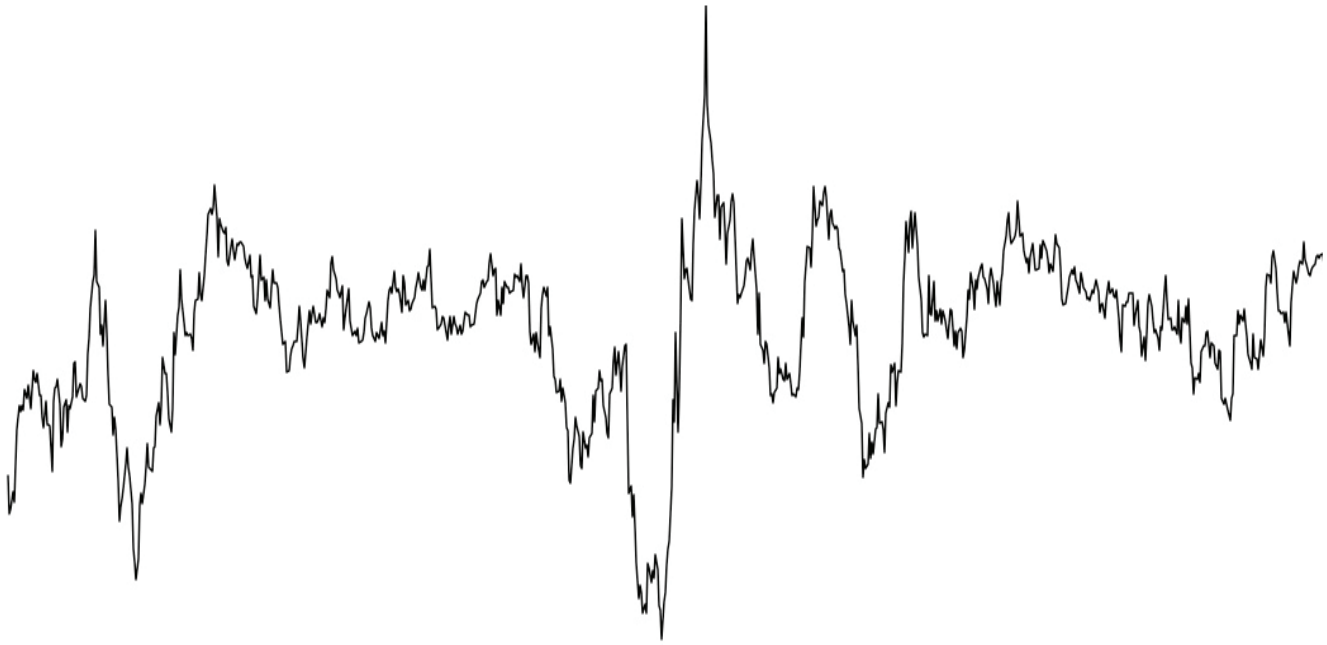
ALPHA SOURCES

JANUARY 22, 2018



EQUITY MODEL = #N/A

Apparently, the flogging of the dollar will continue until morale improves. I said my peace on the topic last week, but that hasn't prevented markets from upping the pressure on the greenback. The prospect of a government shutdown added to the pain last week—it is now a reality—but so far other markets haven't taken note. Bond yields have been rising, although not faster than before the dollar was taken to the woodshed. And equities… well, it's looking pretty good, isn't?

Global equities rallied incessantly last year, and they have come out swinging in 2018. The MSCI World is up a punchy 4.3% year-to-date, and we aren't even through the first four weeks of trading. In case you're wondering, this pace would deliver a cool 74.5% return for the year, if sustained.

Even the most ardent equity bulls probably don't believe that, but I am starting to wonder what exactly we're supposed to expect. **I have also reached the stage where I am struggling to make sense of my equity models.** I concede that the technical picture is mixed. My normalised put/call ratio on the S&P 500 has collapsed, indicating that few investors are bothered to hedge. Breadth, however, remains resilient, hinting the big bear is still far away.

EQUITY MODELS DO NOT COMPUTE

My other equity models are screaming at me to run for the hills, and I am starting to run out of excuses for global equities, especially in the U.S.

