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Asset Management

What to focus on in Global Macro for the week of March 30th, 2020

"There are decades where nothing happens; and there are weeks where decades happen."

Vladimir Ilyich Lenin

Macro Themes on the Radar:

Global Central Banks are facing three problems:

- An exogenous shock that has brought a "sudden stop" to both supply and demand across the globe; effectively stopping cash flow to many businesses and individuals.
- A credit issue, as corporate and some sovereign bonds, are repriced to reflect the "sudden stop".
- A lack of liquidity (both in terms of available funding and market depth).

As far as the Federal Reserve goes, it has now employed all the interest rate and QE ammo remaining. It has also flooded the markets with liquidity and joined forces with the Treasury to buy assets in many different forms. None of this is really stimulus, but an attempt to plug the holes left by the above three problems. At the same time the government is also providing fiscal support in unprecedented size to address the "sudden stop". In the US this is a complicated process as you would expect with lots of political wrangling. At least we have a single government and a central bank that together control monetary policy, the ability to issue debt and the currency. With the Fed asset purchase programs across markets backed by the Treasury acting as the first loss taker, the Fed's role is now to provide the leverage for Treasury directed programs. The politicians are effectively in charge. This is what should be expected at zero rates and QE infinity.

Europe is a very different story. They are tied together by a common currency and a powerful bureaucracy; but lack a common government or treasury. The competing national interests are powerful and have a long history. This gives rise to very disparate sensibilities on what is "right / wrong" in term of budgetary constraint and tolerable inflationary outcomes.

The ECB is united in that its structure allows it to outvote member countries that are more conservative in their outlook of what is appropriate. However, even more so than the Fed, the ECB has reached the limits of its policy tools. Lagarde has for months been warning that the baton will now need to be passed to the governments and the fiscal side.

Here is a quick excerpt from their most recent policy announcement… a lot more QE.

"Over the last week, we have seen conditions in the euro area deteriorate considerably. Our evaluation of the economic situation has darkened. The depth of uncertainty over the economic fallout is now visible across all asset classes, both in the euro area and globally.

This has led to a tightening in financing conditions, in particular at the longer-end of the maturity spectrum. The risk-free curve has moved up and the sovereign curves – which are key to the pricing of all assets – have increased everywhere and become more dispersed. These developments impair the smooth transmission of our monetary policy across all euro area jurisdictions and put price stability at risk.

As a result, the ECB's Governing Council announced on Wednesday a new Pandemic Emergency Purchase Programme with an envelope of €750 billion until the end of the year, in addition to the €120 billion we decided on 12 March. Together this amounts to 7.3% of euro area GDP. The program is temporary and designed to address the unprecedented situation our monetary union is facing. It is available to all jurisdictions and will remain in place until we assess that the coronavirus crisis phase is over.

The new instrument has three main advantages. First, it fits the type of shock we are facing: exogenous, detached from economic fundamentals and affecting all countries in the euro area. Second, it allows us to intervene in the entire yield curve, preventing financial fragmentation and distortions in credit pricing. Third, it is tailored to manage the staggered progression of the virus and the uncertainty about when and where the fallout will be worst."

<u>Since this statement, they have made the size of the PEPP open ended; whatever they deem necessary.</u>

On the fiscal front however, the situation is **much** more complicated and contentious.

Most countries have acted independently to support their own economies already. Fiscal spending has included money for small businesses, healthcare and law enforcement. Italy has announced 100B, France 300B and Germany 750B.

However, a coalition of 9 countries including France, Italy and Spain are demanding "Corona Bonds" issued by the Eurozone as a whole, to mutualize the debt and spending required to deal with the outbreak. The ECB's Lagarde has agreed that this is necessary.

On Thursday, the 27 EU leaders held a 6-hour video conference that ended with a joint statement that effectively passed the buck back to finance ministers. They were instructed to come up with a plan within the next 14 days.

During the call Germany, Austria and the Netherlands flatly opposed corona bonds. Those nations have long opposed any move to mutualize debt in Europe for fear that it would lead to their taxpayers having to directly subsidize the poorer member states.

France's Macron, Italy's Conte and Spain's Sanchez were vocal after the call…

"We are facing the worst crisis of our generation. The future of the European project is at stake. We have to choose between a coordinated and supportive EU and individualism," Spanish Prime Minister Pedro Sanchez tweeted Friday. "We call for a common response to this emergency. Let's ensure a fair recovery."

"If Europe isn't capable of rising to the challenge, the whole European project risks losing legitimacy in the eyes of our citizens," Conte said in an interview.

"The case for such a common instrument is strong, since we are all facing a symmetric external shock, for which no country bears responsibility, but whose negative consequences are endured by all," the leaders of the nine countries, including French President Emmanuel Macron, wrote in a letter.

Instead, Merkel, and other leaders, suggested the Eurozone should tap the €410 billion remaining in the European Stability Mechanism, a bailout fund established to help countries during the EU debt crisis in 2011.

That has supposedly infuriated southern European countries who associate the ESM with the austerity measures attached to bailout loans to Greece, Cyprus, Portugal and Ireland.

The mass migration to Europe in recent years left Italy and Greece feeling abandoned by other EU countries that weren't inundated with new arrivals; the coronavirus rift has exposed the old north-south divide. At the same time the Germans & Co. may be feeling that the southern countries are taking this crisis as an opportunity to push their long-standing agenda.

From Die Welt in Germany:

"The dispute over euro bonds has been smoldering since the beginning of the debt crisis in 2010. But the force with which southern Europeans are now demanding joint debts has never been as strong as it is today. The economic upheavals resulting from the Corona crisis offer Conte and Macron the chance to pay old bills and finally implement long-held plans to convert the euro zone towards a transfer union. The fundamental dispute will flare up again in two weeks at the latest, it is far from over."

There is an adage among historians that any centralized government that isn't able to deal with a crisis gets decentralized. This is decision time for the Eurozone. Can they come together? The bad blood is slowly building, and in the end, it will be the northern European countries that must agree or walk away. If not this crisis than the next.

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

This chart of Initial Claims says it all. Every chart now looks like some version of this or its inverse, depending on the instrument or index.

