# European View – April 2021 (Institutional Use Only)

## SURFING THE BLOB IN EUROPE AND MEXICO AND HEDGING WITH ANTIFRAGILE ASSETS

**Bottom Line:**

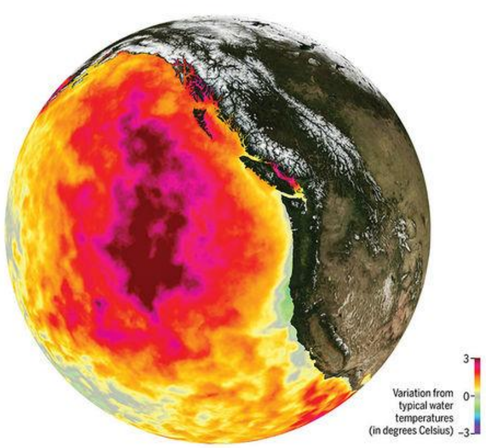
1 – A $10 trillion + blob of central bank liquidity has inflated a rotating bubble from big tech to EVs, SPACs and crypto
2 – Mexican stocks should benefit from the 3 themes of 2021: reflation, steeper curves, and the U.S. consumption boom
3 – Europe has reached "peak Covid despair" but will reopen soon: leisure and tourism stocks still trade at a large discount
4 – Investors should hedge the risk of a sentiment correction with antifragile assets: Japanese stocks and precious metals

From 2013 to 2016, "the blob", a one-million squared miles body of warm water off the coast of Alaska, wreaked havoc around the Pacific rim. Whales starved due to the lack of plankton, Seattle enjoyed good weather, and Los Angeles experienced a rare climatic phenomenon in 2016 – rain.

G-10 central bankers have injected about $10 trillion in financial markets since 2020 and the resulting blob has also created extraordinary outcomes: cryptocurrency joke Dogecoin is worth twice as much as Ford, $13 trillion worth of bonds trade at negative yields, and U.S. equity ETFs have taken a record $140 billion in the past quarter. **The blob has created a rotating bubble, from long bonds to big tech, work-from-home stocks to reopening sectors, and electrical vehicles to SPACs**. I am not smart enough to forecast when these bubbles will pop but I can try to guess where the blob will go next.

The first part of this report will show that **Mexican stocks are at the intersection of the three major themes of 2021: reflation, steeper curves, and a turbo-charged U.S. consumer**. In addition, a massively undervalued Peso and the windfall from soaring oil prices protect investors from Mexico's perennial Achilles' heel – balance of payment crises and a broken energy sector. Canadian stocks are an acceptable alternative bet on these themes for more conservative investors.

In the second part, I will share the conclusion from a recent vacation in France: **Europe has reached peak Covid despair**. However, the current lockdowns, the progressive vaccine rollout, and electoral calculations should allow for the economy to reopen ahead of the crucial summer tourism season. European airlines and restaurants have lagged their U.S. counterparts by about 30 percent this year and hotel chains trade a historically large discount, which I expect to shrink as the continent reopens this summer.




The third part will warn that the blob may be cooling: the StoneX Sentiment Index, which had remained in extreme greed territory throughout the first quarter, dropped by 50 points in April.

**Investors should hedge the risk of a major correction with antifragile assets**: Japanese stocks denominated in Yen should help diversify tech & U.S- heavy global equity indices. Healthcare stocks have the lowest exposure to the three major risks of 2021: rising yields, widening spreads, and lower stocks' valuations. Last, precious metals, which the blob has not touched (yet), are a great way to diversify equity and credit risk, while protecting investors against inflation and a secular bear market for the U.S. Dollar.

Vincent Deluard, CFA Vincent.deluard@intlfcstone.com (+1) 305-925-4922 www.marketintel.stonex.com

# The Blob and the Rotating Bubble

Just as the hot air of the "Ridiculously Resilient Ridge" fed the Pacific Ocean blob for several years, constant liquidity injections from central banks have inflated a sequence of rotating bubbles. Instead of the normal pattern of manic speculation, excessive leverage, blow-off tops, margin calls, and capitulations, these new bubbles never burst: rather, **the blob moves to a new asset class, theme, or sector as its energy is constantly replenished**.

