ALPINEMACRO
A Unique Mind On The Markets

GLOBAL STRATEGY

May 27, 2024

The Bull Has Further To Run

In This Report

Stocks have been rising, while U.S. 10-year Treasury bonds have gyrated in recent months. The latest Bank of America's Global Fund Manager Survey has revealed that equity managers are the most bullish since January 2022, while over 60% of fixed income managers think that bond yields will be higher this year. The survey says that the most crowded trade is long U.S. stocks, and therefore it proposes that a contrarian bet is to short equities while going long bonds.

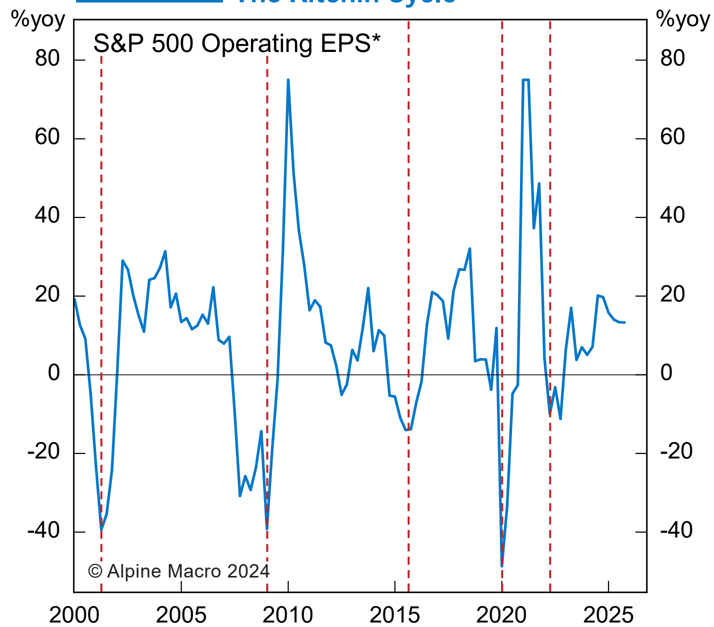
To Follow Or Not To Follow?

Selling stocks while buying bonds goes against the trend, but are these contrarian bets now? We are not so sure. In the real world, it is hard to make a successful contrarian bet because it is never obvious what the consensus is, let alone the timing of a turning point. At present, the VIX index is very low and the market is overbought, setting the stage for a possible pullback. But is the bull market in jeopardy? We think not.

The decision to follow the trend or go against it is always tough. There is no other way but to rely on careful analysis, intuition, and common sense. Given what we know about the current state of the U.S. economy, our best judgement is that the bull equity market has further to run from a cyclical viewpoint.

First, the profit cycle is young and stocks usually do well when earnings are up. Since the pandemic crisis occurred four years ago, per-share earnings have suffered a double-dip recession (Chart 1). It is very rare for corporate profits to go through a "triple dip" within a short period. → ?!??

Chart 1 U.S.: EPS Follows The Kitchin Cycle



*Truncated at 75; 2008Q4 data is removed
Source: S&P Global, including bottom-up forward estimates through 2025

Moreover, the swings in profits seem to follow the Kitchin cycle of three- to five-year fluctuations, largely reflective of the lagged impact of capital investment and inventory cycles. With EPS having just contracted by 13% in 2022, the next profit recession should be several years away, based on the average cyclical rhythm of recent decades. ?!

