Absolute Return Partners

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4 May 2020

Time for Alternative Thinking on Covid-19

Our latest thoughts

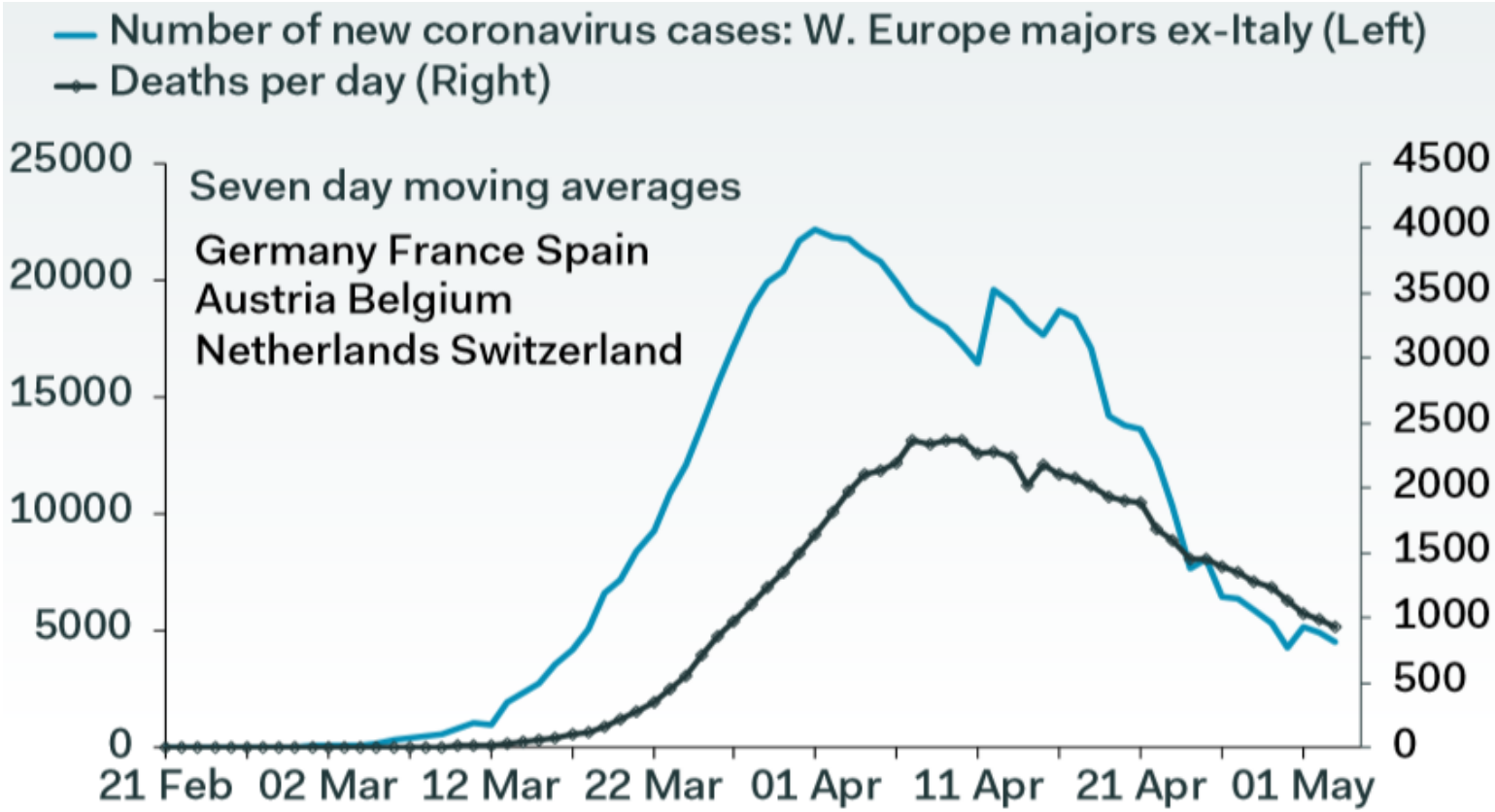
Agenda

Part 1

WHERE ARE WE IN THE DISEASE CYCLE?

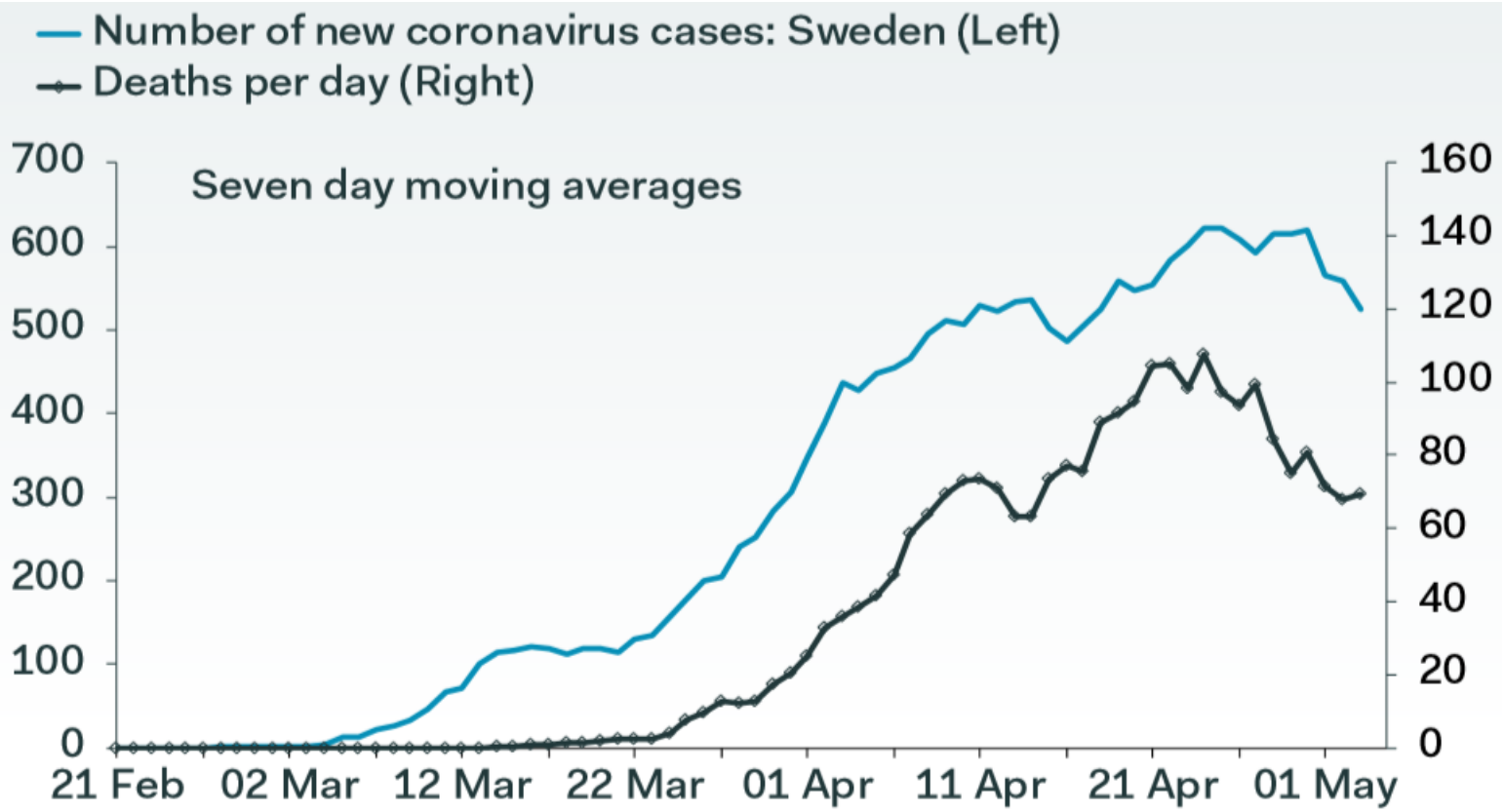
The downward trend in Western Europe continues.

New Covid-19 Cases and Deaths per Day in Western Europe ex. Italy



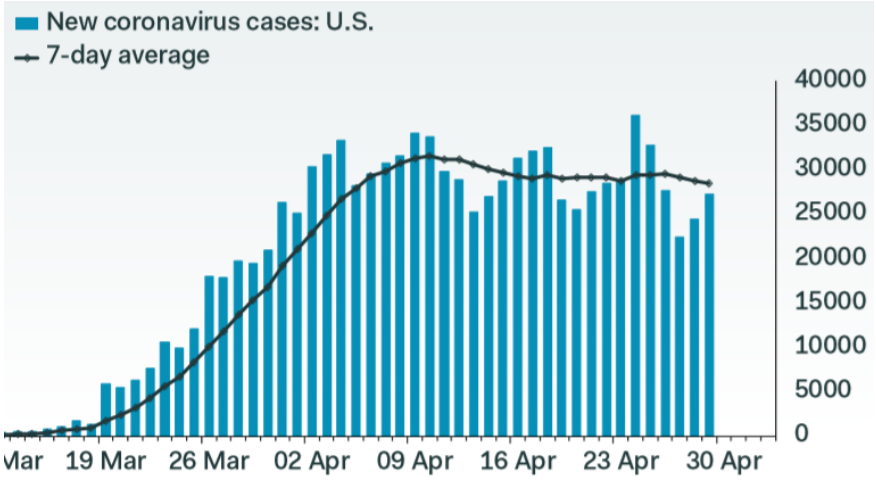
For weeks, the odd one out in Europe has been Sweden, but the numbers have finally started to improve there too.

New Coronavirus Cases and Deaths Per Day in Sweden

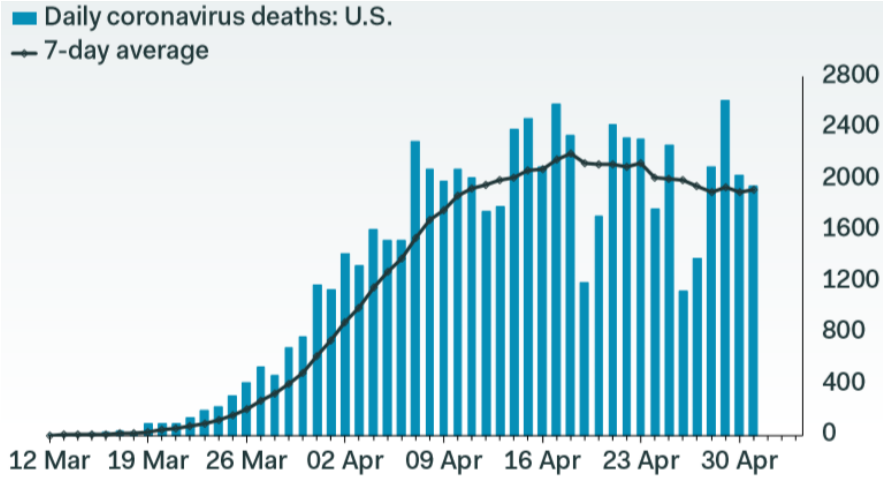


The number of new cases and the number of deaths in the US have finally started to drop, but the slowdown is both modest and erratic.

