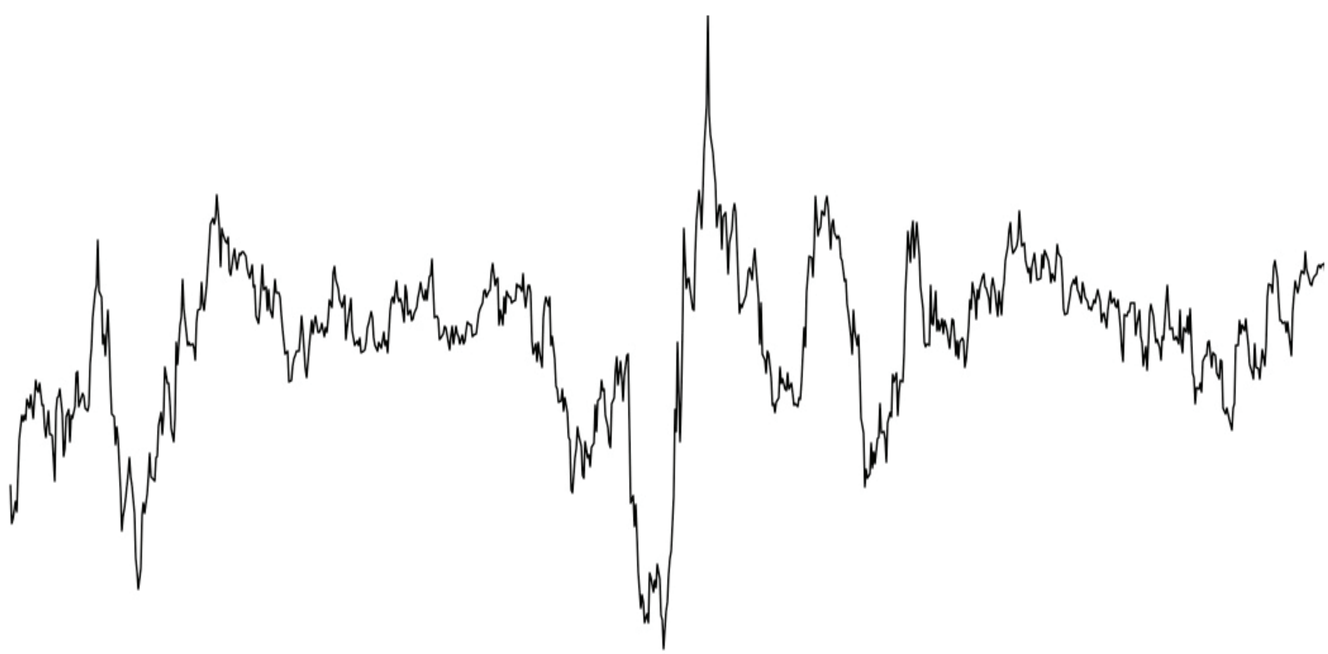
ALPHA SOURCES

NOVEMBER 19, 2018



SLIPPING AND SLIDING

Unfortunately, the stand-out move in markets since my last report—the crash in oil prices—is one on which I have little to say, let alone expertise. I didn't see it coming, and I am not exactly sure why it happened. That said, I am not here to make excuses, so I'll try to connect the dots as well as I can.

A sudden fear of over-supply due to a shift in OPEC policy doesn't seem to cut it as an explanation. I am more inclined to buy the idea of linking it with the jump natural gas prices, deeming it an erstwhile winning spread-trade gone wrong, at least in part. Pierre Andurand's name has been mentioned too, which certifies that this has been a *real* rout in the oil market. Mr. Andurand's $1B commodities fund reportedly shed a cool 20.9% last month.

Whatever the causes of the swoon in oil, it serves as a decent entry the broader market discourse. I am sympathetic to the argument by Cameron Crise, a strategist with Bloomberg, that "Recent energy-price mayhem is just the latest sign that something about these markets looks broken." Cameron goes on: "The presumption of a continuous liquidity spectrum is clearly an errant one." Most readers of these pages will have plenty of recent examples that fit this picture, so I'll jump straight to the grand conclusion.

