LV Longview Economics
Investments. Trades. Macro.

Independent advice and consulting on global economies and financial markets

AAII Webinar

Chris Watling, CEO & Chief Market Strategist, Longview Economics, April 2022

Presentation Overview

UK PM Boris Johnson:
"Pro having cake, and pro eating it"

Two Key Sections:

A. **Short term** (3 – 9 months) **opportunities**;

B. Longer term (end 2022 – 2023/24) theme:

"Policy Normalization and the end of 'TINA'"

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Short Term (2 – 9 months): Market is an 'Emotional Beast'

"Greedy when others are fearful"; Warren Buffett

"Actual risk is equal to the inverse of perceived risk"; Harry Lange, Fidelity Magellan ex fund manager (2005 – 11)

"Buy on the sound of cannons"; Rothschild re: Battle of Waterloo, early 1800s

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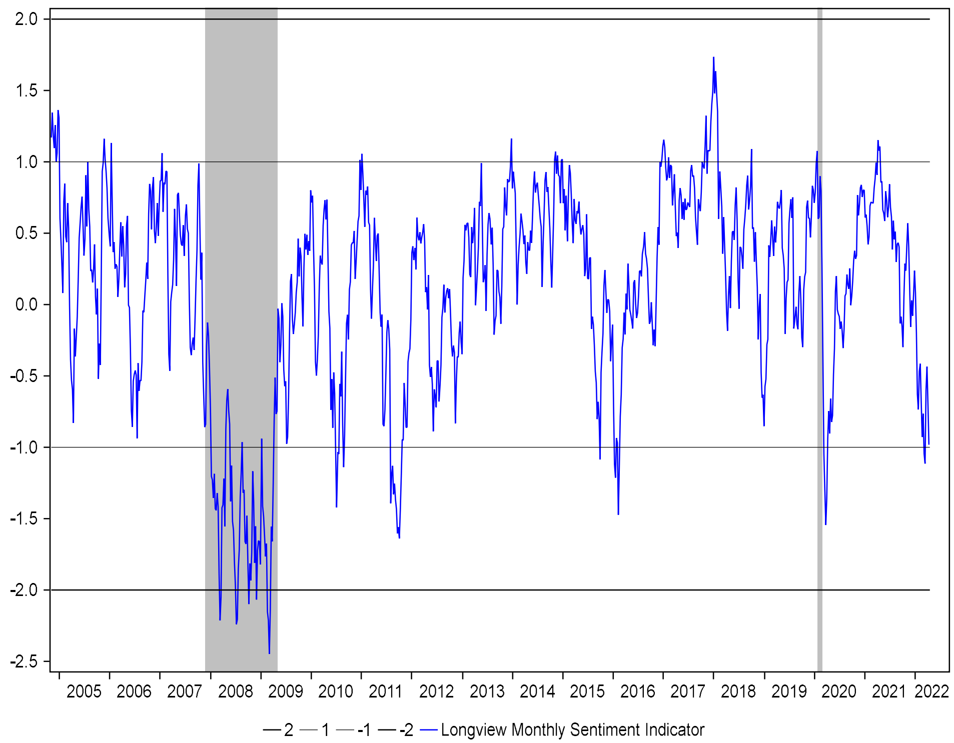
Current Market Emotion: Bearishness Abounds

Sentiment scoring system



Source: Longview Economics, Macrobond

April survey

BofA Global Fund Manager Survey

FMS bottom line: April FMS is bearish as fear of fast & furious Fed sends global growth optimism to all-time low, keeps Wall St stability risks high; though not as bearish as war-shocked March FMS, sentiment is poor (BofA Bull & Bear Indicator back down to

FMS on Macro: global growth optimism @ all-time low (-71%), most since Aug'08 predict stagflation, though most expect today's hot inflation to cool next 12 months.

FMS on Risk: cash levels drop to 5.5% from uber-high 5.9%; #1 "tail risk" = recession, #2 hawkish central banks, #3 inflation, while Russia/ Ukraine falls to #4 tail risk; FMS Financial Market Stability Risk index remains v high & consistent with S&P500 <4000.

March survey

"global growth optimism lowest since June '08 (Lehman)".
"Hegde fund equity exposure lowest since April 2020" – and one of the lowest levels since the GFC.
"60% of investors now expect an equity bear market in 2022".

Source: BofAML Fund Managers' Survey April & March 2022.

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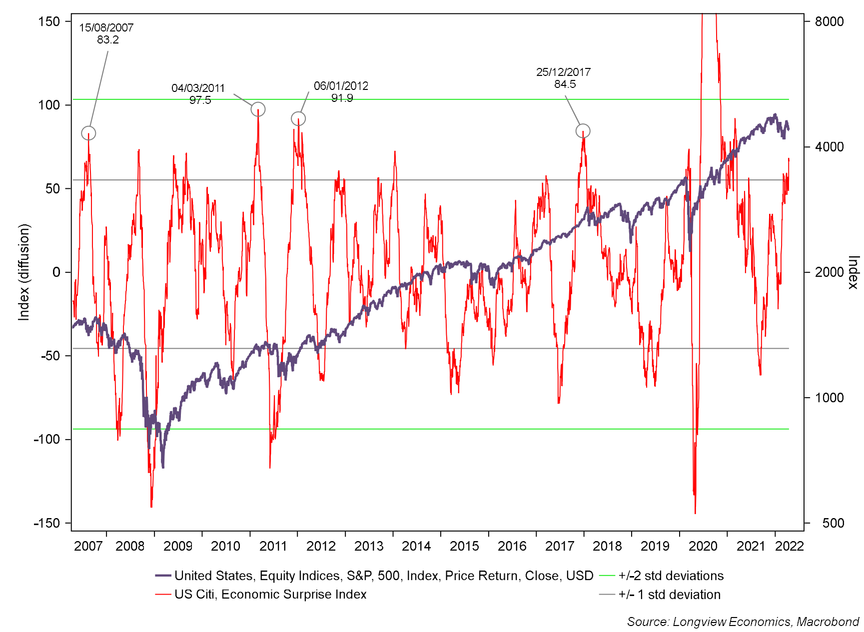
Pessimism - widespread

BofA FMS – global growth optimism

Despite that the econ data is surprising to the upside.....



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What has 2022 really been about (so far)?

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The **beginning** of policy normalization (key point)

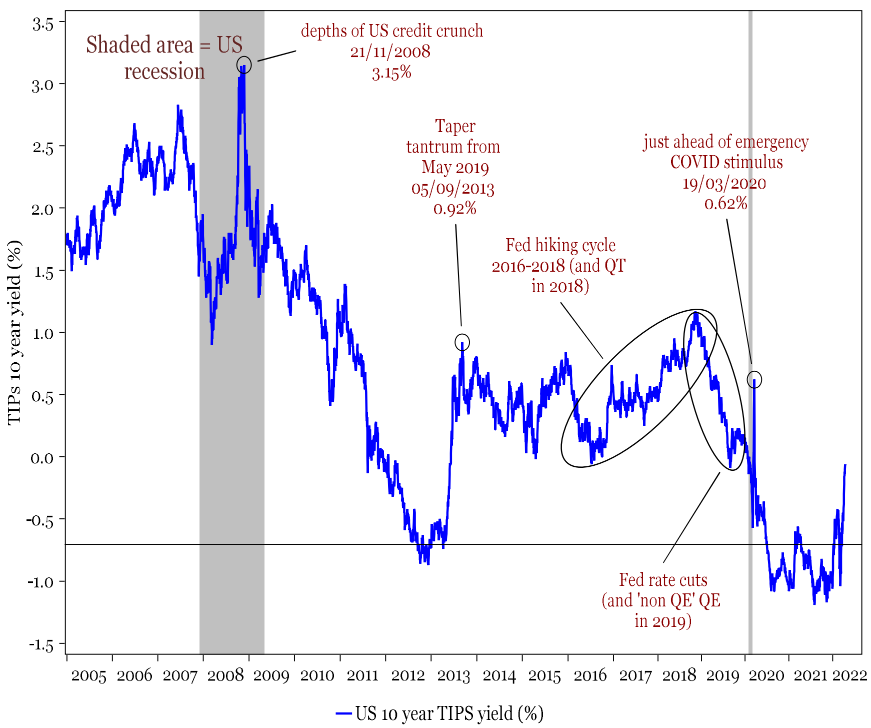
US (& other) 10 Year Bond Yields: Break Down into: i) Implied Inflation; & ii) Real (TIPS) yields

US 10 year bond yields shown with key moving averages

Source: Longview Economics, Macrobond

Policy Normalisation:
Is now Beginning
Should = Higher real bond yields

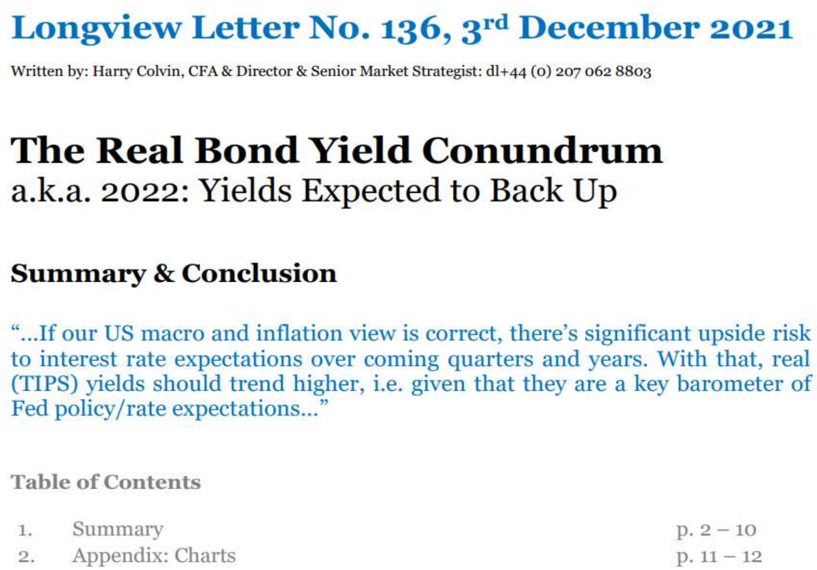
US 10 year TIPS yield (%)



Source: Longview Economics, Macrobond

Four Phases of US TIPS (past 15 years)

Those 'debt deflationary' risks and 'financial repression' dynamics are illustrated by the four different liquidity environments of the past 15 years (i.e. including and since the GFC),



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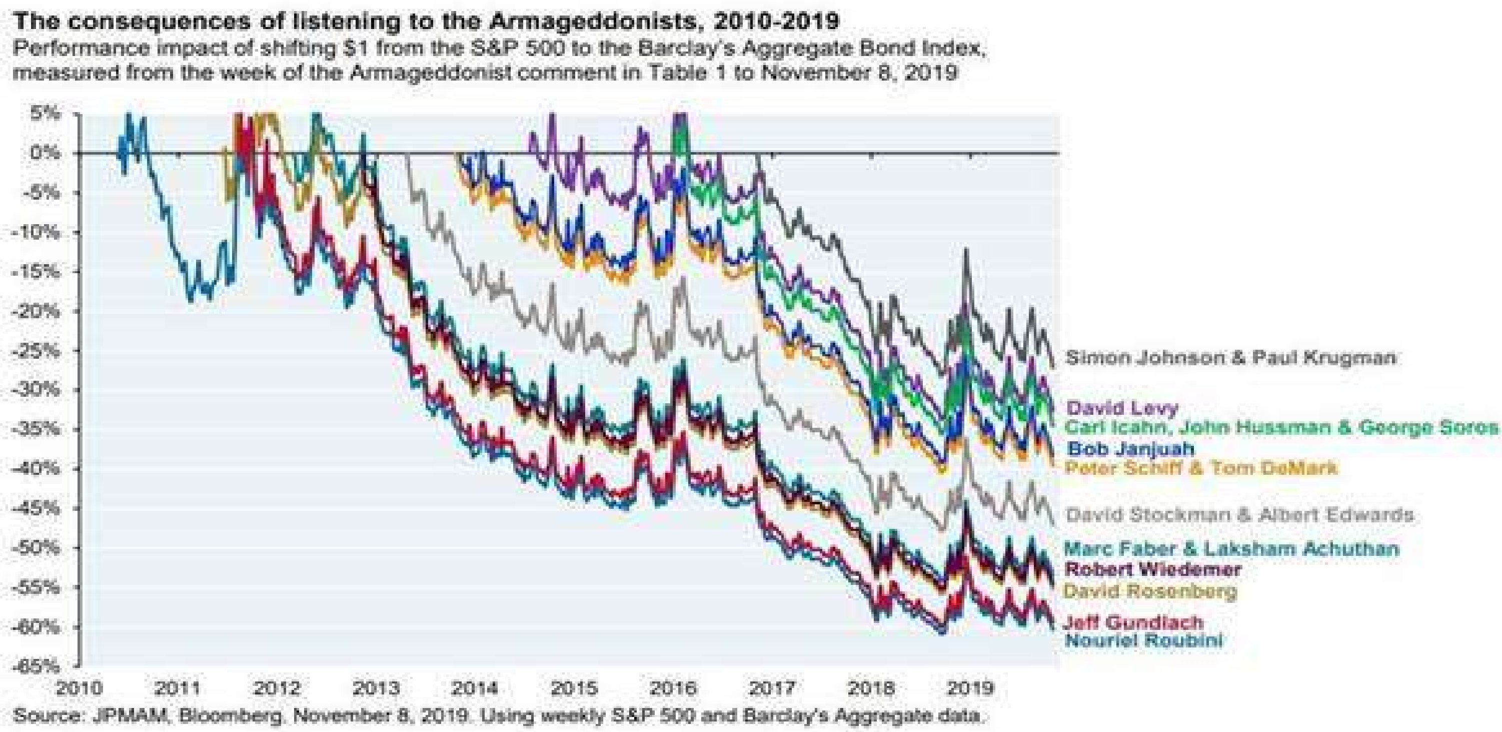
.....BUT......
....Timing is key
The (valuation) Armageddonistas (portfolio performance...)

