On The Verge...

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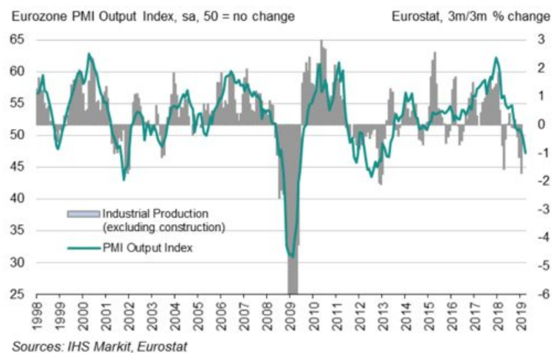
Summary:

- ➢ Europe's PMI numbers
- ➢ FX vol set to follow in Bond vol's footsteps
- ➢ If EURUSD is going to selloff (and DXY rally) now is the time to do so
- ➢ Short-term market sentiment still too bearish but macro outlook now less positively skewed

The latest Markit PMI numbers hit yesterday for the eurozone. They were, how do you say…. fugly?



Here's the link to the full report and an excerpt summarizing the data (emphasis by me).

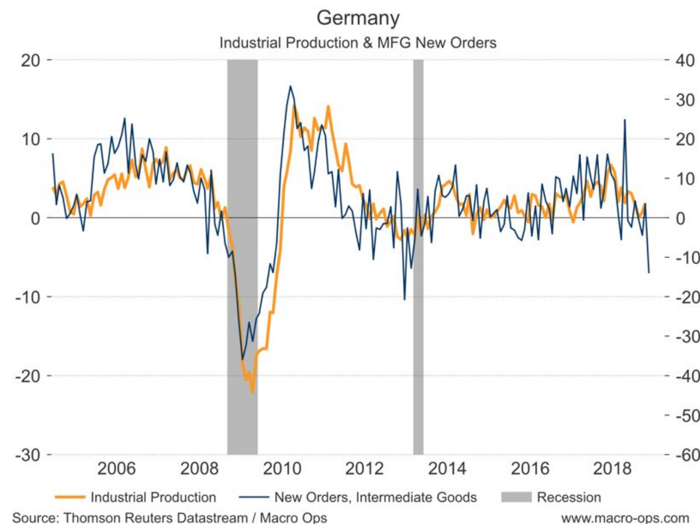
> ***The March PMI data indicate that the eurozone's manufacturing sector is in its steepest downturn since the height of the region's debt crisis in 2012****. The survey is indicative of output falling at a quarterly rate of approximately 1% in March, suggesting that the January rebound from one-off factors late last year seen in the latest official data is likely to prove short-lived.*
>
> ***"Looking at the forward-looking indicators, downside risks have intensified, and the trend could clearly deteriorate further in the second quarter. New orders are falling at a rate not seen since 2012,*** *and disappointing sales mean warehouses are filling with unsold stock.* ***The orders-to-inventory ratio – a key indicator of the future production trend – is at its lowest for almost seven years.*** *Expectations of output for the coming year are also the gloomiest since 2012. "Concerns over trade wars, tariffs,*

> *rising political uncertainty, Brexit and – perhaps most importantly – deteriorating forecasts for the economic environment both at home and in export markets, were widely reported to have dampened business activity and confidence.*

The weak data isn't a surprise. In our December *MIR* I wrote that "Much of Europe is likely to soon enter a recession" and then in a January *Brief* I shared the following:

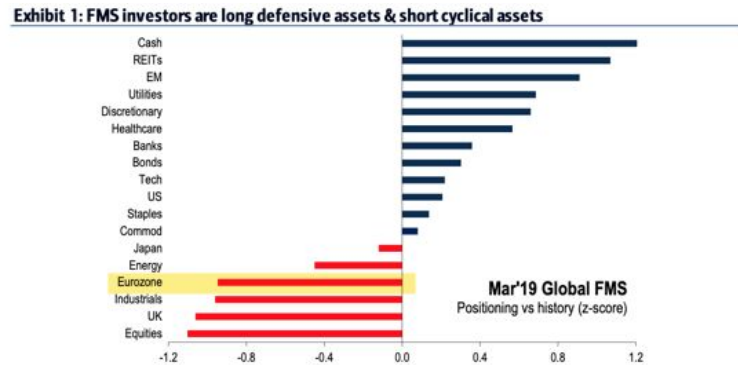
> The Sentix Eurozone economic expectations index has turned deeply negative — the index has a leading correlation to GDP.

