A Unique Mind On The Markets

SPECIAL REPORT

April 27, 2020

Looking For The Next Big Themes

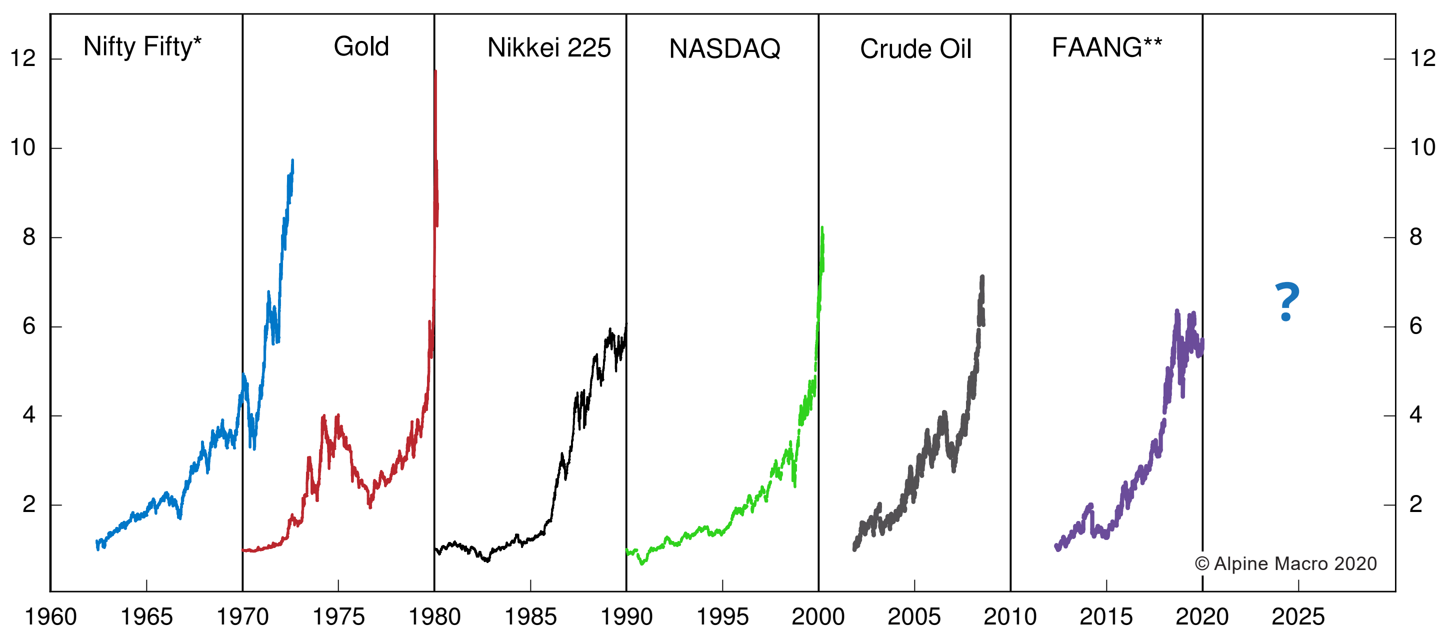
Each decade over the past century, global financial markets have always been dominated by one or two major economic themes and investors could have reaped huge financial rewards simply by getting just one of these major themes right, and investing accordingly.

Not only have these themes shifted from one decade to the next, they have almost always come as total surprises. Therefore, it is never easy to get them right in advance. Nevertheless, it is always a useful exercise for investors to think about and reflect on the long-term big macro stories when making investment decisions.

Decades In Recap

Chart 1 illustrates some examples of the past decades.

Chart 1 Each Decade Has Been Dominated By One Key Investment Theme



Note: All series are deflated by U.S. CPI and rebased to 1 at the starting period
*Equally-weighted index of Coca-Cola, Disney, GE and IBM
**Market-Cap weighted average of Facebook, Amazon, Apple, Netflix and Google

- In the 1960s the big winner was Nifty-Fifty stocks in the golden era of "economic go-go years";
- In the 1970s the winner was commodities and gold on rising inflation and a falling U.S. dollar;
- In the 1980s it was Japanese equities on the "Japanese Economic Miracle";
- In the 1990s it was the NASDAQ index on the internet revolution;
- In the 2000s it was commodities and oil on the "China Miracle";
- Last decade the big winner was FAANG stocks.

What could be the big winner for this decade? The answer to this question must start with the broad macro economic and policy backdrop that will likely prevail in the coming years.

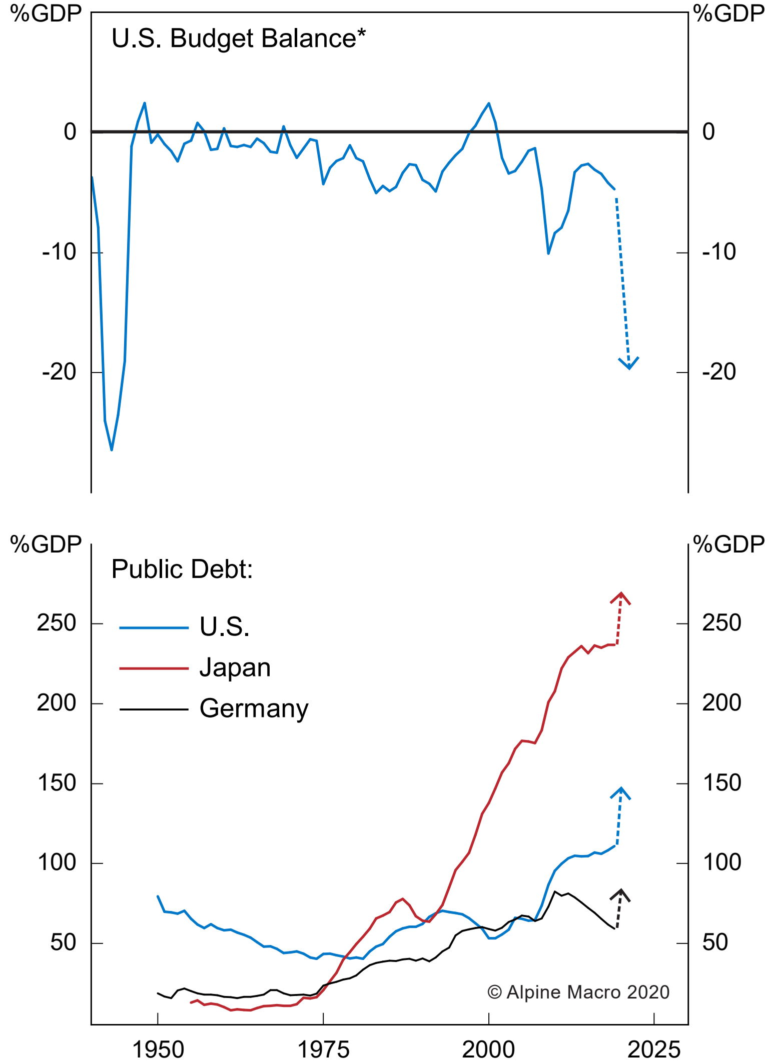
Legacies Of COVID-19

The COVID-19 crisis could prove to be the most important shock to the global system this decade, and it will probably take years for the legacies of the COVID-19 crisis to fully make themselves known and felt. In our view, the pandemic will at least leave several important legacies for the world.

First, governments of major nations have doled out more than $12 trillion to rescue their economies and fight the pandemic, and this will drive fiscal deficits to unprecedented high levels (Chart 2).

