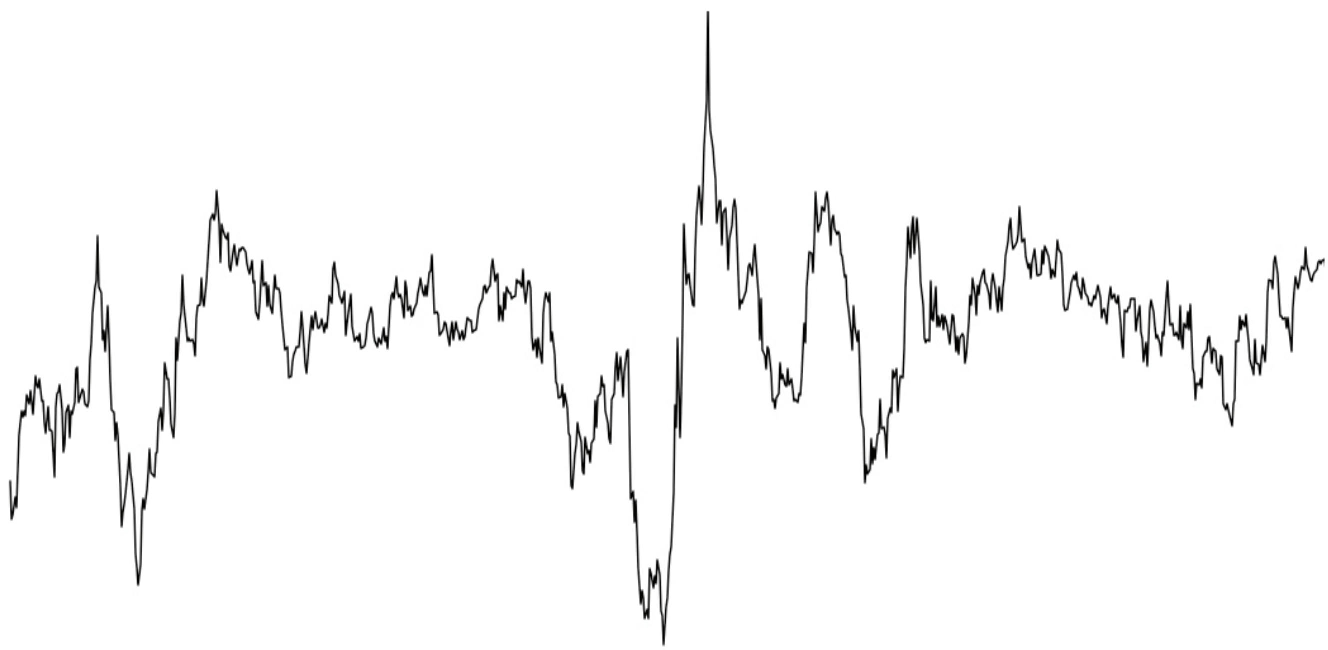
# ALPHA SOURCES

MARCH 30, 2020



# LOOK AHEAD

It is tough to look beyond the depressing daily death dispatches from around the world detailing the tally of the Covid-19 epidemic. Yet that is exactly what investors must do, if they want to have a fighting chance to figure out what happens next. These data are undeniably terrible, but they are known quantities for markets, even in the U.S. and the U.K., where the numbers are rising too fast for their own good. They will continue to rise, for at least a few more weeks, at least. Meanwhile in the world as a whole, two immovable objects are now crashing into each other. We can't return our economies to normal operation due to the risk of an uncontrollable public health crisis, but equally, we can't maintain economic lockdowns indefinitely. The circuit-breaker in the form of a coordinated monetary and fiscal stimulus program to the tune of nearly 20% of global GDP is a stop-gap solution at best. This is because that is arguably the level of GDP that developed economies are set to lose through H1 alone. Contrary to popular belief, you can't just freeze the economy, and then re-start at zero six months later after having printed trillions of dollars. Anyone who makes claims to this effect are, in my view, getting a little too excited about the second-order effects of our present

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misery, which is the economic shutdown itself, and the associated open invitation to unleash the MMT experiment. Don't get me wrong, it is the right thing to do, but as I said, it is a second-order effect.

Taking an objective view at both sides of the coin, it quickly becomes clear that the current path is untenable. We have engineered a narrative, and a setting, in which the economy is crashing 1930s style, people are under house arrest to varying degrees, and if they venture out, they face an invisible enemy out to kill them. The icing on the cake is that if you, or a loved one, do get ill, you risk the nightmarish fate of turning up at the hospital to learn that they're at full capacity. You can end your days coughing up your lungs at home, or in the waiting room. Enjoy life, as they say.

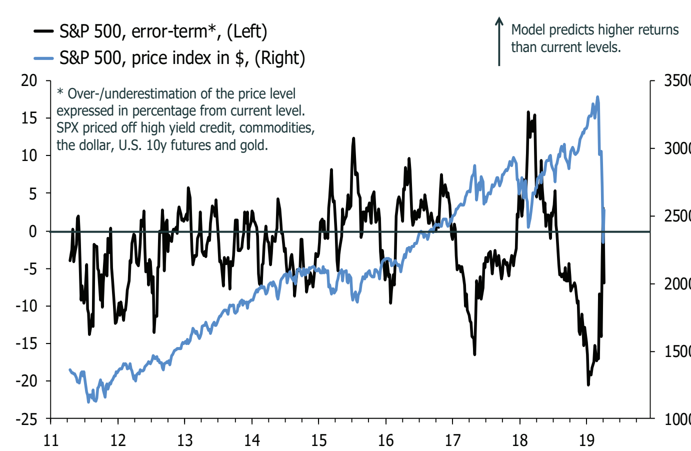
This is effectively self-mandated siege mentality, and it can only be sustained for so long. Eventually, you'll have to declare victory, or come up with another story. Even in the best of all worlds, where we get the outbreak under control, ramp up capacity in our health systems, and develop a vaccine, questions will emerge about what to do if a second wave catches us off-guard.

The alternative is that you come up with another strategy, another story if you will, to fight the virus that doesn't involve euthanisation of the economy. Don't shoot the messenger, but I guarantee that you that we will be forced to pivot towards such an alternative soon enough, however "sub-optimal" it is.

In markets, meanwhile, equities are teasing investors with the idea that this will be all over by the end of Q2, and that we'll be left to ride the waves of economic stimulus from then on in. I have sympathy with that sequence, and associated bull case, but I think the timeline is a little less friendly than implied by last week's rebound.

Put simply, even an amateur punter like me can see that last week's bounce has bear-market rally written all over it. Or as Cameron Crise puts it; "Do you remember the great bull market of October 10-14, 2008? Me neither, and none of these fantastic rallies came close to marking the ultimate low." That is an astute observation.

fig. 01 / S&P 500 at fair value... — fig. 02 / ...but it usually undershoots, a lot

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It can run further, but my intuition if it does, would be to take advantage and raise cash, rather than to chase it. There are at least three fundamental boobie traps yet to be price-in in my view. One, as already mentioned is the prospect of the immediate crisis extending into H2. Two, the incoming collapse in earnings will be extremely hard on some companies and sectors. Three, the damage in credit markets looks severe enough to drive a bankruptcy and rating downgrading cycle, which could hit the market as a whole.

## IT'S ALL ABOUT BONDS ANYWAY

Whatever happens to equities in the near-term, their ultimate fate will be decided by bond markets, and the macro environment after the epidemic. The key here is to look beyond the near-term disinflationary, or even deflationary, impact of the crisis. After all, we might have a bit of luck, and if we do, we'll emerge from this misery with bruised supply chains, an extremely accommodative policy setting, and plenty of pent-up demand. **In other words, inflation could be on the way, or perhaps more aptly, stagflation.** I am torn on this argument. I still think that rapidly ageing populations, and the associated excess savings, are disinflationary. I also suspect that the demand shock will far outweigh the supply shock, at least through 2021.

The counterargument, however, is now so evident that it deserves to be aired. This piece by Charles Goodheart and Manoj Prahdhan is a good synopsis. I don't agree with all of it, but all the key elements are there. In the end, this can be reduced to a simple proposition. Let's say that the current battery of stimulus—which is really life support to prevent economic suicide—will *not* be temporary. **If it isn't, will bond markets be allowed to reflect that?**

It might not be such a bad idea. If central banks moved their focus to the front-end—which is where their influence is strongest—a dose of fiscal stimulus would drive up long-term yields higher, steepen the curve, and, arguably, lift inflation expectations. Isn't that what everyone wants?

I guess it depends, but I struggle to see why it would be a huge threat. The world is awash with excess private savings, and it might not be a bad idea to see how far the curve could indeed steepen before the roll and carry sucked private investors back in; you know, a bit like a *real* market.

In any case, for a government not operating under a budget constraint—see MMT lesson 1—you simply call the central bank and tell it to the interest rate you want, preferably at zero. This policy of *Yield Curve Control* is now rising in favour. It isn't hard to see why. *Policymakers fear that the enormous bill they've been landed with, to see us through the Covid-19 disaster, will stir the erstwhile slumbering bond vigilante.*

The FT is the latest of the broadsheets to illuminate this idea. The argument is simple; we're at war, and we can't allow a market-driven rise in interest rates to rob us of the ability to pay for it. *Given the extent to which the "pre-war" establishment would benefit from this policy, I am not a buyer of that narrative.* But one thing is certain. Policymakers need to make a choice, and as I noted last week, what ever they decide to do, it will be critical for the fates of equities, currencies, real assets and everything in between. It's something to look ahead to.