ALPHA SOURCES

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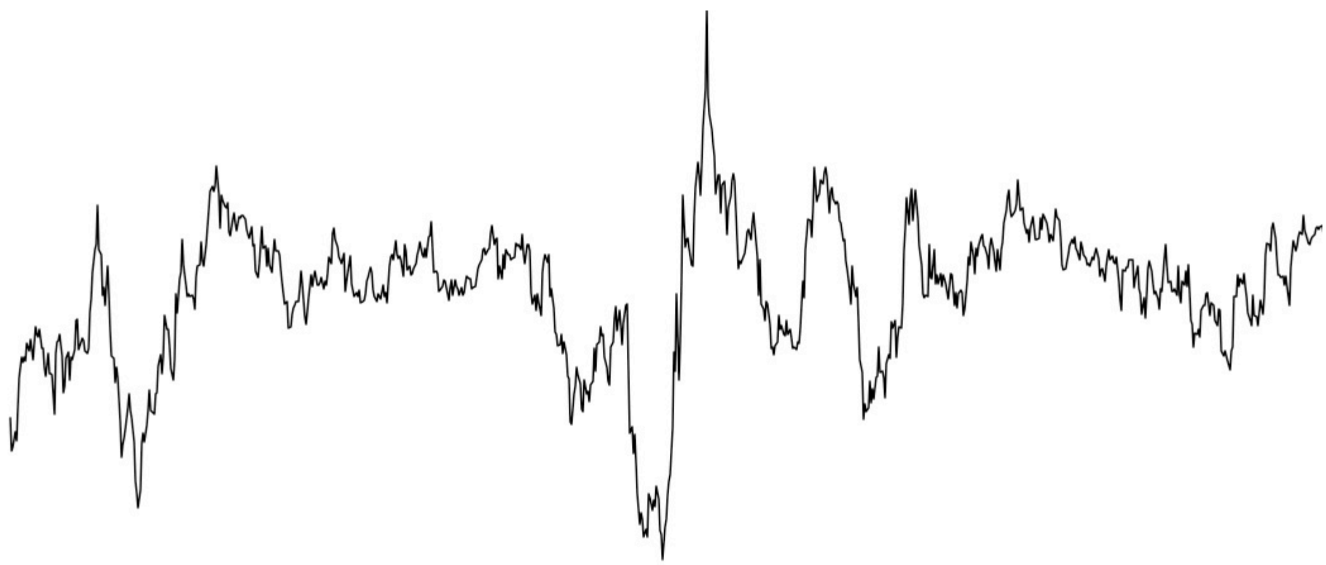

IS THE DOWNTURN OVER?

The most significant change across my favourite market charts in the past few weeks is the fact that the US 60/40 portfolio is now eking out a small *positive* gain on a six-month basis. Chart 01 below shows that my in-house 60/40 index—using the S&P 500 and the US 10y note—is now posting six-month returns to the tune of just over 1%. This reversal from a nadir in six-month returns of almost -20% earlier this year is driven by both stocks and bonds. The S&P 500 is up a bit over 10% since mid-October, and ten-year yields are off their highs. This, in turn, invites the question of whether we're seeing the beginning of a reversal in the decline in stocks, and rise in yields, which have haunted investors this year. I wish I knew. To get at an answer to the question, however, it's best to separate the equity story from the bond market story, at least to begin with.

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As a macroeconomist, my first port of call is to check whether leading indicators support the idea of a sustained reversal in the equity bear market. Unfortunately, they don't. Chart 02 shows that my diffusion index of OECD leading indicators is still pinned to the floor, pointing to a broad-based downturn in global activity. Growth in global trade and industrial production has held up, but it is now faltering. The CBP data are released with a lag, but judging by the downturn in the global PMI and the terrible Chinese trade data for November, we shouldn't hold our breath for good news towards the end of Q4. Chart 03 plots the global equity benchmark against my four-stage macro leading index. The latter remains stuck in its lowest setting, characterised by leading indicators being low and falling. Granted, equities often move ahead of leading indicators. If the rebound in equities continues into Q1, it's possible that leading indicators will flip, offering more convincing support for the idea of a sustained pick-up in risk assets. Until then, however, this looks like a bear market rally. Finally, equities remain challenged by a depressed outlook for earnings—chart 04—and multiple-compressing trend in yields and inflation—chart 05—at least as far as goes the year-over-year change in the P/E ratio.

