TOP DOWN CHARTS

Chart driven macro insights for investors

Weekly Macro Themes – 16 February 2018 - Volume 3, Edition 6

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

1. Global Equities: The global equity market correction failed to shake some of the extremes we are seeing in the major styles/factors, these extremes remain on the risk radar.

2. US HY Credit: There are a couple of early warning indicators stirring in the HY credit space, as a minimum it warrants closer scrutiny of an already risky looking asset class.

3. Equity Risk Premium: The shrinking equity risk premium highlights the changing relative risk/reward outlook as we move later in the cycle.

4. Treasuries Tactics: Bond market sentiment, technicals, and valuations have shifted but could easily move further, particularly given the trends in monetary policy (not time to fade it yet).

5. Gold: Rising real yields and the move from QE to QT put gold at significant downside risk as it comes up against key resistance levels.

1. Global Equities

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1. Global Equities: Given the sharp move in global equities (9% correction across 10 days), I thought it would be timely to review some of the relativities in global equities to see if there was any particular weak spots or standouts.

However, looking across some of the major factors/styles in the global equity space none of them really saw any material/major movements during the correction, some have even extended their run since.

Indeed, the combined momentum, low dividend yield, growth vs value, cyclicals vs defensives chart shows the already extended looking move in this group has actually seemed to have picked up a second wind. Honing in on the cyclicals vs defensives performance ratio, this has likewise moved to a new high, and again looks stretched relative to where the global manufacturing PMI is.

The reason it's worth focusing on cyclicals vs defensives in particular is the extent to which cyclicals relative performance has driven the new bull market – so it stands to reason that this should be a key area of potential vulnerability to the outlook for global equities. Looking across the regions there seems to be an early divergence emerging between Asia/EM and US/Europe, which is something we'll be keeping an eye on.

Bottom line: The global equity market correction failed to shake some of the extremes we are seeing in the major styles/factors, these extremes remain on the risk radar.

1. Global Equities

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Looking across some of the factors/styles in the global equity space it's interesting to note how none of them saw real material movements during the correction, some have even surged since.

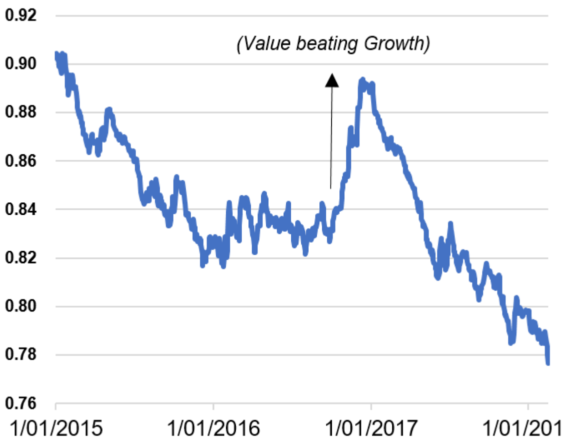
Quality vs Index

Momentum vs Index

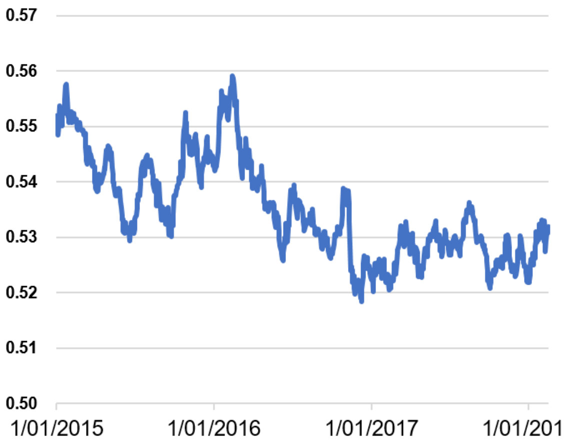
Min. Vol. vs Index

High DY vs Index

Value vs Growth



Large vs Small



EM vs DM

Cyc vs Def

SOURCE: TOPDOWN CHARTS, THOMSON REUTERS, MSCI.

Where relevant all indexes are part of the MSCI All Countries World Index group and all in price only, local currency terms

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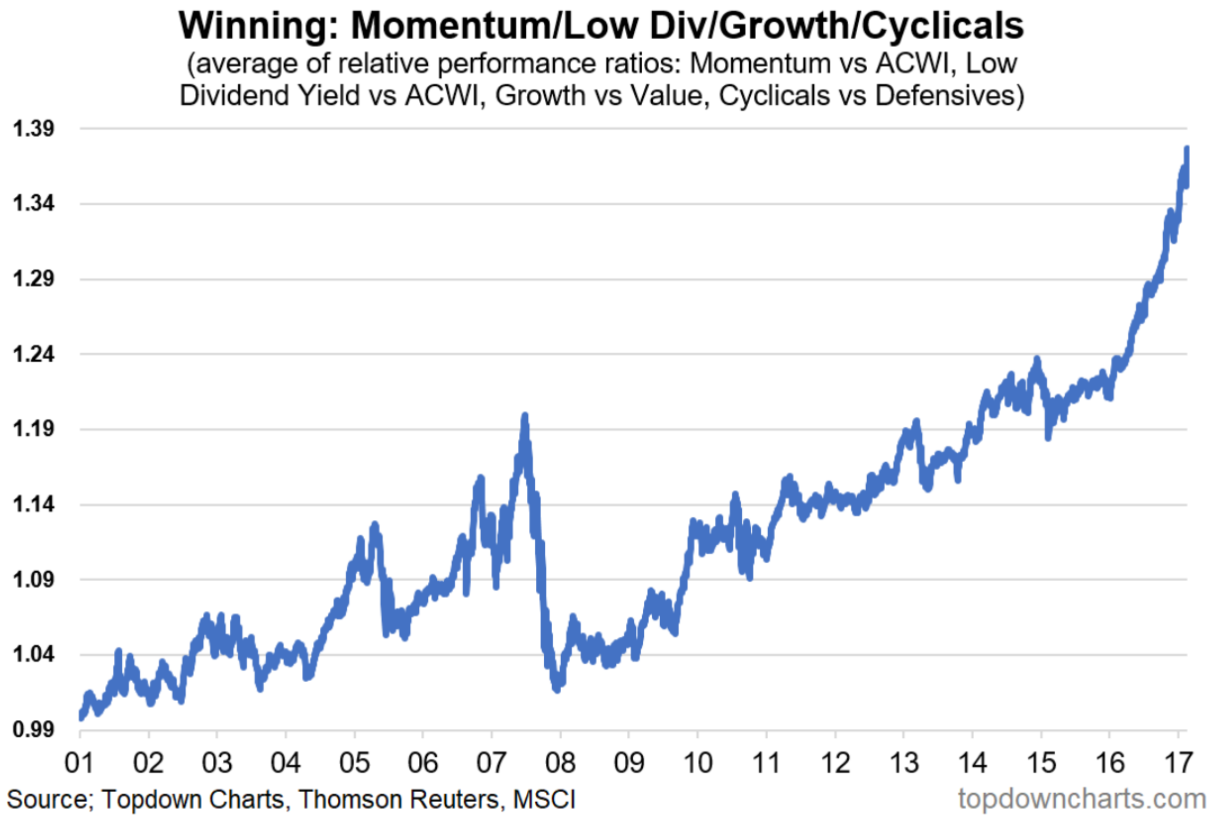

