# TOP DOWN CHARTS

Chart driven macro insights for investors

**Weekly Macro Themes - 26 May 2017 - Volume 2, Edition 20**

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

**1. Global growth in question:** The DM flash PMI has capped out, but positive dynamics in property prices, consumer sentiment, global trade, industrial production and monetary policy remain supportive.

**2. Euroboom:** With positive growth and risk dynamics in Europe, the upturn in inflation is likely to continue, which will see the ECB progressively wind-back easing measures.

**3. Cyclicals vs Defensives:** Cyclicals have had a lot going for them but now valuation is more neutral, the economic rebound has played out, and earnings sentiment is at an extreme.

**4. What to expect for country returns:** Expected returns across countries show generally higher numbers for emerging markets, and across all countries generally lower expected vs historical returns.

**5. NZDUSD:** Policy rate differentials point to rising odds of a downside overshoot for the NZDUSD, while the sentiment/timing indicators present mixed signals.

# 1. Global Growth in Question

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**1. Global growth in question:** The latest round of flash manufacturing PMIs for May saw Eurozone in the lead up +0.3 to 57.0 USA trailing behind, down -0.3 to 52.5 Japan off -0.7 to 52.0 and left the composite flash Developed Market manufacturing PMI down slightly. The main point of concern is that the DM PMI has fallen for 4 months in a row (down -0.75pts off the high), and this move has been mirrored in US 10-year bond yields. Naturally this calls into question the global growth outlook. So is it time to get bearish on global growth?

My view is you want to keep an open mind, but the charts below illustrate the compelling upside support to global growth:

a. Property prices are rising in the major economies (good for confidence, growth, credit/banks)

b. Consumer sentiment is improving in DM & EM (reflects better conditions for consumers: asset inflation, jobs growth, earnings)

c. Global trade growth has rebounded (enables a positive cycle, broadens growth)

d. Industrial production and corporate earnings growth looking better (partly reflects commodity dynamics, but also better growth backdrop

To add to that, monetary policy remains broadly supportive. So as long as these underlying conditions persist it's hard to see global growth really rolling over, without some major piece of the puzzle coming under pressure (e.g. China or US), or some sort of crisis or shock. Thus the global growth outlook seems fine.

***Bottom line:*** The DM mfg PMI has capped out, but positive dynamics in property prices, consumer sentiment, global trade, industrial production and monetary policy remain supportive.

# 1. Global Growth in Question

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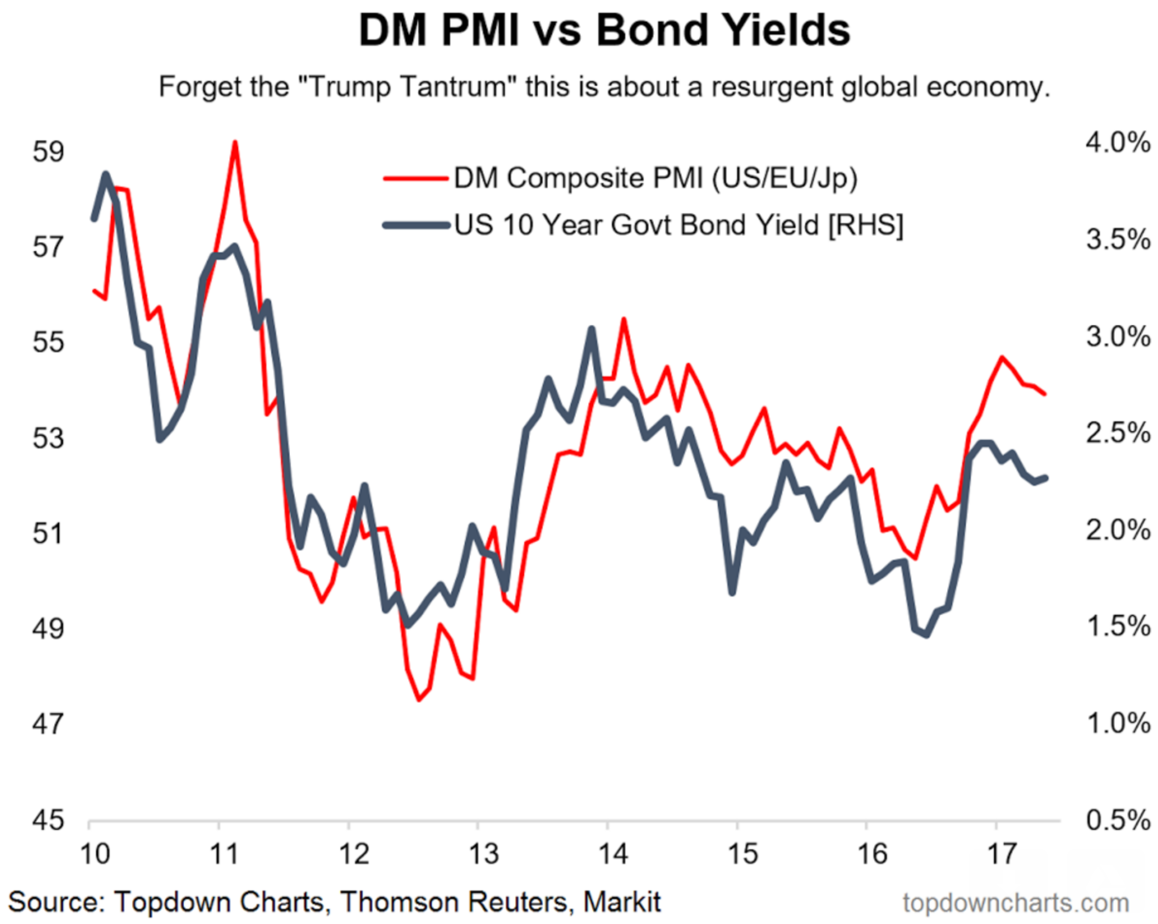
The DM flash PMI dropped for the 4th month. It's not a big drop but it goes against the idea of higher bond yields, and the logical conclusion of further falls would be a slowdown.



# 1. Global Growth in Question

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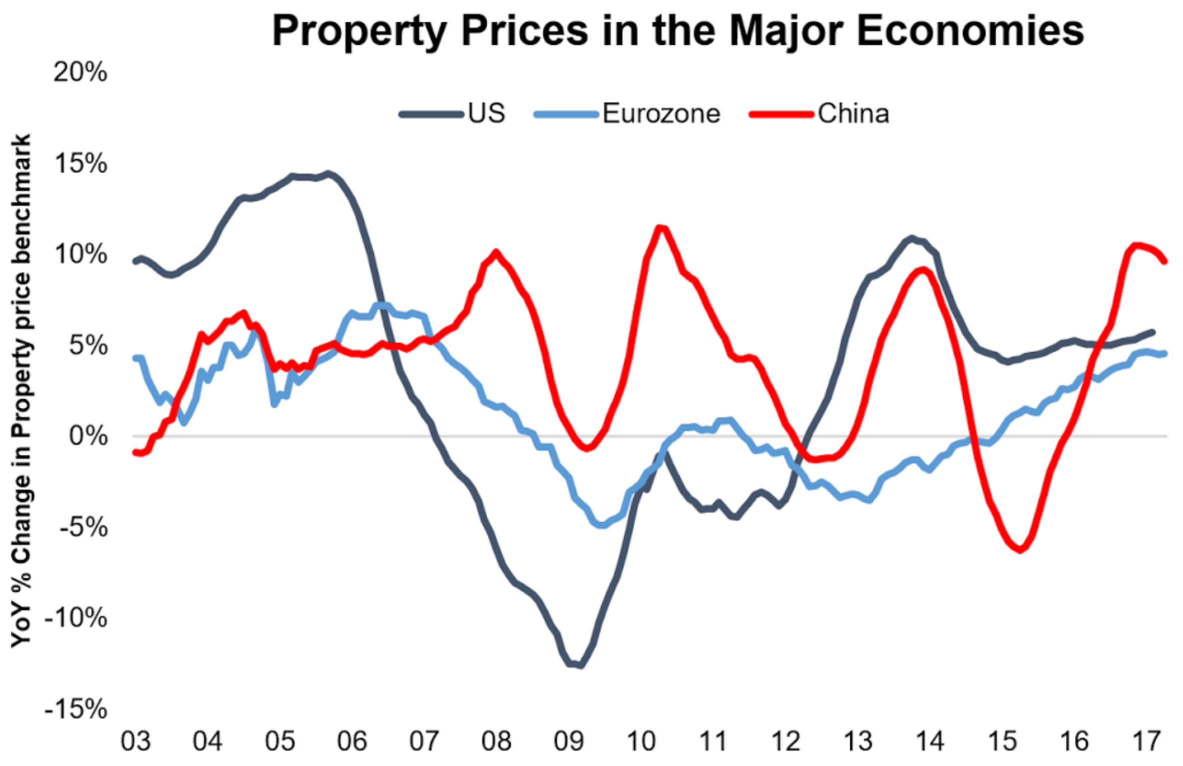
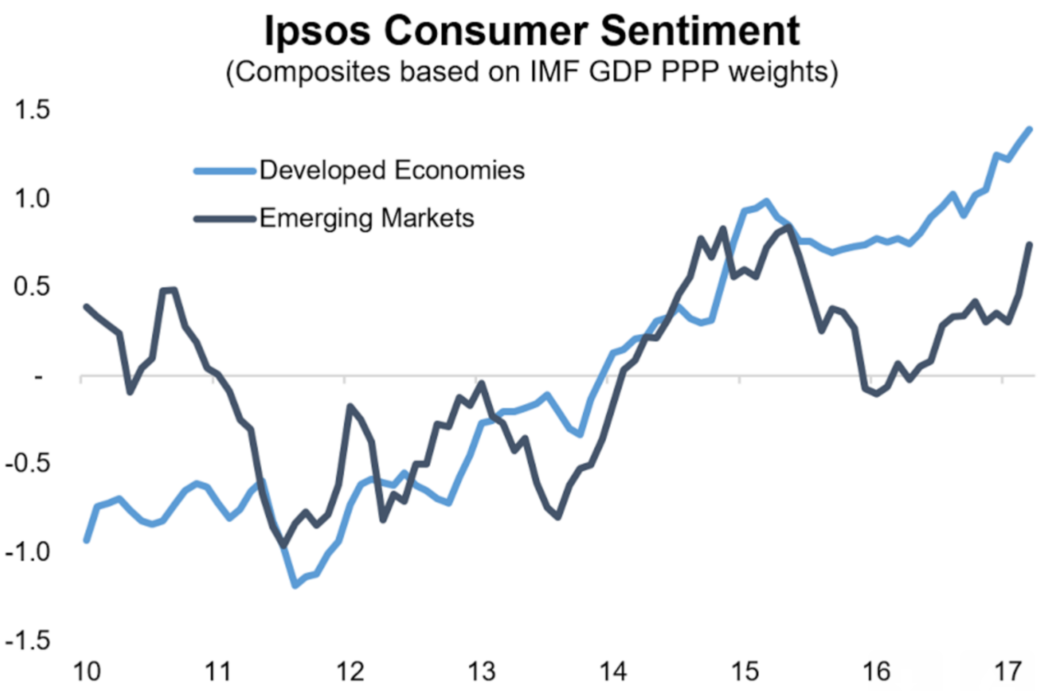
Bullish evidence: property prices are rising in the major economies, and both DM and EM are seeing improved consumer sentiment readings.




