Stephen L Jen (London)

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Bottom line. Low global real interest rates and the near prospect of successful Covid-19 vaccines and therapies suggest that equity prices and prices of real assets (properties, gold) will continue to march higher as we head towards the US Election. I still believe equities have been the smartest and therefore the most trustworthy asset class in this cycle. The global economy should continue to recover reasonably robustly into year-end, even if the rate of growth decelerates modestly in Q4.

1. Global growth may be near the kink in the 'square root' trajectory, as the headline growth rates around the world downshift in late-Q3 to follow growth drivers that are more genuine than a simple bounce from the lockdown. The pandemic shock to the global economy has been more sectoral than geographic, in my view, as sectoral differences in reaction to this shock have led to country differences, since policy reactions from the various countries have been broadly similar.

2. The US Election will become a key driver of asset prices. Not only will a Biden or Trump Administration have different implications for asset prices *ex post*, *ex ante*, the performance of equity markets leading up

to the election could also alter the outcome of the election.

3. Europe and the US continue to follow Japan's experience with stimulus policies. Fiscal dominance will likely prevail in both the US and Europe, as the Fed and the ECB have broadly exhausted their policy options. But just like Japan, the scope for fiscal dominance will also be limited in duration because of the rapidly rising public debt positions. In the end, all countries will come full circle and be compelled to embark on structural reforms, just as Japan was forced to do under Abenomics.

4. With an overhang of idle resources, it will not be easy for the Fed to generate inflation. If there's inflation, it will likely be 'demand-pull' inflation rather than the classic 'supply-push' type. The yield curve in the US, in that case, ought to steepen with equities remaining supported: 'demand-pull' inflation ought to be positive for equities while 'supply-push' inflation would be bad for equities.

5. In my view, the USD is still the 'Usain Bolt' of currencies. The USD is indeed experiencing a cyclical setback – I concede this point, but this is due to 'twisted ankles' rather than 'terminal cancer', with the latter, rather strangely, being the more popular view. The flatter phase of the 'square root' recovery path will likely be marked by US out-performance, which should in turn provide support for the dollar. Already, the correlation between equities and the dollar has gone to zero, and EM currencies have actually begun to weaken against the dollar. The narrowing in the USD weakness foreshadows a potential turn in the dollar, in my view.

Rather than a simple U, V, or W-shaped growth trajectory, it might be more useful to think in terms of a 'square-root' shaped trajectory, where we first see a bounce from a sharp decline, in most economies, followed by a flatter, but still positive, and more protracted phase of economic growth. The first part will be determined by the state of virus control and the timing of the reopening of the economy, while the latter phase should be a better reflection of the underlying policies, sentiment, and economic fundamentals.

1.1. I read a lot of sell-side commentaries claiming that Europe should and has out-performed the US, but I don't see this in the data. Thus far, the US has registered at least as many upside data surprises as Europe has, and, with the exception of Germany, the US does not seem to be lagging behind any other European country; the gap between the popular narrative and actual data from the US and Europe seems strange to me. The charts below show US ISM M versus German IFO, and actual factory orders in the two countries; the chart on the right has different scales. Do you see a big difference between the US and Germany in these charts? Germany is the leading economy in Europe, and the US as a whole still has performed at least as well as Germany. Why is there this impression that the US is struggling? Outside manufacturing, retail sales, ISM NM, JOLTS, and general consumer demand in the US have also been robust. Importantly, the wealth effect in the US is very positive, compared to 2008-09. Equity prices, bond prices, and property prices have surged. This immense wealth effect, coupled with government transfers to support disposable income, ought to support consumption.

