H1 2019 HOW COME YOU TASTE SO GOOD

THE BULL STRUCK BACK FIERCELY!

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

If you had left on Xmas day 2018 for a 6 months space trip and came back to earth at the end of June 2019, it would have been hard to believe how well things had gone for the financial markets during your absence.
Especially if you remember the "Doom and Gloom" atmosphere which prevailed at the end of 2018!
As we are still in early July, it seems to us that it is a good time to comment on what happened during the first half of 2019.

Thanks, essentially to the Federal Reserve and the other major Central Banks pivoting decisively back towards accommodative policy, as early as mid- January, assets of all stripes have rallied this year.

Introduction to a stunning first half

US stocks, and their flagship index the SP500, have logged their best first half since 1997, when the Asian currency crisis was already smoldering in the background, and the Dow Jones Industrial average had its best month of June since 1938. Although one could note that the June rally barely recouped what was lost in May….

Look at chart 1 upper panel next page.

At the same time, the iShares Core U.S. Aggregate Bond ETF had what looks like its best half on record….

The high yield ETF is on track for its second-best half on record.

See chart 1 below, lower panel.

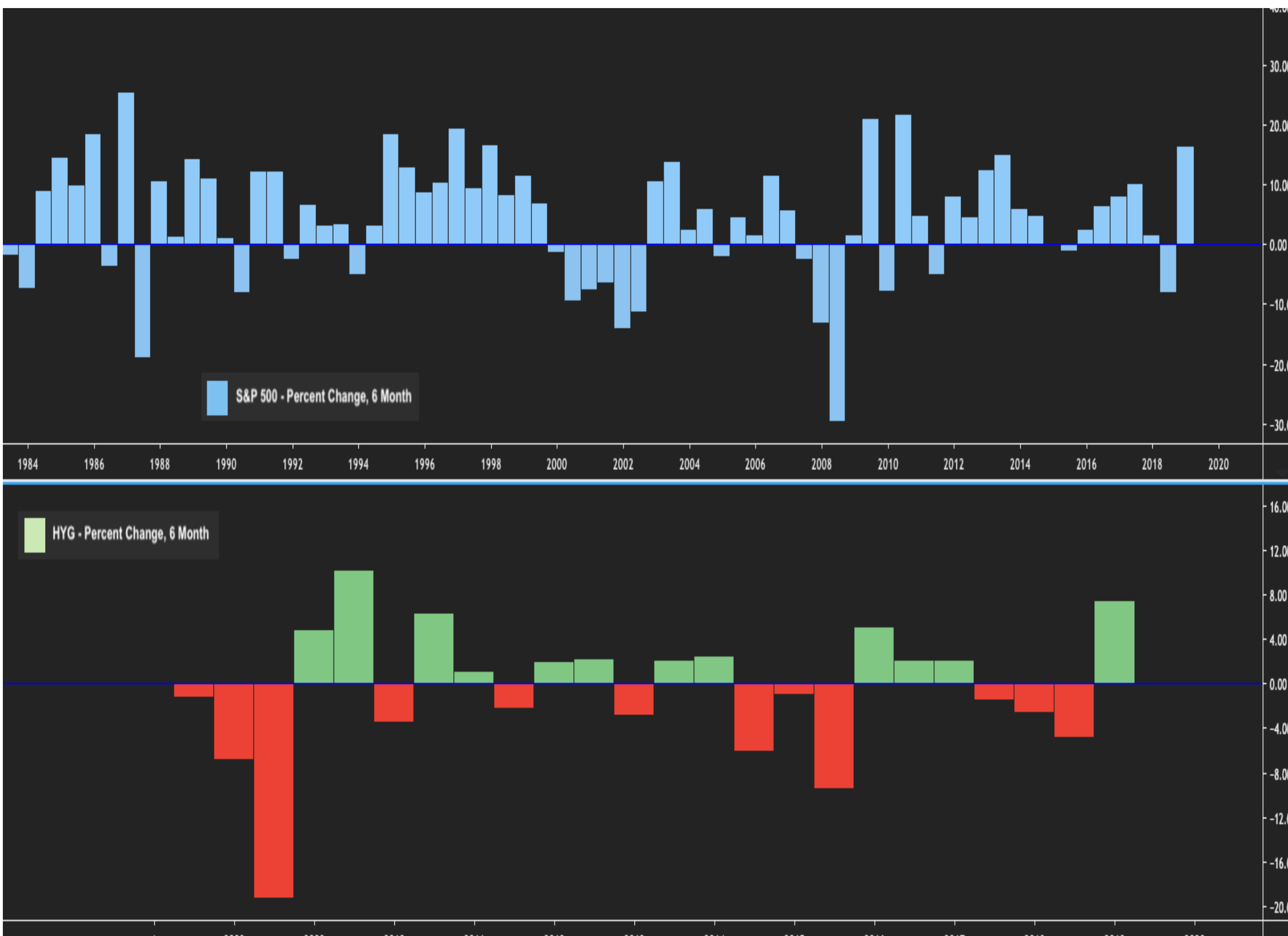

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Chart 1 source: The Heisenberg

Recent gains in the IG credit ETFs have been as the famous blogger The Heisenberg put it: "borderline comical". See graph below of the iShares IG Corp Bonds ETF over the past 12 months: orange line the USD price, and in blue the weekly changes in %.

