Second Half 2019: A BRIEF OUTLOOK

SO WHAT'S NEXT NOW?

Bruno Syrmen
CIO Alternatif - Partner
bsyrmen@seven-cm.com
+33 1 42 33 75 22

As discussed in the conclusion of my previous article about the almost incredible first half rally in virtually every single asset class, during the second quarter of 2019, an ever growing divergence between bonds and equities started to be visible. With the parabolic rally in bonds prices towards the end of June, it reached epic proportions, as you can see with Chart 1 below.

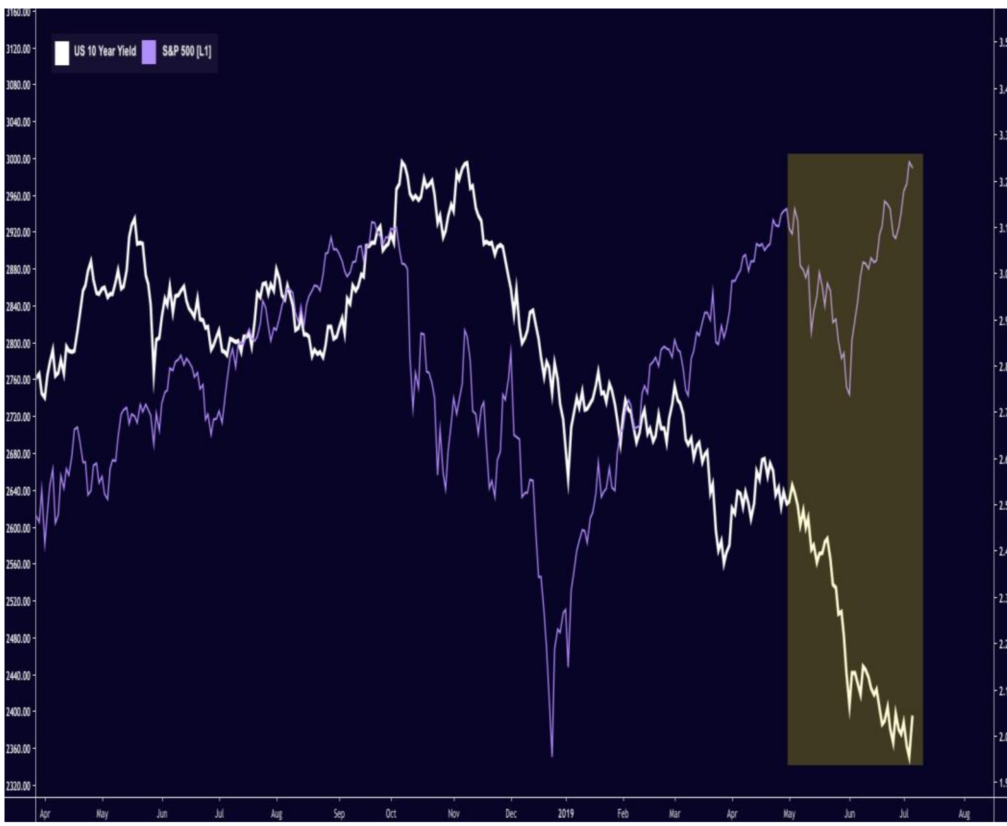


Chart 1: Source The Heisenberg (White:Bonds Yields/Purple: SP500)

The brown part (highlighted) on the right hand side of the graph is known as the "jaws of death"…..

This "dueling bull markets" narrative remained squarely in play last week (first week of July) with US equities surging to new all-time highs and 10-year US yields diving below 2% for the first time since 2016. Long story short, stocks and bonds were bid simultaneously – again….

It’s now time to discuss how to solve this “Epic divergence problem”.

At first glance, we shall consider three possibilities:

- Either the yields start climbing again while equities reach a kind of plateau or even keep rising (but at a slower pace than the yields).
- Or the yields stay where they are now or even keep diving while the equities go through another massive correction.
- Or: a bit of both…. Like in (Red) October 2018.

To sum things up in a very basic way:
If stocks are right, so called "insurance cuts" from the Fed will successfully engineer a "soft landing", a recession will be averted and yields will need to rise, hurting bond bulls.
If bonds are right, the global economy is headed for a tailspin and, eventually, stocks will need to "catch down" to the reality of plunging yields.

But things being, as ever, a bit more subtle, we’ll have to consider another possibility: the case for an Equities Markets “melt-up”…

I/ Sharp rise in yields

A common sense assessment is that even considering the prospect of a global downturn, the bond rally has simply run too far, too fast. Indeed, it reached epic proportions last week as the global stock of negative-yielding debt touched a record $13 trillion and then peaked at around 13.4Tn $ on Thursday the 4th of July.

10-year yields hit record lows in Australia, New Zealand, Germany, Belgium, Austria, Finland, the Netherlands and France, with the latter hitting zero for the first time ever on Tuesday the 2nd of July.

For a more visual representation of these facts, see the chart 2 below.

