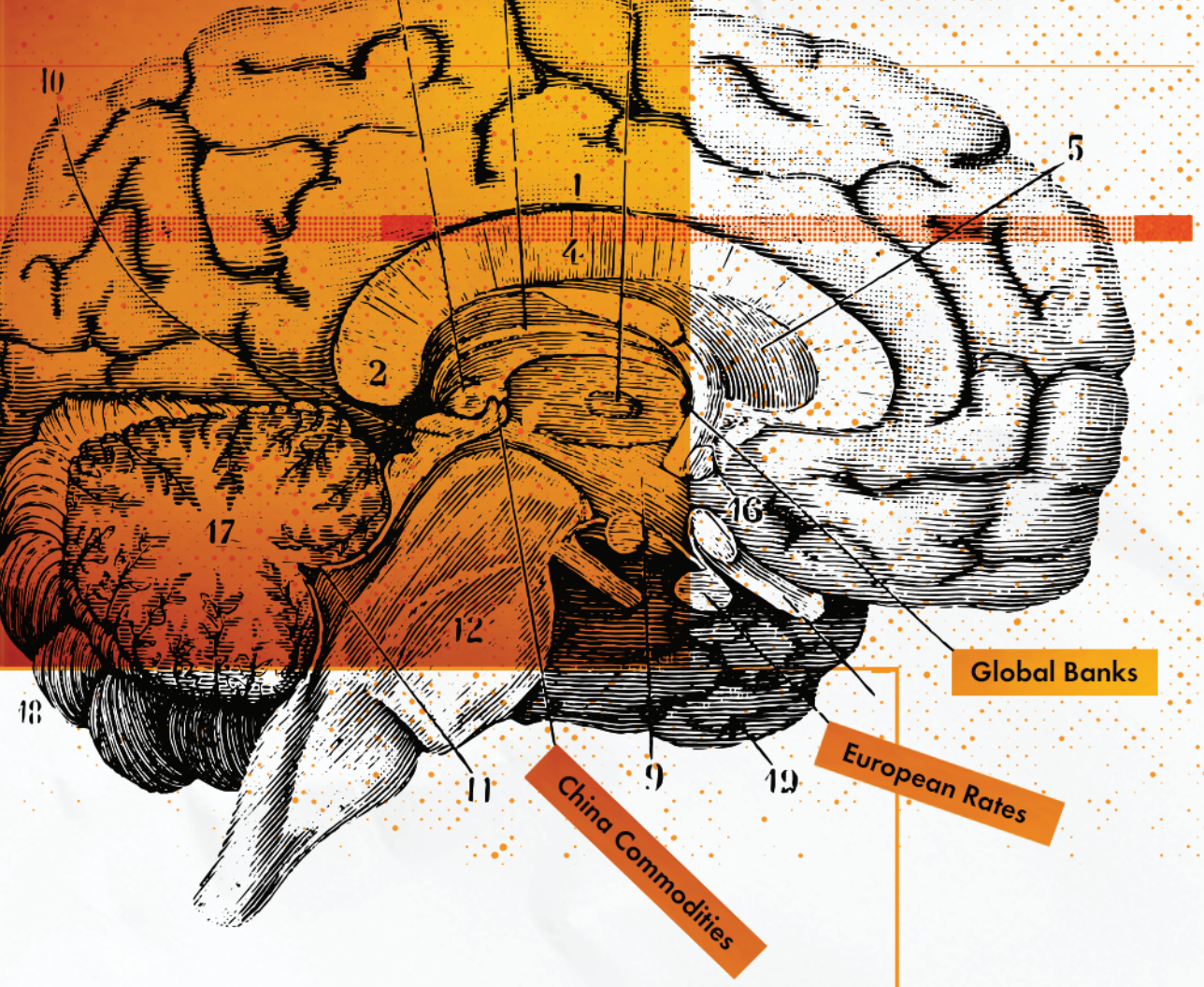


JOIN the Dots

December 10th 2018

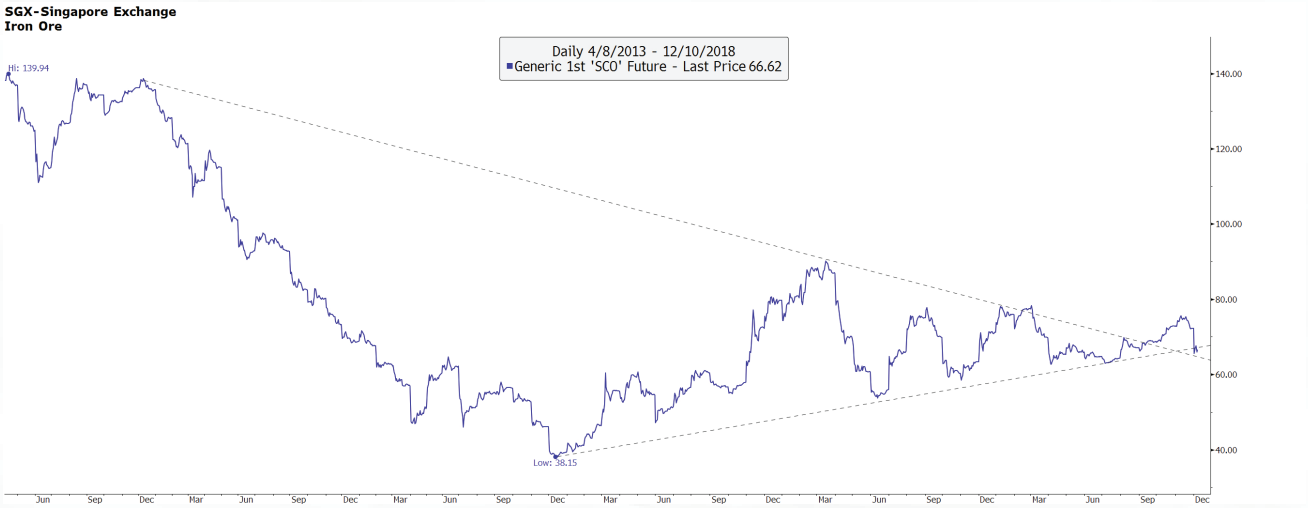
REAL VISION THINK tank™

The Three *Things*

From Chinese Industrial Commodities to European Rates & Global Banks

Chinese industrial commodity prices have been falling. The decline is indicating weaker demand. Declining commodity demand has been driven down the Silk Road in the form of decelerating growth for the manufacturing and exporting nations of Europe. In turn, this has resulted in a weakening of credit quality and therefore the health of European Banks. But what started as weakness in European banks has now gone global.

The red flag from Commodities
Iron Ore: Dalian (DCE) & Singapore (SGX) Exchanges



Iron ore has been at the core of China-lead Asian growth & the associated expenditure on fixed assets (infrastructure, real estate etc). As fixed assets are at the core of a large part of GDP & employment, changes here reverberate throughout the broader sectors. Price falls are signalling weaker future demand.

