Stargazer
Asset Management

What to focus on in Global Macro for the week of May 11th, 2020

Macro Themes on the Radar:

ECB

One Tuesday, in a surprisingly firm 94-page decision, the German Constitutional Court ruled that the ECB's QE Program could be illegal. The ruling directly challenges ECB policy and the authority of the Court of Justice of the European Union. (CJEU).

The ruling accuses the CJEU of a breach of EU treaty law. *The German court dismissed a 2018 CJEU decision to allow the bond purchases and ordered the ECB to provide Germany with adequate justification for the program within the next three months. Should it fail to do so, the Bundesbank, Germany's central bank, would no longer be permitted to participate in the program.*

Lagarde is "Undeterred" (FT) and ECB members dismissive.

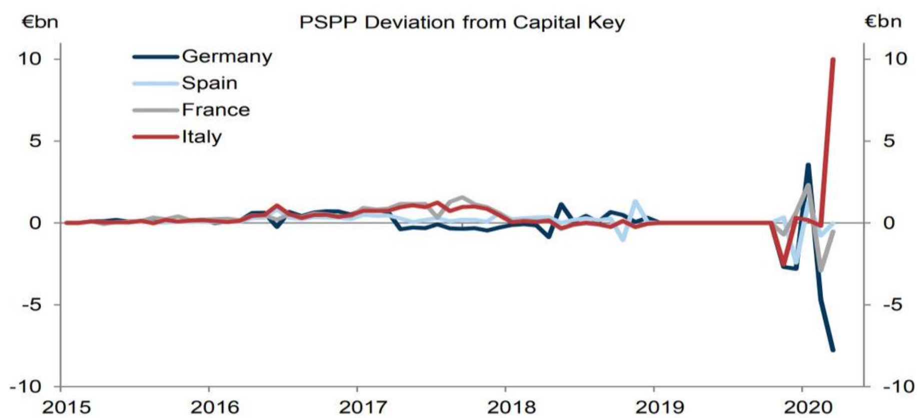
"We are an independent institution, answerable to the European Parliament, and driven by our mandate," she said in a webinar organized by Bloomberg. "We will continue to do whatever is needed, whatever is necessary, to deliver on that mandate. Undeterred." Four ECB governing council members told the Financial Times on Wednesday that the ECB should not respond directly to the German court, arguing such a move would impinge on the central bank's independence and expose it to pressure from other national courts. A majority of ECB council members oppose providing a justification, they said.
"The court's arguments are ridiculous and we could easily answer them in five minutes, but we absolutely should not do so," said one member of the ECB council, who added that this view was shared by the 24 other members of the bank's top decision-making body who held a conference call on Tuesday evening to discuss the judgment. "What is the risk if we reply?" the council member asked. "When the time comes to raise interest rates, another court in a different country will challenge us — then what?"

It may well be that the ECB declines to respond. The Bundesbank however has a legal obligation to do so. This obviously puts Jens Weidmann, President of the Bundesbank, in a very difficult position. It is doubtful that in the end the Buba would be forced to stop participating in QE purchases and potentially even forced to sell what they have already bought. However, given the attitude being projected by the ECB so far, the road to resolution could be very bumpy and acrimonious.

With the deviation from the capital key accelerating over the last few months, the timing is potentially powerful.

Exhibit 3: ECB favored Italy over Germany in March capital key deviation

Net purchases adjusted for redemptions and reinvestments Set to zero Jan-Oct 2019



Source: ECB, Goldman Sachs Global Investment Research

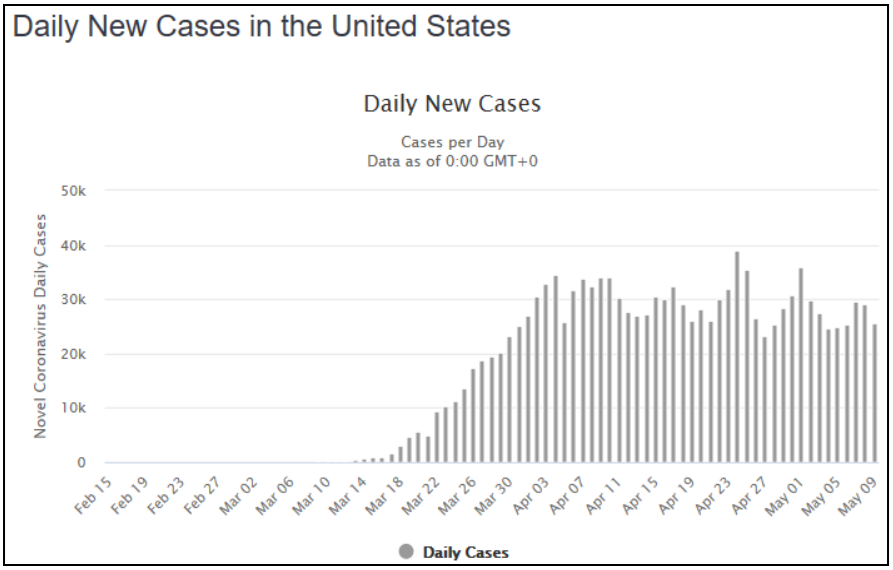
The COVID crisis has had a way of accelerating and magnifying many existing trends.

Since there is still no mechanism for a Eurozone-wide fiscal response, efforts have been on a national basis. Rather than bringing Europe together, the crisis has served to accentuate and magnify the differences. Germany went into the crisis with low but positive growth and was quick to respond with a large €750bln package for the economy. Italy on the other hand, hardest hit in Europe, was already entering a recession prior to the outbreak. Due to their lack of fiscal leeway, their response has amounted to only €28bln, a fraction of the German package. With debt to GDP more than 2x that of Germany, Italy faces a very weak economy, higher borrowing costs and diminished ability to support a rebound.

The ECB is left as the only equalizer in the Eurozone. That role is now being challenged by the Constitutional court of the same country leading the resistance to any meaningful form of debt mutualization in the Eurozone. So far, rather than bringing the Europeans together, this crisis has broadened the economic and national divisions. Europe may be an increasing drag on global growth and a source of growing market volatility unless Germany opts to go all in. The time for that decision is approaching.

