Strategy Chartbook

MARCH 2019 CHARTBOOK

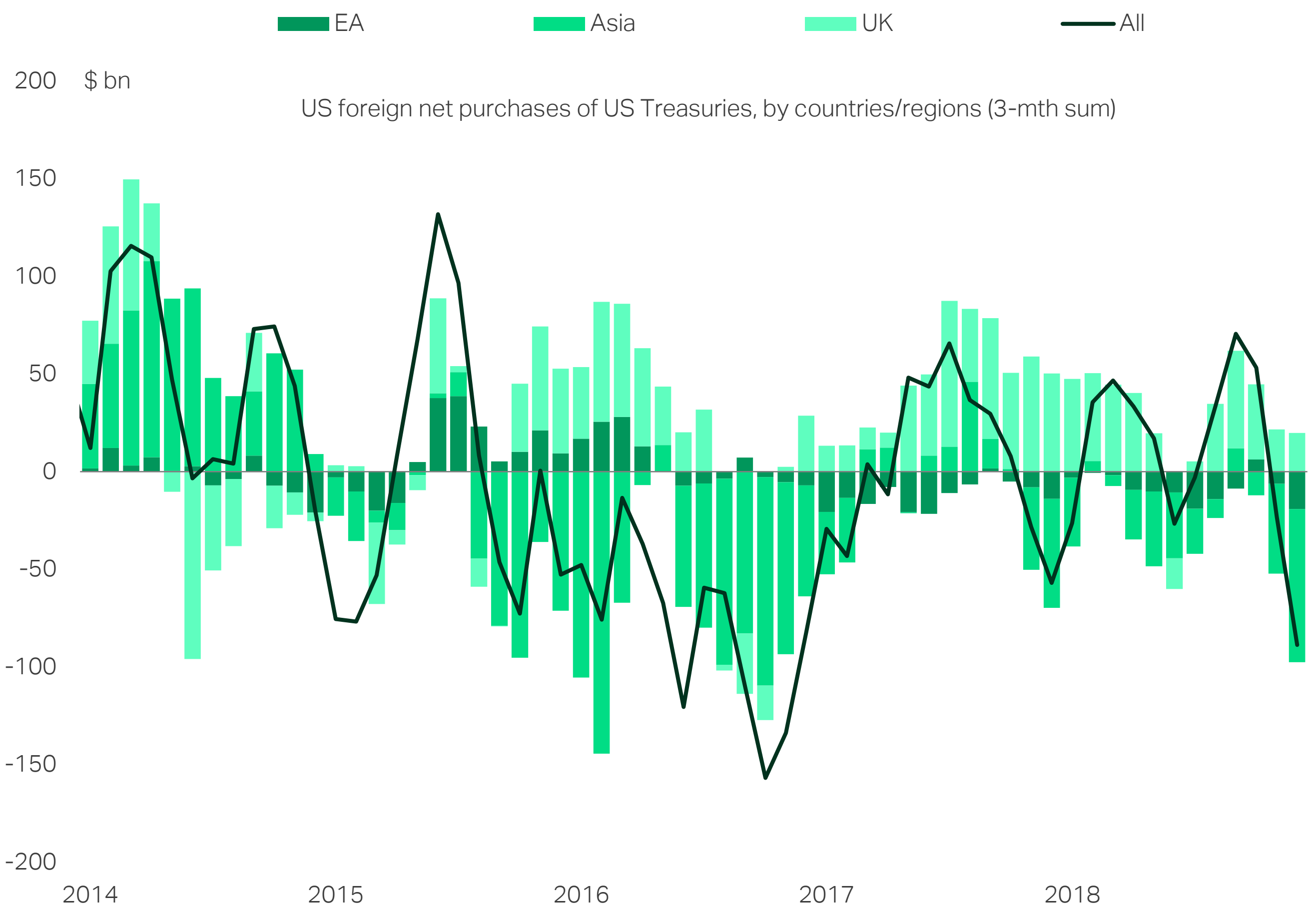
Andrea Cicione / Oliver Brennan

HIGHLIGHTS

- **Macro Drivers.** Negative trade growth and inventory overhang spell further growth slowdown
- **Multi Asset.** Low volatility may not last too long, especially in rates, credit and EM equities
- **Fixed Income.** Foreigners sold $90bn of US govt bonds in Q4, the most since 2016
- **Currencies.** USD is rich and the market is long, but it is more likely to drift lower than collapse
- **Equities.** The VIX below 15 hints at new highs for US equities, but a consolidation phase is still likely
- **Commodities.** Tailwinds for crude – demand dominance, financial markets recovery – are fading

Chart of the month

Foreign US government bond demand is falling



Foreigners sold $90bn of USTs in the three months to December, the most in two years. Although these data are now a couple of months old, they show the vulnerability of US Treasuries: foreign demand is falling now ECB QE has ended, DM portfolio investors get no yield advantage after currency hedging and EM reserve manager demand has slowed. Funding the $1trn budget deficit may need lower clearing prices for US bonds.

Yield volatility is also set to pick up. With the MOVE index close to historical lows, risk is obviously skewed to the upside. Supply-demand dynamics are adverse and given the Fed's desire to wean the market off forward guidance, risk premiums seem to be too low.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* Chinese policy easing should soon filter through domestically as well as to Japan and EA exports.
- *Multi Asset.* Gap between EA equities earnings yield and bond yield close to historical highs.
- *Currencies.* Low and falling volatility is good news for the carry trade.
- *Equities.* The VIX back below 15 suggests this rally has legs (after a period of consolidation).
- *Commodities.* Oil rebound nearing exhaustion after financial markets drag is unwound.

In this month's Chartbook

Macro drivers

Multi Asset

Fixed Income

Currencies

Equities

Commodities

Summary – key points

Macro Drivers

- World trade growth, in all regions, has turned negative for the first time since 2009
- The inventory overhang in the US will weigh on growth in Q1 and Q2, as high-frequency indicators show
- Falling interest rates in China will soon feed through to higher money growth, in turn supporting Japanese and EA activity

Multi-Asset

- The rebound in risk assets this year has left volatility at very low levels in most asset classes. This is unlikely to last
- After large inflows since late 2018, the long EM trade is looking tired, especially in equities; local debt still quite appealing
- The earnings-credit yield gap is near all-time highs in the EA, making stocks good value vs bonds; not so in the US

Fixed Income

- Foreign investors sold US government bonds in Q4 at the briskest pace since 2016
- Most DM investors would lose out in yield terms if buying US Treasuries, so demand is likely to stay weak
- The ECB set to launch more TLTROs to avert a debt cliff-edge in Italy; this will not be a new policy easing

Currencies

- USD long positioning at current levels usually presages an unwinding, but this time round the positioning is not broad
- But with USD the richest DM currency, the currency is likely to gradually weaken this year absent a strong positive driver
- Realised FX volatility is testing its record low, and implied vol is set to follow. In this environment carry currencies should do well

Equities

- With equity technicals swinging from oversold to overbought in the space of two months, has the rebound gone too far?
- Multiples have risen despite negative earnings revisions; we think a phase of consolidation is in order
- But if the VIX remains below 15 chances are that the market peak for this cycle is still ahead of us

Commodities

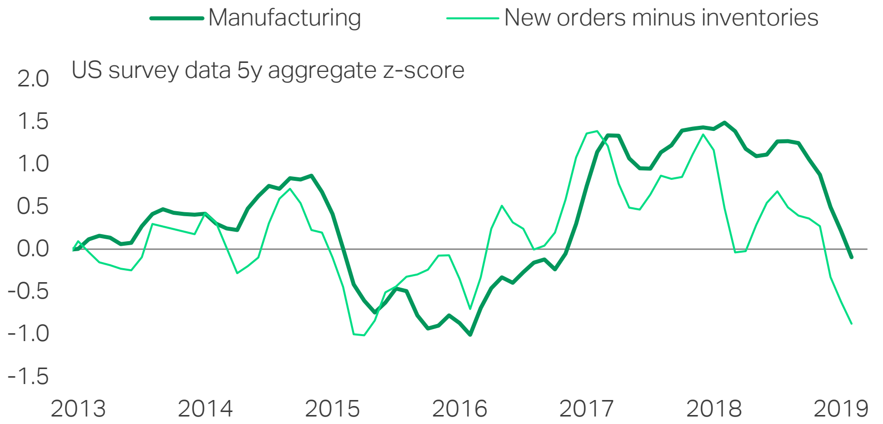
- The bounce in crude this year has been entirely driven by demand and financial factors
- With oil volatility normalised, financial market-related tailwinds are no longer pushing prices up
- After OPEC+ cuts, supply and demand are now back in balance: crude rally to lose steam from here