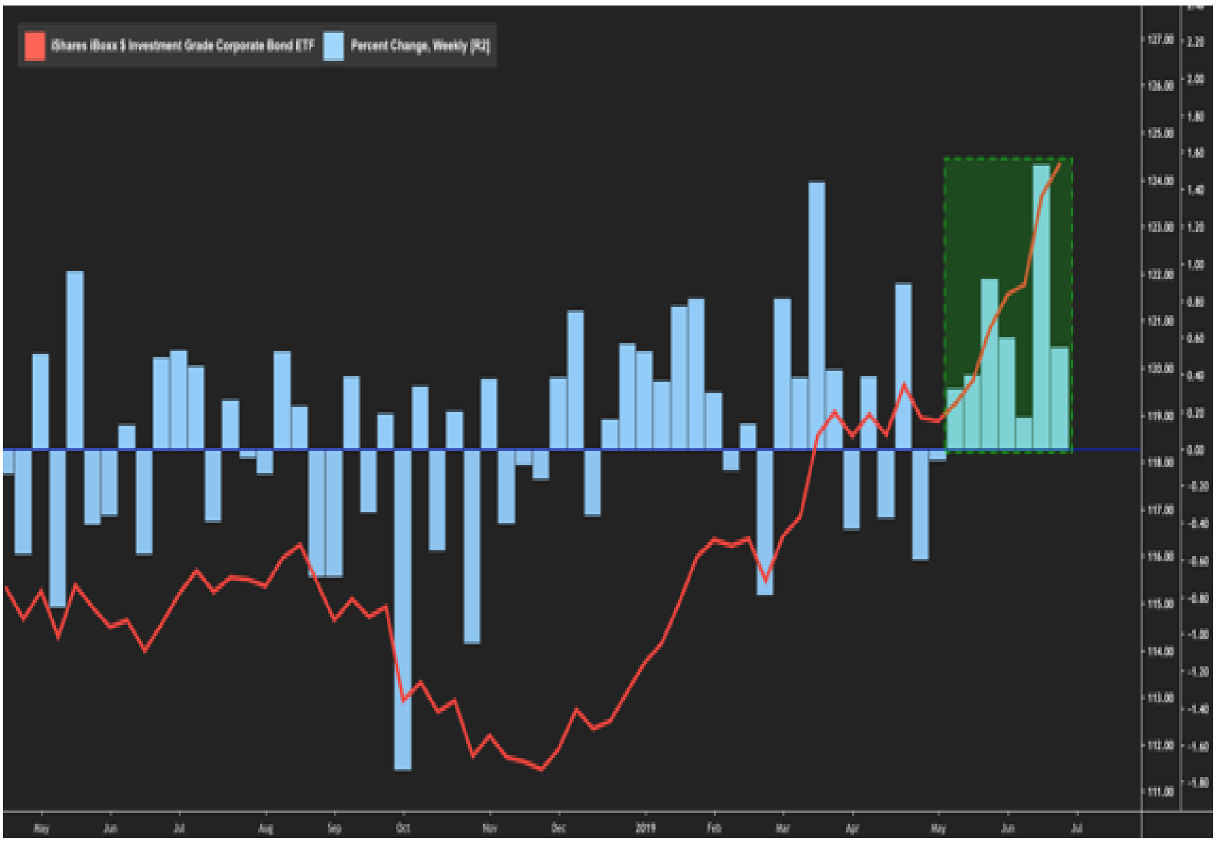

Chart 2: Source: The Heisenberg

And because of the concurrent rally in equities and bonds, this was one of the best H1 performances on record for a standard, 60/40 balanced portfolio. As Goldman Sachs notes, "US 10-year bonds had the best 1H performance since 1995 and the German 30-year bond actually posted a 15% total return, the second-best 6m return in the last 25 years – better than STOXX 600 and close to the S&P 500".
