

## Improving Fundamentals, Exuberant Sentiment

Our long term positive view remains unchanged; in the short term we see an opportunity to lighten-up US bond duration and equity risks

In our 2017 outlook piece, published at the start of this year, we anticipated another positive year for risk-assets. This view has been supported by the strength we see in fundamentals: 1) valuations are definitively not cheap, but neither extremely extended in equity markets; 2) the US and the global economy are growing faster; and 3) the earnings recession is over. After 5 successive quarters of negative earnings growth, we are seeing +7% growth in last quarter's EPS in the US and +12% growth in EPS in Europe. Furthermore, Trump's economic policies on average, will help both the economic as well as the earnings cycle

While we said at the start of the year that we believe investors will benefit during 2017 from being invested- which has already produced material returns, as the S&P500 is +5% year-to-date. A key point from our 2017 outlook was predicting sharper and more frequent market movements in both directions. Given this dynamic, it is crucial to constantly evaluate opportunities to make tactical shifts as well as portfolio hedging strategies.

We recommended that clients maintain increased levels of cash in order to tactically respond to these volatile moments. In this type of environment, those portfolios which are more adjustable to the short-term changes in the market will benefit.

Our structural view of 2017 remains the same: positive. However, now, after the great reflationary Trump rally, which our clients participated in extensively, we are calling for a short-term market correction of risk assets, which would include stocks (around 5%), as well as credit or spread securities. This is due to a confluence of factors, each potentially acting as a hidden ticking bomb.

Below we describe each of the elements we see contributing to a short-term correction:

### 1. Over exuberant Investors

Investors are focusing more on the potential for higher earnings growth and confidence among chief executives. CEOs are investing and hiring more while deploying capital, showing an investor behavior that did not exist even one year ago (during all the post Great Recession period). This is evidence that "animal spirits" have recovered. However, sentiment and "animal spirits" might be overextended in the short-term. Chris Verrone, the technical analyst from Strategas, and one of BigSur's buy-side research partners, expressed their concern as the as the S&P500's 14-day relative strength index, a closely watched

## The Thinking Man's Approach



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Our structural view for 2017 remains positive. The positive fundamental drivers we identified at the start of the year remain intact. However, in the shorter term, there has been huge reflation of risk assets, and the strength and speed of this run up in asset prices will most probably not continue.

The market will start focusing on the Fed's future rate hikes and Trump's agenda will have delays in both negotiations and implementation. This might shift "overly bullish" market sentiment. We recommend our clients to protect against US Bond Duration Risk as well as hedge some of the Equity Risk in the short-term.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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momentum indicator, finished above the 70 level considered the “overbought” threshold. Option activity also points to investors’ overconfidence, as the VIX, a volatility gauge, is trading around 11.5 way below its long-term average of 20 and in line with the era of quantitative easing. As the S&P500 is trading about 8% above its 200-day moving average, a bit extended, these technical factors might make the market re-test that key level.

Some analysts believe the euphoria may be misplaced. They say that these early signs of growth could still fizzle out. In a February report, Goldman Sachs analysts wrote that even if economic indicators look promising, “show me the activity”; real demand, real stock draws and empty warehouses.” A rising dollar could also pose a problem. While the currency declined for most of the first two months of this year, it has rallied in recent days on stronger indications that the Federal Reserve could raise rates at its mid-March meeting.

Judging by the extreme low level of volatility across stock, FX and credit markets, investors have become dangerously complacent about the risks facing the markets. This is because after eight years of low interest rates they are desperate for higher returns. What is clear is that many investors seem impervious to negative news. Thus, the fear is that today’s optimism could implode if — or when — investors start paying attention to downside risks, be that a political shock, a delay in tax reform or signs that protectionism is hurting growth. Exuberant investors have focused on the potential benefits of expansive tax cuts, while mostly ignoring the realities of risks from America-first protectionism and the erection of new trade barriers. Political realities suggest tax reform will get bogged down or watered down, regardless of the claims from the White House.

## 2. Risk of a trade war due to border-adjustable corporate tax or BAT

Tax reform should be win-win: Everybody benefits from a flatter rate structure, even if they lose their favorite carve-outs and deductions. Everybody (except tax attorneys) benefits from a more efficient, dynamic, faster-growing economy. Even more deep-pocketed and numerous are the idea’s opponents, since imports would no longer be deductible under the new corporate tax rate.

Essentially, imports would be taxed at 20%. Wal-Mart and most of the retail industry and petroleum-refining sector are opposed; the majority of the clothing and apparel companies; much of the tourism and higher-education industries. Plus, a variety of conservative groups, including some affiliated with the Koch brothers, plan to attack the idea as anti-consumer. In reality, border adjustability functions as a consumption tax; to many pro-growth types, a consumption tax is the ideal tax system.

