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RESEARCH DISCLOSURES SEE PAGE 16

listening in

Dealing With Viral Deflation

The Pandemic Is Triggering Mix of It, Good & Bad, Says Gary Shilling

The genial and erudite economist A. Gary Shilling is the proprietor not only of the Springfield, NJ-based investment advisory and management firm, A. Gary Shilling & Co., but of Shilling Apiary, which — full disclosure — often gifts me some delectable honey around the holidays.

Despite many years of sampling both, I can't tell you which is sweeter, the output of his bees, or the access I've long been privileged to enjoy to Gary's savvy — and often non-consensus — economic and investment insights. Gary calls them as he sees them, without regard to Wall St. fad or fashion.

For 40-some years now, Gary has been watching the global economy coalesce around a growing surplus of supply from booming Asia, creating first, disinflation, and increasingly, spots of deflation. Now, he says, the coronavirus is triggering outright chronic deflation. And Treasuries, long his faves, still are. Listen in. — KMW

A. Gary Shilling

Hi, Gary. How are you, your firm and your bees surviving quarantine?

Gary Shilling: Well, the bees haven't given me any indication they're not. Then again, they're not really quarantined — as a matter of fact, I've had more problems with swarms than usual — spring is their most active time, with the one queen bee per hive laying about 2,000 eggs a day to build up the

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ranks of the worker bees, all female, who will gather the spring pollen and nectar. I tell them to stay in their hives, but they want to come out and form a new colony — but that's another story.

My company and I have been surviving, anyway, despite the challenges. It's really been different, I've discovered, to work from home *all of the time*. I've often done work from home, writing articles for *Insight*, and such, but never before has our house served as my office for any length of time. My office is only 1.4 miles down the road from my house, but working from it is still a change of venue. It takes some time to get used to it.

Still, our business is running smoothly, with staff calls every working day at 9:00 a.m. sharp.

You're a lockdown slave driver!

GARY: It's just a way to make sure everyone is staying on the same page. Still, I feel that working at home is unreasonably interrupting my life. Normally, when I'm at home or at our beach house, the work I'm doing involves gardening, home repairs or landscaping — not economics and investment. And it's going into our office that signals entering a different world to me.

You are spoiled! You've created your ideal work environment over many years in your office suite — with everything, including your staff, built around facilitating your work. That comfort zone cocoon is missing at your dining room table.

GARY: True, then the other thing has been getting used to being with my wife all day long. We're together for weeks at a time when traveling, but haven't been at home together for this long in our 58 years of marriage. It's said that couples marry for better or worse, but not for lunch!

Especially when you invade her kitchen space, as you admitted in your last letter.

GARY: Well, we have a big center hall, much more than enough space now that our four children are long grown and gone. But, I've just learned that there are territorial boundaries within our abode. I hadn't realized until recently that her large new kitchen isn't just a place for food preparation and consumption — and I was surprised to discover that by setting up my office on the kitchen table, I was encroaching on her space.

That's priceless, Gary. You're the definition of an oblivious husband! But teachable, thankfully.

GARY: I do know better than to argue with you! This pandemic is also forcing me to become semi-literate in terms of electronic communications — but I'm still a long, long way away from being truly proficient.

> **"It's one thing to look at the statistics and see that fewer people are catching the virus, being hospitalized and dying. But it's another to look at the stats and think, "My God, it could be me." I think that the return to 'normal,' whatever that is, going to be very slow process."**

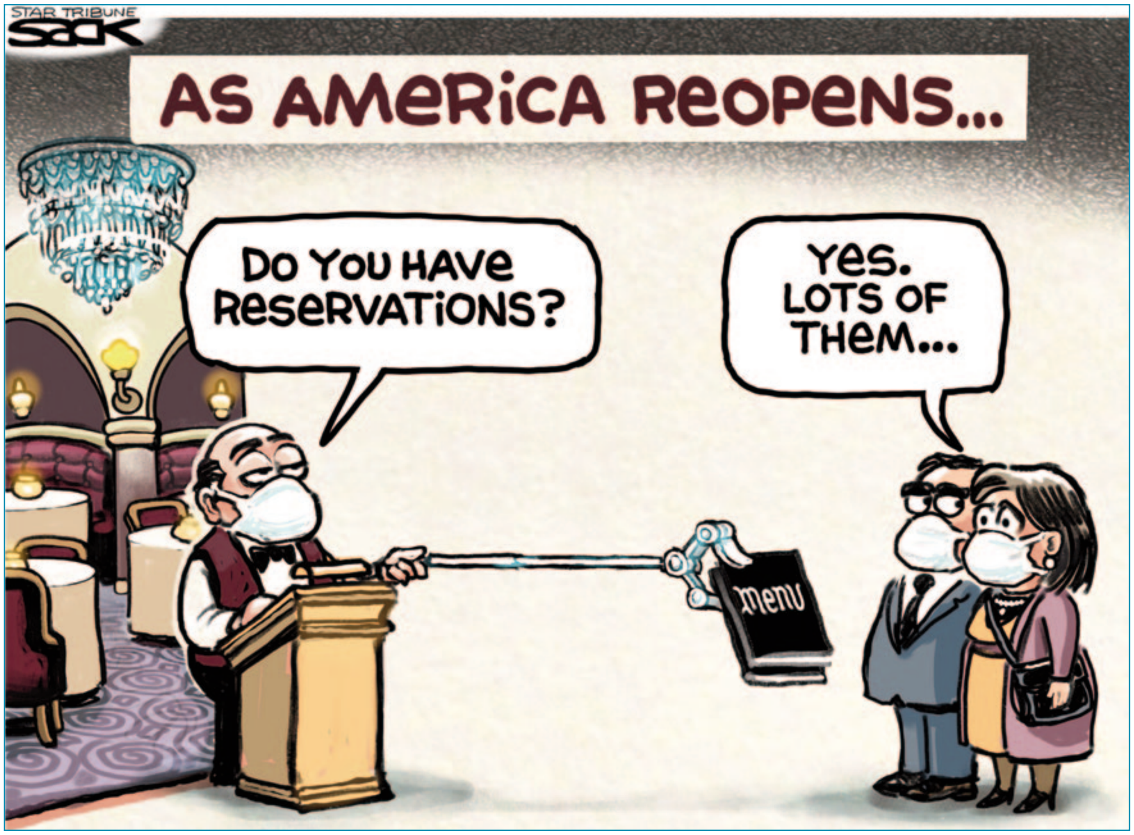
Are you using Zoom for office meetings?

GARY: We do them by phone. Conference calls work just fine. But I'm starting to write our June *Insight* now and simply sending pictures and charts and tables back and forth with my guys — who are working on them for publication — is a challenge. We've got a system worked out, but there are always glitches. I guess this is old hat to you, though.

True. But there *is* a learning curve, and it takes getting used to. It's just that I've been a one-woman band for more than 20 years now. Really, since I left *Barron's*. The traders at Weeden were great to me, but the firm had no infrastructure for research or publishing in house.

GARY: Hey, that reminds me. Have you had any contact lately with Steve Leuthold?

No. But I touch base with his successors at the Leuthold Group from time to time, and hear that Steve is well and happily retired, if you can believe it. He lost his long-time companion a few years back,



Restaurant Distancing by Steve Sack, *The Minneapolis Star-Tribune, MN*

but didn't stay unattached for long; moved out to the West Coast with his new girlfriend, I've been told.

Gary: I wonder if he's still planting a potato crop at his place in Maine?

That, I don't know. Steve used to be as consumed by them as you are by your bees.

Gary: I miss the potatoes he used to swap for my honey. Now, remind me where your office is located physically —

I've converted a sun-porch in my house on the East End of Long Island — in Mattituck on the North Fork.

