North America

Asset Allocation & Delta-1 Strategy

Investor Positioning and Flows

Date
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Strategy Update

The Close Election Risk Premium

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Polls for the US mid-term elections have tightened

In our reading, polls still favor the Republicans keeping or even increasing their lead in the Senate and the Democrats taking the House with a small majority. But they have become a lot tighter over the last few weeks, especially for the House where the number of toss up seats remains large (DB: The Mid-Term Elections Rally: Positioning For History To Repeat, Aug 2018).

Close elections see risk premiums build in the run up and equity markets rally on a clear result

Comprehensive polling data for House elections, which encompass a large number of districts, is lacking. But we see the experience around past Presidential elections, for which polling data goes back several decades, as strongly suggestive. Close Presidential elections saw a risk premium build in equities in the run up, in contrast to those where the result was widely anticipated. Close elections saw equities flat to down in the run up but a strong rally after —independent of who won. This was notable around the last US Presidential election in Nov 2016 as we highlighted at the time (DB: Positioning For The Election, Nov 4 2016). But a very similar pattern has also played out in several other important political votes recently, such as the Brexit vote in Jun 2016, the Italian referendum in Dec 2016 and the French elections in April 2017.

Is there a close-election risk premium in the market now?

As we noted last week, US equities have been trading well below levels implied by growth (DB: What's Priced In? Oct 26 2018). While angst about future growth and earnings has no doubt played a role, it also partly reflects rising uncertainty ahead of the mid-terms. The angst about global growth is itself largely driven by concerns around the trade war whose prospects could be impacted significantly by the outcome of the election.

Equity positioning has declined substantially and is supportive of a post-election rally

- **Equity positioning for systematic strategies has unwound significantly.** Equity exposure for vol control funds, CTAs and risk parity funds is now quite low. While deleveraging can continue if volatility remains elevated, the pace should ease. The risk is now asymmetric to the upside, as there is not much selling left to do but there is considerable potential to re-allocate to US equities if the market moves up and/or vol moderates.

- **Signs of hedge funds deleveraging.** Our signal for equity hedge fund deleveraging, using sector-neutral baskets of the top long/short dollar

HF allocations had a 4sd decline during this Monday's sell-off, and also fell week-over-week. These positions are more likely to be liquidated on industry de-leveraging, similar to the early 2016 global growth panic or rotations like after the November 2016 elections. High participation shorts outperformed this week as the market rallied suggesting short covering activity. ETF volumes have declined while single stock volumes have gone up. Single stock volatility has also risen relative to index volatility, i.e., stock correlation has declined.

- **Futures positions down sharply.** Net long positions in US equity futures are down substantially in the last 4 weeks to the lows seen in May this year, and during the positioning unwind going in to the 2014 mid-term elections. Positions have fallen lower only around large shocks such as the US debt downgrade in 2011, the European financial crisis and China FX devaluation in 2015.

- **The vol term structure has moved from being inverted to flat.** At current levels, it is still similar to that going into the Brexit vote and the 2016 US Presidential election.

- **Outflows have eased.** While large outflows during the initial weeks of the sell-off were in line with those seen during a typical 5%+ pullback, they have since eased over the last two weeks, slightly earlier than is usual. We note that US equities have already seen cumulative outflows of -$80bn since February.

- **Buybacks are back to full strength.** With 3/4 of companies having reported, buybacks should be back to their full pace ($15bn/week).

Does the election outcome itself matter? We would argue the market rallies regardless but the extent and composition will likely be very different

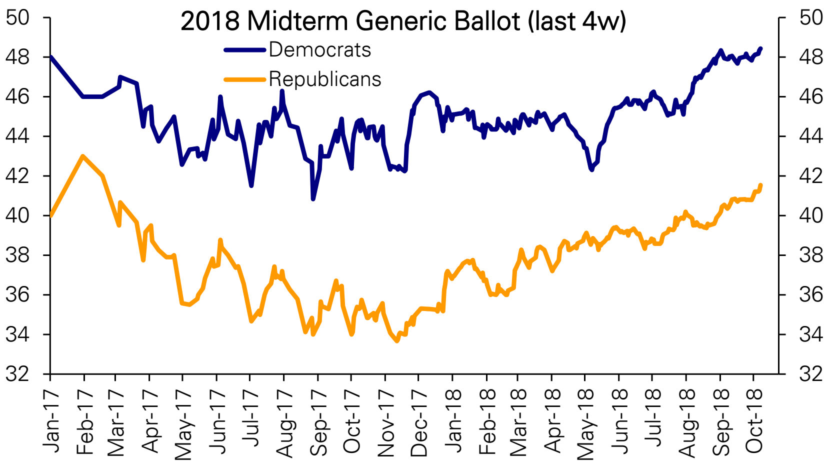
- **US growth is strong in its own right and policy actions have played only a small role so far.** While there is a significant base of market participants who attribute strong US growth to Republican policies, namely tax cuts and deregulation, we see US growth as strong in its own right with policy actions having played at most a small role so far (DB: Can Strong US Growth Sustain? Aug 2018). The already enacted positive policy changes are unlikely to be impacted by either result. Instead we see the administration's creation of trade frictions as having created downside risks to US and global growth.

- **Our base case of the Democrats taking over the House holds the potential to reduce downside risks from trade policy friction.** We see a variety of possible channels through which the administration's agenda on trade is likely to be curtailed by a switch in majority. Congressional investigations and potential impeachment proceedings, even though nominal, would likely use up significant bandwidth while a growing number of Democrats and even Republicans are likely to attempt reducing Presidential power in dealing with trade. If trade frictions reduce, that allows the market focus to shift back on strong US growth; and also ease pressure on global growth and in our view would lead to a stronger eventual rally. The market is currently pricing in almost no growth implying significant scope for a catch up rally.

- **If Republicans keep control of both the House and the Senate that would be interpreted by the administration and the market as public support for the trade war, likely leading to further escalation.** In the very short term while the market might rally due to the aforementioned base of investors who attribute strong growth to the Republicans' policy, we think it prolongs the period of trade uncertainty and hurts growth.

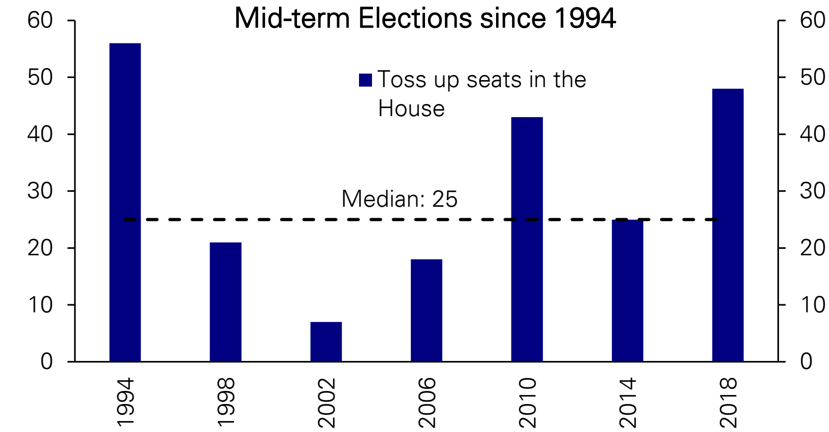
Polls for the US mid-term elections have tightened

Figure 1:The generic ballot poll is still in favor of the Democrats...



Source: RealClearPolitics.com, Deutsche Bank Asset Allocation & Delta-1 Strategy

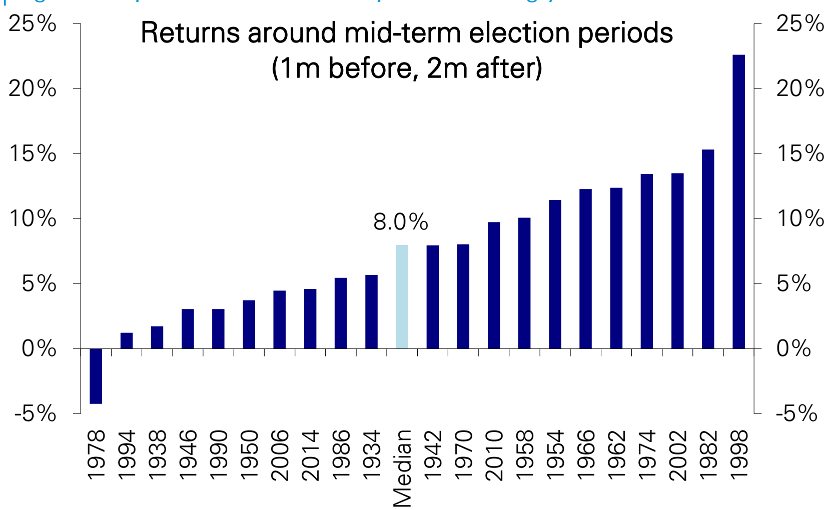
Figure 2: ...but the number of toss up seats in the House is high



Source: cookpolitical.com, Deutsche Bank Asset Allocation & Delta-1 Strategy

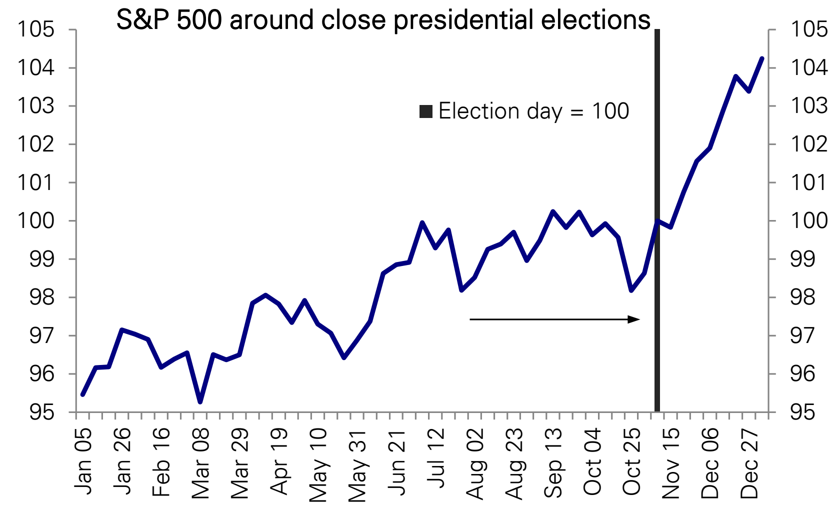
Close elections see risk premiums build in the run up and equity markets rally on a clear result

