17TH JUNE 2020

Financial markets have rallied since April, with investors growing confident that economies will turn around quickly from the fallout from the pandemic.

Their optimism has grown stronger in recent weeks as various countries have started to ease lockdown restrictions and tentative signs of stabilisation have emerged. Daily activity trackers from the likes of Google and Apple show that the most developed countries are edging towards normality, halving the declines suffered during their March and April lows.

China is back to January levels, though the country's unique policy circumstances (regarding lockdown and stimulus) mean it might not be a template for elsewhere.

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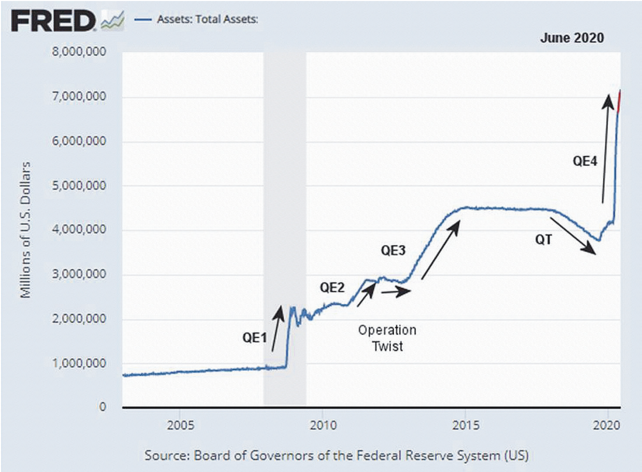
Huge job losses will inevitably have an impact on consumption, which is being mitigated at present by massive fiscal stimulus. Indeed, fiscal deficits are off the charts: In the US alone, the deficit is expected to reach USD4 Trillion this year, some 20% of GDP, without even taking into account the various spending programmes winding their way through Congress. Some 90% of that increase is being financed by the Fed, which has become the ATM of the Treasury (graph below shows the Fed's balance sheet):



This should push the US 'shadow' rate (which takes into account the impact of its unconventional easing) below the previous trough of -4.7% in real terms by the year end, down from the current -3.3% (yes, there is a negative sign at the beginning of those numbers!).

While benchmark interest rates are unlikely to fall below zero, we expect the Fed to adopt a Japan-style yield control curve policy if inflation undershoots its target significantly in the coming months (spoiler alert: it will).

The Eurozone had initially been more conservative in its approach, but a new EUR750 billion rescue programme (a mix of grants and loans), to be funded through a commonly issued bond, is a big first step towards fiscal integration of the single currency region. Even if the plan is watered down, the Franco-German programme could change the EU's medium and long-term economic prospects. Please see below for a section dedicated to this.

While Emerging Market (EM) economies are likely to suffer less of a drop in growth than their developed counterparts, world growth could be down up to 4% this year (peak-to-trough drop of 8%), which would double the fall post-Global Financial Crisis.

Before you dive in, remind me why deflation is so bad? After all, lower prices are good for consumers.

The problem with deflation is that, as the US discovered during the Great Depression, it can be a killer of prosperity because it:

- Discourages consumer spending: Falling prices encourage people to delay purchases because they will be cheaper in the future.
- Increases real value of debt: Consumers and firms have to spend a bigger percentage of disposable income on meeting debt repayments. In a period of deflation, firms will also be getting lower revenue, and consumers are likely to get lower wages. This leaves less money for spending and investment.
- Increases real interest rates: By contributing to an unwanted tightening of monetary policy.
- Increases the risk of real wage unemployment: Workers resist nominal wage cuts so wages tend to be sticky. In periods of deflation, real wages rise, which could cause real wage unemployment as companies are forced to reduce payroll.

Why have US equities bounced back so strongly and quickly?

There are a few reasons.

1. Retail investors have reportedly played an important role in the latest rebound: a record number of trading accounts were opened in the United States after the initial selloff (https://robintrack.net/symbol/SPY). Retail investors must have been helped by risk parity strategies: it is a design feature of such strategies to sell assets when volatility rises and buy them when it falls.

– Counter-argument: Retail investors have historically been quite vulnerable to being led by the herd mentality and tend to be poor at managing risk. See the 'Bonus Section' for a few examples of current popular delusion.

2. In this cycle, the economy came to an abrupt stop, the market quickly caught up with this and asset prices collapsed at a pace never seen before. Investors interpreted this as the capitulation phase of the bear market, and enough of them were willing to bet on a sustained rebound. Since most of the gains from a (true) market bottom happen in the first three months, investors have jumped into stocks for fear of missing out.

