16 November 2020

Of men and mice and some things nice

The investment message below is that we are long equities. Not forever. But for now. And we prefer cyclical sectors over the FAANGs.

We remain neutral on the major currencies. We closed our long euro position on 10 October (see our report *Shifting currency gears*) and removed our short EM currency positions following the US election, *Sorting husks from chaff*, 7 November.

The scenarios depicted here point to everything that is good for equities being bad for bonds. And vice versa. So negative bond/equity correlations are back. One provides a diversification for the risk of the other. We have retained gold as a risk hedge too. That is worth bearing in mind when you consider the binary, time-limited nature of the events to come.

There are reasons to be both optimistic and pessimistic. What are the tenets of the optimistic outlook?

Policy

President Biden is likely to turn out a lot better than most give him credit for. That has been my view since we called for a Biden victory on 23 October (*Dodging Icebergs*). I hold that view more firmly today. The Gotham City antics of the dying Republican administration are more likely to legitimise the incoming regime's mandate than undermine it, at least among those who accept democracy and civic society. That mandate will be enhanced by the appointment of diverse and competent people to the executive surrounding Biden. But, alas, the polarisation and extremism of US society will deepen as Trump sets himself up as "the real President (in opposition)" fanning the flames of extremism and dissent.

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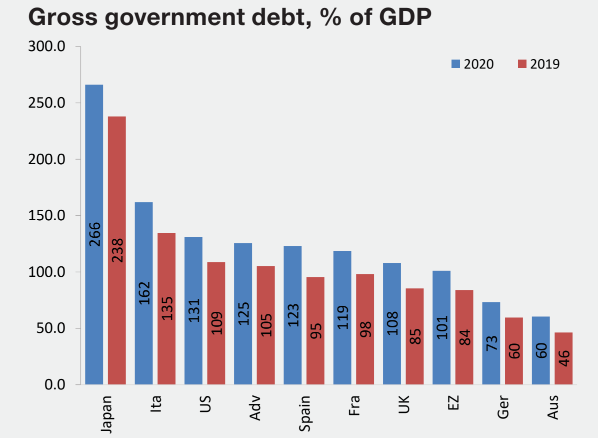

Figure 1. *Source: IMF Fiscal Monitor, Independent Strategy*

I expect just enough, but not too much, Covid stimulus from the Biden administration. This is just as well as the US fiscal deficit and sovereign debt load is already at extreme levels, even compared to the US's peers (Figure 1). The Fed will continue to play ball. Even if the Democrats end up winning control of the Senate (by gaining the two seats being contested in Georgia on 5 January) I doubt that this will herald the advent of market unfriendly policies. The political rhetoric likening the Democrats' tax policy to the most terrible socialist regimes is exactly that — rhetoric.

In general, the policy porridge will be neither too hot nor too cold.

The return to a constructive global policy on Europe, Iran, and even an attempt to reset policy with China (ultimately doomed to fail) will be seen as positives by markets. But most of all, markets will like the renaissance of international trade agreements and a cessation of hostilities between the US and its trading partners. This is why we took off our EM shorts last week.

Covid vaccines

The likelihood of an effective Covid-19 vaccine (*Covid — deus ex laboratorium*, 13 November) producing something close to global herd immunity in 2021 is the second pillar of optimism. There are many risks on the way. The pressure on pharmaceutical companies and researchers to produce results can raise the dangers inherent in the development and approval processes and mass production of vaccines. It also is already leading to hype and wild hope. But, as we pointed out in our report, it is feasible to think of mass inoculation and achievement of credible herd immunity if a handful of the current 200 vaccines under development were to prove effective and could be mass produced and distributed.

But, we have to get to the post-Covid economy first. While salvation might be on the way, the pandemic continues and is likely to get worse before it gets better. Global daily new infections and fatalities are running at 600-700,000 cases and 8-10,000 deaths per day. Both are at, or just below, all-time peaks. The 7-day R0 rate (the number of people infected by each infected person) in Europe is up from 1.33 to 1.98 in the most recent seven-day period and is hovering around 1.58 globally. The markets may continue to be relatively indifferent to this, as long as there is hope of a vaccine. But this would change if the northern hemisphere winter was to make death rates jump again, because the current relatively low fatality rate increased marginally. For example, a rise of 0.5% pts in the proportion of new case fatalities would increase global daily deaths by a quarter. This is one to watch.

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There is no doubt that Covid-19 acts as a lid on the pressure cooker of the world economy. And that if it was removed as a threat, output would be higher and happiness and thus animal spirits, the greater. Furthermore, those economic sectors that have suffered the most from Covid (the unequal victims) would benefit most. The service industries (think hotels, restaurants, entertainment) would be outright winners. In sum, face-to-face services, the employers of the lower-skilled, would recover all their Covid losses … and then some.

Then extrapolate this globally! The worst-affected by Covid have been poor and middle-income countries. Not only were they hit hardest by the collapse in manufacturing, trade and tourism, but their populations were poorly equipped (with the necessary devices and infrastructure) that could have allowed them to work at home, if there were any work to do.

