Covid 19: Why is the equity market going up and where to invest?

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Abstract

The U.S. equity market S&P 500 lost -34% in March 2020, over a 33-day period, due to the covid-19 pandemic. The S&P 500 has subsequently rebounded, +31%, in the 49-day period following its fall. In this 82-day period the European, Japanese and U.S. governments underwent quantitative easing worth around \$3-\$6 trillion. This included the purchase of debt and mortgages, as well as policies involving helicopter money given to the population. GDP (gross domestic product) went down to -6.1% worldwide[1] (2020 vs 2019), unemployment went up from +4% to +20% in developed countries. However, equity markets continued (and continues) to go up.

We explain that the equity market surge is linked to a current and forthcoming worldwide currency devaluation. We propose the following hedging strategy:

During currency devaluation: 2019-2020	When currency devaluation stops	12 months after currency devaluation
Equity market, gold, gold ETF/gold miners ETF	Stay equity market for max 12m, gold, gold ETF	Gold, gold ETF

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[1] Source: imf.org

"The best way to destroy the capitalist system is to debauch the currency."
Vladimir Lenine (1910)

1. Introduction

On February 19th 2020, the S&P 500 peaked at 3'386 and then proceeded to decline over the next 32 days by 34% to bottom on March 23rd 2020. From 23 March the index then climbed 31% over the next 49 days.

In 2020, the immediate stimulus efforts included the following amounts:

	USD in billions (as of 6 August 2020) [2]
USA	1'940
Europe[3]	1'498
Germany	506
France	117
Italy	68
Spain	51
UK	195
Japan[4]	186
China[5]	183

[2] https://www.bruegel.org/publications/datasets/covid-national-dataset/#uk, EUR converted in USD using EURUSD=1.11
[3] https://www.cnbc.com/2020/06/04/european-central-bank-ramps-up-its-pandemic-bond-buying-to-1point35-trillion-euros.html, 04Jun2020
[4] Reuters
[5] www.investopedia.com

To address large debt burdens[6], central banks can employ one or more of these exhaustive methods: inflation, **debt restructuring**, financial repression, wealth expropriation[7]. I will show that the only viable way is worldwide sovereign debt restructuring and propose a solution for investors to protect themselves and their wealth against such an event.

Engineering inflation has been tested and it is too slow to reduce debts[8]. Financial repression[9] (currently implemented since 2009-2020 and implemented in 1945-1980), mixed with negative real interest rate has historically worked to reduce debts[10]. But for financial repression to have a significant impact, it must be implemented much harder what we see today (i.e. August 2020): historical examples show that financial repressions have a negative much lower real interest rates (i.e. -3.5% historically in the USA and -3.8% historically in the UK during the financial repression of 1945-1980)[11]. The last one is wealth expropriation which is disallowed in free market countries such as UK, Germany, Japan and USA. We are left with debt restructuring to reduce debts, which we will analyze further in the following sections.

2. Government Debt Restructuring

Theory teaches us that debt restructuring has exhaustive consequences:

[6] We do not say that the central banks must reduce the debts, we say that the market is expecting the central banks to reduce the debts with a worldwide currency devaluation.

[7] voxeu.org . Financial repression: a country's population no longer has many choices when investing their savings. Rather than having money leaving the country to attract foreign assets, it's funneled towards the government. Governments can also change prices and push capital to its preferred economic sectors. Wealth expropriation: taking private property by a government acting in its sovereign capacity. Nationalisation is a form of expropriation, generally covers an entire industry or geographic region.

[8] IMF paper 2019: https://www.imf.org/~/media/Files/Publications/WP/2019/wpiea2019297-print-pdf.ashx . Only hyper inflation with financial repression could have an effect in developed economies. See as well Investopedia/financial-repression.

[9] See Reinhart, Sbrancia, NBER, March 2011, https://www.imf.org/external/np/seminars/eng/2011/res2/pdf/crbs.pdf using negative interest rate. Those interested in the effect of negative interest rates works, must read that paper.

