ALPINEMACRO
A Unique Mind On The Markets

GLOBAL STRATEGY

March 16, 2020

Atypical Recession

The term structure based indicator suggests 50% odds of a recession in the U.S. (**Chart 1**) and the speed of stock price declines suggests the U.S. economy may have already begun to contract, probably quickly.

If proven, this will be a unique recession because in postwar history, all recessions are typically led or provoked by financial crises or bursting asset bubbles as a result of Fed monetary tightening.

Why Unique?

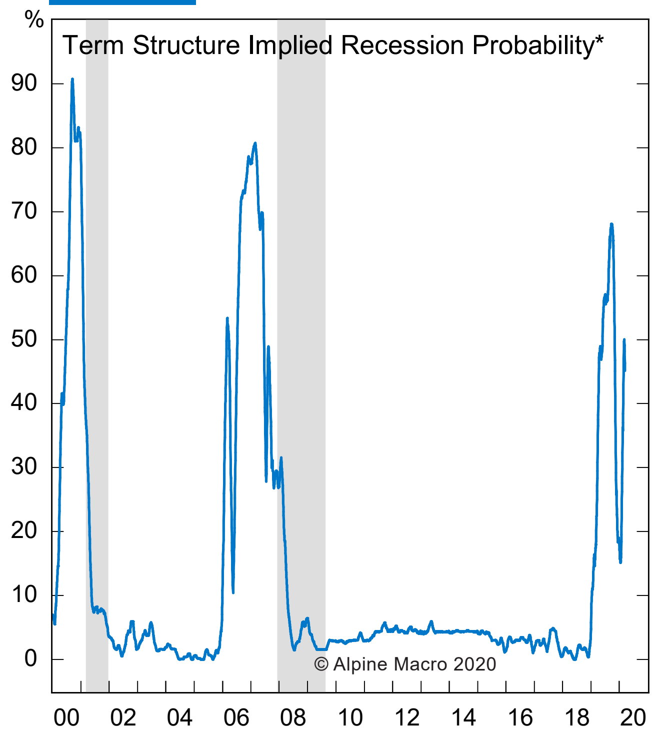
In this COVID-19-led recession, however, the sequence seems to be precisely the opposite: output contraction may come first, as the fear of contagion has begun to scare off consumers, triggering a fall in their spending.

This fall, if unchecked, could lead to spreading bankruptcies, a rising unemployment rate and potentially, escalating financial stress or even a crisis.

Many COVID-19-ravaged economies in the world either have been or are going through economic recessions. They include China, Korea and Italy. It is too early to draw any generalizations of these virus-led recessions, but China's experience is that economic contraction is sharp, followed by a quick rebound (**Chart 2**).

The Chinese pattern probably has everything to do with the draconian lockdowns and quarantine measures taken by the government, together with plenty of monetary and fiscal stimulus to support recovery in the business sector.

Chart 1 Rising Probability Of Recession



*Based on % of yield curves inverted; shown as 1-month moving average
Note: Shaded areas denote U.S. recessions

