Macro Strategy

TRADE WAR UNCERTAINTY FAVOURS IDIOSYNCRATIC RISK

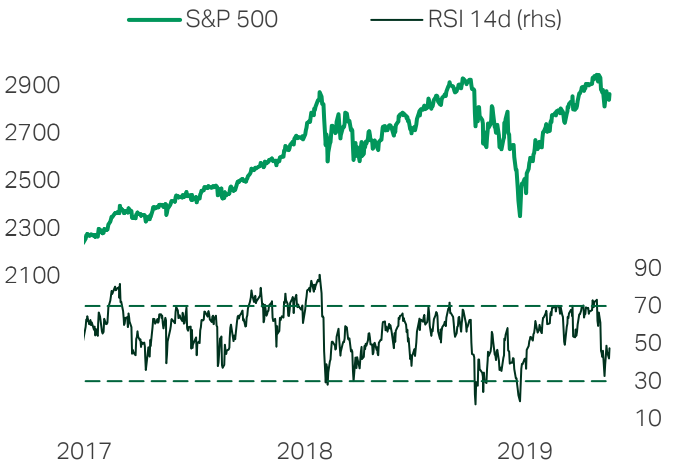
Andrea Cicione / Nikol Hearn

- **Equity markets shrugging off trade war dangers**
- **Uncertainty likely to linger, making directional market calls difficult**
- **We focus on idiosyncratic risk, adding an RV trade in US Healthcare**

Much ado about nothing? If history is a guide, it is entirely plausible to believe that the latest flare-up in the US-China trade conflict is nothing to worry about, being simply the result of Trump doing what Trump does: putting extreme pressure on his counterpart, often at the last minute, in order to obtain the most favourable terms in a negotiation. His dealing with North Korea is an example of such a pattern, with the US president threatening 'fire and fury' shortly before a summit with Kim Jong-un, only to conclude a deal with him shortly thereafter. If this is indeed the case, we could see a swift resolution of the latest spat with China at the G20 summit in late June in Osaka, where Trump and Xi Jinping could pave the way for a trade deal.

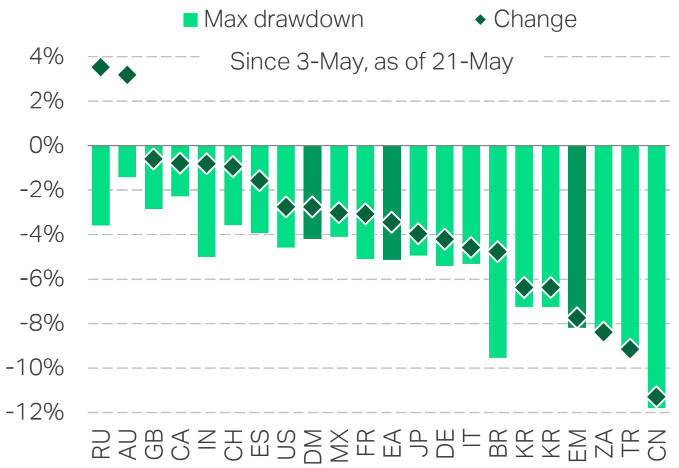
EMs, especially China, still hurting quite badly. This narrative seems to be what many investors are banking on. US equities experienced only a minor drawdown in May, falling by less than 5% from their peaks, and have already recouped nearly half of those losses. Considering that the S&P was overbought and overdue a correction (bottom-left chart), the market reaction to the trade tensions was remarkably composed. However, the same can't be said for all markets. As the bottom-right chart shows, EMs and China in particular have sold off a lot more, and have recovered a lot less, than the US and other major equity markets.

