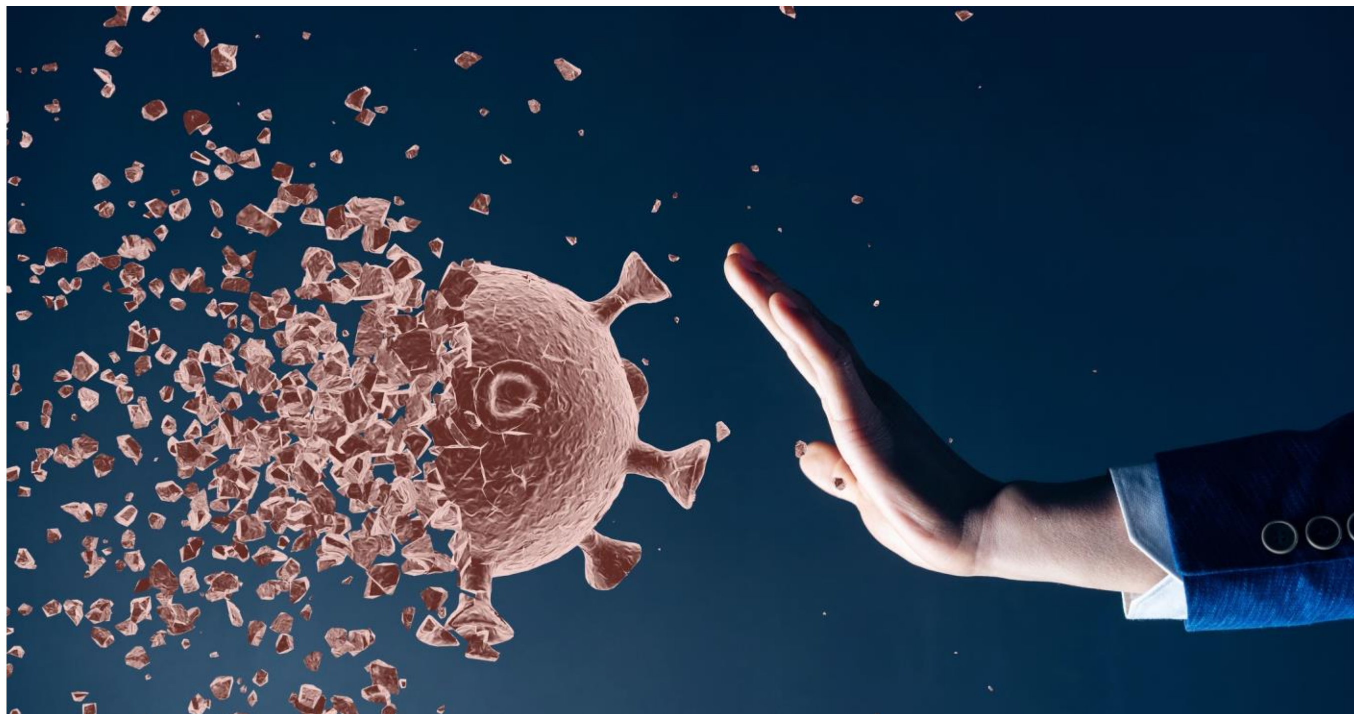
MONTHLY HOUSE VIEWS

June 2020



Glimmers of Recovery

Macro

Over the past month, more and more governments have begun to ease lockdown restrictions, encouraged no doubt by the absence so far of a second wave of infections of CoViD-19. Nonetheless, they will remain vigilant – we still have not seen the peak in active cases – and some restrictions on activity are likely to linger. Business confidence has begun to stabilise as activity levels have stopped plummeting. However, output remains at depressed levels and unemployment levels continue to rise rapidly, meaning that recovery will be gradual. Given these factors, fiscal and budget support packages will remain necessary, with the focus switching from short-term support for companies and households towards measures to foster recovery via investment in areas such as green energy or IT.

