Investment Weekly

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Some sector rotation in stock markets is a sign of health

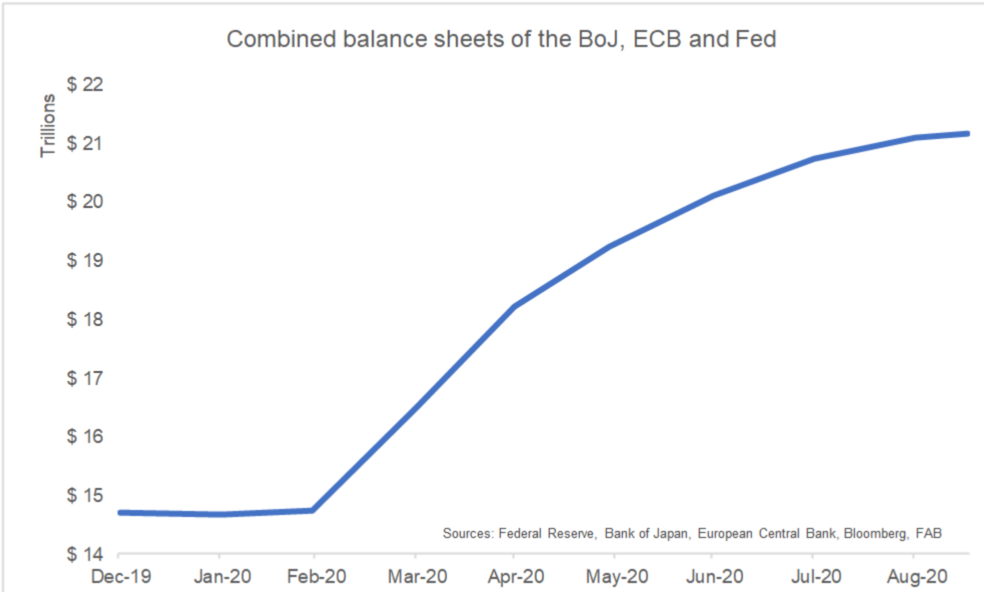
♦ Further short-term weakness in technology stocks, alongside gains in more cyclical sectors suggest a degree of portfolio rotation.

♦ The world's key central banks failed to add more stimulus at their policy meetings last week, leaving investors disappointed with signs of less money-printing.

♦ Nonetheless, the uniform central bank message is that low rates should remain in place for a long time.

♦ This will continue to support long-duration, higher-growth and higher-yielding assets.

♦ The FAB AAC remains slightly underweight in global equities, and overweight in IG bonds and gold.



It has been a tough month for technology investors. The NASDAQ Composite ended the week 0.56% in the red, its third consecutive week of losses. The index has not had a weekly gain since August, during which it gained 9.59%. Nearly all of that rally has been erased in September amid a 5.17% drop so far this month.

Meanwhile, the Dow Jones Industrial Average, more geared to the old economy, is only lower for the month-to-date by 2.72%. Arguably, if it were not for the technology names in the index, it may have even been in the blue this month.

Indeed, a look at sector performances within the S&P 500 suggests some clear rotation taking place. The materials and industrials sectors are the only ones showing positive returns in September, while technology is the biggest loser.

It is probably no coincidence that technology stocks had been the biggest gainers until 31 August. In fact, drilling down a bit further supports the idea that some investors may have started taking profits in the large tech, and related, big winners and have begun to allocate some capital to the laggards, which could fare well in the next two to three years.

Telecommunications, the second worst-performing sector so far this month, is dominated by Facebook, Netflix and Google's parent, Alphabet, which together represent about 60% of that sector's weighting within the S&P 500. About 40% of the weight of consumer discretionary stocks in the S&P 500, the third worst-performing in September, is represented by Amazon alone.

These stocks, together with those that sit within the information technology category, have been among the main drivers of broad stock market index gains between April and the end of August.

The world's key central banks have slowed down money-printing in the past few weeks

The fact that these have lost some ground should not be reason for alarm, though. On the contrary, this probably speaks more in favour of the bull market than otherwise. On 14 July, FAB Investment Strategy noted that if the bull market was to continue, it needed to broaden. At that time, the materials and industrials sectors were still negative for the year, while technology was firmly positive.

