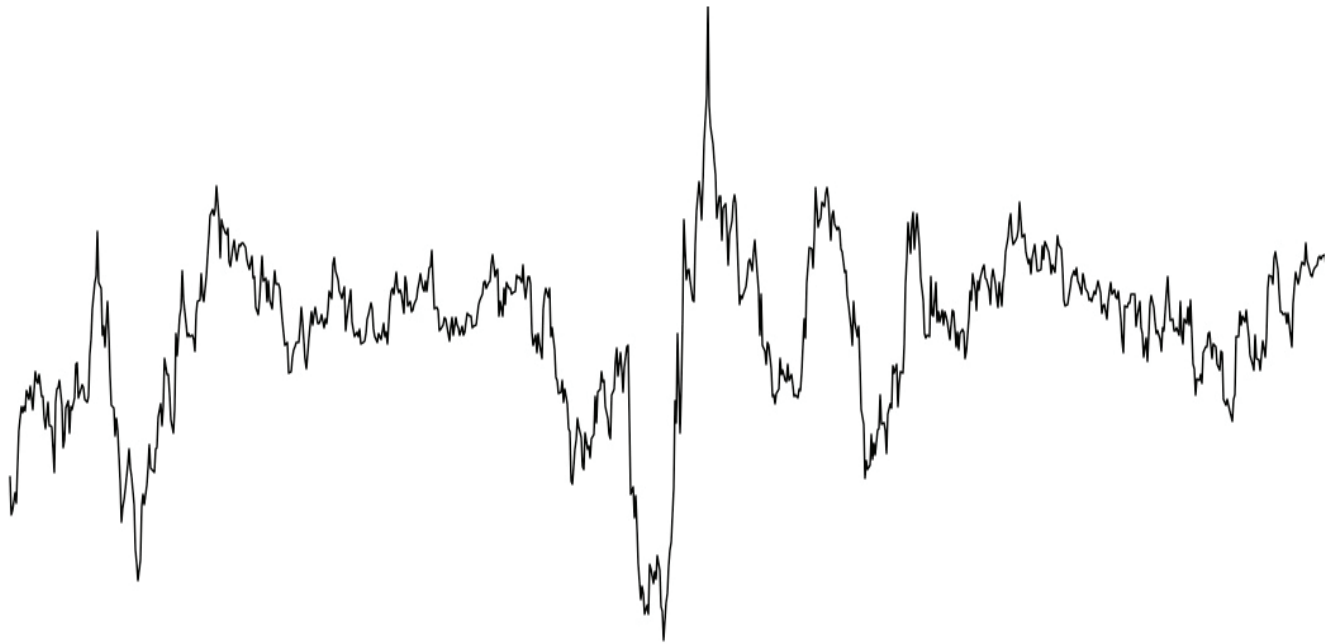


# ALPHA SOURCES

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MARCH 11, 2019



# VALUATIONS TO THE RESCUE?

Equities have wobbled a bit at the start of the month, but unless they lose the plot in coming weeks, it is fair to say that Q1 will be everything that Q4 wasn't; decent and calm. Indeed, the finer details reveal an even more striking dichotomy with the calamity that culminated in the rout at the end of last year. Between June—when the PE multiple peaked at just under 21—and the low for the S&P 500 in the final week of December, EPS rose by 13%, but the index fell by 10%. In other words, the multiple crashed, a story which was repeated across almost all key DM and EM indices. By contrast, the story so far in Q1 is the exact op-

posite. By my calculation, trailing EPS for the S&P 500 and MSCI World are *down* 0.5% and 2.1% year-to-date, respectively, but both indices have rallied smartly. This can only mean one thing; multiples have expanded, and they have indeed, by about 14% in both cases since the end of December. **I am confident that the tug-of-war between multiple expansion and deteriorating earnings will determine the fate of many equity investors in 2019.**

I struggle to see how the slowdown in earnings growth reverses anytime soon. The story will be different from sector to sector, but it isn't for nothing that equity strategists have been talking about an

\* / 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.



“earnings recession” since the beginning of the year; it’s real and it’s happening right now. Nominal EPS on the MSCI World rose +20% year-over-year between the middle 2017 and through most of 2018, but growth has now slowed to 12%, and the macro data signal a further slowdown.

*Multiple expansion won’t stave off the wolf of deteriorating earnings forever, but conditions for equity valuations have shifted in the past six months.* Last year’s rout was, at least in part, driven by the double-whammy of higher oil prices and rising bond yields in the U.S., but this trend is now turning.

