ALPINEMACRO
A Unique Mind On The Markets

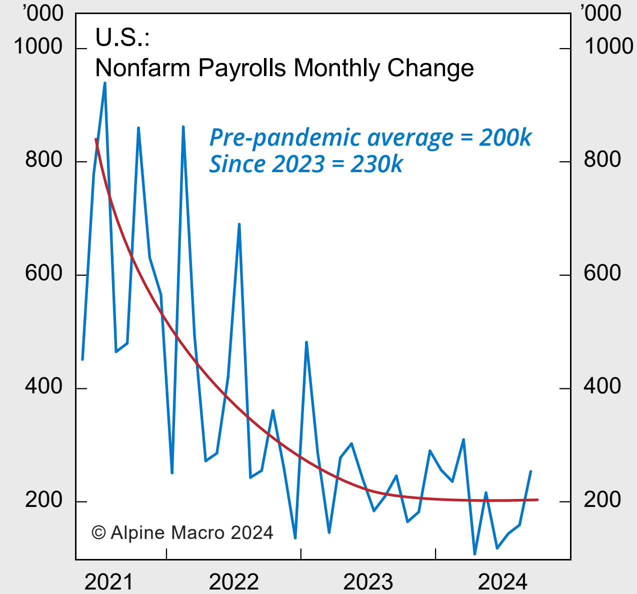
GLOBAL STRATEGY

October 7, 2024

A Word From Chen Zhao

As this week's report goes to press, the Middle East seems to be plunging into a mess, with Iran lobbing missiles into Israel, which in turn promises tit-for-tat retaliation. Oil prices have spiked up 12% as fears of a widening Middle Eastern war intensify. The dockworkers strike in America's east ports also raised concerns of supply-side disruptions, potentially complicating the disinflationary process.

Chart 1 **U.S.: A Normalized Labor Market**



The good news is that the port strike has been suspended. Importantly, the payrolls report last Friday has confirmed, again, that the U.S. economy is moving away, not toward a recession, with the unemployment rate having fallen anew. **Chart 1** paints a picture of a normalized U.S. labor market rather than one in distress.

The resilience of the U.S. economy, together with China's policy stimulus, is a major positive for global stocks, but not necessarily for bonds. We continue to hold the view that the Fed will not cut rates as much as what is discounted by markets. As well, we are upgrading EM to overweight, probably at the expense of Japanese equities, which have had a good run for long.

The biggest threat to the bull market is the escalating conflicts in the Middle East, but it is hard to assess the exact impact on financial markets at this stage. By and large, much will depend on how long these conflicts last and how high oil prices can go. Oil affects inflation and economic activities slowly and as things stand now, the economic impact of the Iran-Israel conflict is limited. However, if the war widens, pushing oil prices to $95-$100, both bonds and stocks will have to adjust downward, probably significantly, to account for rising inflation or stagflation risk.

For those who want to know more about our thoughts and strategies surrounding the escalating conflicts in the Middle East, my colleague Dan Alamariu, our *Chief Geopolitical Strategist*, has released his take on the situation. Please refer to our latest *Geopolitical Strategy* report for more insight.[1]

Best regards,
Chen Zhao

1 Alpine Macro *Geopolitical Strategy* "The Middle East: Major Escalation Is Likely, Either Now Or Later" (October 4, 2024).

"You Are Only As Good As Your Last Call"

ITM fan

All our investment recommendations are currently in the money (Table on page 11). This is no reason for complacency. There is plenty of potential for unexpected surprises, and many things can and inevitably will go wrong. *"You are only as good as your last call,"* a client once said.

The relevant question today is, with all of our investment positions making money, is it too late for investors to enter these positions? Here is a quick review of our key positions, the rationale behind our calls, and our assessment of respective market potential going forward.

German Bunds Versus Japanese JGBs

Clients will recall that we had held the position of being long German 10-year bunds versus shorting 10-year JGBs since August 2023, but this strategic trade was stopped out in early August with a 6.4% gain. Investors should re-enter this spread position because the rationale behind it remains unchanged:

First, inflation is going separate ways between Europe and Japan. CPI inflation in Germany is plunging below 2%, increasing the pressure on the European Central Bank (ECB) to cut rates more aggressively. Inflation in Japan, however, is perking up to 3% (**Chart 2**), and the Bank of Japan (BoJ) is under pressure to raise rates.

Much of Japan's inflation problem can be traced back to the yen's sharp decline since late 2020, and

