Strategy Chartbook

JANUARY 2019 CHARTBOOK

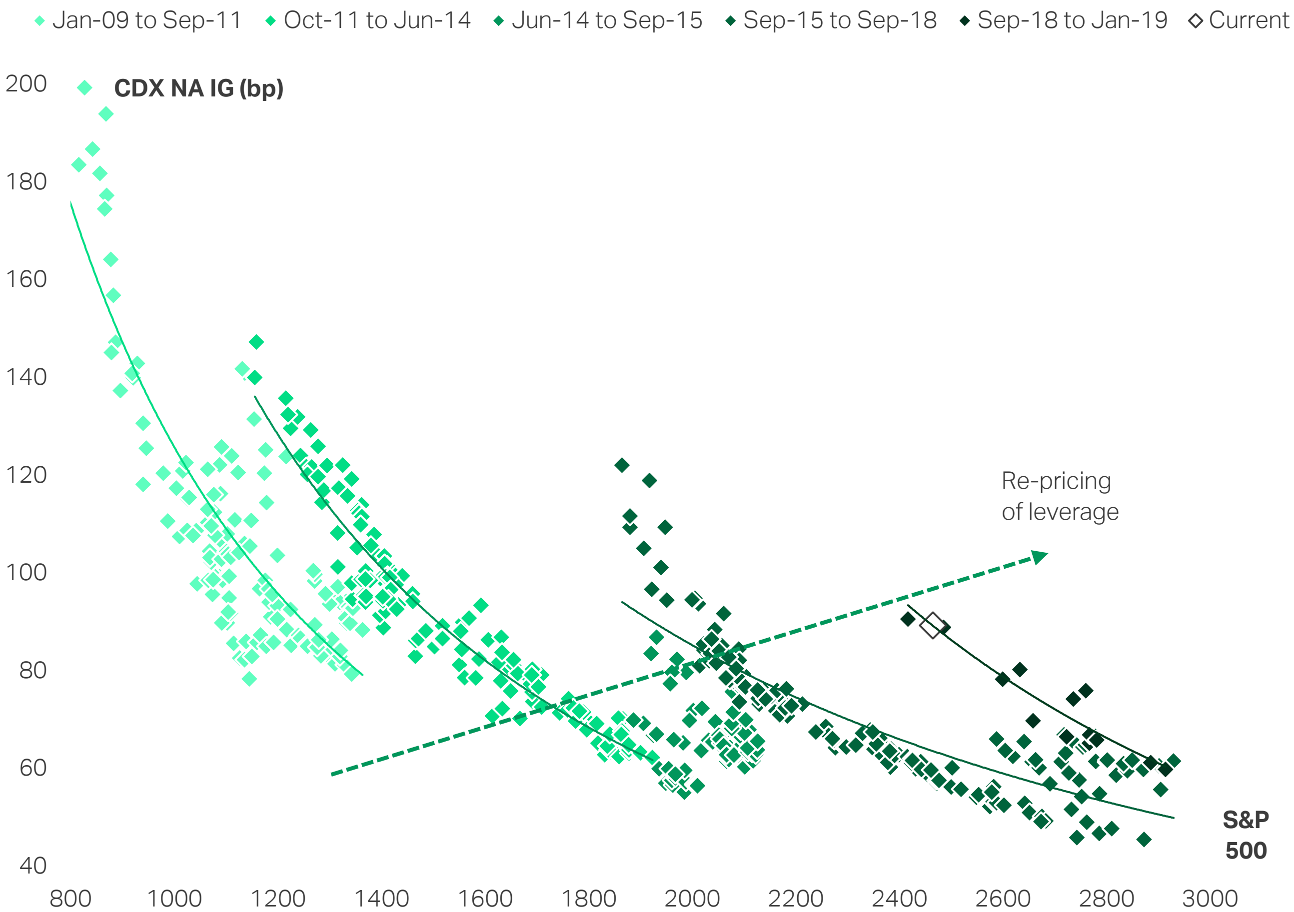
Andrea Cicione / Oliver Brennan

HIGHLIGHTS

- **Macro Drivers.** A synchronised global slowdown and a worrying inventory overhang
- **Multi Asset.** Higher leverage, asset volatility causing credit to underperform stocks
- **Fixed Income.** Fed has so far halted yield curve inversion and bought some flexibility on QT
- **Currencies.** Consensus FX forecasts this year are for small moves, but volatility is rising
- **Equities.** China growth scare causing equity slump, Beijing's response likely to be underwhelming
- **Commodities.** Slower US and OPEC+ output, recovering EM demand to help oil bottom out

Chart of the month

Rising leverage and asset volatility causing credit to underperform equities



Credit spreads and equity prices tend to move in opposite directions, at least in the near term. Over time, however, significant divergence can occur. This is typically caused by changes in leverage and asset volatility. In the last few years rising leverage has led credit spreads to tighten less than the increase in equity prices suggests they should have.

More recently a sharp rise in volatility has resulted in credit further underperforming equities. Rising leverage and asset vol both transfer value from bondholders to equity holders, as the latter are long a call option on the assets (struck at the amount of debt in the capital structure), while the former are short it.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* Most major countries' growth is below-trend and slowing.
- *Fixed Income.* If the Fed slows the pace of QT, global liquidity provision could turn positive again.
- *Currencies.* With Brexit now less than three months away, investors are betting on high volatility.
- *Equities.* China's policy easing should help global equities stabilise.
- *Commodities.* Slower shale output, unwinding of speculative long to help oil find a bottom.

In this month's Chartbook

Summary – key points

Macro Drivers

- Last year the global upswing was raising all boats; this year the opposite is true, with growth in most major economies slowing
- Chinese demand for US exports has fallen sharply, highlighted by Apple's revenue guidance and US-China trade data
- The inventory overhang is likely to weigh on growth in the US and Germany, with the latter at risk of a technical recession

Multi-Asset

- Since 2012 rising US leverage has been the main reason why credit has underperformed equities
- More recently, higher volatility has also caused spreads to widen more than stocks suggest they should have
- But gearing has continued to drift higher too, especially when the Energy sector (which is still deleveraging) is excluded

Fixed Income

- The inversion of the front end of the US curve tends to tighten credit conditions, prompting the Fed to guide for easier policy
- The Fed's policy on QT may become more flexible and could flip global central bank liquidity provision from negative to positive
- Foreign holdings of US Treasuries are falling, but the unwinding of speculative shorts was behind the recent Treasuries rally

Currencies

- Consensus FX expectations this year are for small moves, with only GBP expected to move by more than 3% in 2019H1
- With less than three months until Brexit, GBP implied vol is at its highest premium to realised vol since the 2016 referendum
- EUR is supported by reserve manager demand, but for the single currency to rise it needs the EA growth outlook to improve

Equities

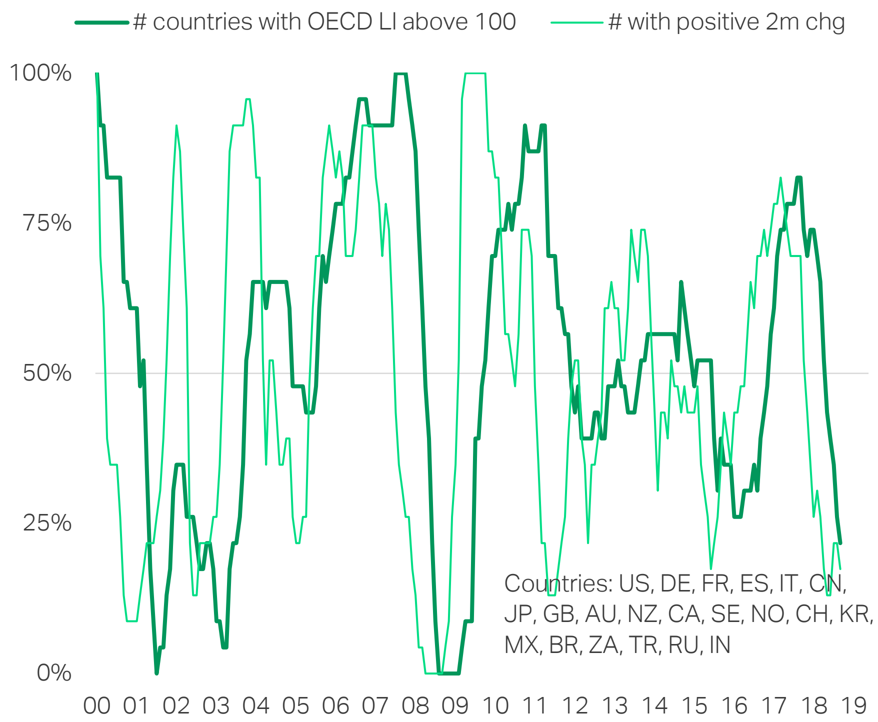
- Concern about Chinese growth was a major reason for the global equity rout at the end of last year
- Beijing's refusal to provide large-scale stimulus, causing M1 growth to slump, has hurt sentiment too
- Utilities and Real Estate are the sectors most vulnerable to refinancing risk in the US