New Covid-19 Cases per Day in the US



Number of Covid-19 Deaths per Day in the US

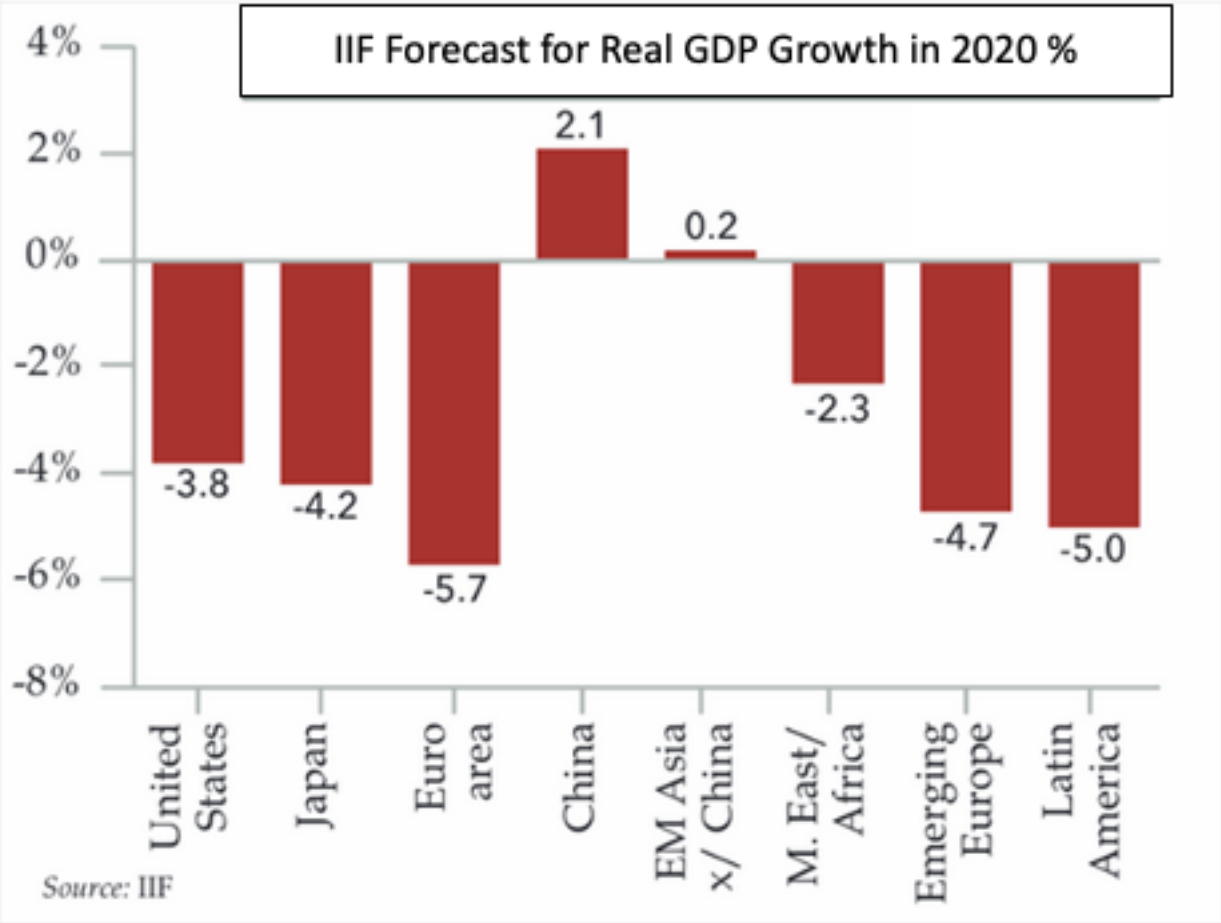


Part 2

THE ECONOMIC COSTS OF COVID-19 & HOW TO FUND THOSE COSTS

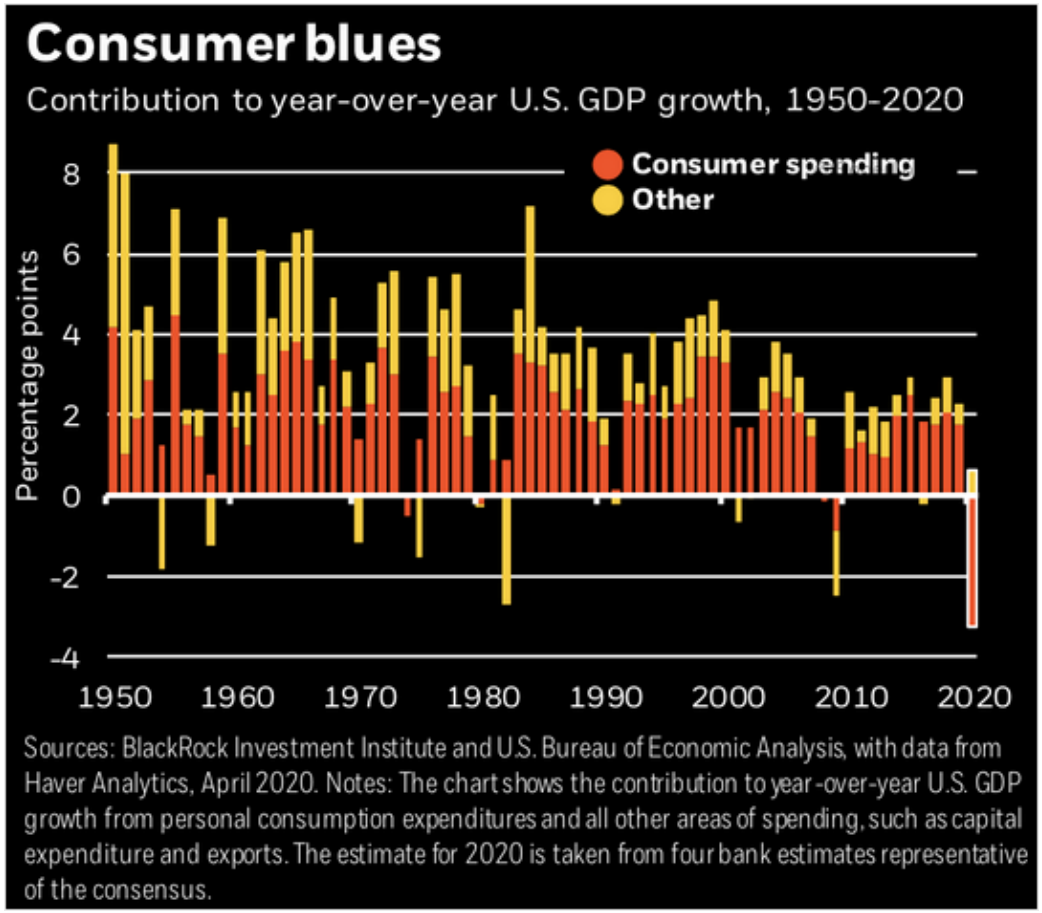
The impact on economic growth will be massive …

Estimated Real GDP Growth in 2020 Post Covid-19 in Various Countries and Regions



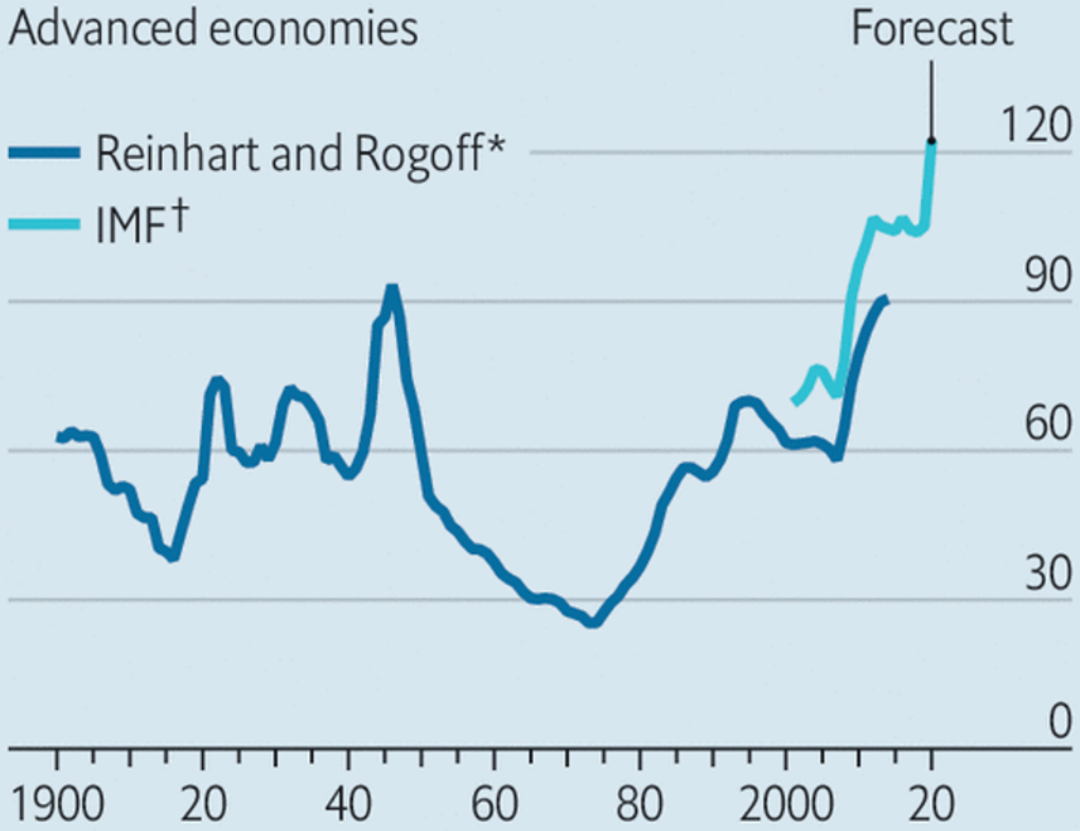
… and it is the collapse in consumer spending that is the main driver.

The Impact of Consumer Spending on US GDP Growth, 1950-2020



DM government debt will increase to $66Tn by the end of this year, taking total DM government debt-to-GDP to 122%.

Gross Government Debt in % of GDP (DM only)

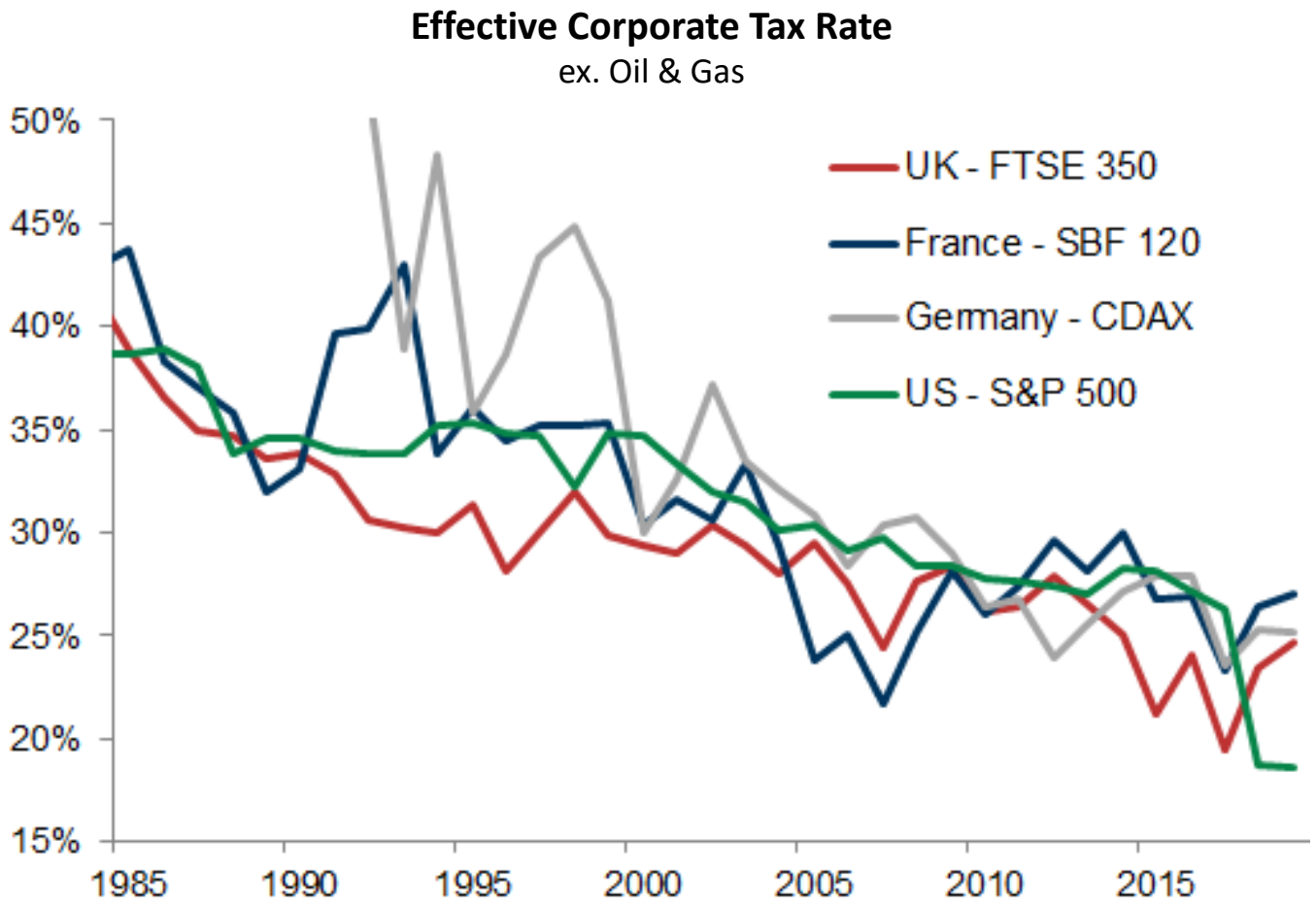


* Simple average, 22 countries. † Weighted average, 39 countries.

