

OUTRAGEOUS

PREDICTIONS

2020 / By #SAXOSTRATS



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Outrageous Predictions 2020 - Engines of Disruption

STEEN JAKOBSEN, CHIEF INVESTMENT OFFICER

Looking into the future is something of a fool's game, but it remains a useful exercise — helping prepare for what lies ahead by considering the full possible range of economic and political outcomes. This is where Saxo's annual Outrageous Predictions fit in: not as a forecast for what 2020 will bring, but as an exercise in considering the full extent of what is possible, even if not necessarily probable. Inevitably the outcomes that prove the most disruptive (and therefore outrageous) are those that are a surprise to consensus.

Leaving 2019 behind, there is again a sense of "it's different this time": that we don't need to mark down risky assets despite economic and earnings slowdowns and the risk of a recession. The idea this time around is that zero and negative yields drive investors into equity with no material downside risk, because policymakers will meet the least aggravation of financial

conditions or recession in the real economy with a mountain of new liquidity. Recent history has certainly justified this dogmatic stance, but if we carry this policy to its logical conclusion, it is a road to ruin. There is no "infinity and beyond" for financial markets – at some point, things begin to break. Disruption lies ahead.

Already, there are a number of cracks in the system that show how past easy money policies are coming back to haunt us: the blow up in WeWork and its enabler Softbank, the Fed's repo malfunctioning, GE's woes, Argentina's currency collapse and the ESKOM debacle in South Africa, just to name a few examples from 2019.

One new concern to us at Saxo is that negative yields are now used to discriminate access to mortgages for low-income households, the elderly and students as regulatory capital requirement demands make credit hurdles too high for that group to get credit. Instead, they

rent at twice the price of owning – a tax on the poor if ever there was one, and a driver of inequality. This risks leaving an entire generation without the savings needed to own their own house, typically the only major asset that many medium- and lower-income households will ever obtain. Thus, we are denying the very economic mechanism that made the older generations "wealthy" and risk driving a permanent generational wealth gap as well as an unfair rent-seeking economy.

In this environment, we see 2020 as a year where at nearly every turn, disruption of the status quo is an overriding theme. The year could represent one big pendulum swing to opposites in politics, monetary and fiscal policy and, not least, the environment. In politics, this would mean the sudden failure of populism, replaced by commitments to "heal" instead of to divide. In policymaking, it could mean that central banks step aside

and maybe even slightly normalise rates, while governments step into the breach with infrastructure and climate policy-linked spending.

The list of Outrageous Predictions this year all play to the theme of disruption, because our current paradigm is simply at the end of the road. Not because we want it to end, but simply because extending the last decade's trend into the future would mean a society at war with itself, markets replaced by government only, monopolies as the only business model and an utterly partisan and atomised public forum for news and information — where lies, deceit and spin mean there is no ability to agree on basic truths and best practices.

Finally, as always, an important Outrageous Predictions disclaimer:

We have been doing Saxo's Outrageous Predictions for close to two decades. Whilst sometimes

viewed as plain fun, the principles behind the Outrageous Predictions resonate very strongly with our clients and the Saxo Group. Not just in terms of what could happen to the portfolios and wealth allocation, but also as an input to our respective areas of business, careers and life in general. This is the spirit of Outrageous Predictions: to create the very conversation which is difficult because today's world has become too partisan and intolerant. As the Australian lawyer and writer Francis Joseph Sheed correctly put it:

'One way to prevent a conversation from being boring is to say the wrong thing'.

Best of luck in 2020 from the Saxo Strategy team,

Steen Jakobsen,
Chief Investment Officer

Chips go cold in AI winter

PETER GARNRY / HEAD OF EQUITY STRATEGY

Diminishing returns on chip application see the SOX Index of semiconductor stocks collapsing 50%.

Since the depths of the Great Recession, semiconductors stocks have been star performers, with the Philadelphia Semiconductor Index (SOX Index) returning 24% annualised compared to 16.6% for the S&P 500, including dividend reinvestments.

Outside of widening deployment in consumer products, semiconductor growth has been driven by an explosion of investment in everything from cloud-based infrastructure and cryptocurrency mining to artificial intelligence (AI), big-data processing and “deep learning”. But in 2020, diminishing returns will mean that semiconductors are set to hit the wall.

In fact, a new “AI winter” is likely coming soon, following the two previous AI winters in the 1960s and 1980s, where actual results for semiconductor applications failed to live up to the hype. This time around, the hype bar has once again been set very high, with AI researchers such as Andrew Ng claiming that AI is the new electricity.

