What to focus on in Global Macro for the week of January 20th, 2020

Macro Themes on the Radar:

On Wednesday, Dallas Fed President Robert Kaplan spoke at the Economic Club of New York. During his prepared remarks he addressed the recent growth in the Fed's balance sheet meant to alleviate the short-term liquidity issues and repo market concerns.

"I do think the growth in the balance sheet is having some impact on the financial markets and on the valuation of risk assets…I want to be cognizant of not adding more fuel that could help create further excesses and imbalances."

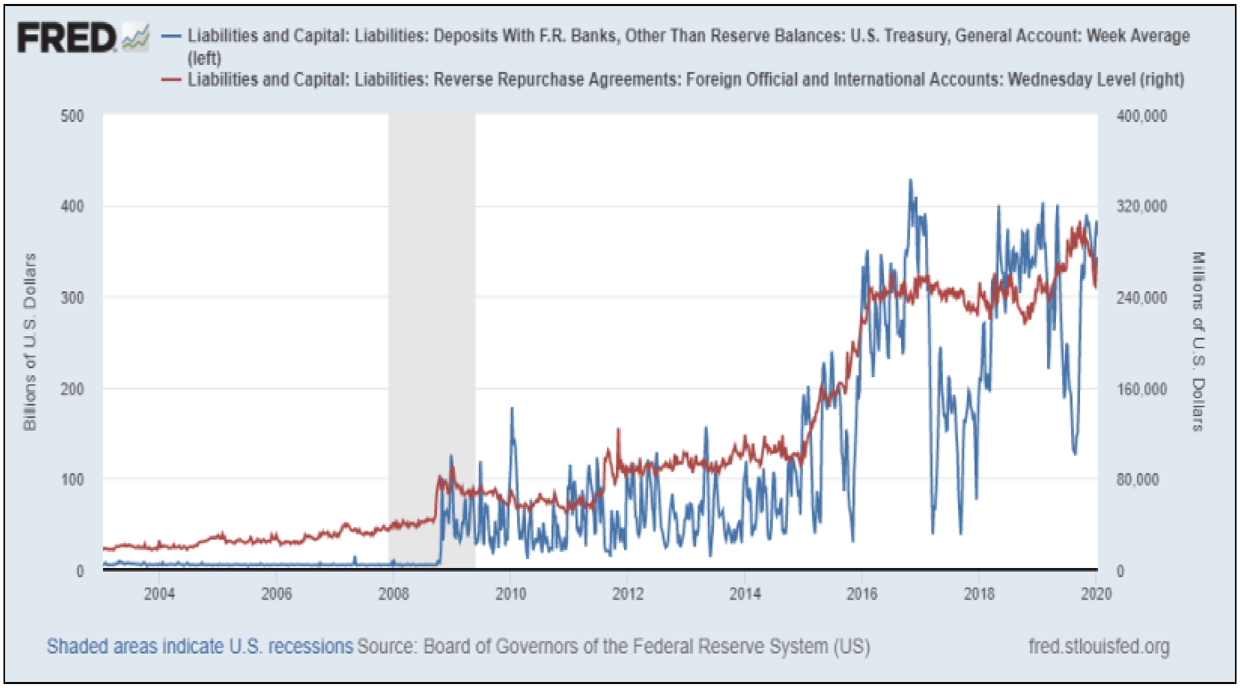
Speaking to reporters after the speech, he indicated that he was *"sympathetic to the concern"* that *"many market participants believed that growth in the Fed balance sheet is supportive of higher valuations and risk assets."* Adding, *"I think it's wise to acknowledge it and be cognizant of that concern as we think about our next actions."*

Clearly, the effects of "Not QE", as market participants are cynically calling it, is top of the mind for some Fed officials. Despite the Fed repeatedly saying this isn't QE, the market doesn't believe them.

What the market believes, is critically important here as that has always been the main channel by which QE works. The market's confidence that balance sheet growth is reflationary for both the economy and financial assets is key. The Fed claims QE works via the Portfolio Rebalance Channel, by which the removal from the market of a portion of low risk assets forces participants to move further out the risk curve. According to the Fed, the current balance sheet add is not QE, because its purpose is just to calm the repo and short-term liquidity markets, rather than provide economic stimulus by buying paper with duration. The market however seems to believe that a larger balance sheet has a mechanical effect on risk taking in general, and the equity market in particular.

At the moment the Fed has been forced to keep adding liquidity via repo and T-bills because at least for now, the situation still demands it. The Fed is stuck, like it or not. In the meantime, the structural and regulatory changes that have contributed to the higher minimum bar for excess reserves are unlikely to go away anytime soon.

