Lombard Street Research

LSR Macro Strategy

9 August 2017

Playing with fire (and fury)

Asset class focus:
- ■ Multi Asset
- □ Fixed Income
- ■ Currencies
- ■ Equities
- □ Commodities

- **Trump 'fire and fury' comments unleash vicious risk-off phase: will it last?**
- **Macro and corporate fundamentals remain good, as Q2 earnings show**
- **Absent an actual military escalation, the cycle should not be derailed**

Disapproval ratings

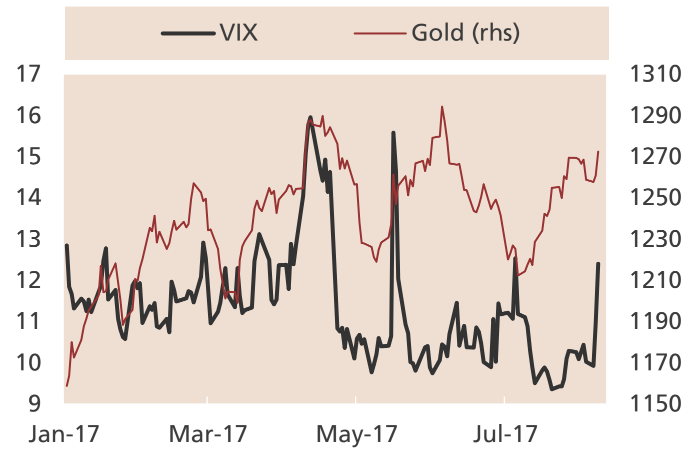
Risk off on latest Trump remarks

After a positive run for risk assets that lasted more than a month, a risk-off phase was bound to kick in at some stage. The catalyst was President Trump's threat to unleash 'fire and fury' on North Korea should it continue to develop ICBM capabilities that might allow it to launch a nuclear attack on the mainland US. Not surprisingly, Supreme Leader Kim Jong-un responded by saying he was considering a military strike on the US Pacific territory of Guam. Markets reacted as one would expect, with equities selling off sharply and safe haven assets (Gold, JPY, CHF) rallying strongly.

Sanctions and threats unlikely to work

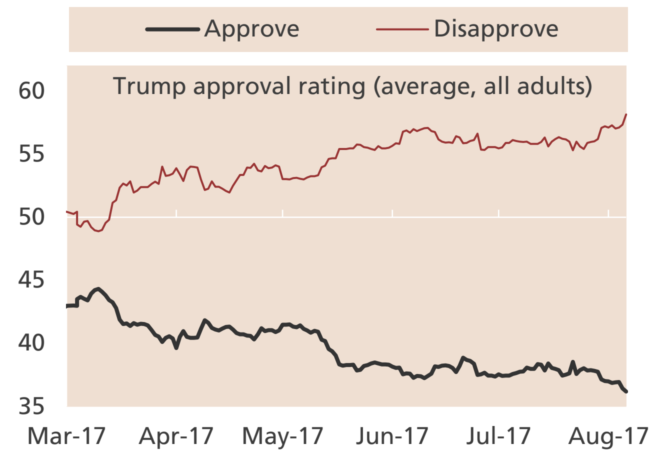
As we argued in a recent China in Depth note ('*Korea circle grown more vicious*', 2-Aug-2017), turning North Korea into a nuclear power has become the defining purpose of Kim's leadership. Nuclear status would make him impervious to sanctions, threats or blandishments. Besides, he probably feels confident that China is not going to side unquestioningly with the US, despite Beijing's voting at the weekend for enhanced UN sanctions against Pyongyang. Judging by the evolving tone of his tweets

Risk off



Source: Bloomberg

Trump's approval ratings in freefall



Source: FiveThirtyEight

on the matter, Trump is becoming increasingly frustrated with China's reluctance to confront Kim.

Periodic rhetoric flare up or start of escalation?

Reducing tension is not on Kim's agenda. Rather, he thrives on it. As for Trump, with his approval ratings steadily falling (right-hand chart on the previous page), he will be ever more tempted to turn his presidency around through foreign policy – as some of his predecessors have done. In other words, this stand-off is not going away anytime soon. The best case is that the rhetoric continues to flare up periodically around North Korea's latest missile test, creating disruptions in the markets; the worst case is that threats lead to military escalation, in which case all bets are off. Which one will it be?

