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Vol. 43, No.4

QUARTERLY INVESTMENT OUTLOOK

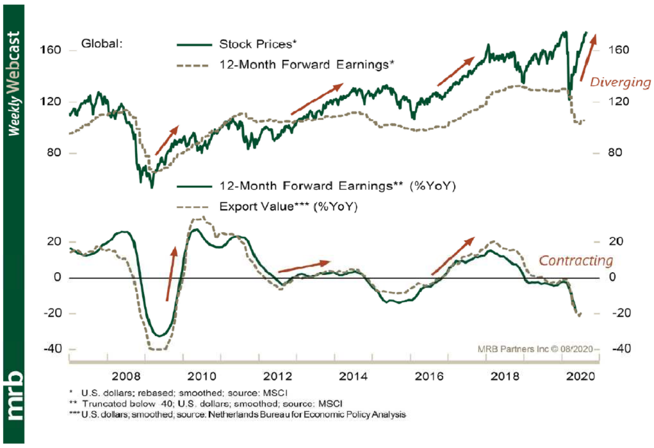
SEPTEMBER 2020

SUMMARY

- **The next bull market phase should feature new leadership. We expect value to take over from growth in the U.S., with foreign equities the new leaders in the global space.**
- The revised U.S. budget outlook 2020-2030 shows Federal debt increasing to 107% of GDP by 2023, the highest level since 1946.
- The Fed has adopted a new monetary policy framework favoring average price level targeting. Interest rates are likely to remain low for an extended period. The Fed has officially abandoned the Phillips Curve which defined a relationship between low levels of unemployment and higher inflation.
- Gold is rising in multiple currencies, a sign of a sustained bull market.
- What's ahead for the dollar? An update on Ray Dalio's book Changing World Order.
- Investment Strategy for a stagflation cycle; a three pronged approach.
- Energy prices could be at a multi-year low.

EARNINGS HAVE LAGGED THE RECOVERY IN STOCK PRICES

As shown in the chart to follow, courtesy of MRB Partners, Inc. 12-month forward earnings growth is contracting on a global basis along with exports. There are, however, hopeful signs of an imminent recovery. Our global reflation gauge comprised of oil prices, bond yields and the trade weighted dollar is at a recovery peak. This augers well for an industrial led recovery and is confirmed by the latest PMI reading for the global manufacturing index at 51.8 for August. The non-manufacturing index was at 51.9 while the global composite stood at 52.4, having traced out a V-shaped recovery from Q12020 which witnessed a sub-30 reading. Noteworthy is that the Composite for Emerging Economies registered a solid 52.9 reading. Nevertheless, from this juncture into 2021 we would expect the recovery to level off. The rebound in copper prices, usually a harbinger of economic strength is an encouraging development.

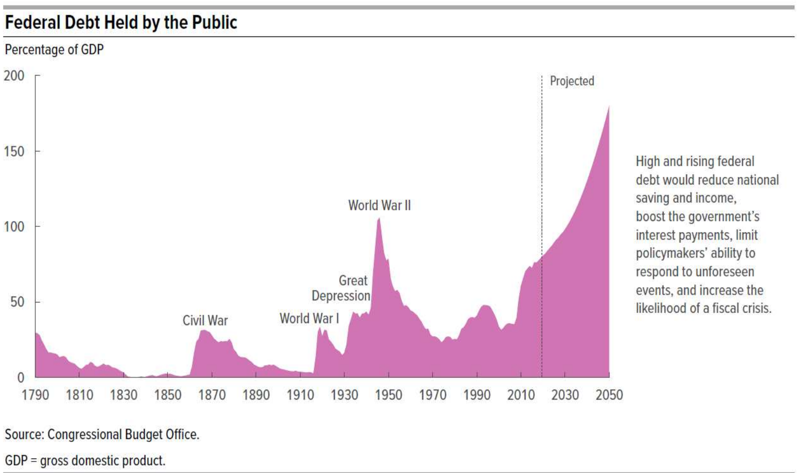


While global ex-U.S. stock prices have lagged the U.S. recovery, there are positive signs that global ex-U.S. may attain a leadership position in the months ahead. For example 8 of the 11 sectors in global ex-U.S. have outperformed the U.S. over the past three months. This could be an early warning sign that foreign equities may become the new leaders in the next bull market phase.