"The Bears sell Newspapers – the Bulls make Money"



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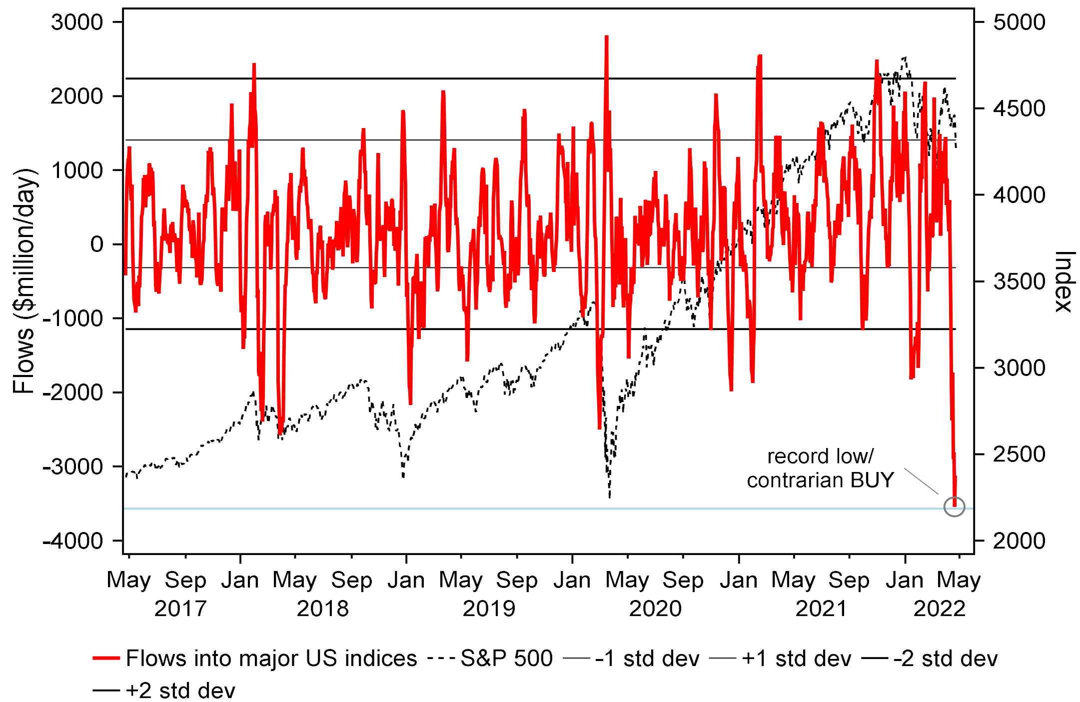
....Timing is Key...

'Be greedy when others are fearful'....Buffett

"short term markets are a voting machine....long term weighing machine"

Benjamin Graham (Buffett's mentor)

US Equity Index ETF Fund flows vs S&P500

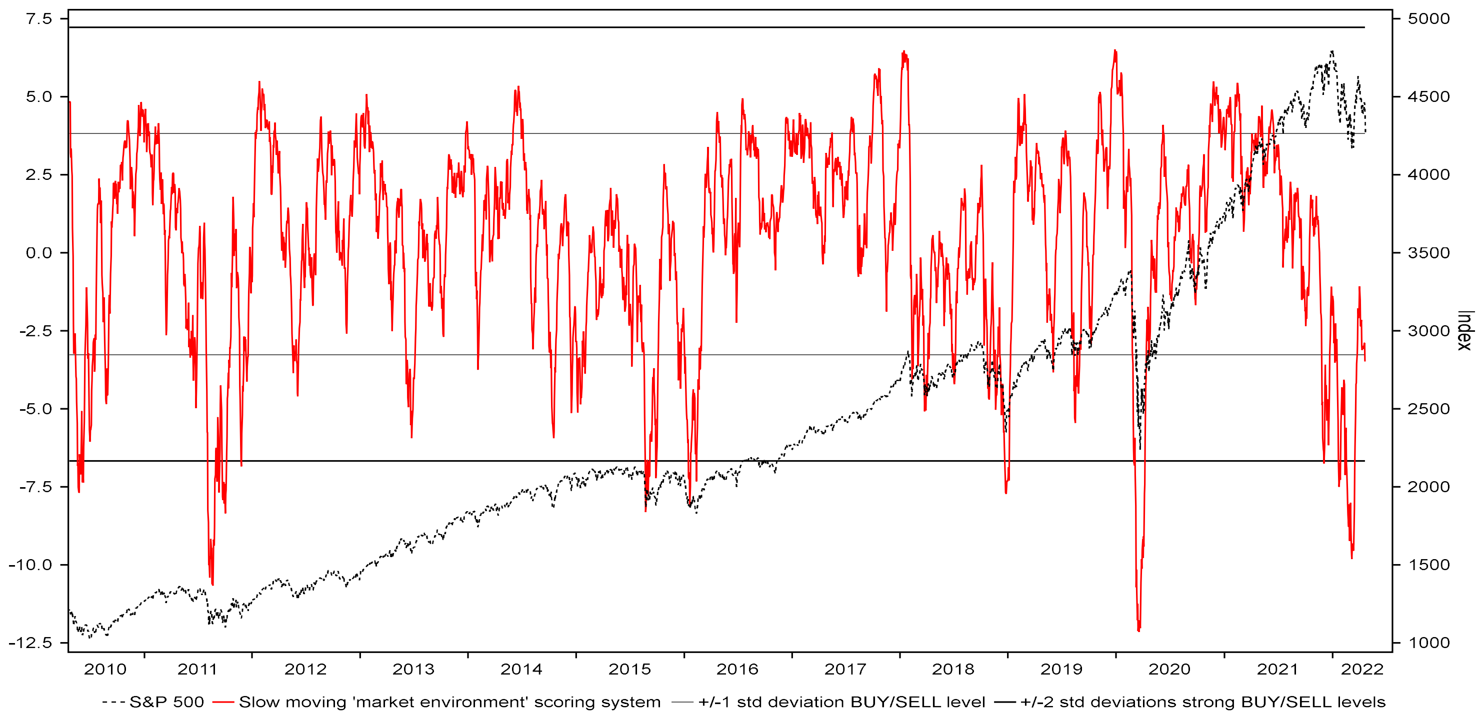


Source: Longview Economics, Macrobond

Key Tactical Market Timing Models: still close to BUY

Longview 'Slow Moving' market environment scoring system vs. S&P500

= 'catch-all model', incorporating five different categories of indicators



Source: Longview Economics, Macrobond

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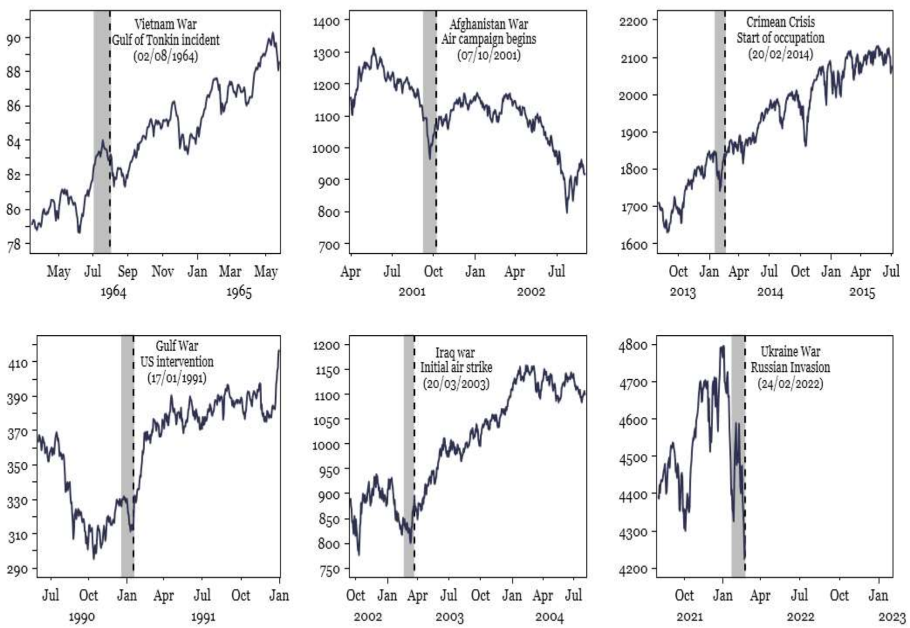
Markets *Usually* Trough on Invasion (BUY on the Cannons)

S&P500 and major conflicts



...although not always.....(there are rare exceptions)...

FIG: FTSE100 and WWII

Source: Longview Economics, Macrobond

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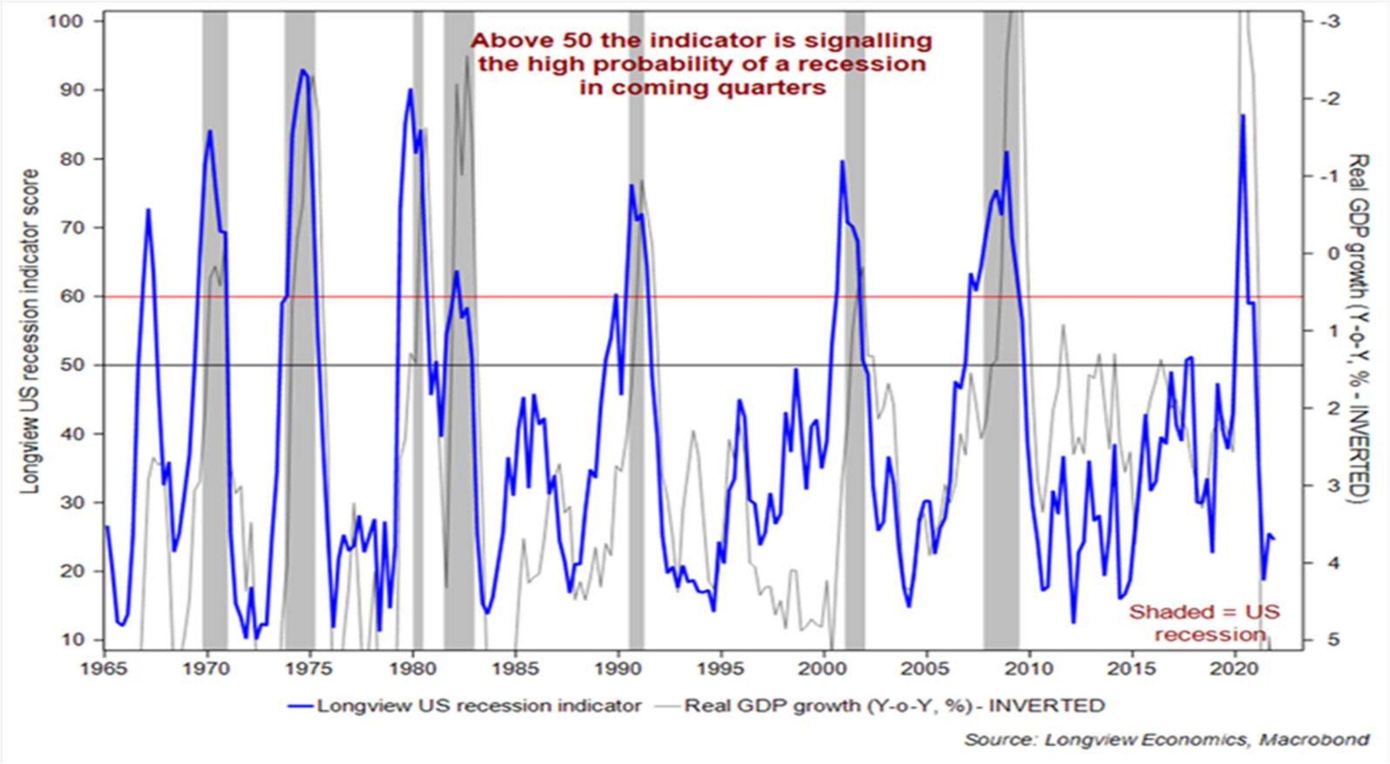
Recession Risk Chatter = HIGH
BUT message of 'The Longview Recession Indicator' -> it's unlikely

FIG 4: Longview US recession indicator vs. real GDP (Y-o-Y %, scale INVERTED)