– Counter-argument: The true market bottom almost never happens after the first loss (i.e. lows tend to be re-tested).

3. This current episode resembles the market response to a natural disaster.

– Counter-argument: The COVID-19 crisis is not a localised natural disaster from which the economy can quickly rebound. If COVID-19 were a natural disaster, it would be sensible to ignore, to some extent, the short-term earnings weakness and focus on the recovery. In as much as COVID-19 leaves deep, lasting scars on the economy, then this argument cannot be 100% true.

You are leaving the elephant in the room for last: is it not mainly about liquidity injections by Central Banks?

Yes: the rebound in risky asset prices owes plenty to the very aggressive easing implemented by global central banks, with the Fed clearly acting as the pace setter. The injection of liquidity from the Fed in recent months has elevated its balance sheet by more than $3tn and we should expect the balance sheet to near $10tn by the end of the year (or 50% GDP).

Where the Fed has moved the needle for risk appetite is through its backstopping of credit markets. Stemming a credit crunch in the very important area of capital markets (the Fed's actions have triggered an avalanche of debt sales from companies since March) certainly helps the equity market, particularly the weakest links. This has the potential to wake up the 'animal spirits' of investors that are desperately looking for places to park their assets.

Crucially, not only do we have the biggest money printing experiment ever but also bank balance sheets are robust enough to transmit this through to credit creation (unlike during the 2008-09 crisis).

So, some businesses are trying to avoid liquidity problems by borrowing even more?

My first boss at JPM used to say this: "Revenue is vanity, margin is sanity, but cash is king".

Many companies are using debt to bolster cash buffers and offset massive revenue shortfalls. If economic growth picks up quickly, this would be deemed to have been a wise way to avoid temporary liquidity problems turning into a crippling solvency risk.

If growth disappoints, the economy and markets will have to cope with a massive debt overhang that results in even greater central bank distortions of markets and lower growth potential. There will be widespread debt restructurings too, and disorderly non-payments.

What about Europe?

In Europe the big news regarding liquidity injections did not come from the Central Bank, but from Germany and France, as their leaders took a step towards a form of integration that has for decades eluded the EU. It may well save the bloc, and its common currency, from an untimely demise.

So you are being positive on Europe. That's a change after many years!

Indeed.

It all started with COVID-19, which wiped out the EU's already fragile economic recovery. Some of the worst-hit European countries, like Italy, were unable to raise funds for large-scale emergency support spending, echoing what happened after 2008. Adding to the pressure, on May 5th, German judges ruled that ECB's public asset purchases (the glue that kept Eurozone together) were outside its mandate.

Historically, German governments have always rejected the idea of mutualising debt to support struggling EU members. However, in a speech in late April, when it became clear that this pandemic would last a long time, Merkel said this: "Europe is not Europe if it's not there for each other in times of undeserved hardship." Side note: It probably helped that she is not running for a fifth term.

Subsequently, Angela Merkel and Emmanuel Macron proposed a EUR500 billion 'recovery fund' that would distribute grants to the hardest-hit regions and sectors of the EU. Under this plan, the European Commission could borrow money on capital markets on behalf of the 27 EU member states against the security of the Union's next 7 year budget, to be paid back sometime after 2027.

500 Billion does not sound so remarkable…

Quantitatively perhaps, but when people write about European integration in a few years time, it could be seen as a watershed moment.

Is this the beginning of a true fiscal union then?

Not quite, as it stops short of a permanent debt mutualisation structure, but it offers a sort of middle-ground solution. It constitutes progress after failed negotiations in prior months, shows some solidarity and creates a new financial instrument to be funded by EU taxes.

Can the EU add more public debt? Is it not over-stretched?

Last year's consolidated EU budget deficit was 0.6% of GDP, so there is room for growth.

Will this be acceptable to other EU countries?

The proposal needs unanimous EU support, and it is already facing some opposition.

The 'Frugals' (Austria, Netherlands, Denmark) favour issuing loans, not grants. On paper, they have a fairly strong position in the sense that this whole thing is located within the EU budget.

In practice, none of them would probably want to go down in the history books as the country that endangered the future of EU by not showing solidarity to other members, nor do they have the size to stand against France and Germany.

What would this mean for European assets?

An agreement on the European Recovery Fund is clearly Euro positive as it further reduces any potential risk premium in the common currency (with the BTPs rally and the narrowing spread vs Bunds providing a case in point).

The deal includes two innovations: ability of the EU commission to borrow on its account and so create a new class of EU bonds; and the fact that the borrowing is to be financed by new European-wide taxes on carbon emissions or financial/digital transactions. Therefore, the leverage on the tax revenue allowed by the ability to borrow could be huge.

