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QUARTERLY INVESTMENT OUTLOOK

APRIL 2020

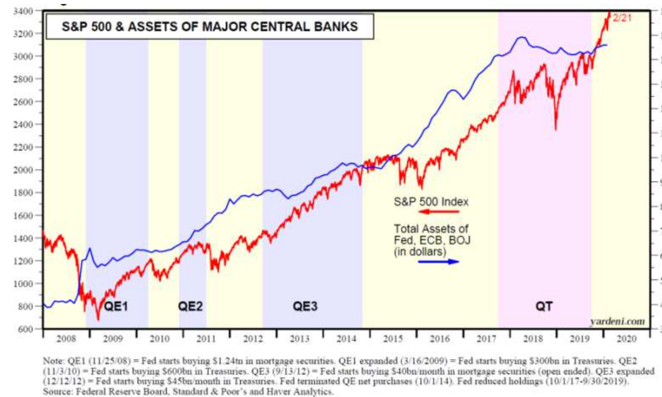
SUMMARY

- The sharp correction in equities featured nine 90% downside volume days within eighteen trading days. This intense capitulation selling is indicative of a bottoming process.
- The Fed should remain accommodative, and is starting a new form of liquidity expansion deemed QE infinity. This is positive for risk assets including equities and commodities, notwithstanding the current equity meltdown. It is confirmed by a steepening of the yield curve.
- Industrial commodities have historically followed gold prices higher. Having lagged in the current cycle due to the China trade dispute and coronavirus, a period of catch up is overdue.
- An inflation warning signal is flashing. The ratio of gold to treasury prices is favoring inflation.
- The global economy is stable and should survive the COVID-19 episode with one perhaps two quarters of negative growth. We would not rule out the use of fiscal stimulus to offset demand weakness created by the COVID-19. This could include direct money transfers and relief for small businesses.
- We view a peak oil price of $80/bbl. as our target despite the recent Saudi move to increase output by 2 million bbl./day. Our research indicates the Saudis have a present capability to increase their oil output by perhaps 200K-300K bbl./day to 10.3 million bbl./day. According to Ghoering & Rozencwajg they don't have the capability of producing 12 million bbl./day.
- Dollar weakness is the missing link to the reflation trade. The dollar is forming a major top.

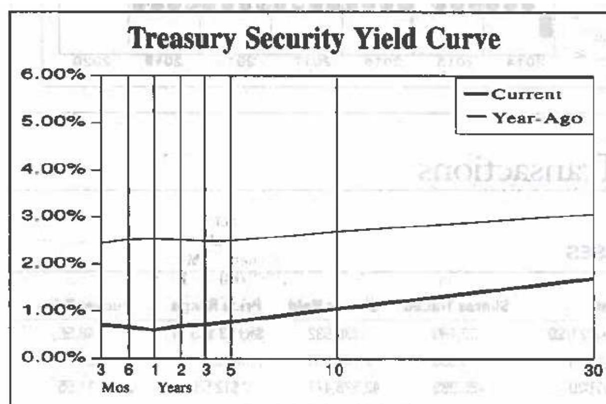
THE FED TO REMAIN ACCOMODATIVE

Apart from COVID-19 that is causing volatility in the world financial markets, there is another more insidious virus at work that could eventually cause volatility in risk assets, i.e. QE infinity. While the coronavirus ultimately will be stabilized (it took WHO three months to issue the all clear with SARS in 2003), we question whether the Fed and other major central bankers will have the wherewithal to change QE infinity.

