10th October 2024

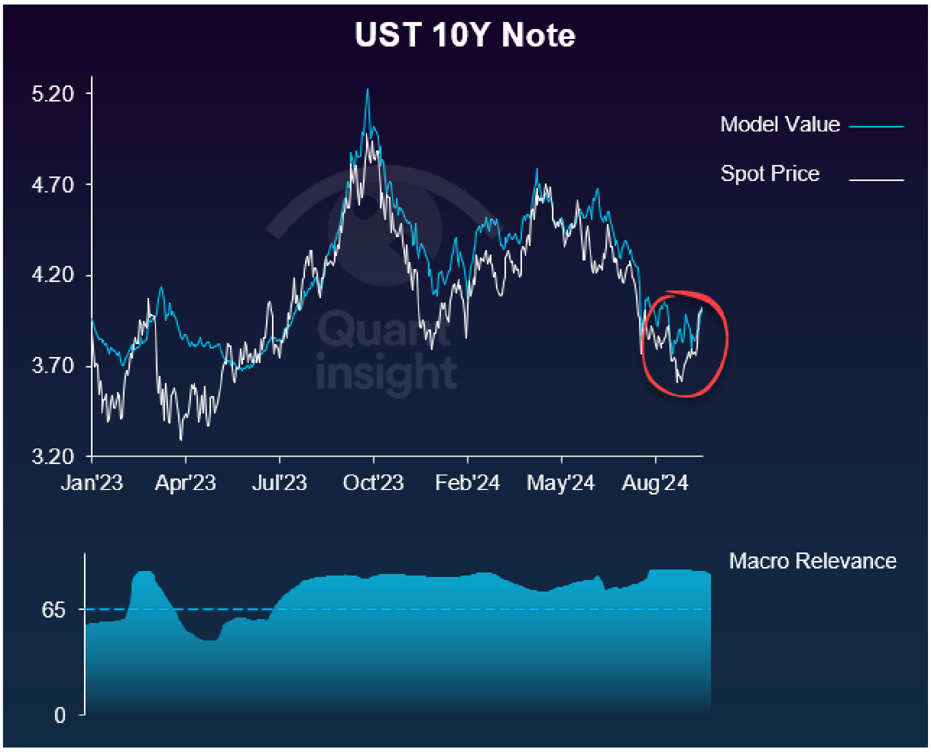
1. Re-pricing inflation risks

Ahead of US CPI today it is worth noting the significant re-pricing of inflation expectations seen since the Fed's 50bp rate cut. Recession fears over the summer pushed 5y inflation expectations 3 standard deviations below their 1y trend.

Since the rate cut, expectations have bounced sharply. 10y TIP break-evens are 30bp wider. In Qi's z-score terms, inflation expectations have risen back *above* trend. A beat today could push this further of course, but it is worth noting a fair degree of re-rating has already occurred.

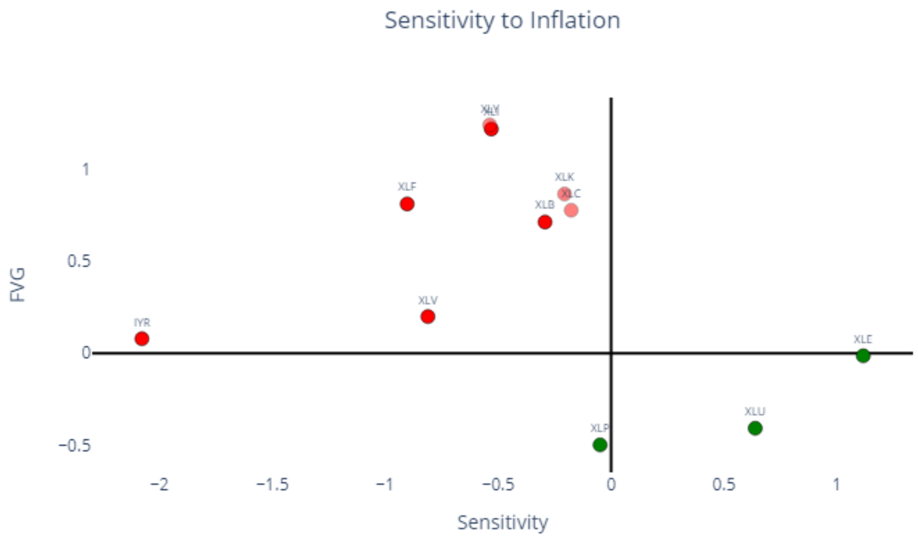
That is also evident in 10y US Treasury yields. Post FOMC, 10y UST yields hit a local low of 3.59%. That was 1 sigma (26bp) too low relative to aggregate macro conditions.

