Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

AUGUST 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News: Inflection Point

Quantitative Tightening and trade tensions are negative for valuations and global growth. The repricing of Emerging Markets in 2018 could lead to a repricing of Developed Markets. Prices gapping down like Facebook Inc. (FB.O) dropping -19% in a day is a bad omen. Timing a top is inherently difficult, near impossible.

We are at the onset of a reversal in the cycle of financial inflows that began after the 2008 financial crisis, when the emerging economies were flooded by abundant liquidity coming from developed economies implementing monetary easing policies. This reversal is already under way in the US economy and is set to spread to other developed economies. Asset prices are already reflecting it to some extent and this repricing will likely continue. The combination of rising rates (impacting financing rates), Quantitative Tightening, and intensified bond issuance (impacting term premium) will increase strains on financial assets, especially lower quality credit and balance sheet intensive securities.

Paradigm shift: The markets tend to see the first reversal as an opportunity to be contrarian. It is not. The onset of a reversal is a sign that the scenario has changed and that a new cycle is under way.

Politics

US-China trade war: The world's two largest economies are on contrasting economic trajectories. The US embarks on monetary tightening to prevent its economy from overheating in the context of the lowest unemployment rate since 2000 and GDP growth set to be the fastest since 2005. The Chinese government has moved toward more flexible fiscal and credit policies to avert an economic slowdown, which could be transformed into a hard landing by the impact of Trump's tariffs.

Risk premia rises because of Fed policy and due to a White House that is imposing trade tariffs on even the closest allies. 'America First' stands for nationalism which has historically lead to isolation in the short-term and to wars in the longer-term. Each passing month highlights how the market regime has changed, with rising interest rates, the culmination of Central Bank asset purchase programs, increasing geopolitical tensions, and trade wars increasing uncertainty and driving volatility higher.

European business confidence is hurt by nationalism spreading in Europe. Brexit remains a known unknown risk. Italian rates suffered.

Economies & Monetary Policies

World economic activity has decelerated somewhat compared to the pace seen in the first quarter of the year but continues to expand solidly, with the developed economies taking the lead. The JP Morgan Global PMI is only 1 percentage point short of its February peak and still indicating strong activity. Most major central banks are gradually drawing down their stimulus programs and, in many cases, normalizing interest rates.

Developed world financial conditions are broadly tightening. Cyclically leading economies (US, UK, Canada) have started tightening with rate hikes to fight inflationary pressures and Australia, ECB and Japan tighten via slowing of liquidity injections.

The US economy is accelerating and the US labor market is tight. There are unequivocal signs of cost pressures in terms of both inputs and wages. Naturally, inflation will pick up as a result. In the months ahead it is highly likely that the core PCE will surpass the Fed's target of 2% p.a. Come August, we will probably see numbers in the range of 2.3% to 2.4%. Meanwhile, annualized GDP growth reached about 4% in the second quarter. In this context the Fed will continue to signal the prospect of stronger monetary tightening than what is expected by the markets.

In Europe, the ECB voted to end its bond buying program by December and this will push up interest rate prices in the region. In the UK, Brexit confusion continued but the economic data will permit another rate hike in August. Norway and Czech Republic, among other countries, are also raising rates.

In Japan the BoJ considers making tweaks to their policy stance.

A reversal of the benign setting for the emerging economies with high liquidity is already under way and will intensify.

Macroeconomic conditions remain remarkably benign in the US and most major economies. Economic growth remains robust the world over. US employment is continuing to grow at a steady rate of around 200,000/month, as it has for the past seven years.

The current situation for sovereigns was compared to Prince Rupert's Drop[i] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[ii]

Equities

Despite tightening policy and slowing growth equities have not yet meaningfully responded and remain near all-time highs.

Mining and mining services stocks generally outperform when bond yields are rising. Tech companies with growing revenue and earnings at high levels are independent of economic growth.

Fixed Income

The cost of fixed income is being repriced globally, one market after the next. We have reached the end of QE and zero interest rate policy in the US.

