Lombard Street Research

LSR Macro Strategy

21 June 2017

Goldilocks's EM porridge is just right

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

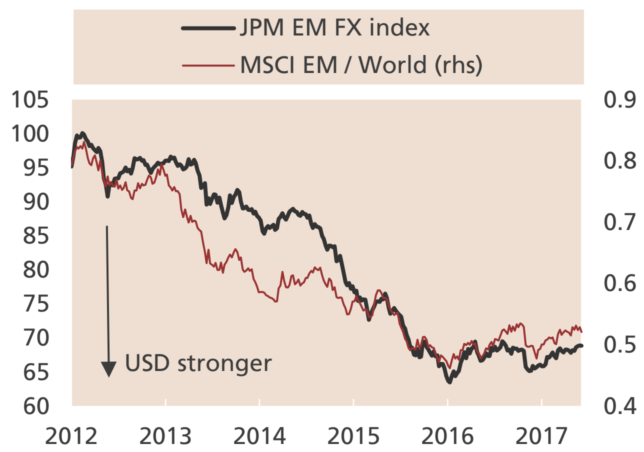
- **Lower inflationary pressure and strong growth bring back Goldilocks**
- **We are bullish equities, particularly in EM, where stocks have lagged DM**
- **We go long the EEM ETF; on UK concerns we go short the FTSE 250/100 ratio**

Inflation later means jam today

Last week's softer-than-expected US CPI data, along with downward revisions to Q1 US wage inflation, have led us to push out our expectations of inflationary pressures into next year. Accordingly, we've moderated our view on the Fed's rate hiking cycle and now expect one more 25bp increase this year. We hold fire on calling 2018 until we see signs of inflation picking up.

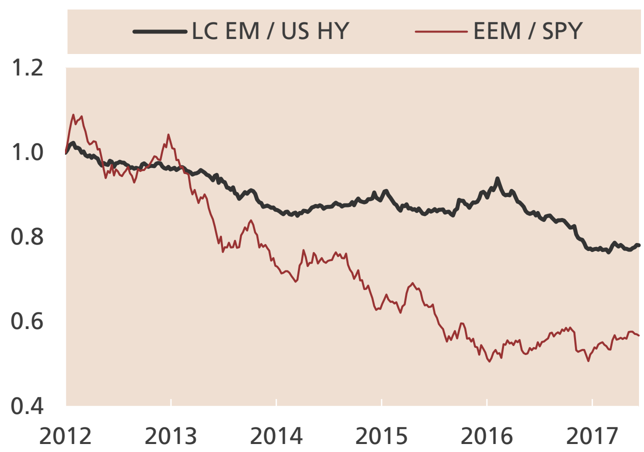
This is good news for risky assets. The unfolding investment environment of improving DM growth and low inflation will be particularly supportive for EM assets, as outlined in this week's EM Watch. In our Asset Allocation framework we have held a positive bias since November on most DM equity markets, which we expect to continue to perform. Just as importantly, the threat of materially higher US interest rates and therefore of a broastronger dollar has receded, which should lend further support to EM assets.

Less risk of dollar strength will be bullish EM



Source: Bloomberg, LSR

EM assets have underperformed this cycle



Source: Bloomberg, LSR

There is still a risk that the Fed's balance sheet reduction programme will spark strong foreign demand for USD and drive up the exchange rate, in an echo of what happened when US money market reforms caused foreign investors to scramble for dollars. But in such circumstances we would expect the Fed to mitigate the impact by reducing its balance sheet more slowly.

As an asset class, EM has underperformed DM for most of this recovery. Both local currency EM debt and the EEM US ETF have done less well than their US equivalents since 2012. Now that we see the risk of tighter US policy and a rising dollar pushed out to next year, we think it's time for EM to catch up.

Since Fed policy started to tighten (the low in the Wu-Xia shadow fed funds rate was May 2014), investment in the EEM ETF – a US-listed fund which tracks the MSCI EM Index – has lagged investment in the SPY ETF. The SPY tracks the S&P500 and its size is a proxy for the broad rise in investable assets in the US. In other words, investors are relatively underweight EM.