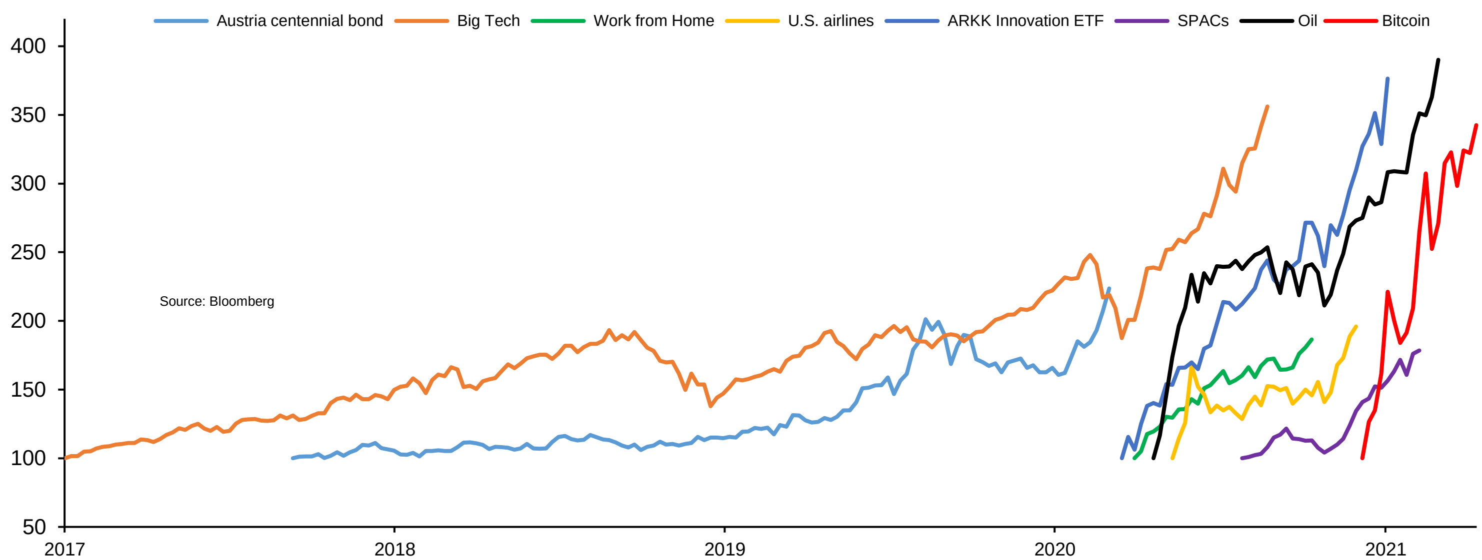
The chart below attempts to summarize the most important bubbles of the past three years. Long bonds can be thought of as "the mother of all bubbles" since the risk-free rate eventually feeds into the price of all financial assets. The longest duration IOU, Austria's centennial bond, rallied by 124% from its first auction in 2017 to the March 2020 low in yields.

U.S. big tech stocks were the biggest beneficiary from plummeting yields: the capitalization of Facebook, Apple, Amazon, Microsoft, and Google soared by 256% between January 2017 and September 2020.

"Work-from-home" stocks, such as Zoom and Plantronics, were the first winners of the pandemic, gaining 86% between March and October 2020. The pace of the rotation and the magnitude of bubbles accelerated after the November vaccine announcement as airlines and oil prices led an explosive rally in the reopening sectors. As interest in the big Nasdaq stocks waned in September, a new crop of speculative high-flyers embodied by the ARKK Innovation ETF flourished in the fall and winter. Last, Bitcoin dwarfed all prior bubbles as its price was multiplied by eight in the past twelve months.

While it is entirely possible that these bubbles keep inflating, I would not chase these speculative manias as there can be no objective exit point. Instead, investors should turn to assets which have not been touched by the blob yet.

**The Rotating Bubbles of 2017-2021**

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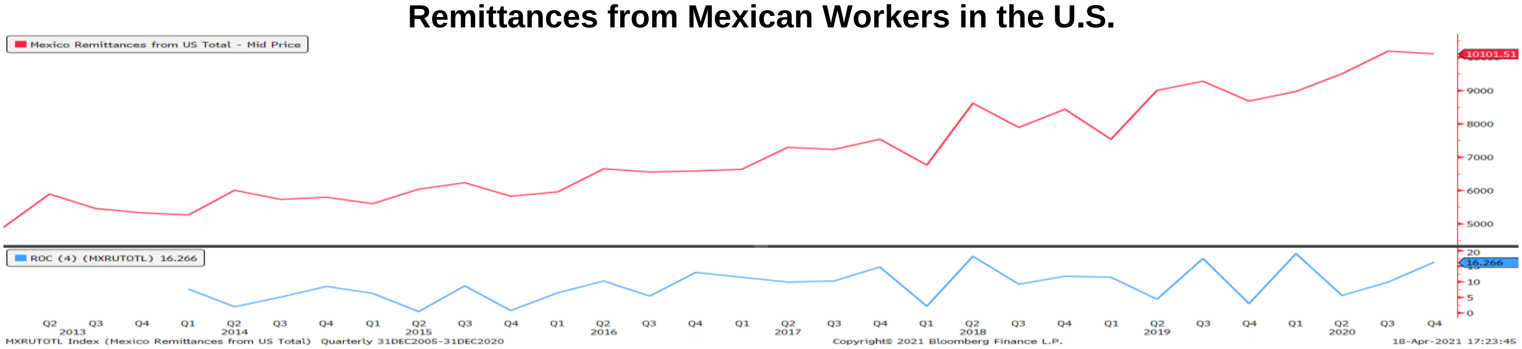
# The Year of Mexico (and Canada)

Three macro themes will dominate capital markets in 2021: reflation, steeper curves, and an explosive surge in U.S. consumption due to pent-up demand, successful vaccine rollouts, and massive stimulus.

