Stargazer
Asset Management

What to focus on in Global Macro for the week of December 21st, 2020

Macro Themes on the Radar:

Fed Recap

The Fed left policy unchanged at last week's meeting. The current rate of asset purchases will continue until we are back to maximum employment, AND inflation is seen to be close to 2% on a sustainable basis, using their flexible average inflation targeting framework. The most interesting points came during the Q&A session of the press conference.

In response to a question about the disconnect between equity prices and bond yields, and whether current asset valuations are a concern, Powell replied as follows:

"… With equities, it depends on whether you're looking at PEs or whether you're looking at the premium over the risk-free return. If you look at PEs, they're historically high. But in a world where the risk-free rate is going to be low for a sustained period, the equity premium, which is really the reward you get for taking equity risk, would be what you'd look at. And that's not at incredibly low levels, which would mean that they're not overpriced in that sense. Admittedly, PEs are high, but that's maybe not as relevant in a world where we think the 10-year treasury is going to be lower than it's been historically from a return perspective." Adding, *"Non-financial corporate leverage is high. We've been watching that, but rates are really low. And so companies have been able to handle their debt loads even in weak periods because rates are quite low. Your interest payments are low."*

Later, he was asked about the sustainability of the growing government debt, by Michael McKee at Bloomberg. Powell replied:

"*In terms of what is a sustainable level, I think the question is we've always looked at debt to GDP and we're very high by that measure. By some other measures, we're actually not that high. In particular, you can look at the real interest rate payments, the amount of what does it cost. And from that standpoint, if you sort of take real interest costs of the federal deficit and divide that by GDP, we're actually on a more sustainable fiscal path, if you look at it through those eyes."*

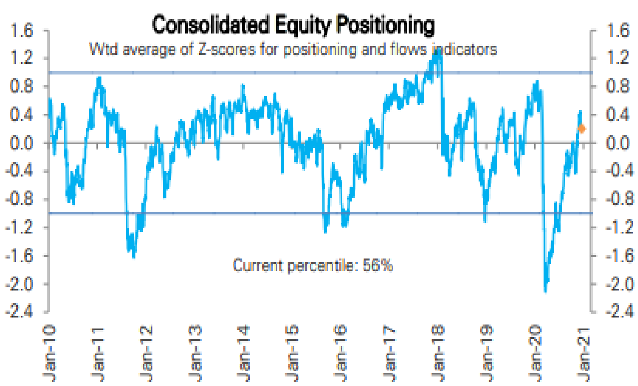
Whether regarding equity valuations, corporate debt levels or government deficit spending, his danger line was determined by the level of interest rates. My takeaway, is that the exit from the current policies is going to be very tricky indeed, and that a sudden jump in bond yields will be met with some kind of yield curve control.

What to Focus on Now:

Sentiment and Positioning

The continued COVID surge, news of a UK mutation and renewed lockdowns/restrictions, is pushing against vaccine excitement as the approval and rollout process continues. Economic data has been slowing a bit, especially in the US as unemployment claims tick up, but the market continues to look through the near-term pain. As discussed last week, positioning is getting extended again and the air is getting a little thin for valuations. High, but not "off the charts". Not all that much has changed since last week.

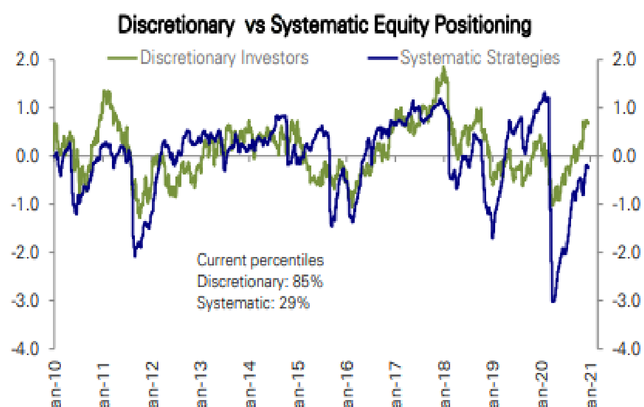
Figure 1: Consolidated equity positioning[1]



*Weights based on explanatory power in regression of equity performance on indicators

Source : EPFR, CFTC, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

Figure 2: Discretionary vs Systematic strategies divide[2]

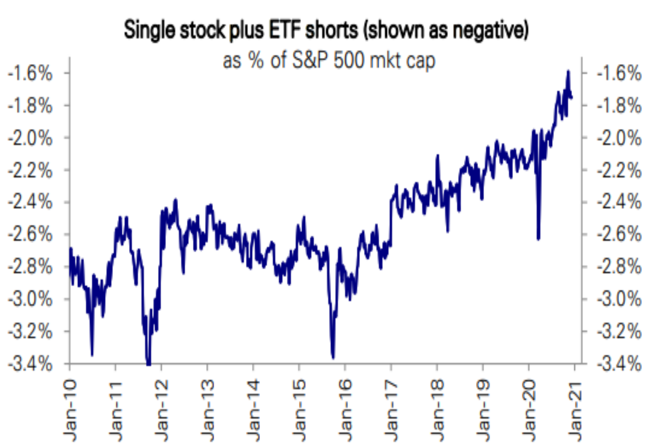


*Wtd average of Z-scores for positioning and flows indicators, weights based on explanatory power in regression of equity performance on indicators

Source : EPFR, Bloomberg Finance LP, Haver, Deutsche Bank Asset Allocation

Shorts have been punished to the point of near extinction.

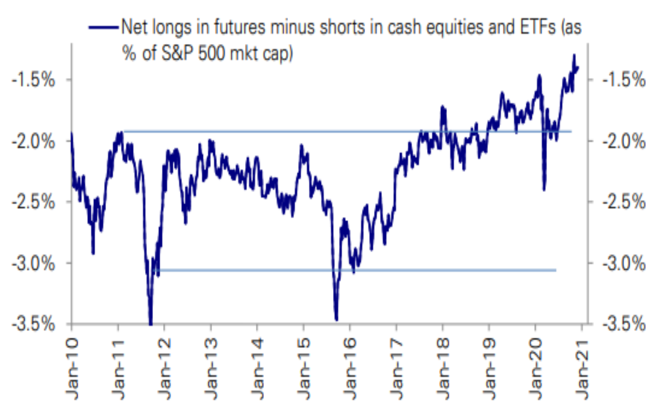
Figure 32: Cash equities plus ETFs short interest



Note: Short interest data as of Nov 30

Source : Bloomberg Finance LP, Compustat, Deutsche Bank Asset Allocation

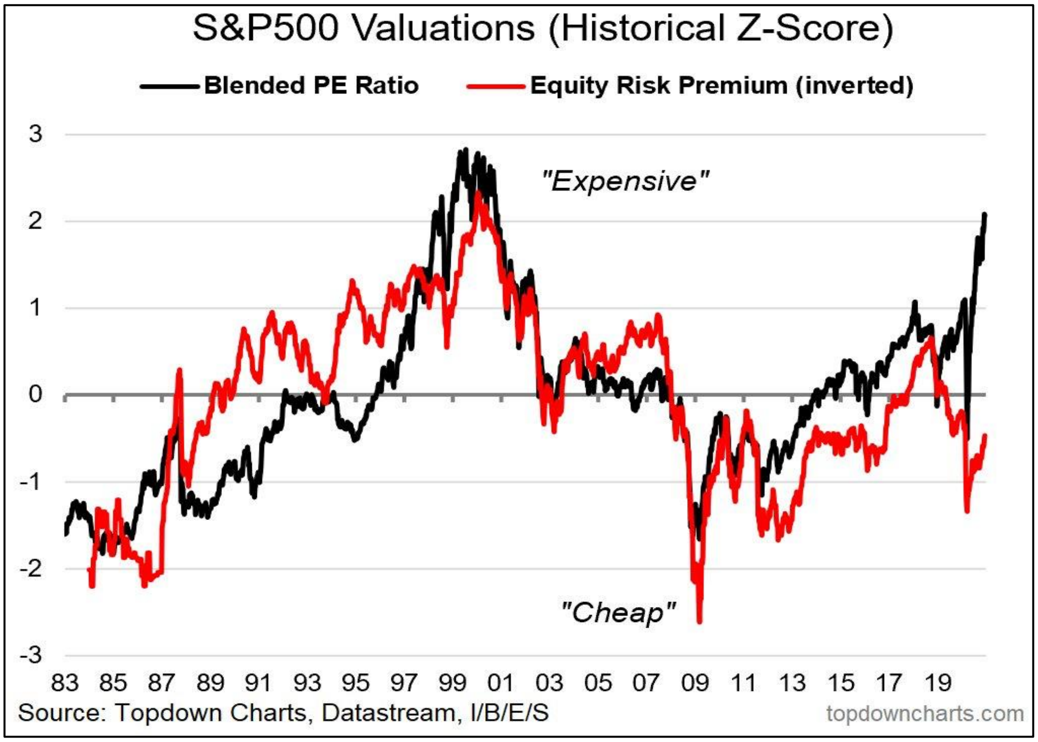
Figure 33: Net longs in futures minus shorts in cash equities and ETFs



