

Up The Beta

Now is the time to increase beta. The steepening of the Treasury yield curve is a heartening development; it signals diminishing recession risk, an improving growth outlook and rising risk appetite among investors. The Federal Reserve delivered its third rate cut last week, and Fed Chairman Jerome Powell sent a message that is more dovish than anticipated. Although the Fed may pause in its rate cuts, it will be a long while before the central bank considers raising rates again.

In addition, the equity/bond ratio seems to have hit a bottom (**Chart 1**), which usually means the U.S. economy and global growth will soon trough out. This is the spot where risk assets tend to break out. It is worth mentioning that the equity/bond ratio has hit three mini-bottoms since 2009, with each reflective of global economic slumps, for various reasons. Investors have been rewarded handsomely by buying stocks and increasing portfolio beta at each bottom. This time around will be no exception.

Raising Risk Exposure

Our asset allocation advice for the fourth quarter has been to underweight U.S. stocks while overweighting Europe and Japan. Our recommended split between risk and safe-haven assets is 60-40%. To increase beta, investors need to bring up risk exposure to 65-70% and increase emerging market (EM) equities to overweight.

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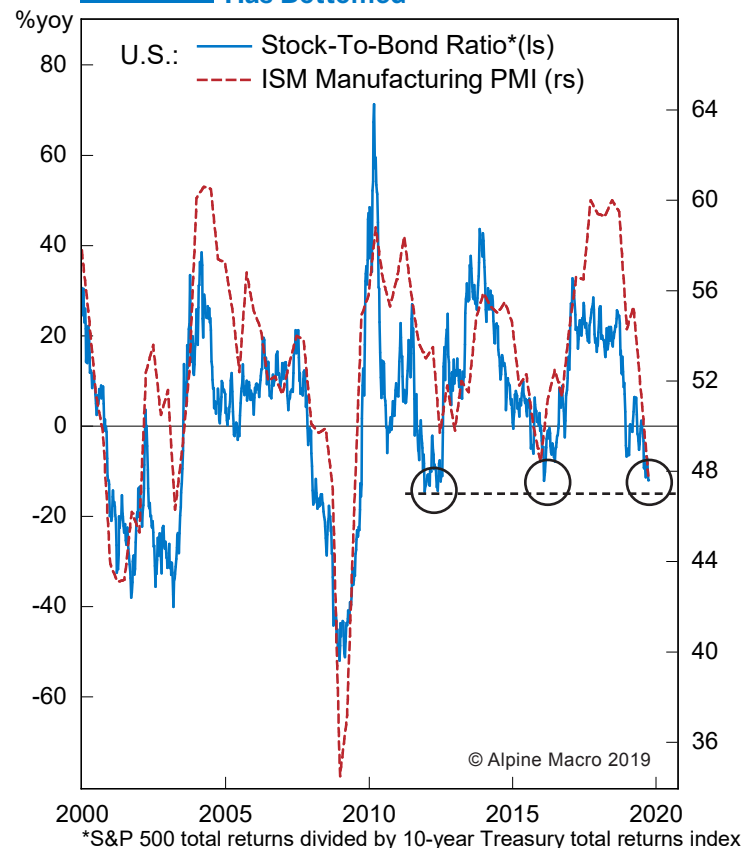
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**Chart 1 U.S. Equity-Bond Ratio
Has Bottomed**



There are three broad reasons for these adjustments:

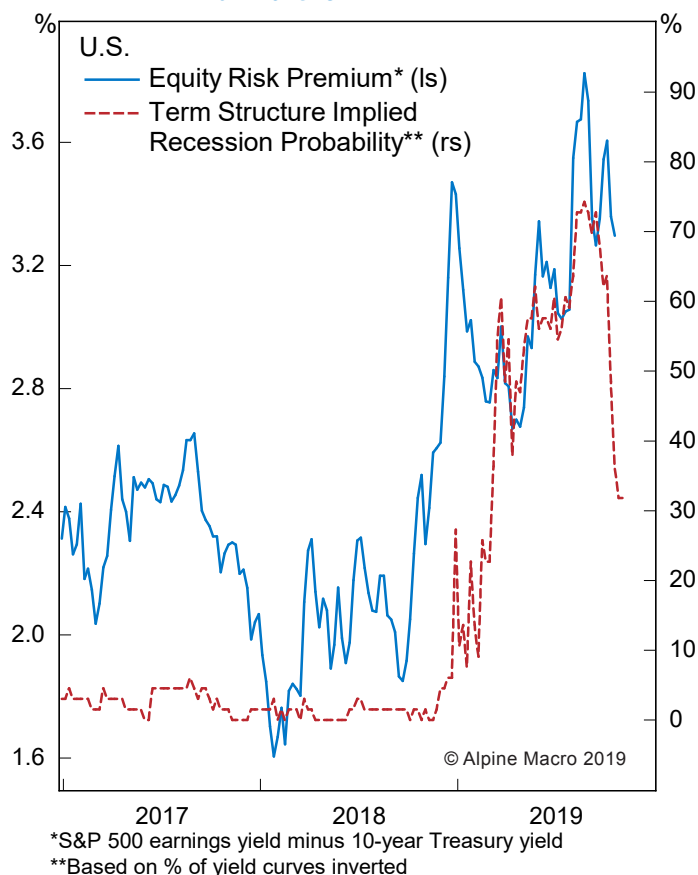
First, global stocks in general, European and emerging market equities in particular, have been pummeled by the Sino-U.S. trade tensions. Intense uncertainty over the global supply chain has greatly clouded the corporate profit outlook, jacking up equity risk premia on global stocks as expectations of a trade-induced U.S. recession have risen sharply (**Chart 2**).

