Investment Weekly

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Politics are getting tricky, but for the long term mind the yield

- **EU officials fail to agree on the form of a 750 billion euro stimulus package over the weekend.**

- **Investors will be watching for progress on a new fiscal stimulus bill after the Republican Senate rejected a US$3.5 trillion bill approved by the Democratic House.**

- **The US Senate is expected to present its own proposal this week, with the Congress set to go on recess in the second week of August.**

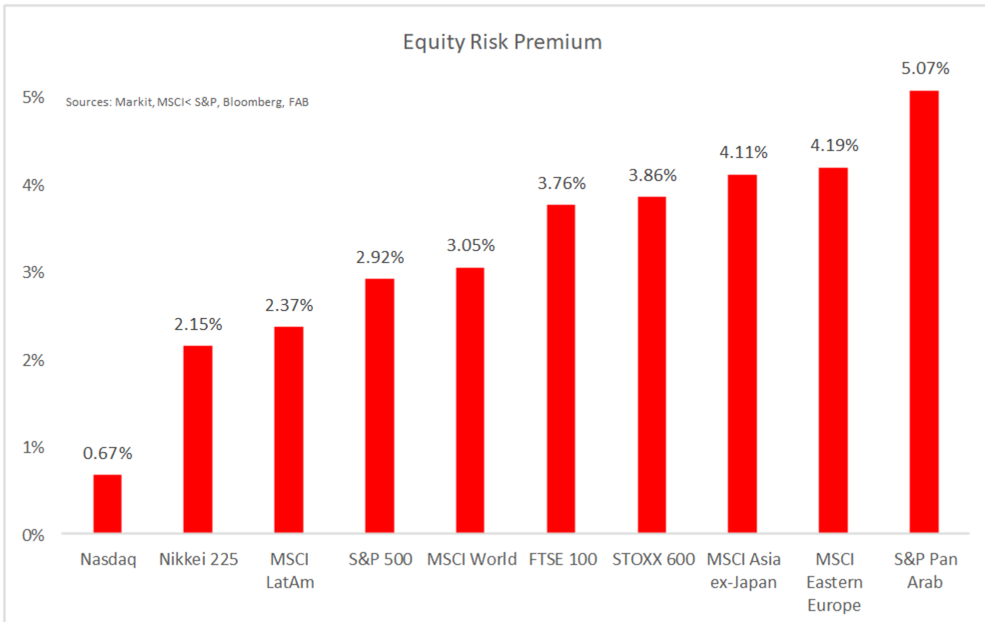
- **Current extraordinary welfare payments are set to expire this month.**

- **While the wrangling may increase volatility, investors are starting to focus on where they can get yield as they consider low rates for longer.**

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

The political landscape is getting increasingly clouded in a few of the world's largest economies, and this could spill over into risk assets. Now, the problem centres around stimulus, and the showdown shaping-up is in many ways reminiscent of the setup in August, 2011. If that does turn out to be the template, investors may want to brace themselves.

Over the weekend, German Chancellor Angela Merkel and French President Emmanuel Macron walked out of a meeting with Dutch Prime Minister, Mark Rutte, after they disagreed over how much of a 750-billion-euro pan-European fiscal stimulus package should be disbursed as grants, and how much as loans.



The seemingly abrupt interruption of discussions is likely to rekindle concerns about European unity, which were revived earlier during the pandemic, when borders closed and some countries refused to help others in the Eurozone financially, or even with medical equipment. The progress in the latest discussions suggested the gaps had been bridged, although the failed meeting could challenge that notion.

Meanwhile, in the US, the Republican-controlled Senate is expected to unveil a fiscal stimulus package this week, in response to a US$3.5 trillion bill passed by the Democratic-controlled House of Representatives about two months ago. Investors will watch closely to see the reception from the House, given that Congress only has a few weeks before it closes for its summer recess. Markets have been banking on additional stimulus as many of the extraordinary welfare payments and payroll protection programs are due to expire this month.

While by many metrics stocks look expensive, compared to Treasuries they are attractive

The risk here is that the two parties make the new stimulus into a blame game, and fail to reach an agreement before the recess, creating a 'stimulus cliff'. Much of the economic recovery the US has staged has hinged on government spending.

Both these situations are eerily similar to what happened in 2011. Then, Capitol Hill had just been split, with the Republicans winning the House in 2010, while the Democrats retained the Senate. President Barack Obama was suddenly faced with resistance to a request for an increase in the debt ceiling of the US which threatened to close the government. Negotiations went until minutes before the recess as Republicans played hardball, and led to a US credit downgrade.

