GLOBAL STRATEGY

May 4, 2020

How To Square The Circle?

In our live *Webcast* last Thursday, my colleague Dave Abramson and I made the case that stock prices at current levels are likely justified by the policy support that has been enacted by monetary and fiscal authorities, but many clients still do not believe that this rally has staying power.[1]

To them, earnings will take a massive hit and the economy will only recover very slowly. Otherwise, oil would not have crashed so badly (**Chart 1**). This is not to mention that the U.S. stock market is trading at very high multiples on a very leveraged capital structure. To disbelievers, all of this will come back to roost.

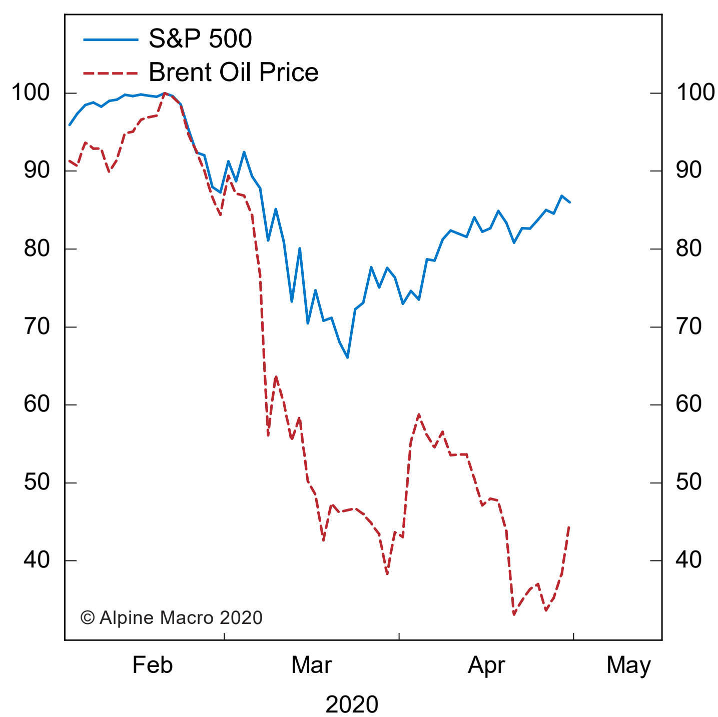
Is The Rally Sustainable?

At first glance, the sharp rally in stock prices since their March lows is profoundly inconsistent with the awful economic reality today: Business activity around the world has imploded as a result of economic lockdowns from Europe to Asia to the Americas. Asset prices should have been way down to reflect this grim reality.

They were in March, but stocks are also forward looking. Unprecedented policy supports, both monetary and fiscal, have stabilized market expectations as they will more than plug the economic hole, thus bridging the gap between the current economic fallout and the expected economic recovery 6 to 10 months out (**Chart 2**).

In fact, a major rally in stock prices almost always occurs when a recession is at its worst spot. This