Central Banks

The recent German Constitutional Court ruling on European Central Bank asset purchases does not appear to have diminished the ECB's willingness to pursue its programmes. Indeed, recent statements by policy-makers suggest that the size of its Pandemic Emergency Purchase Programme could be boosted at the next meeting. The US Federal Reserve (Fed) has similarly given no indication of any wavering of its commitment to pursue its various support programmes, even if the speed of its asset purchases is likely to slacken from the recent heady pace (its holdings have risen 63% since mid-February). In addition, emerging world central banks have been busy cutting rates so far this year, despite marked currency weakness.

Markets

With government deficits skyrocketing across the globe, central bank asset purchases will be key to keeping sovereign bond yields at manageable levels. In addition, the support provided to corporate bond markets should help maintain yield differentials over government bonds ("spreads") at relatively low levels, in particular for better-quality issuers. This provides a supportive backdrop for global equities, especially given the gradual easing of lockdowns thanks to the continued slowing of the coronavirus pandemic and the vast size of government support programmes. All in all, a more neutral stance in terms of asset allocation is now possible.

Bottom line

We suggest moving to Neutral in equities, but remaining underweight in sovereign bonds – today's low yield levels diminish both their return potential and their usefulness for portfolio diversification. We continue to prefer euro-denominated High Yield (HY) bonds over those issued in dollars given their generally better-quality balance sheets. Within equities, the UK may continue to underperform in light of the rising risk that Brexit may occur without a favourable trade deal with the EU. Among emerging markets, we continue to prefer Asia over other regions where the pandemic continues to spread. Oil prices have recovered somewhat from the late-April shock while gold continues to benefit from safe-haven flows in the face of rapid increases in money supply.

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document. CAO9/H1/2020

OUR ASSET ALLOCATION

The table below presents the latest conclusions of our Global Investment Committee

Summary house views

Asset class			Strong UW	UW	N	OW	Strong OW	Change since last GIC
EQUITY		GLOBAL EQUITY			■			+
		United States			■			
		Eurozone			■			+
		United Kingdom		■				
		Japan			■			+
		Emerging			■			
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
		U.S. Treasuries		■				
		U.S. Breakeven		■				
		Bunds		■				
		EMU Breakeven		■				
		Gilts		■				
		Gilts Breakeven		■				
		JGBs		■				
		EM Govies ($)		■				
	CORPORATE	U.S. IG			■			
		U.S. HY		■				
		EMU IG			■			
		EMU HY			■			
		UK IG			■			
		UK HY			■			
		Duration USD*		■				
		Duration EUR*		■				
		Duration GBP*		■				
FOREX		EURUSD			■			
		USDJPY			■			
		GBPUSD			■			
		EURCHF			■			
		EM FX (vs. USD)			■			
CMDTY		Brent	■					+
		Gold				■		
ALTERNATIVE		ALT. STRATEGIES				■		
		L/S Equity		■				
		Event-Driven				■		
		FI Arbitrage				■		
		Global Macro / CTAs			■			
		Cash			■			-

	Positioning	*Duration
O/W	Overweight	Long – 7-10 years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – 3-5 years

EQUITIES	
United States	For now, the scale of the unfolding recession, the multi-decade highs in unemployment and the sharp downgrades to 2020 and 2021 earnings estimates hold little sway. We are Neutral.
Europe	The encouraging decline in the spread of new coronavirus infections has enabled governments across the region to begin to ease restrictions. We move from Underweight to Neutral.
Eurozone	Given the current context, we suggest raising exposure to Neutral.
UK	The country has been harder hit by the pandemic and lockdown restrictions will lifted later than in many continental economies. We remain Underweight.
Switzerland	Swiss high-quality blue chips should remain sought after, suggesting continued resilience for now.
Japan	The scale of support should soften the negative impact on GDP and help Japanese equities perform in line with global indices. We suggest an upgrade to Neutral.
Emerging (EM)	According to the International Monetary Fund's latest forecasts, emerging markets (EM) should register a dip of 1% in GDP this year. We remain Neutral.

