MARKET VIEWS

Market & Strategy Update Q3 2020

PROBUS GROUP

Executive Summary

As economies around the world were shutdown and activity collapsed, central banks disproved the misconception that they had run out of ammunition. In just a few months, rates were cut and balance sheets inflated by over USD 4 trillion. Governments did not stand idle, announcing historical fiscal packages aimed at supporting households and corporations. At the same time, corporations issued record amounts of debt in order to make up for declining cash flows, further weakening their balance sheets. The amount of money supply growth and commitment to keep rates at zero for longer has reinforced the case of real assets, especially gold.

Many countries have managed to flatten their infection curve and reopen their economies, leading to a rebound in activity from the March/April nadir. These monthly rebounds appear significant, but activity remains considerably lower than pre-crisis levels. While the continued COVID spread had so far not raised much worry given the increase in testing, new daily deaths have started to creep up, with worrying developments in the US.

Bond markets continue to price dire growth prospects but equities have gone through a historic rebound, seizing upon the recovery narrative and boosted by aggressive central bank measures. The European newsflow on the possibility of a fiscal union has contributed to the rally. Rock-bottom expectations have been exceeded with the recent economic rebound but further positive surprises are becoming increasingly unlikely. Equities are trading at eye watering valuations even when considering a significant earnings rebound in 2021.

The relentless rise in equities has been mostly fed by retail investors' exuberant trading activity, while professionals have remained pessimistic during this rally. The pervasive bearishness and significant cash on the sidelines has likely contributed to the lack of pullback.

Massive short covering suggest that bears are capitulating, having most likely been converted to the money supply narrative, sharing the view that the amount of money created is guaranteed to find its way to equities. While this argument is certainly compelling given the dearth of alternatives, more convincing evidence that the economy can avoid a prolonged recession is needed to increase equity exposure, especially at current valuations.

Executive Summary

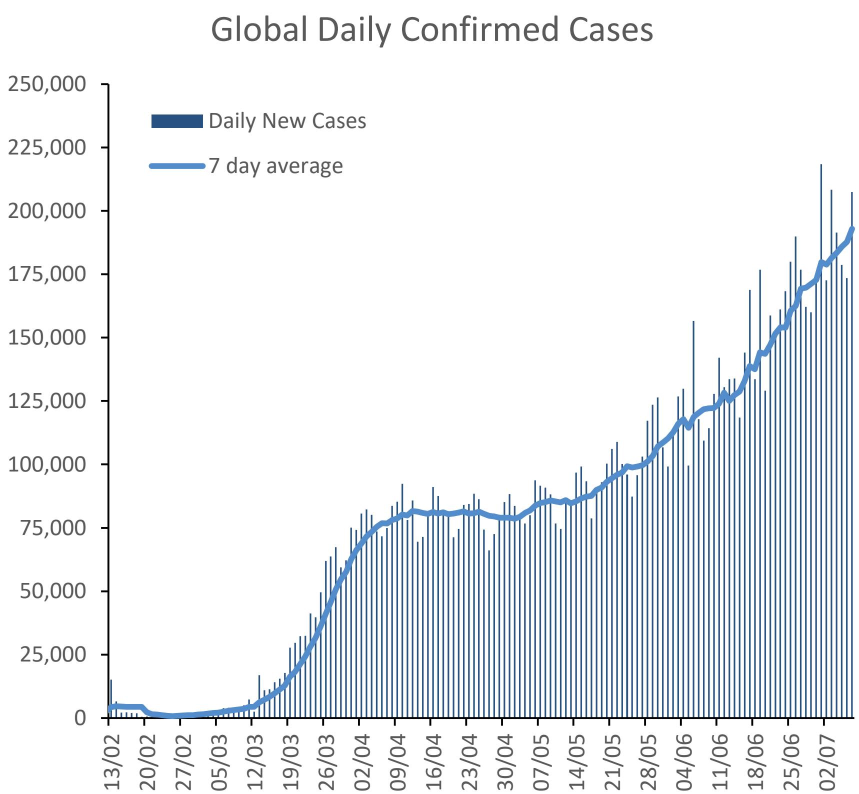
Contrary to other major economies, China's central banks has maintained a very targeted monetary policy, with relatively minor rate cuts and increases in money supply. As a result, Chinese 10Y yields offer a juicy premium over US yields, which have fallen to historic lows. Despite the abundance of risks that have international investors worried, the Chinese market is showing remarkable strength, with the Shanghai Composite breaking out of a key resistance. Caution is required but the rally likely has further to go.

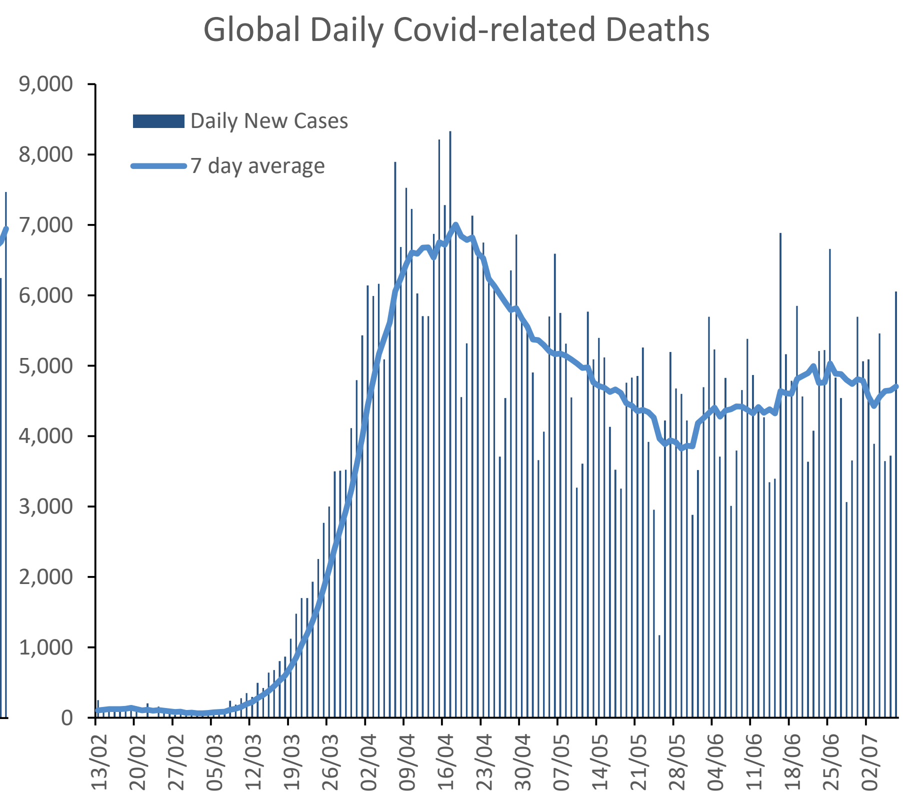
More broadly, the easing of financial conditions in the US has allowed EM central banks to react in a timely manner and their markets to recover. Given the lack of attractive yields in the developed world, foreign capital has already started to flow back to emerging markets since the March panic. We favour debt in South East Asian countries which, in addition to their exemplary management of the virus, offer compelling yield pick-ups over treasuries.

Following a brief dip in negative territory, oil prices have rallied significantly and are now facing key resistance, overcrowded long positioning and the overhang of enormous inventories. While the short term is likely to see a material pullback, rising bankruptcies in the oil patch and capex delays are laying the groundwork for higher oil prices down the line. Oil stocks remain attractive long term investments.

Macroeconomic Context

Greater testing capabilities show higher cases, but deaths reaccelerate



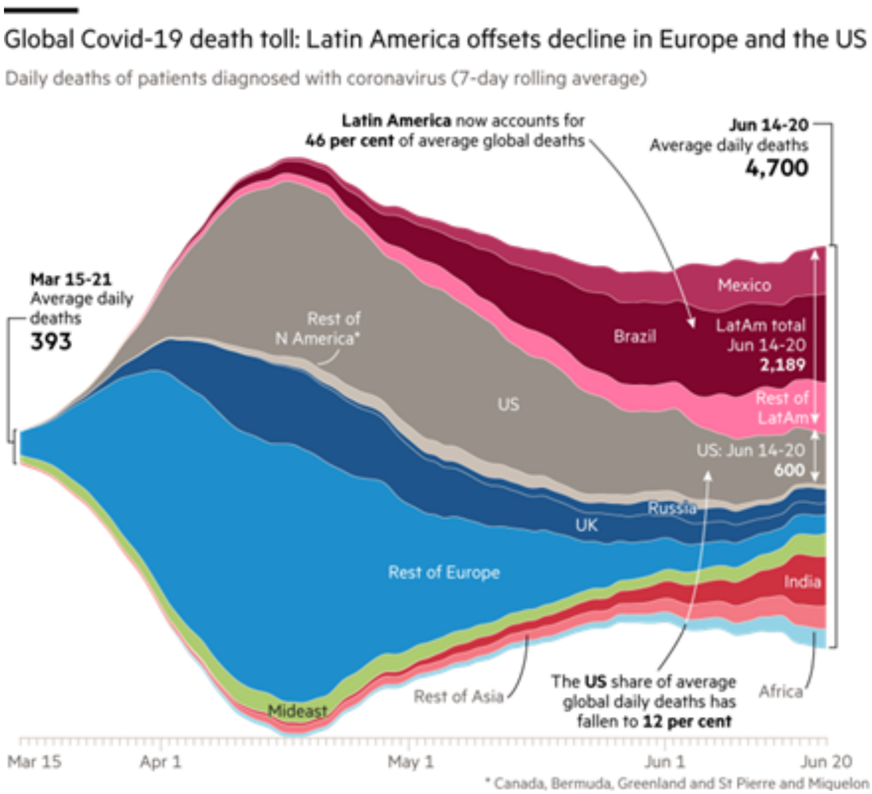


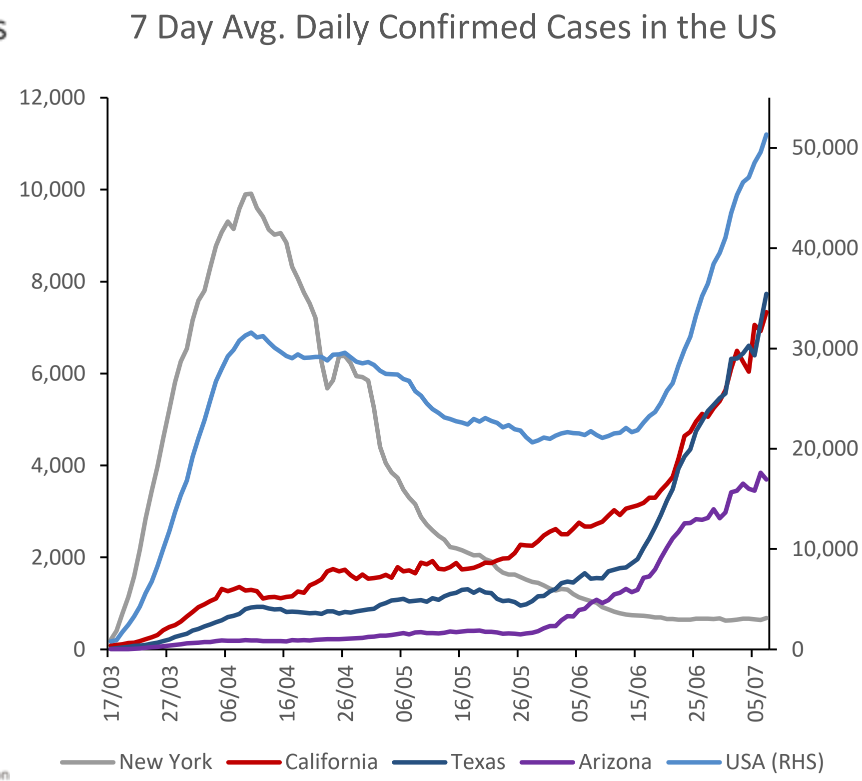
Source: Probus, Bloomberg

While the continued surge in confirmed daily cases may be evidence of greater testing capabilities, the recent rise in the 7 day average of daily deaths suggests that the situation is deteriorating.

Minor second wave outbreaks have so far mostly been contained, but an increasing number of countries and regions are showing worrying developments.

LatAm leading the charge and the US is not out of the woods just yet

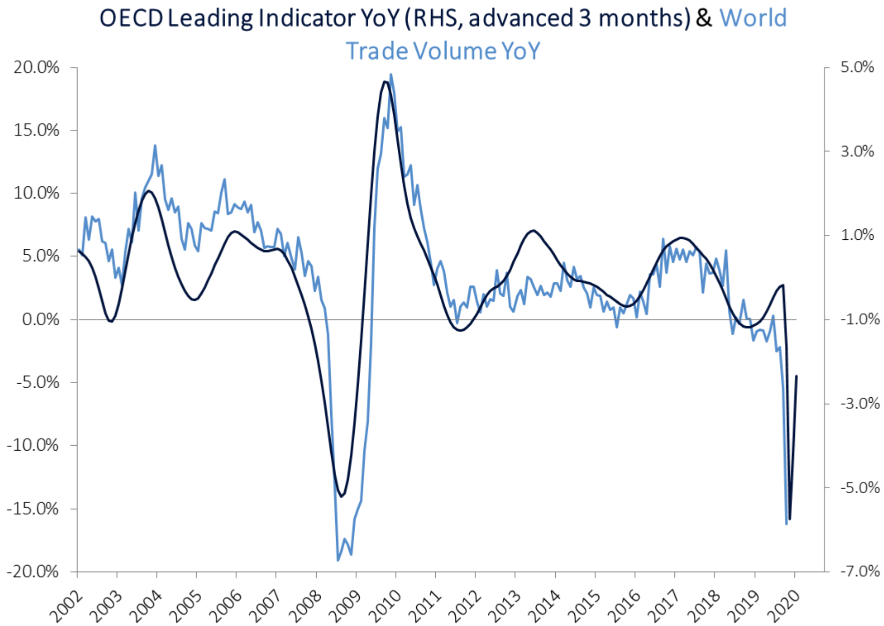


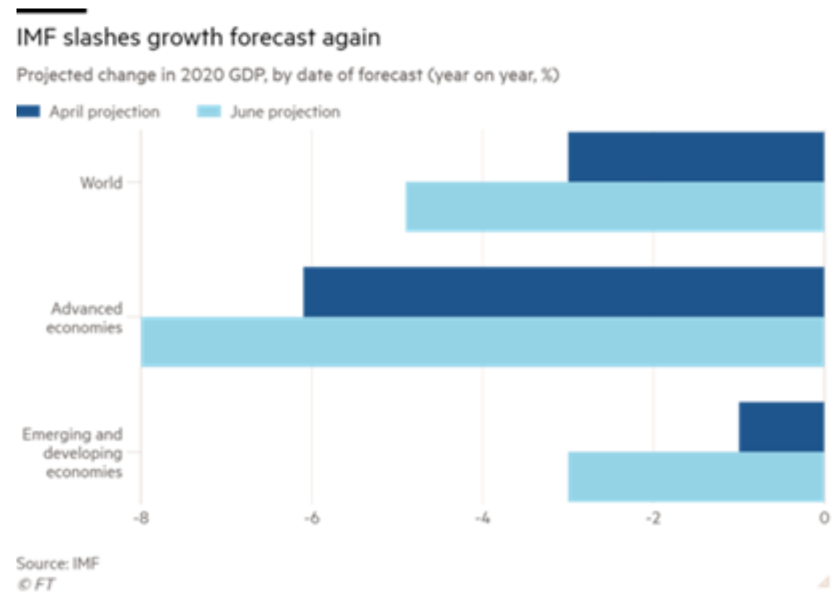


The Financial Times' global death toll graphic shows that the resurgence of daily global deaths is being driven by the developing world, mainly in Latin America.

While Europe appears to have the virus under control, daily new cases keep creeping higher in the US and are likely to keep doing so given high positive test rates in certain states. The market is largely ignoring these developments because there hasn't been a commensurate pick up in new deaths, reducing the odds of a lockdown. Should new deaths start trending upwards in the coming week, the market's ascent will likely be challenged.

Global economic data and trade volume in steep contraction

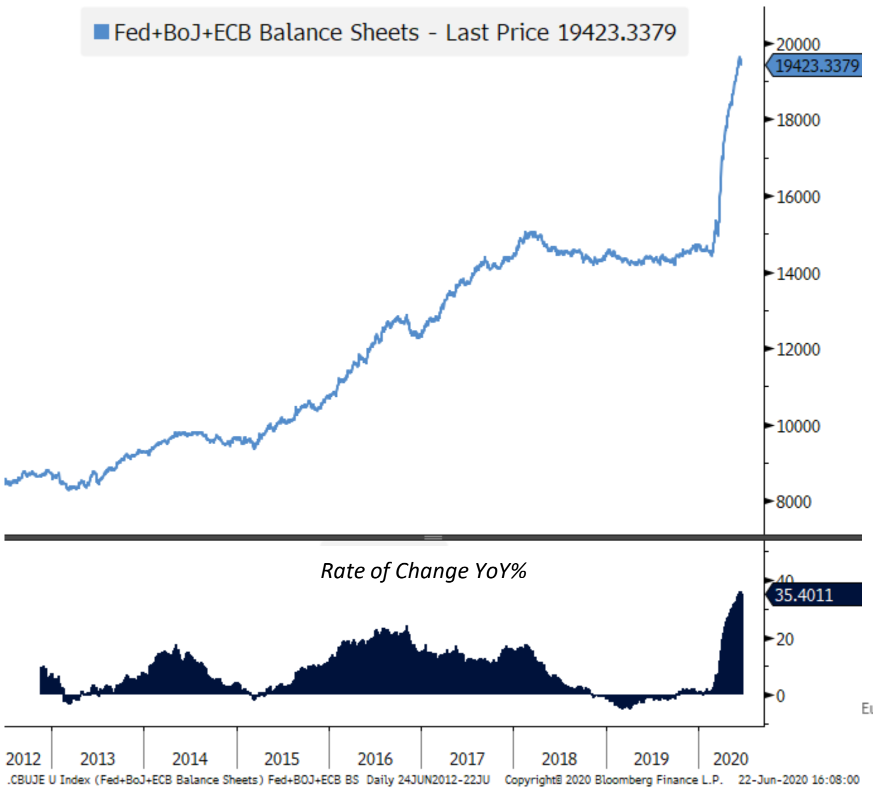


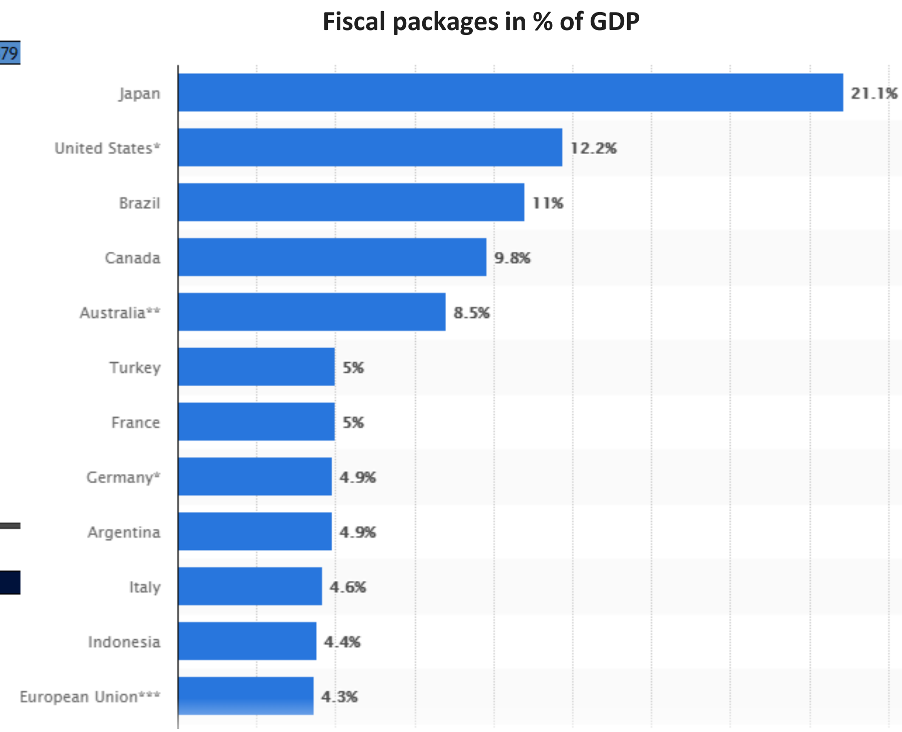


With governments responding to the virus by imposing stringent lockdowns, economic activity was brought to a standstill. The OECD Leading Indicator has dramatically fallen and global trade volume followed suit.

