Strategy Chartbook

FEBRUARY 2018

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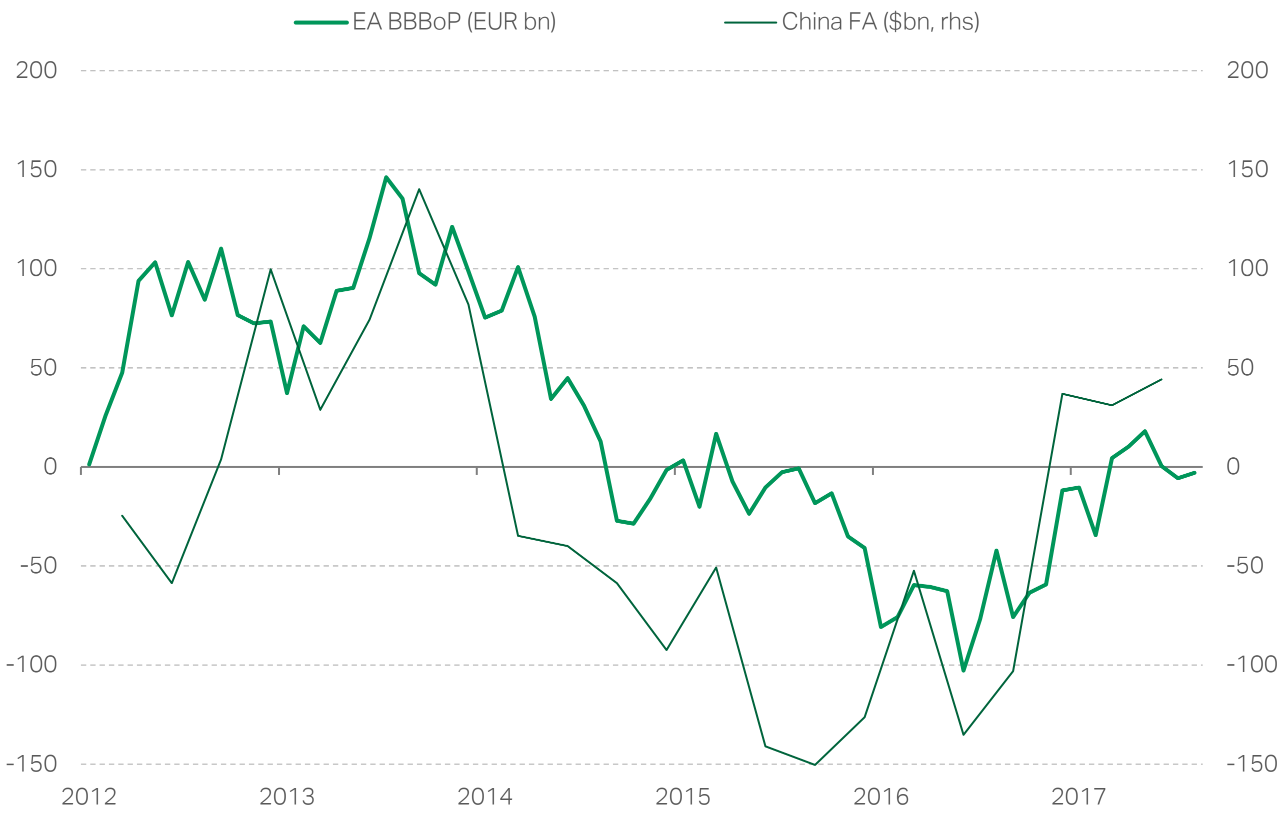
HIGHLIGHTS

- Macro Drivers. Benign growth conditions and controlled deleveraging – what's not to like?
- Multi Asset. Vol to rise from low levels (especially in bonds) but short-vol trades still look good
- Fixed Income. Slowing pace of QE starts to impact markets
- Currencies. Global capital flows no longer imply dollar demand
- Equities. It may be rational to be irrational as the risk of a melt-up remains high
- Commodities. US shale increasingly the marginal price-setter for crude oil

Chart of the month

Global capital flows no longer imply dollar demand



The euro area's broad basic balance of payments (BBBoP: current account, FDI and portfolio flows) is returning to a surplus. With the impact of the EA's massive CA surplus no longer offset by even larger portfolio outflows, the natural tendency will be for the euro to appreciate. At the same time the Chinese financial account (a proxy for capital flight) has also returned to surplus. Chinese capital outflows were a major source of $ demand in recent years.

The extent and suddenness of the dollar's recent slide suggests the pace of the decline will slow from here on. But valuations are not an impediment to further depreciation, as the dollar remains slightly rich – especially against the yen.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* Benign growth conditions and controlled deleveraging – what's not to like?
- *Multi Asset.* Vol to rise from low levels (especially in bonds) but short-vol trades still look good.
- *Fixed Income.* Slowing pace of QE starts to impact markets.
- *Equities.* It may be rational to be irrational as the risk of a melt-up remains elevated.
- *Commodities.* US shale increasingly the marginal price-setter for crude oil.

In this month's Chartbook

Macro drivers

Multi-Asset

Fixed Income

Currencies

Equities

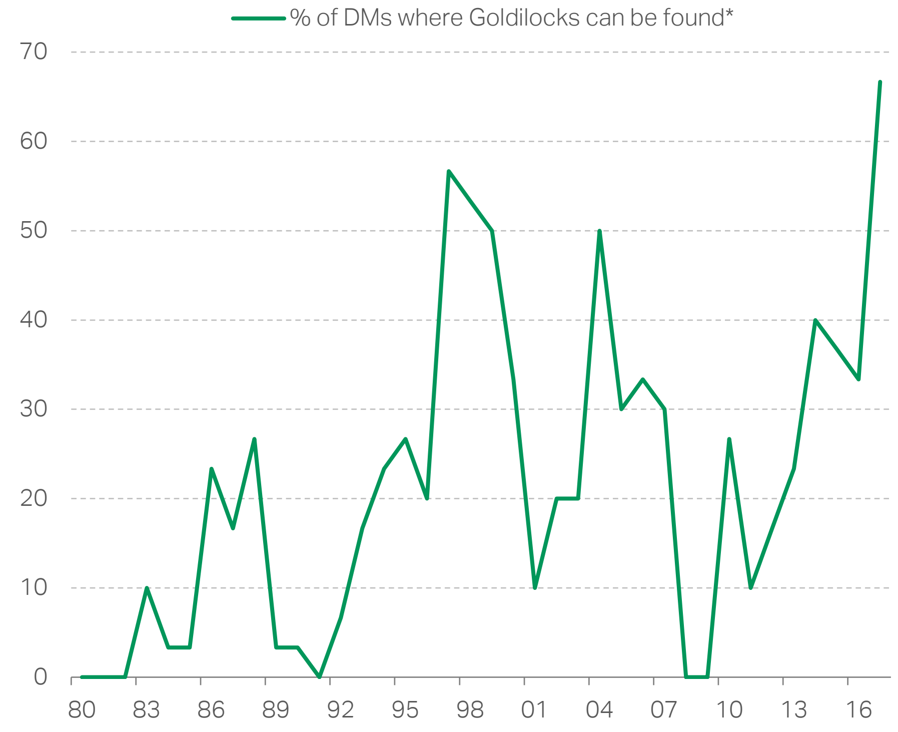
Commodities

Summary – key points

Macro drivers	• Goldilocks is in control: two-thirds of DM economies are enjoying below 2% inflation and above 2% growth • Chinese debt deleveraging is likely to drag on growth this year, but authorities remain in control of credit growth • Euro area growth risks are to the upside; as seasonality predicted, US data have started the year on the weak side
Multi-Asset	• Equity vol is likely to remain low this year, in line with performance before previous market peaks • Bond trading is still driven by one risk factor, while variance in equity and FX markets have more diverse causes • Bond volatility is particularly low compared to its cyclical average, and is set to rise as QE becomes increasingly less important
Fixed Income	• As the pace of ECB asset purchases slows, core and periphery EGB markets are starting to diverge • Fed QT is slower than expected thanks to a rise in MBS holdings • The bond bear market will be contained as Chinese demand is linked to its FX reserves holdings, which are rising
Currencies	• EUR long positioning is building but has further to go • The rise in both the EA BBBoP and China's financial account means falling global demand for USD this year • From a valuation perspective, USD is a little rich and EUR a little cheap; both are likely to overshoot to the other side
Equities	• In the latter stages of a rally high-beta tends stocks tend to outperform low beta • Investor confidence remains range-bound; there is no sign of irrational exuberance yet • Earnings estimates continue to be revised up, particularly in the US
Commodities	• US shale producers have plenty of spare capacity to increase supply if oil prices continue to rise • The US now produces almost as much crude as Saudi Arabia; shale production is likely the marginal price-setter • Brent-WTI spread is falling and has further to go, as net Brent vs WTI positioning also declines

