

As The Tri Polar World Turns - July 2019

July 12th, 2019

MACRO THEMES

The 1st half ended with a bang as June displayed strength on both sides of the ball, capping what JPM calls the strongest and broadest cross asset rally in a decade. The cross asset rally is due in large part to Central Bank (CB) action: 30 CBs have cut rates ytd, 27 of them in EM while the DM CBs have swung into verbal, preemptive action. Markets have priced in a July Fed rate cut & expect more to follow. In Europe Draghi left them wanting more with a reprise of his “whatever it takes” speech leading investors to price in further deposit rate cuts. Our Sell the US in May & Go Abroad thesis did ok with ACWX slightly outperforming US equity in June led by EM and Europe. The G20 meeting provided the requisite “can kick” while the US marked its longest ever economic expansion, something we expect to continue.

Our 2nd Half Outlook foresees greater potential for a risk asset melt up than melt down ([see recent Musings link](#)). **The quartet of a global growth bottom, a relatively quiet trade front, a global easing cycle that includes a Fed insurance cut and ECB easing & a bottom in EPS revisions provides a supportive backdrop for risk assets.** Given ytd performance, we remain focused on our Lower for Longer Global Growth Path thesis which continues to point us to the non US developed equity markets (Europe, Japan) which offer what we have dubbed as the Big Three: EPS growth, room for multiple expansion & potential currency appreciation. In Fixed Income we continue to see value in yield and given \$13T in negative yielding debt globally, we doubt we will be alone. What remains attractive are EM USD debt, US and EU high yield, and Preferred Securities. We remain USD bears and constructive on energy and miners within the Commodity space.

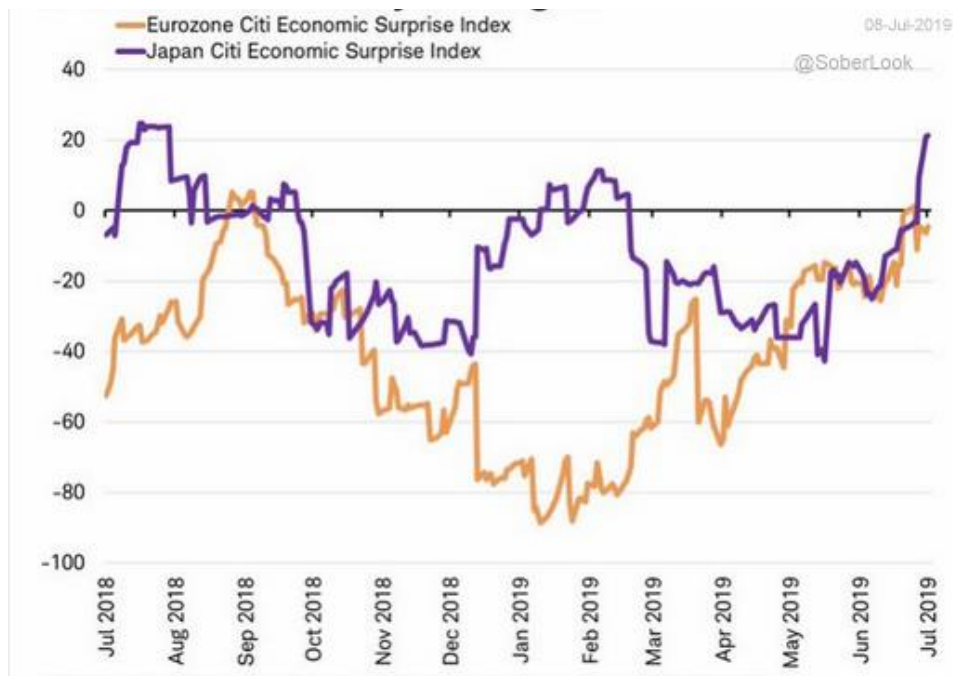
ECONOMICS:

The US “catch down” to the rest of the world continues with weak US economic data across the board. With a huge budget deficit and partisan gridlock in DC the onus once again falls to the Fed to maintain economic buoyancy. The Fed hopes its upcoming rate cut will serve multiple purposes: weaken the USD, steepen the yield curve & help boost inflation. A Fed insurance cut is likely to buffer Q2, Q3 GDP growth in the 1.5% to 2.0% range, perhaps bringing into focus the inflection point between continued US weakness and a bottom in ROW growth.