We have always maintained that President Trump's pain threshold would fall and that his incentive to get a trade deal with Beijing done would increase as the 2020 presidential elections got closer. It seems the Trump administration is more willing to talk than fight now. In addition, Trump's policies on North Korea, Syria and Iran have yielded little or no result; he needs a win on China trade to show to his political base.

Similarly, with growth slowing sharply, Beijing is getting increasingly anxious about the fallout in the Chinese manufacturing industry and its long-term ramifications for the economy. This explains why China is more willing to make concessions that were previously unthinkable. Common interests have pulled the two governments together.

There is no guarantee that the first phase of a trade deal will be signed, but the odds are good. It is difficult to get any comprehensive deal between the two countries, but an extended truce in the Sino-U.S. trade war would allow global stock prices to recover. In our view, a trade truce would be equivalent to a significant drop in interest rates, which will help shore up business activity and lead to a decline in the equity risk premium.

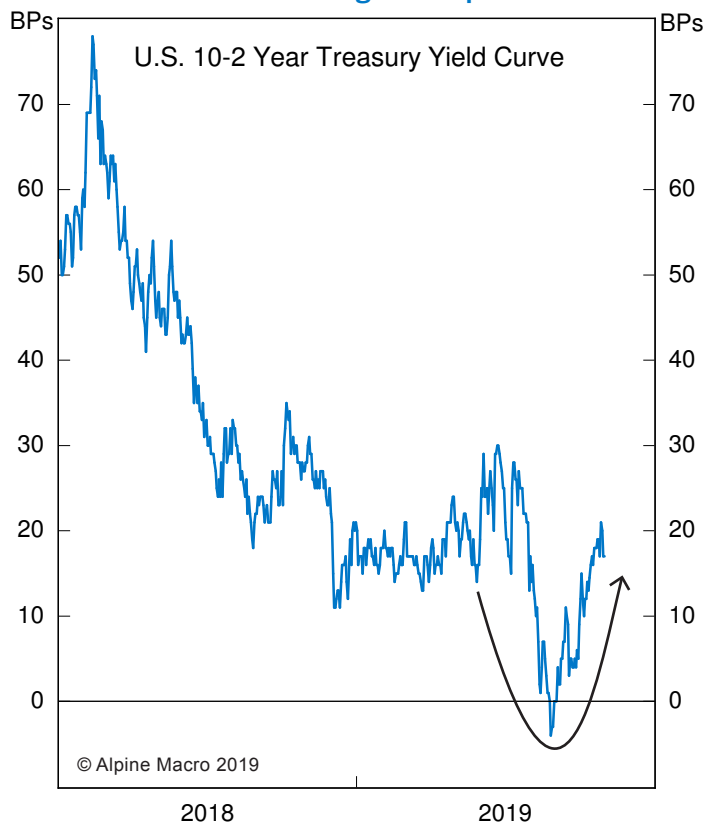
Chart 2 Equity Risk Premium Should Fall Further



Second, the Fed has delivered 75 basis points in rate reductions since July. Although it is debatable whether the three rate cuts by the Fed are sufficient to circumvent slowing momentum in the U.S. economy, the reality is that policy easing has allowed the yield curve to steepen — a sign of an improving nominal outlook (**Chart 3**).

We are of the view that interest rate policy has to be symmetric. If 2% is the natural rate for the U.S. and the Fed mistakenly bumps rates to 2.5%, then the central bank needs to cut rates to 1.5% to stabilize the system. Of course, this could be too academic a calculation because various forces constantly influence the so-called neutral rate. The trade