Macro Drivers Goldilocks and controlled deleveraging

Goldilocks is almost everywhere



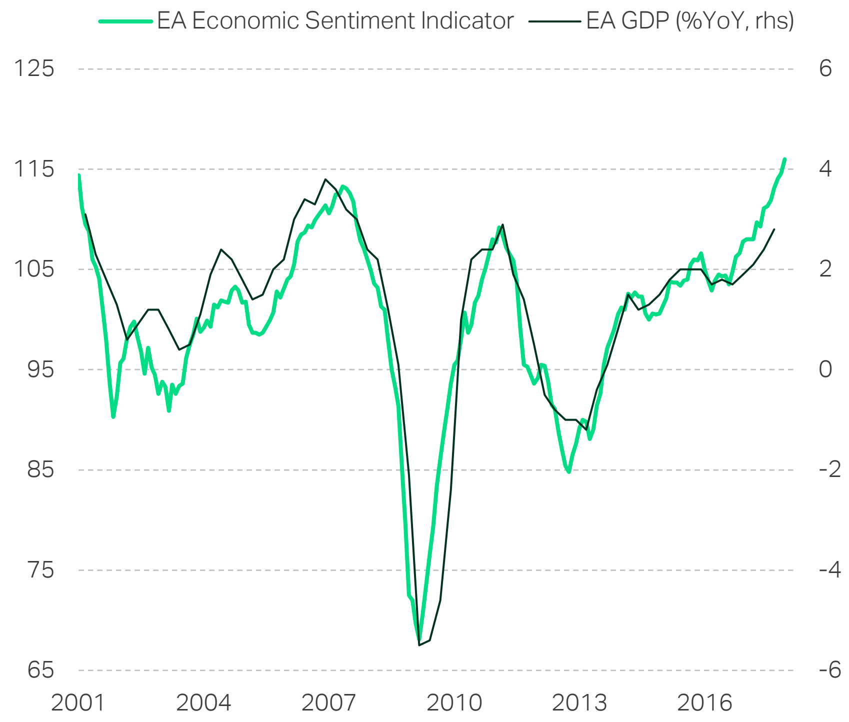
Asset prices remain supported by the Goldilocks economy. In developed markets, most countries are enjoying below 2% inflation and above 2% growth. These conditions are likely to continue in the near term, but Dario Perkins highlights the sinister side to Goldilocks in his most recent Macro Picture.
*(*economies with annual inflation <2% and annual GDP growth >2%)*

China is managing its debt delevering

Chinese growth has stabilised around 6.5%. We expect this year to be characterised by deleveraging and managing bubble risks in property. Credit growth is slowing and the authorities will focus on reducing financial leverage in the riskiest sectors. But resilient exports and robust domestic consumption are set to partly offset the drag on growth.

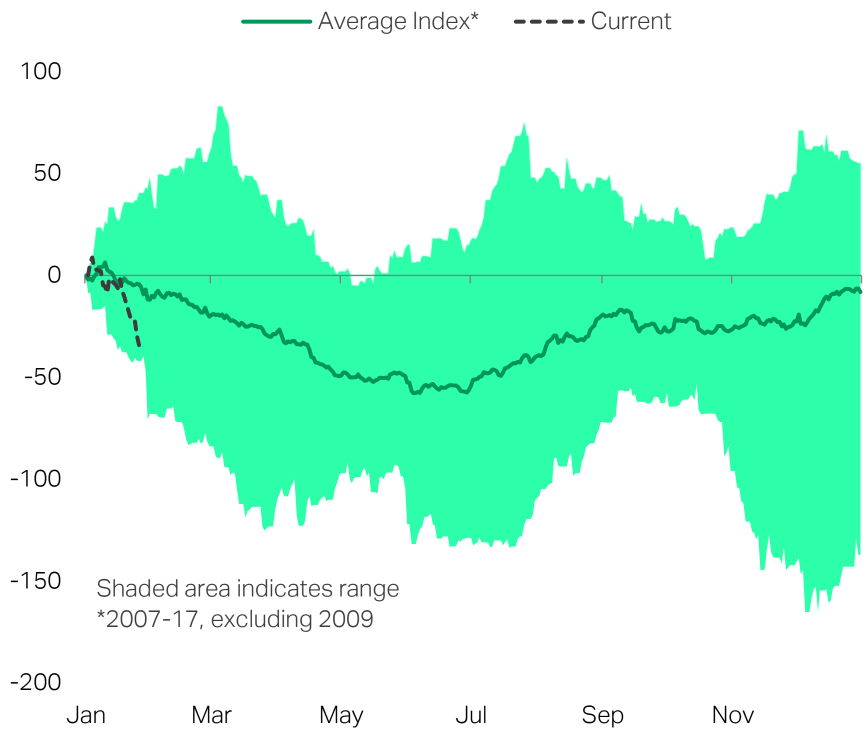
Macro Drivers Euro area outpacing US growth for now

Euroboom goes on



Euro area growth continues to improve, and survey indicators – many at cyclical highs – suggest there is further upside. The recovery has also been broadening out. Germany is still leading the way, but the French economy has also picked up speed since last summer. The euroboom continues apace.

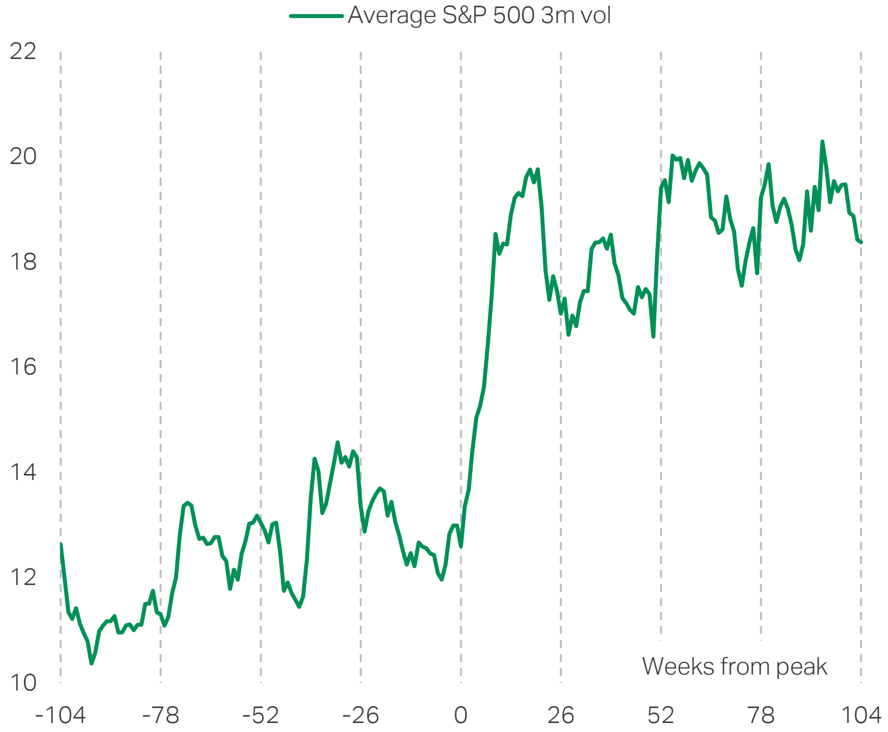
Seasonal softness in US surprises



US economic data tends to disappoint at the start of the year, and 2018 is no exception. However, we do not expect recent misses to develop into any real weakness. US economic activity is lagging for now, but the impact of tax cuts and global reflation continue to drive US stocks to new highs.

