What to focus on in Global Macro for the week of May 25th, 2020

Macro Themes on the Radar:

Europe

Last week's Merkel/Macron proposal for an EU Recovery Fund has made quite a splash. Some are heralding it as a Hamiltonian moment for Europe and the first real step towards a United States of Europe; others think it will amount to another failed attempt at a transfer union and debt mutualization.

The markets seem split between…

- EU-27 will back the proposal in the end (could be a big deal)
- There is insufficient support (back to square one)
- Some watered-down version will end up passing (doesn't solve any problems)

By giving in to French pressure, Merkel has done a meaningful 180-degree turn. Only a bit over a month ago she had told the European Council that she could not agree to grants; now the joint proposal consists of €500bln in potential grants.

Was it the German Constitutional court decision and a fear that Germany would be labeled THE threat to the eurozone's survival? Or, the desire to avoid the pressure to do real debt mutualization via Coronabonds?

Why could it still be a big deal? Or at least a meaningful shift in attitude?

While the EU has borrowed before in its own name and does make transfer payments between members via the budget, this is way bigger is size and scope. The entire EU yearly budget is €170bln after all.

Germany's support for grants vs. insistence on loans, makes for a clear break from past policy and from the other northern countries. Austria, the Netherlands, Sweden and Denmark have stated that they continue to prefer loans to grants. With Sweden and Denmark as members of the EU but not the eurozone, they may be particularly difficult to convince otherwise. Since inception, the EUR has been on shaky ground as it is a currency without a fiscal union between members. The needed approval by countries in and outside the eurozone makes this proposal especially tricky to pass, as any one of the 27 EU members can veto it.

There are still many details lacking in terms of exactly how the bonds would be repaid (probably via budgetary contributions) and with regard to what kind of conditions and reforms might be demanded of the recipient countries in return for the grants.

The funds are supposed to go to those countries most effected by the COVID-19 outbreak. The assumption is that a large chunk would go to Italy and Spain. Will it be enough? Unfortunately, even if all goes well, the funds wouldn't be available until the new year.

The big question remains, does the "Merkron" announcement lay the foundation for a real evolution of Europe and is the issuance of common bonds and the transfer of grant payments the first step towards a true fiscal union? If they can actually get the entire EU-27 on board, without watering it down to the point of insignificance, markets could move on this. It is too early to say, but this needs to be watched carefully. Another announcement and further details of the proposal are set to be released on Wednesday, May 27th.

The ECB has been doing much of the heavy lifting over the last few years and especially during this pandemic. Lagarde has called for more fiscal support and has indicated she welcomes this proposal. The ECB has put the fiscal cost of the pandemic at €1.5trl, while Bloomberg Economics thinks it could be as high as €2.5trl. Even with this potential proposal, most of the fiscal hole will need to be filled on the national level.

Europe has continually preferred to kick the can down the road when given the chance. Only when a crisis becomes critical will they go all in. The jury is out as to whether this is the start of a new era of European fiscal union, or another attempt to do just enough to get past the current crisis. The history of the EU and the eurozone would tend to support the later but maybe there is more to it this time given the German and French backing.

My view is that a final decision on how and if a true fiscal union will ever happen in Europe, will be saved for a time when the EUR is closer to .8000 than 1.09.

Two side notes on Europe:

- On Friday Soros proposed that Europe should seek to issue perpetual bonds as a possible solution. It seems like a crazy solution but is an interesting read. If you are interested in the history of perpetual bonds here is an interesting Bloomberg article.
- Coronavirus has accelerated some trends and ideas. Universal Basic Income or Minimum Income has been a hot topic in some circles over the last year. Spain looks like they may actually give it a shot. Spain's guaranteed minimum income scheme will come with a €55bln price tag.

China

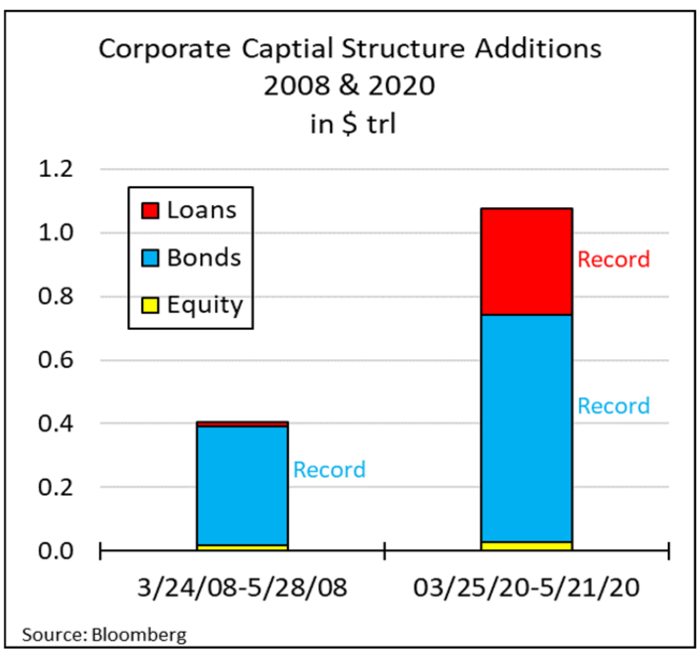
So far markets have tolerated the growing tensions between the US and China. However, the list of potential triggers for China related market volatility seems to be growing daily.

- Quickly deteriorating US /China relations
- Trump tweets that China "desperately" wants Biden, with all its implications
- Potential delisting of Chinese stocks from US exchanges
- HK national security laws and potential US reaction
- New US sanctions for 33 Chinese companies and institutions
- Escalating tensions between China and India in the Himalayas
- Tensions with Australia
- Tensions with Europe

Usually these issues find their way into asset prices via trade worries. With trade already so hobbled and liquidity at full throttle, it is hard to know how bad relations need to get before it matters.

