ALPINEMACRO
A Unique Mind On The Markets

GLOBAL STRATEGY

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COVID-19: Shock, Recovery And Strategy

Is the COVID-19 shock transitory or permanent? In economic terms, "transitory" refers to a shock that does not change the trajectory of the underlying trend in the economy. The antonym of "transitory" is "permanent," which means the underlying trajectory of growth shifts, either up or down, as a result of such a "permanent" shock.

May simply be semantics, but if a shock is transitory, it comes and goes, and the economy is affected only temporarily. Conversely, if a shock is "permanent," the impact lingers for a long time. The Great Depression in the 1930s was a permanent shock, as was the 2008 Global Financial Crisis (GFC). In both cases, the growth trajectory was lowered and impact was long lasting as a result of a badly damaged financial system, forced deleveraging and asset liquidation.

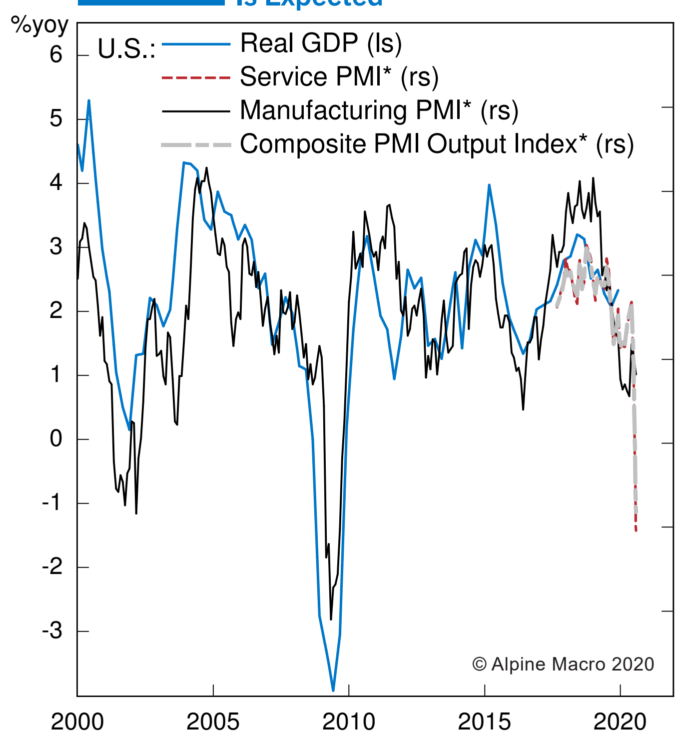
The COVID-19 Shock

It is not immediately obvious whether the COVID-19 shock is transitory or permanent. At first, I thought it was a transitory shock, but events that have transpired since early March suggest it is probably more than that.

One thing is for sure: the COVID-19 recession is unprecedented in both its speed and magnitude (Chart 1), and there is still huge uncertainty over how the pandemic will play out. This is why a variety of opinions flourish on how this crisis will impact the world economy.

The most pessimistic assessment in recent weeks is the prediction of a very long "economic winter," with spreading bank failures, credit defaults, soaring

Chart 1 A Sharp GDP Contraction Is Expected



*Advanced by 5 months; source: Institute of Suppply Management (ISM); Markit inflation, rising social upheaval in the U.S. and even a possible shooting war in the South China Sea between the U.S. and China.

If this very grim assessment proves correct, the COVID-19 shock will be a permanent one that leads to much more carnage in stocks, and much more economic pain. But we are not ready to accept this assessment yet.

