Investment Weekly

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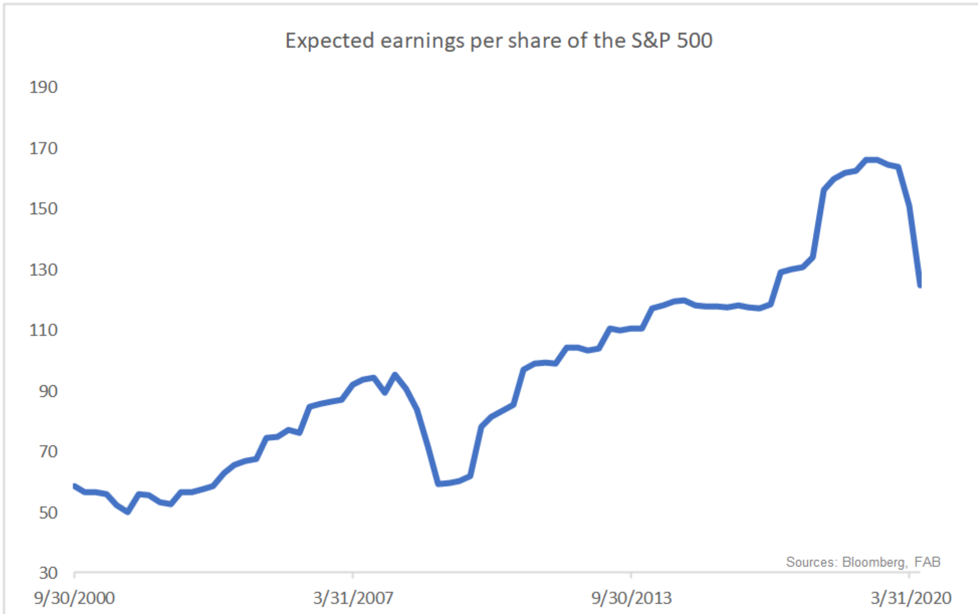
Earnings and politics remain uncertain as cash fuels risk assets



♦ Tensions between the US and China are rising as President Donald Trump is expected to sign a bill that could impose sanctions on Chinese lenders.

♦ The looming US presidential election increases the incentive for American politicians to take aim at China.

♦ Investors are gearing up for earnings season after nearly 80% of companies in the S&P 500 failed to provide future guidance in the last reporting season.

♦ The question is whether the 23% forecast drop in earnings for the second quarter reflects the worst of the pain, or if analysts need to be more bearish.

♦ Yet, record amounts of cash keep fueling the rally in risk asset prices.

♦ The FAB AAC remains underweight in global equities and overweight investment-grade corporate bonds.

It feels a bit like the lull before the storm. After a blockbuster couple of months following the worst sell-off in decades, the S&P 500 eked out a mere 1.84% gain in June. It started July on the front foot, rallying 4.02% last week. Still, the hurdles the index (and other risk assets) has to mount to continue the rally are high. For one, soon the S&P 500 could test 3,232, a level it failed to overcome in June.

Another week of gains like the ones in the past five sessions would see the index touch those levels. Many investors say a break upwards or a retreat could either confirm or deny the bull market, from a technical standpoint.

This sort of analysis has become more important as it has become difficult to assess the fundamental value of risk assets amid record amounts of cash and ultra-low interest rates. Besides, the majority of companies have ceased to provide any indication of how much money they expect to make in the future.

According to Bank of America Merrill Lynch, about 400 of the companies in the S&P 500 failed to give investors any profit guidance in their last quarterly report. It was understandable then, as the world faced a lockdown without precedents and governments scrambled to understand and react to the Covid-19 pandemic.

That lack of visibility makes the upcoming quarterly reporting season more important than usual. Now, companies have a sense of what the world will look like and how consumers are reacting to the lockdowns, the reopening of economies, and to record unemployment across the world.

Amid little guidance, analysts have reduced their earnings forecasts for 2020 by 23%

Hence, chief executive officers will be more hard-pressed to share their expectations with investors. The question then becomes whether, on aggregate, the picture that will emerge starting next week (when the first key quarterly reports are published) will be worse or better than what analysts have predicted thus far.

According to Bloomberg, the consensus is for the weighted earnings per share of the S&P 500 at year-end to be US$125.44 per share, about 23% below the US$163.8 estimated for the current year at the end of 2019. That may still be optimistic, especially given the fact that 7.5 percentage points of this drop were already recorded in the first quarter, which did not reflect the bulk of the shutdowns.