Chart 2 Germany Versus Japan: Diverging Inflation

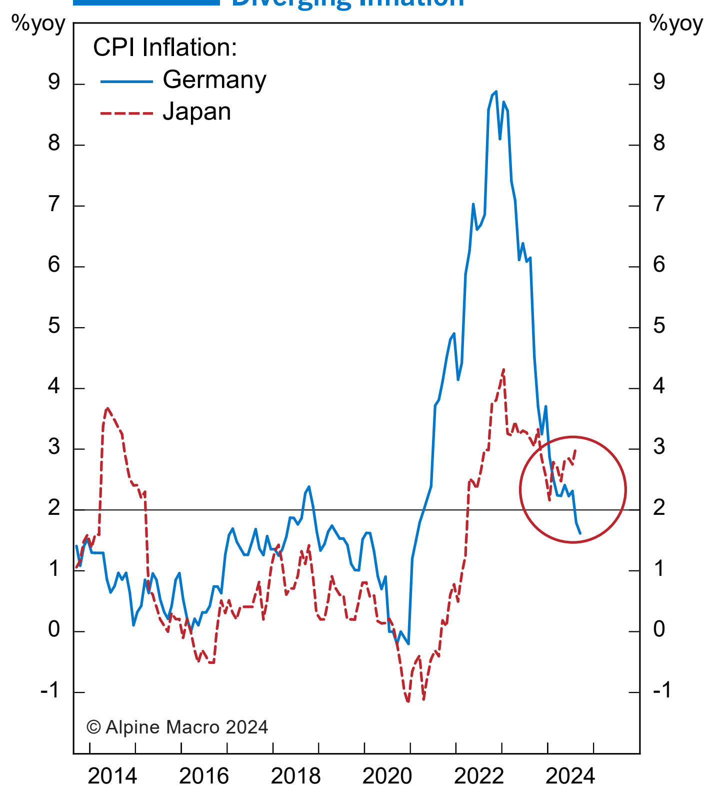


Chart 3 Germany Versus Japan: GDP Growth

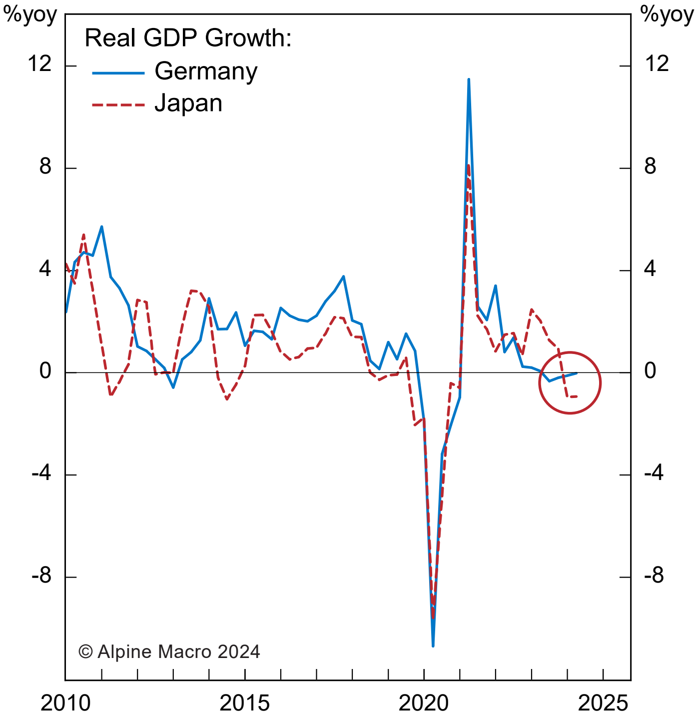
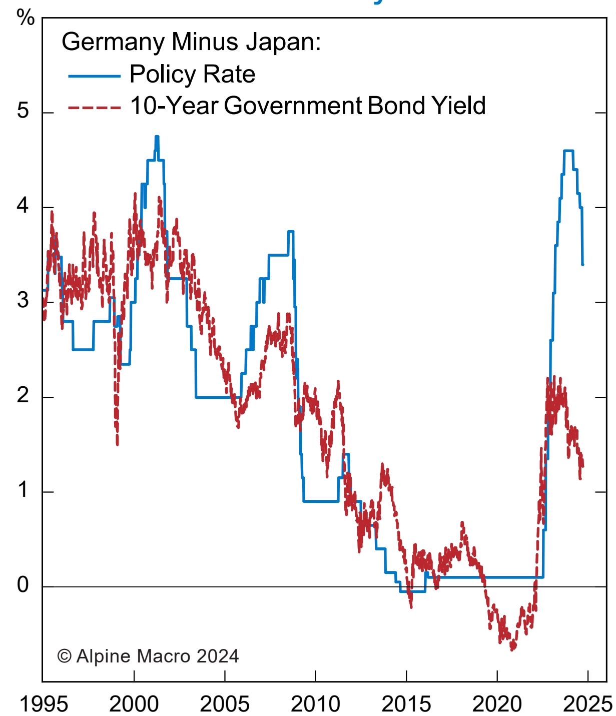


Chart 4 Long Bond Spread Tracks Relative Policy Rates



therefore CPI inflation could fall on a strengthening JPY. Nevertheless, with CPI inflation still creeping higher, the BoJ may face increasing political pressure to raise rates anyway.

Second, as for real economic growth, both Germany and Japan have fared roughly equally (**Chart 3**). In 2021, the German economy recovered from the pandemic crisis faster than Japan's but has stalled since then.

The Japanese economy, however, did well in 2023 on a falling yen, but slumped in 2024 as yen depreciation has slowed. Regardless, it seems that both Germany and Japan have been expanding their real output at about the same pace since the pandemic crisis, suggesting there is no compelling case for real interest rates between the two economies to diverge much.

Finally, bond spreads between Germany and Japan closely mimic the relative policy stance between the ECB and the BoJ. **Chart 4** shows that yield spreads between the two bond markets have fallen sharply, which is reflective of the large decline in the policy spread between the ECB and the BoJ.

