THE GLOBAL CIO OFFICE

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# Now What?

- **Momentum still with equities**
- **A rotation into value stocks may require a burst of inflation**
- **Emerging stocks showing some good relative gains**
- **Bond investors increasingly turning to manager skill for returns**
- **Germany takes over the EU presidency with hopes of progress on a number of fronts**
- **Eurozone equities look set to maintain their recent strength**

As financial markets move into the second half of the year, we, like many investors are reflecting on the question "Now What?"

I hear many a grumble about the recovery of the equity market, but it is was it is. The momentum established at the market lows has carried the day irrespective of whether the virus is yet beaten.

The MSCI ACWI total return index started the year at 268, had a low of 189 (March 23rd) and had recovered 34% by the end of June. The index is just 5.6% below where it started the year. Two-thirds of the recovery came in the first twelve trading days after the market low, giving investors very few days to react and re-invest. And as a measure of the positive momentum in the equity market, 65% of the trading days after the market low have been positive days. No wonder retail investors are piling into their Robin Hood investments.

While the global equity market has recovered a good measure, the riskiness of the market remains elevated. The VIX index is at 28, over twice the volatility levels of recent years.

### Momentum and growth key factors in explain stock performance

That said many an equity investor is taking a positive view of developments. There were some dark days when the unemployment rate was rising exponentially. However subsequent policymaker action has rolled back much of the bad investor sentiment, and you must surmise that the marginal investor believes the policymakers are ahead of the curve. The United States, for example, is seeing some of the most potent upgrades to earnings forecasts seen in the last 12 years. The consensus, bottom-up view, is that at the aggregate level earnings per share of the S&P 500 will be down an estimated 10% in 2020. And the level of earnings at the end of 2021 will be 7% above the 2019 level. In this rosy analyst view, 2020 would be just a blip.

Year-to-date profitability and growth have been the factors that have explained much of the performance of the leading shares. More recently, investors are rewarding companies that are seeing upgrades to consensus earnings forecasts. Such a trend might imply that investors believe the market is fully valued and that the only value is in those companies that are seeing upgrades to earnings forecasts.

The trends seen in the United States can also be seen at the global level. However, momentum probably plays an even more significant role in explaining the performance of the top 300 companies in the year-to-date. Also, we are seeing share prices reacting particularly strongly to any upgrade to analysts' price targets.

### Time for value stocks? – may need some inflation

In seeking stocks that have been left behind in the rally investors must ask themselves is this the time for value stocks? The price relative of the global value index has fallen from an index level of 180 in 2016 to just 74 today — the lowest relative level since 1975. A catalyst for outperformance might require a burst of inflation. For one, all the major central banks remain hell-bent on creating inflation through irregular monetary policy. Secondly, there are some major investment houses out there, such as GMO who strongly believe that this could be the decade of the value stock.

### Emerging market equities show some outperformance

One contrary-to-recent-trends trade that looks like it may be gaining traction is the outperformance of emerging markets versus developed markets. Emerging market equities outperformance over developed markets peaked in 2009. Subsequently, the price relative has halved. More recently emerging market equities have shown some life. Through June, the emerging market equities index outperformed developed markets by around 5% and in the early days are July that has continued. A number of the major countries in the index such as Korea, Taiwan and China have probably dealt with the coronavirus challenges much better the most countries in the West. Hence many Asian economies have got back to work far quicker than those in the West. They have also seen a reasonable recovery in profitability and general economic activity. In the medium-term, the prospect of US interest rates anchored at close to zero should enable emerging market central bankers to maintain interest rates at extreme lows relative to history. Equally, they should also still enjoy significantly better nominal GDP growth than those in developed economies.

### Such low yields limit potential bond market returns

The question "now what?" is probably even more relevant to the global debt markets. The Barclays Bloomberg US Treasury total return index has returned 8.5% since the start of the year. A good measure of the bond market returns has come from the 123bps drop in the US 10-year yield to 0.67%. The only way that US Treasury returns could come close to matching the bond markets returns since the beginning of the year is for US interest rates to go negative. Although the Fed has not ruled this out, it's still not their preferred route to maintaining gross in the US economy. However, you would also say, but it was never the preferred route for either the Bank of Japan or the European central bank.

The underwriting of the US high-grade market and elements of the US high yield market had a particularly stabilising impact not just on US credit, but global developed market credit. The corporate sector remains short of cash flow and in need to access to credit. We can expect central bankers to remain heavily engaged in their respective credit markets intervening when necessary.

### Investors turn to manager skill for returns in bond land

To generate returns in the global fixed income markets, we are finding that asset managers are increasingly turning to absolute return strategies way or dependent on fund manager skill rather than wholly on the yield available in the markets. Of course, managers need volatility in their asset classes to get enough return from their skill set.

In hedge funds, HFRX Relative value fixed income convertible arbitrage index is now up year-to-date by around 4%. The HFRX macro CTA index has muddled through the last few months with most of the funds seemingly positioned for a further sell-off of markets.

## European Union: a pivot to German leadership.

To a background of increasing optimism about the pace of post-COVID-19 recovery, Europe marked two crucial milestones last week. First, on Tuesday, the UK passed the point of no return in respect to the end of its transition agreement with the EU. The transition will now happen automatically on December 31st. The UK did not request an extension. The following day, Germany took up the presidency of the European Council. It is a crucial point in terms of the recovery from the pandemic but also the eurozone's medium-term destiny. Germany will hope to be instrumental in the successful launch of an EU-wide economic recovery programme. Germany has a trade deal with the UK still to complete. On the global stage, they will have to navigate the outcome of the US elections in November and re-set the relationship with China. Quite a menu of challenges.

**Germany's newfound confidence led by a Chancellor that is rapidly approaching the end of her political life marks a startling turnaround over the last year.** Mrs Merkel's acclaimed success in achieving one of the best global records on managing the pandemic is one explanation. Still, Berlin's dramatic shift toward fiscal stimulus in recent months has added to that authority. The latest German package accounts for almost half the total for all of Europe. She is also clearly aware that the next six months represent her political swansong and is determined to deliver, supported by a renewed alliance with Paris. The negotiations on the €500+ billion grant element of recovery fund is hard-fought. However, concessions to the frugal four conservative states on some conditionality for beneficiaries should be enough to win them around. Far more contentious is the formula applied to determine who gets what over coming years with the criteria under constant challenge. It is still likely that the haggling will continue beyond the key summit in Paris in two weeks, but we still expect an outline agreement by September. Meanwhile, Berlin is taking a strict line with London on Brexit; flexible on means yes, but adamant on outcomes such as the preservation of a level playing field in competition to protect the single market.

The negotiations are helped by what seems to be a relatively smooth emergence from the lock-down, certainly when compared to the US. **The better news has supported the re-rating of European equities since early June**. Last week data showed only a minimal rise in the overall EU unemployment rate to 6.7% in May from 6.6% in April; far below estimates for the UK and US economies. Clearly, furlough schemes account for the minuscule increase. The general assumption is that the unemployment rate will rise sharply in coming months as the schemes wind down. However, better than expected retail and industrial production figures over the last month do hint that shorter working hours may take some of the strain avoiding the burden falling solely on payrolls.

**We expect the good news flow to play out in the continued relative strength of eurozone stock markets and a firmer Euro, especially given the support to the recovery still offered by the ECB.**

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