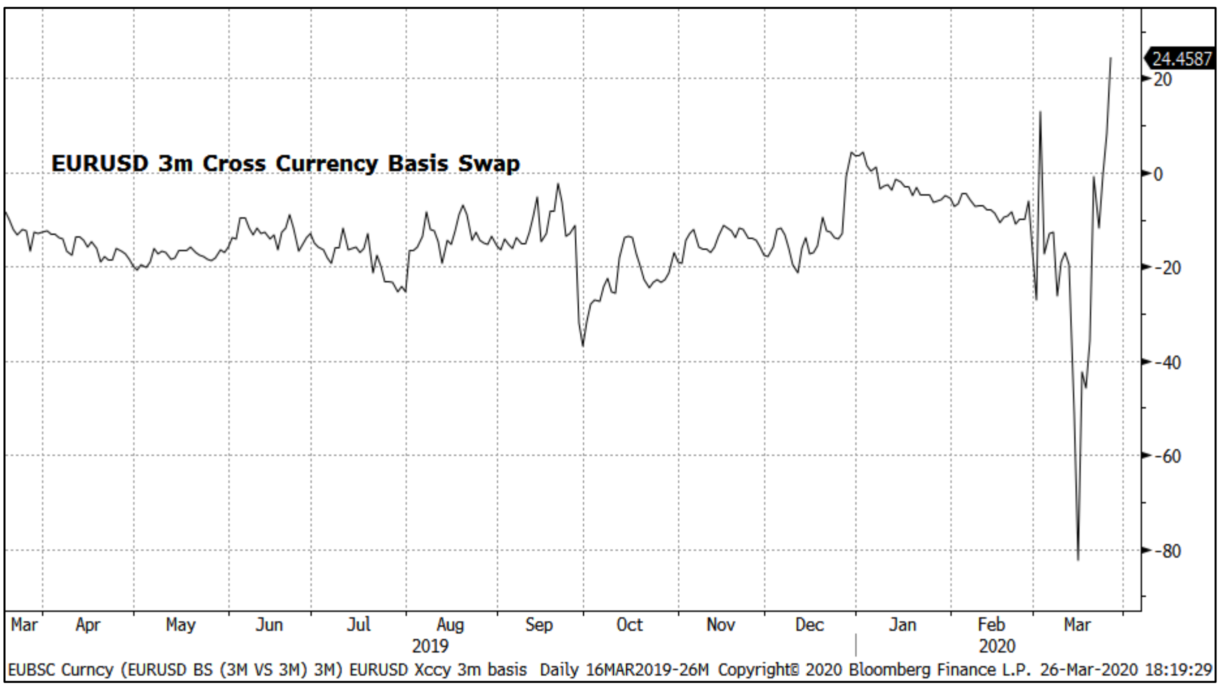
For me charts often provide insight into sentiment and positioning. They provide context for continuing trends and can help you to smell a turn early. A lot of that information flow is now out the window given these moves.

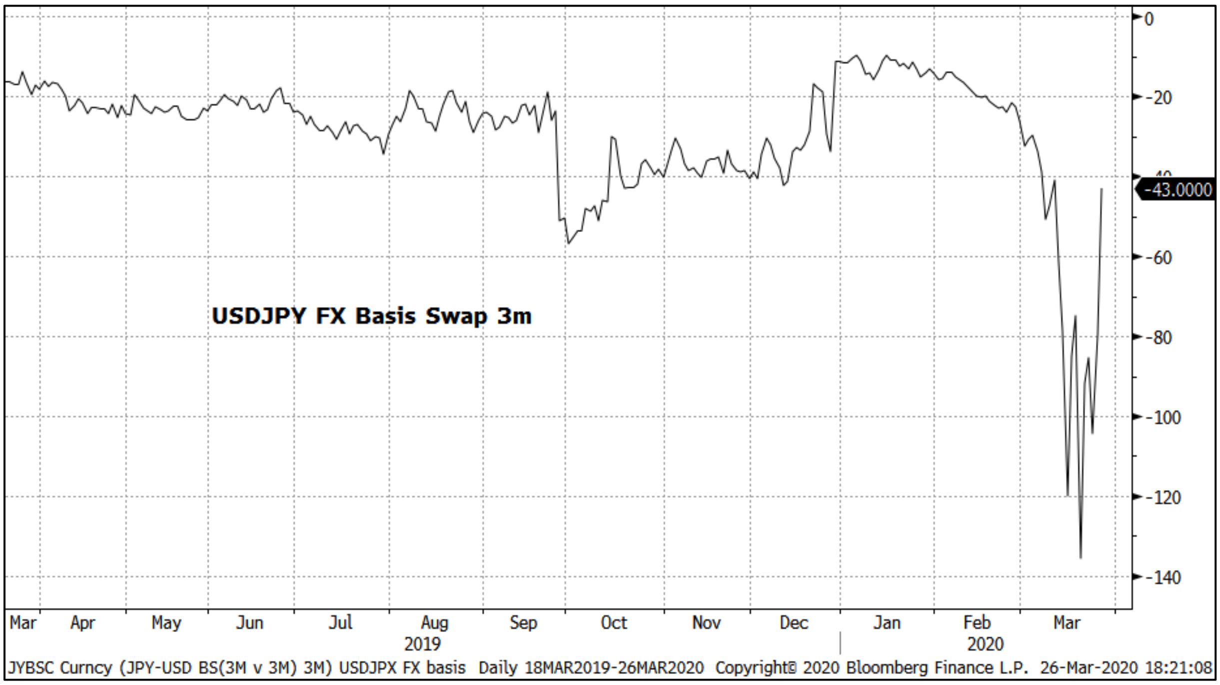
So, what can we watch?

USD

The brewing USD shortage has been at the top of my mid for a while now. It has clearly been for the Fed as well. The Repo mess that started in September of last year presaged the virus outbreak and was a tell for tight USD liquidity. Then the real liquidity storm hit, and it was game on for the dollar. For now, they have drowned the USD into submission with huge amounts of liquidity offered via o/n repo, term-repo and expanded international USD swap lines.

There were no bids for the $500Bln in term-repo offered on Friday. The additional $500 Bln in o/n repo only drew $6.75 Bln in interest. At the same time the currency basis in FX, that had blown out indicating USD funding stress, has returned to normal levels as the swap lines have been utilized.





The result has been a fast fall in the USD. The question remains will it last? Or, do we get a rolling bid for dollars, that just like in repo persistently reappears. The thing about repo and swap lines and all the collateral based programs is that in the end they are only loans. We will see how this develops, but the dollar remains an important part of the puzzle. Currency volatility should remain high in the coming months as politics plays an increasingly meaningful role in policy making. The potential for Yield Curve Control by the Fed and other CB's (either explicit or implicit) will only goose FX volatility as yield curve moves are suppressed and FX remains an open pressure-release valve.

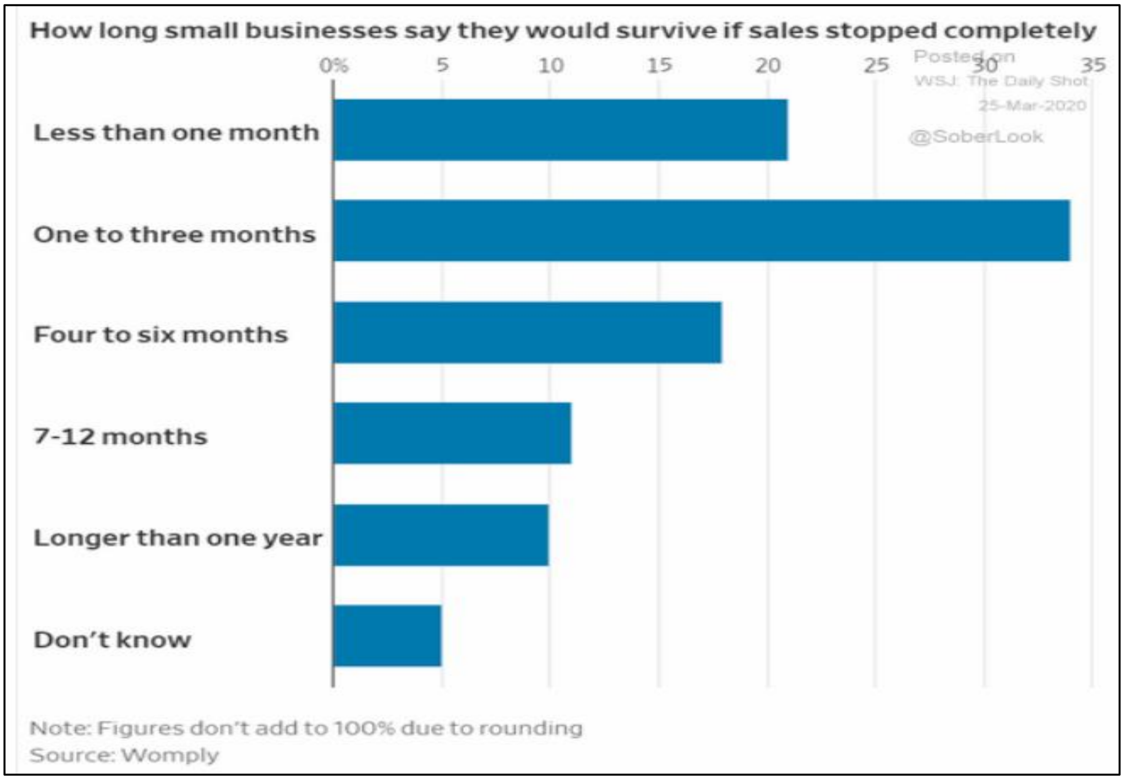
Small Businesses

According to the Small Business Administration (SBA) small businesses (employing less than 500 workers) account for 52% of all US jobs.