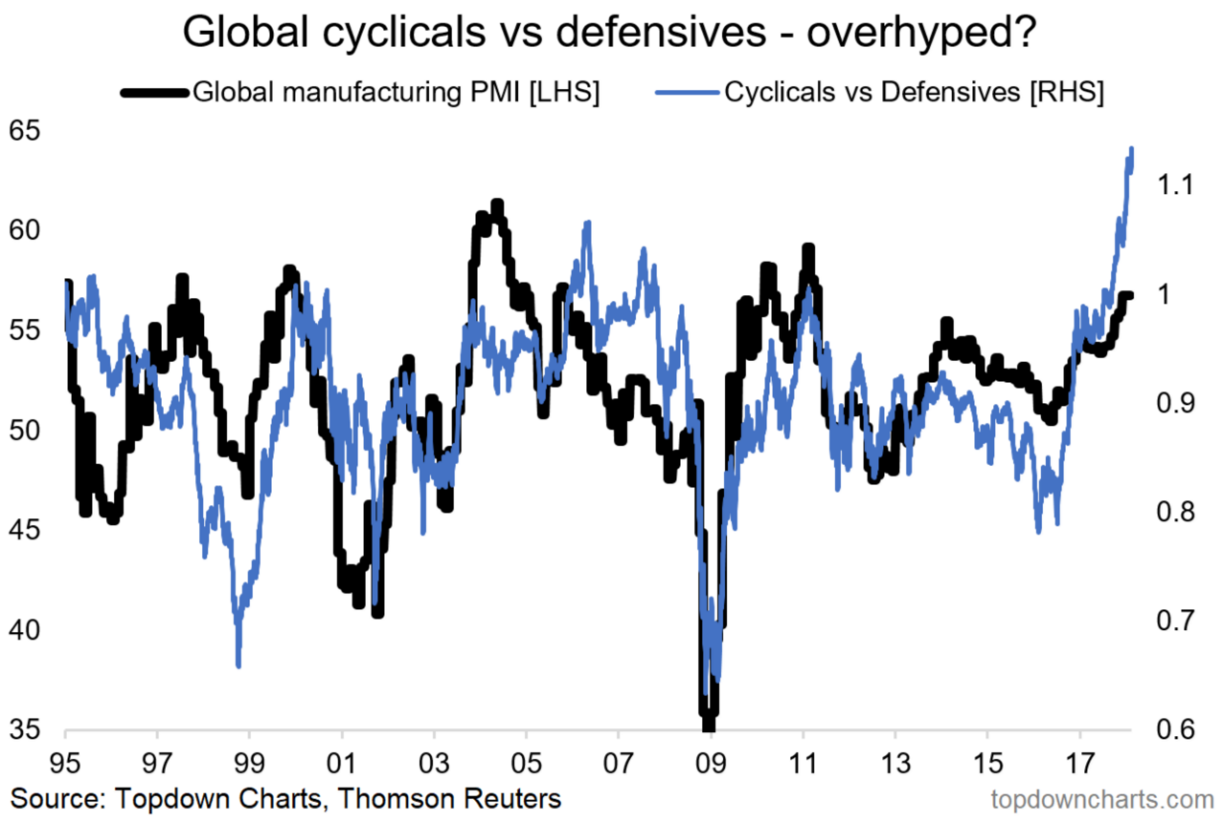

1. Global Equities

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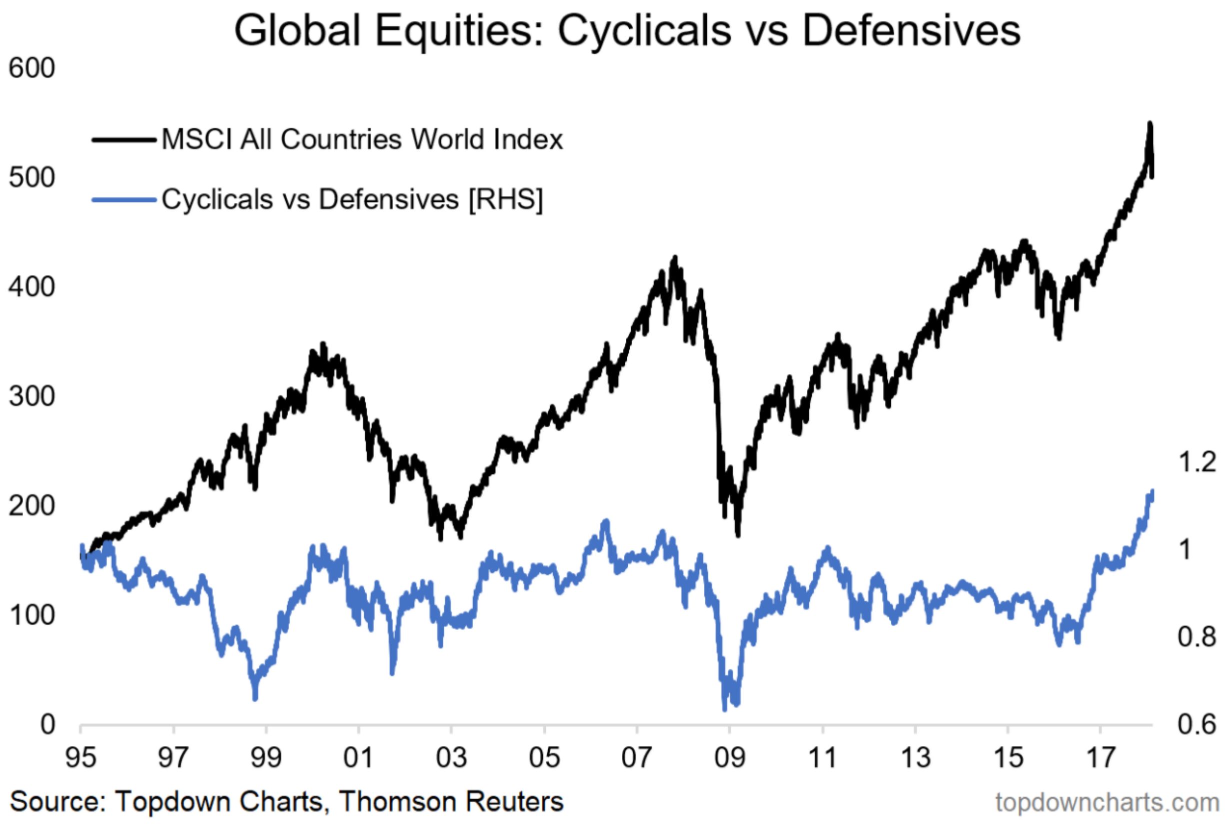
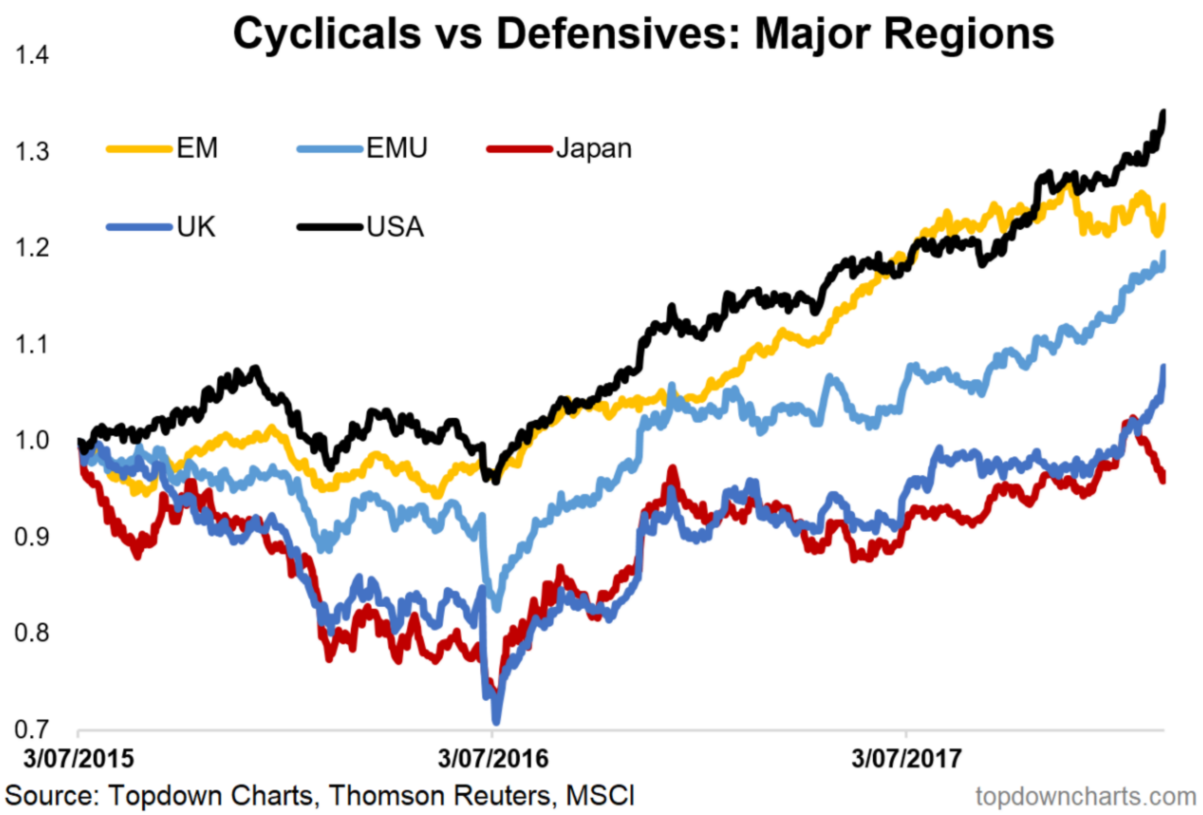
The reason it's worth focusing on cyclicals vs defensives is the extent to which cyclicals relative performance has driven the new bull market – so it stands to reason that this should be a key area of potential vulnerability to the outlook for global equities. Looking across the regions there seems to be an early divergence emerging between Asia/EM and US/Europe, which is something we'll be keeping an eye on.





2. US HY Credit

2. US HY Credit: Along similar lines, US HY credit spreads were left relatively unscathed by the correction – certainly relative to what happened to the VIX. So along with that and me finding some sectoral corporate CDS indexes on Datastream, it's a good time to take another look at this asset class.

Looking at the quartiles chart across the 18 Corporate CDS sector indexes, the trend is similar to that seen in the HY credit space, although notably there was a slight rise in the median in mid-December. You can see this more clearly in the "pressure index" (an average of the average, standard deviation and max-min across the sectors – designed to give weight to sectors on the move). Most of the time this indicator has served as a coincident indicator, but it has potential as an early warner (e.g. now).

Looking at the standout sectors, there are a few that began to rise prior to the stockmarket correction/risk-off episode e.g. personal household, healthcare, telecoms, and retail. While it doesn't seem likely to be something akin to a systemic risk such as a sector like financials, the multi-sector nature of the move does make one marginally more wary of credit. Another reason to worry is the slight increase in the "change in spread" series in the Fed loan officer survey – it's yet to move into net-increasing territory, but the divergence vs credit spreads is notable and overall I would say greater scrutiny as a minimum is warranted.

We can talk at length about the move in the VIX and write it off as simply a result of manipulation and obscenely crowded pain trades – but what's interesting is how rare it is for the VIX to move like this and for credit to basically sleep through it. The economic cycle indicator provides some reconciling in that better economic conditions reduce the risk of default through the sales/cashflow channel. But it also looks to be in the later innings.

Bottom line: There are a couple of early warning indicators stirring in the HY credit space, as a minimum it warrants closer scrutiny of an already risky looking asset class.

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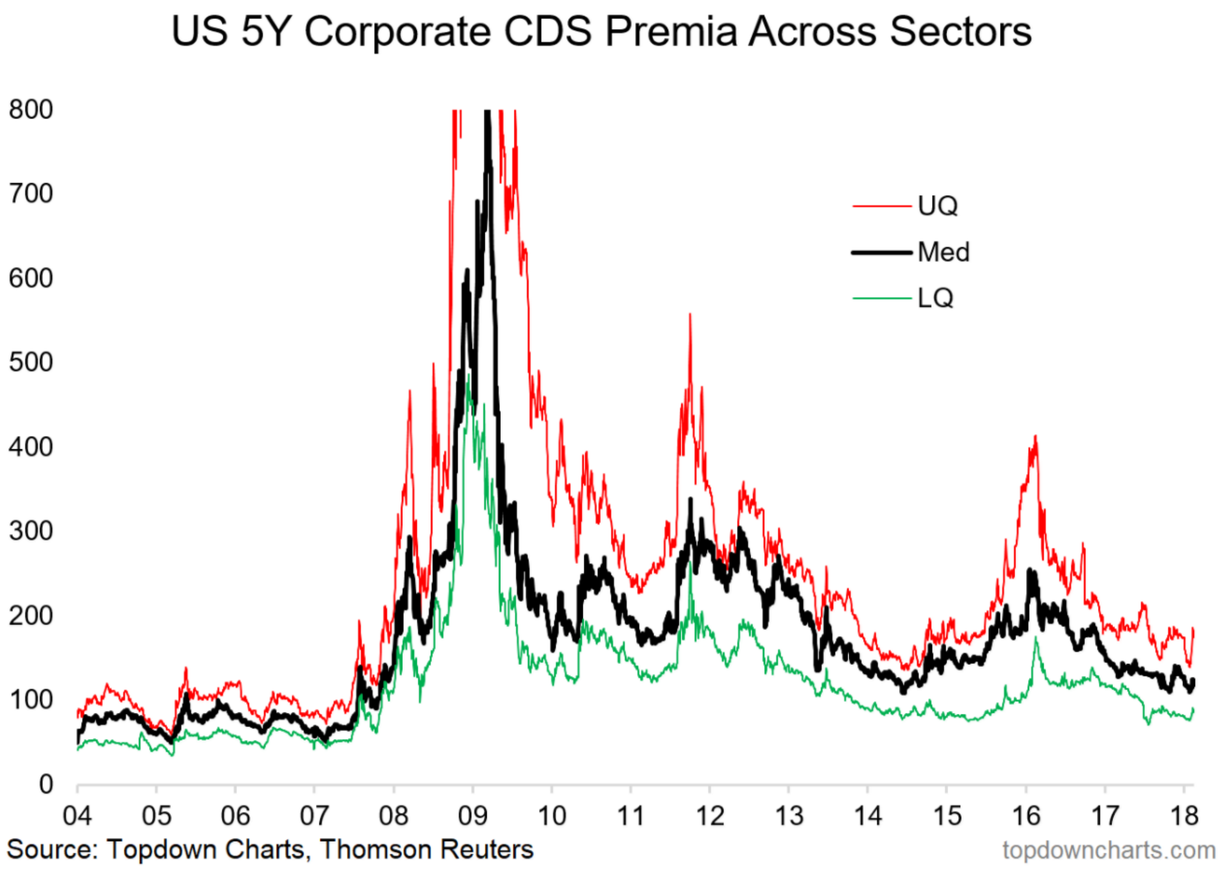

