Strategy Chartbook

# FEBRUARY 2019 CHARTBOOK

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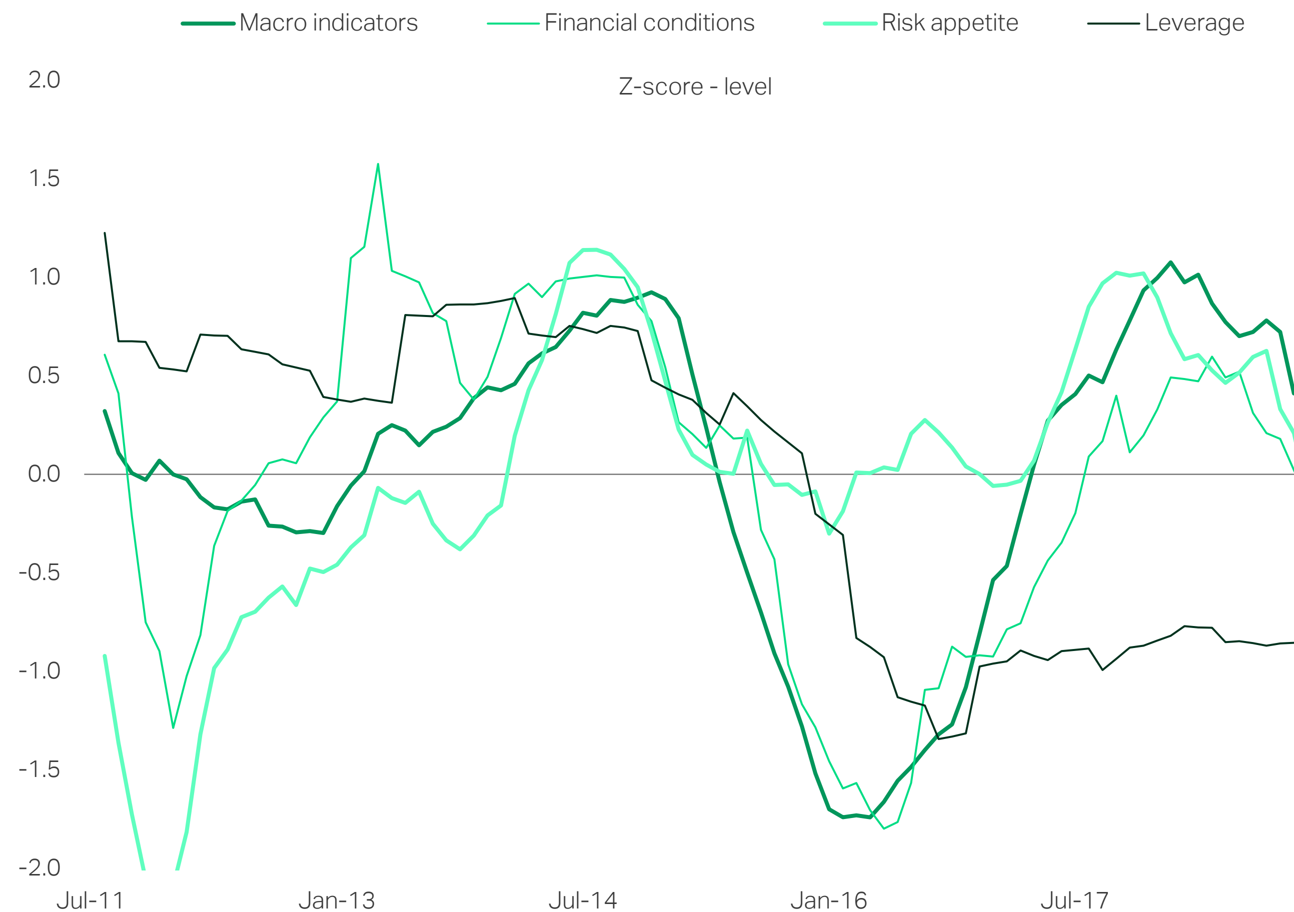
## HIGHLIGHTS

- **Macro Drivers.** Yield curves sometimes overstate recession risk, but growth is likely to slow further
- **Multi Asset.** The credit cycle has moved from the 'downturn' to the 'slowdown' stage
- **Fixed Income.** Fed likely to ease QT policy, helping to calm markets; EA needs (and will get) TLTROs
- **Currencies.** Change in QT pace may end dollar squeeze; upside risks to EUR building
- **Equities.** Tech and Industrials are the US sectors most vulnerable to China's slower growth
- **Commodities.** China's slowdown to keep hurting commodity prices for a few more weeks

# Chart of the month

## Credit cycle in the 'slowdown' stage




Timing the credit cycle is of paramount importance to credit spread investors, but it is a factor that heavily influences the performance of other asset classes, too. We warned last June that credit's best days were behind us. Since then we have gradually downgraded our stance on corporate bonds from neutral to negative on both IG and HY.

To monitor the evolution of the cycle more precisely, we have created a framework that looks at 14 measures in four broad categories – macro, financial conditions, risk appetite and leverage. All but leverage (which has been at cyclical lows for some time) are now materially weaker than six months ago, placing overall credit conditions in the 'slowdown' stage – below cyclical average and deteriorating.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* EM trade boomed on front-loading of Chinese imports. The boom is over.
- *Fixed Income.* Tweaking duration in the Fed's SOMA portfolio could become a policy tool.
- *Currencies.* Balance-of-payments dynamics will test CNY this year.
- *Equities.* Tech and Comms account for more than half of capex growth. Is this sustainable?
- *Commodities.* Slower growth is hindering oil's recovery, as is elevated market volatility.

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# Summary – key points

## Macro Drivers

- Yield curve recession probabilities are sometimes overstated; professional forecasters are not worried yet
- We expect Chinese PPI to move into negative territory, weighing on inflation rates in the rest of the world
- But we also see "QE" in China: authorities are focusing on providing cheaper liquidity to firms, boosting short-term growth

## Multi-Asset

- The credit cycle has moved from the 'downturn' to the 'slowdown' stage
- The measures we monitor to track it (macro, financial conditions, risk appetite and leverage) are either bad or deteriorating
- QT caused a drain in excess bank reserves that sent ripples through financial markets; tapering QT should help

## Fixed Income

- Changing the pace of QT has a small real policy effect, eventually; transmission is mainly via lower vol and calmer markets
- Over €700bn of TLTROs are outstanding, and TLTRO-II is due to start expiring in mid-2020. We expect another round in March
- Gilt inflows are waning now the ECB is no longer crowding out EA portfolio investors; a flip to outflows is likely soon

## Currencies

- The decline in Fed excess reserves supported the rising dollar since last year; if QT slows or ends, USD support will fade
- Upside risks to EUR are increasing as the broad basic balance of payments of the EA is now in surplus
- China's looming current account deficit and signs of increasing capital outflows will put downward pressure on CNY in 2019

## Equities

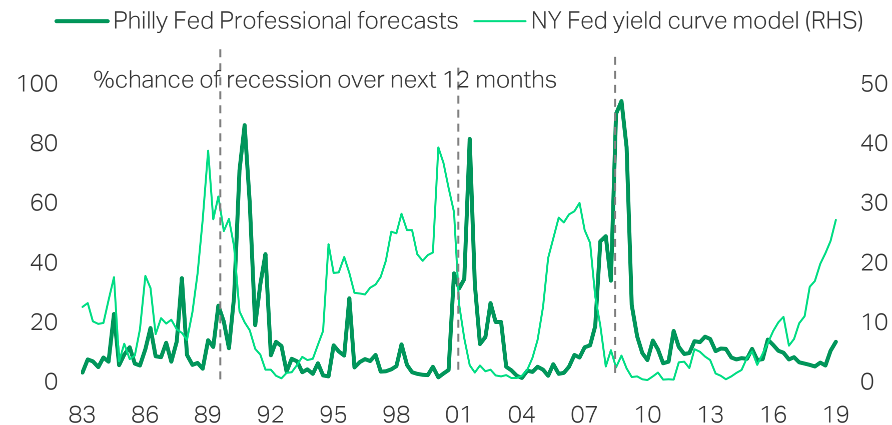
- Technology and Industrials are the US sectors that are most vulnerable to China's slower growth
- Banks should benefit from the Fed easing we expect (QT taper soon, rate cut in Q3) plus upside for yields in the near term
- More than half of the capex surge of the past few quarters has been due to Tech and Comms; this seems unsustainable

