Investment Strategy Update

27th October 2020

CURMI & PARTNERS

Curmi & Partners Research

- Following a surprisingly strong rebound in economic activity during the Summer months, economic data in the Euro Area and the UK is showing signs of renewed weakness as COVID-19 cases continue to increase and restrictive measures are reintroduced.
- Survey-based indices are pointing towards an economic slowdown, and in some countries the risk of economic contraction, particularly as the services sector is expected to weaken as a result of the new restrictive measures, whilst manufacturing remains on an expansionary path across advanced economies.
- Despite a similar surge in infection rate, the economic trajectory in the US seems to be more resilient, given that the rebound in consumer spending and production is expected to continue, albeit at a slower pace.
- The US labour market has continued to recover, however, recent data is showing some fatigue in sustaining the same pace of job gains as in previous months.
- Investors have shifted focus towards the US elections with the increasing odds in favour of a Democratic sweep generally being viewed to be positive for the economy as well as for financial markets.
- The anticipation of a big stimulus package to be launched before year-end under a Democratic-led Congress has spurred optimism on economic prospects and inflation expectations.
- US treasury yields have inched upwards as expectations of a reflationary market environment led to a risk-on market sentiment and increased the scope of reevaluation of the Fed's "low rates for longer" policy.
- Whilst we see the risk of a sharp sell-off in US treasuries to be low at this stage, we acknowledge that US yields can continue to grind higher in the near-term and that risk-reward of maintaining a long duration position became more balanced.
- Given the different growth/policy mix in the Euro Area, we continue to favour maintaining a long duration position in Euro fixed income markets given the subdued inflation outlook and increasing propensity for the ECB to increase monetary stimulus.
- Whilst we expected market sentiment in risky assets to reflect the weakening economic and business conditions during the fourth quarter, the risk of a sharp market sell-off similar to that experienced in March is unlikely.
- The easy financing conditions and accommodative policy stance continue to provide a strong backstop to corporate bond markets whilst supporting the flow of credit to weaker financial profiles.
- In view of the pipeline of fiscal stimulus, most notably the phase 4 package in the US and the launch of the recovery fund in Europe, as well as the expected approval of a vaccine in the coming months/quarters we are looking to add exposure to sectors and businesses that have not benefitted from the market rally following the sell-off in March but are well positioned to benefit as the economies continue to recover.
- Whilst a cautious approach remains warranted, the widening dispersion in asset valuations is increasing the attractiveness of positioning for a market rotation from defensive or non-cyclical stocks to cyclical value stocks as business conditions show sustained signs of improvement.

As we move away from the surprisingly strong Summer months, a diverging pattern is becoming clearer with US economic indicators pointing towards a sustained recovery path, albeit at a decelerating pace, whilst the Euro Area and, more evidently, the UK are heading towards a weak fourth quarter.

Although the concerns surrounding the virus, the US elections and Brexit pose the main risks on the economic outlook, the different growth/policy mix of these economic regions, shows increasing evidence of decoupling supporting the widening in spreads between US Treasury yields versus UK and German benchmark bond yields.

As a result of these underlying dynamics, the reflationary trade is becoming more evident in the US with breakeven inflation rates retesting the highs in anticipation of a favourable election outcome and additional fiscal stimulus to be deployed before year-end.

Traded inflation in the Euro Area and the UK lost ground in view of the weakening momentum as the

surge in cases and reimposition of restrictive measures are threatening the pace of recovery in economic activity. As a result, the past few weeks have generally be characterised by a benign market environment with episodes of risk-off market movements and safe-haven buying.

As the economies are yet rebounding from the March/ April downturn, we consider the upcoming period of economic weakness to be a bump in the road towards recovery whilst growth and inflation forecasts for 2021 have generally held steady or revised upwards.

In hindsight, following an effective economic stop advanced economies have shown a greater ability to jump start the economy, than what many had been expecting, thanks to the deployment of generous fiscal packages and accommodative monetary policy. The surprisingly fast rate of recovery experienced in the Summer months, combined with increased knowledge around the virus, improved testing capabilities and targeted containment measures, provide a level of comfort that another phase of challenging conditions is not expected to result in a sharp downturn to the likes experienced earlier this year.

The positive progress made on the development of a vaccine, the phase 4 stimulus package which is expected to be launched in the US this year, and the deployment of the European recovery fund expected early next year, also provide a constructively positive economic outlook for 2021.

In view of this, we are looking to gradually adjust our defensive positioning in equity with the aim of selectively adding exposure to sectors and stocks that are expecting to benefit from improved vaccine optimism, receding economic uncertainty and a resumption of the recovery in economic activity.

The substantially easy financing conditions, the low growth and low inflation outlook lead us to retain a preference to hold a long duration position in fixed income securities. At the same time, we are becoming comfortable with increasing credit risk in our investment strategy to entities with a resilient business model and a strong financial and cash position.

MACRO

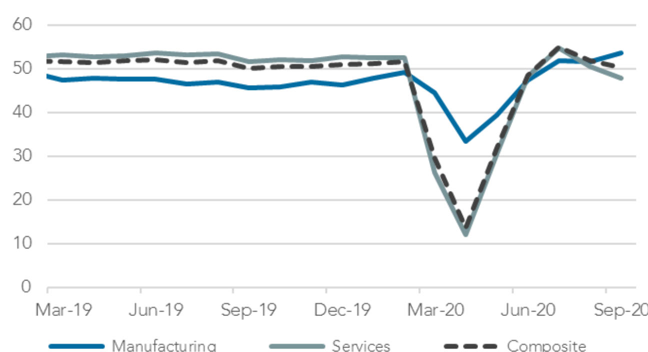
Euro Area

The number of COVID-19 cases has continued to rise steeply in September, with the increase being concentrated in France and Spain. As a response, governments have re-imposed restrictions and curfews with the aim of containing the spread. The new restrictions involve more targeted measures than those imposed in the first wave, however there are already signs that these measures are impacting economic activity.