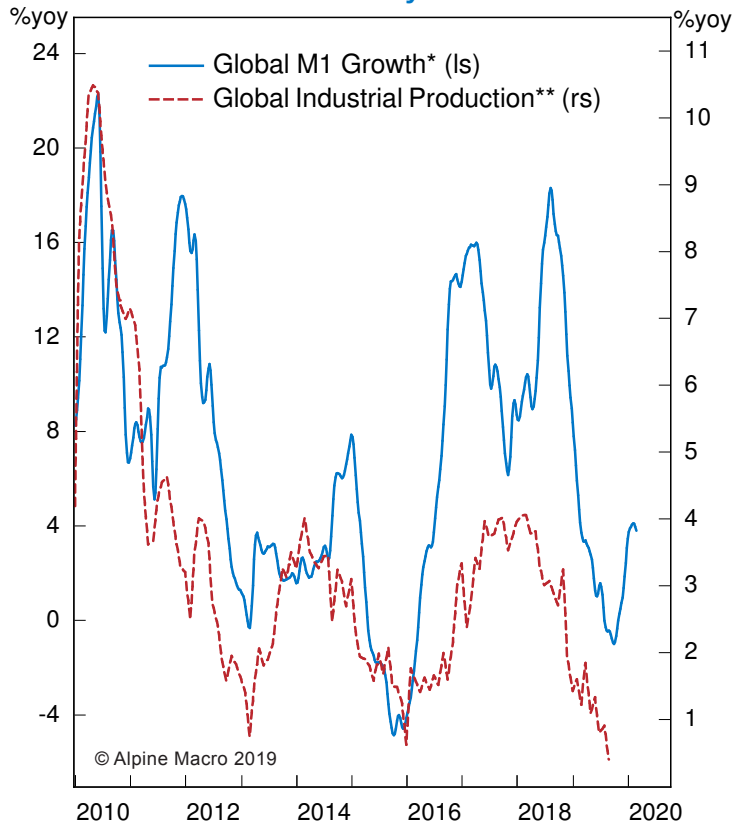


Chart 3 Yield Curve Steepening Is A Heartening Development


truce, a weaker dollar and improving growth in the rest of the world all have a positive impact on U.S. economic growth.

Regardless, it is important to note that all major central banks are in easing mode and global money supply is accelerating again, which often leads to a global economic growth recovery (**Chart 4**). The combination of expanding central bank liquidity, accelerating money supply and falling interest rates is usually bullish for risk assets, high-beta markets in particular.

It is worth emphasizing that the Fed still controls the short end of the curve, and through this channel exerts a huge influence on the entire interest rate structure. As far as stock prices are concerned,

Chart 4 Global M1 Growth Leads Global Economy


*Sum of M1 for U.S., Japan, China and Eurozone in US\$ terms; advanced by 6 months

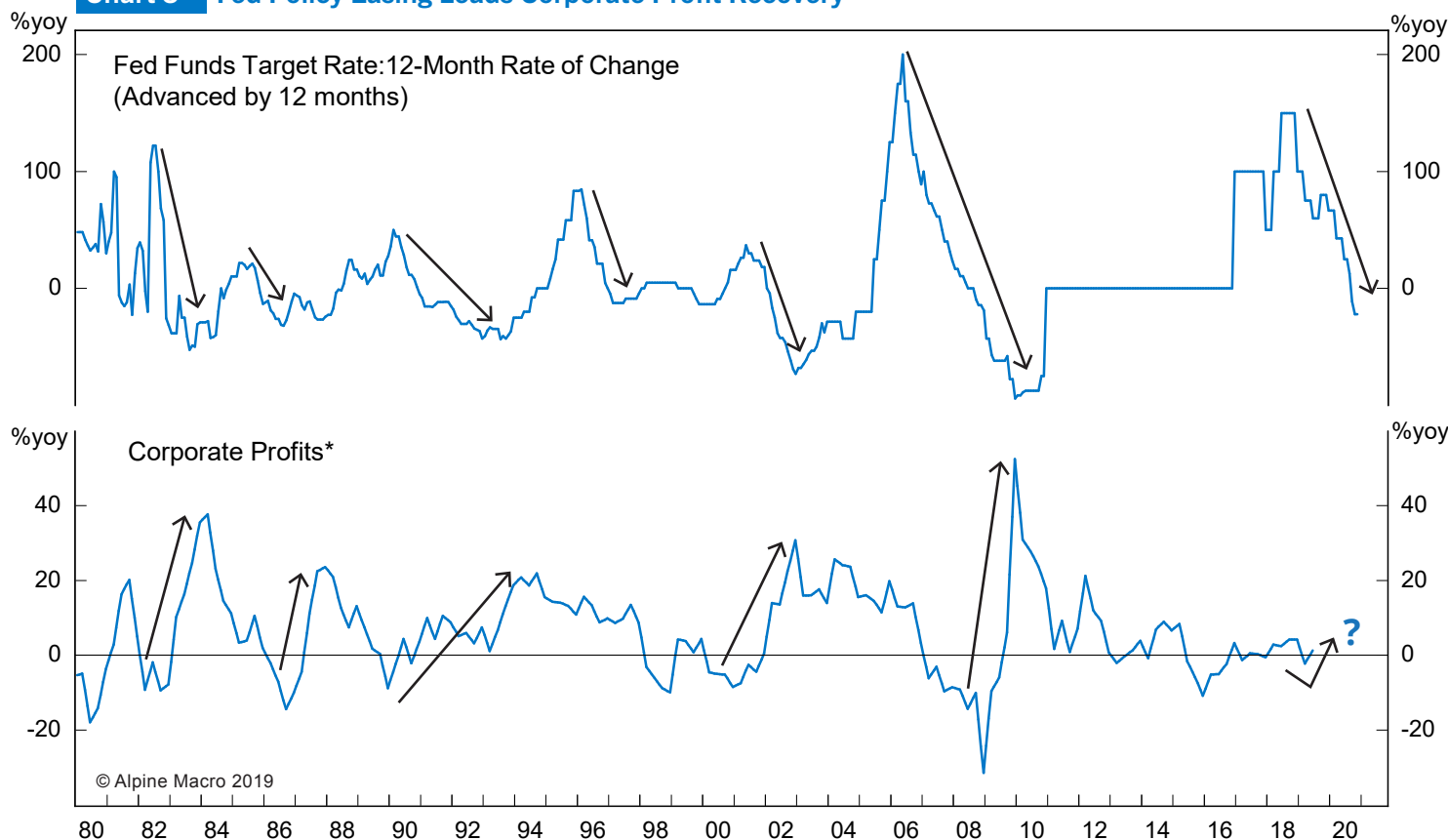
**Source: Netherlands Bureau for Economic Policy Analysis

corporate profits are currently under pressure, but earnings growth should trough out in the first quarter of 2020 because lower rates will boost corporate earnings (**Chart 5**), and a steeper yield curve will help restore banking sector profitability. Of course, if the dollar softens it could make the earnings recovery even stronger.

