TOP DOWN CHARTS

Chart driven macro insights for investors

Weekly Macro Themes – 20 March 2020 - Volume 5, Edition 10

From the top down, here's the bottom lines:

1. Credit Check: Credit is facing a perfect storm as multiple sectors come under pressure, yet (as a result) sentiment and valuations are starting to look attractive from a contrarian standpoint.

2. US Dollar: Treating the USD breakout with scepticism given the procession of false breaks on both sides over the past couple years (also yield support is fading and valuations are getting stretched).

3. Commodities: (more) Bullish medium-term on cheap valuations, supportive capex/supply outlook, and the ZLTEI thesis. Meanwhile short-term/tactical indicators have moved sharply (to contrarian bullish).

4. China Property: China property prices took a hit in Feb, but may bounce back as pent up demand and marginally easier policy helps; this should be supportive for iron ore prices.

5. TIPS/Inflation Expectations: TIPS breakevens (much like their intermarket analogs) are trading at compelling cheap valuations, and mean reversion + the ZLTEI thesis support the medium-term case.

1. Credit Check

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1. Credit Check: First up this week is a quick check in on credit. Clearly credit has taken a hit with the overall risk-off moves – mirroring the volatility in equities as it usually does. Albeit, there have been numerous times where equity volatility spikes and credit doesn't follow suit. And indeed, the story doesn't end here.

There has been very real pressure exerted on the oil & gas sector as commodity prices (oil in particular) have collapsed. Travel & leisure, and retail (which was already in question) have also come under pressure – being at the frontline of the pandemic headwinds. So there are very real and clear sector-specific issues, but then there are also question marks around the broader economy, so it's a perfect storm for credit, and spreads have moved accordingly, both at the high and low quality ends of the spectrum.

Naturally, that makes my contrarian tendencies light up, particularly when I notice spreads (closest thing to valuations for credit) move greater than 1 S.D. beyond long term average… and from a sentiment standpoint passive/ETF flows collapse as investors run for the doors. Clearly risks remain, but at this point sentiment and valuations look good for credit.

The turning point/catalyst could come from any combination of: a turn in the pandemic stats/news (e.g. peaking out of case growth numbers, or drug/treatment breakthrough), and/or simply sufficient monetary/fiscal stimulus so as to short-circuit the risk-off cycle. But for the troubled sectors, easier monetary policy will struggle to speak louder than low oil prices and zero tourism activity.

Bottom line: Credit is facing a perfect storm as multiple sectors come under pressure, yet (as a result) sentiment and valuations are starting to look attractive from a contrarian standpoint.

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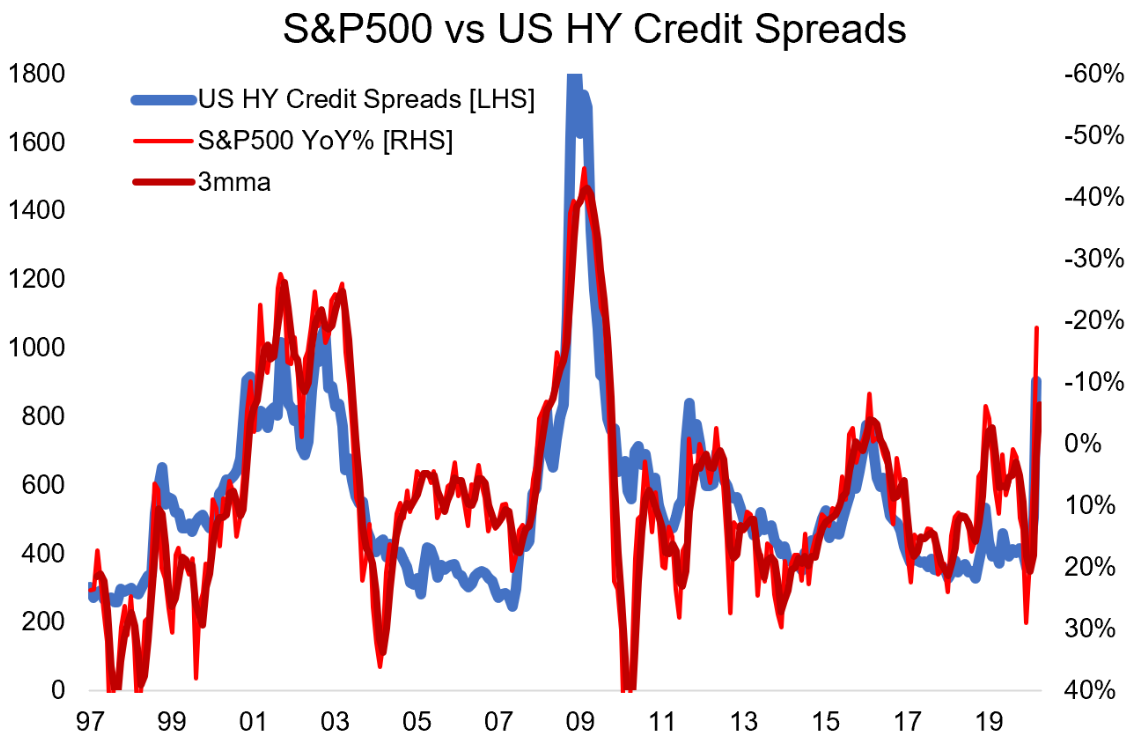
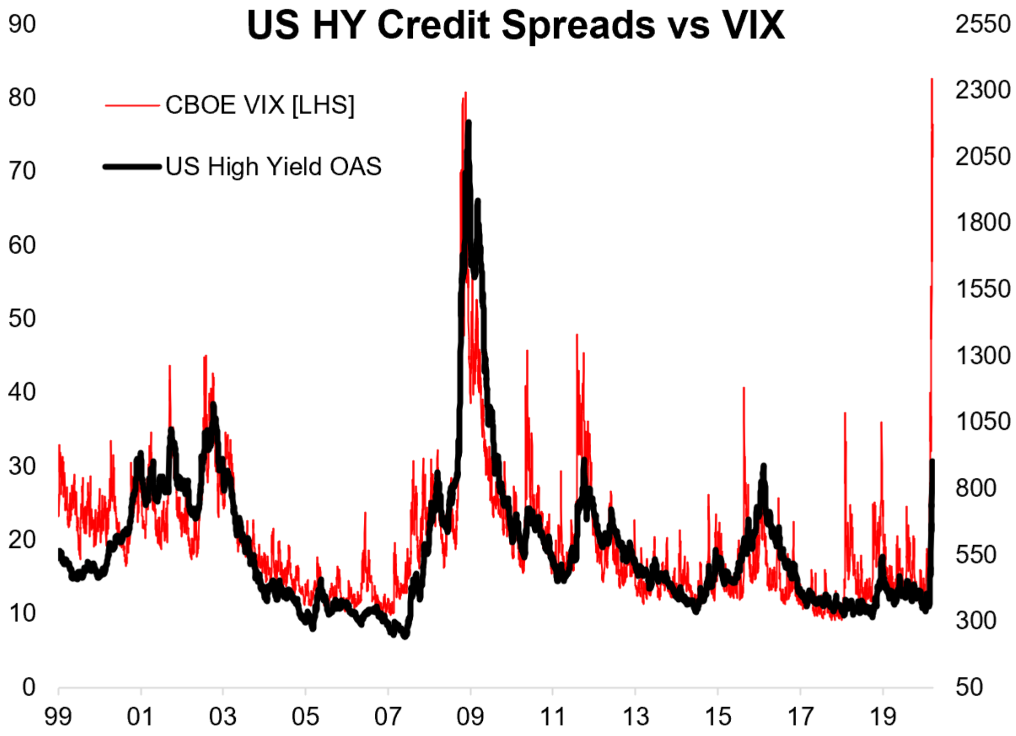


Source: Topdown Charts, Refinitiv Datastream



Source: Topdown Charts, US Federal Reserve, Thomson Reuters

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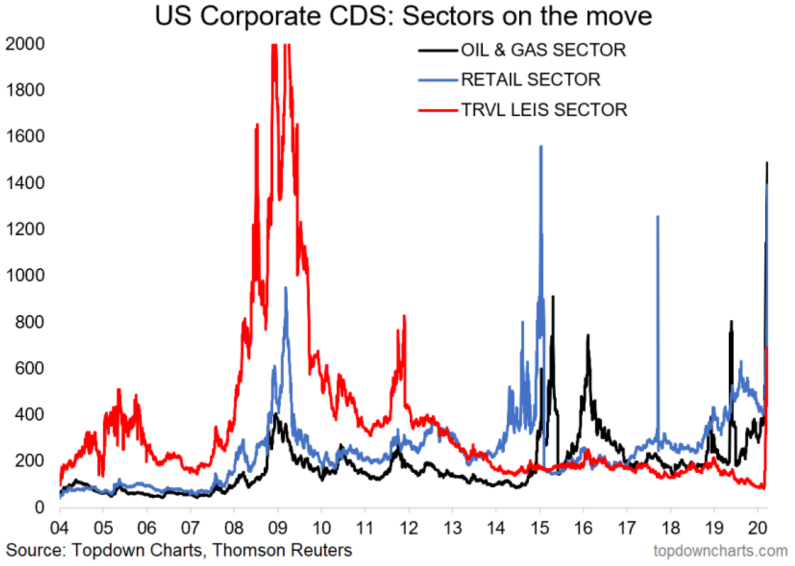

