macro scan

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- ***Rates consolidating as geopolitical optimism rises – what to do in the meantime…***
- ***Increasing probabilities of an upside equity breakout***
- ***Prism's latest advancement (screening equity index options) suggests buying ESH0 3300/3400 call spreads***

A phase 1 China-US "deal" coupled with a Brexit "agreement" has overpowered the data deterioration theme in the past week. What should we look at while fixed income consolidates?

We have spent little time talking equities this year and looking back, for good reason. For the better part of the last six months, S&P's have chopped sideways. However, there is scope that the trendless chop can pivot towards a renewed rally.

What are the catalyst for an upside breakout:

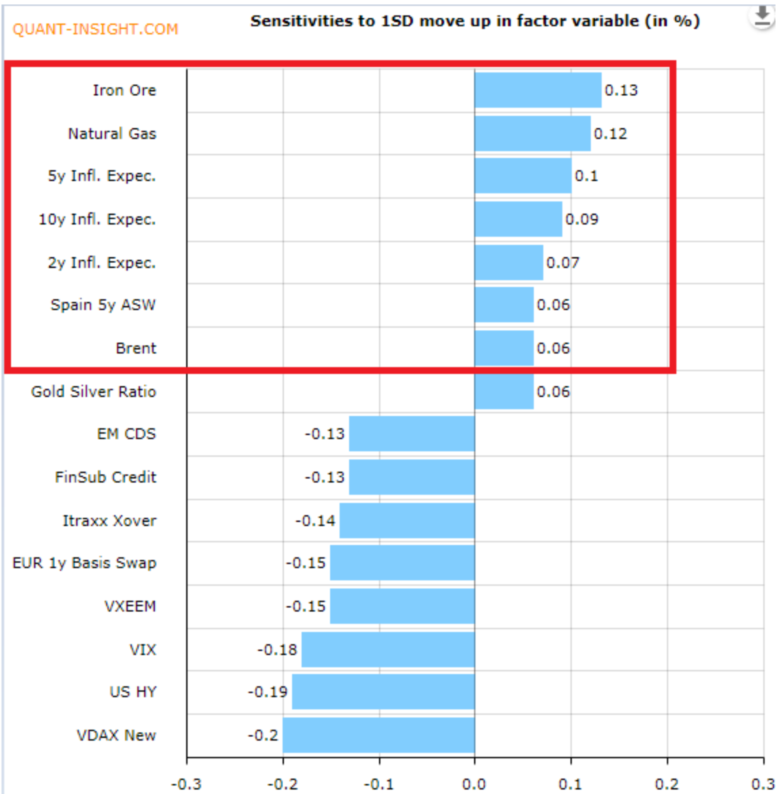
1) **Don't call it QE:** Who cares what you call it. It's a liquidity injection that should free up reserves, keep Fed Effective from rising (substantially), and generally create an environment with improved dollar liquidity. That's historically been positive for equities.

2) **Improved geopolitical risks**:
   a. Trade Wars - I don't think any of us really believe a comprehensive trade war deal is around the corner or that phase 1 is a massive game changer. However, the fact they made even the slightest progress is an incremental positive for risk (yet keep the Fed dovish) and it is looking like China is willing to hold back on IP transfer now according to CCTV. Both side are incentivized to make the negotiations appear like progress is being made. This will be equity supportive as it has been all year despite deteriorating data.
   b. Brexit – think about it this way; this is potentially THREE years of uncertainty getting removed (still needs to pass Parliament).

3) Fed indicating they want the economy/inflation to run hot which will mean a continued dovish stance:
   a. Powell – "tariffs are a one-time increase in prices and is different from inflation" -> we won't react to supply side inflation.
   b. Fed minutes – "most officials saw the benefits of targeting inflation on average" -> AIT which means they will let inflation run above target.
   c. Kashkari – "the best way of assessing supply and demand in the market is to look at the price. The price of labor is wage growth." -> wages have been falling so more accommodation is warranted is what Kashkari is implying.
   d. Evans – "in my view, these difference mean we need to err on the side of providing enough accommodation to get inflation moving up with some momentum." -> more evidence of the AIT mindset inside the Fed

Why is this important? Besides just generally staying dovish to support the expansion, it is critical to know that equities respond well to inflation.

We can see that in running a macro PCA model like Quant Insight which reveals that six out of the top seven positive drivers of equity prices are inflation expectations or commodities that feed into inflation expectations…



4) **<u>Steeper curves:</u>** in the same vein as above, the "let it run hot" mentality should be a steepener as the front end rates remained compressed versus introducing some (dare I say it) term premium in the long end = good for the banking sector of S&P's.