The number of new daily positive cases in the Eurozone has increased significantly since the first wave, some of which can be explained by the significant increase in tests being carried out. Nonetheless, the share of tests turning positive has also increased. There is still a divergence between countries, with the increase in the last couple of weeks being driven by France and Spain

As a result of the increase in positive cases, it is likely that governments will continue to roll-out new containment measures, albeit the likelihood of a broad-based lockdown remains low at this stage. The biggest risk lies, once again, in the hospitality, entertainment and travel sectors.

Following a contraction of 11.8% in Q2 GDP data, Q3 Eurozone GDP data will be released at the end of October. Monthly activity suggests that activity has rebounded quickly once lockdown measures were lifted during the Summer months. In fact expectations are pointing towards a expansion of 9.6% in Q3. The recovery in economic conditions is also reflected in the improvement in Economic Sentiment Indicator which continued to improve in September. Nevertheless, as restrictive measures remain the main treat to the eurozone recovery resulting in a relatively pessimistic outlook for economic performance in Q4.



Source: Bloomberg

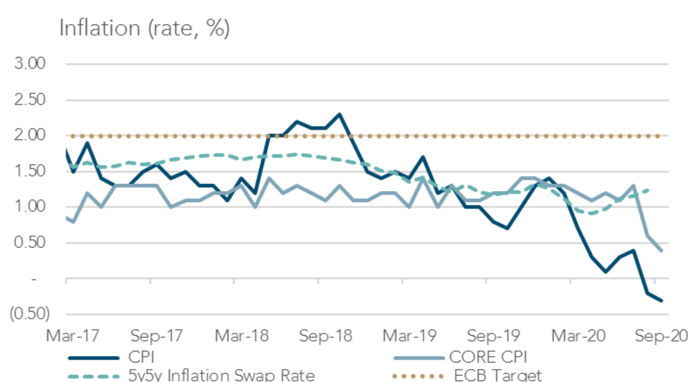
Euro Area services continue to weaken in October, as indicated by the IHS Markit flash Eurozone Services Purchasing Managers' index declining further into contractionary territory to 46.2 in October compared to 47.6 in the previous month. The reading indicates that the majority of businesses have reported a month-on-month contraction in activity. On the other hand, manufacturing activity continued to show signs of improvement, with

Manufacturing PMI increasing to 54.4 in October from 53.1 in September. The reading shows the increased factory activity and growth in new orders while backlogs remain at the highest level over the last few years. In view of this, the impact of the second-wave of containment measures is not expected to impact industrial production as much as services, as restrictions are mainly being placed on social activities and consumer-facing businesses.

Industrial production remains positive but slowed to a 0.7% month-on-month increase in August, following increases of 12.2%, 9.2% and 4.9% in May, June and July respectively. Production of durable consumer goods (6.8%), intermediate goods (3.1%) and energy (2.3%) rose strongly in August, but output of non-durable consumer goods (-1.6%) and capital goods (-1.6) fell. The decline in capital goods was due to a 15% fall in car production, excluding cars, industrial production rose by 2% on a month-on-month basis.

Retail sales, on the other hand, were much stronger than expected, increasing by 4.4% in August following a 1.8% decline in July. August retail sales also surpassed pre-crisis levels by 3.1% (February(, primarily driven by an increase in mail orders and internet sales which increased by 12.4%, suggesting consumer reluctance to go to retail stores.

Headline inflation declined further in September to -0.3%, from -0.2% in August, brought down by a combination of the cut in German VAT, delayed summer sales and heavy discounting in the tourism sector. In comparison to August, inflation fell in 12 out of the 19 Eurozone member states.



Source: Bloomberg

Energy prices continued to be the main drag on inflation, declining by -8.2% in September. Excluding energy, HICP declined from 0.7% to 0.6% in September. Services inflation also continued to decline.

The ECB expects inflation to remain negative in the coming months before turning positive in early 2021 with the outlook remaining weak due to weak demand, lower wage pressures and the appreciation of the euro exchange rate. Demand is expected to remain subdued as a result of the recent round of restrictions and curfew imposed, with a particular impact on services.

Unemployment in the Euro Area increased from 8.0% in July to 8.1% in August, as the number of people classified as out of work rose for the fifth consecutive month.

Government work schemes aided unemployment from surging during the lockdowns, however the number of people on these schemes has declined significantly over the summer months in the major member states. As a result ulterior labour market data shows that there was a large increase in labour market slack. As we have noted in previous updates, the impact on unemployment was expected to materialize with a lag in the Euro Area primarily as a result of the generally stronger employment terms in Europe and the job retention schemes introduced by governments.

The re-opening of schools in September is likely to encourage people to return to the labour market, however hiring remains weak as a result of subdued demand and increased uncertainty from second-wave effects.

Dependence of household income on government subsidies and potential impact on labour markets as governments withdraw or reduce support (especially in the fiscally-weak countries) remains a key concern for employment and consumer demand. The risk remains that employment continues to fall even whilst the economy starts to recover on the basis of (a) fiscal cliff effects and (b) weak business prospects and a high uncertainty weighing on business investment.

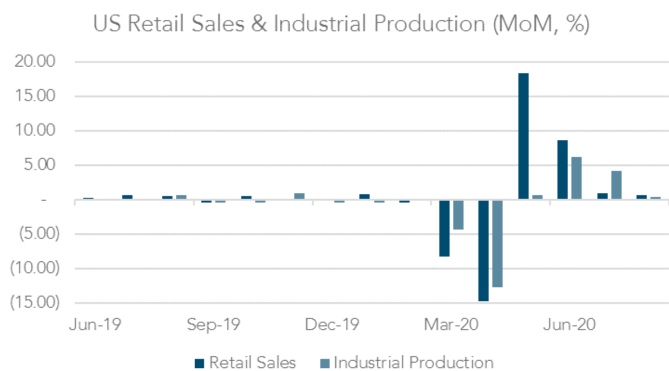
United States

The generally stronger activity data coming out of the US indicates a greater degree of resilience in the recovery path of the economy. Consensus estimates are pointing towards a strong 3Q GDP print following the growth momentum in retail sales and industrial production over the Summer months. 3Q GDP growth expectations are at 30% annualised following a contraction of 31.4% reported in Q2. As a result of the faster pace of recovery compared to expectations, growth forecasts for the full year 2020 have remained supported and revised upwards with consensus forecasts now looking at a 4% contraction.