[10] Negative real interest rate on a government debt is a transfer of money from the investor to the government, it reduces the debt to pay at the end. Negative real interest rate in the USA on the 5Y, 10Y, 30Y started the 24Mar2020. As of June 19th 2020, on the 5Y, the negative real interest rate is -0.73%. During 1945-1980 negative real interest rate, the average USA real interest rate was -3.5%, so we have a way to go down in 2020 and 2021. Source: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=realyieldYear&year=2020

[11] This is average real interest rate during 1945-1980. We did not find data for Japan and Germany.

1. If the individual citizen or corporate is a creditor of the state (through government bonds), then a default by the state could mean a devaluation of their monetary wealth. In 2020[12], **it is not the current path**, because the states are printing money and buying mortgages, government, corporate and high yield debts by hundreds of billions.
2. A banking crisis: because banks must make write downs on credits given to the state. In 2020, **it is not the current path**, because the states are buying mortgages, student loans, paying wages to furlough workers[13], guaranteeing office rents, issuing corporate loans at 0% (i.e. Switzerland) or forgivable loans (i.e. USA).
3. An economic crisis: the consumer demand falls and investors reduce spending **It is the current path**, because demand is falling (i.e. consumers are afraid to go out, saving rates are growing[14], travel is restricted, still internet spending is increasing).
4. A currency crisis because foreign investors are willing to avoid the devaluating currencies. I assert that **this is the case** because all developed countries will take the decision to restructure the debts at the same time. These **currency devaluations** are highly positive for the stock market. We explain the reasoning in the following chapter.

3. Currency Devaluation

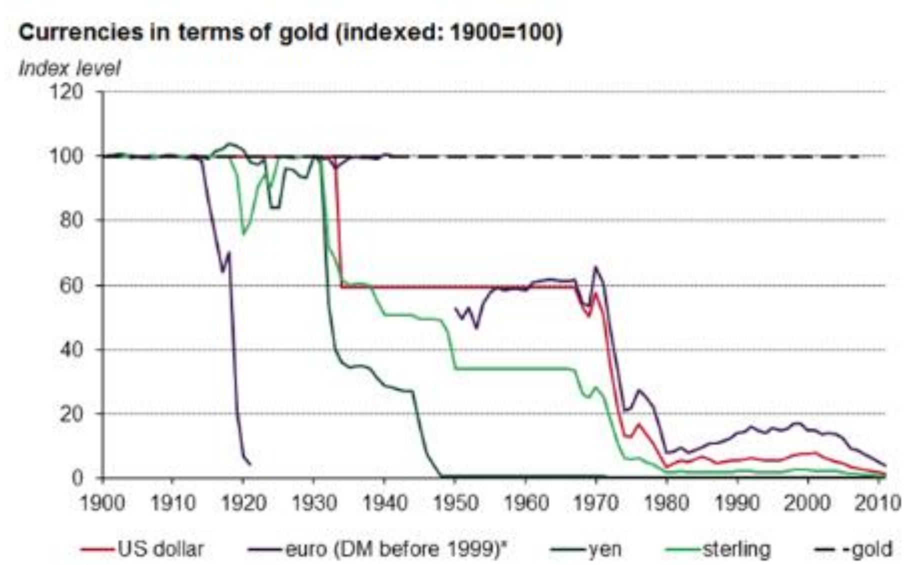
From 1980 to 2020, before each currency devaluation, the stock market went up and after the currency devaluation the equity market continued to go up[15]. Investors anticipate the loss of value of their home

[12] My paper was written in June 2020.
[13] Also referred to as helicopter money.
[14] Bureau of economic analysis USA: average from 1960 to 2019 is 9% savings, but it is 33% in April 2020
[15] I was surprised like you are. Source: http://www.globalfinancialdata.com/can-investors-profit-from-devaluations/

currency and flood money into these following four asset classes: commodities, equities, foreign currencies, education[16], in order to preserve their wealth.

When all major currencies devalue at the same time[17] (in 1931 with deflation and in 1970 with inflation), see Graph 1), then investing in another foreign currency fails to preserve wealth (see Table 1).