This leads us to the outlook for inflation and the fate of the bond market. The picture on inflation is mixed. Recent data through October—chart 06—signal a turn in the DM headline inflation, a shift which should become even clearer in the next few months as base effects shift markedly for year-over-year inflation in oil-related products. The same is the gas for gas and electricity inflation in Europe, though I wouldn't nail my colours to the mast on a forecast until we see how wholesale

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gas and electricity tariffs respond to the rise in demand as cold spell takes hold over the European continent. In the core, meanwhile, my measure of DM inflation has *increased* slightly in the past few months. US and UK core inflation has crept above 6%, and in the Eurozone, core inflation hit 5% in November. To be clear, the house-view from my place of employment is that these numbers will soften soon, but also that they will remain high enough to drive further monetary policy tightening. Looking ahead, my in-house global survey indices paint a mixed picture; chart 07. Inflation pressures in services appear be picking up, indicating that underlying domestic inflation in non-tradables is resilient. By contrast, the outlook for goods inflation is softening rapidly, hinting that core goods inflation will fall sharply in the first half of next year.

The message from bond markets is the context of the inflation backdrop noted above is relatively simple. Long-term bond yields are off their highs—chart 08—resulting in deeper yield curve inversions—chart 09—as front-end yields remain close to their highs, driven by central banks' fight to quell inflation. The key question is how the inversion in 2s10s will resolve, via a fall in short-term rates or a rise in long-term rates? I think that it could be a bit of both in the end, but rate futures are sending a clear signal of over-tightening in monetary policy; chart 10 and 11. The picture is slightly different in Europe and in the US. Eurodollars suggest that the Fed will cut rates next year, but have recently pushed forward expectations of policy easing into 2024. In the euro area, meanwhile, euribors are still signaling further tightening in 2023, and that the ECB will maintain rates some 80bp higher than their end-point in 2022. For

2024, however, markets now see rate cuts, in line with the expectation for US monetary policy.

The run-down above points to a split answer to the question of whether the downturn is over. For equities, it is difficult to tell a story that the recent rebound is anything other than a bear market rally. In bonds, however, the prospect of further policy tightening certainly now seems to offer the promise of a sustained rally in duration, offering some relief for investors with diversified portfolio of stocks and sovereign bonds. If that's true, the inflation trades—chart 12—will be key to watch. I suspect the turn in the fortunes of the inflation trades is real, but it could be challenged in the first half of next year if indeed the downturn in bond prices is now over, temporarily.

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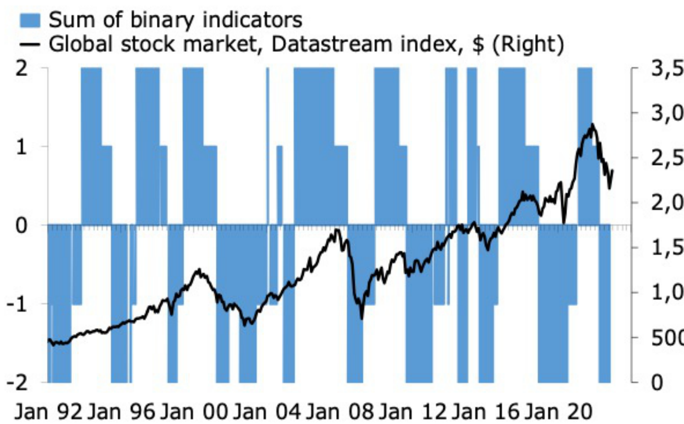
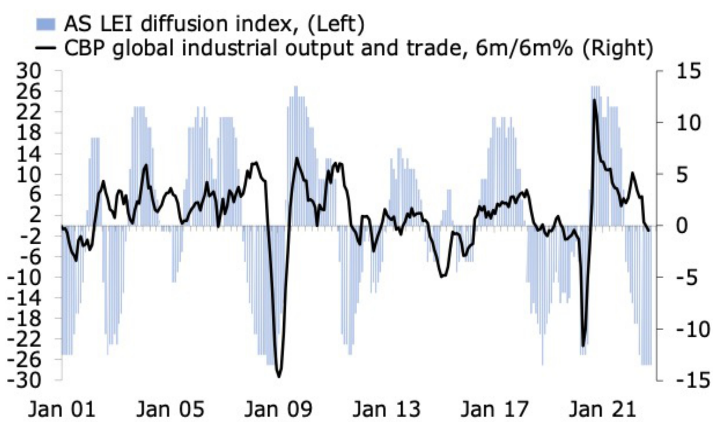
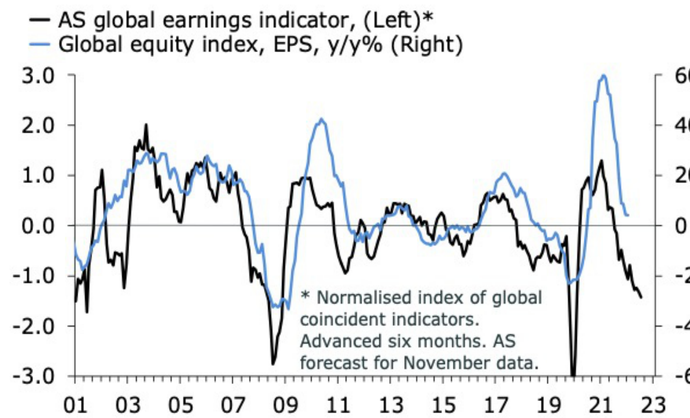
ch. 01 / A glimmer of hope… - **ch. 02** / …But LEIs are still negative for stocks…