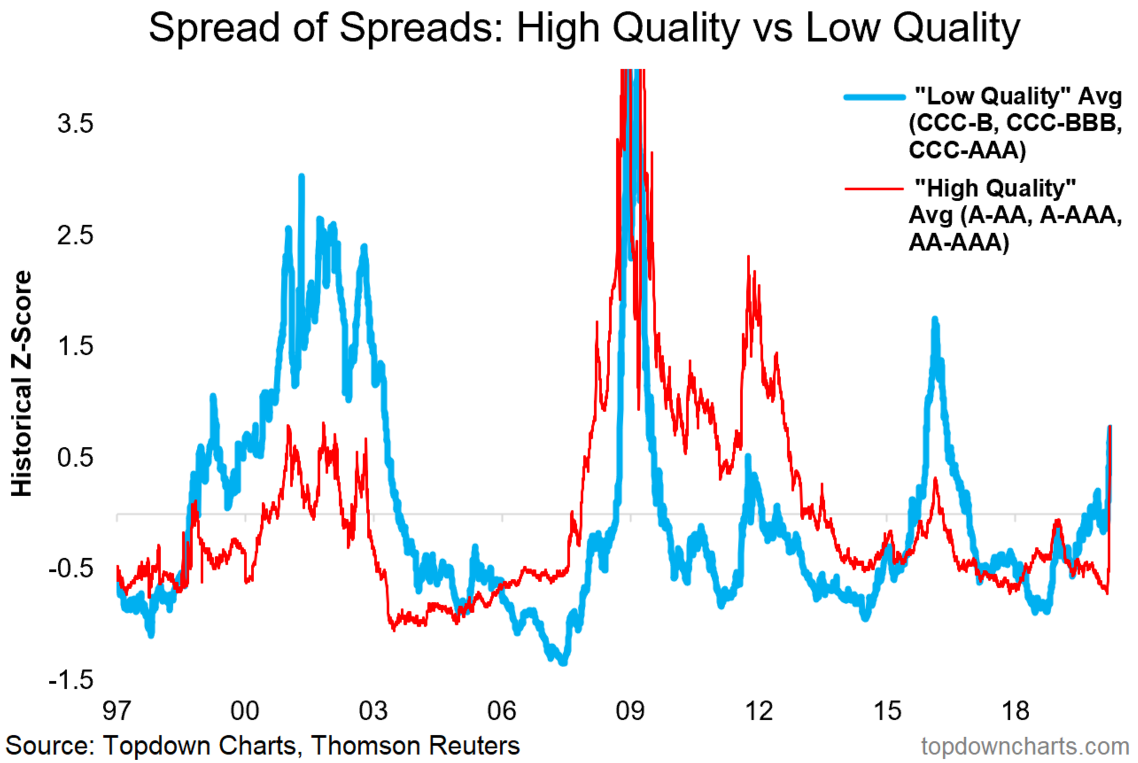

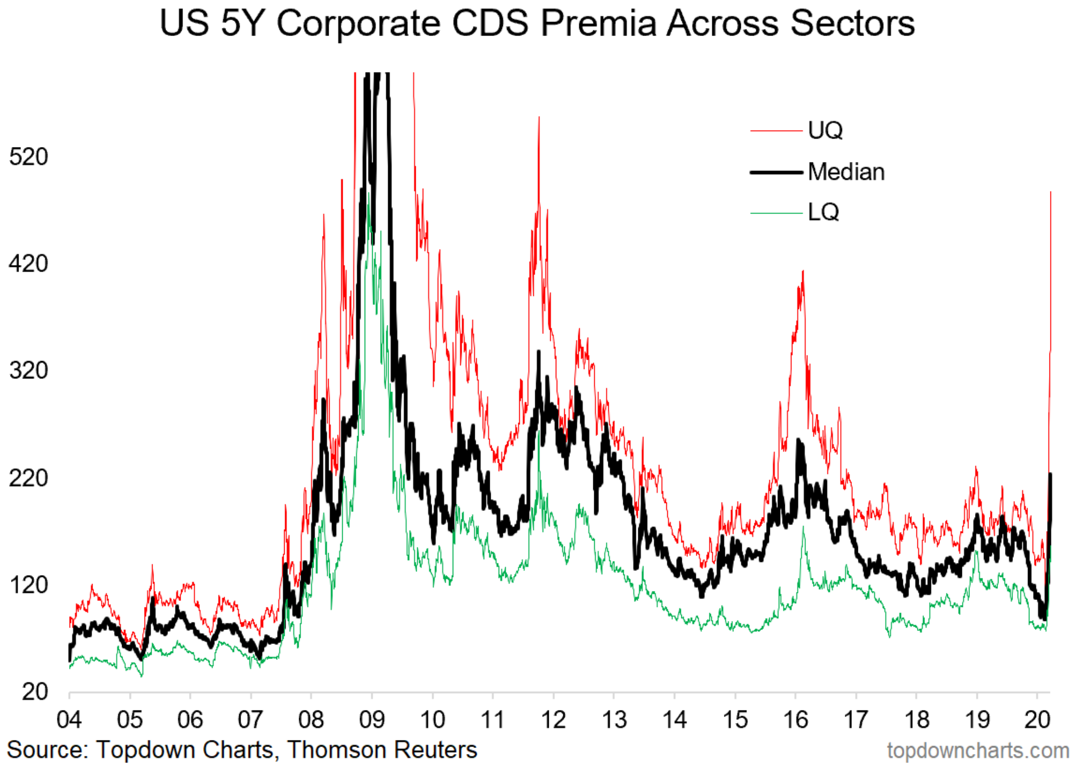

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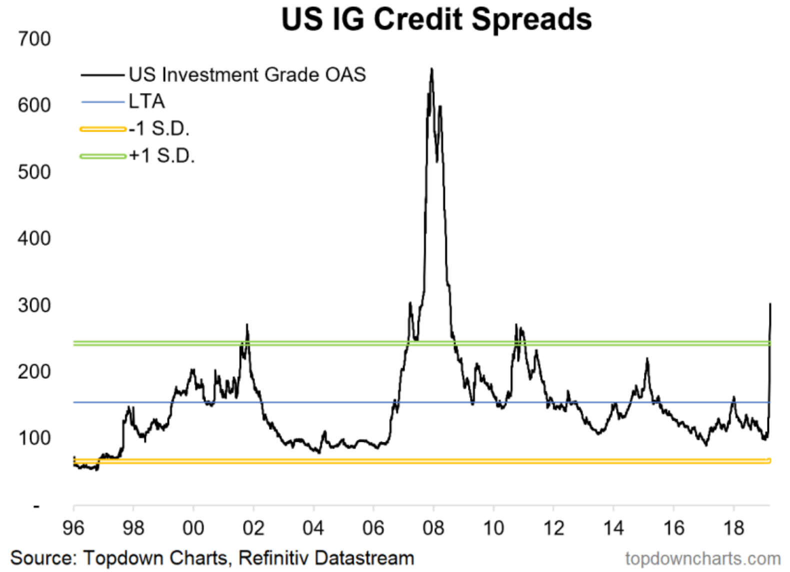

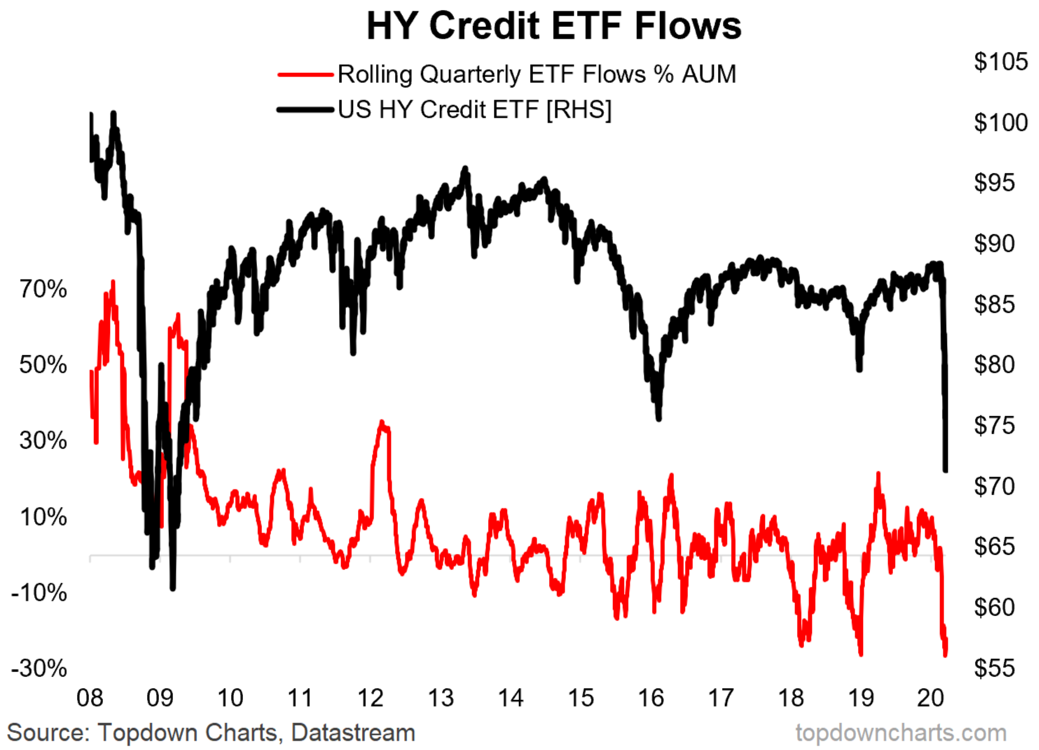

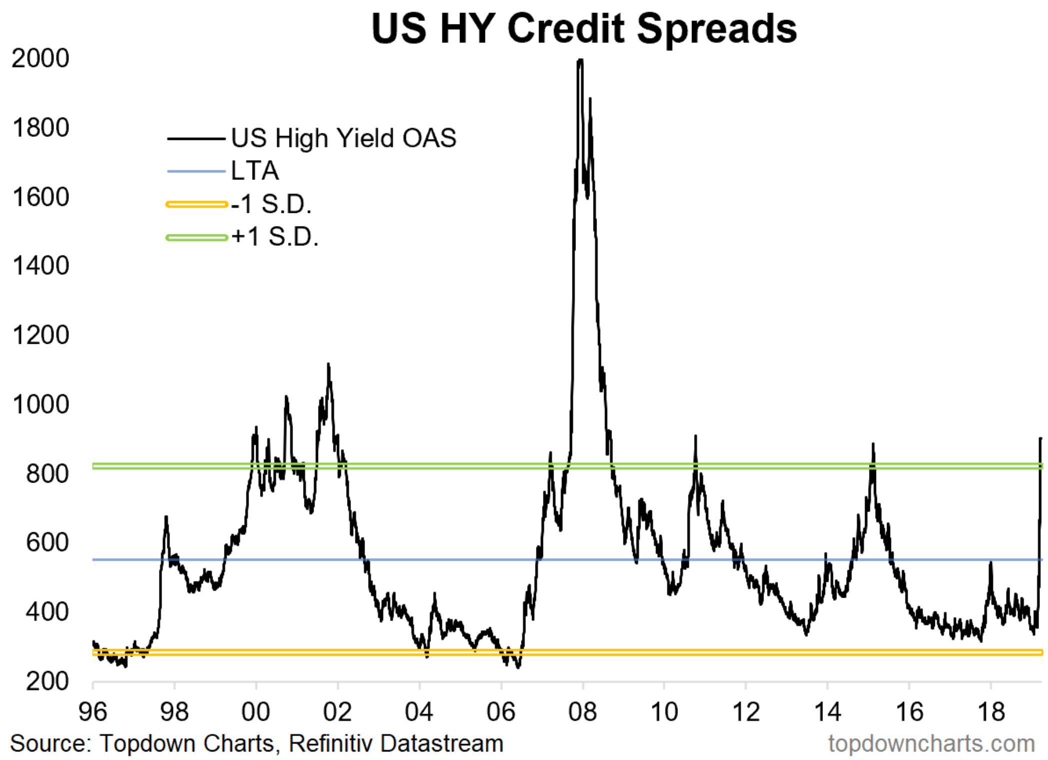

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2. US Dollar

2. US Dollar: It is of course worth checking in on the US dollar, and the much heralded return of volatility is about the only clear thing here. After making a false break down and then bounce earlier in the year, the same actions were repeated again in the last couple of weeks albeit shorter and sharper. Will the current surge end up as another failed breakout? Let's review some historical context first: one thing that sticks out to me on the long term chart is that there's basically 2 types of trading for the DXY: trending and ranging. Ranging is actually much more common, but of course trending gets more attention. I think it's important not to discount the fact that this could just be more ranging, rather than a big breakout and continuous move higher.