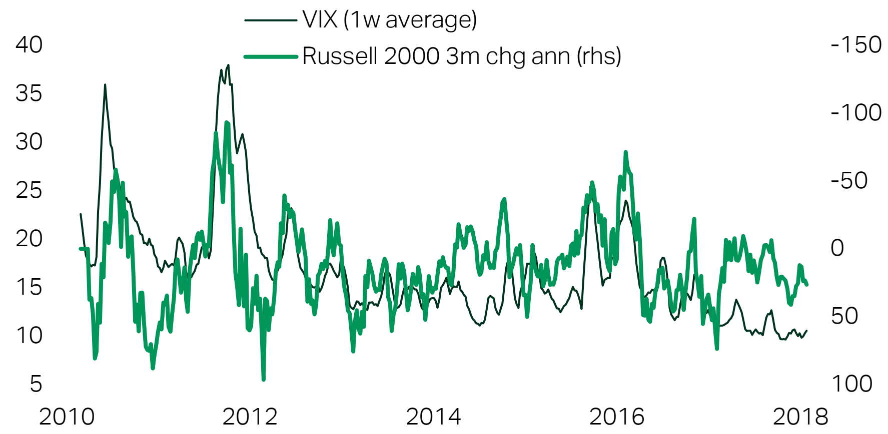
Multi-Asset Short-vol trades to continue doing well

Vol unlikely to pick up materially before equities peak

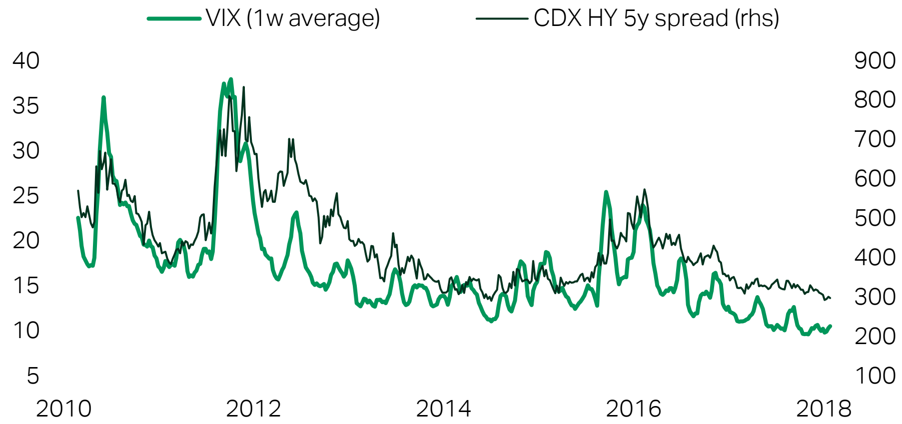


Our analysis of the past 13 major S&P 500 rallies (1929, 1937, 1946, 1956, 1961, 1966, 1968, 1973, 1980, 1987, 1990, 2000 and 2007) shows that realised equity vol tends to remain fairly low before the market peaks. While vol is likely to pick up from 2017's record lows, it should remain well behaved this year, benefiting short-volatility trades.

Small caps tend to do well in a low-vol world…

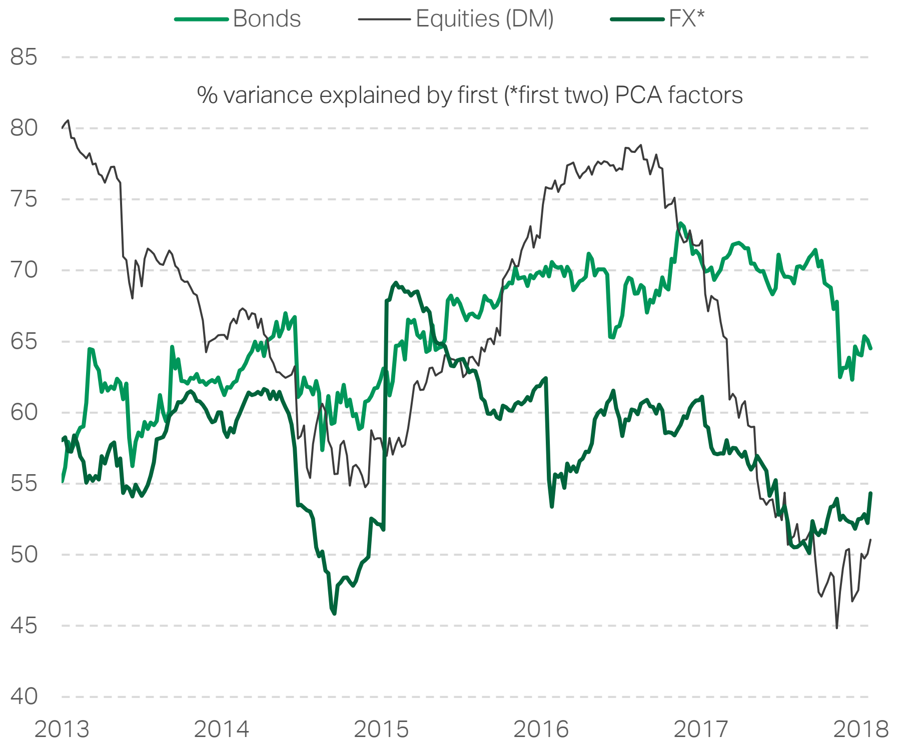


…As do credit spreads



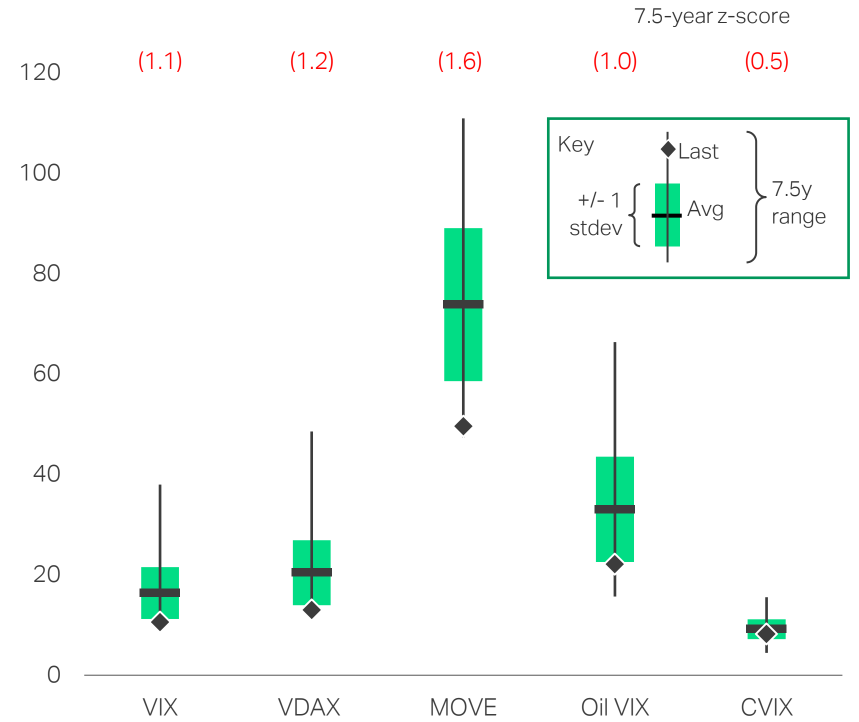
Multi-Asset — But vol set to rise, especially in fixed income

Bonds trading still driven predominantly by one risk factor



Bond returns continue to be driven predominantly by a single risk factor – in this case, quantitative easing. In other asset classes the variance of returns has more diverse causes (although the S&P 500 and the dollar index remain important factors for equities and currencies). This suggests that as QE becomes increasingly less important this year, relative volatility in bond markets looks set to increase.

