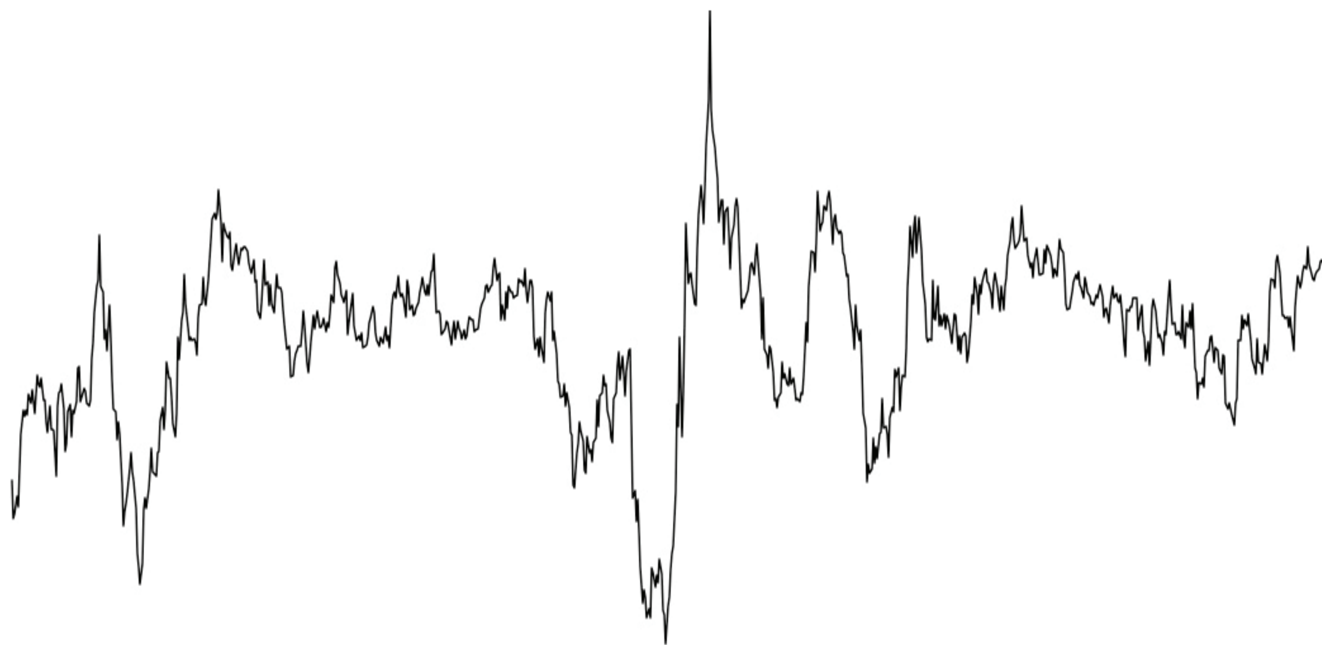
# ALPHA SOURCES

SEPTEMBER 3, 2018



# TWO IDEAS

This will be a short update. I am working on a more extended macroeconomic essay—and I am trying to finish a short story—both of which are stealing time. In any case, I have little to say about the main themes beyond what I said last week. In the bond market, I concur with the points made early last week by Bloomberg's Cameron Crise. Everyone knows the Fed is determined to keep raising rates, but market-pricing suggests that we are close to the end of the road for this hiking cycle. Between those contradicting points of view, the debate about the importance, or lack thereof, of the flattening yield curve has turned into a black hole threatening to consume all other stories in the bond market.

I am sympathetic to that, but I don't think the story is complicated. **The 2s5 and 2s10 will invert in the next six-to-nine months, setting up an end of the U.S. business cycle towards the end of 2019 or at the beginning of 2020.** At least, I think this is a reasonable base case until either of the following things happens. First, the Fed could suddenly decide that it doesn't want to invert the curve. I doubt it, but the appointment of Richard Clarida as Vice Chair—apparently, he cares about the curve—certainly is an interesting development. Second, it is possible



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that the curve can steepen, or hold its current spread, even as the Fed fund rate motors higher. I am not holding my breath for either of these stories to interfere with the trend in anytime soon.

