

November 2, 2020

BILBoard October 2020 – Weathering the pandemic



Overall, as the world emerges more quickly than anticipated from one of the worst recessions on record, growth forecasts have improved; the IMF now expects the global economy to experience a 4.4% contraction in 2020, 0.8% better than predicted in June. This is largely thanks to floods of fiscal and monetary stimulus and the containment of the virus in China and other Asian countries. However, a Corona-shaped cloud still hangs over the economy, threatening to rain on the recovery, undermining confidence, consumption and investment. Some countries are better equipped to weather the virus than others (from both a medical and policy standpoint) and, as such, a very uneven recovery is playing out.

In the US, despite three million active cases of the virus, stabilization is at play thanks to the Treasury and the Federal Reserve. Business confidence is improving and factory activity rose for four consecutive months before September's moderation of -0.6% (which shows it may be difficult to keep pace while the virus persists). On the consumer side, sentiment increased in October, retail sales are stronger than they were before the pandemic (concentrated online, in supermarkets and at building material stores) and the real estate market is particularly buoyant. However, continued confidence somewhat hinges on new fiscal stimulus to further support the economy and the labour market. While the unemployment rate has fallen to 7.9%, long-term unemployed (unemployed for 27 weeks or more) figures are creeping up, most recently by 781,000 to 2.4 million, and labour market slack has weakened employee bargaining power when it comes to wages. Inflation is still on the rise, reflecting an improving economic situation, however we haven't seen a risk of a sudden spike that would instigate a policy pivot from the Fed (especially under its new average inflation targeting). The elections are generating some anxiety and may give rise to short-term volatility (especially if the outcome is disputed), but ultimately, economic cycles are much more important for asset classes than the composition of the US Government. In terms of the currency, we believe the picture less supportive for the US dollar due to the cumbersome twin deficits which could expand further if we see a Democratic sweep in the elections.

In the eurozone, the IMF expects a contraction of -10.2%. Indeed, more rain could be on the forecast, as we wait

for datapoints showing how consumer behavior has been affected by the second round of lockdowns and restrictions. Already, a loss of momentum in the industrial sector is clear, and the pandemic has left a puddle on the labour market, with the unemployment rate on the rise since March (most recently 8.1%) while inflation has all but evaporated (-0.3% in September), in part due to the stronger euro.

In China, with the virus almost snuffed out, the clouds have receded, making way for economic sunlight. The country is an outlier in that it is expected to post positive growth in 2020; the IMF predicts 1.9%, followed by 8.2% in 2021. Demand (external and domestic) is coming back and China is now reshoring certain activities that had been outsourced.

Other emerging markets are still in the thick fog of the pandemic. The IMF predicts growth of -8.1% in Latin America, as “the legacies of the pandemic cloud an already uncertain outlook”, while in India, for example, the economy is projected to contract by -10.3%. Oil exporting countries are at a particular disadvantage.

FIXED INCOME

We are maintaining our previous allocations within the bond space, with a preference for high quality corporate bonds in both developed markets and within our Emerging Market allocation.

While we've maintained a layer of governments as a windbreaker in times of heightened volatility, we are generally reluctant on this asset class, especially in the US and on longer duration. Polls suggest that the Democrats could take victory in the US election. If they do, we could see a much larger stimulus package (c. \$2 trillion) than may have been expected under Republican charge, which could in turn drive rates higher. As such “short Treasuries” is now a consensus trade.

We like corporate bonds given the continued support of central banks. The ECB is expected to continue buying bonds at a pace of up to EUR 10 billion per month. Economists expect more stimulus to be announced in December 2020 and an extension of the emergency program to end-2021. In the US, the bond market is now standing on its own two feet and the Fed has been able to dial down its bond buying, using only a fraction of its firepower. Despite the fact that the Fed's buying is mostly symbolic, if it doesn't extend the program which is set to expire in December, there is a risk of volatility.

High-yield bonds have been trading sideways. In Europe, default rates are low, while being slightly higher in the US (however 4/5 of defaults occurred in the beleaguered energy sector). We are selective on this asset class, preferring companies that have not saddled themselves with too much debt. In the emerging market debt space, corporates are still the most attractive tranche.

EQUITIES

Maintaining an overweight in the US and switching part of our European exposure to China.

Despite rising infection levels, US equity markets were stable up to the last week of October and following September's correction. The Q3 earnings season has been better than feared (over 80% of companies on the S&P 500 have reported a positive surprise), however is still on track to post the second worst set of results since the 2008 financial crisis, and guidance remains opaque. The US has strong prospects given that it is the region where the most prominent growth and "stay at home" beneficiaries are located. It is admittedly expensive, with hopes around new stimulus inflating valuations even further – so the challenge will be for companies to deliver on the earnings front in 2021. The US is the only region to have a minor positive revision amongst analysts, however this has started to level off as they grow a little more sceptical – something we are paying close attention to, especially as earnings results roll out.

With the eurozone underperforming on almost every front, we have gone even more underweight, switching a proportion of our holdings to Chinese equities. Accelerating reforms in China are broadening access to foreign investors, lifting growth prospects while sectors like technology, healthcare and consumption are driving returns.

In terms of style, “lower for longer” interest rate policies are supportive of growth and quality stocks. In terms of sectors, we like healthcare, consumer staples and IT, as well as some late cyclicals such as materials and utilities which have enjoyed strong revisions. Due to wide-ranging dispersions in performance, selectivity is key, and we still prefer to identify top performers within sectors, rather than betting on sectors as a whole.

COMMODITIES

Despite the short-term consolidation in September, we are constructive on gold over the longer term. Bullion ETFs have received record inflows and the price is on an uptrend – above its 100-day moving average. Higher inflation expectations remain supportive.

We are negative on oil. Even though demand has picked up recently, driven by China, it will likely come under pressure again as governments unveil new restrictions on activity. The second round of lockdowns has also limited OPEC’s flexibility to loosen supply, as it planned to do in January 2021.

CONCLUSION

In Japan there are fifty different words to describe rain. There are just as many different rates of recovery playing out around the world, and we aim to position ourselves in locations that are

faring best – namely the US and China. In the coming quarters, the trajectory of the economy will depend largely on countries’ ability to contain the virus, but come rain or shine, a well-diversified portfolio comprising high quality assets is the best way to weather the storm until blue skies return.

28/10/2020		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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