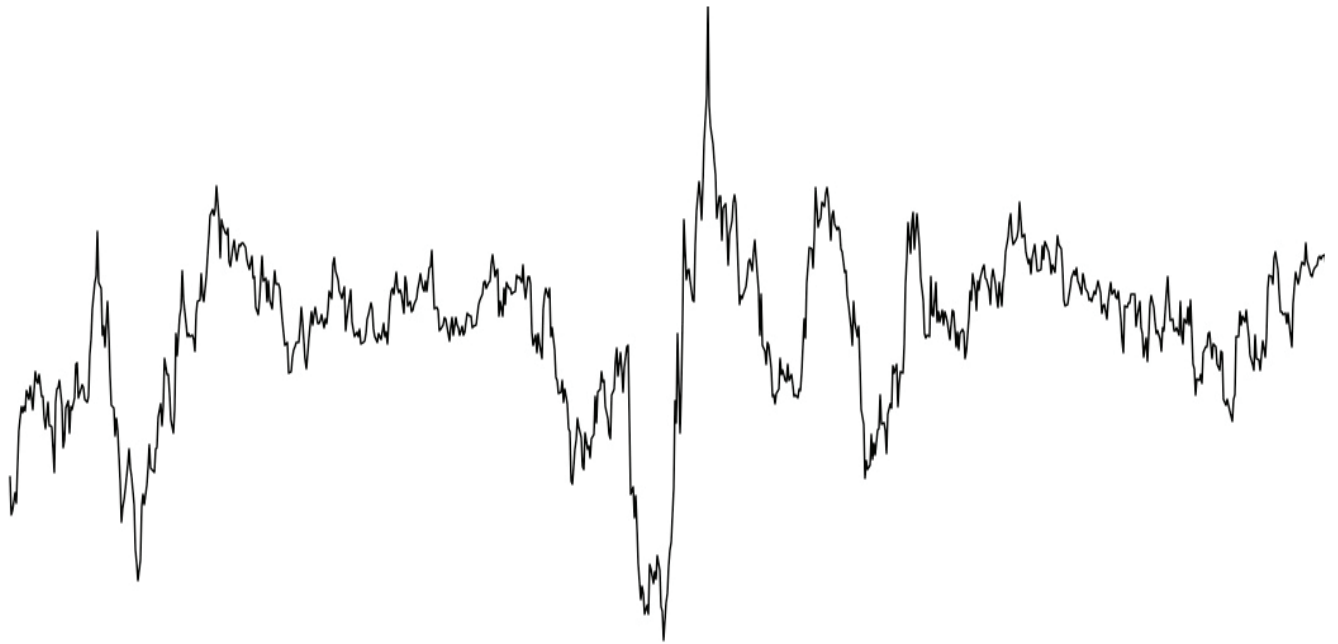


# ALPHA SOURCES

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JANUARY 21, 2019



## HEAD FAKE?

**I**t's been a choppy start to the year, but last week's price action added to the evidence that the bulls have regained control, at least temporarily. The MSCI World and HYG US equity are now about 8% and 5% higher, respectively, from their lows in December, and treasury yields are up across the board. The rebound has been broad-based, but European and EM equity indices have shown particularly promising signs, consistent with the fact that they have, after all, been much cheaper than their U.S. counterparts through the Q4 chaos.

**These headlines are good news, but at this point, I am not willing to treat them as evidence of any-**

**thing but a reflexive rebound in the wake of a horrific Q4.**

Short-term indicators suggest that a lot of fear already has been priced-out. The put/call ratio on Spoos it peaked at 2.7 SDs above its mean on December 27th, but has since plunged to -1.0 SDs. Normally, this would be a sign of complacency, at least in the very short run, but the put/call ratio looks more balanced on Eurostoxx 50, indicating that the picture for global equities as a whole is more neutral.