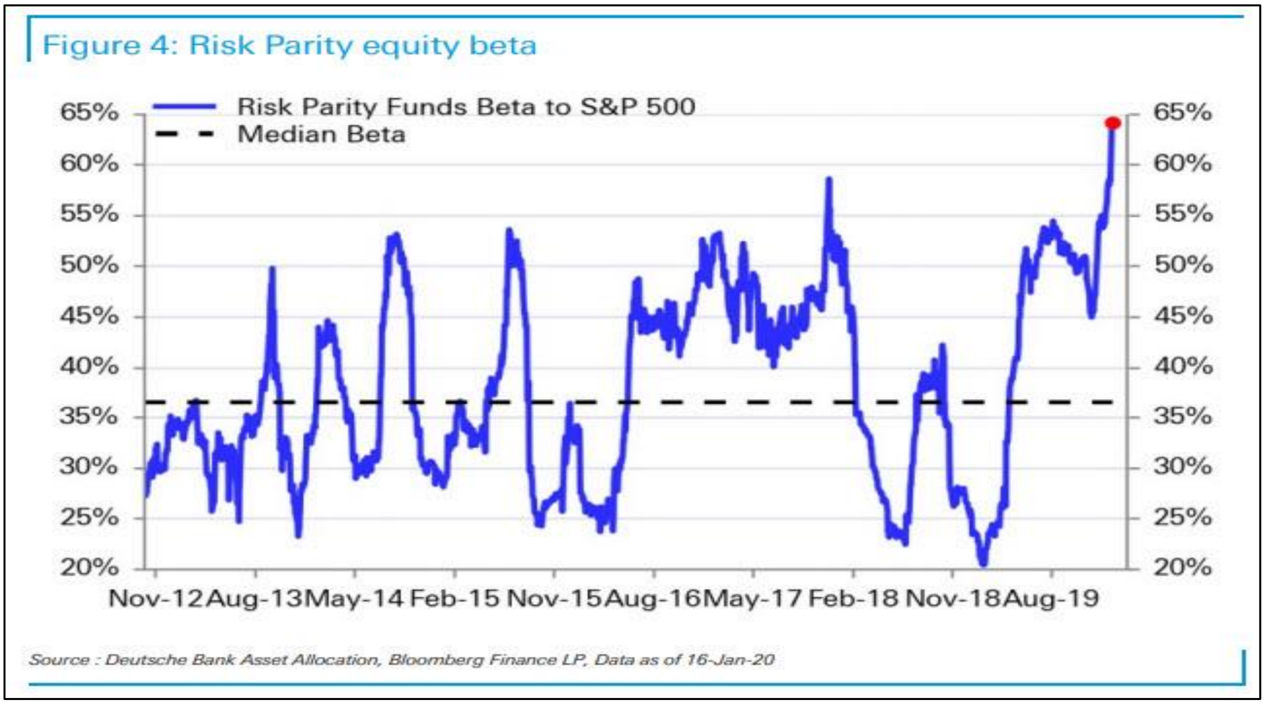
Here are two factors potentially contributing to the problem. Before the GFC the Treasury had accounts with various large Banks, post new regulations however the Treasury now banks with the Fed via the Treasury General Account. In addition, the repo facility for foreign USD liquidity provision is being utilized much more than it had been prior to 2008. As you can see, this has caused more centralization and funding demands that can be volatile.



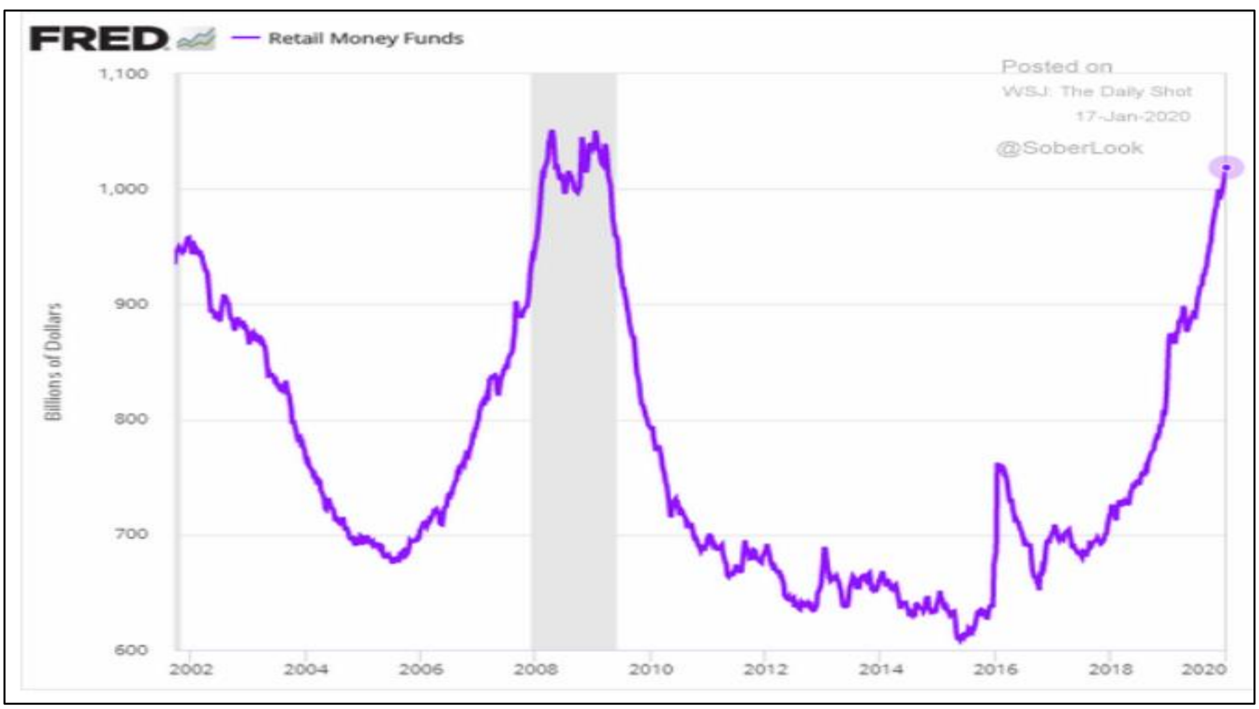
The Fed is starting to worry that they are goosing stocks. Investors have seen QE before and feel they know the playbook. At this point it is QE because people think it is. It will be very important for the market to see if, and how, the Fed tries to regain control of the narrative.