Similar to the month of August, the momentum in retail sales was sustained even while infection rates were rising. Survey-based activity indicators continue to point to a continued rebound, although non-manufacturing sectors seems to be leading manufacturing sectors.

The sustained increases in Retail Sales coming in at 1.9% month-on-month in September compared to expectations of 0.7%, shows evidence that the recovery in con-

sumer spending has continued despite the reduction in unemployment benefits.



Source: Bloomberg

In any case, the rise in cases is bringing about renewed downside risks particularly if we see a substantial upturn in hospitalisations. However, given the experience in July/August, investors seem to be shunning the accelerated rate of contagion for the time being given that the surge in cases during Summer has been brought down with low-cost containment measures.

Moreover, high frequency data is still showing a gradual increase in spending on travel, restaurants and accommodation, whilst the Consumer Confidence Index has continued to increase. Secondly, increase in number of cases is partly due to an increase in testing whilst the rate of positive tests have only marginally increased.

As a result, a new round of localised measures, similar to the measures put in place in August, is not likely to pose a significant threat to the economy.

As we enter the final two weeks of the US elections, investor focus has shifted towards the increasing odds of a "Blue Wave" outcome and the possibility of a larger stimulus package to be ratified sooner rather than later compared to the expectations attached to a divided government outcome.

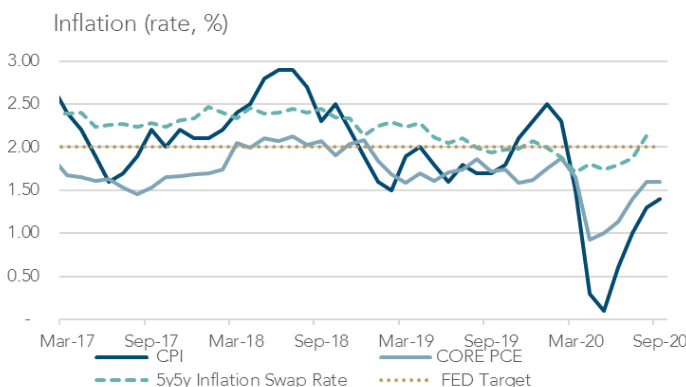
However, the high expectations on the timing and composition of the stimulus package may be overstated. In any case, the expected progress to launch the fourth fiscal package under a democratic sweep is outweighing the perceived threat to the economy that has been attached to a Biden-win. Given the state of the economy and the need to maintain accommodative fiscal stance for the time being is increasingly the propensity for the proposed tax increases to be postponed.

As noted in previous updates, headline inflation has continued to increase coming in at 1.4% in September, up from 1.3% in August, as the deeper slump in prices of goods and services that had been mostly impacted have started to rebound. Prices of new and second hand vehicles have continued to increase, medical care commodities increased whilst energy costs declined at a slower pace. On the other hand, increases in prices for food and shelter slowed, whilst deflation in apparel and transportation services continued to worsen.

Core inflation held steady at 1.59% as the prices of core goods have staged a sharp increase, mainly driven by prices of used and new cars, whilst core services have seen a drop in price levels given the slowdown in rent-inflation which is set to weaken due to the level of unemployment.

Given that industrial production has been lagging the recovery in consumption, the rise in prices of core goods have the potential to increase further. However, price pressures in the hardest-hit services sector are expected to remain weak.

Moreover, gains in used car prices following the demand shift for private transport, are expected to weaken going forward. Core prices have risen at the slowest pace over the last four months.



Source: Bloomberg

On this basis, even though inflation in the US may climb higher, the persisting output gap, aging demographics, high debt levels, elevated level of unemployment and low capacity utilization indicate low risk for core inflation rising sustainably above the Fed's target of 2%.

On the other hand, unemployment continued to decline to 7.9% in September from 8.9% in August. This came as a result of fewer people looking for jobs as the rate of participation declined resulting in a net employment loss of 695k individuals.

As we had noted in the previous update, the impact on US unemployment was more evident and more imminent earlier on with the onset of the crisis, while unemployment in the Euro Area and the UK is still expected to continue to grind higher. US labour market conditions have been expected to continue to improve albeit at a slower pace given that the rate of normalization in the hardest hit sectors is still expected to take longer to recover.

United Kingdom

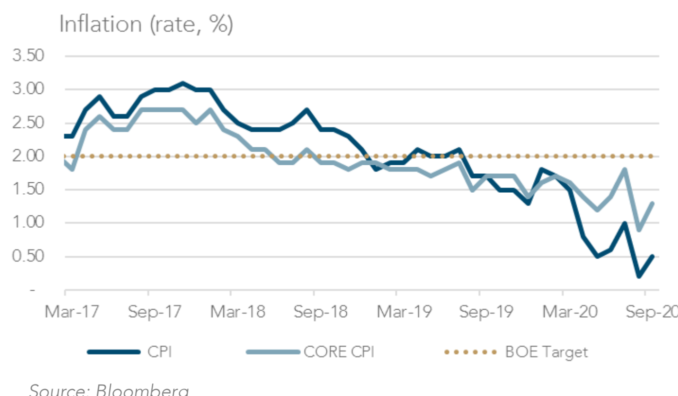
The UK economy grew less than expected, with the pace of recovery slowing down in August. GDP grew by 2.1% in August following an expansion of 6.4% in July and 9.1% in June. On an absolute level, UK GDP remains 9.2% below February levels. The recovery in the UK is expected to continue to slow down further in coming months as a result of the surge in the number of Covid-19 cases and the new restrictions implemented in October.