On the physical side, transistor density and clock speeds in semiconductor chips were approaching theoretical limits years ago. Those constraints have meant diminishing returns on R&D efforts. Intel has spent a cumulative \$86bn in capital expenditures since 2010, with 2019 at three times 2010 levels. But neither shareholder value nor operating profits have scaled with this huge increase in spending.

On the application side, “deep learning” algorithms have created the last leg of hype and the number of researchers in deep learning is around double the level seen in 2014. But according to Francois Chollet, one of the leading figures in the deep learning community, the rate of progress in deep learning applications is the slowest in five years. The AI industry also has a scaling problem: it costs more and more in energy to train their ever-larger models, with less and less marginal improvement. Only the largest companies such as Facebook, Microsoft and Google can keep up. A higher bar of entry will eventually dry up venture capital and innovation for new AI ideas.

Then there is valuation: while earnings in the MSCI World Semiconductor Index are down 17% since 2018, the index hit a new all-time high in October 2019. As reality sets in on the limitations of AI, the SOX Index collapses 50% with deteriorating earnings growth as investments freeze in a new AI winter.



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The sudden arrival of stagflation rewards value over growth

STEEN JAKOBSEN / CHIEF ECONOMIST & CIO

The iShares MSCI World Value Factor ETF leaves the FANGS in the dust, outperforming them by 25%.

Nearly fifty years after the end of the nominally hard-money Bretton Woods system, central banks have reached the end of the road with interest rate policy. Having serially manipulated the market to soften the blow of every recession cycle and therefore preventing the clearing of the system, they have now entirely destroyed price discovery. And from here, the only tool left is outright money printing to stimulate the economy, an MMT-inspired shift in the next cycle that will spike inflation to the highest levels in a generation.

The world has now come full circle from the end of the Bretton Woods system, when it effectively shifted from a gold-based USD to a pure fiat USD system, with endless trillions of dollars borrowed into existence — not only in the US but all over the world. Each credit cycle has required ever lower rates and greater doses of stimulus to prevent a total seizure in the US and global financial system. The mispricing of money and bailing out of zombies has seen productivity growth crater as low rates encourage chasing asset values higher and malinvestment in unprofitable unicorns such as Uber and WeWork. They also allow zombie, debt-laden companies to survive.

With rates at their effective lower bound, and the US running enormous and growing deficits, the incoming US recession will require the Fed to super-size its balance sheet beyond imagination to finance massive new Trump fiscal outlays to bolster infrastructure in hopes of salvaging his election chances. But a strange thing happens: wages and prices rise sharply as the stimulus works its way through the economy, ironically due to the under-capacity in resources and skilled labour from prior lack of investment. Rising inflation and yields in turn spike the cost of capital, putting zombie companies out of business as weaker debtors scramble for funding. Globally, the USD suffers an intense devaluation as the market recognises that the Fed will only accelerate its balance sheet expansion while keeping its policy rate punitively low. US unemployment rises and growth stagnates, even as inflation spikes ever higher. The year 2020 ends with the highest misery index (unemployment plus inflation) since the 1980s.

As the market narrative switches to stagflation, value companies and their solid, right here, right now earnings and dividends are highly prized over the stumbling growth companies, where weak growth weighs and where crazy high multiples were always about the mispricing of capital. The MSCI value ETF leaves the FANGS in the dust.



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ECB folds and hikes rates

CHRISTOPHER DEMBIK / HEAD OF MACRO ANALYSIS

European banks on the comeback trail as the EuroStoxx bank index rises 30% in 2020.

When negative deposit rates were first introduced in the euro area, the purpose was to force commercial banks to seek better returns elsewhere in order to stimulate productive investment, which would result, in theory, in higher productivity and stronger growth. So, what has happened? The investment channel hasn't really delivered yet, and productivity is still too slow in the eurozone. Looking at key innovative sectors, such as electric vehicles, industrial robots or green investments, the monetary union is still lagging behind Asia, most notably China.

The sad reality is that negative deposit rates certainly contributed to increase exports through the depreciation of the euro but, foremost, it also meant a disruption of financial markets and a weakening of financial and banking institutions. Negative market sentiment towards European banks largely reflects a downward revaluation of the long-term profitability outlook. Despite the recent introduction of the tiering system, which has helped to mitigate the negative consequences of negative rates, banks are still facing a major crisis. They are confronted with a challenging economic and financial environment: marked by structurally ultra-low rates, an increase in regulation with Basel IV — which will further reduce the banks' ROE — and competition from fintech companies in niche markets.