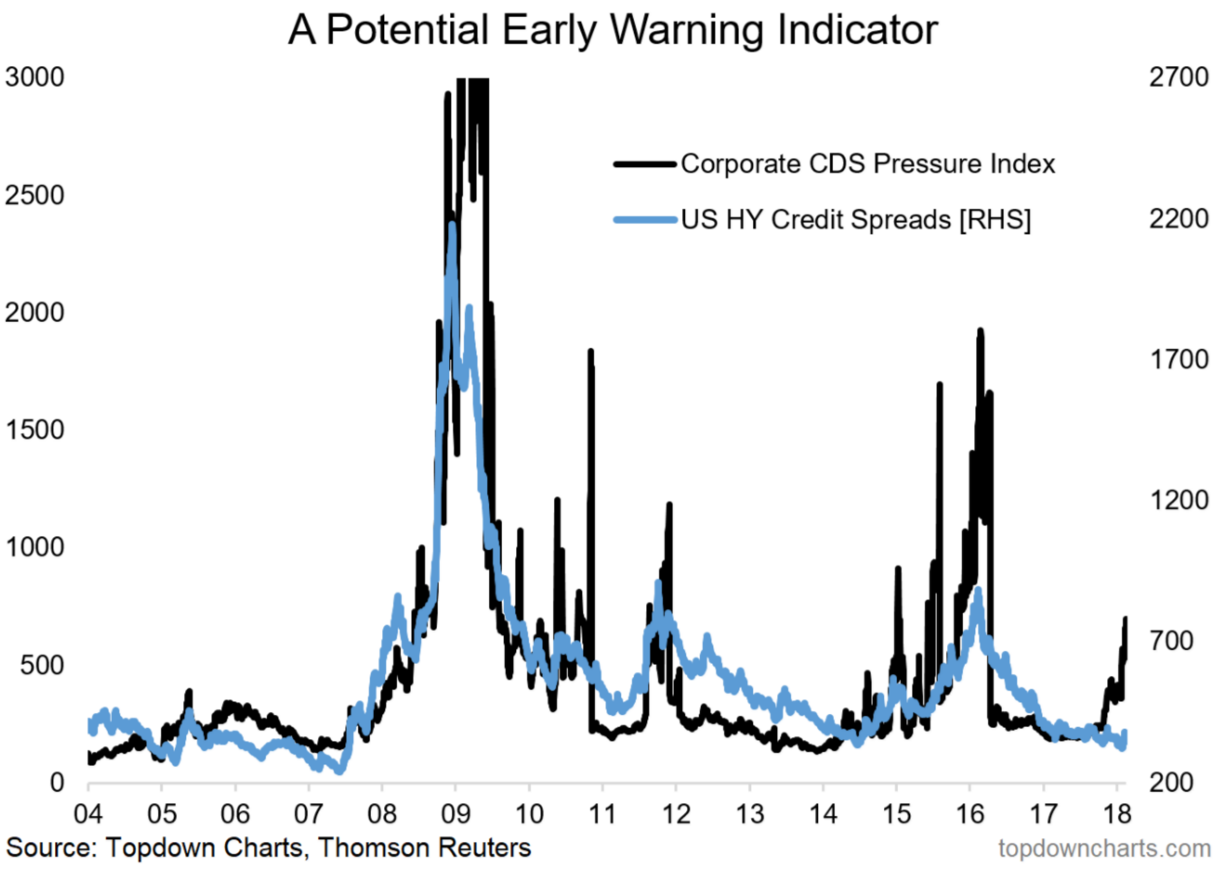

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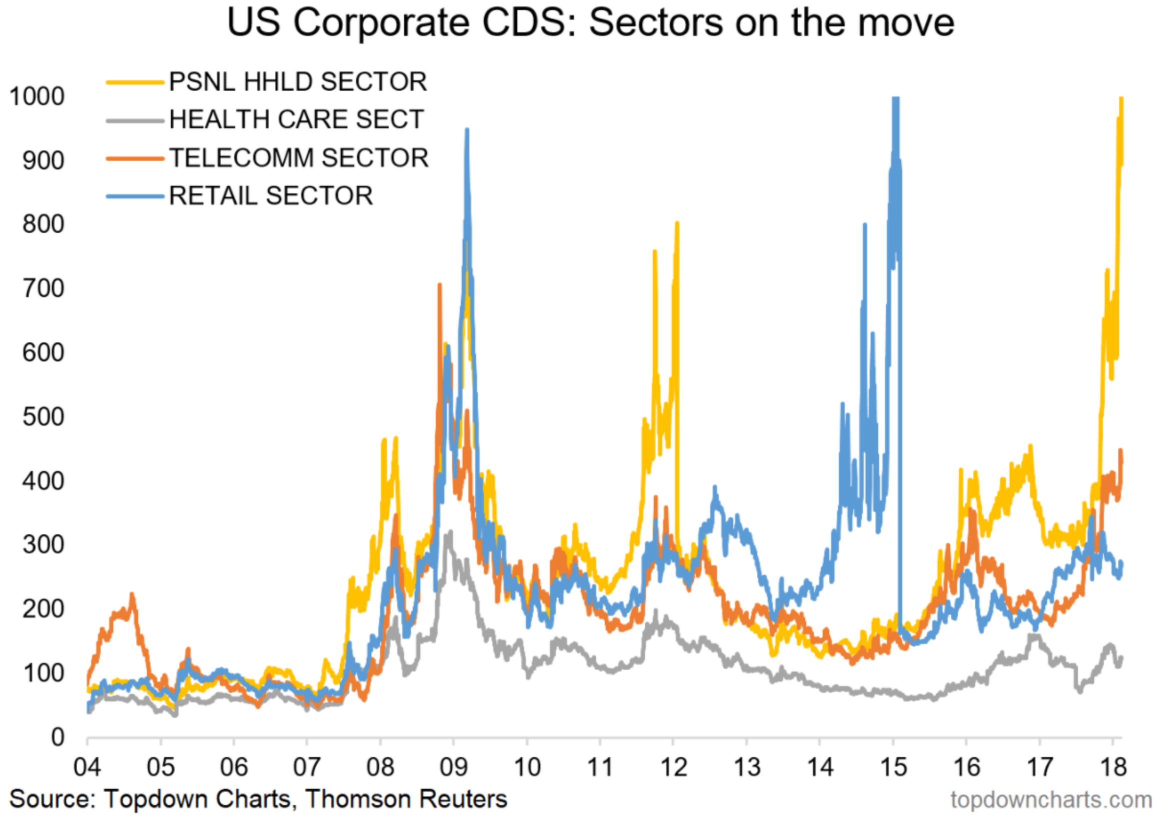

