Gavekal Research

May 2021

Taking a punch, & getting up again

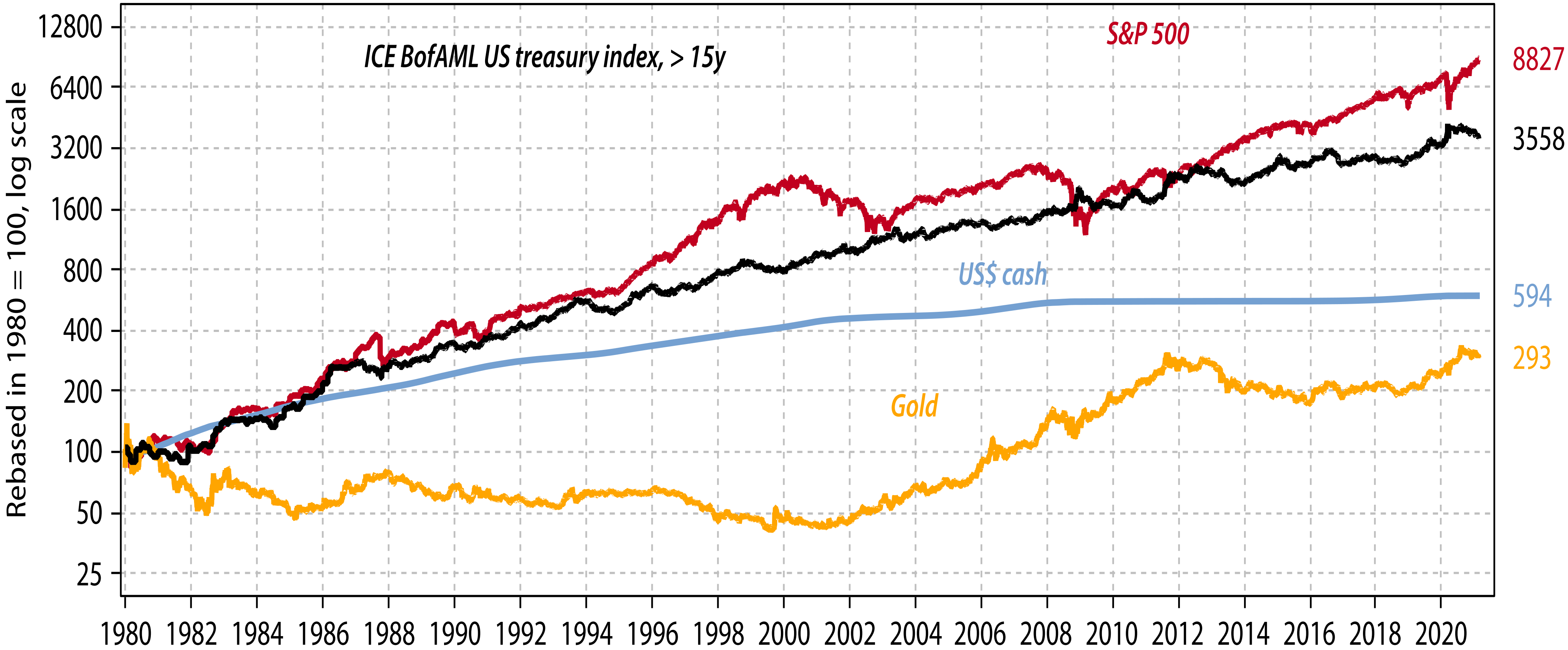
By Louis-Vincent Gave

The Walter Spanghero "philosophy on life"

For forty years, UST have been the nose that protects the portfolio's face

In disinflation, long bonds offer the superior hedge

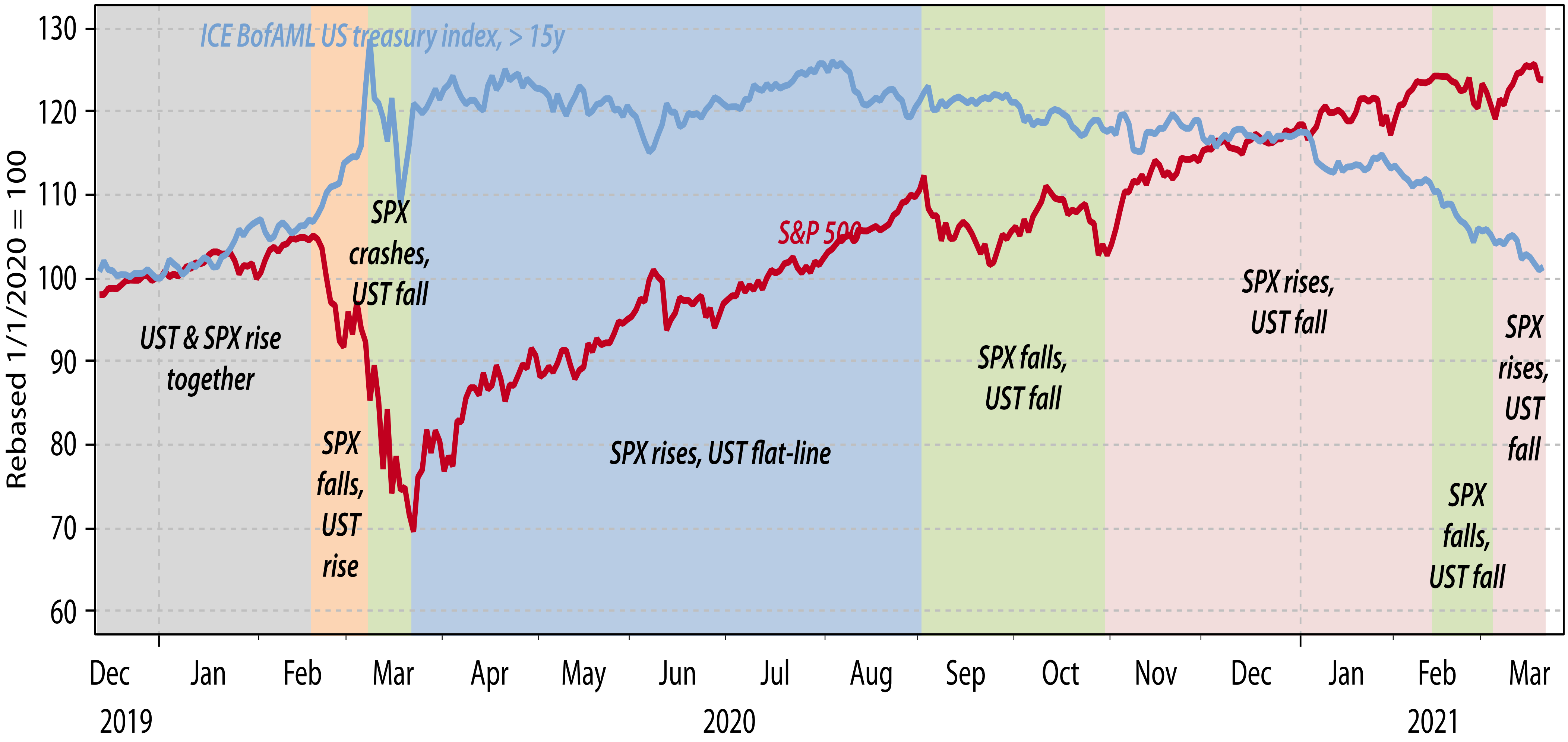
S&P 500, US long bonds, gold & US$ cash in a disinflationary period



Gavekal Data/Macrobond

But in the past year, they have not been protected from anything

Do US Treasuries still hedge the risk of equity corrections?



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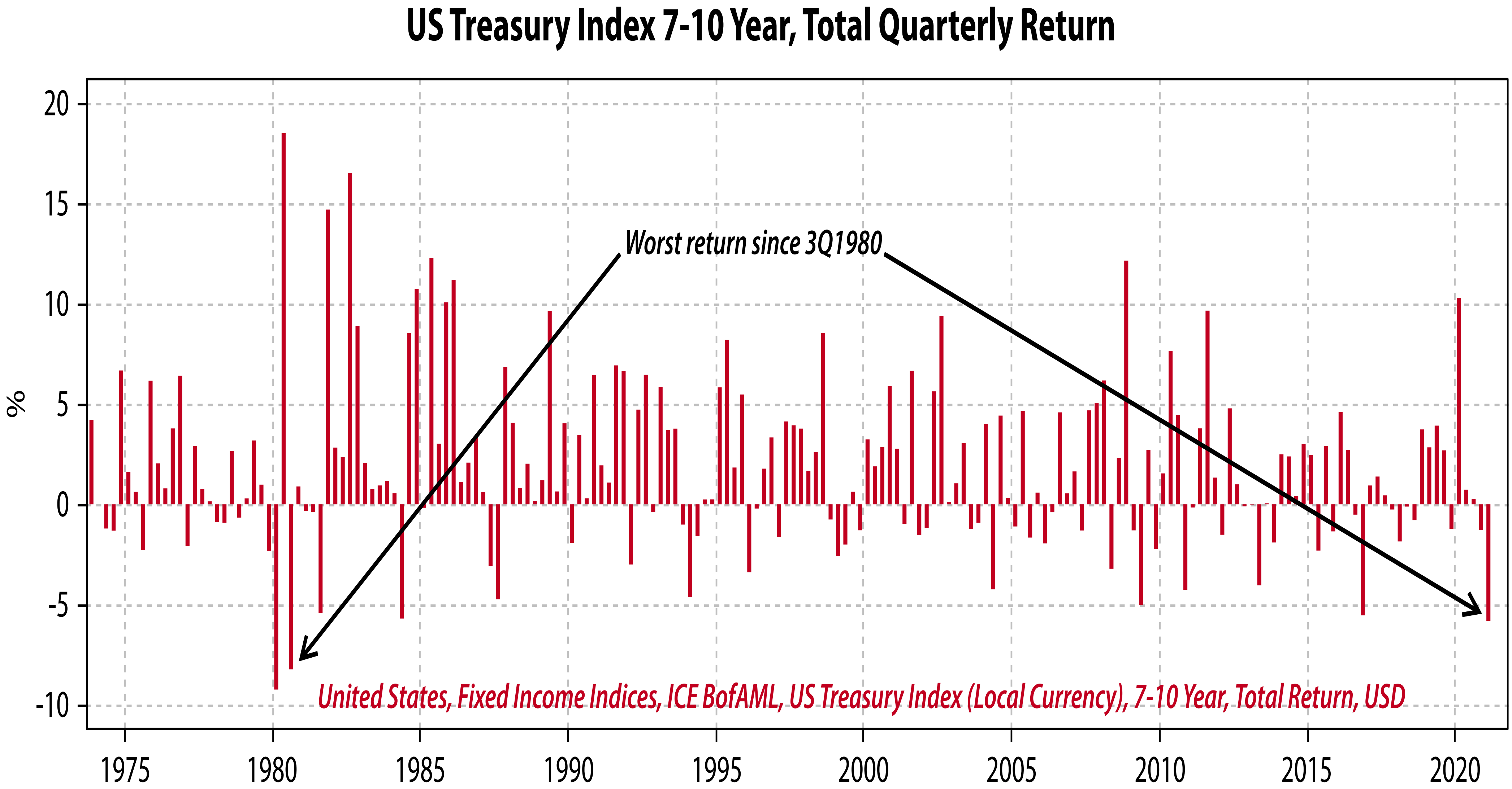
Long-dated UST have just delivered the worst quarterly returns since 1980



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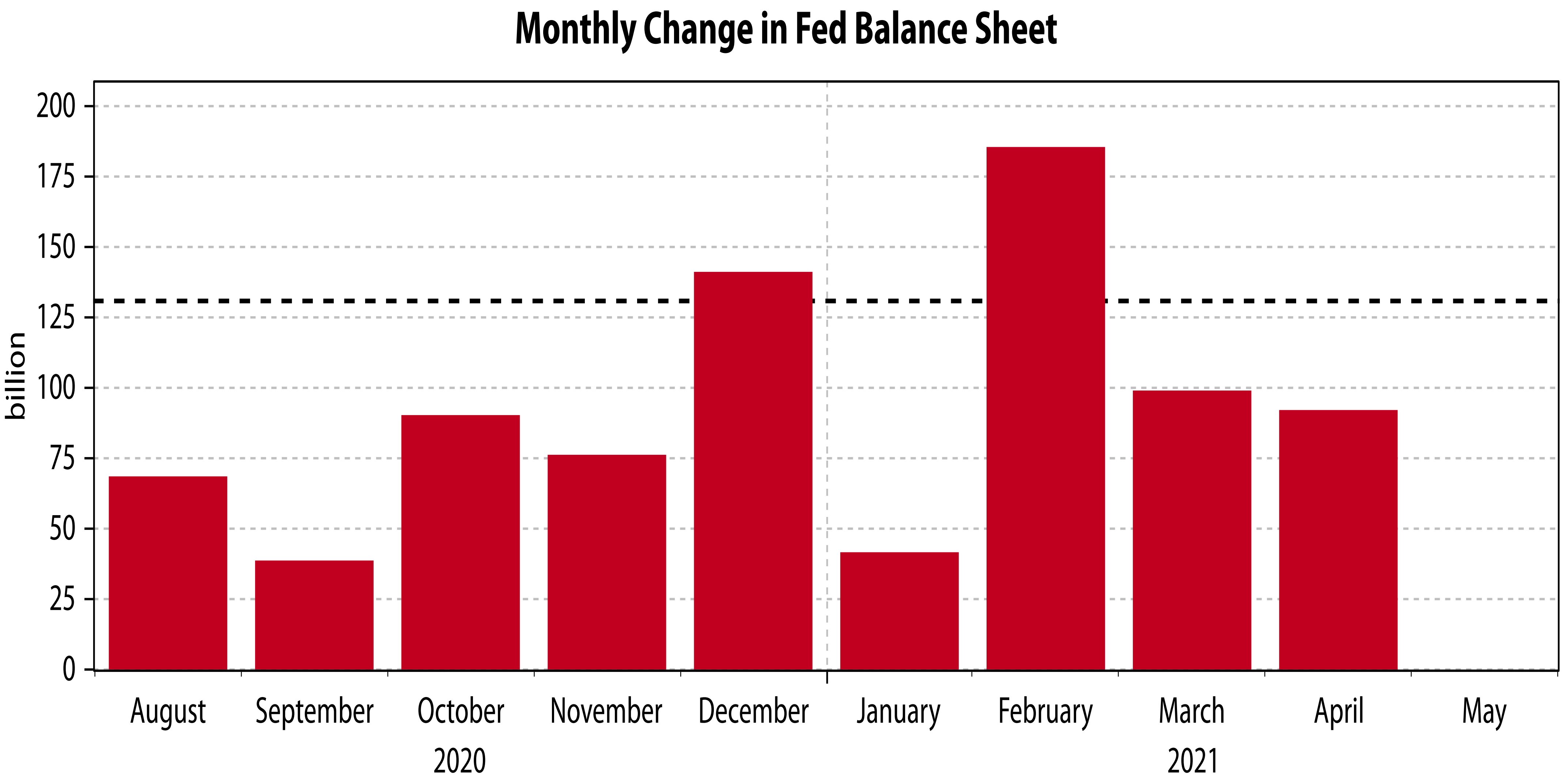
Back in 1980, the Fed was tightening – today, Fed is easing like never before



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Fed buys bonds hand over fist… and bonds sell-off?

Why are bonds selling off when the Fed is buying bonds hands over fist (and promises to do so for a long time)?

Option #1: the bond market doesn't believe the Fed's promise → No sign of that in the Fed's futures fund rates

Option #2: the market is making a mistake and yields are set to collapse again → Always reluctant to default to 'market is mistaken' explanation

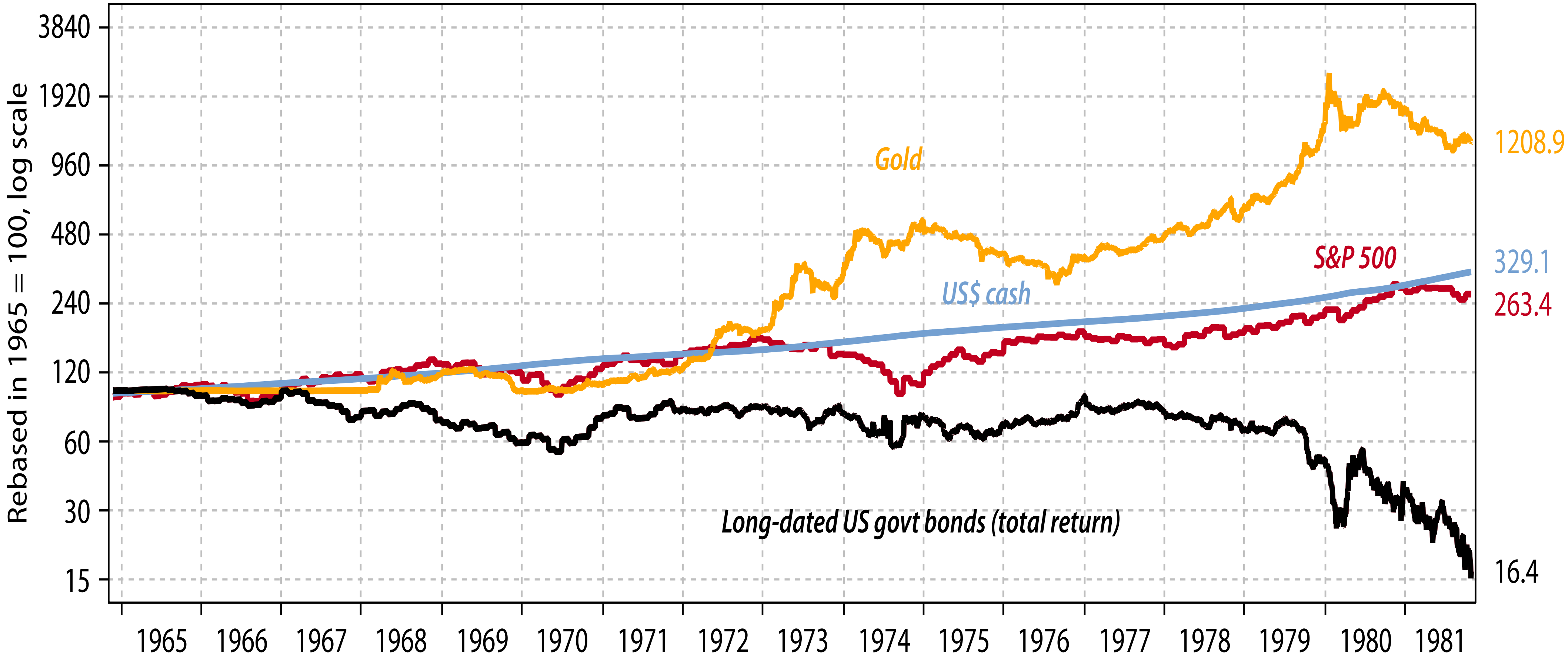
Option #3: issuance is too high and overwhelming an easy Fed → Seems likely

Option #4: bond market is starting to worry about rising inflation → If so, then what?