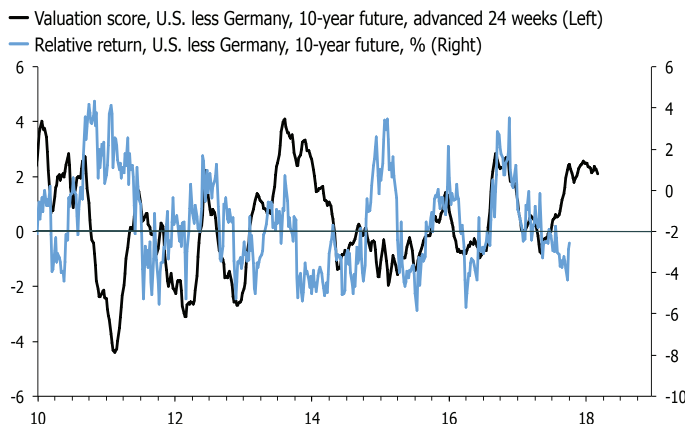
Meanwhile, the discussion about the U.S. yield curve shouldn't detract investors from other stories in the bond market. *The prospect of a tighter spread between U.S. and German 10-year yields is currently the most eye-catching signal from my models.* The first chart below shows the spread between my valuation scores on the TY1 and RX1 futures pushed forward against their relative returns. It is not always accurate, but it has been decent in recent years.

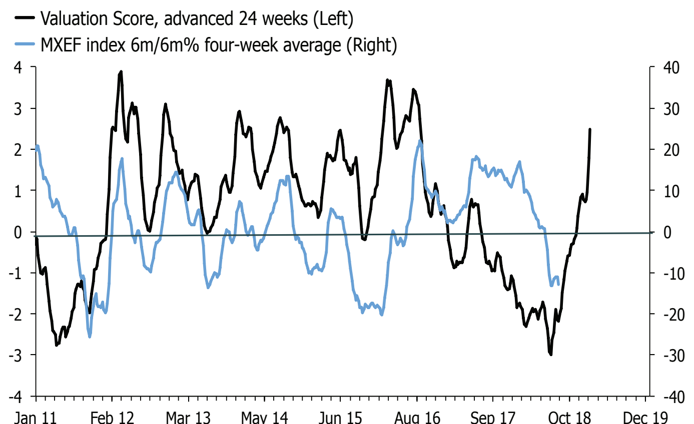
My interpretation of this signal is that bund yields can edge higher from their current low levels of 0.3-to-0.4% even as U.S 10-year yields move sideways or down slightly. I reckon that this is a good little bet for Q4. Currency effects are not taken into account, though, which could be a problem. But I reckon that many, if not most, global bond portfolios are hedged, so perhaps this isn't such a bad idea after all.

In equities, it seems to me that the U.S. market is stretching itself a little bit too far compared to the other major global indices. The put/call ratio on the S&P 500 plunged at the end of August, and the outperformance of the MSCI U.S. relative to the rest of the world is now at an extreme. I am all for the idea that U.S. equities are in a secular bull market, and trend of global outperformance, but I don't want to be chasing that particular story here.

Instead, might I tempt with some emerging market equities? My final chart shows that my valuation score is now sending a clear signal to add exposure to EM equities within global portfolios. This model usually gets it right, over time, but I admit that I am wobbling on this occasion. Global liquidity indicators are still pointing to weakness for risk assets, and it is difficult to see how emerging market equities could escape that, even with attractive valuations. I reckon a u-turn by the Fed, and a corresponding decline in the dollar, would be a catalyst, but that is probably too much to hope for.

fig. 01 / An idea? — fig. 02 / A call for action on emerging market equities



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