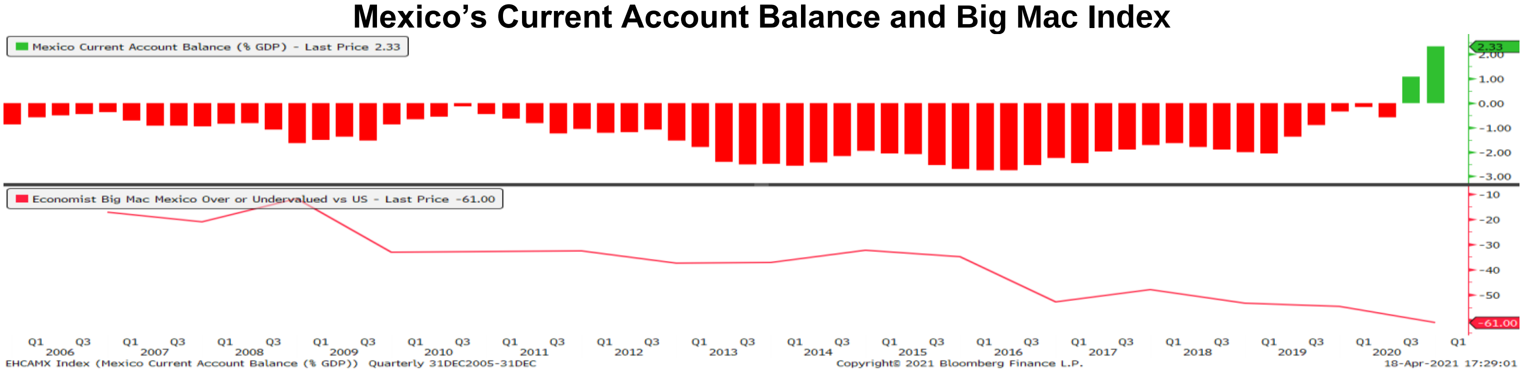
**Mexican stocks are at the intersection all three trends:** inflation-sensitive materials account for 22% of the S&P BMV/IPC index and banks, which benefit from higher yields and steeper curves, represent 15% of the index. The Mexican economy is highly leveraged to the U.S. consumer, as exports to the U.S. account for about a third of GDP. Furthermore, the Mexican economy will surely benefit from Biden's stimulus checks via remittances: Mexicans sent back $10.1 billion this past quarter, 16% more than last year. This trend should accelerate in 2021 as construction costs soar in the U.S. and as more states roll out minimum wage increases.

**Remittances from Mexican Workers in the U.S.**




Balance of payment crises, competition from low-cost countries, and a troubled energy sector have been Mexico's perennial curse, but these risks should not be a concern this year. According to the Economist's Big Mac Index, **the Peso is undervalued by 61% versus the greenback, resulting in a current account surplus of 2.3% of GDP** - Mexico's first surplus in more than 30 years. Competition from China will likely abate: the Biden administration has left the Trump tariffs in place and most companies are trying to shorten supply chains. As I explained in "Three Unconventional Arguments for Secular Inflation", shrinking labor pools and the rise of an Asian currency bloc around a strong Yuan will benefit Mexico's *maquiladoras*. Third, the windfall from high oil prices as well as continued government support for Pemex should allow the Mexican energy sector to limp through 2021.

**Mexico's Current Account Balance and Big Mac Index**

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Mexico is my favorite equity pick for 2021 due my conviction that secular inflation will lead to a decade-long bear market for the U.S.  Dollar, but **risk-averse investors can use Canadian equities to bet on these three macro themes**. The Canadian stock market is also dominated by inflation plays in the energy and materials sectors and rate-sensitive banks. As shown in the table below, the U.S. economic surprise index is the most important macro driver of the performance of Canadian stocks. Quite logically, our country scorecard, which has performed admirably since its inception in January 2018, ranks Canada and Mexico in the top two  spots.

**StoneX Country Scorecard as of April 19, 2021**

| | Fundamentals | | Valuations | | Technicals | | Blended Country Rank | Macro Risk Exposure |
|---|---|---|---|---|---|---|---|---|
| | Growth | Quality | Absolute | Relative | Risk | Momentum | | |
| U.S. | 5.2 | 3.0 | 9.8 | 9.6 | 5.8 | 4.0 | 8.0 | Fed Balance Sheet |
| Canada | 7.0 | 5.7 | 4.4 | 4.0 | 5.3 | 4.5 | 1.0 | US Economic Surprise Index |
| Euro Area | 7.4 | 10.0 | 6.0 | 6.4 | 6.5 | 3.3 | 10.0 | China Economic Surprise Index |
| U.K. | 7.0 | 9.3 | 4.0 | 3.8 | 5.0 | 5.3 | 4.0 | 10-Year yield |
| Japan | 6.0 | 8.3 | 5.8 | 3.2 | 4.3 | 9.0 | 7.0 | China Economic Surprise Index |
| China | 6.2 | 3.3 | 5.2 | 6.4 | 5.3 | 10.0 | 6.0 | Fed Balance Sheet |
| Pacific Ex. Japan | 7.4 | 8.7 | 7.2 | 8.2 | 6.3 | 5.5 | 11.0 | US Economic Surprise Index |
| India | 5.0 | 3.7 | 9.8 | 8.6 | 4.5 | 7.5 | 9.0 | Fed Balance Sheet |
| Latin America | 6.2 | 5.0 | 4.0 | 5.8 | 8.0 | 6.0 | 5.0 | Dollar Index |
| Mexico | 4.4 | 5.7 | 6.4 | 5.4 | 6.8 | 2.5 | 2.0 | Oil Prices |
| Brazil | 4.0 | 3.3 | 3.4 | 4.6 | 8.5 | 8.5 | 3.0 | China Economic Surprise Index |