A correction was overdue



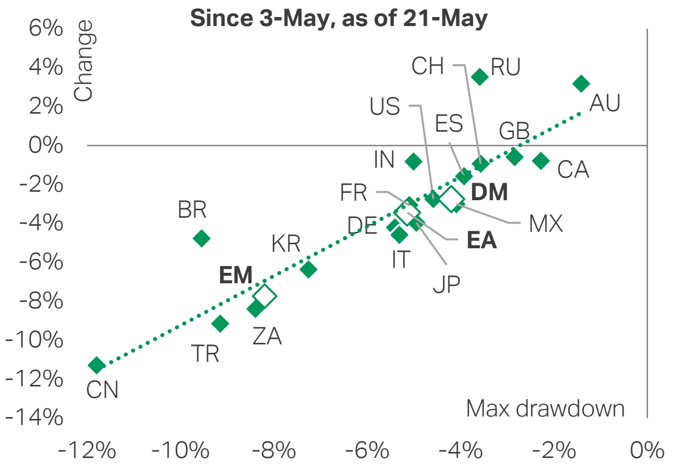
Source: Bloomberg, TS Lombard

Different degrees of sell-off and recovery



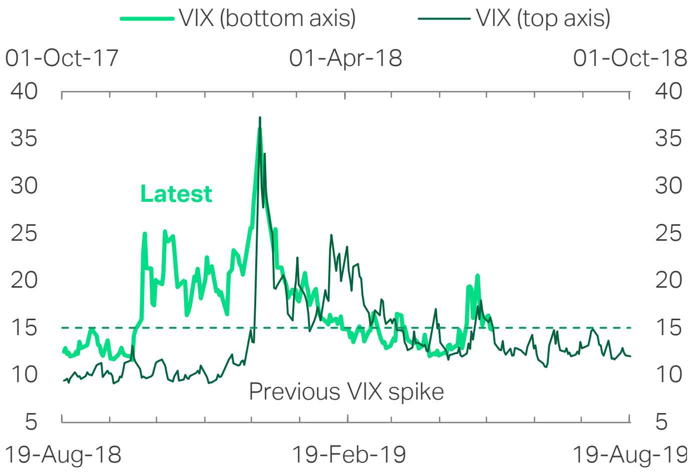
Source: MSCI, Bloomberg, TS Lombard

Largest drawdown => smallest recovery



Source: MSCI, Bloomberg, TS Lombard

Complacency: VIX back below 15 already



Source: Bloomberg, TS Lombard

Investors mostly concerned about China and EMs. The top-left chart exposes a clear pattern in the reaction to trade war escalation across markets. The indices that have sold off the most are the ones that have recovered the least. This suggests investors are mostly concerned about EMs, especially China, and not so worried about DMs.

US not immune. We think that the market reaction betrays excessive complacency by investors about the potential impact of a trade war on the US and the rest of the world. A strong dollar – mostly the result of safe-haven flows and CNY depreciation – would hurt the foreign profits of US companies, which are now substantial (especially for Tech and Industrials). Higher tariffs on consumer products would be a regressive tax that would dent final demand in the economy. And trade-related uncertainty would stop firms from making significant capex commitments.

China's likely response: yuan down, stimulus up. China, on the other hand, will probably respond to any further ratcheting up of the row with further yuan depreciation and more stimulus, which together should help soften the blow. To be sure, the Fed could also react to heightened economic risks by cutting rates, as we expect them to do in Q3. It's unlikely, however, that such monetary easing would be enough to keep the US insulated from the risks.

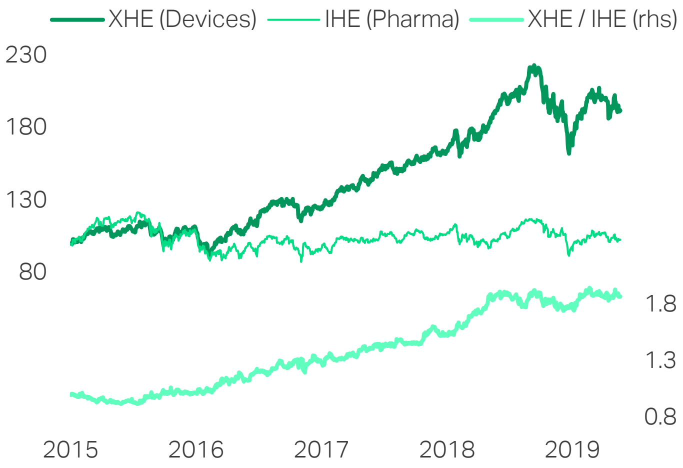
Given the size of the market's relative reaction so far, we keep our long EEM (mostly China)/short SPY trade open this week, as the relative performance of the two ETFs appears to be overextended to the downside. The trade has actually gained slightly since last week, but it remains close to our stop level of 6%.

