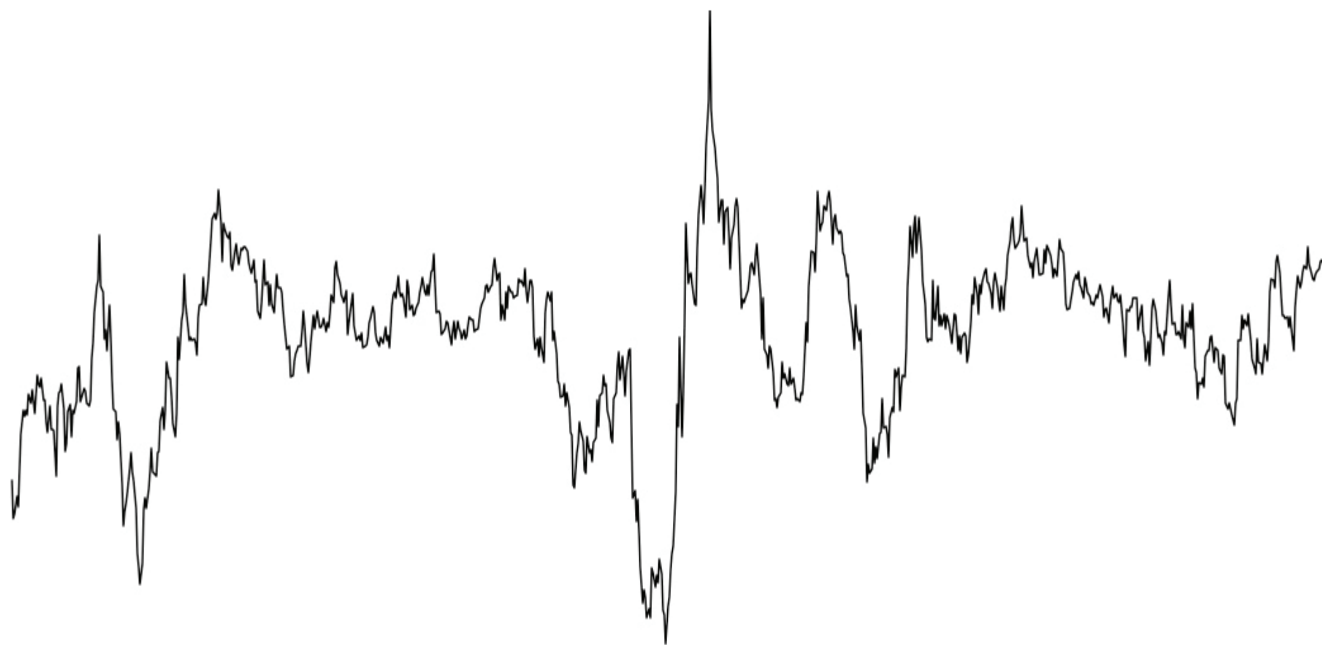
ALPHA SOURCES

NOVEMBER 11, 2019



LISTEN WHEN MARKETS SPEAK

Apologies in advance; it's been too long since my latest report, mainly because I think observing markets has been a bit like listening to a broken record. To re-cap; central banks—mainly the Fed and the ECB—made a dovish pivot at the start of the year in response to the swoon in Q4 18. Whether they meant this to be a relatively modest shift or not, investors ran with the story. Within a few months, markets were bullying Powell into rate cuts and by September, and pricing-in rate cuts and QE by the ECB. **In other words, the multiple-expanding support from a firm central bank put—perhaps even with a sprinkle of fiscal stimulus hopes—has reigned supreme in equities, and driven yields lower, even as fundamentals have deteriorated.** Against this backdrop, the Fed and ECB have delivered, by and large, forcing markets to consider a shift in the Narrative™ that is now too persistent to ignore. I'd break it down into three separate themes.

1) The value & cyclical rotation - The yield curve is steepening, driving outperformance in value equities relative to growth. Specifically, it means that financials/energy are lifting their head and that cyclicals, ex-tech, are muscling their way forward too.

* / 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.

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2) The ROW rotation - EU and EM equities are slowly starting to outperform the U.S., a shift that is directly related, I suspect, to the first point.