AN UPDATE ON THE CBO BUDGET OUTLOOK; 2020-2030

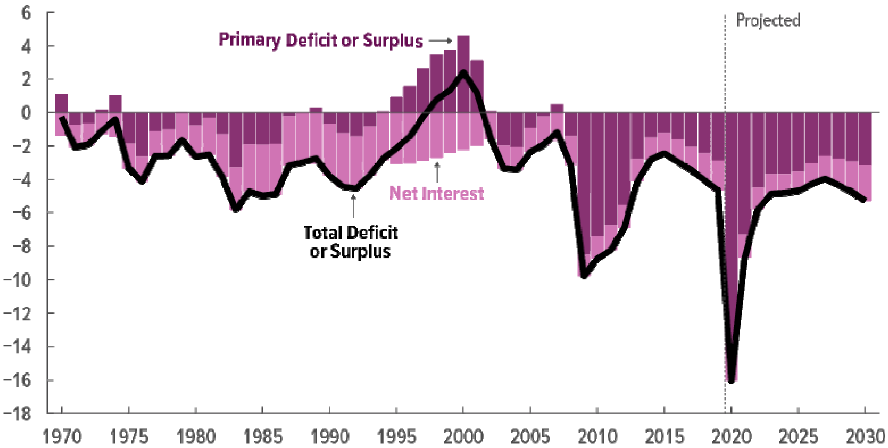
The latest CBO update on the long-term budget outlook has increased the 2020 deficit by $2.2 trillion, mostly due to the legislation enacted to deal with COVID-19. Noteworthy is that deficits over the 2021-30 period total $13.0 trillion, roughly the same as the CBO projected in March, 2020.

Federal debt held by the public is projected to increase to 98% of GDP in 2020. By comparison it was at 79% in 2019 (pre-COVID-19) and 35% in 2007, prior to the Great Financial Crisis. It is scheduled to rise to 107% of GDP by 2023, the highest since 1946 following large deficits associated with WWII.



Reflecting large expenditures associated with the pandemic, outlays are projected to be 50% greater than spending in 2019, equaling 32% of GDP. Nevertheless while they are forecast to decline back to 23% of GDP in 2030, outlays will be well above their 50-year average according to the CBO report. The 1970-2019 average outlays as percent of GDP was 20.4%. Revenues averaged 17.4% from 1970-2019 are expected to be 17.8% by 2030, roughly the same as their long-term average.

A key take away from the CBO budget analysis is that while the primary budget deficit (ex-interest expense) increases sharply in 2020, it declines steadily into 2027. Meanwhile total deficits increase in the final four years of the projection period due to rising interest costs. A key assumption is that there is no recession forecast in the entire projection period, and that interest costs rise due to increasing debt levels, not because of increasing bond yields. A recession along with rising yields would raise the deficit projection significantly along with associated debt levels.



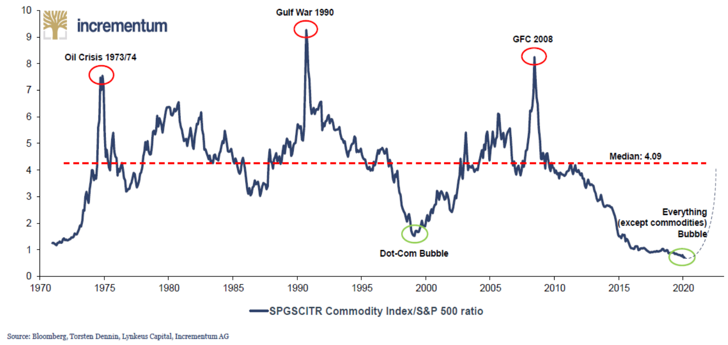
Source: Congressional Budget Office

MONETARY POLICY HAS SHIFTED IN FAVOR OF CREATING INFLATION

At his press conference following the FOMC meeting on July 24-25th Chairman Jay Powell noted that the committee had adopted a new monetary policy framework. In our opinion, this new policy will likely have a profound impact on financial markets for years to come. Specifically, the Fed will target an average inflation rate of 2%. Inflation, as measured by the personel consumption expenditure implicit price deflator, has been running below 2% fairly consistently since the Q2 2012 when it dipped to 1.76% yoy. Prior to the impact of the pandemic in the Q1 2020 it registered a yoy rate of 1.68%, before plunging to 0.6% in Q2 2020.