Commodities

- Both supply and demand contributed to the December slump in oil prices, according to the NY Fed's oil price dynamics report
- But these dynamics are likely to turn supportive: US shale and OPEC+ output should slow, while EM demand should pick up
- Extreme long speculative positioning in WTI has now mostly been unwound, which should help crude prices find a bottom

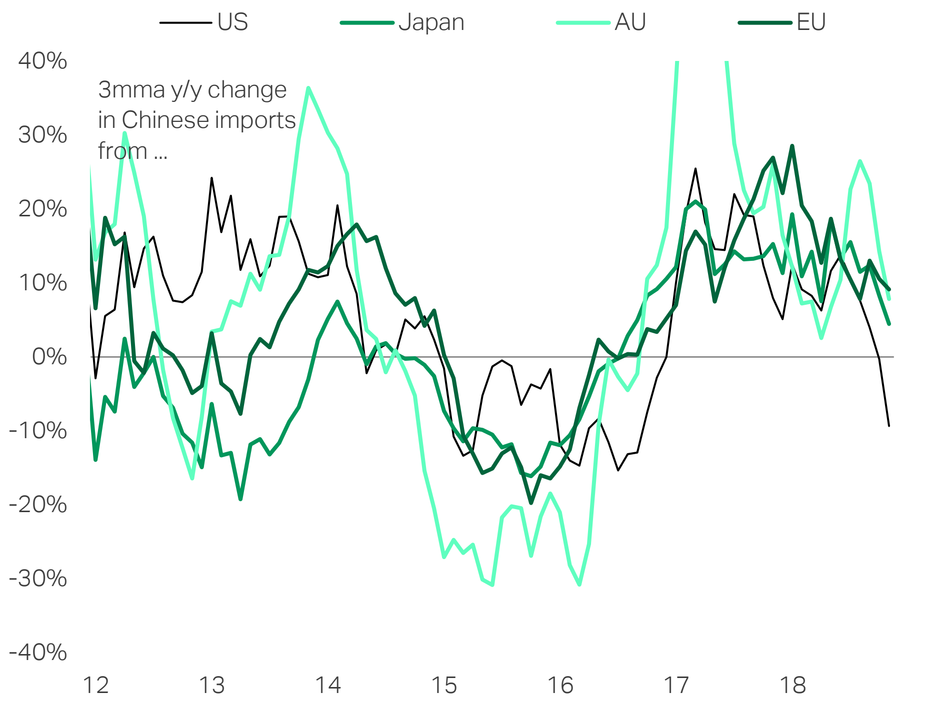
Macro Drivers Synchronised global slowdown

Global growth slowdown broadens



This time last year the consensus view was of synchronised global growth. The slowdown in US activity now suggests the synchronisation is in the other direction. The LIs of 18 of 23 countries are below 100 (implying below-trend growth) and 19 countries' rate of change is negative. The bright spot remains China, where the OECD LI is in the 'recovery' quadrant; recent policy easing will further help the recovery.

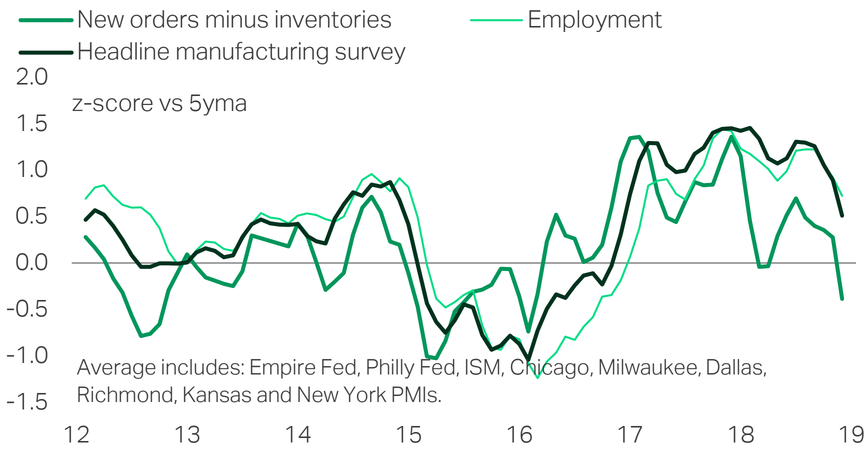
Trade war effects beginning to be felt



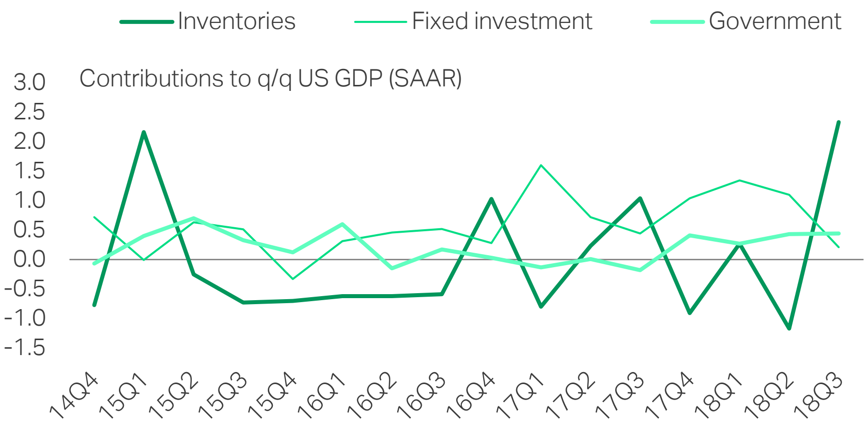
US exports to China fell by 25% in November. Whereas the trade war directly affected the other side of the bilateral trade balance (imports of categories of goods subject to tariffs fell once the duties went into force), this fall in demand is not due to Chinese levies. Apple's revenue guidance downgrade suggests the true reason: Chinese buyers are shunning US products. This collapse in demand is also evident in US data.

Macro Drivers Inventories too high for current demand

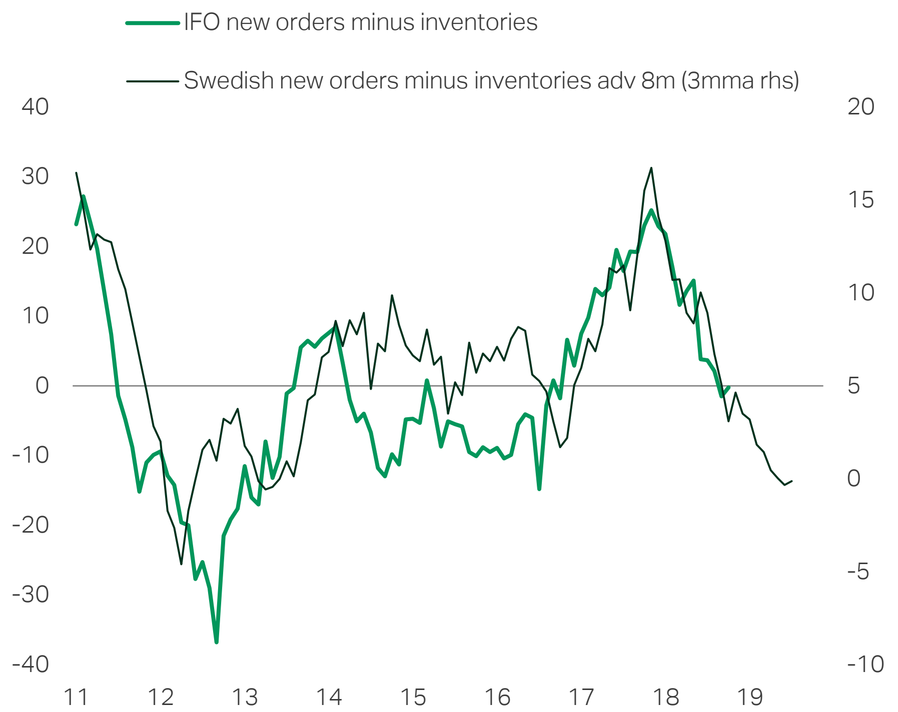
New orders/inventories collapse dragging down US sentiment



