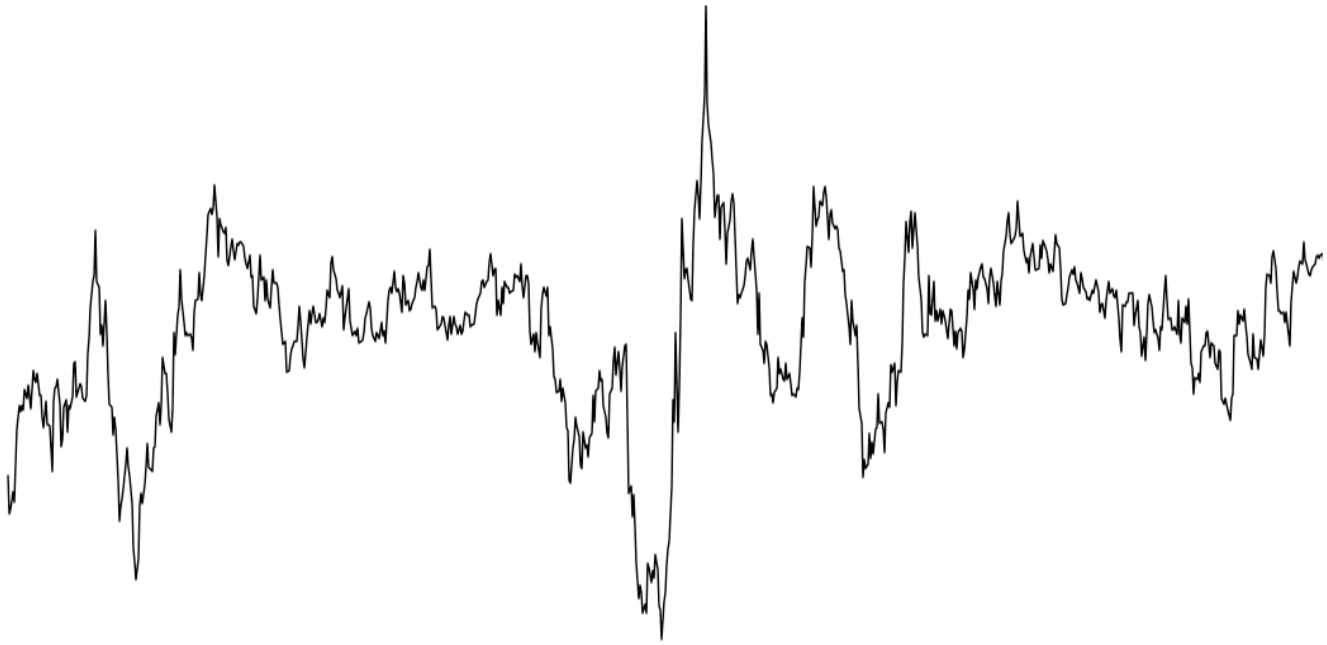
ALPHA SOURCES

APRIL 3, 2018



IT'S COMPLICATED

Last week I complained about information overload, but as we close the book on Q1, the overall story is relatively simple: **It has suddenly become a lot more difficult for investors to extract value from markets across all major asset classes.** My first chart shows what happened at the start of the year. Specifically, it shows the volatility-adjusted performance of the main asset classes in Q1 compared with their recent 12 month performance. The butcher's bill for anyone who haven't been sitting on piles of cash, and long volatility exposure, has been large. Equities have struggled, bond yields have increased, the dollar has weakened, again, while commodities and gold have outperformed.

The volte-face in equities has been extraordinary. The MSCI World, in dollar terms, was down 1.2% in Q1, while its 90-day volatility increased by about 55% compared to the 360-day trailing volatility. This is in stark contrast to the trend before the swoon at the start of February, when low volatility and a gentle rise in headline indices were the only the story that mattered. Across regions, emerging market equities have done relatively well, eeking out a small positive return in Q1. The S&P 500 is flat—the NASDAQ is up marginally—while European and Japanese equities

have been underperforming—in local currency terms—primarily because these indices are very sensitive to FX.

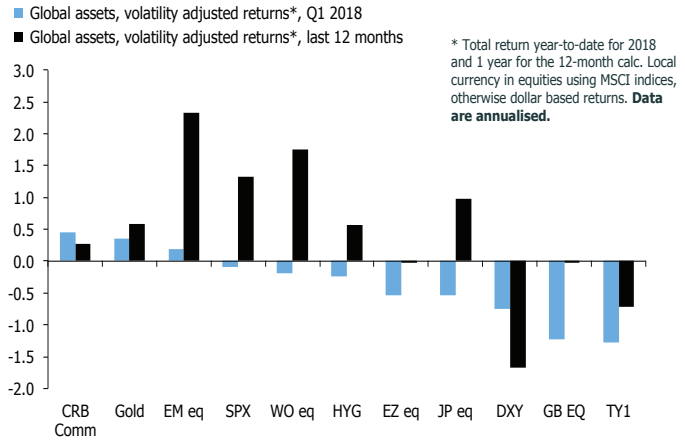
The benchmark high yield index—HYG US equity—also have struggled, although we haven't talked much about it. This is surprising given the sharp increase in benchmark rates and the collapse in inflows to the HYG, and net new HY flows tracked by the ICI.

