The Short, Medium And Long Term Outlook

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At the end of March, just after the collapse of global stock markets and non-dollar currencies had reached its climax, I argued that it was too early to buy equities but probably a good time to sell US dollars. The first of these ideas turned out to be wrong, the second irrelevant. In the month or so after global stock markets hit bottom on March 23 and the dollar spiked on March 20, the S&P 500 has gained 27%, while the dollar has hardly corrected at all—the DXY dollar index is now just -2.7% below its March high. Far from admitting defeat, I think it is worth doubling down on both these recommendations.

In the near term, it remains a coin toss whether lockdowns or stimulus will prevail

Tactically raising cash and moving it out of US dollars allows investors to watch from a safe distance while the immovable object of public health lockdowns and the irresistible force of fiscal stimulus collide. At present this is a totally unpredictable contest. Only when the outcome becomes clearer than a coin toss can investors make strategic plans for the years ahead. Nevertheless, some decisions have to be taken. To help with this process, I have suggested a three-part framework for thinking about how unprecedented economic collapse and unprecedented policy stimulus could affect financial markets (see **Covid-19, Markets And The Economy**). In my view, the post-Covid-19 investment world should be viewed over three distinct time horizons.

Market sentiment and asset valuations are increasingly out of touch with economic reality

The short term outlook over the next one to three months depends on the pandemic's development and, more, on government lockdown reactions. For global equities, these risks are tilted steeply to the downside. The collapse in economic data is not just unprecedented, but worse than almost anyone dared to predict just a month ago. Even more dangerous, the structural damage suffered by some of the fastest-growing sectors of the world economy, such as hospitality and aerospace, looks increasingly grave and long term. Meanwhile, asset values and market sentiment have rebounded from March's lows in a way that is completely disconnected from economic and financial reality—and from the prospects of an early return to economic normality, which now looks even more uncertain and distant than a few weeks ago.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US Baker Hughes rig count (oil & gas) fell to 465 last week, from 529	N/A	US supply adjustment is happening; rig count down -42% YTD; prices remain weak
German IFO business sentiment index fell to 74.3 in Apr, from 85.9 in Mar	Below 79.8 expected; IFO expectations index fell to 69.4, from 79.5; both record lows	Even with lockdown restrictions beginning to ease, normality is distant; expect more stimulus
China's industrial profits fell -35% YoY, up from -38% in Jan-Feb	N/A; auto profits fell -80% YoY in 1Q; chemicals and metals fell -56%	Recovery slow; further YoY falls in profits likely, but pace likely to ease to -15% to -20% in 2Q
Russia cut benchmark rate by -50bp to 5.5%	As expected; CBR indicates more easing likely	Foreign reserve buffer allows room to undertake stimulus without undue pressure on RUB

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The robustness of retail investor sentiment can be seen in the AAII bull-bear spread, which never plumbed the depths of the bull-market corrections in 2010, 2013, 2016 and 2018. By last week it had bounced back to levels typical of the bull market's strongest phase from 2014 and 2017, before falling again on the negative oil price debacle. Other indicators of sentiment have also remained positive. US equity prices, which are higher today than they were in March 2019, seem to imply a rebound to 2019 profits by next year. And bottom-up earnings estimates for the S&P 500 are still down only -10% from 1Q19, with many active investment managers keen to buy the dip.

As a Keynesian, my hunch is that massive stimulus will ultimately propel a vigorous bounce-back...

As an unabashed Keynesian who instinctively believes that government demand management can always overcome supply side problems, I have some sympathy with this bullish market view. My hunch is that unprecedented fiscal stimulus, on a scale far bigger than any the world has seen before even in wartime, will ultimately win the tussle with unprecedented economic collapse, leading to a post-pandemic recovery stronger than the recovery that followed the 2008 financial crisis. If this happens, then a strategic shift to risk-on will certainly make sense sometime before the end of this year.

