ALPINEMACRO
A Unique Mind On The Markets

SPECIAL REPORT

November 18, 2024

My Eurasia Trip

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Last month, I traveled across Europe and Asia, meeting clients and talking to various investors, businesspeople and policymakers. I also made a stop in China for the first time since the Covid-19 pandemic.

Along the way, three questions dominated my conversations: the November U.S. elections, the Treasury market selloff, and Beijing's stimulus plan. With Trump's victory, the first issue is out of the way, but the other two remain.

Specifically, clients wanted to know whether the U.S. would ever hit a "Liz Truss" moment, with Trump expected to cut taxes and blow a bigger hole in the budget deficit.

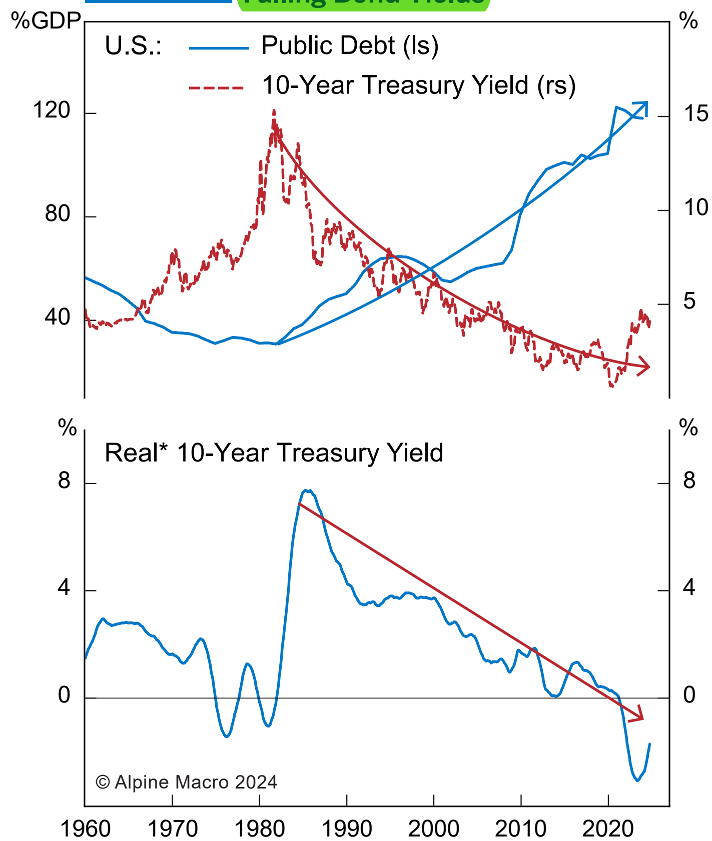
They also wanted to know how to gauge if Beijing has done enough to forestall the economy's weakening momentum.

What Constrains Fiscal Policy

We have published several pieces on the subject of debt, deficits and interest rates, explaining why concerns over a bond market blowup in the U.S. are misplaced.[1] But with so many clients and investors continuing to express their anxiety over the recent bond market selloff, it is worth emphasizing a few key points:

First, those concerned about U.S. debt, deficits and fiscal deterioration need to explain **Chart 1** to

Chart 1 U.S.: Rising Debt Load & Falling Bond Yields



*Deflated by CPI inflation; shown as 3-year moving average

1 Alpine Macro *Global Strategy Special Reports* "Facts And Fallacies, Explained" (July 31, 2023), "What Debt Crisis?" (April 1, 2024) and "Three Macro Misperceptions" (June 3, 2024).

themselves. It shows that the U.S. public sector debt-to-GDP ratio has shot up almost 4-fold since 1975, but bond yields have fallen steadily, both nominally and in real terms.

Similarly, the levels of U.S. government bond yields have shown no correlation with either the size or durability of the fiscal deficit (**Chart 2**). In fact, this correlation has been negative since the 1990s – the bigger the deficit, the lower the bond yields.

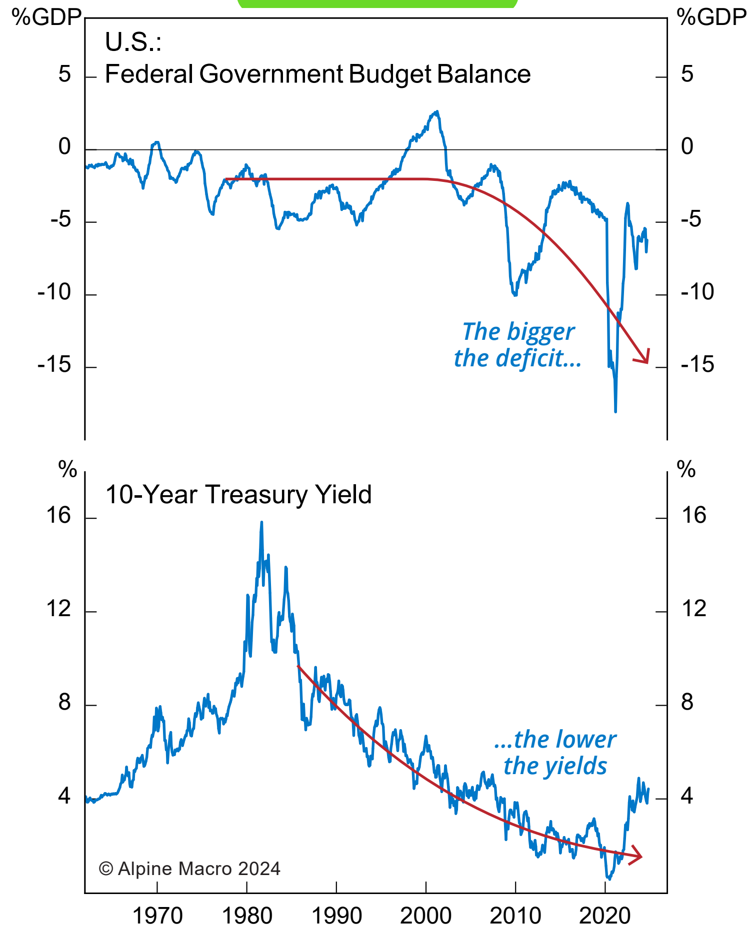
These counterintuitive correlations suggest that, at minimum, the common worry and investor anxiety over the sustainability of public debt levels and the deficit is "much ado about nothing".