Chart 2 China's V-Shaped Recovery

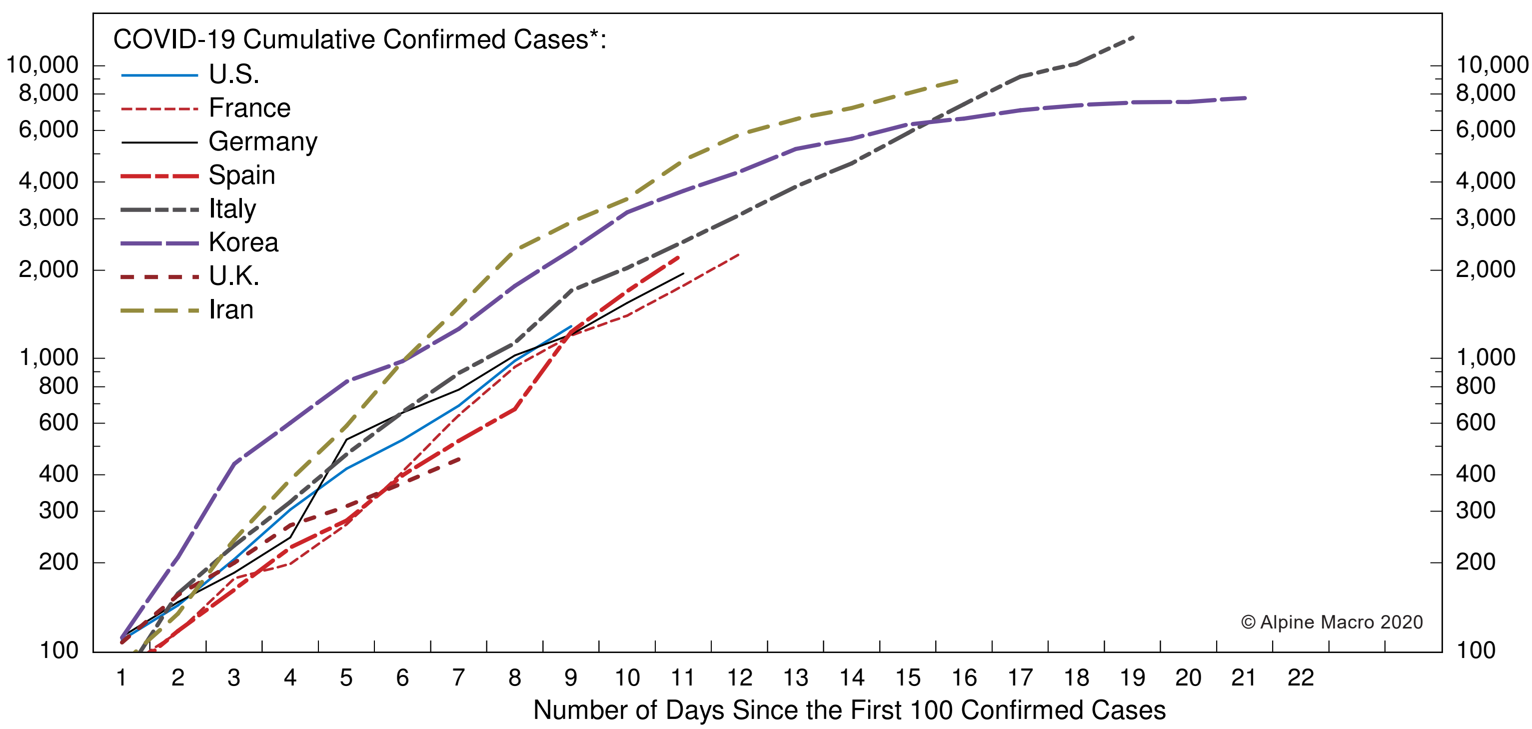
*Average of coal consumption at six major power plants and real estate transactions; shown as 15-day moving average

To what extent the China model can be copied by others remains to be seen. Italy is being forced into a country-wide lockdown similar to what China has done. This suggests the economy is probably going through a period of sharp contraction today.

Not all news is bad. It seems the containment strategy in South Korea is working, with confirmed cases of infections on a downtrend. So far, there has been no financial accident in any of the COVID-19 ravaged countries – in other words, technical recession has stayed "technical."

The unfortunate reality is that the U.S. economy, the largest in the world, is dealing with an early outbreak, and the number of infections will escalate rapidly – especially as official testing numbers begin to increase. The actual numbers of infections could be a multiple of the reported

Chart 3 Pattern Of COVID-19 Outbreaks



*Source: World Health Organization; CEIC; Johns Hopkins CSSE cases. As a result, the U.S. government may have to resort to more forceful measures to combat the disease.

There is no way to estimate how long the recession will last for the U.S. economy. It will largely depend on how quickly the outbreak can blow over. It could be anywhere between two to three months, based on most experts on pandemics.

The pattern of the COVID-19 spread varies from country to country, but it seems that the most intense period of spread lasts between four and eight weeks (**Chart 3**), with forceful lockdowns and quarantines in place.