Macro Drivers Tariff fears hit growth

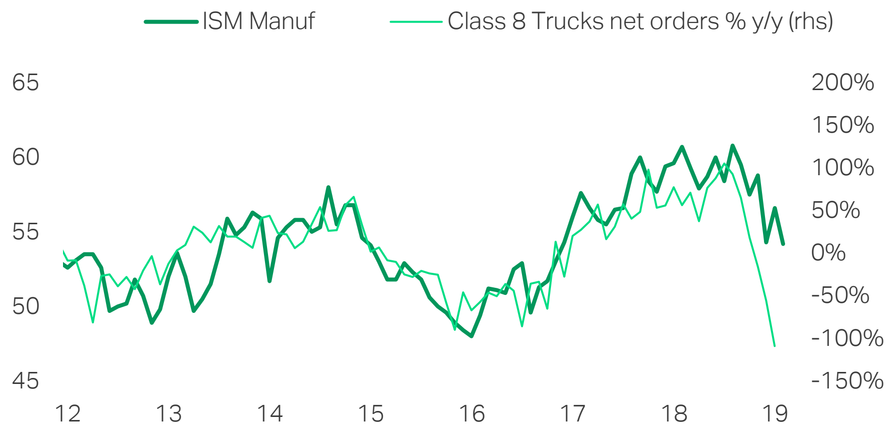
Global import and export growth has turned negative

Imports and exports across EMs and DMs fell in 2018 for the first time since 2009. Inventories were built up ahead of an expected increase in US tariffs on Chinese imports – and possible retaliation – on January 1. But now that tariff escalation is off the table, the US is dealing with an inventory overhang, shown in the charts to the right (and Q3 and Q4 GDP details). We need to see stocks run down before we can be confident of a growth pick-up.

US inventories still a drag on activity as shown by surveys …



… and by trucking activity

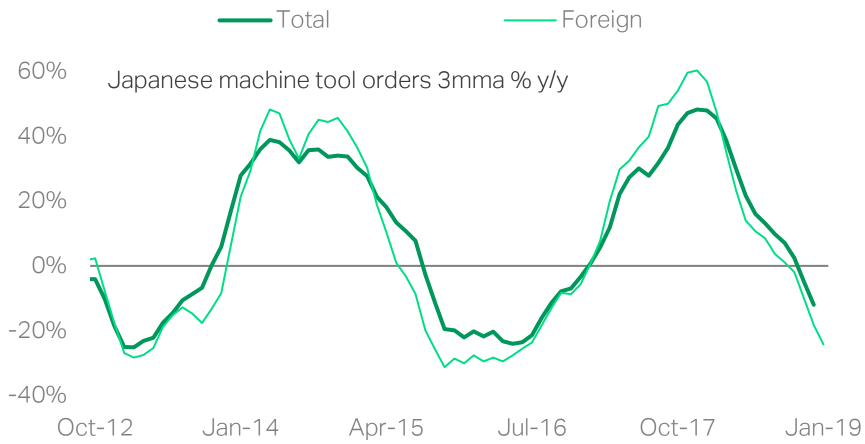


Macro Drivers China easing to boost more than China

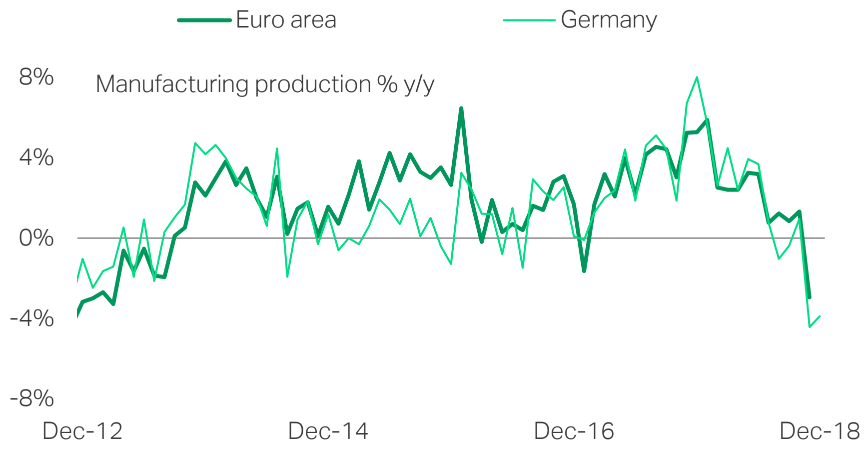
Chinese easing should filter through to money growth soon

We remain sceptical about the efficacy of Chinese-style QE, but it is likely to provide short-term growth support. Tax cuts and easier fiscal policy – outlined in today's NPC speech by Premier Li Keqiang - add to the sense that Beijing will continue to attempt to reflate the economy. As a result, growth is likely to accelerate in H2, which should also help the EA and Japan, whose economies have deteriorated as external demand has waned.

