Investment Weekly

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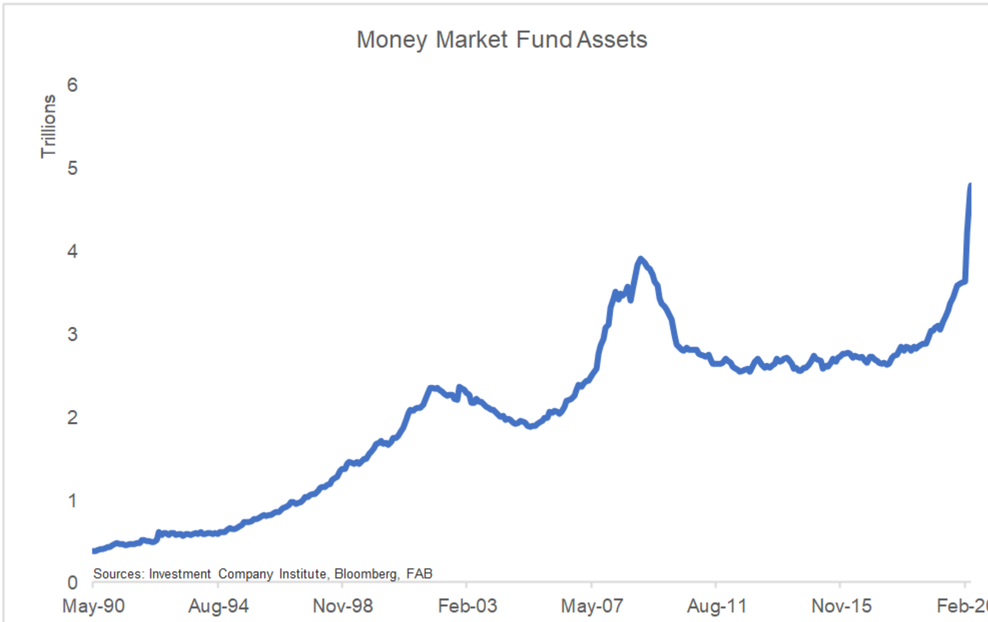
21 May, 2020

Stocks are stuck between a pile of cash and economic reality

- **US stocks rally together with high-yield bonds as central bank liquidity trumps recession impact.**
- **President Donald Trump raises the heat on China ahead of election.**
- **Economists revise their US growth projections suggesting that total GDP for the country could go back to where it was four years ago.**
- **In the first quarter, which only factored in a couple of weeks of lockdowns, earnings shrank at the fastest pace since 2009.**
- **Gold keeps its allure as negative rates spread, with the UK selling its first notes with a yield below zero.**
- **The FAB AAC remains underweight in global equities and overweight gold.**

The S&P 500, perhaps the best proxy for risk assets in general, surpassed a key hurdle this week after closing above 2,939, a level it had struggled to overcome in April. To be sure each time it did so, it retreated a bit. The move seems to evidence the two drivers competing for attention, and which are likely to keep them trading in a range for a while: liquidity and the dire economic reality.

On one side, there is about US$10 trillion in stimulus being thrown into the system to counter the impact of the global lockdown. That money helped many dollar liquidity measures return to normal and has made borrowing so cheap that investing in stocks even at very high valuations makes sense. That money is making its way into funds which are now under pressure to put it to work in risk assets.



A good measure of how much money has made it into the financial markets can be seen in the total holdings of money markets in the US, which reached a record US$4.8 trillion in the week ended 13 May, according to data from the Investment Company Institute. That is equivalent to nearly a quarter of US GDP. That amount comes as funds have reported some of their highest cash levels since Bank of America Merrill Lynch began to track fund holdings, according to their latest fund manager survey.

Most of these funds are not paid to keep cash in money market funds (investors can do that themselves). So, while they may increase their holdings of cash (parked in money markets, usually) in times of stress to meet redemptions, eventually they have to put it back to work. However, with the market looking stretched, many fund managers probably fear getting caught in another sell-off if they deploy their cash right now.

Money market assets, a proxy for cash available for investing, are at a record high

Yet, they are likely to pile into the market as soon as there is another sell-off. That creates a likely floor in the S&P 500, and one that probably applies to most risk assets as well. For the S&P 500, some analysts have pinned that floor around 2,400, a level at which stocks become attractive even amid the current economic slump, especially in light of ultra-low rates.

This huge pile of cash may also explain why risk assets rallied last week even as some of them reached extreme valuations. On a price-to-sales basis, for instance, the S&P 500 has not been this expensive since 2000, in the middle of the dotcom bubble. Other metrics also suggest that US stocks are nearing bubble territory, at least in some sectors.