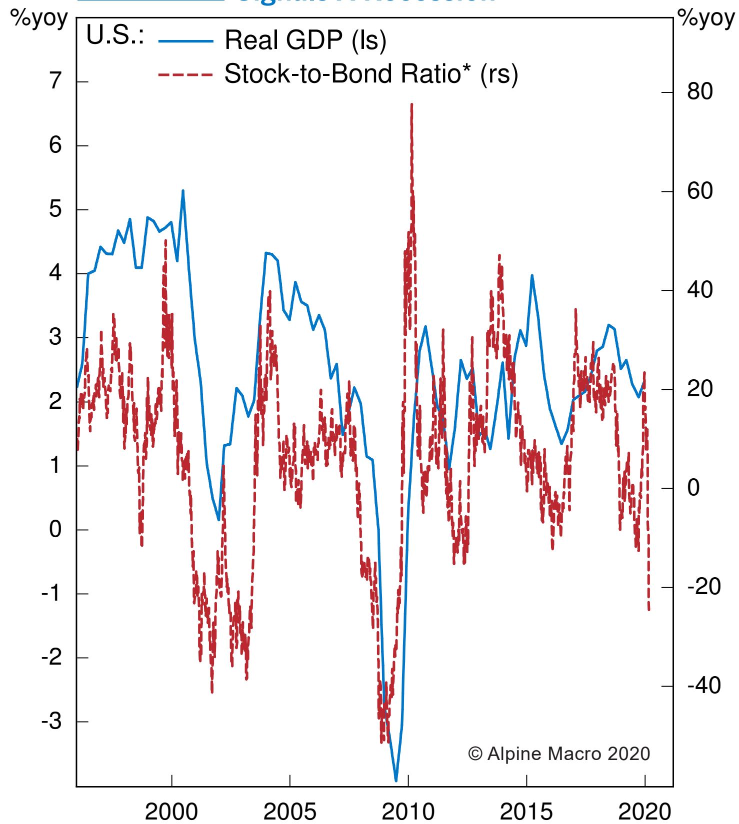
How sharp is the expected downtown? **Chart 4** shows the equity-bond ratio for the U.S., which is the best measure for expected GDP growth. The ratio has fallen precipitously for nearly three weeks and is now consistent with an annualized GDP growth rate of anywhere between zero and -1%.

This could mean a steep fall in GDP in the second quarter on a Q/Q basis, followed by a rebound. The speed and magnitude of the subsequent rebound, however, will depend much on monetary and fiscal stimulus in the pipeline, the latter in particular.

Policy Response

At present, timely policy responses are hugely important to minimize economic fallout and prevent economic contraction from triggering a financial accident. Some strategists and commentators have questioned whether policy stimulus is necessary to salvage the economy from a recession. They say that policy stimulus is not a vaccine that can cure a COVID-19 inspired recession.