FIXED INCOME	
Sovereigns	Although central bank easing should keep downward pressure on yields, sovereign bonds offer little value.
Duration*	We prefer shorter-dated bonds across markets.
Inflation-linked	We are Underweight Inflation-linked bonds, as upside inflation risks should be contained by the poor growth outlook.
Investment Grade	Even if markets remain relaxed about corporate bond risk, the macroeconomic backdrop is not favorable. We remain Neutral.
High Yield	Many US issuers have vulnerable balance sheets meaning rising default risks. Euro-denominated HY is less risky.
Emerging debt (in € and $)	Growth risks remain on the downside, and low oil prices penalise producer countries. We remain Underweight.

CURRENCIES	
EUR/USD	Pending the establishment of the recovery fund proposed by the European Commission, the euro is likely to remain oversold and cheap.
GBP/USD	We expect sideways trading in the near term – higher levels for GBP will have to wait for better news on the virus and Brexit.
EUR/GBP	Government stimulus programmes on both sides of the Channel will push budget deficits much higher. No major moves are expected in the near term.
USD/JPY	Japanese economic growth expectations are better than other advanced economies. However, we don't have a strong conviction that there will be a major move in either direction from here.
EUR/CHF	We do not expect any sustained weakness in the franc against the euro for now and remain Neutral.
Emerging	Many emerging central banks have cut rates in an attempt to bolster domestic economies, but putting further downward pressure on their currencies. We remain cautious and suggest a Neutral stance.

ALTERNATIVES	
Hedge funds	Hedge funds provide a useful source of diversification with a return stream which does not solely depend on rising markets. We are Overweight.
Gold	Gold prices continue to grind higher on robust demand from investors and central banks alike.
Oil	Oil prices have recovered from April's perfect storm and should trade close to current levels for now. We move from Strong Underweight to Underweight.

Source: SGPB, 29/05/2020
* Duration: short = 3-5 years, medium = 5-7 years, long = 7-10 years
HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)

ECONOMIC OUTLOOK

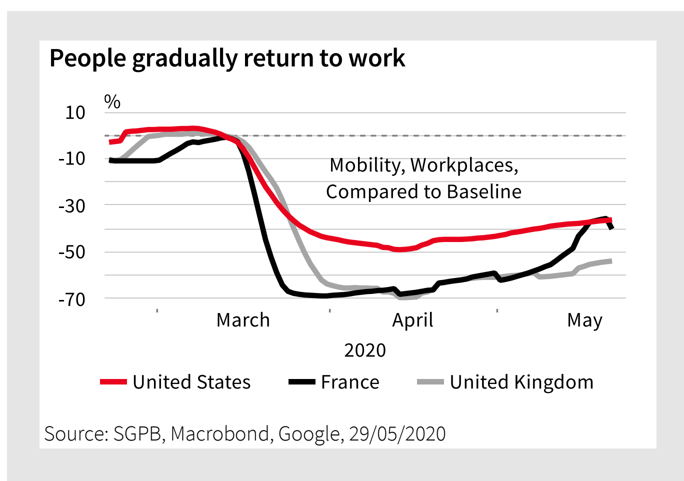
Glimmers of recovery

The latest economic data remains dire by pre-CoViD19 standards. Nonetheless, across some key data, the rate of deterioration is easing. Our base case remains relatively optimistic but we do acknowledge that recovery will be a drawn-out process. For now, our cautious optimism on the outlook suggests that risk assets might continue their uneven recovery.

The latest economic data remains dire by pre-CoViD19 standards: jobless claims from the US showed the avalanche of layoffs has reached 38 million in nine weeks; the preliminary euro zone composite purchasing managers' index (PMI) registered 30.5 in May, signalling deep contraction (50 marks the dividing line between expansion and contraction on a 0-100 scale); and UK retail sales tumbled 18.4% year-on-year in April.

Nonetheless, across some key data, the rate of deterioration is easing – and in times such as these, we can take a modicum of comfort from this. While the US layoffs figure is still rising, it is doing so at a much-reduced pace, with the number of Americans filling for unemployment benefits having eased to 2.4 million in the week ended May 16th, down from a weekly high of 6.9 million two months ago. The euro zone manufacturing PMI came in at 39.5 points, higher than expected and up from 33.4 in April, while the services index rose to 28.7, up from the apocalyptic reading of 12.0. In the UK, PMI figures also suggest convalescence has begun: the manufacturing index reached 40.6, up from 32.6 – and the services sector reached 27.8, rising from the ashes of its previous print (13.4).