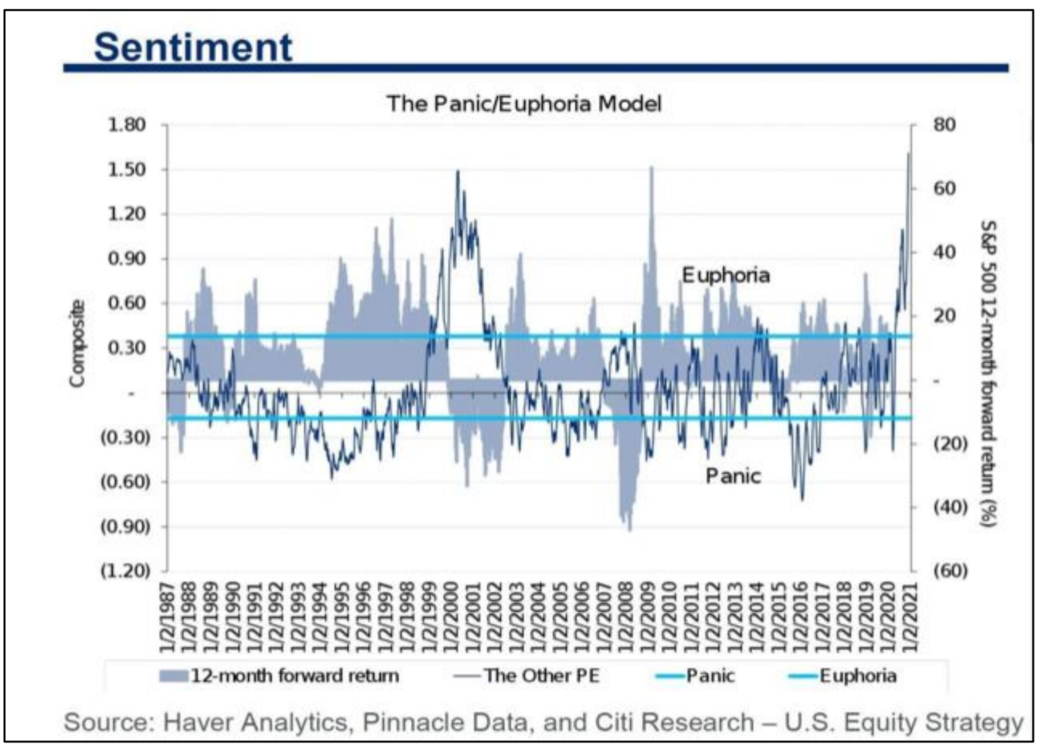
Note: Futures net longs minus single stock and ETF shorts. Shorts data as of Nov 30, S&P futures Dec 08

Source : CFTC, Bloomberg Finance LP, Compustat, Haver, Deutsche Bank Asset Allocation

Here is Powell's Equity Risk Premium. "Cheap" thanks to zero front end and suppressed long-end yields.



But sentiment remains very pumped up … as you might expect given the price action.



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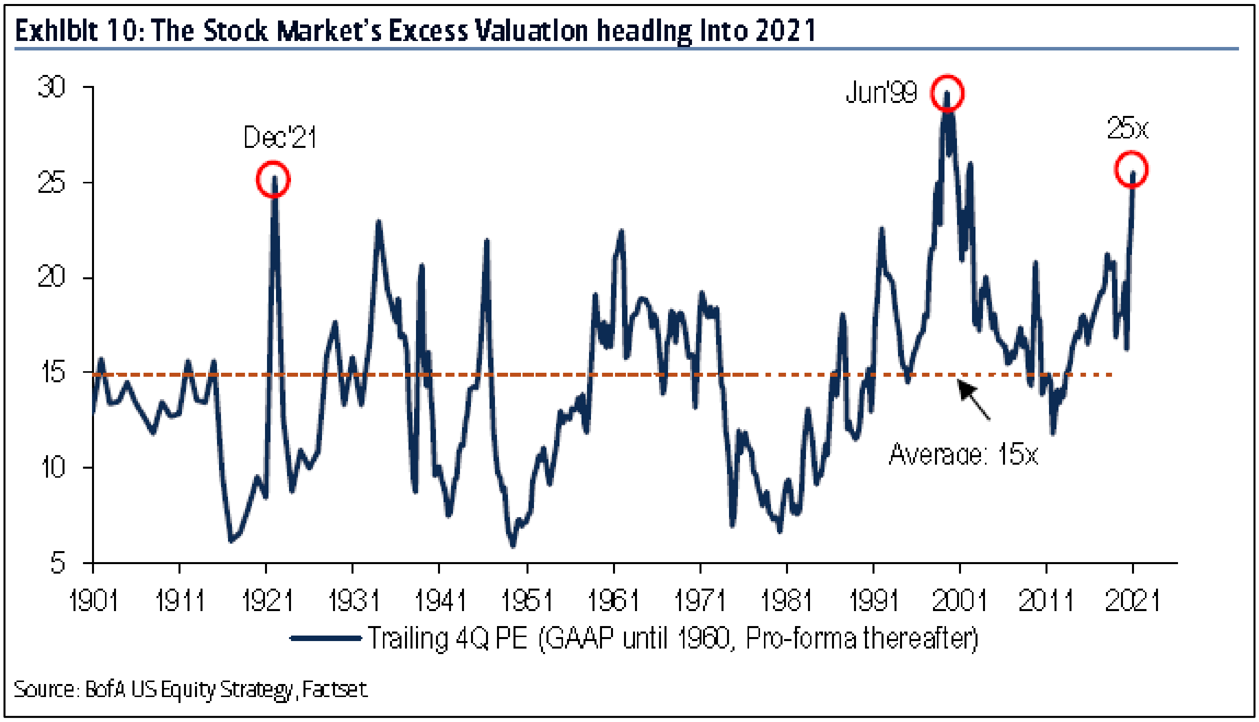
Overall, the market is getting expensive…



…but it has been hard to resist the FOMO.

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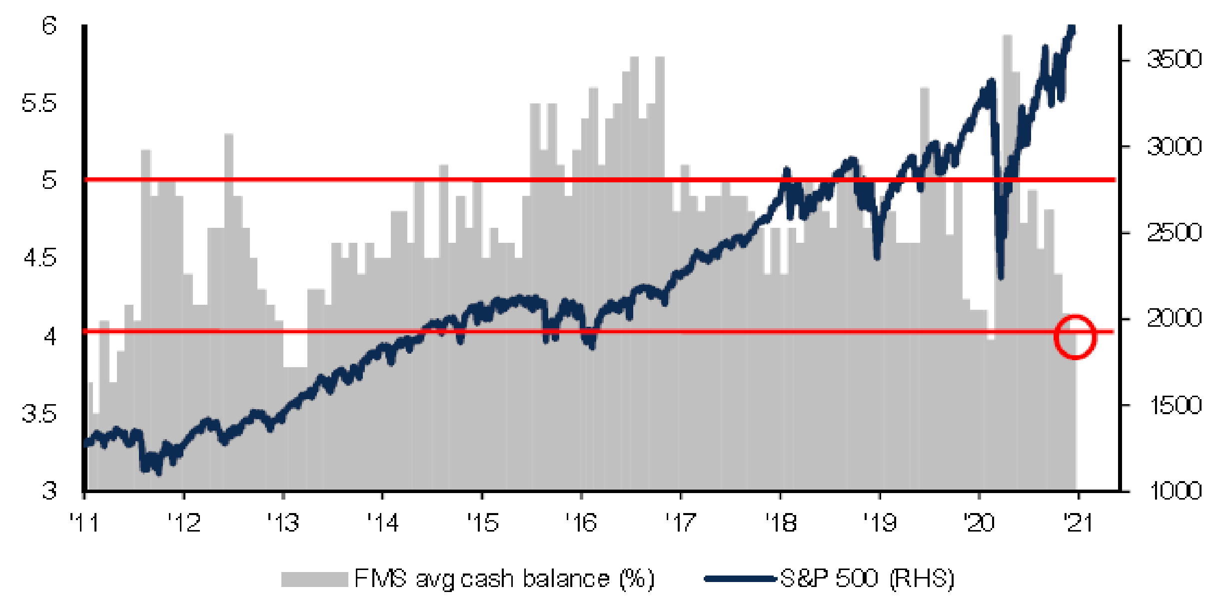
Cash levels have now round tripped to where they started in February.