## Playing the Reopening Trade in Europe

I just got back from a long-postponed two-week vacation with my family in France. The atmosphere was unreal: one year after the first lockdown, the country was still stuck in Covid limbo. Travel  was limited to a 10-kilometer perimeter, with a required (and totally unnecessary) *attestation de déplacement*. Policemen were chasing the tourists on the *Champ de Mars* who forgot about the mandatory 7 pm curfew. Restaurants, cafes, bars, bookshops, museums, and theaters were closed, making Paris as boring as Geneva. Only supermarkets were open, but “non-essential” items were covered in plastic, presumably because paint brushes present a higher risk of contamination than toothbrushes.

To my surprise, most of these restrictions were respected as fines were eventually effective against covidiots after a year of emergency measures. The mood was extraordinarily grumpy, even by Gallic standards. Conspiracy theories were widely popular in the countryside, while city-dwellers raged against the government, which has indeed failed to supply masks during the first wave of infections, botched its track and trace program, failed to anticipate the second and third waves, and tragically messed up the initial rollout of vaccines.

Such a level of defiance could lead to an extremely surprising and potentially destabilizing outcome for the 2022 Presidential election, but for now it seems that **Europe has reached “peak Covid despair”.**

Vincent Deluard, CFA    Vincent.deluard@intlfcstone.com    (+1) 305-925-4922    www.marketintel.stonex.com

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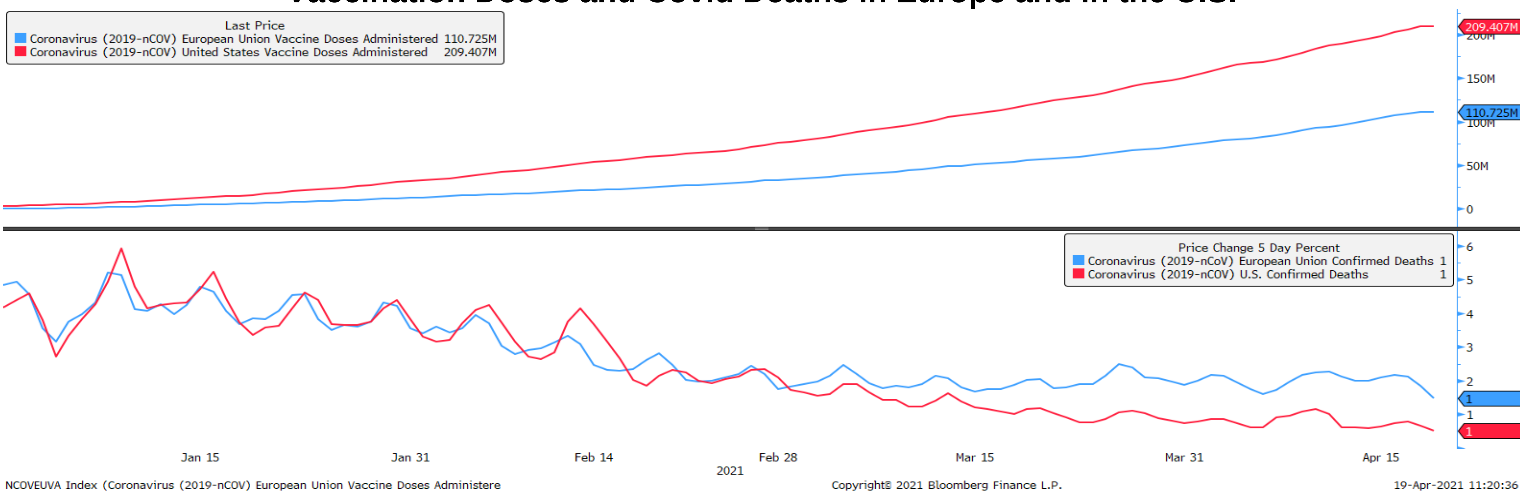
Despite the government's incompetency and the European Commission erratic decision-making, vaccines are finally rolled out. As of Monday, 110 million doses had been administered. **The European vaccination program is about 40 days behind the U.S., which suggests that Covid infections and deaths in Europe should start falling precipitously**. Furthermore, strict lockdowns and warmer temperatures should slow the spread naturally, as was the case in the spring of 2020.

