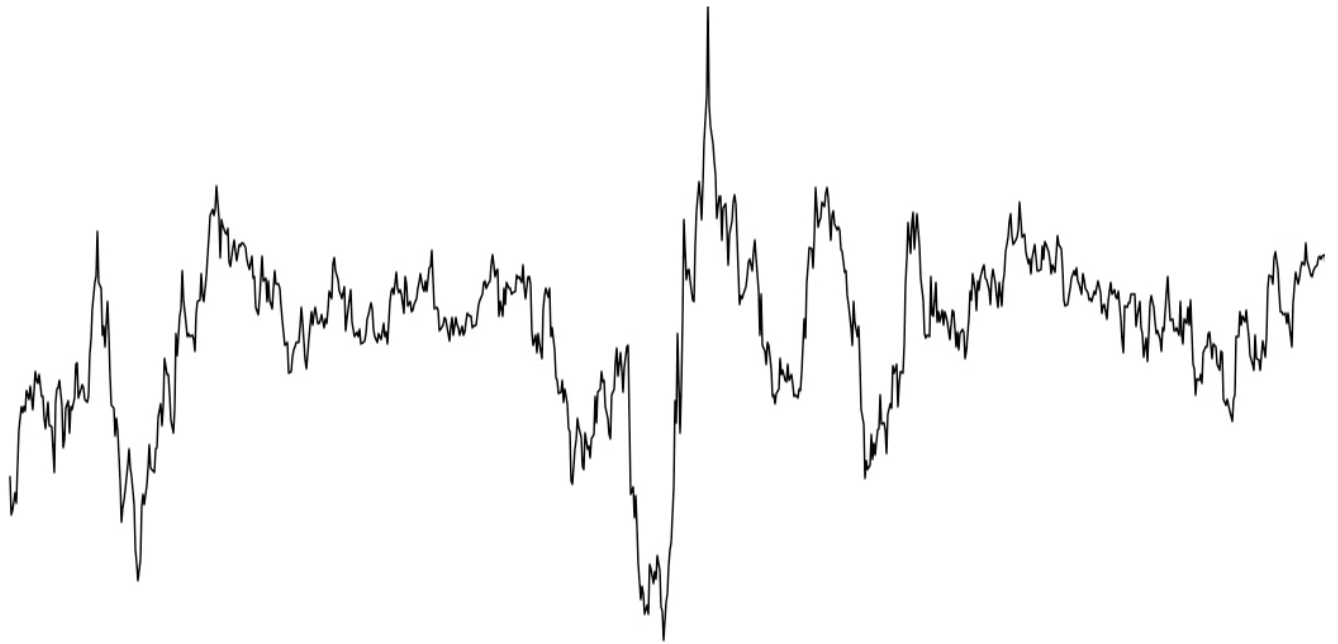


ALPHA SOURCES

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WATCHING AND WAITING

Sometimes it is best just to sit back and do nothing, and perhaps, watching the World Cup isn't such a bad way to spend your time at the moment. [Last week, I laid out what I consider the two main economic and market themes.](#) First, real narrow money and liquidity growth is slowing, which is usually a bad sign for risk assets and second, monetary policy divergence is being stretched to new extremes. I surmise that most of the key macro-trading trends can be derived from these two stories. All other important themes are just crammed into the box labelled political uncertainty, a box which incidentally is increasingly full to the brim. The

consensus is that political risk is the dog that never barks; this true on a headline level. But I can't help but think that markets are a like deer caught in the headlight. *Everyone is waiting for one of the political landmines to blow up, but no one knows what to do about it.*

In the U.S., Mr. Trump has escalated the global trade wars, though markets are not exactly pricing-in the end of the globalised world order as we know it. Rather, they seem to have settled on the idea that the U.S. is winning. Small cap U.S. equities have soared, and the dollar is bid. The latter effectively is an equaliser. If the dollar rises as U.S. imposes import tariffs, the real



economic impact of Mr. Trump’s policies will be curbed, perhaps even neutralised altogether. **Trade wars don’t get real until *capital* movement is restricted—either indirectly or directly—and non-tariff barriers are erected to disrupt global supply chains.** It is fair to say that we aren’t there yet. Indeed, the most likely short-term result of this is that the U.S. runs hot and that its external deficit *widens*; this won’t bother Europe and Asia that much.