Japanese activity at the mercy of Chinese (foreign) demand

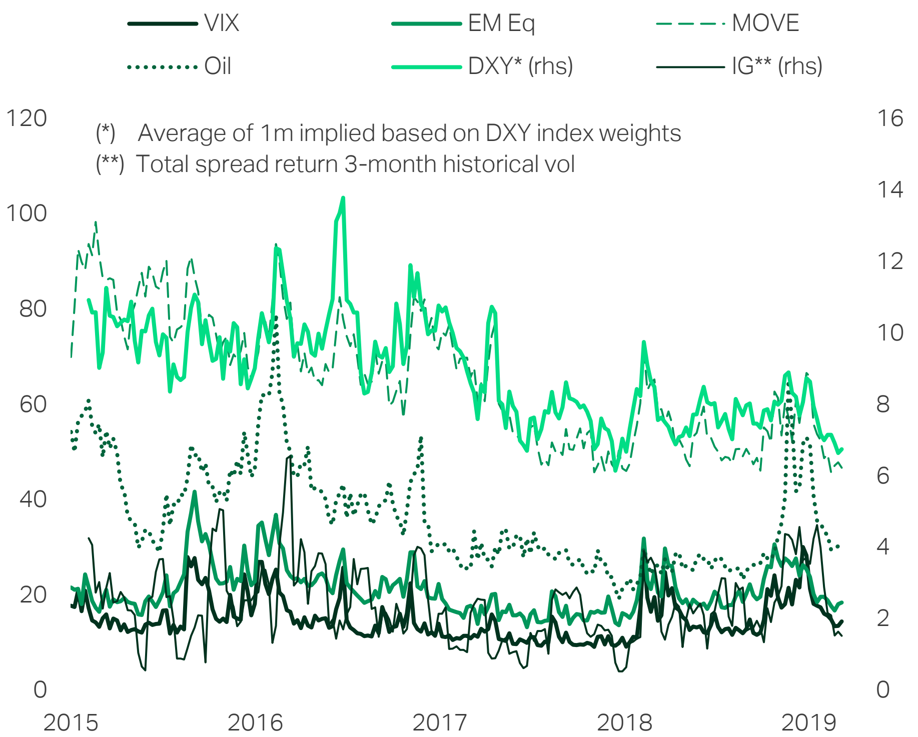


And the EA in a manufacturing recession needs more demand



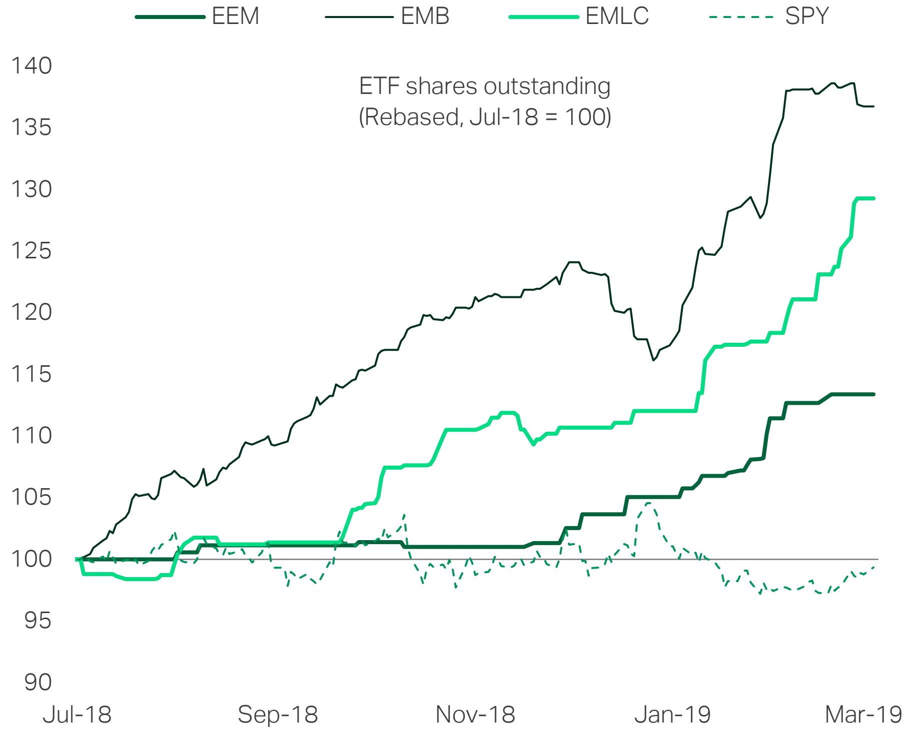
Multi-Asset Vol too low in rates, credit, EM equities

Volatility low in most asset classes



The rebound in risk assets since January has been associated with falling volatility across the board. This looks too complacent and we expect vol to rise in certain asset classes. Supply and demand considerations suggest vol in US Treasuries should climb from here. We also think that credit vol (realised in the chart above) is too low considering the credit cycle is in the 'slowdown' stage.

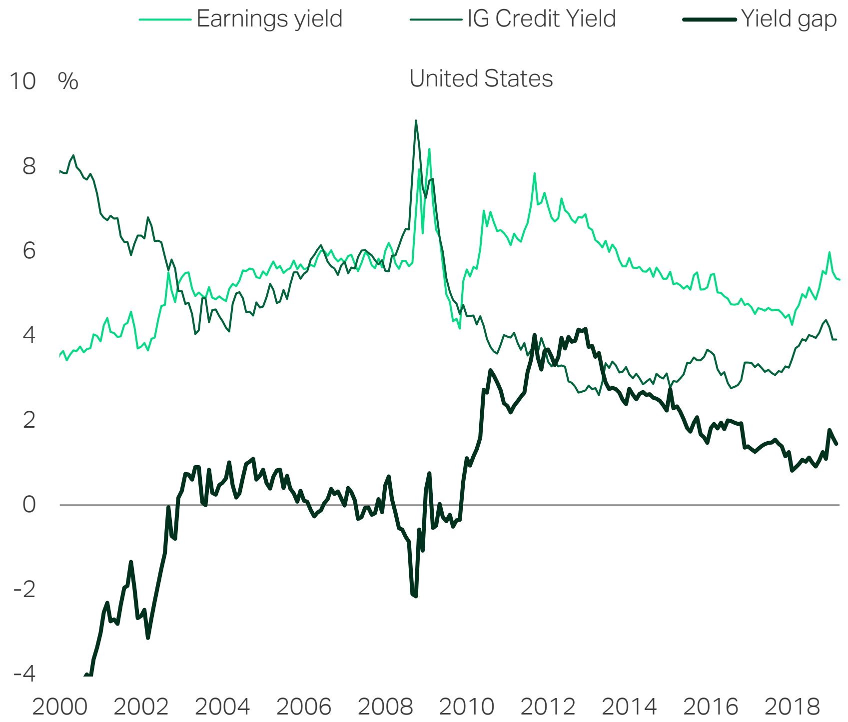
EM assets have enjoyed large inflows since late 2018



Vol in EM equities also seems set to rise. Unlike the US and other major developed markets, EMs have enjoyed large inflows across all asset classes since late last year. Excluding China, EM equities have already started to show weakness. We went underweight in our Asset Allocation model portfolio last month, but we stayed o/w on local debt as inflation dynamics still favour this asset class.

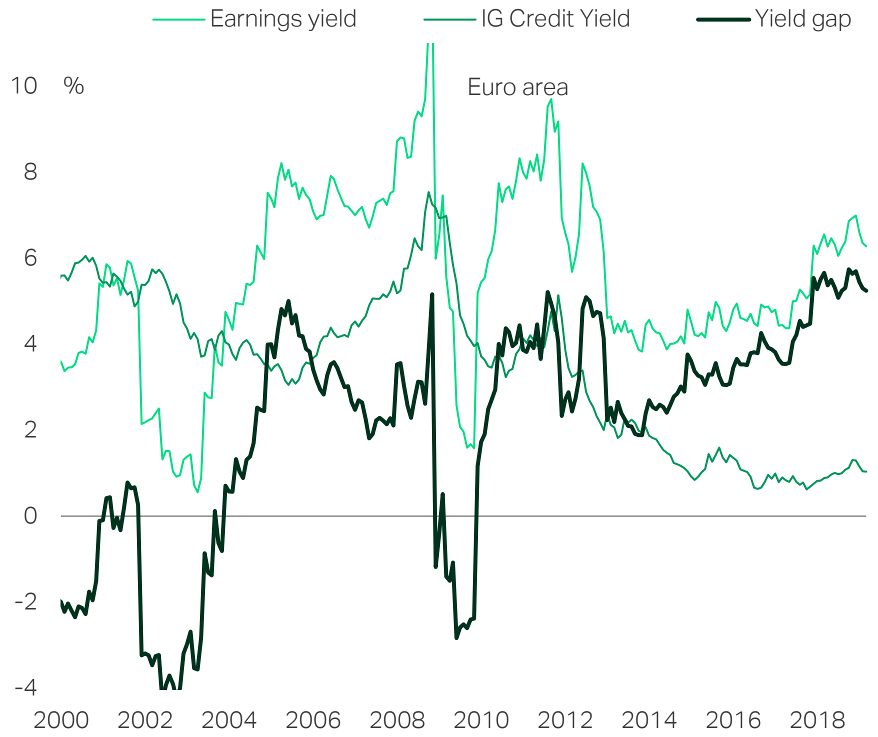
Multi-Asset Yield matters

Equity yield not very attractive vs IG credit yield in the US



Since 2012, the yield advantage of stocks over bonds has been gradually eroded, with the gap falling from 4%+ to less than 1% in early 2018. The recent sell-off in both markets has pushed the equity-credit gap back to about 1.5%, but purely on a yield basis stocks remains relatively unattractive vs IG bonds in the US.

