macro scan

<u>Wednesday, December 4th, 2019</u>

Mark Orsley – Head of Macro Strategy

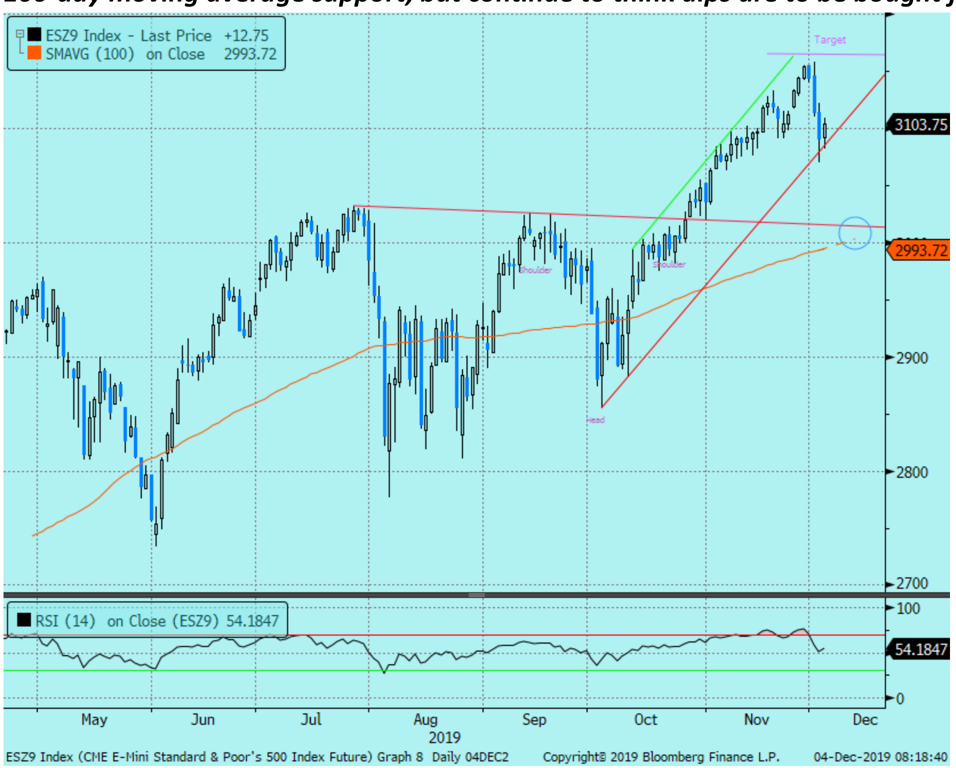
- ***Is the upcrash pause over?***
- ***Fed liquidity injections (via credit channels) allow global trade to pick up which is bouncing non-US data***
- ***German election results point to fiscal stimulus vs. a highly uncertain (contentious) political cycle in the US***
- ***EU inflation improving vs. US inflation (as measured by the Fed) which is falling***
- ***All argue for lower Dollar/higher Euro, tighter US/German yield spreads, and steeper US rate curves***
    - ***And oh yeah, buy the dip in equities***

A quick update on the tactical view + technicals…

Back after some time across the pond seeing clients, and when we last spoke in mid-Nov we were looking for an "upcrash pause." It's been a noisy pause to say the least with a small pullback into making fresh highs followed by the modest selloff we have witnessed this week. Since we last spoke, S&P's are unch'd because (to recap from Nov. 18):

- Positioning in S&P's both outright and option space had flipped bullish
- Phase 1 optimism had been fully priced which skewed the risk towards disappointment (like this week)
- Renewed signs that the data could turn back lower if Phase 1 keeps getting pushed back (see ISM, ADP, PCE)
- Technicals have hit levels where it was just reasonable to start taking profits

S&P mini's have largely completed its bullish inverse head and shoulder pattern (target was 3,165 and the high this week was 3,158) at the same time RSI's were overbought. The overbought condition has been rectified and trend support has held with a bounce. Assigning probabilities; 75% chance S&P's bounce, 25% chance it breaks down from here. If it doesn't hold, the deeper correction would be down to 3,010 region which is the top of the breakout and 100-day moving average support, but continue to think dips are to be bought for the larger play to 3,550 …



In other words, the greater probability is S&P's hold up because you are seeing similar "holds" in other foreign indices. A simple rule is when you get coordinated signals across assets; your confidence level should increase.

Euro Stoxx held trend support…

Nikkei held trend support…

Also continue to think you can use fixed income as your long risk asset hedge (risk parity light). The Fed will need to keep rates compressed and it is entirely possible Trump lingers the trade discussions to force the Fed's hand.