Growth south of the border remains weak with both Mexico and Brazil downgrading their 2019 economic outlooks based on rising tensions with the US, domestic political risk and a general lack of risk appetite. Room exists in both countries for rate cuts as inflation is well below short term rates.

Across the pond the economic news seems a bit brighter. Notwithstanding continued manufacturing woes, June’s European Composite PMI came in at 52.7, representing the highest in 7 months. The Q2 Composite PMI was above that of Q1 suggesting that the overall European economy may be bottoming just as the analyst community has slashed growth estimates. Right on time, the Citi Economic Surprise Index has turned up nicely in both Europe and Japan (**Chart 1**), suggesting that a Bund sell off is imminent.

Chart 1: EU & Japan Economic Surprise Index near 1 year High



Source: WSJ, Charles Schwab, Bloomberg data as of 7/3/2019

We continue to focus more on the service and consumption side of the DM economy given services represent roughly 70% of these economies; continued record low unemployment and above inflation wage gains should be supportive. Europe’s unemployment rate is now the lowest in 11 years. On the production side we are watching the inventory to sales ratio (I/S); as inventories are worked down then the production function should kick back into gear. Inventory levels in Europe are at close to four year lows. Headline risk is high; investment risk is low.

In Asia the production cycle remains anemic. Several CBs have cut rates and more are expected to do so in the months ahead. China continues work to stabilize its economy in the face of continued trade uncertainty while Japan prepares for its VAT hike. Japan’s May Industrial Production was the best in ~18 months while unemployment is at a 50 year lows. Given that 60% of Japan’s exports are machinery/transport a bottom in the global production cycle should be felt first in Japan.

Bottom line - we continue to expect a near term global growth bottom assisted and supported by the global easing cycle now underway. Importantly the US will likely bottom last as it is behind the rest of the world in its economic deceleration cycle (due to the 2017 tax cuts).

POLITICS:

US politics remain depressing with Pres. Trump showing it is going to be one ugly race threatening Mexico, Iran & migrants in the space of a few weeks. Interestingly though he seems to be pulling in his horns on the world stage - backing down on Mexico, no retaliation for the Iranian downing of a US drone, reaching out to Pres. Xi to ensure a G20 meet etc. **We expect Pres. Trump to remain bombastic on the campaign trail but conventional on the world stage as he seeks that age old politicians goal: reelection.**

Expect domestic US politics to heat up though as budget and debt ceiling discussions take center stage. Current forecasts suggest that the US will run out of debt ceiling room in early September; given that much of August is

Congressional vacation time there will be little time to spare. Reports out of DC suggest a Republican Party caucus in turmoil while a vast gulf exists between the Caucus and the White House.

The food fight for Europe's top jobs has finally concluded and while our preferred combo of Vestager and Weidmann didn't make it the pairing of Lagarde at the ECB and von der Leyen as EC head could be quite constructive. **Europe needs both fiscal and monetary policy pulling in the right direction and this leadership combo combined with Germany's poor economic showing (2nd weakest economy behind Italy) makes such action more likely as German economic softness makes it more open to fiscal stimulus.** Brexit remains an open item with Boris Johnson, a lead campaigner for Brexit, likely to be the next PM stoking fears of a hard exit and a sharp drop in sterling.

Asian politics have settled down after the big Indian and Indonesian elections as both reelected leaders focus on governing. A trade tiff between Japan and Korea seems more focused on Japan's Upper House elections later this month than the start of something big. Pres. Xi would seem to have the upper hand in the US - China trade fight given the potential to wait out Pres. Trump post 2020 as China's economy seems to be stabilizing and plenty of stimulus lies in reserve should the US increase tariffs by 25% on the remaining \$300B of Chinese exports; something we continue to think is highly unlikely.