In a best-case scenario, if restrictions are eased rapidly with no resulting second wave of infections, economic data may well see sustained improvement. On the other hand, in the worst case, longer lockdowns may prove necessary and the economic figures could careen downwards again. Our base case remains relatively optimistic but we do acknowledge that recovery will be a drawn-out process.



Source: SGPB, Macrobond, Google, 29/05/2020

We are encouraged by flattened viral transmission rates across previous epicentres in Asia, Europe and North America where daily increases in confirmed cases have tumbled to 1% or below. Moreover, there is some tentative improvement in high-frequency indicators. For example, mortgage applications have started rising again in the US; Tom-Tom's London congestion index shows an uptick; and Google's mobility report for trips to workplaces and shops in France has moved higher.

Nonetheless, we must acknowledge that even a best-case exit from lockdowns would not mean a "V-shaped" recovery. The scale of the economic damage is acute, especially regarding employment. US continuing jobless claims, which measure the numbers receiving unemployment benefits, crossed the 25 million mark in the week ended May 9th – this would imply an unemployment rate higher than the 14.7% officially recorded for April. A large majority of UK PMI respondents in May said they were shedding jobs. And in France, more than 13 million workers are receiving government wage support, some 45% of the total workforce.

Some analysts have made the case that – since this is a services-led recession, the first in history – there is a chance that much of the unemployment is reversed quickly. However, there are good reasons to not put too much stock in that theory. For one, until a vaccine is approved and widely available – something well over a year away according to most experts – social prudence is here to stay. This means lasting downward pressure on consumer demand – fewer tables in restaurants, fewer passengers on planes and so on – which means many jobs are gone, not merely put "on hold". Moreover, judging by the after-effects of the Great Depression, the closest historical proxy we have for today's skyrocketing levels of unemployment, discretionary consumption will decrease across the board. Increased savings rates already point to this.

Bottom line. As Europe and North America begin to ease lockdown restrictions, economic activity is likely to tick higher from today's low base. We expect recovery to be steady, but it will be slow. Of course, many factors could change our view, both positively (e.g. quicker availability of a vaccine than anticipated) and negatively (e.g. a second round of lockdowns). For now, our cautious optimism on the outlook suggests that risk assets might continue their uneven recovery.

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FIXED INCOME

Stay safer

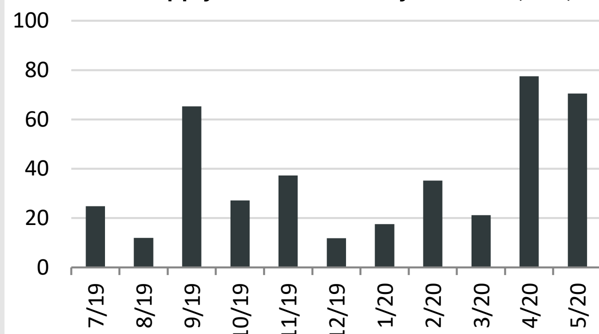
Don't expect the Fed to follow the ECB by moving rates into negative territory. Markets remain relaxed about corporate bond risk, as demonstrated by declining spreads in an unfriendly economic environment for many issuers with vulnerable balance sheets. We prefer better quality credit and suggest avoiding the weakest rating segments within HY.

Sovereigns

US. Two- and five-year yields touched new lows in May, at 0.14% and 0.30% respectively. This is a consequence of Fed rates having been slashed to zero and of expectations that this level will hold for the foreseeable future. In addition, interest rate futures have increasingly started to price the prospect that the central bank might even take rates into negative territory. However, Fed Chair Jerome Powell has ruled this out, judging that their existing tools will be sufficient to tackle the crisis. Instead, the minutes of the last monetary policy meeting show that participants discussed reinforcing their forward guidance on policy, for example via a monthly target for asset purchases. Indeed, we expect purchases to continue, helping keep rates low over coming quarters.

