Some Extremes Held by Speculators Could Force Change

19th August 2018

For quite a few weeks now, our position on equity markets was modestly constructive with a preference for the US over Europe/Japan and with Emerging Markets our least favourite. Then last week, we expressed a more cautious position on equities overall. Generally speaking, we have been happy with how these views have panned out and we believe that the price action in recent months fits the picture we have drawn as a multi-month topping process.

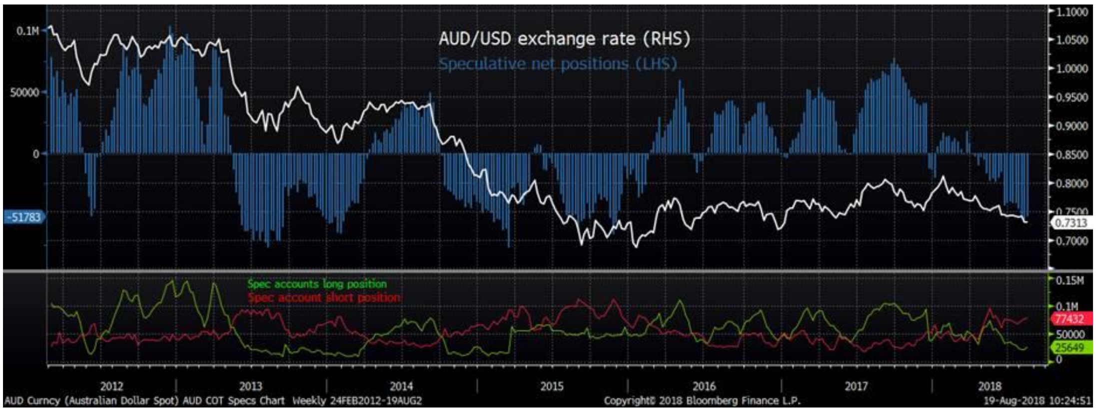
As we sit here this weekend, we have to admit that our level of conviction for the weeks ahead is suddenly rather low. We can make a bullish short term case and a bearish case. When we find ourselves in this position, we just have to accept that this dilemma can happen quite often when attempting to predict the direction of markets. The best thing to do when conviction levels are low is to risk less capital and focus on the big picture. So, we remain of the view that central banks will continue tightening policy until something breaks, and that equity markets may very well be in a multi-month topping phase. In the short term, what is holding our attention more than usual is some extreme positions held by the speculative community; something that is often seen around time of market reversals.

First, let's look at the positions of speculators in the US Government bond market. As can be seen in chart 1, speculators have been adding aggressively to their short positions recently and their net position is now the largest short position on record. Historically, this group of investors are wrong at market turning points, and we are intrigued by the current set up, wondering whether this group may again be wrong with their current bearish position. Are US 10 year notes about to move sharply higher in price (yields lower)?

Chart 1 – US 10 year Treasury Yield and Speculative Positioning

We have written a number of times about the US Dollar in recent months (either bullish or neutral), and positioning here is also becoming a bit lop-sided, with speculators holding mostly bullish Dollar positions against a number of currencies. One good example is the Australian Dollar which has been performing quite poorly and now speculators hold a substantial net short position. If something were to happen to the Dollar, or put another way, if something bullish were to be seen on the macro front, there is plenty of room for speculators to have to sell Dollars and buy back their short currency positions. Could this coincide with lower US bond yields? Quite possibly so.

Chart 2 – The Australian Dollar and Net Speculative Positioning



One more chart on positioning, this time in Gold, where speculators have been aggressively selling in recent months and now hold a net short position for the first time in about 17 years. Gold is definitely oversold now and is on many investors most hated list.

Chart 3 – Gold and Net Speculative Positioning

We'll keep this really simple here. If the Chinese Yuan reverses direction and begins to appreciate against the US Dollar, then Gold should rally quite a lot. Chart 4 below shows the very tight correlation between Gold and the Chinese offshore currency. We all know that China manages the Yuan closely, and after a significant move and at a time when tariff negotiations are being resurrected, we think that the Yuan could rally quite smartly on any positive news.

Chart 4 – Gold and the Chinese offshore currency

Although we have highlighted the above market positions, we would also add here that there has clearly been a whiff of panic in the air as Emerging Market assets have been buffeted around by several factors, not least the collapse of the Turkish Lira. But nothing moves in a straight line forever, and although we have not changed our big picture view, we do see the capacity for a rally in risk assets which would most likely coincide with a weaker Dollar.

That's the good news. The bad? Well, if global equity markets do rally in the weeks ahead, we suggest that policy makers will see this as a signal that their policies are working and so they will continue to tighten policy (until something breaks).

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