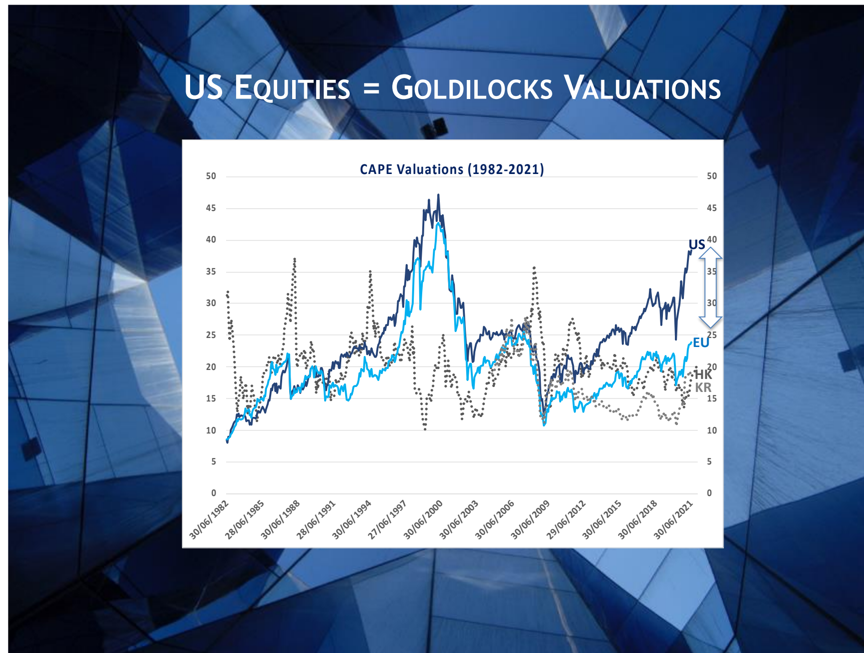



## GOLDILOCKS VALUATIONS

**How do markets respond to peak stimulus, peak globalization and peak big-tech?**

*"This is the least responsible macroeconomic policy we've had in the last 40 years."*
Larry Summers, March 2021

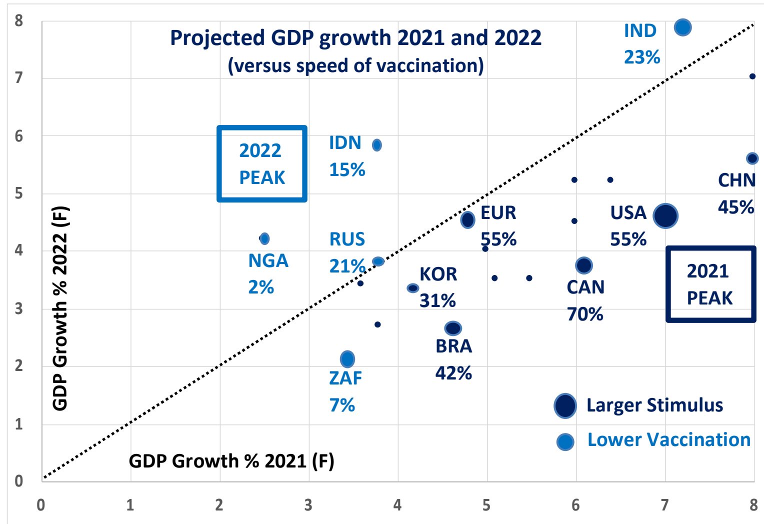
US equity investors have fallen in love with 20 years of **goldilocks**: stable economic growth and low inflation have produced excellent investment returns. Over two decades, US real GDP growth was 2%, including 9/11 and the GFC, US CPI inflation averaged 2.2%, US fiscal deficits were 3.5% and money supply M2 grew by about 6%. Meanwhile, productivity increased with labor supply, global supply chains, world trade rising; and US equity investors earned 6% annually while the dollar was stable. That was a very comfortable goldilocks environment until the pandemic hit in 2020.

Since the start of 2020, US equity markets have gained 35%, as compared to 20% in non-US markets, while US CAPE valuations are now stretching to 38 times earnings. The US dollar has declined by 5%, as the US fiscal deficit rose to 15% of GDP and M2 expanded by over 30%, and consumer prices have increased by 5%. The US economy is on track to expand by 7% in 2021, while both unemployment and the trade deficit are at record levels. This is an exceptional macro-economic situation, which we have not seen over the past 40 years, and just the opposite of the previous goldilocks situation.

Goldilocks fans should be enthusiastic that several vaccines are working to contain the pandemic, that massive stimulus measures are effective to bring back growth, and that competition with China is now moving more into focus. But Goldilocks may be about to face the music of the bears, as valuations have peaked, globalization has peaked, and China with its big-tech industry also has peaked. Markets are now facing unsustainable valuations and interest rates, plus rising inflation and geopolitical risks.