## Commodities

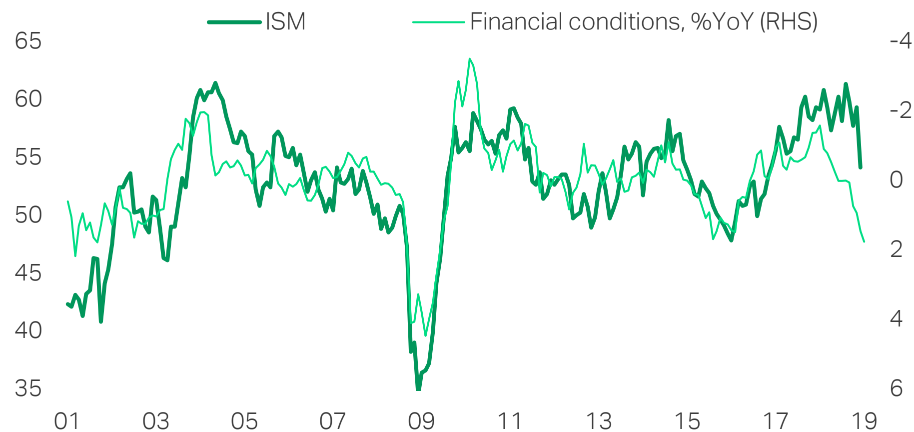
- The collapse in manufacturing surveys is one of the reasons the recovery in oil prices has stalled
- Financial market volatility is also preventing oil vol from normalising and consequently preventing oil prices from rising
- China's slowdown has weighed on industrial metals too, though these remain rich – prompting us to go -1 in Asset Allocation

# Macro Drivers Recession not imminent but growth slowing

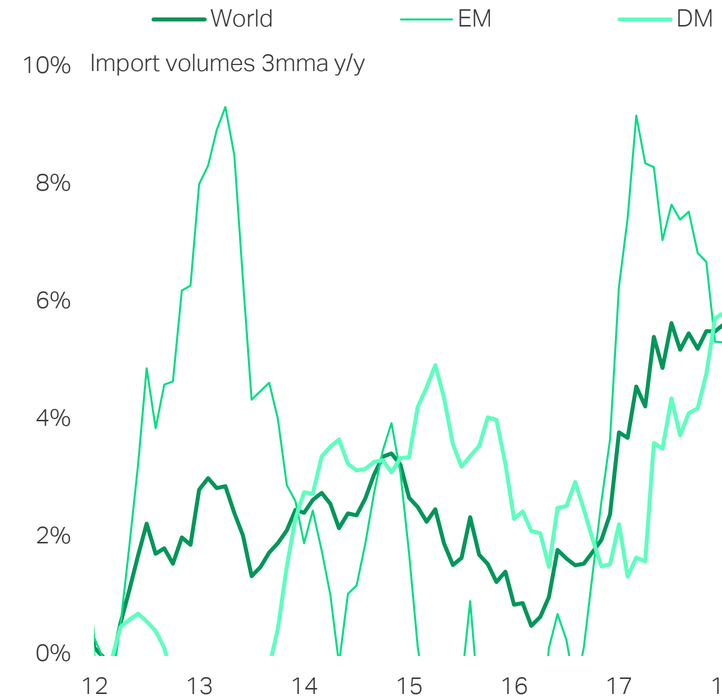
## The US yield curve sometimes overstates recession risks




## But tighter financial conditions suggest growth will slow further



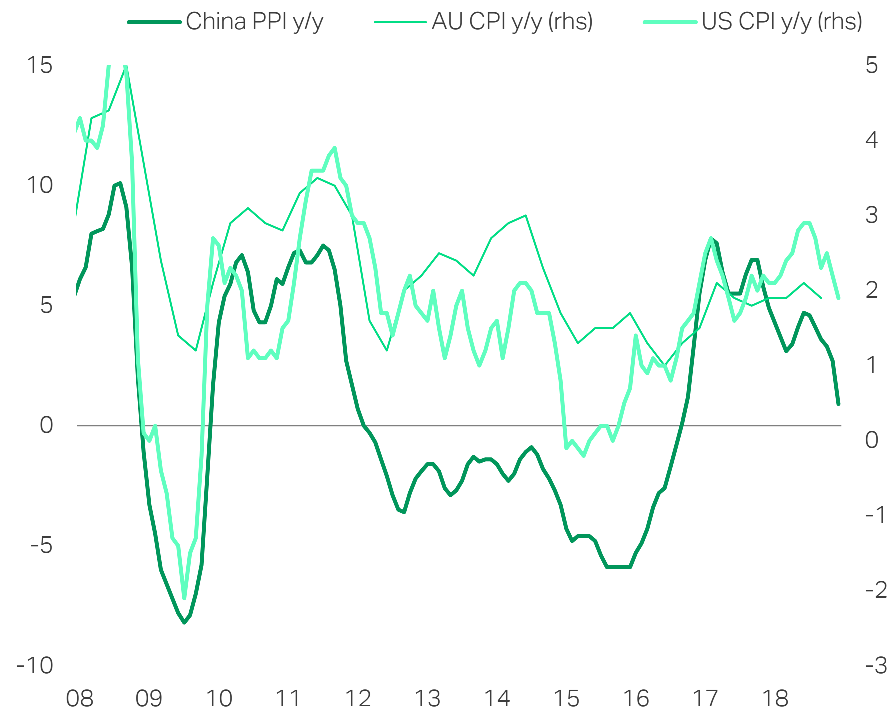

## Global trade slowing after frontloading of Chinese imports ends




Import growth was buoyed by frontloading of Chinese imports at the end of last year ahead of the expected ratcheting up of US tariffs. But this has now tailed off and global demand is slowing. DM exports already reflect falling demand, and preliminary data from Korea (-14.6% YoY in January) suggest the fall is widespread. Slower economic growth is on the horizon, but we expect the Fed to ease policy soon so a recession is not yet on the cards.

# Macro Drivers PPI deflation; bank loan reflation

## China is heading for PPI deflation, negative for global CPI



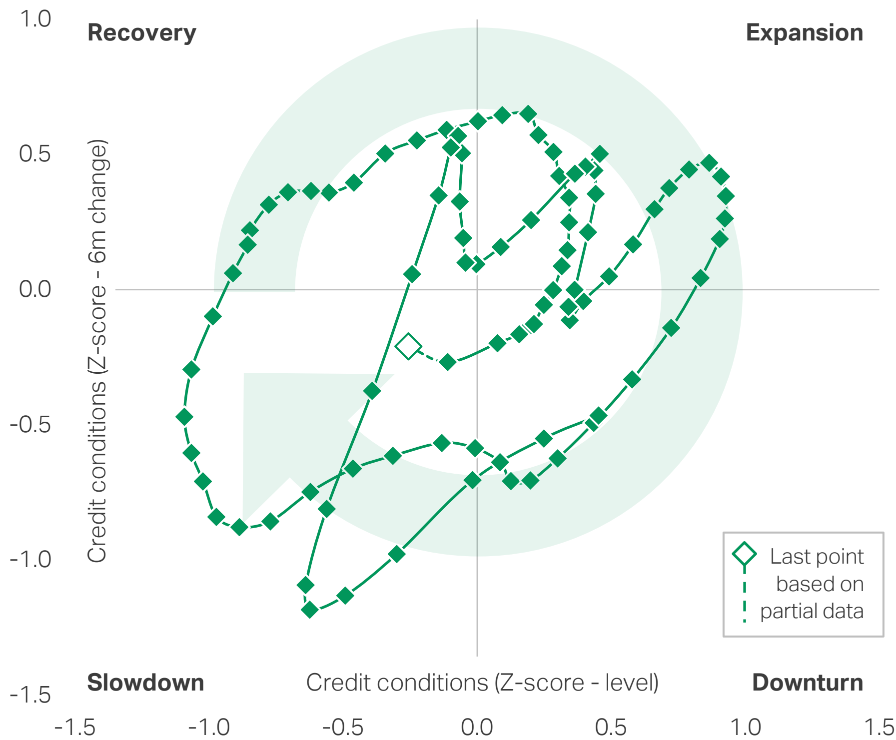

Chinese producer prices are set to fall this year, weighing on domestic industrial profits. PPI deflation in China is also negative for global inflation. The correlation between Chinese PPI and US CPI is over 50%, and Australian inflation – already easing thanks to growth in online retail sales and a housing market slowdown – now has another downside risk.