This week's rally brought the S&P 500 to its highest level since 6 March, before the Covid-19 lockdowns started and at a time when the market was just starting to price in the potential impact of a global curfew on the economy. At yesterday's closing price the index was trading at 18.4 times the expected earnings of its components in 2021. The last time this valuation was so stretched was in 2002.

This is part of the reason why the S&P 500 does not seem to have much upside from here. Even if the index were to revisit its all-time high, touched on 19 February, it would have to rally another 13.9%. At that 3,386.15 all-time high level, the index would be trading at 21 times its expected earnings for 2021 (expectations which, by the way, may be a bit too optimistic still), a level it only held for a few months during the dotcom bubble, and never any other time. That, therefore, leaves the maximum potential upside from here at around 14% and suggests that the probability of this full rally is relatively low.

On the opposite side of the spectrum, if the S&P 500 is to revisit the 2,237.4 low point of 23 March, it will have to fall more than 24.7%. Even if an investor were to consider a 50% chance that either scenario will play out, the potential return is negative 5.4%.

This negative skew is likely to keep investors at bay and could prompt profit-taking every time the index starts getting to the 3,000 and beyond much in the same way that the pile of cash in money markets is likely to put a floor under stocks. Aside from the valuation issue, investors also have to confront the grim economic reality that is surfacing after the lockdown.

Economic growth in most countries plunged in the first quarter as a result of the curfews and social distancing measures put in place to slow the spread of Covid 19. Those numbers, some which were among the worst in contemporary history, only reflected two or three weeks of lockdown. Which means the numbers for the second quarter will be far worse.

So, while investors have been chasing risk assets amid record liquidity and hopes that the global economy will quickly return to normal, the grim reality is likely to set in over time. And that could prompt some soul-searching and helps explain why risk assets have an effective cap for now.

Indeed, the news is only likely to get worse. Experts suggest that there is little doubt that the reopening of several economies will prompt a rise in the number of cases. As long as there are no new lockdowns on the back of a second wave, this should have less of an impact on the global economy but it is dangerous to try and guess how governments will react to a new flare up of the virus.

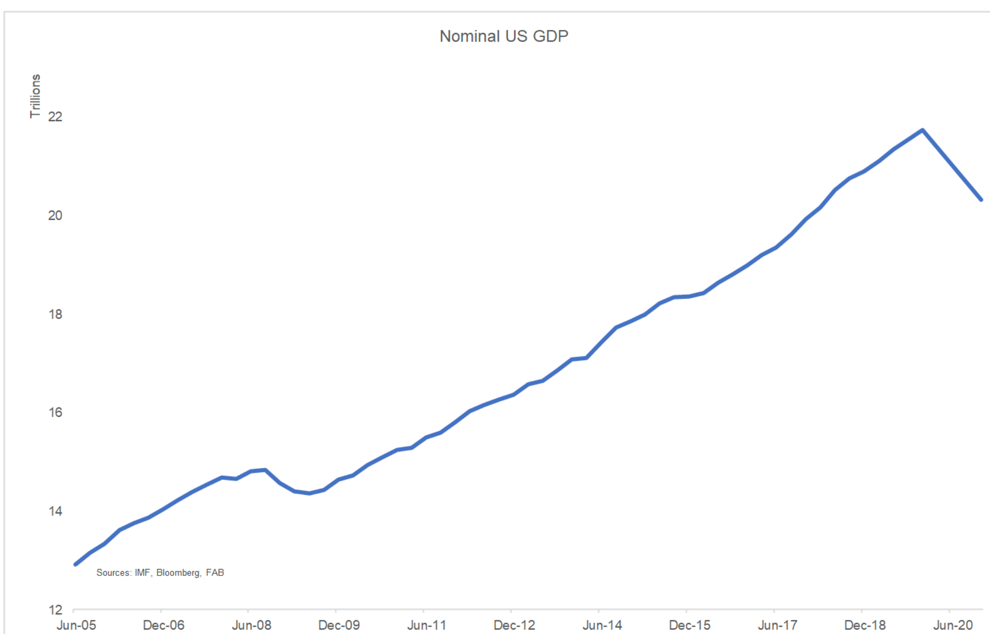
Then there is the issue of politics. With the US elections in November, the country has officially entered campaign season. For President Donald Trump, that means going back to his best tactic: attacking China. The promise of "bringing back jobs" from China was one of the winning catchphrases for President Trump in 2016 and he is back betting on it.

Analyst forecasts for the US economy suggest GDP will go back to what it was in 2016

The impact of the virus and the fact that it probably originated in China is also making attacking the country a bipartisan sport. This week, the US Senate passed a bill that would effectively bar many Chinese companies from being listed in the US and lawmakers from both sides of the aisle overwhelmingly supported it. Given the level of backing, it is likely to sail through the House of Representatives as well and be signed by President Trump.