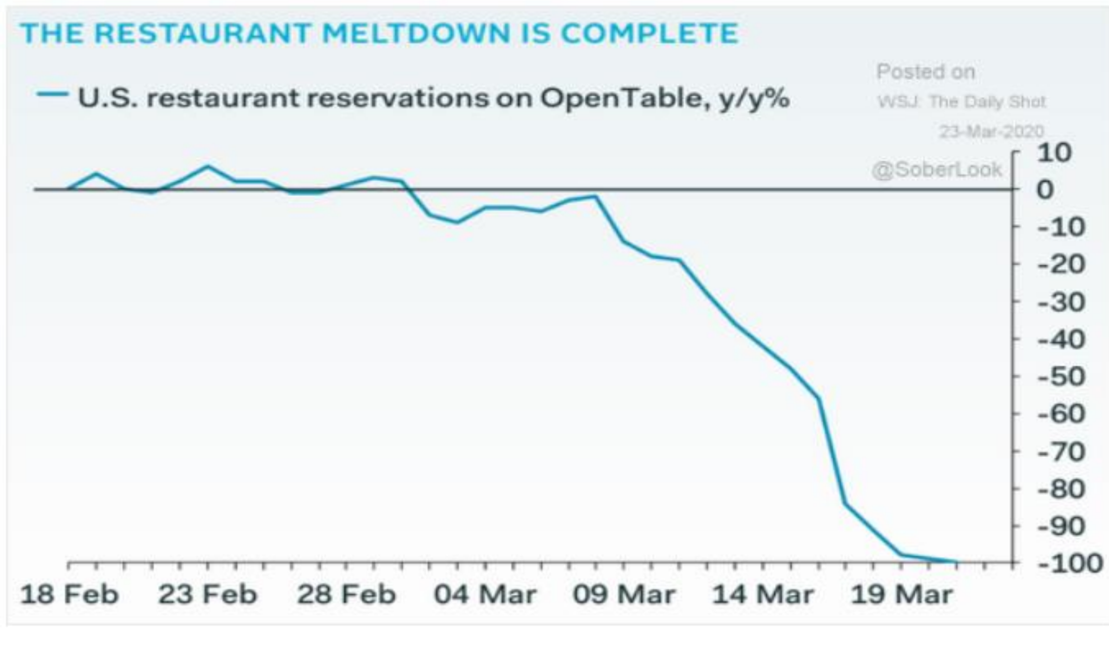
So, it is no wonder that the total and partial lockdowns we are seeing are having a big effect on the employment picture nationally. This is especially true as many of these are service businesses that are shut and don't offer the employees the ability to work remotely. (Please see the Initial Claims chart!)

The governments are offering small business loans and in some cases grants, but this is a cashflow story and how long this drags out is all important.

Weeks should be ok, buts months would be a real problem…

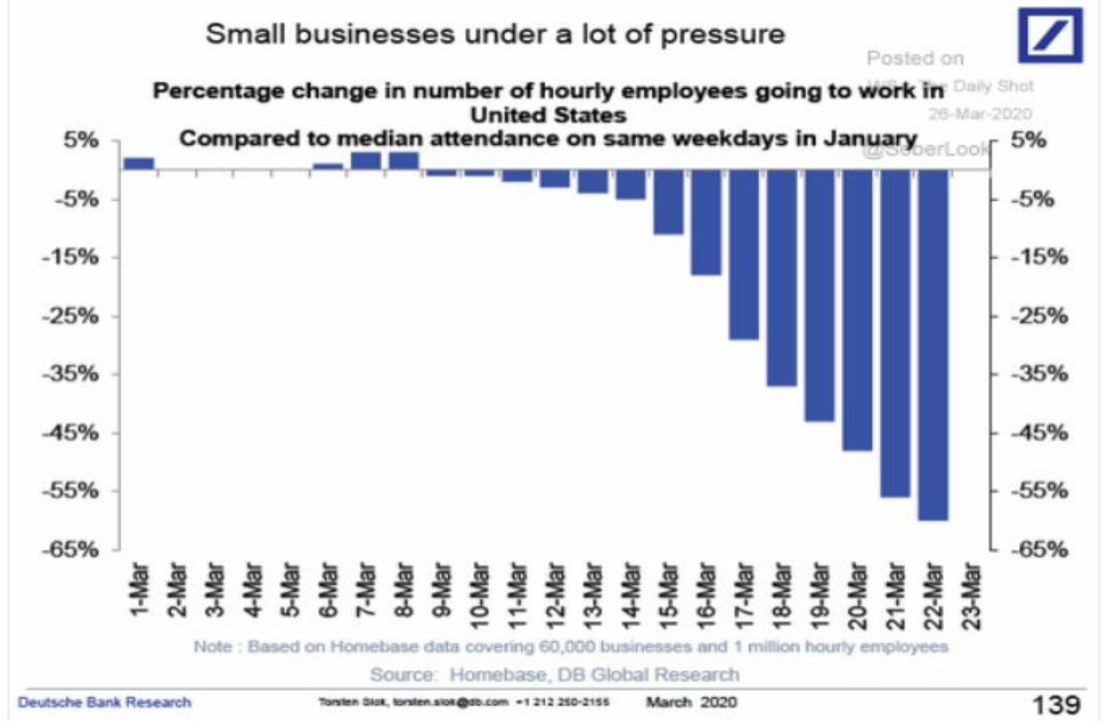


Restaurants are either closed or not being visited.