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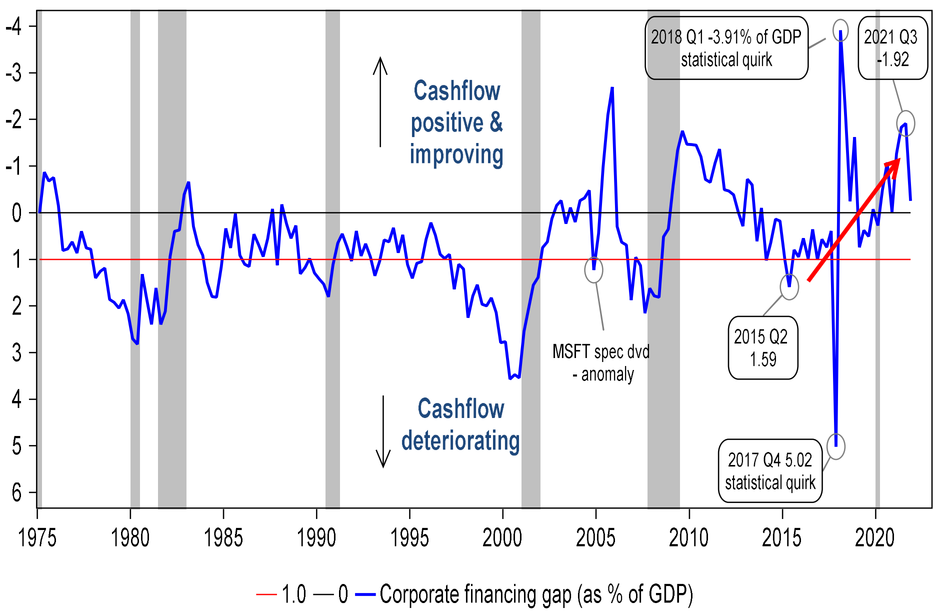
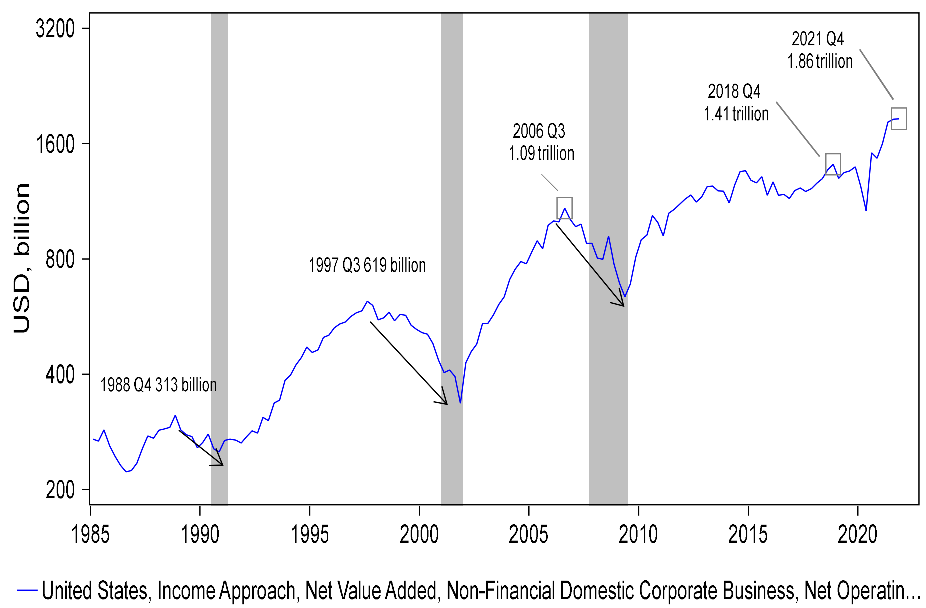
Recession Risk Low: Corporate Sector Healthy!

US corporate sector financing gap (as % of GDP)



Source: Longview Economics, Macrobond

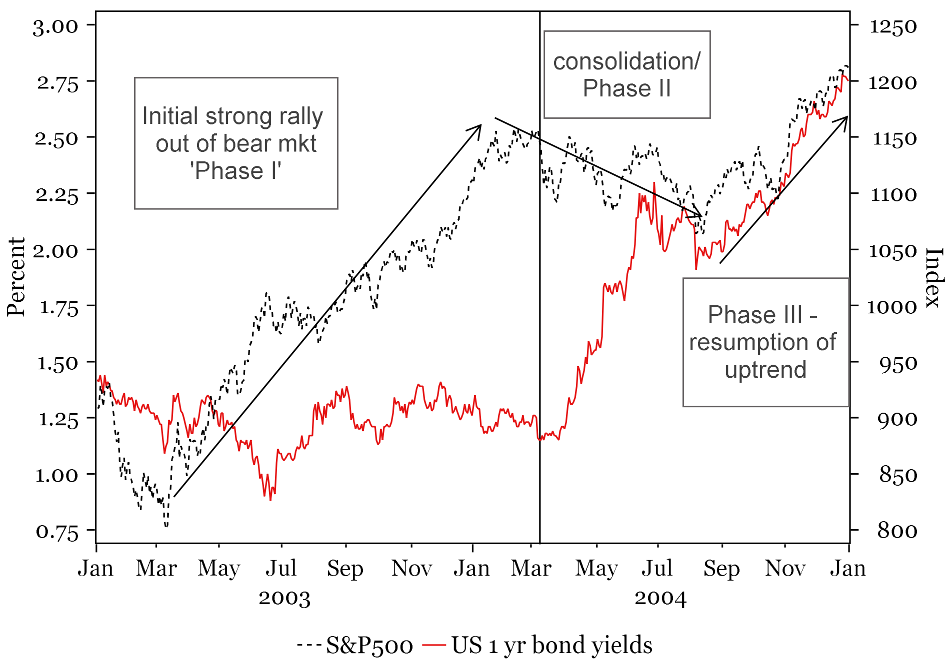
US NIPA corporate profits (US$bn)



Source: Longview Economics, Macrobond

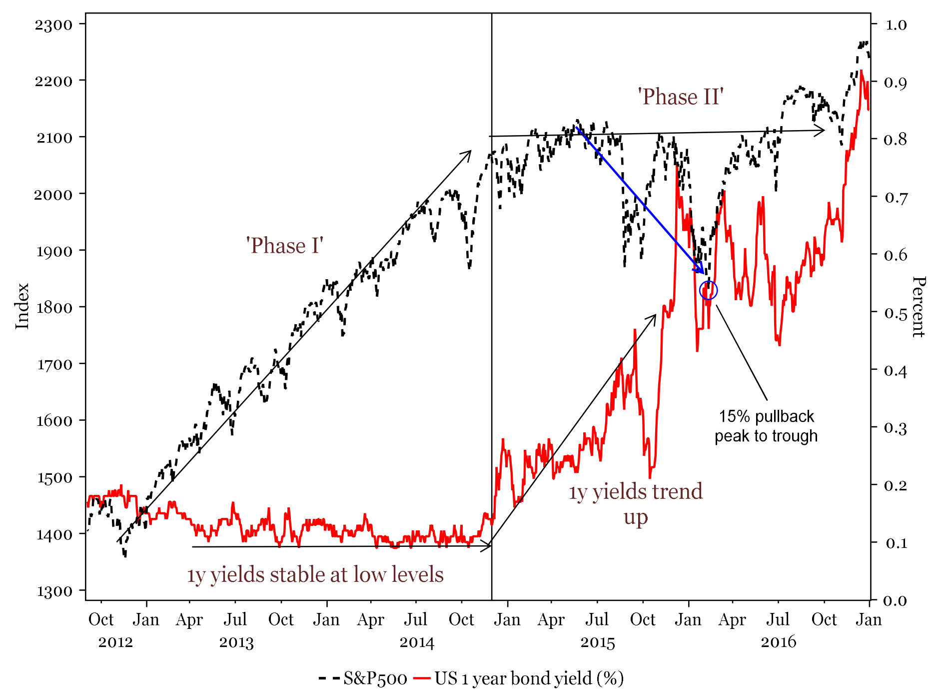
The Shape of Bull Markets
Stylized Cyclical Bull Markets: Three Phases

US 1 year bond yields shown with the S&P500 (Phase II): **2003/04**



Source: Longview Economics, Macrobond

Fig 1b: S&P 500 vs. 1 year US bond yields (2012 – 2016)



Source: Longview Economics, Macrobond

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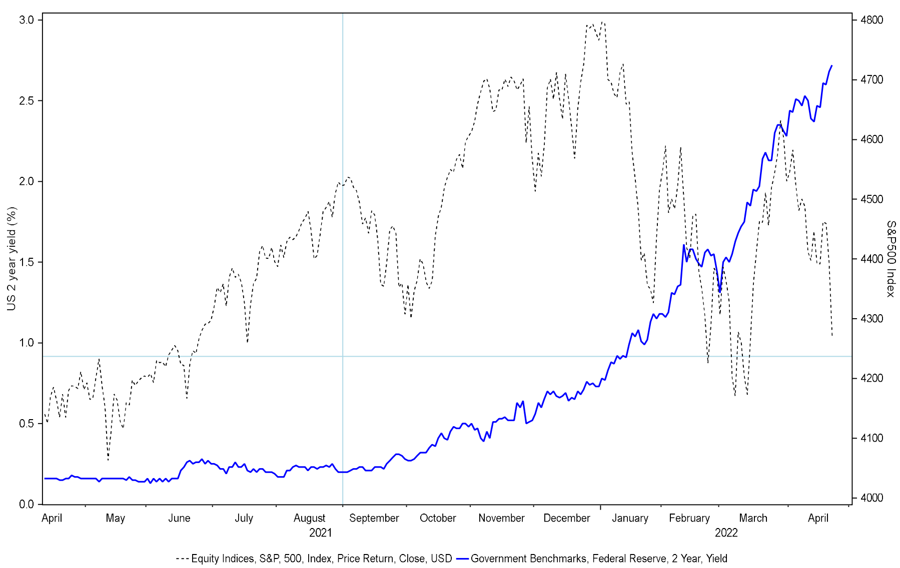
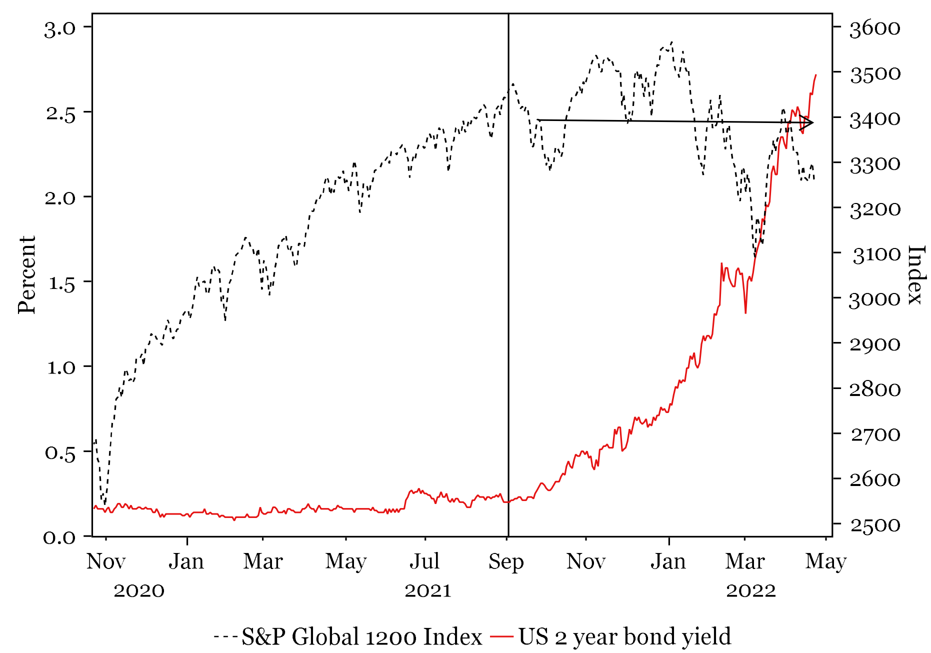
Phase II – been playing out (stylized cyclical bull markets)

US 2 year government bond yields vs. the **S&P500** (2021/22)



Source: Longview Economics, Macrobond

Global equity index vs. US 2 year bond yields



Source: Longview Economics, Macrobond

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Phase III:
resumption of equity uptrend

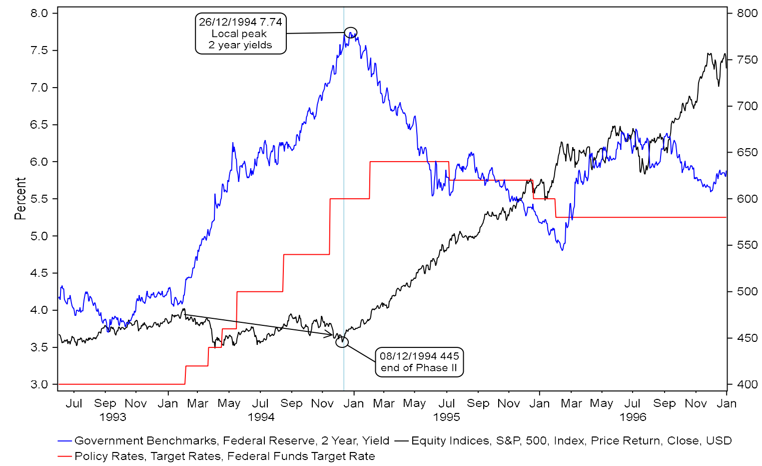
From an equity market perspective there are two key observations:

1. Since mid-March, equities have broadly flat (i.e. price action has been robust) despite the back up in bond yields, which theoretically should put equities under pressure.

2. Respite in the back-up in yields is often associated with the shift of equities from Phase II of a stylized cyclical bull market into the start of Phase III.

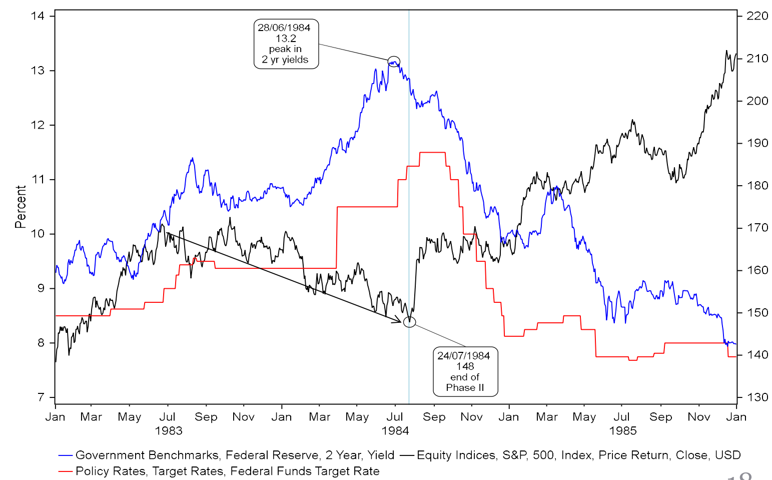
Phase III is then the resumption of the uptrend, which often starts once markets have priced in enough of the forthcoming tightening (i.e. as yields peak).

