Weekly Macro Themes

End of Year Special Edition - 2018

"The End of Year Special Edition takes a different format to the usual weekly ppt chartbook, and presents you with highlights, reflections, and some of the best charts of 2018. I sincerely hope you enjoy it!"
-- Callum Thomas, Head of Research and founder of Topdown Charts

Topdown foreword: As we sign-off on 2018, the contrast vs the relatively calm and easy market of 2017 is profound. In hindsight we left 2017 with overvaluation, excess optimism, and complacency. We now leave 2018 with cheaper valuations, increasing pessimism, and some indicators showing signs of panic.

Looking forward, the theme of "transitions" I think captures a lot of the major moving parts: a transition for central banks from suppressors to sources of volatility, rotation across assets and markets, and a transition stage in the business/market cycle. Risk is clearly elevated, but as the "charts to watch for 2019" also show; so too is opportunity.

In the meantime, please enjoy this selection of charts which I meticulously selected from reviewing all 49 editions of the Weekly Macro Themes report from the year 2018. As an exercise in reflection it's been rewarding and insightful, and I trust you will likewise get a lot out of this special edition.

I look forward to catching up with you in the new year.

Section A. Charts That Worked

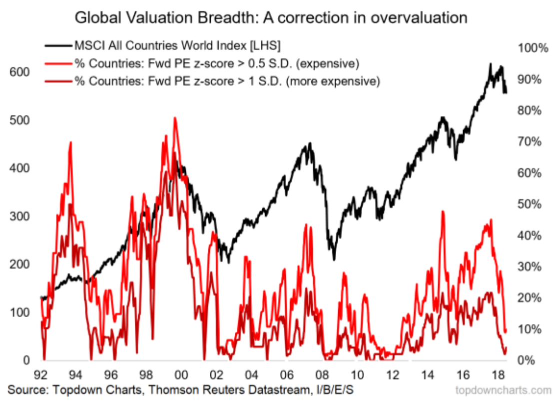
First up is a look at some of the charts and calls that worked particularly well during the year.

1. Global cyclicals vs defensives – I highlighted this with regards to the risk that it posed to global equities given that cyclicals had been driving the new bull market and the way the relative performance line got so stretched (particularly vs the global PMI). Turns out this was a key chart from a risk management standpoint. (19 Jan 2018)

"*the way in which the cyclicals vs defensive relative performance line is trading with regards to the global manufacturing PMI. In this case performance looks stretched vs the economic cycle indicators, something worth noting."*

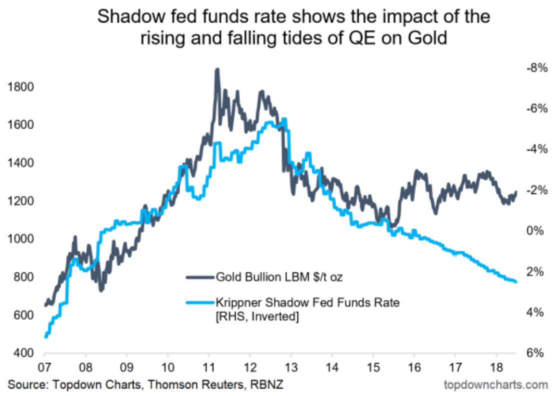
2. Call it luck or foresight, I published this unique chart in last year's end of year special and again in the first edition for the year – global equities peaked about a week or so later. Equally notable is how it has now fully unwound. (12 Jan 2018)

"Similarly, more and more countries are showing up as expensive on a forward PE basis (actually, the same proportion as at the 2007 peak, and prior to the 15/16 mini-bear)."



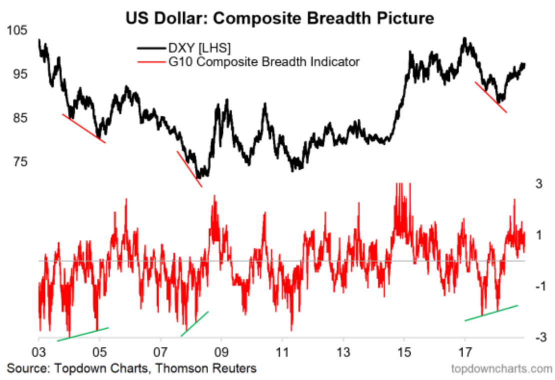
3. Bearish gold: the call was based on a number of factors including valuation, technicals, and sentiment, but also key was the charts of real interest rates and shadow rates. (30 Mar 2018)

"The divergence between gold prices and real interest rates and shadow policy rates is becoming increasingly precipitous. It's a classic case of "one of these is wrong", and given the lingering political/geopolitical risk, and recent drive up in uncertainty/volatility, it's fair to speculate that a big part of this gap is largely down to risk demand, i.e. sentiment, and that is something which can flip quickly."



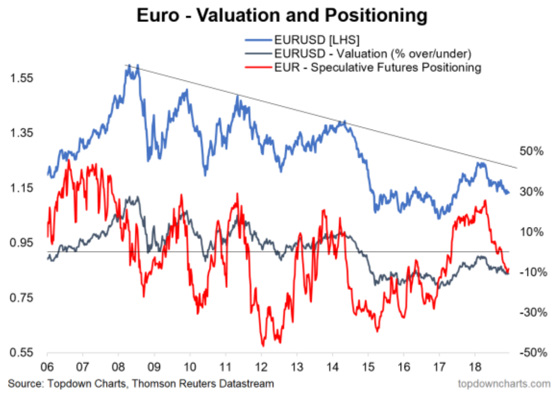
4. Thanks to multiple factors, but in particular this breadth chart, I managed to pick the bottom in the US Dollar Index early this year. (23 Feb 2018)

"From a short-term timing standpoint, the chart showing bullish breadth divergence is an interesting one. This set-up has appeared 2 times in recent history and presaged about a 10-point move in each instance – that is something which would catch folk by surprise. Particularly when you think about where net speculative futures positioning is. So maybe dollar bull market has one last laugh in it."



