October 19, 2011

Global

Tradewinds: Sitting in nowhere land

Equity Trading Strategies
Research

Markets have rallied back to recent highs spurred by…

…US data that has been a bit better in places and not as disappointing...

….rumblings that European policy makers are in the process of devising a levered EFSF and rolling out a financial sector recap plan…

…and moderating Chinese inflation, though growth is still soft.

However, resolution to any of the key risks above isn't ironclad…

…and so we are not yet sure that the current range can be broken just yet.

Market risks have been highly correlated and unresolved.

Faint signs that European financial risk is becoming less influential may be emerging.

Markets remains range-bound, trends cannot be sustained, and short-run volatility is high.

Firmer news of European policy initiatives or continued strength in the US data could help the market break out of its range.

But with the market already back at the top of that range, disappointments from here could put the market back on its lows in short order.

Our tactical trading stance remains neutral, as markets remain stuck, so it seems, in nowhere land.

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1. Sitting in nowhere land

Global equity markets have rallied for much of the last two weeks, with many indices re-gaining tops of their recent ranges. Tuesday's rally accelerated late in the day, with the S&P 500 climbing briefly above 1230 for the first time since early August, before closing at 1225, fully reversing Monday's decline.

In our last Tradewinds, three weeks ago, we noted three areas of concern: the US data and the health of the global cycle more generally, the lack of a clear set of policies to address ongoing European sovereign debt concerns, and ongoing contractionary policy in China and the slowing of that economy. There has been incremental progress on some fronts, though probably not enough has gone "right" to end the nearly three-month-long range trade.

Indeed, the US data has been a bit better in places, rumblings are increasing that European policy makers are in the process of devising a levered EFSF and in rolling out a financial sector recap plan, and Chinese inflation seems to have ticked down, even though growth is still soft.

Markets seem to be responding to some of these impulses with Tuesday's sharp rally led by financials. And on days like this past one, it certainly does seem as if the European tail (risk) is wagging the dog, so to speak. However, we think there is some tentative evidence that financial sector risk is becoming a bit more independent, a sign that we think is quite healthy for markets. At the same time, we don't see a clear enough resolution to any of the key risks above to make us comfortable that the current range can be broken just yet.

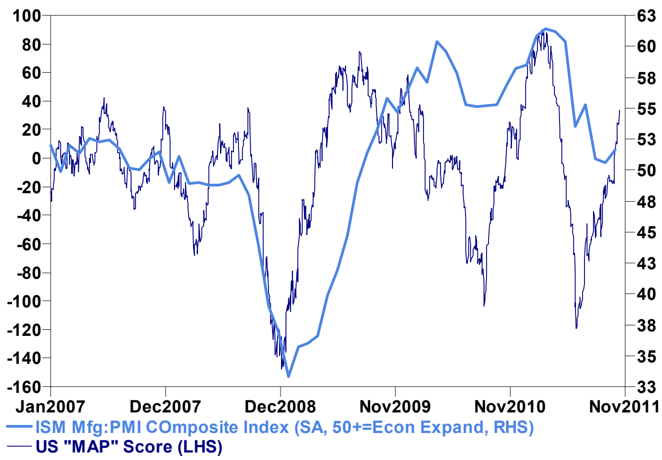
Firmer news on European policy initiatives or more evidence in the US data that September improvement has extended into October would help us get comfortable. But with the market back at the top of the range, disappointments from here, we think could put the market back on its lows in short order. And so, our tactical trading stance remains neutral, as markets remain stuck, so it seems, in nowhere land.

2. Just sees what he wants to see…

As discussed above, we continue to monitor the market's view of three key risks:

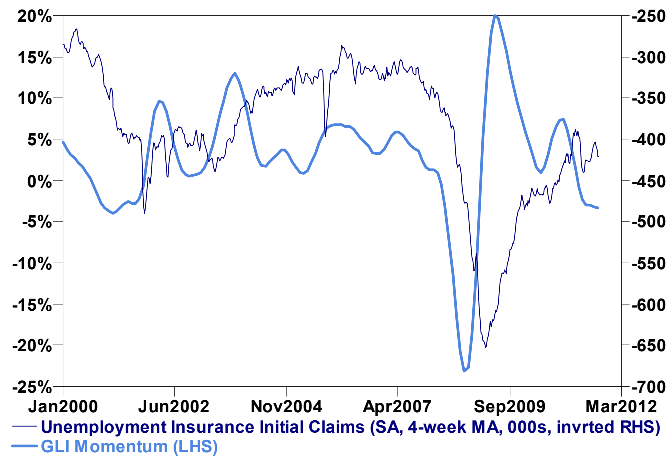
(1) Health of the US and global cycle. Elements in the US macro data set, particularly the September data relative to August, do look better. Both Manufacturing and non-Manufacturing ISMs improved, jobs growth perked up a bit, housing data (starts and the NAHB survey) have gone from moribund to a bit less moribund (and housing stocks have rocketed higher), and data disappointments have given way to some upside surprises as measured by a rolling average of the US econ team's "MAP" score (see Exhibit 1). However, weekly jobless claims remain lackluster and stuck at 400K/week, consumer confidence remains weak, and the Empire Fed survey – an early look at the October data - was weaker than expected. Moreover, outside of the US, growth seems to be incrementally weaker, not stronger, as GLI momentum remains negative (see Exhibit 2).

Exhibit 1: US data have stabilized, and been a bit stronger than expected



Source: Goldman Sachs Research and Haver Analytics.

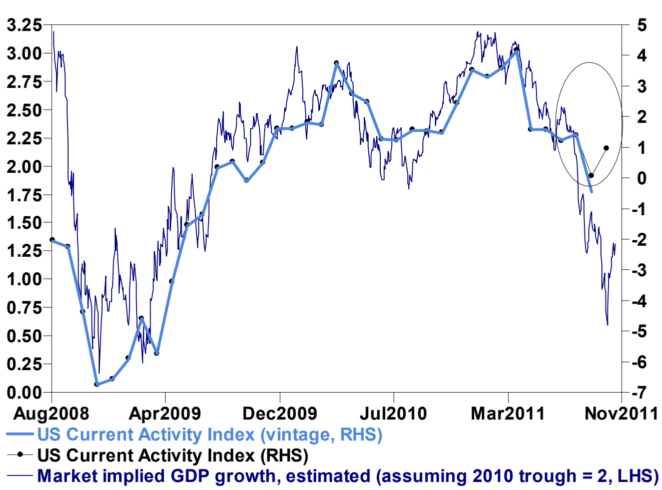
Exhibit 2: GLI Momentum is negative, and the US labor market is soft



Source: Goldman Sachs Research and Haver Analytics.

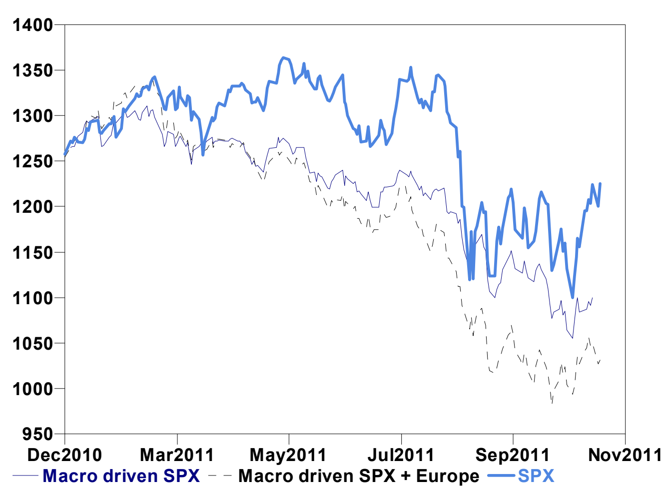
By mid-October, the internals of the US equity market had priced in recessionary outcomes, even as the data had stopped deteriorating and, indeed had shown signs of improvement (see Exhibit 3). Our US team's measure of current activity seems to have bottomed in August – initially suggesting that the economy was contracting, but now showing it just slightly positive, with the September data consistent with nearly 1% GDP growth (annualized).

Exhibit 3: Market growth views weaker than improving data



Source: Goldman Sachs Research.

Exhibit 4: SPX rallying faster than macro factors



Source: Goldman Sachs Research.

