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Global

Global Macro Strategy

Weekly Views and Trade Ideas — Shifting Correlations

- **Macro Backdrop** — Near term correlations, higher UST yields = higher USD and lower stocks. We expect neither to last.
- **FX** — Long USD is already crowded. EUR is supported by medium term fundamentals despite today's ECB rate cut.
- **Rates** — Our carry/ rolldown trades in AUD and EUR boosted by news today. We look to evolve to a flattener in INR rates.
- **Equities** — Small/ large cap outperformance may be stretched in the US but not elsewhere
- **Credit** — We consider the case for buying CDS protection in China vs. selling all Asia.
- **Commodities** — Weak fundamentals driving prices, correlation to stocks lower, diversification benefits rise. Palladium/ gold ratio has more upside.
- Please see both the chartpack and full text via the separate links below. A *Video Summary* of the chartpack will be published on citivelocity.com tomorrow.
- Click here for our accompanying weekly chartpack

Global Macro Strategy

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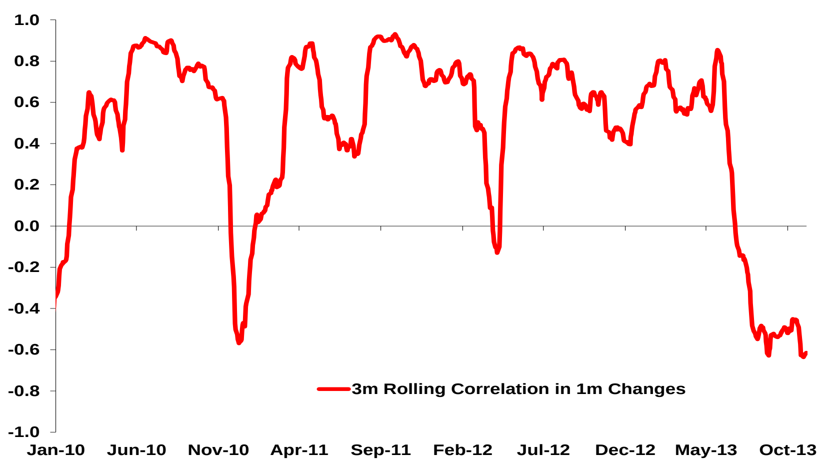
Figure 1. Negative Short Term Correlations Between SPX and 10y UST Yields



Source: Citi Research and Bloomberg

Macro Backdrop: Shifting Correlations

While the ECB rate cut reminds us that some Central Banks are still actively easing, the upside surprise for US Q3 GDP means tapering is still a live issue. What does the assumed associated rise in US bond yields imply for other asset classes?

We have shown before that over the medium term, rising bond yields haven't tended to scupper equity market performance (Slide 2, LHS). Our argument is that higher yields are a signal that economic activity is picking up and hence normally equity friendly.

We have also shown that the USD has tended to weaken not strengthen as US bond yields rise (Slide 2, RHS). The two exceptions are 1983 and 1998, two very specific episodes that do not match today's setting (see *FX*).

On form, equities have rallied over the period of higher bond yields since May, with the S&P 500 at all time highs. The DXY dollar index, meanwhile, is weaker since May.

But, very short term, correlations between bond yields and equities have turned surprisingly negative recently (Slide 3, LHS). Indeed, zooming into the period from August onwards, the S&P 500 tended to rally when Treasury yields were lower locally or contained (Slide 3, RHS). Conversely, higher yields locally have corresponded with a loss of momentum/ brief correction in equities.

Short term correlations between the DXY dollar index and bond yields have also flipped against the medium term trend (Slide 4, LHS). Here too an inspection of very recent history shows the dollar rallying as bond yields rise and losing steam when yields fall (Slide 4, RHS).[1]

Where does that leave us? Well on equities we *are* nervous that, given the corrections when QE1 and QE2 ended averaged 20% or so, we could see increased volatility in early 2014. But, ultimately, lower equities offer a buying opportunity. Lower yields from early 2007 to mid-2012 did not lead to re-rated equities (equity yield did not budge lower). So higher yields may not impact equities too adversely medium term.