POLICY:

As noted above monetary policy has come back to the forefront; preemptive CB verbiage is indeed a powerful spur to risk appetite. The question is whether market participants have gotten ahead of themselves in thinking about what the Fed will do and when. We think so and expect a continued pull back in yields at the long end in both UST and BUNDS given very extended duration bets. US fiscal policy is now focused on budget and debt ceiling issues leaving the Fed as the main game in town. **We expect an insurance rate cut later this month and then the Fed to take its time assessing the state of the economy.**

Brazil's pension reform process has been moving ahead smartly resulting in sharp rallies in both rates and FX. Continued forward progress on the reform side, including tax reform, coupled with room for rate cuts could revive Brazil's dormant animal spirits on the capex front in particular. Mexico has just lost its Minister of Finance over disagreements with the President but former Deputy and now the new Minister (Arturo Herrera) is likely to ensure policy continuity. Mexico has lots of room to cut rates with some of the highest real rates in the OECD.

The ECB may also swing into action, perhaps via a further lowering of the deposit rate (now -.40%) but it too would likely be an insurance cut as signs grow that the economy is bottoming. Once the production cycle and Manufacturing PMIs turn up the reversal of current market positioning and policy expectations could be significant. A combination of an economic bottom and aggressive ECB action could spur a bigger risk appetite than may otherwise exist. The dramatic rally in peripheral European debt would seem to mitigate many of the recent worries with Italy's 10 yr now yielding roughly 1.7%, bringing its spread over Bunds to less than 200 bps, a dramatic reversal from year ago levels. Yet there has been virtually no talk of how bullish a doom loop reversal must be for the banks... in Italy or Europe wide.

MARKETS:

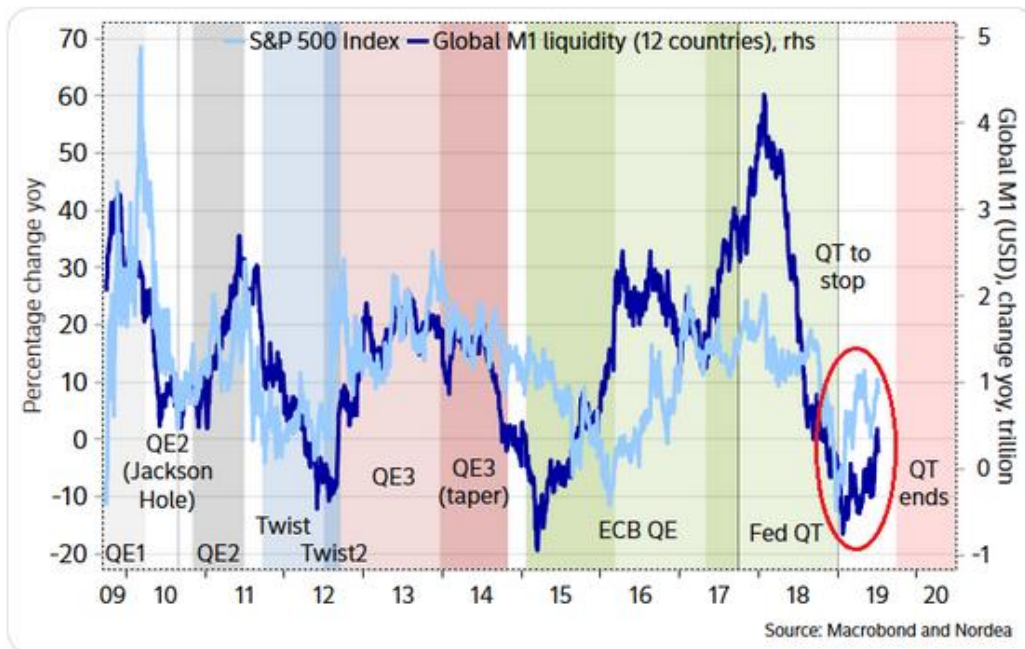
The roller coaster continues - Q4 drop, Q1 bounce, April spring, May swoon, June moon shot. Whats next? Our macro focus on Potential Growth Rates (PGR) and Neutral Rates of Interest (NRI) has helped us navigate the current set up of slashed growth forecasts and YE yield levels, an upturn in CESI and the resultant sell off at the long end in the US and Europe. When the BofA manager survey notes that long UST is the most crowded trade