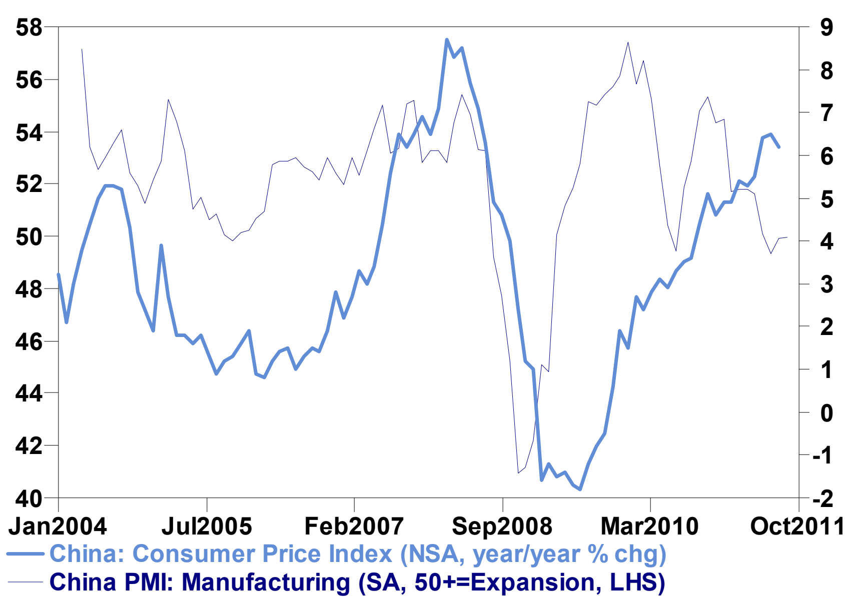
In contrast, the Wavefront US Growth Basket was pricing in outcomes consistent with 0.50% forward GDP growth – close to 2008 lows and consistent with average growth outcomes during a recession (as opposed to the worst quarterly growth seen at a point in time at the depth of a recession).

Market growth views, have, over the last several sessions recovered a bit, and with Philly Fed survey out followed by ISM, and payrolls, we are once again in the data intensive part of the month. Though we are far from upbeat about near term prospects, it is equally hard to argue that, at its lows, the equity market's views of economic growth were "missing something."

At the same time, it seems as if, once again, the index is taking a more optimistic tack than underlying risk factors would otherwise suggest (see Exhibit 4). Looking just at macro risks alone, and even more clearly macro risks and European financial risk, would put the index a good deal lower than current levels. At the same time, however, it is clear shifts in the growth outlook on the back of better data – or extending quick shifts in sentiment with respect to European banks, could quickly close that gap too.

(2) European sovereign risks. In Europe, though no official commitments have been made, reports of a German and French agreement that would pump up the EFSF have boosted markets. Francesco Garzarelli outlined some of the potential ways to "leverage" the EFSF structure, and markets remain focused on the ability of European policymakers to design tools to limit the damage from needed sovereign haircuts/restructuring and backstop European financial institutions. While hope springs eternal, concrete steps toward some of these goals remains absent.

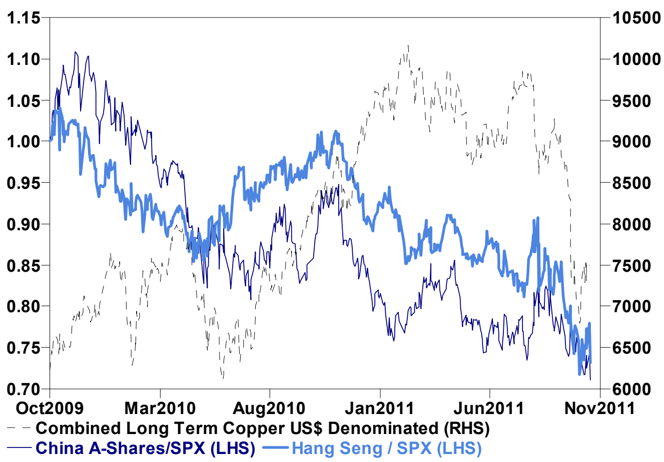
Exhibit 5: China inflation a tick better, growth soft



Source: Goldman Sachs Research.