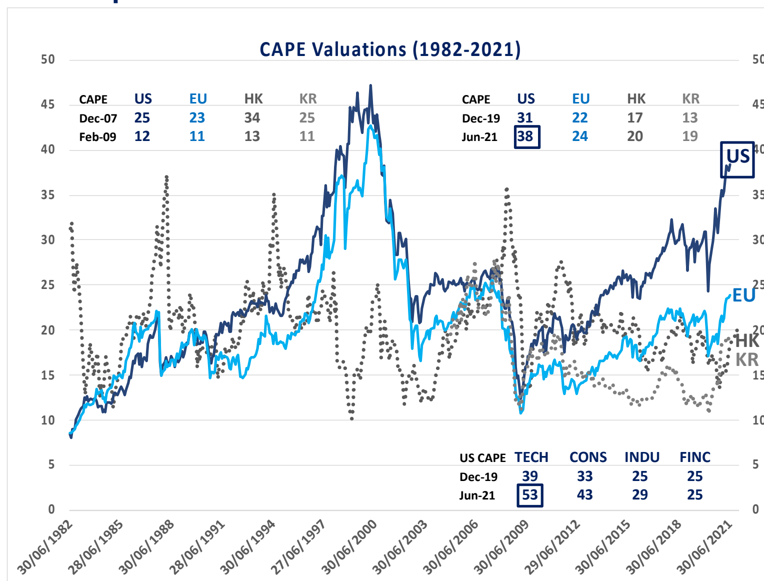
This research note looks at three critical issues: valuations during the recoveries, new drivers of structural inflation, and major geo-political challenges arising from China. Vaccinations have been hugely successful but recoveries in most emerging markets will be delayed into 2022. Valuations in US markets and big-tech look unsustainable. Macro-policies are emphasizing faster recoveries and more decisive decarbonization which will create structural inflation and prompt higher interest rates earlier in 2022. Big-Tech is facing regulatory headwinds and decoupling from China, while geopolitical risks from Taiwan, Iran, and Pakistan are currently underestimated. Market leadership is likely shifting to emerging markets, smaller-caps, and domestic greener industries.

## Vaccinations driving Recoveries — Chart A




Sources: IMF, Morgan Stanley, RBC (2021)

## US Equities = Goldilocks Valuations — Chart B




Sources: Barclays, Robert Shiller CAPE (P/E 10yrs)

## 1 > VACCINES AND VALUATIONS

Who would have thought that multiple effective vaccines could be developed in less than one year and that over 3.5 billion vaccine shots have already been administered?

Who would have thought that multiple countries in Asia could effectively be isolated and contain the pandemic until now (China, Taiwan, Korea, Australia, New Zealand)?

Who would have thought that the US could add over $6 trillion in fiscal deficits and add over $4 trillion to the FED balance sheet since the start of the pandemic?

How do we measure the **cost of the pandemic**? US output losses during 2020 exceed one *trillion* dollars (5% of GDP) as compared to $12 *billion* the US government spent on vaccine development (operation warp speed). And additional US debt from fiscal and monetary stimulus could amount to $10 *trillion* (50% of GDP). That does not include higher health care costs from long covid or mental health, nor any losses from education. And we are barely half-way back on our way to a new normal in the US.

How do **costs compare to benefits** from public health interventions? Without any doubt, vaccines and mask-wearing have had enormous benefits, whereas lockdown measures have come at a high cost. As shown in the Korean example, the US could have used testing and tracing more effectively and saved over 600,000 deaths. If US policies were as effective as Canada's, half of US deaths could have been avoided. But in the worst-case scenario, assuming death rates like in Peru, bad policy could have added an additional one million pandemic deaths in the US. Mathematically, each US-life-saved has cost about $1 m of lost output, and up to $10 m of US debt added by stimulus measures. These calculations illustrate the enormous cost of lockdowns and the reluctance of poorer countries to use such restrictive policies.

When are economies expected to make a **full recovery**? Today, 25% of the world population have been vaccinated at least once, as compared to 55% in the US and 70% in the UK and in Canada (chart A). The Economist is estimating that the world is only 67% back to normal, with 74% in US as compared to 51% in India. In terms of output, China got back to pre-pandemic levels most quickly during 2020, the US has closed its output gap during the first half of 2021, Europe is expected to follow later in 2021, whereas most emerging markets will struggle as vaccinations are lasting into 2022.

How can the **market euphoria** be explained? World equity markets have gained 30% since the start of 2020, and 2021 performance ranks among the top seven over the past 100 years. Projected US economic growth of 7% has not been seen since 1984. And US equity valuations, measured as multiples of through-the-cycle CAPE earnings, have sky-rocketed from 12 in 2009 to now 38 times (chart B), 3 sigma above normal. Lower interest rates cannot explain it, since European valuations remain at 24. Big-tech performance cannot explain it, since HK and Chinese big-tech valuations remain below 20. And successful vaccinations cannot explain it, since Israel and Korea and the UK CAPE multiples remain at 18. So is the US getting into an irrational territory?

## 2> Inflation and Commodities Cycles

Who would have thought that excessive stimulus could finally set off inflation which now could become a "defining macro story of this decade" (Deutsche Bank research)?

Who would have thought that the FED not only doubled its balance sheet in 18 months but continues its MBS buying spree in mid-2021 while US inflation is exceeding 5%?

