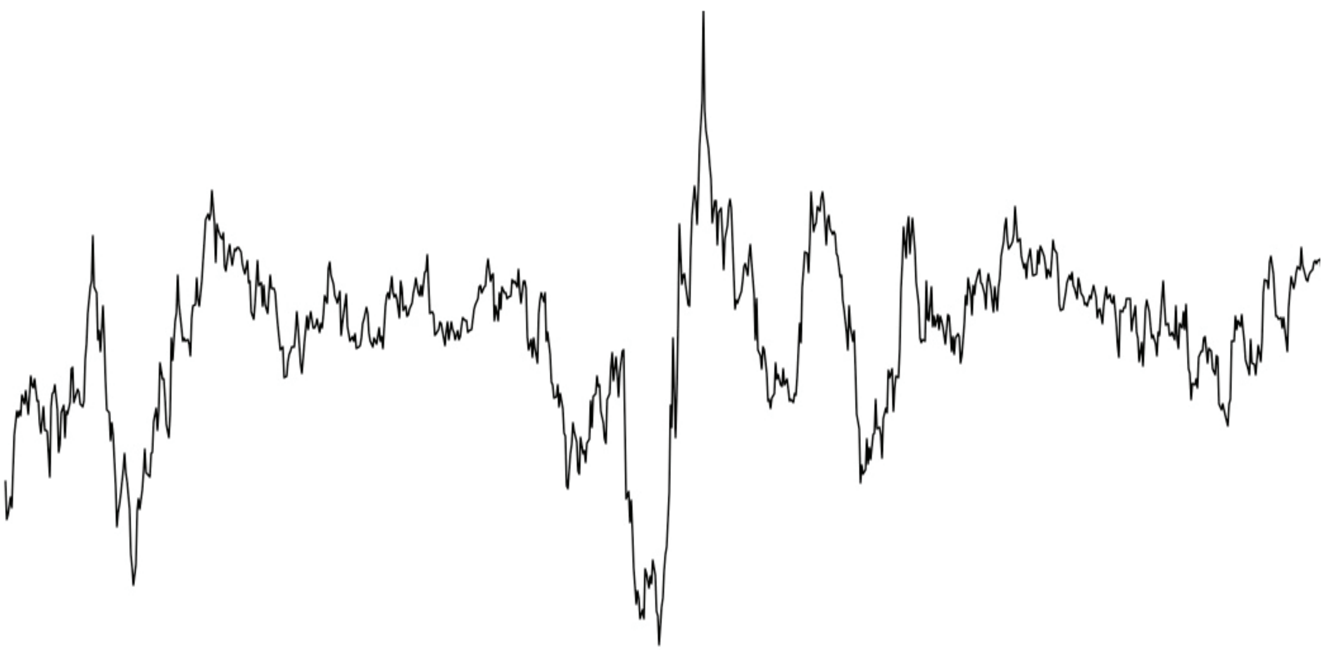
ALPHA SOURCES

JULY 8, 2019



THE NEW REGIME

Friday's *initial* price action in response to the June U.S. payroll report provides a nice microcosm for investors' mood and short-term expectations. The data themselves were so-so. The unemployment rate *increased* slightly, due mainly to a lower labour force participation rate, and wage growth slipped, albeit marginally. Markets, however, homed in on the above-consensus increase in headline payrolls, a 224K jump relative to expectations of a 160K gain, and immediately started selling equities and bonds. Running the risk of skipping several important steps in the argument, I reckon the story is relatively simple. Markets have been angling for a 50bp cut by the Fed in July, a position that was washed out, at least for the time being, by Friday's above-consensus NFP print. Even if this interpretation is right—and it might not be—it doesn't change the main thrust of the story, which I have been trying to describe on these pages in recent months. **Markets have made their bet on further easing by monetary policymakers, and they're now expecting central banks to deliver.** Friday's session suggests that the consensus is easily spooked, though as I type, Spoos are virtually flat on the day, and EDZ9 is still pricing-in two-to-three cuts between now and year-end.

* / 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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Far be it from me to single out anyone, but I had a good laugh when I saw JP Morgan's rationale for the FOMC to cut rates in July: "the most compelling reason simply is that their signalling has been so strong." Allow me to translate that into something more reasonable; *the Fed should cut rates because markets expect them to do just that*. We should probably add a deposit rate cut and more QE at the ECB to the story, just to make it clear what it is markets want, not to mention expect.