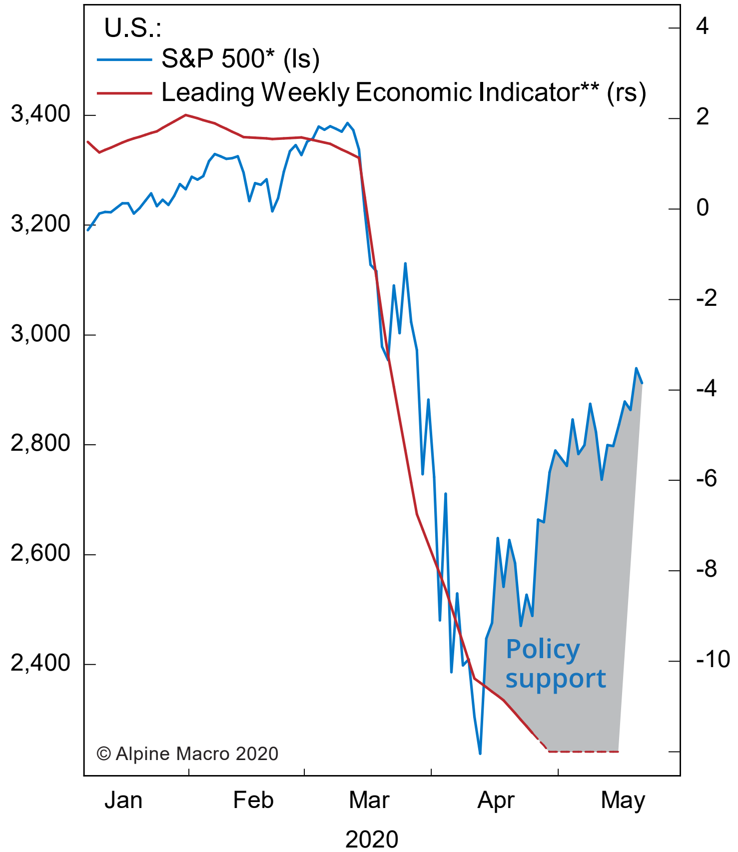
Chart 1 S&P 500 Vs Oil Price



Note: Both series rebased to Feb 19, 2020 = 100

1 Alpine Macro *Webcast* "Oil Crash, Equity Rally And Investment Strategy" (April 30, 2020).

Chart 2 **S&P 500 Vs The Economy: How To Square The Circle?**



*Advanced by 3 weeks
**Source: Federal Reserve Bank of New York, including forecast (dotted line)

was true in the 1990 S&L crisis, the 2001 dot-com bust and the 2008 Global Financial Crisis. Thus, it is not unusual for stocks to rise much earlier than the economy recovers.

Of course, the COVID-19 crisis has caused unprecedented economic contraction and there is always a question whether policy support is enough to fill the economic hole. Our sense is that the fiscal packages launched so far are not only enough to stabilize the economy, but may even over-compensate the actual loss in output.

The U.S. economy produces about US$1.8 trillion in GDP each month, and we know that the overall economy contracted by 4.8% in Q1, which implies that GDP in March was down by 15%. If so, the loss of GDP could be around 50% for April when the economic lockdowns were rolled out in earnest. If partial reopening of the economy begins in May, the net loss of GDP for the month could still be around 15-20%, and the total output loss of the crisis should be about US$1.6-2 trillion, or 7-9% of GDP.

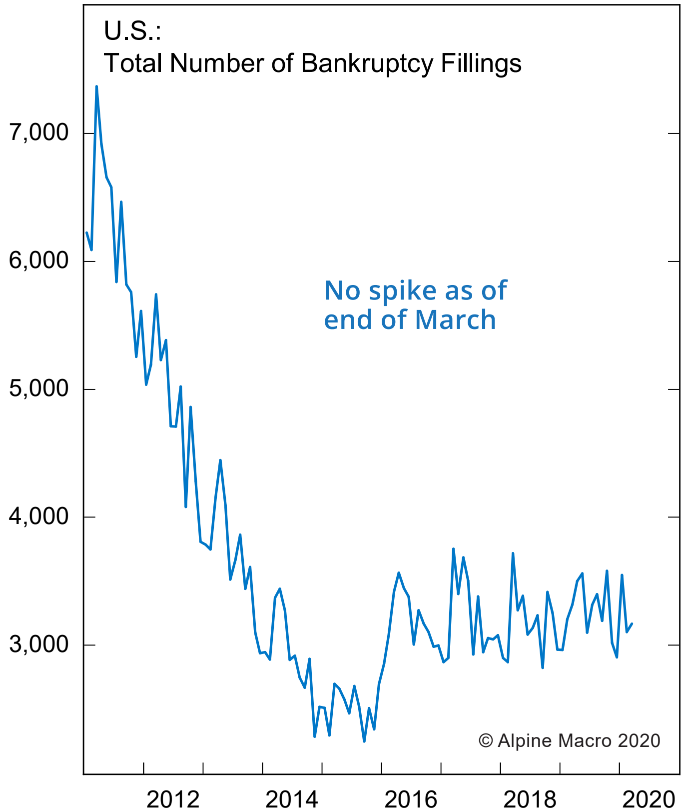
The U.S. government has enacted support packages valued at close to US$3 trillion, which should be more than enough to offset the income loss. It is worth noting that unemployment insurance has been jacked up by US$600 dollars per week for 13 weeks, so the net loss of income for the unemployed could be minimal.

In the meantime, small business loans have kept the majority of firms solvent, and there was no sharp spike in bankruptcy filings as of March (**Chart 3**), although more bankruptcies could be recorded later.

Another interesting statistic: The S&P 500 index began to plummet in late February, and by March 23rd the entire U.S. equity market had lost about US$12 trillion in market value. Since late March, the government has launched US$2.98 trillion in rescue programs, and the Federal Reserve is likely to expand its balance sheet by US$4-5 trillion when all is said and done.

