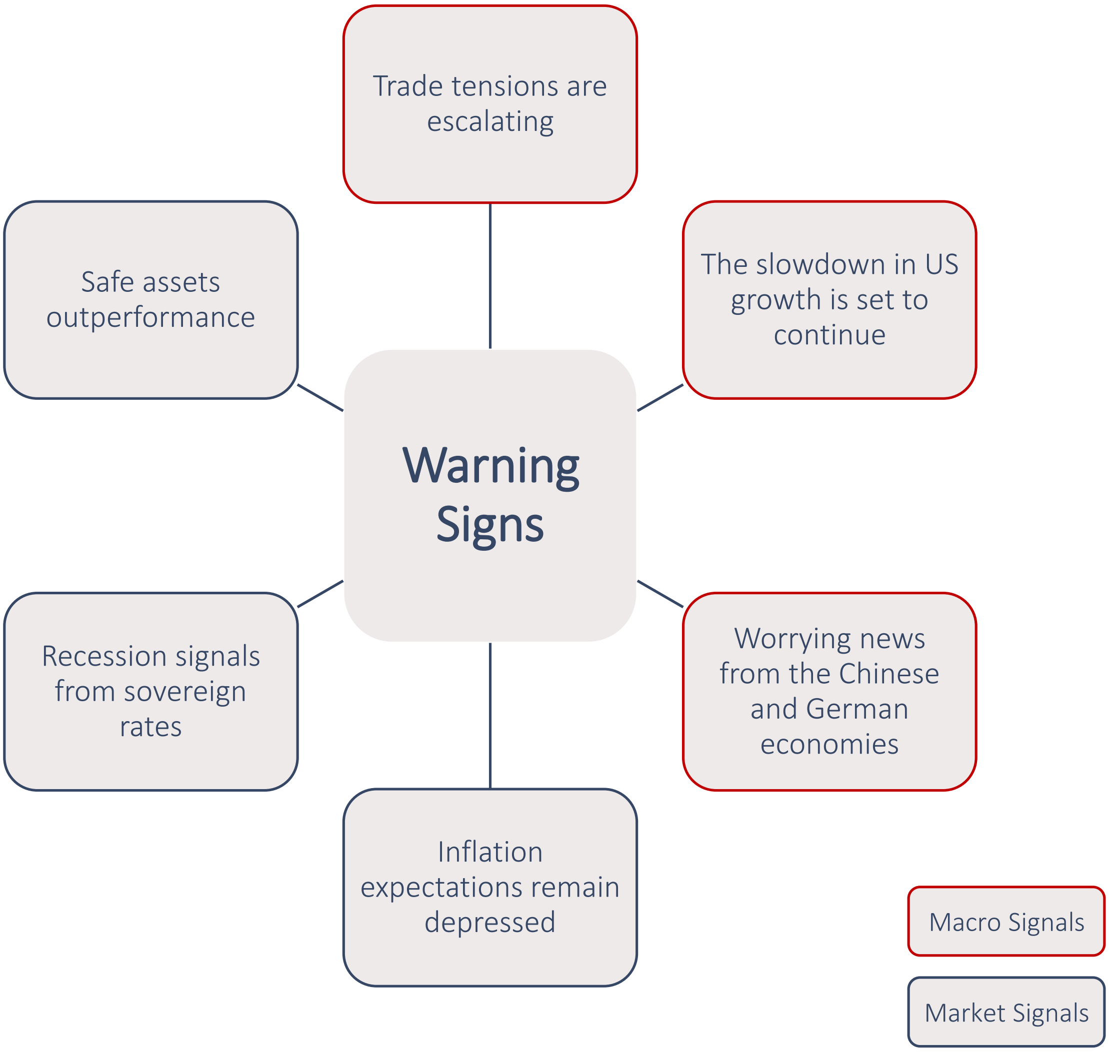
September 2019

T. JOURDE

Red Flags

Key Points

- In this short note, we present a number of red flags highlighting the **deteriorating economic environment.**
- In light of these early warnings, we show that **investors started to hedge their portfolios**.
- Expectations for additional monetary stimulus are high and could lead to a market correction if central banks fail to deliver.
- Therefore, we continue to recommend a **prudent asset allocation** in the coming months.



