

Strategy Chartbook

NOVEMBER 2018 CHARTBOOK

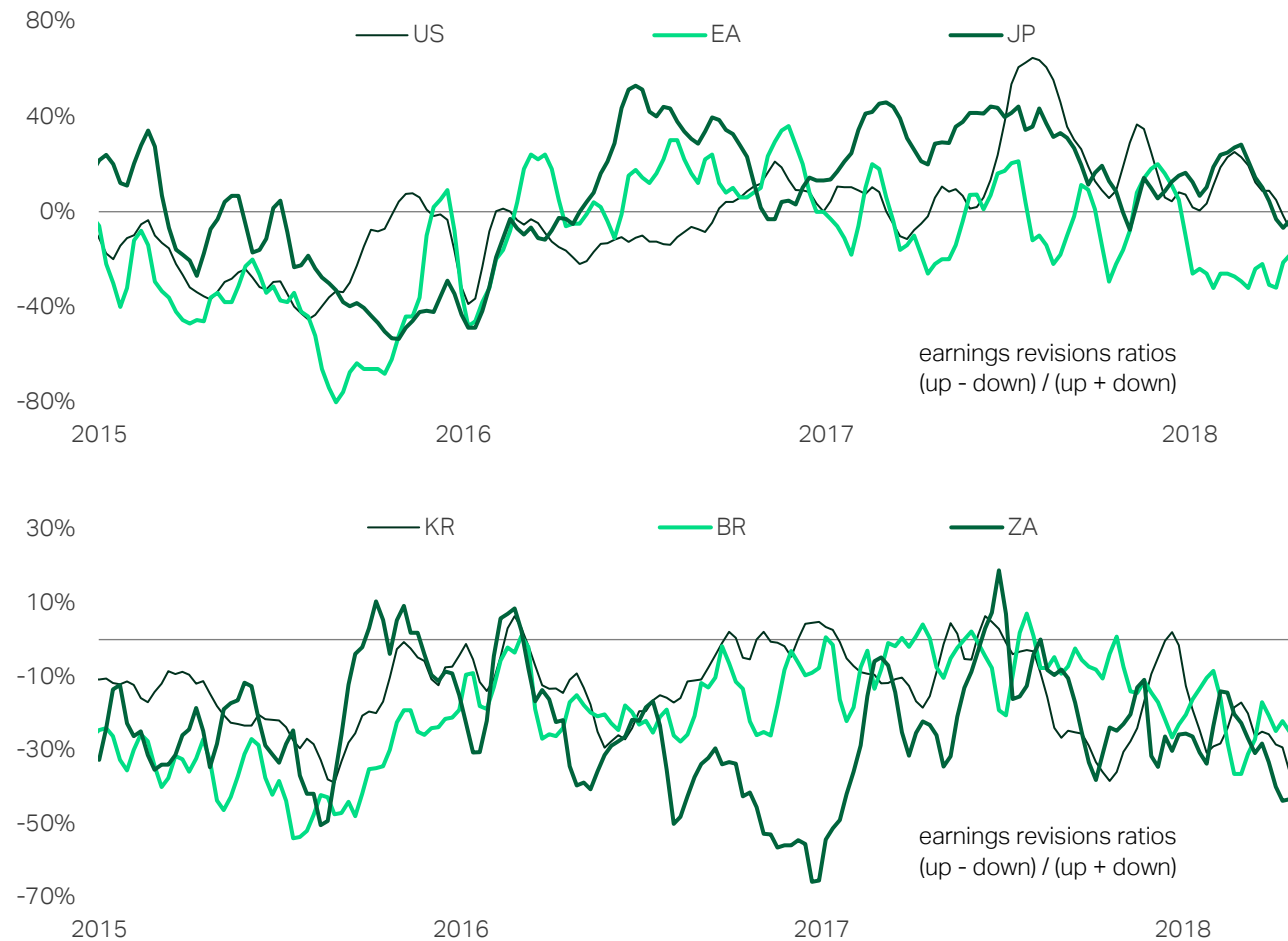
Andrea Cicione / Oliver Brennan

HIGHLIGHTS

- **Macro Drivers.** Growth momentum is slowing, even in the US
- **Multi Asset.** Volatility has picked up in 2018, but it remains well below average
- **Fixed Income.** The QE era is over, real yields set to adjust higher
- **Currencies.** USD tends to rally in November; GBP upside risks and CNY downside risks
- **Equities.** Selloff triggered by sector rebalancing, exacerbated by disappointing forward guidance
- **Commodities.** Supply dominance causes crude price to retreat as sanction fear fades

Chart of the month

Sector rebalancing may have triggered the equity selloff, but earnings revisions made it worse



Changes to GICS sector classification on September 28th have likely been the trigger for the recent equity selloff. Technology titans such as Google, Facebook and Netflix have moved to the new Communication Services sector; ETF and mutual funds tracking the former Tech and Consumer Discretionary benchmarks were therefore forced to liquidate the names.

But if sector reclassification was perhaps the cause of the selloff, news from the Q3 earnings season exacerbated it. Companies are for the most part beating expectations, but the outlook they provided has been less optimistic than expected, leading to negative earnings revisions in most markets.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* Global growth momentum is slowing.
- *Multi Asset.* EM debt, both local and hard currency, struggling as dollar surges.
- *Fixed Income.* US yields breaking out of long-term ranges, and demand side changing.
- *Currencies.* USD seasonal, and widening basis swaps, supportive in November.
- *Commodities.* Crude prices lower on US supply acceleration, reduced Iran sanction risk.

In this month's Chartbook

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Summary – key points

Macro Drivers

- China PMI new export orders has fallen to a two-year low, matching deterioration in manufacturing sentiment in the euro area
- But OECD's leading indicator for China is in 'recovery' – below potential growth but accelerating: has the economy troughed?
- We expect two more 25bp Fed hikes before a pause, but the second one may be at risk as capex growth is falling

Multi-Asset

- Equity vol has picked up in 2018 compared to last year, but remains low by historical standards
- The average drawdown in sell-offs not followed by a recession is 18%; the two -10% episodes this year look like minor events
- A rising USD has been a headwind for EM debt; seasonality in the greenback suggests more pain is in November

Fixed Income

- End of an era: QE now explains less than half of global fixed income returns' co-movement – down from 70%+ last year
- Central banks insist that 'stock matters more than flow', but the term premium correlates more with QE's rate of change
- UST yields (10y and 30y) are breaking out of their 30-year range, just as EM and DM demand for Treasuries is fading

Currencies

- In recent years USD has tended to rally in November, especially against INR, BRL and JPY
- Widening EUR and JPY cross-currency basis indicates scarcity of offshore dollars, which should support USD into year-end
- Upside risks are building for GBP, while CNY downside is likely on the next round of tariffs (which we expect in January)

Equities

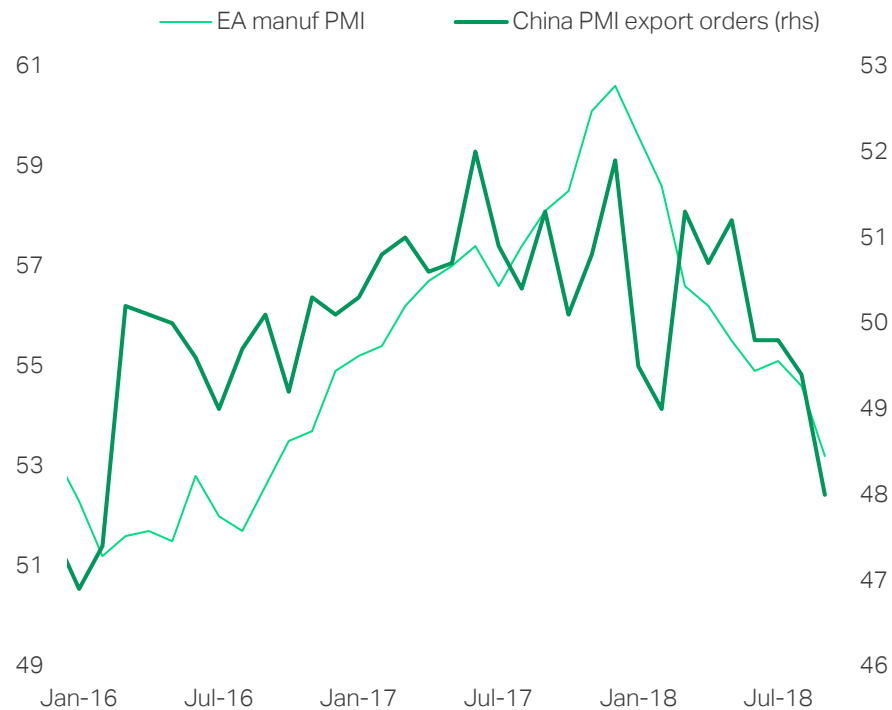
- Changes to sector classification forced fund/ETF managers to sell tech companies such as Google, Facebook and Netflix
- But investor rotation out of Tech and Consumer Discretionary and into Communications has only just started
- Despite earnings growth slowing and regulatory headwinds, we see more upside for Comms vs the S&P 500