Who would have thought that the EU is raising carbon pricing to €60/ton and is adding carbon border taxes while China is creating the world's largest carbon trading market?

How do we distinguish between **temporary and permanent inflation**? US policy makers are stating that temporary disruptions from the pandemic are creating short-term inflation pressures, both from demand-pull (higher stimulus spending, returning demand for travel and entertainment) as well as from supply cost-push (limited supply of semiconductors, higher prices of used cars). On the other hand, structural changes such as reshoring supply chains, reversing globalization, aging populations, power of workers, lower productivity gains, higher consumption versus savings, indexing and un-anchoring of inflation expectations, and monetary dynamics are more permanent.

How can **pandemic stimulus and quantitative easing** pressures be contained? Over the past 20 years, Japan experienced with massive fiscal stimulus and central banks experienced with massive quantitative easing, without any meaningful inflation or change of expectations. Are these new policies merely balance-sheet restructurings (commercial real estate defaults being shifted into banks and pension funds, with massive MBS purchases keeping defaults low)? Or are these policies priming consumers to spend more of their stimulus savings and their real estate and equity market gains especially when wages are rising and commodity prices are increasing substantially?

Are **US politics** currently aligned to exacerbate inflation dynamics? How could the FED chair expect to be reappointed for a second term in February 2022 while creating another taper tantrum that would occur when MBS purchases are scaled back? How could major US companies bring many of their technology and biotech supply chains back home without attracting higher-paid employees who already are scarce? And how could any politician wean off 15% of GDP in annual fiscal stimulus (in 2020 and 2021) just ahead of mid-term elections where infrastructure spending is a popular carrot?

Could **ESG policies and carbon pricing** amplify a massive new commodity cycle? Over the past decade, the US dollar (DXY) has strengthened by 24%, while commodity prices (GSG) have declined by over 50%. Over that decade, US equity markets rose by 15% annually, while non-US markets rose by just 6% per year. That long-term cycle now has turned decisively: the US dollar has lost 5% of its value over the past year, as commodity prices increased by 30% this year and now started a structural bull market. Decarbonization and ESG policies will accelerate that cycle through negative supply shocks until technological progress can absorb the substantially higher carbon prices. Just as the unprecedented stimulus is un-anchoring inflation expectations, carbon prices can become the inflation accelerator until decarbonization has been achieved.

## 3 > Chinese Geo-Politics and E-Commerce Control

Who would have thought that China would implement the most conservative macro-economic policies among the G20 nations and evolve strongest from the pandemic?

Who would have thought that China's regulators are fighting their large technology firms to reduce monopoly rents while promoting their central bank digital currency?

Who would have thought that China-related geopolitical risks ranging from Hong Kong and Taiwan to Iran and Pakistan could dominate the reinvigorated G7 policy agenda?

How does **China's macro-economic response** to the pandemic compare? China was most successful among the G20 to stabilize its economy with limited stimulus policies. The IMF projects Chinese 2021 GDP growth to moderate to 8.4% this year. Chinese fiscal stimulus was limited to 5% of GDP in 2020 and focused mostly on infrastructure investments, while monetary stimulus was contained to reign in the overheating real estate sector. The Chinese currency has appreciated by 7% since early 2020 and foreign investment inflows increased by $230 bn while market valuations remained stable, driven by a 150 basis points premium in interest rates versus US Treasuries.

Why has **China cracked down on its large technology firms** like Ant Group? There appears to be a direct link to the desired control over digital payment systems that were developed by Alibaba and Tencent and the official digital renminbi that is now replacing them to reduce the "monopoly on consumer data held by technology firms" and "the party's ability to exercise control" and "to challenge the dominance of the US dollar in international trade settlement". China's e-commerce already accounts for 29% of all retail sales, and its size is five times larger than in the US. Chinese big-tech stocks (CQQQ) have declined by 30% since February 2021.

To what extent are **Chinese geopolitical risks** reflected in the markets? We are experiencing a global risk-on mode that is now fundamentally disconnected with a leading geopolitical risk measure, that turned negative for the first time in four years. BlackRock's four leading geopolitical risks feature US/China technological decoupling and conflicts over Taiwan, as well as cyberattacks and pandemic fallout. The US military is deeply concerned about threats to Taiwan, given the US policy of strategic ambiguity, where changes could trigger China to undermine US interests worldwide. China has already advanced strategic partnerships with Iran and Pakistan and is increasingly viewed unfavorably over its actions in Hong Kong and Xinjiang.

What **market outlook** would that analysis suggest? We have seen peaks in stimulus and the US recovery, peaks in globalization and big-tech leadership, and peaks in US valuations and risk-on market sentiment. Structural changes are now looming with decarbonization and rising commodities inflation, as well as US-China technological decoupling and rising geo-political risks. Rising interest rates and financial repression are on the horizon for 2022, as well as rising carbon prices and carbon border taxes. The weakening of the US dollar will likely coincide with underperforming US markets and higher returns from small-caps, emerging markets, and from active management.

http://www.emleaders.com/pdf/eml-goldilocks-2021.pdf