Trade tensions are escalating

- The United States-China truce, decided on 29 June, was short-lived.
- At the beginning of August, D. Trump sparked things off by announcing new tariffs on $300 billion of Chinese imports. China retaliated by raising tariffs from 5 to 10% on $75 billion of US products.
- These tensions severely impacted international trade, which experienced its sharpest decline since 2009 in the last quarter (see Fig. 2).

Fig. 1: Trade War Intensity (google trends)

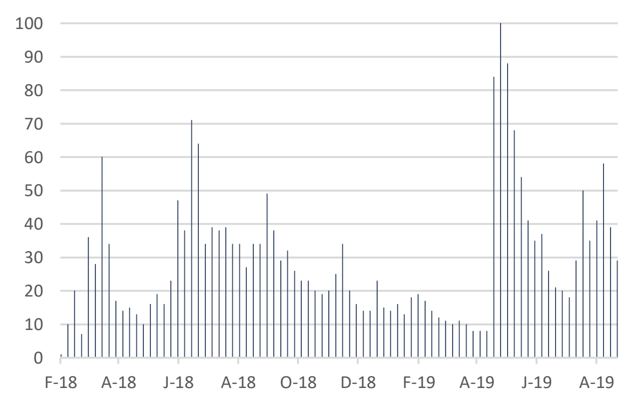


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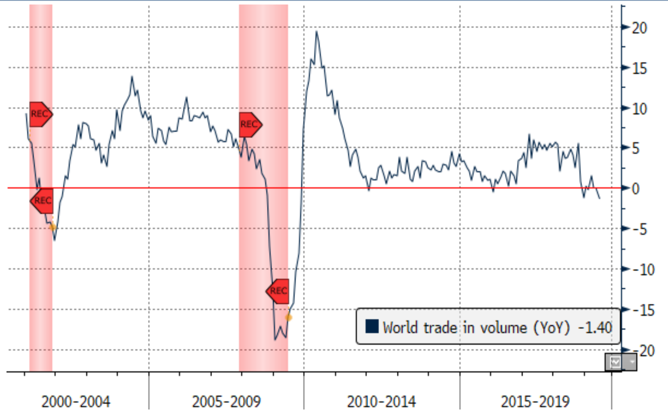
Fig. 2: Downturn in Trade



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The slowdown in US growth is set to continue

- U.S. GDP growth moderated in the second quarter (see Fig. 3). Based on the manufacturing PMI, a leading indicator of the U.S. economy, we expect GDP growth to slow further in the coming months.
- The decline in the growth of investment is also a concern. In fact, Fig. 4 shows that the fall in investment could be a warning signal of recessions.

Fig. 3: Growth Slowdown

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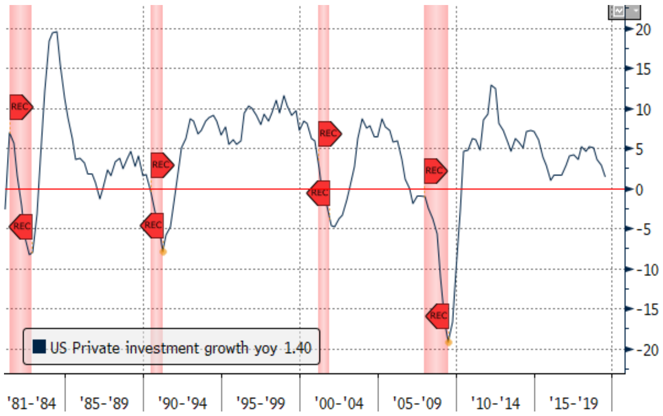
Fig. 4: Private Investment Growth



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Worrying news from the Chinese and German economies

- During the summer, the Chinese economy continued to slow down. Industrial production increased by 4.8% yoy in July, the weakest gain since 2002. In addition, the growth of retail sales decreased significantly in July compared to the previous month (see Fig. 5).

- Germany was strongly impacted by the downturn in world trade. The industrial sector experienced its sharpest downturn since 2009. After reaching a peak in 2018, business expectations fell in August to their lowest level since the global financial crisis (see Fig. 6).