## Chinese bank loan growth highest since 2016

Alongside declining bond yields, the rise in Chinese bank loan growth signals a rapid easing in policy since December. Policy is focusing on providing cheaper liquidity to corporates via official channels, so should be more contained than previous credit easing episodes, but we reckon this bout of Chinese-style QE will still provide a boost to growth in the short term.

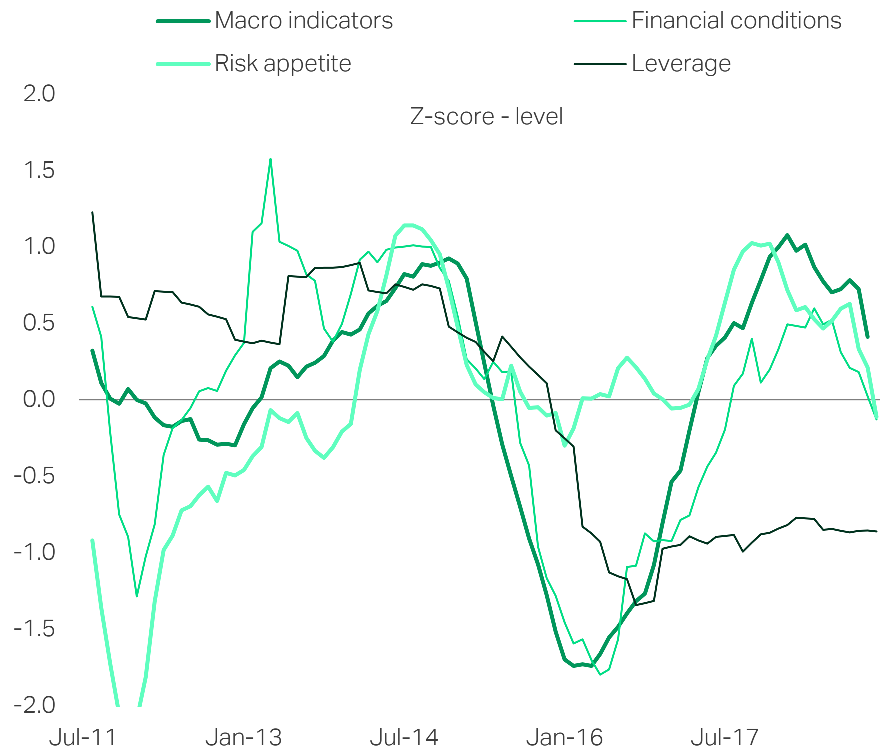
# Multi-Asset Credit cycle in the 'slowdown' stage

## Below trend and getting worse




We noted as far back as last June that the credit cycle was well past its peak, and things have been deteriorating since. In a recent Daily Note we introduced a new framework to monitor the cycle more precisely and found that it is in the 'slowdown' stage: overall credit conditions are below their cyclical average and are getting worse.

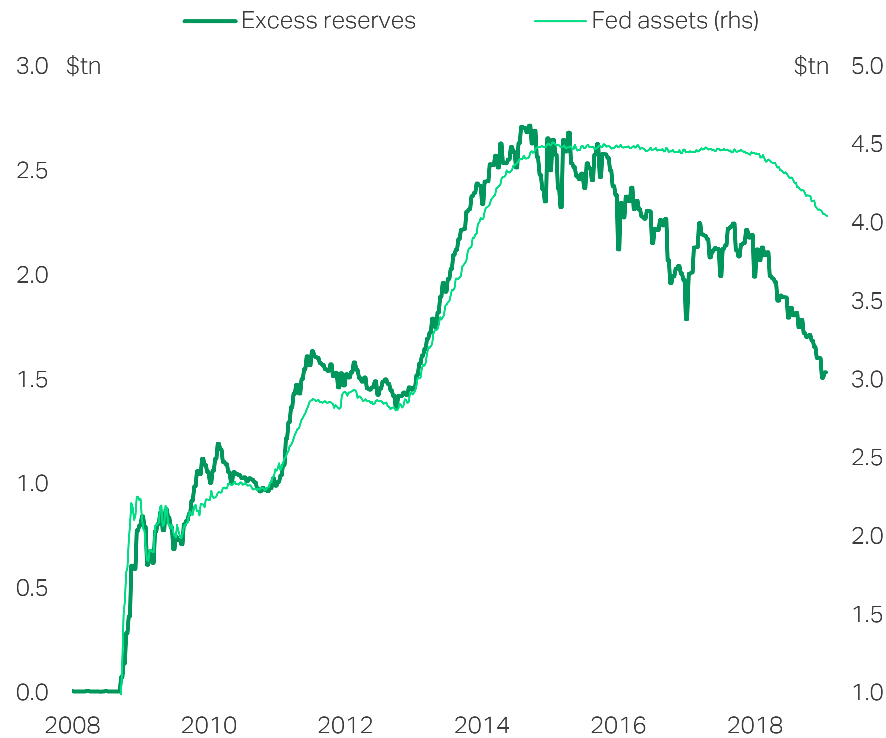
## Most measures deteriorating – or outright bad




We look four broad categories of indicators – macro, financial conditions, risk appetite and leverage. We found that macro indicators remain above trend but are decelerating rapidly; financial conditions are on trend and getting tighter; risk appetite is slightly below average and falling sharply; and leverage is cyclically high but stable.

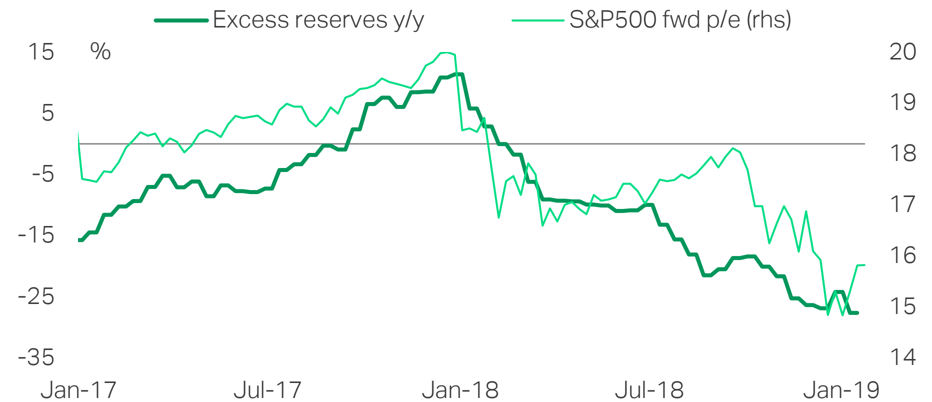
# Multi-Asset QT taper to ease pressure on stocks, bonds

## Excess reserves falling faster than Fed assets

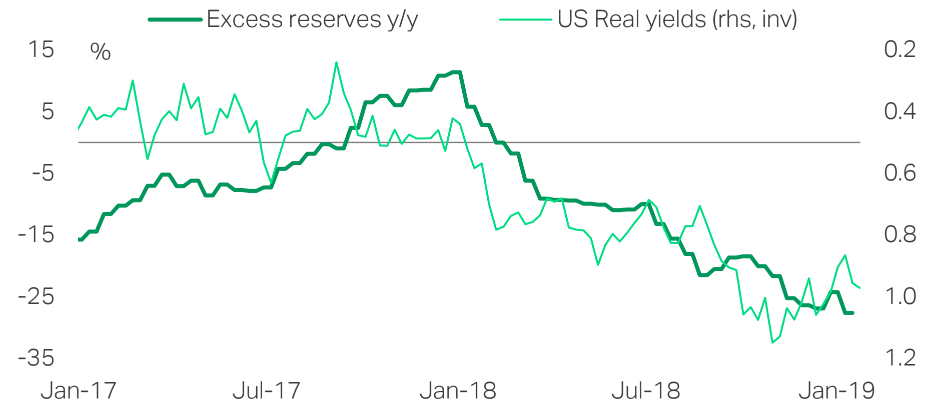



While the reduction in the size of the Fed's balance sheet so far has been minimal (about 10% from the peak), excess reserves have fallen nearly by half, forcing the Fed to reconsider its approach to balance sheet normalisation. We think the Fed will soon 'taper' QT, as both stock valuations and real yields have been affected by the rapid pace of decline in excess bank reserves.

