Thursday, November 7th, 2019

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- ***China and the US continue to make real progress towards the removal of tariffs – inventory restock potential***
- ***Updated technical charts for the cyclical upcrash theme***
- ***At what yield level does the economy and financial markets start to crack again?***

The cyclical upcrash/peak tariff theme is clearly gaining momentum overnight as:

- China/US has agreed to lift tariffs in phases as deal progresses
- China arrests and convicts (death and life sentences) nine fentanyl smugglers in a rare public display of China's effort to crack down on a major issue for Pres. Trump
- China studying removal of curbs on US poultry imports

These just add to the surprisingly growing list of progress being made on trade discussions ranging from IP transfer, enforcement, opening up of Chinese markets, Huawei ban lift, etc.

Why? For Pres. Trump, this gives the US economy enough time to heal in front of the coming election cycle. This isn't just a sentiment boost. There is real green shoot possibilities as manufacturing companies pivot from destocking to restocking (see Nov. 1 note for details).

For Pres. Xi, he apparently would rather deal with the known POTUS than the unknown post 2020 election (Warren?), knows that Trump is in a deal making frenzy for reasons stated above but also as a smokescreen for the coming House impeachment, and to stabilize their economy especially in front of the Lunar New Year holiday.

Whether these various "phase" deals will stick in 5 years is neither here nor there at this point in terms of markets. After a year of economic uncertainty, data deterioration, tweets, and headline bombs; the market is "Tradexhausted" and mis-positioned for a rate of change improvement in trade talks.

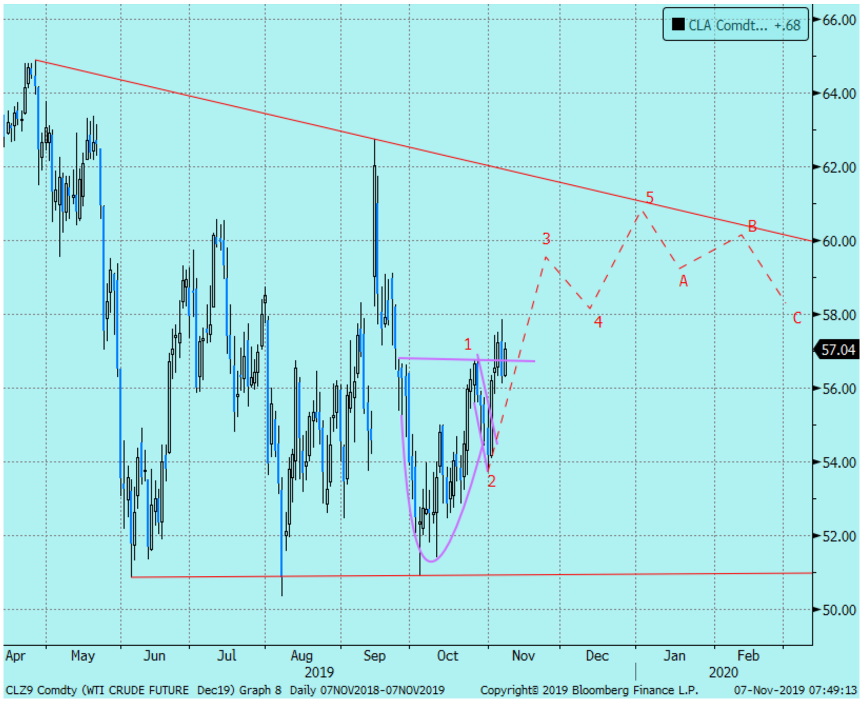
The other point to drive home this morning is to watch what they (China) do and not necessarily what they say. The strongest indicator to watch is CNH. The fact the China is allowing CNH to strengthen below (in USD/CNH terms) the decisive 7.00 level is the clearest indicator that trade tensions are easing.

USD/CNH: all support levels have been taken out. Look for it to fall back into the more normal 6.85/6.95 range…

Let's refresh the chart deck to ascertain where we stand in this upcrash cycle….

