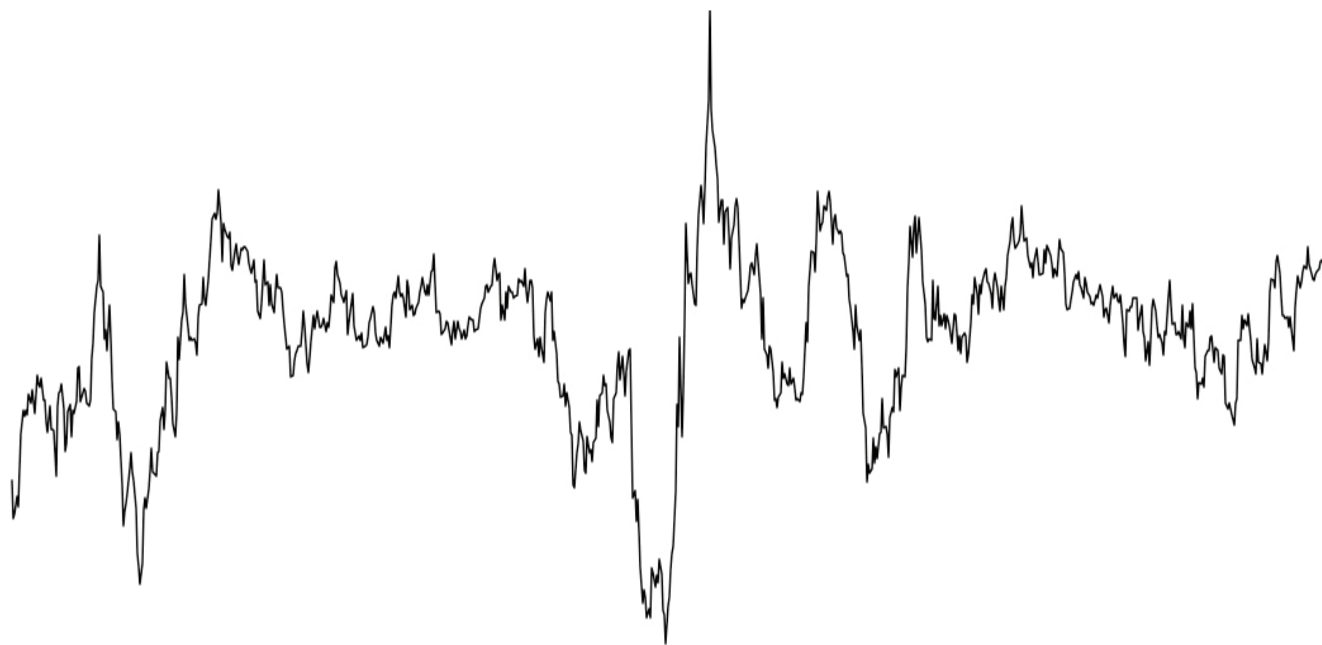
ALPHA SOURCES

MAY 6, 2019



TESTING TIME

The Q1 earnings numbers have kicked up a lot of dust across sectors and individual companies, which is good news for stock-pickers eager to prove their worth. For markets as a whole, though, I see little change in the underlying narrative relative to what I have been talking about recently.

Equity investors remain focused on what policymakers are saying rather than what they're doing, sticking with the idea that central banks, and perhaps even politicians at large, have their backs. Bond markets are nodding in agreement. Solid labour market data in the U.S., and a robust Q1 GDP print, have not dented market-implied expectations that the next move by the Fed will be a *cut*. And in the Eurozone, markets have priced out an adjustment in the deposit rate through 2021. Blackrock's Rick Rieder summed it up neatly last week by referring to the asymmetric outlook for policy. I am paraphrasing, but the idea goes something like this: "If central banks raise rates, they will do so slowly and hesitantly. If they have to cut, due to tightening financial conditions and a slowing economy, they will do so fast and aggressively." I would even wrap in fiscal policy here, though this admittedly tends to operate more slowly, and over a longer timeframe than monetary policy.

* / 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.

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This story of asymmetric policy risks has many familiar labels; goldilocks, the central bank put, or perhaps merely it is a crystalisation of the wall of worry that markets love to climb. Whatever we call it, it is at odds with an economic cycle that has been chugging along since 2013. **Normally, risks are asymmetric in the *opposite* direction at this point in the cycle, as policymakers focus on inflation risks and excessively exuberant asset markets.** The fact that they aren't, at the moment at least, is a powerful tonic for markets.