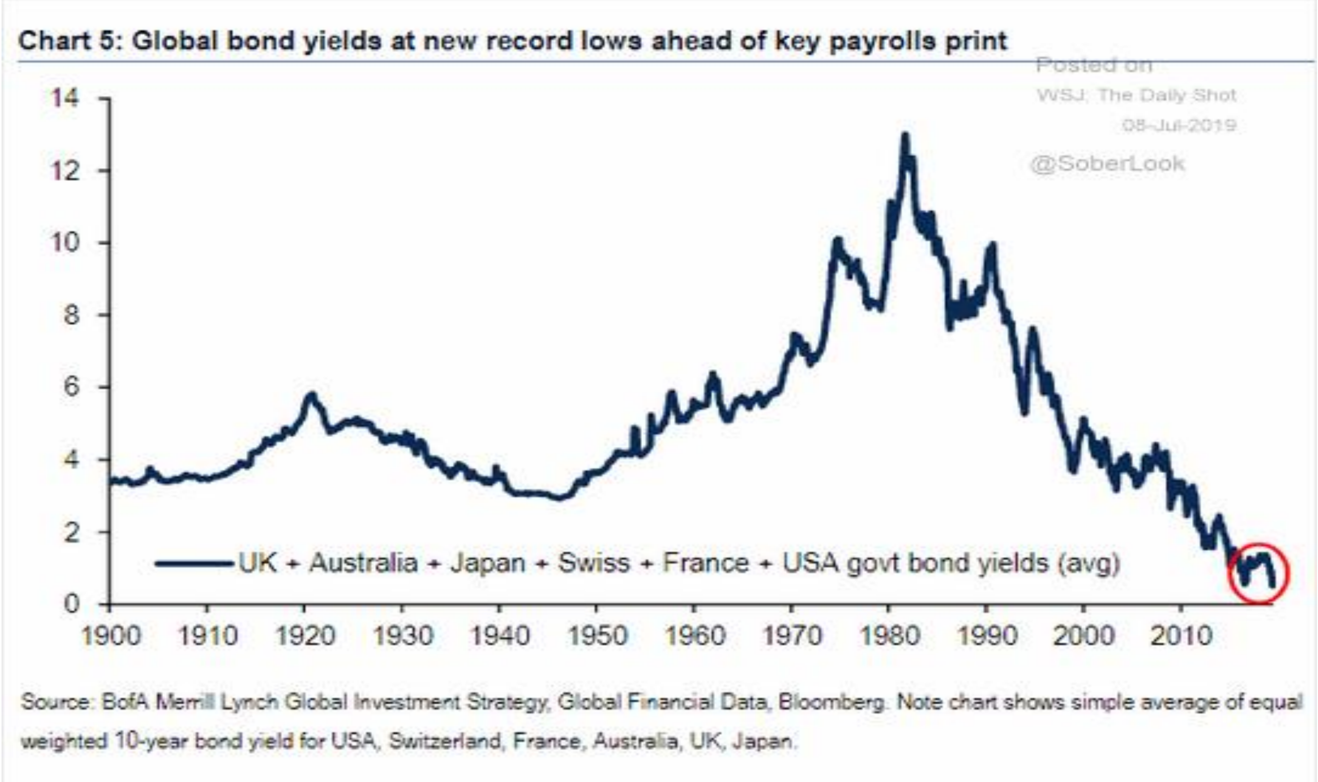


Chart 2: Source: BoAML

The point here is that bonds are simultaneously reflecting:

1/Central banks, and especially the FED, new dovishness

2/The global growth jitters upon which that dovishness is predicated and, to the extent the path lower for yields is attributable to falling inflation expectations:

3/A lack of faith in policymakers' ability to reflate the global economy.

In that context, consider that the bond rally is unfolding against a trio of ostensibly inflationary dynamics, which, in addition to central banks easing or promised easing, now include a weaker dollar and a surging Crude Oil and a still historically low unemployment rate in the US, i.e a tight labor market.

Still, during the whole month of June and especially early July, the global Bonds rally has continued to accelerate at a remarkable pace, spurred along by persistent growth worries and expectations for more accommodation from central banks.

And on Thursday the 4th of July, 10-year German yields fell to -0.41%, below the ECB deposit rate, see chart 3 below.

Chart 3 source: The Heisenberg

And then on Friday the 5th of July the surprisingly good NFP figures triggered quite a sharp increase in the US yields with the 2 year UST-note experiencing its worst day of the year (Up 11 bps)! This is the ultimate evidence of a Bonds market that is now hyper-sensitive to Fed expectations…. And there lies the main risk: in the gap between markets expectations of Central Banks policies (rates cuts and QE) and what they will eventually deliver.

Bear in mind for instance, that Barclays still expect 75bp in rate cuts from the Fed this year, but now look for only a 25bp reduction in July versus 50bp previously, BUT Goldman still estimates that the probability of the FED **NOT** cutting rates at the end of July is 25%.
Would they stay on hold and stick to the current rates, then the market expectations for a July rate cut would have gone from a near certain 50 bps cut on the 4th of July to a de facto unchanged policy in a matter of 4 weeks. The repricing of the whole US Yield curve, and several others yield curves for that matter, would be… savage….

Indeed, although there are currently no signs of inflation as demographics and labor costs both weigh on core inflation (see chart 4), the duration trade is probably the most (over) crowded trade at the moment.