Gary: Oh, it's nice out there. We have a beach house on Fire Island on the South Shore and occasionally we go to the North Fork. Way back, it was all potato and cauliflower fields. I think it's gotten pretty built up since then, but it's still a nice area.

Yes, though thankfully not to the extent of the rest of Long Island. The first time my husband brought me out here, in the mid-1970s, it was farm fields, the Sound and Peconic Bay — and not much else. Since then, many farms have been turned into vineyards and it's all about tasting rooms, farm-to-table and aquaculture. "Agro tourism," God help us, brings out lots of day-trippers. But the year-round population is actually down.

Have you been out to Fire Island since the pandemic hit?

Gary: No. I'm going out to open our beach house next week — and it's going to be different, with the social distancing and so on. We'll see how it goes.

Are they still running ferries to the island?

Gary: Oh, yes. We've got our own ferry, but now you have to make a reservation and they can only take so many people on each trip, so they can maintain social distancing on the boats.

No more packed ferries to Fire Island? Is nothing sacred?

Gary: You bet there's not.

It seems clear at this juncture that the economy is reopening in fits and starts, or faster — even in some places that haven't yet "bent the curve" of the virus.

Gary: Oh, really? You *think*? People have been amazingly compliant about quarantining, but it's finally getting nice outside, and patience is in increasingly short supply. Of course, on the other side of that argument is the virus.

How so?

Gary: It's one thing to look at the statistics and see that fewer people are catching the virus, being hospitalized and dying. But it's another to look at the statistics and think, "My God, it could be me." I think that the return to "normal," whatever that is, going to be *very slow* process.

Why do you say that? Are you trying to kill everyone's FOMO buzz about TINA coming back to town?

Gary: Well, if you look back at the subprime collapse, which spawned the heretofore deepest recession since the 1930s, it ultimately affected almost everybody. But directly, it really affected just the speculators in housing. This viral pandemic, by contrast, is directly affecting everybody, to one degree or another. Not everyone is getting deathly ill when they get it, but there's almost no one who is immune or not susceptible — unless you're in hiding in some hermitage.

Or have already gotten ill but recovered from Covid-19 *and* developed antibodies — and even that is questionable.
GARY: That's right. Even the top virologists and infectious disease specialists don't know very much about this novel coronavirus. Do antibodies produced by people with the infection work to prevent or fight infections in others or even future infections in those folks? If they do, how long does the protective effect of the antibodies last?

There's very little experience with this. Many more studies need to be done. Even this idea of quarantining yourself for two weeks after being exposed to the virus, to avoid infecting others, is just an informed guess about how long it probably takes the virus to manifest with symptoms. There have been cases reported now where the illness has taken longer than that to develop after an exposure. So there's obviously very little known with any certainty.

Except that it seems to be incredibly contagious under some circumstances — even before a person who has it knows he's sick. Or even if she *never* develops symptoms. I saw some stats on the number of infections they found on the Diamond Princess, the giant cruise ship that was quarantined in Japan — and whose passengers, belatedly, were thoroughly tested. Over 600 of the 3700 passengers and crew ultimately tested positive — but slightly over half of those were asymptomatic. Yet the virus makes a whole lot of people something between very sick and deathly ill — if it doesn't kill them after weeks or months of misery — as it did 14 passengers from that ship. Especially the old, poor, or weak.
GARY: I don't know if you've seen Barbara Tuchman's book, ***A Distant Mirror: The Calamitous 14th Century*** —

I finally read it a couple of years ago. It's a great read, like all of her books.
GARY: Then you remember that she went into great detail about the reactions of ordinary people to the Black Plague. She described how they experienced the horror of watching many people, who had been healthy in the morning, dying by nightfall of the Black Plague. And how they behaved in response.

They didn't exactly rush to complete their bucket lists —
GARY: Not at all. In the face of impending death, the people of the Middle Ages didn't decide "to eat, drink and be merry because soon we die." Their response was largely withdrawal from society and despair.

Right. It was social distancing, in some respects. Happily, Covid-19 isn't the Black Plague. On the other hand, when this virus kills, it isn't mercifully quick.
GARY: Still, Covid isn't going to kill 30% - 50% of the globe's population. But I suspect the lasting reaction is likely to be similar.

What do you mean?
GARY: I do think we've got offsetting forces here, to some extent. One is that we know *a lot* more about infectious diseases than people did back in the 14th Century. I mean, people did "social distance" back then to the extent that anybody who had any means got the hell out of town. But they didn't know much about the cause of the disease, much less its cure.

Today, scientists know much more about this novel coronavirus, even if doctors haven't yet figured out how to cure it. But the other side of the coin today is that we've got global jet transportation. In the 1300s, it took quite a number of years, historians figure, for the Black Plague to travel from Asia, via the Silk Road, to Europe. While this time, hey, it took less than 24 hours for someone infected with Covid-19 to make one plane trip from China.

The thing is, nobody on the face of the planet had been exposed to this new pathogen before last November or December, as far as anyone can figure out; no one who hasn't already caught it has any immunity — and for a subset of the population — it's a killer.
GARY: My wife and I took a trip to Southeast Asia right after Christmas — spent three weeks in Cambodia, Laos, Vietnam and Thailand — and came back about the middle of January. We flew out of Bangkok, changed planes in Hong Kong. We knew *something* was going on in China by then — and saw all these Chinese running around the airport in Hong Kong. Luckily, we're okay, but we could have very easily contracted it there.

No kidding. That would have been an awful end to a great trip.

Gary: "Other than that Mrs. Lincoln, how did you like the play?"

Let's turn to what all this pain, suffering and sheer boredom mean to the economy and markets. I admit, I've never seen the likes of this year's wild ride. And it's not yet June.

Gary: Agreed. I'm going to do a short piece for our June *Insight*, titled "The Tale of Two Economies." It will make the obvious point that the stock market is predicting a V-shaped recovery and the bond market is saying, "not really."

Which do you believe?

Gary: It's interesting, I think bond markets have been better forecasters than stocks over the years — and that was certainly true this time. Bonds started rallying, literally at the beginning of January — they started foretelling economic problems — and yet stocks didn't peak until February 19, at 3,393.52 on the S&P 500. [Top chart nearby.]

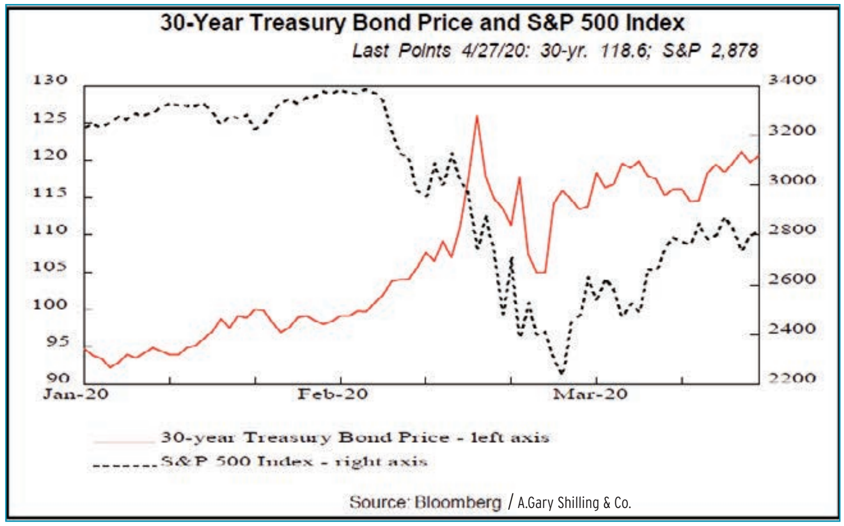
True, but the S&P's subsequent rally has been head-spinning *[lower chart]*—