Commodities

- Price change decomposition by the NY Fed indicates recent crude retracement motivated by supply pick-up
- Global supply has been exceeding demand, on average, since April, reaching a 39m bbl/d surplus in September
- US production has surged in response to higher prices, and exports have picked up due to WTI's large discount to Brent

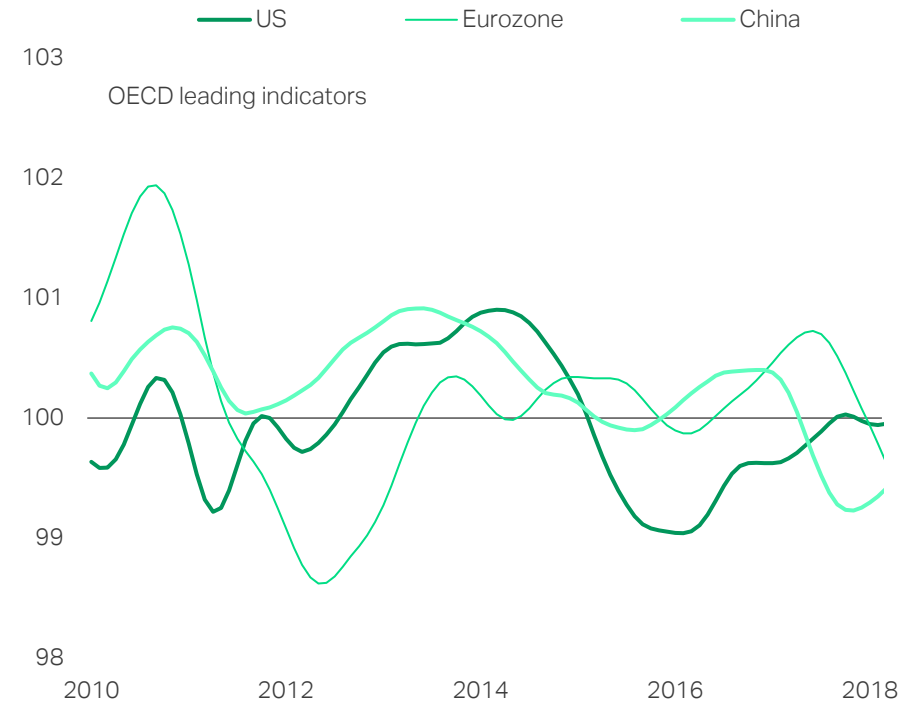
Macro Drivers Slowdown in the pipeline

China and EA PMIs falling to cycle lows



China's PMI readings are remarkably stable, so it's worth taking notice that the new export orders component has fallen to a two-year low. The drop matches the deterioration in manufacturing sentiment in the euro area. Our [GLI](#) has been flagging risks to growth for a few months now, and this latest batch of survey data suggests these risks are beginning to materialise.

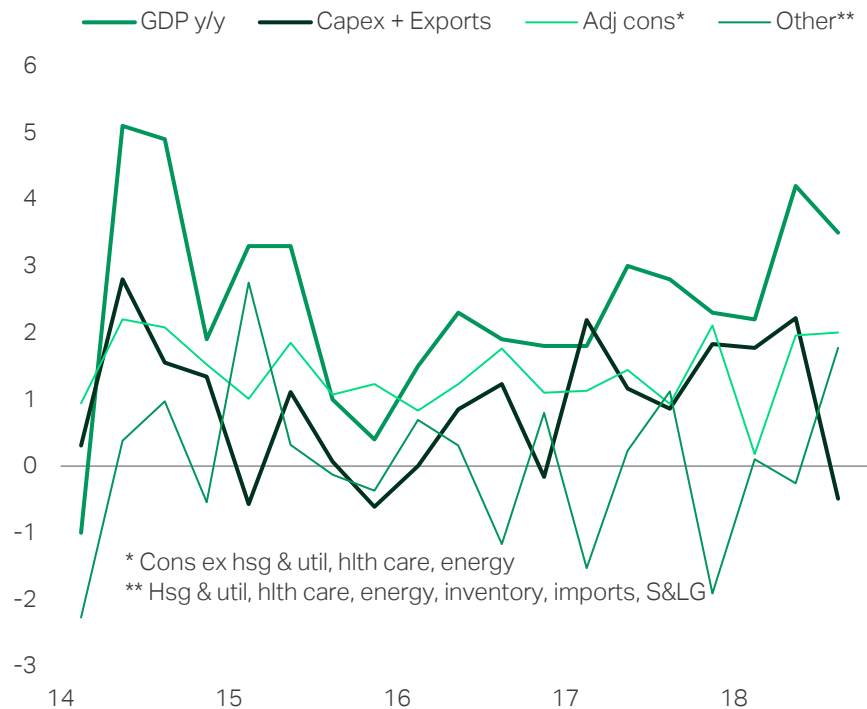
US momentum stalling, China LI in "recovery"



The OECD's leading indicator for China is now in the "recovery" phase. We are not expecting material stimulus in China, but the yuan's depreciation has probably helped. The drop in the euro zone LI corresponds to the decline in the region's manufacturing PMI, while the US has lost momentum since the start of the year. The aggregate global signal remains in "slowdown", a stage of the cycle when equities tend to fall.

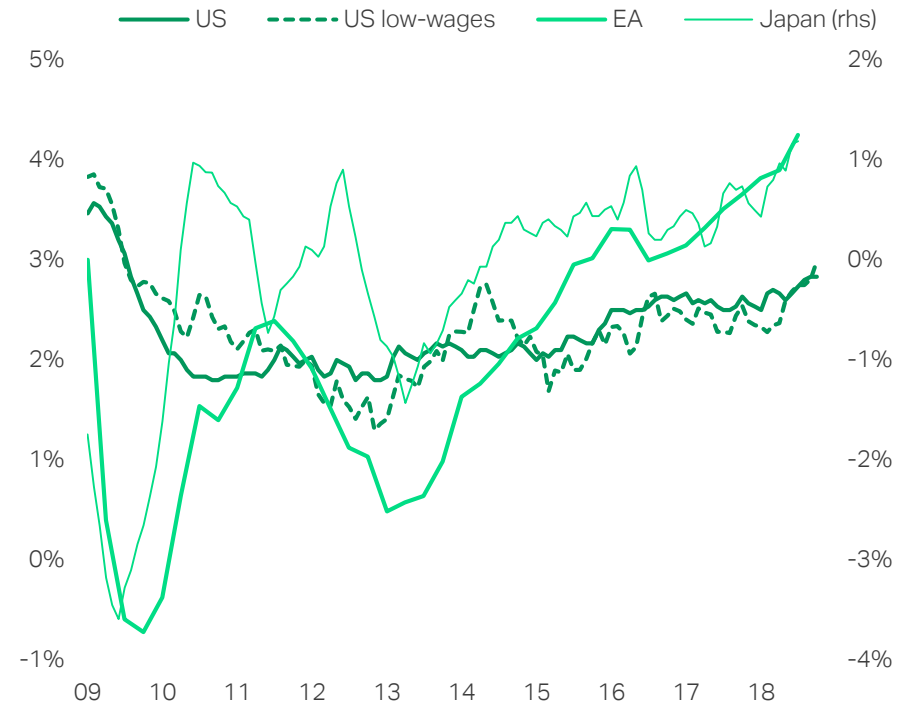
Macro Drivers Falling capex a drag on US growth

Fall in capex growth behind US momentum loss



We expect two more 25bp Fed rate rises, in December and March, before a pause. But the March hike may be at risk as capex growth is falling. Momentum in both business and residential investment is slowing. Yields continue to rise (see the *Fixed Income* section), further impeding momentum. With fed funds now at neutral, further rate hikes will depend on growth rather than merely a desire to normalise policy.

