As the World Reopens

"As the world emerges from this enforced hibernation, investors have to choose between one of three potential outcomes."
– Louis-Vincent Gave on May 14th

As the World Turns was one of the longest-running shows in television history. The soap opera aired for 54 years and compiled 61 Daytime Emmy Awards before ending its illustrious run in 2010. Several Tinseltown staples, including Meg Ryan, Julianne Moore, James Earl Jones, and William Fichtner, even had early-career roles on the program.

As with any good TV drama, conflict was central to the premise of the show. It doesn't take much of a leap to draw parallels between what's happening around the world and a daytime television drama. The emergence and spread of Covid-19 has been a central figure in the world's dramatic narrative since early 2020. But there have been several other sub-plots as well, including protests in the United States and Hong Kong, worsening relations between the United States and China, unbridled stimulus by the US government, and a very dramatic rebound in the stock market.

This week, we are presenting an article from Evergreen Gavekal's partner, Louis-Vincent Gave, on what's in store for markets as the world reopens. The article was originally published on June 1st and at the time, Louis advocated that markets were moving towards what he dubbed "scenario #3." Based on what's happened since the article was published—a crescendo of intense speculation in the riskiest stocks with activity dominated by home-bound day traders—Louis has become increasingly cautious about the market on a near-term basis. (His concerns were reiterated and amplified during an internal research call with the joint Evergreen/Gavekal research team on Monday before markets swooned over the last two days.) With so much still unknown, the below provides a concise overview of three potential outcomes as the world (or at least the Northern Hemisphere) moves from forced hibernation into the summer.

A few weeks ago, I outlined three scenarios that could unfold as the world reopened for business. In scenario #1, the end of lockdowns was marked by a sharp rise in death rates and a rapid move back into confinement; my advice here was to sell everything except physical gold and gold mining stocks. In scenario #2, activity picked up but global growth was soft and inflation non-existent; for this, I advised owning US treasuries and US growth stocks. In scenario #3, the world economy ripped and inflation rose on a mix of pent-up demand, record-high budget deficits, low oil prices and unprecedented money printing; in this event, my advice was to buy cyclicals, financials and emerging markets, while underweighting the US dollar and US growth stocks.

At the time, markets pointed to scenario #2. Treasury inflation-protected securities, aka TIPS, were pricing in less than 1% annual US inflation for the next decade, US growth stocks such as tech and health care were making new highs, and despite massive issuance and money printing, 10-year treasuries were stuck in a tight trading range around 0.6%. Yet in the last few weeks, we have seen financials, materials and even that perennial three-legged donkey with fleas, energy, start to outperform. At the same time, beaten-up currencies like the Brazilian real, Mexican peso and even the Canadian dollar have recovered despite continued bad news (in Brazil, the pandemic seems to be spurring a political crisis). In short, it looks like the market is starting to tentatively position for scenario #3. This makes sense, but the rotation may soon face a number of challenges, namely:

1. **Europe:** The European project faces a “make or break” moment, for without a move towards fiscal union the euro will remain a structurally flawed currency. If policymakers use the Covid-19 crisis to address the single currency’s basic design flaw, the recent rally in the euro and European financials could have legs. A weakening US dollar would also likely boost emerging markets, cyclicals and financials more widely. Yet if the European Commission’s €750bn debt-funded recovery fund gets watered down, the lack of solidarity may cause Italy—whose industrial output is at 1975 levels—to wave goodbye to the common currency. In such a scenario, the market would quickly rotate back towards scenario #2 (favoring US treasuries, the US dollar and US growth stocks), and perhaps even to scenario #1 (favoring gold).
2. **US-China relationship:** This issue is now central to the presidential election campaign, yet it is unclear whether China-bashing ends up as mere sloganeering with little follow-through (like “build the wall”), or instead spurs policies that roll back globalization. To be sure, Covid-19 will accelerate the economic “decoupling” between the two countries that had begun before the pandemic; the question is whether this happens “consciously”, causing only moderate tensions, or if a full cold war develops. Recent events in Hong Kong have raised the chance of the latter. Factors that could point to the US stance being more bark than bite are the following:
    - President Donald Trump recently signed a deal with China so—unless he wants to denounce it—he faces limited room for maneuverer.
    - The Congressional Review Act means that US agencies seldom release major regulations in the run-up to general elections. Indeed, the Act allows Congress to repeal federal regulations within 60 legislative days. Thus, the closer one gets to an election date, the less federal agencies do.
    - Trump must walk a fine line between bashing China, while at the same time ensuring that fears of a new cold war do not spark a stock market collapse, which would not help his reelection chances.

Putting it all together, it seems likely that, at least until the election, China-bashing does not give rise to meaningful measures.

3. **Oil:** The collapse in the oil price has been a key driver of the belief that inflation will stay muted. Moreover, a low oil price raises the specter of bankruptcies and geopolitical instability. But what if, as the world re-opens, oil demand rises, not because of airplane travel (7.5% of global oil demand) but because everyone chooses to drive their car rather than use public transport (before Covid-19, road transportation accounted for about 51% of global oil demand). The unfolding rebound in Chinese car sales does point to this possibility, as does the fact that, somewhat surprisingly for a world reportedly running out of oil storage, oil inventories in Cushing seem to be rolling over—perhaps this is down to the collapse in oil rigs operating in the US (see left-hand chart below).

