. November 2020 .

SILEX

CLEAR CUT

STRUCK BY LIGHTNING

Welcome to CLEARCUT, a monthly discussion on macro and allocation

Maxime Alimi, Head of Macro and Allocation

KEY POINTS

- Time has accelerated: the US election and a Covid vaccine line up as the positive catalysts we expected.
- With a vaccine securing the medium term and maximum policy support in the near term, now could be the best environment for financial markets.
- SPARK confirms a pro-risk stance: overweight in equities as well as High Yield credit.
- Current dynamics are shaking out positioning: there is room for higher interest rates and an equity cyclical rotation.

MACRO

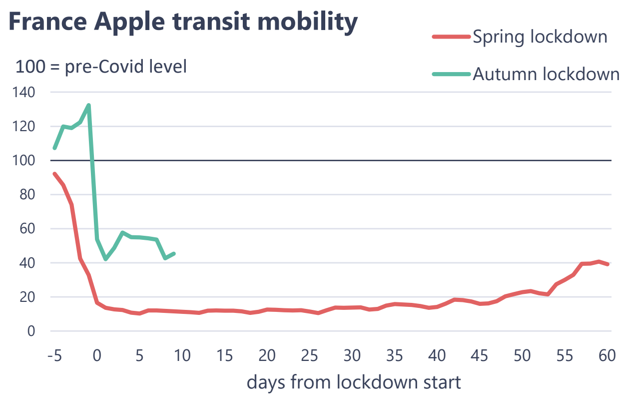
Struck by lightning_ There are times that feel like forever, waiting for events that do not take place. And then, all of a sudden, everything accelerates, and the outlook clears out in just a few days. This is exactly what just happened for financial markets over the past few days, with news on the US election and a Covid vaccine changing the outlook materially. What exactly has happened and what should we make of it?

Not that wrong_ Let's start with the US election. As we had argued in last month's CLEARCUT, polls would have had to be twice as wrong as in 2016 for a surprise to happen. In effect, the presidential race is clear enough that a contested scenario has become highly unlikely. At the time of writing, Joe Biden is three States ahead with a margin of 20 seats in the electoral college. Even though Donald Trump has not yet officially admitted defeat, the judiciary path looks illusory. It is telling that only a small minority of the Republican establishment has called for such a strategy.

2000 it is not_ The worst-case scenario for markets was persistent uncertainty driven by a very tight result and Supreme Court's involvement. We had laid out why this scenario was always less likely than discounted by markets ahead of the election. But clearly the immediate consequence of the election was general relief. This rightly translated into a financial asset rally across board.

Sweet spot_ In addition to clarity, the US election delivered just about the best possible outcome for financial markets, in our view. First, a Biden administration is likely to reduce general uncertainty about US policymaking, especially in trade and foreign policy. Second, a divided Congress, as seems likely, will avoid the most aggressive anti-business measures advocated by the Democrats. These include corporate tax and minimum wage hikes, a mega fiscal stimulus and stringing sector regulation for energy, tech and healthcare.

Exhibit 1: Half a lockdown

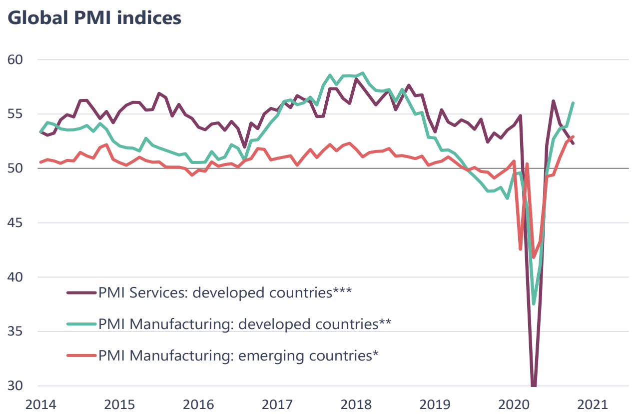


Source: Apple Mobility, SILEX – November 2020

Vaccine irony_ The second massive news of early November was that the vaccine developed by Pfizer and BioNTech has successfully completed phase III testing. This opens the door for an FDA fast-track approval by end November and possible distribution before year-end. This is ironic on two levels. First, the news broke out just days after the US election, fuelling speculations about what a slightly earlier timing could have changed to the election's outcome. Second, the vaccine comes from a German firm founded by Turkish immigrants, a telling example of the benefits from international cooperation and immigration.

