MARKET VIEWS

Market & Strategy Update Q4 2020

Executive Summary

The global economy has staged a significant rebound since the nadir of the crisis back in Q2. A potent combination of extreme monetary and fiscal stimulus helped avoid a disastrous scenario and there are no signs that these measures will be withdrawn for the foreseeable future. The Fed has gone as far as officially adjusting its mandate in order to justify maintaining rates at the zero bound irrespective of growth and inflation dynamics; other central banks are likely to follow. The continued commitment to debase fiat currencies in the hope to stoke inflation and erode record debt levels speaks in favor of holding a sizable allocation in gold. Developed market bonds have never looked more unappealing with USD yields now close to zero and investors are likely to keep looking toward EMs debt, especially in Asia, where yields remain attractive.

Recent months have seen the pace of the recovery slow, with economic data increasingly failing to meet the market's revised expectations. As a result, the equity market rally has mostly stalled across the board. Even if the expectations of a 20% earnings rebound for 2021 materialise, current valuations seem excessive. With US elections upcoming and the virus threatening the recovery, investors should remain cautious and take advantage of the likely volatility to increase their exposure on pullbacks.

Thanks to government measures aimed at supporting incomes, consumption has regained pre-crisis levels in the US and the EU, while manufacturing has lagged. With a 2nd wave of the virus stirring, these consumption led recoveries are at risk, which is probably why consumer confidence has stayed surprisingly weak. In the EU, the services sector is slowing down now that governments are gradually imposing new restrictive measures, inflation turned negative and the unemployment rate rises. The ECB is likely to ramp up asset purchases, which should keep a lid on the EUR.

In the US, the attention is turning towards the election and the necessity to pass a new fiscal package to support the economy. Polls suggest an increasingly comfortable win for Biden. A democratic sweep would likely lead to US equity underperformance and a continuation of the USD's decline.

Executive Summary

Japan's economic recovery has shown more resilience and the virus situation appears to be more benign, which probably explains the market's relative strength during the September pullback. With attractive valuation, political continuity with Prime Minister Suga, Mr Buffet's recent approval stamp and the potential for foreign investors to come back, Japan remains our favorite developed equity market.

The significant easing in US financial conditions has alleviated some pressure for emerging markets, allowing their respective central banks to ease monetary policy and replenish FX reserves. The emerging market index is almost back in positive territory in 2020 but major divergences exist under the hood. China, South Korea and Taiwan are the only positive contributors, as their countries have fared particularly well due to their management of the virus and their rising exports. Other countries remain mostly plagued by the virus, their dependence on tourism or on oil prices.

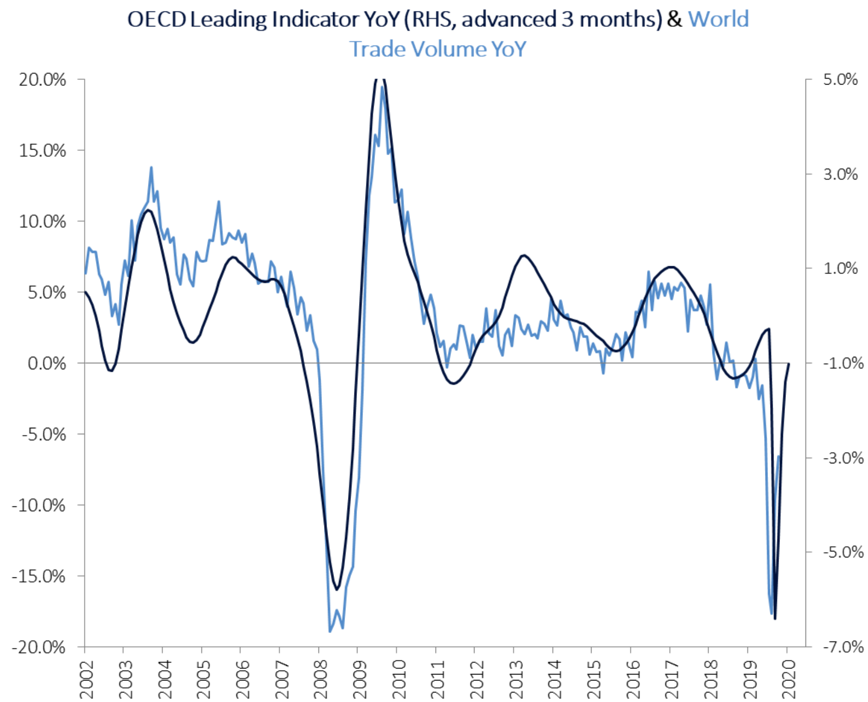
China has captured a large portion of global exports by quickly reopening its industry and focusing on IT equipment and medical supplies. Despite tensions with the US, money keeps flowing into Chinese equities and bonds, as its weighting in global benchmark is being revised higher. With yields offering a record pick up over US yields and equities trading at cheap valuations, Chinese assets remain very attractive.

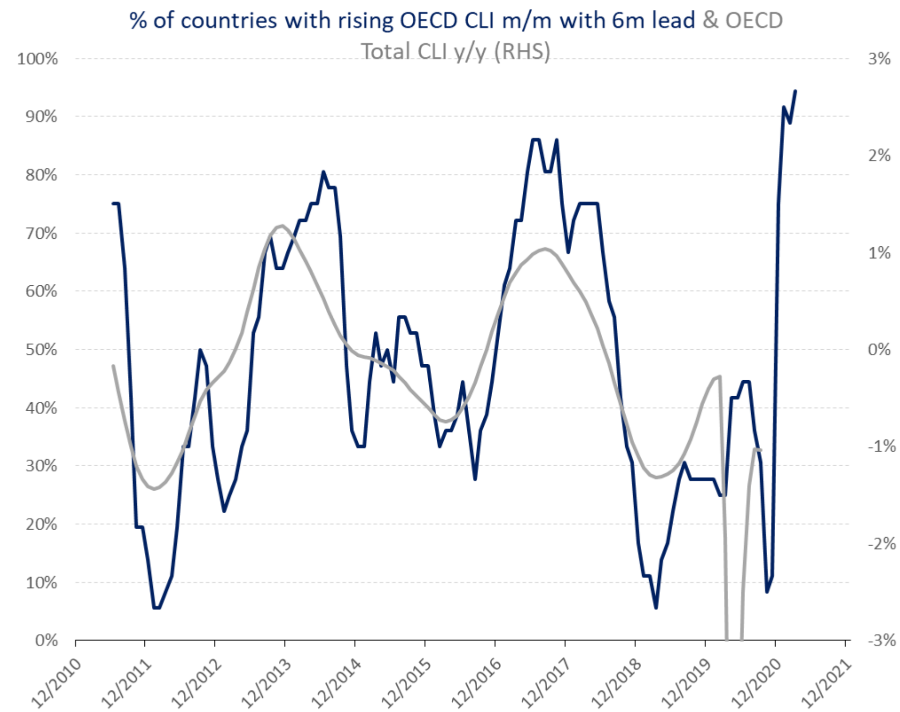
A likely further decline in US oil production, rising bankruptcies and years of falling capex speak in favour of a significant increase in oil prices. However, this may be a 2021 story, as demand remains weak and at risk of further restrictive measures linked to the virus. For the time being, money keeps relentlessly flowing out of the sector, creating attractive opportunities for long term oriented investors.

Macroeconomic Context

PROBUS
GROUP

Economic activity has recovered but remains in contraction

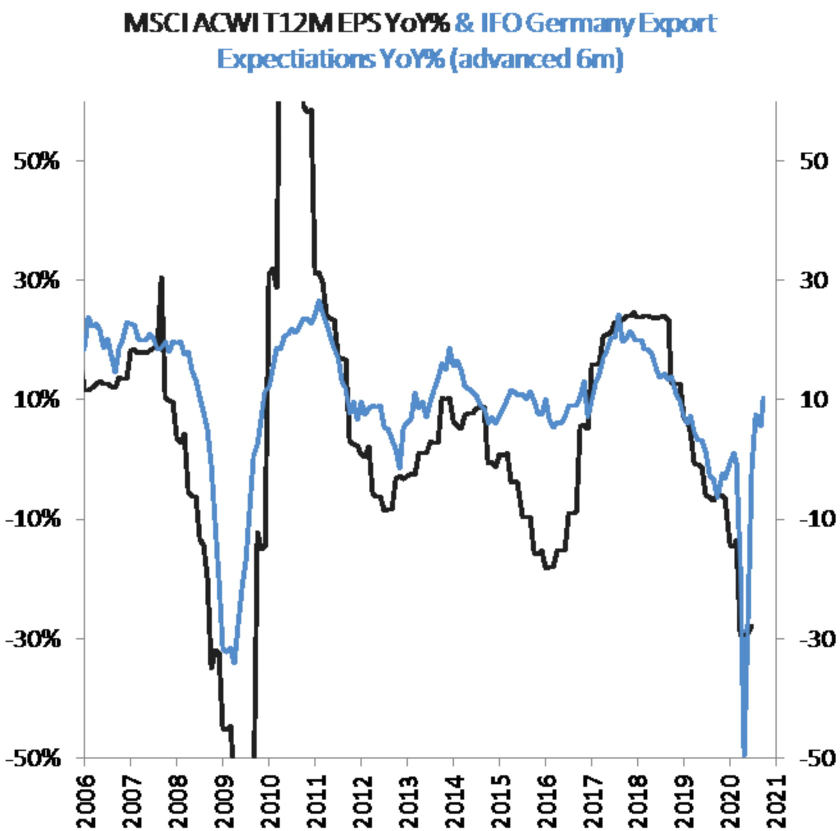


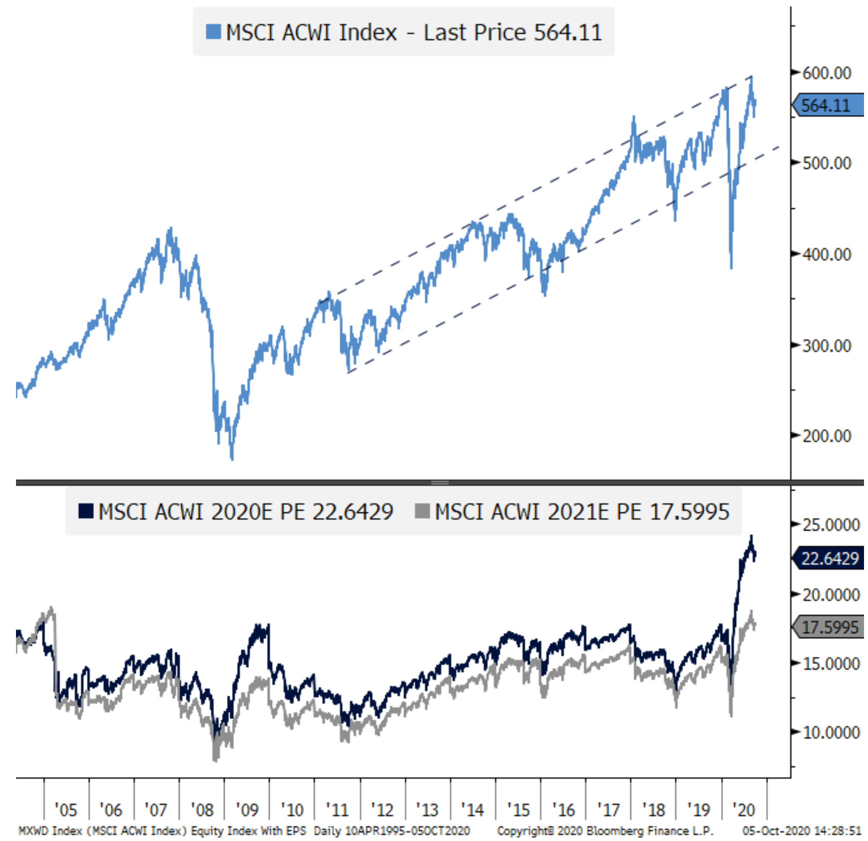


The OECD leading economic indicator has staged a significant comeback as global activity has recovered. It is on the verge of turning positive YoY and we should see trade volume continue to improve over the next few months (left hand chart).

Although the absolute level of activity remains weak, the strength and breadth of the rebound has been very encouraging; 100% of countries currently see improving activity month over month (right hand chart) which typically leads the OECD global indicator. However, the pace of monthly growth has already turned down in some countries, suggesting a stalling recovery.

