ALPHA SOURCES

MARCH 2, 2020

WHAT HAPPENS NEXT?

Last week's price action was one for the history books, or at the very least, it will be up there among the more "memorable" sessions. Events like this leave investors and analysts dazed, confused, and probably, a bit bruised too. The obvious question now is: what happens next? To which the only obvious answer is; who knows. That said, I reckon this question itself has to be answered in two parts. The **first** is whether it's time to buy the dip in risk assets, a question that invites all sort of cliches. It probably depends on your timeframe, not to mention the more obvious point; do you fell lucky? For the record, I re-arranged the portfolio slightly last week, raising cash levels, and selling short-term U.S. bonds in favour of select forrays into existing, and a few new equity positions. Time will tell whether this was a good decision. It certainly seems premature when considering the terrible Chinese PMIs released overnight Friday, though I think last week's swoon has more to do with the spread of Covid-19 outside China. In any case, when Vix has a sniff at 50, I reckon that I have to do *something*. To evaluate whether to buy the dip a bit more thoroughly, I had a look at the put/call ratio on the S&P, which is now teasing short-term traders with the strongest buy-signal since the 2010 Flash Crash and the late summer

* / Data for charts are sourced from FRED, OECD, Eurostat, IMF, BIS, Market Watch, Yahoo/Google Finance, COT, Bloomberg, Investing.com or Quandl, unless otherwise stated.

CREATIVE COMMONS LICENSE, 2020,
CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM

panic in 2011. A sample size of two isn't exactly robust, but for what it's worth, on the two previous occasions when this signal was triggered, May 24 2010 and August 8 2011, the weekly forward return was -0.8%, but the two-week return was +4%. This more or less lines up with my core view. We'll almost surely bounce in the short run—get those Fib retracement charts ready—before making a new low. One thing is certain. *The chop-shop is now open, and it will be difficult for both long and shorts to make a dime in the next few weeks.*

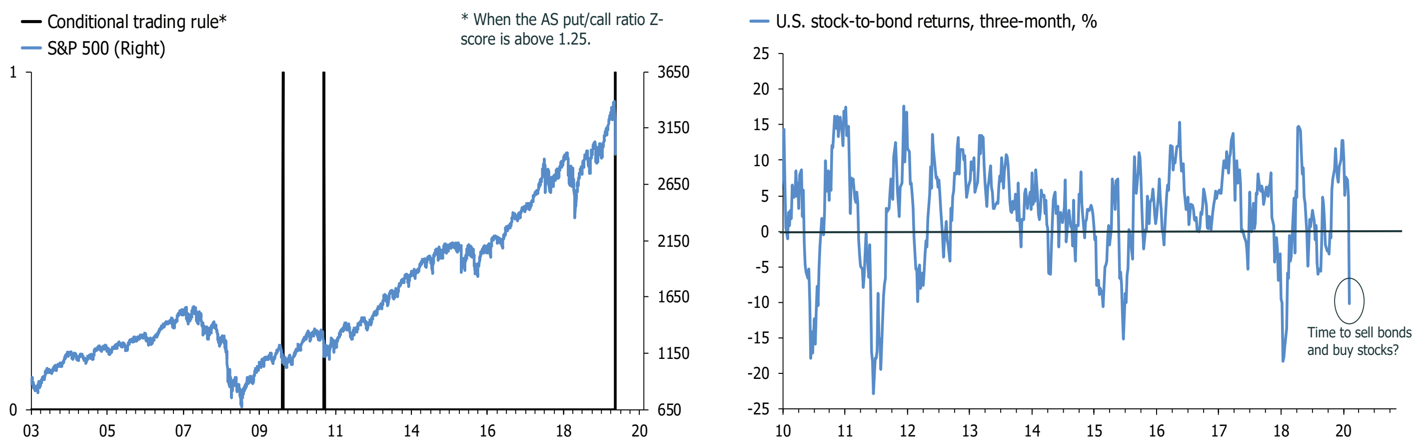
Looking beyond the very near term, let's spare a few praises for the majestic U.S. government bond market. In a trying week, they have provided just about as much safety as one could expect, with yields crashing across all maturities. The question is whether it's time to fade the rally. I think it might be, though I admit that my call on rotating away from the long bond has been wrong, or maybe, if we are very charitable, woefully early.

The second chart below shows that the three-month stock-to-bond ratio is stretched, but not as stretched as in late 2018. I think bonds will underperform stocks over the next three months, though it isn't a clear cut call, which brings me to the more substantial, and **second**, question for investors. Will central banks, and perhaps even fiscal policy, ride to the rescue? More specifically, will policymakers respond, and if they do, will it stop the rot?

