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Global

Tradewinds: The simple bear necessities

Equity Trading Strategies
Research

- Markets stabilized last week and are regaining lost territory
- The news flow from Europe has turned more positive
- But macro data remains soft
- Despite some near-term support, little has been resolved
- The week ahead or so will be critical to assessing risks: the ECB meets, US ISM and payrolls for September are released, Germany and Austria vote on EFSF funding
- International equities have been highly correlated…
- …but some clear macro themes are present
- Weakness in Europe, China, and commodity-producing economies
- Surprising strength in export-focused Korea
- Strength in easing EMs – Turkey and Brazil
- Strength in tech heavy markets – NASDAQ and Taiwan
- Assets that seem vulnerable to resumed downturn include: SPX, NASDAQ, European cyclicals and Korea

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1. The simple bear necessities

After last week's punishment, equity markets stabilized last Friday and have started to meaningfully regain previously lost territory. And yesterday, the S&P 500 closed at 1175, about 4% from lows, but at the same time, back to where it was only last week. Chinese equities climbed 6%, and European markets – led by meteoric one-day 8% gain in financials – also continued to climb. Other asset markets are also taking a more upbeat tack. The USD is down slightly, as EM FX weakness is now partially reversing. US Treasuries have dropped off their peaks and 10-year yields are closing in on 2%. And commodity price declines have halted too.

Following some steep declines, markets have been buoyed by encouraging headlines that have emerged following the weekend's IMF/G-20 meetings. Reports indicate that the EFSF may be expanded and strengthened, a Greek default is (for now) no longer imminent, and the next Troika disbursement seems increasingly likely.

However, early PMI estimates in Europe were disappointing, and the US data set has been underwhelming too. While US consumer confidence has stabilized, early business surveys remain in negative territory but are flat (Chicago) to up a touch (Richmond and Philly) relative to August lows.

Over the next week or so, markets will get even more information about some key risks. In the US, September ISM is reported next Monday (consensus expects a 50.4 print, down two ticks from the August 50.6 read) and payrolls next Friday (consensus expectations are for a 68K print). Parliamentary votes to approve EFSF funding are set to take place in Germany and Estonia on September 29th, Austria a day later and Netherlands in early October. And the ECB meets next Thursday. The market is expecting a cut in rates, and has already priced in 100bps of cuts over the next 12 months. Moreover, the ECB has also become the *de facto* backstop for European sovereign worries, and any comments from them on their ongoing role will be important to monitor.

While better data and faith in European stabilization could push the market through the tops of its recent range in the near-term, we are still inclined to view the current environment as fraught with downside risks, with little resolved despite a bit more optimism.

In Europe, the Parliamentary gauntlet of EFSF approvals remains highly uncertain and full of potential speed bumps. And recasting the EFSF into a leveraged vehicle or a vehicle for recapping the banking system– proposals that right now are still a matter of speculation and have yet to be formally put forth in any detail - would likely require individual parliamentary approvals. Although the US data may have stabilized, consumer and business confidence is soft, the GLI is still in negative territory (on a month-on-month basis), as is the Current Activity Index, European business surveys are slumping, and yet another Congressional funding showdown seems to be looming.

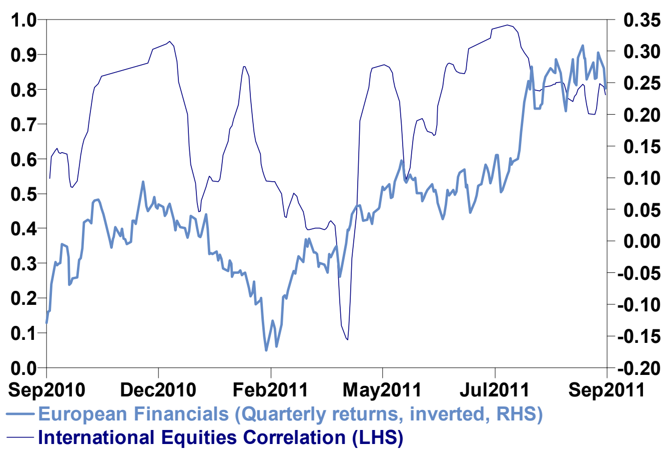
Currently we have no tactical recommendations, nor do our FX and Fixed Income Markets Group colleagues. In essence, we continue to wait for a more solid progress on these fronts – a meaningful improvement in the US data set (with a particular focus on labor market and confidence measures), concrete progress on a banking system recap in Europe, and additional policy easing in the Emerging world, are the markers that will push us to take a more "risk on" stance in equity markets.

