Lombard Street Research

LSR Macro Strategy

13 September 2017

High Yield for the ECB taper

Asset class focus:
- ■ Multi Asset
- ■ Fixed Income
- ■ Currencies
- ■ Equities
- □ Commodities

- **We add an ECB taper trade via high-yield spreads**
- **We raise stops on our equity trades and lift our take-profit target on EEM**
- **We go long USD/CAD again, as data suggest a bounce is due**

Tapering to halt spread narrowing

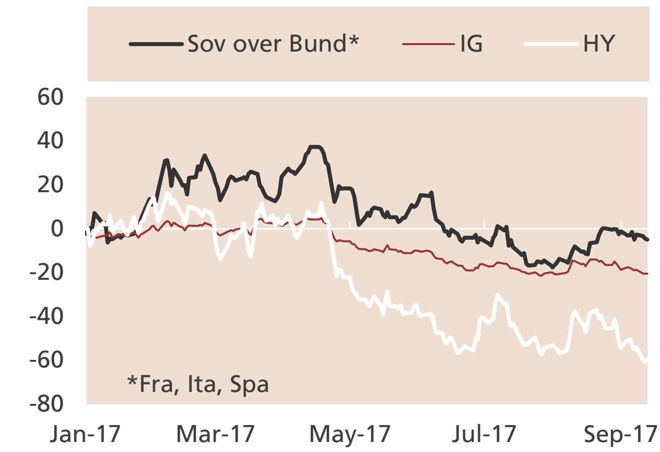
BTP-Bund spread closing in on entry level

In Macro Strategy last month we outlined several reasons why BTPs are likely to be the euro area government bonds worst hit when the ECB unveils plans to wind down its bond buying (‘Italian BTP risks: taper, elections, issuance’). We suggested waiting for the BTP-Bund spread to reach 160bp before entering this trade; the spread has duly narrowed, but we will continue to wait with an eye to putting the trade on in time for the taper announcement.

EU high-yield spreads the outperformer this year

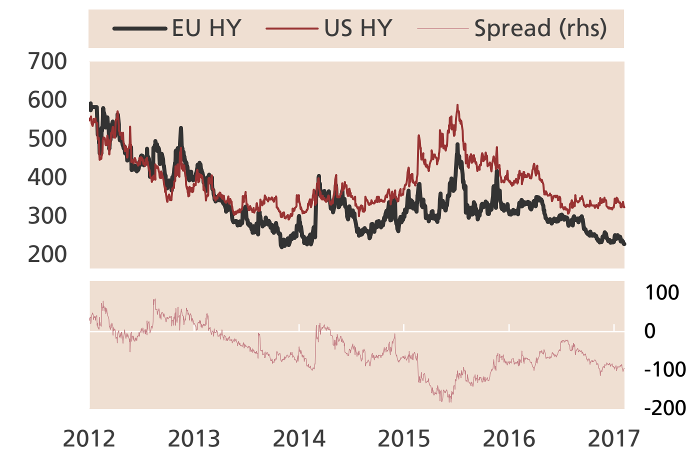
Instead today we add a new ECB taper trade through high-yield credit spreads. High-yield is the one market sector which the ECB did not include in its Asset Purchase Programme, but thanks in part to the APP’s crowding-out effect high-yield spreads have tightened by 60bp this year. Reflecting the strong performance, EU high-yield has moved from trading 70bp over US HY in 2013 to 100bp under today. This spread is

Euro area spreads have narrowed this year



Source: Bloomberg, LSR

EA high yield has outperformed US



Source: Bloomberg, LSR

at a record low, excluding the 2015 energy-driven US HY widening, further highlighting the outperformance of EU high-yield this year.

High-yield spreads to unwind outperformance once taper starts

We expect the ECB to announce its taper next month and to start reducing its monthly asset purchases in January. We have written previously how we expect this process to normalise euro area yields. The ECB's estimates of the effect of its easing programmes since 2014 suggest that, in addition to the 75bp decline in Bund yields, lending rates to non-financial corps fell by around 40bp thanks to the APP. The 60-day beta of high-yield spreads to investment-grade spreads is currently around 3x (for every 1bp move in IG, HY moves by 3bp). As we expect the ECB's actions to cause all spreads to widen, HY should move the most.