What to Focus on Now:

Stocks have been on fire, and hedge fund, CTA and Institutional exposure has been forced back in. For risk parity strategies, equities have been the driver of returns as bonds remain rangebound.



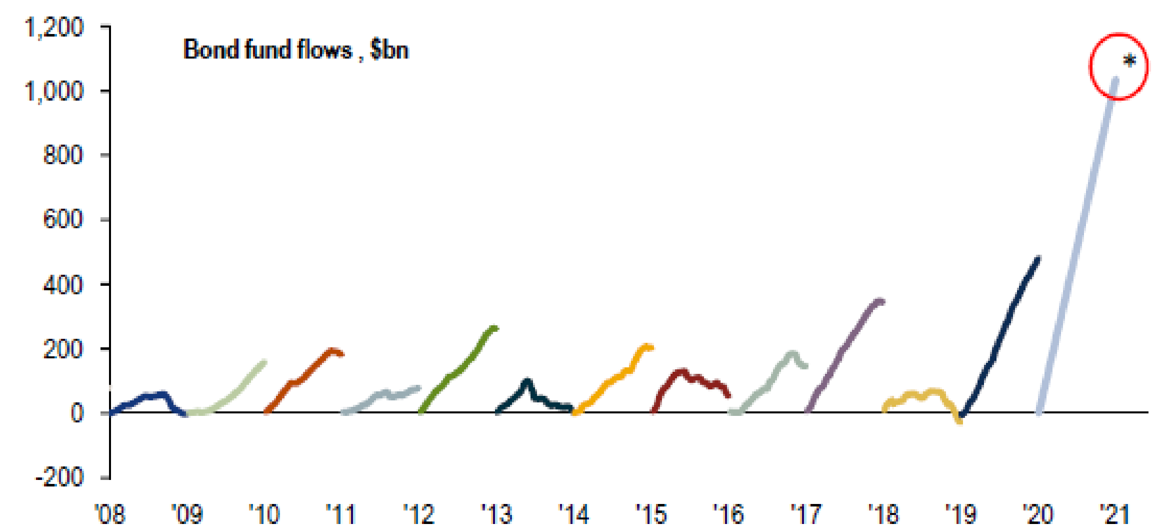
Retail however has been much more reluctant. Lots of people are making comparisons to the runup in the late 1990's, but the exuberance is missing. The big question is, will retail be forced back in as well? So far, they seem to prefer money markets and bonds.



The previous week saw record inflows into bonds. This past week accounted for another $16.6bn according to BoA/ML, for a total of $40bn over the last two weeks.

Annualized, that would come to a breath taking $1tn.

Chart 2: Bond fund flows annualizing $1tn past 2 weeks



Source: BofA Global Investment Strategy, EPFR Global. *2020 annualized

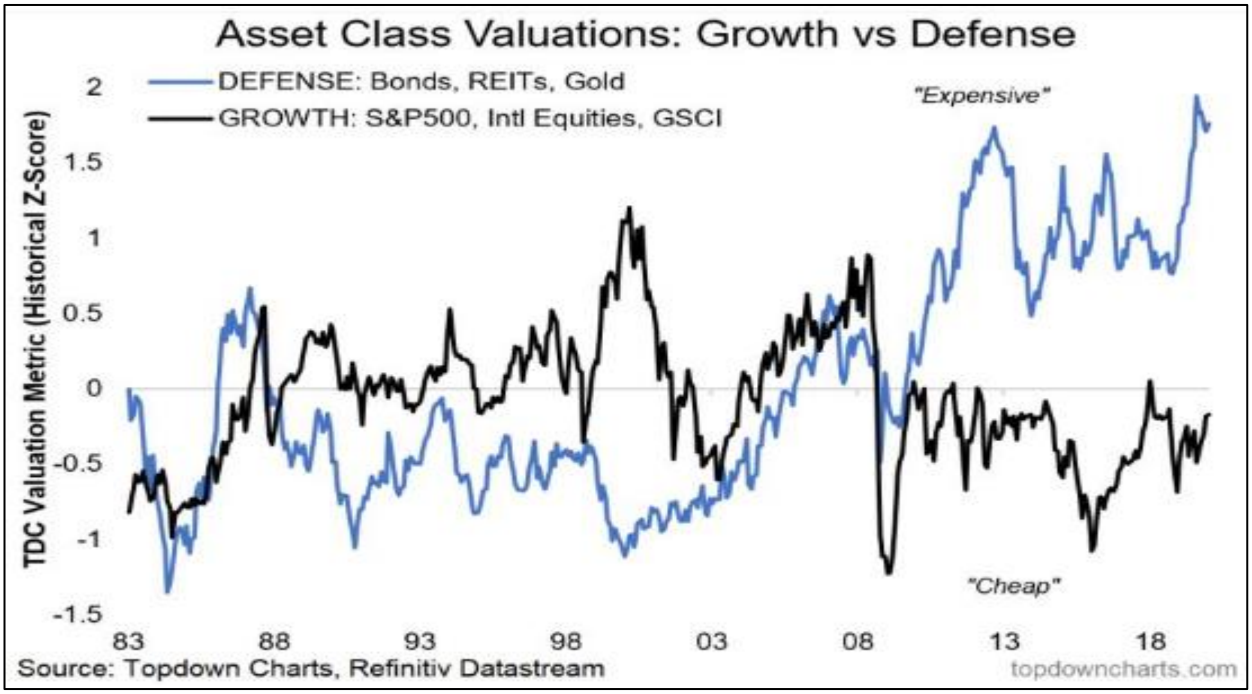
Net flows into equities have been relatively tame by comparison.

