Lombard Street Research

LSR Macro Strategy

2 August 2017

Forget US sanctions: Russia is a buy

Asset class focus:
- ■ Multi Asset
- □ Fixed Income
- ■ Currencies
- ■ Equities
- □ Commodities

- **Weak USD helping EM assets, stocks buoyed by more balanced Chinese growth**
- **We add long Russian equity and rouble exposures via RTSI$ futures**
- **We trail the stop on EUR/CHF further to 1.13, extend target to 1.17**

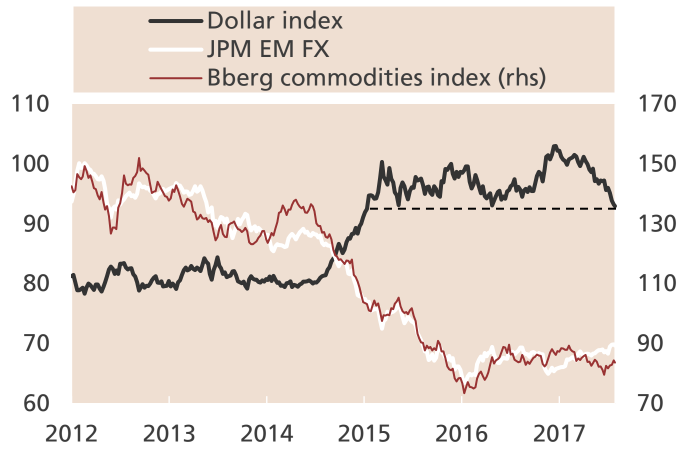
Dollar on the verge of a break lower?

Last week we looked at how dollar weakness has been a boon for EM assets – especially equities – and commodity prices. With the dollar index down almost 10% year to date and sitting on key support levels, is a break lower likely, leading to further strength in EM equities and oil prices?

Valuations, central banks support case for more USD weakness

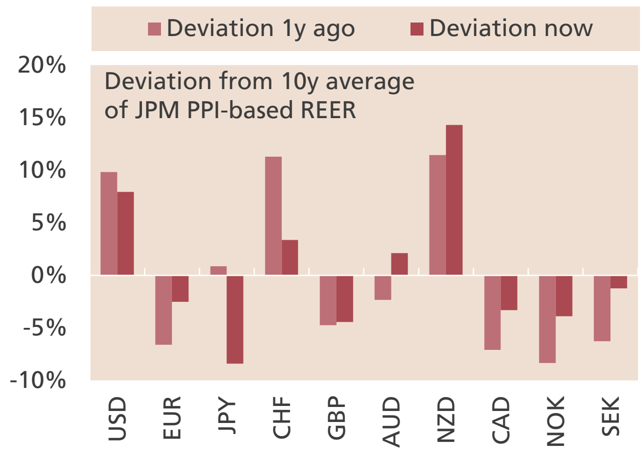
Valuations certainly support the case for continued dollar softness. The real effective exchange rates for EUR, JPY and GBP, the main counterparts of USD in the dollar index, are still between 3% and 10% below their 10-year averages – though the euro has reduced its undervaluation a lot in recent weeks. Besides, currencies don't necessarily stop when valuations reach 'fair' levels. Importantly, unlike in 2014-16, when the Fed was at the forefront of monetary policy tightening, it is now only one of several central banks looking to remove some accommodation. Notably, the ECB is likely to commence tapering its APP in January 2018.

Dollar undoing a big chunk of its 2014-15 gains



Source: JPM, Bloomberg

EUR, JPY, GBP still cheap vs USD



Source: JPM, LSR, Bloomberg

If the dollar continues to depreciate, then the bullish case for EM equities remains solid. Our colleagues at Trusted Sources, in their latest Strategy Monthly, have upgraded EM equities to strongly positive (+2) from positive (+1). They argue that more balanced growth in China - less dependent on government stimulus and debt - is a major positive for global EM assets, equities in particular.

EM equities still appealing, Russia particularly so

We remain exposed to EM equities via our long position in the EEM ETF, which has risen further since our last update a week ago. This week we add a long position in Russian equities. Apart from enjoying the tailwinds that GEMs in general are experiencing, Russia is benefiting from a number of idiosyncratic factors. These are explained in the aforementioned EM Strategy Monthly (where stocks and RUB have both been upgraded to +1 from -1) and in a recent EM Political Economy note ('*Russia: US sanctions, a contrarian case*', 28-Jul-2017).

