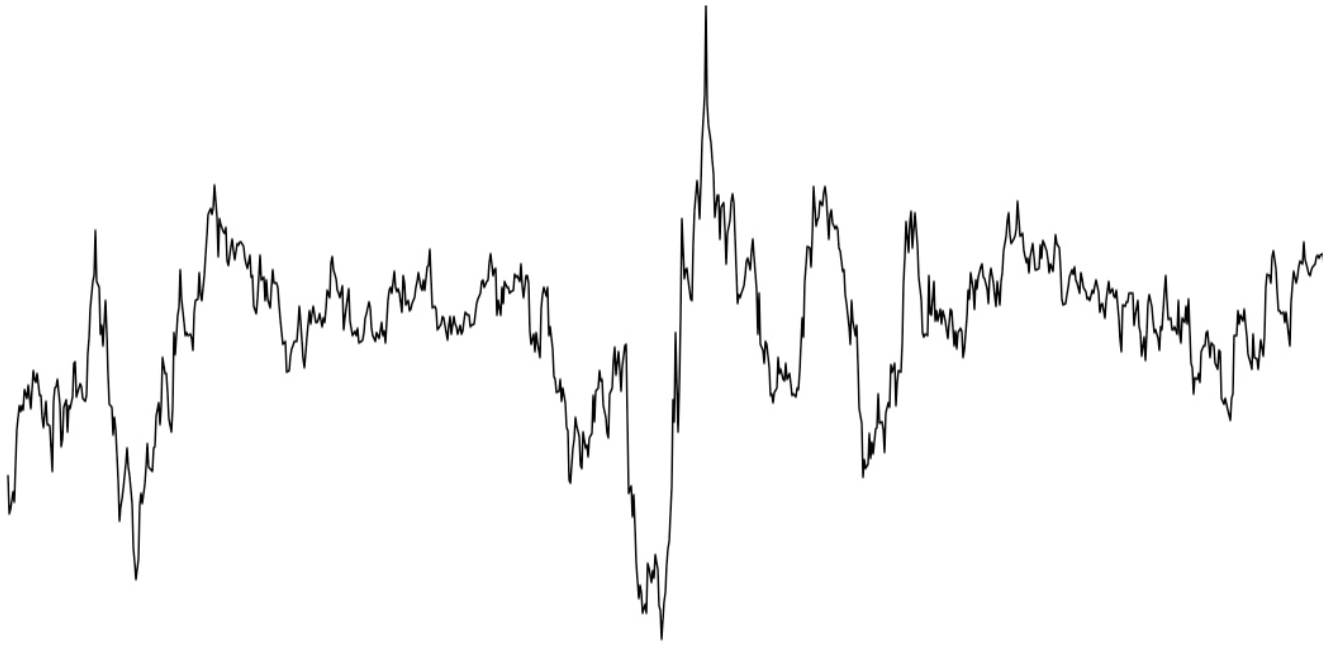
ALPHA SOURCES

JUNE 3, 2019



CIRCULAR REASONING

It's easy to trip over trying to formulate a market narrative at the moment. One interpretation of the dramatic decline in global bond yields is that the smart money is de-risking their portfolios ahead of global slowdown and a rout in equities and credit. The ramp-up in the global trade wars, and still-soggy economic data seem to confirm this version of the narrative, but it is also a somewhat naive story.

The global economy is not in perfect shape, but it is hardly on the brink of a recession, especially not since it is usually coordinated *tightening* by central banks that push the major economies over the edge in the first place.

The market is now pricing-in one-to-two rate cuts by the Fed this year, and three in 2020. The money market curve in the Eurozone is even starting to price in the idea that the ECB will further scythe its deposit rate below -0.4%. The argument in the U.S. is particularly delicious. Last year, the consensus was angling for a recession in 2020 based on the idea that the Fed was in search for a "neutral" FF rate at about 3%. **Now that the Fed has thrown in the towel, the idea is that it will cut rates to prevent the recession that it itself was supposed to have sown the seeds for in the first place, by *hiking* interest rates.**

* / See additional charts on final page.