And note inventory contributed 2.33pp to Q3 GDP



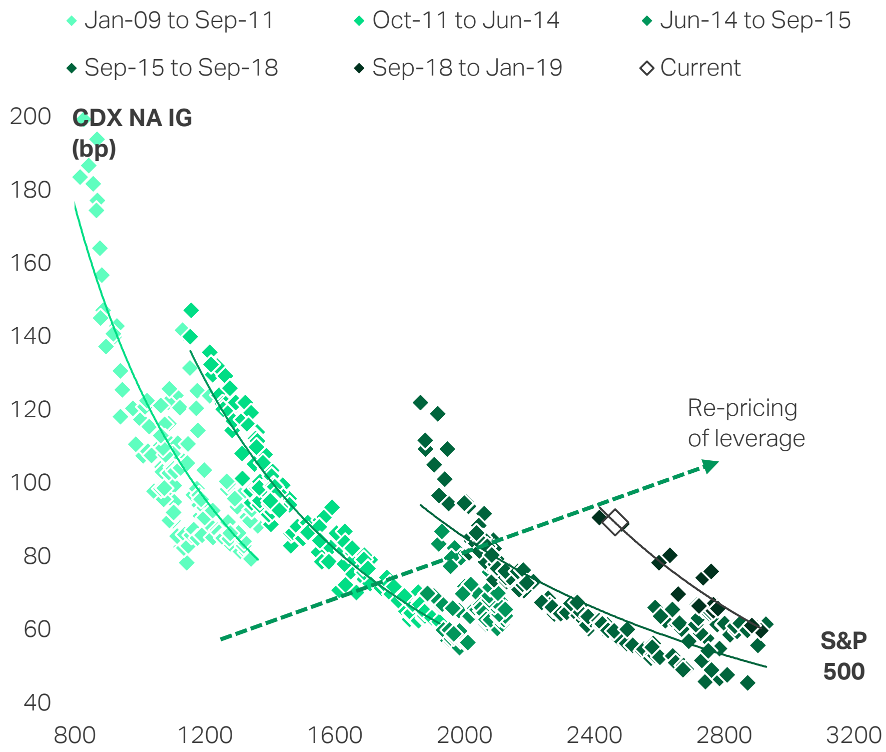
Futher slowdown in Germany ahead



Charles Dumas outlined why Germany could have entered a technical recession in Q4. The inventory overhang has not yet been worked off. Sweden's new orders/inventories ratio peaked eight months before Germany's, suggesting that German activity could continue to slow for at least the first half of this year.

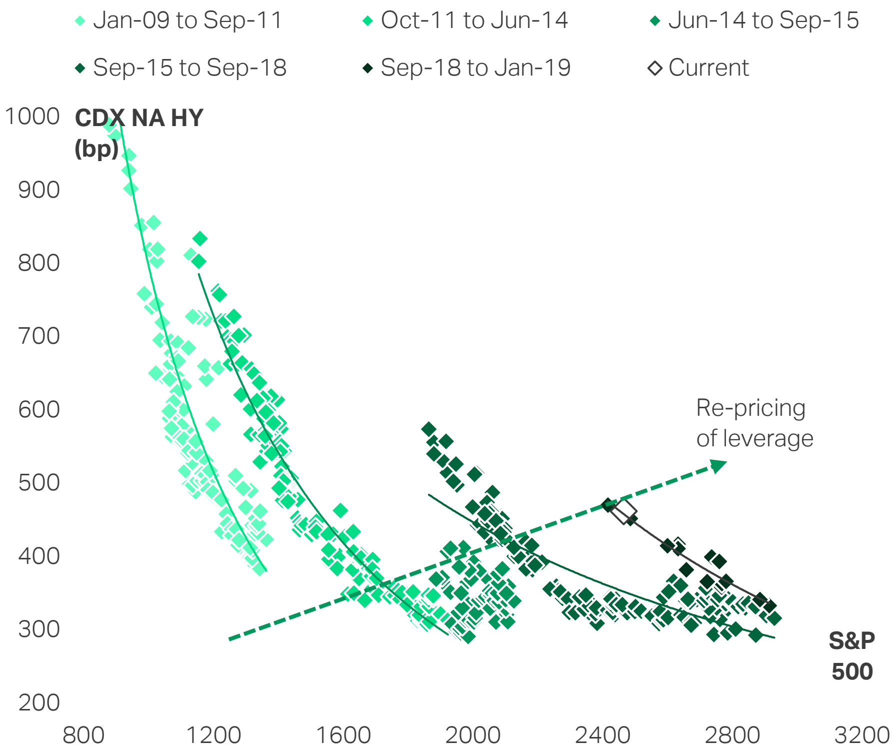
Multi-Asset Credit derating

Rising leverage causing credit to underperform equities



Credit spreads and equity prices tend to move along a 'hockey stick' curve as long as certain fundamental and market parameters remain constant. This is rarely the case, and in the last few years rising leverage has caused credit spreads to tighten less than the increase in equity prices suggests they should have.

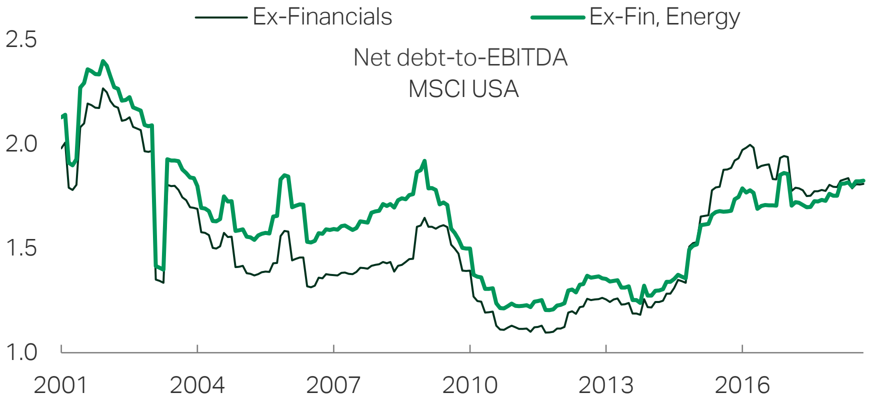
Higher volatility also a factor behind credit lagging stocks



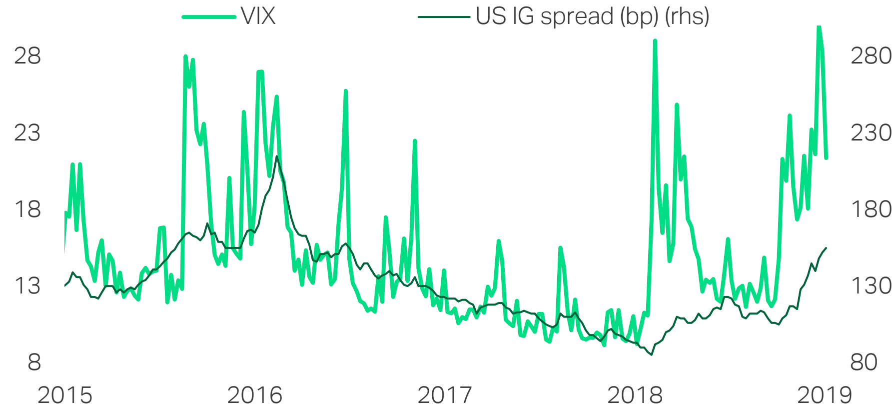
Rising leverage is not the only factor transferring value from bondholders to equity holders. Higher asset volatility does, too, as it makes it more likely that a corporate default will occur, or that equity holders will profit as they own a call option on the assets. Asset vol is not observable, but it is positively correlated with equity vol, which has increased dramatically in recent months.