Liquidity vs. Solvency

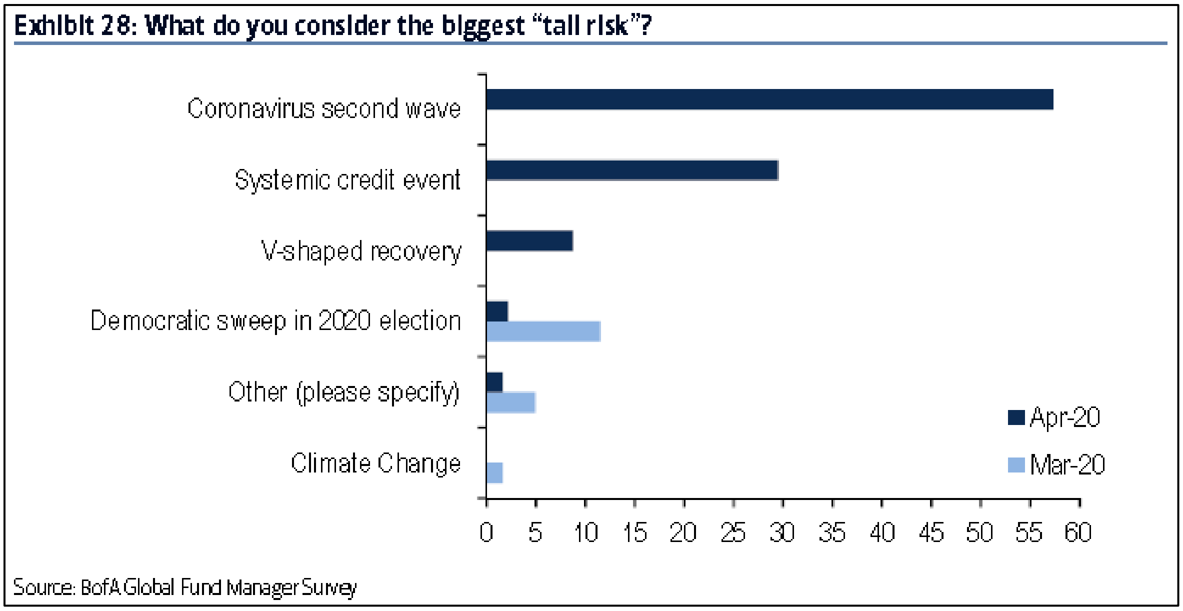
With a string of bankruptcy announcements from the companies hardest hit by the lockdowns, there is growing talk that liquidity is great, but solvency is what really matters now.



Certainly, one of the biggest enduring consequences of COVID-19 is likely to be the much higher levels of debt that it leaves behind. While this is true for consumers, it is especially true for governments and small / large companies. At the same time, cash flow is reduced and there is a great deal of uncertainty around when it will fully recover.

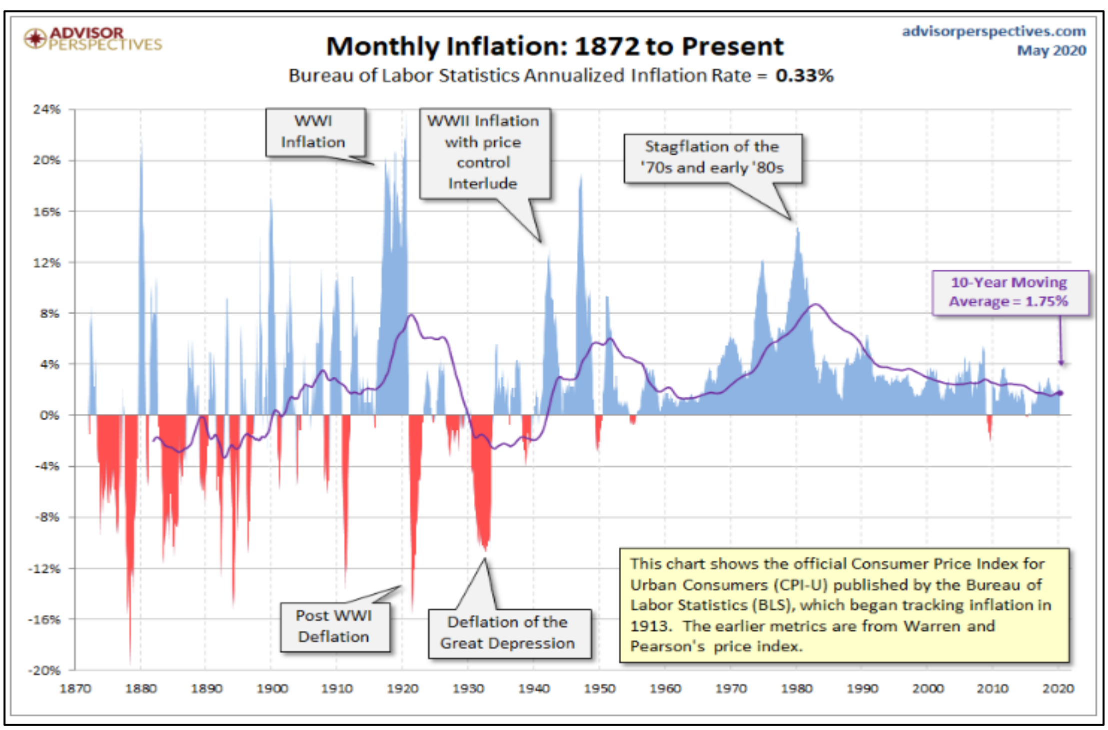
As the bond market has reopened following the Fed's announcement of IG and HY bond buying, companies have not only been drawing on credit lines but issuing bonds.

The two biggest tail risk fears that investors see are both closely tied to these solvency fears. So far liquidity has been enough to keep markets happy but expect this to be a hot topic as economies re-open and we see which companies have made it through to the other side.



Inflation vs. Deflation

This debate is raging as the huge hit to the economy and the unprecedented monetary and fiscal responses are obvious to everyone. Given leads and lags and the inability of stimulus to reach everyone, which way will we break? Is it time for some volatility?



The inflationist argue that there is no way all this printing and spending can't result in a pop in inflation, maybe even a large one. The monetarists will state that "inflation is always and everywhere a monetary phenomenon”. Additionally, with the velocity of money already falling for twenty years and now very low, a further fall is unlikely to overcome the explosion in M2 growth we are now seeing.

The deflationists argue that the massive hit to the economy must result in a global debt crisis as cash flows can’t support ever growing debt and lower growth. The result is a deflationary bust. At a minimum, a deflationary impulse in the near-term.