Income would be taxed only once, when it’s consumed. Savings go untaxed until spent on consumption. Also, compared with the current tax structure, businesses would see less incentive to move abroad in search of lower taxes. The tax might also violate World Trade Organization rules, inviting other countries to impose punitive taxes on U.S. exports. In any case, U.S. tax reforms are



often replicated abroad. A general trade war might be in the offing if other countries adopt their own import-taxing reforms.

### 3. Disconnect between Treasury bonds and Risk Markets (i.e. Equity and Commodity markets)

As the Financial Times reporter Robin Wigglesworth expresses: “While equity market euphoria at the prospect of President Donald Trump’s spendthrift, deregulatory agenda remains undimmed, bond investors are sending a very different message.”

US equity indices have continued to rally this year, propelled by hopes of deregulation, tax cuts, government spending and more business-friendly policies. This week all four of the biggest stock indices achieved yet another fresh records in the wake of President Trump’s speech to Congress last week.

In contrast, there are few signs that fixed income investors think the new administration will be able to jump-start the economy, leading to a durable growth spurt and ultimately much higher interest rates. The bond market does not believe that the growth agenda will be dramatic. The pessimism is longstanding and in part reflects structural challenges facing the US economy, such as falling productivity and ageing populations, as well as a global savings glut that subdues bond yields.

US 2 year rates have moved up significantly (to the highest level since 2009 around 1.34%), pricing-in a higher inflation that is reaching the Fed’s 2% inflation target. Meanwhile, the 10 year Treasury currently at around 2.5% is well below the 3% we saw 3 years ago. While there has been a significant adjustment, in real terms money remains very easy to come by.

### 4. Potential Bond Tantrum

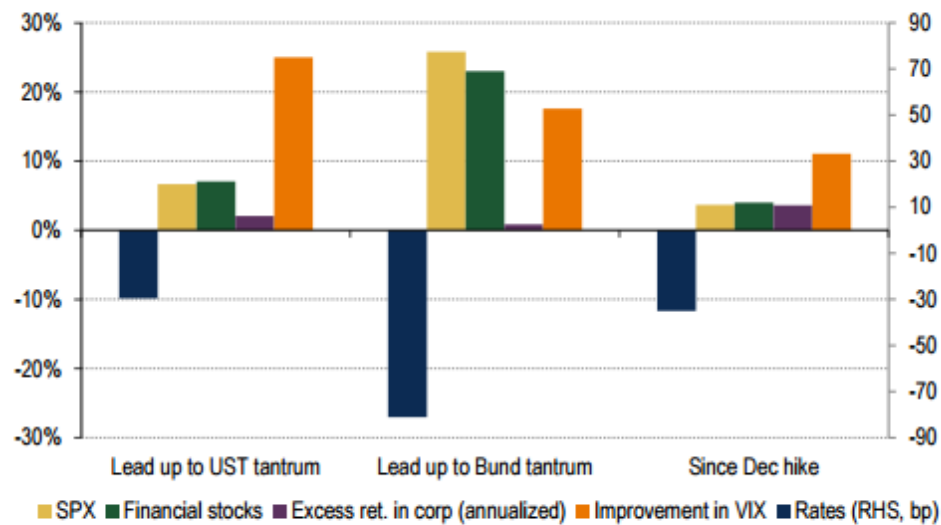
The disconnect in performance just described is usually a precursor to a bond tantrum. Bank of America Merrill Lynch (BAML) analyst Ralf Preusser demonstrate that a historical comparison shows that current divergence between real yields and risk assets (credit, VIX and equities) is unsustainable and sowing the seeds for the next taper tantrum.

BAML concludes that history offers a compelling reason to be cautious on duration after recent market moves. They analyze the divergence between real rates and a combination of risk assets – equities, financial stocks, credit spreads and VIX, three months into and after the prior tantrum episodes. There is no doubt that low real rates help fuel risk assets higher, feeding this disconnect. But at some point, it becomes wide enough to trigger a real rate catch-up.

The chart and descriptions below showcase the performance of real rates and risk assets in leads up to the US tantrum in 2013, the Bund Tantrum in 2015 and since the December Fed Hike.



**Chart 2: The disconnect between real rates and risk assets usually precedes a tantrum**



Note: We use US market variables in all three episodes.  
Source: BofA Merrill Lynch Global Research

- Leading up to the US tantrum: In 2013, real rates were richer by 30bp despite equities and financials being up by 7%, the VIX declining by 25% and annualized excess return in credit exceeding 2%. The following three months brought the taper tantrum where real rates shot higher by 160 bps.
  - Into the bund tantrum: In the 2015 lead-up to the Bund tantrum, the disconnect was wider – real rates were lower by 80bp and equities higher by 25% before the catch-up happened. The following three months saw nearly a 60bp rise in real rates.
  - Since the December Fed hike: Real rates are richer by 30bp, equities are up 4%, financials by 4%, VIX is lower by 11% and annualized excess return in credit exceed 3% – a similar cocktail to the months leading up to the US tantrum, while still somewhat away from the divergence in the Bund tantrum.
5. Signs from issuers point to a back-up in long duration rates

In US corporate bonds right now, it is an issuer's market. CFOs from large corporations with great track records for timing to issue debt, like Apple, Microsoft and AT&T have found so many investors buying, that they were able to supersize their multibillion-dollar fundraisings at the start of February. This has extended to even lesser known US companies, who are all issuing cheap debt. Most corporations have no need for cash – they are making these issues because they want to fund themselves at very low nominal rates (negative real rates) and feel that long rates will soon be higher.