Multi-Asset
Rising leverage and vol hurting credit

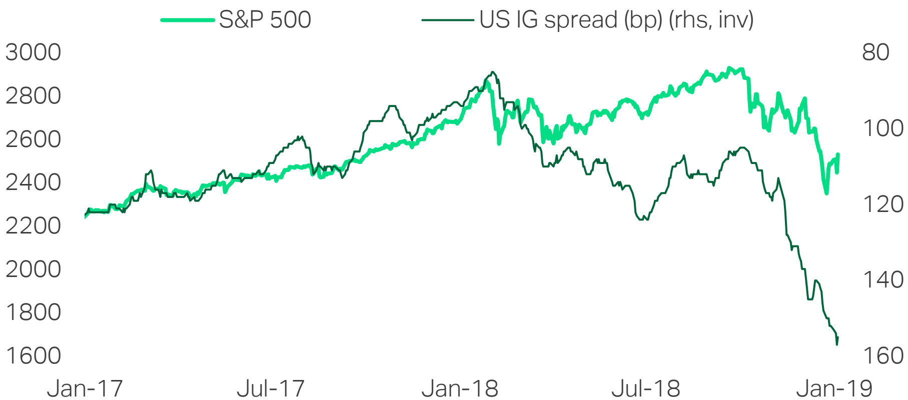
Leverage continues to drift higher in the US



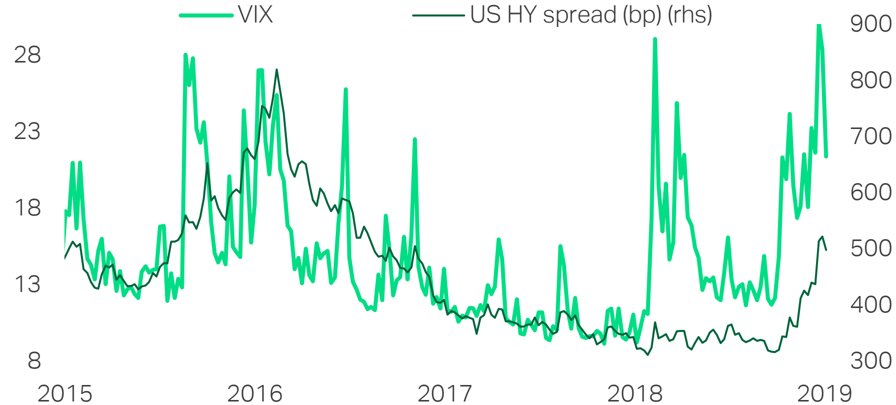
Higher volatility is also pulling credit spreads wider



Higher gearing is causing credit to reprice faster than stocks

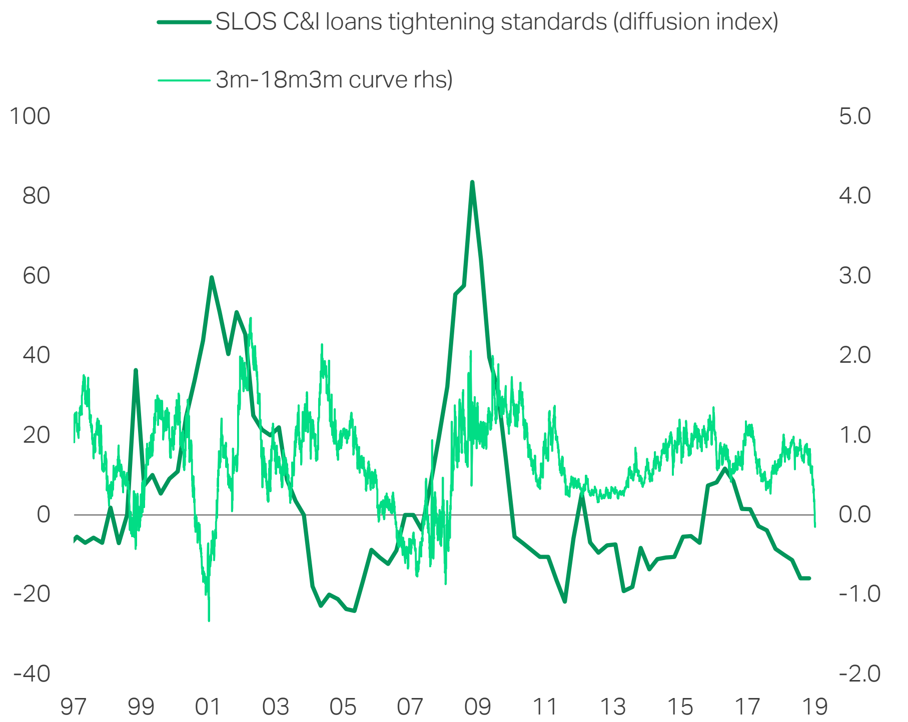


In 2016 HY spreads widened more due to oil's impact on Energy



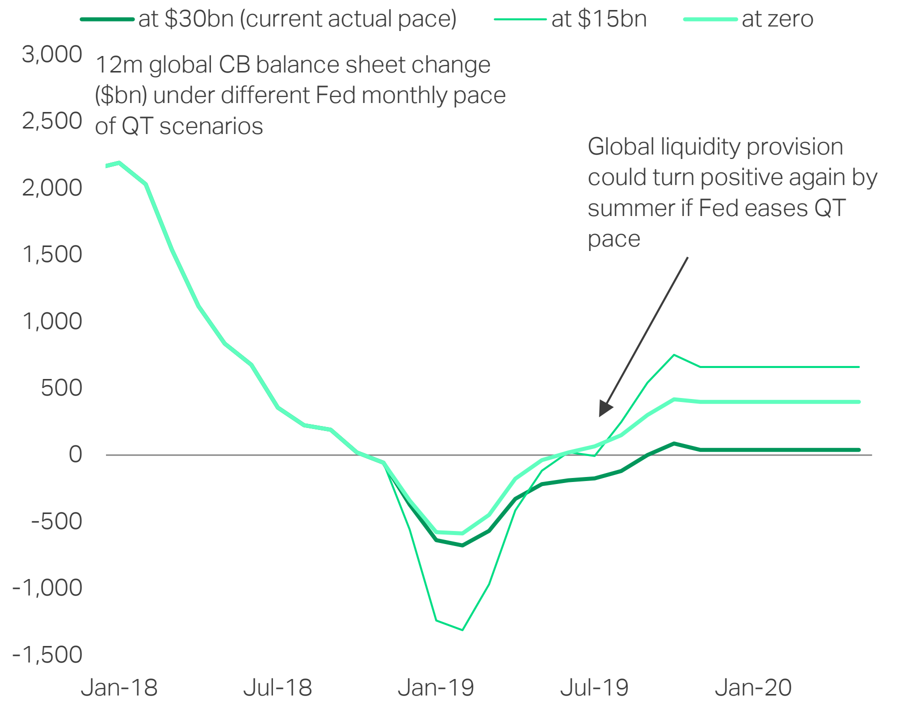
Fixed Income Inversion shock therapy

Rapid inversion risks inducing a credit crunch



An inverted curve usually means tighter C&I lending standards, something which tends to foreshadow recessions. The rapid tightening at the front end of the US yield curve over the last month risks doing the same, even though credit conditions are currently very easy. Our US economist, Steve Blitz, reckons the FOMC is likely to cut rates soon so the curve steepens again, helping avert the risk of a credit crunch.

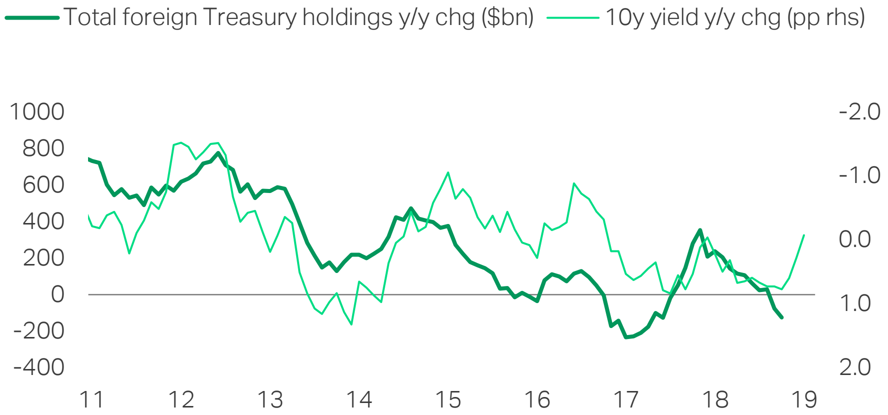
FOMC has bought optionality around QT



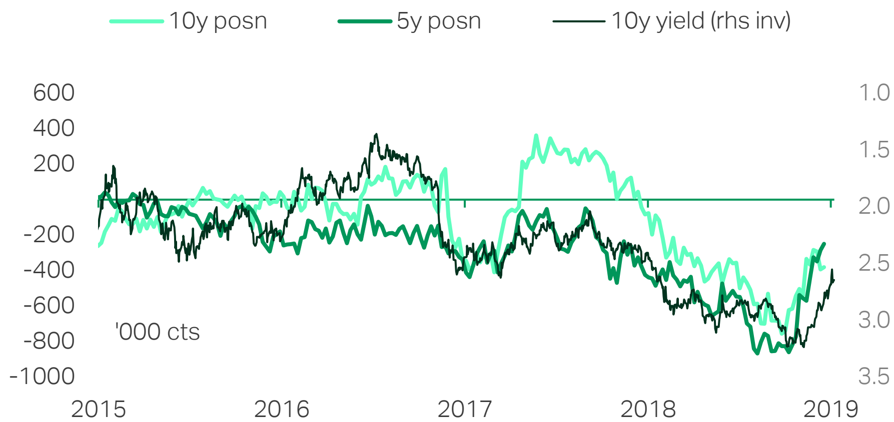
Although the Fed does not think balance sheet normalisation is a policy tool, Chairman Powell acknowledged that the Fed would change the policy if necessary. This was the easing message the market wanted to hear. With the ECB no longer buying assets and the BoJ on autopilot, a change in the Fed's policy could have a material impact on global liquidity provision – and therefore global asset markets – in H2.

