6/28/2020: THE GREAT DISCONNECT THAT MAYBE WASN'T

A popular narrative getting bandied about right now is "the worrying disconnect between the market and the economy" or something along those lines. The headlines below are a sampling.

The narrative is correct, in many ways. There is indeed a large disconnect between the economy and the pricing of financial assets.

Historically speaking, the current market doesn't make *any* sense. It's not following the more "typical" bear market and recessionary playbook.

But, is this the correct take?

I'm not sure. And, in fact, I'm trying my best to remain agnostic and let price dictate the way forward. As long as there's a healthy diversity of opinions behind the trend. I'll trust the market knows more than I.

With that said, let's walk through some of the things I'm thinking about. And make somewhat of a counterargument to the popular narrative. Or, at the very least, try to gain a better understanding of what the market might actually be pricing in here.

For starters, it's important we remember Adam Robinson's "No Sense Algorithm" that I shared last month since there's not a lack of market participants saying "this rally makes *no sense*" (link here).

> *When someone says, "It makes no sense that…" really what they're saying is this: "I have a dozen logical reasons why gold should be going higher but it keeps going lower, therefore that makes no*

sense." But really, what makes no sense is their model of the world, right? So I know when that happens, that there's some other very powerful reason why gold keeps going lower that trumps all the "logical reasons."

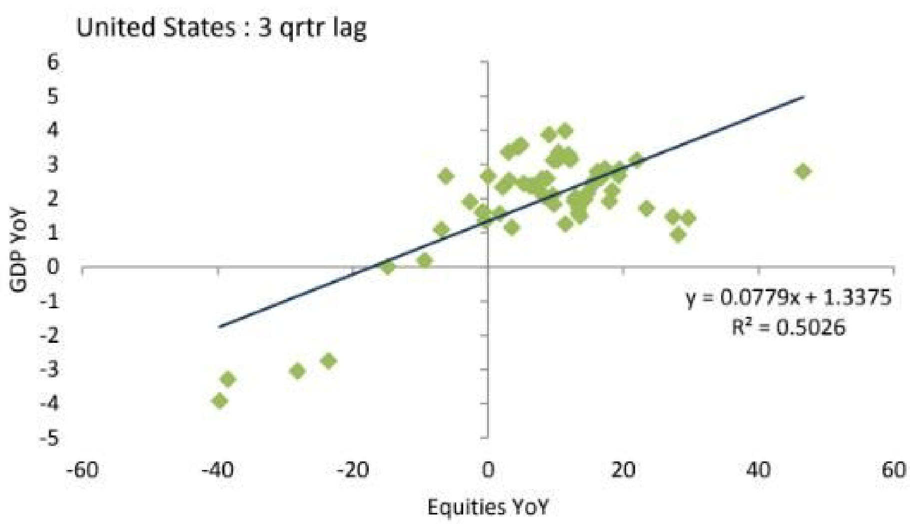
…Things that don't make sense are an Algorithm for finding opportunities. Where do we find good ideas? Look where no one looks. When thing's don't make sense, get into the trade.

Here's where I think people's model of markets and the economy could be off.

First, we all know that the market isn't the economy. That's true over the short-term but over the longer-term, the market is the economy. Since we need economic growth to drive earnings growth and credit growth.

Deutsche Bank shows the positive correlation between the two. DB points out that using simple linear regressions, "current US equity prices are consistent with US GDP growth of +0.7% YoY in Q3… more in keeping with a short-lived shallow recession and a quick shaped recovery, than a deep sustained weakness of historic proportion."

Figure 2:US relationship between GDP and Equity market based on 15Y history



Source :Deutsche Bank, Datastream

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One of the more difficult constructs for people to grasp though is the intrinsic forward discounting nature of the market. Markets only price in the current economic environment in so much as to how it will drive the future, looking 12-18 months out.