But until then, we are inclined to look for areas where the current set of risks has not been fully appreciated by the market or where recent optimism leaves markets most vulnerable to a set of risks we do not yet see as fully resolved. Below we discuss a handful of market moves that catch our attention, but our short list includes: (1) Short Kospi to gain exposure to a less accommodative (than expected) China and (2) short WF European Growth Basket, as a European growth slowdown could intensify even if financial risks are ameliorated.

2. Compass needed to navigate the market jungle

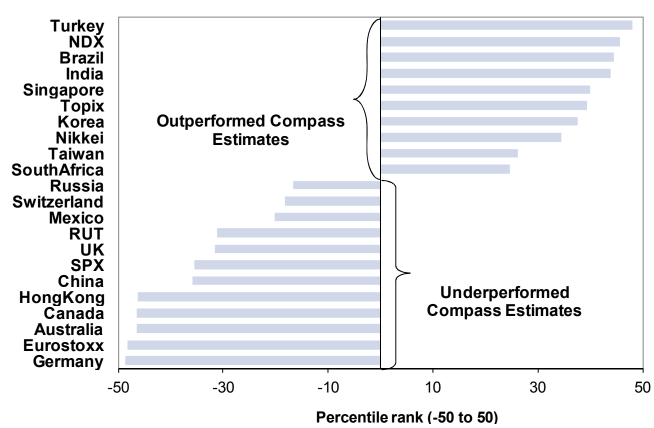
Market trends have been difficult to sustain over the last month or so, with most global equity indices remaining in their (fairly wide) ranges. While discerning the rhythm of these moves has been difficult – and we have been flat from a tactical trading stance in response – global market synchronicity has remained elevated. Average implied correlation across the 20 or so equity indices that we track regularly has climbed again, as the European crisis asserted itself as the main force behind recent equity moves (see Exhibit 1).

Exhibit 1: Equities correlation rose as European Financials came under stress



Source: Goldman Sachs Research.

Exhibit 2: How have markets performed relative to macro drivers?



Source: Goldman Sachs Research.

But elevated correlation may be masking some interesting dispersion. Instead of looking just at absolute returns, we tend to compare how indices have performed relative to a common set of macro risk factors – growth views, oil prices, financial conditions and a broad measure of equity risk. Sweeping out these common effects can lay bare some underlying themes, as Aleksandar Timcenko documented in Monday's International Macro Equity Monitor (see Exhibit 2).

1) At the bottom end of the spectrum, European indices have underperformed their respective leverage to macro risk factors, which is not surprising given the extraordinary set of risks at play there.

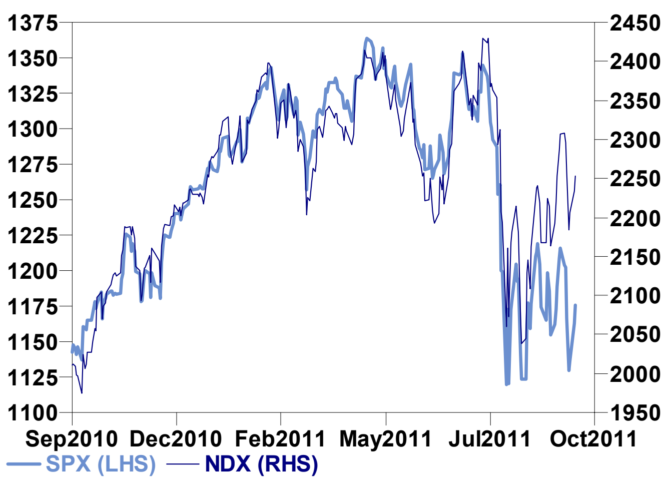
2) Perhaps partially unrelated to European weakness, Chinese equities have underperformed as well. Chinese underperformance has persisted for some time, as policy makers there have yet to back away from their restrictive stance, despite rising risks globally. Interestingly, Korea has outperformed relative its leverage to macro risk factors despite the facts that the Kospi is a highly cyclical market and a major exporter to China.