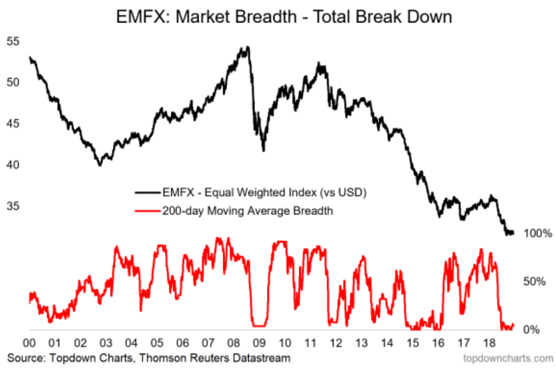
5. Came near perfectly close to picking the top in the EURUSD with this classic chart. (23 Feb 2018)

"What a difference a year makes. Late 2016 the EURUSD saw crowded net-shorts and significant undervaluation (not to mention bullish divergence against the RSI). Fast forward to today and there are crowded speculative longs, more neutral valuations, and a looming clash with the downtrend line (and bearish divergence against the RSI!). While it's very early days, the latest flash PMI readings show a tentative change in leadership between the Eurozone and USA."



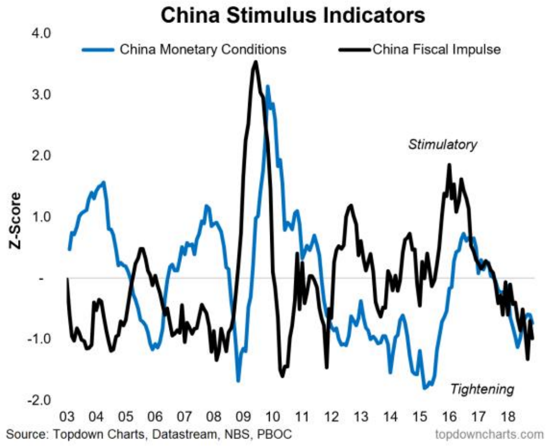
6. Establishing coverage of EMFX this year, I identified in aggregate: overvaluation, narrowing interest differentials, and bearish technicals, this happened to be just before things got really ugly for this corner of the market. (27 Apr 2018)

"*Moving in to technicals, 200-day moving average breadth appears to be breaking down, after what looks like a bearish breadth divergence (higher highs on price vs lower highs on breadth)."*



7. The China Slowdown: for me it looked fairly obvious that China's economy would slow this year, albeit perhaps not as far/fast as I might have thought. The key drivers were an expected softening in the property market (wrong: see chart B.1.), weaker export growth, and policy settings going from tailwind to headwind. (2 Mar 2018)

"Given the stimulus indicators have moved from stimulus being a major tailwind to now at least less of a tailwind, if not a slight headwind, the case for a slowdown seems to be in place."

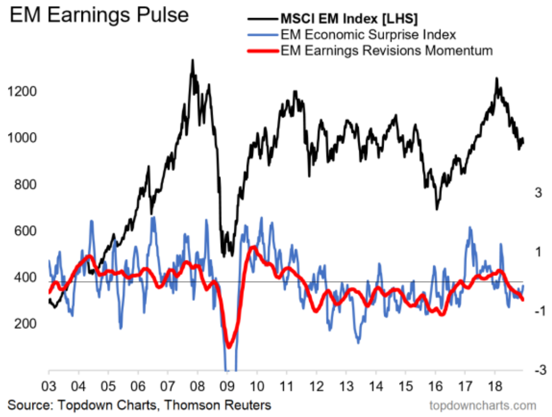


8. Closely related to the China call was the switch to a bearish call on copper. Added to that was slight overvaluation, challenging technicals, inter markets (divergence against copper stocks and Chinese bond yields), and stretched bullish sentiment/positioning. (2 Mar 2018)

"A logical next stop from the China macro picture is a taking stock of the outlook for copper. Given the tendency for copper prices to trade in line with the macro pulse in China (see chart of China PMI vs copper), any possible slowdown in China – even if a soft-landing – casts shadows on the Copper price outlook [makes sense given China accounts for around 50% of global demand]."

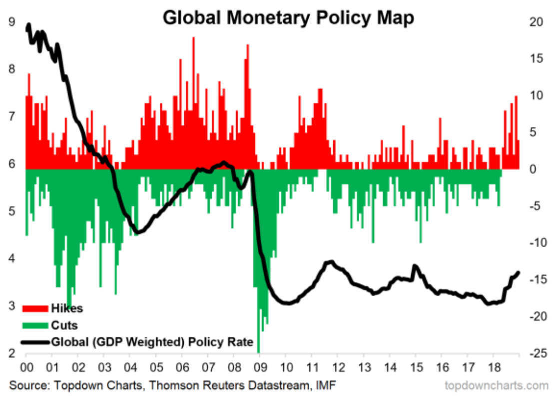
9. Emerging markets – "Tactically Cautious". After being initially optimistic on EM in 2018 due to relative value, it started to become clear that EM risk assets were in trouble as the USD strengthened and EM macro indicators began to rollover, my only regret on this one is not catching it earlier and with more conviction. When facts change, act accordingly. (18 May 2018)

"The composite EM risk sentiment index has rolled over from extreme complacency, and the EM composite OECD leading indicator looks to have topped out. The risk is that the move in risk pricing goes further and weighs on the macro front, where you can see the EM economic surprise index and earnings revisions momentum indicators have already rolled over."



