Mesirow Financial

The great monetary reflation

The secular shift to value

The COVID-19 crisis has caused a major negative shock to the U.S. economy. The magnitude of the fiscal and monetary response, however, is also unprecedented and has the potential to create significant unintended consequences for asset classes. We examine the size and impact of these actions, which we have coined "The Great Monetary Reflation," on an absolute basis and relative to history.

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In this report we discuss the implications for the outlook of the U.S. dollar, commodities, and stocks - particularly growth versus value index performance. If the U.S. Federal Reserve and U.S. Treasury, through their reflationary policy actions, win the war against economic contraction and deflation, which implies GDP accelerates and is meaningfully positive and inflation picks up without the Fed raising interest rates, our expectation is that we are on the cusp of a major reversal in the performance of growth stocks relative to value stocks. The U.S. dollar is in the process of peaking with a major decline expected to commence in the next 12 months while the ratio of value/growth stock performance is near an extreme multi decade low, setting the stage for a secular bull market in value stocks relative to growth stocks to begin in the next 1-2 years. **Based on our analysis, we expect small cap value stocks to participate in this theme and in the subsequent multi-year investment opportunity.**

A Changing Landscape amid COVID-19

Unprecedented Global Fiscal Response

The tragic loss of life and risk of illness stemming from the COVID-19 virus is having a profound impact on global economies. Since the crisis is of "no fault of their own" for each country's residents, most major central banks and fiscal authorities have taken a very aggressive stance to prevent sustained long-term unemployment and a global economic depression. As shown below, the planned global monetary and fiscal response is almost unprecedented at 28% of global GDP.

Table 1: **GLOBAL MONETARY AND FISCAL STIMULUS TO FIGHT COVID-19 IMPACT - 2020 FEB TO JUNE (CSM)**

	POTENTIAL CENTRAL BANK LIQUIDITY INJECTION		POTENTIAL FISCAL STIMULUS		CENTRAL BANK LIQUIDITY INJECTION AND FISCAL STIMULUS	
	$ T	% GDP	$ T	% GDP	$ T	% GDP
U.S.	$6.21	29.0%	$3.30	15.4%	$9.51	44.4%
Eurozone	$1.78	13.3%	$4.01	30.2%	$5.79	43.5%
Japan	$1.03	20.0%	$2.08	40.3%	$3.11	60.3%
U.K.	$0.25	9.0%	$0.14	5.1%	$0.39	14.1%
China	$1.33	9.3%	$1.22	8.4%	$2.54	17.7%
Others	$0.68		$2.35		$3.03	
Total	**$11.27**	**13.0%**	**$13.10**	**15.1%**	**$24.37**	**28.1%**

Source: Cornerstone Macro (CSM)

Past performance is not indicative of future results. Please see the last page for additional, important disclosures.

Sharp Increase in the United States Budget Deficit

In the United States the combined fiscal and monetary planned actions are forecasted to represent 44% of annual GDP, a staggering amount. For perspective, the annual budget deficit in a non-recessionary period is typically 0%-5% of GDP and in recent non-war recessionary periods the deficit has increased to 5%-10% of GDP. Another helpful point of comparison can be seen in a 2010 Congressional Budget Office (CBO) report that details U.S. government spending as a percentage of GDP during prior major wars since 1900. Planned spending on COVID-19, as it stands and as a percentage of GDP, is set to exceed the spending of any war since 1900. The implication is that the U.S. government is fighting a very expensive "financial war" against the fallout of the virus. These actions come with obvious consequences. At the end of April, the CBO forecasted that the federal debt as percentage of GDP in the U.S. is expected to soar to 101%/108% in fiscal 2020/2021 from 79% at the end of fiscal 2019.

