Daily Note
Views, news and topics from today's markets

CANTOR Fitzgerald

Wednesday, 28th November 2018

Morning Round Up

To hike or not to hike?

The Federal Reserve should continue gradually raising interest rates but it is "especially important" to closely monitor new economic data since US monetary policy is getting close to a neutral stance, the Fed's second-in-command said on Tuesday. In a carefully worded speech that comes on the heels of another volatile market drop, Fed Vice-Chair Richard Clarida stressed how difficult it is for the US central bank to determine both the neutral interest rate and the maximum level of unemployment. The Fed has settled into a quarterly rate-hike cycle but signs of a slowdown overseas and several weeks of slumping US stocks have clouded an otherwise mostly rosy US economic picture. A couple of weeks ago it was 10-year Treasuries, last week 5-year bonds: hedge funds are shifting their view of the Fed and US interest rates by magnitudes rarely seen before.

Speculators on US futures markets slashed their bearish bets on 5-year Treasuries last week by the fifth largest amount since the Commodity Futures Trading Commission (CFTC) began compiling data in 1995. This follows the third-largest ever reversal in short 10-year Treasury futures the week before, and underscores the view that the Fed won't raise rates next year nearly as much as it has indicated. Slowing growth and wobbly stock markets won't allow it. Fed officials, led by Clarida, have struck a more cautious and dovish tone in recent weeks. A rate-hike next month is fully priced in, but fed funds futures now only fully discount one more increase next year. The Fed will update its guidance at its December 18-19 meeting, but as of September the broad outlook pointed to three or maybe even four rate-increases next year.

Speculators are clearly taking the "under" on that trade. CFTC data for the week ending Tuesday November 20 show that funds and speculative accounts slashed their net short 5-year Treasury futures position by 124,356 contracts to 446,186 contracts. There have only been four bigger weekly positioning swings in favour of bonds since 1995. Funds' short position in 5-year bonds has virtually halved from the record net short of 867,556 contracts in August, and bullish momentum is accelerating rapidly. It has only been greater twice before: mid-2017 and March-June 2008. The 5-year yield hit a decade-high of 3.10% on November 8 but has fallen right back through 3.00% since. If the prospects for steady and continued Fed tightening fade, the 5-year yield may not be spending much more time above 3.00%.

The outlook for US economic growth next year has darkened in recent weeks, thanks to the Trump administration's tax cuts and fiscal stimulus wearing off mid-2019, a diminishing "wealth effect" from fragile stock markets, brewing global trade tensions, and the cumulative effect of three years of rising interest rates. Plus, the US expansion is already close to the longest in history. The end is drawing closer and funds are beginning to position themselves for it. Can the Fed continue to tighten policy at the same pace or at all? Economists at Goldman Sachs and JP Morgan think so, and are sticking to their forecasts of four rate-hikes next year.

But the San Francisco Fed suggests policy may be too tight already, arguing that much of the pick-up in inflation is down to "acyclical factors", and not the strengthening economy. A flattening yield curve is often interpreted as a sign that the bond market believes the longer-term growth and inflation outlook is dimming, which will limit the scope for higher interest rates. And that's exactly how hedge funds and speculators appear to be playing it. The latest CFTC data show that while funds cut back on their short positions in 5-year and 10-year bonds, they stuck with their huge short position in the 2-year space. They trimmed that position to 361,057 contracts from a record 362,374 contracts the week before. .

Continued overleaf

Source: Bloomberg, CF Research November 2018

Key Upcoming Events

29/11/2018 Fed Minutes
30/11/2018 G20 Summit
11/12/2018 UK Parliament vote on Brexit
13/12/2018 ECB Meeting
13/12/2018 EU Summit

Market View

US markets rallied into yesterday evenings close, resulting in two consecutive positive days after a weak day in Europe. Asia also posted gains on stronger China tech. European markets have opened positive this morning, with US futures pointing to a positive open as well. Yields remain off their October highs, while the euro is currently trading at $1.127. The market will be watching Fed Chair Powell's address today. The major focus of the day will be economic forecasts from both the UK Government and the Bank of England. Mapping out their respective Brexit scenarios. Finally, there will be some US housing data published this afternoon.