Prices on the Dalian Commodity Exchange (DCE) have been under pressure and have now broken their one-year uptrends (first chart above). Their post-G20 bounce is part of the test of this trend break.

The Singapore Iron Ore contract is based on China prices and has a longer history. So far, it has barely broken the 3+ year uptrend, and only a break of 65.50 is likely to signal an acceleration (second chart above).

Rubber - China Spot Grade 1 / SGX Futures

The price rises in this vital commodity have been short-lived since the peak in 2011 with rallies making lower highs. The Shanghai Rubber futures (not shown here) have been recovering for over a week, in what appears to be a counter-trend bear flag pattern. China spot Grade 1 Rubber (light blue, above) & SGX Rubber futures (dark blue, above) show a good correlation. SGX Rubber futures are close to a support that goes back nearly a decade. A break of 119.30 could signal a sharp price drop ahead.

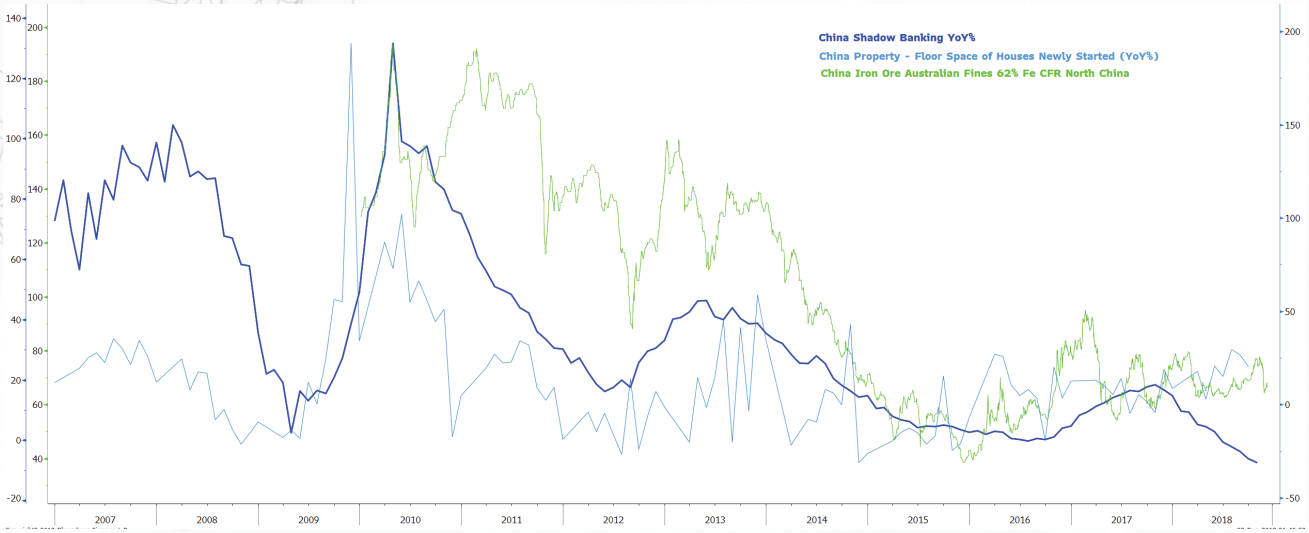
Purified Terephthalic Acid (PTA)

