Strategy Chartbook

SEPTEMBER 2018 CHARTBOOK

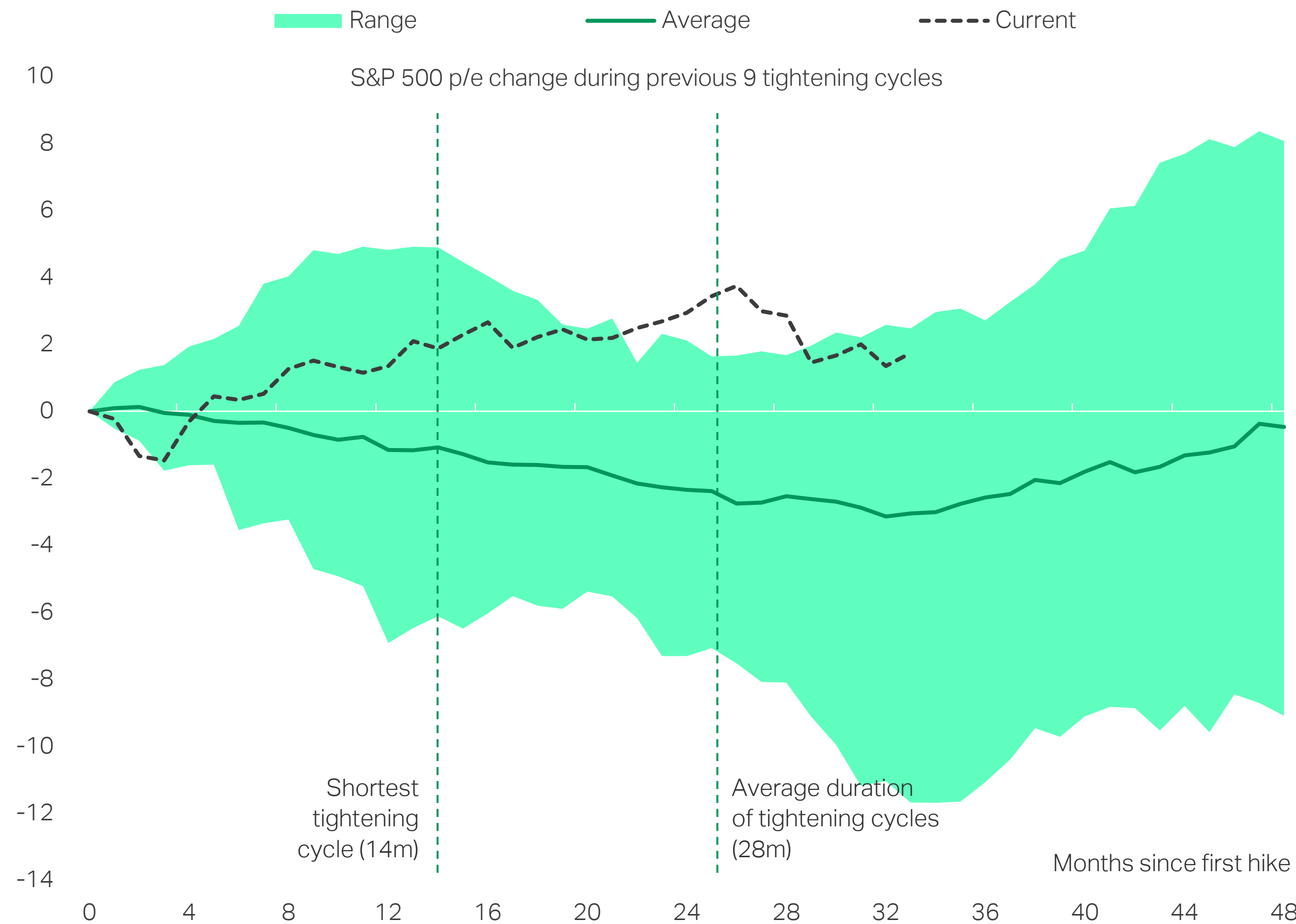
Andrea Cicione / Oliver Brennan

HIGHLIGHTS

- **Macro Drivers.** Late-cycle signs in the US, and Chinese credit growth to pick up
- **Multi Asset.** Liquidity tightening is starting to bite, just as EMs face a perfect storm
- **Fixed Income.** Curve flattening risks inversion, especially as 10y yield has been unchanged for 6 months
- **Currencies.** If trade wars escalate, CNY could fall a lot further
- **Equities.** EMs cheap enough to rebound – but this is unlikely while globalisation is going into reverse
- **Commodities.** Oil demand outlook clouded by trade war, market likely to stay range-bound this year

Chart of the month

Tighter liquidity is starting to bite



US stocks have recently made new highs but valuations remain much lower than they were earlier this year. Falling equity multiples are not uncommon during monetary policy tightening cycles. What is unusual is how long it has taken for this to start happening (see chart).

The decline in p/e's has coincided with the beginning of quantitative tightening by the Fed – which is not surprising given how closely multiples were correlated with various rounds of QE on the way up. Or, perhaps, falling valuations are just a delayed response to higher interest rates.

Either way, tighter liquidity and a stronger dollar (the two are obviously related) spell trouble for emerging markets. Add in the risk of a trade war and EMs are facing a perfect storm.

Elsewhere in this month's Chartbook:

- *Macro Drivers.* Trade war hurting global exports
- *Fixed Income.* With just 20bp to go before inversion and 10y yield not rising, there is little margin for error
- *Currencies.* CNY could weaken much further on trade war escalation
- *Equities.* Trade risk, strong USD causing China (and EMs) to slump, US small caps to thrive
- *Commodities.* Cloudy demand outlook suggests oil will remain range-bound

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Summary – key points

Macro Drivers

- US economy showing signs of a mature cycle, even before trade uncertainty and dollar risks hit
- Chinese credit growth is likely to rise in H2, but we still expect sub-consensus GDP for 2018
- Waning foreign demand for German goods and declining world trade growth could both be signs of the trade war biting

Multi-Asset

- S&P 500 valuations are lower than at the beginning of the year – a typical response to tighter monetary policy
- US Treasury yields appear to have risen in response to higher rates, while equities seem to be more sensitive to QT
- As global liquidity tightens, the dollar strengthens and trade war escalation looms, EMs are facing a perfect storm

Fixed Income

- All but one post-war curve inversion has preceded a recession
- Current curve flattening is driven by rising 2y yields – set to continue, the Fed reckons – as 10y yields risk a move lower
- Money market strains have eased as Libor-OIS spread normalises, but Italian stresses have returned pre-budget

Currencies

- CNY could have much further to fall if it is used to offset rising trade tariffs
- EM FX vol is rising due to idiosyncratic factors rather than threats to supply chains in EM Asia, where risk is still underpriced
- We reckon USD will continue to rise, with net long IMM positioning increasing the risk of a sharp rebound

Equities

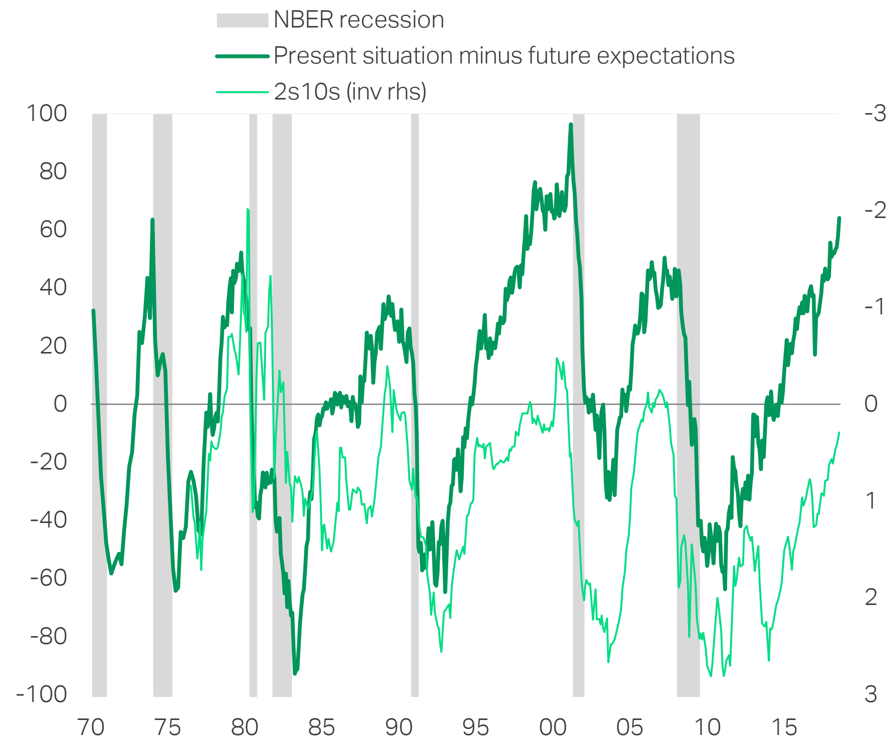
- Relative to DMs, emerging equities have cheapened to levels that have coincided with rebounds in the recent past
- However, EMs never really recovered from the derating of 2012-13; the risk of another derating is growing
- US small caps outperform, Shanghai Comp lags as investors favour US domestic plays over bets on further globalisation

