Q2 2020

QUARTERLY OUTLOOK

By #SAXOSTRATS

A WORLD OUT OF BALANCE

SAXO GROUP

Q2 2020

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An unbalanced world, set to tilt from one extreme to another

By Steen Jakobsen

The COVID-19 coronavirus is the catalyst that reveals the fragility of our financial system and the global economy.

The virus outbreak has set three major macro impulses in motion: a global demand shock, a global supply shock and an oil war that has forced prices to multi-year lows. This final development will result in an enormous destruction of capital and, soon, structural unemployment.

In over 30 years of doing this job I have never seen three simultaneous blows to the economy. I am again reminded of 2008, where small events like BNP Paribas closing their high-yield fund, Bear Stearns closing redemptions on its hedge funds in 2007 and ultimately the failure of Lehman Brothers catapulted markets into a fitful, systemic meltdown that quickly disrupted the economic backdrop as well.

The markets were extremely difficult to trade in this period, just as it was difficult to comprehend all of the moving parts of the broader economic fallout. This current disruption has already eclipsed the 2008 chaos in some markets, as we suddenly find ourselves in a period in which some markets can move up and down more in one day than they did in an entire year. A bull and bear market can happen inside of a week. The behaviour of markets this year is completely without precedent and reflects how illiquid markets are after having suffered this triple whammy of shocks.

> **“In an environment of panic deleveraging, the ‘cash is king’ mantra arises”**

The volatility is a symptom of the worst-nightmare for traders and market makers: when prices become ‘discontinuous’, or gap viciously from one price to the next like an airliner hitting air-pockets. The bid-ask spread goes from some orderly path of 5-10, 6-11, 4-9 to something like a jump from 5-10 to 25-35 to 45 bid- but where is the offer? 70? 90? This tests trading systems on the chaos of inputs. But even more importantly, it forces many financial investors to deleverage as P&L swings become too violent and counterparties send out a flurry of margin calls.

In an environment of panic deleveraging, the ‘cash is king’ mantra arises. Funds, banks, investors and even companies suddenly see not only a dramatic mark-down

An unbalanced world, set to tilt from one extreme to another

of asset prices, but wild swings in correlations across portfolios and swings in P&L.

Central banks, meanwhile, try to move in quickly with 'support' in the form of rate cuts and liquidity provision. For a company or fund relying on credit for some portion of its operations, this may help in terms of the future cost of financing liabilities. But it does not help the price of the equity or credit on the asset side. Here, the 'crowded theatre with a small exit' metaphor applies, with everyone selling to deleverage across the board. And, often, that selling is of assets that are highly illiquid even in the best of times.

This cycle is even worse than past cycles because the current era of low and negative yields has seen a 'reach for yield' that forces market players further and further out on the risk curve and into super-illiquid financial assets such as private equity and high-risk corporate credit.

Markets always become most vulnerable when we are operating with discontinuous price structures. The shakeup we are seeing here in Q1 will change the landscape of investment and risk tolerance going into 2021. But it will also change the long-term allocation model away from a 60/40 bond/equity allocation — or similarly heavy-fixed income-weighted risk parity principles — to proper hedging through commodity exposure (inflation protection) and long volatility (fat tail-discounted price action protection).

If this happens, then investors will be in a better place going forward. The popular idea that the spectrum of asset allocation only stretches from some mix of bonds/ equities to the riskiest 100% long equities has always been flawed, but the illusion of safety was measured in returns, not in risk. Now risk has come back to bite.

The economic outlook

The triple whammy to the global economy almost guarantees that 2020 as an economic year is lost, with policymakers needing to pull out all of the stops to address a real, global recession.

Classically the policy response has been to lower the price of money. But with the Fed effectively zero bound before Q2 even gets under way, we already have all of the world's major central banks at that level (and even beyond in some cases with NIRP). The ability of monetary policy is at best constrained and, at worst, directly detrimental to the ability of economies to respond — as a low velocity of money dictates lower inflation and in the process less net lending demand.

There is now a demand gap, supply gap and an energy sector scrambling to survive as their 2020 cash flows point to major losses for the strong and bankruptcies for the weakest producers.

The market is on the brink of spinning out of control as credit, which is everything in today's market, has dried up — such that US mortgage yields are rising even though 30-year US treasury yields have collapsed. In other words, the market is tightening terms on credit even as the Fed tries to ease by cutting rates.

With the central bank policy tool box empty, we think we are on the verge of full Modern Monetary Theory (MMT), when politicians take the reins from obsolete central banks and expand spending without constraint from debt issuance (true money printing!).

The UK budget was an early indication of this and was drawn up even before the coronavirus impacts began to crystallise. And the concept of the government filling the gap left behind on demand is now even accepted in

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Germany, which issued its own form of Mr. Draghi's 2012 'whatever it takes' speech in vowing infinite support to German businesses large and small through the KfW or government development bank.

Think of the Marshall Plan after WWII, where the US issued infinite credit to war-torn Europe in order to create demand and help the destroyed continent rebuild. In economics, this is Say's law: the idea that supply creates its own demand. And that will be the solution here because failure via debt-deflation and a credit implosion is not an option. Governments will create money far beyond any on- or off-balance sheet constraint. Note how Germany used a government entity, not its budget this week.

Is the system so broken, or unbalanced, that it needs to get worse before it gets better? We will leave that for others to speculate on. But we have full confidence that when we leave 2020 the policy measures taken will prompt strong inflationary forces that even point to the risk of stagflation.

Our allocation will focus on adding long inflation and long volatility to our portfolios. The era of low volatility we saw since the global financial crash was due to financial repression and central banks lowering interest rates. It has now come to a close. We are in an environment of more price discovery, which will mean significantly higher volatility and with it a cleaning out of models for the valuation of private equity and other high-risk assets that are predicated on low interest rates, central bank intervention and a somewhat naïve assumption of multiples that can go up forever.

> **"The global bull market of 2009-2020, the longest in history, just died of coronavirus"**

The global economy has become a financialised super tanker fuelled by credit and low interest. It was heading for **The Port of Deflation**, but this new crisis has the super-tanker changing course as quickly as it can — which is not very quick, and seas are heavy — toward a new destination called **The Port of High Inflation**. The global bull market of 2009-2020, the longest in history, just died of coronavirus. In its wake, we have the weakest economic and political structures since the 1930s.

Buckle up, it's going to be quite an adventure — one like none (save perhaps for the very oldest of us) have seen in our lifetimes.

Safe travels,

Steen Jakobsen
Chief Investment Officer

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Steen Jakobsen, Chief Economist & CIO

Steen Jakobsen first joined Saxo Bank in 2000 and has served as both Chief Economist and Chief Investment Officer since 2009. He focuses on delivering asset allocation strategies and analysis of the overall macroeconomic and political landscape as defined by fundamentals, market sentiment and technical developments in the charts.

Equities facing worst outlook since 2008

By Peter Garnry

Equities have hit multiple speedbumps since 2008. But every time, they came back to new all-time highs fuelled by endless policy action, mostly from central banks. Through quantitative easing and lower rates, central banks have engineered a now-evidently unsustainable investment boom in energy that cannot repay it itself, large-scale buyback programmes among US companies and ever-higher valuations for growth companies.