Valuations to remain rich despite the profit recovery



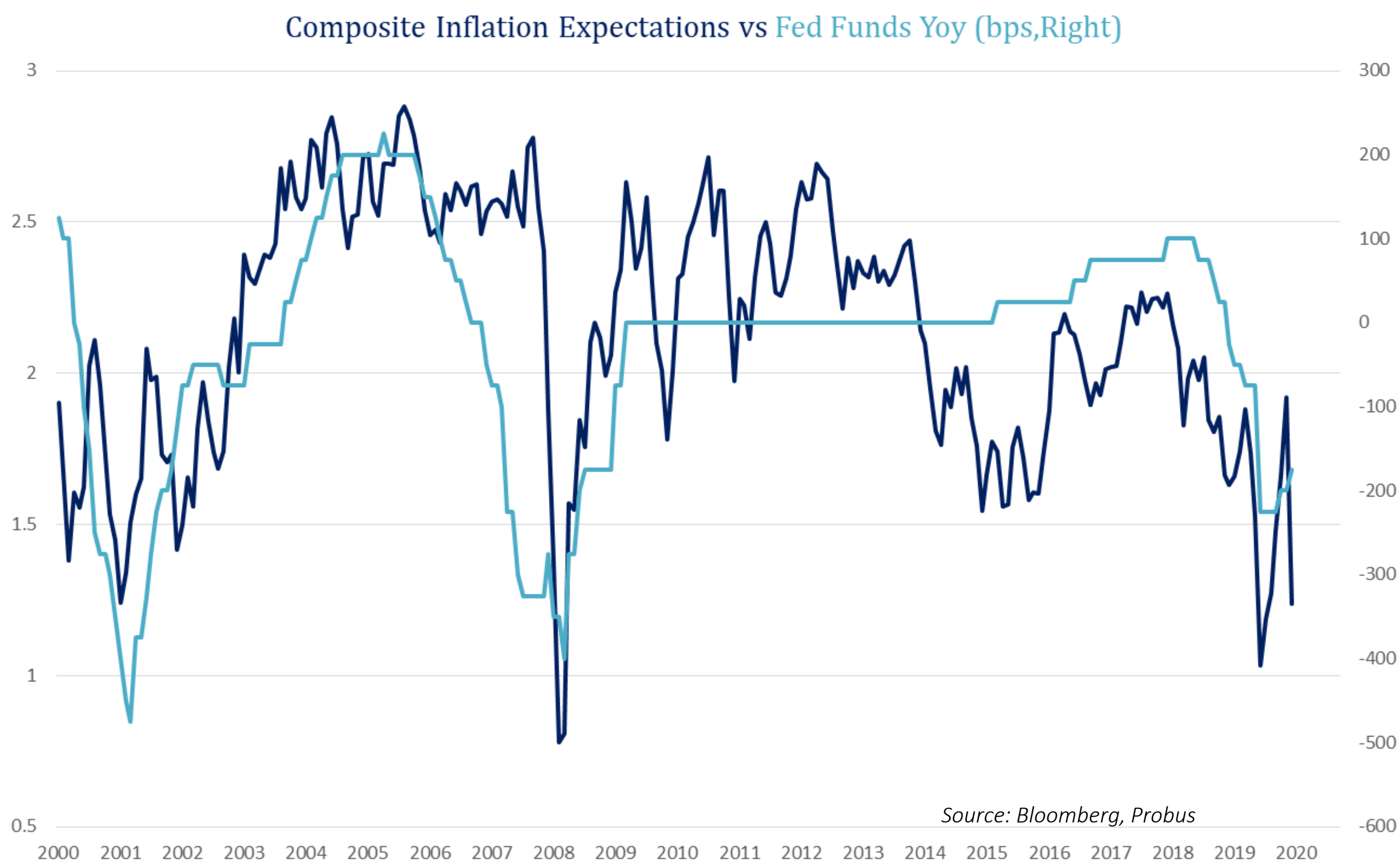


IFO's German Export Expectations has historically led global corporate profit growth by 6 months and implies an upcoming recovery (right hand chart). While an earnings recovery seems quite logical given the rebound in global activity, it is interesting that the IFO has not yet stalled.

However, it seems unlikely that the earnings recovery will be sufficient to justify current valuations; indeed, with E2021 PE at 17.6, which implies over 20% profit growth for 2021, the MSCI ACWI would still be historically expensive.

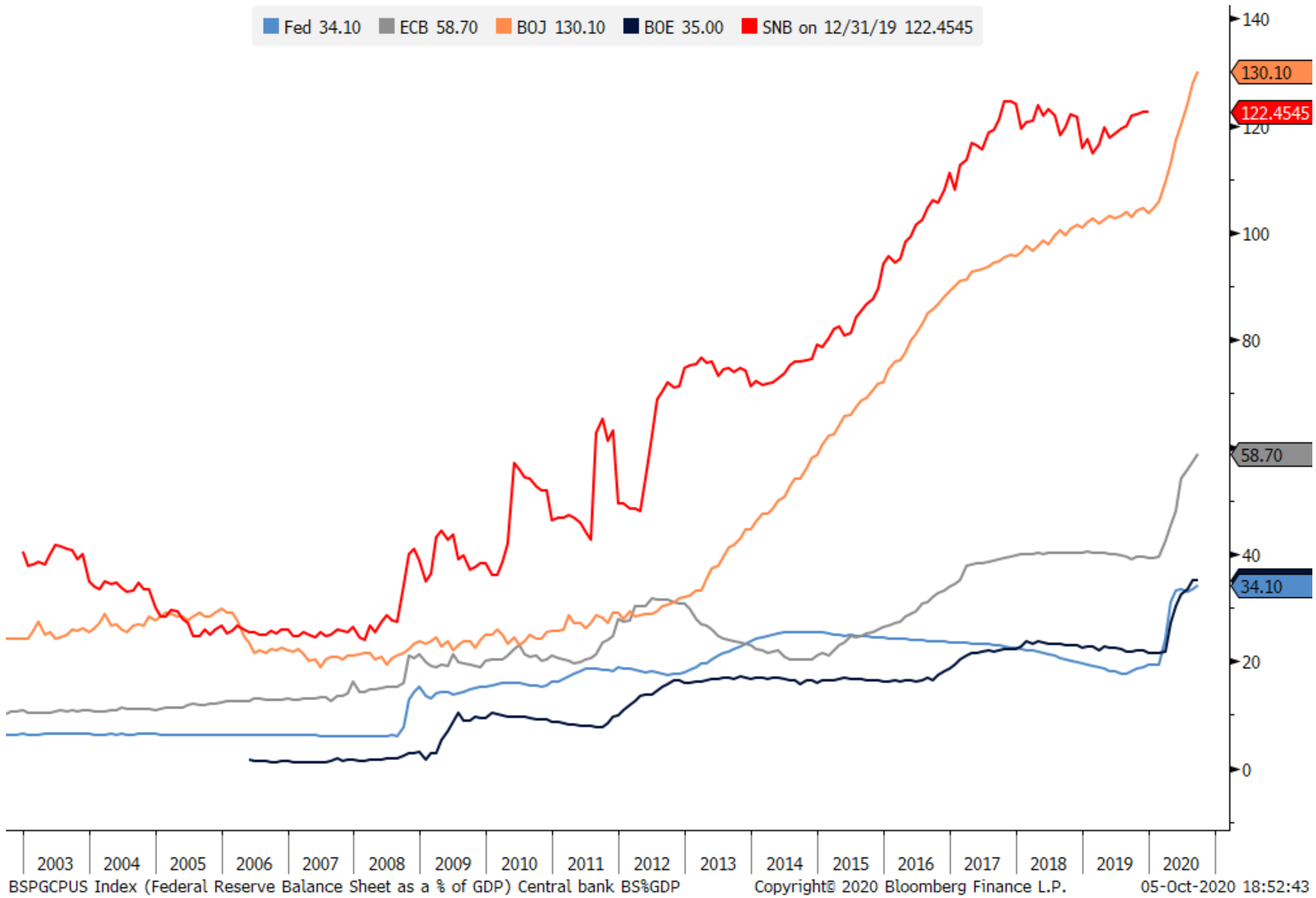
The Fed changes its mandate to justify rates lower for longer

The Fed's latest announcement at the Jackson Hole meeting has certainly added fuel to the fire. By officially adjusting its mandate to a symmetrical inflation target, the Fed has declared that above 2% inflation would be welcomed. Therefore, rising inflation or growth will not lead to tightening policy. This means that the historical relationship seen below between the Fed funds rate and inflation expectations will subside. The Fed, just like other central banks, aims to maintain loose monetary policy for many years to come.

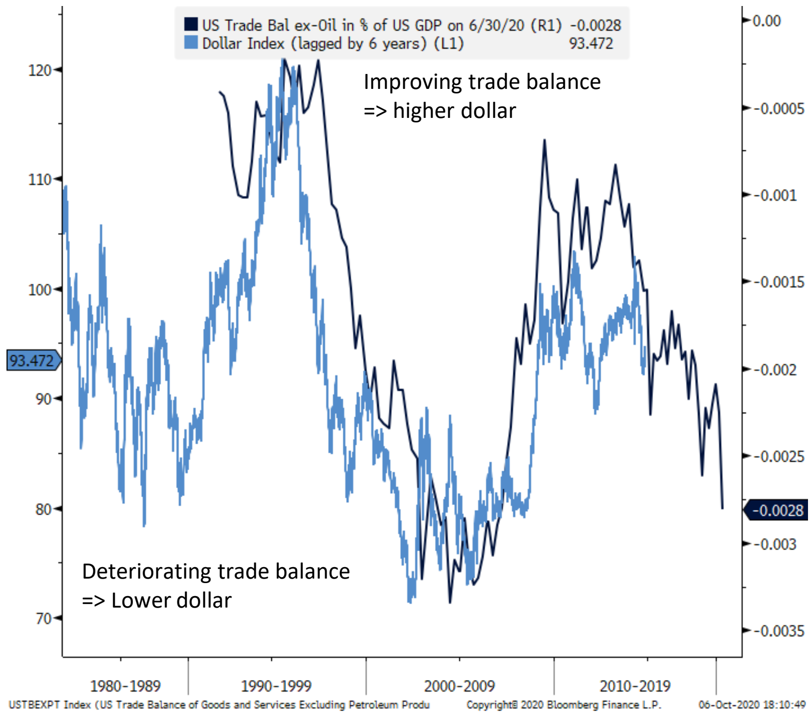


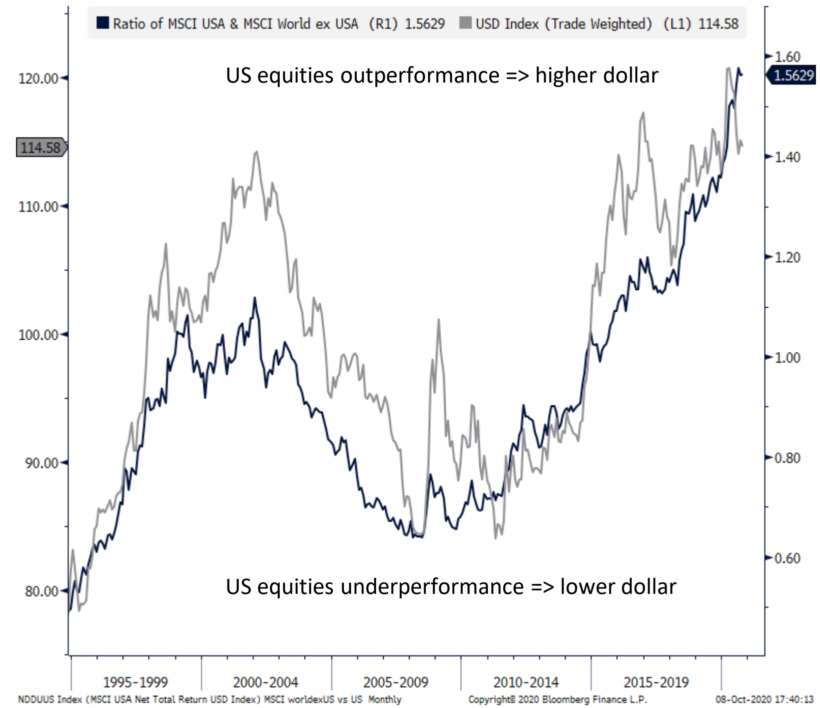
Central banks' balance sheet will do the heavy lifting

Central banks have come out with all guns blazing in response to the virus. The chart below illustrates the sharp expansion in central banks' balance sheets when viewed as a % of their respective economy's GDP. With interest rates now pinned down for the foreseeable future, balance sheet expansion is the primary tool for conducting monetary policy and it appears as if the Fed, ECB and BOE have some space to continue purchasing assets.



The bearish case for the USD is on everybody's lips



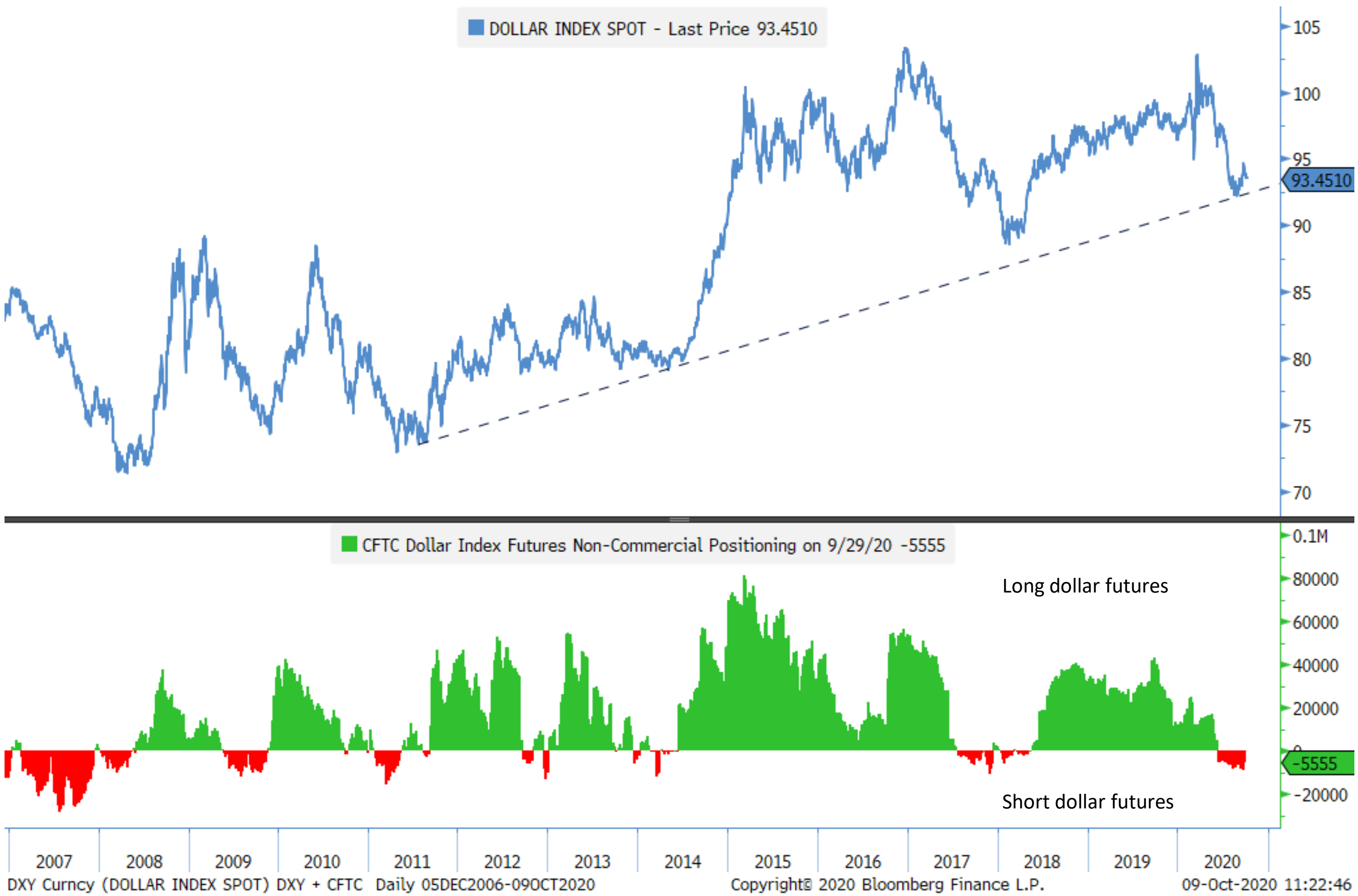


There are arguments, well documented among investors, that may explain the structural weakening of the dollar. First, the US trade balance has been deteriorating for years, which has historically led the dollar lower (left hand chart). Second, now that the Fed has committed to maintaining rates at zero for many years, positive yield differentials, which was one of the dollar's main attractions, no longer exist.