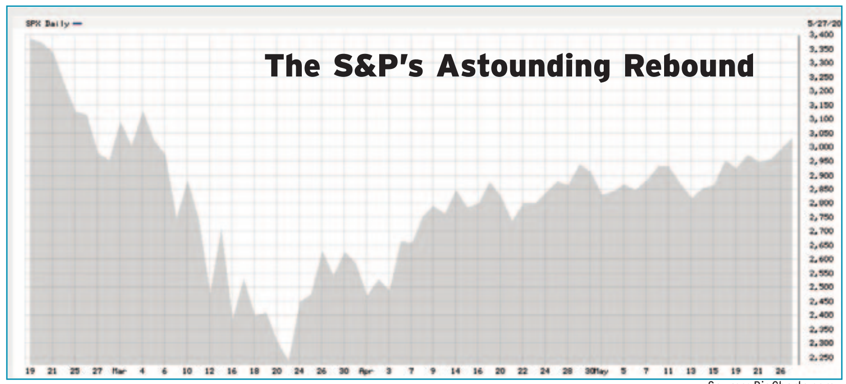
Gary: It has. But as I've written, I think we're in a bear market rally that is very much like the experience of 1929 and early-1930 [Charts, page 6] — where you had that initial 48% decline in stocks, starting on September 3, 1929. In the next two months, the DJIA went down 48%. At that point, most investors seemingly thought, "Okay, this knocked the fluff off the Roaring '20s." After all, stocks had risen 500% during the 1920s and all was well, so stocks rallying back 52% after their plunge felt pretty "normal."

That rally lasted until early-July of 1930. But, as the Depression came into sharper focus — as the unemployment rate leaped from almost zero in 1929 to 25% in 1933 — stocks resumed their decline. And ultimately plunged 89% from the '29 peak. The economy was so damaged that it limped along throughout the 1930s, despite all the New Deal programs that attempted to revive it — only resuming growth because of rearmament late in the decade and the huge government outlays that accompanied WWII.

That's a dismal analogy. Why are you so pessimistic?

Gary: It's pretty straightforward. This pandemic is the most disruptive economic, financial and social event since World War II — with equally far-reaching consequences, I suspect.



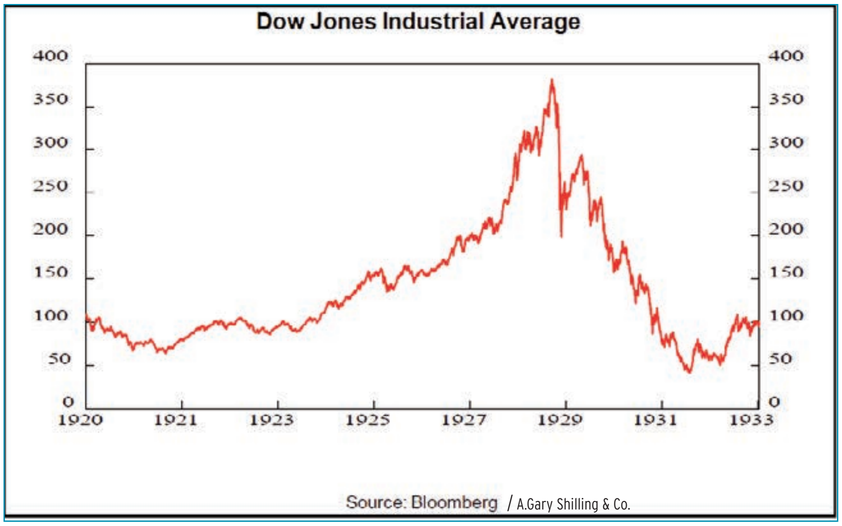


Source: BigCharts.com

I get why the market is rallying, though. Many think — or at least hope — that the coronavirus will soon be under control and that the massive monetary and fiscal stimuli will not only stabilize the economy, but revive it. Those hopes have spawned this substantial rally in stocks, with the S&P 500 index rising 29% between the March 23 bottom and April 17. [It's now up 40% off the bottom, as of Wednesday's close.] With a rise of that magnitude, some see this as the beginning of a new bull market in equities and are anticipating a quick recovery from a sharp "V" recession.

It's certainly testing bearish conviction —

Gary: Yes, but I still regard it as a bear market rally, albeit of unprecedented size. Bear markets that accompany recessions — and this one assuredly does — have historically lasted about 11 months, far longer than the recent one-month plunge. The U.S. stock market has never reached its bottom in less than six months after falling 30% in the face of a recession, according to an analysis by Bank of America. And the S&P plunged 34% this time.



Dow Jones Industrial Average

	Level	% Change
Peak 9/3/1929	381	
First Bottom 11/13/1929	199	-48%
Next Peak, Rally 4/17/1930	294	+48%
Next Bottom 7/8/1932	41	-86%
Total Decline Peak to Trough 9/3/1929-7/8/1932	381 - 41	-89%

A.Gary Shilling & Co.

I think this is a situation similar to what happened in 1929. There was an initial scare — when people worried about the novel virus wiping out civilization. But now they say, "Well, we've gotten all this monetary and fiscal stimuli and the scientists will figure out a vaccine and it's not spreading as rapidly as it was, so all is well."

You're clearly unconvinced.

To me, what still lies ahead are all the effects of this — the staggering loss of life, obviously, which has been strangely invisible, with both hospital visits and funerals impossible — but also the lingering impacts of this enormous disruption to the economy. People still being afraid to go out, the disrupted supply chains and uncertainty about production spending, about distribution, about schools reopening, about demand picking back up. I just think that what we are facing is more of an "L" than a "V."

Meaning you don't see a quick rebound in economic activity?

Gary: No. I expect the lull in economic activity to probably stretch into next year. And, if that's true, stocks from here could easily see another 30% or 40% decline as investors come to realize the extent to which the economy has been damaged.

I'm afraid you're right. Hope springs eternal, clearly, but — having witnessed, professionally, every bear market since the mid-1970s — if this one manages to erase its losses in one giant leap and go on to new highs — I'll be dumbfounded. Anything is possible, but has Fed's liquidity flood actually changed human nature?

Gary: Good question. There's an old saying on Wall Street, "Don't fight the Fed" —

So I've heard.

Gary: Well, many apparently believe that the Treasury and the Fed's massive monetary and fiscal actions will revive the economy rapidly. The Fed and other major central banks have again slashed their short-term reference rates, essentially to zero if not below, and again hyped their assets.

But remember, all the massive monetary and fiscal stimuli brought out to counteract the 2008 financial crisis *didn't* result in meaningful economic growth. That post-crisis recovery ended up being the *slowest* from any recession in the post-World War II era (Chart, top of page 8). Indeed, in retrospect, the only significant effect was the flood of QE money into stocks, which supercharged the recently deceased bull market. Likewise, the gigantic 2009 tax cuts and rebates, along with massive federal spending that amounted to 6% of GDP, didn't seem to have much power at all to move the needle on GDP growth.

Remember too, that the 2007-2009 recession, though it was the deepest this country had experienced (at least up until then) since the Depression, was really concentrated in the collapsing subprime mortgage sector — at least at its onset. This time, the corona crisis is hitting everyone, all at once.

A spanner was thrown into the works —

Gary: Yes, but added to that, the economy was not really in great shape coming into this crisis. Although the herd is now basically saying, "Oh, everything was just dandy until the virus came along," *that was not true* in this country. We were analyzing and writing about that extensively in the last half of last year. The economy was just not in great shape coming into the pandemic. We had slowing of job growth and wage increases and a number of other late cycle indicators that suggested things were not all that hot. So here at AGS, we were looking for a trigger mechanism for the next downturn — which obviously Covid-19 provided.