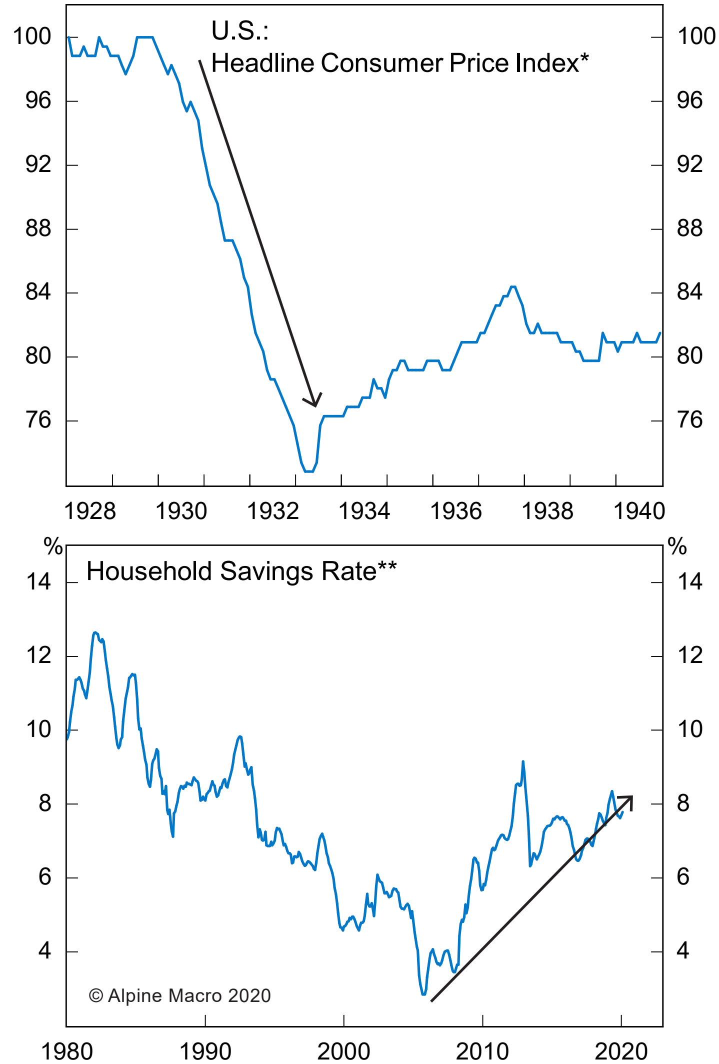
The 1930s was a permanent shock because the Western world went into an extended downward economic spiral as price deflation and debt liquidation became self-sustaining. The vicious circle eventually led to the outbreak of the Second World War (**Chart 2**).

The 2008 GFC was also a permanent shock because it led to a severe credit crunch and prolonged deleveraging. The U.S. household savings rate has risen sharply since then as households have been forced to reduce debt. This has greatly dampened aggregate demand, hence undercutting overall GDP growth.

Will the COVID-19 pandemic bring about long-lasting changes in consumer and business spending like the 1930s and the 2008 GFC? Will banks be reluctant to lend money to businesses and consumers long after the crisis is over? Probably not, in our view.

Perhaps, COVID-19 is so unique that it does not fit the definition of either a "transitory" or "permanent" shock. It is definitely more serious, and may last longer, than a typical transitory shock, but long-term damage on the economic and financial system is likely to be less severe than what was inflicted by the 1930s depression or the 2008 GFC.