Are we entering into a different investment regime?

In inflationary periods, bonds are a disaster

S&P 500, US long bonds, gold & US$ cash in an inflationary period



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The scariest events are usually NOT the most important ones

In 2001, 9/11 felt like the key event. In hindsight, it was China's WTO entry

In 2007, the subprime crisis felt key. In hindsight, the iphone was

Sub-prime gloom picks up after HSBC warning

MARKETS BUSINESS INVESTING TECH POLITICS CNBC TV

U.S. NEWS

BNP Freezes $2.2 Billion of Funds Over Subprime

Reuters
Published 2:55 AM ET Thu, 9 Aug 2007 | Updated 3:17 PM ET Thu, 5 Aug 2010

REUTERS

CNN Money Companies Markets Tech Media

What $100 oil would cost you

With crude hitting $100 a barrel, consumers should brace for record gas prices and higher airfares.

By Steve Hargreaves and Keisha Lamothe, CNNMoney.com staff writers
January 2 2008: 2:33 PM EST

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Crisis & productivity gains

- In 2001, China joining the WTO triggered a surge in global trade, and rising productivity for businesses who could outsource production (see my first book, *Our Brave New World*).

- In 2007, the launch of the smartphone triggered a surge in global productivity (see my third book, *A Roadmap for Troubling Times*).

- The 2008 crisis pushed China to speed up its infrastructure spending and the consequent commodity boom gave birth to the shale revolution (see my fourth book, *Too Different For Comfort*).

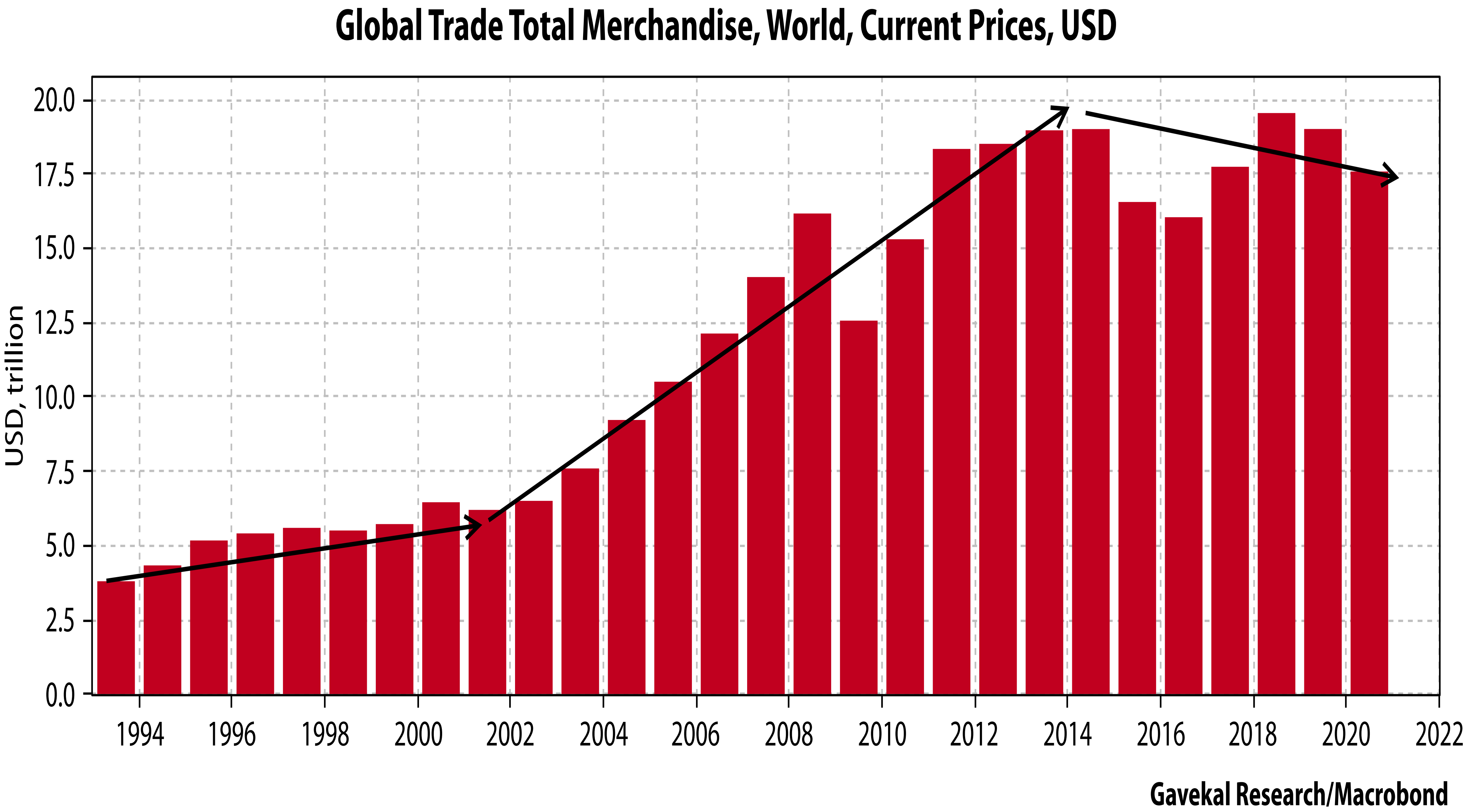
- **Today, how will Covid boost productivity? Or could the legacy of Covid be something all together different?**

Crisis tend to act as accelerators to underlying trends

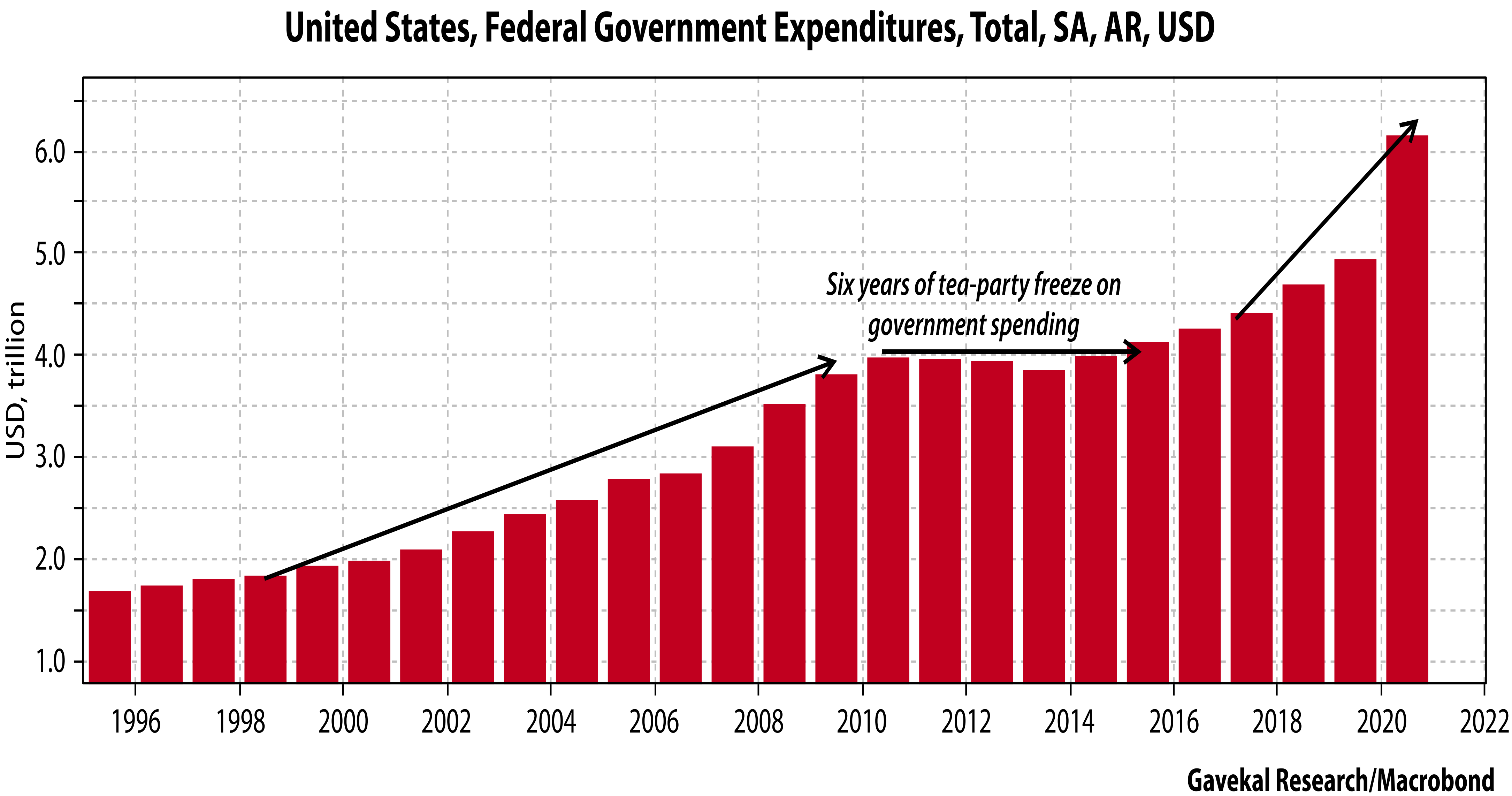
The 2008 crisis led to an acceleration of globalization

- **More free-trade:** the 2008 crisis gave birth to the G-20.
- **Greater China industrialization:** China's unprecedented Keynesian infrastructure spending unleashed an additional 500m workers unto the world.
- **RMB liberalization**: Following 2008, China realized the dangers of remaining 100% dependent on US$ financed trade.
- **Global regulation**: FATCA, OECD black-list, crackdown on tax havens…

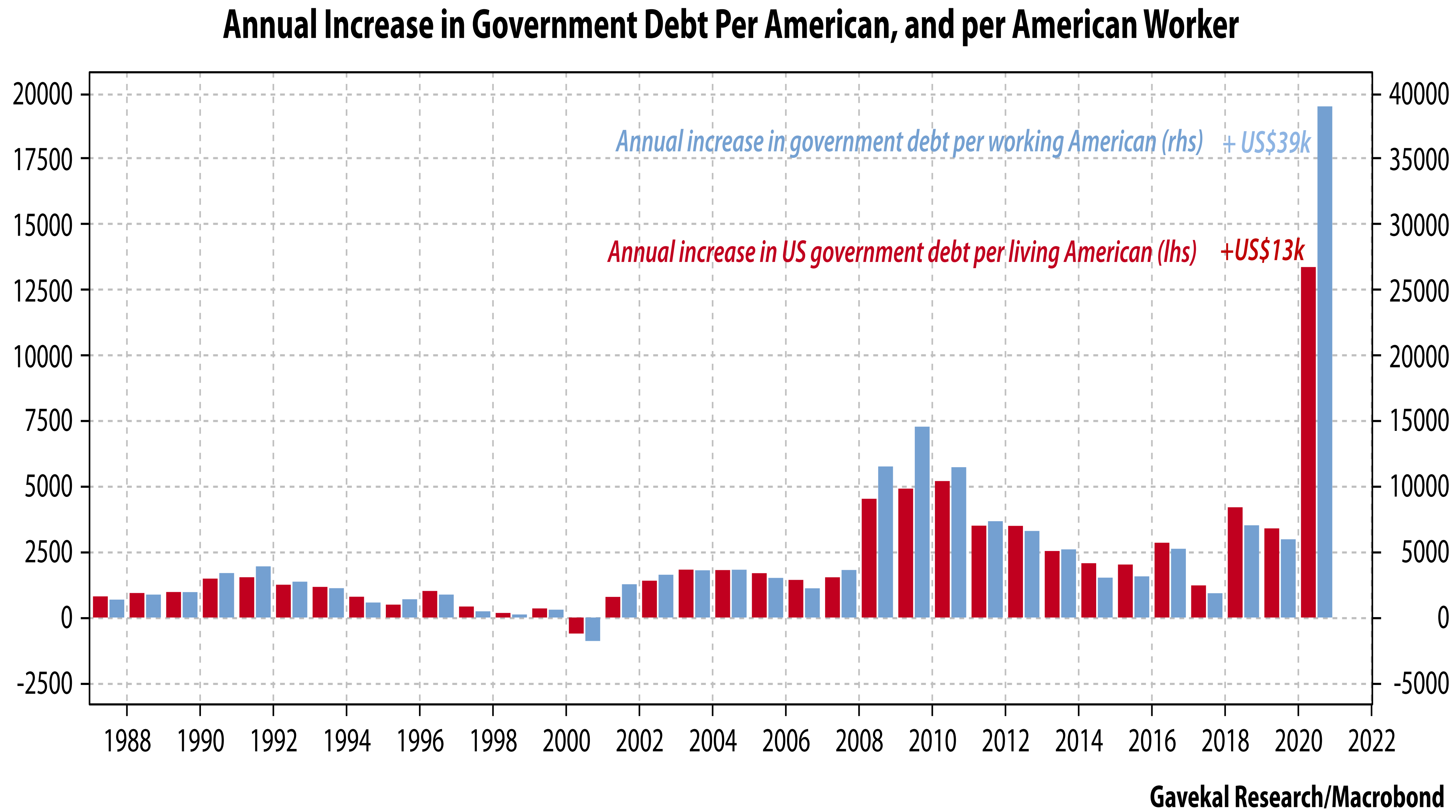
The COVID crisis will lead to further de-globalization



And of course, Covid is leading to greater government spending & regulations



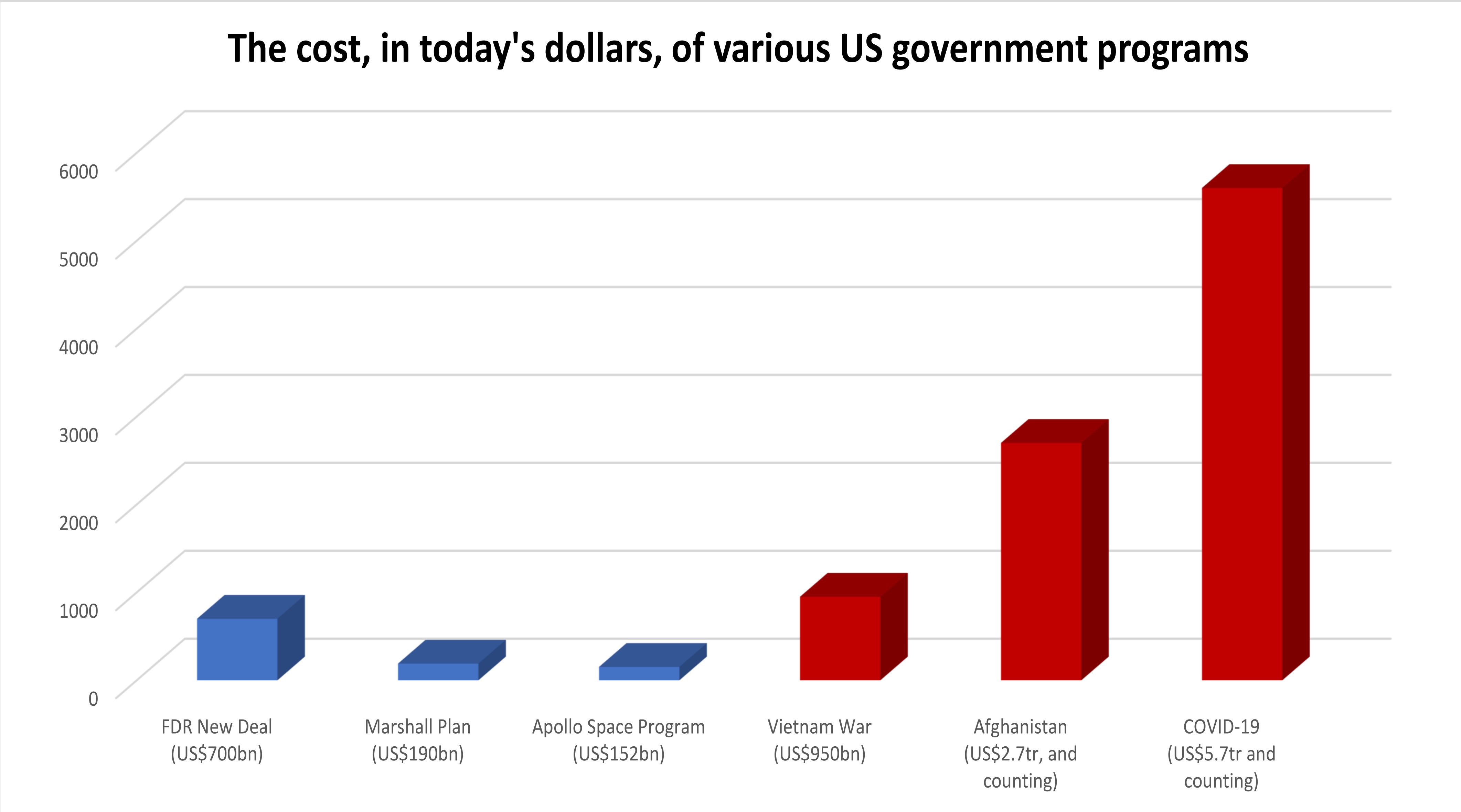
We are living through unprecedented increase in US government debt