The US-China trade war already started disrupting supply and slowing growth over the last year. In Q1 2020 the world economy was hit by the COVID-19 virus outbreak, creating both a supply (Chinese lockdown) and demand (lockdowns in many countries) shock, in addition to an oil price war between Russia and Saudi Arabia which threatens to significantly impact the US oil industry and global investments in general.

Not since 2008 has the world been this uncertain and out of balance. As equity prices reflect the future and growth prospects, they are the most sensitive to the current crisis. Investors are desperate to get out and cash in on years of fat profits.

S&P 500 could decline to 1,600 in worst-case scenario

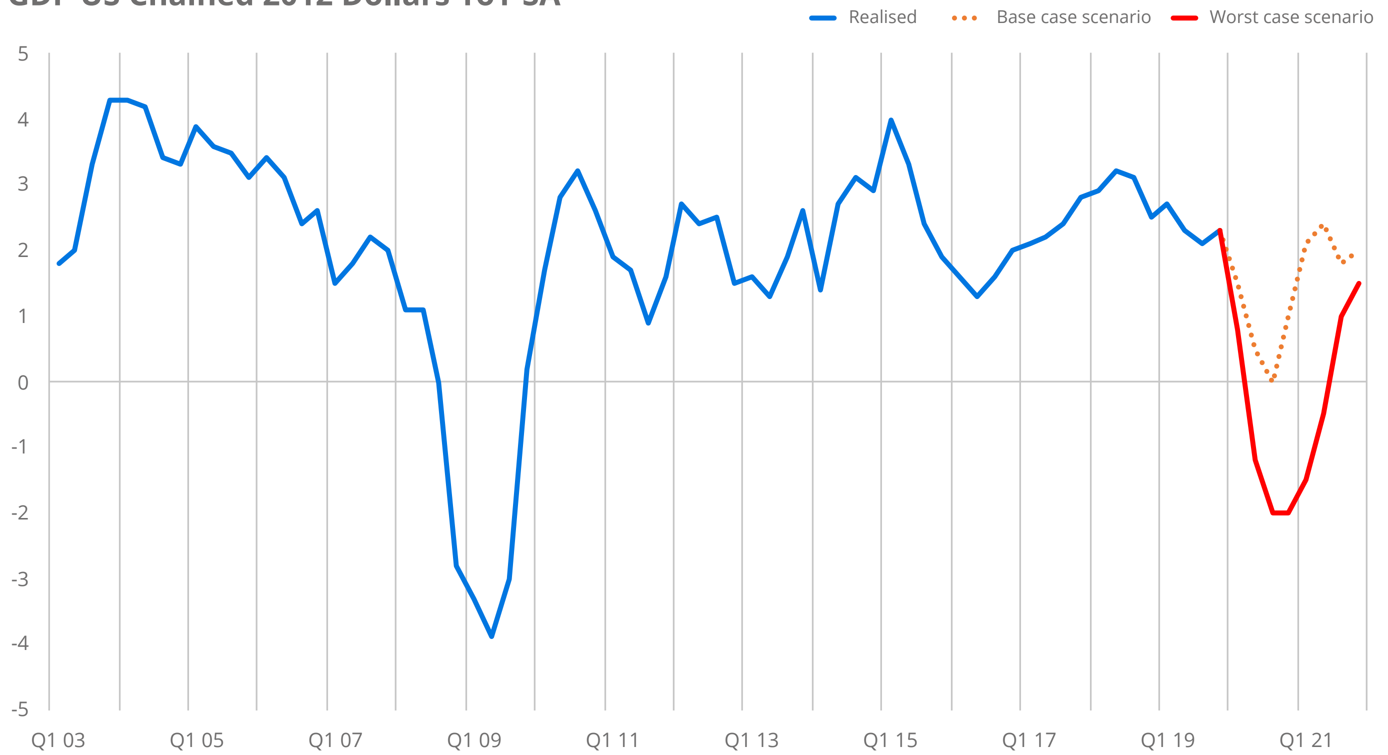
The last couple of months have given investors a glimpse of what's lurking around the corner. Countries have entered lockdown, hospitals have been overstretched and demand for certain products and services has been in freefall. The three most important questions for equity investors, then, are:

1. How much will corporate earnings decline?
2. What will the earnings multiple be during the contraction?
3. What will the shape of the recovery look like?

> **"As equity prices reflect the future and growth prospects, they are the most sensitive to the current crisis. Investors are desperate to get out and cash in on years of fat profits"**

Equities facing worst outlook since 2008

As global pandemics of this type are very rare, all GDP forecasting models can be tossed out the window. We have instead tried to create two types of GDP paths. One is a mild shock to 0% GDP growth and then a quick reversion to trend growth. The other is a 4% drop in growth in a few quarters and a slower recovery that doesn't quite hit trend growth. Many market participants believe in the base case scenario. But with dramatic lockdowns in Europe and the potential for COVID-19 to become seasonal the impact could become deeper and longer.



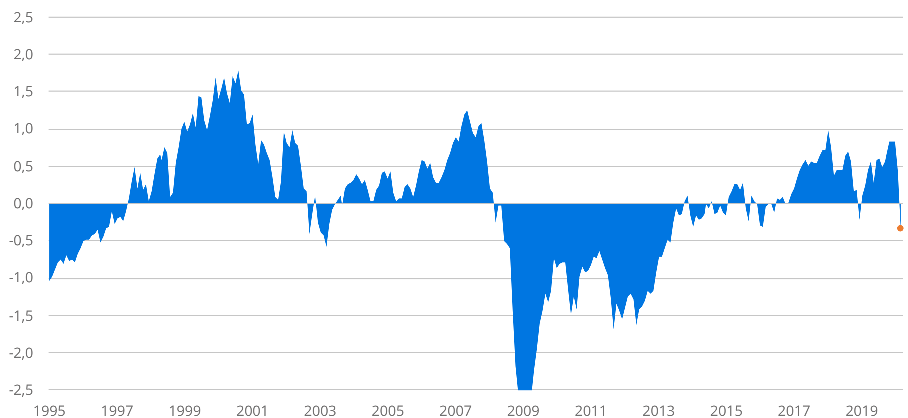
SOURCE: BLOOMBERG AND SAXO GROUP

Equities facing worst outlook since 2008

Based on data since 1954, we can fit a quantile regression on quarterly changes and log EPS on a GDP growth series. Our two GDP paths produce the following EPS paths:

SOURCE: BLOOMBERG AND SAXO GROUP

Given all the unknown variables at play in the COVID-19 outbreak, we lean towards the 25% percentile as more likely than the median paths across the two scenarios. If we take the average of the two 2021-ending EPS scenarios for the S&P 500 then we end up at $108.61, which is 28% lower than current earnings. If we assume the P/E ratio declines to 15 — which is reasonable judging from the yield level and previous crisis — then the S&P 500 could hit 1,600. These calculations are not meant to be precise and should not be taken at face value as there is simply too much uncertainty across too many variables. But the exercise is meant to give investors an idea of how bad things go in a worst-case scenario. The current drawdown in global equities has taken valuations from 0.84 standard deviation expensive to -0.35 standard deviation cheap, and that's before the denominator (earnings, sales and cash flows) has even begun to decline. The valuation picture leaves the equity market with plenty of room for further falls. When the global equity market hits -1 standard deviation cheapness then investors should begin to increase their allocation to equities.