Third, we see an increasing possibility that the dollar bull market reverses direction sooner than later. A strong dollar since 2010 has been a product of weaker economic conditions in the rest of the world and/or a tighter monetary policy in the U.S.

The Fed stopped QE in 2014, began to raise rates in 2015 and has shrunk its balance sheet since 2018.



Chart 5 Fed Policy Easing Leads Corporate Profit Recovery

*Before tax, with inventory valuation & capital consumption adjustments; source: U.S. Bureau of Economic Analysis

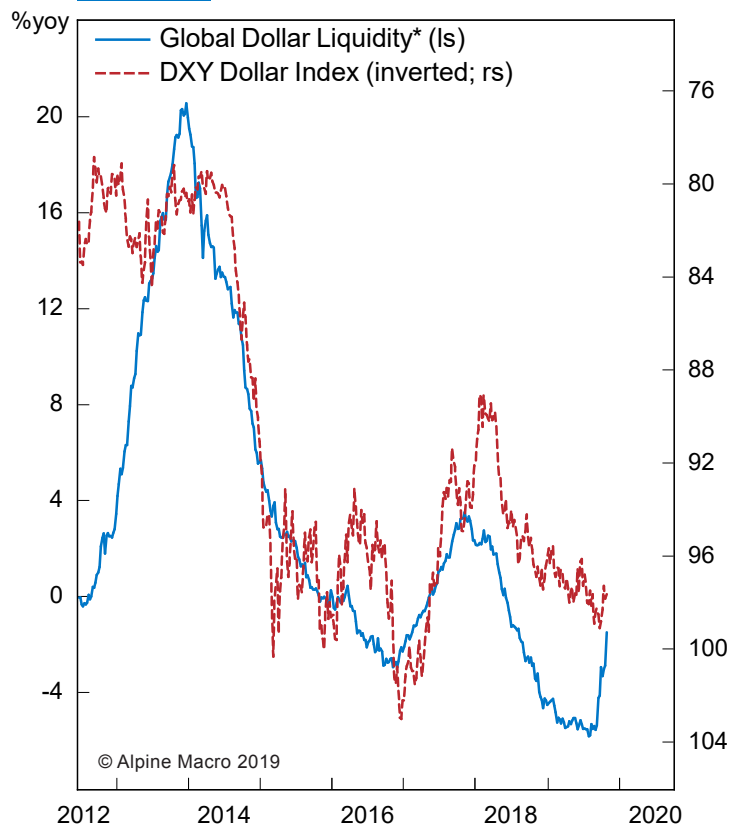
All of this occurred when other global central banks were easing policy desperately. The Fed's action has caused a severe dollar liquidity crunch, holding the dollar high.

Furthermore, the 2018 dollar surge was a classic, textbook case of currency strength. The Trump administration enacted sweeping tax cuts in 2018, supporting economic growth. The Fed, however, was tightening monetary policy aggressively by raising rates. A combination of expansionary fiscal policy and tight money always leads to a strong currency. In the early 1980s we saw a similar policy combination when then-U.S. President Ronald Reagan cut taxes while the Fed tightened money drastically. The net result was a soaring dollar between 1981 and 1985.

Going forward, big, cyclical forces may be reversing:

- The policy combination is in reverse: While the Fed has begun to drop rates and restarted its QE program, fiscal policy in the U.S. has turned restrictive as previous stimulus has run out. The combination of monetary easing and tightening fiscal policy is negative for the dollar.
- With the Fed restarting QE, global dollar liquidity has begun to accelerate again. [Chart 6](#) shows that for the past seven years, the ebbs and flows of dollar liquidity have keyed off dollar fluctuations fairly well. Accelerating dollar liquidity growth is usually bearish for the dollar.

