Deutsche Bank
Markets Research

Global | Economics

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Early Morning Reid

Macro Strategy

After buying a nice plush leather sofa 3 years ago my wife is off to IKEA today to buy a replacement. This isn't necessarily a reflection of tougher times ahead but due to Bronte being obsessed with the leather. She has scratched big holes in the cushions and is now pulling out the lining. Her behaviour is getting better and better but this is one thing we can't train her to improve on. She doesn't scratch cloth sofas but we're going for a value for money deal just in case of further destruction.

Value investors were out in force for most of yesterday helped by a bank rebound and a relatively dovish Yellen but the recovery faded in the last hour of US trading with the S&P 500 (-0.02%) closing pretty much flat as US banks reversed course and WTI Oil fell to a 3-week low at $27.45/bbl (and has weakened further in Asia this morning). At the same time, the Dollar (-0.18%) extended its 3-month low, US 2s10s closed at the flattest since December 2007 after falling below 100bps and Gold (+0.67%) rose to the highest since June last year.

Talking of Oil and Gold, last week we showed a long-term graph of Oil in real adjusted terms, showing that the average real price since 1861 was $47. Following on from that, one ratio we occasionally look at is the ratio of various assets to the price of Gold. So today in the off we update the Oil/Gold ratio back to 1865 and find that the Gold price has just hit an all time high at around 44 times the price of Oil. The previous high of 41 in 1892 has just been exceeded. For perspective, the ratio was at 6.6 in June 2008 and only 12 in May 2014. The long-term average is 15.5. While this says nothing about where the ratio is going in the short-term surely this looks a good trade to exploit over the longer-term for those who care about such things.

Market Data

Index	Close	Change
ITX Crossover	460	-4
ITX Europe 125	118	-3
CDX 125	122	+2
CDX HY - pts	97.02	-0.170
S&P 500	1852	-0.02%
Brent Oil^	30.64	+0.16%
Gold^	1209	+1.17%
10 yr Treasury^	1.67	-5 bp
ITX Sen Fin	129	-5
ITX Sub Fin	298	-13
CDX EM	406	+15
ITX Japan	N/A	N/A
ITX Australia	169	+4
ITX Asia XJ	173	+2
Euro NonSov	103	-1
Euro Corp	173	-1
Euro BBB	232	-1
Sterling NonGilt	186	+1
Sterling Corp	240	+2
Sterling BBB	296	+2
WTI Oil^	26.98	-3.95%
Dollar Index^	95.70	-0.33%
EUR/USD^	1.129	-0.01%
DJ Stoxx 600	315	+1.87%
NIKKEI	15713	N/A
Hang Seng	18526	-3.95%
VIX	26.29	-0.25

^ - Change from previous day's 05.30 GMT to 05:30 GMT. Levels as of 05:30 London time.

Upcoming Events

Release	DB	Prev	Conn
Initial jobless claims	290k	285k	280k

Topical DB Publications

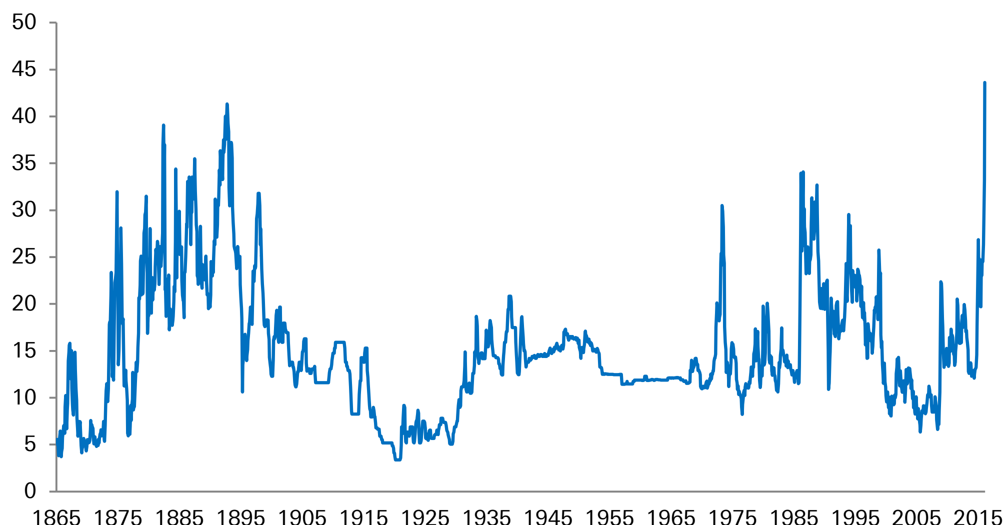
China update: land sales, PMIs and fiscal data, 1 Feb 16
Update - Comments on lower down payment ratio in Cl Feb 16

Update – Comments on China's 2016 growth target, 3
Special Report – How to think about tail risks in China, 16

Special Report – Euroland Strategy: Deja Vu, 5 Feb 16
UK Economic Topic – UK: Beware the first estimate of Feb 16

DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MCI (P) 124/04/2015.

