Investment Weekly

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Even the strongest bulls can get tired

- ♦ **The S&P500 crept to two new all-time highs, eclipsing the previous record posted on February 19**
- ♦ **Investors are discounting a Biden White House this November – but maybe not a Republican Senate**
- ♦ **The divergence between winners and losers makes this a 'market of stocks' - not a stock market**
- ♦ **As we suggested last week, we now expect a more 'normal' market**
- ♦ **Our technical analysis says the fall in the dollar has gone too far, too fast – but the 'big trend' is lower**
- ♦ **The FAB AAC is slightly underweight in global equities, and overweight in IG bonds and gold**

The S&P 500 closed at a new all-time closing high (at 3,397.16) on Friday, up 0.3% on the day and 0.7% on the week – although it looks as though it was becoming very hard work. Technology stocks once again did well, with Apple very much in the frame.

This - albeit slower - market progress was despite the fact that US weekly initial jobless claims disappointed, at 1.1 million, and this helped suppress the yield on the US 10-year, which ended the week at 0.63%, a reduction of eight basis points. We suspect the unemployment claims data was a case of 'bad news is good news', with participants thinking that monetary accommodation can remain for longer. There are signs, though, that investors are beginning to expect a bit too much from the Fed, with the inference - for instance - that its

Chart 1: The Dollar Index

apparent unwillingness to use 'yield caps'/ yield curve control somehow represents a less dovish approach. This also follows an increase in five-year US inflation expectations (to 1.53%), even if not causing red lights to flash, and from very low levels.

There was some genuine good news, though, in the form of US new housing starts (at 1.5 million in July, annualized) usefully beating expectations of 1.25 million, with new permits also doing well. Hard, genuine good economic news is one of the necessary prerequisites for further progress in US equities. In the meantime, maybe the expectations of market participants have now run a bit too far. Plus, getting a safe Covid-19 vaccine could still take months, and in the meantime global infections are rising.

Despite being structural bears of the dollar, a few weeks ago we began to think the dollar index (DXY) could have

US new housing starts at 1.5 million in July, annualized was better than market expectations of 1.25 million

fallen too far, too fast. Last week the DXY rose by 0.2%, and as we witnessed a very bearish crossover in our very long-term moving averages - but such an indicator can often signal a short-term reversal, and that could be what is happening.

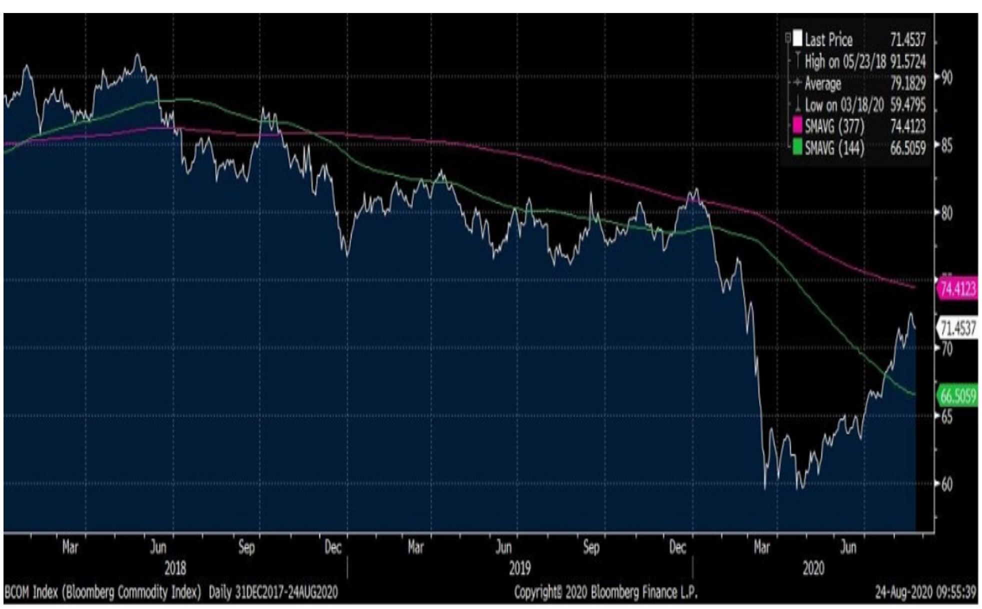
Turning to the fundamentals, at the moment Brexit is rearing its ugly head once again. Both sterling and the euro corrected last week, against the background of both sides noting a distinct lack of progress and with particular regard to a trade deal. Both sides are playing hard-ball, and appear intransigent. In practical terms they need to arrive at a deal before the end of October, before the UK departing from the EU on December