PTA is a petroleum refining product. The futures are traded actively on the Zhengzhou Commodity Exchange (average daily volume regularly in excess of $9 billion). It is used in making Polyester Fiber & Films, Powder Coatings and Insulation Materials. Its end use is widespread and includes Food & Beverages Packaging, Paints & Coatings, Textiles, Electrical and Furniture i.e. it's a base component for a vast range of everyday items.

It had formed a long-term rounding bottom which resulted in a price extension post breakout that exceeded the 161% target price. The sharp fall since has taken it back to breakout levels. The outlook is a lot more uncertain and it will require additional downside tests before a base is formed.

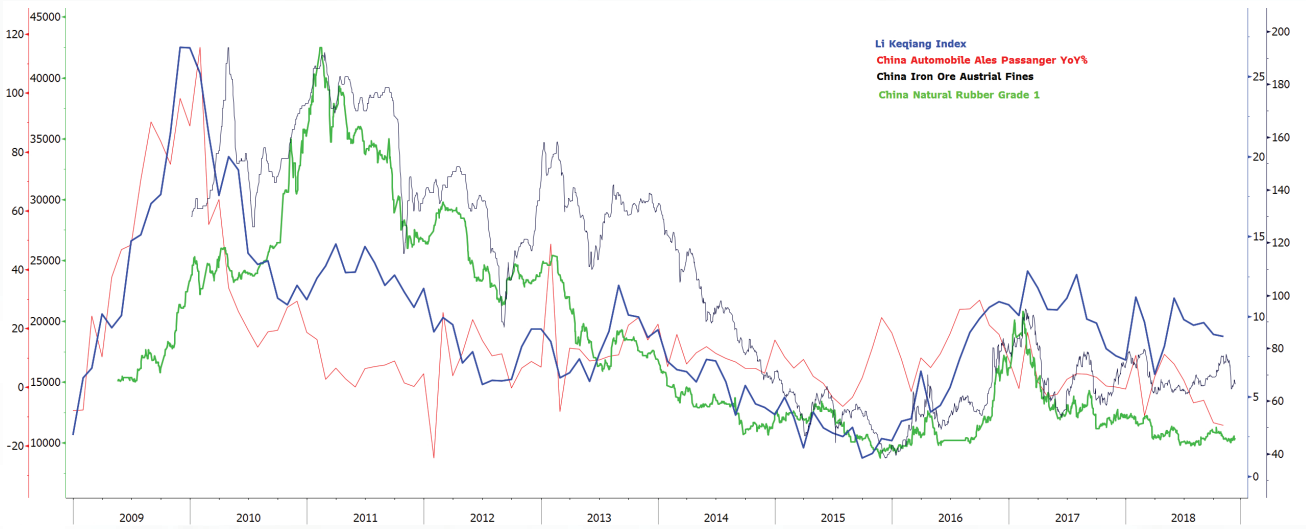
"Commodities are being crushed by credit and liquidity concerns..."

Shadow Banking, Construction of New Floor Space Started & Iron Ore Prices



New Chinese residential and commercial property construction (light blue above) has been ably assisted by the rise of shadow bank lending. Iron ore prices (light green above) have partly reflected the ebb and flow in supply of shadow banking credit (dark blue above). The decline in shadow banking should now become a headwind.

