TS Lombard

1 August 2018

Macro Strategy

LIQUIDITY TIGHTENING ON THE HORIZON

Oliver Brennan

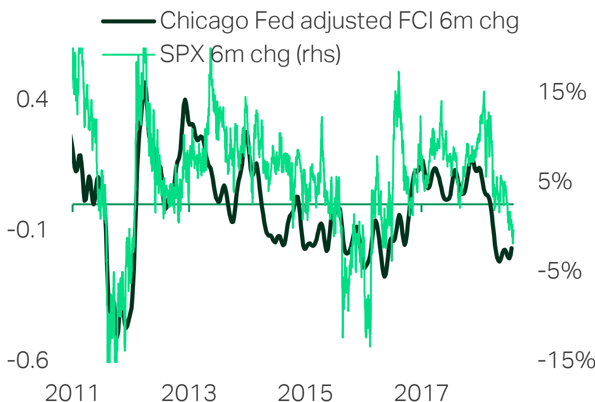
- **Repatriation, Fed QT, Treasury likely to tighten USD liquidity again**
- **Greatest impact on EM assets; domestic USD liquidity should be unaffected**
- **EM still at risk from trade war and slowing China growth; we sell MSCI EM vs DM**

USD liquidity pressures have eased over the last few months. Financial conditions have stopped tightening, providing some respite for stocks. But somebody forgot to tell EMs: countries with low resilience scores (i.e. large current account deficits and low FX reserves) continue to see outflows. But now liquidity pressures are set to rise again, and financial conditions are at risk of tightening.

In Q1, the US Treasury and cash repatriation were the primary reasons for tightening liquidity. The Treasury issued $450bn of new debt and left $129bn of the proceeds in its Treasury General Account (TGA) at the Fed, effectively draining that much cash from the banking system. This squeezed liquidity for all US money market participants, both onshore and offshore. But the biggest withdrawal of USD came as a result of US corporates repatriating $305bn of cash held offshore. The consequence of this was an increase in commercial paper issuance by financial companies to replace the withdrawn deposits, pushing up CP rates, and a tightening of liquidity for offshore USD borrowers, a point we made in Macro Strategy in June.

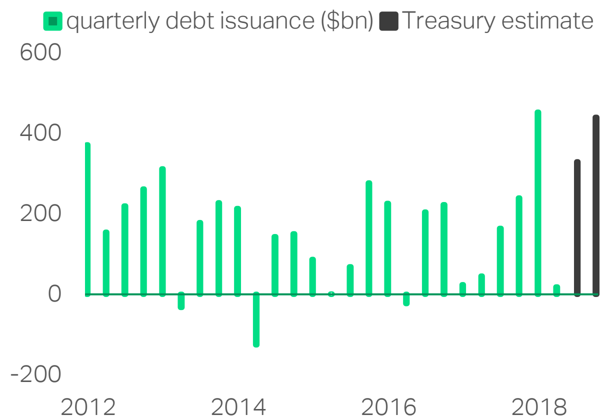
This quarter, Treasury issuance is expected to be high. But the Treasury expects its balance at the Fed to be unchanged. Therefore despite the projected sale of $329bn of new debt, overall liquidity in the system should be unchanged. However, tenors are also important. In Q1 the Treasury's focus was at the short end. It issued $330bn of Bills compared to $74bn of Notes and $44bn of Bonds. As a result, Bill yields rose, closing the Bill-OIS gap (Bill yields historically traded lower than OIS due to strong demand) and pushing other money market rates higher.

Financial conditions tightening has paused



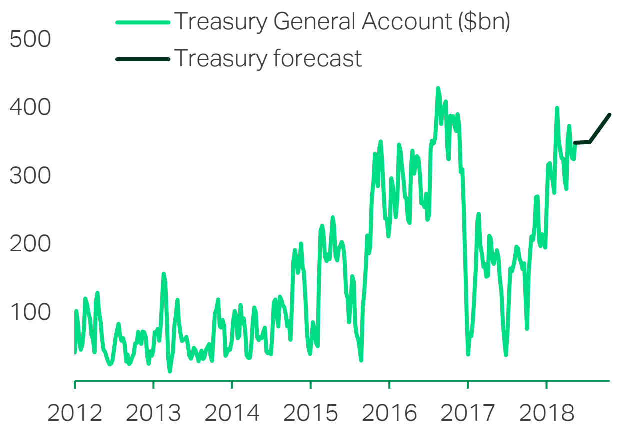
Source: Chicago Fed, Bloomberg, TS Lombard