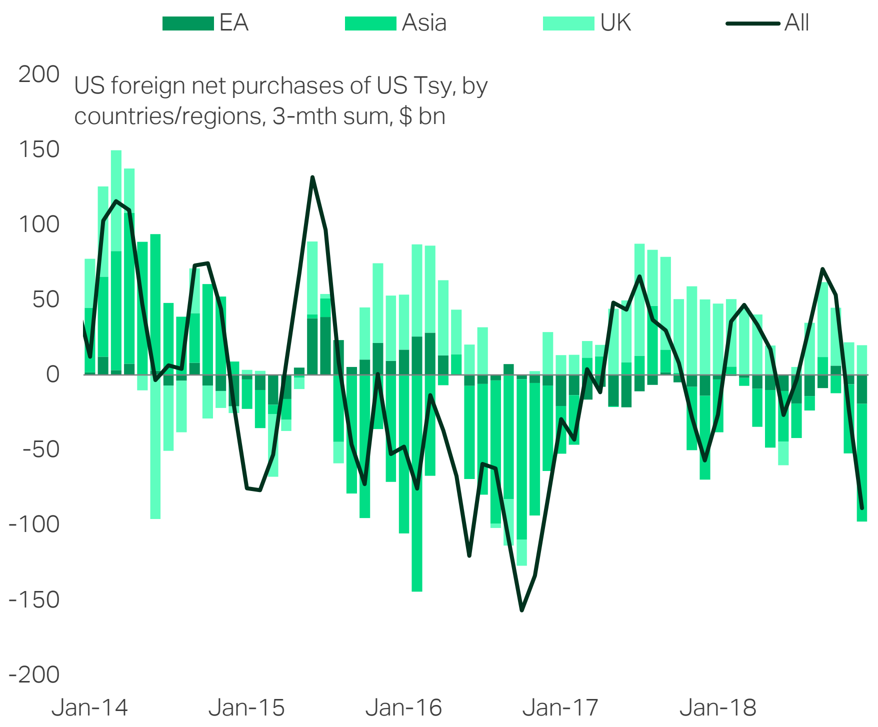
Stocks more appealing in the euro area



In Europe, however, the opposite is true. The equity-credit yield gap has been steadily rising since 2013, and remains close to the all-time high of about 5½%. Obviously, yield is not the only factor when assessing the relative attractiveness of stocks vs bonds, but it shows that EA equities are more appealing than US shares on this basis.

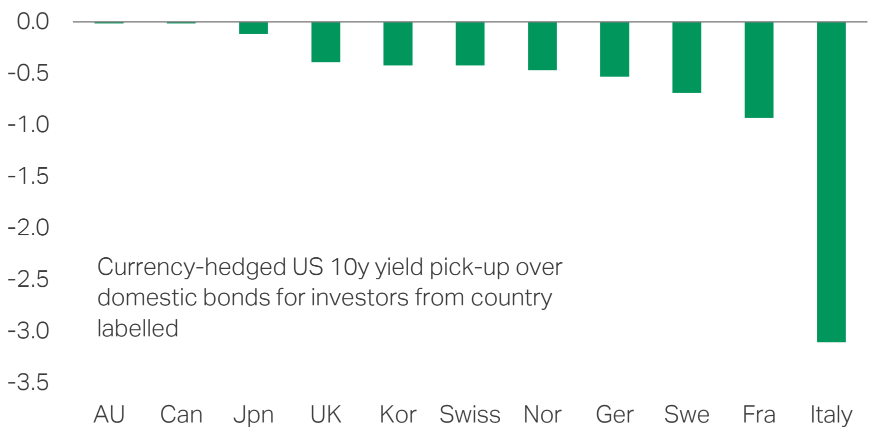
Fixed Income Demand dearth

Foreign US government bond demand is falling

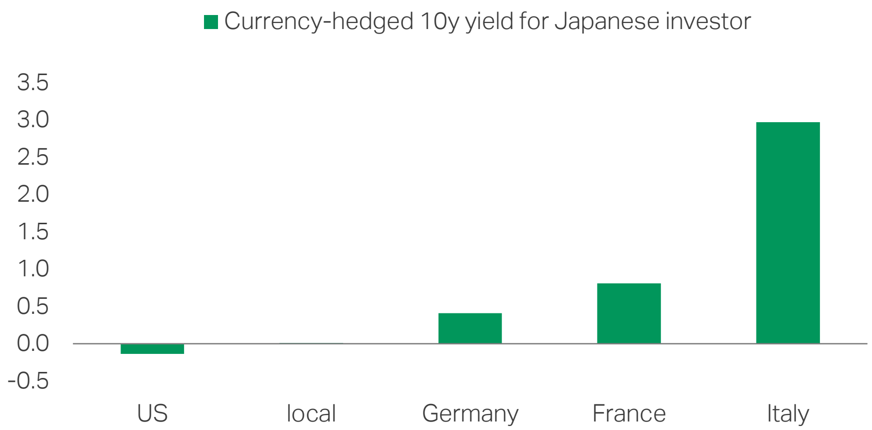


Foreigners sold $90bn of USTs in the three months to Dec-18, the most in two years. Although these data are now a couple of months old, they show the vulnerability of US Treasuries: foreign demand is falling now ECB QE has ended, DM portfolio investors get no yield advantage after currency hedging and EM reserve manager demand has slowed. Funding the $1trn budget deficit may need lower clearing prices for US bonds.