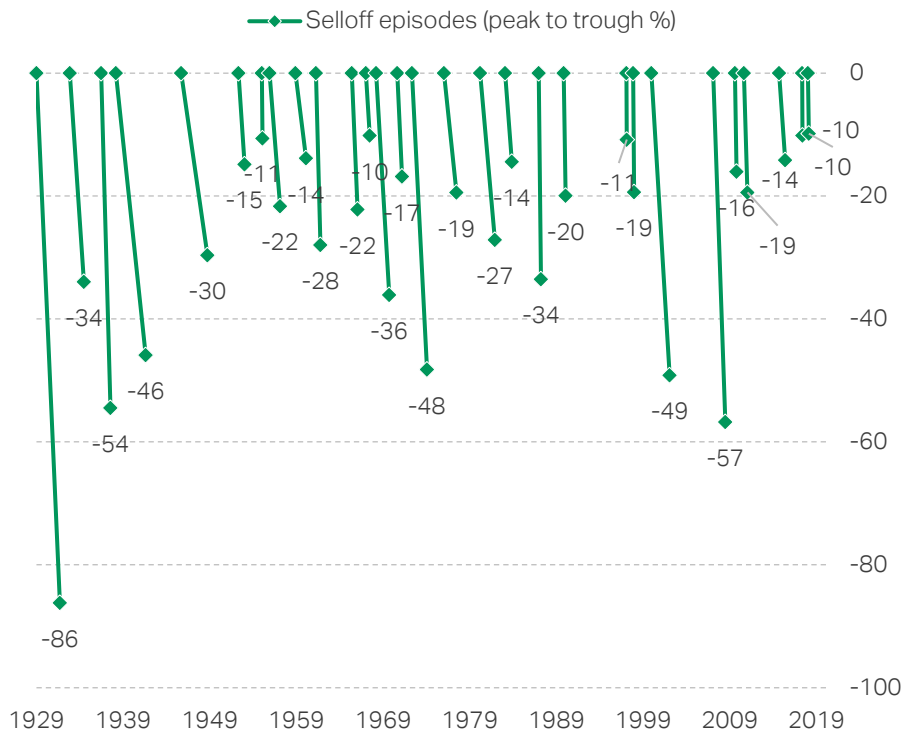
G3 wage growth finally rising



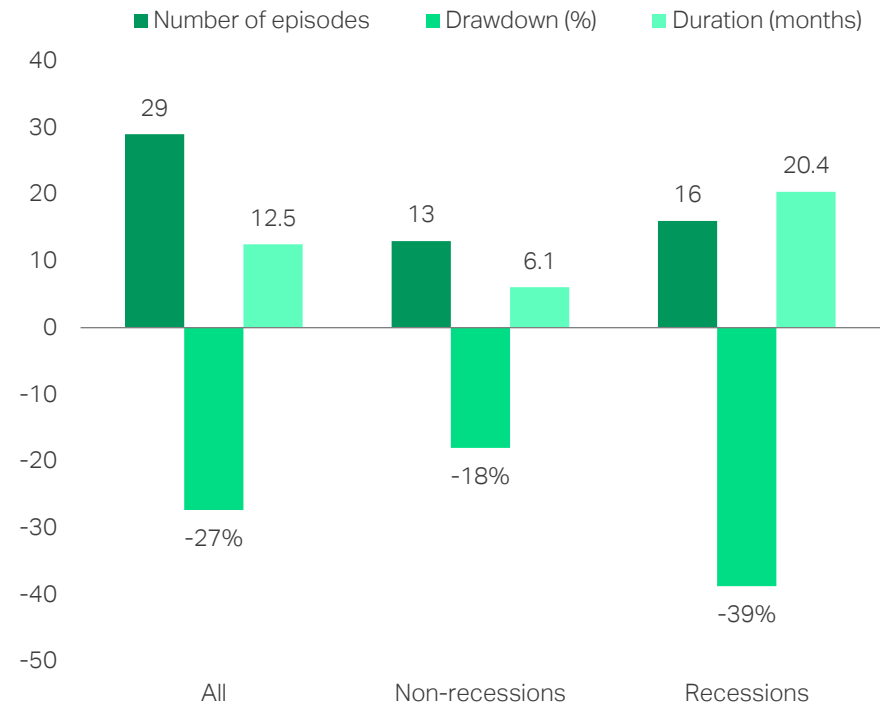
The economic news is not all bad. Wage growth in the US is close to 3%, lower-paid workers are getting raises and wages in the EA and Japan are rising at a record pace for this cycle. In the US, housing capex follows real wages so there may be some relief next year. But this merely exacerbates central banks' conundrum: should they panic about the Phillips curve and follow wages, or yield to bond markets?

Multi-Asset A barely volatile 2018 after a vol-less 2017

Already two 10% drawdown episodes in 2018



But recent sell-offs have been mild by historical standards

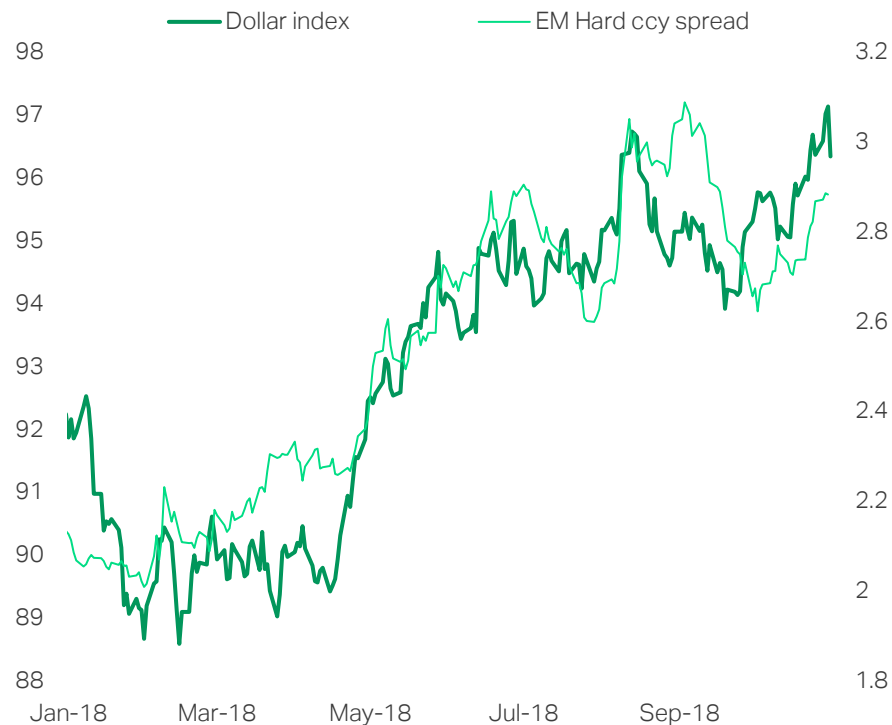


2017 was exceptional for its near-total absence of volatility. The VIX averaged just 11%, the lowest on record. In 2018 the average has been 15.6 so far, still only the 19th highest out of the last 29 years. Similarly, the two major US equity sell-offs this year have been mild, at only about 10% each, just enough to qualify as 'corrections'.