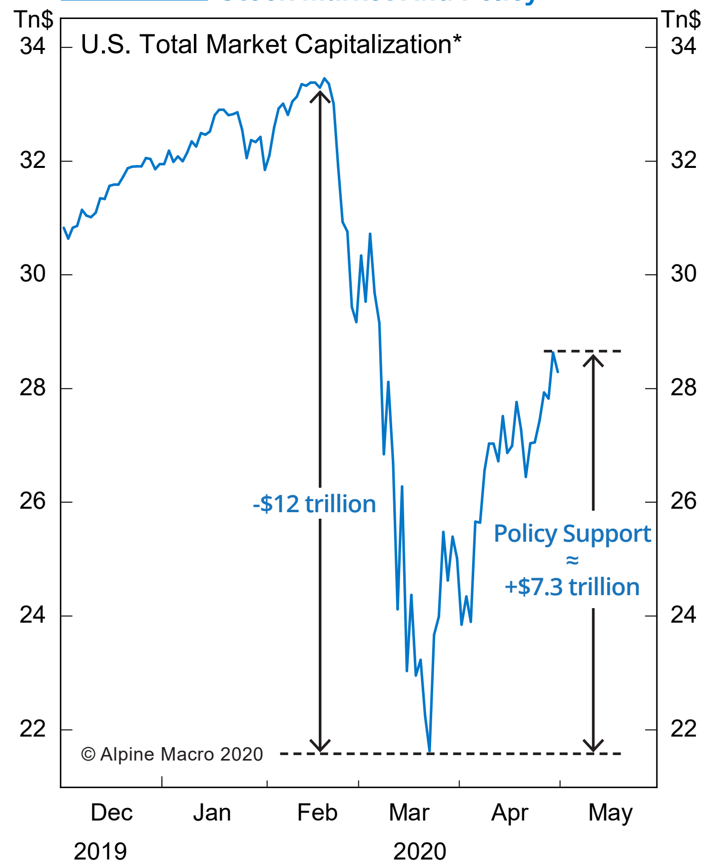
Combining monetary and fiscal expansionary efforts, U.S. fiscal and monetary authorities are pumping over US$7 trillion into the economy, which incidentally is roughly equal to the recovery in total market capitalization, or equity values (**Chart 4**). This could be pure coincidence, but nonetheless it is an intuitive way to think about the interaction between the stock market, policy and the economy.

Chart 3 No Spike In U.S. Bankruptcy Filings



Source: The American Bankruptcy Institute

Chart 4 Interaction Between Stock Market And Policy



*MSCI All-Cap Equity Index

Finally, the front crude contract of the WTI is reflective of what is going on today, not in the future. Moreover, we suspect the oil crash was an exaggerated response to the ongoing economic contraction.

It is entirely possible that America's CARES Act and efforts to save the U.S. energy sector may have kept American oil producers from shutting down production quickly, contributing to the severe oversupply of crude.

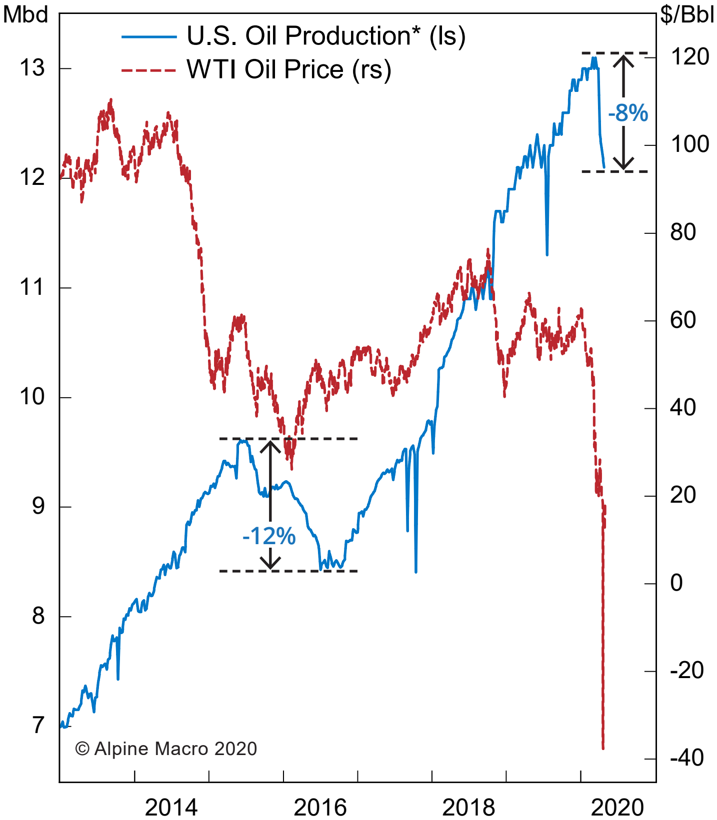
Chart 5 shows that U.S. crude output has barely been cut, despite prices having collapsed to negative levels as a result of surging storage costs. The unique dynamics on the supply side as a result of government bailouts have distorted the price of oil on the downside, thus exaggerating the demand fallout.