Our hunch is that Germany-Japan bond spreads will head significantly lower, suggesting there will be more money to be made by going long bunds while shorting JGBs. Our calculation is that policy rates in the eurozone and Japan should be very close to each other going forward, implying that the steady-state spread between the two policy rates could be headed for zero.

Bottom line: Investors should reinstate the position of being long German 10-year bunds while selling JGBs of the same maturity short.

Chart 5 Gold And DXY Parting Ways

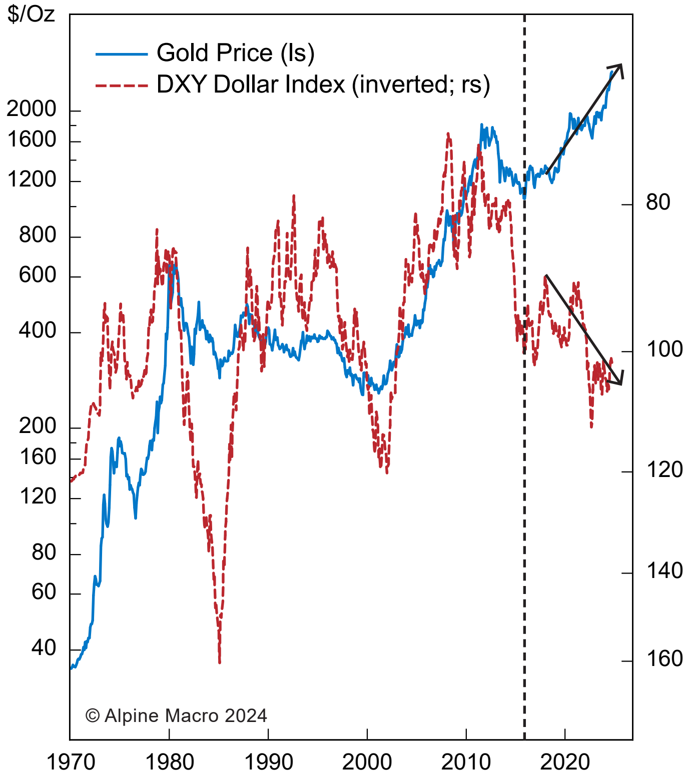
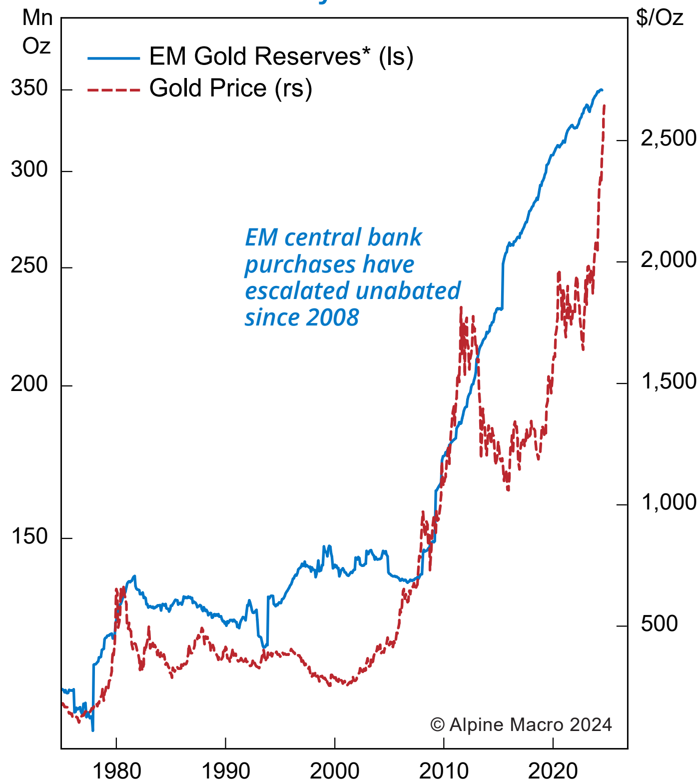


Chart 6 Central Bank Purchases Of Gold Have Skyrocketed



*Source: IMF

Gold, Oil & Copper: More Different Than Similar

In the 2000s commodity bull market, all commodities moved closely together. The combination of strengthening demand from China, inadequate supply and a falling dollar were the key reasons behind rising commodity prices back then.

The rise and fall in the U.S. dollar is always a crucial element for the commodity market. The so-called "denominator effect" means that a weakening dollar tends to push up the dollar price of commodities and *vice versa*. Nevertheless, the dollar correlation with all these commodities has broken down in recent years.

Chart 5 shows that gold bottomed in late 2015 and has risen ever since, irrespective of the dollar trend.

Copper and crude prices also have broken away from the dollar since 2021. What's more, intra-commodity price dispersions have also risen sharply. All of this seems to suggest that underlying fundamentals for commodities are no longer moving in unison.

Should investors buy gold now? The answer is yes. In our view, all managed portfolios should have some exposure to gold. The world has become a dangerous place, with rising acrimony between the U.S. and China, raging wars in Europe and the Middle East, and growing nationalism and extremism.

The financial sanctions on Russia have clearly unnerved China and some developing nations. Many central banks of non-U.S. allies are trying to de-dollarize their reserves by stocking up on gold.