Fixed Income 2019 set to be a year of rising volaility

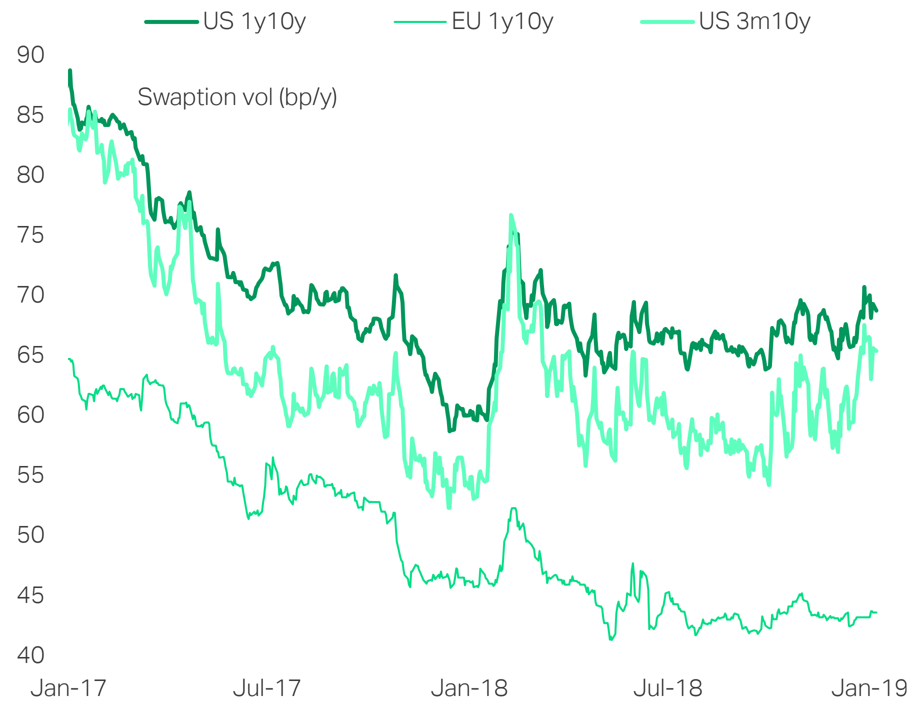
Foreign Treasury flow tends to indicate direction of yields…



…But the recent Treasury rally likely driven by spec unwinding



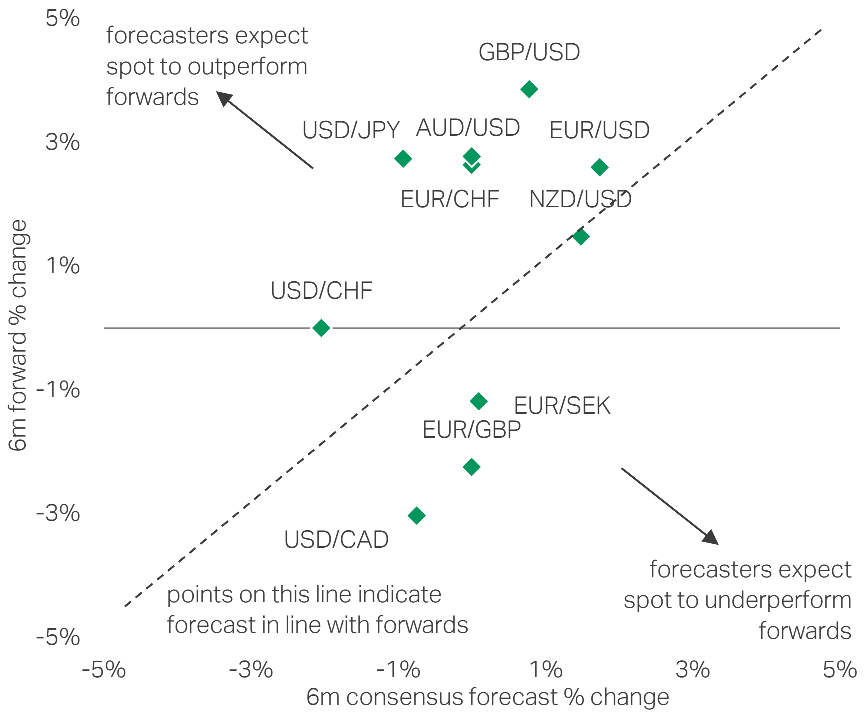
US volatility likely to stay high this year



In light of the recent rally in Treasuries, it is no surprise that rates volatility has risen. This is likely to be the new paradigm in US fixed income, unless the Fed executes a massive about-term on QT. Volatility will rise from 2017's record lows. Meanwhile, the distortion of the Bund market in the euro area – where the official sector own more than 90% of all German bonds – will act as an anchor for volatility and for peripheral yields.

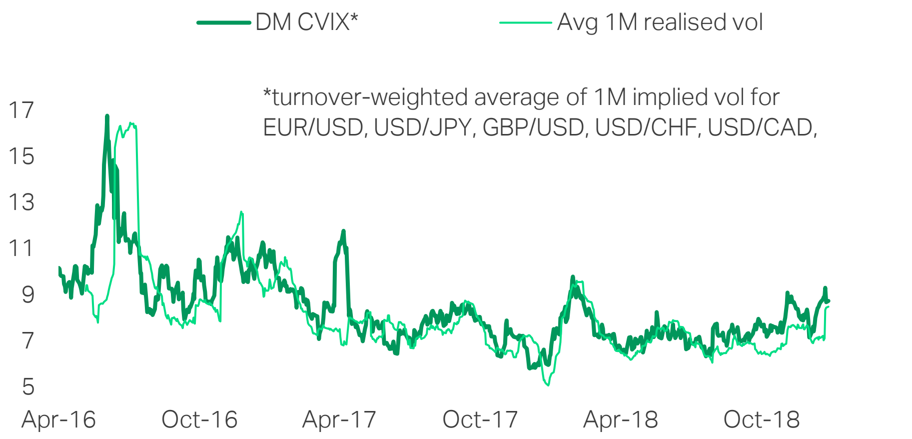
Currencies Higher volatility

Consensus expecting small directional moves next year

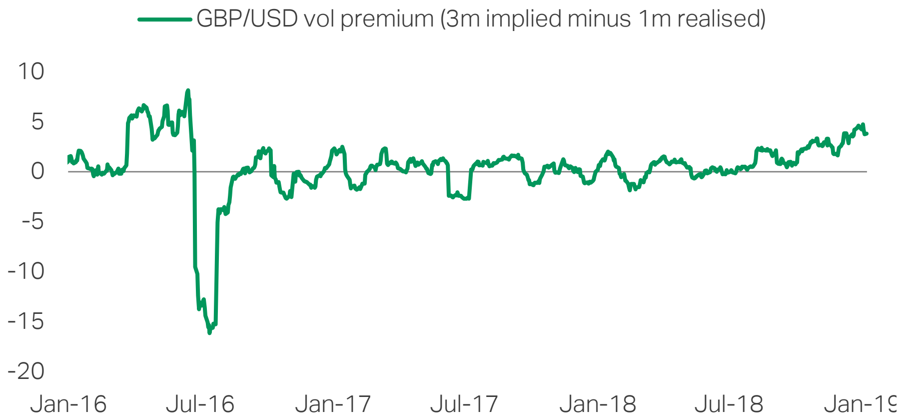


Consensus expectations for this year pencil in relatively small directional moves. The exception is GBP/USD, where the consensus forecast of a 4% rise masks a wide range of Brexit outcomes ranging from no deal to a close relationship with the EU. The small magnitude of spot moves is in contrast with volatility, which is rising across the board, particularly in GBP crosses.

But implied vol has almost doubled since last year's low

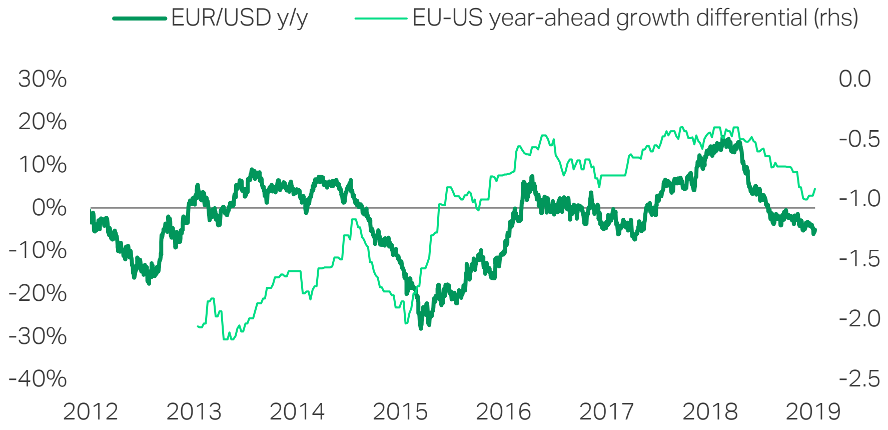


Brexit is now less than 3m away; market expected large FX move

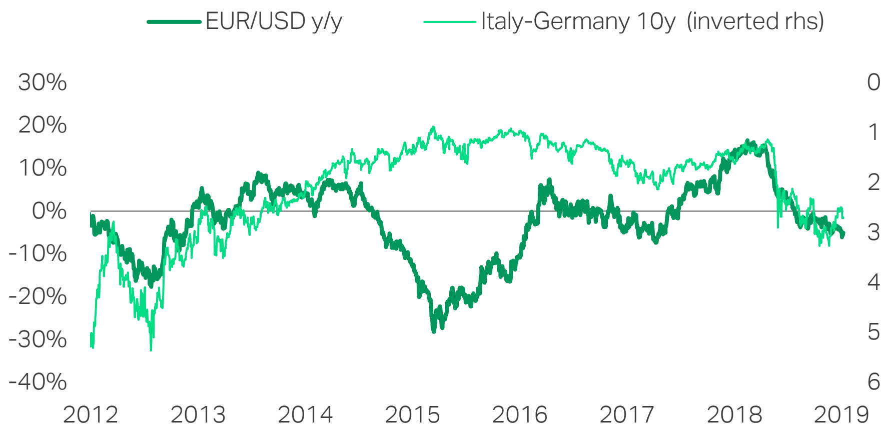


Currencies EUR caught in three cross-currents

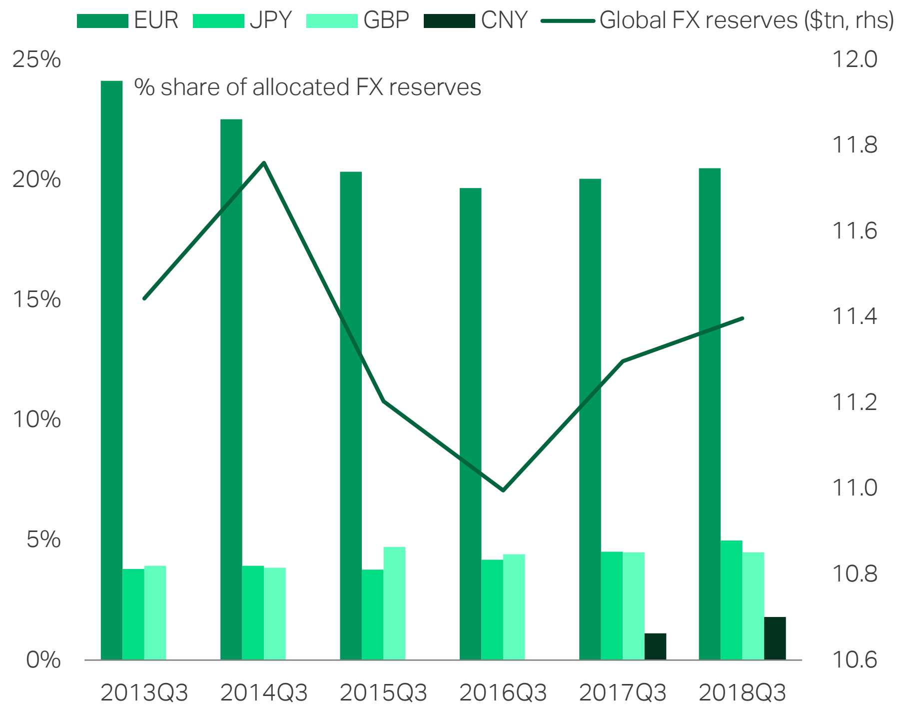
Lower EA GDP growth forecast will likely weigh on EUR/USD



But falling Italy-Germany yield spread is supportive



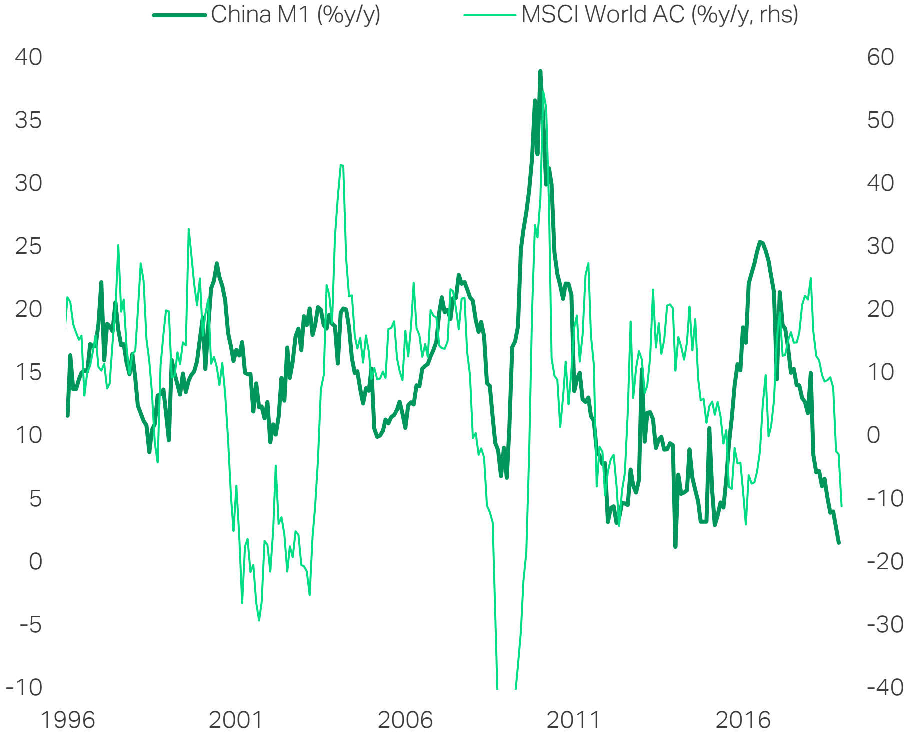
And reserve managers' share of EUR in FX reserves is rising



Last year we highlighted how reserve managers were underweight EUR, having let the EUR share of reserves decline during the euro area crisis. The most recent IMF COFER data suggest managers are rebuilding their EUR positions: the single currency's share in allocated reserves rose from 19.7% in 2016Q3 to 20.5% in 2018Q3. Reserve manager demand should lend long-term support to EUR/USD.

