MONTHLY HOUSE VIEWS

September 2020

Treading carefully

Macro
After an initial fillip to activity driven by the easing of lockdown restrictions across developed economies, recent economic data have painted a mixed picture. Some sectors – such as housing in the US – look strong while others – such as high levels of continuing jobless claims – point to more weakness ahead. With the coronavirus continuing to spread across the globe and many industries facing extended uncertainties – for example, aviation and aeronautics – we expect that the next stage of the recovery will prove more sluggish. However, governments will be reluctant to reimpose nationwide lockdowns, meaning that the recovery should last.

Central Banks
Output gaps – the difference between actual and potential activity levels – remain very wide across developed economies while high numbers of workers are still unemployed or receiving furlough support. This suggests that central banks will remain more preoccupied by deflationary risks than by rising prices. With key rates and government bond yields sharply negative in real terms, we expect that the Federal Reserve (Fed) and European Central Bank (ECB) will continue to focus on asset purchase programmes as the best way to deploy monetary policy. And if activity looks like losing steam, we believe they would not hesitate to increase their quantitative easing.

Markets
Asset purchase programmes by central banks serve to maintain government bond yields at extraordinarily low levels while simultaneously keeping high-quality corporate bonds spreads (the yield differential over sovereigns) at very tight levels. We see more opportunity now in emerging market sovereigns, where we believe the risks are adequately rewarded by the attractive spreads on offer. We continue to prefer equity markets over other asset classes but await further policy easing before adding to positions. The recent strong rally in EURUSD leaves little additional upside in the near term. Gold recently reached our long-term price target and we suggest taking some profits.

Bottom line
We maintain a broadly diversified, balanced approach to asset allocation. Much of the recent rally in equities has been driven by a small number of internet and tech giants, especially in the US, and we would balance exposure to these leaders with other sectors and markets. Overall, we remain Neutral on equities with a preference for the euro zone, which should benefit from a period of sideways trading in EURUSD. Within fixed income, we have upgraded emerging market sovereigns to Neutral while maintaining a preference for Investment Grade (IG) corporate bonds over other segments. After a strong run, we have brought gold exposure back to Neutral.

OUR ASSET ALLOCATION

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

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

	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	Given the collapse in earnings, this rally has come at the expense of valuations. We remain Neutral
Eurozone	Valuations look less expensive than in the US and the recent approval of the EU recovery fund removes some of the perceived risk of euro zone breakup.
UK	UK equities have continued to underperform peers as future relations with the EU remain unresolved.
Switzerland	Swiss high-quality blue chips should remain sought after, suggesting continued resilience for now. We are Neutral.
Japan	The government's stimulus packages are the largest among developed economies as a percentage of GDP, which should help mitigate the impact of restrictions on the economy. We are Neutral.
Emerging (EM)	We continue to Overweight Asia within a Neutral view on EM equities and highlight the growth and valuation attractions of Asian tech stocks.

FIXED INCOME	
Sovereigns	Long rates should remain low as central banks continue to buy large amounts of government bonds.
Duration*	We prefer shorter-dated bonds across markets.
Inflation-linked	Inflation should recover in the longer term. We maintain our Neutral view.
Investment Grade	Markets remain supported by strong demand and abundant liquidity. We remain Overweight.
High Yield	We keep a neutral stance on HY, where the weakest issuers are especially vulnerable to economic woes.
Emerging debt (in € and $)	Abundant liquidity and low US rates provide ample support for EM bonds. We suggest moving from Underweight to Neutral.

CURRENCIES	
EUR/USD	We expect the euro to trade sideways against the dollar in the near term before resuming its rally later this year.
GBP/USD	Brexit worries are likely to keep sterling cheap. We do not expect major moves.
EUR/GBP	With little progress to date in tense Brexit negotiations with the EU, we still see headwinds for sterling.
USD/JPY	The yen has traded higher since late March, but we do not expect the trend to continue.
EUR/CHF	With economic activity resuming and risk appetite reviving, safe-haven flows into francs have been scaled back. We expect some modest further CHF weakness against the EUR.
Emerging	We think it is too early to turn positive as the pandemic continues to spread in several regions like Latin America and India.

ALTERNATIVES	
Hedge funds	We highlight the attractions of Long-Short Credit, emerging market Global Macro specialists and Merger Arbitrage as sources of yield.
Gold	The recent spike in bullion prices to record territory has offered an opportunity to lock in some profits. We move from Overweight to Neutral.
Oil	We expect oil prices to trade sideways in coming months and have upgraded our view to Neutral.

Source: SGPB, 28/08/2020
* 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

A Mixed Bag

After the initial fillip to economic activity from easing COVID-19 restrictions, we expect the pace of recovery to slow somewhat in coming months. New nationwide lockdowns are unlikely but we expect the changes in consumption patterns will linger. Monetary and fiscal authorities will not hesitate to ease further if necessary.

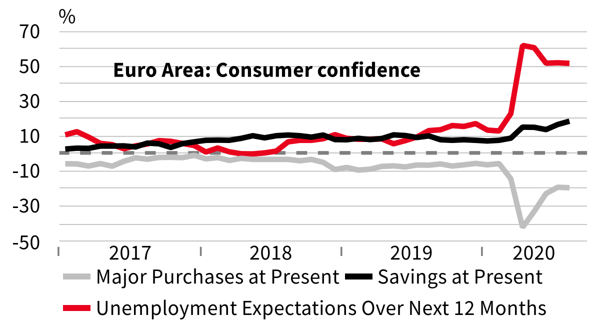
In recent weeks, the pandemic has continued to spread across the globe. In Europe, where severe lockdowns were successful in bringing infection rates down, the gradual reopening of the economy from May has led to a new rise in cases, especially within the 25-40 age group. Governments are understandably reluctant to reimpose nationwide lockdowns or to close borders, but it looks likely that rising infections will slow the recovery, as witnessed by recent batches of mixed economic data.

US. The economy registered a sharp recession in Q2, down -9.5% quarter-on-quarter (QoQ), as lockdown restrictions took their toll on household and business confidence. Since the start of Q3, activity has begun to improve but the recovery is patchy. Some business confidence surveys – such as Markit's Purchasing Managers' Index (PMI) – are back in expansion territory. Others – such as the regional Fed surveys in New York and Philadelphia – suggest the recovery is running out of steam. And the job market appears to have taken a turn for the worse in mid-August with a rise in initial jobless claims.

Euro zone. The contraction in GDP in Q2 was dramatic, registering -12.1% QoQ. However, the latter part of the quarter saw some improvement – for example, industrial production continued its recovery in June, up 9.1% month-on-month (MoM) after gaining 12.3% in May. More recently, the August PMI surveys for the region weakened from July's levels and undershot consensus forecasts, in particular for services where the initial fillip from ending lockdowns has begun to fade.

Given the mixed macroeconomic picture, it is likely that the policy mix will remain very accommodative. Central banks have little reason to tighten policy – indeed, they remain more concerned about deflation than inflation for now, given the wide gap between potential and actual output. We believe that policy-makers will not hesitate to accelerate asset purchases if necessary.

Eurozone consumer confidence remains steady



Source: SGPB, Macrobond, 28/08/2020

Fiscal policy is also likely to remain extremely supportive. The European Union (EU) recently reached agreement on a €750bn recovery fund (representing some 5.4% of EU GDP), to be funded by joint debt issuance. The programme is designed to target help where it's most needed – the "periphery" nations such as Spain and Italy which have been hardest hit by the pandemic. The recovery fund will offer grants to Italy of around 4.5% of GDP, in addition to which the country will be able to borrow up to 5.5% of GDP from the recovery fund at very attractive rates.

The US Congress has entered its summer recess with no agreement on its new fiscal stimulus plans – Democrats now insist that the package should inject at least $2,000 bn while Republicans are adamant that $1,000 bn is the absolute maximum possible. The deadlock is unlikely to be broken until after the return from the Labor Day holiday, but a deal remains necessary ahead of the end of the fiscal year on September 30. Without one, certain Federal departments will shut down, an unattractive prospect with the Presidential election looming only 34 days later.

