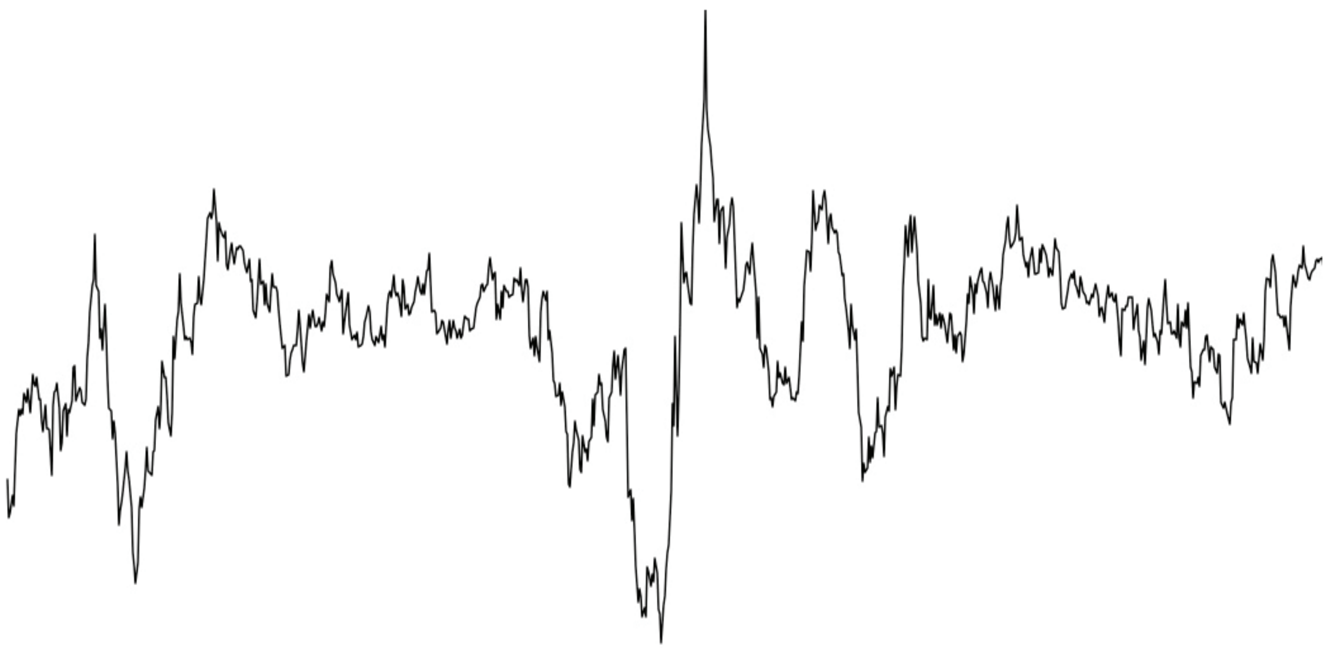
ALPHA SOURCES

DECEMBER 24, 2018



SOME CHARTS TO KEEP YOU WARM

I should have known that the idea of a short-term rebound into year-end, before a leg lower in Q1, was too cute. I suspect this scenario was consensus at the start of December, to which the reply by Mr. Market has been: yours! As I type, equities are careering from one extreme to the other as Fed officials hit the tape. Needless to say, with volatility this high the last few trading sessions of the year can make a huge difference in either direction for the market as a whole. But I think the main conclusion is increasingly clear; 2018 has been a poor year, and Q4 will go down as one of the most horrible quarters for the stock market in a long time.

Let's start with the bad news. Excess liquidity indicators caught the sell-off, and they remain rather grim. Global real M1 growth is still slipping and sliding. Chinese real narrow money is now falling year-over-year, and the U.S.index is not far behind. *It is worthwhile to spell out just how awful the market outlook is, based on this indicator.*

The first chart below shows that the trend in real M1 implies a constant second derivative of MSCI World returns in the next three-to-four months. That, in turn, implies a deep dive in the year-over-year rate to -30% by the end of April, dragging the index down by another 21% from its current level.

* / 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.

The negative feedback loop is easy enough to spot. Survey and hard economic data, primarily in the U.S., remain decent, but that almost surely will change for the worse in Q1, threatening to further knock risk assets.

At some point, policymakers will respond, but it is not clear to me what they would do in the short-term to ease the pressure. In the U.S., the Fed could certainly send a clearer signal of a pause, and perhaps end QT, but I suspect the bar for cuts and/or more QE is high. Similarly, in Europe and Japan, I reckon that the ECB and the BOJ are locked in towards keeping stimulus on a slow burn, unless conditions worsen materially. Finally in China, the PBOC is easing, or so we hear, but it hasn't shown up in the headline data yet.

