A Mini Wake up Call as we Head into Summer?

30th July 2017

Having been far too one directional with exceptionally low volatility in recent weeks, it feels like financial markets received a slight jolt last week just as many will be heading off for summer vacations. Nothing much changed on the macro front of note, and so this mini jolt could simply be a little spasm before markets continue on their merry way. Or, perhaps it’s the start of a long awaited correction of recent, very persistent trends.

But before we jump into this week’s narrative, we would highlight a couple of changes within our “summary of trade ideas” section at the end of this week’s report. We have sold short the German 2 year (Schatz) bond future and also taken partial profits on our Cocoa trade idea. With that highlighted, let’s crack on with the main part of this week’s commentary, and let’s start with equities.

Back in early March, we really began to stamp our feet (tantrum like) arguing that the US equity market was running out of steam in terms of the Trump rally and at the very least was due a decent correction. The S&P 500 was about 2370 points at that time, and has since advanced about 100 points or say 4% - clearly we have not been proved right so far. Several times during the second quarter, we described how we felt that US equities would likely begin a topping process, but that serious downside momentum would likely be delayed until later in the second half. So far, we have been waiting in vain for any evidence that price is topping in the S&P 500, but Thursday’s price action, especially in the red hot Nasdaq, has piqued our interest.

We won’t go over all the old ground on valuation metrics this week, but we do wish to focus on some price action. Although price, as measured by headline indices is higher than early March, we would argue that there has been a loss of momentum which may be the first subtle hints that we may actually see a correction start in the foreseeable future. The first chart below shows the S&P 500 on a daily basis with a simple momentum indicator in the lower panel. As indicated, there is a significant divergence between the two, with the momentum peak in March when we first began to stamp our feet.
The second chart is the S&P 500 alongside the number of stocks on the NYSE that are trading above their own 200 day moving average. The message is the same, except that the divergence between the S&P 500 and this indicator is even greater. We all know that it is mostly a select group of high flying technology names that is providing the power behind the market’s advance. The divergences we see here are further evidence that the underlying health of the market is not as robust as the headline indices would suggest.

And so it was interesting that some concerted selling hit the market on Thursday, arguably with Amazon seen as a trigger for this. Unusually, this selling was seen before the Company released their quarterly results, which were released only after the market closed that day. Interestingly, although the revenue number beat estimates, earnings missed by quite a large margin. Also, strip away the software result, and the core online retailing business remains exceptionally low margin. Now, this is not the first time that investors have worried about Amazon’s lack of profits despite amazing revenue growth. Will it matter for its share price in the period ahead, and perhaps for the wider market? Time will tell.
We have been banging the cautious drum on the S&P for some time and we feel vindicated (well, comforted perhaps that we are not going completely mad) by the number of highly regarded industry professionals that share this view. Professional investors like Paul Singer, Howard Marks and Seth Klarman, all of whom have exemplary performance track records stretching over decades, have all spoken or written lately about how expensive equity markets are, and how they are vulnerable to a vicious bear market at some point.

However, none of us will be proved right until price starts to go down, and with the evidence for that pretty scant so far, we remain in a waiting game. There was a hint of a potential change on Thursday; seemingly on no major news. There was even a modest amount of follow through on the downside on Friday, so at least, we can say it was more than a one day correction. For our part, we see the technical divergences noted above along with the sudden nervous price action of last week as more urgent warning signs. We are somewhat short US equities in our multi-asset macro fund.

Moving onto fixed income markets which remained a bit on the defensive last week, despite many seeing the Federal Reserve statement as leaning dovish again. If there was a particular theme we would focus on in the last week from the bond market, it is the continued rise in European yields despite ongoing extremely easy monetary policies in the region; for example the Swiss 10 year bond yield rose into positive territory for the first time in two years (having hit a low yield of -0.70% a year ago).
The continuing rise in European bond yields is probably occurring for several reasons. For example, regional growth is currently above trend and the ECB will announce its 2018 plans for QE in the Autumn, when they will likely announce a reduction and possible end to the programme. We would also add into the mix that private sector investors are simply much less willing to tolerate negative yields, or let’s look at it this way; the only reason that any price conscious investor would have bought a negative yielding bond last year was because they thought that they could sell at a later date to a greater fool. Well, as more and more bonds move back into positive yield, that greater fool game is over.