3) A weaker dollar(?) - This follows from the second point, but it is an important trend in its own right, especially in light of the dollar-boosting story of of the trade wars, at least so far.

I have drawn charts to support these themes on the next few pages, but I'll start with two contradicting charts for equities. The **first** shows that that central banks' balance sheets are now rising again, supporting a bullish equity position. This perspective is important. Markets asked for central bank easing, they got it, and it seems to have worked.

Trailing EPS for the MSCI World are down just over 4% since the start of the year, but the P/E multiple has increased to nearly 20, from a nadir of 15 in December 2018. This is a striking move in an environment where everyone seems to agree that monetary policy is not working anymore.

The issue with this story is that returns—at least in year-over-year guise—are now poised to soar even if the market goes sideways, or falls slightly, thanks to base effects from last year's crash. In short; trailing performance will continue to look great, but what you see on the screen might not, bringing me to the **second** chart, which will make equity bulls sleep uneasily.

It shows that Spoos are running substantially ahead of the fair value implied by my APT model; a full 12% to be exact. The last time my model was so far offside relative to the market, we first had the Volmageddon—in Q1 2018—and later that year, the gruelling sell-off which eventually set up this year's rally. To be fair, this model is now deeply out-of-sample, and could do with being re-estimated, but I still trust it to perform its basic task; to warn about the risk of mean reversion. On this occasion, it signals that equities are running ahead of cyclical fundamentals—proxied by commodities—,returns in high yield credit, and the move in gold, to which it should be inversely correlated.

fig. 01 / What markets have been betting on

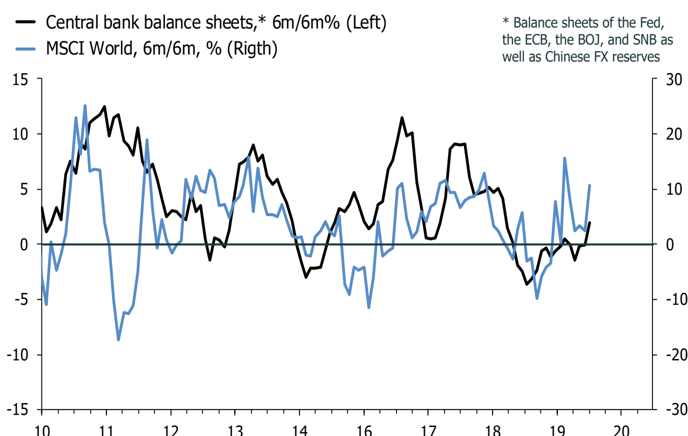
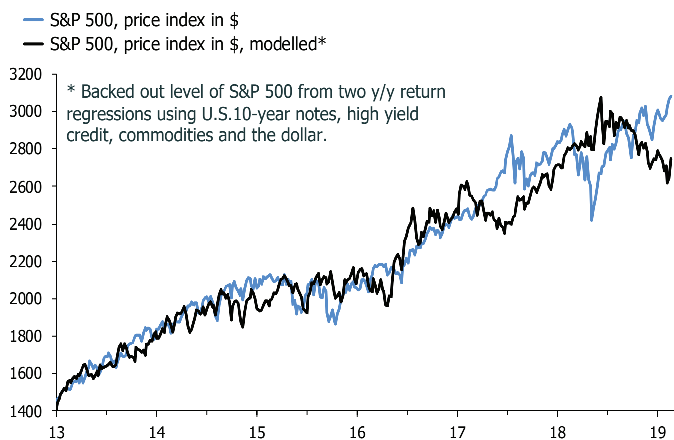


fig. 02 / The mighty spoos headed for a fall?



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The three themes highlighted at the beginning are partially related to the game of wits between markets and central banks. The tentative rotation from value to growth equities, and from U.S. to non-U.S. markets, can be rationalised by the same argument. The rotation in question is correlated to a steeper yield curve—mainly a bear steepener—exactly what we'd expect in a world where policymakers are *overcompensating* for the risk of a slowdown. It follows that if the global economy is *not* about to slide into recession, non-U.S. equities—which have been underperforming—should reassert themselves.

