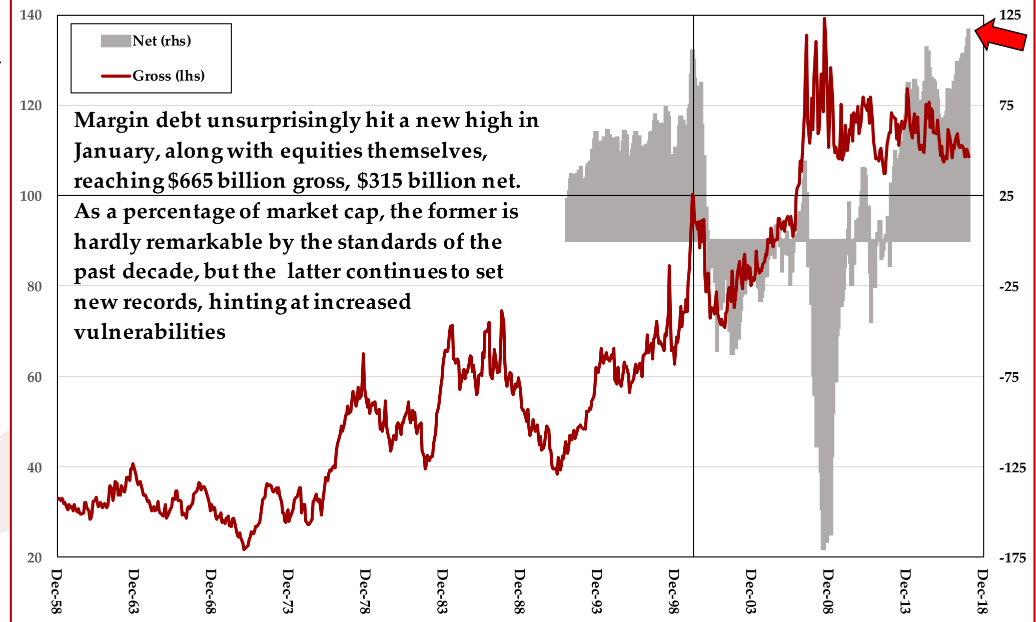
## Alpha, beta & gamma: a world waking up to risk

For some time now, we have hardly been alone in showing charts of the extreme valuations extant in markets.

Central Bank-driven lows in the complex of so-called 'riskless' interest rates have unleashed an interlocking series of mutually reinforcing feedbacks (or, rather, vicious circles) which have led to the forced acceptance of unconscionable levels of risk. Stock valuations are high and recent returns have outrun those delivered by bonds and commodities to a degree without precedent, except in the heady whirl of the (first) Tech Bubble, back at the turn of the millennium. Bond durations are extreme, coupons exiguous, and yields in some cases still negative—not much room in your pension fund for any adverse change in circumstances on *that* account, is there, Grandma?

Credit spreads on the more *déclassé* of securities, whether junk or emerging, have collapsed, covenants have once again been eroded, and even one of the principal perpetrators of the late catastrophe—the CDO—has secured an early release from the slammer, along with his junior accomplice, the CLO.




All of this has allowed multiples and valuations to build up alarmingly in the buy-out and buy-in business where the average EV/EBITDA ratio of 13.2x in the US is now tying with 2014 for the all-time top spot of cash-soaked exuberance. And then there is volatility.

Just a few weeks ago, we saw the VIX dip briefly below 10% for the first time in its 27-year history (a sample stretching to over three decades if we further estimate the measure from its narrower but more venerable VXO stablemate). Finding ways to be short of the measure—and by extension, of many more implicit forms of gamma—had accordingly turned into the classic game of 'picking up pennies in front of a steamroller'.

When it suddenly exploded this week, the VIX jumped straight to the 99th percentile of that same distribution, touching 50 intraday—a number only exceeded around the Lehman bankruptcy and during the epochal Crash of '87. *That* was enough to trigger all manner of hedging flows, portfolio rebalancings, black box stop-losses, and margin-related selling as the stock market hit an air-pocket and surrendered half the gains made in the past six, extraordinary months of relentless ascent, amid some very Hooverian platitudes from those in power to the effect that '*the fundamental business of the country is on a sound and prosperous basis*.'

