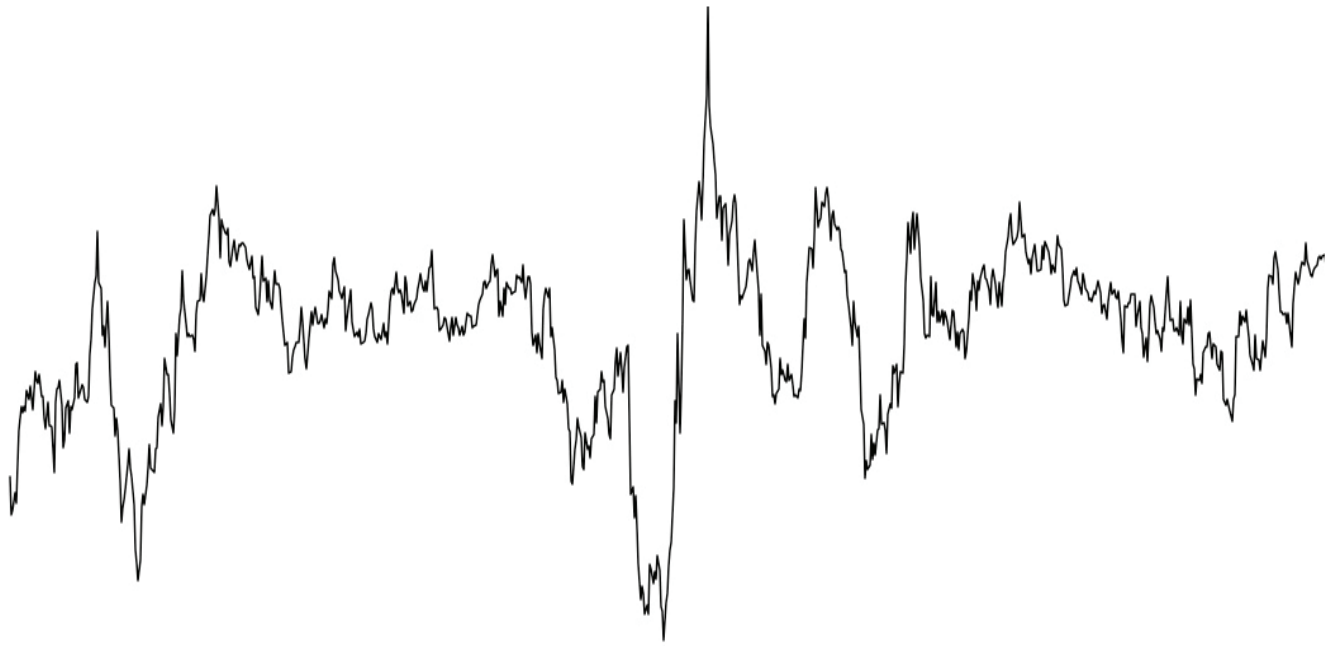


ALPHA SOURCES

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THE GRAND FINALE

Let me run a story by you. The dollar is rising against both its EM and DM counterparts, and U.S. equities—predominantly growth and tech—are gunning higher. By contrast, EU equities are lukewarm, and EMs are outright struggling as balance-of-payment stress take down one domino after the other. In bonds, the U.S. front-end is held up by expectations that the Fed will keep trucking, while the belly and long end are edging sideways. In other words, the U.S. yield curve is, still, flattening. Finally, all measures of global macro-liquidity have rolled over; real M1 growth is falling, and CB balance sheet expansion is kicking into reverse.

To boot, most other leading indices also are exhibiting weakness. If this doesn't sound familiar, it means that you have been living under a rock this year.

I have been recounting this story for several months, and I am getting tired of it. But we haven't yet had the grand finale so it's probably too early to abandon it, as much as I would like to.

In summary, I think we are due a fall in U.S. bond yields, potentially in both the 2y and 10y but almost certainly in the latter. I reckon that this happens alongside, or right after, a final moonshot in the dollar. It should be a cathartic moment for markets, setting the stage for a different story.



BOND YIELDS ON THE BRINK?

U.S. 10-year yields are up about 70 basis points on an annual basis, and I understand the case for further upside. The combination of Mr. Trump’s recklessly loose fiscal policy and a late-cycle economy coupled with tariffs on imported goods are a recipe for inflation. In addition, the Fed has begun to roll off its balance sheet, and the pace of QE in the euro area and Japan is dwindling.

This is a decent story, but the up-trend in long-term yields have stalled this year; yields have been in a tight range since February and have generally struggled to push above 3%. This is consistent with market-pricing, and the Fed’s dots, indicating that the terminal rate is somewhere in this region.