Source: Topdown Charts, Thomson Reuters, BIS

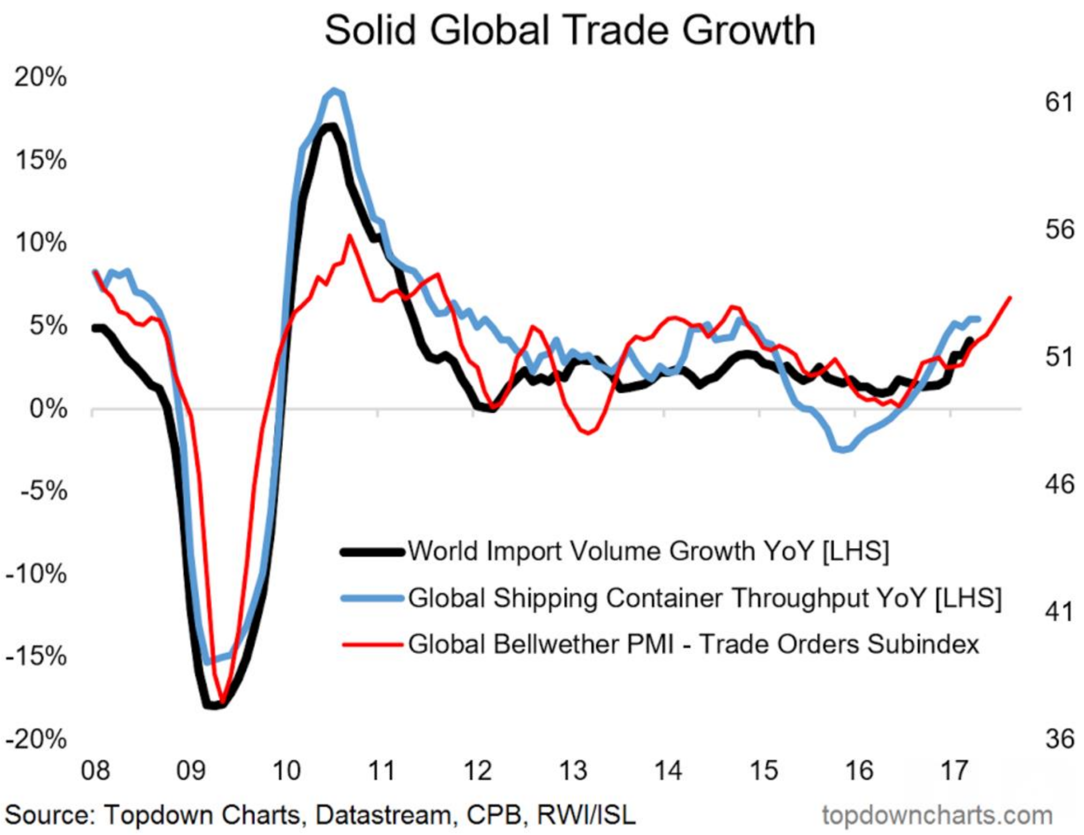


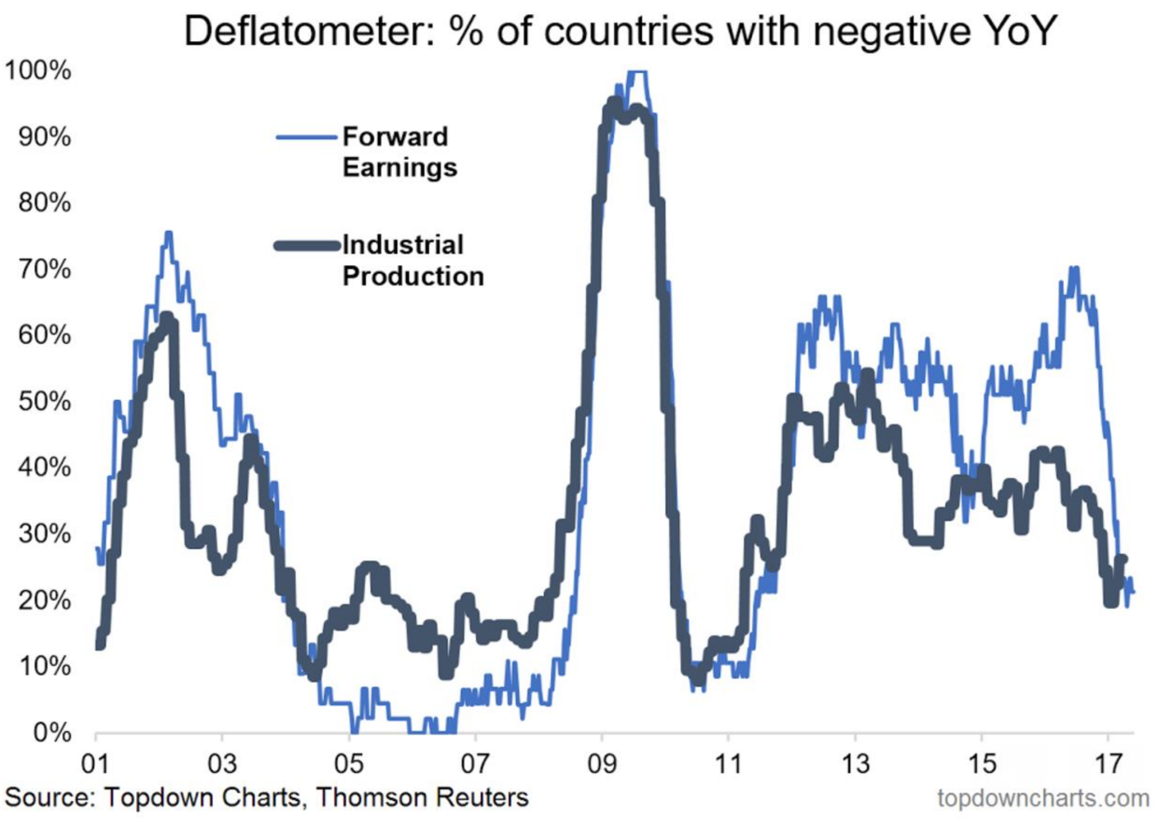

Source: Topdown Charts, Thomson Reuters

# 1. Global Growth in Question

TOP DOWN CHARTS

Bullish evidence: Global trade growth is improving and the number of countries with contracting IP and corporate earnings growth has improved to a 6-year low.



# 2. Euroboom

**2. Euroboom:** A curious thing is happening in the Eurozone. As I've previously pointed to, economic sentiment is running hot. Political risk has peaked - at least on a cyclical basis (and maybe even a structural basis) - and that is starting to get reflected in sovereign bond spreads. And something that a lot of people may find hard to believe is that inflation is making a comeback. I've said it before, and I'll take the opportunity to say it again, the best days of ECB easing are behind us for this cycle, and the balance of risks are to the upside for higher inflation vs deflation.

On the inflation front, we're seeing higher headline and core CPI - partly this comes from base effects, but spare capacity is steadily being deployed as economic confidence and performance improve, property prices as a whole are on the rise, and the trend in the unemployment rate points to a further gradual improvement in wage growth. The commodity rebound may have overstated some aspects of it, but while the magnitude may be 'wrong' the direction is right.