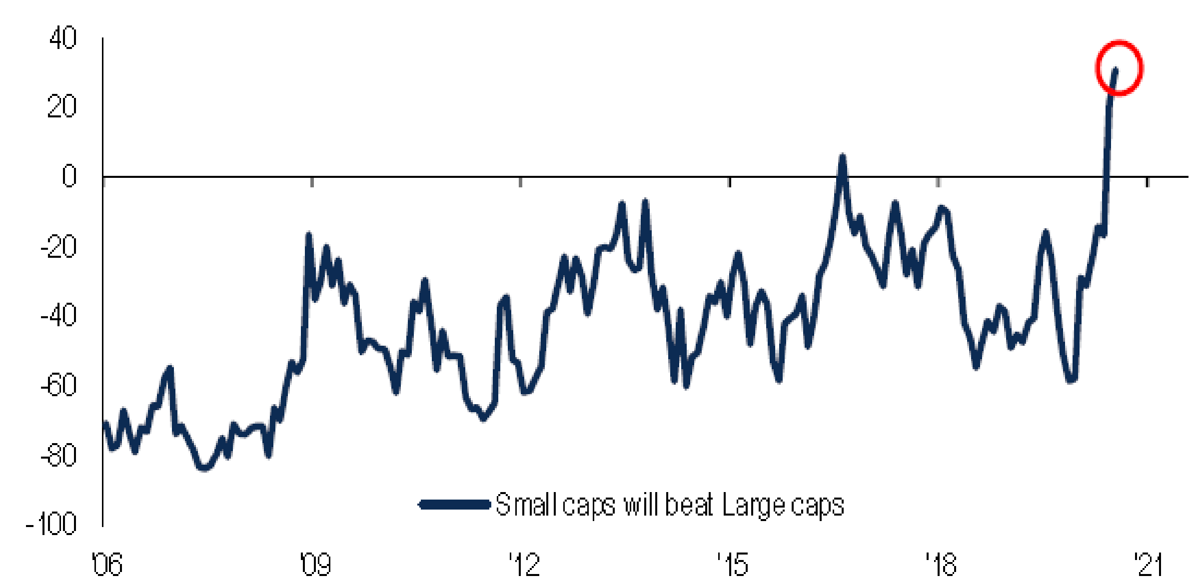
Exhibit 8: December FMS cash levels fell to 4.0%, triggering a "sell" signal



Source: BofA Global Fund Manager Survey

The big change is in where the money is now flowing…

Exhibit 21: Net % Think Small Cap will Outperform Large Caps



Source: BofA Global Fund Manager Survey

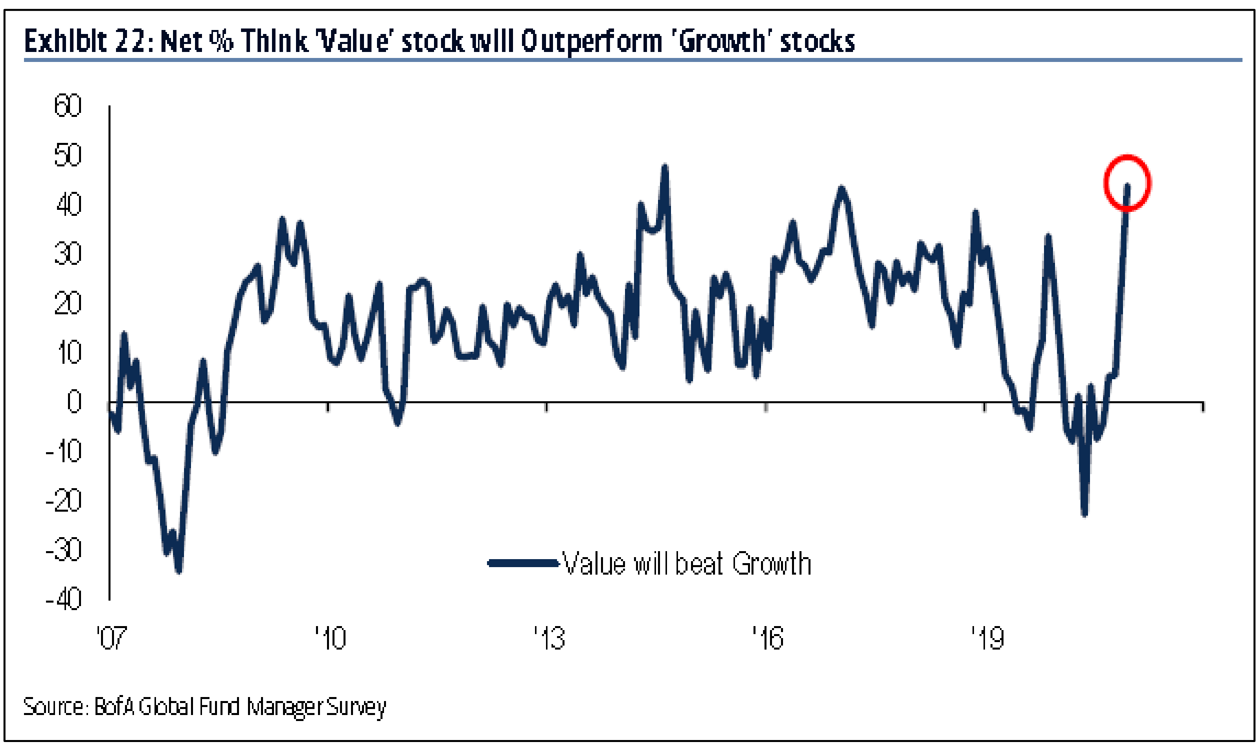
As a result, the Russell has been on fire since November, now up over 100% off the lows.

Its relative performance over the last six weeks vs. other US averages is impressive.

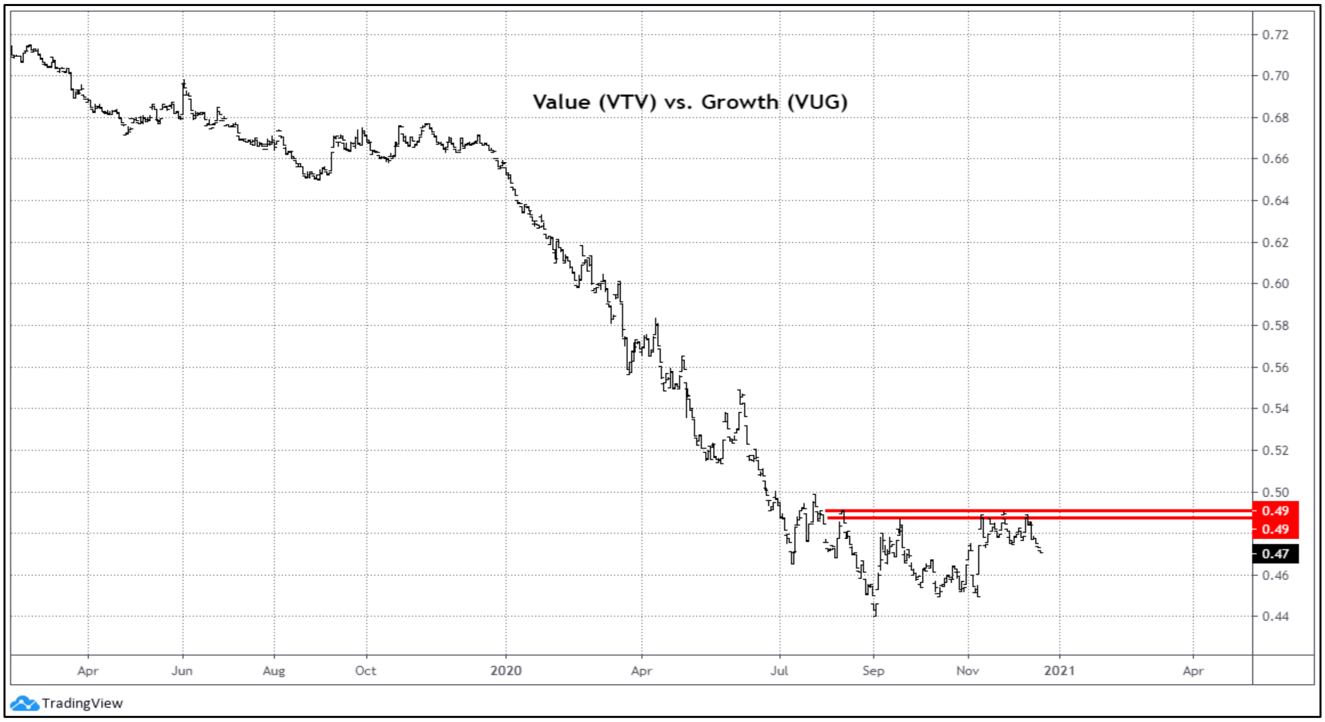
Russell 2000 vs. DJIA

... and vs. S&P

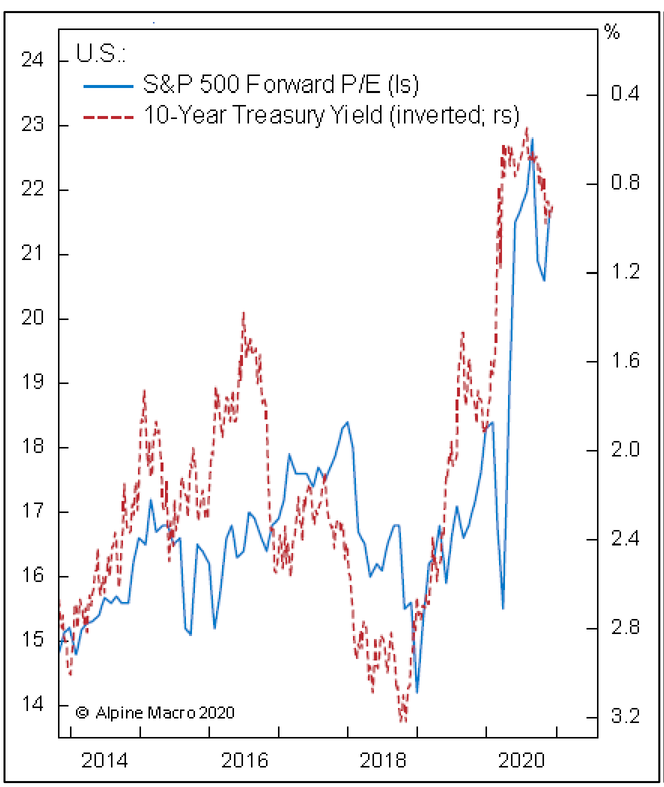
The switch from growth to value has also garnered a lot of enthusiasm.

