## The Context

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The External Risks Hit EMU Manufacturing ... For Now

By Marcus Dewsnap, IGM Head of Fixed Income Strategy

The ECB meets (Wednesday) just a week after the release of the minutes to the last gathering where nigh on the kitchen sink was thrown at the slowing Eurozone economy. Since then, we have also heard about tiered Depo Rates. There are more than a few who think the ECB’s forecasts are too optimistic. But given it is too soon for any more changes to forward guidance, the market will be looking for more information on tiered Depo Rate thoughts plus details on the new TLTRO.

The state of the EMU economy will make for interesting comments during the post-decision Draghi presser. There are tentative signs that the global economy is stabilizing (see HERE for something we wrote) although a great deal seems to be placed on one Chinese data point (manufacturing PMI). Within the Eurozone, both retail sales and services PMIs indicate solid domestic demand (see HERE for something we wrote) and alongside government spending should provide for positive GDP growth. The key is whether the struggles of investment in capital goods spreads to other areas of the economy.

Interesting within the PMIs is the spread between the services and manufacturing versions is at a multi-year wide.

Looking deeper, ABN Amro note that those countries which are more heavily exposed to trade, Germany, the Netherlands and Austria, have experienced a larger drop in manufacturing PMIs since mid-2018, than those less exposed such as France, Spain and Greece (latter has increased).

The global investment slowdown, which is linked to exports from several countries and therefore also the global trade slowdown, means signs of stabilization in the global economy become critical to preventing investment troubles from damaging the rest of the EMU economy. Given we are still at least a month or so away from a China-US trade deal, after which Japan/EU might become a US target, the ECB’s balance of risks will remain tilted to the downside.

This is an excerpt from Marcus’ Week Ahead. For the full piece see HERE.
The first quarter of 2019 will be remembered for the U-turn in global central bank policy, spearheaded by the unprecedented flip-flop by the Fed. It has now completely stalled its rate hike plans this year, with markets pricing in rate cuts, whilst the ECB has been forced to re-commit to whatever support measures are needed, whilst the PBOC has pushed stimulus in the form of fiscal policy.

The most dramatic change has been at the Fed thanks to the stuttering economic performance of the US economy.

Real GDP growth peaked in Q2 2018 at 4.2% q/q saar after Congress’ December 2017 tax cut, but has since decelerated to 3.4% in Q3 2018, 2.2% in Q4 2018 and now tracks less than 1% in Q1 2019. This led the Fed Funds futures strip to fully price a rate cut by Jan-2020 last week, but this has pulled back by 8bp (see dashboard below) as several FOMCers pushed back on the markets’ pricing and even uber-dove Kashkari said it was not time to cut yet. No one expects a move at the May FOMC meeting, although Bloomberg’s WIRP model suggests over 20% chance of a cut at the July meeting, which is too optimistic.

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Q2 Balancing Act For EM FX – cont’d

This dovish Fed outlook has been good news for EM bond investors and supportive for EM FX high yield carry trades, even amid muted economic growth. However, looking at the MSCI EM FX Index we would argue that most EM currencies have not yet priced this in (has flat lined in Feb/Mar), with the JPM EMBI Global Spread also struggling for fresh downside momentum over the last couple of months. EPFR fund flows data shows that inflows to EM Bond Funds, whilst accelerating, are also yet to recover to levels seen a year ago (please see dashboard).

**US Curve Inversion suggest US recession, but not equities**

As the above shows, yields on the mid-to-long part of the Treasury curve have been falling faster than short ones, meaning that the 2y5y spread has fallen to -6.6bp, which is the lowest in more than a decade. More importantly, the spread between 10yr Treasuries and the 1mth T-bills has also turned negative, indicating an inversion in the mid-long part of the curve as well. However, whilst the US curve inversion is suggesting a recession is looming, equity markets are not pricing in a recession even as the bond markets suggests heightened risks. Which market is right?

**Improving fundamentals in China and a bottom in the EZ should be supportive for EM FX**

A recession is ultimately not good news for bond investors, especially in the riskier HY/EM space and thus ultimately EM investors will want to see better fundamentals to sustain what is so far just a liquidity-driven rally (money racing to find yield again). Thus this week’s strong Chinese March manufacturing PMIs were met with a strong response from investors, who are optimistic that this shows the Chinese economy is stabilising, and even starting a genuine recovery. Given the amount of stimulus measures adopted by China, some would argue this was inevitable, but is it sufficient to compensate for the drag from the Eurozone and the US later this year?