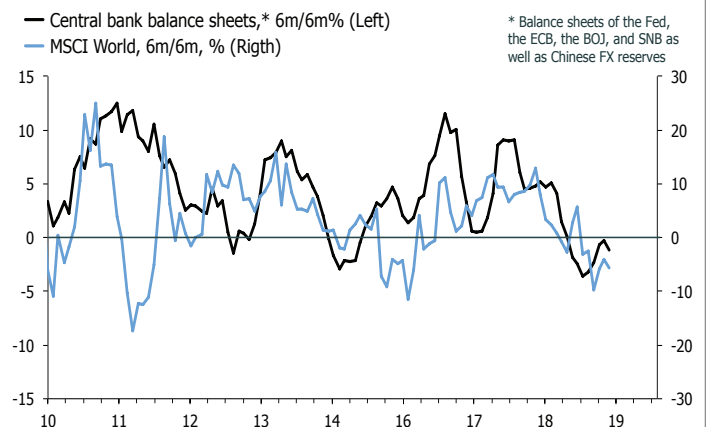
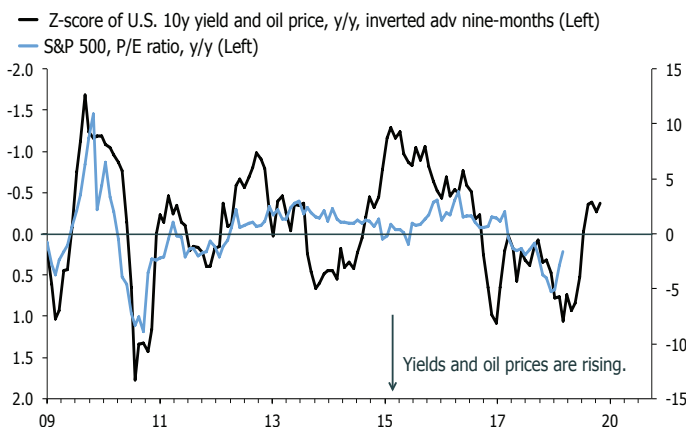
The first chart below shows that 10-year yields in the U.S. and oil prices are now falling year-over-year, signalling further upside for the S&P 500 P/E multiple. We can quibble about the lag—by the strict assumption of the chart below—the recent rebound in valuations is overdone, but the overall picture is clear enough. *Valuations on U.S. equities should increase this year.* With respect to the drivers of this story, I am not going to try to predict the oil price, but

simply note that base effects point to a negative year-over-year rate through most of the year, unless of course, the prices of increases sharply.

In terms of yields, a further rally in equities and stabilisation in the macro data, will re-engage the Fed. But the Fed’s dithering is part of [a much larger story in global central banking](#). The combination of the equity rout in Q4 and deteriorating macro data, especially in China, have revealed the pain threshold of global monetary policymakers.

The shift from the Fed being on autopilot, and the ECB and BOJ gradually withdrawing stimulus, has been replaced by a picture in which the FOMC is on hold, and the BOJ and the ECB are stuck, more or less indefinitely, with ultra-loose policy settings. Add to this the PBOC’s efforts to ease, and the overall story is clear; *the global central bank put is alive and well.* My final chart shows that their combined balance sheet is still contracting, but more TL-TROs at the ECB, increased asset purchases by the BOJ, and perhaps an end to QT at the Fed are all on the menu.

fig. 01 / Will the S&P 500 P/E multiple *increase* in 2019? — fig. 02 / Not yet walking the walk



## ALPHA SOURCES

fig. 03 / Still poor, but early signs of a bottom?

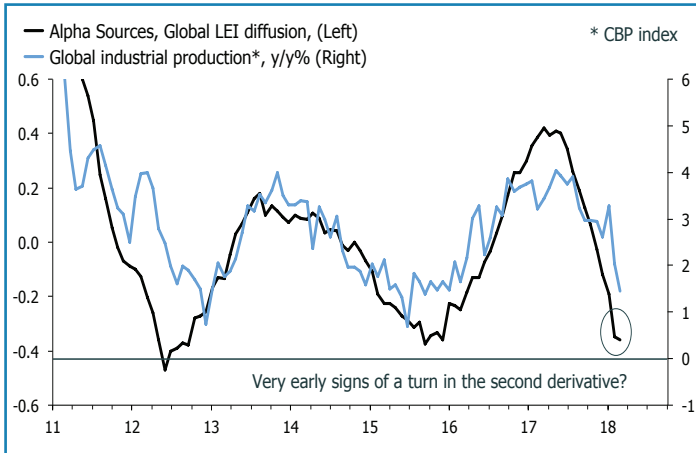
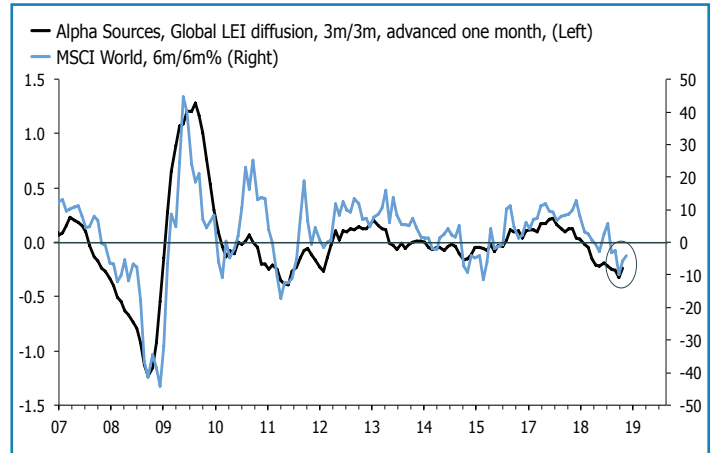


fig. 04 / The second derivative appears to be turning up



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

fig. 05 / The U.S. yield curve is still inverted...