Looking For Surprises

Market sentiment and consensus have swung quickly. In March, the investor mood was dark, pessimistic and even apocalyptic, with many prominent investors giving dire warnings. Positive views on markets were brushed aside as "unrealistic," "delusional" and "unfounded bullish bias."

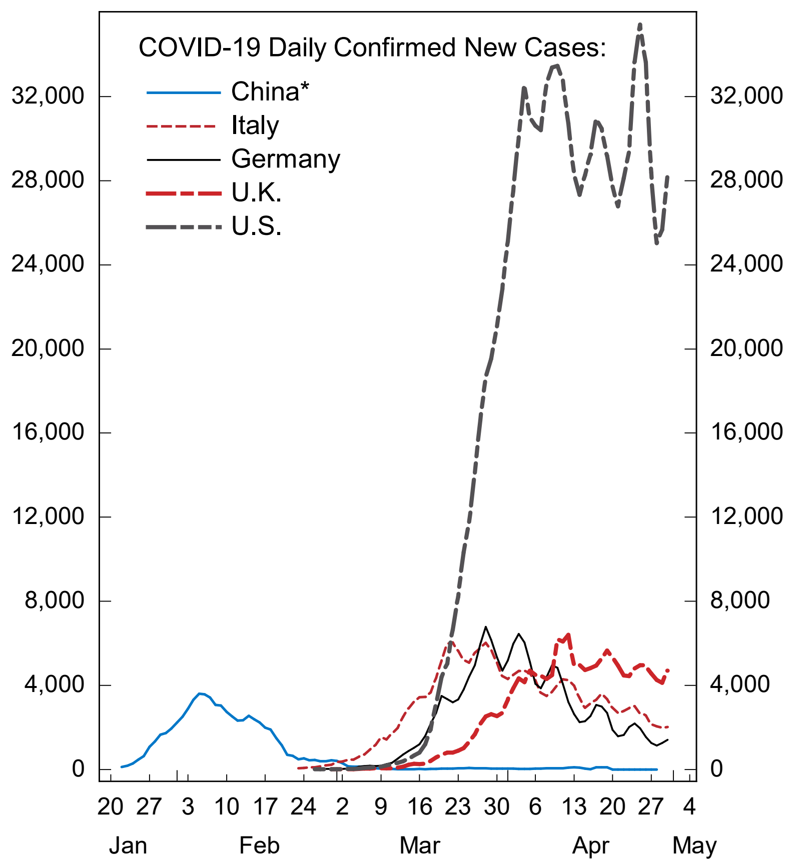
Into the first half of April, when stocks rallied sharply, the narrative changed, with most strategists and analysts anticipating the stock market to either retest the old lows or make new lows.

Chart 5 U.S. Crude Output And Oil Price



*Source: EIA

Chart 6 Are We Ready For Re-opening?



*February 12 & 13 data are adjusted for methodology change
Note: All series shown as 3-day moving averages
Source: China National and Hubei Health Commissions, WHO, Johns Hopkins CSSE © Alpine Macro 2020

With the S&P 500 having rallied 30% off the lows, most strategists seem to have pushed the expected relapse in stocks into the future. The popular narrative today is a "U" shaped economic recovery – a rising risk of a second wave of infections, stock market overvaluation, a potential inflation outbreak, another economic downturn, and so on.