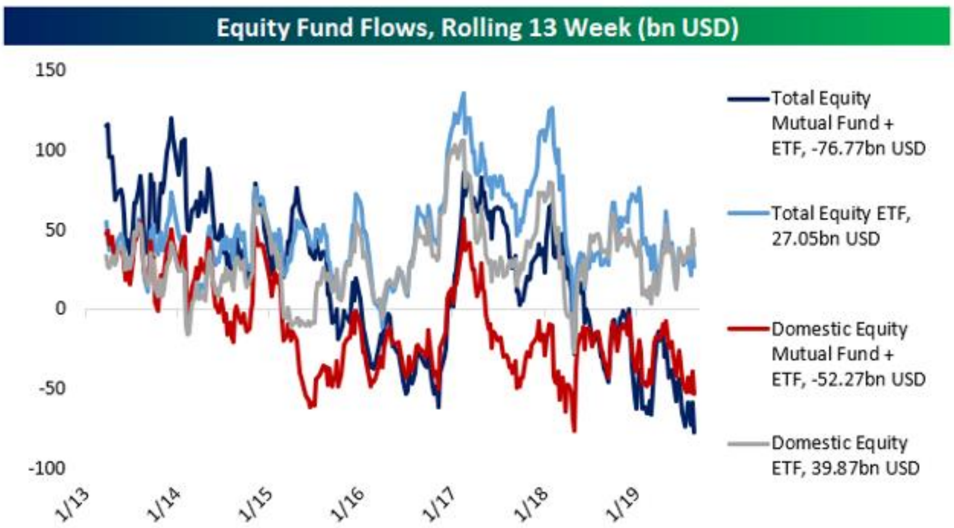
5) **<u>Stabilizing oil</u>**: we have discussed this a couple times in the past month and WTI so far has held $51. The basic gist is: lower production (oil well issues are reemerging and there is less CAPEX due to generally lower prices), Mid East production risks, OPEC cuts, IMO 2020, and positive carry are all reasons why oil, in the face of a global growth slowdown, should begin to stabilize = good for the sagging energy sector. (Note that the seasonals are poor through the end of the year so a rally could very well be an early 2020 event)

6) **<u>Foreign indices are breaking out:</u>**

Nikkei…

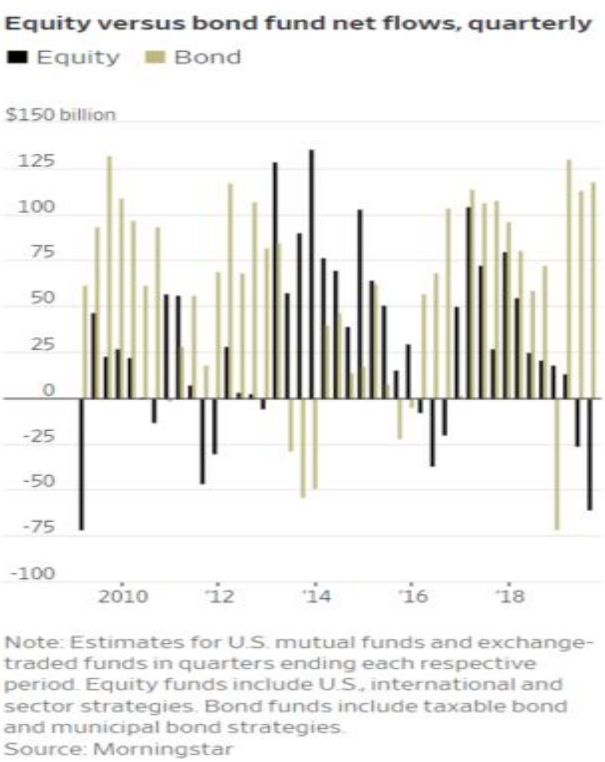
Euro Stoxx…

7) Light Positioning: I think we all know the market is not overly bullish equities. In fact, there has been a lot of head scratching at the ability of equities to hold up despite trade wars, data deterioration, and impeachment talks. We can see here that in the mutual fund world, investors have de-risked all year…



h/t: Seeking Alpha, Bespoke Investment Group

We can further see that the equity purge in the mutual fund space has benefited bonds…



Therefore, a technical breakout to the upside will see investors scrambling to reengage longs. In the hedge fund world, you could very well see the classic year end performance chase.