Second, some say that debt sustainability requires nominal economic growth to be greater than nominal interest rates. Their rationale is that if borrowing costs (r) exceed nominal growth (g) when debt as a share of GDP exceeds 100%, the debt dynamic will become unsustainable as debt servicing costs will eventually exceed revenue. Under these circumstances, the risk of a blowup in bonds begins to escalate.

Again, there is no historical evidence supporting this proposition. **Chart 3** shows America's r>g throughout the 1980s and 1990s, and yet this is the period when bonds went through a sustained bull market.

One may argue that during this period, America's debt/GDP ratio was smaller than 100%. True, but what about Japan? Japan witnessed r>g between 1991 and 2013 when debt/GDP was far higher than 100%, but this long period coincided with the biggest bull market in JGBs in history, where yields fell from 7-8% to less than 1% (**Chart 4**).

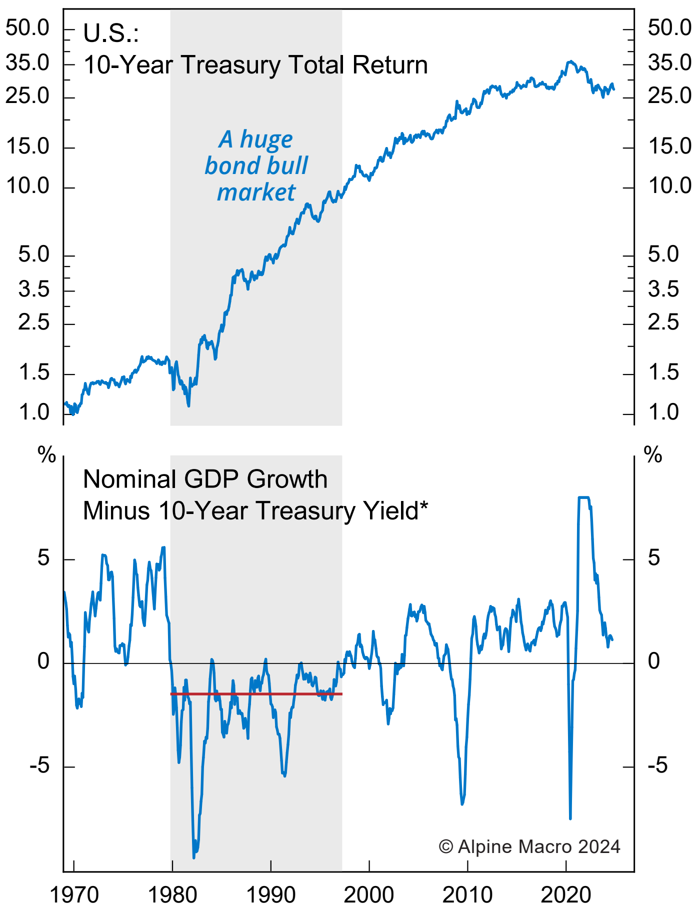
Chart 2 **U.S.: The Bigger The Deficit, The Lower The Yields**



Third, the fundamental misunderstanding about debt and deficits here stems from confusion between the fiat money system and the gold standard. Under the gold standard, public finances always faced a hard constraint – the supply of gold (including gold output and reserves).

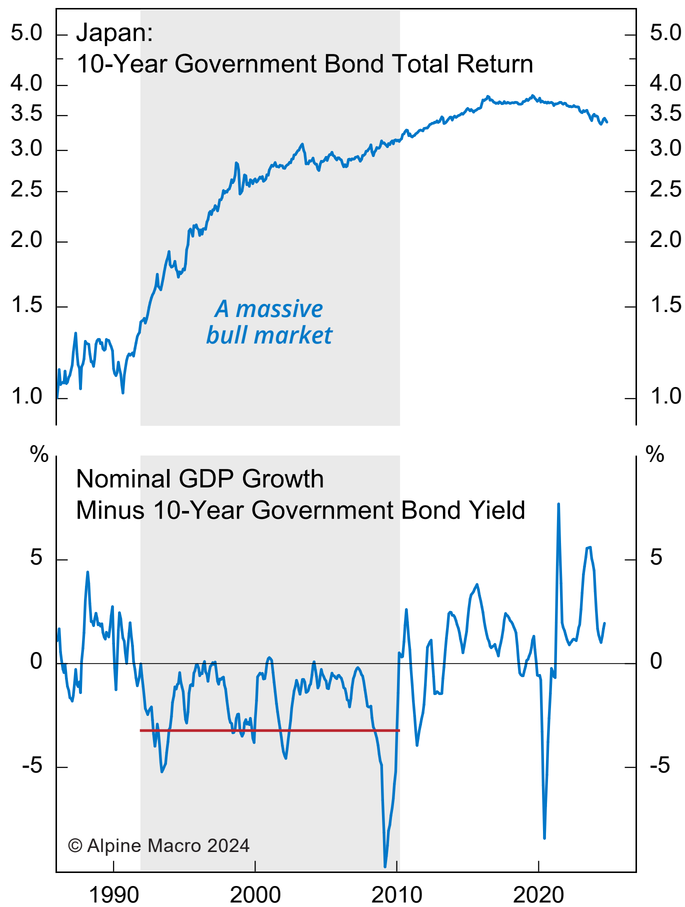
With the central bank playing no role in creating money, it had no or very limited ability to buy government bonds. Under these conditions, a borrowing government would be forced to default on its liabilities once it ran out of money and creditors decided not to lend money to that government.