More than half of the growth in GDP was fueled by the accommodation and food services sector which grew by 71.4% in August. This growth was driven by a combination of the Eat Out to Help Out ("EOHO") scheme while more residents took holidays in Britain due to international travel restrictions. The education sector was the second largest contributor to GDP growth, growing 6.5% in August. Output from education is expected to stay at pre-crisis levels if the majority of students return to school in September. The services sector, which contributes circa 80% of GDP grew by 2.4% in August following a 5.9% increase in July as growth in other service sectors remained weak.

Retail sales grew for the fifth consecutive month, increasing by 1.5% month-on-month as both the value and volume of sales improved. September retail sales were 5.5% above pre-pandemic (February) levels, with online retailing and food sales up 36.6% and 3.7% above pre-pandemic levels, respectively.

Fuel was the only main sector to remain below February levels (-8.6%). Despite recovering from the lows as travel started to recover following the easing of lockdown measures, many people are still working from home resulting in a drag on fuel prices.

Whilst consumers generally returned to previous spending patterns, business investment contracted by 26.4% in Q2. The rebound in business investment remains weak as firms are reluctant to invest due to the risk of further lockdown measures as well as Brexit uncertainty. Business investment is expected to remain low for multiple factors, primarily weak top-line growth, increased indebtedness and ongoing uncertainty due to Brexit.



Source: Bloomberg

Inflation increased to 0.5% in September from 0.2% in August. The largest upward contribution came from transport and restaurant and hotel prices reflecting the end of the EOHO scheme. The upward contribution from transport mainly reflects the larger contribution from the purchase of second-hand cars boosted by an increase in demand as people reduce reliance on public transport due to the pandemic.

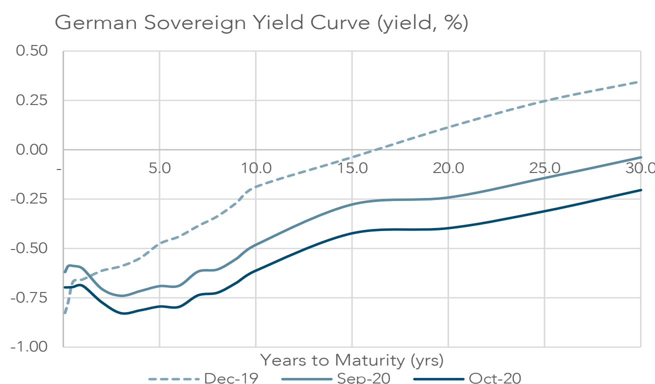
Inflation is expected to remain weak and likely to settle at closer to 1%, as result of base effects over the medium term. Upward surprises in inflation remain unlikely given the expected deterioration in labour markets and the persistent low demand as a result of a new round of restrictions.

RATES

Euro

As a result of the recent intensification in virus contagion across Europe and the imposition of restrictions which weakened the growth trajectory for the European economy, safe-haven buying has once again pushed the German government bond yield curve lower. Conversely, the weaker performance in peripheral sovereign bonds resulted in an uptick in peripheral spreads showing that a degree of sensitivity to virus risk in the sovereign bond space still remains despite the progress made on both the monetary front and the European recovery fund.

Whilst we expect the virus and containment situation to worsen and that the fourth quarter is expected to result in another dip in economic performance several factors still point towards a constructive outlook for stable to tighter spreads across euro area sovereigns. These include: (1) the ECB backstop, (2) the impending launch



Source: Bloomberg

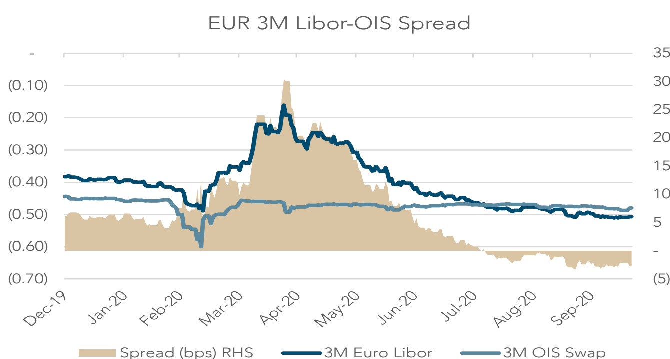
and deployment of the recovery fund, and (3) the prospects of abating macro risks.

Having said that, at this point we do acknowledge that the risk/return trade-off to position for further spread tightening is less attractive, with the exception of specific countries.

Deflation remains a key concern for the ECB whilst the appreciation in Euro is also weakening the attractiveness of European exports. In view of the renewed downside risks to the economic growth and inflation path, expectations are building for further adjustments in monetary policy towards more supportive conditions.

At this point, increasing the Pandemic Emergency Purchase Programme ("PEPP") envelope beyond the current EUR 1.35 trillion mark or cutting rates further into negative territory will have limited effect on the real economy. Government, and corporate, bond yields have been on a downward trajectory whilst the amount of PEPP purchase is still less than half the targeted amount. This means that the ECB can maintain the current pace of purchases well beyond year-end and still be successful in maintaining borrowing costs in check.

Looking at money markets, short-term interbank spreads continue to trade in the negative suggesting limited scope to stir interest rates even lower.



Source: Bloomberg

In view of the seemingly exhausted options available to the ECB, the only (currently available) monetary policy tool which may be tweaked further to provide an additional boost to lending is reducing rates further in their targeted loan-financing programme, known as Targeted Long Term Refinancing Operation ("TLTROs"), with the aim of supporting the flow of credit to the real economy.