While the recovery in many equity prices has been substantial, the global economy is still far behind where it was at 31 December, 2019. Unemployment in the US, for instance, remains higher than it was at the peak of the 2008 financial crisis. In the two years following the third quarter of 2007, earnings fell 50%. Hence, even a crude extrapolation suggests that analysts may still be too bullish.

To be sure, the recovery in US equity prices has been extraordinary, based largely on the speed of government and monetary support, which has been unprecedented. In the US, this has helped bring 7.5 million Americans back to work in the past two months, after a record 20.5 million were sent home, most on temporary layoffs, in April.

Unfortunately, almost every single job added in May and June was attributed to people returning from furlough. Meanwhile, the number of permanently unemployed Americans increased by 588,000 to 2.9 million in June, according to data released by the US Bureau of Labor Statistics.

People are also being more thrifty as they face uncertainty about their jobs and the economy. A survey conducted by Bloomberg News and Morning Consult released last week concluded that Americans would rather spend on basic items instead of luxury, and are likely to avoid many leisure activities in the future. This could have a long-term impact on behaviour and profit margins.

All this suggests that the economic slump, while not as pronounced as originally expected, could be more protracted than the market seems to be expecting. If that is the case, that reality will start to set in with the upcoming earnings reports, as mentioned above.

Then there is the growing issue of political uncertainty, which could add an element of volatility to financial markets. The US presidential election is almost exactly four months away and the picture is looking increasingly difficult for the incumbents.

The latest national polls have Democratic Presidential Candidate Joe Biden leading President Donald Trump by 9-10 percentage points. More importantly, he leads in some battleground states that helped lead Mr. Trump to the presidency in 2016. Senate and House elections are also showing a Democratic tilt, creating the prospect of a sweep by the party that would give Mr. Biden wide-ranging powers to govern and pass legislation, including reinstating some corporate taxes.

Goldman Sachs has estimated that an increase in corporate taxes could remove some 12% of the expected 2021 earnings of US companies, and reverse some of the rally staged in the first few years of President Trump's administration, when corporate taxes were slashed.

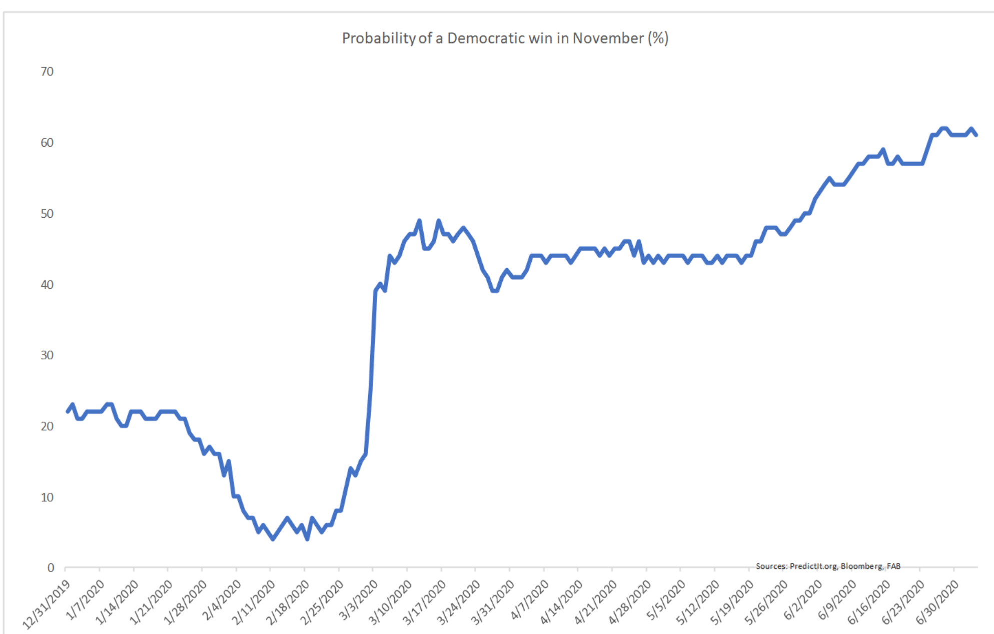
Based on current consensus earnings forecasts, the S&P 500 is trading at 19.3 times 2021 earnings. If the underlying forecasts turn out to be too rosy, and with the prospect of higher corporate taxes (and the ensuing lower profits), a reassessment of the outlook for stock prices would be appropriate.

The latest polls give Senator Joe Biden a clear lead in the US presidential elections

In the near-term, the current Democratic lead creates the prospect of a more aggressive tone against China. Last week, the US Congress passed a bill that sanctions companies that do business with Chinese politicians who supported the new security law in Hong Kong. President Trump is expected to sign the bill this week, starting the clock on what could be painful restrictions on Chinese banks.