Chart 3 **The U.S. Experience: When r>g**



*Truncated at 8
Note: Shading denotes periods when r>g

Chart 4 **The Japanese Experience: When r>g**



Note: Shading denotes periods when r>g

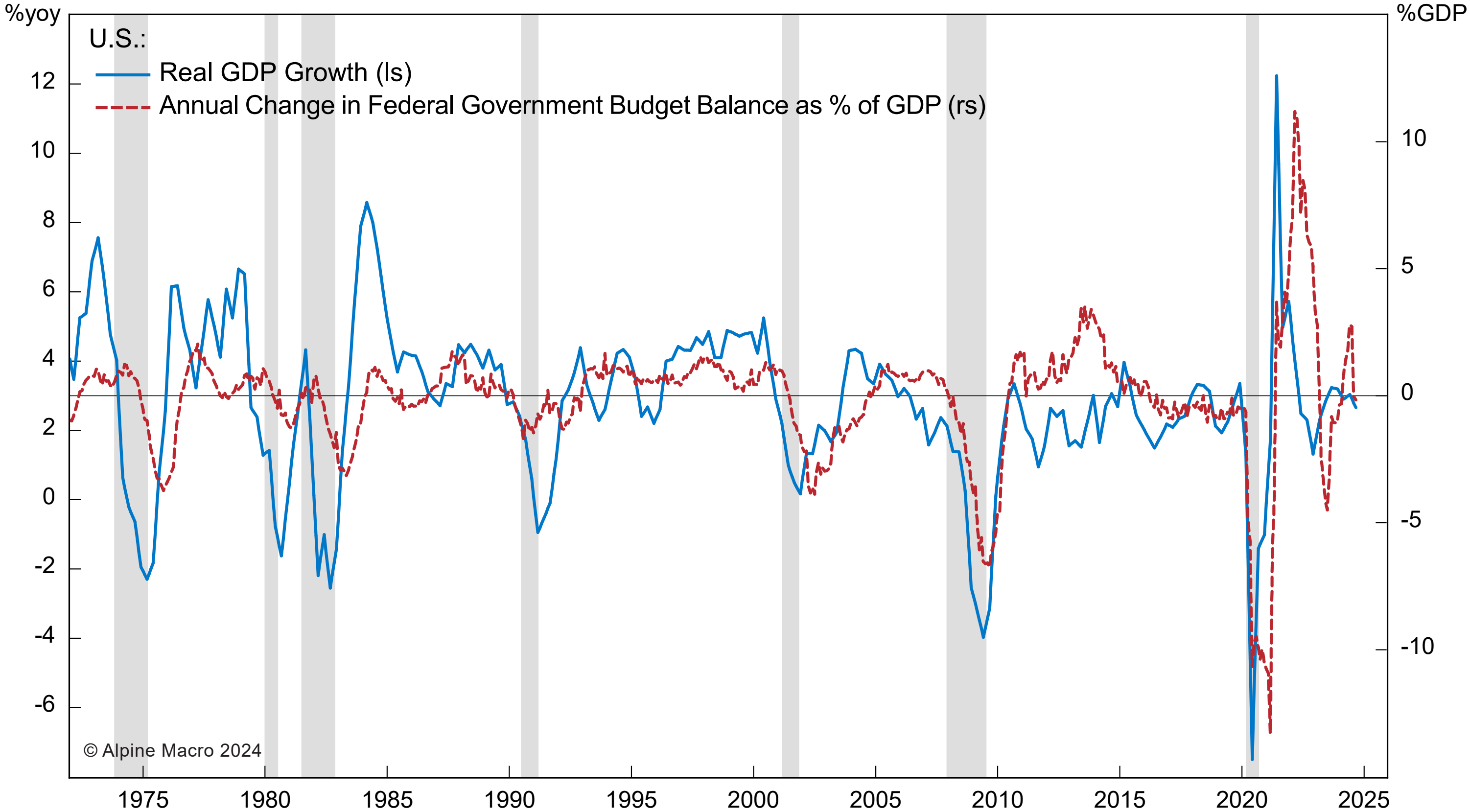
Of course, the government could avoid default by temporarily moving out of the gold standard, as per the U.K. in 1815 and the U.S. during the Civil War when the gold fiat system prevailed for a while. However, these episodes only confirm that the gold standard is the hard constraint for the borrowing government.

By the same token, under the fiat money system, the central bank has unlimited ability to print and expand its own liabilities – various measures of the money supply. As such, a sovereign government should never default on its debt if the central bank acts as a steady "buyer of last resort".

Finally, the ultimate benchmark for sound fiscal policy is NOT judged by a nation's debt-to-GDP ratio or by whether or not it has a large budget deficit. These ratios are simply accounting ledgers reflective of what has happened in public finances in the past.

The only judgement on sound fiscal policy is whether it is counter-cyclical or if it is calibrated according to private sector savings-investment imbalances. In recessions, for example, the private sector rushes to save, which requires the public sector to dissave. Otherwise, a deflationary downward spiral takes place.