Late cycle signals were there for all to see —
Gary: Of course, bear in mind that most people on Wall Street are paid to be bullish, so there's a tremendous bias in that direction. And I know very well that being bearish can be detrimental to job security! As you know, I was fired from Merrill Lynch for forecasting a recession —

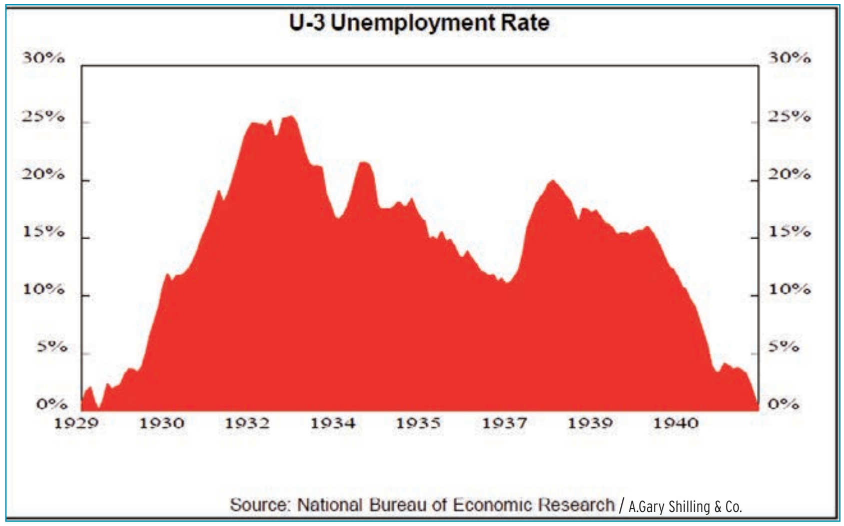
It wasn't exactly what the sales force needed to drum up trading —
Gary: Right — not at all! That brings to mind a really interesting phone call I had from a major institutional client — back at the end of February. As you know, in every issue of *Insights*, we include a list of suggestions for investment positions that align with our investment themes. So in our March issue, which went out at the end of February, we said that we were suggesting substantial reductions in cash positions, to move cash into our other investment themes to take advantage of the unfolding "risk off" investment climate. And luckily for us, after that, the markets really hit the skids. Well, this client called up, and he says, "What do you mean? Dump cash?" And I said, "Well, yes, we want to [use it to] take advantage of this decline."

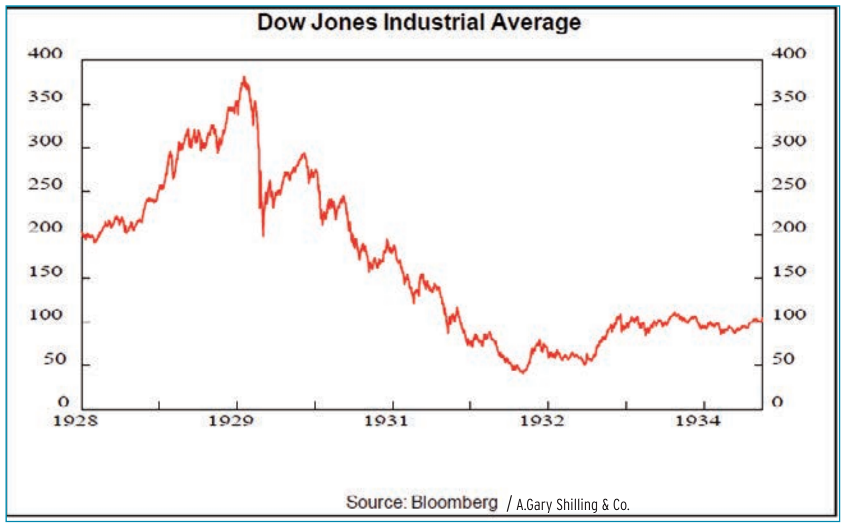
But this client had trouble visualizing the idea that when things are declining, you want to be getting fully invested. His mentality was that you're long-only in stocks, so if the stock market is in bad shape, you want to hunker down in cash. Not that you want to use cash to do things like getting longer the dollar and long-dated Treasury bonds, or shorting commodities, to take advantage of the downside — as we were doing.

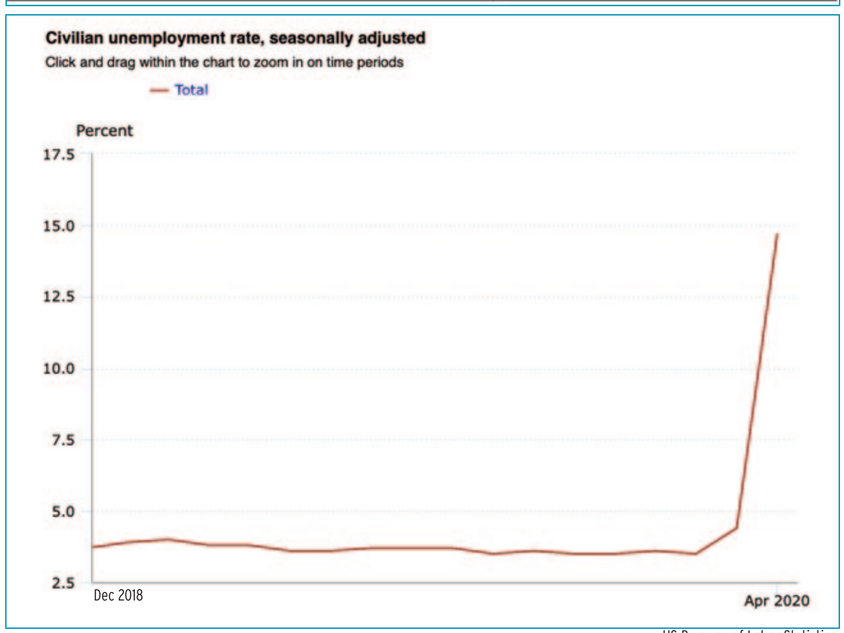
It was an *institutional* client who was having trouble with that?
Gary: Yes. A major, major institutional client.

Did you school him?
Gary: Eventually I made some headway, at least, in explaining why we had basically eliminated the cash. But it's just one of these things.

Why do you say that?
Gary: Well, you've probably heard these stories about somebody who's the child of a missionary to Japan and so speaks perfect Japanese. Yet, when he returns to Japan and starts speaking the language fluently, the Japanese just look at him and say, "Gaijin," or "foreigner." The Japanese *don't hear him* — or can't understand him — because they are so mentally conditioned to believe that westerners can't speak Japanese.







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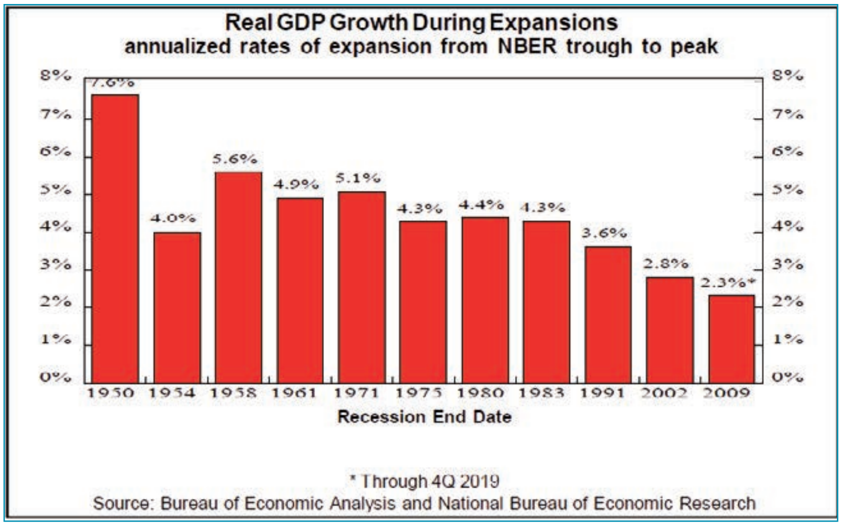

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February 28
March 20
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April 17
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October 30
November 20
December 11

Actually, I haven't heard that one —

Gary: I've been told it several times, by different people. It's amazing, but apparently it's not all that uncommon a phenomenon. The human brain is wired to expect certain things and if its incoming data is completely contradictory, it evidently is capable of just disregarding it.