Foreign investors have no reason to buy FX-hedged USTs

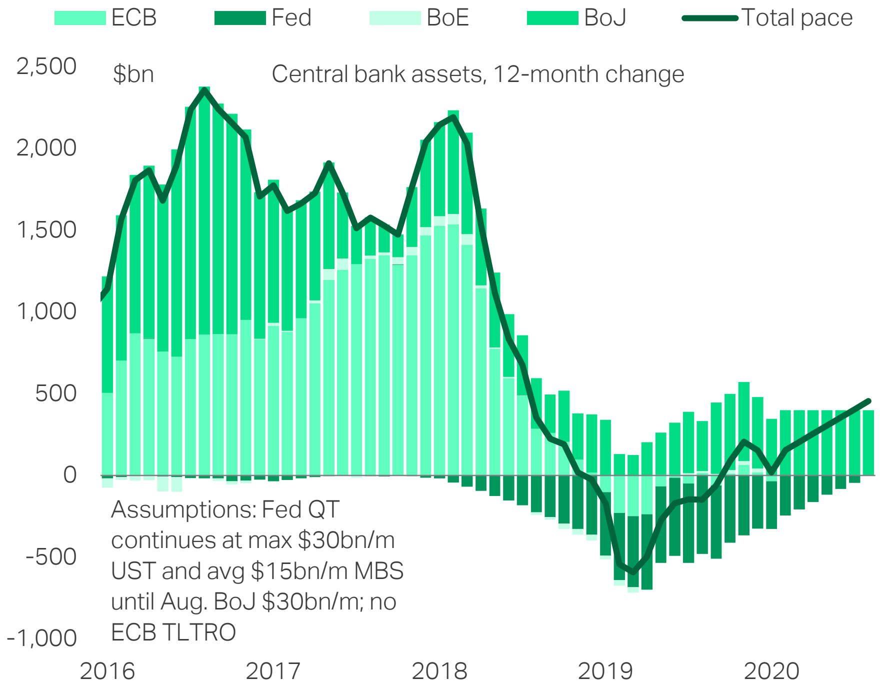


Especially when currency-hedged investing is better elsewhere

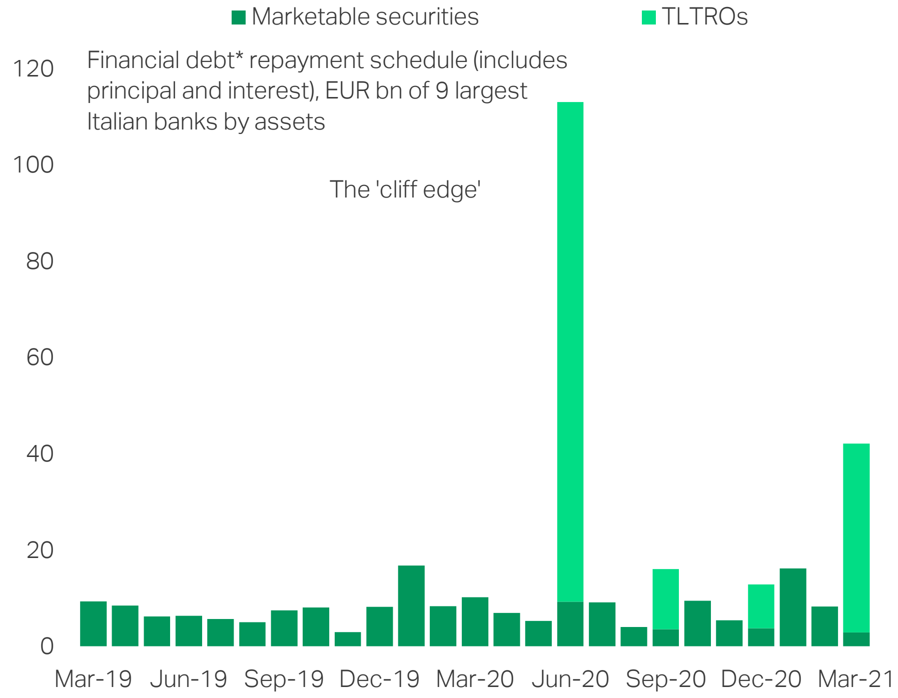


Fixed Income What comes after QT? TLTROs

QT end-date on the horizon



ECB TLTRO needed before the cliff-edge

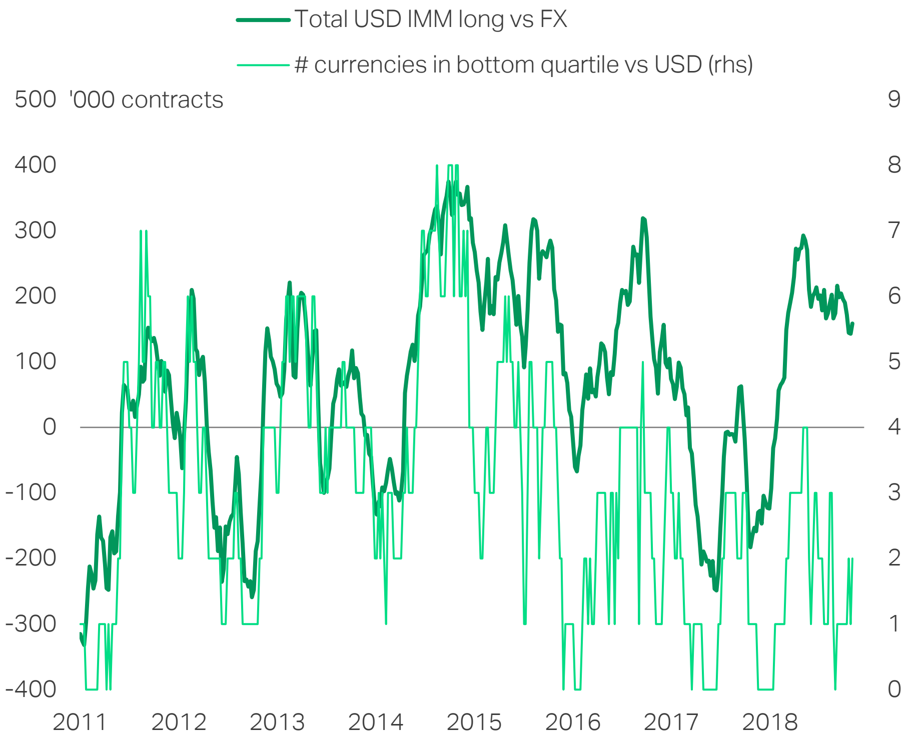


In testimony to Congress, Fed Chairman Powell said the terminal size of the Fed's balance sheet should be 16-17% of GDP. This implies an end date of QT in the summer. Once that happens, we reckon the Fed will have a difficult choice to make in how it manages the remainder of its MBS holdings, which it would prefer to switch into USTs. Soon the BoJ will be the only net provider of central bank liquidity to the world.

TLTROs are excluded from the chart on the left as they may give a spurious sense of the ECB's policy stance. The cliff-edge of borrowing for Italian (and Spanish) banks in June next year is likely to be mitigated by a new round of TLTROs. But rather than an outright policy easing, this lending will merely serve to avoid a sharp liquidity tightening for these banks. Sovereign spreads will tighten, but QE it is not.

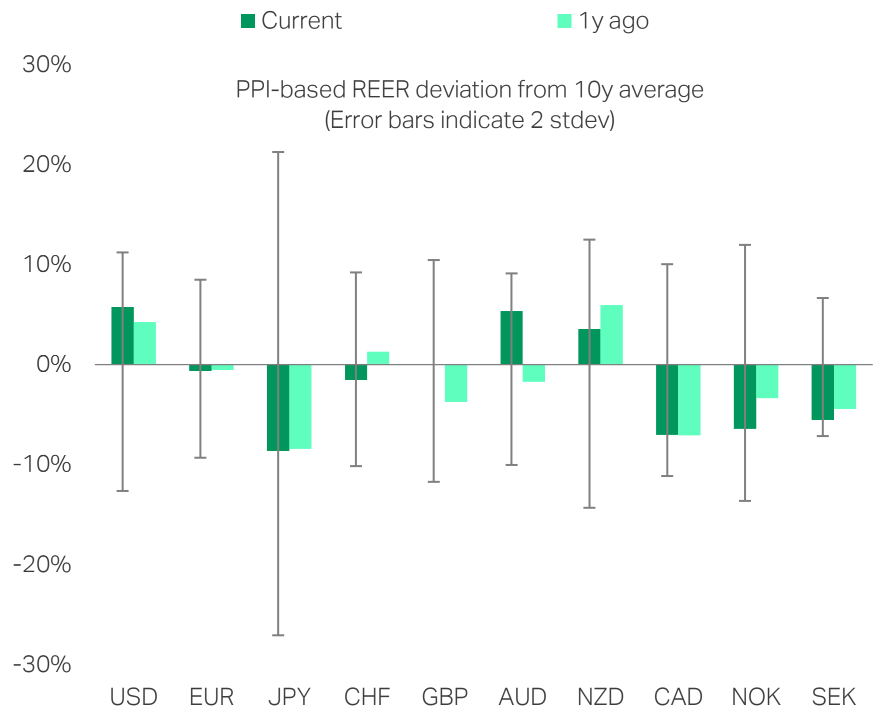
Currencies Long, rich USD to drift lower

Market is long USD but only against selected currencies



Long positions of this size long are usually a warning to prepare for a squeeze, especially if USD falls – see 2015. But this time round USD is owned narrowly, mainly vs CAD and NZD, not broadly. So position unwinding is unlikely to induce a sharp, broad USD sell-off. Instead, renminbi policy (see next page) and valuation (right) are likely to be more important. Both suggest USD is in for a slow drift lower.

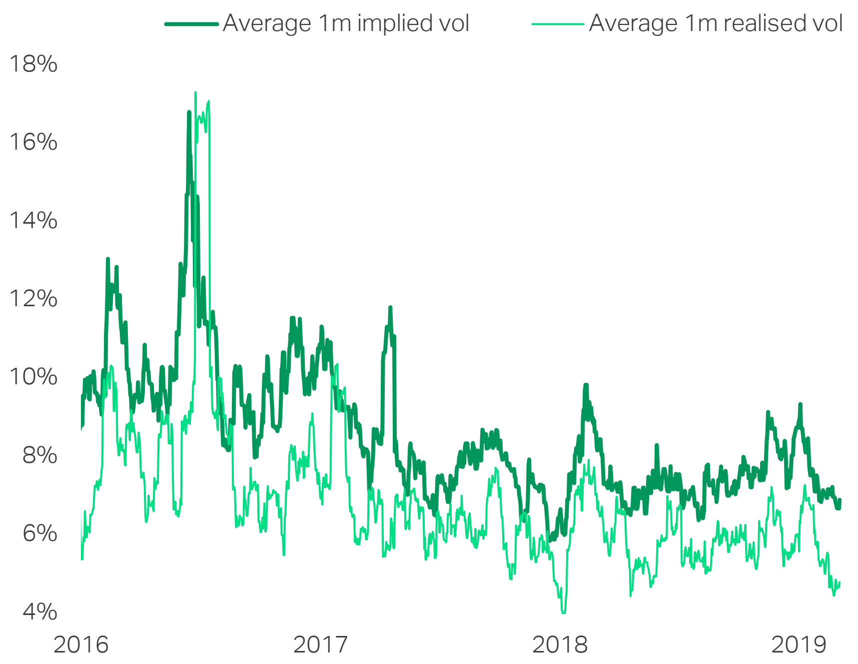
Valuation is a headwind, absent a strong positive force



Like positioning, valuation is not necessarily a headwind or a tailwind for currencies all the time. But with USD 6% richer than its long-term average, a series of USD-positive events must occur for it to stay high. More likely is that USD will drift lowerwith overvaluation the dominant factor in the absence of a particular positive driving force.

