Investment Weekly

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بنك أبوظبي الأول
FAB
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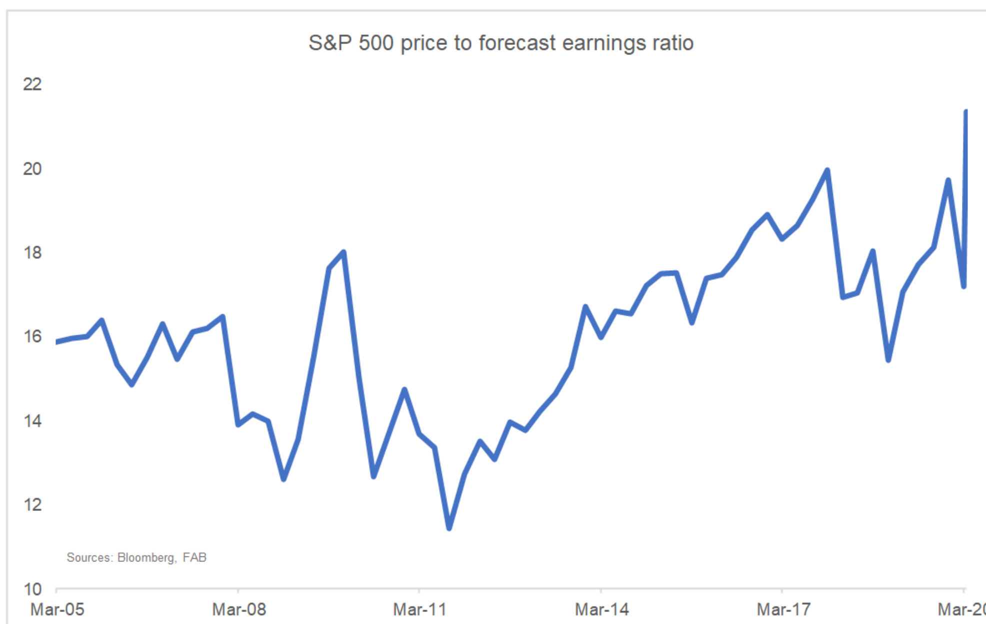
Market bounce provides opportunity to deleverage



♦ The S&P 500 has its first back-to-back weekly gains since mid-February, while the NASDAQ Composite index is only 3.6% lower for the year-to-date.

♦ Investment-grade spreads have returned to 2018 levels, and high-yield bond indices have rallied more than 8% over the last two weeks.

♦ Saudi Arabia raises US$7 billion in bonds, following a trade by Abu Dhabi.

♦ The US, Germany, Denmark and others reveal plans to reopen their economies. Texas sees protests against the state lockdown continuing.

♦ Nearly 22 million jobless claims over recent weeks have wiped out 10 years of job growth in the US.

♦ US banks have begun to set aside billions of dollars to cover an expected rise in non-performing loans.

♦ The IMF predicts the world economy will contract by 3% this year, to be the worst since World War II.

♦ FAB AAC remains underweight equities and overweight gold amid continued uncertainty in markets

In times of volatility, investors are tempted to sell riskier assets when everyone else is doing so. However, markets do not go up and down in straight lines, and some of the best rallies follow sharp falls. Smart investors use such rallies to reduce risk in their portfolios, rather than adding it.

This is food for thought now, since it is unclear whether the stock rally since 23 March is a 'dead cat bounce' or not.

Granted, global central banks and governments are injecting record stimulus into their economies to help them deal with what is likely to be the deepest recession in 90 years. This has gotten investors more optimistic, and some are already discounting the recovery.

Indeed, the NASDAQ Composite, the technology-heavy US-quoted stock index has increased 26.1% since 23 March low. The index is now only 3.6% down for the year, although it remains 11.9% below the record it hit on 19 February. The S&P 500 is still 15.1% below the 19 February high, even after rallying 28.5% since the recent low. Despite the rally in global equities' prices, not a single major index is in the green for the year-to-date.

Perhaps of more concern is that valuations are stretched for many indices, and the recent optimism could increase the risk of another correction. It seems that investors have yet to fully price-in the drop in earnings that the global recession could cause. A recent fund manager survey with more than 150 analysts yielded a median expectation for up to a 44% reduction in earnings this year.

The S&P 500 is already trading at the highest forward PE ratio in more than 15 years

It is likely that many investors have written -off the current year and are looking beyond 'trough' earnings. Accordingly, they expect the forward price-to-earnings ratio to be high (as much as 27x if earnings fall by 30%), but that matters little since 2021 earnings count more. Now, if earnings do fall by 30% this year, followed by a recovery of 35% next year, that would indicate a price-to-earnings ratio of 20x for 2021. That is not cheap, and suggests caution but it is not excessive either.

