ALPHA SOURCES

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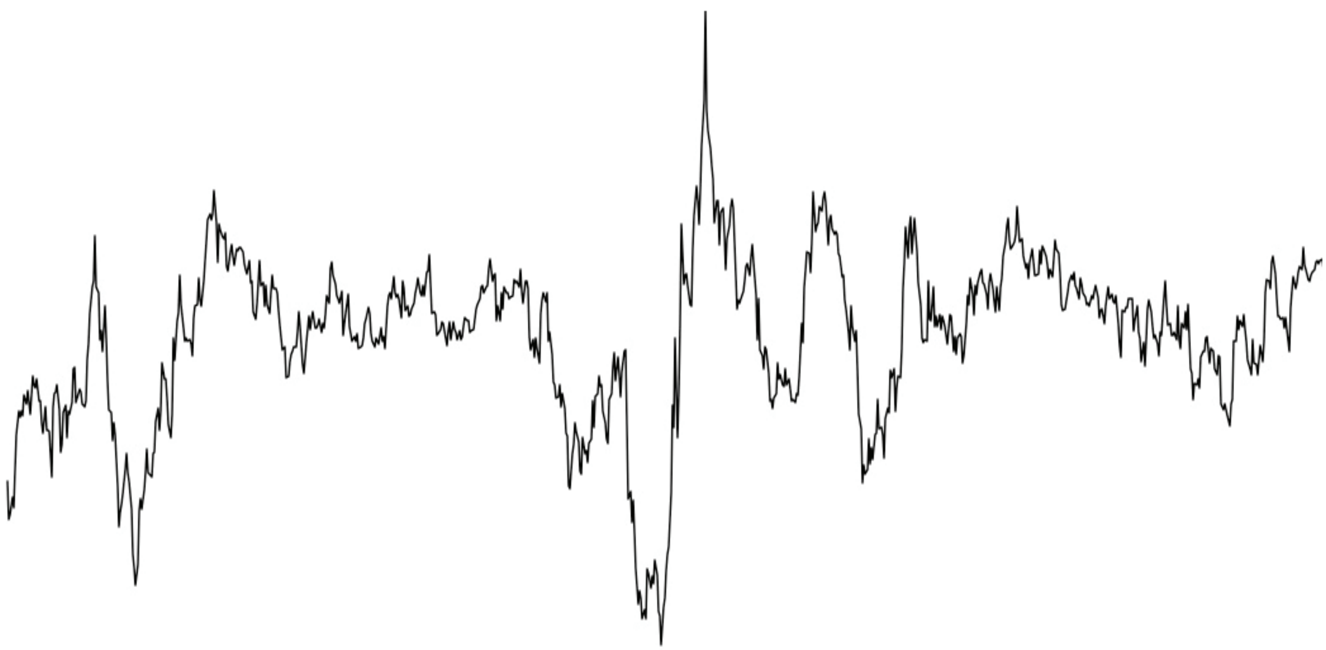


BOB PRINCE IS RIGHT, IN THEORY

Bridgewater Co-CIO Bob Prince was ridiculed earlier this month for his comments in Davos that "we've probably seen the end of the boom-bust cycle." Pundits were quick to draw comparisons to Irving Fisher's infamous remark on the eve of the 1929 stock market crash that the equity market had attained "a permanently high plateau." I sympathise with this interpretation of Mr. Prince's comment. They come on the back of a 21% 12-month rally in the MSCI World, in an environment where trailing earnings have *declined*, by nearly 5%. In other words, the P/E multiple has gone from around 15 to just over 20 in the space of a year, and this in an environment where global growth has been *slowing*. To pile on even further, the recent performance of global equities has been ridiculous, with monthly returns over +2% since September. Naturally, the key for any medium-to-long term investor is to make sure to be long during such periods, but I understand if Mr. Prince's declaration has contrarian investors running for exits. I can't help but feel, however, that the world is upside down. The speed with which Mr. Prince's comments was shot down seems to invalidate the contrarian position to me. I mean shouldn't we be worried only if investors and analysts *agreed* with his comments.

** / 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.

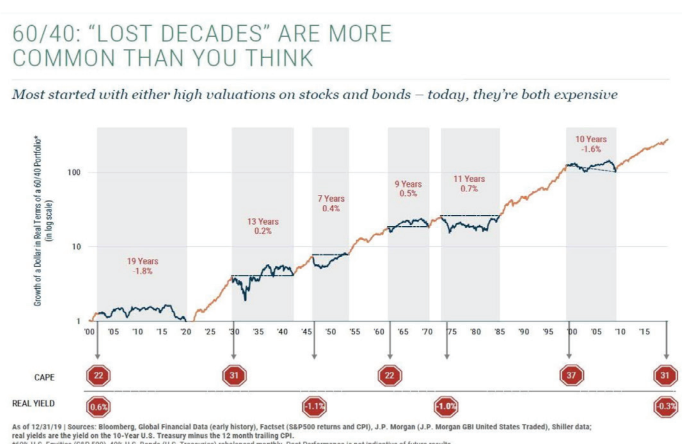
It is not a good idea to start second-guessing the second-guessers in this business, but the point I am getting at is that, well; I think Mr. Prince has a point. His idea, incidentally, echoes an earlier observation by Ray Dalio—founder of Bridgewater—that this time is indeed different, centered on the idea that the normal 'circuit breakers' aren't in place anymore. This is a relatively simple macroeconomic story in the end.

