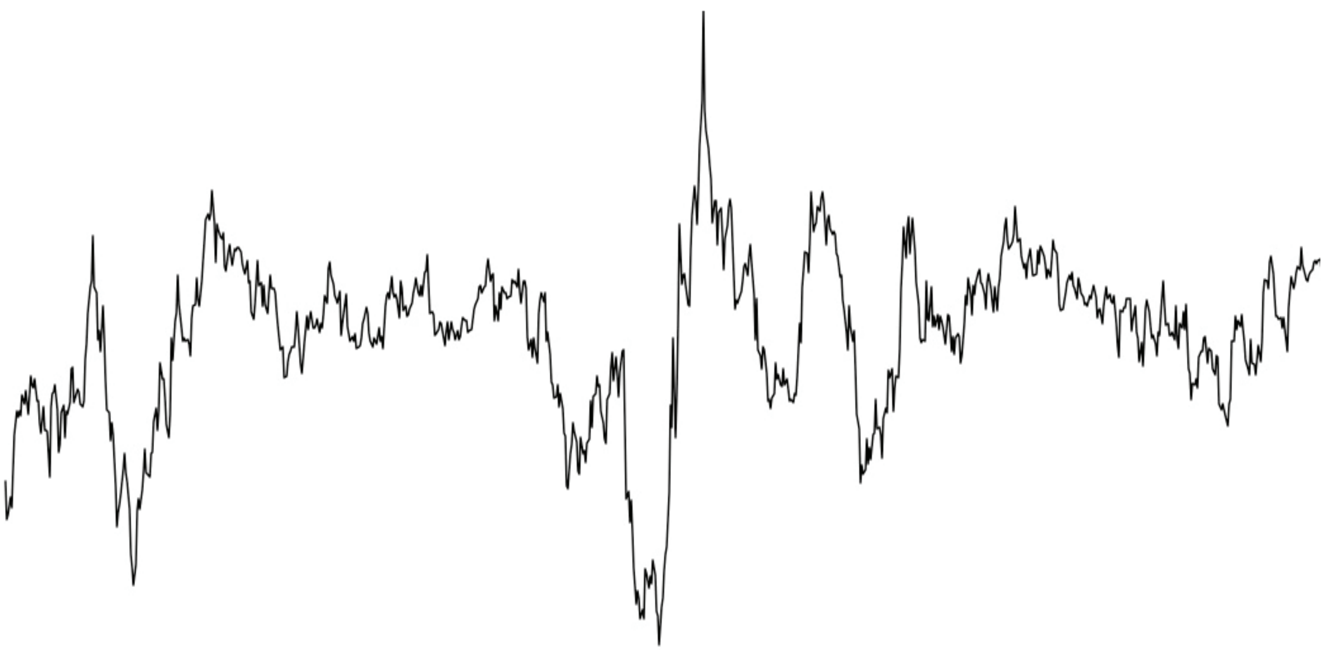
ALPHA SOURCES

MARCH 23, 2020



ALL CHANGE, BUT WHERE TO?

It has been clear for a while that Covid-19 would be a big shock to the global economy, but early predictions of a quick rebound, and a return to normal, now look fanciful. I am now inclined to believe that just about everything will change. My old colleague, and good friend, Jonathan Tepper is musing on a similar note in [a recent piece on Unherd.com](). I recommend that you go read it; it's a great piece.

For my part, I'll split my arguments into two observations, not necessarily market-related, but both are key to understand the evolution of markets and the economy in the next few quarters, and I would suggest, beyond as well.

FLATTENING THE (CASE) CURVE

We are not even through the first quarter yet, but it's fair to say that the first chart on my next page already is the chart of the year. It portrays the "optimal" strategy to combat the virus relative to doing nothing, and a policy of loose mitigation. Leaving the Chinese and South Korean outbreaks aside—as well as the grim disaster unfolding in Iran—I think it's fair to make two overall points. **Firstly**, there has been a significant debate about the correct strategy to combat the virus. The responses have been scattered on a spectrum ranging from (unconfirmed?) pictures of Chinese authorities welding doors shut

* / 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.

to apartment blocks to halt the spread, over to "herd immunity". Or, as former SAS soldier [Ant Middleton's suggests](); "fuck Covid-19", a statement that he, in fairness, has now retracted.

