

'The Great Disconnect?'

by Stephen Nguyen, CFA

There are few certainties in markets and economies and with most countries globally facing what could be the worst economic collapse in the post-war era, it is surprising to see markets and most risk assets continue their remarkable rebound. The shape of the recovery in risky assets certainly looks V-shaped today, as most markets have posted gains of around 30% since bottoming near the end of March. Is this a true reflection of what is going on in the underlying economy or is there a big disconnect?

Conventional wisdom says the market's comparatively modest net decline since the start of the pandemic is due to the fact that the market is forward-looking, and investors have already accounted for what is likely to be a severe drop in second quarter earnings, followed by a sharp recovery. Stock prices reflect a series of expected future earnings, discounted to the present day. Hence, they don't only reflect what is happening now, but also what is forecast for the next several years. Economic data on the other hand is backward looking and only tells us about what has happened in the past.

We should also acknowledge that the composition of the stock market and the economy is very different. Large tech firms (Microsoft, Facebook, Google, Amazon and Apple) represent around 25% of the S&P 500 index, whereas their combined revenues account for less than 10% of US GDP. These large companies also generate a large proportion of their revenues overseas. Stock indices are mostly weighted towards larger companies which may be more likely to survive the downturn and this size bias, may therefore, underplay the impact of the wider economic damage.

The level of support from governments and central banks globally has bolstered investors' confidence that the market will not retest the March lows. Authorities have reacted with extraordinary measures both in terms of magnitude and speed. We have witnessed measures that have never been taken before such as the Fed buying sub investment grade credit (to support the 'fallen angels') and the UK government's coronavirus job retention scheme (CJRS). These actions have certainly calmed the storm.

There are also other explanations for the risk asset rebound rooted in investor psychology. Market momentum and herding behaviour among investors as a result of 'FOMO' - the fear of missing out - is another driver behind the rise in prices. Awareness of other peoples' success spurs investors to jump on the bandwagon.

So, what are the risks to this recovery? Markets remain vulnerable to a turn in sentiment so a second wave of Covid-19 and renewed lockdowns would likely be a major setback. Even before the pandemic, valuations were at lofty levels which might have contributed to the sharpness of the sell-off in March. Today markets are almost back to similar levels so other things being equal - which they are not - they would be sensitive to a pull back. Increasing geopolitical risks such as worsening US/China relations should not be ignored. Shorter term and more local challenges, for example in the UK when the business rates holiday period and the CJRS scheme winds down, will increase the pressure on businesses. We are less concerned over the medium to longer term outlook as this is an event driven shock and we view it as more transitory in nature; a very sharp fall in economic output but a recovery that is less drawn out than a post Global Financial Crisis.

On the back of this very strong rebound in risk assets it is prudent to pause and reflect. We remain optimistic, but we acknowledge the various risks posited above and have adjusted portfolio positioning to retain upside whilst protecting downside, balancing perceived risks and returns to ensure our investors have the highest probability of achieving their stated portfolio outcome whilst reducing shorter term pain.

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Market Focus

- » Estimations now show that 24 of the 50 US states have a R value over 1
- » Oil prices rose for the 7th week out of the last 8 as OPEC+ confirmed output cuts
- » Brent crude rose 8.9% ending the week at \$42.2 a barrel
- » Gold rose 0.8% ending the week at \$1743.9 an ounce

US

- » Anthony Fauci, a US infectious disease expert, suggested that travel to the US may be banned until a vaccine arrives.
- » The Federal Reserve's Chairman Jerome Powel said that, though indicators point to a stabilisation in activity, there is still much uncertainty around the speed and strength of economic recovery.
- » Industrial production had a 1.4% increase in May against +3.0% expected.
- » Data showed the number of housing starts in May at 974k (annualised), compared to 1.1m expected, underperforming expectations.
- » Weekly initial jobless claims came in at 1.5m for the week ending 13th June, a decline from the previous weeks figure but above the expected reading of 1.29m.

Europe

- » At the European Council summit of EU leaders, expectations for an agreement on the EU recovery fund have been managed, with signs now indicating an agreement won't be reached before July.
- » French president Emmanuel Macron lifted most of the country's remaining lockdown restrictions and now aims to rebuild the economy.
- » Germany's R number has increased from 1.79 to 2.88 – based on a four-day average – as new outbreaks have occurred.

UK

- » UK PM Boris Johnson stated a clear aim to conclude Brexit talks by the end of July
- » An Oxford University trial found that a widely used steroid that reduces inflammation, dexamethasone, reduces coronavirus deaths of patients who require ventilation by a third.
- » The number of job vacancies from March to May fell to 476k.
- » CPI inflation fell to 0.5% year on year in May.
- » The Bank of England expanded their QE programme by £100bn, though purchases will be conducted at a slower rate as liquidity conditions have stabilised.