**The markets having since struggled to regain even the most edgy of equilibria, the question is whether this was a salutary '*remember, thou art mortal'* alarum or the first crack in the towering dam of investor insouciance, erected over this past decade of determined, politically-inspired risk suppression. Each successive failure to sustain a rally from here can only give growing support to the second, darker interpretation. In markets such as this, what does not go up, *must* instead come down.**

## Mean reversion & market opportunity

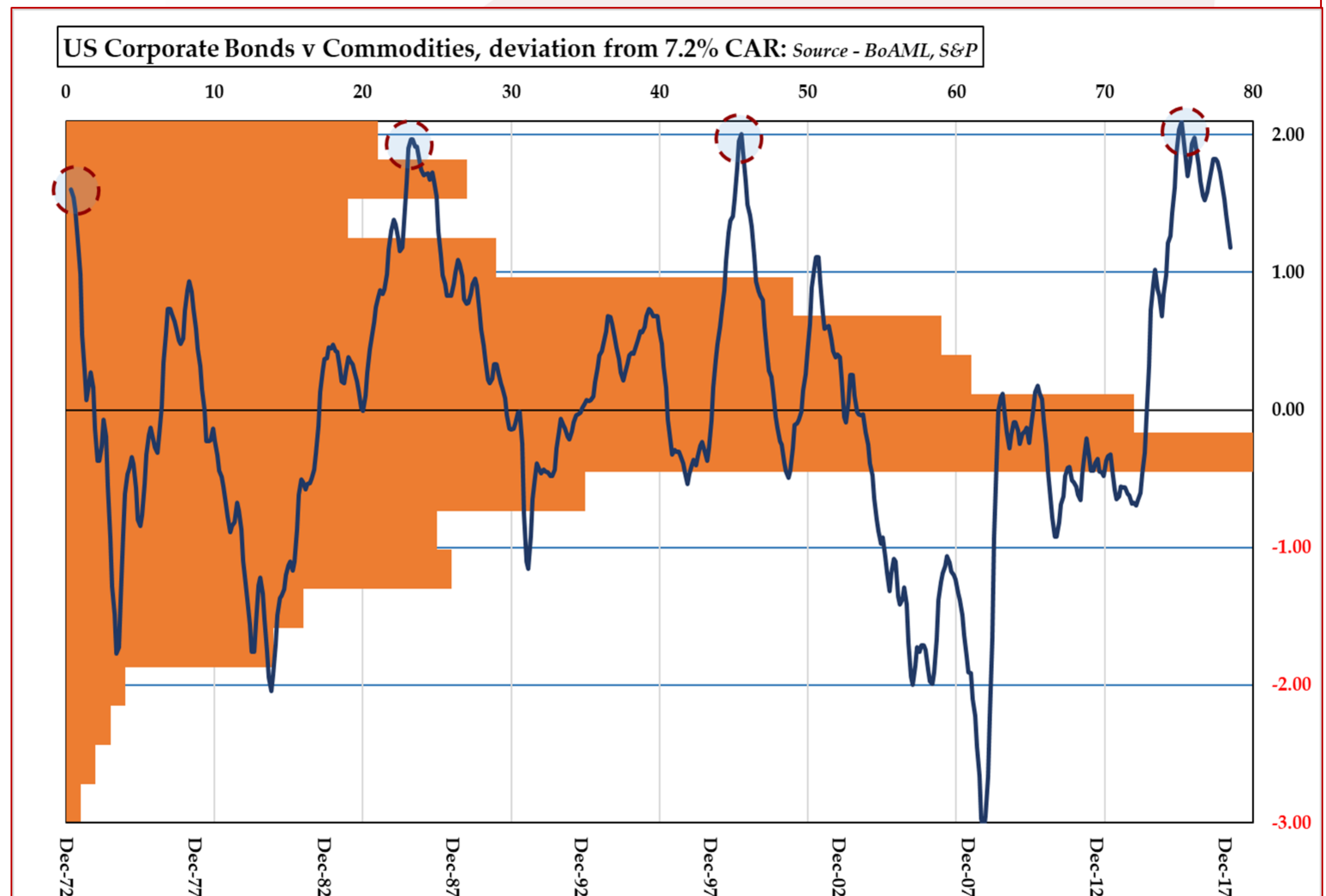
In the course of the very public battle of the egos playing out between DoubleTree's truculent Jeff Gundlach, and that Flower Child of the bond market, Bill Gross, the former seems suddenly to have discovered an enthusiasm for commodities which he has been promoting by showing a graph of the ratio between stock and commodity returns of the type we have long used to illustrate our own arguments in favour of one or the other.

Given that much of the pair's war of words has been played out over just which level each of these *soi-disant* gurus has chosen to constitute *the* definitive point at which the generational decline in bond yields can be said finally to be over, it is a trifle ironic that friend Gundlach did not have his juniors cook up something more like the chart we append here—one which shows that even greater extremes of relative valuation are to be found between commodity returns and their reliably negatively-correlated antitheses in the fixed income market.