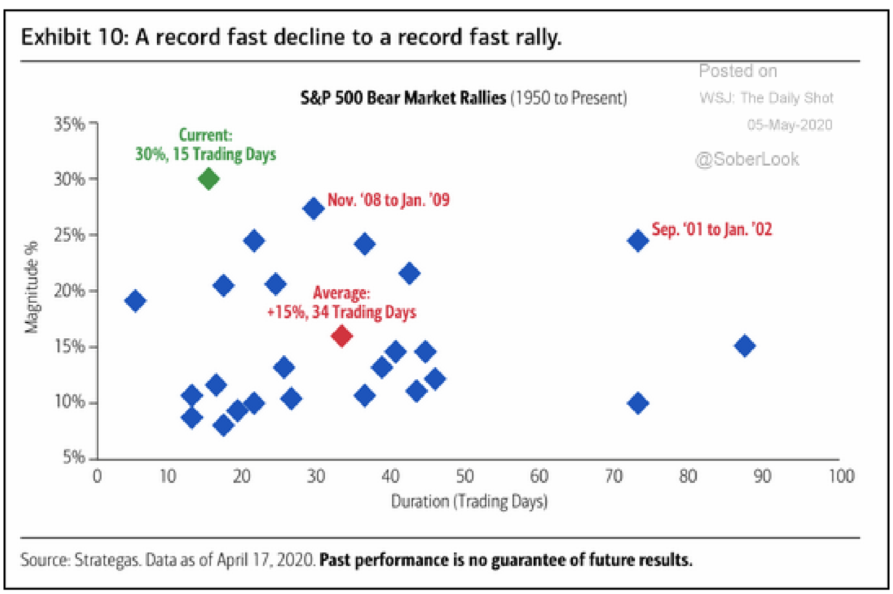
<u>What to Focus on Now:</u>

Economies are reopening in the US and Europe. Infection rates remain rather high, but if adjusted for the increase in testing, are probably a bit better than they look. Policy makers have made the conscious decision to reopen their economies.



The implication is that they will tolerate a certain level of new infections and continuing deaths as long as they are not accelerating. Even if there are pockets or hotspots, they can be dealt with on a local level. The bar for closing down any given country again will be very high going forward.

The prospect of a pickup in activity (potentially a sharp one initially, given the low comparisons and pent up demand) is clearly helping stocks. Add to that the promise of therapeutics like remdesivir and talk of a vaccine being available way ahead of the initial 12-18 month window, and you can see reasons for more optimism.

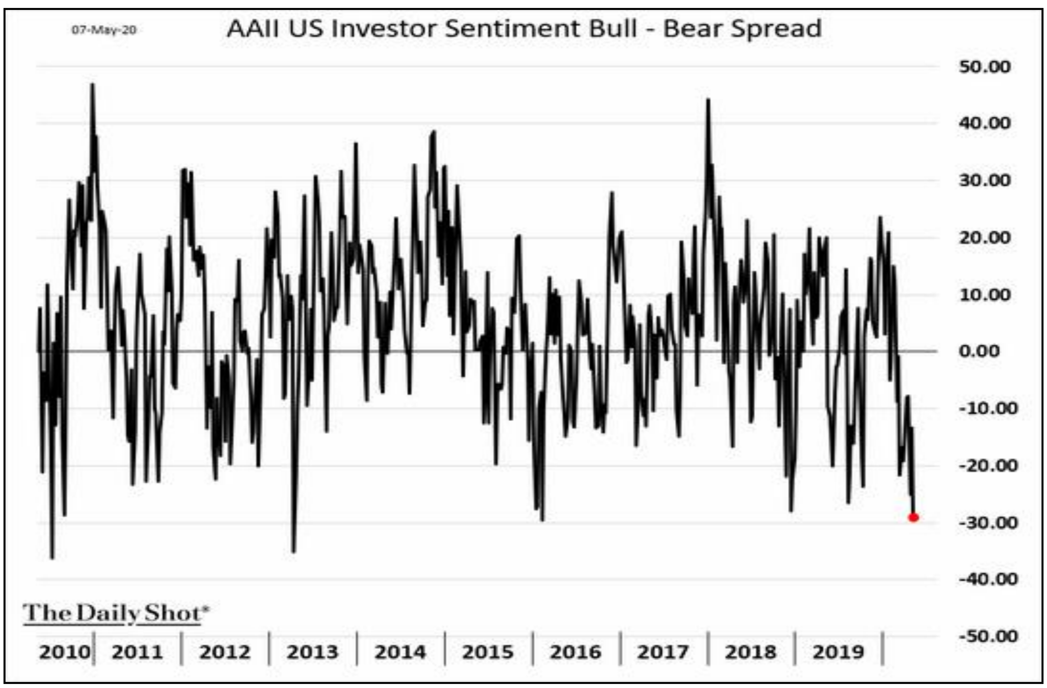


Interestingly, despite the already large rally off the lows, most investors remain quite bearish. The disconnect between the awful economic data we are seeing and the price action in equities is obvious and hard for people to reconcile.

The S&P has managed to rally 10% or more over a 7-week stretch 54 times since 1987.

This is the first - and only - time it did so and more than half of folks still expect stocks to drop.

The only times than > 40% were bearish were Dec '90 and Apr '09.



The fear of a 2nd wave of the outbreak remains high for both consumers and investors. BoA/ML highlights investor sentiment as they currently see it: "9/10 say bear market rally, 8/10 say "U" or "W" recovery, 7/10 say only buy what the Fed buys, 6/10 expect retest of lows, <1/10 say stocks in bull market; consensus remains bearish."

During times like this, price action, flow, positioning and sentiment can be much more important than trying to figure out exactly which fundamental drivers' markets are focused on.