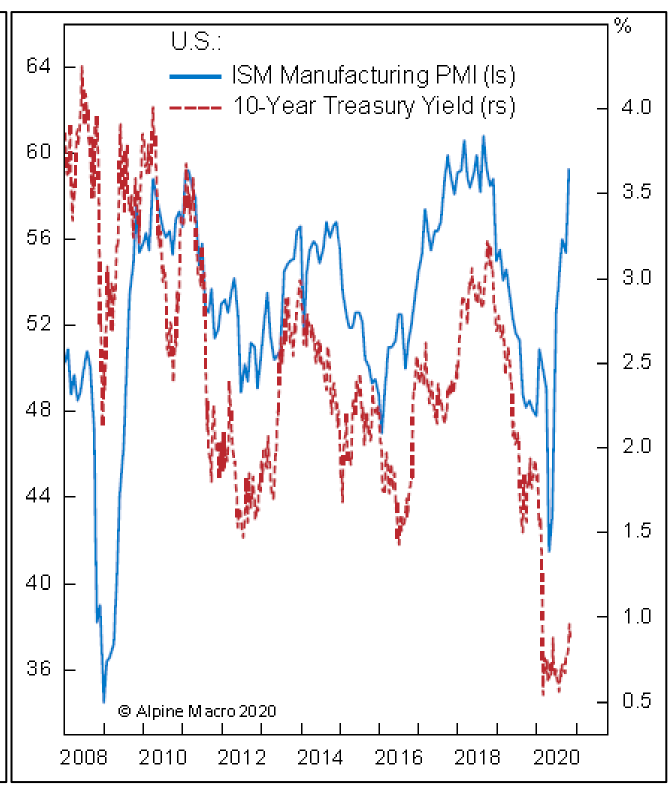


Although so far it hasn't really achieved the same kind of escape velocity. Resistance has held.



While the low bond yields have continued to support P/E's, they have not allowed some of the rotation trades to really get the support they might normally have at this point.





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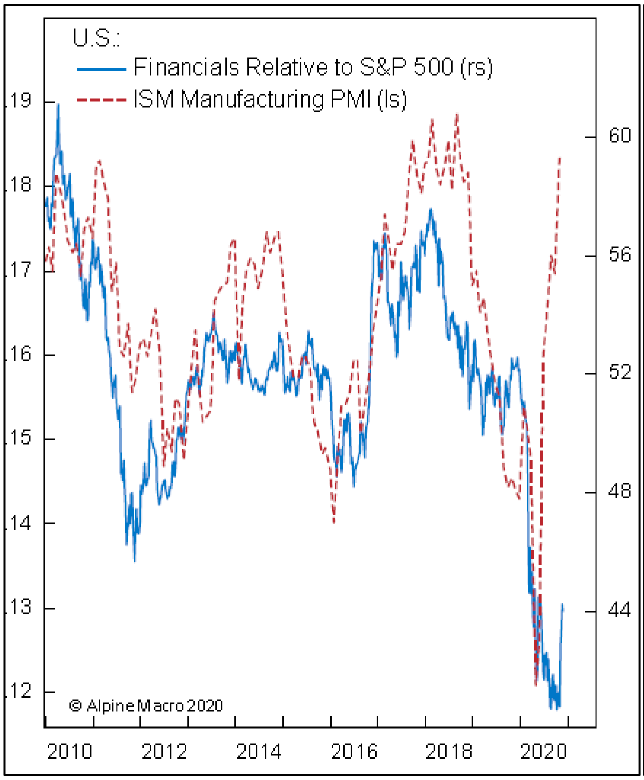
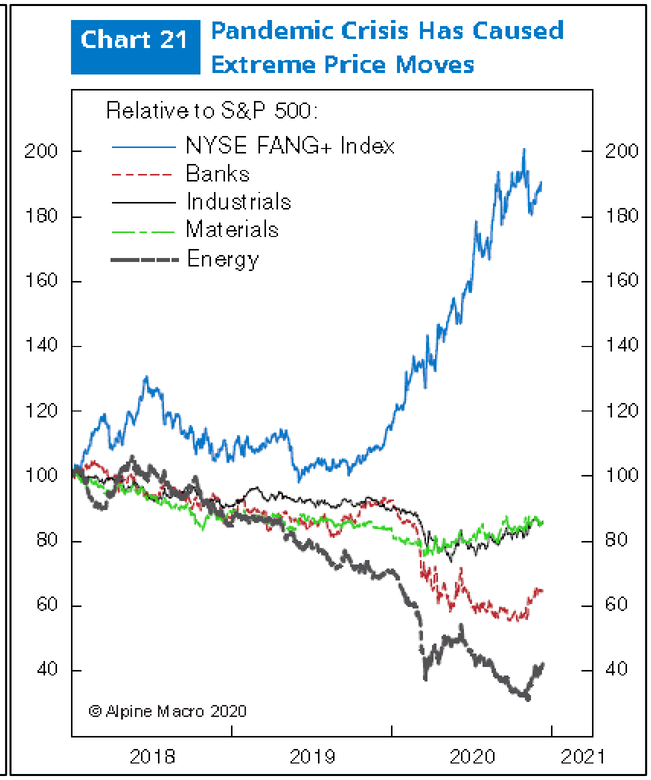
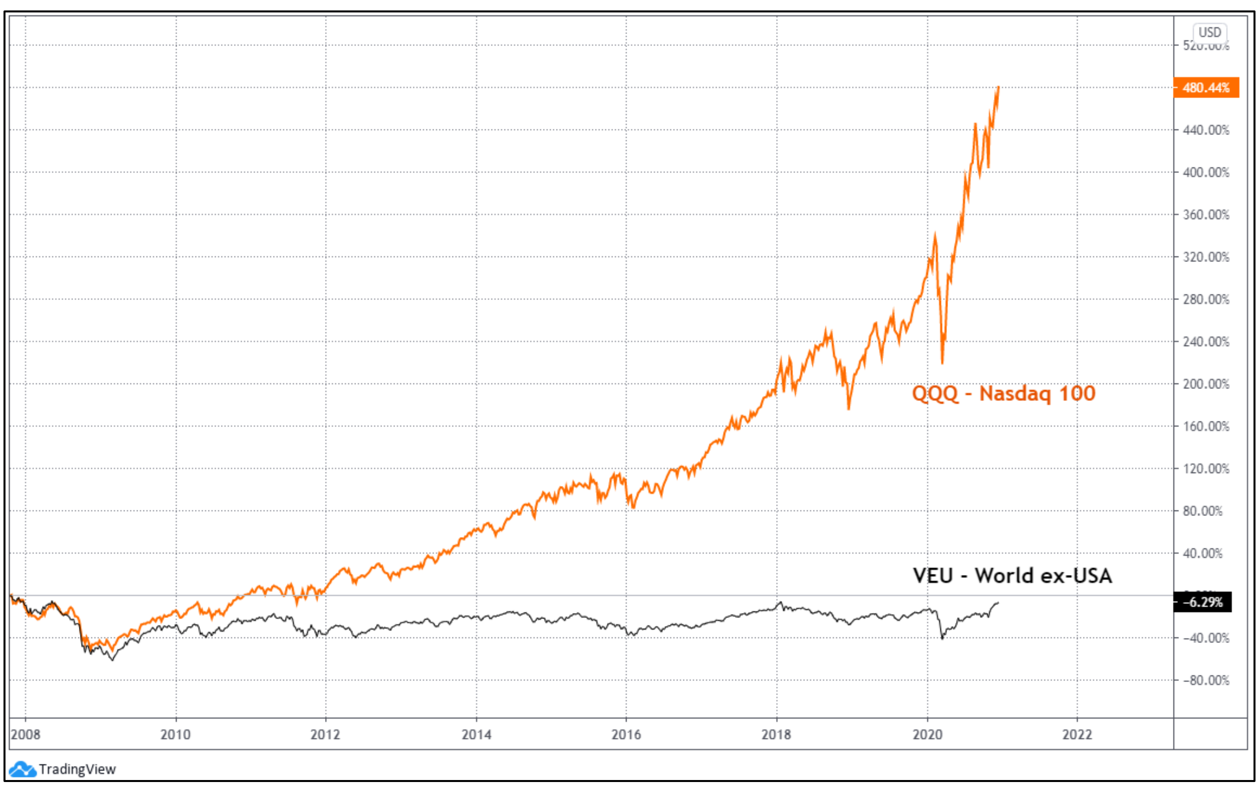
Higher yields (eventually) and reflation should bring more mean reversion.





