Investment Strategy Update

24th July 2020

CURMI & PARTNERS

Curmi & Partners Research

- Developed economies saw an encouraging recovery in retail sales and industrial production in the months of May and June with the rollback of lockdown measures and the reopening of businesses.
- The rate of recovery may start to slow given the high unemployment and the tapering down of government support.
- The rise in new cases in certain regions is increasing risks of a second outbreak indicating a high vulnerability in the recent rebound in activity.
- Consumer cautious behaviour may continue to slow the pace of normalisation as increasing concern around second wave as well as weak consumer confidence may sustain the rise in precautionary saving.
- Inflation may stabilise at the current low levels with the return in economic activity and bottoming out of oil price but the weak outlook for demand and employment will continue to weigh on inflation expectations for the medium term.
- Labour market conditions continue to deteriorate as major economies see a continued decline in employment with wage growth becoming increasingly dependent on government support.
- Rates remain fairly anchored at very low levels in view of the strong central bank policy and signs of improvement in financing conditions across major economies.
- Sovereign bond yields across Euro Area member states continue to re-converge as country spreads tighten given the stabilization of economic conditions and substantial improvements in fiscal support and receding policy uncertainty.
- Benchmark yield curves are expected to remain low and flat given the subdued economic and inflation outlook across major economies.
- Credit markets continued to benefit from increased investor confidence with spreads tightening in investment grade and high yield bond markets.
- Given the persistent challenges in business conditions, operational performance and cash flows, the rates of defaults are expected to increase. However, the relative preference of identifying selected high yield bond positions has increased.
- Despite the surge in cases, equity markets continued to perform strongly going into July. However, the earnings season is expected to be crucial for equity markets.
- We view current equity valuations to underappreciate the underlying risks and high uncertainty on future earnings.
- We remain underweight equities but positive on high growth names with cash generative businesses and strong financial and liquidity positions.

Whilst global economies might be coming out of the deepest recession yet, financial markets have remarkably already recovered most of the ground lost since the lows reached in March.

Although the substantial central bank support and copious fiscal spending commitments have certainly boosted market risk sentiment, the months of May and June provided us also with the first signs of economic recovery possibly indicating that the worst is over and that we are on the path towards restoring normality.

The bottoming out in the rate of deterioration in economic conditions and positive signs of cyclical improvements has supported the positive momentum in financial markets as investors attributed a higher chance that the current pace of recovery will be sustained whilst discounting the risks of a slowdown or a double-dip reversal in economic activity.

The surge in cases resulting from the lifting of containment measures will test the success of the economic reopening across regions. Those areas showing lack of virus control will likely suffer a second round of lockdown at the cost of the progress achieved thus far.

While we acknowledge that current economic and monetary conditions, as well as other technical factors, are

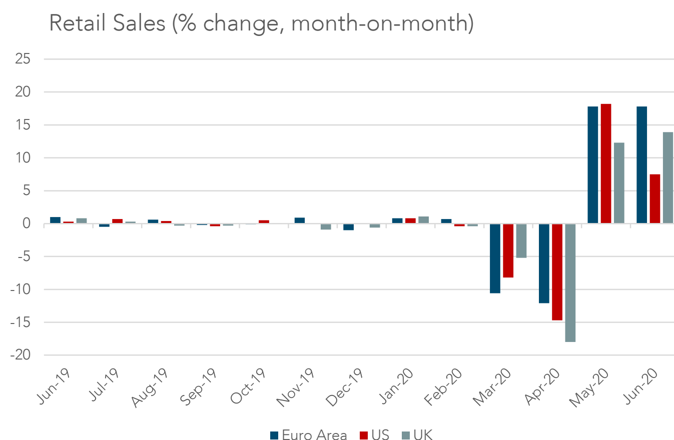
conducive towards positive returns in certain parts of financial markets, we consider current market valuations to generally imply too optimistic expectations on the road towards recovery.

On this basis, we prefer to retain a relatively higher exposure to low risk assets, namely sovereign and investment grade bonds, and a more defensive or selective stance further out on the risk spectrum.

MACRO

The stronger than expected activity data released over recent months, particularly the sharp increase in retail sales and industrial production in advanced economies, suggests that the second quarter GDP contraction may not be as severe as previously feared.