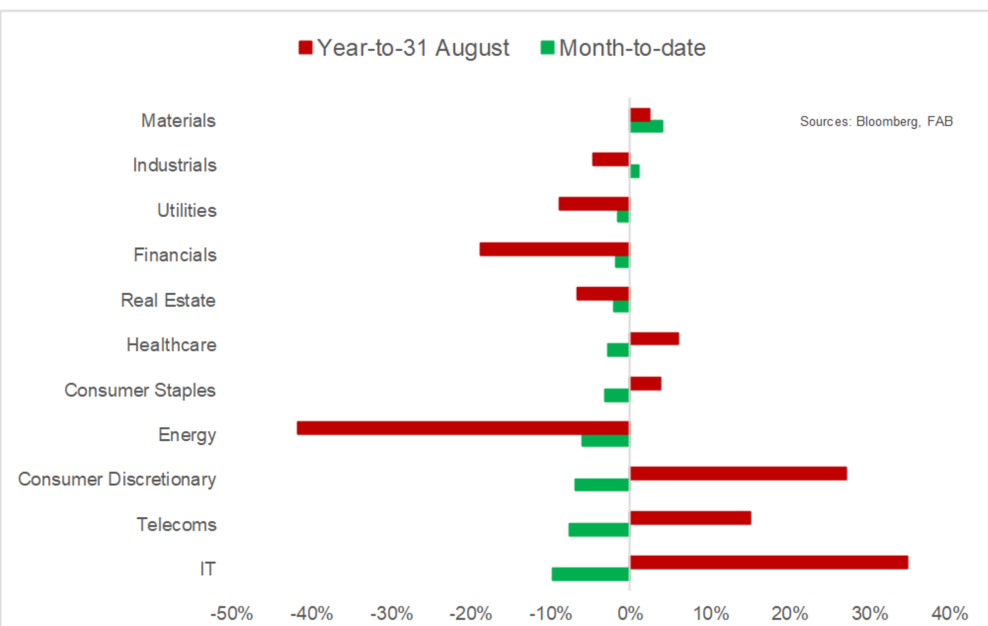
The fact that cyclical stocks are beginning to curry some favour could mean that large institutional investors are starting to believe in the economic recovery after the pandemic lockdown. Even the Federal Reserve is slowly getting more upbeat about that, as the economic projections of its governors showed last week.

The updated consensus forecast for US GDP growth this year among Fed governors was a contraction of 3.7%, according to last week's release. That compares to a median expectation of a 6.5% contraction in their previous projection, released in June. In simpler terms, the Fed thinks the US economy will not shrink so much this year anymore.

Other central banks have offered similar positive revisions of their growth estimates in the past couple of weeks. That may justify some shift toward cyclical stocks, particularly those that are more related to the so-called 'real economy', such as carmakers, miners and homebuilders.

These sectors would also be particularly sensitive to more fiscal stimulus. And that could be where the next round of significant liquidity comes from. The European Central Bank, the Bank of Japan and the Fed all urged their governments to spend more after their policy-setting meetings in the past two weeks.

What these three central banks did not do, however, was announce more monetary stimulus. In fact, the combined balance sheet of all three central banks has almost stopped growing since the end of August. It may not be entirely coincidental that this is also when the equity market rally fizzled.



Still, the balance sheets are not shrinking, they just stopped growing so much. While this means there is not a lot more money to chase risk assets, all the money created in March and April remains in the system.

That may be sufficient to hold risk asset prices at least close to where they are for a further period. Money market fund holdings suggest that may be the case. According to the Investment Company Institute (ICI), recently there was still nearly US$4.42 trillion parked in money-market funds, which is an indicative of the cash holdings of institutional investors. That amount was only US$3.68 trillion at the start of March. As investors raised cash after the sell-off, it went as high as US$4.79 trillion.

In other words, investors added roughly US$1.1 trillion of cash after the March scare, much of it by selling risk assets. Since then, they have put about US$400 billion back to work, but they still have more than US$700 billion sitting on the sidelines and which could be deployed into higher-yielding and risk assets.

Sector performance so far this month suggests some investors are rotating into cyclical stocks

The fund flows and relative performance do not necessarily indicate that investors are moving away from risk assets, instead they may be reassessing their risk exposures across the various asset classes and sectors. Again, according to the ICI, this month saw net negative flows out of equities, and net positive flows into bonds. This is another indication of some rebalancing of portfolios: as stocks rallied, the exposure to this asset class could have breached asset allocation target ranges, prompting required adjustments.

Goldman Sachs analysts predicted in a recent report that some US$200 billion of equity investments could move into other assets as pension funds rebalance in the coming weeks, and after the MSCI World index rallied 50% since 23 March.

While this is nothing to fret about, it could have unintended consequences. The rebalancing is happening amid little new central bank liquidity and ahead of a likely closely-contested US election, which could temporarily exacerbate the fears of some investors. Sharp moves in certain stocks could also trigger margin calls and stop-loss orders, possibly extending the sell-off.

