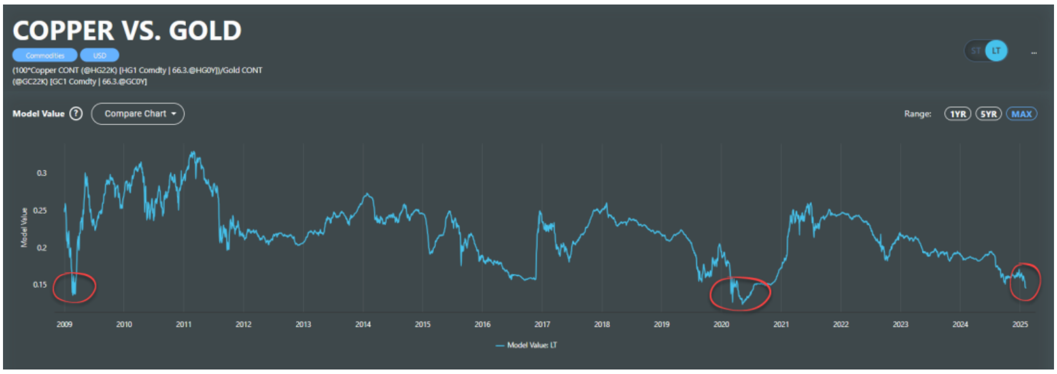
1. A message from bonds & commodities

Much of 2025's early price action seems consistent with the idea we're sitting in the middle of the Dollar smile - a point where economic growth is just decent enough to undermine US exceptionalism & favours the RoW.

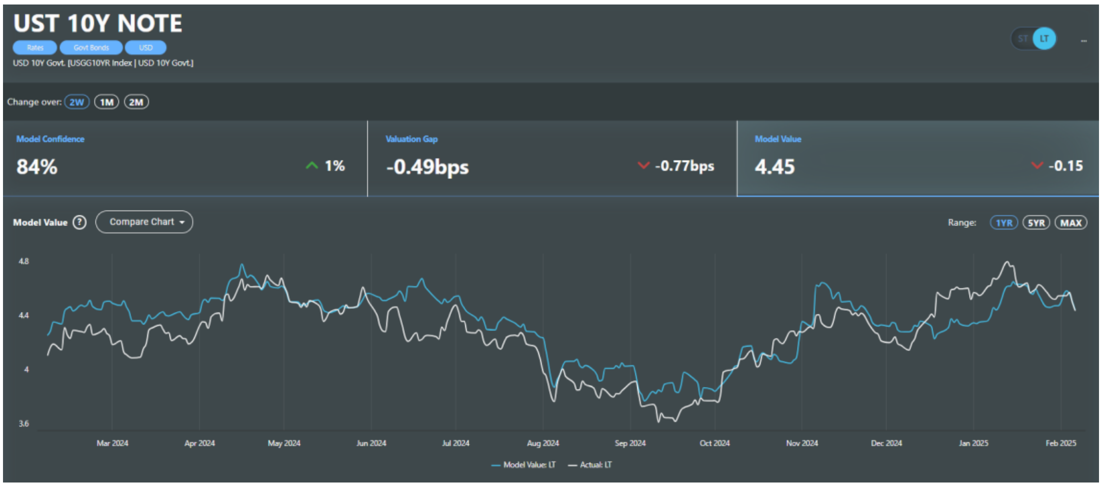
There are two warnings from the commodity & bond market that could disrupt the idea we're in that middle sweet spot.

Firstly, the red warning - Qi's model of the Copper / Gold ratio is falling to levels only previously seen during Covid lockdowns & the GFC.

The ratio of industrial versus precious metals is an old school gauge of the global economic cycle - new lows suggest the commodity market is growing more fearful of a global trade war & hence recession.



Secondly, the amber warning. Since mid-December, UST yields have been too high relative to prevailing macro conditions. Now 10y US Treasury yields are back at 4.45%, Qi's macro-warranted model value.