From a market standpoint, the outlook for bonds and the Euro given what I've outlined here should be pretty clear - upside for bond yields, upside for the Euro... all else equal. It's a little less clear for European equities - on the one hand the macro backdrop is one of improving nominal growth which should be supportive for the earnings side of things, but the tailwind of easy monetary policy is going to dissipate, and a stronger Euro will act as a headwind for those with ex-EZ earnings - the bond yield aspect will be mixed (bad for income stocks, good for bank stocks). On a broader global view, a less actively easing ECB will probably put upward pressure on global bond yields and will reduce the global QE/liquidity impulse. Basically all the things you'd expect to see in a gradually maturing cycle.

***Bottom line:*** With positive growth and risk dynamics in Europe, the upturn in inflation is likely to continue, which will see the ECB progressively wind-back easing measures.

# 2. Euroboom

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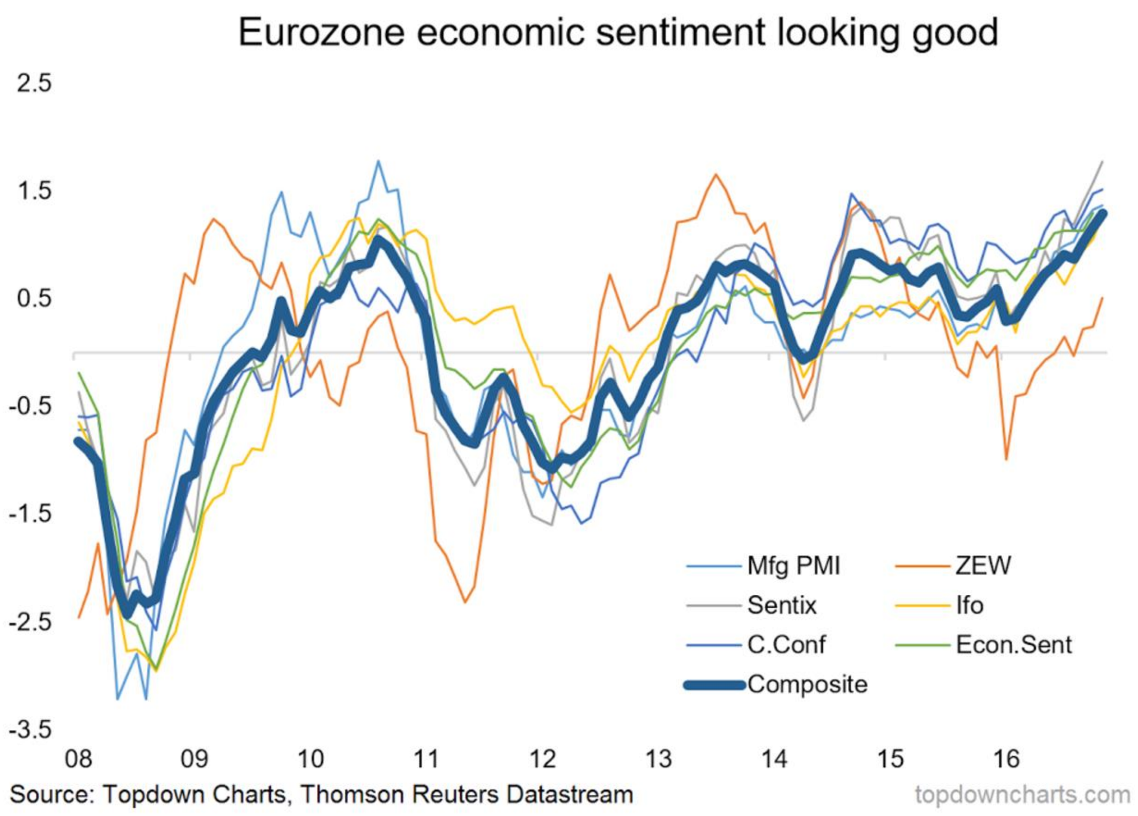
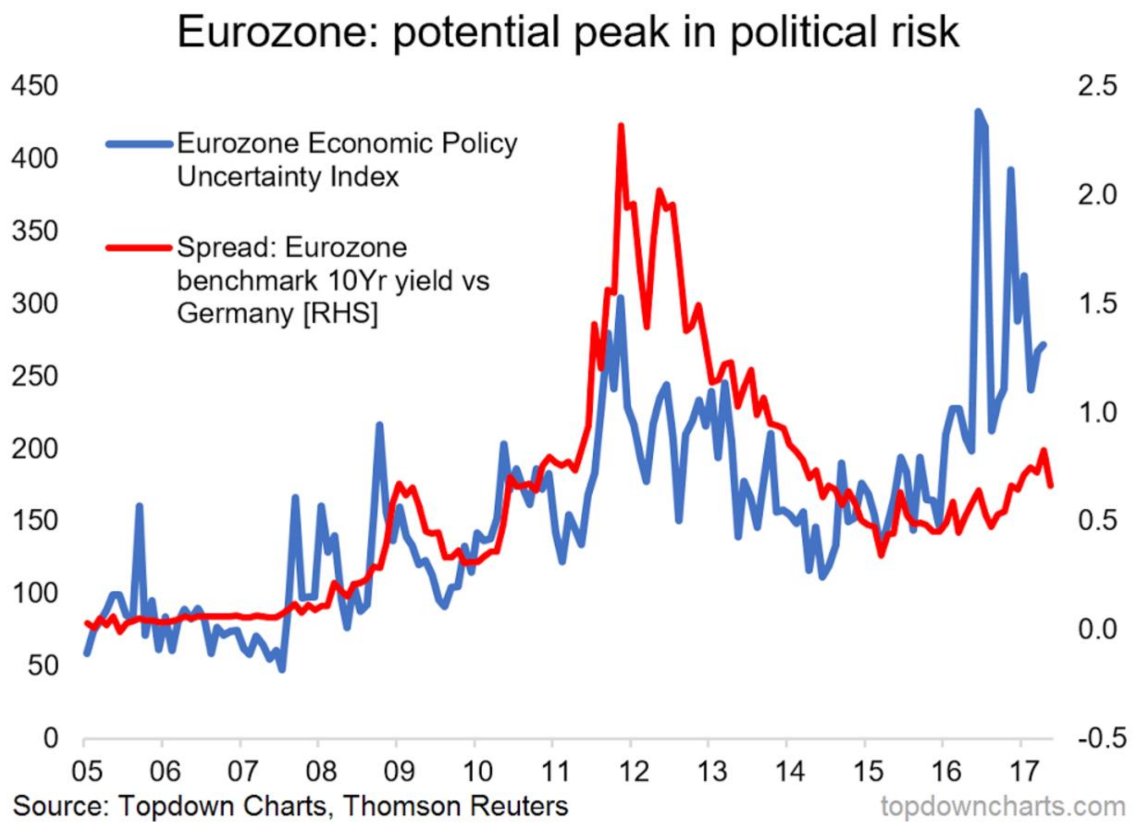
Economic sentiment is at post-crisis highs across a number of indicators, and political risk looks to have peaked at least on a cyclical basis.



