ALPHA SOURCES

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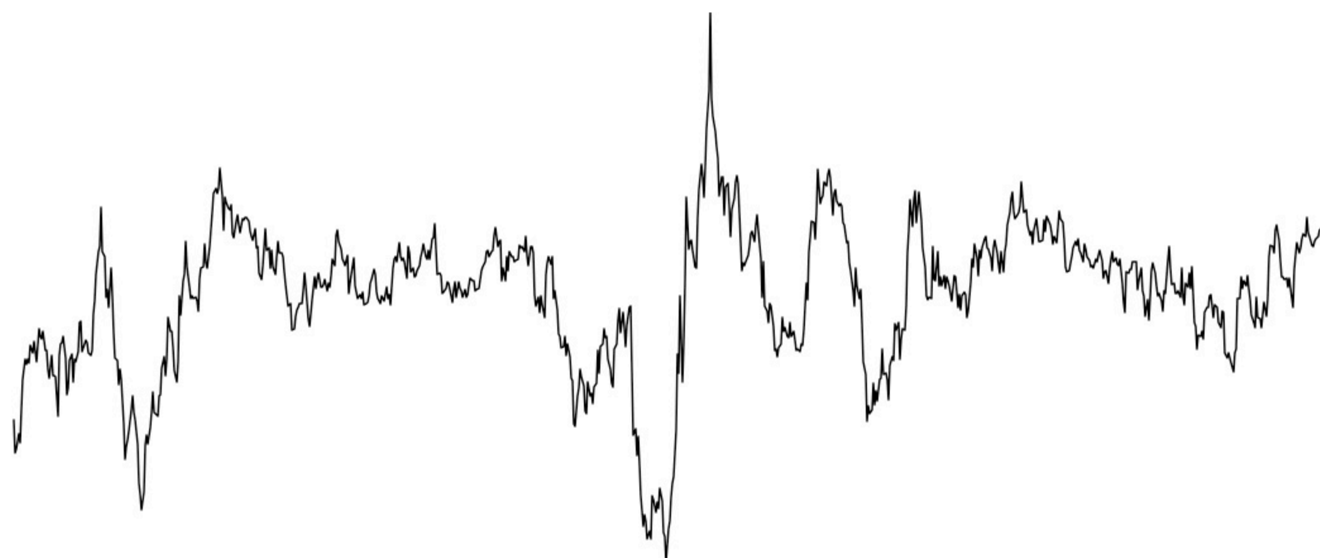

SITTING TIGHT

Financial journalists have had to resort to clichés in the past few weeks to describe the reality that they're being paid to report on. At the start of December, Financial Times' Robin Wigglesworth invoked the "everything rally" to describe a market "too hot to handle", while Bloomberg's Marcus Ashworth and Mark Gilbert have gone for the idea that markets will "defy gravity", again, in 2021. The industry's most widely watched investor survey—the BofA's GMFS—chimes in with the observation that "asset allocators are underweight cash first time since May'13; triggering FMS Cash Rule "sell signal," a sentiment supported by the opening line in ASR's recent study; "this is the most bullish result we have seen in the six year running our asset allocation survey." The bull market in equities is paved with the irrelevance of such skeptical analysis, but sometimes the truth is in fact staring you in the face. This market is flirting with danger, and will soon suffer a significant correction. The more pertinent question, however, is whether I, or anyone else, have the tools or wherewithal to pick a tradable top, and following from that, whether a correction will mark the beginning of a more sustained downturn in equities, and other financial asset prices? As far as the first question is concerned, luck is a thing, but trying to pick even relatively obvious intermediate tops in this market isn't easy. As a friend on the buy-side likes to remind me; "my put options are melting like butter in the microwave." In terms of a more dramatic shift in the trend and narrative, we won't be able to perceive it when it happens, but I don't think such a shift is imminent.

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Having stuck my neck out, with a hedge, it's worthwhile going over the assumptions that forecasters are making for the year ahead. Judging by the outlook pieces that I have seen, the "Great Reflation" is upon us, which is broadly associated with the following assumptions.