At this point, it is fair to say that both of these themes are tentative. My next two charts show that the rotation into value equities remains well within the norms of the overall downtrend. They also show that the relative price action of these two sectors is now moving ahead of the steepening trend in the yield curve. This isn't unusual, and fits my prior. In short; I still think that investors should avoid duration like the plague, even after the recent move. Stick to the front-end, where central banks effectively have thrown in the towel, pledging vigilance in the face of elevated economic risks. Should the hiking bias return, the changes, but I am not holding my breath.

In terms of the cyclical state of the global economy, we're still relying on the idea that perhaps conditions aren't getting any worse. The first chart on the final page shows that year-over-year growth in global industrial production is still trending down, and that leading indicators remain downbeat. The second chart, however, shows that the second derivative is turning up. Sometimes this is all markets need, especially coming off a discernable bottom or top.

Against this backdrop, punters are still bullish on the USD dollar, which makes sense insofar as goes Mr. Trump's ability to bully his counterparts in the trade wars. It makes less sense, however, if we look at the trajectory of leading economic indicators. U.S. LEIs are now falling much quicker than their global counterparts, implying downside to the headline DXY index of +10%.

fig. 03 / Value is taking another run…

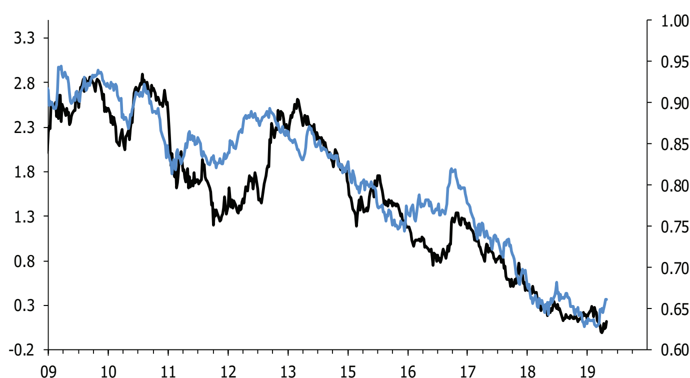
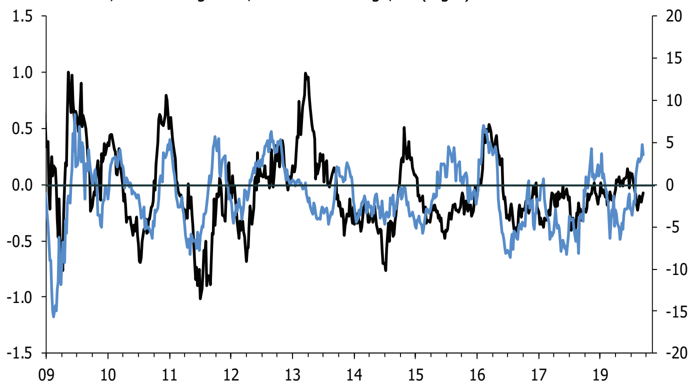


fig. 04 / …and this time, it is ahead of the bond market



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SAVE NOW, BEFORE IT'S TOO LATE

I'll finish this week's missive with a few notes of contemplation. One of the most rapidly rising, and now pervasive, macroeconomic narratives is the idea that excessive thrift is at the core of what is an increasingly structurally ill global economy. If the savers would just spend a little more, the world would be a better place. MMT teaches us that governments with monetary sovereignty have limitless degrees of freedom to invest and write checks, solving everything from the transition towards renewable energy sources—saving the climate—to the challenge of income and wealth inequality. Fiscal stimulus is now the answer in a world where monetary policy has come up short.

The proponents of this line of thought are defining their argument in counterpoint to what they perceive as a counterproductive perma-bearish narrative that has prevailed since the crisis. This is the idea that irresponsibly loose monetary policy has made things worse, not better. Needless to say, the proponents of this view aren't too excited about the idea of MMTesue fiscal stimulus.

The battle fought between these two positions effectively is over the idea of economic virtue, and perhaps even, morality. I am working on an essay that grapples with these issues, but in the meantime, I'll try to make a few objective points on these issues.

QE/NIRP probably *have* fuelled inequality and the misallocation of capital. After all, it isn't odd that we have invented the idea of "community adjusted EBITDA" during an era of extremely loose monetary policy. But we don't have a counterfactual to know what would have happened if these operations hadn't been done, so the decade-long perma-bearish "something is wrong" narrative is rather pointless.