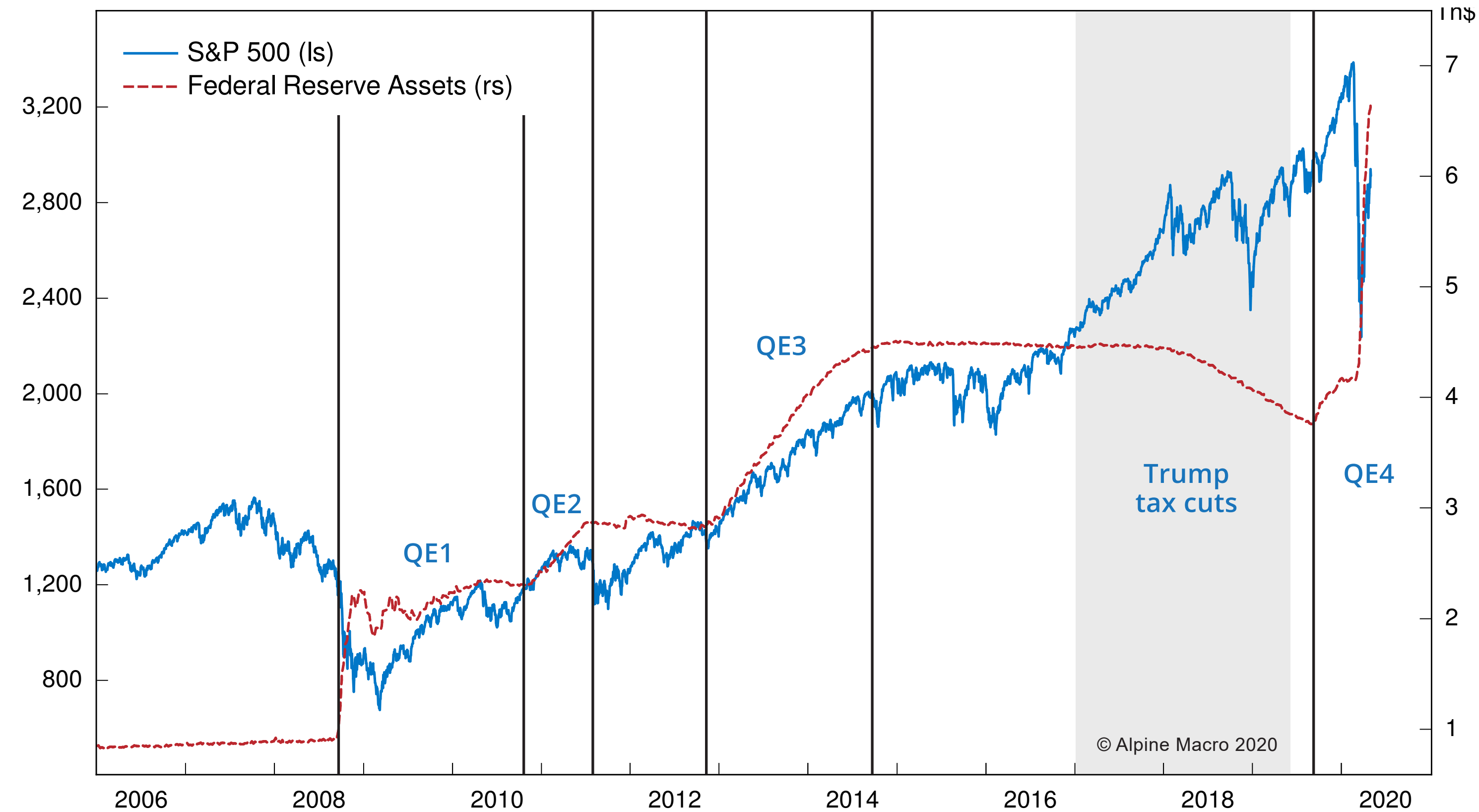
What could be a contrarian bet today, or unforeseen surprises? In our view, investors could be caught off guard by three potential surprises:

The first is a continued advance in stocks. Europe and the U.S. are moving ahead with economic reopening, despite new infections still running at rather high levels (**Chart 6**). This means that policymakers have made a conscious policy choice of reopening the economy while allowing certain levels of infections and mortalities.

In other words, "controlled herd immunity" has become a public policy choice for most Western governments. This is good news for stocks, although not necessarily optimal from a public-health point of view.

We suspect that pent-up demand could be strong, given the prolonged period of lockdowns and self-imposed quarantines across most parts of the world. As such, it is not impossible to see a sharp pickup in

Chart 7 Fed Balance Sheet, Tax Cuts And Stock Prices



economic activity this coming summer. This is not to mention that positive news on the effectiveness of the anti-viral drug remdesivir as a useful medication for treating serious COVID-19 infections could embolden both consumers and businesses, helping the pace of the spending recovery.