With the initial rebound in activity following the economic reopenings, hopes for a swift economic recovery are certainly abundant, encouraged by the massive central bank and government support programs. Whether liquidity injections can make up for such a steep economic contraction in an world already crippled with debt will come to light in the coming months; the IMF appears dubious, and has again cut its economic growth forecasts in June (see chart on right).

Central banks and governments have gone all-in

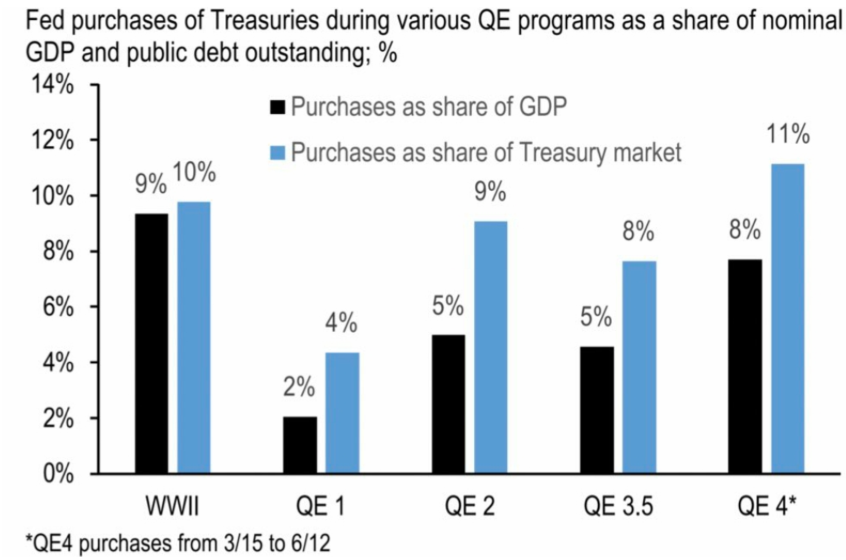


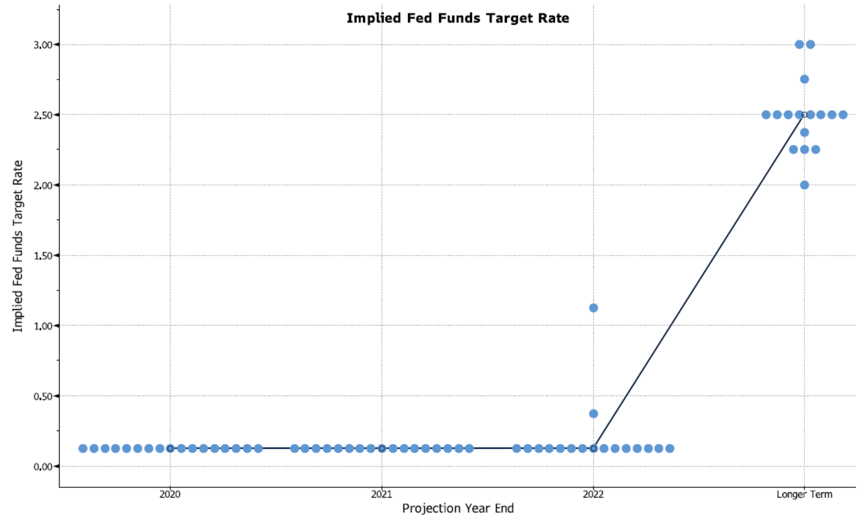


The magnitude of government and central bank intervention is without precedent. The Fed has increased the size of its balance sheet by almost 3 trillion dollars since early March, while the ECB has increased the size of its QE to EUR 1.3 trillion.

At the same time, governments have announced significant fiscal packages all around the world, giving up on austerity measures. Japan and the US stand out as particularly aggressive.

Record QE program and rates at zero until end of 2022





Source: Probus, Bloomberg

The size of the Fed’s QE program far exceeds anything undertaken since WWII, especially when considering the short time span.

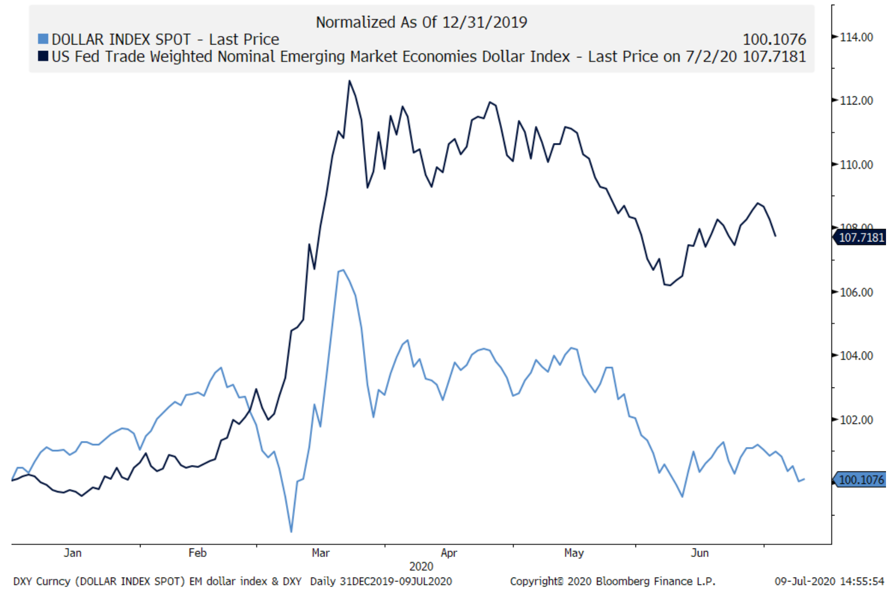
On top of that, Chairman Jerome Powell said during the recent FOMC meeting: “We are not even thinking about thinking about raising rates…”. The Fed has effectively committed to keeping rates at the zero bound until the end of 2022, as the “dot plot” chart illustrates (dots indicate the FOMC members’ projections of where rates will be).

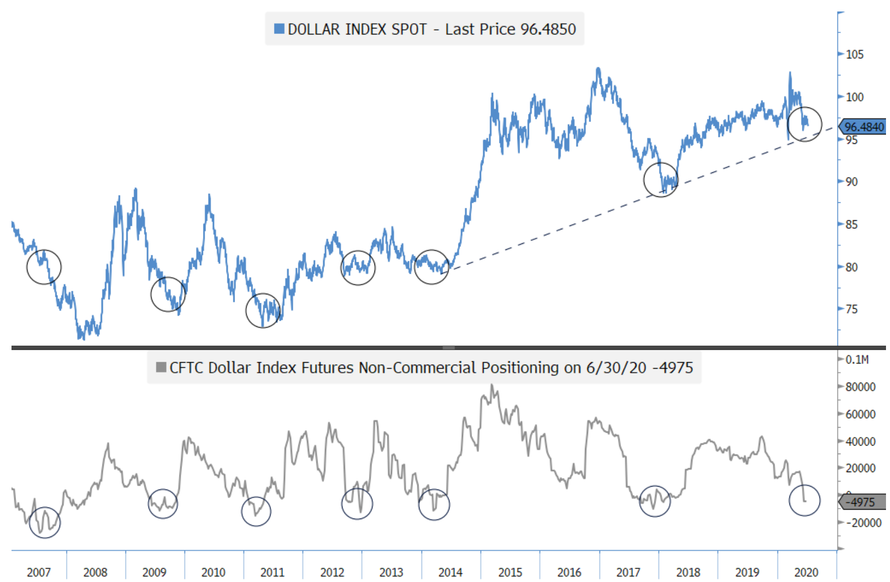
The Fed manages to stop the dollar from rising

The Fed's massive intervention in financial markets has stopped the dollar rally in its tracks, as safe haven flows and shortage concerns had pushed it sharply higher during the panic of March. The dollar has since lost ground against developed (light blue) and emerging market (dark blue) currencies.

The case for a structural decline in US dollars can be easily made given the collapse of interest rate differentials, the virus situation in the US and the amount of money printing in recent months. However, extreme short futures positioning (bottom chart - in grey) on the dollar index and other surveys suggest that this is clearly the consensus.

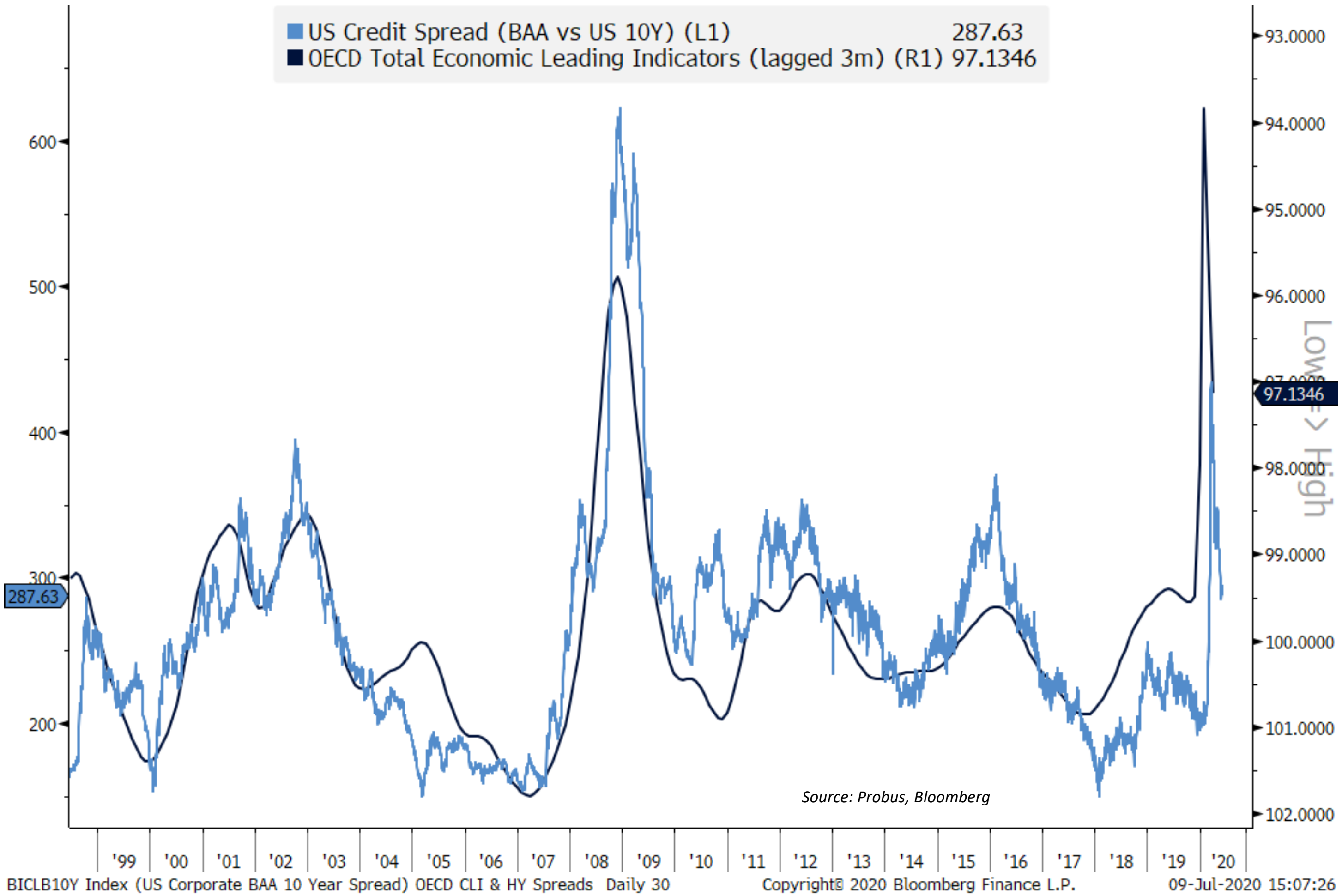
The short term could see further weakness given the positive tone of the market and a retest of the uptrend line around 95 is likely. But the extreme positioning against the dollar has historically been inconsistent with a the beginning of a major decline.





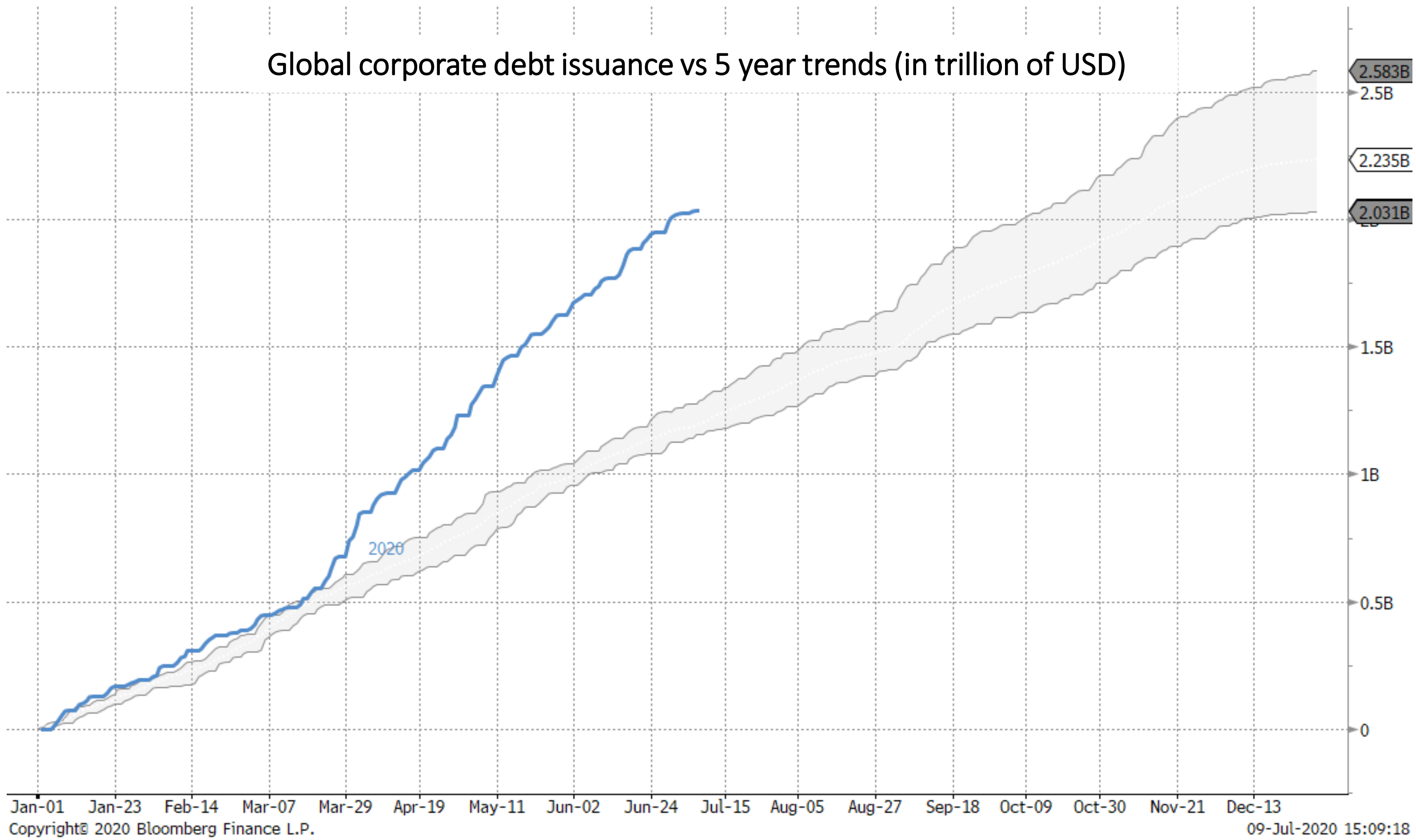
Corporate bond purchases to contain credit spreads

The Fed has taken a significant step by starting to purchase corporate bonds, both investment grade and high yield. While such measures are certainly questionable from a capitalistic and moral hazard standpoint, they have achieved their aim of containing credit spreads. The chart illustrates the historical relationship between economic activity (here proxied by the OECD leading indicator) and US high yield credit spreads.