It is better to look at what is now objectively true. Everyone can identify the potentially adverse outcomes from excessively low rates and running the economy hot. The most obvious are: moral hazard/capital misallocation, asset price bubbles, and high inflation, (the monetarist critique of Keynes).. You're not an Austrian Luddite for noting the potential existence of these outcomes, even if it is equally clear that they're now being ignored completely.

In its simplest form, the MMT discourse is an invitation to accept the rather pleasant idea that there is enough money to go around for everyone, forever. But this story is now accompanied by an entirely predictable redistributive element

Elisabeth Warren in the U.S. and Jeremy Corbyn in the U.K. are the most obvious proponents of this shift, and their core message is, as far as I can see, clear. **Those with little or no wealth are coming for those on the top, with a shovel.** The current pledge that only the rich—the "billionaires"—will have to pay is almost surely wrong, but it also misses the point.

Ms. Warren and Mr. Corbyn wield the sword of fear, poised to strike at the necks of those who are comfortable, because they have achieved said comfort at the expense of others. Are the alternatives worse? Possibly, but I'll save my scorn for Mr. Trump and the U.K. Tories for another day. In the meantime, the tables are about to be turned on the MMTers. After all, the only rational response to such a political shift is to save, like mad, to prepare for the bill.

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fig. 05 / Still weak at the end of the third quarter...

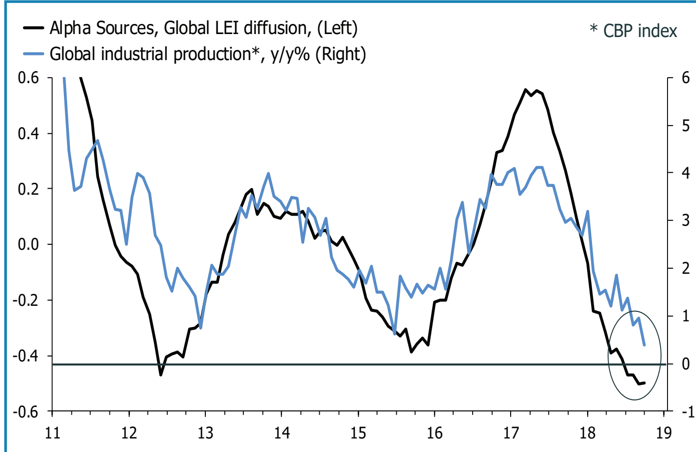
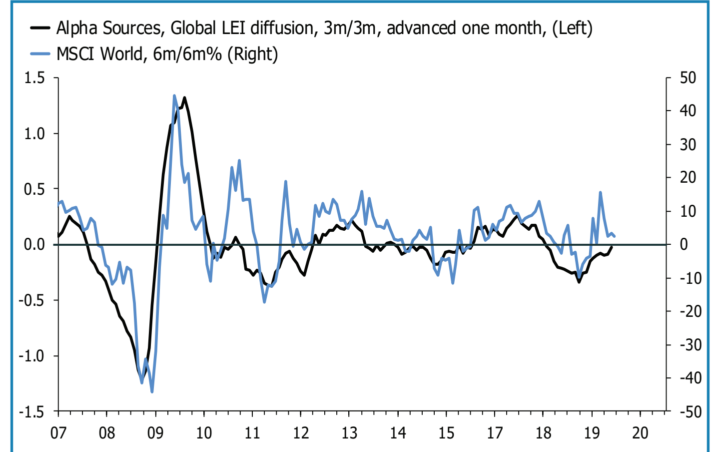


fig. 06 / ...but the second derivative is now turning up



Source: https://www.cpb.nl/en/worldtrademonitor

fig. 07 / Punters are bullish on the dollar...

