Q&A-U.S. equities won't revisit March lows; Corporate defaults could be next trigger: Mohamed El-Erian

U.S. equities will not revisit March lows, **Mohamed El-Erian, chief economic adviser at Allianz,** told the Reuters Global Markets Forum on Tuesday, August 4.

"I suspect the next big correction will likely be one triggered by corporate defaults and other capital impairment events that central banks cannot shield against," El-Erian said.

El-Erian said he expected both fiscal and monetary policy will remain unusually expansionary. "Having said that, effectiveness is an issue in a world of both mandated re-opening reversals and a growing feeling of economic household insecurity."

El-Erian said it was unlikely that the Fed will take policy rates negative. On how long he expected the Fed to stay near zero, he said, "A long time!"

Following are edited excerpts from the conversation:

Q: What is your view on the recovery trajectory?

A: While the outlook is "unusually uncertain," and there are important country differences, I think the recovery will be less of a sharp-V and more towards a modified square root sign. As regards numbers, the last IMF projections come closest to my baseline, albeit with the balance of risk tilted to the negative unfortunately.

Q: Do you see the next crash coming in equities or bonds?

A: Crash is a strong word. I suspect the next big correction will likely be one triggered by corporate defaults and other capital impairment events that central banks cannot shield against. As such, the lowest tiers of the capital structure are most at risk -- including CCC-rated high yield corporate bonds and the like, as well as their equities ... also some emerging markets.

Q: Do you see equities revisiting March lows in this correction?

A: I do not expect U.S. equities to revisit the March lows.

Q: Both monetary and fiscal stimulus seem to remain firmly in place -- What do you expect from the stimulus package and that translating into consumer spending?

A: Yes, and both fiscal and monetary policy will remain unusually expansionary. Having said that, effectiveness is an issue in a world of both mandated re-opening reversals and a growing feeling of economic household insecurity.

Q: GDP growth, both globally and domestically (US), will be uneven. Do you think that future GDP (Q3-4 20, FY 2021) will be driven by Biz spending & exports?

A: Exports will play less of a role as we are likely looking at a period of de-globalization.

Q: What more tools do you see the Fed using from its ammunition from here? Do you see Fed going further, into negative territory?

A: As regards the Fed, the sequence is likely to be stronger forward guidance and more QE, with the related adoption of a more symmetrical inflation target. It is unlikely that they will take policy rates negative. Having said that, I did not expect them to be buying high yield bonds. Re: how long will the Fed stay near zero: A long time!

Q: With the decline in U.S. Treasury yields over recent weeks, do you see the entire U.S. yield curve sinking below 1%?

A: If the US is unable to re-initiate a country-wide process of HEALTY RE-OPENINGS during this period of "living with Covid-19," yes -- the entire curve could trade below 1% nominal

Q: Moving on to the 2020 U.S. elections, can you talk a bit about your (potential) Biden hedge?

A: I have gotten more defensive and, as it turns out, pre-maturely so as the names I have liked have continued rallying despite high valuations. These names were selected on the basis of their strong balance sheets, positive cash flow, good management and being on the "sunny side" of the physical to virtual shift.
Re: elections, I do not make political predictions.

Q: How do you think a Democratic sweep including winning the Senate will affect the policy outlook?

A: Should this happen, we should expect a shift in economic policies towards greater re-distribution, higher taxes and more spending. I wouldn't expect a major change in China-U.S. relations. I would expect the U.S. to re-engage more on other multilateral policy issues.

Q: Have markets priced in higher tax rates under Biden – how high do you see them going?

A: Markets have basically brushed off "fundamentals" -- whether they are economic, political or geo-political -- in favor of what have been incredibly powerful "technicals" powered in great part by central bank policies and higher retail investor participation.

Q: What sectors do you think have the chance of the sharpest recovery on ground, once we have some clarity on vaccine timeline? Also are there any sectors you think are done and dusted for the next 3-5 years?

A: Basically, the re-opening names led by airlines and hospitality. Though this assumes an effective vaccine that is well distributed.

Q: Do you see Biden and the Democrats embrace modern monetary theory, or will bond vigilantes put up a fight?

A: Funny you should ask that! In an unexpected manner, economic policy has been experimenting with BOTH MMT and UBI (universal basic income). I suspect that elements of both will remain.

Q: The U.S. dollar has been on a downward spiral. Short positions last week were close to August 2011 peaks. Do you think it gets worse from here or we have some sort of technical relief rally?

A: We are already almost 10% off the March highs -- and for good reasons. The drivers of currency appreciation have all turned negative for the U.S. at this time, from interest rate differentials to economic fundamentals and valuations, etc. This is actually good news for the economy and markets in the short-term.

Q: Do you think the dollar's status as the world's reserve currency is really under threat?

A: It is hard to replace something with nothing. As such, there is little danger to the traditional standing of the dollar as a reserve currency. But its impact in the system risks being eroded by fragmentation of international trade and investment relations.

Q: If and when the Fed starts exiting stimulus and normalising rates ahead of the world, how do you see that impacting markets and fund flows to emerging countries?

A: Will be a negative, that's for sure. Years of exceptionally stimulative Fed policy have essentially pushed some investors to look far and wide for additional yield, thus benefiting emerging markets. This dynamic would be reversed SHOULD the Fed change its policy stance (which I don't expect it will do for a while). What EM investors should be focusing on is whether the absolute yield they are being offered compensates them for the increasing country risk associated with the COVID-19 shock.

Q: Spot gold prices are approaching the most looked after 2,000-level. Does the rally seem too quick, like a bubble? If not, how much higher will it go, considering the current economic scenario?

A: The rally is understandable given that investors are looking for a broader range of risk mitigating assets now that yields on government bonds are so low. I suspect that we will continue to see greater cyclical and structural allocations to gold -- both of which are price supportive.

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