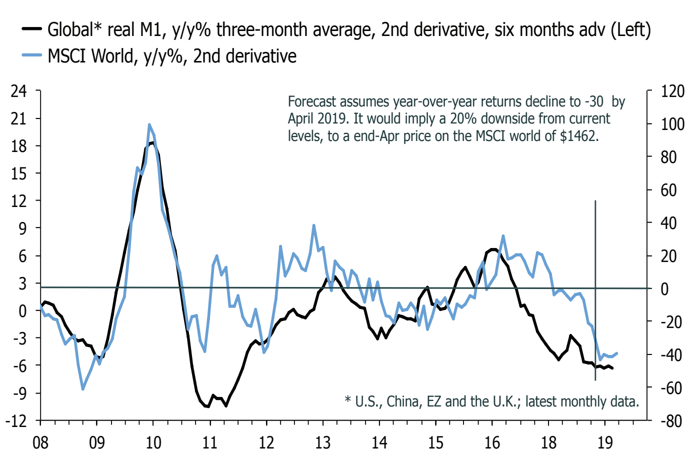
The second chart below shows that the G4 central bank balance sheet is now shrinking, sending a clear signal of weakness in global equities. It *also* suggests, though, that the present sell-off is overdone, a message supported by other indicators. A closer look at those allows me to finish on a bright note.

BUY EQUITIES INTO Q1?

The December carnage in equity markets has predictably stung the portfolio, but it has set up an intriguing out-of-sample test for my home-cooked valuation models. The most interesting of the bunch is my arbitrage pricing model for the S&P 500, shown in the two initial charts on the final page. The model has been pricing equities as expensive for most of the year, but it has made a spectacular reversal in Q4. At the end of last week, it had a fair value for Spoos at just over 2800, implying about 17% upside from current levels.

This singal is supported by the three-month stock-to-bond return, currently at an extreme, and the collapse in the P/E multiple. In other words, the message to the contrarian punter is now clear; buy equities and sell bonds. **This sets us up for a rather tired investment cliché at the start of 2019; short-term upside drizzled with medium-term downside risks, thanks to still-deteriorating liquidity conditions.** Whatever you do, have a great Christmas and a Happy New Year.

fig. 01 / A Christmas nightmare — fig. 02 / It's not pretty, but is the sell-off overdone?