It has at least calmed fears over a China hard landing. While we do not see a repeat of the 2016 China reflation rally, we do predict that the economy is bottoming out. Apart from the PMIs, there have been signs of green shoots for the Chinese economy, in the pick-up of state-led investment and overall credit growth, which should prove supportive for EM FX.

There is also some positive signs in the most recent European data – industrial production and the recent Ifo and ZEW survey have been better than expected, providing an early suggestion of a possible stabilisation.

**EM FX set for volatile Q2**

So the questions as we begin Q2 are plenty: Will the US economy head into recession at the end of the year or early 2020? Will the US yield curve inversion be sustained? Will the economies of China and the EZ stabilise? What will happen with Brexit and what will this mean for the EZ? Will the US-China trade war be dragged out for the rest of the year?

This all points to heightened volatility in Q2 vs Q1, as markets juggle these uncertainties with still supportive liquidity and positioning drivers.

There is a balance to be struck between dovish central banks, benign inflation and the weak global growth backdrop. Further signs of stabilisation in both Chinese and European economies will help shift the consensus towards further EM FX gains, especially if this builds into a more solid recovery. **Thus we expect to see the MSCI EM Index break higher, through recent range highs of 1,658.2, to test 1,700.**

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Consolidates the recovery from 1575.1 (11 September 2018 base/also a 38-month rising trendline) within a two-month 1632.5-1658.2 bullish rectangle.

While 1632.5 (14 February low) supports, watch for an eventual break of 1658.2 (2019 peak - 21 March) to complete the rectangle and signal a fresh leg higher.

Initial resistance is pegged between 1671.8/1679.6 (61.8% of 1731.5/1575.1 fall and 28 May 2018 lower high), beyond which opens 1694.6/1694.9 (76.4% of 1731.5/1575.1 and 11 May 2018 lower high).

Only the loss of 1632.5 and then 1625.7 (8 January low) would suggest near-term topping and risk a deeper decline to 1609.4 (38-month rising trendline).
Arbitrage Concerns as Euro CLO Supply Expected to Fall Short

By Anil Mayre, Senior Credit Analyst

The post-crisis record of EUR27bn of new European CLO supply in 2018 is unlikely to be matched this year, according to participants at last week's IMN European CLO and Leveraged Loans conference.

But that may not necessarily be as negative as it suggests, as lower supply could allow liability spreads to narrow and improve arbitrage.

Around EUR6.9bn had printed from 16 new issues at the time of the get-together, this was up by one deal over the same period in 2018, where 15 new issues raised EUR6.2bn according to IGM data (or a near-identical tally of just under EUR6.8bn from 16 trades when including a reissued transaction).

But those numbers do not give a clear reflection of the current state of the market and mask more significant challenges in the underlying dynamics of the sector.

One panellist said loan supply was down around 40% over the same period in 2018, which was helping to keep loan spreads in check as the same number of CLOs chased fewer loans.

The CLO liability side, on the other hand, has shifted significantly wider. And spreads have displayed a stickiness that has seen this sector lag the tightening of other credit products and weigh on arbitrage potential.

For instance, the 16 deals that priced in Q1 2018 came with Triple A notes in a range of 3m+68bp to 3m+76bp, averaging out at around 73bp across this cohort.

This year, however, CLO managers are paying a hefty premium to that.

Panellists said nine of the 16 deals had been anchored by key investors, with Norinchukin the most commonly cited. And those had priced with Triple As at 3m+108bp or 3m+108.5bp.

That represents an additional 30-30.5bp cost at the senior level, which is not reflected in a commensurate widening of loans spreads.

The cost is higher still for deals sold via general syndication. The seven remaining transactions have priced in a narrow 114-116bp range.

Attendees said that Japanese appetite for European CLOs was continuing, which was understandable given the spreads on offer versus JGBs and other domestic opportunities.

But the longevity of this approach is being questioned.

"If the bid disappears what would it mean for the market? The balance is fine," said one portfolio manager.

"Mezz is coming back but there is no rally in Triple As, it’s a precarious position."

But, the fact that levels had not moved would prolong interest in Triple As, one syndicate official said.

And expectations of reduced supply could lead to spreads trending tighter.

