

House View

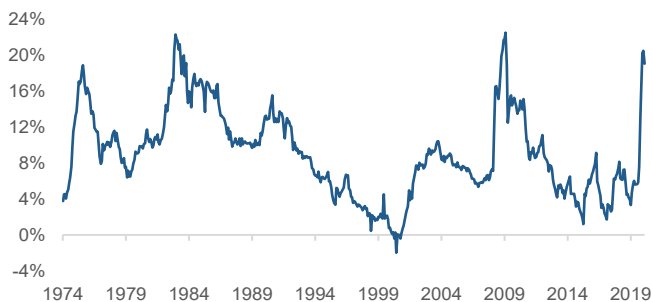
10.09.2020

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With the summer months now behind us, the world unfortunately remains plagued by SARS-CoV-2, and after a second surge in infections, it remains very unclear how the coming quarters will develop in terms of the pandemic. There are a number of potential vaccines being developed at enormous speed and with massive amounts of resources; at this point however, it is highly speculative whether by the end of this year, or possibly much later, the viral threat will be credibly contained.

Major economic damage is now plainly visible throughout developed and emerging markets, the big unknown remains the longer-term effects of now 6 months of a state of emergency in many areas of the economy. So long as governments continue to alleviate the material losses for many, the worst in terms of economic damage will be avoided. However, there will be a lasting effect stemming from these highly exceptional times that the virus has caused. Fiscal deficits and governments' indebtedness will rise dramatically this year, and most probably in the ones to follow as well.

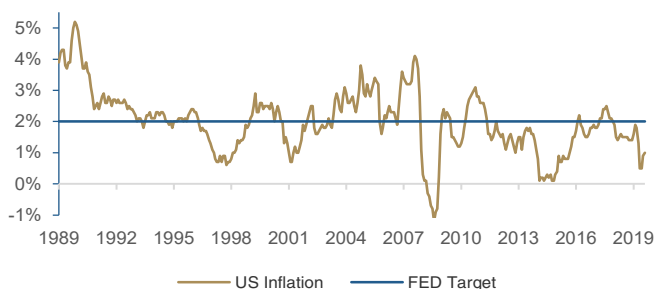
ANNUAL RATE OF CHANGE OF US PUBLIC DEBT



Source: Bloomberg

Back in the old days of financial markets without central banks taking the role of elephants in the room, such a bleak outlook for government finances all over the world would have called the Bond Vigilantes in. They would be pushing bond yields up by strongly selling government paper, forcing the Administration and Congress to credibly signal an eventual reduction in deficits. Today, this avenue of development has disappeared, thanks to central banks actively purchasing bonds, not only of their own governments, but now also actively buying corporate bonds. Unsurprisingly, this has led to a flood of corporate bond issuance. With only two thirds of 2020 passed, the total amount of issuance from the US corporate sector has already exceeded the record of 2017, while US public debt has been growing by more than 30% in the past 6 months on an annualized basis. Yield levels, both for corporate and government bonds, remain at close to all-time lows, thanks to the subtle support by a Federal Reserve which has just announced that inflation rates above 2% would actually be welcome after a period of very low inflation, in order to achieve an "average 2% rate of inflation" Translation: the central bank has come here to stay.

US INFLATION



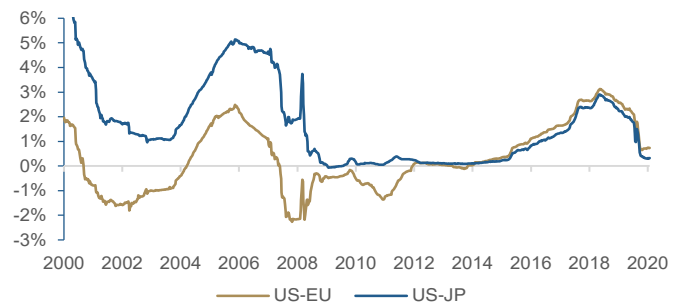
Source: Bloomberg

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What this means for future inflation to us is blindingly clear, as we take the view that certain economic laws of gravity may be suspended due to a number of reasons, but ultimately will drive the beast of inflation out of the bottle, in which it now has been contained for more than three decades, due to central banks taking full advantage of their independence (and other disinflationary factors). Looking at the financial history of the past centuries, the combination of a major fiscal deficit with open and large-scale government bond purchases on behalf of the central bank has in every instance led to significant price rises in the medium to long term. We doubt it is different this time.