Will all that debt ever be paid back? I have identified at least six possible outcomes.

1. Pay down debt by issuing bonds and pay for those bonds through taxation – potentially mixed with a dose of austerity.
   - This has been the classic approach in the aftermath of the GFC with US and Eurozone public spending in % of GDP falling by 3.5% between 2010 and 2019.
2. Change the corporate tax model – see slide 12 .

Is it fair that some of the biggest and most successful corporates pay little in tax?



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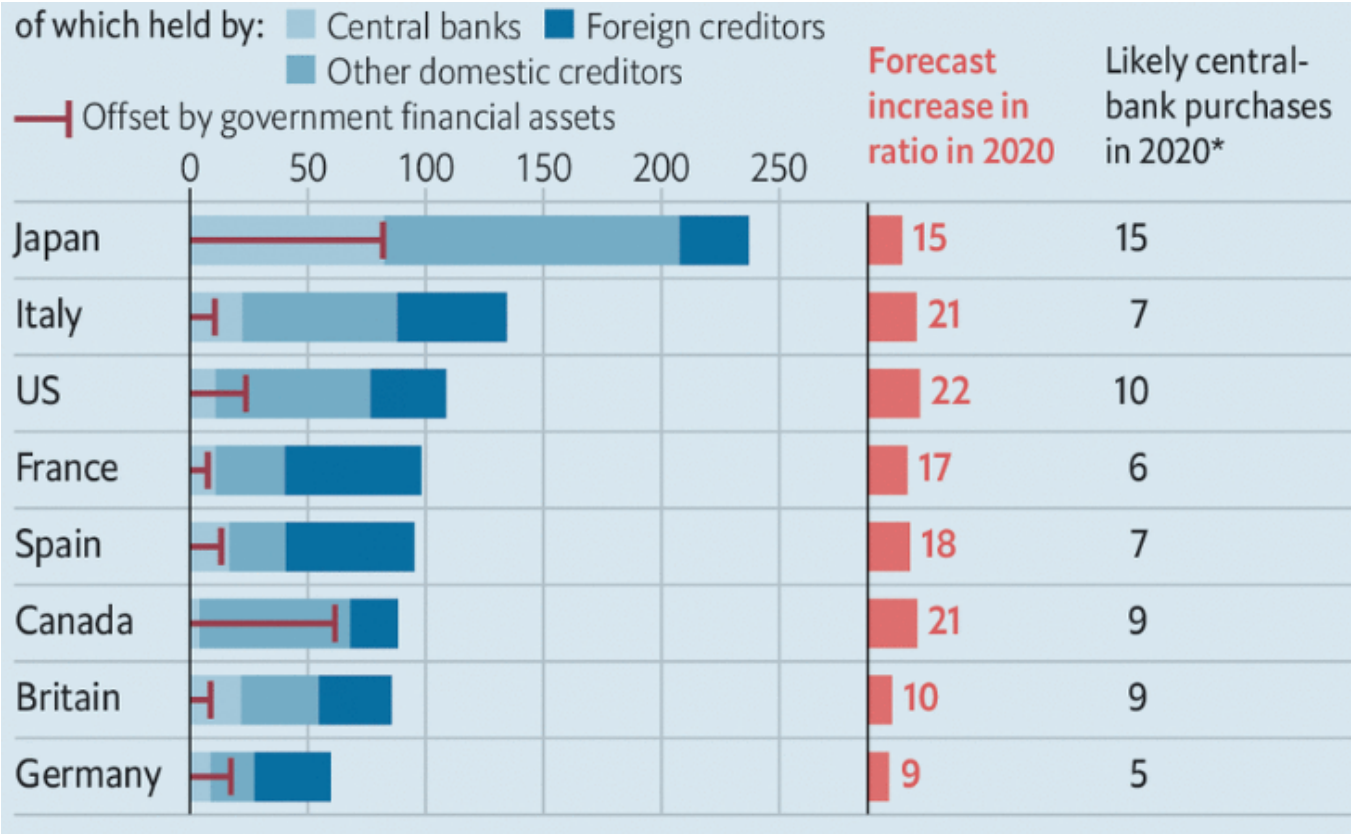
3. Destroy debt through inflation, aka financial repression; i.e. ensure that inflation-adjusted interest rates are negative.
   - This approach was successfully used by DM governments post World War II. Debt-to-GDP in the UK was 259% at the end of the war but, by 1980, it had been reduced to 43%.
4. Destroy debt through default.
5. Introduce the MMT model (Modern Monetary Theory) more systematically – the so-called Magic Money Tree – where there is virtually no limit to government spending, as the central bank will simply print the money required – see slide 14.

Japan is ahead of the rest of the world in terms of adopting MMT with nearly 50% of all JGBs now owned by BoJ.

Gross Government Debt as % of GDP in 2019



* Purchases of government bonds as % of GDP.

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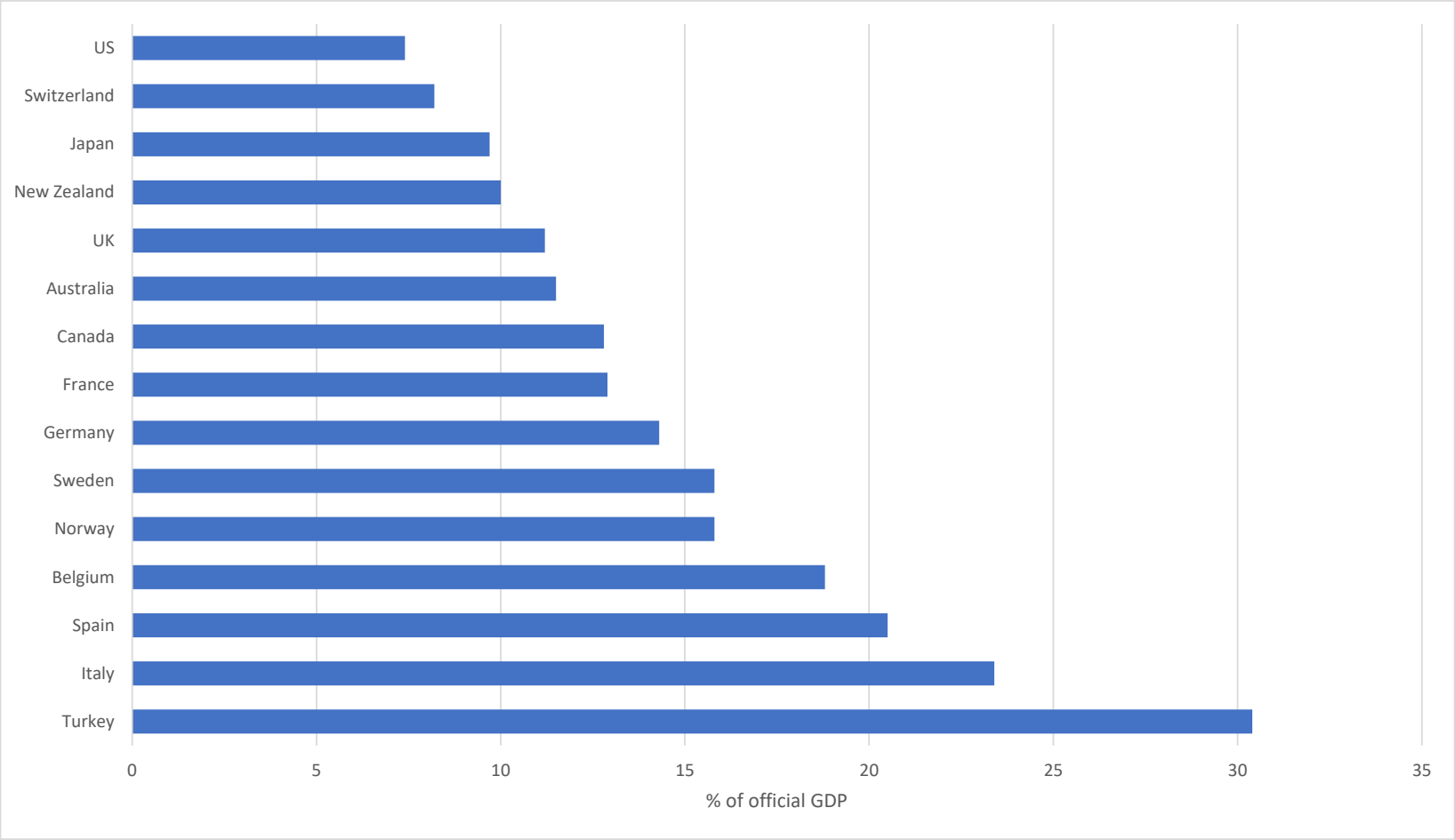
6. Think out of the box – see slides 16-19.

Out of-the box option A: Go cashless sooner than planned.

Some Major Advantages Associated with a Cashless Society

- Less money laundering, as there will always be a paper trail.
- Curtailment of the shadow economy in general.
- Less crime (pickpocketing, burglaries and similar).
- Reduced costs associated with handling of paper money – from printing costs and cash management to transportation and storage costs.

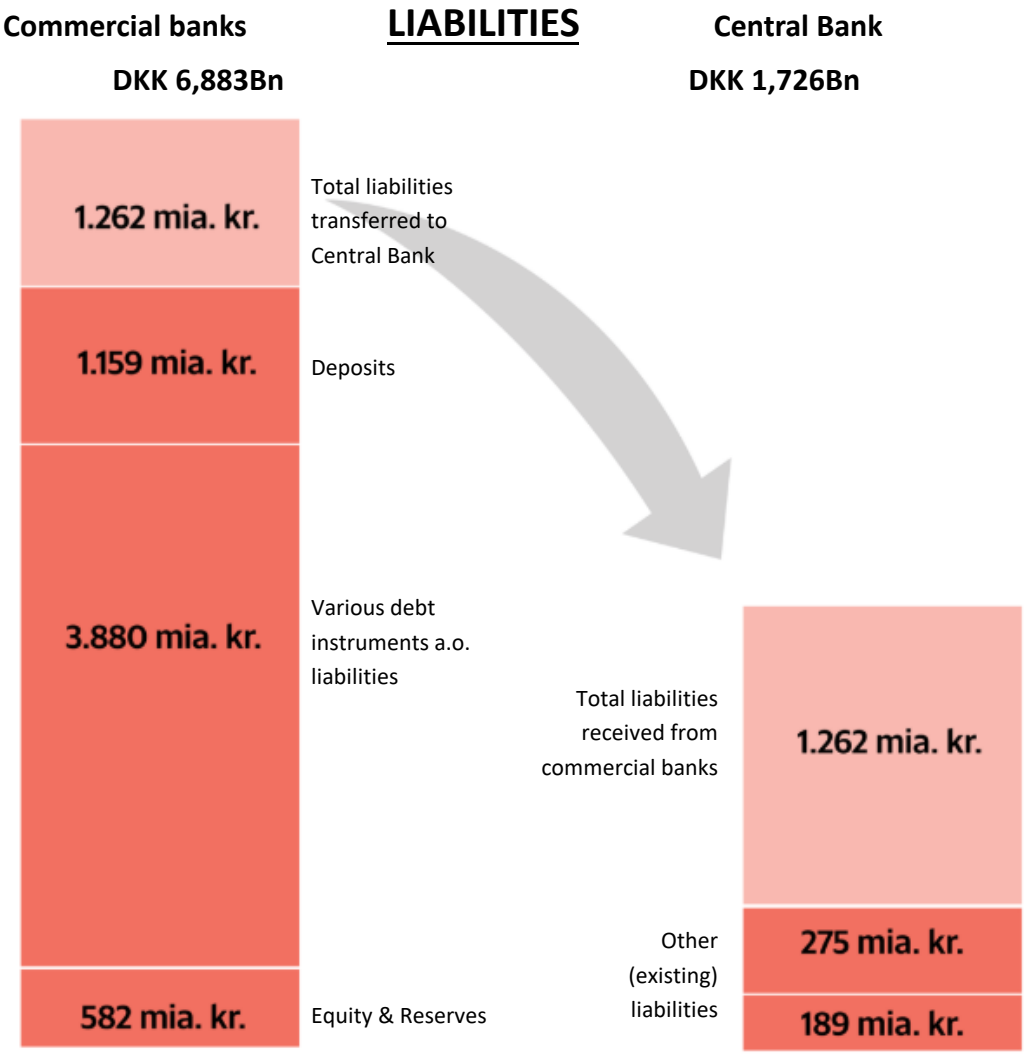
Out of-the box option A: Go cashless sooner than planned.



