ALPHA SOURCES

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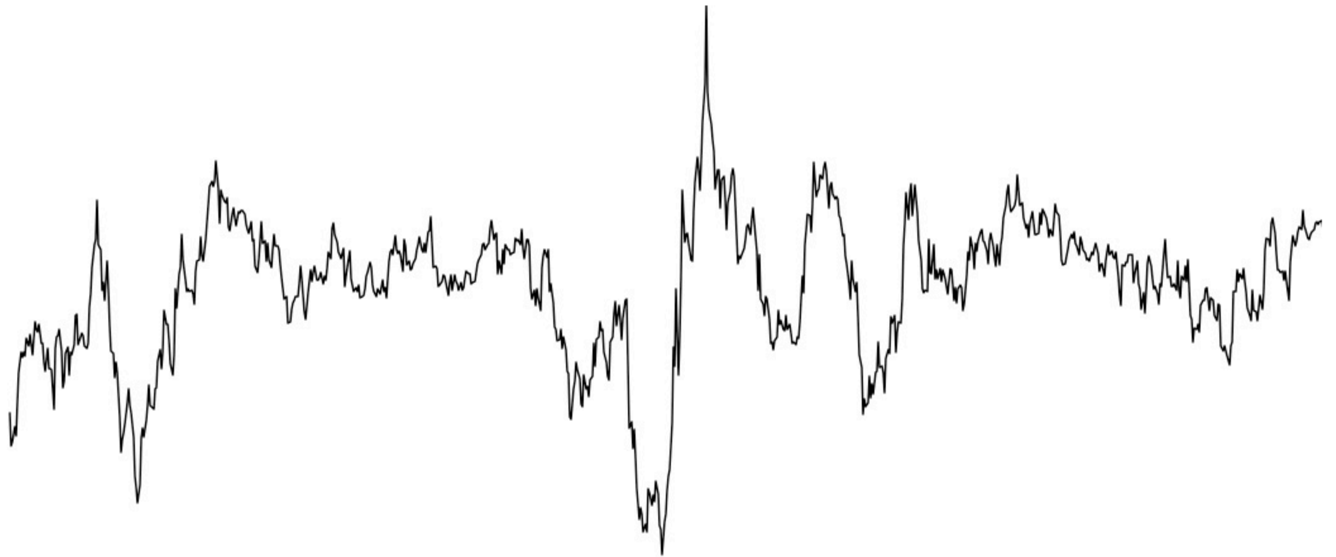

WATCHING, WAITING

It's been a while since I updated my views on markets, which invites humility. It usually takes a few weeks for me to get a feel for what's really going on. I return to my analysis at a point when risk assets are on the back foot, the dollar is rallying, and bond yields are falling, though in all these cases, the moves are so far undramatic. Granted, a quick-fire 7% decline in Spoos since the end of August will have driven some Robinhood punters against the wall, but that's hardly a surprise. Similarly, the dollar is not blowing the doors off more so than it has caught a stretched bearish position off guard. That, after all, is what currency markets do. Meanwhile in bonds; zzz. **In preview; I think risk assets sell off further, the dollar has further upside, and as far as bond yields go, I think they will do more or less nothing.** This is not a hill that I am willing to die on, though,

One of the problems with trying to read the charts at the moment, is that base effects from the collapse during the initial phases of the Covid-19 shock are now coming into view. In other words, it's very easy to convince yourself of the idea that the rally is running out of steam, simply by looking at trailing returns.

The first chart on the next page shows that the six month stock-to-bond ratio on the S&P 500 has now made a full rebound from the collapse in March, forming a peak similar to after the rebound from the swoon in 2018, and after the initial snap-back following the selloff in early 2016. The data are inconclusive, but in any case un-troubling for investors. Out of 92 occurrences since 2004 when the

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trailing six-month stock-to-bond ratio has been at its present level, the one-month and six-month forward returns have averaged 0.4% and 3.9%, respectively. This certainly indicate that returns are now slowing following roaring rebound from the nadir at the end of Q3—the *average* m/m return on the MSCI World has been nearly 6% since April—but it's hardly a signal that investors should abandon ship, especially not with headline indices already having sold off nearly 10% from the highs. For the defensive investor—and I am one of those—what the stock-to-bond ratio might signal is that now isn't necessarily the best time to invest additional capital in the market.

My second chart is potentially more problematic for markets. It suggests that unless central banks pull another rabbit out of their hats soon, returns will fall, sharply. So, will the mandarins come up with something new? I have my doubts, at least in terms of something that will prevent a more moderate path ahead in equities. Don't get me wrong, central banks are not out of bullets. It's just that they have already responded with brute force this year—that's why markets have recovered so sharply in the first place—and the current setup isn't exactly inviting them to push the panic button.

The flip side of a policy put is that sometimes things have to get worse before it reaches its strike price. More generally, the problem for central bankers is that the veil between monetary and fiscal policy has now disappeared. If you don't believe me, just ask the main characters themselves. I am not sure this is the signal central banks want to send, but once you start playing this game, it is difficult to stop. It, in turn, also invites the idea that central banks now have a (perverse) incentive to sit back and let financial conditions tighten, in an attempt to draw politicians back to the table. If that's the sequence, it is one in which markets might want to their chagrin that the reaction to their plight could be longer than usual. I am also sympathetic to Jon Turek's observation that in a world where the virus is still holding back output—either due to lockdowns or changing behavior—the absence of fiscal support could easily force markets to re-rate due to an old-fashioned growth scare. *In short, I don't think the fundamentally positive backdrop for risk have changed, but the near-term picture certainly has, for the worse.* As Cameron Crise put it recently; "Markets really have no business going up in a straight line regardless of how the backdrop evolves. Thinking that they should -- or that policy-makers should address every relatively minor blip with a reaction -- is about as far as it gets from healthy". Well said, which is why I am currently watching, and waiting.

fig. 01 / How much is left in the tank - **fig. 02** / As good as it gets?