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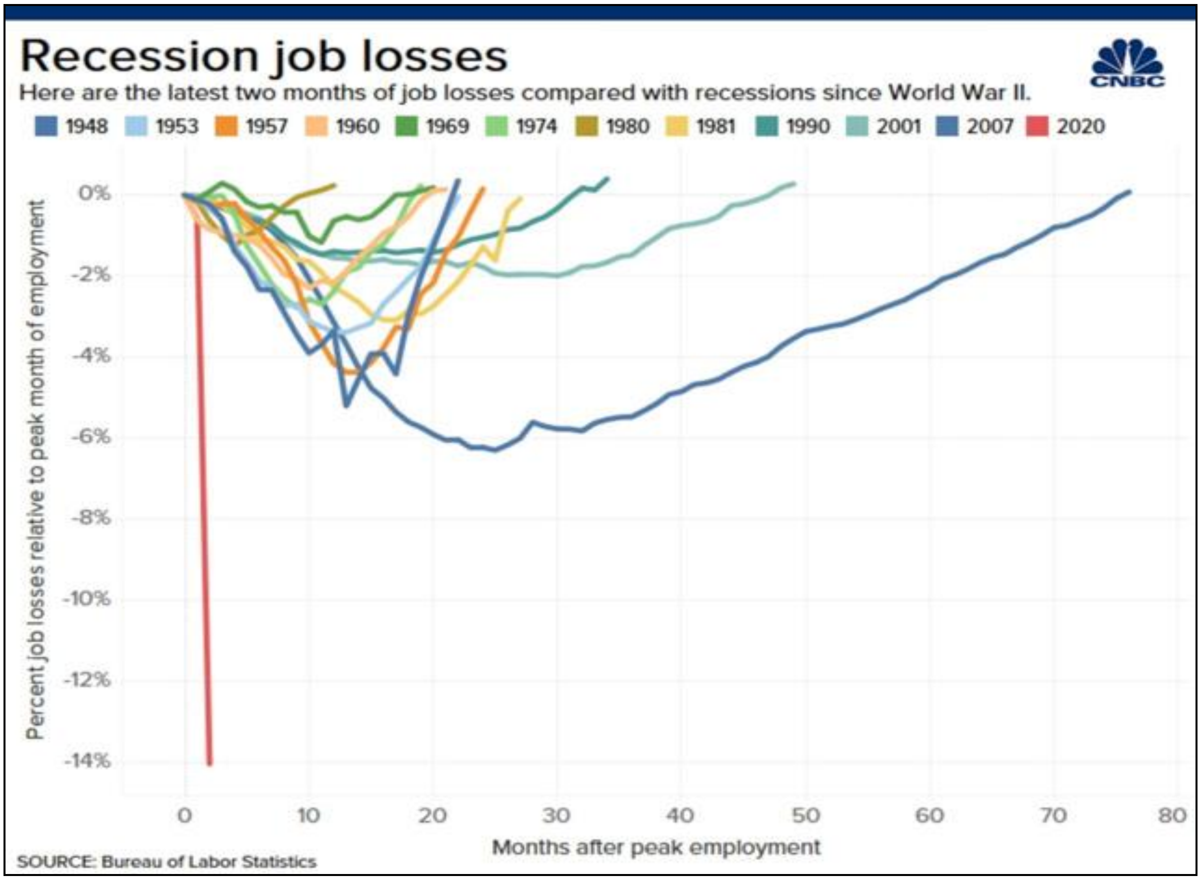
However, a few things are worth pondering.

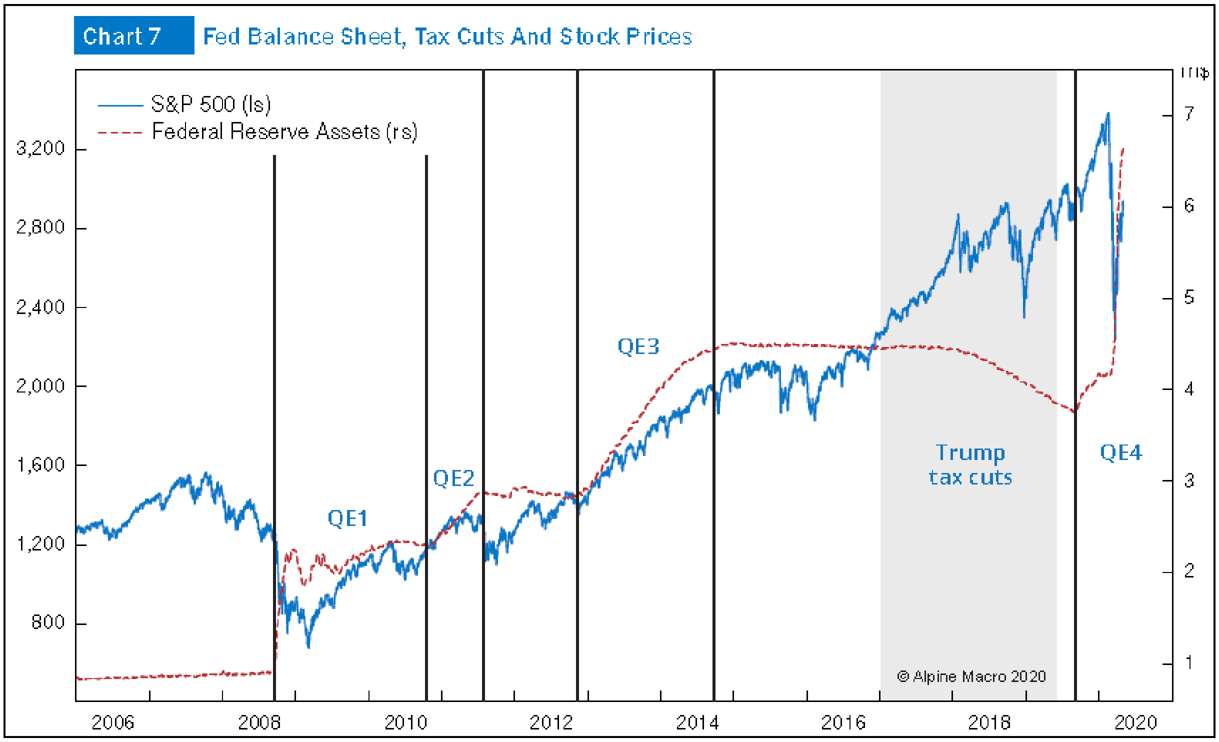
Obviously, the job losses are unprecedented…



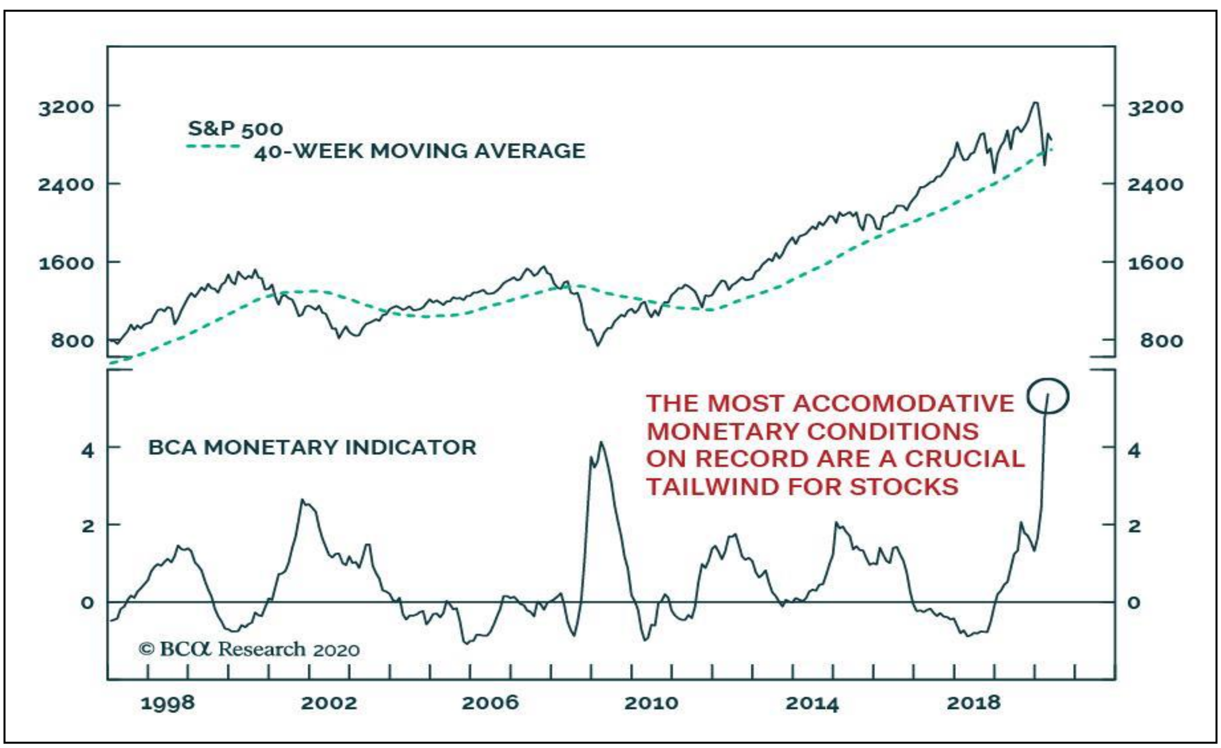
However, that isn't just true regarding the size and speed of the losses, but also their nature and impact this time around.

The US has done more during this recession than ever before in terms of helping to fill the cash flow crater people are experiencing from the job losses. Forced unemployment is different from organic unemployment. This is especially true given the increase in size and duration of unemployment benefits meant to offset the lockdowns. Basically, unless you were making more than $60k in the US, you currently have meaningful cash flow coverage if you are able to claim unemployment. That is a big difference from previous recessions in terms of consumer purchasing power. The steep fall should equal a steep initial recovery as things re-open. Of course, the question is how much do we recoup and how long does it take to get back to the starting point?

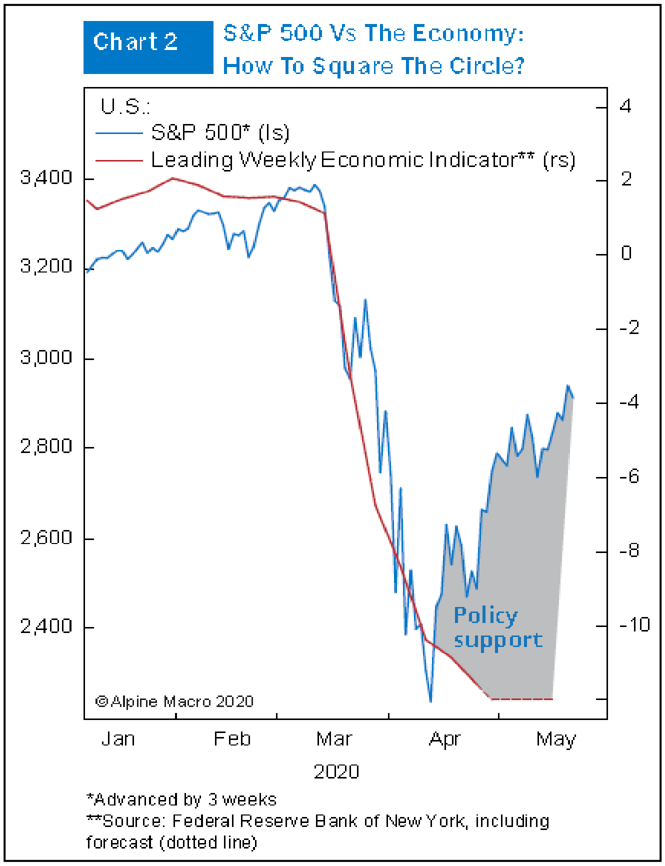
The size, scope and makeup of the policy response is also different this time. Since 2009 we have repeatedly seen the powerful impact of monetary and fiscal policy. At times it can result in stocks diverging from economic activity. Markets have been conditioned for this response.