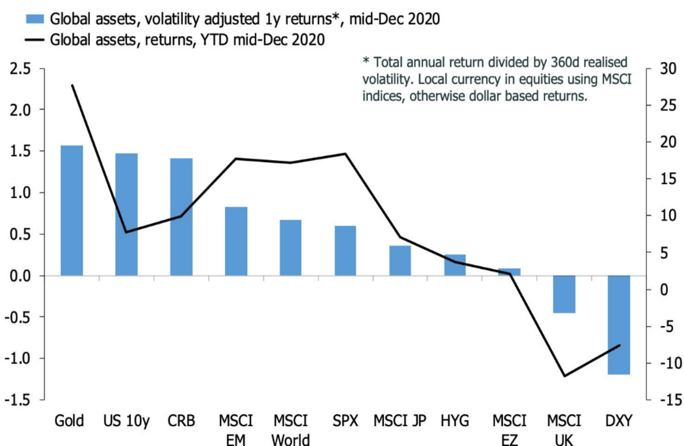
The economy - Pent-up demand in a fully vaccinated economy is recipe a sharp acceleration in GDP growth, especially midway through 2021. Inflation will increase too, though most forecasters are playing it safe. Energy inflation will soar, temporarily, as base effects in oil prices reverse, but the core rate is a different story. Forecasters seem to be aware of the risk that the clash between soaring demand and a constrained supply-side will drive a sharp rise in core inflation, and an associated hawkish policy scare, but the consensus seems to consider this a relatively remote risk.

Equities - Up, up and away is general consensus, though many strategists have nailed their colors to the mast on the idea of a rotation away from growth towards cyclical sectors and value. This, in turn, suggests that non-US G7 and EM equities will outperform their otherwise trailblazing US counterparts. This baseline chimes with the reflation story in the economy, though I am inclined to believe that the consensus really is that everything will go higher next year, regardless of its relationship to the growth or value bracket.

Bonds - This should be easy. Strong growth, higher inflation amid a continued commitment to maintain short-term rates pinned to the floor is textbook case for a bear-steepener. The problem for fixed income strategists is that they're analyzing a market in which policymakers have implicitly, or explicitly, stated that they don't want long-term interest rate to rise too far, too fast. In addition, central banks have shown that they're ready to back this commitment with the full force of QE. With the US 10y sniffing at 1%, the question is how much further the Fed will allow it to go? I don't have the answer, but to my surprise, it seems that the consensus has recently edged towards the idea that the long bond can sell off a bit further, before the federales step in. Whatever the right the answer is, it's important to be up front about the cross-asset linkages here. The further the curve steepens, the stronger the outperformance of cyclicals and value in equities, and it is difficult to build a story for one without the other.

Currencies - The dollar is going down, and nothing will stop it. In fact, it is now in the US self interest to preside over a weakening currency, as it will

fig. 01 / Has reflation already begun? - **fig. 02** / This is starting to look like a trend



help exports and contribute to a rebalancing of the domestic and global economy. Looking beyond the glaring discrepancy between the desire for a weaker dollar, especially against China, and the simultaneous, and increasingly inevitable, geopolitical joust with that same country, a sustained depreciation of the dollar will raise tricky policy questions in Europe and Japan, while providing EM central banks with flexibility, even as growth rebounds.

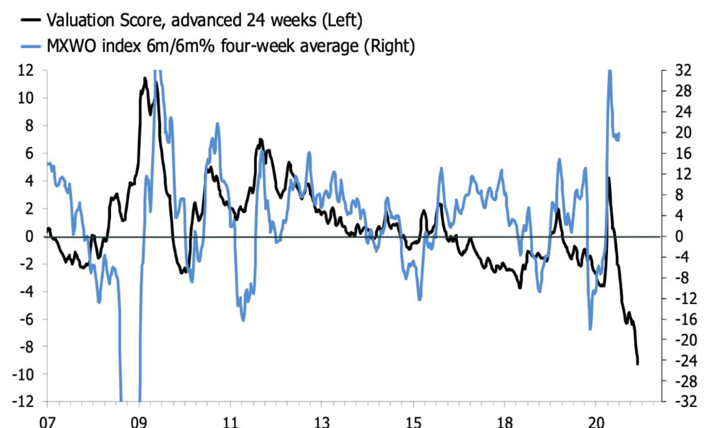
Commodities - A commitment by policymakers to maintain negative real interest rates—by leaning on long-term rates even as inflation rise—should be a good environment for anything and everything that needs to be dug out of the ground or grown on a field.