Treasury issuance to rise in Q3



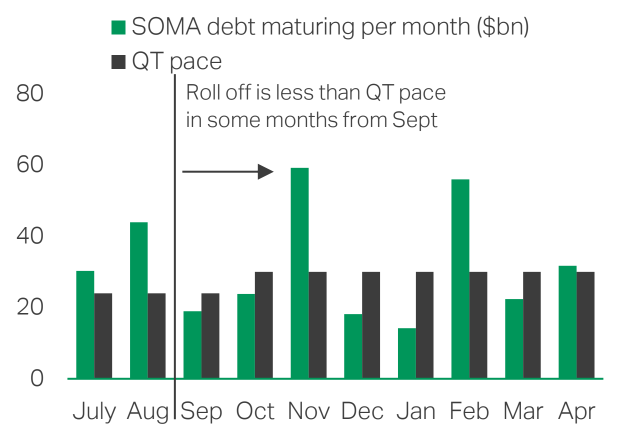
Source: US Treasury, Bloomberg, TS Lombard

TGA balance to remain broadly unchanged



Source: US Treasury, Bloomberg, TS Lombard

Rising Fed QT pace becoming important



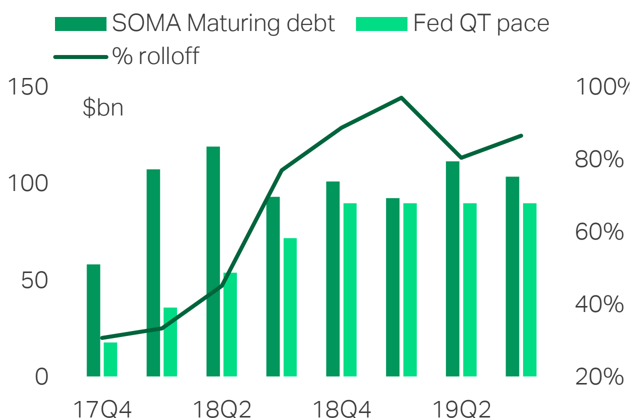
Source: Federal Reserve, TS Lombard

According to the TBAC's recommended financing schedule there will be $60bn of new Bill issuance in Q3 (more than the zero expected) so there will be some upward pressure on money market spreads, but given the lack of outright liquidity withdrawal by Treasury it should be muted. More importantly, most of the issuance will be in bonds of which half will have a tenor of >5y. This profile could cause a squeeze in long-term funding costs this quarter. Tighter liquidity along the yield curve means Q3 may still be painful for externally exposed EM borrowers.

Fed QT pace hits $120bn this quarter. An important difference from Q1 is the speed of the Fed's balance sheet normalisation. In Q1, the Fed lost a net $36bn of US Treasuries, less than one-tenth of Treasury issuance. This quarter the Fed's Treasury holdings are set to shrink by $72bn – almost one-quarter of the Treasury's projected issuance. And next quarter the pace of contraction will quicken to $90bn. This increase in net supply from QT is substantial enough now to be a significant contributor to overall liquidity contraction.

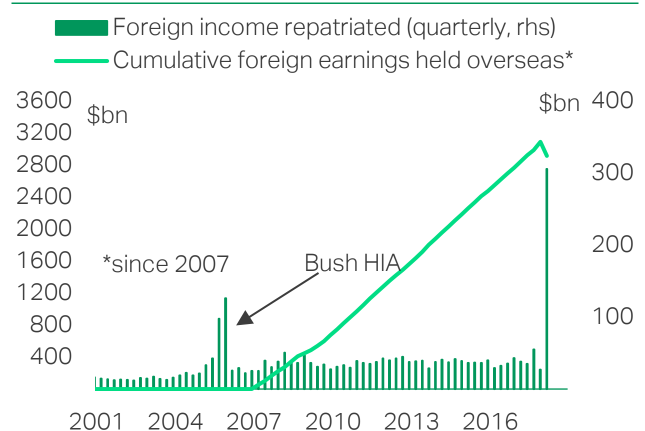
And the SOMA maturity profile suggests QT effects will increase. So far, the Fed has executed its balance sheet reduction programme by not rolling over a percentage, usually less than 50%, of the debt in its SOMA portfolio as it matures. As the pace of reduction increases, there will be times when this will not suffice. The first occasion is September, when only $19bn of Treasuries mature – short of the monthly QT target of $24bn. The same thing happens in October ($24bn vs an increased QT sum of $30bn). But then in November, with large mid-month and month-end maturities, the pace of reduction can catch up with the target again. In any case