The final straw to break, before a significant weakening of the dollar, could be the end of US outperformance of its economy and assets (right hand chart). The risk of such an event seems possible with a major cyclical recovery or the election of Biden, who would also take the soaring budget deficits to even higher levels. As the next slide shows, this is what the market is heavily betting on.

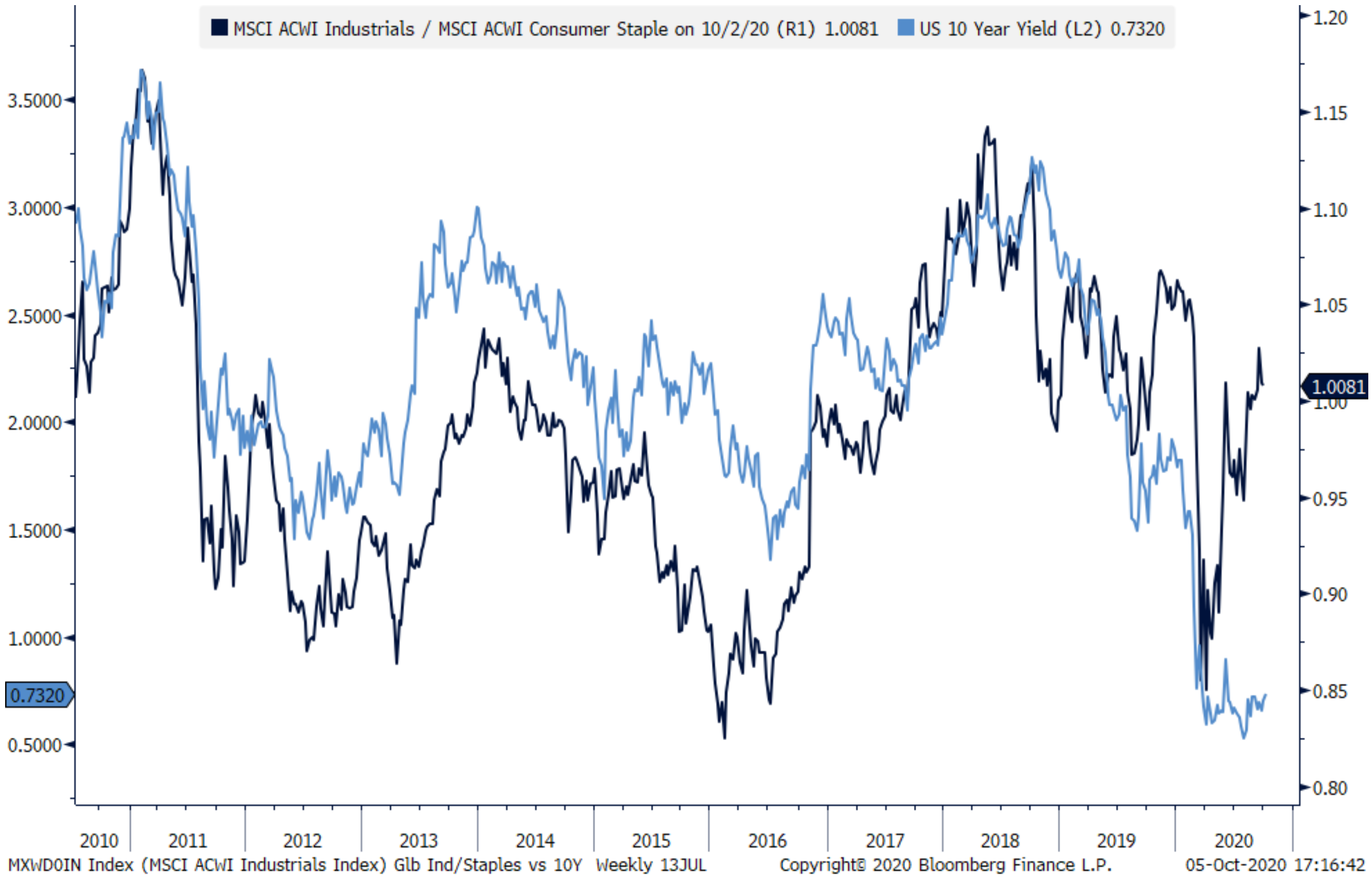
…but the short term bounce in the dollar could have legs

Since the dollar's demise narrative has become consensus, it is not surprising to see that short positions on the dollar vs other developed market currencies are at extreme levels. Even if the long-term case for a weaker dollar remains valid, investors should be wary of a short-term bounce; the short positioning could unwind viciously and election results could trigger such a move. A close below the recent low would suggest more downside.



Long term yields should be higher if the recovery is to be believed

Contrary to the ratio of cyclical to defensive stocks (dark blue), which continues rising as the economy recovers slowly, the US 10Y bond yield remains stuck in a tight range. This extreme divergence suggests that the bond market does not believe in the economic/inflation recovery. If long rates do however start to rerate higher, possibly as a result of an additional US fiscal package, this will likely force central banks into some form of yield curve control (e.g. fixing the 10Y yield at a certain level).



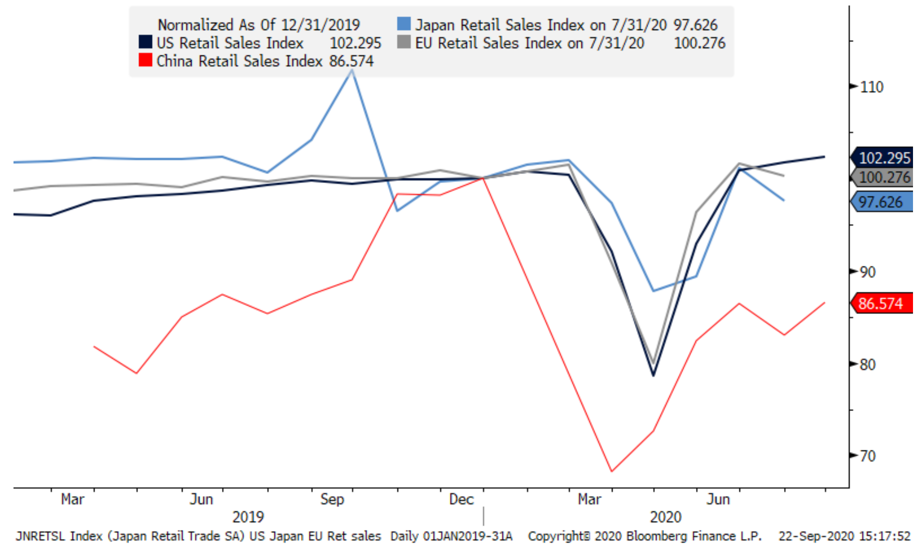
The recovery has not been homogenous across countries and sectors

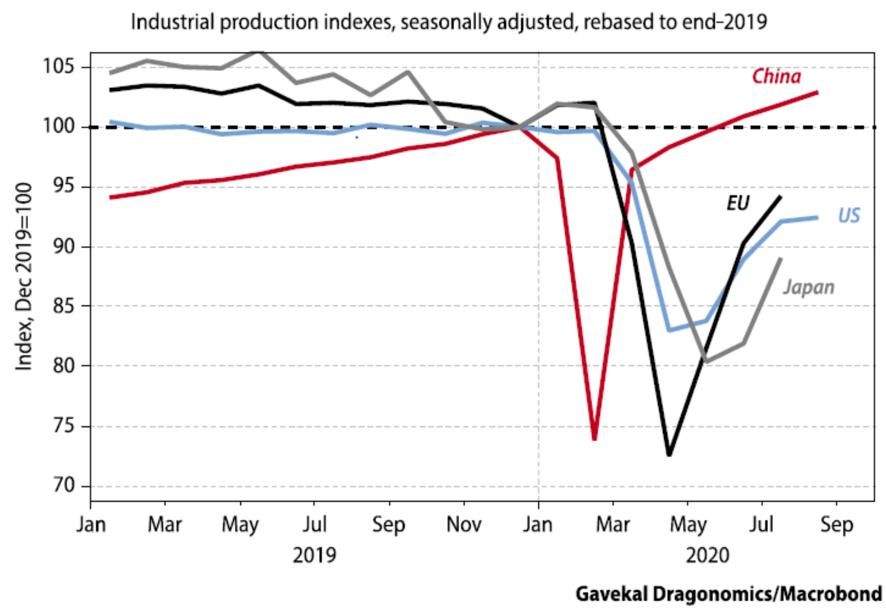
Economic recoveries have varied across countries, mostly depending on the emergency measures adopted by their respective governments.

In the EU and the US, governments have implemented major support measures for households aiming to sustain aggregate demand. As a result, retail sales have recovered sharply to pre COVID levels, as can be seen on the chart at the top, while industrial production levels remain much lower (chart at the bottom).

China on the other hand has focused on reopening its economy as quickly as possible and supporting businesses rather than consumers. Industrial production has therefore recovered to pre-COVID levels, while retail sales remain very weak.

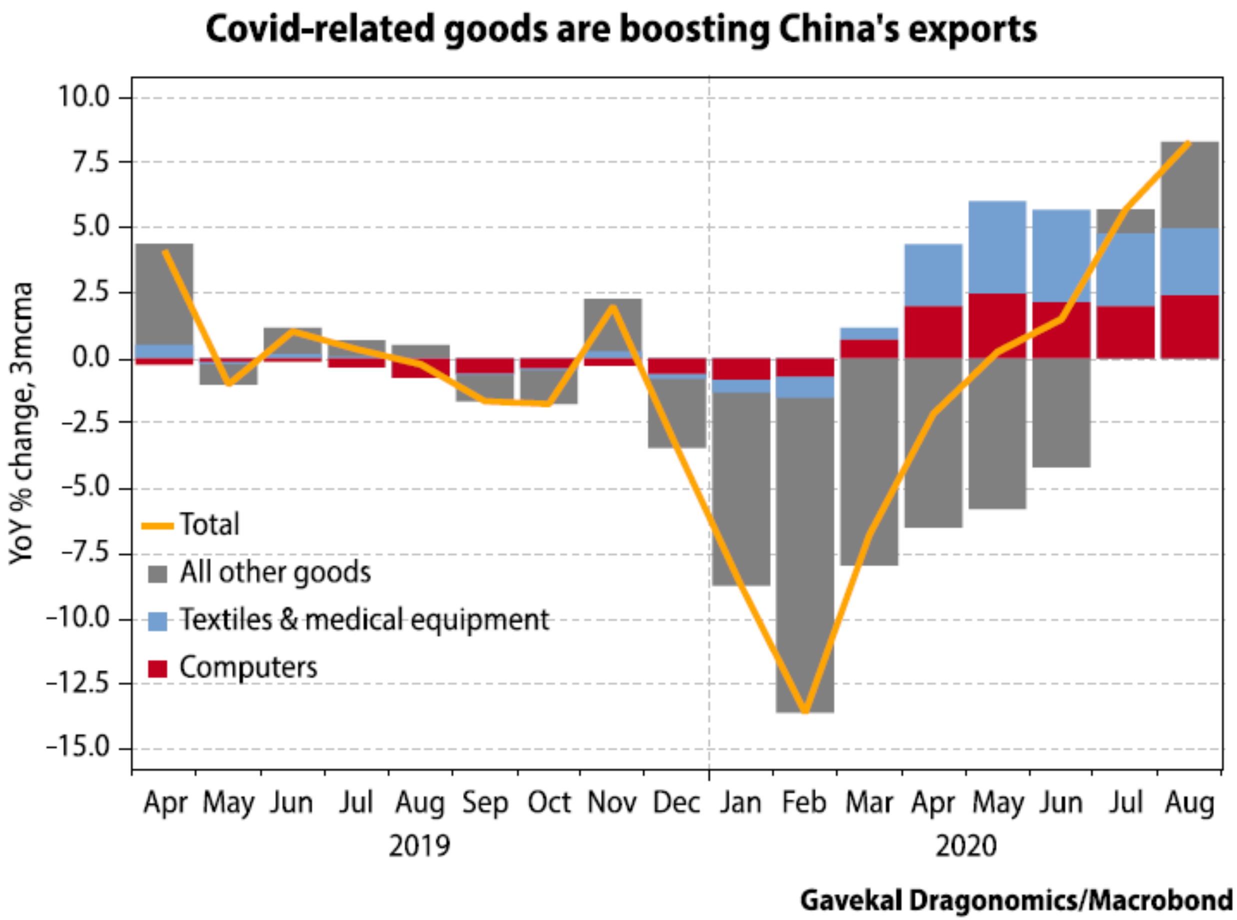
Rising cases in the EU and the expiration of unemployment benefits in the US represent potential headwinds to the consumer-driven recoveries.





