Quick RIC

Deflation and its discontents

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Investment Strategy
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The RIC Outlook

As usual, this month we address some of the questions clients ask most frequently:

1. **There's so much chaos, why do stocks keep rallying?** The S&P 500 has rallied this year because of central bank liquidity, fiscal stimulus, and the deflationary, top-heavy nature of the index. But the tension between the market and the economy is real; in our view, there is risk that Stagnation + stimulus = a significant bubble in growth stocks (Chart 1) vulnerable to either Stagflationary populism or the Elevation of alternatives via industrial policy.

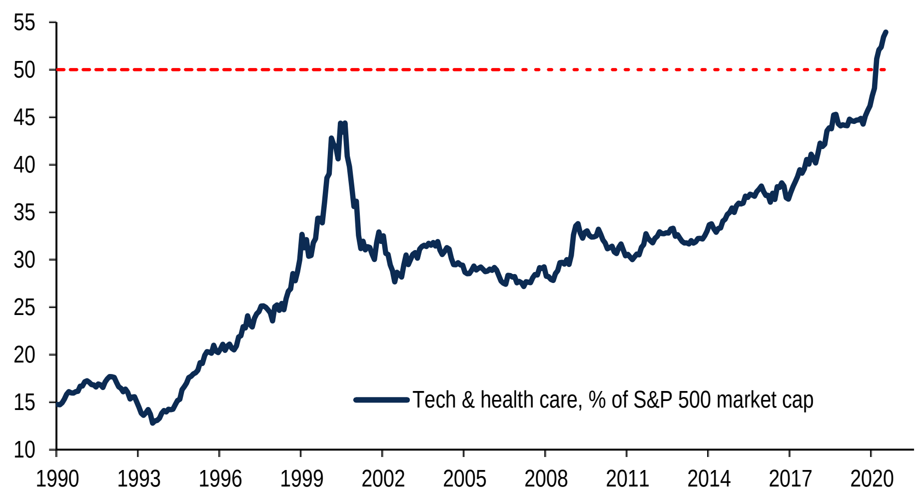
2. **What does the weaker US dollar mean for our "Build America Boom"?** The weaker dollar is good news, signaling improving global conditions & policy success in Europe. A fairly valued dollar makes US exports more attractive and can accelerate our thesis about the rebalancing of global capex.

3. **How is the US/China conflict changing?** Our view on the shift from trade war to capital war is gaining adherents as restrictions and sanctions pile up. We don't think investors will care until 1. capital controls affect Chinese elites & 2. after the US election; a wildcard in 2020 is that China is exporting deflation again (Chart 9).

4. **The End of 60/40 is fine…but where to look instead?** As stagnation blurs the lines between asset classes, investors should take only the risks they want; we like equity, credit (corporates, EM, taxable munis) and liquidity (closed-end funds, gold).

5. **What are the risks few investors are prepared for?** 1. US austerity, 2. an election decided by the House, 3. a vaccine or treatment surprise.

Chart 1: The pandemic sent growth sectors to >50% of S&P 500 market cap for the first time ever



Source: BofA Research Investment Committee, Bloomberg; includes GICS Health Care & Information Technology plus reclassified ex- tech (AMZN, NFLX, GOOGL, GOOG, EBAY, FB, TWTR, TTWO, EA & ATVI).

The RIC Outlook

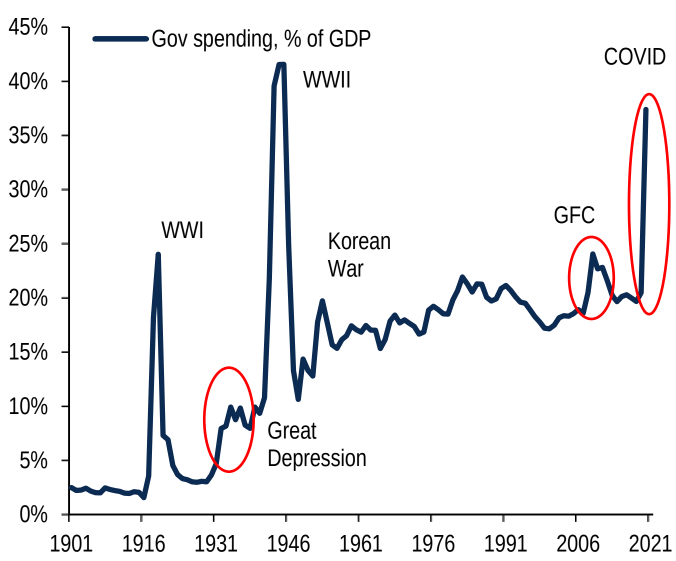
1. There's so much chaos, why do stocks keep rallying?