Aside from the historical perspective, what makes me doubt the rally is the now even clearer rollover in yield support (removes tailwind, and if extended adds headwind). Also valuations are starting to get actually stretched to the topside. So while to a certain extent you have to respect the price action, and although some things have changed since my initial bearish thesis was formed, the yield and valuation charts make me still err on the bearish side.

Quickly on EMFX, market breadth has collapsed (beginning to look oversold: but history tells us oversold can stay oversold/get more oversold!), and my Asian/EMFX indexes have broken down through key levels. Clearly the USD strength and flaccid risk appetite are not helping, and the macro backdrop is hardly worth even thinking about. But valuations are getting cheaper, and for EMFX are now on par with 2009.

Bottom line: Treating the USD breakout with scepticism given the procession of false breaks on both sides over the past couple years (also yield support is fading and valuations are getting stretched).

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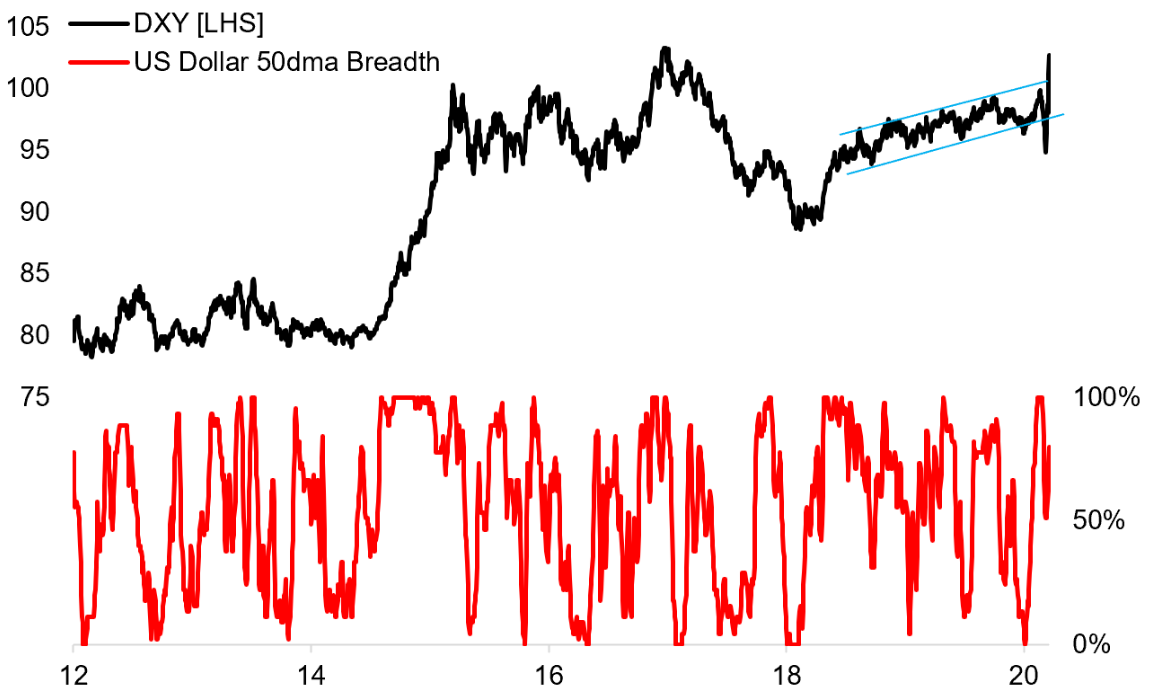
US Dollar Index vs G10 Breadth



Source: Topdown Charts, Refinitiv Datastream

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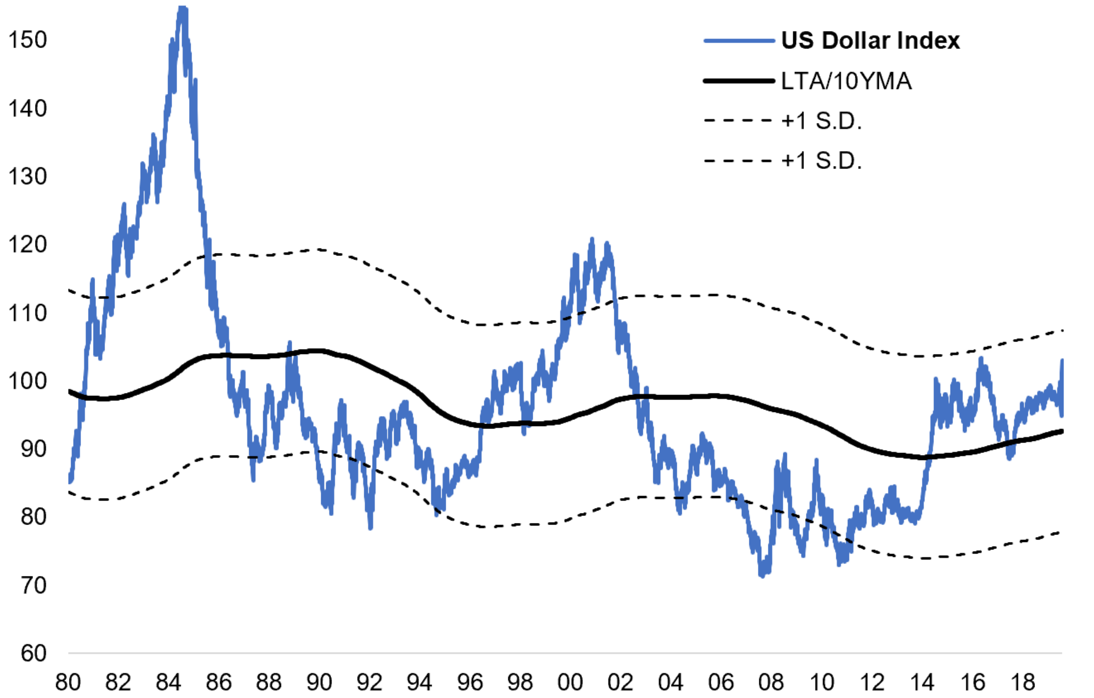
Longer Term Perspective: Cycles and Ranges



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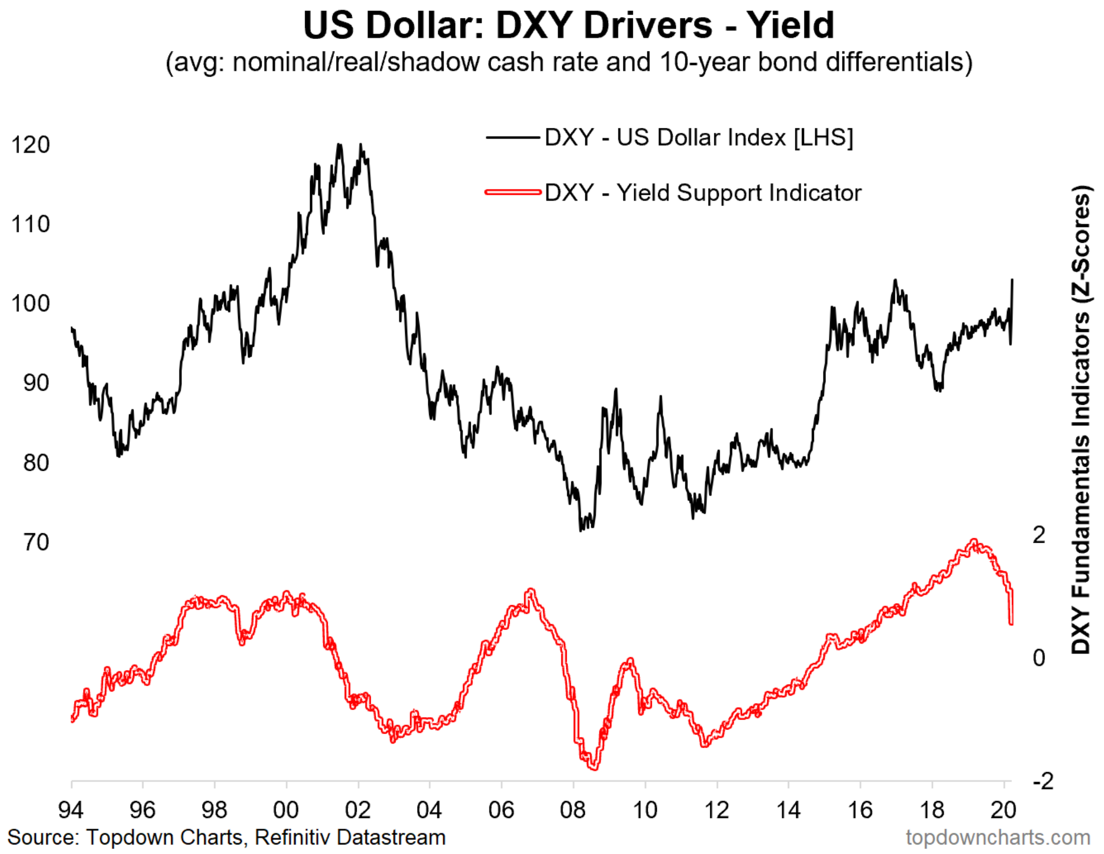