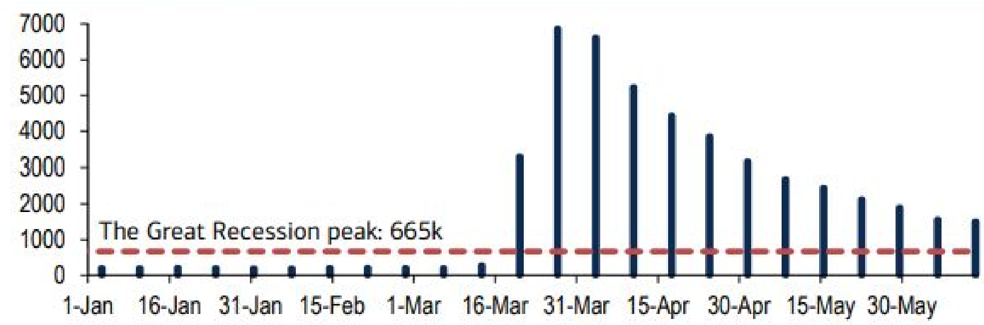
One of the reasons why this is so difficult to execute in practice is that the narrative machine and financial news are completely reactionary and not forward-looking at all. In essence, they're part of a system that plays the Keyne's Beauty Contest at the very first level.

The market does something unexpected, the system reacts by fitting a story to explain the move. This story then gets extrapolated well into the future. Those who become nodes in the narrative network get tunnel vision and become perennial practitioners of confirmation bias.

What the system fails to see is that everyone else is also reacting to this narrative, including policymakers. Not only is the obvious then already priced in by investors but the secondary and tertiary impacts, which include the actions of the very important Game Masters (Central Bankers and Fiscal Authorities), often go without thought… because of tunnel vision, nearsightedness, lack of imagination, reactionary fear… and all that jazz.

Back in March, at the height of the panic. We were facing an unprecedented global economic recession. 14-weeks into the crisis and we're still seeing initial jobless claims running at 2 ½ times the peak rate that was hit during the depths of the Great Recession.

Chart of the day: initial jobless claims are still elevated



Source: Department of Labor

And so far, the Game Masters have responded to the severity of the crisis in kind. The combination of fiscal transfers and direct credit market backstops have been incredibly effective.

For instance, despite the record high level of unemployment, Credit Suisse writes that "Consumer wallets are bursting at the seams, the result of massive government transfer payments… While earnings and other income have fallen by $3.9k per person, transfer payments have risen by $9.3k, on an annual basis… The result is an increase in personal savings from $4.2k to $18.6k. While some portion of this will be banked, previously-quarantined consumers appear ready to reopen their wallets."

Figure 2: Consumer Wallet

	Feb-20	Apr-20	Change	% of April Disposable Income
Comp & Other Income	$41,283	$37,339	-$3,943	66%
Govt. Transfer Payments	$9,946	$19,248	$9,301	34%
Disposable Income	**$51,229**	**$56,587**	**$5,358**	**100%**
Expenditures	-$47,008	-$37,940	$9,068	-67%
Savings	**$4,221**	**$18,647**	**$14,426**	**33%**

The increase in government transfer payments and drop in spending contributed to the jump in savings

Note All measured on an annualized per capita basis

Source: BEA, the BLOOMBERG PROFESSIONAL™ service, and Credit Suisse

Just as importantly, or even more so to markets, is the Fed's recent move to expand its involvement in the secondary corporate bond market. This is unquestionably a positive for credit spreads and liquidity in general.

There's now no longer a requirement for debt issuers to "opt-in" to the Secondary Market Corporate Credit Facility (SMCCF). This suggests a strategic shift by the Fed from being a "lender of last resort" to a regular participant in the credit markets.
Disregard what this move could mean for the structural integrity of markets and our capitalist system. That's a discussion for another day. Right now we're talking about markets, and that is undoubtedly a bullish development.

So the policy response has been incredibly bullish. But the market prices in the future. And judging from the price action over the last three months, it's pricing in a continuation and expansion of such policies. And there are some good reasons to think this will be the case.