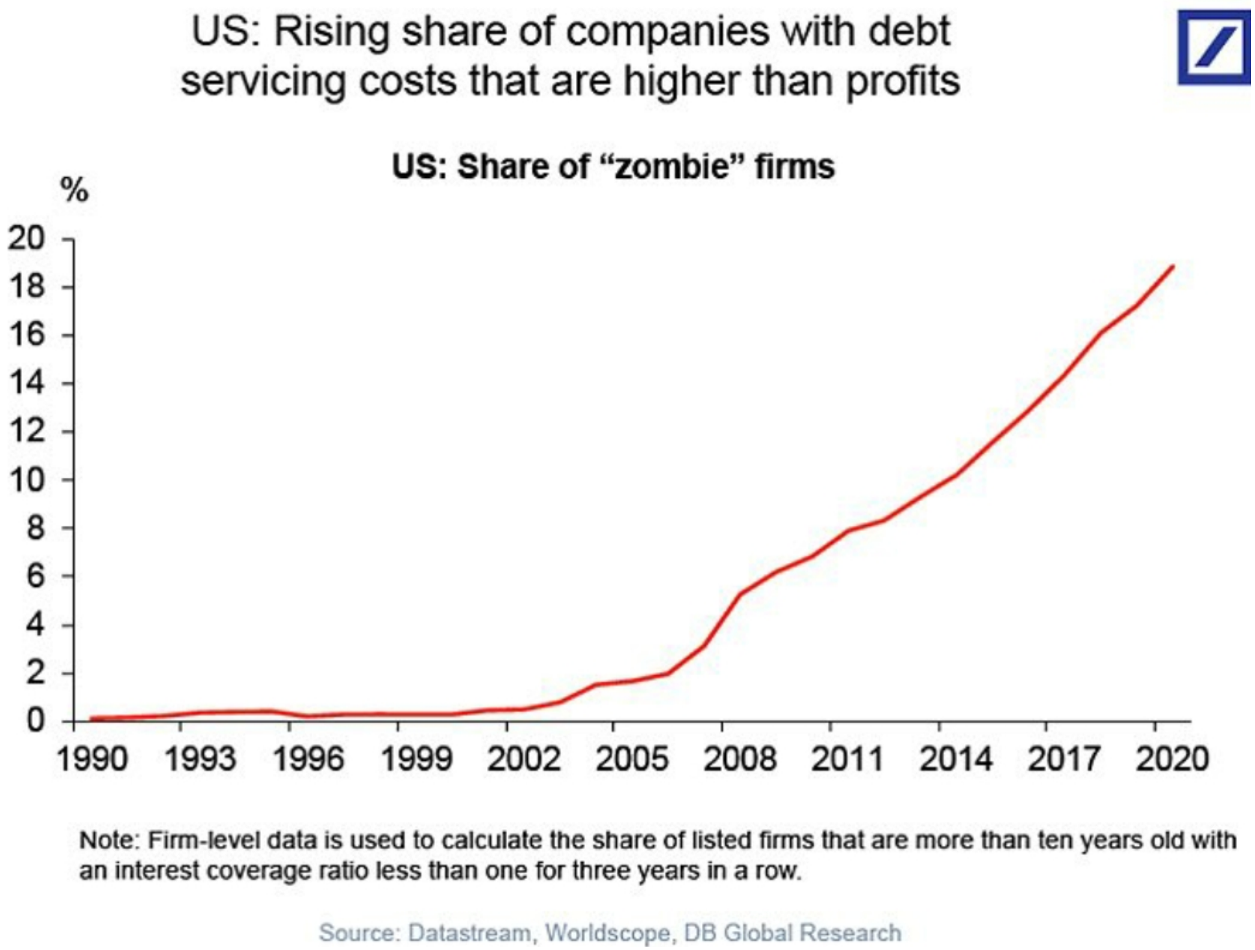
Corporations have gorged on debt to offset falling cash flows

Global corporate debt issuance has outpaced the previous 5-year range significantly, adding USD 2 trillion by mid-year. The pace picked up in March, as the corona crisis spread throughout the world and companies were forced to issue debt to make up for cash flow shortfalls, further weakening their over-leveraged balance sheets. This somewhat explains central banks' urge to maintain rates low.



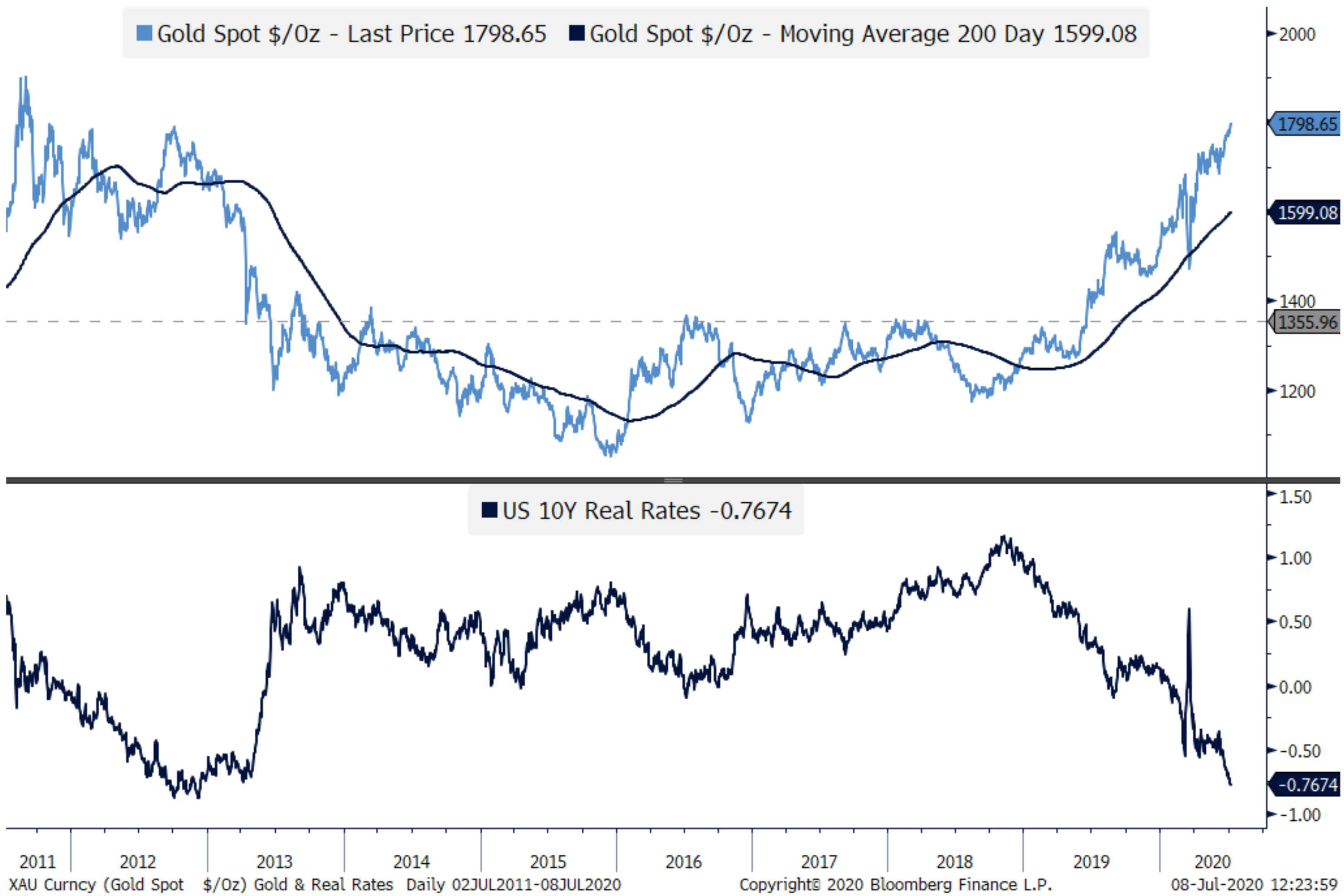
The cost of free money

With central banks committing to zero rates for longer, the share of zombie firms is set to continue on its alarming trend. In addition to wider inequality readings, extra loose monetary policy stops Schumpeterian "creative destruction", effectively keeping zombie firms alive and thereby weighing on economic growth by lowering overall productivity levels.

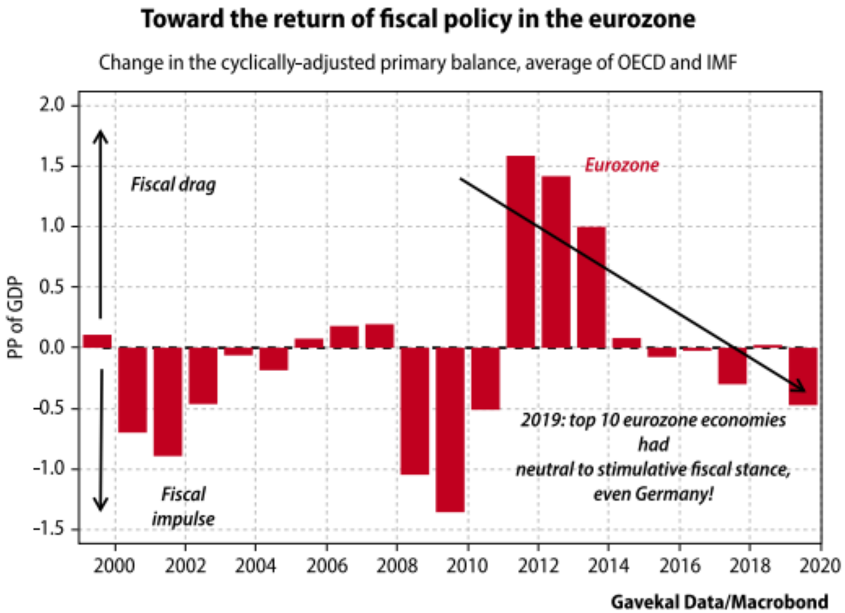


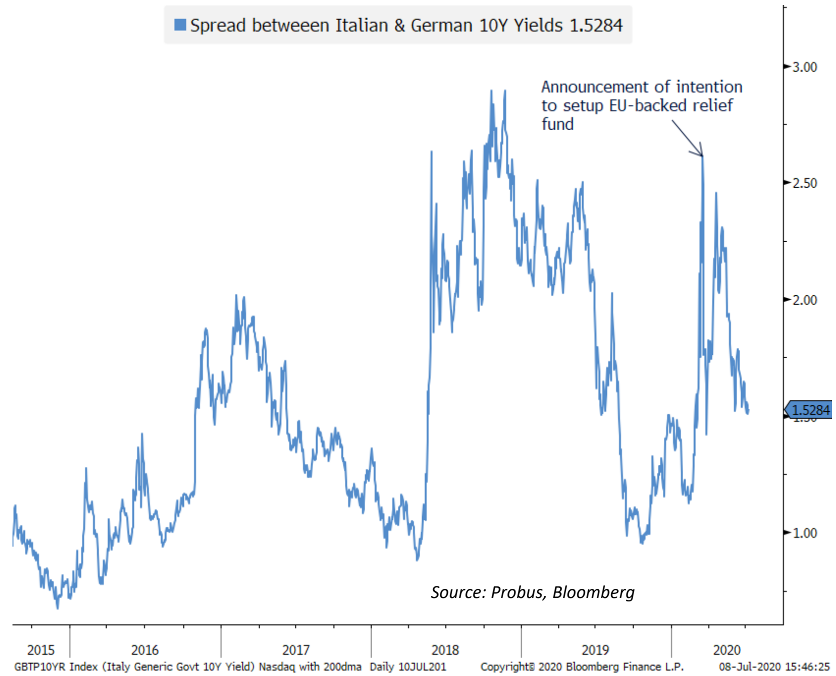
QE-infinity and fiscal largesse continue to favor gold

Central banks and governments have embarked on the largest monetary and fiscal experiments in history and in effect, debasing their fiat currencies against hard assets with more finite supply such as gold. Whether the crisis persists or the massive stimulus pushes financial assets higher, gold (and its miners) should fare well in both scenarios and should be a big part of every investor's portfolio.



EU's minor fiscal package underreports its significance



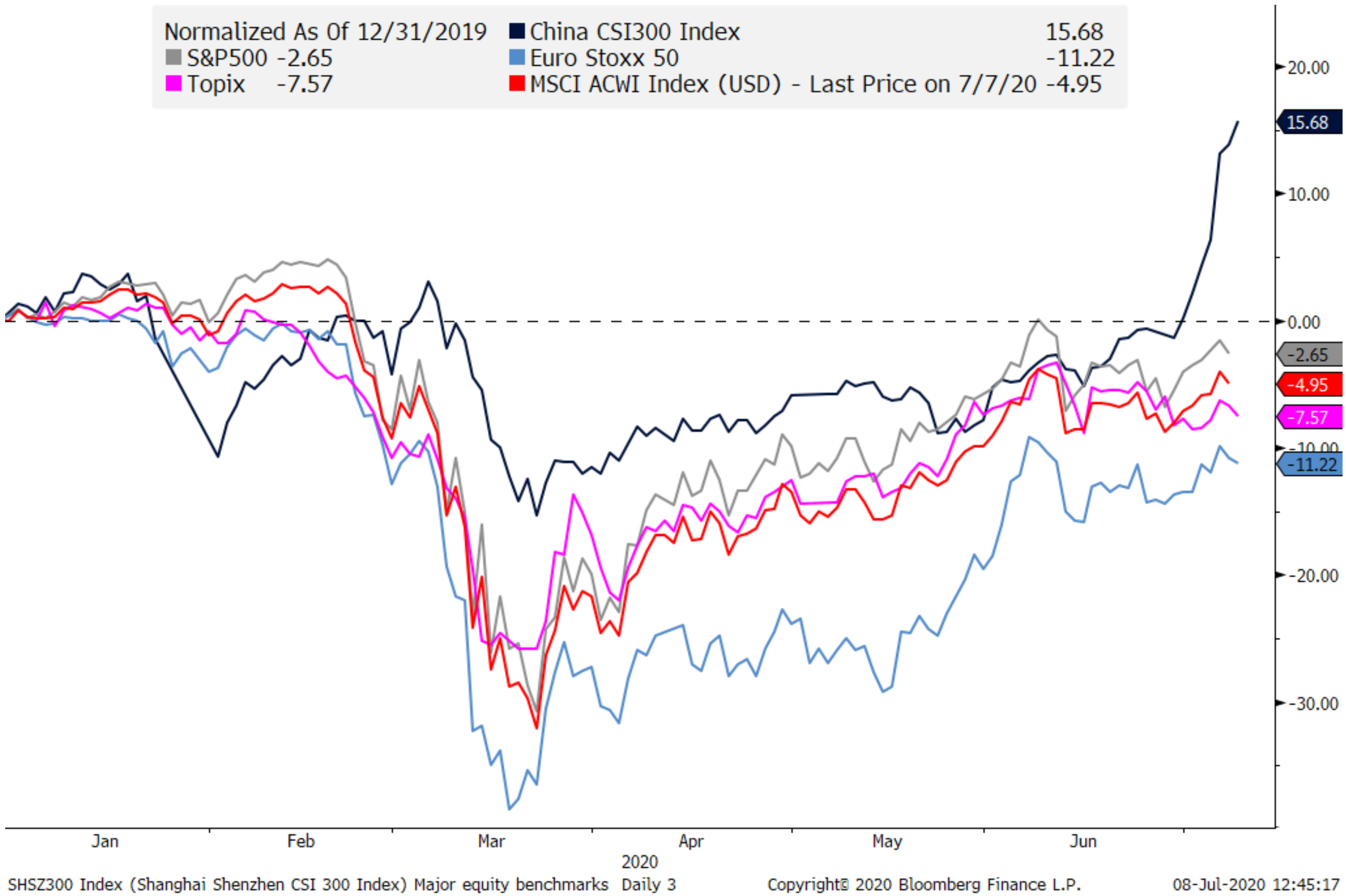


The EU fiscal packages may seem moderate relative to other nations' but they confirm the recent shift away from the austerity policies that had crippled EU growth over the years. Even Germany is giving in to fiscal expansion, recognising the risk posed by the virus and the possibility of rising political tensions.

The initial response to the virus-induced crisis lacked solidarity among EU members, which increased the odds of further political tensions. The Merkel/Macron announcement of a relief fund backed by the EU budget, which still needs to be finalised, is a major step towards fiscal union. This means that support should be granted to the weaker and more badly-hit countries, further integrating EU members. As a result, the spread between Italian and German 10Y yields, a proxy for EU break up risk, has come down significantly. This step towards a fiscal union is also strongly supported by the ECB's monetary policy, giving a lifeline to the EU.

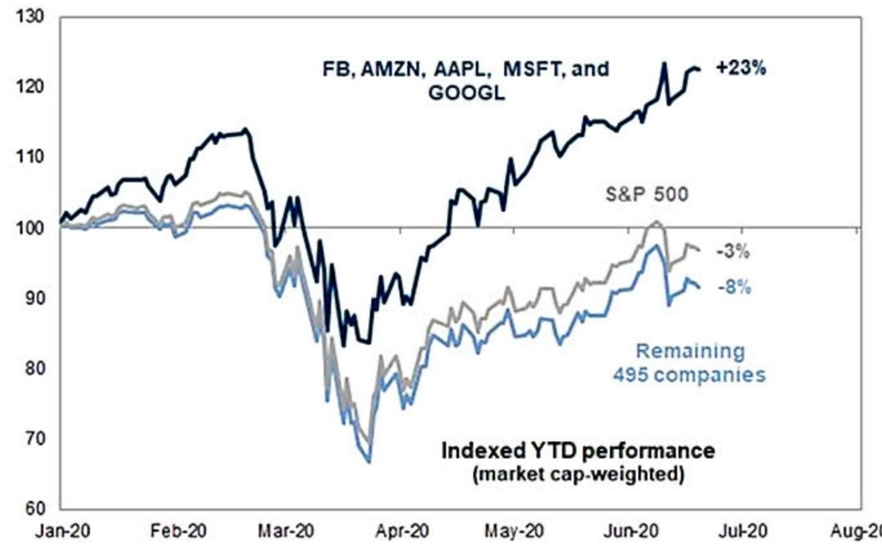
A record-breaking correction and a record-breaking rebound

Equity markets have staged a significant comeback, as economies re-open and activity improves. It is noteworthy that, while the MSCI ACWI is down -4.95%, the index is still down over 9% when excluding the US.