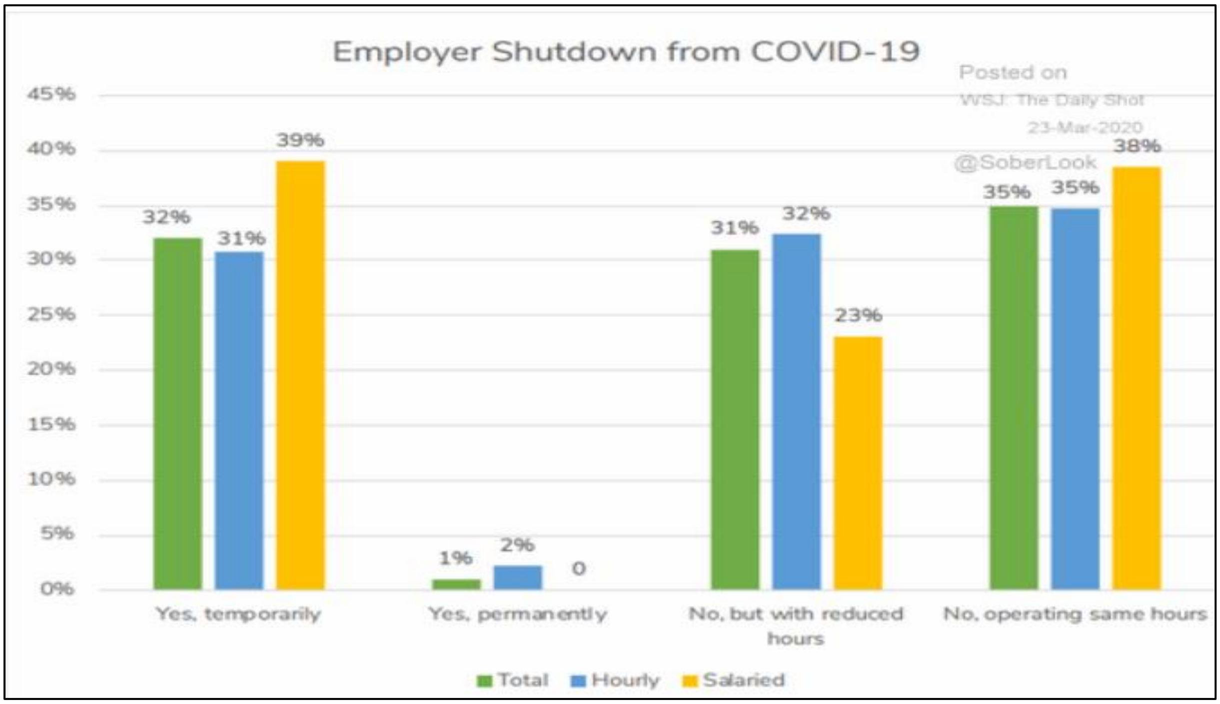


Source: Pantheon Macroeconomics

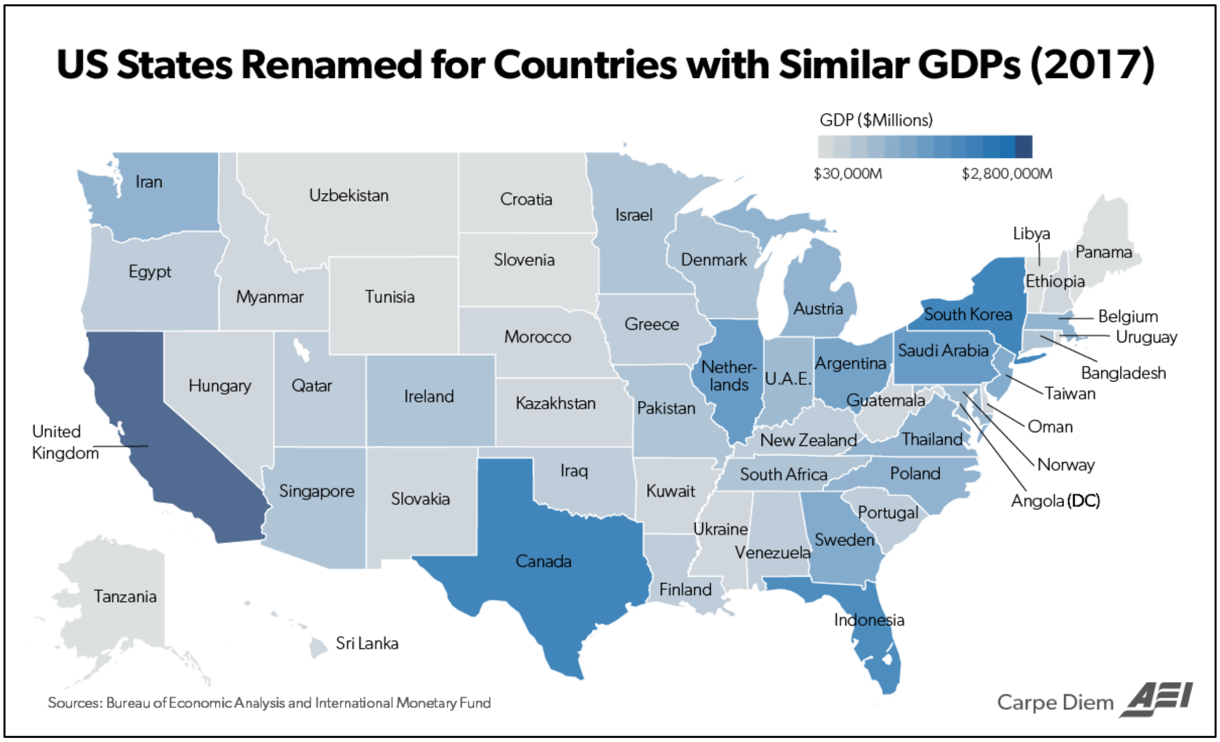
The last two weeks have been increasingly brutal.



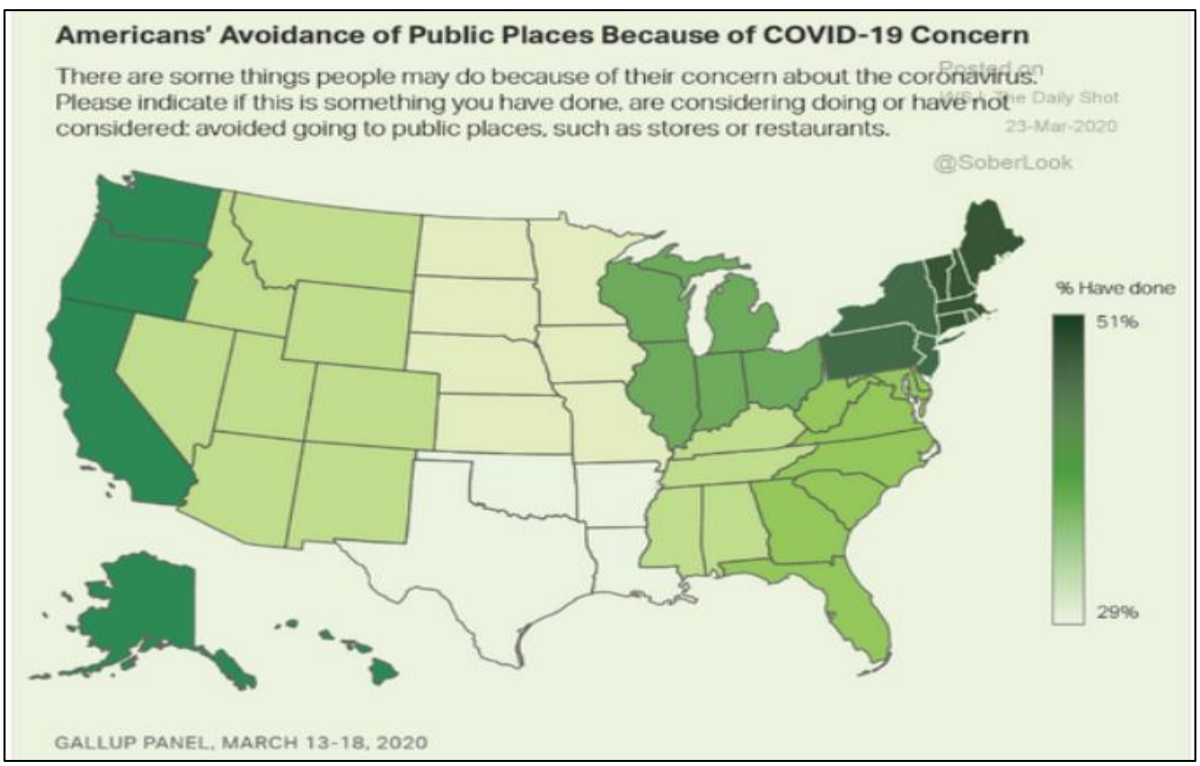
For now, reduced hours and closures are seen as temporary.