The old story goes a bit like this: expansions aren't killed by old age, but by tighter monetary policy, at least if central banks follow anything near-standard reaction functions. As the expansion matures and unemployment falls towards the natural level, and wage/inflation increases, the central bank slowly begins to raise rates. But because it is ultimately targeting lagging indicators, it overdoes it, inverts the yield curve, which, in turn is a prelude to recession, at least in most cases.

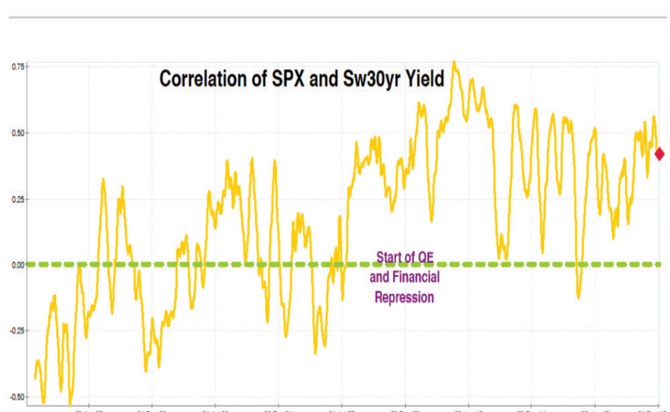
This sequence was more-or-less the framework before the financial crisis, and it seemed as if we were headed in the same direction mid-way through 2018, at least in the U.S. But then something happened. The Fed stepped back and other central banks, primarily the ECB and the BOJ, never got started in the first place, opting instead to double down on already-loose policy. Slowly, but surely, a new policy regime is now emerging, with an entirely new and different reaction function. **In this regime, policymakers are inclined to ease first and ask questions later.** The January performances of Ms. Lagarde, Mr. Powell, and Mr. Carney provide little in the way of evidence to challenge this view. I think investors now have to consider this to be a *structural* policy feature of the global economy.

The cynical interpretation of such a shift is that incumbent decision-makers, having already shuddered in horror over the rise of populism such as it is, are terrified of the political result of taking the economy into recession, even if a relatively mild one. The more generous interpretation is that that trade-off between falling unemployment and rising inflation has shifted—a flatter Phillips Curve—allowing policy more leeway.

fig. 01 / A permanently high plateau? fig. 02 / A fantastic regime for risk parity



Source: GMO



Source: Convexity Maven, January 28

This is a policy mix now ubiquitously known as "running the economy hot."

This environment invites investors to re-think their view of the world in a number of ways. Sources of external and exogenous uncertainty become reasons, to buy, not sell, because they feed into policymakers' reaction functions with a dovish sign. There is a limit to this argument of course; for example, an uncontrollable trade war that limits capital mobility or, to use a current example, a global pandemic that shuts down key economic sectors.

But in the main, the higher the uncertainty, perceived or real, the looser the financial conditions. Once you've accepted this interpretation of the world, the main risk also quickly becomes clear; the worst that could happen would be if central banks reverted to textbook reaction functions—the return of Volcker's Ghost?—in turn implying that too much good news could, paradoxically, be a problem for markets. Alternatively, we could imagine a new U.S. president who doesn't about markets the way that the current one does.

Mr. Prince's comment can be seen as a contemplation on these themes. After all, if central banks won't kill the economic cycle—indeed, if they're predisposed to prolong it for as long as possible—what happens next?

It's certainly possible for the economy to go through cycles, and for markets to respond to them, even when policymakers are inclined to go out of their way to "do no harm." The next few months' response to the coronavirus might be an interesting case in point, especially with China seemingly willing to shut down the country to limit the virus' spread.

Such truly exogenous events notwithstanding, however, Mr. Prince's musings remain relevant. In other words, where does it end? Are we about to embark on 20+ years of unparalleled growth and prosperity under the guidance of always-benevolent policymakers. Or will something nasty happen—war?—to reset the clock. I am not inferring that the clock *has* to be reset to claim that we have a "healthy" economy, but rather that in a world where it it isn't, Bob Prince could be right, at least in theory.

fig. 03 / The picture of a post-crisis cycle

fig. 04 / Commodities don't like the new regime