Table 1: Global asset class flows, $mn

	Wk % AUM	YTD	YTD %AUM
Equities	0.1%	12,014	0.1%
ETFs	0.2%	23,714	0.6%
LO	0.0%	-11,695	-0.2%
Bonds	0.3%	39,845	0.7%
Commodities	0.5%	1,367	0.7%
Money-market	-0.5%	23,566	0.5%

* week of 1/15/2020: Source: BofA Global Investment Strategy, EPFR Global

Overall, the valuations for defensive instruments remain relatively expensive from a historical perspective.

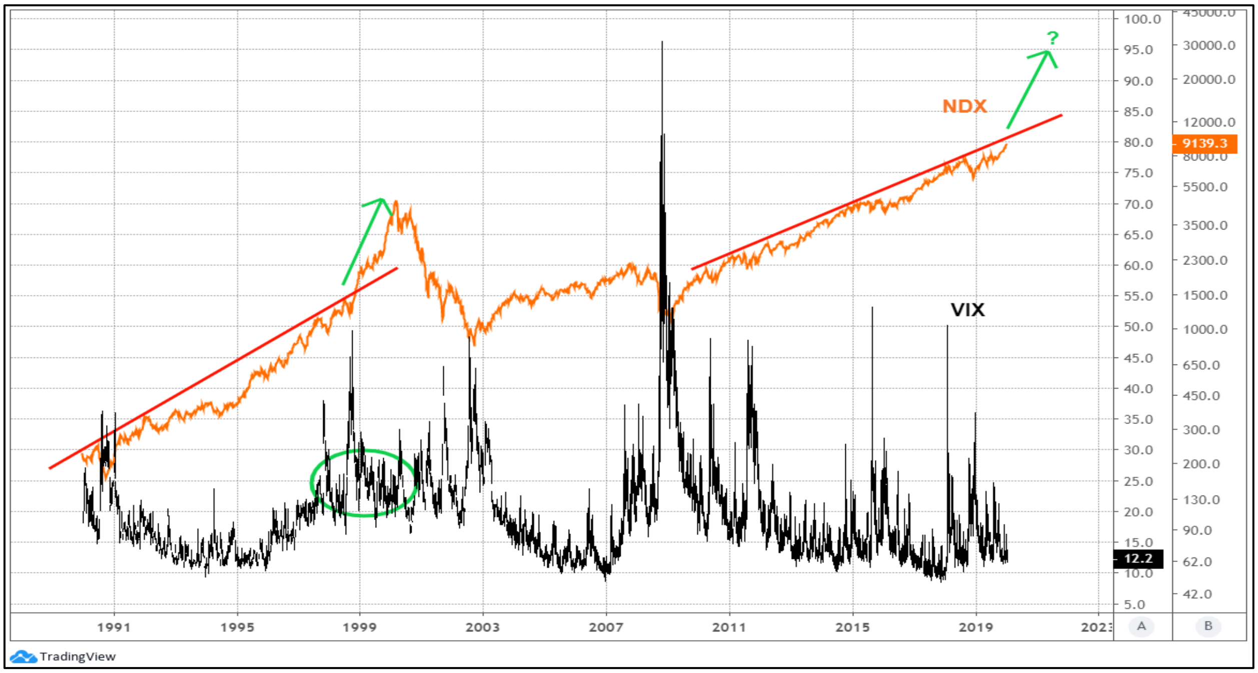


On Friday there was an interesting flow into February 19th VIX 22 calls.

Strike	Calls							
	Ticker	Bid	Ask	Last	IVM	Volm	OInt	sDM
19	19-Feb-20 (32d); CSize 100; R 1.66; UXG0 14.93							
11.5	1) VIX 2/19/20 C11.5	3.40y	3.60y	3.61y	60.71	7	100	.935
12.0	2) VIX 2/19/20 C12	3.00y	3.10y	3.00y	59.91	305	1887	.903
12.5	3) VIX 2/19/20 C12.5	2.60y	2.70y	2.65y	62.00	386	4429	.851
13.0	4) VIX 2/19/20 C13	2.30y	2.40y	2.35y	68.73	1216	5638	.779
13.5	5) VIX 2/19/20 C13.5	2.00y	2.10y	2.07y	71.44	417	731	.717
14.0	6) VIX 2/19/20 C14	1.75y	1.85y	1.75y	74.73	4148	19888	.654
14.5	7) VIX 2/19/20 C14.5	1.60y	1.65y	1.60y	80.13	5745	764	.594
15.0	8) VIX 2/19/20 C15	1.40y	1.50y	1.50y	84.30	14740	30447	.539
16.0	9) VIX 2/19/20 C16	1.15y	1.20y	1.15y	90.14	6834	45276	.450
17.0	10) VIX 2/19/20 C17	.95y	1.05y	1.00y	97.90	32078	20650	.382
18.0	11) VIX 2/19/20 C18	.80y	.85y	.85y	102.33	8502	49258	.323
19.0	12) VIX 2/19/20 C19	.65y	.75y	.70y	107.19	12912	39182	.277
20.0	13) VIX 2/19/20 C20	.55y	.65y	.60y	111.60	18834	100647	.239
21.0	14) VIX 2/19/20 C21	.50y	.55y	.50y	116.14	18569	81359	.209
22.0	15) VIX 2/19/20 C22	.45y	.50y	.50y	120.60	190902	174852	.188
23.0	16) VIX 2/19/20 C23	.35y	.45y	.45y	123.14	771	54654	.161
24.0	17) VIX 2/19/20 C24	.35y	.40y	.40y	128.48	11888	115969	.148
25.0	18) VIX 2/19/20 C25	.30y	.35y	.32y	130.56	14424	140088	.130
26.0	19) VIX 2/19/20 C26	.25y	.35y	.30y	134.45	3233	41456	.119

