BNY
iFlow
MACRO MORNING BRIEFING

July 19, 2024

Rotation Trades and Politics

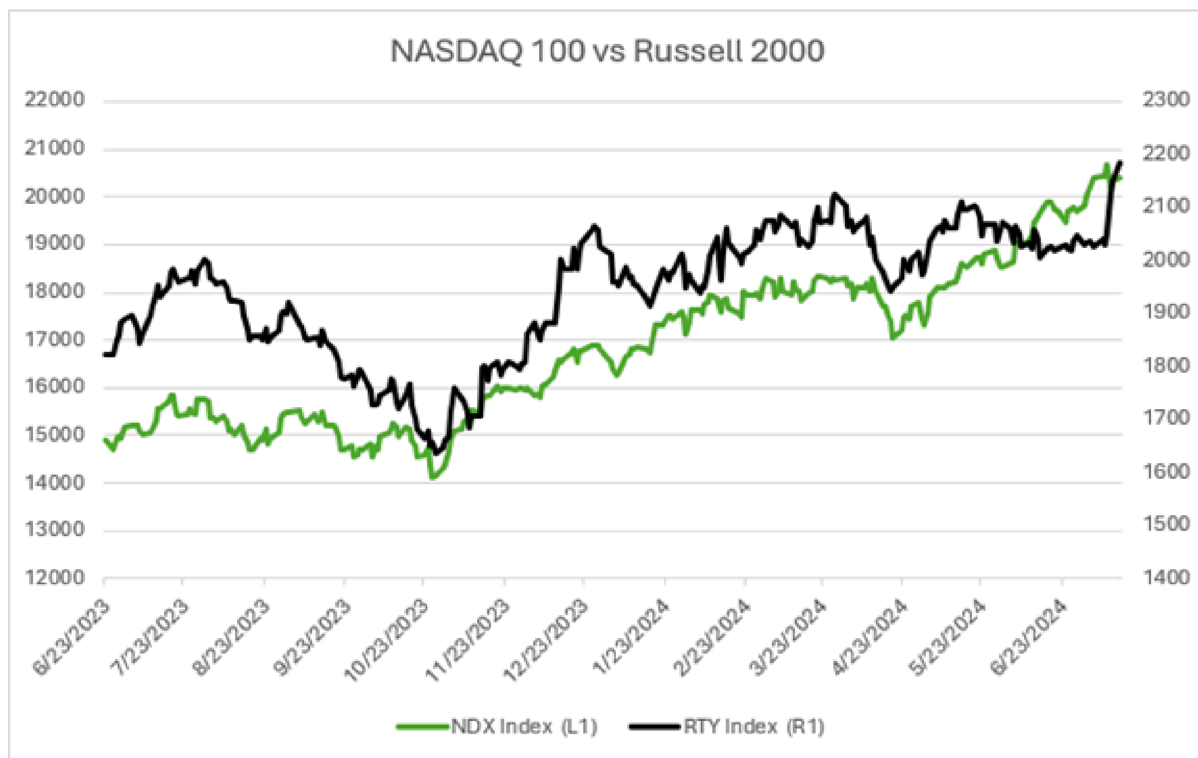
The “Trump trade” is not a new narrative for markets. The first move in US markets started in June after Trump met with CEOs and talked about raising tariffs and cutting corporate taxes. The discussion left yield curve-steepening trades in play, but that was overwhelmed by weaker US economic data and a market moving from 50% odds of a September rate cut to 100%. The rotation trade in US equities started after CPI. This was a 10% move that stands out over the last year. The view that the FOMC can ease in September lifted small caps. This is also a value trade into the 2Q earnings with concerns about high P/E ratios. Some argue this is also a Trump trade as his push for domestic supply over international trade with higher tariffs and lower taxes should help SMEs. Determining which factors matter most might be difficult and not worth the effort. Recent events have increased the market odds of a Trump win, and the Bloomberg interview with the former president highlighted policy views that quickly translated into markets on Thursday of this week. There are three linked trades that represent a rotation from current expectations. What seems clear is that some part of the logic for these trades is more about positions, while all entail the risk of being too early in a long summer and the days until November 5. The analysis of what trades have legs regardless of political outcomes matters for how the summer markets play out.