Figure 3:Equities have historically rallied strongly around mid-terms



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

Figure 4:Close elections in the past have seen strong equity rallies after

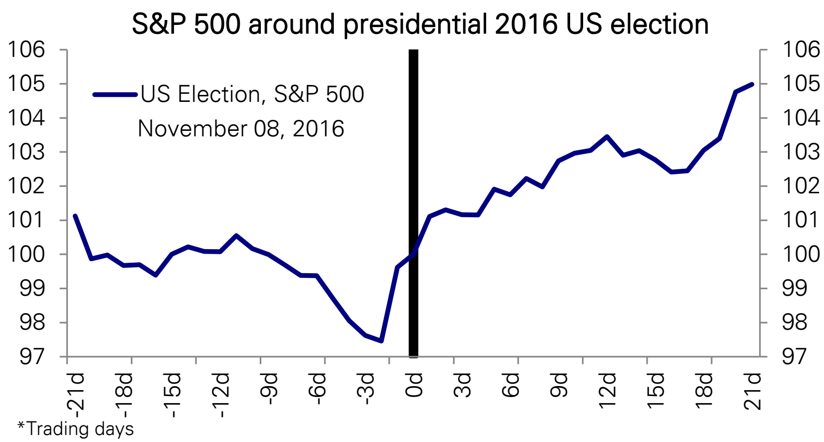


*Includes 1952, 1960, 1968, 1976, 2004, 2012 presidential elections

Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

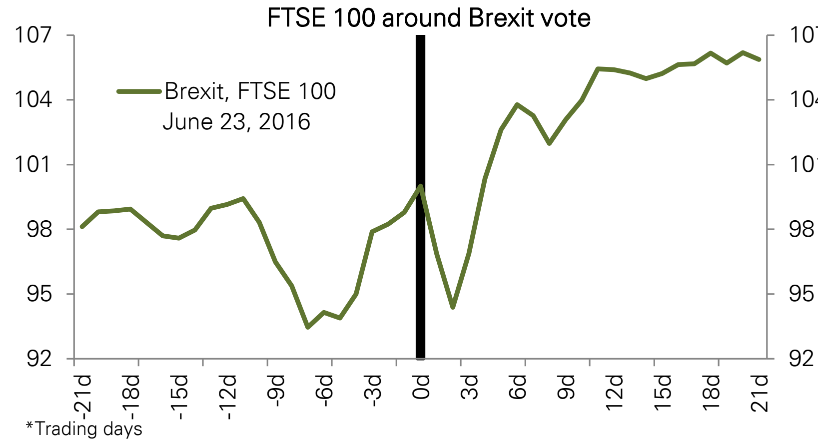
Several recent important political votes saw equities rally after as uncertainty reduced

Figure 5:US Presidential election in Nov 2016



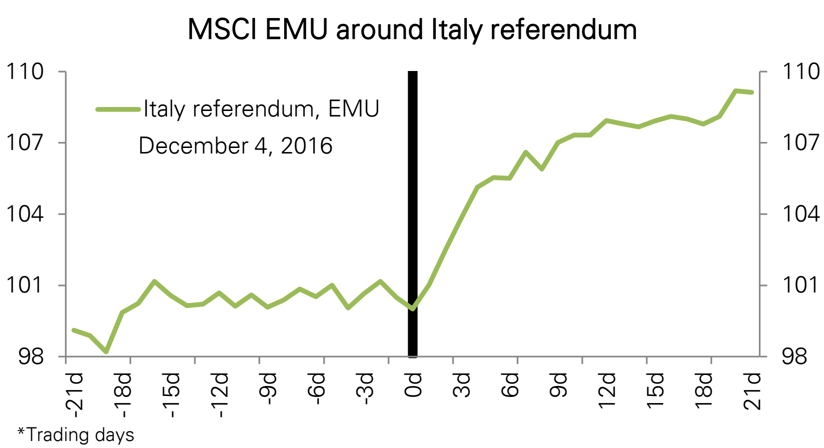
Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

Figure 6: Brexit vote in Jun 2016



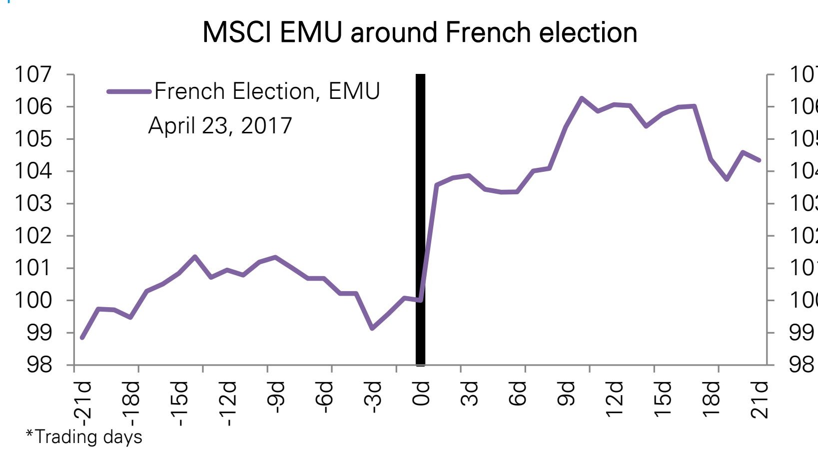
Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

Figure 7:Italian referendum in Dec 2016



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

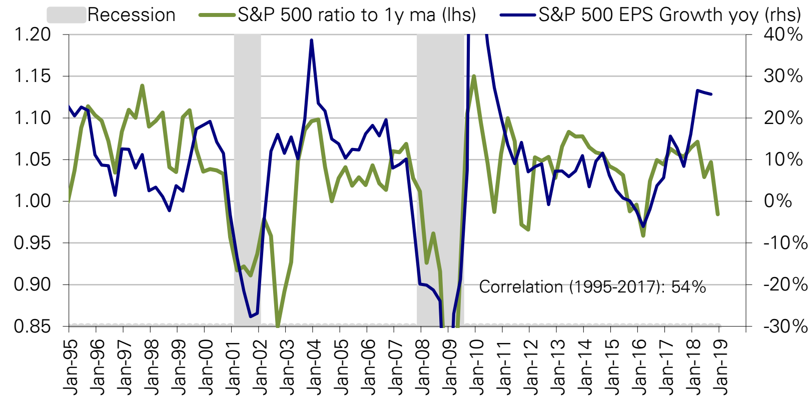
Figure 8:French elections in Apr 2017



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

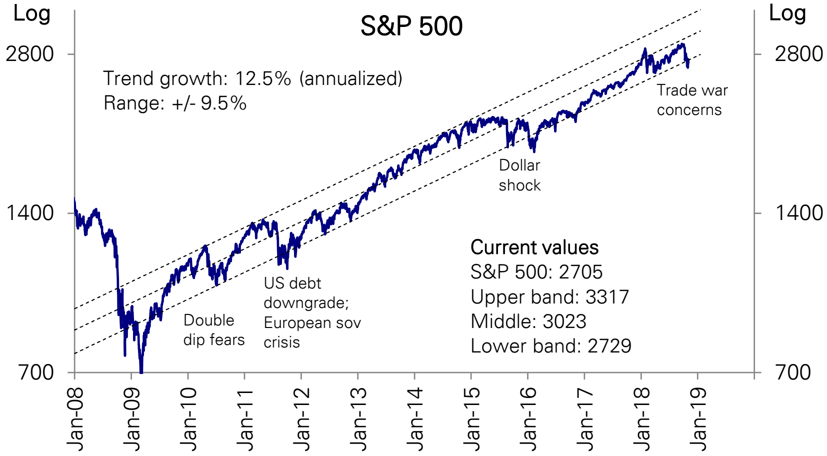
US equities have been trading well below levels implied by growth

Figure 9:Equities are pricing in zero earnings growth



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Haver, Factset

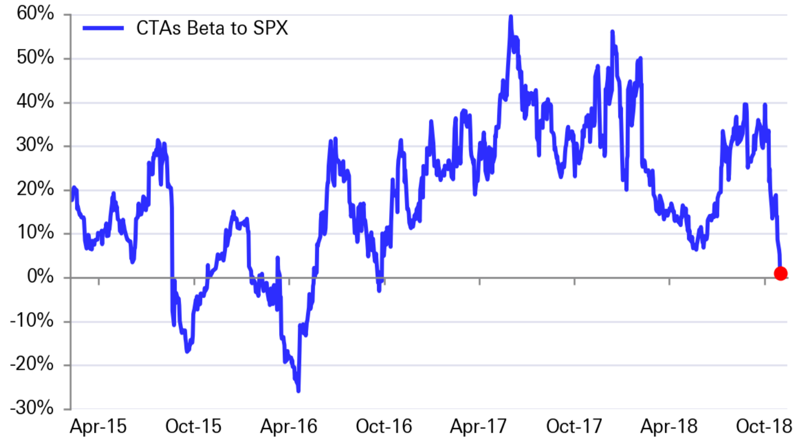
Figure 10:S&P 500 has broken below it's 9 year recovery channel



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP

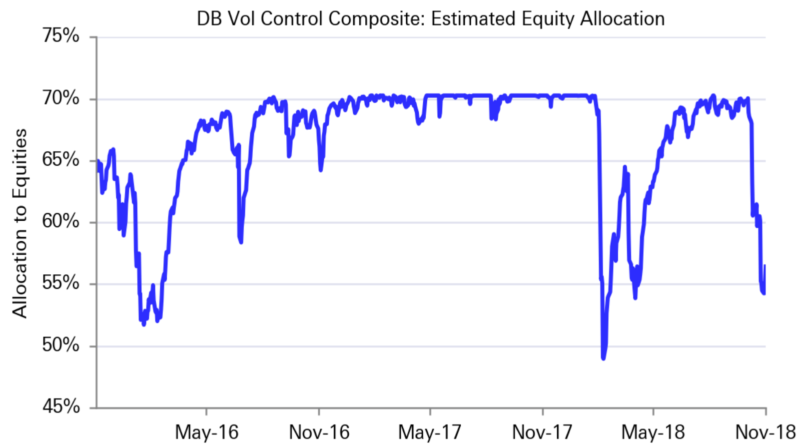
Equity positioning has declined substantially and is supportive of a post-election rally

Figure 11:Aggregate CTA beta to S&P 500 is close to zero



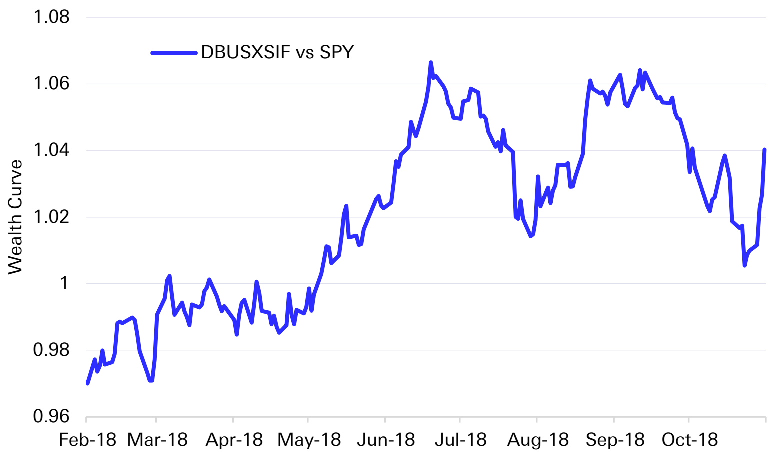
Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, SEC filings, Bloomberg Finance LP, Data as of 1-Nov-18