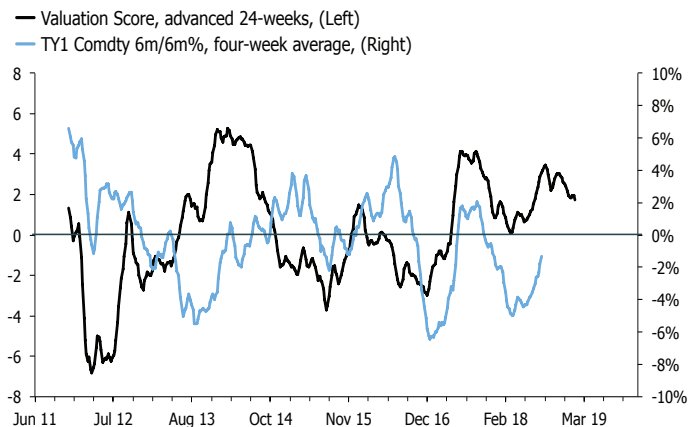
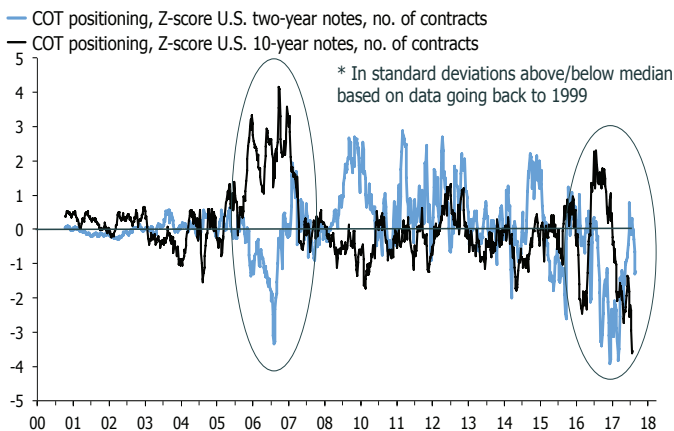
By contrast, yields have held up above 2.75% with consistency, though I reckon that this range will break to the downside soon. *Whatever the long-run trend in bond yields is, bond bears are sitting ducks.* The first chart is probably chart of the week. It shows net speculative short positioning on 10y futures is now at a record it also shows that

investors have resumed selling of 2y futures. The second chart shows that trailing returns on the U.S. 10y future has accelerated recently, and my model suggests that they will rise further.

I see two scenarios in which U.S. bond yields take a temporary stumble. In the first, the Fed doesn’t care about stress in emerging markets, nor the slowdown in global liquidity, and continues to push the Fed funds rate higher. This would make some sense; the U.S. economy is strong, and its asset markets are purring. That said, it’s *also* logical to expect 5y and 10y yields to give up the ghost if the Fed is tightening into a general global slowdown. The dollar strengthens, at least initially, and the U.S. curve inverts.

The alternative is that the Fed blinks, which probably requires indications of spill-over from EM stress into the U.S. economy *and* a further sharp increase in the dollar. In this scenario, front-end yields take a big hit, while the 10-year yield likely will be more sticky. The curve probably steepens, and the dollar weakens, eventually.

fig. 01 / Sitting ducks? — fig. 02 / It is great when a plan comes together





Wargames aside, I am trying to make a simple point. **It's impossible to see a change in this market narrative without a decisive move in bond yields and, or, the dollar.** One or the other will happen, eventually.

EQUITIES TELL THEIR OWN STORY

Equities ultimately will be hostage to big moves in the dollar or yields, but they tell their own individual story too. At the moment, the discussion centres on the outperformance in the U.S. This is understandable given the persistence and intensity of this trend. I happen to have the perfect model to hand. The first chart below shows an estimation that backs out the value of the S&P 500 based on the major MSCI regional indices. We haven't seen this degree of outperformance since early 2013. On that occasion, U.S. equities continued to perform strongly while the rest of the world eventually caught up.

Asset allocators will be hoping for a similar result this time around, but they should be careful not to miss the forests for the trees. Looking beyond the

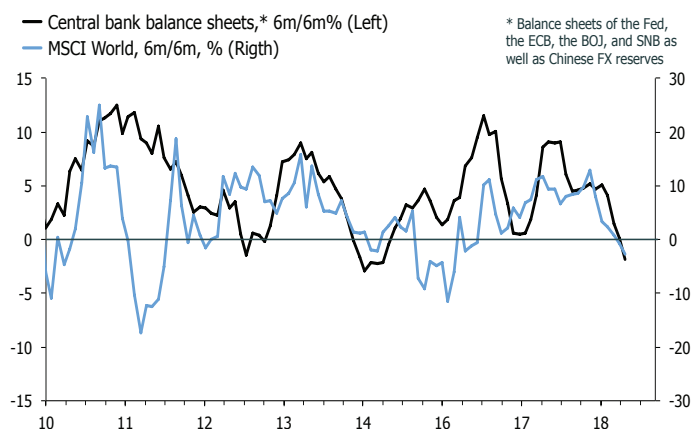
outperformance in the U.S.—which is increasingly narrow anyway—global equities are doing what we should expect in a world of slowing liquidity.

