Investment Weekly

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Catalysts could determine market direction in July

♦ The S&P 500 ended the week down 2.9% as a Friday sell-off driven by one of the index's heaviest-weighted tech names anchored the market.

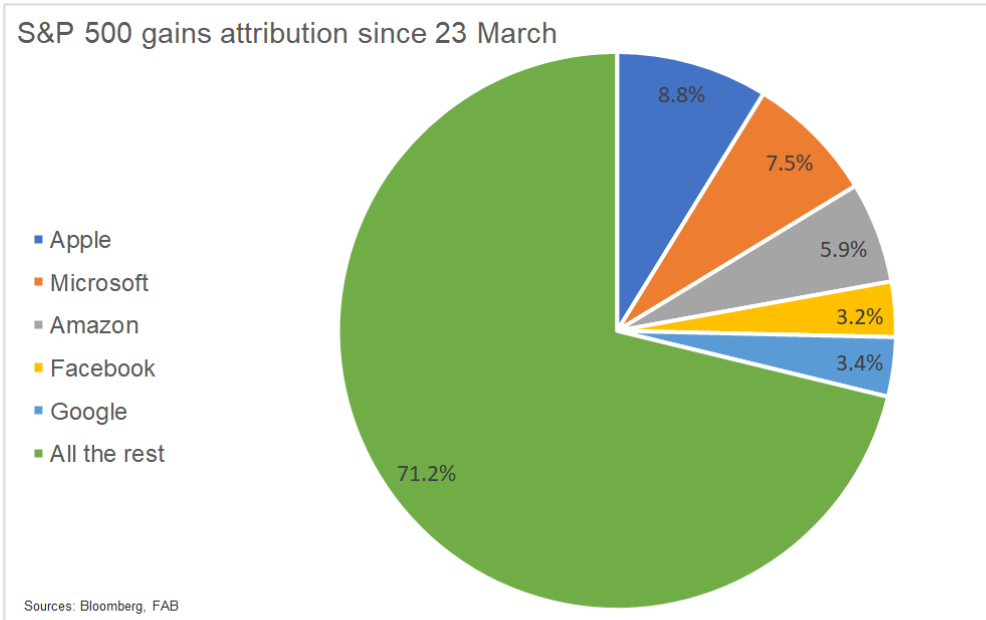
♦ The S&P 500 traded in a range for most of the month of June as investors sought a catalyst for either further gains or new losses.

♦ Any sustained sell-off in technology names could drag the entire index down and trigger a self-feeding spiral.

♦ With further evidence of demand destruction, investors will be seeking news of more fiscal stimulus, particularly in advanced economies.

♦ Yet, record amounts of cash sitting in money market funds and bank accounts in the US, as well as central bank support, suggest there is a floor under any bigger drop.

♦ The FAB AAC remains underweight in global equities and overweight gold.



Seasoned investors often joke that it is no use being right if you are early. And being on point and on time generally is associated with catalysts. Sometimes, a company can have issues for years, and an investor may have identified them, but until the rest of the world realizes it too, and reflects it in the stock price, the investor who has been crying wolf will be penalized with losses.

Risk assets are at a junction in which catalysts will be more important, either to keep the rally since the end of March going or to prompt a correction. Unfortunately, politicians have the control over most of these catalysts.

Look at the positive side, for instance. The S&P 500, and many other risk assets, seem to need a boost to continue to rally as it did until the week before last. After gaining 34.5% since 23 March, the key equity benchmark is lacking momentum to continue going on its own.

In fact, for most of the month of June, the index traded in a range between 3,000 and 3,200. A sharp drop in the second week of the month after the index had breached the key 3,200 level was met with the Federal Reserve's announcement that it would start buying individual corporate high-yield bonds, which helped stabilize it. Since then, it has been in a tug-of-war between bears and bulls.

A breakout in either way may require something unexpected. There is a chance that some bad news related to online media companies led by Facebook last week could be a negative catalyst, but it is yet to be seen if that will be enough.

Five companies have responded for more than a quarter of the S&P 500's gains

On Friday, Unliever, the maker of Dove soap and one of the world's largest advertising spenders, said it would stop posting ads on Facebook. The move was attributed to the social media company's supposed failure to adequately control fake news and hateful content. Unilever was followed by 15 more large companies including PepsiCo, Coca Cola, Hershey and Honda Motor.

The announcement caused Facebook stock to tank 8.3% on Friday and helped drag down the broader stock indices. A broader correction of the stock market, and even of risk assets in general, could ensue if the company's shares continue to drop this week and start to weigh on its social media peers.