Li Keqiang Index, China Passenger Car Sales & Commodities

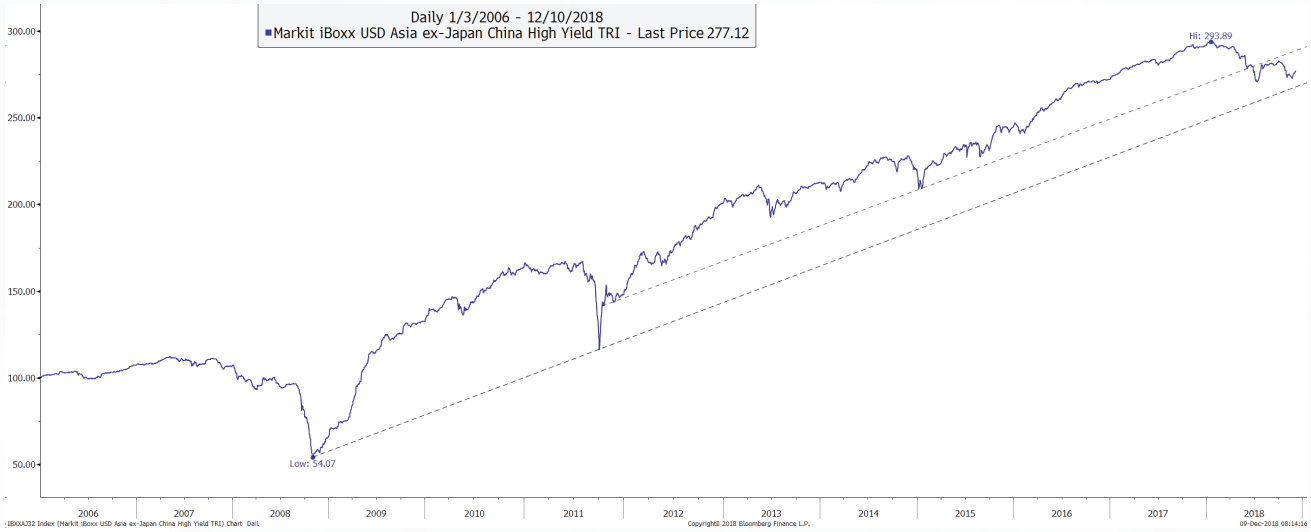


The Li Keqiang Index (dark blue above) is a commercial and industrial growth index that is used by China's Politburo. It comprises three components to measure economic activity: Rail Freight, Electricity Consumption and Loan Disbursed by Banks. It has shown a high correlation to prices of critical commodities such as iron ore (black line above) as well as the growth in sales of passenger cars (red line above). China has been a key car market for certain European economies...

German Bond Yields, China Iron Ore Spot & PTA Futures

Declining bond yields in core Europe (Germany and France) appear, in part, to have been influenced by the general trend in Chinese industrial commodities, which in turn were influenced by Chinese credit considerations. While oil has clearly played a significant role in the drop in global yields, bund yields broke key support in the week that China iron ore (red line above) broke its trend support, the fall in PTA futures was accelerating and coal was falling sharply. The spread in Shanghai Oil and Brent Oil futures also collapsed in the same week. Price fluctuations in China's commodities such as iron ore, steel, zinc and rubber are essential indicators of manufacturing activity not just in China, but in other manufacturing centered European economies.