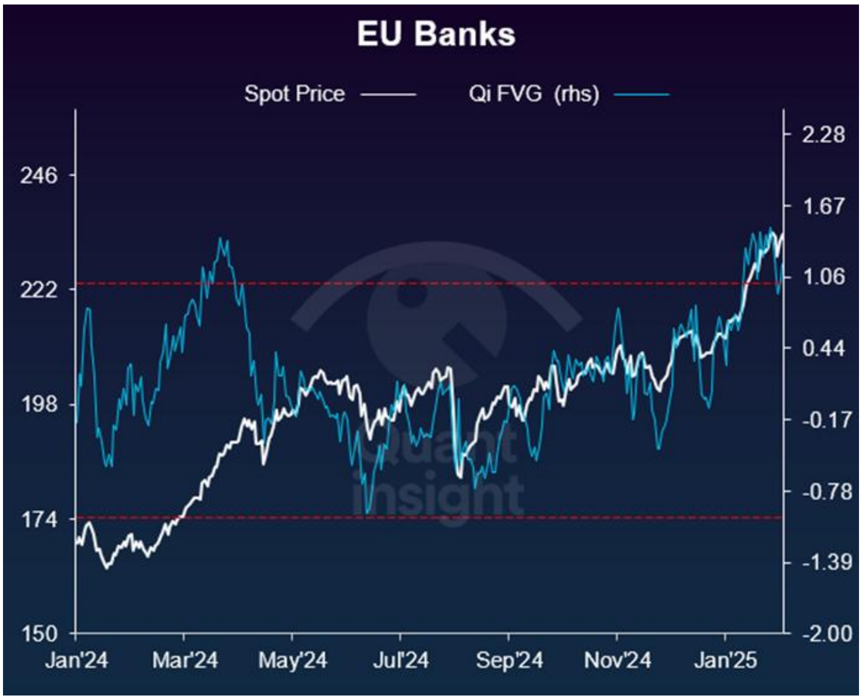
Qi's model is strong (84% confidence) & the market has now mean reverted to macro fundamentals. Going forward, watching Qi model value for clues on macro momentum is critical.

It has fallen 12.5bp since mid-January: rising inflation expectations have been offset by a moderation in economic growth, a pause in the hawkish re-pricing of Fed rate cuts plus more subdued rate volatility. Qi provides a real-time aggregation of these crosswinds.

Bessent has flagged how important 10y UST yields are. That's especially true now since a deflationary signal from both the bond and commodity market together would threaten a host of trades that have been the early 2025 performers.

2. European Banks – too far, too fast

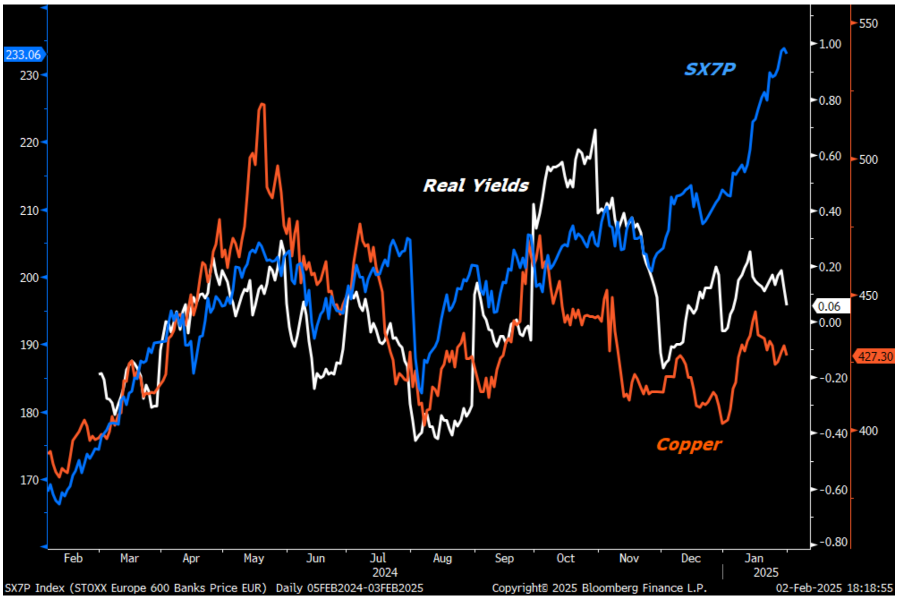
Perhaps a surprising fact is that European banks have outperformed the Magnificent 7 over the last 1yr. Sector performance has particularly accelerated since last November.