In an unprecedented turn of events, in early January 2020, the new president of the ECB, Christine Lagarde — who has previously endorsed negative rates — executes a volte-face and declares that monetary policy has overreached its limits. She points out that maintaining negative deposit interest rates for a longer period could seriously harm the soundness of the European banking sector. In order to force euro area governments, and notably Germany, to step in and to use fiscal policy to stimulate the economy, the ECB reverses its monetary policy and hikes rates on January 23, 2020. This first hike is followed by another a short time later that quickly takes the policy rate back to zero and even slightly positive before year-end.

As the EU simultaneously warms up to fiscal expansion, the market reaction is surprisingly positive, and EU banks are among the best performing sectors in 2020.



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In energy, green is not the new black

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The ratio of the VDE fossil fuel energy ETF to ICLN, a renewable energy ETF, jumps from 7 to 12.

The oil and gas industry came roaring out of the financial crisis after 2009, returning some 131% from 2008 until the peak in June 2014 as China pulled the world economy out of its historic credit-led recession. Since then, the industry has been hurt by two powerful forces. The first was the advent of US shale gas and rapid strides in globalising natural gas supply chains via LNG. Then came the US shale oil revolution, which saw the US become the world's largest oil and petroleum liquids producer, dramatically pushing down prices and return on capital.

The second force impacting the investment outlook for the traditional fossil fuel energy sector, particularly in the long term, has been the increasing political and popular capital behind fighting climate change, causing a massive surge in demand for renewable energy. The "Greta Thunberg" movement has recently increased global awareness, to a level where investors are desperately looking for green energy investment opportunities and large sovereign wealth funds are even reducing their oil and gas holdings to defend against the change of sentiment on all CO2-emitting energy sources.

The combined forces of lower prices and investors avoiding the black energy sector has pushed the equity valuation on traditional energy companies to a 23% discount to clean energy companies. In 2020, we see the tables turning for the investment outlook as OPEC extends production cuts, unprofitable US shale outfits slow output growth and demand rises from Asia once again.

And not only will the oil and gas industry be a surprising winner in 2020 — the clean energy industry will simultaneously suffer a wake-up call. Investors must realise that for clean energy companies, the average return on invested capital versus the weight-adjusted cost of that capital is a terrible 0.5, meaning that the industry is actually destroying capital. The VDE (Vanguard Energy ETF) / ICLN (iShares Global Clean Energy ETF) ratio jumps from 7 to 12 in 2020 as clean energy investment doesn't pay while dirty energy does.



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South Africa electrocuted by ESKOM debt

KAY VAN-PETERSEN / GLOBAL MACRO STRATEGIST

USDZAR rises from 15 to 20 as world cuts credit lines to South Africa.

South Africa closes out 2019 with riveting news, both good and bad. The good news was that the nation's beloved Springboks rugby team took home the World Cup trophy. Their last victory was in 2007, a year which ended with USDZAR below 7, versus 15 now. In carry-adjusted terms, the rand has fallen far less — only some six percent, though with plenty of volatility along the way. That is a near miraculous feat, given the bad news

The very bad news is the South African government announcement late this year that in order to continue to bail out troubled utility ESKOM and keep the nation's lights on, the budget next year is projected to balloon to its worst level over a decade at 6.5% of GDP, a sharp deterioration after the government managed to stabilise finances at a near constant -4% of GDP for the last few years. Late 2019 saw some of the most generous credit conditions for emerging markets in history and the market somehow managed to absorb this news without jettisoning the rand to new lows for the year.

But in 2020, the jig will be up for the country. A brief investigation of the maths shows us why.

In 2007, the last time South Africa won the Rugby World Cup, GDP for the year was \$309 billion in nominal USD. For the four quarters ending at Q2 2018, meanwhile, South African GDP was \$338 billion in nominal USD. That rise may seem small — at less than 10% — but in constant US dollar terms (adjusted for US CPI), this means that the South African economy has shrunk a staggering 9% over the last 12 years. Worse still, the World Bank estimates that its external debt has more than doubled over that period to over 50% of GDP.