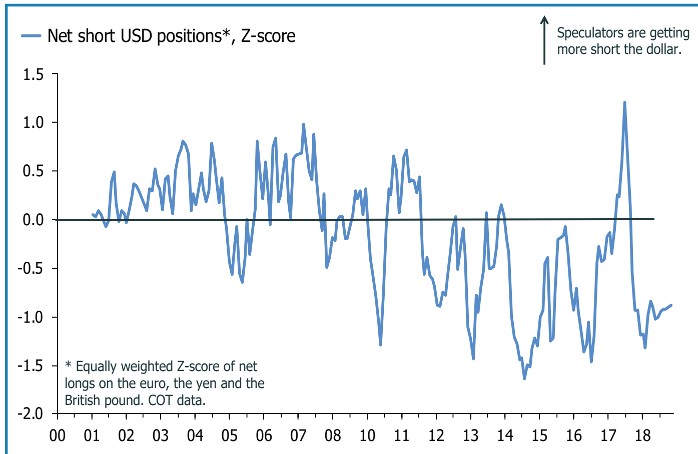


fig. 08 / ...But leading macro-indicators suggest this is wrong call

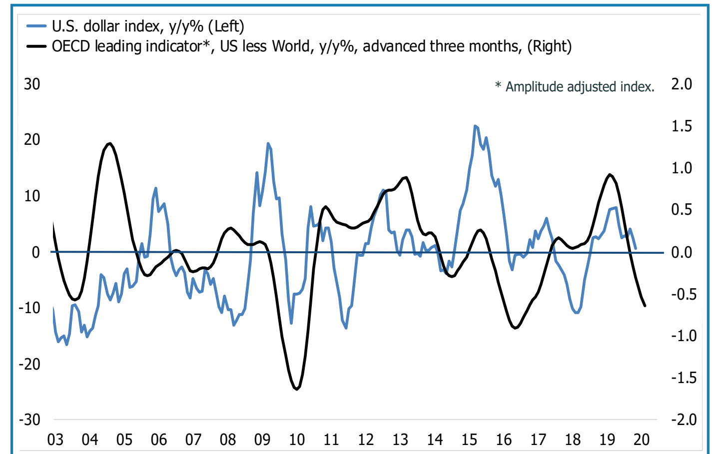


fig. 09 / Markets are still pricing-in cuts in 2020, but fewer than before

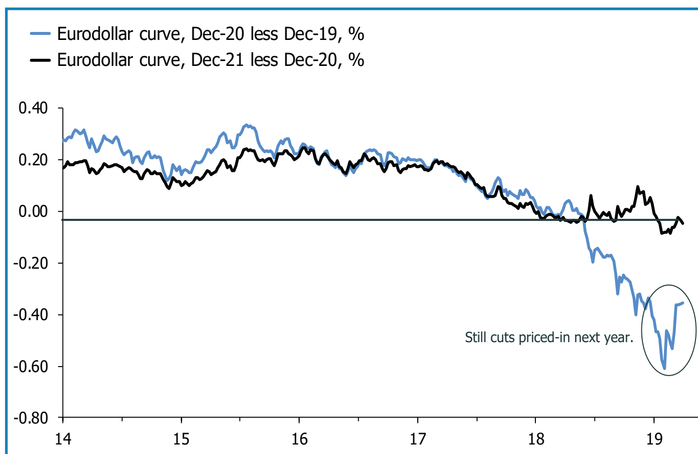
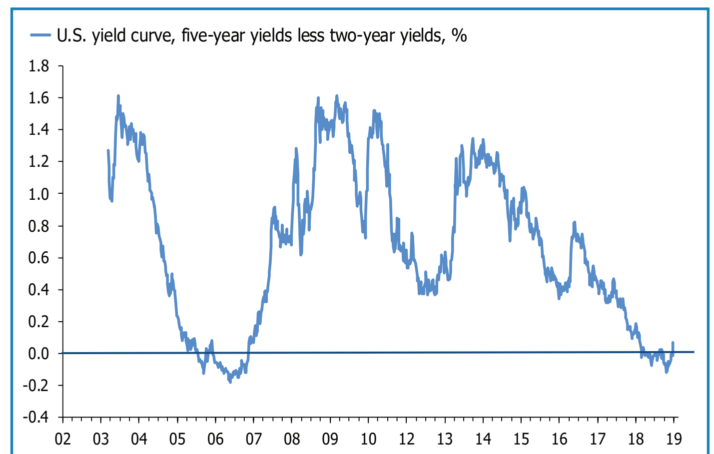


fig. 10 / Starting to look like 2007, which isn't a good sign



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