The correct response is somewhere in between, but it is fiendishly difficult to say where. Whatever the balance is—which may vary from country to country—everyone now appears to be converging on the same response, ostensibly aimed at preventing a public health catastrophe.

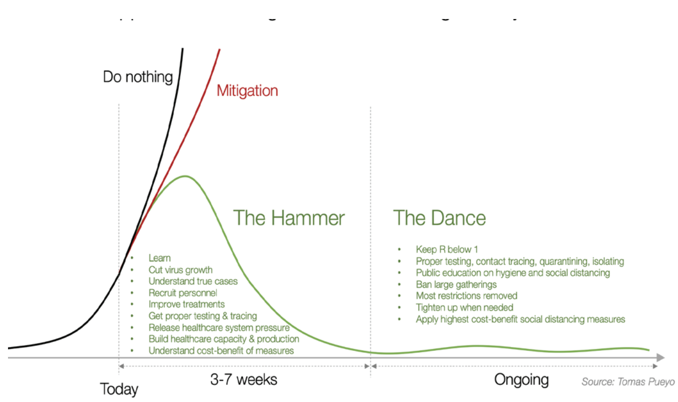
The Europeans had to wake up early and fast given the aggressiveness of the outbreak in Italy, and even as they did, Covid-19 now has a solid foothold on the Continent. Indeed, the outbreak in Italy is morphing into a disaster, even if, in hindsight, it is difficult for me to see that they could have reacted quicker and more aggressively. Across Europe, country by country is now going into more-or-less complete lockdown with increasingly onerous restrictions on economic and social activity as a result.

In the U.S. and the U.K., meanwhile, I think it is fair to say governments here initially thought, or hoped, that the virus wouldn't take hold to the same extent as in China and Europe. They were mistaken, and they are now following the same strategy as Europe. Time will tell whether the delay will prove costly. I fear it will, but I am no expert, and I hope they dodge the bullet.

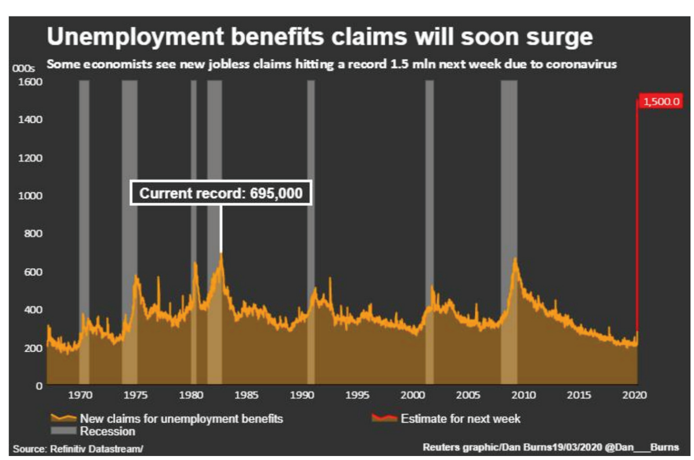
Secondly, the consensus across populations appear to support their governments' actions, though it is difficult to know in earnest. It certainly seems the case, however, that the overwhelming majority of experts—backed by official WHO guidelines—agrees that economic activity should be shut down, temporarily, to combat and limit the outbreak.