Commodities

- US shale is transitioning to sustainable growth; this and glut in the Permian region means US supply should level off
- Oil demand is robust for now, but global activity is slowing, trade wars are escalating, and central bank liquidity is receding
- In 2018 the rally has matured, volatility has bottomed out and the market is close to balance: likely range-trading ahead

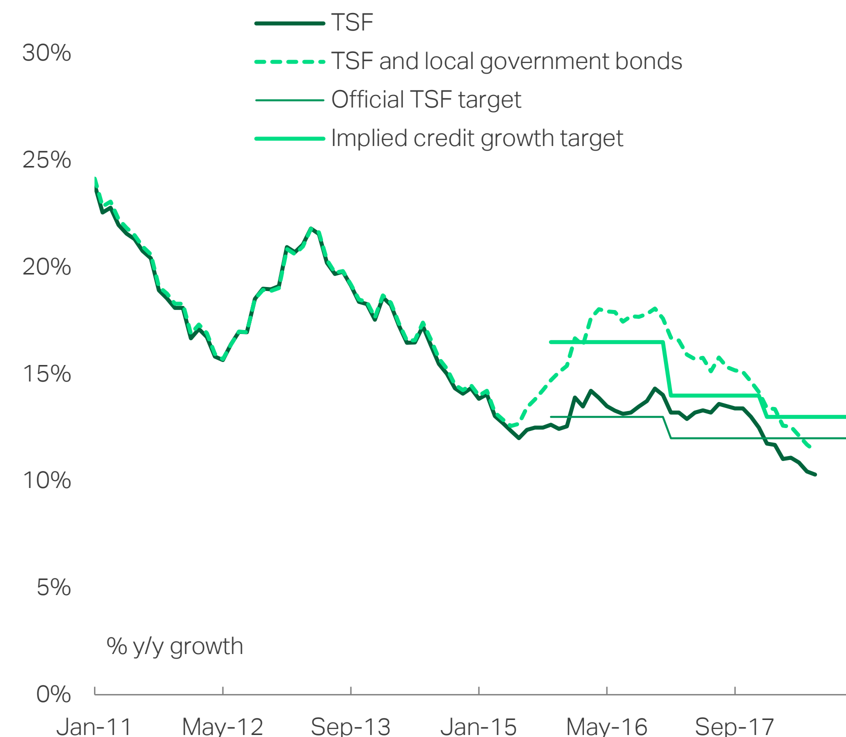
Macro Drivers Headwinds in the US and China

US exhibiting late-cycle tendency, momentum is slowing



The US yield curve inverts before most recessions (see the Fixed Income section for more on this), and other indicators also suggest the US cycle is maturing. The gap between the 'present situation' and 'future expectations' components of consumer confidence is at a cycle high. In this US Watch note, Steve Blitz highlights waning economic momentum, even before dollar and trade uncertainty risks hit.

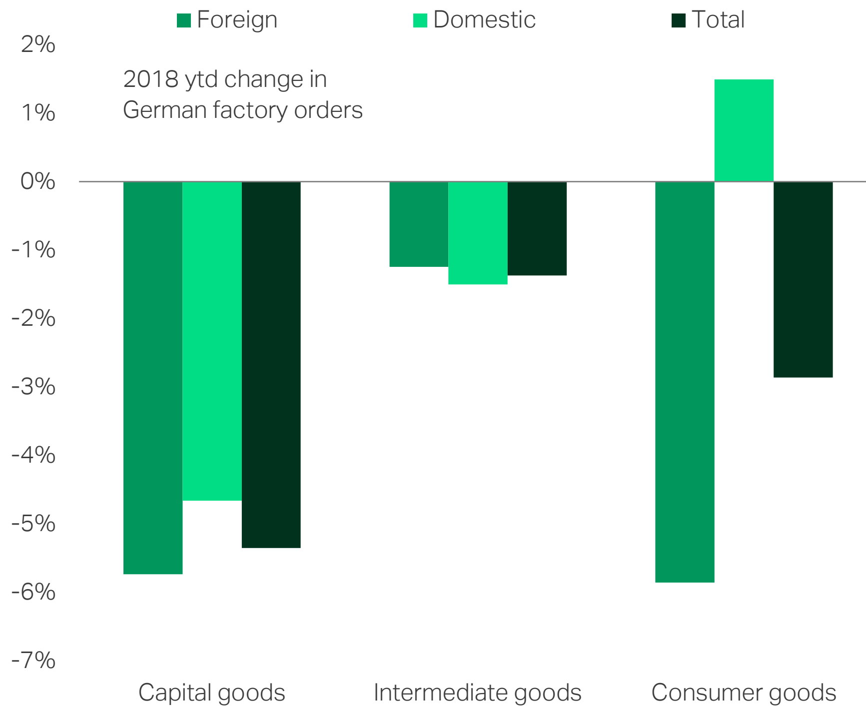
Chinese credit growth slowing



Declining total credit growth in China means the transmission of looser monetary policy to the broader economy is likely to be weak. Credit growth is set to rebound to 13% by year-end, but this will merely mitigate the economic slowdown, not arrest it. We maintain our lower-than-consensus GDP growth forecast of 6.5% for 2018 overall, implying sub-6.5% readings in the second half of the year.

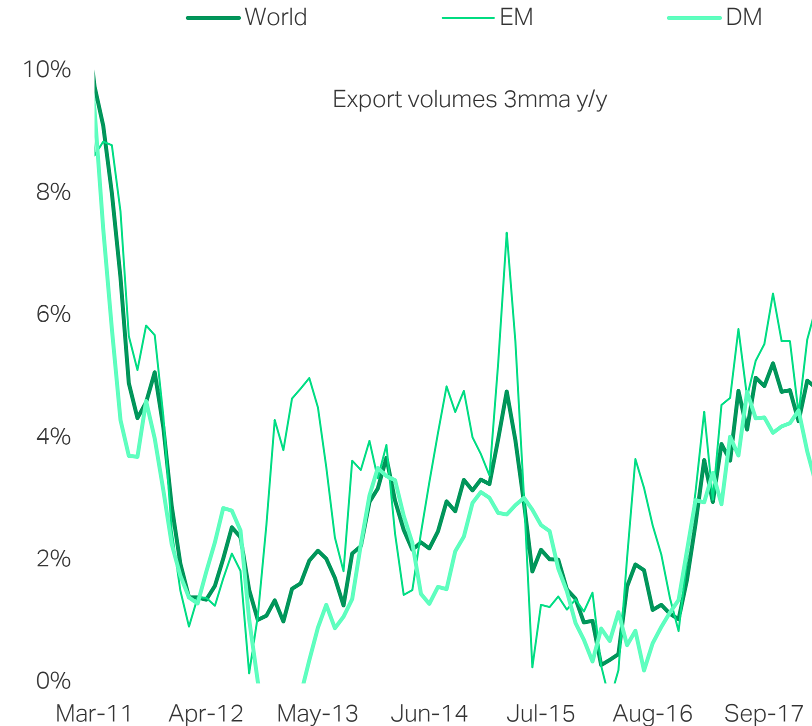
Macro Drivers Trade war already changing behaviours

Foreign demand for German factory goods falling



German factory orders have declined by almost 4% this year; foreign demand in aggregate has fallen by 4.5% while domestic demand is down by 2.8%. Foreign orders from outside the euro area have dropped by more than those from other EA countries. This may be the first sign of trade tensions influencing industrial behaviour; if so, factory orders are already past their cyclical high.