For many years US earnings grew at an average of about 9% per annum, and it would be unusual to see the market trading on a prospective price-to-earnings ratio of much more than twice that – or 19x, possibly 20x.

In any event, there is probably more downside than upside risk in equity markets now. Some of the recent run in US equities has probably been driven by short-covering or expectations of an imminent recovery, without weighing the extent of economic pain ahead. Any negative surprise, such as a surge in new infections and deaths in a major economy or region, could easily prompt another sell-off. The IMF, for one, has underlined that its recent downwardly adjusted forecasts for growth may actually be too optimistic.

It has been nearly a century since the economic news has been this bad. Last Thursday, the US Bureau of Labor Statistics revealed that another 5.25 million Americans had filed for welfare benefits in the week ended 10 April. The number, added to similar filings in previous weeks, indicates 22.5 million Americans have lost their jobs since March began.

For reference, that number exceeds all the net new jobs created in the past decade in the US. It implies that roughly 13.5% of the active labour force in the US recently lost their jobs. Considering the 4.4% unemployment rate as of 13 March, the implied unemployment is now close to 18%, the highest since the end of World War II. Such a level of unemployment is in line with an economic contraction of close to 25%, according to FAB calculations.

China offered a glimpse of the cost of the lockdowns on Friday, as the country said its economy shrank by 6.8% in the first quarter compared to the previous year, its first contraction since records began. The country was already seeing its slowest economic growth in nearly 30 years pre-Covid-19 and the global lockdown is likely to make it harder for growth to return to the 6% pace of last year. China also recently reported that its unemployment rate had risen to 6.2% in February, an all-time high, which means more than 50 million Chinese are without jobs.

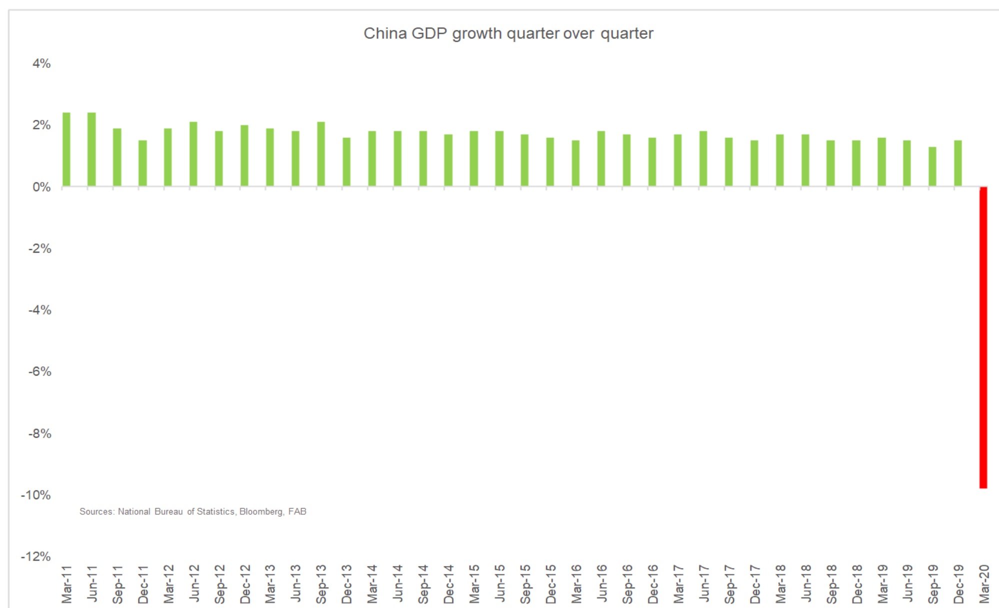
Much of that bad news is priced into current markets. Investors are bracing for negative GDP prints for the US and Europe, especially in the second quarter. Yet, the occasional reminder of the severity of the crisis still unsettles markets. Last week, for instance, the Commerce Department said that retail sales dropped 8.7% in March, the most on record, while the factory output was the lowest since 1946. The depth of the numbers prompted the worst trading day of last week.

Then there is the political instability that could result from the high unemployment becoming the norm across the globe. In the US, for instance, President Trump's re-election is clearly at risk. In some emerging markets it could be much worse. South Africa, Brazil, Russia, Turkey and Mexico have all seen their currencies drop more than 20% in the past year, a number generally seen as a sign of a crisis. That also means imports are so much more expensive for these countries, which pushes up prices for consumers. When unemployment and inflation are both high they often trigger unrest.

