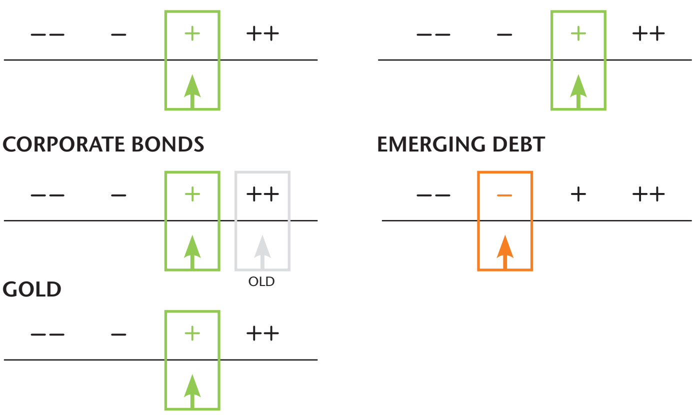
ASSET ALLOCATION INSIGHTS

AUGUST 2020

WHY EQUITY MARKETS ARE ENJOYING THE BEST OF A DIFFICULT SITUATION

Equity markets have enjoyed a three-month rally, but should investors fear a false dawn? At first glance, it is easy to spot what might derail the world's stock markets. After all, there is plenty to be worried about – from fears of a second wave to US-China trade tensions.

ASSET ALLOCATION VIEWS



However, as investors, it is important to make an objective assessment of underlying macro dynamics. To markets, what matters is not how things are in absolute terms, but rather, how does the current reality tally with market expectations.

So far, the outcome on everything from rising economic growth in the face of Covid 19 to US-China tensions has been better than expected. These are now all 'known unknowns', of which everyone is weighing the potential downside, so they are unlikely to trigger a big market reaction.

The big picture on macro remains broadly positive. Economic data shows improvement across the board, with positive momentum driven by consumption and service sectors across all large economies.

GLOBAL ACTIVITY HAS FALLEN OFF A CLIFF, BUT IT IS ALREADY PICKING-UP

WORLD INDUSTRIAL PRODUCTION YoY% (Left)
WORLD TRADE VOLUME YoY% 3M MAV (Left)
WORLD PMI MANUFACTURING (Right)

SOURCE: SYZ, FACTSET. DATA AS OF 07.08.2020.

Due to government support, many households have not lost as much income as feared – and some have even made gains, either through lower spending or support on top of a salary. This is extremely unusual in a crisis, and as lockdown eases, people will resume consumption, which is driving a recovery – even if not the 'V' shape some had hoped for. On the downside, spending is below pre-crisis levels, and some sectors are still suffering, such as hospitality, and they face a long and uncertain road ahead.

However, ultimately we see the risk of a second wave as a potential source of volatility. A full lockdown is highly unlikely at this stage, as it would be too costly for economies, and healthcare systems now have the processes in place to deal with a resurgence of cases.

As long as any further lockdowns are temporary or localised, this will not prevent the recovery from extending. In the US, for example, even if the largest states, California and Florida, remain in lockdown, these states do not represent a large enough percentage of GDP to affect the US' recovery.

EQUITIES – STILL THE BEST GAME IN TOWN

Positive economic momentum, combined with super low nominal rates and central bank liquidity injections, create an environment where everyone is looking to invest into assets that will provide positive nominal, and ideally, positive real income over the next two to three years. As government rates will remain low in nominal and negative in real terms as well, the great hunt for yield continues apace.

While credit offers some yield in absolute terms, this is less attractive than three months ago. In relative terms, the equity market looks more attractive. But investors need to be selective and find companies which will still be posting positive activity and revenues in several years, in an industry that will not fall into post-Covid obsolescence. The downside is that some areas of the equity market will become victims of their own success. Investors need to be very careful about what they are prepared to pay in the post-Covid world.

