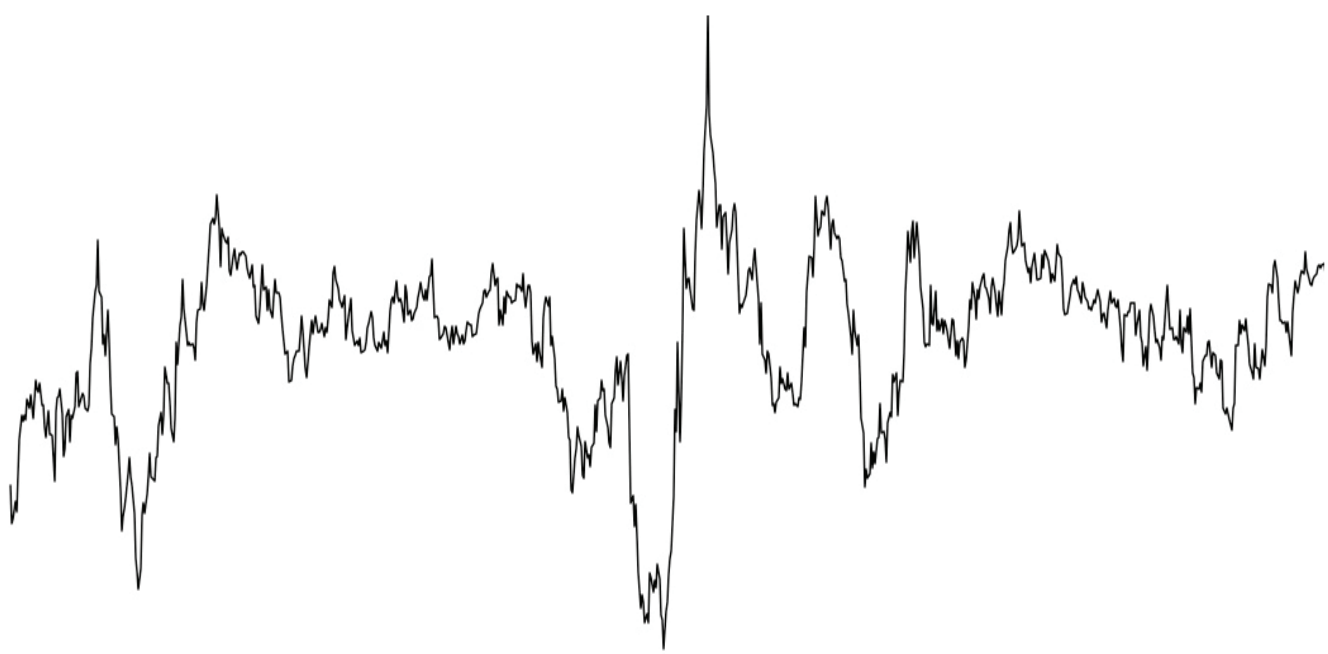
ALPHA SOURCES

MARCH 19, 2018



INFORMATION OVERLOAD

Sometimes when you're faced with too many choices, the best thing is to do nothing at all. When I look at markets, I sense that many investors are thinking along the same lines. If true, I have sympathy for it.

In the U.S. economy, the news flow has invited contradicting conclusions. The February NFP report in delivered a hawkish headline, but sluggish wage growth and a higher labour force participation rate suggest a goldilocks interpretation. It is similar in the global economy. We have the promise of a fiscal stimulus-boosted U.S. economy growing close to 4% adding further momentum to a synchronous global upturn. But data in the Eurozone have disappointed recently, and investors also have to count the risk of a tit-for-tat trade war in tariffs. Geopolitics, as always, loom on the horizon too.

In FX markets, we are still debating whether reckless economic policies in the U.S. will drive the dollar lower or whether Make-America-Great-Again™ will revive the dollar bull. A wider twin deficit, in principle, could deliver both.

We have also been discussing the Libor OIS spread, Italian politics, and of course, the ongoing tragedy of Brexit. **I view markets through narratives, but I struggle to come up with one that captures all of the above.**