Chart 2 Inflation Versus Inflation Expectations Of Bond Markets

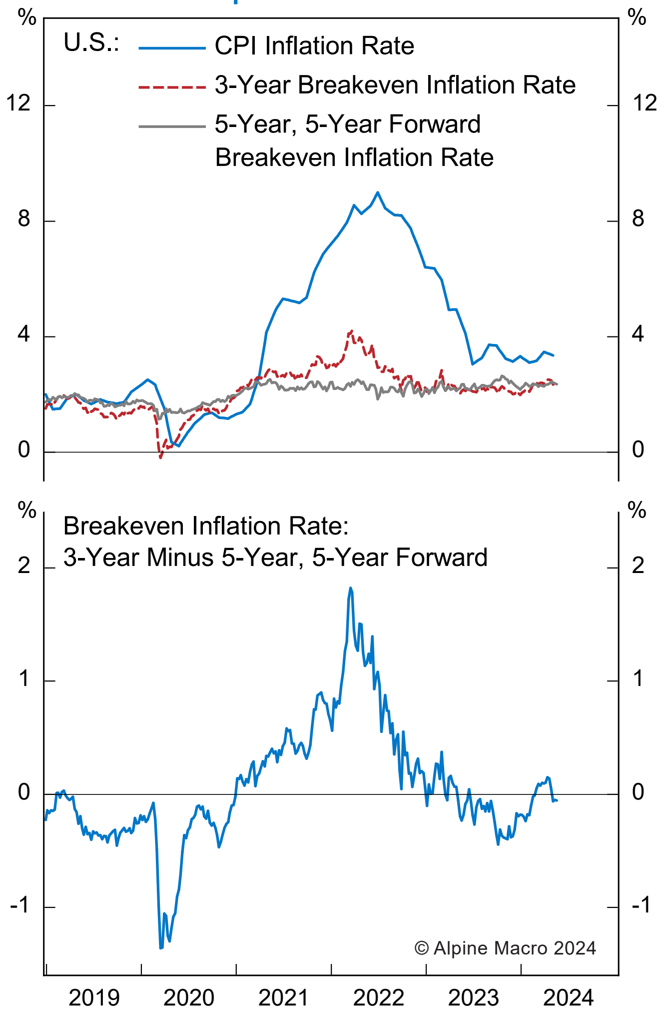
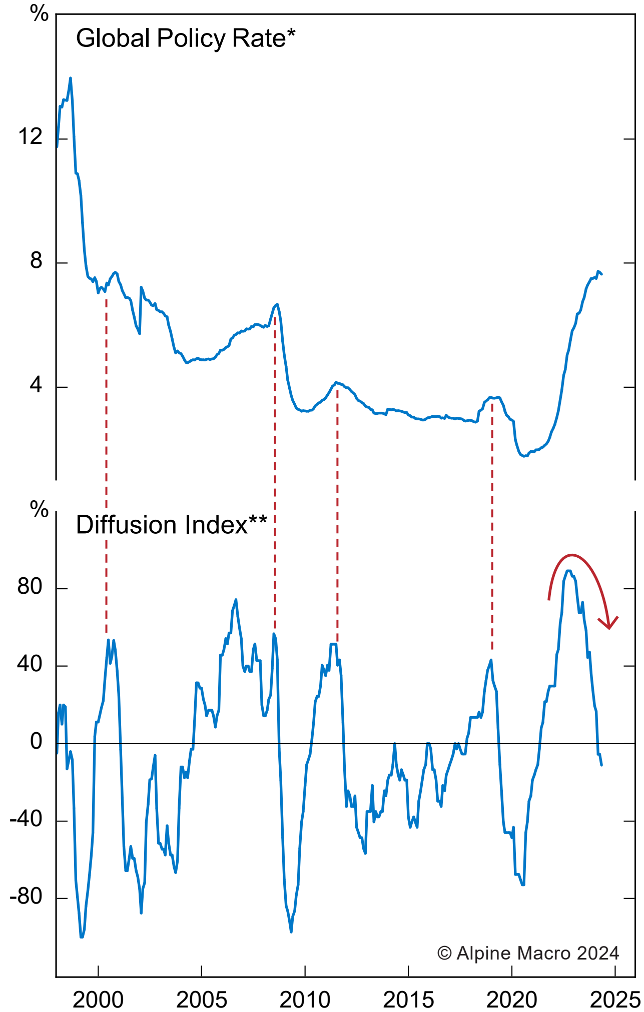


Chart 3 Global Policy Rates And Their Diffusion Index



*Average of 37 DM & EM countries
**Rate hikes minus cuts over a 6-month period as % of total

Second, inflation is more likely to drop than rise, sustainably. All major market signals suggest that disinflation will persist. In fact, the bond market has been much shrewder than most strategists and big-name economists. In 2022, when many people screamed inflation or hyperinflation, the bond market quickly concluded that the inflationary shock would prove transient.

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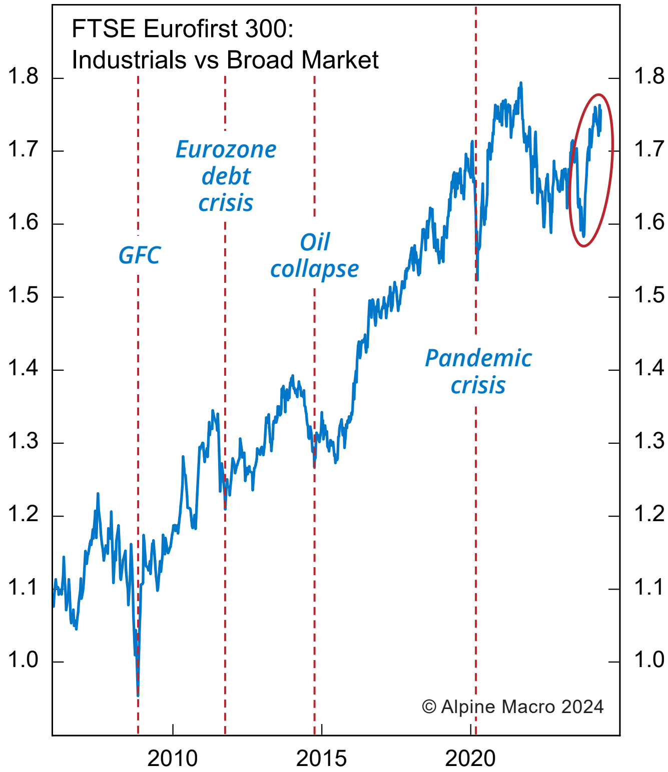
Chart 2 shows that the long-term inflation break-even rate barely blinked throughout the post-pandemic inflation flare-up, while the short end of the breakeven curve has quickly fallen towards the long end, along with the actual decline in inflation.

The recent setback in inflation has caused some commotion in the marketplace, but the entire breakeven curve has not budged at all. In other words, the bond market says that the recent setbacks are likely transient, and disinflation will resume sooner than later. If the bond market is right, selling stocks short is a dangerous proposition.