Fig 5: Phase II and III in 1994 (US 2-year yields, S&P 500)



Source: Longview Economics, Macrobond

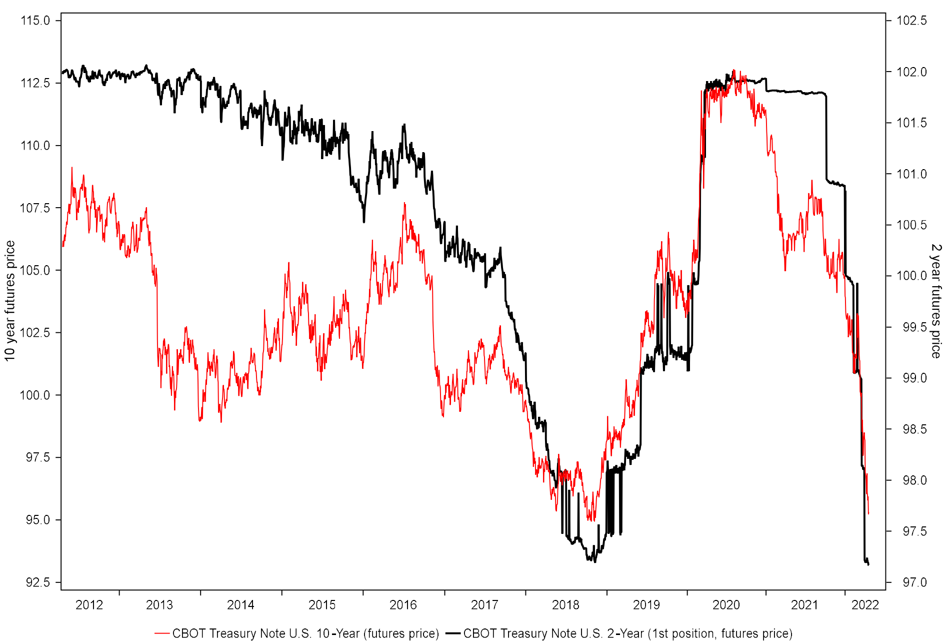
Fig 5a: Phase II and III in 1983/84 (US 2-year yields, S&P500)



Source: Longview Economics, Macrobond

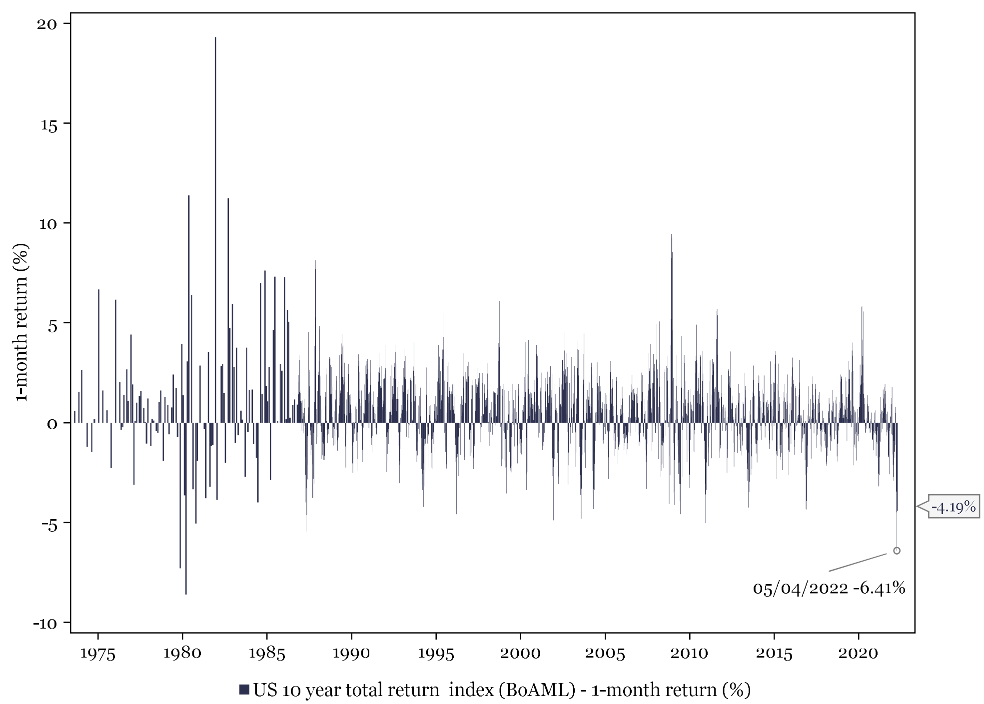
Bonds:
Sharp SELL-off!

Bond futures prices (two and ten-year bonds)



Source: Longview Economics, Macrobond

10 year Treasuries one month SELL-offs (%)



Source: Longview Economics, Macrobond

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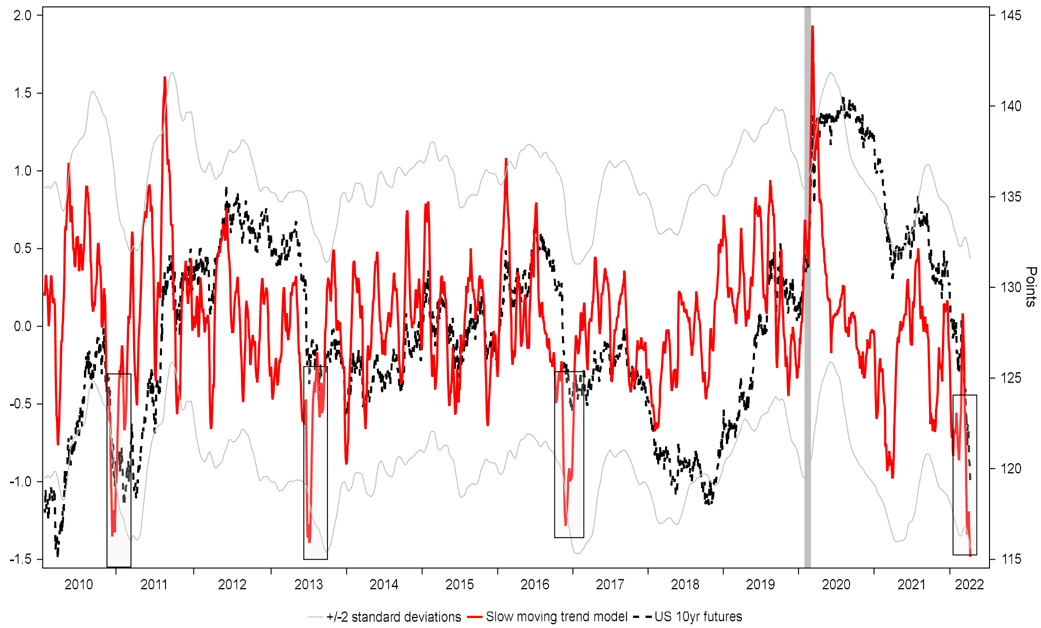
Price Actions in Bonds: Are We at Oversold Levels?

US 10-year bond futures technical indicator shown with SD bands vs. 10-year bond futures prices



Source: Longview Economics, Macrobond

- Bonds have reached their **2 standard deviation oversold level** according to the FMACD** technical indicator.
- This is rare and has only happened **8 times in the past 20 years.**
- On all of these occasions once bonds had become oversold the price either stabilises or rallies.

**** 'FMACD' = fast moving average convergence-divergence model. This one uses the 12 & 26 day moving averages.

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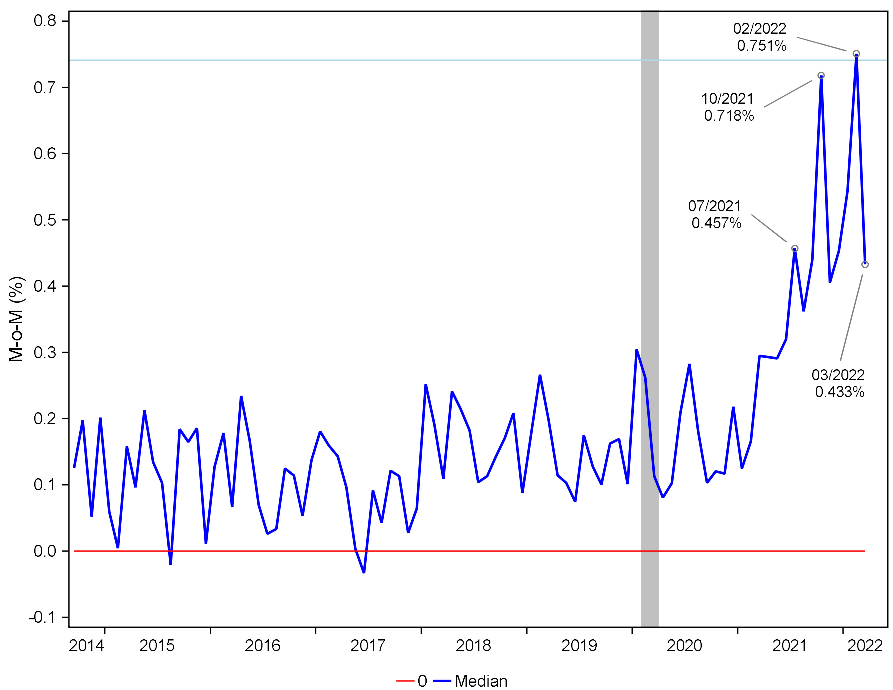
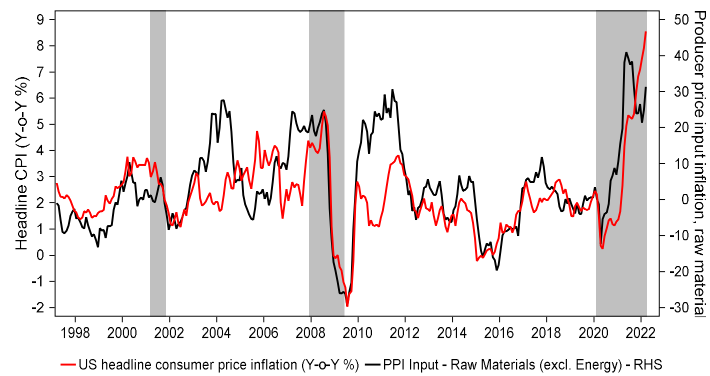
Inflation: Any "Good" News?

FIG 4: US median monthly inflation (M-o-M %)



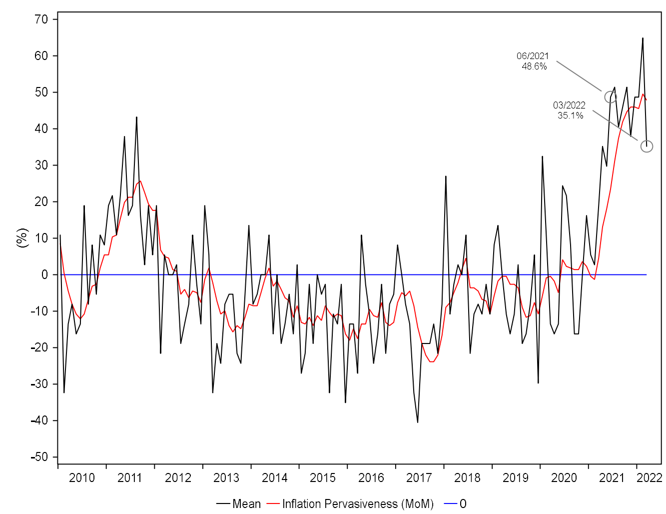
Source: Longview Economics, Macrobond

US PPI raw materials vs CPI (cost push infl dynamic)



Source: Longview Economics, Macrobond

US monthly inflation pervasiveness (using M-o-M gains)



Source: Longview Economics, Macrobond

Equities: Tactical & Strategic Outlook (next 3 – 6 months)

Bull case

1. Market sentiment highly pessimistic (as high as prior bear markets); "60% of investors expect bear market in 2022";
2. Macro growth pessimism = high (yet eco data surprising to the upside).
3. Inflation risks heightened (see BofA FMS)
4. Market timing models – recent strong BUY signal
5. War risk –> still present but reduced in past 4 – 8 weeks
6. Markets: Phase II to Phase III (Phase IIIs often start as yields peak).
7. Bonds – deeply oversold (often stabilise/rally for following 4 – 9 months).
8. Assessed recession risk = low (in immediacy) -→ soft landing expected
9. Equities = cheap again (relative to other asset classes)

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BUT….

Beyond the short term (beyond the next 3 – 9 months)…..

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Fed normally raises rates until something breaks: What Might Break?

"With inflation running roughly three times the Fed's 2% target, "it is appropriate to be moving a little more quickly," Powell said in a discussion of the global economy at the meetings of the International Monetary Fund. "Fifty basis points will be on the table for the May meeting.""

Source: J Powell, April 21st @ IMF meetings

Some Candidates

1. TINA thesis, QT –> end of TINA/reversal of its impact
2. Chinese housing market?
3. Japanese assets etc. – see recent behaviour of Yen/JGBs
4. Western housing?? US housing?
5. US consumer – income squeeze/rates squeeze?
6. US SME businesses (sharp pick-up in indebtedness levels in past 10 – 15 years – see Quant monthly research).

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WHEN DOES TINA END?