The contradiction is real. People can be forgiven for not celebrating in the streets at each new Nasdaq all-time high. As one novelist said recently "we will not wake up, after confinement, in a new world; it will be the same, only a little worse."

That same old world is one of extreme inequality on Main St., where safe suburban Zoom denizens gawk at jobless urban & rural discontents; and extreme inequality on Wall St., with a record bubble in growth stocks vs. muted returns for everything else. The stock market is positive for the year despite all the economic pain because of:

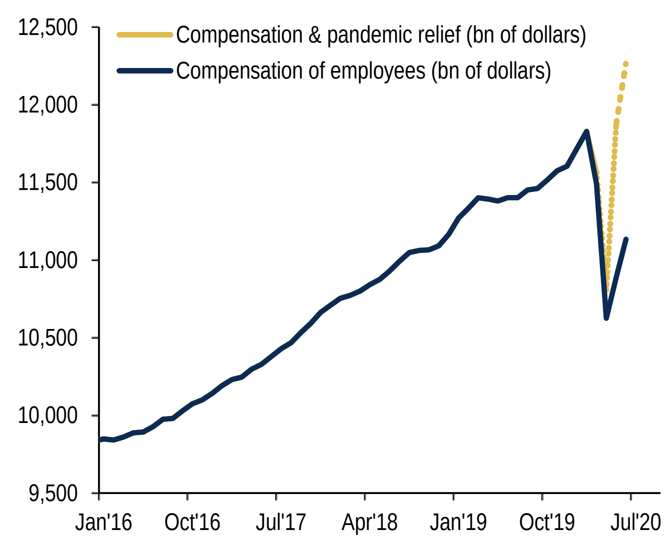
1. **Central bank liquidity**: as Michael Hartnett notes, 2020 has been a year of 167 rate cuts and $8.4tn in CB monetary support, with near-unlimited untapped Fed buying power & yield curve control on the horizon, all to support markets with the explicit understanding that monetary policy can do little for the real economy (link);
2. **Fiscal stimulus**: $2.8tn in fiscal stimulus this year, the most in US peacetime (Chart 2), has been a rousing success; by May government transfers completely plugged the gap, bringing aggregate compensation to the same level as in February (Chart 3). But we know short-term unemployment insurance is unlikely to persist;
3. **Inequality**: most importantly, the market often does not reflect the real economy; defensive growth stocks (tech & health care) account for just 18% of US jobs but now comprise 54% of the S&P 500 market cap (Chart 1 – at the current pace, 100% by 2024); the biggest losers from the pandemic (e.g. retail, airlines, travel & leisure, oil & gas) accounted for 47% of job losses but only 10% of S&P 500 market cap.

Chart 2: Fiscal support has been the largest & fastest in peacetime



Source: BofA Research Investment Committee; Global Financial Data;, White House budget

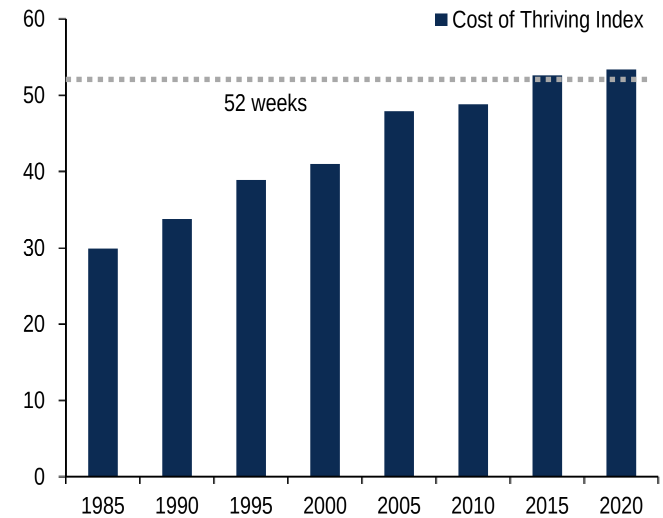
Chart 3: Fiscal stimulus filled the gap in aggregate incomes



Source: BofA Research Investment Committee; Bureau of Economic Analysis; Compensation of employees with March unemployment insurance and April– June pandemic unemployment relief.

