Macro Strategy

DRIVE CAREFULLY: FOG AHEAD

Oliver Brennan

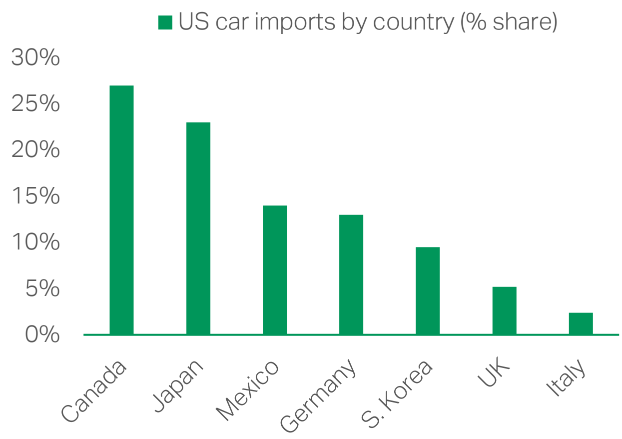
- Global outlook less optimistic; German carmakers facing rising uncertainty
- No-deal Brexit and Trump tariff on auto imports both risks to German exports
- We go short DAX vs CAC; we also reduce risk in our model portfolio

We have long been optimistic on the global outlook, but we are becoming more cautious. We reckon emerging markets have entered a bear market as QE-induced capital inflows over the last several years begin to unwind. We think the credit cycle is past its peak and, although we reckon euro area growth is still above trend despite the soft patch in H1, the synchronised nature of the global economic expansion has frayed.

Global growth is displaying late-cycle characteristics, and downside risks are mounting. Like many investors, we had been assuming that President Trump's threat of trade wars was mostly hot air and would be resolved via some symbolic victories with little macroeconomic impact. But the battles appear to be here to stay. As well as raising the cost of some goods trade between the US and China, another immediate consequence of the confrontation is a pause in US capex growth. Steve Blitz highlighted in a Daily Note last week that orders for durable goods have continued to move sideways. There is scant incentive for manufacturers to build new factories when they are unsure of the business environment in which they will be operating. By contrast, capex is booming in the IT sector: cloud services cost money to set up but will have little incremental impact on GDP beyond the initial investment as few people need to be hired to run them.

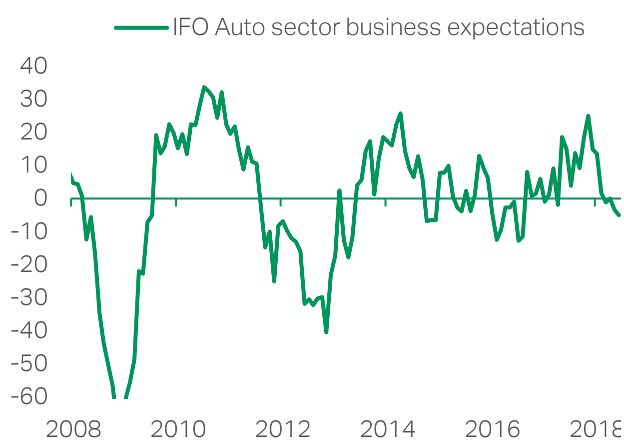
US car imports coming into Trump's sights. In May the US commerce department launched a Section 232 investigation into whether car and truck imports were endangering the domestic auto industry. The department plans to conclude its probe by August; its report and recommendations will likely be ready before the midterm elections in November.