Table 2: **UNITED STATES BUDGET DEFICIT**

	YEARS OF WAR SPENDING	PEAK YEAR OF WAR SPENDING	
	TOTAL MILITARY COST OF WAR IN MILLIONS/ BILLIONS OF DOLLARS	WAR COST % GDP IN PEAK YEAR OF WAR	TOTAL DEFENSE % GDP IN PEAK YEAR OF WAR
World War I	**1917-1921**	**1919**	
Current Year	$20 B	13.6%	14.1%
Constant FY2011	$334 B		
World War II	**1941-1945**	**1945**	
Current Year	$296 B	35.8%	37.5%
Constant FY2011	$4,104 B		
Korea	**1950-1953**	**1952**	
Current Year	$30 B	4.2%	13.2%
Constant FY2011	$341 B		
Vietnam	**1965-1975**	**1968**	
Current Year	$111 B	2.3%	9.5%
Constant FY2011	$738 B		
Persian Gulf War	**1990-1991**	**1991**	
Current Year	$61 B	0.3%	4.6%
Constant FY2011			
Iraq	**2003-2010**	**2008**	
Current Year	$715 B	1.0%	4.3%
Constant FY2011	$784 B		
Afghanistan/Other	**2001-2010**	**2010**	
Current Year	$297 B	0.7%	4.9%
Constant FY2011	$321 B		
Total Post-9/11 - Iraq, Afghanistan/Other	**2001-2010**	**2008**	
Current Year	$1,046 B	1.2%	4.3%
Constant FY2011$	$1,147 B		

Source: Congressional Research Service

Implications of Government Intervention

These U.S. Fed and Treasury actions are intended to offset a sharp deflationary shock and severe recession with Q2 2020 U.S. GDP forecasts no better than -20% and quite possibly even worse. The jump in the U-3 unemployment rate[1] is the fastest on record rising from near trough levels in February 2020 of 3.5% to 14.7% just two months later in April 2020. The U-6 unemployment rate[2] (unemployed and underemployment) has similarly risen from 7% in February 2020 to 23% in April 2020. Conversely, historical recoveries in the unemployment rate have typically been only 1.5% per year, **implying a decade long recovery without government intervention.**

A key question that must be answered to determine the future performance among asset classes is whether the Fed can reflate the economy amidst the damage created by COVID-19. Given the magnitude and speed of the government's response at the start of the crisis and the Federal Reserve's commitment to do "whatever it takes", the acute phase of the crisis should be shorter and sharper than the Great Financial Crisis of 2009, which relied on monetary stimulus and lacked fiscal accommodation. **Today the combination and magnitude of both should instead produce what the recent Federal Reserve actions alone could not: inflationary pressures once economic growth returns.**

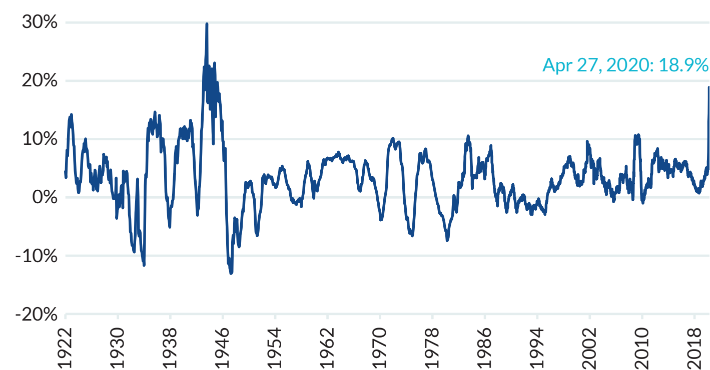
The Trump administration is also approaching global trade differently than prior administrations with its "America first" policies (such as the tariffs on Chinese imports) designed to stimulate U.S. GDP growth and incentivize near shoring of manufacturing activities. Additionally, our sense is that there will be a massive infrastructure bill introduced after the election to "rebuild America", which would increase employment through public work programs akin to New Deal era policies under FDR. These are inflationary policies.

Beyond the short term, however, the sheer magnitude of government spending will have medium-term and long-term consequences that could significantly shift the investment landscape. The U.S. money supply is surging as shown in chart 1 on the following page. In February 2020, the M2 growth rate was 7.2%, but with COVID-19 stimulus the growth rate jumped to 23.1% at the end of May 2020. **An increase this large in a two-month period is extraordinary: this is the largest spike since World War II.**

1. U-3 unemployment represents the number of people actively seeking a job. 2. U-6 unemployment includes discouraged, underemployed and unemployed workers. Past performance is not indicative of future results. Please see the last page for additional, important disclosures.

While economic growth has cratered, and the velocity of money is extremely low right now, if the Fed and the Treasury are successful in engineering an economic recovery during the next couple years there is a significant risk of inflation. This is the Great Monetary Reflation of our lifetimes and this staggering rise in money supply growth has major implications for asset class performance and GDP growth.