As for the USD, and notwithstanding today's price action, we just don't see a fundamental case for a strong US currency – see *FX* below.

FX

Following more than a half century of meetings across at least four continents over the past 4-6 weeks, it is our strong impression that most investors both expect and are positioned for a higher USD based on the "tapering is coming" story. Positioning data on Citi's fund platform seems to bear this out. The swing to reduced USD longs/ small shorts after the September "no go" from the FOMC has reverted to mid to high range USD longs vs. G10 currencies. Everyone thinks everyone else is short. They probably aren't. EUR and GBP shorts look the most extended. We would rather be long both for the medium term. NZD and AUD longs have been slashed. Note that USD longs are now evident globally too in even greater contrast to three weeks ago. EM longs on all major blocs have been cut (Slide 5).

We have tried to show before how the USD has failed to rally more often than not when yields turn higher in the US (see Slide 2, RHS which uses 10y yields but they all turn more or less at the same time so using, for example, 2s makes no

[1] Note that the same applies if you use our equally weighted global dollar index. We use the DXY for consistency with the medium term analysis where the DXY offers greater history.

difference). This is the case even though when US yields trend higher, they typically do so more than yields elsewhere, so spreads widen too. Think 1994. Much higher US yields, lower USD. The exceptions to the rule are just that. Reagan and Volcker in the early 1980's who gave us textbook Mundell-Fleming tight money/ easy fiscal policy and currency strength. And the Nasdaq boom of the later 1990s where US stocks were the only game in town. Neither episode fits today's playbook.

The investor consensus, however, believes that higher yields and a stronger USD dollar go hand in hand and that is certainly the short term correlation (see *Macro Backdrop* above). Indeed, option market pricing also shows this, with most USD smiles skewed towards calls (Slide 6, LHS) and US fixed income markets skewed towards higher yields (Slide 6, RHS).

This opens up opportunities in cross-asset vol space we think. If our view holds true, one could 'fade' the implied positive correlation between the USD and USTs in other words. Picking some of our favorite crosses vs. the USD we have looked at some initial pricing and a trade along these lines is on our radar screen.

On a six month expiry (we are thinking more of a medium term trade and also want to span beyond the March FOMC), one could e.g. sell EUR/USD OTM puts or put spreads and finance OTM USD swaption payers or payer spreads. All else equal, we would prefer the spread structure as this "hedges" against a scenario where the US economy massively surprises on the upside, in which case the USD *would* likely be supported along with higher yields.

Pricing example (all on 6m expiry): one could fully finance a 3.2% strike USD swaption payer (ATMF 2.98%) by selling a 1.31 EUR/USD put (ATMF 1.338). Alternatively, one could fully finance a 3.2%/3.6% USD swaption payer spread by selling a 1.27/1.31 EUR/USD put spread.

Meanwhile, despite the unexpected rate cut today, the EUR has so far held support in a rising channel while a head and shoulders base still looks good to us for a test of the 2011 highs near 1.50 on a one year view so long as 1.279 holds (Slide 7, LHS). EUR looks oversold versus bank stocks and BTP spreads, both of which Citi analysts are bullish on medium term (Slide 7, RHS).

EUR is supported medium term by broad balance of payments flows including a current account surplus of around 2.5% of GDP. Some misnomers exist about this being all down to Germany. In fact, In 2014 Citi forecasts show Italy, Spain, Portugal, and even Greece in surplus. And Ireland will have a whopping 10% of GDP positive balance. And the trends in Slide 8 are pretty clear.

Capital inflows add to this current account surplus in creating a broad balance of payments surplus of around 3.5% of GDP or around 2.5% on a trailing 12mma basis (Slide 9, LHS). These flows are relatively volatile with portfolio inflows running recently about 3.5% of GDP but direct investment outflows at about 2.5% of GDP. The return of the broad balance of payments to near the 3% of GDP level is encouraging, as is the fact that the split is now two thirds current account and one third more volatile portfolio flows.