Too much dissonance and the brain shuts down? GDP dropped at a 4.8% annual rate in the first quarter [revised Thursday to minus 5%] and forecasts for the current quarter are dreadful. So the third and fourth quarters shouldn't have too hard a time doing at least a little better. Wouldn't that technically end the downturn, even if that "growth" is scant?

Gary: Well, you could have a blip or a bounce, or whatever you want to call it. But bear in mind that the National Bureau of Economic Research is the official arbiter of recessions. They are the ones who declare when a recession starts and stops — and they're never in a hurry to do it.

No kidding. Their gaze is strictly in the rearview mirror.

Gary: They usually wait until about six months into a recession to declare its start and at least that long — after a recession ends — to declare that one is finished. Their over-riding concern is to not miss a call.

What's more, the notion that two quarters to the upside (or downside) define a change in the direction of the business cycle is nothing that is supported by anything the NBER has ever said. That's simply a Wall Street shortcut. If you go to the economists who everyone has trusted to date business cycles going back to 1800 or so, they don't take shortcuts to call recessions based on how long GDP has been declining.

So what's your expectation?

Gary: It seems to me that we're going to have a big decline in the second quarter — everybody's forecasting that — economists are competing to see how weak the numbers they come up with can be. Now, is it going to be minus 20%, minus 25%, minus 50%? Pick your number — those forecasts no longer shock anybody — but I think it's the third quarter — the summer GDP numbers — that will prove a shock. I don't think that story will be told until we get close enough to the fourth quarter to realize that whatever pick up is seen in the third quarter will be nothing to write home about.

That would disappoint many —

Gary: Now, of course, stocks discount the future — and I think many bulls have just decided to write off this second quarter — assume it's history— so they're looking over the valley. What I'm thinking is that the valley may turn out to be a very deep and wide chasm — but most investors are expecting to just look over it.

That's pretty easy to do now, but if the summer spools out without much pickup, that will get harder and harder to do.

Gary: Well, that's right. I'm not smart enough to predict all of the squiggles in the path ahead of us, but I just think that on balance this economic downturn is going to look like an "L," with the lower leg sloping down — and lasting longer than most expect here and now. The big declines, yes, are happening in the first and second quarters, but the trajectory will probably continue down throughout the third and fourth and into 2021.

Maybe you're right, if for no other reason than the U.S. economy has never had a recession like this — led by the services sector. And it's being hammered.

Gary: That's very interesting, yes. Historically, the usual deal is that recessions in the past were caused by inventory cycles.

The manufacturing sector led the way. But this definitely isn't the good old days.

Gary: The days of this economy being dominated by the manufacturing sector are gone. It was a natural progression. The services sector grew over time. You can have only so many cars in the driveway, but you can spend infinite money on trips to Asia and medical services and education, et cetera.

We baby boomers are living proof.

Gary: So services have been claiming a steadily increasing share of spending, and purchases of goods, a decreasing share. This has reduced the role of inventories in the economic cycle and it's also reduced the role of manufacturing. The conventional view has been that the transition to a services economy would dampen economic cyclicality — which *was* fine. *Until* we came up against a dramatic demonstration that demand for services also can be cyclical. We are seeing that right now.

Look at travel and recreation — those are services. Even medical care — people are not going in for routine checkups and elective surgery. I assume you saw the breakdown of the dismal retail sales numbers for March. The only category for which sales rose that month was "non-store" sales. Online sales, in other words. Amazon.

Yes, it was the only positive category.

Gary: Everything else — including medical services — was down. So clearly, services are cyclical and as services become more important in the economy, their cyclicality increases in importance.

It was telling to see the Mayo Clinic laying off doctors and nurses at the height of the coronavirus pandemic.

Gary: Because they were in specialties that suddenly couldn't be practiced amid the crisis. That's one of the disadvantages of an increasingly specialized economy — or any system that is hyper-specialized.

My favorite way to illustrate that is with my honeybee hives. At this time of the year, we got 50,000 to 60,000 bees in each hive, but it's a very efficient system. Each hive has only one queen — and she's an egg-laying machine, that's all she is. A good queen can lay 2,000 eggs a day. But it is also a very fragile system. If something happens to the queen, you're in big trouble.

Why?

Gary: Because all those worker bees (that sustain the hive and make the honey) live for only about a month at this time of year. So if anything happens to the queen, for any reason, boy, that colony will collapse in a hurry — unless you get a new queen in there, quick.

What you may not know is that the honeybees we cultivate today in North America originated in the Old World. They are much more efficient pollinators than any native species. But the tradeoff for that extreme efficiency, which is derived from the honeybee's extreme specialization, is increased vulnerability and fragility.

You're implying that our specialized services economy could be making the same sort of tradeoff? Getting more fragile and vulnerable?

Gary: Well, there are a couple of things I'd say. One is, if you go back to the good old days of inventory cycles, what really pulled the economy into a recession was that you got production declines — basically because of mass inventory liquidation. In other words, excess inventories were what touched off the recession because manufacturers had to cut production to let those excess inventories be run down.

But then, once the excess inventories were run down, manufacturers would then have to resume production — first, to rebuild inventories — and that rebuilding of inventories is what would jump-start the economy. The upshot was that you got these very swift declines and very swift recoveries because of the manufacturing inventory cycle.

And my first point is that now, in a services economy, we don't have that inventory cycle trigger. By definition, there are no inventories in services industries — well, maybe your paper and ink.

My biggest monthly expense is often printer cartridges. Meanwhile hospitals, clearly, haven't been holding enough inventories of N95 masks and such.

Gary: My point is that services essentially carry no inventories, certainly not when measured against assets or revenues. Which means there's no inventory buying cycle that can cushion the ups and downs of a services business.

And what our current circumstances are telling us is that because demand for so many services sector businesses is discretionary, those sectors are dependent on people's confidence. So, until we get a vaccine developed and proven and convince people that it is going to work — or until somebody develops a quick cure — I suspect we're going to have only a slow recoveries in a lot of service industries. We looked at retail sales data recently, to attempt to divide them into discretionary and non-discretionary categories.

What did you find?

Gary: We concluded that roughly 47% of retail sales are discretionary and outside of that, other services industries — airlines, travel and recreation and so on — often find that a large proportion of demand for their services is discretionary.

Especially in a stressed economy. Even banking, communications and professional services can become discretionary.

Sure, I'll bet you're not eager to get on another plane — or the NYC Subway!
GARY: Oh, you'd win that bet. I mean, who is? I was slated to go as a speaker on one of those Forbes cruises early next year, but that plan has gone down to Davey Jones' locker.

Cruise companies say advance bookings are up. But I can't believe anybody is eager to board one of those floating Petri dishes.
GARY: I don't know much about them, but what little I have read sounds like they are telling people they won't lose their deposits if they transfer them into other bookings in 2021-2022.

