THE GLOBAL CIO OFFICE

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The Wait-and-See Rally that did not Wait

- **November sees significant returns to most risk assets**
- **Leadership was outside of the US as Europe rebounded strongly**
- **Value in energy and financials outpaces technology**
- **High yield has a vaccine inspired rally,**
- **EM failed to keep up the pace but should see good support**

November saw some extraordinary gains for risk assets. Investors are, in a sense, forced into a market for fear of missing out on returns. That is understandable, but it is not healthy investing. A negative surprise could easily lead to a marked setback/profit-taking. President Trump could still do something untoward, or the Brexit talks could fail. Be careful.

In a rare case of the consensus being right, most investors looked to be positioned for risk and were paid handsomely in November. It will go down as one of the better months in stock market history returns. Not only did the equity market deliver handsomely, but credit markets also were not left behind either, as spreads continued to compress as default anxiety failed to suppress the flow of money into the asset class. The idea of cautiously waiting for some of the considerable risks to abate before entering the market was the wrong play in November. Better to have been all-in.

Equities runaway

The regional breakdown of returns in world equity markets reveals a pattern of previous laggards catching up. In Europe, the strong outperformer was the Greek market, printing a gain of 33%, followed closely by Spain and Italy at 26% and 23% respectively. However, Spain is still down 15% year to date with Italy and Greece down close to 30%. The overall European equity market rose by 19.2% in November, bringing the YTD loss to 10.5%.

This rotation has been abrupt. The impulse behind it may be the growing fear that the valuation of the US market, and the technology sector, in particular, has run too far and that the laggards are due for their day in the sun. The economic data out of Europe has not been spectacular at all. However, hopes of a recovery driven by some extra fiscal stimulus and the roll-out of a vaccine seem to have combined to lure investors into the perceived bargain stocks. Nowhere was this more in evidence than the roughly 34% returned by the bank

sector in European (as measured by the MSCI Europe Banks Index). Some of the stocks in this index had declined to relative valuation levels last seen post-Lehman.

In US stocks, a similar theme of rotation into things previously lagging was in evidence in the market. The worst performer in the S&P 500 on a year-to-date basis is still the Energy sector, which is down 30% with four weeks to go. That did not stop it from posting a 28% gain in November. Two of the other laggards, financials and industrials, delivered 17% and 16% respectively. That outpaced the overall return by the index, which came in at 11%. Technology posted an 11.4% return for the month.

The spike in the energy sector comes at a time when it is still not clear how OPEC+ will cope in a world where energy demand (of the fossil fuel variety) looks to be facing severe challenges in the medium to longer term. The pandemic may prove to be a strong catalyst for structural changes in energy generation patterns worldwide. Not only is there a demand-deficiency issue brewing in the short term, COVID could force many energy importers to accelerate solutions that are not only cleaner but also closer to home. Long supply chains have a reduced shelf life post-COVID, and renewables may be attractive not just from an environmental angle, but also security of supply. As it stands, at current spot prices of oil ($46 on WTI), the much-vaunted influence of the US shale sector is now diminished. The expectation is that a surge in supply would only be viable at prices about $10 per barrel higher than today.

Bonds led by high yield

In the high yield market, the default wave that looks inevitable in April has only really happened in the energy sector, which is dominating the overall default count year-to-date. That said, even the strong run posted by high yield in November has only now pushed it back into positive territory for the year at 4.2%, after a 4% surge in November. That still lags high-grade bonds, which by the end of November had posted 9.3% for the year, of which 2.7% accrued in November alone.

As an interesting aside, convertible bonds are the runaway leader in the fixed income universe for total return in 2020, at 44.3%. However, there is a single line in the convertible index that is dominating all else: Tesla. It has bonds in this index which has distorted total returns in a way that is not likely to be repeated soon.

In spread terms, the overall high-yield index tightened by 99 basis points in November, compared to the BBB universe which practically did not budge. This shows how geared the HY sector remains to positive news. Half of the spread compression for the month happened on the day that word first broke of an effective vaccine. There is still some potential risk for the HY market, but with spreads at the current levels, not much of it is in the price. The market prices a smooth roll-out of the vaccine, coupled with further support from the policymakers. In credit, the implications of a potential curve steepening are important to factor in, but not the critical consideration from a spread perspective.

With the general mood in risk markets one of positive momentum, it is a risky move to cut exposure in HY right now. For sure, the next two quarters bring substantial challenges as the

operating environment begins to normalise (not achieving "normal" for some time though) and policy stimulus eventually begins to wane.

US dollar

Rounding out the risk-on dynamic is the weakness of the US dollar. On a trade-weighted basis, it is down just over 10% from the market peak of risk aversion in March. Its decline has mirrored quite closely the upward move in risky assets, including emerging markets. Arguably, many sovereigns would have faced the same perils as many corporate issuers in dealing with COVID fallout. Not surprisingly, lower-rate (BB and lower) have had a torrid 2020, but have staged a strong recovery in November, posting a gain of 6.5%, narrowing the loss for the year to 2.5%. While there is scope for further improvement, the outlook is still very dependent on liquidity assistance from international agencies such as the IMF.

In higher-quality segments of the bond market, there were good returns for corporate and sovereigns alike. However, with the simple logic of the current mood being one of favouring the worst sectors on any good news, EM debt is still somewhat the laggard overall. It stands to print better gains that other markets should further economic developments turn out to be as benign as they appear at present.

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