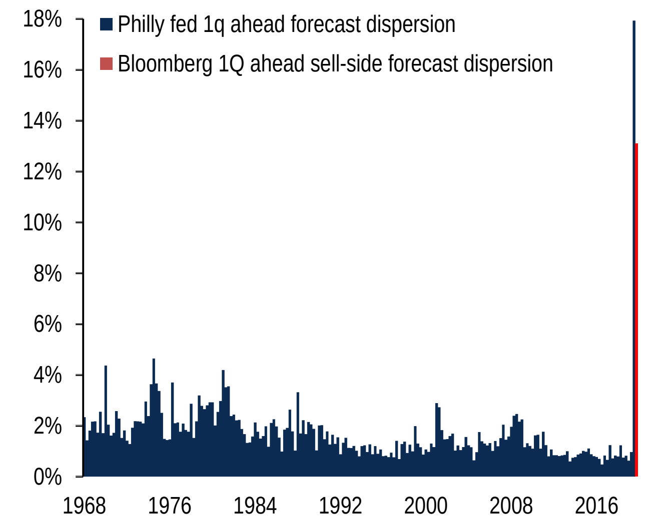
The big **economic** risk is that job losses from the pandemic morph from short-term separations (shallow cuts that can heal) to long-term unemployment, which is scarring. Life for many workers was already precarious before the pandemic: according to the Cost of Thriving Index, in 1985 it took 30 weeks at the median wage to pay for big fixed costs like housing, health care, a car, and education; today it takes 53 weeks of a 52-week year to buy those things (Chart 4). In other words, "thriving" has become impossible for the average worker; it's no wonder that the uncertainty of forecasts for future growth remains near record highs (Chart 5).

Chart 4: It now takes more than a year's pay to cover basic needs



Source: BofA Research Investment Committee, Manhattan Institute; 2020 estimated.

Chart 5: US GDP forecast uncertainty remains near record highs



Source: BofA Research Investment Committee, Philadelphia Federal Reserve, Bloomberg

The major **market** risk is that stagnation + liquidity = a bubble, vulnerable to pinpricks either from stagflationary, volatile populist reactions (tax hikes, China hawks, tech hectoring) or the creation of big alternative opportunities for investment via productivity-boosting industrial policy (see June RIC).

Stagnant GDP, deepening inequality, and the threat of tepid policy make us bullish on the things we don't want to buy (growth, large caps, US, tech) and bearish on the things we want to own (value, small caps, EAFE, industrials) because, without a transformation of developed market economies, any reversal in the ranks of market winners & losers can only likely last a season. In our view, you can't fix inequality on Wall St without fixing it on Main St.

Recalling our framework of Stagnation/Stagflation/Elevation, what the pandemic has made clear is that even successful fiscal support to "plug the gap" in wages and revenues can only bring us back to the best version of a stagnant world, one in which things are indeed "the same, only a little worse."

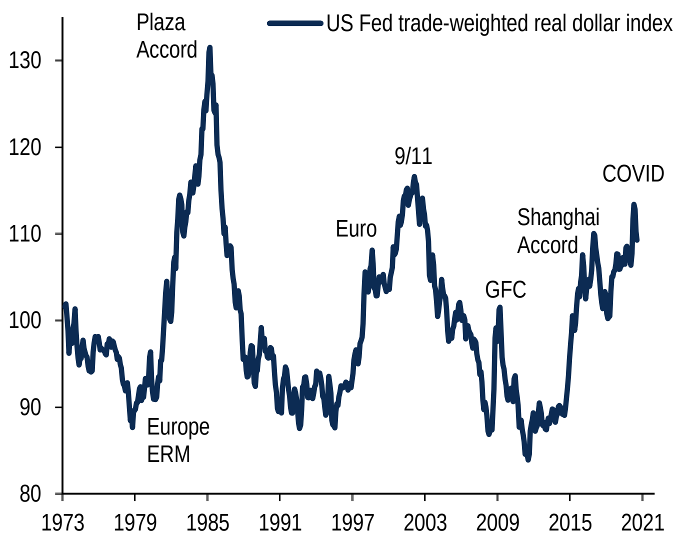
2. What does the weaker US dollar mean for the "Build America Boom"?

However, we still expect a shift toward "Elevation" in coming quarters as the process of global rebalancing has already begun. The thesis of our recent work has been that more corporate capex and public sector investment (R&D, infrastructure) is the only path out of stagnation and the boom-bust cycles of asset bubbles and debt-fueled intervention.