That still sounds optimistic to me — you're saying a robust consumer economy will require good vaccines, broadly administered. That not even possible, we're being told, until next year — if we're lucky.
GARY: Probably, yes. And then, even if effective vaccines are developed and broadly administered, there will be still more questions. Does that mean everybody is going to immediately rush out to restaurants, bars, cruises, theaters and concert halls, et cetera? Or have habits changed?

There does seem to be a rapidly increasing number of cases of a different malady lately — cabin fever.
GARY: Certainly, a lot of us have had cabin fever and would like to get out — for instance, my wife and I usually eat out in a restaurant a couple times a week and we haven't done that for two months. We'd like to do some of those things — but only when we can feel safe doing so. You have to wonder, are some permanent changes being made to long-established habits here?

One of the interesting ones is the idea of working from home. I think a lot of people have discovered that the technology is here to make it very possible to avoid long commutes. Unlike me, they've figured out, finally, how to be productive with all the technology and are even enjoying working from home.

A lot of companies may decide that having employees working from home, at least some days of the week, is something they can do long-term, not just while social distancing makes it impossible to cram people into cubicles. If so, that would mean that a lot of expenses could be cut, for commercial office space, gasoline, transit systems, all sorts of things.

Of course, that presumes that workers have spare space in their homes that they can turn into a work areas — that they haven't just been balancing their laptop on their beds —
GARY: Yes, so maybe some spending would just be shifted into remodeling, finishing basements, or finding larger apartments.

***If* they can afford it. I suspect a lot of priorities are being reordered that could have surprising economic impacts. Not only among millennials.**
GARY: Right. Right. As I said, I've had my staff keep to the discipline of our morning meeting, because I think it's important not to let focus on the business drift off. Some people, like you, have the discipline to work from home with no problem, but other folks don't. They need cues, some kind of spur, to stay focused. We'll see how it works out.

But let's face it, an office in a service industry is a very different work environment than an auto assembly line. The need to have a lot of people coordinating their work in a confined space is simply not there.

As for the discipline to get work done, there's nothing more motivating for an old journalist than a looming deadline.
GARY: Oh, you bet. And when you think about it, the work time lost to, say, walking the dog, while working from home pales next to all the time that is consumed by the typical commute. In metropolitan areas, many people spend at least two hours a day commuting — especially if they're honest about counting all of the time it takes them to get to and from their train station, as an example, for their "30-minute" trip.

My point is that even if people working from home are less-than-fully focused on their jobs all day, and piddle away some time, by not commuting they have a cushion of a couple of extra hours in their day — they're going to have more time to accomplish their work tasks.

Right. Not to mention that Zoom could turn out to be a sly nail in the coffin for the corporate plague of pointless meetings. It certainly brings absurdities and inanities into sharp relief. But the other thing that this pandemic has made quite clear is that this service economy also depends — quite

a lot — on folks who *can't* do their jobs remotely. And the lockdown has thrown, what, 40 million of them out of jobs.

Gary: I don't have any precise estimates on job losses, but you would think, at some point, given the unprecedented flood of filings for pandemic-related job losses, we'd catch up with the inventory of people laid off in the lockdown. And the number of new weekly filings is declining. They started out at 7 million and are down around 2 million. But that's still a lot of people and it does suggest that the whole layoff cycle has not yet been completed, despite the uneven moves to reopen certain parts of the economy. We haven't hit bottom.

No, and the pandemic has vividly demonstrated that the states sorely need to upgrade the capabilities of their unemployment insurance operations — if only they had the funds, they could create a lot of jobs right there. But why do you expect even more job losses?

Gary: We've got companies like the airlines and all of their suppliers looking more realistically now at what kind of passenger loads they're likely to have coming out of this crisis. They took some government money and promised not to lay off staff for a time. But I bet that layoffs are coming there.

Couldn't agree more. As much as I love to travel, I've never enjoyed flying there — even in a premium seat.

Gary: Airlines are a very interesting business. We've looked at it closely over the years and it's actually a terrible business. Because it has very high fixed costs — the costs of leasing planes, hiring crews, buying fuel, all the financing, maintenance, gate fees, and so on. But its marginal costs are trivial. The cost, to the airline, of adding an extra passenger from Newark to LAX is a couple dollars in jet fuel and a bag of peanuts.

As long as they have the empty seat. Yes.

Gary: And economics tells you in that, in that case, the tendency is for the price of that service to go down to marginal cost. And obviously, marginal costs are way below average costs at the airlines, because their average costs are dominated by overhead.

Until the pandemic hit, it looked though, like many airlines had figured out how to squeeze every drop of marginal revenue they could out of their customers.

Gary: It is interesting that the airlines in recent years have shown an amazing degree of discipline.

In torturing travellers?

Gary: I wouldn't say that. But the airlines have basically said, "Okay, we're going to offer cheap fares the public wants, but we're going to fly every plane full." They had resisted their normal urge to expand capacity — and had been uncharacteristically profitable.

But turned flying coach into a cattle car experience, at best.

Gary: Well, now they're faced with an entirely new situation. What are they going to do? They've suddenly got excess capacity but they really can't utilize it. If they don't facilitate social distancing on the planes, they see passenger revolts and are shamed on social media. But if they do, many people still won't want to fly anyway, and they'll lose lots of money. It will be interesting to see how they work this out.

I suspect a lot of capacity is going to get squeezed out of the business — through mergers, bankruptcies, whatever it takes. And flying will only get more costly.

Gary: Yes, I'm not so sure that their marginal cost of adding a passenger isn't also going to go up substantially. Maybe, by one-third if they have to get rid of all of those middle seats to entice people to get on the planes.

Maybe they can turn middle seats into mini-cargo holds —

Gary: They'll obviously have to adapt in a lot of ways — fewer flights, fewer planes, but their operating costs are going higher, and I'm thinking that air travel may once again become more of a luxury than a commodity.

Well, from a green perspective, at least that will lower the airlines' contributions to the ozone hole. But it will still be a pretty tough way to make a buck.

Gary: I'm afraid so.

Where else to you see corporate fortunes changing drastically?

Gary: Well, we have already talked about demand for commercial office buildings being slashed. Other than that, within the real estate sector, I think suburban housing demand may benefit. I know that realtors are telling me they're seeing more people who are looking to move out of New York City apartments by buying homes in suburban areas or even in rural areas, so you may see that switch gaining impetus.

I also think that rental apartments in suburban or rural settings are going to benefit — they have been, really, since the 2007-2009 financial crisis. That was because people either couldn't afford single-family houses or they realized that house prices had declined nationwide in that crisis, for the first time since the '30s — so aren't exactly the sure thing they'd been reputed to be. I would think that rental apartments — and, of course, investor-owned single-family houses will probably continue to benefit.

I presume you don't see a rebound in commercial retail space, though —

Gary: No, malls, I think, are really in trouble. You've had the ongoing shift to online shopping and people are getting used to it. I don't know about you, but there's stuff that, in times past, I would always go to a store to shop for. Now I just go online and, bang, it's here in the next couple of days. As long as I know what I want, I save a lot of time and effort — and oftentimes get it cheaper. So the whole bricks and mortar retail sector — as well as hotels and office buildings — are under considerable pressure.

What do you see happening to consumer spending?

Gary: I rather suspect that people are going to be saving more. The saving rate jumped up — I think it was 13% in March — a big jump up. Sure, that was at least in part because people were stuck at home and they *couldn't* spend. But the Fed's numbers also show that the average household does not even have $400 in reserve cash. And people have just been reminded rather forcefully that they need a lot more. So I rather suspect that savings will go up because they're definitely not spending on much but essentials. In other words, spending in discretionary areas is tanking. And that's not just in things like travel, recreation and dining out. It also means spending on things like cars will be under pressure. If you're not commuting, not driving so much, you don't need to replace your car as frequently. Don't have to buy as many tires, or batteries, et cetera. So I also rather suspect that we're going to see consumer spending more concentrated on essentials as opposed to flowing into discretionary areas.
That doesn't mean people won't want a new suit of clothes occasionally. But they probably won't buy them as frequently, if they want to save money.