10. A key theme for 2018: the turning of the tides in global monetary policy. (12 Jan 2018)

"Even as the world's major central banks have had to step away from interest rates as the key policy tool, there are some clear trends at a global level. With some notable exceptions, the predominant action since 2012 has been interest rate cuts. This story is starting to come full circle in developed economies, and emerging markets likewise look close to the end of their current wave of easing."



Section B. Charts That Didn't Work

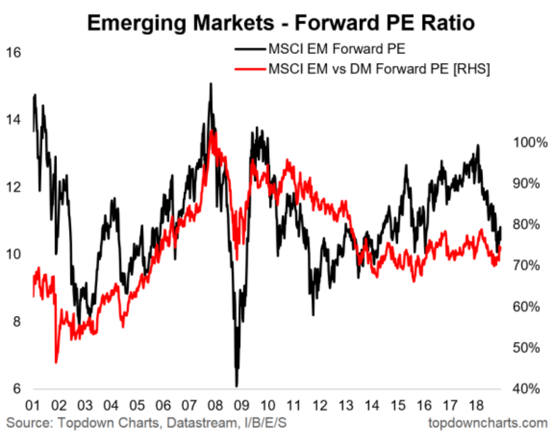
Of course, it wouldn't be complete without a look at some of the charts that didn't work (or shall we say the ones that worked "less well!").

1. China property market slowdown: thanks to unexpected strength in the smaller cities, China's property market defied the leading indicator. The poor performance of the domestic stock market likely also contributed (asset rotation). (9 Feb 2018)

"*the composite lead indicator for China's property market points to cooling in price gains. This is where the rubber hits the road on greater interest rate sensitivity of the global economy."*

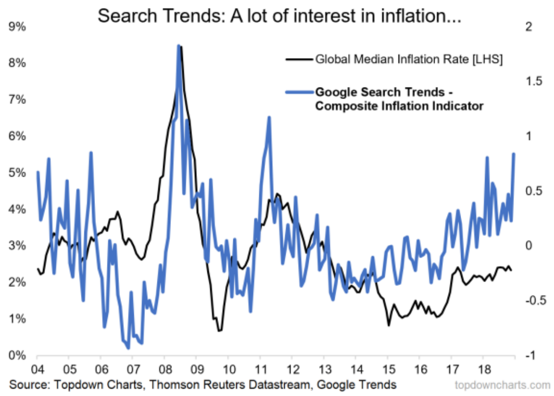
2. In hindsight it was wrong to emphasise relative value when EM was expensive in absolute terms (2 Feb 2018)

"Looking again at EM equity valuations, following the massive rally since the bottom in January 2016 (85% in USD terms), and about a $120B uplift in EM ETF AUM, there has been significant re-rating. Looking at the forward PE ratio the MSCI EM index is trading around the top end of the range since 2001. Yet valuations still lag behind their developed market counterparts, highlighting the importance of relative value at this stage of the cycle.



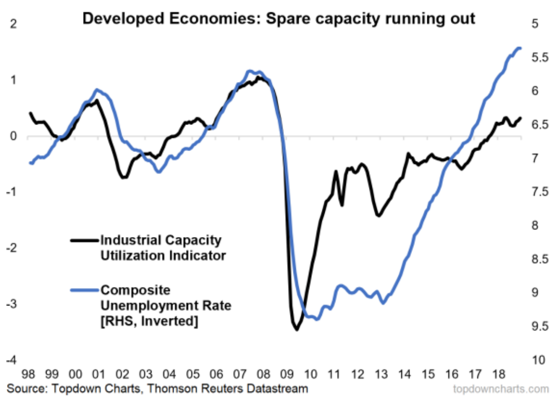
3. The spike in this indicator when I first introduced it seemed to point to a more significant pickup in inflation than actually occurred through the year. Notably though this indicator has spiked again in Dec. (9 Feb 2018)

"*I wanted to see if there was some generalized increase in awareness of inflation, so I looked at multiple search terms in Google Trends and came up with a composite inflation search indicator. This indicator has distinctly turned up lately. This lines up with the expectation of higher inflation based on existing economic trends and also lines up with the global PMI averages for the employment and prices sub-indexes."*



4. Similar to the previous chart, this tightening up of capacity utilization (particularly apparent labour shortages) seemed to point to an acceleration in inflation (and/or capex), maybe it comes next year, but it didn't really come this year. (9 Feb 2018)

"it's worth keeping this chart front of mind as both industrial capacity and measures of labour market capacity continue to tighten up. Barring a crisis or shock, the next step is higher inflation."