and the highest % of managers since 08 expect rates to be LOWER in the next 12 months the likelihood is that the duration rally is overdone. Given the overbought nature and scale of the duration rally a reversal would seem to represent yet another healthy pullback.

The same BofA survey suggests equity investors are the “most bearish” since the bottom, the literal bottom in March 2009. That seems really hard to believe given the S&P just hit a new all-time high, ACWI is up 16% ytd etc etc, but yet it’s true. **Super bearish stocks and super bullish duration = super bearish growth and that is what is likely to be revealed as wrong thinking in the months ahead.** Low growth is not no growth and low growth, low inflation has historically been good for risk assets. The Growth/Value debate remains open though a case is building in favor of a shift as global growth bottoms and the Fed cuts. History also suggests Tech performs poorly post Fed rate cuts. US Tech has also been a prime user of buybacks to a staggering extent; the five largest tech companies spent roughly \$175B on buybacks over the past 12 months, 3x what they spent two years ago. A shift from US/growth/tech leadership to ROW/value would be a game changer.

The G20 can kick is now priced in, leaving the focus on Q2 Earnings season & growth bottoms, together with the Fed and other CB easing action. As liquidity returns to the global system (**Chart 2**) risk asset upside seems greater outside the US. ACWX remains close to 15% off its 2018 high trading at 13x forward EPS with Euro appreciation potential vs SPY at new ATH and trading at 17x forward earnings in expensive USD. An environment where US equity does ok should allow the ROW to do better given the factors above. History suggests that ACWI has 10% upside over the coming six months with a Fed insurance cut and no recession. Add in the G20 can kick, bottoming global growth & underweight investors and that return profile makes sense.

Chart 2: Global Liquidity coming back



Source: Macrobond, Nordea

European equity has done well year to date, surprising many. Further upside can come from a clear growth bottom and potential policy moves on both the fiscal and monetary sides. The sharp Bund rally has capped bank stocks, though a reversal should prove to be supportive. European bank CDS has rallied sharply along with peripheral debt yet the bank equity remains roughly 20% off 2018 highs. Japan trades at 1.1x BV with 9% ROE

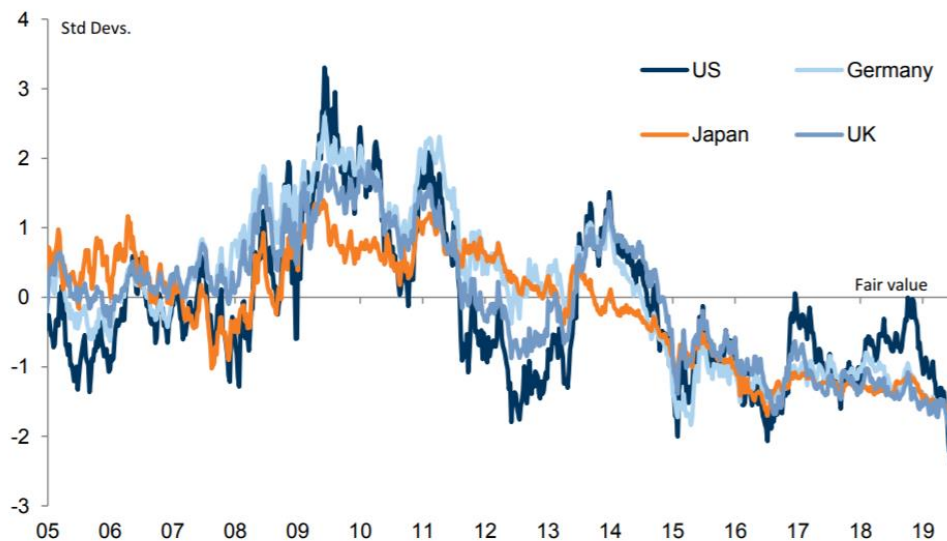
vs the US trading over 3x BV with 16% ROE; Japan’s relative valuation to ACWI is the cheapest in 25 yrs while stock buybacks are at their highest in more than 12 years. We continue to like China and Latin America within the EM equity space.

