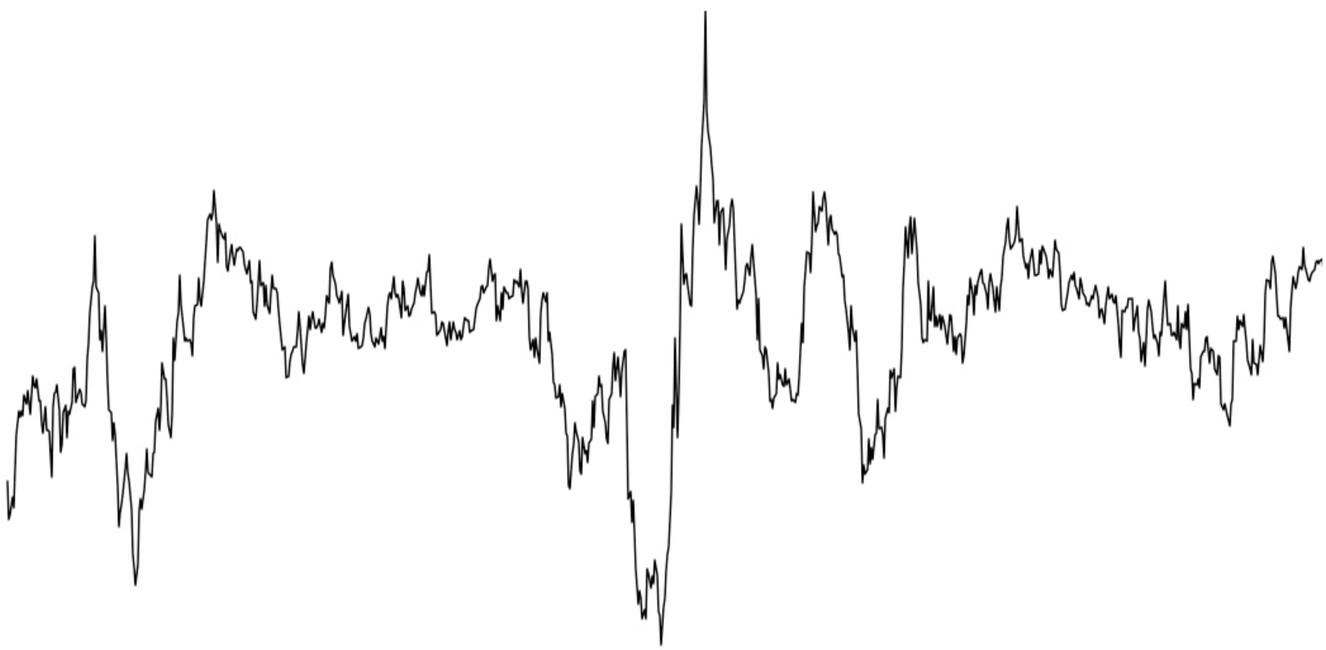
ALPHA SOURCES

JUNE 4, 2018



IT'S TIME TO PLAY DEFENSE

After two weeks on the road seeing investors, I am convinced that portfolio managers are becoming increasingly sceptical about the synchronized global recovery. That's probably a good shout. I recently surveyed global leading indicators, and didn't like what I was seeing. The data since have been worse. My in-house diffusion index of global leading indices has been flat since the start of the year. Its message is simple, global manufacturing accelerated sharply for most of last year, but momentum petered out in Q1. It doesn't yet point to an outright slowdown, though other short-leading indices, such as the PMIs, do.

The signal is more uniformly downbeat for the global economy if we look at liquidity indicators. Inflation is rising, with oil prices at a 12-month high, and nominal M1 growth is decelerating. **Historically, this has been one of the more reliable omens for slowing growth in the global economy.**

Of course, investors don't have to peruse economic data to tell them that something is afoot. Let me see whether I can remember everything. We have had wobbles in emerging markets, the return of political risk and higher bond yields, and even euro-exit chatter, in the Eurozone periphery as well as the morbid fascination that Deutsche Bank is going to blow a hole in the European, and perhaps even in the global economy. Oh, and lest I forget, Mr. Trump has fired the first salvo in the global trade wars, a move that undoubtedly will be met with return fire from the EU, Mexico and Canada. Happy days!

All of these have the potential *to wreak havoc on the global economy, but I am inclined to fade that risk.* EMs are not one asset class, I don't think Italy is leaving the EZ, and I suspect that the risk of DB becoming less relevant is much bigger than the risk that it takes down the global economy. That honour is reserved for a failure of one of the major ETF providers, in my view. I am perplexed by U.S. foreign, and trade, policy in general, but I am cautiously optimistic that this trade skirmish won't escalate into outright war.