The macro drivers reflect the sector's reflationary posture. It wants higher GDP growth, a stronger Euro, higher metals, higher real yields and tighter credit spreads.

However, through this year the valuation gap between spot price and Qi's macro-warranted fair value has expanded to +1.1 sigma. The fair value gap is at its highs relative to the last 1yr. See the chart below where we plot the sector's fair value gap against its spot price – the strong relationship is sending a warning Qi's FVG for the sector is an exploitable mean-reversion opportunity.

To empirically see this disconnect, below we simply plot SX7P vs. copper and real yields.



Idiosyncratic drivers may well have dominated – earnings have been solid and investors have been looking for value in the face of concentrated US market. However, Trump has made clear that he will "*absolutely*" impose tariffs on the EU. Needless to say, any worsening of credit owing to economic impacts from trade war escalation will have an oversized impact on banks.

Thus far, European markets have been exceptionally resilient. There is hope for lack of trade escalation but "hope" is a not a strategy. We are simply highlight that tariff risks are not being fully priced in.

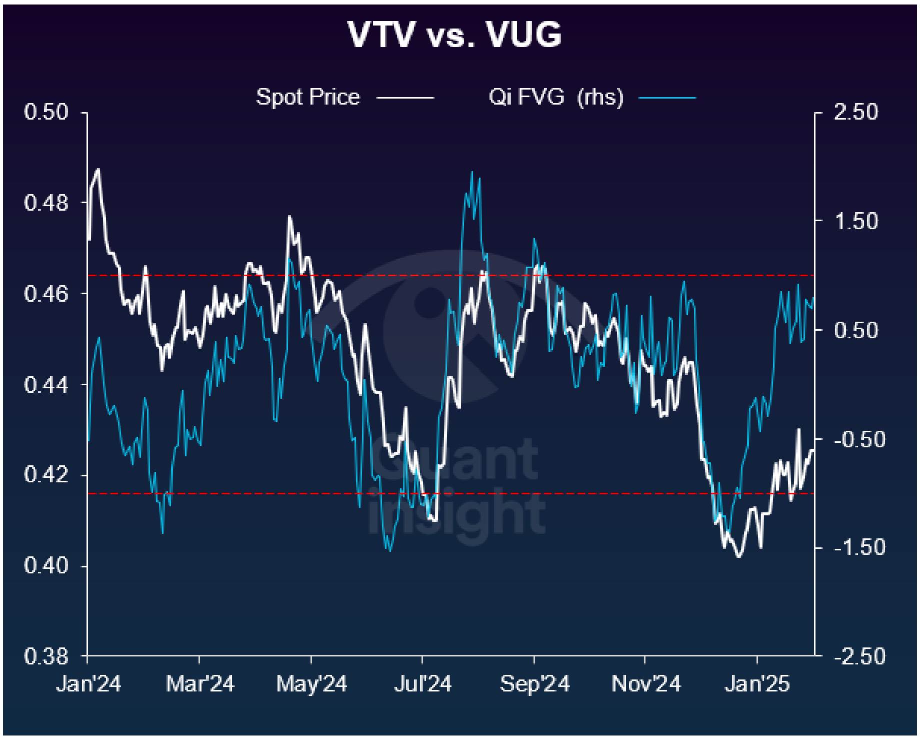
3. <u>Value the Comeback Kid but tariff risks temper the enthusiasm</u>

In line with the observation above on European banks, Value has been outperforming Growth since late last year. This is a reflection of the challenge to the US Exceptionalism thesis. The outperformance we have seen has come alongside the weakness we have seen in the Dollar YtD. See the chart below highlighting the strong inverse relationship of late.