US car imports: NAFTA then Japan and Germany



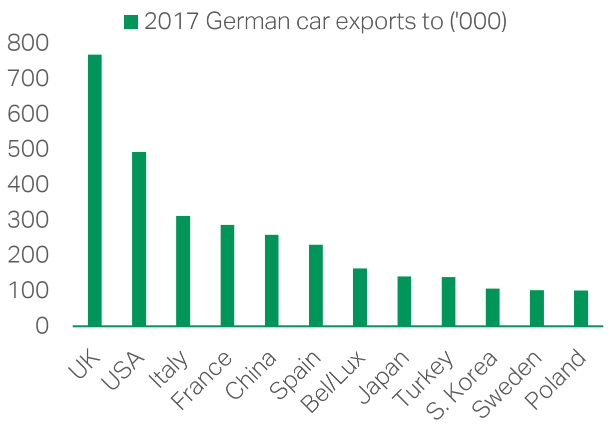
Source: OEC, TS Lombard

German auto sector confidence falling



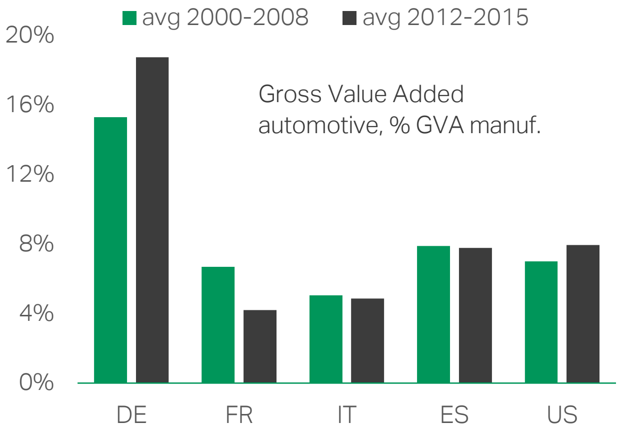
Source: IFO

UK and US are main German export destinations



Source: VDA, TS Lombard

Auto industry central to EU economy



Source: OECD, TS Lombard

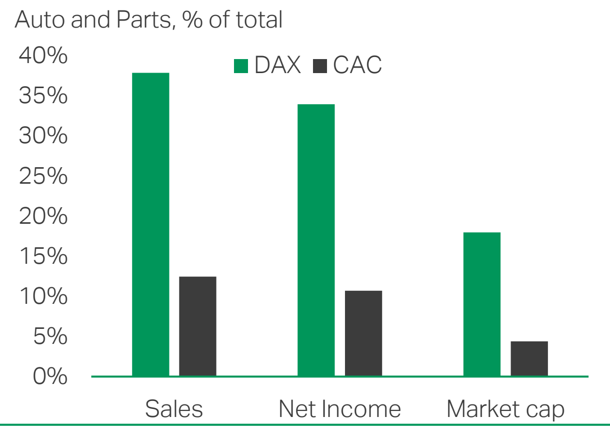
Big car exporters getting worried. Germany and Japan are the world's two largest car exporters. Japanese companies have been through similar upheaval before. In 1982, they agreed to voluntary export restraints to ward off tariffs threatened by President Reagan. But, having not had that imperative to onshore some production, German exporters are more at risk. The IFO auto sector business expectations measure has fallen sharply to -5, the lowest level in two years.

German exporters set to worry for other reasons. It is not just US tariffs which could hurt the German car industry. The sector's largest overseas market is the UK, which imported around 800,000 cars from Germany in 2017. As Brexit negotiations drag on, the risk of losing unfettered access to British consumers will make German exporters concerned for their outlook.

Mainland Europe is also a key export destination for the UK. The UK runs an automotive trade deficit with its main EU partners (Germany, Belgium, Spain, France, Poland and the Netherlands). The country's struggle to navigate a Brexit deal while satisfying diverging domestic demands and respecting various red lines is well publicised, but it is clear that the UK does need to find a low-tariff or tariff-free arrangement with the EU after March 2019. We reckon the final state of Brexit will be "BINO" (Brexit In Name Only), but the road to that destination will be extremely bumpy.

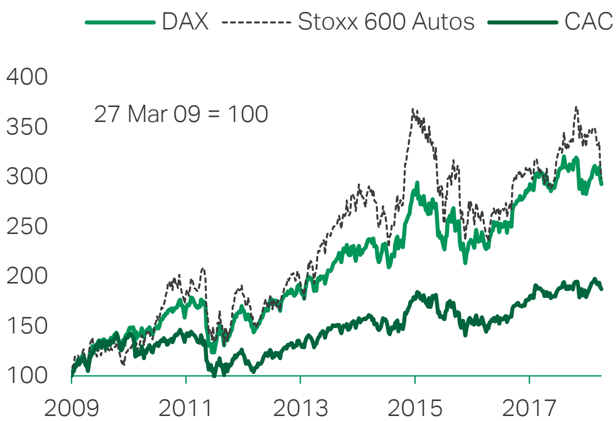
European growth has been built on autos. Automotive GVA is 19% in Germany and around 7.8% in Spain – the same as in the US. The car industry is also the leading contributor to EU R&D, accounting for 30% of the total (vs 8% in the US and 12% in China). Grave threats to the auto

DAX dominated by Autos



Source: Bloomberg, TS Lombard

Post-GFC strength powered by Autos



Source: Bloomberg, TS Lombard

sector would have ripples throughout the euro area. But since Germany's automotive GVA has actually increased since pre-GFC, it is Germany that faces the greatest potential danger.