On the fixed income side the duration play seems way overdone as noted - credit remains in favor on both sides of the pond while preferred securities and EM USD debt offer great risk - return characteristics. Work by GS suggests EM USD debt is among the most attractively valued assets relative to its own 10 yr average valuation. European HY seems attractive as the ECB could restart its corporate bond buying program. **Duration and credit have both been winners in the 1st Half; in the 2nd Half credit would seem to have a better upside.**

\$13T in negative yielding debt would suggest the search for yield continues while better than expected economic data will shock the long end with potential for the UST 10 yr to retrace back to 2.25-2.3%. GS notes the UST 10 year (inverse of yield chart below) is the most expensive relative to its fair value in roughly 15 years (**Chart 3**). The bid to cover ratio for recent auctions have also been quite weak.

Chart 3: Global 10 year Yields Mispriced

Number of standard deviations yields are above or below fair value; GS Sudoku is our fair value model for bond yields



Source: Goldman Sachs

The USD seems close to rolling over but that's been said before. As we have long noted the growth differential between US and EU needs to narrow - the spread differential has done so thanks to the strong US rate rally. Should the USD weaken at all the unhedged offshore buyers could exit in a hurry, something which is most definitely not priced in. Europe’s growth bottom and any sign of inventory rebuild on the production side should spur Euro strength. The Euro screens as among the cheapest currencies relative to its own 10 year history according to Goldman.

On the alts side oil has rallied thanks to the US - Iran tiff as well as OPEC+ decision to renew production limits. Gold has rocked leaving the gold - silver ratio is at a 30 yr wide. Industrial Metals have had a little bounce but needs further confirmation of a China production bottom.

PORTFOLIO STRATEGY AND ASSET ALLOCATION (GMMA)

We have reduced our cash position and added further to our equity overweight as we expect equities to continue to outperform bonds in the 2nd Half.

We remain overweight the non US equity markets with a focus on Europe and Japan given our belief that those markets offer greater room for appreciation based on ownership, valuation and currency upside.

Our EM equity exposure remains focused on China and Latin America; positive policy momentum in Brazil and room for rate cuts in Mexico support those positions.

Sectorally, we have reduced our US Min Vol positions and added to our Cyclical positions in order to gain exposure to an anticipated global growth bottom.

In Fixed Income we remain underweight duration and overweight credit, both in the US and abroad.

We expect USD weakness in the 2nd Half based on Fed rate action, Presidential jawboning, massive twin deficits and a clear bottom in non US economic growth.

In the alternative space we continue to favor energy via our MLP position together with the miners which we expect to be among the winners in a growth pick up scenario.

GLOBAL MACRO SUITE PORTFOLIO CHANGES

Global Macro Multi Asset (GMMA)

- Within equities, we reduced our US Min Vol position and added a US Transports position.
- Within Fixed Income, we added to our US Preferred position which offers attractive risk - return characteristics.
- Within Alternatives we added further to our global mining position and reduced our cash position.

Global Macro Income (GMI)

- As in our GMMA sleeve, we reduced our cash position and added to our US Preferred position while adding to our EM USD Debt position.

Global Macro Equity (GME)

- As in our GMMA equity sleeve we reduced our US Min Vol position and added a US Transport position while adding to existing US Industrials and Oil Services positions. We slightly reduced our European Bank position and added a US Bank position.

I hope you find this monthly piece of value and look forward to engaging with you on a monthly basis as we go thru 2019.

Jay Pelosky, CIO & Co-Founder
TPW Investment Management

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