"Global Macro and Markets Outlook: 2022/23 & Beyond"

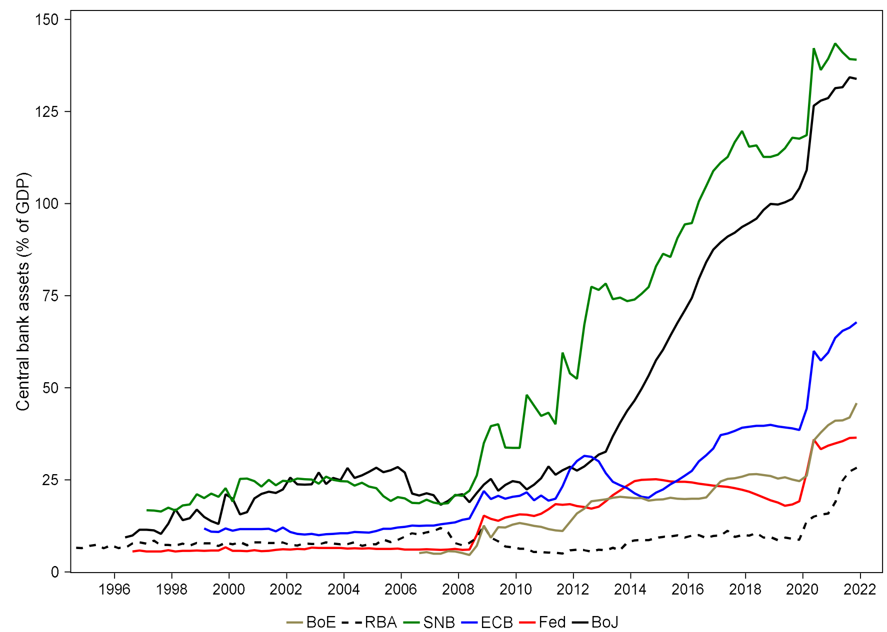
What is TINA?
('There Is No Alternative')

- Central bank buying of financial assets (primarily sovereign bonds, but also others) is pushing investors - private and institutional - up the 'risk curve', to seek out adequate returns (by accepting more risk);

- **Or alternatively:**

- Yields in traditionally risk-free (low risk) assets are now zero or negative, forcing investors to buy alternative higher risk assets (like equities) to generate the return they need (and would have previously generated with sovereign bonds/other low risk FI assets)

Central bank assets (% of GDP)



Source: Longview Economics, Macrobond

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Why do we have 'TINA'?

- Natural extension of debt super cycle, with its three drivers: i) unanchored IMS; ii) CPI targeting (widely adopted from early 1990s onwards); iii) BASEL accords/deregulation of finance (1980s onwards).
- Plus reflection of current western political consensus of 'extend and pretend'; 'bailout system'; 'throw kitchen sink at it' ---> No 'Washington Consensus' for developed markets.
- Consequently, broken banking system post GFC needed time to heal (i.e. rebuild capital +/or shrink balance sheets);
- Shrinking/consolidating commercial banking system balance sheets = absence of lending/Money creation => need for excessive monetary stimulus to offset
- Hence ZIRP, then NIRP & QE
- QE (+ ZIRP/NIRP) = central bank crowding out of private sector ownership of private sector listed assets/pushing market participants up the 'risk curve'.

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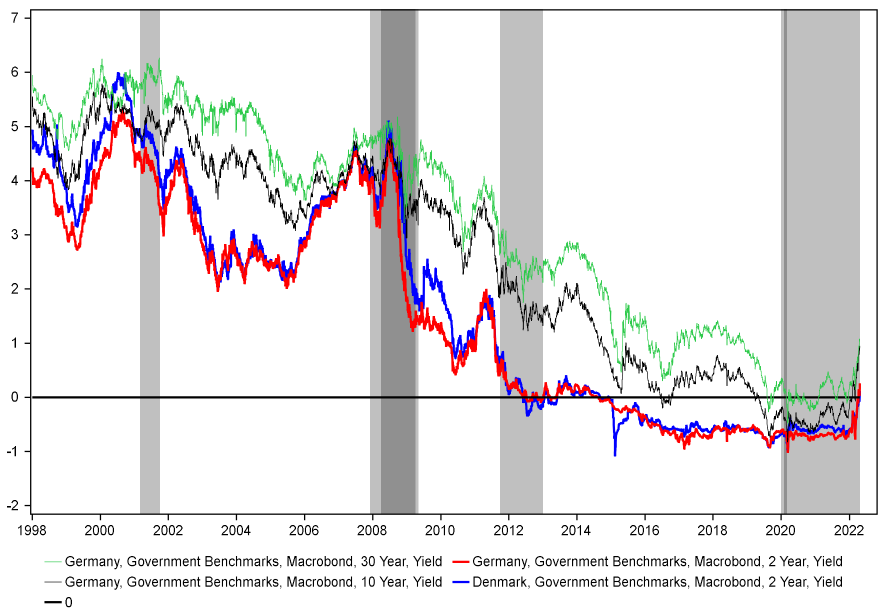
Topsy-Turvy World of Finance
The lender pays the borrower

Various Eurozone short, medium & long dated yields



Source: Longview Economics, Macrobond

- "Deco, a Lisbon-based consumer-rights group that in 2019 estimated that rates had turned negative on more than 30,000 mortgage contracts in Portugal, said the **figure has likely more than doubled since then**….
- …Ms. Santos's is tied to Euribor, which is based on how much it costs European banks to borrow from each other. She pays a fixed 0.29% on top of the three-month Euribor rate…..It has been falling in recent months and is now near a record low, at minus 0.54%.
- Portugal's state-owned Caixa Geral de Depósitos SA said about 12% of its mortgage contracts currently carry negative rates. The number of such contracts rose by 50% last year….**BPI, said it has so far paid €1 million in interest on mortgage contracts to an undisclosed number of customers.**"
- **Source:** WSJ, March 2021 "With Negative Rates, Homeowners in Europe Are Paid to Borrow. Covid-19 pushes benchmarks deeper into negative territory, widening the pool of mortgage holders who receive interest"

What Has TINA Done?

Distorted supply and demand for assets = >

distorted/elevated valuations

(more money chasing fewer assets)

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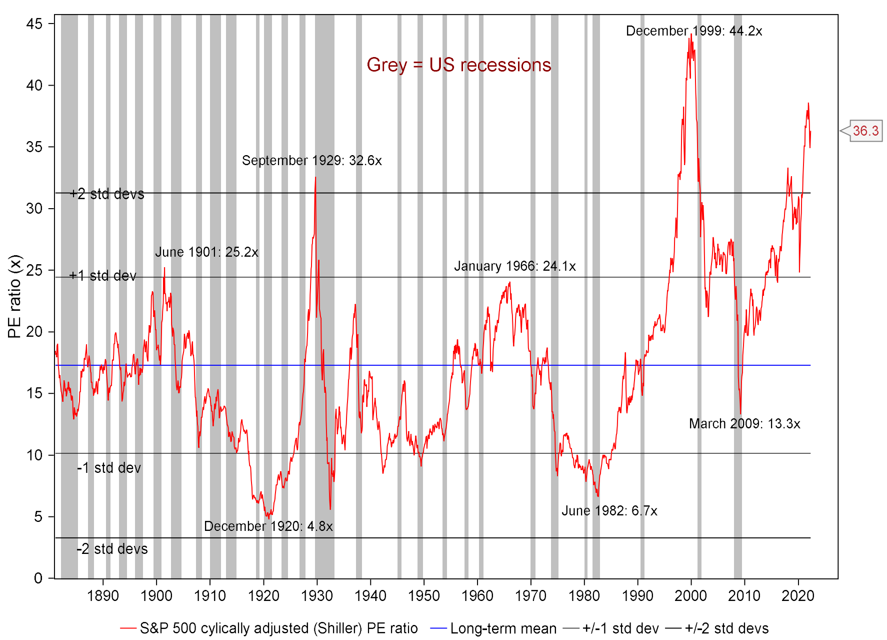
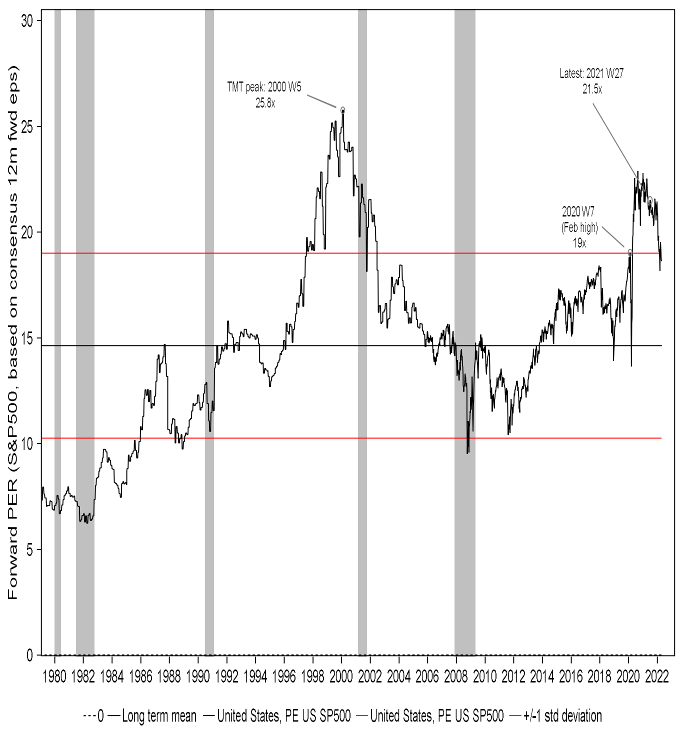
Rich Valuations

Fig 9: Long term US S&P 500 cyclically adjusted (Shiller) PE ratio



Source: Longview Economics, Macrobond

Fig 9a: US S&P 500 PE ratio (based on rolling 12m fwd consensus eps)



Source: Longview Economics, Macrobond

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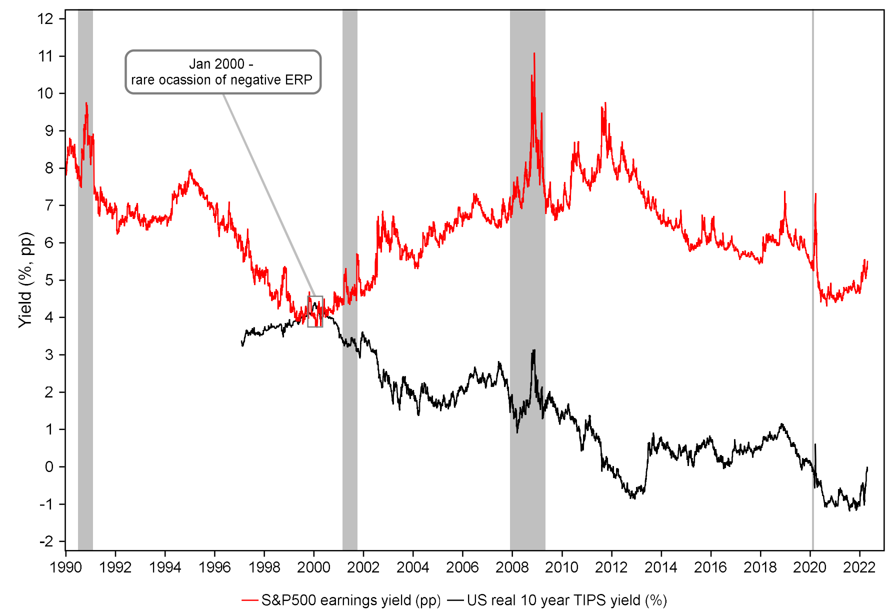
Although not so 'rich' when compared to other asset classes (i.e. TINA)

US Equity Risk Premium model (pp)

Source: Longview Economics, Macrobond

US S&P500 earnings yield & real bond yield



Source: Longview Economics, Macrobond

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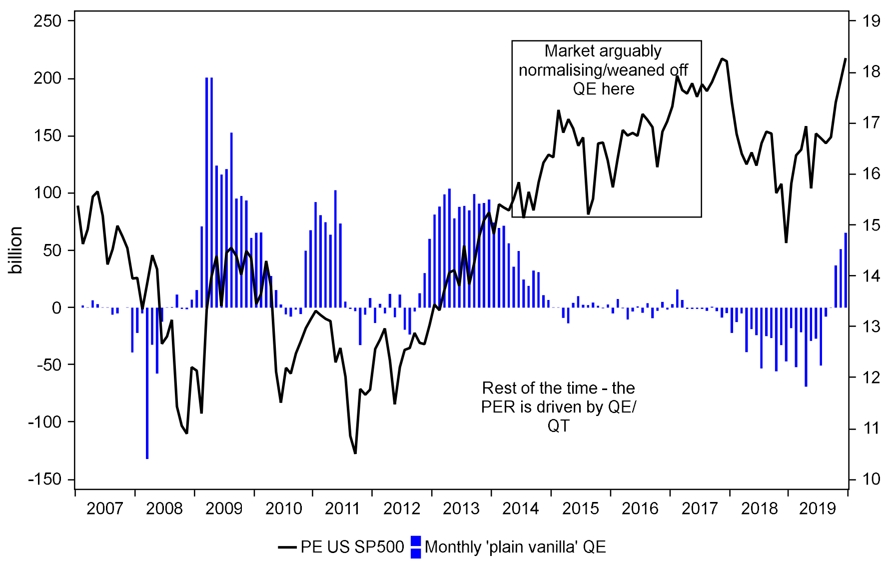
What drives the PER?
Weight of Money/liquidity
Tight Correlation between QE & PERs