Rest of the World/Asia

- » Industrial production in China rose to 4.4% year on year against 5.0% expected.
- » A new cluster of coronavirus cases in Beijing lead to schools being shut and online classes resuming for all grades.
- » After blowing up a liaison office on their side of the border earlier in the week, North Korea have now said they will send troops to border areas where it was previously agreed to remove troops.
- » Japan reported a decrease in the country's exports of 28.3% year on year in May due to coronavirus impacting global demand.

Asset Class / Region	Currency	Cumulative returns			
		Week ending 19 June	Month to date	YTD 2020	12 months
Developed Markets Equities					
United States	USD	1.9%	1.8%	-3.5%	7.3%
United Kingdom	GBP	2.9%	3.5%	-16.1%	-13.2%
Continental Europe	EUR	3.6%	5.0%	-8.2%	-0.3%
Japan	JPY	0.8%	1.2%	-6.9%	4.4%
Asia Pacific (ex Japan)	USD	1.8%	8.1%	-6.1%	1.6%
Australia	AUD	1.6%	3.2%	-9.9%	-7.3%
Global	USD	2.1%	2.9%	-5.5%	4.0%
Emerging Markets Equities					
Emerging Europe	USD	0.3%	2.9%	-22.2%	-12.5%
Emerging Asia	USD	2.0%	8.1%	-3.6%	6.9%
Emerging Latin America	USD	-1.0%	9.4%	-32.7%	-28.8%
BRICs	USD	2.4%	8.2%	-7.2%	2.2%
China	USD	3.2%	8.9%	3.4%	15.4%
MENA countries	USD	0.6%	3.1%	-15.2%	-16.4%
South Africa	USD	0.3%	10.3%	-24.2%	-24.0%
India	USD	2.4%	6.0%	-21.0%	-18.9%
Global emerging markets	USD	1.5%	7.9%	-9.4%	-1.1%
Bonds					
US Treasuries	USD	0.0%	-0.3%	8.8%	10.8%
US Treasuries (inflation protected)	USD	0.5%	0.7%	5.9%	8.5%
US Corporate (investment grade)	USD	1.0%	1.9%	5.0%	10.5%
US High Yield	USD	0.8%	2.5%	-2.3%	2.1%
UK Gilts	GBP	-1.2%	-1.5%	8.8%	11.0%
UK Corporate (investment grade)	GBP	-0.1%	1.0%	2.6%	6.8%
Euro Government Bonds	EUR	0.5%	0.7%	1.7%	2.8%
Euro Corporate (investment grade)	EUR	0.2%	1.4%	-1.1%	0.1%
Euro High Yield	EUR	0.6%	2.4%	-4.8%	-1.2%
Japanese Government	JPY	-0.2%	-0.3%	-0.9%	-1.7%
Australian Government	AUD	0.2%	0.1%	4.2%	4.6%
Global Government Bonds	USD	-0.2%	0.2%	4.3%	5.8%
Global Bonds	USD	0.0%	0.7%	3.4%	5.6%
Global Convertible Bonds	USD	1.7%	2.9%	4.8%	10.0%
Emerging Market Bonds	USD	0.9%	2.0%	-0.2%	1.9%

Source: Bloomberg. Past performance is not indicative of future returns.

Asset Class / Region	Currency	Cumulative returns			
		Week ending 19 June	Month to date	YTD 2020	12 months
Property					
US Property Securities	USD	-1.9%	3.6%	-18.4%	-16.0%
Australian Property Securities	AUD	1.8%	2.6%	-18.6%	-22.3%
Asia Property Securities	USD	-0.2%	6.2%	-15.6%	-14.2%
Global Property Securities	USD	1.0%	6.4%	-16.8%	-12.0%
Currencies					
Euro	USD	-0.4%	0.9%	-0.3%	-0.2%
UK Pound Sterling	USD	-1.1%	0.4%	-6.7%	-2.1%
Japanese Yen	USD	0.6%	0.9%	1.6%	1.4%
Australian Dollar	USD	0.3%	3.3%	-2.4%	-0.2%
South African Rand	USD	-1.4%	1.3%	-19.4%	-16.5%
Swiss Franc	USD	0.2%	1.1%	1.6%	4.7%
Chinese Yuan	USD	0.2%	0.9%	-1.5%	-2.4%
Commodities & Alternatives					
Commodities	USD	3.2%	4.2%	-25.4%	-20.6%
Agricultural Commodities	USD	0.0%	0.6%	-11.2%	-11.3%
Oil	USD	8.9%	19.4%	-36.1%	-31.8%
Gold	USD	0.8%	0.8%	14.5%	29.6%
Hedge funds	USD	0.6%	1.5%	-1.4%	3.0%

Source: Bloomberg. Past performance is not indicative of future returns.

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