macro scan

Wednesday, April 3rd, 2019

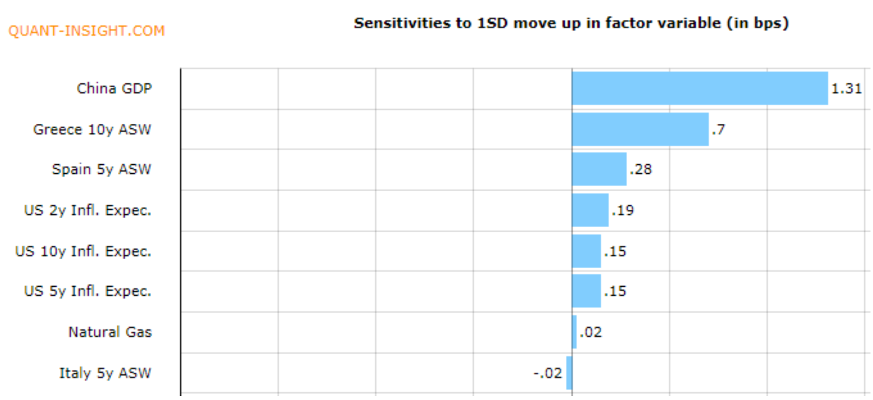
- ***US yields are at a critical juncture where a confluence of factors are pointing to higher yields***
- ***Given the gamma profile and critical support levels that are upon the market; an acceleration of the selloff has become increasingly likely***
- ***Intelligent ways based on Prism models to position for this potential selloff***

The next day or so is going to be pivotal for yields. There are a confluence of drivers that can, at the very least, mean revert rates higher and perhaps even reverse the trend. Let's go through each…

1) **Global economic data** – after the Q1 growth scare, there has actually been some decent **forward looking** data that points to an economic bounce. So I am not talking employment data which lags the cycle, but obviously more enlightening data like PMI's. Since April Fool's we have seen:

    - China "official" and Caixin Mfg PMI's bounce back above 50 and into expansion territory
    - US Mfg PMI "beating" and Atlanta Fed GDPnow bouncing from a 0.2% low in March to a now healthy 2.07%
    - UK Mfg PMI hitting the highest levels since Feb 2018
    - Strong Services PMI's all over the world: China, Spain, Italy, France, Germany, EZ

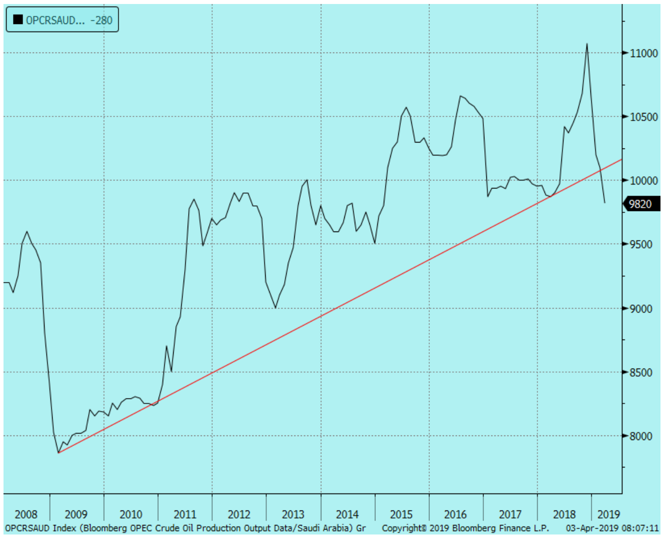
    Why is the bounce in economic data, especially in China, important? Since I have been advocating downside in Blue Eurodollars, if you look at what are the primary drivers of EDM2 from a macro perspective, Chinese growth comes up as the #1 positive driver of higher Eurodollar yields…



    Thus, if the economic data in China is going to bounce higher, we can confidently expect Eurodollars to sell off.

