Macroeconomic Update

Third Quarter 2020

TOTO, I'VE A FEELING WE'RE NOT IN KANSAS ANYMORE

In the iconic scene from the Hollywood musical fantasy, "The Wizard of Oz," Dorothy realizes she has landed in a magical kingdom after being blown out of Kansas by a tornado. It might be an appropriate way to think about the global macro outlook.

The pandemic has blown the global economy into an unfamiliar place. Government budget deficits have mushroomed; public debt ratios have surged. The Organisation for Economic Cooperation and Development (OECD) projects debt ratios 18 percentage points higher, on average, across the organization. This forecast could rise to 26%, depending on the fiscal response to a second viral wave. Central banks want higher inflation and are willing to fund the fiscal splurge. Risk assets have recovered in varying degrees, yet interest rates and bond yields remain at rock bottom and negative in some places. The Bank of England is the latest central bank to probe the possibility of negative rates. The FTSE World Government Bond Index yields 35 basis points (bps). Emerging country fixed income markets have been strong despite budget and monetary conditions that might have triggered a stampede out of them 10 or 20 years ago. The Federal Reserve (Fed) has promised no rate increases for years and wants inflation up. They have hinted at repressing rates and yields if the curve starts to steepen. Discussions are gaining traction about the central bank hosting individual e-accounts as a means to provide faster and more direct support for American homes and businesses. Gold has soared. However, the relatively meek decline in the U.S. dollar is not flagging any kind of impending monetary instability or imminent burst of inflation caused by the surge in the supply of fiat money.

In short, it feels like the pandemic has transported us to the magical world promised by Modern Monetary Theory (MMT). It is a free lunch smorgasbord of deficit spending and money printing without concern for how to repay debts. It is more than unfamiliar. It feels insane.

Importantly, MMT is working for now. And, we expect to see more of it. Re-openings plus all the policy support have produced V-shaped recoveries. The trend in the global economy continues to remain positive. U.S. household net worth is reaching new highs, housing activity is soaring, and real gross domestic product (GDP) is surprisingly close to its high-water mark based on private sector estimates. More than half of the U.S. private sector jobs lost in the initial wave of the pandemic have been recovered.

Despite these positive economic developments, there is no sign of policymaker largesse ending soon and no constituency for fiscal remediation. Even in Europe, any residual Teutonic notions of sobriety have been smashed by the pandemic tornado. The Next Generation European Union (NGEU) fund—as in the next generation pays for it—is the latest manifestation. Born out of the crisis, the fund lashes together monetary and fiscal policy and could become the foundation for debt mutualization across the European Union.

Governments and central banks remain laser-focused on the contraction in employment and nervous about the deflationary/low inflation consequences as the virus resurfaces in waves around different parts of the globe. Their concerns also extend to sundry other items, including but not limited to: worries about permanent jobs and businesses lost as government support begins to wane; volatility/potential violence surrounding the upcoming U.S. election; resumption of the trade war between the U.S. and

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China after the election; and the nature of any societal shifts caused by the pandemic that could alter core organizational and economic structures. The latter includes the likes of a permanent move to remote work, telehealth, or an acceleration in the shift from cash to digital currencies.

We do not believe in free lunches nor do we believe we are living in the land of Oz where all the investment norms have changed. The extremes we are witnessing in policy are a by-product of the extremes in the current macro profile. We analyzed this idea at length in our July commentary. In many ways, the rhythm of events has evolved as it would in any macro cycle. The world economy plunged in the first quarter and liquidity dried up. Policymakers responded in the second quarter in classic counter-cyclical fashion by expanding liquidity and relaxing markets. The economy has been accelerating since. We expect the latter to continue this year and next.

What is different this time is the scale of the events and the starting point. Prior to the pandemic, the lower-for-longer debate centered on the case for secular stagnation. Technology and competition boost supply. Shrinking populations depress demand. These tendencies have fostered the low inflation/deflationary trends in the world and the drift in capital markets toward the zero bound. It has been the main story in Japan for 30 years. There, inflation has averaged 0.2% and the budget deficit 6% of GDP over the last 20 years. With interest rates in Japan at zero, the monetary transmission link has been through fiscal deficits as the offset to the spending drag of an aging and contracting population. Under Abenomics, the shift to MMT came as policymakers realized the only path to higher nominal GDP was through more government spending, and they could fund it without a lenders' revolt by printing money. Yield curve control was implemented as a backstop against discretionary fixed income investors fed up with no return. However, the balance sheet expansion really slowed in 2018 and 2019, suggesting there were not many of those investors left, and the yen has been firm as well. Arguably, this approach probably has kept Japan from deflation. With the pandemic tornado ripping through Japanese and global nominal incomes, the Bank of Japan has launched its own internal review of strategy while the rest of the world catches up. Stay tuned. Helicopter money that bypasses debt issuance in some form may be around the corner in Japan.