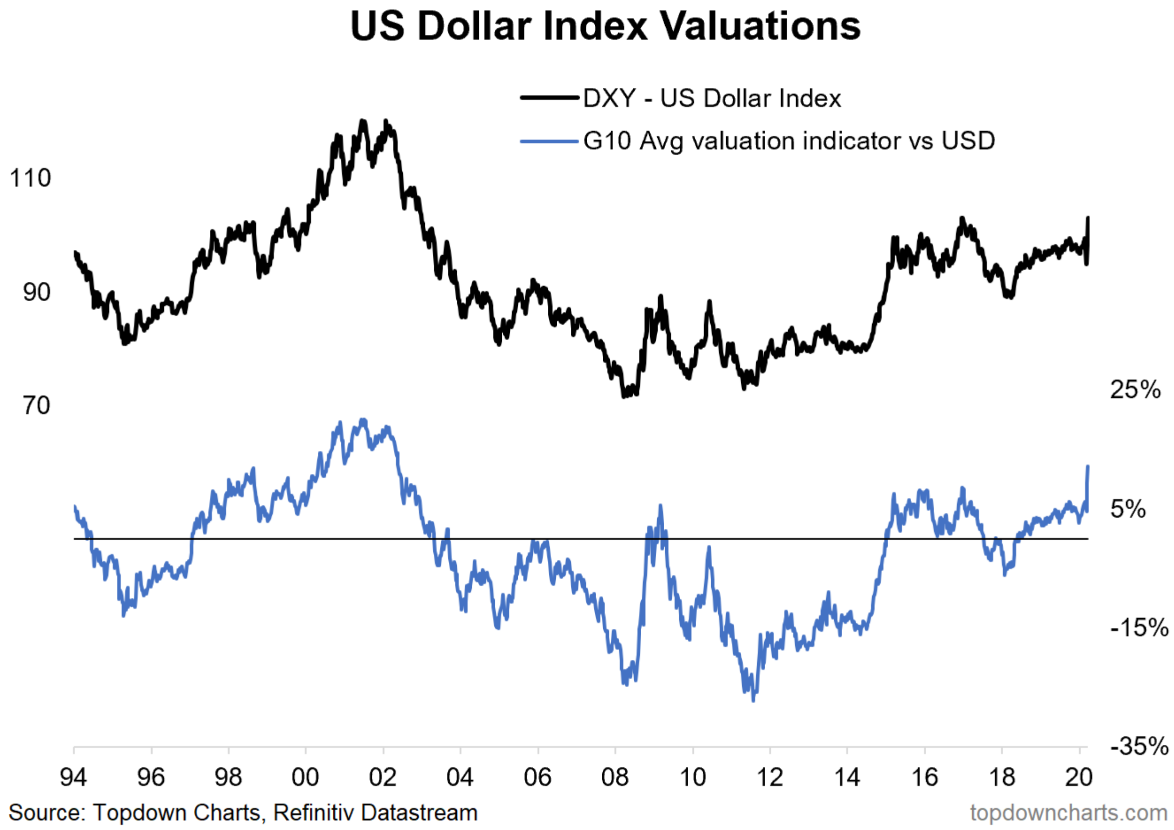

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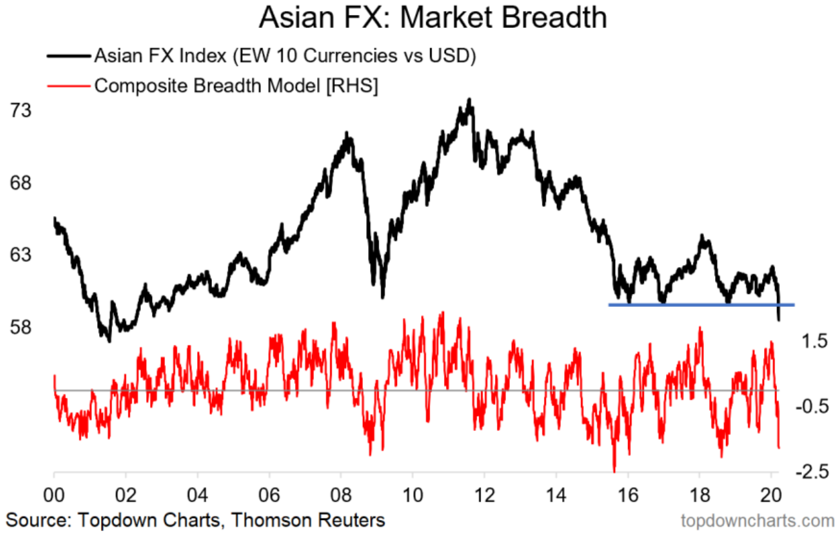

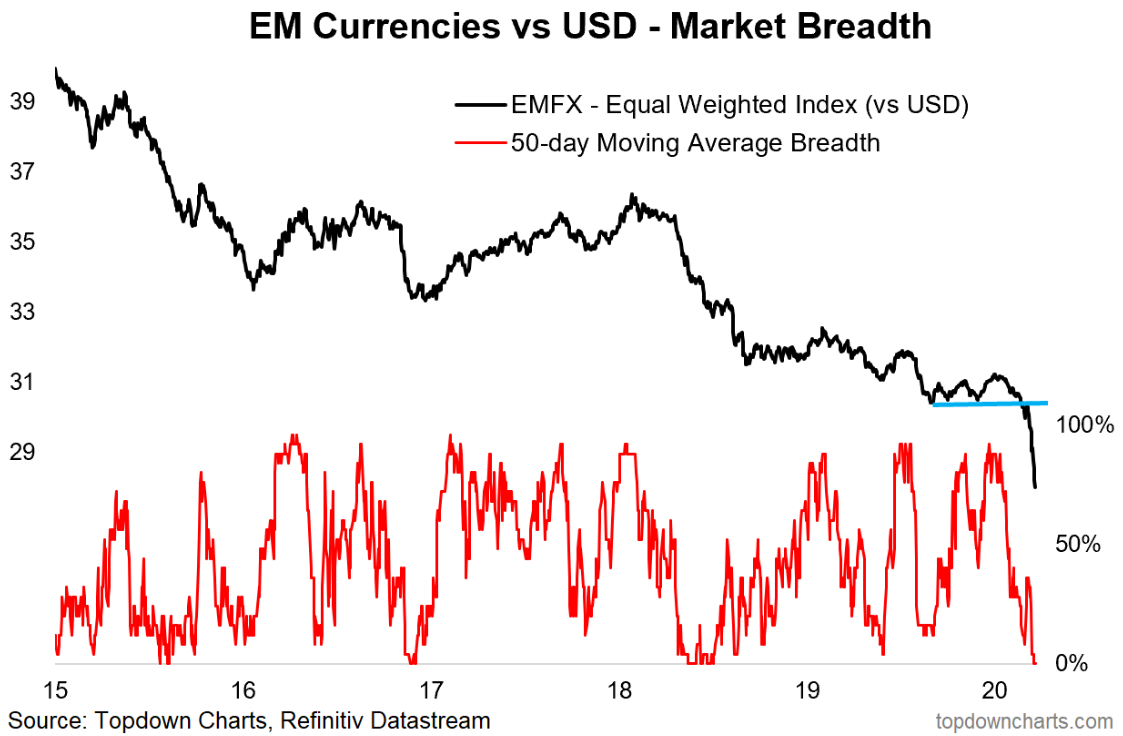

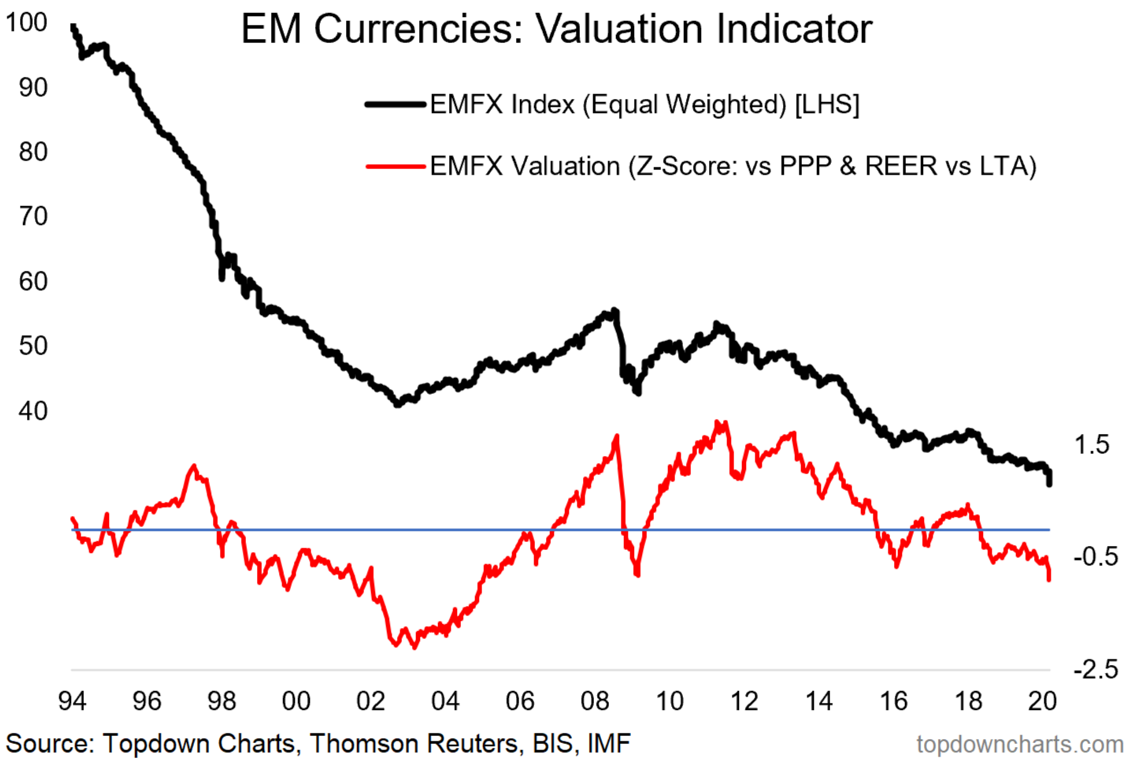

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3. Commodities: The bout of USD strength and collapse in crude (n.b. crude has direct linkages/correlations to a number of other commodities) have weighed on commodities as an asset class. But some of the tactical indicators are looking interesting: breadth is washed out, commodity volatility has moved far beyond 08, and positioning has come down a lot (both in the surveys and futures data), the GSCI light energy is holding support (for now).

Meanwhile, valuations have dropped to near record lows, and commodity capex is likely to take a further hit: which creates the foundations for a more bullish medium-term outlook as supply growth gets curtailed. Obviously the macro/demand aspect has major question marks in the short-term, but as long as there is no major and lasting economic impairment (i.e. a shock hit, and then back to business), and throw in all the stimulus, we should see demand bounce back (and possibly then some).

Even though the short-term/tactical indicators are starting to look quite good, there does remain some uncertainty in the immediate term (what if USD goes higher? what if virus news turns worse before better? what if stimulus isn't enough to break the risk cycle? what if China has a relapse or policy mistake?), the medium-term picture looks compelling. So while my initial bullish take on commodities back at the start of the year was catastrophically wrong, I would definitely be doubling or tripling down on that call now, given the suite of indicators and the "Zero Long-Term Economic Impairment" thesis.

Bottom line: (more) Bullish medium-term on valuations, capex/supply outlook, the ZLTEI thesis; meanwhile short-term/tactical indicators have moved sharply (contrarian bullish).