Chart 2 **The 1930s And 2008 GFC: Two "Permanent" Shocks**

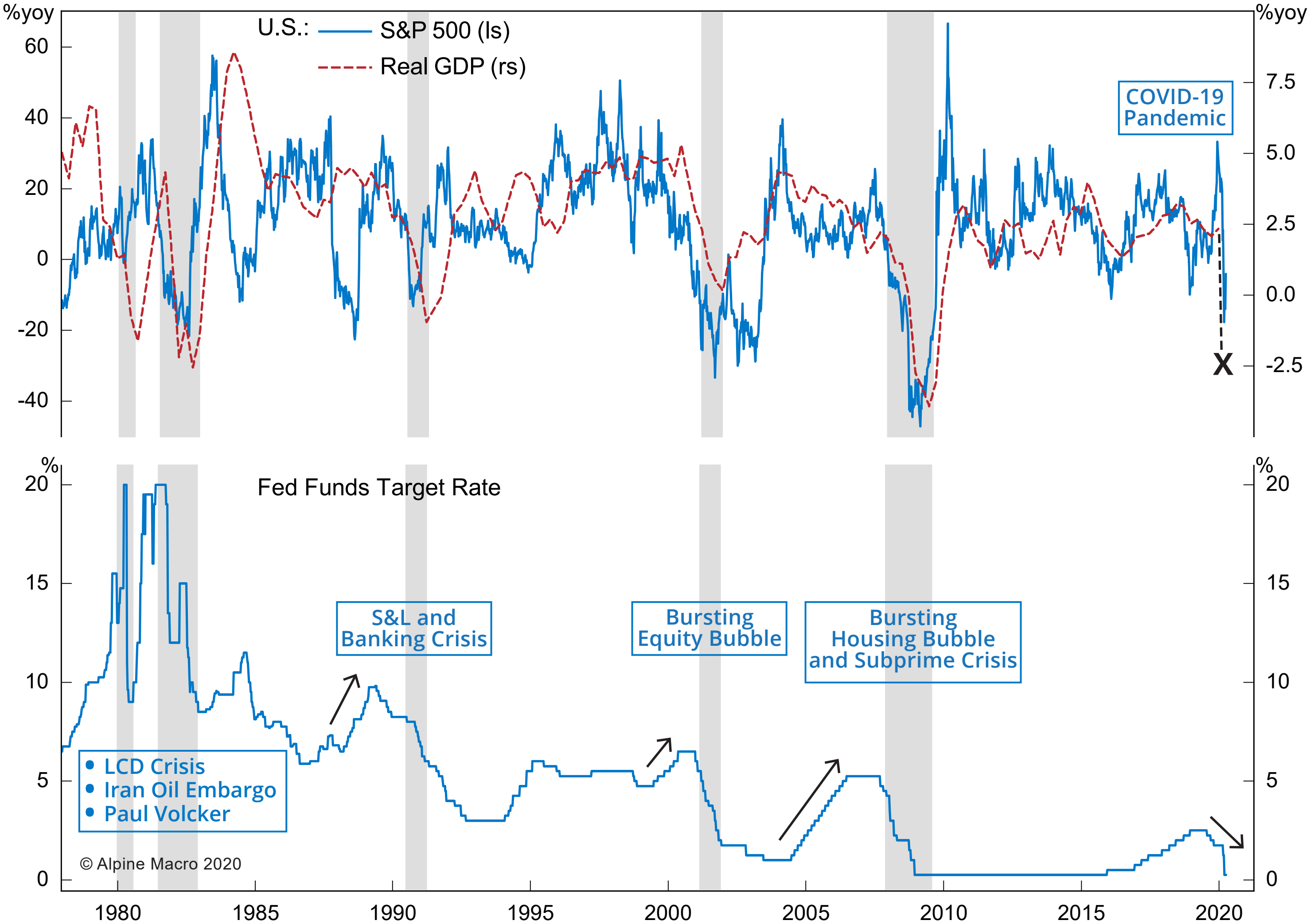


*Rebased to Jan 1928 = 100
**Shown as 6-month moving average

In post-war history, economic recessions have always been provoked by financial crises or meltdowns in asset prices as a result of Fed monetary tightening (**Chart 3**). The COVID-19 crisis is different. It is being provoked by a plague rather than economic excesses and has come suddenly.

Some investors are concerned whether there will be a second shock wave where major financial

Chart 3 COVID-19 Recession Is Atypical



Note: Shaded areas denote U.S. recessions

institutions start to fail as the economic shutdown continues. We don't think this is very likely because the very aggressive and timely policy responses will likely stem any financial instability.

First of all, the size of the fiscal package is overwhelmingly large and will most likely more than offset direct GDP losses as a result of the COVID-19 economic shutdowns. This is unprecedented in the peacetime history of financial bailouts and economic rescues.

Most importantly, when the Fed buys the financial securities of private issuers and lends money directly to businesses, the central bank is effectively also functioning as a giant commercial bank, but with an unlimited ability to expand its balance sheet.

This is a monumental shift because with the Fed underwriting financial stability, it is virtually impossible for any major financial institution to fail – a key reason why TED spreads have come down so quickly, along with an expanding Fed balance sheet (**Chart 4**).

Chart 4 Fed Guarantees Financial Stability

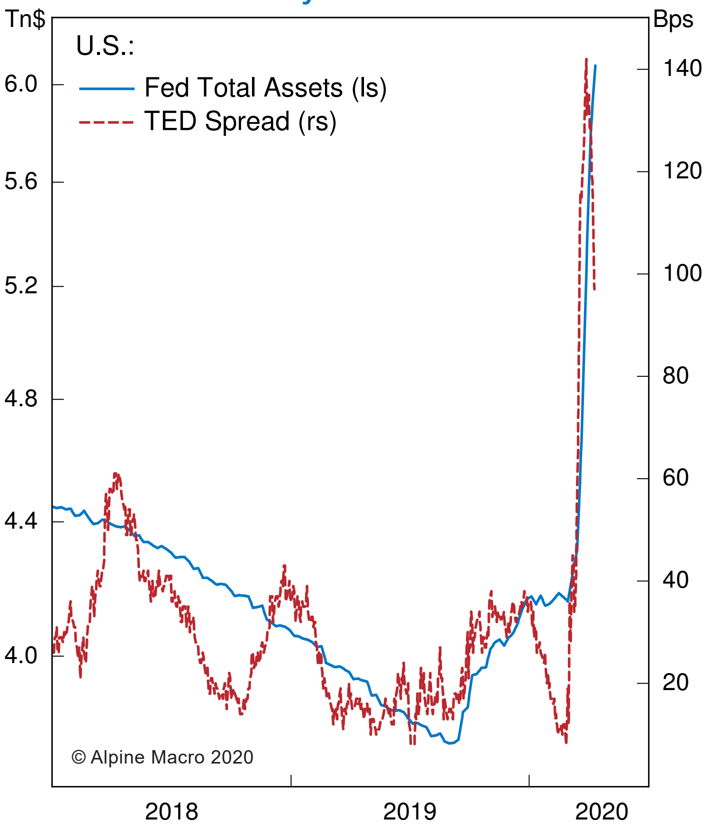
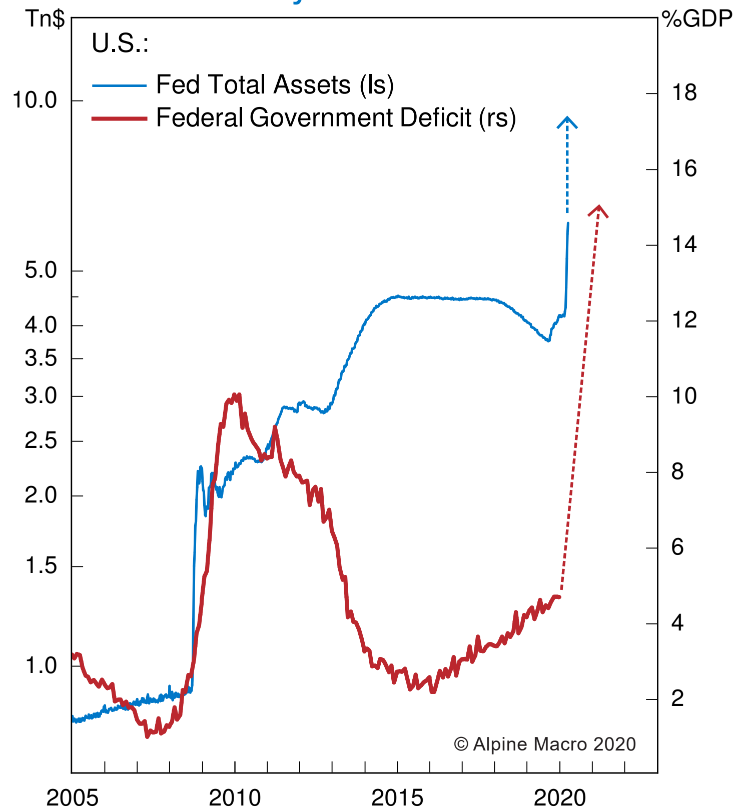