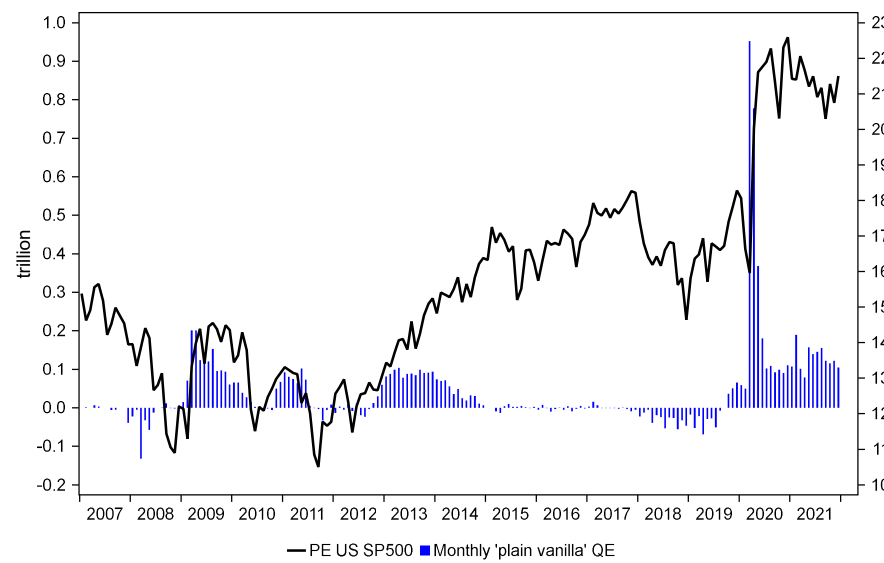
Liquidity → drives asset prices higher

FIG: Net new QE vs. S&P500 PER
(2007 – 2021)



Source: Longview Economics, Macrobond

FIG: Net new QE vs. S&P500 PER
(2007 – 2021)



Source: Longview Economics, Macrobond

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Pretty Much Everyone Is

‘All In’

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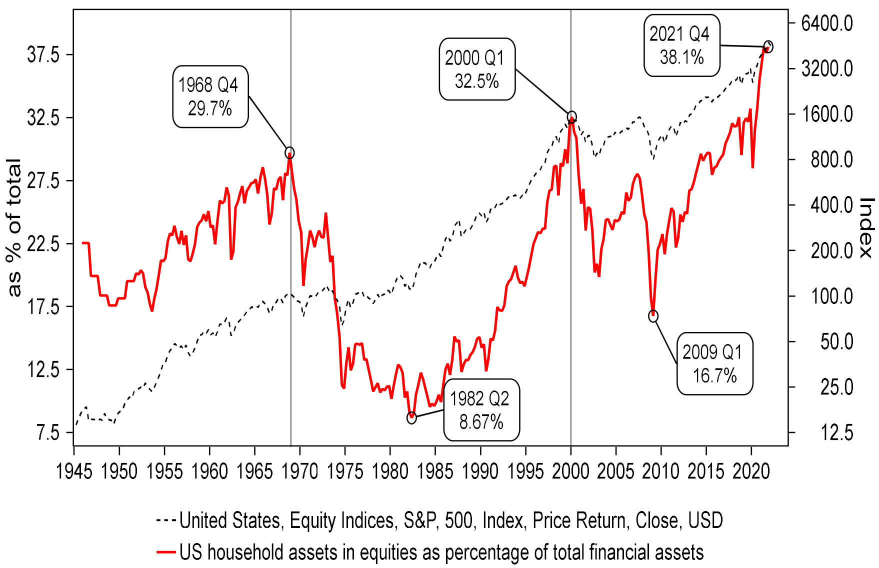
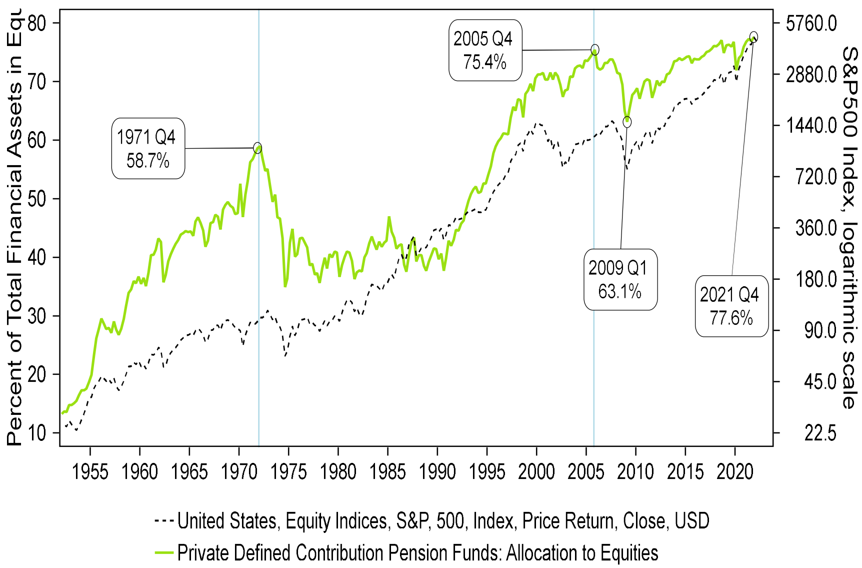
High Exposure to Equity Markets

FIG 1: US Households' equity allocation as a % of total financial assets



Source: Longview Economics, Macrobond

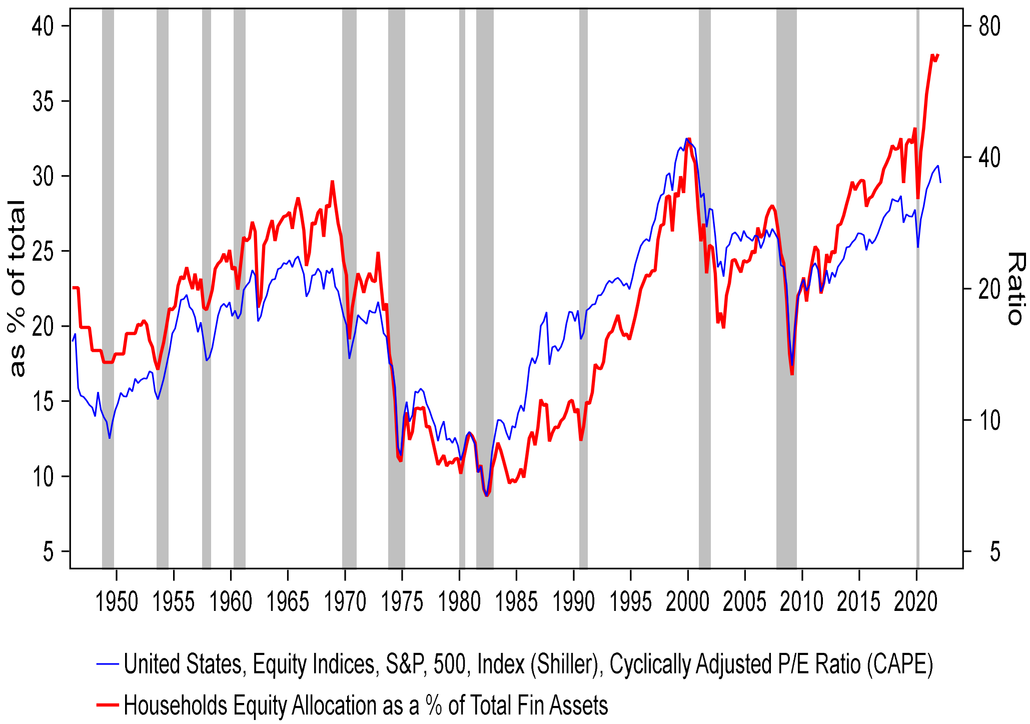
FIG 2: Equity allocation in US defined contribution pension plans (as a % of total financial assets)



Source: Longview Economics, Macrobond

Equity Valuations, Weight of Money & High PE ratios

FIG 5: US households' equity allocation percentage vs. Shiller PE ratio



Source: Longview Economics, Macrobond

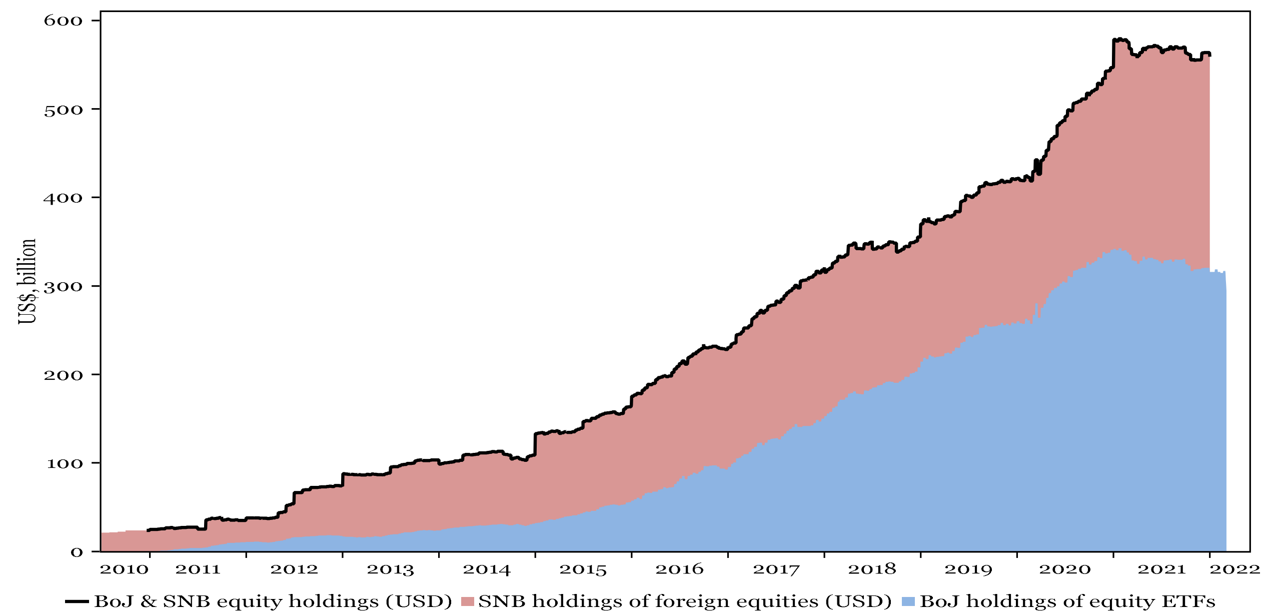
Coincident not causal BUT illustrates vulnerability & both driven by TINA

Weight of Money (who else has been BUYing)

....Central banks and corporates amongst others.....

Putting newly created money to work PLUS financial engineering

FIG 6: Value of SNB's & BoJ's equity portfolios (US$bn)



Source: Longview Economics, Macrobond

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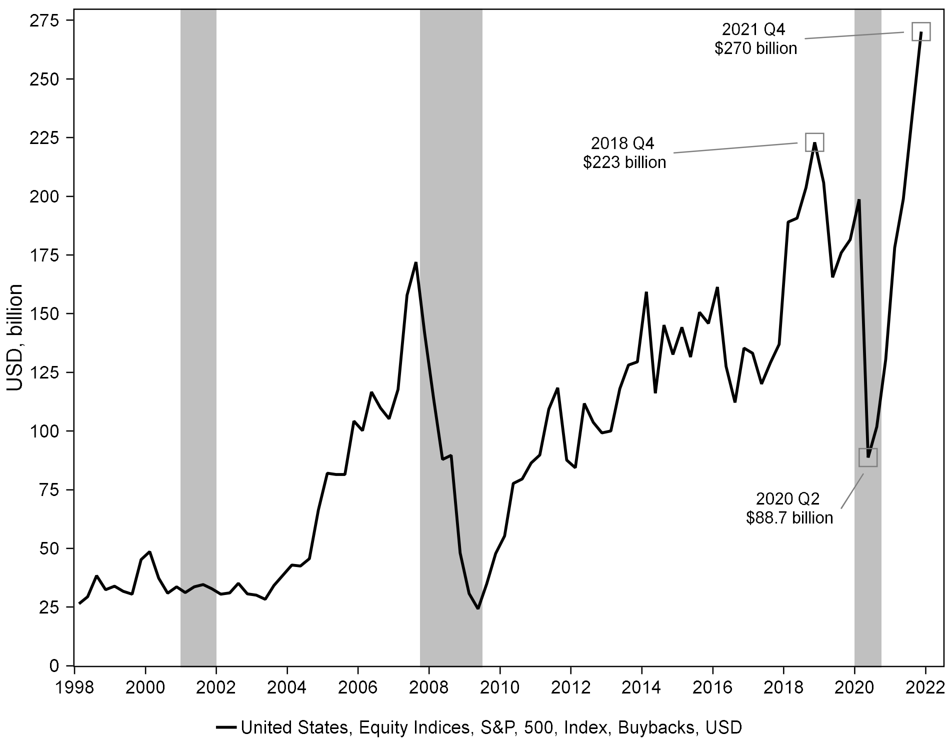
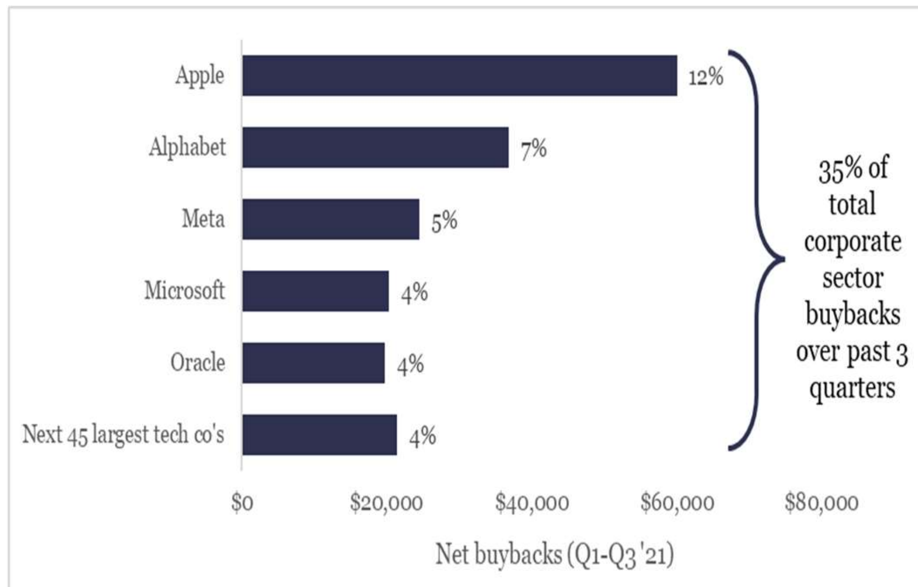
Weight of Money
Who else has been BUYing: Companies!