Chart 4 **U.S.: Equity-Bond Ratio Signals A Recession**

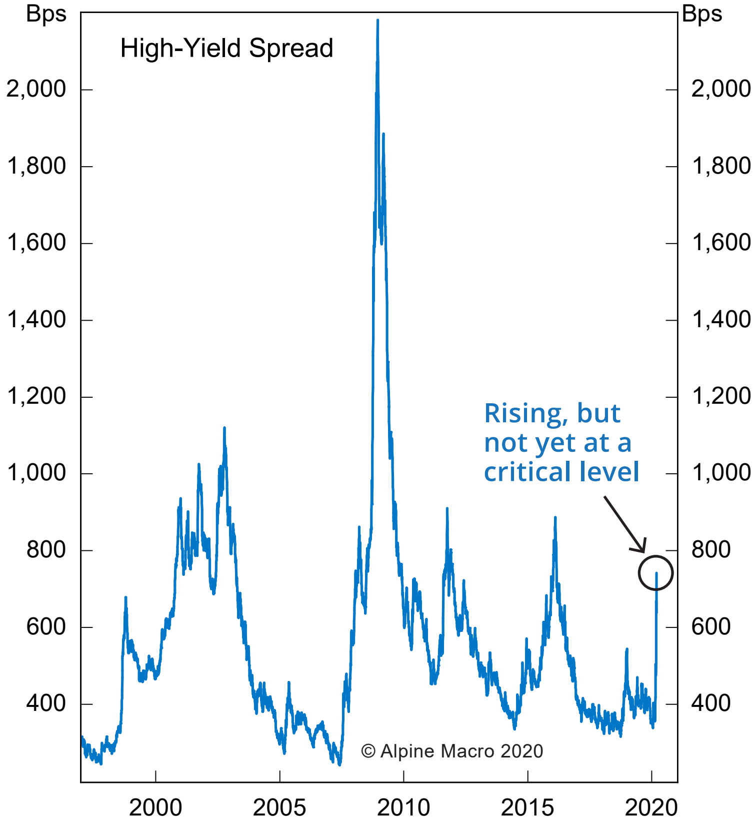


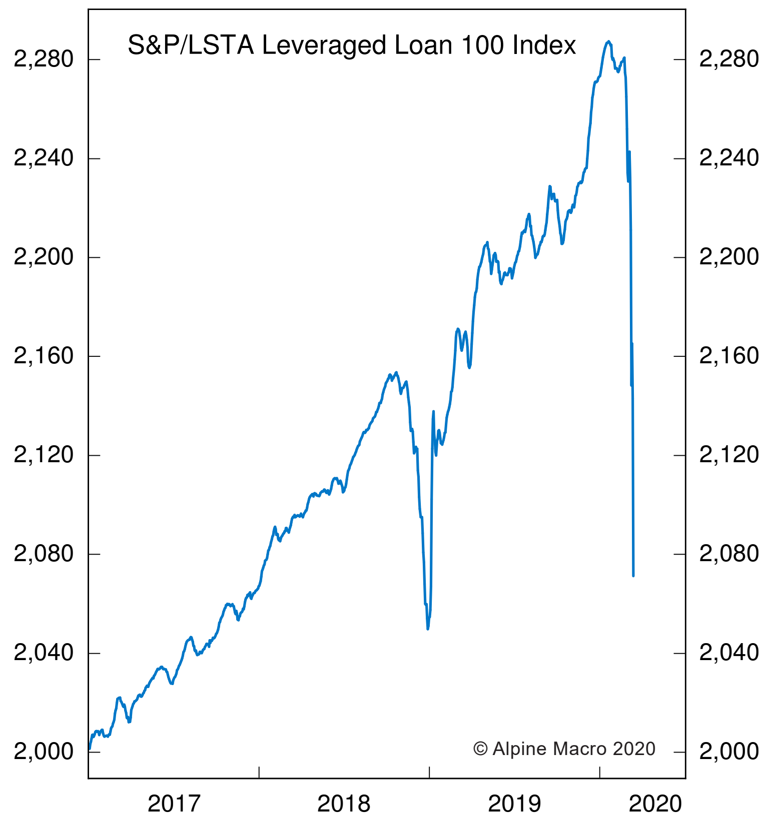
*S&P total returns divided by 10-year Treasurys total return index

This line of argument makes no sense. In a virus-led downturn, it is the authorities' job to act quickly and with overwhelming force to provide businesses and consumers with the necessary financial relief such as tax breaks, loan guarantees, subsidized credit, etc. These measures are aimed at removing solvency risk, allowing companies and people to prepare for economic recovery once the public health crisis is over.

In other words, policy support is not designed to arrest the economy from falling into a recession, but to tide businesses and consumers over this difficult period. This is the only way to prevent a liquidity

Chart 5 U.S.: Increasing Financial Stress





crunch from becoming a solvency crisis that leads to rising bankruptcies and unemployment. This secondary damage is more difficult to heal than a temporary fall in spending.

In this vein, the Fed's aggressive rate cuts and massive liquidity injections via repo operations and a resumption of QE are absolutely needed to ensure ample liquidity as demand for credit lines increases quickly.

These policy moves by the Fed are particularly important to pre-empt a financial crisis. There are already signs of increasing financial stress. The LIBOR spread is rising briskly, suggesting liquidity is getting tight in the interbank market. In the meantime, high-yield spreads are blowing out, and the CLO market is falling sharply (**Chart 5**).