## Valuations have fallen sharply since the start of QT

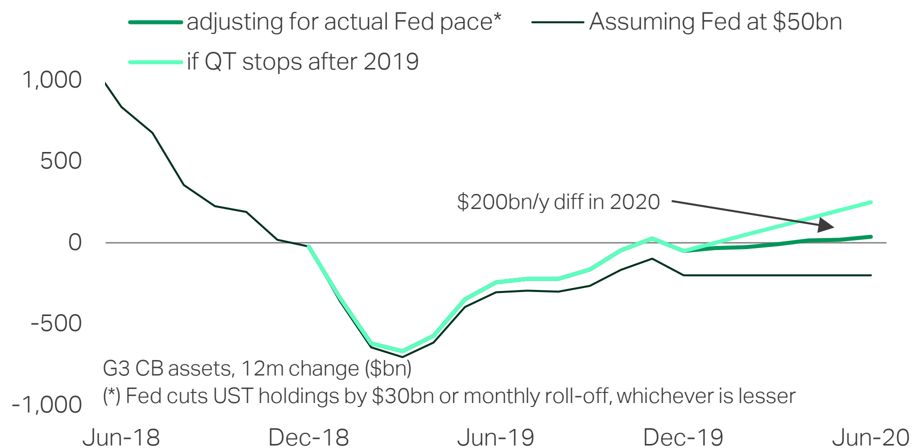



## Real yields moving higher as Fed QT drains excess reserves

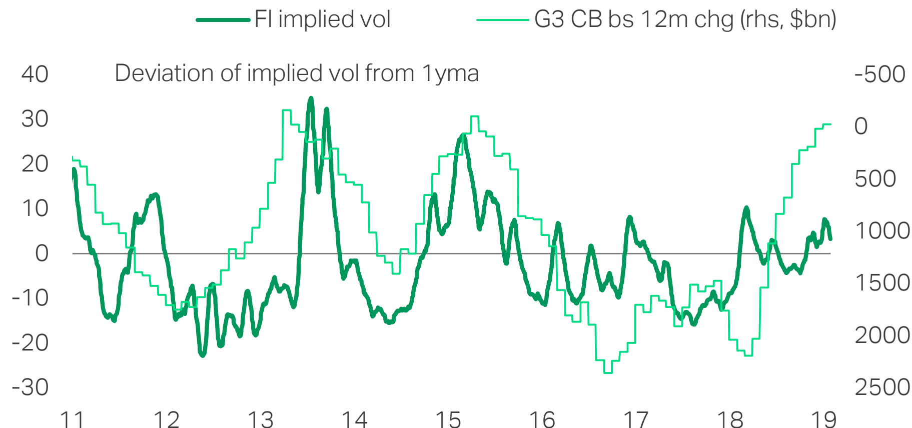


# Fixed Income Fed balance sheet can be an easing tool

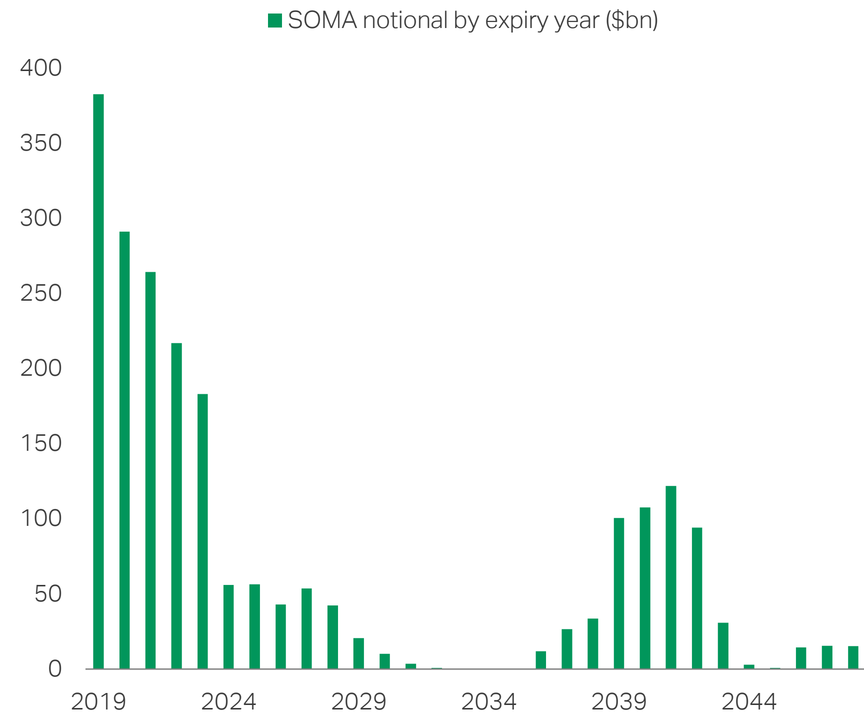
## A QT taper (or halt) has a small real policy effect, eventually




## But it is likely to halt the vol rise, helping to calm markets



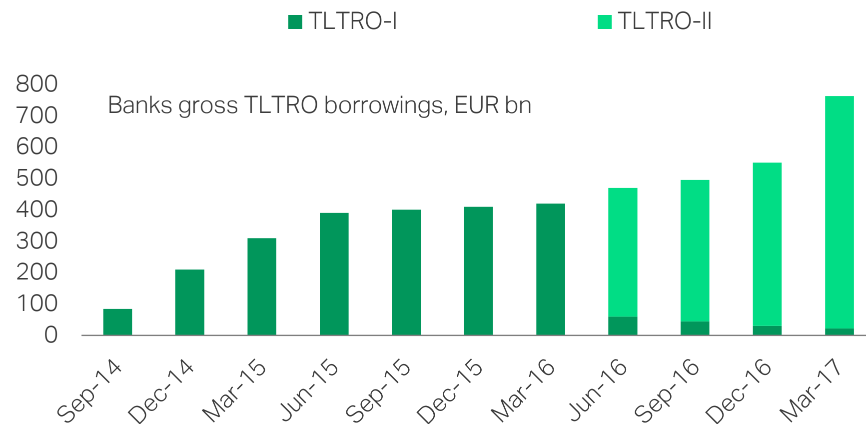

## SOMA portfolio could become a policy tool



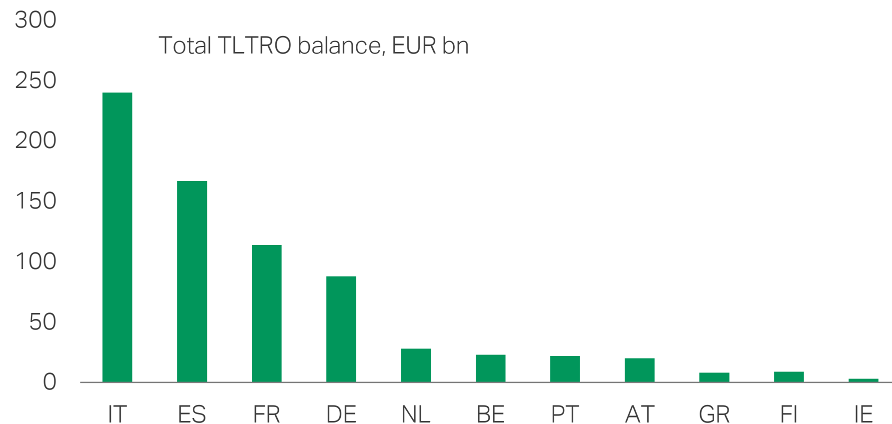

The NY Fed's SOMA portfolio has an average duration of six years. As bonds mature, the Fed tends to reinvest proceeds above its $30bn monthly QT cap across the curve. A policy of reinvestment in short-term instruments would therefore cut the average duration and bull-steepen the yield curve. December's FOMC Minutes pointed out that such a strategy would give the Fed another policy-easing tool in the future.

