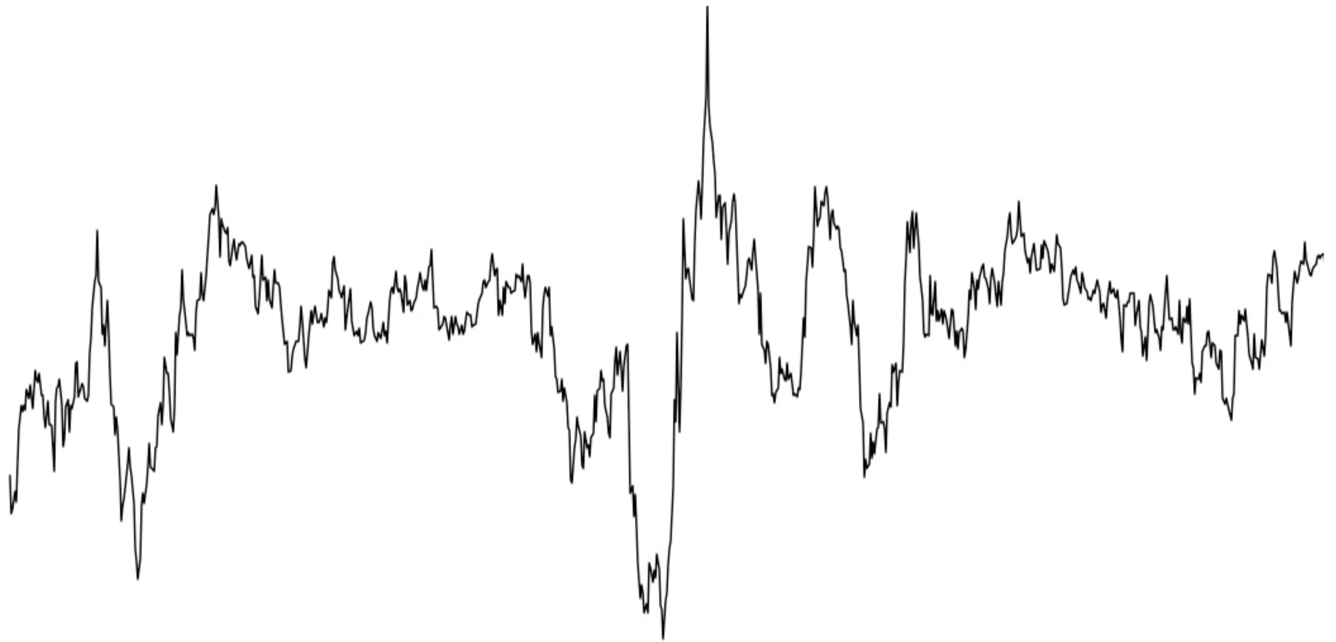
ALPHA SOURCES

OCTOBER 29, 2018



PAIN, AND A SILVER LINING

If you are an equity investor with time to read this, I reckon that I should have the decency to cut straight to the point. **Based on macro liquidity indicators, I see a convincing case for a short-term bounce in global equities into year-end, before—unfortunately—further weakness in Q1.** The main argument is summarized in the two charts on the following page. The first compares momentum—the 2nd derivative of y/y growth—in global equities and global real M1. I am working under the assumption that the year-over-year rate in the global stock index will decline gradually to -10% by the end of March. Adding back into the price points to just under 6% upside between now and the end of December, before a nasty 11% drawdown in the first quarter. This story is supported by the idea that higher yields and rising oil prices are now a significant challenge to multiples, especially in the U.S. Abee makes a similar point over at Macro Man, with the ominous addendum that it'll probably get worse if growth in earnings falter, which they are liable to do, eventually.

The argument for a short-term bounce is straightforward. At the time of writing, the global equity benchmark is down nearly 10% on the month in October, and about 5% for the year. I never

* / See additional charts on final page.

** / 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.

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thought that this would be a particularly good year for equities, but this seems like an excessive reaction, after all.

Needless to say, don't bet the farm on this, but it is a relatively simple story in the end. The market is oversold in the near term, but the overall message from the macro data remains bearish.

THE SILVER LINING

Investors tend to get tunnel vision when markets swoon, focusing myopically on the U.S. As a I said last week, this is probably a mistake. European and EM equities had already been under heavy pressure coming into the the October sell-off. The extent to which everything is being swept away as the U.S. highfliers re-rate, many non-U.S. equity sectors and indices are being pushed towards fire-sale valuations.