Out-of-the box option B: Change the banking model.

Step 1: All current accounts are transferred to the central bank and, going forward, all day-to-day transactions will take place through this account.

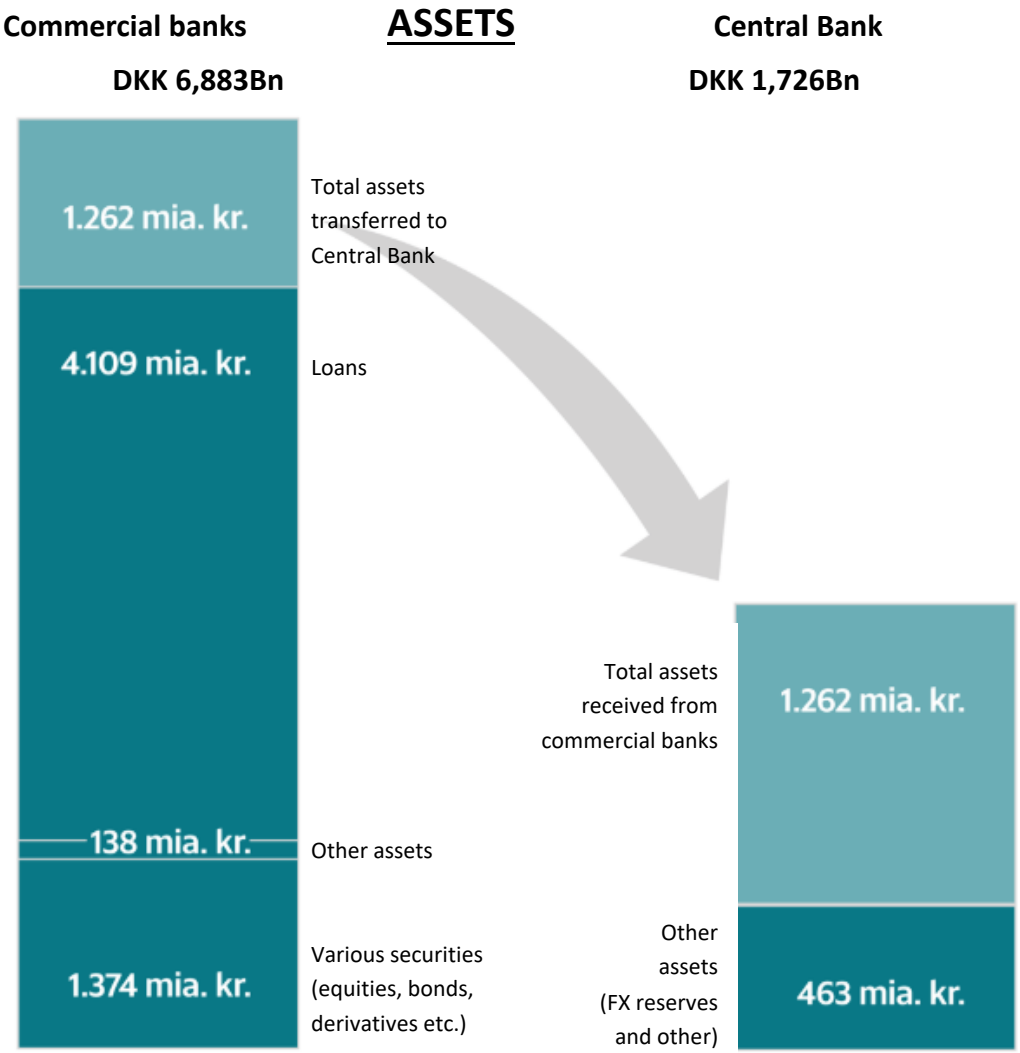
Step 2: This will dramatically reduce commercial banks' liabilities – by DKK 1.262Tn (EUR 170Bn) in Denmark alone.



Out-of-the box option B: Change the banking model.

Step 3: An equivalent amount of assets (DKK 1,262Bn) should then be transferred to the central bank. That would include (some) loans to corporates and house-holds (in total over DKK 4Tn).

Result: Now, the central bank has almost DKK 1.3Tn of working capital – more than four times the funding costs of the Covid-19 crisis so far – and it has a new tool at its disposal. It can offer loans at 0% if economic conditions demand it.



Part 3

THE IMPLICATIONS, SHOULD WE OPT FOR FULL-BLOWN MMT

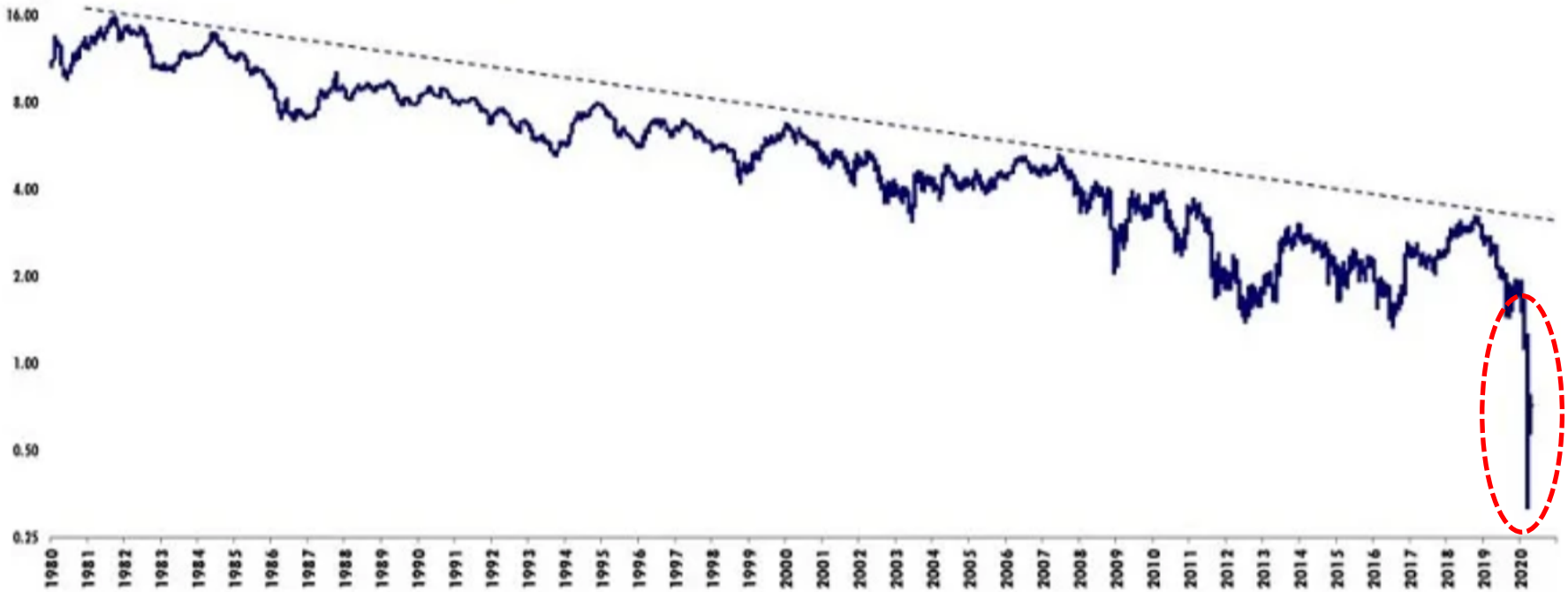
Wars are inflationary whereas pandemics are deflationary

(they say!)

Is a pandemic really deflationary? I am not entirely convinced. In the short term, yes, but what will happen as 'normal' conditions return?