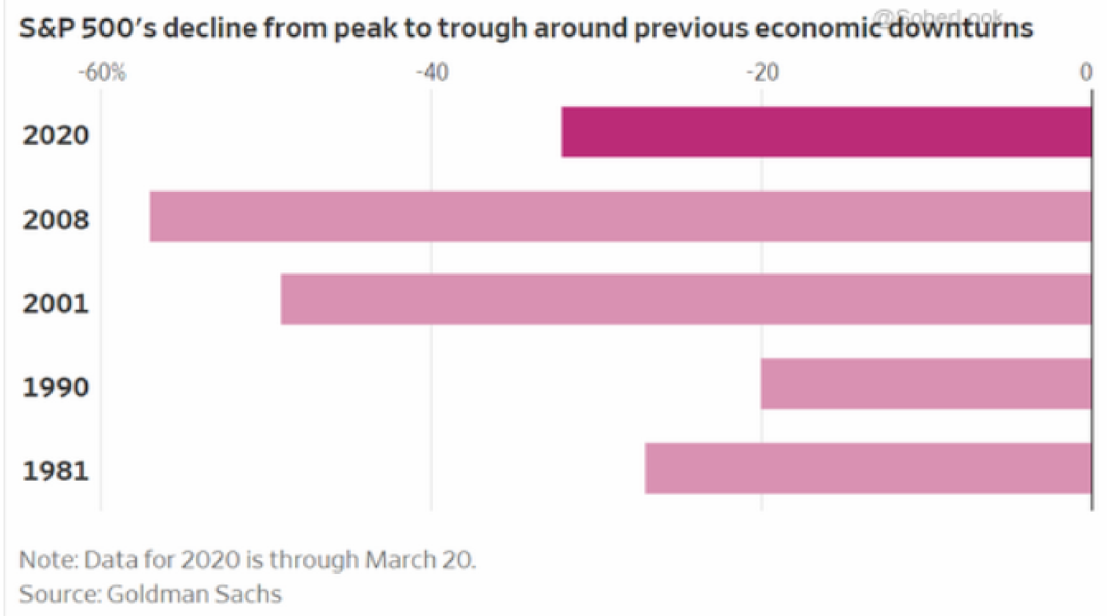
Globally this has been a rolling pandemic as one region, and one country after the other gets hit. The current NYC epicenter is likely to shift as the virus rolls across the country. What states and cities are affected will matter for US GDP. Some States could matter for global GDP.



Since there is no Federal lockdown at this point, each state is managing its own affairs.



There is great uncertainty about what all this means for Q2. Equities have been badly thrashed but not yet to the 2001 and 2008 extremes.



Source: @WSJ; Read full article

Estimates about how bad the employment picture could get are all over the place… ranging from 5.5% to nearly 13%.

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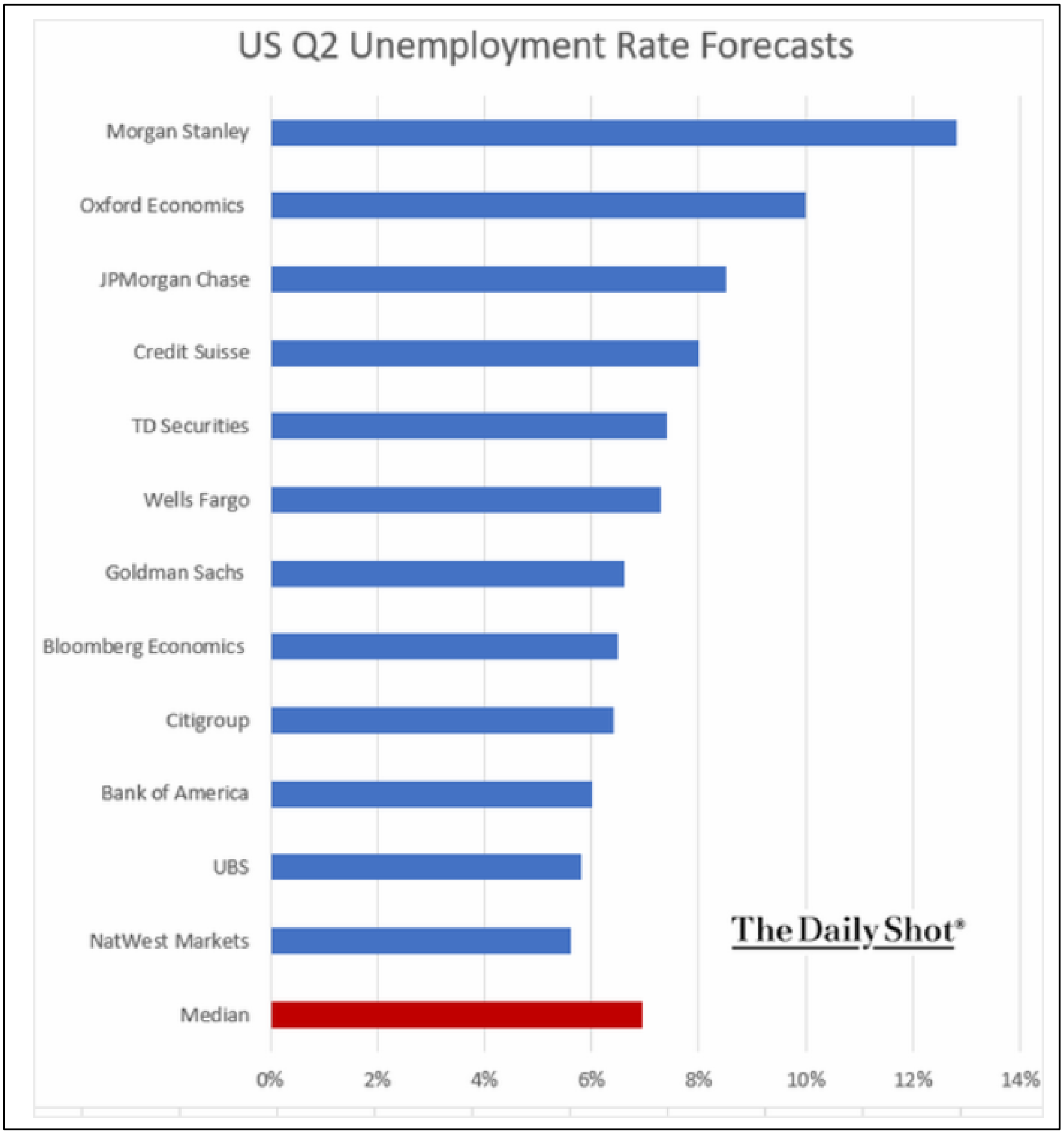

The Q2 GDP outlook is equally uncertain with estimates ranging between a -8% and -30%.