The US numbers are an anomaly against both History & other countries

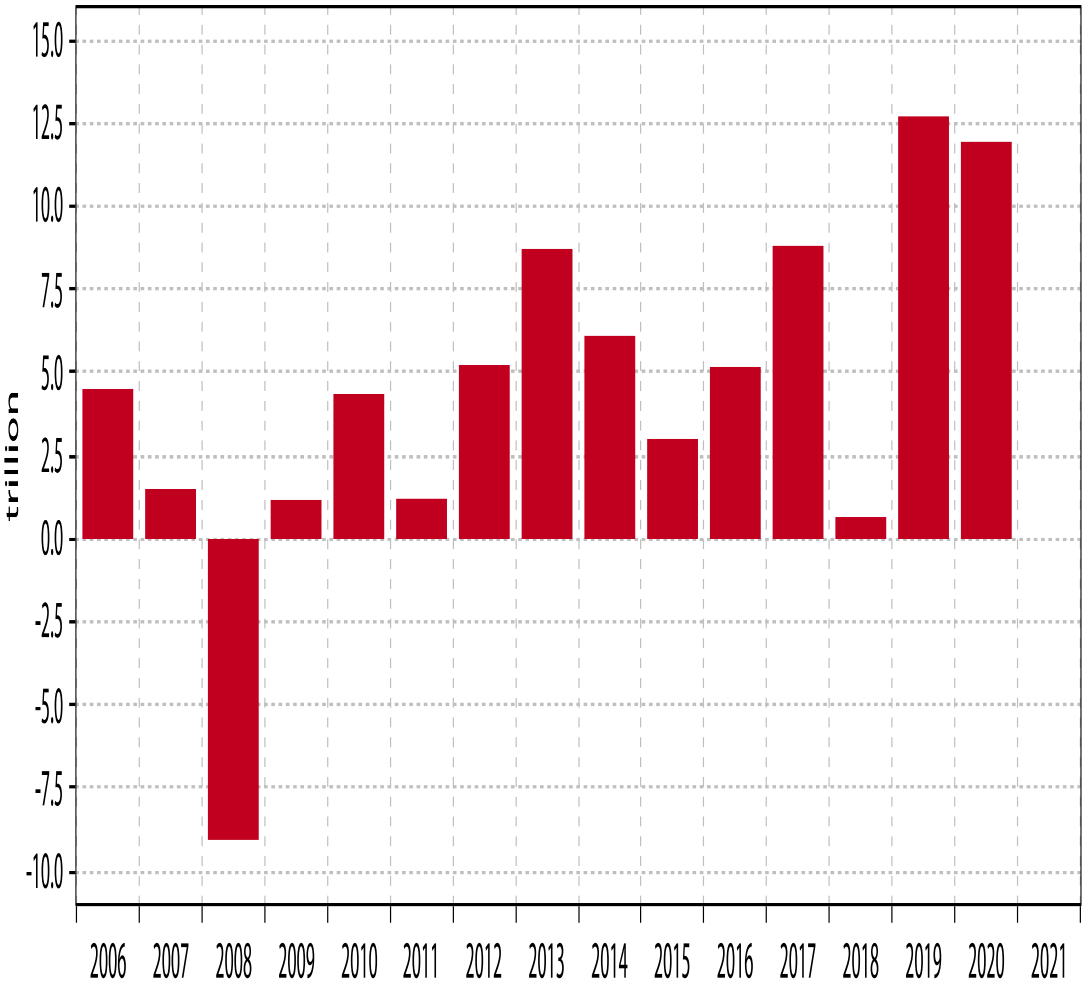
	2020 Government Debt in Local Currency	2020 Government Debt in US$	2020 Increase in Debt in Local Currency	2020 Increase in Debt in USD	Population	Increase in Debt per Capita in US$	Total Debt per Capita in US$
Japan	932,100,000,000,000	9,005,797,101,449	74,500,000,000,000	719,806,763,285	126,500,000	5,690	71,192
USA	22,210,000,000,000	22,210,000,000,000	4,200,000,000,000	4,200,000,000,000	328,200,000	12,797	67,672
Italy	2,400,000,000,000	2,846,400,000,000	206,000,000,000	244,316,000,000	60,360,000	4,048	47,157
France	2,460,000,000,000	2,917,560,000,000	286,000,000,000	339,196,000,000	66,990,000	5,063	43,552
UK	2,020,000,000,000	2,677,712,000,000	350,000,000,000	463,960,000,000	66,650,000	6,961	40,176
Germany	1,790,000,000,000	2,122,940,000,000	370,000,000,000	438,820,000,000	83,020,000	5,286	25,571
Canada	999,900,000,000	763,282,442,748	404,000,000,000	308,396,946,565	37,600,000	8,202	20,300
China	63,239,000,000,000	9,654,809,160,305	10,870,000,000,000	1,659,541,984,733	1,393,000,000	1,191	6,931

Putting today's spending plans in historical context



Will increase in debt fuel productive investment? Or consumption?

USA Annual Change in Household Balance Sheets



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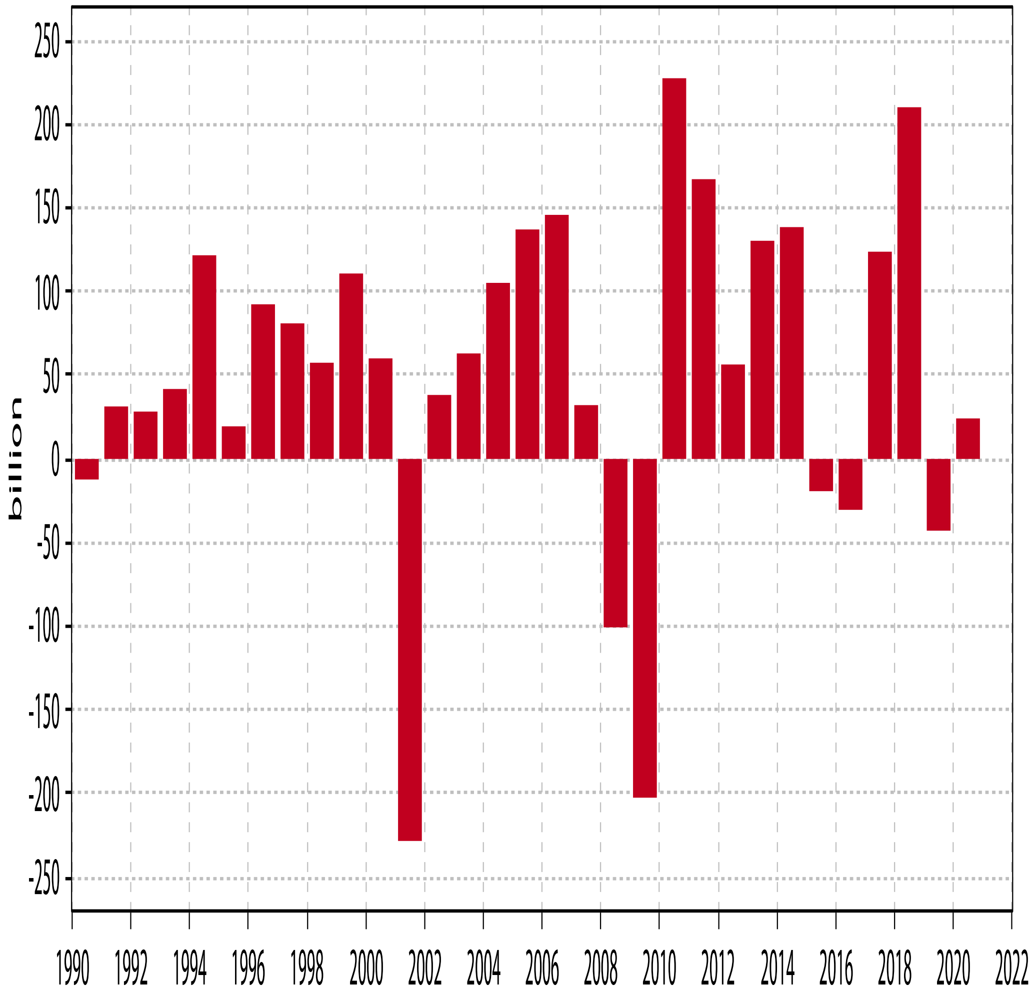
USA Nonfinancial Corporate Business - Annual Change in Total Capital Expenditures



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How is the massive increase in US government debt funded?

How is the massive increase in US government debt funded?

Option #1: government taps past domestic private sector savings

This is usually rather deflationary as government crowds out private sector

Option #2: government taps foreigners to fund its debt increase (i.e.: Germany in 1991)

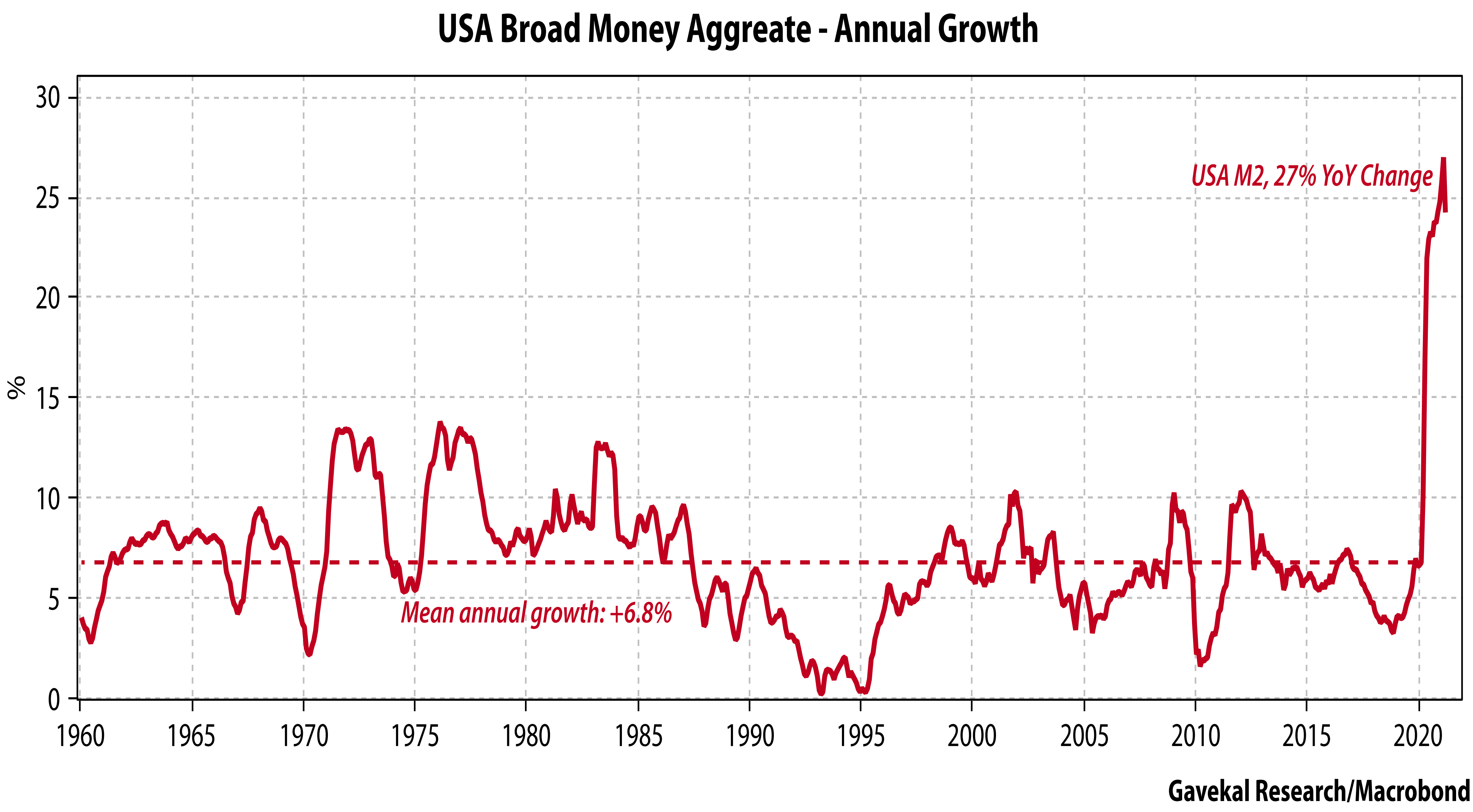
Big increase in the currency and very deflationary outcome

Option #3: government leans on central bank to print new money to fund its spending habit

Usually very inflationary

An unprecedented US monetary policy

Expansion in govt debt is funded by unprecedented money printing



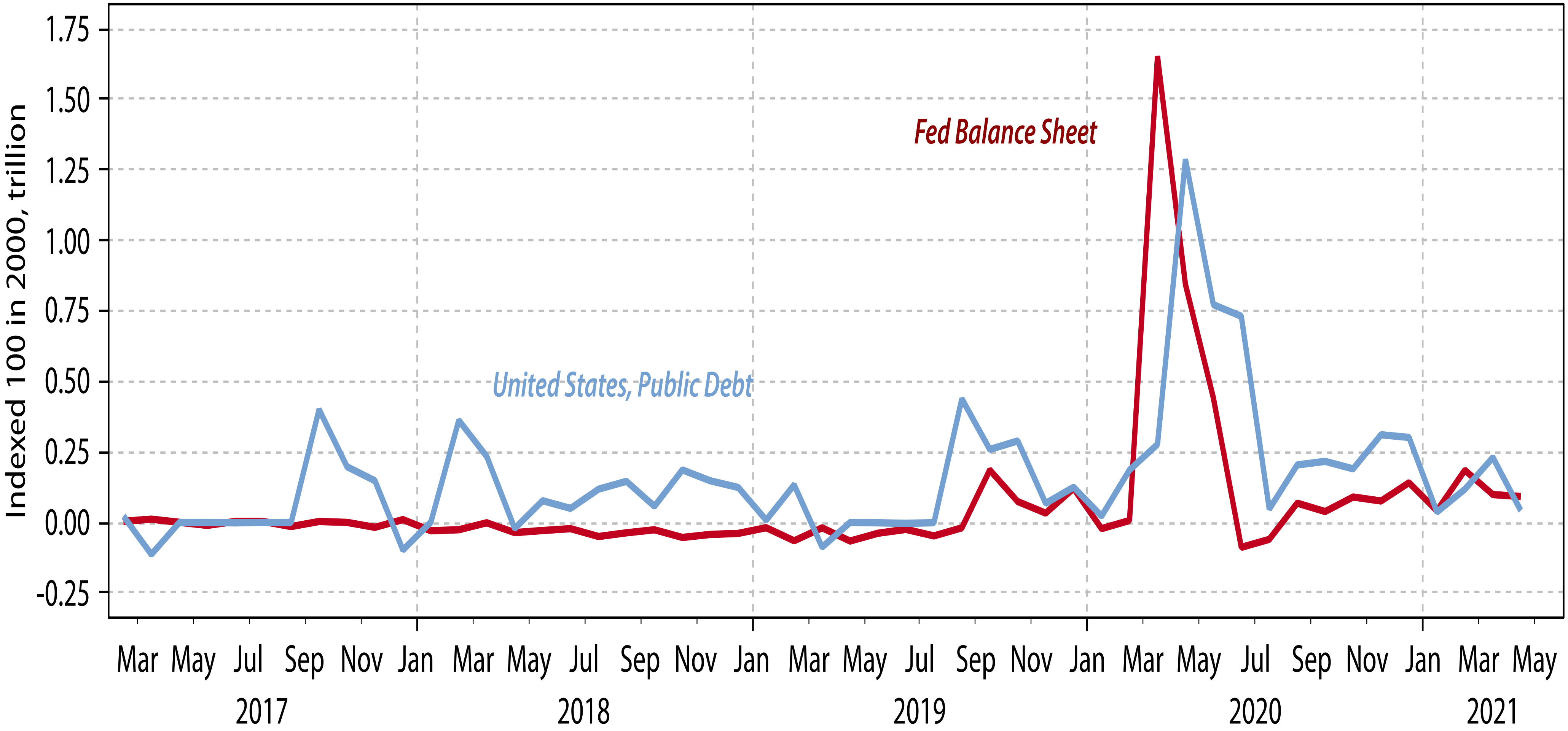
Can the Fed back-away from the US Treasury Market?

"It may be that there is a simple macro fact that the Treasury market being so much larger than it was even a few years ago… that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there… There is thus an open question about whether there will be an indefinite need for the Fed to participate as a purchaser to support market functioning."

Randal Quarles, Fed Vice-Chair for Financial Supervision

Have the Fed & US Treasury already merged?

Monthly Change in Fed Balance Sheet & Monthly Change in US Treasuries Outstanding



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The next big question: will Biden's "infrastructure" spending plan pass?

Will Biden's spending plans get the green light

YES

- Yield curve steepens further
- Financials outperform
- Commodities rally
- Inflation expectations break out further
- US$ weakens over the long term, may rally initially on the back of higher yields

NO

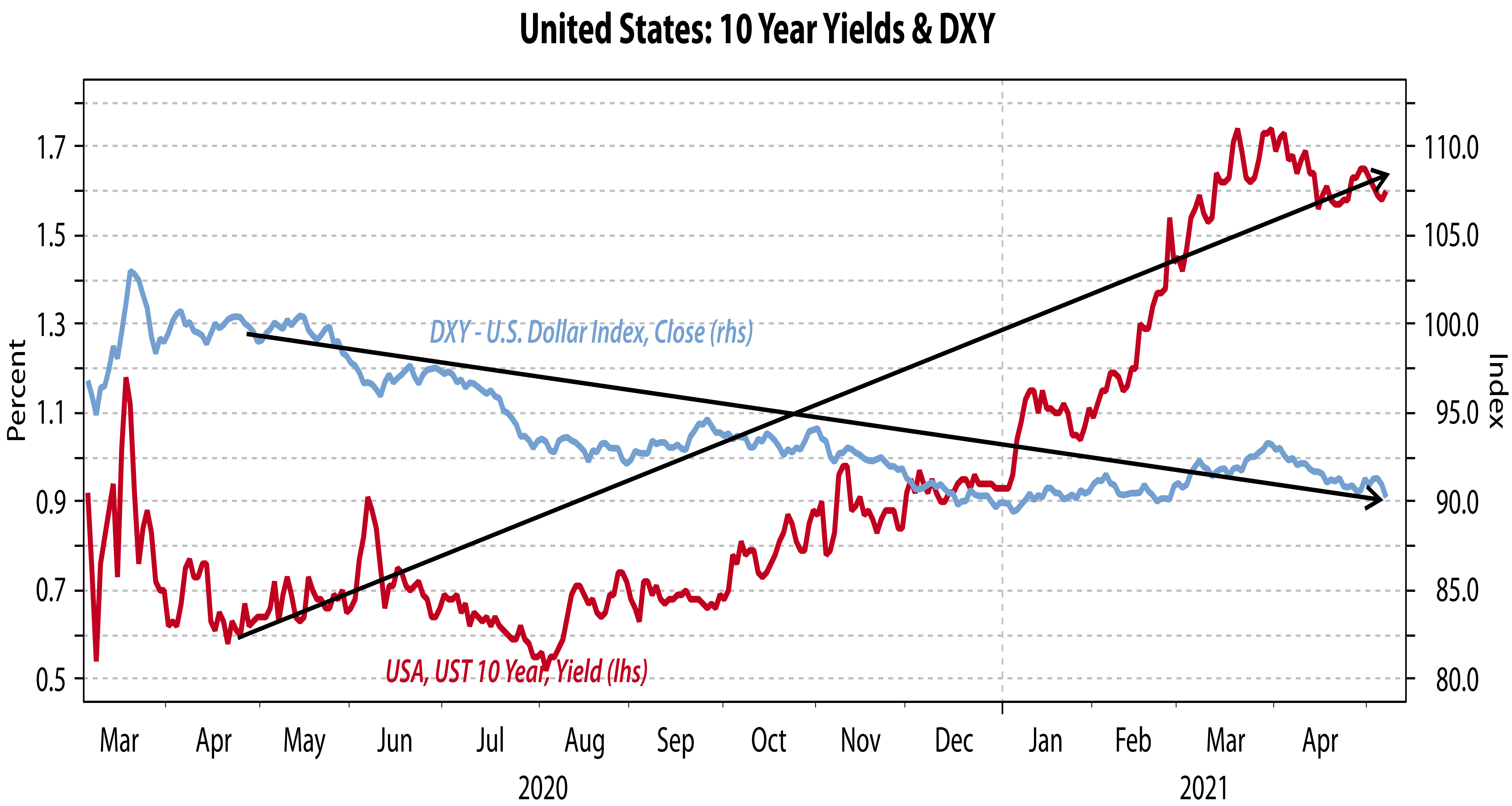
- UST yields fall
- US growth stocks outperform
- US$ rallies
- EM & Commodities struggle

If Biden's plan passes, where do inflation expectation go?