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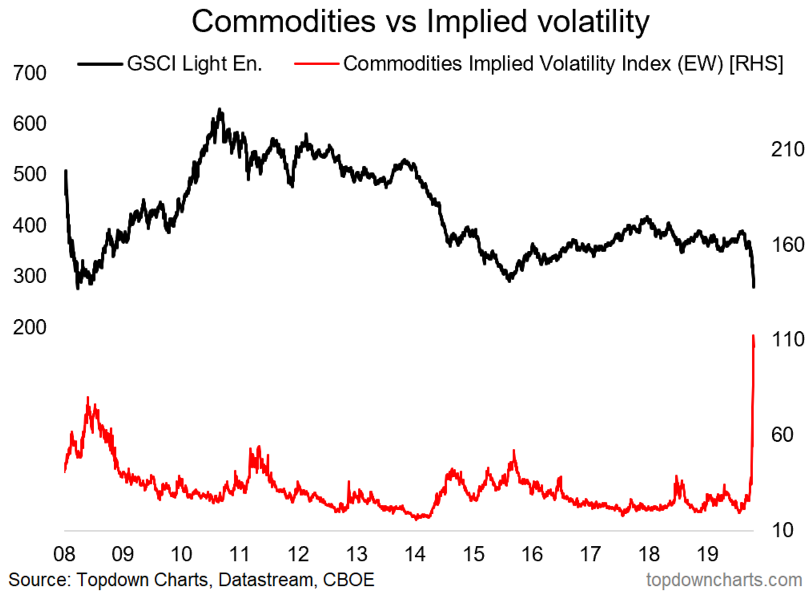

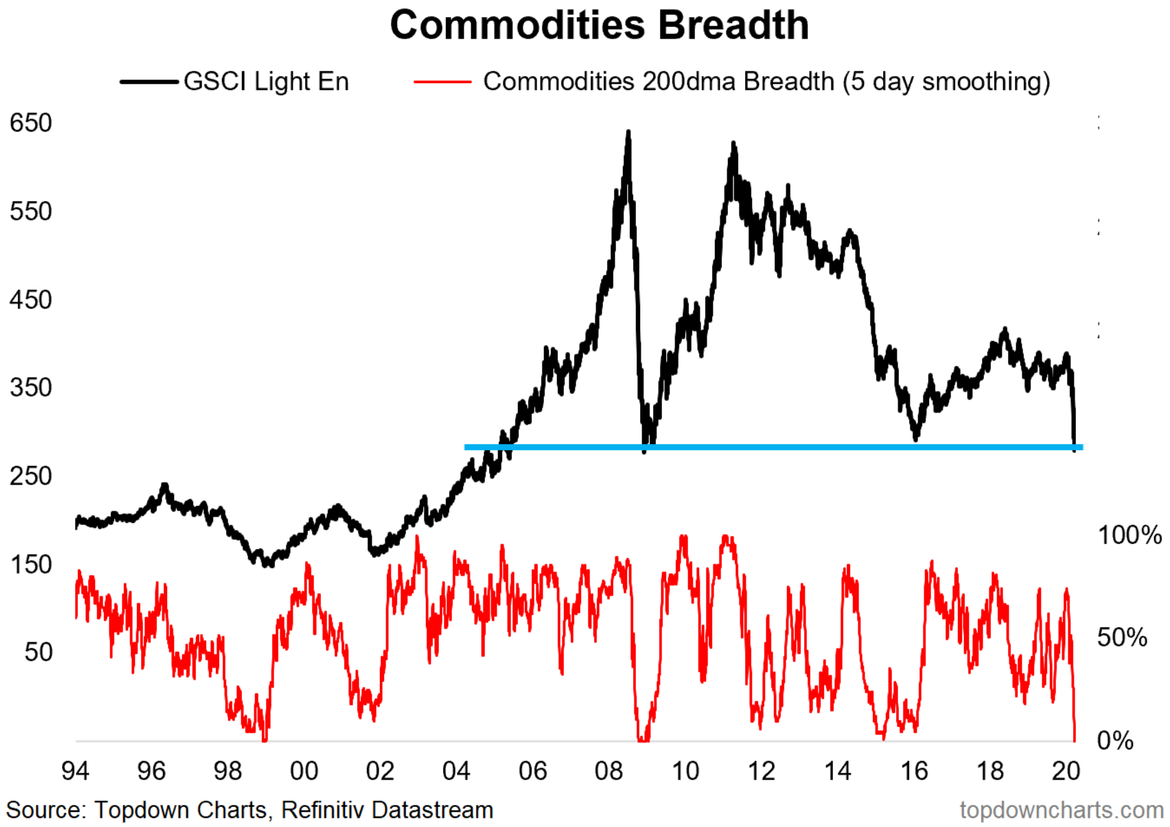

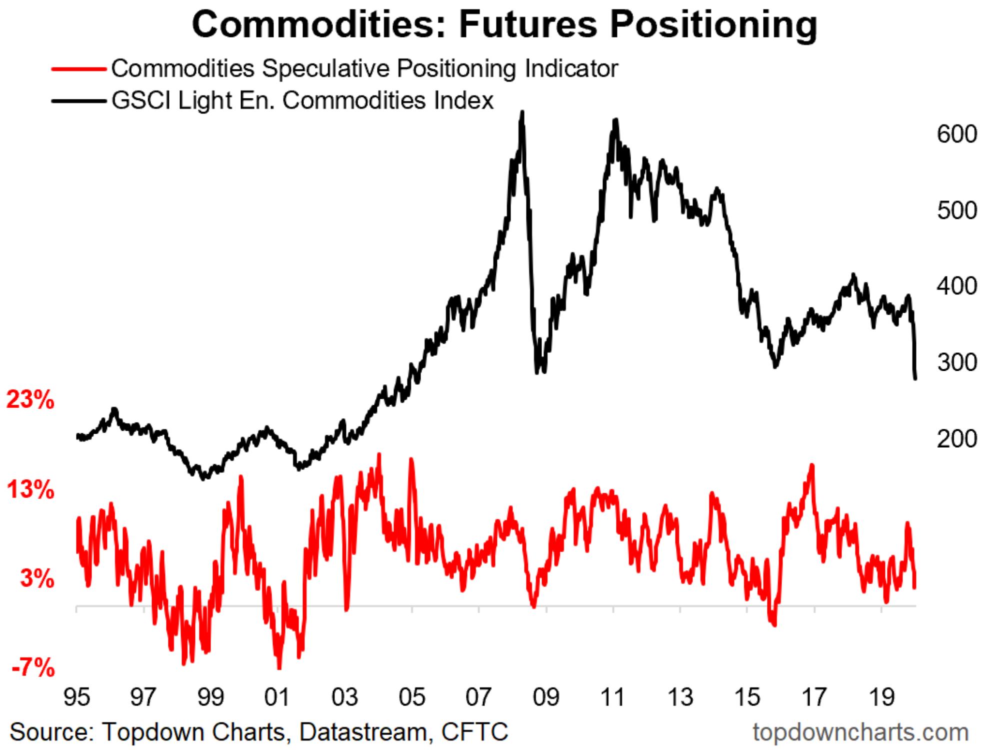

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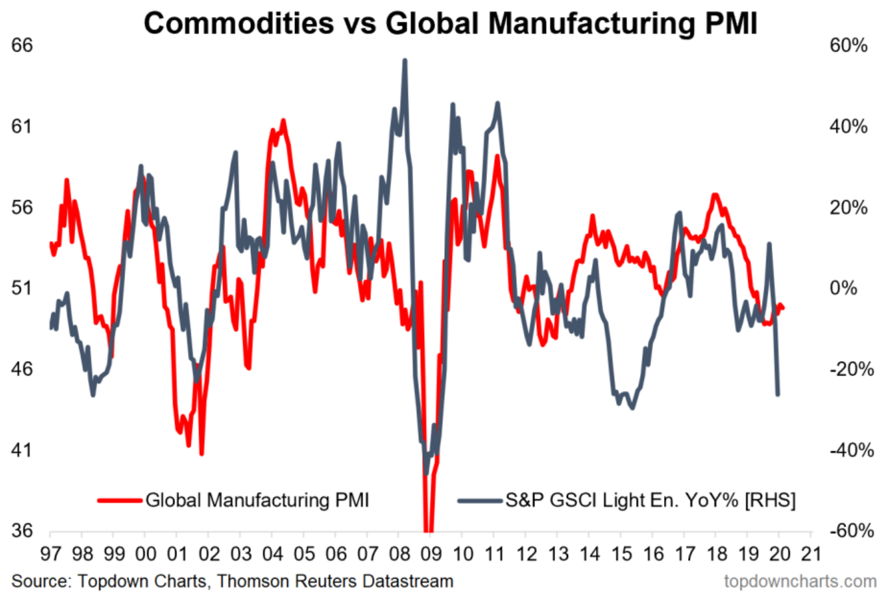