Chart 6 shows that the trend of increasing gold reserves among EM countries started in 2008 and has continued unabated. We suspect this is the key reason behind rising prices.

The bottom line is that although gold prices seem overbought and due for a pullback, we advise clients to buy on price weakness as the structural backdrop for the gold market remains very positive.

What about crude oil and copper? We have been shorting crude oil since late August, while having been long on copper since last week. Clearly, we are betting that these two markets will continue to go separate ways (**Chart 7**). Policy stimulus in China is a bullish factor for both crude and copper, and the worsening wars in the Middle East can jack up crude prices sharply in the short term. However, we are concerned that there is too much oil, but not enough demand beyond the immediate Iran-Israel war.

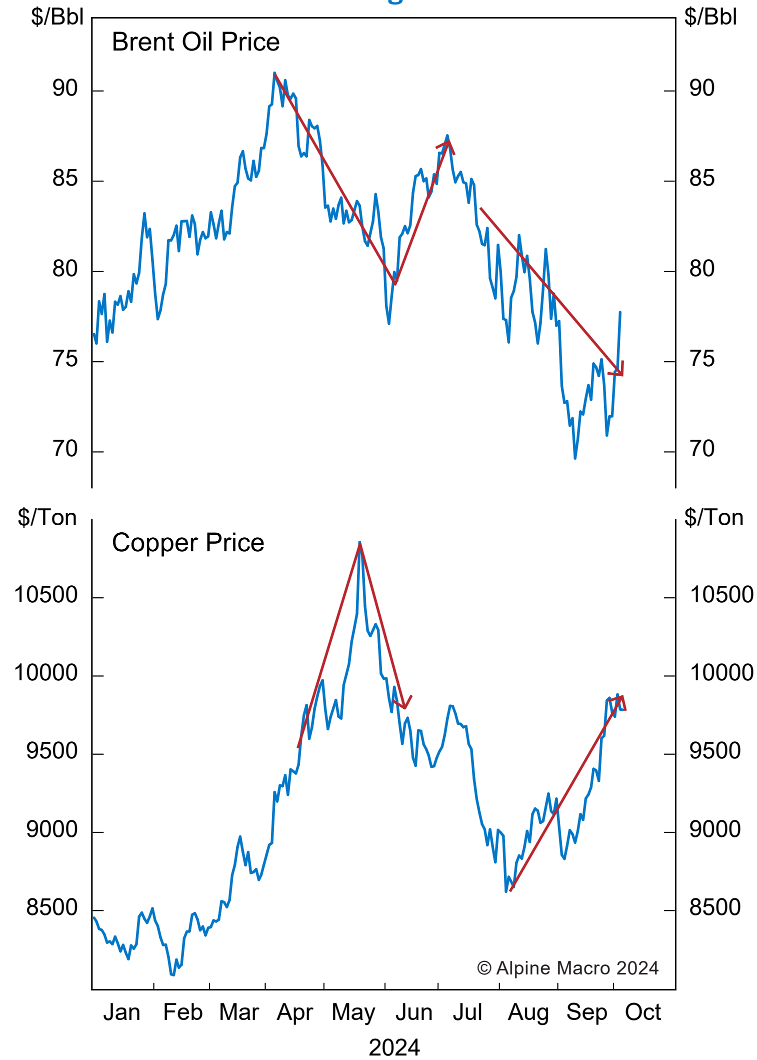
First, world oil production is rising sharply, led by the U.S. Since 2020, the U.S. has become a net oil exporter, with a net outflow of 2.7 million barrels/day.

Second, Saudi Arabia is warning OPEC members that it may drive down crude prices to $50 to punish "cheaters" and regain market share, which is another sign that the world is pumping out too much oil.

Third, China's oil imports have fallen (**Chart 8**), while the country's oil inventory is rising as Beijing stocks up on cheap Russian oil.

Fourth, the driving force behind crude oil consumption is motor vehicles, but China's EV sales have reached more than one-third of total car sales. This has and will continue to undercut crude consumption over time.