At present, it is uncertain how governments will unwind these fiscal imbalances in the coming years, or whether they will unwind them at all. Whatever the case, the economic and financial consequences will likely be borne out in this decade.

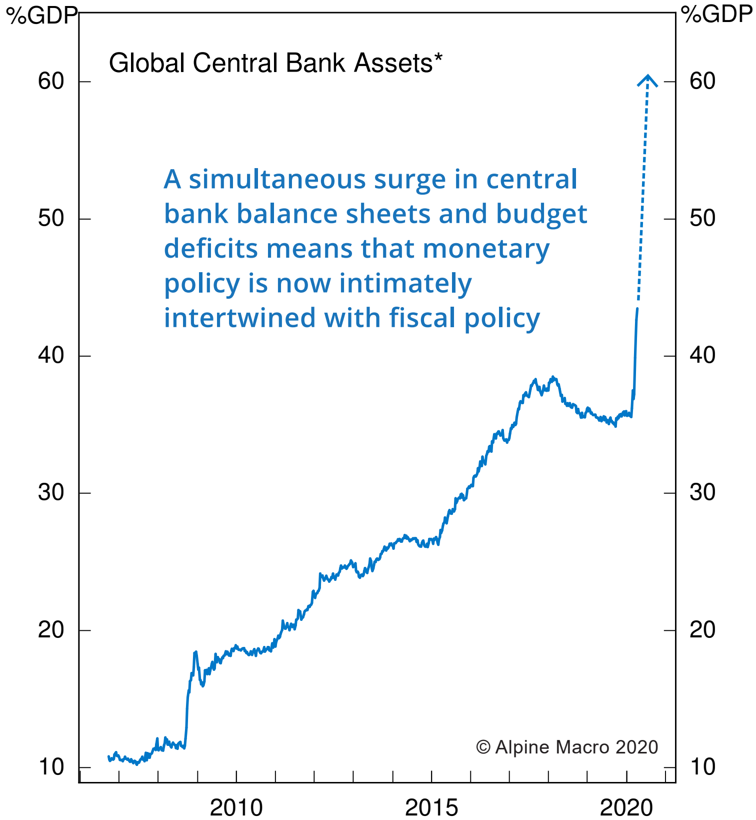
Chart 2 Public Sector Deficit And Debt Will Escalate To Unprecedented Levels



Note: Dotted lines denote Alpine Macro's projected values

The second is the unprecedented levels of central bank balance sheets around the world (Chart 3). This is nothing new: we saw how central bank balance sheets exploded following the 2008 Global Financial Crisis (GFC). What's new is the magnitude and nature of central bank policy actions.

Chart 3 Central Bank Balance Sheet As A Share Of GDP



*Sum of Fed, ECB, BoJ and BoE

Both the Fed and ECB have slid down the quality ladder. The Fed is buying commercial paper, corporate investment grade and junk bonds, and providing loans directly to businesses. The ECB has recently began taking "fallen angels" as collateral from banks for loans.

A decade ago, the investment world all laughed at the Bank of Japan (BoJ) when the central bank began to buy corporate bonds and common stocks. Today, the rest of the developed world has moved in the same direction, with central banks being compelled to also function as commercial banks by extending loans directly to the economy, but with unlimited balance sheets.

In a nutshell, the new trend is that monetary policy is now intimately commingled with fiscal policy in order to be effective. This suggests that Modern Monetary Theory (MMT) has been already applied by authorities around the world.[1]

Third, the 2011/12 eurozone debt crisis decimated southern eurozone economies, leaving a huge scar on the common currency regime. The COVID-19 crisis is the second major blow on the eurozone in less than 10 years, and could become a game changer for the common currency system.

The COVID-19 pandemic has greatly deepened the yawning divide between the eurozone's northern and southern members. The rejection by Germany and the Netherlands of the proposed joint "Coronabond" issuance will be read as an open snub at the financially strained southern members (**Chart 4**).

Worse still, the rebuke was delivered at a time of a massive health crisis, staggering economic losses and tragic human suffering in Italy, Spain and Portugal. It prompted French President Emmanuel Macron to give a stark warning that the EU could unravel unless it embraces financial solidarity.

Regardless of what Brussels will ultimately do, the COVID-19 crisis will cast a long shadow over the sustainability and integrity of the common currency regime.

Fourth, the 2008 GFC has spun public anger towards Wall Street and the political establishment, leading to a rise in political polarization, populism,

1 Alpine Macro *Special Report* "The Long And The Short Of MMT" (May 27, 2019).

Chart 4 Southern European Bonds Under Siege Again

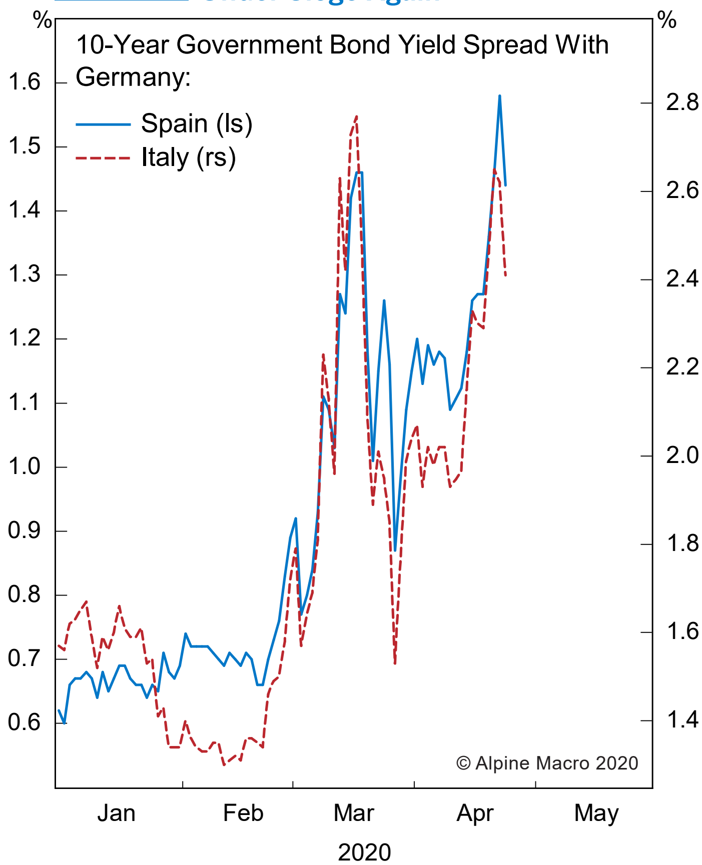
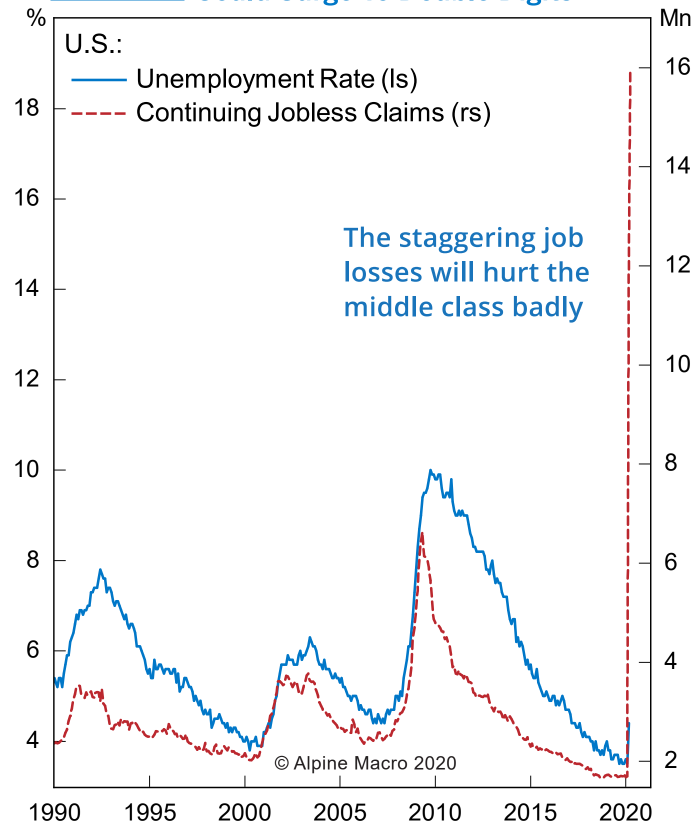