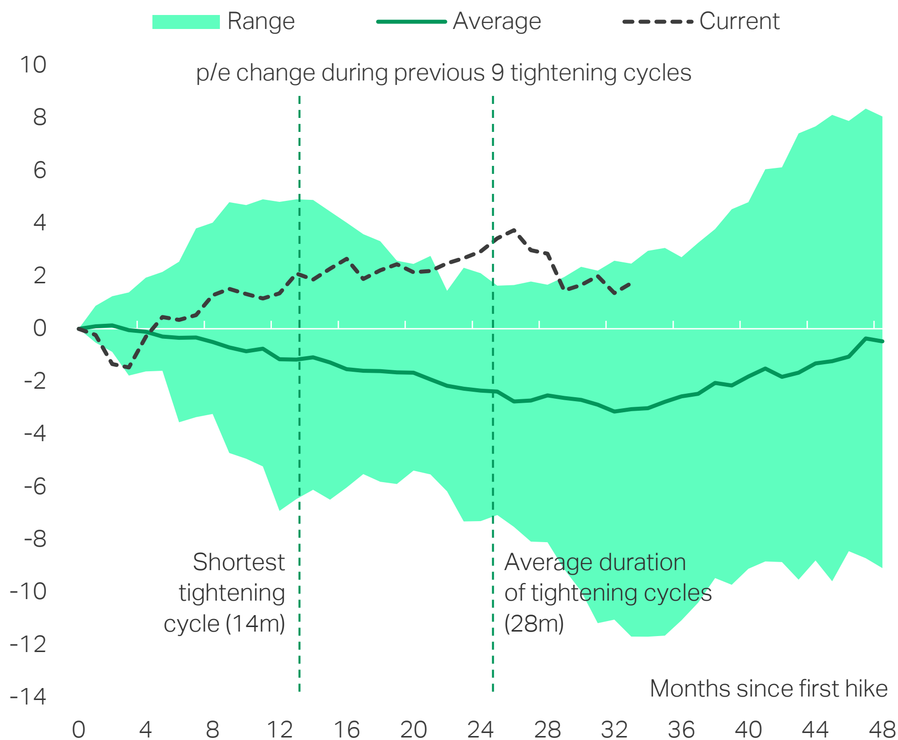
World trade growth slowing



Global trade growth is beginning to slow. The YoY rate of export growth has halved, from 5.2% in October to 2.6% in May. The IMF estimates that a worldwide increase in protectionism could cut global real exports by 15% in the long term, so if this decline is the start of a trade war-driven slowdown, there may be more to come. Our leading indicator is already flagging risks to growth - risks which may well be increasing.

Multi-Asset Liquidity tightening starting to bite

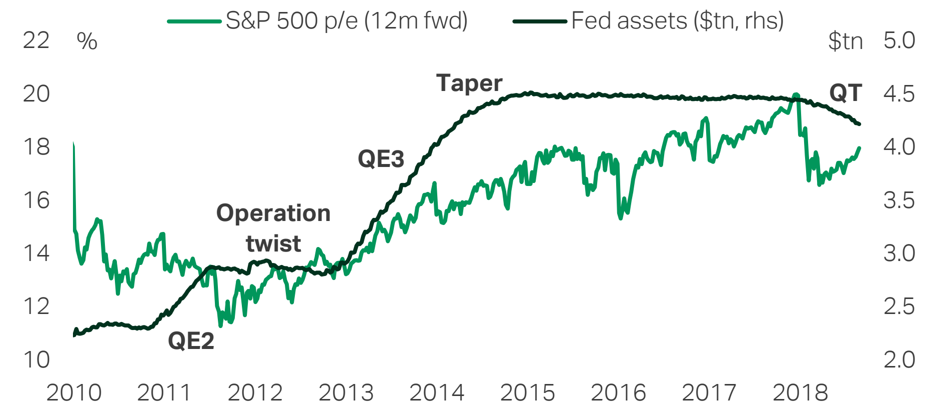
S&P valuations starting to reflect tighter Fed liquidity



US equities have made new highs but valuations are still lower than they were in early 2018. This is not unusual during periods of monetary tightening. What is unusual is that it has taken so long. While bonds are gradually pricing in Fed hikes (reluctantly so, with the UST 2s10s getting ever flatter), equity multiples seem to have been more sensitive to QT than to higher rates.

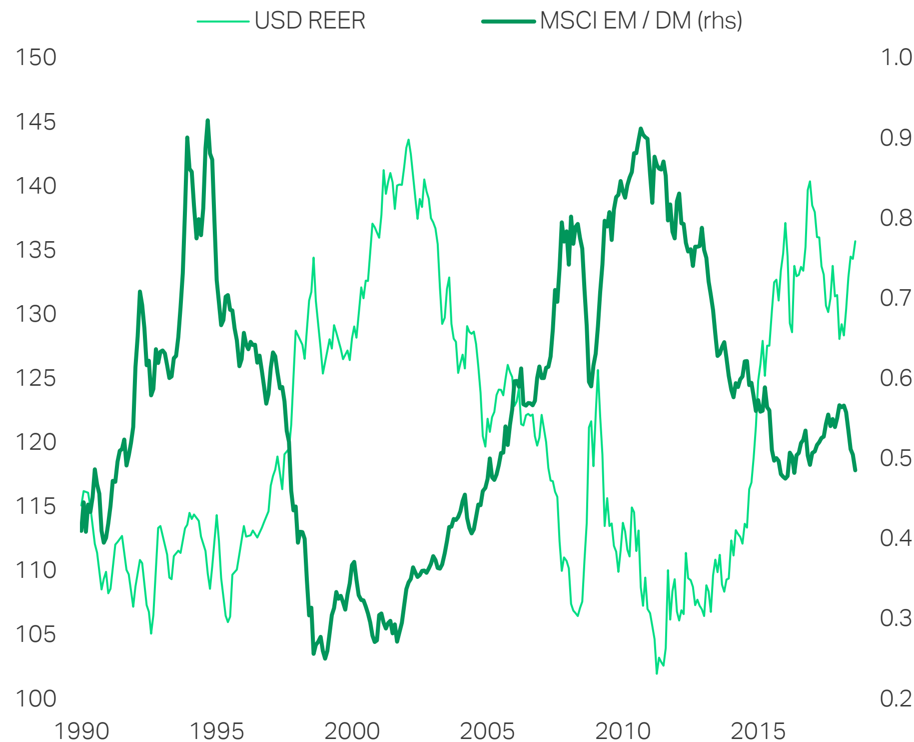
Bond yields reacting to Fed policy rates