1.2. This 'European glass is half-full, but the American glass is half-empty' bias in market commentaries may reflect the trend in virus infections in the US. However, I have always thought that all countries would sooner or later experience second and third waves anyway: if South Korea and New Zealand could not prevent second waves, how could Europe do so? The third chart below shows the trends in new infections in the US and Europe. While the second wave in the US has been admittedly scary, there are mitigating considerations, including much more testing (more than 81 million tests have been done in the US) and a much lower fatality rate than in the first wave. Total Covid-19 fatalities in the US have been very high, at 187K, but the European total is around 167K, i.e., not that different from the US. Already, European PMI in August declined to 51.6 from 54.9 in July but we haven't seen actual US data showing a deceleration. In short, I don't quite see the argument that the US will under-perform Europe in this recovery, at least the argument does not seem as straightforward as many analysts are suggesting.

1.3. What is most extraordinary was the analysts' reactions to the sharp jump in the latest ZEW survey (from 59.3 in July to 71.5 in August). The ZEW survey is based on German institutional investor and analyst outlook. Such a big upside surprise led to some analysts becoming more bullish on the outlook for Germany, because they 'surprised themselves', to find out that they are actually more bullish than even they realised? Do we see the circularity here?

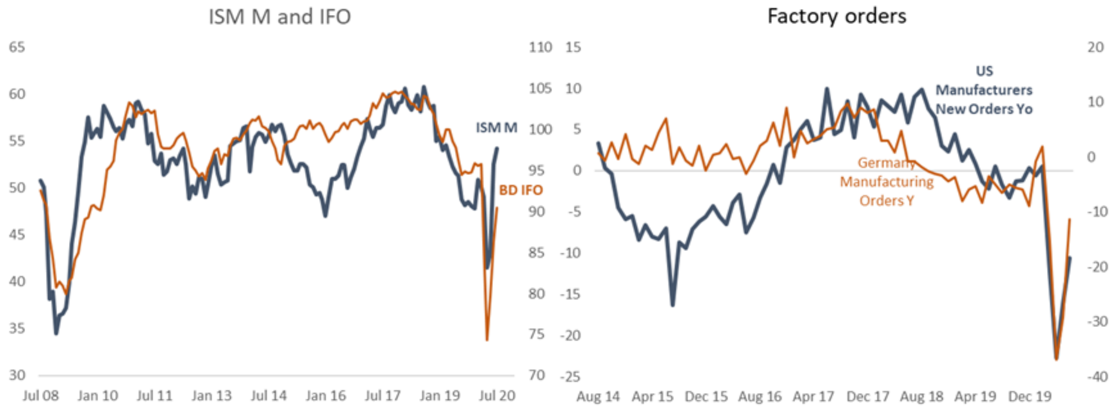
1.4. Also, Europe launches a EUR750 billion Recovery Fund and that's a game changer. The US is contemplating the next phase of fiscal stimulus of USD1.5 trillion and people yawn… The Fed adopts AIT that's dollar-negative, but when the ECB increases its QE operations in the coming months, the analysts will likely celebrate this as growth-positive… I don't recall another time when the commentaries are so unfair; it's as if it is the US' mother-in-law (who has a record short-dollar position in her personal account) commenting on US data.

1.5. What is clear is that, after the initial sharp bounce in economic data across most countries as they reopened, the second wave of infections as well as behavioural impediments ought to depress the speed of the economic recovery in the coming months, until we have reliable vaccines and therapies, I think. This means that the world is likely to have transitioned past the 'pivot' or the 'kink' in the 'square root', moving from the initial bounce to a flatter – but still positively-sloped - part of the recovery. Regular readers of my work should know the distinction I draw between what is 'urgent' in life and what is 'important.' In some ways, the first part of the square root was more 'urgent', and was what analysts were fixated on in the depth of the pandemic. But the flatter part of the square root, to me, is much more important. Also, in the first small 'v', many of the macro variables such as inflation and trade balance are not that useful indicators of the genuine underling trends.