SOURCE: BLOOMBERG AND SAXO GROUP

Equities facing worst outlook since 2008

We are in the phase where policymakers will throw a lot of stimulus against the economy, including various lending programmes from governments and the extension of tax payments (which is essentially just swapping cash flows over time). With the Fed's two panic cuts taking the rate to 0.25% all major central banks are now effectively zero bound. Our view is that sentiment and asset prices could be lifted here due to all the stimulus. But then, as economic activity numbers are published investors will realise more is needed and equity markets will take another leg down. Policymakers have a record of always being behind the curve.

Eventually, however, enough stimulus will be added to the economy that equilibrium is reached. At that time, equities will have bottomed.

Can energy stocks climb out of the darkness?
The energy sector is suffering from both a supply and demand shock and an oil price war between Russia and Saudi Arabia, which could push many US shale producers into bankruptcy. Government policies have changed under the current US administration and we cannot rule out bailouts in the US sector to protect jobs and investments in an election year. Among energy companies in North America and Europe, it is the American energy companies that have seen their implied default probabilities rise the most.

The energy sector is structurally weak after years of trying to rebuild profitability and lower debt levels after the oil price collapse of 2014-2015, so it's inevitable that some companies will disappear. Our view is that investors who want exposure to the energy sector should do it in the strongest energy companies and avoid the weakest (see list for inspiration).

Name	Industry	Implied default rate (1Y, %)	P/E	EV/EBITDA	Mkt Cap (USD, bn.)	Total Return YTD
Neste Oyj	Refining & Marketing	0,001	13,2	7,5	23,4	-11,4
Koninklijke Vopak NV	Midstream - Oil & Gas	0,002	9,9	9,3	6,3	-8,1
Chevron Corp	Integrated Oils	0,005	13,9	5,7	156,8	-30,0
Cabot Oil & Gas Corp	Exploration & Production	0,007	11,4	6,1	7,3	6,2
Exxon Mobil Corp	Integrated Oils	0,023	15,3	6,8	161,3	-44,6
Galp Energia SGPS SA	Integrated Oils	0,038	18,2	5,0	7,9	-42,5
Pembina Pipeline Corp	Midstream - Oil & Gas	0,047	8,1	15,1	11,3	-39,9
Enbridge Inc	Midstream - Oil & Gas	0,066	16,3	13,7	62,3	-16,0
Phillips 66	Refining & Marketing	0,067	6,5	8,8	23,9	-50,7
Kinder Morgan Inc/DE	Midstream - Oil & Gas	0,078	15,7	9,1	33,5	-29,4
Baker Hughes Co	Oil & Gas Services & Equip	0,284	10,2	6,4	13,1	-49,9
Pioneer Natural Resources Co	Exploration & Production	0,347	8,2	4,8	11,7	-53,3
Canadian Natural Resources Ltd	Exploration & Production	0,371	5,7	4,1	16,9	-52,7
Schlumberger Ltd	Oil & Gas Services & Equip	0,495	11,0	NM	22,4	-59,2
Cheniere Energy Inc	Midstream - Oil & Gas	0,644	48,7	10,7	9,0	-42,0
Hess Corp	Exploration & Production	0,701	NM	5,8	10,7	-47,4
ONEOK Inc	Midstream - Oil & Gas	0,764	10,0	10,6	12,7	-58,9
Marathon Petroleum Corp	Refining & Marketing	1,013	4,6	5,5	16,2	-58,2
Halliburton Co	Oil & Gas Services & Equip	1,948	5,9	10,2	6,3	-70,5
Occidental Petroleum Corp	Exploration & Production	3,507	9,0	8,9	12,8	-63,2

Source: Bloomberg and Saxo Group
* Date as of 15 March 2020
** Implied default rate is based on Bloomberg's implied default probability model
*** Total return is in local currency

Equities facing worst outlook since 2008

But even after the economy has recovered, the energy sector will have to transition away from fossil fuels — which was the theme in our Q1 Outlook. This means that there will continue to be an ongoing demand pressure for some end products of the oil industry. Our long-term belief is that the oil and gas industry will not deliver excess shareholder value relative to the equity market over the coming decades. The opportunities in the energy sector will be more tactical and more short-term as the economy goes through the business cycle.

> **“With all the major central banks expected to be effectively zero bound in 2020, the scope for returns in bonds will be low for years to come”**

What comes after 60/40 portfolios and risk parity?

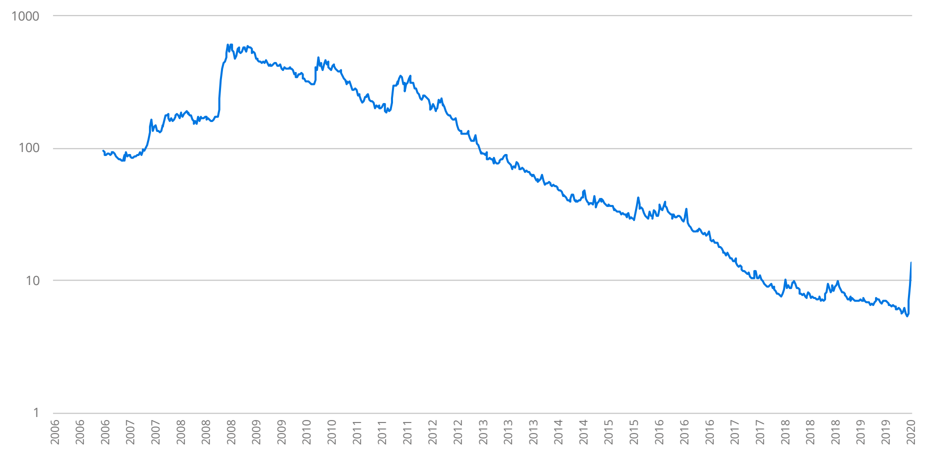
The dramatic volatility and declines observed in the first two weeks of March severely impacted 60/40, and risk-parity portfolios will change their asset allocation in the future. With all the major central banks expected to be effectively zero bound in 2020, the scope for returns in bonds will be low for years to come.

As the oil price war and COVID-19 shocks turn into a liquidity and credit crisis — alongside a breakdown of some parts of the ETF market — asset allocators will be forced to consider tail-risks in their approach. But even more importantly, long-volatility components (benefitting when volatility increases) will most likely enter portfolios as these strategies are the only ones that can really protect in these types of crises. There are many ways to express long volatility, but one is to be long on VIX futures and roll those positions over time. As the VIX forward curve is in contango (upward sloping) there is a negative roll yield to be permanently long this position.