- **Equity sector rotation** – how much of this is about 2Q earnings and positioning against Trump policy discussion, from Taiwan to tariffs?
- **US yield curve steepening** – how much of this is about FOMC easing vs. fiscal policy risks?

- **USD weakness** – how much of this is about intervention and risk positioning, particularly in JPY, against warnings by Trump?

The week has delivered a significant rotation trade out of tech into everything else. The tech sector ETF XLK is off 5.6% as of July 17, while the US small caps IWM rose 9.3%. The largest recovery was in US regional banks KRE – the most-doubted sector for earnings – up 13.8%, while REITs ETF VNQ rose 6.4%. The point is that much of the set-up for markets into 2Q end has unwound on the margins. This is before earnings are released and that makes the risk of any actual negative surprises more volatile.

Exhibit #1: The rotation trade in US shares



Source: Bloomberg, BNY

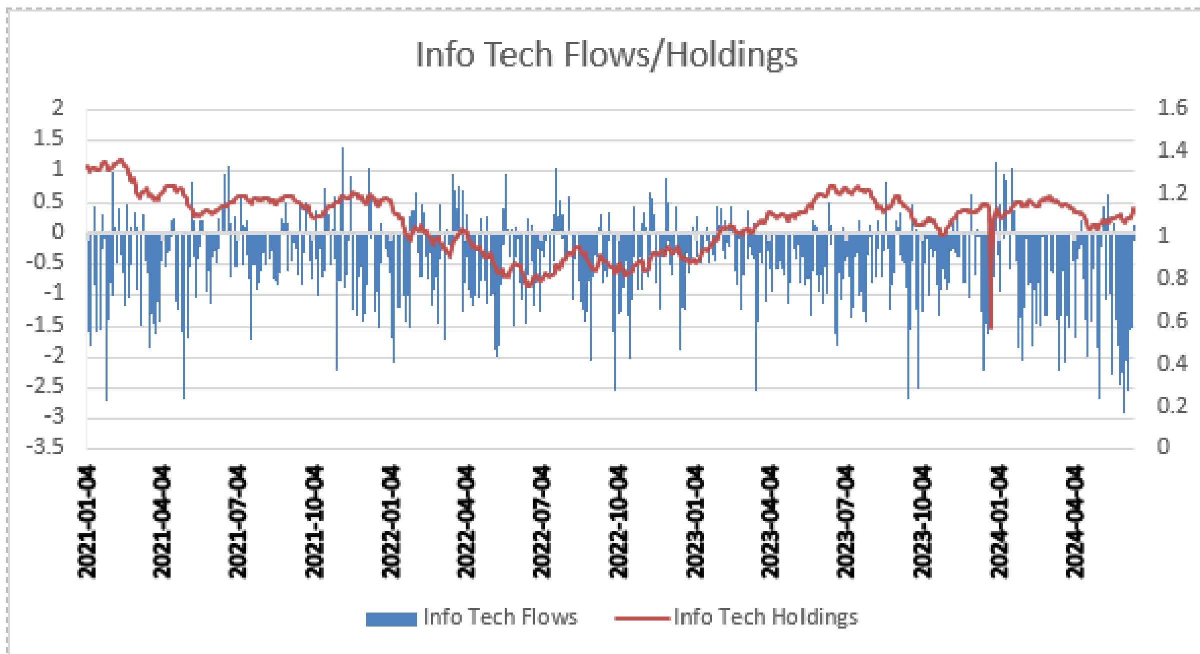
The BNY iFlow data in equities holdings vs. flows data show that in the US holdings are hardly differentiated by sector – the market is set up long stocks into 2Q earnings. The lowest holdings are in consumer discretionary, while the highest is in communication services. The flows that are most negative are in financials and materials, while real estate and IT saw more buyers.

Exhibit #2: US sector holdings vs. flows stand out

Source: iFlow (As of June 30), BNY

The rotation trade in July is not unique and we have seen rotations in IT shares after the quarter ends into the middle of earnings before this episode. Note the cycle of the IT sector over the last three years as positions go to near flat ahead of earnings. Discerning whether this move is now more important than in previous times requires a larger perspective.