EDH1 has formed a bullish reversal pattern off of trend support. Target 98.95 if 98.65 is broken. Can perhaps add back risky assets and use Eurodollars as the hedge…

<u>From a purely technical perspective, it probabilistically appears like the near month long "pause" is largely complete, and the risk from here is the cyclical macro-economic recovery will continue</u>. More on that…

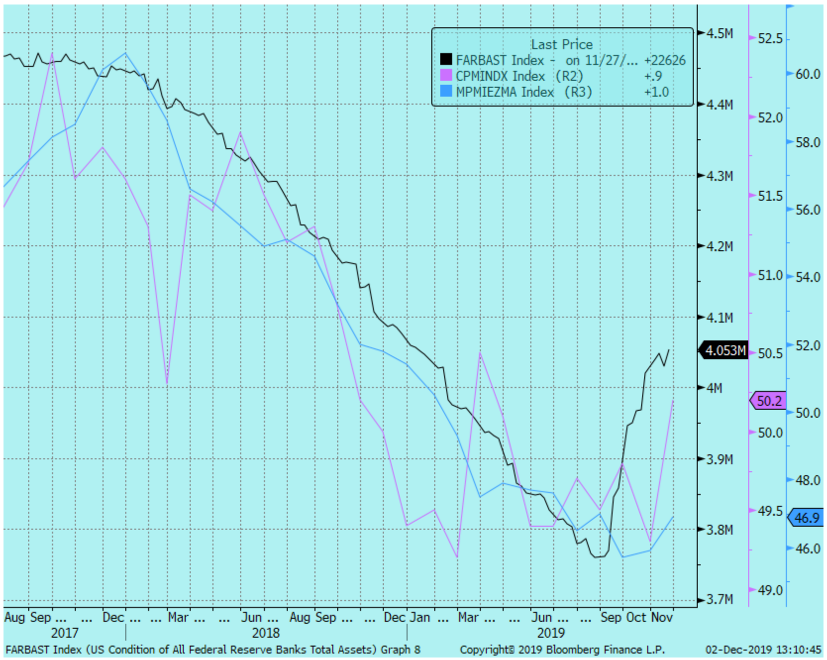
"Winds of Change" was a popular rock song in the early 1990's by the band Scorpion. The song was about socio-political changes happening in Europe – the type of song where you hold your lighter up at the concert (now an iPhone). The song title is apropos for today's discussion…

Outside the US, the improved cyclical story continues to percolate as seen in the PMI "beats" in China and Europe. The world is bouncing/stabilizing and as shown previously through Macro PCA; it all stemmed from Central Bank liquidity injections, namely from the Fed but also the ECB.

To put it succinctly: the Fed injected Dollars into a system that was "short Dollars" which allowed global trade to reemerge, bounce economic data, base interest rates, and lift commodities/equities/rate curves.

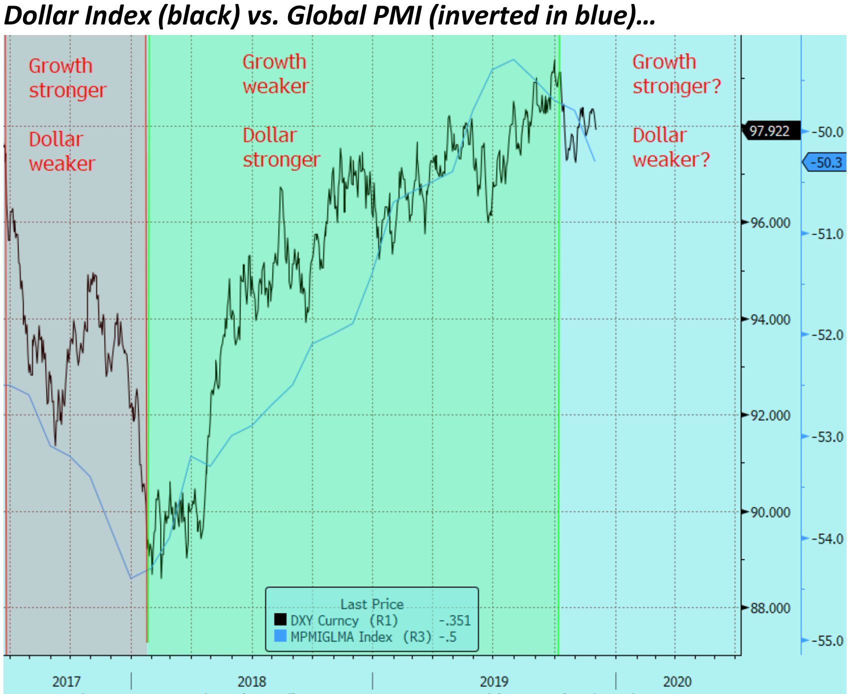
The key point there is <u>the release of Dollars by the Fed allowed a pickup in the global data as Dollars are needed for global trade (via credit channels). To be dramatic, if the world is "short Dollars" then there is nothing to trade. Therefore, the cyclical bounce has much more to do with the Fed liquidity injection than just trade war optimism.</u>