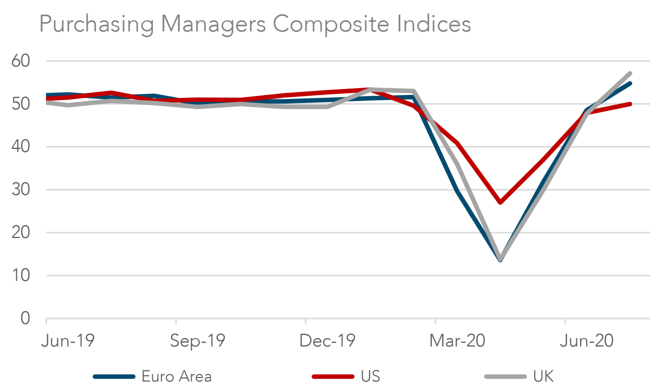
The reopening of businesses and the scale-back of containment measures has brought about the return in economic activity. Retail sales have recovered notably by the end of June reaching levels that are not too far off from pre-crisis levels. Industrial production has also seen a modest uptick, although the extent of recovery is somewhat lagging for the time being.



Source: Bloomberg

A key contributor to the strong rebound has been a return in consumer spending as household income was sustained, or even boosted, thanks to the strong government support and subsidisation of wages across major economies.

Survey-based data on business conditions and expectations, such as the Purchasing Managers Indices, also show a marked turnaround since April with the data-points for June indicating expansion for the first time in manufacturing and services sectors in Europe and in the US.



Source: Bloomberg

Europe

So far the recovery in Europe has been more pronounced given the deeper slump experienced in the months of March and April. Having said that, while consumption has shown signs of improvement, the weak labour market conditions and precautionary household behaviour is expected to continue to weigh on spending over the medium term which is expected to slow down the pace of the recovery. Moreover, the persistently weak global economic conditions are expected to continue to hamper external demand for Euro Area goods and services.

At the same time, the agreement reached by the European Commission on the European Recovery Fund is expected to unleash a powerful financial package which will be targeted to combat the negative effects of the crisis, particularly in the severely hit nations, and boost internal demand across Europe.

Apart from the much needed relief on the swelling national debt levels in the weaker economies, the recovery fund will also mark the first significant step towards some form of fiscal integration amongst member states. It is expected to improve the coordination of fiscal initiatives across Europe primarily through the launch of several programmes and mechanisms which will facilitate fiscal transfers amongst member states and bring about a higher degree of risk sharing. Apart from strengthening the European Union, this initiative can result in a concerted push to start addressing the fragmentation across European economies which has limited the growth potential of the bloc for several years.

With the positive turnaround in recent economic data and the substantial ramp up in monetary and fiscal efforts, expectations are starting to point towards a steadier recovery in the Euro Area. The possibility of a sustained rebound so far seems to be less subject to potential setbacks from large-scale re-impositions of restrictive measures due a substantial surge in new virus cases. The recent increases in the rate of contagion seen across several counties have so far been localized and manageable.

United States

The experience in the US is somewhat different. The surge in new cases and the increase in positive test rates indicates that the rate of contagion across some forty states has materially picked up. This has triggered several states to reintroduce restrictive measures in an attempt to curb the contagion. High frequency data, such as mobility trackers, restaurant diner statistics and shopping mall footfall rates, have come down even in states which have not experienced a similar surge in cases, showing that the increased concern around the virus is more broad-based amongst consumers.

These developments will likely produce a slow down in consumer spending in the US. Furthermore, as global trade remains weak, the probability of a more imminent deceleration in the US economic recovery is becoming more likely. In spite of the weaker outlook, since we do not expect lockdown measures to be imposed on a large-scale, the risk of a double-dip recession remains low at this stage.

United Kingdom

The economic reopening in the UK is lagging the progress seen in other advanced economies. This is primarily due to the fact that the rollback of lockdown measures was initiated later on and at a relatively slower pace compared to other regions. Retail outlets, bars and restaurants were only allowed to reopen in June. In fact the UK's Monthly Business Survey confirms that businesses attribute the weak activity in May to be a consequence of lockdown and social distancing.

UK is seeing localized outbreaks of virus infections which could result in the reintroduction of lockdown measures if the trend continues. This would limit further the enjoyment of expansion in an already slow moving economy.