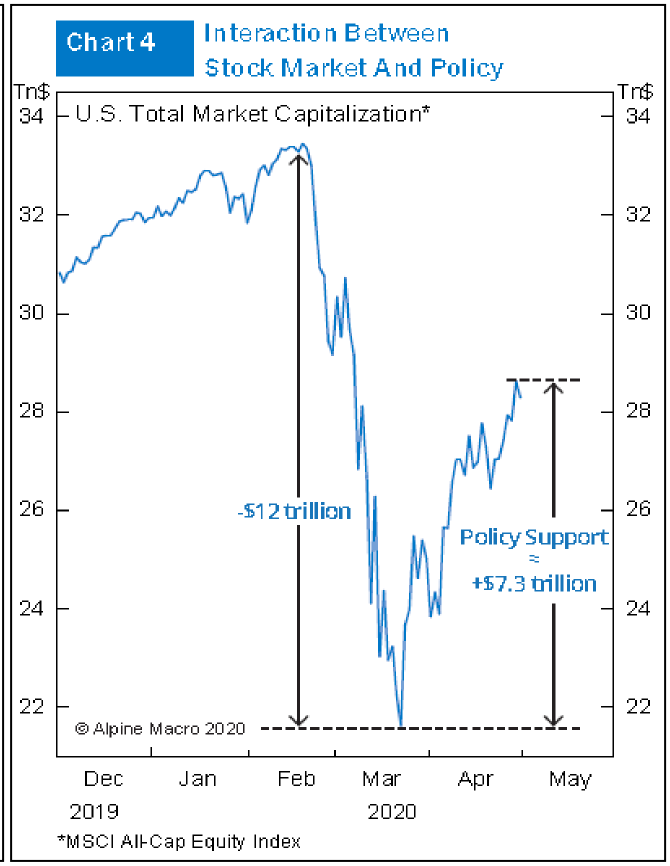


Lots of accommodation now … again.



Alpine Macro points out that the combined monetary and fiscal policy actions are adding $7.3 trl to the economy. This is approximately equal to the recovery in market capitalization/ equity values. As they note: "This could be pure coincidence, but nonetheless it is an intuitive way to think about the interaction between the stock market, policy and the economy."



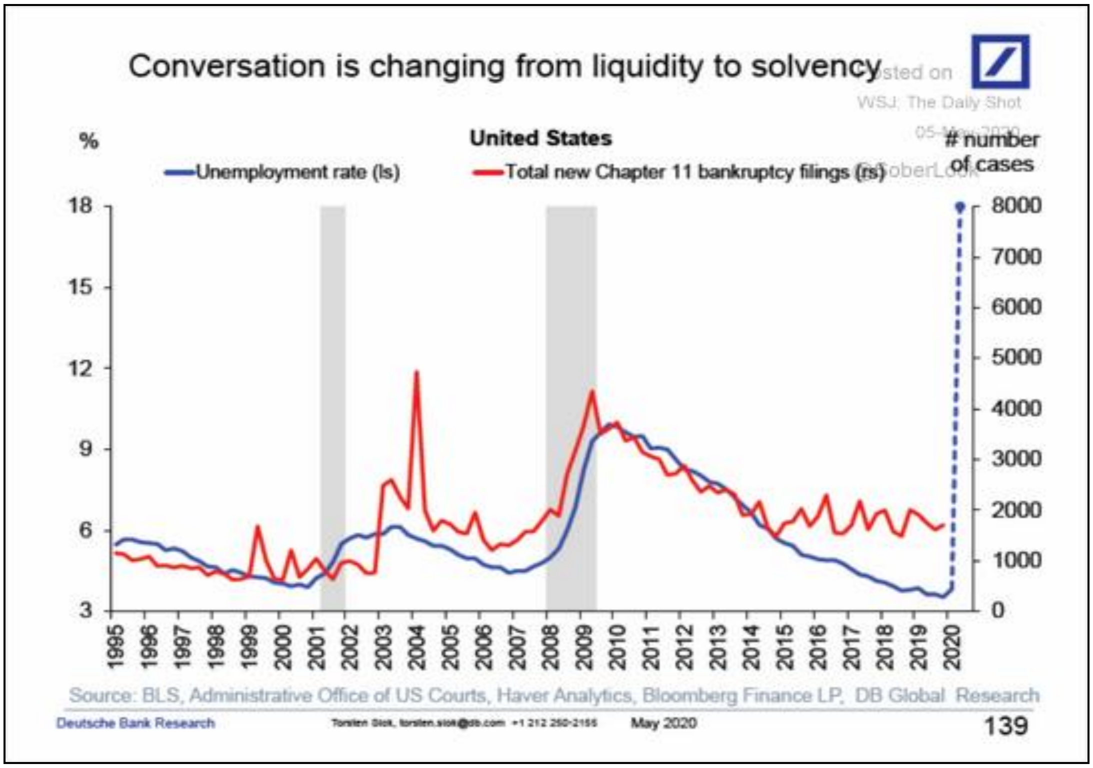


After the bounce

With so many "firsts" ranging from the nature of the crisis, to the economic impact, price action and policy response, it will be important to stay open minded about how the situation is evolving and what comes next.