31. Bullish futures bets on the euro have reached extremes, and a short-term reversal looks very much on the cards. Meanwhile last week saw some weak eurozone economic data, while UK retail sales were good (perhaps as always after residential property prices improve).

The FAB Asset Allocation Committee meets at the end of this week, and the topics to be discussed are both tactical and strategic. Have US equity markets now finally run too far, given the hurdles? What are the important levels to watch on the US 10-year Treasury bond yield? Will the apparently structurally weaker dollar usher-in higher commodity prices that reverse their downtrend? Very much linked to this - but also to the growing share of Chinese equities within global capitalization - should we more seriously consider emerging markets? Can Brent crude prices realistically trade above our currently assumed ‘cap’ of close to $55/ barrel? Lastly, in gold, might we get a chance to re-instate the partial profits we booked recently?

Without meaning to pre-judge the results of those discussions, we can begin to frame some of the factors, and to make it helpful to clients.

Chart 2 : Bloomberg Commodity Index



Firstly, at least investors haven’t had to worry about when the next recession would arrive, as different parts of the world are to greater or lesser degree either in it, or tentatively emerging from it. Certainly the divergence between the winners and the losers from the pandemic probably has some way to run – and one thinks increasingly in terms of a ‘market of stocks’, rather than a collective stock market. In valuation, the P/E on the S&P500 can probably trade in a range of 20-25x 2021 earnings - provided the yield on the US 10-year Treasury behaves itself. A yield of much above 1.00% could hold back stocks via a shrinking equity risk premium. Meanwhile, investors have to look across the earnings recovery valley, attempting to navigate and predict the transition from the current year, into 2021 and beyond. Although we expect technology and related sectors to do well, individual disappointments will be sorely punished. Selected rotation into industrials and cyclicals has begun.

Economically there are some important questions to answer. Will portions of the debt racked-up in recent months be inflated away via currency debasement? In a sense that would be the easy way out, although if interest rates can in practice be kept at or close to zero, many efficient entities will cope. Regarding whether inflation returns, that will partly be determined by (a) genuine commodity shortages, should they materialize (e.g. in copper), and (b) if the *velocity* of money ever reverses; money supply has been let loose by central banks, but falling business confidence caused the velocity of money to partly offset its effect.

In emerging markets, their equities tend to do well for a few years after lying fallow for perhaps five or six – although extreme selectivity is always necessary.

Emerging markets do well every five or six years

Commodities can be the driver here, but these days increasing Chinese equities’ weightings are demanding that global money managers do their homework. Within commodities, crude oil markets currently look very well balanced. The US rig count has fallen steeply as some shale producers were impacted by the lower prices of recent months compared to much of last year. Copper was doing better, and helped by its supply side (falling ore grades), but was then hit by Covid-19. More infrastructure spending would help. Soft commodities are as unpredictable as ever. Regarding gold, we are still structurally bullish, using the yellow metal as a general hedge, but also recognizing that our hedge position had morphed into a winning trade that had become extremely overbought – triggering some profit-taking.