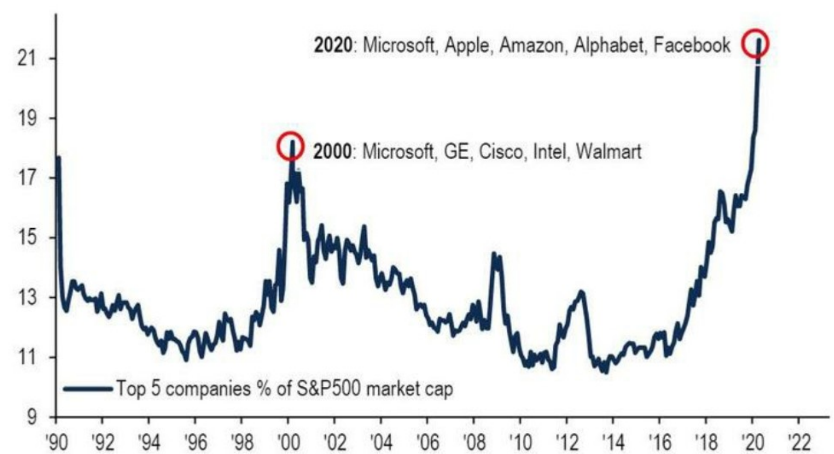
Equity gains have been very concentrated in the US

The divergence between the broad market in the US and the top tech companies is bewildering. Extracting the performance of the top 5 market caps gives a much less rosy picture.



source: Goldman Sachs

Chart 2: S&P500 now more concentrated in the 5 largest stocks than ever

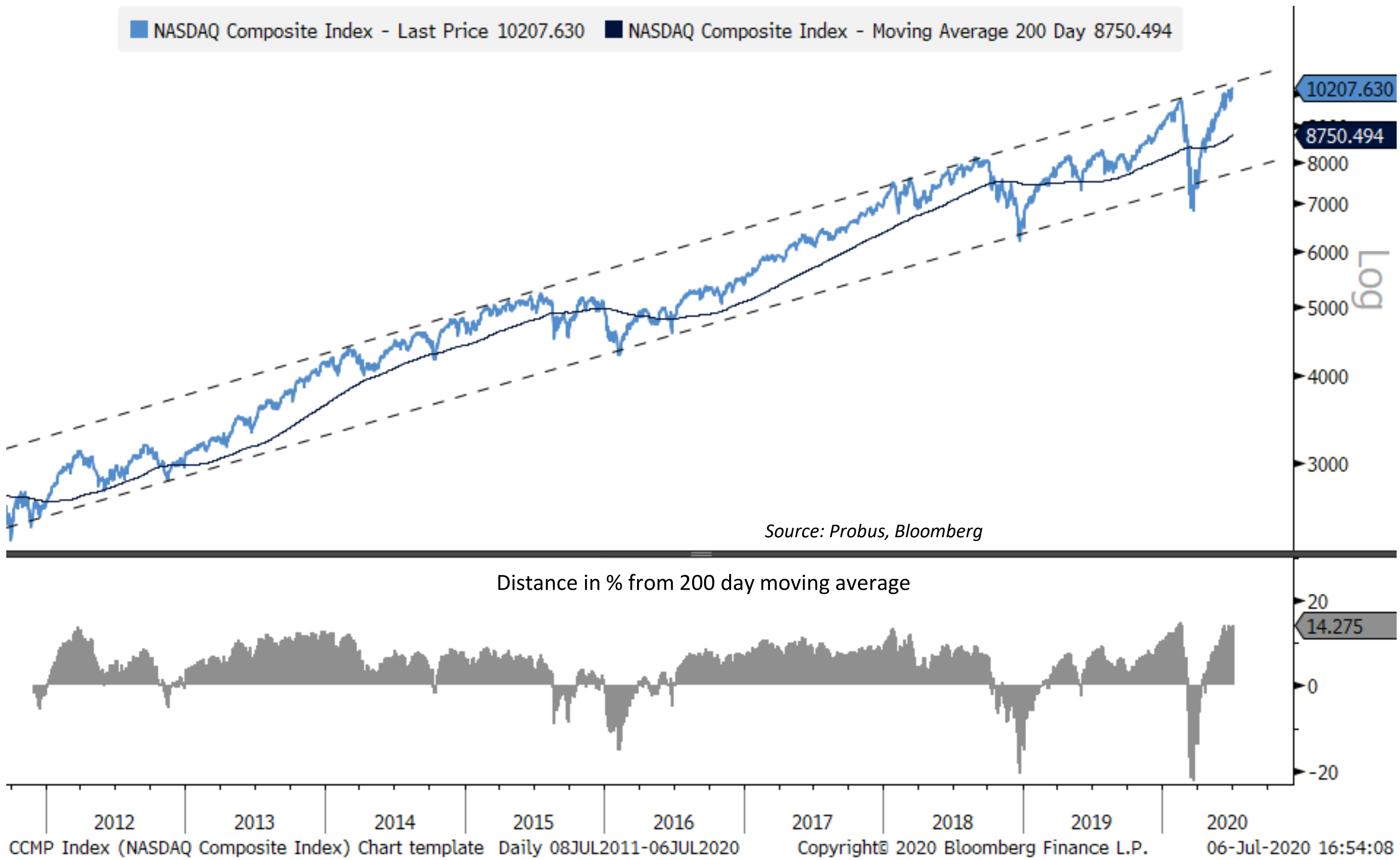


Source: BofA Global Investment Strategy, Bloomberg

As a result, the index is more concentrated than it was in 2000. According to Factset, the top 5 companies account for 21% of the S&P500's market cap, compared to 14% in 2000. It is noteworthy that those 5 companies also account for 21% of the index' free cash flow (vs 2% in 2000). However, this degree of concentration is an ominous warning sign and is unlikely to persist.

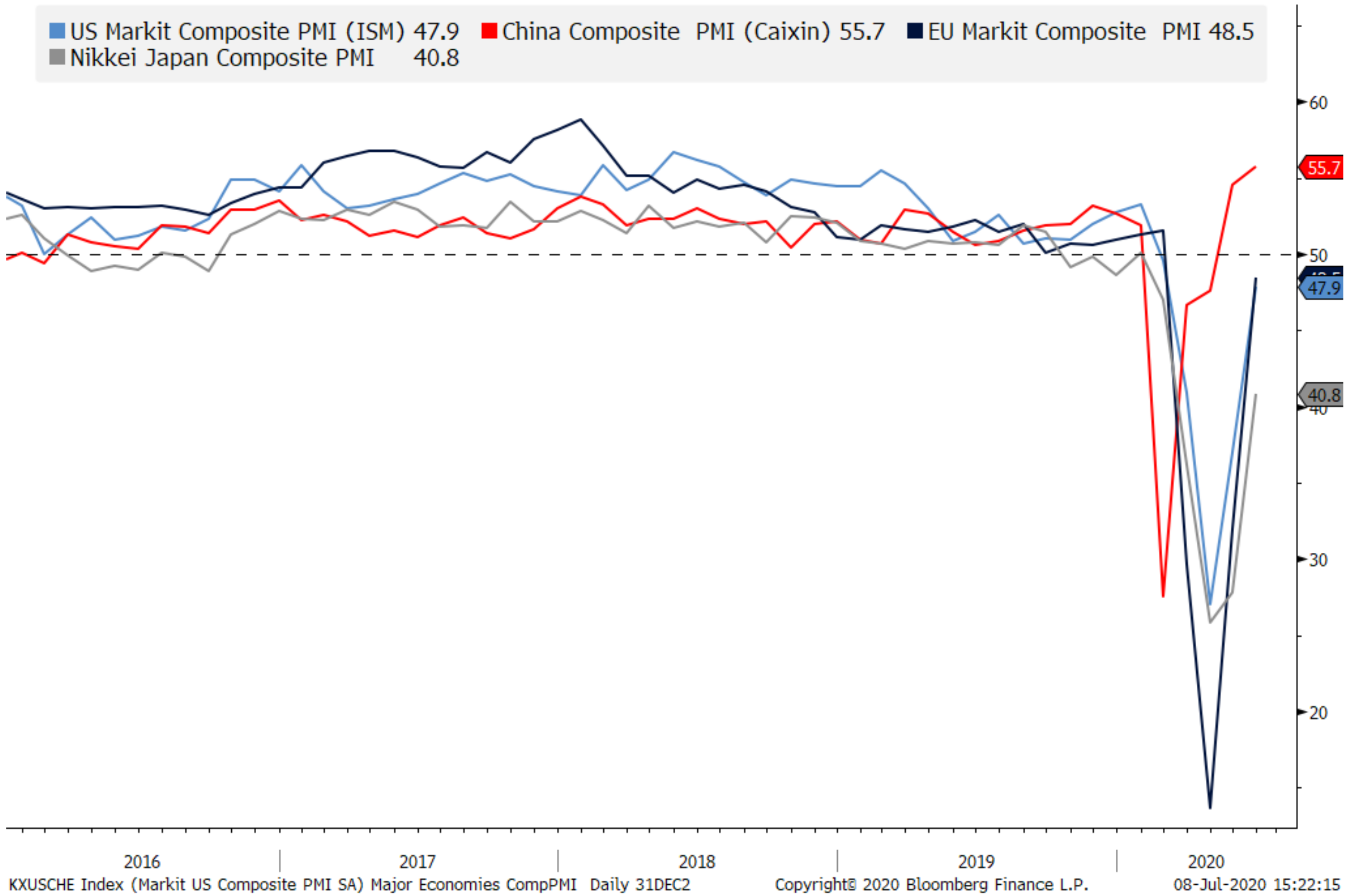
Nasdaq hitting major overbought territory

The strength of the Nasdaq has been mind-blowing and there is no telling when it will end. There are multiple signs suggesting that the rally is overextended; the index is against the upper band of its 10-year channel and is trading close to 15% above its 200-day moving average. Both have preceded at least minor pullbacks in the past.

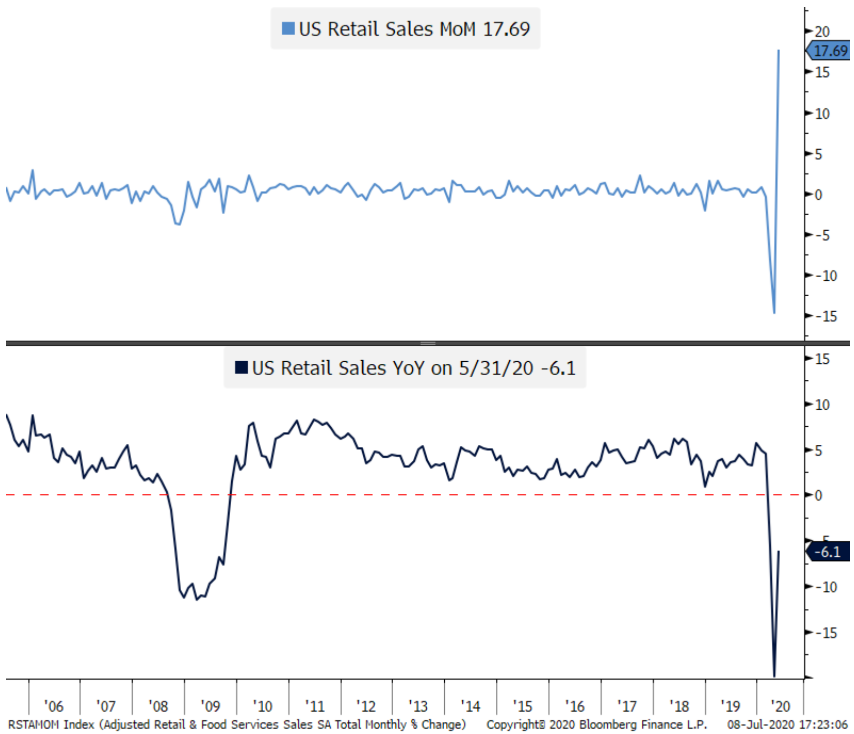


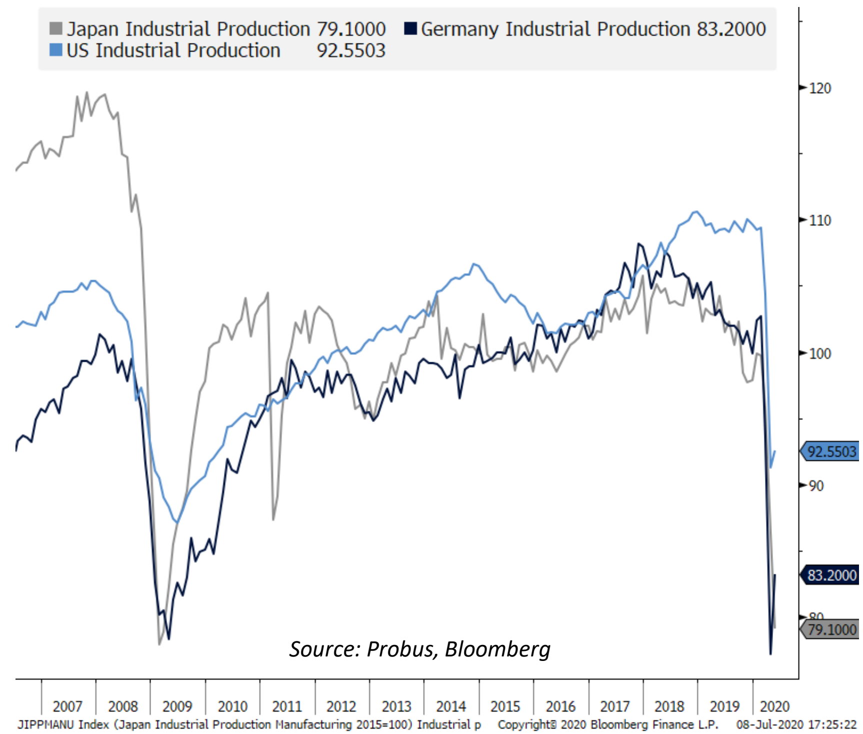
Economic activity rebounds from the March/April standstill

Market sentiment is buoyed by the pick up in PMIs, taking them as a sign that the recovery will be swift. However, PMIs simply show whether the activity is improving or not vs the previous month…A pick up from March/April lows was inevitable but what matters if whether economic activity can get back to 2019 levels.



Month over month changes mask the absolute levels of activity

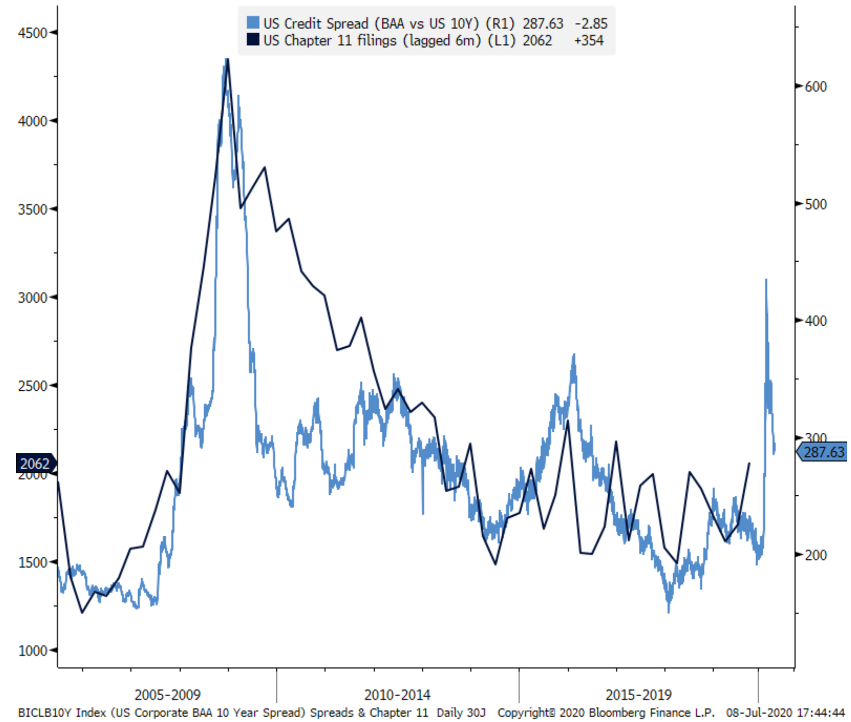


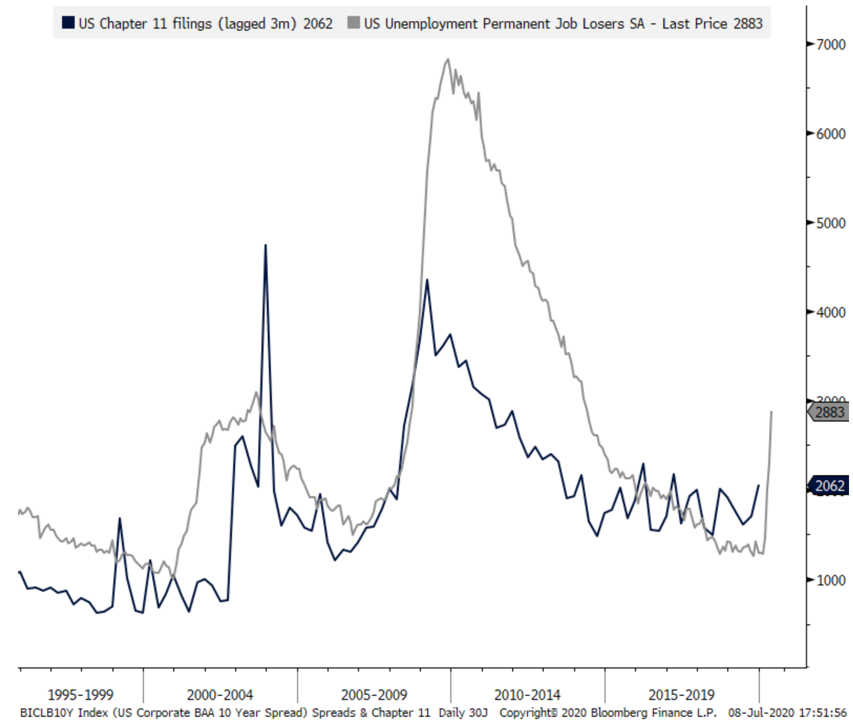


The combination of lower spending, increased unemployment benefits and stimulus checks have supported household income and allowed retail sales to rebound significantly from the April bottom, blowing out even the most optimistic expectations in the US and certain EU countries.