# 2. Euroboom

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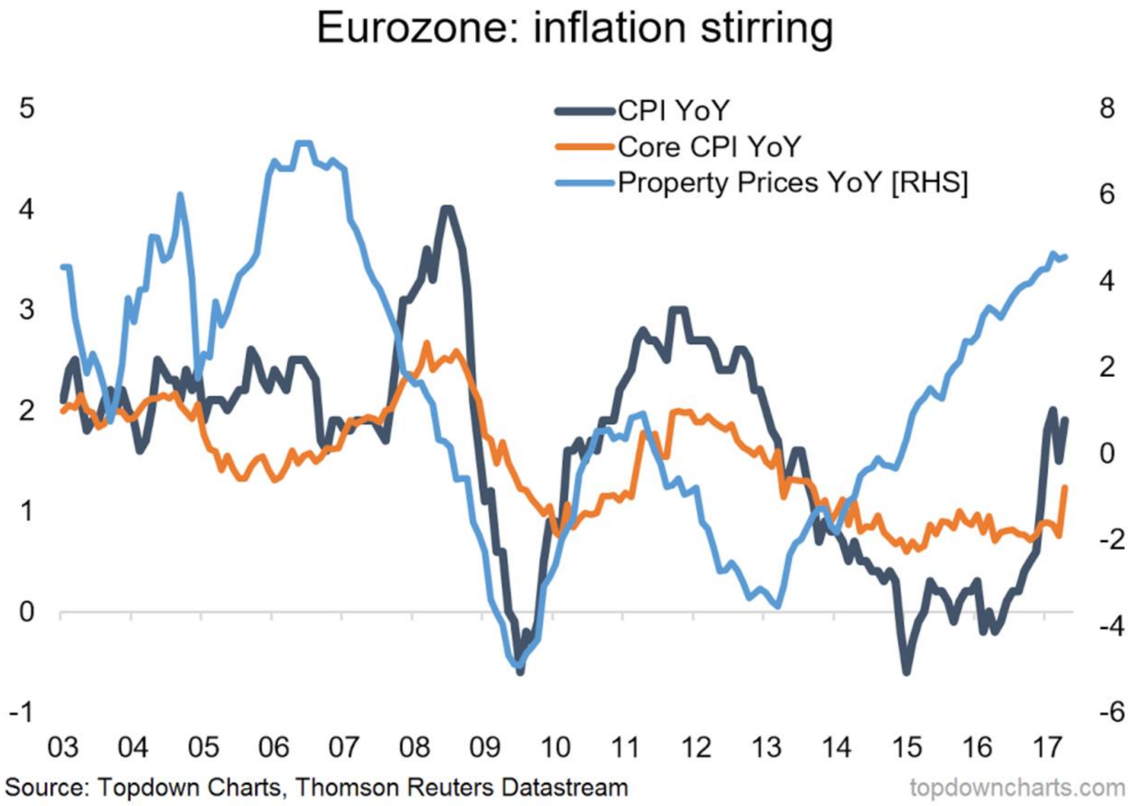
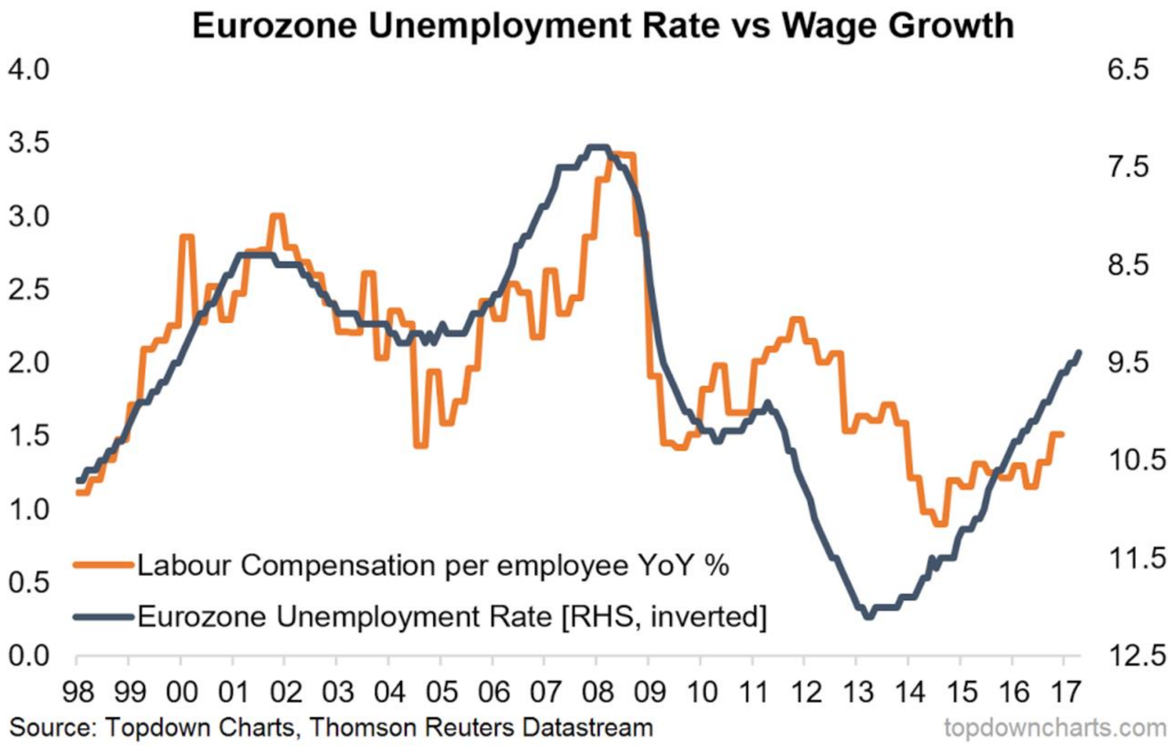
While base-effects are certainly playing their part in the inflation rebound in Europe (headline and now also core CPI), rising property prices, strengthening economic confidence, and what looks to be imminent gradual pickup in wage growth will likely see the risks continue to be weighted towards inflation vs deflation.



# 3. US Cyclicals vs Defensives

**3. US Cyclicals vs Defensives:** Given the strong run in the cyclical sectors I thought I would take the opportunity to build out my models in this space and take a look at what can be an interesting pair-trade or at least something that can give an insight into the broader cyclical and risk-sentiment backdrop. The main takeaway is that after the strong run in cyclicals vs defensives some of the conditions that set them up for that run have either already played through or become much less supportive. Thus odds are that relative performance between them goes neutral at best.

The first thing I looked at is relative valuations (composite view: PE, PB, Dividend yield, EV/EBITDA... z-score of relative value across those 4 factors), which has gone from showing cyclicals as quite undervalued to more of a neutral setting. So there is a small valuation argument, but not as compelling as it was. On the cyclical aspect, the PMI has already undertaken a significant rebound, which looks to have rolled over, so there's not really an upside story there. And another angle - earnings revisions ratios, the relative movement there seems to act like a sentiment indicator (i.e. take a contrarian signal at extremes), and on that front it's gone from multi-year lows to multi-year highs. Thus the odds of further outperformance by cyclicals are not high, and if anything the odds of a reversal are gradually rising.

***Bottom line:*** Cyclicals have had a lot going for them but now valuation is more neutral, the economic rebound has played out, and earnings sentiment is at an extreme.

# 3. US Cyclicals vs Defensives

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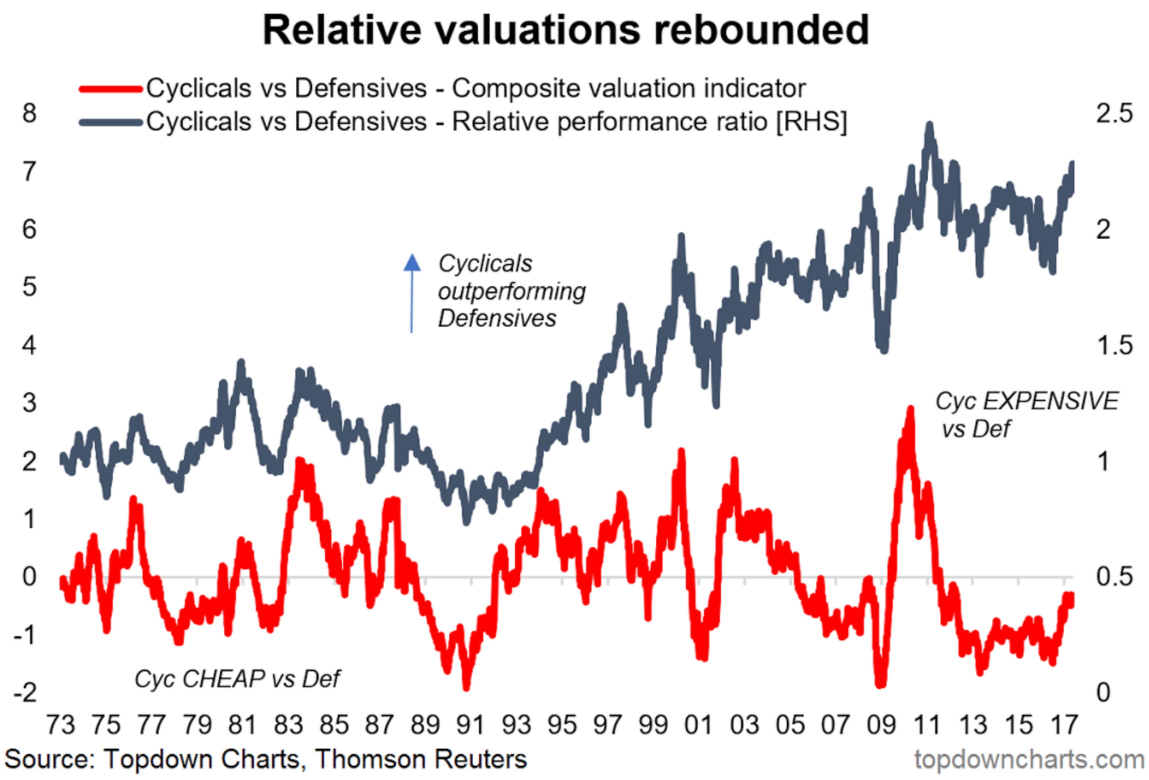
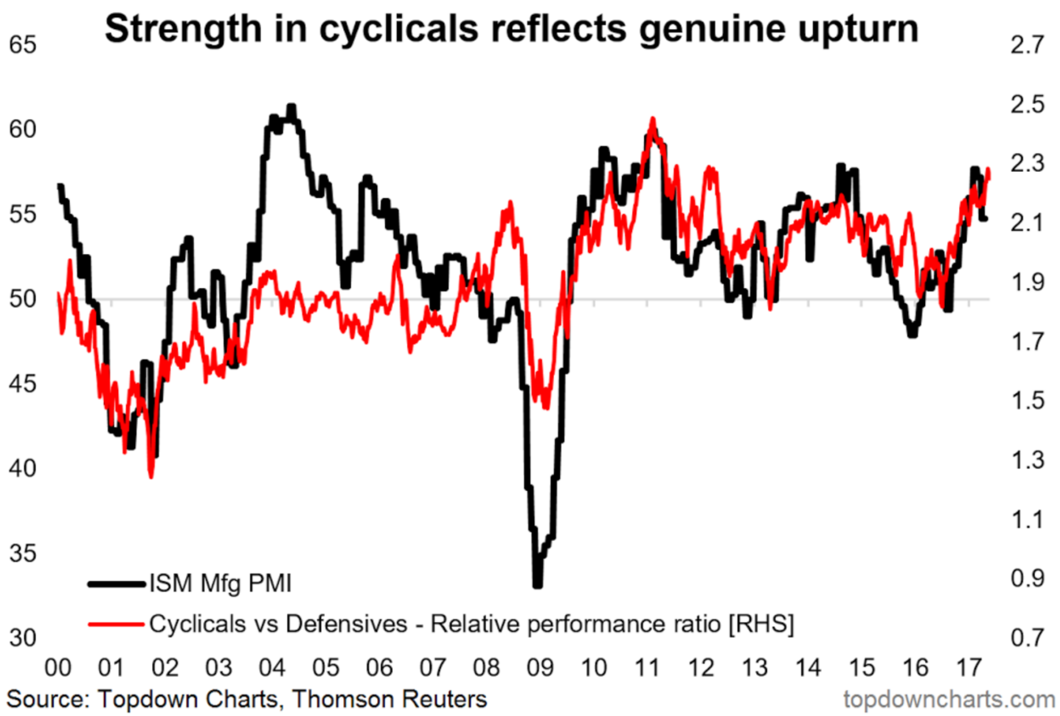
Cyclicals have had a very strong period of performance against defensives as the valuation and economic cycle story lined up (big rebound in PMI and bounce in relative valuations from very cheap levels). At this point valuation is more neutral, and the US economic indicators look to have topped out if not rolled over.