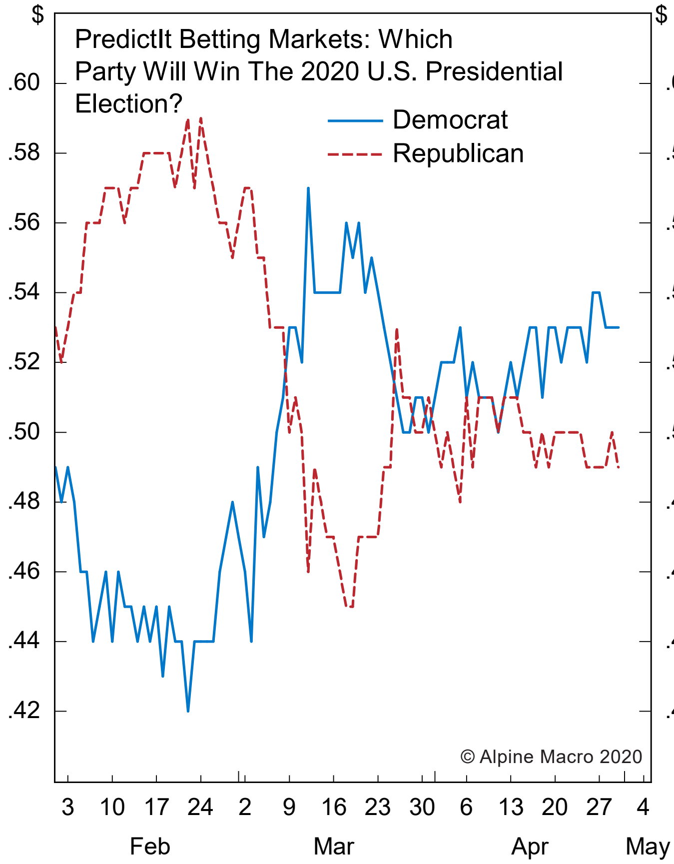
It will take some time for the U.S. economy to return to pre-COVID-19 levels, but this does not necessarily mean stock prices will have to sag again. Stocks and the economy often go separate ways, and this is especially so when there are powerful policy stimuli in the pipeline.

Chart 7 documents how Fed QE programs have become catalysts for strong rallies in stocks since 2008. The only exception is between 2017 and 2019, when the Fed balance sheet shrank, but stocks soared on Trump's tax cuts. Today, both monetary and fiscal policy are running full throttle; the risk is on the side that stock prices could advance at a much faster pace than most anticipate.

The second surprise could be on the negative side. With so many Americans having perished due to COVID-19, debates over Trump's policies and approach in handling COVID-19 will be highly emotional and potentially explosive.

Presidential campaigns on both sides in the months ahead could turn very nasty, toxic and downright dirty very quickly. At present, President Trump's core support has not been seriously undermined,

Chart 8 COVID-19 Has Undermined President Trump's Re-election Chances



even though his odds of wining have fallen since March (**Chart 8**).

It is hard to predict at the moment who will win the election, but a nightmare scenario could quickly develop if the November contest turns out to be very close. Should President Trump lose by a very thin margin, will he lay blame on voter fraud? Trump's fervent supporters could even take to the streets, staging a public revolt. If so, a constitutional crisis could erupt, causing substantial damage to stock prices and the dollar.

Finally, another key risk also on the negative side relates to geopolitics. It appears set that Republican strategy in this election year is to attack China aggressively as the COVID-19 culprit – for the dramatic economic fallout and staggering loss of American lives. This means that Sino-U.S. relations will likely spiral downward quickly.

U.S. Secretary of State Mike Pompeo promised that "China will pay a price" for its alleged cover-up of the outbreak. China has quickly labelled him the "enemy of world peace" who "plays with fire" with China.

These are stern warnings from both sides. Trump has threatened to use tariff to punish China, risking to restart the trade war with China. This could hurt the U.S economy as much as China's. Could the U.S. provoke a military skirmish with China in the South China Sea in order to rally support behind Trump by boosting patriotism or even nationalism? It's not impossible, in our view.