Rather than paying unemployment benefits to laid-off workers, as the US has done, European governments are subsidising the cost of employees as long as their employers keep them on their payrolls. This could, in theory, lead to a quicker ramp-up of consumer demand in the EU.

Let's turn to consumers, which you said in a previous note was key to the recovery. How are they faring?

Many households have built up a stash of savings during COVID-19 lockdowns in the past three months: the shock has caused spikes in unemployment, but most households spent lockdown periods either working from home, furloughed or on direct government income support. With few goods or services available to buy, their savings should have soared.

In the US, some households may have even seen a temporary rise in weekly incomes as they claim jobless benefits of $1,000 per week (higher than half of all working wages) plus the $1,200 one-off government payment.

In the short term, how they view these savings may dictate the speed of recovery from the pandemic. In the long run, it will be all about their confidence around their economic prospects and their job market outlook.

If the public treats the money like a tax rebate, spending could surge (as it did in 2001 and 2008). With private consumption the main driver of economic activity (around 70% of GDP), changes in saving patterns could easily offset any new fiscal measures.

In a previous note we argued that consumers are probably going to be increasing savings as a precautionary measure given uncertainties and the worst unemployment rate in many decades. Also, future tax rises to fix public finances could prompt household caution.

What is clear is that current bloated savings levels mean that confidence, or a lack of it, could have a snowballing impact in the second half of 2020.

As a counter-argument, some readers will point at the US retail sales data released this week, which showed a strong rebound: total sales (which include purchases in stores and online as well as money spent at bars and restaurants) were up 18% in May vs April. This followed a 15% drop in April and a 8% drop in March. While indeed good news that things are improving, overall sales were still down 8% percent from February and down 6% from the same month in 2019.

Some of the sales gains were due to warm weather, a sense of relief after weeks stuck at home, optimism from some that the worst of the pandemic could be over and the stimulus money already mentioned.

The main danger is that by the time you get into July, stimulus checks will be largely spent, and there is no guarantee that Congress will approve more of the same. Then it is back to the unemployment picture as the main driver of prosperity…

Can you summarise before you turn to specific asset classes?

Record-breaking action from governments and central banks is paying off: every day we get fresh signs that the global economy is on the path to recovery. Markets around the world have embraced the good news with gusto… and therein lies a big risk for the coming weeks and months.

There is no question that economies are improving, but they are doing so from a very depressed level and there is still a very long way to go: daily activity indicators show that, even after a significant rebound, the US, EU and Japan are still around 10% below January levels. Besides, May data from China showed a relatively fast rebound on the supply side of the economy, but a much slower take-off in consumption, suggesting a Nike swoosh-shaped recovery rather than the V-shaped one.

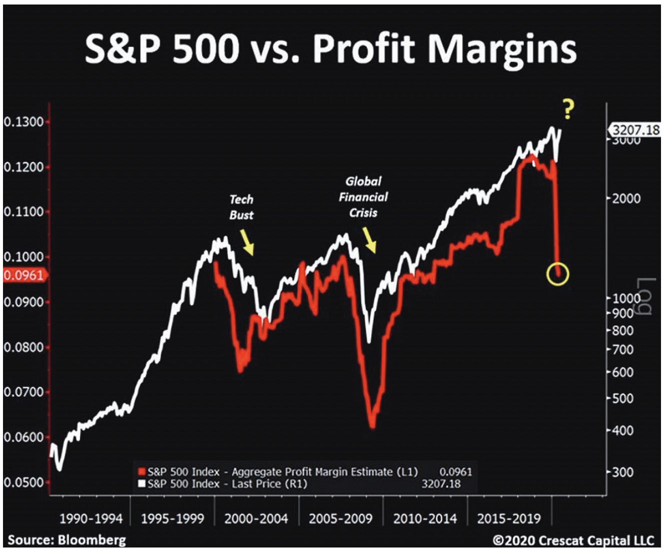
Against this background, US equities are down by only mid-single digits since the start of the year (UK and Europe are exceptions as they are down 15%-20%). That creates a dangerous disconnect between markets and the macro environment.

You have always said that Equity Markets are forward looking, and earnings should improve next year. What is the problem, then?

Let's assume a nearly perfect V-shaped recovery of S&P 500 earnings in 2021 from their collapse in 2020: 25% contraction this year (from 160 to 120) followed by a 25% rebound the next (from 120 to 150). This means that the index will be at nearly 19x 2-year forward earnings. The long-term average for 2-year forward PE is 15x, and multiples higher than 18x have been reached only once before, during the dot-com bubble.