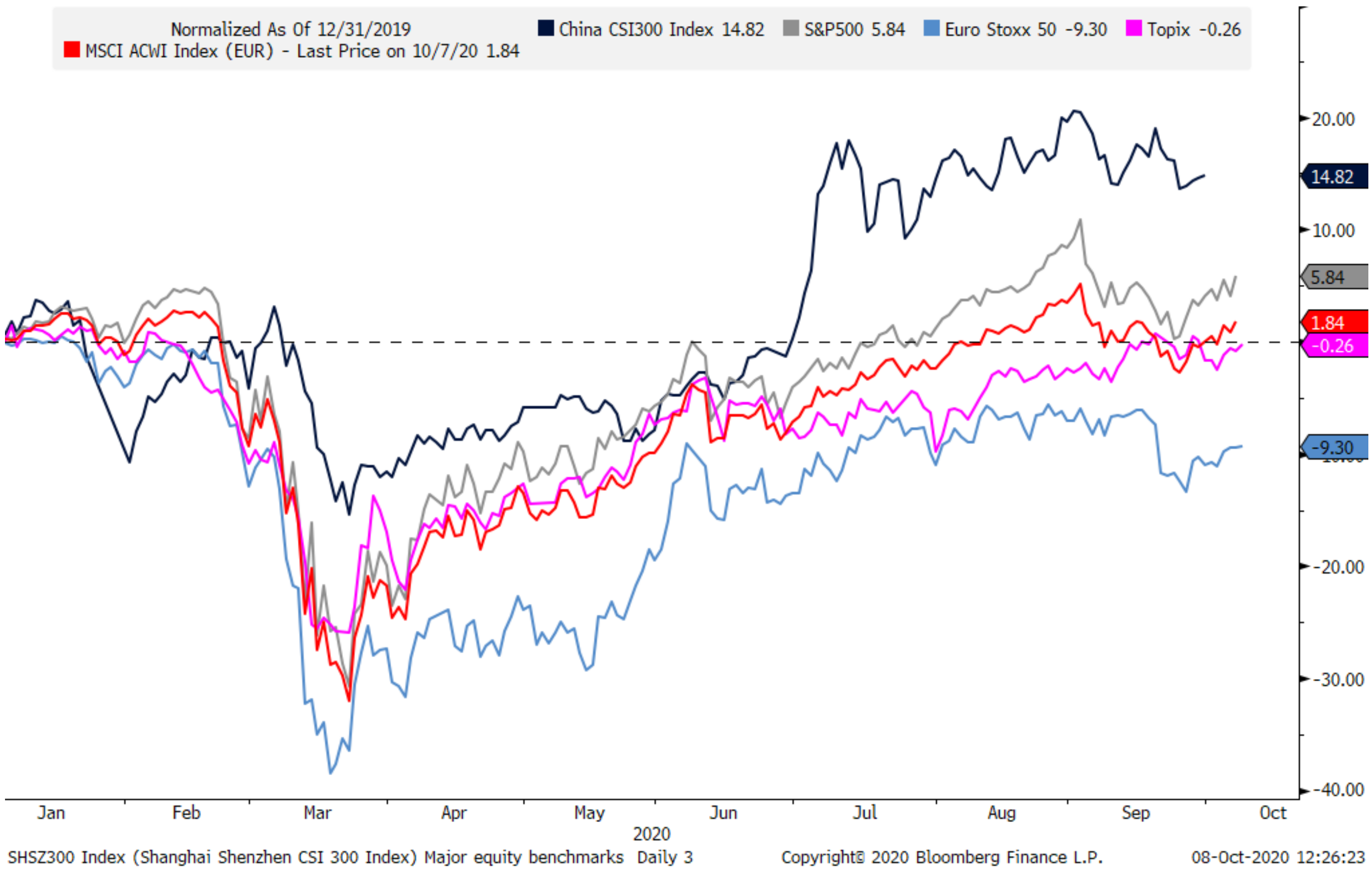
Sometimes strength masks underlying weakness

The rebound in Chinese exports (seen below) has been extraordinary given the benign level of global demand and export growth. As shown on the previous slide, China has effectively taken a bigger share of global exports thanks to the speed of its industry's recovery compared to other major powers. Interestingly, as the chart below illustrates, exports have risen on the back of COVID-related goods such as computers and medical equipment, confirming the idea that China owes its export strength to global weakness.

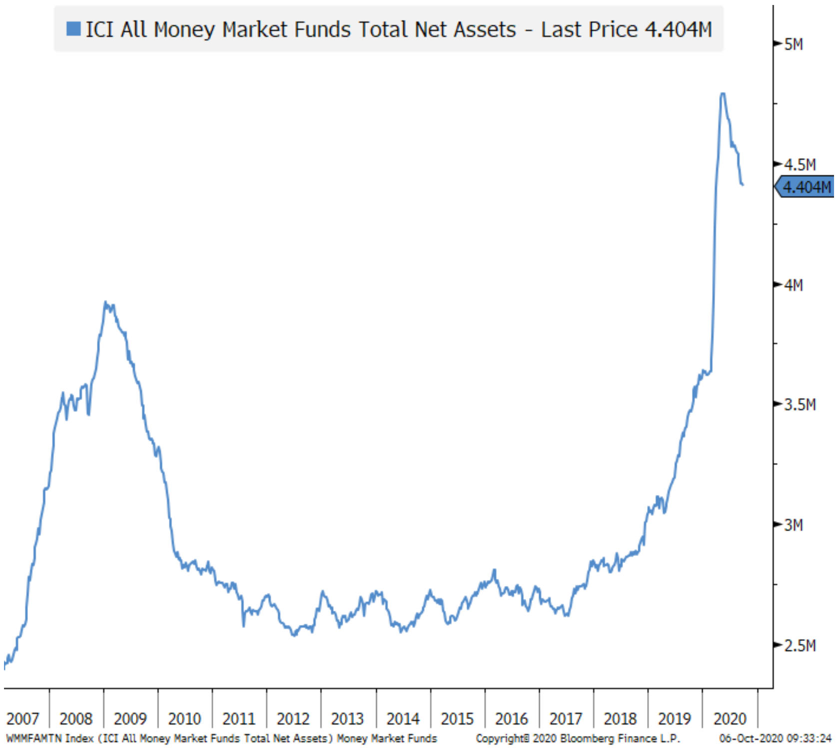


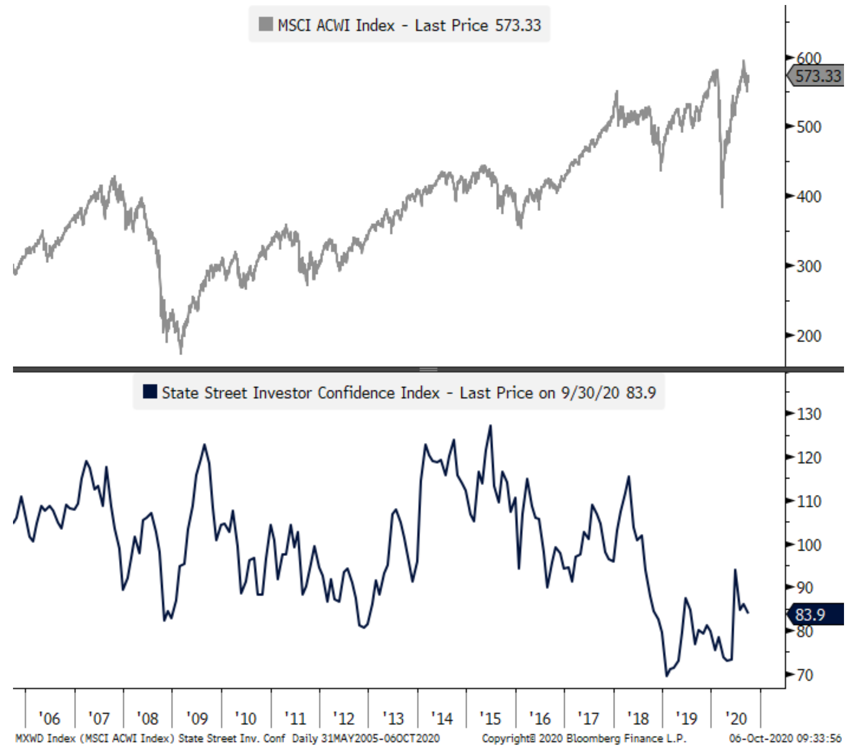
The equity rebound has stalled in recent months

The equity market recovery has been just as uneven, with China being the best performer among major economies and the S&P500 following closely behind. Both indices have been significantly boosted by large tech companies (the S&P500 is barely in positive territory when excluding the 5 largest tech companies). Europe, on the other hand, has been dragged down by its heavy oil and bank weightings. The rally appears to have lost momentum over the last few months.



Investors remain defensively positioned and have lots of cash

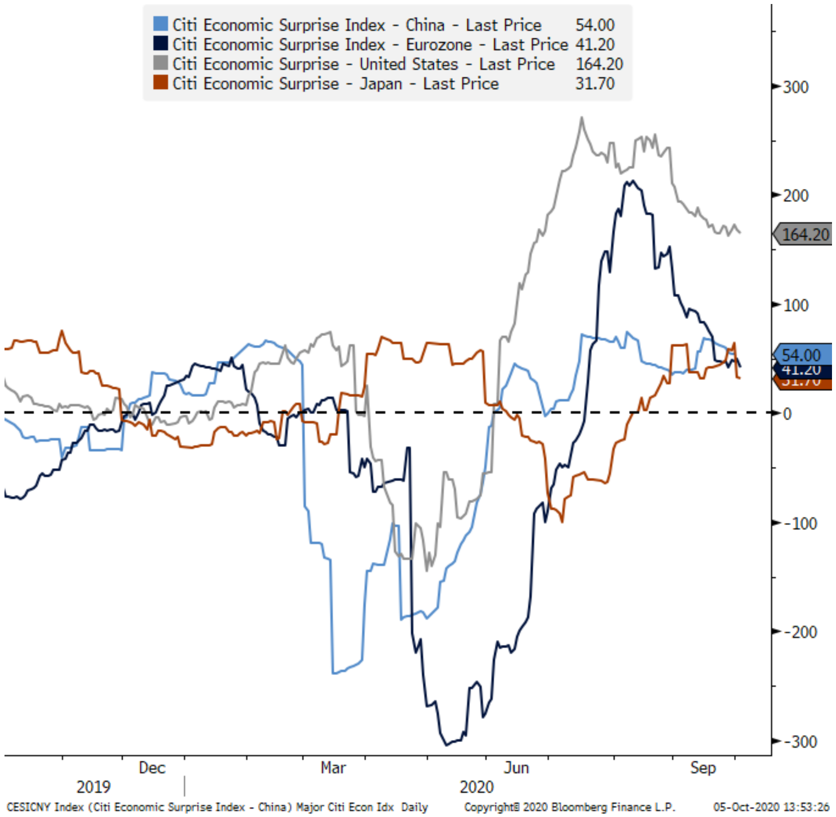


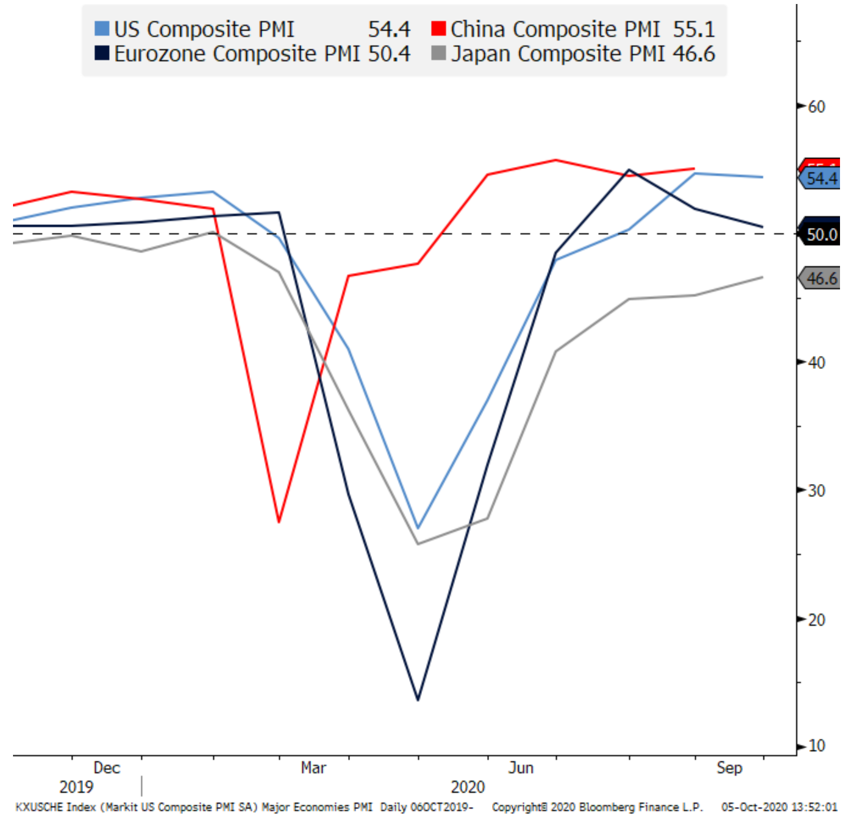


The last few months have seen bouts of speculative frenzy, especially from small investors piling into in the tech sector. Large institutional investors have been wrong-footed and remained significantly underweight during this rally, concerned by the dichotomy between high valuations and weak fundamentals.

This can be seen through the consistently bearish readings on many sentiment indices or through State Street's Investor Confidence index, which measures institution's risk apetite. The amount of liquidity on the sidelines (and the speed at which central banks debase said liquidity) has contributed to the lack of deep pullbacks, as equity exposures are being re-adjusted now that a worst case scenario has been avoided (so far) and that alternatives are scarce. This could create a melt-up in equities should the virus subside or a cure be found.