Inflation expectations are the biggest driver of our 10y UST model accounting for 24% of explanatory power. And the re-rating of inflation meant Qi's macro warranted model value never fell below 3.80% post Fed, and have since moved up to 3.97%. 10y yields have subsequently caught back-up to macro conditions.



2. <u>A US sector cheat-sheet for CPI</u>

The chart overlays the sensitivity of US sectors to US inflation expectations, with their Qi Fair Value Gaps.



Unsurprisingly, Energy is the biggest beneficiary if inflation expectations move higher. XLE sits at Qi model value so there is no valuation edge.

Utilities also benefit which suggests, on current patterns, the sector is less a bond proxy and more a reflation (AI data centre) play. XLU is 0.4 sigma (3.2%) cheap to macro so looks the most efficient trade expression for a CPI beat.

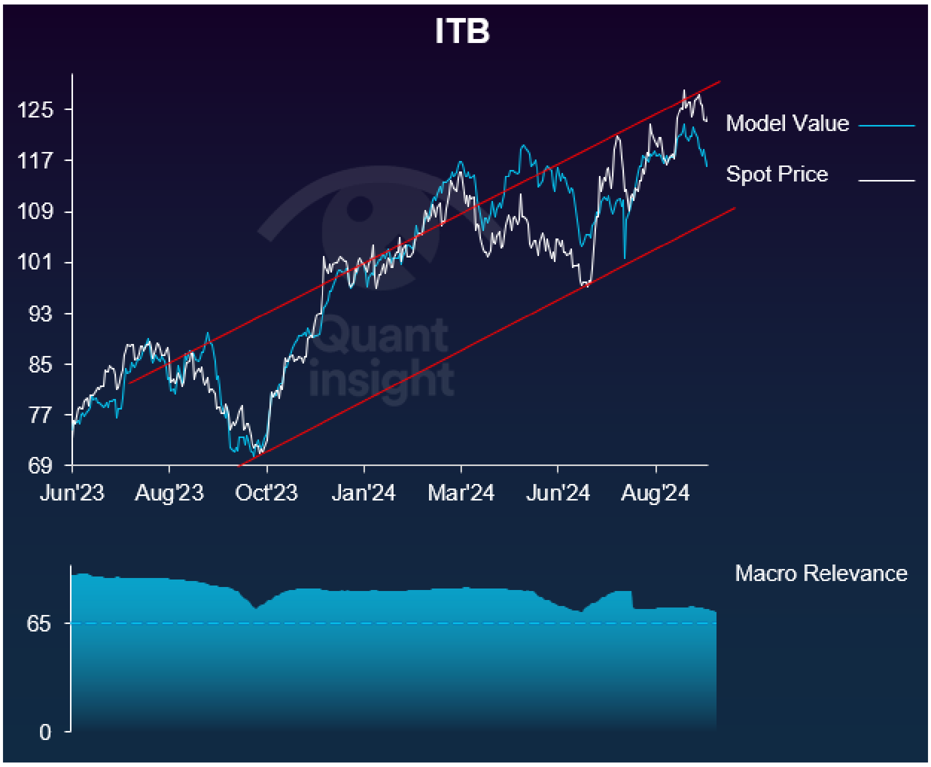
Most US sectors are negatively sensitive, i.e. want lower inflation (Fed rate cuts). XLI and XLY stand out as two of the more expensive in pure FVG terms. But Real Estate is by some margin the sector with the greatest sensitivity. IYR benefits from a miss but is the most vulnerable to a strong report today.