Eurozone. With growth plunging and subdued inflation nowhere near its target, the low rate environment will persist for long, providing critical support through cheap funding. The recent German Constitutional Court ruling on the proportionality of ECB asset purchases has raised a number of legal and constitutional issues, but is unlikely to stop the central bank pursuing – or indeed increasing – its programmes. However, it did serve to highlight the euro zone's over-reliance on its central bank – in this respect, agreement on the new European recovery fund will be crucial. The addition of EU fiscal support to vigorous monetary policy will help yields in weaker countries, hit hardest by the pandemic and facing significant increases in debt levels.

UK. UK rates have fallen further on speculation the Bank of England (BoE) may cut rates into negative territory. While this has not been ruled out, it seems unlikely for now, given recent declarations by policy-makers. Instead, we expect further increases in asset purchases to be the BoE's preferred tool.



Source: SGPB, Bloomberg, 29/05/2020

Credit

US. Healthy Investment Grade (IG) issuance has been well absorbed by investors over the last couple of months, with spreads slightly lower in May. In High Yield (HY), supply has increased since the second half of April, after almost no activity in March, with spreads trending down too. Although markets are shrugging off bad news on the economic front, the outlook remains bleak, especially for the weakest parts of the corporate sector. The most vulnerable companies have been facing increasing liquidity constraints, a trend spreading across most sectors and which will likely lead to an increase in defaults. Such an outcome is not entirely priced in current HY spreads and we remain cautious.

Eurozone. With revenues and income plunging, the earnings reporting season for Q1 has started to highlight the challenges that companies face in the virus-induced recession. However, despite the adverse backdrop, IG spreads continued to ease lower in May. With the ECB providing significant support, markets have been keen buyers of the robust new issuance, which has unsurprisingly been concentrated on bonds eligible for ECB purchases. On the riskier segments, new issuance and inflows into HY have been more moderate, while spreads are rather stable and still well off the March peaks. Euro-denominated HY issuers tend to have stronger balance sheets and better ratings than in the US, which should provide some support in the face of the economic and financial challenges ahead. However, the weakest rating segments face rising default rates over the next few quarters. We therefore continue to prefer IG bonds and, within HY, higher-rated segments.

UK. IG spreads were rather stable in May. Faltering economic growth and Brexit uncertainty are offset by benign markets on the back of central bank support.

Emerging Market (EM) debt

The virus is spreading quickly across many EM economies, as illustrated by the rapid increase in new cases in Brazil, Russia or India, where lockdowns are hitting economic activity. Growth risks remain on the downside, and low oil prices penalise producer countries. We remain cautious.

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EQUITIES

Back to Neutral

Despite the deep ongoing recession and downgrades to earnings expectations, investors have taken heart from central bank and government support packages and are focusing on the incremental improvement in activity as lockdown restrictions are eased in many countries. This has enabled a steady decline in market volatility as markets have recouped some of their losses and we suggest moving allocations back to Neutral.

US. US equities led the rebound from late March's oversold levels until very recently as investors continued to favour US tech giants, pushing the Nasdaq index back into positive territory for the year. Although active coronavirus cases continue to hit new highs, President Trump's determination to push states to ease lockdown restrictions and the vast levels of support provided by the Fed and Congress have sharpened risk appetite. For now, the scale of the unfolding recession, the multi-decade highs in unemployment and the sharp downgrades to 2020 and 2021 earnings estimates hold little sway.

We suggest keeping US stocks at Neutral and upgrading other markets. In terms of sector allocation, we believe that it may be too early for more cyclical, value stocks to continue their recent rally. While they were extremely oversold in late March, sustained outperformance tends to come when long rates are rising on Fed tightening – a combination we view as unlikely for now. Our preference remains for sectors like Technology and Healthcare where earnings have only been downgraded by 8.7% and 5.9% respectively over the past 3 months versus -22.1% for the market as a whole.