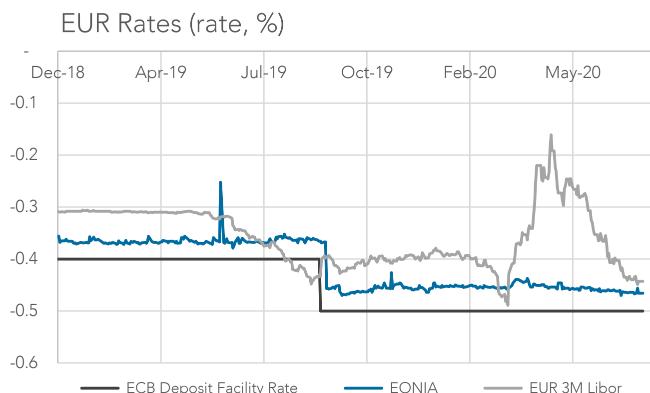
The historically high dependency on sectors that have been hard hit by the virus is expected to result in a relatively slow rate of normalisation in economic conditions in the UK. Furthermore, the uncertainty coming from the ongoing Brexit developments is expected to remain an additional drag on business investment while external demand is also expected to remain weak. All in all, despite the positive month-on-month changes in economic activity, the rate of recovery in the UK is expected to be slow, widening the divergence from other developed economies.

RATES

Euro

Short-term money market rates continue to close the spread to central bank policy rates indicating the continued relaxation of funding stress in Euro. This comes as a result of the substantial intervention by the European Central Bank to ensure adequate access to credit through the launch of short-to-medium term refinancing operations and the loosening of conditions to access such funding.

The stabilisation in the deterioration of economic conditions and some positive signs of cyclical improvements have also eased tensions seen in short-term funding, resulting in an overall improvement in financing conditions in the Euro Area.



Source: Bloomberg

Moreover, the evidence of success of fiscal measures introduced so far and the agreement reached on the recovery fund have also boosted credibility in economic policy across Europe.

Given these underlying factors, sovereign bond yields of Euro Area member states, particularly non-core and peripheral countries, continued to decline resulting in a general compression in the Euro sovereign bond market.

Having said that there is still an elevated level of uncertainty surrounding Europe's economic trajectory and despite signs that the lows may have been reached, projections for economic activity and inflation remain very low. Because of this, a highly accommodative monetary stance is warranted to ensure ample liquidity and access to credit to stimulate the economic recovery.

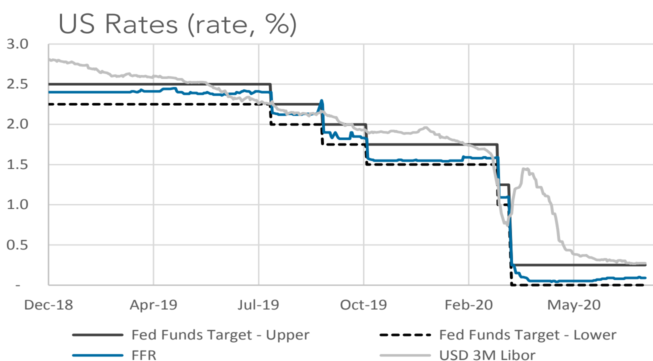
On this basis, we expect the European Central Bank to maintain an ultra-accommodative stance for the medium-term. This is expected to continue to support short-term money markets and bond yields as well as keep downward pressure on long-term rates and bond yields.

The conditions for a continued compression in country spreads in the Euro area and relatively flat yield curves remain prominent in the current environment.

US Dollar

Short-term rates in the US remain anchored at very low levels as the Federal Reserve ("Fed") maintained the policy range for rates unchanged at 0% to 0.25%. Moreover the Fed has strengthened its forward guidance for low rates by conveying a strong commitment to retain an accommodative stance for as long as necessary. The Fed discussed other policy options that it may consider to achieve this objective including the introduction of mechanisms to control the level of long-term yields.

The Fed is expected to complete its framework review this month, however more information on the way forward and further clarity on asset purchases are expected to be announced in September. Despite extensive discussions on yield curve controls, the minutes showed that there is still some concern on the risks related to such a policy, and thus markets are not expecting yield curve control to be the first tool of choice.