Equity multiples more affected by Fed balance sheet



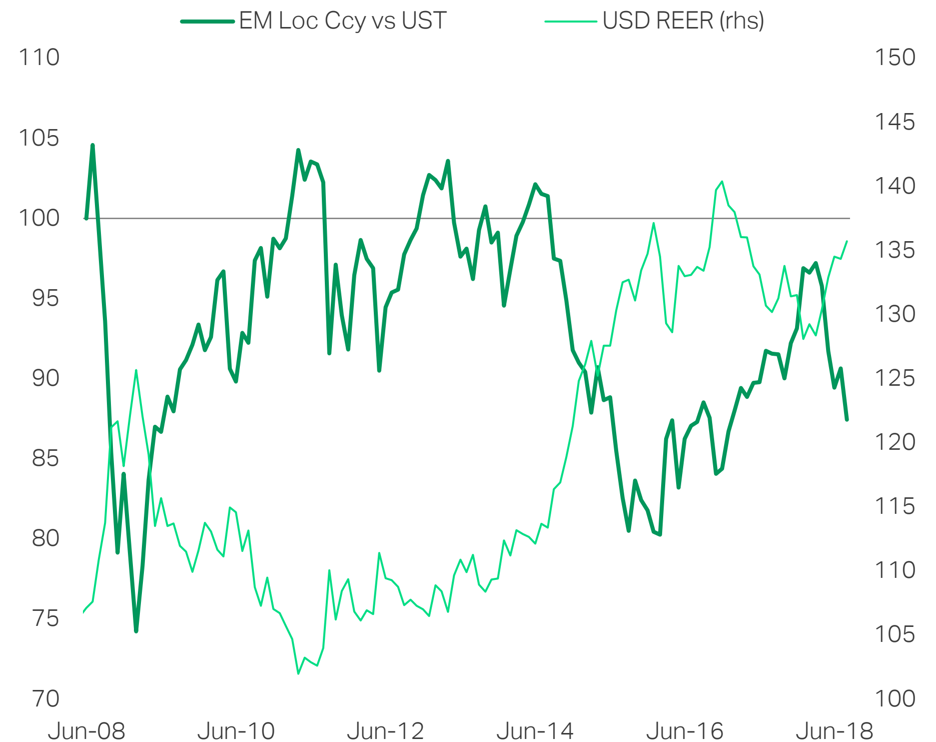
Multi-Asset EM facing a perfect storm

EM equities have never liked a strong dollar



This month our EM Strategy team has turned even more bearish. The crises in Turkey and Argentina are not systemic, but Brazil will probably join the party soon: given how a centrist candidate is unlikely to win the election, its 7% budget deficit will probably go untackled. But the biggest threat of global spillovers would come from a possible further devaluation of the renminbi.

And EM local debt is not too keen on it either

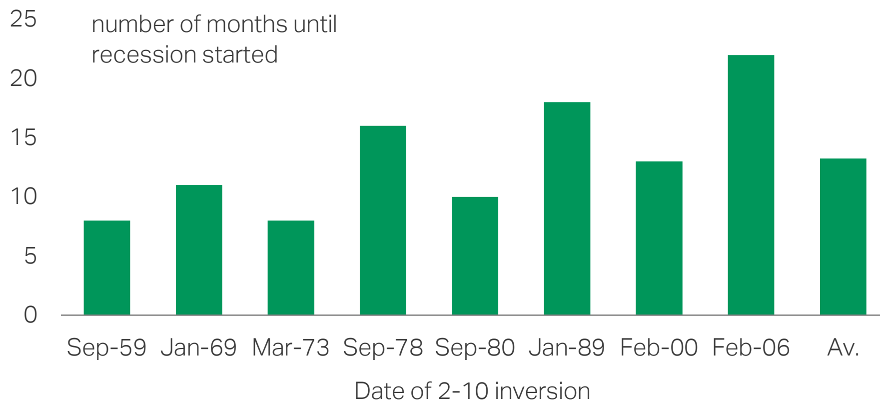


In this month's EM Strategy Monthly we keep our -2 recommendation on EM risk and further downgrade currencies to -1, joining equities and local debt; we stay +1 on hard currency debt. Dollar strength is likely to persist as the Fed carries on tightening monetary policy and trade wars escalate further. An even stronger dollar will probably spell more trouble for EM assets.

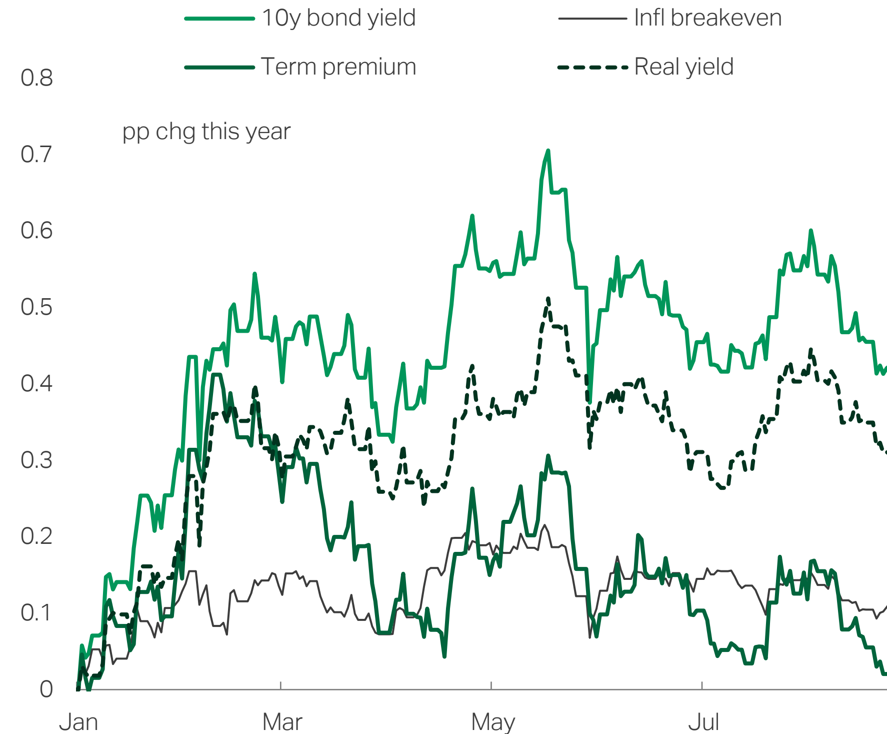
Fixed Income Curve flatting leaves little margin for error

Curve flattening does not mean inversion, but it is getting close

US recession followed all but one (1990s) post-war inversion



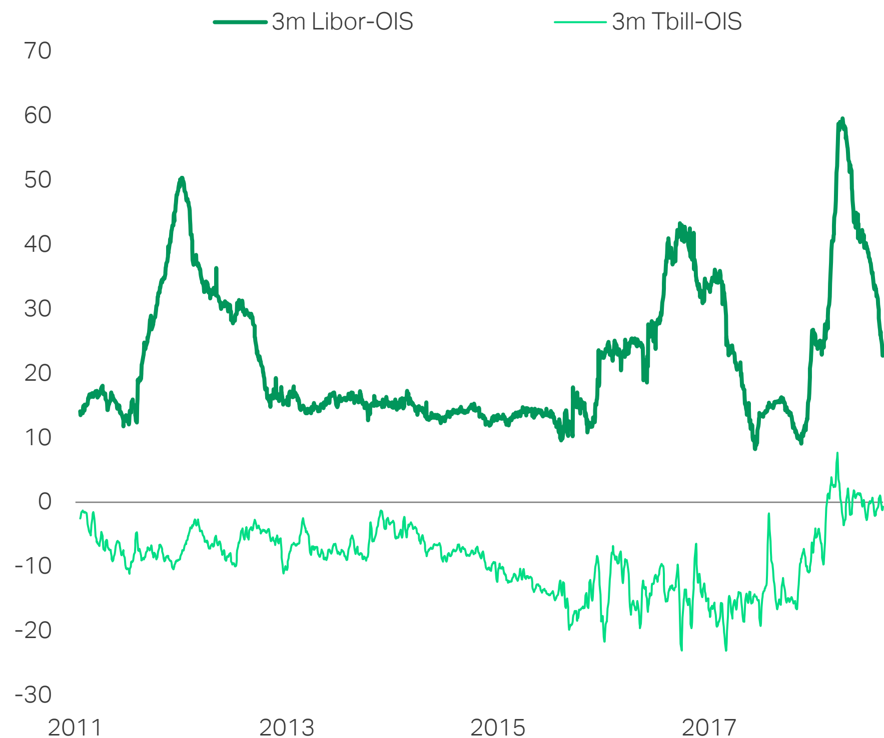
10y yield unchanged for six months



Since February, US yields have fallen. We retain our +1 stance on US (and other DM) bonds in this month's Asset Allocation. And with the term premium apparently falling – rather than, as we expected, rising as ECB QE fades - curve flattening is being driven by the 2y point. And flattening may well continue, especially given the large 10y short position overhang.

