5th December 2024

MacroVantage

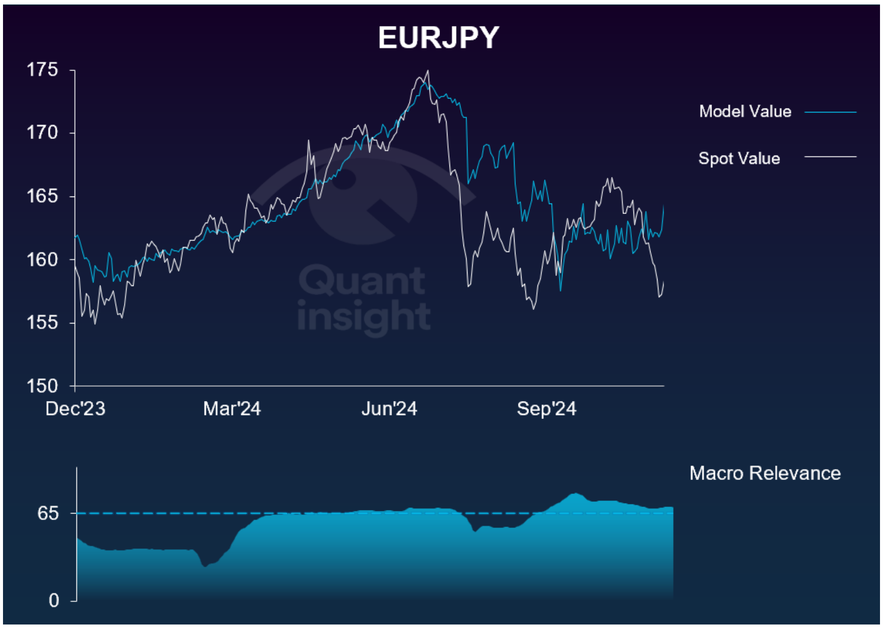
Uncover price dislocations, trade opportunities, regime shifts and sensitivity across asset classes

1. **Red flag on Yen strength**
2. **R2K : Easy money over?**
3. **Long duration equity outperformance underplaying risks of inflation vol**
4. **Semiconductors remain the optimal AI play?**
5. **FTSE MIB vs DAX: A Europe play?**

1. Red flag on Yen strength

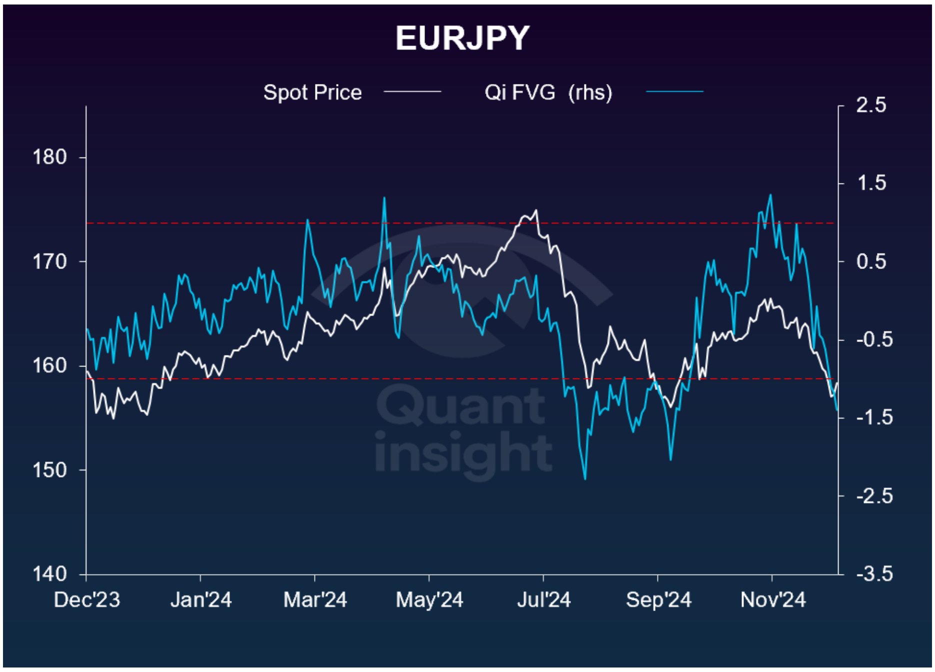
The bond market has moved to price in a good chance of a BoJ rate hike on December 19th. But, on Qi, the Yen has overshot versus overall macro conditions including the recent move in interest rate differentials.