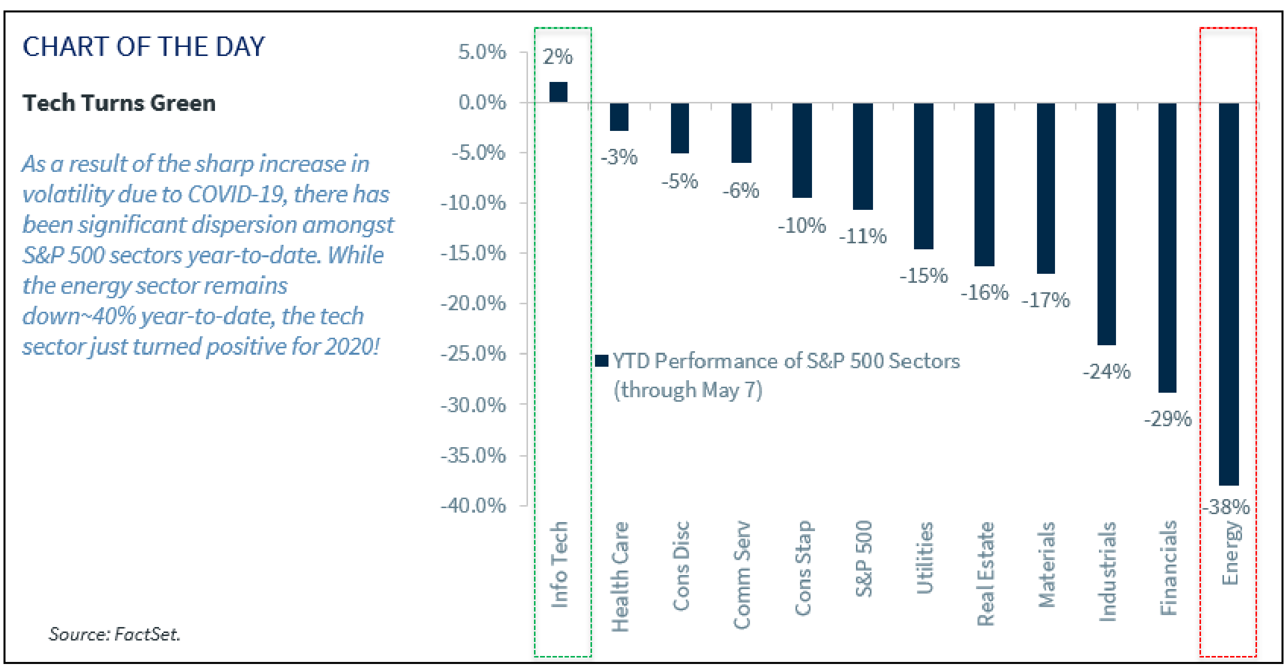
At the moment a W recovery still looks the most likely to me. Markets fear a second wave of the virus in the Fall. That could certainly shake markets. However, it could also be that we get a second wave of economic repercussions as the smoke clears and we see what the actual damage is to SME's and the hardest hit sectors of the economy.

Liquidity is helpful and loans can get you through a temporary rough patch, but they don't guarantee solvency. The crisis will leave consumers, businesses and governments with more debt. Will growth and cash flow be enough to service it?