Market participants said that 2019 has got off to a good start in terms of volumes, but it was mainly the result of clearing the backlog of late 2018 when deals were held back due to volatility and wider pricing in Q4 2018.

One syndicate manager said that oversupply was managing itself, being worked out, but that his bank had not opened a new warehouse yet this year.

Another sell-side banker, however, said that people were being more selective, but there was still demand for opening warehouses for new issues.

One CLO trader said that loan supply being light was constructive for loan spreads but it made it harder to ramp up a warehouse - reiterating the problem of challenging arbitrage with CLO bond spreads remaining constrained in their higher range.

The first banker said there was currently less than 200bp of excess spread available in a transaction, whereas last year it was around 230-240bp, in another indication of the deterioration in arbitrage levels.

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Arbitrage Concerns... cont’d

Multi-layered concerns

It’s not just arbitrage that worries market participants, as weak documents, cov-lite loans, a lack of tiering and sustainability of new managers testing the market were also mentioned.

With more new managers coming to the CLO market in 2018, decisions were as much about investing in the manager itself as well as the transaction.

Another portfolio manager said the performance of a tranche would be tested when it came to selling it – as it also reflected the liquidity of a manager.

And a third buy-sider offered a similar opinion saying the CLO manager team/platform, investment philosophy, sourcing of the assets (was it a clear view on the credits selected?), track record and future positioning of the firm were all factors to be considered when investing.

There would always be idiosyncratic news on individual names that had to be dealt with, despite the current state of the credit cycle being benign.

And this, in conjunction with increased leverage and weak documentation, was an added layer of risk in which the manager would be tested.

Panellists said there was insufficient tiering in the market to reflect this. For example, all non-anchored Triple As have priced in a narrow 114-116bp range.

And it is not only the response to an emergency that differentiates a manager, as access to the collateral in the first place can determine the quality of the portfolio.

"Access to product is an issue. The most successful managers are those that are the most relevant to the supply base" said the CIO of another asset management firm.

Managers needed a broad spectrum of underwriting capabilities, he said.

But as noted above the concerns were not only focused on what managers needed more of, but also on what many market players wanted to see less of.

Weakening documentation has been flagged on many occasions, but earnings adjustments, and not just covenants were also a worry.

Higher leverage and the loosening of basket criteria, particularly when the basket valuation was derived from EBITDA, was problematic.

Conference participants also talked about asset stripping and changes to structural packages as worrying markers for loans and transactions.
Know The Flows – Balance Absent When it Comes to 1Q19

By Cameron Brandt, Director, Research

The first quarter of 2019 ended with EPFR-tracked Bond Funds on their way to their 13th consecutive weekly inflow while Equity Funds stumbled towards their 15th outflow in the past 20 weeks, extending a rotation that began in early January. Bookending this broad trend were strong flows to US Money Market Funds and another quarter of heavy redemptions from Balanced Funds, a multi asset group whose mandates allow them to invest in both stocks and bonds.

Concern among investors that this time, after five years of unrealized anticipation, the post-Great Financial Crisis recovery is finally rolling over was given credence by the world’s major central banks, three of which – the US Federal Reserve, Eurozone Central Bank and People’s Bank of China – put plans to normalize or tighten monetary policy on hold. These trends are reflected in the number of fixed income fund groups in the ranks of the top money magnets during the first quarter and the fact 11 of the 15 groups experiencing the heaviest redemptions were Equity Fund groups.

Europe remains a focal point for investor angst about the outlook for global growth, with threats to the continent’s export story compounded by the uncertainty created by the UK’s unsuccessful efforts to meet its deadline for leaving the European Union and the populist tone of politics throughout much of Europe. The week ending April 3 saw EPFR-tracked Europe Equity Funds post outflows for the 52nd time in the past 54 weeks as Equity Funds collectively recorded an outflow of $7.6 billion while Bond Funds absorbed another $11.4 billion and Money Market Funds $2.6 billion.

At single country fund level, UK, Spain and France Equity Funds recorded their eighth, 17th and 24th consecutive outflows respectively, Saudi Arabia Equity Funds absorbed fresh money for the 14th week running, Australia Bond Funds recorded their biggest weekly inflow in over 15 months and redemptions from Hong Kong Equity Funds hit levels last seen in late 2Q13.
China Insight: The Winter For Wealth Managements Products
Business is Over
By Tim Cheung, Head of China, Riki Zhang EM Analyst

2018 Wealth Management Product (WMP) data was released, suggesting the business transition for the WMP business is on track and the worst of the effects of WMP regulation - on liquidity, capital and credit growth - is now behind us.