USD China High Yield Total Return

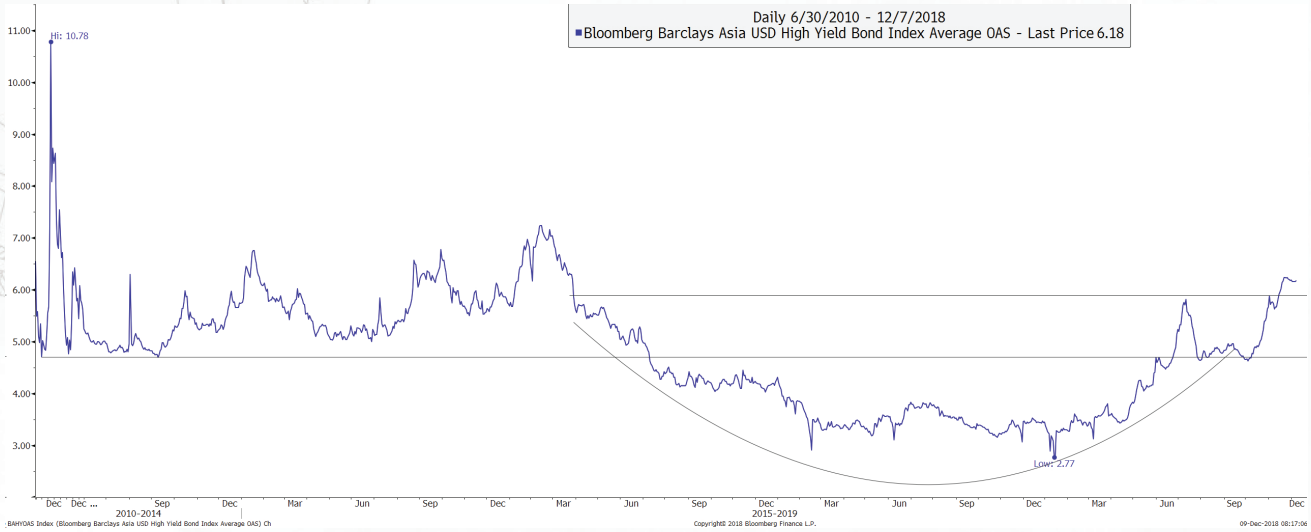


The slowdown is impacting the outlook for lower-rated companies as they find financing costs increase sharply. China's USD denominated High Yield Total Return Index is down -14.88% YTD. This is the second worst year since 2006. The average price of Bonds in the Index is at 88.95 while the RMB Denominated Bond Index average price is 88.39 indicating capital losses for investors.

"Stresses are spreading to banks..."

Value Partners, a Hong Kong-based money manager, identified 100 U.S. dollar bonds of non-state-owned Chinese enterprises trading at yields of 13% or higher. Most are scheduled to mature within the next two years.

Asia High Yield Credit Spreads



China is a large part of Asia High Yield Index and it is driving spreads wider for other Asian issuers. The Index has been weak when compared to Europe or US and is perhaps leading to the widening of spreads. It is above the breakout resistance of the rounding bottom formation.

ICBC Bank - Reflection of Overall Credit Quality

ICBC is the largest listed bank in China, its portfolio spans the entire Chinese economy. Its Credit Default Spreads are forming a rounding bottom. A breakout is likely to signal a deeper deterioration in Chinese credit quality.

"The fall in industrial commodities is signalling weaker demand from Fixed Asset Investments and industrial sectors of the economy.

This, in turn is reflected in falling interest rates and weakening credit quality.

The weakness is flowing westwards to European industrial economies where interest rates are falling, and credit quality is deteriorating..."

European *Rates*

China troubles head west

German Government Bond Yields

Ten year German Government bond yields closed just below the neckline support of 0.325% for two consecutive weeks. This provides the confirmation of the break, suggesting a difficult outlook for Germany and the rest of Europe.

French Government Bond Yields

French Government Bonds have not yet broken support even as the spread to German bond yields have widened due to credit concerns.

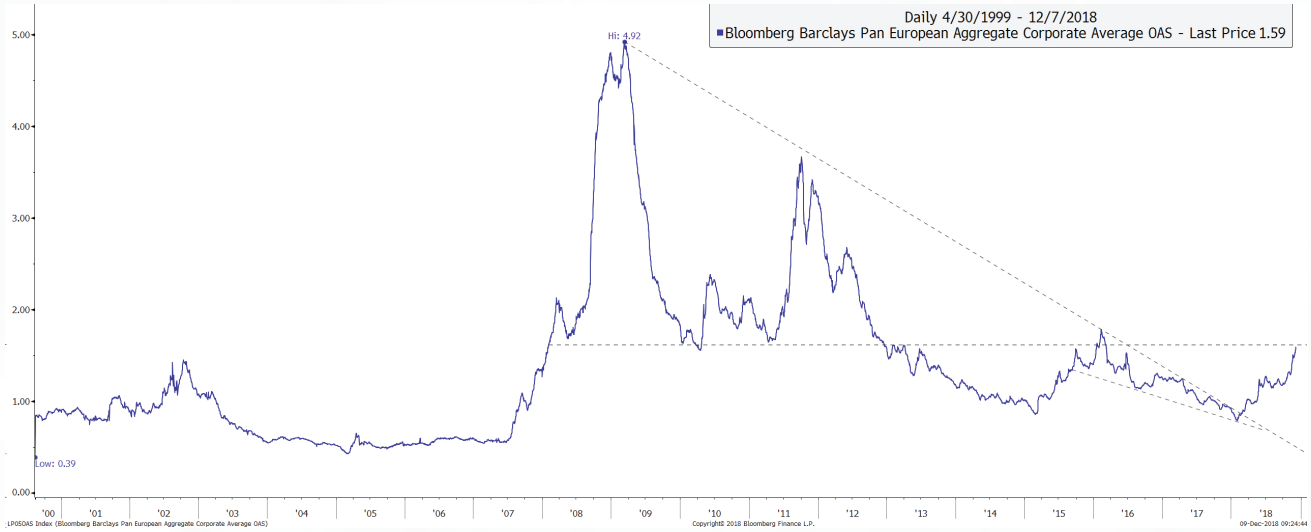
United Kingdom Government Bond Yields

UK's Gilt Yields have broken a triangle pattern to the downside. Irrespective of the Brexit vote investors should focus on the cyclical slowdown. A test of the crucial 1.26% support is an expected outcome. The Brexit end-game will add an additional layer of complexity to this already-deteriorating credit outlook.