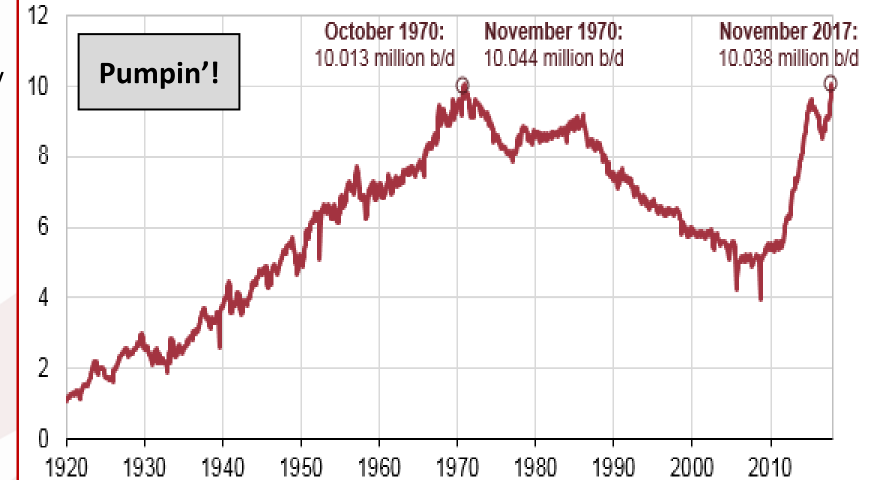
A point of note which a closer inspection of this quasi-periodic relationship will reveal is that not only is it mean reverting, but the tendency—once bonds reach 1 to 2 standard deviations above that trend—is for the back reaction to pull them down, far below it.

Thus, a relative drop of around 60% was seen after the 1972 peak at the start of this history, with further drops of approximately 50% after each of the 1977, 1986, 1999, and 2002 local maxima.

***Any one care to bet that we might just enjoy a similar move this time, too?***



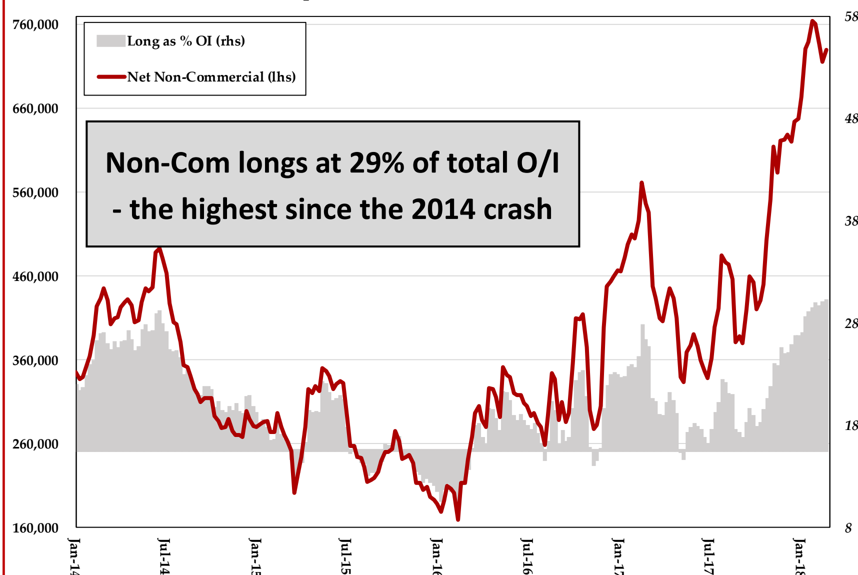
## Drill, baby! Drill! 10mbpd and counting




There is much current focus on the degree of spec long positioning in the WTI contract, which now stretches to more than three-quarters of a billion barrels equivalent (for a combined value of roughly $47 billion at the time of writing). In what is a telling sign of our fixation with all things financial and therefore of our habitual neglect of the substance beyond the symbols, What tends to go unremarked in such commentary is the role being played by the hedging needs of producers themselves.

This is so, even though the EIA itself drew attention to the phenomenon shortly before Christmas, when it noted that an examination of Q3's financials issued by 47 large US firms revealed that they had locked in selling prices on something of the order of 1.2 Mbpd during the trimester. In all, that would amount to the sale of ~110,000 contracts over the period and, indeed, we can see from the COT reports that net commercial shorts on NYMEX rose from 340k to 455k –i.e., by a closely matching 115k. One happy effect of this from a commodity investor's point of view is that these heavy forward sales, coming at a time of relative supply tightness, have pushed deferred contracts below the near ones—a condition termed 'backwardation', the reader will recall—and so adding a useful component of 'roll-yield' to the outright price appreciation of crude itself.

The drillers in question, the EIA tells us, have been making great strides in increasing output, to the point that total US supply has finally surpassed the briefly-attained peak of 10Mbpd, attained way back in 1970. Moreover, the agency has been sufficiently impressed by the performance to further increase its forecasts for the coming quarters, revising its year-end estimate up by 1/2Mbpd to 11Mbpd and placing the immediate peak a further 200k higher by the middle of 2019.