The rise this summer in the value of other currencies against the dollar is another piece of good news, signaling better global macroeconomic conditions and policy success in Europe.

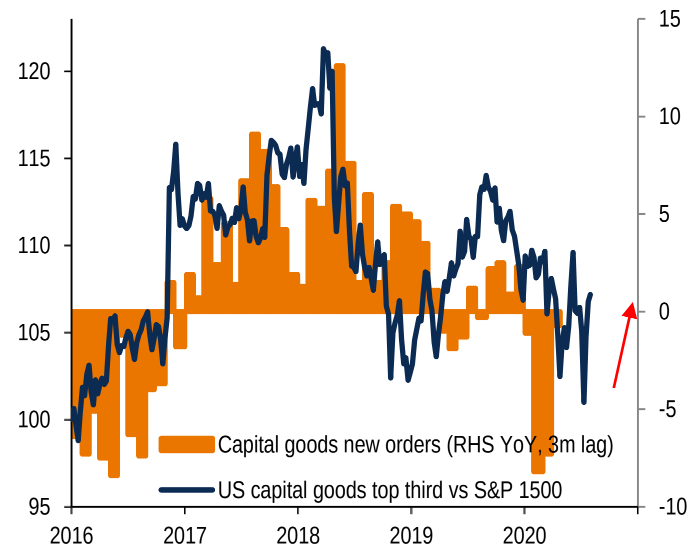
In a true crisis, investors flock to the US dollar and little else (2001, 2008, 2016); the same thing happened in March, sending the dollar to some of the highest levels in the last three decades (Chart 6). As markets have recovered, investors felt comfortable enough to rotate elsewhere in G10 FX, especially after the initial European step toward something like fiscal union.

Chart 6: The dollar hit a ceiling, not debasement
US trade-weighted dollar is in the 85th percentile vs. history



Source: BofA Research Investment Committee, Federal Reserve

Chart 7: Watch capital goods outperformance for the US capex turn



Source: BofA Research Investment Committee, Bloomberg; * ratio of top third of US capital goods companies ranked by revenue share from US

A fairly valued dollar makes US exports more attractive and can accelerate our departmental view about the rebalancing of global capex (for more see our Macro Highlights, below). A recovery in domestic capital goods orders may begin shortly, as companies with a US revenue focus have recently outperformed the broader market (Chart 7). More moderation in exchange rates would be a sign not of fiscal profligacy but that US manufacturing exporters have a fighting chance for the first time in a long time.

3. How is the US/China conflict changing?

Since February, the RIC has been arguing that the US/China conflict will likely shift from a trade war to a capital war. Our view has been gaining adherents as market access restrictions and financial sanctions begin to pile up.

Over the last few years, the administration has focused on the trade deficit with China as a problem for jobs, manufacturing, and security. Every dollar spent on imports is a dollar China earns of exports, revenue which is often recycled into Treasuries, corporate securities, real estate, or other assets by virtue of the US's open capital account.

Instead of fighting on complex trade issues, we expect US policymakers to focus on capital markets and currencies both for operational simplicity and for greater leverage. Possible policy responses include unofficial weakening of the US dollar, explicit capital controls (including taxes on inbound capital flows), or domestic tax incentives designed to bolster industries threatened by Chinese overproduction.

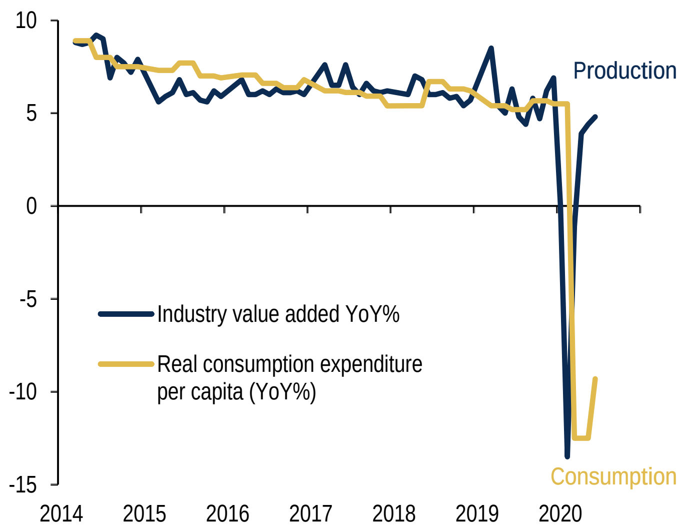
The most important question for investors is when investors will begin reacting to the changing nature of the conflict. We doubt markets will care until 1. capital restrictions affect Chinese elites and/or 2. the policy agenda is clearer following the US election.