# 3. US Cyclicals vs Defensives

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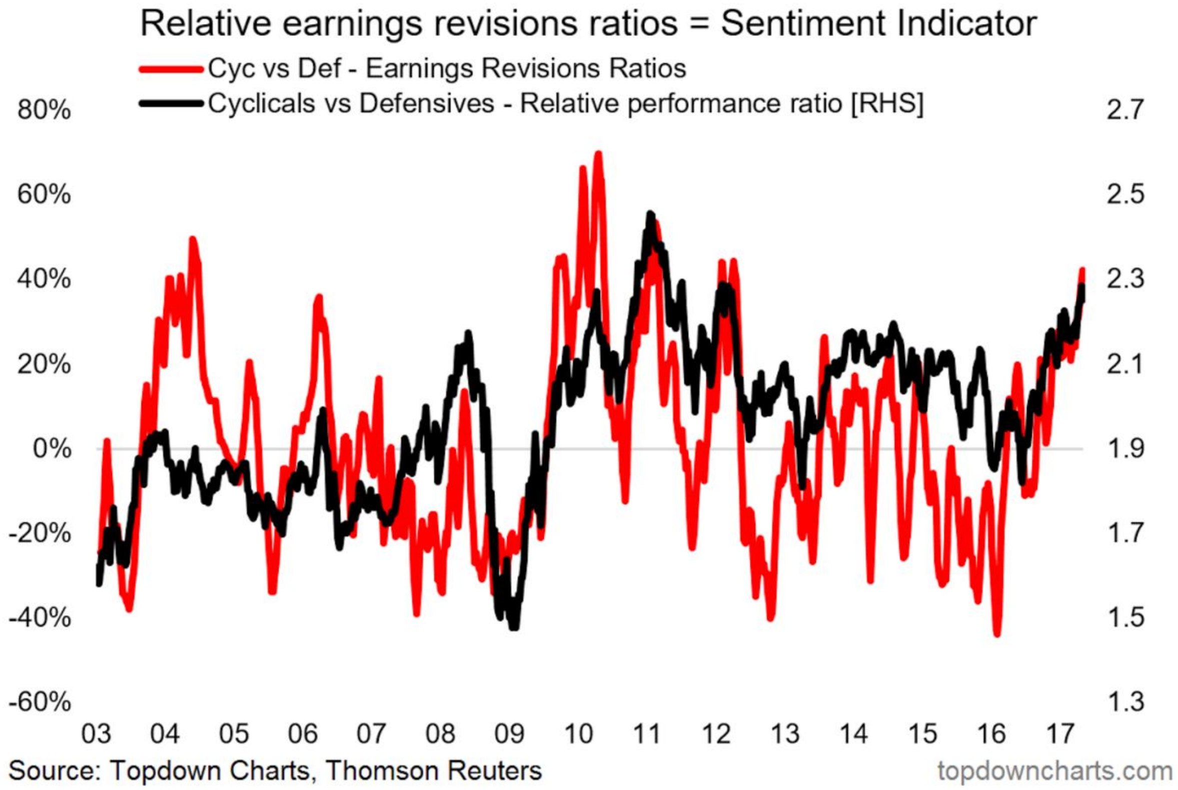
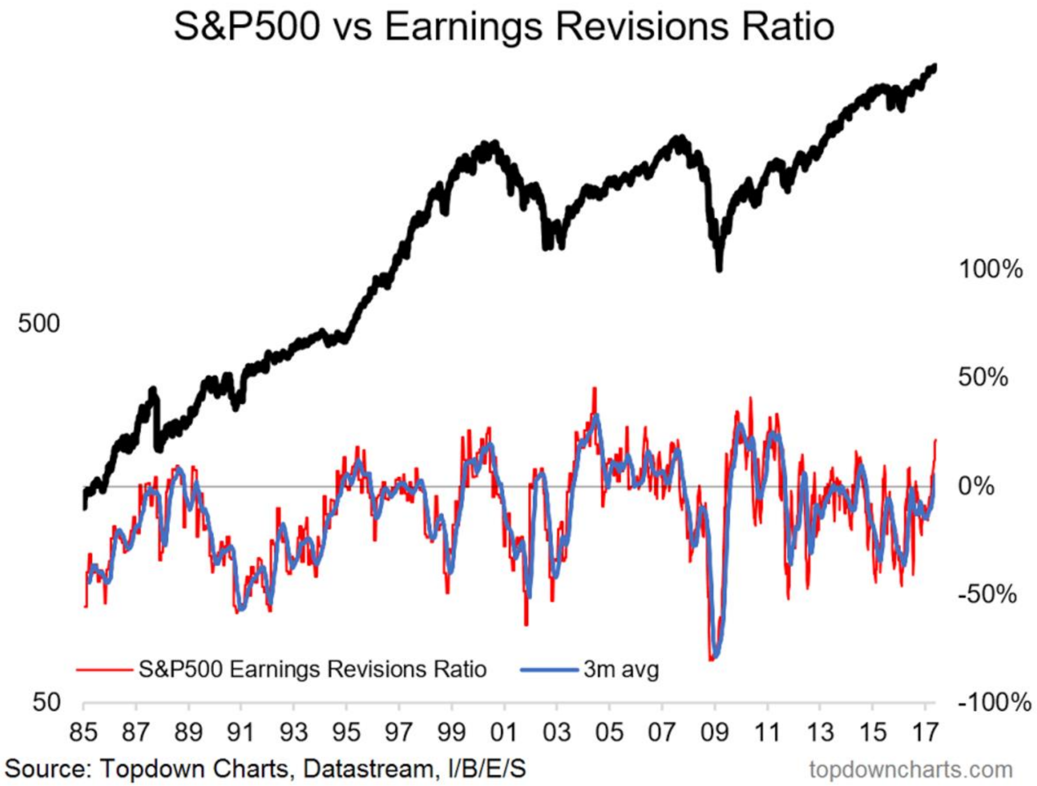
Looking at relativities on the earnings revisions ratios, cyclicals are way ahead - the 6-year high in the revisions ratio for the S&P500 reflects this strength in the cyclicals earnings outlook. However in terms of relative performance, the difference between cyclical and defensive sectors' revisions ratios appears to act as a sentiment indicator (when it's really good it's actually bad - typically signals a reversal).