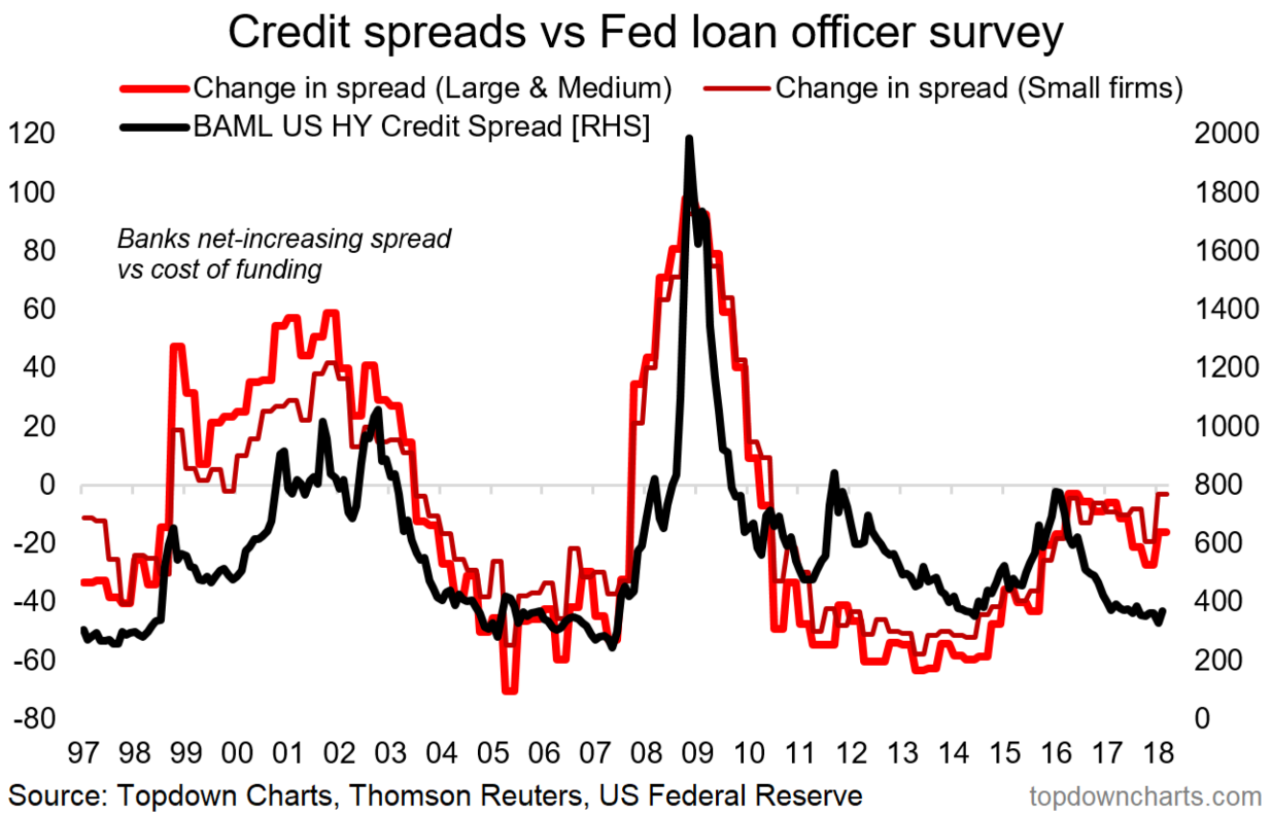

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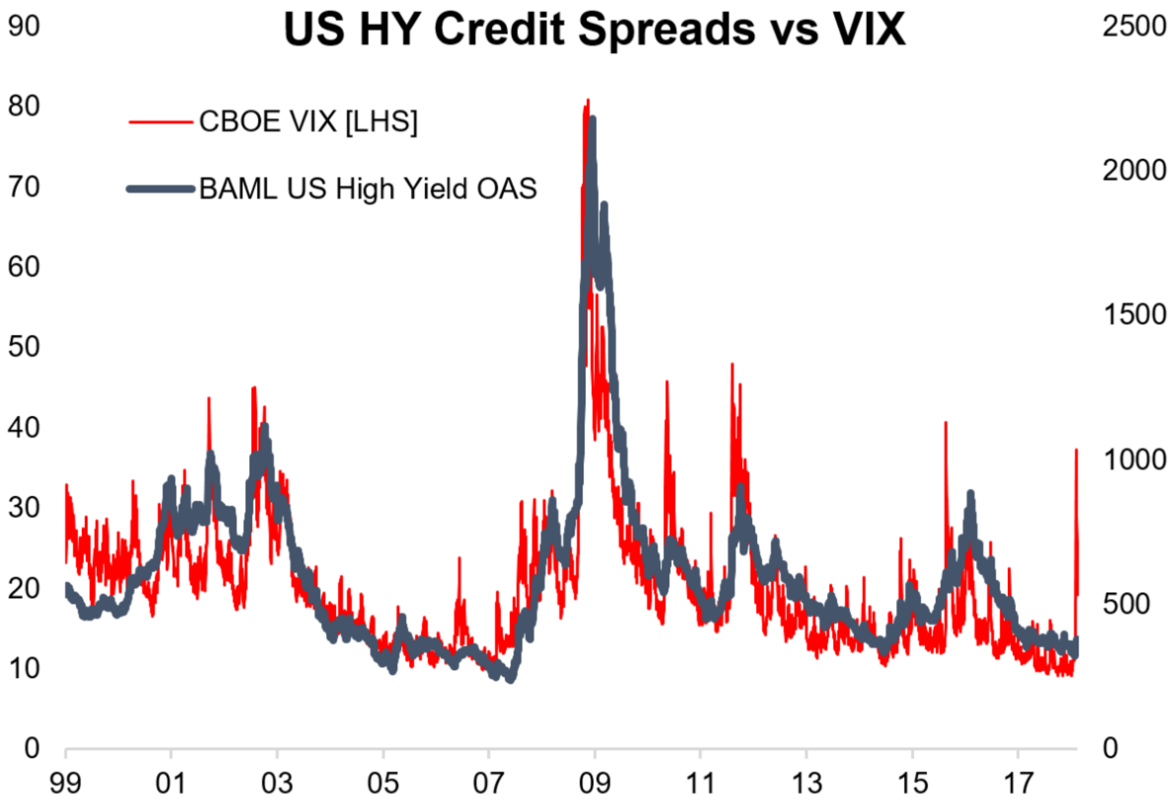
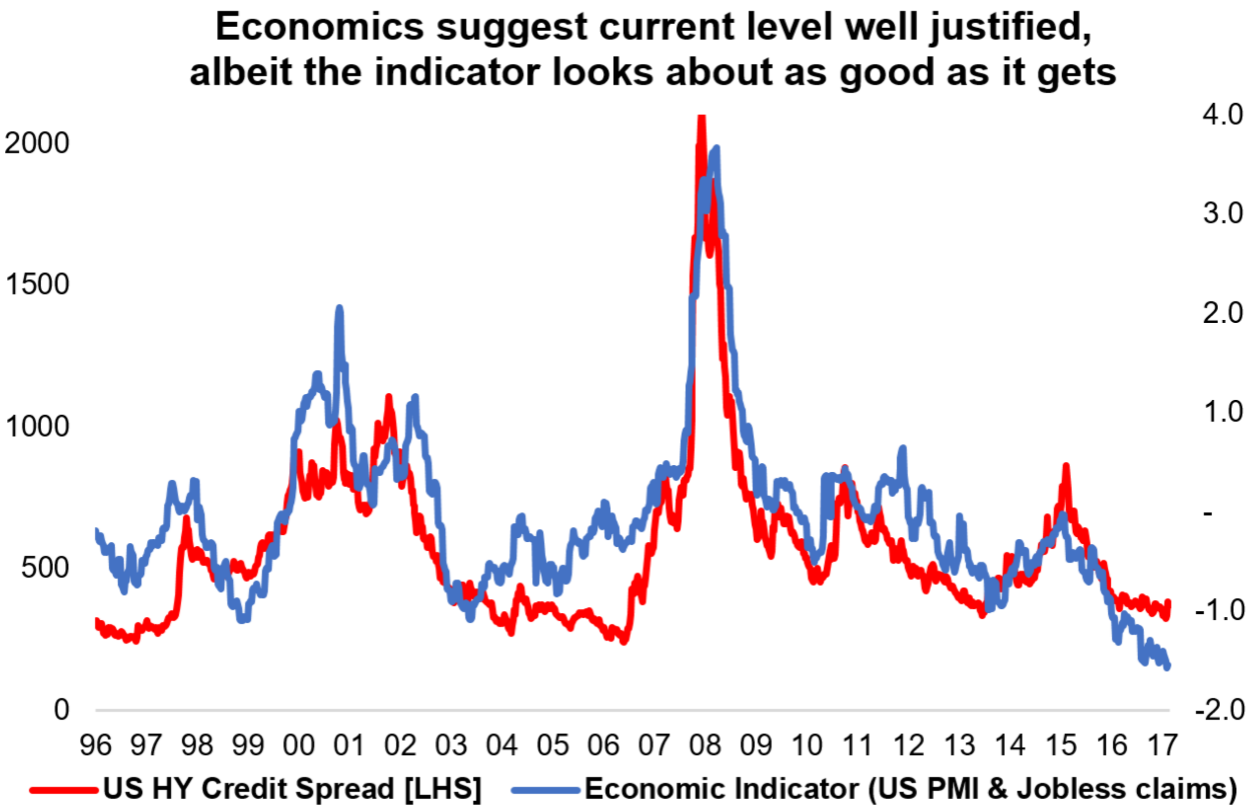


Source: Topdown Charts, US Federal Reserve, Thomson Reuters topdowncharts.com



Source: Topdown Charts, Thomson Reuters, ISM topdowncharts.com

3. Equity Risk Premium

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3. Equity Risk Premium: The trend of rising PE ratios is well documented, and add to that the latest edition of the rise in bond yields you get a squeeze on the equity risk premium from both ends. On a longer term timeframe the moves take the ERP below long term average and the average of more recent history, yet is only approaching the 2007 lows and is still well off the 2000 low.

Looking across countries there is a similar theme across the major DM equity markets. Interestingly, US is at the bottom, and the UK is at the top of this groupings. Outside of the US most of the other DM equity markets still have ERPs well above average.

I've had a few questions about the equity risk premium and the move in bond yields. My thinking is that higher bond yields will be driven (primarily) by a better growth/inflation outlook i.e. better nominal growth – which gets banked by equity owners. Still, as bonds go from offering close to zero or negative expected returns to progressively positive expected returns, and as we get later in the cycle and stockmarket valuations head higher, the relative risk/return outlook certainly moves. It's dynamics like these that may bring a shift in mindset from 'buy the dip' to 'sell the rip'.

Bottom line: The shrinking equity risk premium highlights the changing relative risk/reward outlook as we move later in the cycle.

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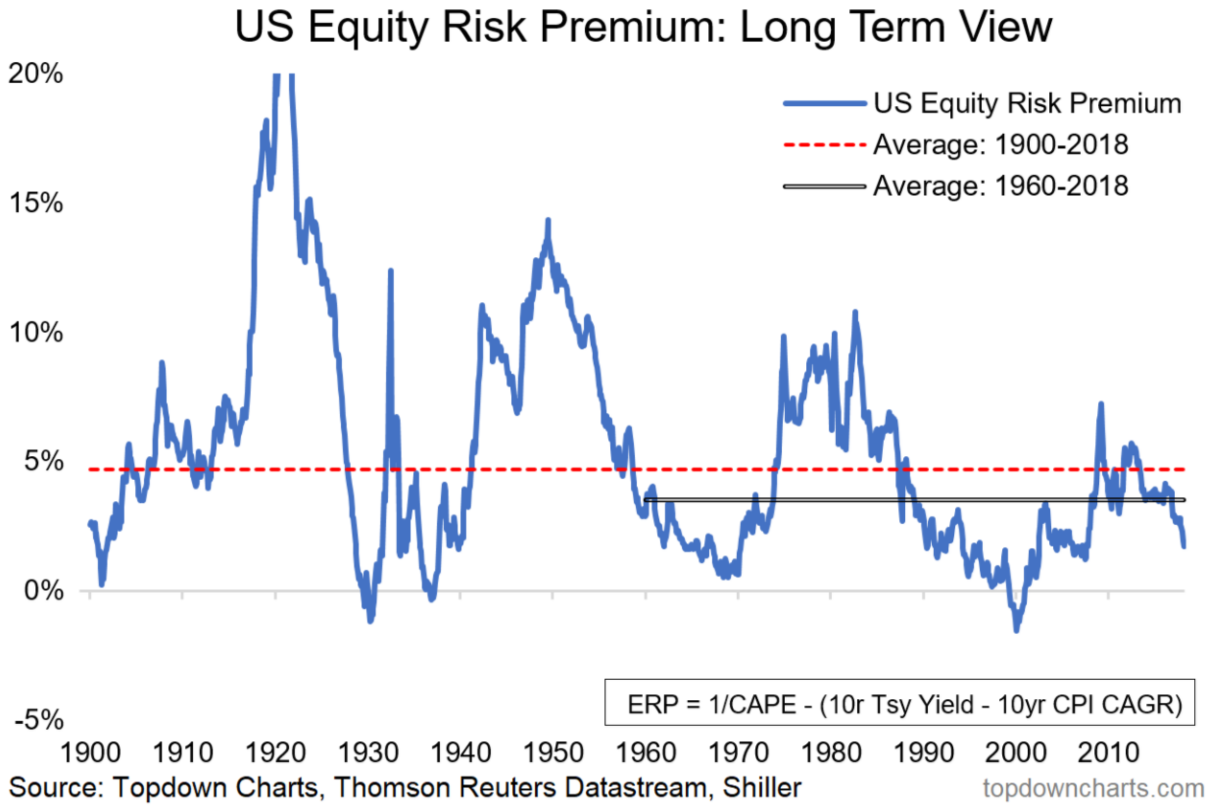