I obviously don't know what is behind this trade. Is it a speculative trade or a hedge for an existing position? With many participants calling for a continued melt-up, and others looking for an impending correction, perhaps this is seen as a way to play both sides?

Remember that during the '99 melt-up in the NASDAQ we had increasingly large daily ranges and the VIX averaged in the mid-twenties rather than the 12 we see today.



Should the market instead get hit by a near-term correction, the VIX hedge would have obvious benefits.

USD

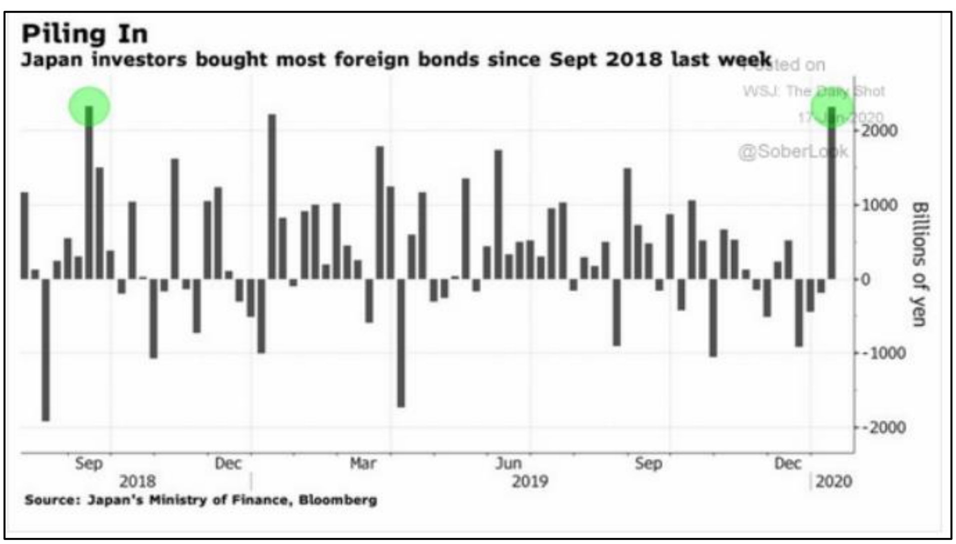
The dollar continues to hold up vs. other developed market currencies. The fact that many of them have negative rates is clearly a factor.

EM has been doing better as capital has been flowing into debt and equity funds. Higher yields and relative value have been drawing in investors looking for the USD to weaken.

Financial conditions remain very easy in the US and the global reserve currency status has a way of transmitting that to the rest of the world.

Having said that, there are plenty of idiosyncratic stories to follow.

JPY has been slowly weakening, and Japanese investors have been happy keeping plenty of capital abroad.



We have now reached big levels in USDJPY. A break above 110.50 then 112.00 would get peoples attention.

The ever-present fear of a risk-off event is preventing people from getting involved for the moment. To get away from this dynamic we will need a driver.

What could get USDJPY moving higher again?

- Meaningful economic deterioration (forcing the Japanese to act).
- Big move up in US yields without a major equity sell-off.
- Large new outflows of investment capital from Japan.
- Europe abandoning negative rates.

The markets have a way of sniffing out coming events, so it is always worth watching the price action… especially with FX volatility at such low levels.

In EM, I continue to like MXN. With still high nominal and real rates, the volatility adjusted carry is certainly attractive.

In addition, with capital flowing into EM in general this is a relatively cheap equity market. In recent weeks it has been breaking out of a multi-year downtrend.

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USD is starting to fall vs. MXN

As Mexican equities in MXN rally.