Indeed, the return of the 30 years German Bund, starting the year with a paltry 0.889% Yield, was greater than the returns provided by the main European Equities indices over the same period…. For those not convinced have a look at the chart below (30 years German Bund yield):

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BV300910 Index (EUR Bundesrepublik Deutschland BVAL Yield Curve 30 Year)

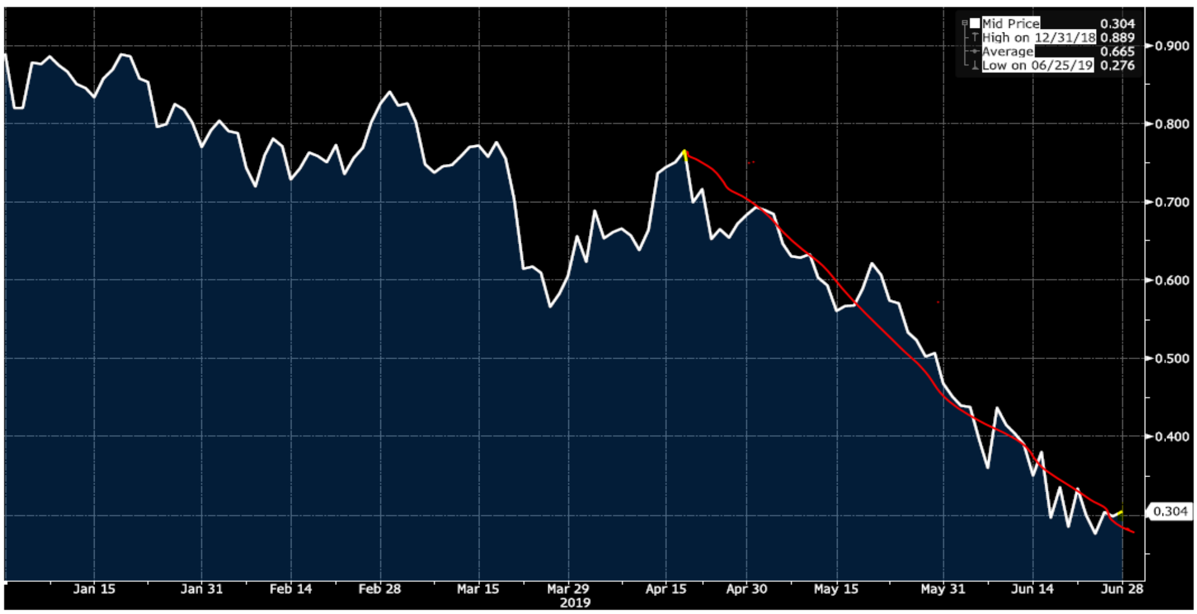
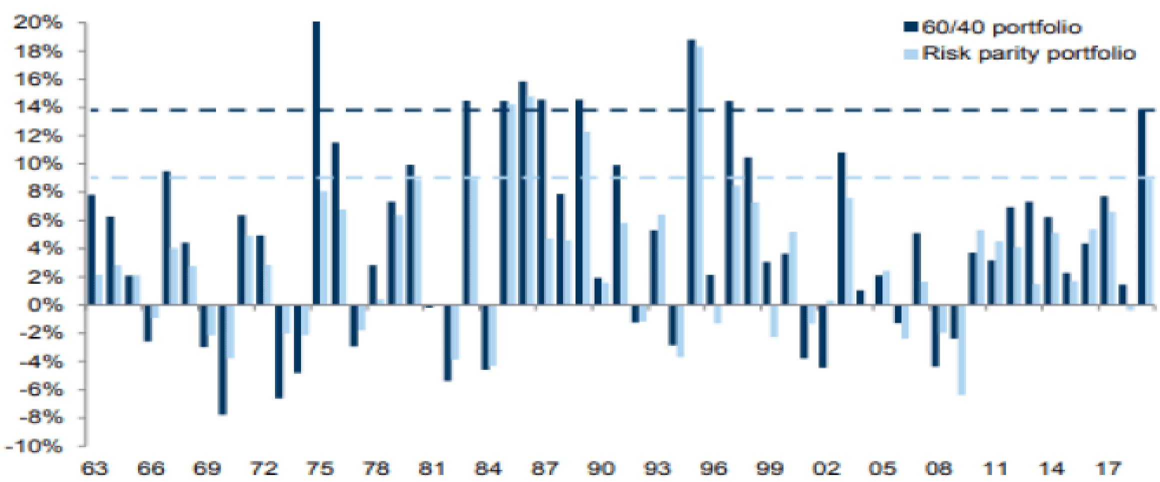


