<u>Key points of Anatole Kaletsky's comments below:</u> 14/5/20 Volatile next few few years:

- <u>1-3 months.</u> Markets highly likely "his view that a significant fall in equity prices is coming"
- <u>1-3 years.</u> "Sometime in 2021, Kaletsky thinks it's very likely another bull market will start after a moderate economic recovery, although he believes earnings will be a lot lower than in 2019." **But the markets have been behaving as if there's 100% probability," he said, yet there's no clear evidence that fiscal or monetary stimulus will avoid a depression.**
- "essentially guarantees zero or near-zero interest rates all over the world, at least for the next two years, and possibly for as long as the next three years."
- <u>3+ years out.</u> **But there will be a price to pay for historic fiscal stimulus and "unimaginably" low interest rates**, he said. "What this crisis represents is **the final reversal of 40 years of monetary policy.**
- **three structural factors — globalization, technology and politics — that have driven disinflation over the last 40 years are also reversing.**
  - **Globalization was already reversing because of the U.S.-China trade war**
  - **technology is shifting from a disruptive force into an inflationary one** as the most successful technology companies in the world change their business models. **"The business models of Google, of Apple, of Facebook, even of Amazon are shifting from disrupting established supply chains to monetizing monopolies.**
  - then there is **politics. For 40 years, the balance of power moved against organized labor in favor of corporations and profits, and against governments and government spending in favor of business and private spending. "That process was already reversing over the last 10 years ….** coronavirus is going to give it a tremendous new boost. This is going to be turbocharged.
  - And therefore, Kaletsky said, by the middle of this decade, **investors need to prepare for inflationary conditions**. Crucially, however, **higher inflation initially will not be accompanied by higher interest rates**, because governments will want them low to keep funding unprecedent debts and deficits at zero or near-zero rates.

https://www.advisorperspectives.com/articles/2020/05/14/gavekals-kaletsky-investors-will-face-losses
Gavekal's Kaletsky: Investors Will Face Losses
14/May/2020

This article is based on a presentation from John Mauldin's 2020 Virtual Strategic Investment Conference, which is being held from May 11 to 21. To register for this conference, click here. The Strategic Investment Conference was just approved by CIMA and CFP for 14 hours of continuing education credits.

An economic recovery should start next year, but there will be trouble later in the decade, says the well-known economist Anatole Kaletsky. In the short term, investors should gird for disappointing equity returns.

Kaletsky told the audience on Wednesday at John Mauldin's 2020 Virtual Strategic Investment Conference that he was not there to make a case for or against lockdowns to prevent the spread of COVID-19. He was not going to focus on what would be good for health, economies or political systems during this time of unprecedented events.

His focus, he said, was to present his view on how investors can make money during the pandemic and its aftermath, or "perhaps more realistically, how we can avoid losing too much money as a result of what's going on."

Kaletsky, founding partner and chief economist of Gavekal Research, known around the world for its insight on global macroeconomics, financial markets and asset allocation, presented a framework for how investors should look at the financial markets over the short, medium and long term. He was part of a panel that included his Gavekal partners Charles Gave, the firm's chairman, and Louis-Vincent Gave, CEO.

"**In the short term, I think we've got to be very cautious and actually downright bearish** and move to more risk-off positions, especially after the very strong rebound that has occurred since the end of March," Kaletsky said. "And today in the medium term, I think there are reasons to be very bullish about risk assets. And I believe that **sometime in the next one to three years, we are going to see another very strong period of risk-on, price gains for equities, for credit, for property** … I think **the long-term consequences of what's going to happen to the structure of the world economy, to the structure of business sectors, and to the balance between government and business all over the world is also going to give cause for caution, and perhaps downright bearishness**."

Short-term horizon (one to three months)

Kaletsky said the rebound in markets, particularly equities, since the low on March 19 was a classic bear-market rally that has drawn in new investors with its momentum. "I think these people are now riding for a fall. And we should expect at the very least a retest of the lows of late March."

He gave several reasons to support **his view that a significant fall in equity prices is coming**.

Kaletsky started with a **technical one**: **Investor sentiment is nowhere near bearish enough**, he maintained. It's not nearly as negative as it was at the bottom of any of the previous three bear markets — in 2008, 2003 or even in the minor bear market of 1992. What's even more surprising, and concerning, is that investor sentiment is still higher than it was during the four corrections that occurred in the bull market between 2009 and 2019, he continued.

In bear markets, **bottoms are almost always retested**. In fact, Gavekal looked at the 16 bear markets in U.S. equities since 1950 and found only one case in which the bear-market bottom was not retested: in 1982, when former Federal Reserve Chairman Paul Volcker abruptly and completely reversed monetary policy and interest rates collapsed.

Kaletsky said there are **also important fundamental reasons to believe equity markets will go down in the short run.** He believes the focus on public health has driven the upsurge in markets over the last several weeks because the news on lockdowns has been broadly better than expected. The fact that lockdowns are getting shorter has contributed to positive sentiment, he said.