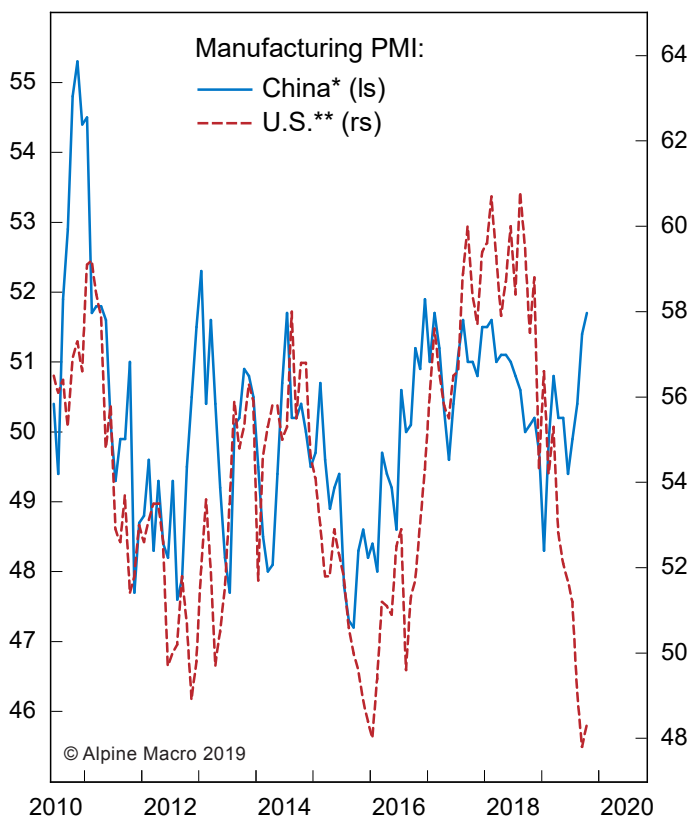


Chart 6 The Case For A Weaker Dollar

*Total Fed assets plus securities held in custody for foreign official and international accounts; source: Federal Reserve

- The Chinese economy is bottoming while the U.S. has softened, as evidenced in [Chart 7](#). Our view is that the Chinese economy will likely stabilize at around 6% early next year, while U.S. economic growth could soften to 1.5%. In the meantime, eurozone growth could also hit a bottom soon. Of course, it is entirely possible that economic growth in the U.S., China and Europe all strengthen a notch next year. If so, the dollar is more likely to fall than rise, a *déjà vu* of 2017.

It is important to remember that the U.S. stock market has beaten the rest of the world nine out of 10 years since 2009, but the investment life

Chart 7 China Vs U.S.: Trading Places?

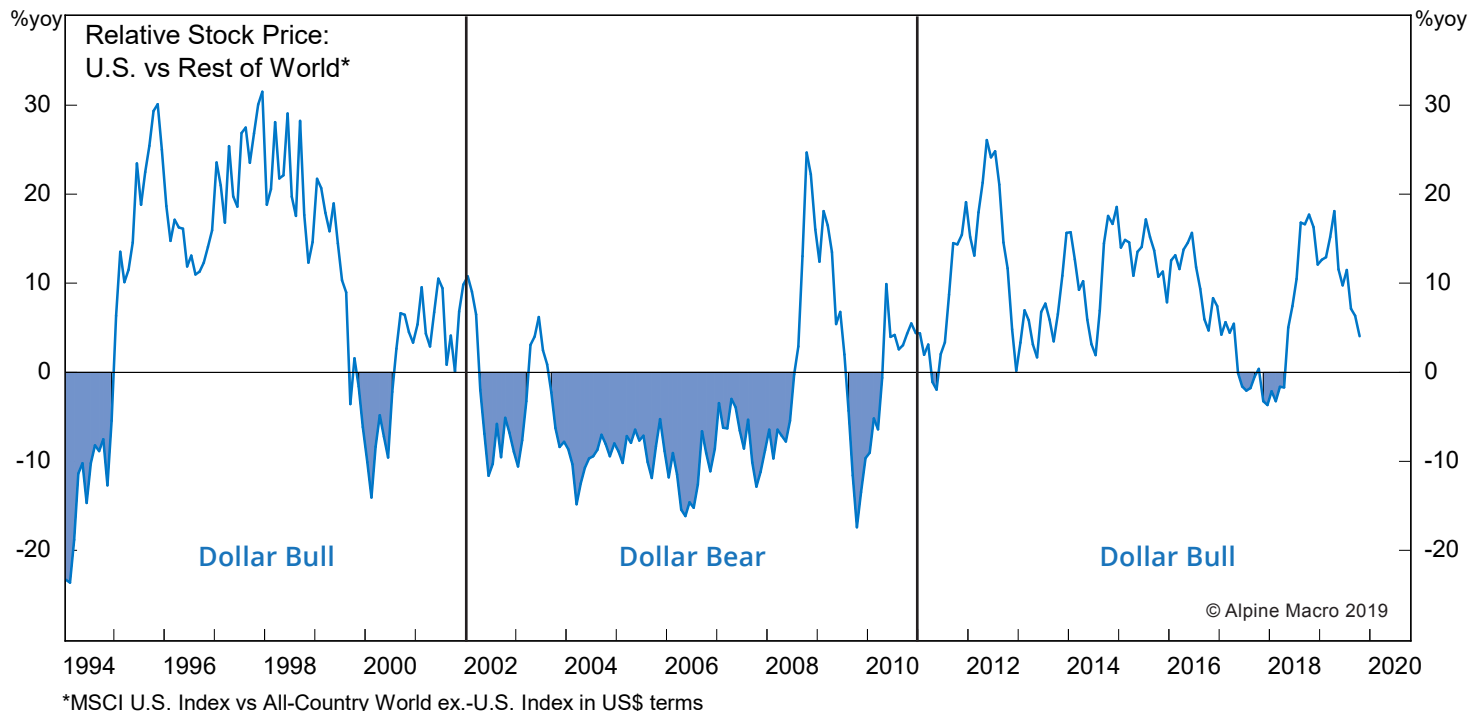
*Source: Caixin, Markit

**Source: ISM

is cyclical, as [Chart 8](#) shows. The under- or out-performance of U.S. stocks relative to the rest of the world is largely reflective of cyclical swings in the U.S. dollar: A falling dollar boosts the relative performance of international stocks, while a strong dollar depresses it. The last time international stocks outperformed U.S. equities was in 2017, when synchronized global growth led to a falling dollar. Therefore, overweighting international stocks is consistent with a bearish view on the dollar.