2) **Crude Oil and metals** – if you recall back to my note on March 13th, I gave a long list of reasons to be bullish WTI and that this would be the final leg up of the rally. Since, we have seen WTI climb from \$57.45 to \$62.60 (the target I gave was ~\$65). The quickest explanation why oil is rallying can be seen in the precipitous decline of Saudi production…

OPEC Crude Oil Production Output Data for Saudi Arabia – has broken its 10-year uptrend…



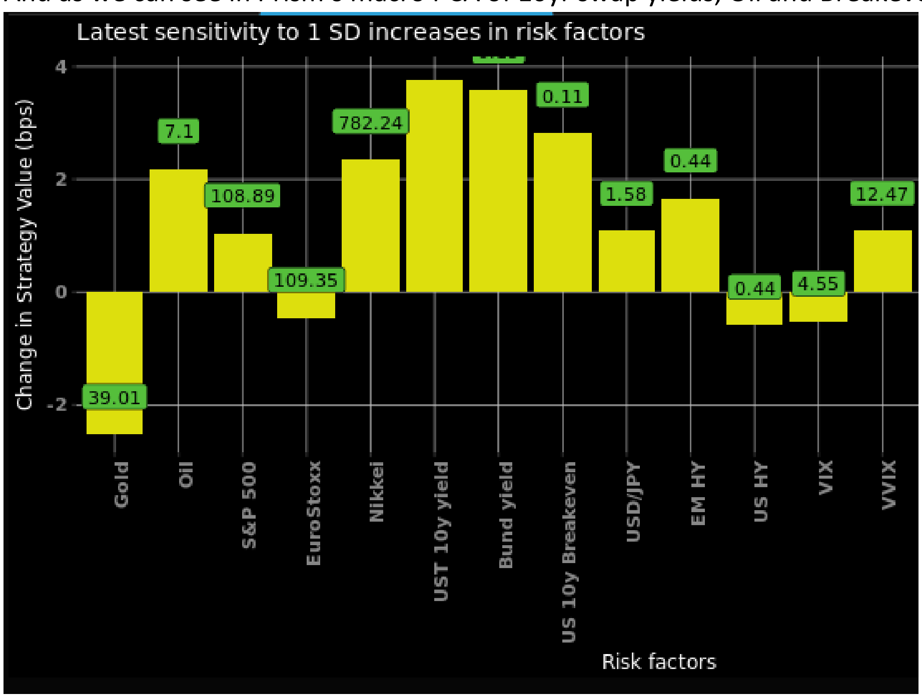
The cleanest explanation why Saudi production is falling is likely to allow the US supply glut to be sopped up which drives prices higher. The new explanation is a report out yesterday proclaiming that the Saudi's largest (and the world's largest as well) oil field (Ghawar) can produce <u>A LOT</u> less than previously thought (3.8m barrels/day vs. 5m expectations). That news has broken WTI out to the upside of its 3-month bull channel and brings it closer to its final target of $65.

WTI has broken its bull channel which usually reflects new news (the Ghawar news likely). The inverse head and shoulder pattern targets $65 which would coincide with the final 5th and final Elliott Wave count. So there is still upside but it is limited from here…

Having the insight on crude oil is obviously important as it feeds into inflation expectations which feeds into nominal yields. Thus, sticking with Blue Eurodollars, you can see how WTI led EDM2 on the way up, and now it is leading it on the way down….

WTI (inverted in purple) vs. EDM2 (candlesticks)….

And as we can see in Prism's macro PCA of 10yr swap yields, Oil and Breakevens are large drivers…



Historically, metals have also been a significant driver of inflation expectations. On that note, it is worth mentioning that <u>China is now limiting steel production in the Hebei and Tianjin provinces to cut capacity. In the past, these kinds of production cuts have led to higher metal prices and we can see today that steel rebar futures are getting perky with momentum shifting to the upside</u>. Higher metal prices tend to lead to higher yields.