The split of portfolio flows favours equities with debt showing outflows (Slide 9, RHS). This probably reflects the actions of the ECB in creating a sort of zombie equilibrium in the EA. LTROs finance periphery banks' holdings, increasing home bias and crowding out foreign holdings as yields/spreads fall. But by reducing EA risk premia, and allowing breathing room on fiscal policy, and thus a slight revival in GDP growth, equity inflows are encouraged instead. We have shown before too that international equity investors underweights in Europe looks far from closed (Slide 10).

Talking of the ECB, should they talk the EUR lower? According to ECB President Draghi, the ECB did not even discuss the EUR level today. Slide 9, LHS shows that the REER is not especially high and the longer that the ECB allows low inflation/ deflation to take hold, the more the nominal exchange rate will diverge from real. With signs of better activity in leading indicators, thawing credit standards in the banks and rising current account surpluses why does the EA as a whole merit a weaker exchange rate?

The internal real exchange rate is still too high in the periphery and too low in the core but that is a different issue. In any case, many Central Banks have recently wanted a lower currency. The ECB would need to join the RBNZ, RBA, the BoE, and various EM CBs in the queue. And, after the refi cut today, what more can the ECB offer to convince markets they mean business on the currency?

We still like EUR higher medium term and suggest buying, especially on dips. It's not clear that the adjustment to the unexpected rate cut today is over yet but with the bullet fired it could still be "sell the rumour, buy the fact" at some point given fundamentals.

Rates

Our short term bias is that core yields will range trade, be rather data dependent and that rolldown or carry strategies are better than outright duration. We continue to like 3 variants:

- Short 2.87% 10y US payers, long 2.65% receivers, both expiring 13 December, nearly a week before the December FOMC meeting. With skew and forwards favouring higher yields, this kind of risk reversal brings in premium and could do well if weak/ distorted data makes delayed tapering look likely

- Receive 1y1y AUD where data are mixed still and the AUD has been too uncomfortably strong for the RBA to drop a slight bias to further ease

- Receive 1y1y EUR where activity is a bit better but inflation still very low and the ECB under pressure to "do something" about low inflation and an allegedly high EUR. Hence today's very helpful refi rate cut

On the latter theme, we are also still long OTM (1.8%) EUR 10y receivers expiring 20 May 2014 and are short the fixed EUR HICPxT inflation swap.

Medium term, front end rates still look low to Fed guidance (Slide 11). Many investors see this as justified given likely lower medium term trend US growth. But others think a 4% terminal Fed Funds rate is actually too low because so much balance sheet expansion must lead to financial instability and/ or inflation medium term. Perhaps the Fed "dots" are not such a bad guide after all given these divergent views, in which case some re-pricing to higher rates may occur eventually.

As for the curve, term premia still look low in a historical context as the Fed data on Slide 12 show. Using averages derived from this data, and with Fed guidance proving our short rate expectation framework, we reckon 10y US swaps should eventually head towards 2.85-3.65% during 2014 as tapering occurs.

Meanwhile, in EM, our receive 5y India OIS vs. pay 5y US OIS trade idea is under water. Indian yields have traded sideways/ slightly higher since we first recommended this position in mid-September, widening the spread to the US where 5y OIS have moved choppily lower over this period (Slide 13, LHS, top). Furthermore, although negative carry on the Indian leg has been cut sharply on sliding overnight rates as the RBI has cut the emergency MSF rate at which most banks were forced to borrow (Slide 13, LHS, bottom), the US leg continues to carry unfavourably.