The S&P 500 VIX Futures Enhanced Roll Index shows the P/L of such a position since late 2006. From market bottom in early March 2009 until the week before COVID-19 volatility began, annualised return was -34%. Allocating just 2% of a portfolio to this type of long volatility strategy would create a 0.68% drawdown on annualised return during non-crisis years. In 2008 and during the first weeks of COVID-19 turmoil the 2% exposure would have added 4.7% and 3.1% respectively.

As drawdowns have a disproportionate impact on long-term performance, it does make sense in asset allocation to add a negative expected return stream because of its negative correlation during crises.

S&P 500 VIX Futures Enhanced Roll Index



SOURCE: BLOOMBERG AND SAXO GROUP

@PeterGarrny

Peter Garrny, Head of Equity Strategy

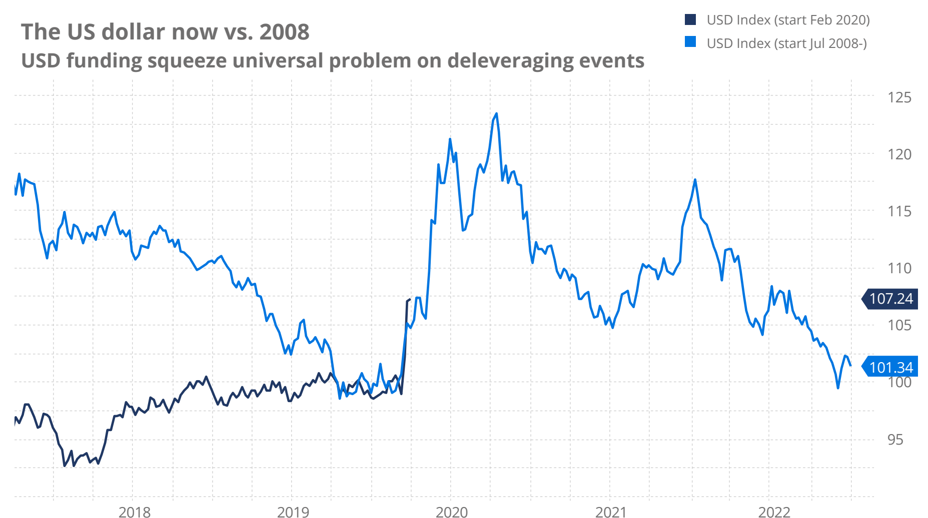
Peter Garrny joined Saxo Bank in 2010 and is the Head of Equity Strategy. In 2016 he became responsible for the Quantitative Strategies team, which focuses on how to apply computer models to financial markets. He produces trading strategies and analyses of the equity markets as well as individual company stocks, applying advanced statistics and models to beat the market.

The great reset is upon us and ends when the USD tops

By John J. Hardy

A great reset of the global debt bubble is upon us.
The first steps washed over the currency market with the usual patterns of risk-off behaviour and squaring of crowded speculative positions. EM currencies have collapsed, the smaller G10 currencies are universally under pressure. Interestingly, the US dollar came under initial pressure against the Japanese yen and euro on the initial deleveraging, but later mounted a broader and more vicious rise akin to what we saw in the worst phase of the 2008-09 crash. This USD rise came even as the Fed, just as then, chopped rates to zero and launched all manner of QE and liquidity facilities.

And it is very likely, just as back in early 2009, that we can't call a bottom for the markets or peak moment for the crisis until the USD itself has turned. It was in March 2009 that both the S&P 500 bottomed and the USD peaked. With so much of the world's debt and other instruments denominated in US dollars, the Fed struggled to get ahead of the contagion as everyone deleveraged in a mad 'dash for cash'. The situation echoes back as far as 1933, when the beginning of the end of the worst phase of the Great Depression came after FDR finally devalued the USD against gold (about three years later than should have been the case).



SOURCE: BLOOMBERG

Chart: Comparing USD in 2020 to USD in 2008-09

We have entered this yet-to-be-officially-named crisis in a very different place than where we entered the 2008-09 financial crisis. The chart above indexes the Bloomberg USD index to 100 starting from Jul 1, 2008 vs. the USD at 100 in Feb 1, 2020.

Back in 2008, the USD was already quite weak as the Fed's prior easy money policies of the 2002-04 era supercharged USD liquidity, investment bank balance sheets and carry trades, with JPY- and CHF- carry trades adding to the global liquidity. This time around, we entered the crisis with a US dollar that was relatively strong, if we use a traditional measure like the USD index (although EM currencies were rather strong on the reach for yield before this COVID-19 outbreak hit). The big spike higher in the big dollar then, as now, goes to show that when crisis comes calling the world can't get its hands on enough US dollars and we likely need the USD lower to call an end to the equity and risk bear market. In 2008-09, it took about 9 months for the USD to top out – can policymakers cut the funding pressures shorter this time around?

The great reset is upon us and ends when the USD tops

The trigger of this credit crunch of unforeseen magnitude is of course the coronavirus outbreak. But the severity of the fallout is a product of a financialised global system made so incredibly fragile by the leverage encouraged by ZIRP and NIRP, plus the QE medicine used to alleviate the ills of the last crisis.

From here, it may take at least a couple more quarters to establish a cycle low in the market and a high in the USD — even as authorities swing more determinedly into action than we have ever seen. This time around, due to the severity of the issue policymakers have no qualms about throwing orthodoxy out the window and printing infinite amounts of cash to drop on the economy. Contrast that with the halting efforts in the US that kept the system from clearing fully from 1929 until the outbreak of WWII in late 1941 with Pearl Harbor. The cycles have been getting shorter since the Great Depression, with market top to market bottom in the GFC coming in around 18 months.

Relative to the global financial crisis, the medicine this time around will include far more helicopter money and far less QE. Real GDP may be slow to recover — but helicopter money is going to help nominal GDP come roaring back at some point first.

A note of encouragement in a scary environment: long-time investors know that crisis points are also the points of maximum opportunity for those with cash in reserve. And the coming six to twelve months will bring extreme value to various oversold assets, regions and their currencies, even if calling the timing of the low is a fool's errand. Below we look at new themes for currencies that we think are likely to emerge as we transition through and to the other side of what may prove a U-shaped recovery with a bumpy bottom into 2021. These FX themes and drivers differ from those of the recent and pre-GFC past, when carry and investment flows in a globalised financial system were the chief focus.

> **“Relative to the global financial crisis, the medicine this time around will include far more helicopter money and far less QE”**

Putting out deflationary fires = inflation?

We are convinced that the policy medicine of MMT will eventually be employed on sufficient scale to avoid deflationary outcomes. If so, and if inflation stages a sharp recovery and even begins to run hot, the key metric that many are likely to focus on for relative currency strength is the real interest rate — how much the CPI exceeds the policy rate at various points on the sovereign bond curve. Those countries overheating the printing press and running ugly, negative real rates will eventually find their currencies weakening rather than benefitting from the initial push of fiscal stimulus.