But the possibility of a V-shaped Keynesian recovery is only a hunch. These hopes have not been justified by any objective evidence. Instead, all the recent news, from dismal economic data and corporate results to hesitant government reopening plans and political and bureaucratic obstacles to fiscal stimulus programs, points to a further deterioration in financial conditions before there can be any credible expectations of improving prospects. In a rational world, this should mean equity prices retest their lows, and possibly fall a long way further.

...but markets appear to be pricing in that hunch with 100% certainty...

What then should we make of the market's bullish behavior? Current market pricing can only be explained by focusing on **the medium term outlook** and assuming with 100% certainty that the Keynesians (like me) will turn out to be right. If fiscal stimulus does prove as effective as I hope (but hope with no more than 50% confidence), then economic growth and corporate profits will surprise to the upside from next year onwards and a new, very powerful bull market should start around the turn of this year.

If this happens, equity prices will eventually soar well above their pre-virus peaks, as near-zero interest rates all the way along the yield curve force investors to attach ever-higher valuation multiples to recovering corporate cash flows. In this situation, the biggest winners will be the internet-related monopolies and nosebleed valuation growth stocks that were already the market's favorites before the virus—and my suggestion just before the virus struck that the post-2009 bull market would culminate in a 1999-style technology bubble might turn out to be have been less ridiculous than it seems today.

...which today appears wildly reckless

Crucially, however, any such bullish scenario will depend on US, European and Asian governments' stimulus measures being implemented without delay and working extremely efficiently. Sometime in the next three to six months, this may become a reasonable expectation. To put money on it today seems wildly reckless.

Finally, it may be useful to start thinking already about **the long-term investment risks** if the medium-term outlook turns out to be as positive as stock market bulls expect and ultra-Keynesians hope. The long-term risks of unprecedented monetary and fiscal stimulus are worrying for all investors but should be especially alarming for investors with significant exposure to supposedly "risk-free" government bonds.

Policymakers will force institutions to hold loss-making government bonds

To allow fiscal stimulus on the scale needed to generate a strong global economic recovery will mean suppressing interest rates to near-zero all the way along the yield curve to limit government debt-servicing costs. Central banks can achieve this for many years, especially if backed by regulations that force pension and insurance funds to buy government bonds even when these are guaranteed to lose money in real terms, and sometimes even in nominal terms.

But the combination of government debt monetization and regulatory financial repression leads inevitably to a day of reckoning for bond investors once central banks lose control of inflation and financial repression begins to break down—and to a consequent upheaval in business models for institutional investors. This is what happened in the late 1950s, when the 10-year US bond yield rose rapidly from 2.5% to 4.7%, before almost doubling again to 8% over the next decade.

The inevitable rise in inflation towards the end of the decade may not harm equities as much as it will hurt bonds

How much the upsurge of inflation and interest rates that seems inevitable by the end of this decade will hurt equities, property and other real-value assets is less clear. Rising bond yields could obviously compress equity multiples and increase property capitalization rates. On the other hand, an inflation-driven capital flight out of bonds into real-value assets could more than offset this valuation effect. This is what happened during the "cult of equities," which began in the late 1950s, when pension and insurance funds started to realize that bonds would never allow them to achieve their required investment returns, and went on to conclude that diversified portfolios of equities, property and other real assets actually entailed much less risk after inflation than supposedly "risk-free" bonds.

A similar shift in favor of real assets is near-certain in this decade, as negative real interest rates make the present "liability-driven" investment policies of insurance and pension funds completely unsustainable. Will a change in the business models of long term saving institutions be enough to sustain equities, property and other real-value investments when bond yields eventually start to catch up with rising inflation?

If policymakers' programs work, look for a return to the 1950s and 1960s

Today we do not need to answer this question, because it is far from clear that the world economy will recover as quickly and easily as the stock market assumes and Keynesian economists hope. But if these hopes and expectations do turn out to be valid, investment conditions for most of this decade are likely to resemble the 1950s and 1960s much more than the decades of monetarism and fiscal austerity that began around 1980 and ended 40 years later with the coronavirus shock.