Chart 1: **US REAL M2 GROWTH (%Y, ADJUSTED BY HEADLINE CPI)**



Source: Morgan Stanley

Implications for Asset Classes

U.S. Dollar

There are several intra-asset class relationships that are affected by this crisis and looking at a longer-term rate of change of 10 years offers perspective. For example, the difference between the decade long rate of change in the U.S. versus foreign G-10 (ex U.S.) 10-year yields over the last couple decades has provided an ~12-month leading indicator for the performance, in terms of direction and rate of change, of the U.S. dollar. This relative yield relationship bottomed right after the Great Financial Crisis and has risen meaningfully over the last decade, supporting the U.S. dollar, aided in the last couple years by the move to negative interest rates in Japan and Germany. However, since the world was made aware of COVID-19 in mid-late January, the U.S. 10-year yield has plunged from 1.8% to 0.6% and the yield gap has narrowed dramatically. The implication is that in the next 6-18 months the U.S. dollar should move meaningfully lower.

In addition, based on our analysis of Federal Reserve rate actions from 1990-2020, **major multi-year turning points in the U.S. dollar index have occurred 1-1.5 years after a material policy shift in Federal Reserve interest rate policy.**

- In February 1994 the Fed began aggressive interest rate cuts and the U.S. dollar bottomed in April 1995, rising ~50% from mid-1995 to the mid-2001 peak, which occurred one year after the rate cuts stopped in May 2000.
- Significant rate cuts began in January 2001 and the U.S. dollar started declining materially one year later in early 2002, falling -34% from over a decade long peak to the early 2005 low.
- Recently, the Fed stopped raising rates in December 2018 and started reducing the fed funds rate in August 2019 with significant cuts from 2H19 to early 2020, implying that the U.S. dollar should start a meaningful decline within the next 12 months. This is a likely outcome after the global liquidity squeeze associated with the COVID-19 crisis abates. The weak U.S. dollar and unprecedented money supply growth combined will have meaningful implications for other assets classes including commodities and the performance of growth stocks versus value stocks as discussed below.

Commodities

Commodities have been in a bear market since their 2011 peak, with the CRY Index falling 11% per year on average. The S&P 500 Index, by comparison, has returned 12% annualized returns since the 2009 low. Obviously, commodities have been a terrible investment, largely due to fundamental issues. The U.S. shale boom has crushed the price of oil, grain prices have suffered from excess supply driven by improved planting and seed technologies, industrial metals have been hurt by the severe decline in Chinese demand following the bursting of the credit bubble, and precious metals until recently have lacked the outsized investment demand that was seen a decade ago.

The direction of commodity prices is important due to their high positive correlation to the rate of change in the money supply. This is logical because commodities are real assets with limited supply in the short term, so the value of the asset rises when the currency in which they are priced decreases. Per chart 2 from Stifel on the following page,

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the 10-year rate of change in commodities and the money supply (M3) trend together. We expect the 10-year rate of change in the CRY Commodities Index to bottom in 2020 (removing strong 2010 performance of +18% and adding weak 2020 performance, -25% YTD). The CRY Index bottomed on 04/21/20, and it remains to be seen if this is the final low. However, the surge in the money supply since March 2020 is suggesting that commodities should be starting their bottoming process in 2020 given the positive correlation discussed earlier. This is critically important because the performance of the commodity index is highly correlated with the relative performance of value stocks to growth stocks (R-squared of 0.84), per chart 3.

Chart 4 shows the relationship is also very strong on a 10-year rate of change basis and portrays how poorly both commodities and the value/growth stock ratio have performed recently relative to history. The major distinction between the value indices and the growth indices is that value is primarily comprised of "old economy" sectors including financials, energy, materials, and industrials while growth indices are mostly comprised of "new economy" sectors including technology, consumer discretionary, and communications. Financials have a very big weight in the value index and a tiny weight in the growth index, while the opposite is true for technology.