The short and the long of it_ Still, the outlook looks now starkly different depending on one's time horizon. A breakthrough on a vaccine significantly alters the medium-term outlook and improves macro and micro prospects 9 to 12 months from now. Progress on treatments and tests solidify this assessment. In the near term though, Covid infection cases continue to look scary and weigh on the economy. True, the lockdown in Europe looks less stringent than earlier this year with mobility data about half as low this time around (*Exhibit 1*). Economic growth will nevertheless be negative in Q4 in most of Europe, while fresh measures cannot be excluded in some parts of the US in coming weeks.

Exhibit 2: Sectoral divergence



*** Poland, Mexico, Chile, South Afr., Russia, China, India, Brazil, Turkey, Hungary, Czech
*** US, Euro area, Japan, UK, Australia, Canada, Sweden, Switzerland
*** US, Euro area, UK, Australia, Sweden

Source: Markit, SILEX – November 2020

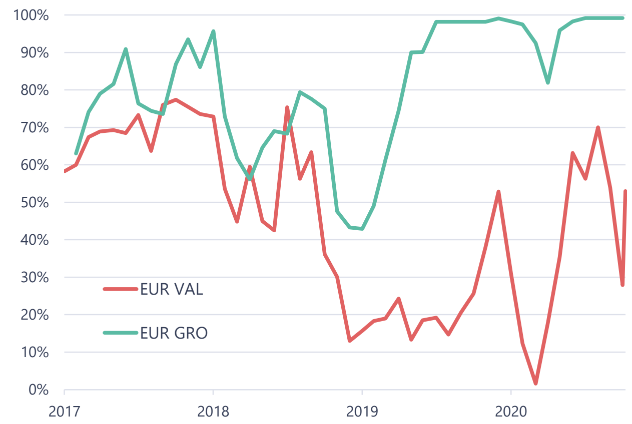
Global vs. local_ This situation translates into a fragmented economy where manufacturing sectors continue to recover while services activity dips (*Exhibit 2*). This has two reasons. First, less strict lockdowns imply that factories continue to run while retail and proximity services are shut. Second, with Asia clearly ahead on its recovery path, global industrial sectors exposed to the East benefit from positive demand spill-overs.

Cynical_ In the end, the conclusion to draw for investors is rather cynical. With a vaccine securing the medium term but the economy struggling in the near term, now could be the best environment for financial markets. As long as growth and inflation are unacceptably low, policy will remain activist and support markets. To that effect, significant announcements should be made by the ECB and the Fed at their December meetings. Things may change when a convincing pickup starts to materialise next year.

Shaking the tree_ The combined news of the US election's outcome and a vaccine materially change the outlook for markets in coming months. In a context of the bull market being very polarised on a narrow set of stocks, the dynamics has room to shift. This can be further amplified by similarly polarised positioning.

Exhibit 3: Valuations are very polarised

European factor valuation percentiles



Source: MSCI, SILEX – November 2020

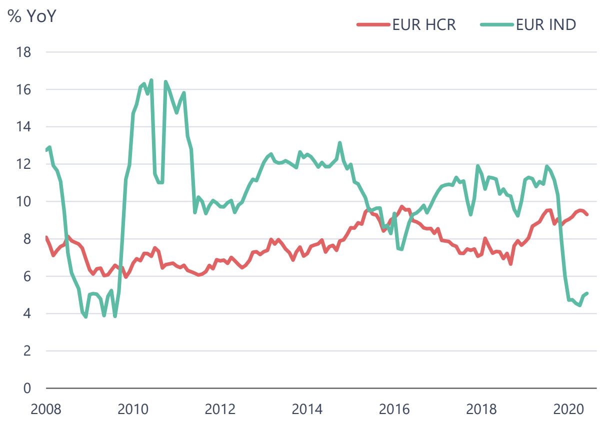
Valuation polarisation_ A fist way of looking at this is obviously the valuation gap between fashionable (Growth) and unfashionable (Value) stocks. Even in an unloved region such as Europe, Growth stocks are as pricey as they have ever been, a gap that has significantly widened on our metrics since 2019 (*Exhibit 3*). This is not new, and we have discussed it several times before. The divergence has to do with a downtrend in global economic growth, accompanied by a similar shift in interest rates. In that context, long-duration assets such as tech stocks outperform short-duration assets such as cyclical stocks.