Though we have still a few weeks to await the corresponding reports for the final quarter of 2017, the CFTC shows us that the total of net shorts then mounted once more to 640k net—a gain of an additional 185k , or 2.1Mbpd—before January witnessed another surge to the 764k we alluded to above, this time representing a further 1.3Mpbd on a quarterly basis.

The caution here, if we examine this latest acceleration, is that it seems a little too rapid to be due only to organic, commercial activity. Looking at the daily run-rate of position accumulation, QIII scored ~1.2Mbpd and QIV 2.1Mbpd, as we have seen, then January rocketed to a whopping 4Mbpd.

**The conclusion is inescapable: the momentum chasers are back in town, warranting a good deal of caution as to price development in the event of any minor reversal of the trend.**

**Sean Corrigan, Chief Investment Strategist**

### Pump up the Jam!

As well as relating developments in commodity prices with measures of ‘real’ economic activity, such as industrial production and merchandise trade flows, our work also looks closely at the interplay the effect with money supply.

Milton Friedman’s lapidary remark that ‘inflation is everywhere a monetary phenomenon’ may be bordering on a truism for us disciples of the Austrian School for whom a perceived surfeit of money IS by definition ‘inflation’—an economic malaise which *usually* (but not *inevitably*) manifests itself in a rise in the cost of living—but it will certainly serve to introduce our discussion here.

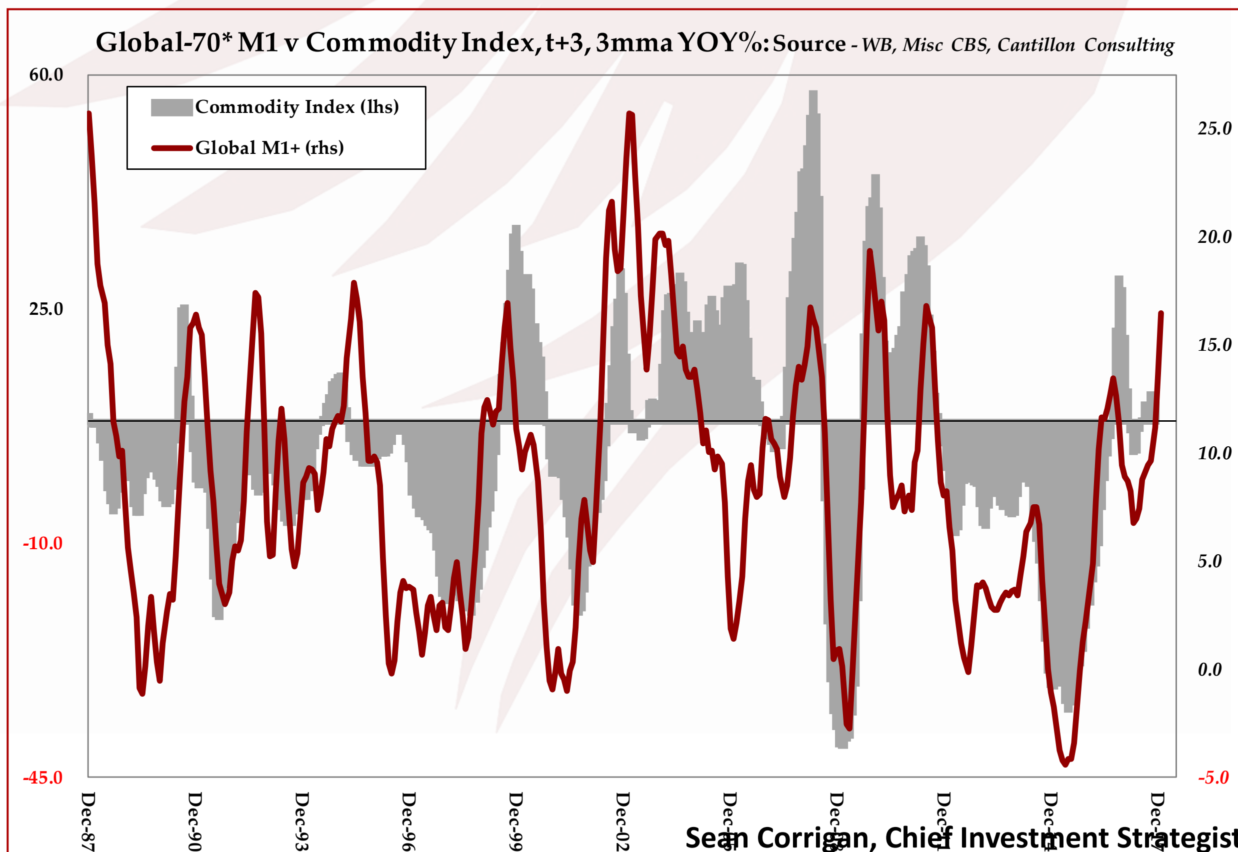
Having constructed a dollar-based measure of the combined money supplies of up to 25 developed countries (19 of them, of course, comprising the present Eurozone) plus eight of the larger emerging ones, we can soon show that not only has it registered an r-squared of 0.75 with commodities over the past three decades, but that both the changes each has undergone *and* those changes’ first differences (their acceleration, if you will) show positive correlations in excess of 50%.

