ALPHA SOURCES

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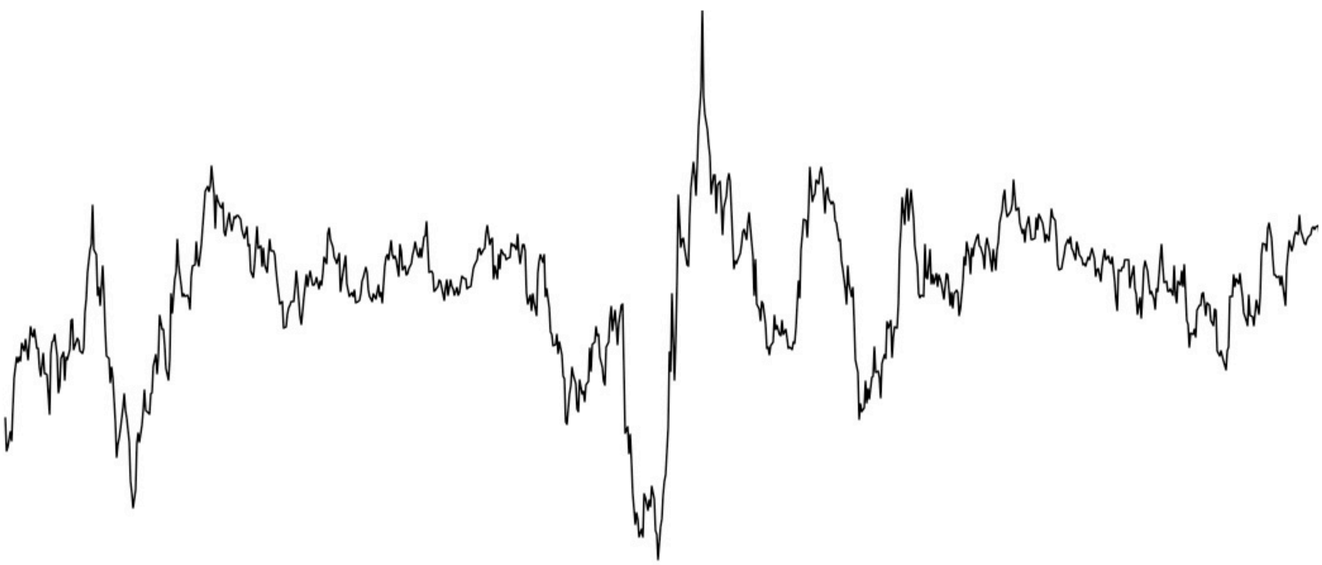
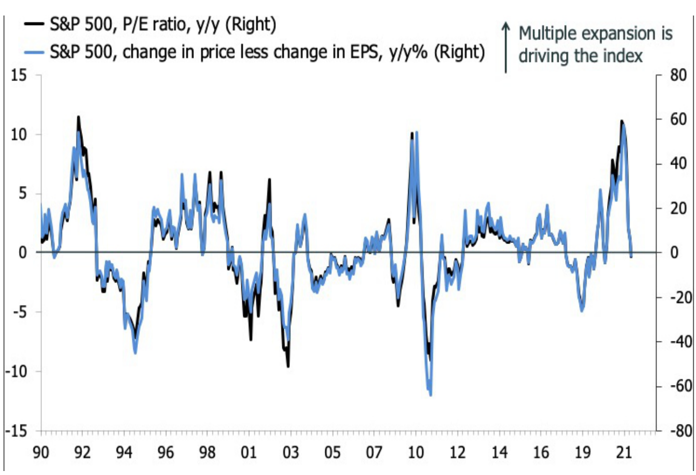