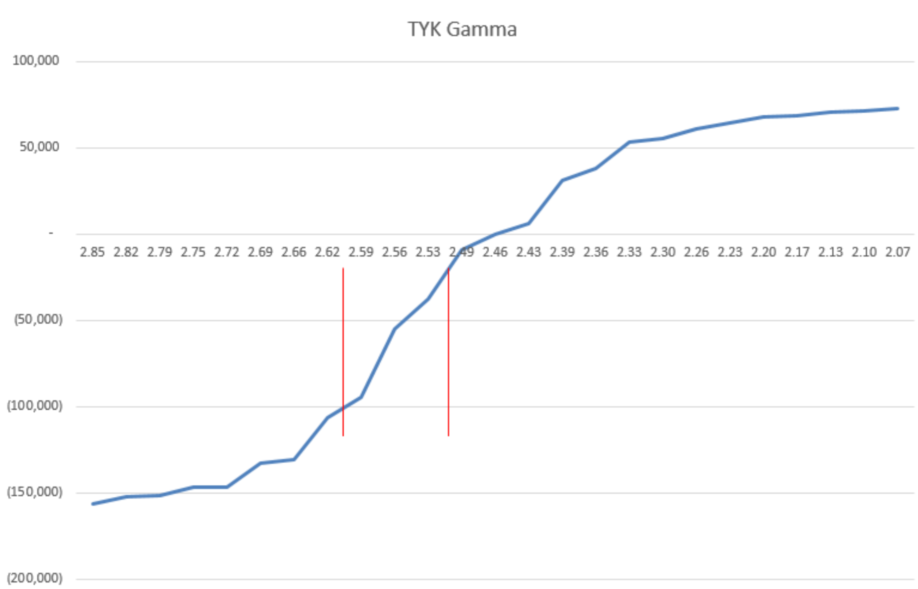
Steel Rebar futures breaking out…

3) **Continued optimism over a China/US trade deal** – FT was out saying that the "US and China draw closer to a final trade agreement." I don't see too much new here as enforcement continues to be the sticking point but the light at the end of the tunnel grows nearer.

4) **Brexit delay** – the market has partially priced in a hard Brexit so that there would be no BOE hikes ever. Therefore, with this Brexit delay that could push off any action for 6m to 1yr, a hard Brexit becomes less likely which will mean the market will have to price out a bit of the pessimism.

These four drivers are important because (1) the market has piled into long fixed income exposures (~16m/01 in Eurodollars alone last week), and (2) as I showed on Monday, there is significant risk that gamma in May expiry UST options like TY's can really accelerate any selloff. In fact, there has only been more gamma added since Monday (~25k more cts of gamma worth) so this 2.50% to 2.60% (in spot cash 10y terms) is the "sweet spot" for this selloff to pick up steam.

May 10yr future gamma profile…



Lastly, I would note that the market is hitting a key trend following support level. For example, the 10yr note future is sitting on the ever important (for CTA types) 20-day moving average at 123-14. A break, especially given the gamma profile above, would also cause an acceleration of the selloff…

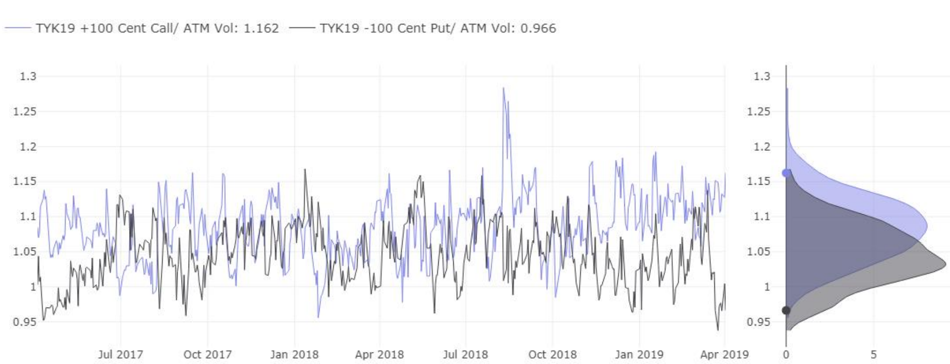
The mantra here this year has been the slowing economic data into the end of cycle dynamic, but even I admit that the market got ahead of its skis with the amount of cuts it priced in for 2019. Those cuts are at risk of being priced out given all the factors I noted above.

I continue to like:

1) Blue Eurodollar downside that I have been pounding the table on for a simple mean reversion:
   - 3EJ 97.625 put for 1.0/1.5
   - 3EK 97.625/97.50 put spread for 2.5/3.0 (this has richened quite a bit since first reco'd it so work bid only)

2) I also like selling Fed Fund futures in 2019 to price out cuts using some carry to buy an upside hedge

3) Also, TY downside looks attractive. From my colleague Rapha, you can see that TY put skew is not only extremely low, but INVERTED to ATM vol…



<u>I really believe it is prudent to have one of these expressions, or variations of, on at this point. Please let us know how we can help.</u>

Kind Regards,

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