Growth, and its close cousin Momentum, is the style more synonymous with the Trump boom trade of higher economic growth, higher rates and stronger dollar. Indeed, its outperformance over Value has come alongside the US equities outperforming RoW World equities.

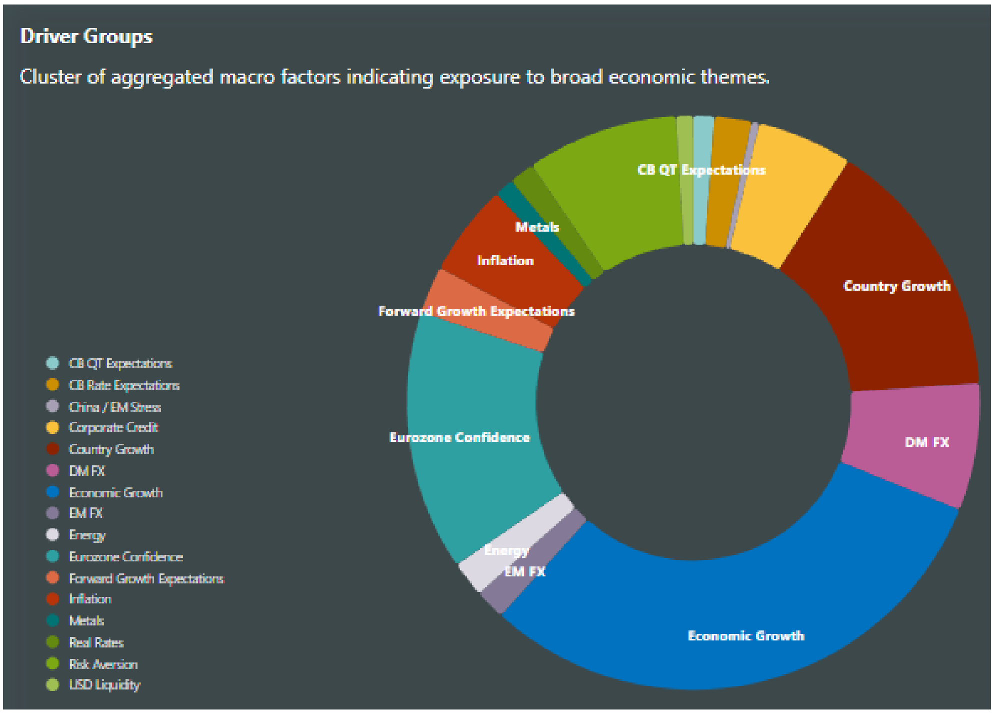
Now delaying implementation leaving scope for negotiations has seen the dollar move lower after the initial Executive Order was announced. However, we do recall that when tariffs eventually materialised in summer 2018, the news did lift the dollar. For now, the lingering tariff threat could limit Dollar downside.

Below we should the relative performance of Vanguard Value vs. Vanguard Growth overlaid with Qi's fair value gap of the pair. The latter is close to the highs of it 1yr range. While, we share the view that US Exceptionalism is at risk (see last week's note), it won't be so straightforward if trade wars escalate.