It will therefore be of some considerable interest to the reader to learn that this measure—having undergone a major retardation between the summer of 2016 and that of 2017—has since quickened appreciably and has lately attained a 16.4% YOY rate of climb which is the fastest since the first great reflationary rebound from the GFC began to fade, back in the middle months of 2011.

Leading the charge, as ever, have been the emerging contingent—their 21.0% rise being the best in over 7 years—but the larger, advanced grouping have not exactly been sluggardly, racking up an impressive 14.6% in their turn.

Looked at in terms of the number of extra dollar-equivalent units of money put into circulation this past twelve months, we find they amount to an astonishing $5.5 trillion and, as such, surpass the emergency, post-Lehman injection by more than a third as well as being in equal in magnitude to the entire stock of such money in being in late 1994 when the Fed was about to end that year’s aggressive tightening cycle.

Interestingly, this towering extension to the world’s spendable medium was built in roughly equal parts of actual new flow additions to

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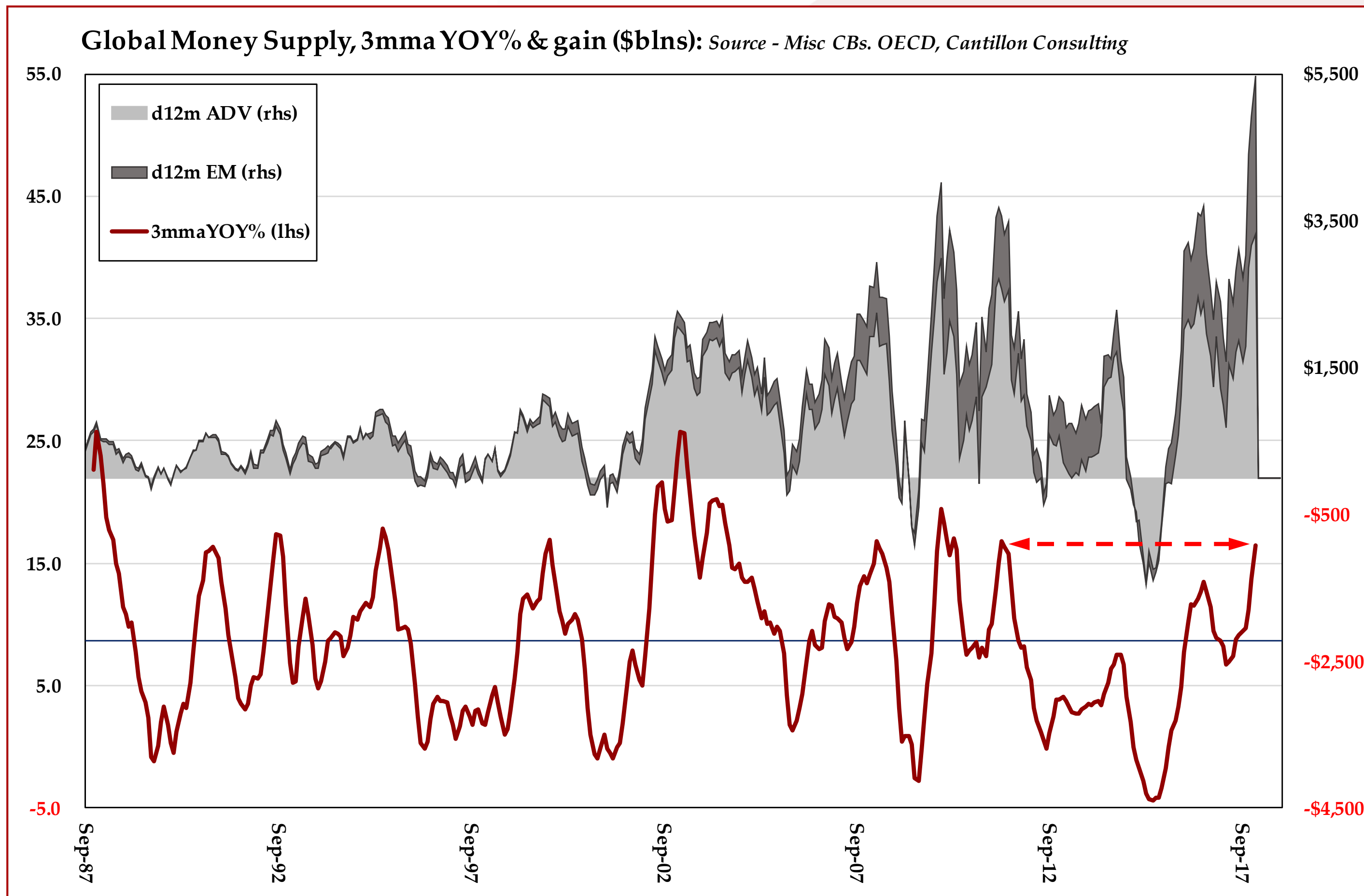
### Pump up the Jam! (contd)