Positive carry remains high, however, at almost 20bp per month. In the current low-yield environment this pick-up is likely to have attracted investors who have moved out along the risk spectrum in a reach for higher returns. High carry also means it is an expensive trade to take on the short side, unless one's timing is impeccable.

Neutralise carry cost by trading relative to US high-yield

To minimise the cost of carry in shorting euro area high-yield, we fund the trade by buying US high-yield. This does introduce some oil price risk, but we are comfortable taking that risk as we do not expect another crash in oil in the near future. We **buy Itraxx Crossover protection (sell risk) and sell CDX HY protection (buy risk)** at a spread of **-97bp** with a **target of -20bp** (this year's high) and a **stop at -140bp**.

We now have two ECB taper trades, the first being our Bund-Treasury spread trade. The proposed BTP-Bund spread trade would be the third, and, as mentioned above, we are waiting for a good entry level. We reckon the EUR has potential to provide further returns in the medium term (see Monday's Daily Note) so we will look to add EUR longs during the current consolidation phase.

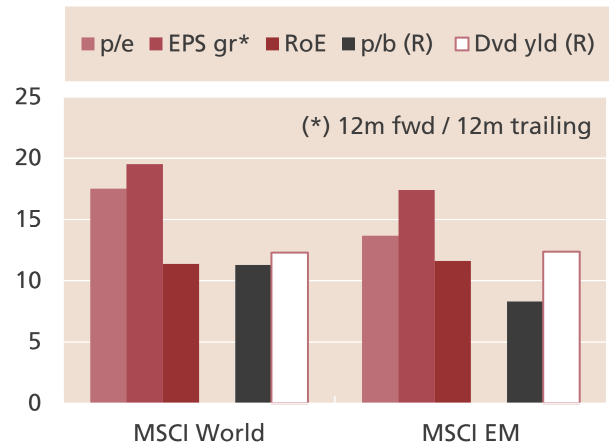
Re-assessing the current portfolio

Raise stop on Russia long

The long equity positions in the portfolio have performed very well, returning over 10% each. The **Russia** trade is still 6% from its target, but to lock in a 6% profit on the trade we **raise the stop to 1075**.

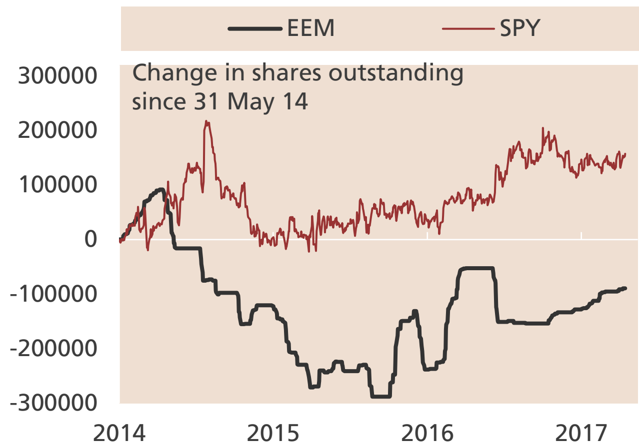
The EEM position has traded within 50bp of its target so it is worth reassessing whether the original rationale for it still applies – namely, that global growth in the