In some ways this is really just the liquidity vs. solvency argument all over again. And it is on a global scale.

While the implications of making the right call are obviously massive, there are so many “never happened before” elements to this current set-up that it is hard to have a prepackaged view.

Instead, I think it best to watch the markets that are still open for price discovery. Unfortunately, the value of the bond markets has been greatly degraded in this respect. This is true for both government and corporate bonds.

We are left with commodities, global equity markets and foreign exchange to light the way.

Overall the USD remains strong. However, there has been a lot of dispersion across currency pairs. EM has generally done poorly vs. the USD, while some high beta developed market currencies have seen more of a bounce. As the global reserve currency and the measure of global liquidity, this matters. The global USD debt outstanding is now north of $100trl. For now, the USD is still the currency to rule them all. A further rise or a turn will have many implications.

A rising USD is generally deflationary for the world. Holding down prices and growth. A falling dollar will have the opposite effect.

The dollar will be strong when US assets are favored but will tend to be soft when other countries and regions are outperforming.

The S&P tends to outperform EM when the dollar is strong. If anything, that relationship has become tighter over the last couple of years.

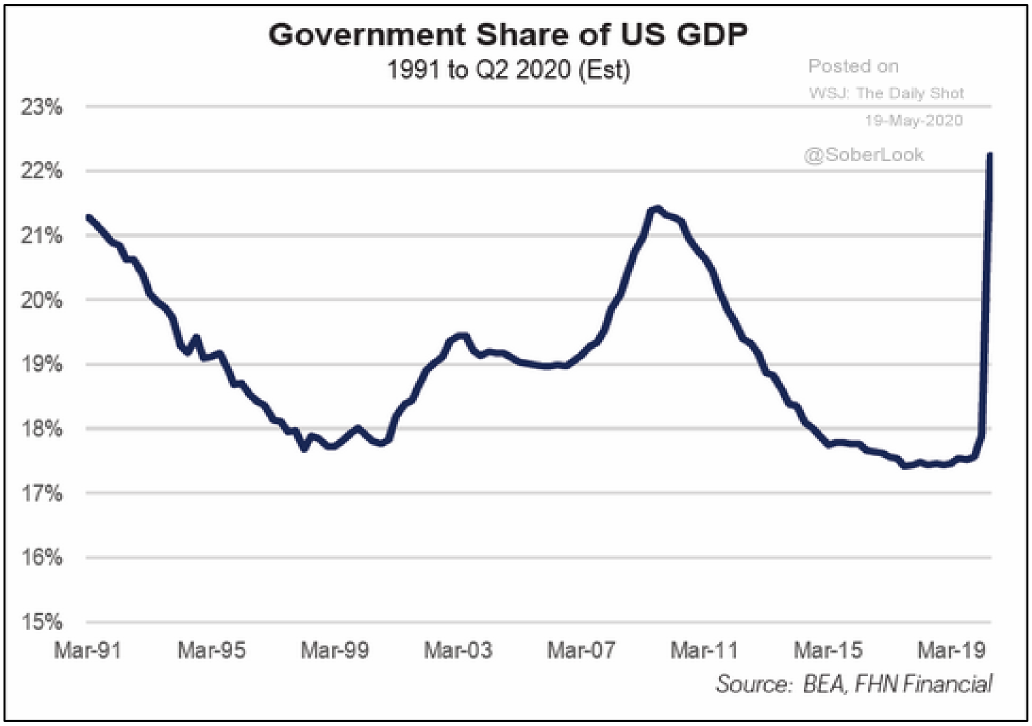
So far, the deflationary backdrop still seems to be driving the price action.

There are a lot of layers to what amounts to one big bet by the markets. Markets have been pricing assets in favor of growth vs. value, globally. The US vs. the rest of the world. The NASDAQ vs. the rest of the US. That is a strong dollar / deflationary world view.

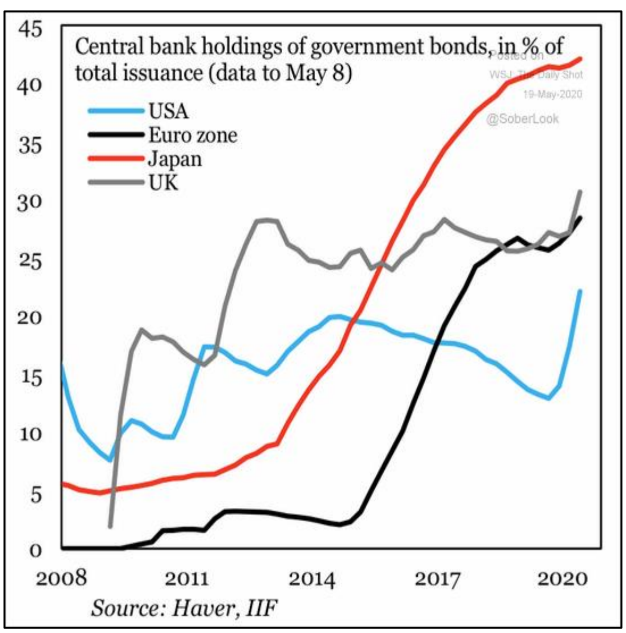
This has basically been the price action since early 2018, and in the bigger picture since 2011/12, which coincides with the European debt crisis.

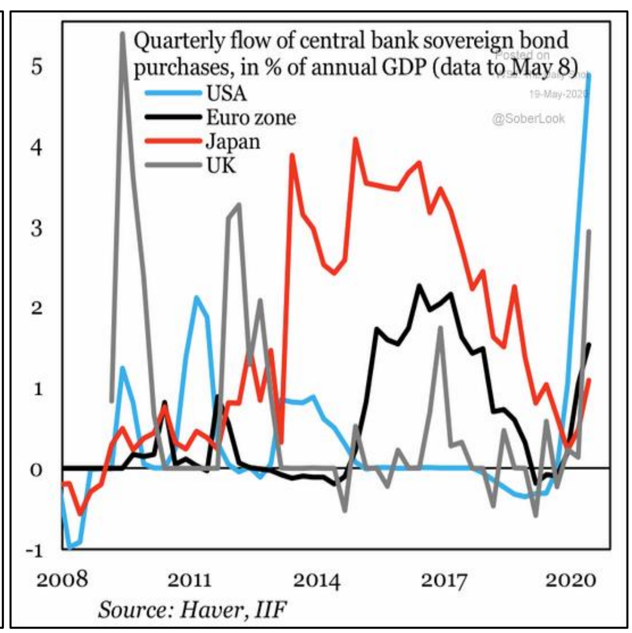
The big question is, does COVID-19 and its legacy change that dynamic or accelerate/reinforce it?