At present levels, various credit spreads do not indicate a crisis. Nevertheless, commercial banks are hoarding cash, and bond investors are concerned about the rising default risk of low-quality borrowers. It is up to the Fed to not only satisfy liquidity demand but sharply reduce funding costs for borrowers at a time of rising financial stress. The Fed is doing both aggressively.

Fiscal response from the U.S. government has been disappointing. President Trump has spent too much time playing down the seriousness of the disease and trying to convince people that COVID-19 is not a big deal. Last week stocks rallied explosively on Trump's promise of a "very dramatic package," only to have found out that he had nothing in hand.

By declaring a national emergency, the White House is able to tap into a $50 billion emergency fund. However, it is not clear whether this is enough to stabilize market expectations and ring fence the economy. Our sense is that a bigger fiscal package is needed, which requires the Trump administration and Congress to reach a bipartisan agreement. The problem is that this is an election year and there is too much politics at play.

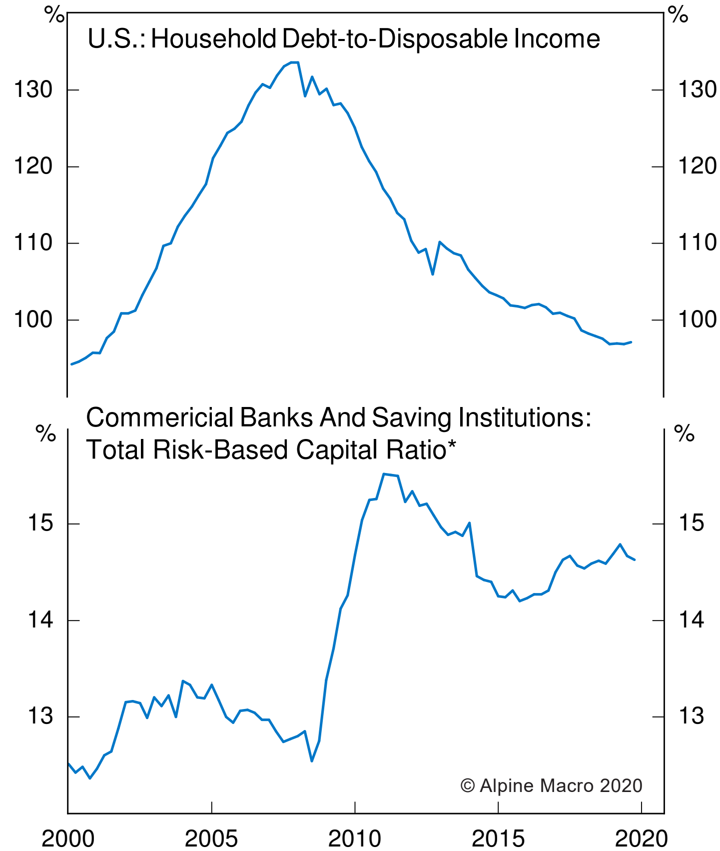
The 2008 Global Financial Crisis (GFC) also hit in an election year when Congress was deeply divided. After Lehman's failure in September 2008, the stock market was hoping for a quick policy response, but the bottom gave out when Congress failed to approve the plan. It took a full-blown financial crisis to get bipartisan support for the TARP plan.

With so much hatred between the White House and House Democrats, it is not clear at this stage whether a speedy, forceful and effective bipartisan package can be delivered. What is clear is that market volatility will stay very high and investor confidence will remain fragile so long as the White House and Congress cannot come up with a convincing plan to stimulate the economy.

Why Is It Different From 2008?

Some have cast doubt on whether the sharp fall in stock prices will be followed by a quick recovery, while others have expressed concern that this crisis could be as bad as the 2008 GFC. Obviously, there are many unknowns and it is a fast-moving situation, but there are a few quick observations to share with clients:

Chart 6 **U.S.: Lower Household Debt, Better Capitalized Banks**



*Source: Federal Deposit Insurance Corporation

This virus-induced recession is most likely a transitory shock. It is different from the 2008 GFC, when banks were collapsing, depositors ran for cover and overleveraged consumers were facing foreclosures. It has taken more than a decade to repair the damaged balance sheets of consumers and lending institutions as the result of the 2008 crisis.