The consequences of such a development, if the past offers any guidance, is a weaker USD. While other major central banks such as the Bank of Japan (BoJ) and the European Central Bank (ECB) are loosening the monetary reins as well, the question of relative supply becomes important. With the Fed's highly aggressive balance sheet increase in the wake of Covid-19, a seven- (vs. BoJ) and five-year (vs. ECB) relative downtrend of the Fed's balance sheet size has ended. Compared to the Yen and the Euro, the Dollar used to offer a significant yield advantage during the period of early 2016 to early 2020, which offset the drag from the US' chronic current account deficit. Going forward, it is hard to foresee any divergence in the future path of interest rates, at least for the coming years.

YIELD DIFFERENCE: 3 MONTH LIBOR



Source: Bloomberg

Taking another view at the US government's budgetary situation, we deem important that "the age of Trump" has brought important change: the Republican party is no longer the one of fiscal rectitude and balanced budgets, but rather the contrary, considering the level of the fiscal deficit in terms of gdp, before the pandemic struck. Deficits of close to 5% of GDP during a period of healthy economic growth were unprecedented, even under President Reagan in the 1980s, the deficit had barely surpassed 5% of gdp. With the Democrats also willing to spend a lot, we cannot see how this grave situation can be resolved without major economic impact. One possibility would be higher taxes, something the Democrats favor to do. The impact on growth, however, could be substantial, and thus weaken the USD further. From a political viewpoint, therefore, the US Dollar appears to be between a rock and a hard place.

Many eyes are fixed on the US elections in two months. The polls suggest the incumbent to lose on November 3, but recalling the experience of 2016 and the constant attacks on the whole electoral process by the in many ways unconventional president, while observing a highly fluid and unpredictable situation in connection with the numerous protests in the country, such an outcome is far from certain. When it comes to setting the economic policies for the coming years, the role of Congress, and especially the Senate, cannot be overestimated. Considering a flurry of policy changes to inundate the US economy, if the Democrats seize control of Congress, and the White House,



the effects on the different industries will be disparate to a high degree. We would even expect that in the case that Donald Trump gets re-elected, while the Democrats seize both chambers of Congress, an important pivot will be reached. Sectors like energy, health care, financials, materials, and quite likely technology could face increased pressure on their margins, while renewable energy companies and related sectors should see a significant boost in demand.

PROBABILITY OF DEMOCRATS TAKING THE SENATE

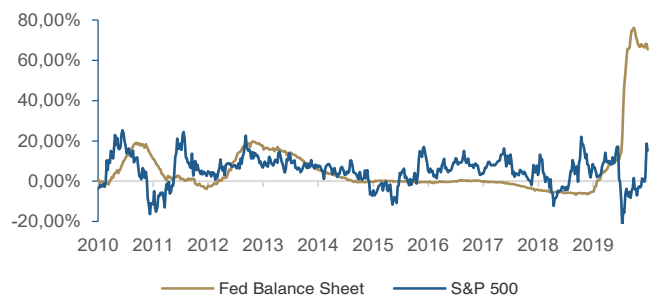


Source: Bloomberg

The geopolitical arena is another source of uncertainty. How will the dispute between the US and China on a bundle of issues develop? The case for détente appears remote, with the Chinese government now openly talking of its intention to reduce its Treasuries holdings “gradually ... under normal circumstances” and that it “might sell all of its U.S. bonds in an extreme case, like a military conflict”. Has the country’s leadership just given a broad hint of its barely veiled plan to annex Taiwan with the use of military force?

If such a development were to occur, financial markets would fall precipitously, in our view. While such an outcome is not our favoured scenario, it appears increasingly likely, given the growing aggressiveness of the Chinese regime, for instance in the South China Sea. Should a major military conflict develop, the case for rising inflation (and for the price of gold as an inflation hedge) would instantly become the focus of all market participants. Some observers consider the ongoing government debt monetization to be the precondition for steeply rising prices. From this perspective, an igniting factor such as war is needed to start the process of an inflationary spiral.

