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Weekly Commentary

Issue **No. 32** | **JULY 27, 2020**

Macro View

By Hubert Marleau

Currency Debasement Is Readjusting the Investment Landscape

Submitted July 25, 2020

What Happened In the Market Last Week Ending July 24:

The desire for risky assets reversed last week even though some conventional economic prints continued to point up, with a litany of companies reporting earnings which easily beat Wall Street expectations. As a matter of fact, the Conference Board's index of leading economic indicators rose in June for the second month in a row, as a result of the incremental opening of the economy, suggesting that the business recovery will likely continue.

The S&P 500 registered a tiny loss of 0.3%—the first one in three weeks because market sentiment turned sour in the latter part of the week over concerns that 1) the economy won't get healthier while the country gets sicker, 2) the rising Sino-U.S. geopolitical confrontation could lead to a nasty economic and diplomatic cold war and 3) a deal for a Phase-Four fiscal package could take weeks to resolve leaving millions of Americans in dire distress.

Consequently, several high frequency indices, which rely on weekly and daily data to get a crude but quick real-time feel of how the economic recovery is doing, have deteriorated thanks to the aforementioned factors. The Census Bureau's Weekly Household Survey, the NY Fed's Weekly Economic Index and the Weekly JEF Economic Activity Index have all fallen for the first time since the end of April. Although, continuing jobless claims dropped to 16.3 million on Thursday from 17.2m in the previous week, the increase in initial claims combined with the overhang of regulatory scrutiny was too much for the overly optimistic tech-market to handle. These negatives convinced me to downwardly adjust my trading range for the S&P 500 to 2900–3275. Additionally, too many

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speculators and traders need confirmation that the V-shaped economic rebound will not turn into a W-shaped path but more like a Nike Swoosh logo.

The Debasement Narrative Is the Big Story:

Over the past four months an appreciable increase in U.S. inflationary expectations and a noticeable decline in the exchange value of the Greenback have occurred. I've been on this wagon for months, warning my readers that the conditions surrounding these two phenomena were not just cyclical but structural. Let's have a look at what has happened since March 23 when the S&P 500 bottomed at 2237. The DXY, a popular measure of the dollar level against other major currencies, peaked at 102.70 and gradually decreased 8.1% to reach 94.38 on July 24th. Meanwhile inflationary expectations, nominal bond yields on 10-year Treasuries less yields on Treasury inflation-protected securities, rose three times from 0.50% to 1.50%. As one would have logically expected, commodity prices collaborated with their own substantial surge. For example, oil prices rose 110% to $41.08, copper 40% to $2.90 and gold 27% to $1898.

I don't want to burden my readers with the various factors that I pointed out in many past missives as to why I believed that the US dollar would be under downward pressure and inflationary expectations would rise. However, I shall add a few new reasons why more debasement danger down the road is much more likely than is commonly held.

Standard economic theory tells us that inflation does not happen when the economy is operating below capacity even if the money supply is surging as it is today. It's normally true. But this time it's different because the pandemic and deglobalization are permanently changing working habits and disrupting supply chains. Shipments are delayed, new orders get shelved and many goods go unfinished. Spare industrial capacity is not as large as commonly believed as the quest for onshoring manufacturing, digitizing business and rebooting production is showing. Many workers are unwilling to show up for work and won't until rising inflation and depleting government relief drive them back to it. This situation is being aggravated by changing consumer behaviour and the very fast replacement of economic activity away from the service areas to others. So far, inflation has not reared its head because online businesses have risen so much that there has been no need to raise prices to protect margins. This will stop when volume growth starts to slow down. Given that the Fed has embraced the

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idea of allowing inflation to rise above its prescribed target in a bid to bolster economic activity, inflationary expectations could easily go above the 2.0%-2.5% range.

The European Union lawmakers have bridged what has been considered for years as an insurmountable obstacle to become a fully-fledged fiscal union which will certainly enhance its creditworthiness. They approved a 750 billion-euro fund to combat the devastating effects of Covid-19. The initiative for a shared fiscal mechanism is a development that could bolster the euro's status as a reserve currency by creating a new set of large liquid bonds for central banks to buy and, in turn , compete with US Treasuries. The EU has a top-notch triple A rating with Fitch and Moody's and double A from S&P. Given that the U.S. lost its yield and growth advantage under completely dysfunctional politics, the DXY could weaken another 5.0% to 89.50.

Investment Implication:

As a rule, a fast deterioration in the exchange value of the dollar has been short-term negative, especially for stocks that are optimistically overvalued. It may partially explain why the big-cap tech stocks were under pressure all of last week. Once the adjustments are over, history shows that when the dollar is on the back foot, financial conditions are easier because it greases the global trade, helps commerce to grow and ensures financial stability in emerging markets. Risk assets usually love it when the world is a friendly place. Moreover, U.S. corporate earnings are always positively affected with downward changes in the dollar. One of Goldman Sachs' pet models shows that a negative 10% change in the DXY comes to a positive 3% change in the S&P 500 EPS. While the observation is interesting, what is even more important to note is that a weaker dollar has in the past been the biggest catalyst for foreign investors to buy US stocks. In this respect, U.S. industrial stocks with large foreign revenues, companies with sensitive sales prices and businesses with inflation prone assets should become superior performers.

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