3) Perhaps linked to the China weakness, commodity prices themselves have corrected sharply after a prolonged period of resilience. Accordingly, commodity-heavy markets too – Canada, Australia and Russia – have underperformed.

4) Some degree of decoupling from these themes appears to be at play as evidenced in the relative outperformance in some prominent EMs. Recent rounds of policy easing in Turkey and Brazil appear to have helped those markets. South African and India have also been quite resilient, though the potential drivers here are less clear.

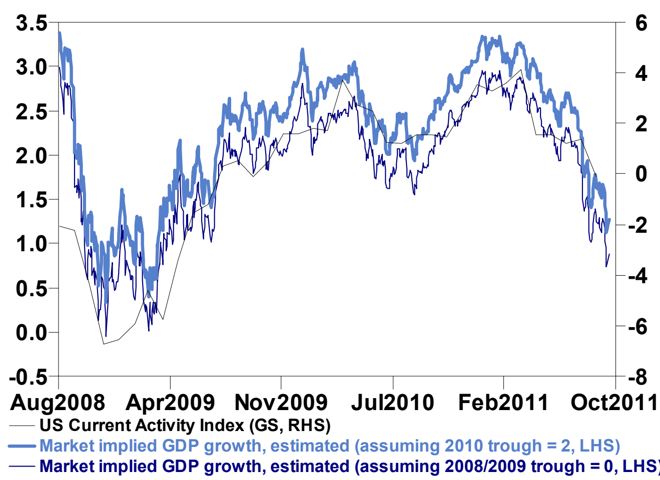
5) NASDAQ is also a stand-out performer, both relative to its macro drivers as well as more simply relative to the SPX (see Exhibit 3). NASDAQ outperformance is probably linked to its light financial sector weighting as well to its balance sheet quality. Taiwan outperformance may also be a reflection of tech sector strength.

Exhibit 3: Tech exposure has been rewarded



Source: Goldman Sachs Research.

Exhibit 4: Growth views remain quite downbeat



Source: Goldman Sachs Research.

3. Looking for downside exposure, but no appetite yet

Although it is difficult to benchmark how markets are discounting the important macro risks at play – European sovereign concerns, a global slowdown, and China worries/policy tightening – we think there are a small handful of implementations that are gaining our attention.

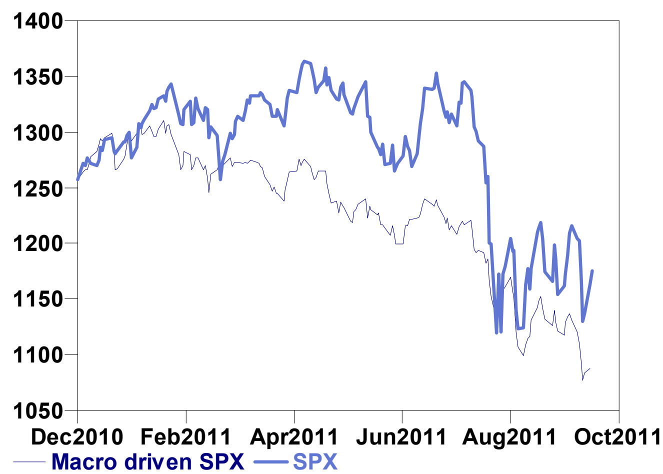
First, the US equity market has already priced in a good deal of weakness. The performance of the WF GDP Growth Basket suggests that long-term growth estimates are now below 1% (see Exhibit 4). The market looks to have priced in a bit more weakness than the data. The Current Activity Index showed the August data were consistent with a monthly run rate of -0.5% real GDP growth (annualized). Incremental September weakness would likely be needed to push the monthly run rate lower from here.

Along the side of sliding growth expectations, US financial conditions have climbed recently and both of these factors have been market headwinds (see Exhibit 5). Although there has been some relaxation of late, the market rally of the past week may be moving faster than the improvement visible in the macro risk factors we track. It is too early to tell if the S&P is diverging in a meaningful way, but after seeing a similar dynamic play out over the summer, we are watching (see Exhibit 6).