> And new intermediate goods in Germany are at their lowest levels since 2012. This indicator has a strong 4-month leading correlation to Germany industrial production, and suggests recession is coming in the next quarter.



Europe is a mess. It's been a mess for a long-time and will continue to be a mess for many years to come. The single currency union was an ill-conceived idea that is destined to fail.

But, also, everybody knows this. The pricing of European stocks reflects this. This is why German equities are trading at 50-year lows relative to the US and why fund managers have very little exposure to the region.

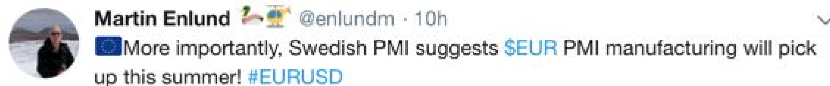


I have no idea what Europe's economy is going to be doing in a year. A hard Brexit could happen, China's slowdown could accelerate significantly thus hitting European exports, or the US could ramp up its trade war. It's also possible that the region's economy soon troughs and continues to muddle along, doing nothing impressive other than not imploding.

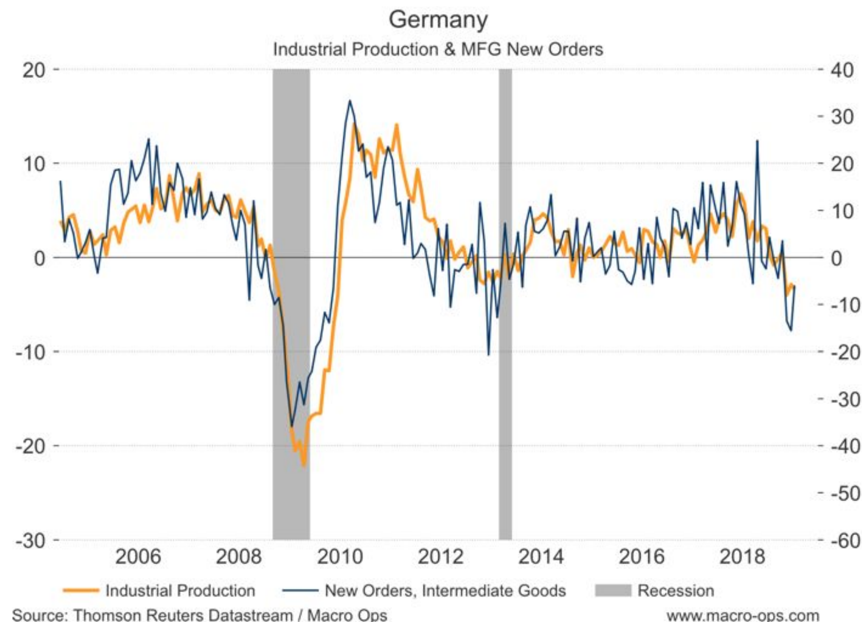
I'm open to all outcomes but I do think that relative to sentiment and what's being priced in, the muddle-through scenario may be the most underweighted.

And as I've been sharing, there are some signs of green-shoots along with coming catalysts that could somewhat reverse Europe's gloomy outlook.

For example, the region is expected to see its largest fiscal impulse in over a decade in the coming year (which I wrote about here). Then there's Sweden's PMI which often leads Europe's and looks to have already based.



Then we have Germany's New Manufacturing Orders index (the chart I shared above) that has a strong 4-month leading relationship to Industrial Production which, like Sweden's PMI, has also turned higher.



And here's Morgan Stanley's take on the poor March PMI numbers (full report here).