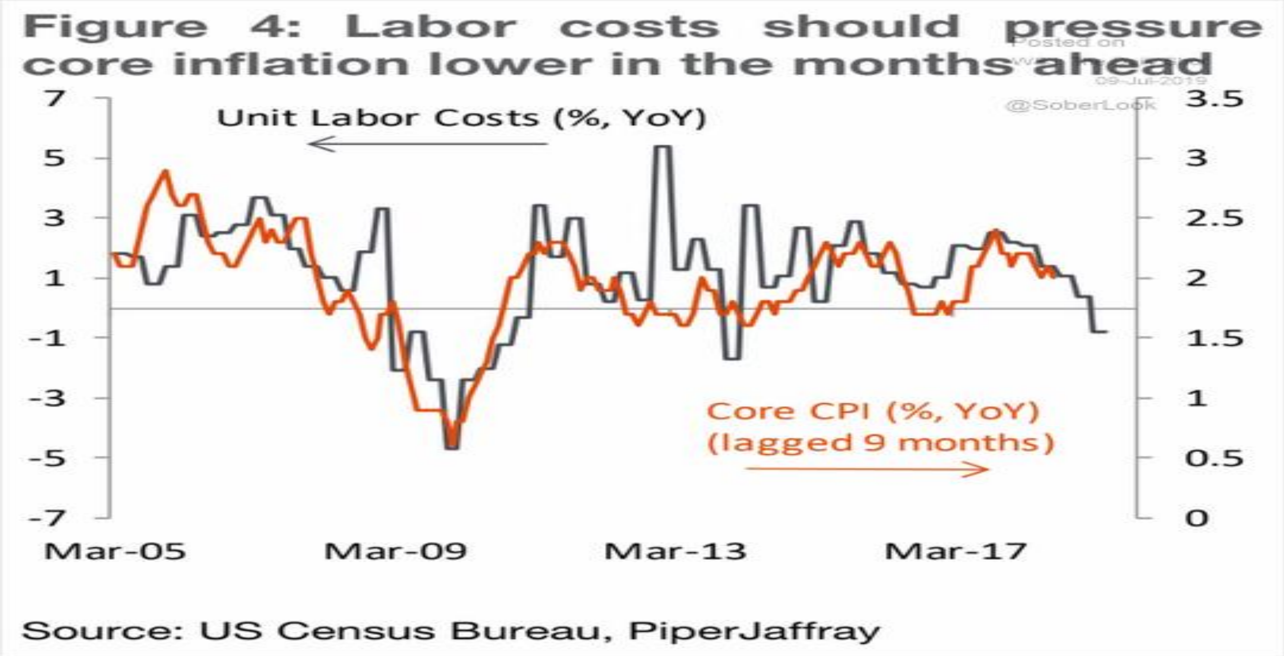


Chart 4: Source: Piper Jaffray

Thus some of the long term bonds are clearly overbought, as the chart 5 below will show you for the 10 year US T-Note.