# Fixed Income EA needs TLTROs

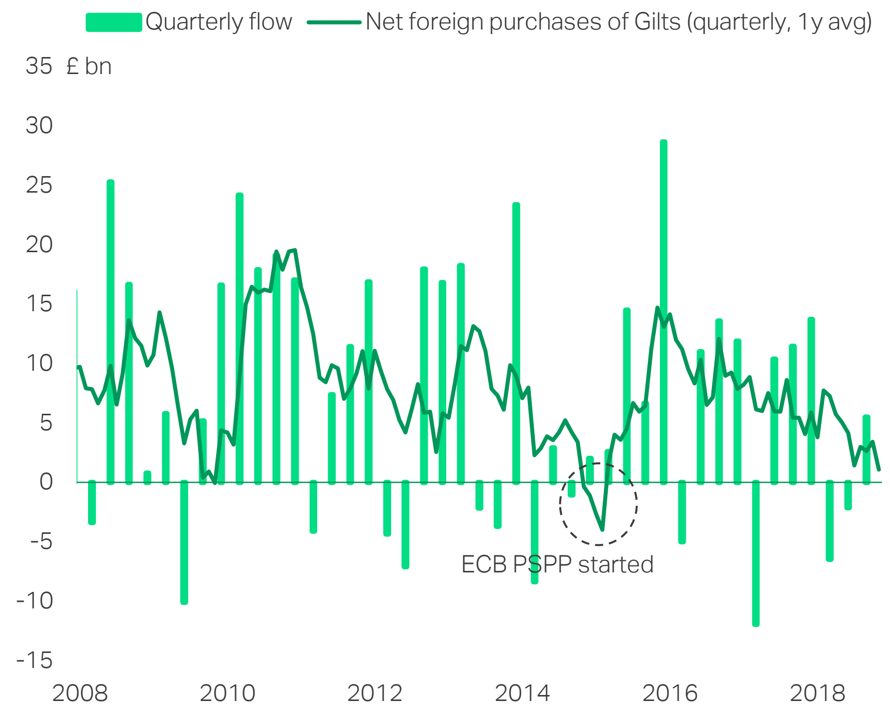
## We expect ECB TLTROs in March, to offset expiring TLTRO-II




## Italy relies on TLTROs, but ultimately they are no panacea



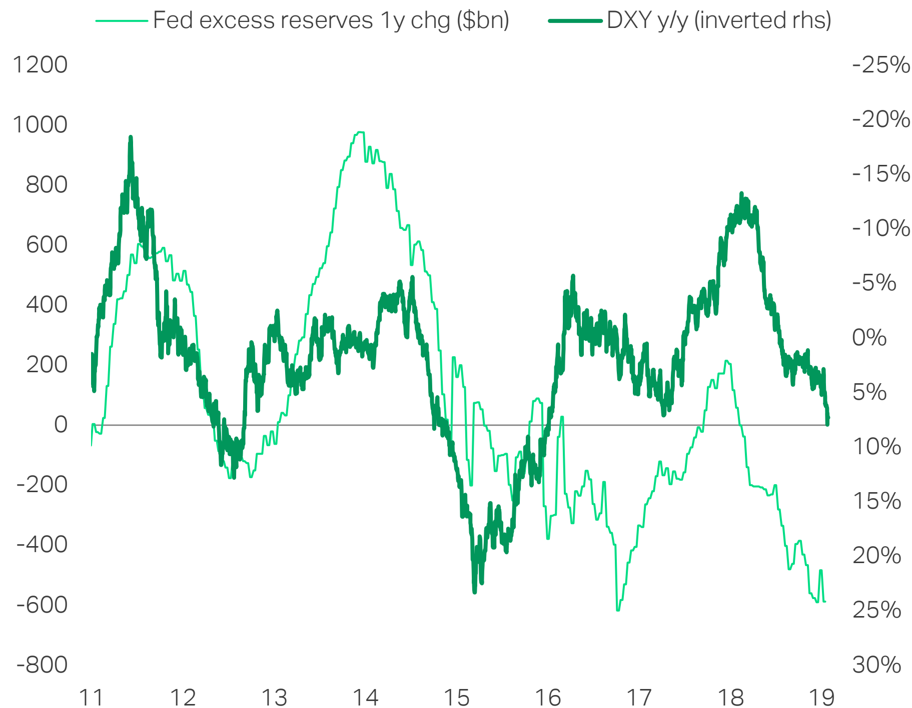

## Gilt trip




Foreign investor demand for Gilts is on the wane. It has dropped from a peak quarterly inflow of £15bn after the ECB started buying government bonds in 2015 to the current pace of £1bn/quarter. Now that the ECB has finished QE and portfolio flows are returning to the euro area (see the Currencies section), it is likely that foreign demand for Gilts will fall further. While Brexit dominates all UK investment decisions at the moment, it is still worth bearing the deteriorating demand picture in mind.

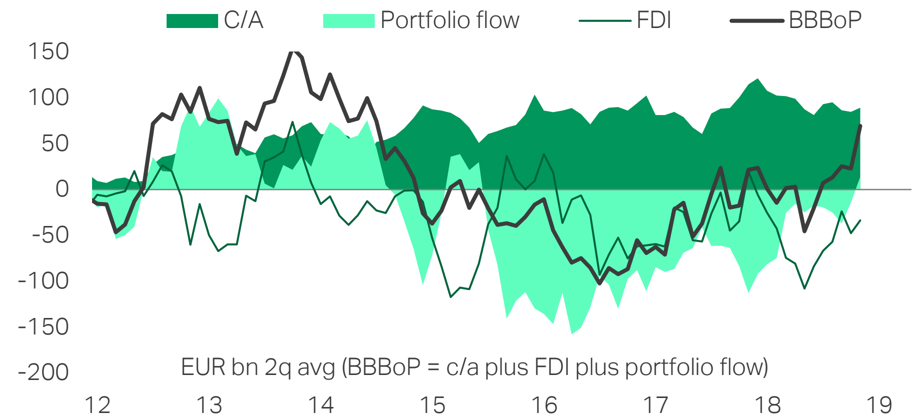
# Currencies USD depends on Fed QT; EUR on data

## Change of QT pace may end the dollar squeeze

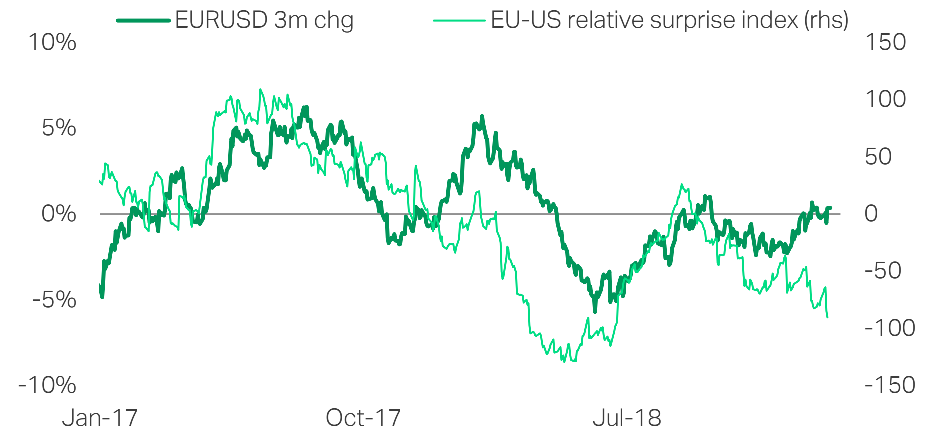



The specific aim of Fed QT was to reduce the size of its balance sheet. But, along with tighter regulation changing the way banks manage their reserves, a decline in the excess reserves component of the balance sheet (defined as total reserves minus reserves required by the Fed) has been one reason why USD has rallied. Tapering QT will arrest the squeeze on excess reserves and probably on USD too.