Hard to make directional calls: we focus on RV in US Healthcare

Our view is that the most likely outcome of the G20 meeting is an extension of the US-China trade negotiations by three to six months. This would be better than continued escalation, but worse than our previous call of a possible agreement being sealed in short order. If we are right, uncertainty about trade will likely persist, undermining consumer and business confidence. The effect of this alone would warrant a downgrade of our global economic outlook; perhaps more importantly, making directional calls would remain extremely difficult for some time.

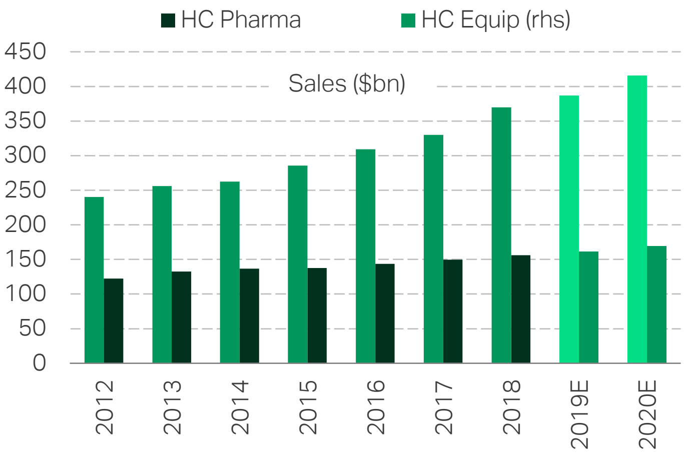
Less systemic, more idiosyncratic. Consequently, we think it makes sense to focus less on making directional macro calls (most of which will be affected by trade developments that are hard to predict) and concentrate more on idiosyncratic stories.

XHE / IHE ration in a range since mid-2018



Source: Bloomberg, TS Lombard

Equipment sales growing faster than Pharma



Source: Bloomberg, TS Lombard

Pharmaceuticals under pressure to lower the cost of prescription drugs. One such theme is a relative value opportunity within US Healthcare, where we think there is more upside in Healthcare Equipment companies than in Pharmaceuticals. The latter sector has been under sustained pressure to bring down the cost of medicines in the US. The House of Representatives passed a bill last week that aims to lower drug prices. While the initiative may be eventually struck down in the Senate, pressure to reduce the prices of prescription medicines will probably continue to mount, as this is a goal that enjoys bipartisan support in Congress and is also advocated by Trump.

Manufacturers of medical devices appear less exposed to such political risk in the near term. The sector is growing faster than Pharma, innovation is rampant and, while technological breakthroughs often help reduce the cost of diagnostic and treatment equipment, these dynamics seem less damaging than the threat of generics for drug makers. In fact, the rapid pace of innovation represents an opportunity to gain exposure to very promising companies in this field. The higher average p/e of stocks in the Equipment sector is justified, in our view, by its faster growth.

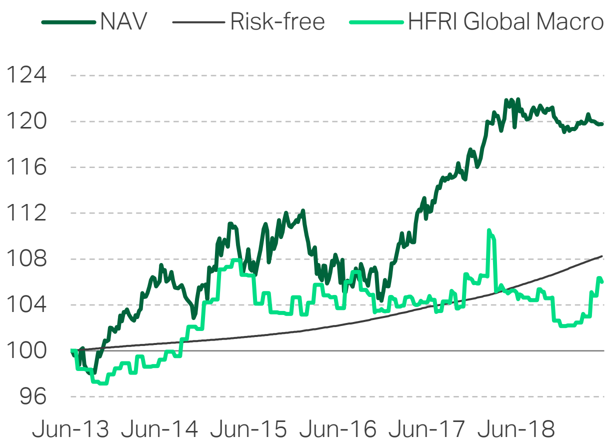
Why now? Following years of outperformance, Healthcare Equipment's returns fell into line with those of Pharmaceuticals about a year ago. Current levels are reasonably attractive, being roughly in the middle of the range of the past 12 months. Given the length of the market's consolidation, plus the renewed push in Congress to lower healthcare costs, we think now is a good time to gain exposure to a sector that has stronger long-term prospects than Pharma. We therefore **buy the XHE ETF against the IHE ETF** this week.