Exhibit #3: IT sector holdings are cyclical to earnings season

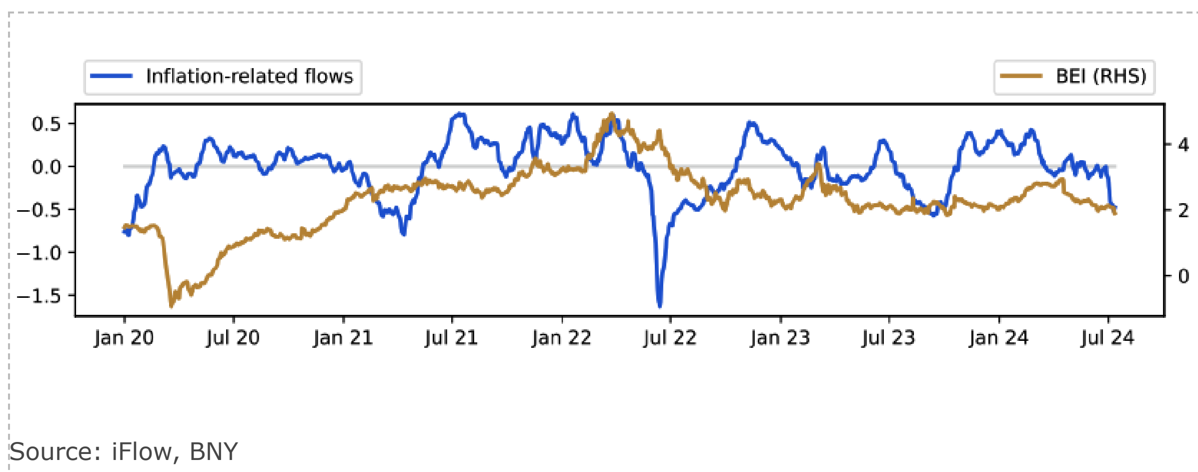


Source: iFlow, BNY

Our flows suggest that equities are bottoming out and being bought in the last two weeks, while from a style perspective US selling of inflation winning trades has

reversed sharply along with cyclicals. The sustainability of the moves from last week depends on how 2Q earnings play out against expectations. The iFlow Mood indicator adds to concerns that this market may be too optimistic for earnings overall globally – the index is in the 99.3% percentile and has been there for 14 trading days, with the median being 19 days over the last 10 years. The bigger picture for global shares is also part of the story, with notable asset allocation shifts from developed market equities to emerging market ones, with EMEA and APAC supported as the selling trend in China shares stalls. The industrial sector was the most sold, while health care and real estate gained.

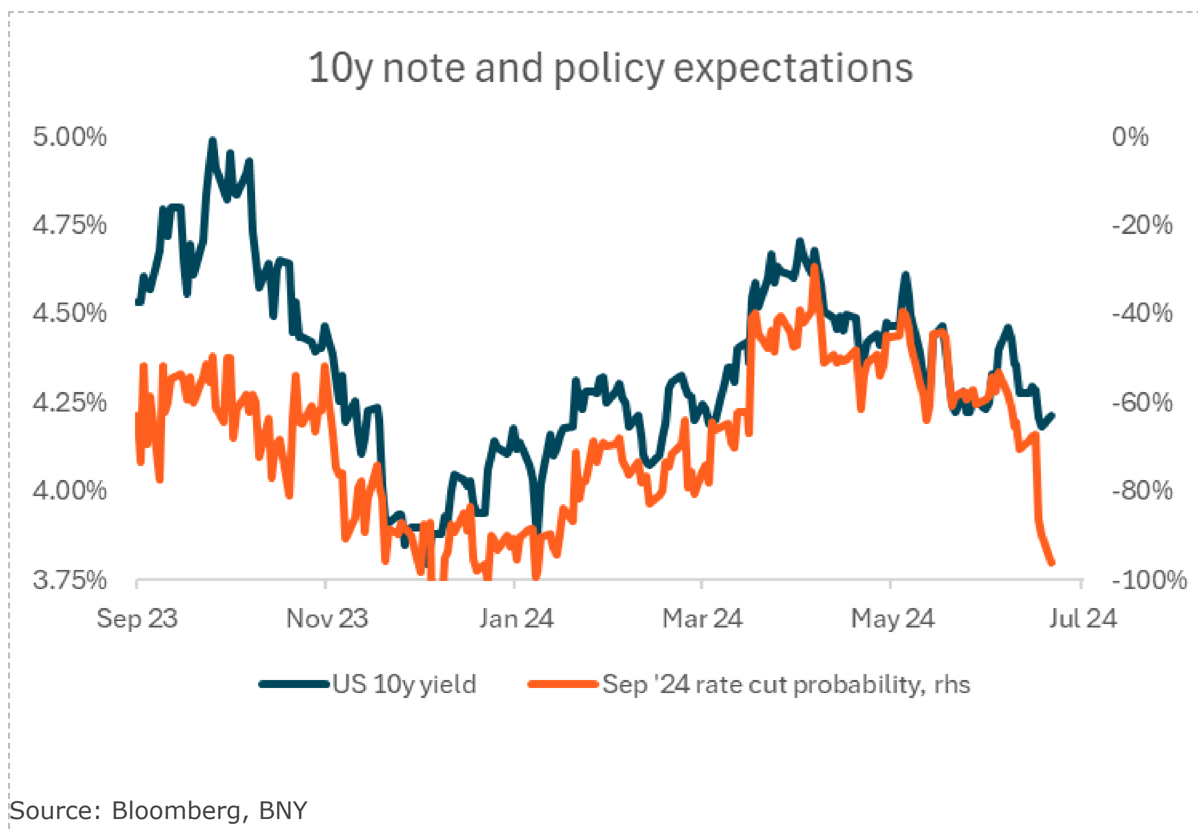
Exhibit #4: Inflation fears have flipped to disinflation