the money supply and of the upward revaluation of its existing stock occasioned by the decline of the dollar on the exchanges. Though this latter element was in fact the largest such contribution in our sample (the euro and the yuan being the main culprits here, with a little assistance from the pound sterling), the printing presses of Messrs, Draghi, Kuroda and Zhou also played a major role by contributing 22%, 15% and 38% of the new flows, respectively.

**The implications of all this for the future should be readily apparent: should the dollar continue to weaken, should the ECB and the BOJ continue to force money into the system, and should the PBoC succeed in not transmuting its renewed regulatory zeal from the current deceleration into an outright contraction, commodity prices should continue to be well-supported and to threaten resistance, rather than support, in the months ahead.**

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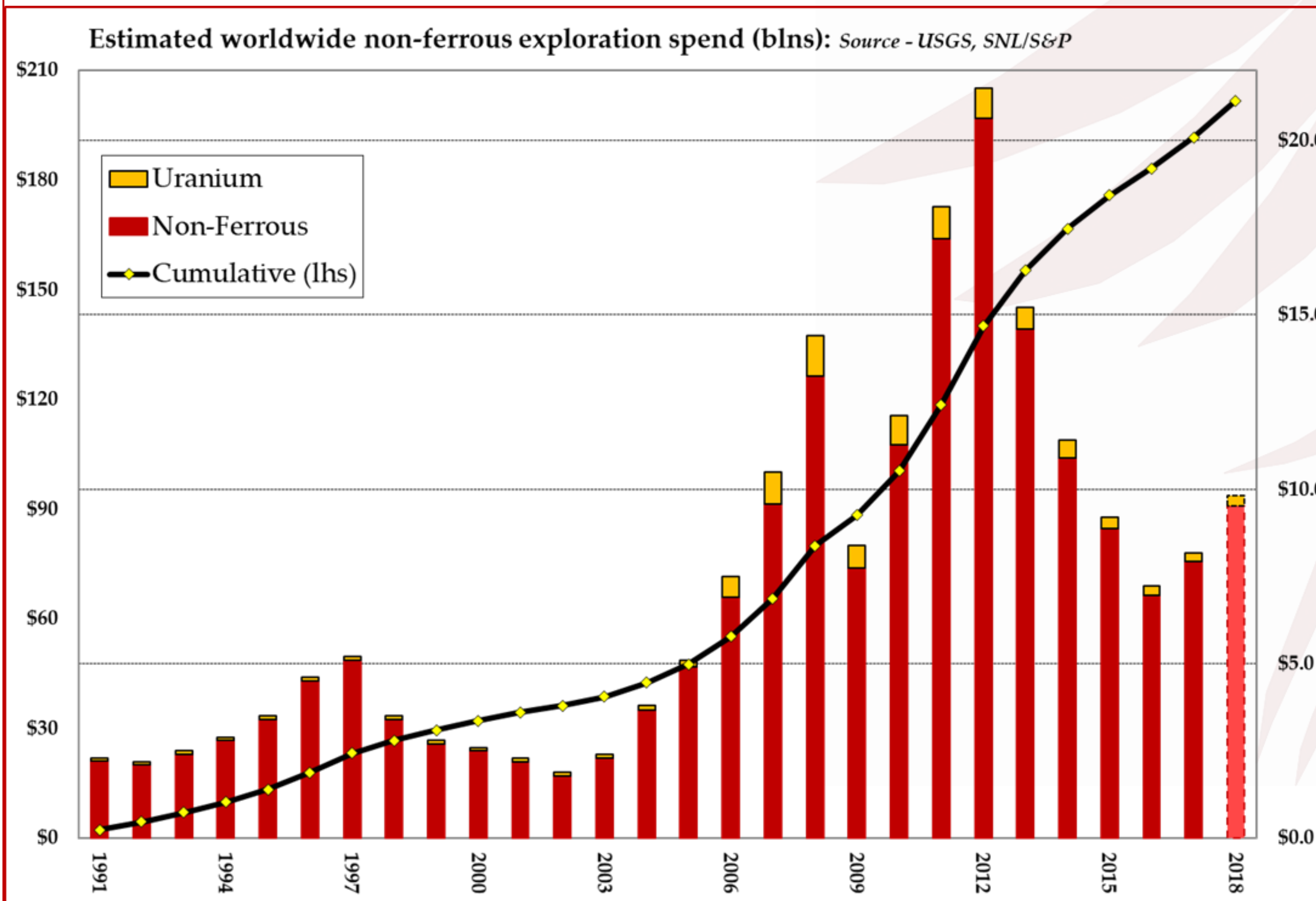
**Way off Base**