Other indicators also suggest that the market can run a further. My first chart shows that that the crash in the U.S. stock-to-bond return ratio at the

\* / 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.



end of 2018 was similar to the plunge during the EZ sovereign debt panic in 2012, and well in excess of the Chinese devaluation scare in 2015/16. It has since made a sharp v-shaped recovery, and past experience shows that it will move higher in the next few months. In short; tactically minded investors should stay long equities, relative to bonds, for the time being. Or in Zervos' risk-parity lingo; more spoos, less blues.

The challenge for investors with chasing the market higher is pretty simple, though. **The sources of downside risks that would have convinced them to de-risk portfolios in Q4 haven't gone away.** Macroeconomic leading indicators are still gloomy, and while I am sympathetic to the idea that investors are looking through evidence of Q4 weakness, what happens if the Q1 data don't pick up?

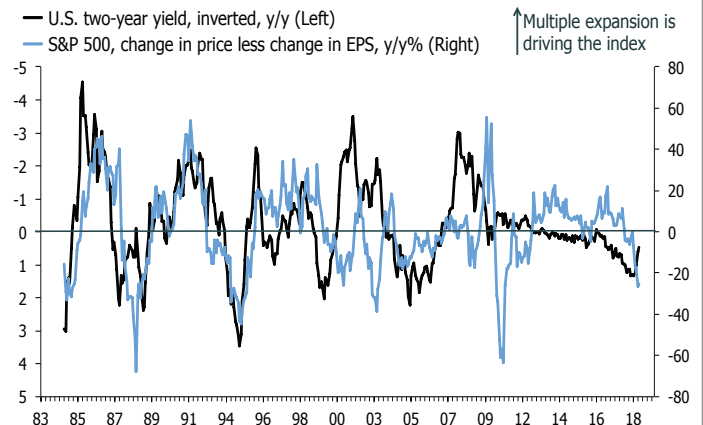
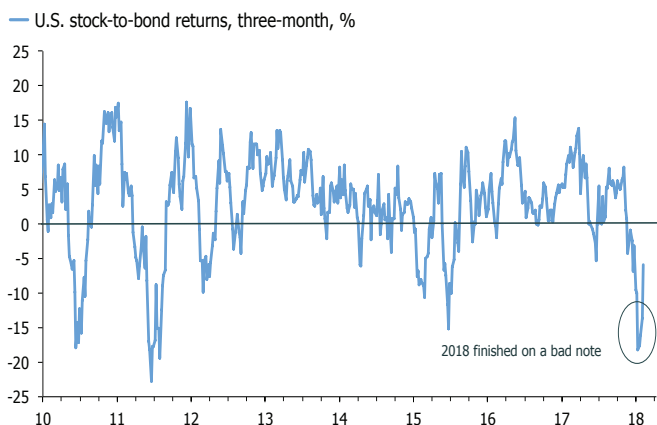
We have known for a while that the U.S. economy would slow in 2019 as the boost from Trump's tax cuts fades, but have markets factored in a much sharper hit to the economy on the back the increasingly painful government shut-

down? Meanwhile in Europe and [China](#), the data also indicate sluggish growth, at least at the start of the year.

Even if investors are adamant that poor macro data won't threaten markets, what about a slowdown in earnings growth? Trailing EPS on the MSCI World increased just over 20% year-over-year in Q3, but I am confident that growth slowed in Q4, and that it will come down further in Q1. Here is the problem: a crash in multiples drove last year's swoon in global equities. In fairness, my final chart indicates that the multiple contraction on the S&P 500 now looks overdone. The dip in bond yields since the turn of the year, point to upside risks. *But if earnings are stung in coming quarters, multiples will increase, even with unchanged prices.*

In addition, [the contraction in global excess liquidity](#) still looms as a threat. Global M1 growth picked up slightly at the end of 2018, but nowhere near enough to change the story of downside risks. If you don't believe me, have a look at [this from Nordea](#); the rebound could be well be a head fake.

fig. 01 / Still mean-reverting — fig. 02 / Is it time to pay a higher multiple on the S&P 500?