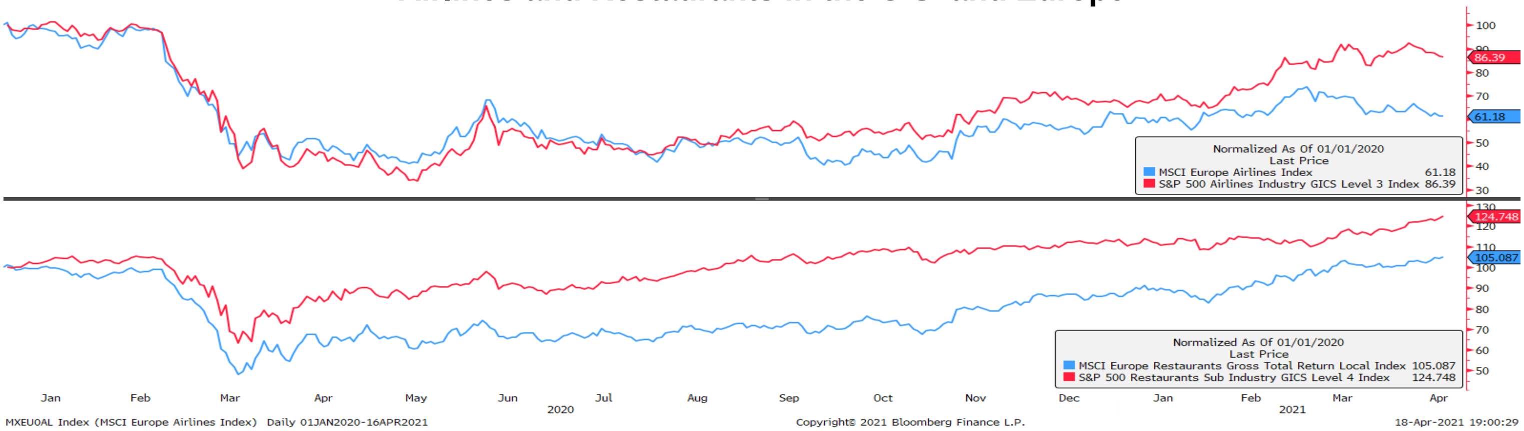
**Vaccination Doses and Covid Deaths in Europe and in the U.S.**




**Political considerations also suggest that Europe will return to some normalcy before the crucial tourism season**. E. Macron's first' term ends in early 2022, while Italy and Spain must go to the polls before 2023. Vacations are a religion in Europe and tourism account for 10 to 20% of Mediterranean countries' GDP. European leaders have locked down their economies for Easter so that they can re-open bars, beaches, and restaurants in the summer.

**Investors have not fully priced in the reopening of Europe's leisure and tourism sector**. The MSCI Europe airlines and restaurants indices have lagged by 30 and 20%, respectively. I expect this gap to close in the coming months as European economies reopen for the summer months.