Do things like this matter?



Or that the Fed is now back with a vengeance as they load up the balance sheet again?





Relative equity performance by sectors, countries and regions as well as FX will help give you an early indication if we start moving to a more reflationary, higher nominal growth world.

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

For all the hand wringing and angst, markets have been very quiet for the last 6+ weeks.

With the Fed buying nearly as much as is being issued, 10's and bonds have been stuck despite the equity market rally.

The dollar has been back and forth as well (Dollar Index).

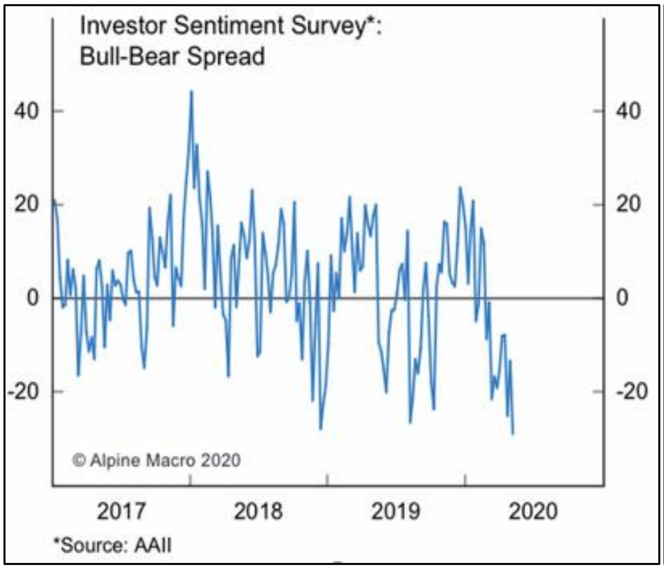
Contact: efill@stargazerfunds.com / SMS, WhatsApp and Voice at +1.203.219.3649

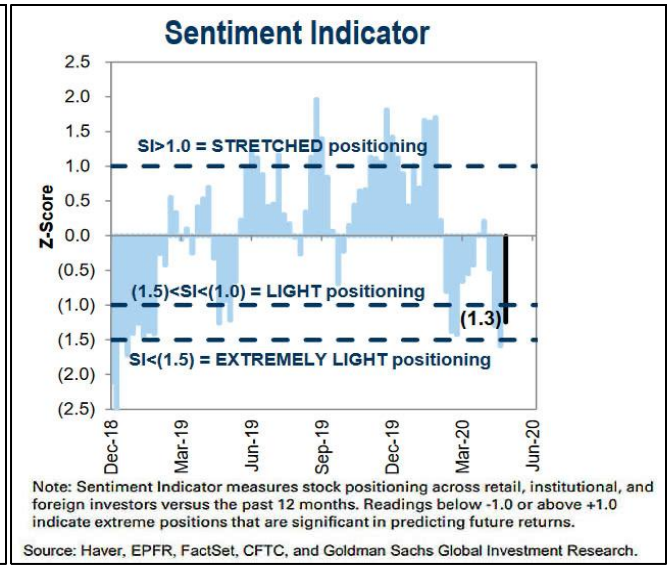
Gold has been in a slow grind higher.

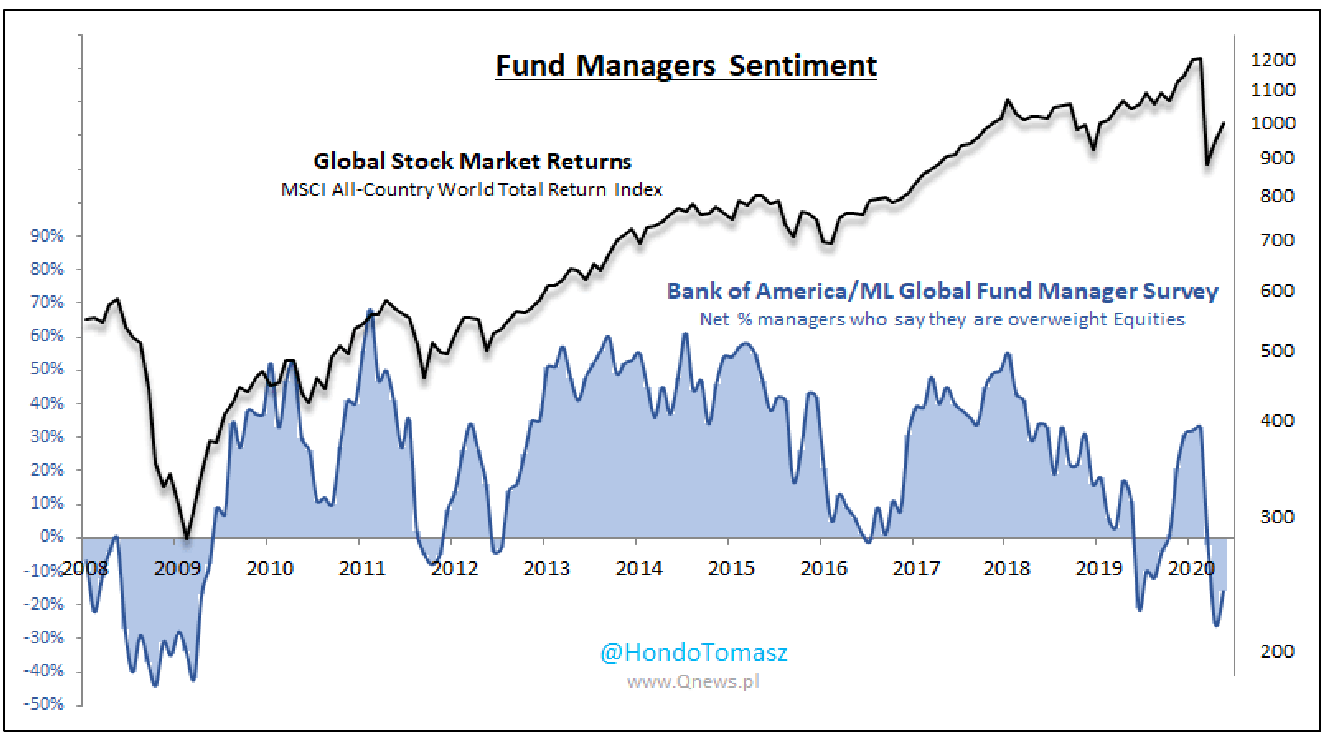
As have S&P's … but really more at the top of the range than a breakout at this point.