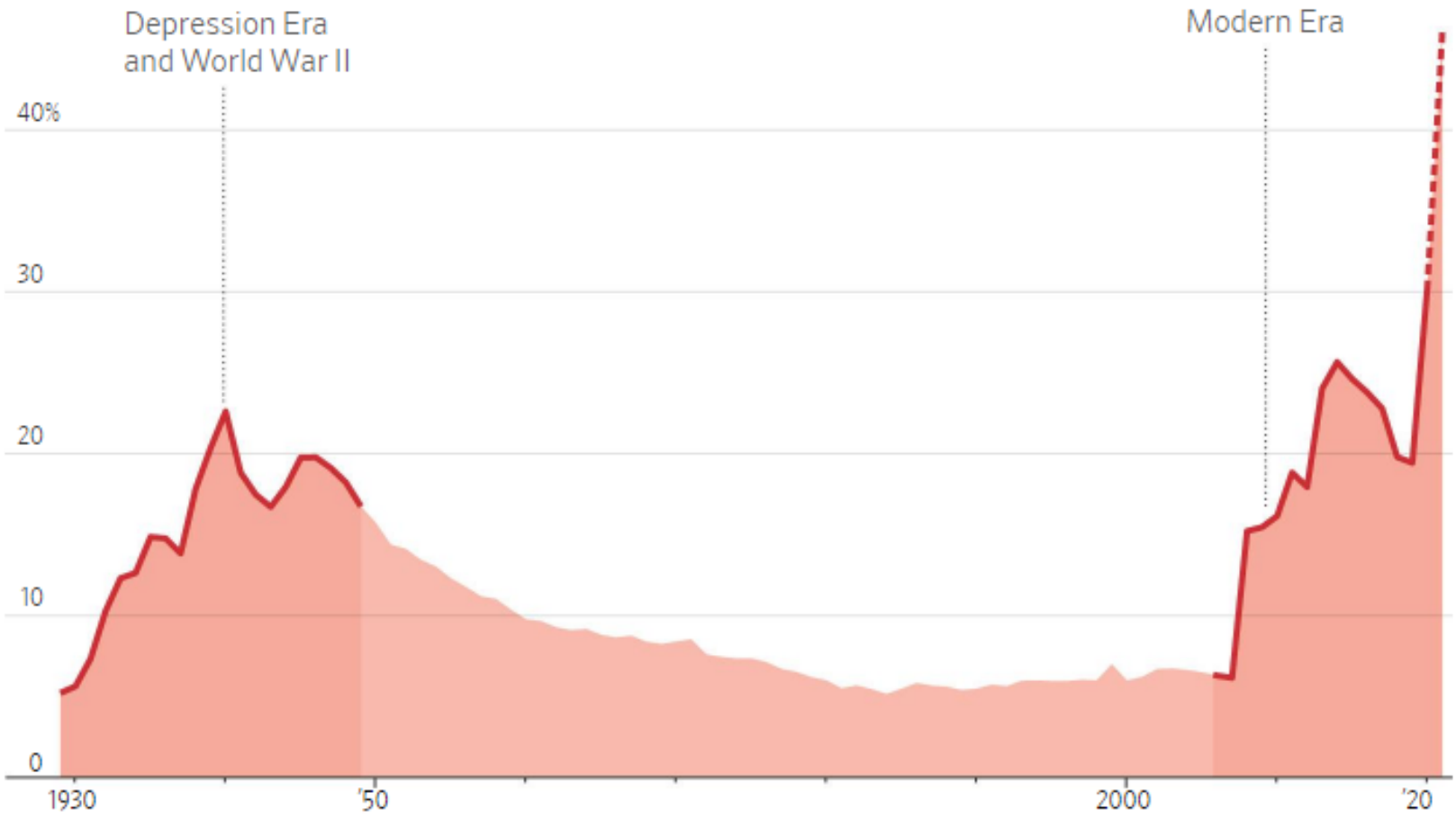
US 10-Year Treasury Yields

Log Scale



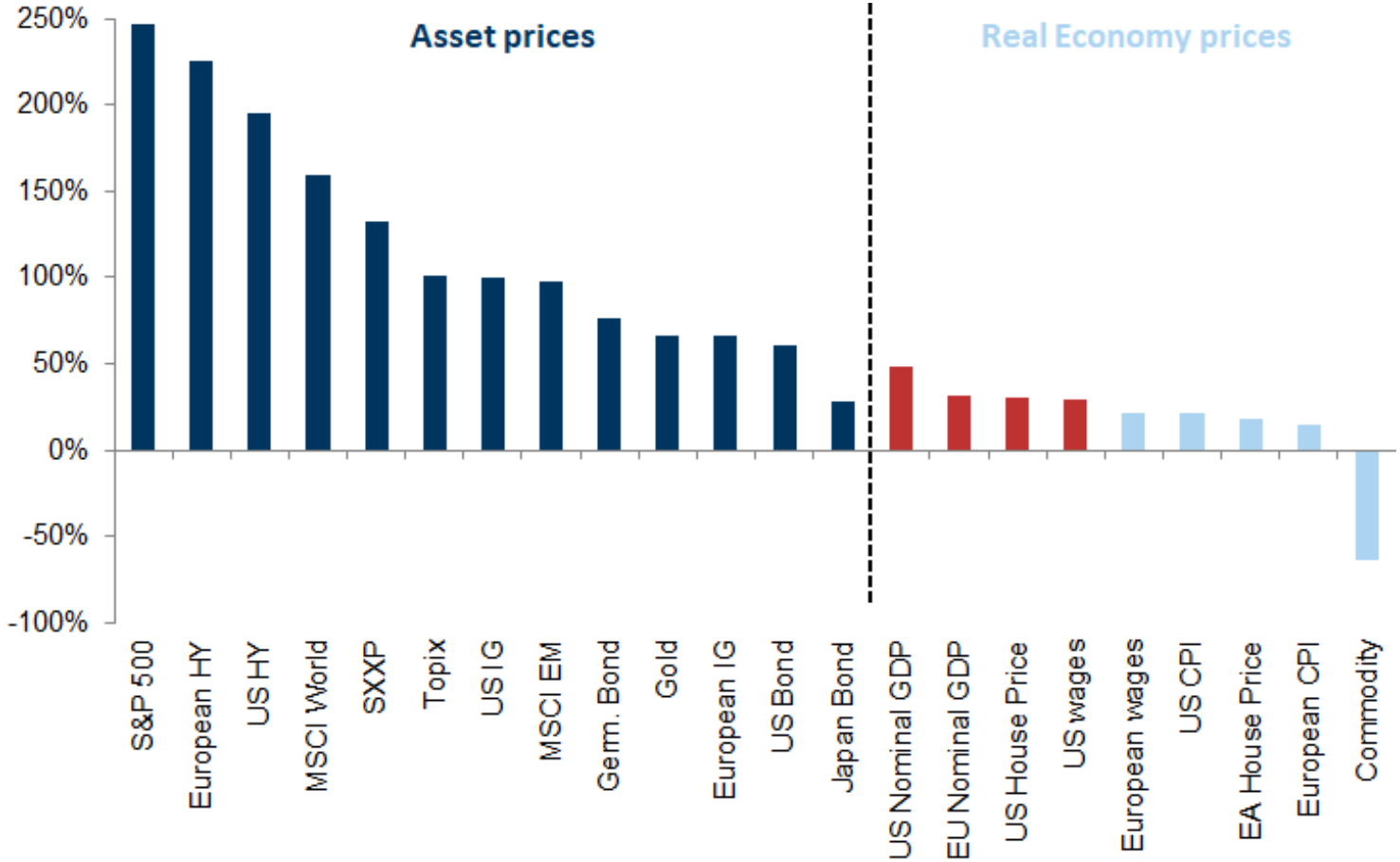
The Federal Reserve Bank's balance sheet is growing massively, suggesting it is desperately trying to stimulate the US economy by providing liquidity.

Federal Reserve Bank Balance Sheet as a % of GDP



A widespread point-of-view is that the Fed's strategy will create further asset price inflation but little consumer price inflation.

Total Return in Local Currency since January 2009

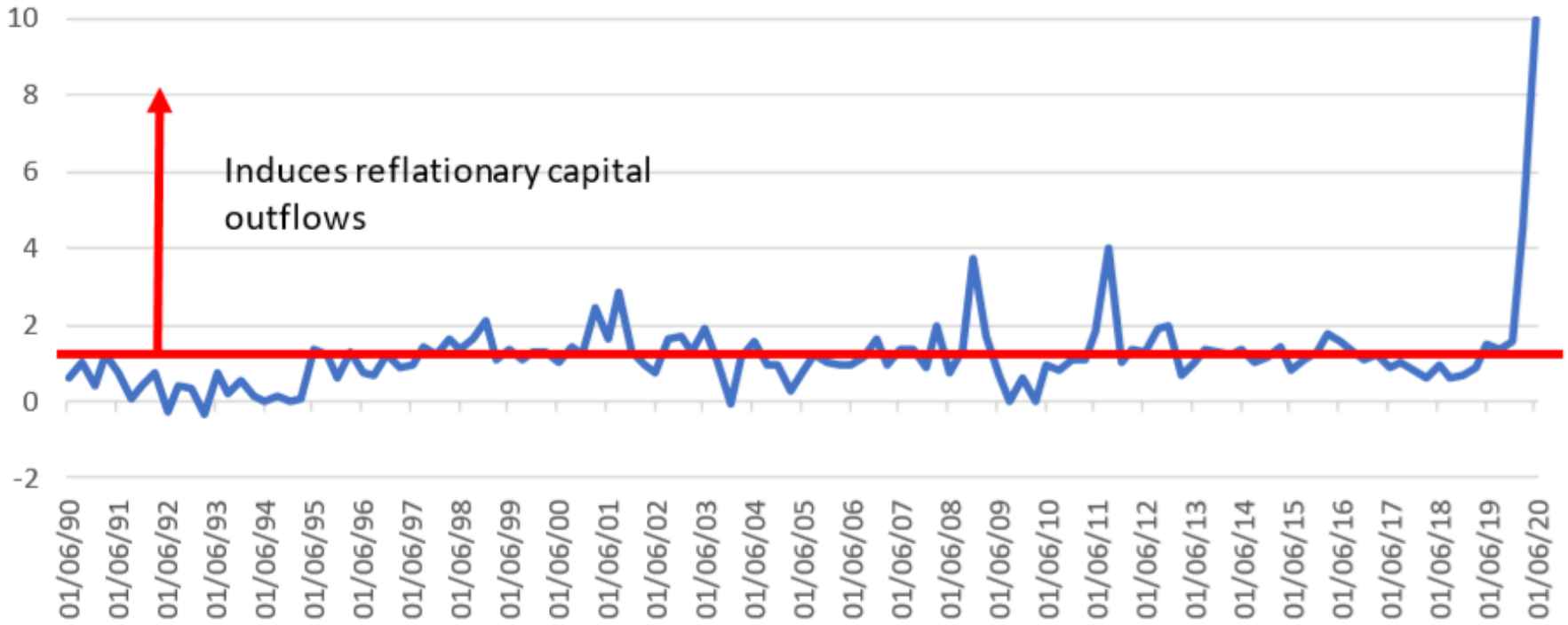


Is it fair to say that the Japanese MMT 'experiment' has only worked so well because BoJ has managed to keep broad money supply (M2) under control?

JPY/USD & M2 Money Supply Growth (%)

With money supply growing much more rapidly elsewhere, do we face an inflation problem down the road?

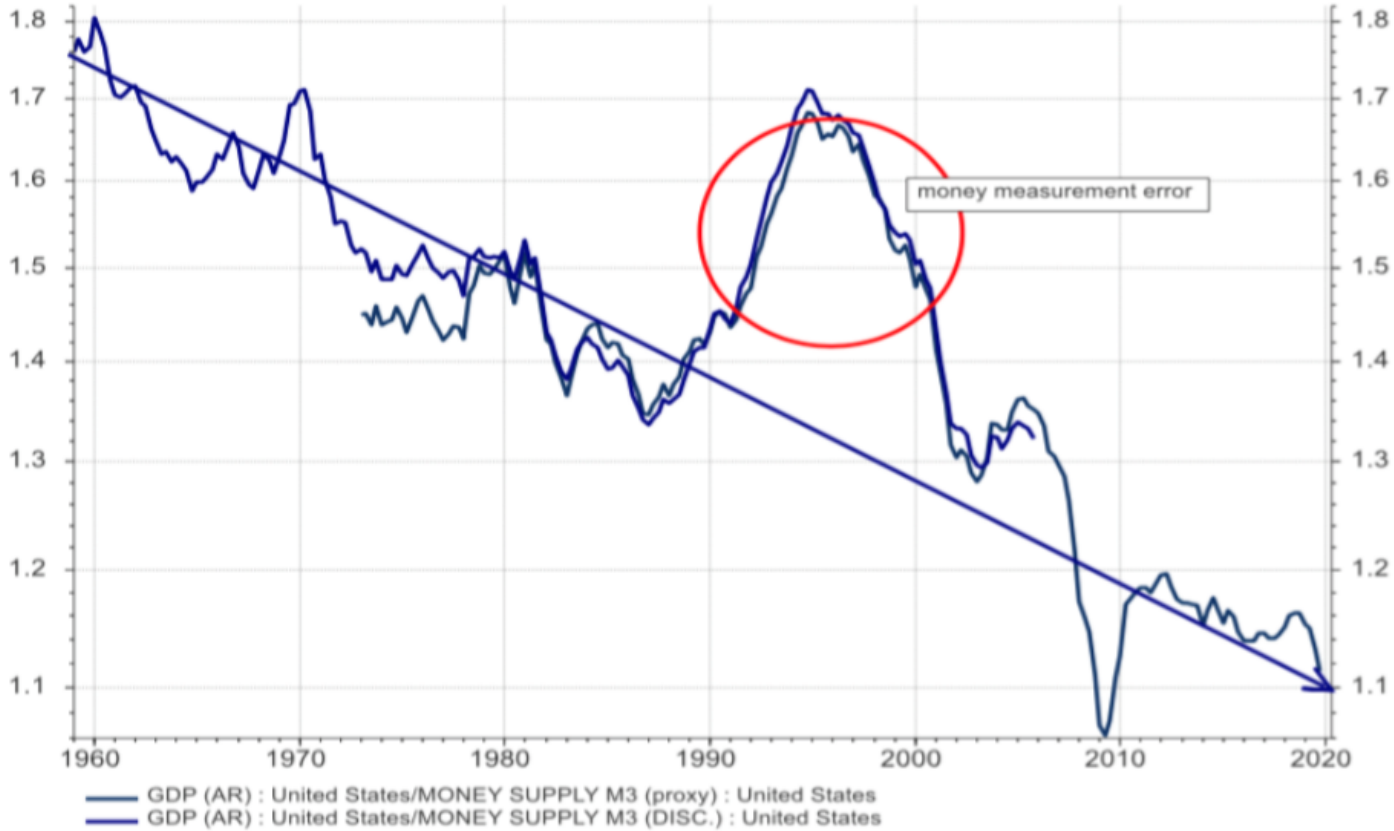
US Money Supply Growth to Potential Nominal GDP Growth



Fisher's identity states that MV = PT. As prices (P) are not rising, and neither are transactions (T), velocity must be collapsing. What will happen when velocity returns?

Velocity of Broad US Money Supply

M3, 1959-2020



Note: The Fed ceased publishing M3 in February 2006. All numbers since are proxies estimated by MacroStrategy Partnership LLP.