We are considering lifting the US leg of our position and replacing receive 5y India with a curve flattener: receive 5y vs. pay either 1y or 2y rates (Slide 13, RHS). While the drop in the overnight funding rate means that we could put on an outright receive Indian 5y OIS trade on at zero cost today, the overnight rate may now re-anchor to the repo rate, rather than the MSF rate, because emergency rises in the MSF rate have been fully unwound. Citi economists now expect one more repo rate move by March – see yesterday's India Macroscope – which given fresh weakness in the Indian rupee in recent trading sessions may well be needed as Fed tapering draws closer. The belly of the Indian curve, meanwhile, should stay bid as growth remains soft, flattening the curve.

Equities

Equity market performance has been uneven in 2013 and while returns have been good across DM they have been even better for investors in small cap, peripheries, banks and select cyclicals. Is this high beta outperformance set to continue or is it time to take profit and rotate?

Small cap outperformance across markets can be seen in Slide 14. However, this is most pronounced in the US with Europe and Japan lagging. The fundamental case for small cap outperformance is strongest in the US. On top of the regular cyclical outperformance of high beta names there is a particular domestic focus for many US investors. They want exposure to higher levels of US growth relative to global. Therefore, more domestically focused small caps should have a relative advantage to their multinational large cap peers. Our equity strategists point, in particular, to price underperformance of global 'mega caps' despite healthy balance sheet and earnings (Mega Traps).

But has this trend gone too far? PE ratios have been increasing across the board. But, the ratio of small caps PE to large caps has been approximately 1.5 times for the last couple of years. This suggests that small caps price growth have been supported, in part, by earnings growth (Slide 15). However, the same ratio was only 1.2 on average during the last cycle as can be seen on the RHS. This prompts our US Strategists to suggest some potential for a large cap catch-up (Small Looms Large, But Large Outperformance Is Likely), based on a return to longer term small/large cap PE ratio and conditional on improving macro environment globally. However, in the short-term absence of a catalyst, we think a rerating of US small cap down seems unlikely even if risk/reward seems less optimal from here.

Earnings surprise this quarter in DM does seem to favour large caps (Slide 16). It also indicates that an earnings recovery is still missing in Europe.

Slide 17 illustrates that neutral earnings growth in Europe has not deterred investor inflows with periphery countries in particular seeing the biggest inflows. Longer-term, the best performers have been core country indices led by the DAX and followed by the CAC and FTSE in Slide 18. However, in the last few months the higher beta peripheries have retraced much of 2012 losses putting in some of the biggest percentage gains in Europe in 2013. The RHS illustrates a cyclical outperformance story in Europe (with the exceptions of Basic Materials and Healthcare) despite this being not particularly supported by an associated earnings growth. Our European strategists suggest combining the best performers of both in a barbell strategy of combining 'risk' stocks and 'quality' with a cyclical slant: banks, insurance and autos with a combination of both periphery and core names; avoiding mega cap (Risk On — Move On, What Next?) .

In Japan our strategists also like cyclicals and financials which they regard as a beneficiary of Abenomics. They expect the market to shift into high gear on the back of better earnings in November and then for it to fall back as we approach year end

on profit taking to take advantages of tax breaks. (November market outlook: Initial rise on earnings recovery, then fall on profit-taking)

Credit

There has been a high beta performance in credit as well as equity with many of the same themes such as periphery/small cap outperformance. Having said this, correlation has been much higher everywhere compared to equity markets. In the US, investment grade and HY have remained in lock-step with only moderate outperformance of HY through the rally. In Europe, however, Crossover has benefited more from our high beta / peripheral theme, with many HY names recovering. We've been looking for a correction wider to get long Crossover versus investment grade but so has much of the market resulting in a fairly constant grind tighter. We don't see an obvious catalyst for a correction short term.

An alternative 'long high beta' trade has recently been suggested by our credit strategists: sell protection on Senior Financials and buy it on Investment Grade (Long risk Senior Fins. vs. short risk Main). Many of names in Senior Fins are also in IG and this trade is purely a Fins outperformance one; our equity analysts and our credit analysts are overweight fins as perceived macro risks unwind in Europe. This trade benefits from being low volatility and carry positive. However, as with the Crossover/IG trade, it tends to be fairly market directional.

