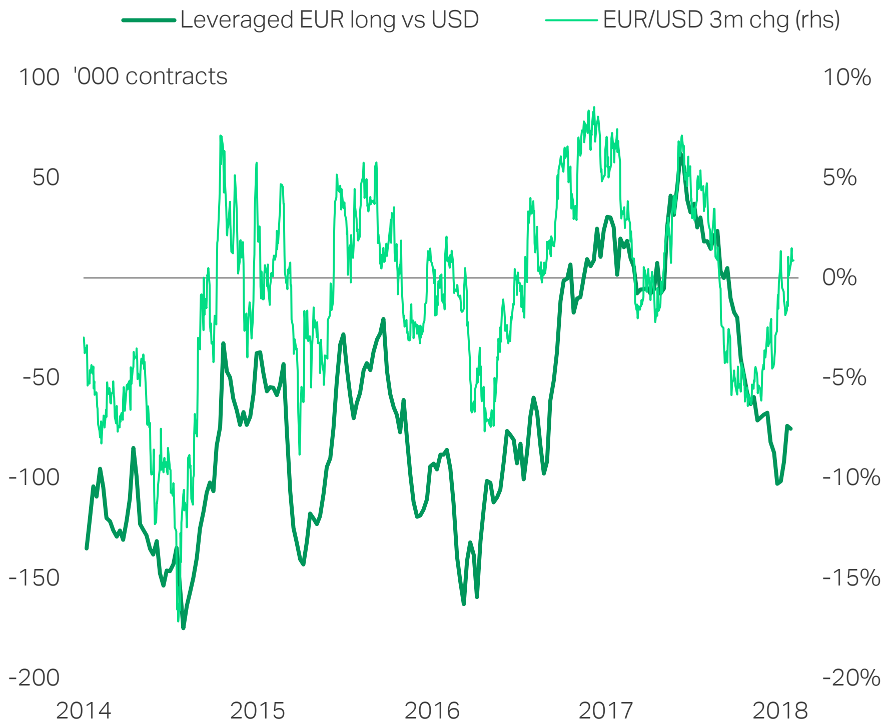
Instead, tax reform and pension funds may be key



The tax break which enabled companies to enjoy a 35% tax credit against a 21% tax rate by funding their pension schemes created excess demand for US Treasuries. At the same time, pension fund defeasance (replacing investments with a strip of Treasury income) has gathered pace since the start of the year. The tax break ended on 14th Sept, just before the sharp rise in yields.

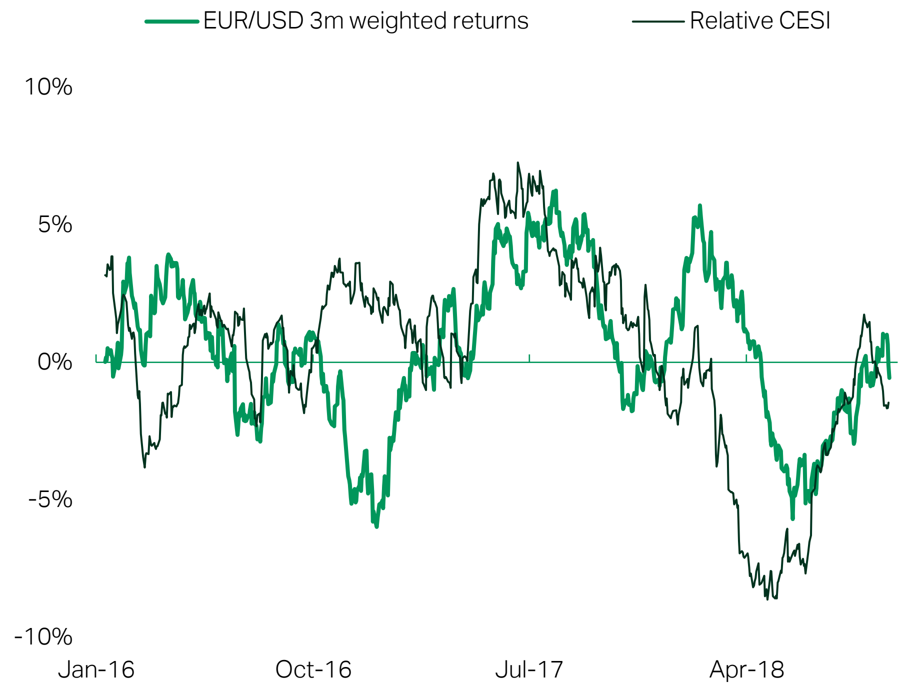
Currencies USD picture against DM is mixed

Market positioning for a USD rally against DM



Speculative investors have built a large USD long against DM currencies. But the performance of EUR, in particular, is testing this position. If DM currencies do not start to weaken against USD, there could be a short squeeze, pushing USD down further against DM currencies.