Chart 4 **Eurozone: Industrials Stocks Signal A New Expansion Cycle Ahead**

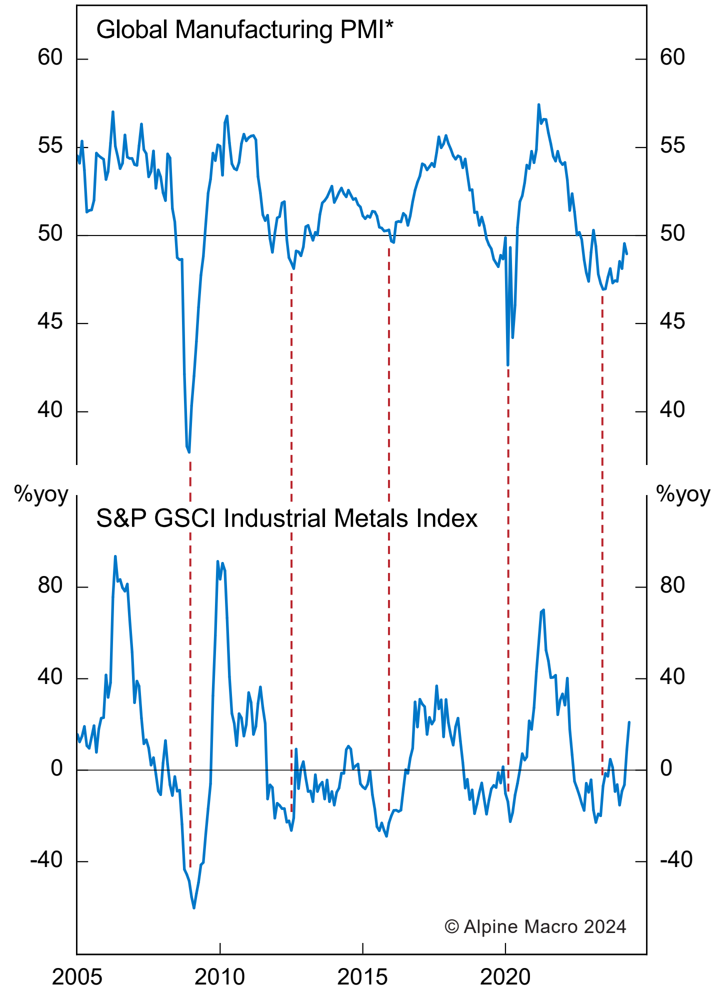


Third, central banks around the world have stopped hiking rates and some have begun to ease. **Chart 3** is the policy diffusion index. It indicates that a policy reflation cycle is about to start. What is worth mentioning is that, in the past, a global monetary easing cycle was usually prompted by a recession and/or a financial crisis.

This time around, however, central banks may begin cutting rates in response to lower inflation, not to recession or some kind of financial crisis. We suspect any policy easing will further stimulate the bull run in stocks, potentially creating a mania-like environment.

Fourth, the rest of the world economy is getting stronger, which is good news for risk assets. China has made a policy U-turn by launching a sizable stimulus program aimed at stopping the downward

Chart 5 **Global PMI And Metal Prices: Confirmation Of A Manufacturing Recovery**

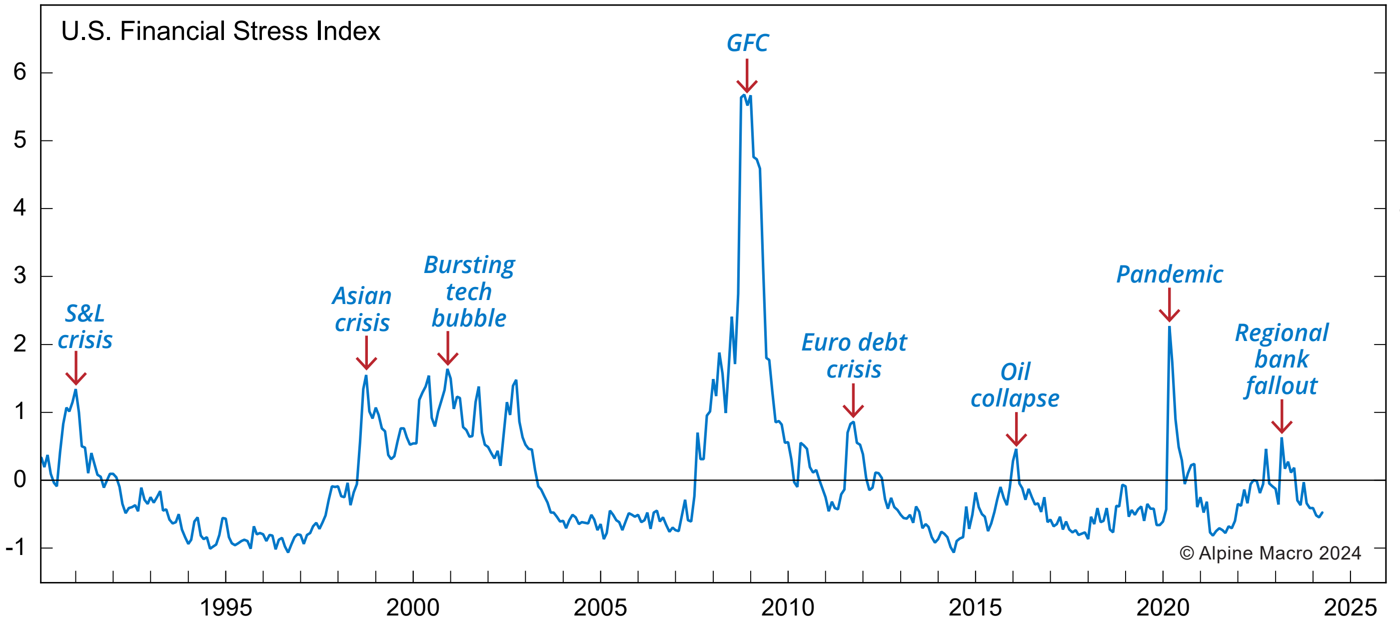


*Includes China's Manufacturing PMI (50%), U.S. ISM Manufacturing PMI (25%) and EU Manufacturing PMI (25%)

spiral in real estate and bolstering consumer spending. The Chinese stock market likes the news, with the real estate sector jumping nearly 30%.

The European Central Bank will likely ease in the summer, which will help the struggling eurozone (EZ) economy. The EZ industrial sector usually leads economic recoveries, and the recent out-performance of industrial stocks suggests that the EZ economy could enter a new expansionary cycle (**Chart 4**).

Chart 6 Financial Stress Has Fallen Since The Regional Bank Crisis



Source: Federal Reserve Bank of Kansas City

Chart 5 shows that global manufacturing PMI is turning up, though admittedly from very depressed levels. The key point here is that the sharp rally in the Industrial Metals Index seems to confirm that the broad world economy is strengthening. because of Cu?

Fifth, shorting stocks/going long bonds is essentially a recession trade. This would work if the U.S. economy fell into a recession this year or in 2025.

There are indeed many strategists promoting the recession thesis today, but the problem with this view is that financial and economic stress in the U.S. economy is easing, not increasing (**Chart 6**). Historically, there has been no recession in the U.S. that is not preceded by an economic crisis and rising financial stress.

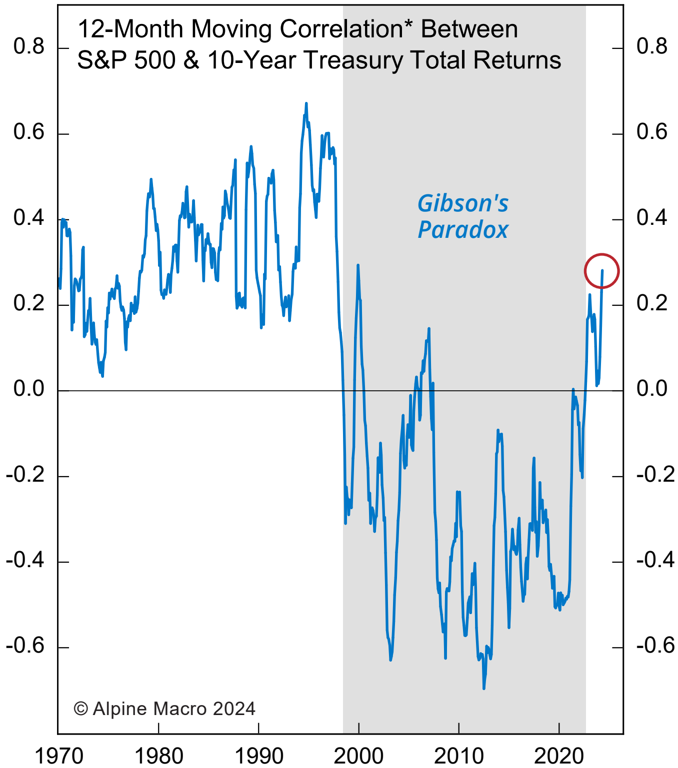
Of course, there are always unforeseen risks that could cause bad surprises. Today, the biggest tail risk is that inflation stays stickier than market expectations, forcing the Fed to raise rates anew. In this bad outcome, both stocks and bonds will suffer, and the recession risk will rise.

We think this is a risk with, say, a 5% probability or less. Do you really want to structure a strategy purely based on tail risks? In our view, tail risks should be dealt with *via* insurance, not by core strategy.

Finally, there is also a problem with market correlation. **Chart 7** shows that bonds and equities have become positively correlated since late 2022, and there is no evidence that the equity-bond correlation has flipped back to the so-called Gibson's Paradox. If inflation indeed surprises to the strong side and rates move higher, both stocks and bonds would likely fall. Being long bonds will not help much.

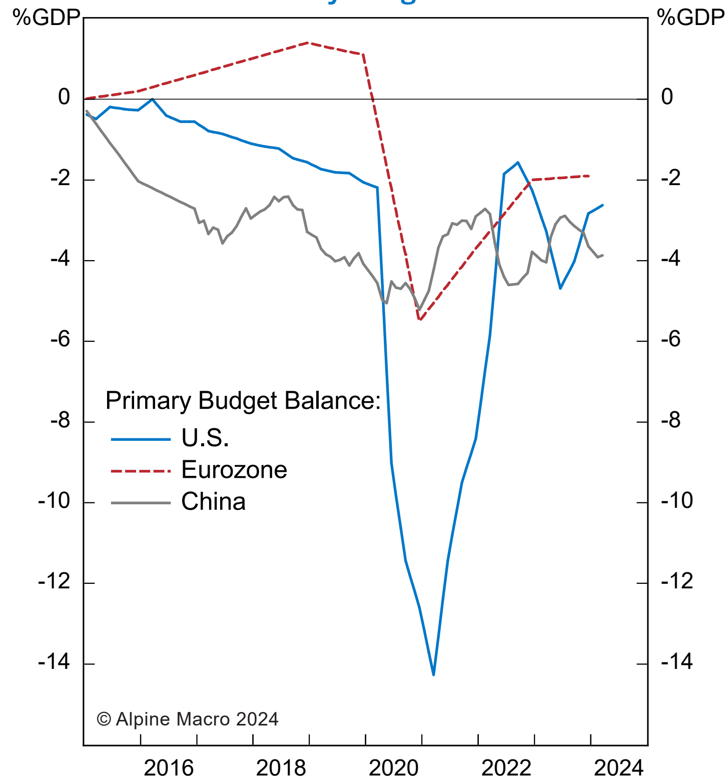
Bottom line: betting on recession, stagflation or sustainably higher-than-targeted inflation may not prove to be a true contrarian bet. We prefer to stay long equities, while keeping a benchmark bond duration.