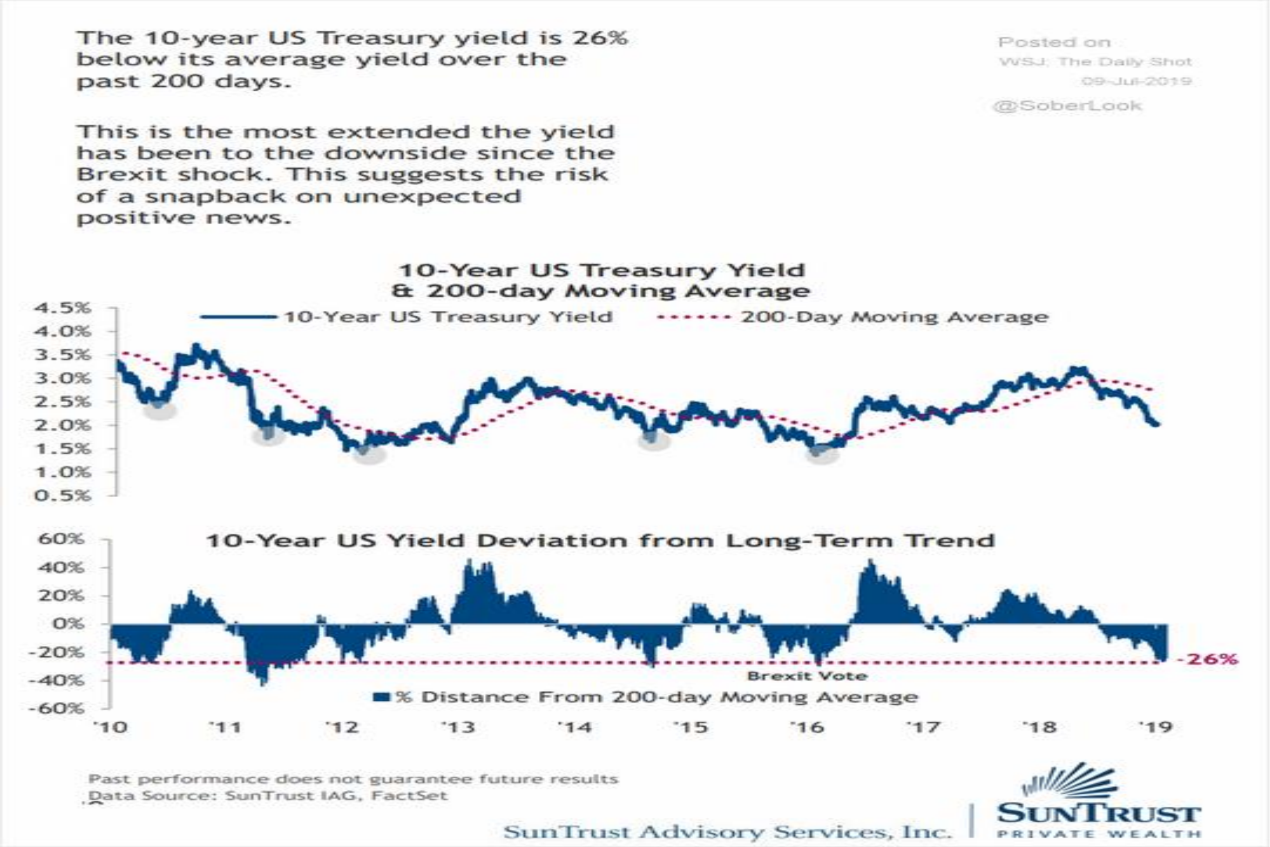


Chart 5: Source: Sun Trust Private Wealth Management

Under those circumstances, things can unravel very quickly…. And you would probably see a lot of outflows from Bonds funds, dragging prices lower and yields higher, while some of the money could be redirected into equities.

II/ Massive correction of Equity markets

Given the current levels of Interest rates in many countries and the growing expectations of more accommodative monetary policies from the Central banks around the world, equities indices benefit from a solid base on which to build. Therefore the solving of the "Epic divergence" via a collapse of the equities markets can happen if and only if a recession hit either the Chinese economy or the US economy.
At the time of writing the equities markets players seem to have total confidence that the monetary powers that be CAN help the main economies to avoid recessions and engineer so called soft landings. And more than the constantly increasing probability of recession in the coming 12 months as calculated by the NY FED: see chart below:

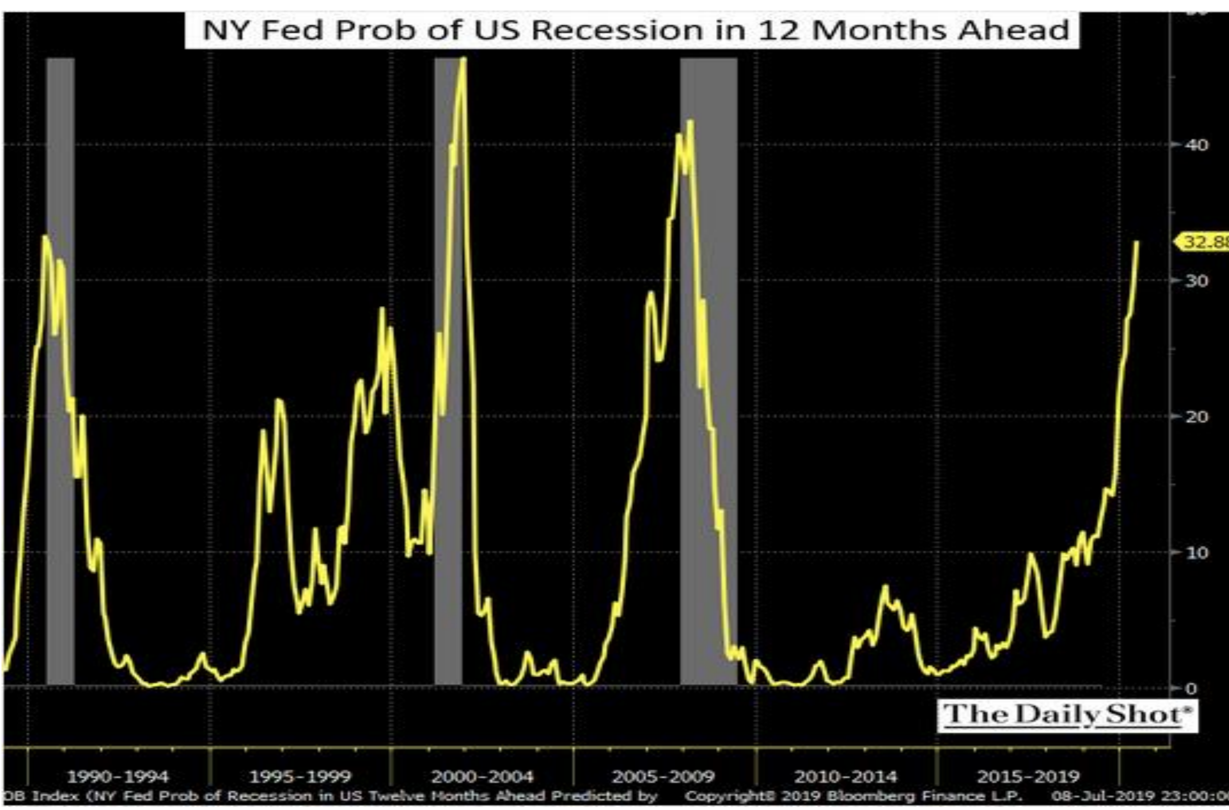


Chart 6: Source: WSJ: The Daily Shot

what investors and Equities markets players should really worry about is the appalling record of central Bankers to predict, let alone prevent, recessions….
Looking specifically at the FED record, among others, the odds that they cut the Fed Funds rates too little too late do not seem to be that low: they never even correctly forecast any of the US economy recession….
In such a case, that would be the bear which would strike back fiercely…
We wanted to show you a quite interesting chart (below) in which you overlap the entire Citigroup Economic Surprise Index (since 2003!) against the S&P 500 Total Return Index's 6-month % change.

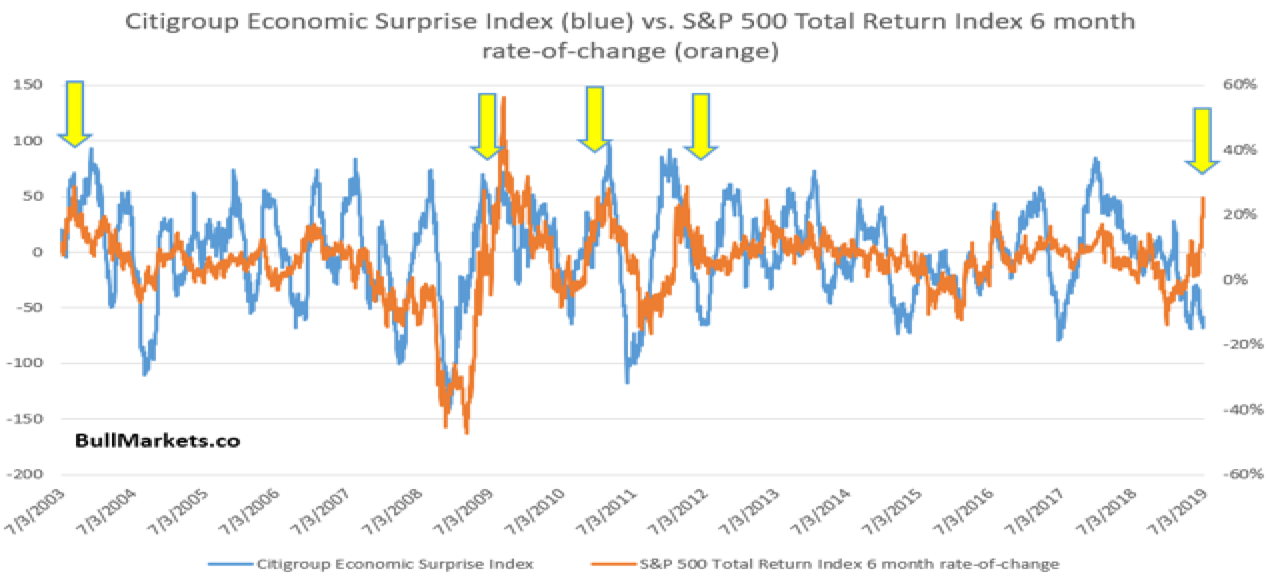


Chart 7: source: Seeking Alpha/BullMarkets.com

This is indeed one of the largest divergences ever. You can see that S&P rallies (yellow arrows) usually saw much higher Economic Surprise readings than the dismal numbers we are currently getting…..
And just to reinforce the bearish argument for stocks: On Monday the 8th of July in the morning you could find the following article on Bloomberg:

Morgan Stanley Turns Bearish on Global Stocks as Challenges Grow
Lowest allocation to equities in at least five years:
MS Elevated valuations and profit headwinds among the concerns
By Adam Haigh

(Bloomberg) -- Morgan Stanley cut its global equities allocation to the lowest in five years, and downgraded its investment recommendation to underweight, saying the outlook for stocks over the next three months looks particularly poor. Profit forecasts remain too optimistic, as measures of manufacturing health around the world keep deteriorating, strategists including Andrew Sheets wrote in a note Sunday. Expectations for looser central bank policy are high,…

III/ The two jaws converging at the same time

But the displayed "disconnect" between plunging bond yields and record-high stocks does not necessarily has to "resolve" itself by stocks diving or yields exploding higher. Both jaws can actually tend towards each other together.
As the financial blogger Heisenberg put it: “Don't forget to what you owe your good fortune. There is no doubt that a good part of the near 20% gain investors have enjoyed on the S&P in 2019 is attributable to the Fed's dovish shift. While stocks rallied on the promise of easier monetary policy, bonds surged as investors priced in lower growth outcomes, subdued expectations for inflation and a lower neutral rate. As yields fell, the global stock of negative-yielding debt grew, surpassing $13 trillion, providing a powerful tailwind for investment grade and high yield credit, which rallied alongside stocks and bonds. 2019 has been the year of the "everything rally" and multi-asset portfolios (e.g., a standard 60/40 fund) have enjoyed spectacular returns.”