Markets did not like it. From 22 July to 8 August, when Congress finally reached an agreement to avoid the government shutdown, the S&P 500 fell 16.8%. At the same time, political wrangling in Europe also took its toll. Between 25 July and 23 September, when there was some clarity about the future of the European Union, the STOXX 600 index fell 20.5%.

There was a lot of stimulus in the system at that time, but rather less than there is now, so the magnitude of any drop may be smaller. However, if the political games go too far in Washington and Brussels, markets could get choppy for the remainder of this month.

For investors focused on the longer-term, however, an increase in volatility may offer a chance to pick up higher-growth and higher-yielding assets. The near-term backdrop is uncertain, and it is becoming increasingly clear that the economic recovery may take longer than initially expected, but one thing is for sure: interest rates are going to remain very low for a very long time. In such an environment, investors are likely to continue to pay a higher premium for growth and yield.

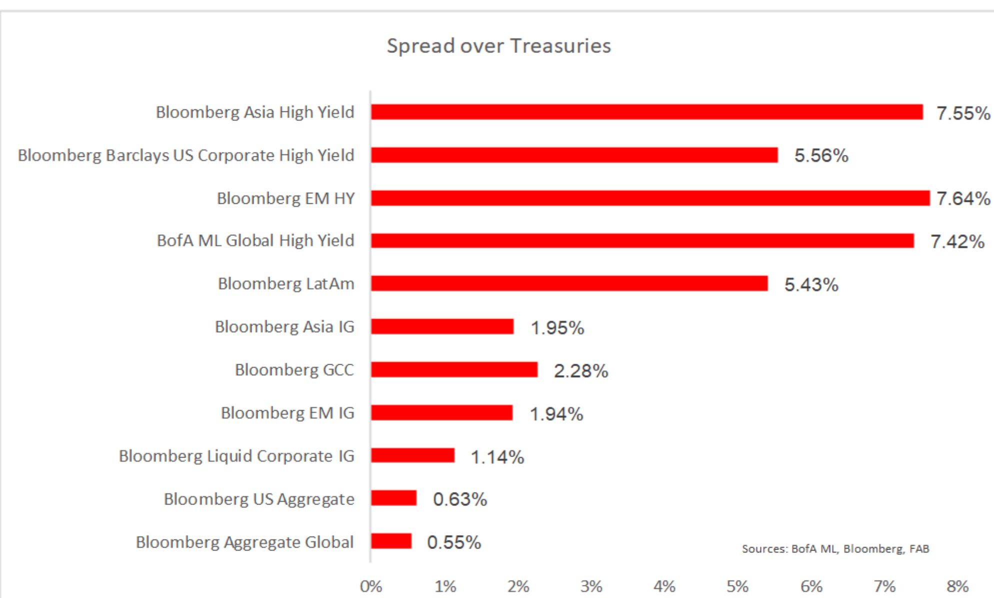
That fact alone favours investing in stock markets, even if some indices may look expensive by certain metrics compared to their historic averages.

The S&P 500, for instance, is trading at nearly 26 times this year's expected earnings and just below 20 times the forecast earnings for 2021. That compares to a 10-year average of 16.3 times for current year earnings.

Looking at that measure alone would make the index a screaming sell. However, the 4.31% current earnings yield of the S&P 500 looks very attractive when compared to the 10-year US Treasury yield of 0.63%. In fact, the difference between the two is near the highest in the past 30 years, making stocks very attractive on that basis alone.

The case is different for the tech-heavy NASDAQ, which offers an earnings yield of only 2.03%, much less attractive than the S&P 500's. Here, however, investors are banking on growth prospects. Over the past decade, the tangible book value per share of the S&P 500 increased 21.67%, while the S&P 500 expanded a mere 0.87%. That is one way to measure how much the assets in the companies that comprise the two indices grew over time, as opposed to simply their returns.

Asian bonds are offering the best duration-adjusted returns in the fixed income space



To be sure, while an equity investment promises higher yields and growth than bonds right now, they also entail much higher volatility. The S&P 500 has had average 360-day volatility of 14.5%, and the NASDAQ has had 17.6%. Meanwhile, the Bloomberg Barclays Global Aggregate index had volatility of 4.7%, and the Bloomberg Barclays US Corporate High Yield index's volatility was 4%.

Hence, on a volatility-adjusted basis some parts of the fixed income space remain attractive. The best way to look at which parts are most attractive is to compare the current yield offered by a bond index to that of US Treasuries and adjust it for its duration, which is a measure of sensitivity to interest rates, and of bond volatility.

Using that approach, the best risk-adjusted returns currently seem to be in the emerging markets space, particularly in Asia, and in high-yield. The Bloomberg Asia High-Yield index currently offers 755 basis points of yield above US Treasuries, and its broader EM counterpart offers 764 basis points. The EM index, however, has a duration of 5.31, compared to the 3.02 of the Asian index. US corporate high-yield is offering 556 basis points of yield more than Treasuries, with a duration of 3.86.