Markets are pricing in a permanent decline in the cost of capital rather than focusing on income and earnings, which is boosting valuations. Dispersion of valuations is extreme within asset classes, but the relative rankings of both equity regions and sectors is similar to pre-COVID-19 levels.

Translation: at this moment equities seem, on average, priced for a best case scenario/perfection.



Are US equities in bubble territory then?

In 1996, Alan Greenspan's allusion to "irrational exuberance" was taken as a hint that markets might be overvalued. Back then, the aggregate forward 12-month PE ratio for the S&P 500 was around 16x, compared to over 21x today. However, there is a crucial difference: back then 10-year Treasury bond yields were at 6%, compared to 0.7% today. Valuations are high, but as long as bond yields remain so low we cannot talk about a 'valuation bubble'.

What is your asset allocation stance?

For all the optimism generated by falling infection and death rates in much of the world and enthusiasm for fiscal and monetary stimulus, the possibility of subsequent waves of contagion cannot be discounted (I am writing this as Beijing is trying to contain the latest cluster of infections). At the same time, businesses face carrying heavy new burdens, such as having to restructure the way they operate to meet social distancing guidelines.

There is of course the (small) possibility that those expecting a sharp V-shaped recovery are right, but while in March it was down to the bears to make a compelling case for a continued fall in equity prices, in June the burden of proof has shifted to the bulls.

The world is a better place than it was in March or April, but the risk reward for many areas of the risk spectrum is not.

From an asset allocation perspective, we should remember four main lessons of the past:

- Crises accelerate trends.
- Crises expose and penalise the weakest links most severely.
- Winners are always those companies that survive through time.
- Those who survive, end up thriving as there is less competition come recovery time.

An investor without clear objectives is like a traveller without a destination. We have built our asset allocation with resilience in mind, and we are very aware of our investment objective: to preserve and grow wealth on a steady basis.

Within equities, the bias is towards stocks that have the balance sheet strength and the Profit & Loss resilience to see through this crisis: earnings will be all over the place this year, so the focus needs to shift from valuation multiples to the ability to sustain free cash flows and having lower debt levels. The environment continues to bode well for STAR stocks.

On the fixed income side, we are focused on sectors that entered this crisis in a position of strength (for example, large banks and insurers) and on other large employers that are best positioned to be self-sustaining through times of turbulence. These are the owners of their own destinies.

We continue to include Gold as part of the asset mix. For economies to recover, monetary and fiscal policy will have to fill a large output gap that is likely to persist for many years. Elevated uncertainty around the consequences of these global easing packages increases Gold's attractiveness given its lack of credit risk and proven track record as a store of value. With such low yields, even modest inflationary pressure could prove painful for bond holders if real rates stay in negative territory. Low opportunity costs and relative invulnerability to any future rise in inflation will probably attract more interest from investors. Ultimately, a big driver in the price of Gold is growing concerns about flat currencies, which are set to continue to be debased as more printing goes on. This trend could even accelerate should some governments push for weaker currencies if and when their economies weaken after the recovery phase, because of potentially limited room for additional fiscal or monetary easing measures.

Bonus Section: Popular delusion

Nothing defines humans better than our willingness to do irrational things in the pursuit of phenomenally unlikely payoffs.

Since my last note we have had a few examples that have taken this definition to a whole new level:

- Earlier this week, Nikola Motors, a small electric vehicle producer saw its market value go up 100% on June 8th to $23B… for a company that has never generated a profit. Is this the case of an Amazon-type situation where investors are less focused on profit margins than they are on revenues? Not really, as Nikola has generated $58,000 in revenue in Q1 this year. Yes, you read that right: NOT 58M, but 58K. What's the deal then? Like Tesla, it is also named after the 19th century inventor Nikola Tesla, and that must be priceless…
- Hertz has announced the FIRST EVER $1 Billion stock issue by a company in Chapter 11 bankruptcy: In exchange for a cool Billion, the lucky investors in this stock issue will be subordinated in the capital structure to $17 Billion of debt in a bankrupt company currently trading at 40 cents on the dollar. Whatever they are smoking cannot be legal unless you are in one of the green states in this map: https://www.businessinsider.com/legal-marijuana-states-2018-1?IR=T.

I started my professional career around the time when the dotcom bubble showed that a bull market powered by crowd psychology can overwhelm anyone who stands in its way and that it can be profitable in its final explosive expansion.

Is following the herd momentum a case of bravery or foolishness in ignoring fundamentals? I will let you decide.

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