> *Along with the move in bond markets, the poor March PMI numbers for Germany and France do little to support our view that the European macro backdrop looks set to turn up in the coming months.*
>
> *However, we do not think these data points negate our thesis, and a number of other macro releases are moving in the right direction. In fact, such was the collapse in the German manufacturing PMI (its reading of below 45 is consistent with all prior troughs excluding 2008) that it is now down to a level that has previously been a strong buy signal for the DAX and the Autos sector, as we describe here. With valuations for the latter particularly low, it might not take much in the way of good news to engineer a rebound in share prices.*
>
> *In this regard, Harald Hendrikse flags a number of potential positive catalysts including the end of inventory de-stocking in China, the end of negative YoY sales growth in Europe, a rebound in production volumes post a tough 1Q and easier comps as we move through the year.*

Just some food for thought.

All of this has been top of mind for me because I'm still expecting a [big macro move](#) in the major dollar pairs (euro included) to begin soon. We're about to see FX vol expand similar to what we've been seeing in the bond market.

Exhibit 1: FX volatility has underperformed the recent rise in bond volatility

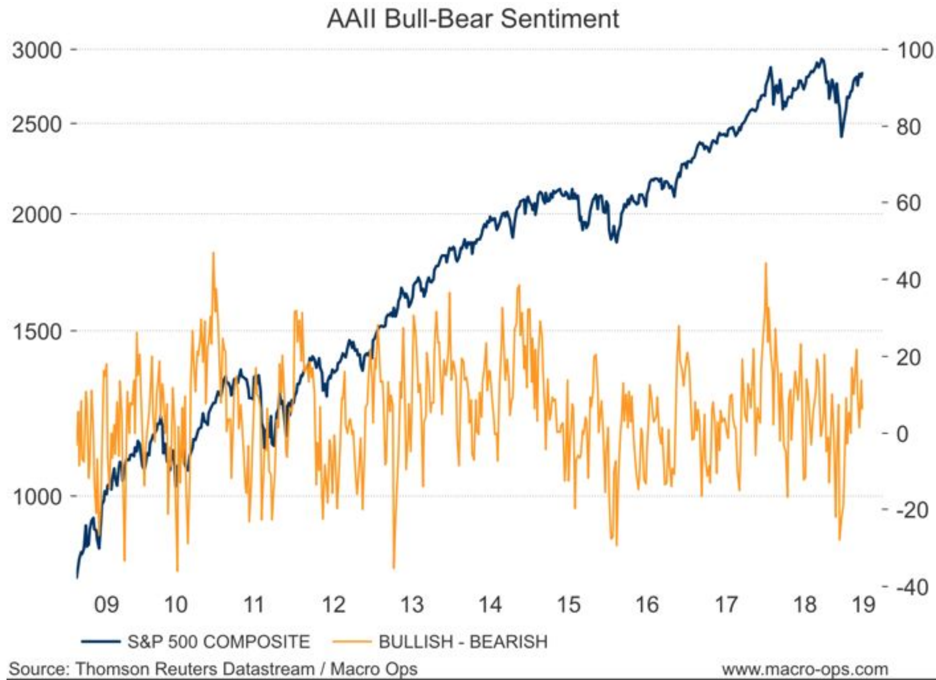
Source: Macrobond, Bloomberg, Morgan Stanley Research

The horrendous PMI report gave the euro everything it needs to break lower. So if it's going to do so then it should do so soon. If it fails to breakdown by the end of next week then the odds of it breaking to the upside increase significantly.