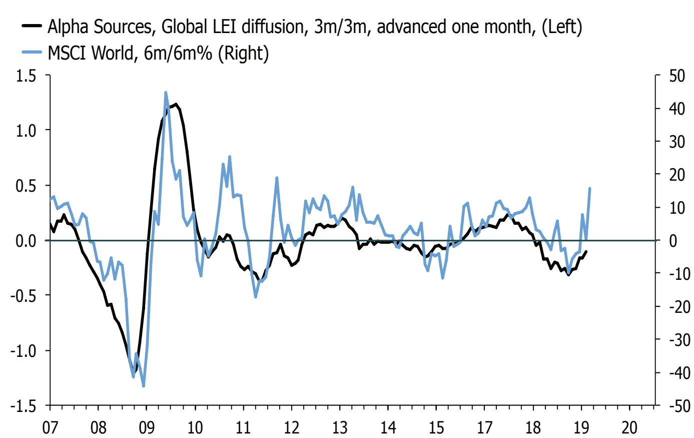
The interplay between central bankers' communication, markets' expectations and final policy action is always delicate. But it is fair to say that the pendulum has swung to the extreme in the past six months. Analysts talk a lot about the signal from policymakers to markets, but on this occasion, its all about the message from markets to the central banks: "Deliver what we want, or suffer the consequences."

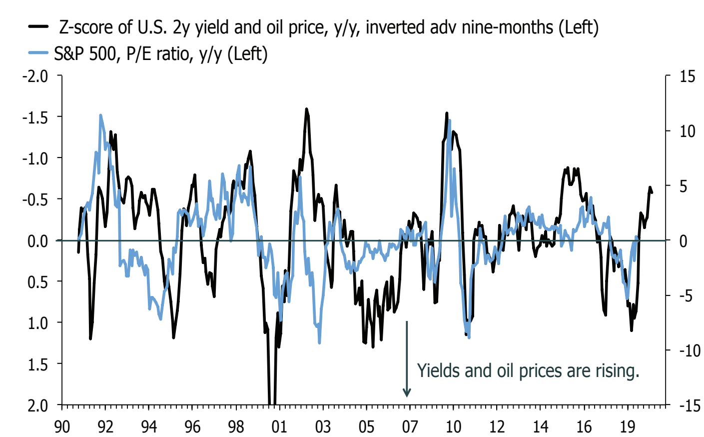
History suggests that this is a dangerous gambit to make by markets, but in the current environment, investors are relying on two assumptions. First, that central banks are either sufficiently willing to flip-flop—in the case of the Fed—or already predisposed to easy policy, in the case of the ECB and the BOJ. Secondly, markets have settled on the idea that central banks are terrified of making a mistake, in effect being blamed for causing an adverse shock to the economy or markets.

The bet is that central banks are now more inclined to ease first, and ask questions later, rather than operating based on the opposite, and more traditional, reaction function. This is a profound a shift in narrative compared to the standard story in which the expansion eventually is snuffed out as monetary policy tightens the screws to prevent an excessive rise in inflation and undue excess in asset markets.

At this point, the debate often becomes normative. The current macroeconomic discoure is heavily influenced by the green shoots from those who believe that arcane notions such as output gaps, Nairu, and moral hazard constitute un-necessary strait-jackets from which policymakers are finally escaping.

fig. 01 / Running ahead of fundamentals… — fig. 02 / …but a higher multiple could still save the day





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If the costs of loose monetary policy are negligible, or even non-existent, the idea of insurance rate cuts and "running the economy hot" suddenly become valid, even noble, policy aims. The proponents of MMT are cut from the same cloth, with the detail that they favour a substantial *fiscal* response as well.

HOW WILL IT PLAY OUT THEN?

I fear the long-term consequences of this shift, but most investors don't have the luxury of thinking about that. Citigroup strategist Matt King captures the mood perfectly in his recent note, invoking the idea of "pricing to policy, not pricing to fundamentals."

The two charts above illustrate this in equities, where returns are running well ahead of the trend in the macro-data, not to mention defying the fact that earnings growth stalled. None of this matters, though, because multiples have been racing higher. This, in my view, is exactly evidence of Mr. King's dictum. This idea extends to the bond market via the proposition that global rates are converging on the lowest common denominator. In case you haven't noticed; in a world of free capital mobility, that is low, effectively close to zero.

The reality so far this year is that equities and bonds have rallied in tandem, a pleasant world for investors, but also one that is unpleasant when the trend reverses. In this sense, I'd invite investors to heed the famous Fitzgerald tagline that: "The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function."

Looking ahead six months, my home-cooked models suggest that equities and bonds will *both* weaken in the short term. I suspect that this will happen because central banks will struggle to deliver according to now very-stretched market expectations. The upshot, though, is that such a sell-off will feed straight into the same central banks' new reaction functions, forcing them to ease policy, eventually. After all, if the costs generally associated with loose economic policies are zero, and markets are "pricing to policy", that looks like a regime change to me.

fig. 03 / Equities are about to take a breather... — fig. 04 / ...and bonds look wobbly too