Although equities have certainly rallied, it has been very uneven, and US big tech is still the unchallenged leader. The further you get from FAANGM the less impressive the rally has been.

Despite the rally, sentiment remains bearish no matter how you slice it… Maybe it is simply the lack of signposts I mentioned before…







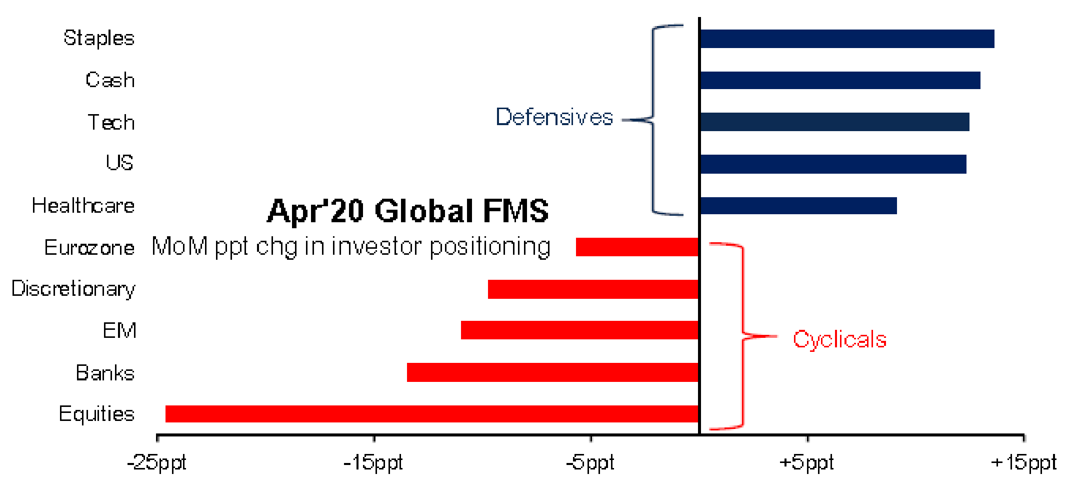
Some interesting stats from BoA/ML:

- ***Context****: 2215 out of 3042 global stocks remain in bear markets (20% below their all-time highs); $15tn stock rally must be placed in the context of $30tn collapse in Feb-Mar.*
- ***History****: bear market rallies in 1929, 1938, 1974 saw avg 61% rebound from lows (after avg 49% drop) …would take SPX to 3180 this rally.*

- ***Positioning**: BofA May Global Fund Manager Survey…just 1/10 expect a V-shaped recovery vs. 8/10 expecting U or W-shaped recovery & 7/10 saying it's a bear market.*
- ***Policy**: past 8 weeks central banks have been buying $2.4bn per hour of financial assets (this will fade to $608mn in coming weeks).*

Last week saw continued defensive flows…

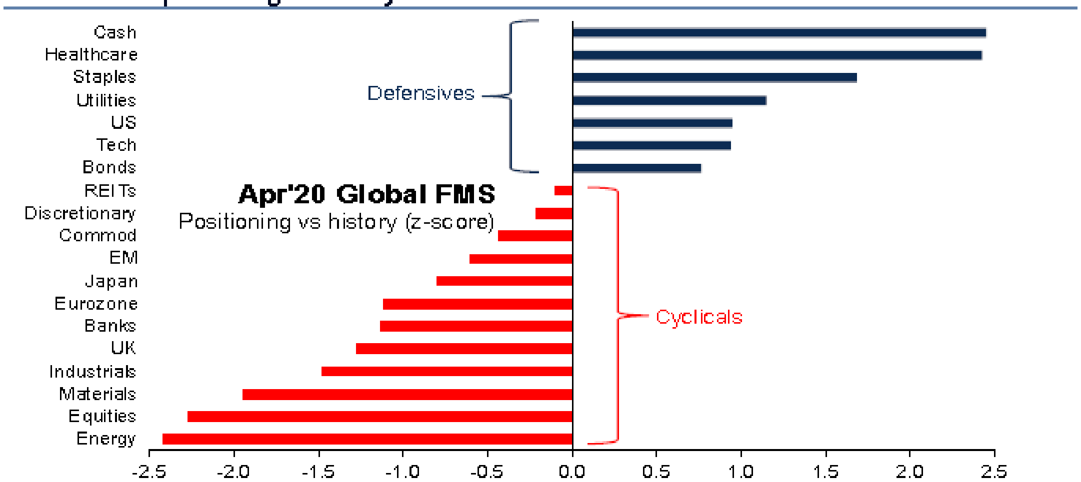
Exhibit 8: FMS investors OW defensives and capitulate out of cyclicals



Source: BofA Global Fund Manager Survey

Adding to already very defensive positioning by fund managers.