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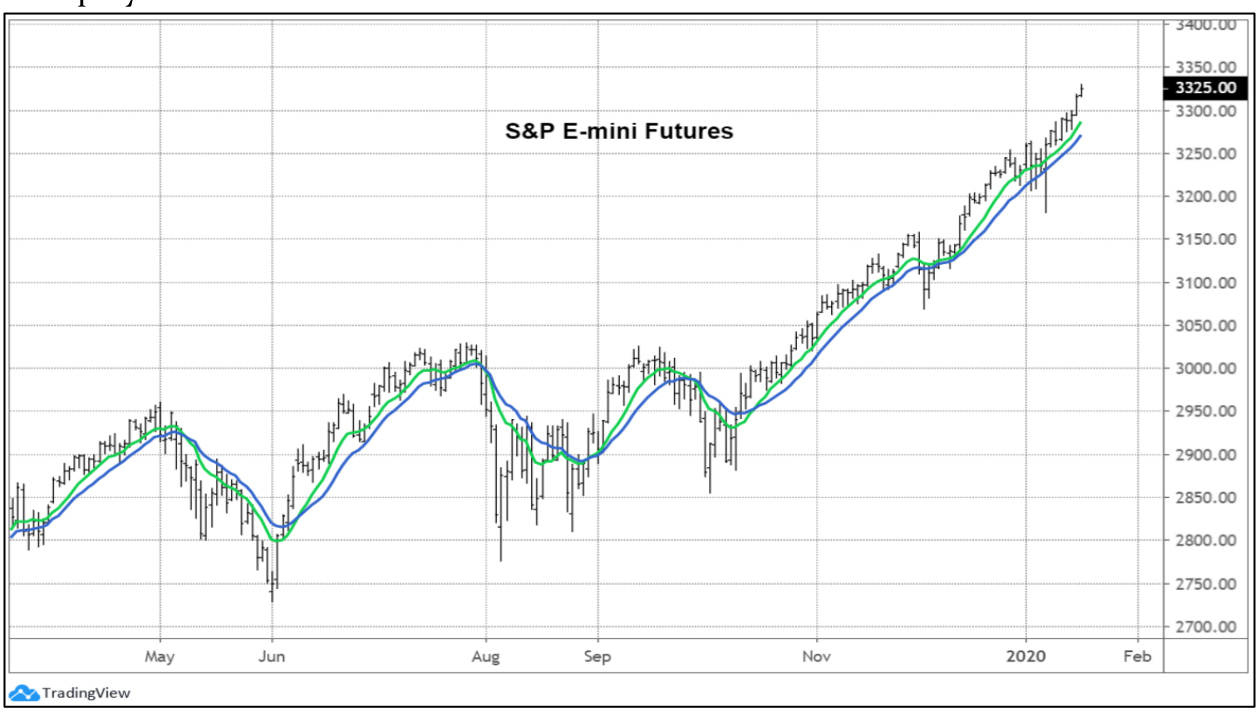
In the US, Bond prices continue to hold their range as bullish and bearish flows cancel each other out and the economic data remains mixed.

US Equity momentum remains intact.



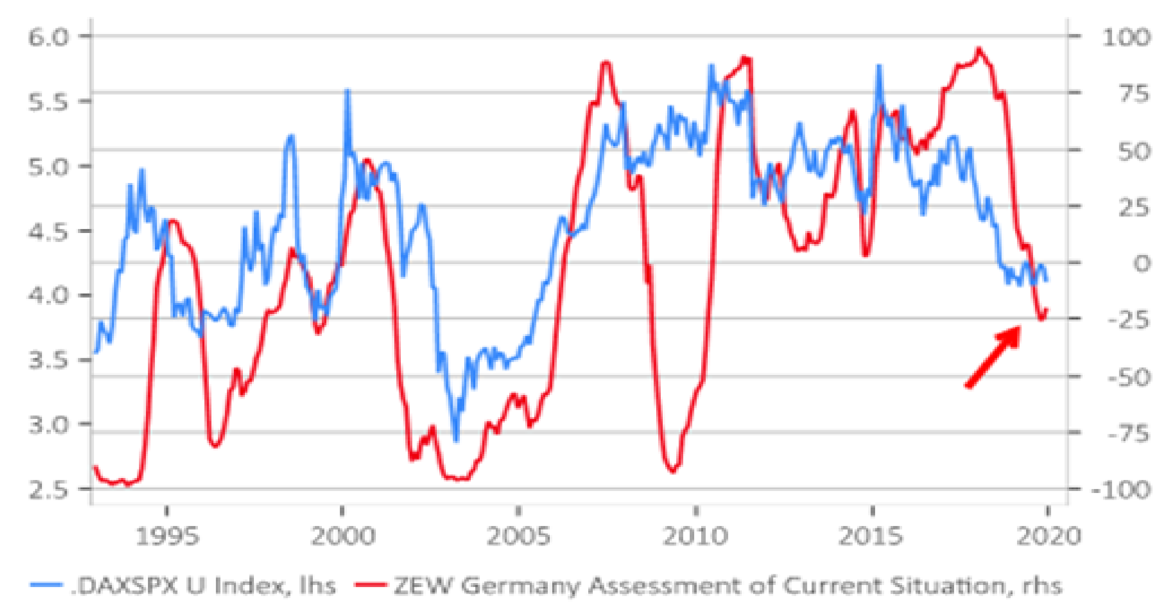
Economic Data

Last week's data was mixed at best. Industrial production was soft as JOLTS job openings also fell to 2-year lows and consumer sentiment came off the boil. Housing starts for December, on the other hand, came in at 13-year highs. However, analysts were quick to downplay it, as the seasonality has a big effect on the rather small base this time of year.

Next week's data calendar includes flash Markit PMI's for the US, UK, Eurozone, Japan and Australia. We have ECB, BoJ and PBOC monetary policy decisions and of course headlines from Davos. Davos is worth watching as the environment will be front and center this time. Any nod to Green Bonds or environmentally focused fiscal spending will be worth parsing.