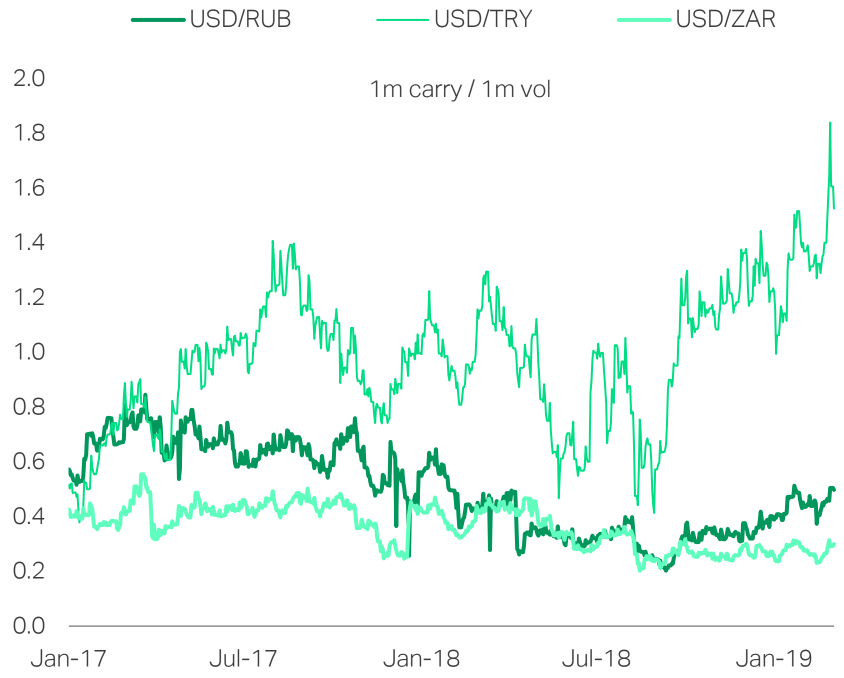
Currencies FX is boring, making carry exciting

Volatility declining now trade war risks have eased



Realised volatility in the major FX pairs is close to its lowest-ever level. The implied volatility premium is currently above 2pp, but has been 1.7pp on average over the last 12 months. So implied volatility is likely to follow realised volatility lower. Signs of détente in the US-China trade war, and of policy easing from major central banks, have eased tail risks. Although there is little sign of directionality in some of the major pairs, this should support a rally in risky currencies.

Better risk outlook and falling vol support the carry trade

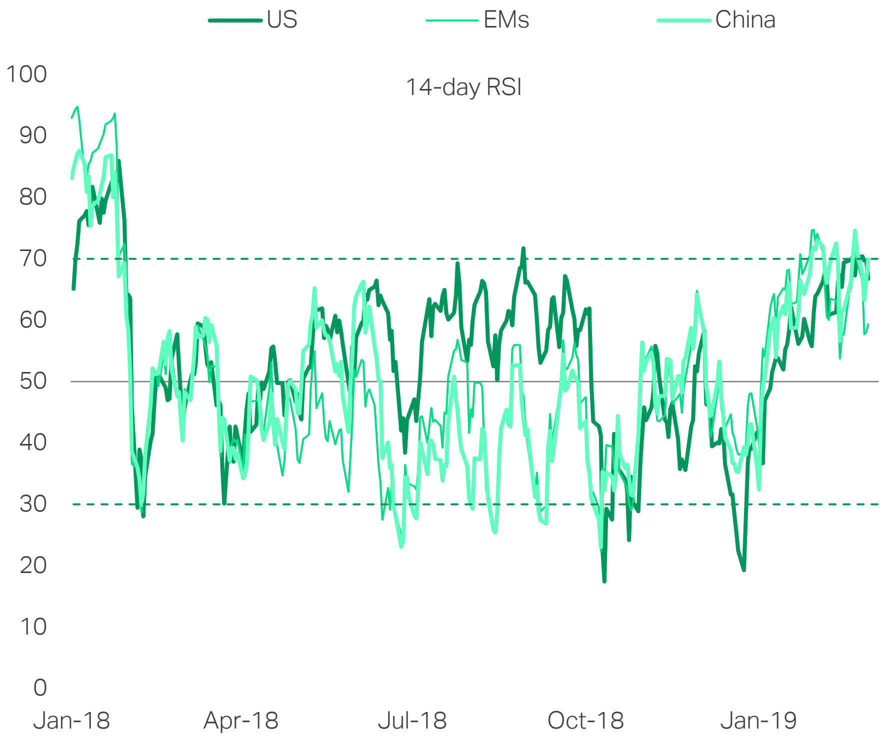


In this environment, the FX carry trade should do well. We added short EUR/TRY to the Macro Strategy portfolio last week: TRY has the highest carry/vol ratio among high-yielders, adequately compensating for idiosyncratic risks. And as FX volatility declines further – across the majors, CNY and into emerging markets - TRY (and other high-yielding EM currencies) will continue to attract speculative inflows to earn the carry on offer.

Equities

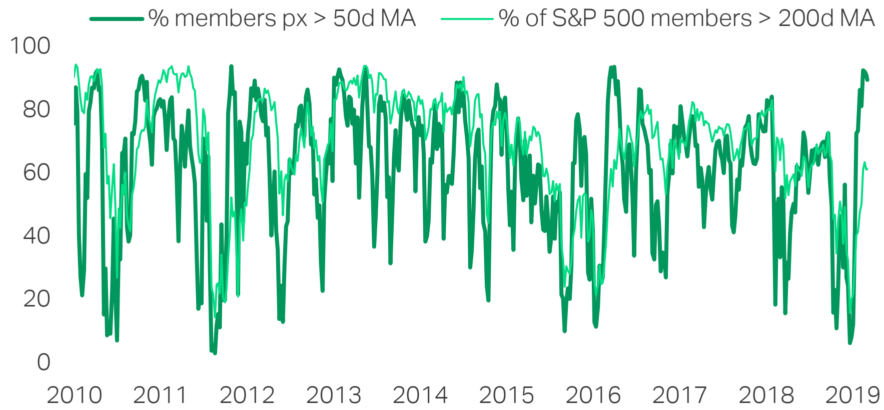
Chase the rally or take profit?

EMs no longer oversold, but China and US are

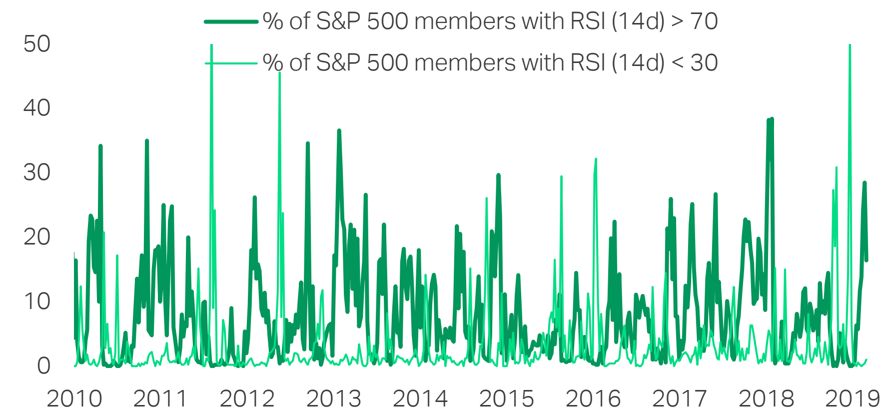


Synchronised central bank dovishness helped global equity markets recover from oversold conditions in December. But has the rebound gone too far? Multiples have risen despite negative earnings revisions, while technical indicators remain in overbought territory. We think a phase of consolidation is in order. This could be a sharp sell-off or, more likely, a period of stagnation lasting a few weeks.