Fixed Income Money market funding squeeze over

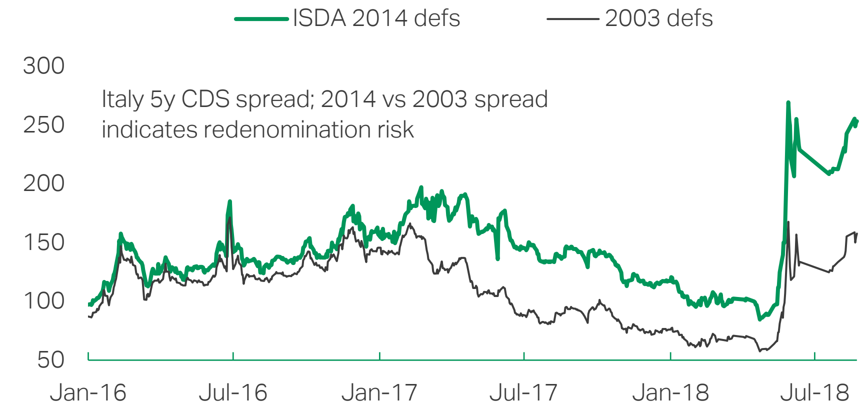
Libor-OIS narrower, but funding costs still rising



In Q1, we ascribed the rise in Libor-OIS spreads to increased Treasury Bill issuance and to US corporates repatriating cash. Since then, the TBill-OIS spread has been stable around 0bp, which is "correct" for equivalent risk-free instruments. The fall in the Libor-OIS spread offers some relief for funding markets, but with US rates 50bp higher than in January, funding costs are still at a post-crisis peak.

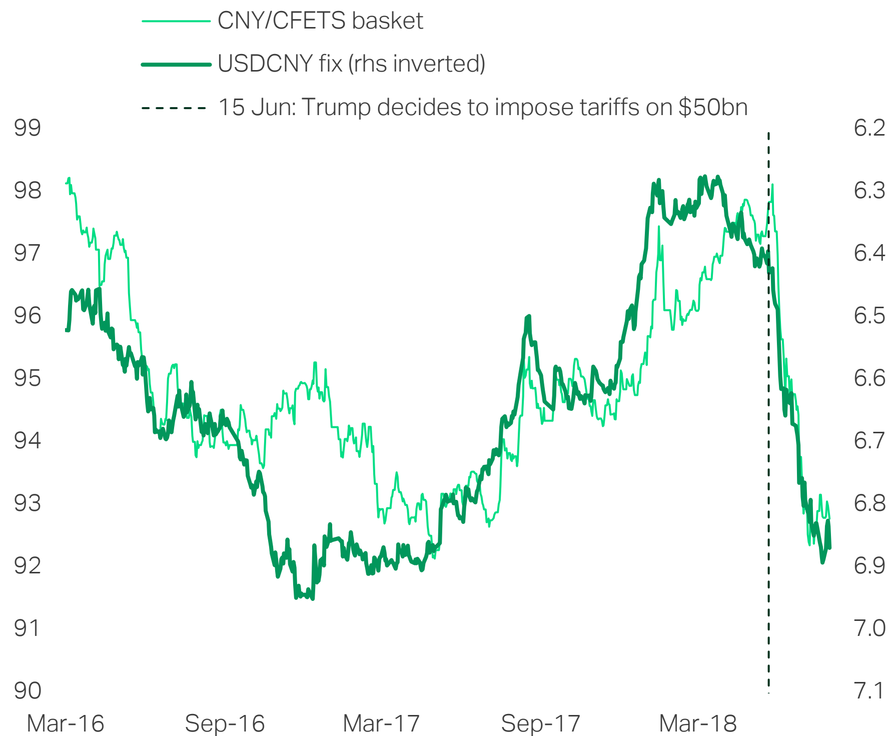
BTP spreads are widening as the government's budget nears…

…and default (and redenomination) risks rise again



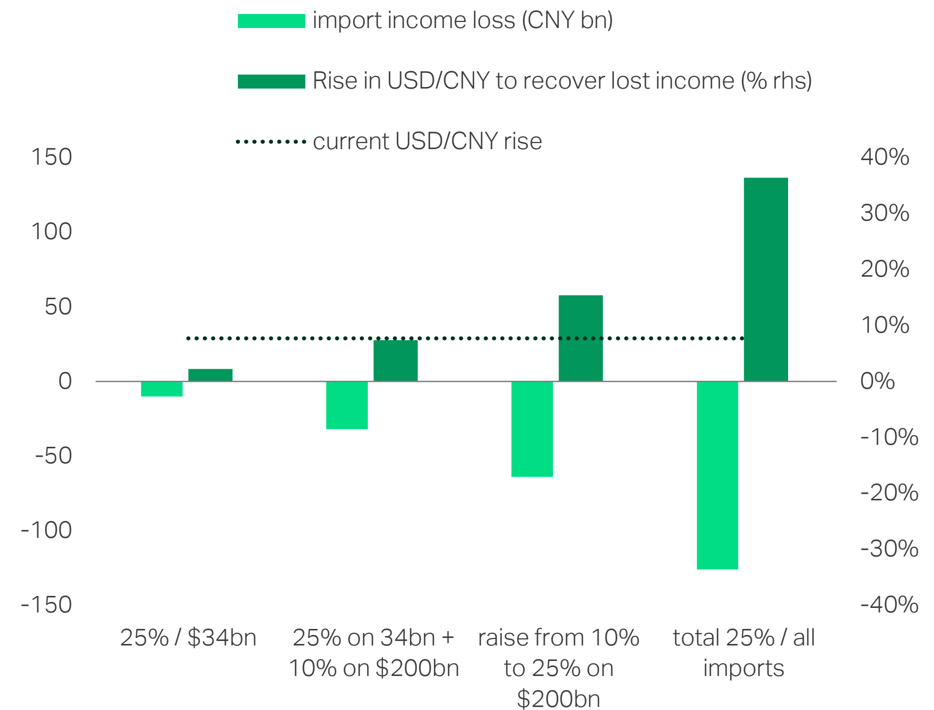
Currencies CNY response to tariffs logical

CNY unilateral weakening started after 15 June



CNY hit its high against USD in March this year, but the currency started to materially weaken after President Trump decided to start imposing tariffs on imports from China, announced on 15th June. The sharp fall in CNY since then has prompted policymakers to stabilise the currency at current levels but (see right) more weakness may be necessary if tariffs escalate.

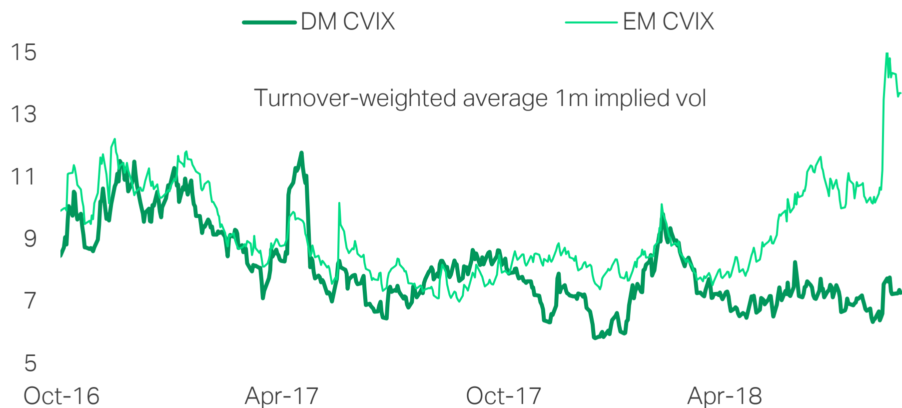
Scenario analysis quantifies further CNY weakness if tariffs



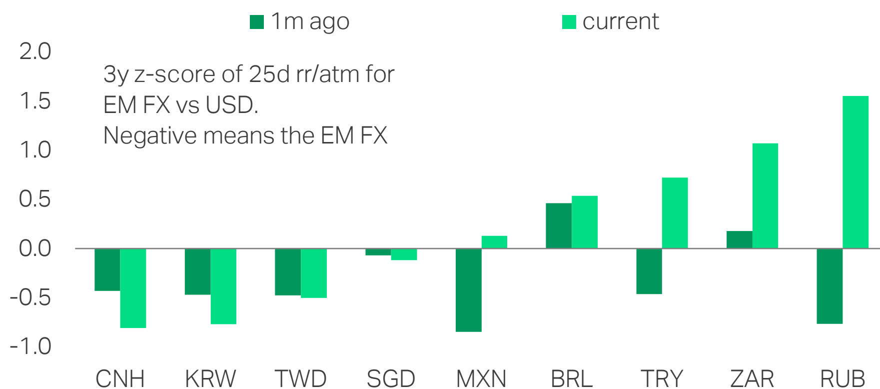
By calculating the exchange rate move required for a hypothetical exporter to recover their pre-tariff local currency income, we estimate that the 8% fall in the CNY to date offsets in aggregate the threatened 10% tariff on a further $200bn of imports. But if Trump delivers his threat of a 25% tariff on all imports from China, CNY will need to fall much further to offset the impact.

Currencies EM vol not rising in Asia despite trade risk

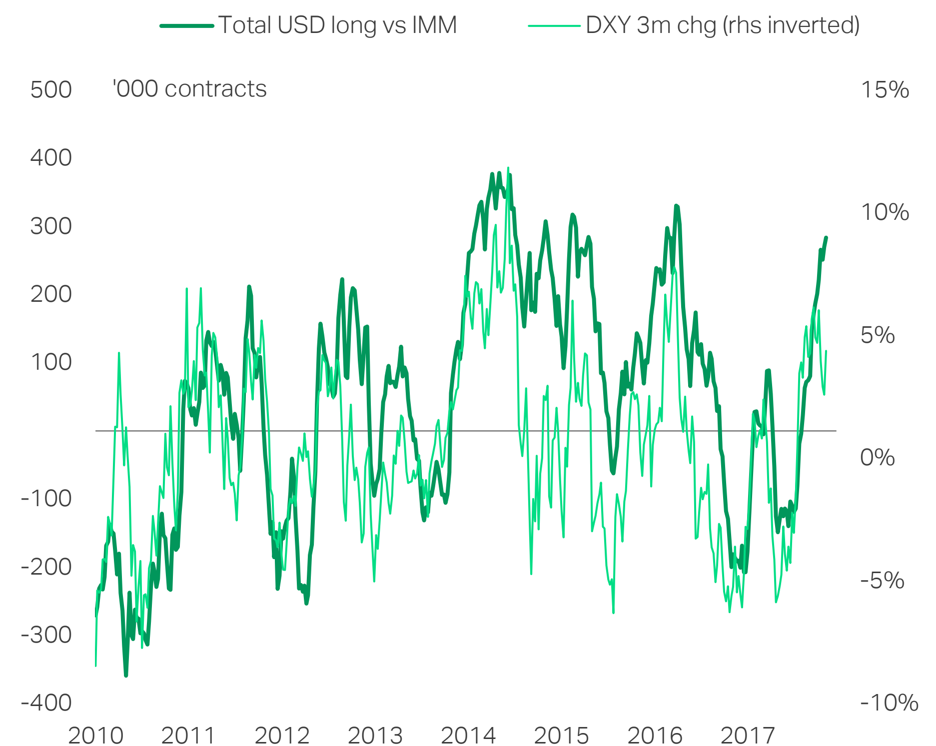
EM FX implied vol has risen, driven by risks in BRL, TRY, ZAR and



But EM Asia downside risk is still underpriced: put skew there has



USD long build-up increases chances of a sharp rebound

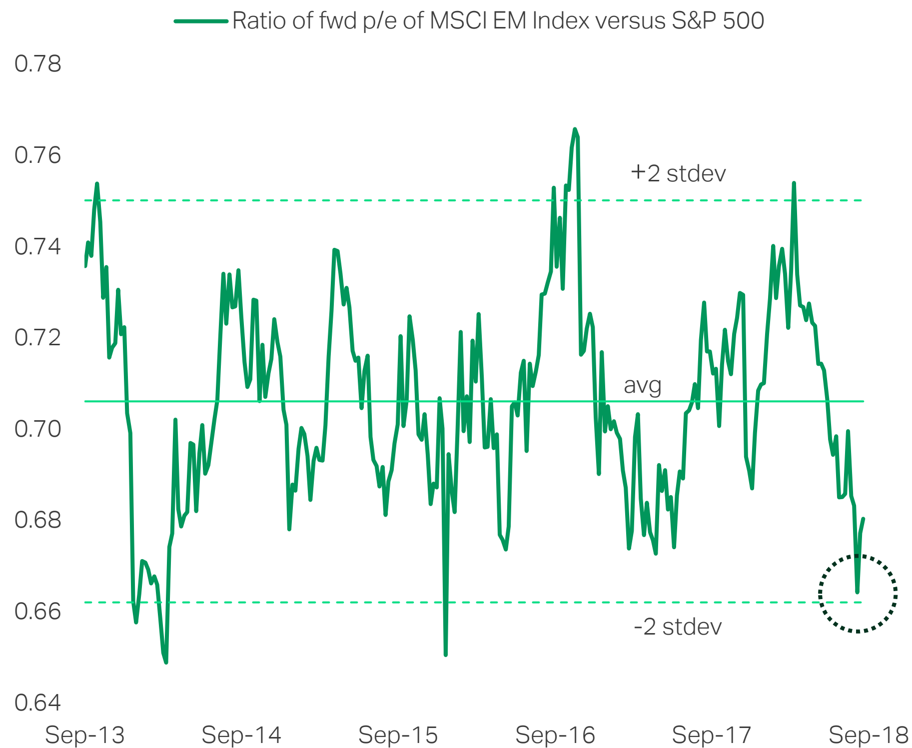


In last month's chartbook we showed how FX return/positioning correlation falls when positioning becomes extended. The net USD long is approaching its 2014 and 2015 high and, although there are still good reasons to expect continued USD strength (economic growth, relative policy, trade wars, EM risks), the size of the position means the chances of a sharp rebound are rising.

Equities

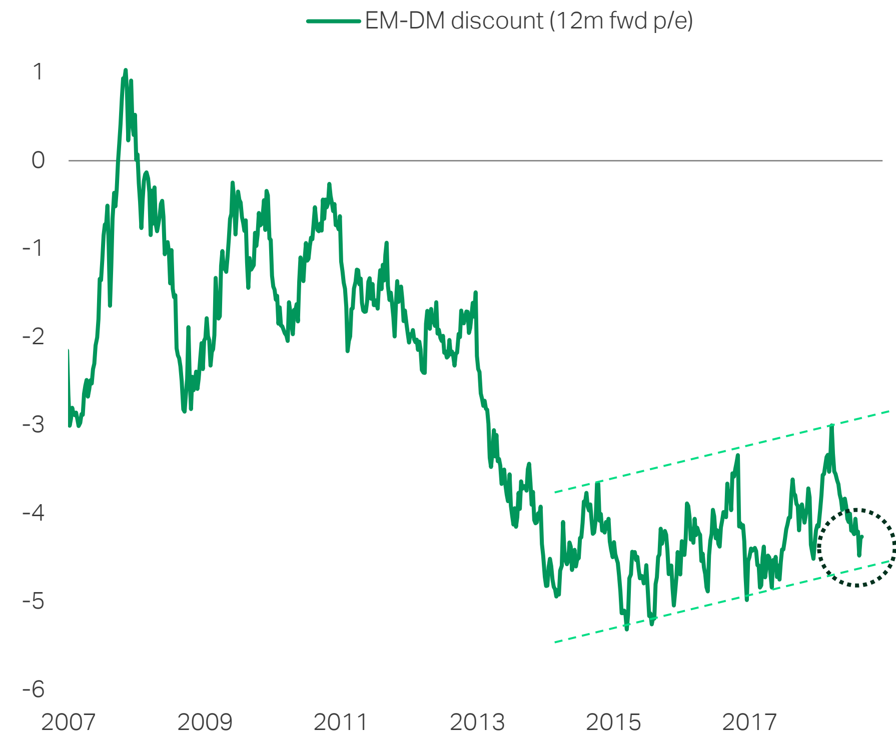
Are EMs cheap enough to rebound?

EMs rebound vs S&P 500 near the -2 standard deviation level



Emerging equities have tentatively rebounded as the ratio between EM valuations and the S&P neared the -2 standard deviation level. In the recent past, cyclical EM outperformance has followed relative valuation dips of this magnitude.

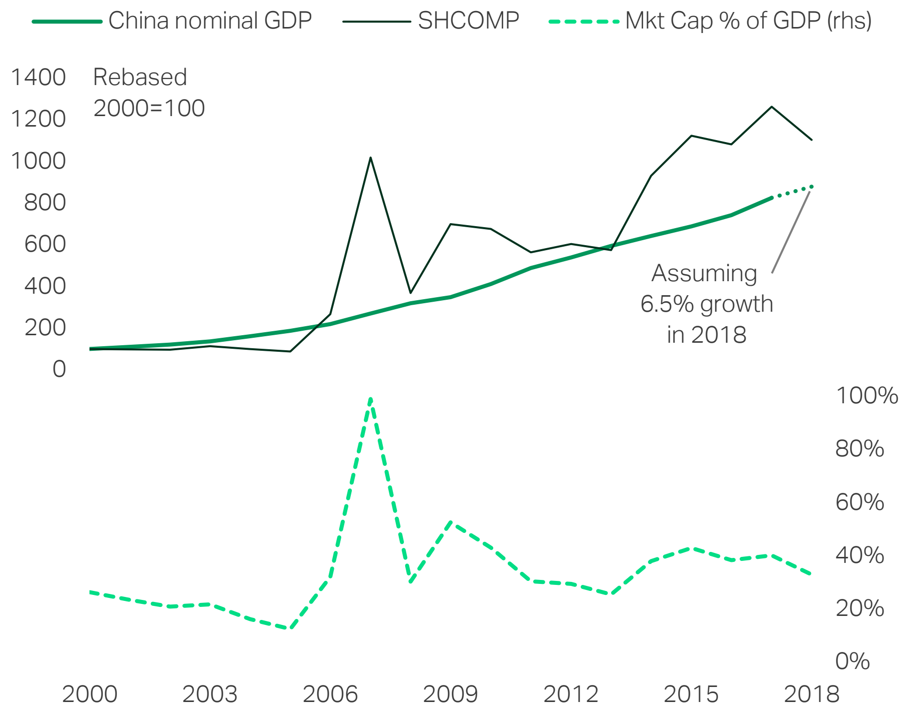
EMs never recovered from the 2012-13 derating



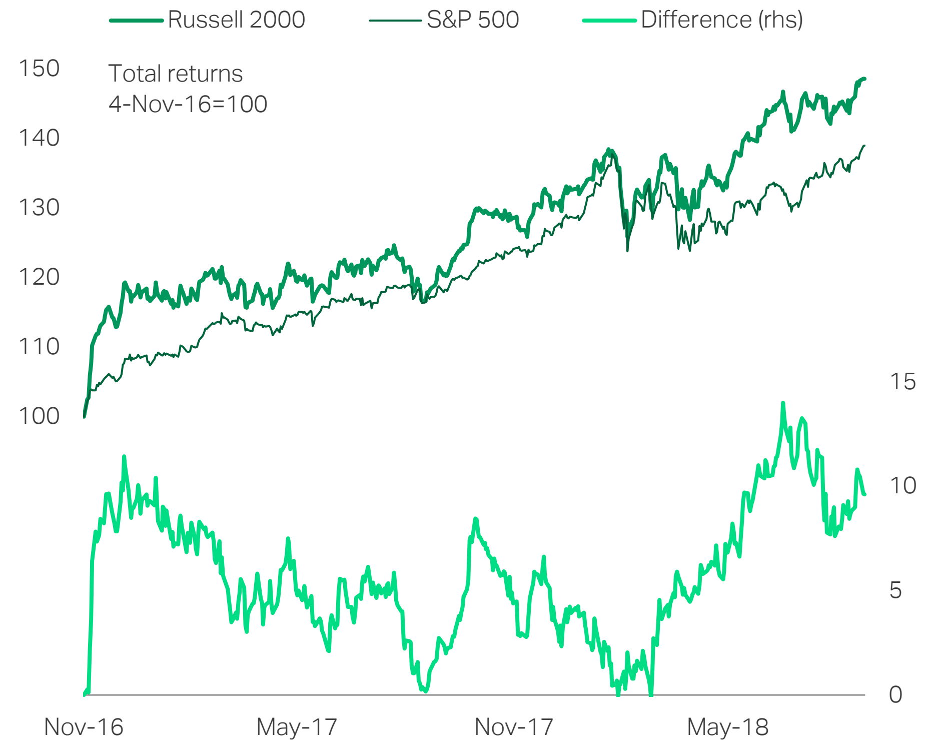
However, EMs never really recovered from the 2012-13 derating, with EM equities trading at a much larger discount to DM shares than in the aftermath of the global financial crisis. With trade wars threatening to send globalisation into retreat, not only does a full EM recovery now seem unlikely but the risk of a further secular derating is growing.

Equities — Is globalisation going into reverse?

Are Chinese equities an absolute bargain in the long term?



US small caps back to trading at a premium to S&P 500

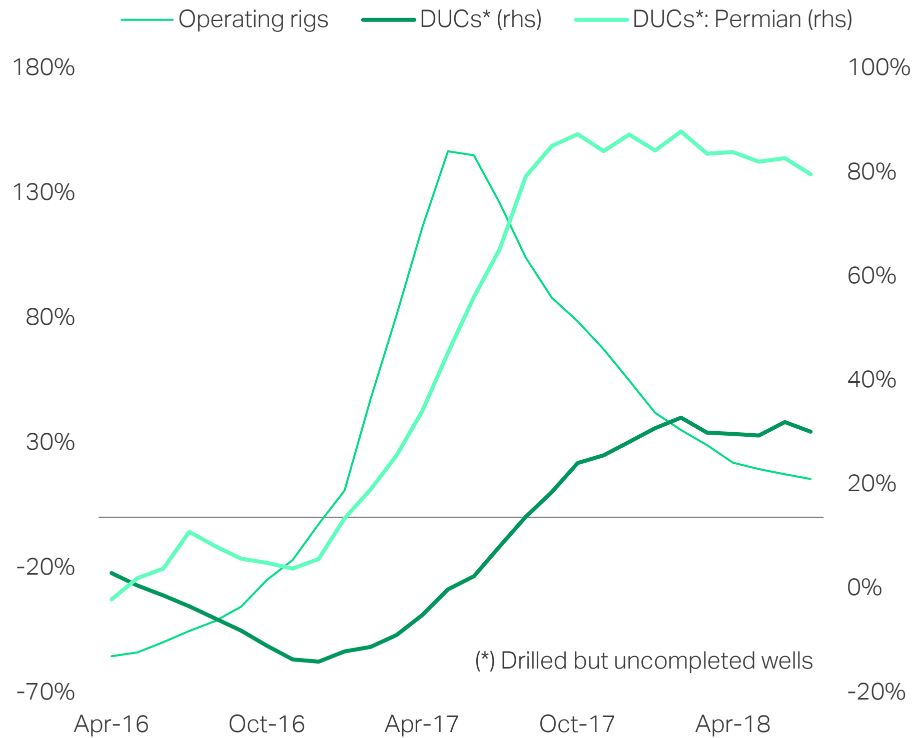


The Shanghai composite has failed to keep up with economic growth in China in recent years. After the 2008 bubble, the SHCOMP market cap was worth about 100% of GDP, but it has since declined sharply and is now only about a third of domestic output. The upside potential is huge, as the market cap-to-GDP ratio is much higher in DMs, especially so for truly global market indices (US, Switzerland, UK, etc.).