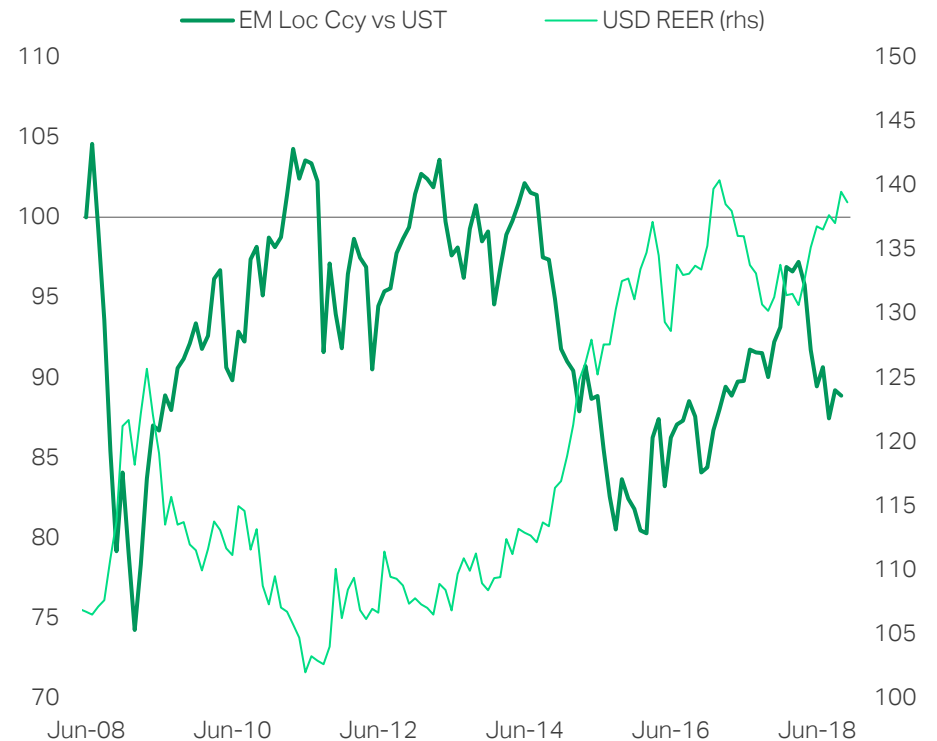
The average drawdown of the past 29 significant sell-offs (equities down more than 10%) has been -27%. There have been significant differences between episodes associated with a recession (-39%) and those that weren't (-18%). But even against the non-recessionary sell-offs of the past, what we have witnessed so far this year has been rather unremarkable.

Multi-Asset EM debt struggling as dollar surges

EM hard currency spread wider with stronger dollar



Local currency debt underperforming on greenback strength

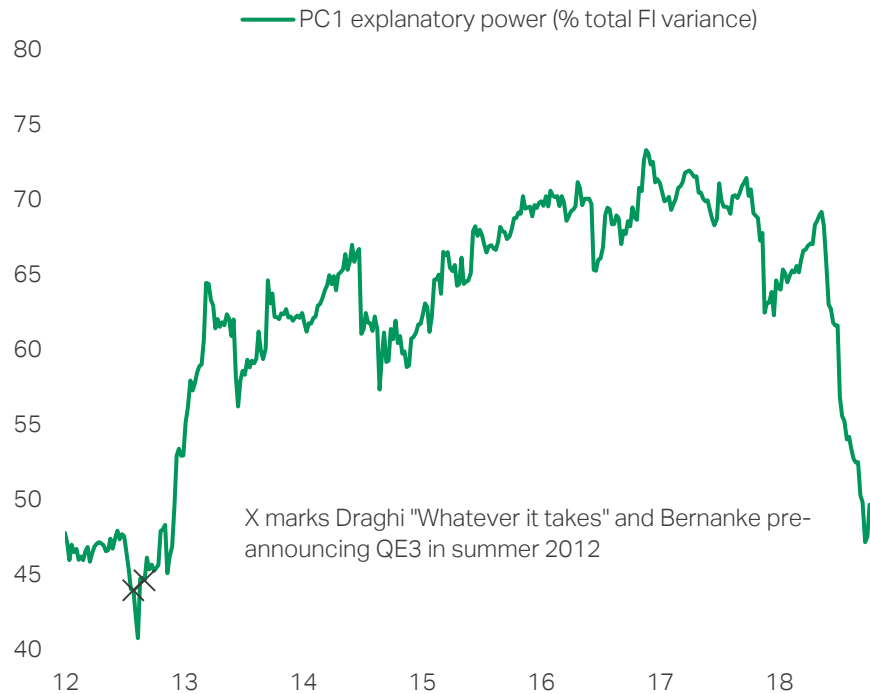


Our EM strategy team have kept their overall stance on EM risk at -1 this month, even though they noted that one of the main reasons to be cautious – the trade war – is already past ‘peak Trump’. Within EM assets, hard currency debt remains their pick (with a relative +1 score). But even if EM credit has easily outperformed local rates in the past six months, the asset class remains under pressure due to a strong dollar.

The negative relationship between USD and local currency debt is not as robust as that with hard currency debt, but a stronger dollar has been a major headwind for local rates too.

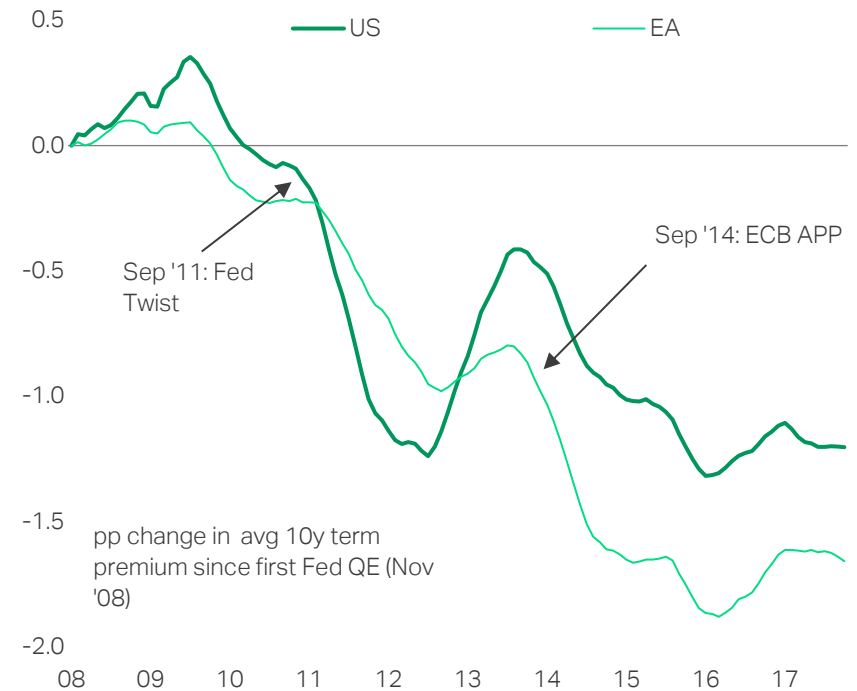
Fixed Income End of an era

QE no longer the most important factor for fixed income



The QE factor behind global fixed income returns has almost fallen back to its pre-2012 level. As the impact of QE fades, volatility and risk premia will rise, especially the term premium (see chart to the right). Its influence is set to be felt beyond fixed income markets, raising the risk premium on assets across the board.

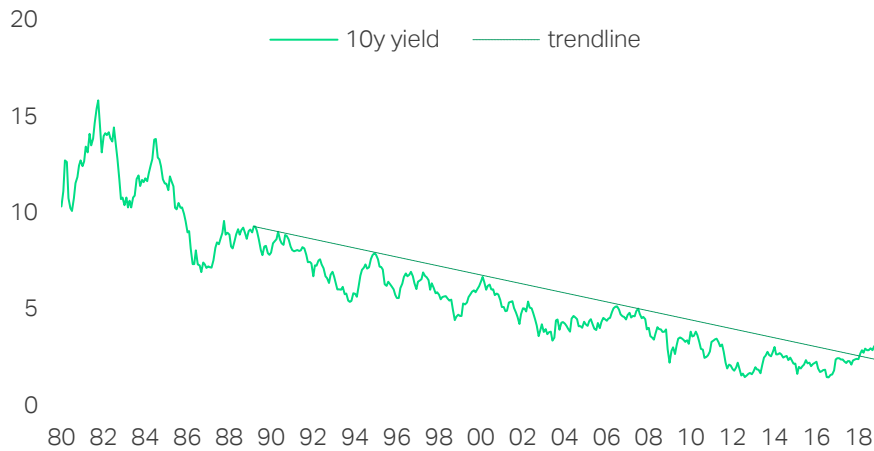
Term premium (and so real yields) may have a long way to rise