Figure 12:Vol control funds in early stages of adding equities exposure



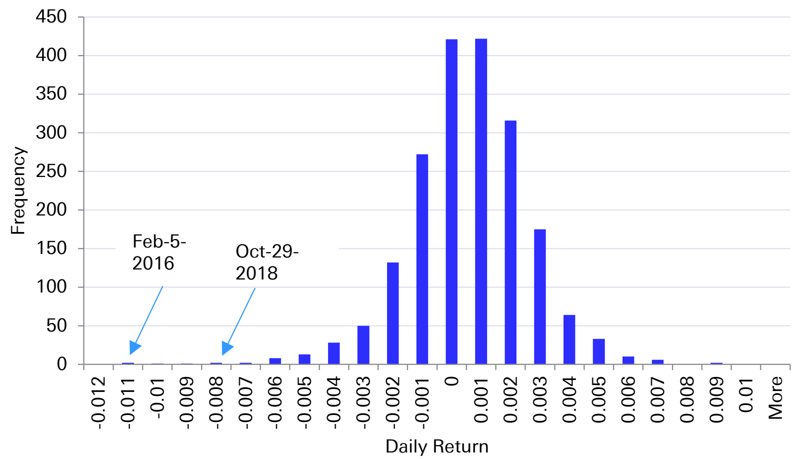
Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, SEC filings, Bloomberg Finance LP, Data as of 1-Nov-18

Figure 13:High participation shorts (% float) outperformed this week



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP, Data as of 1-Nov-18

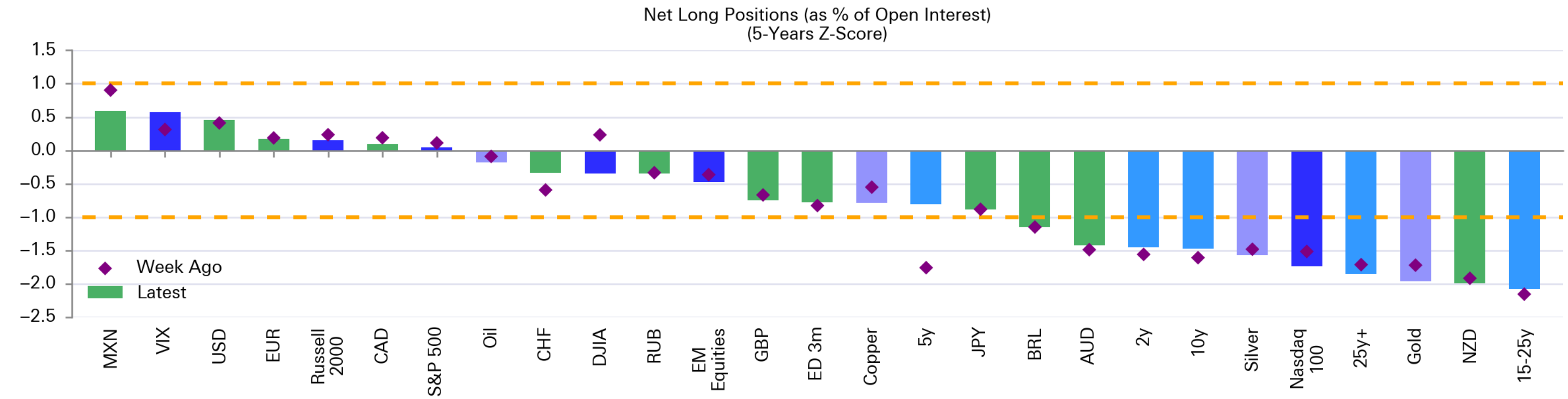
Figure 14:Hedge fund long-short based on high $-allocations showed signs of deleveraging last week



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP, Data as of 1-Nov-18

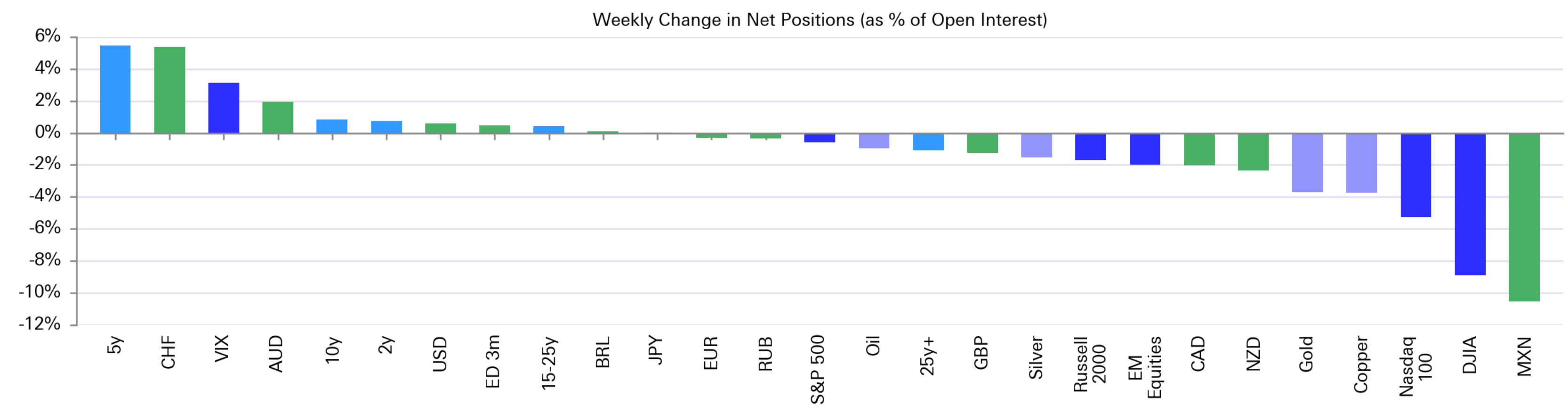
Cross-Asset Futures Positioning and Flows

Figure 15: Investors in aggregate have the most risk in FX futures



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18.

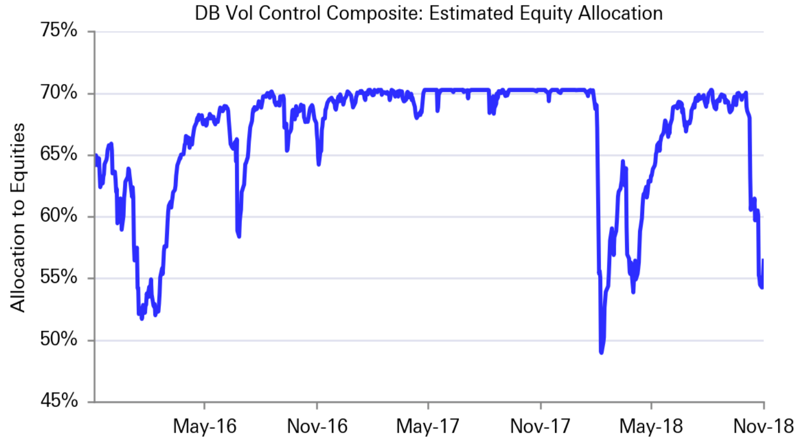
Figure 16: Investors cut exposure to NASDAQ 100 and DJIA and added to long VIX



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18

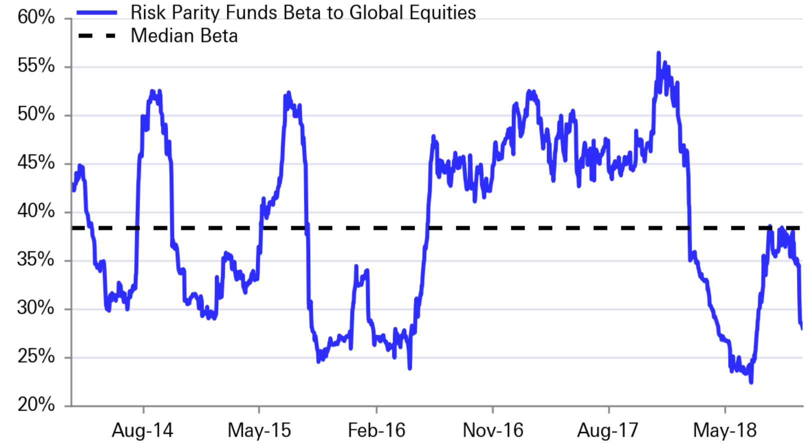
vFLARE: Volatility-Sensitive Systematic Strategies

Figure 17: Vol control funds are in the early stage of add equities exposure



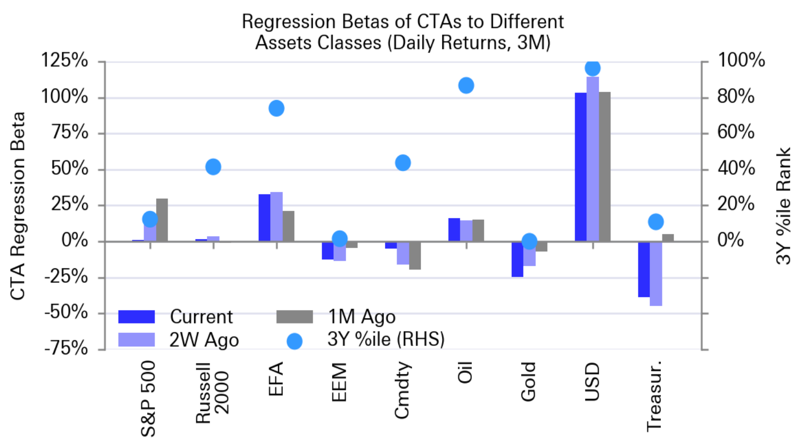
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, SEC filings, Bloomberg Finance LP, Data as of 1-Nov-18

Figure 18: Risk parity likely sold additional equity beta as realized volatility remained high



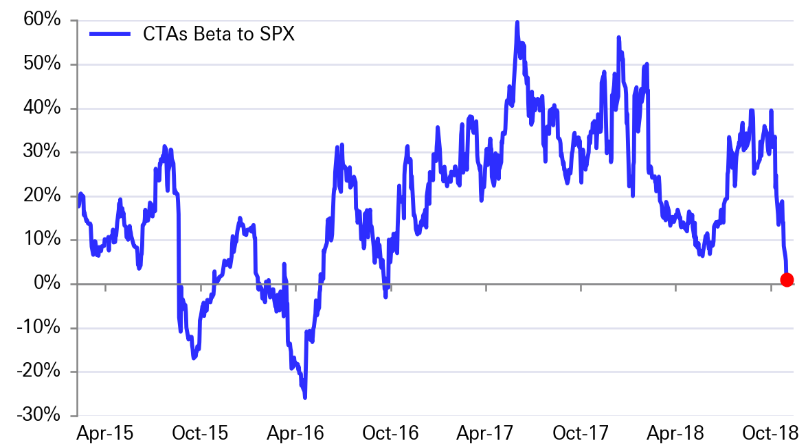
Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, SEC filings, Bloomberg Finance LP, Data as of 1-Nov-18