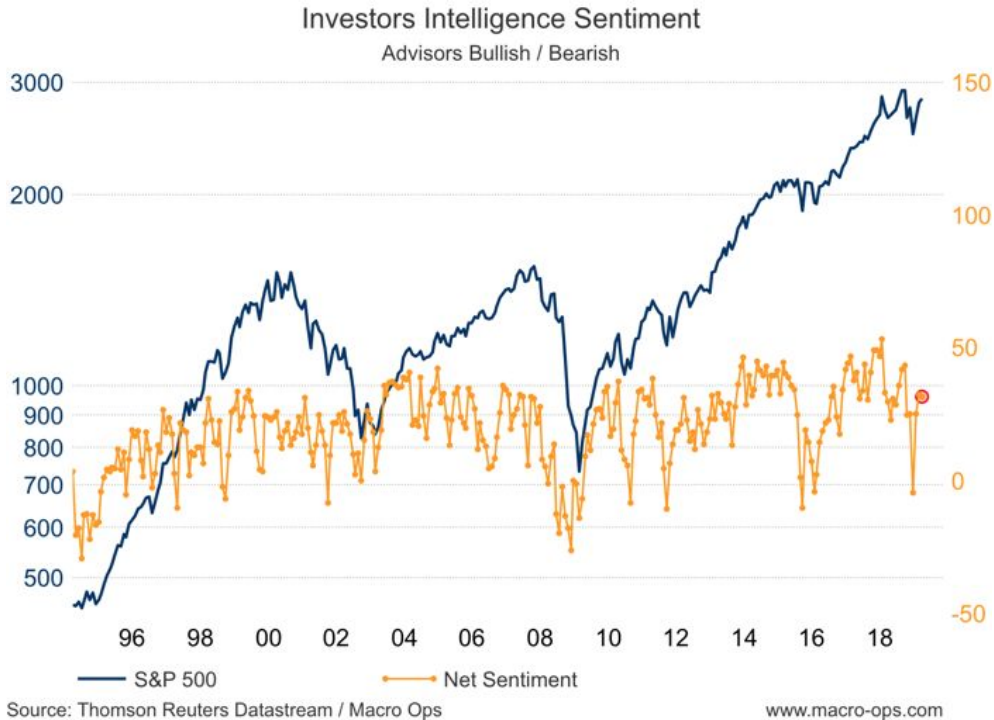
The dollar (DXY) chart looks decidedly more bullish (chart is a weekly). If we see a daily close above the spot 97.65/70 level then we will flip our positioning and aggressively get long the dollar, likely through short AUD and EUR pairings.

The US stock market continues to work through its overly negative sentiment and positioning. Small-caps (IWM) are a few points away from retaking their 200-day moving average.

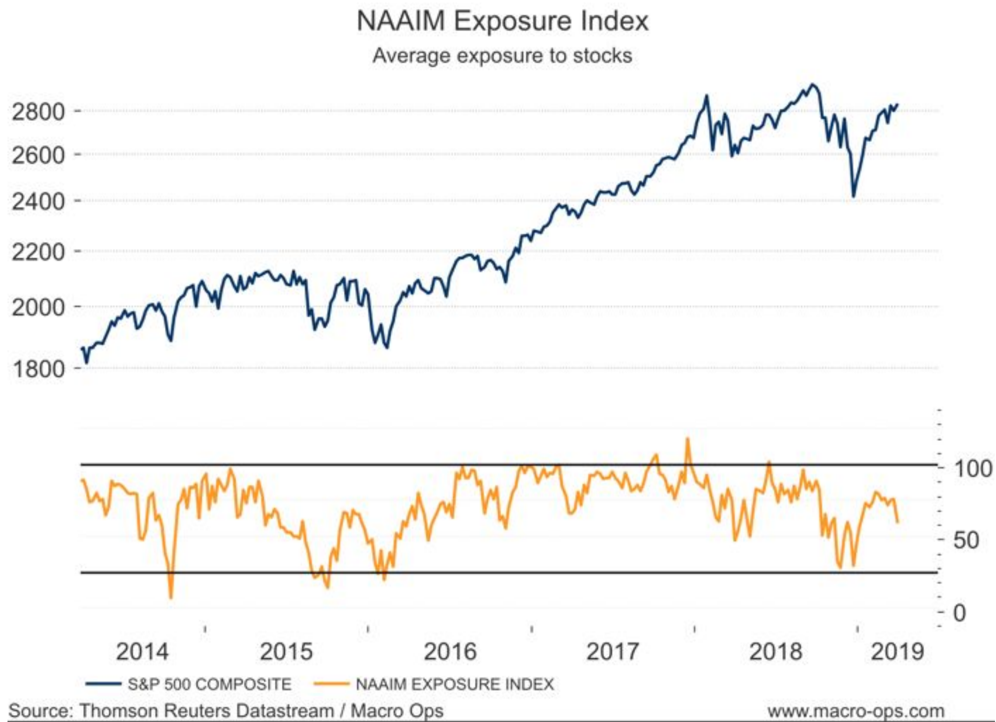
Despite the SPX's vertical run and now being within spitting distance of new all-time highs, we haven't seen sentiment and positioning reflect signs of FOMO which means there is likely more short-term upside to come. AAII Bull/Bear sentiment is giving a neutral reading.