"Recovery slowdown driven by weak manufacturing is pushing Government bond yields down, but differentiation of sovereign credit quality is clear to see.

The market has started to be concerned about European Credit because it is not benefiting to the same extent from the overall decline in Government bond yields."

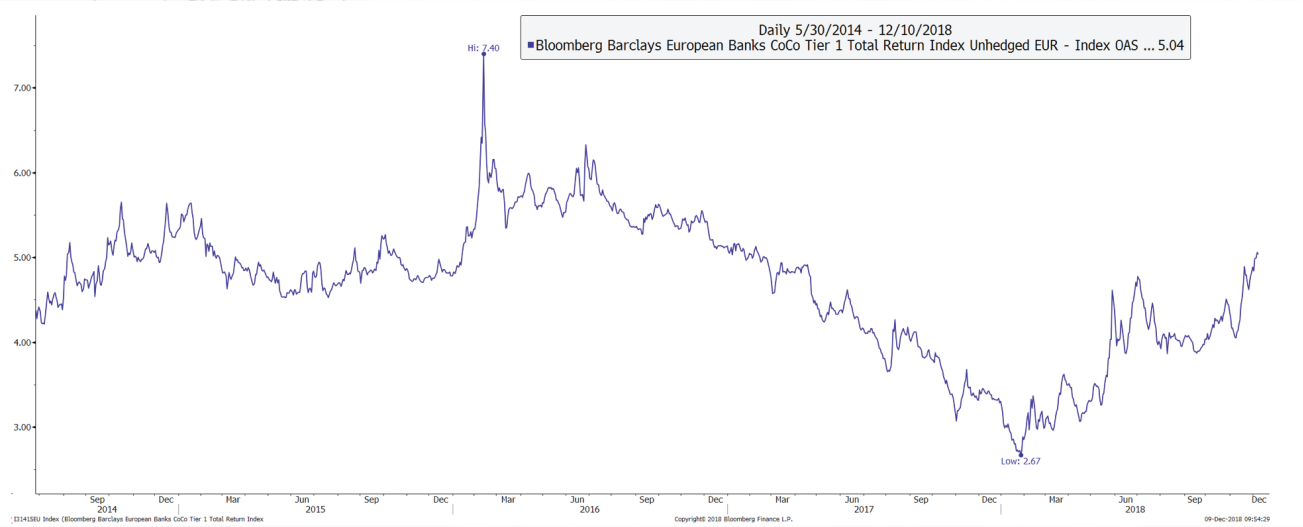
European Aggregate Corporate Credit Spread



The European Aggregate Corporate Credit spread is at the key 11-year resistance. It broke the downtrend from 2008 and a bullish descending wedge to get to this resistance in the 1.62 area. A break here gives a reasonable probability of a more substantial move up in spreads.

The absolute lows were in 2005, when there were mostly high-grade issuers. In recent years the volume of high yield issuers has lowered the overall quality of European credit. Primary holders of high yield debt (loans) have migrated from banks to the relatively less experienced retail investor. European credit has been underperforming equities since 2015. Equities 'should' catch down to that underperformance in credit.

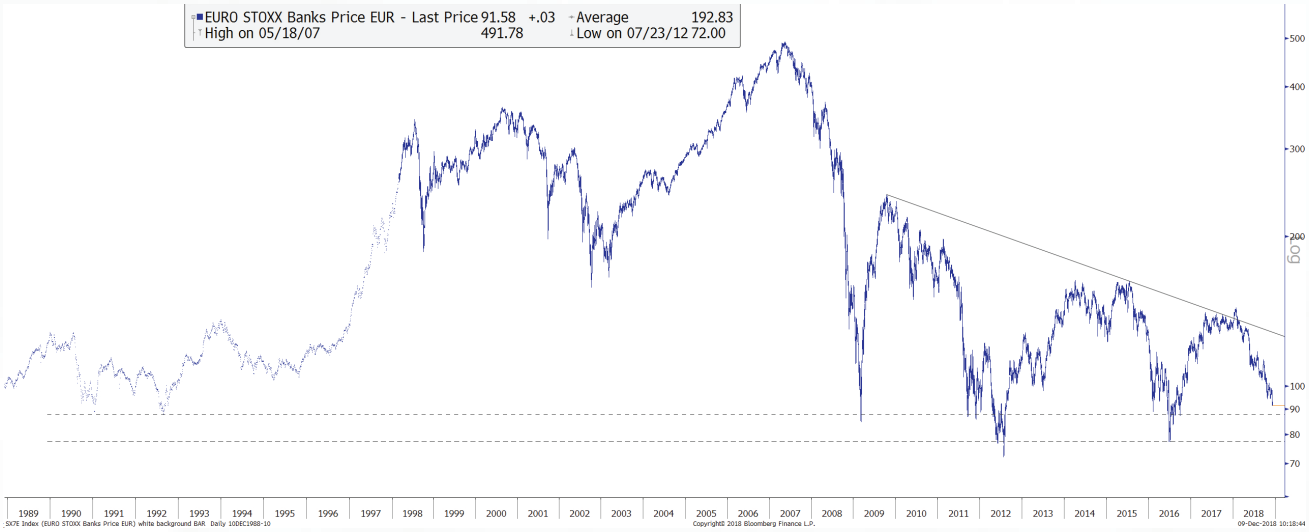
European Bank Contingent Convertible Tier I Bonds (CoCo)