This is not the case today, with much-reduced consumer debt and well-capitalized banks (**Chart 6**). The corporate sector capital structure is much more leveraged than before due to share buybacks, but the very subdued capital investment over the past few years suggests that most companies are not dealing with over-extended balance sheets or mounting bad investment.

Chart 7 Stock Market Crash Hurts President Trump's Re-Election Odds

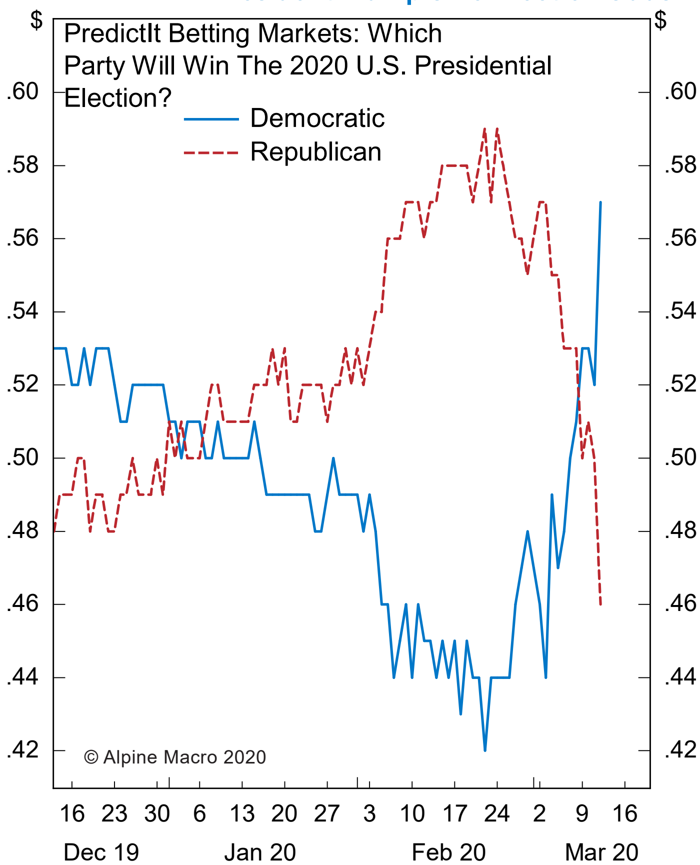
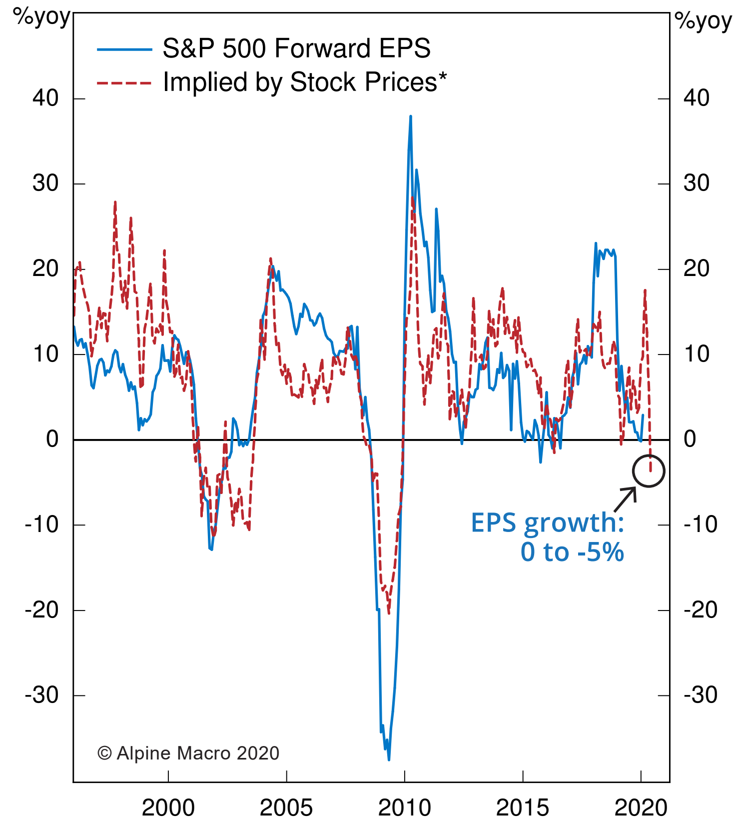