The pace of the economic recovery could be losing steam

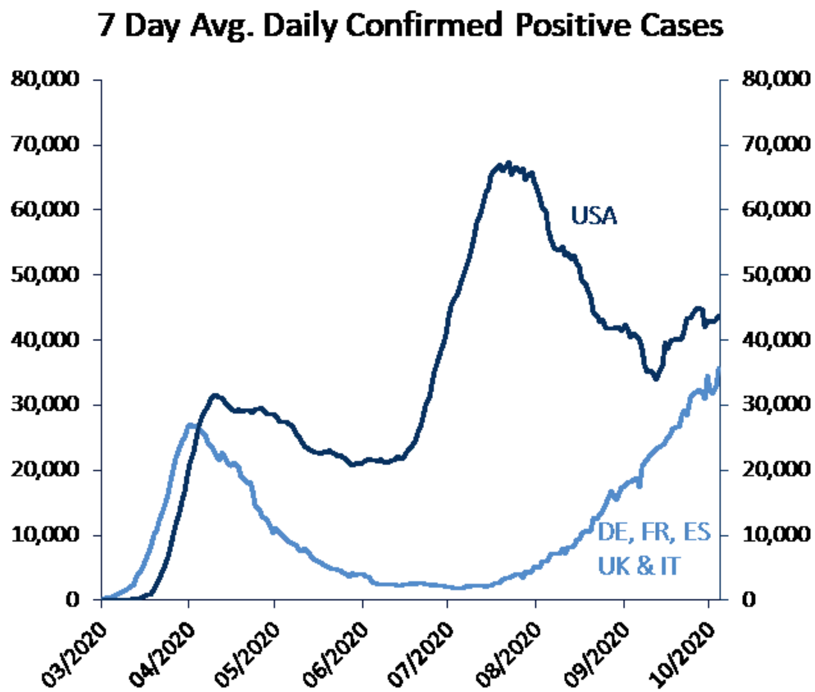


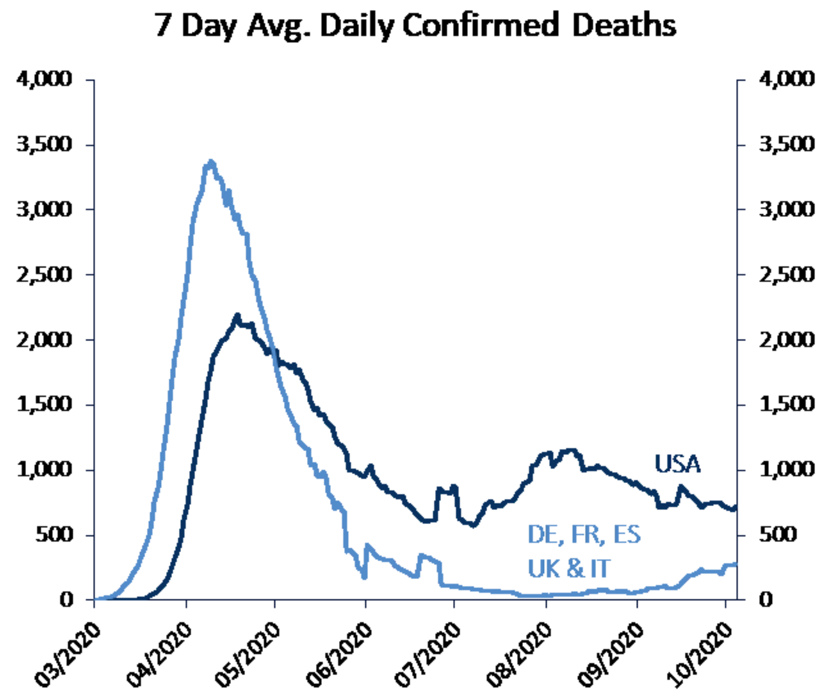


Positive economic surprises (i.e. better economic data than expected) have been a major support for equities during this rally, as rock-bottom expectations were easily exceeded.

Positive surprises have become scarce since August, as can be seen on the left hand chart with falling Citi economic surprise indices. In parallel, early signs are emerging that the economic rebound may be losing steam. Major economies' PMI indices falling to move higher in recent months, dragged down by the services industry.

The recovery depends largely on the path of the virus this winter

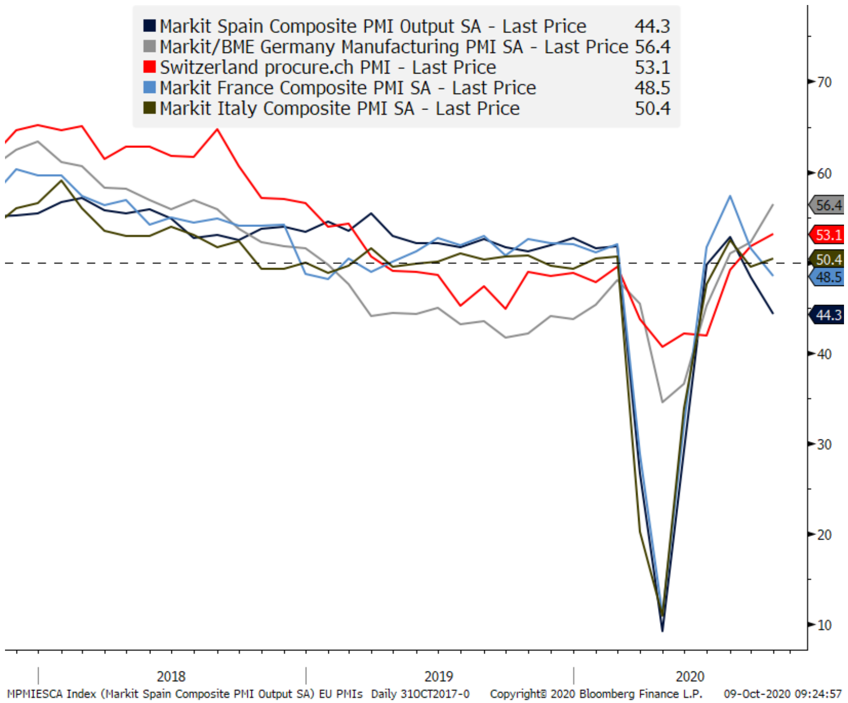


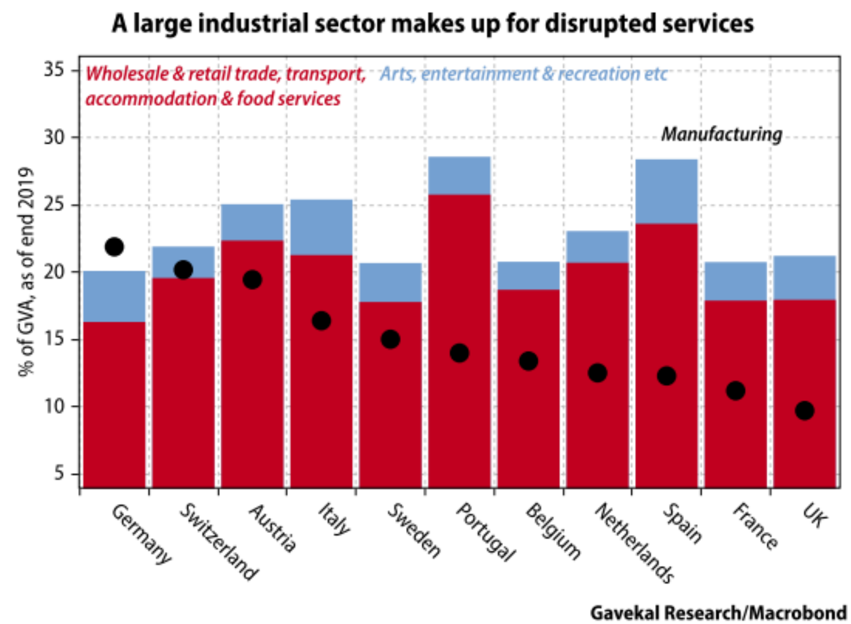


The rise in Covid cases in Europe and the US presents a major risk for markets in the coming months. For the time being, most of it can be ascribed to increased testing since the number of daily deaths has not picked up commensurately.

So far, only minor restrictions have been imposed in certain countries such as France, Spain or the UK. However, should cases become more severe during winter and deaths start to rise meaningfully, governments could be compelled to impose more stringent restrictions on movement and travel, which could stop the recovery in its tracks.

The EU’s second wave is threatening its recovery

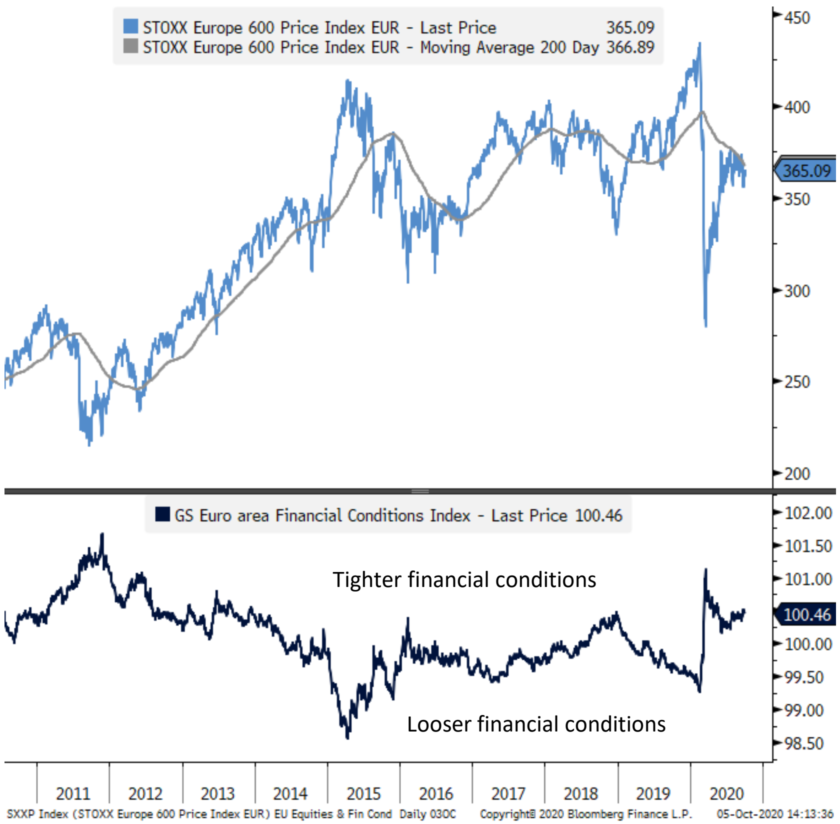


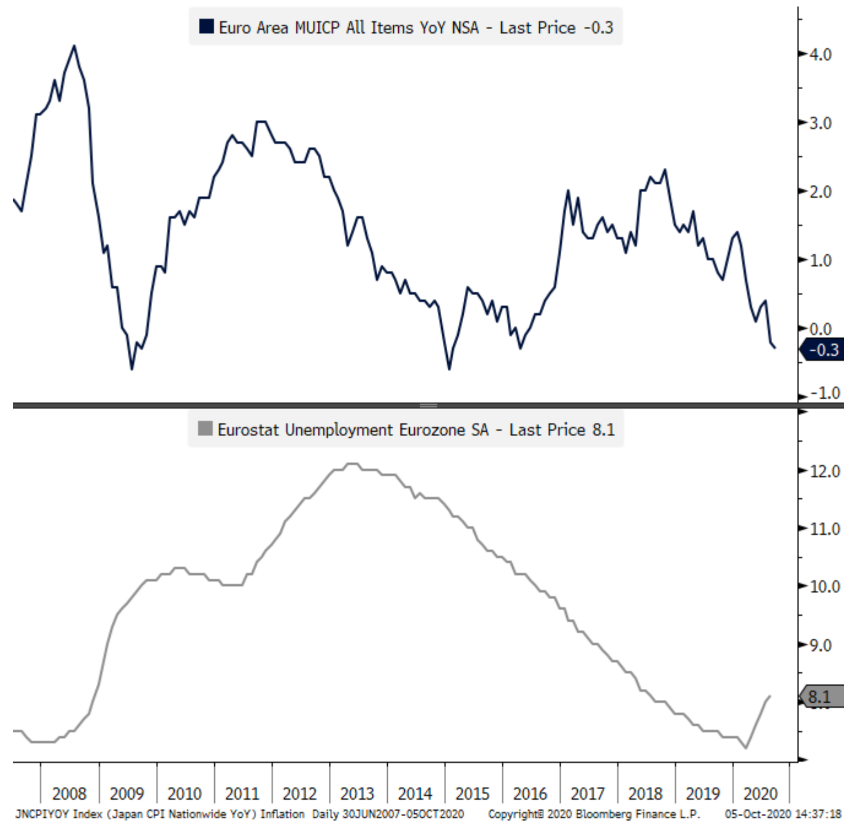


The EU’s recovery appears to have stalled, with PMIs turning lower in the last 2 months. The 2nd wave of COVID and the consequent restrictions imposed by certain governments are to blame. This can be seen in the diverging paths that various economies have taken, depending on the composition of their economy (right hand chart).

Overall PMI readings are currently being dragged down by the services industry, which is most affected by the resurgence in cases. Germany and Switzerland have industrial sectors that account for 20% of output, offsetting the pressure currently seen on consumption. On the other hand, Spain and France derive only 10-12% of their value added through manufacturing, which would explain their current economic weakness.