** / 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.

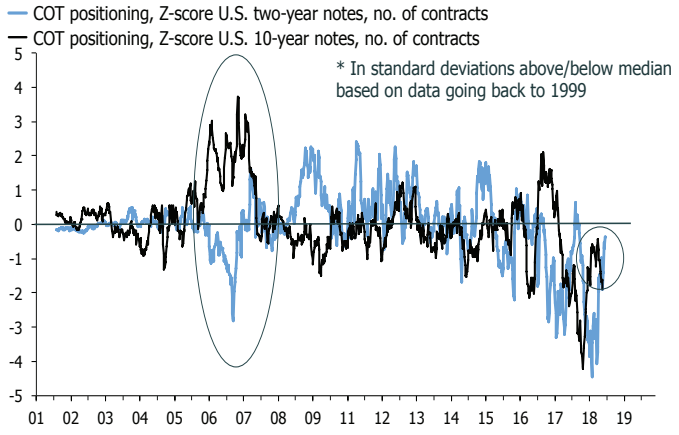
Something doesn't make sense, but I am here to help. We need to add at least two elements to this puzzle for the pieces to fit. **First**, positioning. The COT data have been telling a spectacular story of a huge increase in net short positions across the curve through 2017 and 2018. These positions have been caught out by the shift in narrative in the past six-to-nine months, and the first chart below indicates that the squeeze isn't over yet. The recent move has been dicey for sure, but I think we'll see a 1-handle on the 10y, and perhaps a USDCNY above 7 for the added drama, before the final washout.

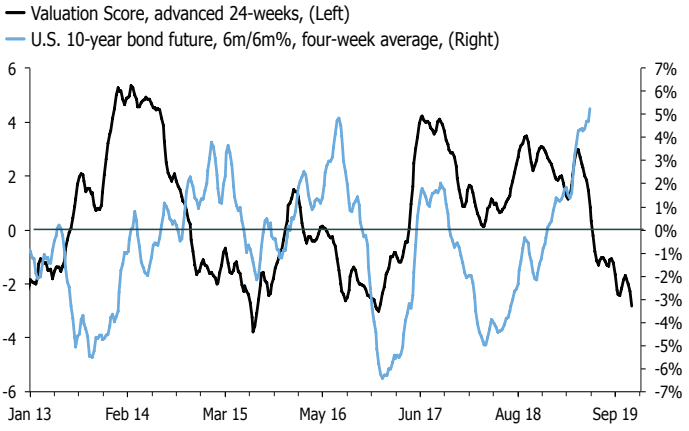
Secondly, global monetary policymakers have spent the last six months telling investors that the world is a very uncertain and scary place. Mr. Powell's flip-flopping at the Fed has been particularly egregious. In that context, markets have gone for an exposed throat, attempting to create the conditions for a self-fulfilling prophecy. So far, they are succeeding. On Friday, economists from JP Morgan and Barclays announced that their economists now expect the Fed to cut rates later this year; twice or even three times. With the U.S. 2y trading well inside the Fed funds rate, this leaves FOMC in a pickle. It would probably prefer to do nothing, but even that now requires them to tell markets, and the Street's economists, to jog on. It's *possible* that Mr. Powell et al. take a stand, but markets clearly assume that they won't, so the scene is set for volatility on either side.

In this environment, I reckon sticking with front-end exposure is the easy bet, at least for the rest of the year. At worst, the Fed will do nothing, and if they do hike, it likely will be accompanied by all kinds of reservations about a lower terminal rate, flexibility and the like. Of course, if they succumb to market expectations, and initiate an easing cycle owning the front-end will be an excellent trade.

The long-end is more complicated. My model—second chart below—is screaming to run for the hills. This makes sense in a world where the Fed, and other major central banks, are so terrified of causing a slowdown. Markets are

fig. 01 / The squeeze isn't over yet — fig. 02 / Is the rally in U.S. duration over?





currently pricing-in *global* japanification, but that sentiment won't persist unless the global economy hits a brick wall in H2. If it doesn't, long-term rates should eventually be able to recover a bit. By contrast, the idea that concerned central bankers will remain extremely tepid in moving short-term rates is a safer bet I think, at least until they *tell* markets otherwise, in clear terms.