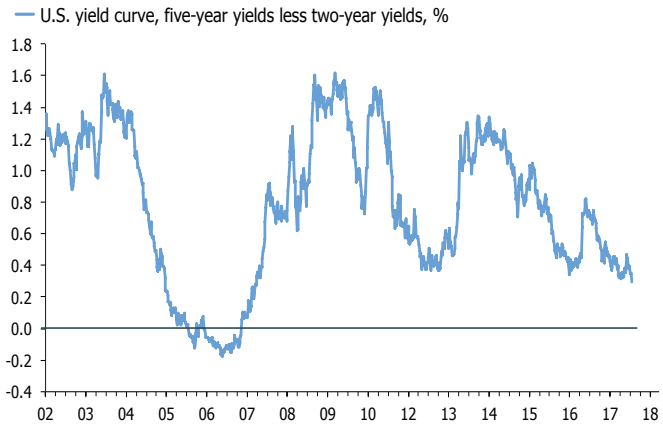
The lack of attention to the weakness in high yield is partly because the traditional source of *severe* stress in high yield credit—sharply falling commodity prices—has been absent. But it is probably also because a plethora of other stories has been grabbing investors' attention. Maybe a further rout in Tesla's bonds or a downgrade in GE's credit rating will propel corporate bonds back to the agenda. *If we continue to see, and talk about, higher short-term rates—be it 3m LIBOR or 2-year yields—it ought to spill over into stress for borrowers exposed to variable rate lending or those with an overweight of short-term debt liabilities.* In most cases, such borrowers are found in high yield space.

In the textbook world of diversification and modern portfolio theory, weakness in risk assets is offset by outperformance in government bonds. This, in turn, provides a measure of relief for balanced portfolios when volatility increases. In the first quarter, however, rates have pushed higher across the curve, leaving U.S. 10-year futures at the *bottom* of the pile among the main global assets. The long bund re-asserted itself at the end of the quarter, but not enough to change the main story.

We will continue to spend a lot of time in Q2 discussing rates. The Fed's reaction function seems clear. Unless the world falls apart, the hiking cycle will continue. A terminal rate of 3%-to-3.5% appears to be the consensus. But how quickly the Fed gets there, if at all, depends on rates further out the curve. For all the talk about fiscal-stimulus induced growth above 3%—or a panic-induced rise in yields due to a rising deficit—the curve has flattened further. The second chart below shows that the spread between two and five-year yields fell to a new low in Q1. To

fig. 01 / The market giveth…and taketh — fig. 02 / Still flattening





me, a 2s5s flattening to a cyclical low, perhaps even eyeing an inversion in the next six-to-nine months, is a signal that the cycle is about to come to a screeching halt. *It is a relatively simple story about a U.S. recession, probably towards the end of next year.*

This narrative is confronted, though, by the idea that the Fed, in part, is hiking in response to stronger growth in the pipeline—due to a wider twin deficit—and that hidden slack in the labour market, and higher productivity, will accommodate such higher growth without stoking higher inflation. *We have been debating these stories for the best part of a year, and I suspect we will continue to do so in Q2.*

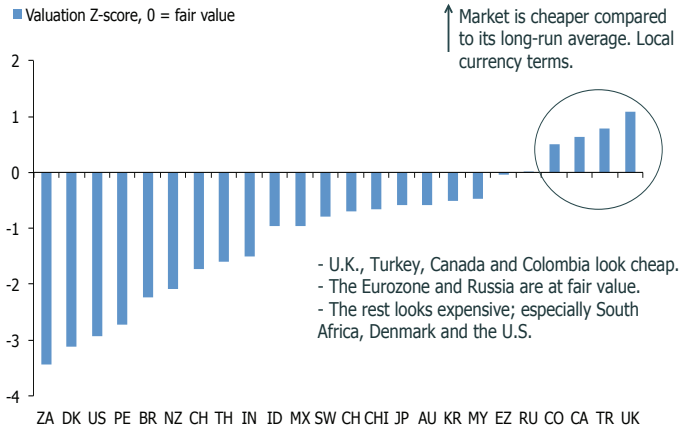
The Fed's position on all this is uncertain. Some Fed officials appear sensitive to a flattening curve, hinting that it could be enough to put the breaks on the hiking cycle. I am surprised, however, that none of them has resorted to the global savings glut. If they do, it would signal their intention to keep hiking, even if mid-to-long term rates rise more slowly than the Fed funds rate.