The ESKOM fiasco may be the straw that will break the back of creditors' willingness to continue funding a country that hasn't had its financial or governance house in order for decades. Other uncreditworthy EMs will be drawn into the abyss as well in 2020, with the most differentiated performance across EM economies in years. USDZAR rises from 15 to 20 as the country teeters toward default.



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US President Trump announces America First Tax to reduce trade deficit

JOHN J HARDY / HEAD OF FX STRATEGY

A tax on all foreign-derived revenue scrambles supply lines and spikes inflation. US 10-year inflation-protected treasuries yield 6% in 2020 thanks to a rush of investor interest as the CPI rises.

The year 2020 starts with reasonable stability on the trade policy front after the Trump administration and China manage at least a temporary détente on tariffs, currency policy and purchases of agricultural goods. But early in 2020 the US economy struggles for air and US trade deficits with China fail to materially improve, while Chinese purchases of agricultural products can't realistically increase further. Eyeing polls showing a resounding defeat in the 2020 US Presidential election, Trump quickly grows restive and his administration drums up a new approach in a last-ditch effort to steal back the protectionist narrative: the America First Tax.

Under the terms of this tax, the US corporate tax schedule is completely reconstructed to favour US-based production under the claimed principles of "fair and free trade". The plan cancels all existing tariffs and instead slaps a flat value-added tax of 25% on all gross revenues in the US market that are sourced from foreign production. This brings stinging protests from trading partners for what is really just old tariffs in new clothes, but the administration counters that foreign companies are welcome to shift their production to the US to avoid the tax. Furthermore, the administration claims that the "fair and free" portion of the new America First Tax is that the 20% rate is indexed to the size of the US trade deficit as a % of GDP and would fall to 5% in the event the US moves into a trade surplus.

Faced with these stern terms, US corporations scramble to re-shore production wherever they can to avoid the punitive tax. With the US jobs market already tight, wage inflation and inflation generally push higher. Market anticipation of years of poor budget discipline and a rising CPI as the official US CPI measure moves toward 5% as the year draws to a close sees a swarm of investor interest in inflation-protected US treasuries.



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Sweden breaks bad

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A massive and pragmatic attitude shift washes over Sweden as it gets to work to better integrate its immigrants and overstretched social services, driving a huge fiscal stimulus and steep rally in SEK.

Olof Palme's legacy can still be felt in the Swedish society — with its focus on equality and welfare, as well its overall exhortation to always “do the right thing”. But as often seems the case in Swedish policymaking, just as they took progressive taxation too far and collapsed the economy in the early 90's, they have now taken political correctness on immigration so far that they have become politically incorrect. They are ignoring the large and growing contingent of Swedes who are questioning that policy, shutting them out of the debate.

A parliamentary democracy should offer a big enough tent to allow all groups of reasonable size a voice in the debate, but the traditional main parties of Sweden have taken the unusual collective decision to ignore the anti-immigration voice which has grown to represent more than 25% of the Swedish voters. The justification and intentions were good: openness and equality for all and safeguarding the Swedish open economic model. But anything taken too far can overwhelm, and to survive, all models need to be able to change when facts change.

Sweden has failed miserably on this point and has paid the price through woefully overstretched social and community policing services, housing shortages and even a rise in violent crime: from intimidation to gang activity. The other Nordic countries now talk of “Sweden conditions” as a threat, not as a model of best practice.

Sweden is now in recession and with its small open economy status is extremely sensitive to the global slowdown. This sense of crisis, social and economic, will create a mandate for change.

With its very low rates and unnecessarily large budget surpluses, Sweden is better equipped than most to rehabilitate its model with a massive increase in spending on education, reschooling, apprenticeship, social housing and efforts at true integration. This fiscal spend will drive EURSEK down, strengthening the Swedish Krone. In 2020, Sweden again becomes a leader and a role model, not because it's politically correct, but because in the end it will “do the right thing” by rehabilitating a model that has broken bad.



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Democrats win a clean sweep in the US 2020 election, driven by women and millennials

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The 2020 US election puts the Democrats in control of the presidency and both houses of Congress. Big healthcare and pharma stocks collapse 50%.

The polls going into 2020 don't look promising for Trump, nor does the electorate: 2018 mid-term elections and limited 2019 elections in the US showed that voters living in suburbs across the US are turning in droves against the Republican party of Donald J. Trump. Plus, the marginal Trump voter in 2016 and in 2020 is old and white, a demographic that is fading in relative terms as the largest generation in the US now is the maturing millennial generation of 20-40-year-olds, a far more liberal and less white demographic.