Chart 7 U.S.: Equity-Bond Correlation



*Based on daily returns

Chart 8 The Big Three: Primary Budget Balances



More On Disinflationary Boom

At the other end of the spectrum of various economic outcomes, there is an increasing probability of a disinflationary boom that could unfold this year and beyond. Perhaps, "boom" is too strong a word: synchronized global expansion could be a more apt description.

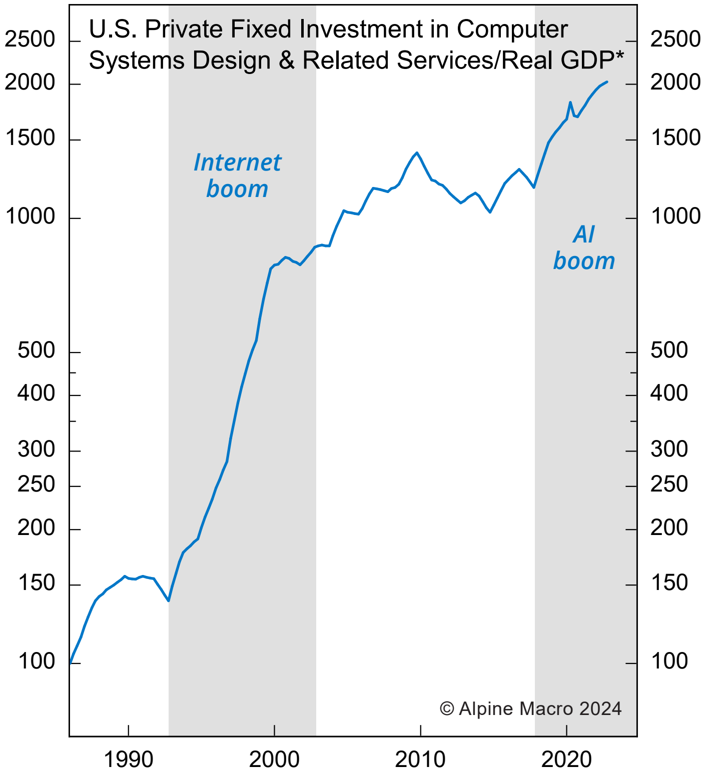
Semantics aside, this synchronized expansion is likely to be driven by rising labor productivity rather than by a dramatic expansion in money, credit and/or fiscal stimulus. Although much attention has been paid to the U.S. fiscal stimulus, the reality is that there will unlikely be much new stimulus going forward from any major countries around the world, except for China (**Chart 8**). ??

Why a disinflationary boom? There are two basic considerations – the U.S. and China. The first is that we are convinced that the world, led by the U.S., is on the cusp of a major AI boom whose size, depth and impact will be at least parallel to, if not greater than, the internet revolution of the 1990s. LOL!

Nvidia's gangbuster earnings results suggest the U.S. corporate sector has been putting large sums of capital into AI-related data centers, with the resulting improvement in corporate efficiency being almost immediate. **Chart 9** shows that the strong upswing in private capital investment in technology-related hardware and software is mimicking what happened in the 1990s.

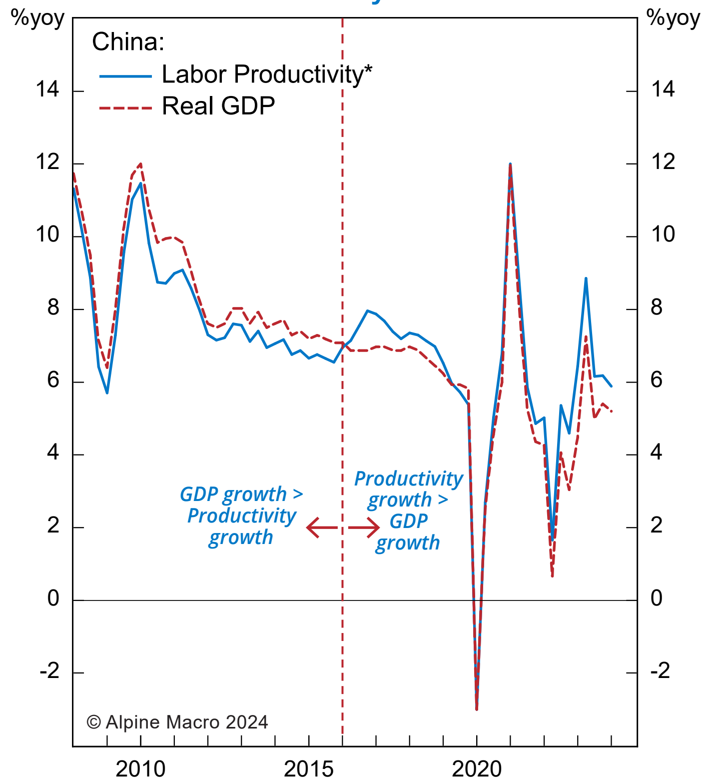
The internet lifted U.S. labor productivity by about 1-1.3% per year from the second half of the 1990s to the first half of the 2000s, creating a sustained disinflationary boom. We suspect that AI could do a