CoCo Bonds were introduced after 2008, primarily to provide capital to beleaguered banks. They are convertible into equity in the event of losses or reduced capital, in return for a fixed coupon. The analogy is a Catastrophe Bond where your capital can be reduced or entirely wiped out should the Tier I capital come under pressure. The yields are rising, but an event risk is clearly not priced in. Investors have been chasing yield, having (blind) faith that the ECB will prevent or manipulate conditions that could lead to the equity conversion or loss participation.

"CoCo Bonds are trading like investment grade sub debt / Tier II sub debt. It has yet to price capital reduction risk..."

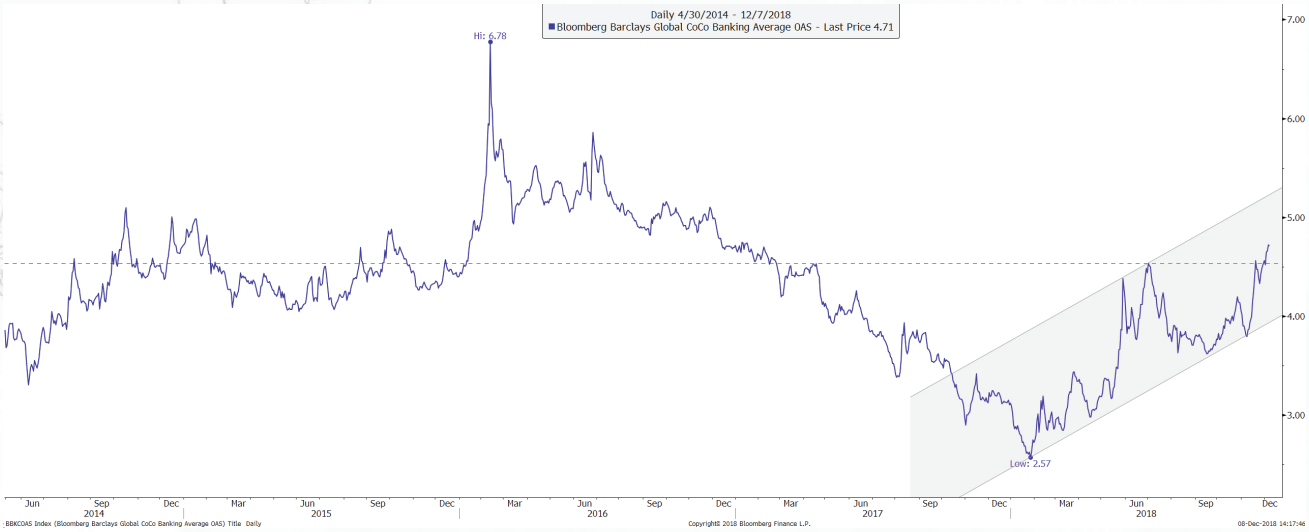
Stoxx Bank Index



European Banks have been making lower highs since 2007 and remain in a downtrend. There is vital long-term support which is about 5% below current levels. A rally from sub 90 is plausible, but unless we see downside capitulation and/or a reversal with momentum, it points to a 'sell-on-rallies' strategies and an implicitly weaker economy.

"The Bank issue is not just a European one..."

Global Contingent Convertible Tier I Bonds (CoCo)



Global CoCo bond spreads have also widened.

KBW Global Bank Index (Systematically Important Banks)

This is an index of global and systematically important banks (effectively banks that have been placed under increased supervision). It is generally true that banks have more capital to face a downturn today than they did in 2007. Their equity prices, however, will care little if the market fears a period of extended credit deterioration and/or broad economic weakness

The chart shows a series of inverted rounding formations, typically they resolve to downside.

"The High Yield market moved risk from banks to retail.

Banks may be ill-equipped to take slack from the drying up of liquidity in high yield loan and bond markets.