Fig. 5: Chinese Economy

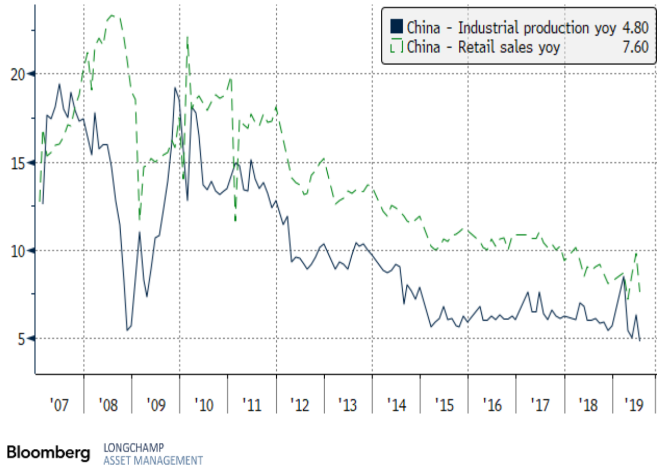
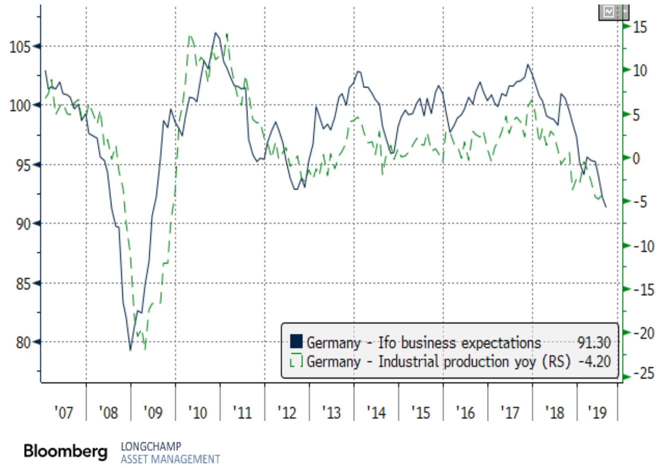


Fig. 6: German Economy



Inflation expectations remain depressed

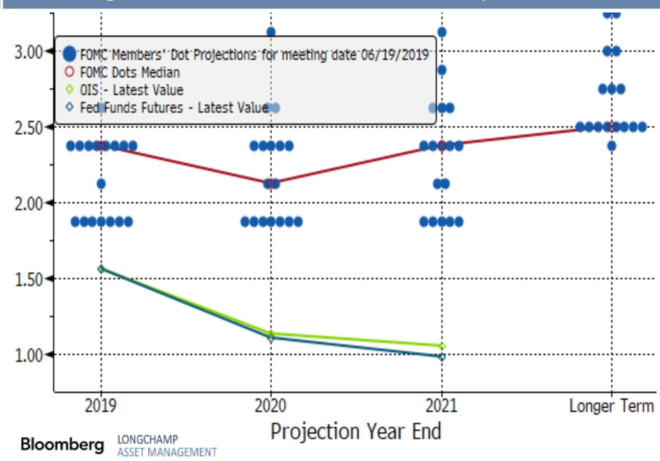
- The decline in inflation expectations (see Fig. 7) show that investors believe the United States and Europe could, like Japan before them, head towards secular stagnation.

- Therefore, market expectations for additional monetary stimulus are high. Investors believe that the Fed could lower again its rates two to three times this year (see Fig. 8).

- We argue that the current market equilibrium lies too much on the shoulders of central banks.

Fig. 7: Inflation Expectations

Fig. 8: FOMC Dots vs Market Expectations



Recession signals from sovereign rates

- For the first time, Germany's 10-year rates fell below the ECB deposit rate in August (see Fig. 9). This phenomenon is a result of investors' negative perception of the economic environment. Furthermore, this reflects the fact that investors expect significant monetary easing from central banks.
- Based on the difference between the 10-year and 3-month Treasury bill rates, the New York Fed calculates a 37% recession probability in the United States twelve months ahead (see Fig. 10).