Chart 2: **COMMODITY PRICES VS. U.S. (RECONSTRUCTED) M3 MONEY SUPPLY**

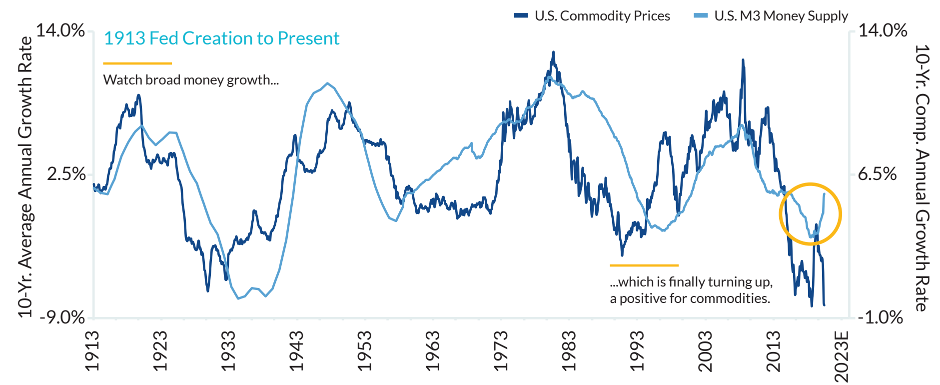
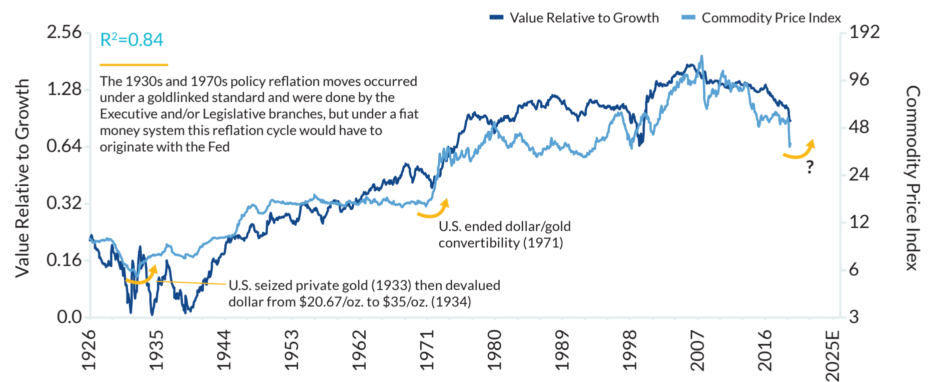
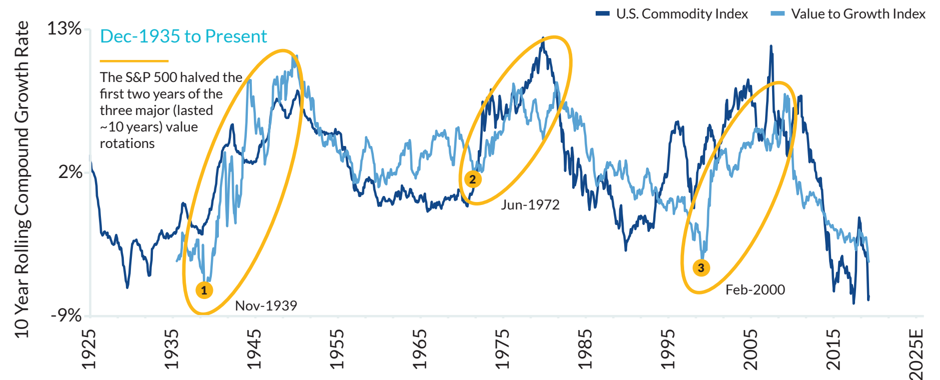


Chart 3: **VALUE RELATIVE TO GROWTH VS. COMMODITY PRICE INDEX**



Source: Stifel

Chart 4: **U.S. COMMODITY INDEX VS. VALUE TO GROWTH INDEX**



Source: Stifel

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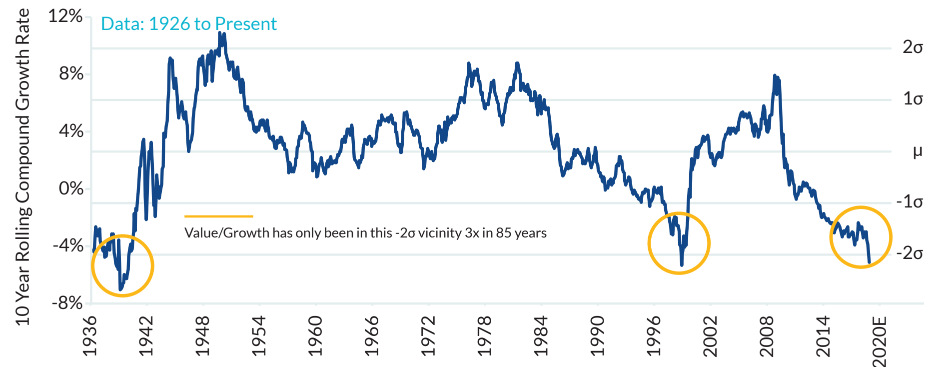
Finally, in chart 5 we see that the current degree of underperformance of value stocks versus growth as defined by Stifel is a two standard deviation event only seen two other times during the last century in 1939 and 1999. We would note that these events occurred just before or during equity bear markets as measured by the S&P 500 performance adjusted for inflation.