Finally, most high-beta markets are significantly cheaper than U.S. equities. The forward P/E for the German DAX is 15.3. It is 13.5 for emerging market



Chart 8 Relative Equity Performance: U.S. Vs Rest Of World

equities. This compares to 18.6 for the S&P 500. In price-to-book terms, European stocks and emerging markets are both trading at an over 50% discount to their U.S. counterparts.

Of course, this type of comparison can be too simplistic, because different markets have different earnings profiles, interest rate structures and economic environments — all impacting the fair value of a stock market. It is never easy to tell which market is definitively cheaper than others.

Table 1 sums up the composition of stock market returns for select markets. It is clear that the U.S. equity market has delivered the highest earnings per-share growth over the past 10 years, while multiples have stayed virtually flat. As a result, total returns in U.S. stocks have mimicked EPS growth.

However, the dollar returns in EM, Europe and Chinese shares have languished amid either poor EPS growth, severe multiples contraction or

Table 1 Market Returns Decomposition (December 2009- September 2019)

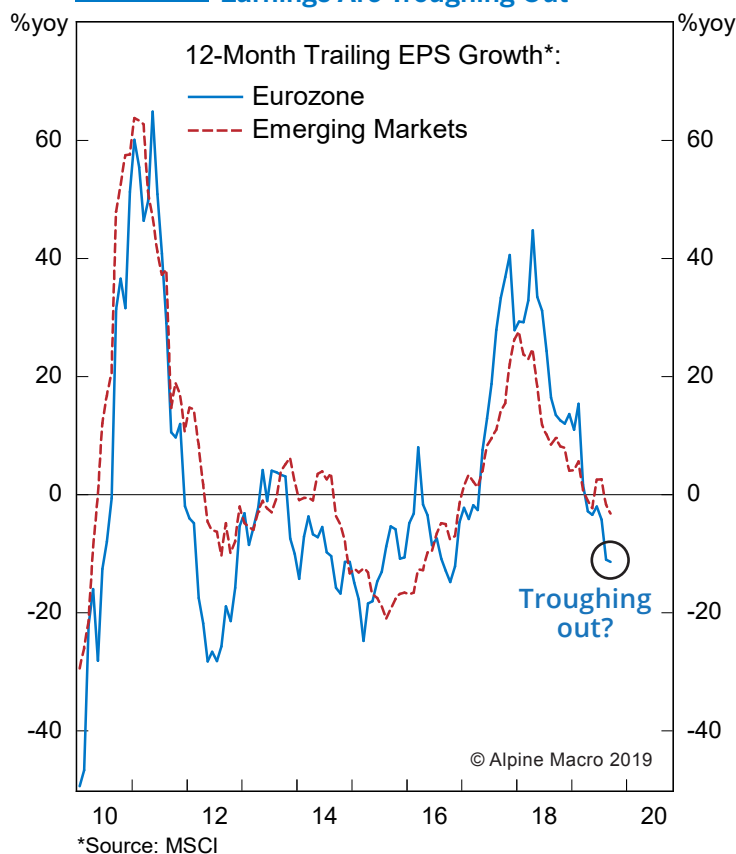
	U.S.	Emerging Markets*	Europe*	China (A-Share)
EPS	10.4%	3.1%**	3.6%	7.5%
PE Valuations	0.1%	-3.0%	1.0%	-6.4%
FX	—	—	-2.8%	-0.5%
Index Return (Annualized)	10.5%	0.1%	1.8%	0.6%

*Source: MSCI Indexes

**In US\$ terms



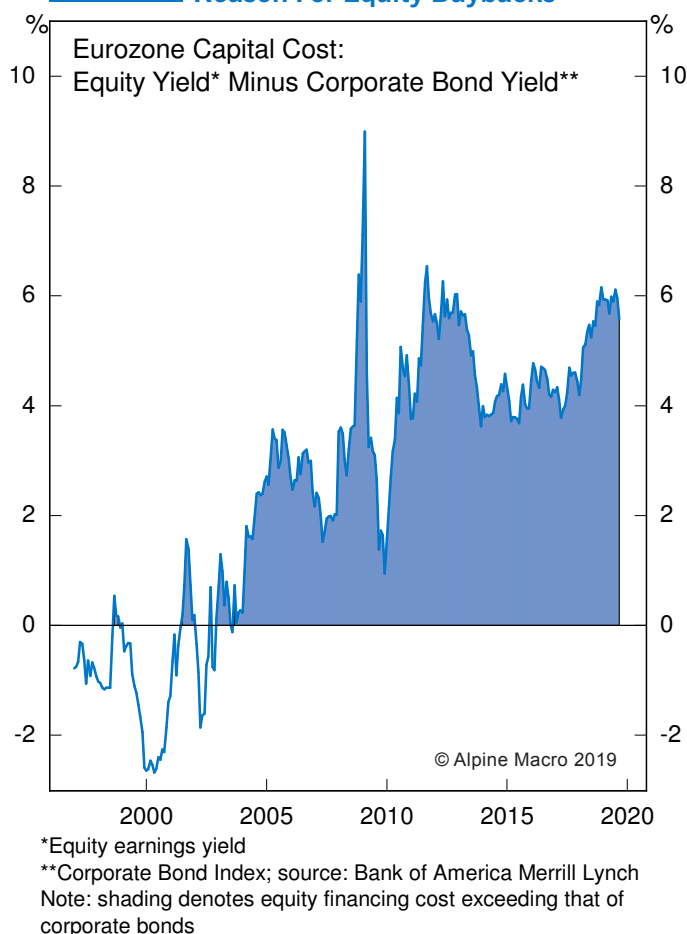
**Chart 9 Eurozone And EM:
Earnings Are Troughing Out**



foreign exchange losses. Nevertheless, we should also keep in mind that earnings in most high-beta markets are currently seriously depressed and most likely in a trough (**Chart 9**). This means that multiples for normalized earnings for both EM equities and European stocks are likely lower than reported numbers.