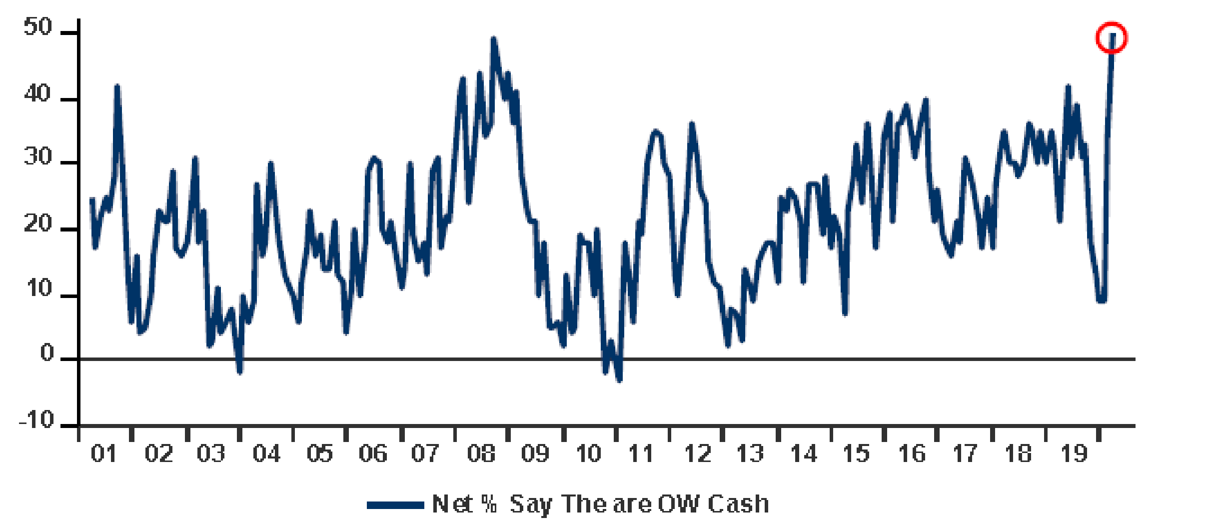
Exhibit 9: FMS positioning vs. history



Source: BofA Global Fund Manager Survey

Investors have a lot of cash they are sitting on.

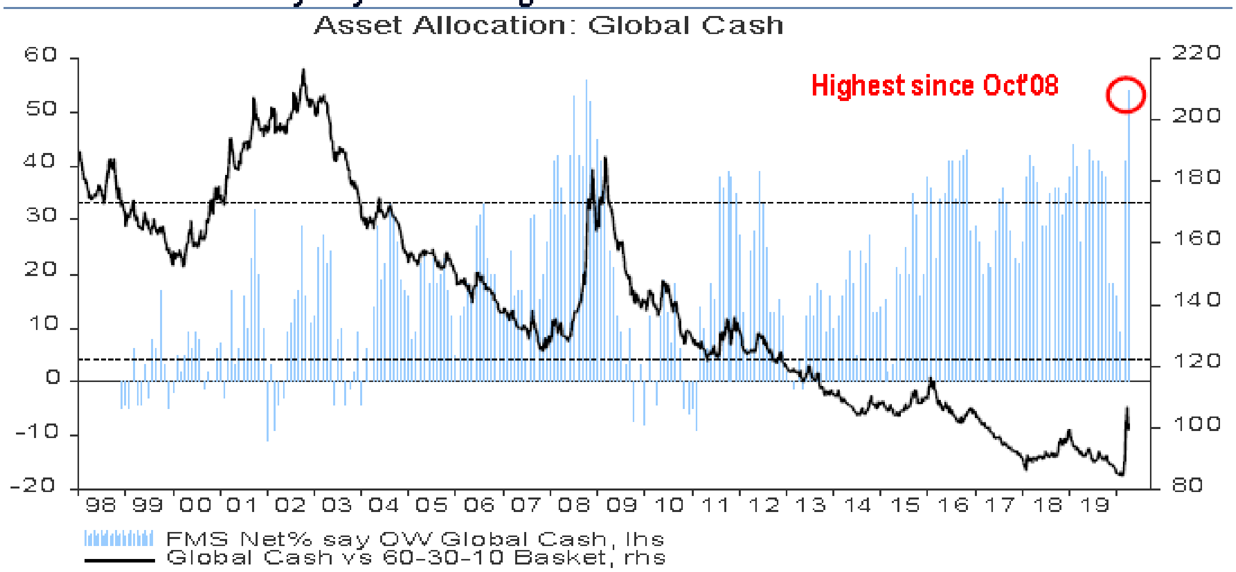
Exhibit 11: FMS Investors overweight cash like never before



Source: BofA Global Fund Manager Survey, Bloomberg

So far, no sign of changing their minds…

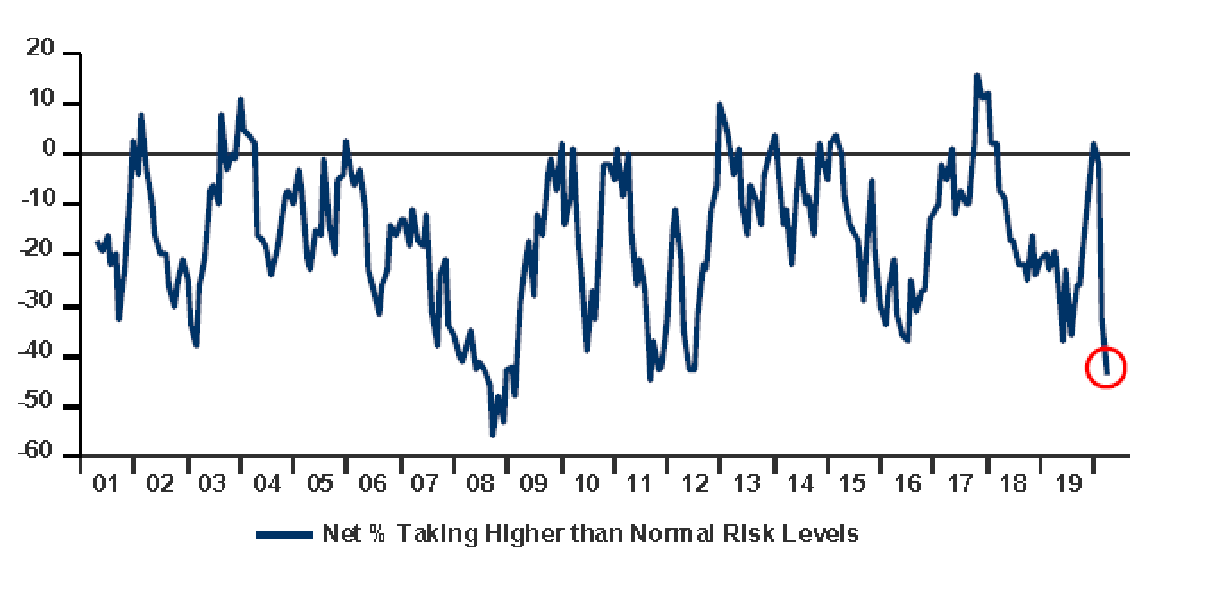
Exhibit 36: Net % AA Say they are overweight Cash



Source: BofA Global Fund Manager Survey

And as you would expect given the above, have very little tolerance for risk.