Market Moves

	Value	Change	% Change	% Change YTD
Dow Jones	24749	108.49	0.44%	0.12%
S&P	2682	8.72	0.33%	0.32%
Nasdaq	7083	0.85	0.01%	2.60%
Nikkei	22177	224.62	1.02%	-2.58%
Hang Seng	26683	350.60	1.33%	-10.82%
Brent Oil	60.76	0.55	0.91%	-9.14%
WTI Oil	51.98	0.42	0.81%	-13.97%
Gold	1214	-1.52	-0.13%	-6.85%
€/$	1.1273	0.00	-0.14%	-6.10%
€/£	0.8848	0.00	-0.15%	-0.38%
£/$	1.2741	0.00	-0.05%	-5.71%

	Yield	Change
German 10 Year	0.334	-0.02
UK 10 Year	1.369	-0.02
US 10 Year	3.0535	0.00
Irish 10 Year	0.978	-0.01
Spain 10 Year	1.558	0.00
Italy 10 Year	3.30	0.0080

Source: Bloomberg, CF Research November 2018

Continued from the front page...

Effectively, funds are positioning for a flatter curve through short-term yields remaining elevated and longer-term yields drifting lower. The curve has flattened over the last couple of months as stocks have wilted and growth fears have mushroomed. It's not inverted yet - the classic precursor of every US recession in the past half century - but it's back at August's multi-year low and now only 23 basis points away from inversion. Of course, stretched positions, pricing, valuations and momentum are usually flashing lights for hedge funds to go against the tide and bet the other way. We're not seeing it right across the US bond market yet though.

ICG - Valuation provides opportunity

Closing Price: €4.40

News

Due to a collection of issues ICG has suffered a 30% drop in value since mid-March. On Monday we reinstated our Outperform rating as we felt that recent headwinds are now more than reflected in the share price. ICG will release a Q3/18 trading update on Thursday the 29th of November .

Comment

Since February this year consensus expectations for FY18 EPS share has fallen by 31%. This has been driven by two dominating factors rising fuel costs and the cancellation of a number of sailings (due to the delay in the delivery of the W.B Yeats and disruption to the Ulysses). From the beginning of the year until the middle of October oil rose by 29%. This was reflected in a 14.3% increase in fuel costs in H1/18. While the RoRo freight has an ability to pass through this cost inflation rather quickly, car revenues do not. The delay in the delivery of the W.B Yeats has caused significant disruption this year. It was originally set to enter service in July, however delivery was pushed back to late this year. This adversely affected both revenue and customer sentiment. In the final week of June, the commencement of the busiest period for Irish Ferries, it was confirmed that the Ulysses ship had sustained technical issues leaving it out of service for five weeks. While the effect on half years was minimal, management expects a material impact to be present at full year results. It is also important to keep in mind that Group EBITDA which fell by €3.5m in H1/18 was primarily a result of the loss of charter revenue following the sales of the Jonathon Swift (€15.5m) and the Kaitaki (€45m).

While the above explains the majority of earning downgrades for the year, the recent stock price drop has been driven by Brexit uncertainty. While the outcome of Brexit remains unknown, it is difficult to envisage a situation where ferry transport between Ireland and the UK stops functioning. Should the worst occur, management have stated its ability relocate/charter its tangible assets on other global routes.

While we acknowledge the headwinds facing ICG (namely Brexit) we see the current share price as an opportunity for the clients. The stock is now trading at 14.2x its blended 12m forward P/E. This is the lowest level it has traded since the beginning of 2017 (as the multiple compressed on Brexit vote in 2016), a 17% discount to its 5 year average. Consensus remains for a 26% drop in EPS this year however the expectation is that this will then increase by 42% in 2019.