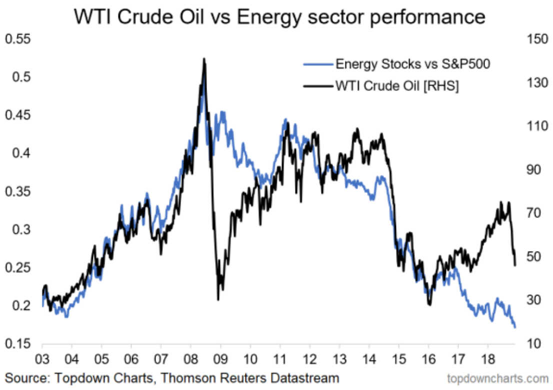


5. The lead indicator for global trade was pointing to further acceleration earlier in the year, but softer import growth in Europe and DM ex-US stymied this: (12 Jan 2018)

***"**Looking again at what was a key theme and a key call of 2017, the recovery in global trade growth, the near-term outlook appears to be for more of the same. This reflects the strength in the PMIs and also reflects + reinforces the synchronized growth dynamics which appear to have emerged."*

6. I initially used this chart to outline the case for energy stocks, but then later used it to highlight the downside risks for crude oil (in hindsight, a much better use of this chart!): (9 Mar 2018)

***"**The divergence between WTI crude oil and US energy stocks still resembles a gaping maw – one that will no doubt close at some point or another. The big question is which way. And knowing the answer will also create knowledge of a solid trade idea. Thinking of energy stocks, it also brings to mind the market cap weighting charts, which shows energy ranking at the lowest level since 2003, yet interestingly the share/weighting of energy sector earnings has turned up from the lows."*

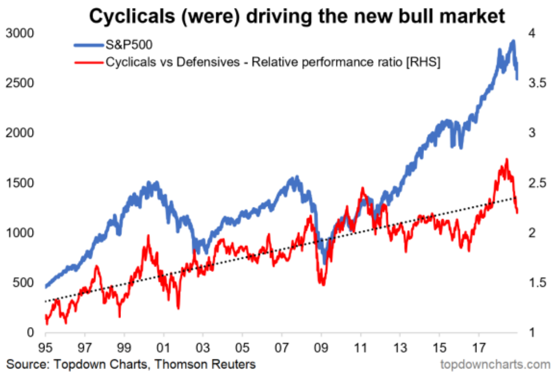


Section C. My Favourite Charts

These are some of my favourites – mostly ones I simply enjoyed coming up with (some of my favourite moments are designing a new chart/indicator which brings a completely new perspective or insight).

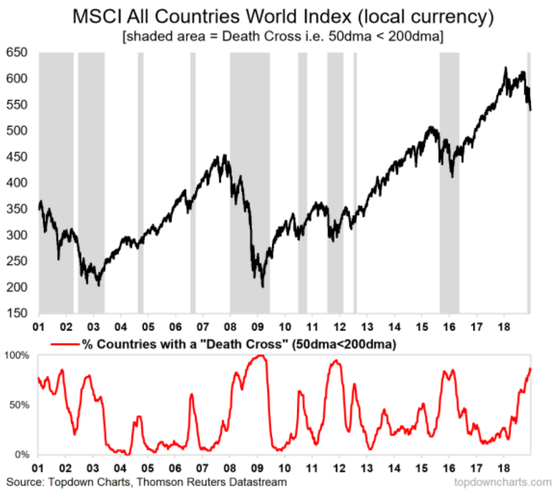
1. This chart showed US cyclicals vs defensives as once a source of strength for the S&P500, and then a source of risk. (12 Jan 2018)

"relative price performance looks very stretched, and both absolute and relative valuations look stretched. …this creates a vulnerability for correction risk given how key cyclicals have been in driving the new bull market."



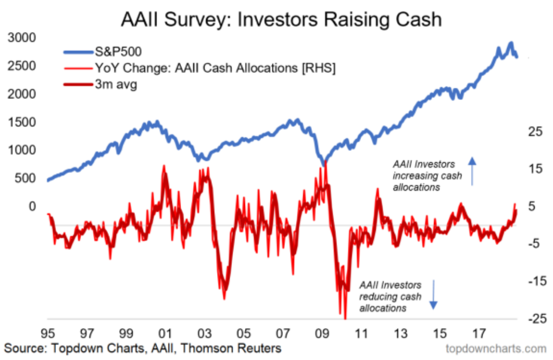
2. For all its faults, the "death cross" can be useful in identifying major market regime transitions. This one shows the picture for the ACWI and across countries. (30 Nov 2018)

"the so called "Death Cross" i.e. where the market in question's 50-day moving average falls below the 200-day moving average… The point of this signal is to attempt to flag major turning points (down) i.e. to serve as a bear market warning indicator."



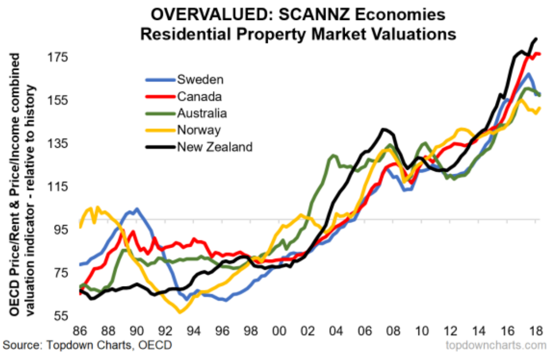
3. Cash money now: this chart shows the pace at which investors are increasing/decreasing cash allocations and as of November it is surging – importantly, this is coming off of record/cycle low portfolio allocations to cash. (7 Dec 2018)

"chart shows the YoY rate of change in cash allocations (a higher reading basically means investors are raising cash [although I do note that the market can drift allocations higher, but even then there's still an active decision about whether to rebalance or not]). This indicator has reached the same level as in early 2016 when the market bottomed."