8) **Technicals:** The long-term, extremely bullish inverse head and shoulder pattern that formed from Sept '18 to June '19 is in motion. From a more tactical perspective, you will likely get a small pull back in the near future and then a topside breakout. Ultimate target = 3600…

As you all hopefully know, Prism was founded based on our analytical platform which works to "optimize" your interest rate view. An exciting announcement is that Prism will soon be able to screen ideas in the equity world.

Without further ado, I screened for equity index structures in S&P's that:

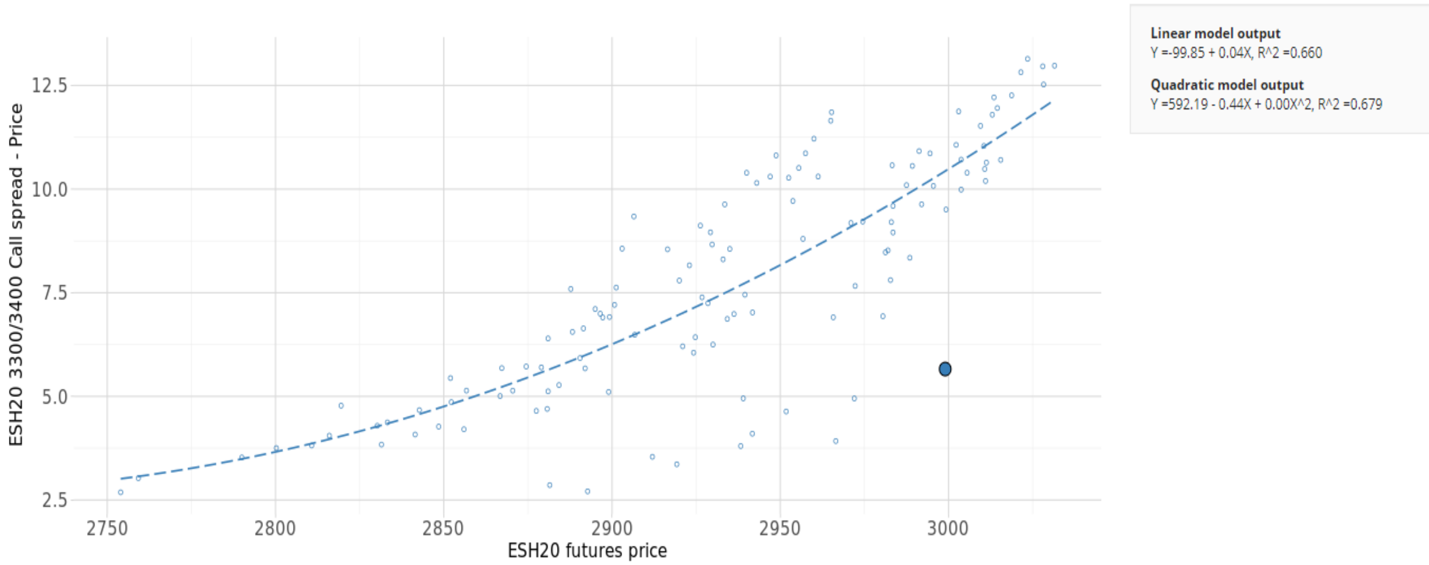
- Only have a max loss that is limited to premium paid (only lose a small, defined amount if the view is wrong)
- Have at least a 5 delta (nothing too wingy)
- Have a 6-month vol percentile lower than 50% (I want a good vol entry point)
- Have a 6-month relative price percentile lower than 50% (again confirming a good entry point)
- Have a 6-month historic leverage ratio of the relative strike greater than 0 (I want a relative strategy that has paid out over the last 6 months)

91 structures fit that screen and here are the top 10…

Contract	Full Strategy Name	Strike	Futures	TTE	Moneyness (%)	Delta	Settlement	Price	Price Rel Percentile [6m]	Strike LVol Percentile [6m]	HistLevRatRel [6m]
es						.06,			,.5	,0.5	0,
ESH20	3300/3400 Call spread	3300	2993	0.43	-10.3	0.08	4.50	5.1	0.24	0.32	1.41
ESH20	3300 Call	3300	2993	0.43	-10.3	0.11	8.50	6.5	0.19	0.32	1.29
ESH20	3250/3350 Call spread	3250	2993	0.43	-8.6	0.13	8.00	9.9	0.33	0.31	1.25
ESH20	3250 Call	3250	2993	0.43	-8.6	0.18	13.75	12.9	0.25	0.31	1.20
ESH20	3250/3300 Call spread	3250	2993	0.43	-8.6	0.08	5.25	6.4	0.38	0.31	1.11
ESH20	3200 Call	3200	2993	0.43	-6.9	0.28	22.50	23.4	0.31	0.31	1.01
ESH20	3200/3300 Call spread	3200	2993	0.43	-6.9	0.17	14.00	16.9	0.43	0.31	0.90
ESH20	3150 Call	3150	2993	0.43	-5.2	0.38	36.50	38.6	0.36	0.31	0.81
ESH20	3200/3250 Call spread	3200	2993	0.43	-6.9	0.10	8.75	10.5	0.48	0.31	0.76
ESH20	3100 Call	3100	2993	0.43	-3.6	0.48	56.00	58.5	0.39	0.30	0.65

