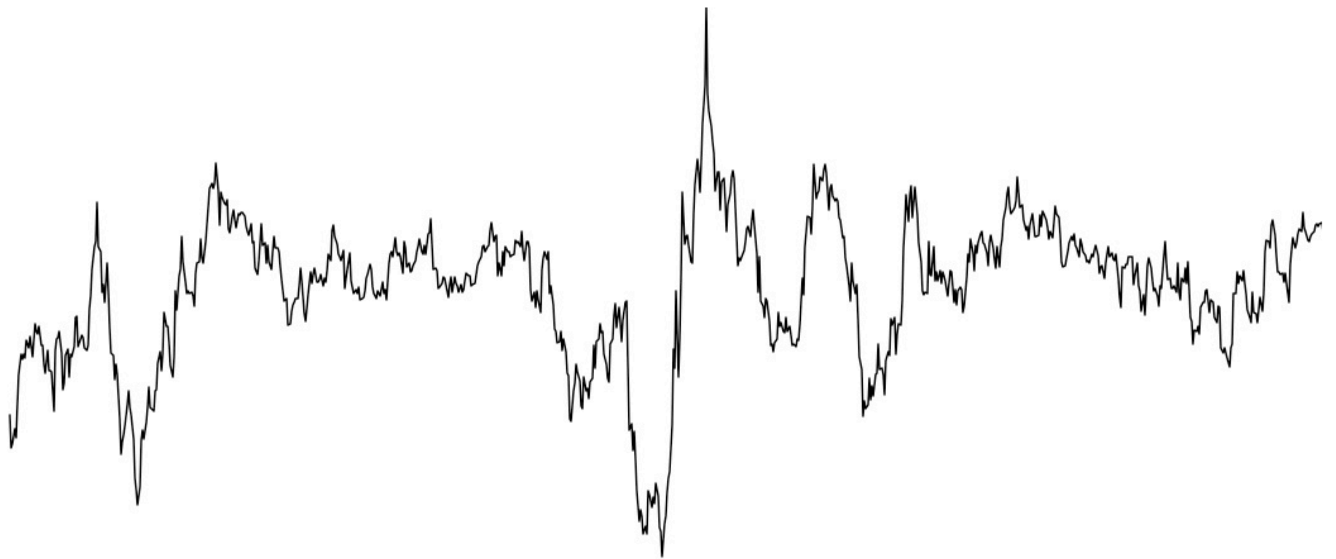
ALPHA SOURCES

JANUARY 18, 2021



AN UNSTABLE EQUILIBRIUM

Investors remain locked in discussion about the same issues they were mulling before the holidays. The rollout of the vaccine—however frustratingly slow in some countries—means that the light at the end of the tunnel for the economy is probably not an oncoming train. That's great news, but the counterpoint is that markets have long since priced-in such an outcome, leaving investors vulnerable to the famous adage that if they're buying the rumour, they're also likely to sell the fact. In that vein, I am happy to double down on my comments at the end of last year that you should now be looking to stash away profits rather than putting new money to work. On that occasion I showed two charts to warn about incoming multiple contraction in equities, proxied by valuations on the S&P 500, and my in-house valuation score, which is also headed for the basement. The first chart on the next page shows that the six-month stock-to-bond return ratio in the U.S. remains pinned close to cyclical highs, also hinting that equities are about to give up some of their recent gains, with bonds rallying in appreciation. The second chart shows what happened the last time stock-to-bond returns were this stretched. It occurred in the run-up to the Flash Crash in 2010, before the swoon in the summer of 2011, ahead of the drawdown in May 2012, not to mention during the Taper Tantrum in 2013. Based on this albeit short sample, investors should brace for volatility in H1.

CREATIVE COMMONS LICENSE, 2021,
CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM

Sometimes markets have to find out what the strike price of the policy put really is, and policymakers have to be reminded that've written the option in the first place.