Common sense will likely prevail

With events still unfolding, it's too early to take a definitive view. We therefore take stock this week and hold off from adding trades to our portfolio. If pushed, we'd say that, as with many other past outbursts by Trump, common sense will eventually prevail and the drama will give way to a calmer, more sensible approach.

Back to basics

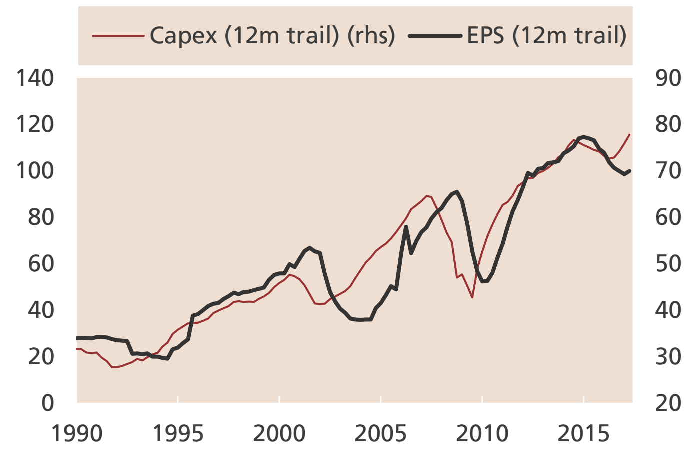
More capex in US and Europe…

If it came down only to fundamentals, there would be little doubt that today's moves in the markets would be temporary. Today's LSR Daily note ('*Corporate profits up, capex to follow*', 9-Aug-2018) looks at the latest reporting season, what to expect from capex in coming quarters and what this will mean for margins and profits. The conclusion is that solid earnings in the US and Europe indicate that a further pick-up in capex is very likely, as capital investment tends to follow corporate profits with a lag (left-hand chart below).

…to be important growth driver

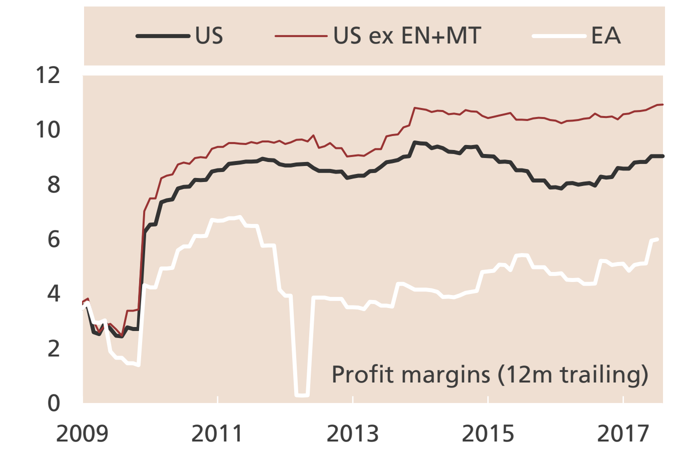
This suggests that profit margins, although close to cyclical highs, will probably be protected, despite increasingly tight labour market conditions (right-hand chart below). By choosing investment over labour, companies should be able to avoid paying higher wages while drawing from a pool of less-productive workers. And easy financial conditions will enable capital spending to go ahead even at those companies that can't rely fully on internal cash flow to fund investment. In sum, capital spending should be an important growth driver in the next couple of years. Accordingly, we remain positioned for a continuation of the current cycle via trades tapping into the themes of 'global reflation' and 'ECB taper'.

