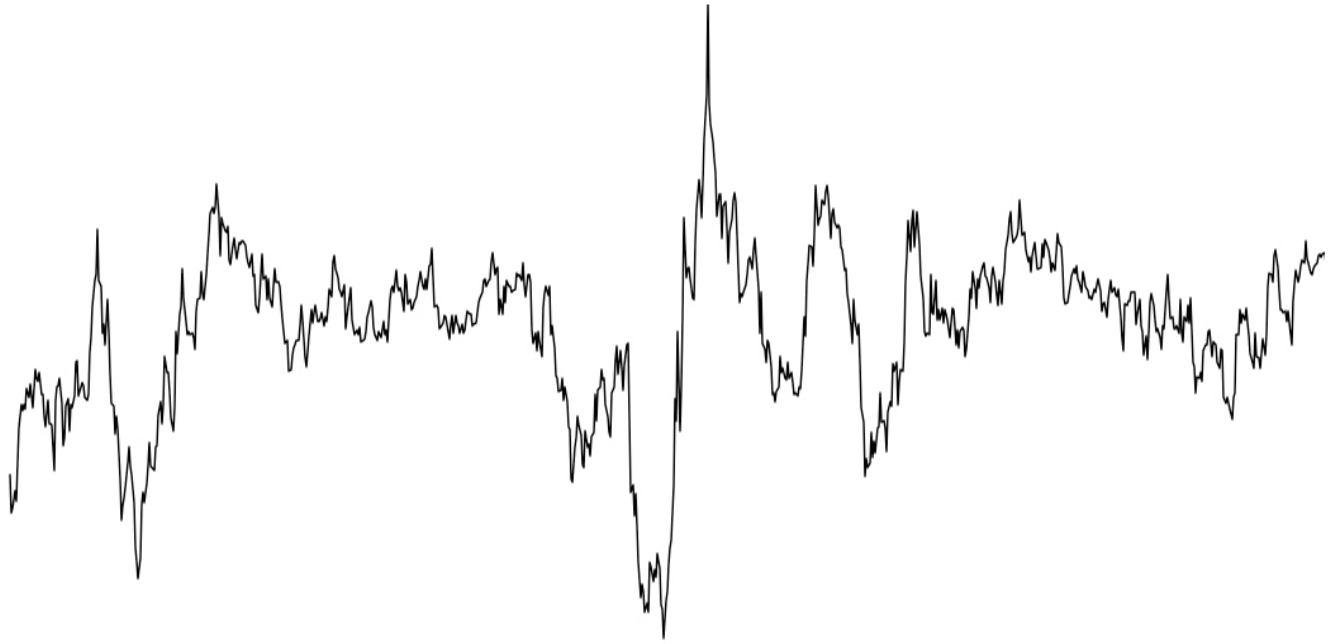


ALPHA SOURCES

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THE END OF EASY STREET

One great quarter down, only three to go to wash away the horror show of 2018. The [portfolio](#) did well, though it is still bogged down by a number of single names which are beginning to look a lot like value traps, of the nastiest kind. I am, as ever, optimistic about redemption in coming quarters, but I fear that the retired Macro Man, a.k.a. Bloomberg strategist Cameron Crise, is right when he says that; *"the sobering reality for asset allocators is that the returns of balanced portfolios are going to struggle mightily to approach anything like 1Q performance."* It won't be as easy for punters from here on in, but they'll do their best.

Bond markets have taken centre stage in recent weeks, aided and abetted by significant dovish shifts in the communication by both ECB and the Fed. The result has been a heart-warming rally in both front-end and long-end fixed income, or a pain trade if you've been short, and the U.S. yield curve showing further signs of inversion. The 2s5s went a while ago and now the 3m/10s is gone too, which, apparently, is a big thing. [As per usual](#), economists and strategists are squabbling on the significance of this price action, and I doubt that I'll be able to settle anything here, so I will stick with the grand narratives, which are tricky enough.

* / Data for charts are sourced from FRED, OECD, Eurostat, IMF, BIS, Market Watch, Yahoo/Google Finance, COT, Bloomberg, Investing.com or Quandl, unless otherwise stated.



We should respect the curve, but this doesn't look like a "normal" inversion. In the classic scenario, the Fed is trucking along, and when the curve does start to invert, they say it doesn't matter. Now, however, it is inverting because long rates are falling quicker than short rates. So, what's going?