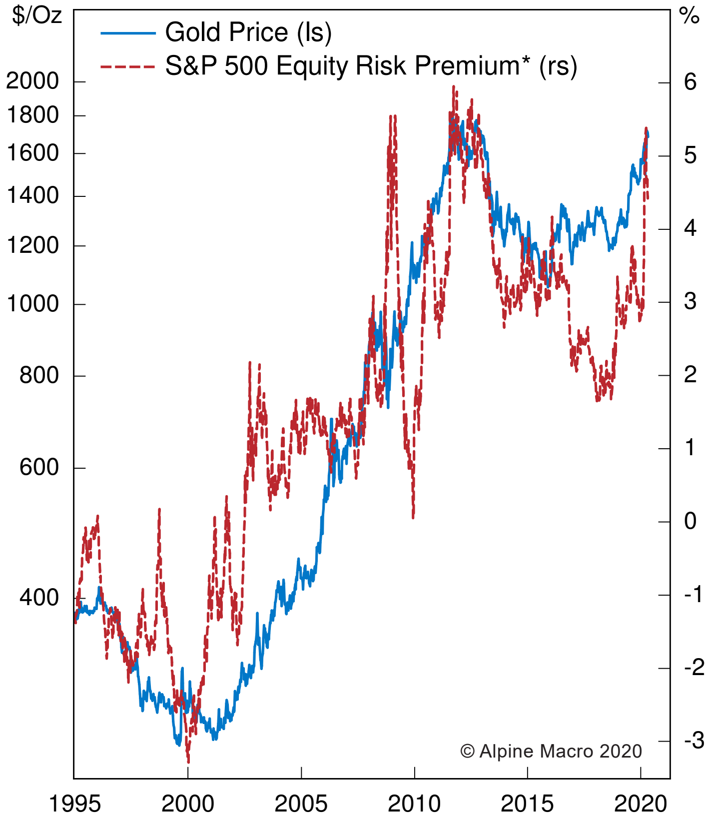
It is difficult to assign a probability of a direct Sino-U.S. military confrontation. We think it has a low probability of occurring, but with devastating economic, financial and political ramifications on the world if it does.

Investment Strategy With Heightened Uncertainty

Investment strategy over the next three to six months should take both sides of risk into consideration. Investment strategy has to be leveraged on the ongoing stock market recovery, but at the same time, portfolio construction has to take into consideration the political and geopolitical risks we discussed.

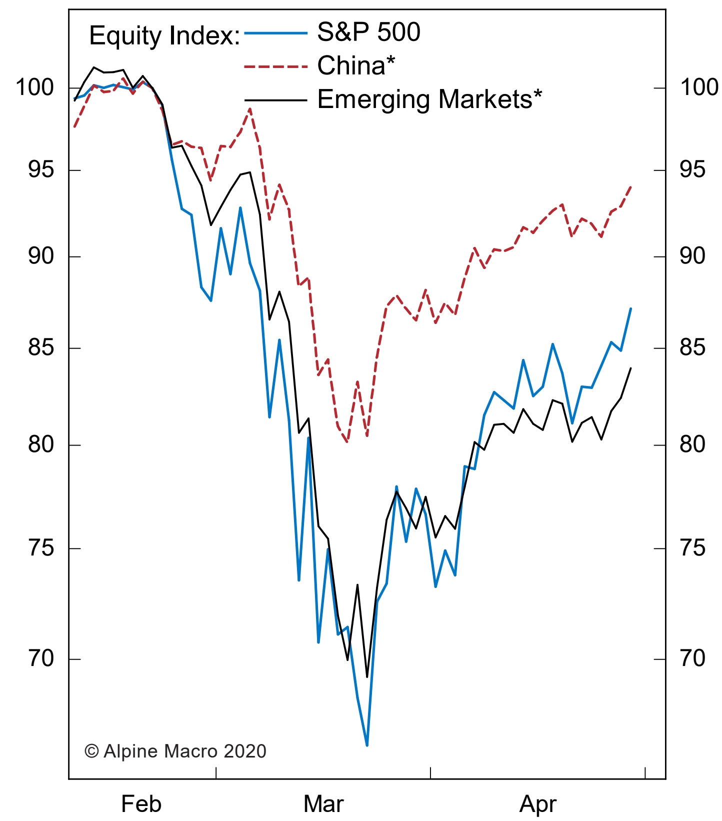
It seems that such a "barbell structure" would make sense in this new environment – i.e. investors should continue to own growth stocks to reap the benefit of

Chart 9 Gold: A Hedge Against A Risky World



*S&P 500 current earnings yield minus 10-year Treasury yield

Chart 10 Relative Equity Performance



*MSCI Mid & Large Caps in US$ terms
Note: All series rebased to Feb 20, 2020 = 100

the stock market recovery, but at the same time they should allocate a meaningful portion of their portfolio into gold or gold stocks to hedge unforeseen risks.

It is important to know that such a portfolio is not a "barbell" structure in a strict sense, as there is no such thing as "risk parity" here. For example, unlike bond prices, gold does not demonstrate a reliable negative correlation with stocks over the longer run.

However, gold does seem to thrive on a rising equity risk premium or a falling dollar (**Chart 9**); both would occur, should the U.S. presidential elections or China-U.S. rivalry careen dangerously toward some sort of disaster.