Maturing SOMA debt to mostly roll off



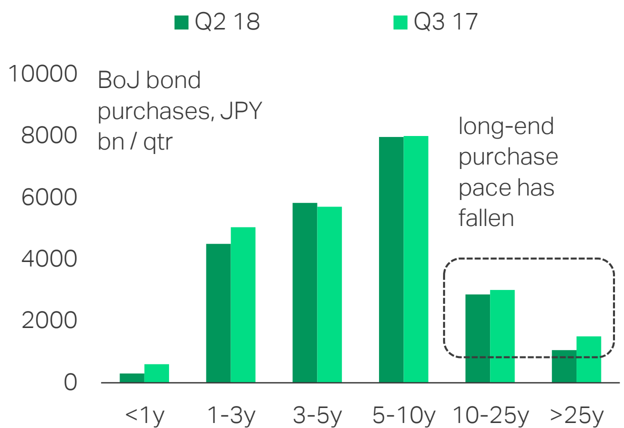
Source: Federal Reserve, TS Lombard

Corporate repatriation likely to continue



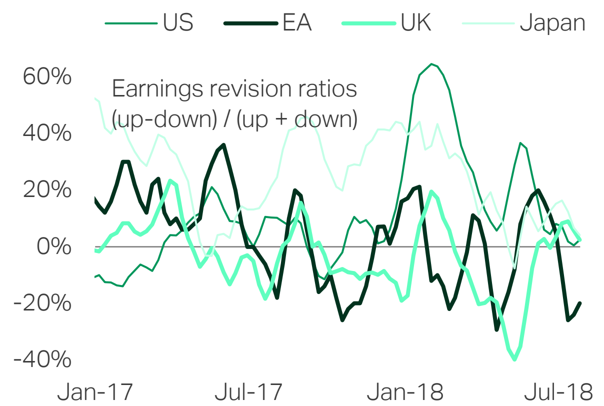
Source: Datastream, TS Lombard

BoJ buying less overall and less duration



Source: BoJ, TS Lombard

Earnings revisions in EA are negative



Source: Bloomberg, TS Lombard

the percentage of maturing debt allowed to roll off is set to rise towards 90%. As QT quickens the impact on the market will increase.

Corporate cash repatriation is likely to continue. The repatriation of $305bn in Q1 led to record buybacks: the 10 companies with the largest overseas cash holdings bought back a total of $52bn of shares. So far in the Q2 reporting season, with a couple of companies left to report, $34bn of share repurchases have been announced by these companies. Using buybacks as a guide to repatriation volumes, at least $200bn could have been brought back onshore in Q2. This has already happened so it will not necessarily hit offshore USD liquidity in the future. But, with profits retained overseas since 2007 still over $2.5tn (some of which will remain abroad, of course), a high pace of repatriation is likely to continue, reducing USD liquidity available to foreign borrowers.

BoJ no longer the global liquidity backstop. The BoJ is now the only major central bank which is not *formally* winding down its extraordinarily loose monetary policy. But as we discuss in today's Daily Note, the central bank is taking cautious steps towards the exit. As far as liquidity provision goes, the BoJ is buying around ¥40trn worth of assets annually, half the policy target of 'about 80 trillion yen'. The bank is also shortening duration by reducing its purchases of 10+y bonds. And by stating that it will let 10y yields trade in a +/-20bp range around zero, the BoJ implies that they can rise to 20bp – a significant tightening in financial conditions compared to the 2018 average of 5bp.

EM assets remain vulnerable. In recent weeks, the threat of trade wars has hogged the headlines. But liquidity strains are likely to come to the fore again. Externally vulnerable EM countries (see our recent Global Financial Trends and Daily Note on EM FX reserves) are likely to suffer further losses due to both liquidity and trade risks. We retain our strongly negative stance on EM risk in EM Strategy Monthly, as trade frictions remain intense and Chinese growth is still slowing. This week we add a relative value **short MSCI EM / long MSCI DM** position to the model portfolio.