The second chart below that the MSCI World is now falling on a six-month basis, consistent with a contraction in G4 central balance sheets. To be fair, the global stock market has achieved this “correction” by moving sideways. But look under the hood, and you'll find that EMs and EU indices are exhibiting significant weakness.

I am not cherry-picking my indicators, in case you're wondering. All gauges of global liquidity that I look at have rolled over, signalling lean times for risk assets. In addition, broader-based leading economic indicators also are showing weakness, though they continue to signal decent growth overall.

The counterpoint to this downbeat story is that significant divergence between sectors and countries *ought* to offer opportunities. Technology, consumer discretionary and industrials have been the stand-out performers in global equities on a 12-to-24 month basis.

fig. 01 / One market to rule them all? — fig. 02 / It's all going according to plan





Telecoms and staples have been the big losers, while Healthcare, energy and financials have been lukewarm. They are doing great if we stretch the period to a two-year view, but not so good on a y/y basis.

The point I am getting at is straightforward: If bond yields decline, it will be accompanied by a rotation in equities towards the traditionally defensive sectors. More specifically, if the yield curve steepens, it ought to drive outperformance of value over growth.

I think these stories offer a more reasonable basis for discussing the outlook for equities than the idea of an imminent 2008-style crash. Accidents happen, but experience in this expansion suggests that preparing for them can be a very costly strategy.

Divergence also is a key story across the major country-indices, which should provide some comfort to global investors. My final chart ranks MSCI indices based on their long-run valuation Z-scores estimated with P/E, P/B and P/S ratios. The swoon in emerging in

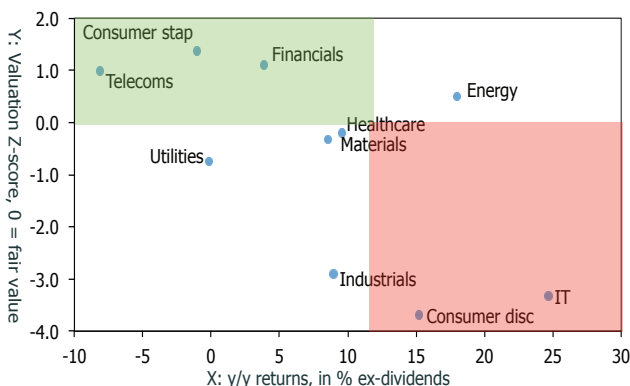
markets have created value in select pockets, though China—which matters most for index huggers—is not outright cheap, despite recent weakness. Turkey, Chile and Colombia come out strongest in EM, while the UK, Canada and South Korea are most attractive among the mature economies. Turkey is a particular case; the present chaos will undoubtedly set up a good opportunity for contrarian investors, but I have no idea when or how the situation is resolved.

I notice that Chile and Colombia are being singled out as the next potential fault-lines in EM space. By the yardsticks of Argentina and Turkey, though, I think they'll be absolute fine.

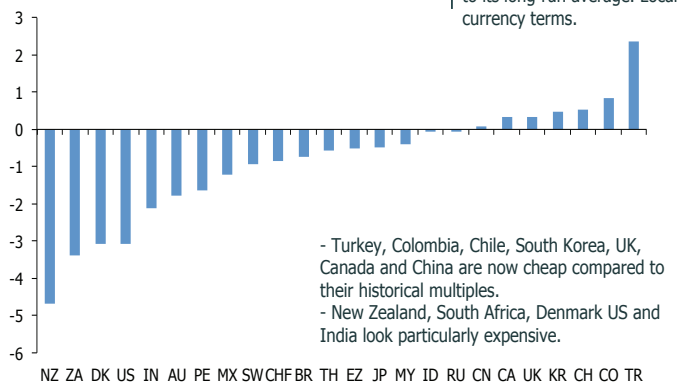
On the other side of the coin, equities in New Zealand, South Africa and Denmark are best avoided. The MSCI New Zealand, for example, is trading at a dizzying 44x earnings. This seems a tad much for an index with a dairy producer and an airport operator two of its four largest constituents. That said, I profess ignorance on NZ equities, so don't bet the farm. It's probably better to wait for the grand finale in bonds and DXY.

fig. 01 / Trading places? — fig. 02 / Pick your horses wisely

• MSCI World, GICS 1 sectors, valuations vs trailing returns



■ Valuation Z-score, 0 = fair value



↑ Market is cheaper compared to its long-run average. Local currency terms.

- Turkey, Colombia, Chile, South Korea, UK, Canada and China are now cheap compared to their historical multiples.
- New Zealand, South Africa, Denmark US and India look particularly expensive.