Investment Strategy Update

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If this rally is to continue, it needs to broaden out

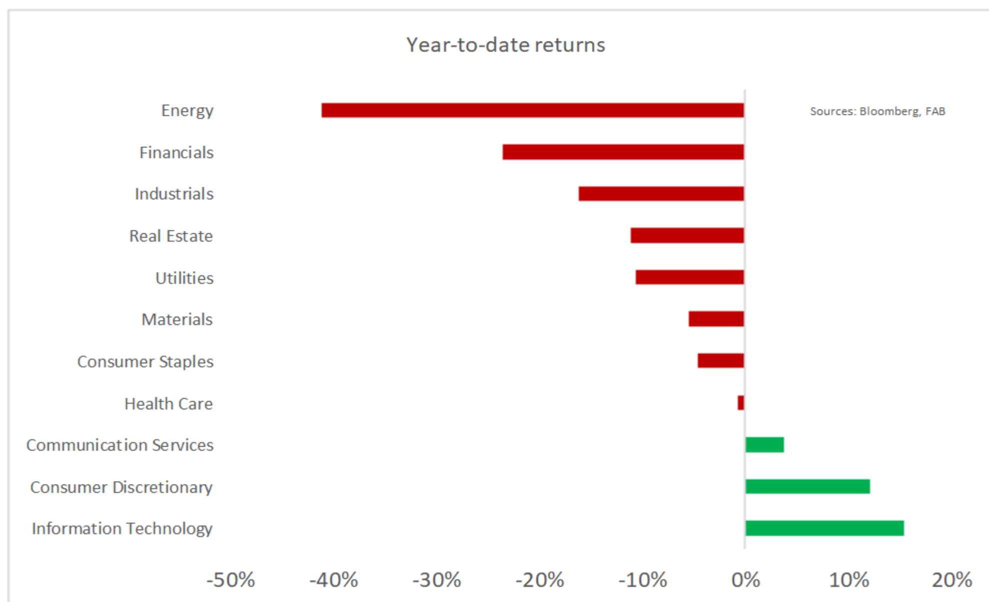
♦ **Market rally so far has been centred around technology megacap shares.**

♦ **These companies have proven track records of generating profits and have big cash reserves, making them defensive investments.**

♦ **The lockdowns because of the pandemic have also accelerated behavioural changes that benefit these companies' businesses.**

♦ **However, if the stock rally is to continue, it needs to broaden out to the sectors which are more sensitive to economic growth.**

♦ **FAB AAC remains overweight high-quality investment grade bonds.**



By many measures, the recovery in the stock market has been breathtaking. At one point yesterday, the S&P 500 had turned positive for the year-to-date and it has rallied 41% since its recent low on 23 March. That, however, pales in comparison to the Nasdaq Composite index, which is up 51.46% since the March low, and broke multiple records in the past two weeks, which helped it be up 15.81% for the year to date.

The discrepancy of the two indices hints at something less bullish happening in global stock markets. The recovery has been mostly led by technology megacaps, with five stocks accounting for more than a quarter of the gains so far. That can be understood from the perspective that these companies all have large cash holdings and a proven track record of generating outsized profits and growth. Plus, the behavioural changes that made them big have been accelerated.

For the rally to continue, however, it needs to broaden out to other sectors, particularly so-called cyclicals, which tend to do better when the economy is growing.

Some areas have actually started to catch up, but more for their own particular reasons. The S&P 500 materials subindex is up 51% since 23 March, though it is still down 5.45% for the year. Much of those gains, however, were related to a huge rally in copper and iron ore prices which have helped some of the biggest components of this subindex soar recently.

Financials, in the meantime, remain 23.5% down for the year, even after having rallied 33.5% since their recent low. That sector got a boost today from better than expected earnings from the biggest US bank, JP Morgan. To be sure, the lender also had higher than expected provisions. Much of the gains it logged in the second quarter may not come back, though, as they related to a slew of new bond issues which may slow down into year-end.

Cyclical stocks have hugely underperformed technology names so far this year

In similar fashion, the second quarter results for material companies may very well be horrid while those for healthcare companies may be amazing. Those numbers are backward facing, though. High healthcare sales in the past three months may actually translate in fewer sales in the future as buyers frontloaded their orders amid the pandemic.

Meanwhile, slower growth in construction since March may bear no relation to the future demand of raw materials, which could get a boost from infrastructure spending. So far, investors seem to be sending a message that they are not confident that the future will be that good for the economy. Unless that perception changes and cyclicals start to rally, there is only so much the stock market can gain.

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