## EA BBBoP improvement signals support for EUR strength

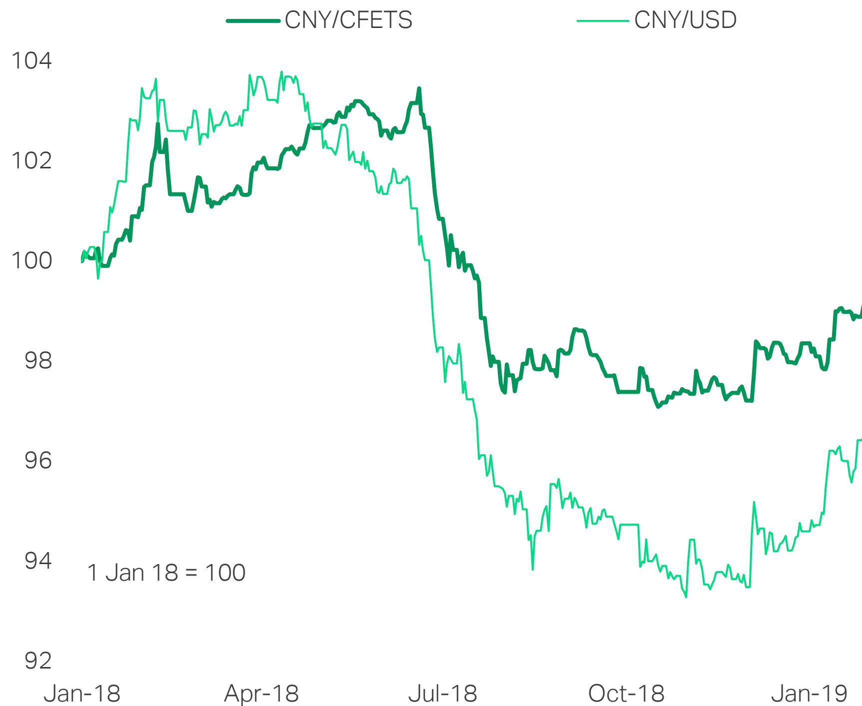



## But for the currency to rally economic data need to improve



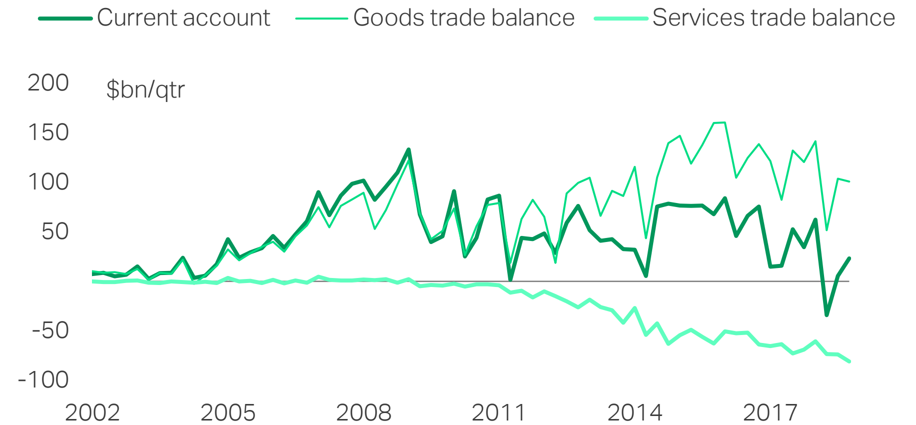
# Currencies CNY stability to be tested by BoP

## CNY close to unchanged vs basket

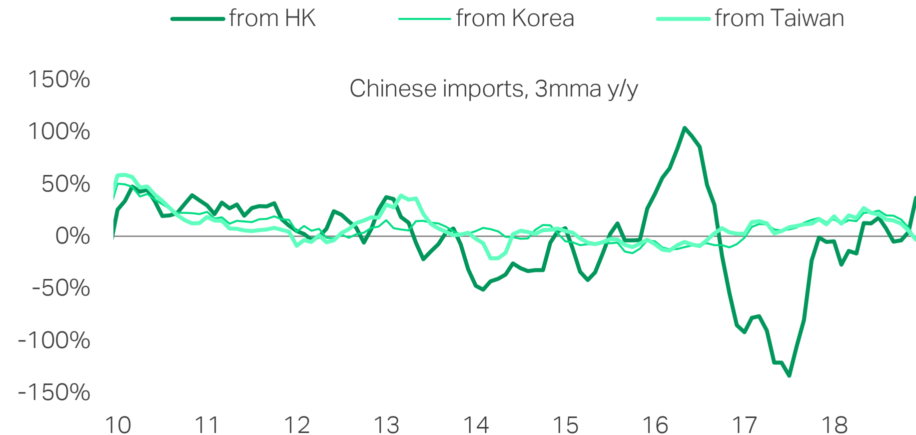



The renminbi has recovered some of its 2018 losses and is almost unchanged against the CFETS basket since the start of last year. This stability will be tested in 2019 as the C/A to swing into deficit due to falling goods exports. Trade data with Hong Kong are out of line with other imports. This is reminiscent of 2015/16, when over-invoicing disguised large capital outflows from China, causing CNY to fall by 12% vs USD.

## But we expect the current account to fall into deficit this year



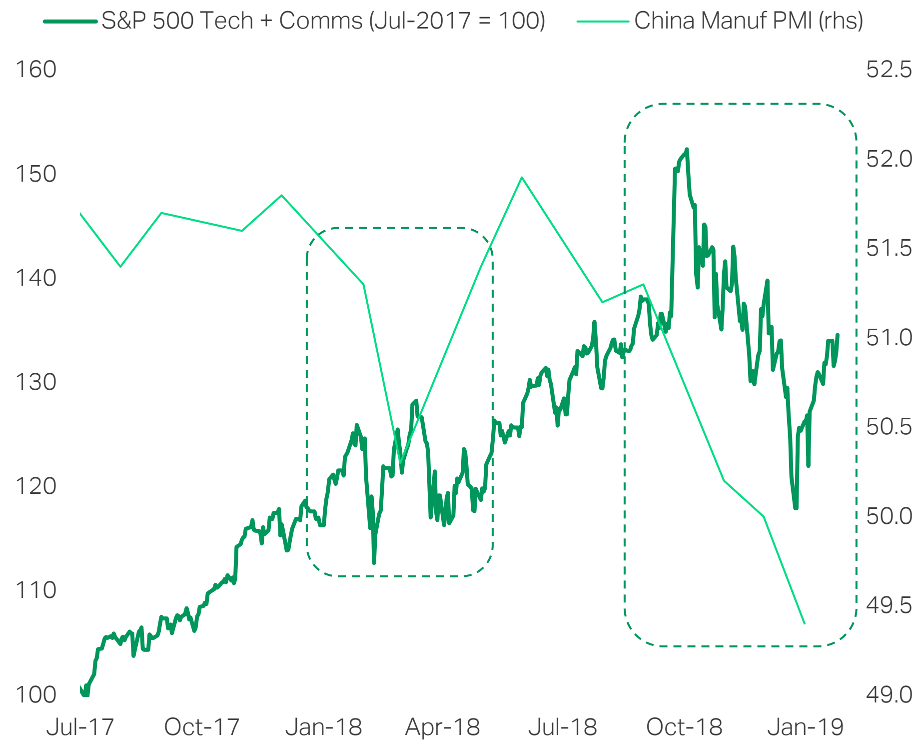

## Rise in imports from HK is reminiscent of 15/16 capital outflow



# Equities

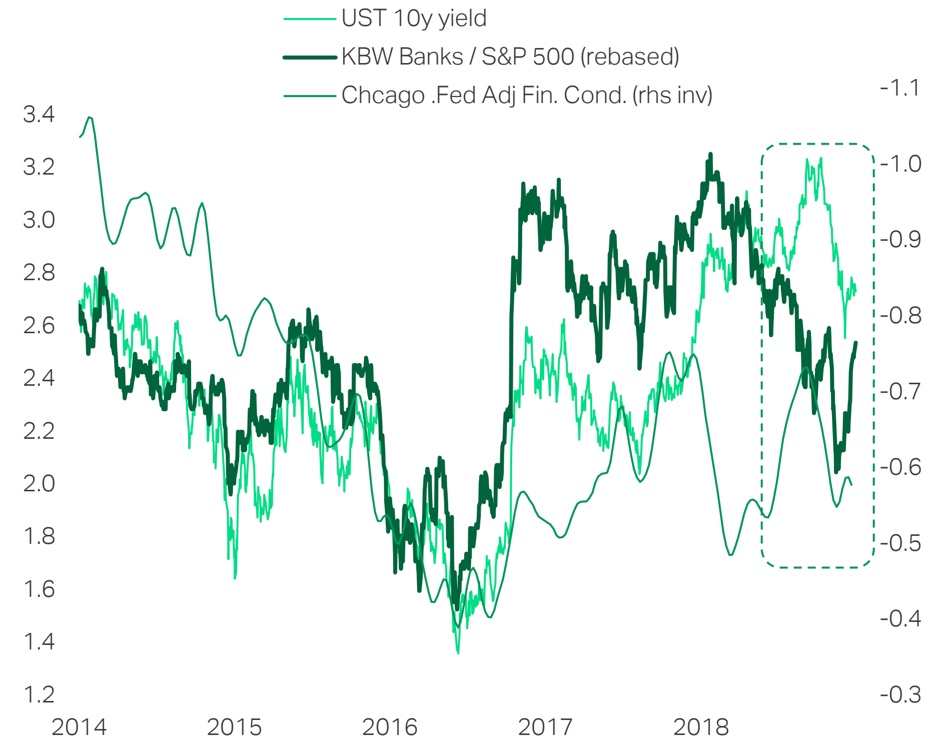
## Tech vs Banks

### Technology companies vulnerable to China's slowdown




We highlighted in a recent Daily Note that US Technology and Industrial companies are especially exposed to the slowdown in China, as they derive about 60% and 40%, respectively, of their sales from non-domestic markets. Since we expect Chinese data to remain weak in H1, these sectors look particularly vulnerable. A recovery is far from assured.