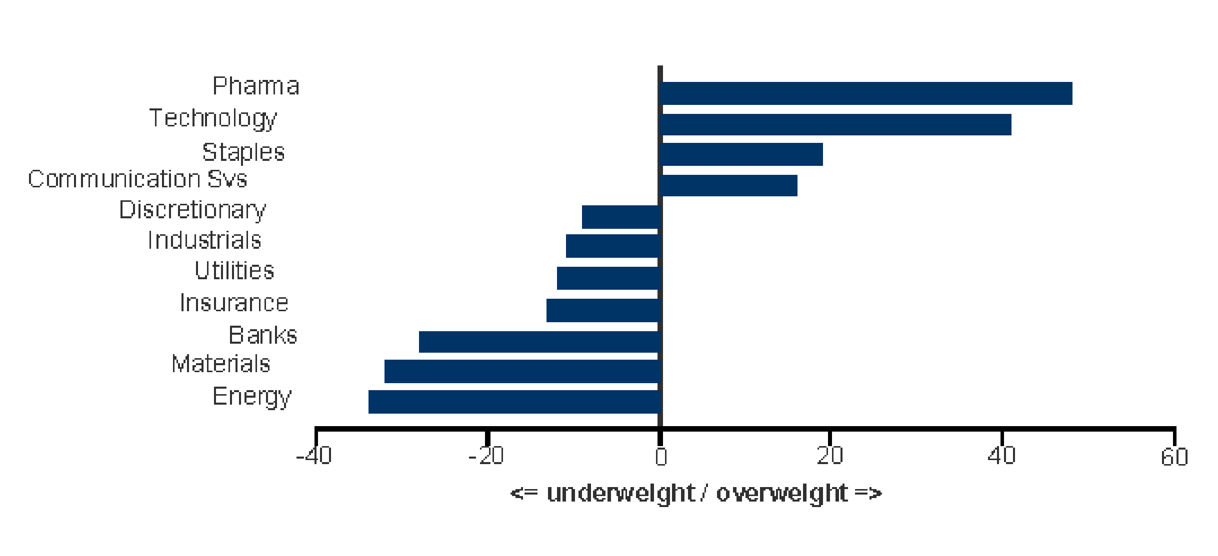
Exhibit 30: What level of risk do you think you're currently taking in your investment?



Source: BofA Global Fund Manager Survey

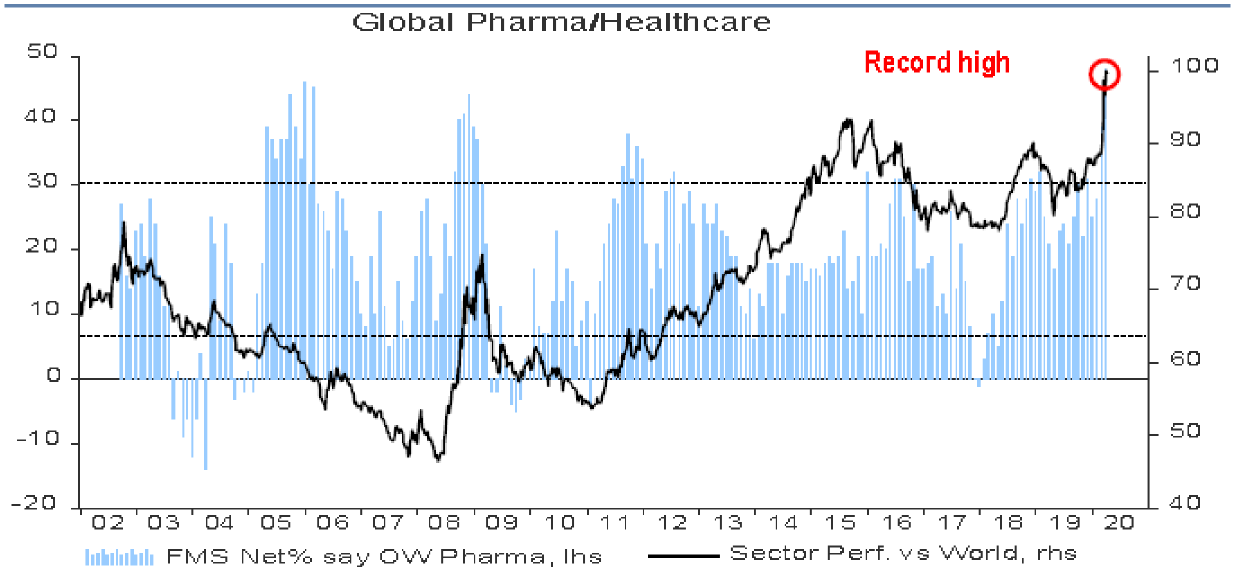
Besides the US tech names, positioning and sentiment to the defensive Pharma/Healthcare sector remains prominent.