**Airlines and Restaurants in the U.S. and Europe**

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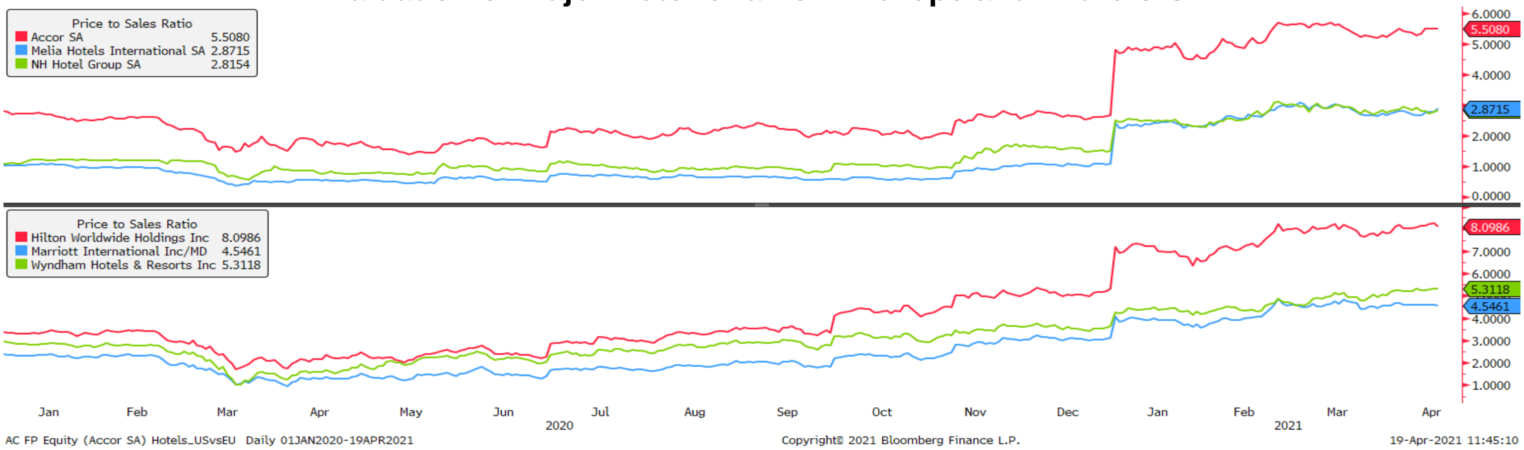
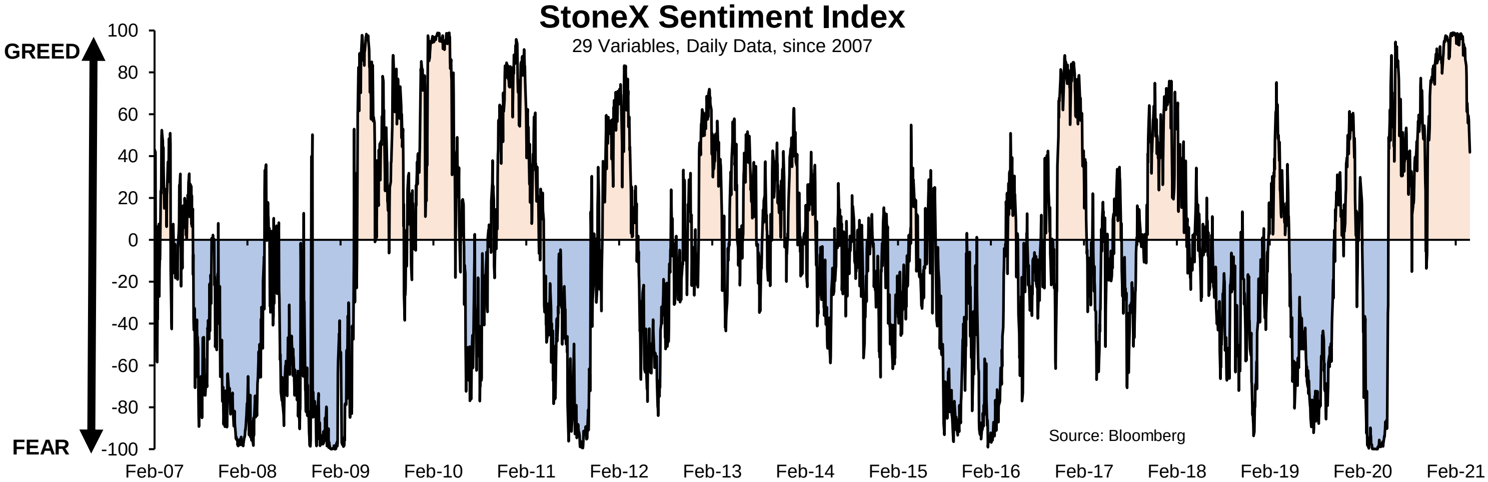
Similarly, **European hotel operators trade at ahistorical discount to their U.S. competitors**. Major Spanish hotel chains can be bought at 2.8 times sales, versus 5 or 8 in the U.S. France's Accor, the third largest hotel operator in the world, trades for 2.1 times book value, versus 7.7 for the S&P 500 hotels index.

**Valuation of Major Hotel Chains in Europe and in the U.S.**




## Hedging with Antifragile Assets

"Stonks only go up" has become the mantra of our era of meme-driven trading. Just as the Pacific Ocean blob survived the cold winters of the Pacific Northwest, the bull market has ignored rising rates, a deadly third wave of infections, and mounting inflationary pressures thanks to sustained central bank liquidity injections. The StoneX Sentiment Index has indicated greed since May 2020 and has spent the entire first quarter in extreme greed territory, the longest stretch in history. However, the index has dropped by 50 points since the end of March (chart below). This sentiment correction could be a short-lived and overdue pullback like the brief Nasdaq selloff in September, but **investors should hedge the risk of a real bear market with "anti-fragile" assets.**