Talking to investors around the world, we're staggered by the consensus that Trump is a shoo-in for a second term. They and the markets are in for quite a shock: voter turnout in the 2018 midterms point to heavy turnout in 2020 as well, as the younger generation is in a rebellious mood. Millennials and even the oldest of "generation Z" in the US have become intensely motivated by the injustices and inequality driven by central bank asset market pumping and fears of climate change, where President Trump is the ultimate lightning rod for rebellion as a climate change denier.

We believe that elections are lost far more than they are won. In 2016, the uninspiring, unpopular avatar of the Democratic elite establishment, Hillary Clinton, failed to motivate many on the left to even show up at the polls and lost the election to a fired-up mass of Trump voters who wanted to overturn the system. This time around, the vote on the left is thoroughly rocked by dislike of Trump - with suburban women and millennials showing up to express their revulsion for Trump. The Democrats win the popular vote by over 20 million, grow their control of the House, and even narrowly take the Senate. Healthcare is the single sector that is in for a strong headwind from a Democratic clean sweep in the election, as Medicare for all and negotiations for drug pricing bring a massive haircut to the industry's profitability.



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Hungary leaves the EU

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EURHUF spikes to 375 as Hungary's leadership and the EU fight over Hungary's place in the union.

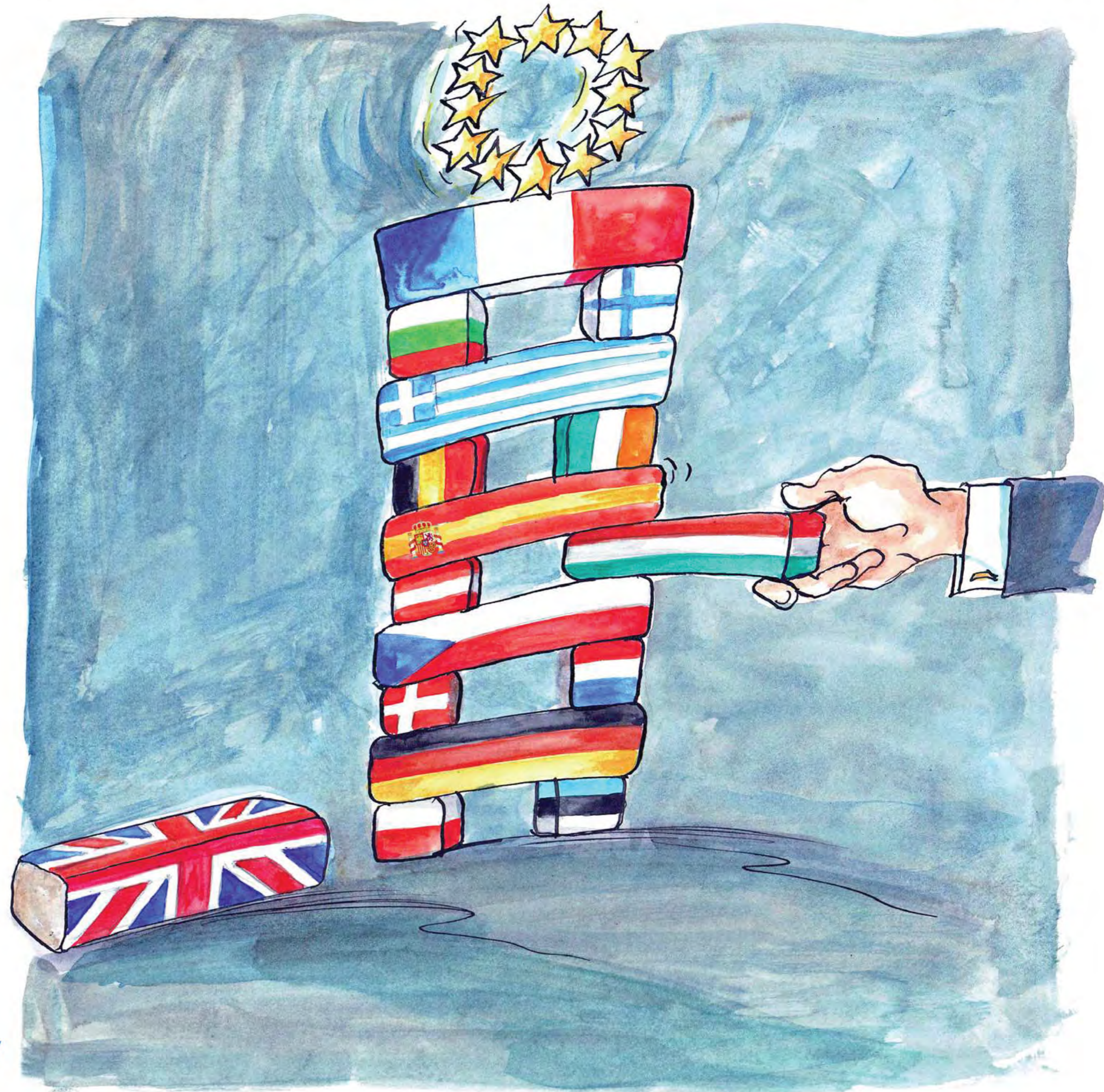
Hungary has been an impressive economic success since it joined the EU in 2004. But the 15-year marriage now seems in trouble after the EU initiated an Article 7 procedure against the country, citing Hungary's – or really PM Orbán's – ever-tighter restrictions on free media, judges, academics, minorities and rights groups, which in the opinion of the EU does not conform with the rule of law, weakens democracy and does not conform with EU values. A divorce is increasingly likely and we could see Hungary take steps to follow the UK out of the EU by end of 2020.

