

September 21, 2020

BILBoard September 2020 – Waking up the economy



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Typically an unpopular month amongst market participants, September kicked off true to form with a tantrum that left the tech-heavy Nasdaq in correction territory. We

understood the decline to be technical in nature, driven by profit-taking and the laws of gravity, rather than the more ominous kind of sell-off, driven by a deteriorating fundamental outlook. Indeed, US stocks had already completed a round-trip from Covid lows, shooting back up past pre-pandemic highs, leaving valuations (especially technology names and those that fall under the "Corona / Stay-at-Home" umbrella) looking extremely bloated. These valuations were inconsistent with the macro picture – they suggested a global economy springing out of its deep, lockdown-induced slumber, in a magnificent V-shaped recovery. As we know, it's not always easy to pull ourselves out of the sweet stickiness of sleep; the global economy is only very slowly returning to normality, aided by a double-shot of caffeine from monetary and fiscal policy makers.

MACRO

Our base

case for a gradual recovery remains intact, though this will be measured in quarters, rather than months, and it will not be without setbacks. The US elections, Brexit, US/China disputes, and the virus are just some of the ongoing risks that could unsettle the outlook.

In the US,

to this point, Fed Chairman Jerome Powell has stated that "the recovery has progressed more quickly than generally expected," but cautioned that "activity remains well below pre-pandemic levels" and noted that the pace may slow as "the path ahead remains highly uncertain." To support the economy, the Fed is continuing with its dovish policy mix of bond-buying, credit facilitation and ultra-low rates (which are expected to remain at 0-0.25% until 2023 according to the refreshed dot-plot). Inflation pressures seem to be building, but these are unlikely to trigger a policy remix, with the Fed now tolerant of inflationary overshoots under its new "average inflation" targeting framework.

On the

bright side, the central bank upgraded its growth projections and now expects to see a 3.7% decline in GDP this year, a smaller contraction than the 6.5% decline expected in June. The US Fed is forecasting that the US economy will reach

pre-pandemic levels by the end of 2021. The manufacturing sector is pushing ahead while durable goods orders suggest that business investment is slowly recovering from a standstill. However, profits are still dwindling (down 15% in Q1 and 8% in Q2) and for corporate margins to return to their former levels, the US needs its consumers.

After the post-lockdown "pursuit of happiness" shopping sprees, consumer confidence has stalled, suggesting that purse strings could be tightened again. Consumer activity relies on a healthy labour market and 11.5 million jobs having been wiped out since February. It therefore comes as no surprise that full employment is now a key focus for the Fed, which expects a median unemployment rate of 7.6% for 2020, down from the 9.3% forecast in June.

Fiscal policy measures have provided critical support for households and small businesses, but more will likely be needed. With gridlock on Capitol Hill, the amount and timing are still unclear. So far, the economy has proven resilient to the expiration of benefits, but without further fiscal aid, pent-up demand could easily fade away.

"IN EUROPE, IT SEEMS THE SNOOZE BUTTON HAS BEEN PUSHED ON THE RECOVERY FOR NOW."

In Europe, it seems the snooze button has been pushed on the recovery for now. Recent data shows a loss of momentum in the industrial sector and disappointing consumer spending, raising doubts about the sustainability of the initial rebound, especially with infections and unemployment both trending upwards. Inflation is still in a deep slumber on the continent, removing any dilemma for the ECB, which kept rates at -0.5% at its most recent policy committee meeting, while pledging that it would run its €1.35 trillion pandemic emergency purchase program through to the end of June 2021 at least.

"CHINA'S ECONOMY IS LESS LETHARGIC AND ITS RECOVERY MAKES IT AN OUTLIER, BEING THE CLOSEST OF ALL MAJOR ECONOMIES TO ITS PRE-PANDEMIC ACTIVITY LEVELS."

China's

economy is less lethargic and its recovery makes it an outlier, being the closest of all major economies to its pre-pandemic activity levels. After its corporate sector spent months in recovery mode, China's consumers are finally joining the recovery effort. Retail Sales rose for the first time this year in August, clocking a 0.5% gain. This came as the unemployment rate inched lower to 5.6%, from 5.7% in July. The trend of easing inflation gives the central bank more room to manoeuvre moving forward.