Month over month changes from March/April to the May rebound appear dramatic and make the headlines, but data needs to be observed on a year over year basis to truly understand the depth of the virus' impact. As can be seen on the chart on the left, US retail sales remain significantly lower than last year. Looking at industrial production levels across developed markets gives a similar picture (right chart).

Avoiding bankruptcies at all cost



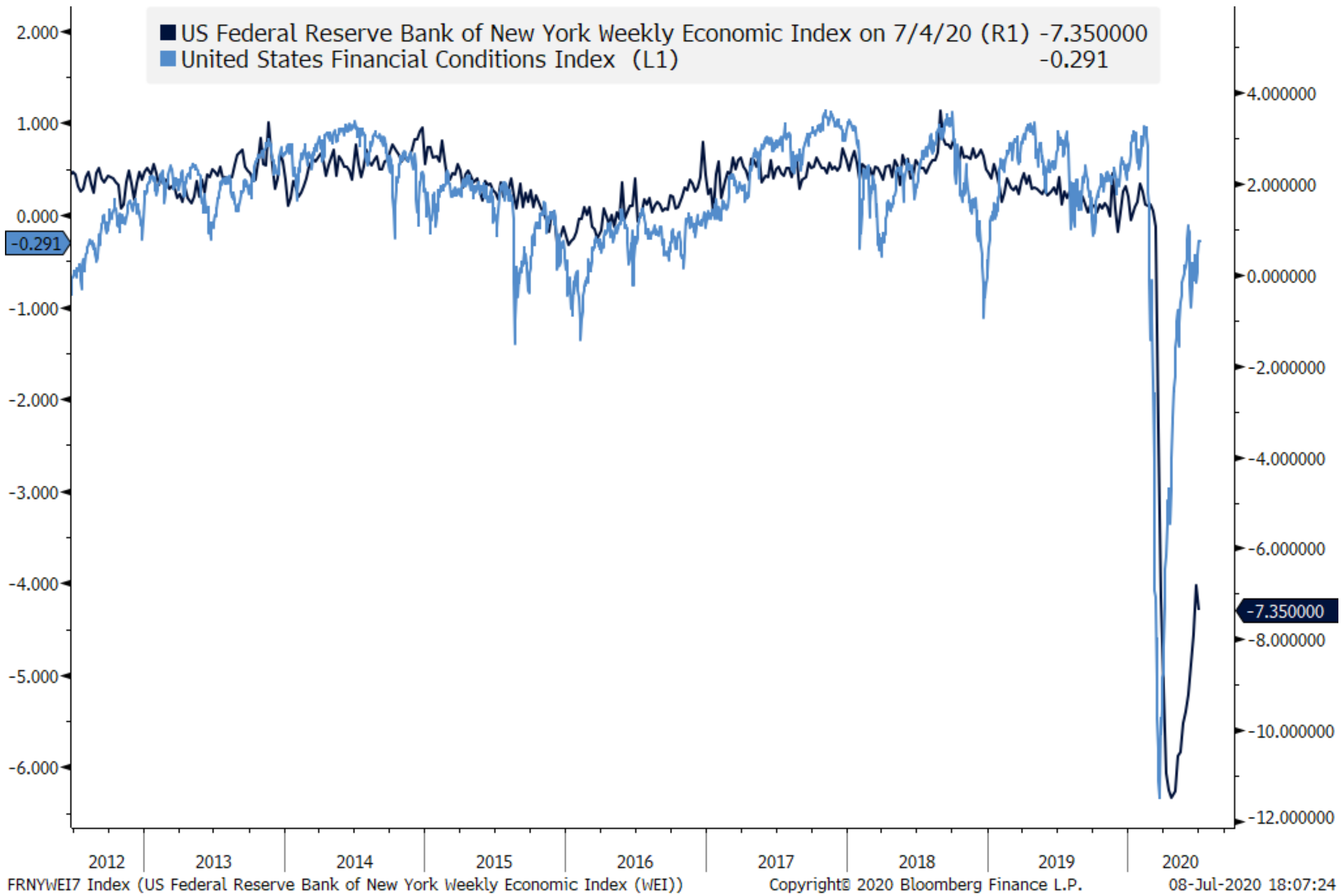


Whether consumption and broad economic activity can continue their rebound will depend on how quickly people can get back to work, which in turn will depend on the number of bankruptcies. Of course, that is assuming that governments will withdraw their income substitution measures…The chart on the left shows that US credit spreads have a tendency to lead bankruptcy filings by 3 to 6 months. This somewhat explains the Fed's extreme involvement in credit markets (notably through corporate bond purchases) to lower financing costs.

Initially, the increase in unemployment was classified as temporary, as companies were supposed to rehire laid off workers. But as the chart on the right illustrates, permanent job losses are on the rise, confirming that bankruptcies are accumulating.

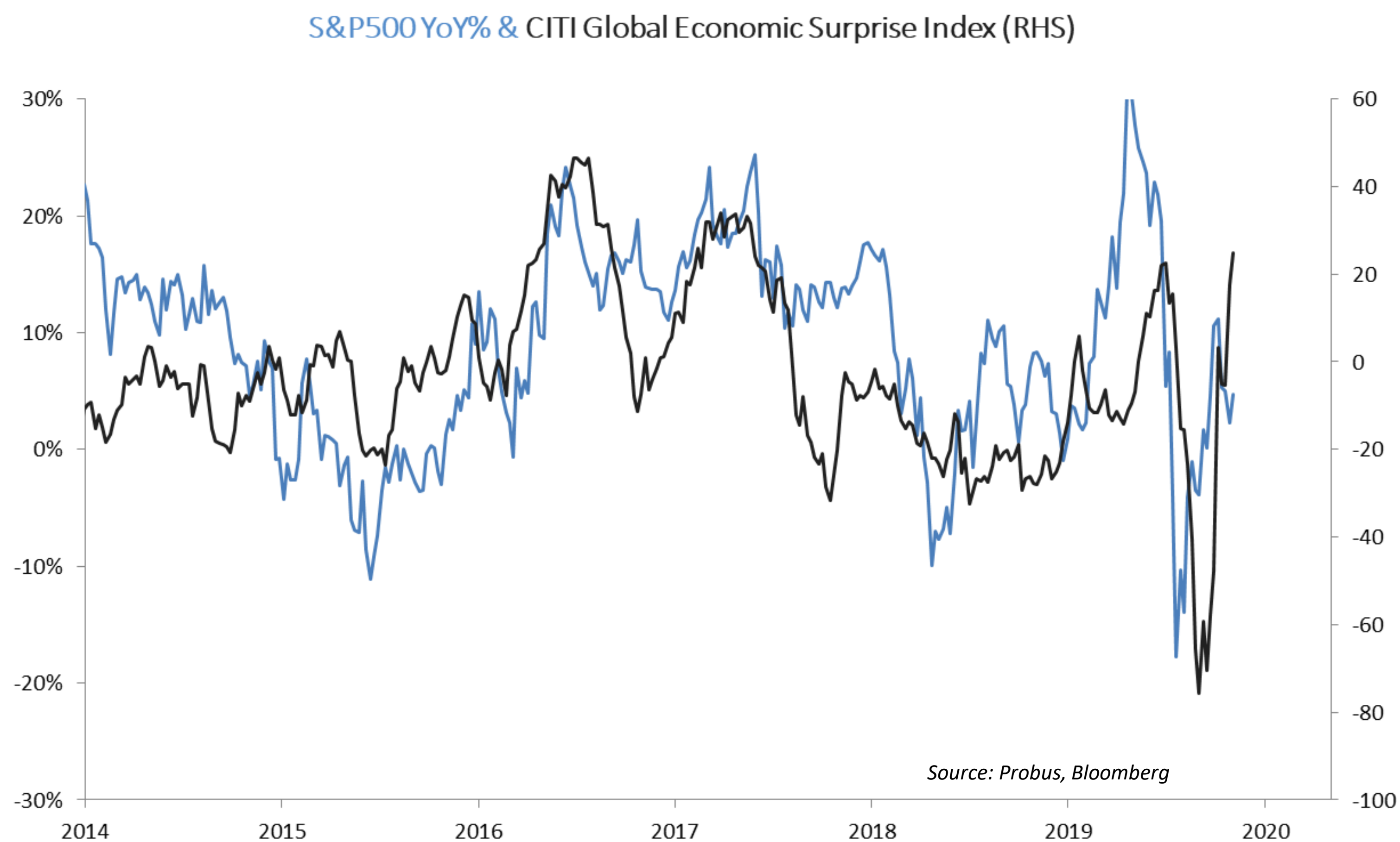
Economic activity vs financial conditions

The dichotomy between economic data and markets is well advertised. Its magnitude however remains sobering, as is shown below by the gap between US financial conditions, which directly influence markets, and the Fed's weekly economic indicator. The hope is that these loose financial conditions rapidly feed through to the real economy.



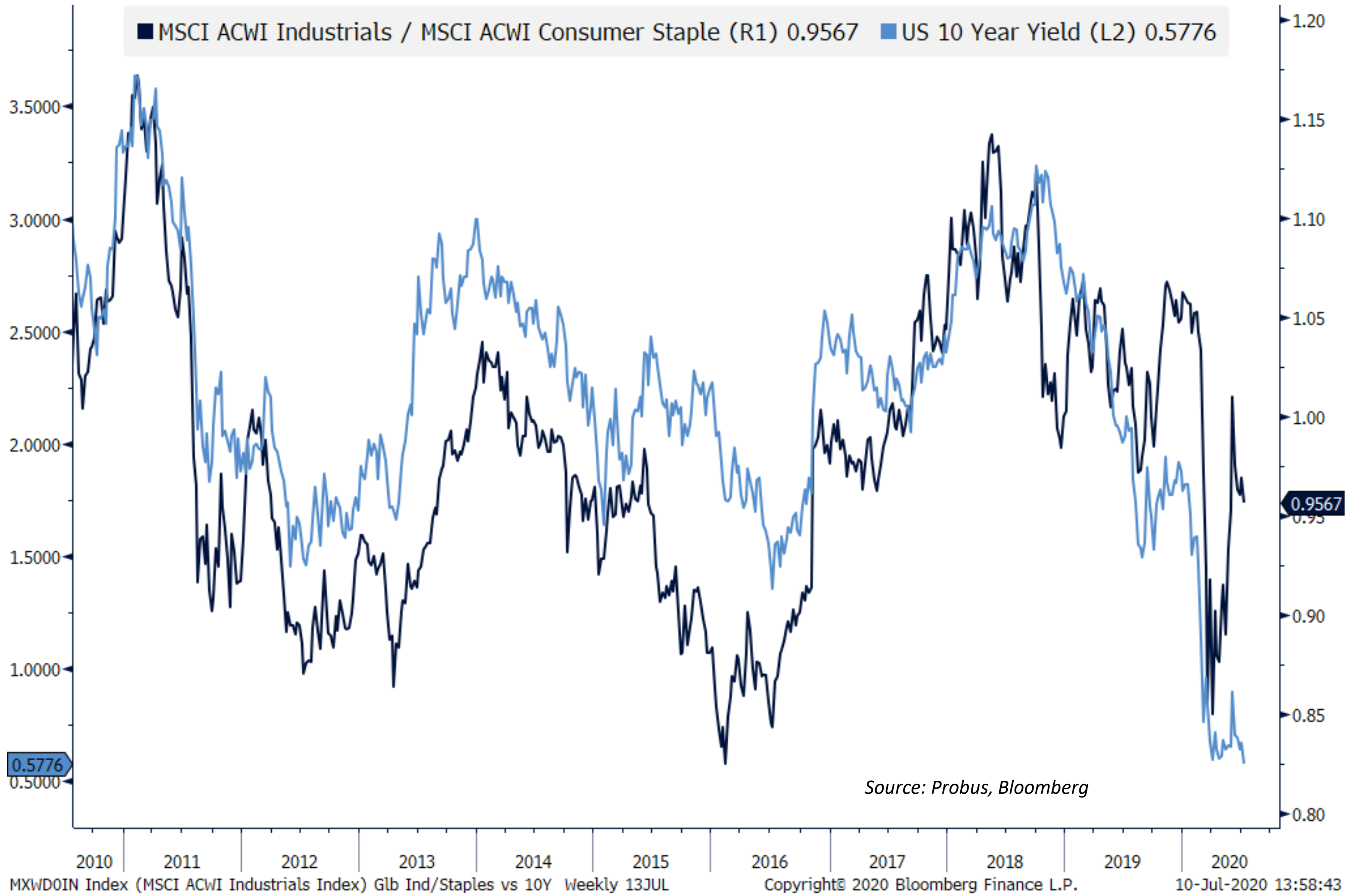
The scope for continued positive surprises is narrowing

Although economic activity remains weak on an absolute basis, positive surprises (rising dark line) due to overly pessimistic expectations have contributed to rising equities. As hopes of a swift recovery is becoming the consensus, the scope for further positive surprises narrows and the pressure falls on strong economic data to live up to the revised expectations, in order to sustain this increasingly stretched rally.

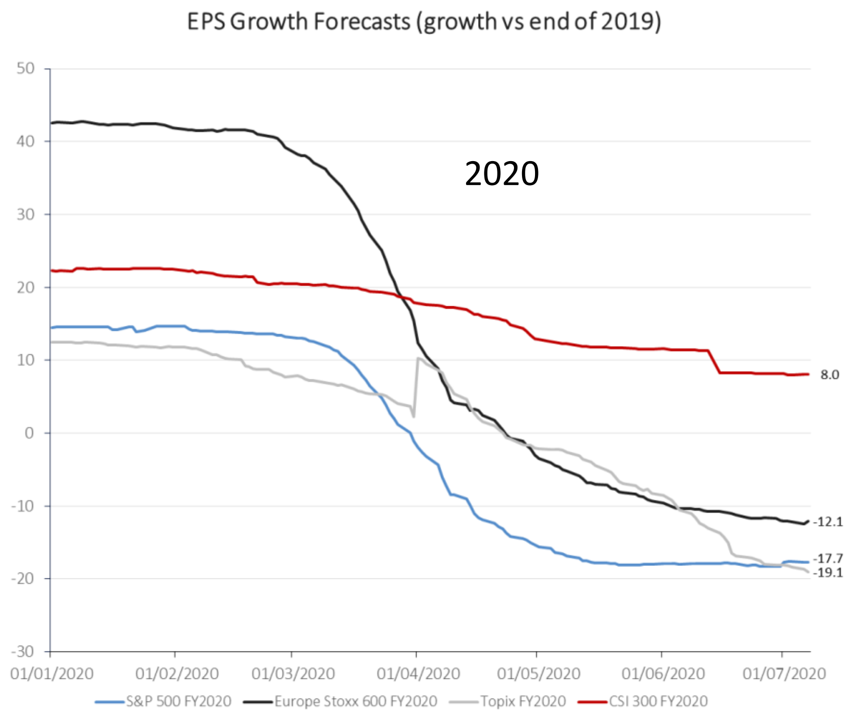


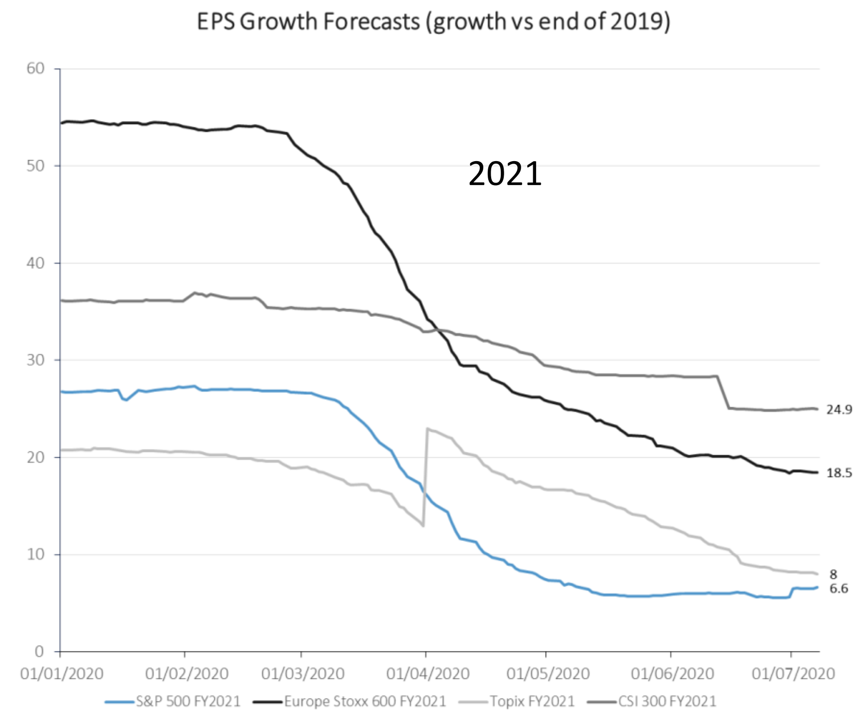
Bonds do not confirm the recovery narrative

Bond yields are not confirming the recovery narrative conveyed by equities. The recent outperformance of industrials vs defensives (dark line rising) is in stark contrast to bond yields, which keep grinding lower. A reversal in yields would be necessary to give credence to a potential cyclical upturn.