Goldman Sachs wrote in a report last week that they expect:

> *Congress to enact another $1.5tn (7% of GDP) in fiscal measures, most likely in late July or early August. While Congress' initial policy response to the coronacrisis was swift and powerful, it now faces a number of fiscal deadlines, including the likely exhaustion of some businesses' funds secured though the Paycheck Protection Program (PPP) by late June, the start of the new fiscal year for nearly all states on July 1—with many states confronting significant revenue shortfalls—and the expiration of the extra $600/week jobless benefit on July 31.*
>
> *To address these fiscal cliffs, we expect Congress will provide more targeted support to the hardest-hit businesses, partially extend the extra jobless benefit at a lower rate of $300/week through year-end, and approve at least $200bn in additional fiscal relief for states. We also expect Congress to provide another round of stimulus payments to households similar in magnitude to the prior round. Taken together, we now think that roughly $800bn of additional fiscal support will be enacted this calendar year, bringing total CY20 discretionary spending to around $3.4tn. We think this stimulus will more than offset the decline in disposable income resulting from increased job losses, and see full-year disposable income growing by around 4% in 2020.*

In essence, this explains where the market is today.

There are two GIGANTIC opposing macro forces at work (1) is the HUGE liquidity shock caused by COVID mandated shutdowns and (2) is the, so far, equally impressive policy response.

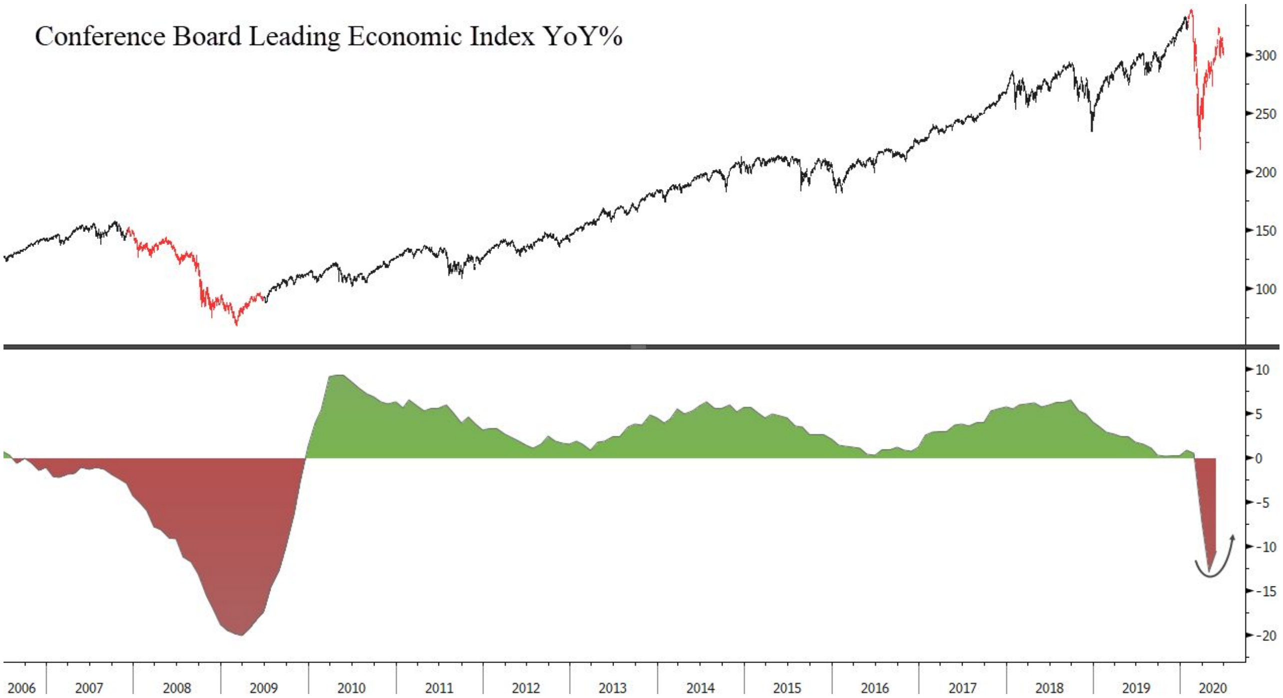
Where the markets go from here will be determined by these two factors; whether COVID brings about another round of mandated shutdowns and whether policymakers can stay on top of the crisis enough to keep things afloat until we get a handle on the virus.

There are plenty of BIG "ifs" in there and no lack of unknowns. It's important to remember that the future doesn't yet exist. No one knows how this will play out. Not even the market. And since there are so many variables and exponential unknowns in this equation, we should expect a lot of back and forth in the tape until some greater clarity comes about as to which macro force will win out, the virus, or the aggressive policymakers.