Chart 5 U.S. Unemployment Rate Could Surge To Double Digits



nationalism and racism around the world. The COVID-19 crisis will greatly exacerbate these trends, causing potential social instability in the future.

The pandemic has hurt the "little guy" – minorities and inner-city families – much worse than others. The lower middle-income class has suffered the largest job losses, with over 60% of laid-off workers not having the option to "work from home" (**Chart 5**).

In addition, the 32 million Americans without health insurance are probably hurt more than others by the viral infection. Any post-mortem of the COVID-19 pandemic could reveal that this group may have suffered a disproportionately larger share of infections or even mortalities.

The acute economic plight will likely bring to bare many contentious and potentially explosive issues on social justice, income inequality and fairness of economic policy.

It is difficult to predict precisely how or where these issues will lead us to, but the rising trend in political radicalization and populism will likely intensify in the post COVID-19 world.

Finally, the China-U.S. rivalry will escalate. The crisis has spurred strong China-bashing among U.S. politicians as Trump tries to find a scapegoat for America's high mortality rate and large number of infections. A recently leaked memo by the National Republican Senatorial Committee reveals that Brett

O'Donnell, a top Republican strategist, is advising GOP candidates to address the COVID-19 crisis by aggressively attacking China.

But nationalism is also on the rise among the Chinese who view America as an imperialist power that is trying to undermine China's economic rise and bully them into submission. President Xi Jinping espouses the populist inspiration of the "Chinese Dream," which in essence is not much different from Trump's mantra of "Making America Great Again".

In short, the two economic giants will be on a collision course on multiple fronts this decade. More confrontation and less cooperation will characterize Sino-U.S. relations in the post-COVID-19 world.

Deflation Or Inflation?

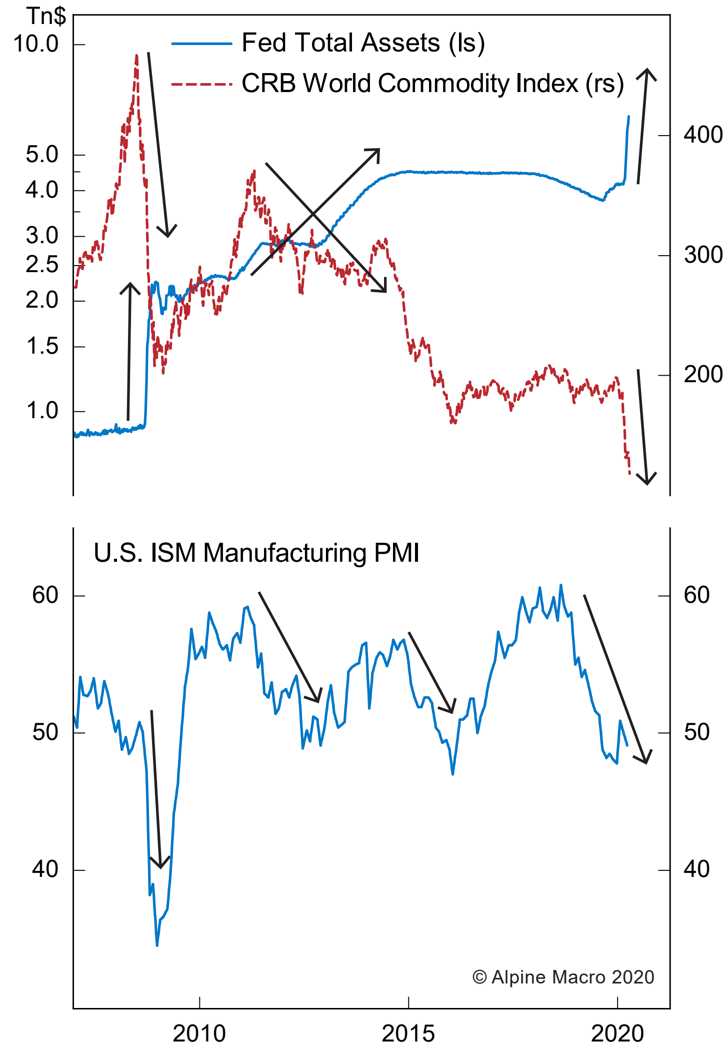
From an economic point of view, all discussions will boil down to a single key question: Are we heading toward an outbreak of rising inflation in the post-COVID-19 environment, or are we dealing with a more deflationary world this decade? Our answer is, more deflation first and a possible return of rising inflation later.

First, are huge increases in budget deficits in the developed world inflationary? The answer is no.

Budgetary outlays during economic recessions represent one-time increases in public sector demand. So long as these stimulus programs and packages are non-recurring, they do not create continuous demand, and thus have no lasting impact on inflation or economic growth.

The more relevant question is: What happens when the authorities begin to pull the proverbial rug out from underneath the economy?

Chart 6 Fed QE Programs Are Associated With Whiffs Of Deflation



Ideally, the government should withdraw stimulus at a speed resembling the pace of private sector recovery. In reality, this is easier said than done. Pulling out support too soon or too fast will put the economy at risk, but doing so too slowly or too late would risk a temporary spike in inflation.

In reality, no one can exit at the "proper" pace, but past experience shows that policymakers almost always withdraw support too early, causing undue market volatility and economic weakness, adding to deflation risks.

Japan has tried many times to normalize policy, only to find itself sink deeper in deflation. The Fed has had its own fair share of premature moves, leading to the "taper tantrum" in 2013, commodity collapse in 2015 and a 20% crash in stock prices by the end of 2018.

All of this suggests that investors should be very careful about rising economic risks, especially when the pandemic starts to fade, and policymakers prepare to exit from the current policy setting.