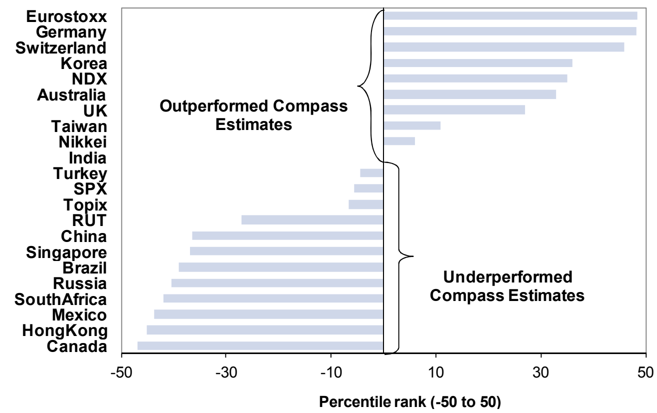
(3) China slowing but not easing. In China, the most recent batch of economic data was not particularly encouraging. ISM there remains below 50 (just below) and real GDP growth (Y/Y) slowed a bit too. They have allowed their currency to strengthen, while a plus from the perspective of global balances, this is an incremental form of tightening domestically. However, alongside a bit of a growth slowdown, inflationary pressures seem to be abating somewhat too; with CPI inflation just beginning to moderate (see Exhibit 5). Lingering worries about China have kept Chinese markets contained (see Exhibit 6), with markets in other commodity-producing economies, including Russia, Canada and Mexico, underperforming as well (see Exhibit 7).

Exhibit 6: China worries linger



Source: Goldman Sachs Research.

Exhibit 7: How much have indices out or underperformed macro drivers?



Source: Goldman Sachs Research.

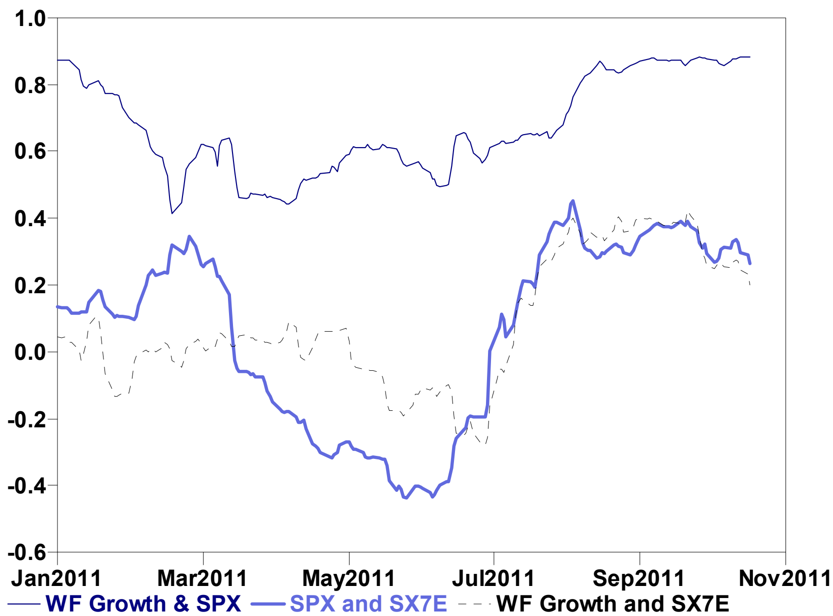
3. Knows not where he's going to

While some progress has been made – most clearly with respect to the US data – the market continues to seem largely trapped and swayed by perceptions about the European situation. Interestingly, it seems as if some of that Europe focus may be waning just a very little bit.

Exhibit 8 shows correlations (over 21-day windows) between the (5-day) SPX returns, and some of the key macro risk factors we have been focused on recently—the equity markets view of economic growth and European financial sector risk. Interestingly, the degree of correlation between the overall market and growth views – while high throughout – fell earlier this year but more recently has climbed to highs. At the same time, the correlations between growth risk and European financials, and index returns and European financials had also climbed sharply earlier in the summer, and maybe have, more recently, waned ever so slightly in the last few weeks.

While far from ironclad, we think evidence that risk factors can "decouple" is healthy for the market. But until it is clear that those risks have decoupled, it may prove difficult to isolate a trading view.

Exhibit 8: Correlation with European financials is high...but moderating?