This is actually the normal pattern for EM currencies. Watch the coming months very closely for this inflation transition to arise, as the demand crunch risks destroying capital and thus the available supply of key products once the economy finds its feet again. Plus, as the dust settles in coming quarters, investors should track the purchasing power measures of various currencies as we inevitably discover that some are proverbial babies that have been tossed out with the bath water, as is always the case in a crisis. These could include SEK, CAD and (with some patience) sterling and Aussie.

The great reset is upon us and ends when the USD tops

Autarky and a new Deglobalisation

The coronavirus outbreak and the US-China trade policy hostilities that preceded it are likely to add to the deglobalisation impulse that was already underway before the virus outbreak. Countries and economic blocs like the EU will have a vastly increased interest in ensuring that key security and health products — think medicines, surgical masks and ventilators; some basic goods; national defense products and electricals — are made closer to home. This will drive investment and current account considerations that will prove critical for currency fundamentals, with perhaps fewer traditional financialised capital flows.

Those countries that are vulnerable from a current account perspective could be punished (the UK needs to show it can balance its current account if this era of financialisation is waning, for example). On the flipside, the traditional major export powers like Germany (EUR or dare we ask DEM eventually?), Singapore (SGD) , Sweden (SEK), Switzerland (CHF) and others may find this a less friendly environment for their currencies as their access to international markets is reduced — all relative to purchasing power as noted above.

Commodity exposures

With the era of over-financialisation likely ending, hard assets and commodities that are difficult to produce or replace domestically could experience a renaissance and drive significant gains for individual currencies. The AUD, NZD and CAD are likely eventual winners in this category (once they get to the other side of their domestic credit bubble unwinds). So could the BRL and even the RUB, from extremely cheap levels.

The USD is also a winner here, but needs a significant markdown in the years ahead to allow a global recovery to proceed. And it could be in trouble from a real interest rate perspective, as discussed above. The JPY is vulnerable if commodity imports rise and deglobalisation risks its export markets, alongside long-standing issues like its shrinking labour force and enormous retired population.

Ending the USD dependency

In addition to the drivers above, likely the most interesting theme afoot in coming years will be the scramble to find alternatives to the US dollar. This crisis is proving even more clearly than the last one that the fiat-USD-as-global-reserve-currency system is dysfunctional beyond all attempts to salvage it. Complicating the search for an alternative is the fact that in a deglobalising world, Bretton Woods-style arrangements will prove very hard to come by.

“The USD needs a significant markdown in the years ahead to allow a global recovery to proceed”

@Johnjhardy

John Hardy, Head of FX Strategy

John Hardy joined Saxo Bank in 2002 and has been Head of FX Strategy since October 2007. He focuses on delivering strategies and analyses in the currency market as defined by fundamentals, changes in macroeconomic themes and technical developments.

Commodities look to fiscal bazooka for support

By Ole Hansen

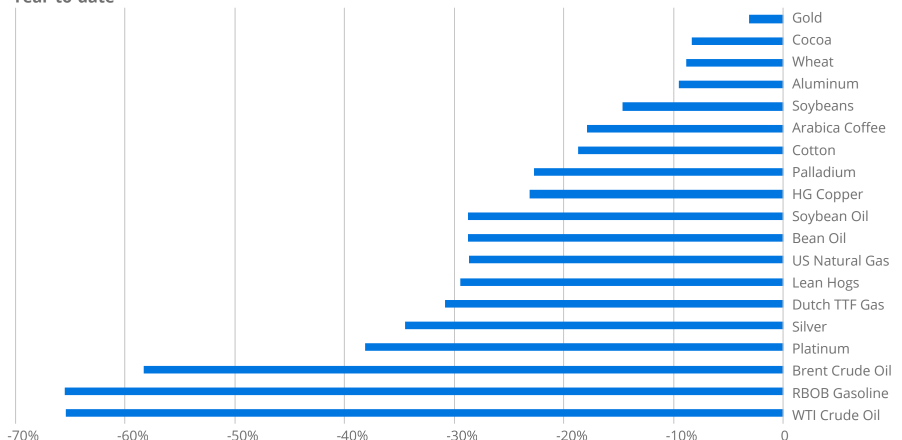
The coronavirus outbreak has set three major macro impulses in motion. They will all have a major impact on commodities, especially the energy sector, over the coming months. The global economy is currently dealing with the biggest demand shock since the global financial crisis, plus a global supply shock and an oil price war which is driving a destruction of capital. The lockdowns in China at the beginning of the outbreak have now spread to the rest of the world, most noticeably Europe and the US. The short- to medium-term result is going to be a slump in global growth, rising unemployment, rising mortgage rates and lower consumer confidence.

“The potential risks to supply could see some markets find support sooner than the demand outlook suggests”

The second quarter is likely to begin with the focus squarely on the price-damaging impact of the dramatic drop in demand for many key commodities: from crude oil and industrial metals to some agriculture commodities. But as coronavirus continues to spread it is very possible that the supply outlook will become challenging as well. Miners and producers may begin to feel the impact of staff shortages and breakdown in supply chains. The impact of lower fuel prices is being felt from agriculture to mining as it drives down input costs. However, the potential risks to supply could see some markets find support sooner than the demand outlook suggests.

Without making any price predictions, we’ve taken a look at some of the commodities that could potentially benefit from the current troubling developments.

The impact on global growth and demand will be significant. With millions of people around the world being ordered to work from home and refrain from traveling, the demand for transportation fuel has collapsed. The drop in consumer confidence, meanwhile, will impact demand for consumer goods.



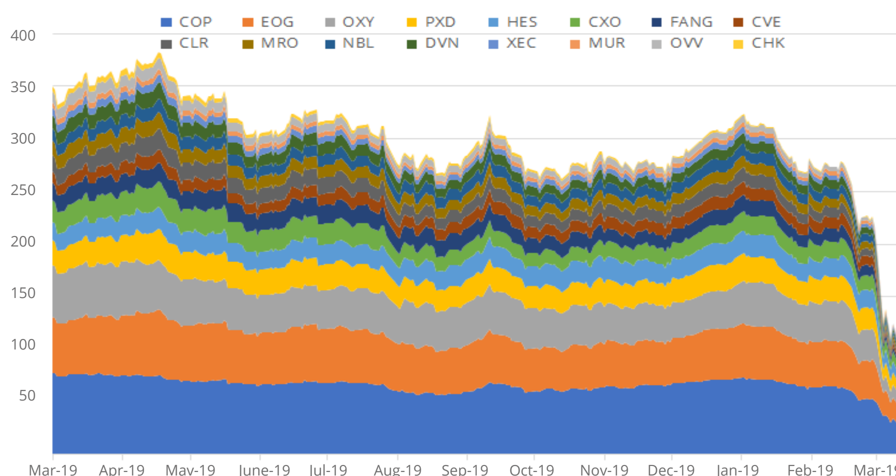
SOURCE: BLOOMBERG AND SAXO GROUP

Commodities look to fiscal bazooka for support

The biggest effect has so far been seen across the energy sector. A combination of strong non-OPEC supply growth and a weakening outlook for global demand led to the inevitable breakdown of OPEC+ co-operation on March 6.