A Special Opportunity?

Back in early March, we recommended clients overweight Chinese stocks on China's policy responses and signs that infections were under control. **Chart 10** shows that the MSCI China Index has outperformed the SPX since the end of March by a significant margin. Nevertheless, emerging market equities as a whole have underperformed the SPX.

The underperformance of the EM Index has largely been caused by Latin American equities, which have been sold down sharply. The Latin American currency index has also fallen precipitously, with the BRL plunging to new lows.

At present, investor sentiment toward Latin American assets has reached a bearish extreme, with reports of rampant capital flight, crashing commodity prices and swirling speculation of potential impeachment of Brazilian president Jair Bolsonaro. All of this is reminiscent of the 1998 emerging market bottom.

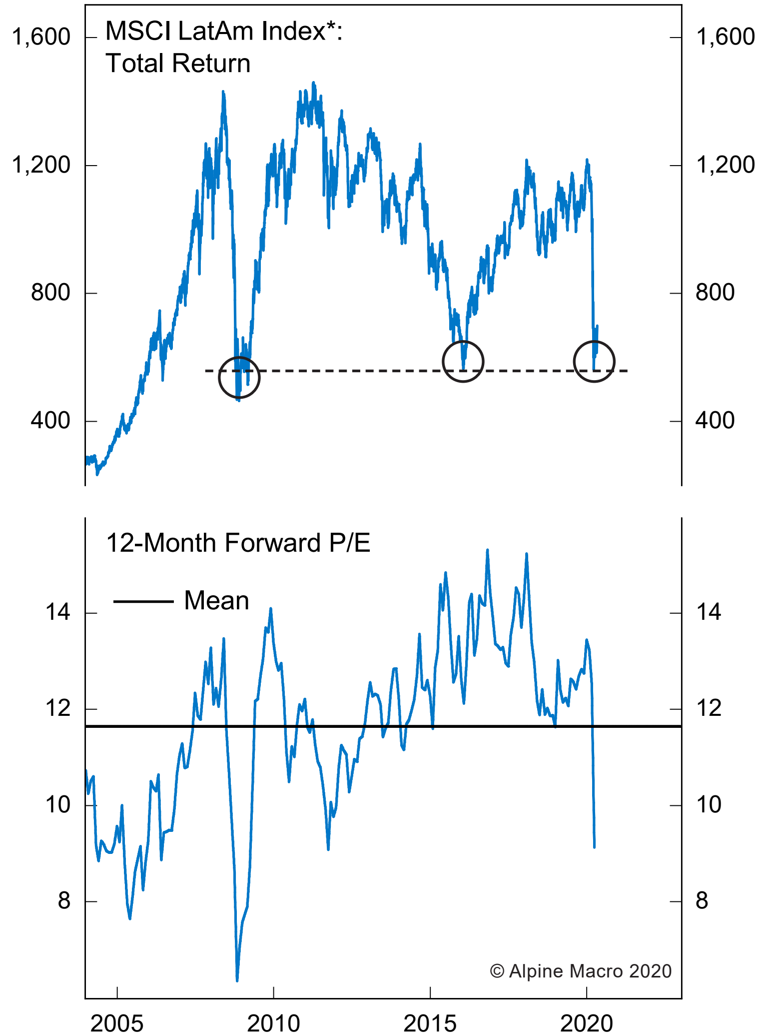
There is no question that Latin American economies are facing a very tough time, with many countries being strained by already limited financial resources to fight the COVID-19 pandemic. Nevertheless, it is also worth noting that despite all the problems and negative publicity, the Latin American equity index has stopped going down recently.

Chart 11 shows that historically there has been massive support at current price levels. The fact that the market is trading at a single-digit P/E means that a lot of bad news might have already been discounted.

Bottom line: Investors with high risk tolerance should buy the Latin America Index without hedging currency.

Chen Zhao
Chief Global Strategist

Chart 11 LatAm Stocks Are Bombed Out



*Large, Mid & Small Caps

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	–	–	8.2%
Long Defensive Basket[1]	2/24/2020	–	–	–	8.8%
Short 10-year German Bunds Hedged	3/2/2020	-0.627	–	–	-0.2%

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%	-	-	-1.6%
Long AUD/CAD	4/6/2020	0.86	Rolling -1%	-	-	5.0%
Buy U.S. High-Yield Corporate Bonds (ETF: JNK)[2]	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 stopped out of the U.S. High-Yield Corporate Bonds 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.

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.