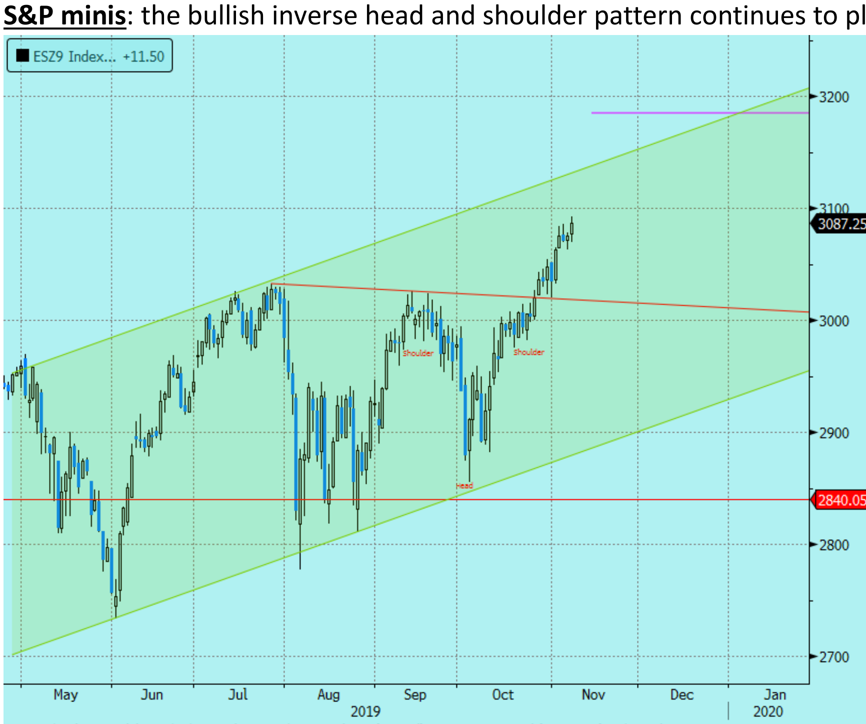
If you recall our discussion on the positive cyclical feedback loop. The Fed's liquidity injections was driving basis swaps higher which was taking nominal yields like US and China 10yrs higher. Those rising yields were driving cyclical commodities like Copper higher. The last remaining piece to the cyclical commodity story was WTI which was being compressed by its normal seasonal patterns (refinery maintenance). That has started to abate and WTI is now in a much more positive stance to join the cyclical upcrash party.

WTI: bullish cup and handle in place with a potential breakout occurring this week. The pattern measures up to the low $60s which coincides with the Elliott Wave count…

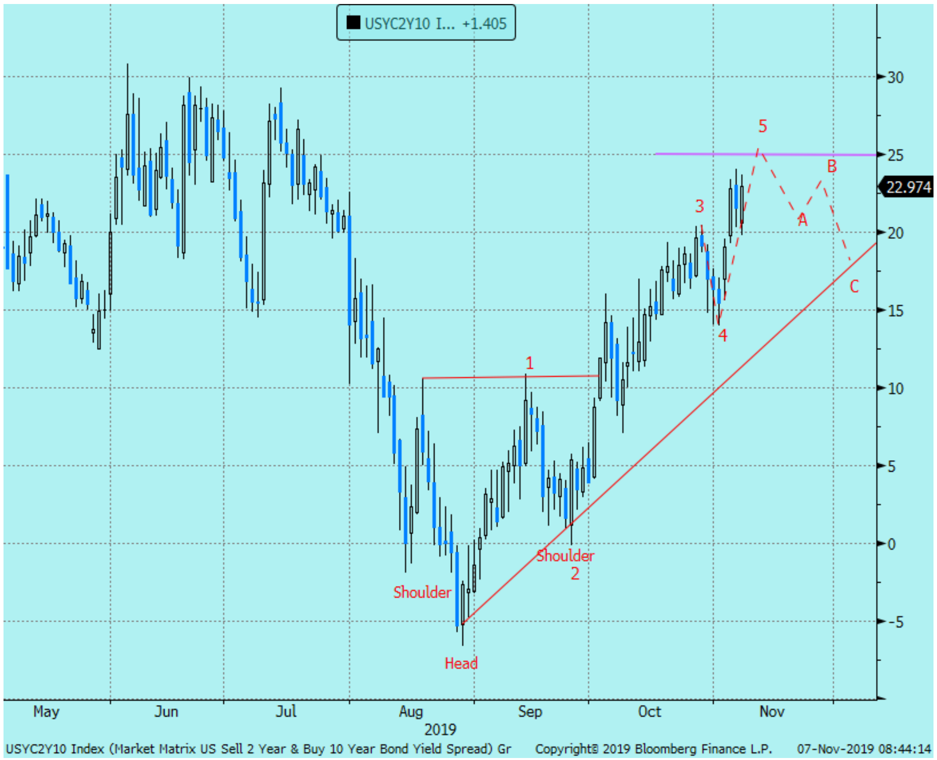


Then those higher commodities (feed through to inflation exp.) were driving risk assets and rate curves (2s10s) higher.

S&P minis: the bullish inverse head and shoulder pattern continues to play out. Target 3,185…



US 2s10s: it has been a great run but the first target of 25bps is near. There may be a larger steepening trade to come, but let the ABC correction play out, reassess, and then buy the dip to play for the larger move…



Lastly, the $64,000 question has been where the sell in duration end? Since this has been long end led (as Fed policy pins the front end more), let's take a look at 10ys.

US 10yrs yields: after some dip buying yesterday (strong 10yr auction), 10yr yields are attempting to break out higher once again. Notice the two inverse head and shoulder patterns (one denoted in red letters, the other in purple). Both measure conveniently to the 38.2% Fib retracement level of 2.12%. That is where the selloff likely will be completed…

That puts TY around 126-24, so the **TYZ9 127-24 put for '7/64s** is reasonable downside here if you want to play for the last leg of the selloff or need a hedge (15 days to expiry, -18.5 delta).