Chart 5 Two Legacies Of Massive Policy Intervention



Note: Dotted lines represent Alpine Macro's projections for the Federal budget deficit and Fed balance sheet by the end of 2020

Of course, there will be vulnerable and low-quality borrowers that will fail, leading to a rise in corporate bankruptcies. But many more firms and jobs will be saved.

In a nutshell, in previous recessions the Fed and the government always acted carefully, trying to avoid "moral hazards" or political backlash. Today authorities are under no moral, political or even legal constraint to bail out the economy and financial markets.

All of this means that authorities will do whatever it takes to preserve the integrity of the financial and banking systems, allowing the ensuing recovery to be freed from persistent drag from a badly damaged financial system or sustained deleveraging pressures.

Economic "Re-Start": How?

Monetary and fiscal authorities in most parts of the Western world have effectively socialized economic risk via various economic rescue packages and central bank interventions through QE programs.

The cost of these actions is a large rise in budget deficits and public debt, and an astronomical rise in central bank balance sheets (Chart 5). The benefit is that these programs will likely minimize the permanent damage inflicted on the underlying economy by the COVID-19 crisis.

As far as investors are concerned, the question is how the coming recovery will play out. China is "the first in and first out" in this crisis and its experience could help shed some light on how this crisis will play out in the West.

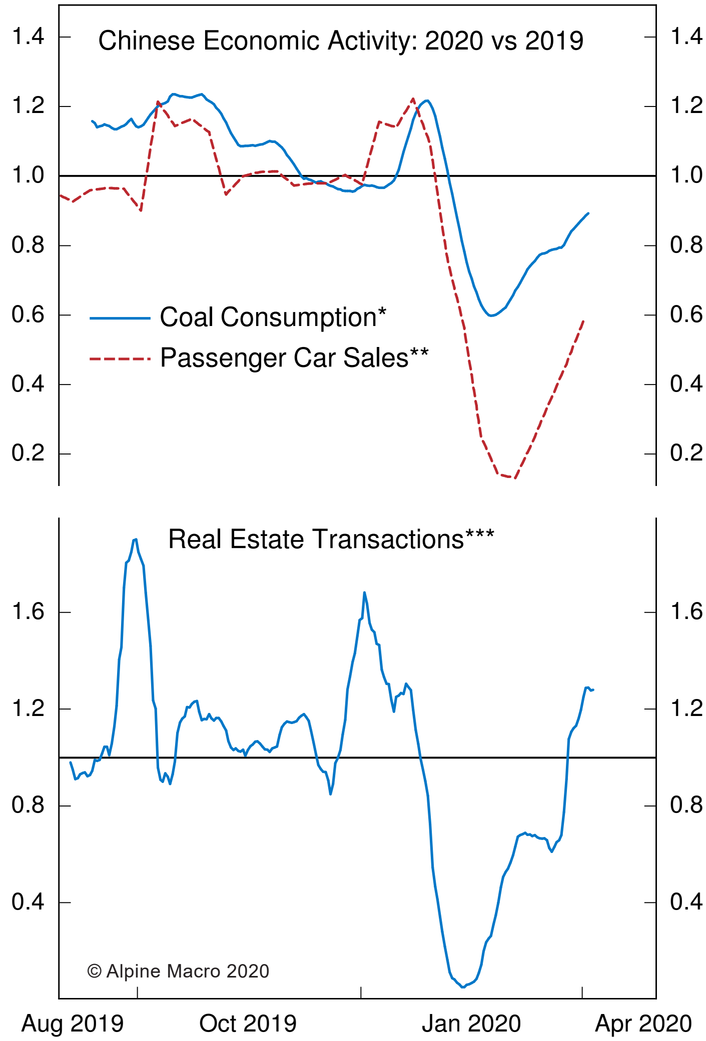
Chart 6 shows that China's coal consumption, after a cascading fall in February, is recovering. Nevertheless, compared with the same period last year, it remains 10% lower, suggesting the overall economy may be running at 90% of its pre-COVID-19 activity levels. However, real estate transactions have more than recovered.