Chart 9 AI Boom Underway



*Rebased to Jan 1986=100

Chart 10 China: GDP Versus Productivity Growth



*Real GDP divided by economically active population
Note: Both series are truncated at +12/-3

similar trick for the U.S. economy. U.S. non-financial sector productivity is rising at a 3.5% annual rate, a very high level for a well-developed economy.

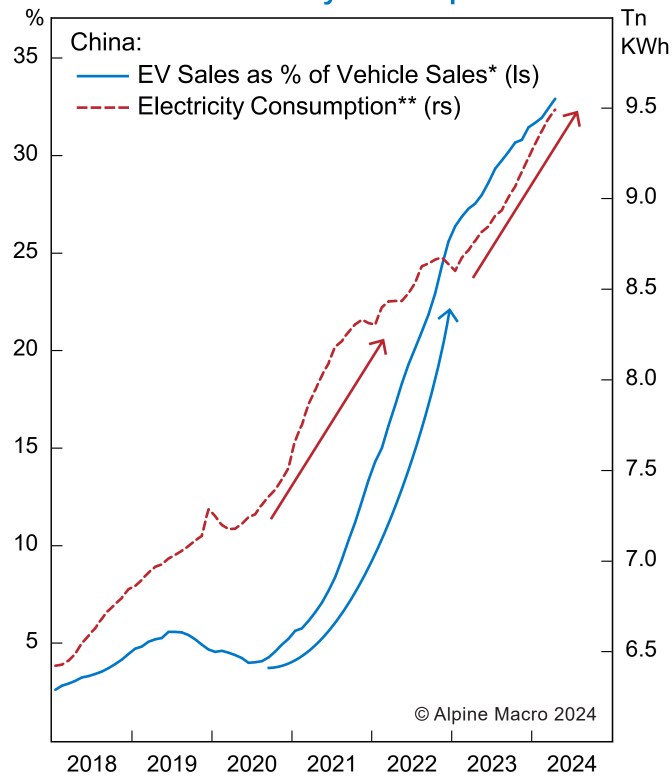
China is a different story, but with similar results. It is an economy that has suffered from insufficient domestic demand, too much savings and periodic deflation. The Chinese government has been extremely stingy in providing policy stimulus. Against this terrible economic background, the economy still eked out 5.3% growth. How has it done so? The answer is productivity.

China's labor force has dropped 4.5% since 2015 and total employment has contracted by more than 3% for the same period. This means that labor productivity growth is the only factor carrying economic growth. With the labor force shrinking by 0.4-0.5% a year, productivity growth for the Chinese economy has been nearly 6% per annum to generate 5.3% GDP growth (**Chart 10**).

This is not surprising, given China's rapid pace of automation and its labor productivity levels remain much lower than high-income economies. However, the impact of China's continued, large productivity advances will be enormous for the rest of the world because of the economy's size.

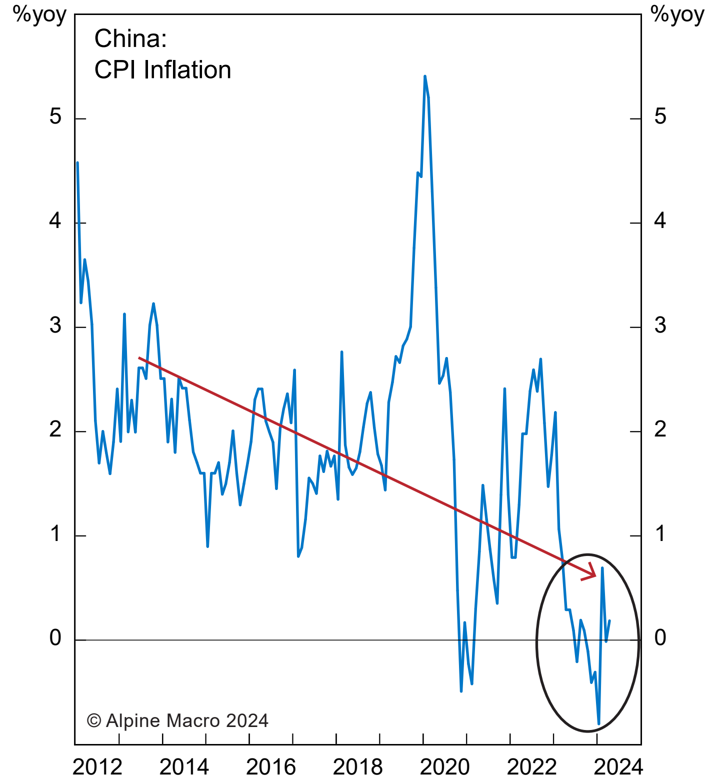
The Western battle against Chinese EVs is just one example of the consequences. The truth is that Chinese EV producers are hyper-competitive; they can not only cause an upheaval in the global auto industry, but also destroy other automakers quickly.