Specifically, interbank WMP continued to fall, reaching CNY1.2tn as reported, down 62% y/y from CNY3.3tn in 2017 (chart A).

Meanwhile, non-standardized assets (NSAs) on-balance-sheets contracted 29% y/y in 2018 (vs -27% y/y in 2017) (chart B). These included various kinds of asset management plans/products issued by other financial institutions.

Despite a softening of the regulatory tone, banks continued to compress their on-balance-sheet NSAs. In 2H18, this contracted by 13% y/y (vs 18% y/y contraction in 1H18). However, some banks (AGRBK, CHINAM and HSBANK) saw a notable rebound of their NSAs. HSBANK is the one which is particularly worth worrying about, as its NSAs accounted for as much as 35% of total assets, vs 0.3% for ABC and 6.5% for CMB at 2018-end.

On the negative side, we noted a rebound in off-balance-sheet WMPs by 10% y/y in the system. We attribute the rebound to the softening of regulatory tone.

With financial deleveraging already being downplayed by the central government, we expect the contraction of shadow assets (on-balance sheet NSAs or off-balance sheet WMPs) will contract, if at all, at a milder pace this year than in 2018 (chart C).
Meanwhile, banks were seen increasing the provision level on all of the above-mentioned assets (chart D).

Most banks stepped up their credit costs much more than expected in 4Q 18 due to a more stringent NPL recognition requirement (all 90-day+ overdue to be booked into NPLs) and to further raise their loan loss reserves (for both on/off balance sheet exposures).

The credit cost of 1.35% in 2018 was an above cycle average and combined with the reserve-to-loan ratio for the sector reaching 3.06% in end-2018, the highest in 10 years (chart E), there should be enough reserve buffers to support a lower credit cost in 2019.

Admittedly, we still see risks in both NSAs and WMPs, but we believe the overall risk is manageable due to a relatively high loan loss reserve ratio.
The following pages are dedicated to:

Technical Analysis

IGM’s global team of Technical Analysts constantly look for interesting patterns in prevailing price action of a broad range of currency pairs, fixed income and commodity products.

We will highlight the most compelling on these pages.

For information on the full spectrum covered, please contact your Account Manager.

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EUR/USD – Rejection Off 1.1448 Suggests Further Downside

Technical Analysis by Andrew Dowdell

- Attempts to stabilise near the 200-Week MA have lacked conviction and the 50-Week MA has now turned lower.

- Latest rejection off 1.1448 (just ahead of 1+ Year channel resistance) keeps the pressure on the downside.

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**STRATEGY SUMMARY**

Risk seen lower to 1.1110, possibly the 1.0906/1.0778 zone, before bulls attempt to re-group. Above 1.1448 stabilises.
EURIBOR M9-M0 – Downside Risk Whilst 8.5/9.5 Caps Corrective Widening

Technical Analysis by Ed Blake

- Extended the 14-month narrowing trend to 1.0 (27 March record low), ahead of corrective widening
- Daily/weekly bullis divergence suggests near-term recovery potential towards clustered resistance between 8.5/9.5
- While this caps, watch for fresh narrowing to 1.0, below which signals inversion to projection targets at -4.5/-8.0
- Only over 9.5 would suggest near-term basing and allow further widening to lower highs at 14.0/16.0

STRATEGY SUMMARY

Sell into near-term corrective widening towards 8.5/9.5 in anticipation of renewed narrowing to 1.0, perhaps projections at -4.5/-8.0. Stop and reverse on a sustained break over 9.5
COMEX Copper – 7½ Month Base Projects Strength to 302.04/313.32

Technical Analysis by Ed Blake

- Bulls completed a 7½ month base over 254.30 (2019 low – 3 January) and rallied 298.85 (1 April high), before easing
- While dips hold 283.45 (25 March base/pivotal trendline), bulls will re-target the 298.85/302.70 cluster
- Studies are constructive and above 302.70 opens 313.32 (Fibonacci retracement) then 319.10 (7½ month base target)
- Only a reversal below 283.45 would avert this year’s recovery and suggest extended consolidation over 254.30

STRATEGY SUMMARY

Buy into near-term dips as we await a break over 298.85/302.70 targeting the 313.32/319.10 zone. Place a protective stop beneath the 283.45 higher low.
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