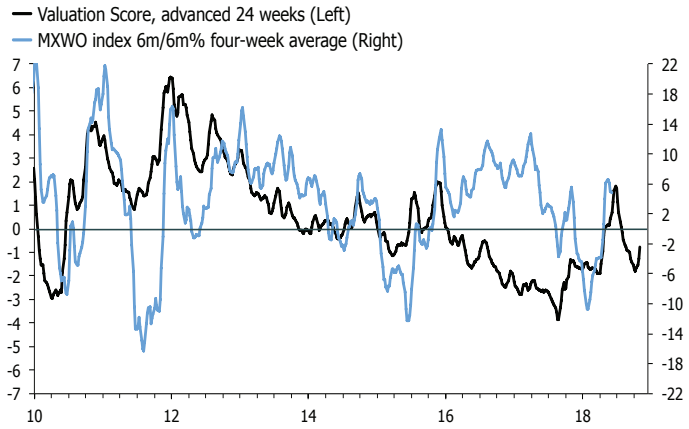
WHAT ABOUT EQUITIES THEN?

For equities, the stumble in May was overdue. The U.S-Chinese trade spat has morphed into a more sinister story for markets, in the extreme threatening to re-write the rules of global capital mobility. Meanwhile, bonds are sending all kinds of ominous signals, usually associated with economic slowdowns and recessions. The hit last month notwithstanding, the question seems to be; why is the MSCI World still up nearly 10% year-to-date? Part of the rebound can be explained by mean-reversion from the horrific Q4, but in the main, equities are beset by the same circular reasoning as bond markets are.

After all, why sell equities out of fear of global trade wars and recessionary signals in bonds, when those are precisely the conditions that are most likely to prompt monetary easing. **In other words, markets still believe the idea of a global central bank put, and perhaps even a Trump put too.** This is easiest to see by considering that earnings-per-share probably are now *falling* slightly on an annual basis, while the P/E multiple is up nearly 15% y/y.

I don't have a crystal ball, but in response to Seeking Alpha commenters prodding me about my specific view on equities, I should, at least, be crystal clear this week. **I think the next three-to-six months will be difficult for equities.** The strike price of the Trump/central bank put is a good deal lower, and *if* long-term rates rebound, they're just as like to do so in the context of stagflation-lite than as a sign of a rebound in cyclical optimism. Equities won't like that, and neither, will risk-parity trades. Perhaps a hit to these strategies is exactly what's needed to end the current bout of circular reasoning.

fig. 03 / Is the best behind us for 2019? — fig. 04 / Multiple expansion offers hope