Chart 3 source: Bloomberg

And clearly Risk Parity Portfolios loved it! See graph below

Exhibit 5: One of the strongest 1H performances for multi-asset portfolios

YTD performance of multi-asset portfolios based on S&P 500 and US 10-year yields



Source: Datastream, Goldman Sachs Global Investment Research

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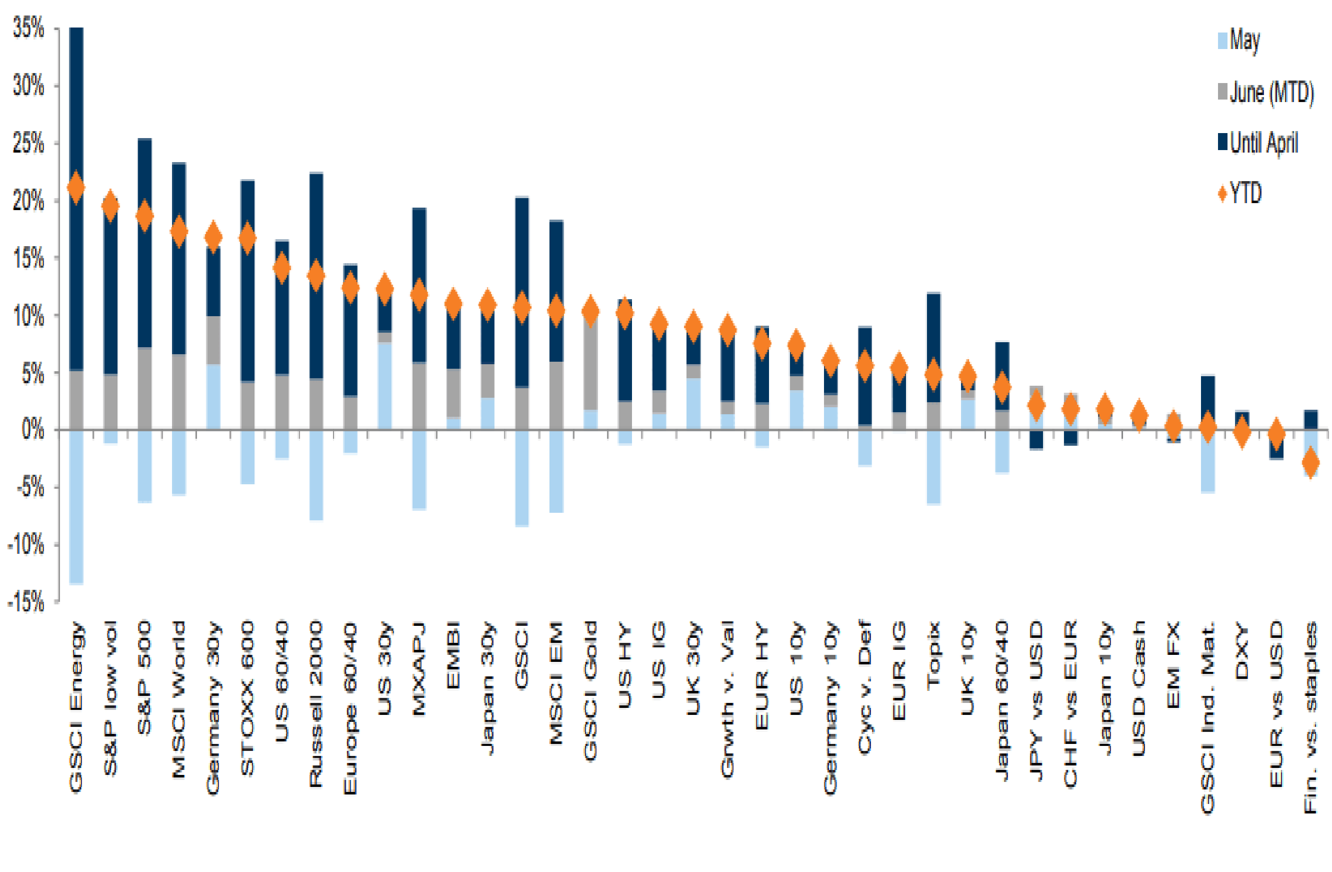
Chart 4: Source: Goldman Sachs GIR