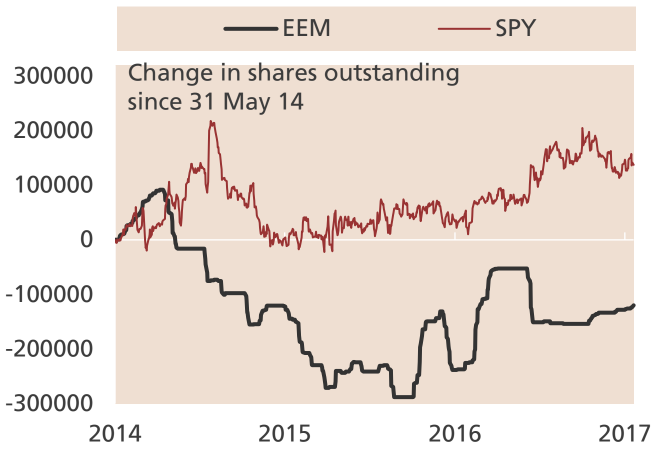
Valuations also support owning EM rather then DM equities. The forward p/e for MSCI EM is 12.6x compared to 17.3x for MSCI DM. The discrepancy in EPS growth expectations is slightly lower, at 21% for EM vs 24% for DM, but EPS expectations have been rising more rapidly for EM than DM – another positive signal for EM outperformance from here on.

Although the EEM ETF includes exposure to China, the slowdown in Chinese growth that we expect should not become a headwind. The largest holdings in the ETF are effectively tech: the likes of Tencent, Samsung and Alibaba and returns are driven by tech: EEM has a 84% correlation (5y monthly returns) to the MSCI EM tech GICS sector.

Finally, the decision by MSCI to include 222 China A-Shares in its EM index may not deliver an immediate boost to EM equities. At 0.73% market cap weighting, the potential inflow is around one-quarter of average daily volume in Shanghai and Shenzhen. All else equal, it is likely to mean only reallocation rather than new flows. But it is a net positive for sentiment towards EM assets and may highlight the degree to which some investors remain underweight.

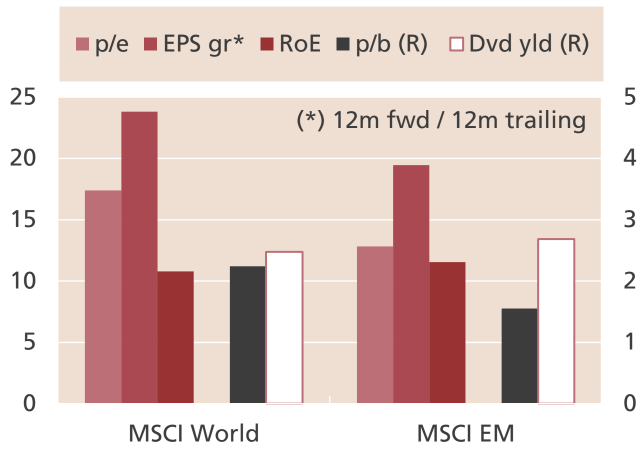
We **buy the EEM US equity ETF at 41.10** and set our **t/p at 44** (near the previous high) with a **stop at 39.50** (below the 100d moving average).