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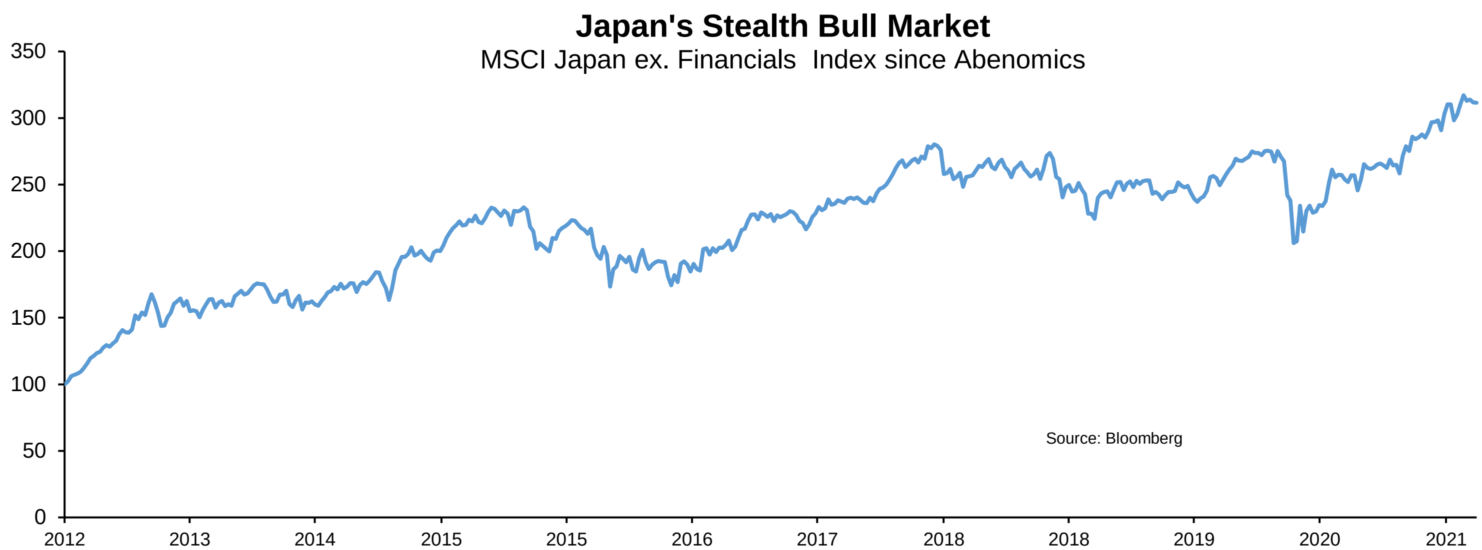
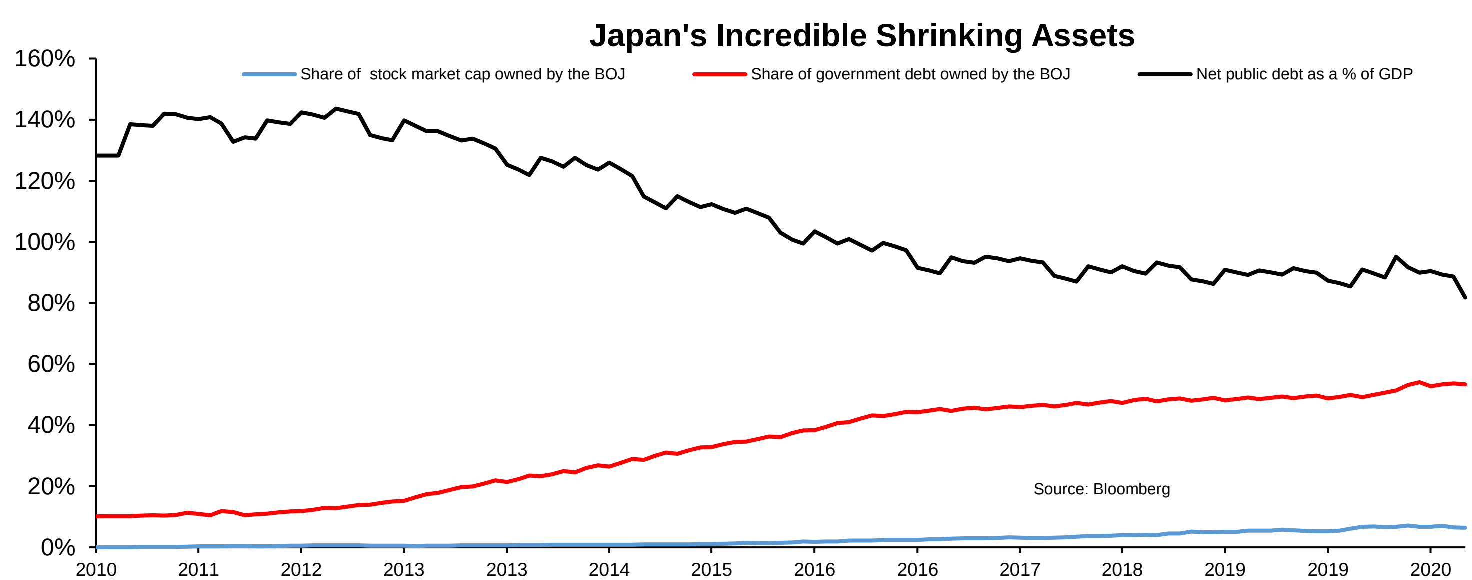
As I explained in "Two Portfolio Adjustments for the Post-Covid World", Japanese assets are a great way to diversify U.S. and tech-heavy global equity portfolios. Industrials and consumer discretionary stocks are the two largest sectors in the TOPIX Index at 23% and 18%, respectively. Excluding financials, Japanese stocks have been on a remarkably consistent bull market since the start of Abenomics in 2012 (chart below). Furthermore, **the negative correlation between the Yen and risk assets greatly reduces the volatility of Japanese shares for foreign investors**.




Contrary to the U.S., where IPOs, secondary offerings, and insider sales are increasing the supply of stocks, Japanese assets are shrinking. The Bank of Japan has cut in half the country's public debt and owns about 8% of the stock market. These purchases should continue to offer support for Japanese assets' prices and protection against abrupt changes in investor sentiment.