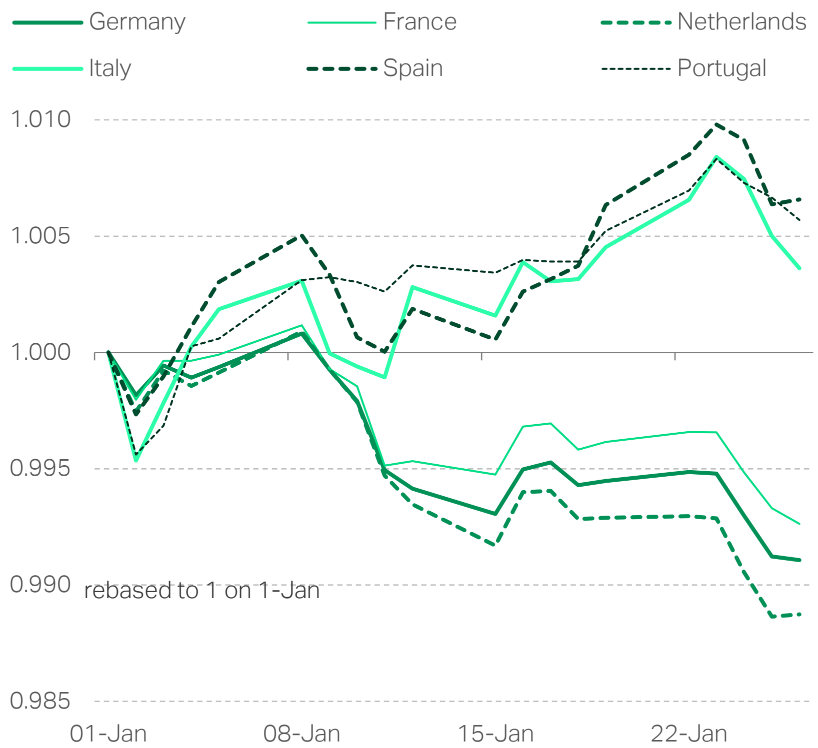
Volatility low across asset classes, especially in bonds



Implied volatility remains low across asset classes, though not to the same degree. Fixed income vol, at 1.6 standard deviations below its cyclical average, looks particularly low, supporting the results of our principal component analysis. Following the recent dollar sell-off, FX implied vol has bounced back close to its 7½-year average, with the z-score rising from -1.7 in December to -0.5 now.

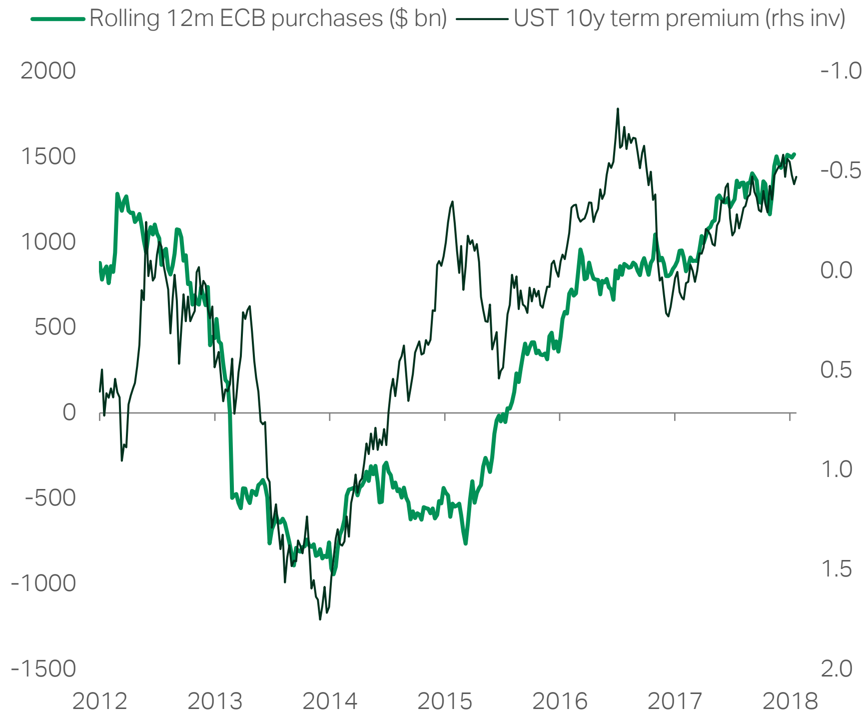
Fixed Income Slowing pace of ECB QE starts to impact markets

EA government bond divergence



So far this year, euro area core (Germany, France, Netherlands) government bond indices have weakened while those of the periphery (Italy, Spain, Portugal) have strengthened. As the pace of ECB asset purchases slows in 2018, the assets most distorted by QE – Bunds – are likely to be the most affected as prices fall back to fair value.

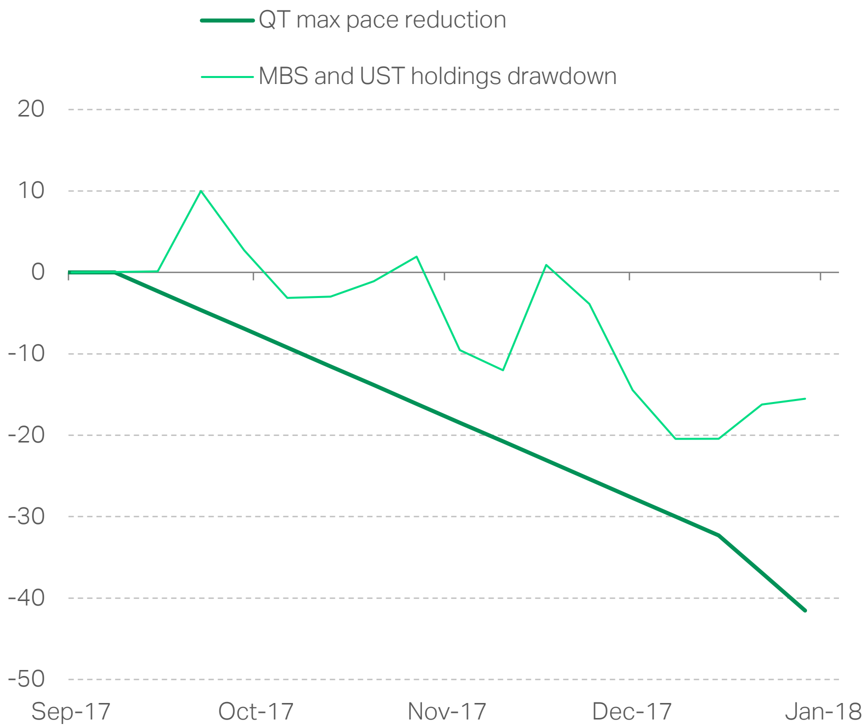
Term premia likely to rise



Term premia should also rise across the world as the pace of ECB asset purchases slows. The ECB is mostly responsible for 2017's fall in the US term premium and, as we showed in last week's Macro Strategy, the distortive effect of QE is slow to fade away.