EPS estimates remain optimistic for 2021



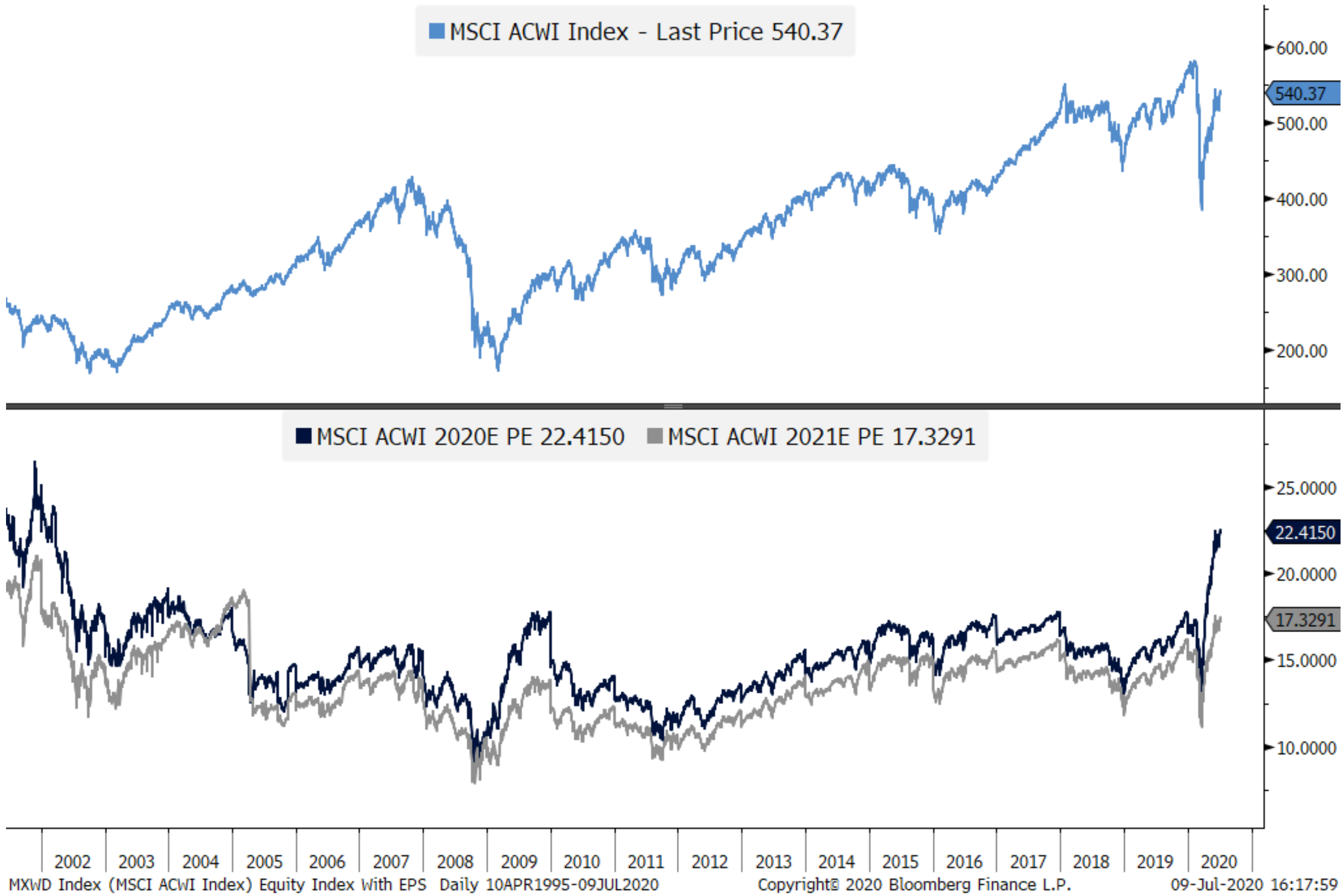


Earnings growth expectations have been drastically revised lower for 2020. For example, from 15% growth to almost 18% contraction in the US and from over 40% to a 11% contraction in the EU. This seems appropriate given the amount of economic damage.

However, the consensus expects a dramatic EPS recovery in 2021, ending the year 6.6% higher than in 2019 (30% higher than in 2020) in the US and 18.5% higher in Europe.

Valuations pricing in best case scenario?

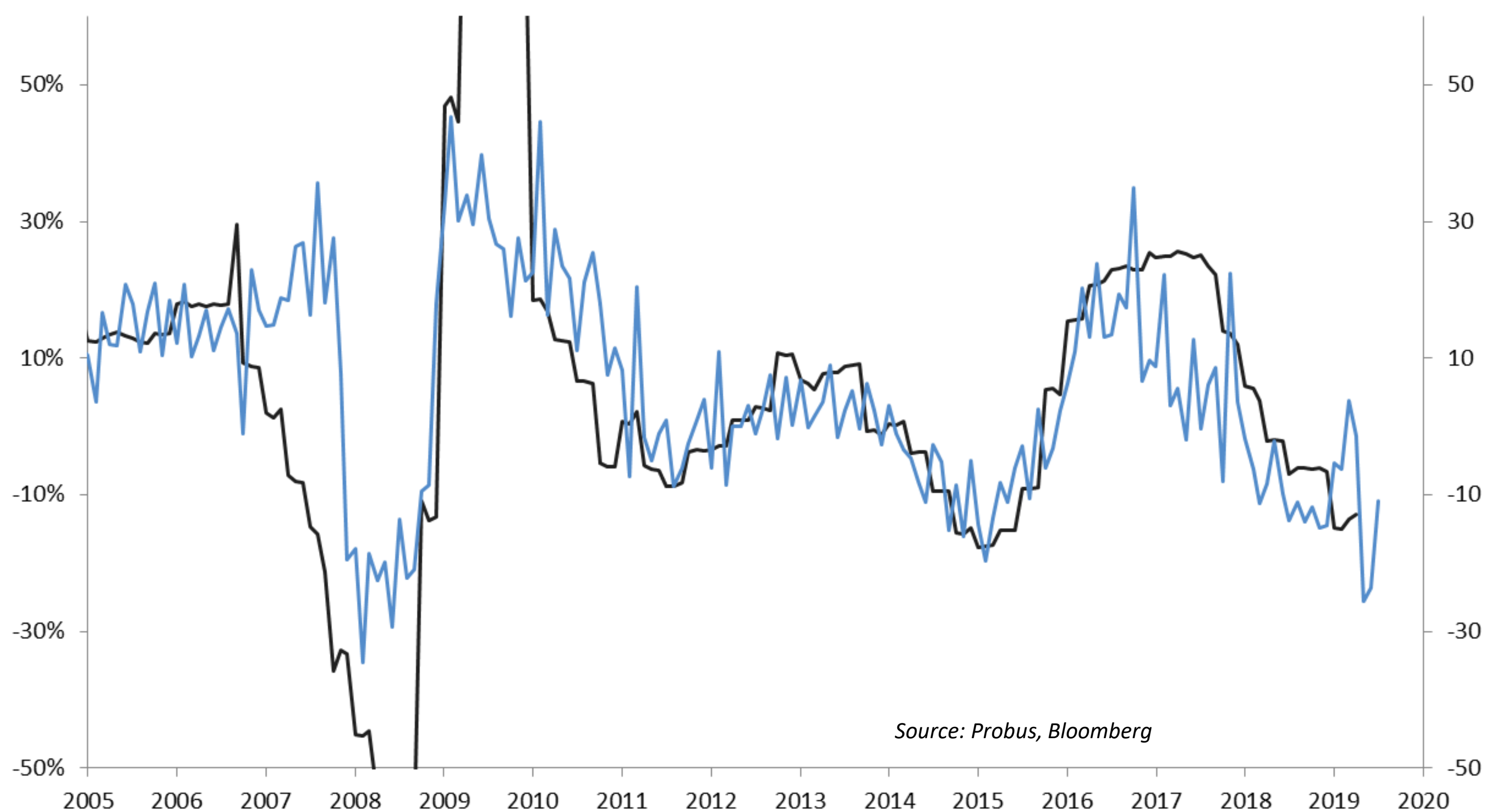
With 2020 and 2021 estimated PEs at eye-watering levels, the market is pricing in a significant earnings recovery. While a possibility, this best case scenario seems to be fully priced in; the upcoming earnings season (especially guidance from management) will be an important test for the market's rise.



South Korean exports don't give much hope for a strong rebound

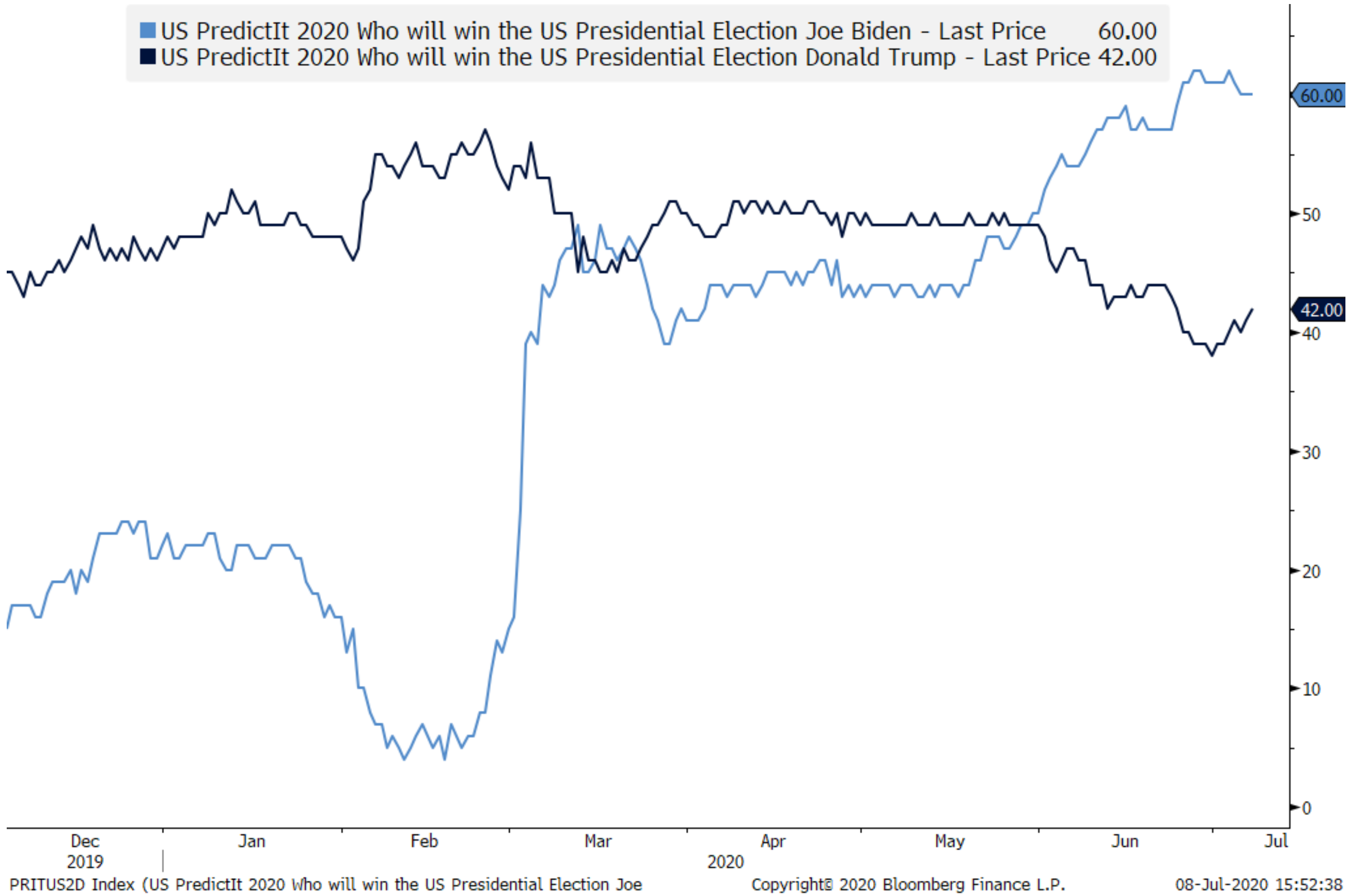
Thanks to their broad spectrum (autos, petrochem, IT equipment, semis, ships, etc), South Korean exports are a good bellwether for the state of the global economy. The chart shows that they have a 3 to 6-month lead on the EPS of the MSCI All Country World Index. Exports contracted by -10.9% in June, confirming the pick-up from -25.5% in April and -23.6% in May, but remain very depressed and suggest continued EPS weakness.

MSCI ACWI T12M EPS YoY% & South Korean Exports YoY% (advanced 6m)

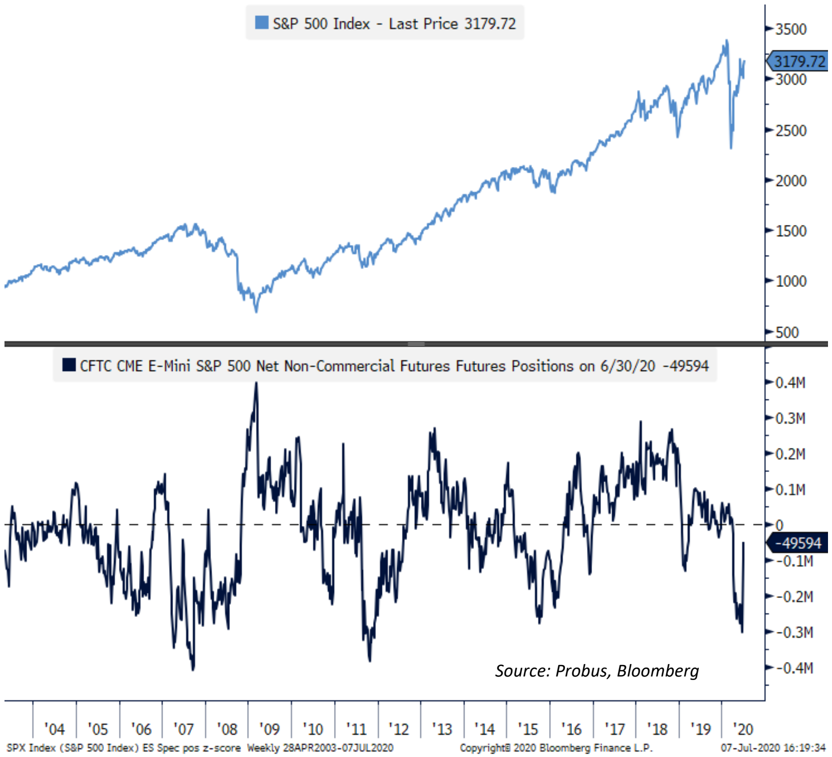


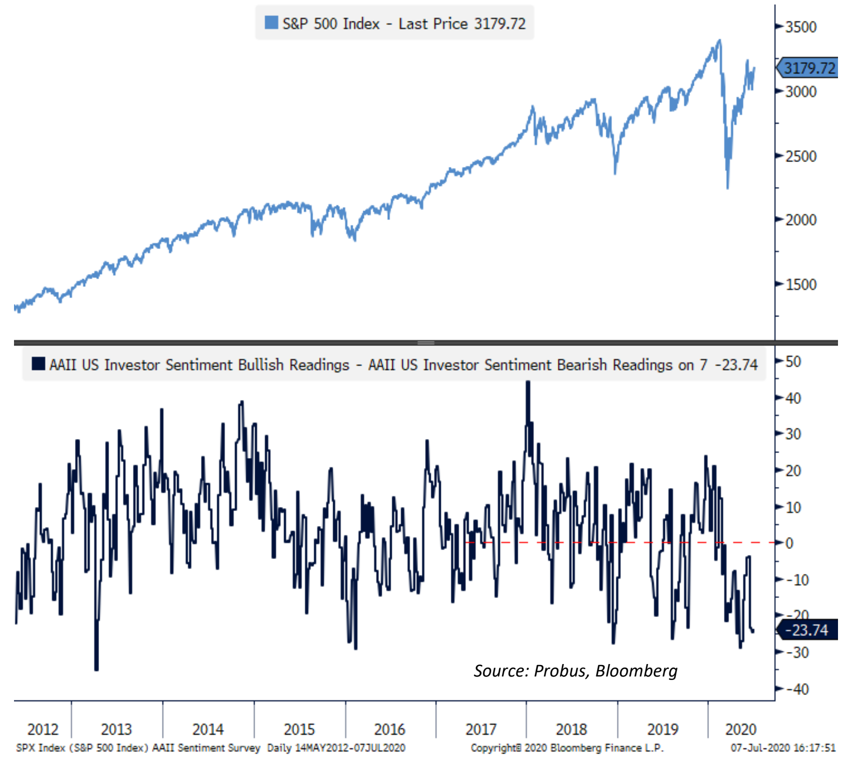
Political tensions are creeping up in the US

According to PredictIt, an online polling platform for financial and political events, Biden has taken a clear lead over Trump for the US election. Equity markets appear remarkably complacent about the risk of a Biden presidency. As elections grow closer, the market is likely to wake up to this risk. Goldman Sachs estimates that tax reform could push EPS lower by 12% in 2021.



Sentiment has been extremely pessimistic for professional investors



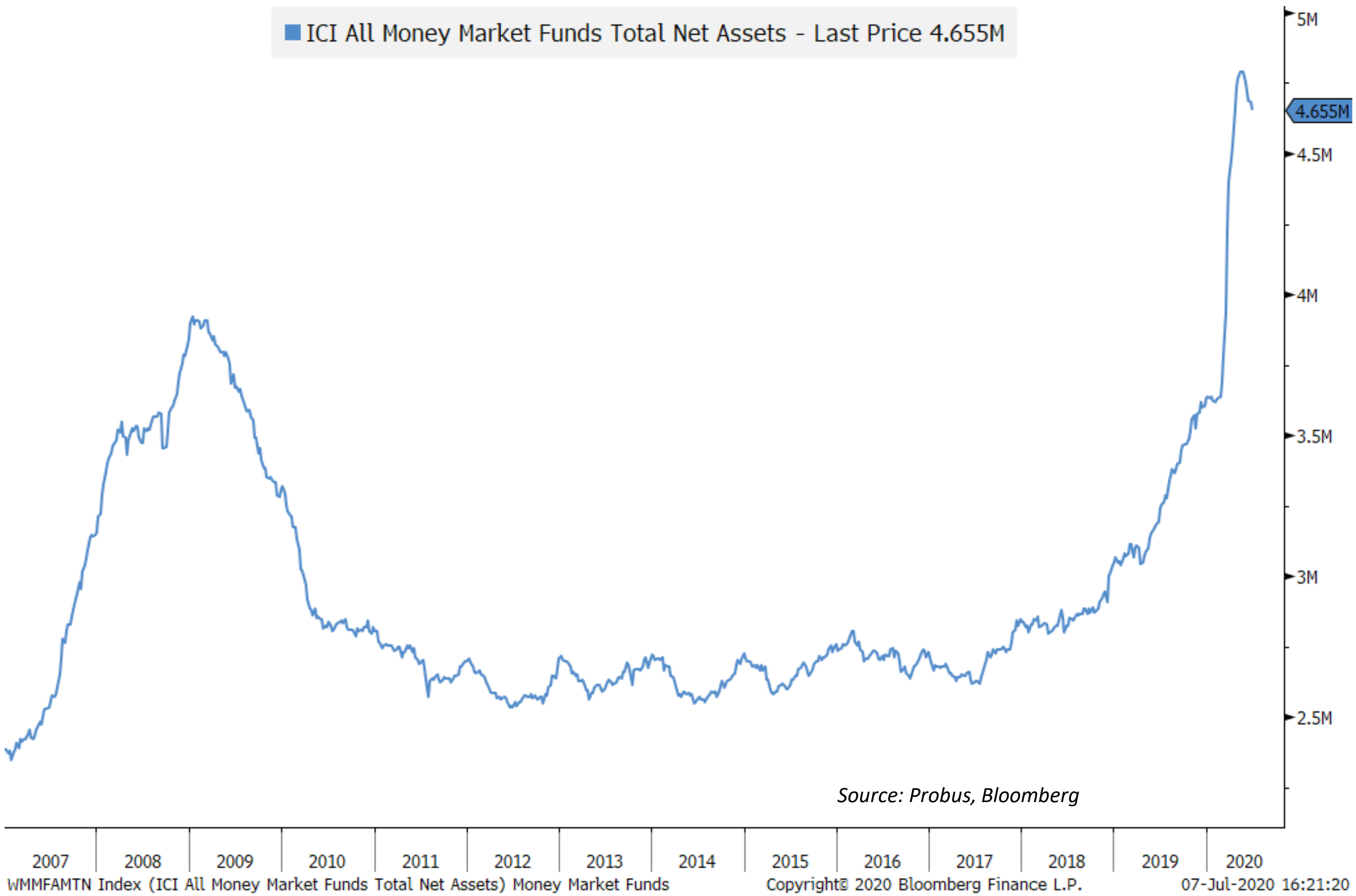


The difficulty of buying into the recovery narrative has been a common theme among professional investors, with pessimism remaining extreme throughout the rebound. This can be seen in many ways, such as the short positioning on S&P500 futures (left chart) or the AAII sentiment readings (right chart). Markets have a tendency to feed on pessimism, as the enormous amount of cash on the sidelines (see next slide) can be activated when investors give up on the bear case and adopt the money supply narrative (see slide 31).