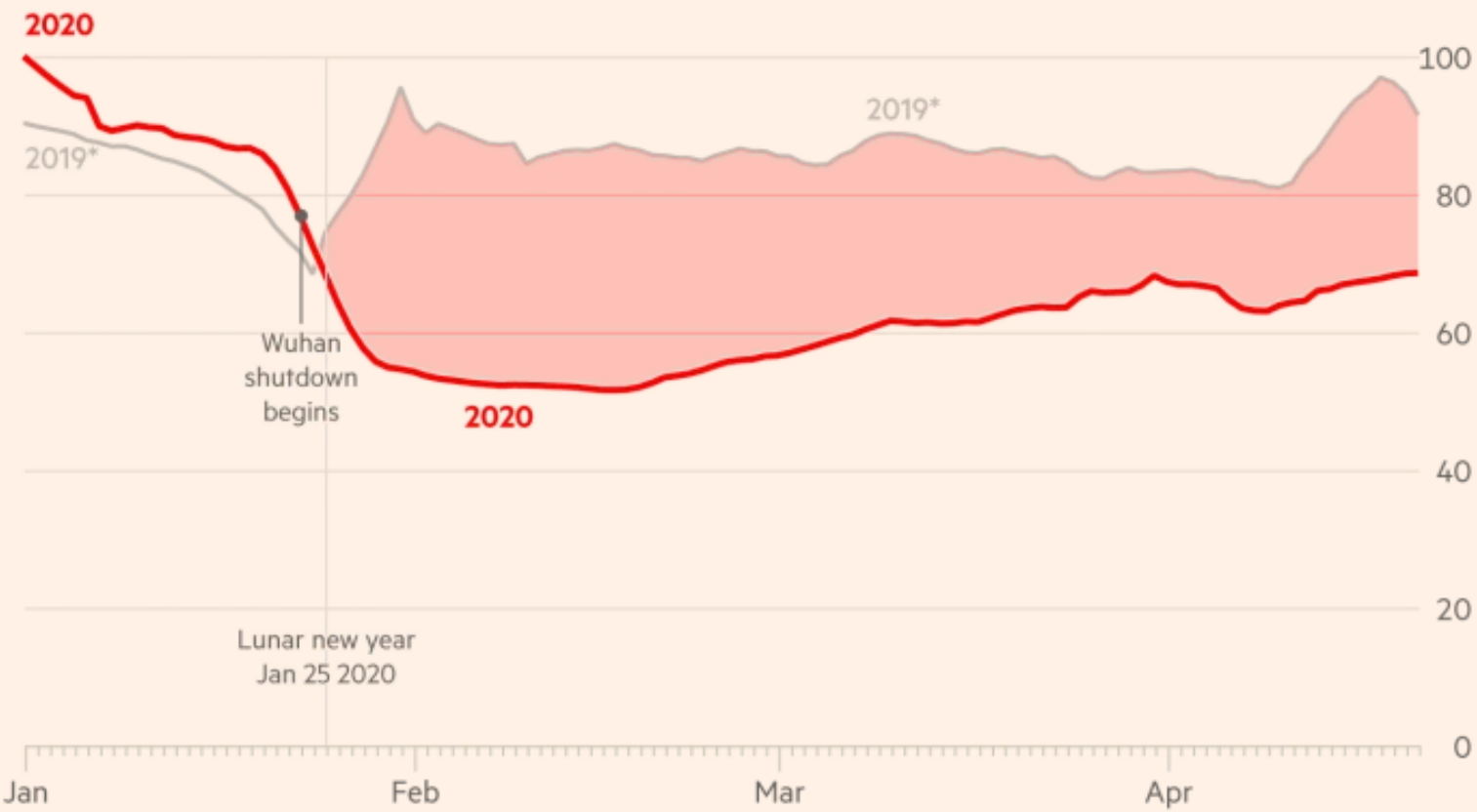
Source: Goldman Sachs Global Investment Research

Part 4

A COUPLE OF INVESTMENT OPPORTUNITIES

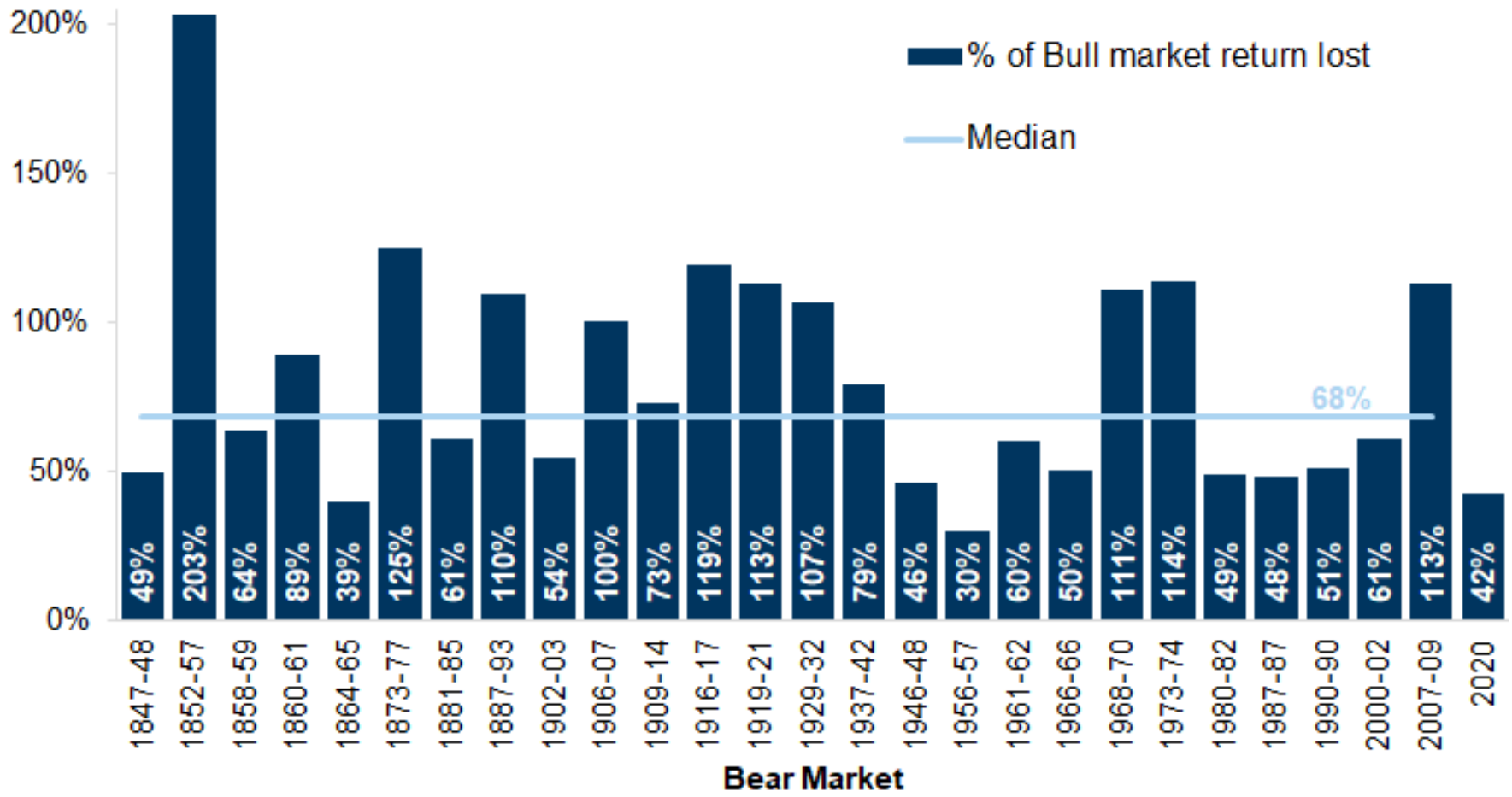
Recent equity market performance suggests that investors expect a V-shaped recovery, but recent trends in China suggest otherwise.

FT Chinese Economic Activity Index



Our advice is not to invest in equities more broadly as it is too risky at current entry levels.

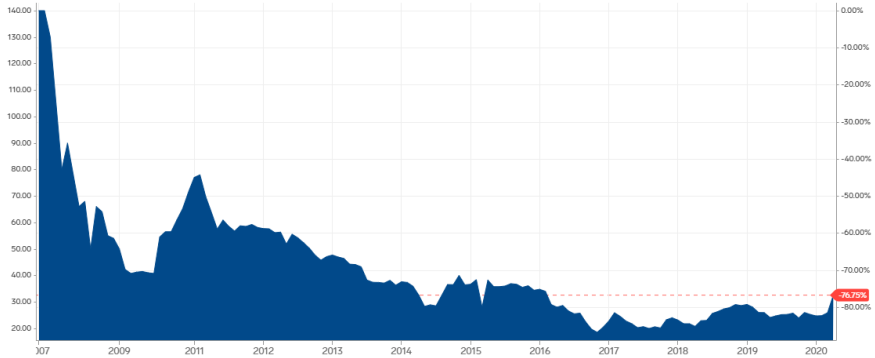
Proportion of the Bull Market Return Lost in the Subsequent Bear Market



Investment opportunity #1: Uranium.

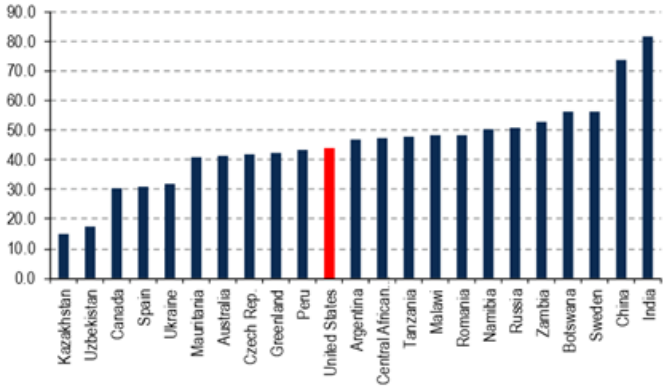
- Uranium is the predominant fuel in nuclear power plants.
- Uranium prices have been in a near-constant bear market since 2008. Prices ran up in 2006-07 due to a short squeeze but collapsed in the aftermath of the GFC. The disaster at the Fukushima nuclear power plant in March 2011 brought an end to any recovery attempt.
- The uranium market has been oversupplied for several years but that is about to change. As long as market prices remain below breakeven prices, as they currently are in most countries, mining companies are very unlikely to add any new capacity, i.e. we know that the uranium market will be undersupplied for most of the 2020s.

Uranium (U_3O_8) Prices Since the GFC



Uranium Production Cost by Country

US$/lb

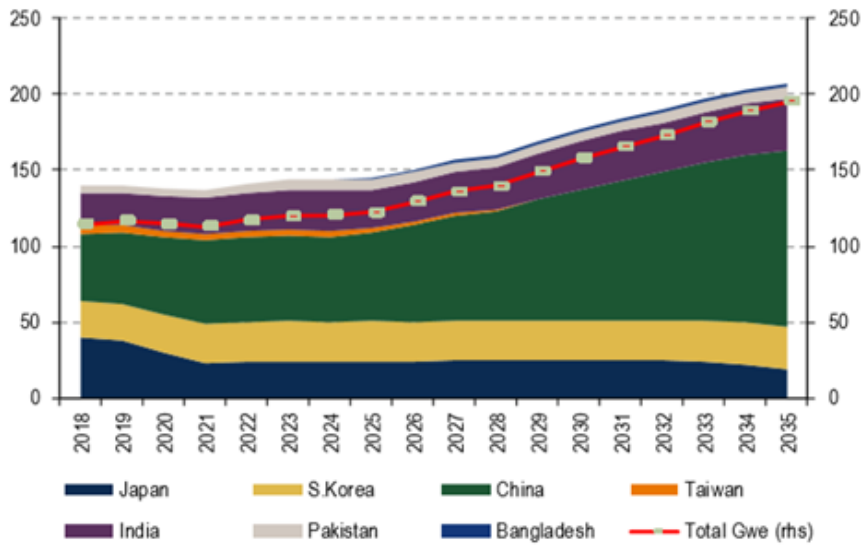


Investment opportunity #1: Uranium.

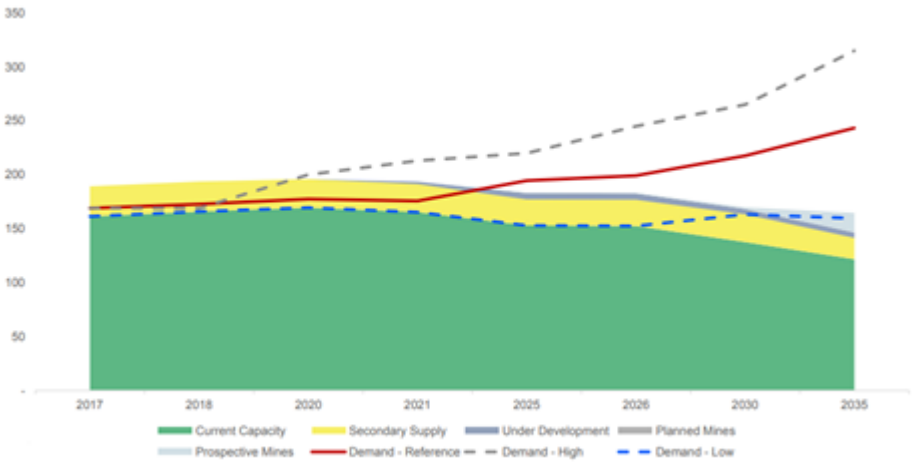
- Demand for uranium is very predictable, as a nuclear power plant cannot cut electricity production in quiet times. It is all or none.
- There are approx. 460 nuclear power reactors in operation worldwide with a combined production capacity of about 400 Gw_e.
- 55 new reactors are under construction, mostly in Asia, with a further 100+ reactors on order in 30 countries, adding about 120 Gw_e of global production capacity.