Our long SPX short CDX trade has been performing well very recently with the SPX hitting fresh highs and CDX retreating a few bp.

Elsewhere, we've been looking at methods of reducing the carry on our Asia Ex Japan trade. Essentially we like the idea of hedging some China risk against our portfolio but the timing and trigger for spread widening remains uncertain and 130bp per year is an expensive hedge. One possibility is to replace a more general Asia trade with a more specific People's Republic of China trade. China CDS is more liquid than Portugal and less liquid than Spain. It is also cheaper in carry terms at only 82bp per annum. We could either switch our short to China outright or to give it positive carry we could consider an RV against either the Asia Ex index or against another name in the basket like India. A risk of this sort of RV is that the high degree of correlation will limit the performance in the event of a China shock (RHS of Slide 20). However, the benefit of running with a carry positive trade over what might be a long period of time outweighs this. It's on our radar to put this China/Asia trade on in parallel to our existing trade for now and look to take our outright Asia Ex short off on any near term widening.

Commodities

In recent months we have highlighted the apparent decoupling between commodity markets in aggregate and broader risk appetite measures. The historic relationship between equities and commodities has been 'all over the place' in the last decade – both negative and positive regimes can be observed on the scatter chart on Slide 21. But as much of the 2010-2011, QE induced, 'very high beta' episode was an anomaly (red crosses), we have reversed back sharply and swiftly into a negative beta regime (blue crosses).

Indeed, in the period since the local trough in late 2011, the S&P 500 rallied from near 1100 to just under 1800 – in previous regimes, this would have been accompanied by a 30-40% rally in the CRB commodity index, yet commodities have trended sideways to lower ever since. Interestingly, shorter term rolling correlations have also fallen sharply in recent months and are at negative levels not seen for five years (Slide 21, RHS). And this isn't due to variation amongst single commodities leading to a sideways aggregate commodity index – it's true across the major commodity complexes as shown on Slide 22.

There are two broad conclusions to be made from this. Firstly, commodity specific fundamentals will matter again in a broad commodity market sense, as well as for individual commodities. In a medium term time frame, the bellwether commodities face a bearish supply and demand dynamic, with supply growth outpacing sluggish demand for most – also see the 4Q'13 Commodities Macro Market Update for details. Second, even though medium term return forecasts are thus mostly negative, these reduced/negative correlations open up diversification opportunities for cross-asset portfolios – one of the reason Citi's medium term Asset Allocation is overweight energy markets.

Otherwise, in terms of our more tactical macro portfolio, the only commodity exposure we currently hold is our palladium vs. gold RV trade. Price action this week has been constructive and we have finally moved back into positive P&L.

We have often shown how the precious metal RV is driven by both better risk appetite (via the palladium leg) and higher UST yields (via the gold leg). In an attempt to formalise this, we have regressed the metal ratio on the level of the S&P 500 and UST yields (Slide 23). Statistically, both show up as significant and the fit is quite good over an observation window of several years[2].

Since the beginning of the year, we include an out-of-sample estimate, currently suggesting more upside could lie ahead. The yellow metal rally since July has seemingly run out of steam near resistance, and the completion of a wonky head and shoulders top could lead us back to around $1100/oz (Slide 24). Further gold downside could help reverse the gap seen in our regression. We continue to hold for now.

Please see Slide 25 for a list of open trade ideas.

[2] Running this on shorter time samples, R2 of 80-90% can be achieved.

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Please contact us for further details on the options recommendations that appear in this note.

EUR vs. USD Receiver Swaptions:

Holding long Bund or receiving EUR swaps can be hard in a marked-to-market sense, as both markets remain correlated to US FI. While we ultimately expect a wedge to be driven between rates markets of the two regions, daily moves remain highly correlated. Note that the spread is correlated to risk-appetite. With implied volatilities near their lows, holding optionality for lower EUR/higher USD swap rates looks attractive we think. By selling near ATM USD swap receivers, we can fully fund slightly OTM EUR swap receivers, and keep a small take-in. If, as we expect, the sell-off in US FI persists, we will be looking to buy back the USD receivers, which would leave us with a cheap medium term EUR rates downside trade.