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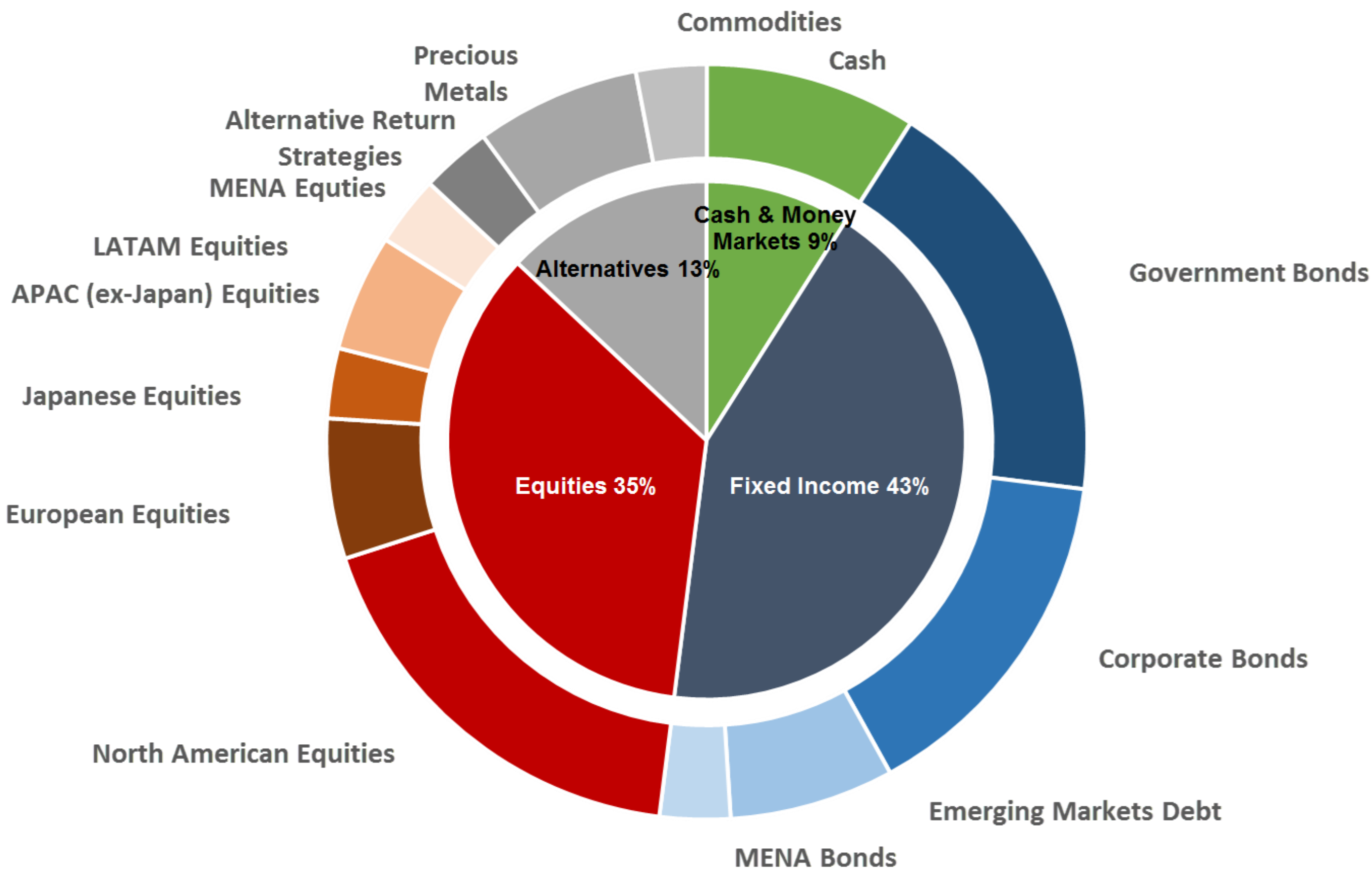
Current Tactical Asset Allocation



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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