China's experience seems to suggest that manufacturing, finance, construction, real estate, online sales and farming can come back rather quickly, and auto sales are also rebounding briskly. However, the hospitality industry, airlines and mass transportation are slower in their return.

To what extent the Chinese example can apply to the Western world remains to be seen, but it looks certain that it will take some time for the U.S. economy to climb back to its pre-COVID-19 capacity. President Trump is talking about reopening the economy "sooner than later" but has not given any details on how he plans to roll out that strategy.

There are many possible ways to "reopen" the economy: A partial opening (starting with less infected areas), a controlled opening (starting with less risky sectors) or a full opening with tightened surveillance and testing, like in China, Korea and Taiwan. Whatever the option, some restrictions, either self-imposed or government-sanctioned, will remain in place and dampen the expected recovery.

Chart 6 China's Uneven Economic Re-Start



*At six major power plants; shown as 14-day moving average
**Shown as 4-week moving average
***Average of unit and area of property transactions

Regardless, it seems unrealistic to expect a V-shaped economic rebound or speedy return to pre-COVID-19 activity levels. Another big uncertainty is a lack of global coordination: Some countries may still continue with lockdowns with borders closed, while others could reopen their economies and try to reopen their borders. It is not clear how different policies regarding border openings will affect foreign trade.

What is the bottom line?

First, we may have to live with the virus for a while. For as long as we do not have vaccines or effective drug therapy, the world economy will limp along, and may not soar back to its full capacity. However, we have to trust the ingenuity of modern science. With so much capital pouring into COVID-19 vaccine and drug research, we will find the ultimate solution sooner than later.

Second, even if the economy follows a U-shaped recovery, stock prices can recover quickly. Markets are always forward looking, typically 6 months ahead or more. The recent rally in stock prices could indicate that investors at large look for a return to some normalcy in the next 6-12 months. This, in our view, is a reasonable assumption.

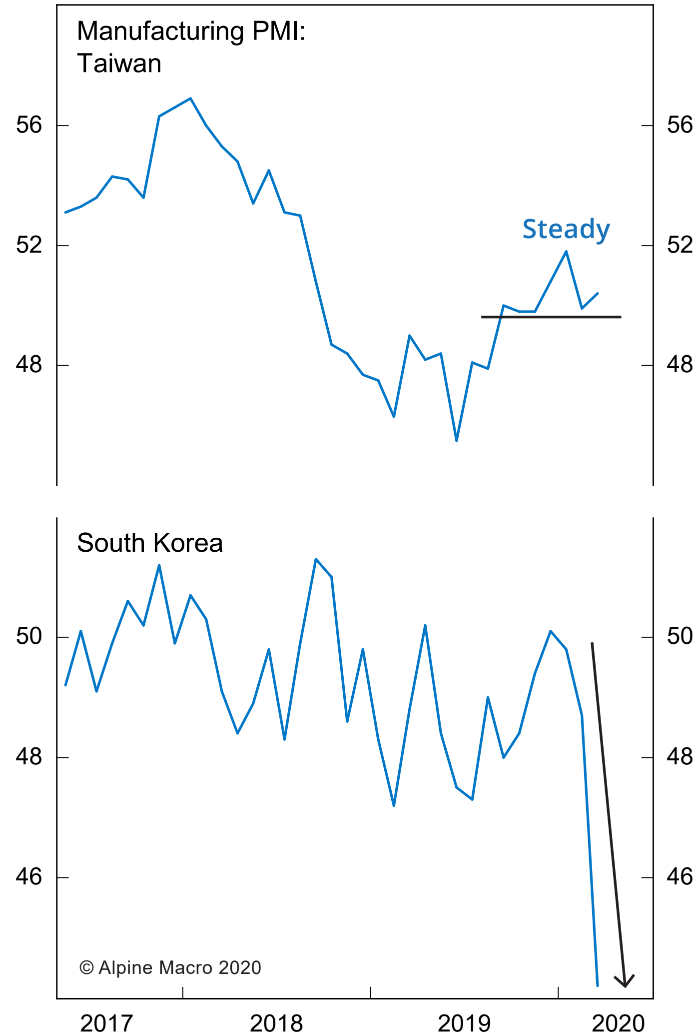
Finally, public policy must be recalibrated to fit the new reality. Taiwan is a stunning success in its fight against COVID-19. It has brought infections under complete control, with total infections at 388 and mortalities at 6 in a population of 24 million on a tiny island.