### Banks to benefit from QT taper, with yield risk to the upside

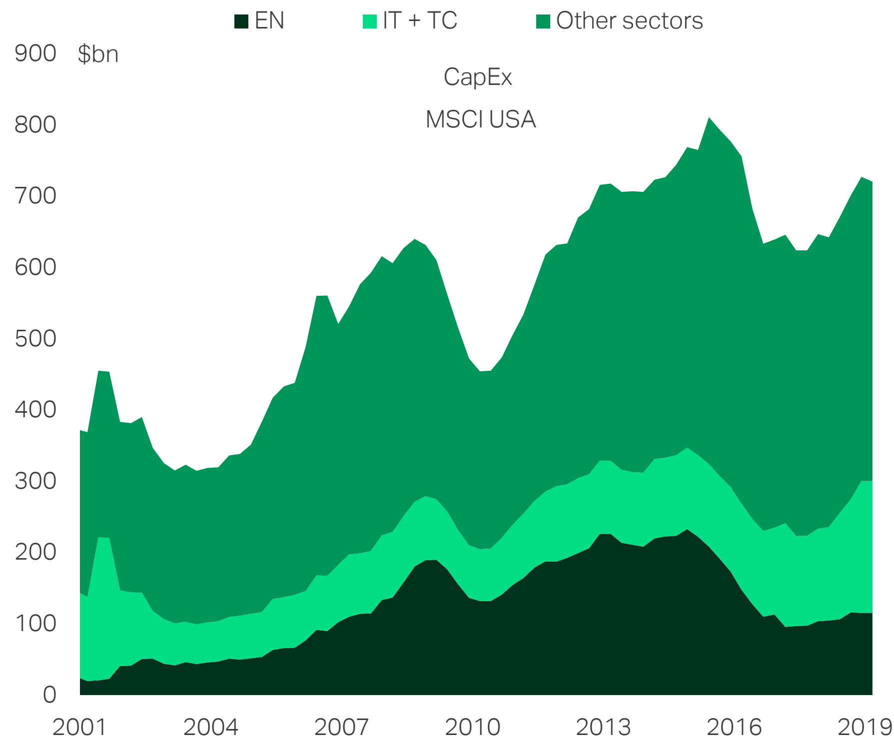



Banks' relative performance decoupled from Treasury yields when financial conditions tightened as a result of Fed policy and wider credit spreads (see *Multi Asset*). We expect some degree of monetary easing by the Fed (QT taper soon plus a rate cut in Q3), with yield risk skewed to the upside in the near term. Banks should benefit on both counts.

# Equities

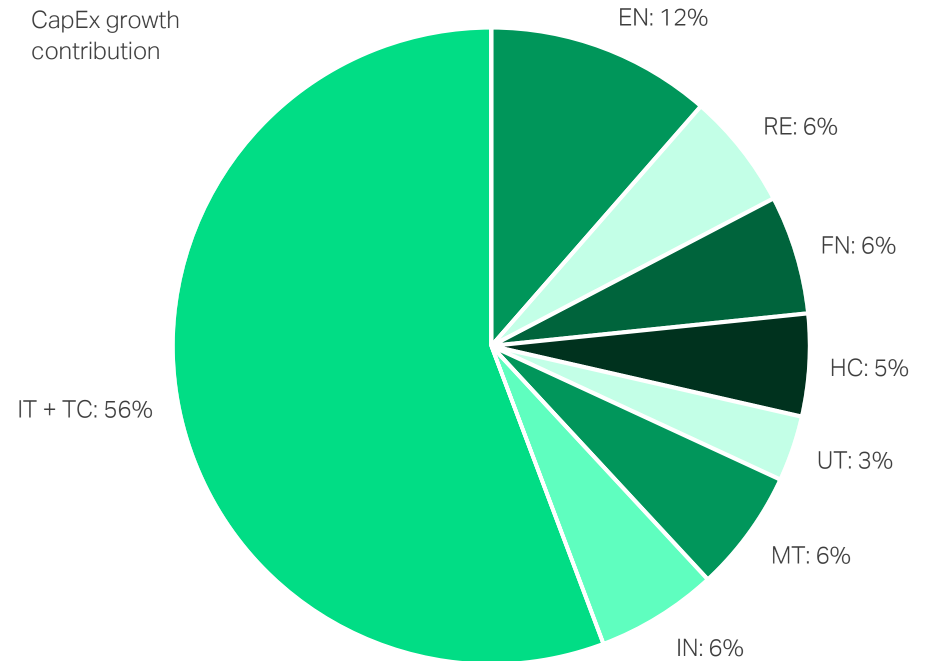
## How sustainable is the Tech capex surge?

### Corporate capex has picked up sharply in recent quarters…




Aftr a dearth of capital spending in the wake of the oil price crash in 2014-15, corporate investments have picked up sharply in recent quarters. Tech (IT) companies, some of which are now in Communication Services (TC), have led the charge. With Tech threatened by China's slowdown (see above), is this capex recovery sustainable?

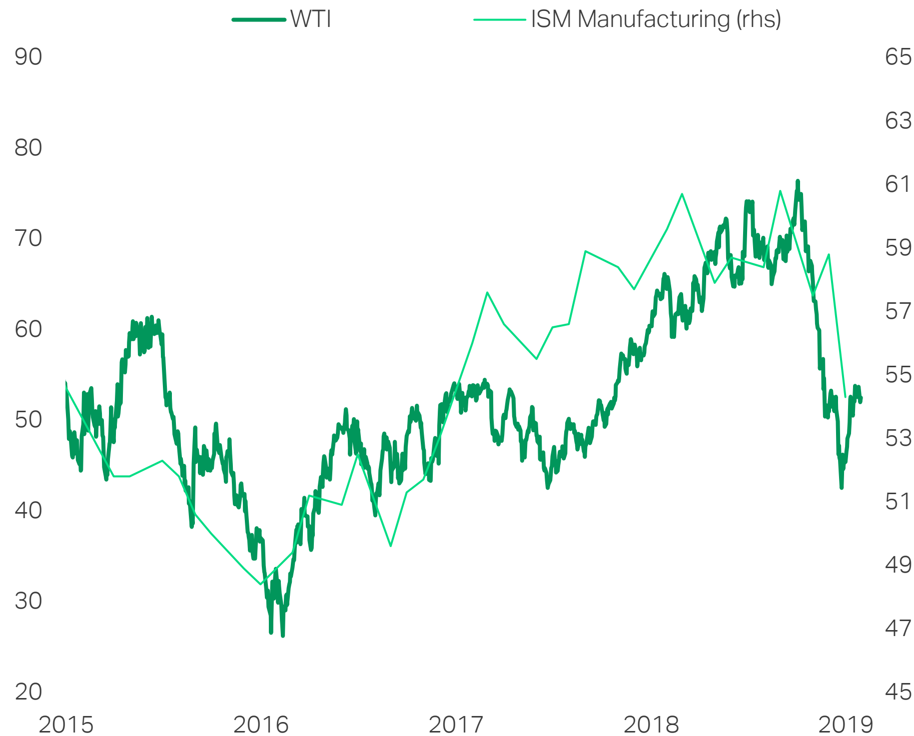
### …But more than half of it comes from Tech/Comms




Tech and Comms account for one-quarter of all capex by US large caps, and a whopping 56% of all capex growth in the last 12 months. As capex tends to follow profits with a four-quarter lag, the slowdown in Tech earnings (due to China) bodes ill for a continuation of the strong investment trend beyond the short term.