Chart 5 Countercyclicality Of Fiscal Policy Versus Business Cycles: A Long-Term Perspective



Note: Shading denotes U.S. recessions

By this standard, U.S. fiscal policy has done a reasonably good job in history, with large doses of fiscal supply often having been injected at times of bad recessions (**Chart 5**). Of course, the cumulative results from these actions are rising debt/GDP ratios.

One thing investors do need to keep an eye on is that the U.S. government's commitment to the countercyclicality of fiscal policy has weakened in the past decade.

For example, the first Trump tax cut took place in 2017-2018 at a time when the Federal Reserve was tightening monetary policy. Similarly, a large dose of fiscal stimulus was applied in 2023 *via* Biden's Three Acts, and this was also a time when the Fed was tightening monetary policy to rein in inflation.

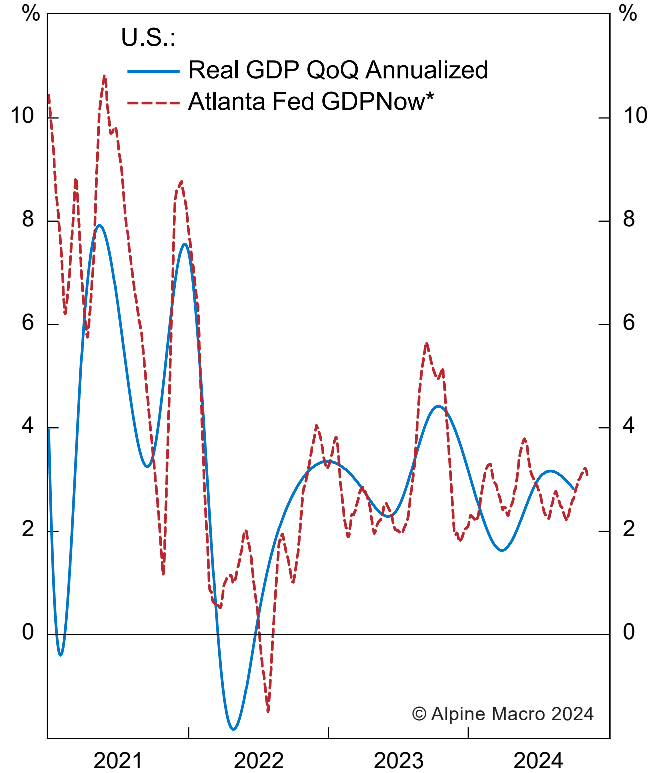
Fiscal actions in these two episodes were not ideal, as in both cases fiscal policy ran against monetary policy, which complicated the central bank's policy actions and reduced the effectiveness of monetary policy.

Going forward, the potential policy conflict between the Fed and the White House could be a potential risk causing market tensions, not the so-called "fiscal risk premium".

Fed Policy

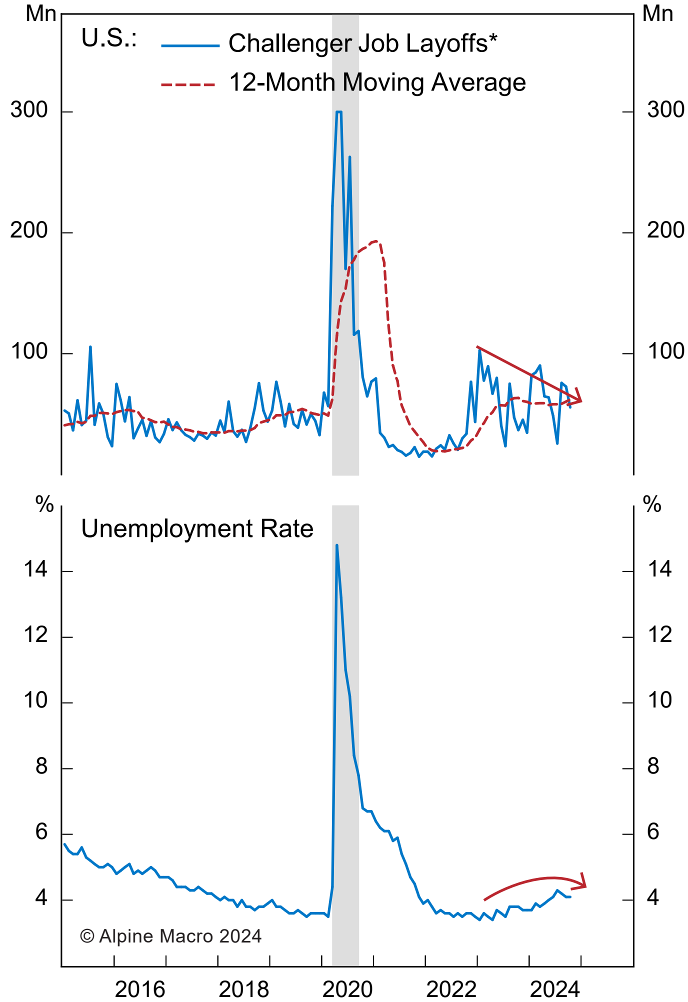
For some time, we have argued that the terminal policy rate could be around 4%, specifically, 2% steady-state growth plus 2% expected inflation.

Chart 6 GDPNow: Steady Growth At 2.5%



*Shown as 1-month moving average

Chart 7 U.S. Labor Market: No Sign Of Imminent Problem



*Truncated at 300; source: Challenger, Gray & Christmas, Inc.
Note: Shading denotes U.S. recession

Obviously, the terminal rate is a moving target which will be affected by many factors, including economic performance, fiscal policy, inflation, geopolitics, etc.