Instead, Saudi Arabia started an all-out price war by dumping the price while ramping up production. Whether the intended target was Russia or high-cost producers in the US shale oil industry, the impact on oil has been devastating. If the aim was shock and awe, the timing has been perfect — global demand has fallen off a cliff as the global community goes into lockdown to combat COVID-19.

Brent crude oil has dropped to an 18-year low. The SPDR Energy Select ETF (XLE), representing some of the biggest US oil companies, has more than halved since December. A group of 12 major independent US oil and gas producers, meanwhile, have seen their market cap collapse to below $90 billion from above $300 billion in December.



SOURCE: BLOOMBERG AND SAXO GROUP

Given the fact that most oil producers (including Russia and Saudi Arabia) are currently selling at a price well below their budget break-evens, we will eventually see the market recover. However, before that happens the virus either needs to show signs of retreating or we need to see a meaningful and long-overdue reduction among high-cost production companies in places like the US and Brazil. In addition, the long road to recovery back towards the $50 to $60 range in Brent will be hampered by the rapid rise in global stocks. These will need to be reduced before Brent can recover — we recommend you to take a look at Peter Garnry's assessment of which companies could end up being potential winners and losers.

Staying with energy sector, it is our belief that a meaningful reduction in US shale oil production over the coming months may lead to a long-overdue reduction in associated gas production. Rising production, a mild winter across the northern hemisphere and the virus-related drop in activity have all helped send global gas prices sharply lower. US gas prices touched a 25-year low in March. Depending on how quickly production slows, we see gas prices rise beyond levels currently reflected in the forward market.

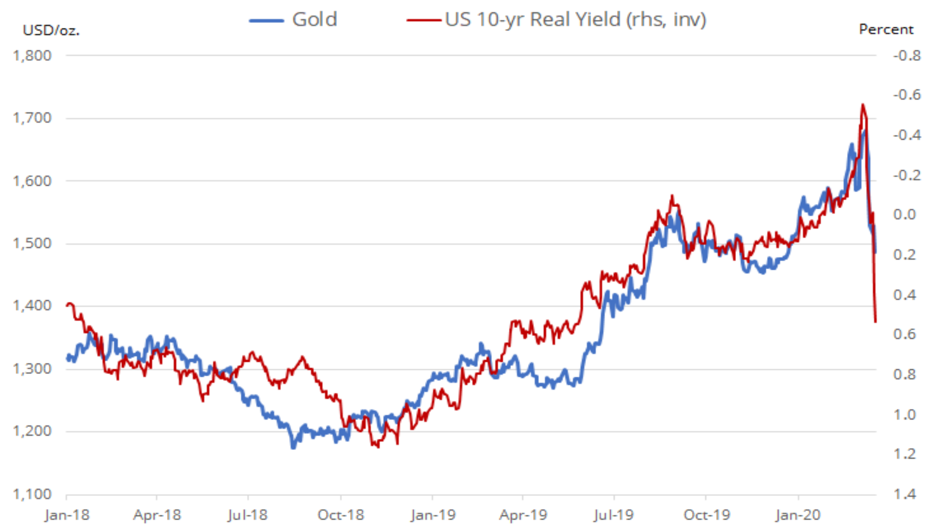
> **"Given the fact that most oil producers (including Russia and Saudi Arabia) are currently selling at a price well below their budget break-evens, we will eventually see the market recover"**

Gold's failure to rally as COVID-19 spread and economic uncertainty rose has brought back memories of 2008. During the early part of the GFC, all assets were sold as investors deleveraged to realise cash or pay for losses elsewhere. In the early weeks of the crisis, gold suffered a 27% sell-off to $725/oz before beginning an ascent which eventually took it to $1920/oz. The rally started in gold mining stocks before moving to gold and it took another few months before the stock market finally bottomed out. With this in mind, we are keeping a close eye on gold mining companies through the Vaneck Major Gold Miners ETF (Ticker: GDX:arcx). We also have to keep in mind that the cost of fuel, which accounts for 20% of mining costs, has collapsed. Gold miners have therefore, at least for

Commodities look to fiscal bazooka for support

now, not suffered the hit that the drop in gold would otherwise imply.

We believe the long-term reasons for holding gold have, if anything, been strengthened by current developments. While official interest rates have been slashed, corporate bond yields have been rising. The broken transmission between central bank actions and developments on the ground is likely to trigger a major fiscal and potential inflationary response from governments around the world. US 10-year real yields, another major driver of gold, have risen sharply in response to much lower inflation expectations. We believe this move is unsustainable and that real yields will eventually move back into deeper negative territory.



SOURCE: BLOOMBERG AND SAXO GROUP

The aggressive sell-off in crude oil hasn't helped gold. The Russian central bank has been a strong buyer of gold in recent years. That buying has now stopped, and depending on how long it takes before crude oil recovers, we could potentially see Russia become a net-seller. After all, they will have to cover the shortfall of oil slumping below their budget break-even, which is somewhere close to $40/b.

Silver's complete collapse to an 11-year low in March drove its relative value to gold down by more than 50% below the five-year average. A combination of inadequate liquidity to withstand the aggressive dash-for-cash phenomenon and its correlation to economic growth are helping drive the steep loss. Once the market stabilises, we see the potential for a strong recovery with traders focusing on its relative cheapness to gold.

HG copper, which started the year with a forecast of a small supply deficit, finally broke key support at $2.50/lb. However, with the outlook for aggressive fiscal measures and the potential risk to supply from virus-related disruptions, we see risk being skewed to the upside in Q2.

Ole Hansen, Head of Commodity Strategy

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Demographics: The missing piece

By Christopher Dembik

The view of many investors is that the latest market developments related to the COVID-19 outbreak are a temporary downturn in a 10-year secular bull market, similar to those previously seen in 2016 and 2011. Their main argument is that loose monetary policy, including low interest rates alongside accommodative monetary policy such as QE, will continue to serve as the main market driver.

We have been here before, notably during the secular bull market of the 1950s and early 1960s. During most of that period, the Federal Reserve followed a 'lean against the wind' monetary policy that ultimately lead to the Great Inflation. Too-loose monetary policy had a dramatic effect on the economy and the level of inflation. Policymakers at the Fed misjudged how hot the economy could run without increasing inflation pressures and when CPI started to rise, monetary response was too slow. Oil and food prices only exacerbated the issue.

In 2020, the global economy is facing a much more difficult challenge that may lead to similar consequences if not controlled: stagflation. In the coronavirus era, state emergency and the double shock on supply and demand are likely to depress growth sharply, thus increasing risk of recession. Governments are ready to do 'whatever it takes' to mitigate the crisis. We are moving from 'bailout the banks' in 2008 to 'bailout SMEs and anything else' in 2020.

> **"We are moving from 'bailout the banks' in 2008 to 'bailout SMEs and anything else' in 2020"**

The huge fiscal stimulus that is coming is likely to increase inflationary pressures in months to come. Contrary to common thinking, at Saxo we doubt that the coronavirus is a temporary market shock. We think that COVID-19, along with another underestimated factor, demographics, will precipitate the end of the secular bull market.