Over the weekend, S&P released its keynote estimates of the scale of global non-ferrous mining exploration activity for 2017, together with a broadbrush ‘guestimate’ of what 2018 might hold in store.

On the face of it, things were fairly positive, with last year’s outlays rising by more than a fifth from the prior period and with projections that, given the ongoing firmness in metals prices, that something of the same order might eventuate again in the current one.

However, on closer inspection, there are one or two caveats, the first of which relates to that fact that last year’s gain was the first recorded since the bull market peak of 2012 and that it still left expenditure at barely more than a third of that high, unchanged in essence from the levels of a decade ago. Even if 2018 lives up to the hype, this will still leave such investment where it was before Lehman’ collapse and at less than a half of that seen during 20012’s ill-timed triumph of hope over expectation.




The second is that the ever-dominant gold sector increased its share of the spend to ore than 50% - accounting for over three-quarters of the annual increment as it did.

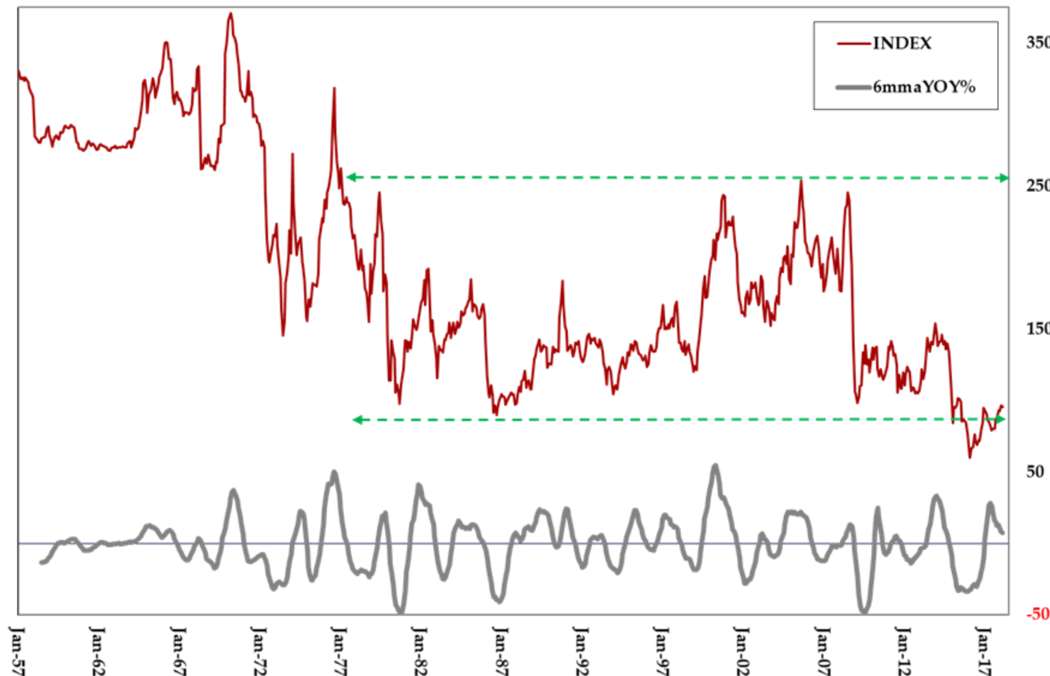
Base metals – the things we actually NEED, the cynic might say, only managed to attract 30% of the pot and while there are obviously more immediate ways in which funds can be used to help address some of the multi-year visible supply shortfalls being felt in the likes of lead, zinc and nickel, it would be nice to believe that some thought is being given to the medium and long term needs of global industry.

### Fool's Gold

Gold continues to frustrate both bull and bears, seemingly capped in the $1360s and yet solidly bid just above $1300 – though the picture looks a little less reassuring if we try to abstract from the greenback's weakness by plotting gold in euros, yen, or even a recently defibrillated sterling.