6-MONTH CHANGE: FED BALANCE SHEET VS S&P 500



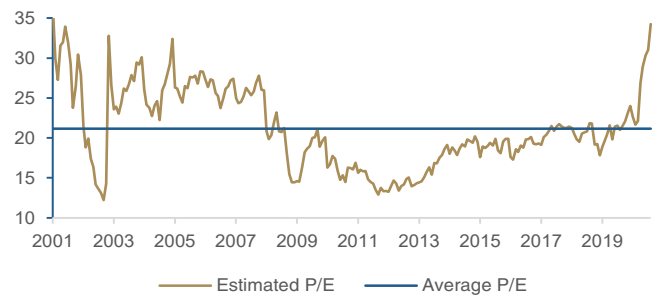
Source: Bloomberg

So where does this all leave us? Markets have rallied astonishingly quickly because of all the government support poured over the pandemic-stricken economies. A lot will hinge upon central banks’ “forward guidance” when or rather if they are willing to take away the punch bowl or, as we like to call it, wean markets off the monetary morphine they have provided them with for more than a decade (some would even say: 25 years). At this point, the uncertainty with the second wave of the pandemic, coupled with an already

strained private sector, will have central bankers abstaining from anything that might be considered hawkish. Therefore, the possibility of further equity market rises cannot be negated. As long as the Fed keeps growing its balance sheet, setbacks should be limited.

There are, however, some developments that speak in favor of a cautious investment strategy. Valuations have risen to levels unseen since the dot-com bubble. Especially technology stocks appear to be priced for perfection. In an environment of very low interest rates throughout the yield curve, this appears justified as growth stocks’ high growth rates mean high profits in the distant future. With the discount factor “translating” these future profits to their net present value (i.e. today’s valuation) standing at the current record low levels, the net present value approach is severely distorted. Therefore, any upmove in yields should display cracks in the lofty valuations of many growth stocks.

NASDAQ’S RECORD VALUATION

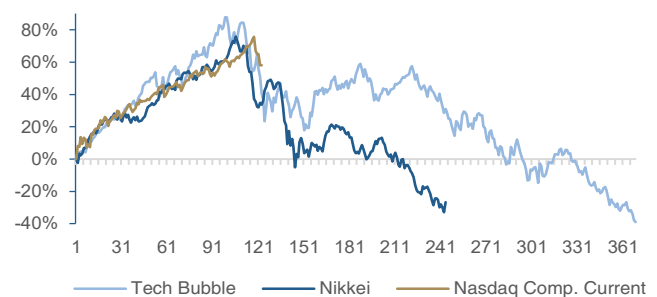


Source: Bloomberg

Recent days’ setbacks in cryptocurrency prices, and bellwether stocks such as Tesla and Apple, in our opinion prove that a significant number of retail investors can move the needle for a certain time. However, with such high numbers of recently opened accounts at retail brokerage firms such as Robinhood, steep setbacks must be taken into account as some recent price developments increasingly look exactly like previous bubbles (Nikkei in the 1980s, dot-com bubble, Bitcoin prices in late 2017/early 2018).

We recommend to focus on real assets going forward, such as gold and other commodities, while equities should not be seen as the best inflation hedge: In the period December 1968 – May 1974, the S&P 500 lost almost 60% in real, that is inflation-adjusted terms, and almost reached this nadir again in March of 1980. We continue to be positive on digital assets and see an opportunity to add to positions in times of weakness.

A NEW BUBBLE?



Source: Bloomberg - Nikkei Weekly Data, Tech Bubble & Nasdaq Current Daily Data

CONCLUSION

- ▶ The pandemic rages on, but financial markets appear to not be concerned. Central bank largesse is needed to sustain the rally, however.
- ▶ We expect the fourth quarter of 2020 to display above-average volatility due to a number of influencing factors such as the economic repercussions of Covid-19, the US elections, but also geopolitical stress points.
- ▶ A blue wave appears possible, in such an event markets could take a dive for then a major turn in economic policy must be expected. We consider the Senate majority to have the highest impact on market reactions.
- ▶ The outlook for inflation looks very bleak in the medium term. Real assets continue to be a good hedge against rising prices, and digital assets should be considered as diversifiers to precious metals.

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