Indeed, the Taiwanese economy may well escape a recession, with manufacturing PMI having stayed stable in recent months while it is collapsing almost everywhere else (**Chart 7**). The Taiwanese example says that it is possible to minimize the economic damage while getting the spread of COVID-19 under control.

Markets: Mean Reversion And 5-Year Expected Returns

Most market pundits and investment elites are on the side that the recent market is a sucker's rally,

Chart 7 Taiwan May Escape A Recession



Source: IHS Markit

and that prices will retest their old lows or even make new lows before prices find a bottom.

It is pointless to even try to pick the bottom, given the enormous uncertainty. Our advice to clients has always been to stick to your discipline, focus on long-term value and be convinced that the underlying economy will survive the health crisis. Along this path, the forces of mean reversion will eventually prevail and reward those who bought stocks when price declines looked the most ominous and frightening.

Table 1 5-Year Expected Returns

Expected 5-Year CAGR (1)* (%, in Local-Currency Terms)		Dividend Yield (2)	Multiple Expansion (3)	Earnings Growth (4)
U.S.	8.7%	2.01	2.64	4.0
Euro Area	12.5%	3.39	6.61	2.5
Germany	9.2%	2.90	3.29	3.0
Japan	7.0%	2.14	3.35	1.5
Emerging Markets	10.8%	2.64	1.66	6.5
China	8.6%	2.26	(0.68)	7.0
5-Year U.S. Treasurys	0.41%	-	-	-
5-Year German Bunds	-0.55%	-	-	-

* (1) = (2)+(3)+(4) where (2) = 5-year average dividend yield, (3) = CAGR of 5-year average P/E over current P/E, and (4) = expected nominal GDP growth
Source: MSCI Mid & Large Cap indexes

Table 1 sums up our estimates for expected returns in different asset markets five years out, when the world economy returns to normal. Here, "normal" is represented by the five-year moving average of key variables such as P/E ratio, dividend yield and nominal GDP growth. It should be noted that the current P/E ratio is calculated by using current stock prices divided by the pre-COVID-19 EPS.

European stocks seem to have the highest expected return, which stems from the fact that European stocks have fallen the most and have the highest dividend yields.

Japan, on the other hand, has the lowest expected annual returns because it has the lowest nominal GDP growth, which limits corporate profit growth.

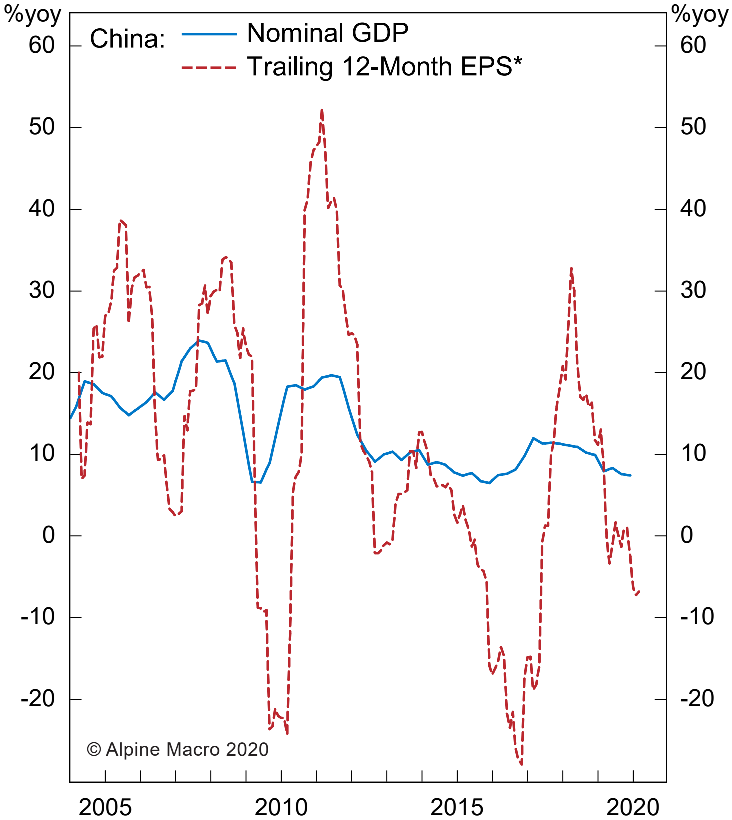
The key driving force for the rather high expected equity returns is multiples expansion. With stock prices having fallen sharply around the world, "mean reversion" suggests that prices will likely rise faster than earnings in order to allow the P/E ratio to return to its steady state. This is why bear markets often, albeit not always, create good buying opportunities.