And they can work from home in jeans and sweats — which aren't nearly as pricey.

Gary: Moving on, I don't see this crisis having much impact on capital spending.

Why is that?

Gary: We've had too much excess capacity which has depressed capital equipment spending for years in this country, and I don't see that going away. Particularly, if we continue to have a globalized economy.

That's a big question. Globalization is becoming a favorite whipping boy for all manner of problems.

Gary: Well. if the politicians kill off all of our imports and then stimulate the economy with monetary and fiscal money, hey, they could create inflation, no question about it. They'd quickly create a situation in which domestic demand far exceeded domestic supply and prices would surge. But as long as this remains a globalized economy, I don't think that's a problem.

There's no doubt, though, that we're going to see some shifts. You may have seen the guest piece by Dennis Gartman in our May *Insight* suggesting how we could reinvigorate the pharmaceutical industry in Puerto Rico, now that the Covid disruption has demonstrated the vulnerability of supply chains sourcing so heavily in China.

That did catch my eye. I hadn't realized he's shut down his newsletter.

Gary: Well, Dennis has some health issues that he says were just making it physically impossible for him to write it in a reasonable amount of time.

Sorry to hear that. His piece made a lot of sense.

Gary: Yes, I think both Puerto Rico and Mexico could benefit a lot from bringing pharmaceutical production back there. If they can do it inexpensively enough. I mean, international supply chains don't exist because some guy wants to get on a plane to Taiwan every week to check a factory there and then a distribution center in Japan and so on. They exist because they've proven to be the *cheapest* way to create pharmaceuticals or to put together semiconductor chips in South Korea and then get them to assembly plants in China where they can be turned into consumer products like iPhones. That's why international supply chains exist and if you disrupt them, those products get more expensive.

Now, maybe you can reorient supply chains, and bring other countries into play. But certainly, during any transition, there's going to be more inefficiency — and higher costs.

No argument. But I'm wondering whether sheer efficiency will continue to be so highly prioritized, post this pandemic. I

wonder if some measure of resiliency won't also come into the calculus.
GARY: Good point.

I think it's made an impression that "the greatest country in history" has had to turn, for instance, to a cottage industry of crafters on Etsy to produce face masks. The U.S. industrial base hasn't just been hollowed out. It's been virtually obliterated. I think we had more organized industry in the colonial era.
GARY: Who's the colony and who's the mother country?

The politics of protectionism can get ugly and self-defeating very quickly. I'd hope we could be smart and rational enough to find ways to incorporate more supposed "externalities" — like resiliency, social costs and environmental protection — into business decisions, as well as efficiency. Who knows, that might even drive some increased capital spending.
GARY: Maybe. But bear in mind that as we've evolved more and more into a service economy, that by its nature implies more and more domestic production. You can't really import services. Yes, you can import the services of doctors working in Delhi, who can read computerized x-rays in the middle of the night. Or maybe the services of some IT workers. But the majority of service industries do require domestic production.

Okay, but isn't this crisis, in a sense, providing a huge object lesson in the value of creating more balanced — resilient — economies, instead of highly specialized, but perhaps more fragile, ones heavily oriented to either services or manufacturing?
GARY: I think that's true. I don't know about you, but I just was getting to the point where almost any manufactured product I picked up was labelled, "Made in China."

I think that's pretty universal now. Do you see the demand for commodities ever picking up, Gary? I know they are a favorite short of yours.
GARY: They have been, for quite a while. Real commodities prices have been declining, actually, since the mid-1800s. Yes, we get occasional spectacular price spikes, during wars and oil embargoes and things like that. But other than that, commodities prices just decline.

Haven't you heard, "there's only so much "(fill in the blank) on the Earth" —
GARY: Of course. But human ingenuity beats shortages any day. Always has and always will. Commodities are a long-term negative bet because — the whole globe is becoming more and more of a service economy — that's true here and it's even true in China. At any stage of development, services grow faster than goods. This essentially means there's less and less demand for commodities — and they're very price-sensitive to supply and demand. My favorite short in commodities is copper because copper goes into almost everything manufactured. Also, also copper — unlike oil — doesn't have any cartel that can screw up a perfectly good economic forecast at the drop of a hat.

As Bin Salman just proved again, in trying to drive America's frackers out of business.
GARY: Of course, this latest Saudi maneuver was very poorly timed because it coincided with the collapse in demand when the virus hit.

What about the bond market here? You've been a bond bull forever. But rates really can't drop far from here, at least without going negative. And the Fed doesn't want to go there.
GARY: Yes. Full disclosure, I've been a bond bull since '98 when the 30-year bond yield was 14.6%. I said, in writing, that we were having the bond rally of a lifetime — and now the yield is down at 2.4% on the 30-year.

But I still think rates will go lower. This rally still has legs. Now, of course, I've never bought Treasuries for yield — I couldn't care less what the yield is, as long as it's going down. I buy Treasury bonds for the same reason that most people buy stocks — for appreciation. And I certainly think we could go to 1% on the long bond.

Which doesn't sound like much of a move — except when stated in percentage terms. Or imagined on a logarithmic scale.
GARY: Absolutely. A yield drop from 3% to 2% pushes 30-year coupon Treasury bond prices up by 19.6% and — if rates drop further to 1%— by another 22% (Chart, nearby). For the zero coupon Treasuries we favor buying, the appreciation in both cases is 34%.

Now, will we go to negative yields on a 10-year note — like you have in Japan and in Germany? I kind of doubt that.

Coupon and Zero-Coupon Bonds: Return On 1 Percentage Point Decline in Interest Rates

Yield	30 Years Coupon Bonds	30 Years Zero-Coupon Bonds
15%	—	—
14%	7.0%	30%
13%	7.5%	30%
12%	8.1%	31%
11%	8.7%	31%
10%	9.5%	31%
9%	10.3%	32%
8%	11.3%	32%
7%	12.5%	32%
6%	13.8%	33%
5%	15.4%	33%
4%	17.4%	33%
3%	19.6%	34%
2%	22.0%	34%

Because?
Gary: Because the Fed really doesn't want that. But there is a spillover — if you look at the entire post-war period, historically, a 100-basis point decline in Fed Funds spills over into a 36-basis point decline in 10-year yields and to a 24-basis point decline in 30-year yields — but the further out you are on the yield curve, the less affected other rates are. It's really inflation, in the long-term, that is the key. The correlation between Treasury bond yields and CPI inflation, over that entire period is 60%. So when you think about all the other things that are at work there, that really says that inflation is the key in the long run, to higher rates.

And you're not among those wringing their hands about an uptick in inflation here —
Gary: No. I think we're really looking at *deflation* here. And if that's true, then you should see further declines in rates. And bonds will also retain their safe haven appeal, as well.

In fact, we've seen this disinflationary environment ever since QE was introduced amid the 2008 financial crisis. Despite all of the monetary and fiscal firepower the Fed and the Treasury were bringing to bear, the forces of disinflation — and now deflation — held the upper hand. Now it is deflation, as well as the global demand for the safety of Treasuries that is pushing yields down.

The irony, in retrospect, is that so many financial industry players were adamant back then that QE would produce runaway inflation.
Gary: I can remember, after '08 there were some very well-known hedge fund managers who were so convinced that QE was going to result in double-digit inflation that they introduced funds denominated in gold. That didn't exactly work out.