In any case, given that deficits are expected to remain at high-single-digit levels in 2021, increasing the size of PEPP further may still be required to keep borrowing costs low and sustain the expected increase in net issuance of government bonds.

However, the size of monetary stimulus is becoming less relevant whilst more targeted fiscal support is more important to combat the downturn and support the recovery.

Whilst the intra-week movements of euro benchmark yields show some correlation to the US 10-yr Treasury yield, the widening in US-DE spread is likely to continue as upside (election) risk for US yields may keep treasury yields buoyant whilst Brexit and cyclical deterioration in Europe will continue to weigh on bund yields.

Current market conditions are conducive for low and flat yield curves in Euro. We therefore expect benchmark yields to remain stable at low levels for the time being with a low risk of a market sell-off.

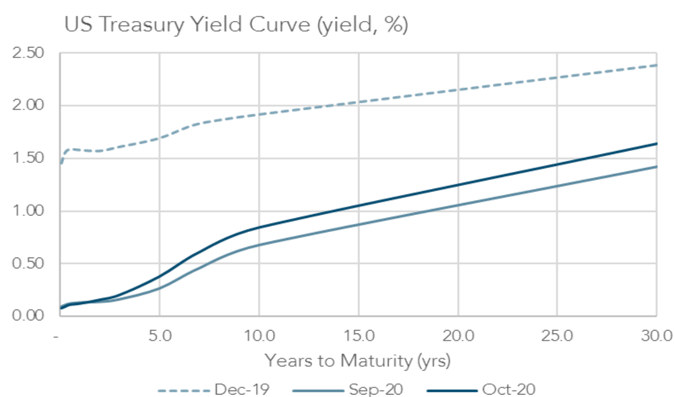
In conclusion, given the current inflation dynamics, weak outlook and current policy mix, our preference is to maintain a pronounced long duration position in Euros.

The recent move lower in bund yields is allowing space for non-core and peripheral yields to decline to new lows. In view of the highly successful Euro Bond sale and the ongoing PEPP purchases, euro-area peripheral spreads may tighten even further and trade even below pre-pandemic levels.

US Dollar

Over recent weeks the US Treasury yield curve has steepened as long-end yields trading higher. The steepening in the curve came with a corresponding uptick in breakeven inflation rates which have reversed the downward move of September and are retesting recent highs.

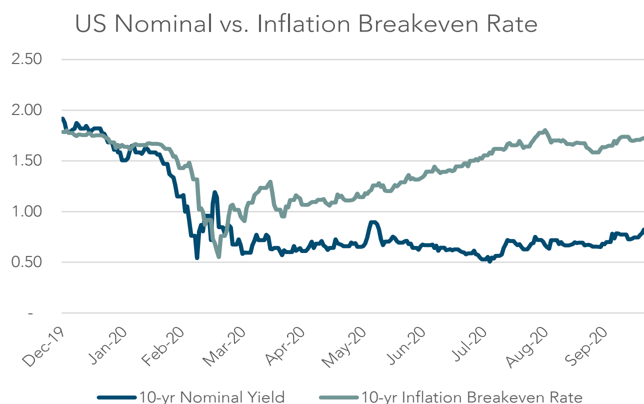
This reflationary trade came as investors viewed the increasing odds of a Democratic sweep to be positive for economic growth and inflation in view of the highly anticipated phase 4 fiscal stimulus package which would be expected to be larger and deployed faster, compared to expectations attached to a divided government outcome. Whilst an agreement over the stimulus package is becoming less likely to be reached before the election, the rising polls in favour of a 'Blue Wave' win are increasing expectations of a sizeable post-election fiscal stimulus package and higher public in-



Source: Bloomberg

vestment.

The overnight index swap (OIS) curve also steepened in anticipation of an eventual reassessment by the FED in view of the improving economic data and outlook. In combination with the sustained improvement in economic data, the prospects of a reflationary market environment have been pulled forward whilst the expectations of potentially sooner upward adjustments in policy rates has steepened the OIS swap curve.



Source: Bloomberg

The UST curve has steepened as the short-end remained anchored in view of the high hurdle for the FED to move away from the current dovish stance irrespectively of the recent improvement in economic prospects and market sentiment.

As we have noted previously, short-term spikes in 10-yr Treasury yields have been driven by expectations around the growth outlook and market sentiment. The episodes of spikes in yields have been triggered by better-than-expected data around labour market conditions and inflation, in the form of either:

a. a reversal of safe haven flows stimulated by risk-on market sentiment (typically when combined with rallies in equities or rotation into cyclicals); OR

b. Pricing in of earlier retreat by the Fed in market interventions and normalisation of policy (typically when combined with pull-back in USD weakness).

We still maintain that the conditions remain for the uptick in (traded) inflation to be cyclical rather than structural. In other words, realised inflation is expected to follow the growth path to a certain extent but more permanent structural issues on productive capacity and demand are expected to cap the rise in inflation rates over the longer term.

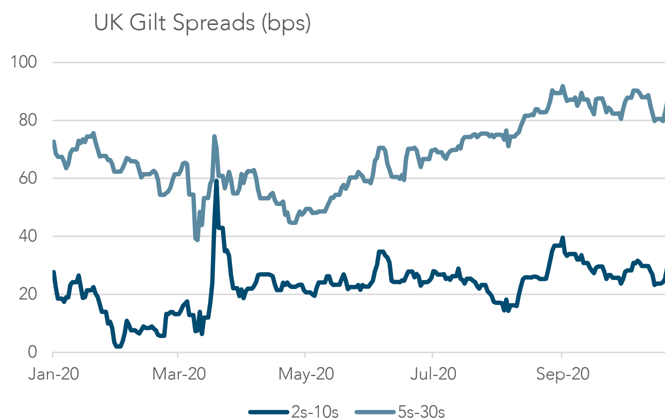
The potential for the US curve to continue to gradually steepen as long-end yields trade higher is building up especially in view of the improving economic data, expected increase in fiscal support and the Fed's average inflation targeting. This means that long-end rates can move higher but short-end will remain anchored in view of the pronounced FED commitment on low rates.