However, we think the wildcard in 2020 is that China has begun "exporting deflation" once again (Chart 8). By ramping up industrial production (increasing exports) but repressing household consumption (decreasing imports), China is creating conditions for another current account surplus and "global savings glut". Historically this has always been a major headwind for US equities, especially small caps (Chart 9).

As David Cui notes, internalizing Chinese policy stimulus has become an explicit goal, even if it does exacerbate global imbalances, cause an unmanageable buildup of leverage, and threaten the stability of the financial system and the renminbi. Doubling down on "Made in China 2025" import substitution *sotto voce* may only accelerate the shift toward a capital war.

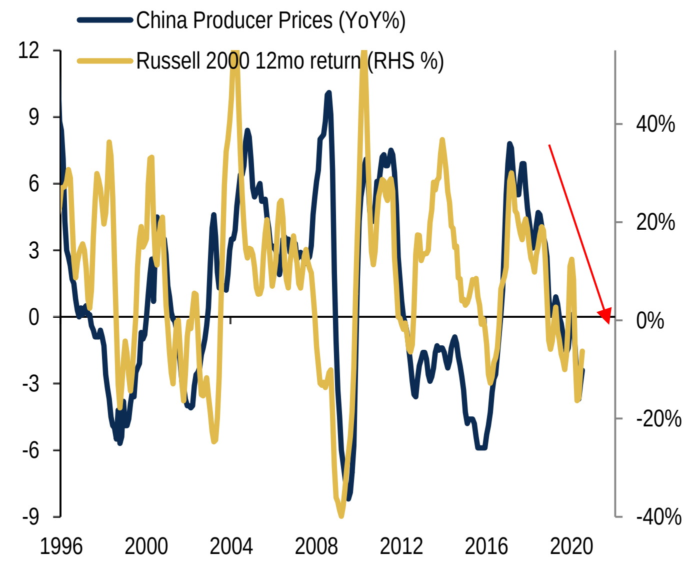
Chart 8: "Made in China 2025" import substitution is alive and well

China is ramping up industrial production while suppressing household consumption



Source: BofA Research Investment Committee, Haver

Chart 9: China exporting deflation has hurt US small business



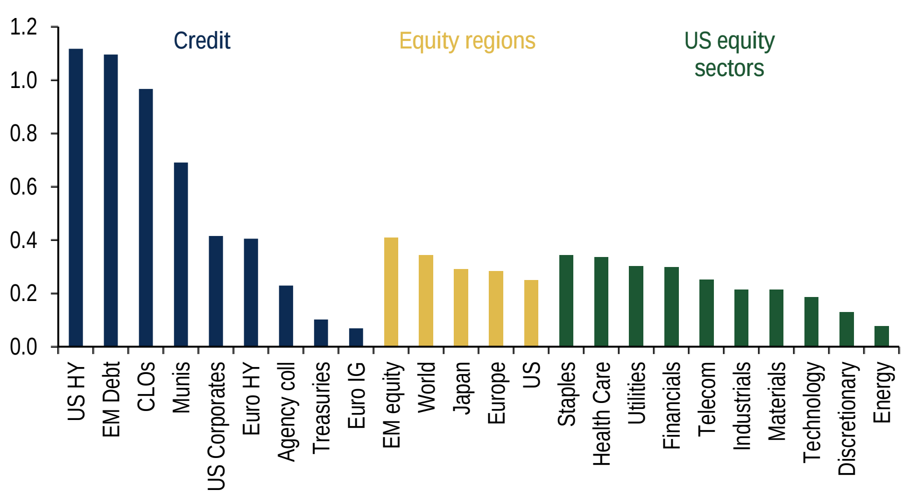
Source: BofA Research Investment Committee, Haver

4. The End of 60/40 is fine…but where to look instead?

Since we started the conversation last year about the End of 60/40, it has come to dominate discussions among clients. One common question is how investors who understand the unattractiveness of Treasuries should allocate instead to fixed income.

First, we would emphasize that secular stagnation is blurring the lines between traditional asset classes. Is a 30-year Treasury bond really so different from a high-flying consumer tech stock that pays a 0.7% dividend? Neither provides investors with a positive inflation-adjusted income stream, and both would look suddenly very unattractive in our Stagflation or Elevation scenarios.