Another reason for investors to overweight European stocks is the potential funding arbitrage opportunity. The gap between equity funding costs and corporate debt costs is 600 basis points (**Chart 10**). For any publicly traded company in Europe, a debt-equity swap can easily boost EPS dramatically.

**Chart 10 Large Gap In Capital Cost:
Reason For Equity Buybacks**



Granted, European companies have been reluctant to restructure their balance sheets by issuing debt to buy back shares. But negative interest rates and bond yields could be the catalyst needed to trigger a rise in equity buybacks.

The bottom line is that Fed rate cuts, renewed QE and preliminary signs of a bottoming Chinese economy argue for a weaker dollar and stronger performance in international stocks versus the U.S. Emerging markets and Chinese shares should do well in the next few months and thus investors should buy these markets in major price dips to augment beta.



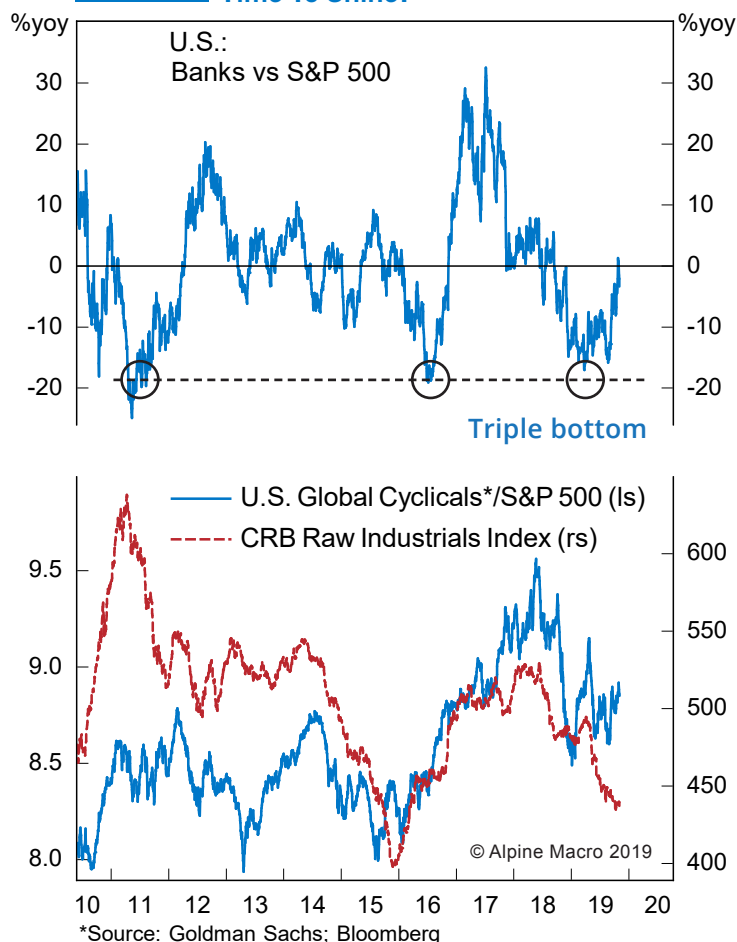
Buy Some U.S. Banks And Global Cyclical

U.S. banks and global cyclical stocks were crushed in 2018 as a result of the global manufacturing recession, weak commodity prices and a flattening yield curve as the Fed pushed up the short end of the curve. Going forward, these sectors are likely to outperform the average index (**Chart 11**):

- A steepening yield curve is always good for bank margins. Historically, a steepening curve tends to lead to better bank performance versus the benchmark.
- U.S. global cyclical stocks tend to outperform in the early stages of a global manufacturing recovery and strengthen commodity prices.
- A weaker dollar usually helps global cyclical stocks' performance, as a falling dollar typically precedes a pickup in global economic activity and rising commodity prices.
- Both U.S. global cyclical and bank stocks are trading at significant discounts to the average index, and are the main components of the value index.

The bottom line is that both U.S. banks and global cyclical stocks can generate substantial amounts of beta at the early stages of a global economic rebound. Both sectors did well in 2016-2017 on policy reflation and a global economic rebound. They should do well next year, if the Fed easing and Chinese fiscal stimulus manage to turn a slowing world economy around.

Chart 11 Banks And Cyclical:
Time To Shine?



Housekeeping

- Our long copper/short gold trade was technically stopped out, but we reinstate this position, with an increased stop at a rolling 10%. This pair trade has a high volatility, with average daily moves at around 1%. The rationale of this recommendation is consistent with our strategy of increasing beta and therefore, we increase our stop loss in order to allow the trade to run its course.
- Buy Chinese A shares (ETF:PEK), with a -5% rolling stop.