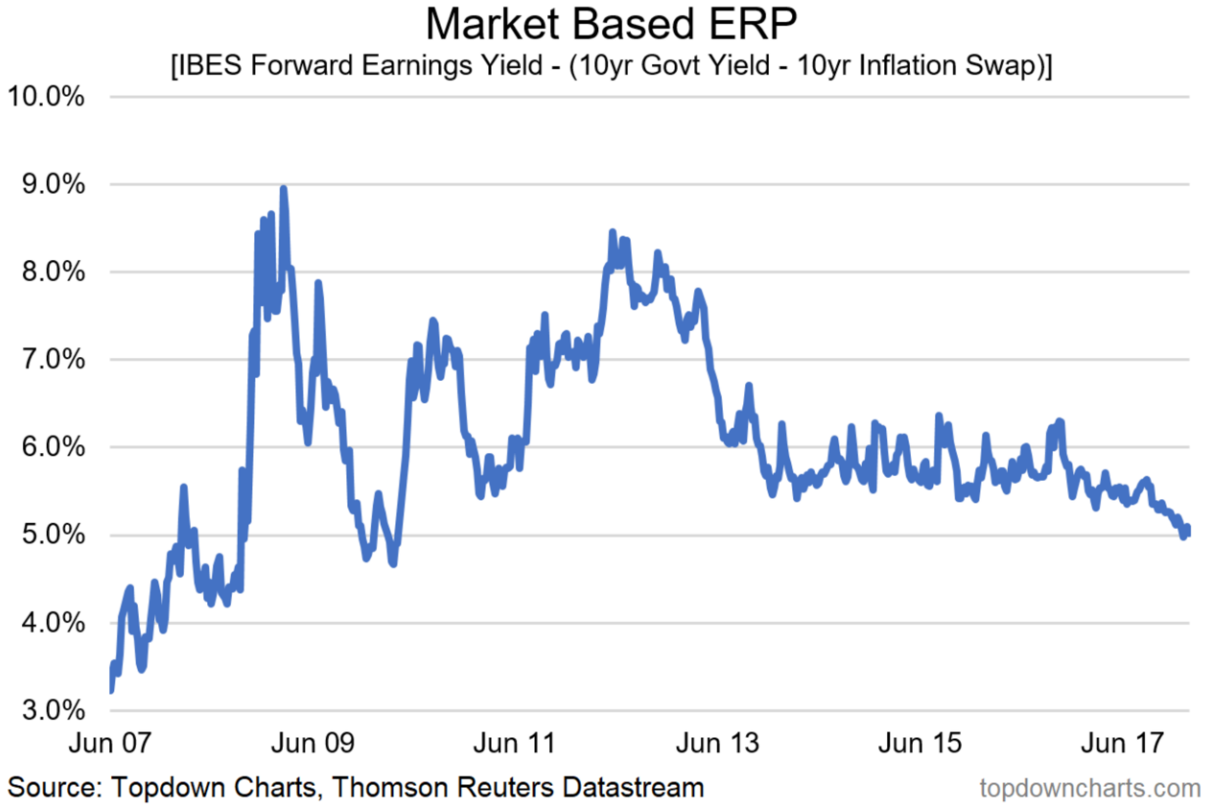

3. Equity Risk Premium

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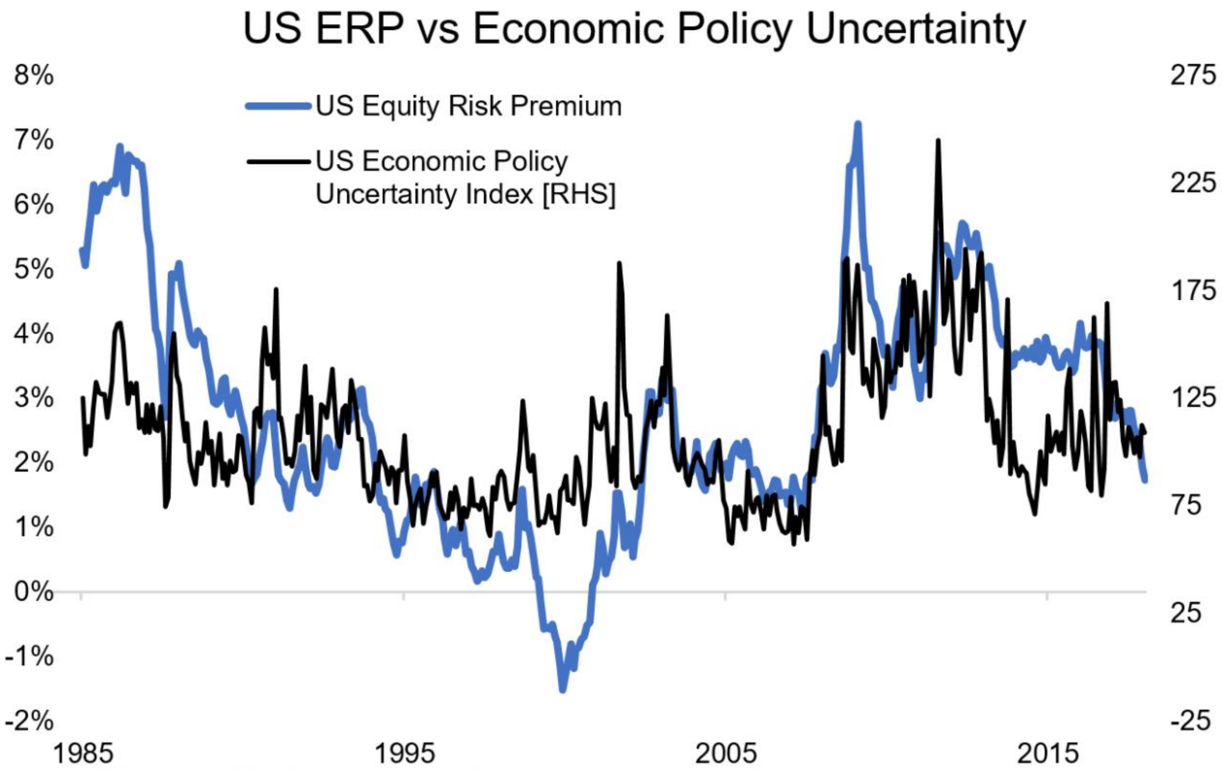
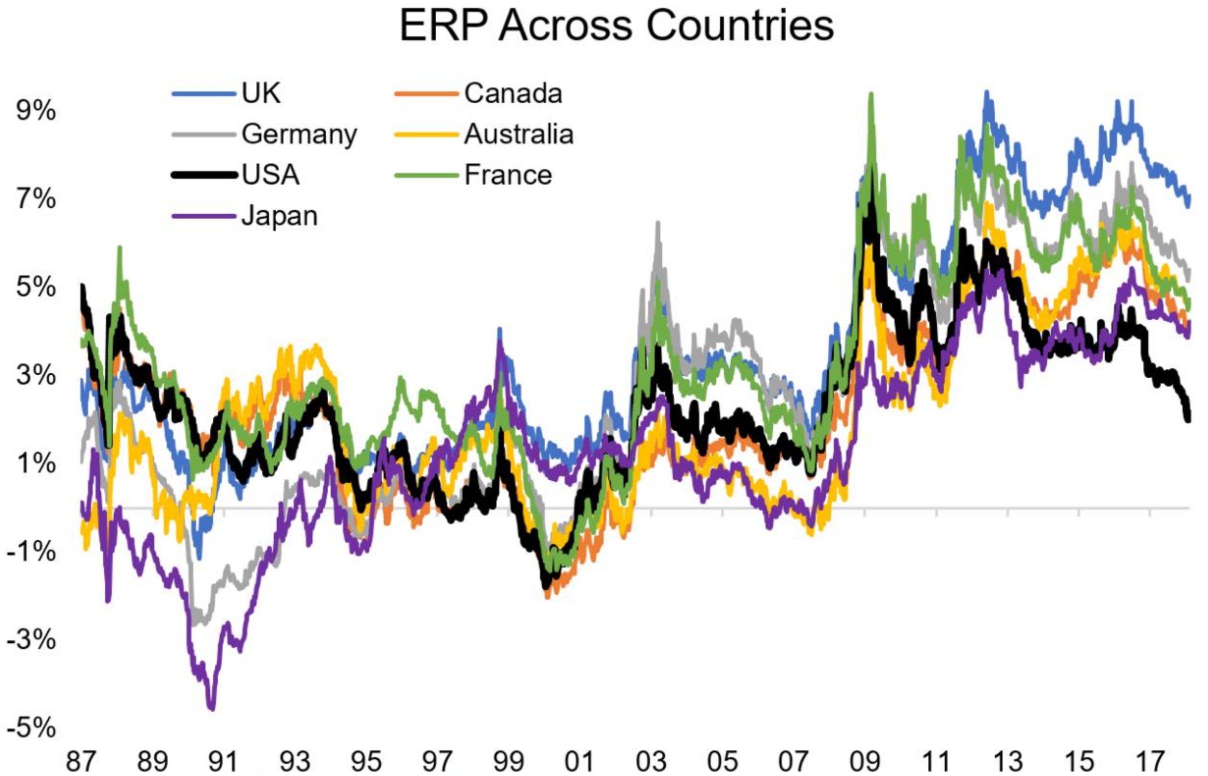
Putting the US ERP into context, the first chart shows how there seems to be a sort of required risk premium for times of greater economic policy uncertainty (makes sense), yet with the global monetary policy tides turning it's up for debate as to whether policy uncertainty goes lower. Looking across countries there is a similar theme across the major DM markets. Interestingly, US is at the bottom, and the UK is at the top of this grouping.



Source: Topdown Charts, Thomson Reuters Datastream, Shiller topdowncharts.com



Source: Topdown Charts, Thomson Reuters Datastream topdowncharts.com

4. Treasuries Tactics

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4. Treasuries Tactics: Reviewing the charts from when we previously covered this issue, the breadth indicator has clearly moved further towards oversold, but is yet to reach the same washout levels seen in previous bond tantrums. Likewise sentiment has certainly shifted, but is yet to hit extremes – certainly not yet at the point where you would take a high conviction contrarian view.

Likewise, valuation, while now less expensive, is still distinctly in the expensive zone, and it would take a move toward at least 3.5% or higher to neutralize valuation (which would also bring it into line with where the DM composite manufacturing PMI implies it 'should' be). So while there will come a time to fade this move, conviction would be low until it gets above 3.5%.

One wildcard is the path of monetary policy. Already the Fed has begun passively shrinking its balance sheet (treasuries reduced by $30B so far), and the annual rate of change in the BOJ and ECB balance sheets is on a declining path. This changes the supply/demand picture from a flows standpoint and any surprises could trigger a cascade effect. Naturally this would also create opportunities.

Bottom line: Bond market sentiment, technicals, and valuations have shifted but could easily move further, particularly given the trends in monetary policy (not time to fade it yet).