Eurozone. Analysts have continued to revise 2020 earnings forecasts ever lower – down 27.5% over the last 3 months – as the scale of economic disruption becomes apparent. The ECB president, Christine Lagarde, recently revised down her outlook for the economy, and now sees a fall in GDP of between -8% and -12% this year. However, the encouraging decline in the spread of new coronavirus infections has enabled governments across the region to begin to ease restrictions. The ECB remains committed to its support programmes despite protestations from the German Constitutional Court. And the European Commission has issued its blueprint for a €750bn recovery fund – funded via EU bond issuance and repaid via increased member contributions and new taxes – which, although much needed, will be fiercely contested by some members.

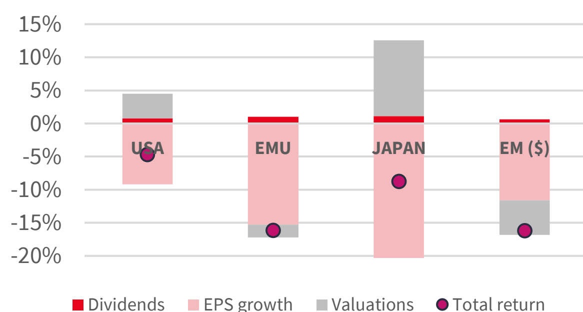
In this context, we propose raising exposure to euro zone equities to Neutral. For now, we suggest concentrating on more defensive, high quality stocks in sectors like Healthcare, Consumer Staples or Utilities. Cyclical sectors like Industrials and Consumer Discretionary still trade at premium valuations while earnings expectations continue to decline.

UK. UK equities have trailed European markets so far this year. The country has been harder hit by the pandemic and lockdown restrictions will lifted later than in many continental economies. Moreover, there has been no breakthrough in negotiations with the EU regarding the post-Brexit relationship, which raises the risk that future trade could be on World Trade Organisation terms. All in all, we suggest focusing on more defensive sectors as UK equities may continue to lag their peers.

Switzerland. Swiss equities have proved rather resilient so far in 2020, despite upward pressure on the Swiss franc against the euro, which has prompted SNB intervention. The average downgrade to 2020 earnings expectations over the past 3 months (at -12.2%) has been much lower than other global markets, thanks to the market's high exposure to global leaders in defensive sectors.

Japan. Japan recently announced another stimulus package, just as the economy begins to emerge from the state of emergency. The new package is worth JPY117 trillion, some 20% of GDP, and follows a similarly-sized package in April, making Japan's measures proportionally the largest among developed economies. The scale of support should soften the negative impact on GDP and help Japanese equities perform in line with global indices. We suggest an upgrade to Neutral.

Emerging Markets. According to the International Monetary Fund's latest forecasts, emerging markets (EM) should register a dip of 1% in GDP this year, followed by a 6.6% bounce in 2021, compared to -6.1% and +4.5% respectively for advanced economies. Asia is likely to be more resilient than other regions, thanks to modest growth of 1.2% in China and 1.9% in India – economies across the region are already beginning to recover from the lockdowns. We reaffirm our strong preference for Asia within a generally Neutral stance on EM equities.



Source: SGPB, Macrobond, 29/05/2020

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CURRENCIES

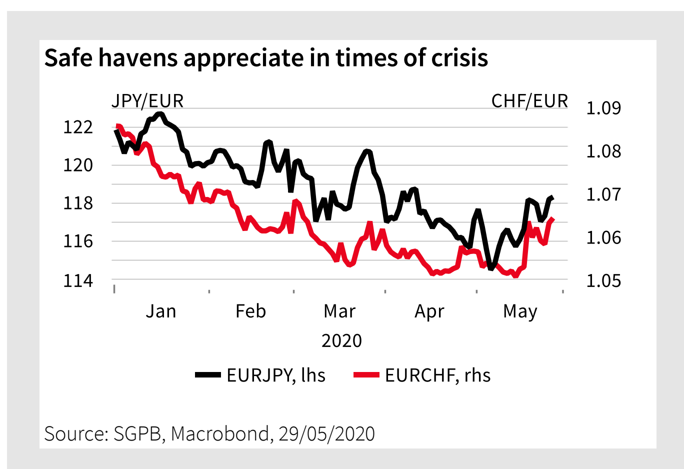
Treading Water

Has FX lost its sense of direction? Volatility has fallen, but we suggest treading carefully. Risk sentiment has improved in the global markets, but lockdown restrictions are being eased only gradually and unevenly.