Trade: Buy 1y 1.80% EUR 10y Swap Receiver for 190c vs. Sell 1y 2.45% USD 10y Swap Receiver for 287c. At spot EUR/USD of 1.2866, net premium take-in of 33c of EUR notional. Spot 10y swap ref: 2.08% (USD) and 1.62% (EUR).

After the move higher in USD yields, and the widening of the USD-EUR spread, we can now buy back the USD receivers for less than the premium we took in at inception. In other words, we can guarantee a profit whilst maintaining (admittedly quite OTM) EUR yield downside exposure.

Trade (unwind USD leg): Buy back 2.45% USD 10y Swap Receiver expiring 21May2014 for 41c (entered at 287c). At EUR/USD spot of 1.335, we thus spend 31c of EUR notional vs. previous net premium take-in of 33c of EUR notional, guaranteeing a 2c profit. We remain long 1.80% EUR 10y Swap Receiver expiring 21May2014 (bought for 190c). Spot 10y swap ref: 3.03% (USD) and 2.19% (EUR).

Credit vs. Equity:

At this point in the leverage cycle we expect equities to keep outperforming credit as corporates increasingly engage in equity friendly and credit unfriendly activity. While credit is starting to look a little compressed, equity valuations remain attractive, giving them greater scope for upside. As we have mentioned before, the beta between credit and equity tends to have a convex relationship. In other words, as markets rally and credit compresses, the scope to outperform equity decreases.

By putting this trade on in calls we make it conditional on a rally, which is where we have most conviction. Also, a small gap has opened up recently in the relative relationship between 3m CDX and SPX vol with CDX options marginally more expensive as can be seen in Figure 1. Optimally we like to enter into it at zero cost so that in case of a sell-off we don’t end up out of pocket.

Trade: Buy 79 SPX 21 Dec ATMF 1695 calls for 44 ticks and Sell $100m 5y CDX IG21 18 Dec ATMF 85 receivers for 35 ticks leaving a small net premium of $2400 [ref SPX = 1700, CDX = 80bp]

USD Swaption Risk Reversal:
Today's weak NFP print is likely further to lengthen investors' expectations of full on QE. If the Fed is expected to delay further any tapering announcement, UST yields may continue to drift lower with the lopsided head and shoulders top evident in 10y yields suggesting a drop to 2.20% is possible if data are weak enough short term. Such a rally would likely contain the seeds of its own destruction since it was higher yields that played a part in the Fed decision not to taper in September. Lower yields now could yet bring tapering forward again though that does not mean a rally cannot happen first if near term data are soft and inflation remains very subdued. We exploit the forwards and skew in US swaptions to sell payers/ buy receivers ahead of the December FOMC. Given the market pricing, we can position for zero cost with a receiver struck near spot and a payer struck around 20bp higher.

Trade: Buy 13Dec2013 USD Swaption Receiver struck at 2.65% at 66c (7.3bp equivalent). Sell 13Dec2013 USD Swaption Payer struck at 2.87% for 68c (7.6bp equivalent). Net premium take-in of 2c (0.3bp equivalent). Spot ref (10y): 2.68% Forward ref (10y): 2.75%

Risks
When buying calls and puts (or receivers and payers) the maximum loss is the premium paid. When selling calls (or receivers), the maximum potential loss would occur as the index spread decreases but is limited by the index spread being floored at zero. For puts (or payers), the maximum potential loss (amount below the strike) would eventuate should the index price fall to zero. Sector index options are cash settled. The above calculations do not include any additional fees or transaction costs. Note that ratio writing would leave the writer uncovered in one leg of the trade. Past performance is not an indicator of future results.

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Appendix A-1

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