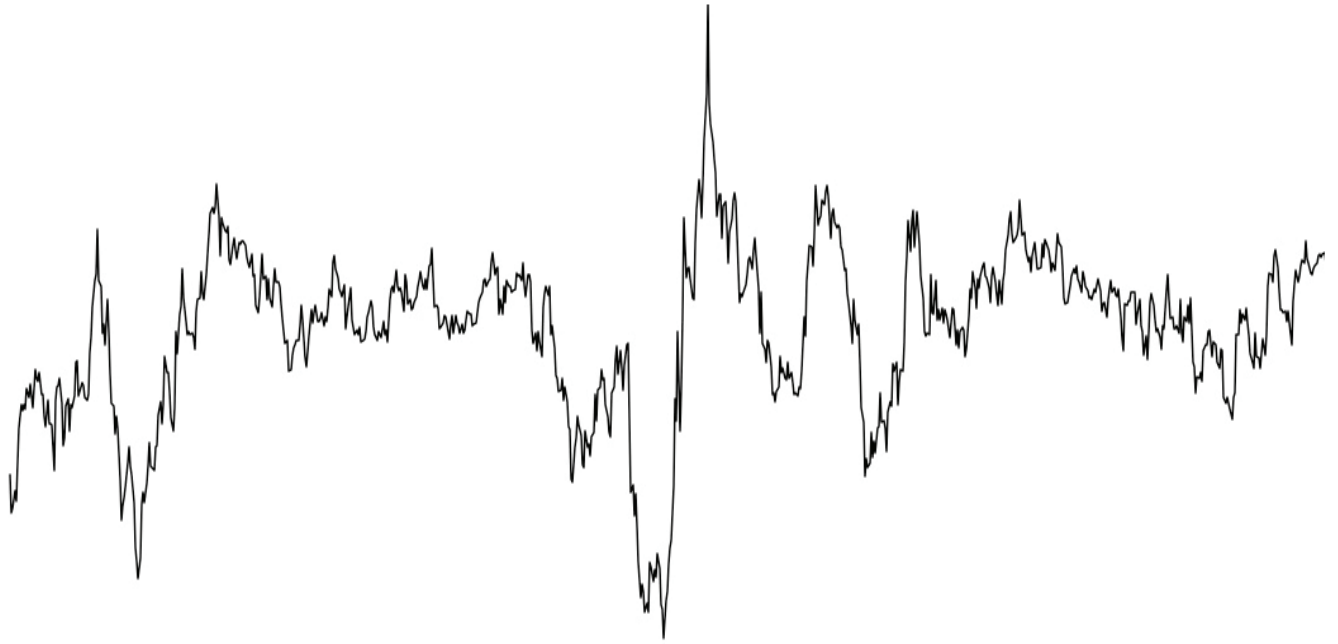


ALPHA SOURCES

JANUARY 8, 2018



AS YOU WERE

On a headline level, 2018 has started exactly as 2017 finished. Stocks are up, U.S. short term rates are up—but the dollar has traded heavy—and economic data continue to tell a story of a synchronised upturn in global growth. The bears are furious, or perhaps just confused. [Hussman recently published a prepper's guide to a hypervalued market](#). And value investor extraordinaire—and famed bear—Jeremy Grantham from GMO [invokes](#) the “highest-priced markets in US history,” but also proclaims that we’re now in the “melt-up phase” of the bull market. I am all for holding opposing views at the same time,

but markets demand a view and a position. So which is it Mr. Grantham? Long, short, or flat? I am not holding my breath for an answer. I have long since left the extremes behind. Picture a spectrum with Hussman and GMO at one end, and the wet-behind-the-ears trader, who have never experienced a sizeable drawdown in Spoons, at the other end. Hint: You want to be somewhere in between.

Separating signal from noise is an important skill in this game, and markets currently are throwing a number of curve balls at investors. What better way to kick off 2018 than by highlighting the ones that matter.



HOW STRONG IS GLOBAL GROWTH?

A common refrain from the bearish community is that equities are detached from economic fundamentals. I call bullshit on that narrative. The swoon in Q1 16—labelled the “Chinese devaluation scare”—came on the back of a dip in global growth. The sizzling rebound in equities since has gone hand-in-hand with a broad-based *upturn* in global economic momentum. The first chart below shows that global leading indicators are turning up, and that industrial production is responding accordingly. Economic data always include an inherent lag, but the message here is clear; hard data in the next few months should be solid.