Chinese GDP had its worst contraction on record in the first quarter due to Covid-19

The cost of the dollar debt that companies in these countries binged on for the past decade is also going up with the devaluation of local currencies, and that is still likely to be the case if the US dollar weakens – because any weakness will be mainly against the major currencies, not against EM currencies. Corporate foreign currency debt from developing nations more than tripled in the past decade, according to the Bank for International Settlements. That could translate into many companies, and even nations, defaulting on their debt, something that in itself could jolt global investors again.

Markets have started to price an economic recovery after the current downturn, but they may not be ready for more unexpected events. Hence, the FAB Asset Allocation Committee (FAB AAC) remains underweight equities. Yet, it has also remained invested through the volatility peaks, which helped it recover some of the losses from the end of March. Similarly, the FAB AAC has kept overweight gold even amid small downward moves . The amount of gold held by ETFs reached an all-time high on Friday night, which suggests there is more upside for it. In volatile times, it pays to have a cool head.



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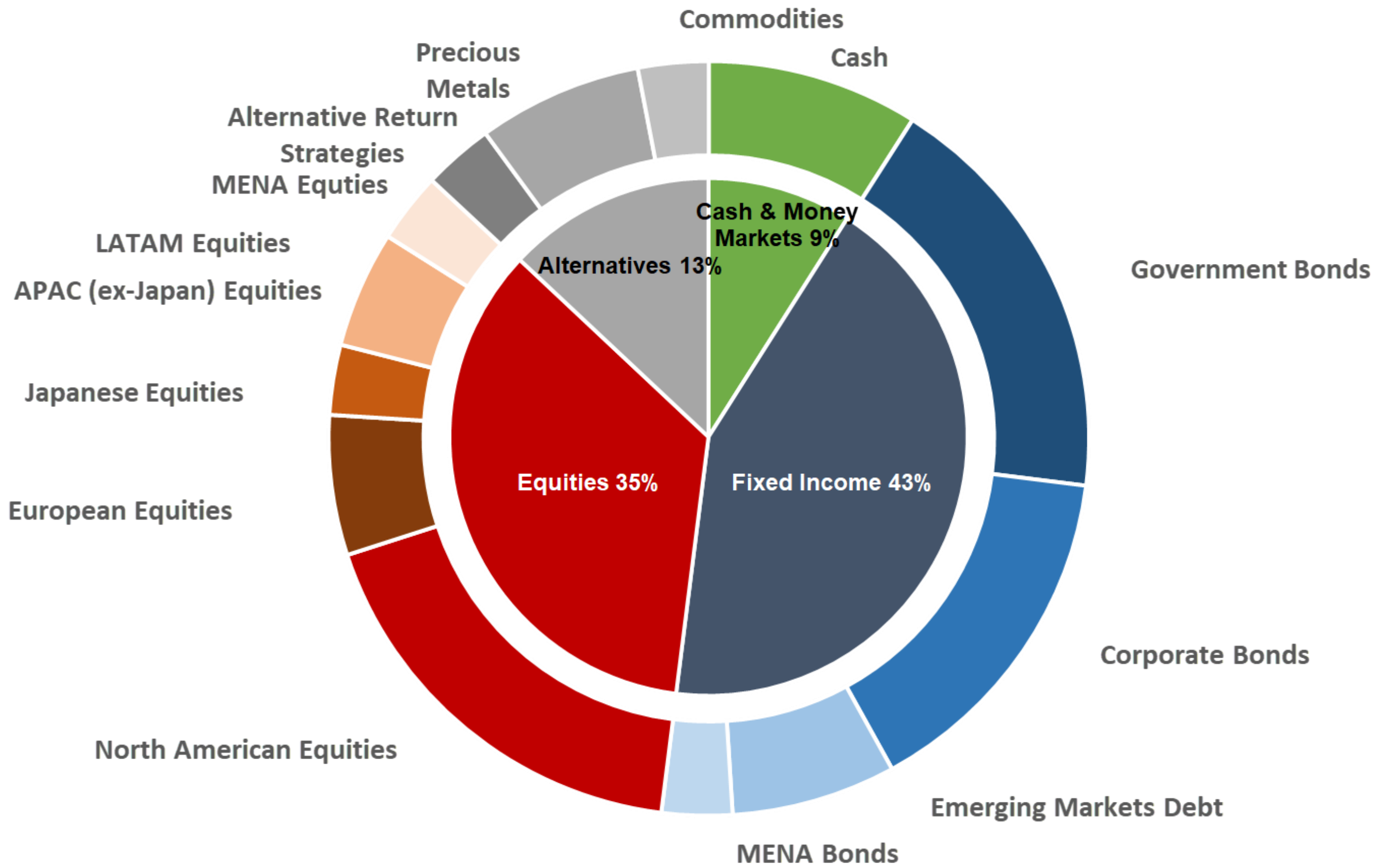
Current Tactical Asset Allocation



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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