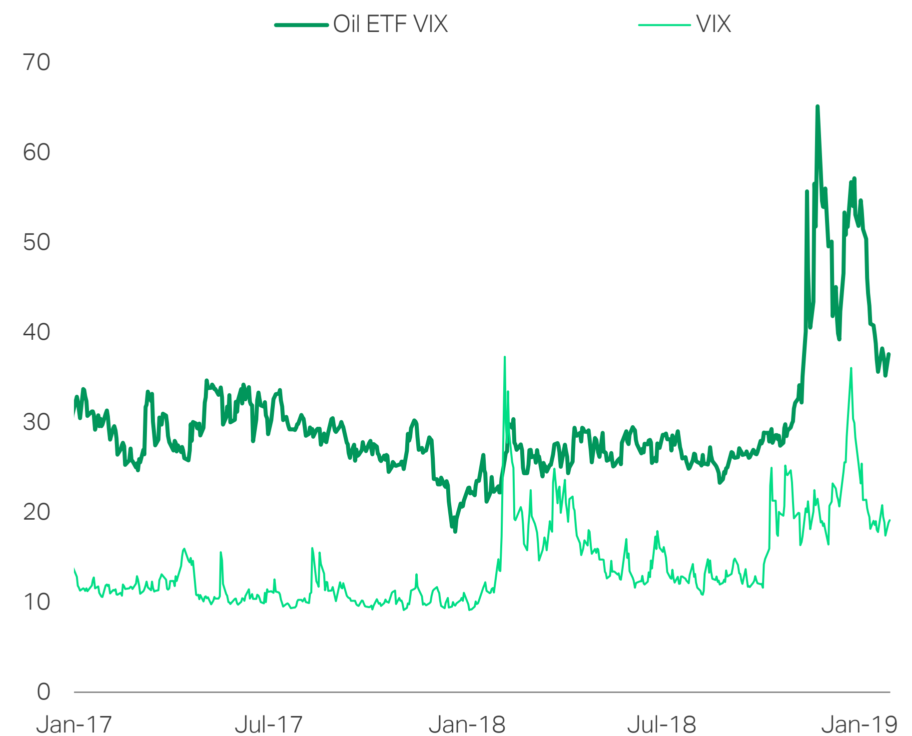
# Commodities Crude oil hostage to growth, markets, data

## Slowing growth hindering oil price recovery




The collapse in manufacturing surveys in the US and elsewhere is one of the reasons the recovery in oil prices has stalled in the past couple of weeks. Stubbornly high volatility in financial markets also helps explain why oil's vol has not subsided and why prices keep bouncing.

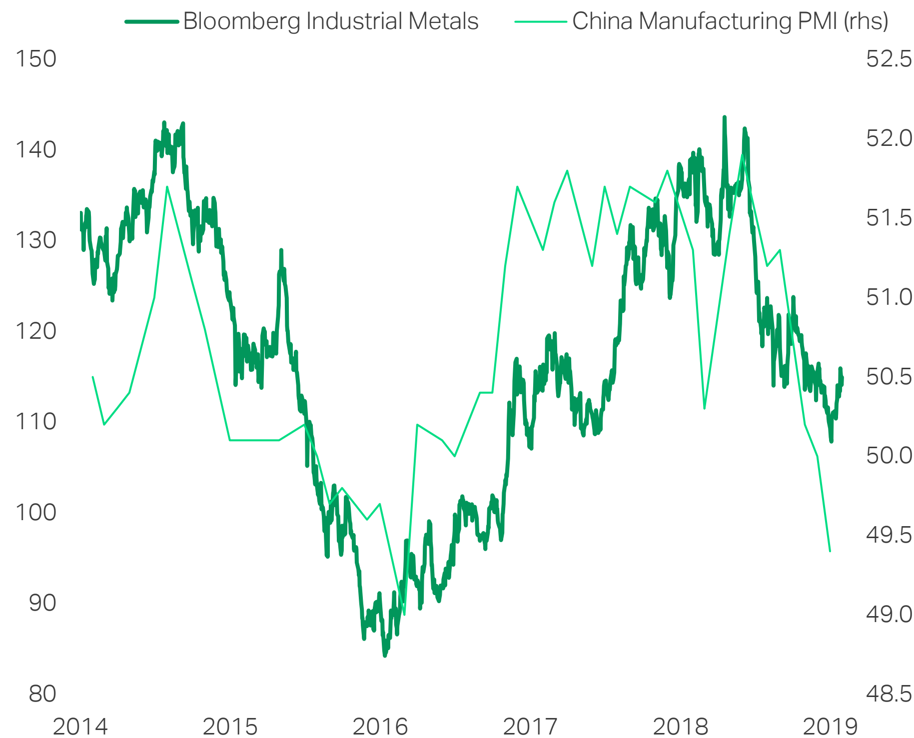
## High volatility in financial markets also a drag on crude prices




We kept our **+1** bias on Energy Commodities in Asset Allocation this month, following December's upgrade. However, we believe that the lack of reliable data from China (Lunar New Year) and the US (government shutdown) will prevent sentiment from improving significantly in the next few weeks .

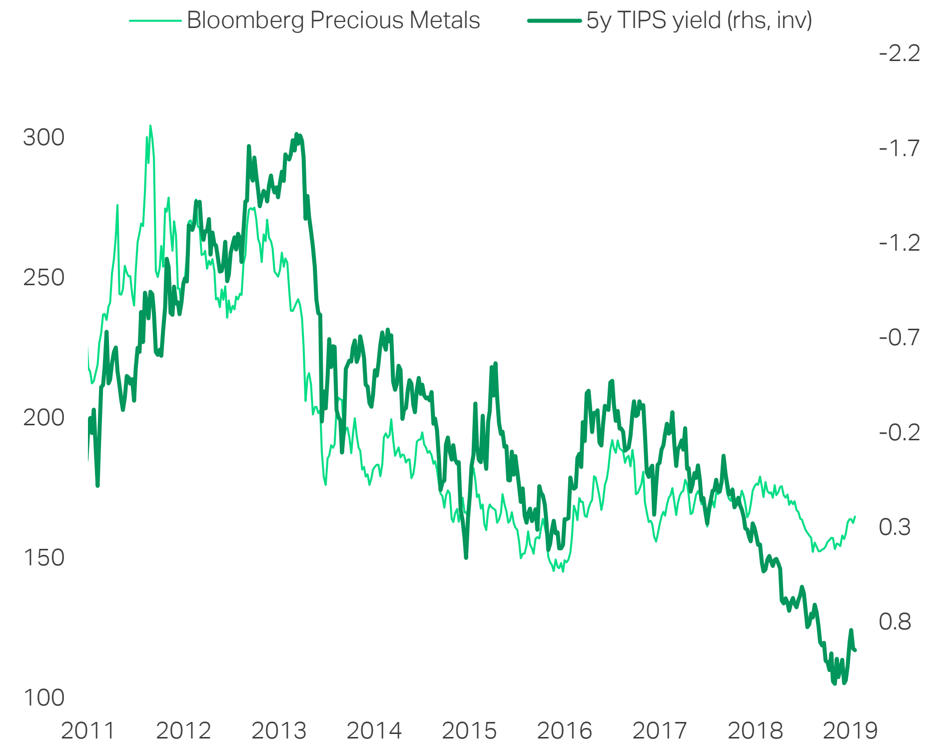
# Commodities Metal bashing

## Industrial metals trading rich considering China's slowdown...




China will likely continue to slow down in H1 before the effect of easier policy and stimulus starts showing up in the data in H2. We have downgraded Industrial Metals to **-1** in Asset Allocation to reflect this prospect. Another reason is that copper and other base metals remain too expensive considering the extent of China's slowdown.

## ...And precious metals are rich compared to real yields




Gold and other precious metals were strong in H2 2018 and have remained robust so far this year. Market vol is likely to stay elevated for now, lending support to precious metals. Nonetheless, we remain neutral in Asset Allocation because we continue to expect real yields to rise as the end of global QE leads to a normalisation in term premia.

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