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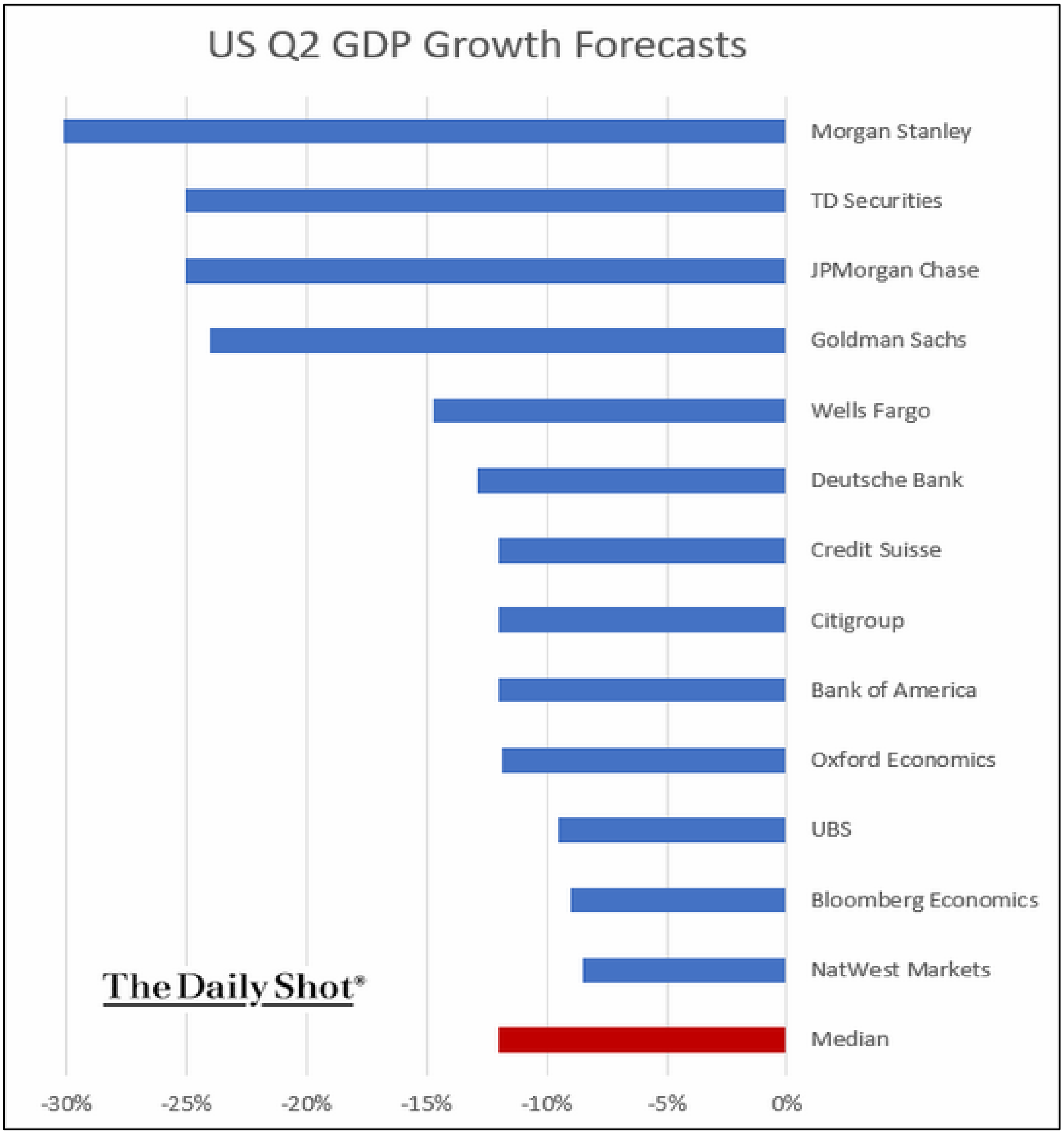
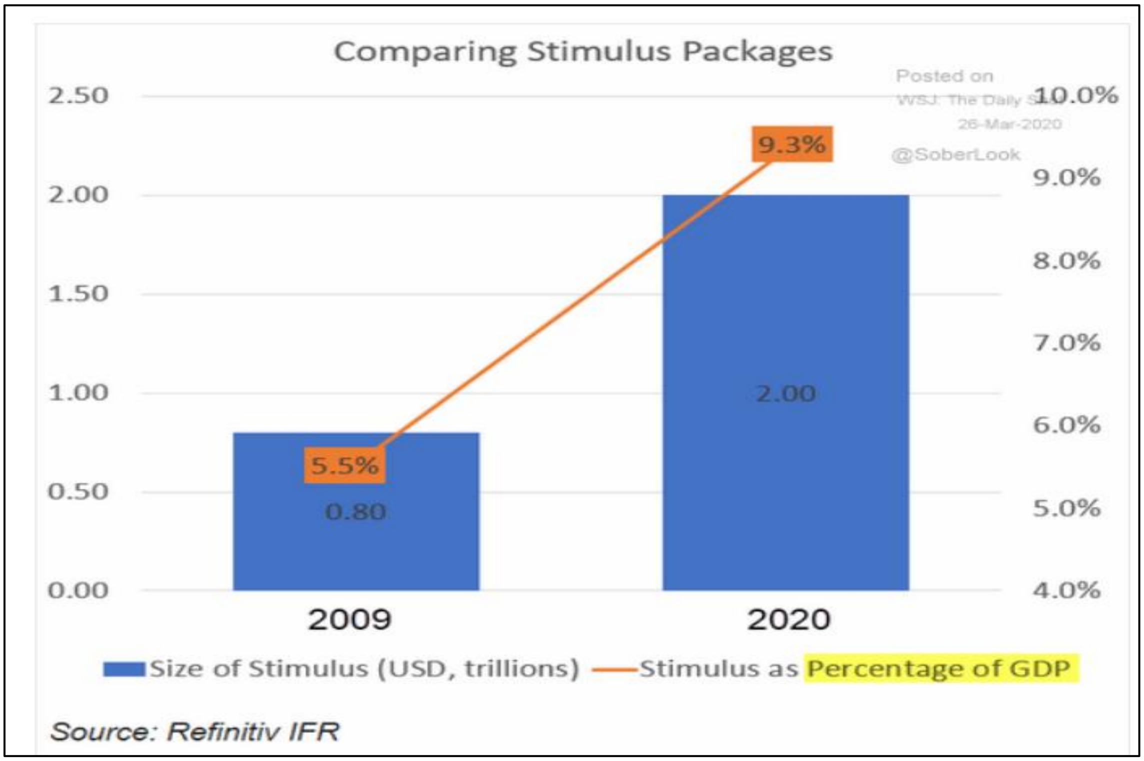


Although equity markets have not yet sunk as far as in 2008, the reaction from the Fed and from policy makers has been far greater … and much faster.

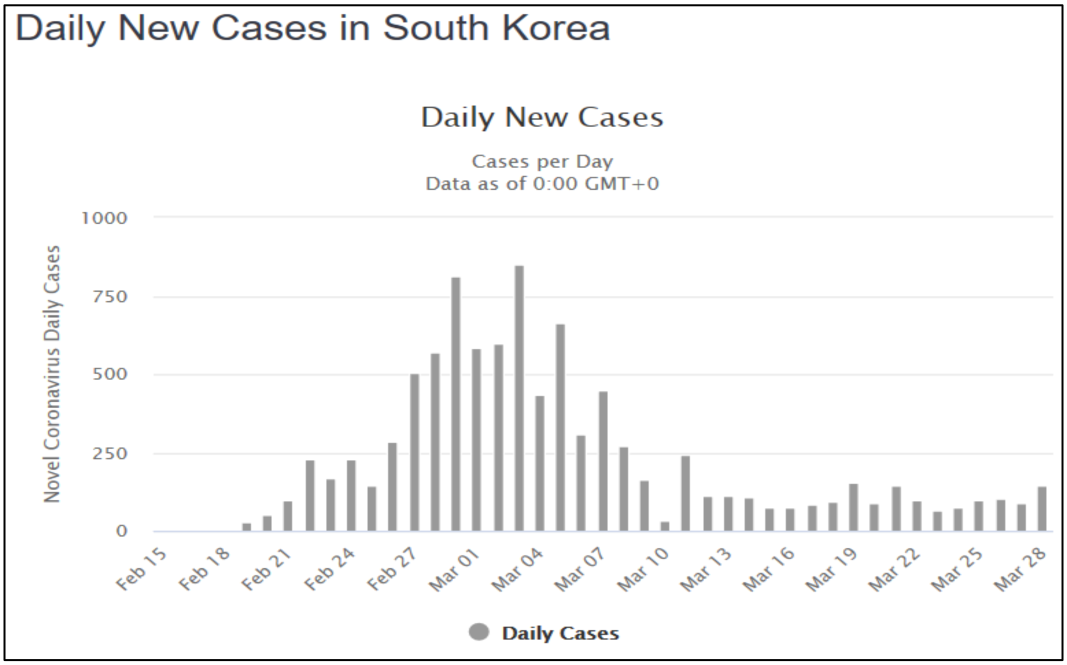
All that and we are only five weeks off the all-time highs in equities!