Concentrated in Germany, and concentrated in the DAX. Making cars requires a lot of capital and a lot of workers. The car industry directly employs 1m people in Germany, compared to under 250k in Italy, France or Spain. Autos account for 35% of total sales and 31% of total net income of the companies that make up the DAX, despite comprising only 15% of the index by market cap. Since the GFC, the importance of the auto sector to Germany has grown, thanks to a declining share of revenues and profits from financials. The post-GFC recovery in the DAX owes a lot to the successes of the auto sector.

Profit warnings the first sign of vulnerabilities. Daimler issued a profit warning last week, following China's decision to increase tariffs on certain US imports (Daimler sells a large number of US-manufactured SUVs in China). The DAX's dominance of European equity markets since the crisis may now be at risk. Today's FT report that the EU is considering international talks on cutting car tariffs also shows how big a vulnerability this sector could be.

We sell the DAX and buy the CAC. We are not bearish on the euro area economy overall. Growth is slowing, but from well above trend to slightly above trend. We see US tariffs and Brexit as rising risks to the auto sector, and we judge the German stock market to be the most exposed in such circumstances. The French stock market has a similar sectoral composition to Germany, but its consumer discretionary sector is not dominated by autos. In addition, it has a beta to the DAX around 1. By **selling the DAX and buying the CAC** we attempt to isolate the risk of tariffs without taking a negative view on the broader economy.

Portfolio changes this week

In light of our more cautious stance on the macro outlook we reduce risk in our model portfolio, which lost 50bp this week.

Taking off our bet on 2019 Fed rate hikes. We bought the EDZ8-EDZ9 eurodollars spread in February, when Chairman Jay Powell suggested the Fed would become more pragmatic (and therefore more hawkish) in its outlook. However, since we have now turned less positive on the US outlook we are less certain that there will be more than two rate rises in 2019. We take off the trade for zero pnl.

Taking profit on half of our 1y10y payer swaption. Last November we bought a payer swaption to express the view that US yields would end 2018 above 3%, and that volatility would rise as QE faded away. We continue to expect US yields to rise towards the end of the year, and close 2018 around 3.25%. Factors that push up yields will come to the fore once more this quarter: heavy Treasury debt issuance resumes after a hiatus in Q2 due to a seasonal surge in tax revenues and the Fed has picked up the pace of QT. But downside risks, hitherto mostly related to positioning, are building, and any escalation of trade wars could usher in a severe risk-off episode. We reduce risk and book profits on half the trade.

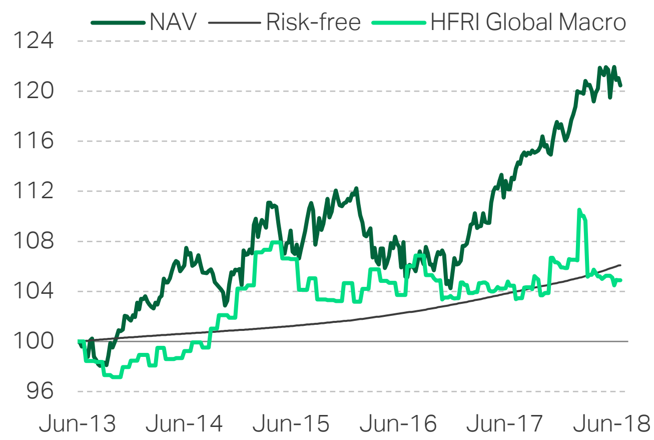
PBoC comments suggest broad CNY weakness is done. On previous occasions when the PBoC has pledged to "keep the yuan exchange rate basically stable" it has done just that in the following weeks. As Bo Zhuang wrote on Monday, China has not weaponised the yuan and is unlikely to do so. There is probably still some scope for the yuan to decline against the CFETS basket, but it is now close to Bo's year-end expectation of 'towards 94'. **We take off our short CNY/KRW** position, but in light of our positive stance on RUB in Asset Allocation and EM Strategy Monthly, **we keep short CNY/long RUB for now**.

