ALPHA SOURCES

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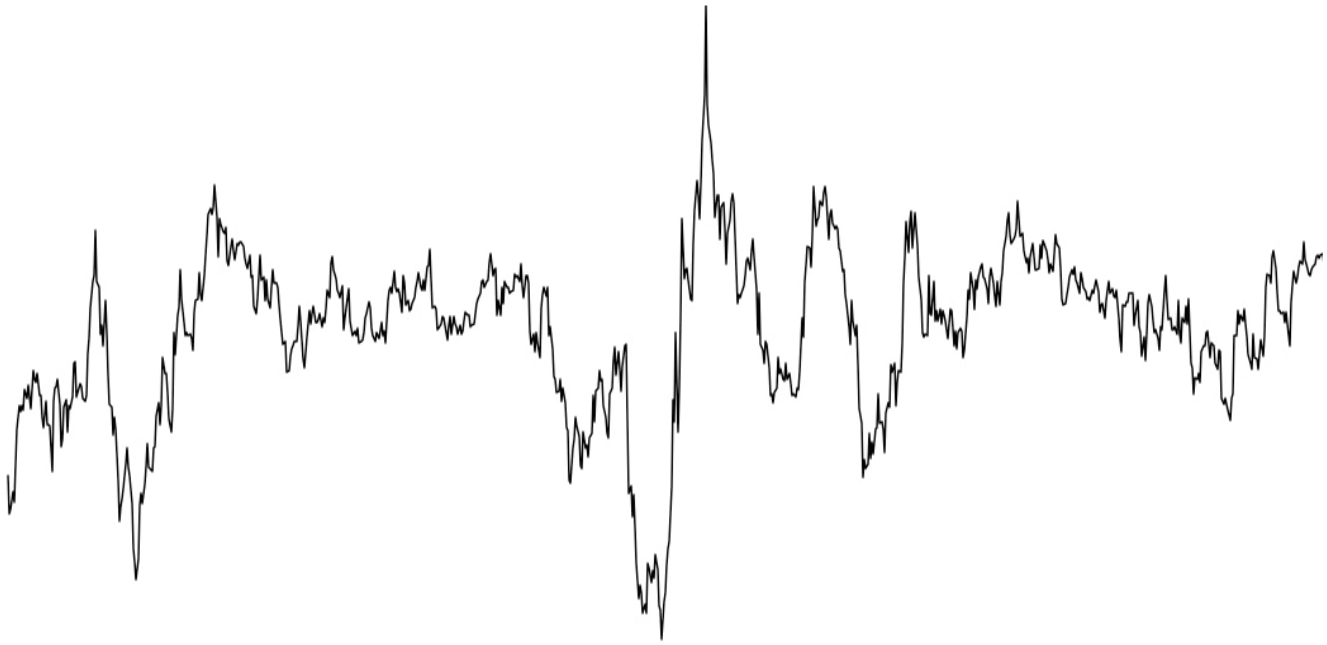

DOUBLING DOWN

I am short on time this weekend, so I am doubling down on the story I told last week, with two more charts and some additional comments. The first chart updates picture of the startling spread between price change in S&P 500 and its multiple. As of last week, the U.S. large cap equity index was down 0.2% on the year, but trailing earnings were rising just under 22%. The only way to square these two headlines is to note that the P/E multiple has crashed, from a high of nearly 23 in January to 18 today. The silver lining is easy to spot. The market is now about 20% cheaper than it was at the start of the year, a significant re-rating.

The flip side is that paying 18 times earnings for the S&P 500 is *not* egregiously cheap. **If growth in earnings roll over, a further decline in multiples would, at best, lead to stagnation; at worst, it would drive prices much lower.** That's certainly a significant risk if you consider that this year's impressive jump in earnings, at least in part, have been driven by tax cuts, which won't be repeated next year. It gets even worse if we start to change the assumptions around share buybacks, another important support for earnings growth via its denominator-reducing effect on the share count in the EPS calculation.

* / Data for charts are sourced from FRED, OECD, Eurostat, IMF, BIS, Market Watch, Yahoo/Google Finance, COT, Bloomberg, Investing.com or Quandl, unless otherwise stated.

To hammer this point home, consider a relatively conservative scenario in which the S&P 500 trades at about 18 times earnings over the next 12 months, and where year-over-year growth in EPS gradually declines to 5%. With this simulation, I arrive at a low for the S&P 500 at 2590 in April next year, before a rally to 2761 in November, on EPS of $153.2. That's 4.5% higher than today, but also about 5% lower than the high of 2900 in August. In short, I struggle to get excited about U.S. equity beta.

WHO IS RIGHT ON U.S. BOND YIELDS?

My final chart builds on my argument that the front end in U.S. treasuries is looking vulnerable to a squeeze. It shows that *speculators'* positioning is now extremely stretched to the short side. With oil prices crashing, financial conditions tightening and markets pushing the Fed for a dovish hike next month, this position is beginning to look like a sitting duck to me. This chart from Barchart.com breaks down the positioning in more detail. Interestingly, it shows that asset managers have been adding exposure to two-year futures, while leveraged funds have increased their shorts. I stand with the former.

One on the arguments that I have been championing this year is that U.S. bond yields close to, or above, 3% offer good value, especially in a world where equities are struggling. This is not a call on a Fed u-turn. I am not smart enough to ring the bell at the top of the hiking cycle, but I have two points on my side.

First, whatever happens to rates next year, the notion of the Fed being on autopilot, with 3-4 hikes a year, is now being challenged by markets. Even if the Fed manages to push short-term rates sustainably above 3%, an interim re-pricing is more than likely.

Second, with two-year yields close to, and the 10-year slightly above, 3% the U.S. interest rate structure is now very close to the Fed own's estimate of the neutral rate. To be sure, for the Fed's story to play out in full, rates need to rise further, but unless we are willing to contemplate a much higher neutral rate, a story for another day, we closer to the end than the beginning.

fig. 01 / What if earnings roll over? — fig. 02 / Priced for an accident