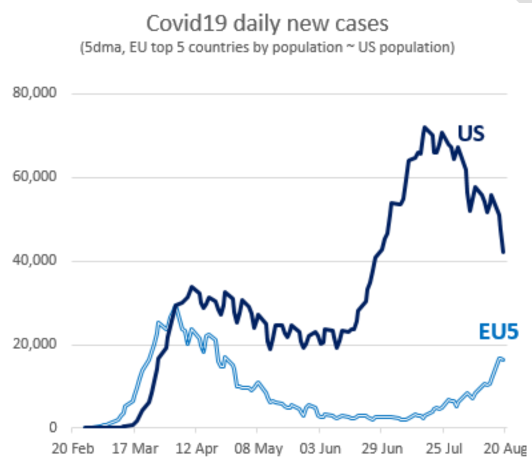
1.6. The ECB's Chief Economist Phillip Lane made the point at Jackson Hole that the ECB is also thinking about 'two stages' that includes a crisis-fighting stage and a more normal stance of trying to achieve its inflation target. I think this notion is consistent with the 'square root' idea.

1.7. In addition to the gear shift in the headline growth rate of economies, I've also stressed the importance of being aware of the cross sectional (or sectoral) changes, in addition to how the various macro variables change over time. (In general, I've felt that the market tends to be excessively focused on time series variations but not focused enough on cross-sectional changes…) Especially in the current setting, as analysts we need to be inquisitive of the diverse sectoral impact this pandemic shock has had and will continue to have. Tech and pharma have out-performed, and rightly so. This is not just a short-term impact but also, especially for tech, a long-term verdict on where the global economy had already been moving toward and the pandemic shock merely accelerated this inevitable trend. I do feel that hotel and airline industries will eventually return to their full strength as it is human nature to want to travel and explore the world; the timing of this prospective recovery is harder to predict though… In any case, I think the pandemic has had a bigger impact on the various sectors than on different economies. My prediction is that we will come to realise that the lasting impact of this pandemic shock will be more sectoral than cross-country, and the message from the equity markets is revealing and correct.

1.8. Having said the above, I do believe that, in the second, flatter, phase of the 'square root' path, the US has a better chance of out-performing Europe, simply because the US' potential growth rate is significantly higher than that of Europe. Europe's economic exposures to China (double that of the US) may have assisted Europe's initial recovery, but as China also enters its flatter phase of the recovery and waits for vaccines and therapies like everyone else, I think the US is in a solid position to out-perform, economically, in the coming months. Do we all remember that Germany was on the verge of falling into a recession in 2018H2 and 2019, before the pandemic hit?



Source: Refinitiv Datastream and Eurizon SLJ Capital Limited



Source: Refinitiv Datastream and Eurizon SLJ Capital Limited

This will be an important election; those from all sides of the political debate in the US would agree, I think. For the financial markets, it will also be consequential.

2.1. A key proponent of MMT (Modern Monetary Theory) – Stefanie Kelton – was once Bernie Sanders' economic advisor. I agree with the consensus view that a Biden Administration would make MMT much more likely and it would thus be more negative for the dollar. Higher taxes, in addition, would not be great for US equities, and how the tax proceeds would be spent also might not be that good for the US assets. A second Trump term, on the other hand, ought to be relatively more positive for the dollar and equities. If you haven't done so, please take a look at '*2020 Democratic Party Platform*' – a 92-page summary of the policies the Biden Administration intends to undertake. Given that the policies listed there are polarly different from those under Trump, it seems reasonable to expect the election to be consequential for the financial markets. Policies under a Biden Administration would likely mean weaker US equities, weaker bond prices, and a weaker dollar. I have this simplistic view heading into the big event in November, knowing full well that what policies are actually implemented might be different and the impact on the financial markets, therefore, might also be different from what I now expect.

2.2. Not only will the outcome of the election (including the results for the Congressional seats) be, ex post, consequential for the financial markets, the performance of the equity markets, ex ante, could also affect the outcome of the election. We have noted previously that, based on US history, if US equities were up in the 100 days leading up to the election, the incumbent party occupying the White House had a close to 90% probability of retaining the White House. The 100-day clock began on August 5, 2020. Since then, the S&P and Nasdaq are up 6.1% and 6.9%, respectively. The logic is that US voters, in the past, tended to consider the economy and the likely impact of policies on their financial holdings and property prices. I have no idea if this assumption is still valid, given the very complex social situation in the US. But it is a statistic for your consideration.

