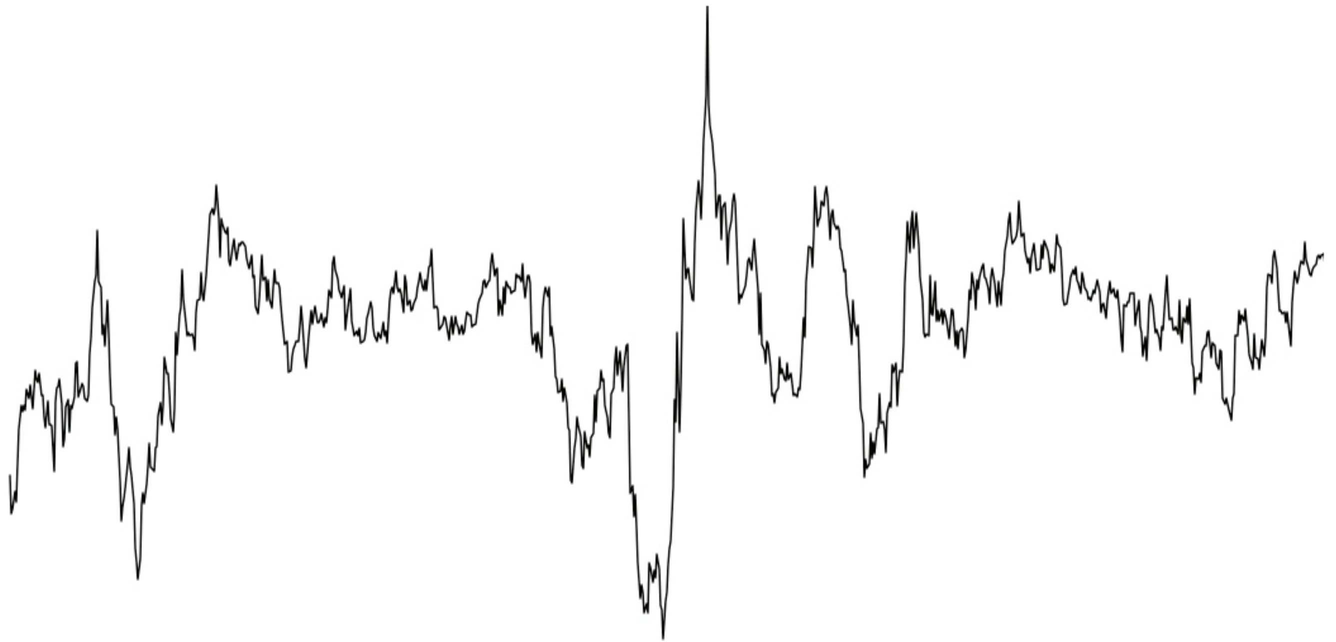
ALPHA SOURCES

OCTOBER 15, 2018



I SPY, VOLATILITY!

As sell-side strategists parse the entrails of positioning data, and update their greed & fear models, to guess whether markets are due a rebound, investors should not forget the big picture. **The conditions for further weakness remain in place.** On the macro-level, the sharp slowdown global liquidity has been warning for a while that global—more specifically U.S.—equities had been rallying on borrowed time. Closer to the ground, the sell-off suggests that the multiple-crushing rise in bond yields and oil prices finally got the better of risk assets.

The perma-bears will tell you that this is the drawdown to end all drawdowns, dragging global equities down to the netherworld of 2008 and 2009 price-levels. They have absolutely no justification for making such a call, but it won't stop them peddling this narrative. Prudence suggests that we keep a close eye on liquidity in the credit market and, more specifically, signs of *illiquidity* in corporate bond funds and ETFs.

The short-run is anybody's guess, but if the recent past is a guide, it'll go something like this: The market will rebound, eventually, retracing about half of the initial plunge. It will then roll over again, making a new low—the classic double-bottom—which can be bought aggressively. This process usually is very

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volatile and takes about eight weeks, in this case setting the stage for a nice X-mas rally. It is *possible* that global liquidity indicators and bond yields will be supportive for equities at that point, though I am not getting my hopes up.

I suspect that investors will soon start angling for a dovish hike by the Fed in December, but it is far from clear that the data will allow the Federales to deliver that. In addition, Mr. Trump probably hasn't helped investors by blaming the Fed for the sell-off. If the new Chair wants to show markets that he can't be bossed around, now would be a good time to show that. If the wheels come off, yields *will* crack, but for now, the uncomfortable truth is that bonds have not provided much protection from the sell-off in equities.

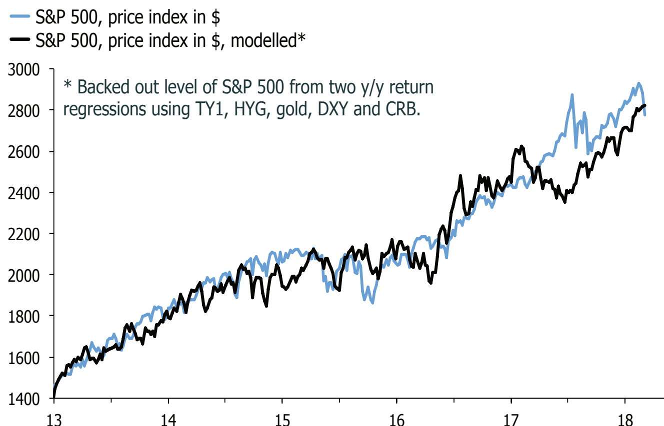
EM TO REBOUND FIRST?

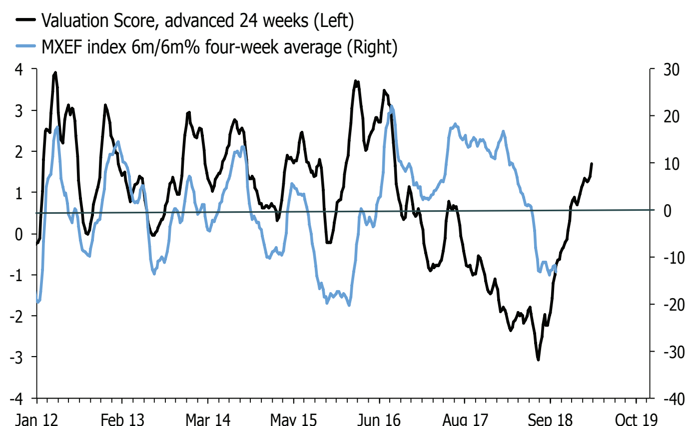
U.S. equities have outrun just about everything this year, but last week's swoon pulled the S&P 500 back to the ground. The first chart below shows that Spoos are now below its fair value, based on a standard global asset arbitrage pricing model. This is good news for the bulls, but this dip follows nearly 12 months of the S&P 500 running *above* its fair value. Assuming some form of symmetry, it is now due an extended period below its implied value.

One iron-clad rule of equity drawdowns is that investors' focus tends to narrow on the fate of the U.S. market. This makes sense given its weight in the global index, and its overall importance. But on this occasion, investors should keep a keen eye on the rest of the world too. Last week's plunge comes at a time when European and emerging market equities already have taken a good beating. **They'll follow the lead of U.S. volatility in the near term, but I am backing them to recover first, given how badly they have been undeperforming this year.**

A decline in U.S. front-end yields, for example, would be a catalyst to buy EM. My final chart shows that trailing returns on the MSCI EM have collapsed, but also that my in-house valuation score points to better times ahead. Keep an eye on this one, just in case.

fig. 01 / Back to fair value? — fig. 02 / Don't focus too much on U.S. equities





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