The potential shift in value over growth has lots of room, IF we do get the reflation.



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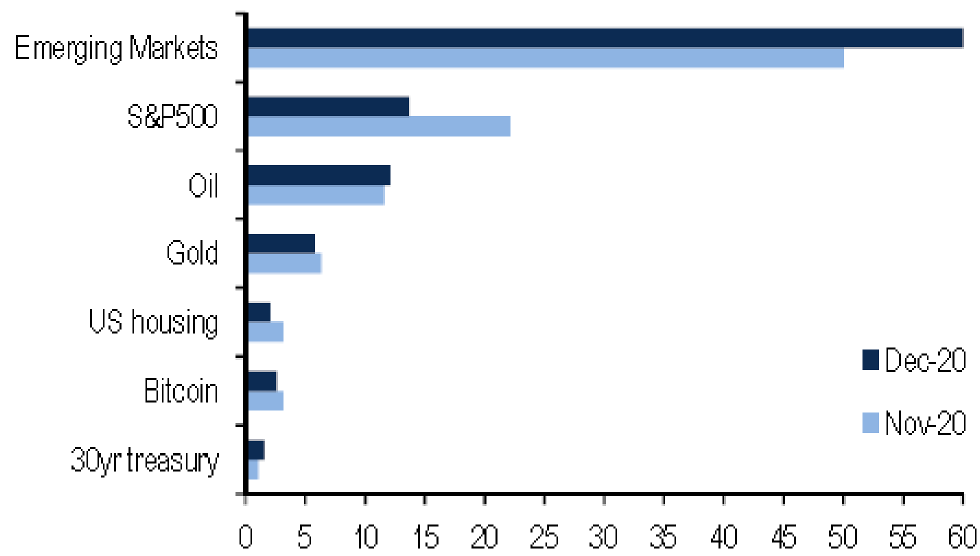
As reflation should mean a weak USD, EM provides a double allure. This hasn't escaped market participants…

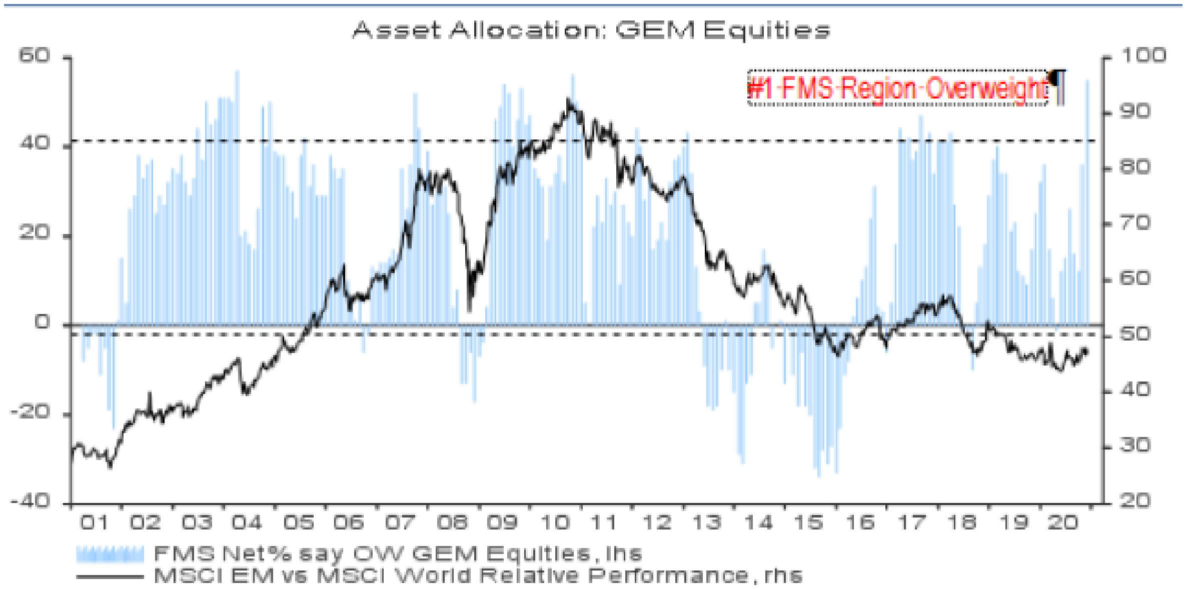
Exhibit 12: What asset class do you think will outperform in 2021?



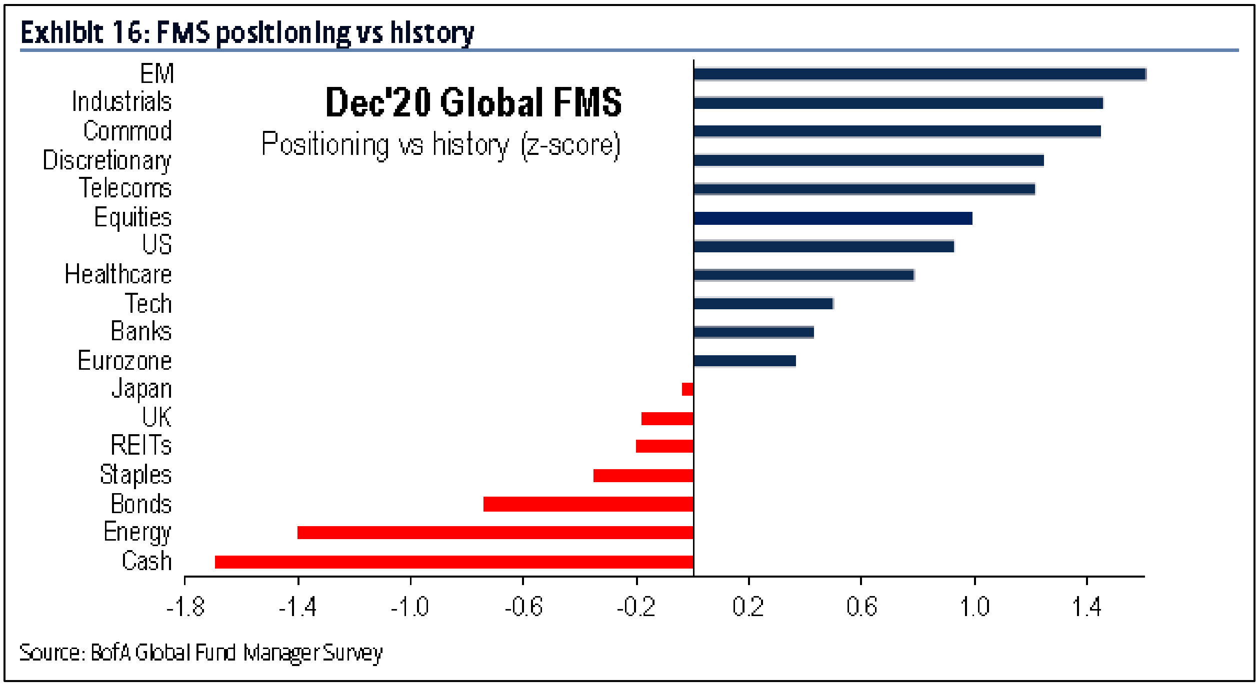
Source: BofA Global Fund Manager Survey

… and they are increasingly positioning for it.

Exhibit 44: Net % AA Say they are overweight GEM Equities



Source: BofA Global Fund Manager Survey

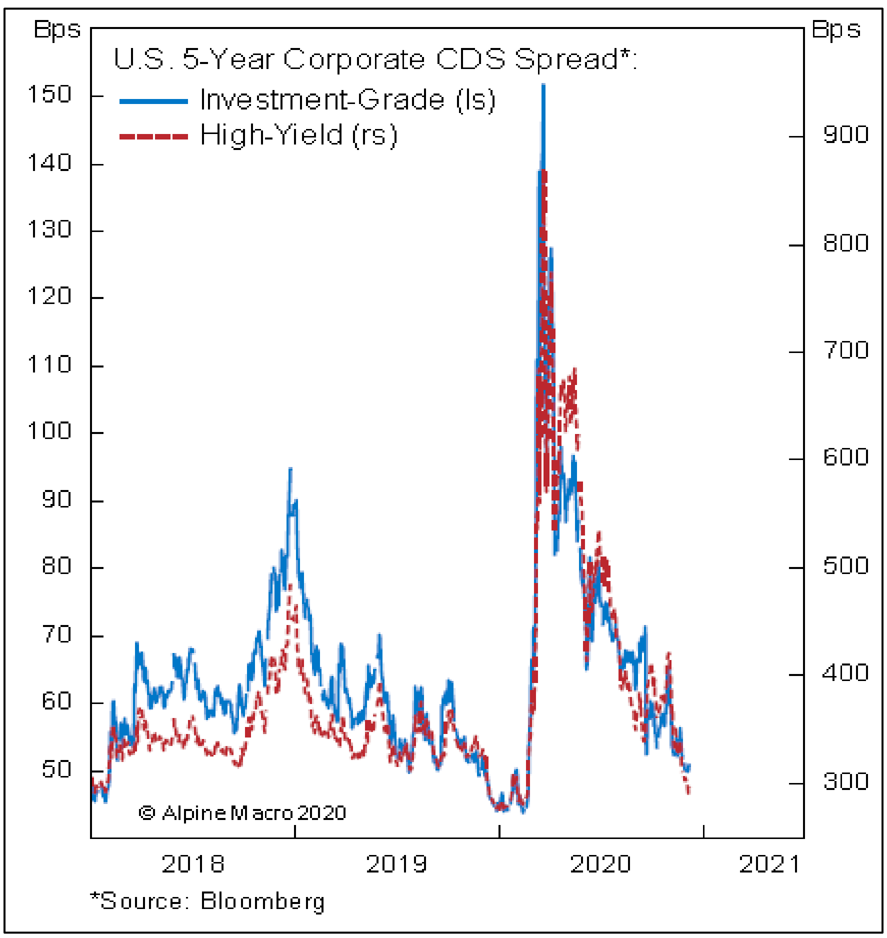


EEM (despite its weighting flaws) is performing, but IF this is a real turn for EM, it is only the start.