Chart 8 Stock Market Discounts A Sizable Fall In EPS



*Based on regression of 12-month forward EPS against S&P 500 annual price returns

Besides, borrowing cost is falling fast and the Fed is vigilant on financial stress. Therefore, there is nothing seriously blocking the economy from recovering quickly once the spread of the disease is contained.

Political Ramifications

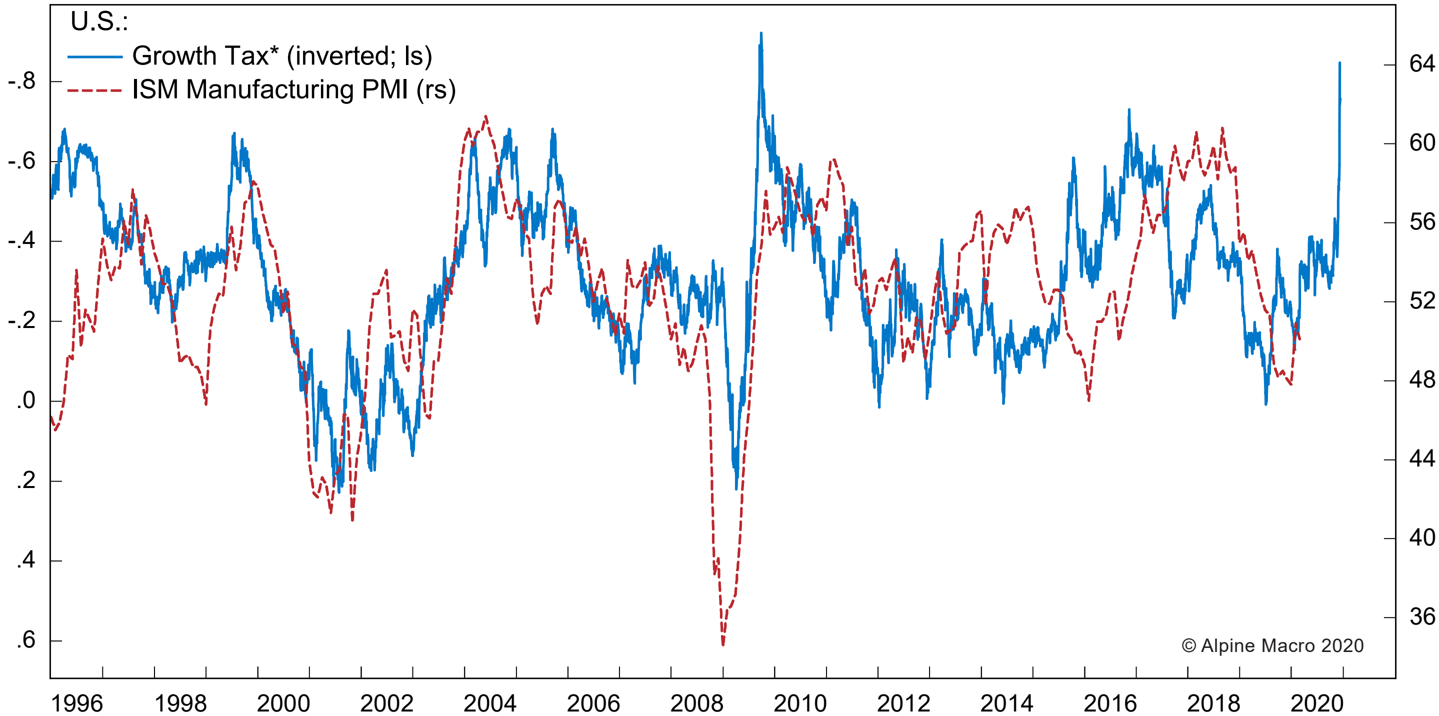
The stock market crash, rising odds of a recession and Joe Biden's surge in the democratic primaries have cast a big shadow over Trump's re-election chances. Chart 7 shows how the election odds between Trump and whoever will be the Democrat candidate have flipped in recent weeks.