S&P 500 market breadth recovering



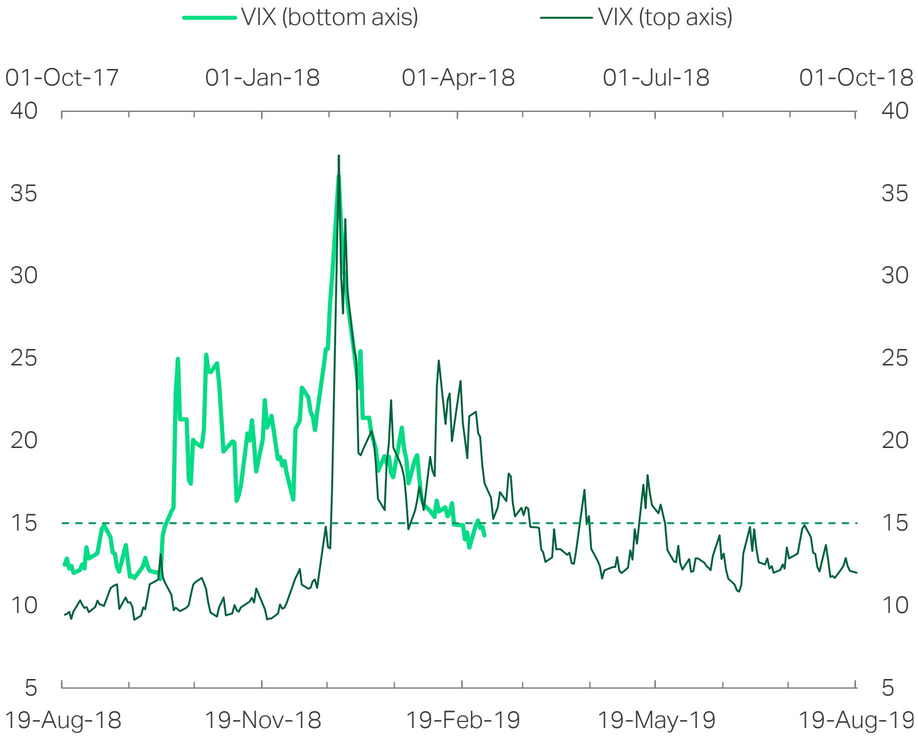
US market went from oversold to overbought very quickly



Equities

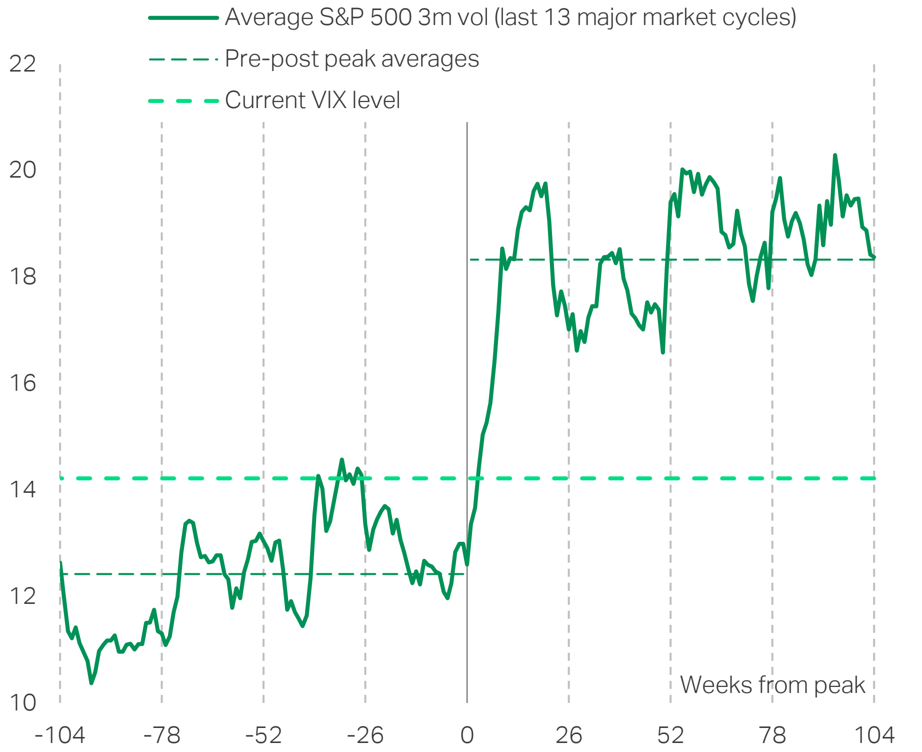
VIX below 15 suggests peak still ahead

Has the VIX moved below 15 sustainably?



New Zealand equities made new all-time highs this week. Will other markets follow through, or are we 'past the peak'? The S&P appears to be on the right side of history on this. The VIX has recently fallen below 15 and, if it stays there, chances are that US equities will soon recover all of their 2018 losses.

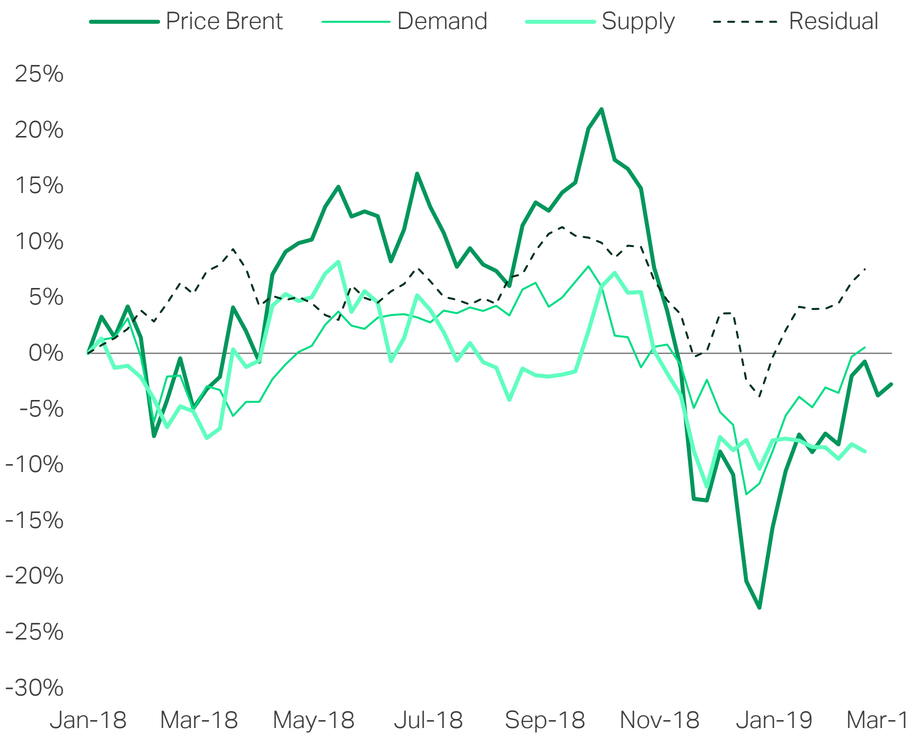
It looks like volatility is still in the 'pre-peak' range (just)



Historically, volatility only moves to a higher plateau *after* the market has peaked. Inevitably, there are vol spikes before the peak too, but they tend to be relatively short-lived. If the VIX remains in its pre-peak range, the S&P should soon go on to make new highs.