Bottom line. After the initial fillip to economic activity from easing COVID-19 restrictions, we expect the pace of recovery to slow somewhat in coming months. New nationwide lockdowns are unlikely but we expect the changes in consumption patterns will linger. Monetary and fiscal authorities will not hesitate to ease further if necessary.

FIXED INCOME

Summer doldrums

The summer season has been rather quiet for bond markets so far, with interest rates and corporate bond spreads moving in narrow ranges. Also, implied volatility in US government bonds, a gauge of investor nervousness and uncertainty, has dropped to new lows. We maintain our preference for Investment Grade (IG) corporate bonds.

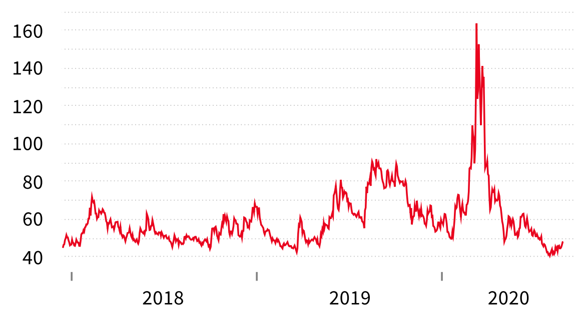
Summer is not always a quiet time in financial markets. The summer months in 2007, 2011 and 2015 saw investors glued to their screens instead of relaxing on the beach, as important events unfolded during the holiday season. This year, with a pandemic spreading across the globe and so many unknowns regarding its development, the ingredients were in place to keep tensions high. Nevertheless, summer has proved rather calm for both government and corporate bonds, but of course this is no guarantee of a quiet autumn.

Sovereigns

US. After new lows at the beginning of August, 10-year yields have moved higher and are now back to 0.68%, around their average between April and July. However, real 10-year yields, as measured by inflation-linked bonds, have dropped to fresh lows and now stand at -1%. As a consequence, implied expected inflation (i.e. the difference between the two) is up and now stands at 1.7%, close to the Fed's 2% inflation target. Upcoming announcements around the Fed's new policy framework may see expected inflation move higher again if they suggest the central bank is becoming significantly more relaxed about rising prices. Otherwise, we do not expect big upward shifts.

Eurozone. The new €750bn joint stimulus plan approved by European governments will see the EU become an important issuer in the euro bond market. Given its high issuer rating, this will significantly increase the pool of "safe" bonds available to investors. The plan will also reduce funding needs for individual countries, easing upward yield pressure on weaker issuers. Moreover, ECB asset purchase programmes remain in place. This will help keep yields low for both core and peripheral countries.

US Bond Implied Volatility - becalmed again



Source: SGPB, Bloomberg, 28/08/2020

UK. Recent discussions at the Bank of England suggest negative interest rates are not on the agenda and that asset purchases and forward guidance will be the preferred tools.

Credit

US. Yield differentials ("spreads") for both IG and High Yield (HY) bonds have traded in a narrow range in August. IG issuance has been very high this year but easily absorbed by markets – deals were well oversubscribed with only small yield concessions. Going forward, we expect less issuance: first, the need for funding will decline gradually; second, companies will at some point begin to think about repairing their balance sheets by reducing their debt levels. However, it is unclear if this shift is imminent – although fundamentals are under stress, markets remain supported by strong demand and abundant liquidity.

Eurozone. Spreads fell marginally in August for both IG and HY bonds. But while second quarter earnings surprised on the upside, they were still the worst on record. This is a reminder that European fundamentals are under stress too and need to be repaired. Although profits can only rebound from current lows, it is a long way back to pre-crisis levels, while companies still need to scale back their high levels of leverage. However, investor demand remains strong and liquidity is abundant, thanks to generous central bank purchase programmes, providing strong support to credit markets. IG remains our preferred choice in this uncertain context.

UK. In line with eurozone markets, IG spreads tightened slightly in August, shrugging off growth and Brexit worries. The sterling market has also benefited from great liquidity support.