Dollar Index. There is no escaping the fact that the virus will continue to cause widespread economic difficulties. Throughout the crisis, the dollar has fared well as investors have sought safe havens. Moreover, the dollar has been in especially heavy demand from emerging markets, due to fears of a shortage. The Fed did ease these worries by offering cheap access to dollars, but the USD remains robust for the time being. The broad Dollar Index is trading close to its average level for the year and, until life returns to some form of normality across the globe, we shouldn't underestimate the greenback.

EUR/USD. In recent weeks, EUR/USD has been stuck in a 1.08-1.10 range as investors have fretted that the German Constitutional Court ruling against the ECB's asset purchase programme might lead to a weakening in monetary support. However, the European Commission recently proposed the creation of a recovery fund worth €750 billion – funded by EU borrowing in markets – to help those members and industries hit hardest by the coronavirus pandemic. If approved by the 27 heads of state – by no means a foregone conclusion – this would represent a major step forward for euro zone integration. For now however, the euro is likely to remain oversold and cheap.

GBP/USD. Sterling has trended lower versus the dollar over the past month. Until new cases decrease further and a clear lockdown exit strategy is announced, GBP/USD is likely to be stranded at current levels close to 1.22. In the background, EU/UK trade talks continue but with little progress being made. Although this must be a particularly difficult time for breakthroughs, the end-June deadline for requesting a postponement – a move PM Johnson has ruled out – is fast approaching. Overall, we expect sideways trading in the near term – higher levels will have to wait for better news on the virus and Brexit.



USD/JPY. There have been some major swings this year, with a wide trading range between 102.00 and 112.00 since the pandemic took hold. Japan hasn't been as badly affected by the crisis as the US, and the IMF expects its economy to shrink less than other advanced economies this year. USD/JPY has been in a modest downtrend since the beginning of April, but we don't have a strong conviction that there will be a major move in either direction from here.

EUR/CHF. The Swiss National Bank's total sight deposits – a good proxy for currency interventions – have shot higher since mid-February as the central bank seems to have been attempting to prevent the franc dipping below 1.05. Since May 15 when the French and German leaders unveiled their proposal for the EU recovery fund, EUR/CHF has moved higher on hopes that the blueprint might resolve some of the tensions between euro zone members. However, this remains to be seen and we do not expect a major upside breakout for the euro for now.

EM currencies. With oil prices down by about 50% this year, there has been no let up for EM producers. Moreover, the latest hotspots for the CoViD-19 pandemic are all in large emerging economies. Brazil, for example, has been hit hard by both factors and the real has fallen 30% since the beginning of March. Furthermore, much emerging market borrowing is done in US dollars, which can be a costly when the greenback is strong and debts need to be repaid. Moreover, many emerging central banks have cut rates in an attempt to bolster domestic economies, but putting further downward pressure on their currencies.

USD/CNY. Chinese GDP contracted by 6.8% in Q1 in the carnage of the coronavirus outbreak. This has prompted the authorities to avoid setting a growth target for the first time in decades as the country attempts to shore up domestic economic conditions. Moreover, geopolitical tension have spiked. The US administration blames China for the pandemic and threatens new trade tariffs while China's National People's Congress has moved to "safeguard" national security in Hong Kong, signalling the end of the territory's independence. US senators have retaliated by introducing a bill that sanctions Chinese party officials. This has led the yuan to weaken well past the 7-mark, approaching its weakest level since 2008.

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ALTERNATIVES

After the Perfect Storm

Oil prices have recovered from April's perfect storm and should trade close to current levels for now. Gold prices continue to grind higher on robust demand from investors and central banks alike. Hedge funds provide a useful source of diversification with a return stream which does not solely depend on rising markets. We suggest remaining Overweight.