Having said that, we do not expect a sharp sell-off in long-end yields (similar to the Taper-Tantrum situation in 2013). As the market is looking through the pre-election gyrations around the fiscal deal, the risk-reward of a long duration position in US yields has become more balanced. A continued improvement in economic prospects on the back of fiscal stimulus post-election and increased supply to finance the package is likely to provide further upward pressure on US yields.

GBP

Whilst the UK has seen a worse-than-expected deceleration in growth compared to other advanced economies, the UK sovereign yield curve remained fairly stable over the past few weeks with movements in long-end Gilt yields showing some correlation with UST market driven by vaccine optimism and COVID headlines.

The widening differential between 5-year yields and 30-year yields underscore the expectations that the UK economy will enter a period of higher inflation in the future (post-Brexit) whilst downward pressure on the short-end and belly of the curve remain driven by the short and medium-term outlook on the UK economy, central bank policy, the Brexit overhang and the path of the virus.



Source: Bloomberg

The outlook for the UK economy remains highly uncertain as the second wave of COVID-19 cases in the UK will likely result in another economic downturn - the expectations that the impact from COVID would dissipate as the economy gradually recovers have reversed. Following a recovery during the summer months, economic conditions remain weaker than throughs during normal recessions and the path of virus has increased the likelihood of a challenging winter.

The tightening restrictions and increase in unemployment shows that the economy is loosing momentum and that it is heading towards another period of weakness.

The development of these adverse conditions have increased further the probability that the Bank of England will increase once again its quantitative easing programme, even though some MPC members noted that such a move would do little to improve spending or consumption.

The probability that the UK leaves the EU with a trade deal in place before year-end is a significant economic risk as the higher costs of trading under WTO terms is a severely worse situation for the UK given that the EU is its largest trading partner (over 40% of UK-exports sold to EU).

Despite the heightened downside risk factors, the Gilt market remained significantly supported by BOE purchases currently targeting a total of GBP 745bln of QE holdings. Market expectations have been growing around another increase in the target size of QE holdings. On the other hand, the expectations of further rate cuts by the BOE have been pushed further out into next year as MPC members have indicated that they are not yet technically prepared to implement a negative interest rate policy.

In view of the deteriorating activity data since the last MPC meeting, the next meeting in November is expected to show material changes in the BOE's assessment of current conditions and outlook in view of the heightened economic and political risks with the possibility of additional measures being announced before year-end.

The economic recovery remains highly dependent on the substantial fiscal and monetary policy support and remains conditional on how household, businesses and financial markets react to developments around health and Brexit going forward.

With a substantially weak growth and inflation outlook, elevated uncertainty and the likelihood that the MPC will increase monetary accommodation further, a long duration position in Sterling bond market remains warranted.

CREDIT

Credit markets delivered a mixed bag of performances over the last month. Credit spreads within the Investment Grade ("IG") space tightened by a larger degree during the past month when compared to the prior month. Conversely, EUR and GBP high-yield ("HY") debt experienced an increase in yields as bonds sold off. Credit spreads within the U.S. HY market continued to perform well tightening by 19bps since September.

During the past few weeks, the rally in IG debt and the decline in HY markets can be explained by the risk-off market sentiment as investors sought safety within less risky assets given the events which have unfolded over recent weeks.

In Europe, the increase in COVID-19 cases and the reintroduction of restrictive measures explain the sell off in high yield debt and the market's preference for investment grade debt as the European economy continues to show signs of weakness.

The sell off within the European HY market eroded the gains that were achieved during the prior month. The EUR HY space is still trading well below its pre-pandemic level on a total return basis with the most notable losers found within the Transportation sector.

In the US, while the situation around the pandemic has continued to worsen, the market's focus shifted towards the U.S. presidential election, with election polls indicating a victory for former Vice President Joe Biden over the incumbent Donald Trump, and the passing of further fiscal stimulus to aid the American economy. While the decline in yields within the U.S. IG space is consistent with the other markets, the significant tightening of spreads within the HY segment during the past month can be mostly explain by the market's expectation of further fiscal stimulus.

In the U.K., similar to the Eurozone, the rise in COVID-19 cases and the introduction of restrictive measures to contain the spread of the virus has continued to dampen economic prospects which explains the rally in IG credit and the sell-off in HY debt. The breakdown in talks between the U.K. and the European Union on a possible Brexit deal have further weakened the region's economic prospects.

Capital markets experienced somewhat of a resurgence during the month of September as the total amount of issued debt across each bond market surpassed the levels seen in August. Data gathered for the first two weeks of October show that the level of debt issuance is unlikely to surpass those seen in September. The lower levels of issuance for the first few weeks of October can be explained by the increased uncertainty given the news flow surrounding COVID-19, the implementation of restrictive measures by Governments and the issuer's preference to stay on the side-lines until a winner from the U.S. presidential election emerges in November.

For the last 6 months, fundamentals and technicals have been broadly in alignment, and have worked to-

gether to support the rally. The rapid rebound in economic activity from the depths of the March/April lockdown has translated into a much better than expected 3Q20 earnings season thus far.

On top of this, the ECB purchase programme has been buying a steady €10bn/month of corporate bonds, and now owns over 25% of the eligible universe. At the same time, the global search-for-yield has been relentless, with $14tb of negative yielding debt globally, which has continued to drive a rotation out of sovereign bonds and into corporate credit.

These forces are now beginning to diverge. While the technical picture remains strong, the economic backdrop has deteriorated markedly in recent weeks, with a number of analysts revising Euro Area GDP forecasts lower due to the announcement of new social distancing measures (albeit more permissive than during the first wave) to combat the second wave of the pandemic. Euro area composite PMI has dropped back into contractionary territory in October, despite being backward looking data from the earliest stages of the second wave.