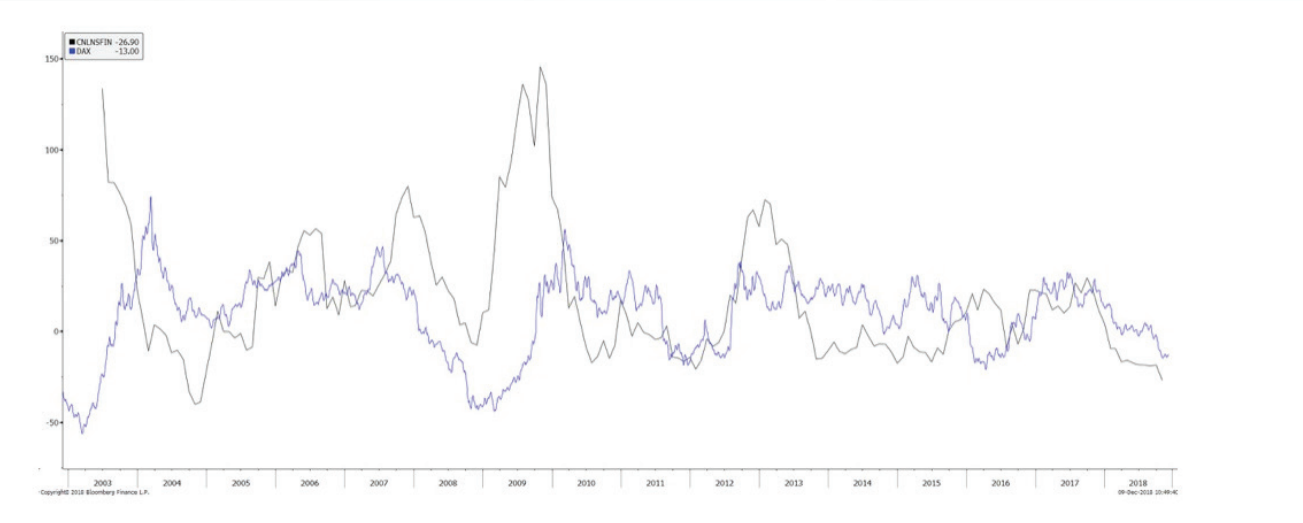
Bank equity looks weak despite assurances from regulators that they have a larger capital cushion."

One More Thing - DAX

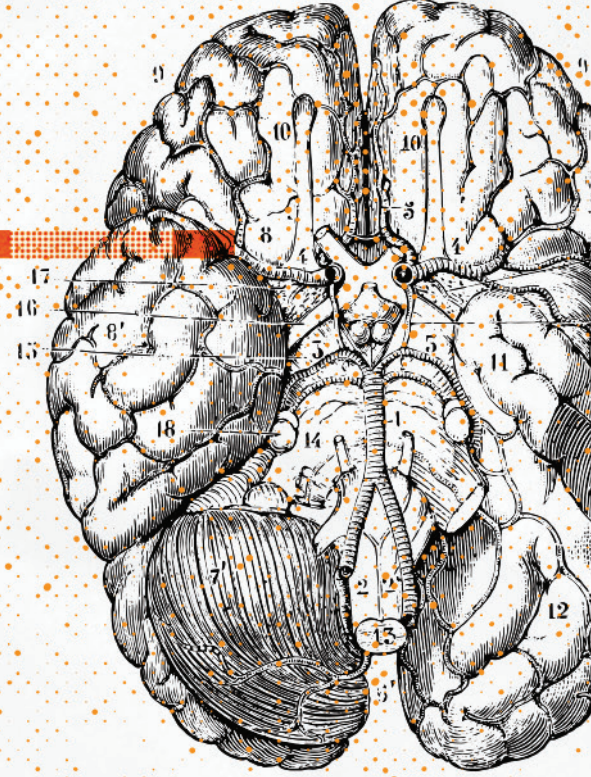
Germany's two big car export markets after the US are China & the UK. China is the most profitable with margins the highest globally. The UK is another major destination for German auto exports, onto which Brexit is breathing increased uncertainty. With more factories being built in its largest export market of the US, the outlook is extremely uncertain. The German bank sector has shown no signs of finding a durable bottom. Credit, commodities and cars suggest that the broad trend for the DAX remains down.

The long-term trend line break and diamond shaped top imply that it should remain a higher-beta bear to the declines in broad based global equities. Downside targets remain at 9773.

Dax Returns & China Aggregate Finance YOY% Changes



"Turning full circle, the final chart shows that the YoY performance of the DAX (blue line) appears to have been influenced by the changes in Aggregate China Financing (six-month moving average), which itself was the driver of Chinese shadow banking and commodity demand."



JOIN the Dots

REAL VISION
THINK tank™