Breakeven inflation rates on 5y TIPS: inflation expectations have broken out

Gavekal Data/Macrobond

And where does the US$?



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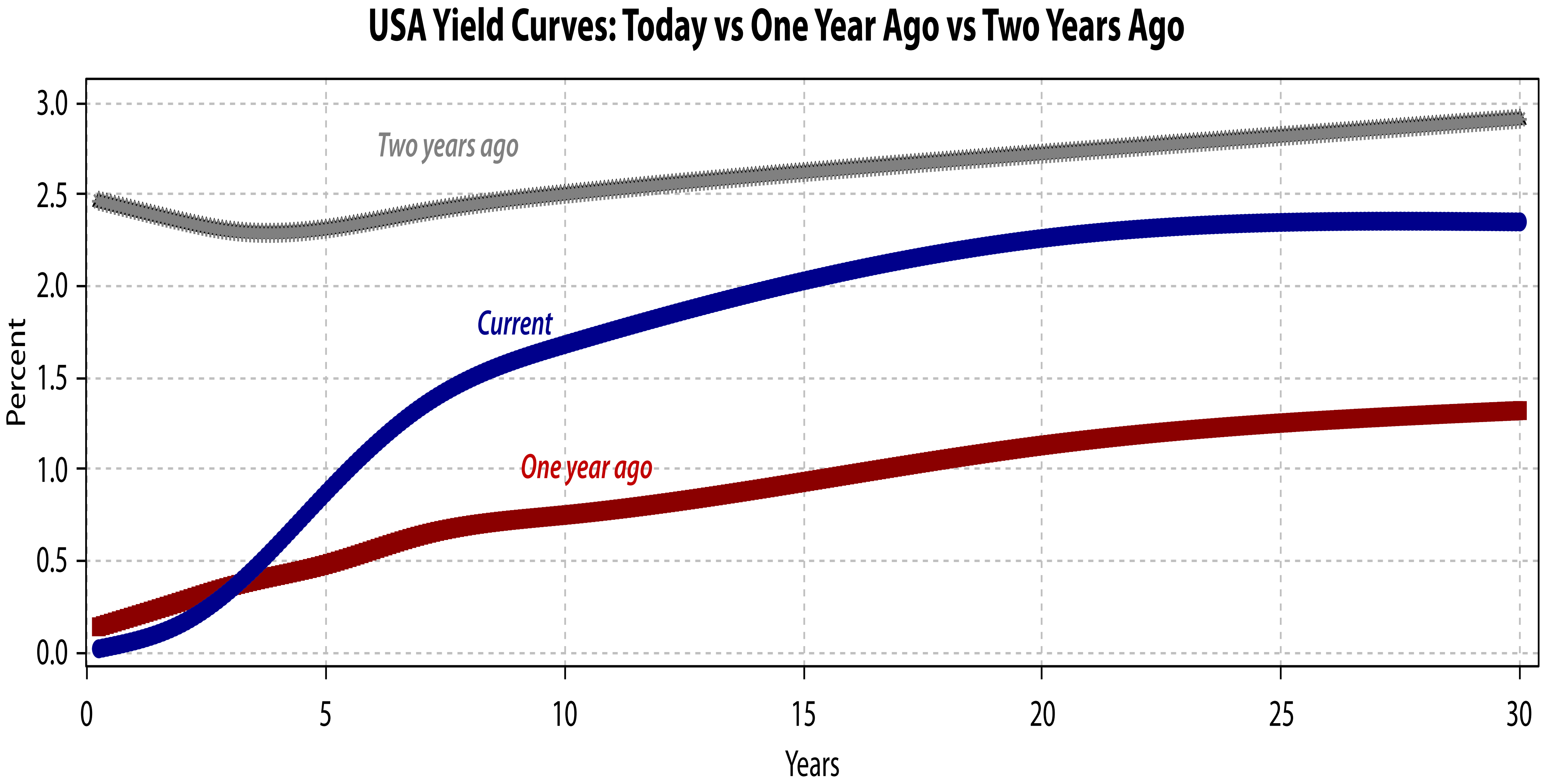
The EU quandary: summer re-opening or autumn riots?

As US re-opened, US yield curve steepened



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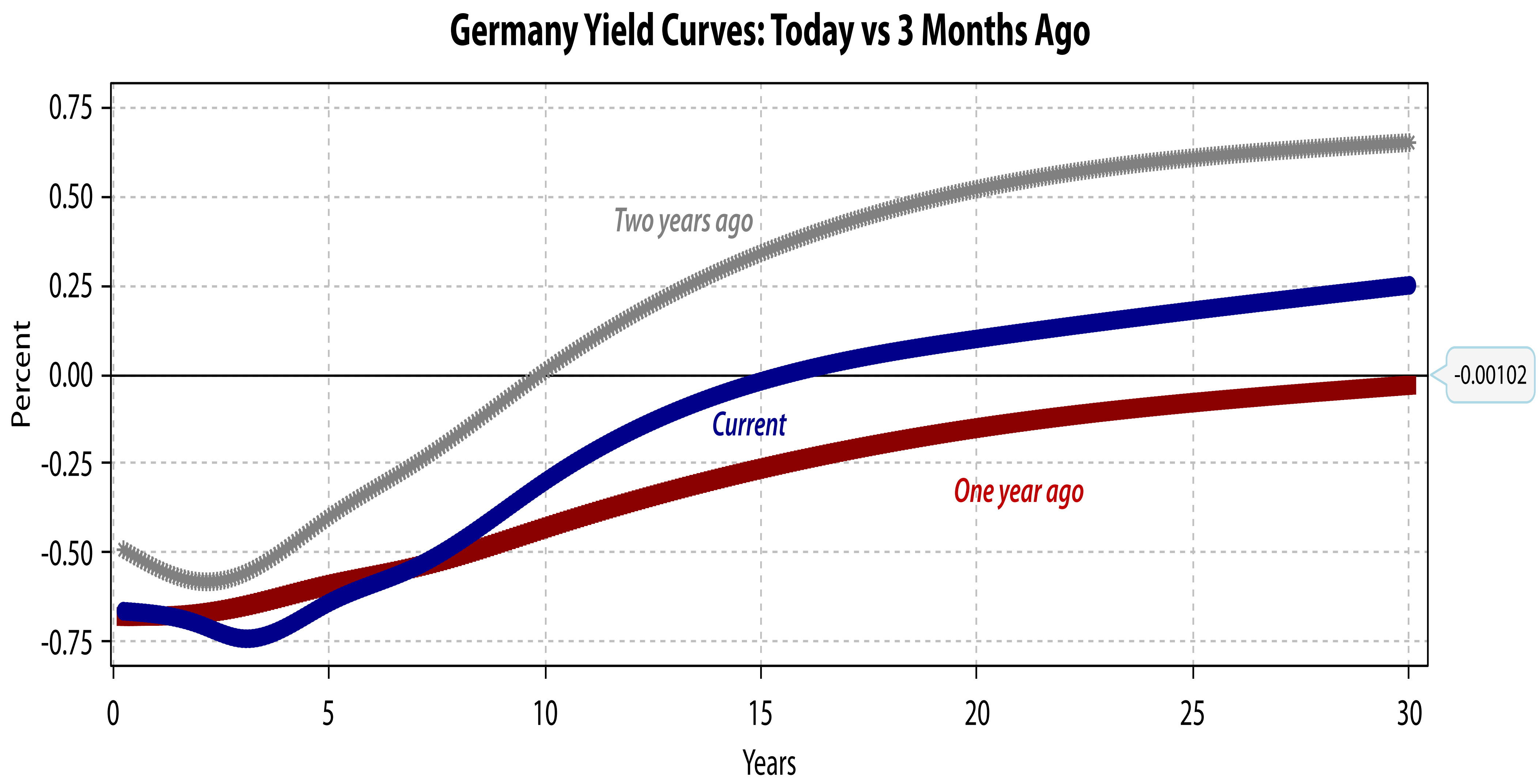
Europe yield curve has yet to really steepen



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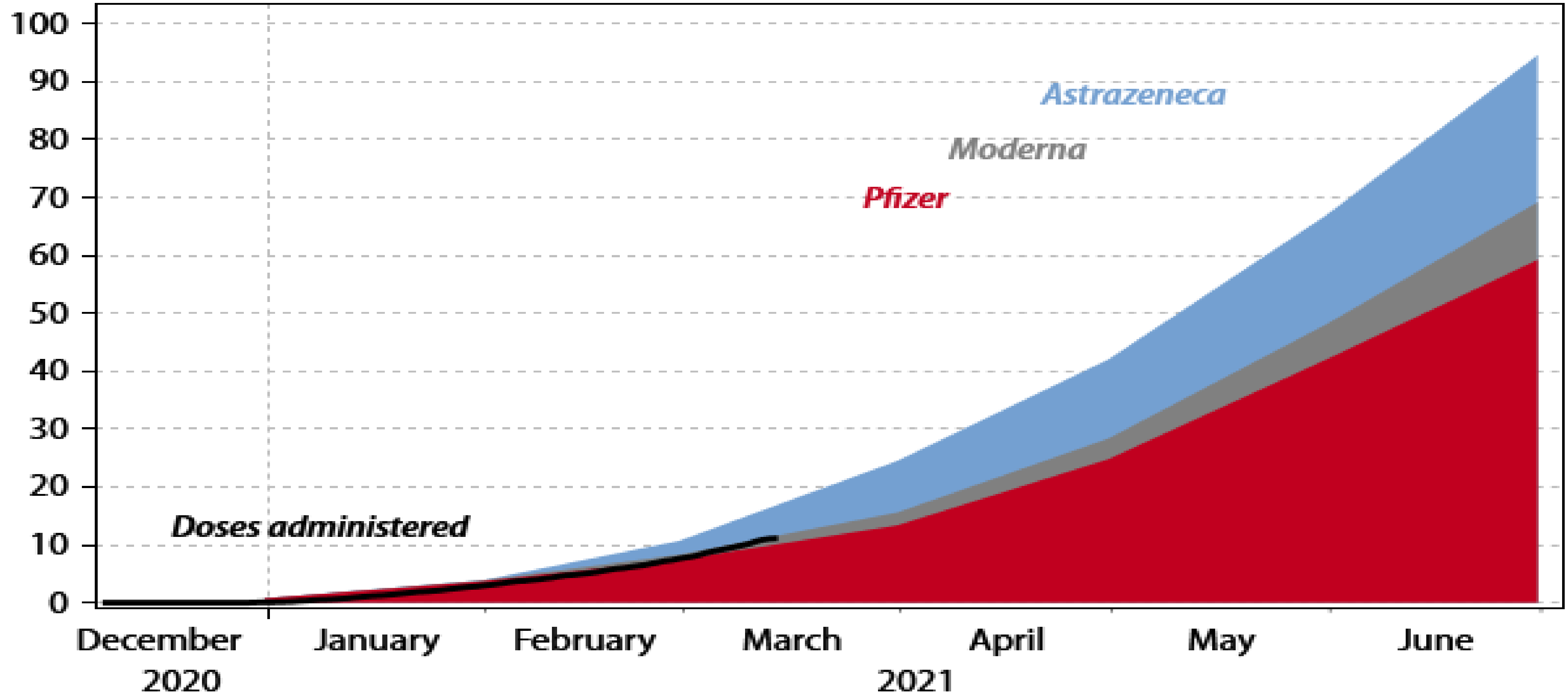
This could be because Europe has been hapless in vaccine roll-out

Vaccine deliveries to the EU are set to accelerate over the next quarter

Expected delivery of Covid-19 vaccine doses per 100 people, based on French govt. schedule



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Begging the question of whether Europe will have a summer

Will Europe open in time to have a half-way decent summer season?

YES

- EMU long bond yields rise more than UST yields
- EMU yield curves steepens
- EMU financials outperform
- Euro rallies
- Commodities rally

NO

- **We have to start worrying about EMU political risk. Serious risks of riots in the fall**
- EMU stocks continue to underperform
- US$ rallies
- UST rally
- EM, EMU & commodities struggle

How will energy weigh on the productivity balance?

The energy cross-roads

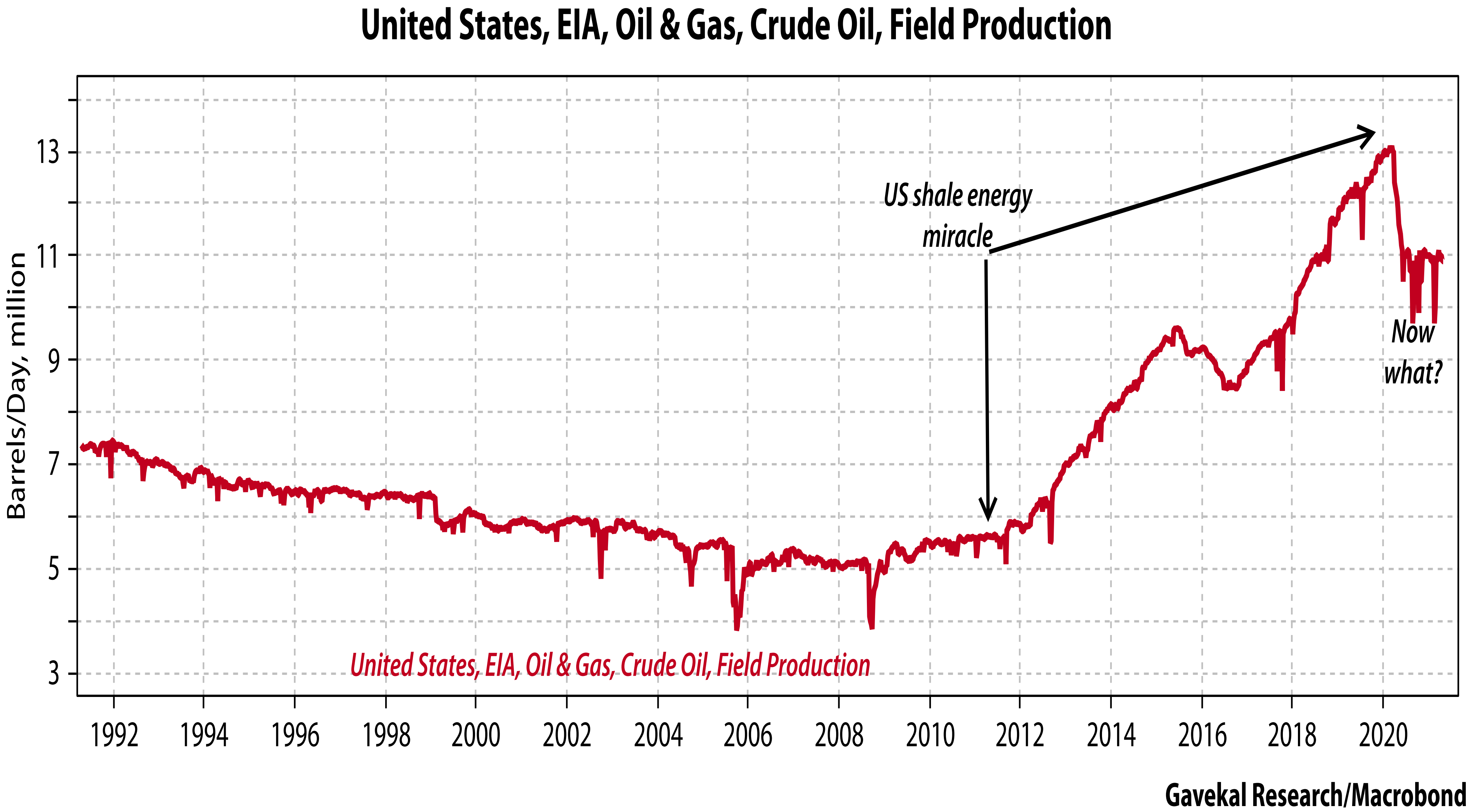
- Most economic activity is transformed energy of one sort or another.

- The past 200 years have really been about man moving from less efficient energy (wood, whale oil…) to more efficient energy (coal, then oil, then natural gas, then nuclear…). We are now trying to transition away from carbon to renewables.

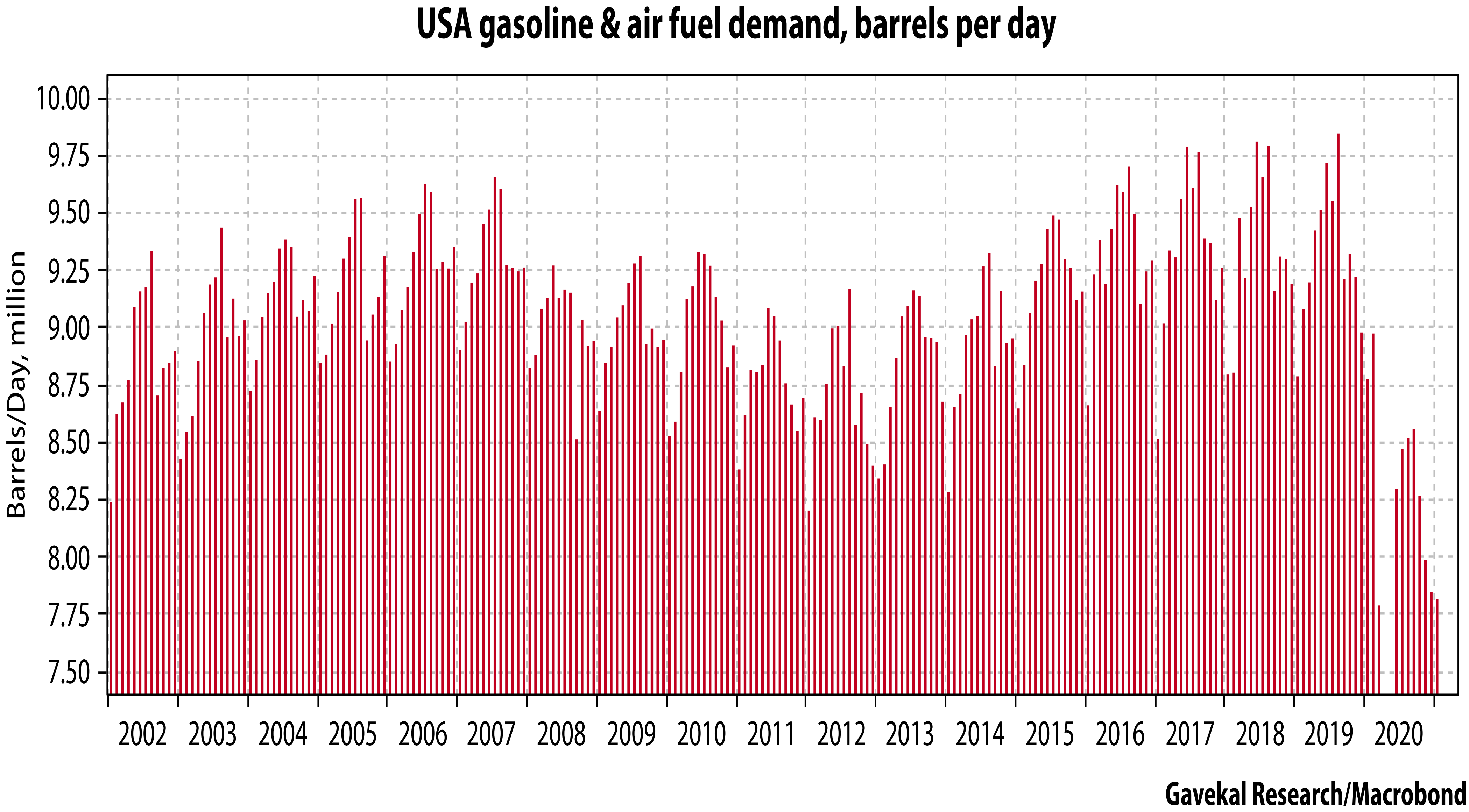
- Will this boost, or crush, productivity over the long-term?