Fed Balance sheet (black) vs. China Mfg PMI (purple) vs. Euro Mfg PMI (blue)…



If trade can continue to recover, then the story will become global growth convergence as the rest of the world catches back up to the US. When global growth converges, the Dollar typically weakens.

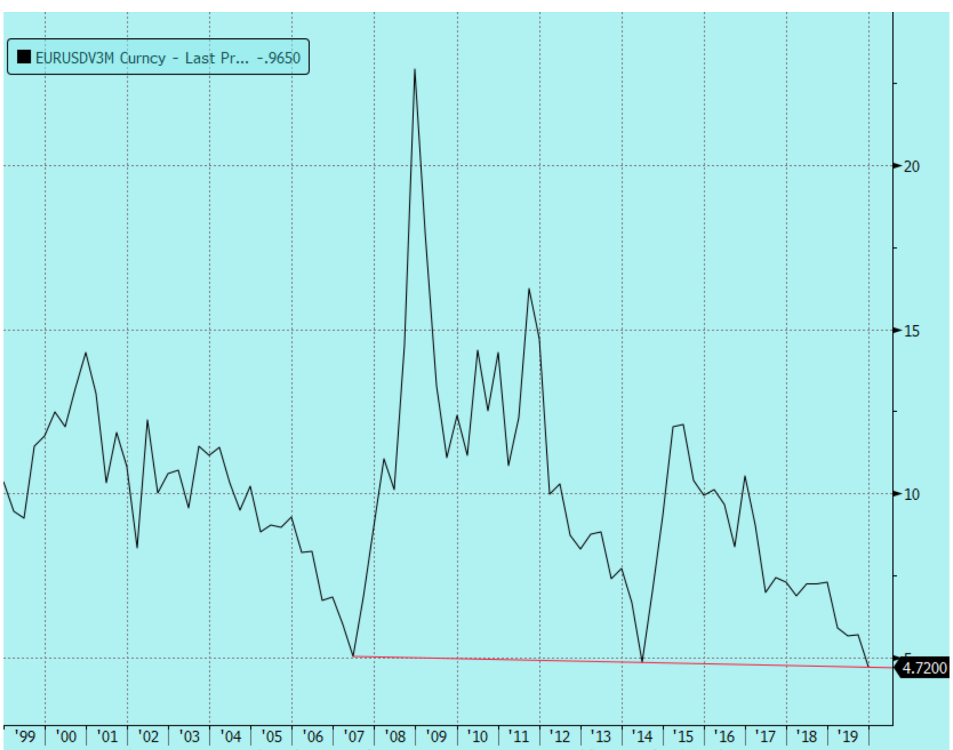
Dollar Index (black) vs. Global PMI (inverted in blue)…



The manufacturing bounce should be further exasperated by the inventory re-stock by the manufacturing sector we have previously discussed and if manufacturing PMI's are going to bounce, <u>regions levered to manufacturing and who have suffered the most will therefore bounce the highest. Enter Europe</u>, the most unloved region in the world with its sagging manufacturing sector and long-term structural issues.

EUR/USD has been forming a descending wedge (usually reconciled with an upside breakout) and has now formed a bottoming, bullish inverse head and shoulder pattern….