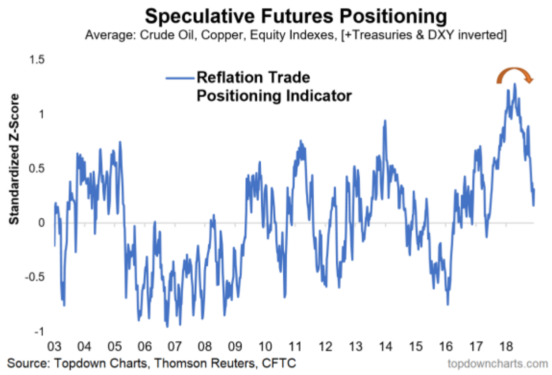
4. SCANNZ (Sweden, Canada, Australia, Norway, New Zealand) – an odd lot of countries with some distinct commonalities; a key one being overvalued property markets. (14 Apr 2018)

"Aside from equities, as hinted at, there have been some pockets of particular overvaluation open up across global property markets. For example, US commercial property is looking stretched on a real price basis vs long term average. And as a reminder, I previously mentioned the "SCANNZ" economies and how their significantly overvalued property markets are vulnerable to the global turn in monetary policy – hopefully they don't end up like that other bad acronym the PIIGS (but at least you can say you heard of the SCANNZ here first!)"



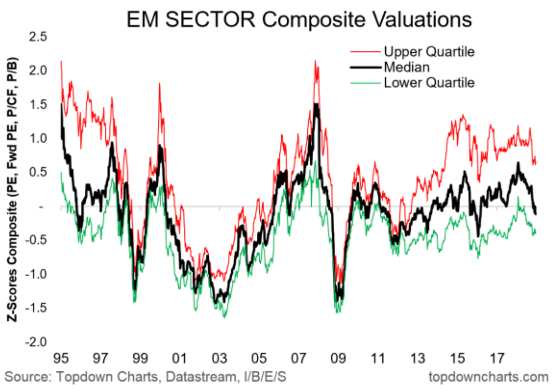
5. The reflation trade speculative futures positioning indicator – this one got to an extreme and then began to rollover, effectively giving advance warning of the global risk-off trade in Q4. (22 June 2018)

"the collapse in the economic surprise index must reflect previous excessive optimism. In a sense, this optimism can be seen still hanging in there in the "reflation trade positioning indicator", which combines the signal of speculative futures positioning in crude oil, copper, US stock indexes, and treasuries & DXY (both inverted to be consistent with the overall signal)."



6. Median sector valuations for EM flagged the expensiveness of EM equities early this year (same signal for median of countries). (2 Feb 2018)

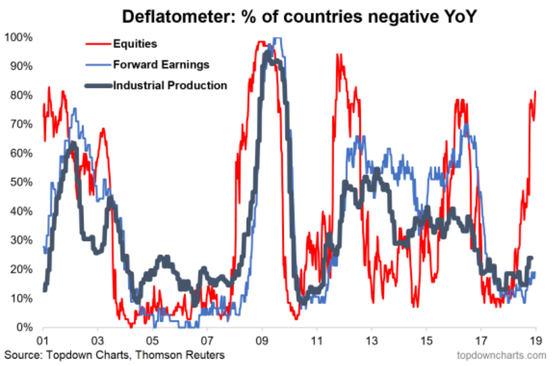
"Taking another angle on EM equity valuations, …show the lay of the land in EM sector valuations (the charts show the upper/lower quartiles and median sectors – using a combined historical z-score of the trailing PE, forward PE, price to cash earnings, and price to book ratio). The median helps characterize the general trend and level (being less affected by outliers), and in this respect reinforces the conclusion that EM valuations are becoming lofty. The gap between the UQ and LQ also highlights the relative value angle (between sectors) again."



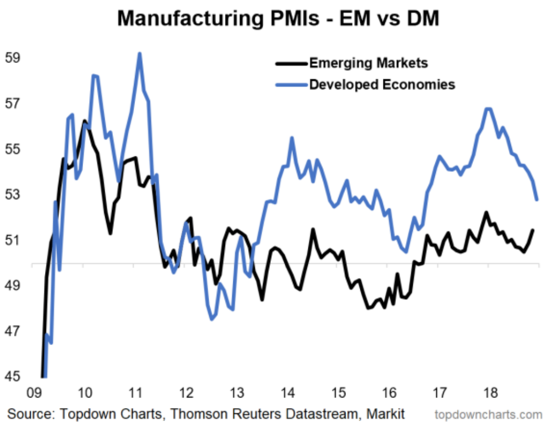
Section D. Charts to Watch in 2019

As interesting and sometimes amusing as it is to look back, as investors we get paid for looking forward, and there's a few existing trends and themes that will remain front of mind and be key to keep on the radar in 2019. Following is a selection of the key charts and indicators we will be watching in the new year.