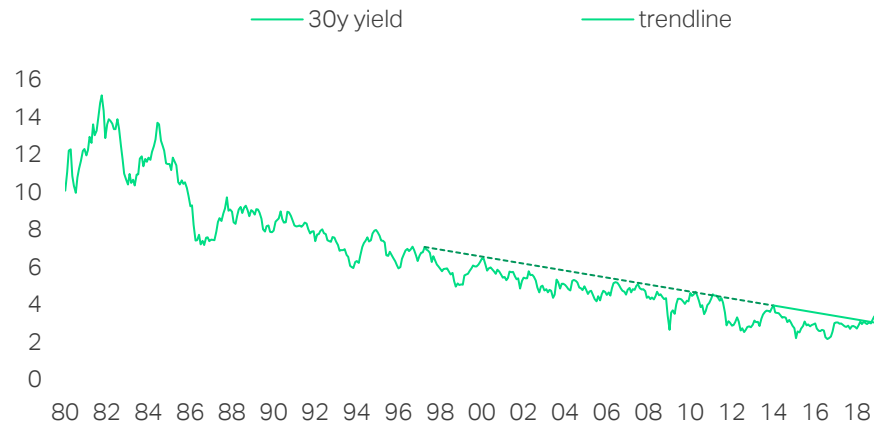
Central banks' assessment of the efficacy of QE suggests 'stock' matters as much as 'flow'. Be that as it may, the initial 'flow' of QE cut term premia and, at least in the US, the end of the flow saw them rise again. With term premia so low, there is a risk that decompression will cause curves to bear-steepen and have a further knock-on effect as yields rise by more than is warranted by real growth and inflation expectations.

Fixed Income Treasury yields breaking out

10y Treasuries have broken out of long-run bull market



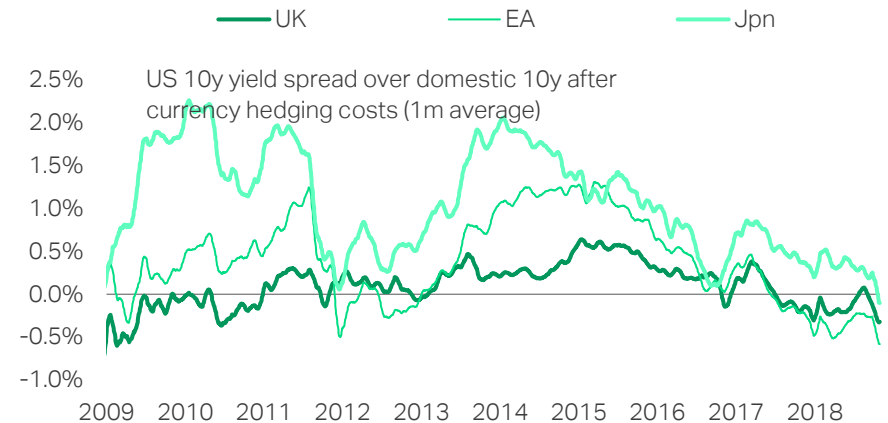
And 30y may have done so as well



EM demand for Treasuries is falling as USD rises and reserves

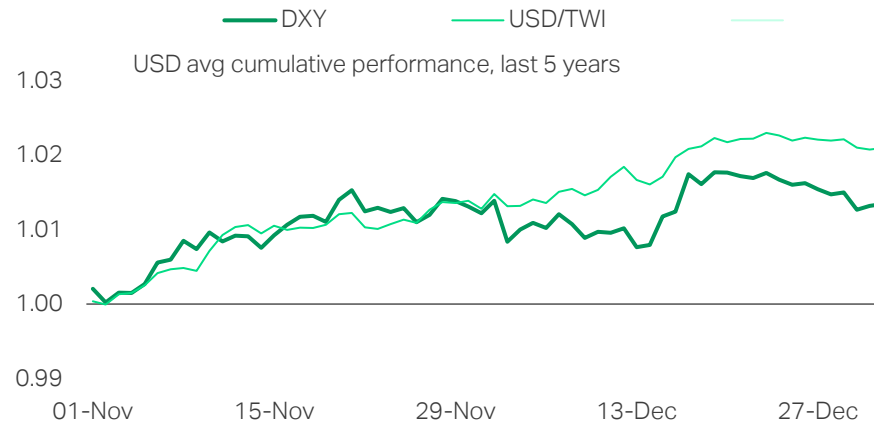


DMs have no incentive to buy unless US yields rise more

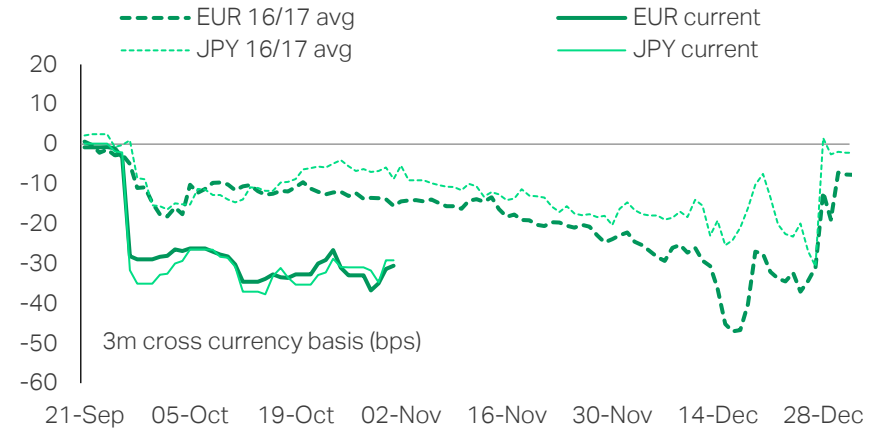


Currencies | USD strength likely to continue in November

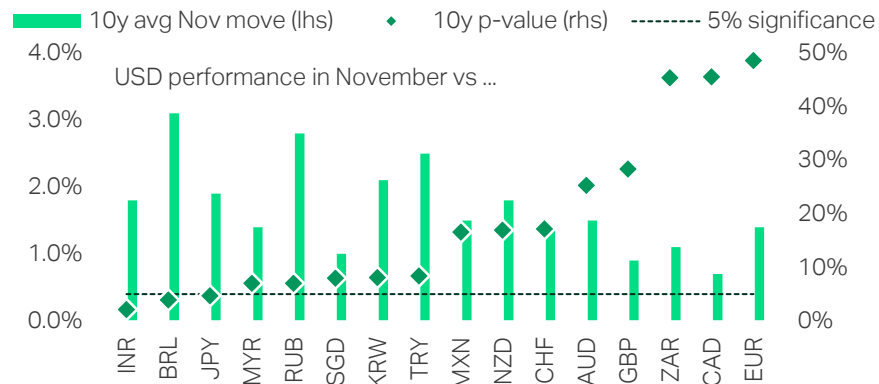
In recent years, USD has tended to rally in November



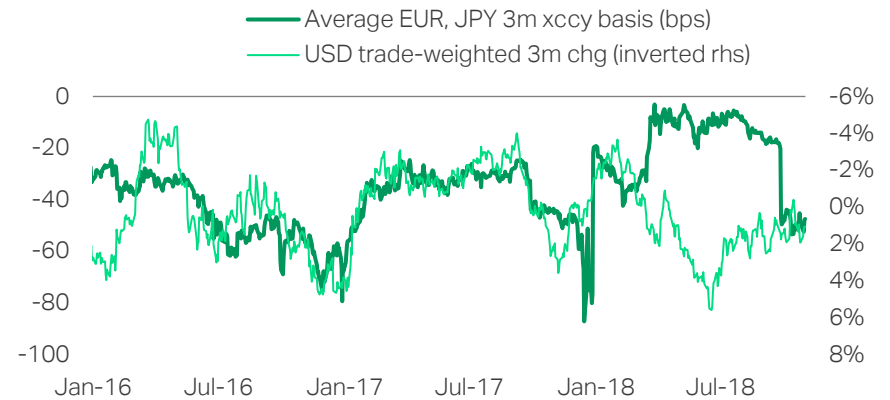
Widening EUR and JPY basis swaps a reminder of scarce offshore USD