Graph 1[18]: historical developed market currency devaluations



[16] These are the only 4 asset classes which do not devaluate during a currency devaluation. Equities mean domestic stocks with pricing power domestically or international stocks generating revenues outside the devaluating countries. Real estate price increases less in the home currency than the currency devaluation, in addition there is a risk that the government freezes the rents paid to the owners (see xxxxx). Collectibles are difficult to invest in when the amount to invest is USD1b (see Financial Market History: Reflections on the Past for Investors Today, David Chambers, Elroy Dimson). Investing in education is irrelevant for an investor willing to preserve his/her cash value.

[17] This is my assumption for GBP, USD, JPY, EUR to eliminate the states' debts at unison. Otherwise it will be a cascade. In history (source: Ray Dalio, https://www.linkedin.com/pulse/changing-value-money-ray-dalio/), twice the developed countries' currencies (USD, GBP, JPY) devaluated at the same time: 1931 and 1970.

[18] Source: https://news.goldcore.com/us-dollar-euro-dm-before-1999-yen-and-sterling-depreciation-against-gold-since-1900/

Table 1 Annualized Returns during and after the two worldwide currency devaluations[19]

	before	before	before	during	after	before	during	after	after	before	during	during
	1930	1931	1932	1933	1934	1971	1972	1973	1974	2018	2019	Jan-Jul20
Equity Market (S&P500)	-28%	-47%	-15%	47%	-6%	11%	16%	-17%	-30%	-4%	31%	0%
Gold (USD)	0%	9%	-8%	**27%**	**32%**	16%	49%	**67%**	**72%**	-3%	**15%**	**31%**
Fixed Income (Baa corporate)	1%	-16%	24%	13%	19%	6%	14%	11%	4%	-3%	15%	4%
USD devaluation vs Gold	0%	-8%	9%	-21%	-24%	-14%	-33%	-40%	-42%	+3%	-13%	-24%

Source: alternativesoft.com, www.macrotrends.net, http://pages.stern.nyu.edu/

Table 1 shows that equities do well during, but not after and less than the currency devaluation itself. Gold does well during and after (see bold) Fixed income Baa corporate does well during and after the currency devaluation, but less than the currency devaluation itself.

Between 1980 and 1995, 27 currency devaluations occurred. Table 2 displays the average return for the domestic equity market returns in $, 6 months before and 12 months after each devaluation[20]. Table 2 shows that it was beneficiary to be invested in equities after the currency devaluations[21], to be more precise from month 3 to month 12[22].

[19] The two worldwide currencies devaluations (1930s with deflation, 1970s with inflation) precisely happened at these dates: 01Jan1933, 01Jan1934, Dec1971, during 1972, Feb1973.
[20] Using USD instead of USD (i.e. adding the stock market return to the currency loss), the values are -22% (instead of +4%) and +25% (instead of +41%).
[21] I tried to find patterns to determine when to buy / sell the equity market and gold. Nothing.
[22] Month1 to Month3 after the devaluations generate an average cumulative return of -9%, but it is difficult to time as it is just 3 months. Source: http://www.globalfinancialdata.com/

Consequently, the intelligent investor's strategy has to:

a. Ride the equity markets and invest in gold/gold ETF/gold miners ETF during the time the governments are printing money[23]. This is the currency devaluation period.
b. As soon as the money printing stops, sell the equity markets and rotate into gold, gold ETF[24]. This is the end of the currency devaluation period. Historically, there is a maximum of 12 months window to sell equities.
c. If there are signs of inflation in prices/wages or deflation (like 1933, 1972), sell the equity markets and rotate only into gold/gold ETF