Current trade recommendations

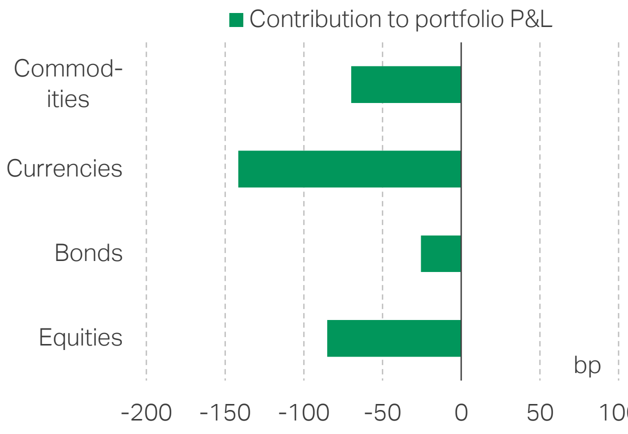
Theme / Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Risk hedges							
Long VIX September call spread	10-Apr-19	1.1	1.2	0.06			Equity mkts discount trade war de-escalation and policy easing; risk of a correction
Long USD/CNH	10-May-19	6.85	6.94	1.26%			Hedge against further trade war escalation
China leading the bounce							
Long EEM vs SPY	24-Apr-19			-5.54%			Foreign (Chinese) growth likely to outperform US
Dollar diversification							
Long AUD/USD 3m call spread	17-Apr-19	0.26%	0.06%	-20bp			Falling vol. stable CNY, China stimulus, iron ore and positioning
Short USD vs EUR, CAD, RUB, KRW	3-Apr-19			-1.2%			Reserve diversification, seasonals and improving China sentiment
Idiosyncratic risk trades							
Long XHE vs IHE	**22-May-19**			**0.0%**			**Strong sales growth in HC Equipmt; pressure on Pharma to lower prices**

Bold indicates new trades or changes made this week.

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	19.76%	6.00%
Annualized Return	**3.07%**	**0.98%**
2016	-4.89%	0.14%
2017	9.67%	2.47%
2018	2.98%	-3.48%
YTD	0.19%	3.92%
MTD	-0.05%	
Volatility (ann.)	4.33%	3.98%
Sharpe ratio	**0.39**	**-0.08**
Sortino ratio	**1.28**	**0.40**
Alpha (12m, vs HFRI)	-0.13%	
Beta (12m, vs HFRI)	-0.14	
Corr (12m, vs HFRI)	-0.19	
Corr (12m,vs MSCI World)	-0.12	
Corr (12m, vs JPM GBI)	-0.03	
Max drawdown (12m)	-3.03%	-2.78%

* Calculated using excess returns & monthly volatility

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long BRL / MXN (17-Oct-18)	55
US 2s10s steepener (07-Nov-18)	48
Long US Consumer Disc. (09-May-18)	43
Short MSCI EM / long MSCI DM (1-Aug-18)	39
Fed Funds Futures Oct19 (23-Jan-19)	29
Worst	**Contrib. (bp)**
Short Brent /WTI spread (19-Sep-18)	-70
Long 1y10y USD 2.9% payer (28-Nov-17)	-54
Long EUR / short GBP, CHF, AUD, USD (04-Oct-17)	-44
EUR/USD Call Spread (16-May-18)	-42
Long EUR / short AUD (03-Oct-18)	-38

Authors

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