US sanctions news mostly in the price

In short, we think that even though the US Congress approved fresh sanctions against Russia, new geopolitical risks are unlikely to crystallise. The relatively muted market response to the passage of the sanctions legislation suggests that most of the potential bad news is reflected in today's cheap valuations. Besides, a broad-based economic recovery is evident in Russia, fuelled by increasing real wages and a rebound in retail sales. Importantly, orthodox monetary and fiscal policies continue to enjoy political support, which should help the rouble recover a little from recent weakness. Oil, a major determinant of the performance of Russian assets, may not be massively supportive given that current levels are close to the top end of what we regard as a reasonable range ($45-50/bbl). At the same time, continued dollar weakness would probably put a floor under crude prices. We therefore add a **long position in RTSI$ futures** as this gives exposure to both Russian equities and the RUB.

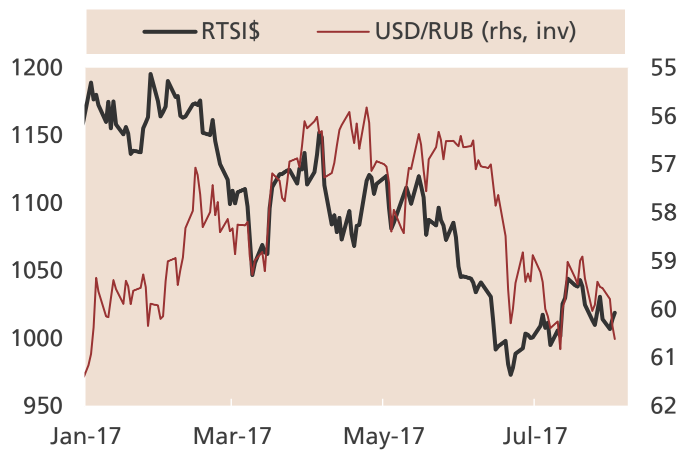
Q2 earning season: EA still on top

EA equities' dollar returns well ahead of US shares'

Looking beyond EMs, it's the euro area that has posted the best dollar returns so far in 2017. While the Euro Stoxx and the MSCI EA have declined in local currency terms in recent weeks, that is entirely due to the appreciation of the euro (right-hand chart below). Correcting for the currency effect, euro zone stocks are leaving US shares in the proverbial dust this year and are only slightly behind EM equities.

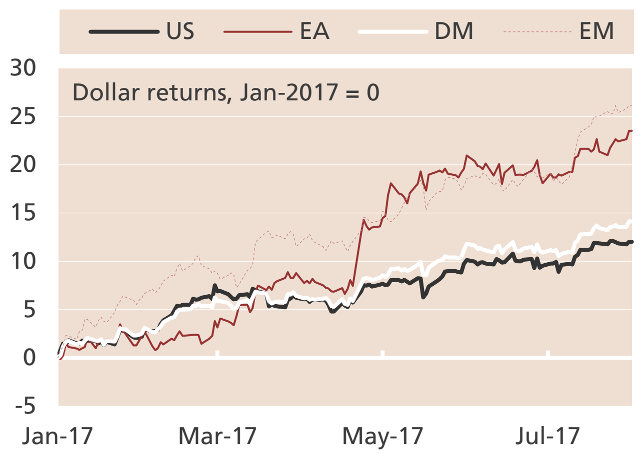
Part of the outperformance is due to the strength of the euro area economy. Q2 GDP, at 0.6% q/q, came out in line with consensus expectations. We had thought a more

Russian equities, RUB retracement done?