A drubbing of the dollar is part of the story; Eurozone equities, for example, are flat in local currency terms since the middle of last year. By contrast, non-US investors with large holdings of U.S. equities have seen their unhedged performance diverge significantly from the impressive headline push higher in the indices. **U.S. equity strategists who stick their neck out with a bearish call are in part calling for a rebound in the dollar.**

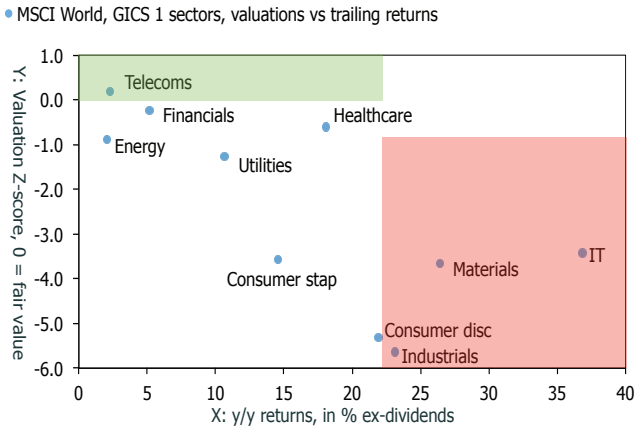
Currency effects notwithstanding, the message from my U.S. equity models is uniformly bearish. The first chart below shows one of my fundamental models for the S&P 500. It prices Spoos in relation to the other major asset classes, all in USD terms. The performance of the S&P 500 is currently diverging from other major asset classes to an extent never seen before, at least in this data sample.

On Friday, the model pointed to a fair value of S&P 500 at 2400, 16% lower than its present level. My other model, which derives a value for the S&P 500 relative to other global equity indices, is less downbeat. It suggests that Spoos should be trading hands at 2615, 9% below its Friday close.

Headline valuations don't offer much uplifting news either, for U.S. and other global indices alike. **The price-to-sales ratio on the S&P 500 is now in the 99th percentile based on data going back to 1991.** The corresponding number for the MSCI EU ex-UK and the MSCI EM is 87th and 88th, respectively.

Nosebleed valuations have been a fact of life in equity markets for an eternity. The silver lining is that sector rotation has provided opportunities to participate in the market, even for investors with a hint of value-oriented methodology. That is still the case. The second chart below shows that telecoms, financials, energy and healthcare still a semblance of value. That said, if I look at the charts of these sectors—

fig. 01 / One of them is wrong — fig. 02 / Is there anywhere to hide?



with the exception of telecoms—I am starting to wonder whether there is any place to hide at all. For their part, growth-focused investors will laugh at my affinity to telecoms, accusing me of stepping into the quintessential value trap. To that, I retort that they will have their comeuppance soon enough.

The first chart below shows the trailing returns of the NASDAQ, and my forward-looking valuation score. The outlook is for pain. **No one who reads this will sell NDX based one of my homegrown models, but at least consider the fact that the good news—even in Bezos' shop—has been priced in, at least in the medium term.**

GIMME BONDS THEN!

Last week I proposed the idea that bonds were starting to create value, both in absolute terms and relative stocks. But the consensus seems to be in the other direction. Equity eggheads on Bloomberg TV have been solemnly promising viewers that the real "melt-up" in equities won't begin before investors sell their bonds and buy stocks, in size. I suppose that is possible, but colour me scecptical.

I think it is easier to imagine a world in which yields go up at the same time as equities come under pressure. With respect to the alternative, it is bumping up against stock-to-bond return ratios that are starting to look stretched. It also has to overcome the fact that the trailing dividend yield on the S&P 500 is now lower than the U.S. 10-year yield.

The second chart below shows that punters are now turning wholesale negative on bonds. Speculators have been net short two-year notes for ages, which has been a good trade as yields have caught up with the reality of a more aggressive Fed. Positioning can get more extreme, but also suggests that bearish sentiment on bonds could be sensitive to a change in the story. As a GBP based investor, the combination of a U.S. two-year yield above 2% and GBPUSD closing in on 1.40 currently looks much more attractive than chasing equities higher. I have begun to position the portfolio accordingly.

fig. 03 / On borrowed time — fig. 04 / How bearish can markets get on bonds?