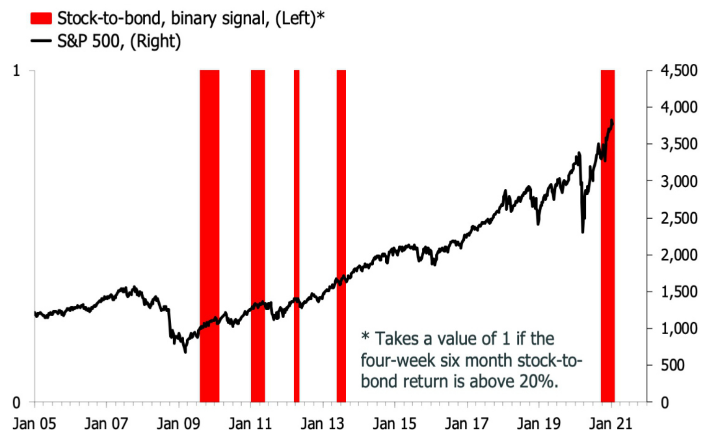
Even with that in mind, however, it's difficult to escape the idea that post-Covid world is still set up to support financial markets. The incoming U.S. administration is trying to find $2T in fiscal stimulus, and Mr. Powell recently assured markets that the Fed is not about to have a conversation about tapering, sending a clear message to Raphael Bostic that Fed officials shouldn't be going around entertaining markets about reducing the pace of QE at the end of 2021. Policy in the rest of the major economies is set up similarly, though you wouldn't know by looking at their bond markets, yet.

The story is simple. The global economy will beat the virus, aided and abetted by unprecedentedly strong policy stimulus. In a world where most of the attention is focused on boosting demand, and where supply already appears to be struggling to keep up, reflation is the easy trade to make. A steepening yield curve, outperformance of cyclical value in equities and accelerating price inflation in commodities have been key ingredients of the price action since Pfizer's vaccine announcement brought into view the idea that we may actually soon beat this thing.

In this context, the comments from Mr. Powell noted above are neither here nor there, especially in the context of yield curve control. I distinctly remember strategists and economists spending a considerable amount of time calibrating their view of the world to the idea that the Fed would not allow long-term interest rates to rise too far too fast. The idea, as far as I remember, was that the FOMC would implement yield curve control around 1% on the 10-year. Now, apparently, analysts believe that the Fed now welcomes a steepening yield curve, and that it won't do anything about it as long as it doesn't tighten financial conditions via a decline in stock prices. This is an enticing shift in the narrative. It is the argument that the rotation into value and small caps will continue, and that the Fed doesn't care as long as the overall market is motoring higher.

As an economist I agree. To the extent that a steepening yield curve is a sign that the economy is on the mend, it is also a sign that central the bank's policy is working. A (bear)

fig. 01 / Extended stock-to-bond returns... - **fig. 02** / ...often leads the market lower



curve steepener with a locked front end also has an inbuilt correction mechanism. The increasingly attractive roll and carry will eventually lure non-official buyers to allocate capital to the bond market.

As an observer of markets, however, I am skeptical. **The shift in the narrative from the assumption that the Fed would put the U.S. treasury market on war footing to one in which a rise in long-term interest rates—while yields everywhere else are pinned to the floor—is suddenly welcome doesn't pass the smell test.** As it stands, the U.S. 10-year yields are carving out a range above 1%, up around 50 basis points since their nadir in the middle of last year, the yield curve has steepened by the same, reflecting a front-end locked at zero. Rate **expectations**, however, are moving. The final chart shows that the market is now pricing an aggressive lift-off at the Fed by 2023. It's possible that the FOMC is happy with this, but it still feels like an unstable equilibrium to me. Either, the rise in yields and rates accelerates, or someone or something will knock it on its head. This can be true, by the way, even if we are now in the foothills of a more sustained post-Covid reflation story.

BIDEN'S GLOBAL POLICY PIVOT

Speaking of unstable equilibriums, I am now very interested in the line taken by the new US administration on China, and economic relations with the rest of the world in general. Let's summarize the setup. The new US political establishment is keen on fiscal stimulus, preferably via direct money transfers to households, a policy which will widen the trade deficit, unless you assume that import elasticity has collapsed. That's fine, unless of course stimulus leaking out via the external balance is seen as a gross injustice, which I think is an increasingly consensus view. Michael Pettis summarizes the view here, noting that if the rest of the world doesn't play ball, "unilateral restrictions on capital and trade flows".

This is effectively the idea that if the US sends a cheque to its stimulus-deprived populace worth $2000, China and Germany must send a comparatively larger cheque to their consumers, and if they don't, the US should move to limit capital and trade inflows, imports, from these countries. I think this would be madness, but it doesn't really matter what I think. What does matter, though, is that markets would crash if such a policy was suggested, let alone tried.

fig. 03 / Still scope for value to outperform... - **fig. 04** / ...but is this o.k. with the Fed?