That's why my base case has been and still is, for an extended range of sideways chop in US markets. And, as I said at the start, I'll let price guide the way as we navigate these uncertain times.

Oh, and one last tidbit to help explain the bull case.

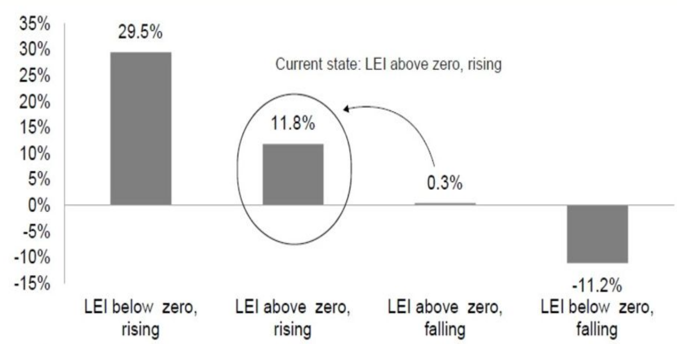
The Conference Board LEI bottomed in March and has since turned up.



It just so happens that the SPX's best returns occur when the LEI Y/Y is below zero and rising. When that's the case the index averages annualized returns of 29.5%.

It's still too early to declare that a bottom is in on this cycle in the LEI. Again, that's up to developments around the virus and future policy responses. Nonetheless, this is something to keep in mind if the Game Masters are able to thread the needle just right. That's a tall order, I know. And not one I'd say I think is highly likely. Though, it's not impossible either.

Exhibit 63: Average annualized equity returns sorted by LEI phase
S&P 500 Index



Note: based on rolling monthly periods back to January 1960. The year-over-year change in the Conference Board Leading Economic Index was used as the basis for above/below zero, and the month-over-month change was used as the basis for rising/falling. Source: Wolfe Trahan & Co., Bloomberg, RBC GAM

So let's continue to keep an open mind. Explore the possibilities. And let price dictate the way. Because, sometimes, the things that make "No Sense" make you the "Most Money".

Technical Outlook

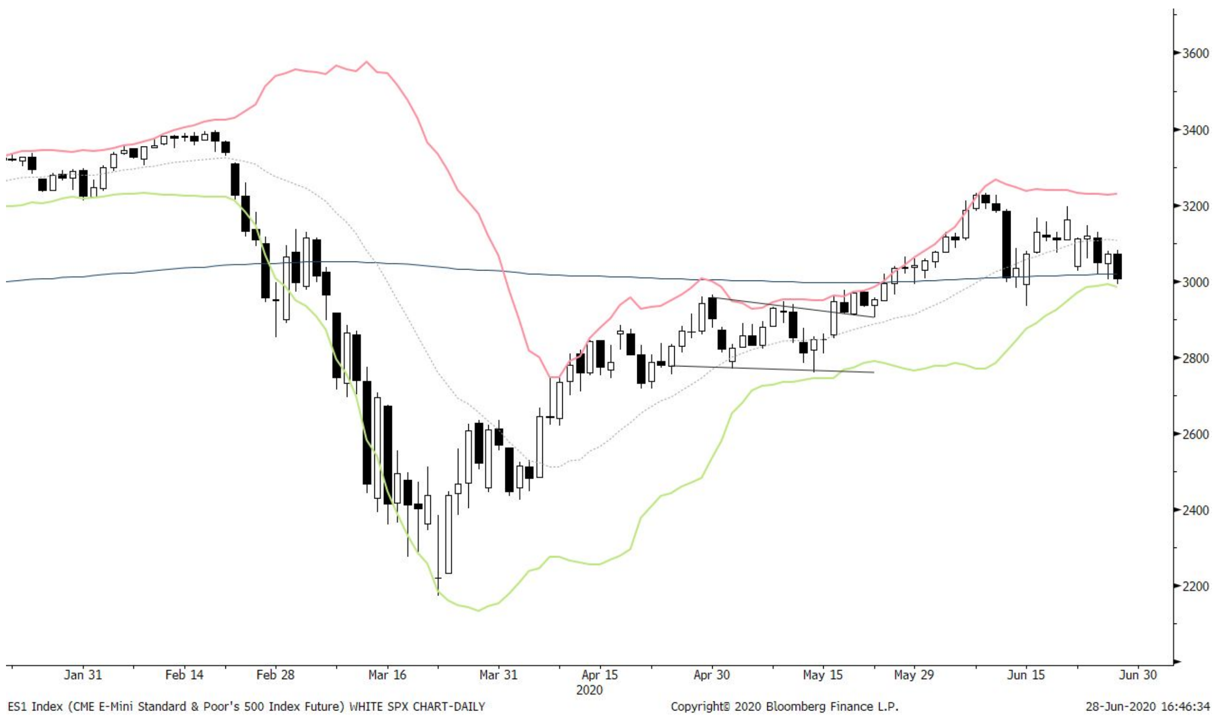
The SPX (daily chart below) closed near its lows on the week.