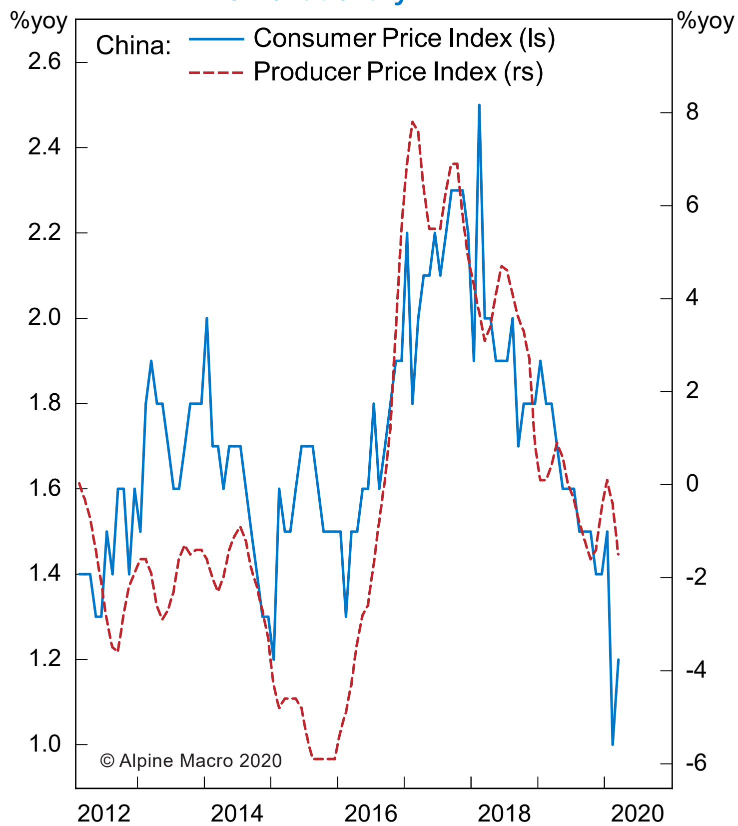
Second, how about central bank balance sheets? Will the bloated central bank balance sheets lead to rising inflation? There is no proven link between central bank QE and inflation either. Since the 2008 GFC, the large increases in central bank balance sheets have mostly coincided with intensifying deflationary pressures in the global system, rather than with rising inflation or a strong economy (**Chart 6**).

When interest rates fall to zero, the size of a central bank's balance sheet is relevant only with regard to the creation of free reserves – not how much aggregate demand can be generated. Whether commercial banks will use the newly increased reserves to make new loans is not up to the central bank to decide at all.

Further, a central bank is forced to use QE to fight against economic weakness or rising deflationary risk – the key reason why QE, or the central bank balance sheet, is associated with rising deflationary pressures.

Third, the COVID-19 crisis has created a huge output gap in the global economy and it will take some time for most countries to climb out of this large hole.

Chart 7 **China : The COVID-19 Crisis Is Deflationary**

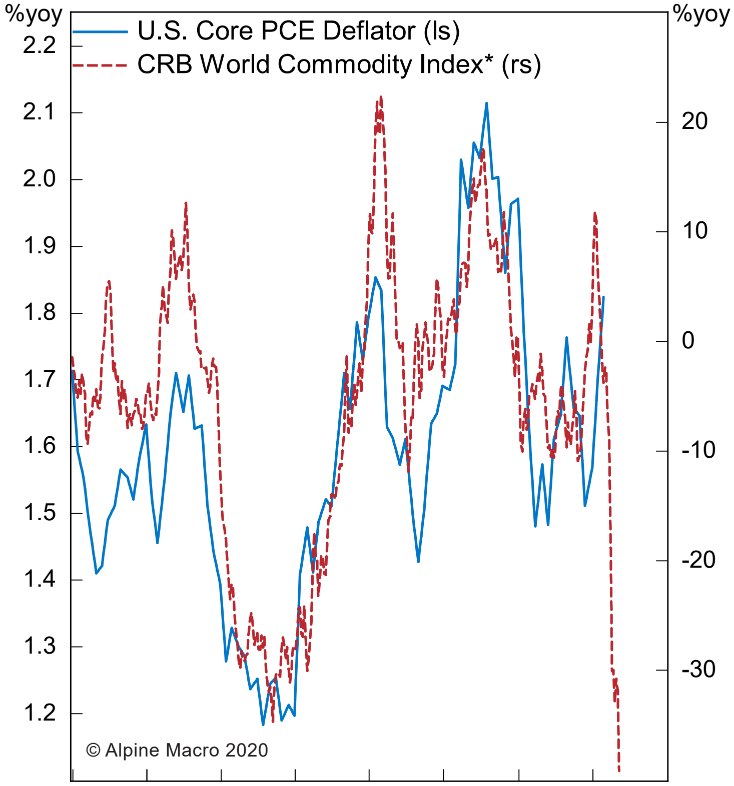


Importantly, the Chinese experience is that, while the capacity utilization of suppliers can be ramped up quickly, demand returns much more slowly and prices are pressured downward (**Chart 7**).

Finally, the recent sharp fall in commodity prices, oil in particular, will create a strong whiff of deflation across the world. **Chart 8** shows that the last time the CRB index had a similar drop was in 2008, leading to a dive in U.S. core PCE inflation about three months later.

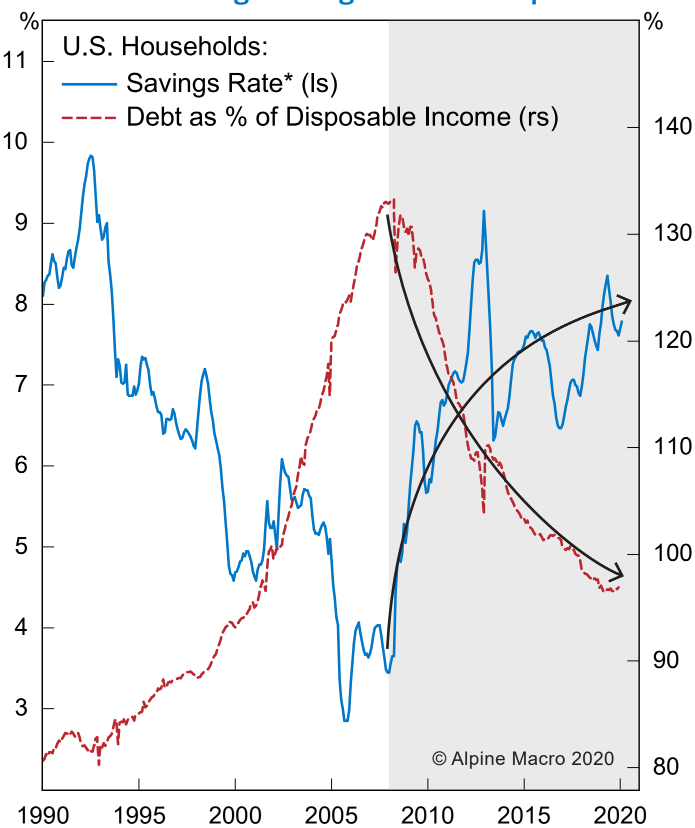
We expect that the core PCE deflator could drop to fresh lows on the current deep economic freeze, negative crude oil price and the staggering loss in consumer incomes (and demand).

Chart 8 U.S. Core PCE Inflation Will Crash



*Advanced by 3 months

Chart 9 The 2008 GFC Has Produced Long-Lasting Economic Impact



*Shown as 6-month moving average
Note: Shaded area denotes post-2008 GFC era

Our projection is that U.S. core PCE inflation will fall to below 1% by the end of this year, the eurozone will see mild deflation, and that COVID-19 will torpedo Japan's effort to re-inflate its economy, causing CPI there to fall again.

All of this means that central banks will be forced to stay hyper-accommodative over the next 12-24 months.

A Mid-Decade Transition?

There is a case to be made that the world economy will slowly transition away from a highly deflationary setting and move into a more inflationary environment, probably around the middle of the decade.

First, the COVID-19 crisis is a natural disaster, which means that the full recovery in the global economy is a function of when a vaccine or effective drug therapy can be made widely available to the public.

This is very different from a financial crisis, which often produces long-lasting economic or financial consequences. For example, long after the 2008 GFC ended, American consumers were forced to deleverage (**Chart 9**), and badly damaged banks were reluctant to lend. Even today, American households are still saving more to pay down their debt.