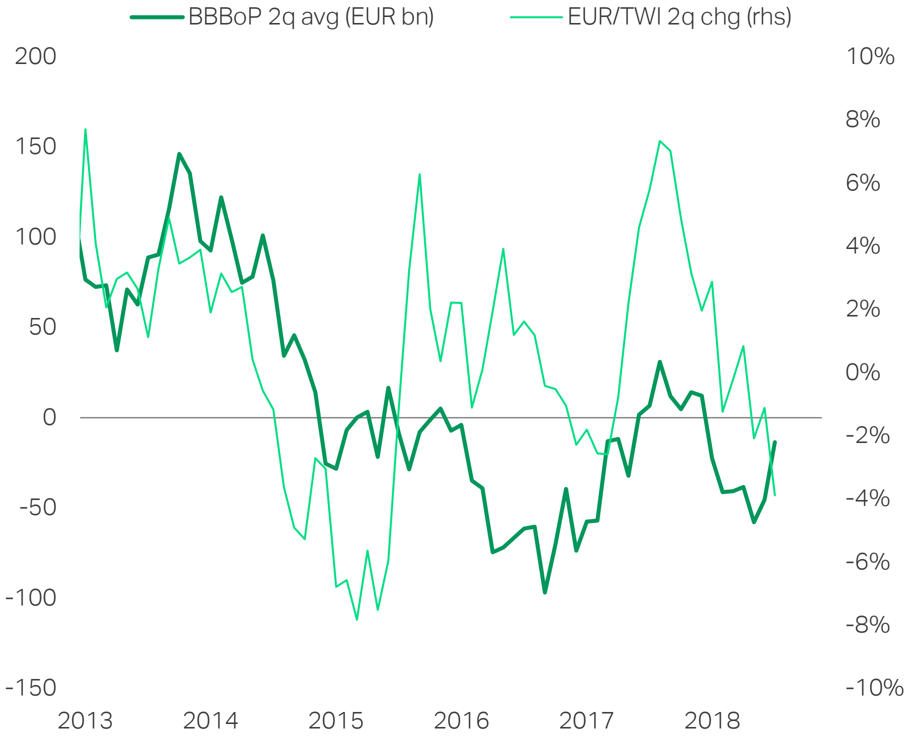
But recent economic data have helped EUR/USD to rise



One reason why USD has not continued to rally is a relatively weak run of data in the US. The US economic surprise index declined from May to August while the euro area surprise index rose from June to August. This helped to halt the EUR/USD decline. This month the relative surprise indices have turned in favour of USD: all in all, the current picture for USD against DM is mixed.

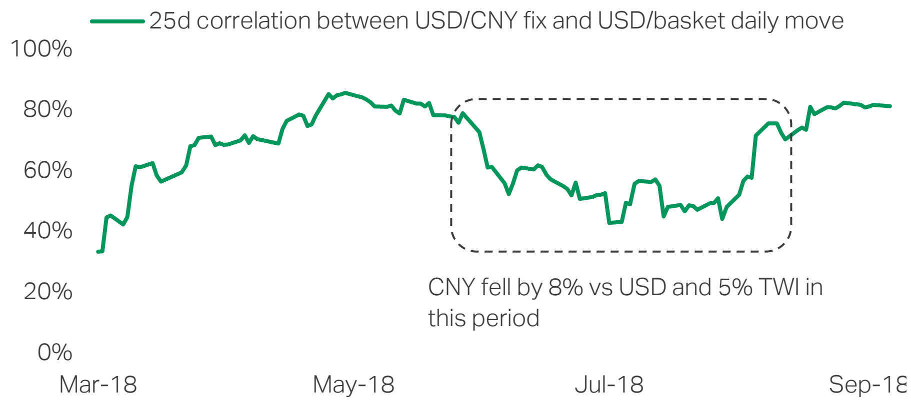
Currencies Flows potential support for EUR rise