However, investors haven't focused on the news about global activity and financial performance, which has gotten worse, he said, and "continues to defy expectations on the downside."

He acknowledged that some investors might argue that everyone knows second-quarter results will be terrible and the market is already looking beyond that to an economic recovery. Kaletsky doesn't disagree that an economic recovery is coming, and possibly a very strong one, if it turns out the Keynesians are right that the fiscal stimulus will overcome the possibility of an economic depression.

"Even if you were talking to John Maynard Keynes today, what he would say is that there's perhaps a 60% or 70% or 80% probability that Keynesian economics will prove right this time, and will trigger a pretty sharp V-shaped recovery by, let's say, the first quarter of next year. **But the markets have been behaving as if there's 100% probability**," he said, yet **there's no clear evidence that fiscal or monetary stimulus will avoid a depression**.

Kaletsky said asset prices in many markets, and technology stocks in the U.S. market, are back at all-time highs from before anybody had even heard of the coronavirus, and that indicates certain investors are behaving as if there's 100% probability of a recovery next year.

Medium-term horizon (one to three years)

Sometime in 2021, Kaletsky thinks it's very likely another bull market will start after a moderate economic recovery, although he believes earnings will be a lot lower than in 2019.

Why? Because in addition to the coronavirus crisis there's been another unprecedented event — the collapse in interest rates. "And not just a brief collapse of interest rates, but a complete change in the way monetary policy is conducted and the relationship between monetary and fiscal policy, which essentially guarantees zero or near-zero interest rates all over the world, at least for the next two years, and possibly for as long as the next three years."

In particular, he expects the yields on 10-year U.S. Treasury bonds to trade in the range of zero to 1.5% over the next two or three years, and as long they remain that low, equities with P/Es of 20 or even 30 look attractive, they are reasonably priced, he said. "Once we return to equities which look like they have sustainable earnings, and those earnings are on equity prices with P/Es of 20 to 25, those P/Es will look downright cheap compared with an interest-rate range of zero to one-and-a-half percent," he stressed.

Long-term horizon (more than three years)

But there will be a price to pay for historic fiscal stimulus and "unimaginably" low interest rates, he said. "What this crisis represents is **the final reversal of 40 years of monetary policy**, which has been directed to reducing inflation, keeping it down and making sure that like Dracula, it never rises from the dead." "That monetary policy already began to change as a result of the 2008 crisis. But now it's completely reversed. The purpose of monetary policy (NOW) is to get inflation up, keep it up and make sure it never collapses back towards zero. And even more importantly, make sure that interest rates remain low enough for the foreseeable future for governments to be able to continue financing their unprecedented debts and deficits at near-zero rates."

He added three structural factors — globalization, technology and politics — that have driven disinflation over the last 40 years are also reversing, partly as a result of the COVID-19 virus and partly for other reasons.

Globalization was already reversing because of the U.S.-China trade war, but that reversal will continue even more dramatically as a result of the aftereffects of the virus, Kaletsky said.

Meanwhile, **technology is shifting from a disruptive force into an inflationary one** as the most successful technology companies in the world change their business models. "**The business models of Google, of Apple, of Facebook, even of Amazon are shifting from disrupting established supply chains to monetizing monopolies**. These successful technology companies have established unbelievably lucrative global monopolies, and from now on, their business model is to maximize the profits stemming from those monopolies. That's inflation. If you think about it, Apple is probably the most inflationary single force in global consumer markets today. It's a brilliant business model; it depends on producing slightly improved products every year-and-a-half or two years, and then charging a 50% price increase for those."

And then there is politics. For 40 years, the balance of power moved against organized labor in favor of corporations and profits, and against governments and government spending in favor of business and private spending. "That process was already reversing over the last 10 years as a result of the long-term political aftereffects of the financial crisis, which I wrote about in my book, *Capitalism 4.0*, nearly 10 years ago, but clearly this coronavirus is going to give it a tremendous new boost. This is going to be turbocharged, the shift from labor to capital, from business to government, in the balance of power in markets and economies all over the world, that by its nature is also going to be an inflationary force."

And therefore, Kaletsky said, by the middle of this decade, investors need to prepare for inflationary conditions. Crucially, however, higher inflation initially will not be accompanied by higher interest rates, because governments will want them low to keep funding unprecedent debts and deficits at zero or near-zero rates.

"And that means that monetary policy is going to lag behind rising inflation," he concluded. "Instead of heading off and getting ahead of rising inflation, monetary policy is going to be continuously behind but essentially repeating the experience that began in late '50s gradually accelerated in the '60s and ultimately culminated in the great inflation of the early '70s. The good news though is that that process took 20 years to build up, and I think it is only just beginning."

Dorothy Hinchcliff is editor of Advisor Perspectives.