Although the COVID-19 crisis has punched a large hole in GDP, it has so far inflicted limited damage to the financial system. **Chart 10** shows that U.S.

Chart 10 U.S. Bank Assets Are Surging Along With Fed Balance Sheet

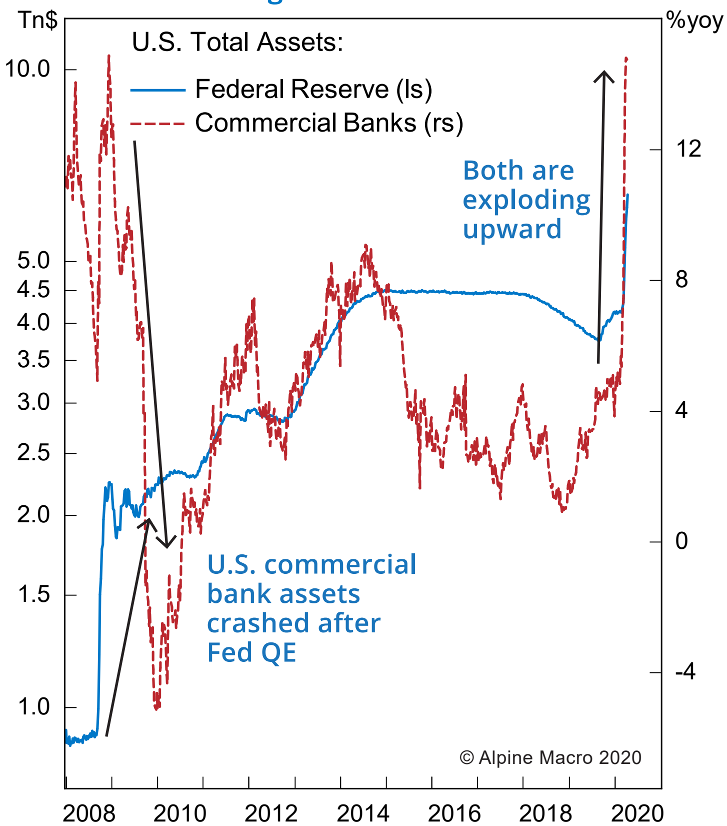
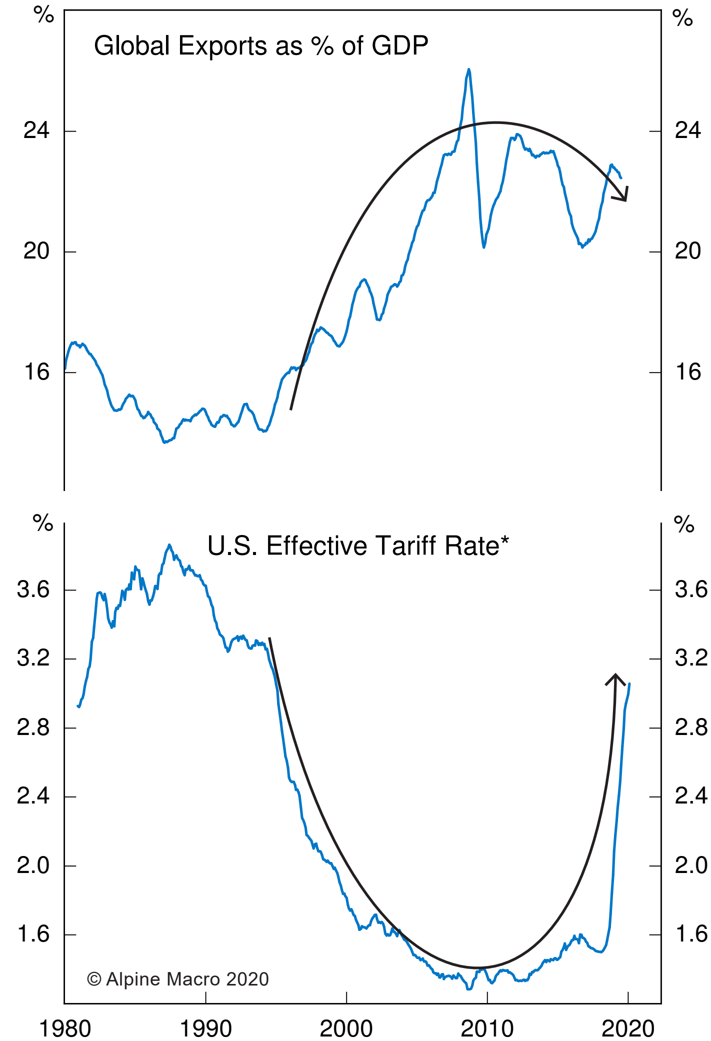


Chart 11 Retreat Of Globalization



*Total government tariff revenues divided by imports

commercial banks are pushing out loans at a record pace — a very different experience from the 2008 GFC when total commercial bank assets collapsed even after the Fed sharply increased its balance sheet via QE.

Of course, the rapid credit expansion by commercial banks is largely underwritten by the Fed balance sheet. Nonetheless, money and credit are pushing into the economy, causing broad money and credit to shoot up quickly. This is a different experience from the 2008 GFC, with unknown economic consequences.

Second, the COVID-19 crisis will hasten the retreat of globalization. The Sino-U.S. tariff war before the COVID-19 pandemic already had a negative impact on global trade, contributing to its rapid contraction (**Chart 11**).

The acute shortage of respirators and medical supplies in Europe and the U.S. during the COVID-19 pandemic will be used by trade protectionists to sharpen their argument of onshoring manufacturing businesses, potentially triggering a wave of production and capital repatriation.

Should higher tariff rates and rising nontrade barriers become a global phenomenon in the next several years, economic stagflationary pressures will likely rise.

Third, Elizabeth Warren and Bernie Sanders represent a populist movement from the far-left. Their influence and substantial political support should not be ignored, regardless of who wins the upcoming election.

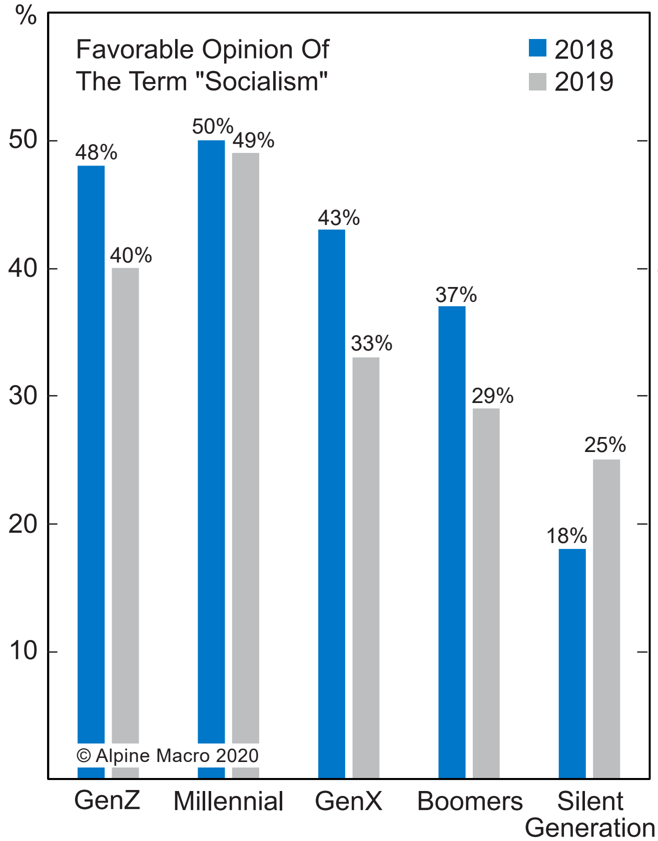
Chart 12 shows that a large portion of American millennials favor socialism today and they will influence U.S. politics and policy well into the future. It is not inconceivable that the American electorate swings towards the far-left, after having tried Trump's version of a far-right economic agenda.