In our view, demographics are the ultimate indicator of how the economy and the market will evolve decades in advance. In 2011, a research paper released by the Federal Reserve Bank of San Francisco entitled 'Boomer Retirement: Headwinds for U.S. equity' pointed out the strong link between stock market performance and the US population's age distribution. Using data from 1954 through 2019, it found that booming population explained about 61% of the variation of the P/E ratio over the sample period.

In the post-war period, a phenomenal increase in the population generated record

Demographics: The missing piece

levels of income, great wealth, higher consumption and increased economic activity. At the same time, groundbreaking innovations increased productivity and created new industrial clusters. The combination of booming population and industrial innovations were key factors behind the bull market.

Now, the booming population is the missing piece that may put a definitive end to the secular bull market. The baby boomer generation — which represents more than 76 million people in the US alone — is transitioning out of the workforce and drawing down on its retirement funds. This may structurally depress equity valuations in the coming years.

There are not enough buyers in front of them to compensate when they eventually sell. The younger population, whose size is shrinking, is for the first time on record less optimistic than the oldest generation. This will have a direct impact on money behaviour and favour saving rather than investing, despite low interest rates.

Even if they want to invest on the stock market, millennials cannot. The everyday consumer has never really recovered from the last recession and inequality is increasing, at least in the US, which does not draw a bright outlook for spending in the future. We can already observe the same exact situation in the US real estate market. Baby boomers are offloading their huge rural properties, but millennials cannot afford to buy them. Demographics will disrupt not only the stock market — they'll disrupt the financial sector as a whole.

> **"The younger population, whose size is shrinking, is for the first time on record less optimistic than the oldest generation"**

Retirement of the baby boomers happens at the worst time ever for the stock market, when other structural factors are already affecting the macroeconomic outlook. Loose monetary policy, for example, has dramatically increased debt-to-GDP ratios — which are now at unsustainable levels — and diverted capital from productive investment. The amount of debt in the system, especially in the private sector, is dragging down productivity and the economy overall.

The system that prevails, which is centred on central banks providing unconditional liquidity, is inefficient and has not been able to foster the emergence of decisive disruptive innovations. We are reaching the limits of this system, with spreads on high yields reaching crisis-levels on the back of the COVID-19 outbreak.

Christopher Dembik, Head of Macro Analysis

Christopher Dembik joined Saxo Bank in 2014 and has been the Head of Macro Analysis since 2016. He focuses on delivering analysis of monetary policies and macroeconomic developments globally as defined by fundamentals, market sentiment and technical analysis.

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Get to the chopper

By Eleanor Creagh

By the time this goes to print, a lot could have changed already — that is how quickly information is moving while financial markets, policymakers and communities grapple with the global pandemic.

The CBOE VIX closed at a record high of 82.7 today, surpassing even GFC closing levels, and daily moves of +/- 5% on the SPX are normal. At this stage, sentiment is stretched and we are probably nearing peak panic, but that does not necessarily coincide with the market bottoming. With limited quantitative data related to the virus outbreak, precise forecasts are scarce.

> **As yet, relative to previous crises, valuations have not become outright cheap**

We are in unchartered waters with respect to both the global public health crisis and financial market conditions: hence the heightened cross-asset volatility. To have real confidence in a relief rally, volatility must reset meaningfully lower.

For now, the AUD remains under pressure as recession looms, but being a risk proxy there will be moments of optimism. The Reserve Bank of Australia (RBA) has lowered the cash rate to the effective lower bound of 0.25% and adopted QE policy in Australia, aiming to maintain the 3-year bond yield at 0.25% and support liquidity in fixed income markets.

Heightened volatility and risk aversion; a domestic economy that's already in the midst of a pre-existing slowdown; stretched consumers saddled with high household debt levels and a shift to unconventional monetary policy are all weighing on the local unit. The palpable rush to the USD certainly isn't helping. The US dollar remains a safe haven in the midst of the global equity market and liquidity rout, cementing the path for recession as the strong dollar compounds the virus damage.

The virus outbreak has sent tremors through highly leveraged financial markets, revealing multiple fault lines that we previously caught glimpses of in Q4 2018 and September 2019. These fault lines were patched over, fuelling the ever-extending complacency and yield reaching which have lulled markets and volatility alike throughout the past decade of central bank intervention. In the wake of the global pandemic, the fault lines are now fissures.

Moreover, the record lows in volatility that drove a generation to chase excess yield, momentum and passive mania have been replaced with soaring volatility, stressed liquidity and deleveraging across all corners of financial markets. Even the havens are not safe while many dash for cash.

Get to the chopper

US equity markets recorded a seven-sigma move last week. Under a normal distribution, the expected occurrence of this event is equal to one day in 3,105,395,365 years, a period almost five times longer than complex lifeforms have existed on the planet. Clearly, we are not assessing these probabilities correctly. Not only has risk been misgauged due to the prior decade of financial repression surpassing volatility and spurring complacency, but the assumptions upon which we build our asset allocations are wrong and vastly understate true risk.

As Steen highlights in the introduction to this outlook, the popular idea that the spectrum of asset allocation only stretches from some mix of bonds and equities has always been flawed. This most recent rout could truly shake the long-term allocation model away from a 60/40 bond/equity allocation.

Markets are dealing with a health crisis that cannot be appeased by central banks. As the baton is passed to governments, who will be stepping up to provide cash directly to businesses and households, we enter a new regime. Whether the shockwaves of this event are truly enough to shift traditional industry thinking remains to be seen, but we should at least see a more broad-based approach to diversification over the long term — thus increasing exposure to the potential higher volatility regime shift.

Although the virus is a shorter-term issue, some of its ramifications will be long lasting. It has not only laid bare the fault lines in financial markets, but also the systemic risks embedded in our heavily interconnected and globalised supply chains. The US/China trade war was a warning shot for the global flow of goods and a reminder that tectonic shifts are underway for global geopolitical architectures and international cooperation.

Vulnerabilities throughout global supply chains, 'just in time' manufacturing models and the pursuit of cost minimisation above all else have been exposed by the virus outbreak. The crisis of confidence among communities has been perpetuated by political fragmentation, populism and pro-nationalist sentiment.

This means the tailwind for the ongoing de-globalisation shift has only grown — and with it, nationalism, protectionism and localisation.

If low inflation has been perpetuated by globalisation and a 30-year spate of deregulation, the opposite should be true down the line. But only once the global economy emerges from the deflationary demand shock the virus crisis and oil price war brings. The assumptions that have underpinned asset prices for many decades are shifting, which favours increased portfolio diversification to counter trend assets to achieve superior risk-adjusted returns. For example, by building long-term allocations to real assets that benefit from eventual higher growth and inflation — such as commodities and precious metals.

What is currently a liquidity crisis could fast become a solvency crisis as the simultaneous shocks to demand and supply weigh on the balance sheets of otherwise solvent SMEs. This crisis is about too many to fail, as opposed to too big to fail. Distressed entities (businesses and households) desperately need a lifeline to maintain wages, rents and other such payments that do not stop as economic activity grinds to a halt. That cash flow support will be vital in providing goodwill payments to casual workers who lose shifts, extended sick pay for those unable to work and preventing layoffs for those businesses facing a material impact from the COVID-19 outbreak.