EU BBBoP heading to surplus is positive for EUR

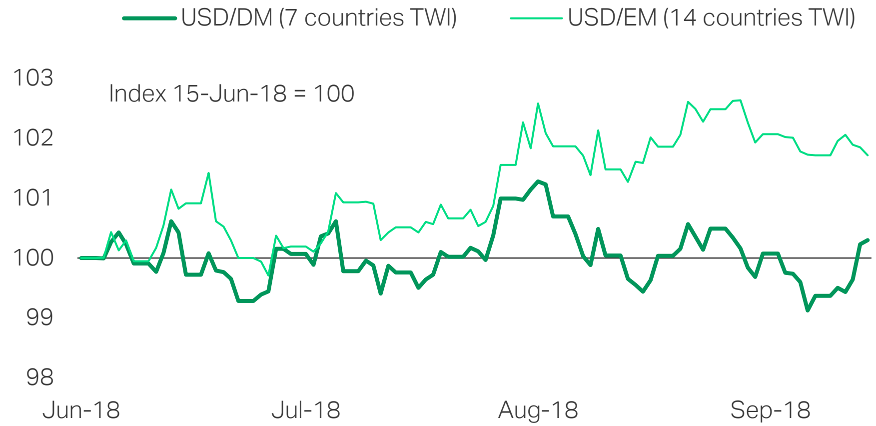


In 2015 the ECB's extension of asset purchases crowded out euro area investors and created large portfolio outflows, pushing theeuro area's broad basic balance of payments (BBBoP) into deficit. With the end of QE on the horizon, the pace of portfolio outflow is slowing and the BBBoP is heading towards surplus. When this happens, EUR tends to rally, just as it did in 2017H1.

CNY depreciation on hold for now (but we expect 15% more)



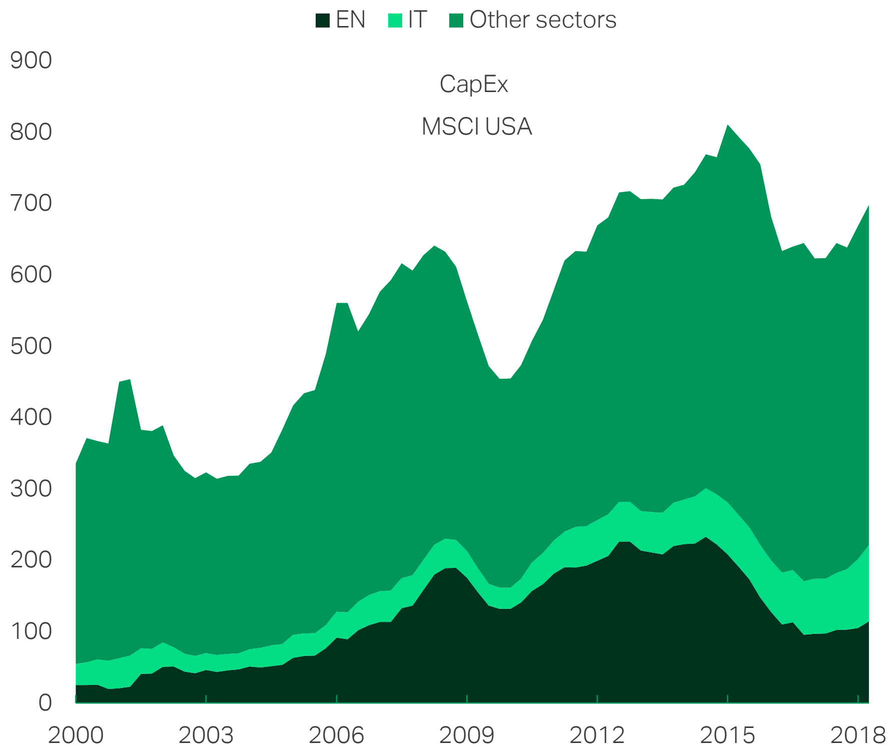
USD strength on trade has been vs EM: no DM contagion yet