It is possible, and even likely, that future administrations will use MMT to justify more government handouts, subsidies, new entitlements and other goodies. This type of spending and programs create permanent demand out of thin air and therefore are inflationary by nature.

Last but not least, we suspect that future U.S. administrations will face the old "gun versus butter" dilemma, a popular expression in the 1960s when former President Lyndon Johnson not only tried to preserve and expand Great Society Programs, but also engaged in an arms race with Russia and fought the Vietnam War.

The U.S. has enjoyed absolute military dominance since the collapse of the Soviet Union in the early 1990s, and this dominance has been achieved in large part through maintaining a huge defense budget, which is bigger than total defense spending for the next-largest 10 countries combined.

Chart 12 American Millennials Favor Socialism

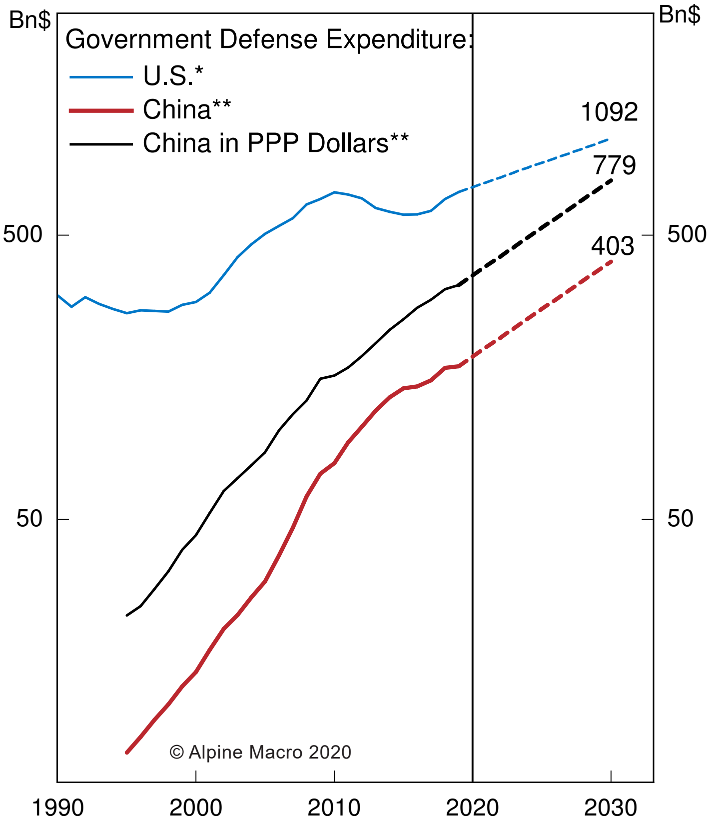


Source: Victims of Communism Memorial Foundation

The only country that could amount a credible challenge to America's military supremacy, at least in regional terms, is China. China's defense budget for 2019 was $173 billion, or 1.2% of GDP, while defense outlays for the U.S. were $710 billion. After adjusting for purchasing power parity (PPP), China's defense spending is around $334 billion, or 47% of America's.

If China's nominal GDP growth rate is projected to be around 7.5-8%, down from 9.5% in the last decade, and the U.S. economy grows at 4% per

Chart 13 Defense Spending: China Vs U.S.



*Projections based on 4% annual growth
**Projections based on 8% annual growth

year nominally, the gap between the two countries' defense spending will shrink significantly by the end of the decade, unless the U.S. jacks up its defense budget sharply (Chart 13).

It should be noted that America's defense expenditure as a share of GDP was 8.6% during the Vietnam War in the 1960s. It was 5% in the 1970s when the U.S. was in an arms race with the Soviet Union. Today, the U.S. spends 3.6% of GDP in defense.

We suspect that anything beyond 5% in defense spending could prove to be unsustainable and inflationary in the longer run, especially given that there are already large sums committed to many entitlement programs, which will grow to 8% of GDP because of an aging population, according to CBO.

In other words, there may be limited non-inflationary resources for future administrations to sharply increase military spending. Nevertheless, the U.S. may have to raise defense budget anyway in order to maintain military supremacy over China in the coming years, risking a return of rising inflation.

Possible Winning Candidates

Before you read on, please keep in mind that the big winner in each decade has always come as a total surprise. Therefore, by definition, our projection must be speculative in nature with a high degree of subjectivity. Several ideas are in order:

Gold

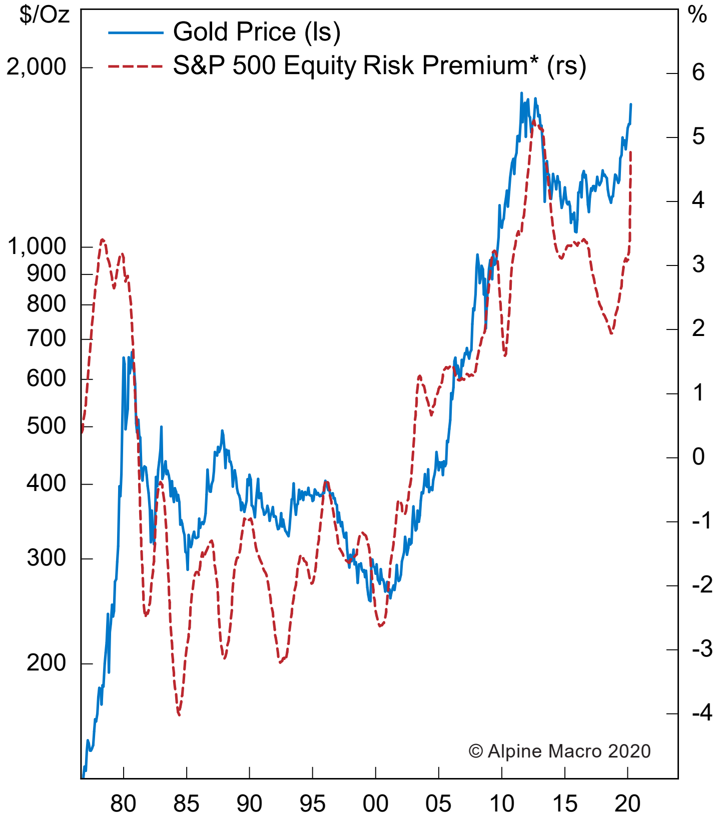
Gold holds the promise of being a major winner this decade for a few possible reasons. Gold is always regarded as a safe-haven asset and tends to thrive on economic turbulence, policy uncertainty and rising economic volatility.

With government bond yields compressed to nothing, gold could thrive on a sustained surge in hedging demand. Chart 14 shows how gold prices have behaved over the past several decades along with the ebbs and flows of the U.S. equity risk premium.

It is possible that the equity risk premium will stay high, given the monetary, fiscal and geopolitical backdrop. Unwinding monetary and fiscal imbalances is a risky endeavor, as evidenced by the post-2008 GFC experience.