Emerging Market (EM) debt

Abundant liquidity and low US rates provide ample support for EM bonds. Although many issuers will suffer long-term fallout from the COVID-19 crisis, in the form of higher fiscal deficits and debt levels, lockdowns have been less severe than in advanced economies, meaning that growth is likely to be more resilient. Given the attractive yield pick-up, we have upgraded EM bonds to Neutral.

EQUITIES

Back to Black

Global equity markets have received ample support from monetary and fiscal policy since the pandemic struck, enabling global indices to recover dramatically to register positive performance for the year so far. However, the pandemic is still not under control and we await further easing before moving away from our current Neutral allocation.

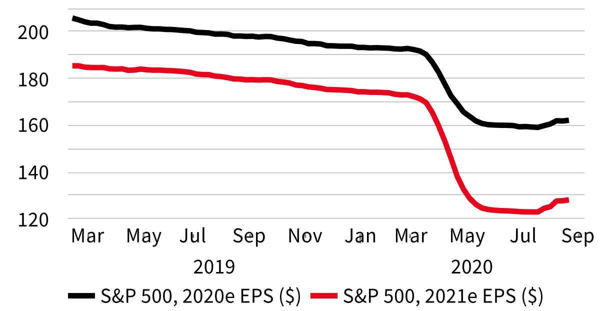
US. The second-quarter earnings season provided a series of positive surprises, with earnings-per-share (EPS) beating expectations by 20% taking the S&P500 to new all-time highs. However, the scale of the surprises simply reflects very low expectations – EPS for Q2 actually declined 33% YoY. Moreover, as illustrated in the chart, consensus expectations for 2021 EPS remain below pre-crisis forecasts for this year.

Given the collapse in earnings, this rally has come at the expense of valuations. The forward price-to-earnings ratio (PER) is now by far the highest since the tech bubble in 2000-2002, leaving little further upside potential. As mentioned in previous reports, much of the year-to-date (YTD) performance (and multiple expansion) has come from a small number of mega-cap technology stocks. The IT sector index is up 33% YTD while the S&P500 has gained 8%. Given these distortions, we suggest a balanced spread across sectors within a Neutral allocation.

Eurozone. Like their US counterparts, euro zone stocks outperformed EPS expectations for Q2 with earnings coming in 24% above forecasts. The consensus now expects EPS to fall 37.3% in calendar 2020 compared to last year, followed by a 51.1% rebound in 2021. Much of course will depend on how businesses recover from this year's disruptions, but we do not expect that governments will reimpose nationwide lockdowns.

Over the past six weeks, euro zone equities have underperformed global averages in local currency terms, as investors reacted to the marked appreciation in the euro, up almost 4% against the USD. Bouts of currency strength are often viewed negatively for export-sensitive markets like the euro zone. However, valuations look less expensive than in the US and the recent approval of the EU recovery fund removes some of the perceived risk of euro zone breakup. All in all, we remain Overweight within an overall Neutral equity allocation.

EPS expectations remain below pre-crisis levels



Source: SGPB, Macrobond, IBES, 28/08/2020

UK. With the UK registering larger numbers of COVID-19 deaths than its neighbours and the future trade relationship with the EU still unresolved, UK equities have continued to underperform global averages. However, this has left the market looking cheap on measures such as price to cyclically-adjusted earnings (CAPE) and price to book value (P/B). This justifies a Neutral allocation in our view.

Switzerland. Switzerland is typically considered an expensive market compared to its peers, given the prevalence of high quality defensive growth stocks. However, Swiss equities currently trade at a much lower price-to-earnings ratio than the euro zone. This is thanks to the resilient outlook for earnings – the consensus only expects a -8.9% decline this year versus -37.3% for the euro zone. All in all, it is no surprise that Swiss equities have outperformed other regional markets.

Japan. Tokyo is another defensive market which has outperformed this year. The government's stimulus packages are the largest among developed economies as a percentage of GDP, which should help mitigate the impact of restrictions on the economy. The International Monetary Fund expects a -5.8% decline in GDP this year compared to -8.0% on average for advanced economies, which helps explain the resilient outlook for this year's earnings. We remain Neutral.