- Over the short-term, could under-investment in carbon create price issues?

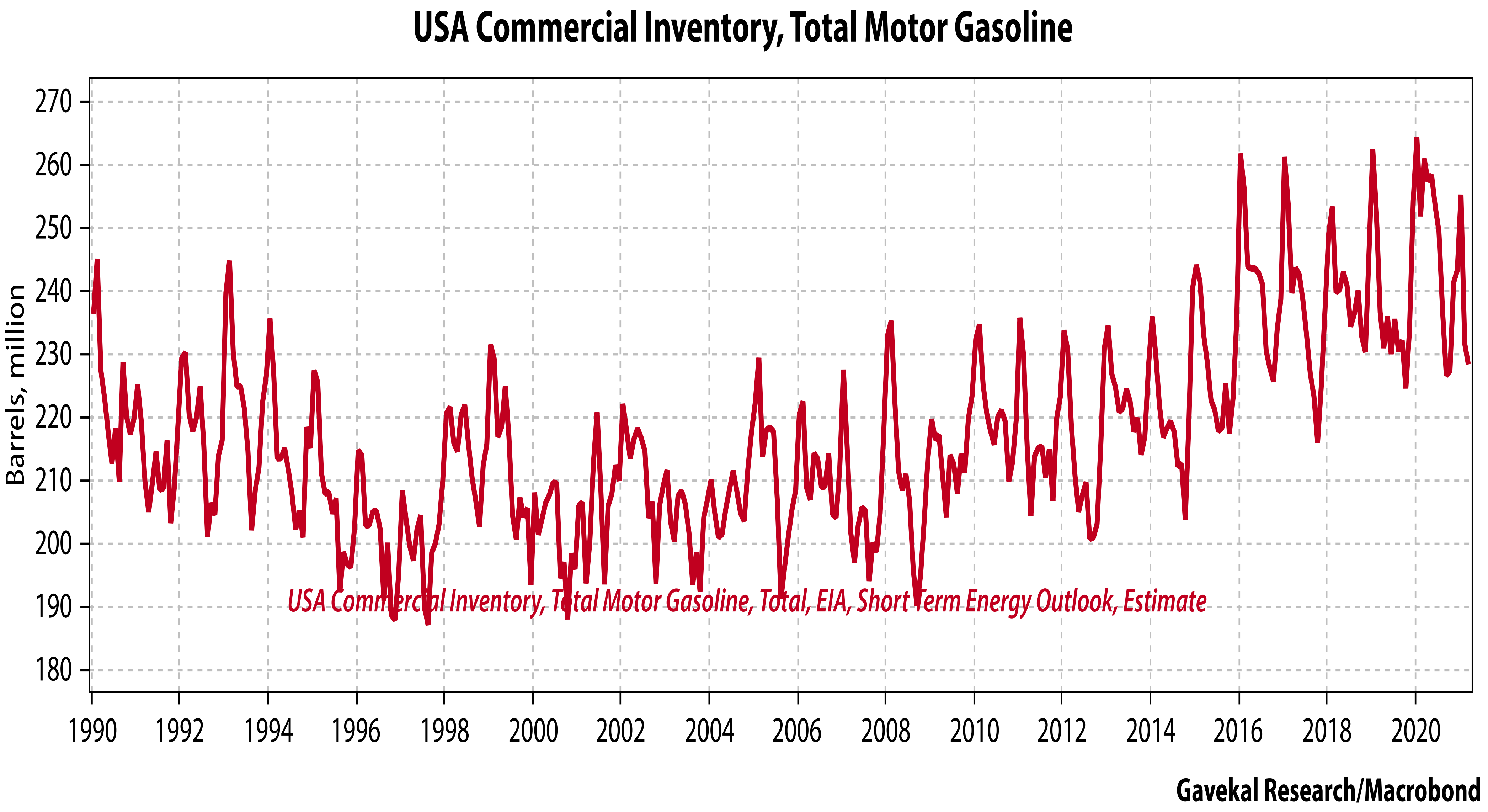
Will US oil production bounce back?



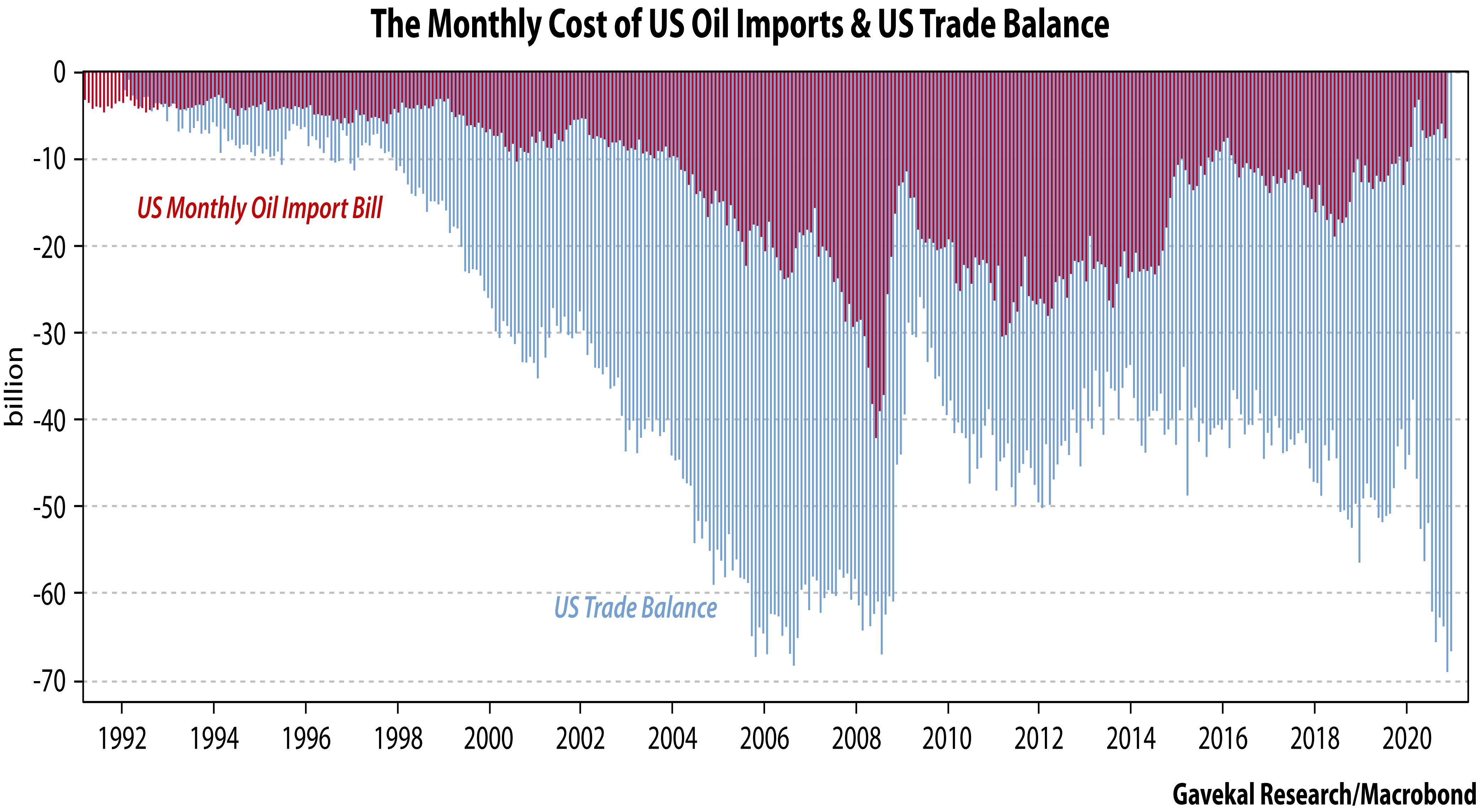
This summer's US driving season likely to break all records



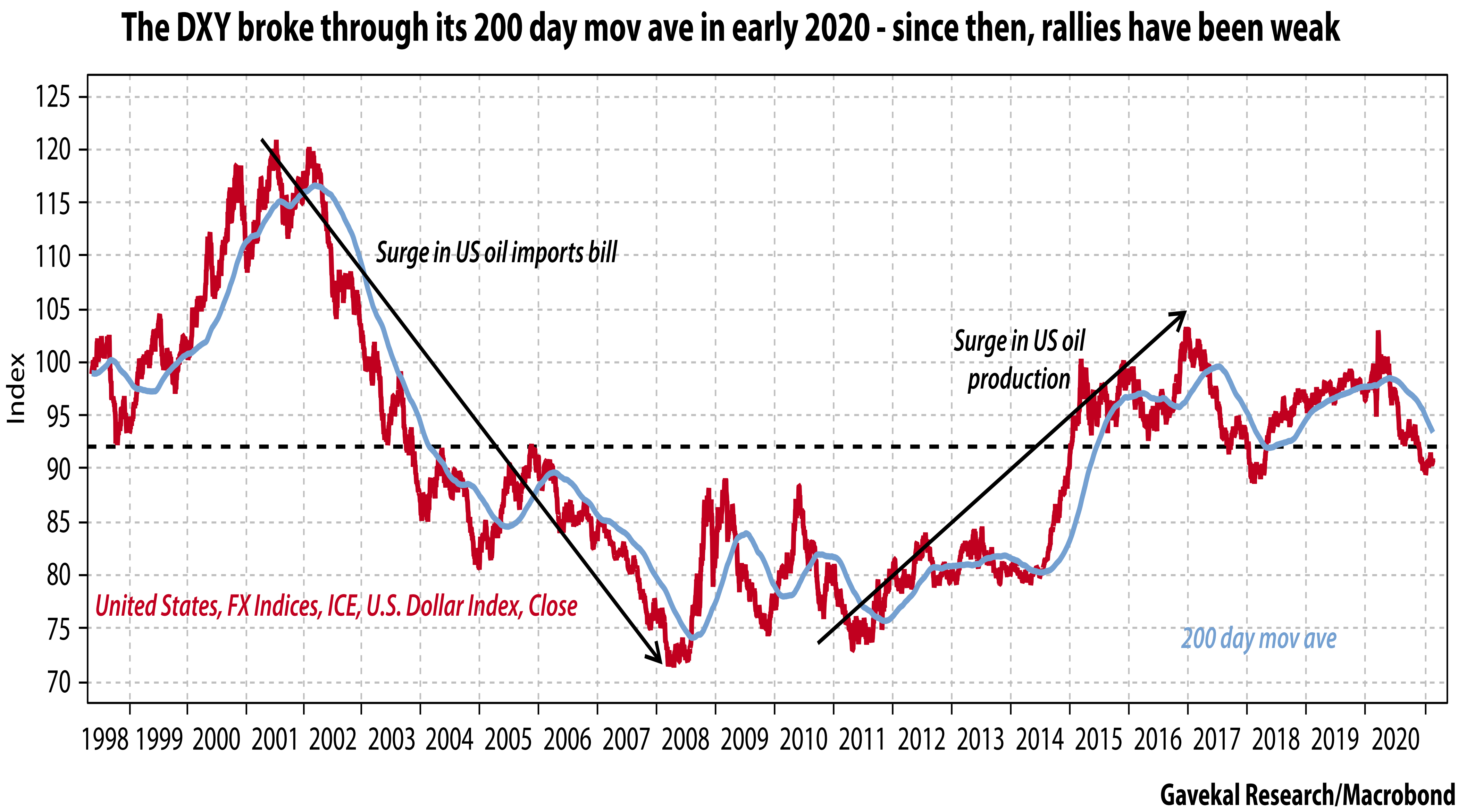
Inventories are not as high as one might expect



If oil shoots up, the US trade balance is likely to deteriorate further



And if so, where will the new petro-dollars be recycled?



In the short term, oil is likely to keep rising. Perhaps in long-term as well

Will US have a strong driving season?

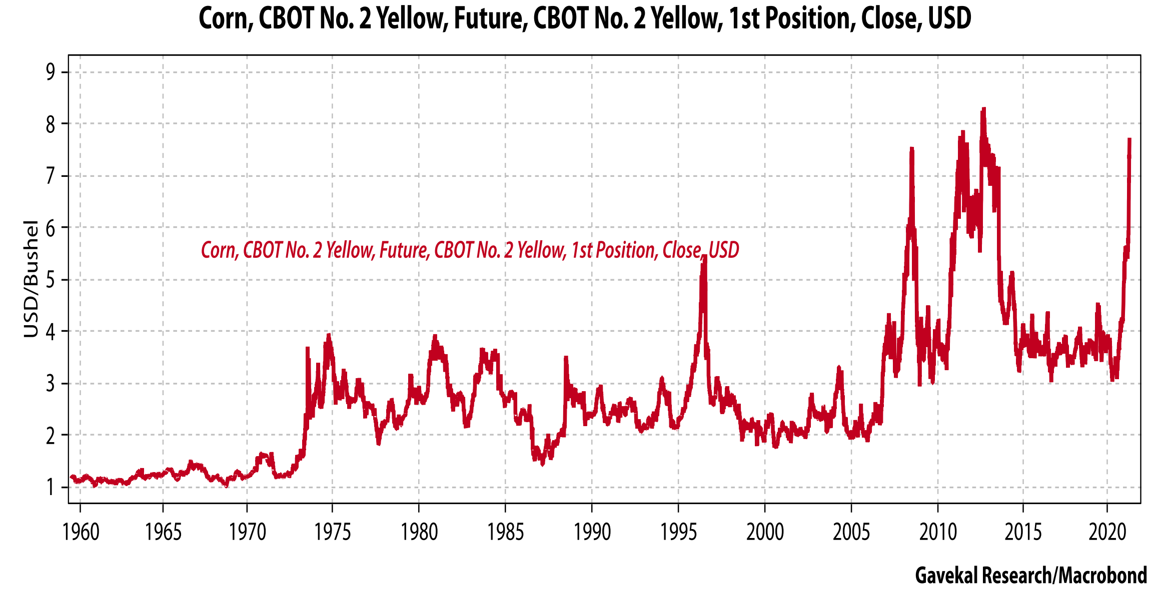
YES

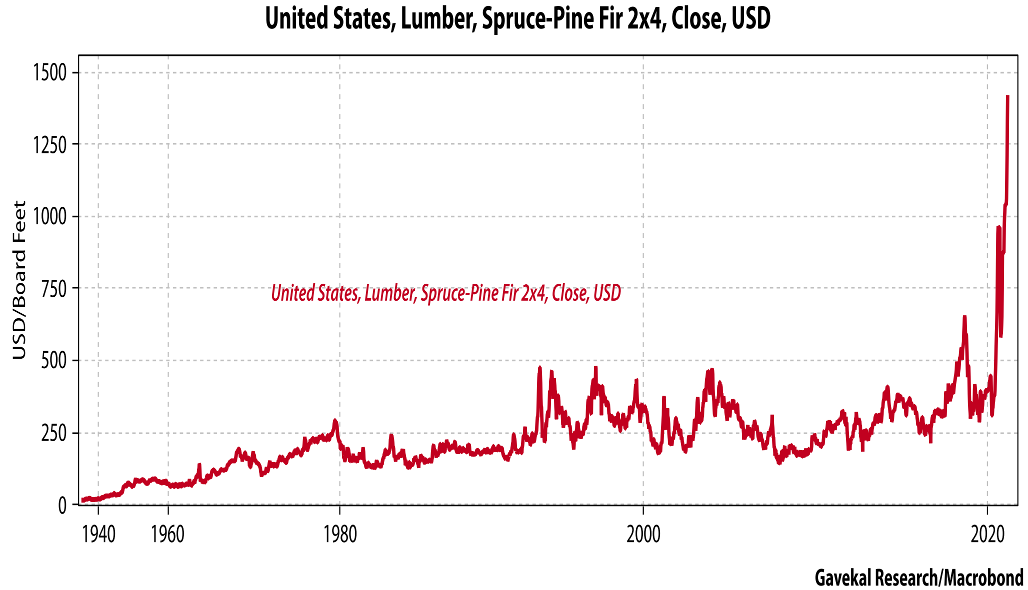
- Oil prices likely to break out on the upside (especially if while US goes driving, we also have Europe re-opening + India stimulus kicking in).
- Energy stocks to continue outperforming
- Yield curves to steepen further
- US$ to go down, most likely against RMB (where petro-dollars will be recycled)