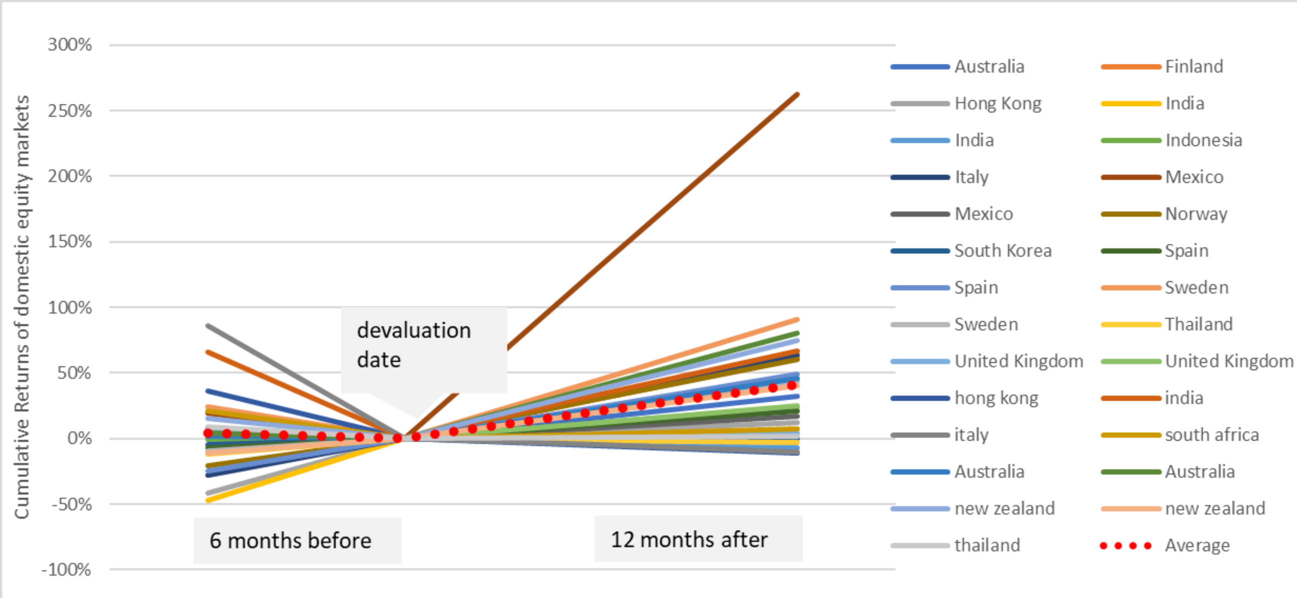
Table 2 Domestic equity market returns in home currency before and after the 27 currency devaluations, for the period 1980-1995

	Domestic Equity Return in domestic currency, 6-Mo Before	Domestic Equity Returns in Dom. currency, 1-Yr Later
Average cumulative return of all devaluations	4%	41%

Source: http://www.globalfinancialdata.com/, alternativesoft.com

Graph 2 Domestic equity market returns in home currency before and after the 27 currency devaluations, during the period 1980-1995 (average in dotted line)

[23] There is an advantage of not being in the equity market at the devaluation announcement, but it is hard to time
[24] Gold miners ETF outperforms on average the Gold ETF by +15 to +20% when equity market is bullish but underperforms the Gold ETF when equity market is bearish. Source: Dominic Picarda, www.investorchronicle.co.uk, 2013.



Source: alternativesoft.com, globalfinancialdata.com

4. Conclusion

I have established that the Covid19 crisis will lead to a debt restructuring, which is currently creating worldwide currencies devaluations, equity market and gold are rising in prices, the equity market will go down at the currency devaluations ending just for 1 to 3 months and there is no need to time the currency devaluations: investors have only to wait for the currency devaluations, invest in gold at that time and finally stay in the equity market for a maximum of 12 months.

To summarize, the intelligent investor strategy is:

a. Ride the rising equity markets or/and invest in gold/gold ETF/gold miners ETF during the time the governments are printing money[25](i.e. 2019-2020)

b. As soon as the money printing stops[26], sell the equity markets and rotate into gold/gold ETF. There is a 12 months window to rotate.

[25] There is an advantage of not being in the equity market at the devaluation announcement and for 3 months.
[26] To determine the date when it stops, there are different types of currency devaluation: a sudden like those from 1980-1995, 1933 or progressive like in 1971-1973, 2019-2020. Sudden is easy: as soon as you have the first devaluation, you have 12

c. If there are sign of inflation in prices/wages or deflation (like in 1933 or 1972) during the currencies' devaluations, sell the equity markets and rotate into gold/gold ETF/gold miners/gold miners ETF.

During currency devaluation	When currency devaluation stops	12 months after currency devaluation
Equity market, gold, gold ETF/gold miners ETF	Equity market for 12m max, gold, gold ETF	Gold, gold ETF

months to go out of the equity market from that date. For progressive devaluations, after having analysed 1980-1995, you have 12 months to go out of the equity market.