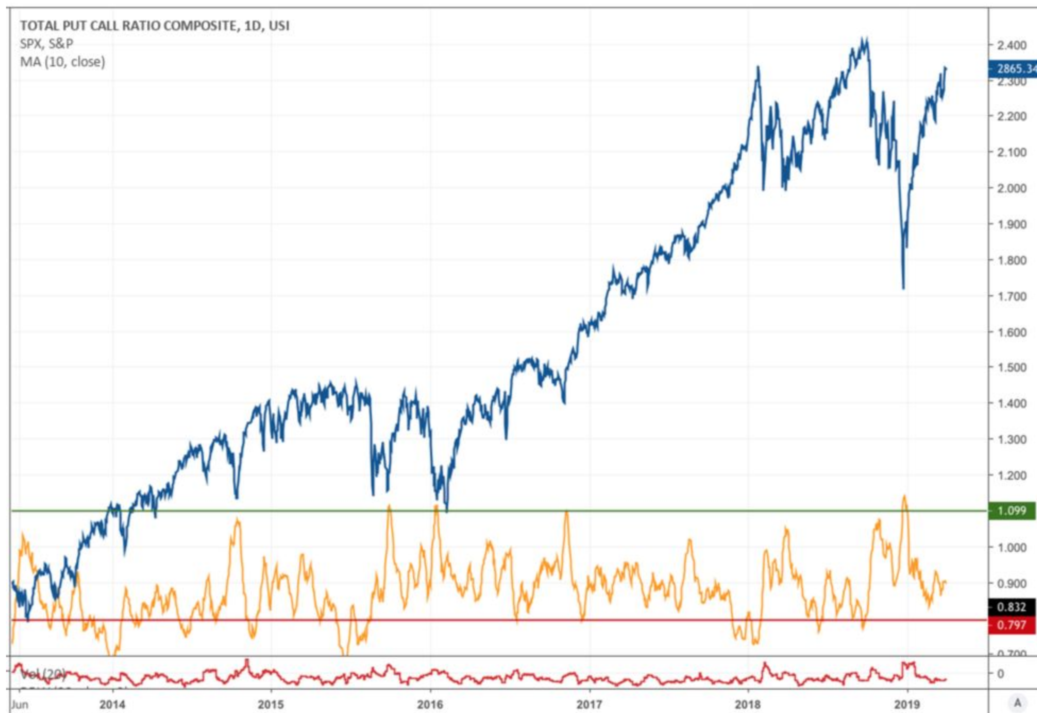
Same with our II's Bull/Bear indicator.



The NAAIM Stock Exposure Index has actually been trending lower showing investors don't trust this rally.



And our 10-day average Total Put/Call ratio (orange line) is still elevated which shows that complacency has not set in yet.



The trend up is also being confirmed by credit (LQD/IEF), cyclical vs defensive sectors, and semis (SMH). All in all, the path of least resistance continues to be up for US stocks for the time being.

I suspect we'll soon see capitulation from the bears sometime in the next week or two. This will flip these sentiment/positioning indicators and we'll then look to get more defensive.

Our recent bond short trade is off to a good start (write up here). I'm moving our stop up to breakeven on the trade.

Same with our long crude trade. WTI has retaken its 200-day moving average for the first time since October.

But looking at the same chart on a weekly basis shows that it's now up against some significant resistance here in its upper weekly Bollinger Band and 50-week moving average (red line).

We should see some type of pullback soon. The extent of which will largely be dependent on what the dollar does. If the dollar breaks higher then we'll book profits and close out this trade.

That's all I've got for this week!

I'll be putting out the MIR later this week where I'll be discussing the deteriorating macro environment along with a deeper dive into energy.

If you've got any questions for us in the meantime, let us know in the Comm Center. Have a great week!

Your Macro Operator,

Alex