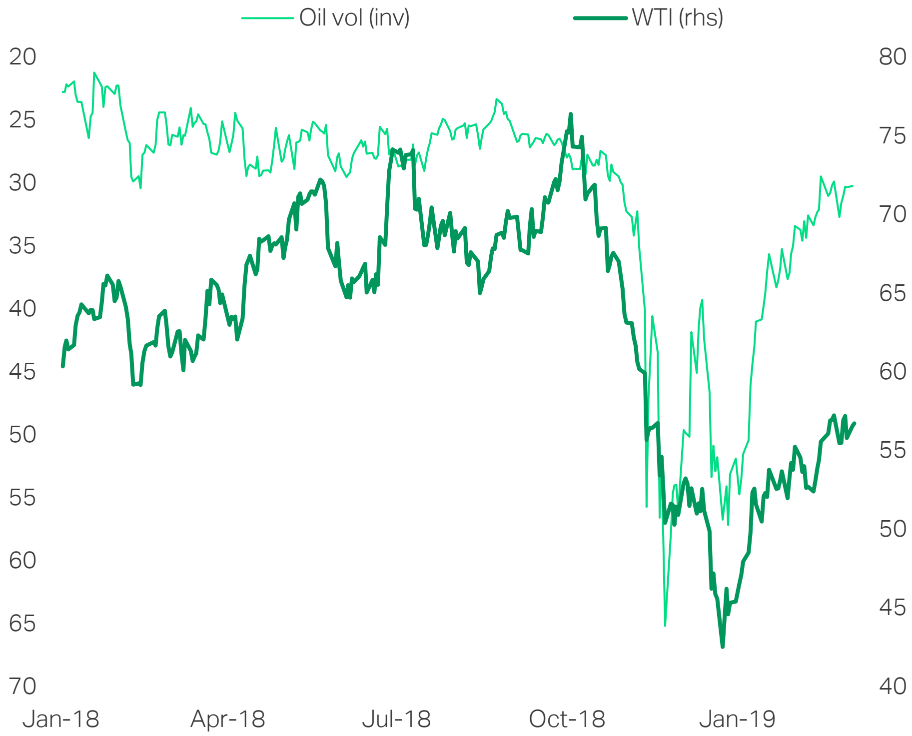
Commodities Oil rebound to lose steam

Recent increases in Brent prices driven by demand factors



The rise in oil prices from the December 2018 low has mostly been driven by improving demand, according to the NY Fed decomposition model. However, a big chunk of the gains was due to factors not related to either supply or demand. These were probably financial market factors, which were a drag in the sell-off and were mostly undone in the rebound.

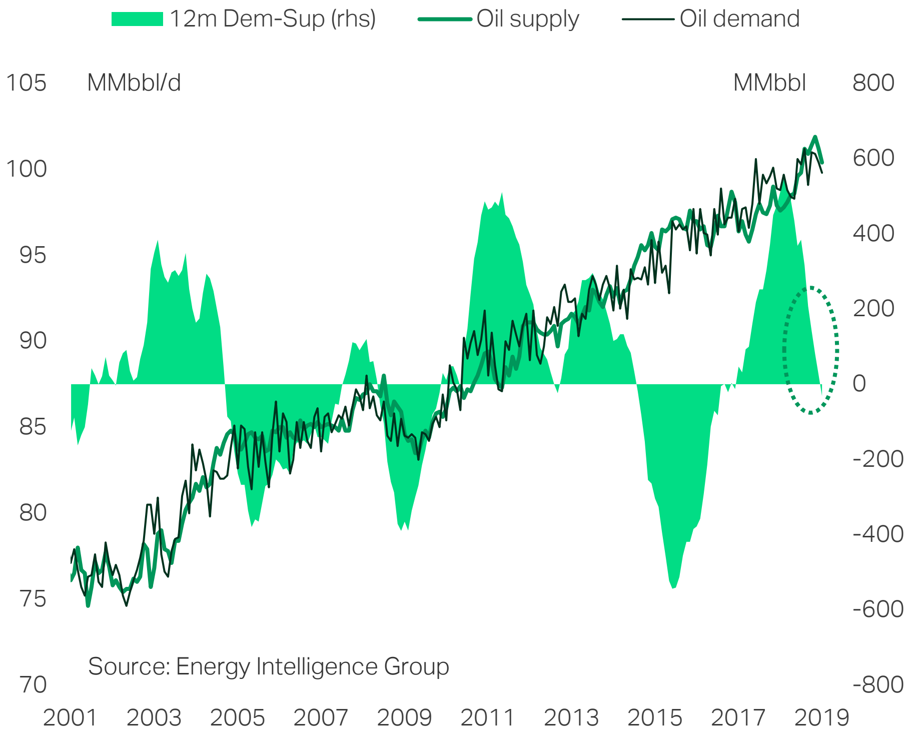
Oil volatility has normalised



In a recent Daily Note, Konstantinos Venetis argued that the 'easy gains' in oil have now been achieved, and that the market will struggle to go materially past $60 for WTI and $70 for Brent – effectively toning down our previous upside bias. Oil volatility has now normalised, confirming that the 'financial factors' of the late-2018 sell-off have now been undone.

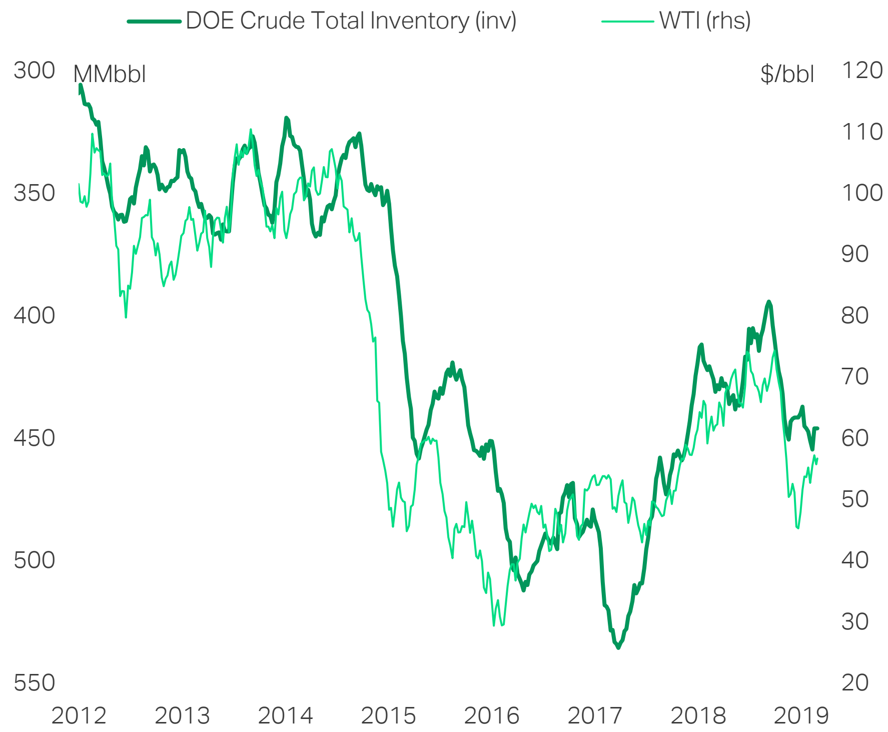
Commodities Oil supply-demand back in balance

Demand-Supply gap closed



Demand and supply are now in much better balance than in 2016-18, when strong consumption led to higher crude prices, and the second half of last year, when supply took leadership, causing prices to fall. Recent OPEC+ cuts should help keep the demand-supply gap stable.

US inventories do not warrant significantly larger gains



US crude inventories fell last week, sparking gains in WTI. Looking beyond one-week moves, the level of US inventories is high enough and doesn't suggest that large WTI price increases are needed to stifle demand.

Authors

Andrea Cicione

Head of Strategy

Oliver Brennan

Senior Macro Strategist