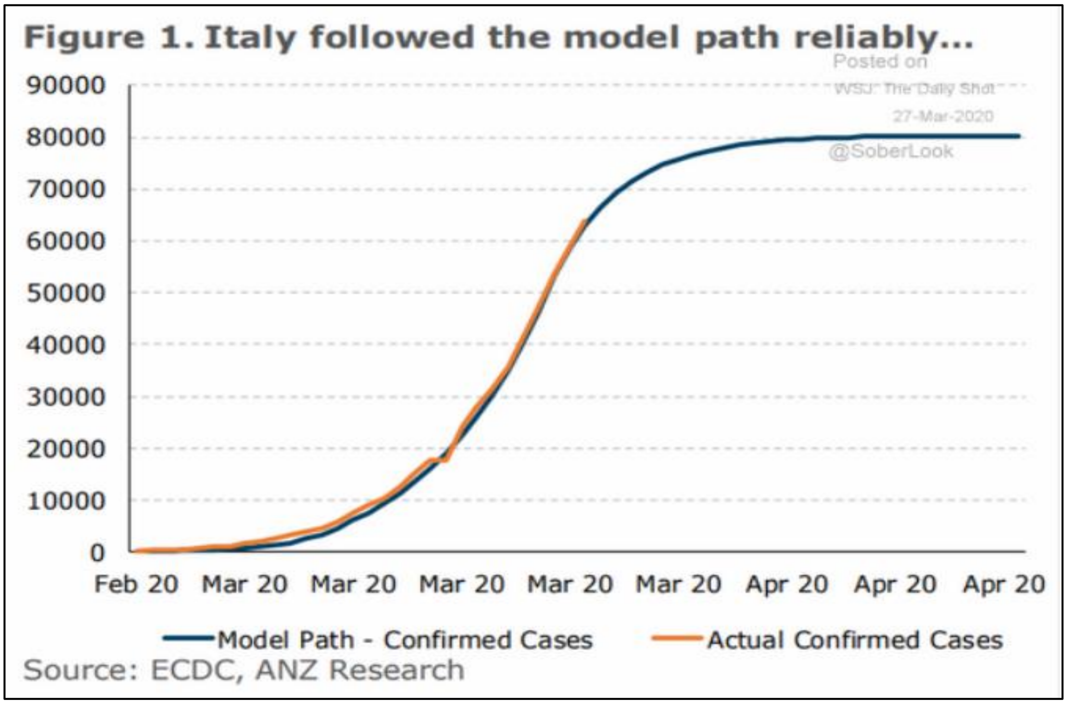
I'm watching daily new cases…

While this may be a flawed number due to availability of testing in different countries, it should still give us a sense of when the growth rate peaks.

In South Korea, where they went all out with testing it was fastest.



But, Italy seems to be following the model and is likely going to slow.



The number of daily cases is stabilizing … hopefully.

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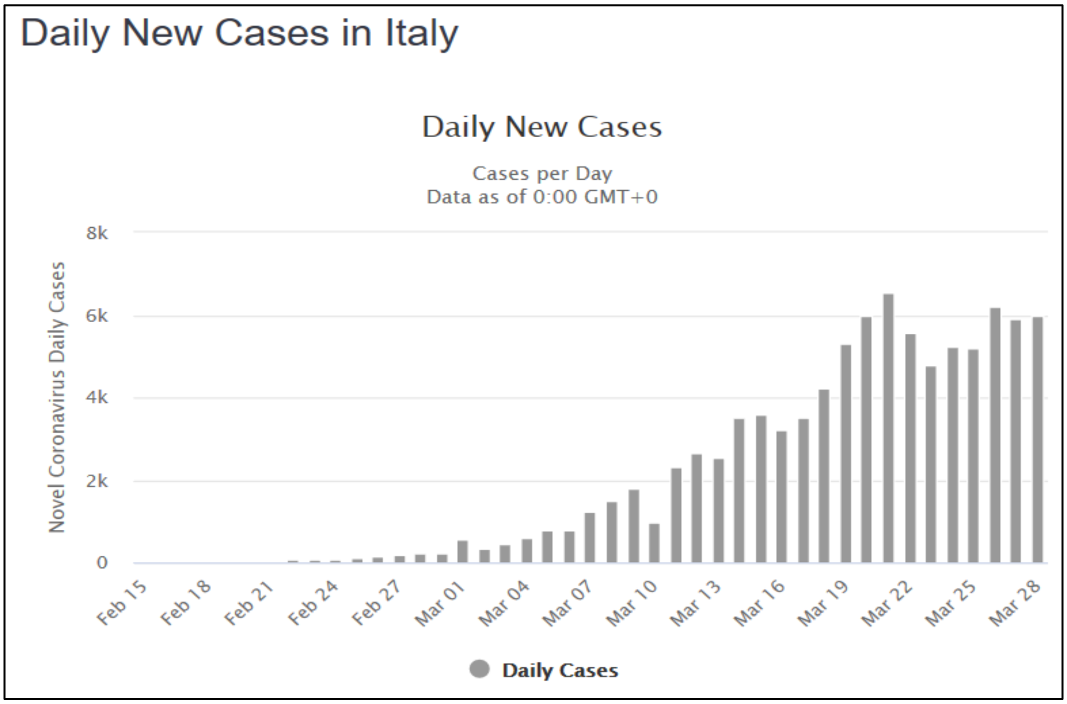
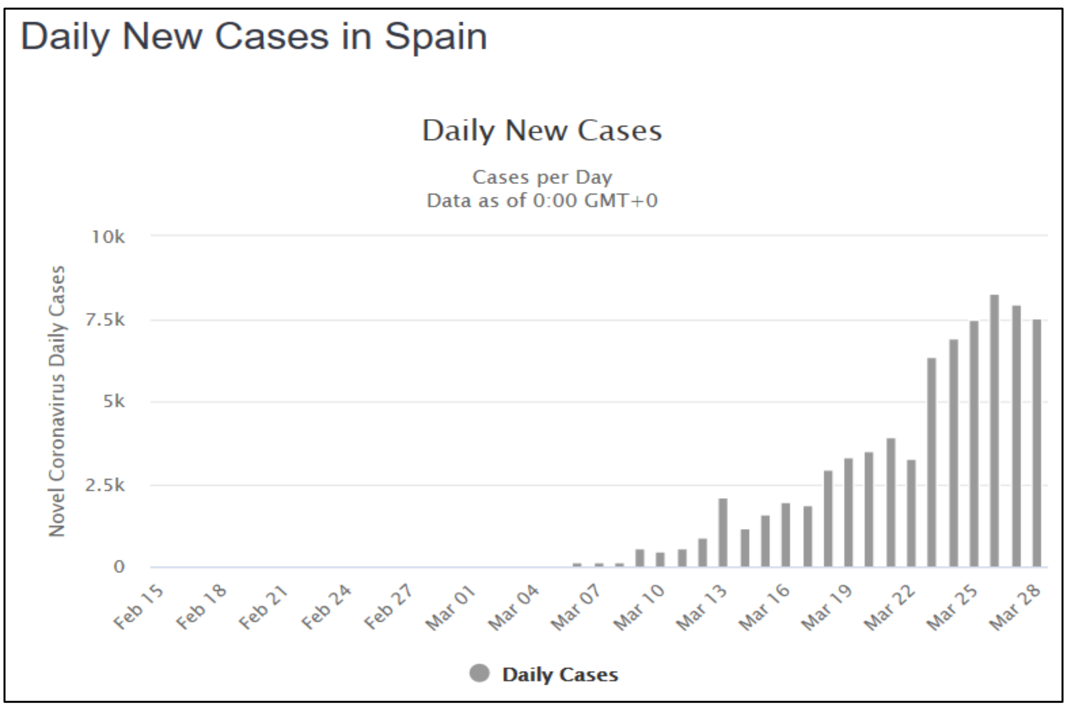
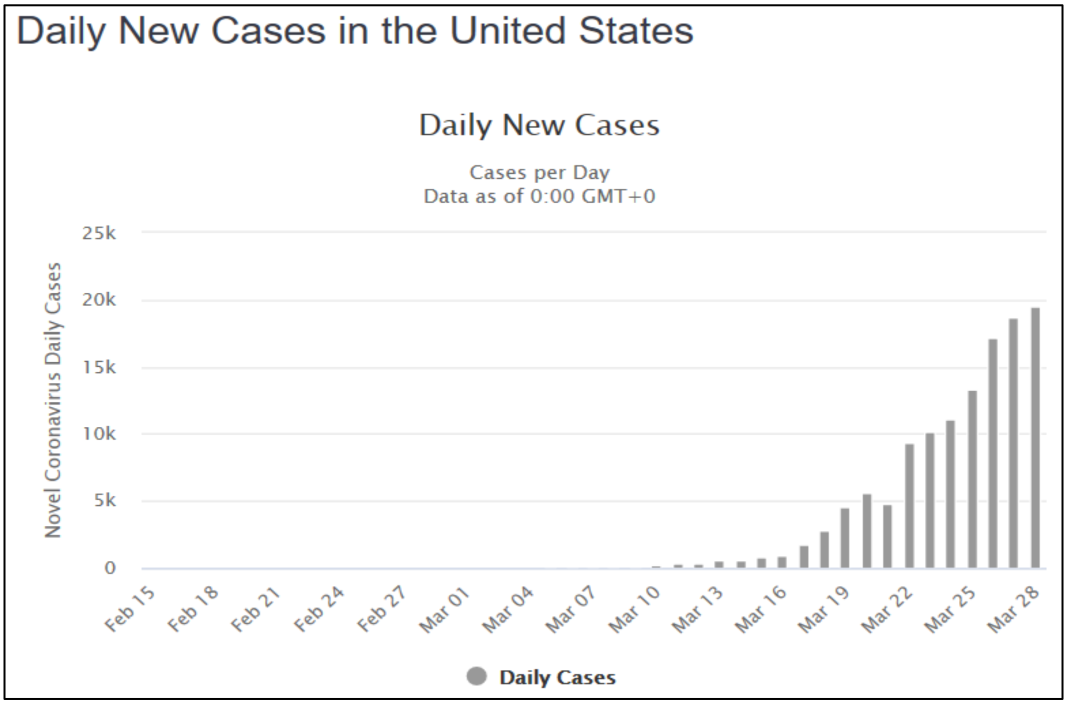


