SILEX
CLEAR CUT

VOTING WITH YOUR WALLET

Welcome to CLEARCUT, a monthly discussion on macro and allocation

Maxime Alimi, Head of Macro and Allocation

KEY POINTS

- Markets have struggled to march on as concerns about the pandemic and US elections weigh on.
- We think both will deliver positive outcomes and see excessive discounting of negative scenarios today.
- SPARK moved back to overweight in equities: we buy on dips and position for a cyclical rotation.
- Other attractive segments include High Yield credit, financial debt as well as cyclical commodities.

MACRO

It feels like 2019, doesn't it?_ 2020 will certainly be a year that all of us will remember. So many memories will be different from previous years and what will remain from this experience in the 'world after' is certainly a debate worth having. Still, on financial markets, we are entering the last quarter with questions that look oddly similar to last year. After a massive rally since April, the market seems to have been struggling of late. Valuations are high on average, but positive catalysts are lining up before year end. Many investors have missed parts of the upside by remaining on the side-line for too long. Can Q4 2020 look like Q4 2019?

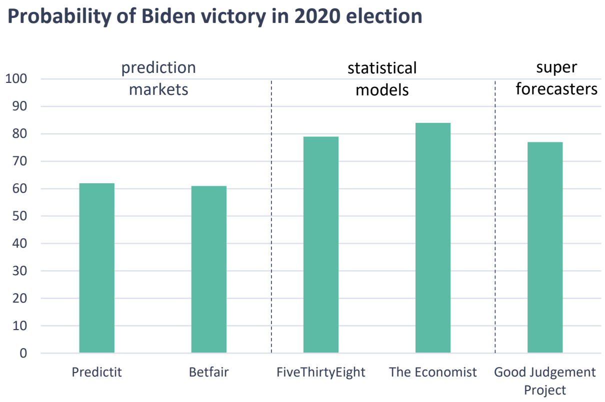
Second wave_ The first reason for markets to start having second thoughts about the rally has been the progression of Covid-19 in recent weeks. The number of new cases is now running higher in France, Spain and the UK compared to the spring. In the US, the curve is stubbornly flat. These developments have triggered renewed pressure on governments to introduce restrictions to activity, weighing on market expectations for growth. According to

Bloomberg, 2020 growth consensus was revised down since August for countries like the UK, Spain, or Japan.

Keep it focused_ We remain of the view that the risk of general shutdowns remains low. As argued last month, the data on fatality rates and hospitalisations remain manageable while the political tolerance for another round of confinement is highly debatable. Governments will have no choice but to deploy targeted and sectoral measures whose economic cost can be offset by fiscal policy.

Race against the clock_ Also, vaccine developments are encouraging. Several candidates in the US are running for approval by the FDA before year end, while in China the Sinopharm candidate is already being used at scale. Once a vaccine is confirmed, we doubt that the pandemic can remain a key concern for financial markets.

Exhibit 1: Overview of election forecasts

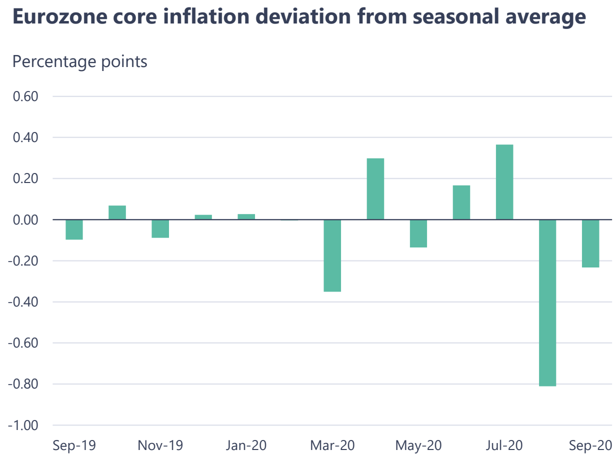


Source: SILEX – October 2020

Election trauma_ The other key concern for markets is the US presidential election. In that regard, forecasts are converging: Joe Biden has a roughly 75% chance of winning (*Exhibit 1*). Still, markets have been traumatised by two past events: i) the 2000 election and the subsequent 36 days of uncertainty; ii) the 2016 election and the surprise victory of Donald Trump. We think both scenarios should not be overestimated. First, the last election's statistical anomaly was to some degree explained by Cambridge Analytica. Second, we should refrain from falling into a recency bias: anomalies are not more likely to occur because they recently occurred. They remain anomalies after all.