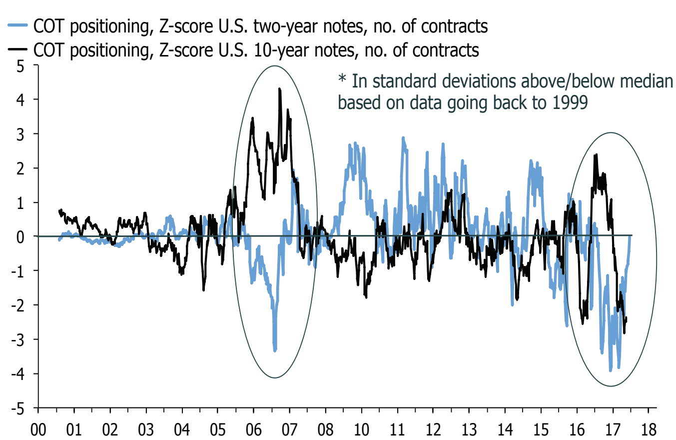
These flash-points probably will be catalysts for *looser*, or less tight, monetary policies, in time. *For now, though, they are not friendly to global growth and confidence.* My spider sense is tingling, and I think we are in for a shift in investors' sentiment.

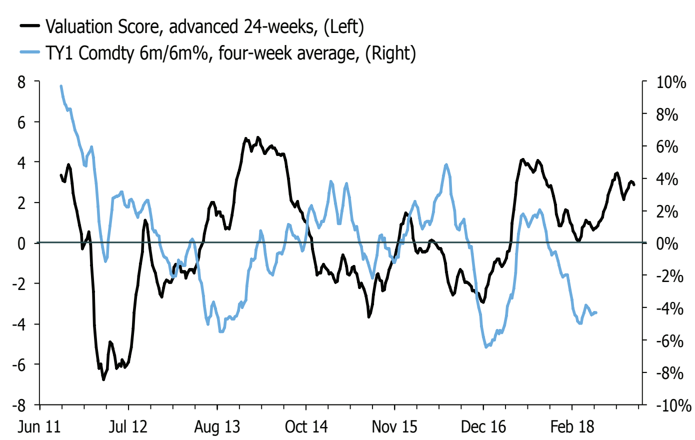
CLEARING POSITIONS IN U.S. BONDS

The consensus short in U.S. government bonds has been the first victim—in the major asset classes—of the change in tune on the global economy. This is one of the few things that I have been right on recently, and I don't think the move is over yet. Even if the U.S. economy is rising above the rest, it is possible that fears over global growth, and generally over-extended positioning, can push yields lower, temporarily.

The first chart below shows that speculators are no longer confident that U.S two-year yields will drift higher. Indeed, they are on the verge of switching into a net-long position on the U.S. front-end. That would be a sea-change. Given the resilience of the dollar—in part because of political uncertainty in other major currencies—cash in the U.S. still seems like a decent proposition. The 10y also looks good. Speculators are still heavily net short, although I suspect these data will have moved quite a bit when we get new data tomorrow. Finally, my model also points to upside for the 10y note.

fig. 01 / Not so sure about the Fed anymore — fig. 02 / Stay the course on the long bond





THE DEFENSIVE ALLURE?

In equities, no amount of Italian bond yield spikes or trade wars will alter the fundamental challenge for the bears. If they want to sell, they need to come up with a story for weakness in tech stocks, or more generally, in the growth and momentum factors. *So far, this has proven extremely difficult.*

Looking beyond the question of whether Spoos, and by extension the MSCI World, will crack over the summer, valuations across GICS 1 sectors send a clear signal. Investors should load up on defensives, and sell cyclicals, including tech. This trade is consistent with the idea that bond yields will fall further. **But it will also sound like a siren song to many investors.**

Telecoms were cheap at the start of the year, but guess what; they are now cheaper. But *all* the traditionally defensive sectors, including financials, can't be value traps at the same time. The divergence between conumer staples and discretionaries is interesting as is the fact that healthcare—to a big extent JNJ—is back in the green zone.

NOT EVERYTHING IS EXPENSIVE

Rising even further above the murky details, not everything in global equities looks expensive. My final chart shows that six major markets seem attractive compared to their long-run valuation multiples. Of these, Turkey is probably an outlier. It is certainly cheap, but also riddled with risks not captured by headline multiples. Anything other than a quick smash-and-grab needs to be considered carefully.

Elsewhere, the data hint at a few interesting regional pair trades. In North America, investors should fade the threat from trade wars and go long Canada/Mexico funded by a short in the U.S. Further south, longs in Colombia, Chile and Mexico look attractive if paired with a short in Peru. Malaysia stands out in Asia, and finally, U.K. equities are a decent proposition despite speculation that the country will descend into Mad Max 2.0 when it leaves the EU next year. The dollar likely is the ghost in the machine for the success of many of these trades, though, so the message is clear; it's time to play defense.

fig. 03 / The siren song of old-school defensives? — fig. 04 / Look to the right for options