Source: iFlow, BNY

When you consider the effect of US rates on the stock market, a few points stand out. First is the correlation of equities to sovereign bonds in our flows – with a -0.903 correlation, this is in the 96% percentile and has flipped from positive to negative since June 27. The second point about bonds is that the flows we have seen and holdings of US bonds have had a duration bias – with 2/10Y and 2/30Y consistently seeing buying in the long-end. The third point is that rate expectations for the Fed in September were highly correlated to the US 10Y yields until the Trump trade started up again in July.

Exhibit #5: 10-year bond yields correlate to the Fed but...



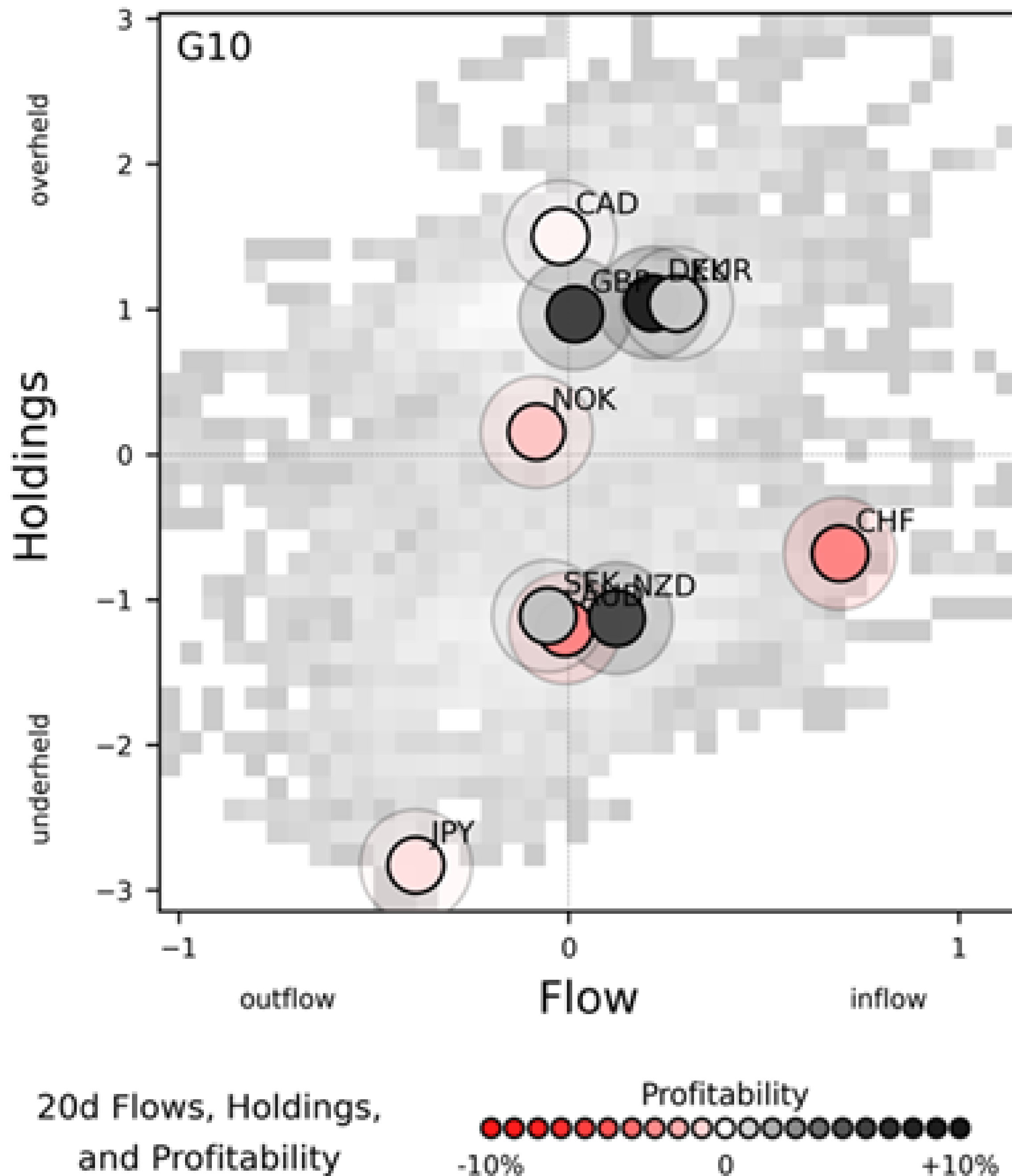
Source: Bloomberg, BNY

The FX correlations around lower interest rates and the Trump trade are harder to differentiate. Our carry indicator in FX flipped from near extreme negative correlation back to flat over the month to date – and that is the most important factor to consider when trying to determine if a September rate cut by the FOMC matters more than the fear of a USD weakness policy under a Trump presidency. Also adding to the noise of factors behind the dollar weakness is the JPY and MOF intervention on the US CPI release. This makes clear that Fed rate cuts matter significantly in the short term to Japan and indirectly to the APAC region. Given our positioning in JPY in the G10 FX world, JPY bounce backs to 152 or lower seem likely if we see further data supporting a Fed easing policy and should we hear more about any Trump plans for USD "fair valuation" efforts.

