Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

NOVEMBER 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News: Inflation Pressure

Get ready for a year-end rally. The bull market in US equities is likely to continue as corporate profitability remains strong. Interest rate-sensitive sectors should be avoided as long as the Fed keeps on raising rates. Emerging Markets are also likely to recover from the major underperformance so far in 2018.

The main risks are politics and monetary policy. Implied volatility is set to rise as key events approach.

A rich environment for macro trading has started in earnest because of momentous changes in the global political and economic backdrop. The rise of nationalism leads to a weakening of global law and order, increasing risks in financial markets. The most important from the standpoint of a macro opportunity set has been the progressive withdrawal by central banks from their heavily distorting and volatility-suppressing direct participation in government fixed income markets.

Politics

US-China trade war: The economic impact has yet to hit Asia but impact deepens. When Xi Jinping will meet Donald Trump on November 30[i] a deal would be a risk on signal.

The outcome of the US election next week amidst a polarized electorate is a known unknown. Even if Dems were to control the House the White House economic policy would likely only be affected next year. 'America First' stands for nationalism, which has historically lead to isolation in the short-term and to wars in the longer-term.

Economies & Monetary Policies

Financial conditions are getting tighter. Stocks face a dichotomy between good news from corporate earnings and bad news from monetary policy.

Economies face narrowing output gaps and rising inflation yet markets continue to expect accommodative central bank policies. Wages are rising in the US, UK, Europe and in Japan. Investors may be underestimating the probability of tighter monetary policy. The risk is that markets respond asymmetrically.

The US economy is accelerating and the US labor market is tight. The US growth outlook for 2019 has strengthened. There are unequivocal signs of cost pressures in terms of both inputs and wages. Inflation will pick up as a result.

The risk is higher for the Fed to hike more, not less than the market has currently priced in. The risks to inflation have become asymmetric.

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

Equities

The recent stock market sell-off was likely a correction rather than an economic signal. Since 1934, the market was up every time before and after mid-term elections.[iv]

The biggest EM countries are all engaging in reform while the developed markets are still overly reliant on low interest rates. For macro traders, shorting DM and buying EM looks like a trade with attractive risk/reward.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating.

Fixed Income

The cost of fixed income is being repriced globally, one market after the next. The balance of risks to bond yields relative to market pricing is heavily skewed to the upside.

Distressed investing a theme for next year: QE goes into reverse and there are big debt loads on some public and private balance sheets. The Sears default is a major event for distressed investing next year.[v]

USD yields could move substantially higher in order to entice international investors to finance the rising US deficit[vi]: 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.

Emerging Markets Currencies & Debt

With the election in Brazil behind us risk appetite for EM assets might return. Still, 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.[vii] 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

Oil: US shale production growth could peak later this year.[viii] The extension of the OPEC cut through the balance of 2018 cemented a bullish underlying supply/demand balance. Almost all oil capex has been directed toward US shale production.[ix]

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.[x]

Asset Allocation

Wise to look for diversifying assets and / or strategies. Implied vol is likely to move higher before long.

Start to allocate towards macro trading, long and short: Longer-term, there are multiple headwinds for asset prices. Currency devaluations and defaults are likely to rise in 2019.

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

November 1, 2018

[i] The next G20 summit in Buenos Aires, Argentina is scheduled on November 30 until December 1, 2018

[ii] Equinox Partners

[iii] 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."

[iv] Source: Deutsche Bank

[v] Sears Holdings filed for Chapter 11 bankruptcy protection on October 15, 2018 with $5 billion debt on the balance sheet.

[vi] Karya

[vii] 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.

[viii] 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

[ix] Horseman Global, BBL Commodities

[x] Regal Funds Management