4. <u>Similarly, DAX outperformance at risk</u>

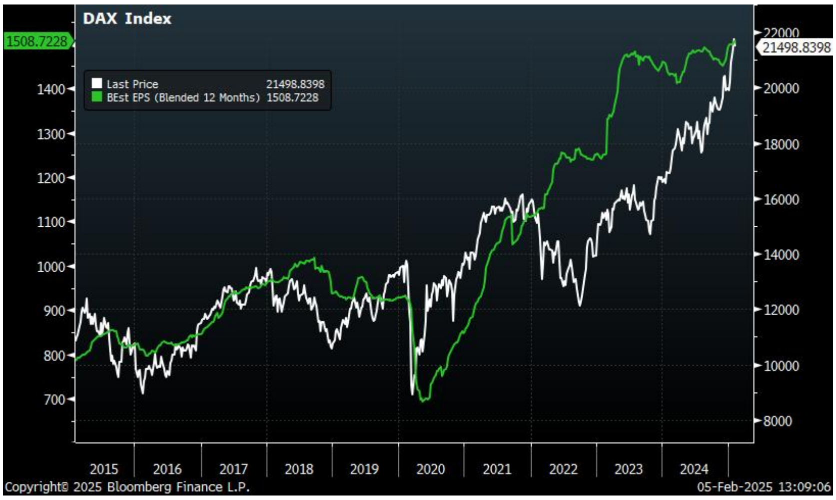
Perhaps another surprising fact, the DAX posted in Jan its best monthly performance since November 2023! Economic growth is *the* largest broad macro driver of the index. See the chart below. Thus far, global growth expectations have been rising whether we see the Citi global economic surprise index or the Eurozone and Japan composite PMIs moving above 50. Alongside, there is an expectation that the results of the forthcoming German elections act as a catalyst to release the debt brake and pursue a more expansionary fiscal policy.



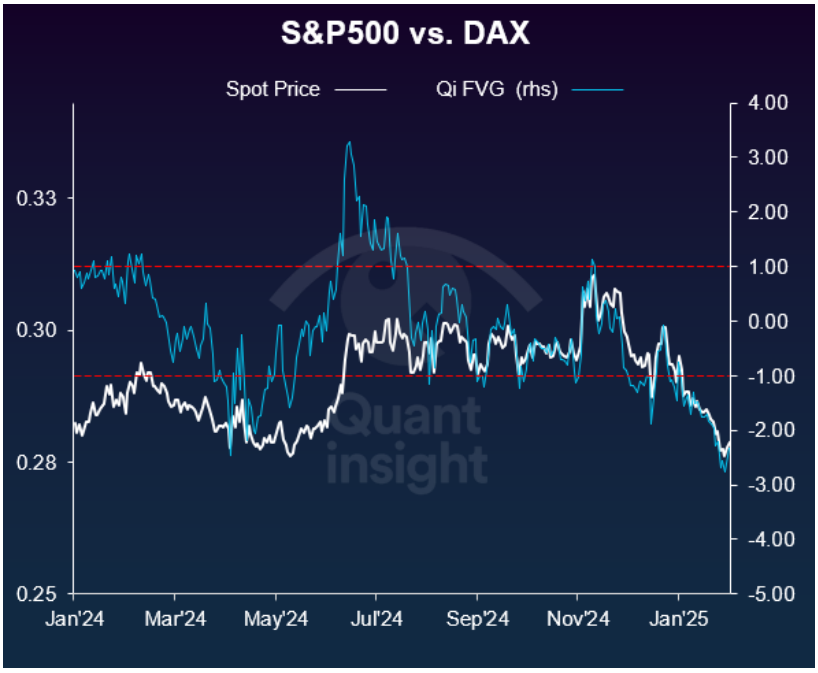
However, earnings expectations have been relatively stagnant over the last year in comparison to price performance i.e. we have seen significant PE expansion. See the chart below.

Further, within Europe we know that the beta to global trade is highest in Germany. The likes of Autos and cyclical sectors would be the most vulnerable on higher trade uncertainty.