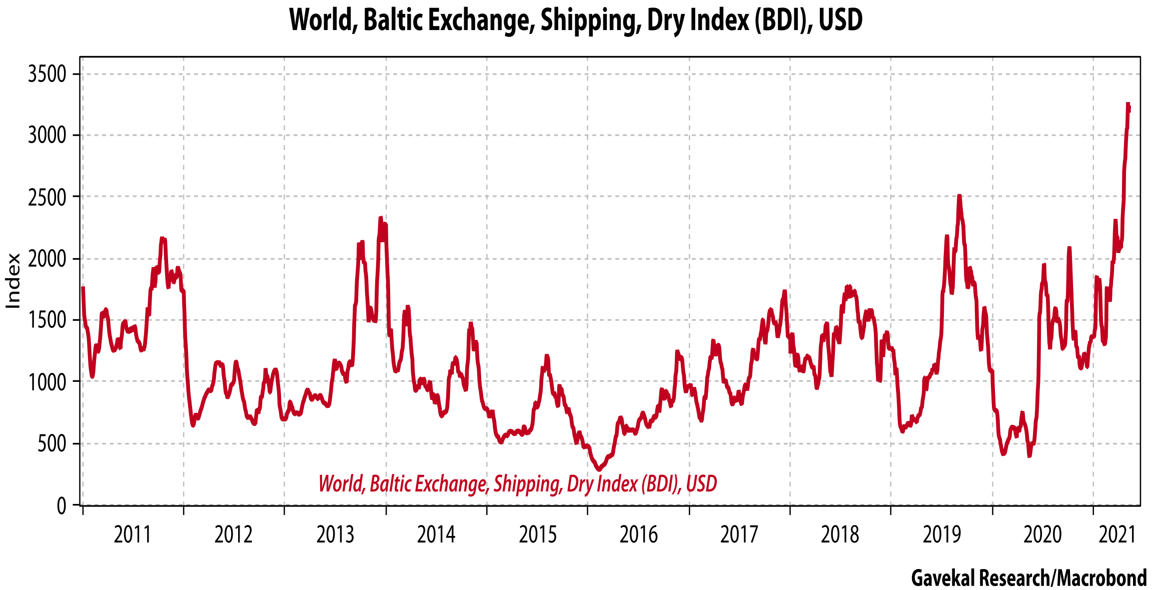
NO

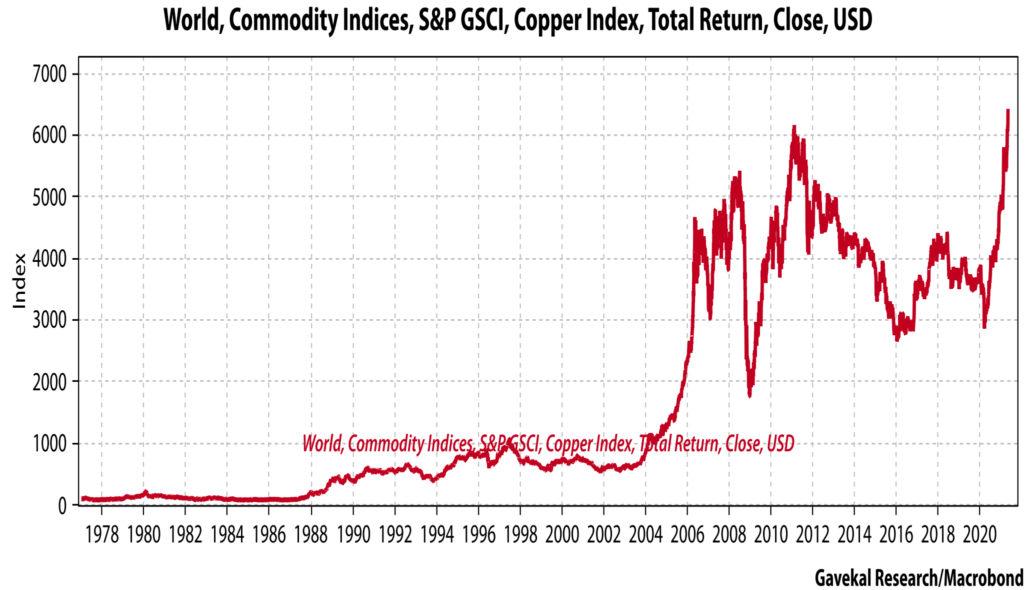
- Energy prices roll over/energy underperforms
- Yield curve flattens out
- EM/financials/commodities struggle
- US growth stocks outperform

Beyond oil, what happens to other commodities?



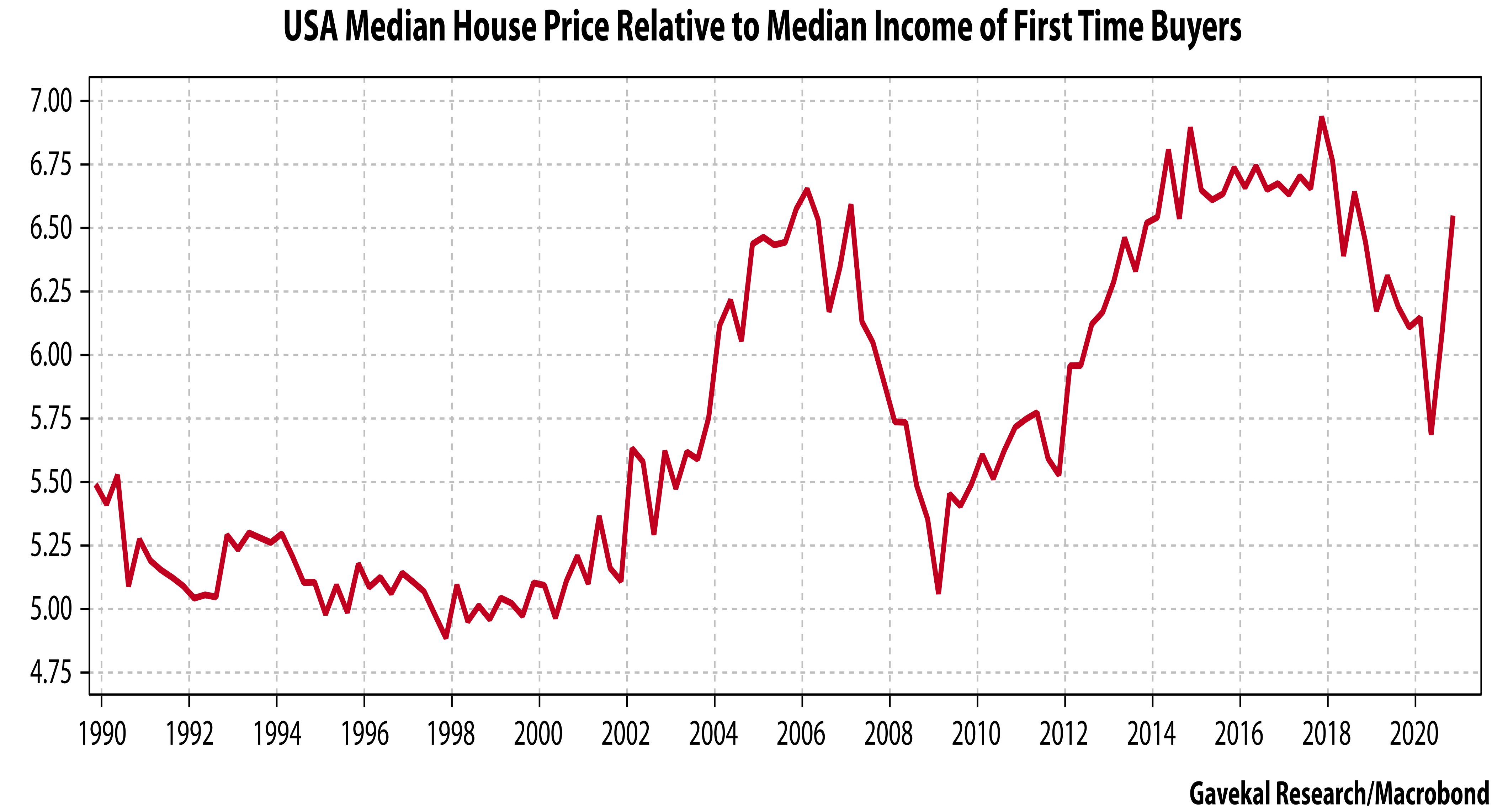




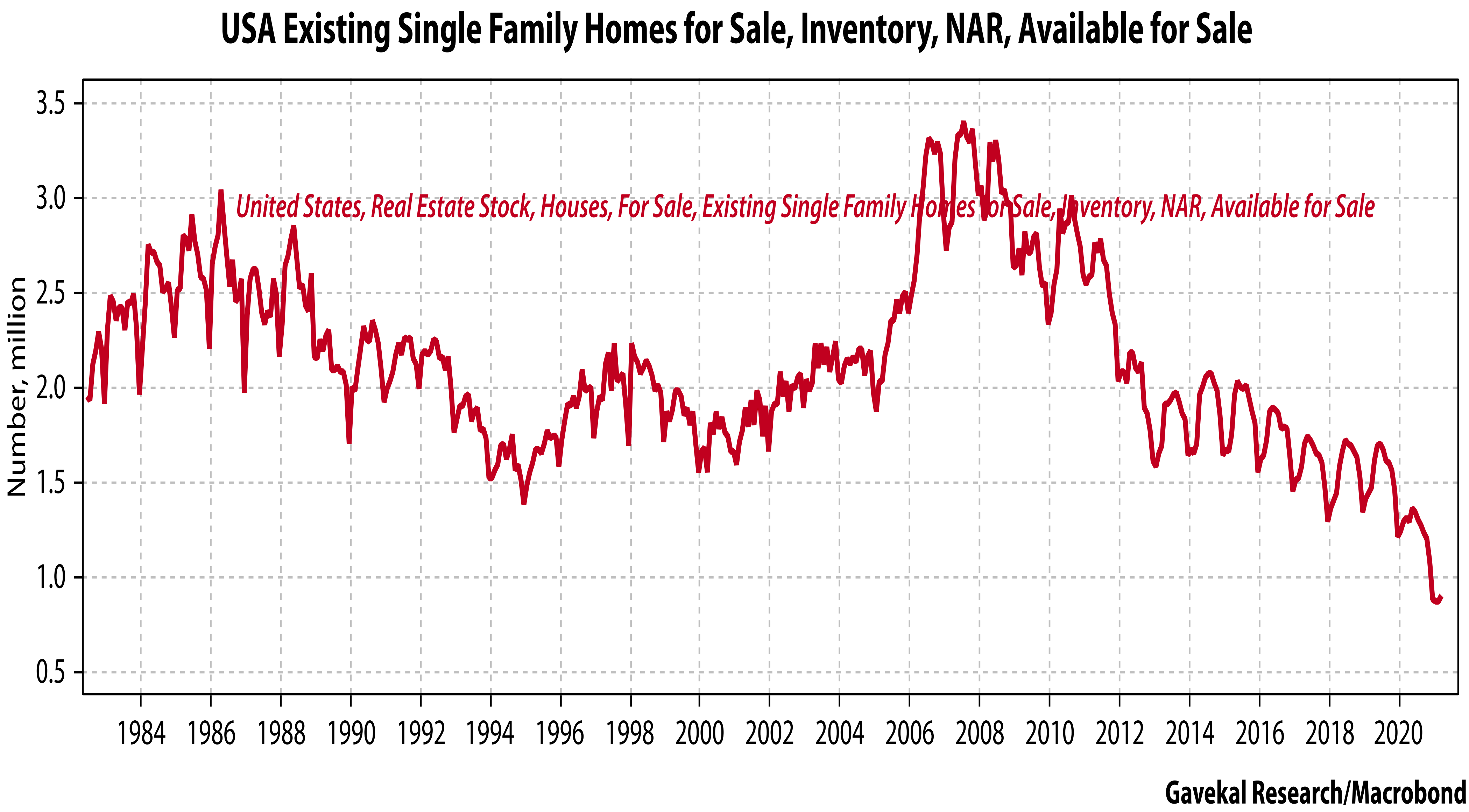


As commodity prices rise, what happens to housing?

USA homes are back to being expensive



But unlike in 2006-08, there is no inventory available



The picture on residential housing points towards higher prices

Will real estate become ever more un-affordable

YES

Then wages will have to rise

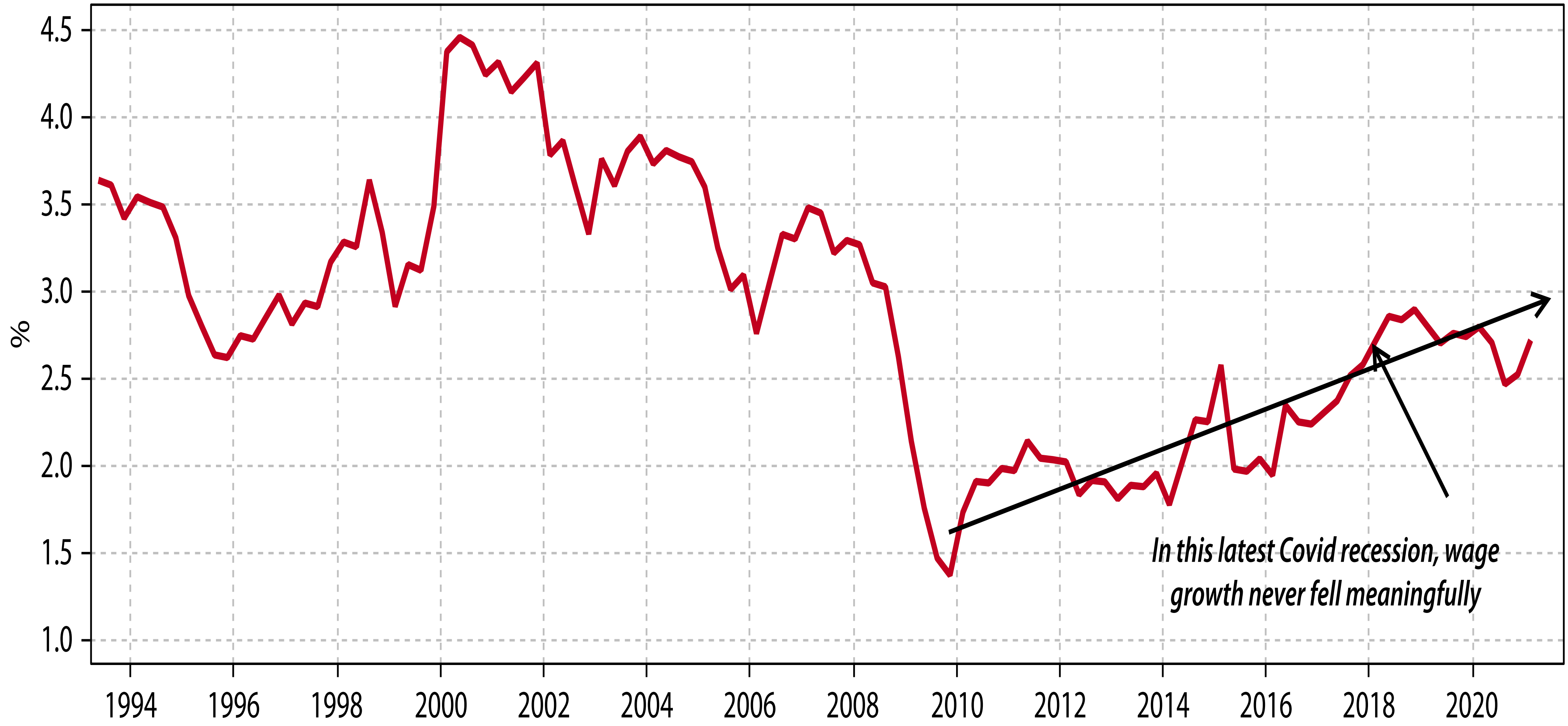
NO

Why wouldn't they? Construction costs are rapidly rising, material costs are through the roof, there is no inventory to speak of and the Fed continues to promise low interest rates?

The labor market unknown

The case for deflation is that wages remain in check

USA Employment Cost Index, Total Compensation, Civilian Workers, Total, YoY % Change



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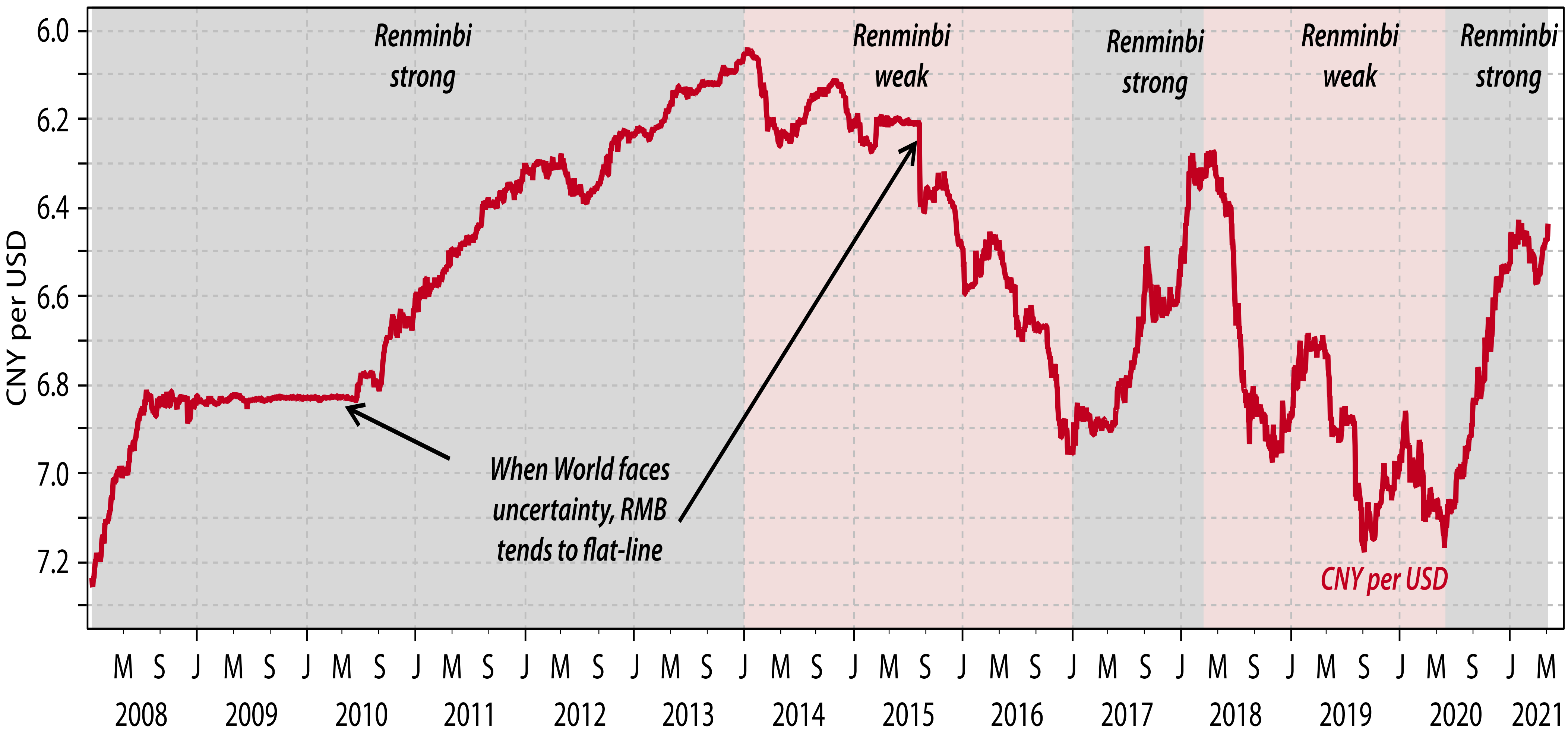
Rising RMB means that we won't trade in Western Workers for Chinese workers