Figure 19: CTAs cut S&P 500 exposure and added to Gold short



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, SEC filings, Bloomberg Finance LP, Data as of 1-Nov-18

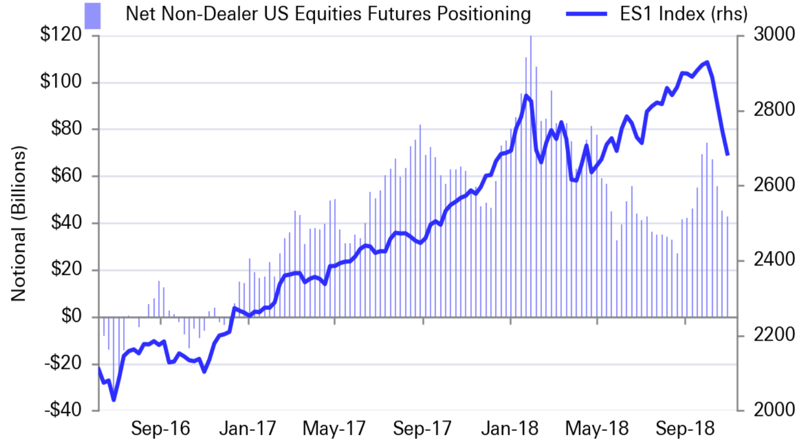
Figure 20: Aggregate CTA beta to S&P 500 is close to zero, and some funds likely turned short



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, SEC filings, Bloomberg Finance LP, Data as of 1-Nov-18

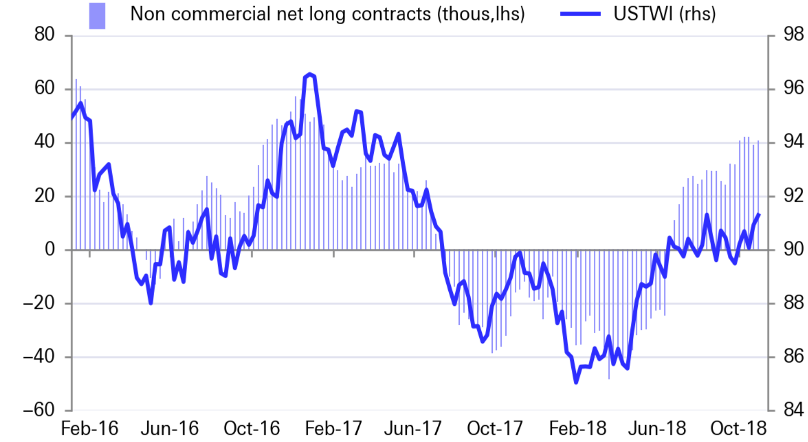
Futures Positioning: US Equities, USD, WTI Oil, & 10Y Treasuries

Figure 21: US equity futures positioning



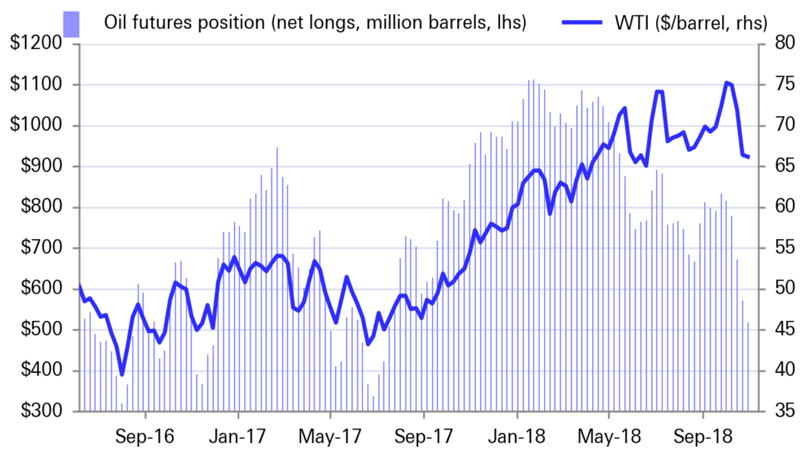
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18

Figure 22: Dollar futures positioning



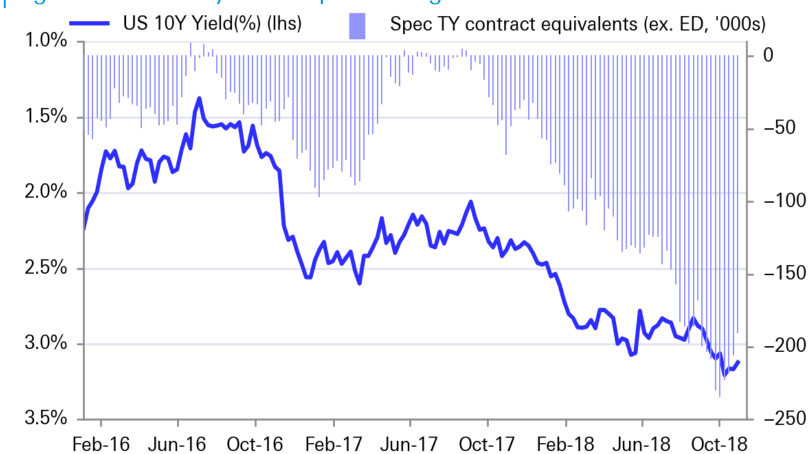
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18

Figure 23: Oil futures positioning



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18

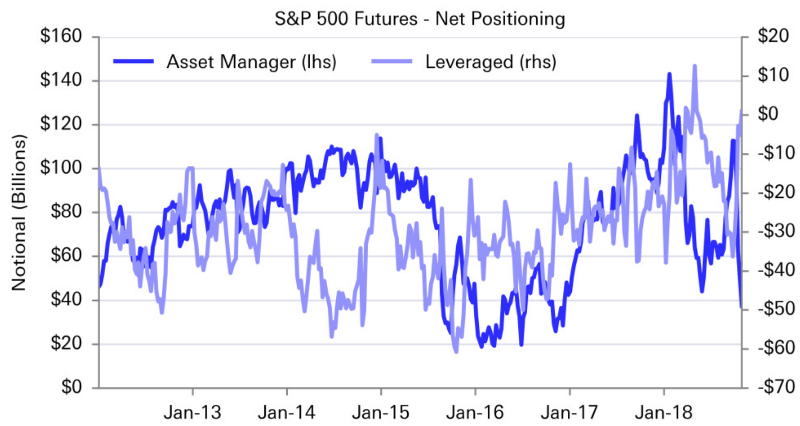
Figure 24: Treasury futures positioning



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18.

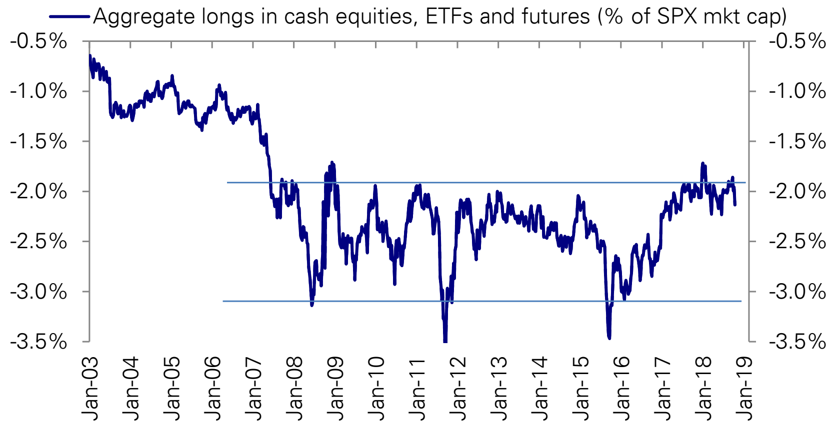
Futures Positioning: US Equities

Figure 25: Leveraged Funds and Asset Managers futures positioning



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18.

Figure 26: Aggregate futures positions and shorts in single stocks and ETFs



Note: Futures net longs minus single stock and ETF shorts. Shorts data as of Oct 15, S&P futures Oct 23

Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP.

Figure 27: Leveraged Funds have lighter US equity exposure than AMs- 1Y Percentile Ranks

	SPX	RTY	NDX	DJIA	MSCI EM	MSCI EAFE
ND-LONG	6%	19%	26%	21%	38%	43%
ND-SHORT	58%	64%	19%	100%	47%	9%
ND-NET	6%	11%	47%	9%	42%	55%
AM-LONG	42%	55%	26%	57%	62%	70%
AM-SHORT	17%	75%	72%	100%	89%	13%
AM-NET	60%	51%	23%	6%	40%	92%
LM-LONG	8%	8%	13%	15%	28%	13%
LM-SHORT	77%	34%	4%	8%	13%	36%
LM-NET	11%	15%	85%	32%	64%	26%
OT-LONG	57%	72%	96%	8%	66%	83%
OT-SHORT	87%	83%	57%	6%	75%	43%
OT-NET	15%	15%	83%	32%	28%	87%

Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18.

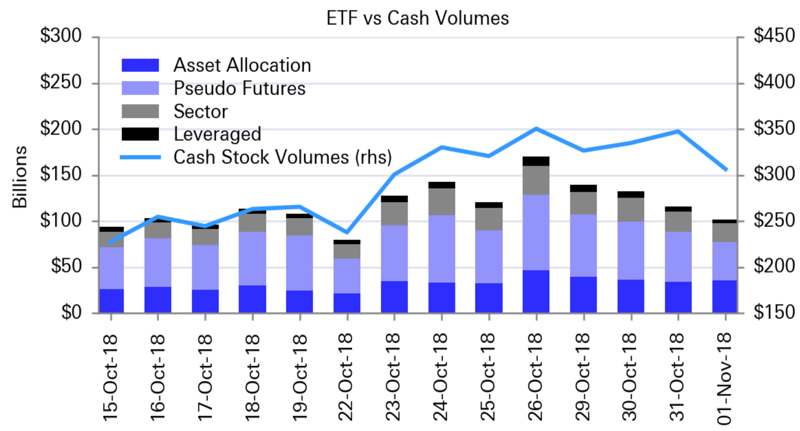
Figure 28: Leveraged Funds cut short equity exposures - 1Y Z-score of WoW Change

	SPX	RTY	NDX	DJIA	MSCI EM	MSCI EAFE
ND-LONG	-0.04	0.07	-0.63	-0.56	-1.31	-0.72
ND-SHORT	0.45	1.63	-0.54	-0.43	-0.73	0.9
ND-NET	-0.36	-1.02	-0.23	-0.37	-0.58	-1.1
AM-LONG	-0.47	0.99	-1.15	-0.33	-0.73	-2.64
AM-SHORT	1.22	1.22	-0.48	-0.63	1.81	-0.03
AM-NET	-1.05	0.58	-0.98	-0.07	-1.27	-2.38
LM-LONG	0.45	-2.04	0.8	-0.86	-1.1	0.43
LM-SHORT	-1.11	0.99	-0.28	0.22	-1.78	-0.11
LM-NET	1.08	-1.91	0.8	-0.82	0.66	0.44
OT-LONG	0.53	-0.02	1.45	0.06	-0.52	0.15
OT-SHORT	0.93	-0.16	-0.42	-0.06	-0.52	1.98
OT-NET	-0.32	0.01	0.99	0.09	0.14	-1.62

Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Data as of 30-Oct-18.