This story rests on a big assumption. *Can the global equity market as a whole rotate away from (U.S.) growth/momentum leadership* without *everything getting destroyed?* My former colleagues at Variant Perception has produced this great chart, indicating that U.S. equities are due underperformance, though it doesn't say anything about the absolute performance of the rest of the world.

The bond market matters too. Even in the face of a near 5% downday on Thursday, U.S. 2-year yields still managed to fall only 5-to-10 basis points. In other words, the prospect of continued Fed rate hikes continue to keep markets in a vice. Risk parity strategies, in particular, have been destroyed this month.

Eurodollar futures, though are starting to move. The spread between the Dec-19 and Dec-18 rate expectations has made a sharp reversal in response to the sell-off in equities. Markets are now undoubtedly looking for a dovish hike by the Fed in December. I am not sure that they'll get it, especially not with Mr. Trump openly blaming the Fed for the wobbles in the stock market.

The balance of risk is shifting, though, especially if the chaos in equities continue for much longer. This is the final sliver of the silver lining. A host of equity sectors and country-indices almost surely would fly, if the Fed changed its tune on rates next year, even slightly.

fig. 01 / Winter is here — fig. 02 / We have seen worse, but not that often

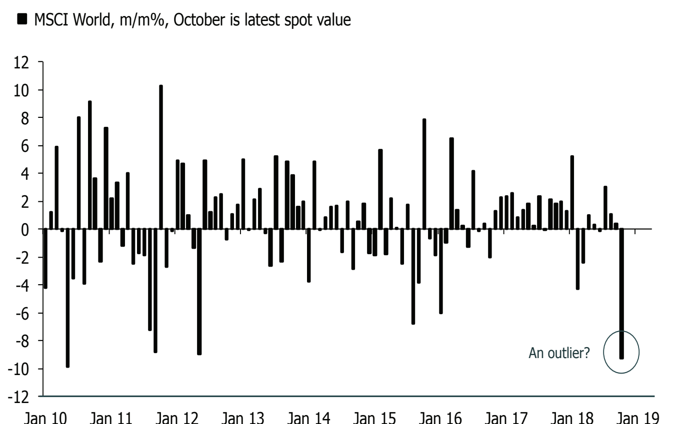

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fig. 03 / U.S. stock-to-bond returns can go lower in the near term…

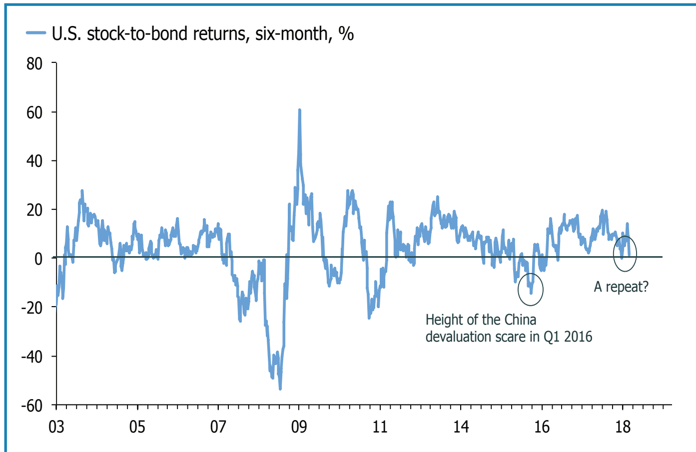


fig. 04 / …But the German ratio is beginning to look stretched

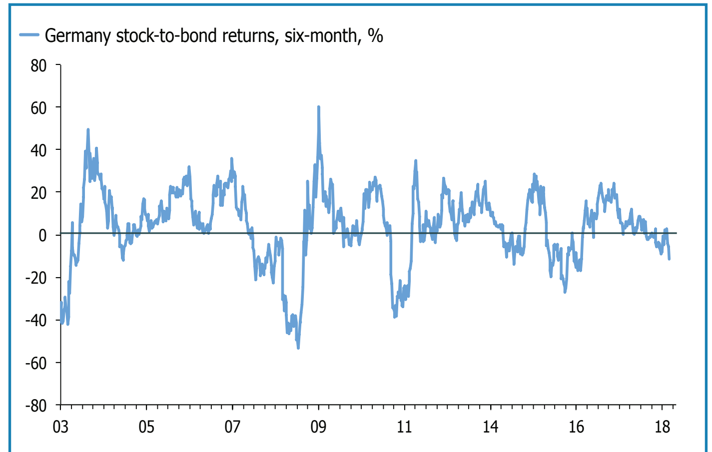


fig. 05 / Is this story still relevant for investors, or all priced-in?