The reason is the heavy weight that this sector and technology in general has acquired within the S&P 500 and the US's largest indices. According to Bloomberg, 28.8% of the gains in the S&P 500 was attributed to the stocks of five companies, Apple, Microsoft, Amazon, Facebook and Alphabet, the owner of Google. Put another way, less than 1% of the index generated more than a quarter of the gains in the latest rally. As as result, these five companies represent 21.6% of the overall index too and anything that affects them tends to drag all the other 495 shares.

If that does happen, some key levels will need to be observed. If the S&P 500 breaches through 2,900, it could prompt a broader sell-off, as automatic sell and take -profit orders get triggered and tend to create a self-feeding spiral. At that point, investors will be watching for positive catalysts to put a floor under any sell-off.

In any case, some announcements are likely in July. Many of the stimulus programs enacted in late March and early April, such as additional welfare or cheap loans and grants to companies that keep employees on payroll, expire by the end of next month. At that point, the US Congress (as well as other legislative arms across the world), are either going to let them lapse or announce new stimulus.

Hopefully, governments will heed the warning of the IMF, which noted last week that the destruction of income and demand because of the shutdown prompted by the coronavirus pandemic will cause a deeper than expected recession this year. The Fund said that it expects the world to contract 4.9% this year and to grow 5.4% next year. It previously had expected a 3% contraction and a 5.8% growth.

Much of the adjustment was due to more severe infection rates and economic slowdowns in emerging markets than expected. The Fund revised down growth expectations for both this year and next by an aggregate 2.8 percentage points for emerging markets, compared to a 1.8 point revision for advanced economies.

If the IMF forecast materializes, the aggregate gross domestic product of developed economies will end 2021 still 4% below where they ended 2019. Developing economies are still likely to end 2021 slightly below where they ended 2019, by far the worst two-year outcome for the group since the IMF started to track growth across the world.

The IMF noted, however, that its forecasts carry a lot more uncertainty than in the past, partly because of what can happen depending on the continued government response to the global recession. Which brings this back to catalysts.

With the equivalent to nearly 300 million jobs having been lost across the world and about 80% of the 2 billion self-employed people in the world affected by the lockdowns, it is hard to put a value on how much income has been lost. Some economic theories suggest that the lost private income has to be replaced by government income, even if the central banks are printing money to finance it. That was exactly what governments did, and it seems to be working.

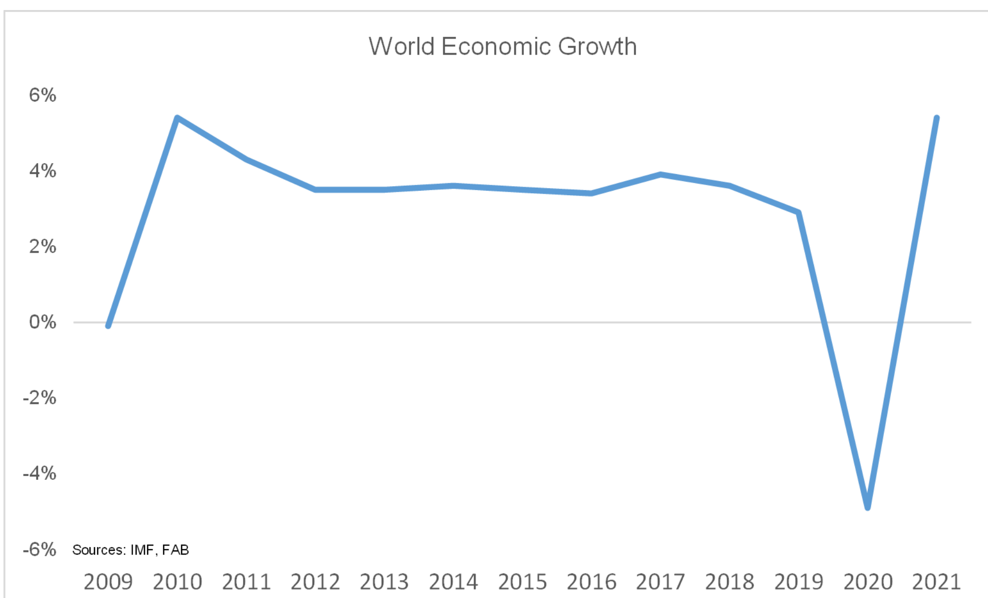
The IMF has revised further down its growth expectations for this year and for 2021

If that plug is pulled too early, though, the weight of the lost private income will compress the economy, and risk assets. That could prompt a more severe credit crisis and other threats to financial stability.

Now, the next leg of the fiscal stimulus is also a bit more complicated. Governments have started to weigh whether continuing to pay people to stay out of work will act as an incentive for them not to look for a job. Hence, some are defending that more fiscal stimulus takes a different form.