The Yen screens as rich versus every one of its G7 peers on Qi. There are four models which are in regime (model confidence > 65%) and where the Fair Value Gap is greater than 1 sigma. USDJPY, EURJPY, AUDJPY and CADJPY all suggest the risk-reward favours a Yen retracement.



The profile is the same in each case. Macro-warranted model value is rising, spot has been falling & Qi has a bullish divergence pattern. EURJPY shows the pattern which is consistent for each cross.

It also shows the 1y correlation between spot price and Qi's FVG is decent. That suggests this low in the FVG could mark a local low in spot EURJPY.



Back-testing the historical efficacy of these signals shows USDJPY here is in "coin toss" territory so it's not the optimal trade expression for tactical Yen bears. But EURJPY (71% hit rate, +1.7% average return), AUDJPY (71%, +1.6%) & CADJPY (69%, +0.9%) all suggest there's decent upside to play for here.

Finally we note the Nikkei 225 was 1 sigma cheap to macro conditions at the start of the week. The FVG has subsequently narrowed but it remains below model value and the Yen features as a negative driver, i.e. a weaker Yen would provide another tailwind for Nikkei upside.

2. R2K sensitivity to HY credit spreads has dropped to zero – the easy money is over

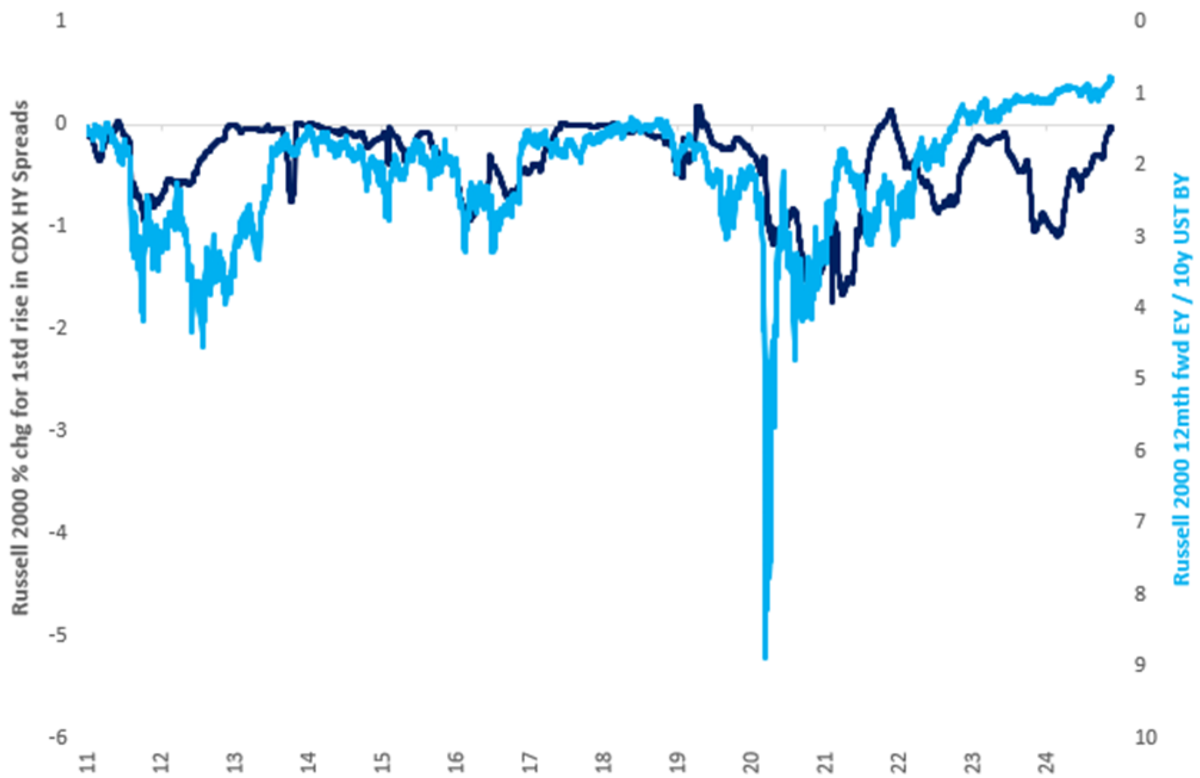
"Long until inauguration day" and "Don't fight the seasonals" have become common parlance in the financial media. Since the election, the highest short interest stocks have rallied almost twice as hard as the most popular VIP longs as the market jumps to the laggards vs. the mega cap techs of the universe.