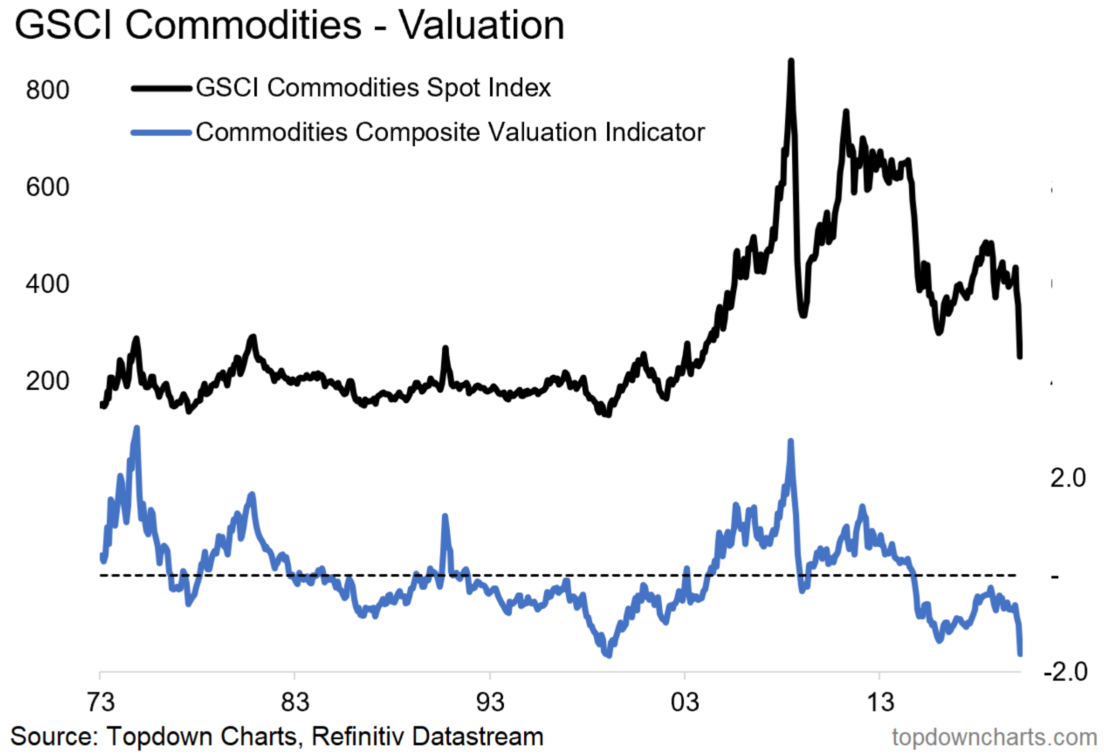

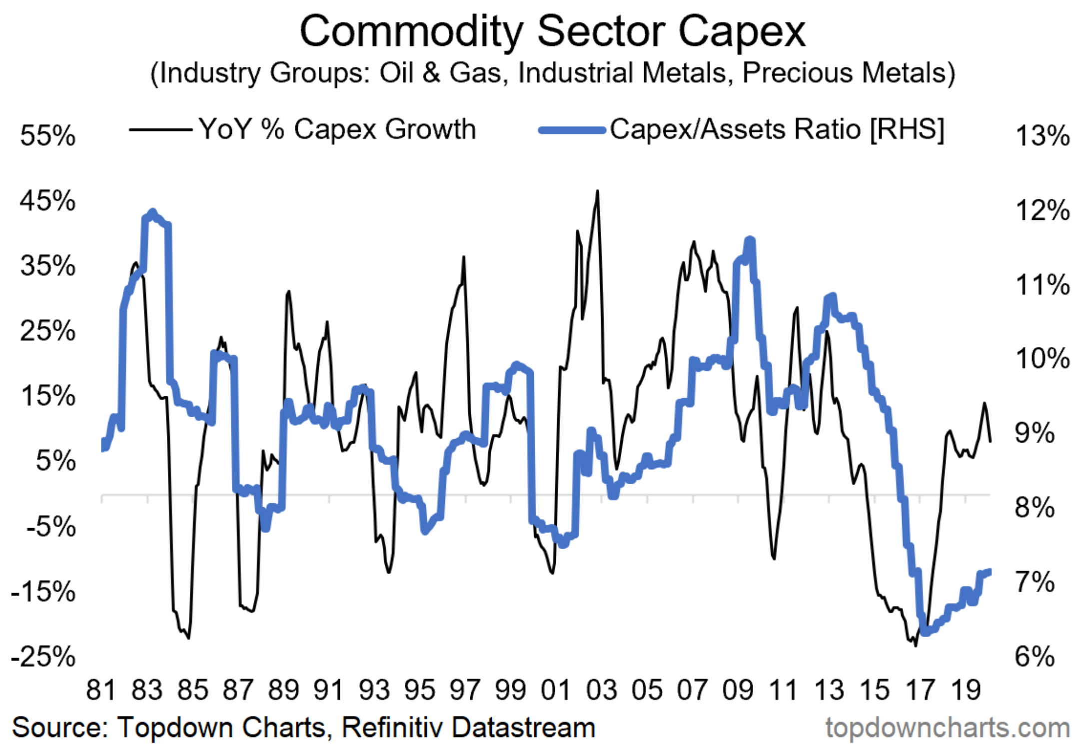

4. China Property

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4. China Property: The February house price data for China was (unsurprisingly) very weak, with property prices down on the month in most cities. This comes on the back of a trend of slowing price gains. But with apparently better virus numbers out of China, the focus now turns to the March data and beyond. At the moment the lead indicators are mixed: property stocks point downward (maybe sentiment effected though?), M1 growth remains low vs average, but 5yr govt bonds yields suggest upside (as would an expected overall easier monetary/macpru/fiscal policy backdrop.

I would tend to give the latter a bit more weight, particularly also given the price action in iron ore, which appears to be looking through the one-off(?) shock to real estate FAI growth. Indeed, given sentiment/news effects around China and with all the other stuff going on (difficult financing conditions, trade woes, short-term human capital impairment), arguably supply growth is challenged in the immediate term.

The March consumer sentiment data for China has shown a slight rebound, and that would be the base case (that data rebounds when the virus gets under control). But timing could be an issue: if China itself gets back to business but the rest of the world is still in lockdown, then that will present a clear headwind to China from an external demand standpoint (still a key driver for China). So while stimulus efforts to date have been disappointing/piecemeal, a softening of inflation and weak global demand pulse could drag China into doing more… which would likely help property (and iron ore demand).

Bottom line: China property prices took a hit in Feb, but may bounce back as pent up demand and marginally easier policy helps; this should be supportive for iron ore prices.

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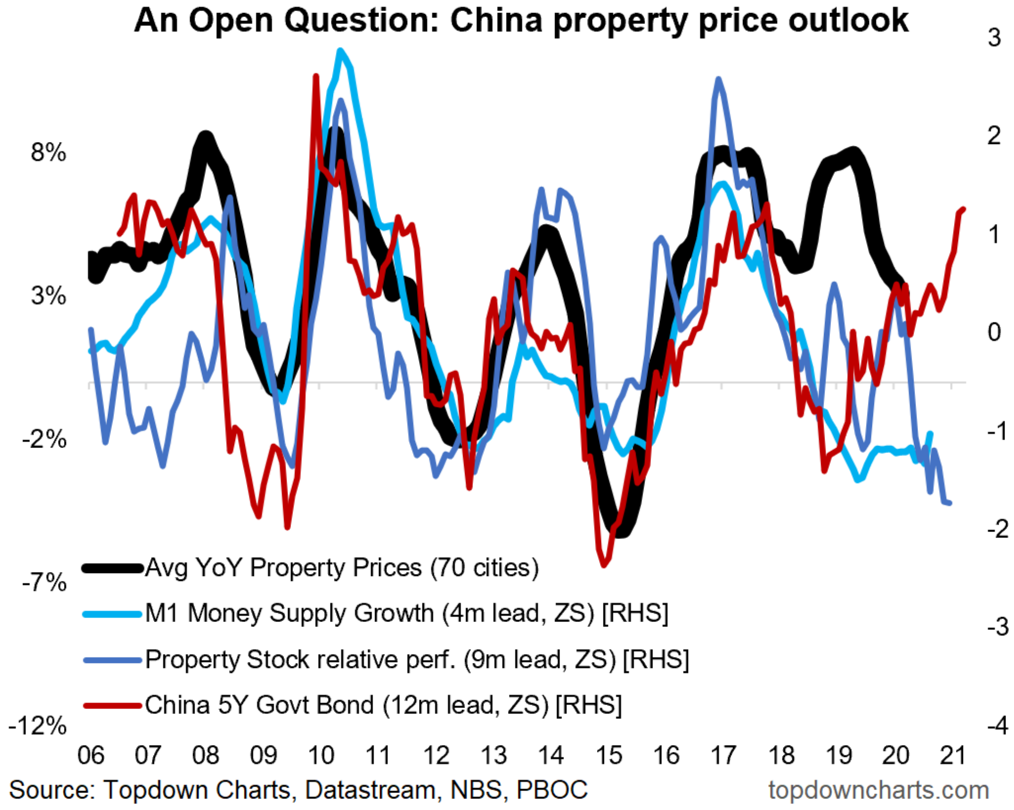

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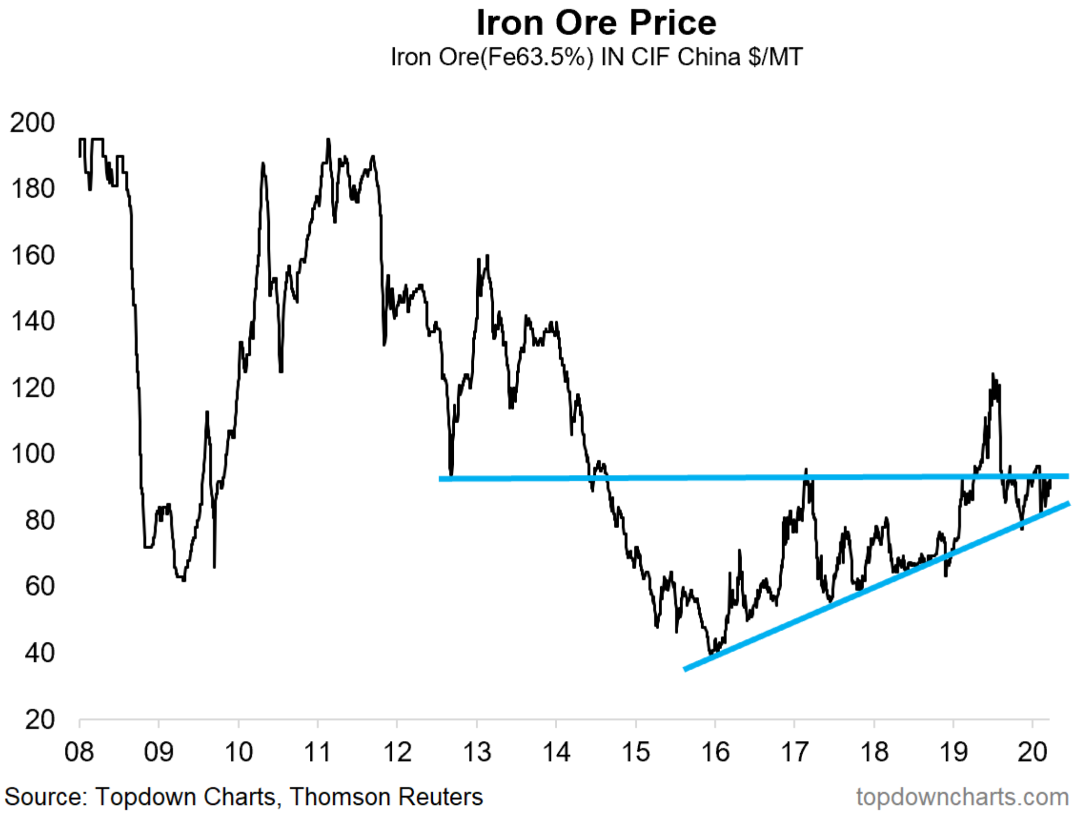