There is endless irony here: a major portion of Hungary's economic success since 2004 comes from EU capital transfers. One estimate from KPMG estimates that EU membership's net effect on Hungarian growth was at some +3.0% of GDP per year, but despite this high correlation the government in Budapest is seeking confrontation with Brussels whenever possible.

The pushback from Hungary's leadership is that the country is only protecting itself: mainly protecting its culture from mass immigration. Plus, they maintain that it has a right to decide for itself. But an open economy with insular governance, immigration and press rules? It's an unsustainable status quo, and the two sides will find it tough to reconcile in 2020 as the Article 7 procedure moves slowly through the EU system.

PM Orbán is even openly talking about how Hungary is a 'blood brother' with the renegade Turkey as opposed to a part of the rest of Europe, a big shift in rhetoric that has not gone unnoticed in Hungary — as well as among bureaucrats and politicians in Brussels.

That this change of tone coincides with EU transfers all but disappearing over the next two years is hardly surprising. But it will leave Hungary's currency, the forint (HUF) on the back foot and take it to a new, much weaker level of 375 in EURHUF terms as the markets fear the disengagement or reversal of capital flows as EU companies reconsider their investment in Hungary.



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Asia launches new reserve currency in move away from US dollar dependence

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An Asian, AIIB-backed digital reserve currency takes the US dollar index down by 20% and tanks the US dollar 30% versus gold.

The US dollar as the world's chief reserve currency has always been a two-edged sword, both for the US, and for a rising China — which has done well by funding itself in US dollars, absorbing global capital to drive the greatest growth in a single nation's economy the world has ever seen.

But the USD as reserve currency is outliving its usefulness for the region. To confront a deepening trade rivalry and vulnerabilities from rising US threats to weaponise the US dollar and its control of global finances, the Asian Infrastructure Investment Bank creates a new reserve asset called the Asian Drawing Right, or ADR, with 1 ADR equivalent to 2 US dollars, making the ADR the world's largest currency unit.

The ADR is driven by blockchain technology and regional central bank reserves are powered up with quantities of this reserve currency — equivalent to a combination of existing gold reserves, current non-US dollar FX reserves, GDP size and trade volumes. As a reserve asset, the ADR is not tradeable by the general public, but represents a basket of currencies and gold, with the Chinese renminbi heavily prominent in the mix and the US dollar weighted at below 20%.

The move is clearly aimed at de-dollarising regional trade. Local economies multilaterally agree to begin conducting all trade in the region in ADRs only, with major oil exporters Russia and the OPEC nations happy to sign up due to their growing reliance on the Asian market. Blockchain technology ensures stability of the money supply and tracking of transactions in the currency. Export revenues received in ADR can be converted back into local currencies by central banks and a deepening market of ADR-based bonds and other financial instruments, also secured on the blockchain, deepens the liquidity and trust in ADRs as a reliable asset.

The redenomination of a sizable chunk of global trade away from the US dollar leaves the US ever shorter of the inflows needed to fund its twin deficits. The USD weakens 20% versus the ADR within months and 30% against gold, taking spot gold well beyond USD 2000 per ounce in 2020.

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