

Confusing and Conflicting Signals. Contamination by QE.

Its all rather confusing. But not any more so than usual. Things are always confusing in the present and clear in the past. What is confusing today, are the number and strength of the conflicting signals. We therefore consider, in broad summary, the bull and bear cases for general conditions.

The bull case.

The US economy is onto a sustainable recovery. Europe appears to be editing recession bnnand establishing a sustainable recovery. Even China appears to be stabilizing sufficiently for the government to embark upon structural reform. Japan has staged a remarkable comeback under the new, or old, prime minister. Only the emerging markets look a bit tired. Markets have experienced some turbulence mostly because the US Fed has publicly contemplated the gradual withdrawal of extraordinary stimulus. This has send interest rates higher and bonds lower. Emerging market assets have corrected sharply on an apparent switch in capital allocation. However, generally, the signs mostly point to a healthier global economy with the tapering of QE testament to central bank confidence in the US and China, which is undergoing their own brand if QE tapering.

The bear case.

There is some convexity around the bear case. Fundamentally, the US economy's growth is both weak and potentially unstable. Unemployment numbers are only suppressed by a declining participation rate. Inflation numbers are not indicative of a strong recovery. The housing market seems to be slowing as mortgage rates climb. Corporate profitability seems to have

peaked. Earnings growth has been powered by the financial sector and only then by a reduction in provisions for bad loans.

Europe remains financially fragile with most of the problems back ended until after Merkel, hopefully, wins the German elections. Greece, Spain, and Portugal are cash flow insolvent with Italy not far behind. The Draghi Put is untested and hopefully will remain so.

In the emerging markets, Brazil and India struggle to regain competitiveness while the current accounts of Indonesia, India and Turkey lead a pack of deficit countries raising fears of crisis. And China's semi closed capital account may insulate it from contagion, but its debt levels and opaque shadow banking system represent a significant tail risk.

Making sense of all the signals.

Both bull and bear signals coexist as they often do. Complicating the analysis are the outright conflicting signals between fundamentals and market prices. With little evidence of inflation, US rates are expected to rise and the term structure has indeed already steepened. The market regards QE tapering with trepidation even as it is a sign of underlying strength in the economy. Emerging markets still represent the main marginal driver of global growth yet capital has fled on apparently no significant catalyst.

One of the complicating factors is QE itself. Administered as an analgesic during the crisis it has sheltered the economy and the market to the extent that it is hard to estimate the health of the economy without QE. Such uncertainties plague asset markets.

The lack of an unadulterated signal also impairs the ability of policy makers to measure the normal equilibrium condition

of the economy. Policy makers end up making policy to manage legacy policies, and are required to think iteratively through the feedback loop. Feedback loops are as we have experienced in the past, rather unstable and unpredictable. This makes policy increasingly difficult to get right.

For the investor, the level of noise risks swamping signal. Short term trends can be confusing and provide false signals. Longer term horizons can mitigate some of this. What it means is that I am for the moment suspending my usual reliance on shorter to medium term signals in favor of longer term ones, and relying more on fundamental, bottom-up security selection than on tactical, momentum driven, macro trading. For the moment.