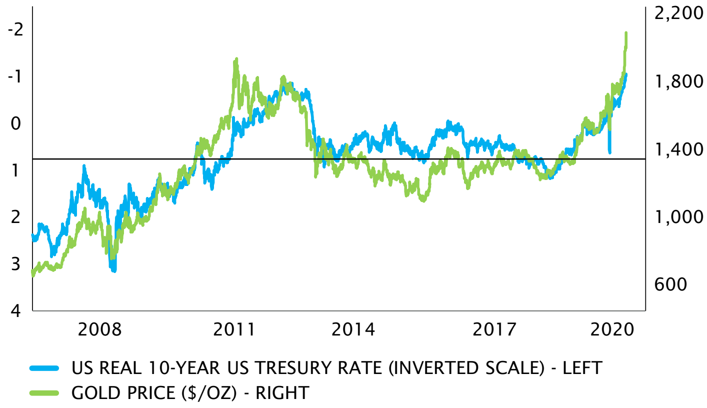
Broadly, the trends of the past few months remain in place, with valuations in the tech, consumer and healthcare sectors still rising. Meanwhile, sectors acutely impacted by Covid are still suffering. If a vaccine is made available, the catch-up potential for these under-performing sectors, such as hotels, travel and leisure, will be quick and very large. We are monitoring the risk of sectorial rotation, but believe it is still too early to position for this.

Inflation linked bonds continue to be attractive compared to nominal government bonds with the decline in real rates. Recently, the inverse correlation between gold and real rates has been particularly strong. In fact, the latest acceleration shows gold is moving ahead of real rates, anticipating further falls. This is related to central bank attitudes to inflation, with the Fed conducting a review of its inflation strategy.

Currently, the Fed has a dual mandate – to target the lowest level of unemployment, and stability in prices. In the past few years, sustained low inflation has raised questions around this framework and the set 2% target, which was responsible for rate hikes and the end of QE. In September, the Fed is expected to announce a new average inflation target, which aims for an average of 2% over several years. This means if inflation rises above 2% after two years at 1%, the bank would leave it unchanged until inflation averages out to 2% over the period.

This supports speculation on gold prices, as real rates could be allowed to fall further. Given gold has no fundamental value, we would not be surprised to see prices rise further – by as much as 10 percent or even higher.

GOLD PRICE AND USD REAL 10Y RATE (INVERTED SCALE)



SOURCE: SYZ, FACTSET. DATA AS OF 07.08.2020.

FEARS OF HIGH INFLATION UNWARRANTED

As developed economies converge towards lower growth and lower inflation, or "Japanify", we believe inflation is not a sustained structural risk. Gone are the days of double-digit inflation – an increase from 1% to 2.5% is not an inflationary risk. If central banks opt for an average inflation measure and do not react to changes immediately, this leaves room for inflation to nudge upwards, but it does not change the structural environment which prevents true inflationary development.

We maintained our positive equity stance and preference for IG credit and inflation-linked bonds. We slightly reduced our preference for IG credit, which was at the maximum allocation due to a once-in-decade opportunity. While it delivered very strong performance and low volatility, there is less value to be found now and it no longer represents a bargain.

In parallel, we raised our preference for high yield. Until last month, we were under-invested in high yield despite attractive valuations because we felt there was not enough visibility to move into lower quality bonds. Now, with confirmation of central bank support, we feel more confident adding to our allocation. Beyond the recent rally, valuations are still attractive.

That the upcoming US presidential election is not taking centre stage, underlines the extraordinary times in which we live. While a democratic sweep would see action on tax increases and re-regulation in healthcare and financials, the current context creates little incentive for the administration to adopt an overly aggressive stance.

Normally, a democratic administration replacing a republican one is elected on public spending promises, which it has to deliver while taking care of parlous deficits. Now, with approved spending programmes and 0% borrowing, the deficit is no longer an important consideration.

There is also bipartisan support for fiscal spending. Therefore, any tax increases would merely be symbolic. A new Democrat administration would not risk raising taxes and re-imposing strict regulation while the economy is recovering, and risk breaking this momentum.

CONTRIBUTORS

ADRIEN PICHOUD, CHIEF ECONOMIST & SENIOR PORTFOLIO MANAGER
adrien.pichoud@syzgroup.com

FABRICE GORIN, SENIOR PORTFOLIO MANAGER
fabrice.gorin@syzgroup.com

NEED MORE INFORMATION: COMMUNICATION@SYZGROUP.COM