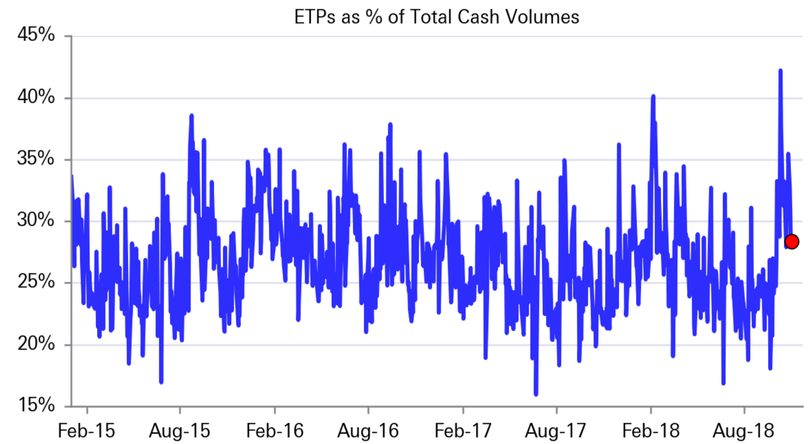
ETFs: Volumes and Flows

Figure 29: ETF volumes declined this week, while stock volumes remain elevated on earnings



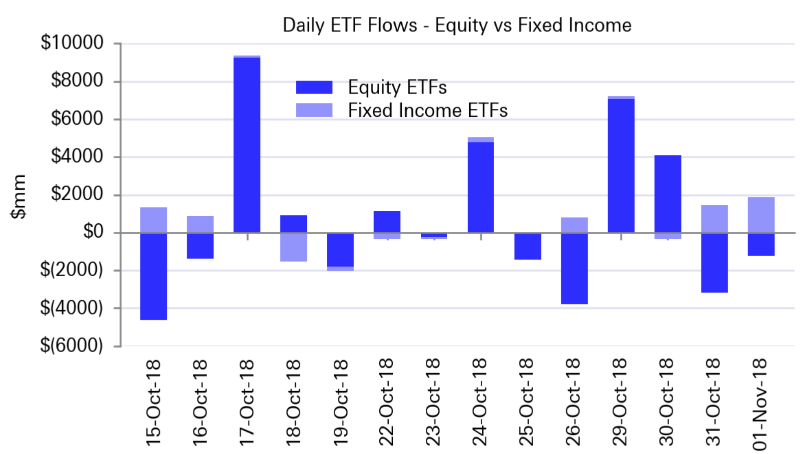
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Factset, Reuters, Bloomberg Finance LP, Data as of 01-Nov-18.

Figure 30: ETF volumes have normalized following the sell-off spike



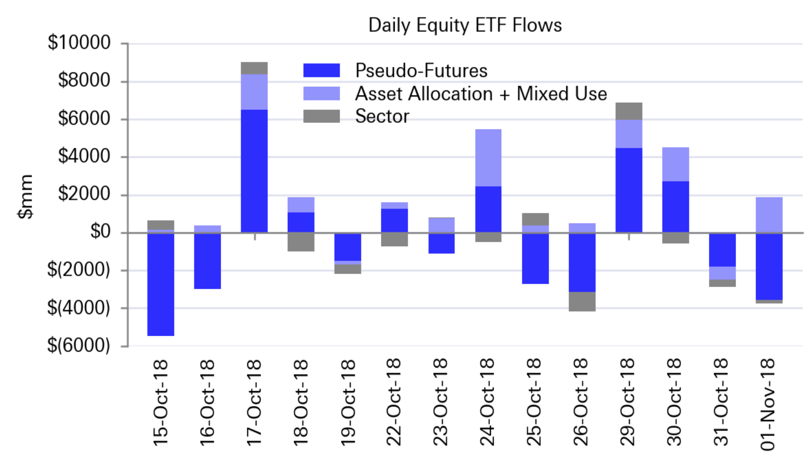
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Factset, Reuters, Bloomberg Finance LP, Data as of 01-Nov-18.

Figure 31: ETFs have seen inflows following the recent selloff...



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Factset, Reuters, Bloomberg Finance LP, Data as of 01-Nov-18.

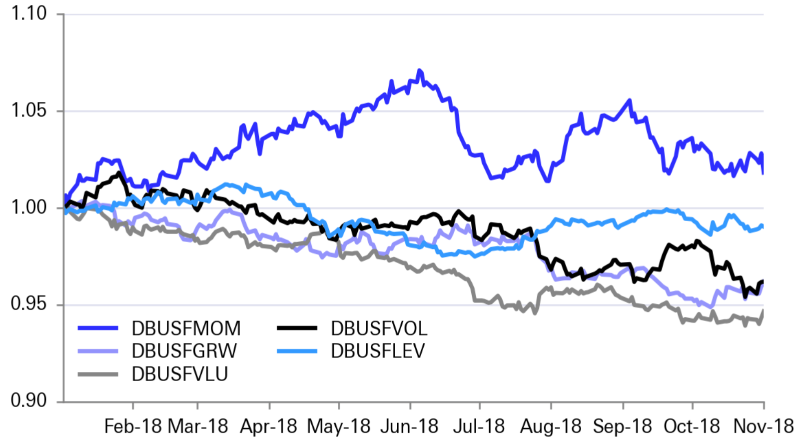
Figure 32: Outflows from equity ETFs have been driven by pseudo-futures, not likely asset allocation



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Factset, Reuters, Bloomberg Finance LP, Data as of 01-Nov-18

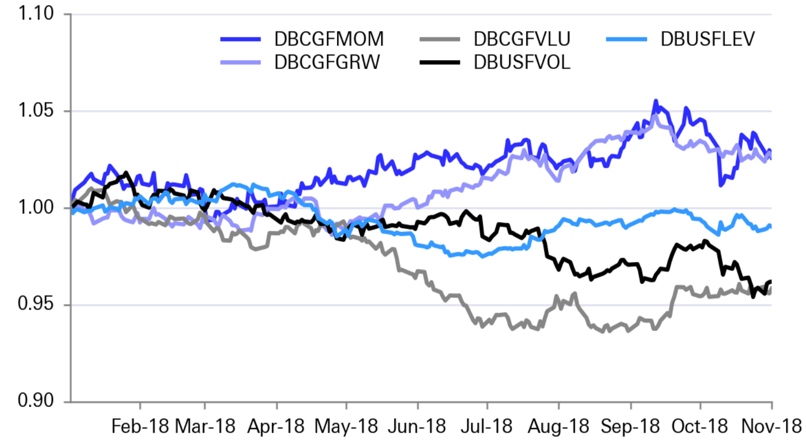
Equity Premia: Fast Factors, Hedge Funds, Themes

Figure 33: US Fast Factors: Momentum underperformed amid muted factor returns



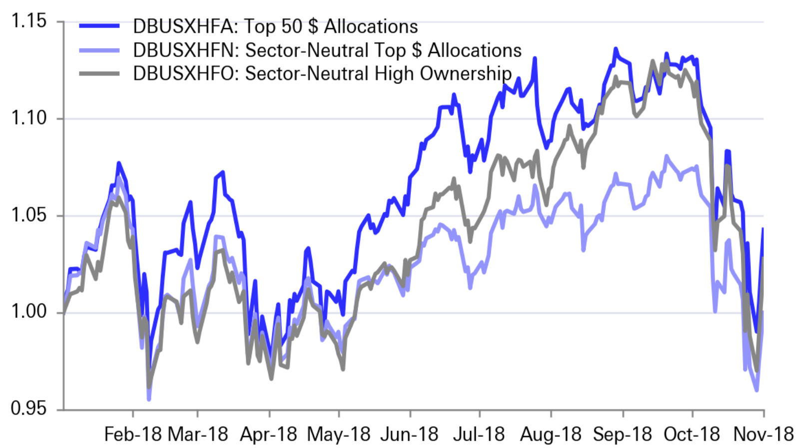
Source:Deutsche Bank Quantitative & Delta-1 Strategy, Axioma, Factset, Bloomberg Finance LP, Data as of 01-Nov-18

Figure 34: Europe Fast Factors: Residual Volatility showed signs of recovery last week, suggesting improving risk sentiment



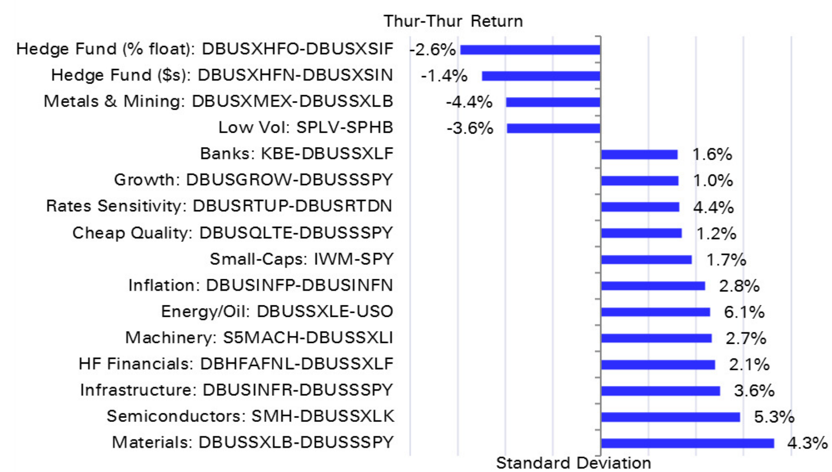
Source:Deutsche Bank Quantitative & Delta-1 Strategy, Axioma, Factset, Bloomberg Finance LP, Data as of 01-Nov-18

Figure 35: Hedge Fund: Top $-allocations proxy saw 4 stdev move during the week's selloff before a sharp recovering



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, Axioma, Factset, Bloomberg Finance LP, Data as of 01-Nov-18

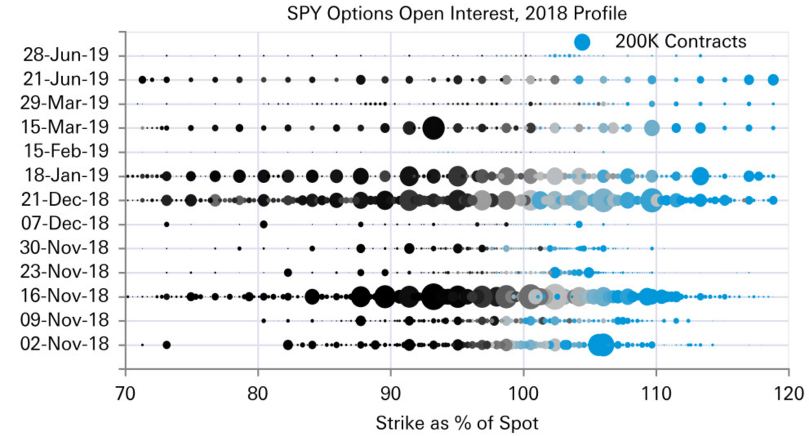
Figure 36: Thematic Baskets: Materials, Semiconductors, Infrastructure outperformed over the week, while DB hedge fund deleveraging proxy underperformed