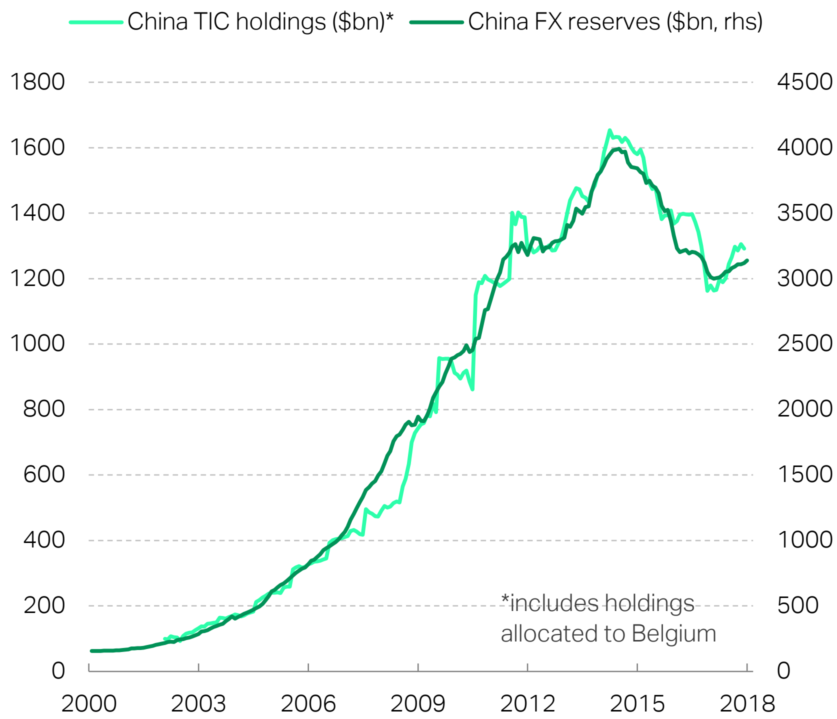
Fixed Income Fed QT slower than expected

Fed balance sheet has shrunk by only $15bn so far



Another reason why the distortive effect of QE is lingering is the slower-than-expected pace of reduction in the Fed's balance sheet. Treasury holdings have fallen by around $18bn (vs possible $25bn maximum). But, thanks to an *increase* in MBS holdings (perhaps because, with rates rising, there is no prepayment incentive), the Fed's total balance sheet is only $15bn smaller than pre-QT (vs $41bn max possible).

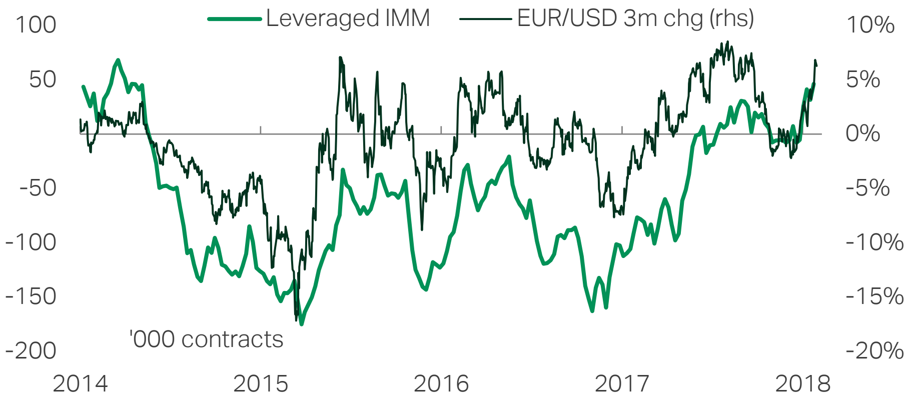
China unlikely to start selling Treasuries



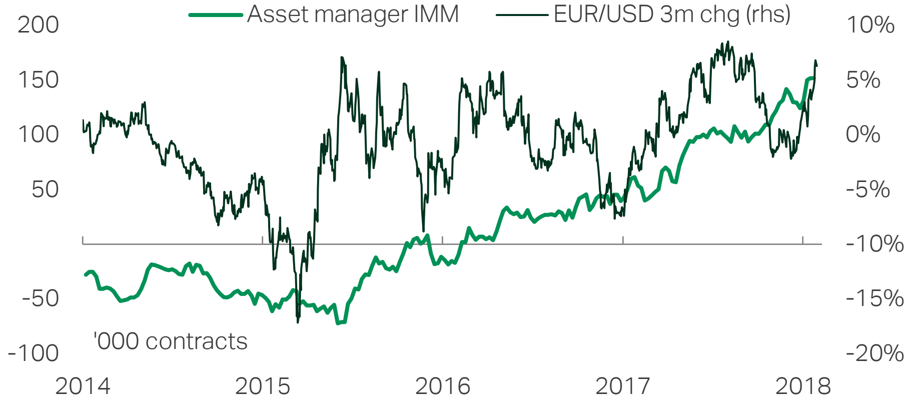
Chinese demand for US Treasuries is determined by its own FX reserve growth, rather than Beijing's perception of value. As FX reserves are now rising again, Chinese demand for Treasuries will also increase. As long as this source of demand lasts, it is unlikely that the sell-off in Treasuries will become disorderly. .

Currencies Further upside for EUR

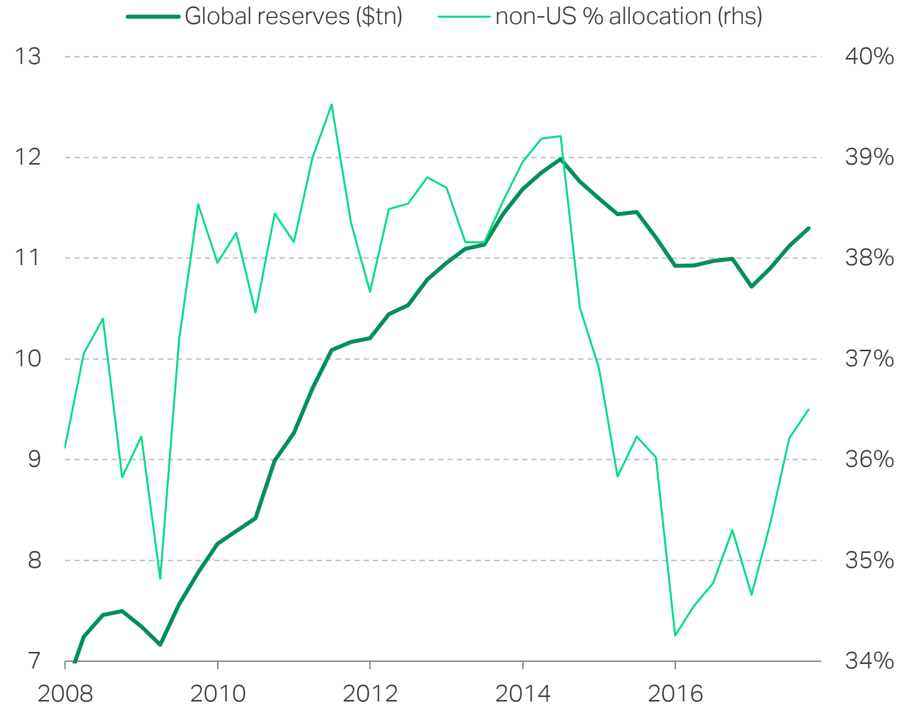
Speculative EUR longs have only just started to build