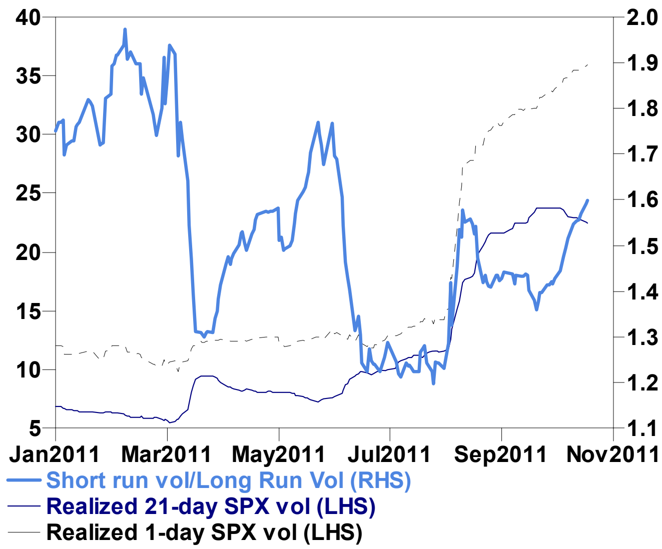


Source: Goldman Sachs Research.

And so, taking directional views remains difficult both because of the influence across risk factors and also because each risk on its own remains unresolved. Hence, markets still seem directionless.

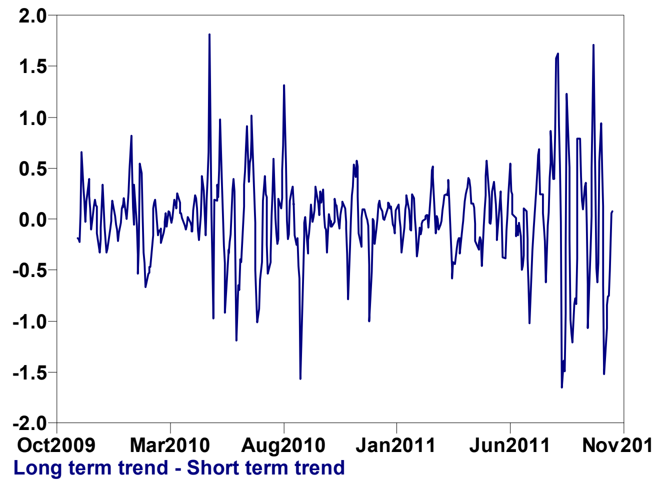
Two charts illustrate the recent choppiness of markets by comparing elements of short-run returns, which have zigzagged, and longer-run returns, which have stagnated. Exhibit 9 plots the realized vol of 1-day SPX returns relative to the realized vol of 21-day SPX returns. Daily returns have been exceptionally volatile, reflecting sudden shifts in market direction, while longer-term returns have been more stable, averaging out the underlying noise, as it were.

Exhibit 9: Short-run realized vol has climbed, while long-run realized vol is stable



Source: Goldman Sachs Research.

Exhibit 10: S&P 500 has not been able to sustain a trend



Source: Goldman Sachs Research.

Exhibit 10 shows another interesting way of quantifying the degree to which markets have been "trendless," by showing the difference between short-term trends (say, over 5-days) and longer-term trends (say, over 21-days). The "counterfactual" is that a market trends constantly over time, and so, the long and short term trends would be the same. But if the difference between long and short run trends shifts sharply, that indicates that market direction is not sustained, and that "trend breaks" are common. While noisy, it seems that over the last few months, short and long term trends have shifted sharply, reflecting the inability of the market to sustain directional moves.

With such dynamics still solidly in play, and with clear resolution of the key risks still not in evidence, we are leery of taking directional risk, and accordingly the Markets Group has had very few tactical trade recommendations as of late. Uncertainties remain unresolved, and so we do not have a firm directional bias. Improvements in any of the key risks we have identified would push us toward a more positive stance, but at the same time, the lack there of, particularly with markets seemingly extended, would push us in the opposite direction.

Top trades*

- Stay long the Nikkei 225 (NKY), with a target of 12000, opened on 1 Dec, now at 8772.54.
- Stay long EEM, with a target of 55, opened on 30 March, now at 39.27.

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

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