Periods of renminbi strength and weakness since the financial crisis



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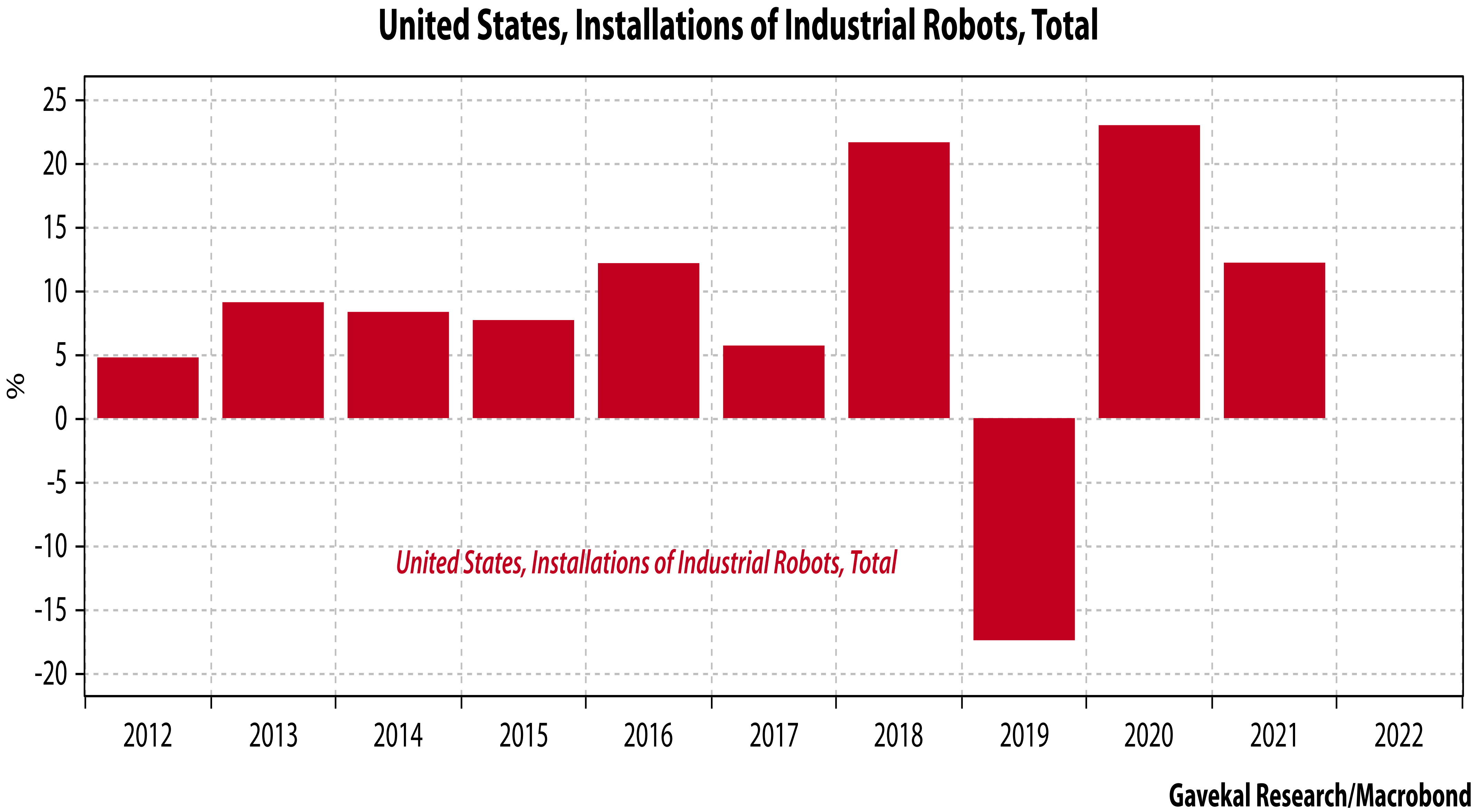
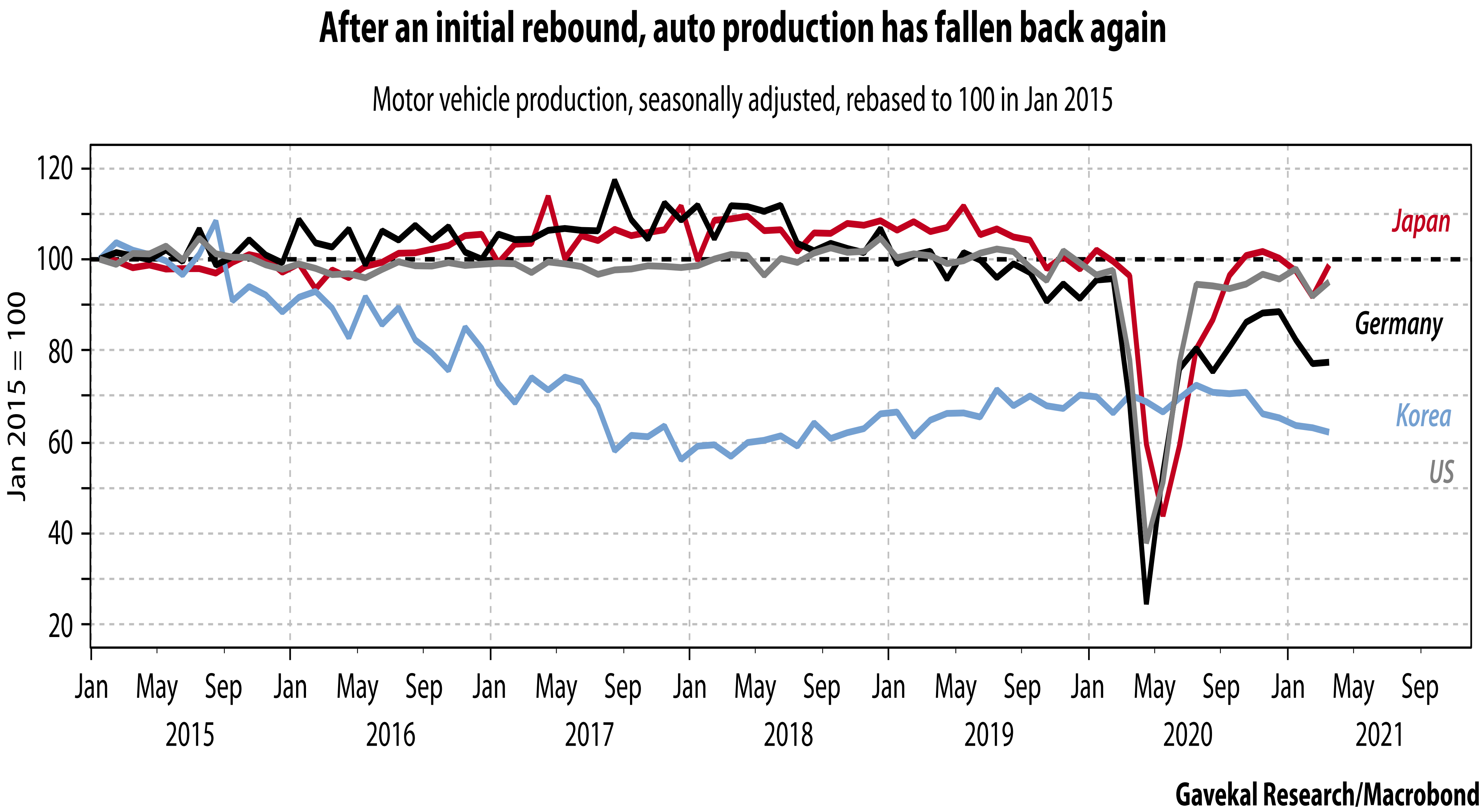
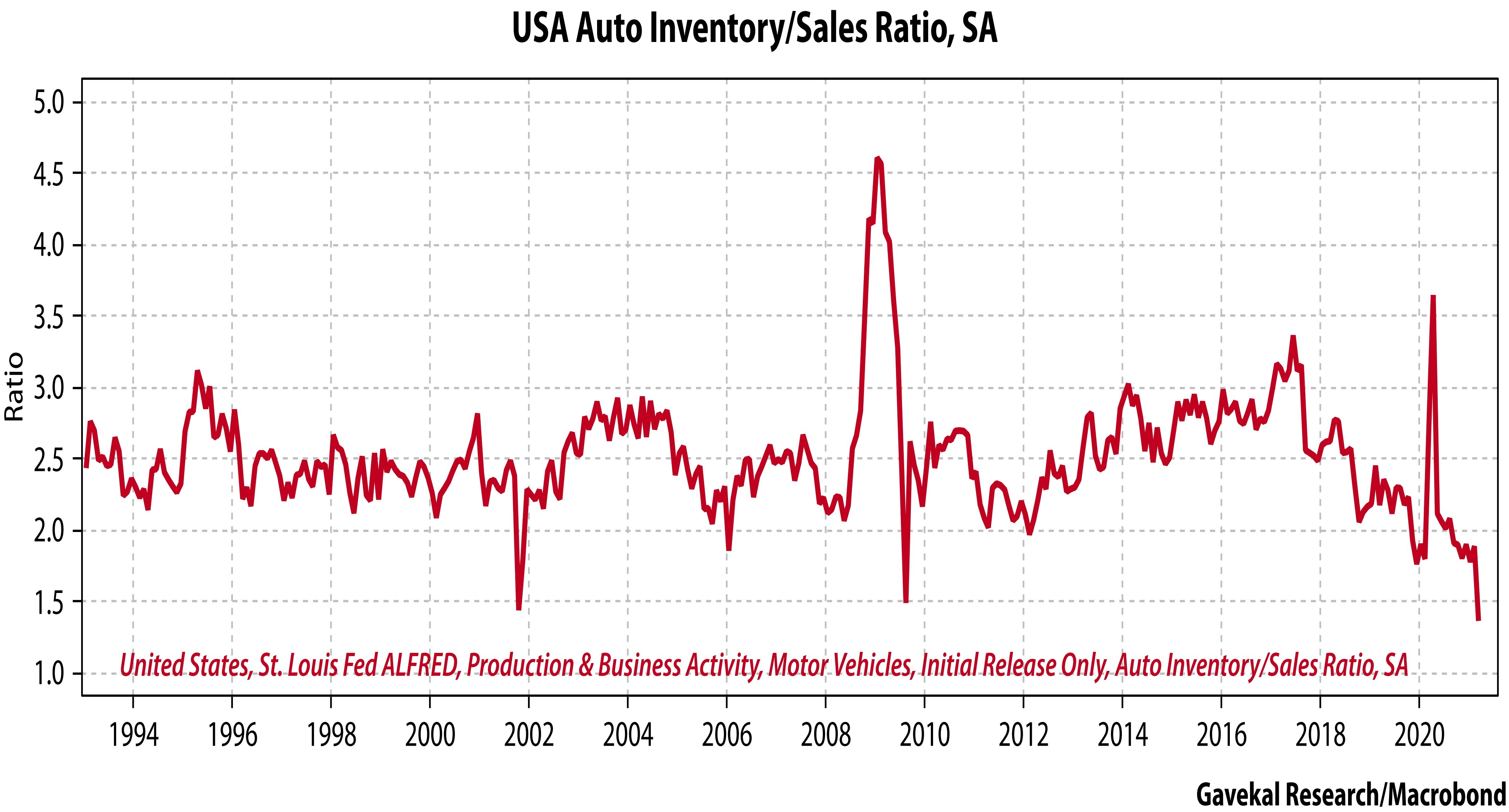
A world with no semiconductors = a world without robot competition?



The semiconductor shortage has come in at an unfortunate time



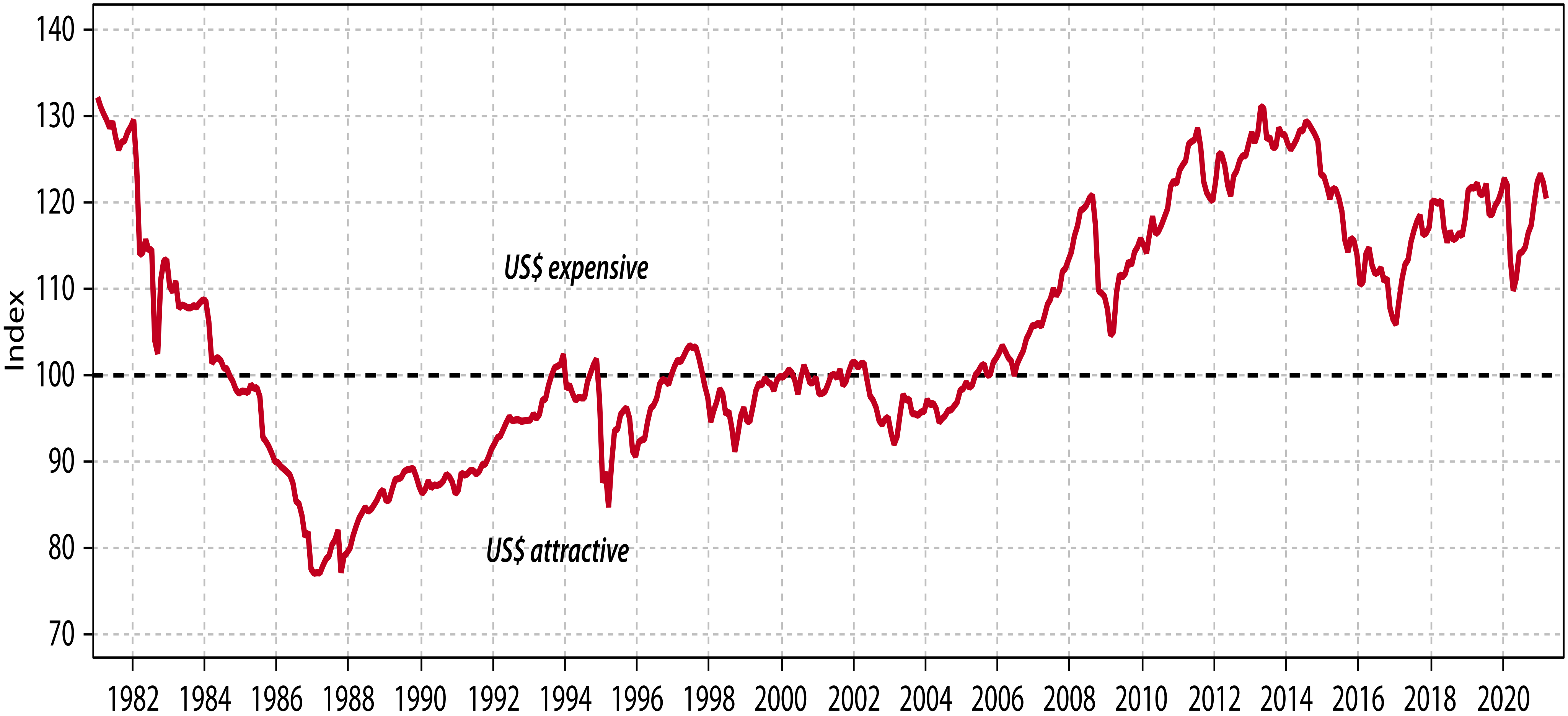
Hopefully, your teenager doesn't crash your car this summer…



A reverse Asian Crisis?

Could we witness a 'reverse' Asian Crisis?

Emerging Markets FX Indices, CPI-Based Exchange Rate Index



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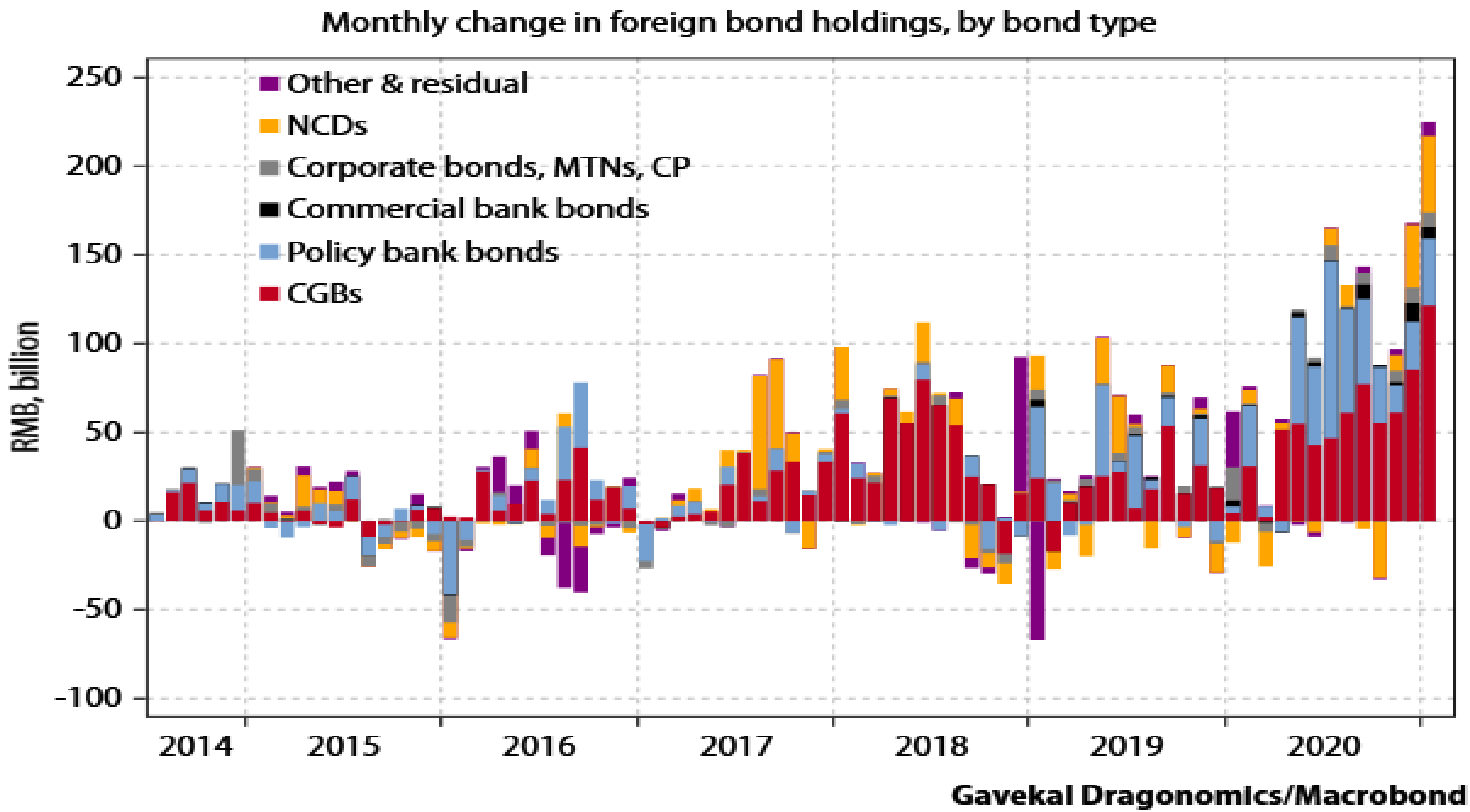
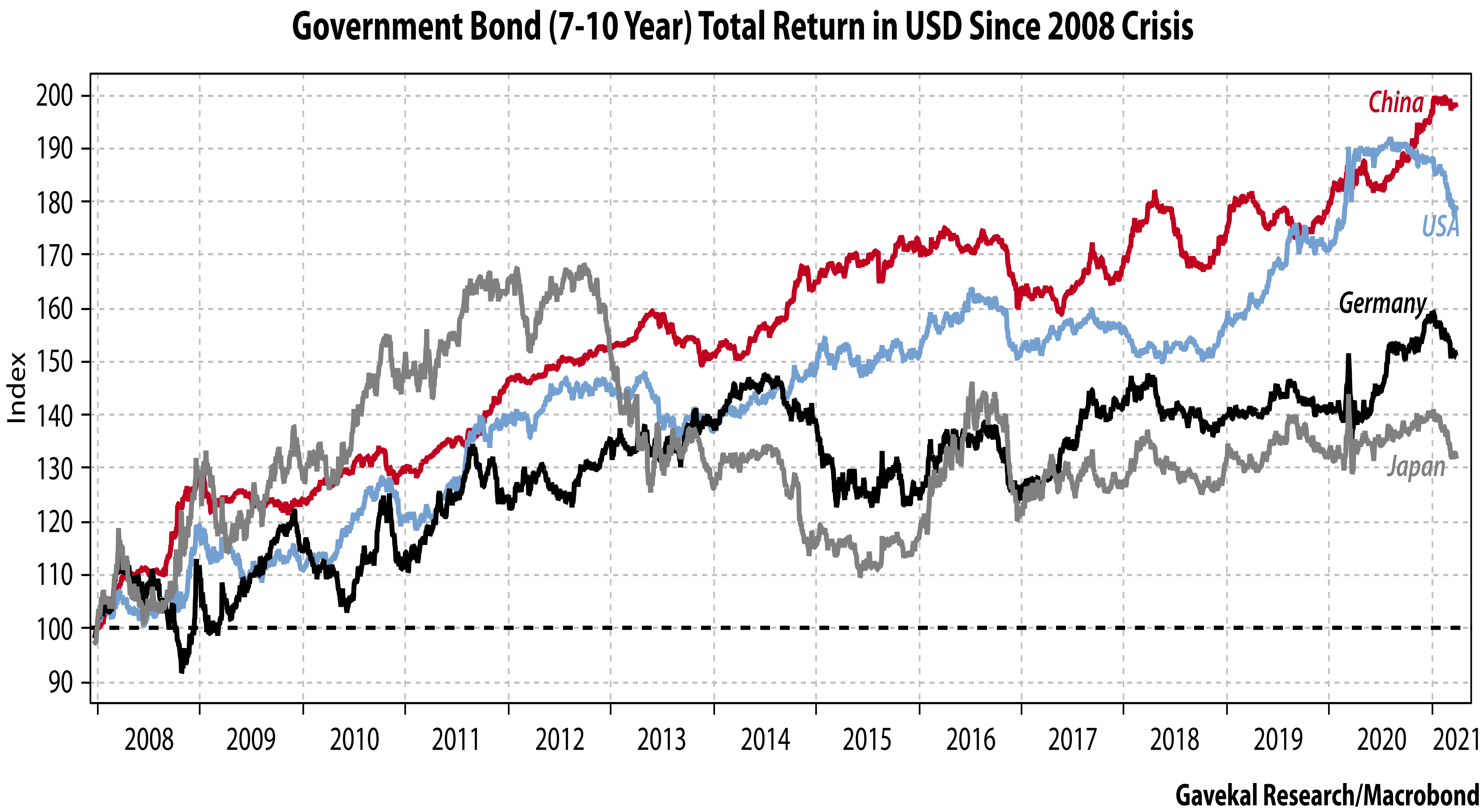
Foreign money is pouring into Chinese fixed income