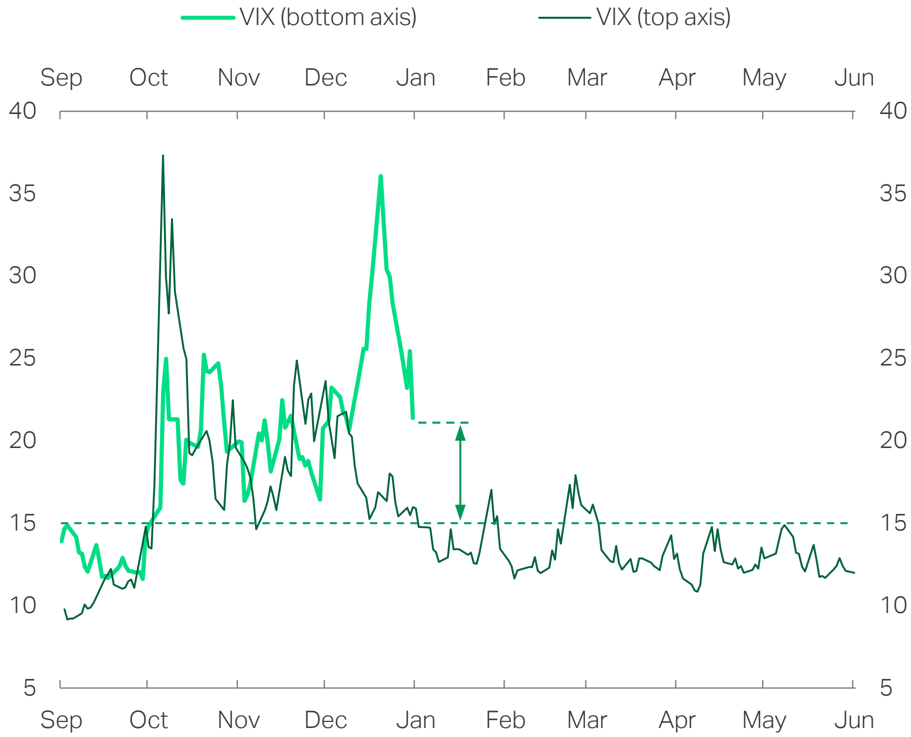
Equities China and fear

Beijing in ‘wait and see’ mode causing market rout



Beijing's refusal to provide a large-scale stimulus as it did in the past is leading investors to panic about the impact of a global slowdown. While we think that any stimulus will be underwhelming, it's unlikely that M1 growth will fall much further, especially as the PBoC continues to free up bank liquidity. Absent a global ‘recession’, which we do not forecast, stocks should soon begin to stabilise.

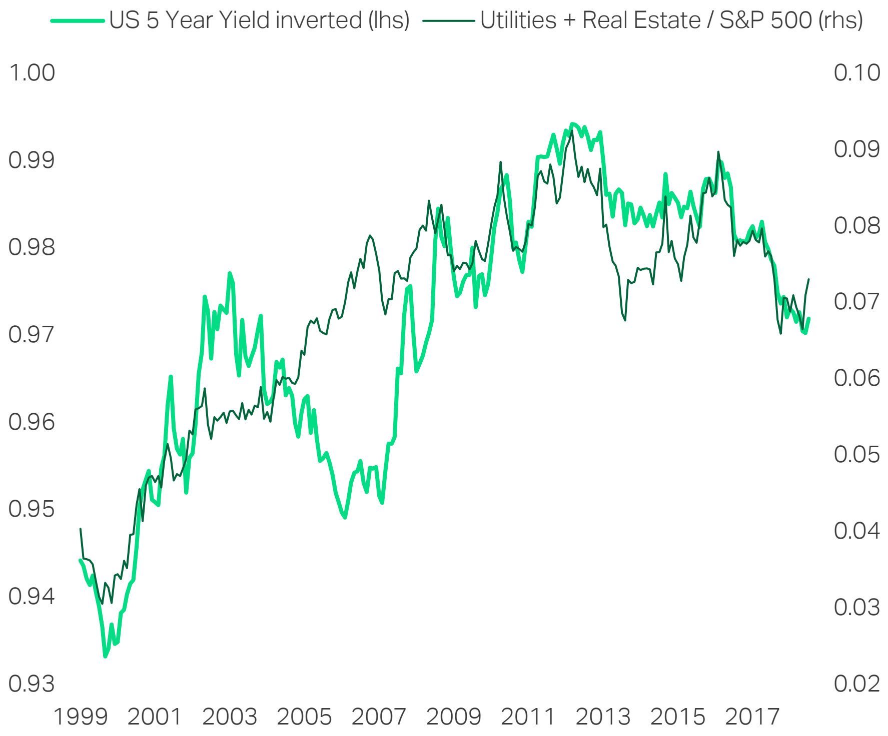
Full market recovery unlikely unless ‘fear gauge’ falls below 15



However, a full market recovery will remain elusive unless the VIX ‘fear gauge’ falls significantly from here. As we have pointed out before, volatility tends to stay below 15 before a market peak, and well above it during a bear market. In the latest sell-off, the VIX has failed to ‘normalise’ at levels below 15, unlike earlier in 2018. Vol will need to drop significantly (and stay low) for equities to make new highs.

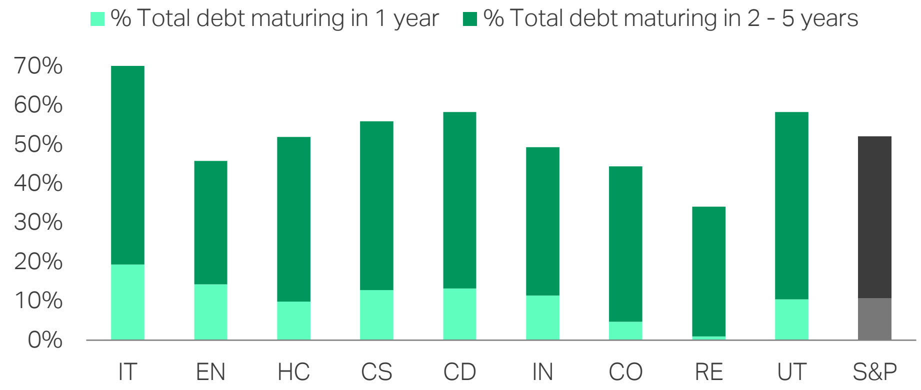
Equities — Refinancing risk for US corporates

Utilities, Real Estate vulnerable to refinancing risk

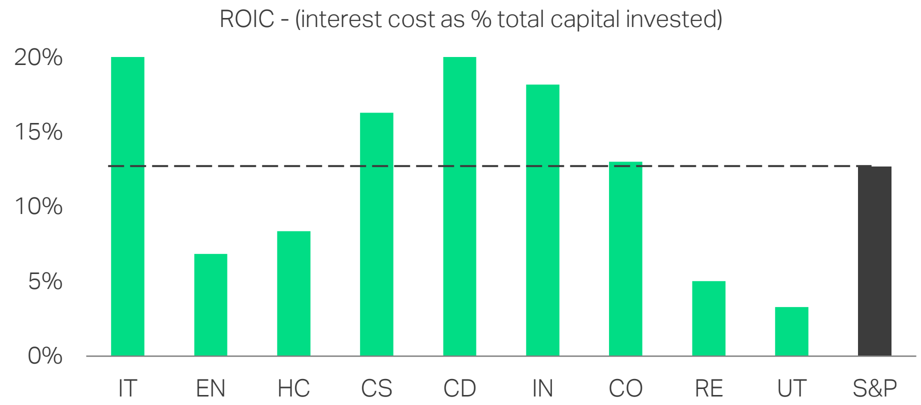


US Utilities and Real Estate have underperformed in recent years due to their high dividend yields, making the sectors 'bond-like'. An added drag for them is their higher-than-average refinancing risk, owing to their elevated indebtedness (26% and 42% of total assets, respectively), steep rollover schedule (especially UT) and the small margin between their return on capital invested (ROIC) and cost of debt.