HOLDING PATTERN IN EQUITIES

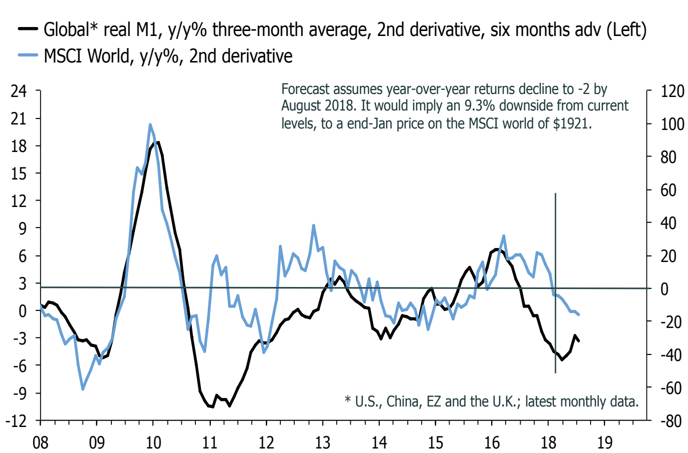
Global equities are still shaking off the after-effects from the February crash, so it is probably unfair to hold this market to ransom for anything at the moment. The MSCI World is up 2% since the beginning of March, but still 5% off the peak in January. It's normal for equities to trade sideways—with higher intraday volatility—after a drawdown, so this is as expected. Looking ahead, strategists also appear undecided on whether equities will break their sideways movement to the upside, or whether a further leg down is in the cards.

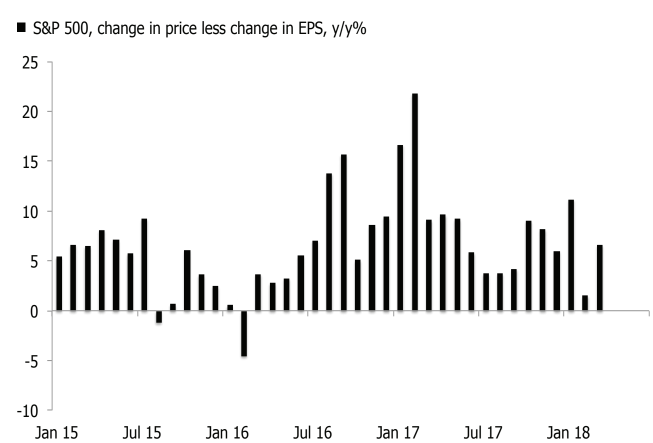
The majority of my models suggest that equities are due for further weakness. My fair value model for the S&P 500 has turned up, but at 2542, it still signals downside to the tune of just under 8%. I get the same message from my composite valuation and technical indices. Finally, global liquidity conditions also are becoming less supportive of equities. Citigroup's Matt King has been pounding the drum on [the fading support to risk assets from QE](). I have been struggling to replicate Mr. King's results, but I agree with the overall point. *The marginal boost to risk assets from excess liquidity is waning.* The first chart below shows that the second derivative of equity returns have rolled over, consistent with a similar trend in global M1. No one trades these models, but the message from my market-based indicators is unanimous; equities are 10% overvalued, at least.

Looking beyond secondary pricing models, a break-down of the S&P 500's return shows that the lift from multiple expansion is fading. This isn't hugely surprising. The second chart below shows that prices soared ahead of the increase in earnings for most of last year. This pace in multiple expansion was never likely to be sustained.

Nominal earnings are rising about 10-to-15% year-over-year, and risks are tilted to the upside in light of the tax reforms. If we use this framework to compute a year-end target for Spoos, we get 2941, which is just shy of 7% *higher* from here. With this backdrop, you have to assume a *contraction* in multiples to take a bearish position.

fig. 01 / Liquidity momentum is slowing — fig. 02 / Fading multiple expansion?





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Faced with the downbeat signal from headline equity indicators, I have patiently been positioning the portfolio's equity allocation in single-name value stocks and defensive sectors. It isn't exactly going according to plan, at least not in relative terms.

The first chart below shows that the ratio of value to growth has recently collapsed to a new low. This points to another lesson for equity bears. **They need to come up with a catalyst for a reversal in the bull market in big tech, and in the growth "factor."** The most obvious source is a regulatory assault on the rising market power of Amazon et al., but I am not holding my breath for action anytime soon.

BACK TO CURVE FLATTENING?

The outperformance of growth in equities is closely tied to the bond market via the close correlation to a flattening yield curve. This makes sense for two reasons. First, if long-term *economic* growth expectations are falling, firms who deliver strong topline growth should trade at a premium. Secondly, a low discount rate, r, and high growth, g, leads to soaring valuations in standard models, most prominently in versions of Gordon's Growth Model.

Just as in equities, bond investors also have exhibited indecision recently. At the start of the year, rates were pushing higher across the board, and the curve was steepening slightly. After the February swoon in equities, however, the rise in long-term yields has been checked, and the curve has flattened. Speculators remain heavily net short both front-end and long-term bonds. **I stand by my call that exposure to U.S. fixed income is not the worst place to be.**

I am undecided, though, on whether the curve steepens or flattens. Specs are positioned for a steeper curve—they are more aggressively short 10y than 2y contracts—but that doesn't always lead the curve. Besides, investors are more interested in discussing the merits of three or four Fed hikes this year than the shape of the curve. This week's Fed meeting will bring us closer to an answer, but probably not closer to the end of information overload.

fig. 03 / One strategy to rule them all? — fig. 04 / Investors are betting on a steeper curve