Given the level of household debt, another key area of concern for Australia is the labour market. With household leverage ratios at almost 2x incomes, a spike in unemployment could prompt a far more serious economic fallout. That is why it is paramount for the government and the RBA to consider maintaining job security as a focal point in their response measures.

The fiscal package to date is just the first line of defence that's needed for the Australian economy. More will be necessary. The measures so far pale in comparison to the New Zealand government's package, which is approximately 4% of GDP relative to the Morrison government's 1.2%.

Get to the chopper

The Australian economy comes from a position of weakness and desperately needed a fiscal contribution even before the virus hit. The economy has lost momentum since the second half of 2018: unemployment has risen, the private sector is in recession and both business and consumer confidence has been in the mire. In addition, more recently the combination of bushfires and drought have served a one-two punch to Australia's economy and battered the agriculture, tourism and recreation industries even before any travel bans came into place.

> **"US equity markets recorded a seven-sigma move last week. Under a normal distribution, the expected occurrence of this event is equal to one day in 3,105,395,365 years"**

Things are moving quickly — far quicker than they did in the GFC — markets and shutdowns included. For each stimulus package announced, a corresponding travel ban is enacted or city is locked down. Shutdowns, border closures and disruptions are moving at such a pace that economists and markets alike cannot mark down growth expectations quickly enough. As the number of infections continues to rise globally, the likelihood of these measures becoming more aggressive will further impact economic activity.

With so many unknowns at large, forecasts seem little more than vague verbiage that are consistently marked to market. However, what is certain is that an exceptional policy response is necessary. TINA (there is no alternative) can be applied in a different sense as monetary policy pushes on a string and unemployment rises. Policymakers must underwrite the demand shock and helicopter drop payments directly to households along with support for cash-strapped businesses. We have little doubt of this, given multiple conjectures toward wartime action to buy time in the virus fight while we await a vaccine or immunity. Although even this is no perfect solution, as the hit to sentiment and therefore demand cannot easily be reversed by monetary or fiscal policy. While consumers are fearful of the threat of a global pandemic, confidence will be hard to restore. Hence why containment efforts and public health policy are equally important in supporting confidence.

Although stimulus packages may ease downside risks to the economy, for markets to really recover the onus will be on reduced COVID-19 transmission rates, increased immunity and a clear containment of the outbreak. As yet, relative to previous crises, valuations have not become outright cheap. Nevertheless, hope springs eternal both in financial markets and humanity, so there will come a time for bargain hunting. However, as the rulebooks go out the window in terms of crisis rescue packages, we may eventually enter a different investment paradigm. The extraordinary fiscal stimulus, a de-globalisation tailwind and eventual recovery in economic activity will bring at the very least higher inflation expectations, and long-term bond yields may eventually rise. Perhaps we'll see an opportunity to rethink diversification beyond the traditional 60/40 and a comeback for value, cyclicals and commodities.

Eleanor Creagh, Market Strategist

Eleanor Creagh joined Saxo Bank in 2018 and serves as the bank's Australian Market Strategist, responsible for creating, implementing and monitoring equity strategies and research for traders and investors, as well as developing quantitative models and customised mathematical frameworks for institutional clients. Eleanor holds a double major in Finance and Economics from the University of Sydney.

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China will be the first to sail out of the Global Storm...

By Kay Van-Petersen

As we go to press, the only thing that I have complete conviction on is a lack of conviction in the near term. We are in the midst of the epitome of a bear market in equities. A lot of the price moves we are seeing across asset classes are clear signs of distress and the fight for liquidity over anything fundamental or rational. Fear, plus the fear of fear, reign supreme. That the VIX is over 80 — some seven times higher than mid-January, with a 12 handle – is a testament to that.

There is blood on the street and positions are being slaughtered: the S&P is down 25% year to date. However, one has to take a step back and remember that this is what happens after you have the longest bull market run in history. The S&P climbed around 400% from its 2009 lows to its all-time high of around 3390. Other names such as Amazon are still up over 1200%, despite a 20% pullback from its recent all-time high.

As always, context is everything. This too shall pass, life will continue and eventually uncertainty — and fear — will peter away. After more education and curbing measures, time decay on virus concerns will set in. As the rest of the world catches up with what Asia went through in January and February, fears will generally lessen.

> **"One has to take a step back and remember that this is what happens after you have the longest bull market run in history"**

We need a resetting of expectations around fundamentals and earnings as policymakers deal with the challenge of the triple threats: a demand shock, a supply shock and the destruction of capital in the energy market (where once again Putin demonstrated that he is the undisputed Grandmaster of all chess moves).

The point to keep in mind is not about the validity of the rising numbers of virus cases in the US and Europe. Instead it is direction and the fact that Asia (especially China, Hong Kong and Singapore) has a lot of historical experience, expertise, resources and procedures for dealing with outbreaks – especially given the epicentres of SARS ten years ago. Europe and the US just don't have that.

China will be the first to sail out of the Global Storm...

What we will see in the next few weeks is the exceptional job China, Singapore & Hong Kong have done of containment. The numbers in Europe and the US are likely to get dramatically higher over the next four to eight weeks.

However, with the Northern Hemisphere summer coming in, time is on their side. That, plus a potential breakthrough toward a vaccine. These are potential advantages that Asia did not initially have.

While China has lead the world in regards to the economic slowdown that we are in the midst of – talks suggest Q1 China GDP could be in the -10% to -20% range – we are also likely going to be entering a quarter or two where that slowdown ripples across the eurozone and the US.

So the paradox here is that from Q2 China's growth is likely to accelerate as the rest of the world decelerates. For those who will rightly flag that the US and eurozone will have lower demand for Chinese goods, don't forget Asia's demographics and secular consumer spending, healthcare, biotech and infrastructure themes. China does about 50% of its trade with Asia. Most of Asia benefits more from rising growth in China than rising growth in the US or eurozone. Also bear in mind that China will be coming from the lowest of bases: zero. Construction companies, real estate and infrastructure-linked players should be the first place for investors to look. With an eventual return to the service economy – restaurant chains are once again opening across the country – some provinces are claiming to be almost back to 100% normal.

> **"The paradox here is that from Q2 China's growth is likely to accelerate as the rest of the world decelerates"**

The higher beta names that face China are obviously Singapore, South Korea and Taiwan. They are still not yet showing signs of economic traction upward, but are worth monitoring closely for a follow through of Chinese activity later this quarter.

Blue-chip, high-dividend and solid balance sheet names are worth looking into. In a world with ever structurally lower yields (the Fed has now cut rates by 150 basis points in March alone), names like CK Hutchison (1 HK) are yielding close to 6% unlevered. Alternatively, Altria (MO, old Philip Morris) are yielding around 9% unlevered — and that's with respective -30% & -23% YTD pullbacks respectively.

@KVP_Macro

Kay Van-Petersen, Global Macro Strategist

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