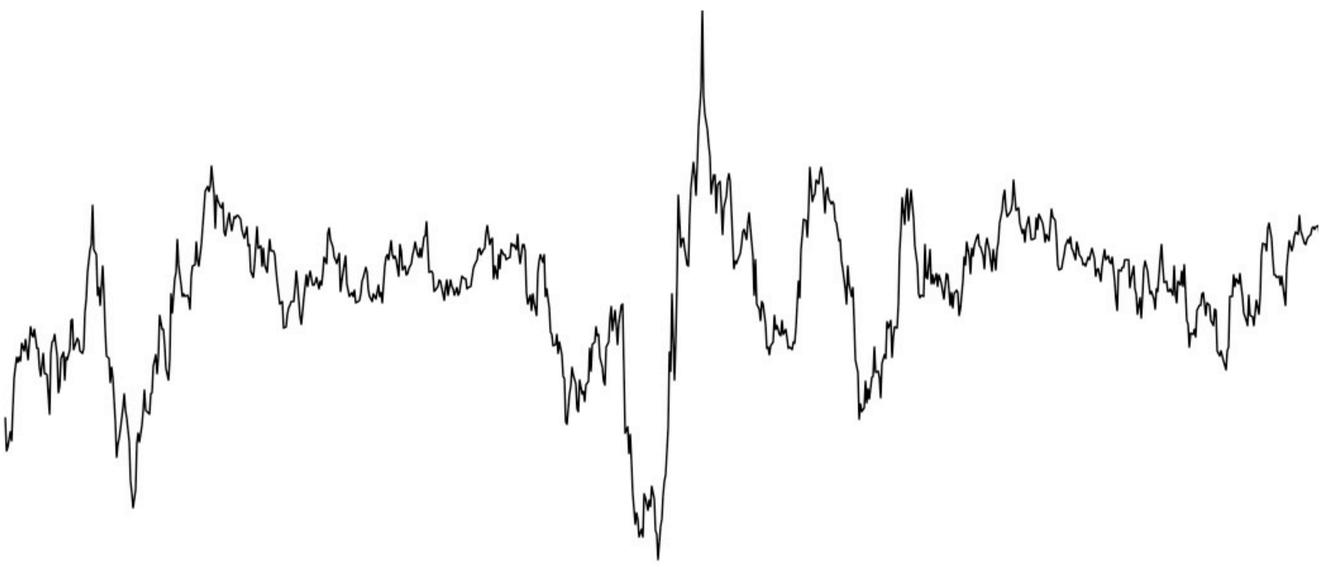
ALPHA SOURCES

OCTOBER 18, 2021



MAKE YOUR BETS

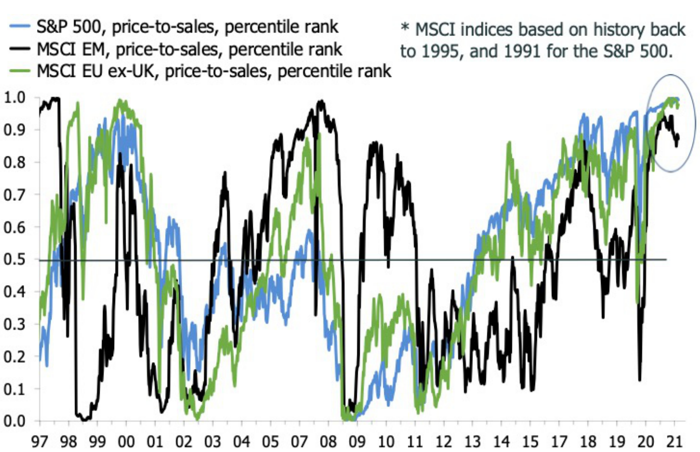
It's been ages since I checked in on markets, but I am a happy, and a little dismayed, to report that investors and analysts are trampling around in the same weeds. Is inflation transitory or not? Will supply-side disruptions persist? And what about fiscal and monetary policy; will one loosen and the other tighten? In fairness, we *have* seen a shift in the economic outlook, for the worse. The reopening bump in economic activity, as virus restrictions were eased, is over, leaving economists to ponder what pace of growth to expect as the pandemic-induced macro volatility recedes. This moment was always coming, but almost on cue, we now have to contend with a litany of downside risks in the form of a real-income sapping rise in energy prices and a real estate crunch in China. These headwinds haven't put much of a dent in risk assets, yet. The MSCI World and S&P 500 are down a paltry 1.5% and 2.5% from their highs at the start of September, respectively, and are still holding on to handsome year–to-date gains, 14.7% and 18.9%, respectively.

