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QUARTERLY INVESTMENT OUTLOOK

JULY 2020

SUMMARY

- Central bank balance sheet expansion has been the main driving force behind the cyclical bull market in stock prices. The fading of pandemic stimulus should slow asset purchases allowing stock prices to consolidate. Bear markets almost always end with a change in leadership.

- History shows pandemics, although exogenous events change economic behavior and have inflationary consequences.

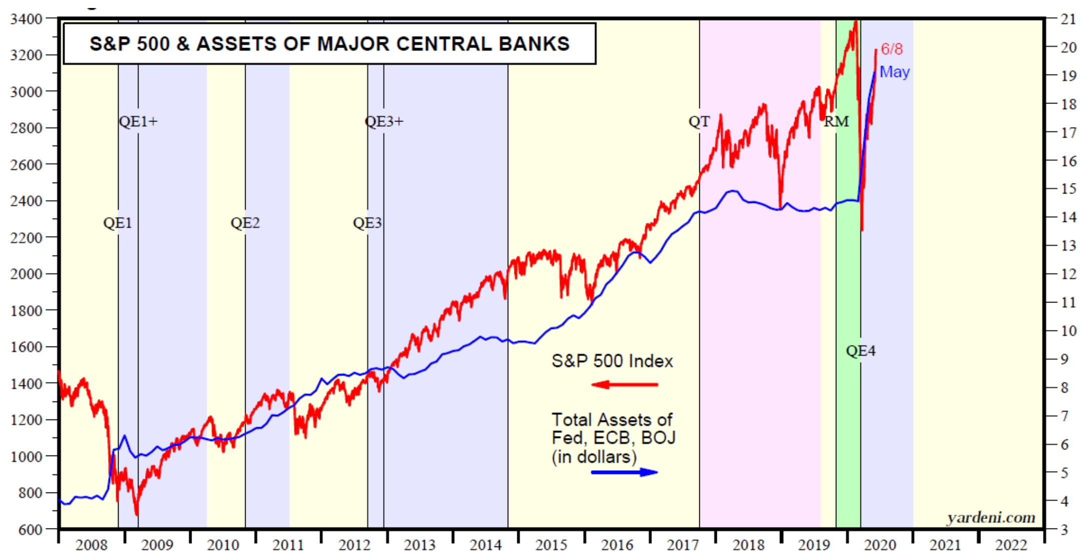
- Rapid growth in M2 money supply will result in increasing inflation expectations, rising credit demands and ultimately higher inflation.

- China policy is turning pro-growth. Combined with recently announced stimulus measures from the Eurozone should foster a global industrial led recovery.

- Any attempt by the Fed to peg its policy rate will only exacerbate underlying inflation trends.

CENTRAL BANKERS BULL MARKET

The chart to follow courtesy of Yardeni Research, shows the combined central bank assets of the Fed, ECB and BOJ since 2008, (blue line) plotted alongside the S&P 500 (red line). Most analysts would agree that since the GFC the roc in the major central banks assets have largely explained the trend in stock prices. This is evidenced by strong gains in the S&P 500 during the three periods of quantitative easing. As the Fed began reducing its holdings of treasuries/mortgages (QT) in 10/2017, lasting through 9/2019, market volatility rose sharply while investment returns suffered. Their strategy changed radically in 2020 with the arrival of COVID-19! The Fed pivoted sharply in the direction of massive ($4 trillion) purchases to counter the deflationary impulse created by the pandemic. In addition fiscal policy turned accommodative with over $2.7 trillion in added stimulus.



Note: QE1 (11/25/08-3/31/10) = $1.24tn in mortgage securities; expanded (3/16/09-3/31/10) = $300bn in Treasuries. QE2 (11/3/10-6/30/11) = $600bn in Treasuries. QE3 (9/13/12-10/29/14) = $40bn/month in mortgage securities (open ended); expanded (12/12/12-10/1/14) = $45bn/month in Treasuries. QT (10/1/17-7/31/19) = balance sheet pared by $675bn. RM (11/1/19-3/15/20) = reserve management, $60bn/month in Treasury bills. QE4 (3/16/20-infinity).
Source: Federal Reserve Board, Standard & Poor's and Haver Analytics.