Just to drive the point home, let's have a look at cross-asset performance globally, and let's start with a very interesting chart, courtesy of Goldman Sachs.
This chart is very telling, as it breaks out May in order to show you how the rekindling of the trade conflict weighed on certain assets, mainly commodities and stocks.

YTD total return performance in local currency



Source: Datastream, Haver, Goldman Sachs Global Investment Research

Chart 5: Source: Goldman Sachs GIR

Let's be crystal clear, H1 2019 has been truly remarkable. In many ways, this year has been the polar opposite of 2018, when "cash" (in USD) outperformed roughly 90% of global assets.

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Highlighting some of the winners.

Whatever the allocation method you used at the end of 2018 (fundamentals, discretionary, quantitative, trend following, random choices, throwing darts) it was virtually impossible to lose money during the first half of 2019, unless you bet on the Equities markets Volatility (VIX) which went from 25% to 15%: the exception to the rule….
Even the ever growing bearish talks around the dollar which are set to finally take their toll on the greenback were not enough to send the DXY index in real negative territory! It finished flat on the period, Ok if you insist it was actually slightly DOWN (From 96.173 to 96.13…).
Among the winners, apart from Oil related Energy commodities which recovered from their real crash of Q4 2018 spurred by the escalating tensions with Iran, and all the equities Markets which recovered from the Q4 2018 slaughter, some were really amazing not to say unexpected:

- The SP LOW Volatility Sub Index made of low volatility stocks like Utilities and Health Care companies, i.e defensive sectors was the best performing factor on the period. And would you have been long of that you would not have suffered in May… Comfortable…
- The long duration plays. We did talk specifically about the German 30 years Bund already, but not far behind were the 30 years T-Bonds JGB and Gilts, all returning more than 10%….
- Even the Commodities, other than Energy and Precious metals, managed to return positive numbers like the Industrial metals (+3.46%) despite being closely linked to the Chinese Manufacturing PMIs. Or remained perfectly flat like the Agricultural or Grains sub-indices.