This points to a potentially volatile October, particularly for the best-performing stocks. However, once the US election is past and especially once a coronavirus vaccine is available, there is some reason to believe that risk asset prices could once again move higher.

If that is the case, then investors may look at some of the laggard sectors. Not all will merit the attention. Bank stocks, for instance, are among the worst-performing in the S&P 500, and may have difficulty breaking that pattern because low rates are usually not good for lenders.

Other areas, such as energy, may have better long-term prospects than the current consensus implies. In any case, the last few months of this year may be a time for investors to step back and position themselves for years of easy money and low interest rates.

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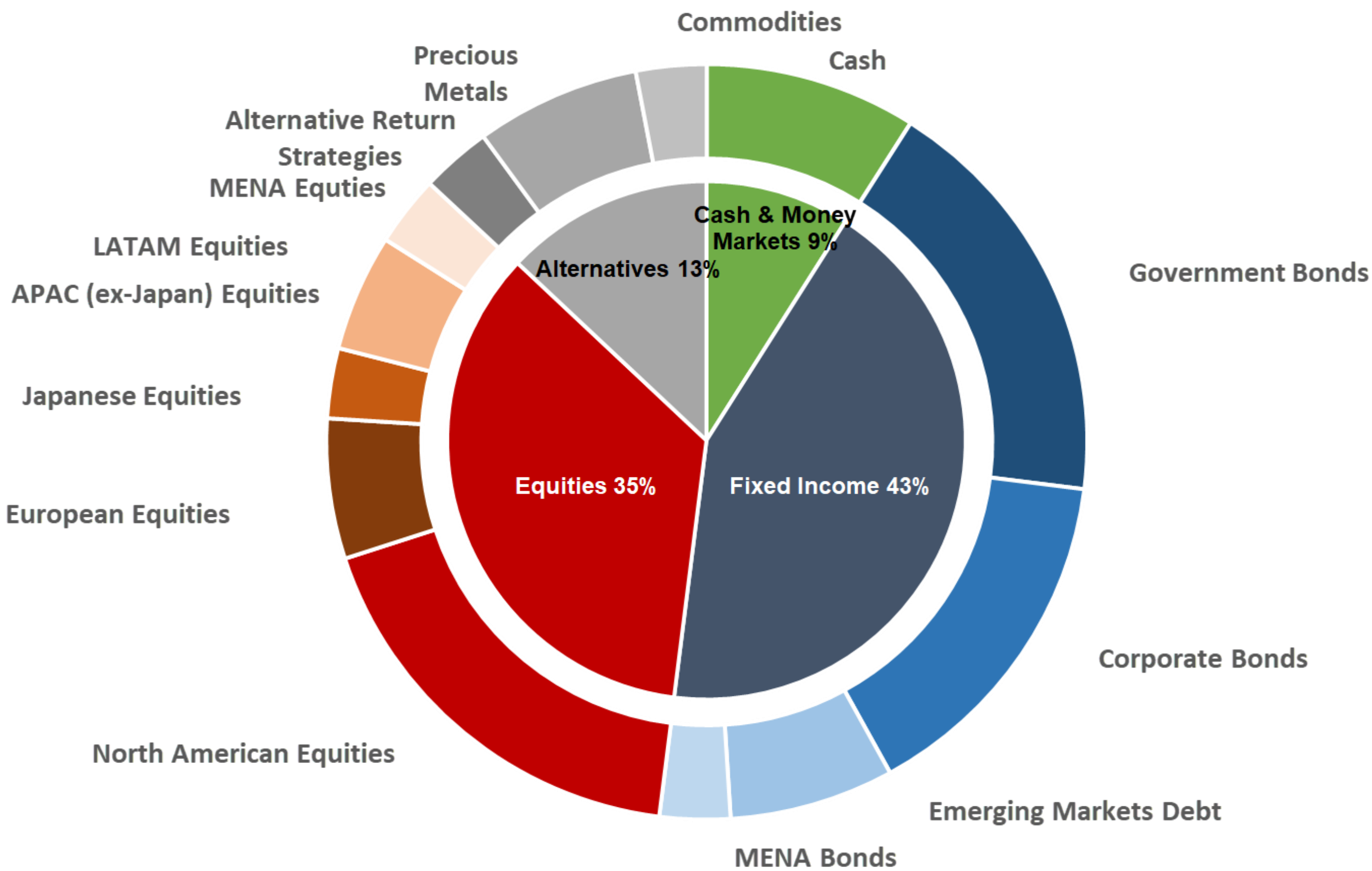
Current Tactical Asset Allocation



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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