Statistically, the strongest sell signals are INR, BRL and JPY

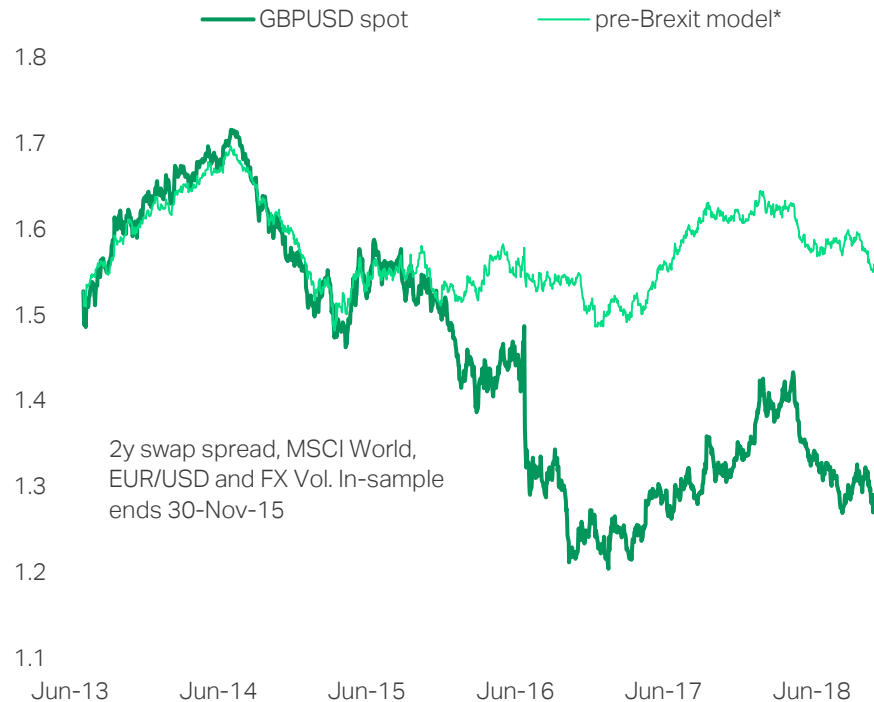


Wider basis swaps tend to support USD too



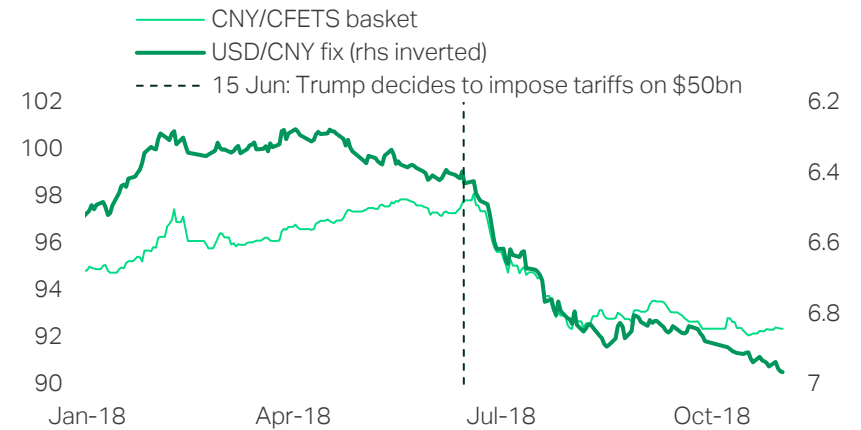
Currencies Upside risks for GBP, downside for CNY

GBP Brexit discount is becoming attractive

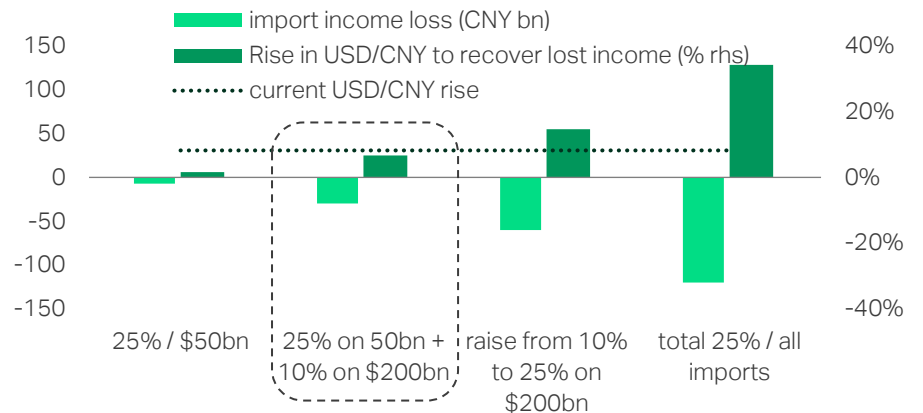


GBP/USD is almost 20% below this pre-Brexit regression model. Of course, it is very unlikely that Brexit is cancelled, so even under the best possible deal the currency will not regain such levels. But the model provides a rough benchmark for assessing risk/reward in the volatile negotiations: we are looking for a dip to buy.

Recent CNY fall merely reflects USD strength; more to come

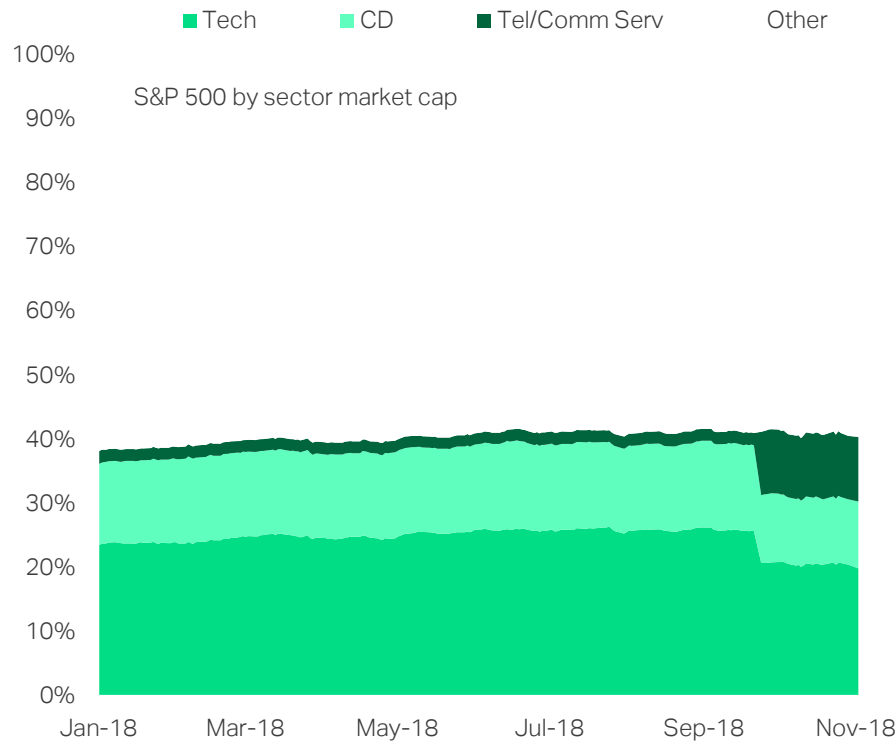


Next bout of CNY weakness likely on next round of tariffs



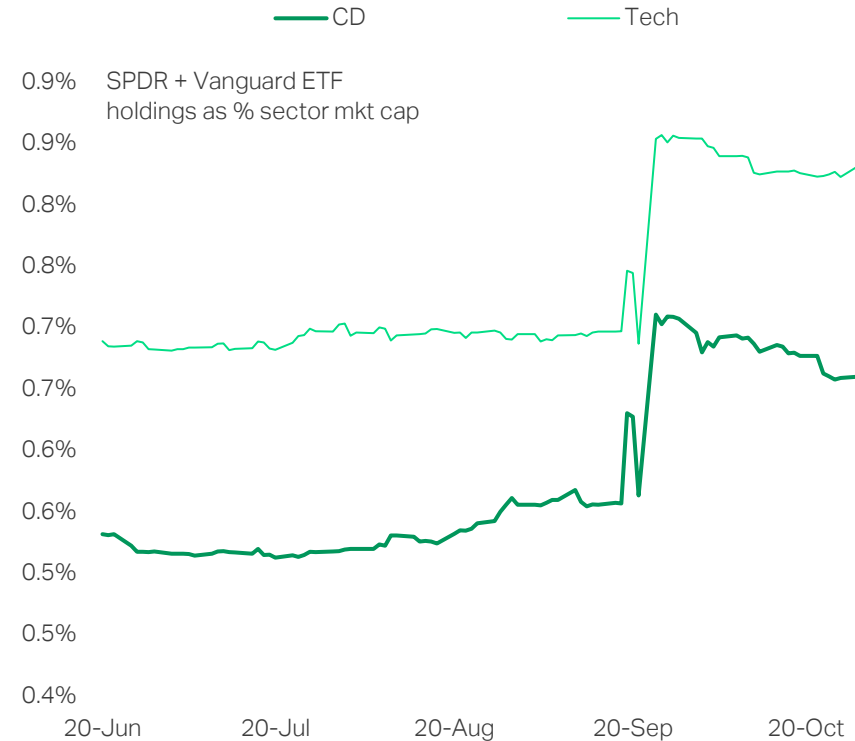
Equities Sell-off mostly due to sector rebalancing