Outside of valuations the shorter and medium term tailwinds remain in place. Recent headwinds have subsided with oil prices falling by 32% over the past two months and issues regarding the fleet look to have passed. In our opinion, the growth trajectory for the next few years remains strong. The delivery of both the W.B Yeats this year and the Hull 777 in 2020 will provide additional required capacity and an increased number of sailings. Customer sentiment toward the company will pick up following the disruption over the summer, with management undertaking additional marketing strategies. Bar the worst outcome from Brexit, we expect both Car and RoRo sector volumes to maintain low to mid-single digit growth. The Container and Terminal Division continues to perform, with the segment posting a CAGR of 10% over the past 5 years. We expect this segment to maintain growth with the economic backdrop remaining robust. Finally we have conviction in its ability to prudently manage its assets and finances. Over the past two years the disposal of the Jonathan Swift and the MV Kaitaki provided an after tax gain of €13.7m and €24.9m respectively.

We maintain our positive outlook on the stock but advise clients to be cognisant of the Brexit risk when investing. Investors should also be cognizant of reduced liquidity given the stocks market capitalisation.

David Fahy, CFA | Investment Analyst

Emerging Markets look attractive on Dollar weakness

Closing Price: $38.02

News

Many emerging market indices have had a difficult year led lower by Argentina (Argent: -47%), China (CSI 300: -21% & Hang Seng:-6%), Mexico (S&P/BMV:-17.6%) and South Korea (KOSPI: -14%). Brazil (IBOVESPA:+5%) and Russia(MOEX: +5%) have however managed to deliver positive returns year to date. All of these returns are presented in euros, with local currency weakness often a significant drag on euro denominated performance of country index performance.

A consistent headwind to emerging market performance over the last ten months has been dollar strength (DXY:+9.5%) and higher US interest rates. Given that many emerging market governments and companies issue dollar debt, the higher interest rates and stronger dollar have made it much more expensive to repay capital and interest on this debt. Further to this, concerns that a trade war could escalate have weighed on investor sentiment toward some emerging markets.

The recent plunge in energy prices should reduce the requirements for the Federal reserve to continue to raise rates at the current pace. With many global strategists expecting the dollar to soften through 2019, we may see emerging markets get much needed support over the next twelve months. Some banks have recently upgraded emerging markets to overweight in 2019 expecting that China could use fiscal stimulus to support growth.

Comment

Any positive sentiment toward emerging markets stands out at present given how negative consensus has been toward the asset class. Consensus remain underweight emerging markets but have been adding to the asset class over the last four to six weeks. This has led to an improvement in performance of emerging markets relative to developed markets.

This morning the Hang Seng Index has broken out of a six month downtrend with both index heavyweights Tencent and HSBC both trading close to a two month high. A review of Tencent's most recent quarterly results highlights revenue and earnings growth of 24% and 30% respectively. Year to date, HSBC has extracted three quarters of its profits from Asia which grew an impressive 13% YoY. Year to date, Tencent is trading down by 22% and HSBC by 12% which highlights the extent of their derating relative to earnings growth.

For investors who wish to increase their EM exposure there is a listed iShares MSCI EM UCITS ETF USD (Dist) (IDEM LN) for investors to consider.

Darren McKinley, CFA | Senior Equity Analyst

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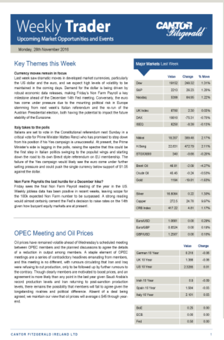

Weekly Trader

On Mondays, we release our weekly note in which we provide a view on equity markets for the coming days, and highlight a number of equities which we believe provide exposure to the important themes unfolding in the markets. Our in-house Investment Committee meets on a weekly basis to craft this strategy, thereby allowing clients to dynamically position portfolios to take advantage of the most up to date market developments.

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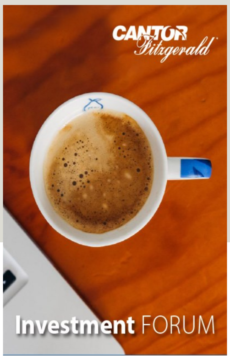

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Regulatory Information

Issuer Descriptions: (Source: Bloomberg)

Irish Continental Group plc: ICG markets holiday packages and provides passenger transport, roll-on and roll-off freight transport, and container lift on and lift-off freight services between Ireland, the United Kingdom and Continental Europe.

Historical Recommendation:

Irish Continental Group plc: We moved our rating from Under Review to Outperform on the 26/11/2018

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