With positioning no longer a tailwind, and sentiment getting very stretched, I continue to look for warning signs that a meaningful pullback in equities is imminent. However, so far there is little to hang your hat on.

The increasing uniformity of views is a bit worrying and has me second guessing myself. Reflation is assumed, as are much better earnings and growth, a falling dollar, and slowly rising bond yields. With the CB's still fully engaged and more fiscal spending likely, the levers for further upside are still in place. Still, you need to be vigilant for the "tell" that something isn't going as expected. I still think that at this point, the best catalyst for continued dramatic gains next year, is a full-blown bubble. I don't discount that possibility at all. If it happens, a likely candidate could be clean energy stocks. The downside surprises could include a rapid loss of control over global long-end bond yields, a mutated virus that requires a new vaccine, or renewed Bond and USD rally which would reignite deflationary concerns. Rounding out a short list of potential downside surprises has to be a slide towards insolvency by a growing number of companies and individuals, as some of the economic damage proves too big to recover from. This last one is a big enough concern for policy makers, that the G30 has done a report, co-chared by former ECB President Draghi and former Bank of India Governor Rajan, on how to deal with a hobbled corporate sector should it become necessary.

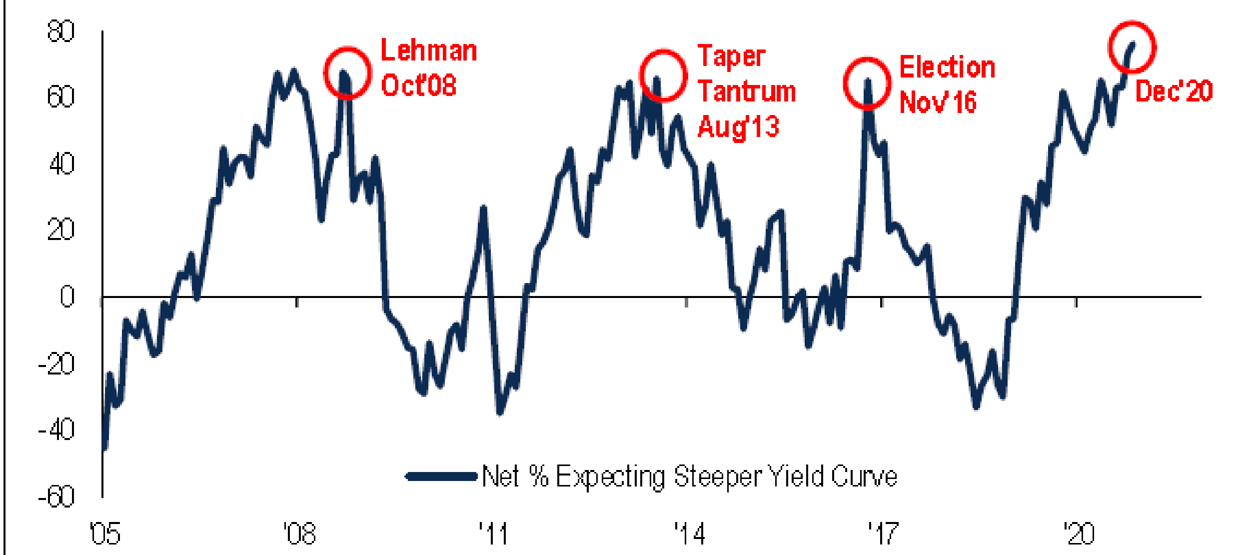
Besides the usual hedges, Alpine Macro points out that given its current low levels, CDS might be an interesting way to hedge some exposure.



Bonds

As you might expect given the reflation views in the market, long-end yields are expected to rise further despite the only slow progress recently.

Exhibit 7: Yield curve expectations continue to trend higher, new all-time high



Source: BofA Global Fund Manager Survey

Keep a close eye on an acceleration through 1.75 above, or 1.5 below, in 30 year yields.

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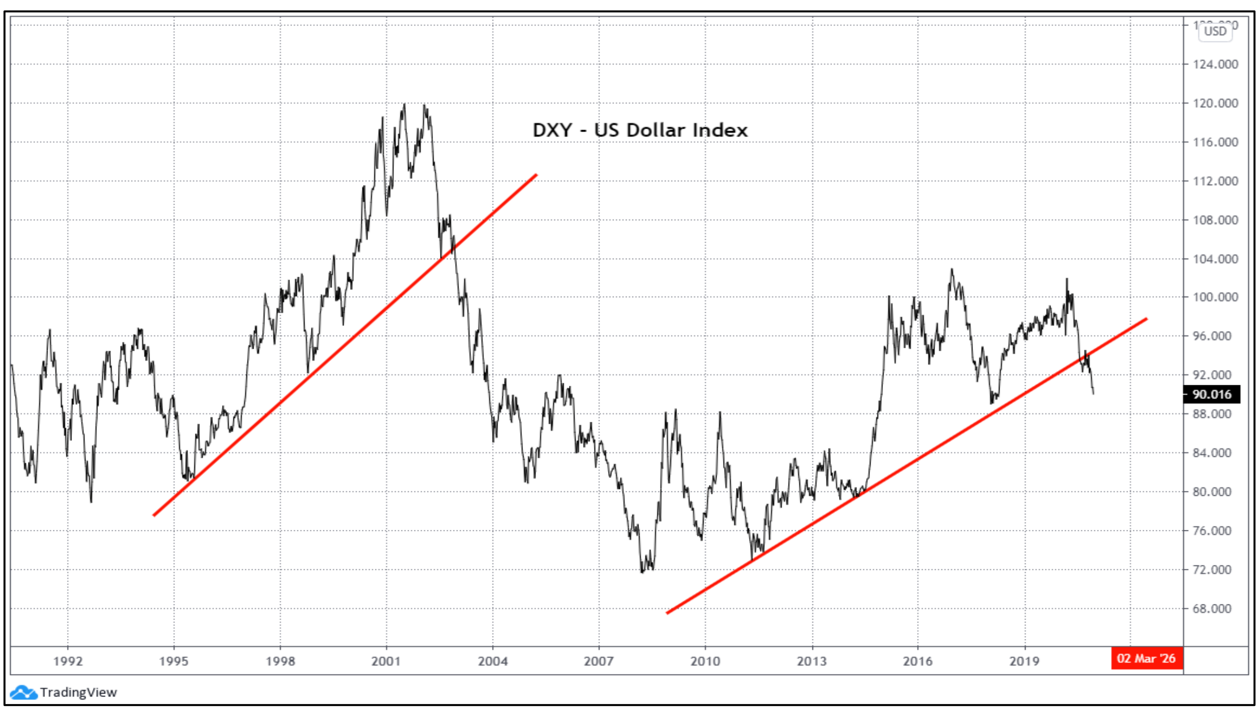
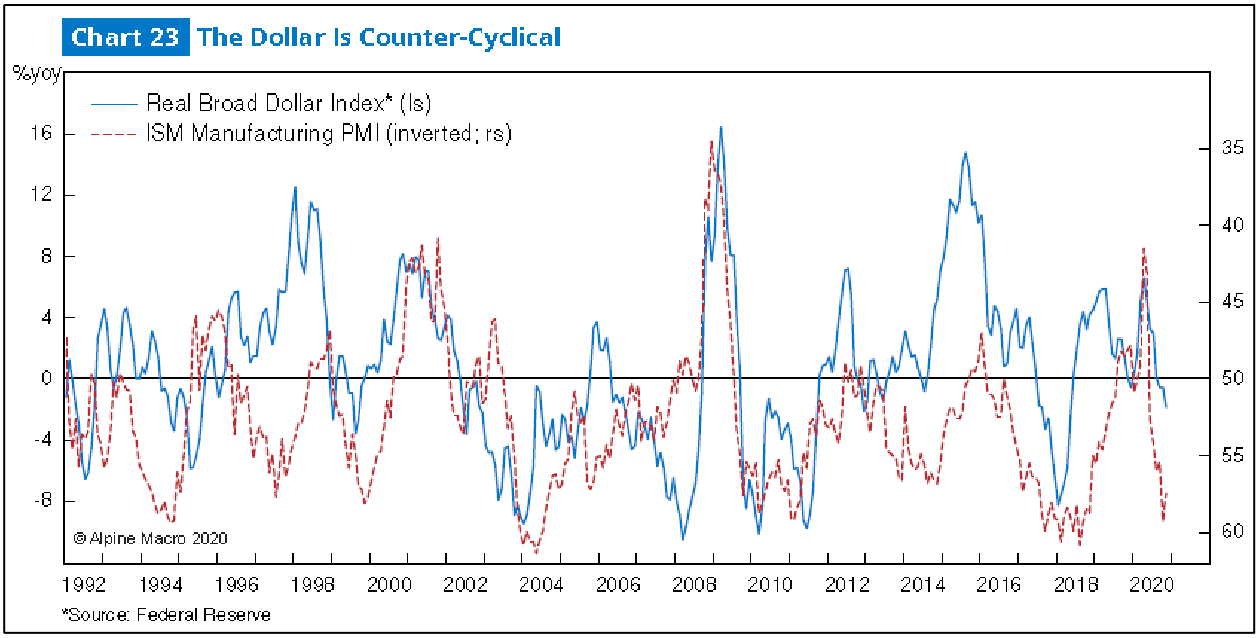
US 10-year yields have been threatening a move higher for weeks now. I would guess the recent COVID surge is keeping a lid on them. Of course, all the CB forward guidance and zero or negative front-end rates isn't hurting. However, a rapid break higher will kick off more rotation while a break lower might inflict some pain on many of the recently entered positions in equities.