The regime change detailed on these pages over the past 12 months suggests that central banks, and perhaps even fiscal policy, will throw the kitchen sink at Covid-19. Why wouldn't they? After all, policymakers have spent the past year confirming what markets have been pricing-in via rate expectations and bonds. Namely, that central banks intend to "do no harm", and that they will ease first and aks questions later.

Why wouldn't they respond to a true exogenous shock such as the Coronavirus? Last week shows that markets trying to drag central banks to the trough—witness the shift in U.S. rate expectations!—and I struggle with the idea that they'd stop short.

fig. 01 / Do you feel lucky? — fig. 02 / Lighten up on bonds, buy stocks?



CREATIVE COMMONS LICENSE, 2020
CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM

The counterargument levied against this prediction is that economic stimulus of the kind that can be delivered quickly is helpless against a shock like Covid-19. I concede that, but it is essential to be clear about the underlying assumptions. **Central banks and governments can't prevent exogenous shocks, and the idea of a policy put shouldn't be judged on that basis; it should be judged by the speed and scope of the *response*.**

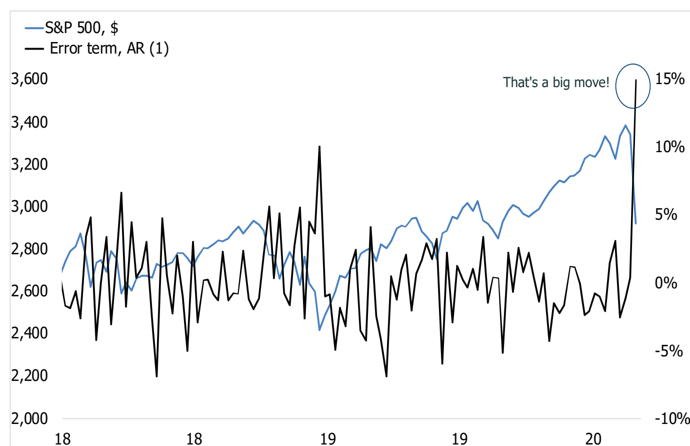
In this context, the idea that Covid-19 is largely, and mainly, a stagflationary supply-shock—that demand-side stimulus can't cope with—seems to run counter to evidence on the ground. Indeed, it was the slowdown in Chinese *demand*, as a result of the measures to contain the outbreak in Wuhan, that showed up first in markets via sharp declines in commodities.

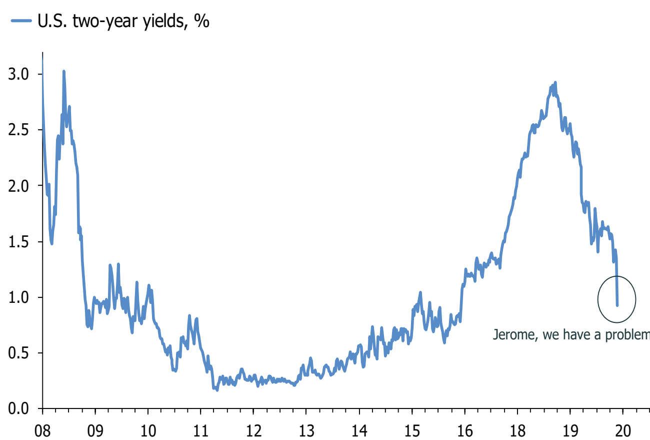
Whatsmore, because the Covid-19 outbreak is now morphing into a real economic shock, it is also bound to have an impact on the real variables that policymakers care about, mainly growth and employment. To state the obvious, 2020 growth forecasts are going to come down, dramatically, anytime now. And as uncertainty over the extent of the virus itself—it's public health risks and economic costs—grow, firms will stop short of hiring, or even start to lay off workers. I'd add here that the violence of the shock also could well unseat the smooth functioning of financial markets, via the disruption of contractual settlements, refinancings and the like.

Economic policy absolutely can and should react to such disruptions, and my core argument is that our current crop of decision-makers are primed to respond more aggressively, rather than with timidness and hesitation.

In fact, I am tempted to double down on this argument with the view that Covid-19 could well be the catalyst for the full pump-priming monetary and fiscal union that so many observers have been calling, if not yearning, for. Would such a shift alleviate the pressure on risk assets in the short run? Probably not, but look beyond the near-term convulsions, and I think that it just might be a marker for what happens next.

fig. 03 / Mean reversion favours the bold — fig. 04 / Calling Mr. Powell, you're up guv





CREATIVE COMMONS LICENSE, 2020,
CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM