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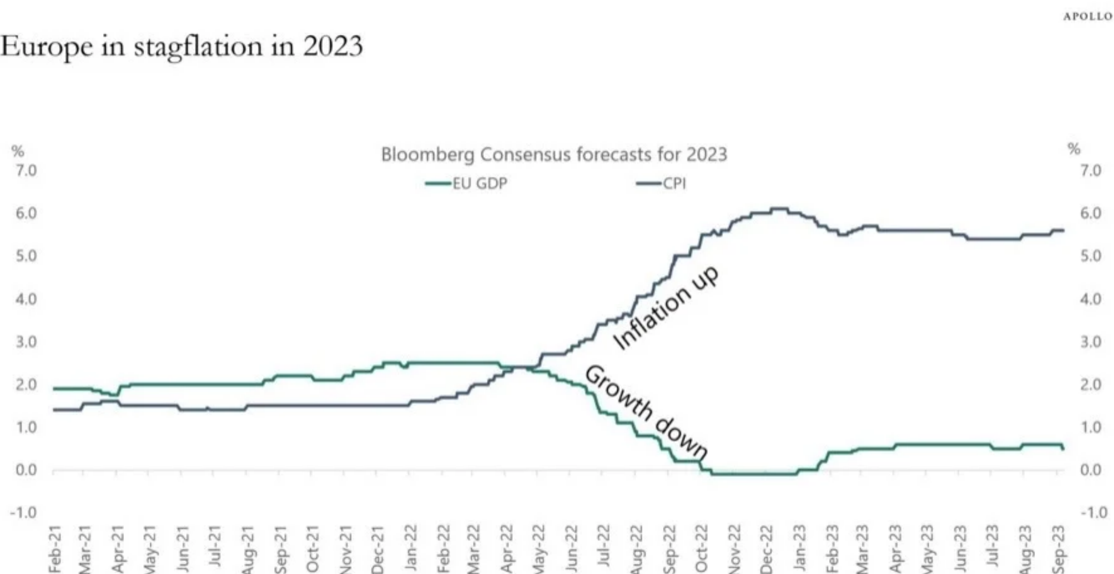
Kryptonite!

Q4 is just four trading days away. What will be the key theme? Santa Claus rally or recession?

For some, it's stagflation rather than recession that is the biggest fear. And Europe is probably the poster child for that risk scenario currently.

Which makes the current picture from Qi's investment clock somewhat concerning.

The chart below is from Apollo. It captures Bloomberg consensus forecasts for economists' growth and inflation projections for Europe. The message is clear - stagflation with falling economic growth but sticky inflation.



Source: Bloomberg, Apollo Chief Economist

That combination is all the more concerning when viewed in conjunction with the Qi investment clock which follows industry convention with **one important difference**. It divides assets (here global equity indices) into quadrants with each quadrant capturing a macro regime. The regimes are industry standard and follow the typical business cycle - boom, recession, Goldilocks, stagflation.

Economic growth and inflation are the two variables that dictate which regime / quadrant any equity index lies in. **But the key difference is how that is measured.**

Traditional investment clocks rely on the **discretionary view** of the asset allocator. That is probably influenced by factors such as history (behaviour during previous cycles) or fundamentals (during an energy-led inflation shock, for example, is the country a net oil exporter or importer). Such analysis is **subjective** and **relies on history perfectly repeating itself.**

Qi's proprietary version of PCA means we capture the *independent* pattern of association between an equity index and economic growth (Now-Casting tracking GDP) and inflation expectations (inflation swaps). **Country indices are allocated a regime on the investment clock by maths not opinion.**

The first standout from the chart above is how NASDAQ is in a boom regime. But while the sensitivities are smaller, what is equally striking is **the confluence of European equity indices in the Goldilocks quadrant.**