Chart 10: Cross-asset comparison of yield per unit of risk



Source: BofA Research Investment Committee, Bloomberg, Refinitiv

Instead of thinking only in terms of traditional asset classes, we can think in terms of sources of risk. Every investor has to take risk somewhere, and we suggest allocating capital only to the kinds of risk one wants to take. Today, that means equity, credit (corporate, EM, and taxable municipal), and liquidity (closed-end funds and gold):

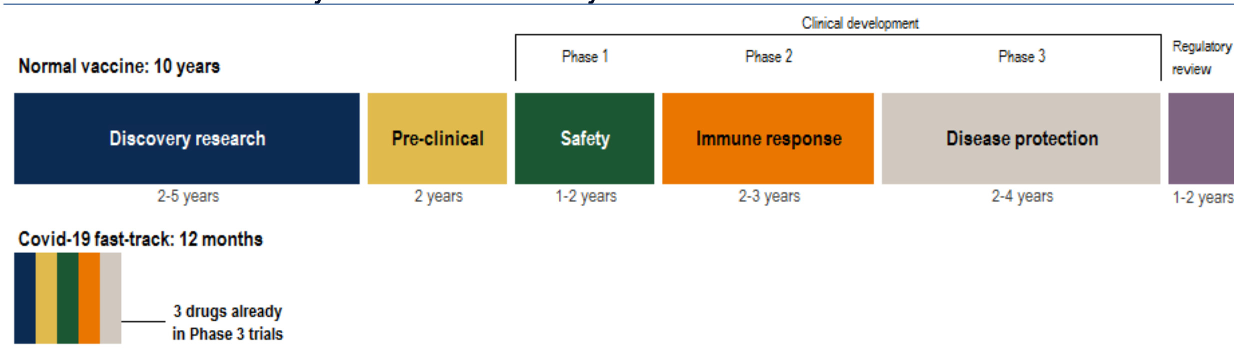
- In this month's interview, Hans Mikkelsen (link on page 1) argues that improving macroeconomic data makes cyclical corporate bonds attractive, but that investors ought to hedge against interest rate risk. The team has US spread target of 125bps.
- Emerging market debt is becoming more attractive as global conditions improve, and our strategists have published a primer on EM debt ETFs and options;
- Our municipal bond team is looking for $200bn to $400bn for state & local governments in the next stimulus package, and they argue that taxable munis may outperform corporate bonds this year (link);
- Many of our Buy-rated closed-end funds are trading at discounts (8-15%) to their net asset values, with yields on high-quality issues of 4% or more. Eli Lanik flags some attractive opportunities in municipal, preferred, and senior loan CEFs (link);
- Finally, gold can be thought of as a measure of whether it makes sense to buy "anything but government bonds". Today, the price is confirming the message from bonds, that there's some economic normalization (1.6% breakeven inflation), but not enough growth for the Fed to raise interest rates (0.6% 10-year Treasury yield). A -1% real yield makes "anything but bonds," including gold, a decent alternative.

5. What are the risks few investors are thinking about?

Here are three surprises that could have a big impact on markets:

- **Austerity**: for Aristotle, "incontinence" is an inability to do what one knows is good, usually caused by a weakness of the will. Nearly everyone in Washington understands the need for >$1tn of support ($400+/week unemployment insurance is key; $200 = disaster); the lack of progress suggests Congress may have exhausted its resolve; or that a greater vice is at work–the calculation that economic pain now translates to more votes later. In either case, only a market correction would wake policymakers from their dogmatic slumber. While others are hedging the election, consider preparing for a Q3 buying opportunity;
- **A House-selected President**: on the other side of Nov. 3rd, if concerns about expanded voting procedures, mail-in ballots (NY Democratic primary saw ~20% of ballots rejected), or recounts in contested states delay results, state officials could refuse to certify their electors; without 270 electoral votes for any candidate, the Constitution requires the House to select the president, but with one vote for each state delegation, Republicans would likely hold the majority;
- **Vaccine surprise**: we are all hoping for 12 months not 10 years (Chart 11) and six vaccine candidates in large-scale phase three trials, with some already entering mass production; Regeneron has begun a phase three trial for its drug mix with preventative and acute infection treatment possibilities (link). Financial assets are not priced for a "return to normal" in 2021 and the risk worth considering is that an early vaccine could spark a significant tactical rotation out of deflationary defensives and into cyclical sectors.

Chart 11: A vaccine could be ready in 12 months instead of 10 years



Source: BofA Research Investment Committee, Wellcome Trust

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