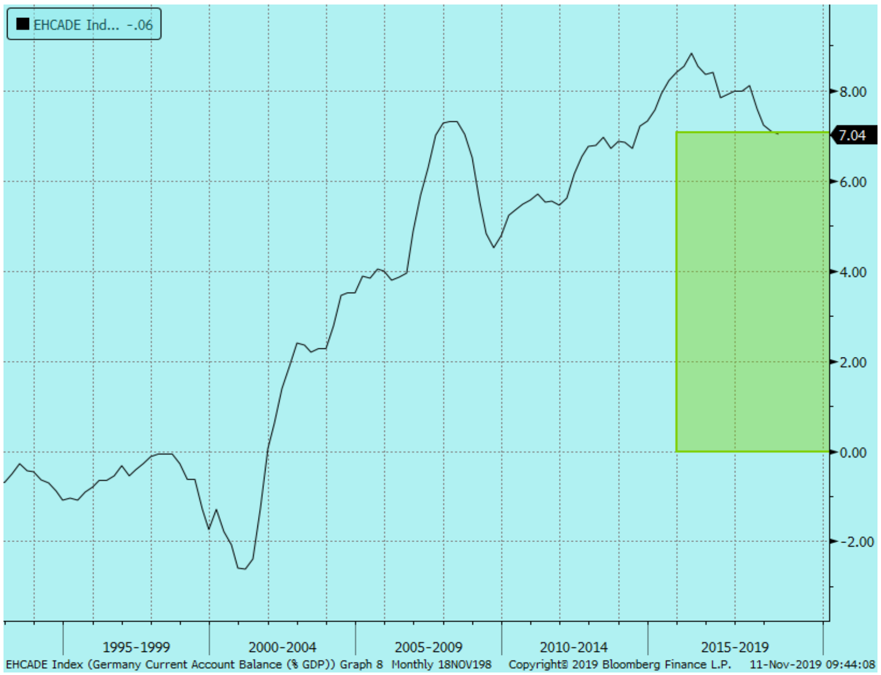
And what a time to go against the consensus and BUY Euro upside as EURUSD 3m implied vols are at all-time lows….



Besides the economic data bounce stemming from central bank liquidity injections that should lead to global growth convergence, the real "Winds of Change" is being sown in Germany. Surely you saw the German elections which shunned the fiscally conservative CDU party in favor of the left leaning SPD party who will be more willing to spend their current account surplus to stimulate growth. Merkel, long opposed to current account deficits, is now in serious risk of losing power after 14 years. A major political shift is underway and how a coalition gets formed bears watching over the coming weeks.

One consensus view is that Germany will never institute fiscal stimulus but that thought is now at risk after this weekend's water shed election. Not to say fiscal is around the corner, but the foundation continues to be laid to spend, and markets will begin to price in the rising odds of stimulus.

Germany has plenty of room for fiscal expansion (C.A. %GDP)…



Further, the reason we all have sold the Euro since 2011 was its long-term political issues that makes the Euro structurally unviable while the US stood in a solid stance politically. However, entering into the contentious US 2020 election cycle, can we still say that? Could the political risks now lie more in the US in 2020?

Which brings us to one of our highest conviction trades at the moment, US/Germany 10yr spread tighteners.

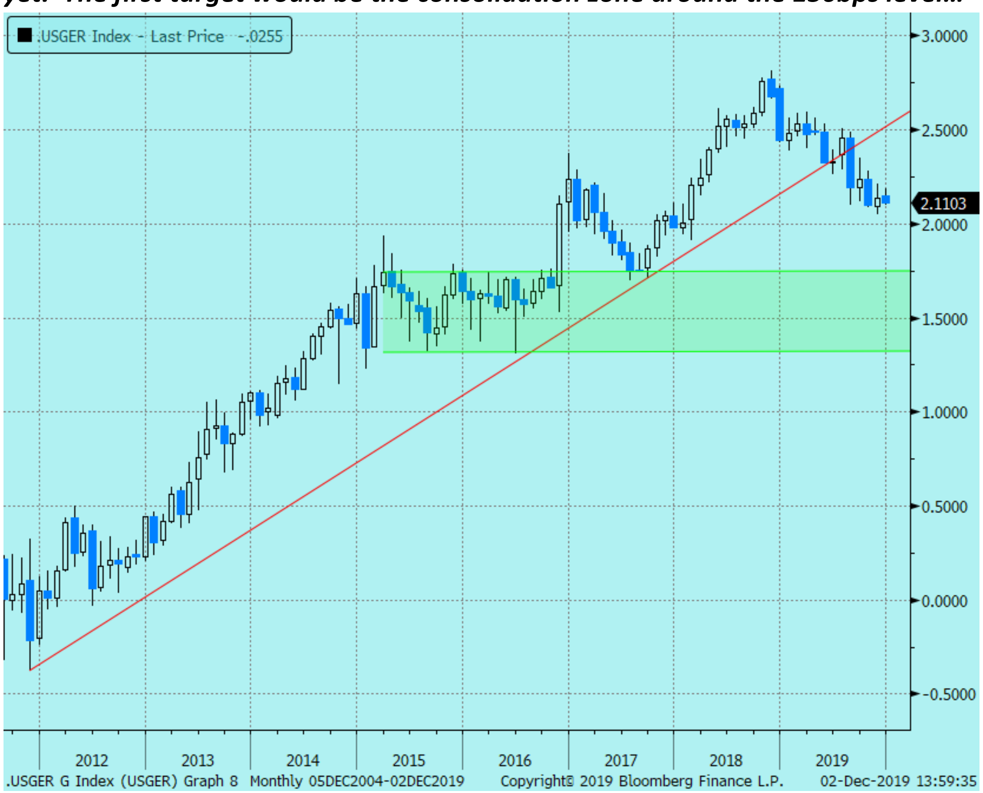
The US/Germany 10yr spread was one of the best trending trades this year as UST's outperformed Bunds in the rally. In this world of global growth convergence + the rising odds of (surprising) German fiscal stimulus; there is now the chance that both sides work.