EQUITIES

Changes: *Emerging Market exposure adjusted to reflect our preference for China.*

The market correction did not meaningfully change equity valuations, which remain on the expensive side. This is especially the case if you consider the fact that the better-than-feared earnings season has not influenced revisions dramatically. In fact, the US is the only region to have had a positive revision in aggregate earnings expectations (and a minor one at that). We still give preference to the US despite it being the most expensive region, due to the fact that it is home to the most prominent growth, "stay-at-home" companies and digital champions, which are expected to continue to prosper as long as the virus remains rampant. We remain underweight European equities, which are underperforming the broader market. Within our Emerging Market exposure, holdings were adjusted to reflect our preference for Chinese equities which held up well during the recent correction, and which are supported by stronger fundamentals. Other EMs, for example in Latin America and India, are still battling their first wave of Covid.

In terms of style, the rotation from growth to value was brief and primarily US-based. We currently do not see any strong catalysts for a sustained outperformance of value stocks. Overall, we prefer to cherry-pick quality stocks from the array of sectors given the huge dispersion of returns, while closely monitoring some cheaper sectors and those with positive earnings revisions.

FIXED INCOME

Changes: *Emerging Market debt holdings partially switched from HC Sovereigns to HC Corporates*

Continued central bank largesse is inflating government bond prices and for now, yields seem stable. However, within this space, we maintain our exposure to inflation-linkers, which should continue to rise to reflect the likelihood of higher inflation over the longer-term as the recovery trundles on.

In the corporate space, as the hunt for yield intensifies, spreads have retraced a large part of their widening and should move in a sideways fashion from here on out: Central banks are preventing any material widening, whereas further retracement would require a material catalyst, such as a vaccine. The negative trend seen in ratings seems to have reached an inflexion point in Q3, supported by a strong issuance of "general purpose" bonds as companies pursue balance sheet resilience. At the same time, investors have demonstrated a strong appetite for new issues and a willingness to hold fallen angels.

In the Emerging Market Debt space, we believe that EM corporates should now reassert themselves, supported by lower capex and financial discipline. To elaborate, declining local rates provide EM Corporates the opportunity to replace hard currency (HC) debt with local currency (LC) debt, improving balance sheet robustness. At the same time, valuations are attractive with the yield differential over US Corporates, corrected for duration, still wide from a historical perspective (c.316bp). In Defensive and Low profiles, 50% and 100%, respectively, of the current EMD exposure (now fully invested in HC sovereigns) was moved to HC EM Credit.

CONCLUSION

If the economy was personified, it would be yawning, reluctantly stretching, contemplating getting up, maybe with the Greenday song “Wake me up when September ends” playing in the background. All the while, central banks and fiscal policymakers are there pulling off the duvet, trying to coax it out of its slumber. Markets running on hope, liquidity and momentum seem to have overlooked the fact that this will take some time, as well as the fact that only a vaccine (and associated effectiveness and trust in it) will convince the global economy to jump back onto its feet.

16/09/2020		DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation	Equities	●	➔	●	➔	●	➔	●	➔
	Bonds	●	➔	●	➔	●	➔	●	➔
	Cash & cash equivalents	●	➔	●	➔	●	➔	●	➔
Equities	Europe	●	➔	●	➔	●	➔	●	➔
	USA	●	➔	●	➔	●	➔	●	➔
	Japan	●	➔	●	➔	●	➔	●	➔
	Emerging Markets	●	➔	●	➔	●	➔	●	➔
Bonds	Government Bonds - Developed	●	➔	●	➔	●	➔	●	➔
	Corporate - Investment Grade	●	➔	●	➔	●	➔	●	➔
	Corporate - High Yield	●	➔	●	➔	●	➔	●	➔
	Emerging Market Debt	●	➔	●	➔	●	➔	●	➔
	Total Return	●	➔	●	➔	●	➔	●	➔
Commodities	Oil	●	➔	●	➔	●	➔	●	➔
	Gold	●	➔	●	➔	●	➔	●	➔

Stance: Indicates whether we are positive, neutral or reluctant on the asset class

Change: Indicates the change in our exposure since the previous month's asset allocation committee

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