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Axioma, Factset, Bloomberg Finance LP, Data as of 31-Oct-18

S&P 500 Options: Open Interest, Vol, Skew, Correlation

Figure 37: SPY open interest remain concentrated at 90-110% spot with further monetization of ITM puts

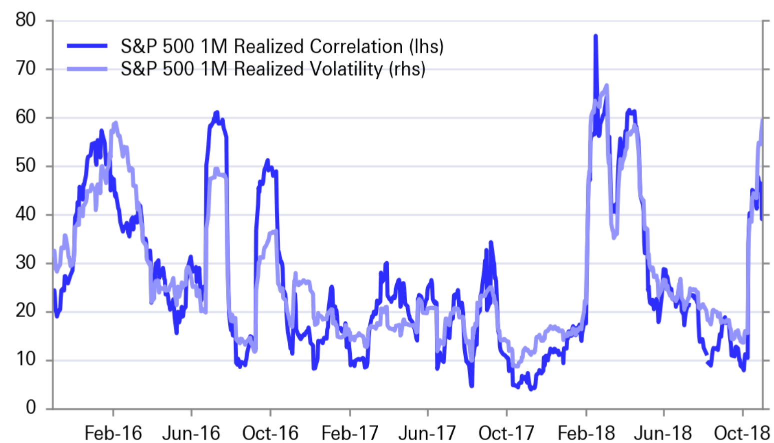


Source: Deutsche Bank Quant & Delta-1 Strategy, OptionMetrics, Bloomberg Finance LP. Data as of 31-Oct-18.

Figure 38: Put-call ratio currently at the lowest level since early 2017

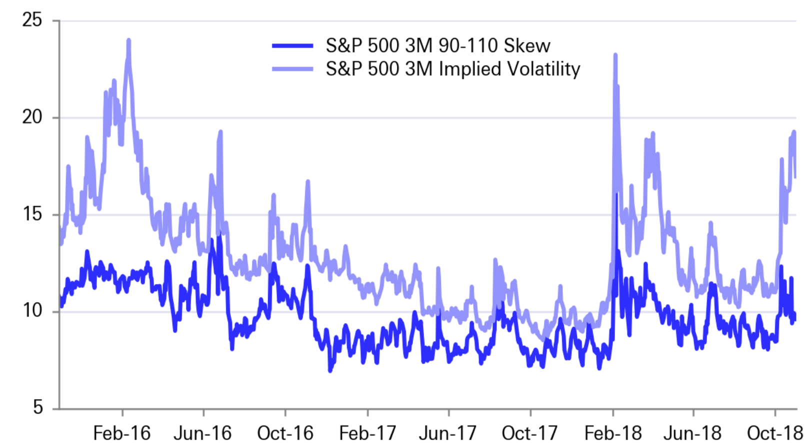
Source: Deutsche Bank Quant & Delta-1 Strategy, OptionMetrics, Bloomberg Finance LP. Data as of 31-Oct-18.

Figure 39: Realized volatility increased while correlation declined, suggesting stock volatility increased on average last week



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP, Reuters. Data as of 01-Nov-18.

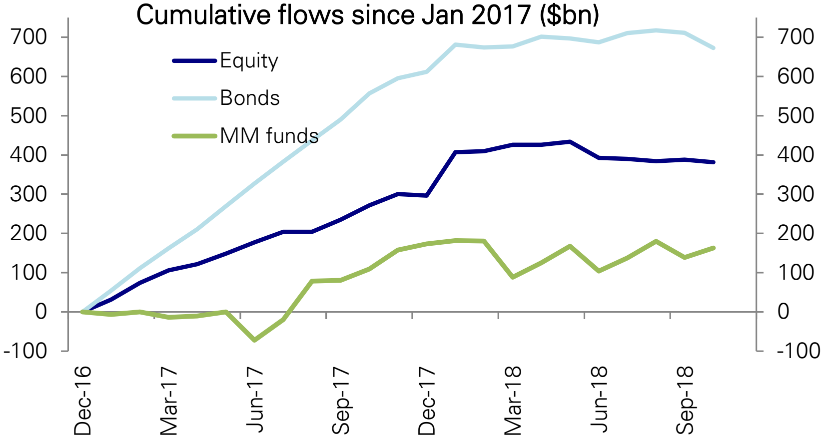
Figure 40: Implied volatility remain elevated in recent weeks



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, Bloomberg Finance LP, Reuters. Data as of 01-Nov-18.

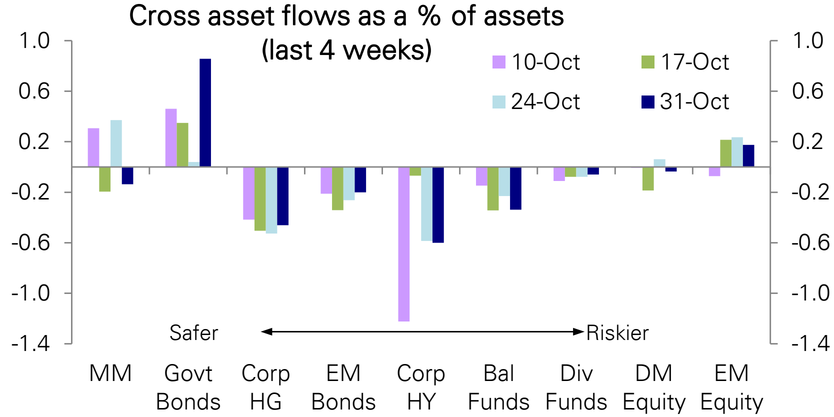
Cross-asset flows

Figure 41: Flows across asset classes cumulative since 2017



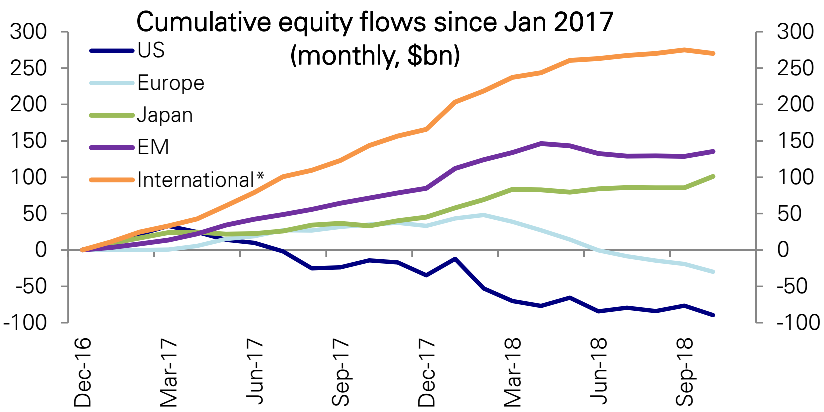
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

Figure 42: Cross asset flows last 4 weeks



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

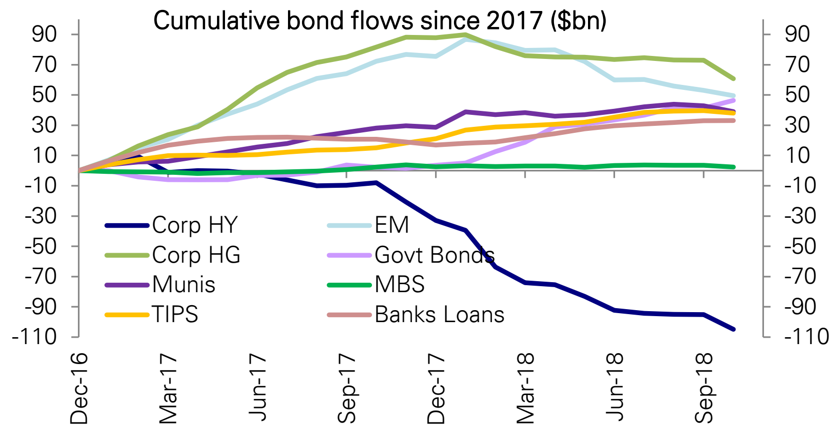
Figure 43: Equity flows across by region



*Funds with a global mandate, overwhelmingly tend to be focused on DM ex-US

Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

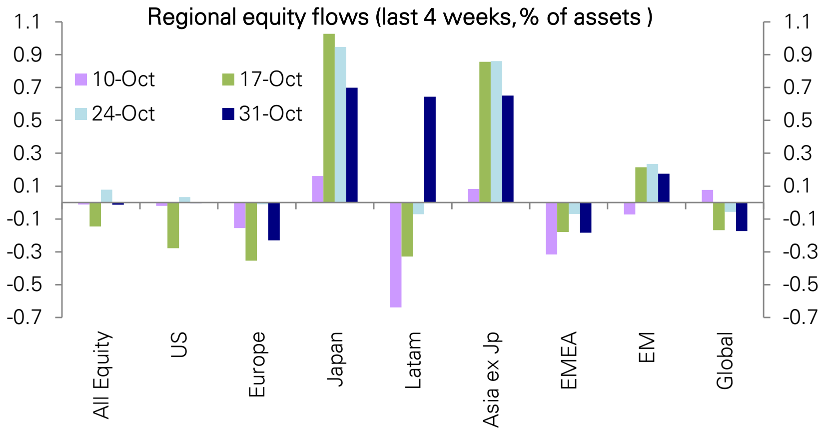
Figure 44: Bond flows by category



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

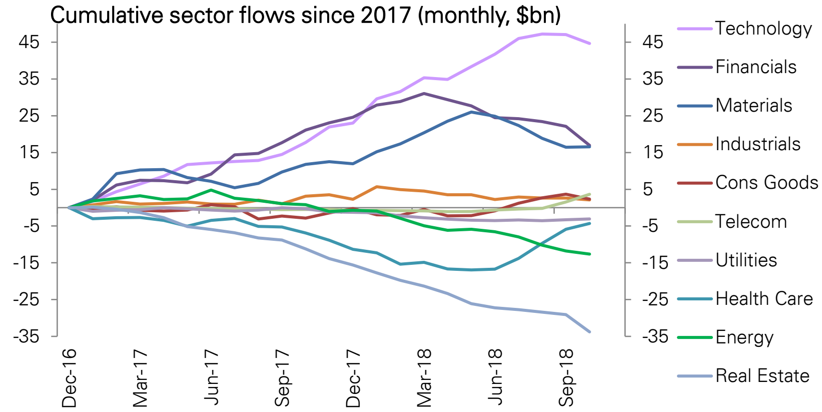
Equity Flows

Figure 45: Regional equity fund flows last 4 weeks



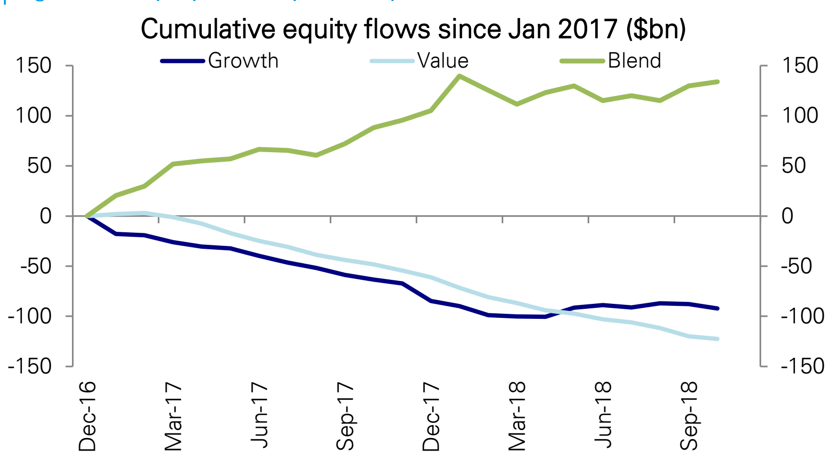
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