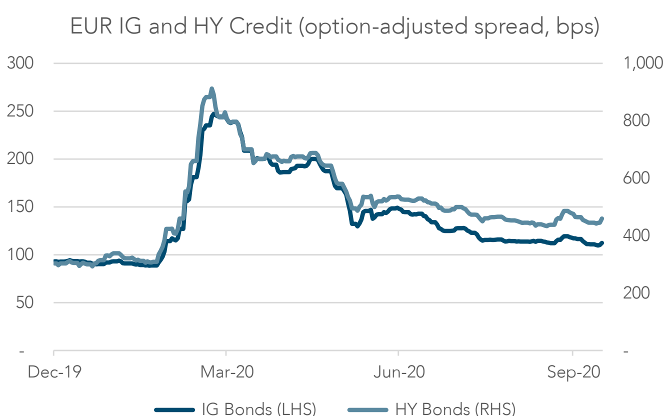
Nevertheless, the view remains that credit as an asset class is currently more of a policy tool than a pure open market, and in broad terms, we expect any move wider in credit spreads to be met with greater central bank buying. Current market expectations are for the ECB PEPP to be upsized by €500bn in December, and a further €250bn in mid 2021.

We expect high grade investors to continue to be reluctant to sell exposure, given concerns about being unable to source risk back again later given the overwhelming presence of the ECB as a buyer. As such, any buying opportunities at wider levels are likely to be short-lived, and primary markets will continue to offer thin new issue premiums to investors. On top of central bank support, weaker growth is also mitigated to some extent by fiscal support and vaccine hopes.

Recent polls point to rising odds for Democrats gaining unified control of both chambers of congress as well as the Presidency. The view within credit markets currently is that, whilst investors may be concerned about the long term impacts on certain sectors of IG credit, we must recognise that in the near term, the large fiscal stimulus expected from this outcome will be good for all risky assets. Biden's agenda involves a large increase in government spending and transfer payments that is only partially offset by higher corporate and personal taxes. Investors appear to be cautiously accepting the view that if public spending precedes any tax increases, it should strengthen the conviction in owning some cyclical exposure and potentially moving down in the rating spectrum.

We continue to like the IG space as the greatest direct beneficiary of asset purchase programs and the attractiveness of the asset class versus sovereign credit in absolute terms. However, recent negative news flow in relation to rising COVID-19 cases and weaker macro data has driven a +27bp IG/HY spread decompression within the Euro credit space. During our last strategy update, we highlighted that headline risk may lead to spread decompression, though also that this should be seen as an opportunity to selectively add into the space. Our preference remains for counter-cyclical business models that have proven to be resilient through 2020.

With regards to Brexit, it appears increasingly likely that reaching any deal will run into November and be accompanied by complaints from the European Parliament that it will not be given enough time to properly consider any Treaty before ratifying it. The next catalyst in the calendar is the EU-China summit in Berlin on November 15th, with reports suggesting the EU Council could meet the following day to sign-off a UK-EU agreement if one is in place by then. Nevertheless, given uncertainty and additional headline-driven volatility into the "final stretch" of negotiations, we remain cautious on GBP risk.



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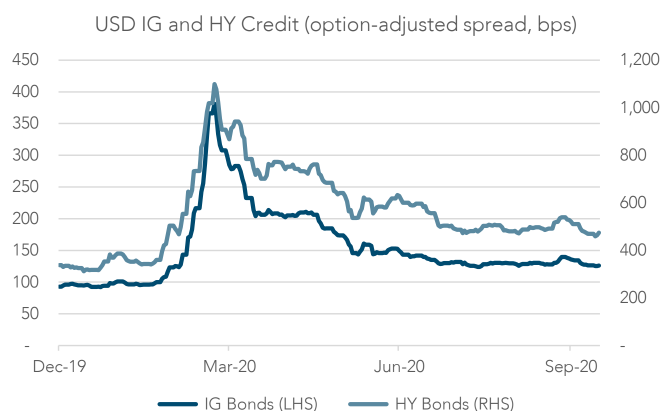


Source: Bloomberg

EQUITY

As we head towards the end of 2020, a volatile year for the equity market where investors had to endure steep drawdowns, quickly followed by strong rallies, we believe that we are at a very important juncture. Looking closely at the big moves in the equity market, as well as the lofty valuations, in a period of very low interest rates, it is clear that a lot of the good news around a vaccine is already being priced in by investors.

We think investors need to be prepared for two scenarios, one in which a vaccine is approved and another if there is a vaccine disappointment. In the first instance, we strongly believe that gains at an index level from a vaccine approval announcement will be limited, bearing in mind the price action seen over the past months. However it is clear that value stocks have lagged during the recovery, despite their relationship with the macroeconomic performance. We believe that value stocks could outperform growth in the event of a vaccine approval announcement.

On the other side of the spectrum, investors are exposed to a vaccine disappointment. The longer a vaccine remains unavailable the more difficult the path to normality will be. Not only that, with no vaccine the risk of another national lockdown remains on the table. The impact of this event on the global economy would be severe and this event would probably see equities falling to March lows, or even making new lows. This makes for a very interesting final chapter for 2020.

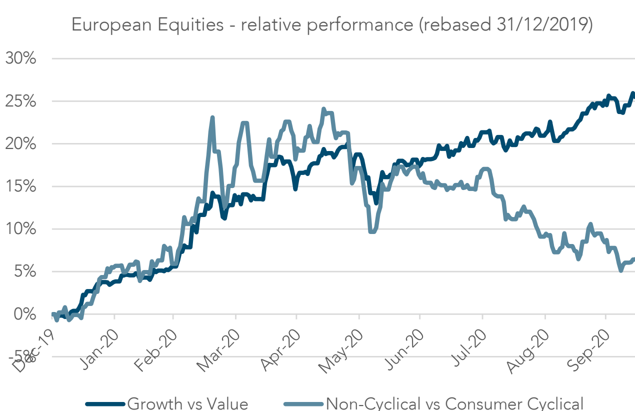
The third quarter of the year marked the second consecutive quarter of positive performance, following the steep sell-off in the first quarter. The MSCI World Index delivered a total return of 3.4% (measured in EUR) during 3Q20, despite a weak performance in September following a particularly strong month in August.