* / 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.

Even broad-based, and notionally diversified, market exposure currently feels picking up dimes in front of the proverbial steamroller. Recently, it's been arduous work just to stand still, even with what seems as relatively low risk. Of course, picking the exact point at which the steamroller catches up with investors can be profitable, but good luck trying to do *that*.

The collapse in oil prices potentially has important implications for other markets too. Unless it jumps straight back to +$70, headline CPI and PPI rates are about to come crashing down. This is a trivial prediction—base effects alone mean that inflation will fall sharply in Q4 and Q1—but I reckon that it could be significant for bond yields and investors' interest rate expectations.

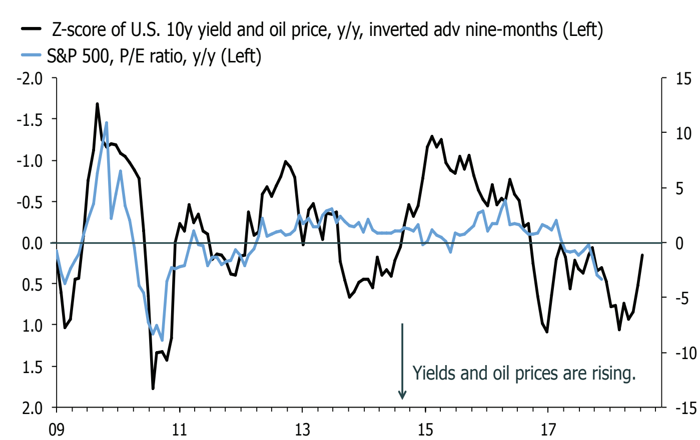
Rising volatility and softening global growth mean that markets are now angling for a dovish December hike from the Fed. I am no Fed-watcher, but it seems like the notion of the Federales stuck on autopilot is under serious threat. In fairness, Eurodollar futures imply that investors have reduced their bets for Fed hikes next year, but not by much. In addition, neither two nor 10-year yields have budged much, and speculators continue to hold significant net short positions in both.

I have no complaints with the idea that U.S. rates should go higher, but few things in markets move in a straight line. *If I had to nominate the next candidates falling victim to Cameron's dis-continuous liquidity-spectrum, the U.S. treasury market would be be high on the list, with yields moving lower.*

In equities, the drop in oil prices ought to help multiples, with a lag, but it is too soon to say anything for certain. My combined Z-score of oil prices and yields continue to point to multiple contraction, which is exactly what is happening. The P/E ratio on the S&P 500 was just over 22 at the start of the year, and is now "just" 18.7.

The breakdown of these data is fascinating, if also a bit scary. The difference between the year-over-year change in the P/E ratio and EPS has widened to a whopping 17pp in October and November. In other words, had it not been for

fig. 01 / A sitting duck? — fig. 02 / The big squeeze in U.S. equity multiples



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EPS growth of +20% y/y, this model suggests that U.S. equities would have been incinerated, and not just stung.

DON'T ASK THE MACRO DATA FOR HELP

The outlook doesn't get better if we overlay our analysis with the macro data. My diffusion index of global leading indicators has collapsed signalling downside risk for global hard data.

If my index is correct, global industrial production growth is about come crashing down. The upshot is that equities tend to price these movements in advance. In addition, the next shoe to drop, if at all, likely will be the U.S. data, adding further pressure on the Fed to disengage its autopilot.

The picture gets worse, however, if we home in on global money and liquidity indicators. Global real M1 growth has plunged to 1.7% year-over-year, a pace last observed in the summer of 2008, ahead of the financial crisis. This sombre message is strengthened by the fact that global central banks are no longer expanding. In fact, the aggreagate balance sheet by the Fed, ECB, BOJ, and SNB, with Chinese FX reserves for good measure, is now shrinking.