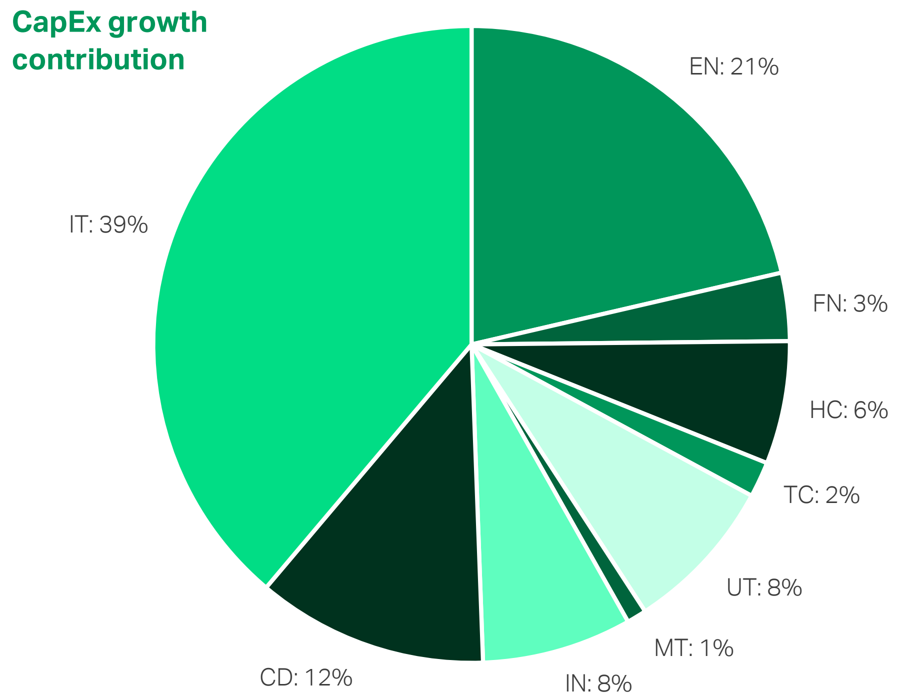
Equities

US capex to keep rising

US capex continues to pick up



Tech, Energy capex dominate growth – both likely to accelerate



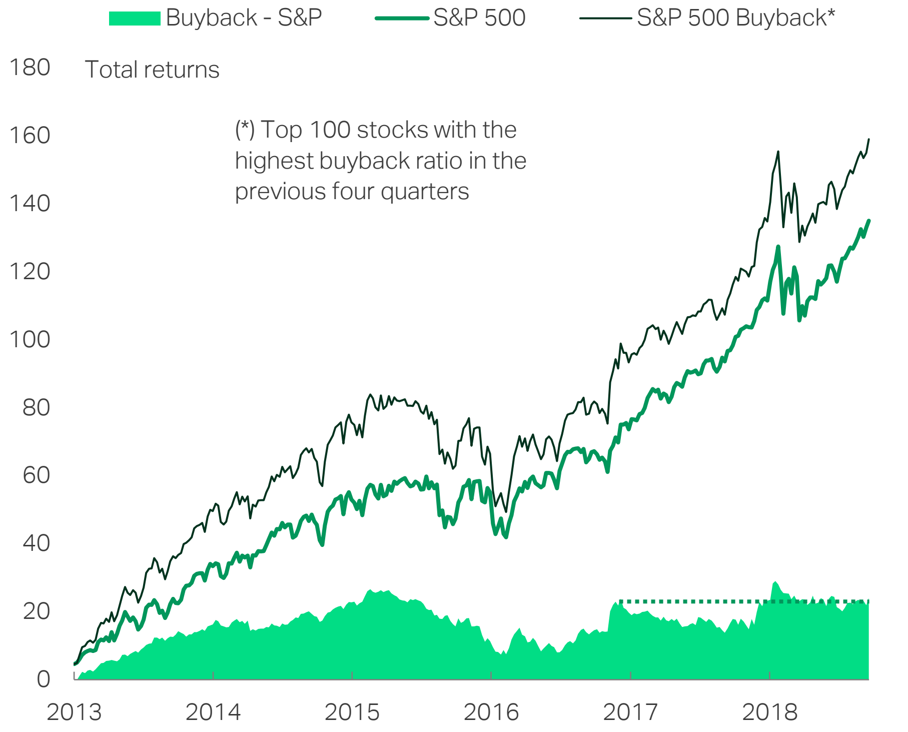
When we last looked at US capex in July, there were only hints of a pick-up. We argued that those hints could soon turn into something more tangible, and the latest corporate data seem to confirm this.

Just like a quarter ago, capex growth is dominated by Tech, accounting for 39% of the latest YoY increase (up from 36% in July). Energy has seen its share of capex growth go up even more, to 21% of the total (from 16%). Tech capex tends to follow profits with a 9-month lag, while Energy's mirrors oil with a 6-month lag. Given the recent trends in corporate profits and crude prices, the outlook for capex remains bullish.