Through May stocks have recovered virtually all of their 34% decline. According to Chen Zhao of Alpine Macro (formerly BCA Research) the recovery has tracked prior periods noticeably 1998/99 Russia/Brazil crisis, 9/11 terrorist attacks, and the 2008/09 housing crisis. In each of these bear markets the Fed slashed rates, kept them low for an extended period, well past the crisis. All were characterized as V-shaped stock market recoveries. Where do we go from here?

Ira Epstein, noted futures chartist/analyst with Linn Associates, believes a generational low was set on March 23rd, which is unlikely to be breached in the foreseeable future. He reasons that the bear market was largely a response to a health crisis as opposed to a financial meltdown. The cost has been huge in terms of lost output, rising unemployment coupled with an unprecedented increase in fiscal liabilities. We believe the policy response was necessary and should ultimately close the roughly $8 trillion output gap! At least until a vaccine and/or treatment is discovered. In addition, we can't rule out another outbreak in the Fall. In fact, until the economy normalizes and continuing unemployment claims recede, which may take the balance of 2020, equity market volatility is likely to remain elevated. Following a near vertical rise in March/April the trend in Fed asset purchases is beginning to slow. We expect the Fed to gradually decrease its rate of asset accumulation. We have previously documented the strong link between the level of Fed assets and stock prices. **Therefore we anticipate a consolidation in stock prices to follow**. The market has risen above formidable resistance at the 100/200 day moving averages, a bullish development.

WILL COVID-19 ULTIMATELY BE INFLATIONARY?

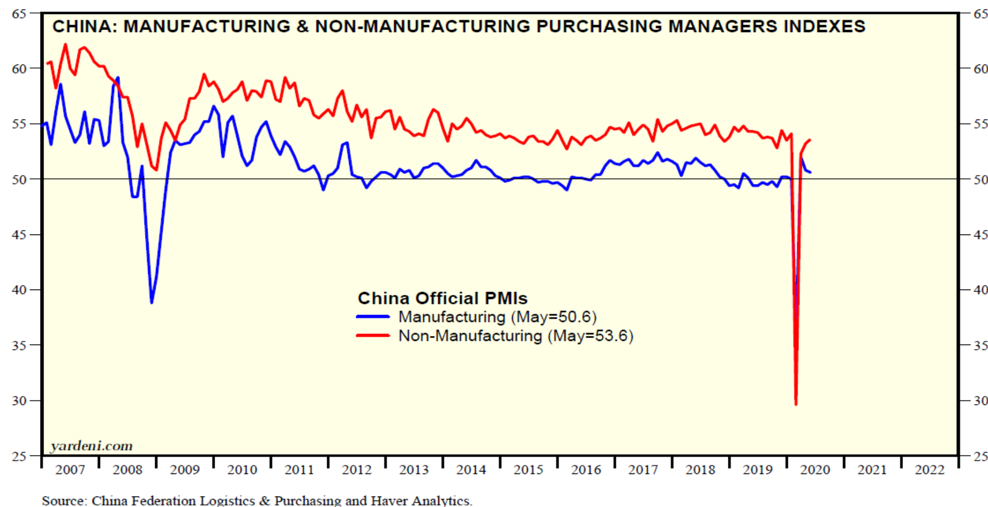
In the short-run the pandemic's impact on the general price level is deflationary. In a recent Grant Williams podcast Neil Howe, noted historian and author of "The Fourth Turning", which marks an era of secular upheaval and repeated crisis, reviewed the history of pandemics. He cited evidence that pandemics have the effect of reinforcing inflationary outcomes. For example the Spanish Flu of 1918 led to immigration restrictions in the 1920's. In this context Trump's southern border and evolving China policies, encourage U.S. companies to relocate. Inexorably this should result in higher future production costs i.e. contribute to inflationary trends. COVID-19 is an accelerator of trends that had been emerging i.e. de-globalization, protectionism and nationalism. The aftermath of the pandemic will likely change corporate behavior as supply chains are modified, thereby contributing to the underlying inflation.

IS M2 MONEY SUPPLY GROWTH INFLATIONARY?