# 4. What to Expect for Country Returns

TOP DOWN CHARTS

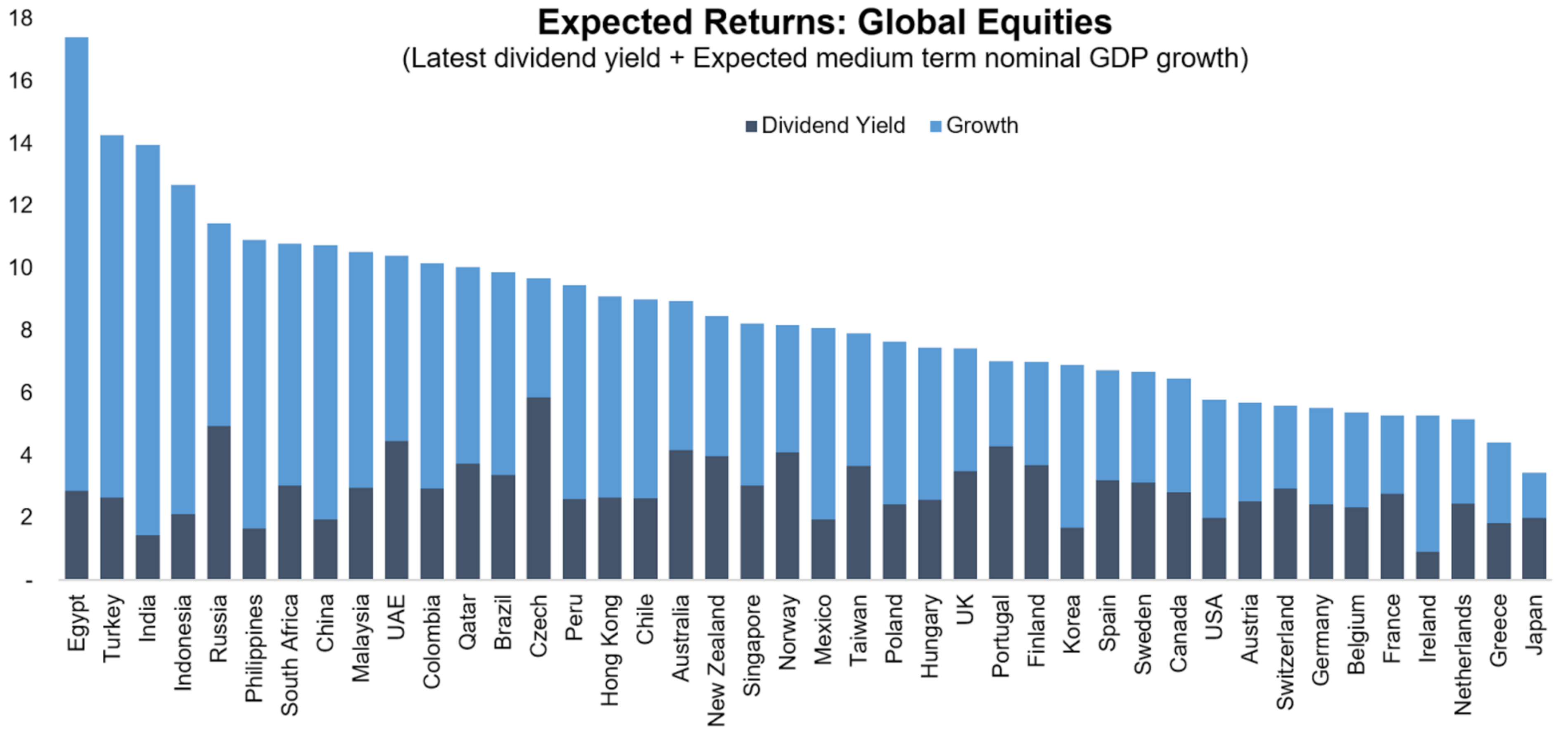
**4. What to expect for country returns:** This one was partly just an excuse to start building out data and models for expected returns (I've got it on the agenda to start calculating some generic expected returns for clients to cross check against or supplement into their SAA reviews, and just for general information). So it's very much a work in progress. The main method - expected returns for equities on a country-by-country basis - takes a yield + growth approach, with the latest dividend yield from Reuters being the starting point and nominal growth inputs informed by history, IMF forecasts, and a dash of judgement (I looked separately at real growth and inflation -- using nominal growth as a proxy for earnings/capital growth). As these are generic expected returns, they're in local currency terms, so no currency or hedging adjustments have been made and in this instance no valuation forecast adjustment is made either i.e. no assumption on mean reversion of PE ratios is incorporated, for example - albeit the dividend yield is a form of valuation so there is some valuation information in it.

Comments/observations would be: EM countries generally have higher expected returns. Expected returns broadly line up as you might expect against historical volatility. There is a loose fit between expected and historical returns - but notably most countries have lower expected vs historical returns (i.e. they are on the right-hand side of the line in the second scatter plot) - which lines up with the longer-term theme of lower expected returns in general.

***Bottom line:*** Expected returns across countries show generally higher outputs for EM. Across countries, expected returns are generally lower vs historical returns.

# 4. What to Expect for Country Returns

As you might expect, it's mostly emerging economies with the higher expected returns (partly reflects higher growth as well as often times higher inflation).

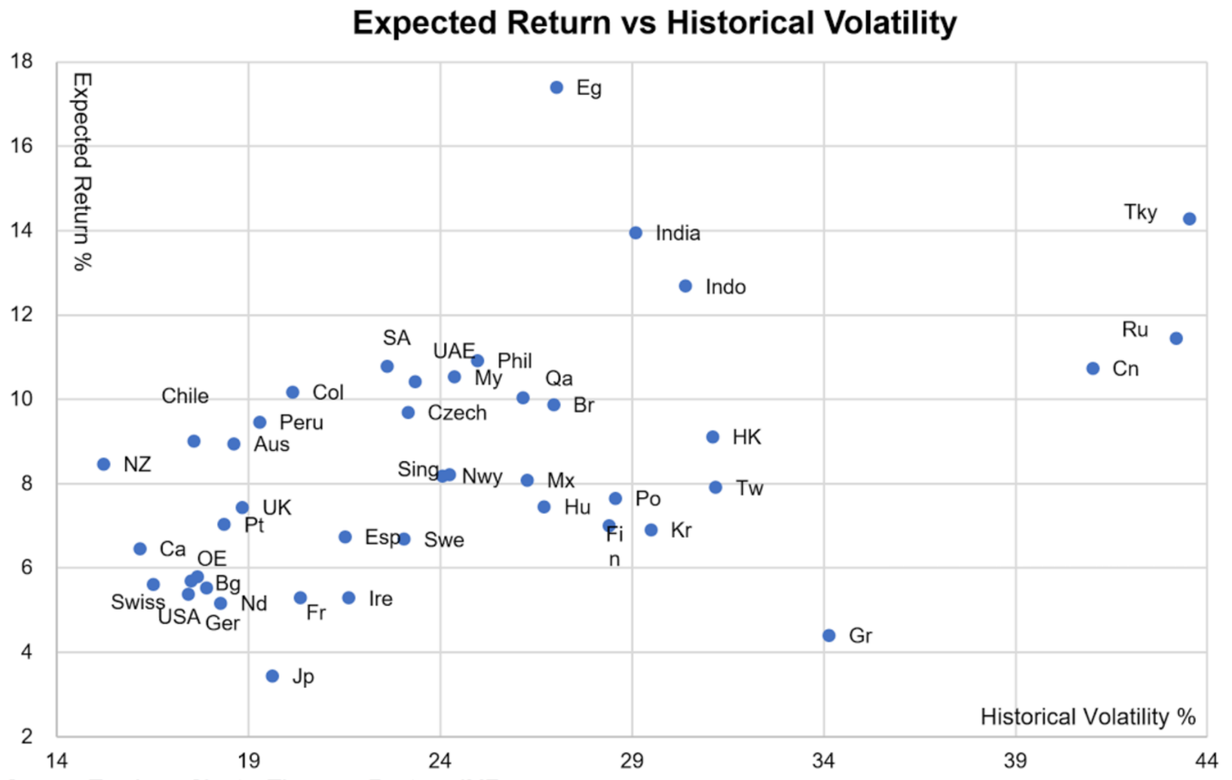


Source: Topdown Charts, Thomson Reuters, IMF

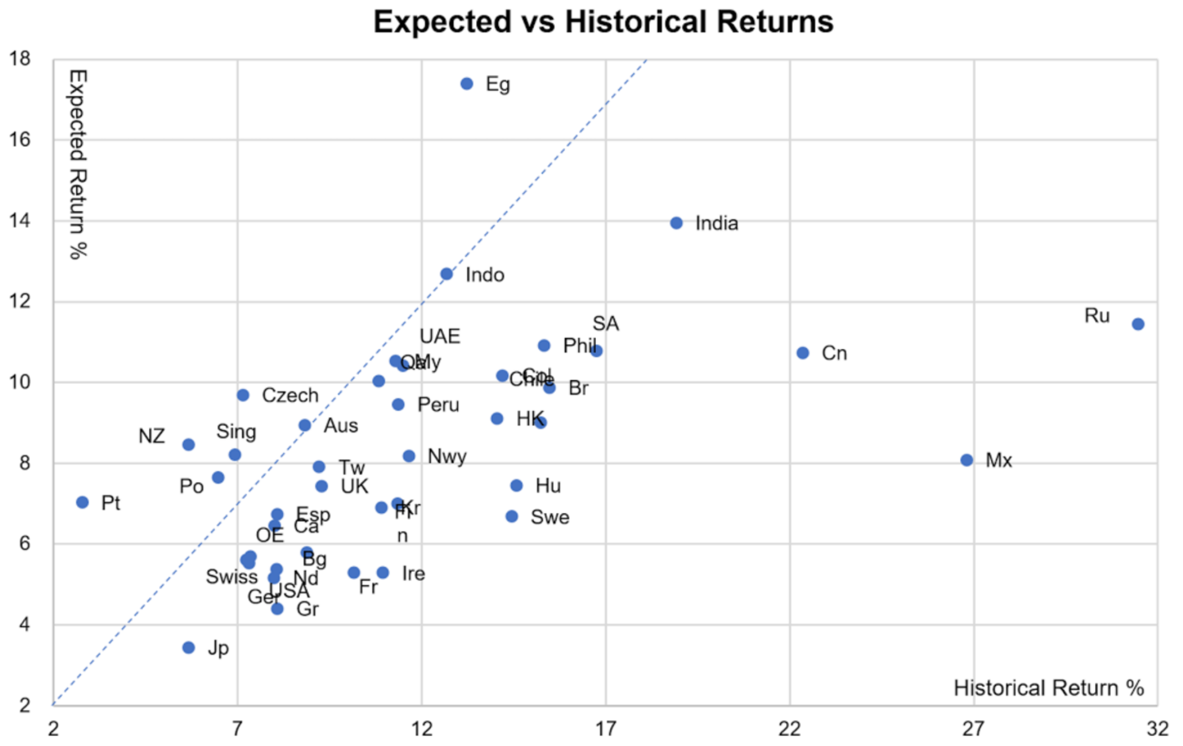
# 4. What to Expect for Country Returns

TOP DOWN CHARTS

Scatter plots: included below is the standard return vs risk (historical volatility) chart, and a view of expected vs historical returns.