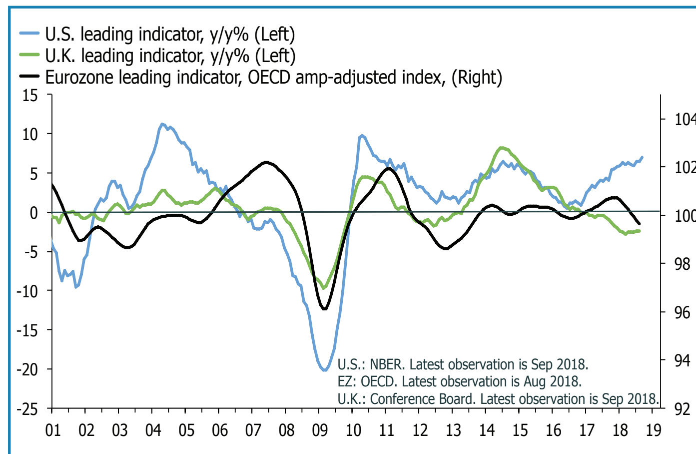


fig. 06 / Equities are panicking, but nothing to see in credit, yet

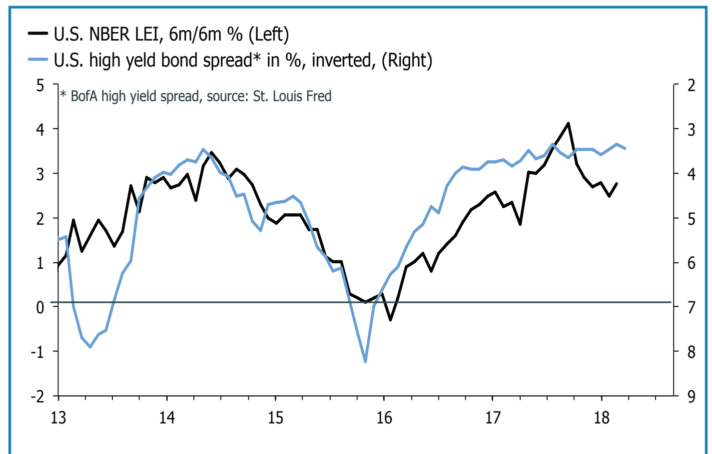


fig. 07 / Going, going ... but not yet gone

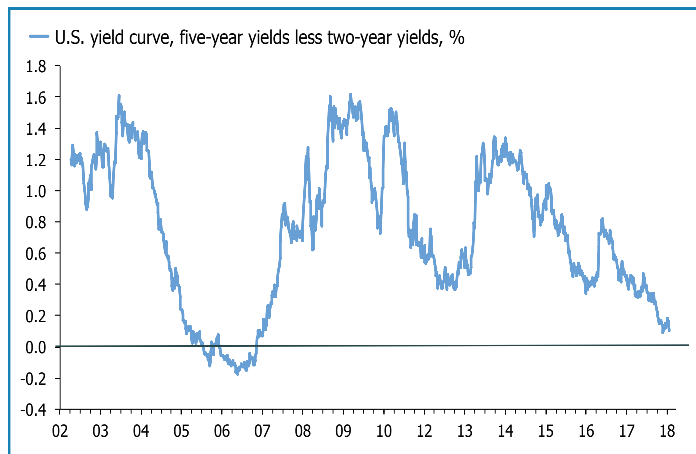
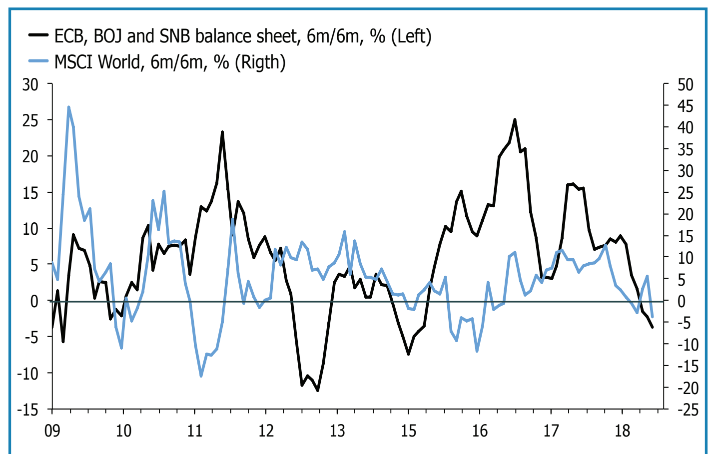


fig. 08 / The three musketeer of global liquidity growth are flagging



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