The late nobel Laureate Dr. Milton Freidman used to say "inflation is always and everywhere a monetary phenomenon." Classical monetary theory assumes that as M2 money supply increases, inflation expectations rise, and with a lag of roughly eighteen months inflation. Real growth also benefits to a lesser degree. The transmission mechanism is money velocity. Velocity is defined as the ratio of GDP/M2, where GDP equals price times transactions. It measures the turnover of M2 which is dependent on the growth of lending within the commercial banking system. Fractional lending has the effect of creating both deposits and reserves. An increase in bank lending causes a rise in money velocity, thereby benefitting nominal GDP. As depicted in the chart below, loans and leases in all commercial banks are expanding at 11.6% yoy, up from 4% yoy pre-pandemic. The sharp rise in borrowing is directly related to pandemic stimulus. Policy makers expect this stimulus will not only make up for lost demand, but through the fiscal multiplier, increase future levels of economic activity, leading ultimately to increasing credit demand.

In order that economic growth becomes self sustaining, credit growth must exceed that of nominal GDP. As of this writing M2 money supply is rising 23.2% yoy. Noteworthy is that inflation breakevens have risen from 26bp in mid-March (max deflation impulse) to 130 bp presently. During the same period the 10/30 year Treasury spread widened from 61 bp to 71 bp. We believe the 10/30 year spread widening is sending a signal that inflation expectations are set to move higher.

CHINA POLICY IS TURNING PRO GROWTH



Source: China Federation Logistics & Purchasing and Haver Analytics.

In view of the fact that China is no longer officially targeting 6% GDP growth, we expect policy to become more accommodative. This could involve a three pronged approach. 1) increasing the fiscal budget deficit to 4.5% of GDP, up from 3% which has been in effect for the past three years. 2) stimulating the growth of social finance (non-bank credit) which has slowed to a c.a.g.r. of 3%, down from 14% in 2012. 3) increase spending on infrastructure (including 5G, semi-conductor research, high speed rail, electric grid etc.) which has also declined sharply from 16% c.a.g.r. in 2014 to flat presently.

PEGGING INTEREST RATES IS ULTIMATELY INFLATIONARY

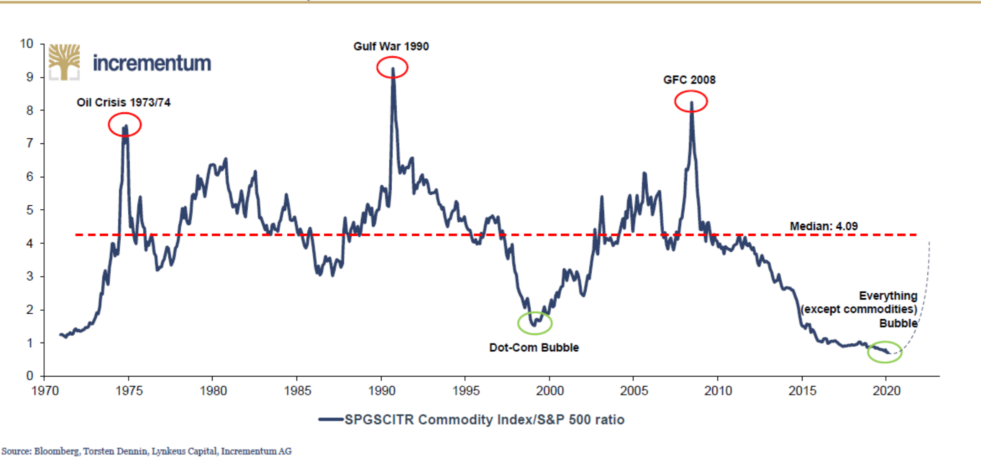
Many analysts believe the Fed will ultimately be forced to peg interest rates. The debt/GDP at the federal level is already in the danger zone above 90%. The Fed/U.S. Treasury would like to avoid a situation where the interest paid on federal debt moves above the rate of GDP growth. At that point debt/GDP would rise rapidly. During the 1942-52 war and post war periods, the Feds pegged the Funds rate at 2.5%. We expect once bond yields break out and begin trending higher the Fed will adopt a similar peg. However, to the extent that credit growth strengthens, while inflation expectations are elevated, then low rates may ultimately contribute to higher inflation. In addition should the dollar weaken this would cause import prices to rise. These trends would be exacerbated should global rates

trend higher while U.S. rates remain pegged. In reality pegging rates will only serve to postpone inflationary pressures arising from higher borrowing costs. The negative impact will be transmitted through downward pressure on the dollar. Import and commodity price levels should adjust higher fairly quickly.