Some like it short_ Markets always prefer clear outcomes and abhor confusion and uncertainty. This may be why the 2000 scenario may be excessively discounted today. It remains highly unlikely, however. It requires that not only the national results are so close that the decision falls onto a single State but also that results are tight in that specific State. Of course, President Trump refusing to commit to a peaceful transition as well as a last-minute appointment at the Supreme Court are bringing flesh to this narrative, but the big picture remains that it is a tail scenario.

Exhibit 2: The pandemic is deflationist - period



Source: Eurostat, SILEX – October 2020

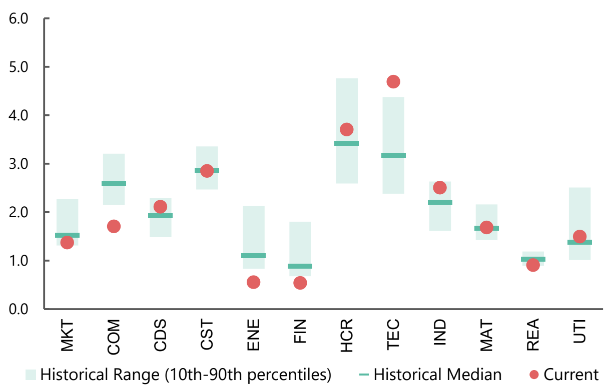
Congress in the picture_ The 'Democratic sweep' is the most likely outcome (60% chance), implying that the Blue party wins the White House and the Senate. Its main implications would be a massive fiscal stimulus involving fresh infrastructure spending as well as regulation on some sectors such as Tech, healthcare and the environment. Market implications are outlined below.

ECB under pressure_ In Europe, while governments are busy coping with the pandemic and Brexit, the ECB is facing all-time lows in inflation (*Exhibit 2*). At the recent ECB Watchers conference, President Lagarde outlined the options on the table to adjust the central bank's strategy over the medium term. But for the coming months, pressure is building for additional asset purchases. Investors need to consider these as a permanent feature of the monetary policy toolkit.

Still feels early_ Markets started to sputter in September after five months of nearly uninterrupted rally. Still, in our view, the environment looks as fresh as that of an early cycle and conducive to more gains. Surely, aggregate valuations are not exactly those of an early cycle. But the dispersion in valuations is remarkable: rarely have we seen at the same time sectors trading within the 10% cheapest of their history and the 10% most expensive (*Exhibit 3*).

Exhibit 3: Valuations are very polarised

Europe Sectors Price/Book Ratio

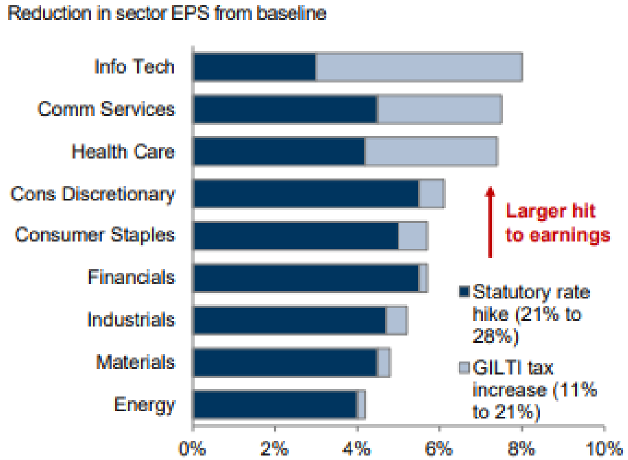


Source: MSCI, SILEX – October 2020

Earnings season_ We have discussed the macro drivers of the story, i.e. a vaccine approval and a reasonably smooth election. On the micro side, the earnings season starting these days may initiate the catch-up of cyclical stocks. The earnings revision cycle looks to be turning for the better and company guidance is likely to drive markets higher in sectors battered by the Covid shock. In early October, European earnings revisions are already highest in sectors like Financials, Consumer Discretionary and Industrials.

Election trades_ Many investors are scratching their heads as to what the various election scenarios may entail for markets. One may remember how most market participants had failed to anticipate the rise in stock markets following Trump's election in 2016. Today, a key component of consensus thinking is that a Democratic administration should hike corporate tax, leading to a decline in earnings to the tune of 5%. A stronger fiscal boost may offset this, however. Coupled with the usual 'buy the rumour, sell the fact' pattern in financial markets, we view a Democratic sweep as broadly neutral for equities directionally.