Support for that position now faces a stern test. The economic shock generated by the initiatives needed to beat Covid-19 is about to hit, and it will be a tsunami. Economists predict that U.S. jobless claims will soar be nearly 2 million this week, and in Europe the March surveys will reveal that growth all but ground to a halt at the end of Q1. This realisation will crystalise the obvious question of whether destroying econom-

fig. 01 / 2020 in one chart — fig. 02 / Yes, this could actually happen



Source: [Thomas Pueyo, March 19 2020]()



Source: [Reuters]()

ic growth and wealth is worth it. *At this point, a majority agrees that it is, but make no mistake; this sentiment could flip quickly as the crunch in growth and liquidity ripples through the economy.*

Comparisons between projected Covid-19 fatalities and, for example, annual deaths in road accidents have been made early on, but such crude juxtapositions don't do the dilemma justice. Road accidents are a well-known variable, while the Covid-19 epidemic is an unknown one. For that reason alone, they can't be compared. This editorial in the WSJ, however, comes closer;

"If this government-ordered shutdown continues for much more than another week or two, the human cost of job losses and bankruptcies will exceed what most Americans imagine. This won't be popular to read in some quarters, but federal and state officials need to start adjusting their anti-virus strategy now to avoid an economic recession that will dwarf the harm from 2008-2009."

The balance between following the expert advice to "stop everything" and the "contrarian rebel" is currently firmly stacked in favour of the former. But as the lockdown persists, and as the economic damage worsens, people confined to their homes—potentially with no income, job or ability to move at all—*will* turn in favour of the latter. I'd go as far as to say that human nature prescribes it.

I am tempted to put a cynical spin on this. Those who believe economic euthanisation is our best bet arguably also are those best positioned to deal with it in the first place. The conflict between them, and those who are about to ravaged economically is real. Eventually, and inevitably, this conflict will impinge on politics. When that happens, discussions that currently seem unthinkable about balancing the loss of lives with the costs of further economic destruction will become very real too.

My own view? What choice do we have? **We can't let this thing rip through society unchecked, simply because the ensuing public health crisis would quickly morph into the same economic crisis that we are now trying to prevent.** As for the right balance, trial and error will provide the answer in the end.

How this plays out is anybody's guess. It will depend on the severity of the outbreak, and the economic damage, as well as the possibility of a second wave in China, which would suggest that containment doesn't work. Finally, it will depend on the success of the response by governments, a response morphing into a combined monetary and fiscal stimulus push unlikely anyone could have ever imagined.

THAT'S A LOT OF MONEY

I have stopped counting, but the numbers are getting bigger. As I type, Germany has just announced a fiscal stimulus package worth 10% of GDP to cushion the blow from the virus. This move follows on the heels of a week during which hardly an hour passed without a central bank or a government pledging hundreds of billion in support. This week will see the grand finale in the form of a U.S. fiscal package.

I reckon 10-to-15% of global GDP is now on tap in terms of fiscal stimulus, not counting the near-endless amount *of liquidity provided by central banks.* We're going full MMT, an experiment that could decide the course of markets and the global economy over the next decade. There will be a time for a closer examination of the long-term consequences of this shift, but for now, two themes seem most obvious to me.

1) Who gets what, and how much?

The catch-phrase above has been my stab at MMTers since this theory re-rose from the ashes. I have never received a good answer, but we're about to find out. The overwhelming political pledge to shower the economy with as much money as needed to get us through is partly driven by benevolence. I am cynical at heart, but I truly believe that. Make no mistake, however. It is *also* conceived as a circuit breaker to the idea that people eventually will rebel against the lockdown, because politicians know that they will, eventually.

I hope it works. It's certainly clear that policymakers are throwing the kitchen sink at this, but the next step, however, is equally important. **Policymakers have to get the transmission mechanism right, and this could prove difficult**

Governments and central banks have correctly identified that the (non-financial) real economy will take it on the chin, unlike in 2008 and 2009, when the crisis started in the financial sector. The point that this is not a financial crisis has been touted as good news. It is, but then again, might not be. It's simple to create vast amounts of liquidity to support financial institutions with direct recourse to central banks' open market operations. It is also easy to print money to finance government spending and transfers. *It is not necessarily easy, however, to transmit such policies to the parts of the economy that is hurting.*

It's difficult at this point to see how policies such as salary compensation, tax deferrals, and current transfers to everyone will filter into the real economy. Indeed, some governments also are toying with the notion of cancelling rent, mortgage and utility payments, adding a further layer of complexity.