Corporate bond ETFs stand at USD300B, more than seven times the inventory on bond dealers' balance sheets estimated at USD40B.[iii]

USD yields could move substantially higher in order to entice international investors to finance the rising US deficit[iv]: US corporates need to refinance $4 trillion of bonds over the next five years (Wells Fargo Securities, May 9, 2018; $ca. $700 bn in 2018, $750bn in 2019 and $880 bn in 2020). About $3 trillion is investment grade, mostly in the lowest rungs BBB / Baa, with the rest in high-yield. Higher borrowing costs look to coincide with tighter credit conditions. If companies will be forced to refinance at higher rates, credit conditions could erode leading to a vicious circle of more downgrades and pushing bond buyers to seek out better-rated issuers. A positive is the Republican tax overhaul with the new legislation leaving some firms with more cash.

Emerging Markets Currencies & Debt

EM show symptoms of a broader weakness in the structure of global financial markets. Negative turn in EM debt since mid- April.

EM currencies with large current account deficits and a large portion of their debt in foreign hands (Turkey & Argentina) have sold off steeply. Countries on borderline of economic weakness could get sucked into the vortex (e.g. Indonesia, South Africa, India, Brazil).

EM debt at a record USD11trn with liquidity at US$4.9trn in 2017.[v] A rise in USD rates speeded by the turn of QE to being a net negative, could destabilize bond markets globally creating a serious headwind for all fixed-income asset prices.

Commodities

US shale production growth could peak later this year.[vi]

Generally bullish views on commodities based on strong demand growth, supply disruptions and depleting inventory levels in energy and metals markets (a further positive for inflation). Trade tensions are not (yet) seen as a drag on commodity prices with the possible exceptions of soybeans where flows cannot be rerouted given the size of US exports and Chinese imports.

Oil is in a bull market. The extension of the OPEC cut through the balance of 2018 cemented a bullish underlying supply/demand balance. Risk of an oil spike has increased if EM demand improves and US production disappoints.

Almost all oil capex has been directed toward US shale production.[vii]

Exploding demand in rare earths such as lithium, cobalt and graphite because of increasing popularity of electric vehicles.[viii]

Asset Allocation

Short rates

Short credit

Slightly long equities

Since 2008 huge growth in structured products sold to retail investors around the globe. Essentially, these products sell volatility, which is like selling insurance. Large increase of selling portfolio insurance is a compression of vol indices (VIX, VKOSPI, etc.). => long vol e.g. Quest

Wise to look for diversifying assets and / or strategies. Long vol trades tend to be too expensive in equities and in bonds. Yet, implied vol is likely to move higher before long. Merger Arb or event driven strategies profiting from M&A offer attractive risk/rewards. Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen.

Roland Eberhard

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[i] Equinox Partners

[ii] Wikipedia: "Prince Rupert's Drops (also known as Dutch tears) are toughened glass beads created by dripping molten glass into cold water, which causes it to solidify into a tadpole-shaped droplet with a long, thin tail. These droplets are characterized internally by very high residual stresses, which give rise to counter-intuitive properties, such as the ability to withstand a blow from a hammer or a bullet on the bulbous end without breaking, while exhibiting explosive disintegration if the tail end is even slightly damaged. In nature, similar structures are produced under certain conditions in volcanic lava.
The drops are named after Prince Rupert of the Rhine, who brought them to England in 1660, although they were reportedly being produced in the Netherlands earlier in the 17th century and had probably been known to glassmakers for much longer. They were studied as scientific curiosities by the Royal Society and the unravelling of the principles of their unusual properties probably led to the development of the process for the production of toughened glass, patented in 1874."

[iii] Gavekal, May 8, 2018, "The Illusion of Liquidity, and Its Consequences"

[iv] Karya

[v] Bank for International Settlements: between 2010 and 2017 the total value of emerging market debt securities outstanding more than doubled from US$5trn to around US$11trn. Yet over the same period, according to the Emerging Market Traders Association, trading volumes in emerging market debt fell, sliding from more than US$6.5trn in 2010 to US$4.9trn in 2017.

[vi] Rig count in the Permain basin has flatlined around 460 with new production at 620 brl/day to a new production of 285'000 brl/day. Legacy decline is over 300'000 brl/day implying that Permian output could fall in the next few months. Source: Horseman, 25.07.2018

[vii] Horseman Global, BBL Commodities

[viii] Regal Funds Management