How long?_ The question is whether the combination of a Covid vaccine, lower political risk and ultra-accommodative policies can sustainably change these dynamics. Since the financial crisis, Value rotations have on average lasted four months. Clearly the valuation gap points to significant room for catch up but that will not be enough in the absence of a catalyst.

Earnings push_ Fortunately there is also a fundamental reason for this shift. The Covid-19 pandemic has led to a dramatic downward revision of long-term growth for a number of sectors (*Exhibit 4*). Were a vaccine confirmed in coming weeks, there would be room for a large reassessment of this pessimistic view. It does not mean that there will be no sequels from this crisis. In most of the exposed sectors, some companies will not survive, or will take years to erase the legacy debt accumulated through the pandemic shock. Nevertheless, the best-in-class companies in these industries should benefit from a significant re-rating of future earnings growth.

Exhibit 4: Lots of catch up on earnings expectations

Long-term earnings growth expectations

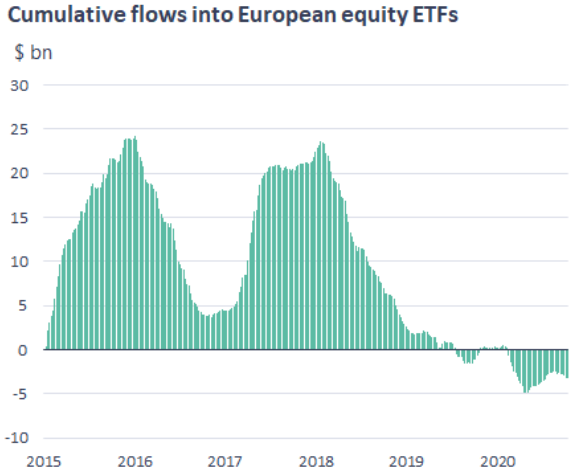


Source: IBES, SILEX – November 2020

Deserted_ Finally, positioning should amplify this rotation. The equity rally this year took place on thin volumes and on a narrow set of stocks. As an illustration, the concentration on the S&P 500 has reached multi-decade highs after many years of outperformance from the tech mega-caps. Another way to look at it is that the cumulative flows into European equity ETFs since 2015 is negative (*Exhibit 5*). Over the past few days, significant flows came into US Value stocks but much less into cyclical-oriented foreign markets like the Eurozone and Japan.

Oil returns_ Another asset experiencing significant volatility recently is oil. In our view, it is still likely to be range-bound despite the significant rebound of the past days. Clearly in the near term, oil is benefiting from both the BioNTech vaccine and from a divided Congress that limits chances of a tightening of energy regulation. Still, the medium-term picture remains one with doubts about oil demand in a world engaged in a green transition. Also, supply-driven volatility remains considerable while the OPEC is increasingly unreliable as a shock dampened. As a result, we keep oil exposures low and buy only opportunistically when oil prices fall below the implicit range that triggers a reaction from producers.

Exhibit 5: Light positioning in non-US markets



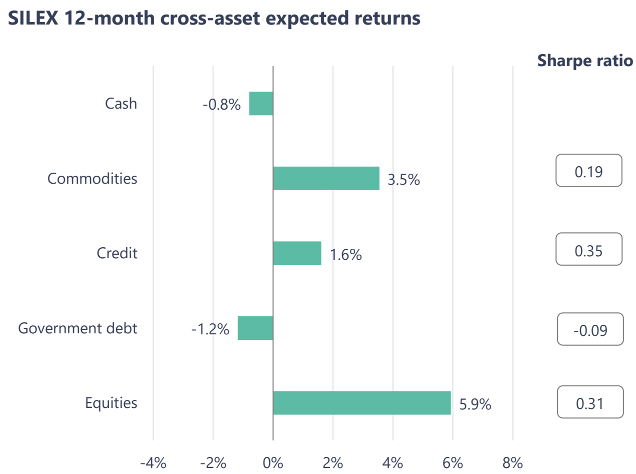
Source: Bloomberg, SILEX – November 2020

Duration risk_ On the rates side, we see the uptrend in US Treasury yields as intact. True, the fiscal stimulus is unlikely to be as large as initially expected under a Democratic Congress. But the boost to nominal growth should leave its mark. Also, even though central banks are likely to extend their asset purchases in the coming weeks, the market will be starting to look beyond those measures. The Fed may start to taper its purchases in the second half of 2021 while significant issuances remain necessary to fund deficits. Our view is that US interest rates will go up in coming months.