One idea that is widely agreed upon is infrastructure investment. That has pros and cons. On the positive side, historical evidence suggests that building more highways, railways, ports and telecommunications increase growth for many years into the future. The works also generate jobs which have a much stronger long-term multiplier effect.

The drawback is that it takes time for public works to start, and in the meantime unemployment bites. Furthermore, such spending is heavily politicized and, at least in the US, a lot of debate is likely to happen in Capitol Hill before any sort of infrastructure bill is approved. A realistic scenario is to think of it coming after the election. In the meantime, the lack of a positive catalyst could well turn into a negative one.



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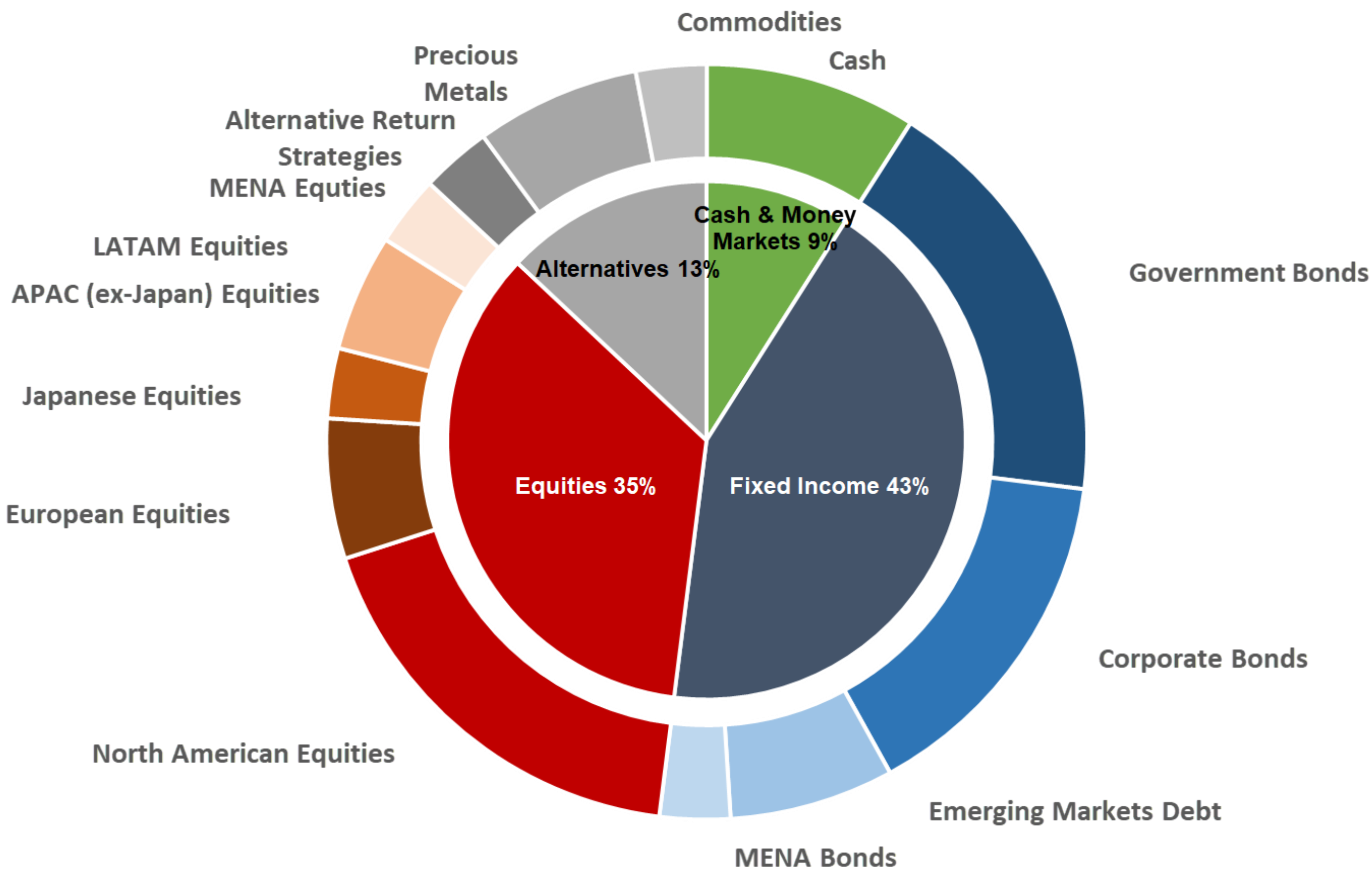
Current Tactical Asset Allocation



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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