We tend to regard gold as an insurance asset -- whether providing some degree of protection against central bank overkill on the inflationary side, or against more general financial system overstretch and the periodic crises to which such episodes all too frequently give rise.

In times where such conditions do not apply – and when other stress indicators, such as volatility and credit spreads are not too elevated – we look to gold to underperform proper industrial commodities.

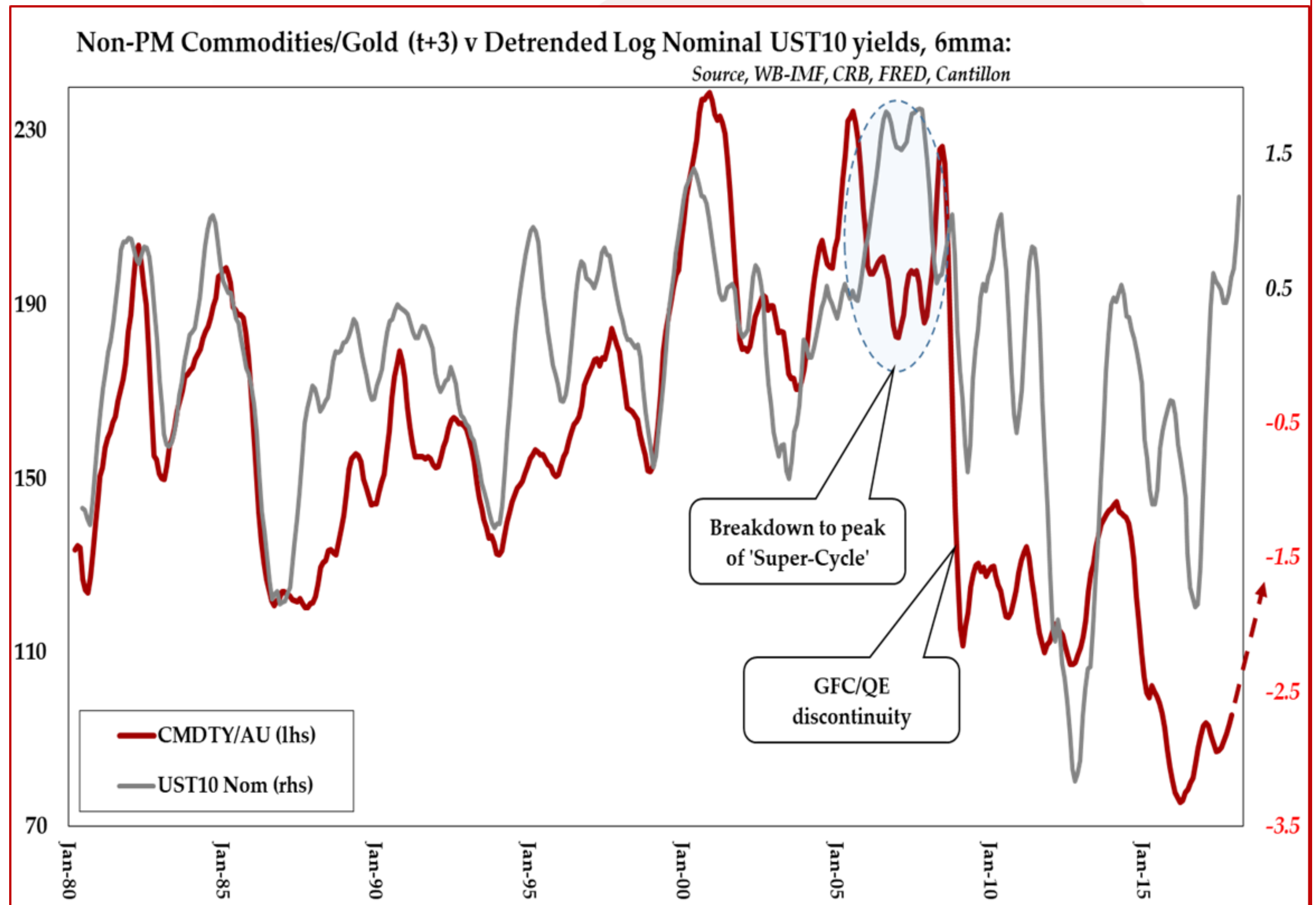



Against these, as our second graph shows, gold is already very generously valued in terms of the modern era's range of possibilities, further lessening its relative appeal.

### Fool's Gold (contd)

A final caveat can be seen in our third graph where we plot normalized changes in the ratio of industrials to gold to deviations of US Treasury yields from trend (something which makes sense in the context of the latters' tendency to fall sharply as systemic tensions mount).

The recent rise in the long-term rates – if slightly abated in recent sessions – have nonetheless been substantial enough these past few weeks to argue strongly against gold leading any break higher from here for commodities in general

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