Source: Bloomberg

US treasury yields continue to be driven by the unprecedented measures rolled out by the Fed at the start of the pandemic. Whilst the stabilisation of the yield curve and anchoring of low yields has now been in place for several weeks, there was a further shift downwards more recently, as risk aversion increased following a pick-up in Covid-19 cases in certain US states. Additionally, concern related to the economic recovery, the pullback in equity markets, and the risk of disappointment with corporate earnings provided a further pressure for yields to remain at historically low levels.

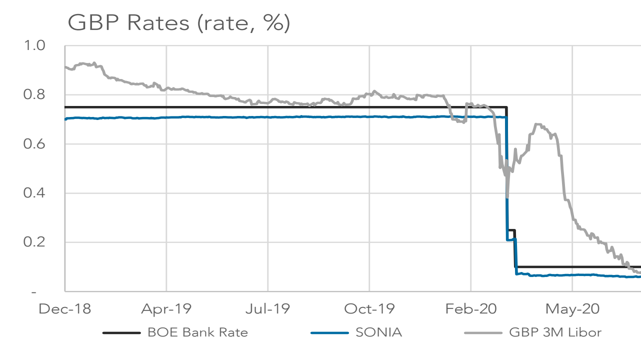
We continue to expect US benchmark yields to remain relatively stable due to policy measures and expectations thereof

Whilst in previous updates we referred to potential episodes of vulnerability in long-term yields, driven by improving economic conditions and other technical factors, the risk of a volatile sell-off in US treasuries has somewhat moderated for the short term.

Sterling

A lot of investor focus remains on the divergence between the market and the Bank of England (BoE) on the need for further interest rate cuts into negative territory and the benefits of such a move. The debate is in turn driven by differing levels of conviction on recovery prospects for the UK economy.

Similar to EUR and USD markets, short-term money market rates have contracted down towards the policy rates and short-term funding tension abated.



Source: Bloomberg

During its last monetary policy meeting in mid-June, the BoE maintained the bank rate at 0.1% and indicated that it will continue with the asset purchase program to purchase £200 billion worth of assets, including both government bonds and non-financial IG corporate bonds. Additionally, the BoE also increased the target stock of Gilt purchases by an additional £100 billion, expecting that by the end of the year the total stock of government bonds purchased will amount to £745 billion. The BoE noted that "liquidity conditions have stabilised", allowing for a slower pace of asset purchases than what was required in the midst of the pandemic.

The Debt Management Office ("DMO") announced that it plans to issue an additional £110 billion of bonds between September and November, bringing total issuance plans from the start of the fiscal year to £385 billion.

Despite the strong increase in supply, demand for Gilts remains strong, as seen in recent bond auctions, supported by the BoE's bond purchase programme. Since April, longer dated bonds have stabilised at a low range whilst yields on shorter dated gilts continued to decline as the probability of a v-shaped recovery continues to the diminish.

In view of the current situation and the necessity for the BoE to remain heavily involved in markets through Gilt and corporate bond purchases, we expect Sterling rates to continue trading at the current low levels.

CREDIT

The continued improvement in financing conditions and short-term funding markets, the central bank asset purchase programmes and some positive signs of economic improvement have continued to sustain the remarkable recovery in corporate bond spreads across Investment Grade ("IG") and High Yield ("HY") bond markets.

The general tone in credit markets remained positive as the first half of the year came to an end, except for relatively short episodes of minor pull-back related mainly to resurgence of Covid-19 cases and investor concerns on the fragility of the recovery.

However, with the economic outlook remaining challenging, certain sectors and individual corporate issuers are still underperforming, as reflected in the relatively high level of dispersion in current market pricing in corporate bond markets.

It is important to note that despite the high level of uncertainty, this period was also characterised by exceptionally strong capital markets, as issuance volumes hit record levels in a number of spaces of the market reflective of relative strong investor confidence as the pricing of new bond deals often closed towards the tight end of indicated price guidance.

While companies continued to take advantage of the support provided by policy makers, investors have now shifted focus to second quarter results with the objective of assessing the extent of the damage to financial profiles of issuers.

In the current environment, corporate fundamentals remain challenging. It is noted that, in addition to the underlying financial position at the onset of the crisis and the direct impact on revenues, the extent of such impact is often effected by other factors including, relevant cost structures, the company's commitment to capital expenditures and the vulnerability in cash flow management and access to liquidity.