Europe shielded_ In Europe, there may be less upside, however. Inflation dynamics are diverging, and the ECB is likely to prolong its accommodative policy for longer than the Fed. In the near term, the rate cut in December is still on the cards, in addition to further asset purchases within the PEPP or APP. We like peripheral spreads still and see room for further compression, as cyclical risk fades and the ECB relaxes constraints on its purchase volumes on these markets.

Credit overweight_ As we are cautious on duration and sovereign debt, we allocate most of the fixed income allocations to credit and especially high yield. Spreads are attractive on a relative basis compared to investment grade, while we see default rates as having peaked. Seasonality also looks favourable as issuances typically fade into year-end. With interest rates pinned down by central banks, the search for yield will resume and favour lower-quality segments.

Exhibit 6: SPARK expected returns and Sharpe ratios



Source: SILEX. Euro-based investors – November 2020

Better prospects_ What does SPARK make of these views? Expected returns have improved since last month despite the positive market performance, as we have revised our expectations higher (*Exhibit 6*). Implied volatilities are a tad lower across the board, but we see more room for a decline before year-end, allowing for sizable risk assets' allocations.

SPARK pro-risk_ Overall, our view remains clearly pro-risk in our model allocations. We think it is too early to doubt the recovery and that significant upside remains in many parts of the market. We are overweight in equities, high yield credit and financial debt. In commodities, our preference goes to industrial metals. We also see some upside in emerging market debt and currencies, in the context of a broader US dollar decline.

APPENDIX

SILEX Cross Asset Allocation

Market	Rationale	Allocation Strong under-weight / Under weight / Neutra l / Over weight / Strong over-weight
Fixed Income	• Duration is expensive but under central bank control. Credit markets are attractive.	
Equities	• Policy risk has come down and the macro is supportive. We are overweight into year-end.	
Commodities	• Copper has our preference as oil looks mostly range bound. Gold may benefit from a weaker dollar in the near term.	
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.	

SILEX Fixed Income Allocation

Market	Rationale		Allocation
			Strong under-weight · Under weight · Neutra · Over weight · Strong over-weight
Euro Government Bonds	• Duration is at extreme prices as QE runs at full speed. • Peripheral spreads remain attractive ahead of the ECB December meeting.	Short end	
		Long end	
US Government Bonds	• The long end is vulnerable to stronger economic prospects. • The Fed should prolong asset purchases well into 2021.	Short end	
		Long end	
IG Euro Credit	• The ECB is buying large amounts of corporate credit. • Spreads have largely normalised and expected returns are less favourable.		
IG US Credit	• Spreads have now normalised with strong policy support while duration remains 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 are very attractive on a relative basis. Defaults are not expected to pick up and issuances are moderate.		
HY US Credit	• Spreads have widened and opportunities are opening up. • Defaults in the energy sector are well anticipated now. • Issuances are coming down 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.		

SILEX Equity Allocation

Market	Rationale	Allocation
		Strong under-weight · Under weight · Neutral · Over weight · Strong over-weight
United States	• The election's outcome is positive as policy risk is coming down. The economy is resilient despite Covid cases.	
Eurozone	• A massive policy support should limit macro downside. The true catalyst should come from a vaccine confirmation.	
Switzerland	• The defensive bias may lead to underperformance in an upturn, although Pharma is favoured at the moment.	
United Kingdom	• Cheap valuation looks attractive but sanitary and policy risks are not gone.	
Japan	• Valuations are relatively cheap, and positioning is very light. Attractive market in a cyclical rebound.	
Emerging Asia	• The Chinese market is powering ahead, supported by a large tech sector. Korea and India look attractive.	
Emerging Europe	• Russia may benefit from a rebound in oil markets. Turkey and South Africa 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.	

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This article was finalised on 11 November 2020.

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