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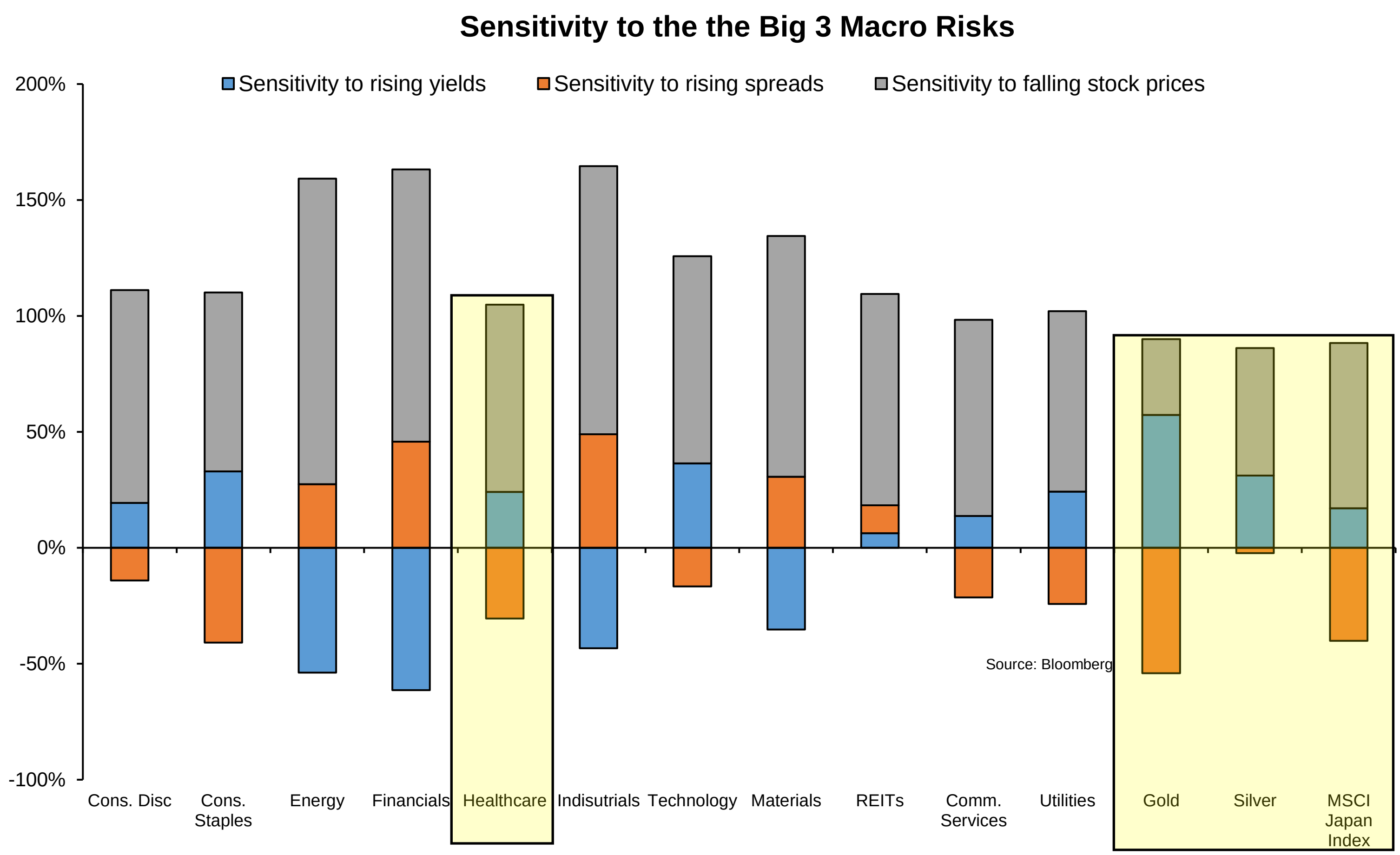
Last, I maintain my long standing bullish view on healthcare and precious metals, which have not benefitted from the blob of global liquidity (yet). The fundamental case was explained in "the Next Big Thing? Healthcare Obviously" and "the 800-Pound Gorilla in the Room: (Hyper?)-Inflation" so I will focus on portfolio construction arguments.

Asset allocators face three major risks in 2021: rising yields, widening spreads, and falling stock prices. These risks could easily materialize sequentially: rising yields would cause stress on leveraged corporations, which would widen spreads, and eventually trigger a bear market for stocks.

The chart below shows that healthcare is the least sensitive U.S. sector to these three risks. While I generally dislike overvalued U.S. stocks, few investors can avoid the country altogether: large healthcare stocks, which will benefit disproportionately from government stimulus, are a good way to maintain exposure to the U.S. stock market without piling into crowded trades in the tech and reopening sectors.

Similarly, **precious metals and Japanese stocks denominated in Yen have a low correlation to U.S. stock prices and attractive risk-off characteristics**. **They should help stabilize my potentially risky bets on Mexican stocks and in the European travel, tourism, and leisure sectors**.

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