Asset manager positioning tends not to be related to EUR moves



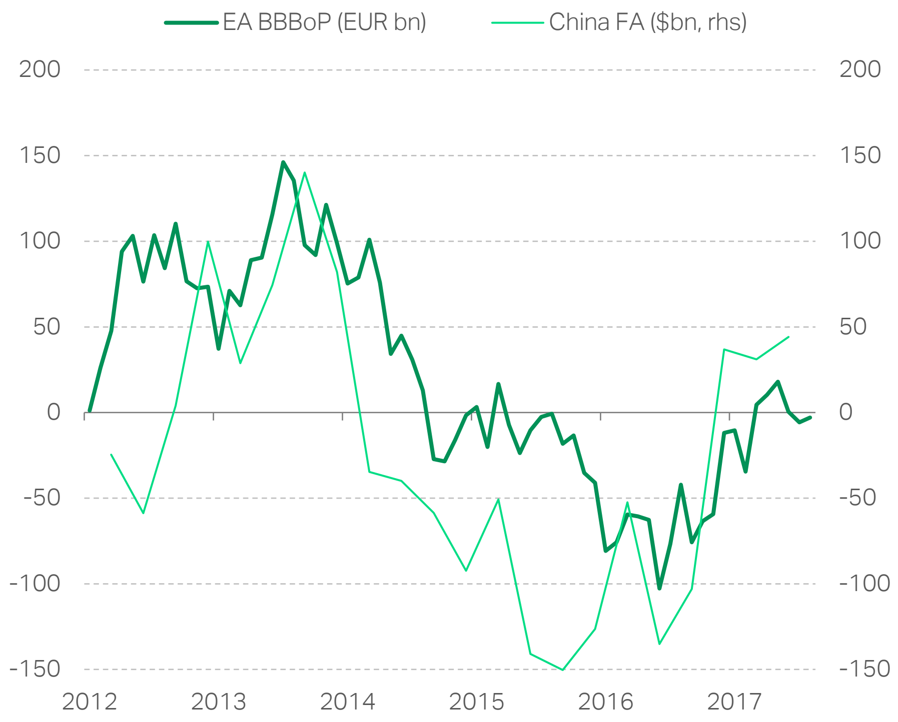
The rise in global FX reserves is positive for EUR



Synchronised global growth is attracting capital to emerging markets countries, many of which operate managed currency regimes. As central banks lean against local currency strength, FX reserves rise. The share of non-USD currencies in global reserves is likely to rise, supporting the second most widely held currency - EUR.

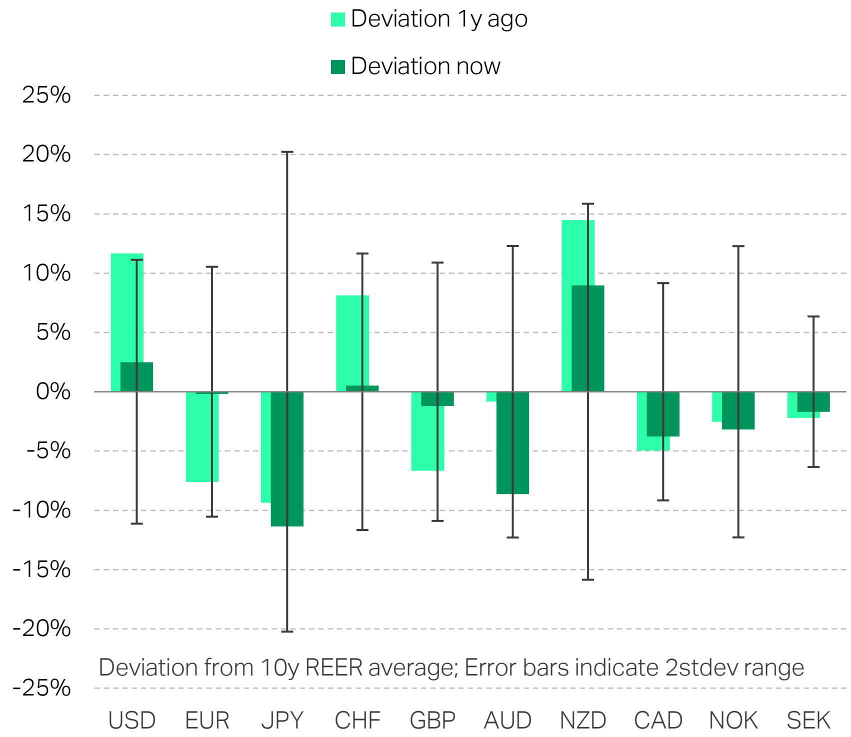
Currencies Further downside for USD

Global capital flows no longer imply dollar demand



The euro area's broad basic balance of payments (current account, FDI and portfolio flow) is returning to surplus. The Chinese financial account – a proxy for capital flight – has also returned to surplus. These were major sources of dollar demand in previous years. No longer.

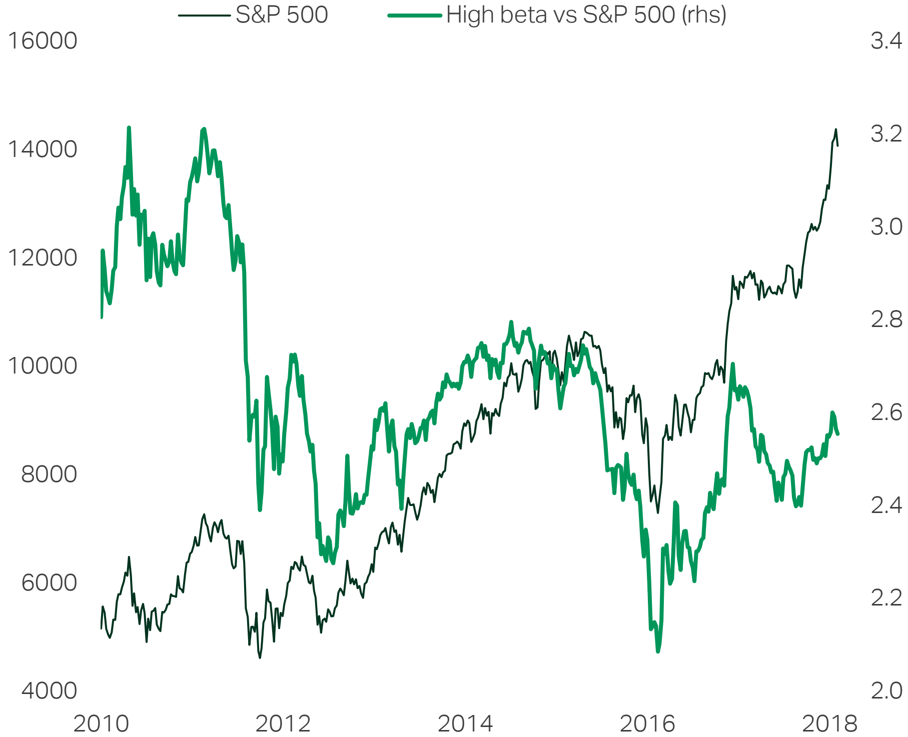
Valuations still favour a dollar decline, particularly against JPY



The dollar has declined by around 9% (trade-weighted) in the last 12 months. It is no longer egregiously rich, but there is room for it to fall further as currencies tend to overshoot during such adjustments. The trend decline in USD is unlikely to turn around until the currency is clearly cheap.

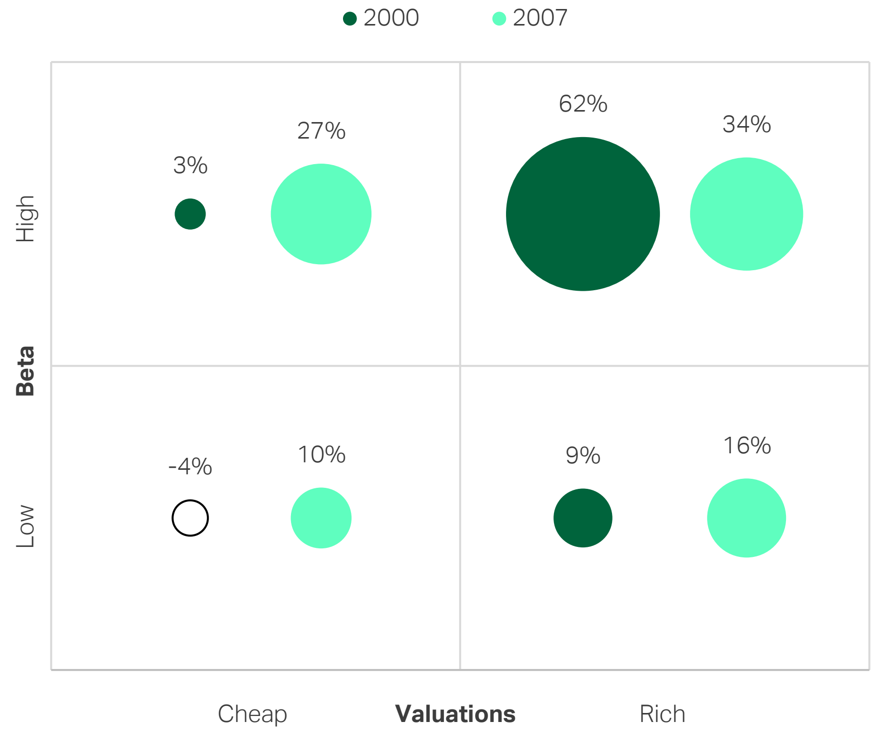
Equities Rational to be irrational

High-beta outperformance to continue



In the latter stages of an equity market rally high-beta stocks tend to beat low beta. High-beta outperformance has already begun, but it looks as if it can go a lot further..