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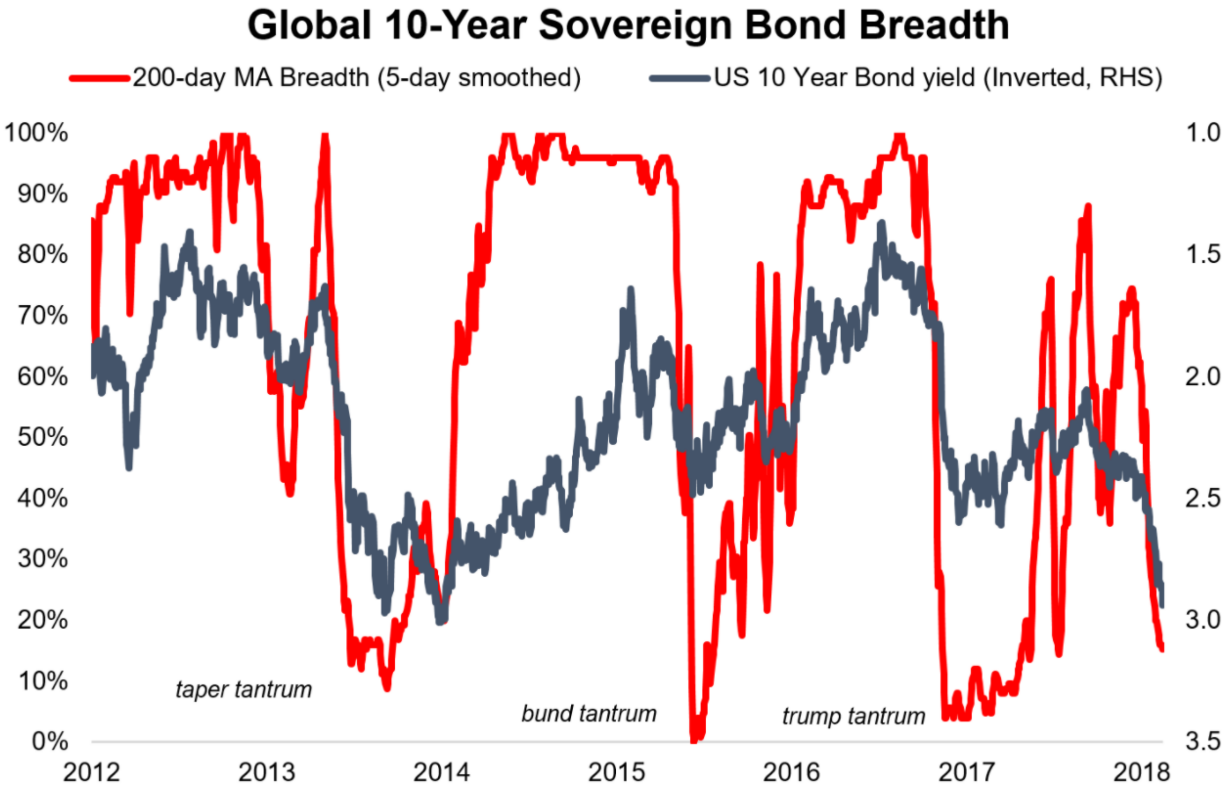

Source: Topdown Charts, Datastream

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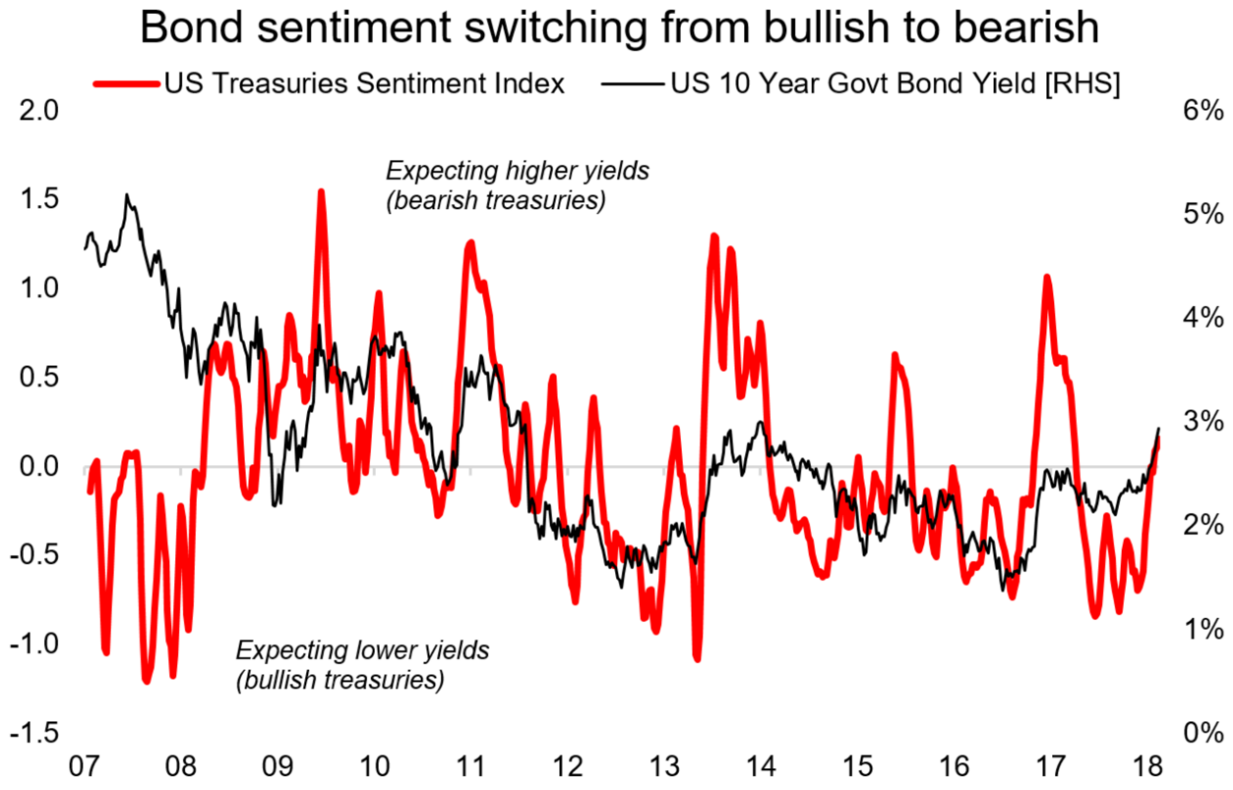

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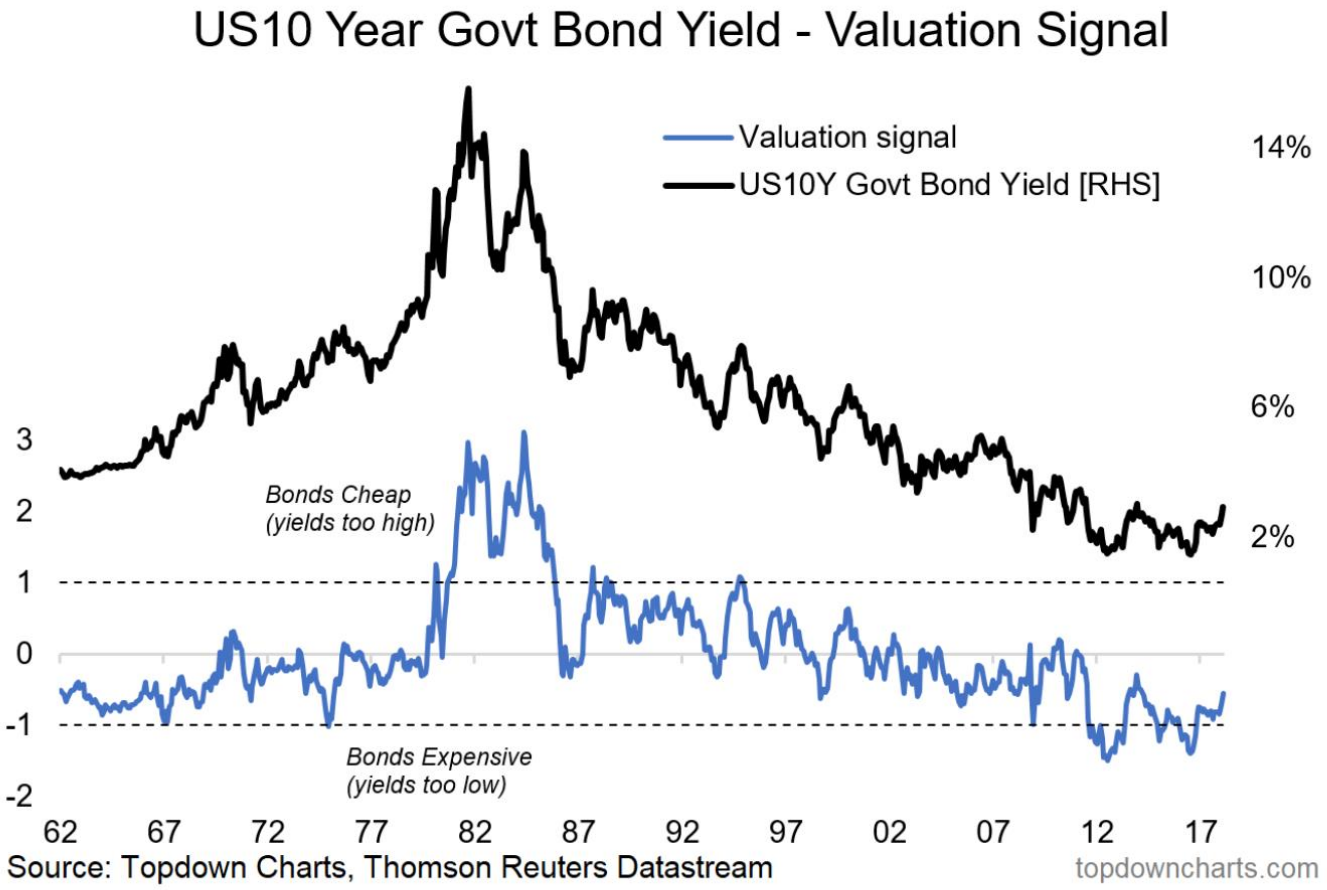