The latest CFTC futures positioning data shows that shorts have been covered aggressively over the past two weeks. As positioning becomes more neutral, odds of a healthy correction increase.

Pessimism and lots of cash on the sidelines

The staggering amount of cash on the sidelines will have to find a home at some point and this is a key argument for many bulls. However, this picture is distorted by the fact that yields are at historic lows even in the US now, making holding cash somewhat more attractive than long term bonds. This does however suggest that alternatives such as gold, real estate and EM debt could see disruptive inflows.

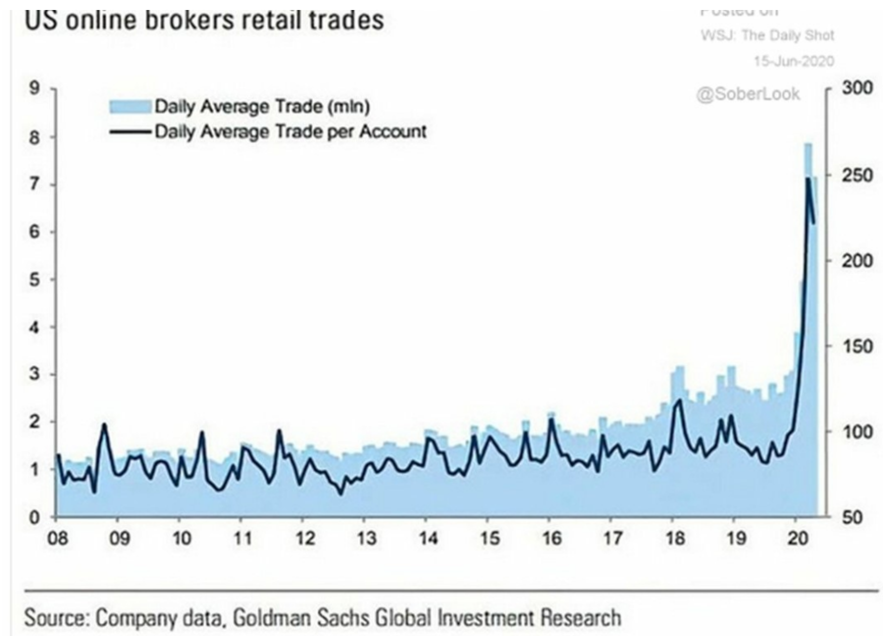


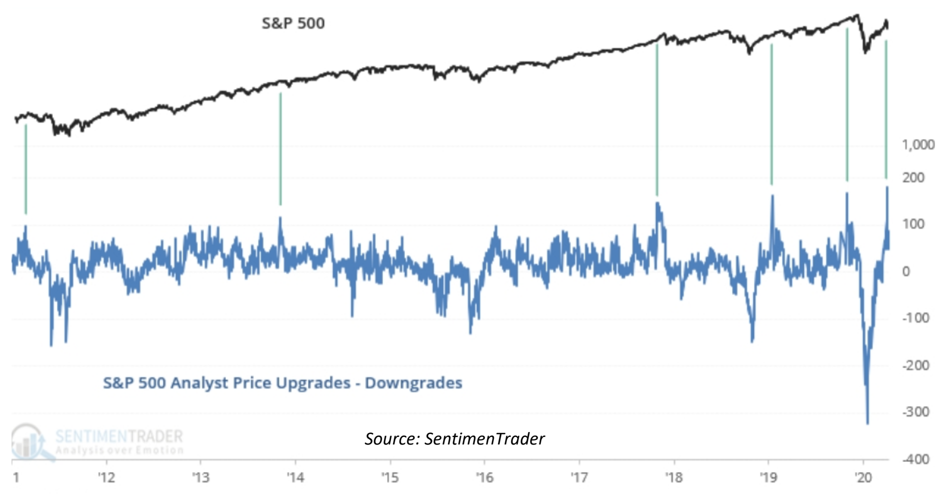
Retail investors are partying like it is 1999 – and they were right!

While professional investors have remained very cautious throughout this rebound, retail investors have jumped in the market in record numbers. This is one of the few signs of exuberance seen in the markets today.

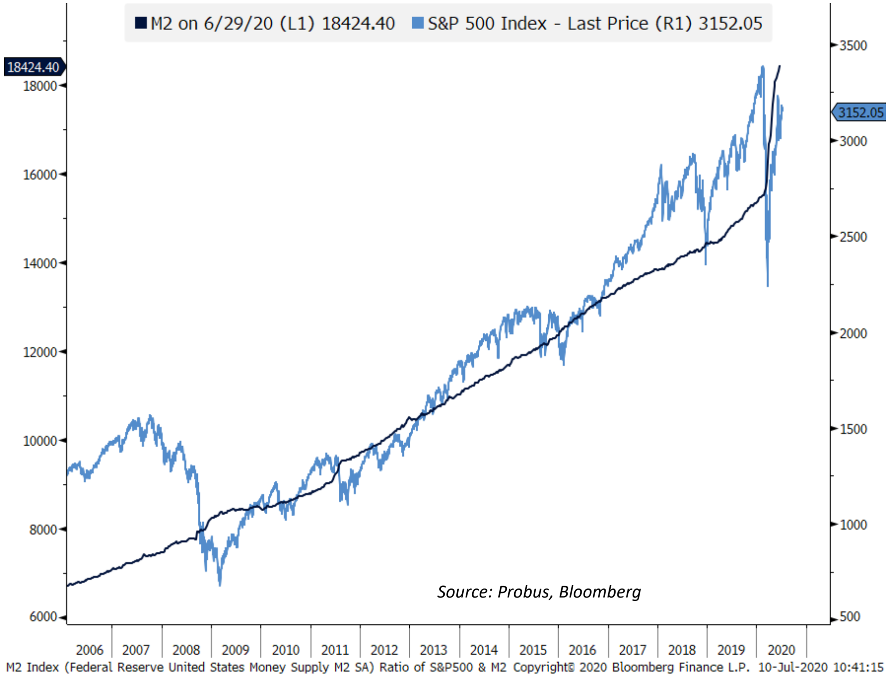
Another sign that bears are capitulating is the fact that the put/call ratio is back to levels showing that protection against downside risk is not on investors' minds anymore. Historically, this is when protection has been required.

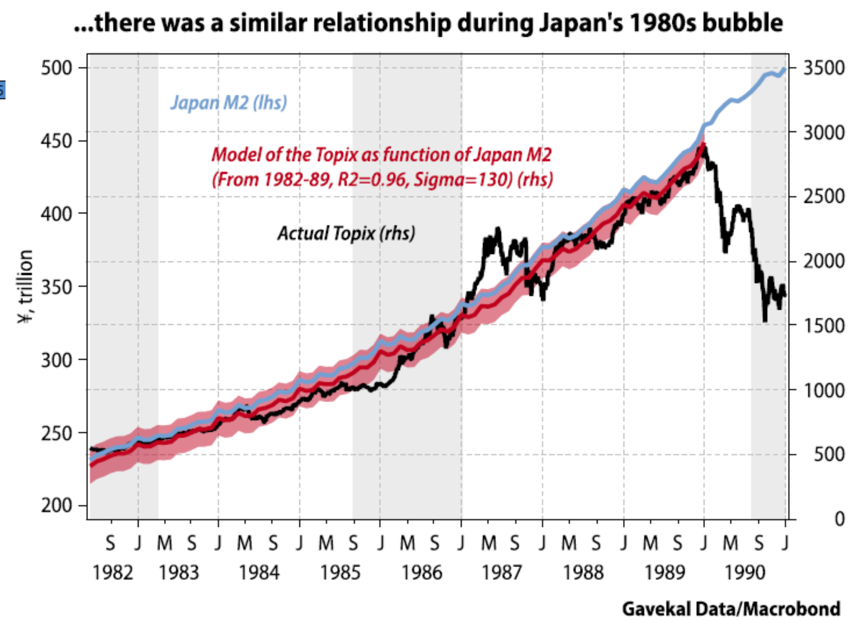
Analysts are upgrading their S&P500 price targets in record numbers. This is in stark contrast to their extreme downgrades 3 months ago. Historically, such extremes in analyst projections should be taken as contrarian indicators, even though in the short term it can trigger further flows within banks.





The money supply narrative



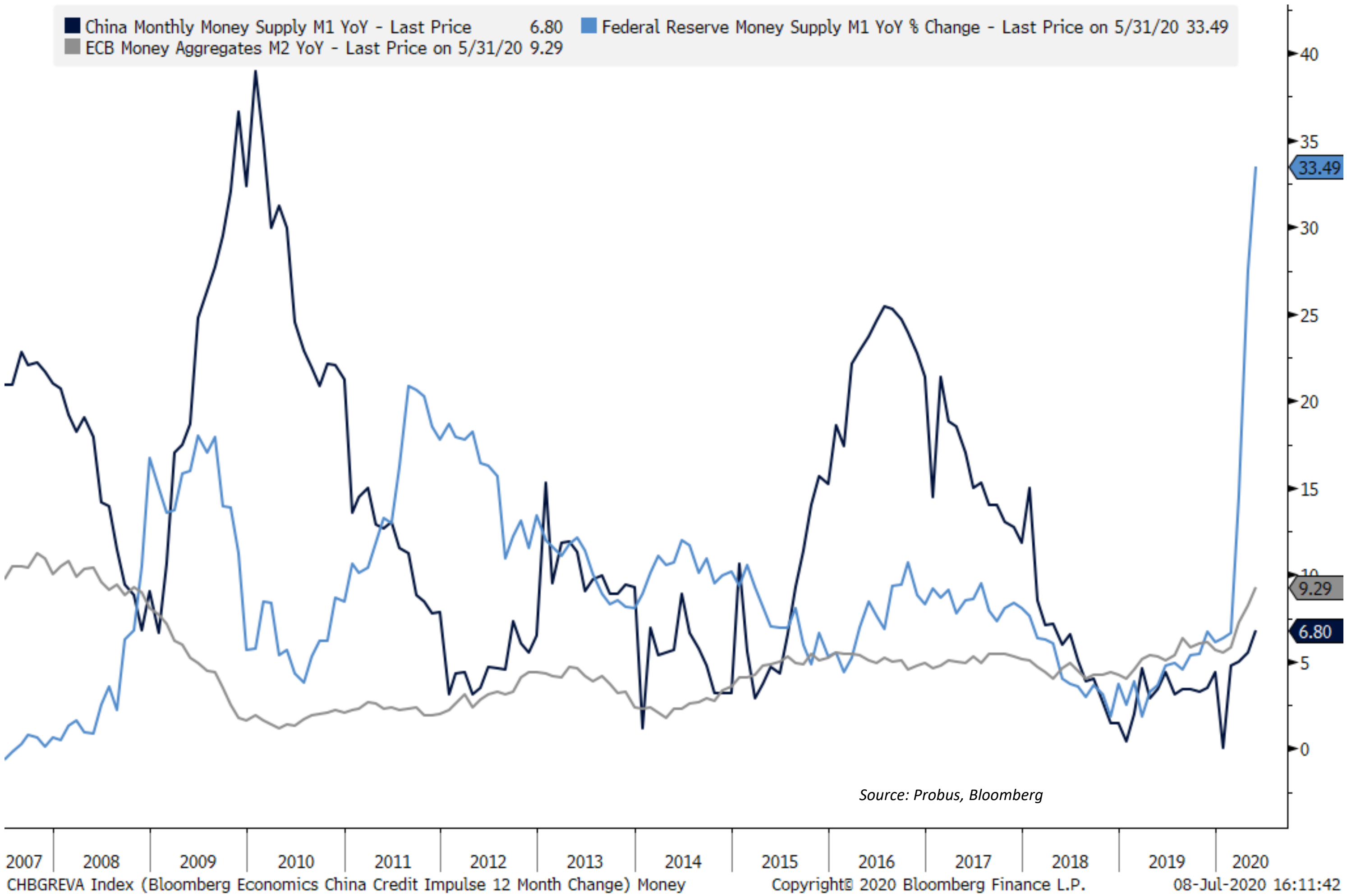


The argument of rising equities due to rising money supply is very compelling and is a big part of the current narrative. This intuitively makes sense, as money supply represents potential demand and the value of existing assets represents supply.

In fact, the correlation between money supply (M2) and the S&P 500 has been very high over the last 10 years, making it seemingly and iron clad rule. However, a similar relationship existed in Japan between 1982 and 1990, at which point the credit bubble burst and the relationship broke. Increases in money supply failed to prop up equities from that point onwards. A clearer view of whether the economy will recover swiftly from the recent shock is therefore necessary to invest based on this relationship.

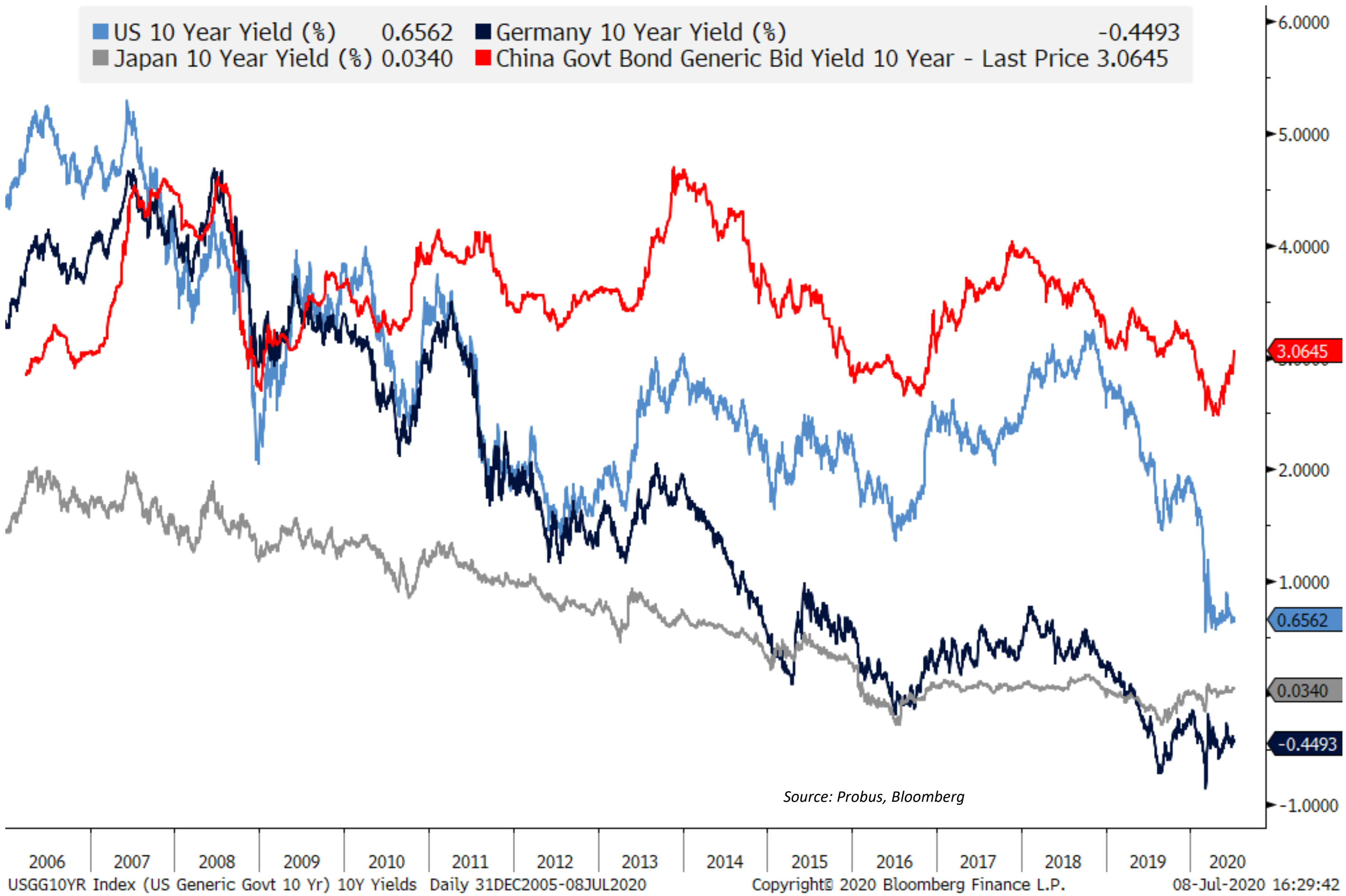
Contrary to developed markets, China’s response has been moderate

Contrary to 2008 or 2016, when China stimulated the global economy through massive increases in debt and spending, the government has kept its monetary and fiscal response very targeted through bank loans, minor rate cuts and mostly infrastructure projects. China therefore still has some ammunition, should the situation deteriorate or tensions flare up with the US.