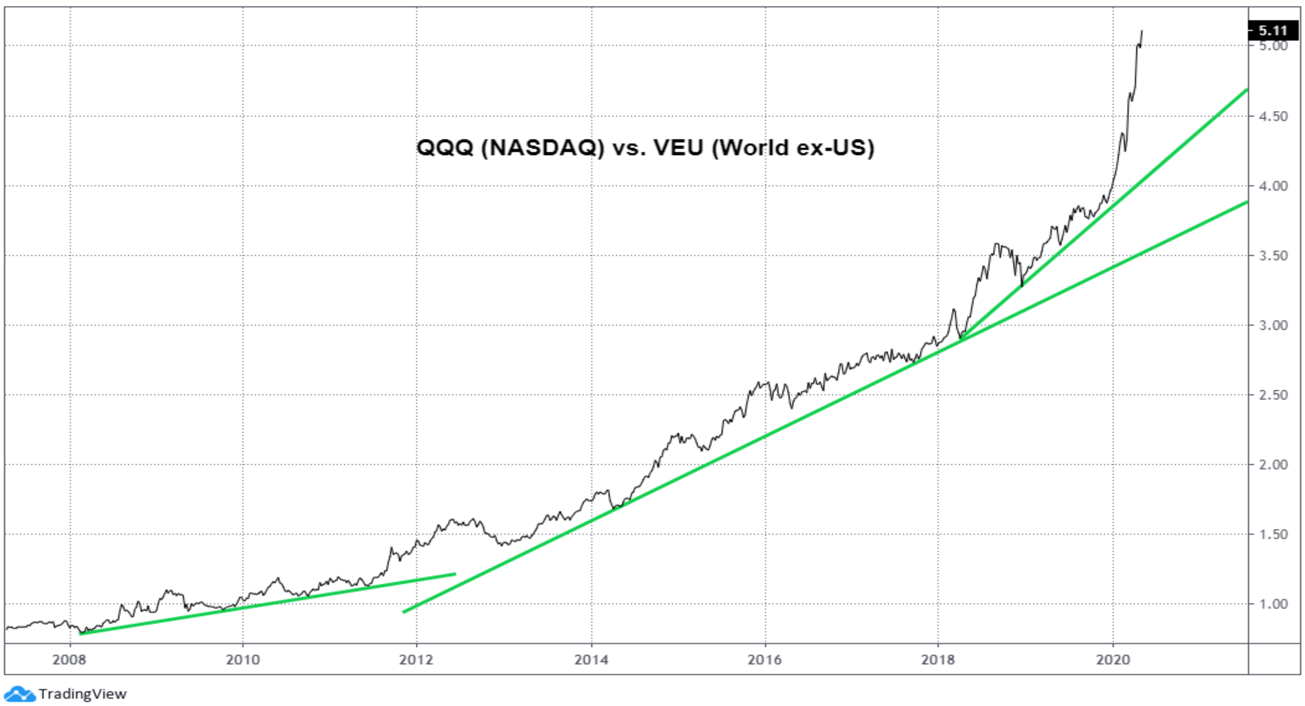


Markets

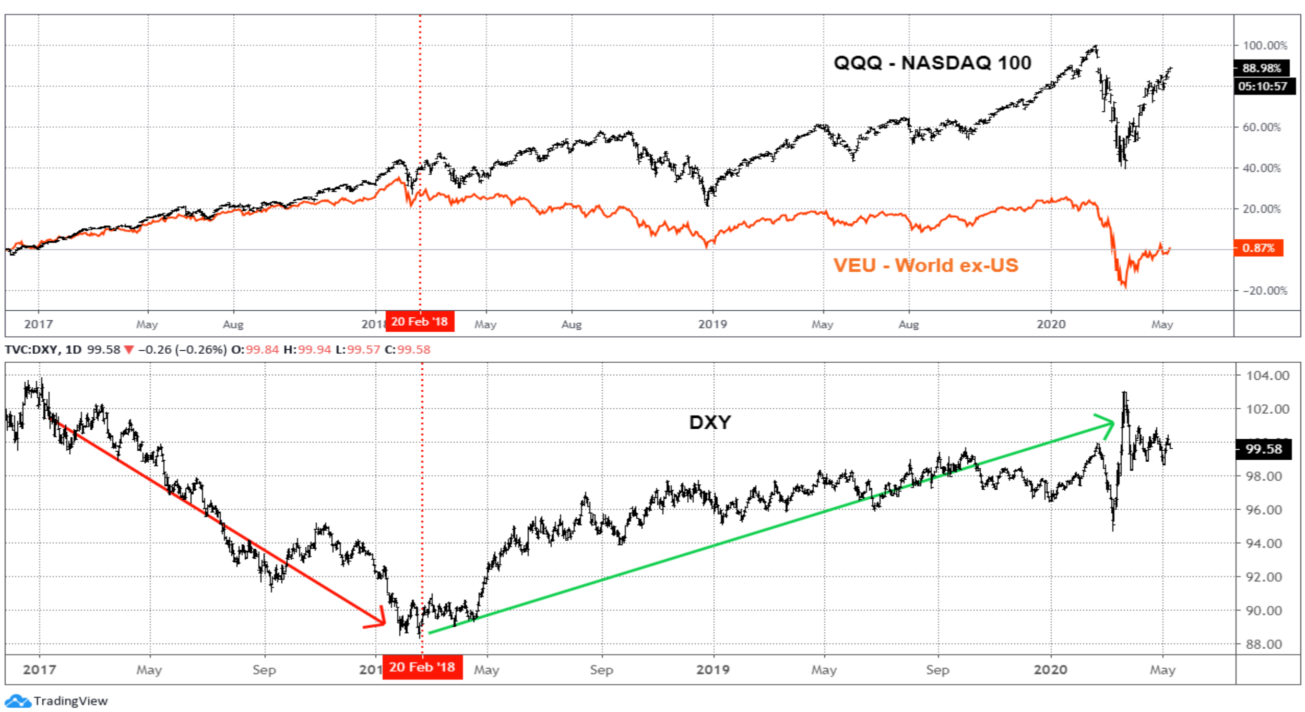
The NASDAQ has been the leader in the US and globally YTD.



However, this leadership is nothing new. It started in earnest at the end of the GFC and has been persistent ever since. There have been pauses and points of acceleration along the way. The first acceleration was during the European Debt Crisis in late 2011.



The most recent acceleration of the trend started in early 2018 as global growth started to stall. These periods of increasing NASDAQ outperformance have been accompanied by USD strength.



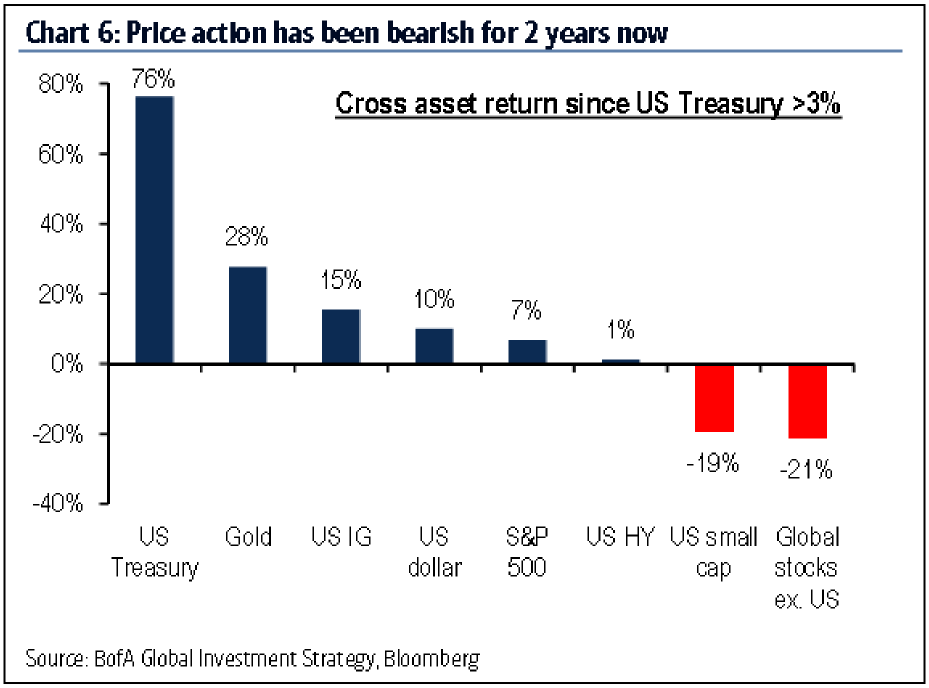
As Europe (2011) and then EM (2018) faced challenges and uncertainty they started to underperform as the global version of growth vs. value gained traction. The NASDAQ benefited and the USD rallied. This created a positive feedback loop for US assets (NDX, Bonds and USD in particular) and a negative feedback loop for everything else.

Yes, US earnings have certainly been better. Relatively more buybacks in the US helped, but so did the presence and large weighting of the US technology giants. (FAAGM now makes up nearly 20% of the S&P and 45% of the NDX by weight)