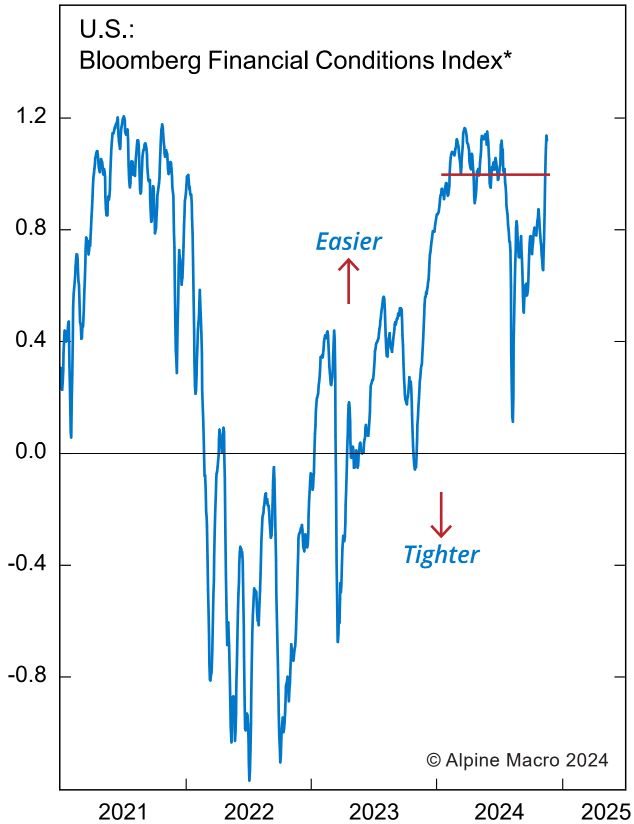
For instance, if the steady-state growth rate in the U.S. has risen to 2.5% because of higher labor productivity, or if there is a large amount of fiscal stimulus implemented next year, the terminal rate could be higher. But for the time being, we think 4% is a reasonable level.

The Atlanta GDPNow model is projecting 2.0-2.5% growth (**Chart 6**) for Q3, while the labor market data has been too noisy to provide a true picture. Nevertheless, the declining unemployment rate is a positive sign that the labor market is holding steady, as are subdued layoff announcements (**Chart 7**).

Some have argued that the sharp rally in stocks has lowered the capital cost and eased monetary conditions. This could stimulate growth and inflation. But the offset is that bond yields have moved higher, and the dollar has strengthened, both of which tend to tighten monetary conditions. **Chart 8** shows that the Financial Conditions Index has not changed much in recent months.

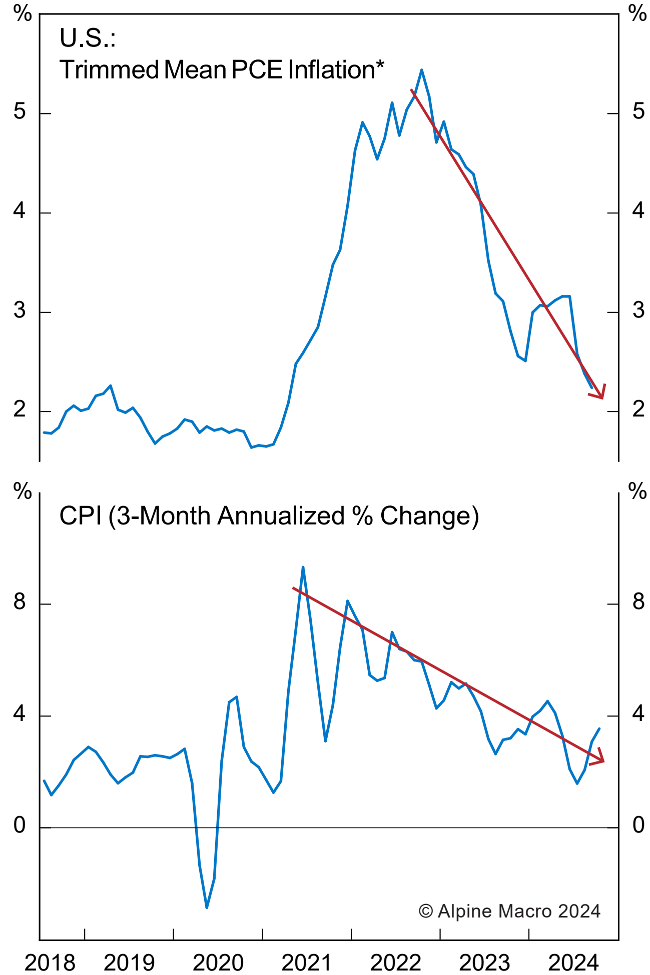
The biggest factor to watch is Trump's promised tax cut, specifically when and how big. At present,

Chart 8 **U.S. Financial Conditions Index**



*Shown as 1-week moving average

Chart 9 **U.S.: Disinflationary Trend Remains Intact**



*6-month annualized; source: Federal Reserve Bank of Dallas

neither is clear. What is clear is that Trump has a strong mandate to deliver what he promised, and therefore, the corporate tax rate will be reduced.

Clearly, if tax cuts are deep and fiscal stimulus is sizable, the Fed's calculus will have to change, and the central bank must take fresh fiscal stimulus into consideration. This could mean either fewer rate cuts or even renewed monetary tightening later in 2025. At present, it is hard to make a call as there are too many unknowns.

Last but not least, the inflation picture is also hugely important for Fed policy. So far, most indicators for core PCE inflation remain pointing down (**Chart 9**). Importantly, labor productivity has accelerated since the Covid-19 pandemic crisis, while wage pressures have cooled. The CPI report last week also confirmed that the disinflationary trend has persisted, paving the way for further policy easing.