But then, for policymakers to deliver, the data need to remain weak-ish, otherwise the case for more easing won't be as strong. But there's a very fine line. You want things to be just bad enough to keep central banks from reassessing this year's epic dovish pivot, but not so bad that a global recession comes calling.
Under those circumstances, to quote Nomura's analyst Charlie McElligott: when a trade becomes over-crowded (Duration play for instance rather than long Stocks at the moment) one-sided and extreme, any subtle tiny shift in the narrative “is enough to drive a far more outsized move in trend themes and asset prices than the macro catalyst itself should merit in isolation".

So any potential "rogue" inflation print for instance poses a serious risk. A case in point being Friday the 5th of July and the NFP print. Not that anybody believes a sudden inflection on the inflation front is likely, but that just makes the situation all the more precarious; and within one hour, you had the 2 years T-Note yield up 11bps and the S&P 500 index down 1%.

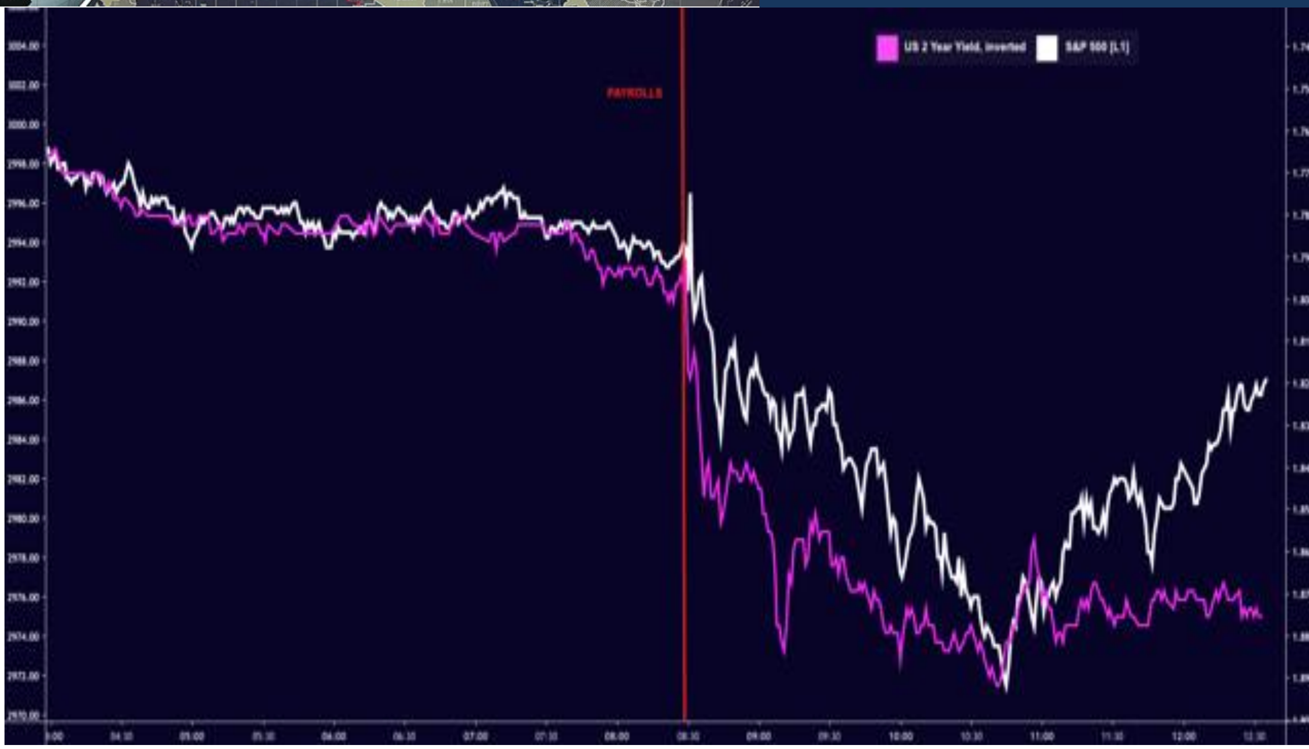


Chart 8: Source: The Heisenberg (White Curve: 2Years Yield Inverted)

So try to imagine now what would be the markets reactions if the FED were to disappoint on "decision day"… A remake of the first fortnight of (Red) October 2018 would not be surprising then.
And you would get a simultaneous and quick convergence move.
But before jumping to the conclusion of this article, let's consider a case which is more and more talked about in the Markets circles:

IV/ The Case for A "Mini-Bubble" or "Melt up" of the Equities

Indeed, the "melt-up" calls have grown louder over the past week. Coming from various corners of the markets, we thought interesting to elaborate on that. Let's start with Anatole Kaletsky's (Gavekal partner) views:
"The endlessly debated conflict between bullish equity investors and bearish bond markets is an illusion. In fact, far from contradicting one another, the signals from equity and bond markets are mutually reinforcing. As argued above, low bond yields simply reflect the near certainty of very low short-term interest rates persisting into the next decade. Meanwhile, new highs on Wall Street and near-record prices for many European and Asian companies exposed to global economic growth, as opposed to weak domestic conditions in Europe, are justified if the world economy continues to expand in real terms by around 3.5%.