The US (S&P 500) delivered a total return of 4.1% (in EUR terms) during 3Q20 compared to 0.5% for European equities (Euro Stoxx 600). We believe that this is related to the surging cases of COVID-19 cases in Europe which has lead to a weakening economic environment. This is particularly clear when looking at the performance of German equities since German stocks are considered to be a proxy for global trade, equalling the performance of US stocks with a total return of 4.1% during the period. Elsewhere, China was the best performer among the indices we follow with a total return of 9.1% during the period, which reflects the earlier recovery from the COVID-19 impact.

Global equities have recorded a total return of 2.8% since September up 15th October, the strongest performance in the first 15 days of October since 2011. It seems that the global economy is slowly recovering from the pandemic shock (except for Europe) as inflation concerns seem to have abated. Inflation in the US has been picking up from the April lows which could partly explain the negative performance in growth stocks during September.

Global equities are trading on a 19.0x FY21 PE multiple compared to a 10-year and 5-year median of 14.5x and 15.2x respectively. This valuation premium needs to be viewed in the context of very low interest rates on the one hand, but also the current risks brought about by COVID-19 on the other. This has also been the result of a higher market capitalisation weighting to growth stocks, when considering that the top 5 stocks on the MSCI world are Facebook, Alphabet, Amazon and Microsoft, and growth stocks traditionally trade on a higher PE ratio.

We expect two events to dominate the fourth quarter. The US election and the COVID-19 vaccine will be key market movers during 4Q20. Price action over the past weeks suggests that investors are ignoring downside risk, which could lead to volatility as these events get closer and big moves if a negative scenario materialises. Brexit has become a sideshow at the moment with



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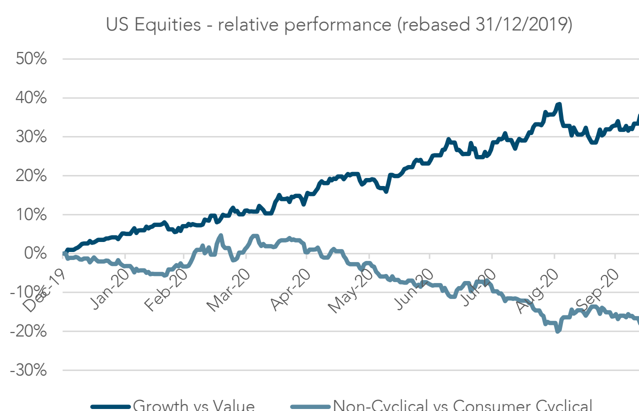

Source: Bloomberg

investors focused entirely on other events, but it must be stressed that the economic impact this could have on both the UK's and EU's economy is significant.

Despite the uncertainty, we ascribe to the current base case that a vaccine will be approved by the end of 2020 or early in 2021. The Good Judgement Project, a forecasting services firm, have attributed a 71% probability that an FDA vaccine is approved and is available to inoculate 25million people in the US. The probability of the vaccine being available and distributed between January and May 2021 has increased from 53% on 18th October to 64% on 21st October. On the other hand, the probability for the vaccine to be approved and distributed between June and September 2021 fell from 27% to 23% during the same time frame. This view seems to be supported by Dr. Fauci, who in a recent interview said that a "safe and effective" COVID-19 vaccine should be widely available by April 2021. He added that researchers should know by November or December whether some vaccines trials have a safe candidate and that even in the event that a safe candidate is determined.

Given our expectations on how the equity market is likely to respond to such an announcement, we are looking to introduce tactical adjustments in our strategy which in our opinion, can benefit from potential market mispricing. We see no big gains to be made at an index level following the strong moves we have seen in the previous months and we therefore consider a highly selective approach to be the more viable and effective course of action.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Stable	U/W	Benchmark bond yields benefitted mainly from central banks' policies and the generally weak expectations of economic growth and inflation. Outlook for periphery credits is well supported, but as noted in previous updates, the strong rally seems to be showing some signs of fatigue at current levels. However, the agreement on the Recovery Fund and additional monetary stimulus could add further momentum going forward. In addition to maintaining exposures as hedge, this could offer marginal tactical opportunities. We maintain an underweight stance to sovereign credit given the predominantly negative yield on offer for the asset class in absolute terms. Underweight exposure in held through tactical long positions where investors still stand to benefit from spread compression whilst also maintaining absolute returns above 0% in yield terms.
Investment Grade Corporate Bonds	Positive	O/W	Investment grade bonds remain attractive, however, on a relative basis, we are becoming more comfortable with maintaining a high exposure given the spread differentials versus sovereigns bonds and the view for stable to tighter spreads. Strong central bank support is expected to continue to sustain the current levels in spreads which underpins the benefits of maintaining a long duration exposure within this space, in order to earn a higher carry, 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 even though economic conditions have continued to stabilise.
High Yield Corporate Bonds	Neutral to Positive	O/W	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. We continue to seek opportunities on a name-by-name basis. In line with our view last month, we view the minor spread decompression between high yield and investment grade as an opportunity to pick up additional exposure in the space.
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 To Neutral	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. We are turning more bullish on cyclical industries in view of the potential for a vaccine to be approved before the end of 2020 and the impact this would have on sentiment, and consequentially, once it is widely distributed, on the macroeconomic backdrop. We could see a re-rating of cyclical/value stocks if this happens and we are positioning our portfolios to benefit from such a move.

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

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