And to reiterate the Trifecta case for SPX pointed out in yesterday's report, we have:

- **Sentiment/Positioning:** Still overtly bearish with the only exception being Put/Call ratios. I think this unusual dichotomy is due to the fiscal transfers and the entrance of new retail traders to the market, speculating with their stimulus money — the data of small options traders definitely supports this. But, also, I believe it's due to institutions who are largely positioned defensively, buying calls over the last month so they can participate in this rally that they certainly were not expecting.

- **Liquidity:** Credit spreads and financial conditions are still largely supportive of equity prices here. That's why I think any selloff we do see will be capped to the more vanilla 10-15% variety.

- **Breadth:** Participation in this move has deteriorated from fairly strong levels over the last two weeks. But, it hasn't deteriorated so much that it puts the odds in favor of a large selloff.



I can see the short-term market path playing out a few ways here.

One is that we start next week off with a strong selloff below the lower daily Bollinger Band (green line). But the selloff is short-lived, 3-5% from current levels. It forms a bear trap and the market ramps back up (I think it maybe wants to close that Feb 24th gap at 3,320).

An equally likely scenario is that we see the market start a more aggressive selloff down to around the 2,750 range before finding a bottom and chopping sideways for a bit. It's hard to see the market going for another major leg down here with sentiment and positioning being where they are. Of course, we can't completely rule that out either. Anything is on the table if COVID were to lead to widescale shutdowns again.

My thinking here then is that I want to stick with my current long positions that are working in my favor (have strong technicals) and dump those that are not. Bonds and gold are still working as a free hedge, so I'll up my exposure to both until we get another buy setup on the SPX, which could come this week or in a couple of weeks.

I'll be cutting our position in OSG, the shipping stock, on Monday at the open. It's near our risk point and I should have cut this one sooner once the virus growth started picking up again. I'll also be taking the remainder of our long position off in the long MXNUSD trade. I like the potential for this trade longer-term but the positioning against the dollar makes me think we could see a short USD washout move soon (I'll be exploring that more in a later note).

That's all I've got for now. Hit me up in the CC if you have any questions!

Your Macro Operator,

Alex

The Four Pillars Portfolio			YTD Return			
			13.6%			
The Core	Allocation					
Large Cap Equities (/ES_F or VOO)	25%					
Short-term Bills (/ZT_F or VGSH)	25%					
Long-term Bonds (/ZB_F or TLT)	25%					
Gold (/GC_F or GLD)	25%					
Big Bets	Thematic	Cost Basis	At Risk	Notional %	Risk Point	Last Price
Overseas Shipholding Group (OSG)	Deep Value/Cyclical	$2.27	200bps	9%	$1.70	$1.76
Cameco (CCJ)	Deep Value/Cyclical	$7.25	Above B/E	13%	$8.50	$9.88
Altisource Portfolio Solutions (ASPS)	Deep Value/Swing	$10.16	B/E	7%	$10.16	$15.07
Bed Bath & Beyond (BBBY)	Deep Value	$7.86	50bps	6%	$6.85	$10.04
Bollore (BOL)	Hidden Deep Value	$2.46	B/E	14%	$2.46	$2.78
MXNUSD (6MU2020)	Swing	0.04191	B/E	--	0.04045	0.04298