The current P/E ratio for the Chinese stock market, based on the MSCI Mid and Large Cap Index, is higher than its five-year moving average. This is partly due to the fact that Chinese stocks have fallen less than others during the recent global stock market rout, and partly because of the corporate profit contraction since 2018, which has driven up the P/E ratio.

Nevertheless, Chinese corporate profit growth has massively underperformed Chinese nominal growth for the past two years, and it seems likely that corporate earnings will outgrow nominal GDP in the next five years (**Chart 8**).

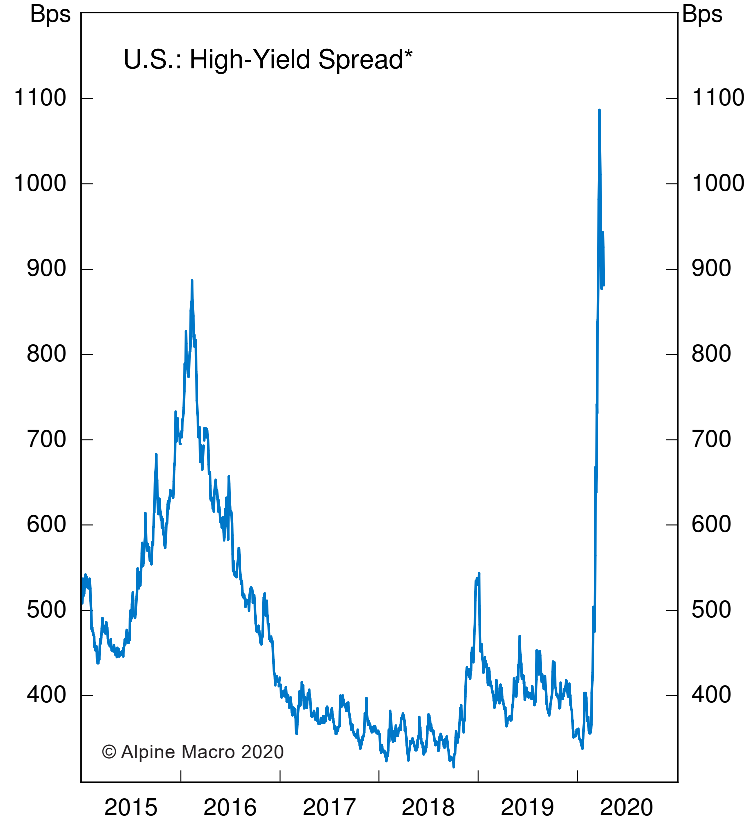
This means that longer term, China's nominal GDP growth, which is higher than most other countries, will partially compensate the negative impact of

Chart 8 China: Earnings Growth Has Fallen Far Below Nominal GDP Growth



*MSCI Mid & Large Cap Index

Chart 9 Buy High-Yield Corporate Bonds



*Source: BofA Merrill Lynch

today's profit contraction and the resulting higher P/E on return calculation.

Expected five-year returns on government bonds in the developed world will be extremely meager, ranging from -0.55% for German bunds to 0.4% per annum for U.S. Treasury bonds, respectively. This is the key reason why we have always recommended buying risk assets on price dips while reducing bond exposure.

A note of caution: All estimates are based on local-currency returns. In reality, foreign exchange rate fluctuations will make a world of difference for global asset allocations. Therefore, active foreign exchange rate management holds the key to investment success of any global portfolio.

Finally, investors should take note that this kind of exercise is never meant to give a precise five-year forecast. Rather, it is to provide a framework to think about expected asset returns on different asset classes and markets. The key message here is that over the longer run, stocks will most likely do much better than government bonds.

New Trades & Housekeeping: Buy What The Fed Buys

The Fed has broadened its asset purchase programs to include some of the recent fallen angels – specifically, investment-grade (IG) bonds that have been downgraded to junk as a result of the COVID-19 shock. In addition, the Fed has also begun to buy ETFs to shore up the market.

The credit market is still not functioning properly, with spreads remaining too wide in some of the markets that are being targeted by the Fed's asset purchase programs. **Chart 9** shows that the high-yield spread remains very high. We recommend clients buy high-yield ETFs, of which the Fed is a guaranteed buyer. Although most high-yield ETFs are 20% off their lows, they remain 7-8% below their pre-COVID-19 levels. Throwing in the Fed's 150 basis-point rate cuts, there is still considerable upside potential left for investors.