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fig. 03 / A further leg lower for global industrial production growth?

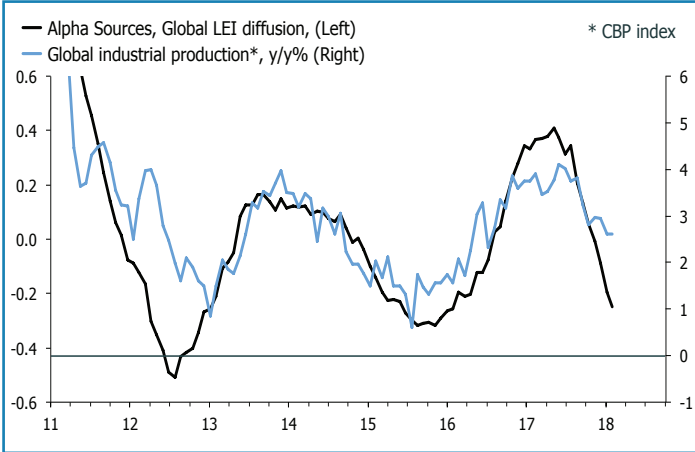
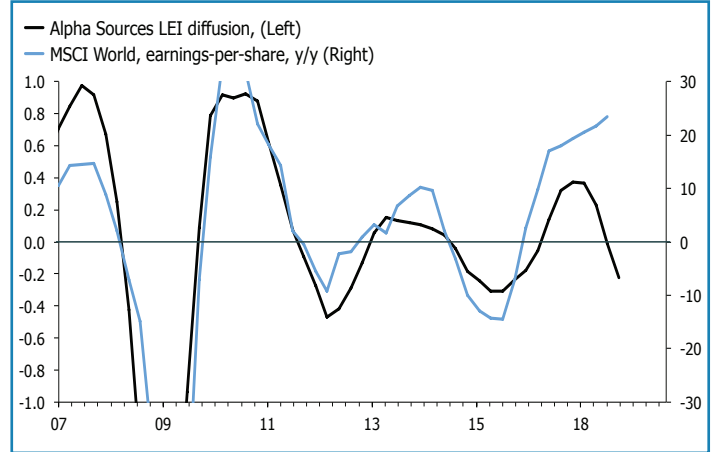


fig. 04 / The next shoe to drop in the global equity market?

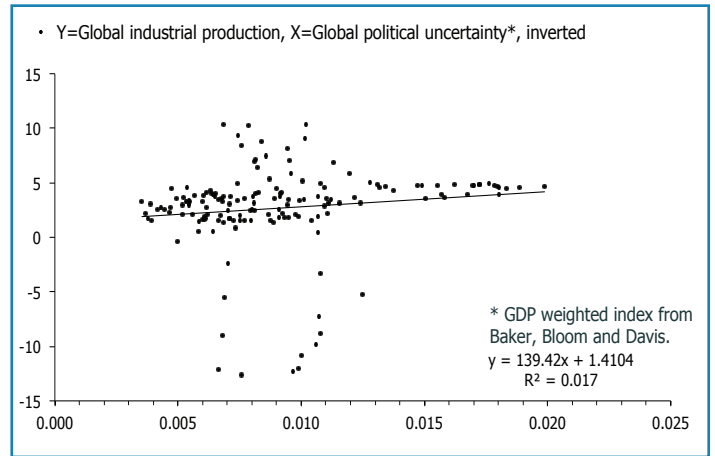


Source: <https://www.cpb.nl/en/worldtrademonitor>

fig. 05 / The increase in measured political uncertainty is looking grim...



fig. 06 / ...But we probably shouldn't be too worried



Source: <http://www.policyuncertainty.com> and <https://www.cpb.nl/en/worldtrademonitor>

fig. 07 / My real M1 indicator is not improving...



fig. 08 / ...and I am not the only one flagging this risk



Source: <https://e-markets.nordea.com/#!/article/47366/nordea-view-high-bull-trap-risk>