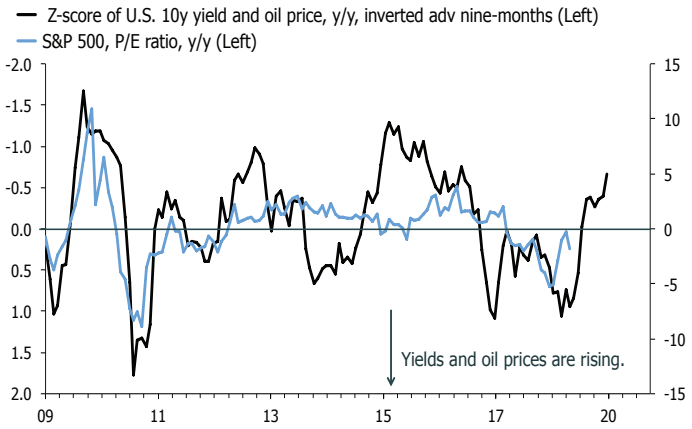


fig. 03 / Latest revisions point to a still-subdued outlook…

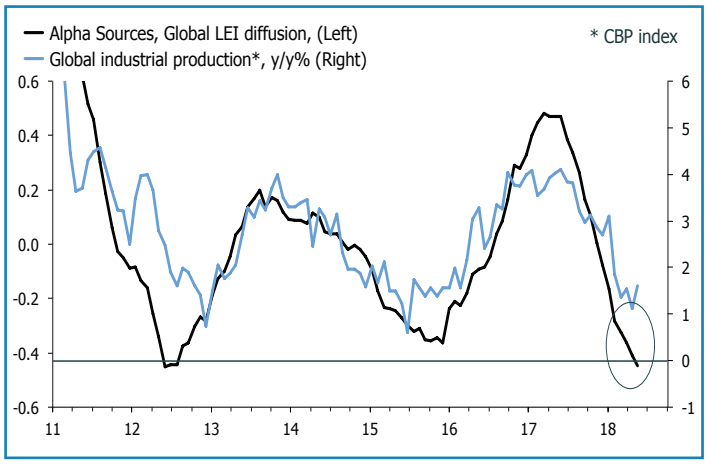


fig. 04 / …And markets are still ahead of the turn in the 2nd derivative

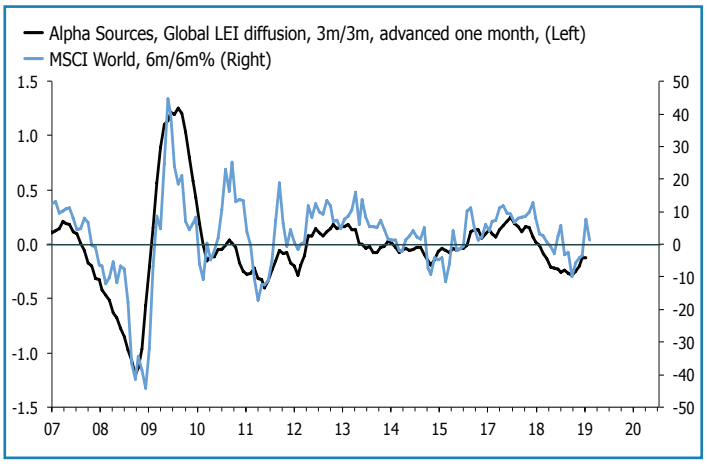


fig. 05 / A small upturn in the Eurozone of all places…

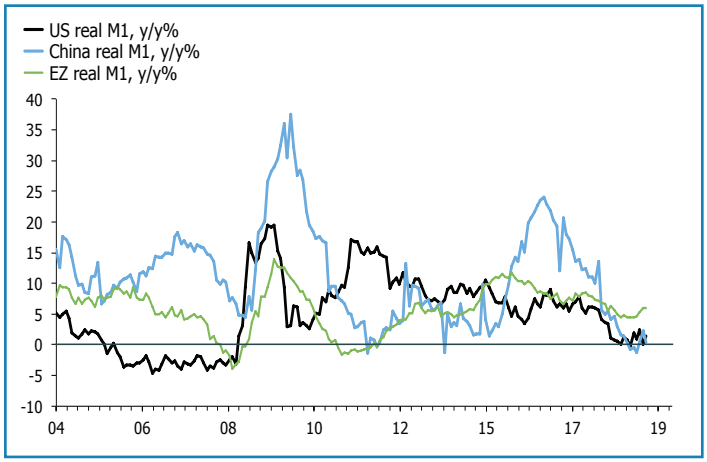


fig. 06 / …But the overall message for global equities is sombre

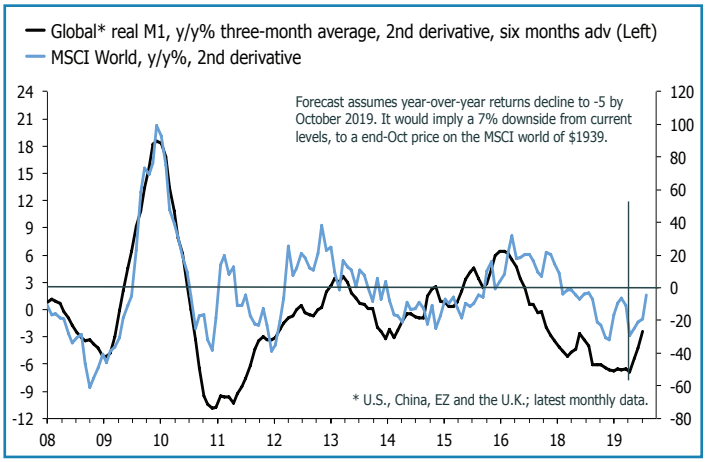


fig. 07 / EDZs have spoken; a recession is hitting in 2020

fig. 08 / Brutal relative wealth destruction for value investors