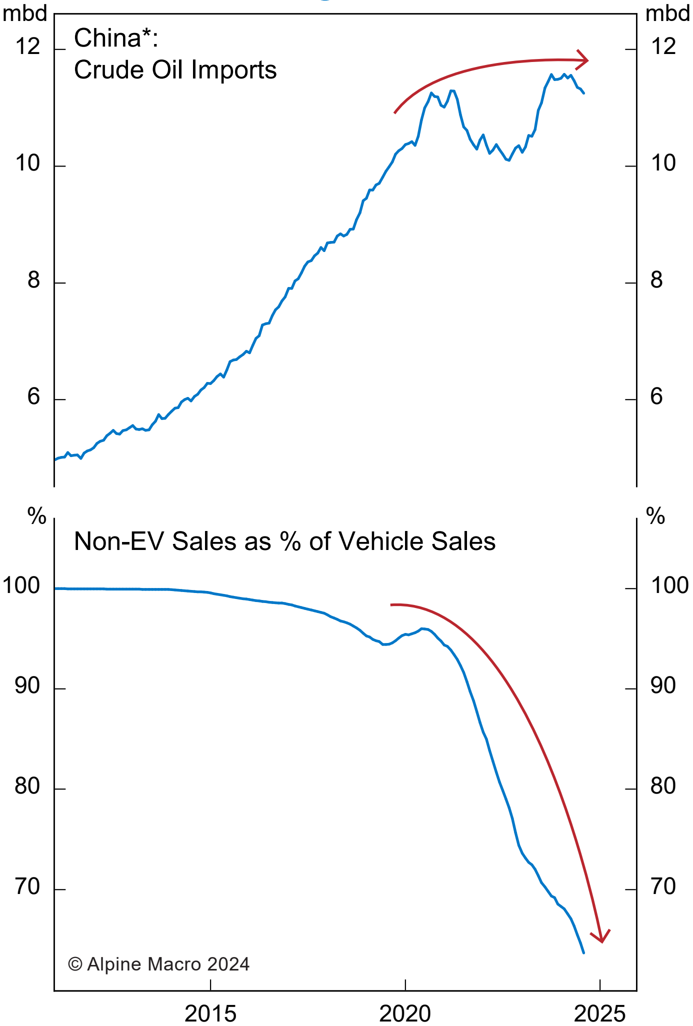
Chart 7 Oil And Copper Have Often Diverged



Finally, Brent oil cannot break above $80/barrel despite enormous tensions and conflicts in the Middle East. If supply is tight, such conflicts should have sent oil to over $100/barrel.

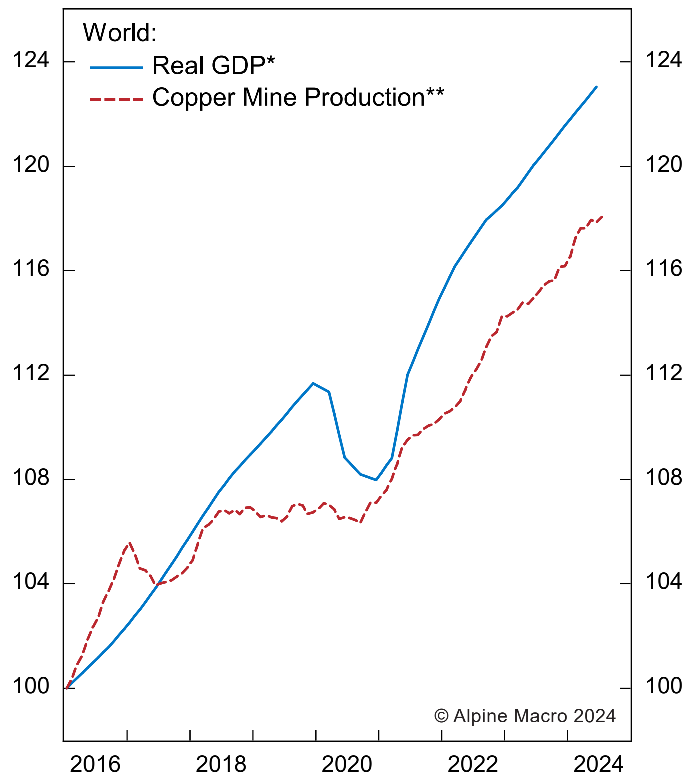
The fact that Brent oil still sits at $78 raises the question of what might happen if tensions in the Middle East actually calm down.

Chart 8 China's Oil Energy Demand Is Shifting



*Shown as 12-month moving average

Chart 9 Copper Output Has Lagged World GDP



*Source: World Bank
**Shown as 12-month moving sum
Note: Both series are rebased to Jan 2016=100

The bottom line is that we are staying short on our crude contract position but have set a tight stop at $79 to control risk. The geopolitical tensions are hard to predict, but should oil prices indeed break out to significant new highs such as $85 to $90, we would regard that as a new entry point to short the market again.

On copper, the structural backdrop is different. Global copper mine production has only increased 18% since 2016, translating into 2% annual growth. The world economy, however, has expanded 23%, or 2.6% a year (Chart 9). At a minimum, copper supply is tight.

Of course, there have been some major negatives for the copper market, one of which is the global manufacturing recession. Nevertheless, **Chart 10** shows that although the ISM manufacturing PMI remains in contractionary territory, copper prices have begun to rise lately.

Weak ISM manufacturing PMI but strengthening copper prices could be a signal of inadequate supply in the copper market. With China having begun to reflate aggressively, copper prices could rise significantly higher – a key reason we have gone long the copper contract.

Chart 10 Manufacturing Cycles Affect Copper Prices

KRE, IYF And IWM

We bought regional banks (ETF: KRE) almost a year ago and have added U.S. financials (ETF: IYF) and the small-cap index (ETF: IWM) since mid-August. Today, the reasons for going long these sectors remain very valid:

First, historically, financial crises almost always create value, and the 2023 Regional Bank Crisis has proven to be no exception. Most regional banks were sold down sharply as a funding crunch unfolded during mid-2023, but the Federal Reserve was also quick to react.