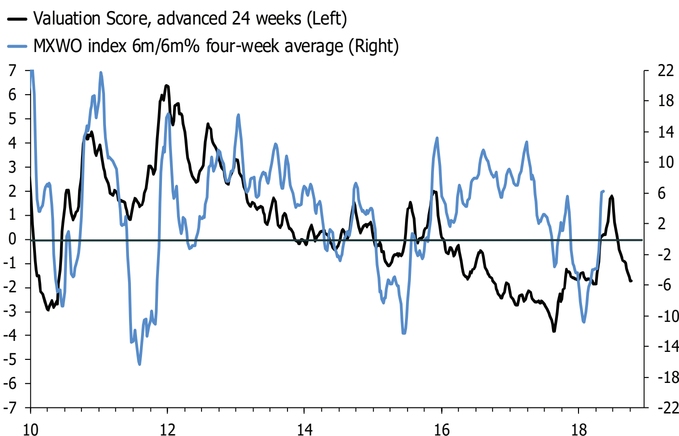
For risk assets, it means that credit spreads have narrowed and equity valuations expanded despite a sharp slowdown in global growth since the middle of last year. Meanwhile in bond markets, yields have declined across the board.

Economists are trying to keep investors honest by pointing to the discrepancy between exuberant asset markets and still-subdued macro leading indicators. I share that sentiment, but green shoots are now emerging. Real M1 growth in China and the Eurozone have picked up, and the hard data have come in better than implied by surveys, especially in Europe. This will be a curse in disguise if it prompts policymakers to rethink their cautious stance, but it is fair to say that more is needed.

Meanwhile, the bears are emerging from hibernation, seeking to exploit the fact that carry-chasing vol-sellers once again appear to be getting over their skis. A bull market in vol-selling, rising equity prices and falling bond yields is a combination that we have seen before in this expansion. *It's nice as long as it lasts, but experience suggests that nasty reversals almost always puncture such periods of comfort for the bulls.*

As I type, Mr. Trump has unnerved market participants on an otherwise docile Sunday afternoon through this tweet suggesting that the tariff on Chinese imports will be hiked to 25% on Friday, in sharp contrast to expectations of a much softer trade deal. The dollar will rally tomorrow, and equities will sell off. It could be testing times for the bulls, but more specifically, it will also be testing time for the idea of a central bank put, and whether markets buy it.

fig. 01 / Running on empty in equities? — fig. 02 / Is the rally in U.S. duration over?



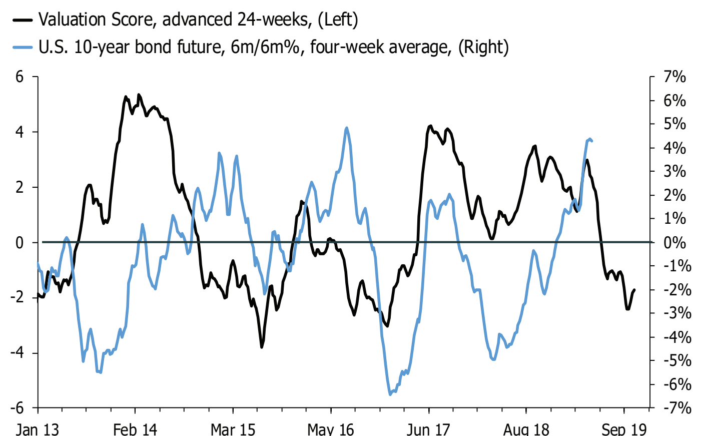


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fig. 03 / Signs of a short-term bottom in global economic growth…

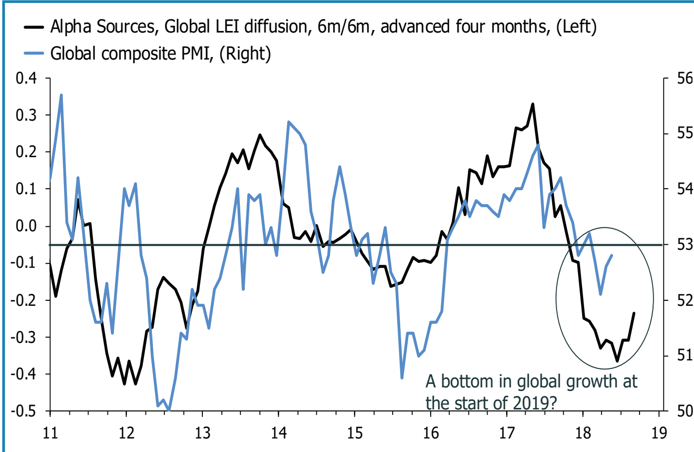

fig. 04 / …But markets are way ahead of the curve, to their detriment?