The make-up of returns YTD across the major US indices reveals striking differences – 76% of the Mag 7's 57% return ytd stems from higher earnings growth expectations; contrast that with the Russell 2000 where only 9% of the 20% return ytd stems from rising 12mth fwd EPS – 91% of the return has come from PE expansion.

The point is that easy money on Trump trades have made and are much more priced for higher nominal growth expectations vs. the 2016 setup. We should not be expecting the low vol environment of ~10 VIX in 2017 to repeat. In particular, the debate around a higher neutral rate will continue. The tails have become fatter.

Qi's lens on the Russell 2000 warns of the risk between expectations and reality – R2K factor sensitivity to HY credit spreads has dissipated to almost zero on our model. Ordinarily, there is a large negative relationship i.e. higher spreads, weaker small caps. Back in the Spring, CDX HY spreads hit 312bps vs. 295bps today. Over the same period, the Russell 2000 has rallied 20%.

The narrowing of sensitivities to zero has occurred in the past BUT the difference today is that credit spreads are back at their multi-year tights. The below chart shows that sensitivity since 2011 (dark blue). Alongside I show the ratio of the R2K 12mth fwd earnings yield / UST bond yield (light blue) – the message is the same – a "yellow" signal the easy money is over and those earnings expectations better start ramping up soon.



3. Long duration vs. short duration vulnerable, underplaying the risks of higher inflation vol

In the immediate aftermath of Trump's win, the domestic agenda of deregulation, tax cuts and tariffs was deemed as stoking inflation. In recent weeks, that narrative shifted to the growth risks from DOGE cost cutting, trade wars and a potentially fading Citi economic surprise index.

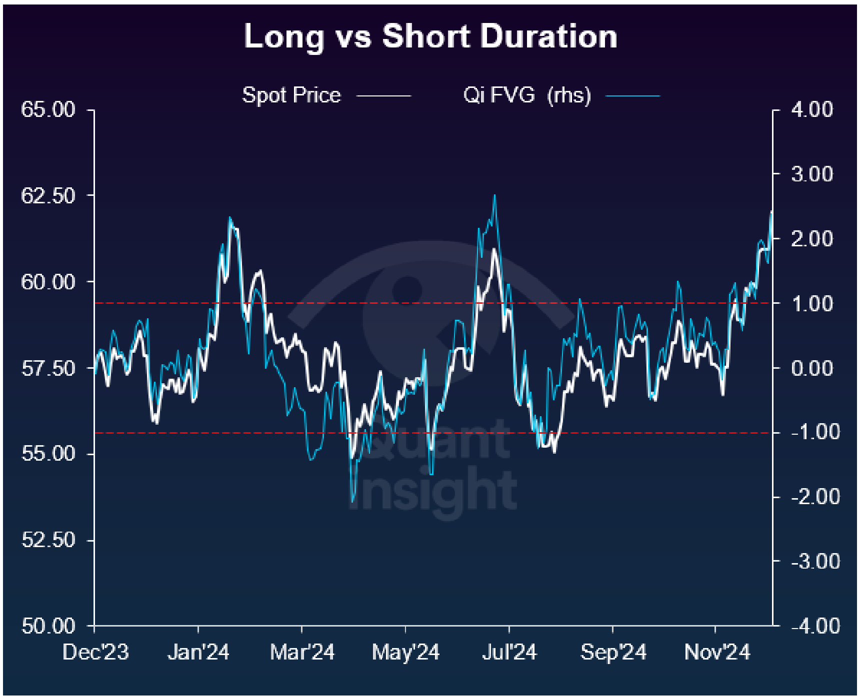
That said, we should expect inflation volatility to remain elevated compared to the post GFC decade - a backdrop of stalling globalisation and heightened supply risks which are likely reinforced by Trump's policy proposals.