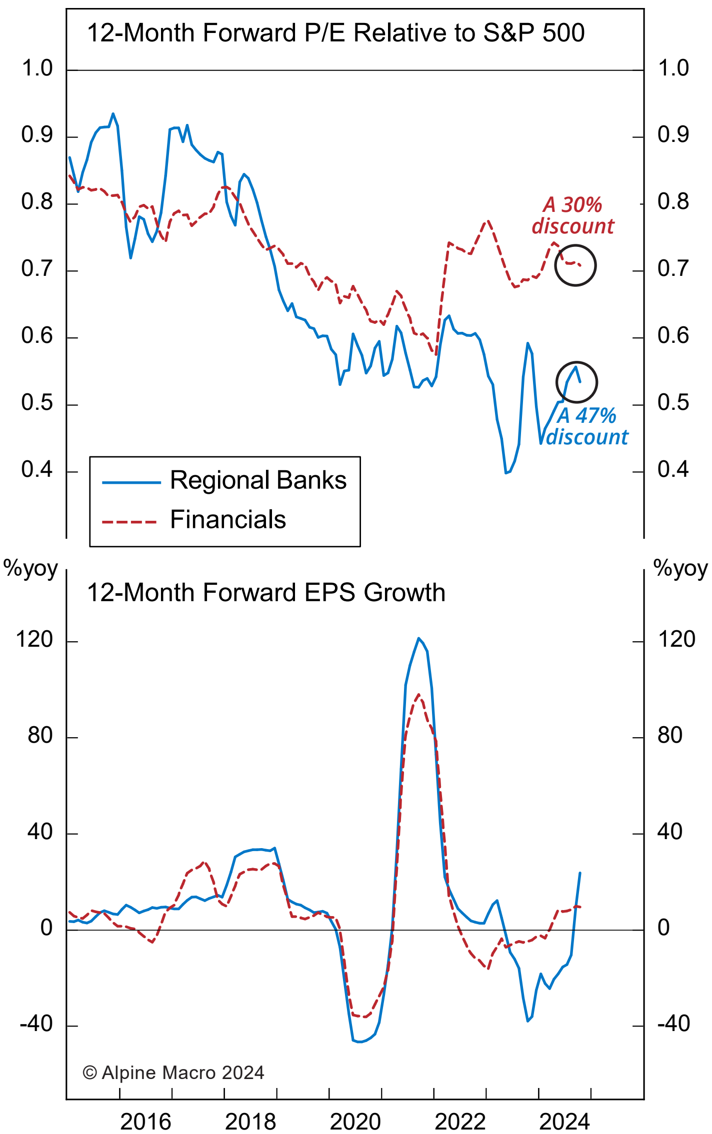
Toward the end of 2023, there were signs that the crisis was slowly passing, and deposits were returning to regional banks – a key reason we bought the sector back then.

Currently, regional banks are trading at 12 times forward P/E, a 47% discount to the overall market (**Chart 11**). This is very attractive, particularly given the fact that earnings growth for regional banks has been constrained by rising short rates. Going forward, falling short rates and a steepening yield curve will help regional banks.

Second, we believe that the bull market will likely broaden out to lagging sectors where multiples are low, but earnings will benefit from lower rates. Like regional banks, the financial sector as a whole looks attractive as it is also trading at a significant discount to the overall index.

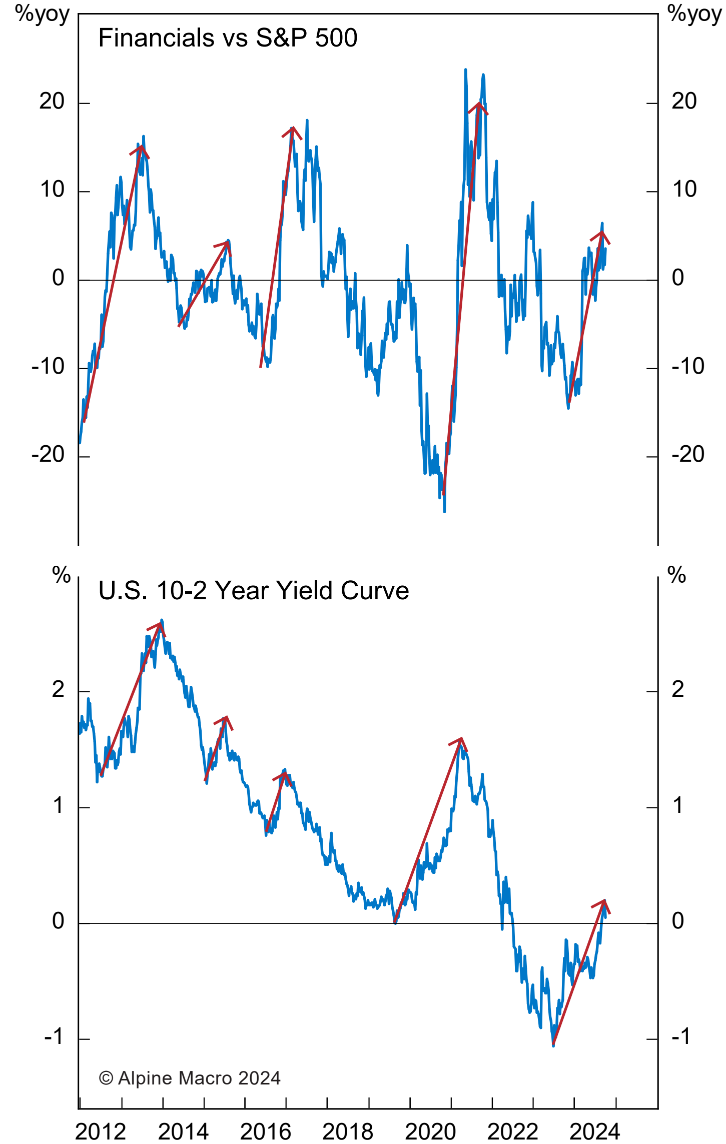
Importantly, with the Treasury yield curve having largely dis-inverted, the pressure on net interest

Chart 11 The Case For Buying IYF And KRE



Note: All series are shown as 3-month moving average; source: Bloomberg Finance L.P.