Equities

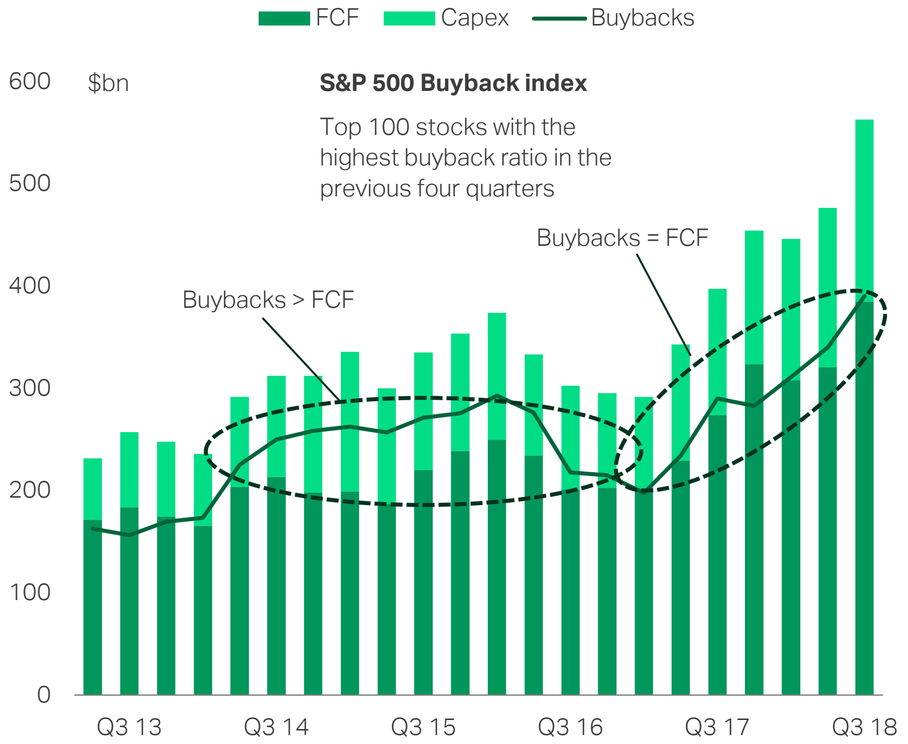
Record buybacks not impeding capex

Buybacks no longer boosting stock prices



Since the beginning of 2017, the S&P 500 companies that have carried out the most purchases of their own shares have performed in line with the market. In 2013-2015, however, 'buyback stocks' managed to beat the market. During that period, companies borrowed to repurchase their shares. Since then, they haven't needed to. No leveraging up, no outperformance.

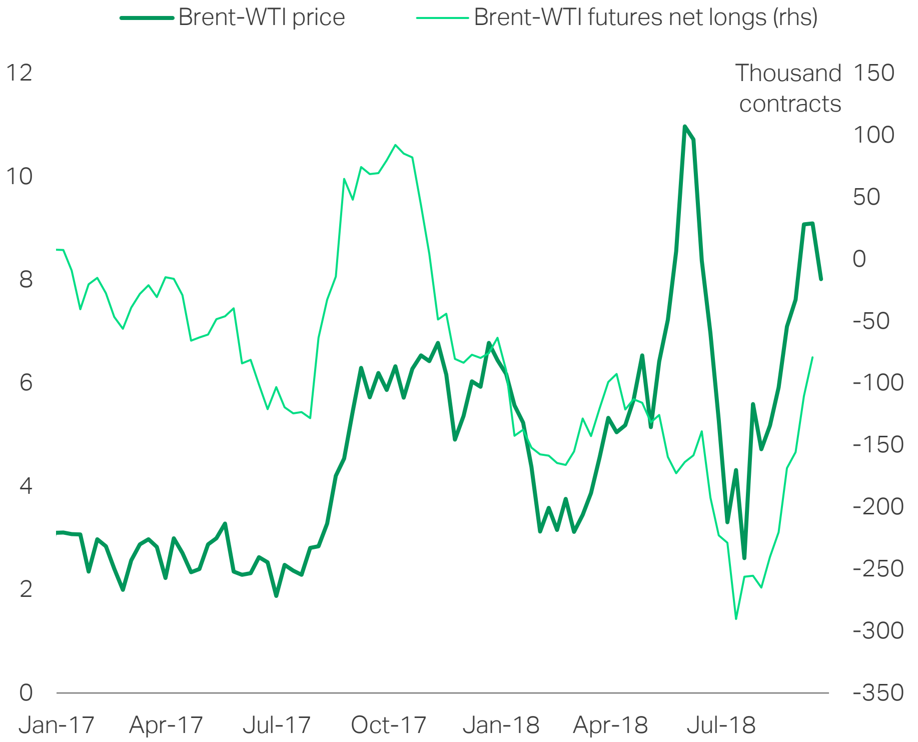
Companies now using FCF to fund buybacks