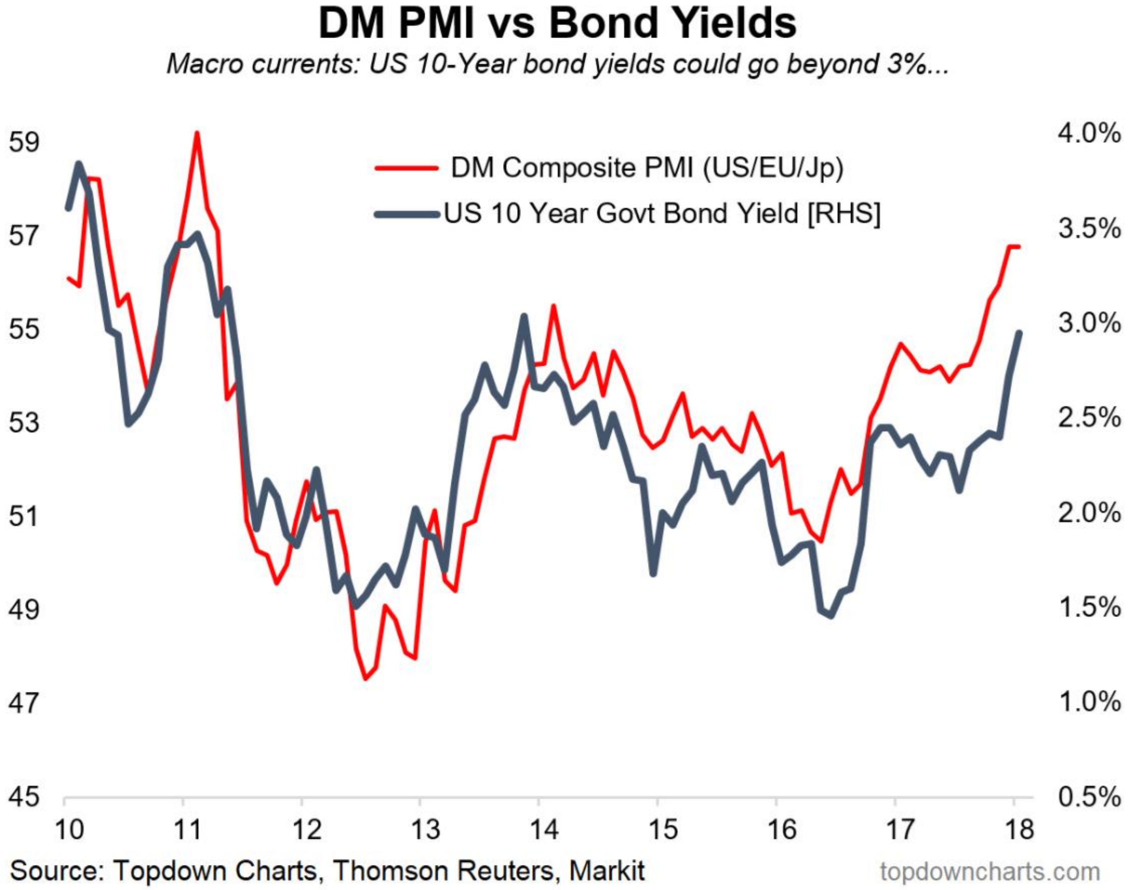

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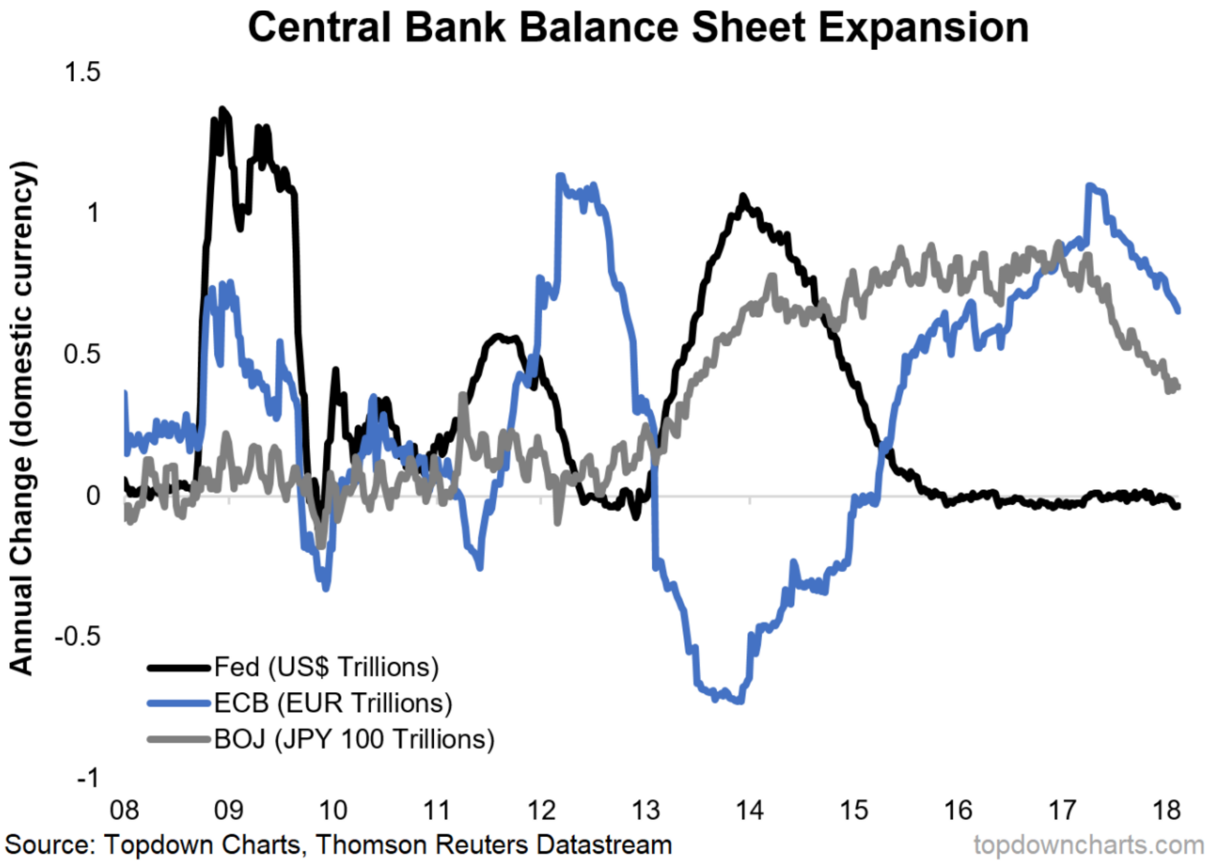

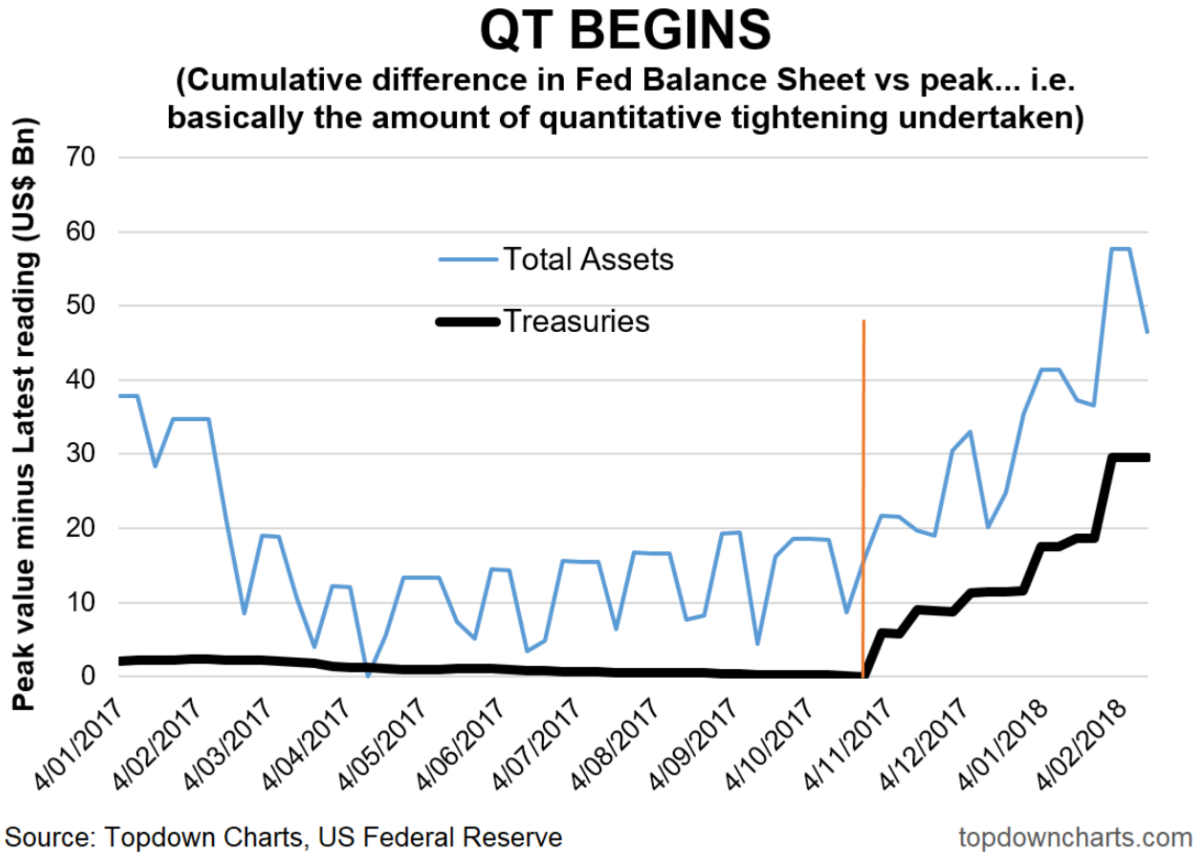

5. Golden fork

TOP DOWN CHARTS

5. Gold: Gold is at a fork in the road. Spending all this time looking at the move in bond yields and equity risk premiums, naturally this brings the topic of real yields up and of course real yields are of significant interest when it comes to the gold price. Certainly more so when you see a divergence opening up like the one we are seeing now (chart 1). It also lines up with what's going on with US monetary policy as the shadow rate moves from big negative to positives and threatens to send the gold price lower.

Yet this comes as gold is dabbling in an upside breakout of the downtrend channel and is brushing up against a key resistance level. Speculative futures positioning is not extremely crowded, but there remains significant net-longs. Meanwhile implied volatility is starting to stir from record lows. Looks to me like the risks are weighted to the downside, potentially significantly so.

As Yogi Berra once said to Joe Garagiola[1], "When you come to a fork in the road, take it."

Bottom line: Rising real yields and the move from QE to QT put gold at significant downside risk as it comes up against key resistance levels.

1. (apparently as he was explaining how to get to his house from New York)

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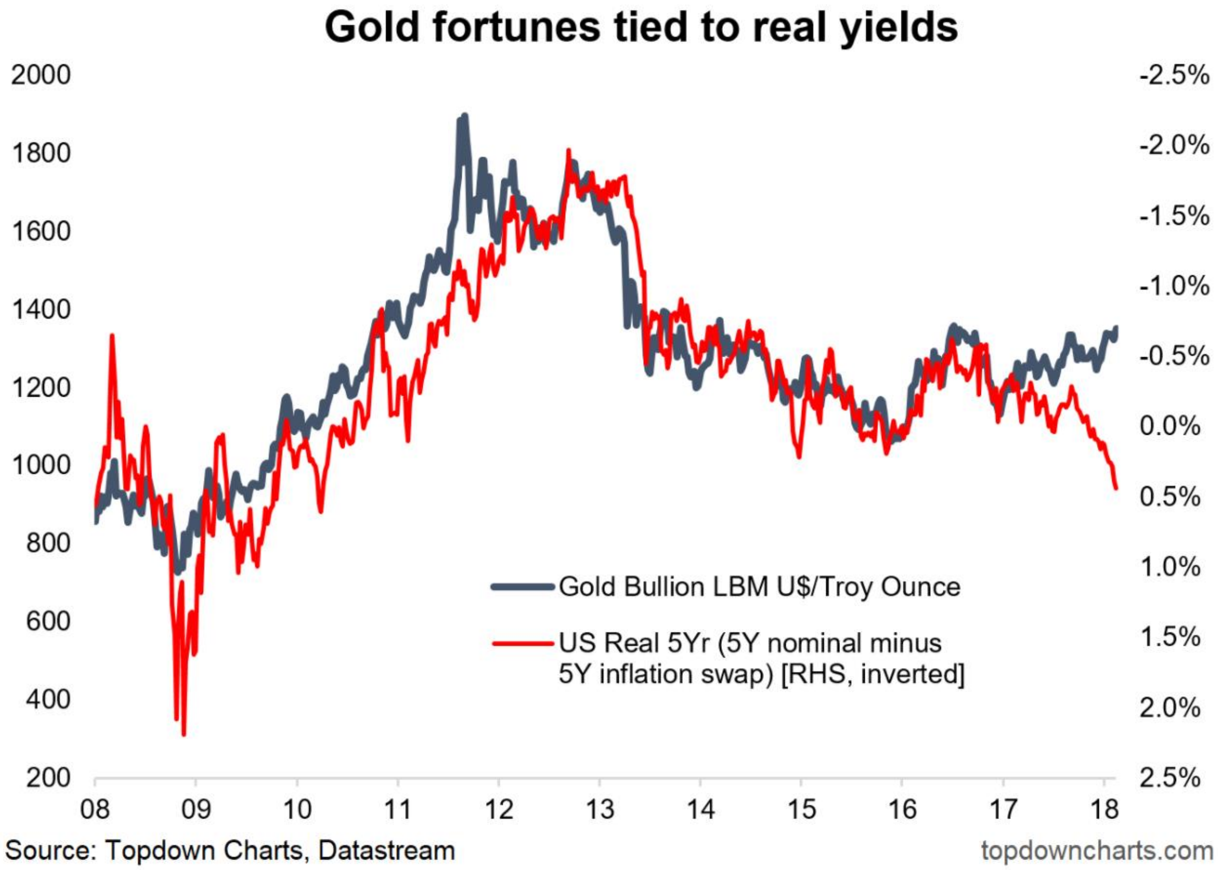