Chair Powell gave a pretty good speech at the Jackson Hole event, highlighting the key evolution in the Fed's policy framework. Much has been written on this topic. I have the following thoughts to add to the discussion.

3.1. Compared to before, the adoption of flexible AIT (average inflation targeting) is a dovish turn. That's clear. What is less clear is if this policy tilt had already been priced in and whether the Fed will ultimately be successful in generating inflation. (For a good, intuitive, justification for AIT by the Fed, please take a look at the SF Fed paper '*Average Inflation Targeting and the Effective Lower Bound*' that emphasizes the importance of keeping inflation expectations supported.) If the global output gap remains large and unutilized factors of production (labour supply) linger, inflation, at least the traditional 'cost-push' inflation seems unlikely in the near future.

3.2. To the Fed, the Phillips Curve is not flat; only one half of it is flat while the other half is sloped just like before. This is one way to justify the Fed's asymmetric policy reaction function and its anxiousness in propping up inflation expectations. (3) If the Fed is successful or is seen by the market to eventually be successful at generating inflation, the yield curve in the US should steepen.

3.4. I never thought that the Fed would signal at Jackson Hole that they were close to announcing YCC/YCT (yield curve control), mainly because the financial conditions (stock prices, interest rates, and the dollar) are already extremely easy and interest rates, in particular, may be too low for the Fed to contemplate YCC now. The Fed is obviously able to conduct YCC but is unwilling to do so, until interest rates are higher. My guess is that the 10Y UST yield needs to be above 1.00% for YCC to happen. One feature I don't fully understand yet is why the Fed used the term YCT (target) rather than YCC. They could have been trying to convey a sense of humility.

3.5. Real interest rates will remain very low for an extended period of time. This should be supportive for equity prices, especially for the equity prices of companies with high expected earnings growth. I've long argued that contemporaneous (one-year forward) PE is not that meaningful when interest rates are so low, and the yield curve is so flat. A flat yield curve means higher NPV of earnings in the out-years. And, for an incremental decline in interest rates, companies with higher earnings growth should experience larger surges in today's equity prices. This has been my logic, since March, for being positive on not just equities, and not just US equities, but equities of the US tech companies.

3.6. Property prices should do well all around the world in the coming years, I'm guessing. Even properties in major metropolitan cities ought to recover eventually, after Covid-19 becomes history.

3.7. The Fed will likely elaborate on the details of their new framework of AIT at the next FOMC meeting on September 16, 2020. Investors should, in any case, keep in mind the likelihood that the coming years will be marked by 'fiscal dominance'. The GFC was a nominal shock but Covid-19 was a real shock. There is a legitimate role for fiscal policy this time, in addition to the fact that money policy has run its course.

These three economies are as different as they come, and each is exceptional in their own way. But when we in finance use terms like 'American Exceptionalism,' we usually mean the special traits of the US to encourage exceptional innovations, profits, and business ideas with consequences for the financial asset prices. The term is not meant to be all-encompassing. This is why I was surprised to see so many analysts writing about 'European Exceptionalism' supplanting 'American Exceptionalism' simply because of superior virus control (which is debatable, as I suggested above) and the Recovery Fund, and because the EUR has gained a mere 10% in value against the dollar.

4.1. The US tech companies could become as dominant and powerful as the Dutch East India Company of the 17th Century, whose value, at its peak, reached USD7.9 trillion in today's terms. The second-most valuable company in history, in today's terms, was the French Mississippi Company (USD6.8 trillion) in the 18th century that had monopoly rights in the Americas. Both the Dutch East India Company and the Mississippi Company made their money from trading with then emerging markets and resources; the tech companies of today have monopoly over the newest resource: information. Not only does Europe not have any company that comes close in terms of their presence in tech, Europe does not yet have the environment conducive to such companies emerging in the foreseeable future.

4.2. The demographic trends of the US and Europe are heading in opposite directions.

4.3. The idea of the European Recovery Fund began with the Merkel-Macron meeting on May 18, 2020. Since then, there has been a sea change in the general sentiment regarding Europe. But I struggle to identify anything that would substantiate the concept of 'European Exceptionalism' to the extent that European assets will be expected to outperform US assets, because all that the Recovery Fund has done is to reduce a left tail risk, without shifting the 'mean' of the distribution to the right.

4.4. Indeed, the Stoxx-50 has been flat since late July, while the S&P and Nasdaq has risen by 8% and 12%, respectively, since then, suggesting that the improving economic outlook in Europe has ceased to further propel European equities and/or the higher EUR is already starting to undermine some of the earnings support. The argument of European out-performance driving the EUR higher is not supported by the recent relative equity market performances.

4.5. China stands out in many ways, in comparison to the US or Europe. Without boring you with observations I assume you already know, I highlight the starkly different policy path Beijing has taken this year. In contrast to the US or Europe, Beijing has refrained from adopting an aggressive monetary policy. If anything, Beijing's stance has been restrained, and its focus has quickly shifted back to structural reforms and the prevention of future bubbles. The financial reform czar Guo Shuqing commented that both the Fed and the ECB were making a big mistake in firing their last bullets. Indeed, after the global recession of 1990 and 2008, there were aftershocks (EMS Crisis of 1992 and the European Debt Crisis of 2011-12). It is thus likely that the world will experience aftershocks in the next 2-3 years, probably related to the debt market (e.g., mass bankruptcies and corporate defaults). Central banks ought to be prepared for these risks, so Mr Guo believes, by not exhausting its arsenal. (By the way, I've argued that the European Recovery Fund may have been aimed at inoculating Europe from precisely such an aftershock in the coming years.)

The RMB has been supported by the higher interest rates in China, and fiscal stimulus has been focused and selectively delivered to specific parts of the economy. China's prudent prosecution of policies with a framework of 'dual circulation' has been impressive. 'Dual circulation' is the idea that there are two distinct ecosystems in China supporting the export market and the domestic market. Given that global demand is expected to take time to recover, China should focus on nursing the domestic economy back to health and focus less on the export sector. Of the three big economies, I think China has definitely been exceptional in its emphasis on 'Arrow 3' rather than Arrows 1 and 2 like the US and Europe have been in this cycle. Further, China's policy of 'socialising investment' by focusing on infrastructure investment and other activities that produce a lot of public goodwill is worth emulating. China is also exceptional in the dominance of its federal/central government over the local governments. The centralization of policies has allowed China to continue to operate like a big corporation, with clear advantages in the short run but with disadvantages in the long-run.

4.6. On the dollar, I concede (again) that I was not right in the past months. The dollar did weaken as everyone else argued it would. In retrospect, I think that, in fighting the narrative that the dollar and the US economy and society are in a terminal decline, I underestimated the power of the low real interest rates on the dollar, similar to the experience post-GFC when the Fed's ZIRP powered a 'Beta Convexity' trade whereby both equities and bonds rallied while the dollar weakened. In other words, in my eagerness to argue that the USD is still a 'Usain Bolt' currency, I ignored that Bolt could not run with twisted ankles and much slower runners were able to get a head start. In any case, I still strongly believe in American Exceptionalism in the traits that matter for asset prices, including the dollar. Neither the EUR nor the RMB will come close to challenging the dollar. In my opinion, in thinking about the hegemonic international currency, increasing returns and the US's dominance in international finance are much more important than the relative size of the US economy, social stability, and geopolitics. Yield differentials may have cyclical effects on exchange rates, but they don't change the secular backdrop for currencies.