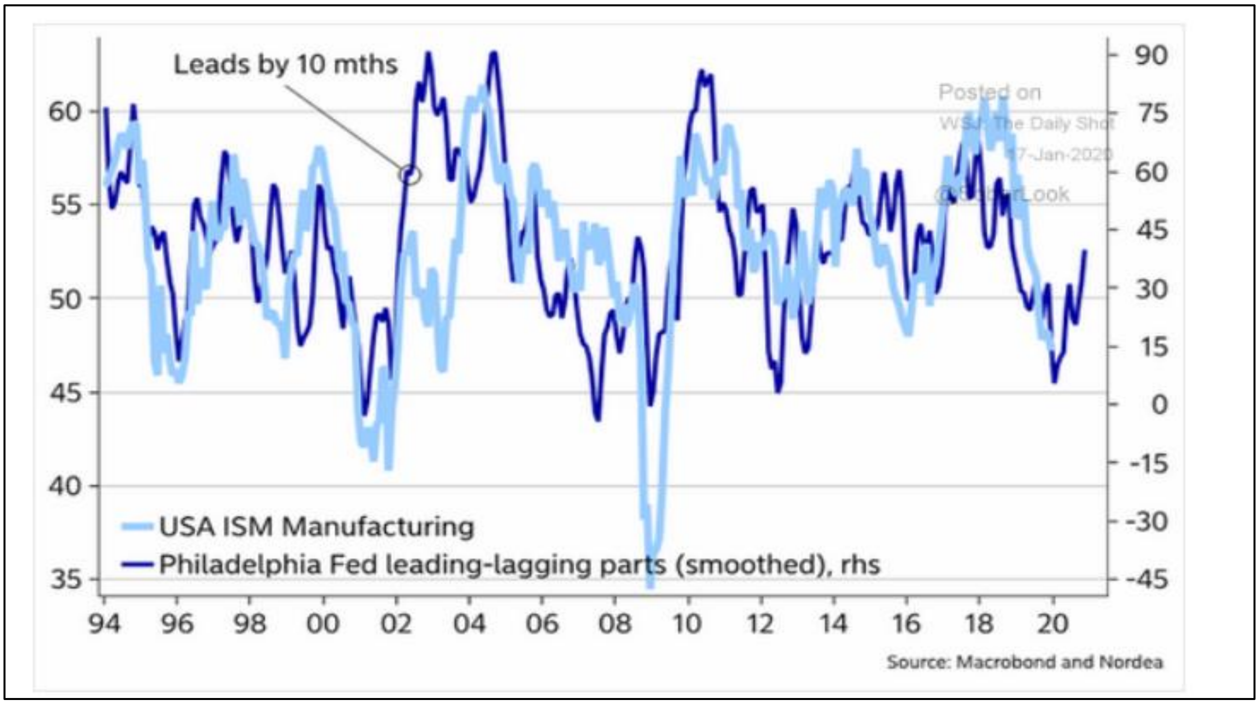
ZEW data out of Germany will be important to gauge the extent of any European economic progress.

Chart 5: DAX/SPX ratio vs Germany ZEW survey

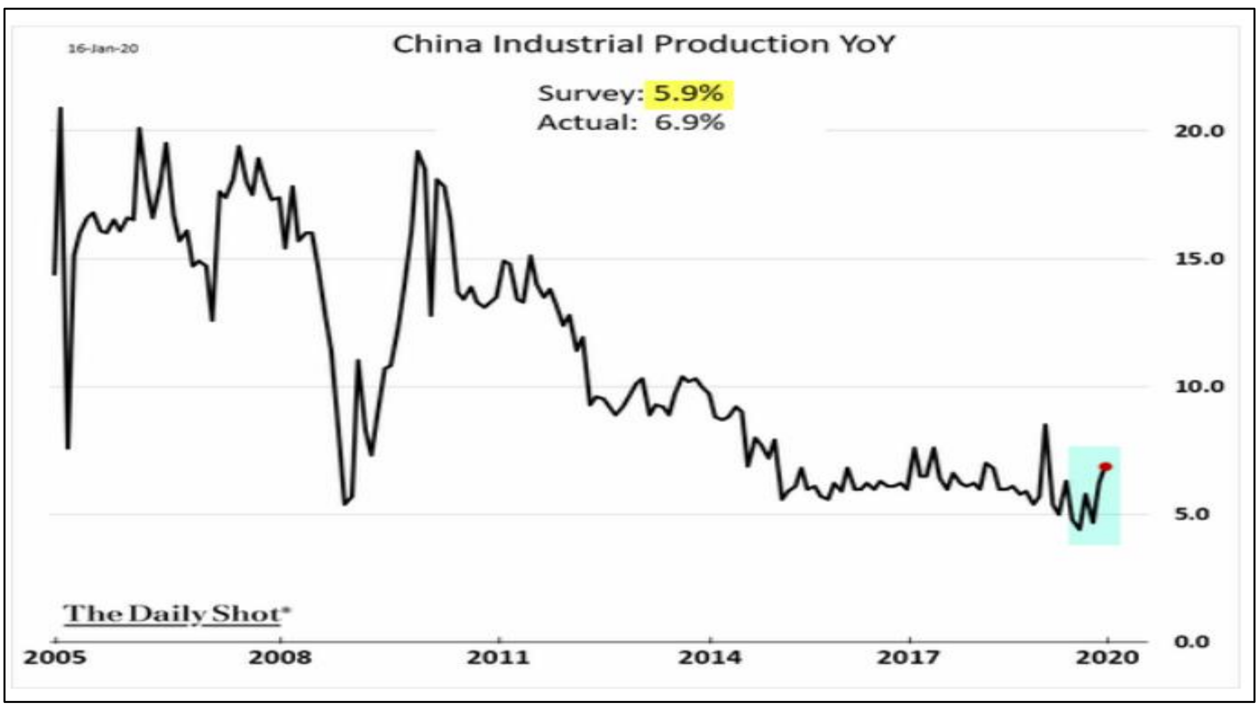


Source: All Charts UBS Knowledge Network, Bloomberg, Macrobond, Norges Bank

The flash PMI's for US should help us understand if manufacturing is finally starting to pick up again or not.