The ECB will have to do more to ease financial conditions

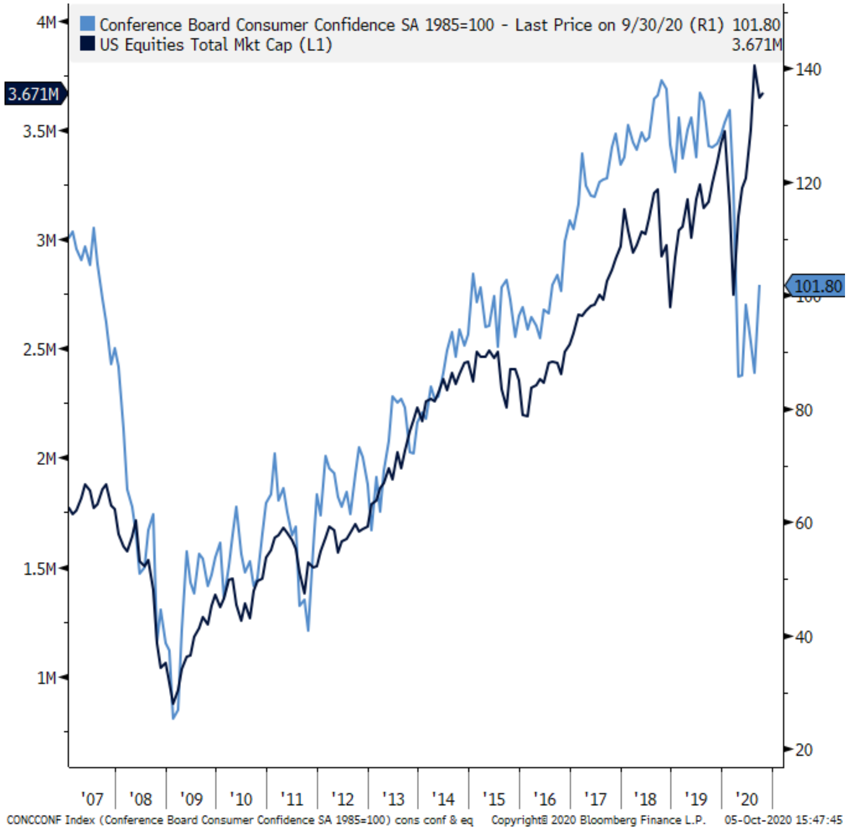


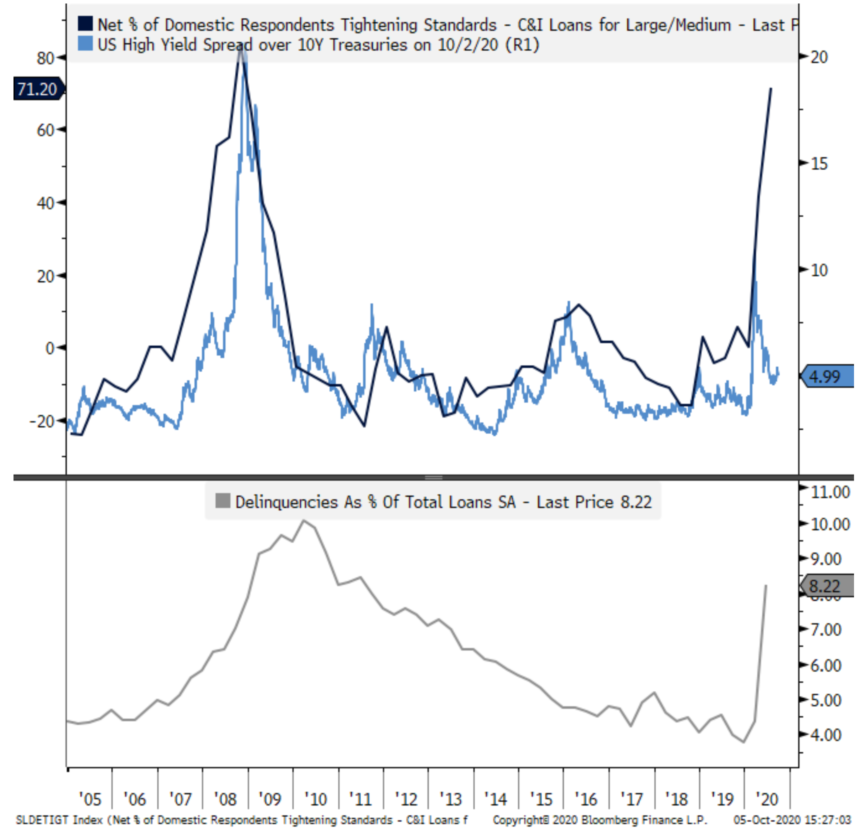


Despite the ECB's intervention, financial conditions (left hand chart – dark blue) remain relatively tight. Given the strength of the EUR, negative inflation (right hand chart – dark blue) and rising unemployment now that companies are starting to lay off workers, the ECB will have to do more to keep the recovery intact.

Ms. Lagarde has in fact mentioned the possibility of adopting a flexible inflation targeting mandate similar to the Fed's, which seems to pave the way for further action. Equity markets have failed to cross above the 200day moving average (left hand chart – grey line) and will need to break it to confirm the continuation of the rally.

In the US, a new fiscal package will be required to keep the recovery going

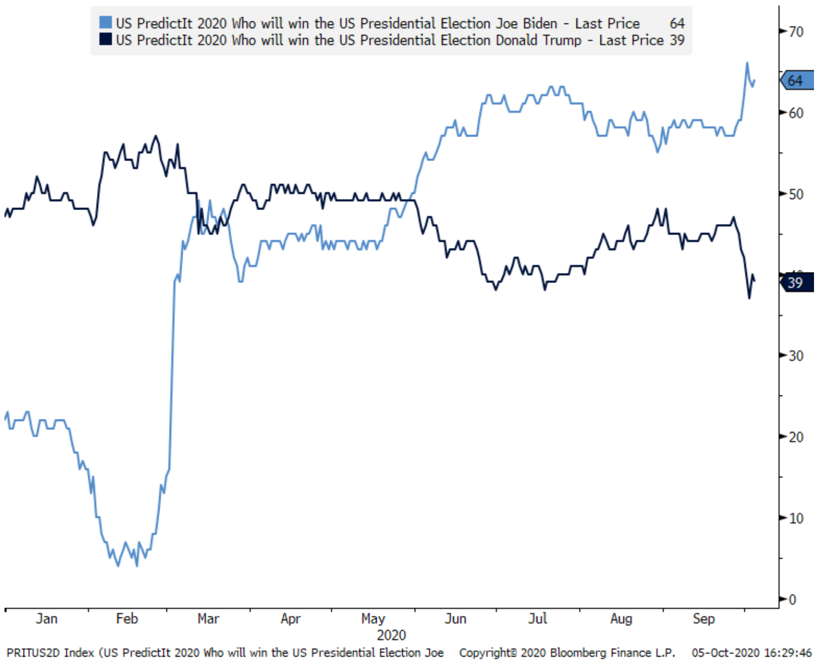


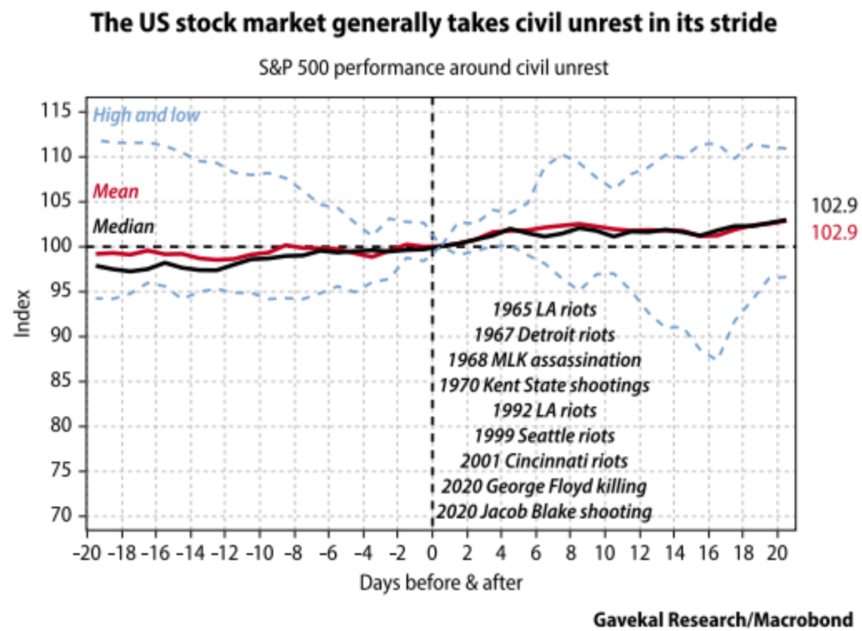


The lack of a convincing rebound in consumer confidence, despite the recovery in retail sales, has been a dark spot in the US economic recovery. It has formed a worrying contrast with the market rebound and lofty valuation (left hand chart).

US banks have continued to report tightening lending standards (dark blue), which has historically been associated with stress in the bond market through rising credit spreads (light blue). While the Fed's heavy hand in the bond market appears to have put that relationship to rest (for the time being), rising loan delinquencies (in grey) suggest that the bond market's calm may not be representative of the economic reality.

US election risks take center stage as Biden's lead widens

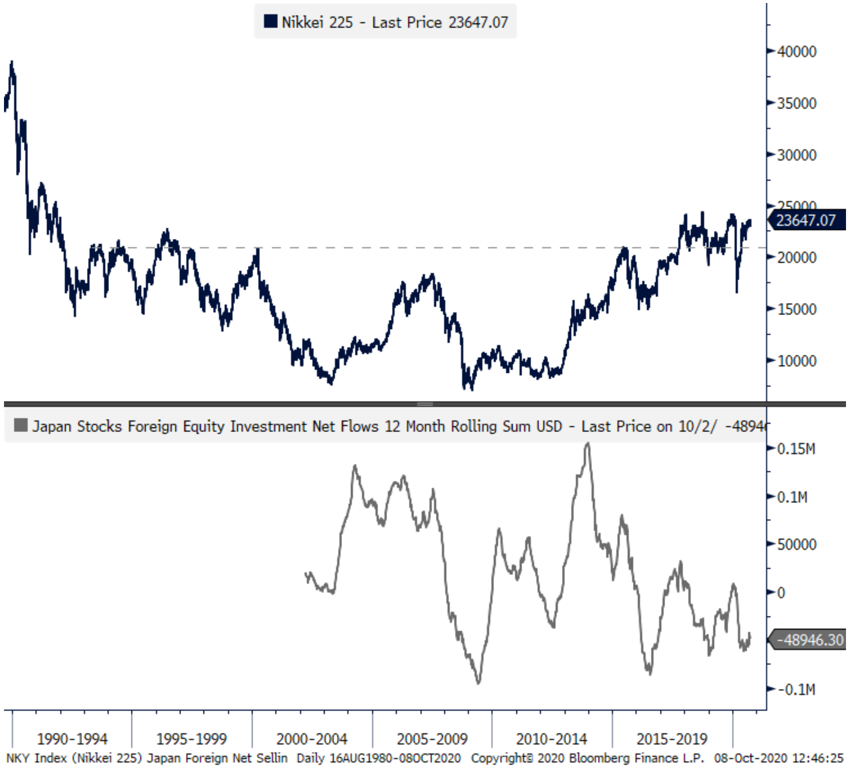


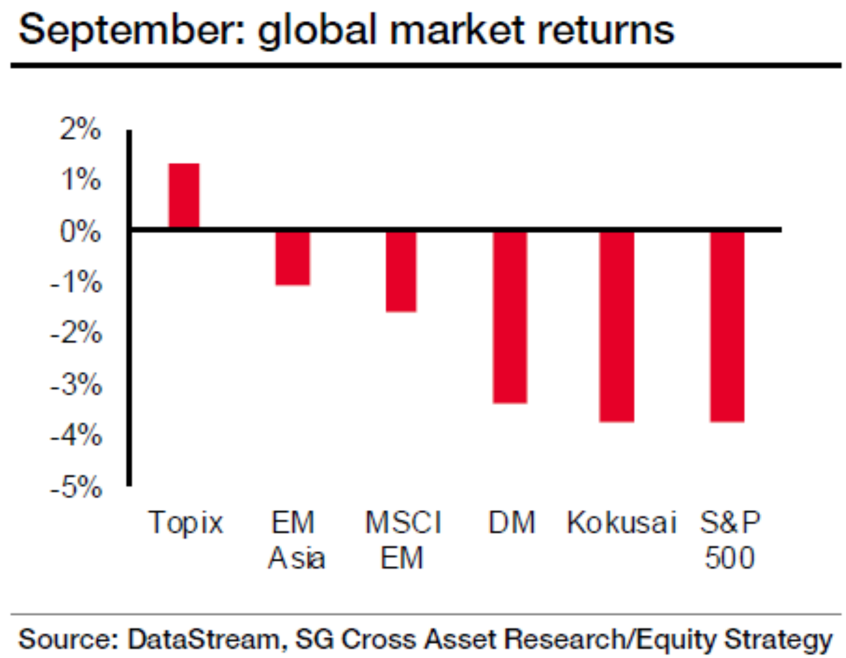


The news flow around the US presidential race has been particularly worrying, with Trump declaring that he might not recognise a Biden victory, especially in the event of mail-in voting. Many investors are worried about this scenario as it would likely see a further increase in civil unrest, especially in the event of a tight election. Interestingly, Gavekal shows (right hand chart) that US equities have been largely indifferent too previous periods of (sometimes significant) unrest.

The bigger concern for investors should be the implications of a clean sweep by Biden, which is what bookkeepers' odds currently imply. Such a victory would mean higher taxes and regulations, more green investments and likely lower tariffs and geopolitical tensions. This would likely precipitate the end of US outperformance and be positive for EMs.

Japan shows resilience and could start attracting foreign flows again

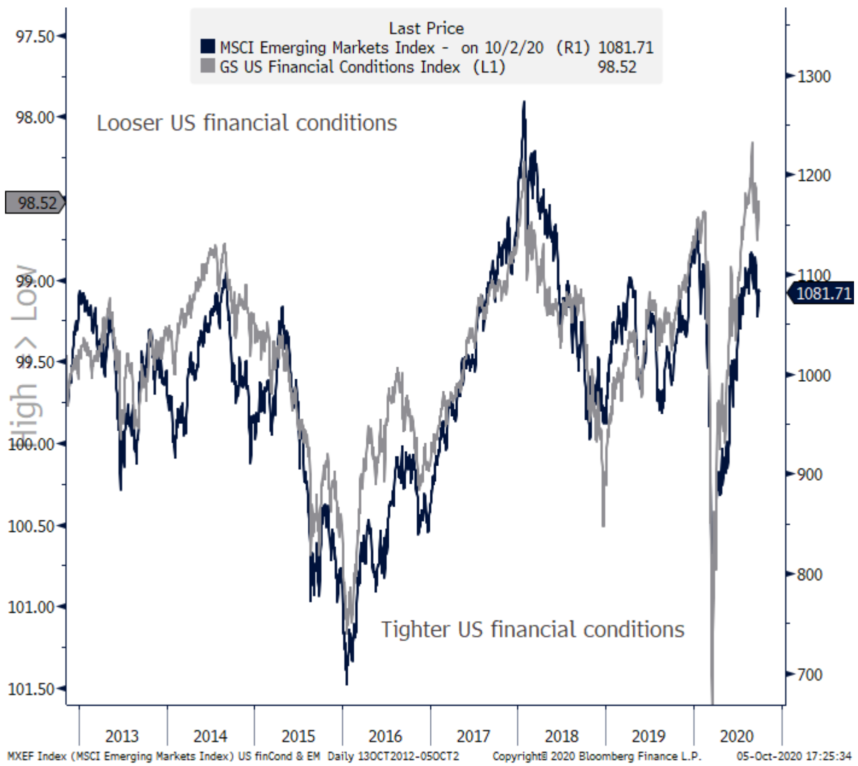


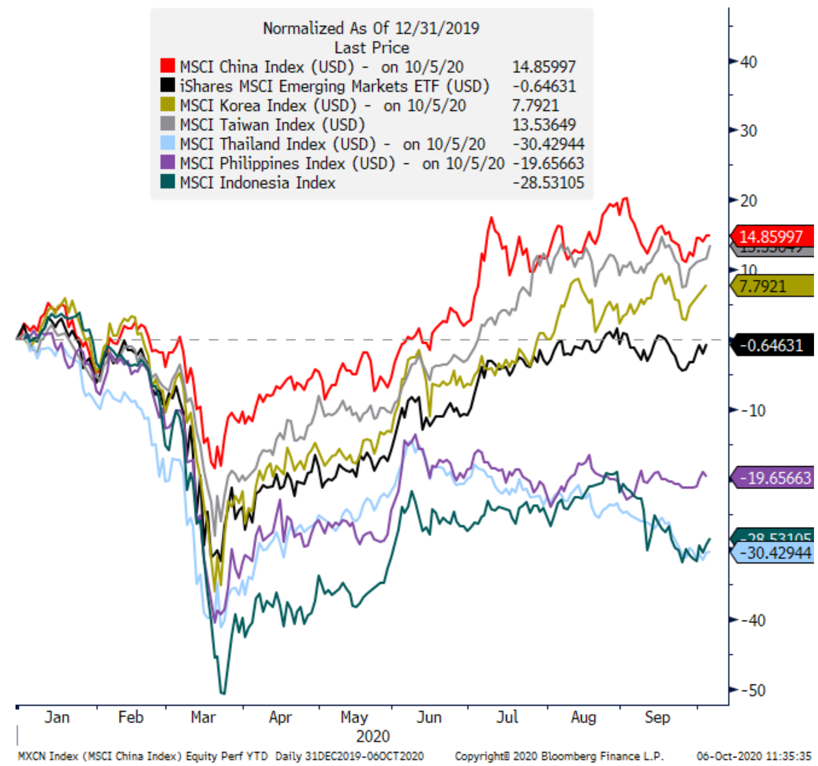


Japan's Abe has resigned and Mr Suga has taken the helm as Prime Minister. Suga is business friendly and has been working alongside Abe in the definition of his policies; Suga therefore represents continuity.