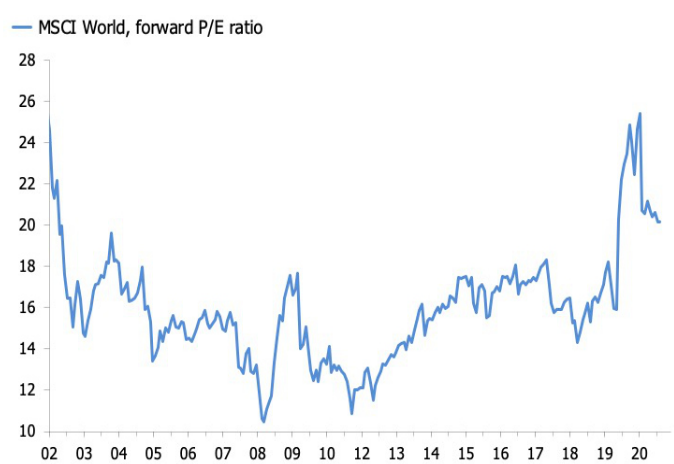
COMPLACENT TIMES

Having just spent ten days on the beach in Ibiza, I am able to provide strong circumstantial evidence that European tourism is back, at least for a while. Granted, the clubs—which I am now too old to go to anyway—are still closed, but hotels, restaurants and beaches were full as ever. Given that 80-to-90% of activity on the island takes place outside, in a sunny and relatively windy coastal environment, the virus wasn't much of a threat, even though numbers had been climbing prior to our arrival. Indoor mask mandates, which are now commonplace, really was the only sign of the virus as far as we were concerned, notwithstanding having to navigate the byzantine testing and tracking rules for travel. The Dutch nurse who performed our pre-travel Covid-test informed me and my wife that tour operators on the island had hoped that August this year would see activity levels return to 50% of its 2019 level, before claiming that the true number is closer to 80%, and that operators are expecting to extend the season into October. If that's true, it adds to the evidence that economic activity in Europe will improve further in the next few months. That’s good news.

Meanwhile in markets, I have returned from my holiday with lots of ideas, but before we get to that, I'll ease my way into the running commentary circuit by looking at the main headlines. Equities wobbled a bit midway through August, but they have since regained their mojo, all but confirming that the bull market in equities remains strong and unchallenged. Granted, even a casual look at valuations will raise alarm bells that future returns have been sacrificed for present gains. It is interesting in this respect that the P/E multiple on the S&P 500 is now falling slightly on a year-over-year basis, as the first chart below shows, indicating that rising earnings are now doing the heavy lifting for stocks. This isn't necessarily an issue, though it does raise some questions about the upside over the next six-to-12 months. The MSCI World, for example, is currently trading at a trailing P/E of 24, with earnings 7.5% above their pre-virus level. The forward P/E is at just over 20, against a pre-virus average of about 16, with analysts expecting earnings to rise by about 20% over the next 12 months, just about the average gap between trailing and forward earnings based on data going back to 2001. If the trailing multiple does nothing—which, at the moment, means that it won't fall further—upward momentum is now waning. That's not necessarily a death knell for equities. I agree with Cameron Crise, a strategist with Bloomberg, that; *"the evidence suggests that valuation alone is unlikely to be a catalyst [for a sell-off], and that the market can continue to get more expensive as long as the money*

fig. 01 / No more help from valuations? - **fig. 02** / Is the future priced fairly?





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printer goes brrr. When the taper comes in earnest next year, perhaps that's when things will get interesting."

This brings us to the topic du jour; QE tapering, and the risk of a slowdown in the pace of monetary stimulus, or perhaps even outright tightening. A reduction in the pace of QE is coming, in both the US and Europe. Indeed, the pace of asset purchases already has slowed after surging in the initial phases of the pandemic. Overall, however, risks seem balanced to me.

Monetary policymakers are keen to stress that tapering is conditional on the continuation of the recovery, and loose financial conditions, hinting that the policy put is alive and well. In fact, my view is that monetary policy has surrendered itself to fiscal policy, implying that central banks will have to print more or less in line with what the treasuries want, or need, to issue. As I have explained in previous posts, the uncomfortable question for markets is at what price in equities and bonds central banks perform a u-turn? No one knows, not even policymakers themselves. In other words, if tapering has no impact on markets, it's reasonable to expect the process to continue until it does, sending a signal to policymakers that they have gone too far. I have little doubt that the consensus narrative quickly will converge on the idea that central banks are making a mistake if and when financial conditions tighten due to reduced stimulus.

In this sense, the fact that economic growth and inflation are now slowing, in part due to base effects, and the sustained threat from the delta, or any other, variant, isn't a huge issue for markets. A drop in the pace of

fig. 03 / Will EDZ curves now flatten... - **fig. 04** / ...leaving room for a steeper 2s10s?