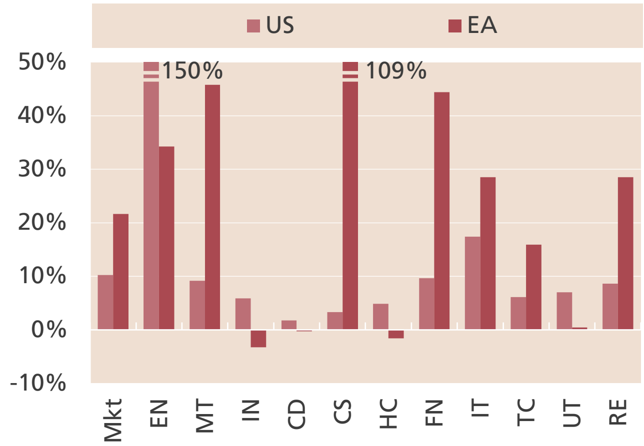
Source: Bloomberg

EA stocks lagging EMs but ahead of US year to date



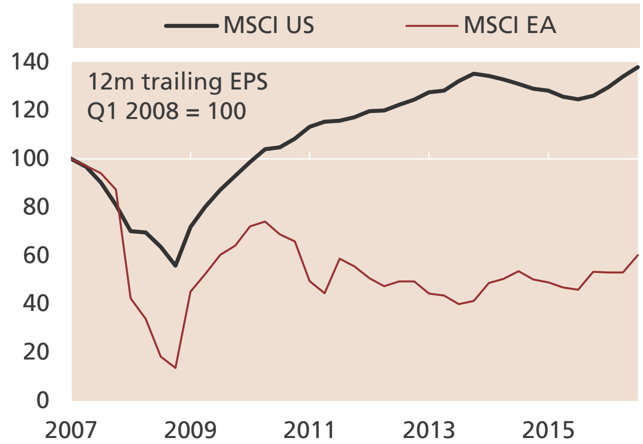
Source: MSCI, LSR, Bloomberg

EA earnings growing faster than US



Source: Bloomberg

More EPS catch up to do for EA equities



Source: MSCI, LSR, Bloomberg

robust number was possible, given the solid hard data of the past couple of months. The downward revision of Q1 GDP growth was also slightly disappointing, as were the latest PMI readings published yesterday. Nevertheless, the euro area is growing at more than twice the trend rate of about 1%. We believe it is way too early to start entertaining thoughts that the best part of the cycle is behind us.

EA companies posting stronger earnings growth, surprises

The current reporting season supports this view. With more than two-thirds of US and EA companies having reported their Q2 results, the picture emerging is that European firms are posting better numbers than their American counterparts. Profits are rising faster in the EA (23% y/y vs 10% in the US), as are sales (6.5% vs 5.7% in the US). What's more, euro zone profits are beating analysts' expectations by a larger margin (13% vs 5% in the US), though sales surprises are lagging slightly (0.8% vs 0.9% in the US). Looking at sectors, earnings growth is more consistent in the US, where y/y numbers are positive, whereas the variance is greater in the EA (left-hand chart above).

Still plenty of catch-up potential

Looking ahead, we still see room for further EA outperformance. Not only are valuations cheaper in the euro area, but EPS growth potential is a lot greater because earnings in Europe haven't recovered from the GFC as much as in the US due to the euro crisis of 2011-12 (right-hand chart above). And while more earnings growth is currently discounted in the EA than the US (39% 12m forward vs 18%, respectively), the gap between the two growth rates has come down in the past couple of quarters.

EUR/CHF: stop trailed to 1.13, target raised to 1.17

Over the past week our portfolio of trades has posted 56bp of performance, driven by EUR/CHF (+56bp) and EM equities (+11bp). Our GBP/USD put spread has subtracted 14bp of performance, while the overall contribution of other trades was minimal. A retracement in EUR/CHF is a risk in the short-term, given how sharply the cross has risen (the largest one-week move since the SNB de-pegged the franc from the euro in January 2015). But we keep the trade on for now and **extend the target to 1.17**, while we **trail the stop to 1.13** – above our stated target of 1.12 when the position was initiated on 17-May.