Furthermore, the public health crisis has put America's health care system in the spotlight again. Already, health care costs have risen to the number one concern for American voters, and the COVID-19 crisis will rekindle the debate on whether America's health care system is adequate to handle a public health crisis. It is possible that Obama-care will regain popularity in America.

Some Thoughts On The Markets

First, the current economic backdrop is bullish for the CNY. This is because the Fed is being aggressive in reflating, but fiscal stimulus is stingy and slow to come by. On the other hand, China is relatively stingy in doling out monetary stimulus, but has been generous on fiscal support. This would suggest a rising CNY versus USD. Besides,

Chart 9 **Falling "Growth Tax" Signals A Strong Economic Rebound**



*Combination of the dollar, oil price and interest rates, standardized and advanced by 9 months

the growth dynamic is also in favor of China where economic growth is passing the worst, while the U.S. economy is weakening. Stay long the CNY.

Prior to the COVID-19 outbreak, we envisioned a weaker dollar in the second half of the year when the Fed would begin cutting rates. This story is moved forward by the virus crisis. With the Fed likely pushing rates back to the zero lower bound soon, the overall dollar bull market is showing signs of stress. We suggest clients trade the DXY dollar index on the short side.

Second, the severity of the selloff in the U.S. stock market has been amplified by several factors, including elevated valuations prior to the selloff and the unknown nature of the COVID-19 outbreak.

At present, the U.S. stock market anticipates forward earnings to grow by 5% a year out. This is way too optimistic. The rapid fall in stock prices implies that the stock market is discounting a 5% decline in per-share earnings (**Chart 8**).

With a trailing P/E at 17, a 5% fall in EPS would suggest a forward P/E ratio of around 18 times, a level that is probably close to fair value, especially given where bond yields are. Of course, stocks could fall more, but that would make equities look cheap.

Finally, although wealth destruction is painful, we should keep in mind that there will be an end to the COVID-19 outbreak. At that point, the world economy will be left with plenty of policy stimulus, much-reduced interest rates and bond yields, very low energy costs and large amounts of pent-up demand.

Chart 9 shows that the recent fall in bond yields, a softening dollar and collapsed crude prices will serve as a major cut to the "growth tax." In history, such a growth tax cut has always led to a rise in economic activity, but asset prices usually rally before economic recovery.

Furthermore, the speed of the expected stock market rally could mirror how prices have fallen. This is the key reason investors should neither try to time the market bottom, nor sell into the panic.

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	–	–	-2.9%
Long Defensive Basket[1]	2/24/2020	–	–	–	0.1%
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
Long EM USD Sovereign Bond[2]	1/9/2019	784.77	Rolling -3%	3/9/2020	869.11	10.7%
Long GBP/USD[3]	11/18/2019	1.2897	Rolling -5%	3/11/2020	128.42	-0.7%
Long Copper	2/17/2020	259.95	Rolling -10%	-	-	-3.8%
Long MSCI China Index[4]	3/2/2020	62.96	Rolling -5%	3/6/2020	63.48	-3.0%
Long MSCI China Index/ Short S&P 500	3/9/2020	59.67/274.23	Rolling -5%	-	-	-0.6%
Short USD/CNY	3/9/2020	6.96	Rolling -5%	-	-	1.3%

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 EM USD Sovereign bond trade with a 10.7% gain on 03/09/2020.
[3] We stopped out of the long GBP/USD trade with a 0.7% loss on 3/11/2020.
[4] We stopped out of the long MSCI China Index trade with a 3% loss 3/6/2020.

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.