Source: Topdown Charts, Thomson Reuters, IMF




Source: Topdown Charts, Thomson Reuters, IMF

# 5. NZDUSD Outlook

TOP DOWN CHARTS

**5. NZDUSD:** I often quote my service fees to ex-ANZ prospective clients in US dollars, so being domiciled in NZ I really should have a view on the NZDUSD. And judging by the charts, it looks like risks are weighted to the downside for the NZDUSD (so I should try and get some more USD revenues!). The main argument is policy rate differentials. Already they point to headwinds for the NZDUSD, and with the RBNZ on hold (at least, in their view, until late 2019) and the Fed set to hike again in June and probably another 1 or 2 times this year it will only strengthen that argument. The other aspect is that against the valuation indicator, the NZDUSD usually overshoots, and it's quite plausible to make a case for a downside overshoot.

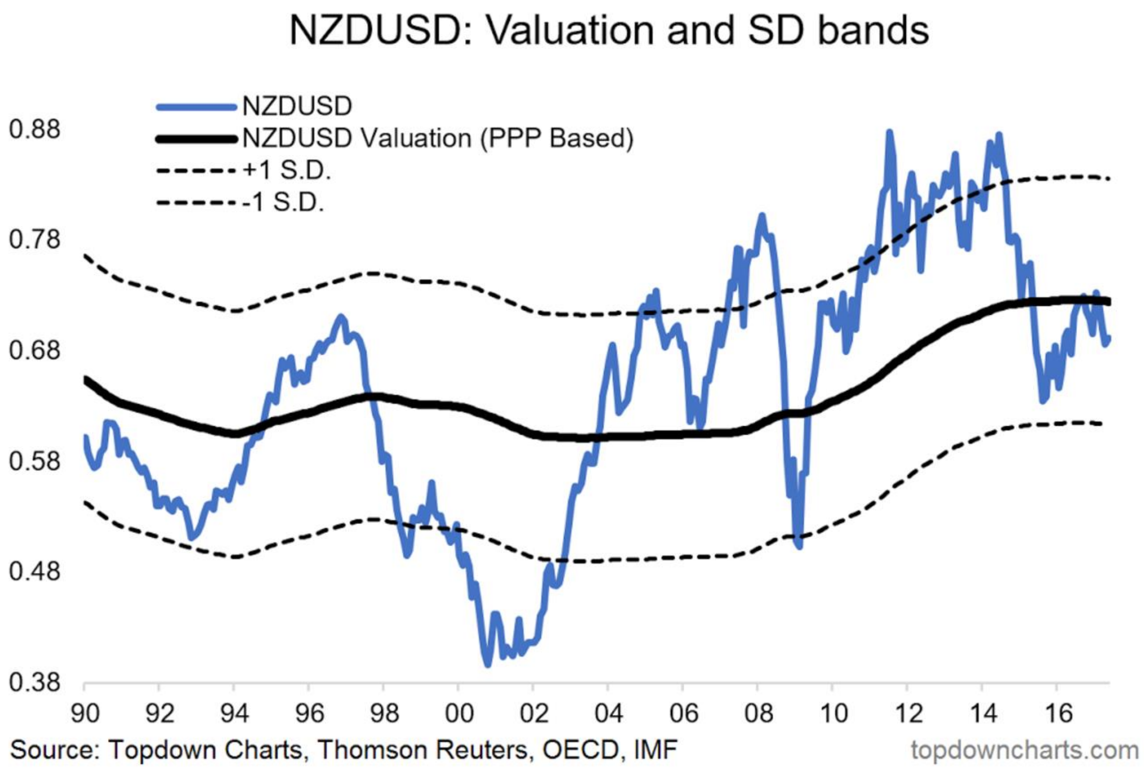
In terms of the sentiment/timing indicators, speculative futures positioning is stretched to the downside - which it usually will be when the NZDUSD is falling, but when it gets to extremes the odds of at least a rebound are elevated. On the other hand, FX market implied volatility has fallen notably, to levels which you could describe as complacent - and in the past when you see volatility compress like this it often precedes a big move, and most of the time such a move is to the downside (e.g. 2005, 2007, 2012, 2014). So while the signals are somewhat mixed on the sentiment/timing front, the direction of policy rate differentials and the tendency to overshoot puts odds on further downside for the NZDUSD.

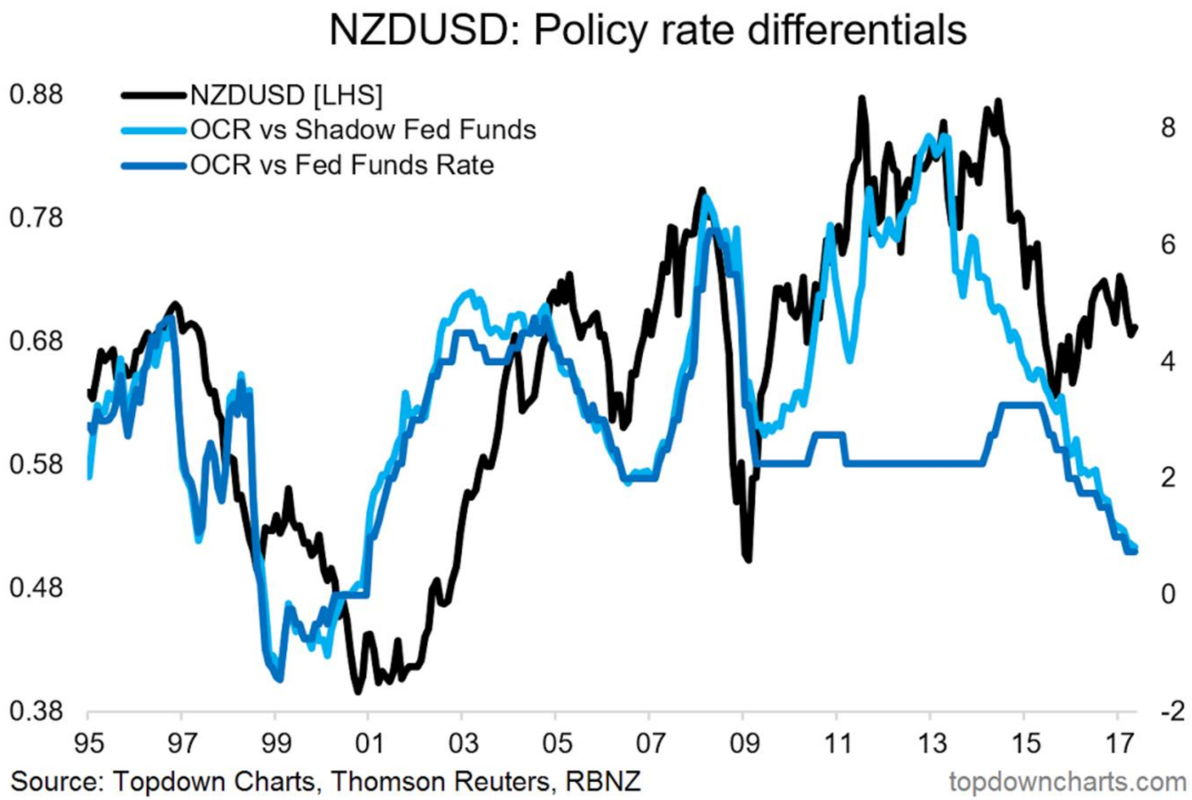
***Bottom line:*** Policy rate differentials point to rising odds of a downside overshoot for the NZDUSD, while the sentiment/timing indicators present mixed signals.

# 5. NZDUSD Outlook

TOP DOWN CHARTS

The NZDUSD exchange rate is trading below its valuation proxy (blended PPP conditioned with 10YMA), but could easily overshoot to the downside given the movement (and expected movement) of the monetary policy interest rate differentials.