[Cameron Crise’s recent missive](#) argues that this global “boom” is more modest than the bulls would have us believe. Perhaps. But if this is true, doesn’t it just mean that core inflation pressures will be slower to build and that goldilocks—which markets love—are more likely to persist? “Just right” seems to be preferable to a “BOOM,” at least in the current environment.

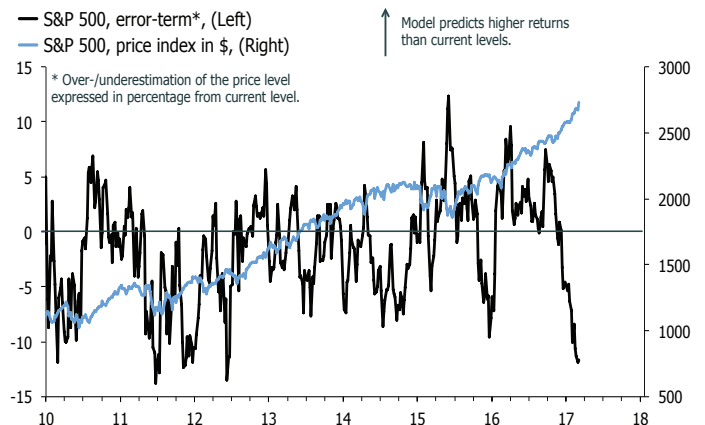
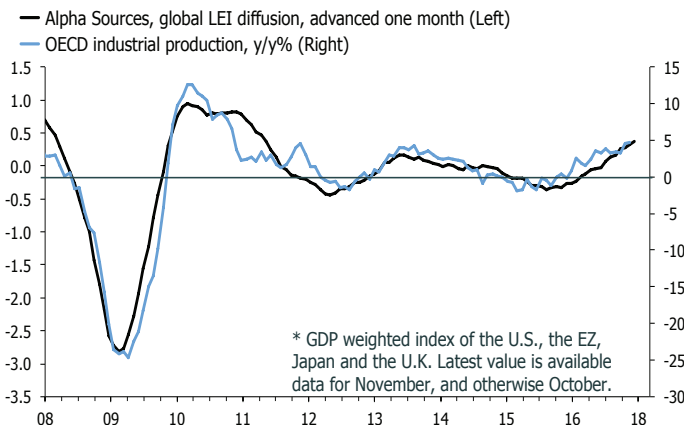
FORGET SPOOS, BUY COMMODITIES?

Goldilocks is the perfect scenario for equities, and the mighty Spoos—and its close brethren—have not disappointed. The index finished 2017 up about 20%, and have come out swinging in 2018; it was up just over 2% last week.

A healthy and stable global economy, however, is not the only reason that equities have had a good start to 2018. My in-house put/call index jumped to a 15-month high on the first trading day in January. Apparently, punters were worrying about a turn in the trend at the start of the year. **And there is nothing this market loves more than to climb a wall of worry.**

Looking ahead, valuations are challenging, and the second chart below shows that my fair value model for Spoos warns about downside risks. But these headwinds won’t necessarily kill off this bull market on their own. In fact, evidence suggests that they don’t matter at all. Just ask those analysts who have been using valuations or technicals to talk equities down in regular intervals since 2011.

fig. 01 / Don’t fight the trend? — fig. 02 / Spoos are running ahead of everything





Instead, *rotation* between asset classes—and equity sectors—have offered plenty of opportunities. **To that effect, 2018 has started by teasing investors with the idea of a sustained upturn in commodities.** The primary catalyst has been the continued increase—and recent range break-out—in oil prices. This, in turn, chimes with [the fact that energy equities look relatively attractive at the start of 2018.](#)