The risk with both high-yield and emerging markets, however, is a rise in defaults. Nearly US$190 billion in dollar bonds have defaulted this year so far, just US$8 billion shy of the record set in 2009. Given the increase new virus cases and how some countries are rolling back reopening plans, the number is likely to continue to grow.

This does not mean investors should avoid high-yield. The asset class typically trades in line with equities, but with lower volatility, so it is likely to continue to find favour. It is just a matter of choosing the investments carefully. That is also true for equities.

Still, the 'low rates for even longer' assumption means that investors will continue to buy these riskier assets as they try to get better growth and yields.

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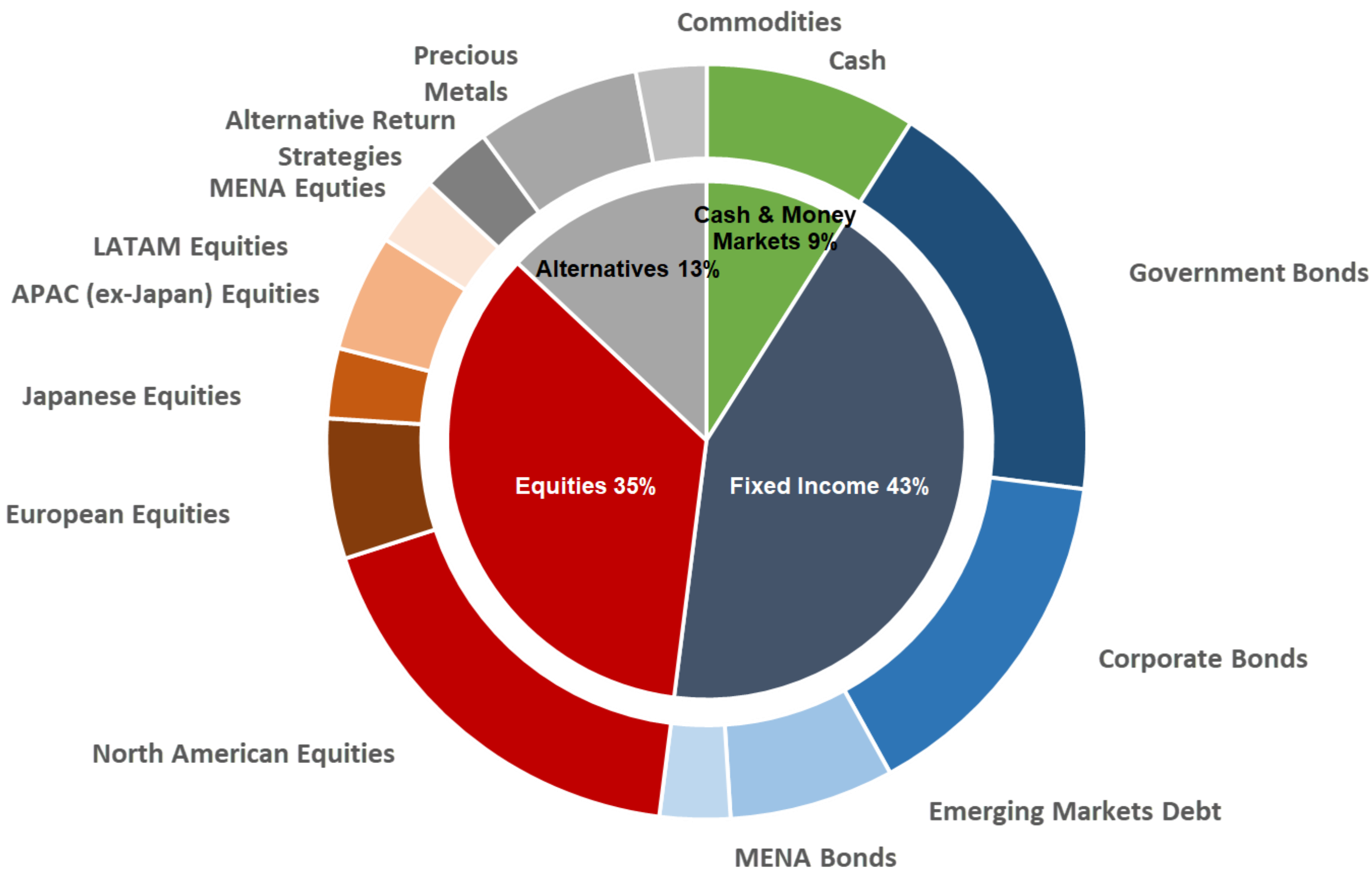
Current Tactical Asset Allocation



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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