Chart 11 Are EVs Driving China's Electricity Consumption?



*Shown as 12-month moving average
**Shown as 12-month moving sum

Chart 12 China Is Still Treading Deflation



It is hard to pin down what exactly this productivity-led economic expansion means for global financial markets, but as far as we can see, a few implications are in order:

- AI competition between the U.S. and China means large investments in data centers and a subsequent surge in power consumption. Meanwhile, China is the world's largest auto market and EV sales have already snapped up more than one third of domestic vehicle sales (Chart 11). This might have contributed to the soaring electricity consumption in China in recent years. All of this could mean a strong surge in power consumption around the world, creating extra stress on the existing power infrastructures in the major economic blocs.

- Productivity-led economic growth suggests that real growth will stay rather strong, but inflation will be pulled lower by the supply side. For the U.S., this could suggest that 10-year Treasury yields may not fall much as TIPS yields should stay high, but the surprise could be lower-than-expected inflation, and thus a lower inflation breakeven rate.

- For China, the combination of rising productivity growth and a lack of domestic demand means price declines on hyper-competitive Chinese products. **Chart 12** shows that China may stay in a quasi-deflationary environment for longer, even if the government starts to reflate now. This will likely sustain global goods deflation, at least for a while longer.

- Onshoring, friend-shoring and de-risking will all lead to dramatic relocations in world manufacturing and a sustained rise in capital investment in the manufacturing sector. This is already driving up demand for industrial commodities at a time when the global mining sector remains grossly under-invested. This could imply that another bull market in commodities is either here or will soon arrive. It has been a reccurring pattern that mining investment always follows prices (Chart 13). The recent jump in commodity prices could suggest rising mining investment in the coming years.

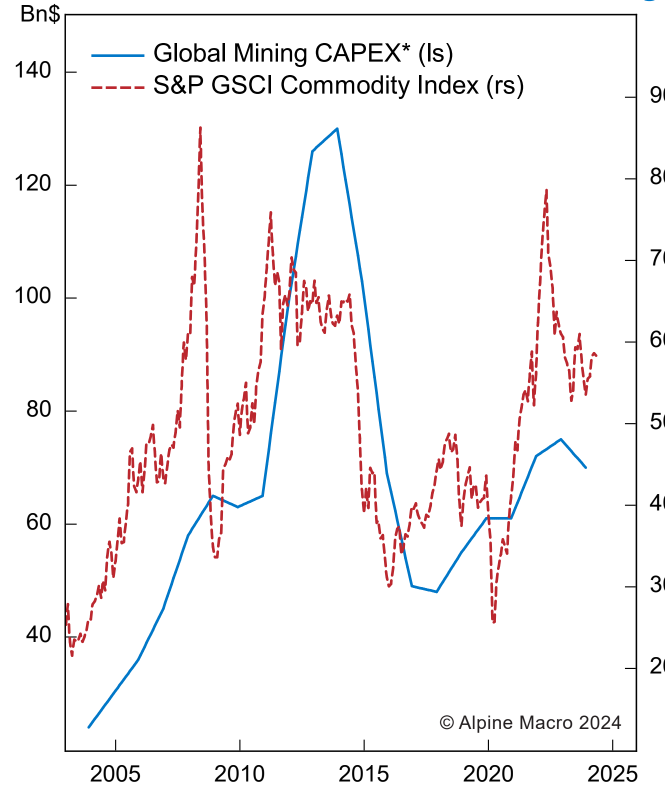
A Few Thoughts On Commodities

Copper and gold have been going through a sharp pullback, which is likely technical rather than fundamental in nature. Both markets have moved far ahead of themselves, and the recent gains are mostly powered by retail inflows. A setback in both markets is inevitable. Therefore, we are treating the recent fall in copper and gold as an opportunity to buy. We are setting up a stop-buy for copper at $4.55.

Natural gas could enter a powerful upswing. Prices have already risen by 70% from the recent bottom and this could only be the beginning of a much bigger move.

- U.S. electricity consumption should rapidly accelerate in the coming years, in large part to satisfy the anticipated explosive growth of energy-intensive AI data centers. Natural gas, together with nuclear power, are well-primed to meet this demand, as renewables have yet to sufficiently scale up and coal is shunned.

Chart 13 Commodity Price Surges Always Follow Underinvestment In Mining



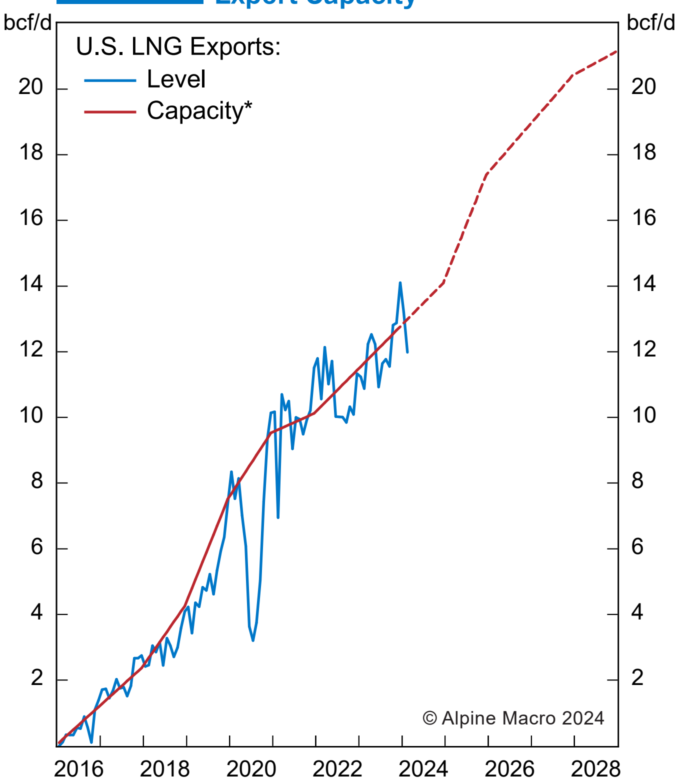
*Top 40 mining companies; source: PwC analysis