The Japanese economic recovery continues and has not yet shown similar signs of stalling compared to those in Europe, which probably explains the equity market's remarkable resilience during the month of September (right hand chart). Encouragingly, the Nikkei is back above the key multi decade resistance despite heavy selling from foreigners (left hand chart). With attractive valuations, a contained virus situation and the recent approval stamp by Mr Buffet, foreign investors may start to look back toward Japan and push this attractive market higher.

North-east Asia shines bright with EMs





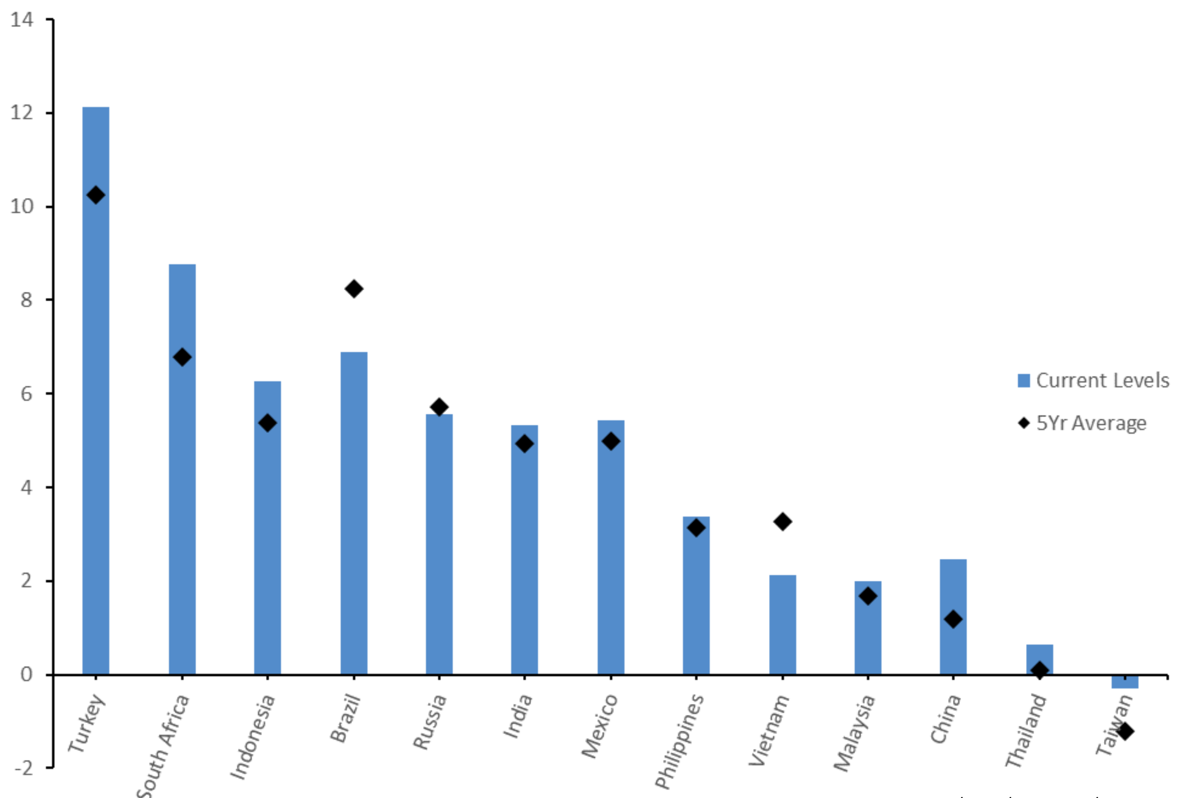
The extreme loosening of US financial conditions has been a major boon for emerging markets (left hand chart), as yields have fallen and the dollar has weakened, allowing EM central banks to ease their monetary policy too.

At the same time, rising demand for IT products and medical supply has disproportionally benefited countries like Taiwan, China or South Korea, which have also better managed their COVID outbreaks. These tech heavy countries are the only positive contributors YTD in the MSCI EM index (right hand chart). Other Asian countries have fared much worse, as they are still grappling with the virus (Indonesia, Philippines) and/or are simply more dependent on tourism revenues and oil prices.

EM debt continues to offer highly attractive real yields

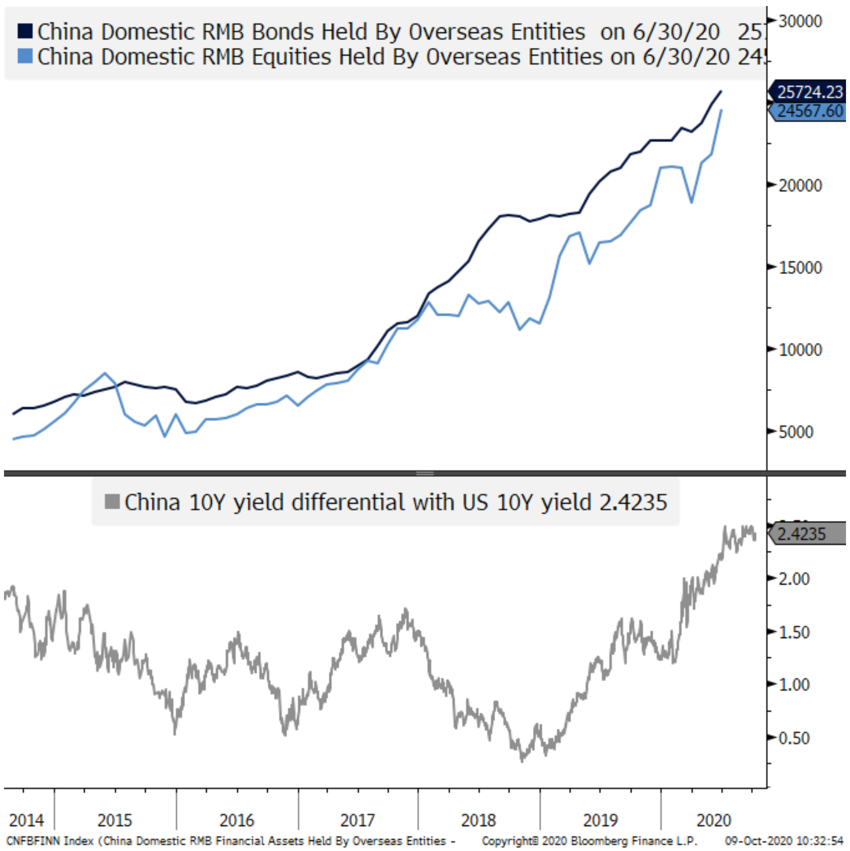
Flows are likely to keep heading towards EM debt, where real yield remains positive and differentials attractive compared to developed markets (see chart). We remain selective within the EM local currency debt segment and currently favor Chinese and Indonesian debt, while Indian debt is slowly becoming attractive again.

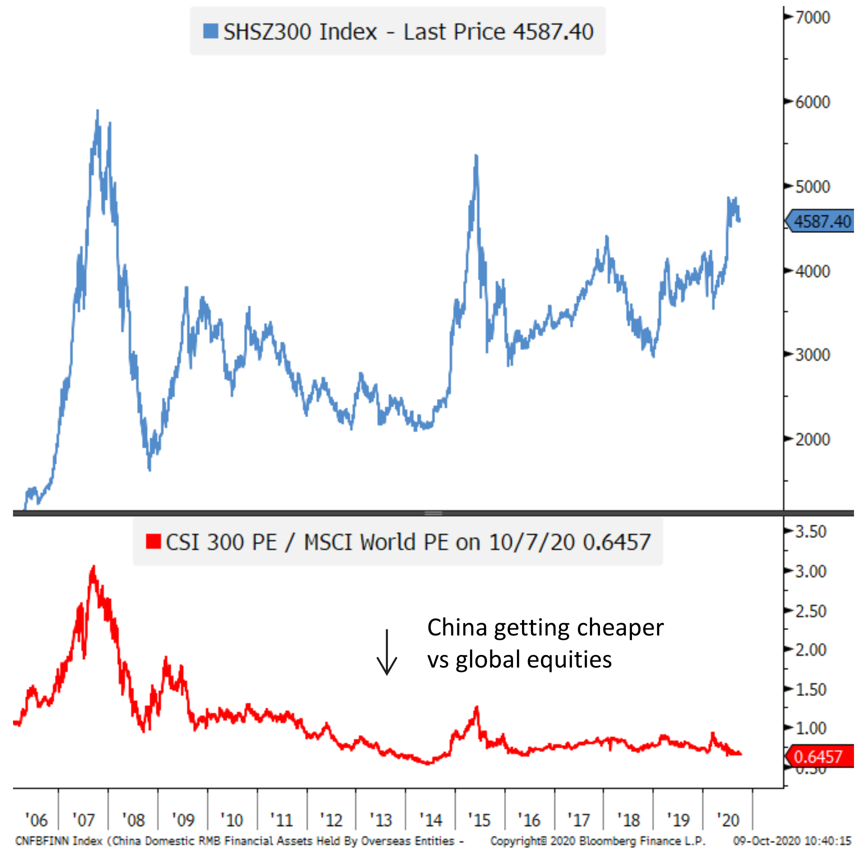
10 Year Yield Spreads over US Treasuries



Source: Bloomberg, Probus

Chinese bonds and equities are particularly attractive

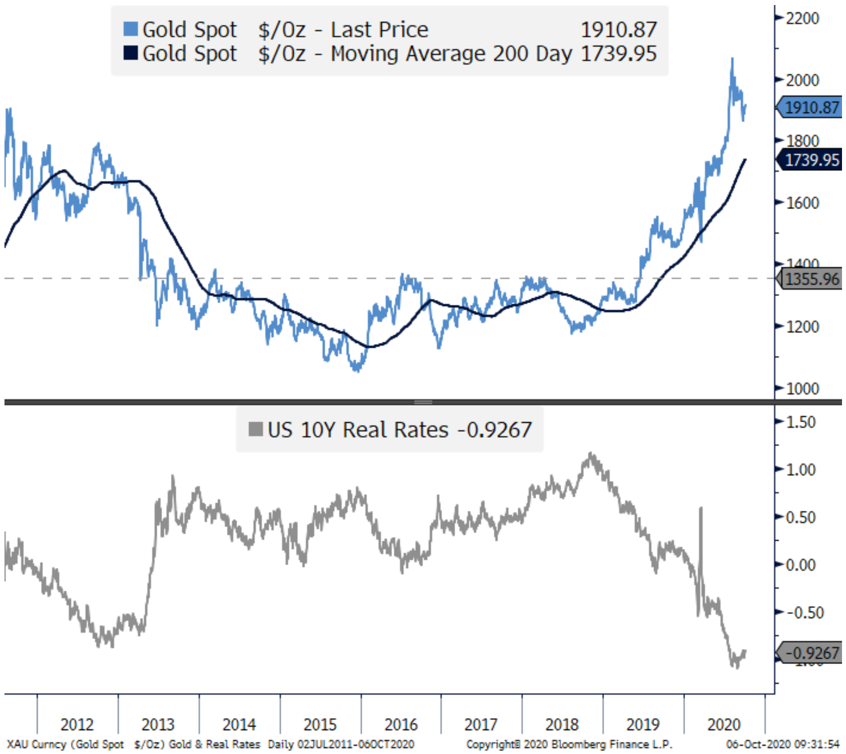


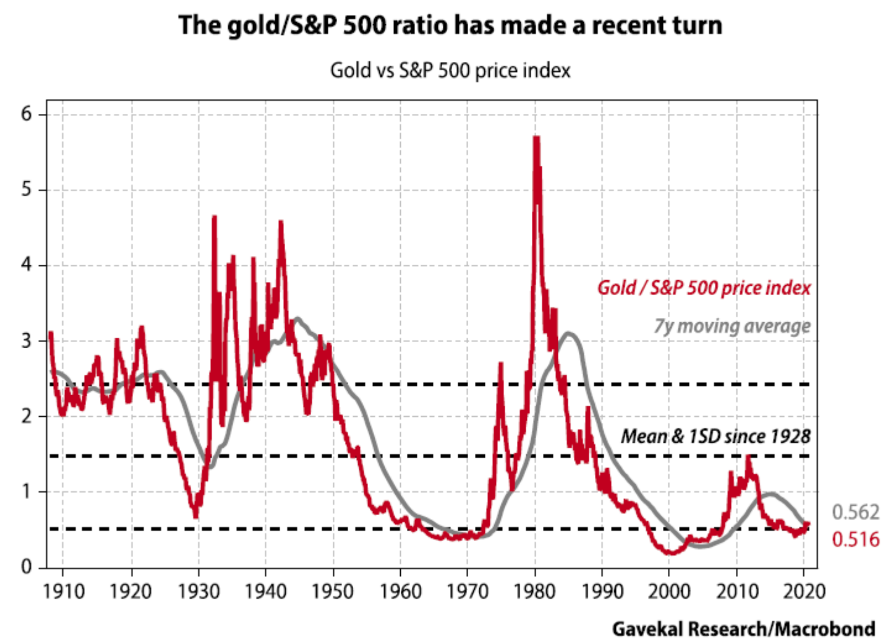


Despite the continued worries around US-China trade relations, money keeps flowing into Chinese equities and bonds (left hand chart). This is the direct consequence of its increasing inclusion into global benchmarks, as China continues opening up its financial markets.