Qi shows that the DAX would benefit from a weaker EUR reflecting its global exposure. Our concern is that the flipside is the EUR can act a risk-on / risk-off barometer. As we showed in last week's note, a strong dollar has tended to mean under-performance of non-US markets historically.



What it striking to us is the Qi fair value gap for the S&P 500 relative to the DAX has hit 1yr lows. Therefore, tactically, this is not an area where we want to push the "US exceptionalism at risk" narrative. See the chart below.



Quant insight

5. <u>USD downside</u>

At the start of the week, USDCHF screened as 1 sigma (2.5%) rich to macro conditions. A historically significant level with back-tests revealing it has a 76% hit rate as a bearish signal.

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FVG_Back_Test(['USDCHF'],1.0,0.25,65,'2009-01-01','2025-02-03',['Short'],'Long Term')
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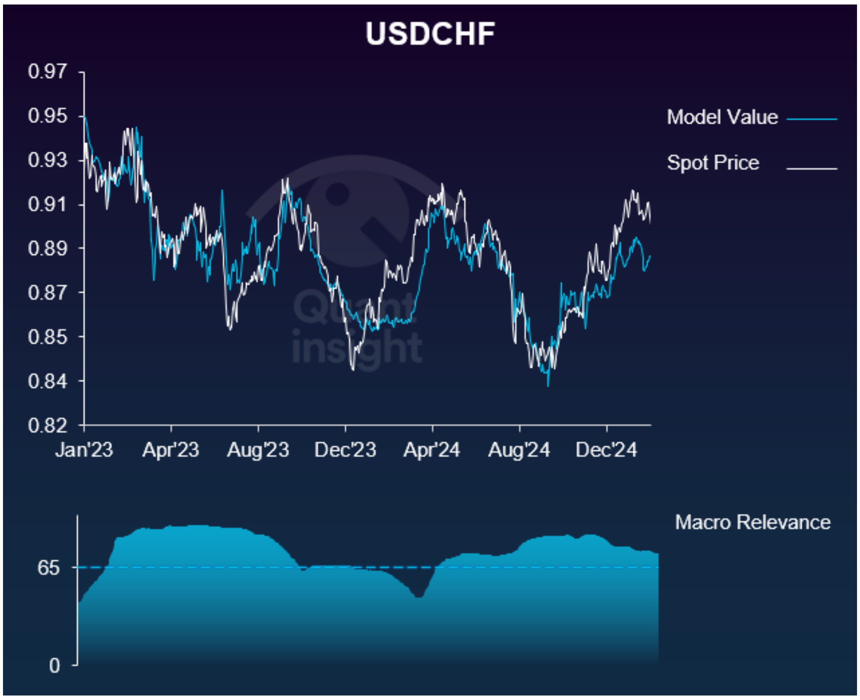
✓ 3.2s

	Results
Hit Rate	76.190476
Avg. Rtrn	1.263375
Ann. Rtrn	25.549613
Median Rtrn	1.126983
Avg. Max Gain	1.957463
Avg. Max loss	-1.393730
Avg. Holding Period	13.904762
Median Holding Period	10.000000
No. of Trades	21.000000
Avg. Win	2.420989
Avg. Loss	-2.440991
Win/Loss	0.991806

That Fair Value Gap has subsequently narrowed but the cross still sits 1.6% above macro-warranted fair value.



Both the Dollar & Swiss Franc are considered flight-to-quality beneficiaries, but Qi's model (which has 75% explanatory power) suggests the Franc remains the ultimate safe haven. Current patterns show higher VIX is consistent with lower USDCHF.

The upshot is twofold. Firstly, the negative relationship with risk aversion means - at these levels - it's increasingly tough to justify USDCHF upside based exclusively on a "risk off" mood in markets.

Secondly, at the broader macro level the risk-reward is skewed to USDCHF downside. That's regardless of whether VIX is above or below 20; and especially true with regard to Bessent & 10y US yields given that interest rate differentials screen as the dominant driver of the cross right now.