Andrea Cicione
andrea.cicione@lombardstreetresearch.com

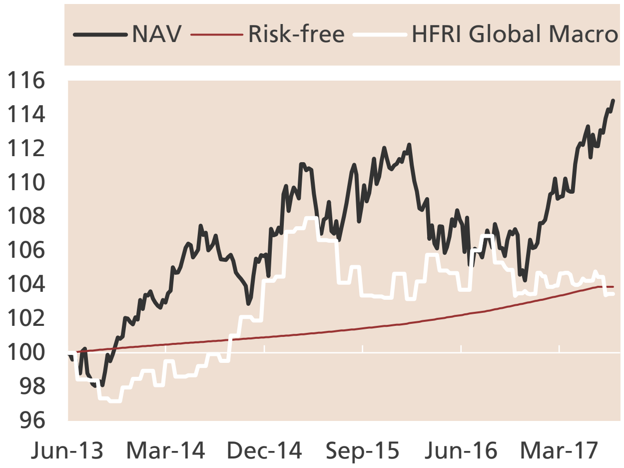
ⓘ Disclaimer

Current trade recommendations

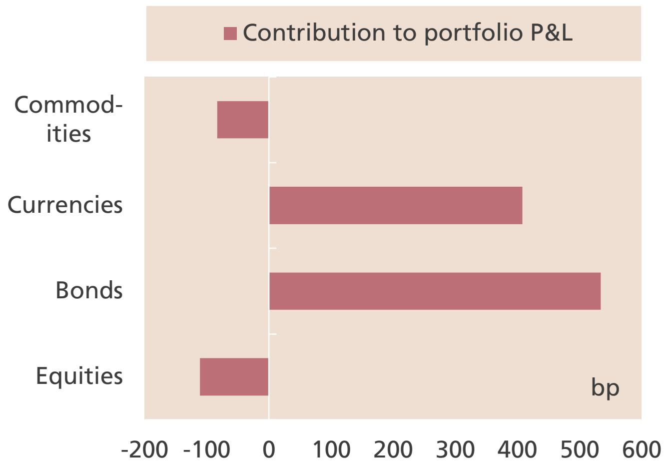
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global reflation								
	Long EM equity (EEM US)	21-Jun-17	41.10	43.93	6.9%	45.75	42.75	Benign inflation outlook, EM cheap and underinvested
	Long Russia RTSI$	02-Aug-17	1014.4	1014.4	0.0%	1200	900	
	Long EUR/SEK 6Sep17 put spd	14-Jun-17	21bp	42bp	21bp	n.a.	n.a.	Rising Swedish inflation and EA growth
Dollar tailwind to high-beta assets								
	Long USD/TRY 3Aug17 put spd**	03-May-17	38bp	0bp	-38bp	n.a.	n.a.	Hawkish CB, high carry/vol, room to catch up other EM
UK soft patch								
	Long GBP/USD 29Sep17 put spd	29-Jun-17	35bp	13bp	-22bp	n.a.	n.a.	Monpol expectation too hawkish; soft patch expected
ECB Taper								
	Long 10y UST / Short Bunds	05-Apr-17	210bp	178bp	25bp*	160bp	186bp	Spread too wide due to ECB asset purchase programme
	Long EUR/CHF	17-May-17	1.0900	1.1459	5.2%	**1.1700**	**1.1300**	Taper starts policy divergence; CHF safety inflow slowing
Premature tightening								
	Long USD/CAD 31Oct17 call spd	12-Jul-17	41bp	20bp	-21bp	n.a.	n.a.	CAD too strong to support Canadian growth

*Bund-UST pnl includes 7bp (of yield) cost of Bund benchmark roll **Expiring tomorrow

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio performance metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	14.83%	3.47%
Annualized Return	**3.38%**	**0.82%**
2014	4.35%	5.61%
2015	3.99%	-1.26%
2016	-4.89%	0.14%
YTD	8.48%	0.15%
MTD	-0.21%	
Volatility (ann.)	4.70%	3.74%
Sharpe ratio	**0.53**	**-0.02**
Sortino ratio	**1.09**	**0.20**
Alpha (vs HFRI)	3.49%	
Beta (vs HFRI)	0.05	
Correlation (vs HFRI)	0.04	
Correlation (vs MSCI World)	0.15	
Correlation (vs JPM GBI)	0.01	
Max drawdown	-7.57%	-4.40%

Best and worst trades

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long 10y UST / short 10y Bund (05-Apr-17)	184
US 2s10s flattener (08-Mar-17)	130
Long 10y USTs / short 10y Gilts (30-Aug-16)	120
Long 10y Bund / short 10y OAT (14-Dec-16)	117
Short USD / long RUB (09-Nov-16)	108
Worst	**Contrib. (bp)**
Long US Banks / short S&P500 (03-May-17)	-139
Long GBP / short USD (07-Sep-16)	-105
Long Gold (02-Nov-16)	-97
Short AUD / long CAD (27-Jul-16)	-67
Short CAD / long MXN (26-Oct-16)	-60