Chart 12 Financials Versus Yield Curve

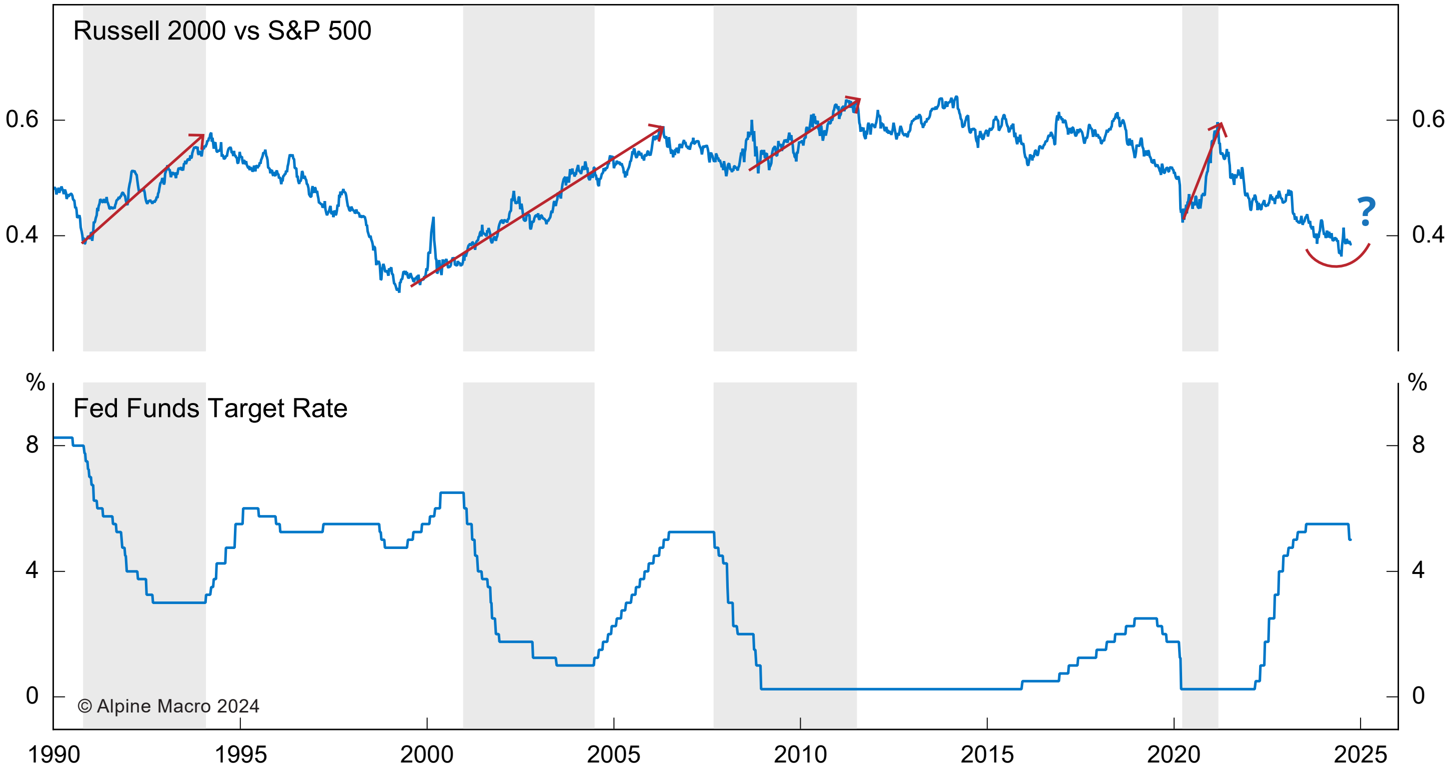


margins will disappear. Historically, banks and financials almost always outperform the benchmark when the short end of the curve falls faster than the long end (Chart 12).

Finally, we also bought the small-cap index as a speculative trade. Small-cap earnings have been severely depressed since 2022 due to rising short rates as most small businesses borrow from the short end of the curve. Nevertheless, the earnings cycle is on the cusp of reacceleration as the short end of the curve has fallen sharply and the economy stays strong.

Historically, monetary easing cycles always lead to or coincide with periods of small-cap outperformance, though the longevity of these periods varies wildly (Chart 13). We expect that small caps will do better than large caps if short rates continue to fall this year and in 2025.

Chart 13 Small Caps Versus Short Rates



Note: Shading denotes periods of falling or low interest rates

Treasury Bonds: Duration, Rates And The Dollar

We cut our bond duration to benchmark on August 5th and our bond model suggests that the fair value for 10-year Treasury yields is 3.75%, suggesting the bond market is somewhat undervalued.