Exhibit 47: Global sector sentiment (% saying overweight - % saying underweight)



Source: BofA Global Fund Manager Survey

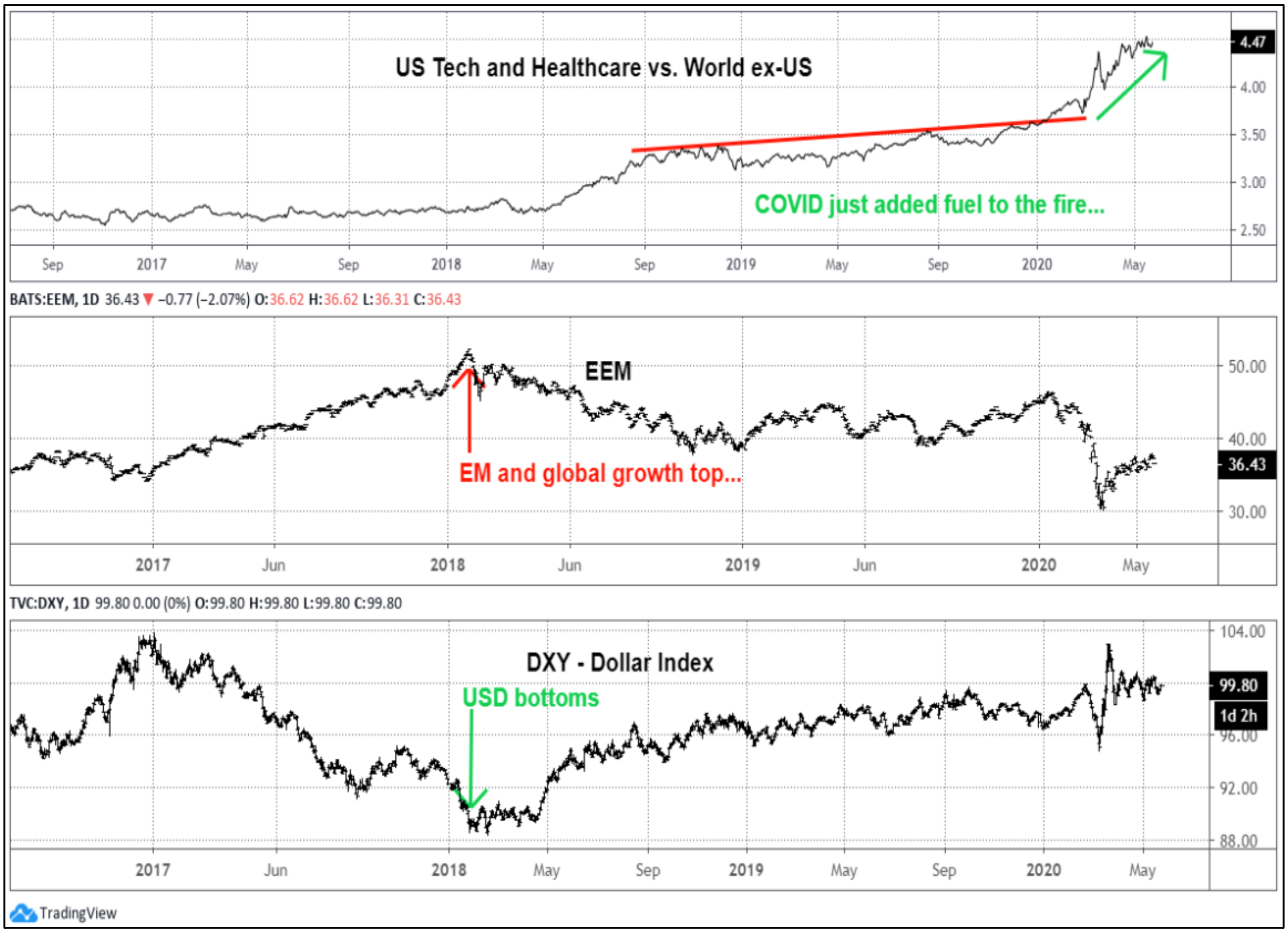
Exhibit 53: Global Healthcare



Source: BofA Global Fund Manager Survey

That has worked out well as it has trounced the cyclicals with the crisis.

US Tech and Healthcare outperformance has so far accelerated with the advent of COVID as they continue to be a no confidence vote on global growth.



Given the lack of visibility into what comes next here it is worth looking at some tail trades.

Positioning is already largely aligned with the ugly current economic picture. However, there is a great deal of liquidity, and capital can move in a rush. Implied volatility has come down a lot and we have just spent the better part of the last two months in ranges. It might be time to take a stab at some out of consensus year end price targets for both bullish and bearish scenarios. Maybe especially some that don't fit your preferred view.

Stargazer
Asset Management

Important Macro Data Releases and Events for the Week

Monday 5/25/2020	Memorial Day Holiday
	GDP w.d.a. YoY (Q1) Forecast: -2.3%, Prior: -2.3%
	IFO - Business Climate (May) Forecast: 78.8, Prior: 74.3
	IFO - Current Assessment (May) Forecast: 81.9, Prior: 79.5
	IFO - Expectations (May) Forecast: 75, Prior: 69.4
	BoC's Governor Poloz SPEECH
Tuesday 5/26/2020	Gfk Consumer Confidence Survey (Jun) Forecast: -18.6, Prior: -23.4
	Chicago Fed National Activity Index (Apr) Forecast: -, Prior: -4.19
	Housing Price Index MoM (Mar) Forecast: 0.3%, Prior: 0.7%
	S&P/Case-Shiller Home Price Index YoY (Mar) Forecast: 3.2%, Prior: 3.5%
	Consumer Confidence
	Dallas Fed Manufacturing Business Index (May) Forecast: -, Prior: -73.7
Wednesday 5/27/2020	EU Financial Stability Review
	Richmond Fed Manufacturing Index (May) Forecast: -47, Prior: -53
Thursday 5/28/2020	Durable Goods Orders ex Transport (Apr) -14%, Prior: -0.6%
	Durable Goods Orders ex Defense (Apr) -, Prior: -16.5%
	Durable Goods Orders (Apr) -18.1%, Prior: -15.3%
	GDP Price Index Q1 Forecast: -, Prior: 1.4%

GDP Annualized Q1 Forecast: -5%, Prior: -4.8%

Nondefense Capita; Goods Orders ex Aircraft Forecast: -, Prior: -0.8%

Initial Jobless Claims Forecast: 2m , Prior: 2.438m

Initial Jobless Claims 4-week ave. Forecast: - , Prior: 3.040m

Continuing Claims Forecast: - , Prior: 25.073m

Friday
5/29/2020

CPI -Core YoY (May) Forecast: 0.9%, Prior: 0.9%

CPI YoY (May) Forecast: 0.2%, Prior: 0.3%

Retail Sales MoM (Apr) Forecast: -11%, Prior: -5.6%

Fed's Chair Powell - Princeton 11am - Moderated by Alan Blinder