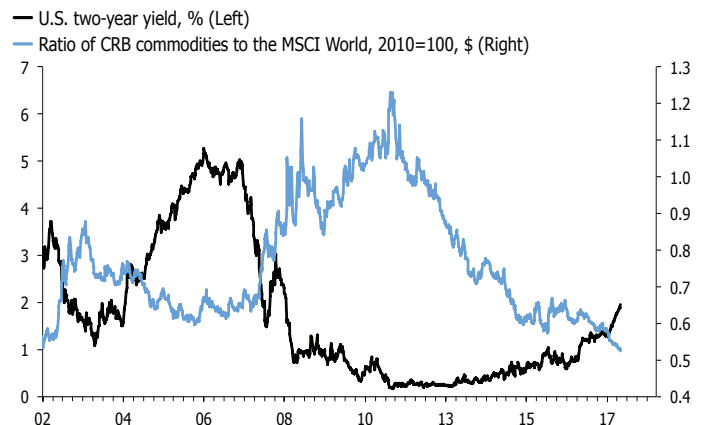
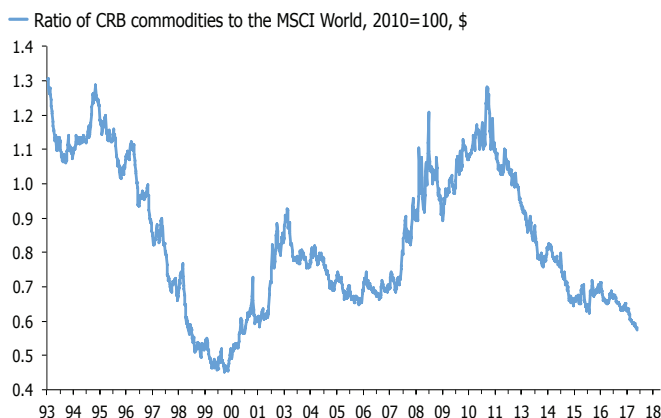
Belief in mean-reversion, though, also is playing a role. Commodities have been sluggish for a long time, and investors are betting that inflows from a low base will produce a winner in 2018. Normalised at 2010 values, the headline CRB commodities index is close to a record low vis-a-vis the MSCI World.

Another argument for commodities to flex their muscles turns the normal model upside down. Traditionally, we treat commodities as a risky financial asset, and as a positive beta to global excess liquidity. When central bankers open the taps, “unprintable stuff” goes up in value.

If ZIRP and QE become structural, though, the link between liquidity and commodities reverse. Abundant liquidity leads to unproductive investment and excess capacity, which drives up supply and prices down. As a result, when rates rise and liquidity is withdrawn, supply is constrained and prices go up, with a lag. This narrative requires that the economy maintains some form of momentum as financial conditions tighten. After all, the traditional model of commodity prices partly assumes that their prices are pro-cyclical.

The fortunes of oil prices in the next few months will tell us a lot about what drives commodities. The spot price of CL1 is gunning for \$65, close to the level where you would expect U.S. shale cowboys to start pumping like mad. But interest rates in the U.S. have shot higher—and are still rising—which could change the story. The idea is that the marginal producer needs money to ramp up production, but that funding will be less easy to come by now that benchmark yields are higher. If this is true the elasticity of shale production to

fig. 03 / It's been a long slump — fig. 04 / Long lags between yields and commodities?





higher prices will be a negative function of higher yields. I suspect we are about to find out whether this framework is sound or not.

KEEP AN EYE ON CHINA

Every year a select number of analysts proclaim that the great unravelling of China’s debt binge—the notorious “hard landing”—is at hand. This year is no different, but it is juxtaposed by the sense that China is serious about changing its ways. The economy is rebalancing, allegedly, and the [One Belt One Road initiative](#) hints at China’s *global* economic aspirations.

A rebalancing and more assertive China probably is good news. But I am worried about the current account surplus, which dipped to a decade low of just over 1% of GDP in Q3. Most economists agree that rebalancing in China is necessary. But *markets* are accustomed to the idea of a command-control economy in China under the stewardship of the PBoC. The ability to micro-manage the flows of credit and investment is diminished, however, if

you require external financing to fund domestic consumption and capex.

If China is a ticking debt time-bomb, a current account deficit would be an ominous sign for its economy and markets. Where will yields in China go if foreigners have to chip in to deliver on the government’s growth targets? Alternatively, how much will the CNY depreciate—or domestic growth slow—to balance the external books? In both cases, the question is how much deflation, a Chinese external deficit will export to the world.

USDCNY is now close to 6.45, which is where the PBoC drew a line in the sand in Q3 last year. Whether they do the same here will tell us a lot about the appetite for an appreciating currency and a dwindling external surplus.

My colleague Freya Beamish does not expect China to slip into an external deficit in 2018. But this is partly because she expects growth to slow on the back of slower investment and household borrowing. Rebalancing in China probably is good news, but it also carries new risks.

fig. 05 / Are we ready for a Chinese CA deficit? — fig. 06 / Will PBoC intervention save the day again?