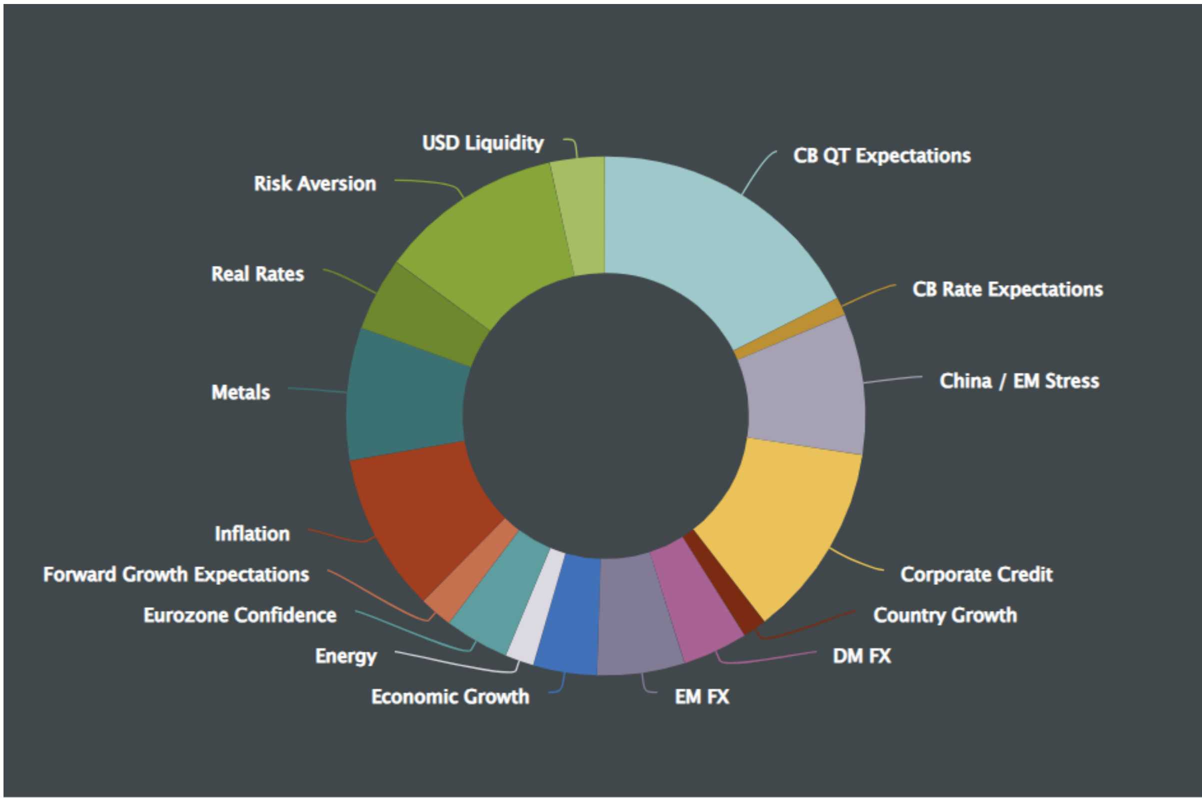
The Euro Stoxx 600, DAX, CAC, IBEX, FTSE MIB are all in that top left quadrant. Again it is worth stressing the sensitivities are modest: close to zero for economic growth, while the relationship with inflation is a small negative.

But the basic point remains - if the Bloomberg consensus above is correct, **this is the worst possible combination for European equities.**

Is there any respite? This view focuses on just two factors - economic growth and inflation expectations. What about the rest of the macro complex?

We've observed that growth is not a major driver currently. Inflation is a top driver for these models - European equity indices need inflation to conform to target.

And that speaks to the other key drivers in the current macro regimes. Rate volatility, credit spreads and risk aversion typically screen as the three biggest factors currently. **European equities need well behaved inflation, because they need the Kool-Aid of easy money from the ECB.**



The pie chart above simply shows the relative importance of all the macro factors in our DAX model. A quick way to ascertain which macro factors are driving the current regime.

And it does offer some potential relief ***if*** you believe in an ECB pivot. Put another way, investors need to have high confidence that we don't see a policy mistake from the ECB that engineers a sharp tightening in financial conditions and subsequent hit to risk appetite.

The textbook Central Bank policy response to stagflation entails higher-for-longer rates and an acceptance of weaker growth while we wait for inflation to subside. For many equity investors, that will read like the definition of a **policy mistake**.

And sadly it is particularly dangerous combination for the region which, if the economists are right, seems most likely to experience it.

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