US corporate buybacks (quarterly data, $bn)



Source: Longview Economics, Macrobond

Net buybacks (key US tech co's, $m)



Source: Longview Economics, Factset

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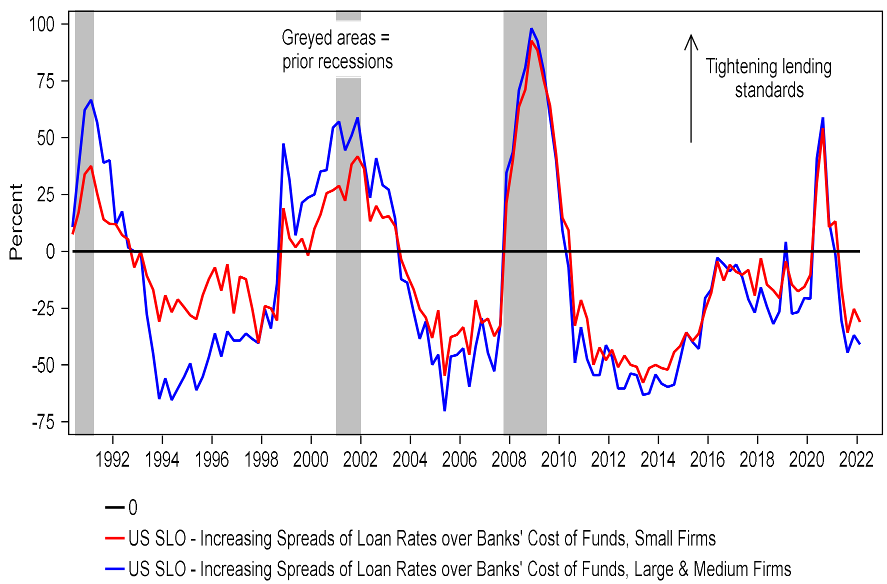
When Does 'TINA' End? When QE is reversed? When interest rates go up? When money gets tight?

US corporate sector credit conditions



Source: Longview Economics, Macrobond

Table 1: US traffic light indicators – updated 11th March 2022 (& 4th April)

i) Tightness of Monetary Conditions		
Yield curve	RED	Curve has now inverted (10s2s - just)
Real short rates	GREEN	(notably) Negative real rates
Real shadow Fed funds rate	GREEN	(real) Shadow Fed funds - notably negative
M1 money supply growth	GREEN	Grwoth rate has slowed sharply - but is still at high level
~~Median ratio of new mortgage rates to old rates*~~	~~GREEN/AMBER~~	~~Was above 1 in 2018 & 2019 but now back to low levels (i.e. 0.7). (NB readings above 1 typically signal a forthcoming recession)~~
*data currently not available/investigation ongoing		
ii) Tightness of Credit Conditions		
Credit conditions – corporate (tightening lending standards)	GREEN	still at loose levels relative to history (Q1)
Credit conditions – corporate (Increasing Spreads of Loan Rates)	GREEN	Still at loose levels relative to history (Q1)
Credit conditions – household	GREEN	At extreme/loose levels
Credit Conditions – Banks: Economic outlook as reason for easing/tightening conditions	GREEN	Sharp loosening in recent quarters
Credit Conditions Banks' reasons for easing/tightening: 'Specific Industry problem'	GREEN	Significant loosening in the past year
NACM Credit Managers Indices (Manufacturing & Services)	GREEN	At loose levels on latest data
NFIB small business credit conditions	GREEN	Reasonably loose
iii) The state of financial conditions		
US HY Corp bond spreads	GREEN	Spreads are tight relative to history
TED spreads	GREEN	Close to record tight levels
Kansas City Financial Stress index	GREEN	At low levels relative to history
US CCC HY corporate bond spreads	GREEN	Close to/just above record tight levels
iv) State of Corporate Sector Health		
Corporate financing gap	GREEN	Strong cashflow surplus (i.e. consistent with ongoing economic expansion)
Corporate cashflow earnings less uses (non-financial, i.e. post share buybacks)	RED	Sizeable deficit – after adjusting for share buybacks
NIPA Corporate profits	GREEN	Ongoing growth
Corporate profit margins model (nominal GDP growth LESS unit labour costs)	GREEN	Sharp expansion in recent quarters
v) The message of leading economic indicators		
Leading Economic Indicators (conf. board Y-o-Y%)	GREEN	Strong M-o-M readings (Y-o-Y growth rate still high)
vi) Wealth effect and other indicators		
Car sales	AMBER/RED	Trending lower in recent months (although distorted by component supply issues)
Housing	AMBER/GREEN	Some housing activity is softer
Weekly jobless claims (smoothed)	GREEN	Back at low pre-pandemic levels
US H'hold Wealth Effect	GREEN	Net household wealth at record highs

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Inflation – longer term drivers

Beyond the short term

- Six key drivers:

1. Labour market tightening
2. Shelter inflation
3. Banking system – expansion thereof....
4. Monetary inflation & Demographics
5. Changed nature of fiscal & monetary policy/effective helicopter money
6. Deglobalisation – increasingly multilateral geopolitical world (long term supply chain impacts/removal of global efficiencies)

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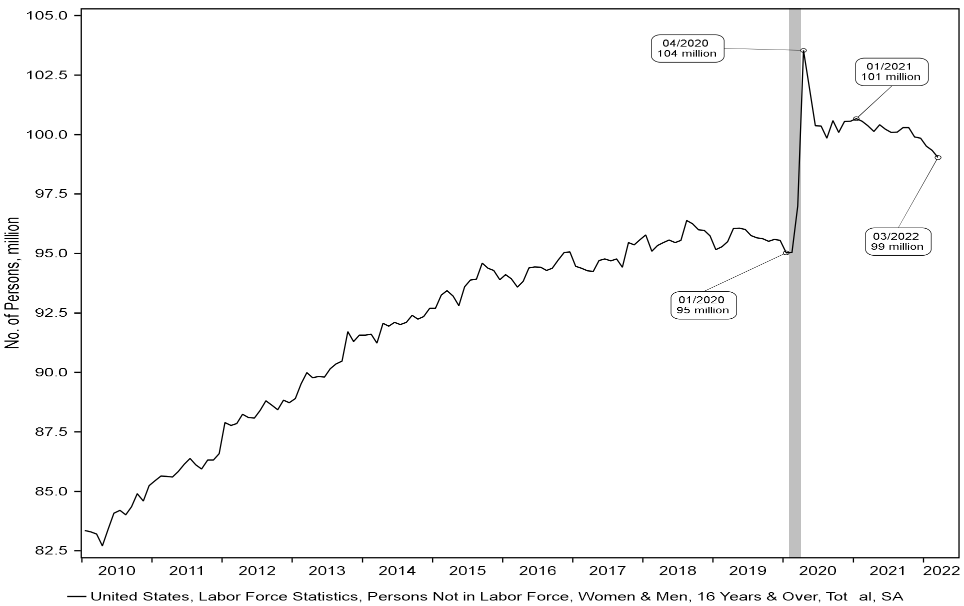
Labour Market

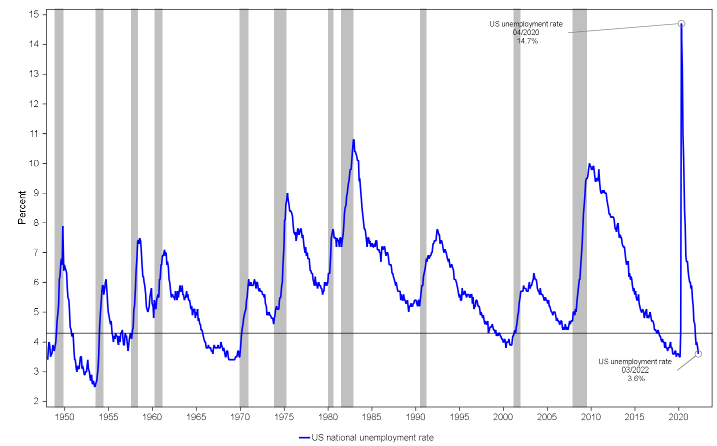
Civilians not in labour force (i.e. not participating)



Source: Longview Economics, Macrobond

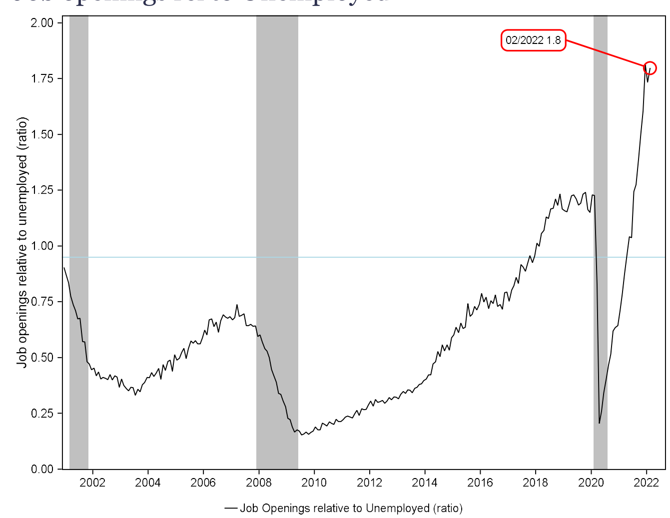
Long Covid, for example, is estimated to have affected 1.3 million people in the UK (source: Office for National Statistics). An equivalent US figure, therefore, is 5.2 million. Even if half, or a quarter, of those affected are unable to work properly (due to fatigue/other symptoms), that's a substantial reduction in available labour relative to estimated 3 - 5 million remaining spare workers.

US unemployment rate



Source: Longview Economics, Macrobond

Job openings rel to Unemployed



Source: Longview Economics, Macrobond

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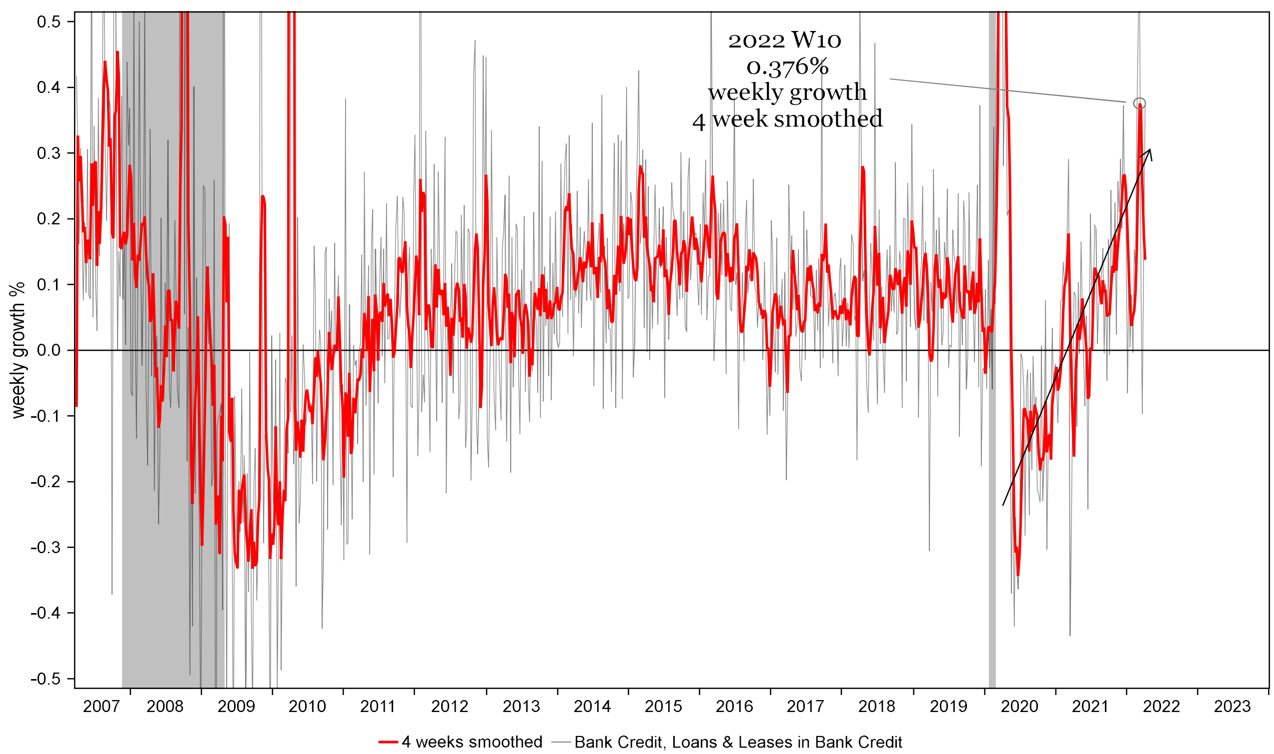
Credit growth – accelerating…

US bank lending (i.e. all loans and leases), weekly growth rate (with a 4 week rolling average)