<u>To say it differently; any selloff will be Bund led from here on out (a lot more room to sell off as ECB is moving away from further rate cuts) and rallies led by the US (has a lot more room to rally as Fed will cap yields, i.e.: not hike). Notice the past two days when the spread tightened in both the duration sell off on Monday and the rally on Tuesday.</u>

German 10yr yields have broken its 1-year downtrend and formed a bullish (higher yields) base via an inverse head and shoulder pattern. The target if -20bps gives way would be…wait for it…. +30bps…

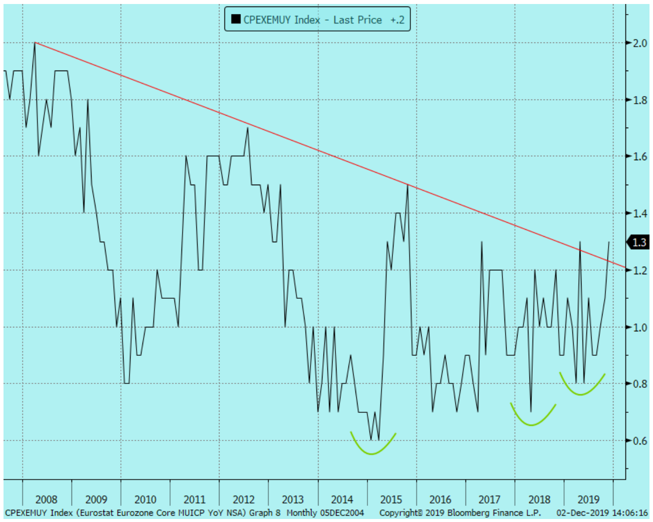
It's almost impossible to say it, but the Bund chart is flipping bearish (higher yields). However, perhaps the savvier way to play is to take the duration component out of it as it's been a fool's game to short German fixed income.

US/Germany 10yr spread has only just broken a multi-year uptrend – meaning if you missed it this year, it's not over yet. The first target would be the consolidation zone around the 150bps level…

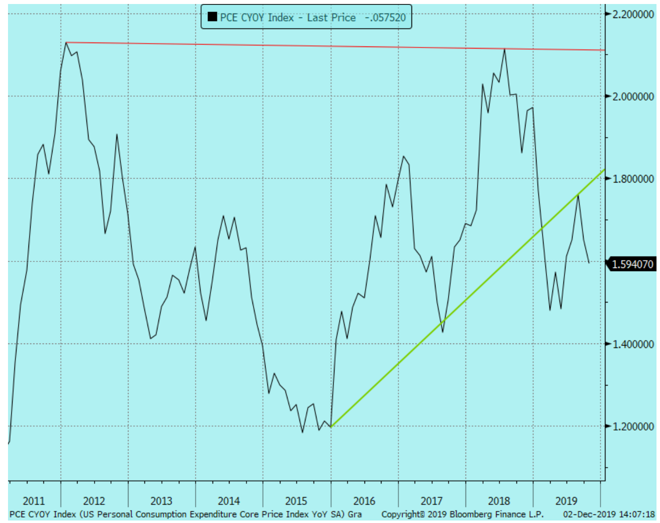


Also driving this developing Europe convergence theme is the fact inflation is moving the way of the Eurozone. As we saw recently, core inflation in Europe is rising and conversely core Inflation in the US (as defined by the Fed) just fell.