Exhibit 4: Democratic victory's impact on earnings



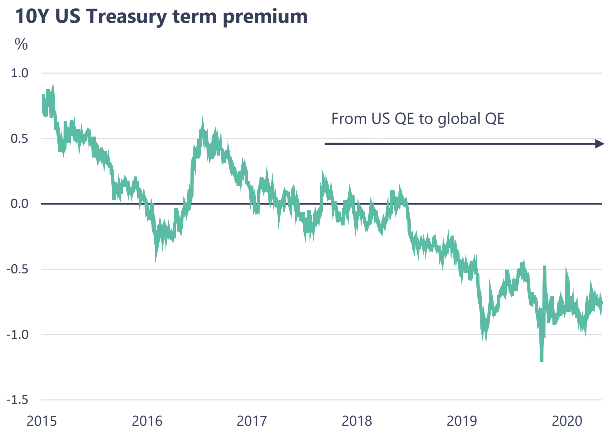
Source: Goldman Sachs – October 2020

Cyclical rotation_ Within the equity market, two key factors lead us to expect an acceleration in the sector rotation. First, an economic acceleration amplified by fiscal policy should disproportionately benefit cyclical sectors that have lagged so far this year. This will be especially true of companies exposed to the infrastructure spending programme that a Democratic Congress looks set to unveil. Second, the corporate tax reform should impact sectors to various degrees, with a larger impact on Tech, Communications and Healthcare (*Exhibit 4*).

Discrimination_ The regulation outlined in the Democratic manifesto should impact some sectors with meaningful discrimination. Big Tech may have to do with privacy and competition. In Healthcare, Pharma could have to cope with constraints on drug prices while health services could benefit from universal medical coverage. In Energy, green companies could get a major boost compared to polluting businesses.

Going abroad_ The impact of the US election is likely to travel abroad as well. A cyclical rotation is likely to lead to the outperformance of markets such as the Eurozone and Japan. Latin America could also benefit, although fundamentals are shakier in the region. Were the US dollar to materially depreciate, such an environment could encourage US capital to leave the country. On many metrics, US equity investors are deeply under-invested in foreign markets after nearly 10 years of domestic outperformance.

Exhibit 5: Term premium may have found its floor



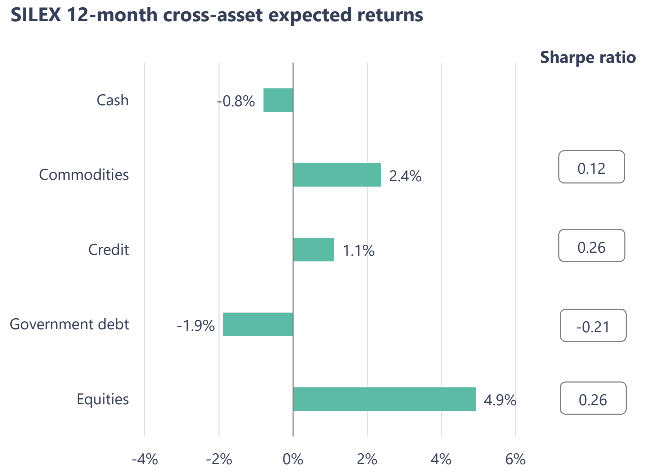
Source: ACM, SILEX – September 2020

Duration risk_ On the rates side, the US election should make the current level of interest rates unsustainable. Although we do expect the Fed to maintain its forward guidance and Treasury purchases for the time being, the boost to nominal growth coming from the fiscal package should leave its mark. Also, inflation may be fuelled by regulation and schemes supporting wages. From a technical standpoint, the spectacular debt issuances that the US government will have to offload to the market will not be met by official sector purchases. China is reducing its holdings and the rest of the world is just not enough. As a result, the path of least resistance is an adjustment in prices. And judging from the level of the term premium, it would not take much to see a marked rise in real yields (*Exhibit 5*).

Dollar pause_ We had warned last month that the positioning on a dollar decline was excessively extended. That called for a consolidation, if not a snapback. CFTC data point to the beginning of an unwind in recent weeks but more may have to come. As a result, we do not expect any meaningful move in the greenback for now, although we stick to a medium-term scenario of steady depreciation at the expense of the euro, commodity currencies as well as emerging market currencies.

