ALPHA SOURCES

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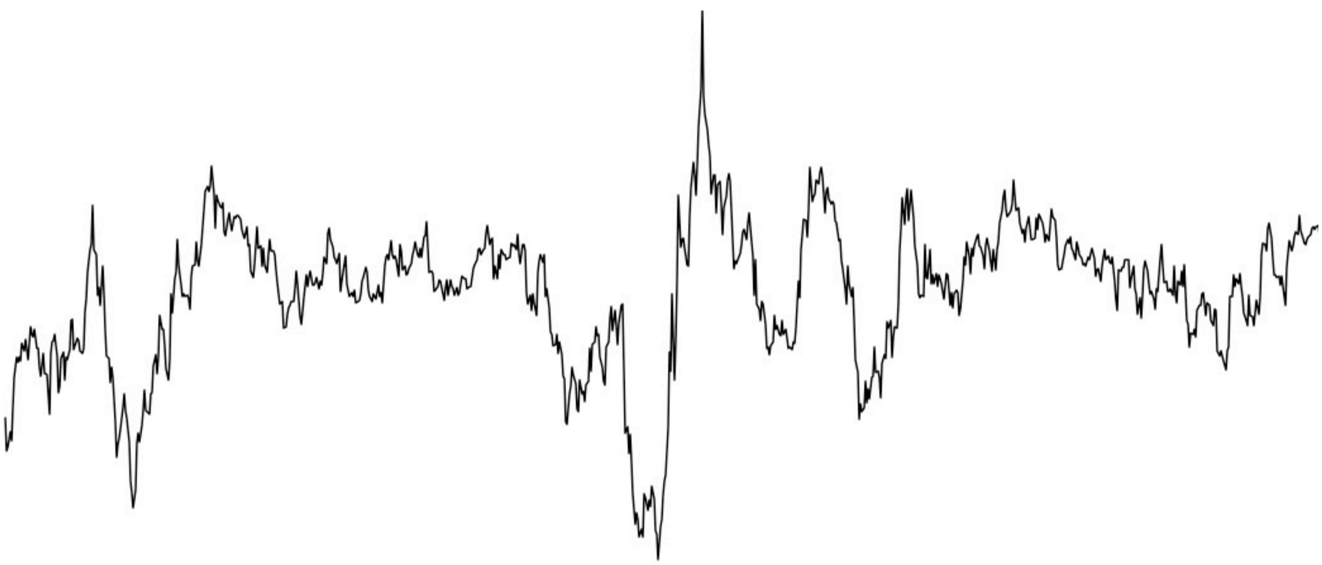

HAS THE EASY MONEY BEEN MADE?

As my previous post can attest, my mind has been focused elsewhere in recent weeks—and I am also preparing a my next long-form essay to boot—but I thought that I'd have a peak at markets all the same. The Fed's (non)decision on yield curve control came and went without any significant shift. The FOMC has now locked down the funds rate until the end of 2022, at least, more or less in line with what markets were already expecting anyway. That said, the shift to "time-contingent" forward guidance—over 30 months no less—is a significant step. It caps a remarkable transition from a Fed on auto-pilot in late 2018—with the 2-year yield aiming for 3%—to one now "not even thinking about thinking about raising rates." A lot of water has gone under the bridge since then, but it's difficult to escape the conclusion that the shift in U.S. and global monetary policy over the past 24 months is fundamental. The idea of a central bank put was born a long time ago, but it's difficult to imagine a version stronger than its current form. **Quite simply, policymakers won't tolerate, and can't afford, tightening financial conditions, of any kind, and over any time horizon, however short and temporary.** I have spent considerable ink on these pages arguing that this makes the rebound in equities, in the face of a crashing economy, more-or-less reasonable. In fact, it's normal for equities to exhibit their strongest return-profiles early in the rebound, as a positive function of sharply rising excess liquidity as policy shifts, but also simply thanks to a low base. After all, it has to pay for those with the guts to buy at the lows.

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Using policy as a guide, there is no reason to stray from the course. I have little doubt that monetary and fiscal policy will continue to throw everything they've got at this, which makes the counterpoint equally simple. If we get an indication that they *won't*, we should run for cover, quickly.

Even in a world of near-unlimited liquidity, however, diminishing returns, or even just consolidation, is a thing, and it seems like we've hit that point. The first chart below provides one of the simplest quantitative illustrations to that point. It shows that three-month stock-to-bond returns in the US has made a full recovery, from an extreme low of -30% in March, to just over 13% now, at the upper end of its range.

Note that this is *not* a signal to short. I back-tested a binary signal with the index above 13%, on three-month forward returns of the S&P 500. Since 2003, this setup has produced an average *positive* return of just under 5%, with n=48, and just six instances of negative outcomes.

This result does suggest, however, that short-term returns will be weaker in Q3, than in Q2, which really shouldn't surprise anyone. In addition, the inevitable return of the virus as economies reopen—or in the case of the US south, seemingly choosing to ignore it—ought to shift risk sentiment for the worse, at least at the margin. Renewed lockdowns are not impossible.

My final chart offers tries to capture a theme, which is increasingly becoming the overarching global macro story. The decision by the issuer of the world's reserve currency to lock rates at zero over any reasonable forecast horizon, combined with virtually unlimited liquidity provides cover for the rest of the world. I realise that there is now a high brow debate underway whether the dollar isn't in fact an exorbitant *burden* for the US, rather than the original notion that it is a privilege. **I'll have more to say about that another day, but to the extent that the dollar's role can still, in some cases, be understood as a privilege for the US, the Fed's policies are now extending this advantage to the rest of the world.**

The most obvious example is the explicit support via dollar swap lines, but the implicit support is important too. In the context of emerging markets, my final chart plots this via a relatively flat intersection between financial conditions—short-term bond vs the policy rate—and macroeconomic fundamentals. The idea is that the Fed's pump-priming offers cover for EM central banks to run loose monetary policy, perhaps even QE, without the normal constraints imposed via the exchange rate channel, and imported inflation. The Fed won't admit it, and it won't set policy according to it, but it is, still, the central bank of the world.

fig. 01 / The easy money is made - **fig. 02** / The macro-equivalent of the Fed put