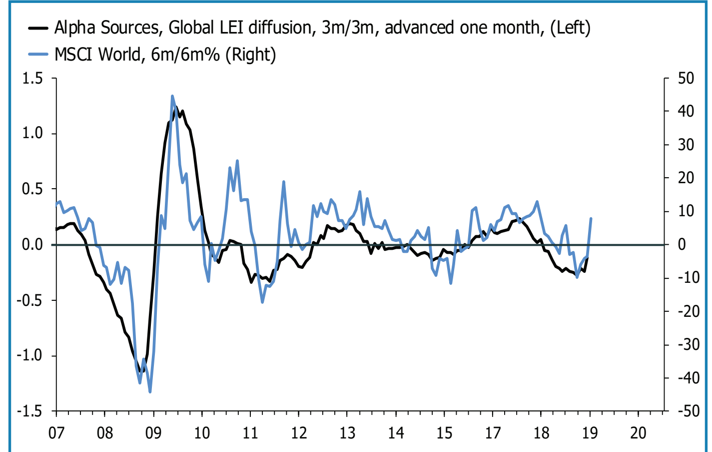

fig. 05 / Quantitative tightening at the Fed is still a drag…

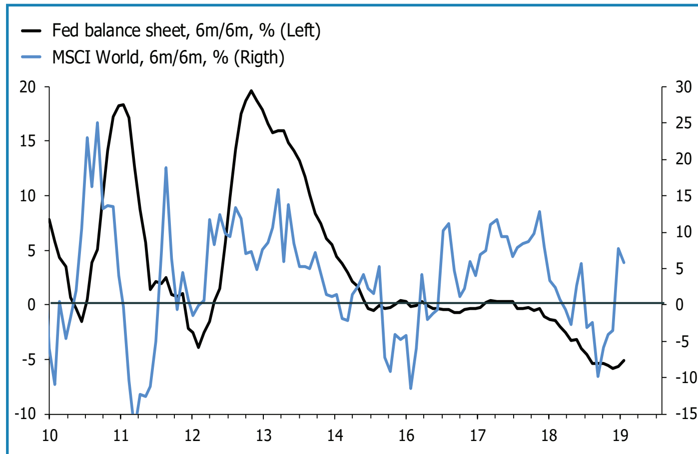

fig. 06 / …But other CB balance sheets are expanding again, slowly

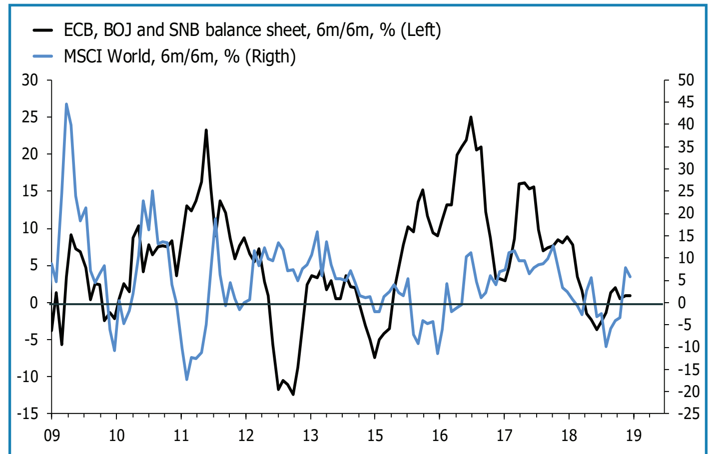

fig. 07 / All eyes on this chart in the next few weeks, back above 7?

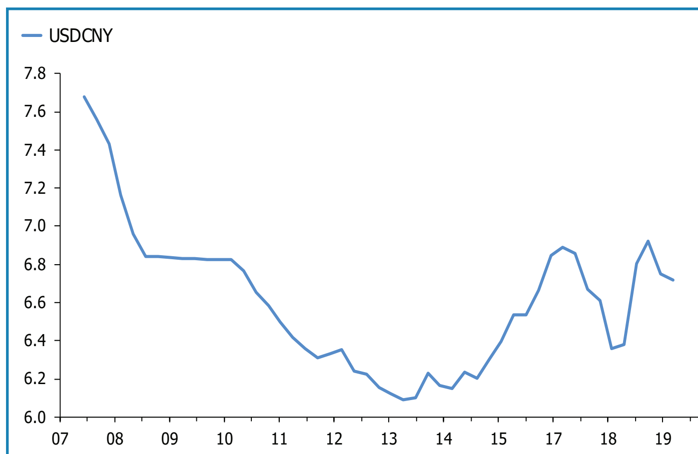

fig. 08 / When in doubt, stick to the flattener and growth stocks?

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