Figure 9: ECB Deposit Rate vs Bund

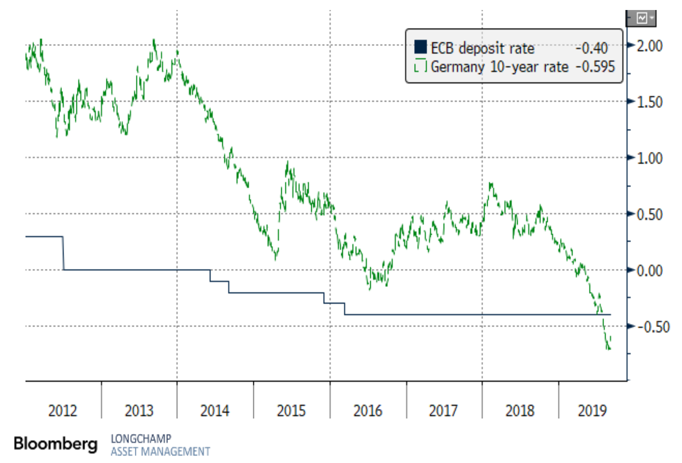
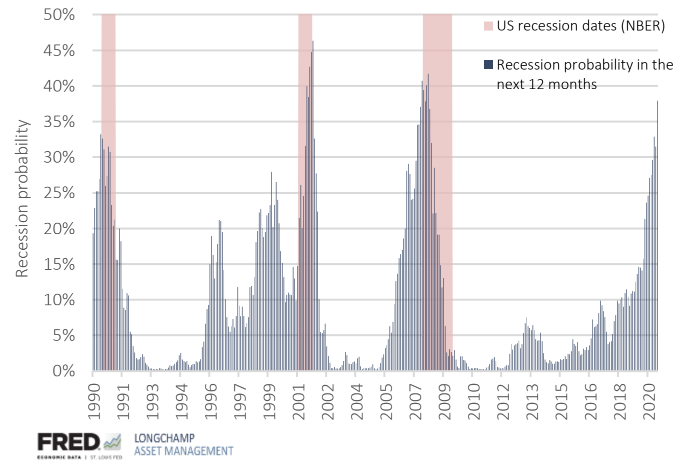


Figure 10: US Recession Probability



Safe assets outperformance

- In light of these red flags, investors started to hedge their portfolios. From the beginning of 2019 to September 9, gold and silver increased by 17,5% and 19,3%, respectively. In addition, the yen, traditionally considered as a safe-haven currency, rose by more than 4% against the dollar since April 2019 (see Fig. 11).
- Over the past few months, investors also purchased put options to protect their portfolios. As a result, the put/call ratio based on the S&P500 index recently reached a two-year high (see Fig. 12).

Fig. 11: Gold, Silver and Yen

Fig. 12: S&P500 – Ratio Put/Call

Asset allocation

- Our prudent asset allocation performed well this summer.

- The rise in protectionist tensions penalized equity markets. We continue to underweight the equity class and prefer defensive positions (minimum volatility factor; defensive vs cyclical stocks).

- The slowdown in global growth had a negative impact on sovereign yields. Moreover, in Italy, the hope of a coalition between the Democratic Party and the M5S led to a narrowing of the spread between the Italian and German rates. We remain bearish on US yields, especially compared to European rates.

- We keep our long position on the EURUSD, as (i) economic momentum in the US and Europe are likely to converge and (ii) currency valuation models indicate that the dollar is overpriced. We also maintain a short position on GBPUSD as an insurance against a hard Brexit. Finally, we keep our position on the yen, which performed well in August due to the rise of uncertainty.

- Finally, our position on silver performed well in recent months. In fact, the demand for silver increased amid (i) uncertainty, (ii) low interest rates, and (iii) cheap price compared to gold.

Key Trades - as of August 2019

Asset class	Key trades	Direction	Returns	Start date	P&L LtD (local/hedged)	P&L LtD (in euro)	P&L MtD (local)
Equity	Low volatility factor	Long	%	June-19	2,0%	4,8%	1,7%
	Defensive vs Cyclical	Relative value	%	May-19	-2,1%	-3,7%	1,5%
Bond	US Linkers	Long	Bps	January-19	-80,1	-80,1	-28,0
	Italy	Long	Bps	September-18	-231,5	-231,5	-54,5
FX	EURUSD	Long	%	April-18	-1,9%	-1,9%	-0,8%
	GBPUSD	Short	%	August-19	0,0%	0,0%	0,0%
	USDJPY	Short	%	January-18	3,0%	3,0%	2,4%
Commodities	Silver	Long	%	October-18	29,0%	32,8%	13,0%

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