As could be expected, the ratings and default rate scenario is negative – Moody's notes that the trailing 12-month global default rate reached 5.4% at the end of June, which marks the highest level in a decade. General expectations point towards a potential rise to around 10% or higher by the end of the year and into 2021.

Whilst the current environment confirms the relevance of adopting a more selective stance in investing, it is also noted that, historically, periods of high default rates do not preclude above average returns in credit markets. In fact, in line with historical recoveries of credit markets in the past, we see the scope for tightening of spreads to continue, especially as benchmark yields are expected to remain low and relatively flat, providing for a benign scenario.

The relative preference for IG bonds vs HY bonds has now become less evident and the scope to proactively select investments in HY is becoming attractive.

We consider key risk factors that may challenge our outlook across credit markets to be:

- Deterioration in virus trends leading to a second round of broad-based lockdowns;
- Economic recovery pans out at a slower pace than currently anticipated by market participants;
- Sharp steepening in benchmark curves, possibly triggered by an accelerated turnaround;
- Geopolitical risk events, such as disruptions from the US election.

Source: Bloomberg

Source: Bloomberg

EQUITY

Headlines around COVID-19 remain the main market mover for global equity markets, five months on from when the virus started to spread outside of China. Equity markets retreated slightly in June, as growth in new confirmed virus cases picked up in the United States.

However, the virus uncertainty has not deterred equity investors, with indices still close to the levels seen in February. Global equities rallied 24.4% in USD terms during the second quarter of the year. This was the best return generated during the period by global equities over the past 20 years, well above the median return of 2.6%. The Nasdaq index was the best performer among the main indices, with a total return of 37.0% in local currency terms and 33.1% when returns are measured in Euros. The next best performer was the DAX, an export oriented index that generally performs well against a backdrop of improving macro trends.

Nevertheless, the strong performance in the second quarter of the year cannot be viewed in isolation. Whilst the second quarter was a strong quarter for equities, first quarter was the worst. Global equities lost 20.9% in local currency terms during the first quarter and 19.2% in euro terms—the worst return during the first quarter over the past two years.

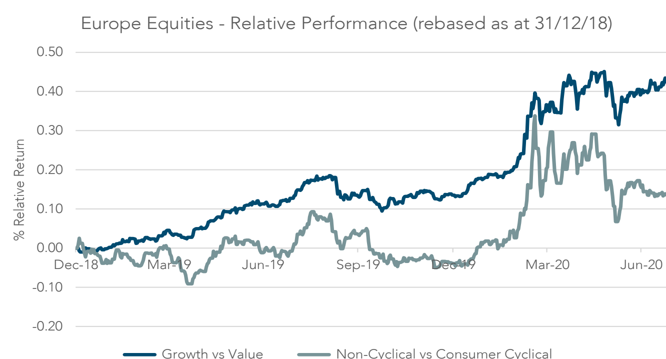
Looking at the market performance for the first half of the year, global equites lost 5.5% in local currency terms, the worst return since the first half of 2010. Unsurprisingly, the Nasdaq index and CSI (China) were the top two performers during this period. Tech stocks have shown their resilience during the crisis, both in terms of financial performance and price performance. On the other hand, Chinese stocks benefited from an earlier relaxation of lockdown measures.

Other regions fared worse during the first half of the year. European stocks, as measured by the FTSEuroFirst 300, fell 11.8% - the worst return since the first half in 2008. UK stocks fell sharply, with the FTSE 100 losing 22.4% in Euro terms and 16.8% in sterling terms, marking it the worst performance in the first half of the year in the past 20 years. Japanese stocks fell 4.1% (total return in euro terms) while Australian stocks fell 11.9% over the same period.

Looking ahead the earnings season will be crucial for equity markets. Our view remains that investors looked through the weakness in earnings during the first half of 2020 and are instead focusing on management commentary around outlook and whether profit guidance will be reintroduced. The improving macro-economic data should be supportive for third quarter earnings, but the surge in new cases, particularly in the US, could cloud the outlook.

Equity valuations are not seen to be fully pricing in risk as valuations remain elevated relative to the past. This means that investors are prepaying for future growth in earnings. Historically this has happened at the end of a bear market, when the rate of deterioration in economic data slows and near term visibility improves. The equity risk premium declines and valuations rise. Whilst this was acceptable during past bear markets, the situation today is not so clear cut. Investors are prepaying for earnings growth, ignoring the uncertainty. Economic data has been improving, but the risk from COVID-19 has not abated. This is something that investors need to take into consideration before buying into equities and hoping that the worst is now behind us.