And with the bond market implying that central banks will, rightly or wrongly, keep interest rates near zero forever, then it is perfectly reasonable and natural for equity markets to apply ever higher valuation multiples to the earnings that businesses can generate in conditions of decent real growth. Putting all these messages together, the outlook for equities and other risk assets is generally bullish. But this does not mean that equity prices can keep rising and bond yields can keep falling forever. At some point, the equity market will over-estimate the likelihood of strong global growth or the bond market will over-estimate the likelihood of further central bank rate cuts."

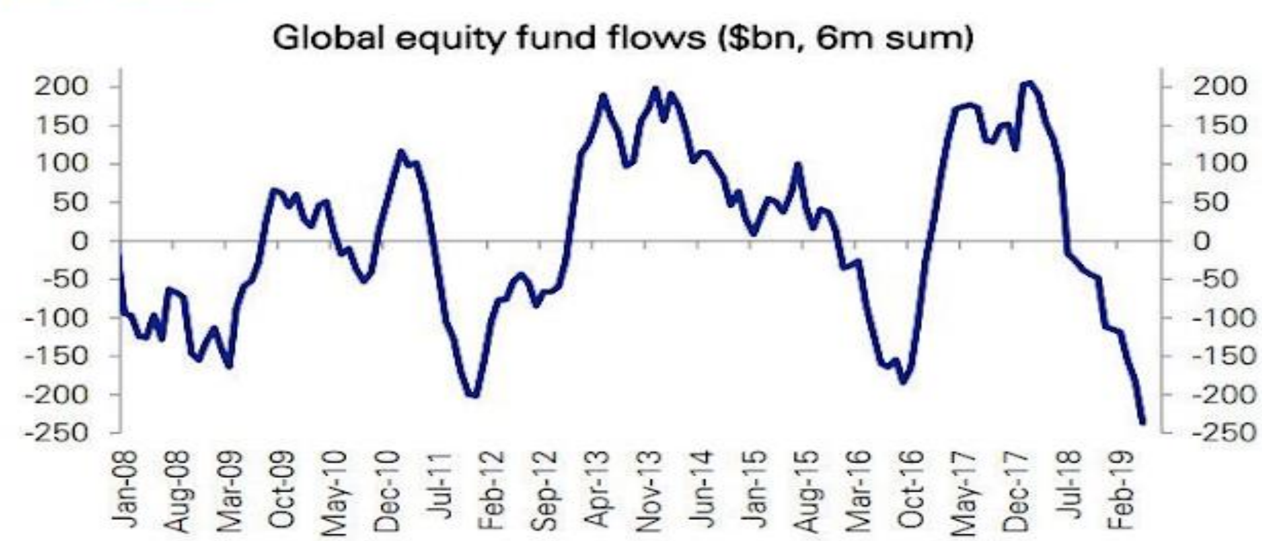
Which he summed up himself by: "Equities are pricing in steady global growth, which will be aided by low interest rates if bond markets are right". Obviously, the last condition in this statement is not a given…

Then you have a whole cohort of analysts, pundits, or strategists who have, rightly, noticed that the 2019 rally has actually been characterized as a "flow-less" affair!

The bull thesis relies in part on those who have missed out being "forced" in.

Global equity funds have seen around **$138 billion in redemptions** this year, with the breakdown betraying a net outflow of -$41.2 billion from US funds (-$83.0 billion from active, partially offset by a +$41.8 billion inflow to passive vehicles). As Nomura's Charlie McElligott commented last week, "there is a significant 'high cash' component which could act as fodder for a grab-in across both risk assets and further into bonds, with money market funds experiencing a massive +$195.8 billion inflow YTD, which is 93rd percentile since 2000". See the two following charts for a clear visual:

Figure 2: Equity outflows over the last 6 months now the largest on record in dollar terms...



Source : Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver

Chart 9: Source: Deutsche Bank

SEVEN CAPITAL MANAGEMENT
39, rue Marbeuf 75008 Paris - France - Tel. +33 1 42 33 04 50
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Chart 10: Source: FT

Barclays have also revised much higher the probability of a 2019 “Mini bubble”. They simply point out that between expected Fed-driven multiple expansion, near-term mechanical catalysts (e.g., funds being compelled to re-engage as stocks move higher, knock-on effects from systematic vol. selling) and, in a general sense, the prospect of record highs prompting inflows and bringing in sideline cash, the ingredients are there for another push higher.