Exhibit 5: US financial conditions have climbed recently

Source: Goldman Sachs Research.

Exhibit 6: Slow improvement in the macro risk factors we track

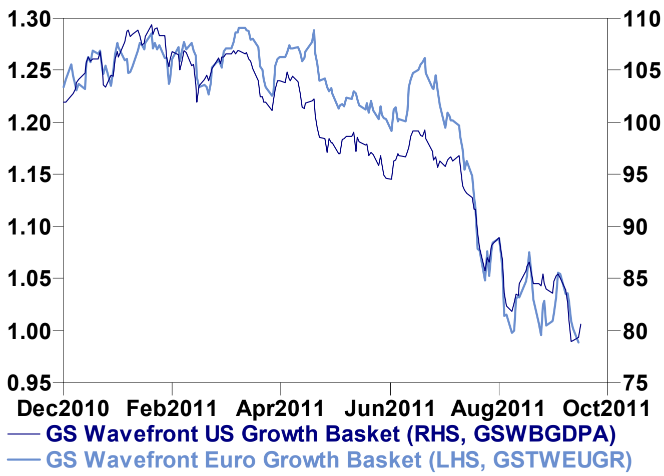


Source: Goldman Sachs Research.

Second, a European version of Wavefront growth (GSTWEUGR) – the most cyclical bits of Eurostoxx relative to the most defensive bits – has also priced in weakness commensurate with risks elsewhere (see Exhibit 7). And it does not appear that the equity market is "missing" anything. And amelioration of European financial system stresses may provide a short-term boost to growth views. But even if the fog surrounding the resolution of European financial system stresses is lifted, European growth risks may still persist for some time.

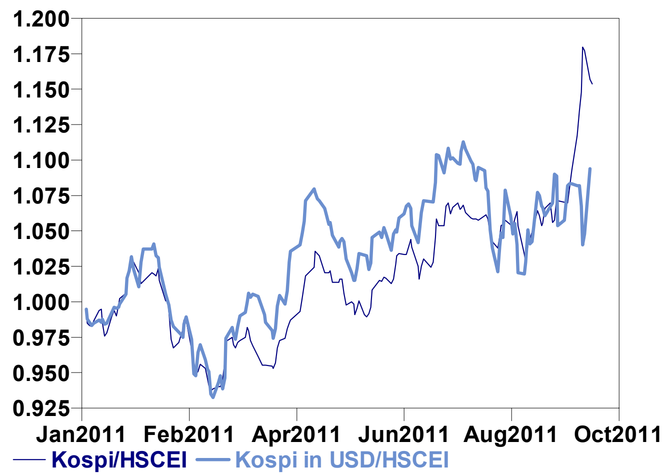
Third, long-standing Chinese equity underperformance and the more recent commodity price selloff point to growing market concerns about a Chinese reacceleration. While it is hard to benchmark how much deeper Chinese underperformance can run, we think trading laggards to this shift may be more appealing. On this score, the relative outperformance of Korean equities -- which attenuated a bit when the KRW depreciation is hedged out – could be an attractive implementation (see Exhibit 8).

Exhibit 7: US and European WF Growth Baskets have both priced in weakness



Source: Goldman Sachs Research.

Exhibit 8: Korean equities could be an attractive implementation



Source: Goldman Sachs Research.

Indeed, Korean export growth has slowed – though exports to China have bounced a bit – possibly reflecting some of these linkages. While certainly suggestive, the Kospi on an absolute basis has certainly sold off sharply recently and, with PE multiples in the 8.9 for this year and 7.8 for next, traditional valuation metrics make Kospi look quite cheap.

With markets current rallying, it may be premature to express these more negative views. Markets could continue to approach the tops of their recent ranges particularly if the data improves, or if the ECB and European Parliaments and policymakers provide more clarity on a resolution there. Equally, any new disappointments could quickly reverse nascent optimism, and with markets off their lows, that is the shift for which we will be looking.

Top trades*

- Stay long the Nikkei 225 (NKY), with a target of 12000, opened on 1 Dec, now at 8609.95.
- Stay long EEM, with a target of 55, opened on 30 March, now at 37.58.

*"Recommended trades" and "Top trades" are trading strategies that we are actively recommending to clients.

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