Capex tends to follow the profit cycle



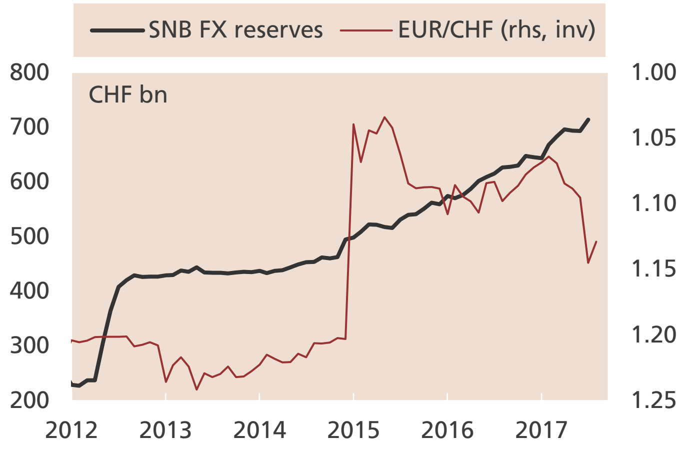
Source: Bloomberg

Profit margins continue to widen



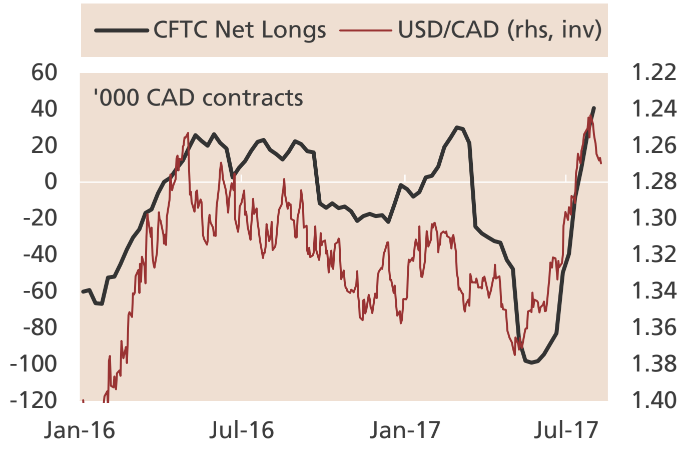
Source: MSCI, Bloomberg, LSR

SNB FX reserves mounting again



Source: Bloomberg

CAD bears squeezed out



Source: CFTC, Bloomberg

EUR/CHF trailed stop hit on safe haven flows

Long EUR/CHF stopped out on flight to safety

Our long EUR/CHF position was closed out today after the cross dropped below our 1.13 stop-loss level. With SNB foreign currency reserves hitting new all-time highs this month after two consecutive declines (left-hand chart above), we had considered taking profit this week at close to 1.15, despite having extended the target to 1.17 only seven days ago. However, a flight to safety today beat us to it, causing the surge in the CHF that we had feared could happen. Nevertheless, having exceeded our initial target of 1.12, the trade has been successful, producing an overall gain of 3.8%.

CAD shorts unwind means more USD/CAD upside

USD/CAD has finally started to rebound, helping our long call spread trade recover some of the losses it had accumulated since inception. In part this was due to general dollar strength, with the greenback advancing against a broad range of currencies over the past week. But some of the gains in USD/CAD were specific to the loonie. After the BoC hiked rates in July, the market quickly priced in another 25bp increase before the end of the year. This led to a massive short squeeze as investor positioning on the CAD had been very bearish (right-hand chart above). As those bearish bets have now been fully unwound, there should be more scope for USD/CAD to appreciate further, especially if the US dollar's recent strength continues.

Portfolio gained 25bp this week

Elsewhere, our portfolio has added another 25bp of performance since the last update. The best-performing trades were Long EEM ETF (+15bp), Long GBP/USD put spread (+13bp), the Long Russia RTSI$ position opened last week (+6bp), and Long USD/CAD call spread (+5bp). On the negative side of the ledger, our Long 10y UST/Short Bund subtracted 14bp of performance and Long EUR/SEK put spread 11bp. Our long USD/TRY put spread expired worthless on August 3rd, resulting in a loss of 38bp (the premium paid at the start of the trade). As the value of the options had already dwindled virtually to zero last week, the trade didn't detract from this past week's performance.