EM valuations are still more attractive than DM



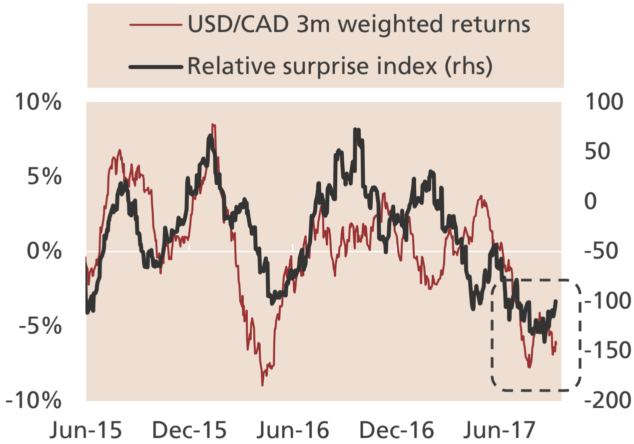
Source: MSCI, Bloomberg, LSR

Inflows to EM have picked up but still lag S&P



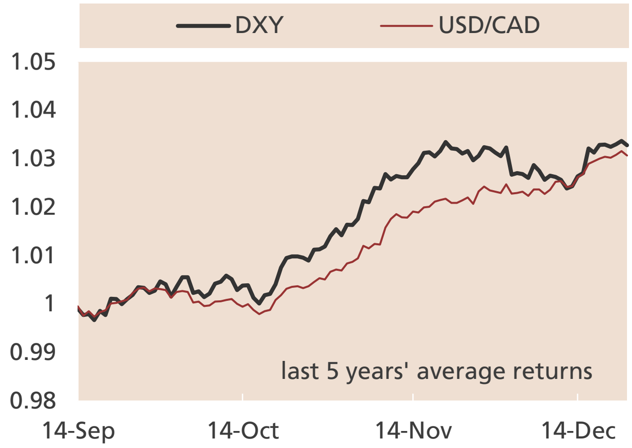
Source: Bloomberg, LSR

Relative data supports US over Canada



Source: Citi, Bloomberg, LSR

USD and USD/CAD seasonals into year-end



Source: Bloomberg, LSR

Raise stop and t/p on EEM long

Goldilocks phase is bullish for global equities and that EM equities are cheap and under-owned compared to DM. Our conclusion? US and euro area growth still supports the Goldilocks paradigm. Relative valuations are unchanged: on a p/e basis, MSCI world is trading at 17.5x while MSCI EM trades at 13.7x. And relative ownership still points to room for EM buying. So we keep the **EEM** trade and raise the **target to 49.00. We also raise the s/l to 43.70,** locking in 6.3% profit from the original entry.

Finally, our long-USD trades have lost all of their value in the last week following the high UK inflation print and rally in GBP/USD. Fundamentally, we still believe positioning for a dollar bounce offers the best risk/reward, particularly as rate hike pricing for this year and next remains subdued (fed funds futures currently imply just one 25bp increase by the end of 2018). However, the balance of risks in the UK has changed. The government has backed away from a hard Brexit, today's Daily Note paints a more positive picture for UK growth and accelerating inflation has brought forward market expectations of rate rises. Rather than adding to our GBP/USD short, we will wait for better entry levels on EUR/GBP, where the portfolio rebalancing argument supports GBP weakness.

Re-enter long USD/CAD through options

Our long USD/CAD position was thwarted by strong Canadian economic data and a second rate rise from the Bank of Canada. Market pricing is for another hike, probably by the end of this year. But relative economic surprises between the US and Canada have flipped in favour of the US. The currency cross tends to move in line with such shifts, reflecting the assumption that central bank policy expectations will follow relative economic performance. In any case, as expectations for Canada are now elevated, the upside for CAD is limited. Seasonal factors are another reason to expect a dollar bounce. This is particularly true of the USD/CAD pair, which has rallied in Q4 in each of the last four years.

We add to **USD/CAD** through a new call spread: **15 Dec 1.2350-1.2750 in 1x2** ratio, for **35bp** (1.2150 spot ref), with a potential pay out of 9x premium at 1.2750. This trade will begin to lose money above 1.3150; it reflects our view of a dollar bounce rather than a secular shift, but if spot breaches 1.27 we will consider taking the trade off.

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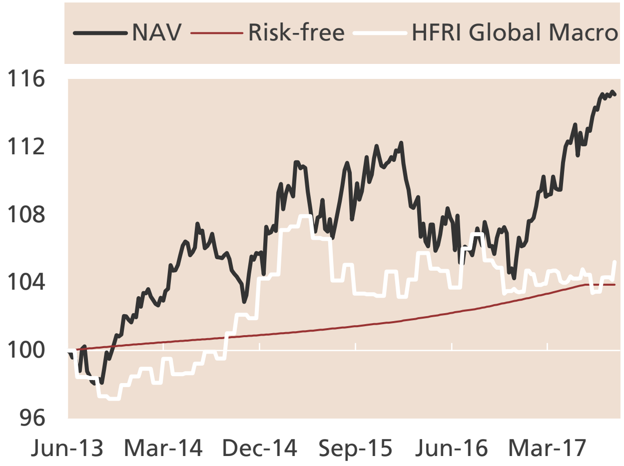
Current trade recommendations