Given high equity valuation levels there could be an asymmetry developing - going forward there will be less of an equity tailwind from lower rates / further policy easing, whereas higher rates have the potential to deliver greater pain

So clearly, the growth / inflation mix needs to be just right otherwise bond term premia will continue to move higher. In turn, this would keep equity / bond correlations elevated i.e. higher bonds -->> lower discount rate -->> higher stocks.

The relative performance of longer duration (e.g. non-profitable tech / biotech growth etc.) vs. shorter duration stocks (e.g. oil drillers dependent on near term cashflows) will likely be a good tactical barometer to judge the reaction function to rates. The former cohort would be more vulnerable to higher rates.

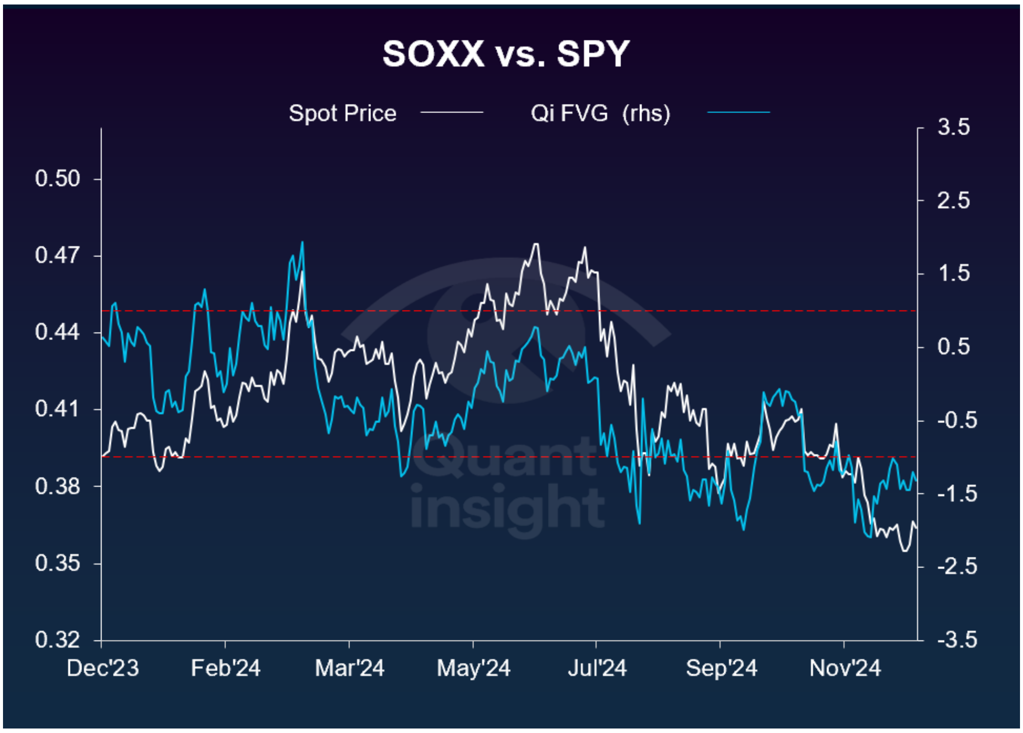
In the election aftermath, long duration stocks have seen significant outperformance i.e. current market sentiment underplays the risks from higher inflation vol. Qi's macro relational model suggests the GS basket of long duration vs. short duration stocks as sitting 2.4 sigma (~5%) above Qi model value. That valuation gap is close to the highs of the last 5yrs. Further, its high correlation to the spot price of this basket pair suggests it is offering a good mean reversion signal. The pendulum on the inflation vol debate tactically seems to have shifted too far one way…



4. Semiconductors remain the optimal AI play?

The Trump rotation theme has favoured small caps and value plays, but also coincided with a debate around the next leg of the AI trade. One theory is that semiconductors pass the baton to software stocks as the next beneficiary.

Relative to macro conditions, that thinking may have moved too far in the near term. Qi shows semiconductors are cheap outright, relative to the software sector and relative to the broader market.



SOXX screens as as 1 sigma (6.4%) cheap to aggregate macro conditions. The RV of SOXX vs. IGV sits 1.1 sigma (8.5%) below Qi's macro-warranted model value. While the SOXX / SPY model is 1.3 sigma (10.6%) cheap to macro – chart above.