The second chart below updates the relationship between momentum in real M1 and the rate of change in global equity prices. *Notwithstanding a tepid rebound into year-end, it is impossible to pain anything but an ugly data with these numbers.* My estimations suggest that global equity prices will be falling by nearly 15% year-over-year by April next year, hinting at a downside from current levels of about 11%.

The silver lining amid this litany of bad news is that sector rotation *appears* to be offering investors some help. This is a big deal. *The litmus tests for this equity market always was whether it could rotate away from growth–mainly in the U.S.—with everything getting destroyed.*

So far, I am encouraged by what I am seeing, especially in telecoms. Another big test is whether beaten U.S. homebuilders can rally if rate expectations are marked down. As long as we can still tell such stories, I am inclined to believe that investors, with a bit of work, can avoid slipping and sliding.

fig. 01 / No help from the macro data — fig. 02 / No good will come of this

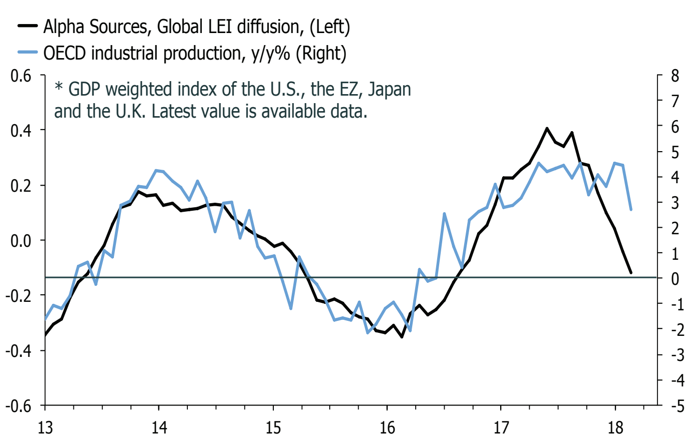

fig. 03 / The great contraction in global central bank balance sheets...

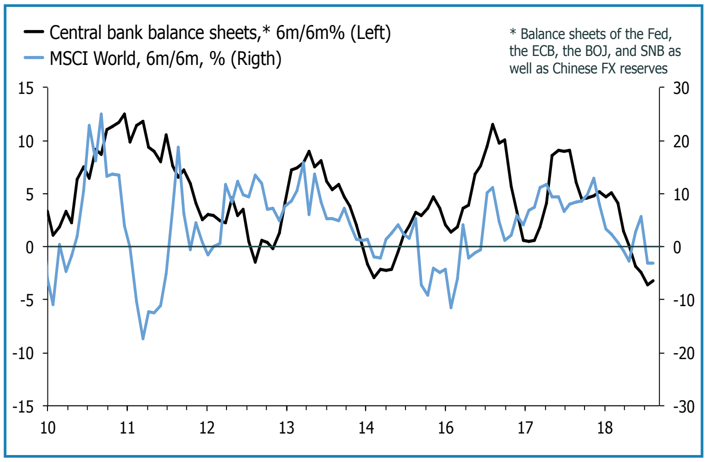

fig. 04 / ...Quantitative tightening is well under way in the U.S.