Chen Zhao

Chief Global Strategist



Investment Recommendations

Strategic Positions (6 - 12 months)

Recommendations	Open Date	Open Levels	Closing Date	Closing Levels	P&L Since Inception
Long 10-year U.S. Treasuries/Short 10-year German Bunds Hedged	3/1/2019	2.755/0.182	-	-	3.4%

Tactical Investment Positions (3 - 6 months)

Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long EM USD Sovereign Bond	1/9/2019	784.77	Rolling -3%	-	-	10.5%
Long DAX Hedged ¹	5/10/2019	12060/1.1233	Rolling -3%	-	-	7.9%
Long Copper/Short Gold ²	10/28/2019	267.55/1505.3	Rolling -10%	-	-	-1.2%
Long Brazilian 10-Year Sovereign Bond Unhedged	9/23/2019	7.052/4.147	Rolling -3%	-	-	8.6%
Long Chinese A-Shares ³	11/4/2019	-	Rolling -5%	-	-	-
Long U.S. Bank Stocks ⁴	11/4/2019	-	Rolling -5%	-	-	-
Long U.S. Global Cyclical Stocks ⁵	11/4/2019	-	Rolling -5%	-	-	-

Note: Our currency trades include carry. P&L is calculated using futures contracts.

¹ We have hedged EUR exposure on the long Dax trade from 8/5/2019 to 10/28/2019

² We stopped out of the long Copper/Short Gold trade but are reinstating it with a rolling -10% stop loss

³ We are initiating a new long Chinese A-Shares trade with a rolling -5% stop loss

⁴ We are initiating a new long U.S. Bank Stocks trade with a rolling -5% stop loss

⁵ We are initiating a new long U.S. Global Cyclical Stocks trade with a rolling -5% stop loss

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Alpine Macro, founded in 2017, is an independent global investment research firm based in Montreal, Canada. We focus on the analysis of major macro economic forces and specialize in forecasting the direction of global financial markets, while providing actionable recommendations on investment strategy and asset allocation.

Our Leadership

Chen Zhao, Founding Partner and Chief Global Strategist From 2015 to 2016, Chen was Co-Director of Macro Research at Brandywine Global Investment Management. Prior to Brandywine Global, Chen spent 23 years at BCA Research. As a Partner, Managing Editor and Chief Global Strategist, Chen developed and wrote BCA's China and Emerging Markets publications in the 1990s. Chen became the firm's Chief Global Strategist in the 2000s and was the author of BCA's flagship publication, Global Investment Strategy from 2005 to 2015. He holds an MA in economics from the Central University of Finance and Economics, was a visiting scholar at the University of Illinois at Urbana-Champaign and pursued post graduate studies with a PhD candidacy at McGill University.

J. Anthony Boeckh, PhD, Founding Partner, CEO & Editor-In-Chief Tony was previously Founder, Chairman, Chief Executive and Editor-In-Chief of Montreal-based BCA Research for 34 years. He authored The Great Reflation (Wiley) in 2010 and was publisher of, among others, the Bank Credit Analyst, a monthly big-picture analysis of the U.S. and global economies and financial markets. He is a founding trustee of the Fraser Institute in Vancouver, British Columbia — an economic “think tank” dedicated to free market principles. Tony has a PhD in Finance and Economics from the Wharton School, University of Pennsylvania, and a B.Com. from the University of Toronto.

David Abramson, Partner, Chief U.S. Strategist & Director of Research Prior to joining Alpine Macro, David was a Macro Strategist holding a variety of senior roles at BCA Research. Most recently, he was Chief U.S. Strategist and also Director of Research for the firm. During his 28 years at BCA Research, David launched and managed the European Strategy and Commodity & Energy Strategy services. In addition, he was the Managing Editor for the Foreign Exchange Strategy and the China Investment Strategy services. He has taught international finance to MBAs at McGill University for 20 years, and is on the Client Committee of the Kenneth Woods Portfolio Management Program at Concordia University.

Yan Wang, Partner and Chief Emerging Markets and China (EMC) Strategist Prior to Alpine Macro, Yan spent 15 years at BCA Research, as Managing Editor and Chief Strategist for BCA's China Investment Strategy service, and played a major role in formulating BCA's view on the Greater China region and emerging Asia. Prior to joining BCA, he spent six years as an equity analyst in China and Hong Kong. Yan holds an MBA in Finance from McGill University, an M.A. in Economics from Tianjin Institute of Finance and a B.A. in Finance from Nankai University. He also holds the CFA designation.

Harvinder Kalirai, Partner and Chief Fixed Income & Currency Strategist Before joining Alpine Macro, Harvinder spent a decade with BCA Research, where he headed the firm's Foreign Exchange Strategy service from 2008 to 2016 and Daily Insights from 2016 to 2018. Prior to BCA, Harvinder was Head of Currency Management at CIBC Global Asset Management. Previously, he held various positions at State Street Global Markets, including Senior Macro Strategist (London), Head of Currency Research, Asia-Pacific (Sydney), and Senior FX Strategist (Boston). Harvinder began his career at the Bank of Canada in 1995 with an MA (Economics) and a BCom (Finance) from McGill University. He also holds the CFA designation.