Tech and CD titans moved to Communications



Changes to the GICS classification on September 28 forced ETF and fund managers tracking Tech and Consumer Discretionary benchmarks to sell titans such as Google, Facebook and Netflix, as these names have been moved to Communication Services. The S&P 500 peaked shortly before the reshuffle took effect. As Tech has been the main performance driver this year, rebalancing has likely been the trigger of the sell-off.

ETF investors did not follow the reclassification

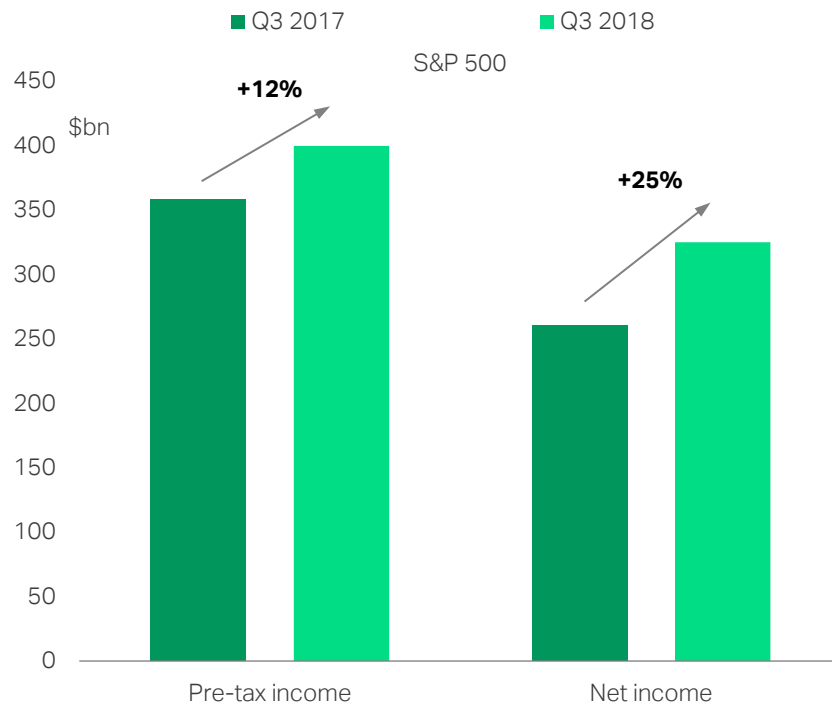


Rational investors who wanted exposure to the Tech titans should have sold part of their ETF/mutual fund holdings on September 28 and bought into Communication Services. This has happened only to a limited extent, meaning that prices still reflect an imbalance of motivated sellers and buyers of former IT/CD companies. For this reason we've gone long Comms vs the S&P 500 in our latest Macro Strategy.

Equities

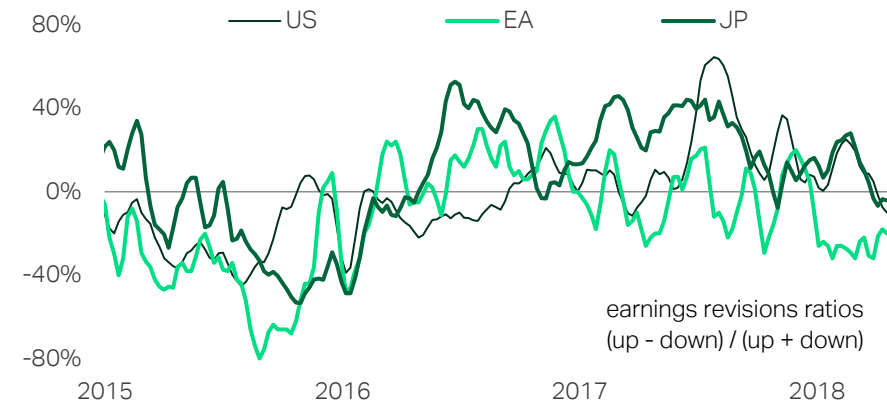
But earnings momentum is fading

US after-tax profits still going strong, but momentum to fade

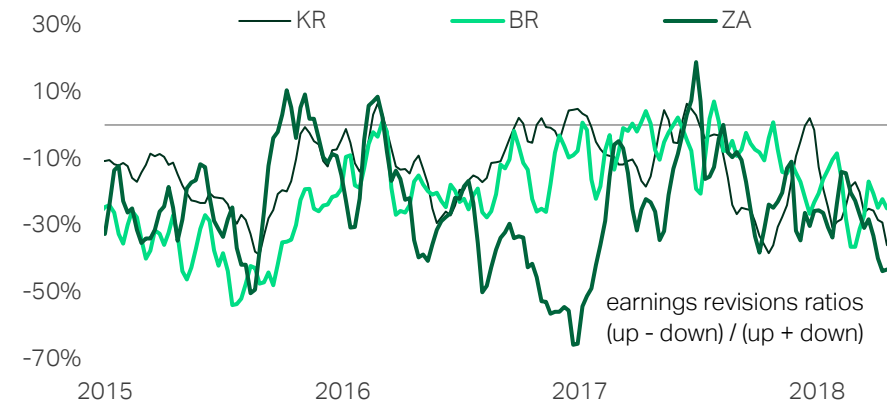


The US reporting season is producing mostly positive surprises, but earnings growth will likely lose momentum in 2019. Pre-tax profits have been growing at low single-digit rates. In 2019 net income growth should be similar. Lower forward guidance has led to downward revisions. Technical factors (GICS reclassification, see above) compounded the deterioration in the fundamental outlook, aggravating the sell-off.