The increased aggression could peak in October, just ahead of the election, when the phase one trade deal that China and the US signed in January comes up for a review. Given the economic impact of the lockdowns on the country and across the globe, China is unlikely to have met at least one of the US's demands from that agreement: buying US$200 billion of US products. That could mean that the deal is scrapped, only to be picked up again after the election at the earliest.

Markets may have been able to look past the bad economic data for now amid so much liquidity, but a renewed trade war and a potential flare up of new Covid-19 cases is likely to push it into another correction. However, fret not, as at that point cash sitting on the sidelines will probably pour in to rescue risk assets again.



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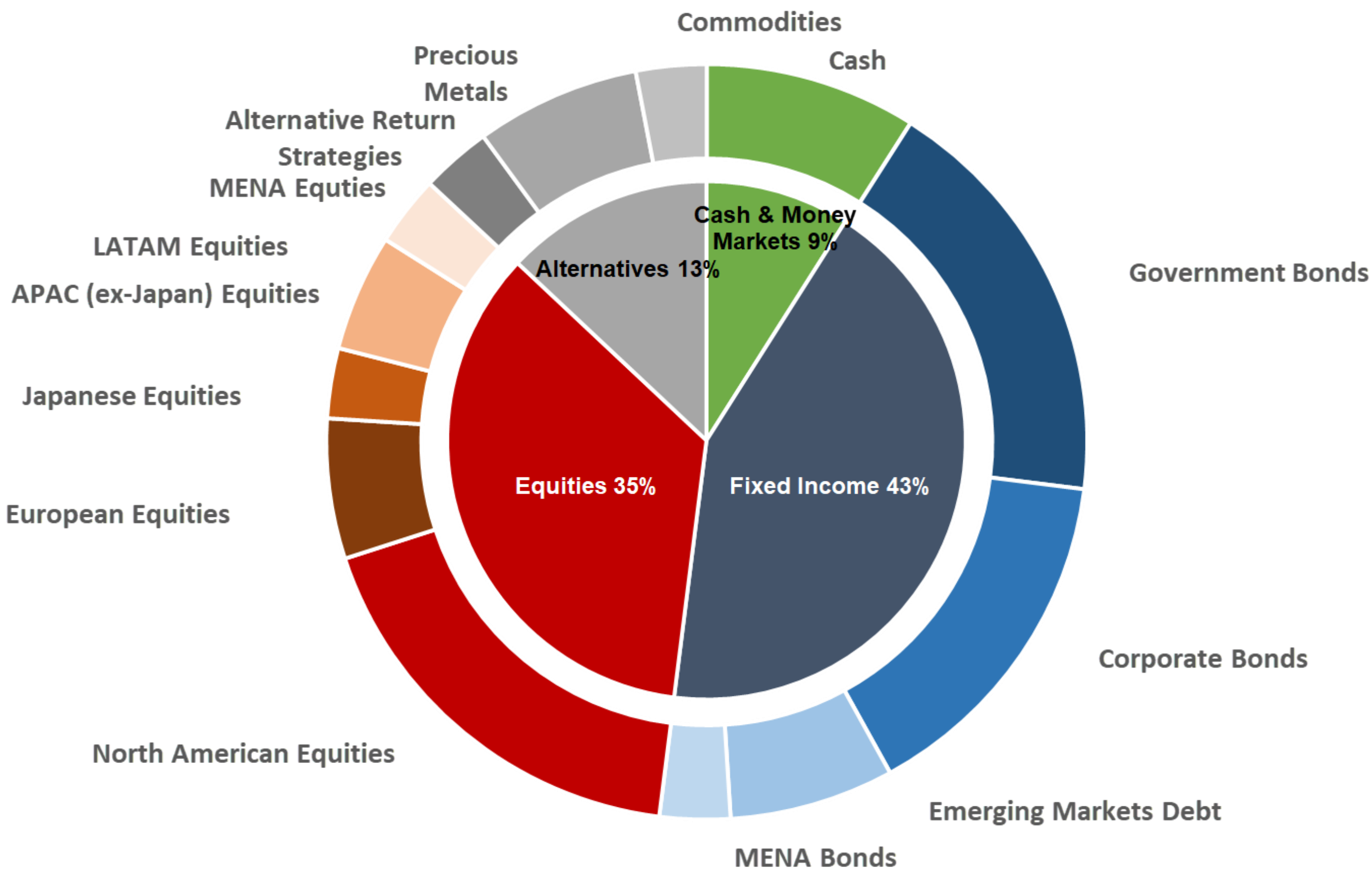
Current Tactical Asset Allocation



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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