Figure 46: Sector fund flows



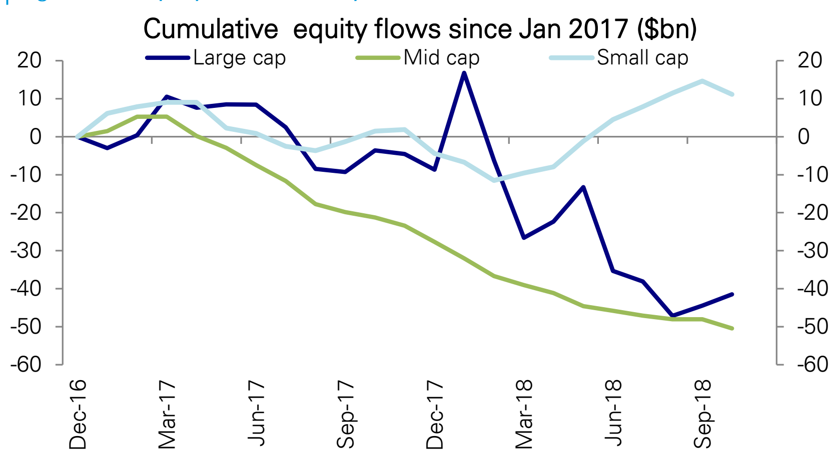
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

Figure 47: Equity flows by fund style



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

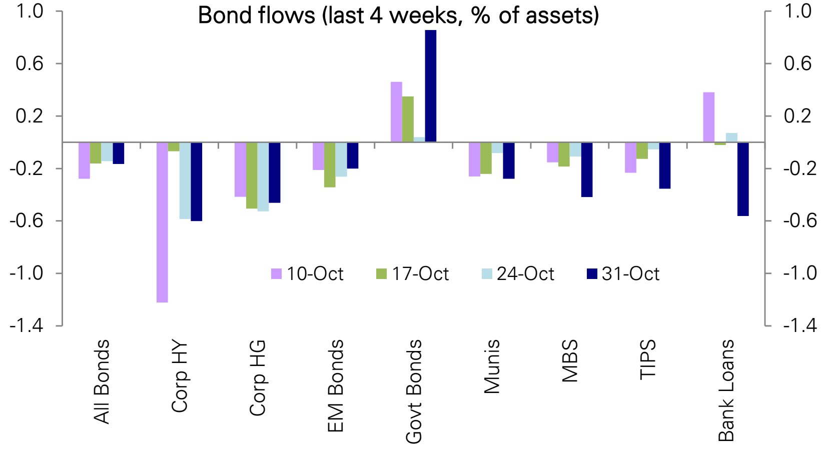
Figure 48: Equity fund flows by size



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

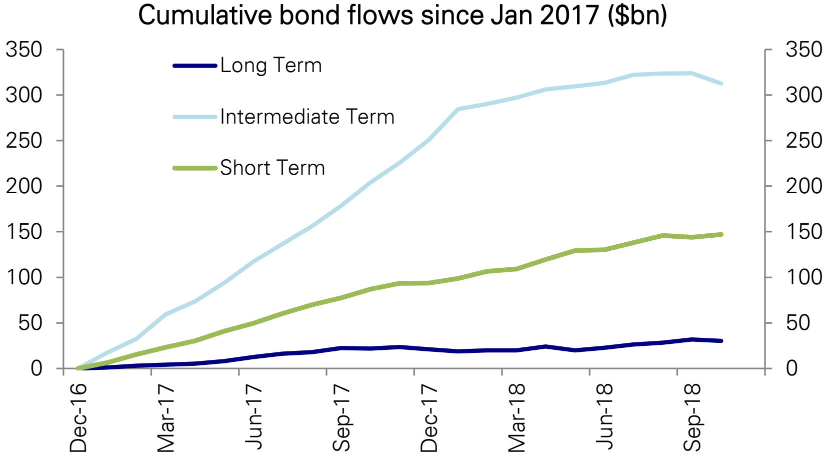
Bond fund flows

Figure 49: Bond fund flows by category last 4 weeks



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

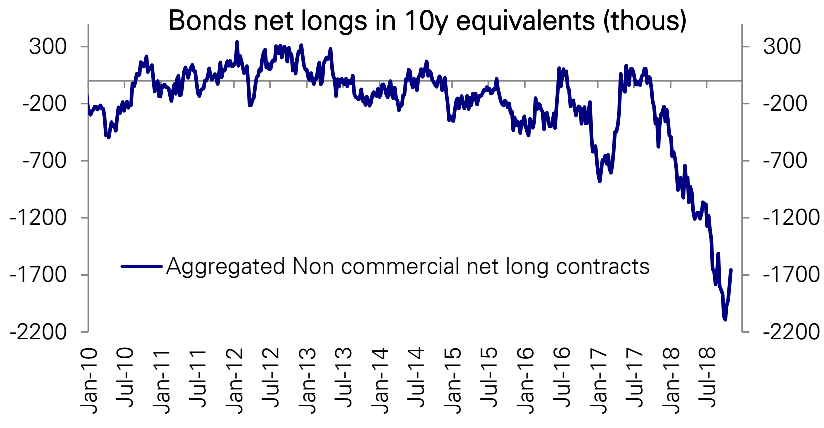
Figure 50: Bond fund flows by maturity



Source:Deutsche Bank Asset Allocation & Delta-1 Strategy, EPFR, Haver Analytics, Data as of 31-Oct-18

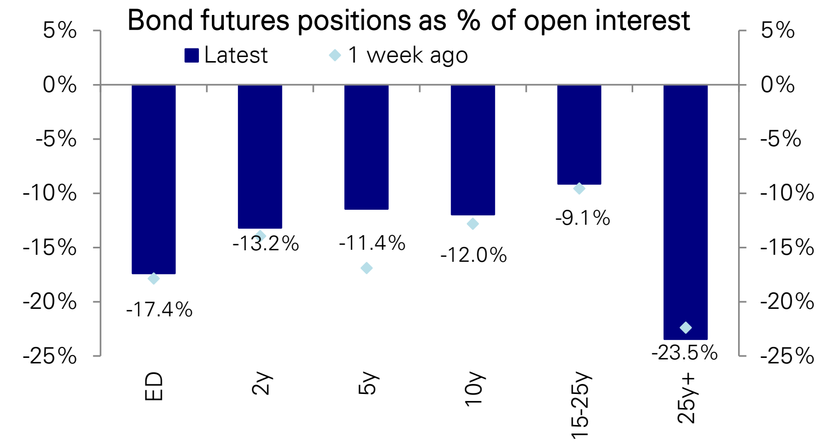
Bond futures positioning

Figure 51: Aggregate bond futures positioning



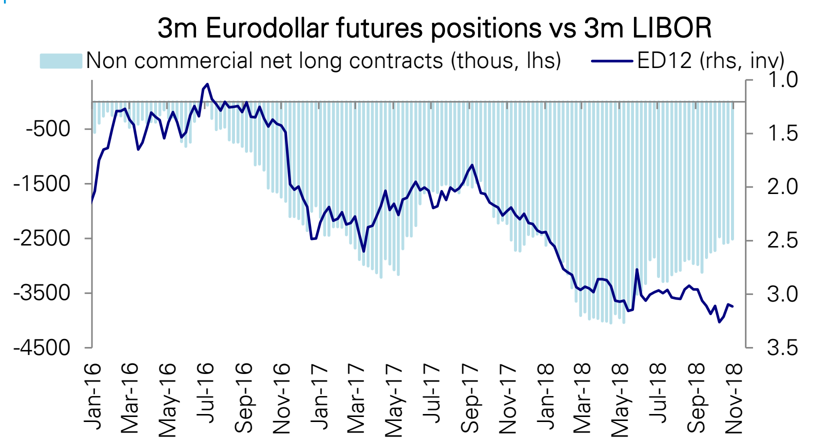
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Haver Analytics, Data as of 30-Oct-18

Figure 52: Bond futures positioning by maturity



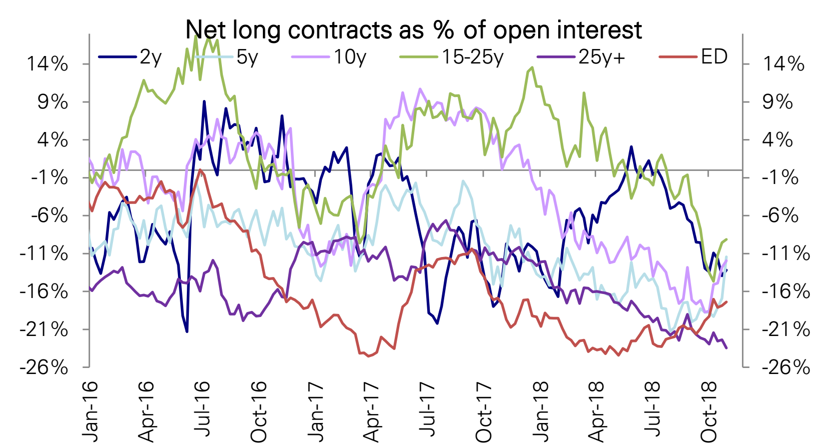
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Haver Analytics, Data as of 30-Oct-18

Figure 53: Eurodollar futures positioning



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Haver Analytics, Data as of 30-Oct-18

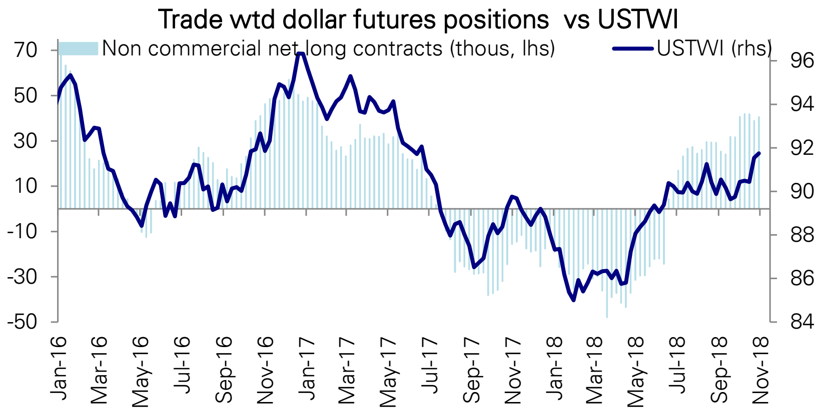
Figure 54: Bond futures positioning by maturity