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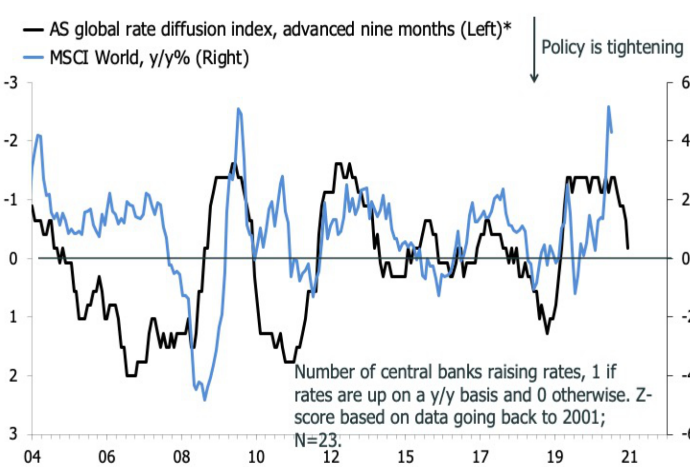
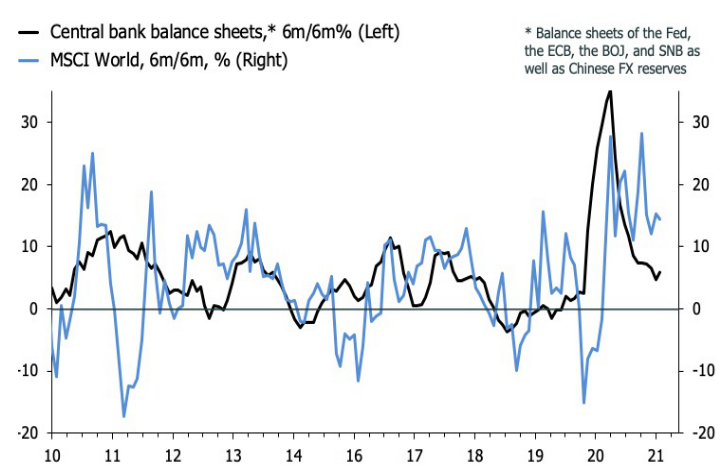
growth and inflation has been coming, and only the most naive of observers think that the vaccines would be a silver bullet, eradicating the virus. Rendering the virus a non-issue is as much a political challenge as it is a medical one.

To the extent that these currents prompt policymakers to remain on edge, delaying or postponing the reduction in stimulus, it is good news for markets. Based on the initial reaction to Fed chair Jerome Powell's eagerly anticipated Jackson Hole Speech, markets are taking the idea of less-loose monetary policy in their stride. Interestingly, Mr. Powell made a clear distinction between tapering—which is likely to commence soon unless something dramatic occurs—and rate hikes, which were kicked out into the long grass, or at least, this is what many commentators seem to have interpreted. This latter bit is interesting considering still-relatively steep EDZ curves in the 2022 and 2023 tenors—chart above drawn before Powell's speech—implying hikes to begin as early as next year. That's still possible, but now probably less likely, and it will be interesting to see where short-term rate expectations settle once the dust clears. Jon Turek summarizes Mr. Powell's performance neatly with the idea that it was "hawkish on taper, dovish on hikes." If that's true, one implication could be that the steepener trade is back on, as I have been speculating. If the front end is put back in the box, the long should allowed to stretch its legs as purchases slow, if, as I suspect, fiscal policy remains accommodative.

More generally, global monetary policy is already tightening as my fifth chart below shows, which, if sustained, often drives

fig. 05 / Global rates are now rising - **fig. 06** / A further slowdown in QE is coming





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equity returns lower with a lag. Admittedly, this trend is driven by central banks in emerging markets—LatAm, Russia and Turkey—which isn't necessarily a leading indicator for higher rates in the G7, let alone the G4. Based on Mr. Powell's comments last week, rate hike expectations in the major developed economies should now ease, especially given that we know rates in the Eurozone and in Japan aren't going anywhere, anytime soon. **As far as the trend in QE is concerned, however, investors now have to assume that growth in major central banks' balance sheets will slow further, and quickly, going into 2022.** This is a threat to markets but as I explained above, I am confident that policymakers will rein in the taper quickly if markets throw a tantrum, even a slight one.

If I am right, investors are now left in the odd situation of having to fret a hawkish shift in global monetary policy while at the same time being reassured that a policy-induced sell-off wouldn't last long. This seems like a good setup for buying short-term put options, though the put/call ratio charts I have seen recently suggest that the price of such protection is already steep. Perhaps then, best thing to do is to stay the course, safe in the knowledge that if the dip arrives, it will be a buyable one. This is complacent for sure, but after all, we live in complacent times.

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