Interestingly, the companies that have been the busiest buyers of ther own shares are the ones that have enjoyed faster cash flow growth than the market. Not only has this allowed them to repurchase shares without making their balance sheets riskier, they have also been able to give a much stronger boost to capex. This suggests profitable companies are investing in future growth, returning only excess cash to shareholders.

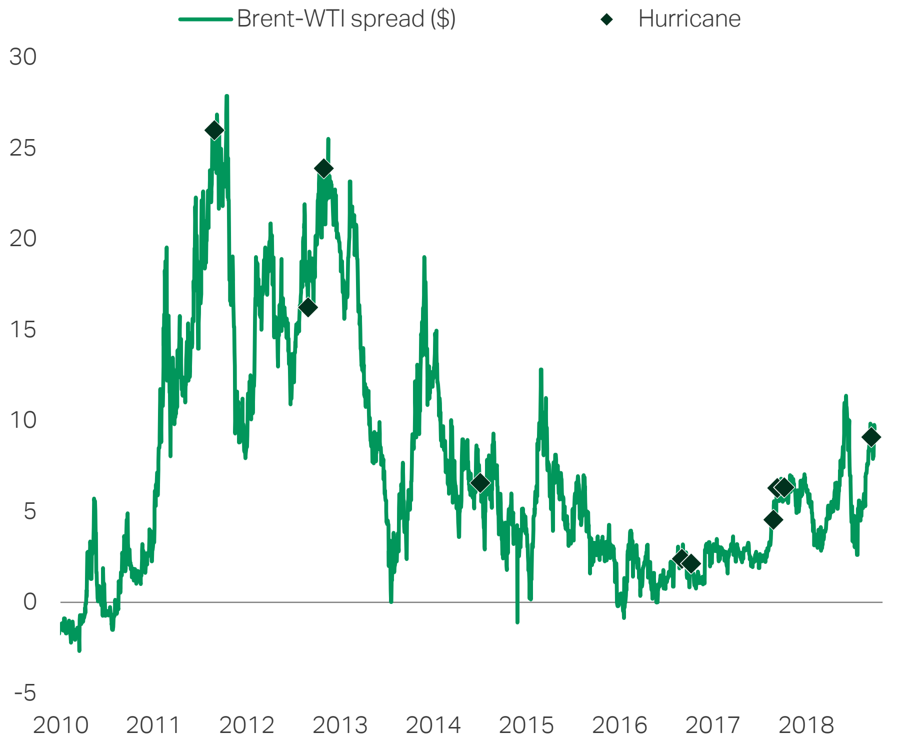
Commodities Brent-WTI spread to narrow

Positioning has adjusted to reflect WTI glut, Iran sanctions



The Brent-WTI spread increased to nearly $10 last week, almost matching the $11.50 widening in June. A glut in the Permian basin (depressing WTI prices) and the threat of sanctions on Iran (boosting Brent) are the main causes. The market has caught up with this move and speculative positioning has responded to reflect these drivers. The momentum behind the spread widening is likely to wane from here on.