We continue to recommended a slightly underweight position in the asset class, which takes into consideration the high valuation levels, uncertainty over the virus developments and the US/China trade relationship. We think that the current valuations are not pricing in the potential impact from a second wave on the global economy and corporate profits. Notwithstanding, news flow around a vaccine has been positive in recent weeks. We remain positive on the prospects for high growth names in the near term, as long as these companies are generating significant cash flows and have a solid balance sheet.



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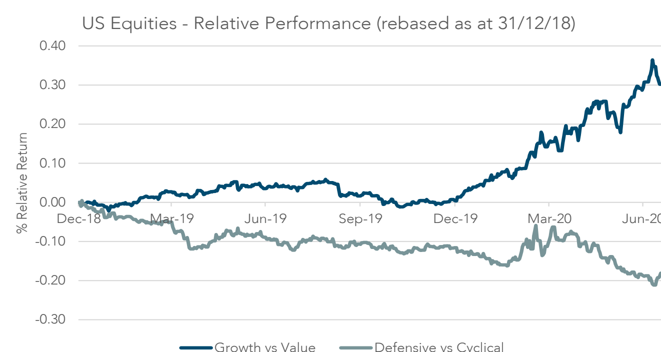

Source: Bloomberg

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Stable	N	Benchmark bond yields continue to benefit from strong central bank support and forward guidance. This is seen to more than compensate for the determination of governments to increase public debt to intervene with substantially supportive fiscal measures. Given the increase in monetary support as well as the agreement reached on the European recovery fund, peripheral spreads remain well supported. However, given the strong performance over recent weeks, the possibility of further upside is fading in the near term. In addition to maintaining sovereign bond exposure as a hedge against risky assets in a multi-asset portfolio, improved positioning may also offer potential tactical opportunities.
Investment Grade Corporate Bonds	Positive to Neutral	O/W	Investment grade bonds remain attractive on a relative basis given the spread differentials to historic levels, but at a lower level of conviction. Strong central bank support is likewise expected to continue to sustain the compression in spreads which underpins the benefits of maintaining a long duration exposure within this space, particularly in view of the low interest rates and low inflation outlook. The risk of downgrades remains prevalent and requires close monitoring in view of the challenging business conditions and general sentiment in credit markets.
High Yield Corporate Bonds	Negative to Neutral	N	The full long-term impact on the virus is yet to be realised, and the damage dealt to weaker credit profiles is yet to become clearer possibly with the release of the second quarter financial results. High yield markets have rallied considerably from the mid-March lows. Having said that, improved market conditions may provide scope to pro-actively seek opportunities on a selective basis. The scope to remain selective in carrying high yield positions remains while the scope to opportunistically identify unjustifiably discounted bonds is starting to emerge.
Emerging Markets Corporate Bonds	Neutral	N	Confidence to add exposure in emerging market corporate bonds is starting to increase given signs of stabilisation and the reopening of the global economy. This should improve return prospects from emerging market bonds particularly given that US yields continue to trade at relatively low levels while the EM bond market has not yet recovered to the same extent as other bond markets. While our selection remains tilted towards more conservative financial profiles, the scope to continue to de-risk specific positions may be considered on an individual name basis.
Equities	Negative	U/W	Our defensive stance in equities due the widening dislocation in valuations against the deteriorating company fundamentals and a challenging economic outlook offered some protection against the pullback in equity markets in June as fears of a second wave started increasing. We prefer to retain an overall underweight allocation in equities combined with an overarching factor tilt towards quality stocks and growth stocks. However, we have adjusted our positioning to include exposure to renewable energy as well as luxury goods in selected stocks given the strong ability of companies to grow cash flows and retain a strong balance sheet position. In terms of sector positioning, we prefer to remain underweight cyclical industries and retain our core positions in staples, healthcare and technology. At the same time, we remain on the lookout for potentially attractive opportunities in severely discounted cyclical equities that stand to benefit from the slow improvement in conditions brought about by the relaxation of containment measures.

N = Neutral *O/W = Overweight* *U/W = Underweight*

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