Percentage of total issued debt maturing in the next five years

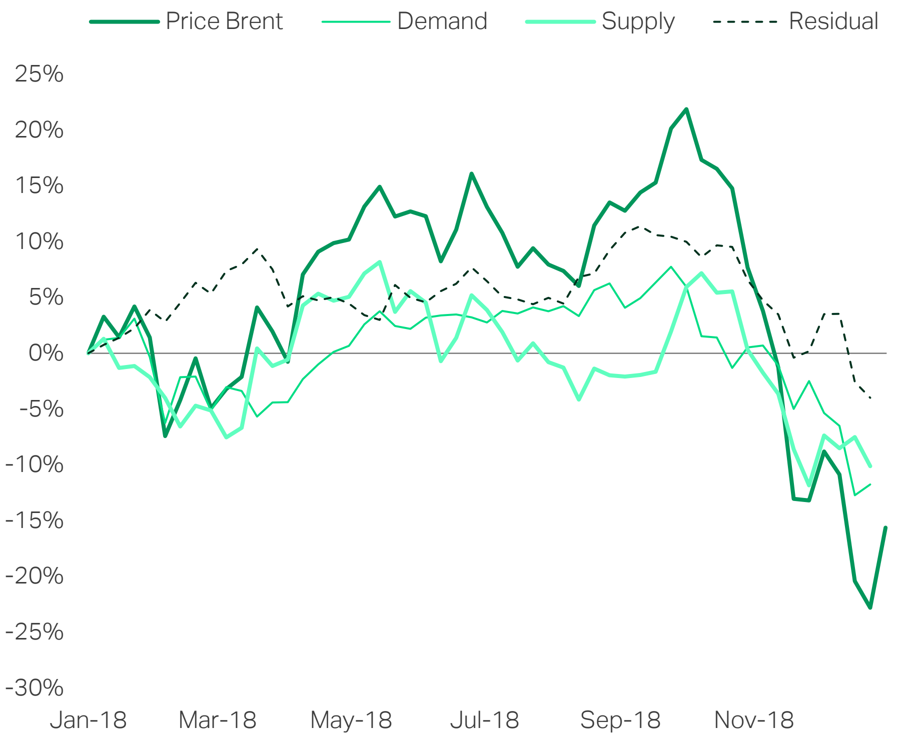


Small margin for UT and RE to absorb rising cost of debt



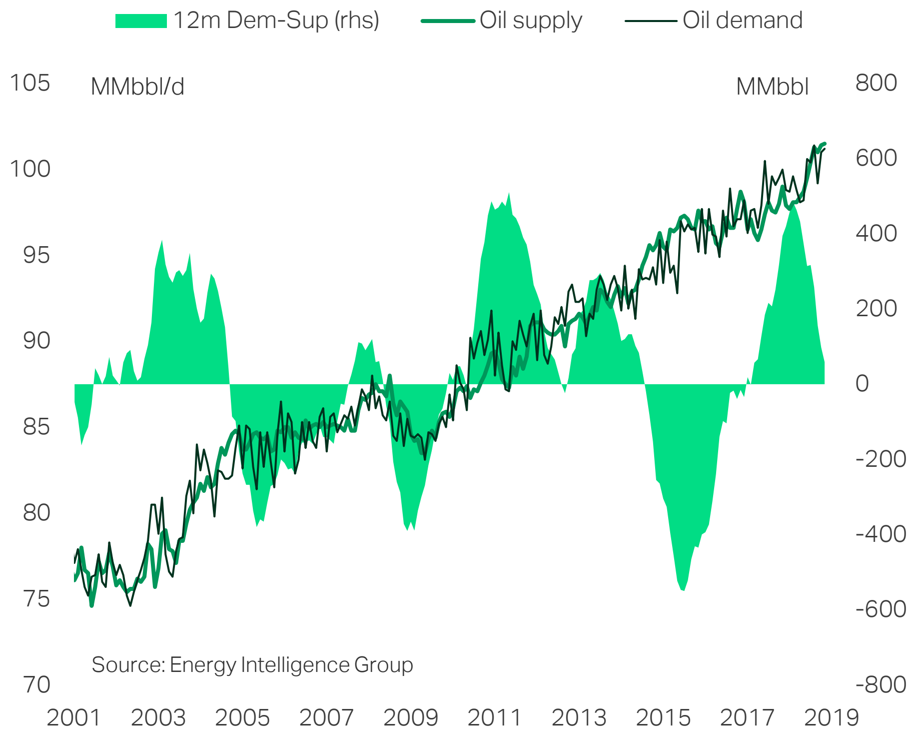
Commodities Supply/demand supportive for oil

Weak demand, strong supply have caused oil to fall further



Brent dropped nearly 18% in December before recouping about half of those losses in the last couple of weeks. According to the NY Fed's oil price dynamics report, both supply and demand contributed to the drop – with some of the move still unaccounted for, causing the residual to decline as well.

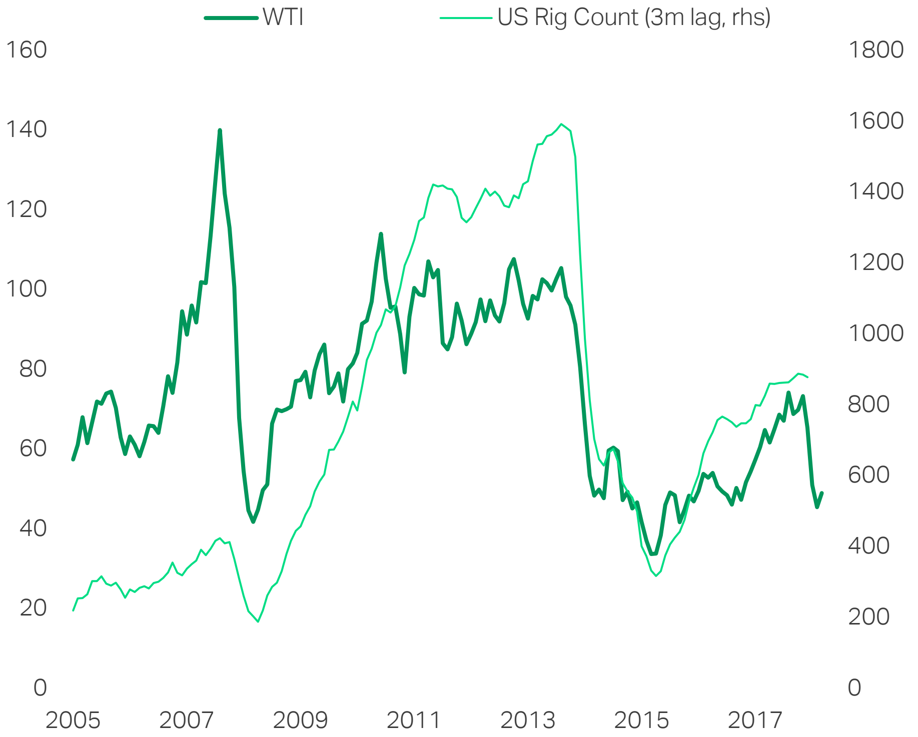
But oil supply/demand dynamics are likely to turn supportive



Supply and demand are now broadly in balance and their dynamics are likely to become supportive: OPEC+ has agreed on material production cuts; US shale output is likely to slow at current price levels; EM demand should pick up with stronger EM currencies and lower prices; and, all the while, spare capacity remains low.

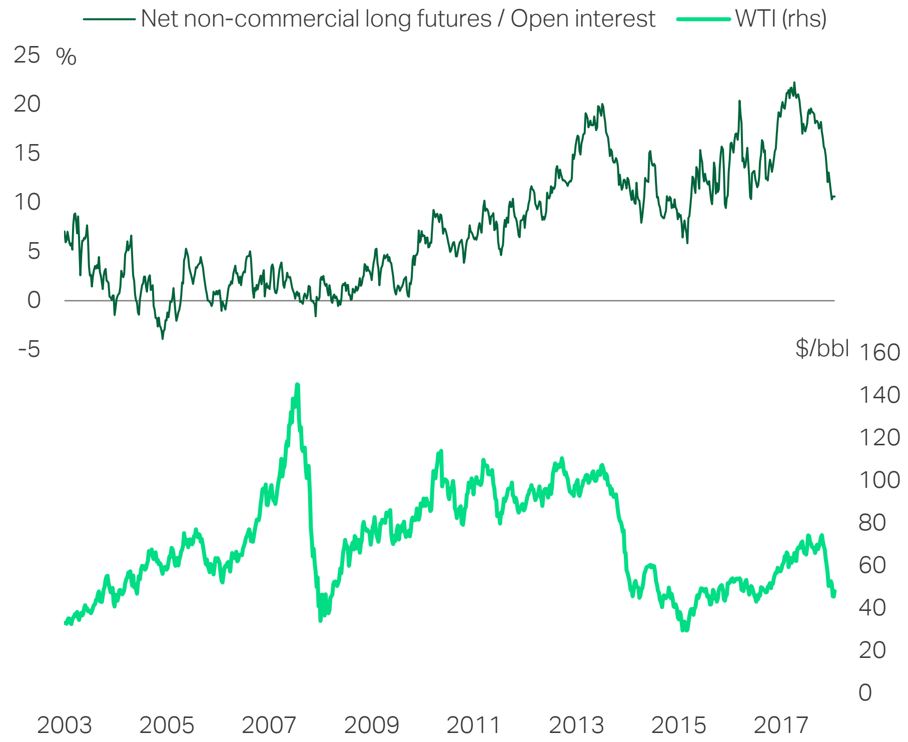
Commodities The bullish case for oil

US shale production bound to slow



US shale rig drilling tends to follow oil prices with a three-month lag. The collapse in oil prices over the past three months should soon result in a drop in the number of active rigs and reduced output.

Speculative long positions flushed out



The sharp drop in oil prices has resulted in the closure of large speculative long positions in the past couple of months, significantly reducing the chances of a further decline.

Authors

Andrea Cicione

Head of Strategy

Oliver Brennan

Senior Macro Strategist

Disclaimer