The bottom line is that the bond market is still not attractive, and we advise against aggressively increasing duration. Conceptually, the real rate is determined by the underlying economy, inflationary expectations are decided by the Fed, and the term premium is influenced by other factors, mainly global savings.

With a steady-state growth rate of 2% and a 2% inflation target, we reckon the term premium to be around 30-50 basis points. If so, long bond yields at 4.3-4.5% seem reasonable.

China Impression: Beijing And Hangzhou

I spent one week in China, traveling from Beijing to Hangzhou, a financially prosperous city with about 10 million people. It is also where Alibaba was created and is headquartered. In my view, the vibrance, vitality, and hustle & bustle that once characterized these places were notably absent.

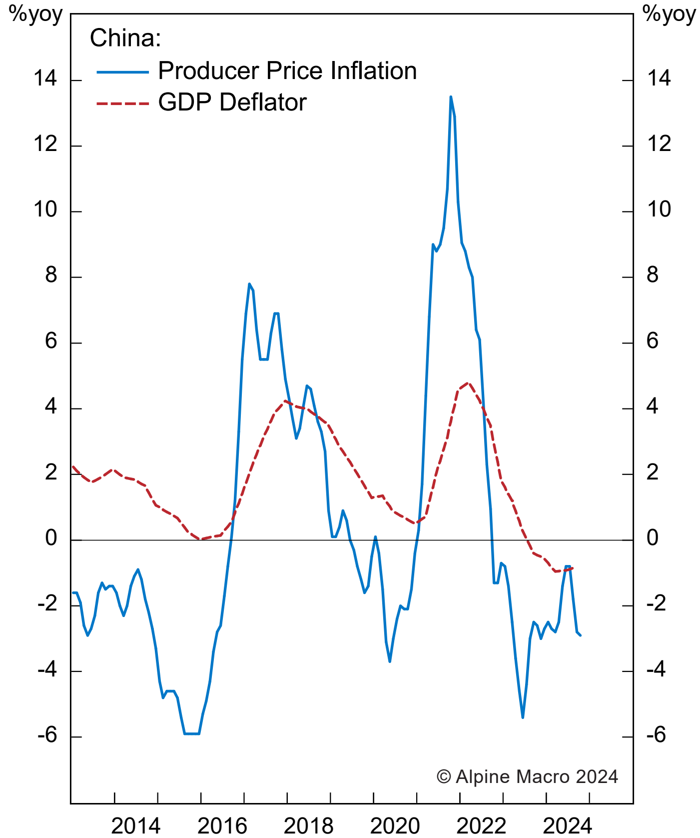
My sense is that foot traffic on Beijing's busy streets is probably 20-30% less than in 2019 when I last visited. I was told that migrant workers are mostly gone as there are no jobs for them and living expenses in Beijing are prohibitively expensive. Many delivery boys are university graduates who cannot find other jobs that fit their training or skillsets.

Yiwu is a satellite city of Hangzhou and is where the world's largest wholesale market is located. There are five gigantic exhibition halls with 6.4 million m^2 of space and more than 100,000 permanent booths from suppliers.

I was told that the city, once jammed with merchants from all around the world, is going through contraction with merchant visits having halved. Foreign merchants, mostly from third-world countries, are few and far between.

Restaurants in Beijing and Hangzhou are fiercely competitive and offer various discounts to lure patrons, but most restaurants I went to were half-empty even at peak times. A restaurant owner in Beijing told me that people are dining out less than before and are very careful about what they order.

Chart 10 China Is Deflating



It has become abundantly clear that China has a massive demand problem, and I am puzzled why it has taken the government so long to take any decisive action.

The Chinese government is very concerned about debt, and policymakers worry that any large-scale stimulus program will lead to more debt accumulation and ultimately financial trouble. The instruction from the very top is that "economic security" overrides any other policy objectives.

This is a ridiculous requirement, particularly for a country with such large excess savings. With the private sector saving way more than it can absorb *via* investment, the government must borrow and spend for the private sector. Otherwise, growth will weaken and price levels will fall, as China is currently going through (**Chart 10**).

The Package And Markets

On November 8, Beijing announced a US$1.4 trillion debt swap program for the next few years to alleviate financially strained local governments. The package will allocate $340 billion each year for the next three years to swap hidden debt from provincial governments, aimed at easing the financial burden on local governments.