Growth beats value, high beta beats low beta in last year of rally

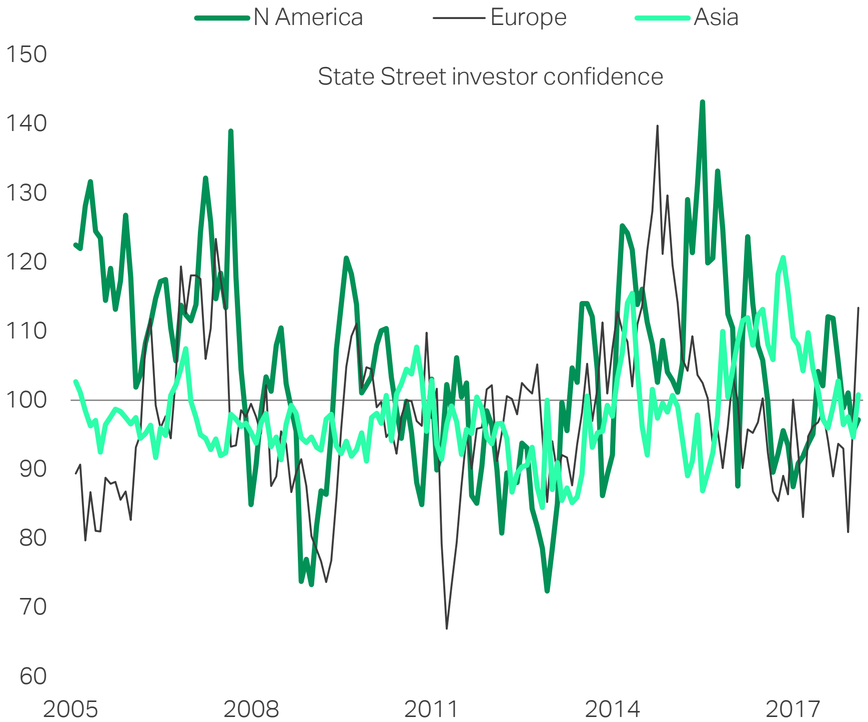


In both 2000 and 2007, S&P 500 high-beta stocks outperformed low-beta shares in the last year of the rally, and the more expensive ones beat the cheaper. The performance difference was much more pronounced in 2000 than in 2007. That's because equities were in a bubble in 2000, while in 2007 the market crashed before stocks could become expensive.

Equities

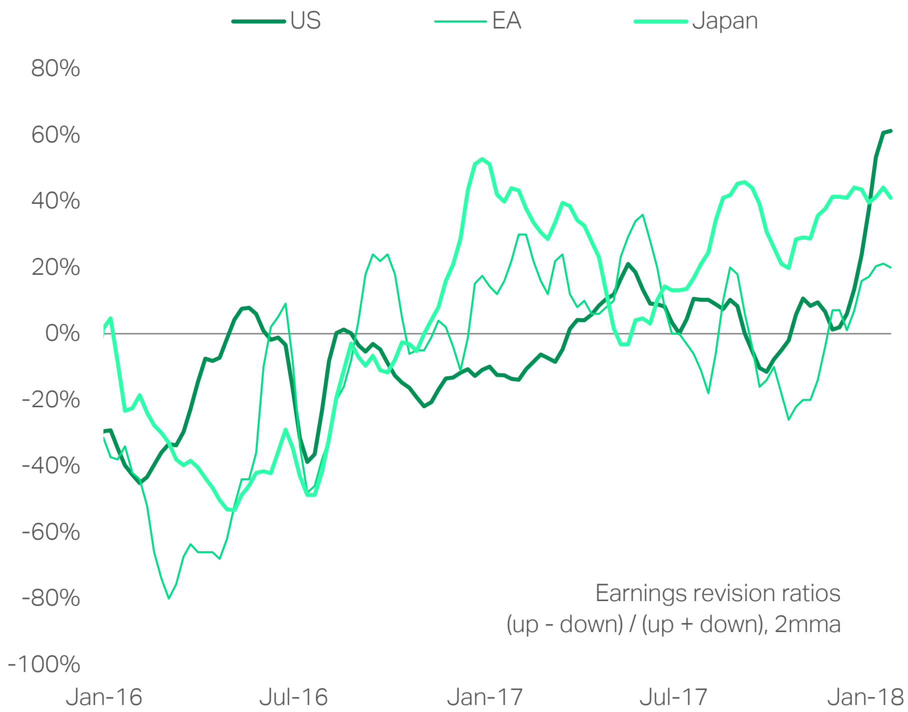
Rational exuberance

No sign of irrational exuberance in US, Europe or Asia



Investors don't appear to have fully bought into the equity rally yet, according to the State Street investor confidence survey (tracking actual buying and selling by institutional investors). Confidence on Europe has turned positive again but remains close to neutral, while the US and Asia remain slightly negative.

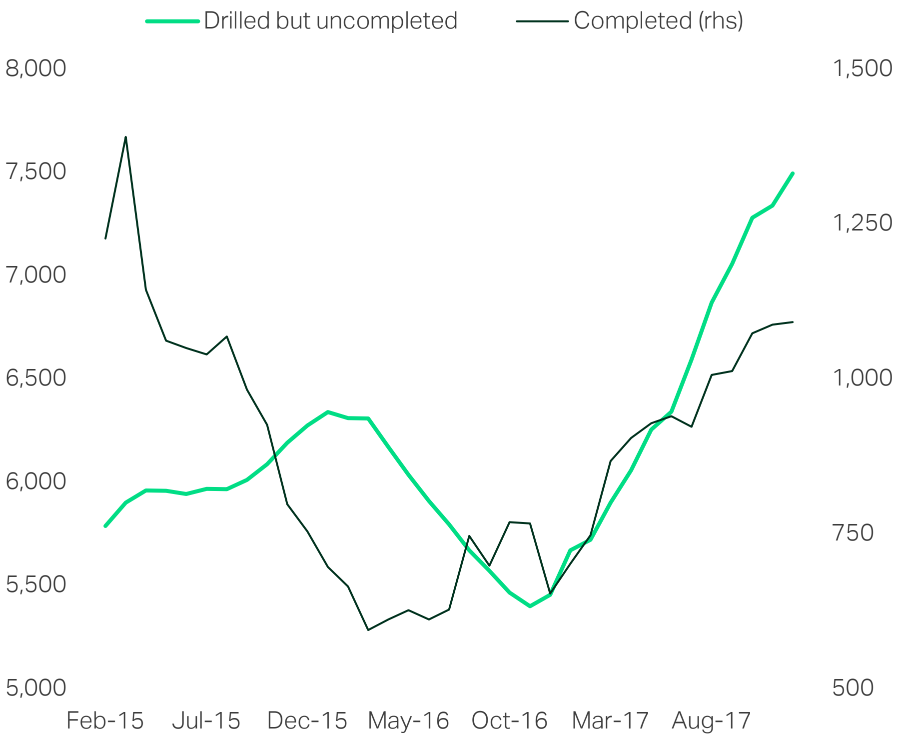
Earnings upgraded as companies revise forward guidance



Meanwhile, earnings estimates continue to be revised up as companies announce better-than-expected results and raise their forward guidance. This has been particularly the case in the US, reflecting the positive impact of the cut in corporation tax.