Chart 5: **VALUE RELATIVE TO GROWTH, TOTAL RETURN INDICES**



Source: Stifel

Small Cap Value Stock Performance

With the surge in the money supply, expected weakness in the U.S. dollar, and commodities that are close to (or at) a bottom, we believe we are close to a multi-decade low in the ratio of value versus growth stock performance, consistent with charts 6 and 7. These are the catalysts for change. The missing ingredients for material small cap value stock outperformance are faster economic growth (both nominal and real) along with absolute levels of inflation. Value stocks are more sensitive to changes in economic activity given their typically slower growth, higher cyclicality, greater exposure to positive inflation, generally lower profit margins, higher capital intensity, and thus lower valuations. **In a reflationary period with faster economic growth, driven by employment gains and rising inflation, small cap value stocks should exhibit a greater rate of change in revenue and earnings growth** relative to a slow economic period than growth stocks. When combined with the valuation discount of small cap value stocks relative to their growth stock peers, there is a meaningful opportunity to close the performance gap. Per charts 6 and 7 from Furey Research Partners, when both economic growth and inflation are high, small cap value stocks have materially outperformed small cap growth stocks. This is exactly what we began to see in mid-May 2020 with dramatic small cap value stock outperformance relative to large and small cap growth stocks as the economy is recovering from the COVID-19 crisis faster than previously expected which would be a prelude to a more significant shift to value over the next 18 months.

Chart 6: **MEDIAN ANNUAL SCV LESS SCG RELATIVE RETURN (1910 TO 2017)**

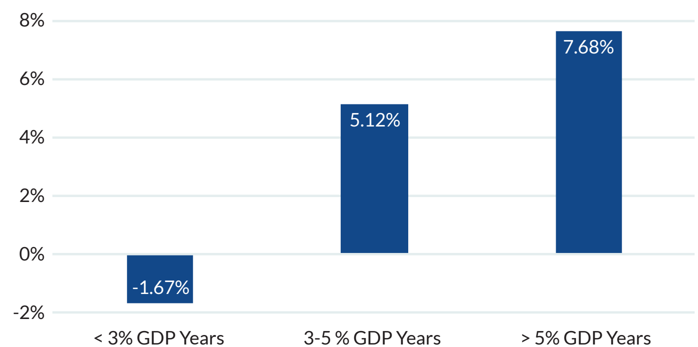
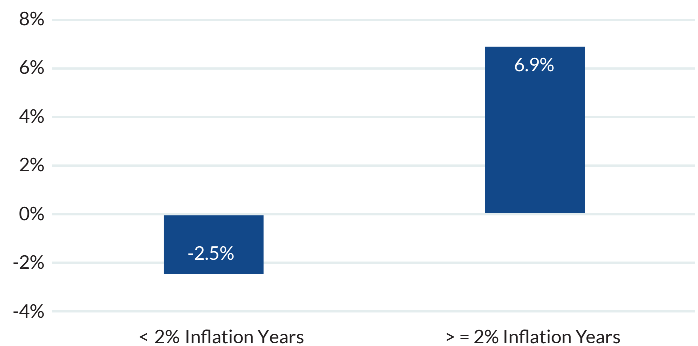


Chart 7: **MEDIAN ANNUAL SCV LESS SCG RELATIVE RETURN (1910 TO 2017)**



Source: Furey Research Partners

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Conclusion

In the next 6-12 months we will have clarity on whether the Fed wins the war on deflation and whether asset classes respond as we expect. There is an endless number of unknown variables including the size and timing of second waves of the virus across the globe that could delay the timing of these shifts, but we believe global government actions to stimulate growth have put the ingredients in place for a secular value bull market over the next 5-10 years.

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The TR/CC CRB Excess Return Index (CRY) is an arithmetic average of commodity futures prices with monthly rebalancing.