4.7. Finally, I observe that none of the major economies seems to view currencies from a mercantilist lens anymore. China, for a long while now, has not had such a view, despite the general presumption to the contrary. The ECB, under Lagarde, does not seem to be as sensitive to the rise in the EUR as Draghi did. Even in the US, there has been a 180 in recent months on the dollar. For example, Treasury Secretary Mnuchin said recently

'*We want a stable dollar… The dollar reflects lots of money coming back into the United States… it is the reserve currency of the world and we're going to protect that… There's nowhere else to invest than the US… People don't want to invest in the EUR; they sure don't want to invest in the RMB… So there's a lot of dollars coming to the US*.'

This trend is consistent with my view that the capital account is now much more important than the current account in driving exchange rates, and policy makers understand this.

Global fiscal stimulus and monetary stimulus have been administered with a roughly 3:2 ratio (about USD12 trillion in fiscal stimulus versus USD8 trillion in QE). But this ratio will likely move toward 1:1 as sustained QE eventually catches up to fiscal stimulus, I think. Despite their protestations to the contrary, central banks will effectively be conducting MMT in the coming years, as the line between creating bank reserves and financing government debt will be blurred. In any case, this policy mix ought to be a powerful support for equities, almost indefinitely.

The table below is my latest outlook/forecast for the major asset classes. I made two revisions.

First, I'm more confident that the S&P will continue to march higher in the next 3 months. This is partly in response to the Fed's latest commitment to AIT.

Second, I have changed the short-term outlook for EURUSD from '+1' to '-1', due to the historical pattern that in the period leading up to the US election, the USD tended to rally, and also reflecting my expectation that the US economy will start to outshine others in the flatter part of the recovery. By the way, spec positions to short the dollar recently reached post-2011 highs. Considering the strongly-held and richly-positioned trade to sell the dollar, the magnitude of the dollar decline since May has been relatively modest.

Other than these two changes, my view remains broadly unchanged. Low real interest rates will continue to drive equity prices higher. The UST 10Y yield should move into the 0.80-1.00% range. RMB should be strong, while EM currencies will likely weaken. The US election should support my outlook, I think, making US equities increasingly 'calendar-driven.' Finally, I find it interesting that, judging from positioning, the market as a whole, compared to my own view, is less convinced of a further rally in equities and much more convinced of a lower dollar: spec short-dollar positions have just hit a historical high.

(As of August 31, 2020)

Our Market Forecasts

	3M		End-2020		
	Bias [-5, +5]	Conviction	Bias [-5, +5]	Conviction	Comments
SnP	+3	■■■■□	+3	■■■■□	Ultra-low discount rates should flatter equities.
UST 10Y yield	+1	■■□□□	+2	■■■■□	Yields modestly biased to the upside, suppressed by the Fed.
WTI	+2	■■■□□	+3	■■■□□	The best indicator for current strength of global demand.
EURUSD	-1	■□□□□	-3	■■■■□	A relief rally now, but sub-par growth will weigh on the EUR.
USDJPY	0	■□□□□	+1	■□□□□	JPY not as good a safe haven as before.
USDRMB	0	■□□□□	-2	■■■■□	RMB is an important nominal anchor for Beijing.
USDEM	-3	■■□□□	-3	■■■□□	EM FX should strengthen with the global recovery.

6.0 Inflation in the US

I've discussed previously that there is an important distinction between 'demand-pull' and 'cost-push' inflation, and that we will likely see the former rather than the latter, and that we will likely see this type of inflation appearing in the US before elsewhere. This has implications for the UST market. To put things into context, after the sharp backup in yields in China in Q2 as the bond markets there were allowed (and even encouraged) by the PBOC to fully price in the economic recovery, the next bond market to experience a sell-off will likely be the US. European bond markets will likely behave like Japan and will remain repressed.

7.0 The highs and lows of productivity growth

A recent SF Fed paper (August 3, 2020) with this title made the interesting point that the US economy has experienced long periods of high and low productivity growth phases. Their estimates suggest that the US has been in the low-growth regime since 2004. Extrapolating this recent trend, productivity growth would be 0.6% by 2025. But if somehow US productivity growth reverts back to a higher rate seen prior to 2004, it would be around 1.1% by 2025. 0.5% growth difference is huge, I think. My suspicion is that, in response to such a severe shock, the US has a decent chance of reorienting its economy quicker than many other economies to adopt more tech and more productive ways of doing business. Some jobs will of course be lost forever, if there is such a structural shift. But I remain hopeful that the US will eventually emerge from this crisis a stronger and more resilient economy.