Spain is behind Italy.



And the US is still rising.



The problem, as we have seen in Asia, is that even when we peak, it doesn't go away. That is when it will get very tricky to get the mix right of reopening the enonomy to prevent permanent enonomic damage and keeping the virus under control.

We are trading the spread between current prices and the most probable outcome.

Both are moving targets. A fast and deep further selloff in equities in the near-term sets us up for a potentially better outcome than priced. A rally or range over the next week or two on the other hand widens the spread in favor of a potentially more painful outcome not yet being priced.

The trading tools of fundamentals, positioning/flow and technicals/charts are still effective, but correlations are broken across many markets and many of the longer-term charts have been rendered useless by massive price spikes. This is a market where as soon as an idea becomes consensus it is in danger of getting unwound.

Bigger picture I think lots of the assumptions of the last ten years will have to change. As the power of Central Banks fades and is replaced by Finance Ministers the drivers for markets will change.

I agree with Hartnett at BoA/ML. The 2020's will be very different from the 2010's

Chart 1: 2010s vs 2020s

2010s	2020s
Deflation	Stagflation
Wealth	Health
Humans	Robots
Boomers	Millenials
1%	99%
Wall Street	Main Street
QE	MMT
Capitalists	Workers
Bailouts	Helicopters
Low tax es	High tax es
Lev erage	Sav ings
Buy backs	Capex
Globalization	Isolationism
Chinese grow th	Chinese liquidity
Priv ate Equity	Hedge Funds
US dollar	Gold
Grow th	Value
Large cap	Small cap

Source: BofA Global Investment Strategy

Important Macro Data Releases and Events for the Week

Monday
3/30/2020

- Business Climate (Mar) Forecast: - , Prior: -0.4
- Pending Home Sales MoM (Feb) Forecast: - , Prior: 5.2%
- Dallas Fed Manufacturing Business Index (Mar) Forcast: - , Prior: 1.2

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Tuesday 3/31/2020		**Non-Manufacturing PMI (Mar) Forecast: 37.8, Prior: 29.6**
		NBS Manufacturing PMI (Mar) Forecast: 45, Prior: 35.7
		Unemployment Rate s.a. (Mar) Forecast: 5.1%, Prior: 5%
		Unemployment Change (Mar) Forecast: 28k, Prior: -10k
		Consumer Price Index - Core YoY (Mar) PREL Forecast: 1.1%, Prior: 1.2%
		Consumer Price Index YoY (Mar) PREL Forecast: 0.8%, Prior: 1.2%
		Chicago Purshasing Managers Index (Mar) Forecast: 40, Prior: 49
		Consumer Confidence
		Tankan Report on Manufacturing
Wednesday 4/01/2020		Caixin Manufacturing PMI (Mar) Forecast: 45.8, Prior: 40.3
		Retail Sales MoM (Feb) Forecast: - , Prior: 0.9%
		Markit Manufacturing PMI (Mar) Forecast: - , Prior: 45.7
		ADP Employment Change (Mar) Forecast: -150k, Prior: 183k
		ISM Manufacturing Employment Index (Mar) Forecast: - , Prior:46.9
		ISM Manufacturing PMI (Mar) Forecast: 44, Prior: 50.1
Thursday 4/02/2020		Initial Jobless Claims Forecast: - , Prior: 3m
		Initial Jobless Claims 4-week ave. Forecast: - , Prior: 998.25k
		Continuing Claims Forecast: - , Prior: 1.803m

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Friday
4/03/2020

Caixin Service PMI (Mar) Forecast: - , Prior: 26.5

Nonfarm Payrolls (Mar) Forecast: -300k???, Prior: 273k

Unemployment Rate (Mar) Forecast: 4%???, Prior: 3.5%

ISM Non-Manufacturing PMI (Mar) Forecast: - , Prior: 57.3