China has been showing nascent signs of a bounce…



However, news of a worrying outbreak of Coronavirus in China could hinder progress. Back in 2003 when SARS hit HK and China, it shaved 0.3% off of GDP and caused capital outflows.

New York Times on Sunday: "BEIJING — The authorities in China reported a third death from a mysterious virus and more than 130 new cases over the weekend, including ones found in Beijing and southern China for the first time.

The jump in cases raised questions about how the virus is being transmitted and added to concerns about the spread of the illness ahead of China's busiest travel season.

The health commission in Wuhan, a central Chinese city where the virus originated last month, said early Monday that 136 new cases had been detected on Saturday and Sunday. Nine patients were critically ill, and one died.

Two of the cases were reported in Beijing, and one in Shenzhen, a booming metropolis in the south, near Hong Kong. That brought the total number of cases in China to around 200, more than double the number reported just a day earlier."

This is clearly one to keep on your radar in the coming days.

Actionable Trades and Developments:

Equity Indexes: Like EWW for EM in general rally and MXN specific breakout.

US momentum still holding up so far.

Fixed Income: Like June 98.50 Eurodollar calls for 4 ticks, just in case Fed is forced to unexpectedly cut more.

Commodities: Still like Gold big picture but sidelined for now. Platinum had a major long-term breakout.

Currencies: Short USD and EUR vs. MXN.

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Important Macro Data Releases and Events for the Week

Monday
1/20/2019

- **PBoC Interest Rate Decision Forecast: - , Prior: 4.15%**
- Industrial Production Forecast: -8.1%, Prior: -8.1%
- Eurogroup Meeting
- Producer Price Index MoM (Dec) Forecast: 0.1%, Prior: 0%
- **World Economic Forum - Davos**

Tuesday
1/21/2019

- EcoFin Meeting
- **BoJ Monetary Policy Statement and Interest Rate Decision**
- UK Unemployment Rate (Nov) Forecast: 3.9%, Prior: 3.8%
- ZEW Survey - Economic Sentiment (Jan) Forecast: 5.5, Prior: 11.2
- **ZEW Survey - Current Situation (Jan) Forecast: -12.4, Prior: -19.9**
- **ZEW Survey - Economic Sentiment (Jan) Forecast: 4.3, Prior: 10.7**
- **World Economic Forum - Davos**

Wednesday
1/22/2020

- Chicago Fed National Activity Index (Dec) Forecast: -0.3, Prior: .56
- CPI Core YoY (Dec) Forecast: 1.9%, Prior: 1.9%
- Housing Price Index MoM (Nov) Forecast: 0.2%, Prior: 0.2%
- Existing Home Sales MoM (Dec) Forecast: 5.42 m, Prior: 5.35 m
- **BoC Monetary Policy Report and Interest Rate Decision: No change Expected**
- **World Economic Forum - Davos**

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		Merchandise Trade Balance Total (Dec) Forecast: Yen 88.1 B, Prior: -Yen 82.1 B
Thursday 1/23/2020		Employment Numbers (Dec)
		Leading Indicators (Nov) Forecast: - , Prior: 90.9
		ECB Interest Rate Decision Forecast: 0%, Prior: 0%
		ECB Deposit Rate Decision Forecast: -.50%, Prior: -.50% Press Conference
		Initial Jobless Claims Forecast: - , Prior: 204k
		Initial Jobless Claims 4-week ave. Forecast: - , Prior: 216.25k
		Continuing Claims Forecast: , Prior: 1.767m
		World Economic Forum - Davos
Friday 01/24/2020		**Markit Manufacturing PMI (Jan) PREL Forecast: 43.3, Prior: 43.7**
		Markit Service PMI (Jan) PREL Forecast: 54, Prior: 52.9
		Markit PMI Composite (Jan) PREL Forecast: 50.7. Prior: 50.2
		Markit Manufacturing PMI (Jan) PREL Forecast: 45.1, Prior: 46.3
		Markit Service PMI (Jan) PREL Forecast: 53, Prior: 52.8
		Markit PMI Composite (Jan) PREL Forecast: 51. Prior: 50.9
		Markit Manufacturing PMI (Jan) PREL Forecast: 47.6, Prior: 47.5
		Markit Service PMI (Jan) PREL Forecast: 49.4, Prior: 50
		Markit Manufacturing PMI (Jan) PREL Forecast: 52.3, Prior: 52.4
		Markit Service PMI (Jan) PREL Forecast: 53.1, Prior: 52.8

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Markit PMI Composite (Jan) PREL Forecast: 52.5. Prior: 52.7

Chinese New Year