Current trade recommendations

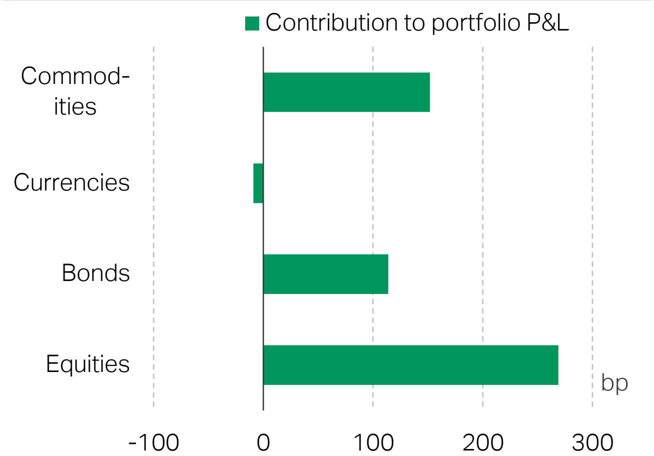
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global cycle								
	Long CDX IG 5y protection (short risk)	20-Jun-18	63.00	67.00	5bp	75.00	55.00	US investment grade to underperform as credit cycle past its peak
Trading trade troubles								
	Short CNY/KRW**	28-Mar-18	170.00	168.42	0.9%	164.00	175.00	Korea currency manipulation to end, KRW to catch up
	Short CNY/RUB	27-Jun-18	9.60	9.55	0.5%	9.00	10.10	Russia more resilient to current risks than China
	Short DAX vs CAC	04-Jul-18						German car industry at risk from tariffs and Brexit
ECB Taper								
	Long Bunds / short OAT 10y	14-Mar-18	24.5bp	33.7bp	9.2bp	50bp	15bp	ECB cornered Bund market, OATs to react more to end of QE
	Long EUR/USD 14Sep call sp	16-May-18	41bp	20.5bp	-20.5bp			EUR to rebound and risk of more hawkish ECB
End of QE distortion								
	Long 1y10y USD 2.9% payer incl hedge	29-Nov-17	86bp	154bp	152bp*			FI distorted by QE; unwind will raise yields and vol
New Fed Chair, new reaction function								
	Long EDZ8- EDZ9**	28-Feb-18	33bp	33bp	0bp	50bp		Room for more rate hike pricing in 2019

Bold indicates new trades or changes made this week. *P&l includes p&l on 3m hedges. **Closing today

Model portfolio historical performance



Performance contribution - last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	20.45%	4.90%
Annualized Return	**3.73%**	**0.95%**
2015	3.99%	-1.26%
2016	-4.89%	0.14%
2017	9.67%	2.47%
YTD	3.75%	-0.91%
MTD	-0.23%	
Volatility (ann.)	4.64%	4.12%
Sharpe ratio (12m)	**1.10**	**-0.02**
Sortino ratio (12m)	**2.43**	**0.18**
Alpha (12m, vs HFRI)	8.25%	
Beta (12m, vs HFRI)	0.16	
Corr (12m, vs HFRI)	0.22	
Corr (12m,vs MSCI World)	0.35	
Corr (12m, vs JPM GBI)	0.21	
Max drawdown (12m)	-2.35%	-4.16%

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)	155
Long Canada 10y / short USTs 10y (18-Oct-17)	145
Long EM equity (21-Jun-17)	125
Long WTI / short Brent (06-Oct-17)	86
Long OIH US equity (14-Feb-18)	82
Worst	**Contrib. (bp)**
Long Bund 10y / short BTP 10y (20-Sep-17)	-140
Long AUD/USD put (25-Oct-17)	-61
Long USTs / short Bunds (24-Jan-18)	-33
GBPUSD Put spread (26-Jun-17)	-32
Long BTP / short Bund (16-May-18)	-31

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