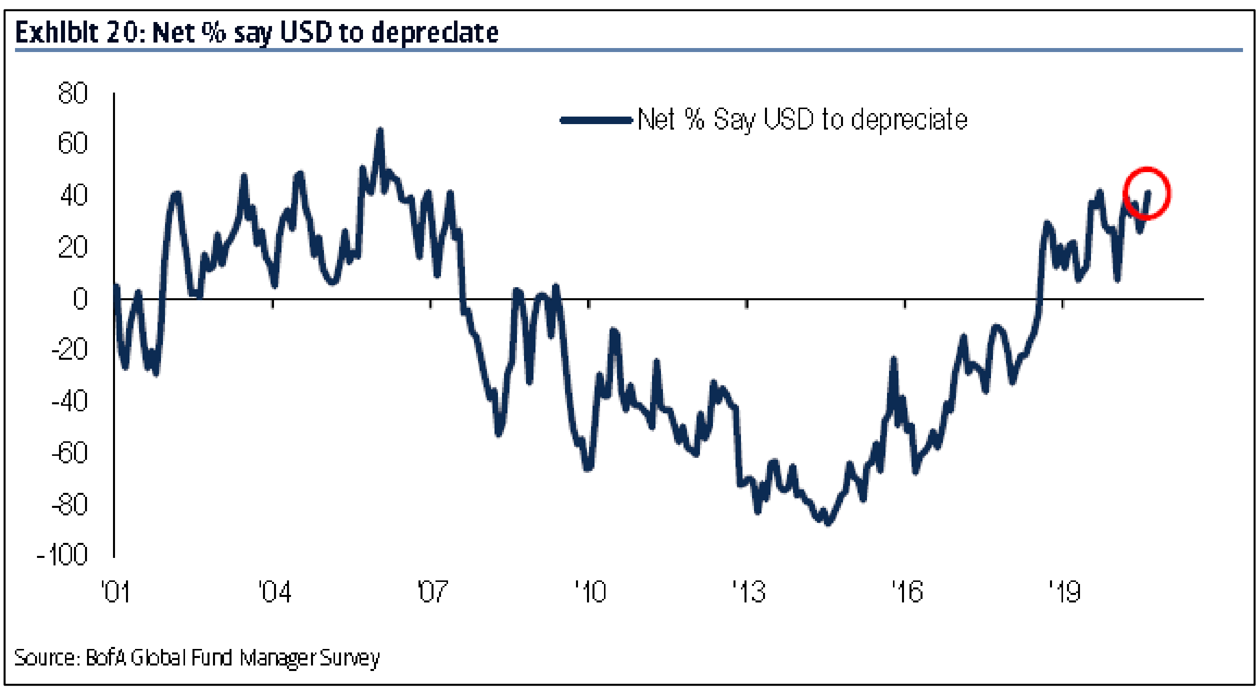
FX – The USD has seen a big break and an acceleration lower.



There is lots of talk about how it is being driven by relative CB easing and M2, etc. I see it a bit differently. While the quick relative drop in US rates has certainly helped, the reflation and global recovery trade is now the real driver. As the global reserve currency, it is the final arbiter of global liquidity and a falling USD kicks off a virtuous cycle for reflation.



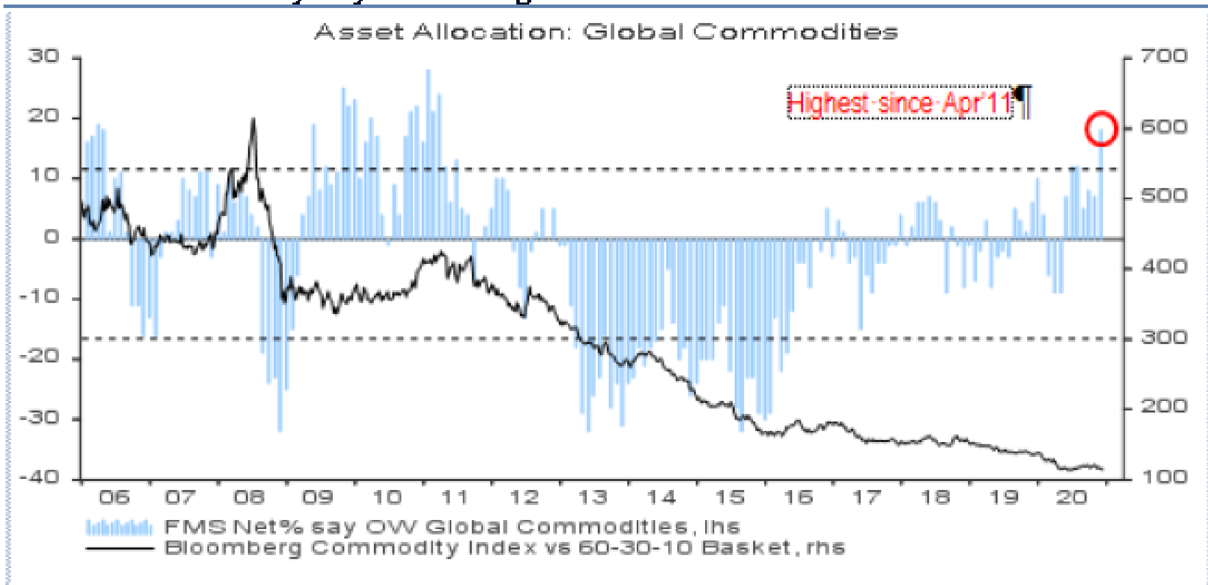
It is tempting to second guess oneself here as well, as it's obviously not the start of the move. But I would note that during the last extended bout of dollar bearishness, between early 2002 and early 2008, the DXY fell about 40%.



Commodities

If the USD trade continues, commodities should continue to perform overall. Again, the linkage to reflation and a falling USD is so obvious that flows have already been strong.