Still, as you say, the Fed clearly doesn't want to go below zero on the Fed Funds rate —
Gary: Well, they've seen what happened in Japan and Europe, where negative rates haven't induced borrowing and spending. Instead, they've encouraged more saving. People figure they've got to save more because their assets are declining in value with negative rates — which is exactly the opposite of the effect the central bankers wanted.

So I think the Fed has basically decided, "We'll let those guys do the experimenting. We're not going to do it." Still, the futures markets have recently suggested negative real nominal rates in the U.S.

Who would you rather fight, the futures markets, or the Fed, which has basically said it will create any tool it needs to avoid that?
Gary: And it will. The watch word of the central banks is basically pegging rates, and inflation.

Anything but outright deflation.
Gary: Well, they have seen the devastating effects of deflation in Japan, which over the majority of the last 20 years, had year over year declines in the CPI. Of course, that encourages everybody to wait to buy. So inventories build up, and excess capacity pushes prices down further, confirming deflationary suspicions. So they wait even longer. What has been the result for Japan? A very heavy drag on GDP growth. It has averaged only 1.1% annually for the last 20 years — which is just trivial growth.

So Japan is the poster boy that scares the Fed about deflation. They also worry about the fact that debts are denominated in nominal terms in most cases, but the ability to service them can decline in deflation, so in effect the real cost of debts goes up. And that bugs the Fed, for obvious reasons.

You mean, considering the size of their balance sheet — not to mention the heavily leveraged position of most of the U.S. corporate sector, even before the pandemic.
Gary: Oh yes. And a lot of that leverage was piled on to pay for corporate stock buybacks or dividends.

At least the consumer sector, by contrast, had the wit to pay down its debt, in aggregate terms, since the last recession.
Gary: A process that was greatly aided by the prepayment or write-off of a lot of mortgage debt.

Okay, but in the here and now, why are you

so sure that $3 trillion-plus of fresh bail-out liquidity won't spark inflation?

Gary: Because that money is basically replacing a contraction in the private economy. And as long as we're in a globalized world, we're in an excess supply situation, and that excess supply will continue to swamp the surge in money — just as it has for the last decade. Look at Asia, they're big producers and parsimonious consumers. There's a savings glut. That's what happens. And when you've got more supply than demand, what happens to prices? They go down.

So the deflation you've been predicting forever is upon us?

Gary: We've been living with disinflation and I think we're now seeing chronic global deflation starting to unfold, with the corona crisis adding to the downward pressure on prices from globalization. And self-feeding deflation, as I said, curtails spending, increases the real cost of debt and punishes heavily leveraged borrowers — but it benefits Treasuries.

And that's why you are taking refuge in Treasuries?

Gary: Well, as I mentioned earlier, we're into long Treasury bonds, we're short a little bit of the S&P in portfolios we manage. I want to have a toehold in that position because I think there is a second leg down coming in the stock market. But it hasn't unwound yet. Then we're also long the dollar. It's pretty straight-forward macro portfolio if you will.

Are you also still short commodities and junk bonds, even though the Fed is now buying fallen angels?

Gary: We covered our shorts in junk when the Fed moved into that market. That was a case of a great fundamental forecast being screwed up by the regulators. When the ultimate deep-pocket investor suddenly decided they'd support junk bonds, we exited. I'd rather have that cash on the balance sheet in this uncertain environment.

Gary, you've long made a distinction between good and bad deflation — which is this?

Gary: Well, bad deflation reigned in the 1930s' Great Depression as demand collapsed after the 1929 stock market nosedive revealed the over-leveraged nature of the financial system. Bankruptcies spread rapidly and were followed by massive lay-offs and pay cuts for those still working. So demand collapsed as incomes vanished. Wholesale prices and employment nosedived in tandem and the unemployment rate skyrocketed to 25%. That stood in sharp contrast to the good deflation of the latter part of the 19th Century, when the American Industrial Revolution and the growth of the railroads translated in a sustained rate of productivity growth unequalled in U.S. history — which had the side effect of collapsing prices on manufactured goods. But that vastly expanded sales, as ordinary citizens could afford to eat better and buy manufactured products for the first time. Even though nominal wages were falling, prices were dropping even faster, so real income grew.

I hear more similarities to today in your description of bad deflation, I'm afraid.

Gary: I think it's a bit of a mix. It's good deflation because global supply has mushroomed with international trade spurring output, especially in China and other places in Asia. But it's also bad deflation, because much of the income resulting from all of that global production is being saved, curtailing demand.

What's more, assuming the corona crisis depresses demand in the West, as I expect, while also promoting higher rates of saving while output in Asia continues to climb — that just creates more deflationary pressure from excess supply. Assuming, that is, that the U.S. and other developed nations don't throw up all sorts of barriers to imports. I continue to think globalization is the most significant global economic development of our lifetimes, but it forces us to examine all sorts of variables on a worldwide, basis — instead of a more familiar national lens. Nothing is getting less complicated.

Phew. Do you have any upbeat words to the wise to offer?

Gary: Not a lot. I think the best thing would be for people to be prepared for a pretty rough next year or so. And if things turn out to be better than I expect, then okay, they'll be happier. And otherwise, at least they won't be profoundly stressed or disappointed.

Thanks, Gary. I guess some prudence wouldn't really hurt.

Welling on Wall St. Interviewee disclosure: Economist and author A.. Gary Shilling, Ph.D. is president of A. Gary Shilling & Co., Inc., the economic consulting and investment advisory firm he founded in 1978. That was after Gary did stints as the a senior vice president and chief economist of White Weld & Co., and at Merrill Lynch,Pierce, Fenner & Smith., where, at age 29, Gary set up Merrill's first economics department and served as the brokerage firm's first chief economist. Prior to Merrill Lynch, Gary worked for Standard Oil Co. (N.J.) (now Exxon), where he was in charge of U.S.and Canadian economic analysis and forecasting. Gary received his bachelor's degree in physics, magna cum laude, from Amherst College, where he was also elected to Phi Beta Kappa and Sigma Xi. Earlier, as a high school senior, he ranked 12th in the nation in the Westinghouse Science Talent Search. Dr. Shilling earned his master's degree and doctorate in economics at Stanford University. While on the West Coast, he served on the staffs of the Federal Reserve Bank of San Francisco and the Bank of America.

The author of many books, a number of them on disinflation, and a frequent contributor to Welling on Wall St. and its predecessors, Gary is well-known in Wall St. Twice ranked as Wall Street's top economist by polls in Institutional Investor, he was also named the country's No. 1 Commodity Trader Advisor by Futures magazine. The Wall Street Journal has cited him many times for his on-the-mark economic forecasts. In 2003, MoneySense ranked him as the 3rd best stock market forecaster, right behind Warren Buffett. Gary is also the longest-running columnist at Forbes magazine, where he has been challenging the consensus since 1983, and he is a regular columnist for Bloomberg View. He also appears frequently on Bloomberg radio and television, as well as on other investment media. In his spare time, Gary is an avid beekeeper.

Gary's economic and advisory services — including his monthly *Insight* newsletter — are guided by his two long-standing principles: 1)Human nature changes very slowly over time, if at all. Therefore, history is relevant because human beings will react to similar circumstances in similar ways. The trick, however, is to find the relevant piece of history on which to draw parallels. In this sense, forecasting is an art, not a science. And 2) The objective of forecasting is to identify the significant but undiscounted aspects of the outlook. This is where the true opportunities for investors lie and where business can get the jump on competitors. A rehash of the consensus view, which is fully discounted in security markets and business plans, is of limited value. Gary's approach is top-down, using his economic, financial and political analysis to develop investment themes that will impact business and financial markets short and long-term. A. Gary Shilling & Co., Inc. is registered as an Investment Adviser with the State of New Jersey, Bureau of Securities (NJBOS). For more information, see agaryshilling.com

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