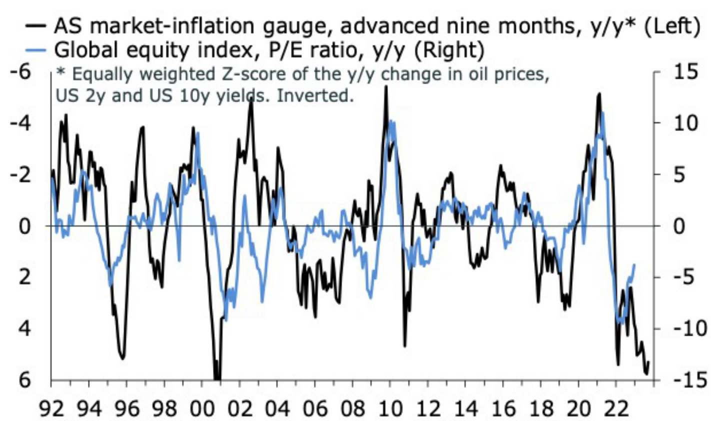


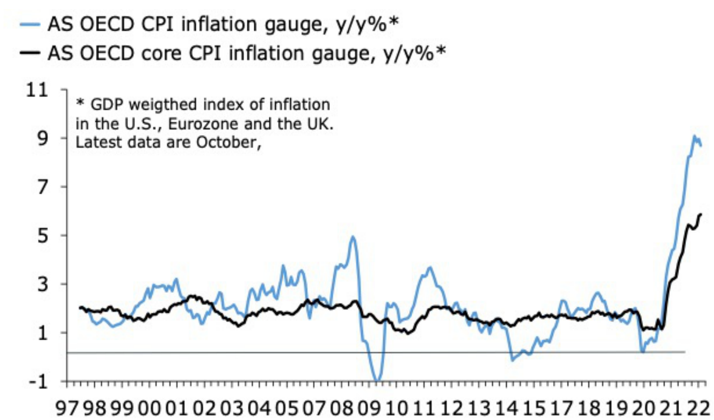
ch. 03 / The slowdown is just starting - **ch. 04** / …and is yet to fully hit earnings





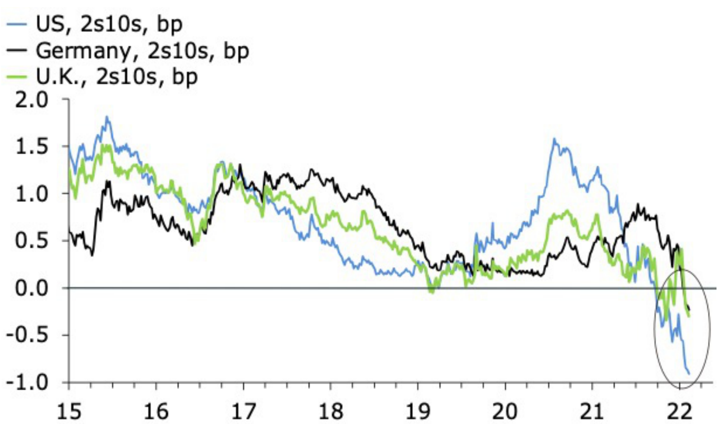
ch. 05 / Inflation is still a threat to multiples - **ch. 06** / The core is still rising…

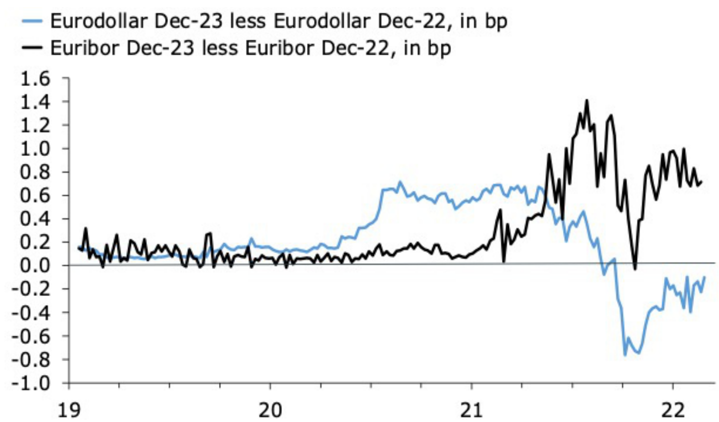




ch. 07 / …and services inflation is firming **ch. 08** / Off their highs…

ch. 09 / …Driving a deeper inversion - **ch. 10** / US rate cuts next year?





ch. 11 / The great easing in 2024? - **ch. 12** / All over for the inflation trade?