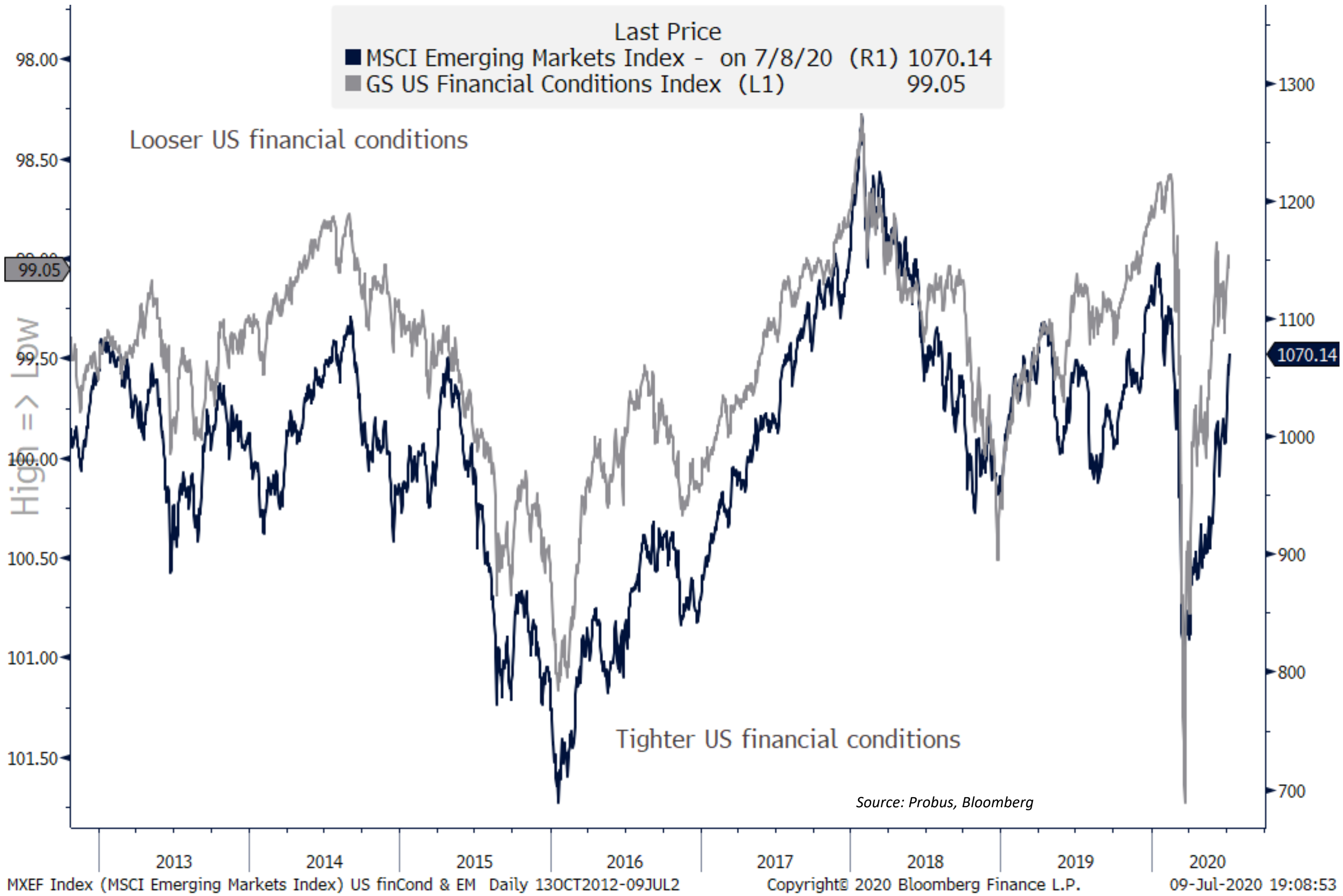
US yields join their peers at the zero bound

US yields have collapsed to historic lows and joined their EU and Japanese counterparts near zero. China's resistance to extreme monetary measures has allowed it to maintain a relatively juicy 10-year yield of 3%. Investors will have no choice but to seek higher yields in EMs.

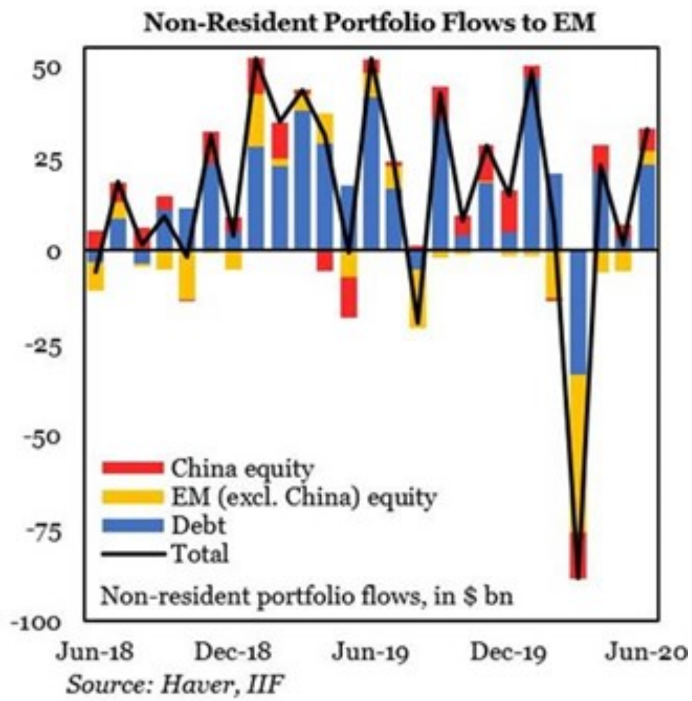


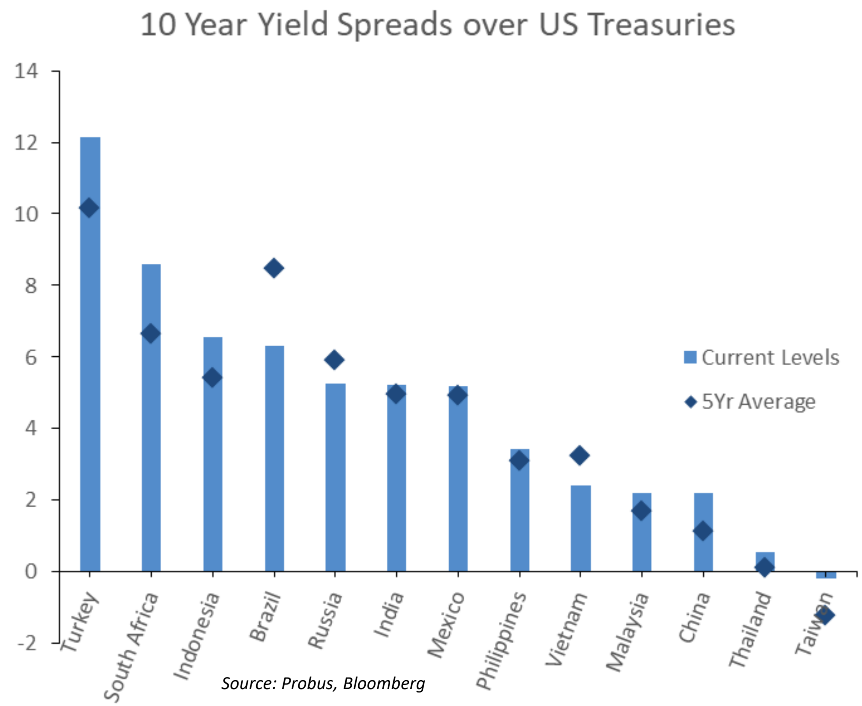
Emerging markets helped by looser financial conditions

The Fed's significant monetary policy response has eased dollar pressures and loosened financial conditions. This has allowed emerging markets to recover despite China's moderate response.



Foreign capital is coming back to EMs in a loose monetary environment



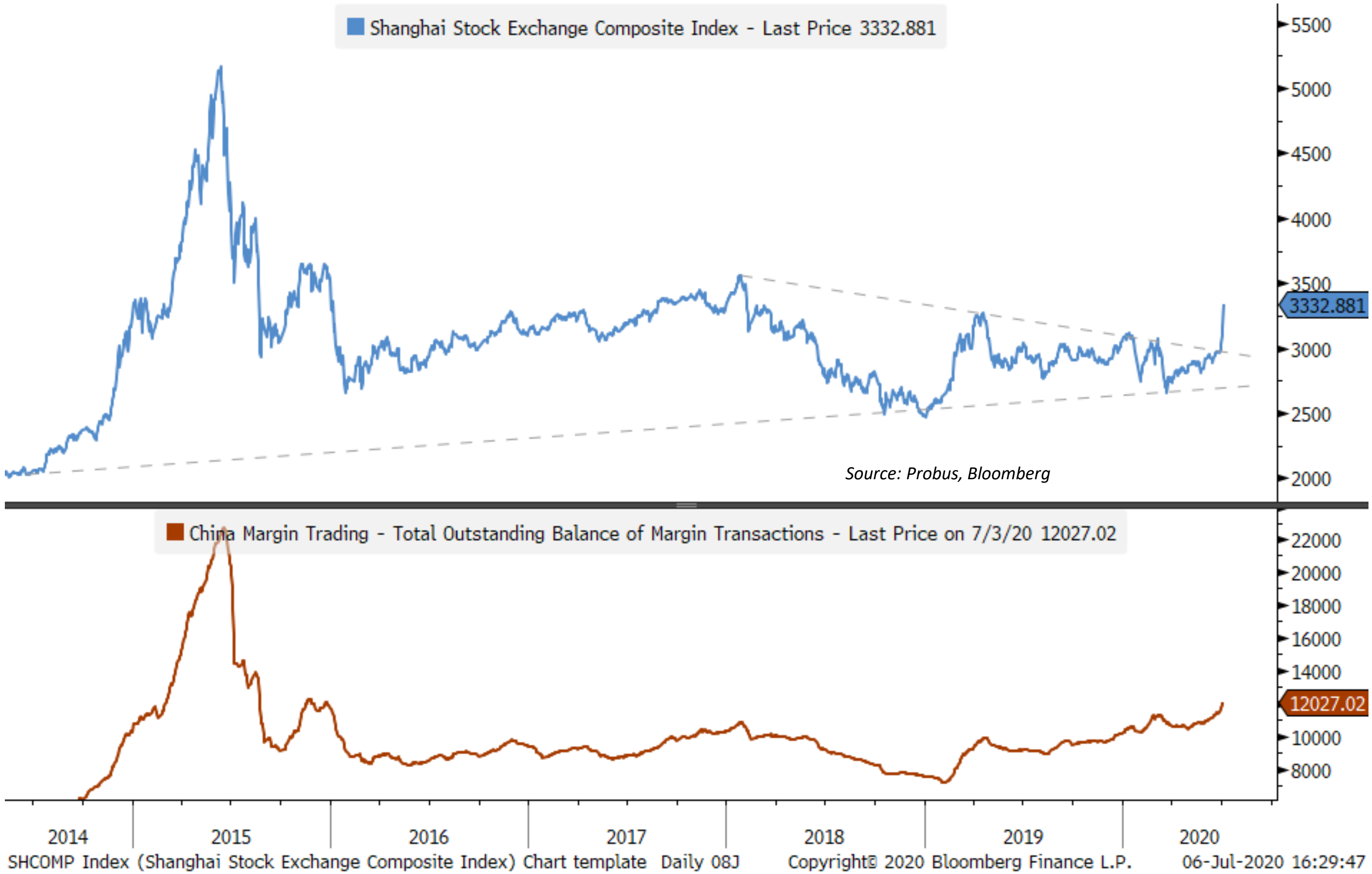


Emerging market flows have rebounded strongly after March's virus-induced dramatic collapse, mostly on debt instruments so far, as the chart on the left shows. This trend is likely to persist now that developed market central banks have committed to keeping rates at zero for longer and that yield curve control is on the table.

We continue to favour South East Asia where central banks, aided by Fed's aggressive monetary response, have been able to react both on the monetary and fiscal fronts without causing further currency depreciation. In addition to an exemplary handling of the virus and being beneficiaries of lower oil prices, these economies offer yield pick ups over the US 10Y that are quite attractive and in most cases even higher than the 5 year average. While capital has mostly poured into debt given the lack of alternatives (and will continue to do so), it is likely to overflow into equities, where valuations remain mostly attractive.

Chinese equities take off

Despite the abundance of risks that have international investors worried, the Chinese market is showing remarkable strength, with the Shanghai Composite breaking out of a key resistance. Signs of speculative frenzy that echo the 2015 bubble are emerging but we appear to be at an early stage; margin debt (in orange) and valuations are much lower, while state media are publishing articles to encourage participation in the market.



Oil price rally facing short term headwinds

Following a brief stint in negative territory, oil prices have rallied significantly and are now facing key resistance and overcrowded long positioning (top right). Oil demand is slowly recovering while supply has fallen off a cliff. However, the overhang of enormous inventories (540m barrels in the US) make further short term gains unlikely, especially with renewed virus fears.

On the other hand, rising bankruptcies in the oil patch and capex delays are laying the groundwork for higher oil prices down the line and justifies holding onto oil stocks and adding to them on weakness.

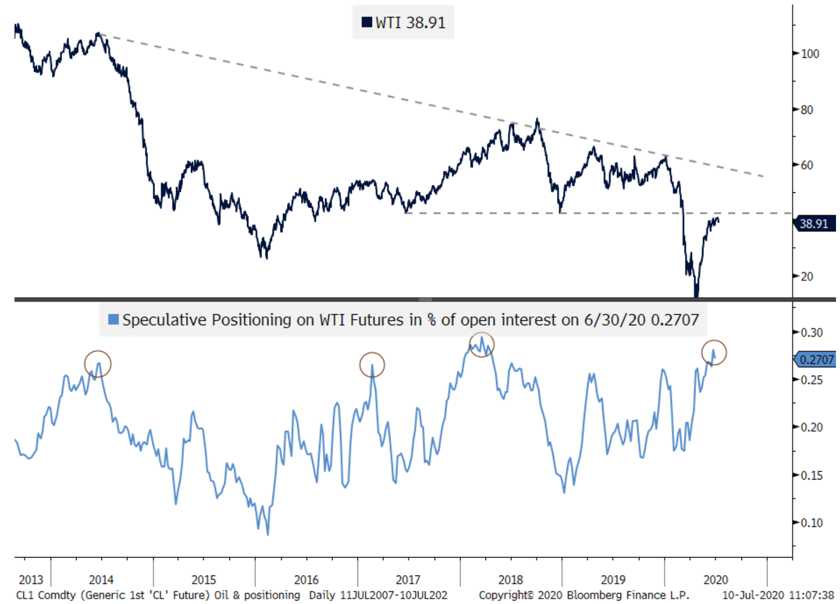
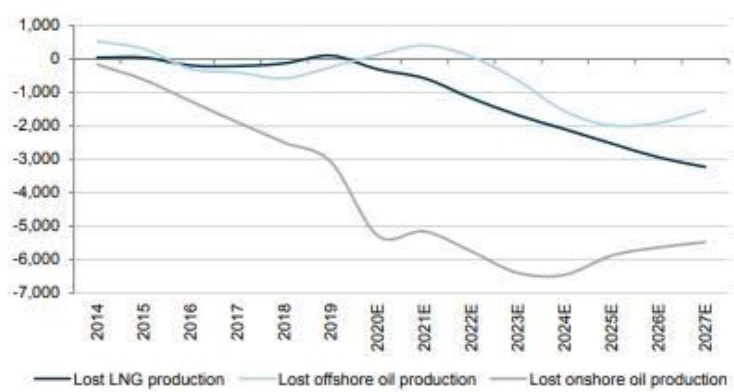


Exhibit 1: Delayed investment decisions on long-cycle developments take c. 8 mn blpd out of 2025E oil supply...

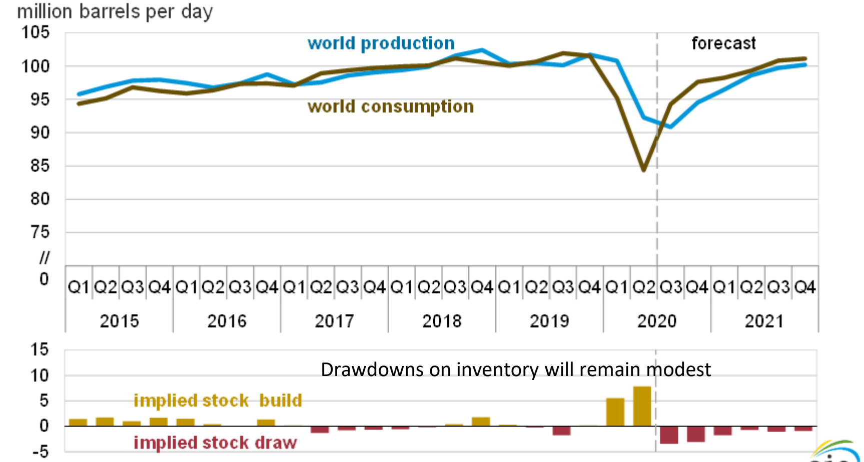
Top Projects lost LNG, offshore and onshore oil production from long-cycle developments in mn boe/d; Top Projects 2020 vs. Top Projects 2014 expectations



Source: Goldman Sachs

World liquid fuels production and consumption balance

million barrels per day



Source: Short-Term Energy Outlook, July 2020

Disclaimer

This document has been prepared using sources believed to be reliable. The author and distributors of this document expressly disclaim any and all liability for inaccuracies it may contain and shall not be held liable for any damage that may result from any use of the information presented herein. The statements and opinions it incorporates were formed after careful consideration and may be subject to change without notice. Past performance is not indicative of future results. Values of an investment may fall as well as rise. This document is intended for information purposes only and should not be construed as an offer or the solicitation of an offer to buy or sell any investment products or services. The use of any information contained in this document shall be at the sole discretion and risk of the user, being directed at Professional Clients as defined under the rules and regulations of the Dubai Financial Services Authority (DFSA). Probus Middle East Limited is regulated by the DFSA.

DATA PRIVACY POLICY IMPORTANT NOTICE
PROBUS recognizes the importance of keeping the personal data of its customers and other counter-parties confidential and protecting their privacy rights. As a consequence, PROBUS has adopted a global privacy policy consistent with applicable standards. Our Data Privacy Notice can be found using the following url: https://www.probus-group.com/data-privacy-notice