Bottom line: The effects of the Trump trade are not fully priced in markets according to our iFlow data. The yield curve could steepen further if we see evidence supporting the views of a Congressional sweep for Republicans and a Trump win. However, the moves by the FOMC in September also matter to how the USD and bonds trade with risks for any fiscal expansion after the election leading to less not more easing bias. The role of technology investments by companies, driven in part by the IRA and other Congressional acts, may also be part of the Trump trade risk as the incentives could be unwound through presidential executive orders. The tech rotation story is the one that is most overblown in its link to politics and is more

dependent on actual earnings in the sector and the September rate decision by the Fed.

Exhibit #6: Market already short USD but not everywhere - particularly JPY



Clouds: distributions over trailing 1,000 days

Sources: Bank of New York Mellon, WM/Refinitiv

Data as of 2024-07-17

Source: iFlow, BNY

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

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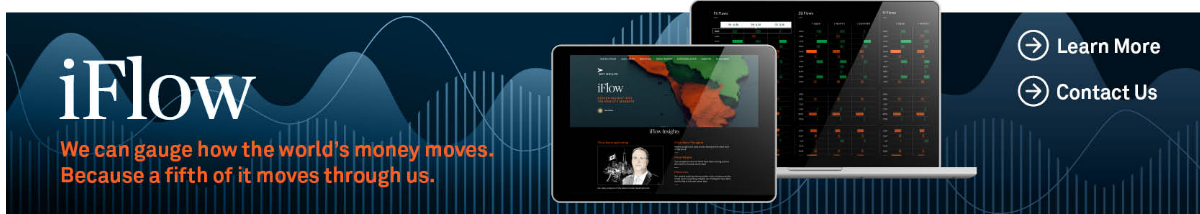

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