Commodities

Oil

Crude oil prices have recovered from April's perfect storm of collapsing demand and brimming storage capacity with US futures contracts trading back above $30 per barrel (/b). Recent real-time data from companies like Google and Tom-Tom suggest that commuters have begun to use their cars again, meaning that oil demand should be starting to pick up. On the supply side, Saudi Arabia has announced further output cuts of 1 million barrels per day (mb/d), in addition to the 9.7mb/d agreed by OPEC and Russia, while US production has fallen 1.7mb/d since early March.

However, we expect activity and travel restrictions to linger as countries fret about the risk of a second wave of infections. Moreover, many employees may continue to work partly from home for the foreseeable future while many travellers are reluctant to resume flying, meaning that demand for fuel may not return to pre-coronavirus levels for some time. This means that producers may find it difficult to boost output back to 2019 levels and that oil prices may struggle to last year's levels.

All in all, the dust from April's perfect storm has settled which warrants an upgrade to our rating to Underweight.

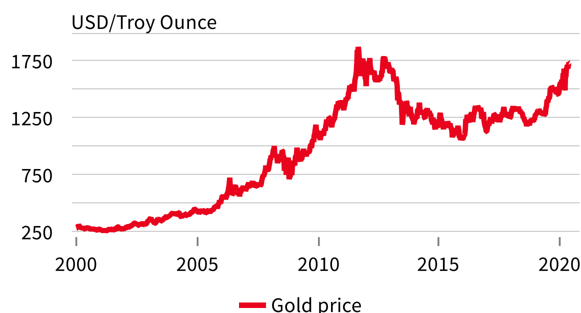
Gold

With the exception of a brief dip on margin-call selling in early March, gold prices have steadily gained ground, up over 13% year-to-date to around $1,720 per ounce.

Demand has been strong. April saw 170 tonnes (t) of purchases by gold ETFs, the highest monthly total since February 2016, taking buying over the past 12 months to 879t, just above the previous records in 2009 and 2016. Moreover, central banks continue to add gold holdings to their currency reserves – especially in the emerging world. They bought 179.3t in the first quarter, in line with the heady pace which saw them purchase record quantities last year. In addition, consumer demand in China – one of the largest physical gold markets – has shown signs of recovery in April and May as restrictions are eased.

With central banks ramping up asset purchases and government deficits reaching unprecedented peacetime heights, gold continues to represent an attractive store of value and an independent source of investment returns. We remain Overweight.

Gold's safe-haven status has been precious this year



Source: SGPB, Macrobond, 29/05/2020

Hedge funds

Long/Short (L/S) Equity

The savage decline in equity prices in February and March and the rapid subsequent rebound proved challenging for L/S investors with little difference in performance across different stocks within sectors. The latter part of the Q1 earnings season saw more dispersion as investors begin to focus anew on fundamentals. However, we remain cautious for now.

Event Driven

Special Situations managers tend to run concentrated portfolios, often with high exposure to Consumer Discretionary stocks, a combination which hurt during the flash bear market but helped in the rebound. Price differentials between predator and prey in M&A deals have widened, offering attractive potential returns in Merger Arbitrage. All in all, we suggest Overweighting Event Driven funds.

Fixed Income Arbitrage

L/S Credit funds with a focus on High Yield have held up well during the crisis – their focus on balance sheet quality means they have little exposure to distressed issuers. In Multi-Strategy Fixed Income Arbitrage, much of the recovery in emerging market government bonds is behind us, but we expect more dispersion between different sovereigns ahead, meaning improved return potential.

Global Macro / CTAs

Real-time measures of activity suggest substantial differences between countries given great divergence in their tactics to exit lockdowns. This creates new opportunities in currencies and sovereign markets for Global Macro traders. For trend-followers (known as CTAs) on the other hand, the strong trends which drove markets first one way then the other during the crisis may be lessening in intensity, warranting a Neutral stance.

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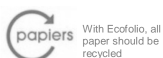

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