Emerging Markets. After many years of underperformance, emerging market equities have almost kept pace with developed markets so far this year – up 2.5% YTD including dividends versus 5.8% for the MSCI World. This performance has been greatly aided by China, the largest emerging equity market, which has gained 21.5% so far this year. We continue to Overweight Asia within a Neutral view on EM equities and highlight the growth and valuation attractions of Asian tech stocks.

CURRENCIES

Back in the range

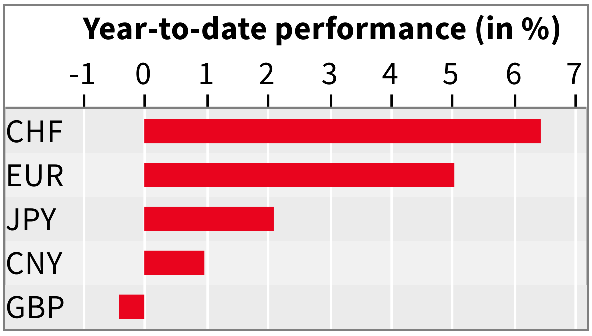
After the recent bout of dollar weakness, we now expect most currencies to trade sideways in a broad range. Gradual economic recovery suggests little need for safe havens, interest rate differentials are low and likely to remain so while the dollar looks less overvalued than in late March.

Dollar Index. After a sharp rise in March on safe-haven flows, the dollar index has weakened again and now stands 3.5% below end-2019 levels. Its safe-haven appeal has waned as economies began to emerge from lockdown and, moreover, the dollar has lost much of its interest rate and yield advantage over other currencies on Fed easing. Looking ahead, we expect a period of sideways trading – risks abound (such as tensions with China, election uncertainty) which could provide a temporary boost to the dollar.

EUR/USD. The euro recently reached its highest level against the dollar since Spring 2018, on collapsing yield differentials and optimism about the €750bn EU recovery fund. However, the fund will take some months to launch and the renewed spread of coronavirus infections in Spain and France has raised question marks about the pace of recovery. In this context, we expect the euro to trade sideways against the dollar in the near term before resuming its rally later this year.

GBP/USD. Sterling also benefitted from dollar weakness over the summer, trading back close to 1.32. The pandemic appears to be under control for now which should aid recovery, although some restrictions still remain in place. However, intensive trade negotiations with the EU have yielded no progress so far and only four months remain until the UK leaves the single market, an uncomfortable prospect for exporters. All in all, Brexit worries are likely to keep sterling cheap.

Currency performance against the US dollar



Source: SGPB, Macrobond, 28/08/2020

USD/JPY. The yen has trended steadily higher since late March despite the revival in risk appetite. Part of the explanation lies in USD weakness, and part in the perceived resilience of the Japanese economy. Japan's stimulus plans have been impressive – equivalent to around 40% of GDP – while the International Monetary Fund expects a shallower recession there this year than in other advanced economies. Nonetheless, we expect continued range-trading.

EUR/CHF. The Swiss franc has moved away from the 1.05 level over the summer, enabling the Swiss National Bank to scale back its currency interventions. With economic activity resuming and risk appetite reviving, safe-haven flows into francs have abated. Moreover, the successful agreement to launch a €750bn EU recovery fund has removed much of investors' worries about euro zone break-up. We expect some modest further CHF weakness against the EUR.

EM currencies. Emerging market currencies look cheap. JP Morgan's index is still trading close to its all-time lows while price inflation appears to be broadly under control (there are obvious exceptions like the Argentinian peso or Turkish lira). Nonetheless, it is still too early to turn positive – we think the dollar's bout of weakness is over for now, and the pandemic continues to spread in regions like Latin America.

USD/CNY. Contrary to our expectations, the renminbi has continued to rally against the dollar and is currently trading close to its high for the year. The People's Bank of China appear to have judged that further currency weakness would be counter-productive given rising US-China tensions – on COVID-19, on trade and on Hong Kong's new national security law. With recent talks on trade suggesting both parties are satisfied with progress, we now expect the renminbi to trade sideways against USD.