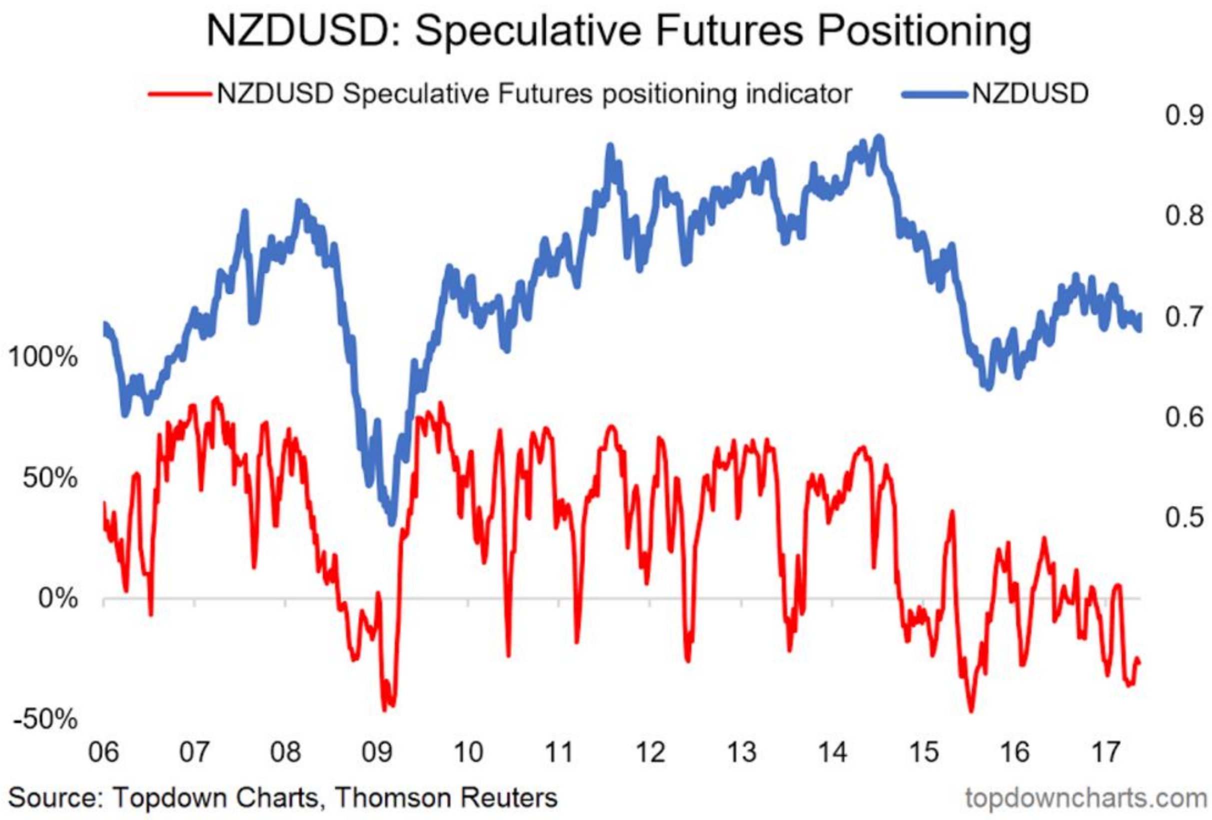


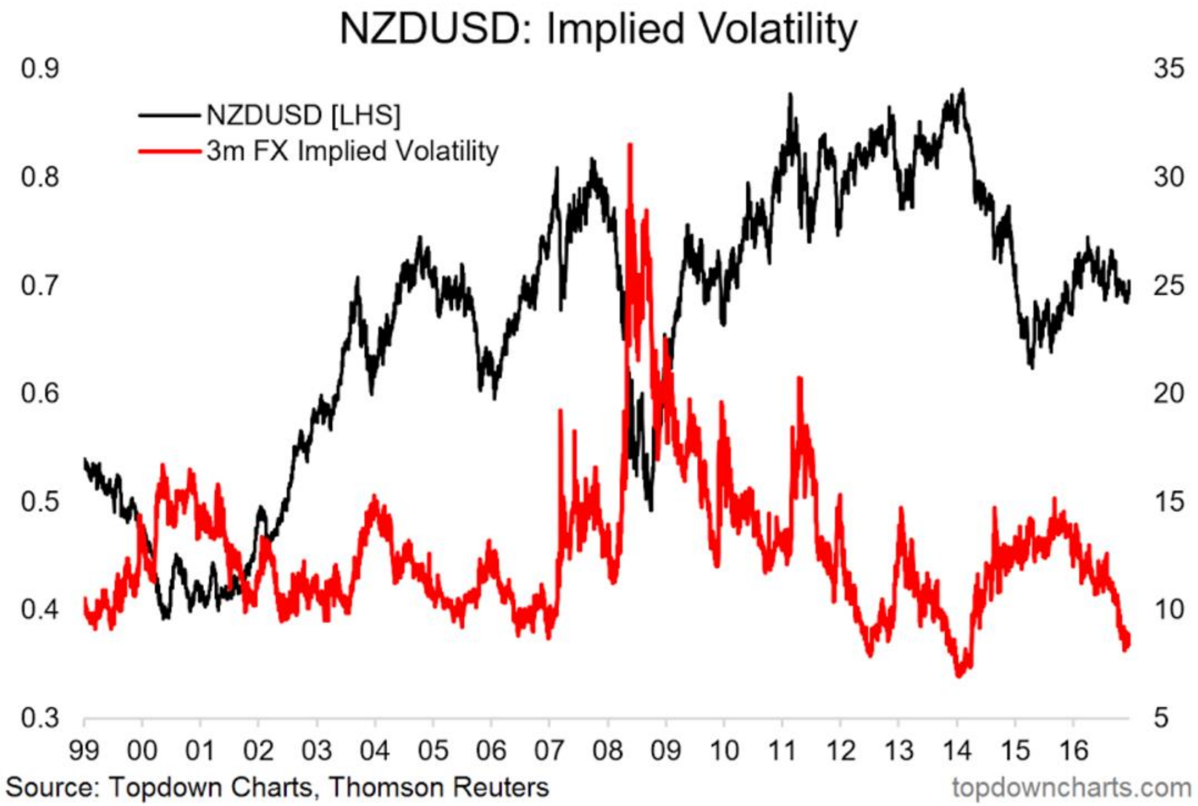



# 5. NZDUSD Outlook



On a sentiment and timing view, futures positioning is stretched to the downside (which makes it liable to a short term bounce), whereas implied volatility is probing the lows: which is often a condition found when the market is complacent and a big move is due (usually down).

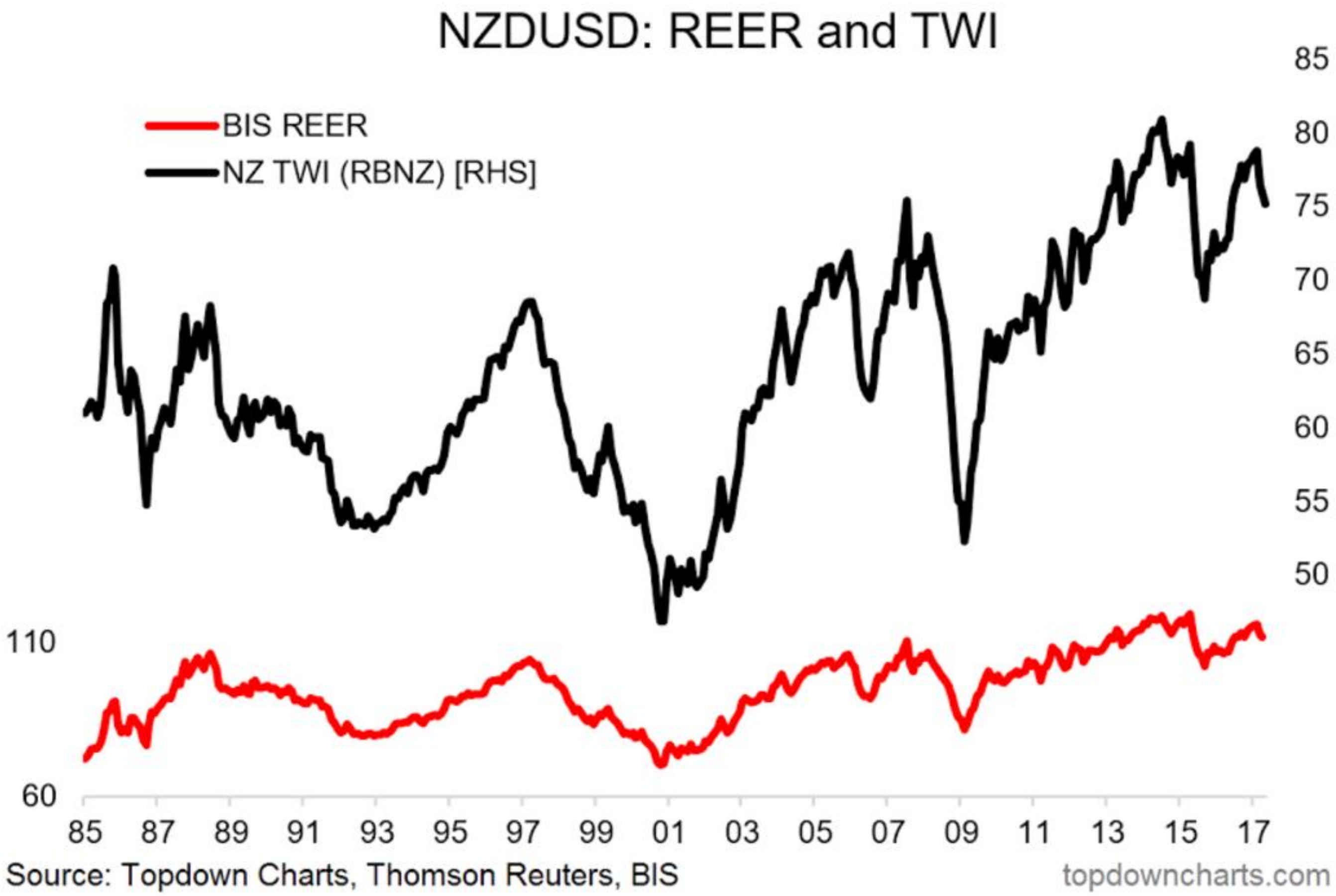


# 5. NZDUSD Outlook

TOP DOWN CHARTS

Bringing in a TWI view, the NZD has trended up well beyond the historical range (same on a real effective exchange rate basis).



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