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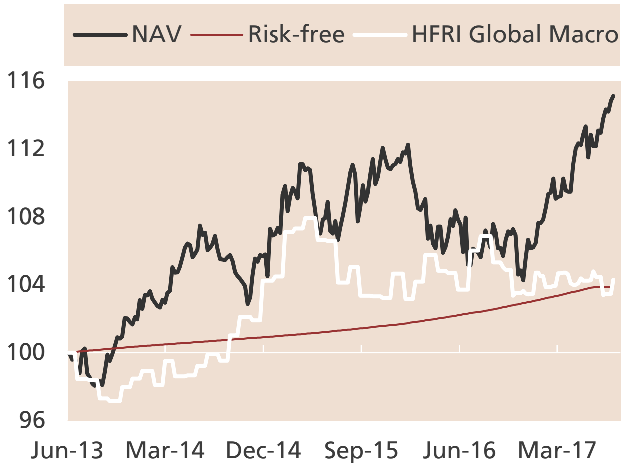
Current trade recommendations

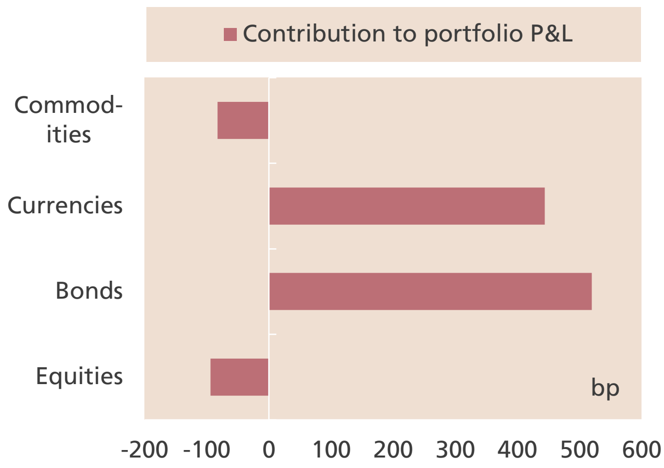
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global reflation								
	Long EM equity (EEM US)	21-Jun-17	41.10	44.26	7.7%	45.75	42.75	Benign inflation outlook, EM cheap and underinvested
	Long Russia RTSI$	02-Aug-17	1015.0	1038.4	2.3%	1200	900	GEM tailwinds, US sanctions priced in, cheap valuations
	Long EUR/SEK 6Sep17 put spd	14-Jun-17	21bp	36bp	15bp	n.a.	n.a.	Rising Swedish inflation and EA growth
UK soft patch								
	Long GBP/USD 29Sep17 put spd	29-Jun-17	35bp	26bp	-9bp	n.a.	n.a.	Monpol expectation too hawkish; soft patch expected
ECB Taper								
	Long 10y UST / Short Bunds	05-Apr-17	210bp	179bp	24bp*	160bp	186bp	Spread too wide due to ECB asset purchase programme
	Long EUR/CHF**	17-May-17	1.0900	1.1300	3.8%	1.1700	1.1300	Taper starts policy divergence; CHF safety inflow slowing
Premature tightening								
	Long USD/CAD 31Oct17 call spd	12-Jul-17	41bp	27bp	-14bp	n.a.	n.a.	CAD too strong to support Canadian growth

*Bund-UST pnl includes 7bp (of yield) cost of Bund benchmark roll **Stop loss triggered today

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio performance metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	15.11%	4.30%
Annualized Return	**3.42%**	**1.01%**
2014	4.35%	5.61%
2015	3.99%	-1.26%
2016	-4.89%	0.14%
YTD	8.74%	0.96%
MTD	0.03%	
Volatility (ann.)	4.70%	3.71%
Sharpe ratio	**0.54**	**0.03**
Sortino ratio	**1.10**	**0.24**
Alpha (vs HFRI)	3.46%	
Beta (vs HFRI)	0.07	
Correlation (vs HFRI)	0.06	
Correlation (vs MSCI World)	0.15	
Correlation (vs JPM GBI)	0.01	
Max drawdown	-7.57%	-4.40%

Best and worst trades

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long 10y UST / short 10y Bund (05-Apr-17)	170
US 2s10s flattener (08-Mar-17)	130
Long EM equity (21-Jun-17)	120
Long 10y USTs / short 10y Gilts (30-Aug-16)	120
Long 10y Bund / short 10y OAT (14-Dec-16)	117
Worst	**Contrib. (bp)**
Long US Banks / short S&P500 (03-May-17)	-139
Long GBP / short USD (07-Sep-16)	-105
Long Gold (02-Nov-16)	-97
Short CAD / long MXN (26-Oct-16)	-60
Long INR / short KRW (04-Jan-17)	-59