Inflows to EEM have lagged



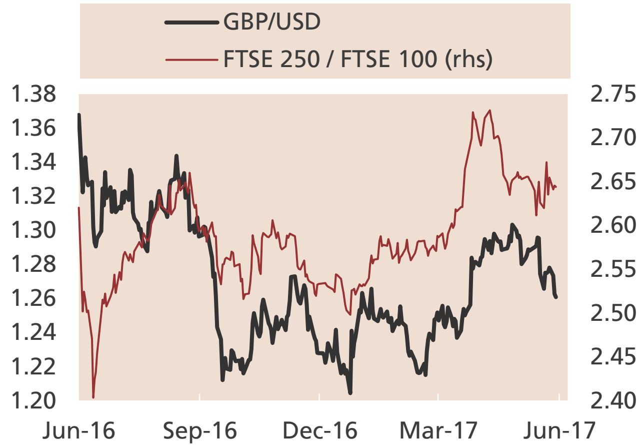
Source: Bloomberg, LSR

Valuations support EM over DM



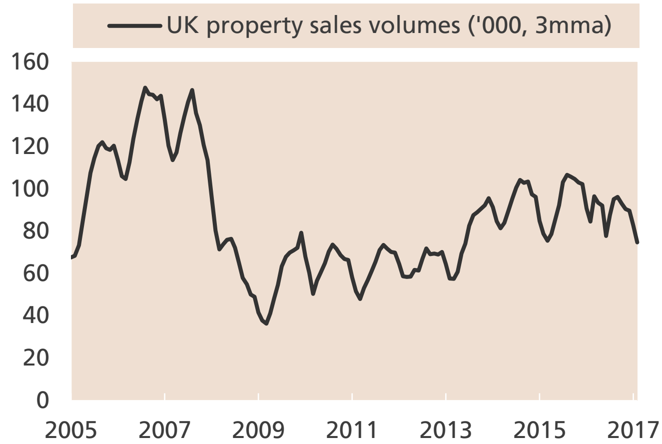
Source: Bloomberg, LSR

FTSE 250 / 100 ratio resilient despite GBP fall



Source: Bloomberg, LSR

UK property market activity slowing



Source: Land Registry

Brexit negotiations start positively but…

Despite his protestations to the British public, David Davis, the UK cabinet minister in charge of exiting the EU, struck a conciliatory tone at the start of talks on Monday with Michel Barnier, the chief EU negotiator. By conceding to the EU on its preference to discuss the divorce terms first, he may be hoping to gain some credit ahead of talks on post-Brexit trading ties, which will be trickier.

Market expectations of a softer Brexit have risen since the general election robbed the Conservative party of its parliamentary majority. The scant evidence we have on the negotiations does not yet belie this view. But there is plenty of legwork to be done; optimism has arrived too soon and too easily and risks during the next 21 months of talks are to the downside. Indeed, the UK government still needs to set out a Plan B to ensure businesses can continue to invest with some assurance of what the 'worst-case' outcome looks like should the talks fail.

Meanwhile, the UK economy continues to roll over, throwing into sharp relief the decision of three hawks on the Bank of England's Monetary Policy Committee to vote last week to raise interest rates. Would the Bank really hike at a time of weakening consumer confidence, declining retail sales and a fragile property market? We suspect not. But there is also little room for easier policy from here on. We think UK domestic stocks will underperform for two reasons: over-optimism on Brexit and weakening domestic demand. We discussed the **short FTSE 250 vs FTSE 100** view in our weekly note on 31 May and we put the trade on today through the September futures. We are looking for a **move back to this year's low** in the ratio (-5%) with a **stop above this year's high** (+3.5%). We are cognisant that liquidity constraints on the FTSE 250 side, both in the future and ETFs, restrict the practical size of this trade and we will look to express the view through currency markets if the opportunity presents at better levels.

Elsewhere in the portfolio this week, the **US 2s10s hit its take-profit level**. We are broadly in line with market expectations for Fed hikes from here on, so we do not see great risk-reward in reinstating the trade yet. Our **Eurostoxx/SPX trade was stopped out for a 3% loss** on European underperformance.

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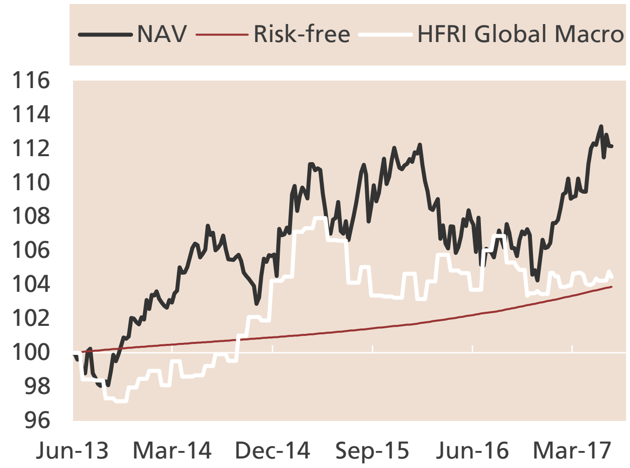
Current trade recommendations