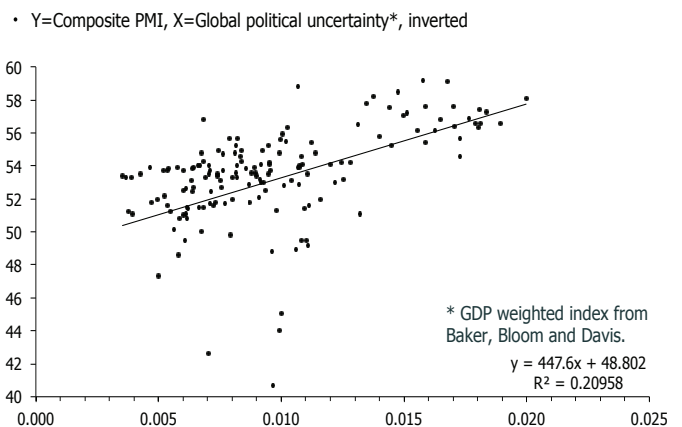
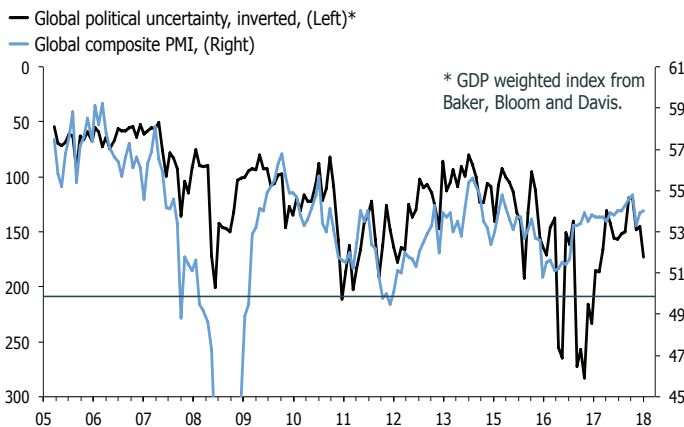
Elsewhere in Europe, I am struggling to keep count on the number of political banana skins. Italy’s new government is a wild card, a stand-off over Eurozone economic reforms is looming, the migrant crisis is creating rifts in the EU as a whole and within its individual governments, and finally, the tragedy that is Brexit is about to reach its climax, one way or the other.

Political risk in Europe, though, is a strange animal. It is a frustrating source of discounted asset prices for investors. And no matter how many reforms they do in Brussels, the EU/Eurozone will not become an “optimal” political or

monetary union overnight. In any case, those with intellectual capital invested in the break-up of the EU and the Eurozone will never be satisfied, until and unless the project fails. To their chagrin, though, political risk in Europe also often tends to instil a sense of urgency, and to create centrifugal sources. *These make the club stronger over time, even if it happens, for example, in the context of jettisoning principles of decency in the treatment of asylum seekers and other non-Western migrants.*

Looking at the quantitative evidence, it is understandable that investors try to avoid the hullabaloo of political risks. The first chart below shows that global political uncertainty—here proxied by the Baker, Bloom and Davis index—isn’t a good leading indicator for global growth. The second chart shows a regression trying to explain the global PMI. The relationship is barely significant from a statistical point of view. Perhaps the BBD index is just an imperfect measure of political risk, but more likely; it’s easy to agree political risk is elevated, but it isn’t easy to act on it.

fig. 01 / Not exactly a close relationship — fig. 02 / Better than random, but not much





PAIN OR GAIN IN EM?