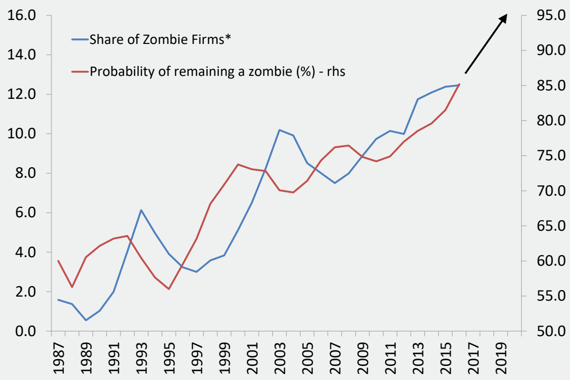
This is a scenario of reintegration into the world economy of those whom Covid banished. It is hard not to imagine that this would benefit the world politically, in terms of wealth creation, output and demand growth, and of course corporate profits.

This may seem like gushing optimism from one melancholic by nature. But it is only one side of the story.

Pessimism has not vanished — watch for these

There are plenty of reasons to circumscribe such an ode to joy. First, comes the shape of the post-Covid economy. All of what is described above will tighten supply and demand and make a return to "normalised" monetary policy a "must". But the "must" may not be enough to make normalisation of monetary policy happen, because of the debt levels incurred by governments (and corporations) during the crisis. These debts would be unsustainable if interest rates ever reflected fundamentals such as default risk, or even rose enough to match the recovering economic cycle. The result makes it likely that central banks will sustain excessively low short-term interest rates. But that will not utterly rule out rising long-term rates, which the central banks will be powerless to stop completely.

Share of firms defined as "Zombie"*, %



*Firms with an interest coverage ratio less than one for three consecutive years and over 10 years old

Figure 2. *Source: BIS, Independent Strategy*

Down the road, meaning after 12 months, it is likely that inflationary risks will rise as a result of overly-loose monetary policy, closing output gaps and the end of globalisation (which made things cheaper for decades).

And there is another factor that will both limit supply growth and has the potential to raise inflation after a time. The subsidised credit that the state and central banks ladled into the corporate sector during the Covid epidemic has created a new stock of zombie corporations, on

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top of the elevated existing stack (Figure 2, page 3). Their zombification is made more permanent by the fact that Covid changes demand patterns permanently. These firms will not see their markets return to normal. Zombification, which looks like accounting for 40% of the corporate sector once this all washes through (according to the BIS), is not only a tax on productivity and supply but can boost inflation too.

The nature of the Biden administration

To define the mammoth task Biden faces: it is to heal the polarisation of US society — a process that has been underway for a generation. This is a task that will take decades. Trump grew vegetable-like out of the dark soil of inequality, social discontent and discord in all its rotten forms. Trump didn't create the rot. He expressed it. Undoing it is more than just about replacing Trump. It is about a root and branch remaking of America. Without this, the US cannot lead the world. US economic prowess will wane. Its people will pay the price. So will the rest of us. I personally doubt very much that Biden has the vision, energy or time to achieve this herculean task. I hope I am wrong. But this means my optimism about the market reaction to the new Biden administration is not a long-term thing.

China

Doubtless the Biden administration will try to reset relations with China. But after an initial honeymoon and some permanent improvement in language, it will be a Grand Old Duke of York operation — marching his troops up the hill and then back down again.

There are sound reasons to think so. The Democrats dislike the Chinese Communist Party (CCP) administration as much as the Republicans. So, to "ease up" on China, Biden has to get something in return. Biden will offer to row back on tariffs (which rightly he doesn't think work) if China offers concessions on human rights, the CCP control of the economy, and militarism.

China will offer nothing on any of these fronts because it cannot. The current crackdown on China's hi-tech and social media mega corporations — from Ant to Alibaba and beyond — is intended to eliminate an alternative power centre to the CCP. These companies, and their leaders, were becoming a potentially uncontrollable alternative seat of power. So much for free markets!

But the real message is how vulnerable and weak the Chinese leadership feels itself to be, for it to attack the Golden Goose upon which it economically depends. One does not have to look in Hong Kong's new political system to understand that Xi Jinping is out to eliminate all opposition to the CCP utterly. As part of the process of self-legitimising, once one enemy is eliminated, Marxist parties always shift the target to the next real or imaginary enemy — domestically and internationally. That is one reason why Biden will be barking up a gum tree. China cannot offer meaningful concessions on human rights, the state-controlled economy or militarism, because to do so would weaken the CCP itself when it already feels under threat.

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An example illustrates why Biden cannot be seen to be soft on China. Trump issued an executive order on 12 November, prohibiting all US investment in Chinese companies deemed to be a "Communist Chinese Military Company" (purposely, the term is undefined and so as wide as a barn door). From 11 January next year, US investors will be prohibited from purchasing the securities of such companies and must divest their ownership by 11 November, 2021. The powers granted to the Treasury Department permits the use of all powers under the International Emergency Economic Powers Act. These include asset freezes and confiscations. This is a typically vague bit of US international coercion, worded to maximise the scope of its threat and make it riskier to undertake the widest possible range of business activities targeted.

Of course, this is an Executive Order which can be revoked by the next Executive. But under what circumstances? Biden cannot waltz into the White House and let "Chinese Communist Military Companies" start buying US sub-5nm chip-making equipment in return for nothing. No! Trump is setting up a poisoned chalice in this (and many other domains) which limits Biden's freedom of policy movement and helps set Trump up as the "Real President in Opposition", waiting in the wings to make America great again.

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