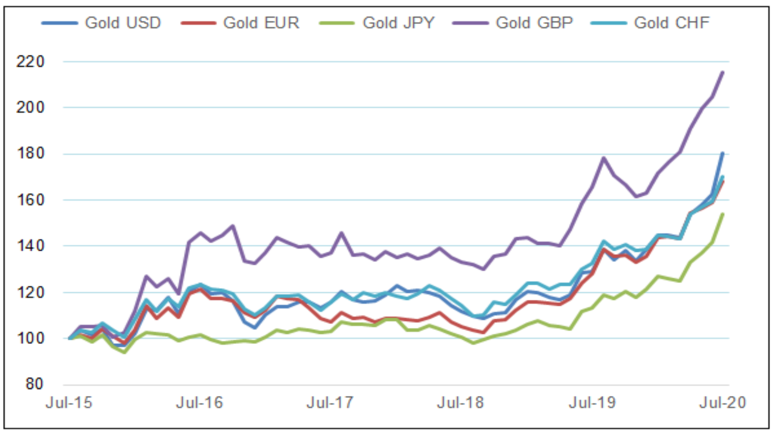
Henceforth, the Fed will allow the inflation rate to exceed its 2% target level until it reaches an average 2% rate. This change in Fed policy rejected the long held view that is implicit in the Phillips Curve, namely that there is an inverse relationship between low unemployment and higher inflation. Time will tell as to the wisdom of this policy shift. However investors have been forewarned that the Fed is going to pursue an inflationary monetary policy, ergo don't bet against this outcome! We have long maintained that such a shift was inevitable, and have structured our client portfolios to benefit. Our positioning has included commodity producers (gold, silver, copper and oil), industrial companies with pricing power, a core holding in select global ex-U.S. countries, and Treasury Inflation Protection Securities. The recent Fed policy shift has strengthened our conviction in this inflation hedged investment strategy.

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



GOLD: THE "CANARY IN THE COAL MINE"

The rise in the price of gold is sending investors a signal that despite recent equity market new highs, the global financial system is unstable. This is detailed in the following section which summarizes research by Bridgewater Associates founder Ray Dalio entitled "Changing World Order." Gold is, and always has been, the foundation of all reserve currency systems. It is a store of value that a reserve currency needs in order that confidence in its ability to retain purchasing power can be sustained. Without such confidence the system will ultimately revert to some form of fiat currency. The fact that gold is rising in multiple currencies is confirmation that it is in a long-term bull market.

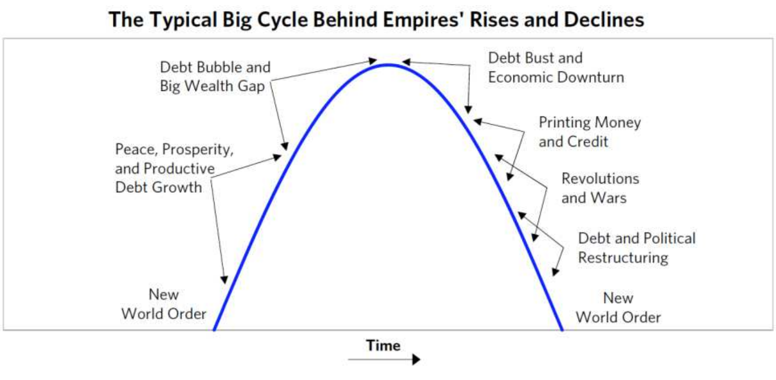


WHAT'S AHEAD FOR THE DOLLAR'S RESERVE CURRENCY STATUS?

We have been following Ray Dalio's evolving book entitled Changing World Order, which traces the history of reserve currencies, and seeks to determine reasons for their ascendency and ultimate demise. The Dutch, while a relatively small country, became a world power in the1600's. The U.K. followed a similar path before peaking in the 1800's. The U.S. became a superpower after WWII, and is now in relative decline, while China is emerging as the next possible reserve currency. Dalio measures the relative strength of a country's wealth and power in terms of several factors. These include education, trade, innovation, output, competitiveness, financial center, military and reserve currency status. They combine to form a "Big Cycle" where growing wealth and prosperity leads to income inequality, excess consumption, rising debt and ultimately currency debasement, devaluation and collapse. (See chart on page 5).

He asks the question "Where is the U.S. now?" He notes that it has been 50 years since the official closing of the gold window, which has witnessed a period of ever expanding credit. Following the Great Financial Crisis the U.S. has experienced a period of private credit contraction, largely offset by public debt expansion. Dalio believes we are nearing the end of a long-term debt cycle which will be accompanied by accommodative monetary policy. "Money printing is the most expedient way to rid oneself of debt." This is happening at a time of "big wealth and value gaps and there is a rising world power (China) that is competing in trade, technology, capital markets and geopolitics."

In his recently released Chapter 4, Dalio notes that reserve currency status is dependent on a central bank's ability to print money (reserves). The loss of this power Dalio suggests would be a devastating blow to the dollar's hegemony. His guess is that the U.S. is roughly 75% through its long-term debt cycle $\pm$ 10%. He notes that reversing the process is virtually impossible as it would necessitate a period of austerity that has little political appeal, and would only exacerbate the negative impact of income inequality.



Courtesy: Changing World Order, By Ray Dalio

INVESTMENT STRATEGY FOR A STAGFLATION CYCLE; A THREE-PRONGED APPROACH

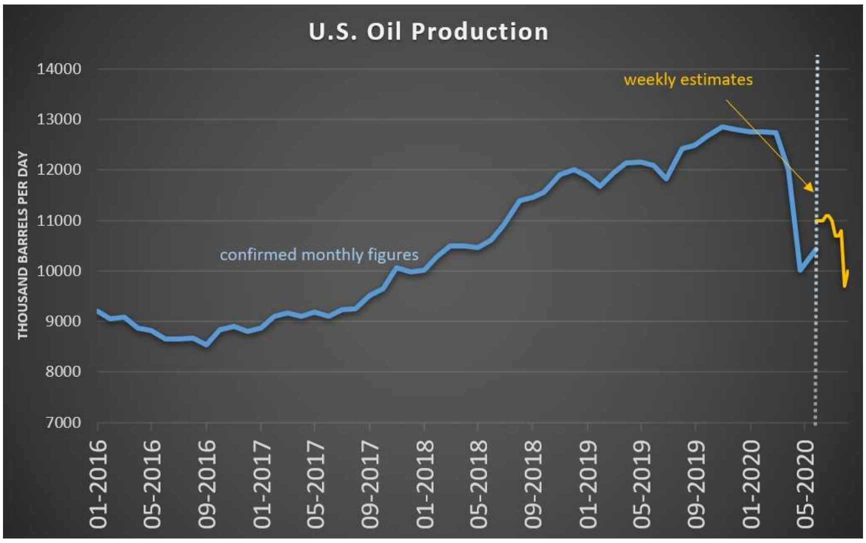
We are recommending a three-pronged strategy for investors which should protect their portfolios from an incipient inflation. First, in domestic equities we advise being long industrial commodity producers such as Freeport (copper/gold) and Total SA (oil/gas). Also hold a core position in gold/silver miners. Junior miners (McEwen Mining) have lagged and should offer excellent capital appreciation. Second, in global ex-U.S. equities we would hold positions in Japan, Europe and China. These regions are cheap relative to the U.S., have also lagged and should benefit from dollar weakness. They also tend to offer higher dividend yields. Third, we advocate holding Treasury Inflation Protection Securities in lieu of treasuries. Treasuries are expensive and are vulnerable to rising yields.

AN UPDATE ON ENERGY

According to natural resource research specialist Goehring & Rozencwajg shale producers have pretty much exhausted their Tier 1 acreage, and have not been able to raise productivity on Tier 2 wells. As a result there has been a 75% decline in the U.S. rig count to 180 currently operating. Usually there is a two month lag between the rig count and production, which is already down by 2.5 million bbl/day since January 2020. Goehring & Rozencwajg expects U.S. production to decline by an additional 2 million bbl/day by 2021 yearend.

The International Energy Agency had initially expected oil demand to decline by 30 mil./bbl due to the collapse in global spending resulting from the pandemic. In fact Q2 witnessed a decline of 10 million bbl/day and energy markets could end 2020 with demand losing roughly 1 million bbl/day. Many people are choosing to drive to work rather than using public transportation to maintain social distancing. This is allowing oil demand to normalize quicker than expected. Also emerging markets demand (60% of global) is recovering strongly.

The bottom line is the energy markets could face a supply deficit in the 3-4 million bbl/day range by 2H2021. The markets are simply not expecting this outcome as they trade in contango, with futures prices at a premium versus the spot price.



Source: oilprice.com

RISKS

- Treasury issuance dwarfs Fed purchases
- U.S. dollar corrects in a disorderly manner
- Inflation arrives sooner than expected

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July 2020