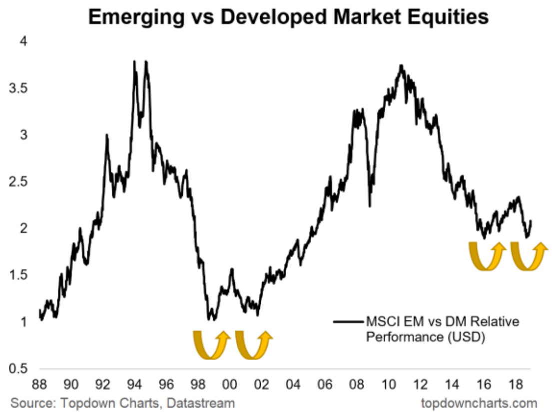
1. Deflation Risk: as I write, over 80% of world equity markets are in "deflation" (price negative YoY%), the risk here is that we see the black and blue lines turn up (proportion of countries seeing forward earnings and industrial production contracting on an annual basis), and if they do it will probably leave us all feeling a little black and blue, because when it comes to economic deflation, what we're really talking about is the risk of a global economic recession. Keep this chart front of mind and top of your radar next year.



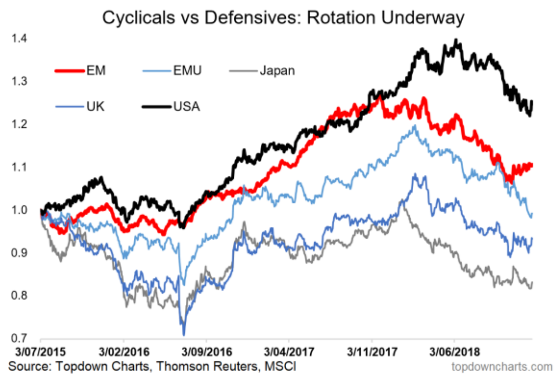
2. Manufacturing PMIs: down with DM, up with EM? It's early days, but we've been seeing some stabilization in EM economic data (and softening across DM). Given the growing size and influence of EM economies this could be a key chart in determining how the previous chart plays out.



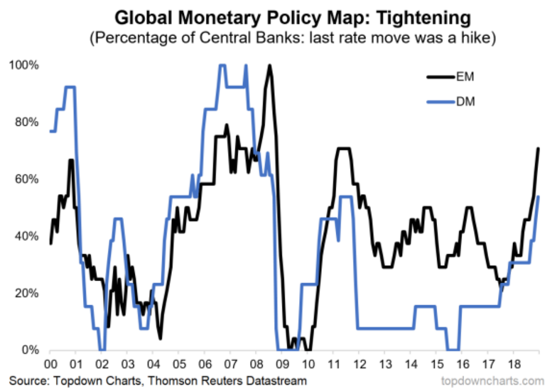
3. EM vs DM – Equities: this one also ties in closely with the previous chart, because this emergent economic divergence is among the many factors which I think will help EM equities comfortably outperform vs DM in coming years.



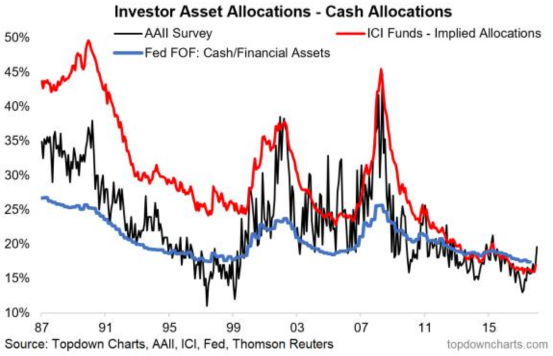
4. Global cyclicals vs defensives – a key theme in 2018 with rotation well underway. But the key one here (EM again!) is the red line and the nascent rebound: watch closely for follow-through.



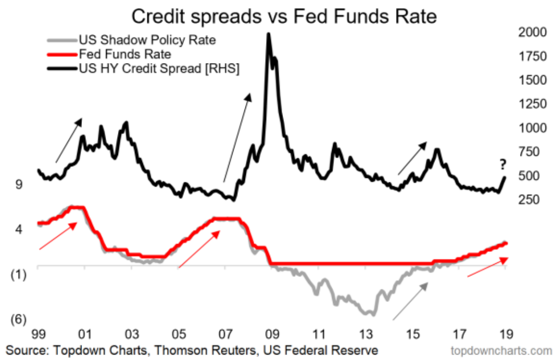
5. More and more global central banks are shifting into tightening mode. My guess is we'll see more of the same here and more of monetary policy being a source (vs suppressor) of volatility.



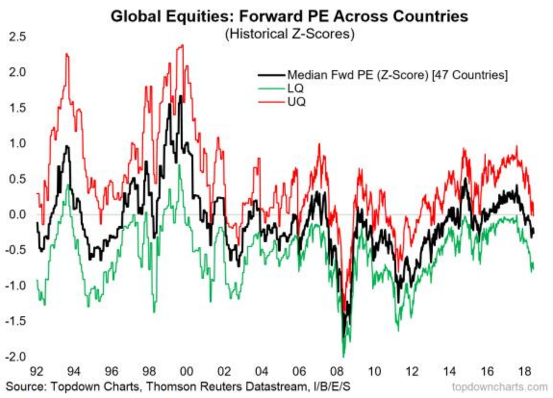
6. One impact of monetary policy tightening is that cash becomes incrementally more attractive (as an income generating asset) beyond its core role of capital preservation. Look for cash allocations to rise from record lows.