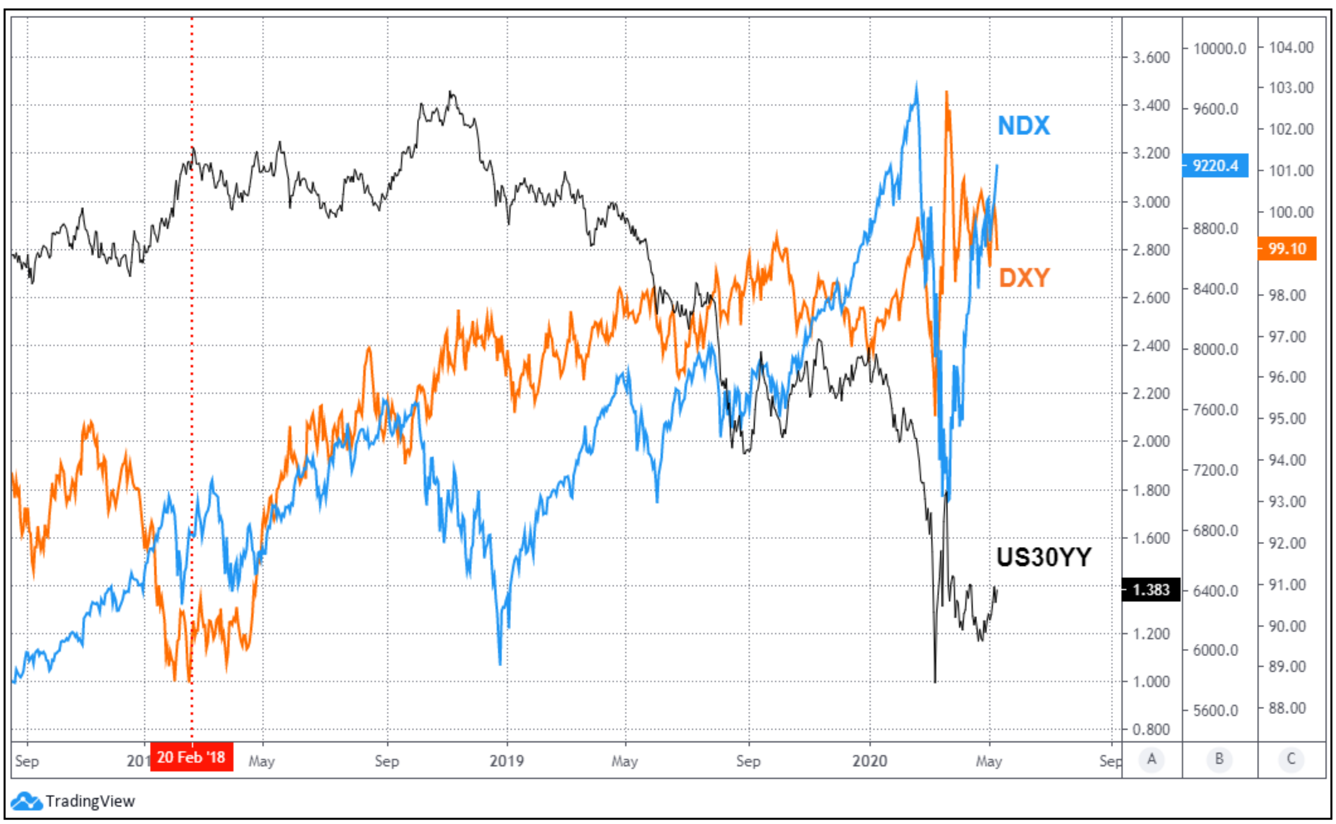
In 2016 we saw a little pullback as a reflation narrative took down the USD and bond markets and took up all the EM and commodity related names for a bit. It didn't last.

The NASDAQ outperformance since 2018 has had a backdrop of relatively "bearish" price action from other asset classes overall.

Bonds and Gold have been in demand while small caps and non-US equities have been out of favor.



Here is another view. There has been a flight to quality and growth.



Some of the tech names have become as good as gold in fact... kind of amazing how this relationship has jelled since late last year.

The wealth transfer from the old to the new economy is ongoing and powerful. While much of it has already been priced, continued global economic weakness could still lead to further outperformance.

Next Week

With some USD weakness over the last few days we have seen an instant flow to small caps, and EM as the NDX underperformed. For that to be sustained, we will need to see higher bond yields and a weaker USD; signaling a pickup in global growth and reflation expectations. If bonds are not allowed to weaken because of implicit or explicit yield curve control by the Fed, then the USD should take all the pressure.

Either way watch the dollar.

If it holds up or even gains renewed strength, expect the Nasdaq to continue its outperformance and bond yields to stay on or near the lows.

If it weakens, look to EM and commodity stocks and currencies. The timing doesn't really feel right for that yet, but maybe we can get a respite during the ^ part of the W…

Don't forget Powell speech on Wednesday at 9am!

Important Macro Data Releases and Events for the Week

Monday
5/11/2020

Nothing much

Tuesday
5/12/2020

Consumer Price Index YoY (Apr) Forecast: 3.7%, Prior: 4.3%

Leading Economic Index (Mar) Forecast: - , Prior: 91.7

CPI ex-Food and Energy MoM (Apr) Forcast: -0.2%, Prior: -0.1%

CPI ex-Food and Energy YOY (Apr) Forcast: 1.7%, Prior: 2.1%

Fed's Quarles SPEECH

Fed's Mester SPEECH

Wednesday
5/13/2020

Fed Chairman Powell SPEECH 9am EDT

Industrial Production s.a. MoM (Apr) Forecast: -12%, Prior: -0.1%

PPI ex-Food and Energy Forecast: 0.9%, Prior: 1.4%

Thursday
5/14/2020

Harmonized Index of Consumer Prices YoY (Apr) Forecast: 0.8%, Prior: 0.8%

Economic Bulletin

Initial Jobless Claims Forecast: 2.5m, Prior: 3.169m

Initial Jobless Claims 4-week ave. Forecast: - , Prior: 4.173m

Continuing Claims Forecast: - , Prior: 22.647m

Friday
5/15/2020

- NBS Press Conference
- Industrial Production YoY (Apr) Forecast: 1.5%, Prior: -1.1%
- Retail Sales YoY (Apr) Forecast: -7.5%, Prior: -15.8%
- GDP QoQ (Q1) Forecast: -2.1%, Prior: 0%
- GDP QoQ (Q1) Forecast: -3.8%
- NY Empire State Manufacturing Index (May) Forecast: -65, Prior: -78.2
- Retail Sales ex-Auto MoM (Apr) Forecast: -8.6%, Prior: -4.5%
- Retail Sales Control Group (Apr) Forecast: -3.9%, Prior: 1.7%
- Retail Sales MoM (Apr) Forcast: -10%, Prior: -8.7%
- Industrial Production MoM (Apr) Forecast: -11.6%, Prior: -5.4%
- Michigan Consumer Sentiment Index (May) Forecast: 68, Prior: 71.8

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