PM Abe has announced his intention to resign due to health reasons. Here are some thoughts I have on Abenomics, on whether it has been a success.

8.1. Japan's structural challenges were intertwined, as hostile demographic trends and other supply-side issues (market competitiveness, labour market efficiency, corporate governance, etc.) had a 'multiplier effect' with the eroding macro foundations. All along, public debt has risen steadily, while deflationary forces lurked.

8.2. To fight this debt-deflation tendency in Japan, Abe's 'Three Arrows' strategy was quite appropriate, as it replaced a previous policy stance that was disproportionately focused on monetary stimulus. Even now, I am not sure if most people understand what 'Three Arrows' really meant. To many in the West, the concept is 'additive,' in that it would simply be three sets of policies: monetary, fiscal, and structural. But the origin of 'Three Arrows' comes from an ancient Japanese folklore story, which in turn came from a Chinese folklore story, about a warlord father who, on his deathbed, tried to urge his three feuding sons to stop fighting each other. He took out one arrow, and easily snapped it in half. Then he took out three arrows and could not break them as a set. This was to demonstrate to his three sons the importance of banding together. The Chinese version is based on a farmer, using three chopsticks…

8.3. Abenomics, therefore, was a set of policies that were exceptionally-well marketed to the Japanese public, because everyone in Japan understood the reference to the folklore – that all three sets of policies were necessary and that none of the three could substitute the others. Marketing this complex idea in such simplistic and intuitive terms prevented much bickering about the different parts of the policy platform and allowed Abe to prosecute the very difficult 'Arrow 3' (structural reforms) without having to explain why monetary stimulus and fiscal stimulus alone would not suffice.

8.4. Abenomics have been so effective that whoever succeeds Abe will likely not alter the economic policies. Those who were monitoring Japan's economy a decade ago should remember how challenging the situation was, both economically and politically. After taking over from PM Noda of the Democratic Party in 2012, it was a hard fight for Mr Abe to eventually launch Abenomics, which were controversial with plenty of factions resisting reforms. The fact that there is minimal resistance now is testament to the effectiveness of the campaign.

8.5. The bad news is that, looking ahead, monetary stimulus has run its course; so has fiscal stimulus. Structural reforms will continue, as countries, like individuals, have to continuously restructure themselves. But the hope of doing enough to allow the government to one day discharge its debt in a normal or conventional manner seems unlikely. But just as Japan has been forced to innovate new unconventional policies which were eventually mimicked by other countries, it will likely continue to lead the world in policy innovations, I am guessing. The trouble is that it is not clear to me what the next new policy could be.

Why do countries and airlines not do more ‘pooled C-19 testing’? A few years ago, I walked into Beijing International Airport. The security guard gathered travellers in groups of 20-30, and, in one go, wiped all of our hands and bags for tests for explosives. At Heathrow, this is done randomly and individually. But I think Beijing’s approach makes more sense. Pooled tests like the ones done in Beijing are administered in bunches of 20-30 people, and if the test comes up negative, which is normally the case, all of the travellers in the group are released. But if the test is positive, then further tests would be administered to identify the one passenger. Why can’t airlines and airports do the same with Covid-19 tests? All passengers on a flight could be sampled before they board, in groups of 20. A not-too-overwhelming number of tests would then be processed at the departure airport during the flight. Upon landing, if any of the tests comes up as positive, then the 20-some passengers would be quarantined at the destination while the rest of the passengers can be confident that they have tested negative. This ‘pooled testing’ could be done in offices, restaurants, or for families: one test for the whole family, in one go. And with offices, all workers could feel confident that none of them is positive. Such ‘pooled tests’ could conceivably be done on a daily basis.

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