ALTERNATIVES

Locking in some profits on gold

We return to Neutral on both oil and gold – the recent spike in bullion prices to record territory has offered an opportunity to lock in some profits. Within a generally constructive stance on Hedge funds, we highlight the attractions of Long-Short Credit, emerging market Global Macro specialists and Merger Arbitrage as sources of yield.

Commodities

Oil

According to the International Energy Agency (IEA), total global oil supply gained 2.5 m barrels per day (mb/d) to 90 mb/d in July. Saudi Arabia has already ended its voluntary 1 mb/d additional cut and OPEC and Russia have decided to ease output cuts from 9.7 mb/d to 7.7 mb/d from August, which should contribute to further normalisation of oil production. All in all, global supply looks set to fall by 7.1 mb/d on average in 2020.

However, demand is expected to fall faster, down 8.1 mb/d this year. The Spring lockdowns hit demand hard as much economic activity ground to a halt. Since then, the easing of restrictions has seen a steady increase in demand. Nonetheless, aviation demand is likely to remain severely curtailed for many quarters while the resurgence in COVID-19 cases has seen the improvement in mobility data begin to stall.

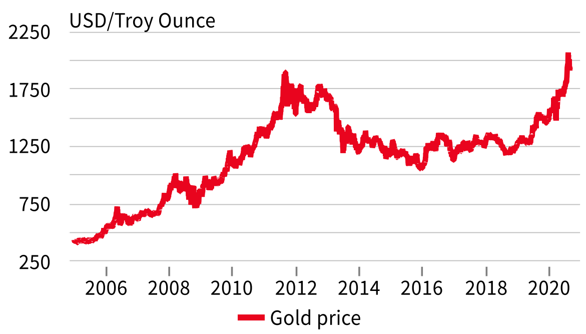
We expect oil prices to trade sideways in coming months and have upgraded our view to Neutral.

Gold

Total gold supply fell around 6% in the first half of 2020 to 2,192 tonnes (t) as COVID-19 disruption hit both mine output and recycling, which account for approximately 75% and 25% of supply respectively. Mining in China – the world's largest producer – fell 9% in H1 but easing restrictions on activity should see some pick-up in output in H2.

Gold demand also faltered in H1, down 6% YoY to 2,076t with consumer demand particularly hard hit. Net purchases of ETFs remained robust at 734t, up 6-fold compared to H1

Gold price hit new record highs



Source: SGPB, Macrobond, 28/08/2020

2019. Investment in bars and coins declined 32% to 149t, but the biggest declines came in central bank purchases (down 39% from H1 2019's record highs to 233t) and in jewellery demand (which slumped 46% YoY to 572t). Looking ahead, we expect demand to recover as retail outlets for jewellery and coins resume more normal activity after lockdown.

Gold recently reached our 12-month target in new record-high territory and we have scaled back exposure from Overweight to Neutral.

Hedge funds

Long/Short (L/S) Equity

We continue to prefer variable bias funds in the L/S segment. They have demonstrated their ability to adjust exposure to the market, moving short in March and then increasing positions to take advantage of the recovery. Overall however, the dispersion between individual stocks' returns has declined recently, thereby reducing opportunities for L/S managers.

Event Driven

Despite fears of a summer lull, corporate activity has remained robust over July and August. A $306bn flurry of M&A deals was announced in August, creating ample opportunities for Merger Arbitrage specialists. Moreover, a number of restructurings have been floated – for example, a break-up of UK insurer Aviva – offering a potential fillip to Special Situations funds.

Fixed Income Arbitrage

Despite ample support from central banks, the crisis has put pressure on corporate balance sheets and we have witnessed a spike in defaults on corporate bonds, particularly among US issuers. This is playing to the strengths of L/S Credit Arbitrage managers thanks to their strong credit analysis and robust risk controls.

Global Macro / CTAs

We remain Neutral on trend-followers (known as CTAs) – much of the strength in equity markets is concentrated in a few mega-cap tech and internet stocks, while the rest of the market is stuck in a range. The best opportunities for Global Macro funds are to be found among emerging markets given the wide disparities in macro fundamentals and COVID-19 responses.

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