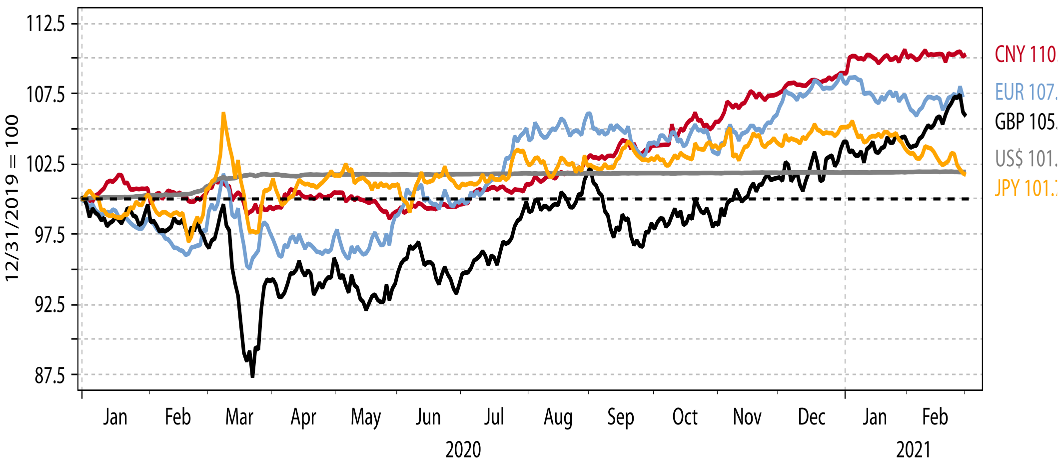
Because returns have been good



Because the RMB has been the world's strongest major currency

The renminbi is the best performing major currency since the start of the pandemic

Total return on 1y T-bills or equivalent, in US$ terms



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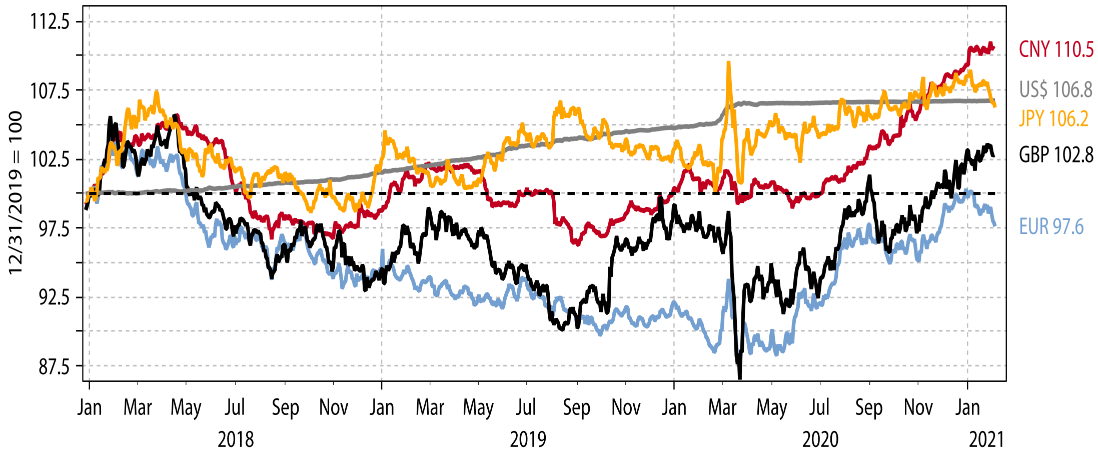
RMB is best performer over past three years

Total return on 1y T-bills or equivalent, in US$ terms



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RMB is best performer over past five years

Total return on 1y T-bills or equivalent, in US$ terms

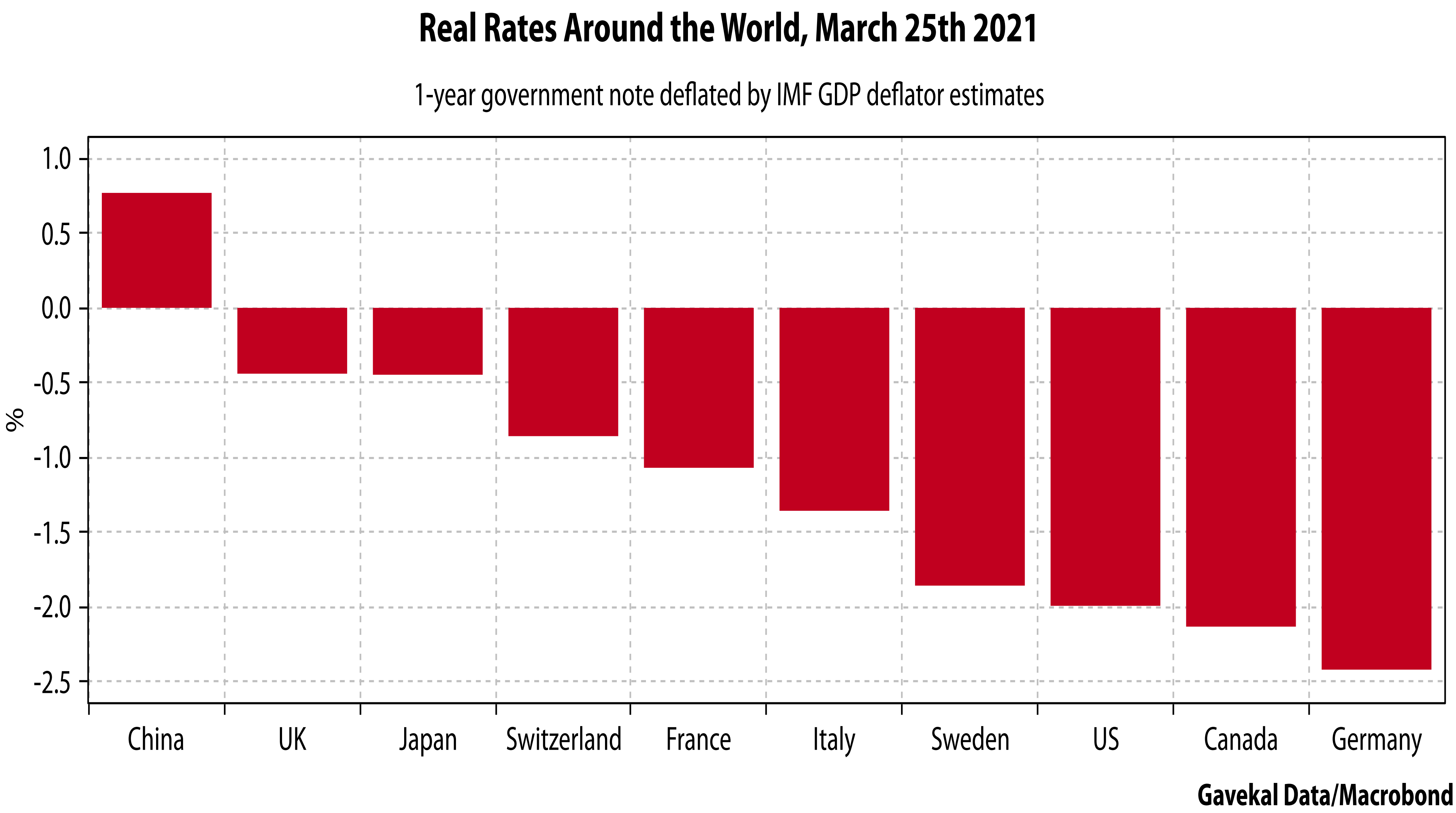
Gavekal Research/Macrobond

RMB is best performer over past ten years

Total return on 1y T-bills or equivalent, in US$ terms

Gavekal Research/Macrobond

And because China is only major market offering positive real rates



Combine that with record trade surpluses of US$50~US$70bn a month

And we are left with all important question: where will Chinese money go?

How will China recycle its large currency inflows?

- Buy US Treasuries? → Unlikely
- Buy Commodities → Bullish commodities, Bearish US$, Bearish Bonds
- Allow RMB to appreciate → Bullish global growth, Higher inflation, Buy Emerging Markets, Buy Industrials
- Buy foreign assets → Bullish EM
- Buy gold → Maybe?

The West vs East policy split has broad investment repercussions

Western World	Asia (and most EM)
Easy money	Mild tightening of monetary policy
Easy fiscal	Tighter fiscal & regulatory policies
Steeper yield curves	Flatter yield curves
Weak currencies	Strong currencies
Accelerating inflation	Inflation in check (thanks to strong FX)
Buy: Residential, Hotels	Buy: Logistics, Commercial, Offices

Where will the deflation come from?

Where will the deflation come from?

- In a world in which we have:

a) rising energy prices,
b) rising food prices,
c) rising metal prices,
d) rising RMB exchange rate,
e) rising mortgage rates,
f) record low housing inventories
g) surging shipping rates,
g) surging lumber prices,
h) record low automobile inventories,
j) unprecedented shortages of semis
k) significant supply chain disruptions
& to top it all
j) Unprecedented easy money
k) Unprecedented levels of government spending

…. **should we worry about inflation**? Maybe? Or if not now, when?

- Alternatively, turning the question around: **where will the deflationary headwinds come from to negate the above inflationary impulses**?

⇒**From Asset Prices?** That's 'bad deflation'. Central banks won't let it happen.

⇒**From Wages?** In today's political environment, that would be dangerous.

⇒**From Tremendous Productivity Gains?** On the back of what investments?

What have the romans ever done for us?

Apart from the sanitation, medicine, education, wine, public order, irrigation, roads, the fresh water system and public health… what have the romans ever done for us?

My beliefs

1. We have moved from a world of weaker RMB, falling yields, falling oil and stronger US$ to a world of rising RMB, rising yields, rising energy prices and weaker US$. ***In other words, the investment environment has been turned on its head.***

2. **Have portfolios adjusted to this new reality? In such a short period of time?** It seems unlikely.

3. **Western central banks may soon have to decide** between allowing yields to rise (Buy financials) or capping yields and sacrificing their currencies (buy gold, buy Asian currencies).

4. **One key question is whether equities and US treasuries will remain negatively correlated**? Given the likely break-out in inflation, this seems unlikely. Bonds are a dangerous asset class and should only be owned in the stronger currencies (i.e.: RMB, KRW, RUB, AUD, CAD…).

5. **The unfolding US$ bear market** should unleash a period of outperformance for emerging markets, for commodities and for value.

Portfolio Construction

A portfolio, like a team, needs assets that do different things at different times

Building a portfolio like a rugby team

Anti-Fragile | Contrarian | Anti-Fragile — *Front-Row*

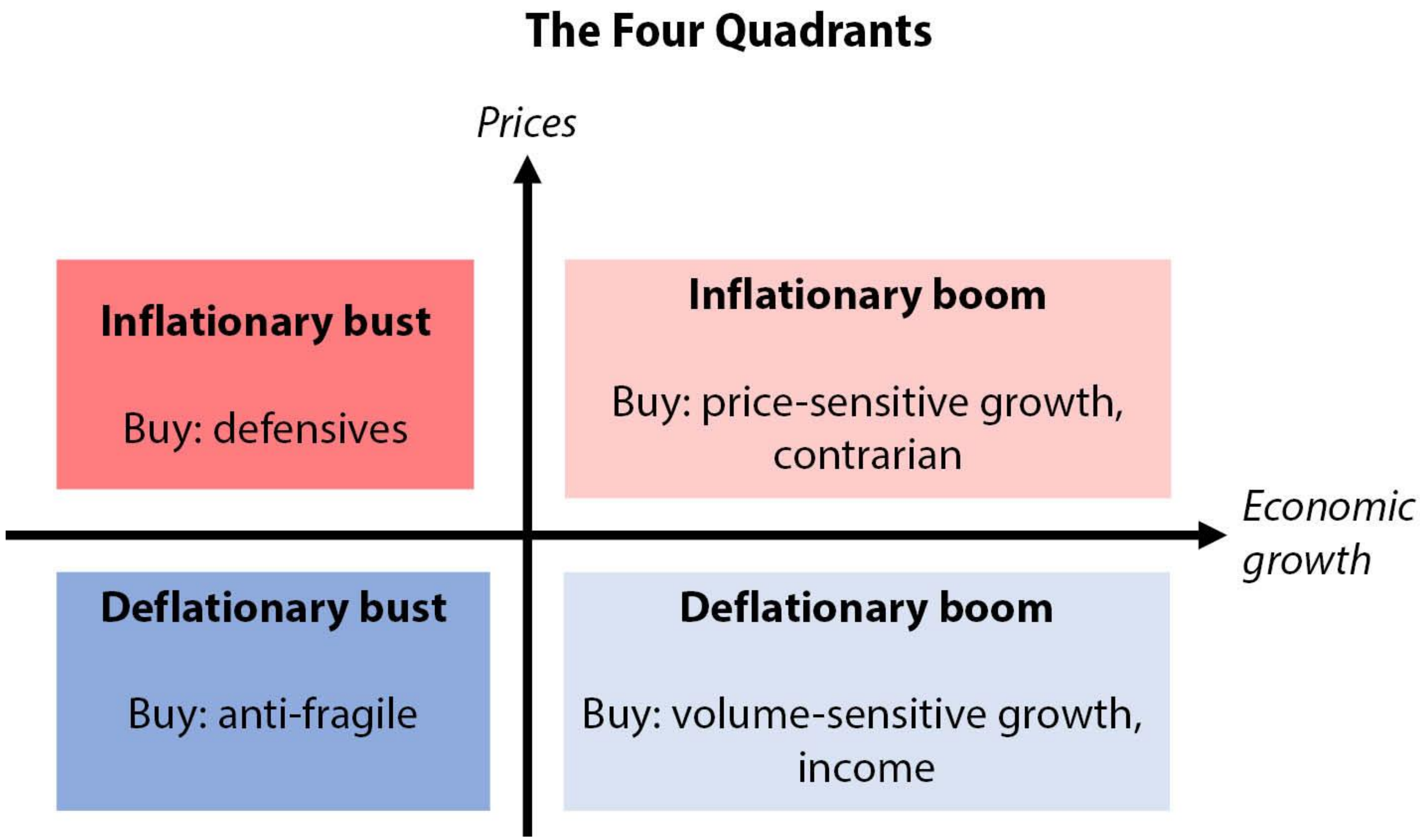
Income | Income — *Second-Row*

Defensive | Defensive | Defensive — *Flankers*

Price Sensitive | Price Sensitive — *Half-backs*

Volume Sensitive | Volume Sensitive | Volume Sensitive | Volume Sensitive | Volume Sensitive — *Players that either drop the ball, kick the ball, or otherwise profit from the work of others*

The weather road-map



The important inflation cross-road

	Deflationary Environment	Inflationary Environment
Contrarian	- USD - US Treasuries - German Bunds	- EM Financials - Re-Opening Plays (casinos, airports, airlines, cruise ships…)
Income-Producing	- US Real Estate - US Corporate Debt	- Big Oil, MLPs - EM Bonds
Defensives	- Utilities - Big Pharma	- Food/Agricultural Commodities - Staples
Price-Sensitive Growth	- EM Real Estate	- Japan - Metals, Steel, Rare Earths
Volume-Sensitive Growth	- Software, Cloud, E-Commerce, Fintech - Biotech	- EM Consumer - Video Games - Semiconductors
Anti-Fragile	- Big Tech, Green Energy - JPY, CHF	- Chinese/Asian Gov Bonds - AUD, NZD, NOK, CAD - Gold, Silver

Contact and disclaimer

Thank you!

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