And this brings us to looking at a new trade we implemented this week in our multi-asset macro fund. Given the above market dynamics, surely we should expect more of the remaining negative yielding bonds that remain in Europe to drift back to zero and into a positive yield. In particular, short dated German yields should begin to drift higher as the QE programme is wound down especially as they still yield less than the ECB’s deposit rate (currently at -0.40%) and the overnight rate that banks can lend to each other (currently at -0.36%).

**Chart 3 – German 2 year bond yield with ECB deposit rate and balance sheet**

As can be seen in chart three, it was really only the addition of QE in early 2015 that forced the yield on the two year German bond below the ECB’s deposit rate. We would suggest that as QE is wound down, we should expect the two year yield to move slowly up to the deposit rate, perhaps even a bit higher. Further out, if the European economy continues to recover (or more likely the ECB realises that negative rates are a disastrous policy) perhaps the ECB will raise the deposit rate back to zero.
The benefit of selling short a negative yielding bond is that we get paid to do so. If yields do remain constant, we can expect to make an annualised return of +0.67%. Of course, if yields move higher as we expect, then our return will be greater. Can the trade go wrong? Of course it can. If something goes horribly wrong in Europe and the ECB decides to do even more QE and cut rates further into negative territory, then we will likely be on the losing side, and so we have to have a stop in place which we do. That said, we think the probability is greater that the yield drifts higher from here.

One question that needs to be considered here is whether we can be right on both bond and equity prices falling at the same time – the much feared taper tantrum type of experience that the US suffered back in 2013. The answer is, of course, yes; bond and equity prices can fall together at the same time. It has been rare in recent years to see this happen, but then the post GFC environment has been like no other in history, and when things go wrong, we should expect extraordinary things to happen.

So, to wrap things up this week, we are cautious again on US equities whilst also expecting short dated German yields to rise in the months ahead. Equity markets do appear to be losing momentum but evidence that prices are declining is somewhat thinner on the ground. This really brings us back to a core strategy we have talked about before; the Fed is normalising policy (both balance sheet reduction and further rate rises) and we think that they will continue to do so until something breaks. We also think the ECB is navigating a somewhat similar course.

With many concluding that the Fed has turned more dovish as their concerns increase over inflation being too low, we are taking a slightly contrarian view here. However, we will take the evidence as it comes especially with regard to market prices. We would like to see US stock indices move immediately lower in the next two weeks otherwise we fear our timing is yet again awry. For the German bond short position, we hope to have this trade on for some time, as we suspect it will be a slow burner.

**Summary of trade ideas highlighted in our weekly commentaries**

As noted above, we have sold short the German 2 year (Schatz) bond future and taken profits on the second tranche of Cocoa we bought. With regard to the taking profits on Cocoa, as many of you will know, we like to keep the P/L ticking over when we can and there was no other reason for taking profits. We have also raised the stop on the initial Cocoa trade to our entry price, thereby guaranteeing a profit on the overall trade.
This is not meant to be a model portfolio and it is not meant to constitute any investment advice. This is purely a way of keeping track of specific trade ideas that we highlight in our weekly investment commentaries. These ideas will consist of the more important or higher conviction ideas that we implement in our multi asset macro fund. We have chosen to have a notional starting portfolio value of US$5 million; the reason being that we can also illustrate how much risk we are taking on each trade as well as keeping a cumulative track of how our main trade ideas are performing. This is a notional portfolio only and does not represent any portfolios that we manage. However, for the sake of clarity and consistency, we do put these trades into our multi-asset macro portfolio alongside other trades that we do not make apparent here. The prices we show in the table above are the prices we transact at for our macro fund, not including any trading expenses.

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