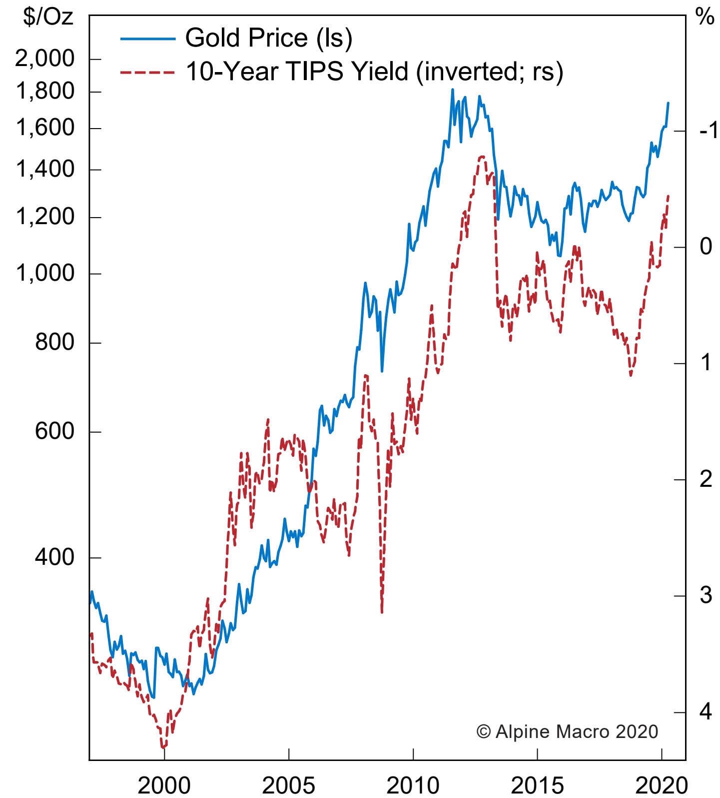
We saw last year how trade wars can upset stocks and cause gold prices to soar. America's upcoming

Chart 14 Gold Vs Equity Risk Premium



*S&P 500 current earnings yield minus 10-year Treasury yield; shown as 12-month moving average

Chart 15 Gold Is Closely Correlated With Real Bond Yield



confrontation with China will be significantly worse than what we went through during the most recent tariff war.

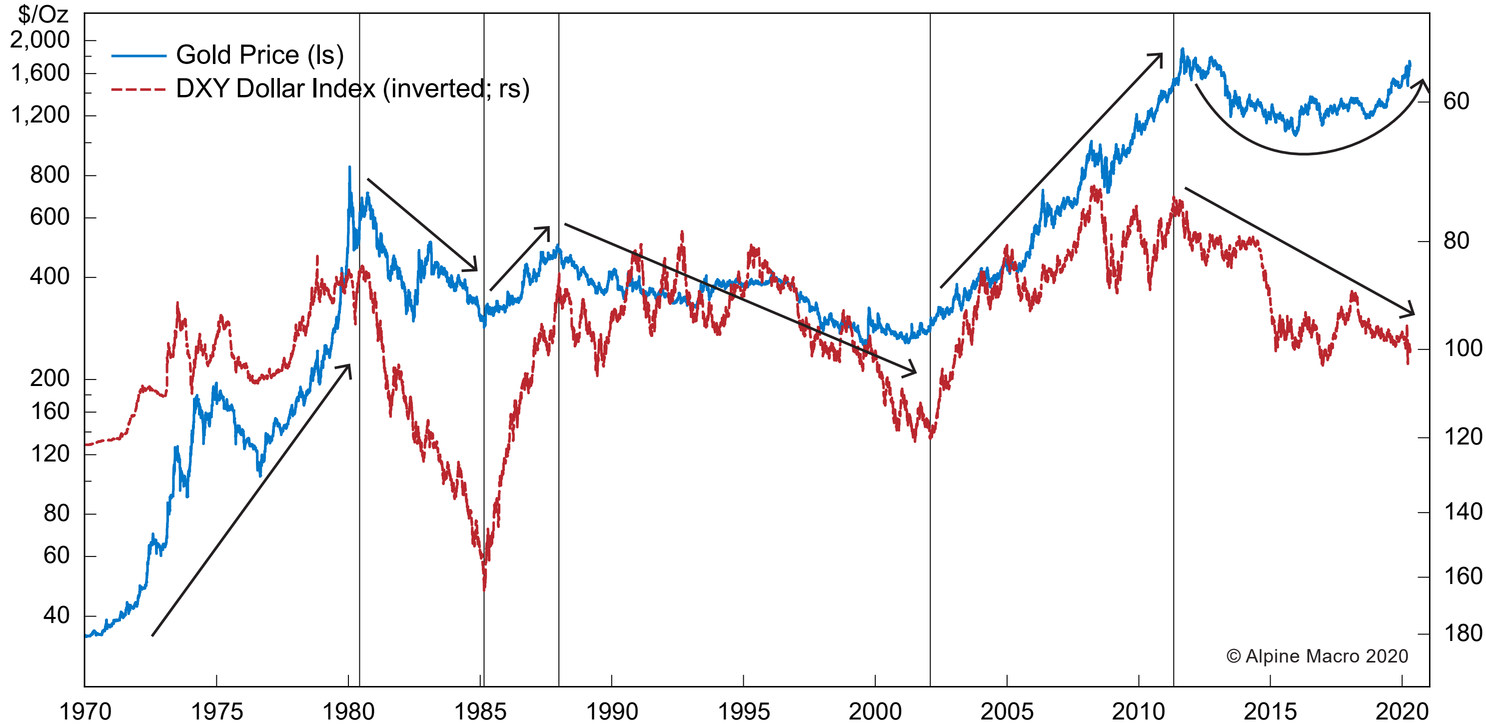
Moreover, in a world of zero interest rates, the main channel through which monetary policy can impact aggregate demand is the currency market. Therefore, competitive devaluations could become a recurring phenomenon as major economies battle against slow growth and increasing deflationary pressures.

The problem is that with a floating exchange rate regime, when all central banks are trying to devalue *via* QE, no currency will be devalued. However, gold as a quasi-monetary standard will likely be revalued higher relative to all fiat money.

Further, there is a clear correlation between rising gold prices and falling real Treasury bond yields (**Chart 15**). Interest rates and long bond yields will stay low for an extended period, even after the COVID-19 pandemic fades away. Central banks around the world will likely use negative real interest rates to heal a badly wounded world economy. Gold will likely benefit.

Finally, the long-term trend in gold prices suggests that gold tends to thrive on a weakening U.S. dollar. **Chart 16** shows how gold price fluctuations have largely keyed off the DXY since the 1970s. Nevertheless, it seems that the negative correlation between the two has broken down since 2018, when the dollar stayed strong but gold prices broke out.

Chart 16 Gold Vs Dollar: Negative Correlation Until 2018



The bullish interpretation of the diminishing impact of the U.S. dollar on gold prices is that a range of other factors such as real rates, central bank QE and the equity risk premium are becoming more important than the DXY in setting the price of gold. Of course, should the dollar weaken in the future, it would make gold prices even stronger.

Continuation Of The Last Theme

It is interesting to note that previous recessions were always provoked by financial crises, and as such, each bear market/recession always brought about leadership change in the U.S. stock market.

Chart 17 shows that the bursting technology bubble led to a prolonged period of underperformance of growth stocks versus value, and the 2008 GFC broke the back of bank stocks for over a decade.