Commodity shock_ Commodities were the most sharply impacted by the September correction. Oil took a beat on weaker expected demand as well as persistent concerns about peak demand and an acceleration in the energy transition. In the near term, we see the market balanced in the 40-45$ area and look to buy dips below that range. Copper however may have suffered from long positioning after a very strong run. Still, we see upside in industrial metals on the back of aggressive Chinese macro policies and the broader cyclical recovery.

Exhibit 6: SPARK expected returns and Sharpe ratios



Source: SILEX. Euro-based investors – October 2020

Over/under_ What does SPARK make of these views? Expected returns are not great but have broadly improved after the September price action (*Exhibit 6*). Best opportunities on our metrics lie in equities and cyclical commodities, although the latter have much lower expected Sharpe ratios due to high volatility. Risk/reward is similar between equities and credit but in the latter, High Yield stands out as the most attractive given poor returns from duration.

Best of both worlds_ Finally, the lack of return in buy-and-hold traditional bonds may lead investors to diversify away and consider niche segments. One we have discussed at length is financial debt, which looks compelling at the moment in terms of elevated yields and low default risk. Another is convertible bonds, which have the ability to provide equity upside exposure with fixed income downside risk.

APPENDIX

SILEX Cross Asset Allocation

Market	Rationale	Allocation Strong under-weight · Under weight · Neutral · Over weight · Strong over-weight
Fixed Income	• Duration is expensive and vulnerable to massive supply. Credit markets are most attractive in High Yield.	
Equities	• Excesses in Nasdaq have been washed out and the macro is supportive. We are back to overweight.	
Commodities	• We have taken some profits on gold after a strong run but keep moderate exposure to oil and especially copper.	
Convertible Bonds	• Buying convexity makes sense in an environment where investors want equity exposure with less risk.	
Cash	• We reduced cash to seize tactical opportunities in equities.	

SILEX Fixed Income Allocation

Market	Rationale	Allocation	Strong under-weight · Under weight · Neutral · Over weight · Strong over-weight
Euro Government Bonds	• Duration is at extreme prices as markets adjust to central bank purchases. • Large issuance volumes are a key risk.	Short end	
		Long end	
US Government Bonds	• The long end is more vulnerable to a correction. • Inflation is normalising quicker than expected.	Short end	
		Long end	
IG Euro Credit	• The ECB will be buying large amounts of corporate credit for a long time. • Spreads have partly normalised and expected returns are moderate.		
IG US Credit	• Spreads have now normalised due to strong policy support while duration has become a risk. • Preference for senior secured debt and gradual return to cyclical names.		
HY Euro Credit	• Investors are being pushed to non-ECB eligible assets. • Spreads have normalised less on a relative basis. Defaults are moderate as are issuances.		
HY US Credit	• The Fed's purchases are a major support. • Defaults in the energy sector are well anticipated now. • Issuances could be falling into year-end.		
Euro Financial Subordinated	• Fiscal federalism is a game-changer for the structural risk premium in the sector. • The current crisis does not threaten banks' solvability in a context of regulators' leniency.		
Emerging Market debt	• EM debt looks cheap and risks are decreasing as the US dollar starts depreciating. But macro is fragile after the pandemic.		

SILEX Equity Allocation

Market	Rationale	Allocation
		Strong under-weight / Under weight / Neutral / Over weight / Strong over-weight
United States	• Valuations are high but the policy response has been compelling. More opportunities on the cyclical sectors.	
Eurozone	• The fiscal response is a game-changer. Valuations are attractive and US investors may return to the market.	
Switzerland	• Valuations remain high and defensive bias that may underperform in a cyclical rebound.	
United Kingdom	• Cheap valuation looks attractive but Brexit risks are lingering.	
Japan	• Valuations are relatively cheap, and positioning is very light. Attractive market in a cyclical rebound.	
Emerging Asia	• The Chinese market has re-rated. Korea and India look attractive. Taiwan looks expensive and more vulnerable to political risk.	
Emerging Europe	• Russia may benefit from a rebound in oil markets. Stay away from Turkey and South Africa that are vulnerable to capital outflows.	
Latin America	• Brazil may be turning a corner in the pandemic. Positive risk appetite should favour a high-beta region.	

This article was finalised on 06 October 2020.