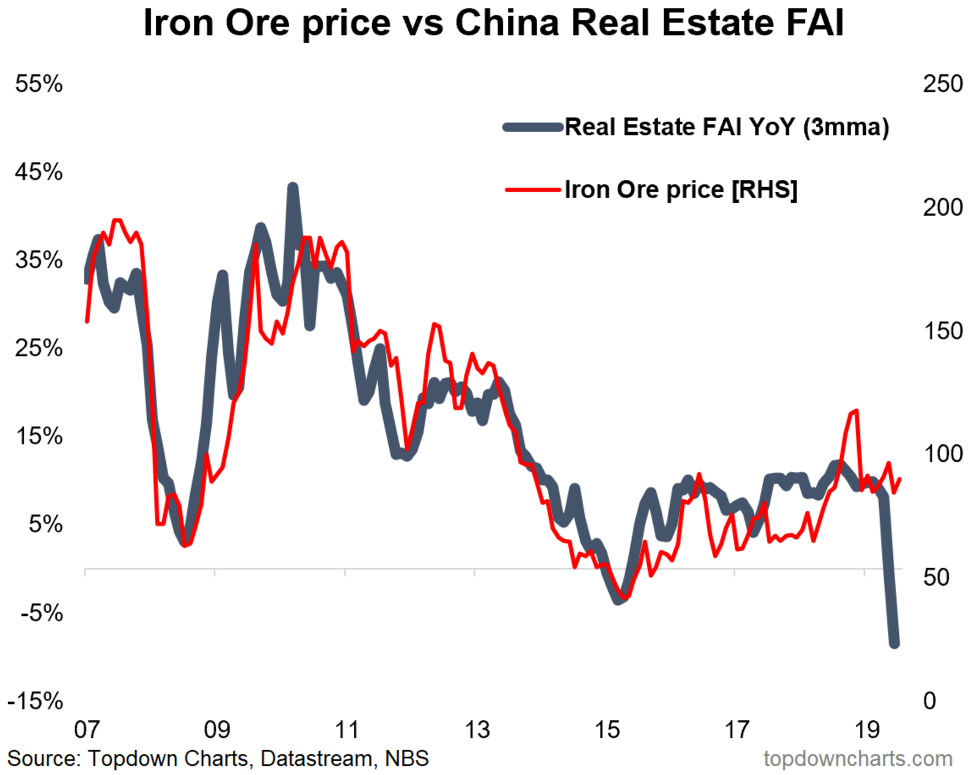

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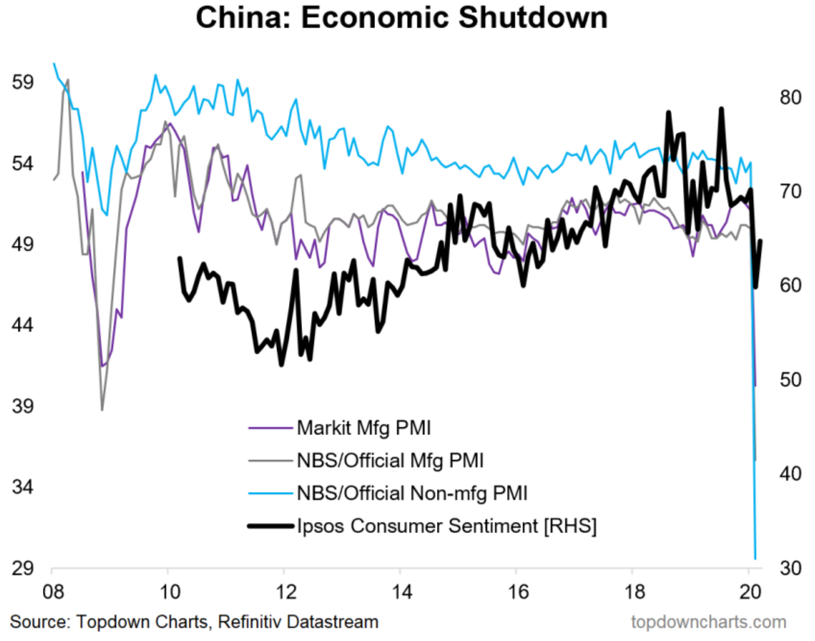

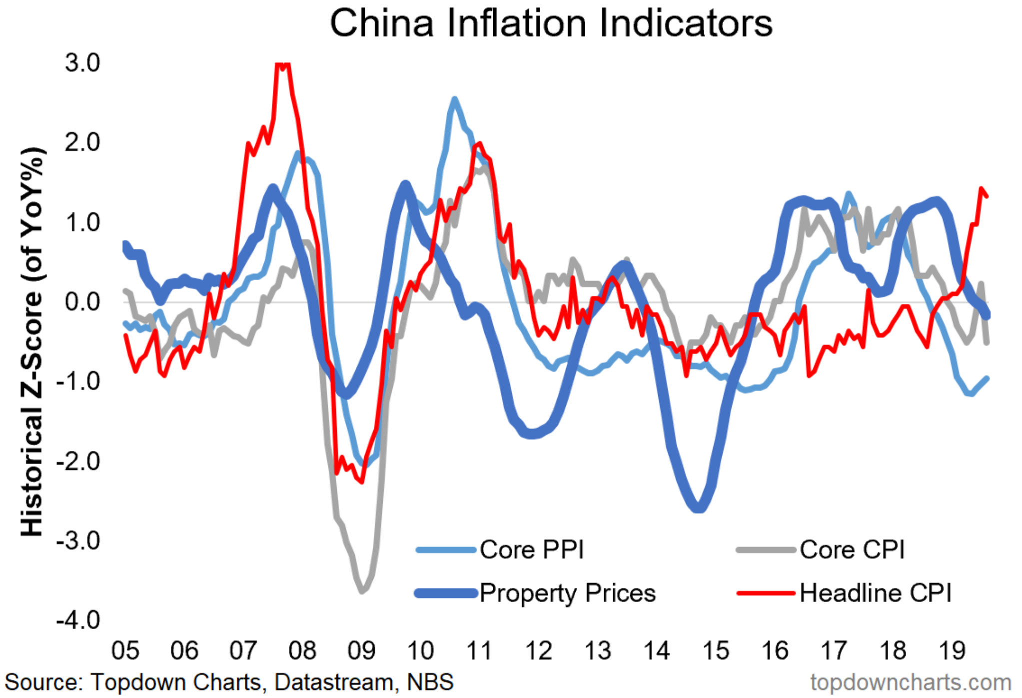

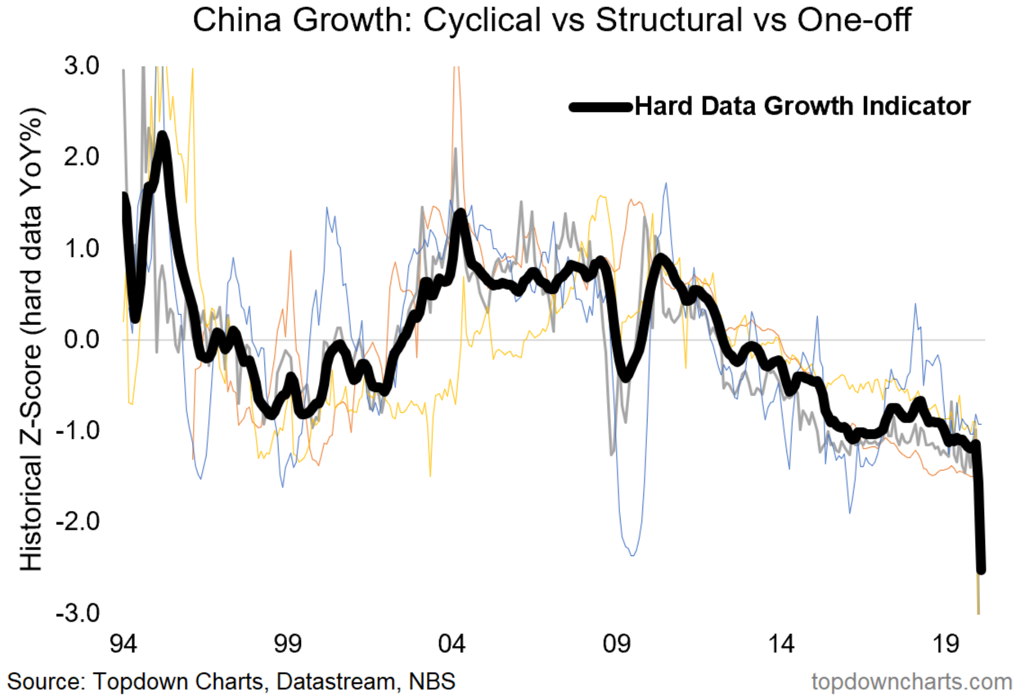

5. TIPS/Inflation Expectations

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5. TIPS/Inflation Expectations: Lastly, much like commodities (for partly obvious reasons – given the linkages of crude oil prices and inflation), TIPS breakevens have gone from cheap to very cheap. All the things that typically correlate with TIPS vs Nominal Treasuries relative performance have been hammered (crude oil, copper, EM equities, EM local currency bonds). At this point they're all in a very similar basket of cheapness (on my indicators, commodities, emerging market equities, EMFX, are all cheap). When things turn these will benefit significantly. Albeit, short-term uncertainties linger.

In terms of broader US inflation expectations, we've seen a clear collapse, and the interesting thing is there appears to be an obvious mean-reverting tendency in the composite (all surveys and indicators) inflation expectations, so over the medium-term the expectation of mean-reversion should help the case here. But there is a direct/indirect link with the economic pulse (e.g. the ISM vs breakevens chart), so much like the other growth/risk sensitives, we probably need to see the worm turn there before things change here.

Earlier this year I remarked how the unemployment rate across developed economies was at record lows, and this could be viewed as very tight capacity and were growth to rebound it could result in upside risk to inflation. I still think there is merit in that idea, particularly if the ZLTEI thesis holds, but short-term there is considerable uncertainty on the path of the unemployment rate, so I have left it out of the analysis for now. Notwithstanding, TIPS breakevens see compelling value at this point.

Bottom line: TIPS breakevens (much like their intermarket analogs) are trading at compelling cheap valuations, and mean reversion + the ZLTEI thesis support the medium-term case.

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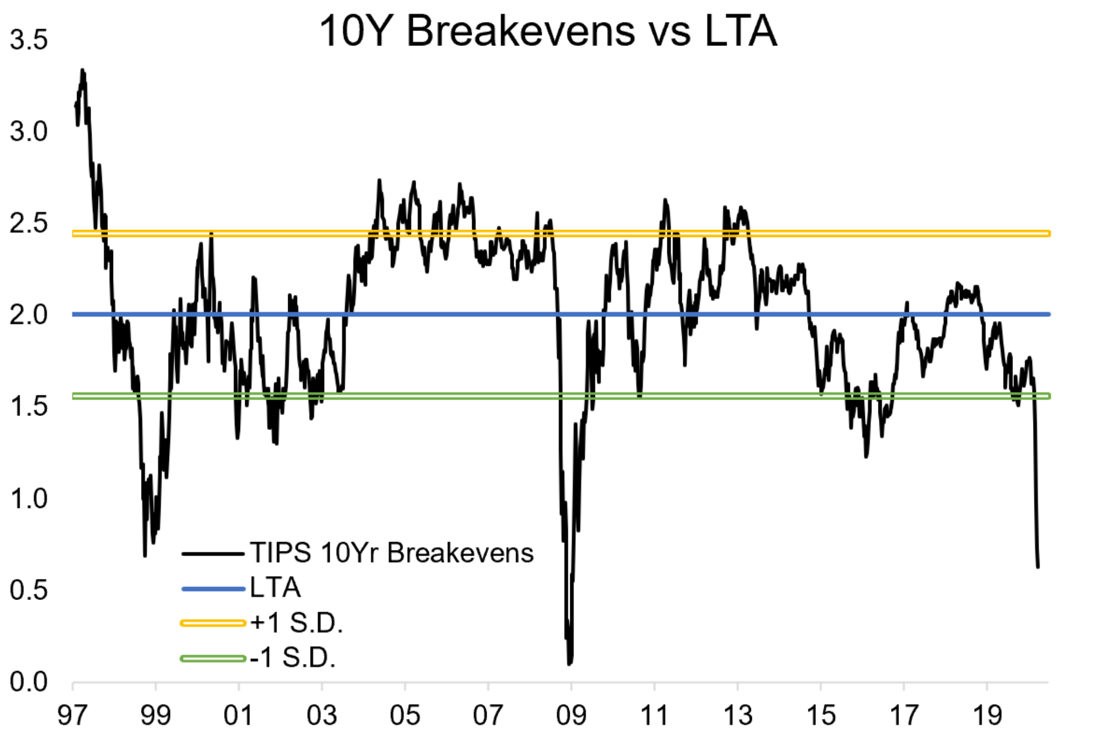