EZ Core Inflation…

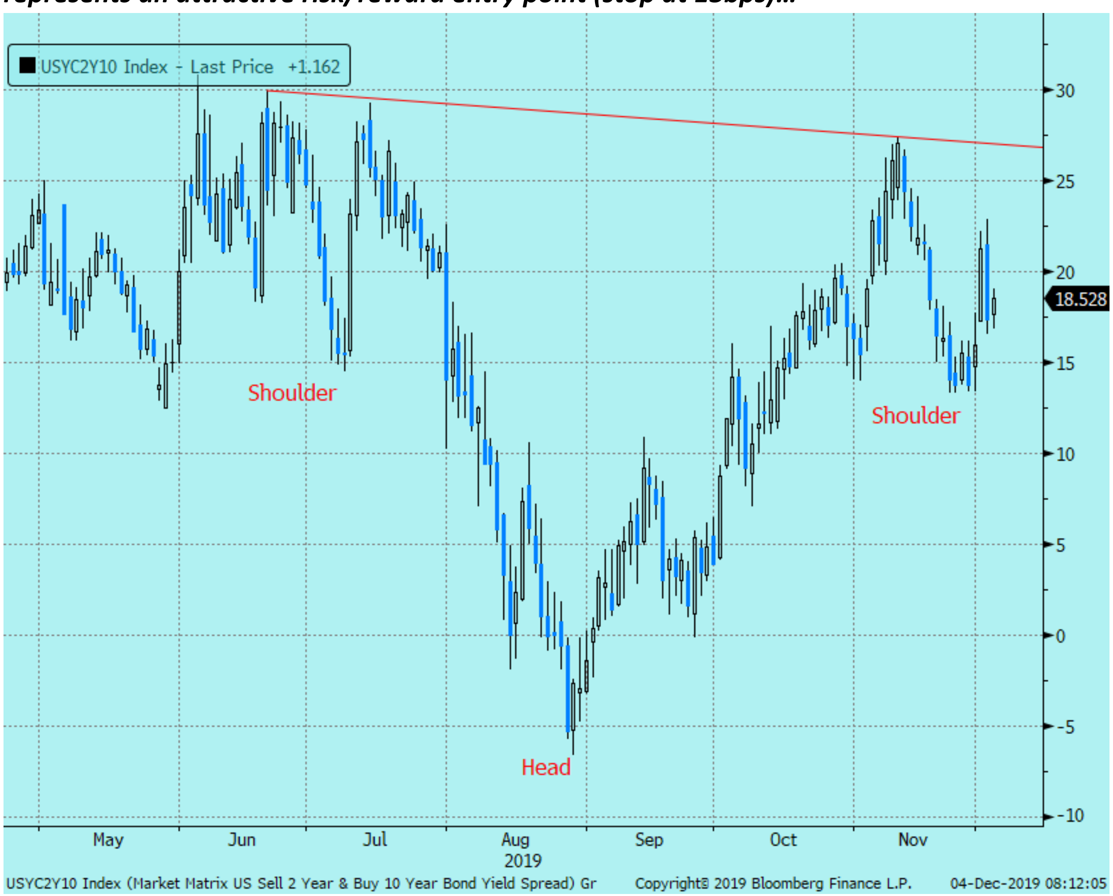


US Core PCE Deflator…



Lastly, as shown previously, when the Fed injects liquidity, curves steepen. Also when there is fiscal stimulus developing around the world (Germany, Japan – now upsized, UK, Thailand, Hong Kong, India to name a few), that also argues for steeper curves.

US 2s10s forming a large bullish inverse head and shoulder. Target will be 60bps if 26bps breaks. The dip here represents an attractive risk/reward entry point (stop at 13bps)…



<u>Bottom line</u>: we can now identify multiple drivers and inflection points for a weaker Dollar/stronger Euro and a continuation of the TY/Bund spread tightener.

1) **Global growth convergence – PMI's bouncing in RoW vs. US**
2) **Political "Winds of Change" in Germany (fiscal conservatives starting to get pushed out) vs. political discord in the US**
3) **Inflation profile moving towards Europe (to the chagrin of the entire market)**

We can also identify where all this started via macro PCA which is Fed liquidity injections which is unlikely to cease any time soon. That should provide the tailwind for further global growth.

The winds have changed.

<u>General trades to consider:</u>

- Buy S&P + EDH1
- US/German 10yr spread tighteners (can sell TY puts vs. buying RX puts – call for details)
- US 2s10s steepener

Kind Regards,

Mark Orsley
Head of Macro Strategy, North America

prismFP

130 West 42nd, 23rd Floor Tel +1 646 205 6193
New York, NY 10019 Cell +1 914 456 9446
United States Email orsley@prismfp.com

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