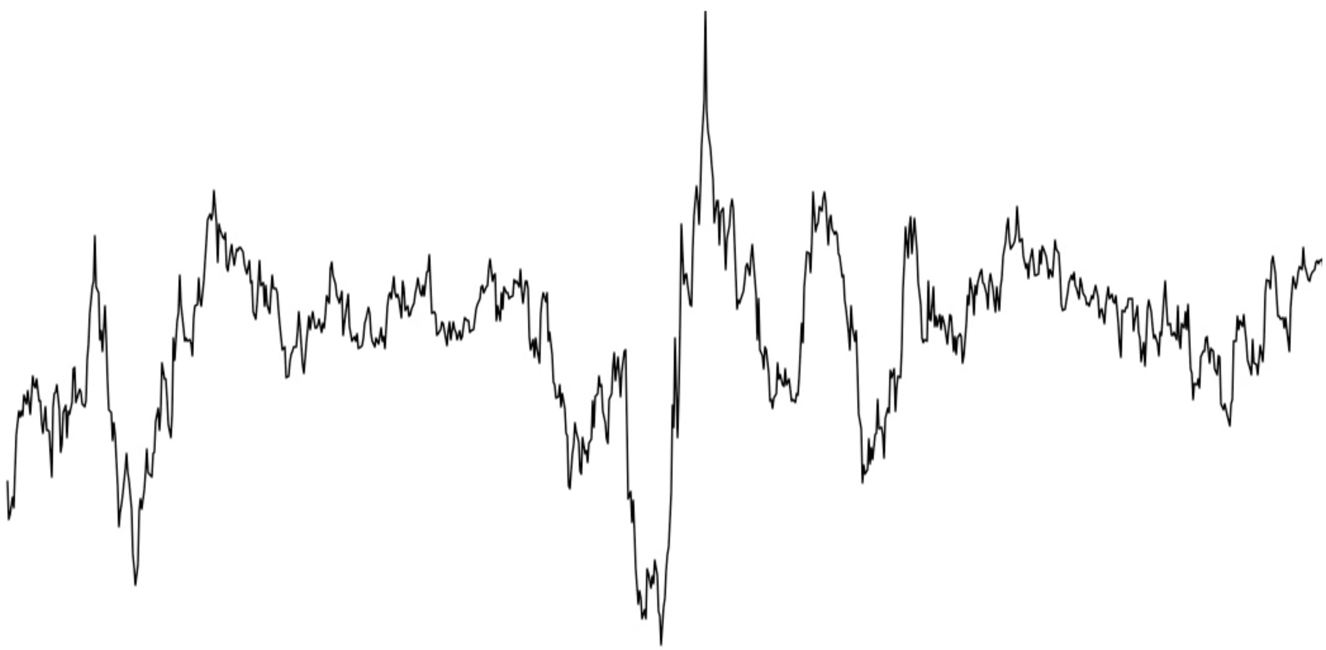
ALPHA SOURCES

APRIL 30, 2018



MULTIPLY THIS

Churn is probably the best way to describe equity markets at the moment. Inter- and intra-day volatility have increased, which is great news for the traders—and investment banks, apparently—but it isn't much help to the rest of us. It reduces the signal-to-noise ratio, which has already been stung by the persistent cloud of political uncertainty, the threat of trade wars and related themes. Everyone likes to talk about this, but these events have, so far, been of no consequence whatsoever to markets as far as I can see.

All that moaning notwithstanding, I am happy to report that the portfolio had its first decent month of the year in April. I was beginning to wonder whether I could be *that* bad at picking my horses. My confidence is now restored slightly, although I am still behind the mighty Spoos. Also, the next calamity is never far away. **Equity strategists are now telling me to worry about another thing: The multiple-crushing rise in oil prices.** Looking beyond the idea that a higher oil price *ought* to result in divergence between energy and the rest of the market, the idea is simple. A sharp rise in oil prices drives up inflation expectations and bond yields, both of which are poison for valuations. Multiple-expansion turns into contraction, and equities struggle.

UNDER ATTACK FROM MULTIPLE SIDES

The idea that higher oil prices will dent equity multiples is *particularly* interesting at the moment, for two reasons. **First**, we were told that the rise in oil prices was capped around $60 because of near-infinite supply elasticity in U.S. shale production. But this idea has been challenged by the sustained rise in prices. Some analysts argue that U.S. shale producers are more capacity constrained than markets think and that they are not the global swing producer everyone assumes. If these original assumptions are wrong, prices could increase much further.

Second, in a market obsessed and driven by growth stocks—mainly large tech—a rise in oil prices and rates could be a nasty combination for the major equity indices. This is *especially* the case if the yield curve steepens, as long-term yields run away from short-term rates. For the record, though, I see little risk of that in the near term. I think investors should consider buying U.S. 10-year bonds, in size, at least as long as short-rates are rising.

Whatever happens to the curve, the evidence is mounting that U.S. equity multiples are starting to struggle.By my calculations, April is on track to be first month, since February 2016, that the year-over-year increase in the S&P 500 *falls short* of the rise in nominal earnings. In absolute terms, the trailing P/E multiple fell by 0.3 points in March, and probably will have declined by 0.2 points once all is set and done in April.

The first chart below suggests that this, in part, can be explained by the Fed's hiking cycle. Sustained periods of higher short-term rates tend to be associated with multiple-contraction. The second chart below attempt to add oil to the analysis. It shows that a Z-score of the U.S 10-year yield and the oil price often *leads* the excess change in the S&P 500 relative to nominal earnings. The recent simultaneous increase in 10-year yields and oil price sends a clear signal that the P/E multiple is unlikely to increase much this year. Indeed, it probably should fall slightly. The question then becomes how much strong earnings momentum is worth.

fig. 01 / Higher yields squeezing the S&P 500… — fig. 02 / …And now oil prices are rising too