- The ongoing build-out of U.S. LNG export capacity also opens a significant new channel of demand for domestic production. With considerably higher global prices, shale gas producers are moving LNG abroad tick-for-tick with the export terminals coming online (Chart 14). Over time, the arbitraging pressures will likely push up domestic prices.

- On the supply side, the breakneck pace of expansion is all but over, with the sector set to run into the same depletion and productivity limits as shale oil.[1] Trend growth, currently in the low single

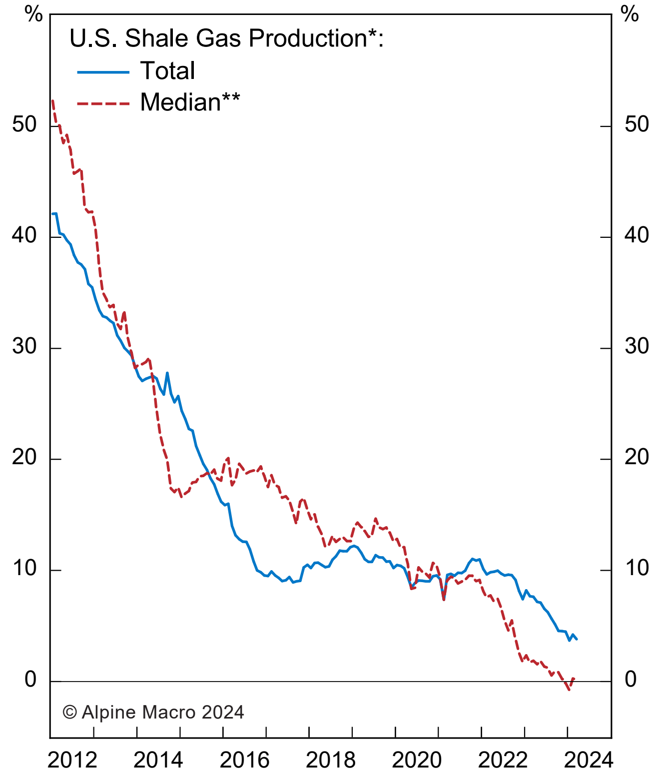
1 Alpine Macro *Global Strategy Special Report* "Is Shale Tapped Out?" (October 23, 2023).

Chart 14 U.S.: Expanding LNG Export Capacity



*Dotted lines denote forecast based on projects either under construction or approved for construction
Source: EIA

Chart 15 Diminishing Output In Shale Gas



*Shown as 5-year annualized growth rate
**Calculated across 12 shale basins

digits, should decelerate further, as two-thirds of shale plays have already passed peak output and the median growth rate is now zero (**Chart 15**).

- While absolute inventory levels are high, they have fallen substantially when measured in days of consumption supplied. They have declined from a peak of 43 days in 2012 to 31 days at present, the lowest reading in 25 years. This acute drawdown raises the risk of a supply crunch.

- Natural gas is cheap on a secular basis. In energy-equivalent terms, it trades at nearly a 90% discount to crude oil. This valuation, seen only three times in the past century, has typically marked sustainable bottoms in natural gas prices.

Bottom line: buy natural gas futures contracts or ETF (UNG).

Chen Zhao
Chief Global Strategist

Investment Recommendations

Tactical Investment Positions (3 - 6 months)

Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long 10-Year German Bunds/Short 10-Year JGBs	08/07/2023	2.6%/0.62%	-	-	-	4.4%
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	45	-	-	3.3%
Long Latin American Equities (ETF: ILF)	12/04/2023	27.78	25	-	-	2.0%
Long Russell 2000 (ETF: IWM)	01/08/2024	196.73	185	-	-	4.7%
Long Chinese Equities (ETF: MCHI)	03/04/2024	38.91	Rolling -8%	-	-	15.6%
Long Gold (ETF: GLD)	04/01/2024	207.82	-	-	-	3.9%
Long S&P 500 Energy (ETF: XLE)	03/25/2024	93.26	-	-	-	-2.0%
Long Italian Equities (ETF: EWI)	04/08/2024	37.36	-	-	-	3.4%
Short 10-Year JGBs	04/29/2024	0.83%	-	-	-	0.7%
Short EUR/USD	04/29/2024	1.07	-	-	-	1.1%
Long Nikkei 225 Hedged	05/06/2024	38,835	-	-	-	0%
Stop-Buy Copper[1]	-	-	4.55	-	-	-
Long Natural Gas (ETF: UNG)[2]	05/27/2024	-	-	-	-	-

Note: P&L is calculated using daily closing prices.
[1] We are initiating a stop-buy for Copper at $4.55.
[2] We are initiating a Long Natural Gas (ETF: UNG) trade.

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