With the 10Y yield currently offers a record 2.4% premium over US treasuries (grey line) and the equity market, despite having risen 12% in 2020, is trading at a significant 35% valuation discount to global equities (red line). Both asset classes offer compelling opportunities.

New all-time highs for gold but risk of short term pullback



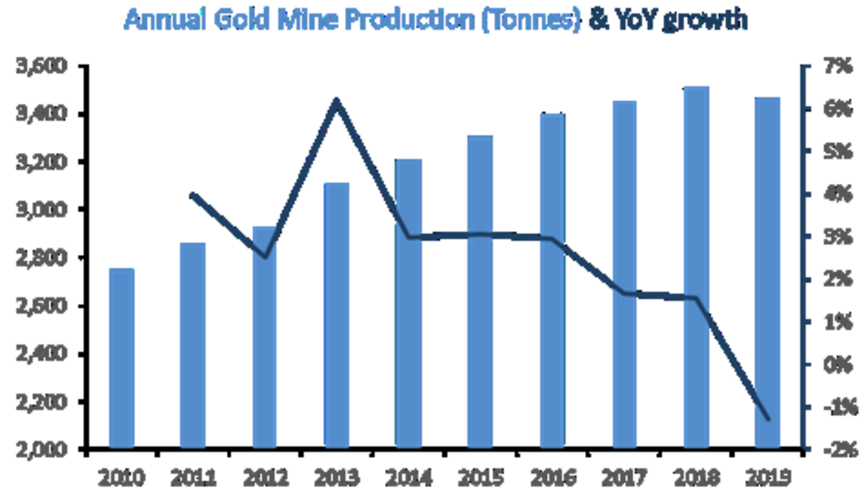


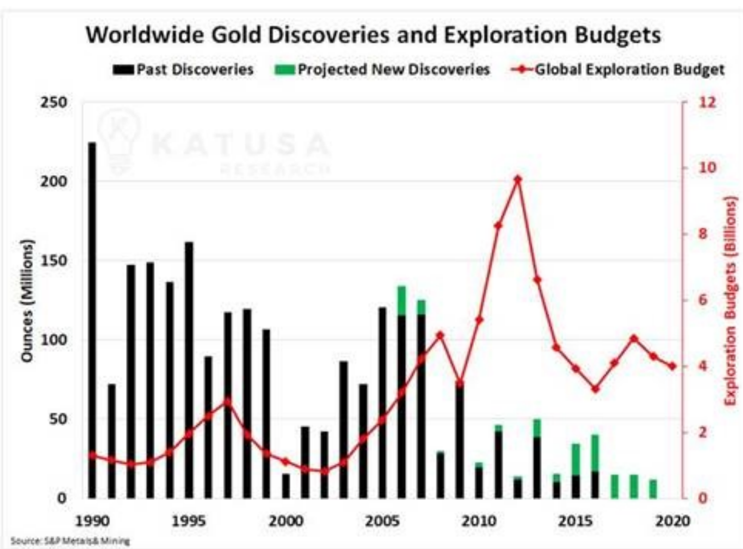
Gold has cut through its all time high resistance level of around $1900 per ounce, as real rates have reached new lows in the US. Gold has started to outperform equities but remains cheap relative to the S&P 500 (light blue), reinforcing the long term bull case. In other words, equities may have rallied when expressed in USD, EUR or GBP (or any easily printable currency) but not against gold, the strongest currency around.

While a rebound in the USD or real rates could lead to a pullback for the bullion, it will likely prove temporary given the continued debasement of fiat currencies, gold's inelastic supply and the impossibility of real rates rising durably. The 200 day moving average would be a great level to add to existing positions.

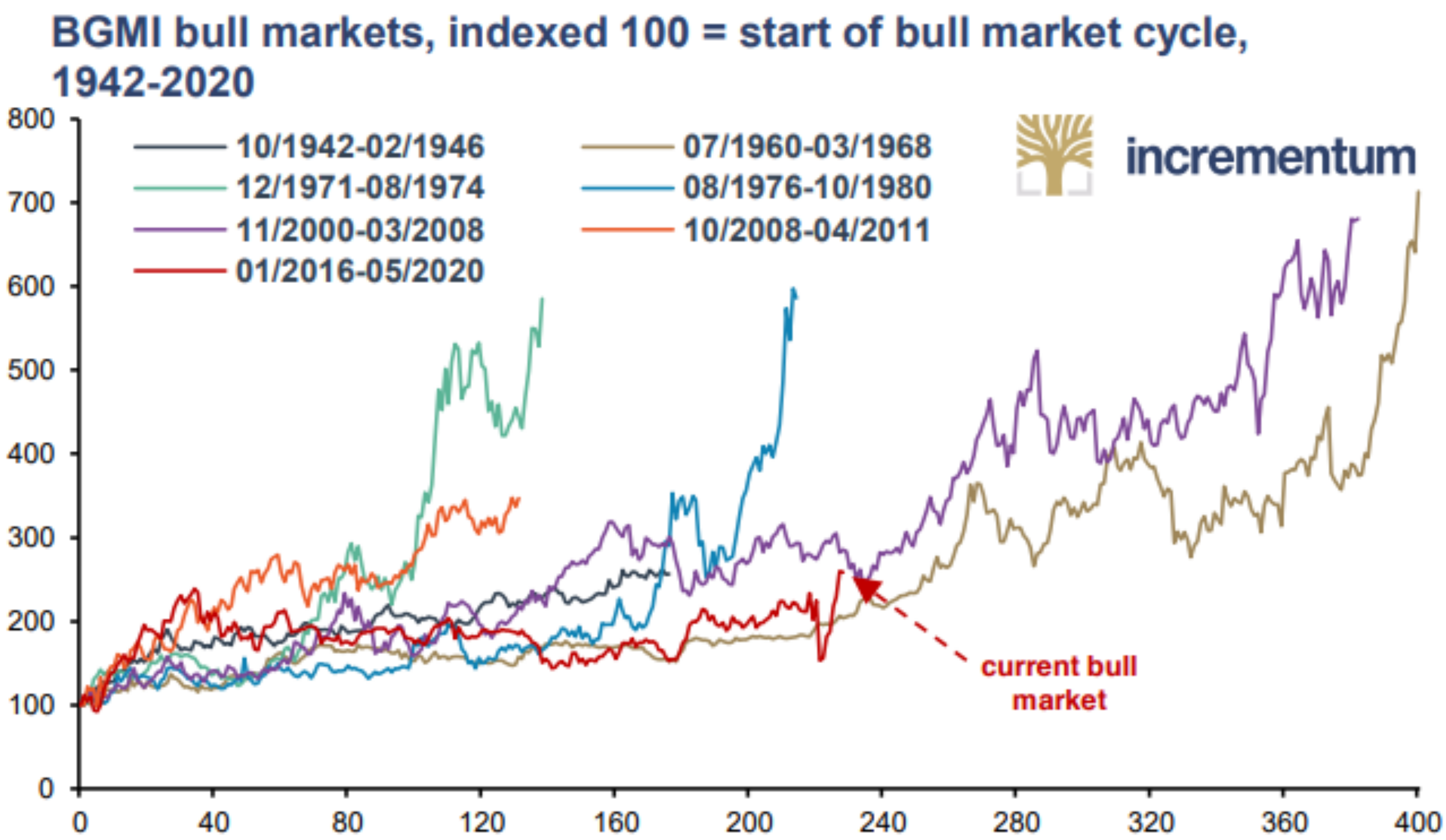
Gold production decline and undervalued miners

- Gold exploration budgets have been reduced over the last 9 years and discoveries have plummeted.
- Gold production growth has been declining for years.
- Gold miners remain undervalued relative to the metal's price.





If history is any guide, gold has room to run

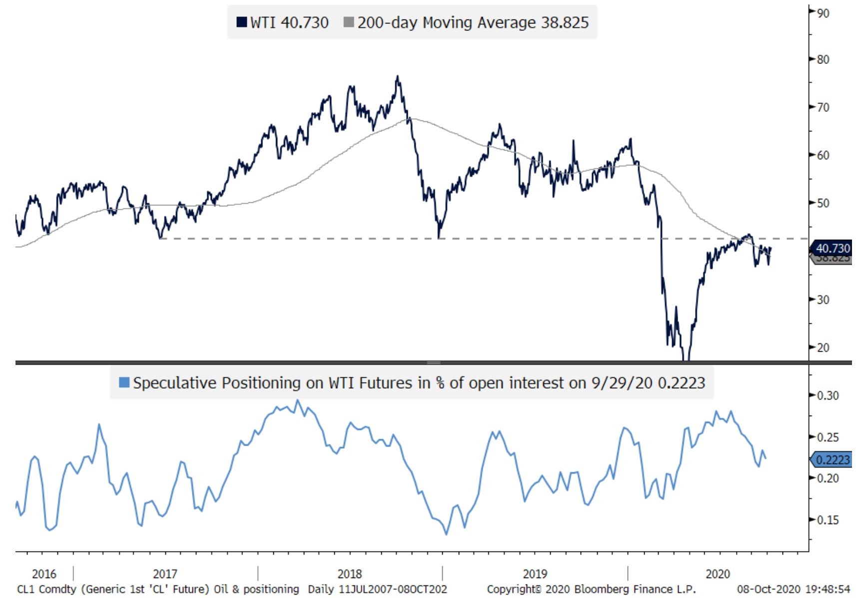


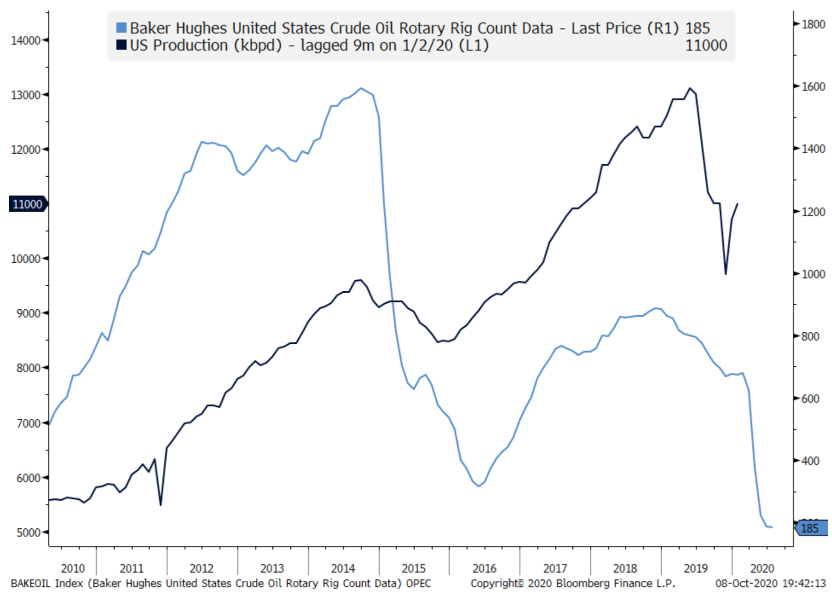
Source: TheDailyGold.com, Nick Laird, goldchartsrus.com, Incrementum AG

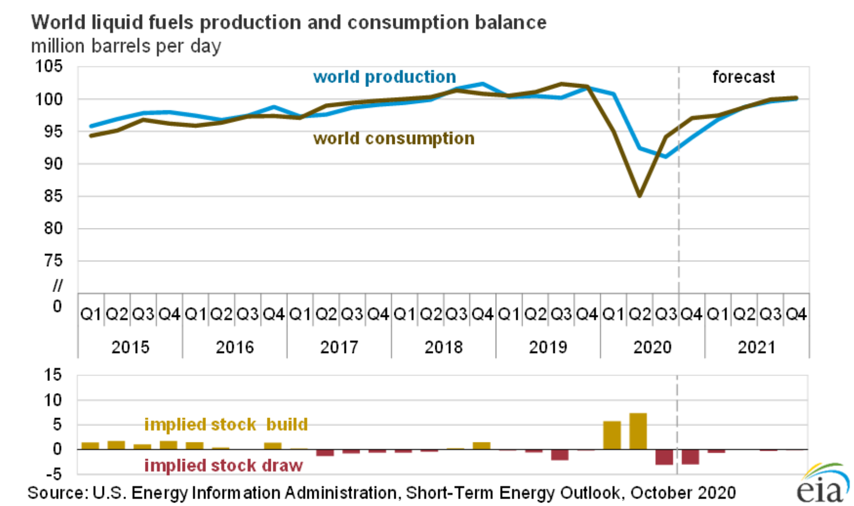
Oil price recovery likely delayed despite coming fall in US production

Despite the recent rebound, US production should keep falling in the coming months given the low number of rigs in operation (lower left hand chart). While declining US production combined with years of low capex is a recipe for higher prices, this should not be on the cards before 2021 given the current state of demand .

Oil prices are unlikely to exceed the key USD 40-45 resistance (top right chart) in the short term. Money is leaving the oil complex at historic rates, with the sector representing the lowest ever weight in global indices. The relentless selling pressure is unnerving but also creating great opportunities for patient investors.







Cryptocurrencies slowly making their way in the world

While we have been long advocates of gold, due to its relatively inflexible supply and store of value track record over millennia, other assets are likely to shine just as bright in a world of continued currency debasement. For example, Bitcoin (and other cryptocurrencies) has many attractive attributes: no counterparty risk (when properly stored), a finite and predictable supply, technological promise, and limited institutional ownership.

However, adoption is starting to scale up, with Bank of America considering cryptos as cash, many large US firms and hedge funds recently endorsing this asset class' potential and central banks experimenting with their own token…With the recent break out of a massive consolidation, the path of least resistance appears to be up.

Source: Bloomberg, Probus

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