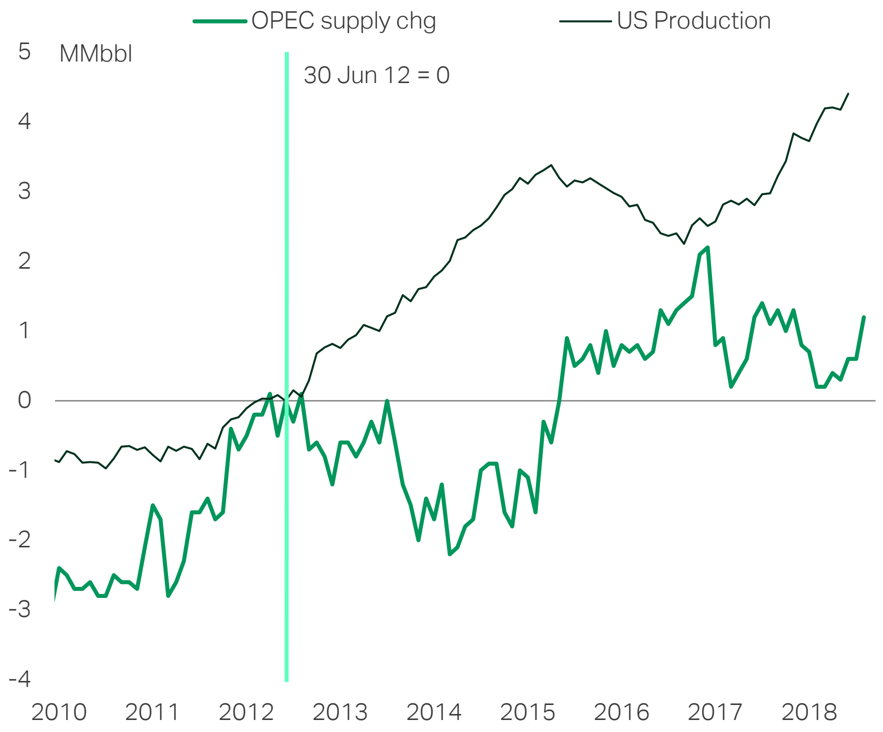
Unlike in 2017, hurricanes aren't playing a major role this year



Hurricane Florence didn't cause the disruption in refinery demand that storms in previous years have, causing a near-term fall in WTI demand. Hurricanes haven't been a factor in the latest Brent-WTI spread widening, and they are unlikely to become one in the near future. There is only one more weather system in the North Atlantic at the moment, and it's a few weeks away from the US east coast.

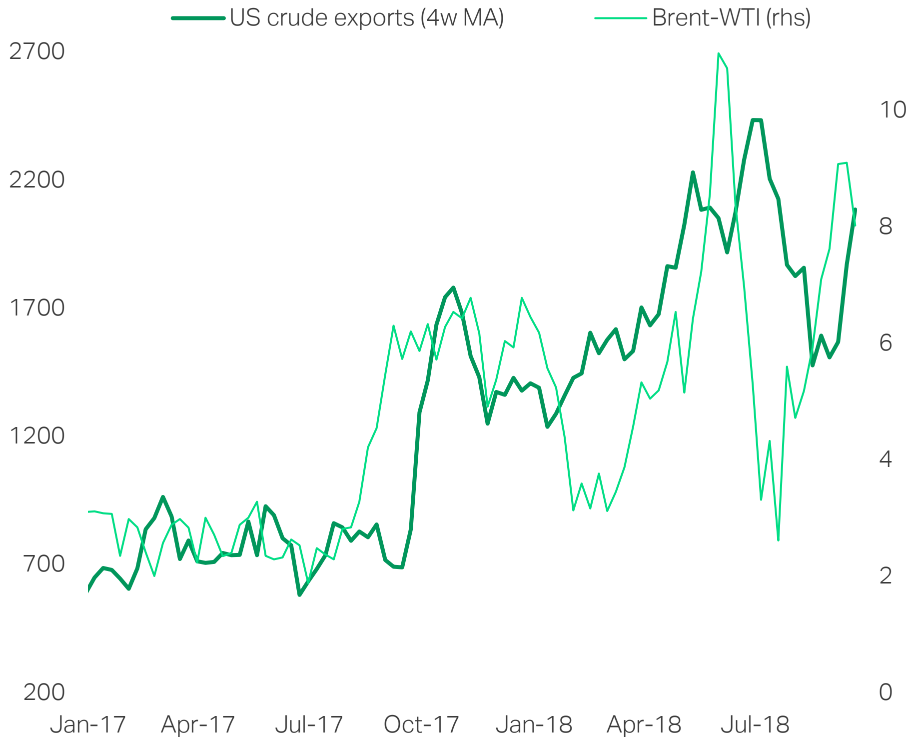
Commodities Fundamentals support spread tightening

OPEC supply picking up faster than US output



Although Saudi Arabia has indicated a degree of comfort with higher prices, it will continue to act to stabilise at least supply if not prices. In fact, OPEC output has already picked up in recent months, outpacing production from the US. This should keep the Brent-WTI spread in check.

US exports responding to large price gap



In response to the premium in Brent prices over WTI, US exports have picked up sharply this month, as US producers take advantage of the arbitrage between crude markets.

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