After all, if households stop paying their bills, those at a loss on the other side will be compensated by the government, or I should think so at least. These tools are the right instruments, at least in theory, but we shouldn't be naive. **You do not conjure trillions of dollars out of thin air without some of that money ending up in pockets that strictly don't need it while bypassing those that do.**

The riposte to this point usually is that it doesn't matter if a few rich people get a cheque as long as the poor do to. Well, if that's what you really think, I have a bridge to sell you, paved with virtue signalling, envy, opportunism and a sense of fairness. The big test in the next few months could well be a rebound in markets—after all, that's why we're printing in the first place—just as the anvil falls on the real economy.

2) Unlimited power

Another key sub-plot to this crisis is that central governments are now in the midst of power-grabs normally reserved for wartime. Ostensibly, there is a benevolent sequence in play here. Governments are taking drastic steps to prevent a public health crisis, and are trying to limit the economic costs of such steps. Everyone is currently nodding in agreement, but time is an unappreciated factor here. This is supposed to be temporary, but will it?

I have already implicitly staked my claim that there is a limit to the duration that governments can keep economies on full lockdown. It's plausible that governments eventually will have to pivot towards a longer, yet looser, regime with some social distancing, in effect allowing parts of the economy to breathe.

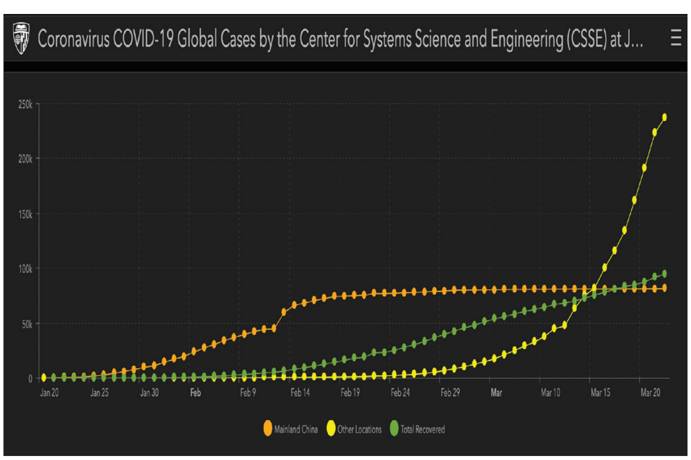
In terms of the economic response, however, we are about conduct a fascinating experiment. The Fed has crashed into the zero bound, governments are about to transfer money into households' bank accounts en masse and provide firms with unlimited, and free, liquidity. **However efficient and equitable these measures filter into the real economy, it is difficult to believe that governments and central banks will snap their fingers and pull back in three months.** The crisis won't be over by then, and the beneficiaries of these policies will argue that they still need the money to keep moving forward.

The prospect of emergency economic stimulus being subject to hysteresis raises a critical question for markets. Will the bond vigilantes finally stir from their sleep? I suspect they will, but even if I am right, that would only be half of the story. What will policymakers do in response to higher bond yields? *To me, that's the most important near-term question for markets at the moment.*

If bond markets are allowed, or forced, to absorb the cost of tying the economy over through the outbreak, yield curves will steepen. This, in turn, ought to drive a shift in equity markets with value—financials and energy—outperforming the broader market.

Alternatively, central banks adopt yield-curve-control, locking the curve at zero through the 10y or even beyond. If they do that, they signal the desirability of negative real rates for as far as the eye can see. This should solidify the out-performance of growth stocks, and assets positively correlated with negative real rates, primarily, I suspect, gold and property. All change indeed, but where to? We don't yet know.

fig. 03 / Everyone wants this curve to flatten… — fig. 04 / …but what about this one?



Source: [Johns Hopkins]