COMMODITIES SHOULD LEAD THE INCIPIENT INFLATION CYCLE

Commodities are most sensitive to changes in the global industrial economy. They are one of the first asset classes to benefit from global reflation. They respond strongly to changes in global liquidity. Based on the strong uptrend in our reflation gauge comprised of oil prices, bond yields and the trade weighted dollar, we anticipate an uptrend in the global industrial economy. As such commodity prices should enter a cyclical bull market. Gold is usually a good leading indicator of industrial commodities. The fact that gold is advancing in most currencies is a testimony to it being in a sustained uptrend. The chart below, courtesy of Incrementum, shows the Goldman Sachs Commodity Index/S&P 500 Stock Index ratio since 1970.

Commodities – The Biggest Contrarian Investment?
GSCI TR/S&P 500 Ratio, 01/1971–02/2020

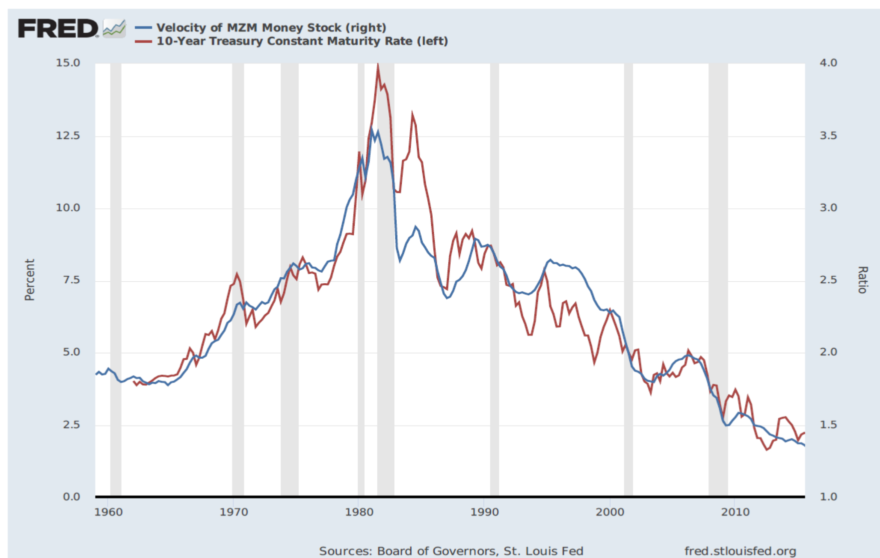


Source: Bloomberg, Torsten Dennin, Lynkeus Capital, Incrementum AG

The ratio is at a 50 year low and one of the lowest readings in 120 years. Although Chinese exports as a percent of GDP has declined to 20% from over 40% over the past 5 years, they are still a significant driver of the demand for industrial commodities including steel, copper and aluminum. Copper is used in a variety of industrial products, including both wind and solar driven turbines. Electric vehicles use 2-3x the amount of copper compared with ICEs. EV charging stations and the electric grid will also consume growing quantities of copper as the future is built around distributive power.

A STRONG LINK EXISTS BETWEEN MONEY VELOCITY AND BOND YIELDS

As shown in the chart below a strong relationship exists between money velocity and 10-year Treasury bonds yields. A rise in velocity is associated with rising yields while a decline in velocity contributes to falling yields. Velocity is the ratio of GDP/M2 which currently stands at 1.3. It takes a dollar of M2 to generate 1.3 dollars of nominal GDP. Alternatively when bond yields are less than the yoy change in nominal GDP, growth is stimulated through rising velocity. Businesses are incentivized by relatively low yields to borrow and invest. Normally real growth is the first to benefit. As the output gap closes, inflation takes hold and growth becomes self sustaining.



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July 2020

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