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Monthly Update – July 2020

As at 16 June 2020

Summary

- The negative consequences from the spread of Covid-19, coupled with the now-positive pick-up in economic activity and monetary policy stimulus, have almost balanced themselves out worldwide. Consequently, this has led to an equilibrium of upward and downward forces in financial markets.
- We are, therefore, seeing a decline in the strength of trends and in volatility across equity, energy and credit markets. However, a slightly positive underlying trend persists. Nonetheless, government bonds may have already entered a downward trend.
- A slower than previously expected recovery of the global economy is becoming apparent. However, this negative influence on markets is compensated for with extremely expansive monetary policy. Moreover, a second economic shutdown is becoming increasingly unlikely. Nonetheless, localised Covid-19 outbreaks are still to be expected, which could dampen economic recovery and consumer confidence.
- The current balance of positive and negative forces is quite fragile and therefore markets are susceptible to disruption. We therefore remain neutrally positioned across all our strategies and are monitoring leading indicators to enable us to react quickly. We pay particular attention to potential changes in monetary policy, as the current situation in financial markets is very much monetary-policy driven.

Highlights and key changes

- The global economy continues to recover, but at a slower pace than previously expected. This is due to cautious and reluctant consumers, as well as obstacles that are still in place, such as social distancing measures. In certain sectors, like car production and to some extent luxury goods, there is evidence of pent-up demand, which is translating into brisk sales. In other sectors, such as the aviation industry, the outlook remains extremely subdued. By the end of the year, the maximum occupancy rate for the commercial airline industry is only expected to reach 50%.
- No extreme regional differences are currently visible. Europe appears to have benefitted from a stronger recovery owing to its industrial and manufacturing sectors, plus its lower dependency on the still subdued services sector. This is where the US has a structural disadvantage (it has a high dependency on services and a lower industrial production

share). However, this has been more than compensated for with more expansive monetary policy from the Fed. China and various other Asian countries meanwhile, appear to be ahead of the US and Europe in the recovery process, but do not differ fundamentally from the rest of the world.

- At a sector level, however, there appears to be some significant differences. Here, there are signs of slowing momentum in previously strong performing growth and technology stocks. Meanwhile, stocks from previously troubled sectors, such as energy and consumer-related areas, have caught up considerably.
- The sustained expansionary monetary policy from central banks – especially the Fed – is striking. Monetary stimulus was given a further boost by the Fed recently, after it announced it would expand its corporate bond purchase programme. This step is significant because it facilitates crisis-financing for many companies and helps improve liquidity in the right market segments. Government bond purchases are currently less effective. In addition, this expansion of the purchase programme is practically preventative in nature. Credit markets have been relatively stable for some time now and have recorded significant price gains in recent weeks. The additional push by the Fed reinforces this movement and is not really crisis management. Apparently, the aim is to prevent a sudden deterioration of the situation in advance by all possible means. The European Central Bank could also therefore, expand its stimulus programmes again in the coming months if necessary.
- However, financial markets are now becoming increasingly dependent on central banks. The negative effects associated with a slower-than-expected economic recovery are simply compensated with newly printed money. While this is positive for the equity, credit and commodity markets over the short term, it causes investment fundamentals and valuations to diverge. In the medium term, this could lead to severe corrections.
- Significant risks therefore remain. Central banks are determined to do everything needed to stabilise financial markets. However, this policy will only continue until the first signs of inflation appear. This is not yet the case, but the situation can change at any time. Interest rates, which are starting to rise again slightly, could be harbingers of higher inflation expectations to come.
- A further risk is the diminishing effectiveness of monetary policy. The recent stagnation of the M1 money supply in the US (see chart on the next page) is a signal that the money pumped into the system by the Fed is no longer leading to an expansion of the money supply, which is a very important component for financial markets. Whether this is only a temporary phenomenon is unclear.
- Increasing global public debt is not a problem in the short to medium term. In an emergency, central banks will assist with purchases and thereby try to control the yield curve structure. The danger of another major economic shutdown is also diminishing. Nevertheless, the Covid-19 case numbers are likely to increase again in the foreseeable future due to the loosening of the rules so far, therefore creating uncertainty for a long time to come.
- In this environment, we remain neutral in terms of equity and credit risk exposure and have kept duration in our portfolios close to their respective benchmarks. We have also continued to reallocate away from well-performing sectors (technology and growth) toward former pandemic losers (transport, consumption and energy), with a focus on financially solid companies. In addition, we continue with our comprehensive sector analysis so we can identify those opportunities that would benefit from the potential near-term availability of a Covid 19 vaccine.

Topics on the radar

The momentum of the US M1 money supply is currently declining. M1 has historically been a good barometer for the effectiveness of central bank policy on equity markets. The slight decline so far is not yet alarming. However, it shows the declining sensitivity of the money supply to the Fed's continuing high liquidity injections. A portion of the new money created 'disappears' in the system. Further developments must, therefore, be closely monitored.

Chart: US money supply M1



Source Reuters Eikon

Please note with regards to the table of asset class preferences:

In the current fast-changing environment, we have decided not to present the usual table of country and sector preferences. Relatively static information is of limited use as positioning can change quickly. Our current preference has been on debtors whose credit quality is high enough to survive a prolonged recession. We also prefer securities with good market liquidity. However, due to improvements in the indicators we look at, we are increasingly seeking opportunities in challenging sectors with a high recovery potential.

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