DAX vs CAC view: hit by Juncker, helped by earnings revisions

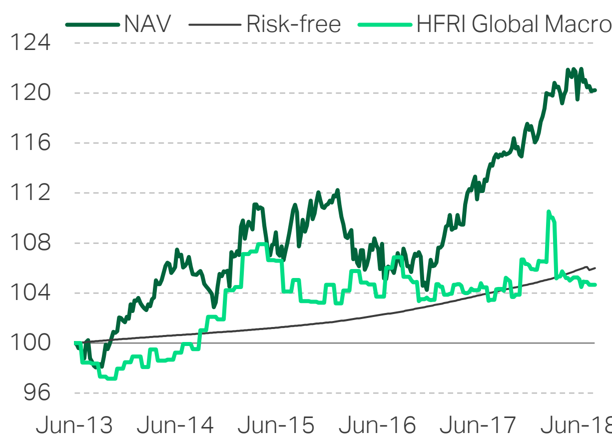
Our short DAX vs CAC position was predicated on the German car industry facing possible US tariffs and Brexit-related trade costs. Since the Trump-Juncker meeting appeared to end positively, carmakers briefly rallied - though we do not think the EU will concede anything material: this is more a delay in the battle than a conclusion. But DAX outperformance has been eroded by the earnings season, with euro area companies – particularly carmakers – scaling back earnings guidance. We may just be seeing the beginning of trade war effects, so we retain our DAX vs CAC position for now.

Current trade recommendations

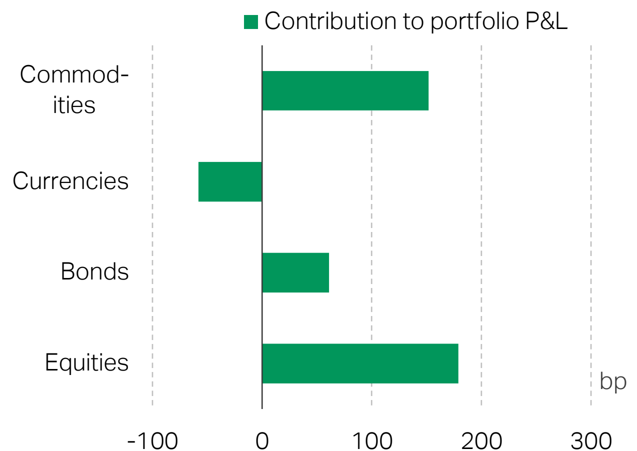
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global cycle								
	Long CDX IG 5y protection (short risk)	20-Jun-18	63.00	59.00	-4bp	75.00	55.00	US investment grade to underperform as credit cycle past its peak
	Short MSCI EM vs MSCI DM	**01-Aug-18**						**Liquidity conditions to tighten again, and trade war risk still looming**
Trading trade troubles								
	Short CNY/RUB	27-Jun-18	9.60	9.23	4.0%	9.00	9.50	Russia more resilient to current risks than China
	Short DAX vs CAC	04-Jul-18			0.0%			German car industry at risk from tariffs and Brexit
	Long USD/KRW 3m call spread	25-Jul-18	50bp	43bp	-7bp			Vol relatively low , Korea exposed to CNY risks and trade risks
ECB Taper								
	Long EUR/USD 14Sep call sp	16-May-18	41bp	10.1bp	-30.9bp			EUR to rebound and risk of more haw kish ECB
Brexit in name only								
	Short EUR/GBP 4m put spread	11-Jul-18	26bp	21.7bp	-4.3bp			Despite the noise, BINO is the most likely outcome and is bullish GBP

Bold indicates new trades or changes made this w eek.

Model portfolio historical performance



Performance contribution - last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	20.23%	4.66%
Annualized Return	**3.64%**	**0.89%**
2015	3.99%	-1.26%
2016	-4.89%	0.14%
2017	9.67%	2.47%
YTD	3.56%	-1.14%
MTD	-0.42%	
Volatility (ann.)	4.63%	4.08%
Sharpe ratio (12m)	**0.60**	**-0.10**
Sortino ratio (12m)	**1.68**	**0.06**
Alpha (12m, vs HFRI)	7.36%	
Beta (12m, vs HFRI)	0.18	
Corr (12m, vs HFRI)	0.25	
Corr (12m,vs MSCI World)	0.36	
Corr (12m, vs JPM GBI)	0.24	
Max draw dow n (12m)	-2.35%	-4.39%

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long 1y10y USD 2.9% payer (28-Nov-17)	152
Long Canada 10y / short USTs 10y (18-Oct-17)	145
Long WTI / short Brent (06-Oct-17)	86
Long OIH US equity (14-Feb-18)	82
Long WTI (14-Feb-18)	66
Worst	**Contrib. (bp)**
Long Bund 10y / short BTP 10y (20-Sep-17)	-140
Long AUD/USD put (25-Oct-17)	-61
Long 10y UST / short 10y Bund (05-Apr-17)	-53
Long USTs / short Bunds (24-Jan-18)	-33
EUR/USD Call Spread (16-May-18)	-32

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