The bill has a one-year grace period before it starts to penalize lenders and other companies which deal with most Chinese politicians (given that the Hong Kong security law passed unanimously in the Politburo). This could affect especially China's biggest banks — which also happen to be the largest in the world — as it could cut them off from access to dollars.

It is hard to describe the impact this would have. Only the Industrial & Commercial Bank of China, the world's largest lender, had US$179 billion in foreign currency loans at the end of December. The total for all Chinese banks is multiples of that. Cutting the Chinese out of the dollar system could have catastrophic effects. For now, investors will watch Beijing's reaction to the legislation. Hence, common sense suggests caution towards risk asset prices, even if technical factors and the weight of money might suggest otherwise.



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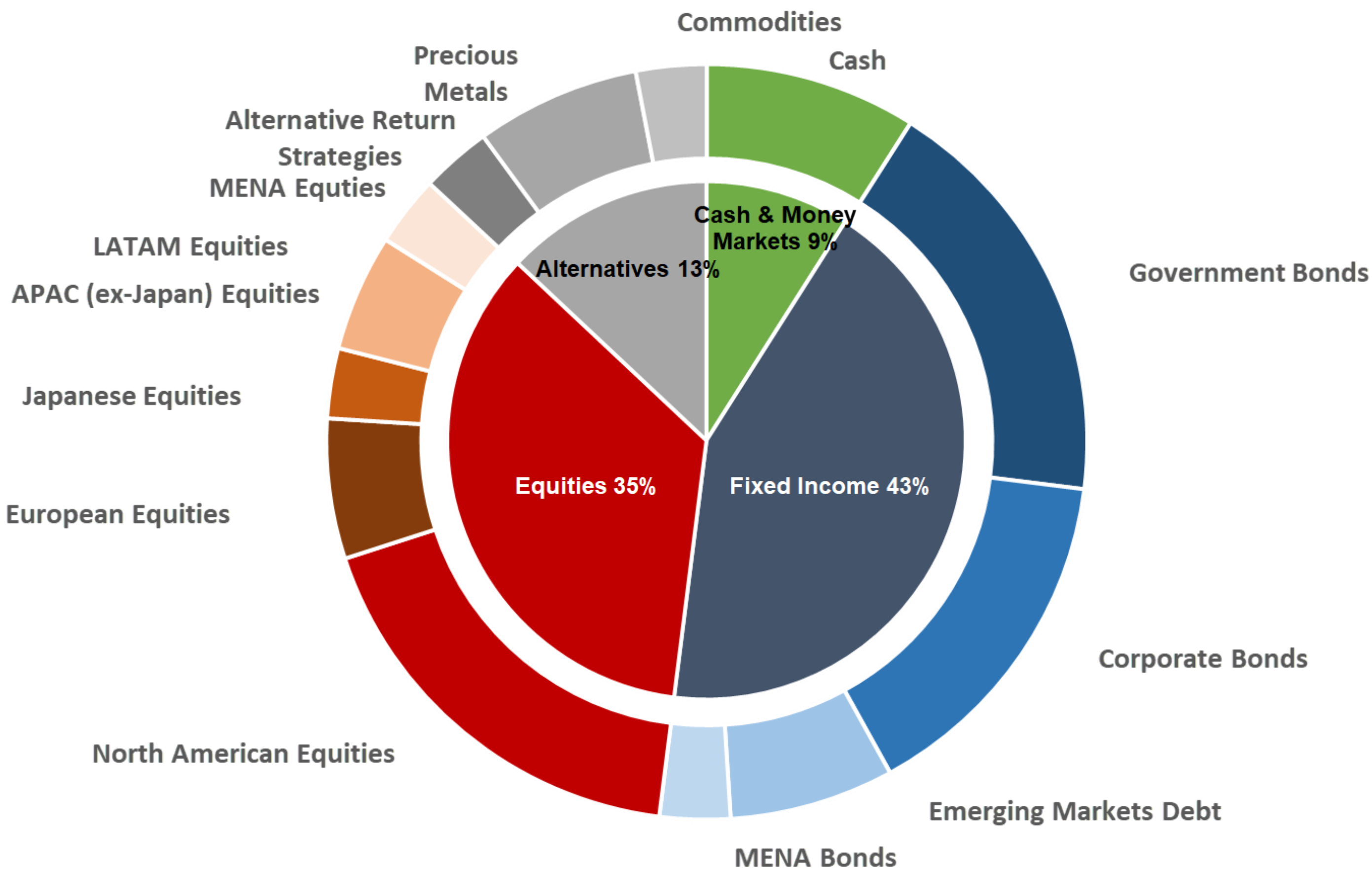
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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