Strategically, should bond yields fall substantially below fair value, we will likely go short duration. By the same token, if bond yields spike much higher than 4%, we will likely overweight duration again. A few points are worth noting:

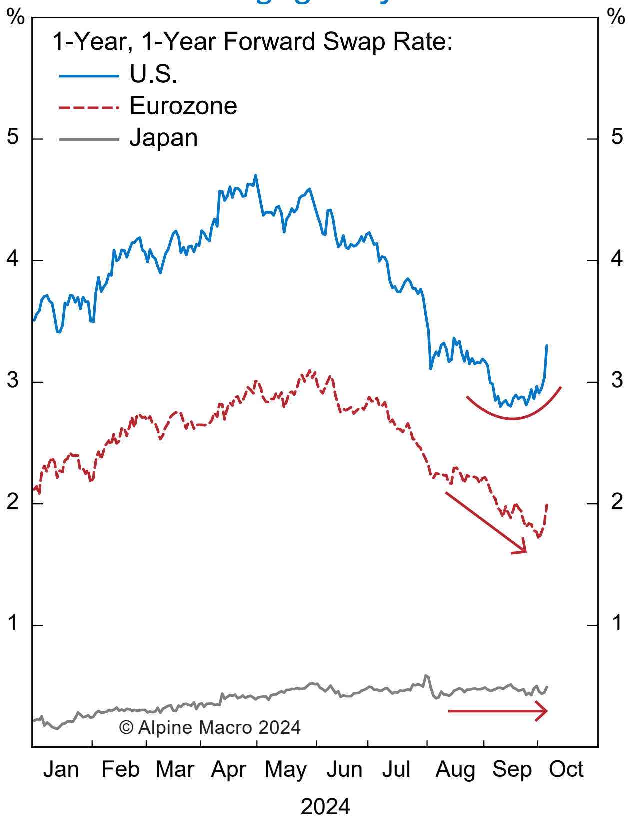
There is no sign that the U.S. economy is falling apart, and we are doubtful the Fed will cut as deeply as what is priced in by the markets. The labor market has cooled, but so far there is nothing that seems to be ominous and indicates an incoming recession.

It seems that R* is higher than in pre-pandemic times: household deleveraging is over, productivity growth is on the rise and the U.S. labor force is expanding at a fast pace due to a rising participation rate as well as large inflows of undocumented workers. If so, the Fed will not need to bring short rates to 3.0%. Perhaps, 4% could be the new normal as far as the policy rate is concerned.

Chart 14 shows one-year interest rate swaps are already diverging between the eurozone and the U.S. At a minimum, the ECB needs to cut rates more aggressively than the Fed, which implies that the downside potential for the dollar is limited.

I have literally been saying this

Chart 14 Interest Rate Swaps: Diverging Policy Outlook



Source: Bloomberg Finance L.P.

New Ideas

- Buy China A-shares on pullback. We recommend a "stop buy" for ASHR at $30. Chinese shares have surged more than 25% since last month, setting the stage for a pullback. Short-term, the Chinese stock market will be volatile, but the market remains cheap, and Beijing's stimulus program seems to be more serious and aggressive than before.

- We are closing our long position in the Nikkei 225 (NKY), while adding a long position in EM equities (ETF: EEM). The rally in Japanese stocks has been big and lasted for long. A stronger yen, tighter money and peaking earnings growth for Japanese stocks will likely create headwinds for Japanese equities. However, emerging markets could fare well in the coming months on China's more aggressive policy reflation, lower multiples (forward P/E of 14 times) and falling interest rates in the developing world.

- We are closing our long TLT with a gain of 6.5%.

Chen Zhao
Chief Global Strategist

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	53	-	-	19.7%
Long Gold (ETF: GLD)	04/01/2024	207.82	Rolling -5%	-	-	17.9%
Long Long-Dated Treasury Bonds (ETF: TLT)[1]	06/10/2024	90.89	95	10/04/2024	95.55	6.5%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	3.7%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	2.2%
Long Nikkei 225 Unhedged[2]	08/19/2024	37,389	-	10/04/2024	38,636	1.6%
Short Brent Oil	08/26/2024	80.00	79	-	-	2.4%
Long Copper	09/30/2024	4.55	-	-	-	0.4%
Long 10-Year German Bunds/ Short 10-Year JGBs[3]	10/07/2024	-	-	-	-	-
Long Emerging Market Equities (ETF: EEM)[4]	10/07/2024	-	-	-	-	-
Stop-Buy China A-Shares (ETF: ASHR)[5]	-	-	30	-	-	-

Note: P&L is calculated using daily closing prices.
[1] We are closing our Long Long-Dated Treasury Bonds (ETF: TLT) with a profit of 6.5%.
[2] We are closing our Long Nikkei 225 Unhedged position with a profit of 1.6%.
[3] We are initiating a Long 10-Year German Bunds/Short 10-Year JGBs trade.
[4] We are initiating a Long Emerging Market Equities (ETF: EEM) trade.
[5] We are initiating a stop buy for China A-Shares (ETF: ASHR) at $30.

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