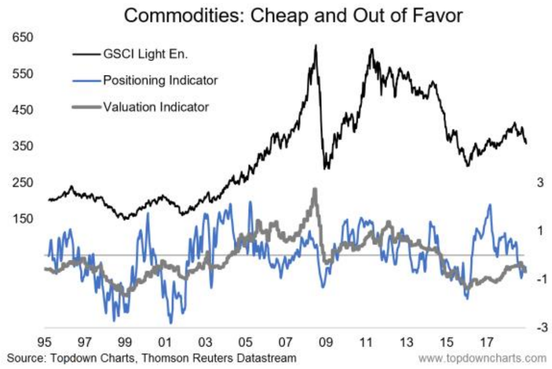
7. Higher cash rates may cause issues for those who opted to push risk for income: credit is in the final innings; anticipate wider spreads ahead.



8. In the wake of the currently ongoing global equity market correction it's becoming easier and easier to find a bargain. Valuations have already reset to some of the previous major market lows. While global equities could get cheaper yet, the probability is increasingly in favour of long term investors at these levels.



9. Beset by numerous headwinds and cross-currents this year, commodities end 2018 looking un-loved and undervalued. As with the previous chart, there's always room to go lower, but as long as the global economy avoids recession and if China/EM do ultimately stabilize and improve the case for commodities starts to look good. And it's often that you see commodities tend to do well later in the cycle. As the window starts to close for US dollar strength, that could be the final element to fall into place for commodities (and EM).

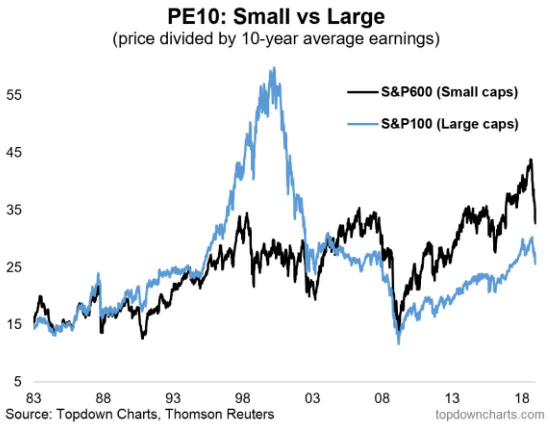


10. Last but not least is China again (the China stimulus chart was number 10 last year, and it remains very important [chart number A.7 this year]), this time China A-shares in particular. A lot has gone wrong for China this year, and in my mind that simply sets the stage for things to go at least less wrong, if not right for China next year. Trump has helped make China A-share valuations great again (cheap again). All that's required now is a catalyst and I can see multiple candidates.

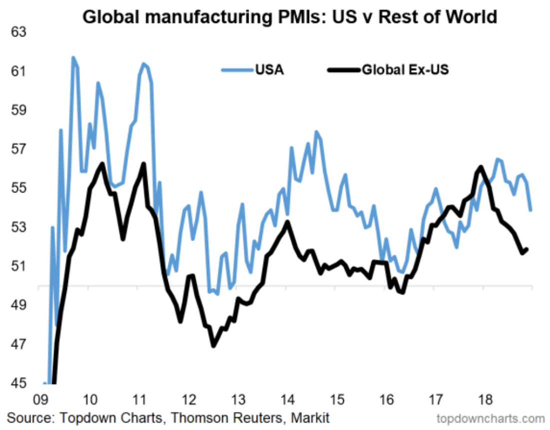
Section E. Honourable Mentions

Those charts worthy of mention but not quite fitting in the previous categories…

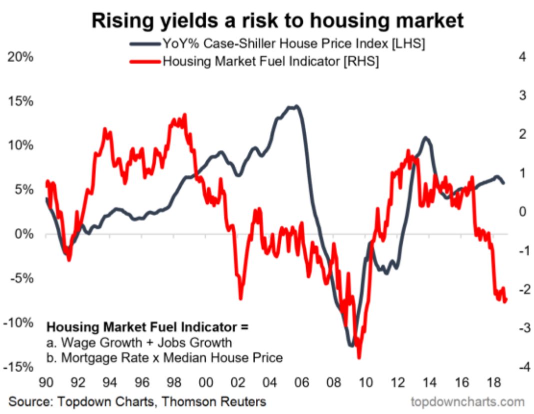
1. US small cap stock valuations hit a record high… before being sent right back down to earth.



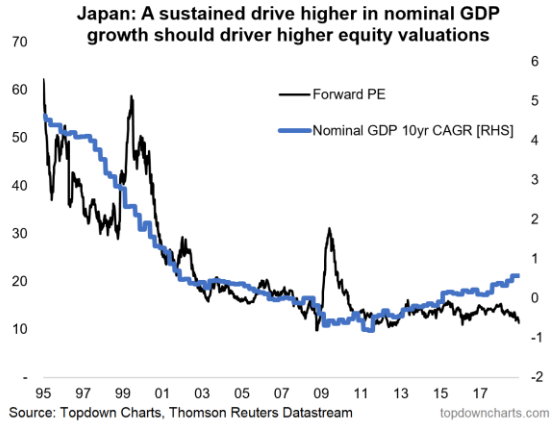
2. US vs the world: a window of divergence looks to be closing, and this could be a key for USD.



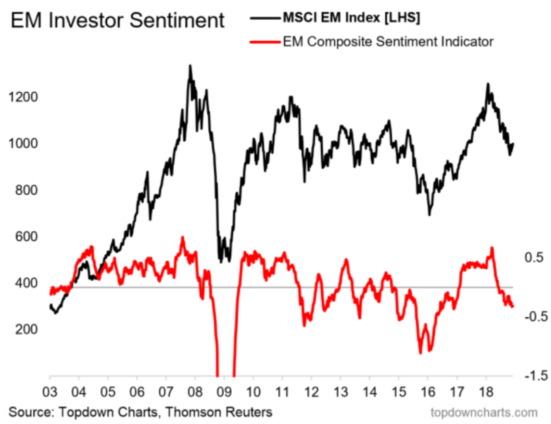
3. Can US housing take more hikes?