And the list of sectors or sub-sectors benefitting from the euphoria is virtually endless: even the pure trend following strategies which suffered badly in 2018 posted their best performances since 2008!

Let's now consider a couple of other asset classes, not mentioned in the Goldman report.
First the US Municipal Bonds: as you will see on the graph below, the Muni Bonds rally from the 20th of January was relentless, with only three noticeable and brief consolidation periods. On the 30th of June 2019 the total return was 8.47%. This can seem poor, even laughable compared to the 30 years Government Bonds, but bear in mind that some of these bonds have been issued by municipalities or States which are not in their best financial shape….

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Still, whoever the issuer, whatever the maturity (and here again the longer the better…) these bonds were consistently going UP in price, boosted by the relentless and fierce hunt for yields.

Chart 6: source: Bloomberg

And finally I wanted to draw your attention to some financial products which are not yet officially an asset class: the Cryptocurrencies.

They were not even mentioned in the Goldman report, or in any other report issued by any other bank for that matter, but they had a tremendous first half.

To the extent that, in terms of performance, they emerged as the BIG winners. True, they were just coming out of a kind of Nuclear winter during the whole of 2018, with losses of 80% for Bitcoin or 90%+ for many others. So the probability of a bounce was obviously far higher than it had ever been. But still what a rebound it was!

- Bitcoin (BTC): up 180,15% (From 4511.85 to 12640$)
- Ethereum (ETH): up 135.62% 5from 130.04 to 306.405)

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XETUSD Curncy (XET-USD Cross Rate)
BTC1 Curncy (Generic 1st 'BTC' Future)

Chart 7: Source: Bloomberg

BTC: Purple curve, LH scale and ETH yellow curve RH scale.

And some other crypto-Currencies skyrocketed even more, LITECOIN for instance. Although they are all far away from their peak bubble highs. Typically BTC is still 40% lower and ETH roughly 85% lower and 90% lower for the vast majority of these.

Arguably, at the end of the first half, as stated by many commentators and especially Barclays head of macro Research: Ajay Rajadhyaksha:

"The biggest development in financial markets in Q2 19 is the breath-taking rally across global rates. 10y US Treasuries have rallied 50bp in the past three months, the front end of the US curve is now pricing in over 100bp of easing by end-2020, and ever larger parts of the world's bond markets keep sliding into negative yield territory. Central bank rhetoric has affirmed market pricing, with the June FOMC strongly hinting that rate cuts are coming and ECB President Draghi stating that "in the absence of improvement" in inflation data, "additional stimulus will be required."

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All seems as it should be: the global business cycle might be turning over in part thanks to trade tensions, central banks are going to ease accordingly, and bond markets are pricing this in. But if this explanation is correct, someone forgot to tell the world's risk markets. US equities just hit all-time highs, global stocks are up over 15% on the year, and credit spreads in the US and Europe are well below the levels of December 2018, let alone the more serious widening in January 2016. What gives? How does one reconcile the gloom in bond markets with the cheery disposition of risk assets?"

Where to now in the second half of 2019

Indeed, this year, virtually everything on the planet has performed well.
So what gives? That's the 64 Billion $ question.

The global growth outlook has darkened (quite obvious when you study the Manufacturing PMI) and central banks have turned even more dovish since May 22, when Bank of America cut their 2019 yield forecasts in a now famous note that carried the title "Marking to misery"…

Since then, almost all the main banks have drastically revised their 2019 yields forecasts, one of the last to do so, Goldman at the end of June: they now see 10-year German yields at -0.55% by year-end and 10-year JGB yields at -0.30%. Their outlook is well below market forwards.

The now "massive divergence" between bonds and equities is all the talk right now in market circles. This apparent "anomaly" isn't really perplexing yet. As the Heisenberg recently put it: "The explanation is that equities are hoping the Fed has enough ammo and credibility to head off a recession and bonds are reacting both to the promise of a return to accommodative policy and the economic weakness which necessitated the dovish pivot in the first place."

We'll discuss the various scenarii to solve this "divergence problem" in a future article. There are three main 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.

B. SYRMEN
4th of July 2019

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