Source: Longview Economics, Macrobond

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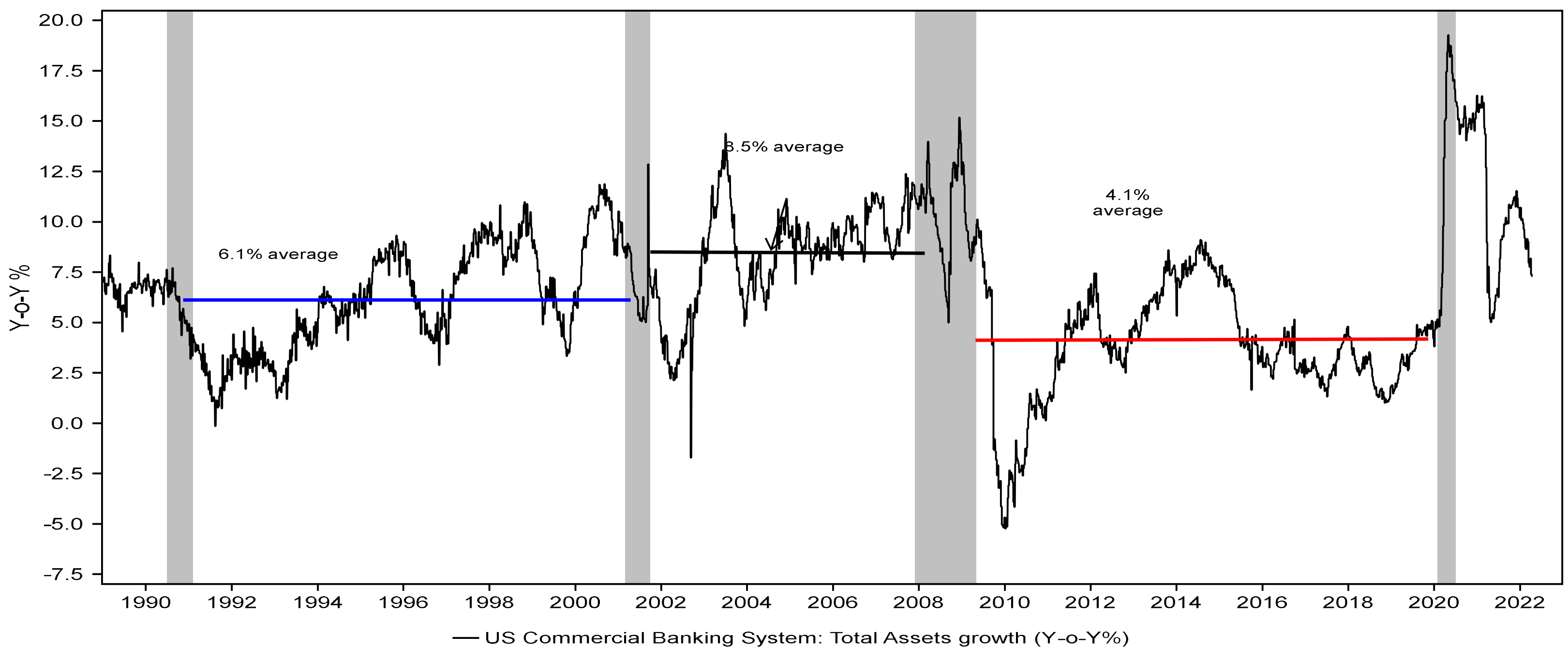
US Banking System: Total Assets Growth (By econ cycle)

iii) Inflation & the Banking System

FIG X: US Commercial Banking System annual growth (Y-o-Y %)



Source: Longview Economics, Macrobond

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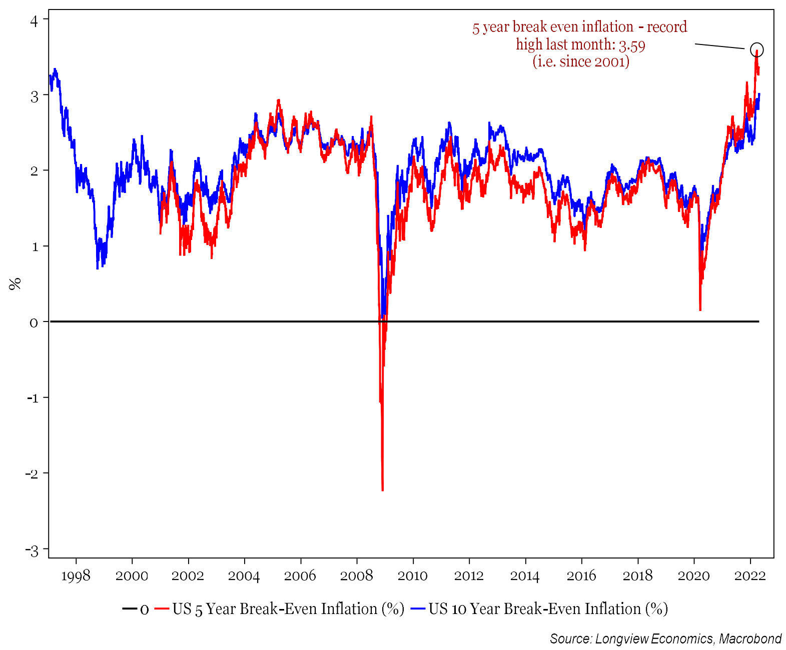
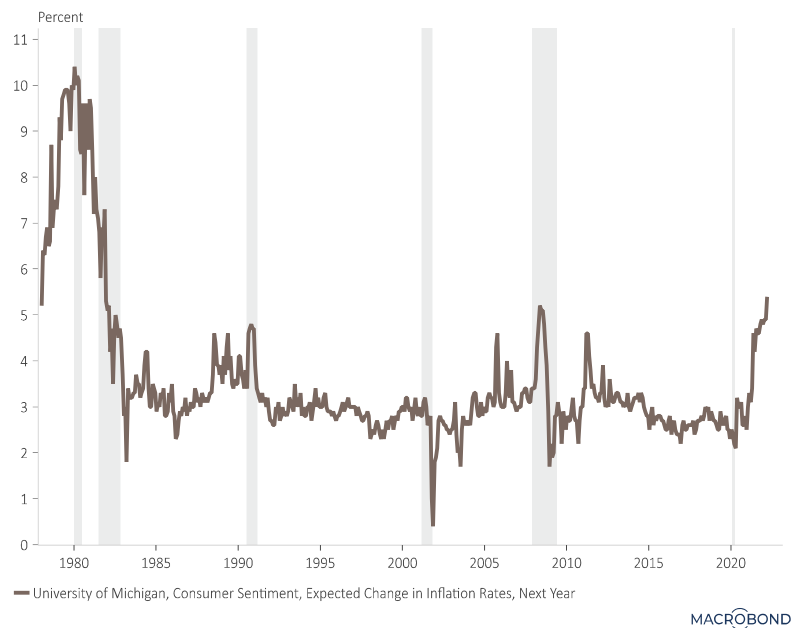
Inflation expectations – becoming unanchored? Or temporary phenomenon?

US breakeven inflation (%)



US Michigan sentiment 1 year inflation expectations (%)



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What Brings about the end of Bull Markets?

Three factors bring about the end of bull markets

93% of the 28 corrections in the S&P500 in the 77 years from 1928 through to 2006 were caused by some combination of the following three factors:

1. In anticipation of a US/global economic recession;
2. Tight money/a rising cost of capital; &/or….
3. A shock

Valuation, alone, is rarely, if ever, the cause of a correction in equity markets

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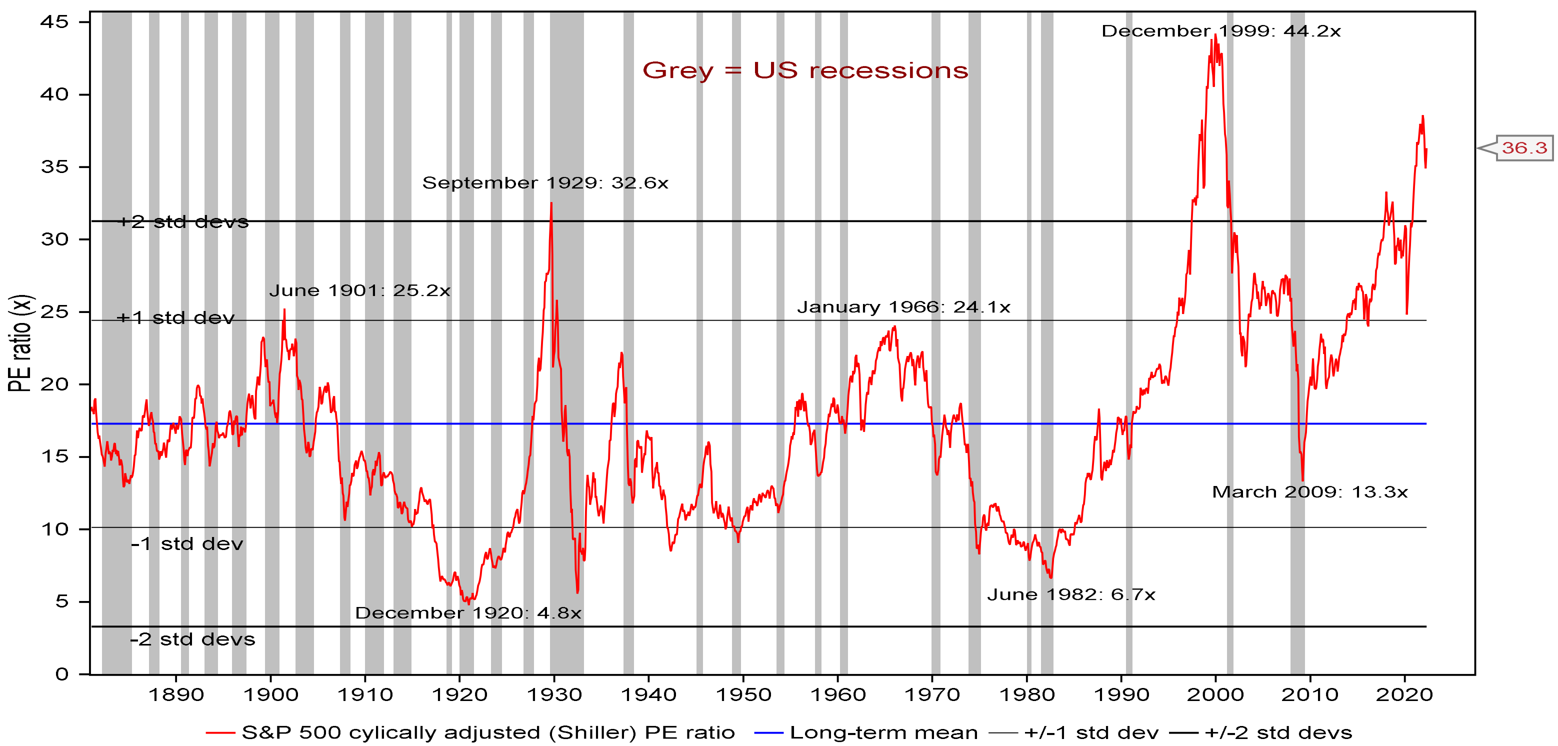
Over the VERY long term Valuations mean revert!

US Shiller PE ratio (1881 – present)



Source: Longview Economics, Macrobond

When it looks like a duck, quacks like a……

Grantham's 'super bubble view' – the '3 sigma' bubbles

Executive Summary

All 2-sigma equity bubbles in developed countries have broken back to trend. But before they did, a handful went on to become superbubbles of 3-sigma or greater: in the U.S. in 1929 and 2000 and in Japan in 1989. There were also superbubbles in housing in the U.S. in 2006 and Japan in 1989. All five of these superbubbles corrected all the way back to trend with much greater and longer pain than average.

Today in the U.S. we are in the fourth superbubble of the last hundred years.

Previous equity superbubbles had a series of distinct features that individually are rare and collectively are unique to these events. In each case, these shared characteristics have already occurred in this cycle. The checklist for a superbubble running through its phases is now complete and the wild rumpus can begin at any time.

Charles Kindleberger's view on Bubbles:

Three things create bubbles;

One thing ends them!

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BUT…for now….#
Latest changes to strategic portfolios (31st March)

Benchmark & Recommendations – updated 31st March '22

Table 2: Benchmark & Recommendations[2]

RISKY Assets				**SAFE Assets**			
Asset	L'view B'mark (%)	Mar '22 weight'g (%)	OW/UW (pp)	Asset	L'view B'mark (%)	Mar '22 weight'g (%)	OW/UW (pp)
DM Equities	25	32	*+7*	Developed Sovereign Debt	25	20	*-5*
EM Equities	10	14	*+4*				
Commodities	5	9	*+4*	Cash	15	5	*-10*
HY & EM Corporate Debt	5	5	-	HG Corporate Debt	10	10	-
EM Sovereign	5	5	-				
Total RISKY	***50***	***65***	***15***	**Total SAFE**	**50**	**35**	***-15***

Source: *Longview Economics*
[2] split of safe haven assets vs. risk assets (& vs. benchmarks)

Key 'Top-Level' Portfolio Recommendations

- **Sovereign bonds (& HG credit):** Back to UW (i.e. by 5pp in sovereign/neutral IG);
- **DM equities:** Increase OW (from +3pp. to +7pp);
- **EM equities:** Remain OW (+4pp);
- **Commodities:** Increase exposure by +1pp more (i.e. now commodities is +4pp. OW rel to benchmark);
- **High yield credit:** Stay NEUTRAL;

Portfolio Construction: Recommended Strategic Asset Allocation

Recommended changes (31st March) – Front page

Quarterly Global Asset Allocation No. 49, 31st March 2022

(i.e. 6 months – 2 years global asset allocation views)

Written by: Harry Colvin, CFA, Director & Senior Market Strategist, Longview Economics

Major Local Low Likely In: Add Risk in Strategic Portfolios

Summary Extract:

"……Added to which, recessions only occur historically when: (i) money becomes tight; and/or (ii) the US/Western corporate sector becomes overstretched and vulnerable. Neither of those preconditions are currently in place…"

Table of Contents – Key Sections:

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