This current balance of supply and demand favors issuers, and has caused the extra yield on corporate bonds relative to Treasuries to fall to its lowest level since 2014. According to Barclays' most recent data, the average spread is 118 basis points, compared to 210bp a year ago.

### 6. Trump's administration growth forecasts are too optimistic

While incoming administrations frequently present an optimistic outlook for the economy as it plans the budget. In the case of the Trump administration, the 10 year forecasts for GDP growth (usually referred to economic growth) differ way more than usual. While the Fed, the Economic Council of Advisers as well as private growth estimates are in the 1.8%-2%, the Trump administration is forecasting it at 3%-3.5%. While BigSur agrees that tax code reform, a tax holiday for companies repatriating corporate cash, increased infrastructure and military spending will boost growth; if indeed the Trump Administration delivers on their promises to maintain social security and Medicare programs, the expansive fiscal policy will no doubt create a budget deficit which would increase the cost of debt; starting from a \$20T US debt, is not a great beginning.

Dale Jorgenson, a Harvard economics professor who specializes in such projections says that while his base forecast is for the US economy to achieve a 1.8% annual growth over the next decade, labor force qualifications are deteriorating. Aging population and a stagnation in educational attainment of the workforce are contributing to worsening labor force skills, and therefore will have a negative impact in production. Although major policy changes such as a tax-code overhaul could boost growth to 2.4%, he emphasizes that a 3% growth is not possible.

### 7. Political Risk

In our 2017 outlook, we shared our view that Brexit and the Trump triumph highlight the decline of the party system and the end of the old left/right divide and cautioned that we hadn't seen the end of nativist and protectionist politics. We continue to see this materializing: The latest poll on the French presidential election showed the far right candidate Marine Le Pen as the clear winner in the first round vote which will be held in late April.

In consequence, premium investors are demanding to own French debt over German bunds, surging demand to a four year high (the highest since the Eurozone crisis). See the graph to the right: the





spread on the yield on 10-year French debt and Bund equivalent bonds exceeded 80bps last month.

Ms. Le Pen's National Front party has pledged that France will leave the euro. While polls indicate that she would lose in the second round run-off, whoever her opponent is, investors are paying particular attention to this election given the political surprises in the UK and US in 2016, and are already taking hedging measures against this low-probability but high-impact outcome.

On the US front, there still is a lot of uncertainty around President Trump's execution. While his policy ideas seem to be clearly formed, the implementation is much more uncertain. One month into his presidency only 34 of the almost 700 key Senate-confirmed positions have a candidate announced. Although President Trump will likely not give a State of the Union, he will have the opportunity to address Congress on February 28th. Newly inaugurated presidents typically give this type of speech instead of a formal State of the Union address. In his address to Congress, Trump will have the opportunity to directly discuss his vision and agenda.

## Conclusion

Our structural view for 2017 remains positive. The positive fundamental drivers we identified at the start of the year remain intact. In the shorter term, there has been huge reflation of risk assets, and the strength and speed of this run up in asset prices will most probably not prevail. The market will start focusing on the Fed's future rate hikes and Trump's agenda will have delays in both negotiations and implementation, which in turn, might shift "overly bullish" equity market sentiment. While the 2 year Treasury yield of 1.35% (the highest level since 2009 and more than 2% higher than the 2 year German Bund) is pricing-in 3 or 4 rate hikes, the 10 year Treasury at 2.5% is still over 50 bps lower than 3% it was just 3 years ago.

Finally, we recommend our clients to protect against US Bond Duration Risk as well as hedge some of the Equity Risk in the short-term. Some ideas for implementing these recommendations are detailed below:

### 1) US Bond Duration Risk

We recommend that clients evaluate their fixed income portfolios and mitigate duration risk, especially clients holding long duration assets whose objective was to pick-up some extra yield.

### 2) Equity Risk

We see a pull-back of up to 5% in equities in the short term. Thus, we recommend clients to either buy protection or reduce their exposure, especially for those clients with an over-weighted stock exposure. For example, the cost of a 3-months at-the-money put option on SPY is 1.75% of notional; the cost of a 3-months 5% out-of-the-money put option on SPY is 0.58% of notional. When markets correct, we will re-evaluate when to buy back exposure or close the hedges.



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