3. Qi bearish divergence signals across US cyclicals (XLF, XLI, ITB)

We noted in "*Macro Hub*" earlier this week that the S&P500 macro beta impulse was tentatively stabilizing around multi-year lows, i.e. have the diminishing sensitivities to macro reached a floor? Qi's models suggests bull curve steepening, lower inflation expectations, a weaker dollar and 10yr rates stabilisation are still important for stocks. Aside from being on inflation watch, we have the start of earnings season beginning with the banks. Does election uncertainty lead to conservative guidance for Q4? What about the geopolitical uncertainty? Bottom-line, the path up for stocks may be getting narrower.

Qi's valuations models are now highlighting bearish divergence signals across a range of US cyclicals, i.e. where the spot price has rallied over the last week but, in contrast, the Qi model price has fallen. See below snapshots of XLF (+0.8 sigma) and XLI (1.2 sigma). Has cyclical optimism over-extended in the near term?

We would also highlight the risks around the ITB ETF. Homebuilders have delivered among the strongest returns over the last year of any US industry. Qi's models show the macro backdrop has now become a drag to performance. At the heart is whether FCIs have now seen their floor – thus far, ITB has been a beneficiary of a weaker dollar, lower real rates, tighter HY corporate credit and bull-curve steepening.



4. Canada's TSX – short term over-optimism?

A new bearish divergence signal on the Canadian SPTSX. Tighter FCIs (wider credit spreads, higher real rates) plus VIX back > 20 have pushed Qi model value 3% lower since late September. Thus far, the market has ignored this deterioration in macro conditions leaving Canadian equities 1.1 sigma (3.8%) rich to macro.

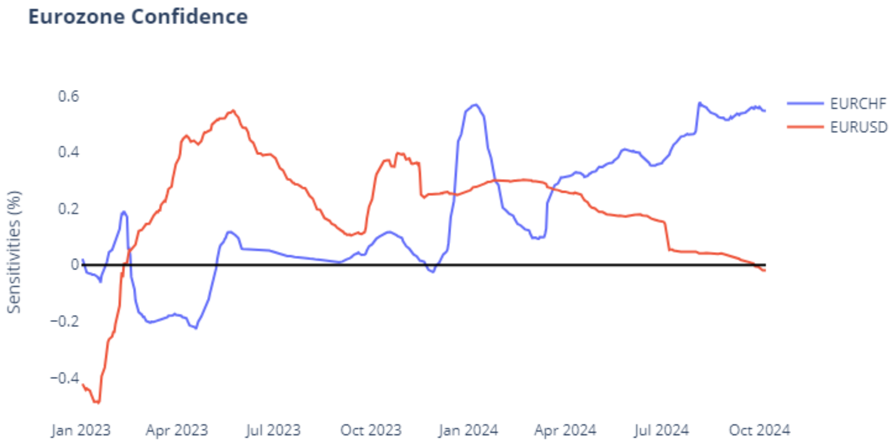
Copper is also a notable positive driver for Canadian equities, alongside global GDP. However, copper has fallen ~5% over the last week. Again, we ask has cyclical optimism gone too far?

5. **French downgrade? EURUSD vs. EURCHF**

The French budget is back in the headlines. Key will be the reaction of the rating agencies, all three of whom deliver their verdict over the next few weeks – Fitch on October 11th, Moody's on the 25th and finally S&P on the 29th.

Fears of a possible downgrade will prompt many to consider short EURO fx positions. But while many will instinctively look to EURUSD downside, Qi's unique sensitivity analysis suggests the most efficient trade expression is more nuanced than that.

The chart below shows the sensitivity of EURUSD and EURCHF to Qi's Eurozone Sovereign Confidence factor.



EURCHF sensitivity is high and rising. This factor is the biggest single driver of our model which currently has a R-Squared of 82%. In sharp contrast, EURUSD sensitivity has fallen to zero. Instead, interest rate differentials dominate explaining 38% of the variance in EURUSD.

EURUSD downside only makes sense if you believe a French downgrade prompts the ECB into being more dovish relative to the Fed. A French downgrade that doesn't result in a policy response, will have a far greater drag on EURCHF.