It's easy to spot the contrarian trade here. Betting against the reflation trade means selling equities, buying the long bond, and fading weakness in dollar. I am open to a variation of this trade that includes buying the Nasdaq, funded by shorting value equities. I've come up with worse trades on these pages, but there is a kind of double-bluff going on here. Duration, U.S. tech and DXY have worked very well for a long time, so maybe it is simply time for the reflation trade to stretch its legs.

It is difficult to fault the consensus for assuming a very accommodative policy environment next year given what policymakers have been saying and doing. But what about what they will do in the future? To the extent that markets are still operating with the benefit of a policy put, investors need to consider the possibility that everyone needs to be reminded where the strike price is, at some point in Q1. Last week's non-action by the Fed is a hint. After all, why would the FOMC do more in an environment where markets are roaring and a vaccine imminent? The answer, rather cryptically, could be that the Fed won't do more until financial conditions tighten sufficiently to remind it why it needs to support markets in the first place, a reaction function that probably applies to fiscal policy too. It wouldn't be first time that we've seen this dynamic, and if experience is any guide, policymakers will step in, eventually, to prevent undue harm to investors' portfolios.

As far as the broader reflation trade is concerned, I am inclined to believe that it's already here. The first chart above plots the inflation year-to-date returns of the main global asset classes as of December 18. The fact that gold, commodities and duration already are on top of the pile, in inflation adjusted terms, seems to fit a reflation story with an associated policy pledge to prevent inflation, either realised or expected, from driving up long-term interest rates.

fig. 03 / What if multiples contract, sharply, in 2021? - **fig. 04** / Clear and present danger



I was also surprised to see that the MSCI EM is now beating the mighty Spoos year-to-date—though admittedly the 360D vol measure drawn from Bloomberg looks a bit wonky—while there is still plenty of work to do for non-US developed markets, especially for the UK equities, which have been a shower of misery this year compared to the global benchmark.

I WANT WHAT GS IS SMOKING

Having set the scene above, I am going to spend the final bit of this missive picking on Goldman Sachs. I am sure they can take it. Earlier this month, the bank issued its 2021 US equity outlook, invoking a return to the roaring 20s. Their baseline for the S&P 500 is, it is fair to say, punchy. GS predicts that Spoos will advance to 4300 by the end of 2021, a forecast split between a predicted 29% jump in nominal EPS, from $136 to 175, and a P/E multiple of 24.6. Let's start with earnings. Based on trailing earnings at the end of 2020, firms listed on the S&P 500 are on track to record a 14% year-to-date decline in profitability this year, while the number based on annual averages is somewhat more modest, at 8%.

My reading of GS' numbers suggests that they're expecting EPS on the S&P 500 to be about 15% above its pre-virus level by the end of 2021. Anything is possible, but that's stretching it, a bit. It gets even funnier when we consider the valuation. The trailing P/E multiple on the S&P 500 has motored higher since March, from 15 to just shy of 30, against an average since 2015 of just over 20. It's certainly possible that valuations remain elevated as GS expects—note that the bank is allowing for a decline in valuations next year—but there is plenty of room for error. Consider for example pricing an EPS of $175 at 20 for a price of 3500, some 6% below the closing price on Friday December 18.

Matching these back-of-the-envelope calculations, and GS' assumption, to my own models suggest that I should be running for the hills. Chart number three above shows that the P/E multiple is now rising nicely year-over-year, consistent with the trailing decline in the price of oil and short-term interest rates. By this time next year, however, the same model predicts that multiples will be collapsing, assuming a constant trend in oil prices and interest rates. This is a very naive forecast in the end, but it does suggest that something has to shift for the market to sustain the current trend—negative rates at the Fed?—even assuming a punchy rebound in nominal earnings next year. I am all for a sustained rotation into cyclical and value equities—I am even positioned as such—but the idea that such a change can deliver the kind of numbers GS are suggesting, on its own, seem dubious to me. The second chart above shows my valuation score, which is also warning of clear and present danger

I have run these models long enough to know that they're not sell/short signals, but I respect them enough to stand pat when they're this terrible. In the context of next year's reflation nirvana, it seems that markets are priced for a lot of good things to happen, and a remote risk of any bad stuff. I concede that this is the way market participants have been groomed to think, and more often than not, taking the other side has been the losing trade. But sometimes, markets and policymakers need to be reminded of the (Faustian) bargain that they're part. I think we are now close to one of those occasions, so on the eve of a near-total lockdown of my local area forcing me to sit tight, I am going to do the same in my portfolio.