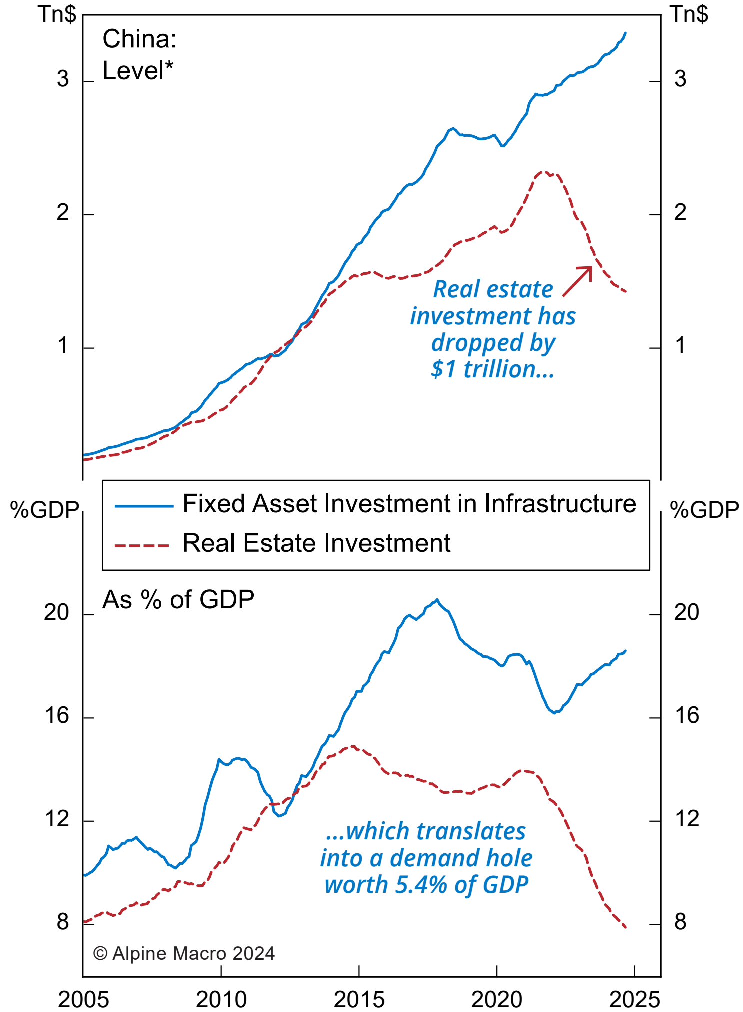
The biggest problem with Beijing's package is that it is not a stimulus package, but a debt-swap plan. Specifically, there is no "G", nor is there fresh fiscal stimulus in the form of major tax cuts. The debt swap may help ease financial pressures on local governments but will do little to address the inadequate aggregate demand problem.

How much policy stimulus does China need to forestall the weakening economic momentum? Here is our rough calculation: the real estate meltdown has wiped out $1 trillion in real estate investment, which is worth about 5.4% of GDP (**Chart 11**).

There is also a secondary loss of consumer demand related to the property market. The sharp fall in property prices has crimped Chinese household net worth, forcing consumers to save more and spend less to rebuild their lost wealth.

There is no direct data on how China's household savings rate has behaved, but time deposits held by

Chart 11 China: The Fallout In Real Estate Investment



*Shown as 12-month moving sum

Chinese residents as a share of nominal GDP can be used as a proxy for household savings because bank deposits are a meaningful part of Chinese household wealth (**Chart 12**). Based on historical correlations and IMF/FT estimates, the Chinese household savings rate might have moved up 3% or more since 2021.

Put another way, the total loss of aggregate demand could be as much as 8-9% of GDP, consisting of a 5.4% meltdown in real estate investment and a 3% rise in the savings rate.

Chart 12 Gauging China's Savings Rate

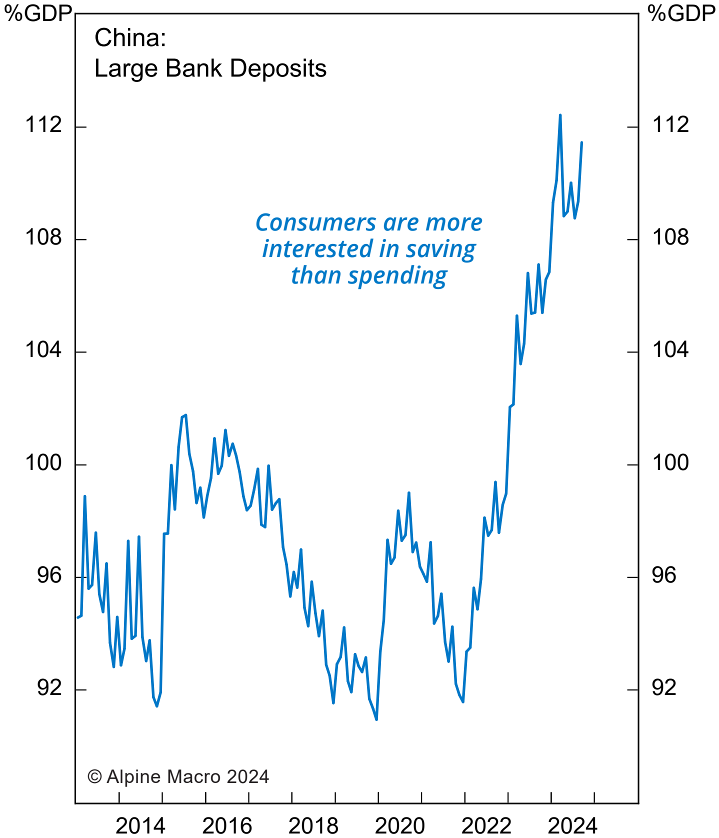
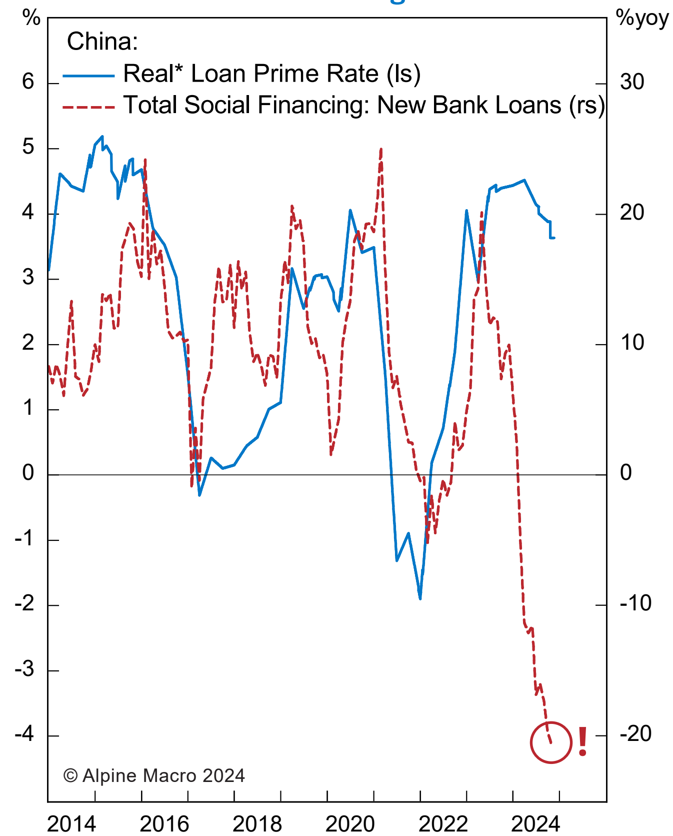