Nuclear Power Generation Capacity Forecast

Asia and Oceania



Supply/Demand Imbalance (U_3O_8 per mmlb)

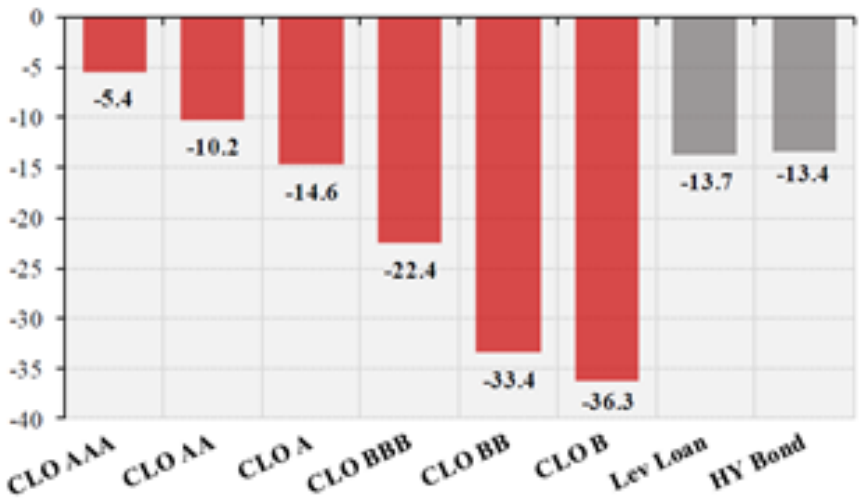


Investment opportunity #2: Dislocated credit markets.

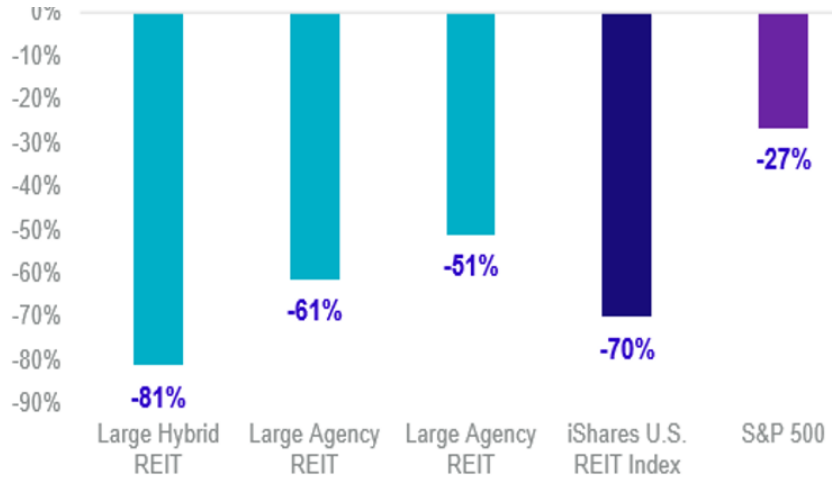
- Credit markets have been affected much more dramatically than equity markets by the sudden drop in economic activity caused by the Covid-19 outbreak.
- Many leveraged credit investors have been forced to sell because of margin calls, opening up attractive investment opportunities.
- If central banks are determined to save the corporate sector from collapse at almost any cost, as we believe they are, the current crisis is more a liquidity crisis than a solvency crisis, which can be taken advantage of.
- When investing in credit at the moment, one has to be more discerning as to credit quality than was the case prior to the crisis, not least as the short to mid-term outlook varies significantly from industry to industry and from company to company.
- We have identified a small handful of investment managers who are well-positioned to take advantage of this opportunity set.

Investment opportunity #2: Dislocated credit markets.

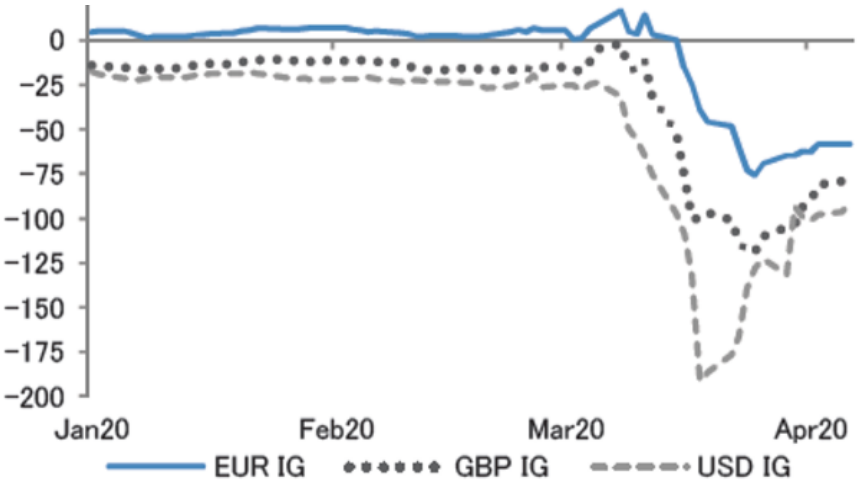
CLOs: Price Decline in March to the 23rd



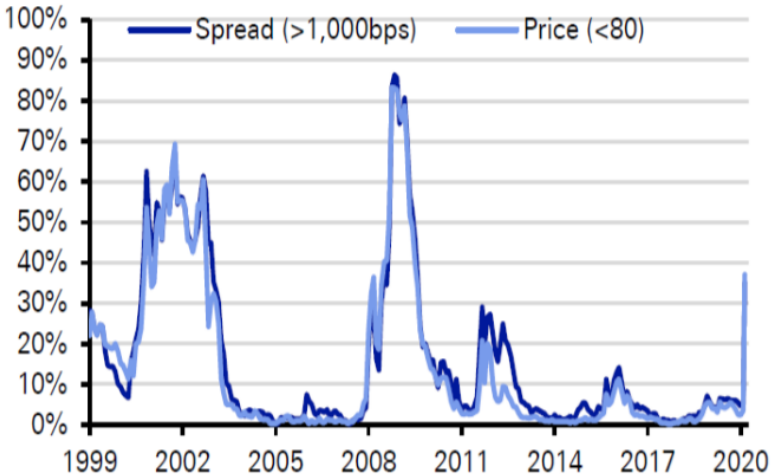
US RMBS: Market REIT Performance



Credit Relative Value: Bond-CDS Basis in Global IG



High Yield Credit: European HY Distressed Ratio



Appendix

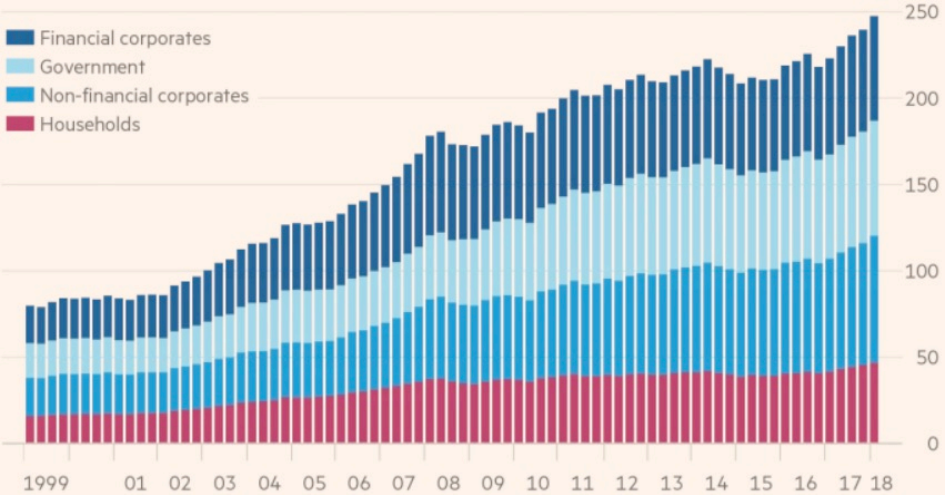
THE SIX MEGATRENDS

Megatrend #1

The End of the Debt Supercycle

- In the early stages of a typical debt supercycle, GDP and debt grows 1:1, but that ratio deteriorates as the cycle matures. All prior debt supercycles have come to an end when GDP grows only $0.20-0.25 for every dollar of added debt. China is now at 0.21 and the US at 0.28.
- The fact that ΔProductivity and ΔGDP are both struggling to gain momentum at present are powerful indications that we are fast approaching the end of the current debt supercycle.

Total Global Debt ($Tn)

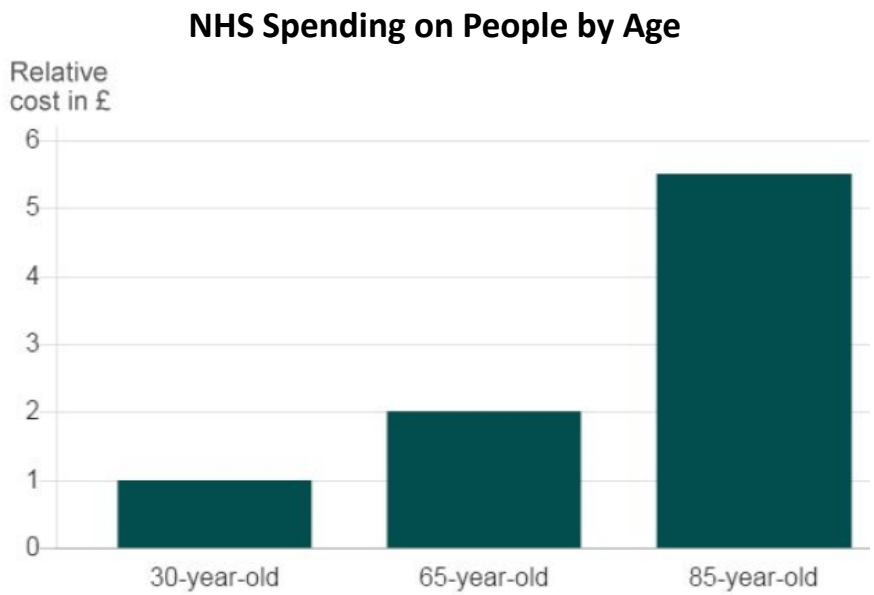


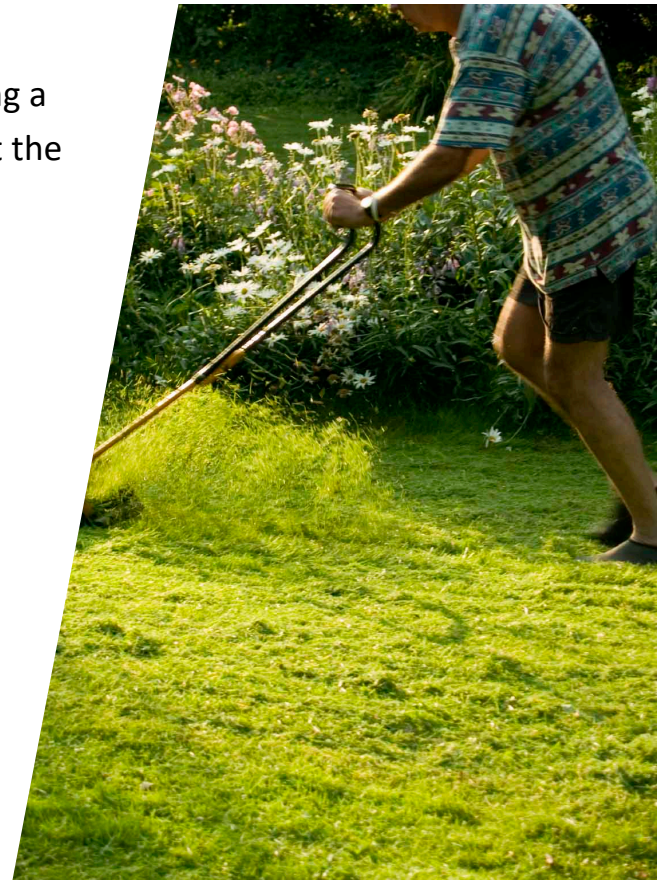
 | Source: Financial Times.

Megatrend #2

Changing Demographics

- 150 million OECD workers will retire between now and 2050.
- Servicing the elderly is extremely costly. According to the NHS, servicing a man in his mid-80s is 5-6 times more expensive than servicing a man at the age of 30 (see below).