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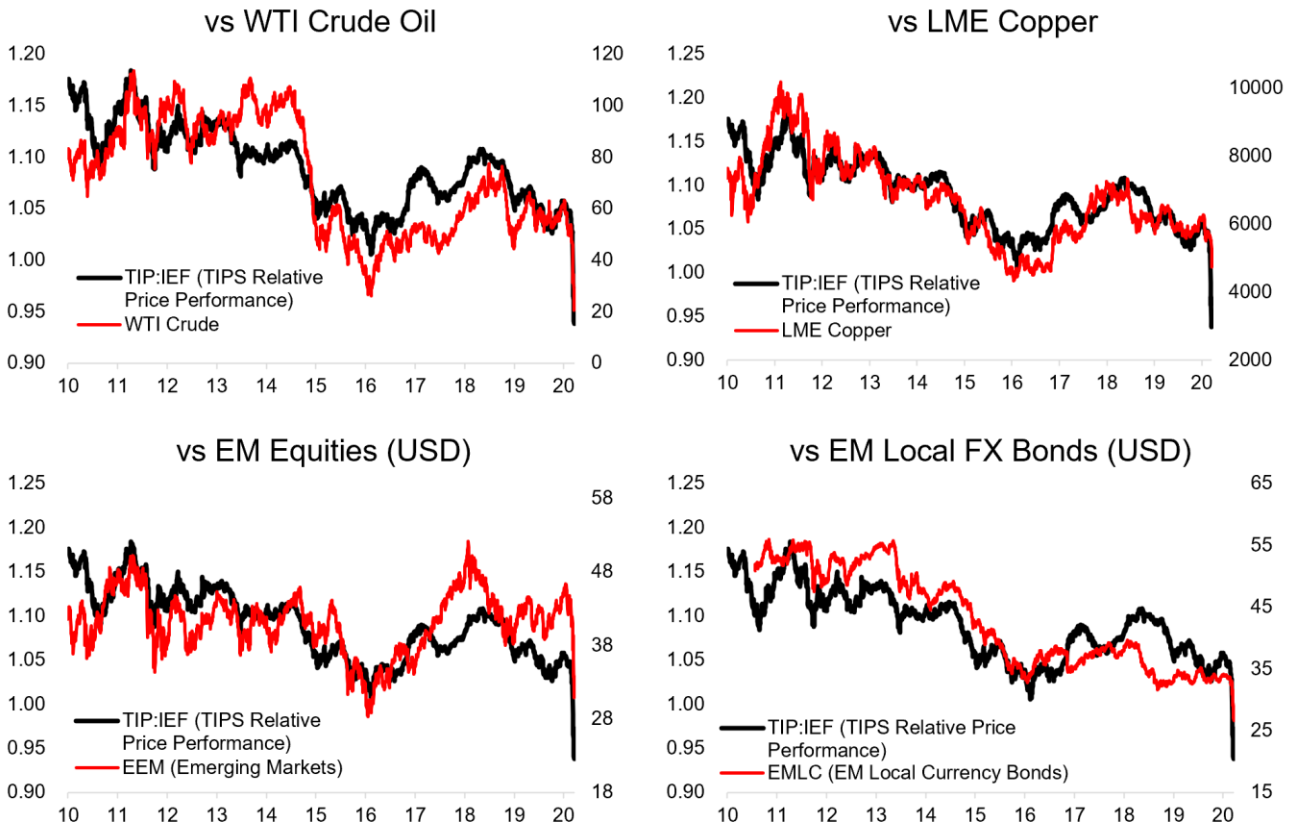

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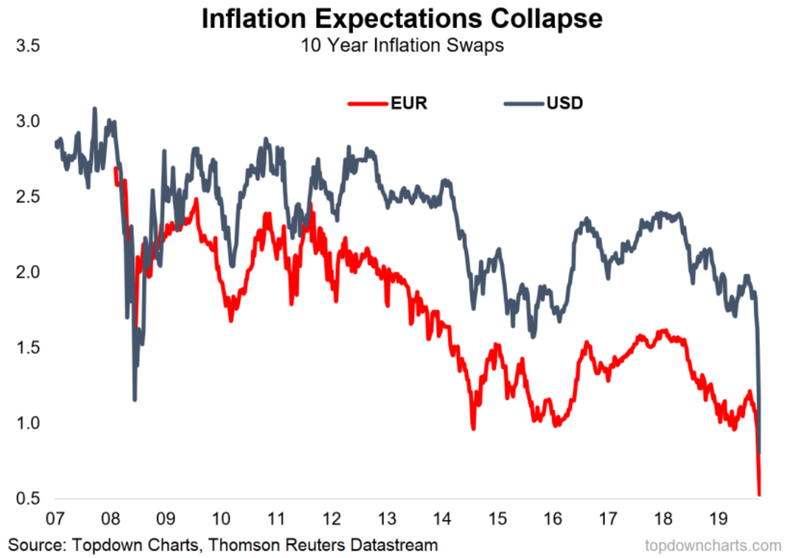

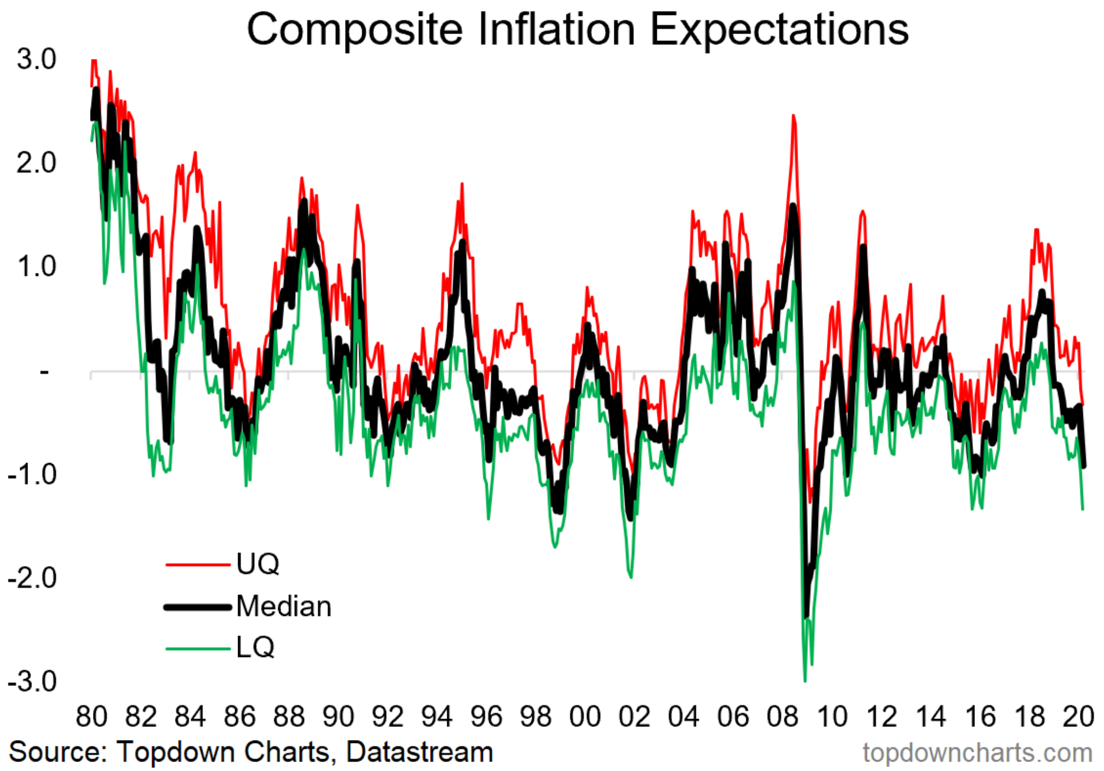

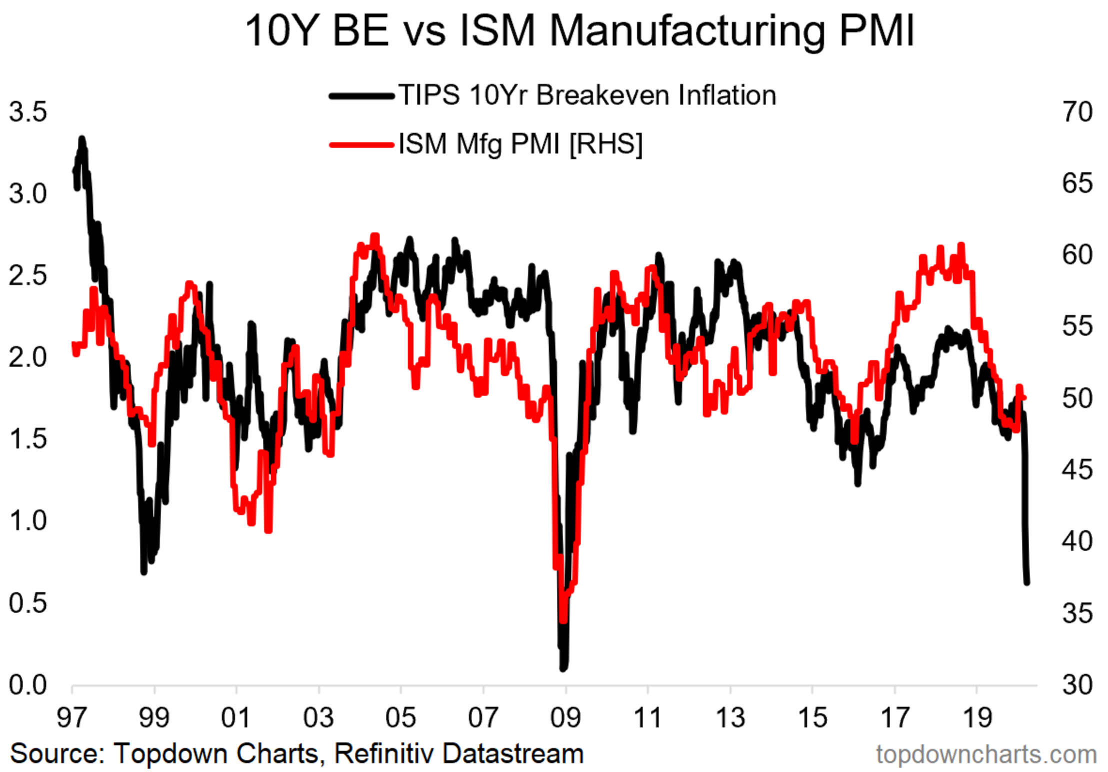

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