Chart 13 China: Real Borrowing Costs Remain Too High



*Deflated by GDP deflator

So far, this huge demand hole has been offset by the following:

- a gain in infrastructure investment of around 2% of GDP,
- an increase in net exports of around 1.5% of GDP,
- about 1.5% price deflation,
- and a 1.5% increase in the budget deficit.

In other words, all these adjustments amount to 6.5% GDP, which means that there is still a 2% demand gap that needs to be filled. In the case of a Trump tariff hike on Chinese goods, the gap could get much bigger as higher tariffs could take down China's net exports significantly.

China needs a stimulus package at least as large as 4.0% of GDP a year to push the economy out of its deflationary trap, put GDP growth back on its potential growth trajectory and restore the 2% inflation target. Moreover, the stimulus needs to be upgraded significantly in case of a sharp increase in U.S. tariffs on Chinese exports.

The key point here is that the announced package falls far short of the size needed to push the economy back to its potential growth path. **Chart 13** shows that China's real interest rates remain very high even though bank loans are contracting severely. Why hasn't the People's Bank of China already reduced the policy rate to zero? What are they waiting for?

On a positive note, the authorities in Beijing have also indicated that more stimulus will be forthcoming, if needed. For the time being, Chinese stocks have been in a holding pattern (**Chart 14**), while copper is testing critical levels. China-related assets seem to be waiting to see what else is in the policy pipeline.

So What?

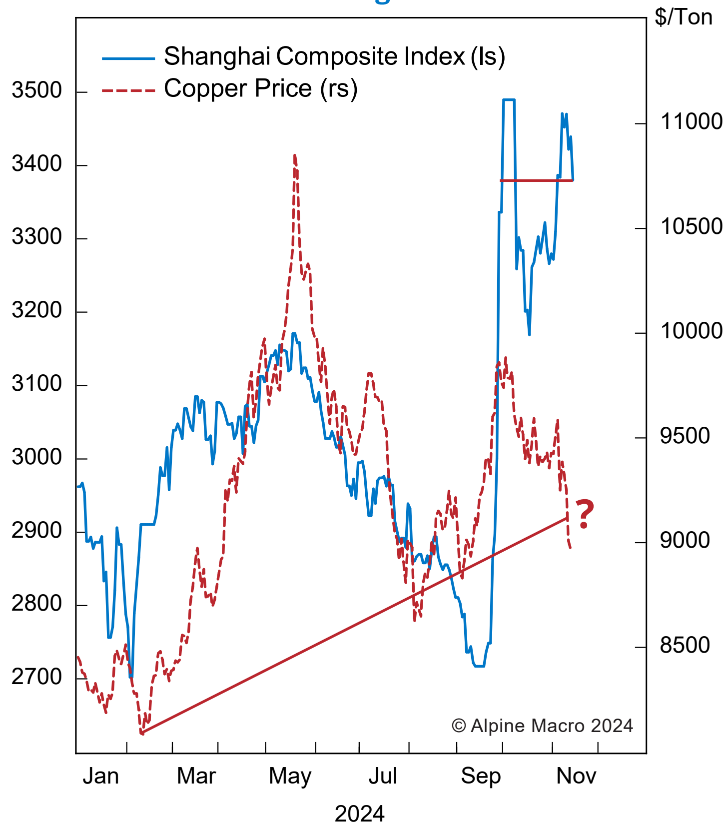
- Maintain a 70/30 split in equities and bonds.
- Stay overweight U.S. equities.
- Deploy a barbell strategy with growth stocks on one side and Trump-favored sectors (Banks, Aerospace & Defense, etc.) on the other.
- Stay neutral duration for fixed income portfolios.
- Stay bullish on gold but be short crude oil.
- Stay cautious on industrial commodities.

Housekeeping

Our long gold position (ETF: GLD) was stopped out with a gain of 18.9%. The gold market remains overbought and could correct more. We recommend a stop-buy for GLD at $225.

Chen Zhao
Chief Global Strategist

Chart 14 China-Related Assets: In A Holding Pattern



Investment Recommendations

Tactical Investment Positions (3 - 6 months)

Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	Rolling -8%	-	-	41.2%
Long Gold (ETF: GLD)[1]	04/01/2024	207.82	Rolling -5%	11/11/2024	247.11	18.9%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	14.2%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	6.6%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	0.5%
Short Brent Oil	10/22/2024	76.00	-	-	-	6.4%
Stop-Buy Gold (ETF: GLD)[2]	-	-	225	-	-	-

Note: P&L is calculated using daily closing prices.
[1] Our Long Gold (ETF: GLD) position was stopped out on 11/11/2024, with a profit of 18.9%.
[2] We are initiating a stop-buy for Gold (ETF: GLD) at $225.

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