Chen Zhao
Chief Global Strategist

Investment Recommendations

Strategic Positions (6 - 12 months)

Recommendations	Open Date	Open Levels	Closing Date	Closing Levels	P&L Since Inception
Long Gold	1/27/2020	1,571.53	–	–	7.8%
Long Defensive Basket[1]	2/24/2020	–	–	–	7.5%
Short 10-year German Bunds Hedged	3/2/2020	-0.627	–	–	2.1%

Tactical Investment Positions (3 - 6 months)

Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Short USD/CNY	3/9/2020	6.96	Rolling -5%	-	-	-1.2%
Long Oil[2]	3/30/2020	20.09	Rolling -10%	4/6/2020	27.735	38.1%
Long AUD/CAD	4/6/2020	0.86	Rolling -3%	-	-	2.5%
Buy U.S. High-Yield Corporate Bonds (ETF: JNK)[3]	4/13/2020	-	Rolling -5%	-	-	-

Note: Our currency trades include carry. P&L is calculated using futures contracts.
[1] The Defensive Basket trade is comprised of 55% long-term Treasurys, 30% gold, 15% JPY/EUR.
[2] We stopped out of the Long Oil trade with a 38.1% profit.
[3] We are initiating a new Buy U.S. High-Yield Corporate Bonds trade with a rolling -5% stop loss.

Alpine Macro, founded in 2017, is an independent global investment research firm based in Montreal, Canada. We focus on the analysis of major macro economic forces and specialize in forecasting the direction of global financial markets, while providing actionable recommendations on investment strategy and asset allocation.

Our Leadership

Chen Zhao, Founding Partner and Chief Global Strategist From 2015 to 2016, Chen was Co-Director of Macro Research at Brandywine Global Investment Management. Prior to Brandywine Global, Chen spent 23 years at BCA Research. As a Partner, Managing Editor and Chief Global Strategist, Chen developed and wrote BCA's China and Emerging Markets publications in the 1990s. Chen became the firm's Chief Global Strategist in the 2000s and was the author of BCA's flagship publication, Global Investment Strategy from 2005 to 2015. He holds an MA in economics from the Central University of Finance and Economics, was a visiting scholar at the University of Illinois at Urbana-Champaign and pursued post graduate studies with a PhD candidacy at McGill University.

J. Anthony Boeckh, PhD, Founding Partner, CEO & Editor-In-Chief Tony was previously Founder, Chairman, Chief Executive and Editor-In-Chief of Montreal-based BCA Research for 34 years. He authored The Great Reflation (Wiley) in 2010 and was publisher of, among others, the Bank Credit Analyst, a monthly big-picture analysis of the U.S. and global economies and financial markets. He is a founding trustee of the Fraser Institute in Vancouver, British Columbia — an economic "think tank" dedicated to free market principles. Tony has a PhD in Finance and Economics from the Wharton School, University of Pennsylvania, and a B.Com. from the University of Toronto.

David Abramson, Partner, Chief U.S. Strategist & Director of Research Prior to joining Alpine Macro, David was a Macro Strategist holding a variety of senior roles at BCA Research. Most recently, he was Chief U.S. Strategist and also Director of Research for the firm. During his 28 years at BCA Research, David launched and managed the European Strategy and Commodity & Energy Strategy services. In addition, he was the Managing Editor for the Foreign Exchange Strategy and the China Investment Strategy services. He has taught international finance to MBAs at McGill University for 20 years, and is on the Client Committee of the Kenneth Woods Portfolio Management Program at Concordia University.

Yan Wang, Partner and Chief Emerging Markets and China (EMC) Strategist Prior to Alpine Macro, Yan spent 15 years at BCA Research, as Managing Editor and Chief Strategist for BCA's China Investment Strategy service, and played a major role in formulating BCA's view on the Greater China region and emerging Asia. Prior to joining BCA, he spent six years as an equity analyst in China and Hong Kong. Yan holds an MBA in Finance from McGill University, an M.A. in Economics from Tianjin Institute of Finance and a B.A. in Finance from Nankai University. He also holds the CFA designation.

Harvinder Kalirai, Partner and Chief Fixed Income & Currency Strategist Before joining Alpine Macro, Harvinder spent a decade with BCA Research, where he headed the firm's Foreign Exchange Strategy service from 2008 to 2016 and Daily Insights from 2016 to 2018. Prior to BCA, Harvinder was Head of Currency Management at CIBC Global Asset Management. Previously, he held various positions at State Street Global Markets, including Senior Macro Strategist (London), Head of Currency Research, Asia-Pacific (Sydney), and Senior FX Strategist (Boston). Harvinder began his career at the Bank of Canada in 1995 with an MA (Economics) and a BCom (Finance) from McGill University. He also holds the CFA designation.