From a fundamental stand point, one can wrap their head around why 10yrs stall out around 2.12%. If you think back to 2018 when it first became apparent how sensitive the world became to rising yields, the market and the economy started to crack once 10yr yields were in the 3.0%-3.25% zone. Back then the economy was growing at 3.0%-3.5%.

Now the US economy is growing around 1.7%, but let's give it a little bump as trade wars ease to 2.0%. That means a 2.12% 10yr would be about that same magnitude where if yields go any higher; the market/economy will start to turn lower once again. We have already seen some of the housing data disappoint recently as yields have risen.

Meaning, yields will not rise higher than growth.

Why does this happen? There is simply too much debt in the world to service, and higher yields only exasperates that servicing issue in addition to the refinancing of that debt.

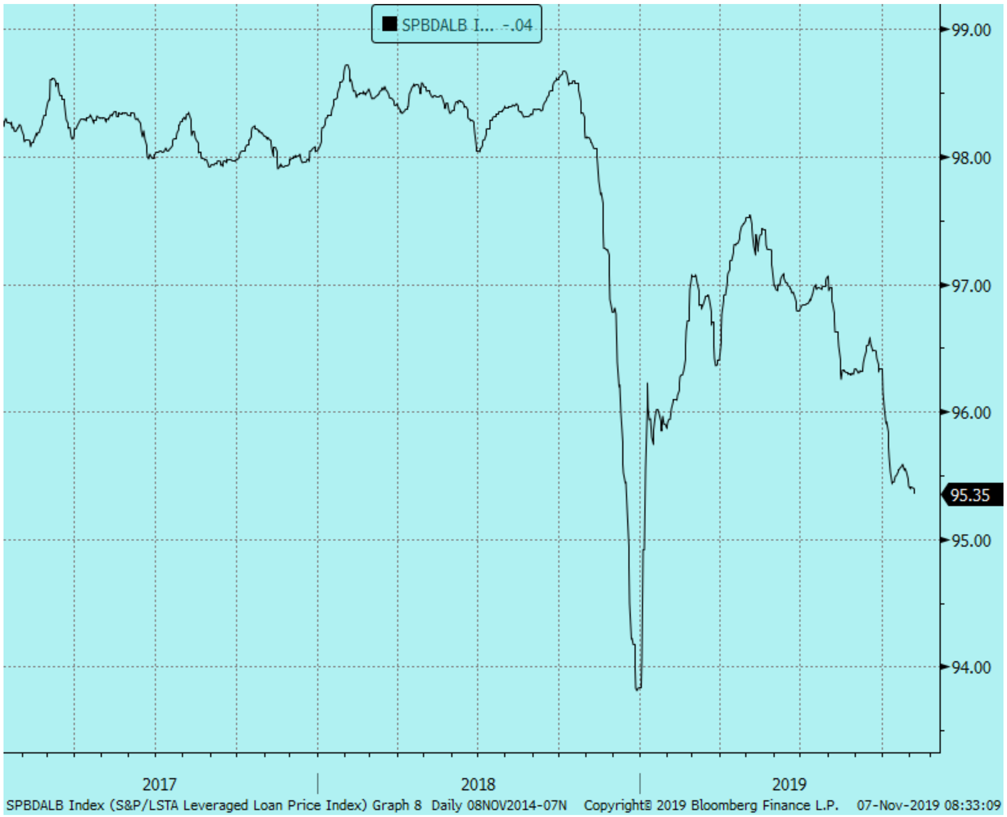
The High Yield debt market would be the obvious starting point and you are already starting to see some cracks that higher yields would only amplify.

- Defaults are starting to turn higher
- Recovery rates are falling sharply
- Upgrade/downgrade ratio is falling

All that likely explains as yields have risen why credit spreads are not following S&P's higher. In other words, unlike equities, HY credit has not broken to new highs.

HY CDX (prices in black) vs. S&P mini's (purple)…

And then I am sure you have been starting to see this chart. Leverage Loans prices are declining…



Bottom Line: the cyclical upcrash theme is thriving with more to go. The ironic aspect of all of this is eventually rising yields (above 2.15% call it) will crack the "system" once again and slip our talking point back to the data deterioration theme. Watch the sensitive HY and Leverage Loan market as your guide.

Playbook:

- Remain in S&P upside
- Own cyclical commodities
- Tactically stay short the long end but don't overstay your welcome – yields can only rise so much
- 2s10s you can start taking partial profits, but be mindful that any correction will be temporary (next phase a bull steepener as rates cracks the system once again?)
- Use FFZ9 long as your cyclical upcrash hedge – most of the cuts have been priced out, the Fed is not hiking

Kind Regards,

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