Figure 1: Ratio of Gold to WTI Oil since 1865



Source: Deutsche Bank, Bloomberg Finance LP, GFD

A big reason behind the rally in Gold this year has been a flight to quality and the fading expectations of further Fed tightening in the next twelve months. Yesterday Yellen stuck largely to the script in acknowledging market concerns emanating from tightening financial conditions, while at the same time refusing to fully close any doors still open to the Fed later this year. That said the overall tone was certainly of a dovish leaning. Much was made of the passage suggesting that 'financial conditions in the US have recently become less supportive of growth, with declines in broad based measures of equity prices, higher borrowing rates for riskier borrowers, and a further appreciation of the dollar'. Yellen said that should these developments prove to be persistent then they 'could weigh on the outlook for economic activity and the labour market'.

On the inflation front, Yellen made reference to the fact that the 'committee expects inflation to remain low in the near term' but again made reference to the belief that many of these factors remain transitory. There was a focus on China with the Fed Chair acknowledging that 'intensified uncertainty about China's exchange rate policy and the prospects for its economy' had played a role in exacerbating global growth concerns as well as a role in the collapse of oil prices. She highlighted that this could cause 'financial stresses in commodity-exporting economies' and for 'commodity-producing firms in many countries' which would impact foreign activity and demand for US exports.

A big part of the Q&A was the focus on how downside risks should be responded to through policy action. Yellen opined that 'we've not seen shifts that seem significant enough to have driven the sharp moves we've seen in markets' but did acknowledge that the developments warrant close watching. Yellen was careful to suggest that she would not jump to any premature conclusions, while also noting that 'I do not expect that the FOMC is going to be soon in a situation where it's necessary to cut rates'. Fed Funds contracts closed fairly unchanged by the end of play with the probability a hike this year still hovering around 30%.

Looking at the latest in Asia this morning, markets in Korea and Hong Kong are open for the first time this week, although are largely playing catch up with the big falls that we've seen for risk assets in that time. The Hang Seng is currently down a steep -4.03% while the Kospi has dropped -2.97%. Mainland China

exchanges are still closed although the Hang Seng China Enterprises Index (HSCEI) is down nearly 5%. Markets in Japan are closed for a public holiday. There's better news in Australia where the ASX is currently +0.95%, although the Aus iTraxx index is 4bps wider as we go to print. US equity market futures are weaker while Gold has surged above $1,200.

Moving on. As we highlighted at the top, yesterday saw the 2s10s Treasury yield curve go below 100bps for first time since December 2007. After spiking as high as 1.772% in early trading, the benchmark 10y yield tumbled into the close, eventually finishing over 5bps lower on the day at 1.668% and just off the 12-month lows. 2y yields finished unchanged at 0.686% meaning the spread of 98bps is the lowest since the 6th December 2007. This is one of our favourite lead indicators of the business and default cycle and the flattening that has occurred in recent years is one of the reasons we think credit conditions have been tightening for a few quarters now and why our default models have been showing a continued pick-up in defaults into 2017-2018. To be fair the last four recessions have not started until the yield curve (2s10s) has inverted. We're still some way off that but the fact that we're at the flattest for over 8 years is a warning sign.

There was finally some good news to report for European equity markets yesterday as the Stoxx 600 (+1.87%) benefited from a financials-led (Banks +4.42%) rebound to close up for the first time this month. Having been heavily hit in recent days the IBEX (+2.73%) and FTSE MIB (+5.03%) finally got some much needed relief. European credit indices also had a better day although did finish well off their tights. The iTraxx senior and sub-financials indices ended up 5bps and 13bps tighter respectively which helped Main in particular close nearly 2.5bps tighter, although the index had been closer to 8bps tighter pre-Yellen.

Staying with credit, our US credit strategists published their latest note earlier this week (Chickens Come Home to Roost, 8 Feb 2016) wherein they construct a proprietary dataset to forecast expected US default rates. The team uses index transition data to capture all forms of default – bankruptcies, out-of-court restructurings and distressed exchanges – to build a robust market-based dataset that is more detailed, precise and timely than that available from ratings agencies. The most striking revelation of the data is that DM HY commodity names appear to already be in a full cycle, with issuer-weighted default rates at 15.9% (14.9% par).

Assuming that commodity defaults rise to 20% for the year ahead and that ex-commodity defaults hold steady at 4% as they forecast, the overall default rate for DM USD HY (Commodity weight: ~20%) would hit 7.2% - magnitudes higher than the 1.85% default rate seen last year! Rising credit pressures across a spectrum of non-commodity industries and downward pressure on recovery rates in energy bonds should only serve to further compound already apparent risks. Here is a link to the report. http://pull.db-gmresearch.com/cgi-bin/pull/DocPull/10410-D790/7455153/0900b8c08ac2c337.pdf

Wrapping up, yesterday's economic data was focused on what was a pretty soft set of industrial production reports in Europe. Data for France (-1.6% mom vs. +0.3% expected), Italy (-0.7% mom vs. +0.3% expected) and the UK (-1.1% mom vs. -0.1% expected) all missed relative to expectations, while manufacturing reports for France and the UK were also soft for the month of December.

Turning to the day ahead, there's not alot for us to report with no economic data of note due out in Europe and just the latest weekly initial jobless claims data due in the US this afternoon. Instead the focus will again be on Fed Chair Yellen when she is due to speak in front of the Senate at 3pm GMT. Her

prepared remarks could mirror what she said yesterday so the focus will be on the Q&A. Away from this we'll also get the Riksbank's latest monetary policy announcement where current economist expectations are for another cut in the main policy rate deeper into negative territory (10bps cut to -0.45%). Earnings wise today we have 20 S&P 500 companies set to report including AIG and PepsiCo.

Appendix 1

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