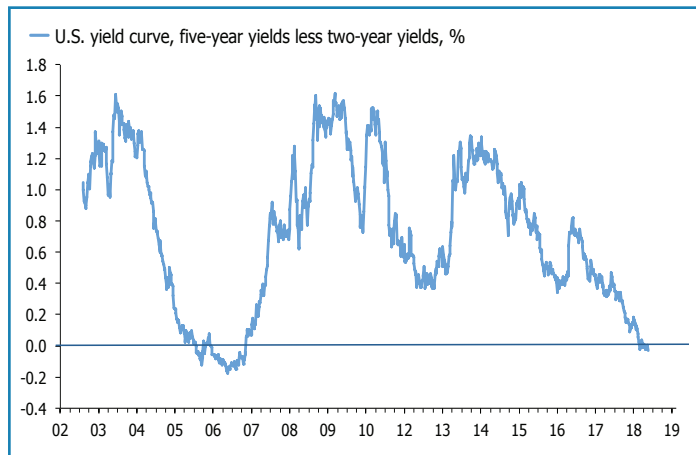


fig. 06 / ...But speculators are becoming less bearish on the front end

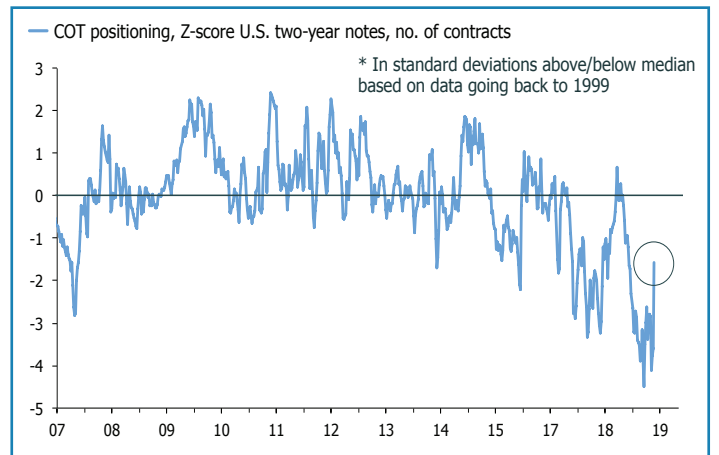


fig. 07 / A bottom for the DAX relative to the mighty bund?

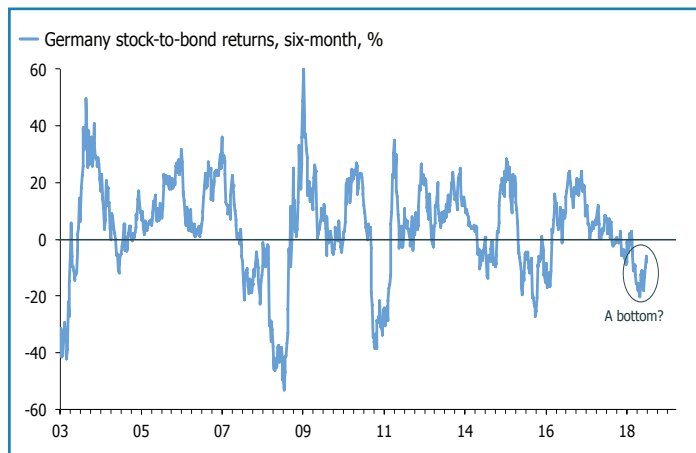
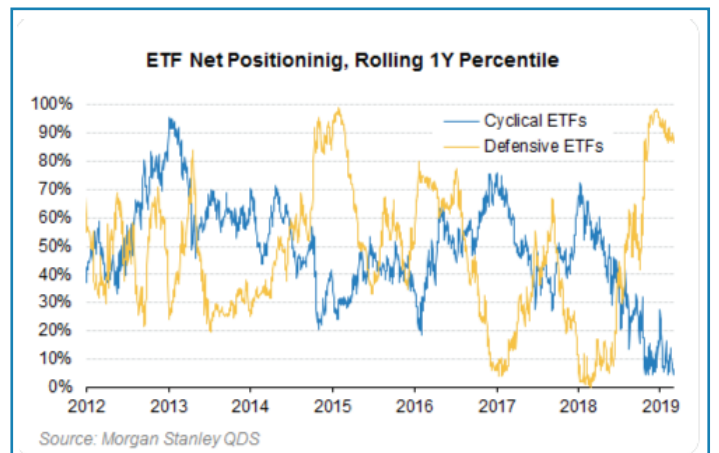


fig. 08 / All change for a bet on cyclicals in the next 12 months?



Source: Morgan Stanley, [via Driehaus' Twitter feed](#)