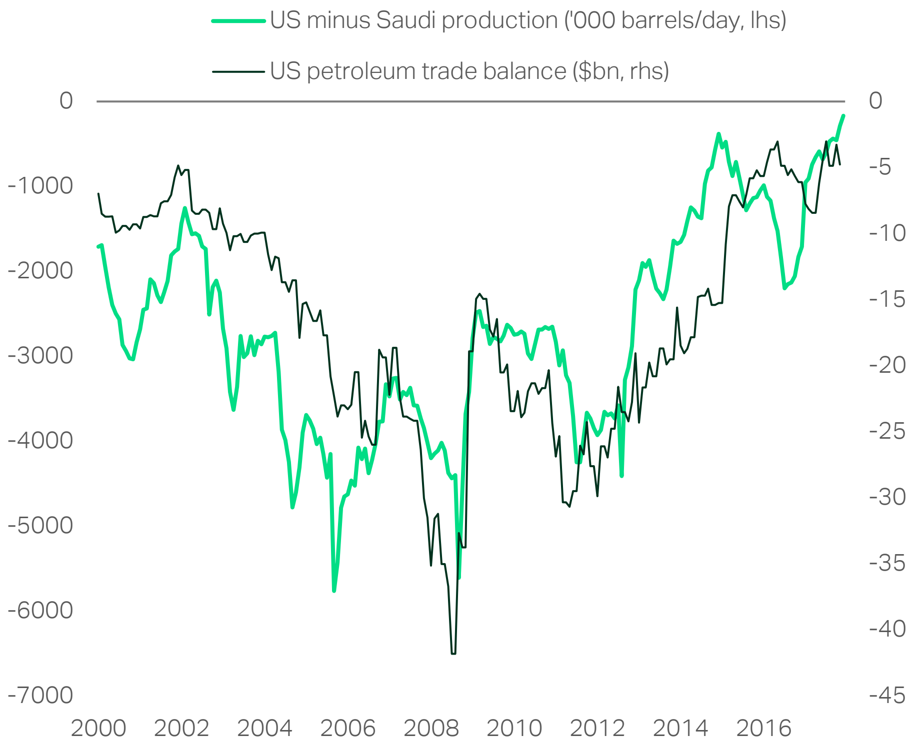
Commodities US shale increasingly the marginal price setter

Shale output can be ramped up quickly if needed



WTI has risen 50% since mid-2017: is the global oil market starting to be under-supplied, and can the rally continue? Our view is that oil should stay in a $60-70 range for now, as higher prices would elicit a significant supply response from US shale producers. The number of drilled but uncompleted wells, which can be turned on fairly quickly, is at an all-time high, while completed wells continue to recover.

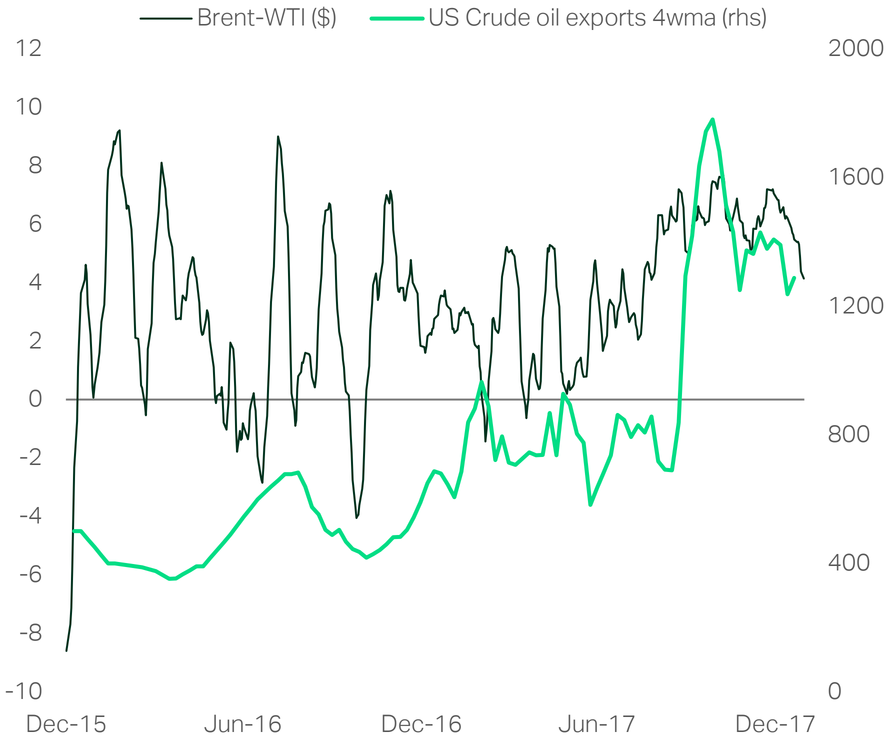
US close to energy independence



Additional US supply would likely find its way onto the global oil market The US is virtually energy independent now, producing nearly as much crude as Saudi Arabia. This suggests that global oil prices are unlikely to surge substantially above levels at which marginal US shale production is profitable.

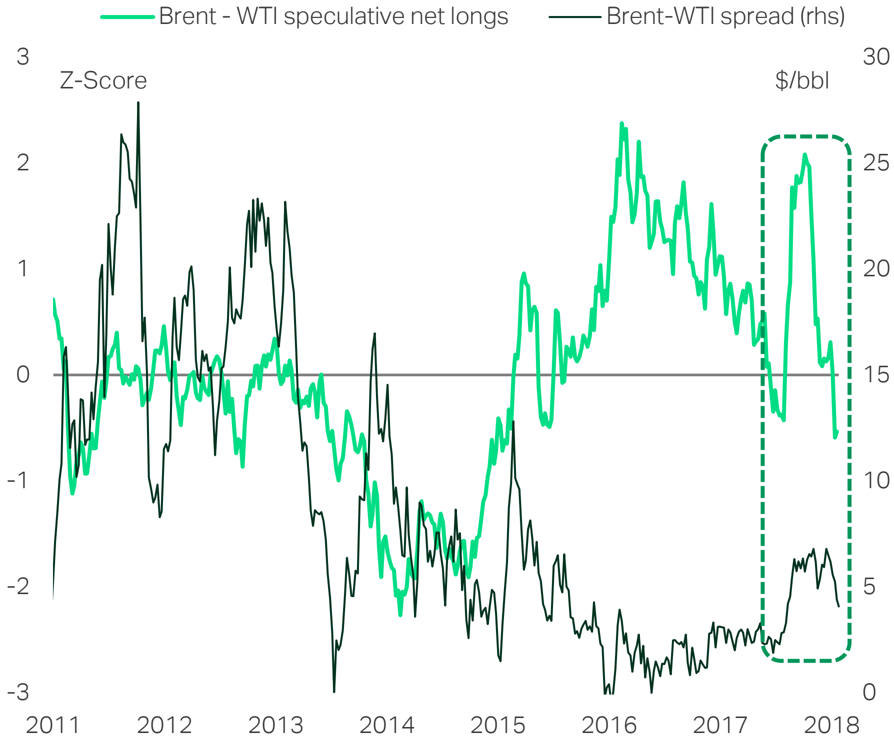
Commodities Brent-WTI spread to fall further

Brent-WTI spread normalising after sharp rise



US crude exports are normalising after the damage caused by Hurricane Harvey hit refinery capacity. Inventories in the US have been falling since March last year, and this has helped WTI prices catch up with Brent.

Speculative positions falling, so is the Brent-WTI spread



Investors are also no longer sure a Brent-WTI spread of $5-7 can be sustained and have massively scaled back their bets on a rising difference between the two benchmarks. We shorted the spread on 6-Oct-2017 and keep the position open with a target of $3/bbl.

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