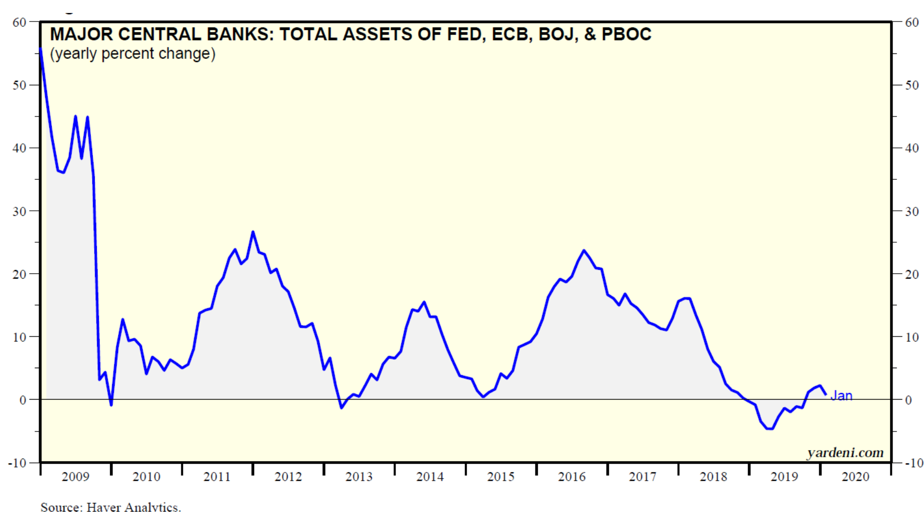
The following chart, courtesy of Yardeni Research, depicts the total assets of the Fed, ECB and BOJ (blue line). It is a fact that the major balance sheet expansions QE1, QE2 and QE3 each lifted the S&P 500 stock index (red line). During the taper period (4Q 2017 - 3Q 2019) the market trended higher, but most of the gain followed a 20% correction in 4Q 2018, after which the Fed indicated its intention to end tapering.



In September 2019, the repo rate spiked up to 7%. Repurchase agreements are a mechanism whereby banks that need short-term funding, can access liquidity by depositing collateral, usually short-term treasuries with the Fed. The funding is short-term with the borrowing bank agreeing to buy back the collateral, usually within days. There was much speculation as to what caused the spike in repo rates. The exact cause is outside this discussion. Rather, our focus is on the future course of monetary policy. The Fed's response to a spike in the repo rate was the creation of a funding facility to alleviate the liquidity shortage. They subsequently agreed to purchase $60 billion Treasury bills through April 2020. While the Fed officially denies this bill purchase program is a form of QE, its effect is the same, namely to support risk assets. The aforementioned funding pressure was probably caused by a combination of regulatory changes (Dodd Frank, Basil 2) and the ongoing need to fund the Federal fiscal deficit, which could continue throughout the decade. Ralph Delguidice, an analyst with Pavilion Capital Markets, believes regulatory changes are having the perverse effect of manufacturing demand for treasuries. He contends that absent this demand yields would be much higher.



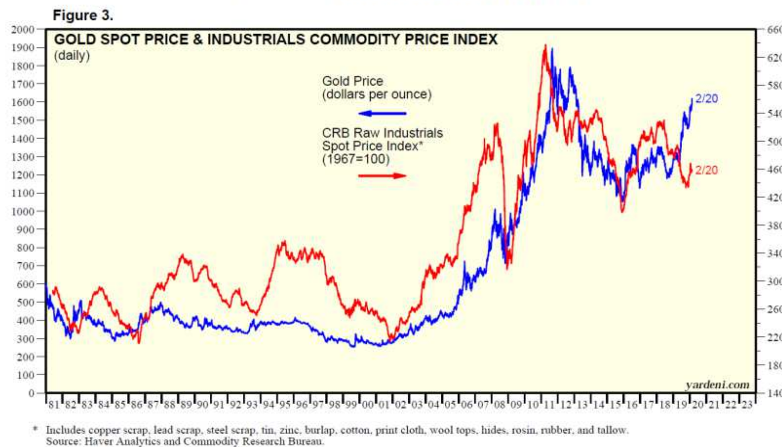
Noteworthy is that during the current period of heightened market volatility the U.S. Treasury yield curve has steepened across all maturities. Prior to the Fed reducing their policy rate to zero, the curve had reinverted, signaling a tightening in liquidity. The recent Fed move to zero rates plus the reactivation of $700 billion of QE has contributed to a steepening of the treasury yield curve. A steep curve is a strong signal that the reflation of the U.S. economy is working. Shown below is the yoy change (in trillion dollars) in the major central bankers balance sheet. It seems the current cycle of balance sheet expansion has only modestly resulted in positive growth through January 2020. This is yet another warning signal that the central banks are "behind the curve" and need to be more accommodative. It is unfortunate that this liquidity expansion is occurring at full employment when the Fed normally is set to tighten policy.



COMMODITIES TO CATCH UP WITH GOLD

Finally, the dollar strength over the past 18 months is sending another warning signal that monetary policy is too restrictive. Dollar strength has a depressing effect on commodity prices as they are priced in dollars, hence a stronger currency lessens demand. Commodities have been hit with a "perfect storm" of a stronger dollar, a China trade dispute lasting 18 months, and the COVID-19 virus**.** Copper is the most widely used industrial commodity. Holding near strong technical support at $2.00/lb. is a testimony to the internal strength of the global economy. Shown in the chart to follow, courtesy of Yardeni Research, is gold (blue line) plotted alongside industrial commodities (red line). Gold tends to lead changes in industrial prices, but is currently deviating. We think this gap will close with commodities playing catch up.

Gold & CRB Raw Industrials



AN INFLATION WARNING SIGNAL IS FLASHING

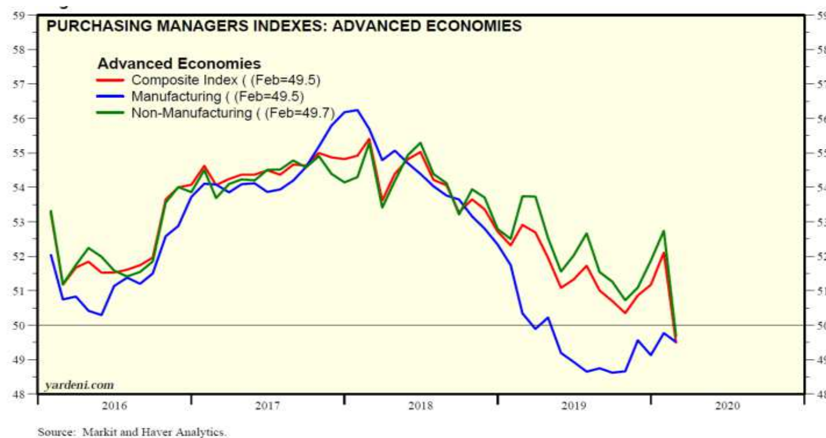
Our long standing thesis is that the new decade will usher in a period of slow growth coupled with rising inflation. This thesis is predicated on the assumption that the Fed will act as "buyer of last resort" accommodating the Treasury issuance of debt in order to fund our ever growing Federal deficit. Congressional Budget Office estimates our deficits could average 4.6% of GDP, lasting over five years. Noteworthy is that their forecast assumes interest on the debt is capped at 3%, and that the U.S. economy avoids a recession. Both may prove overly optimistic!

We are seeing early signs that the forces of inflation are already starting to emerge. A confirmation of this trend is the relationship between the gold priced in dollars and the price of aggregate treasuries. The theory is that when gold prices rise faster than treasury prices, the forces of inflation are greater than deflation. This relationship is shown in the chart below, which measures the long-term trend of the ratio of gold to the U.S. Aggregate Bond Total Return Index. The trend as shown by the ratio is favoring a period where the forces of inflation are dominant.

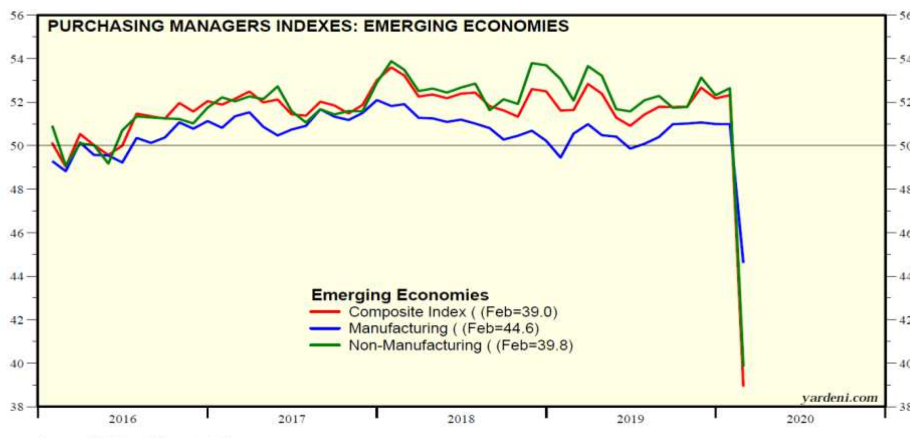
Source: Sprott Article 03/05/2020

THE GLOBAL ECONOMY HAS WEAKENED AS ADVANCED ECONOMIES LAG EMERGING MARKETS

The Purchasing Managers Index Advanced Economies weakened noticeably during Feb., 2020, with the composite index declining to 49.5, signaling contraction in output. The Manufacturing component dipped to 49.5, down from 52.7 in January (pre-COVID 19 virus). We expect additional stress in manufacturing in March. It is encouraging that the non-manufacturing (services) sector of Advanced Economies registered a reading of 49.7 for February, but has actually trended higher since the Fall of 2019.



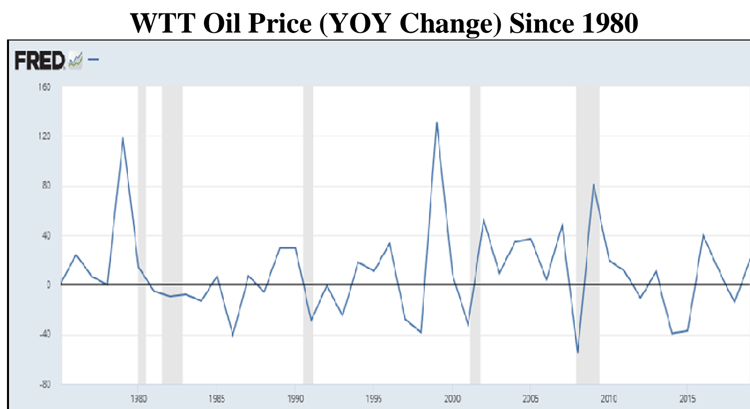
As shown in the chart below, the Purchasing Managers Indexes for Emerging Economies declined sharply during the month of February, with the Composite Index at a "bombed out" level of 39.0. This was largely due to the decline in the PMI for China, the source of the COVID-19 virus. Tracking new cases in China shows that the virus has peaked in March, and factories are restarting, with an estimated operating capacity utilization of 60%-70%.



HISTORY SUGGESTS OIL PRICES ARE HEADED TO $80/BBL.

The chart below shows the yoy change in the price of West Texas Intermediate Crude Oil. The shaded columns depict NBER designated recessions. Counting the double dip in 1980-82 as one data point there were four recessions. Oil prices spiked above +80%, leading the recessions of 1980-82 and 2000-03. They also spiked to +80% during the Great Financial Crisis. They rose ahead of the Gulf War Recession of 1990, but remained below +40% yoy. We believe oil prices are setting up for another spike, to +80%. U.S. production is set to flatten or decline due to a combination of declining rig counts, lower well productivity as the positive effect of high grading Tier 1 wells fade, and increasing U.S. decline rates. The recent price war was initiated by the Saudis driving WTI crude to $31/bbl. will ensure that U.S. production growth in 2020 is nominal at best. Our forecast for an increase in U.S. production for 2020 is well below market expectations of an increase to 900K to 1.1 mil bbl./day and should result in a significant upward move in prices as we enter the summer driving season. The recovery in demand will be more gradual, but we expect it to be flat in 2020 and grow by 1 mil bbl./day in 2021.

WTT Oil Price (YOY Change) Since 1980



THE U.S. DOLLAR IS THE KEY TO UNLOCKING THE REFLATION TRADE

There are three levers that drive reflation. They are lower oil prices, lower interest rates/bond yields and lower currency. Oil prices have recently dipped to $31/bbl. A year ago they trading above $56/bbl. The ten-year treasury under 1.00% is at a new cyclical low and more than half the level less than 2.70% in February 2019. Both lower oil prices and bond yields are stimulative for future economic activity as they benefit purchasing power.

The U.S. dollar has been the weak link in the reflation trade. On a trade-weighted basis the dollar has appreciated by 6.1% over the previous twelve months. A stronger dollar makes our exports less competitive while lessening the cost of imported goods, thereby pressuring import prices. It also

cheapens the value of foreign sourced revenue. Roughly 40% of S&P 500 revenue is sourced in the global markets. Finally, since key industrial commodities are traded in dollars, a stronger currency imparts downward pressure on commodities. We should also mention the fact that many emerging market economies have significant dollar denominated debt outstanding. A stronger dollar can hasten a debt crisis especially if those countries are exporting commodities.

At this juncture we believe it would be positive for reflation if the U.S. were to pursue a weak dollar strategy. The trend to lower interest rates combined with increasing Fed purchases of treasuries (QE infinity) should inexorably weaken the dollar.

John Cooper, CFA
Vincent Catalano, CFA
Pete Daly
April 2020

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