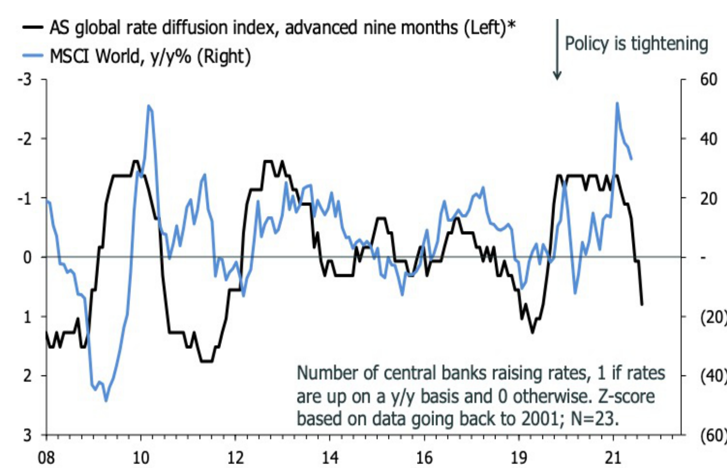
Granted, the MSCI EM is looking a little soggy, not surprising given that it is more directly exposed to woes in Chinese property. It is now *down* slightly year-to-date, by just under 2%, thanks to an almost 12% slide from the highs earlier this year in February. The first chart below shows that the MSCI EM has now given up on its all-time high valuation, even as the S&P 500 and the MSCI EU, ex-UK, are holding on to theirs. Investors will be hoping that EM equities are *not* a leading indicator.

Equities, however, are a sideshow compared to the drama in rates. While economists are still busily debating whether inflation is here to stay, and whether monetary policy should respond, the reality is that it already is. The second chart below shows that global monetary policy is now tightening, significantly. Specifically, the chart shows that the rate of policy tightening is now as quick as in early 2011 and later 2018, both periods which preceded significant sell-offs in equities. To be clear, this shift in policy is primarily driven non-DM central banks having to chase commodities-fuelled inflation, and lean against the associated risk of imported inflation due to currency appreciation.

If market-pricing is anything to go by, however, central banks in developed economies will follow soon. My third chart is astonishing. It plots the 21-22 and 22-23 EDZ implied rate curves, indicating the Fed will soon be hiking rates, aggressively, presumably after it has dialled down its QE program by Q4 next year. The steepening in the 22-21 curve, in particular, is fascinating, hinting that the FOMC will start driving up rates next year, only shortly after tapering QE to zero.

fig. 01 / EM valuations giving up the ghost? - **fig. 02** / Monetary policy is tightening





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The idea of an imminent lift-off in interest rates is not just a US phenomenon. In the U.K., Markets are now certain that the BOE will raise rates within the next three-to-six months, and even in zero-bound locked Europe, markets are now pricing-in an increase in the ECB's deposit rate. To me, this positioning makes little sense in light of the price action in risk assets. **Either rates markets are wrong, or equities are mis–priced.**

The potential trades are juicy indeed. I'll start with the obvious one. I you take rates markets at face value, I'd argue that equity valuations are ripe for a correction. I realize the road to hell, or heaven(?), is paved with people calling the end of the bull market. That is not what I am proposing. What I am saying is that the rate of monetary policy tightening currently implied by rate markets is inconsistent with equity valuations at all-time highs. Remember also that it's more than likely that a setback in equities would derail market expectations of rate hikes, proving my point, in reverse.

In rates, I have my eyes on the roll and carry in the belly of the US curve. The second chart below shows that the 2s5s has *steepened* even as front-end pricing has shifted towards more aggressive rate hikes. That seems like an opportunity to me. If the Fed is really about to hike as aggressively as markets expect, I doubt 5-year yield can continue to outpace the rise in the 2-year for long. Alternatively, you discount the whole idea of policy tightening and buy some 2-year and EDZs. After all, there seems to be a disconnect with what rate markets are pricing and what policymakers are saying. Either way; it is time to make your bets.

fig. 03 / Does anyone believe this? - **fig. 04** / Shouldn't this be flatter?