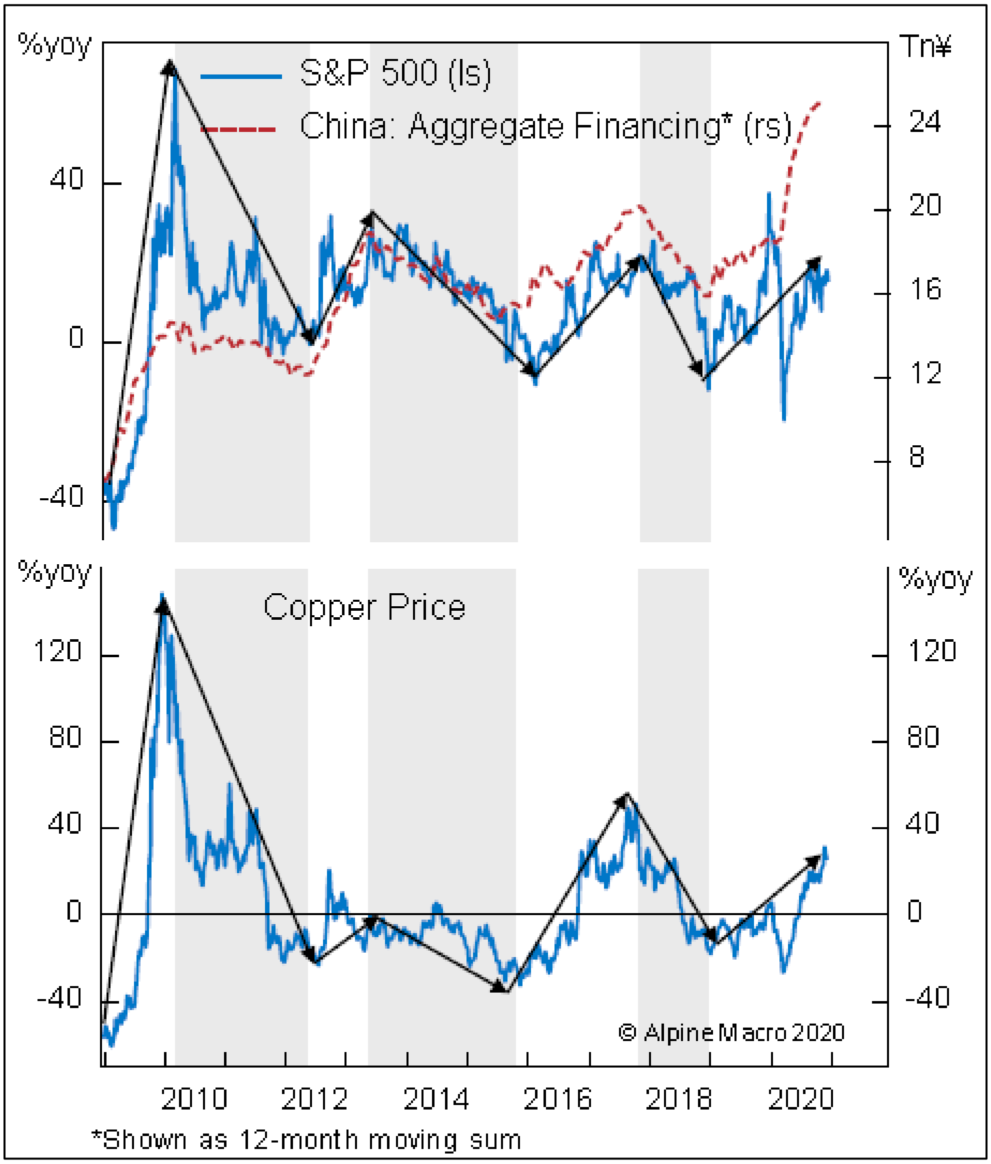
Exhibit 38: Net % AA Say they are overweight Commodities



Source: BofA Global Fund Manager Survey

At least some indices are now at big levels.

There are lots of different flavors in commodities and they all have their own story. Copper is seeing supply issues as Chinese demand has jumped and speculators see it as a recovery trade.

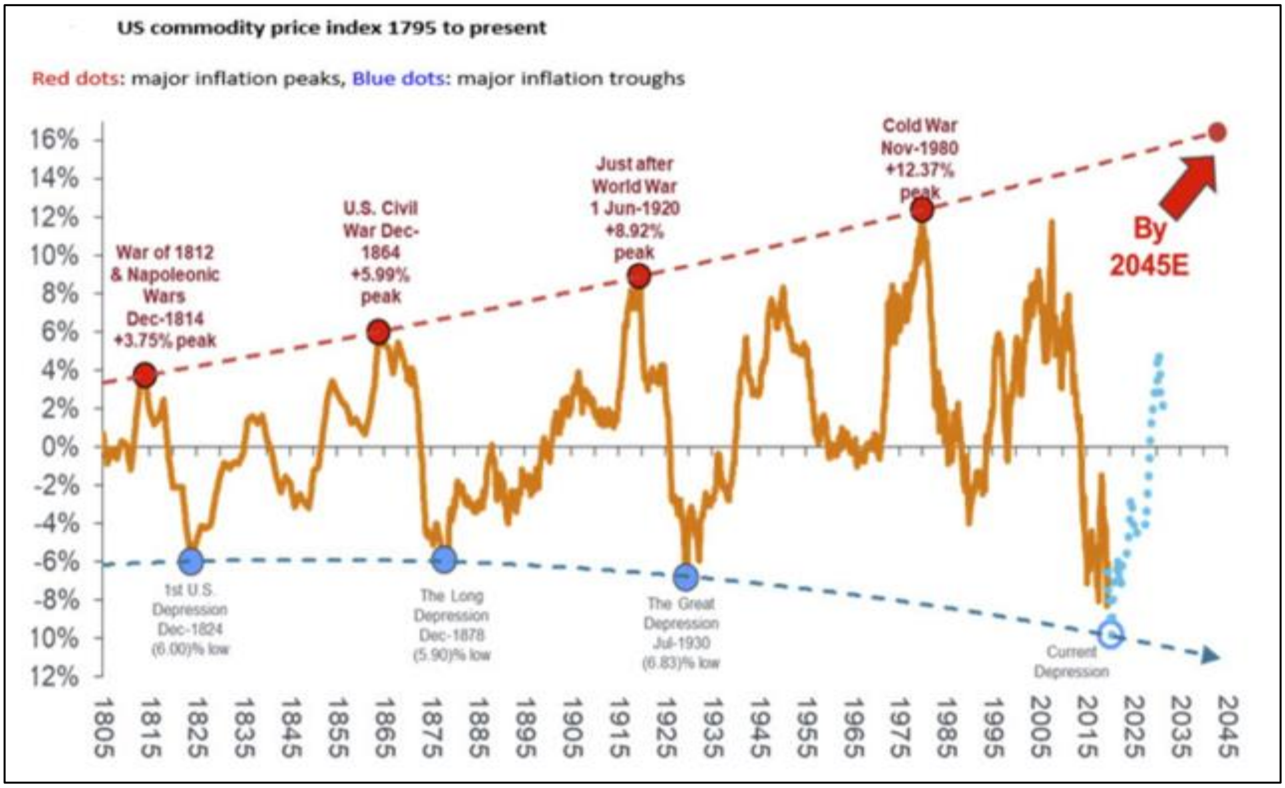


The dollar clearly plays an important role, but the individual fundamentals need to be understood.

Corn and soybeans have had big moves over the last few months, while precious metals like gold and silver went quiet.

Rather than an investment vehicle, this is an entire investment class potentially coming to life after a long winter. I'll be spending a lot more time on looking at ways to play commodities in the coming months.

Here is a long-term commodity cycle chart that is exciting, but obviously to be taken with a grain of salt. After a long Winter, Spring for commodities?



With regard to inflation, I thought this was well put:

"The Big Lie is that yesterday's and today's credit-financed promises will be honoured tomorrow in today's money....We may have already reached the point at which the rebalancing of the public finances is impossible without a resurgence in inflation, implying falling leverage ratios and lower real asset prices."

Peter Warburton
Chief Economist, Economic Perspectives

I think there is little doubt that the authorities want it, the question is are they prepared to do what it takes, or will we need another round of economic pain first?

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Given the time of year, and unless there are big new developments to look at, next week's piece will be a run through charts to keep an eye on for 2021.

Important Macro Data Releases and Events for the Week

Monday
12/21/2020

- PBoC Interest Rate Decision (Sunday night)
- Chicago Fed National Activity Index (Nov) Forecast-, Prior: 0.83
- Consumer Confidence (Dec) Forecast: -17.6, Prior: -17.6

Tuesday
12/22/2020

- Gfk Consumer Confidence Survey (Jan) Forecast: -9.5, Prior: -6.7
- PCE QoQ (Q3) Forecast: 3.7%, Prior: 3.7%
- Core PCE QoQ (Q3) Forecast: 3.5%, Prior: 3.5%
- GDP Annualized (Q3) Forecast: 33.1%, Prior: 33.1%
- BoJ Monetary Policy Meeting Minutes
- Trade Balance MoM (Nov) Forecast: -, Prior: 7,456M

Wednesday
12/23/2020

- Leading Economic Index (Oct) Forecast: 93.8, Prior: 93.8
- Core PCE -Price Index MoM (Nov) Forecast: 0.1%, Prior: 0%
- Core PCE -Price Index YoY (Nov) Forecast: 1.5%, Prior: 1.4%
- Personal Income MoM (Nov) Forecast: -0.3%, Prior: -0.7%
- Personal Spending MoM (Nov) Forecast: 0.3%, Prior: 0.5%
- Initial Jobless Claims Forecast: 900, Prior: 885k
- Initial Jobless Claims 4-week ave. Forecast: - , Prior: 812.5k
- Continuing Jobless Claims Forecast: -, Prior: 5.508m

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Michigan Consumer Sentiment Index (Dec) Forecast: 81.4, Prior: 81.4

New Home Sales MoM (Nov) Forecast: 988K, Prior: 999K

Thursday 12/24/2020	Durable Goods Orders ex Transportation (Nov) Forecast: 0.5%, Prior: 1.3%
	Durable Goods Orders ex Defense (Nov) Forecast: -, Prior: 0.2%
	Durable Goods Orders (Nov) Forecast: 0.6%, Prior:1.3%
	Nondefense Capital Goods Orders ex Aircraft (Nov) Forecast: -, Prior: 0.7%
	Christmas Day Holiday
Friday 12/25/2020	Christmas Holiday / Boxing Day Holiday

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