Negative revisions for all major DM markets

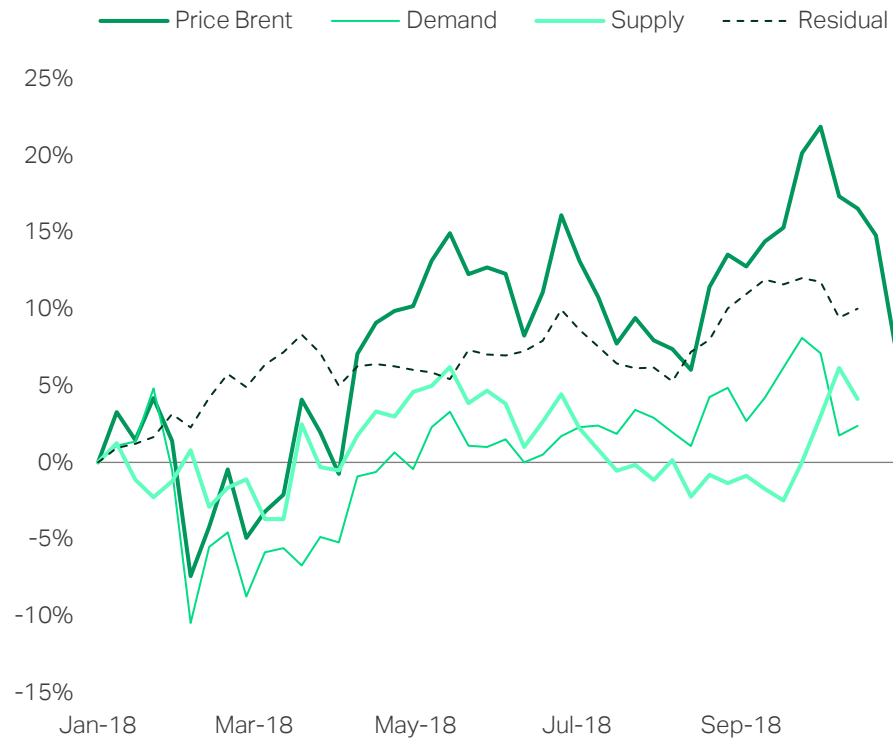


EMs' situation worse still



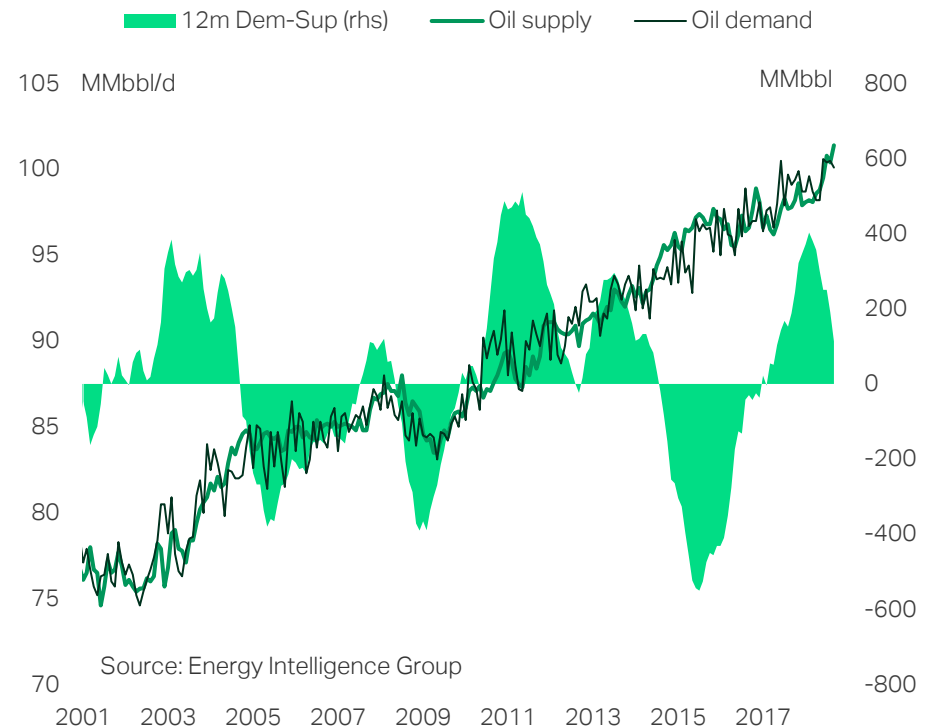
Commodities Oil supply winning over demand, again

Supply boost behind recent fall in Brent price from peak



Analysis carried out by the NY Fed suggests that a surge in demand was the main reason behind Brent prices scaling their recent highs, but it was a boost in supply that caused them to fall from there. Further drops have been caused by Trump suggesting that [sanctions against Iran might not be as harsh as previously thought](#).

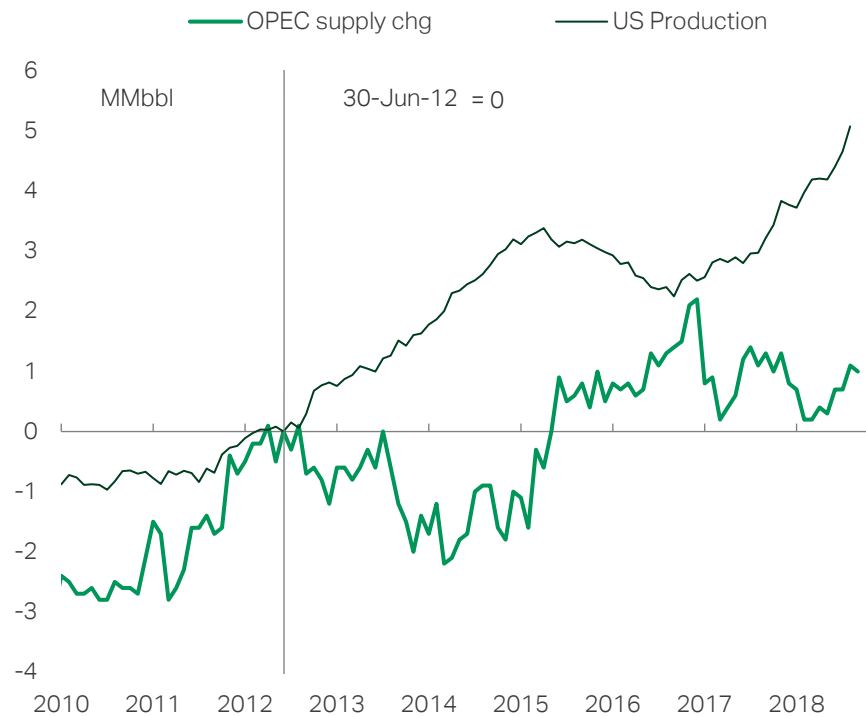
Supply outstripping demand in six months to September



Global supply started exceeding demand in April, but the surplus grew in September, reaching 39m bbl/d. In the six months to September, the oversupply has averaged 7.7m bbl/d.

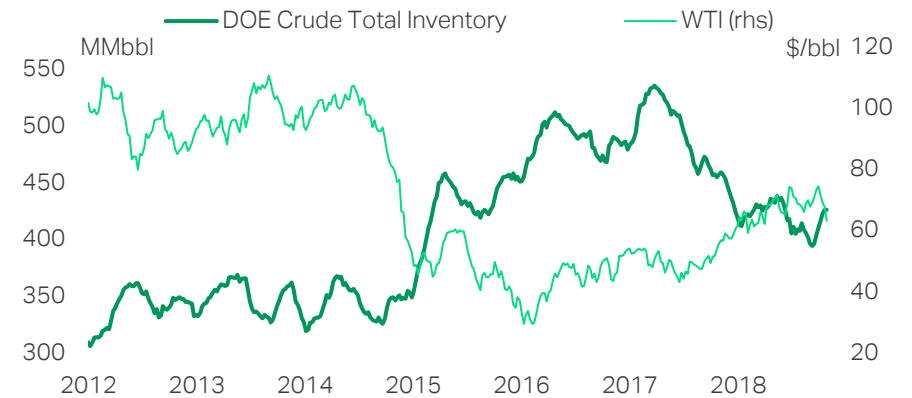
Commodities US supply and export response

US production continued to pick up through the summer

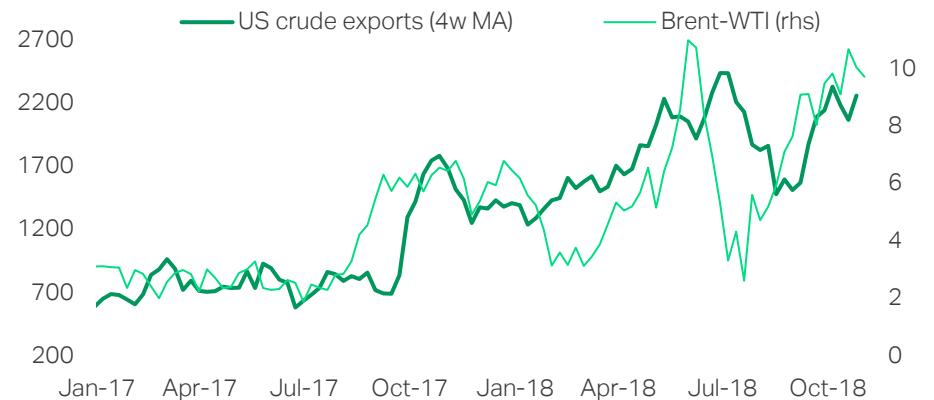


US output increased over the summer months in response to higher prices, reaching an all-time high in August. The strong supply trend was sustained in September and October, with inventories rebounding from their recent lows. Exports remained robust as a result, causing the spread between Brent and WTI to narrow slightly.

US inventories sharply higher...



...despite strong exports



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