Since 2009, this FVG has only been seen on twelve occasions when the model is in regime. Using this as a +SOXX-SPY entry level produces a 92% hit rate and an average return of 3.04%. Time for semiconductors to reassert their dominance?

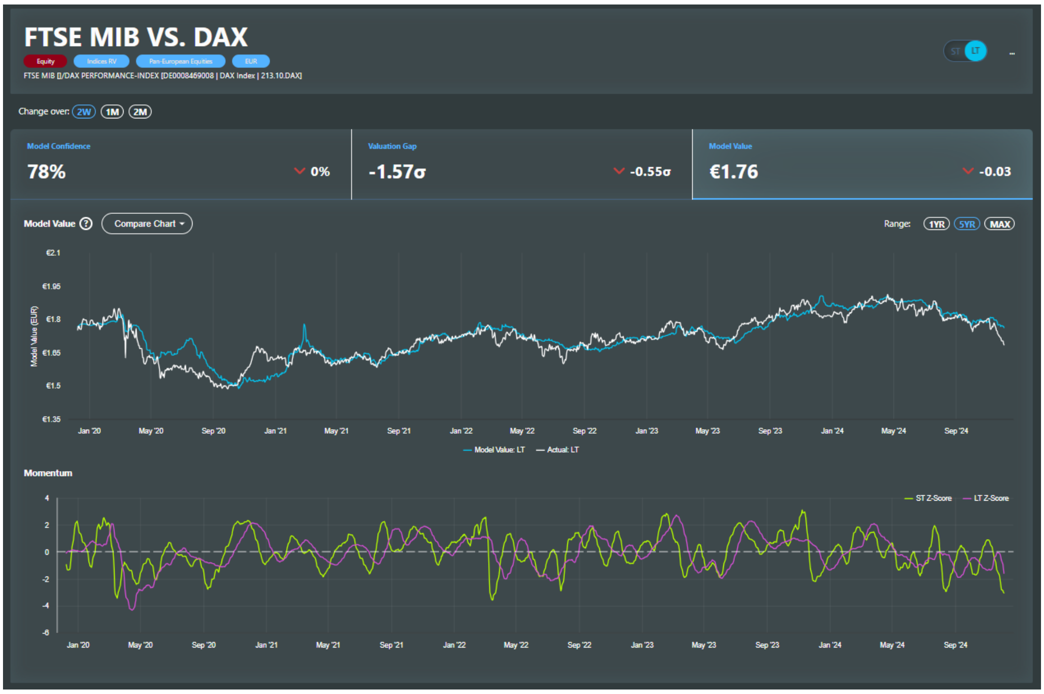
5. FTSE MIB vs DAX: A Europe play?

Despite all the concerns about Germany (China auto competition, energy problems), the DAX continues on its merry way making highs driven by expectations of global reflationary GDP growth and easier financial conditions. The MIB on the other hand is flatlining but is driven essentially by the same factors with one exception, the MIB wants the EURUSD to stop dropping and this sensitivity is at a high just as the EUR is close to its lows.

Looking at the RV cross MIB vs DAX we see the following:

- Solid model confidence of 78% -- the RV is being driven by macro
- A valuation gap of ~1.6sigma or 4%+ cheap to model
- Model momentum heading towards multi-year lows and should be watched
- Key drivers being EURUSD stabilisation / reversal, European confidence improving and easier financial conditions

If the EU authorities and the ECB are going to tackle the problems of the European economy with industrial and monetary policies, then this may be an interesting cross with less risk than outright plays.



Top Drivers
Driver Delta
Shows the % move in the model value for a 1σ move higher in the driver
Select Date
Top Drivers
All Drivers
NEGATIVE DRIVERS
POSITIVE DRIVERS
JPY 10Y Real Rate
VIX
VXEEM
VDAX
ECB Rate Expectations
Itraxx Xover
Itraxx Japan
FinSub Credit
Euro 5s30s Swap
US HY
EUR TWI
Spain Sov. Confidence
Italian Sov. Confidence
Copper
China GDP
Greek Sov. Confidence
USD Liquidity - JPY
WTI
Germany GDP
Italy GDP
-0.30
-0.25
-0.20
-0.15
-0.10
-0.05
0.00
0.10
0.20
0.30
0.40