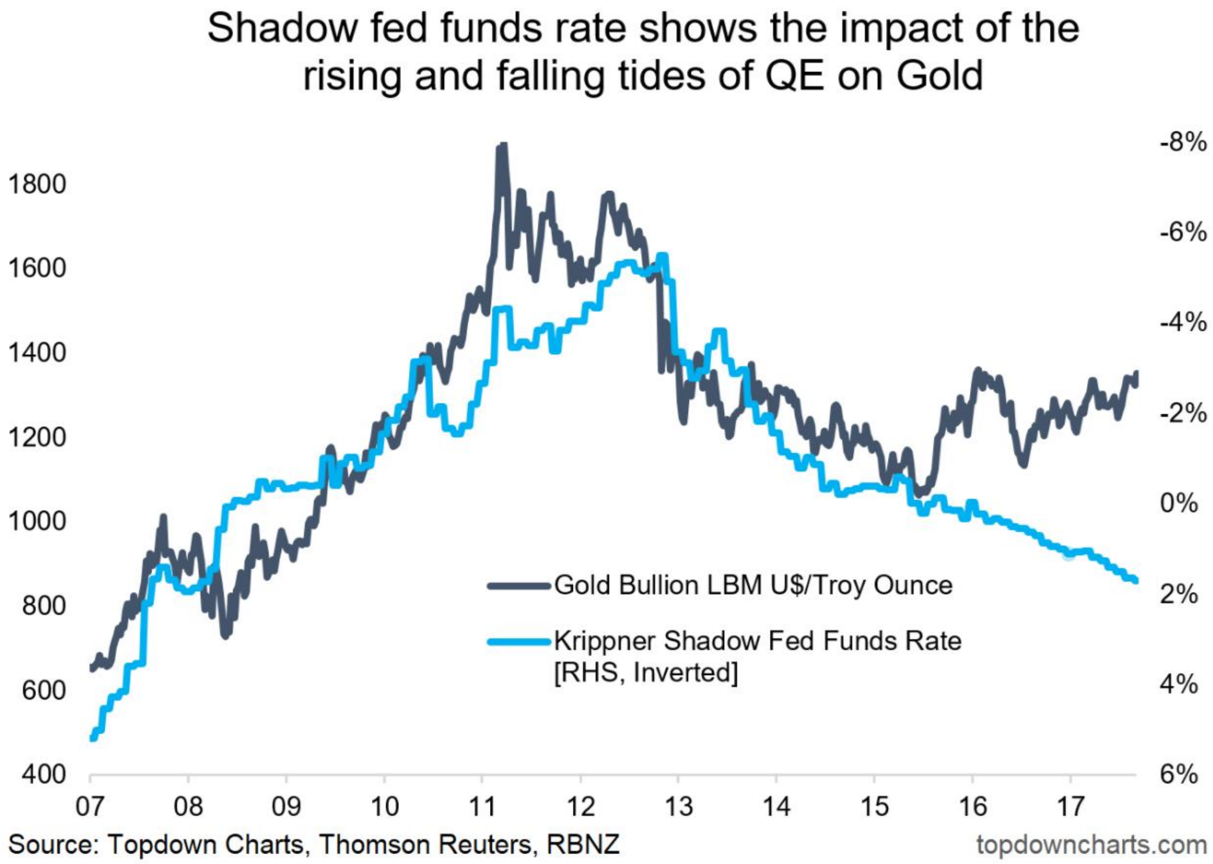

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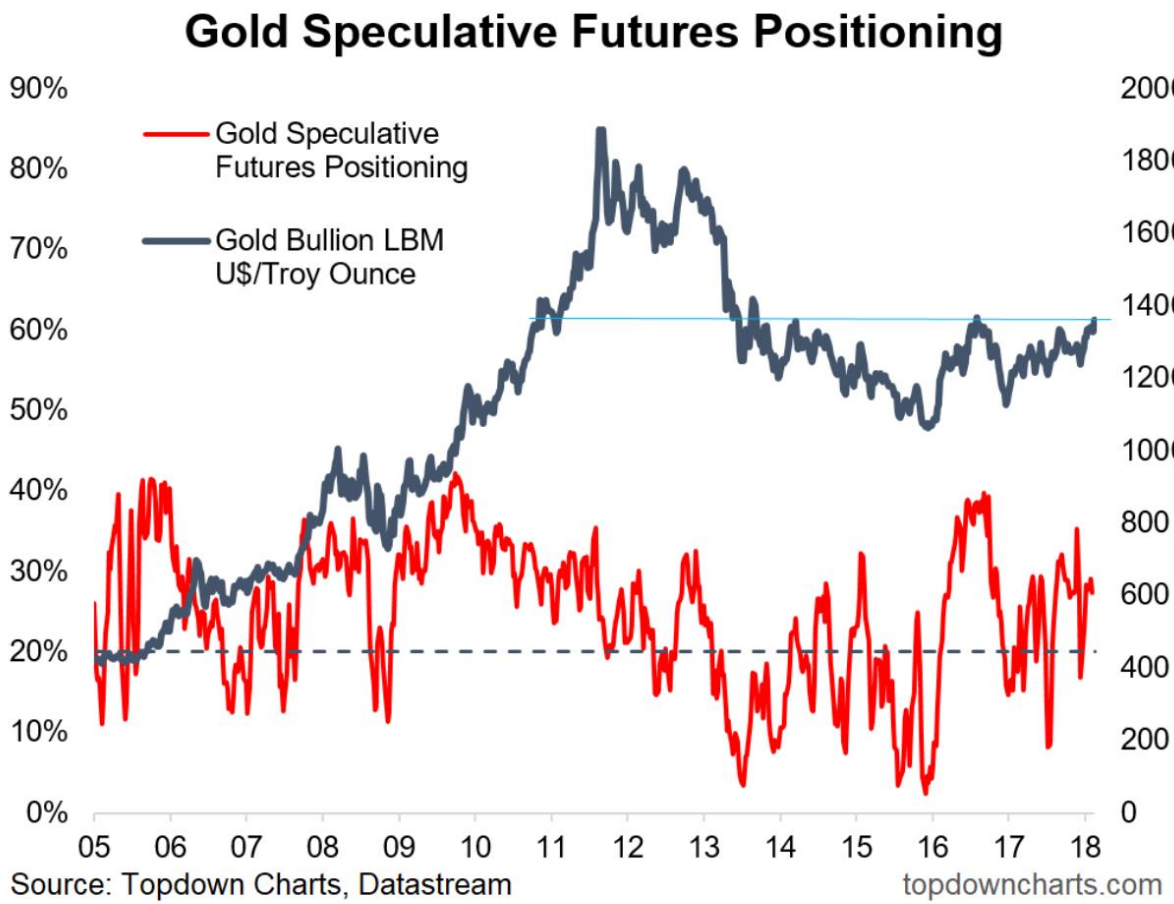

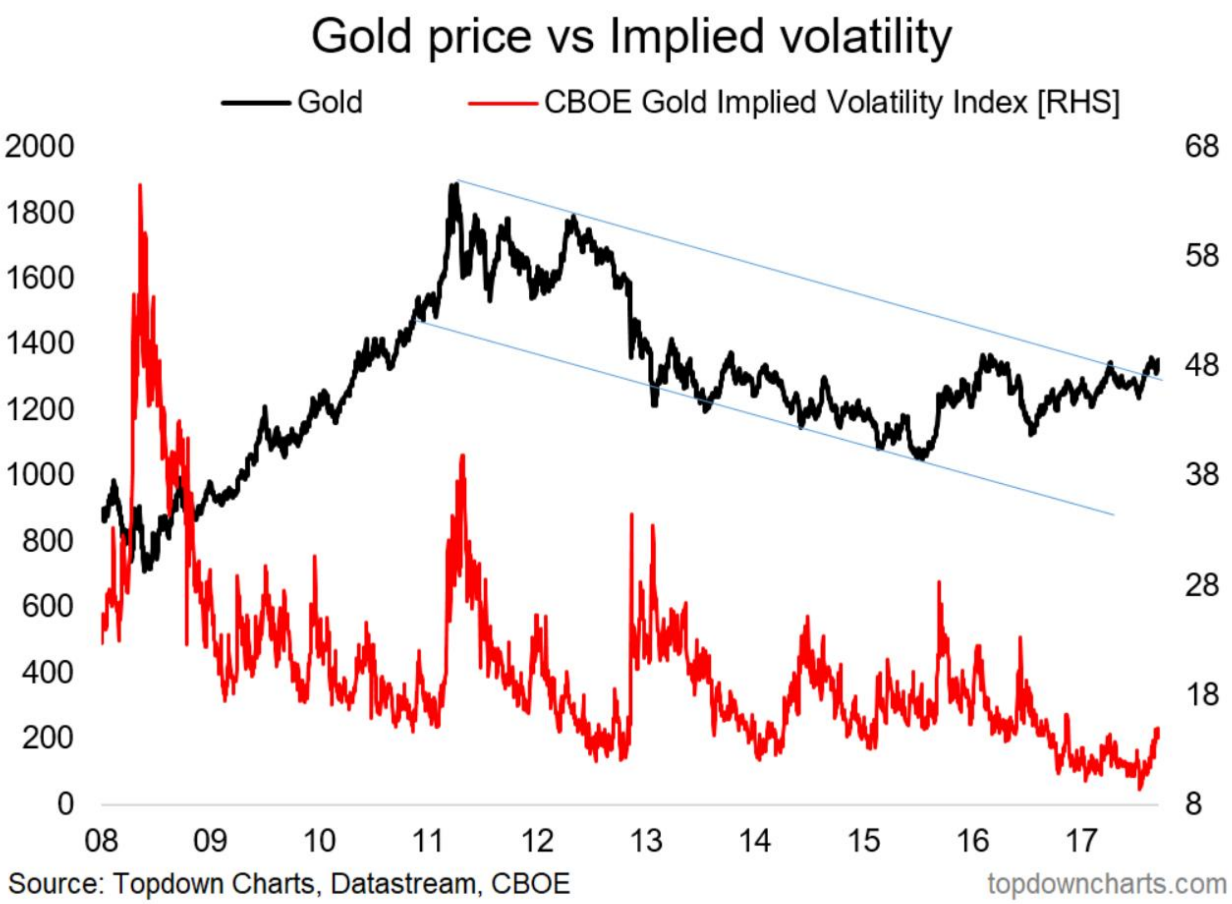

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