The COVID-19 recession comes from a natural disaster, and most likely proves to be a transitory shock. If so, the old theme and trend of a relative bull market in growth stocks may continue.

FAANG stocks have been the big winner since the end of 2008, and it is not impossible that the next big winner will emerge from a similar theme.

Of course, the biggest winner may not necessarily be the same group of stocks such as FAANGs. **Chart 18** shows that the Information Technology (IT) index has risen sharply relative to the broad market since 2014, suggesting that the bull market in IT stocks has returned.

The pharmaceutical, biotech & life science (PBL) sector could emerge as a new winner. The PBL index is flirting with new highs. With so much money pouring

Chart 17 Financial Crises Often Change Equity Leadership

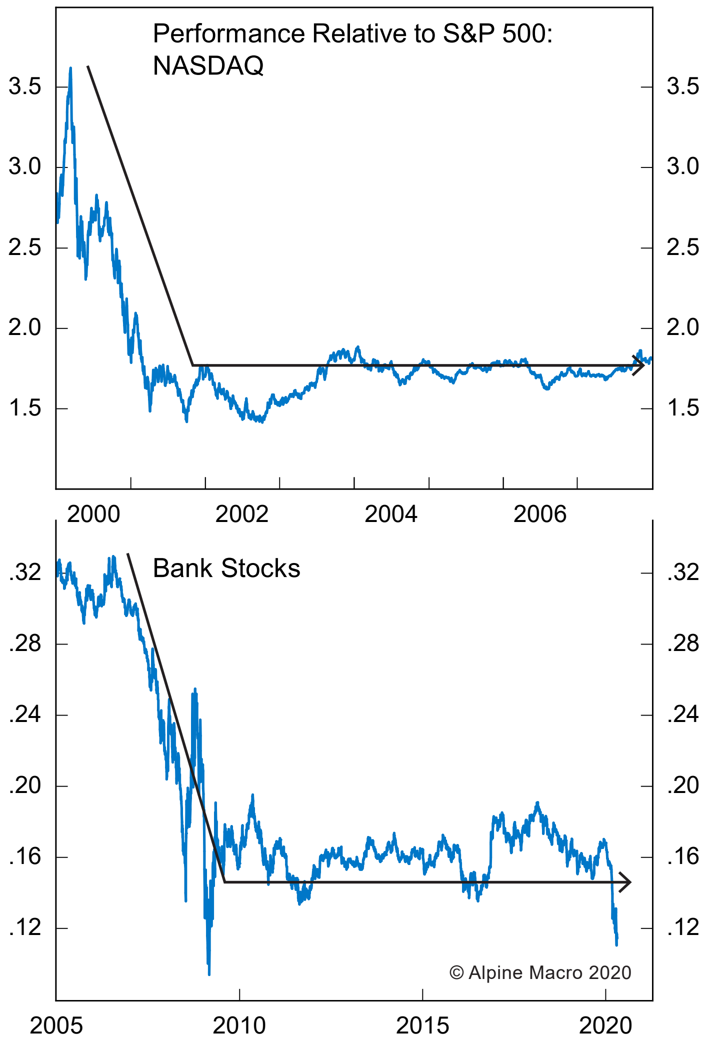
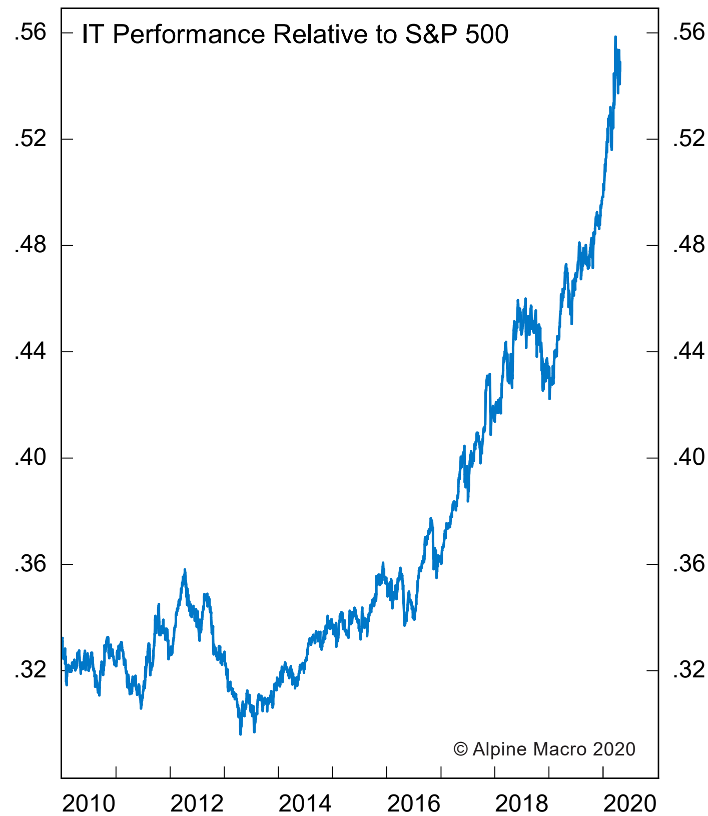


Chart 18 Bull Market In IT Stocks Has Returned



into COVID-19 drug and vaccine research, this sector could emerge as a major winner.

COVID-19 will change government thinking for every country. If a nation spends 1-2% of GDP a year in defense to prepare for a war or conflict, it should spend at least the same amount or more to increase preparedness for another pandemic. If so, the PBL sector will be a primary beneficiary.

Another growth theme could revolve around 5G. When the world moved from 3G to 4G LTE, it was about faster connections. The evolution to 5G is so much more. The combination of speed, responsiveness and reach could unlock full capabilities of other hot trends in technology, offering a boost to self-driving cars, drones, virtual reality and the internet of things.

Candidates For Total Surprises

The big winner each decade almost always comes as a total surprise to the investment community. No one would have ever thought that technology stocks would have emerged as the big winner from the 1990 S&L crisis.

Similarly, in the late 1990s when oil prices crashed to less than $10 a barrel, no one would have ever dreamed that commodities would boom in the following decade. In this vein, it is useful to ask: What market moves might be a total surprise to most investors?

Crude could be a candidate, especially with WTI spot prices crashing to negative territory. But with electric cars becoming increasingly popular, demand for crude oil could be structurally constrained. Nevertheless, it may not be far-fetched to think other industrial commodities could boom under the following conditions:

- An unexpected post COVID-19 economic boom;
- A prolonged period of supply cutbacks and under-investment in the mining sector;
- Copper demand could go through an unexpected surge as electric cars rapidly replace combustion engines;
- After a decade-long bull market, the dollar finally starts to go down.

With the exception of under-investment in mining, none of the above trends are obvious at all and thus would be a surprise to the market if some or all elements fell into place.

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	–	–	9.8%
Long Defensive Basket[1]	2/24/2020	–	–	–	10.6%
Short 10-year German Bunds Hedged	3/2/2020	-0.627	–	–	1.0%

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%	-	-	-1.8%
Long AUD/CAD[2]	4/6/2020	0.86	Rolling -1%	-	-	4.7%
Buy U.S. High-Yield Corporate Bonds (ETF: JNK)[3]	4/13/2020	100.41	Rolling -2%	4/21/2020	98.4	-2.0%

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 are tightening stops on the Long AUD/CAD trade to a rolling -1%.
[3] We stopped out of the long U.S. High-Yield Bond trade with -2% stop loss on 4/21/2020.

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.

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