But still the main argument seems to be the one put forward by Tom Bowley for instance:
“So money is rotating into treasuries here in the U.S and globally. The S&P 500 is setting all-time highs with money rotating **INTO** treasuries. That's impressive and supports the notion that **equities will soar when money actually begins to rotate away from treasuries**.
That's also the history of the stock market. We tend to see very strong gains in the S&P 500 when the 10 year treasury yield ($TNX in the chart below) is rising:”

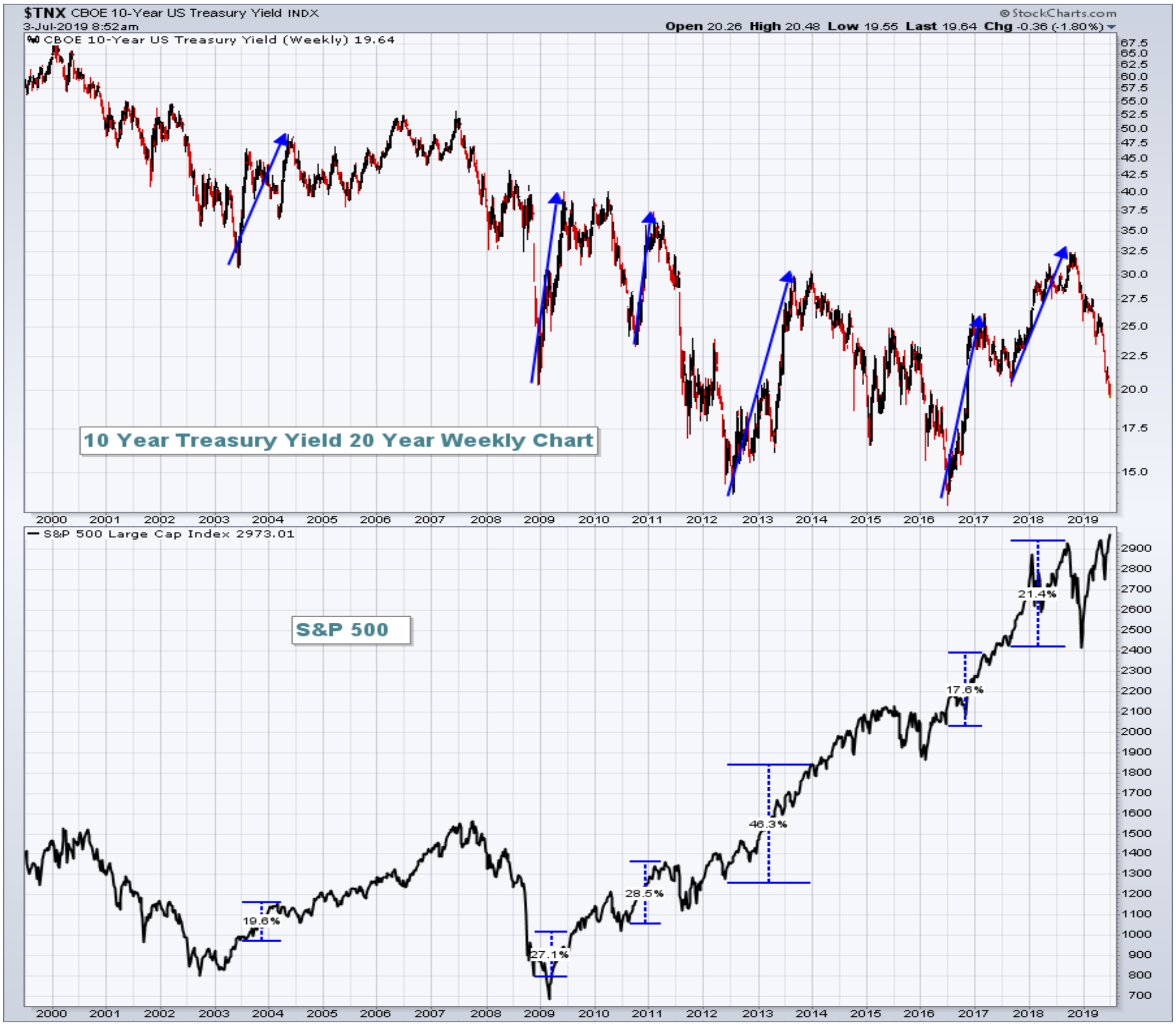

Chart 11: Source: StockCharts.com

And last but not least, another Wall St veteran M. Grant which concluded his contribution in the Gartmann Letter with:
"So, there you have it, boatloads of cash created form nothing, interest rates going down, Equities up, Real Estate up, Bond yields down, and all because the world's central banks have done the "impossible." They thought negative yields were impossible, everyone thought they were impossible. They learned they were possible. Now they are continuing on with their programs, as the ECB is about to start a new Quantitative Easing plan, and America will have no choice except to follow along. Just watch! »

V/ Conclusion

So it seems clear now that following M. "Super" Mario Draghi's "Whatever it takes" call version 2.0 and the dive into the abyss of the Bonds yields more and more people are now looking for at least a temporary continuation of the divergent move of Equities markets and Bonds yields.
The way this divergence will be "resolved" or at least the way the growing gap will start to shrink will eventually depend on which market was effectively, or was considered as being, "OVER-optimistic".
My guess, for what it's worth, is that:

- The FED WILL CUT on the 31st of July, as they know too well the price to pay for disappointment, following a lack of action which would be seen as a sudden tightening of financial conditions.
- The Bonds markets are "right" more often than the Equities ones….

But as usual in the modern financial markets, the timing of the "convergence" move of the so called "Jaws of death" will be the most important thing. That's also the most difficult…

Bruno SYRMEN
10th of July 2019

Chart 9: Source: Deutsche Bank