The one country in the world where things are getting back to a kind of pre-virus normal is China. China's authorities have been able to enforce quarantines and lockdowns unlike the authorities in the West's open societies. Correspondingly, Chinese bond yields have renormalized to where they started at the beginning of the year. From a longer-term perspective, China has been following the MMT playbook ever since the Global Financial Crisis. The collapse in U.S. household borrowing laid bare China's massive excess savings. Since 2008, China has used its domestic bank lending program as a surrogate for fiscal spending in an economy where low government bond yields provide a subsidy to predominantly state-owned borrowers. The consolidated budget, once in surplus in 2008, has fallen into deficit at a national level of close to 15% of GDP; its debt-to-GDP ratio has been continuously increasing. Lastly, China's labor force has peaked. Society may grow old before getting rich. Deflation would be rampant were China's authorities to redress its fiscal imbalance anytime soon. Furthermore, whenever they do worry about leverage, deflationary forces surface quickly.

The Fed completed its own policy review during the quarter and concluded that it was wrong about the macro environment for most of the last 12 years. It seems to have accepted that the world is closer to the zero-bound than it thought; it has concluded the Phillips Curve model for guesstimating inflation has not worked too well given these longer-term forces, and it has openly called on the government for more fiscal support. That is a politician's dream and will be part of any policy platform regardless of political affiliation.

So, what are the limits to rock-bottom rates?

The near-term risk is of a stronger economic recovery than currently expected that causes the U.S. yield curve to steepen. Most investors expect the pace of the global recovery to slow from the V-shaped re-opening phase. Based on the slope of the curve, the implied probability of the yield on 10-year Treasuries staying flat or falling further is close to 70%. It seems that even a modest normalization in yields is priced at close to tail-risk levels.

Our base case has been and remains that the U.S. and the world will learn to live with this disease and/or discover a treatment/vaccine. Tailwinds to growth are gathering: the accumulation of hundreds of rate cuts around the world, the lagged influence of falling bond yields, increases in household net worth, and cheap energy. All this should imply a gradual rise in bond yields and steepening of the curve. How high they go is a different question. Equity market multiples, one of the drivers, or rising household net worth could be very sensitive to this trend and act as a governor on the pace of the increase.

Monetary policy is a clumsy policy lever. The hit to GDP, led by services and the surge in personal savings, has produced an interest rate that is a subsidy to economic sectors less affected by the pandemic, like housing. Who thought in March that a lockdown would result in people reacting in a way that created a housing boom? Is something similar possible in the service sector? As we learn to live with the disease and/or overcome it, the growth upside could come more quickly than expected, especially if a vaccine or therapy emerges that results in people feeling safer. We continue to think of the shock from the pandemic as more like a natural disaster than a classic economic recession. Consequently, we view this upside risk as fairly significant. If the curve begins to steepen, which would be normal under these circumstances, there is open speculation that the Fed would

adopt some form of yield curve control to limit the upside. The central bank has altered its operating strategy and says it is prepared to let the economy run hot in order to reach an average inflation rate of 2%. Policy rates at the front end of the curve are unlikely to change for the foreseeable future, but the curve could gradually steepen.

The longer-term risk to rock-bottom rates is inflation.

Surging money supply growth around the world has ignited worries about inflation. That is not our view, at least for the time being. There remains unusual excess capacity in land, labor, and capital. It is possible that inflation could perk up as savings rates drop and the velocity of money increases if people become confident enough to re-open the service sector and start flying in airplanes again. The prevailing tail-risk attitude that this will not happen anytime soon is something to which we have been giving a lot of thought, particularly with monetary and fiscal policy in the land of Oz. If that turns out to be more real than imaginary, today's central bank reaction functions and the tools being deployed will provide the roadmap on what would evolve in that environment. This is an issue we will explore at a later date.

OUTLOOK

As discussed earlier, our base case for macro information risk is a positive one. We think that global growth will continue to improve, possibly faster than expected, especially if a credible and widely available vaccine is launched. Bond price profiles in the developed sovereign bond markets are very extended.

Corporate bond spreads have retreated to more normal levels from the anomalous state of the market earlier this year. Our expectation is for a gradual backup in government bond yields as the global economy recovers. Corporate yields should narrow another 25 bps or to historically normal spreads as the recovery progresses and corporate profitability improves.

Despite the decline in the dollar since March, the currency remains overvalued on almost any basis of comparison. Balance-of-payment flows have become harder to read during the pandemic, but the outlook for the U.S. budget and current account deficit argue for the currency to be weaker the further out the time horizon. There may be volatility around the outlook heading into year end, owing to the election and a buildup of short positions, at least in the smaller futures markets. Sterling is by far the most undervalued of the majors by a stretch, its price discount a by-product of the tortured Brexit process. We continue to expect a solution in the eleventh hour. The Japanese yen has been trending higher but repeatedly pulling back from the 105-level relative to the U.S. dollar since 2016. Fair value may not be much higher at around 100, but the combination of a soft dollar and insurance ahead of the election have us in this zero-yielding market.

As an asset class, emerging market currencies display one of the largest price anomalies relative to traditional metrics. This is an asset class that has not gained much traction, which in some ways speaks to the broader macro outlook. Global growth is picking up, but a sense of strength to the expansion is not there yet. We find the degree to which various emerging countries have tried to follow the path of MMT quite incredible, which means that any currency or duration decision requires more than the usual attention. Where we do see the biggest opportunity within this group is commodity-related countries, including Chile, Colombia, Brazil, and Mexico.

Summary: The pandemic may have put the global economy into an unknown territory, but there is still opportunity for growth and a way home once a vaccine is made available.

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