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Haver Analytics, Data as of 30-Oct-18

FX futures positioning

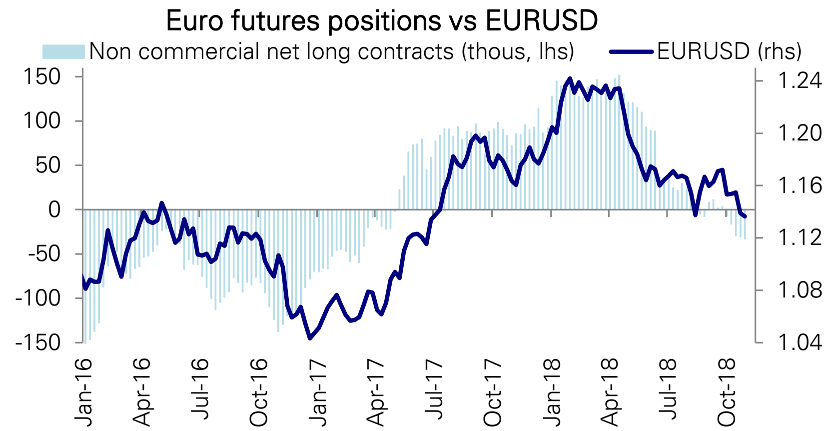
Figure 55: Trade weighted dollar positioning



Trade weighted positions in JPY, EUR, GBP, AUD, CHF and CAD are used for calculating

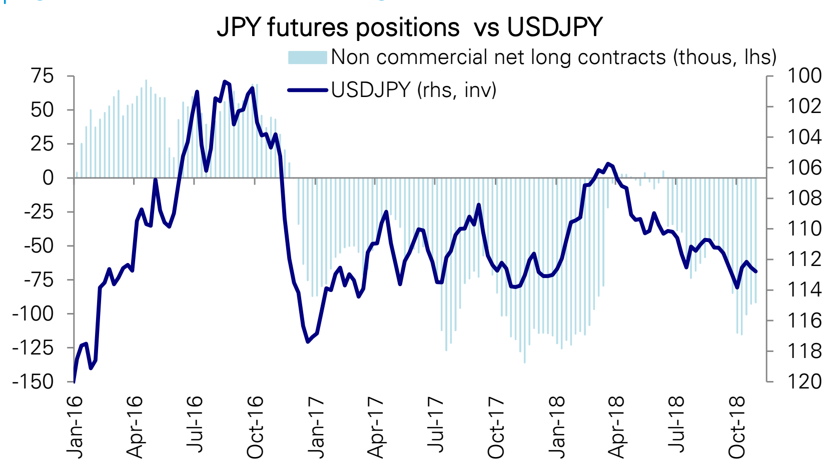
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, FRB, Haver Analytics, Data as of 30-Oct-18

Figure 56: Euro futures positioning



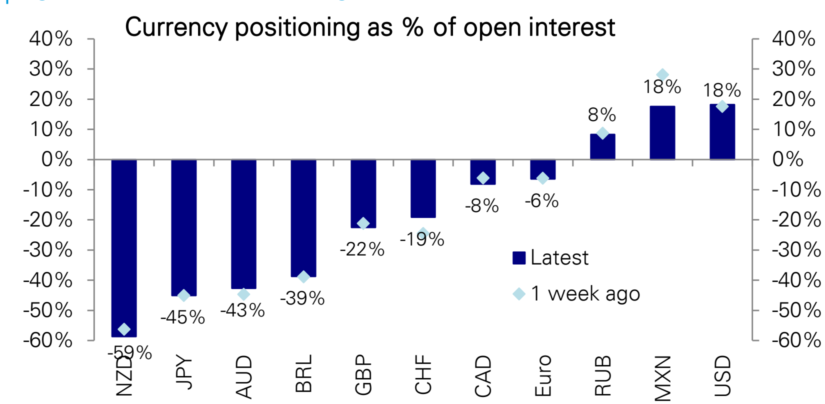
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, FRB, Haver Analytics, Data as of 30-Oct-18

Figure 57: Yen futures positioning



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, FRB, Haver Analytics, Data as of 30-Oct-18

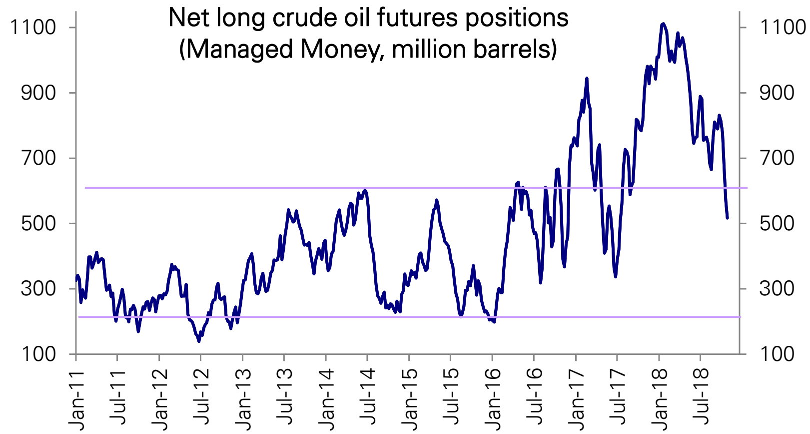
Figure 58: Futures positioning across currencies



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Haver Analytics, Data as of 30-Oct-18

Commodity futures positioning

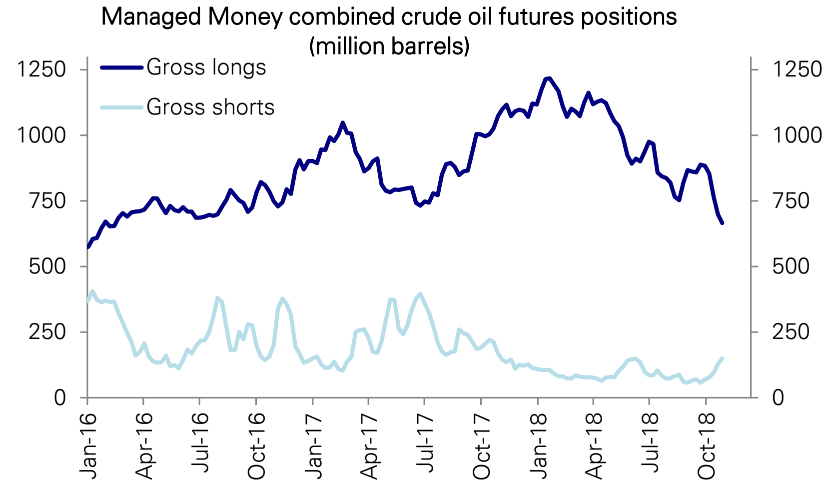
Figure 59: Oil futures positioning



Note: Net positions of combined WTI and Brent crude oil positions

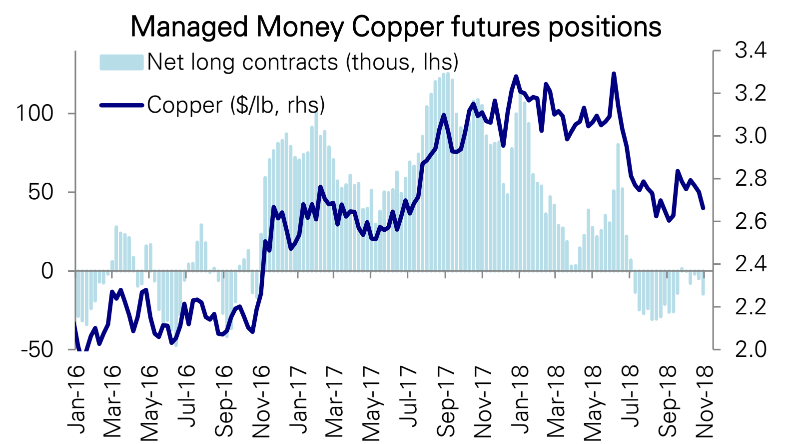
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Haver Analytics, Data as of 30-Oct-18

Figure 60: Oil futures gross longs vs shorts



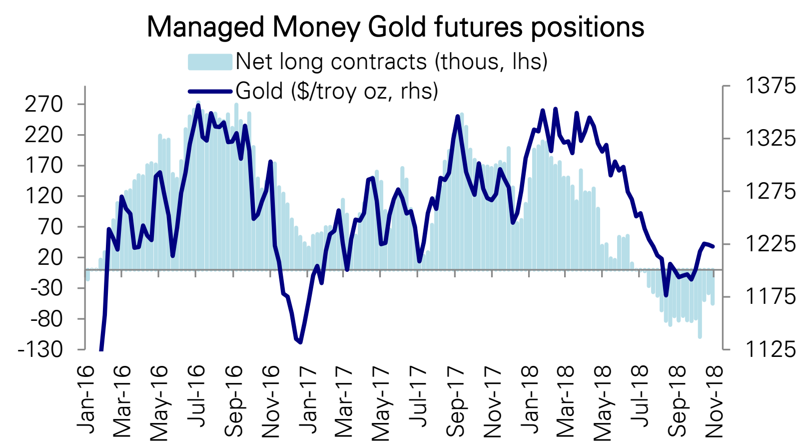
Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Haver Analytics, Data as of 30-Oct-18

Figure 61: Copper futures positioning



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Haver Analytics, Data as of 30-Oct-18

Figure 62: Gold futures positioning



Source: Deutsche Bank Asset Allocation & Delta-1 Strategy, CFTC, Bloomberg Finance LP, Haver Analytics, Data as of 30-Oct-18

Appendix 1

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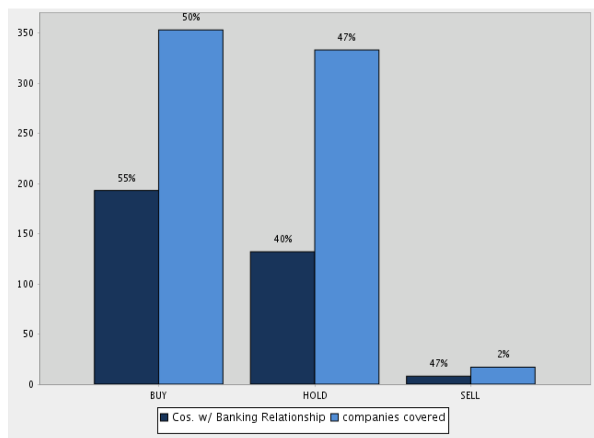

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