One of my buyside friends was kind enough to share the recent investor survey from Absolute Strategy Research, ASR, with me over the weekend. Its conclusions are straightforward. Investors are now much less upbeat on the global economy, confirming that the transition from a synchronised to a de-synchronised global upturn is now consensus. Investors surveyed by ASR are less upbeat on equities as a whole, but remain upbeat on the U.S. market at the expense of growing negativity on non-U.S. equities, especially in emerging markets.

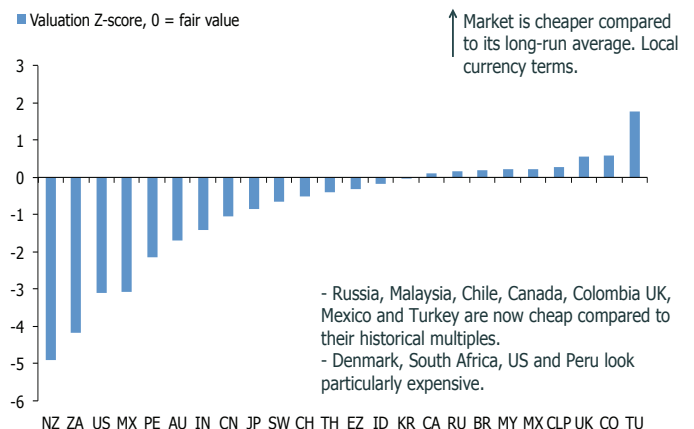
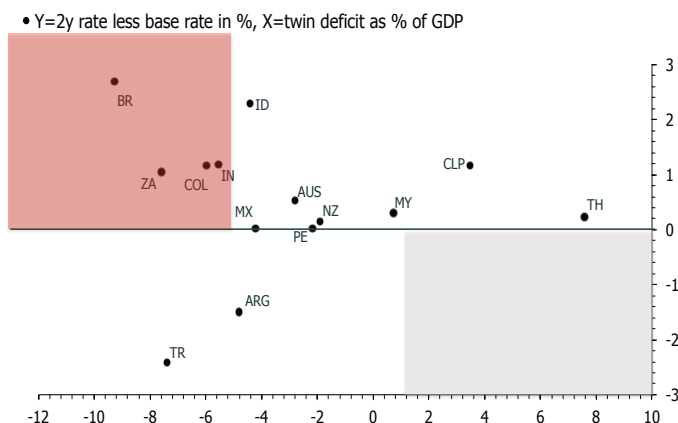
The plight of EMs is understandable. In many countries, the combination of questionable economic policies and shoddy political institutions makes it difficult for investors to focus on upbeat long-run demographic fundamentals and opportunities for capital deepening. In addition, the hiking cycle in the U.S.—which probably won't finish anytime soon—has exposed EM borrowers with USD-denominated foreign liabilities. More generally, higher rates in the U.S.

often force inflation-targeting EM central banks to move too as weaker currencies increase inflation risks. Adding insult to injury, the Chinese economy also is slowing—[we know this because the authorities are now easing policy](#)—further increasing downside risks.

The first chart below tries to quantify the risk across EMs*. It plots the difference between the 2y bond yield and the base rate alongside the twin deficit as a % of GDP. The idea is simple; A high twin deficit and a two-year yield far above the base rate indicate that the central bank is behind the curve.

Brazil stands out. It has a large twin deficit—mainly due to a big fiscal short-fall—and the 2y yield is 270bp above the Selic rate. Turkey and Argentina are still risky, but at least, the central banks have now caught up with the bond market. Indonesia also looks risky, as does Colombia and South Africa. By contrast, Chile and Malaysia seem more resilient, which is interesting because those two equity markets are cheap based on their long-run average multiples. Maybe emerging markets aren't all pain?

fig. 03 / Who's still behind the curve? — fig. 04 / A few opportunities for the brave



* AUS and NZ are there because they *sometimes* correlate with EM.