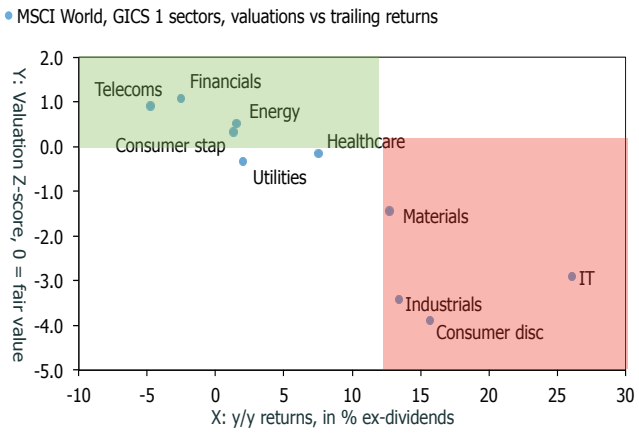
LOOK BEYOND "BUY THE DIP"

In equities, the debate will remain centered on whether investors should buy the dip. Yesterday's price action in the U.S. suggests that the answer is no, consistent with the signal from weakening global liquidity growth and most of my medium term valuation models. The put-to-call ratio does look elevated, though, indicating that a short-term reversal is increasingly likely.

Whatever happens with the ubiquitous Spoos, though, a number of key stories are playing out below the surface. **The first chart below shows that the majority of global stock indices are expensive, but the U.K., Canada and Colombia stand out as relatively cheap.** The U.K. is interesting in light of a deteriorating macro picture and increasing uncertainty over the post-Brexit environment. The question is not whether things can't get worse—they can—but whether most of the Brexit discount hasn't already been priced in. That said FTSE 100 is a global index, so Cable will play a key role in this story. Based on recent evidence, it is difficult

fig. 03 / A few good opportunities? — fig. 04 / Sector rotation to save the day?





to imagine U.K. equities performing without a weaker pound. I want to sell GBP based on fundamentals, but the chart looks bullish, so perhaps I have to wait before pulling the trigger on increasing my exposure to the FTSE 100.

Across the GICS 1 sectors, the tide seems to have turned against the major technology firms. Facebook has had to explain its privacy policies following the Cambridge Analytica revelations, which has prompted politicians and regulators to up the pressure. This story has been brewing for a while, but markets haven't been taking it seriously, up until now. **If this proves to be a narrative with staying power, technology stocks, and the market as a whole, will take a good beating.**

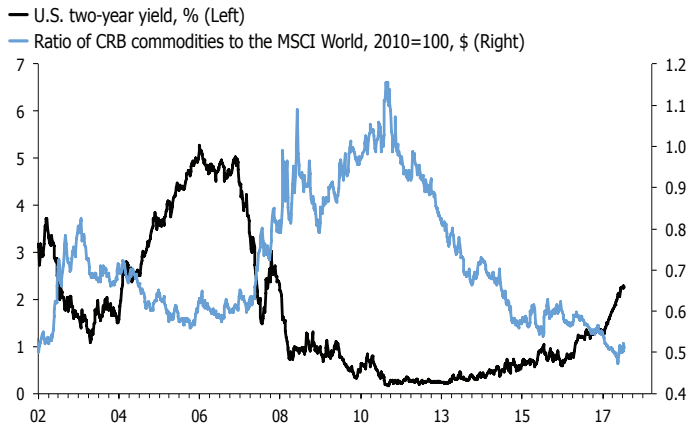
The tech story will clutter the airwaves, but the second chart on the previous page shows that other sectors look attractive. The key question is whether these stocks can rise even if the market as a whole trades sideways or slightly down. I am optimistic that they can—especially in telecoms—but I concede that it might be a long shot.

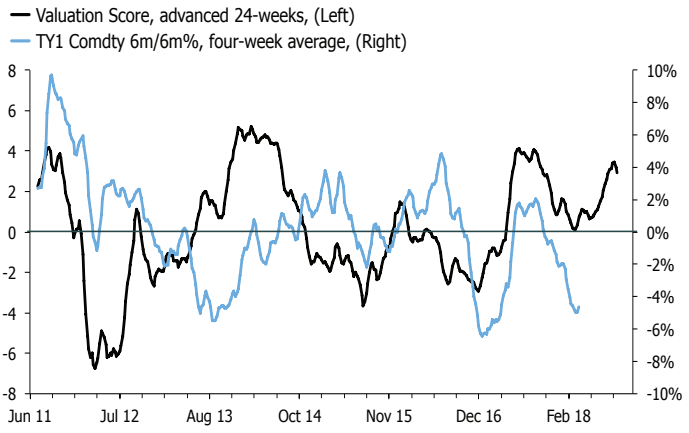
WHAT HAPPENS NEXT?

I am sympathetic to the idea that commodities continue to outperform. As far as I can see the story is that ZIRP and QE drove prices lower due to excess capacity. It stands to reason that the opposite will lead to higher prices. In addition, commodities remain close to record cheap relative to equities. The dollar, however, is key. **A soft dollar takes the shine away from the relative outperformance of commodities.** This is especially the case for non-USD investors facing rising hedging costs, a topic we have been debating in the context of rates. Even for USD portfolios, the lift from commodities exposure is a mixed blessing if it only serves to keep up with a loss of purchasing power as the dollar weakens.

Finally, I remain bullish the long bond in the U.S. My final chart suggests that returns on the U.S. 10-year are trying to carve out a bottom, and my valuation score points to further upside. Whether this happens with or without higher short-term rates is a story for another day. After all, it's complicated.

fig. 05 / Are commodities forming a bottom? — fig. 06 / The long bond in the U.S. to do well?





Source: Financial Times, February 2018