It seems that once again oil prices have shown themselves slave to the old adage that “the cure to a high oil price is a high oil price, just as the cure to a low oil price is a low oil price”. And obviously, if oil prices continue to rise, this could cause a profound shift in the investment environment.

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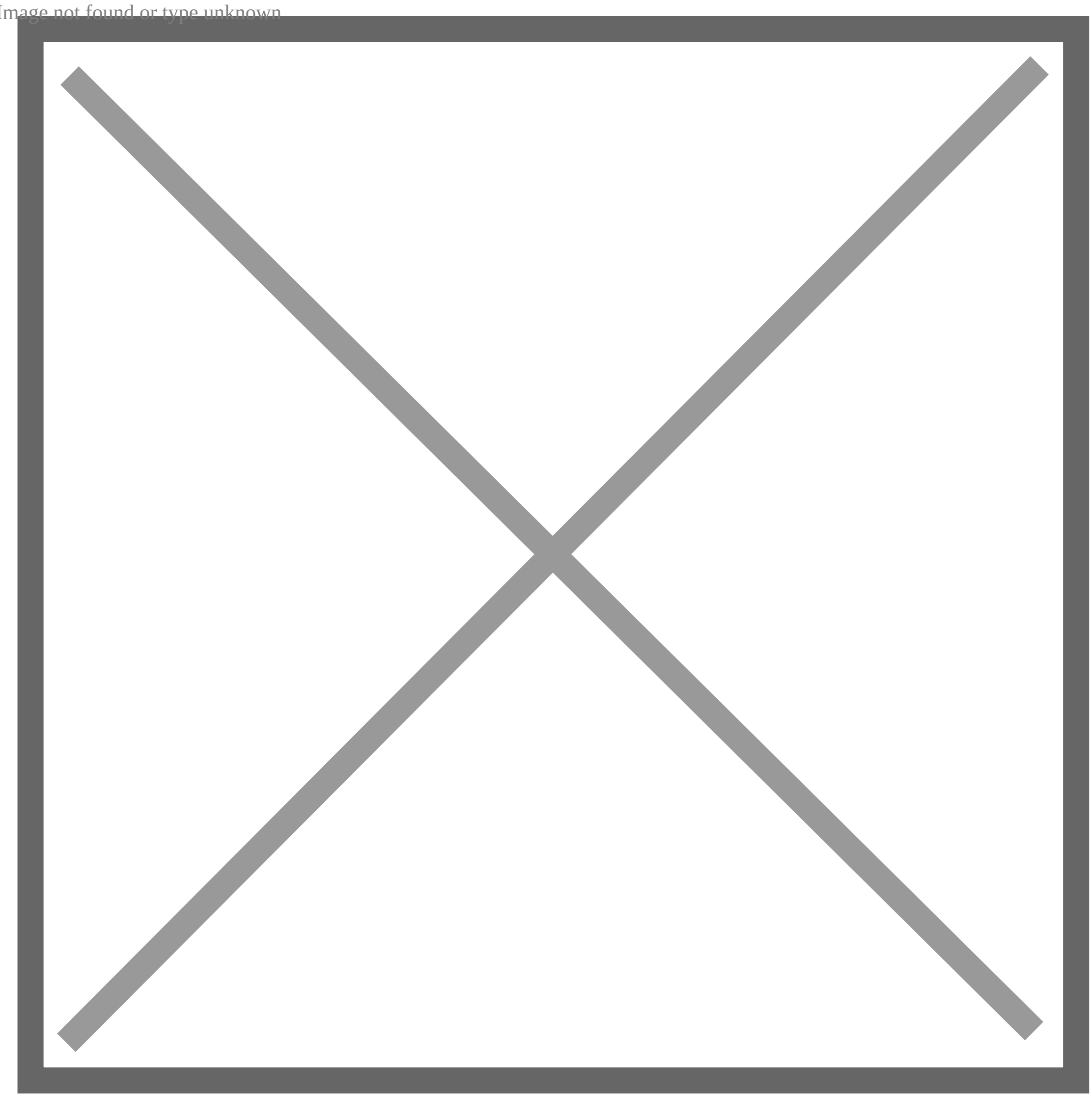

4. **The funding of US debt:** The US budget deficit in this fiscal year is set to hit a not inconsequential US$3.7trn. Fortunately, the Federal Reserve has increased its own balance sheet by some US$2.9trn in recent weeks (see right-hand chart above) but that still leaves the Treasury needing to raise US$800bn. It begs the question: who will fund the rest? If it is the Fed, then the shift from scenario #2 to #3 is likely to accelerate, for as the Covid-19 crisis abates investors will focus on the twin effects of massive US government debt expansion and monetization; this may cause the dollar's "refuge" bid to vanish. If the Fed does not step up, then the burden will be carried by US banks, the US private sector and foreign investors. Such an outcome would be far less bullish for global risk assets and could see the US dollar rise meaningfully. Today, however, there are few reasons to think the Fed will back away.

Putting it all together, the markets are starting to shift from scenario #2 to scenario #3. Absent three disruptive developments—a fresh euro crisis (possible), a sharp worsening in US-China relations (also possible), a renewed collapse in oil prices (unlikely given production constraints) or a Fed that starts to taper its asset purchases much earlier than anyone expects (unlikely)—this movement makes sense.

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