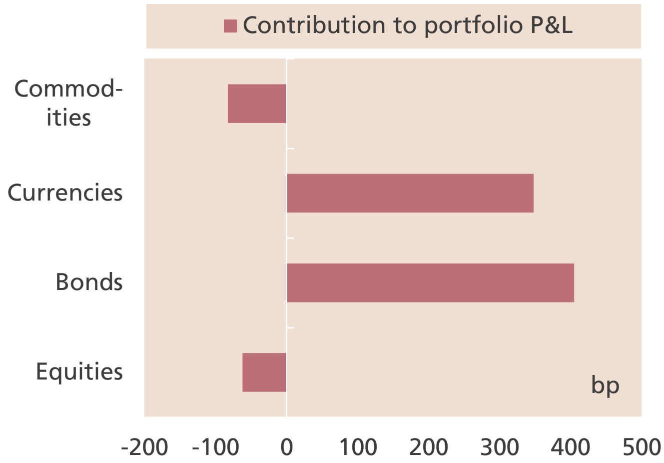
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global reflation								
	Long EM equity (EEM US)	21-Jun-17	41.10	45.44	10.6%	**49.00**	**43.80**	Benign inflation outlook, EM cheap and underinvested
	Long Russia RTSI$	02-Aug-17	1015.0	1128.1	11.1%	1200	**1070**	GEM tailwinds, US sanctions priced in, cheap valuations
UK soft patch								
	Long GBP/USD 29Sep17 put spd	29-Jun-17	35bp	2bp	-33bp	n.a.	n.a.	Monpol expectation too hawkish; soft patch expected
ECB Taper								
	Long 10y UST / Short Bunds	05-Apr-17	210bp	177bp	23bp*	160bp	186bp	Spread too wide due to ECB asset purchase programme
	Long Itraxx XO / Short CDX HY	13-Sep-17	-97bp			-20bp	-140bp	EA HY to rise on ECB taper, US HY neutralises carry cost
Monpol tightening								
	Long USD/CAD 31Oct17 call spd	12-Jul-17	41bp	1bp	-40bp	n.a.	n.a.	CAD too strong to support Canadian growth
	Long USD/CAD 15Dec17 call spd	13-Sep-17	35bp			n.a.	n.a.	US-CA econ data turning, CAD hiking fully priced
Korea risks lead to rebalancing								
	Long INR/KRW	30-Aug-17	17.520	17.632	0.60%	18.10	17.20	NK-US risks lead to investor rebalancing away from Korea

*Bund-UST pnl includes 9.5bp (of yield) cost of Bund benchmark roll. **Bold** indicates stop or target changes

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio performance metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	15.09%	5.22%
Annualized Return	**3.34%**	**1.20%**
2014	4.35%	5.61%
2015	3.99%	-1.26%
2016	-4.89%	0.14%
YTD	8.72%	1.85%
MTD	-0.20%	
Volatility (ann.)	4.61%	3.70%
Sharpe ratio	**0.54**	**0.09**
Sortino ratio	**1.08**	**0.29**
Alpha (vs HFRI)	3.32%	
Beta (vs HFRI)	0.07	
Correlation (vs HFRI)	0.05	
Correlation (vs MSCI World)	0.15	
Correlation (vs JPM GBI)	0.01	
Max drawdown	-7.57%	-4.40%

Best and worst trades

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long 10y UST / short 10y Bund (05-Apr-17)	151
Long EM equity (21-Jun-17)	131
US 2s10s flattener (08-Mar-17)	130
Long 10y Bund / short 10y OAT (14-Dec-16)	117
Short USD / long RUB (09-Nov-16)	108
Worst	**Contrib. (bp)**
Long US Banks / short S&P500 (03-May-17)	-139
Long Gold (02-Nov-16)	-97
Long GBP / short USD (07-Sep-16)	-95
Short AUD / long CAD (27-Jul-16)	-78
Short CAD / long MXN (26-Oct-16)	-60