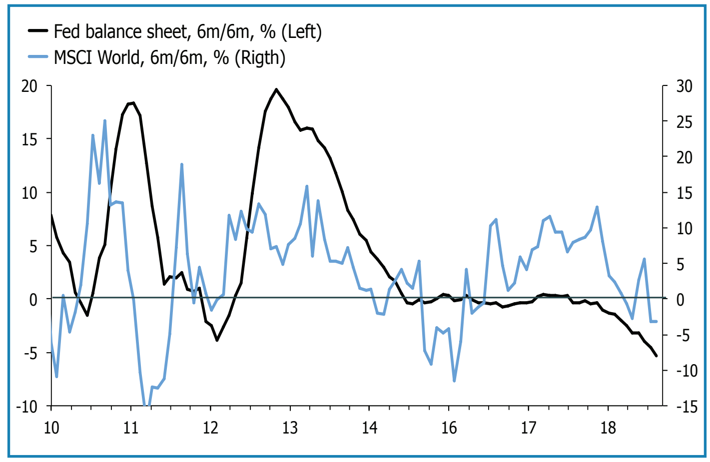

fig. 05 / The surplus-economies are less of a help than they used to be

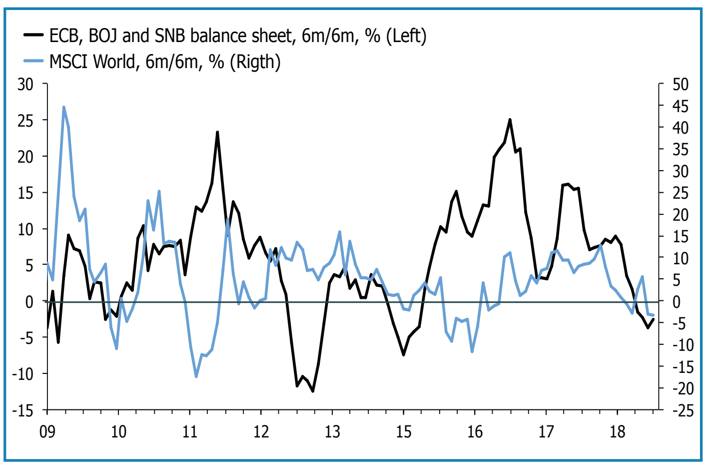

fig. 06 / FX reserve growth in China has stalled this year...

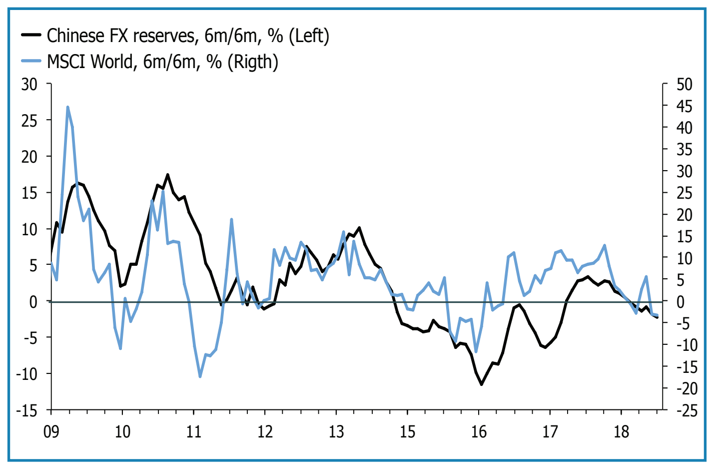

fig. 07 / ...Coinciding with a brutal contraction in narrow money growth

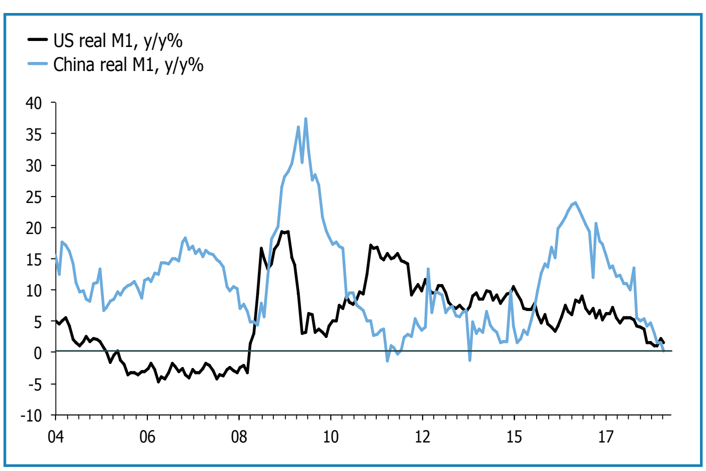

fig. 08 / U.S. small caps are underperforming sharply, a rebound?