Perhaps investors are taking the view that the Chinese stock market won't have a chance to reach global scale if globalisation is going into reverse. The mirror image of this is the outperformance of more-domestically focused small caps in the US. This may be a short-sighted bet but, as long as the risk of an escalating trade war looms, it may be the safe one to make.

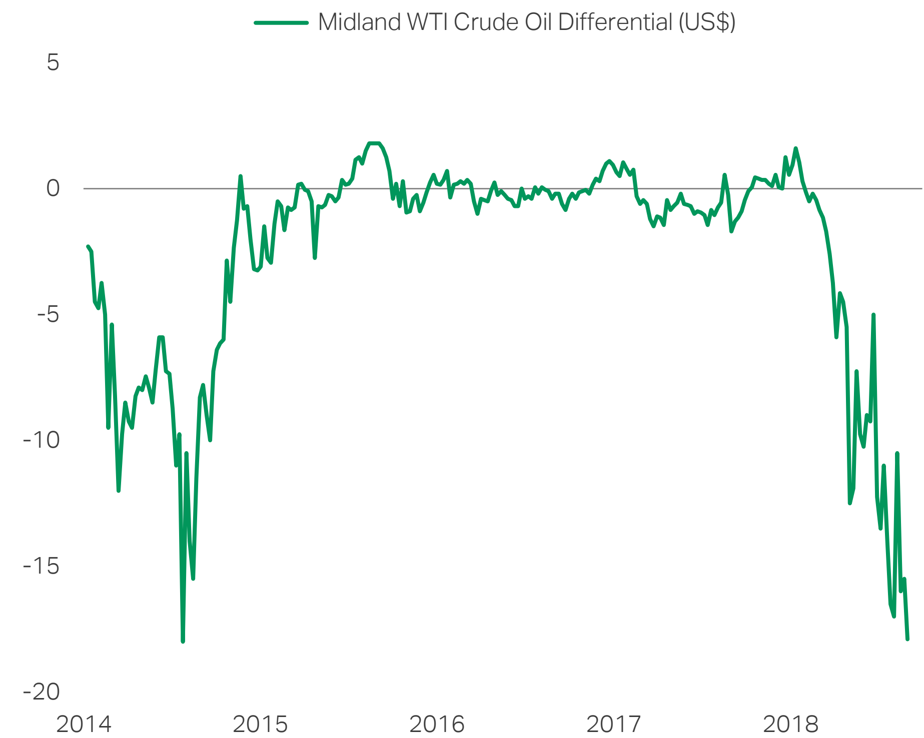
Commodities US shale transitioning to sustainable growth

US shale pulling in the reins



Higher prices have underpinned the US shale industry's transition from expansion at all costs to a more sustainable growth model. This year, drilling has slowed, output gains have cooled forward hedging has eased and M&A has picked up.

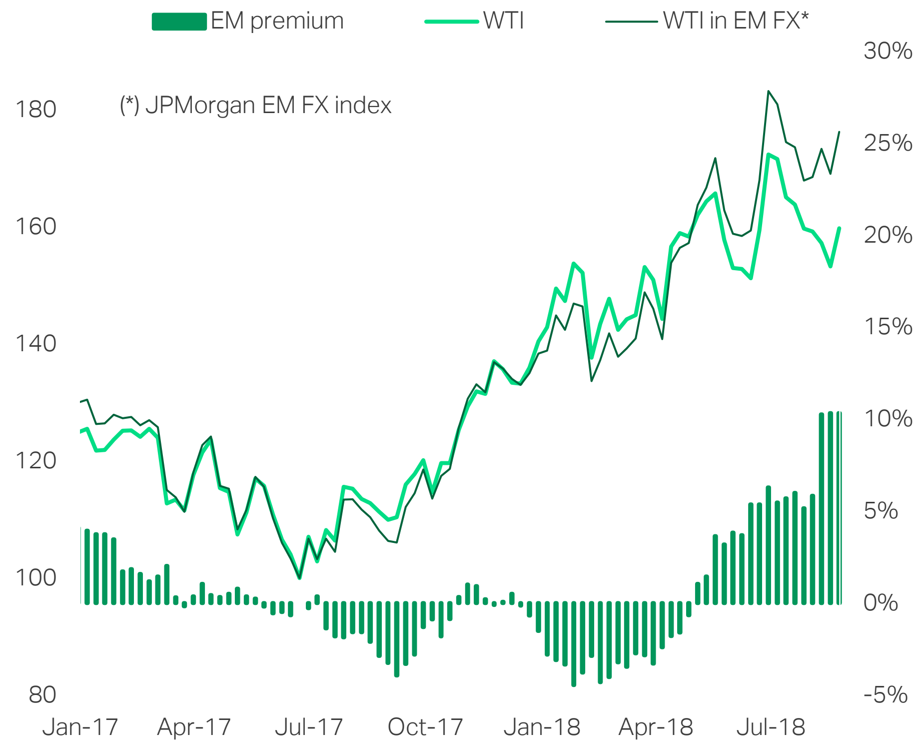
Permian glut



Meanwhile, the combination of surging output and limited pipeline availability has caused a supply glut in the Permian region – by far the shale industry's dominant growth source. This has resulted in a tight US market marked by large discounts, as captured by the wide differential between oil priced in Texas (WTI Midland) and the benchmark (WTI Cushing).

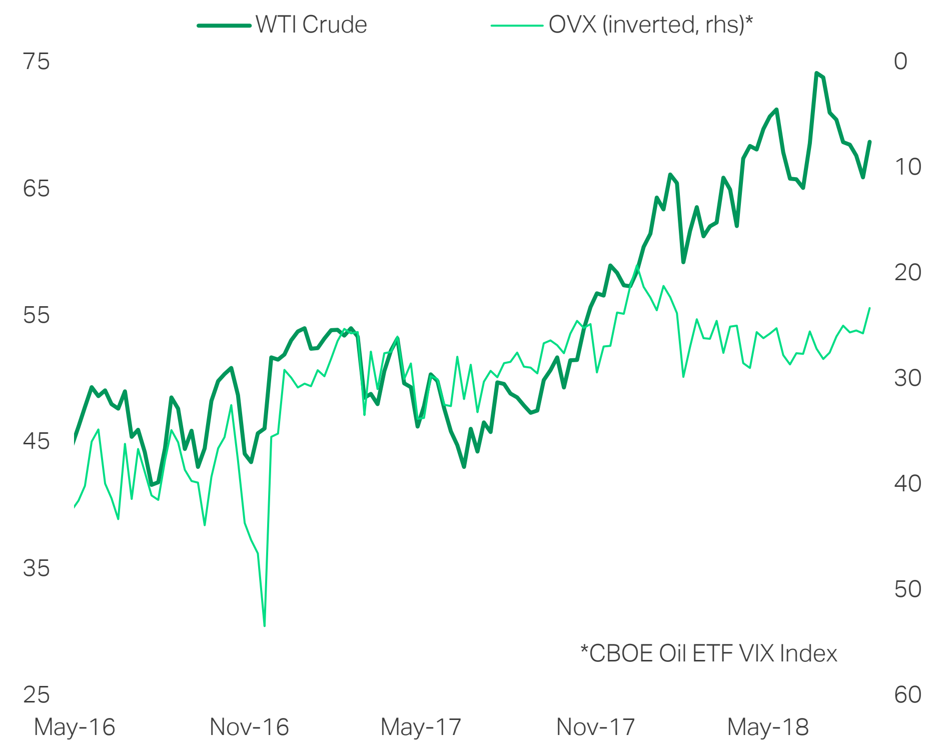
Commodities Mature rally means oil in a range for now

EM pain further clouding demand outlook



Oil demand remains robust for now, but global industrial activity is slowing, trade wars are intensifying and central bank liquidity is receding. Importantly, the currencies of EM economies – the driving force behind global crude demand – are under pressure, making oil much more expensive than it is for DMs.

Vol has bottomed out and has decoupled



The easy gains for oil are behind us. In 2017, the stars were aligned, with supply tightening, demand accelerating and investors turning bullish. In 2018, the rally has matured: volatility has bottomed out and the market has moved closer to balance, consistent with range-bound prices around current levels for the rest of the year.

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