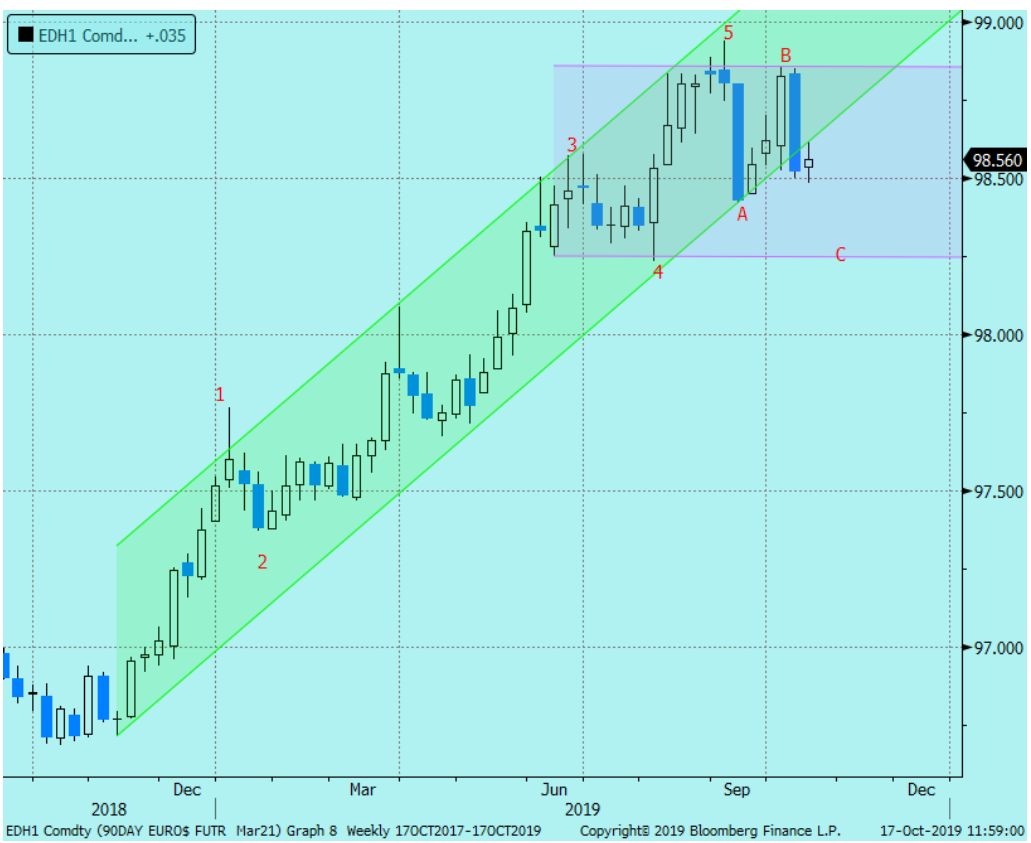
The **ESH9 3300/3400 call spread for 5 points** screens on top. That will pay out 19 to 1 your premium if S&P's rally 13% over the next five months. Not out of the question given the bull case stated above.

As you can see in the quadratic regression of the call spread vs. S&P futures, the call spread is "cheap" to the level of the market. At this level in S&P's, the regression implies that the spread should be worth more like 8-10 points, or said differently, you are essentially getting into a S&P long delta trade around 2875.



The S&P upside will pair nicely with books that are long duration or have fixed income upside structures. If optimism keeps rising, the S&P long will help offset the losses in the long duration trade.

As we can see here, the 11-month bull channel is potentially breaking down this week, and an S&P breakout on the back of rising optimism could be the next potential reason for further losses in Eurodollars.



Eurodollars could very well be entering in a corrective period. You will want to buy the dip again at some point (definitely if we get to 98.25), and the long Eurodollar + long S&P position makes sense not only as a hedge trade, but with an easy Fed on the horizon both sides could provide alpha.

To put it differently, being long S&P's is more sensible than short fixed income which will be frustrated by a continuously dovish Fed.

Kind Regards,

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