One way to rationalise it is to entertain the idea that global central banks have taken onboard the MMT-notion that the costs of having looser policy are much lower than the costs of tightening too much, too soon. In other words, their reaction function to the ebbs and flows in global economic growth—which is more-or-less the cycle in China—should now be considered asymmetric. The cynical version of this argument is that central banks are terrified of making a mistake, or more specifically, they don't want to be blamed for causing a recession or a downturn.

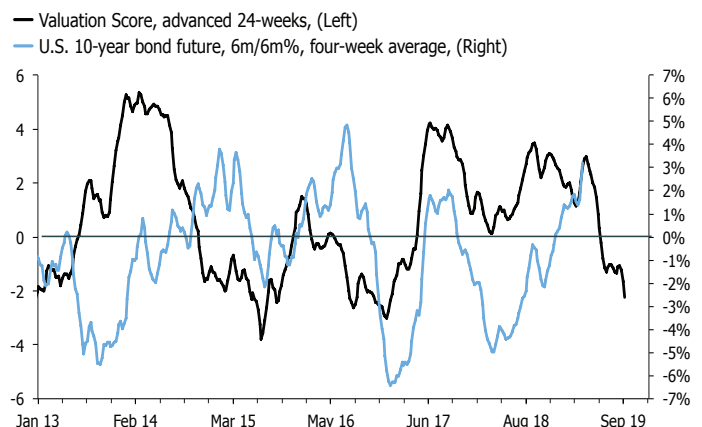
A world in which central banks are predisposed to ease first, and ask questions later, could be a nice world for investors, but there is a catch. **It's possible that the Fed and the ECB are**

now making a mistake when they tell investors that the global economy is in a very precarious position.

It could become a self-fulfilling prophecy driving financial markets, and perhaps even real economic agents, to act as if a recession is underway, or already here. The notion that the central banks "know something markets don't"—they don't by the way—fits the price action in bonds. EDZs are now pricing-in rate cuts by the Fed, but the curve has still managed to bull-flatten thanks to a strong rally on the long-end; ouch!

Another version of this story is the idea that the Fed was misestimating last year, when it was signalling to markets that it was on its way to hit a neutral rate of about 3% at some point in 2020. The dots are on their way to a more reasonable 2.5%, which means that we are now settled in equilibrium. The Fed can lean back and do nothing, safe in the knowledge that the economy is neither hot nor cold. This is a complacent position in my view. The data that central banks use to steer policy rarely stand still. They *trend*, which eventu-

fig. 01 / Spot the inversion in the Eurodollar curve — fig. 02 / An early 2019 top for duration?





ally requires a policy response in either direction. In this sense, the rather obvious risk at this point is that the economic data lead the Fed and the ECB to the conclusion that the world is not in such a bad place after all. Such a row-back will be a painful and volatile one, especially in fixed income.

Meanwhile, those who pray at the altar of the yield curve as a recession indicator are, as per usual, trying to have their cake and eat it. Last week, a big Wall Street bank advised clients “to prepare for a recession” followed by the suggestion that investors shouldn’t be underweight equities, yet. That’s ridiculous. I realise that empirical evidence indicate that equities continue to perform well a while after the curve inverts, but this story doesn’t pass the smell test.

If we are about to go into recession, equities and credit are very mispriced, and the U.S. front-end is a screaming buy via the bull-steepener. Those two views are simple to express in markets, and arguably represent the defining actions that investors must take if they’re preparing a for a recession.

The obsession with the yield curve as a recession indicator is a bit of a straitjacket. For the U.S. to suffer a non-2008 recession, I reckon you need the consumer to roll over hard, over several quarters, and/or a big inventory drawdown dragging down gross capex. Surely, we need more information than the yield curve to ascertain whether this is about to happen? **I think the curve is just as likely to steepen via a sell-off in long rates, as markets settle on the notion that the world is not as grim as the Fed and the ECB have been telling us recently.**

Base effects are favourable for this story to play out. The macro data have been horrible recently, and we now see [early signs of a rebound in the second derivative](#). If sustained, this should be more than enough to shake the dovish consensus in fixed income markets. In terms of equities, though, it won’t be easy from here. My final chart shows that trailing six-month returns will shoot higher in Q2, even with a flat quarter, indicating that the days of riding on Easy Street is over, at least for now.

fig. 03 / Bottom-fishing in global macro — fig. 04 / Looks likely will be deceiving in Q2