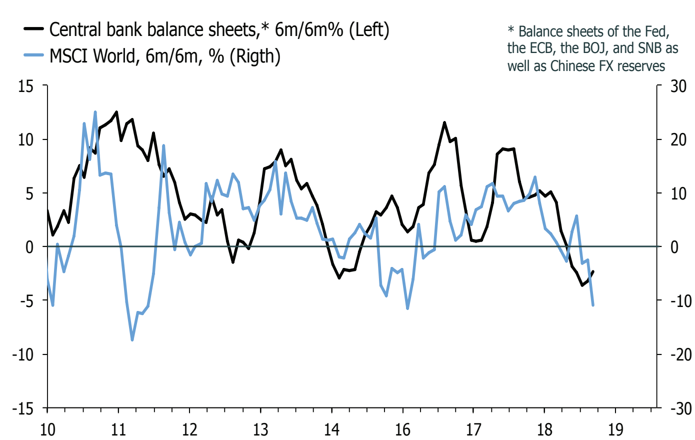


fig. 03 / U.S. equities have gone from an outperformer to a dog…

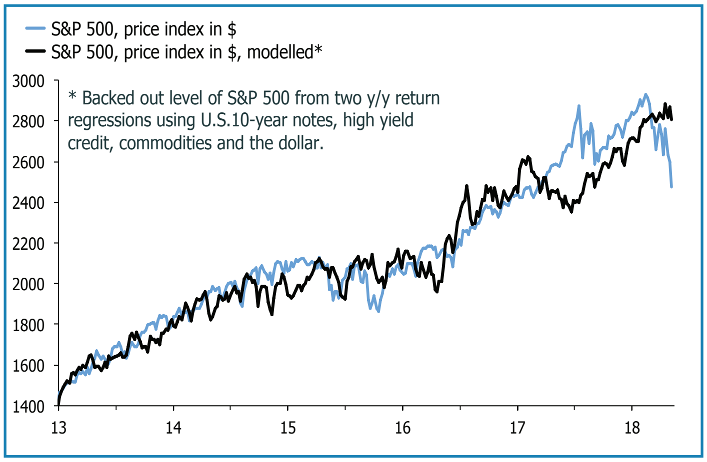


fig. 04 / …and the model doesn't get much more extreme than this

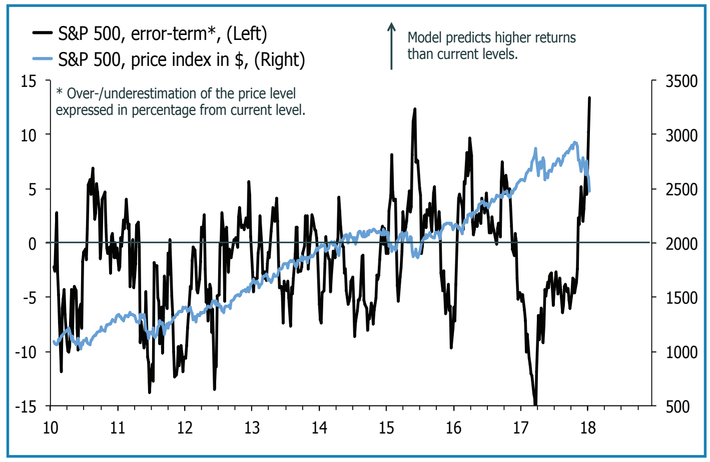


fig. 05 / Global equities are slowly, but surely, creating value

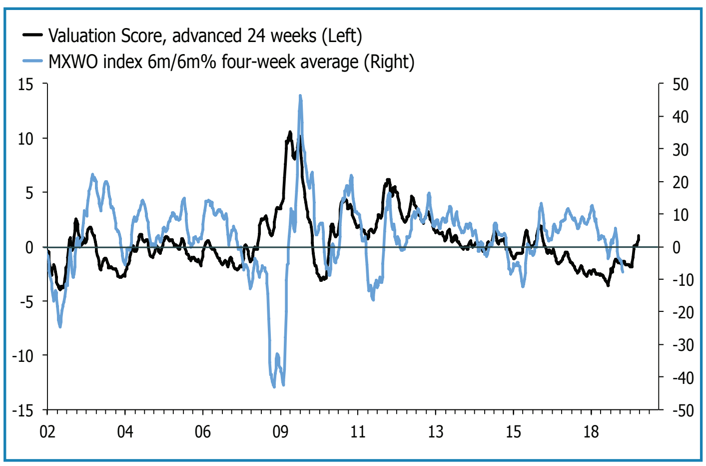


fig. 06 / Cyclicals to outperform defensives in the next 12-to-18 months

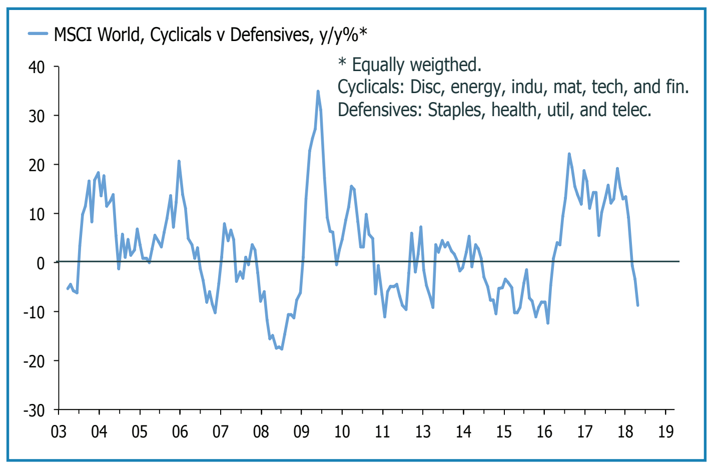


fig. 07 / The contrarian is buying stocks and selling bonds into Q1

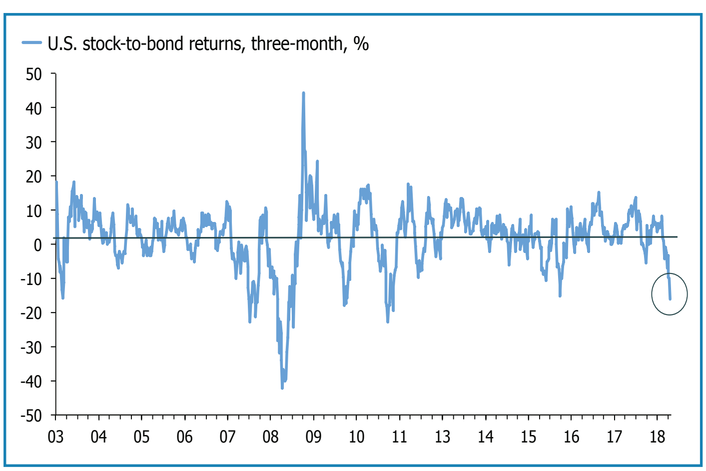


fig. 08 / It can get worse for U.S. equity valuations, but not much