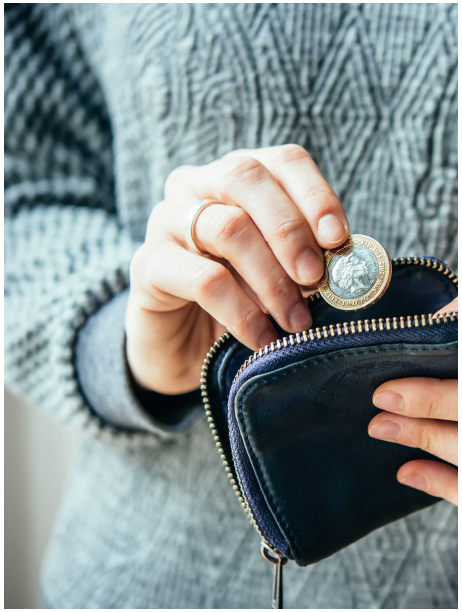


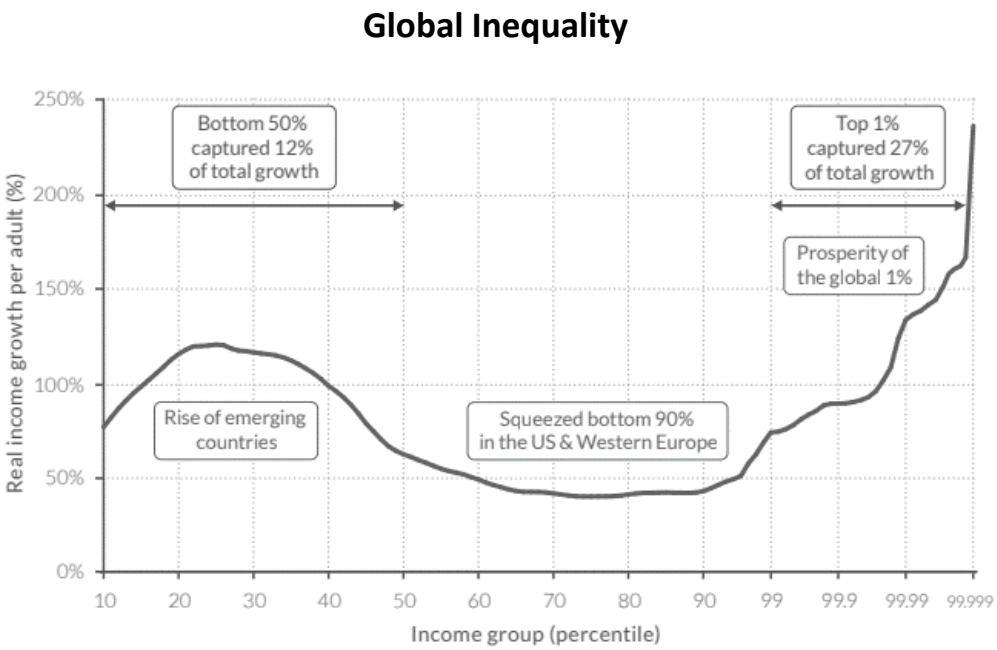


Megatrend #3

The Rising Gap between Rich and Poor

- Workers in many countries have not experienced any meaningful growth in real wages for years.
- Low or no real wage growth negatively affects aggregate demand and partly explains why GDP growth is so low everywhere.





Megatrend #4

Rise of the East

- In PPP terms, China has more middle class families now than the US.
- The first thing people spend more money on when living standards rise is more and better quality food – almost always more protein-rich food.
- One should seek exposure to the phenomenal growth in the Chinese economy without being exposed to the over-leveraged financial system in China.

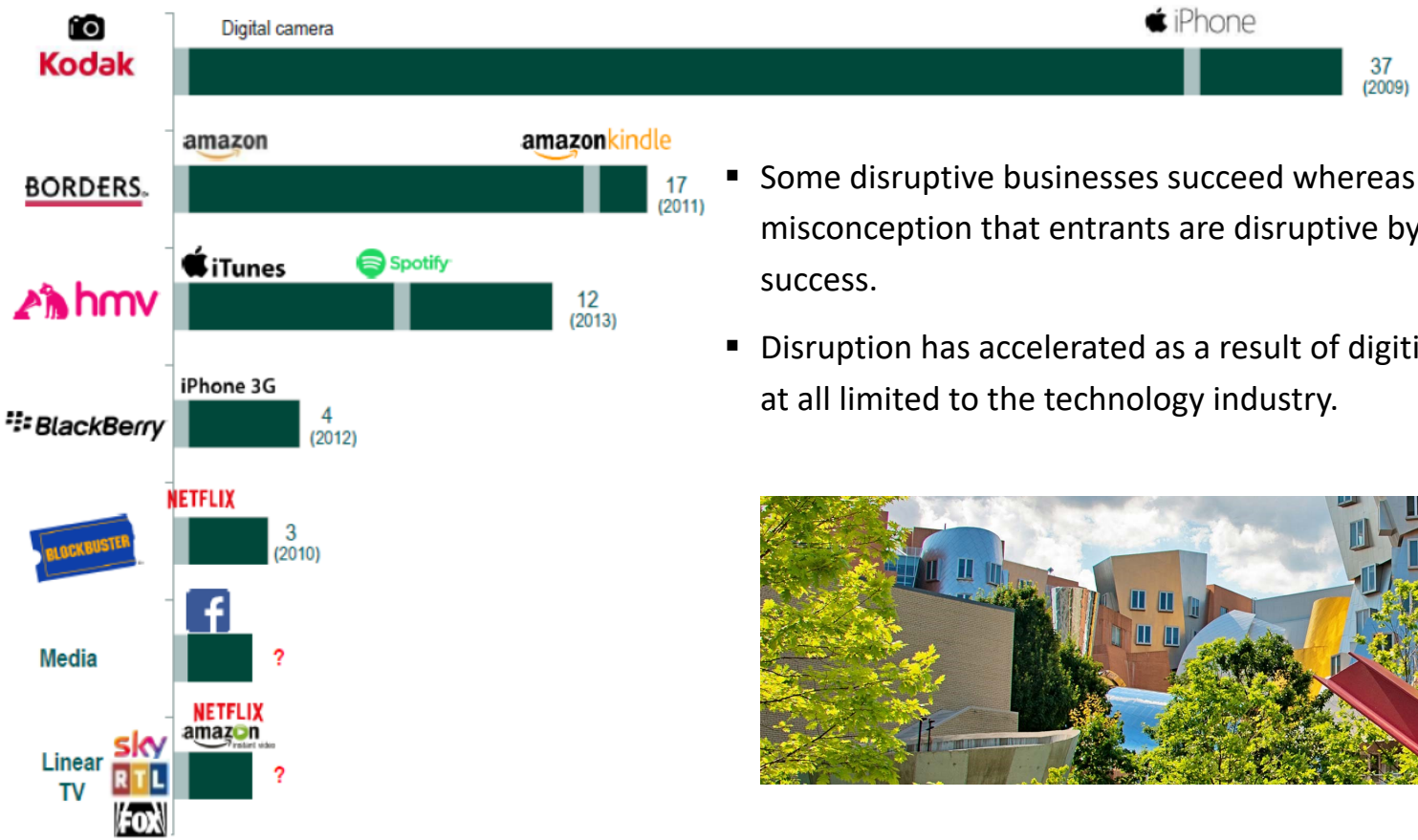
Chinese GDP Catch-Up under Various Assumptions

		Annual Chinese GDP Growth		
		3.00%	5.00%	7.00%
Annual US GDP Growth	1.00%	2047	2032	2027
	1.50%	2057	2034	2028
	2.50%	n/a	2041	2030

Megatrend #5

The Age of Disruption

No. of Years to Disrupt Incumbent's Businesses



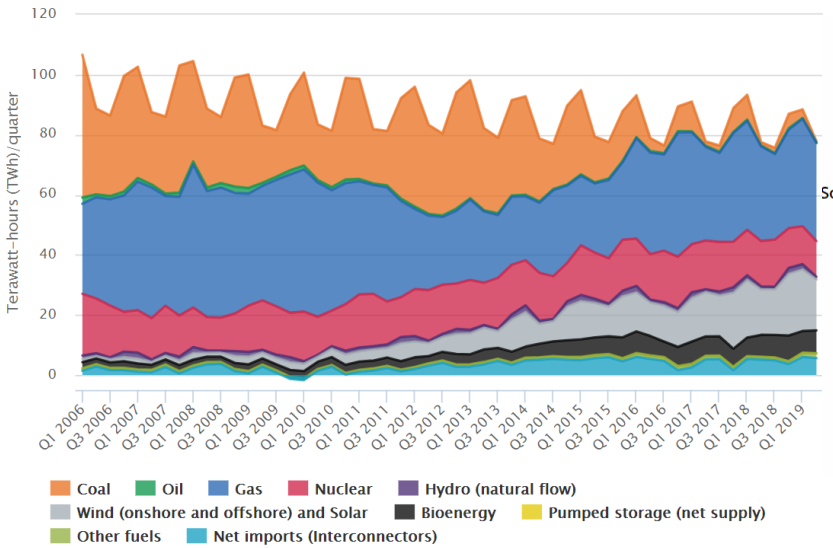
- Some disruptive businesses succeed whereas others don't; it is a misconception that entrants are disruptive by virtue of their success.
- Disruption has accelerated as a result of digitisation, but it is not at all limited to the technology industry.

Megatrend #6

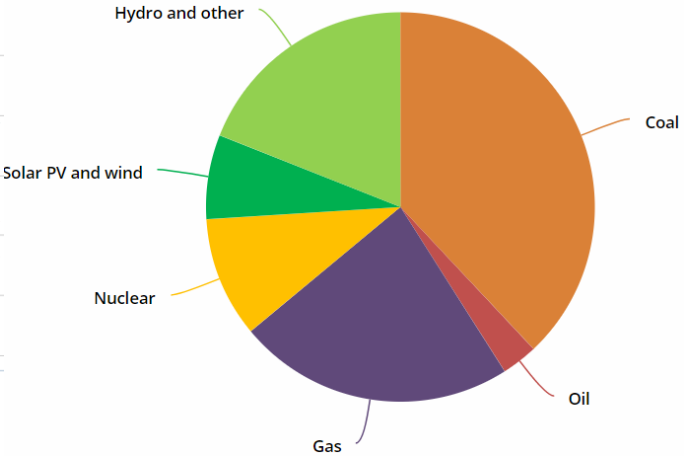
Climate Change

- The fight against global warming will drive governments all over the world to electrify most transportation and heating, dramatically reduce demand for fossil fuels.
- Food production must rise 60% in the next 20 years, and food production accounts for nearly 70% of all freshwater consumption globally. With the climate change doing damage to our water supplies, how will this pan out?

UK Fuel Mix in Electricity Generation



Global Fuel Mix (2018)

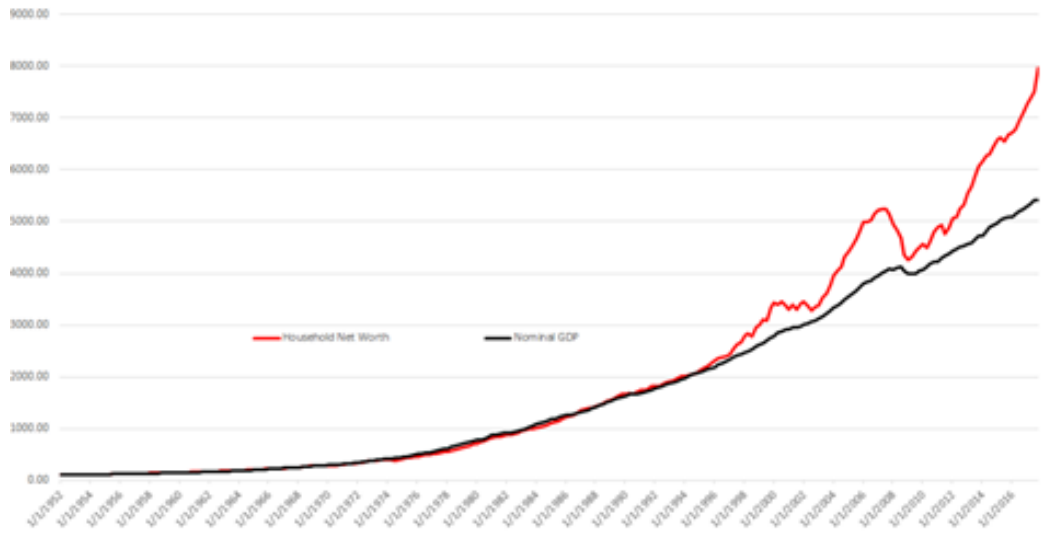


… and the aggregate result of those six megatrends

Mean Reversion of Wealth-to-GDP

- Asset prices have grown much faster than GDP since the mid 1980s and, in the long run, one *cannot* outgrow the other.
- Every single time wealth has deviated meaningfully from its long-term mean value, it has regressed to the mean, and US wealth is now 520% of US nominal GDP against a long-term mean value of 380%.

Total US Household Wealth as % of GDP since 1950



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