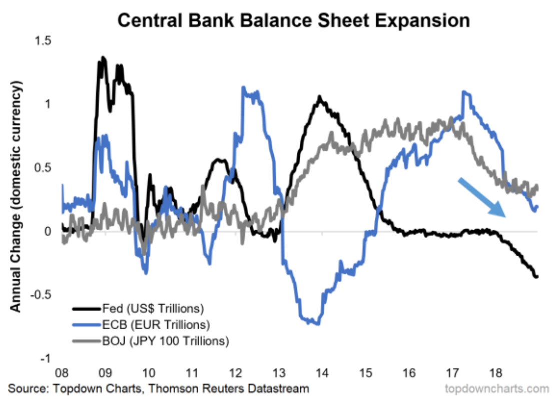
4. Japanese equities look cheap, especially as on some measures Japan's economy looks to have turned the corner (Abenomics starting to work).



5. EM investor sentiment indicator – not quite the same level of panic and abandon as 2009 or 2016, but it is in the zone of contrarian bullishness.



6. The completion of the grand monetary policy experiment: QE-to-taper-to-QT, already this has had a wide-reaching impact on global markets, and this newly established tool of central banks should be thought of as a wildcard (particularly as it can both be turned off and back on...).



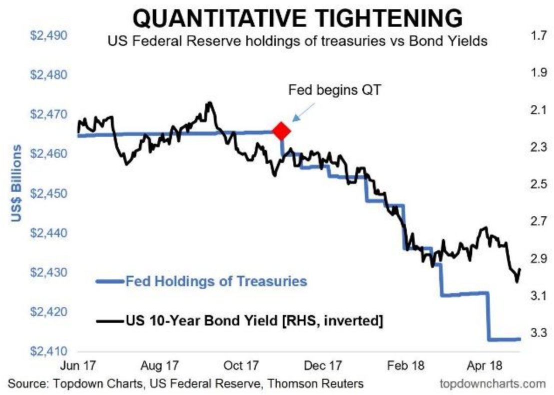
Section F. People's Choice Charts

In this section I defer to our followers on Twitter (@topdowncharts) for the most popular charts based on views and engagement. These charts are not updated to the latest as with those in the previous sections (helps explain why folk were so interested in them at the time – as always, just email me if you want to see any of these or others updated, or if you had any questions in general).

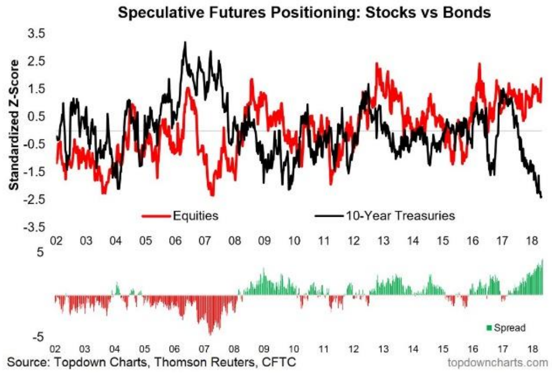
P.S. be sure to follow us on Twitter and let me know if you ever want a shout out or retweet for your business (clients only!).

1. This one raised a lot of eyebrows – a combined view of leveraged bets on US stocks… close to half a trillion in leverage added by traders in the past 5 years. The unwind however has begun.

2. Another one to raise some eyebrows… we can debate about the best way to display the series in this chart (i.e. level vs rate of change), but the key point is that it appears as though the commencement of quantitative tightening was a key catalyst to the push higher in bond yields (shown inverted), which makes intuitive sense.

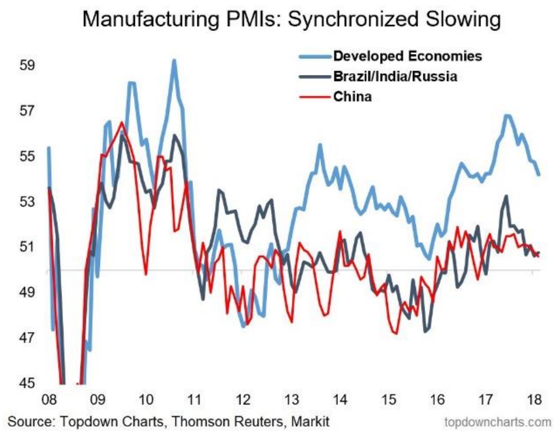


3. Speculative positioning – a double bet. This chart showed extreme net-longs in equities, and big net-shorts in bonds… sort of a compound bet.



4. The I/B/E/S consensus long term average earnings growth for the S&P500 – could say there was some excitement on the outlook.

5. It quickly became apparent as the year went on that we were entering into a synchronized softening of growth momentum globally. Time will tell if this is just a late-cycle growth scare or something more sinister…



Report by Callum Thomas, Head of Research at Topdown Charts

About Topdown Charts

Topdown Charts provides chart-driven research across a global macro and multi-asset universe. The key offering is the Weekly Macro Themes report which has been designed specifically for multi-asset portfolio managers, active asset allocators, and macro-driven fund managers. The perspective is that of a buyside strategist and the key deliverables of the report are: investment idea generation, top-down global macro insights, risk management input, and asset allocation research.