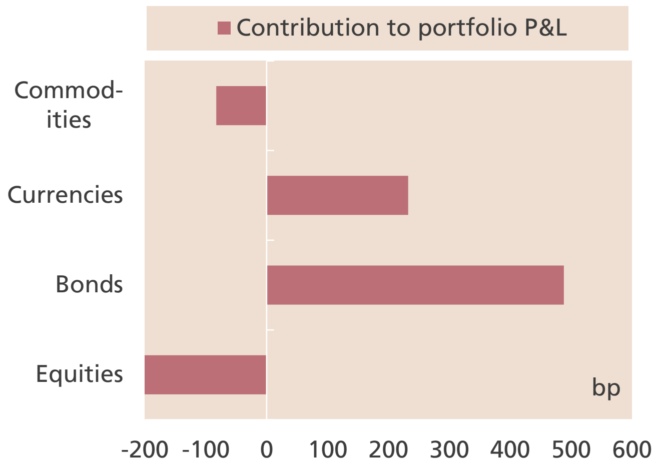
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global reflation								
	US 2s10s flattener*	24-May-17	96bp	80bp	16bp	80bp	90bp	Fed tightening risk underpriced, UST yield curve to flatten
	Long EM equity (EEM US)	21-Jun-17	41.10	41.08		44.00	39.50	Benign inflation outlook, EM cheap and underinvested
	Short FTSE250 / long FTSE100	21-Jun-17			0%	-5%	+3.5%	Downside Brexit risks, weakening UK economy
	Long EUR/SEK 6Sep17 put spd	14-Jun-17	21bp	16bp	-5bp			Rising Swedish inflation and EA growth
	Long ESTX50 / short S&P500**	24-May-17			-3.0%	4.0%	-3.0%	Early vs late cycle growth, valuation difference
Dollar tailwind to high-beta assets								
	Short BRL/MXN	24-May-17	5.695	5.470	3.7%	5.20	5.60	Political risk threatens Brazil growth; Mexico beta to US
	Long USD/TRY 3Aug17 put spd	03-May-17	38bp	35bp	-3bp	n.a.	n.a.	Hawkish CB, high carry/vol, room to catch up other EM
ECB Taper								
	Long 10y UST / Short Bunds	05-Apr-17	210bp	190bp	20bp	160bp	205bp	Spread too wide due to ECB asset purchase programme
	Long EUR/CHF	17-May-17	1.0900	1.0856	-0.4%	1.1200	1.0780	Taper starts policy divergence; CHF safety inflow slowing

*Took profit 14th June, **Stopped out 15th June

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio performance metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	12.16%	4.46%
Annualized Return	**2.88%**	**1.08%**
2014	4.35%	5.61%
2015	3.99%	-1.26%
2016	-4.89%	0.14%
YTD	5.95%	1.11%
MTD	0.16%	
Volatility (ann.)	4.67%	3.74%
Sharpe ratio	**0.42**	**0.05**
Sortino ratio	**0.93**	**0.26**
Alpha (vs HFRI)	2.88%	
Beta (vs HFRI)	0.07	
Correlation (vs HFRI)	0.05	
Correlation (vs MSCI World)	0.14	
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 INR, IDR / short USD, GBP (30-Mar-16)	131
US 2s10s flattener (08-Mar-17)	130
Long 10y UST / short 10y Bund (05-Apr-17)	121
Long 10y USTs / short 10y Gilts (30-Aug-16)	120
Long 10y Bund / short 10y OAT (14-Dec-16)	117
Worst	**Contrib. (bp)**
Short EUR/GBP (18-May-16)	-157
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)	-78