GIO
Q4 2020

26 October, 2020

Markets are on hold, awaiting clarity about the future

♦ The political landscape will impact the announcement of additional fiscal and monetary stimulus.

♦ However, with the prospects of low rates and asset purchases by central banks for some time, investors are forced to seek returns in risk assets.

♦ Incremental stimulus from any of the larger central banks could help determine some of the flows.

♦ It remains profitable to borrow in US dollars and invest in other currencies, which suggests the weakening trend for the greenback could continue.

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

For the rest of this quarter, risk asset prices will likely be driven by a tug of war between the searches for safety and yield.

In 1991, Amos Tversky and Daniel Kahneman found that individuals respond "more strongly to losses than to gains." They also framed the concept of availability, which says that people tend to be more aware of risks shortly after having experienced them. "After each significant earthquake, Californians are for a while diligent in purchasing insurance," Dr. Kahneman wrote in his 2011 book, "Thinking Fast and Slow".

These two so-called biases could be important drivers of market activity in the fourth quarter. Those people who made back their first-quarter losses, or who are even sitting on profits for the year, are likely to reduce the overall risk of their investment portfolios.

Such psychology could curtail significant gains for most risk assets, at least for now. It was also one of the reasons why the FAB Asset Allocation Committee in its last meeting of the third quarter kept a slightly underweight stance in equities (the best proxy for risk assets), and an overweight in gold and high-grade bonds.

If the recent memory of sharp losses in March is not enough, investors still face significant uncertainty until year-end. On the political front, voters in the world's largest economy, the US, go to the polls to decide who will be president for the next four years. Also up for grabs are enough seats in the US Senate to change the balance of power in the country.

Nationwide surveys give former Vice-President Joe Biden a lead over President Donald Trump. However, to win the US election a candidate has to win at least 270 of the 538 electoral college votes. In other words, they have to win each state.

Investors could be cautious in Q4 after one of the fastest bear markets in recent history

In the last election, President Trump flipped the vote in three states: Michigan, Pennsylvania and Wisconsin, which had voted Democratic for the previous decade. This time, the state-by-state polls show that Pennsylvania, with 20 electoral votes, could be the tie-breaker. Poll-tracking website 270towin.com currently shows that President Trump could win 163 electoral votes and Senator Biden, 290, with the outcome unclear for 85 other.

It has seldom been this close and that unnerves investors. However, there is another concern related to what US politics will look like after November. After winning the House of Representatives in 2018, Democrats now have a significant probability of flipping the Senate too.

While that fact has received less attention, it perhaps matters as much as the presidential outcome. If, for instance, President Trump secures a second term but the Senate becomes Democratic, his opponents will have the ability to veto the President's decisions. Depending on their control margin of the two chambers, they can also override the President's vetoes. Finally, whoever controls the Senate has power over the nomination of justices and Federal Reserve governors.

If there is a so-called blue sweep, a situation which entails the Democrats taking the White House and the Senate, commentators have suggested that Vice-President Biden could roll back some of the corporate tax cuts enacted during President Trump's administration. That would have a significant impact on corporate earnings, and could prompt US equities to be slightly de-rated.

However, given the state of the US economy, there is a growing consensus that even if Democrats win, they would not touch corporate taxes immediately. There is, however, higher uncertainty bout the what happens if Democrats take over Congress but the White House remains Republican. This scenario could see President Trump unable to do much in terms of new infrastructure projects or fiscal stimulus.

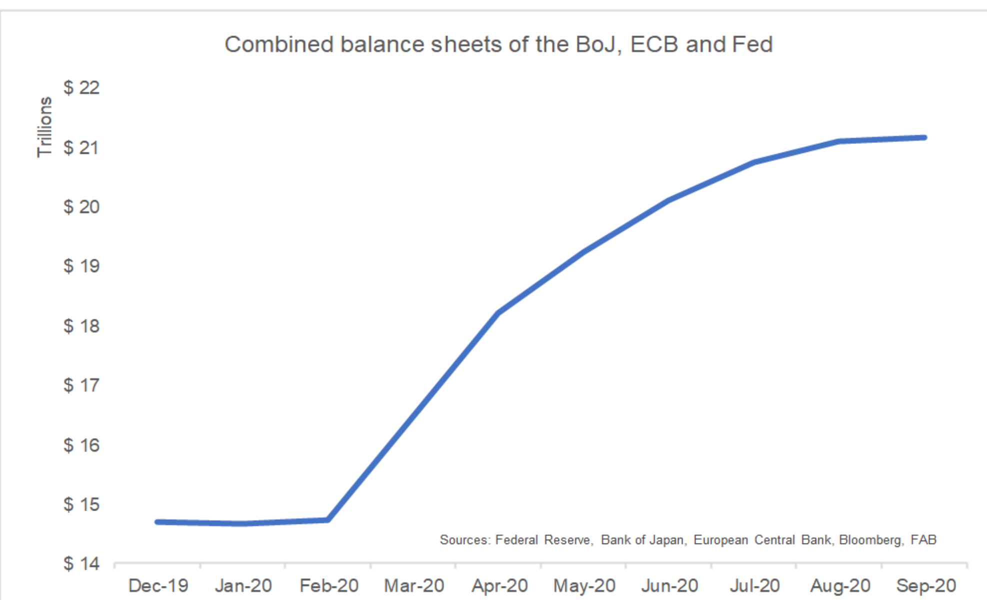
The Democratic Party under Senator Biden wants significant infrastructure spending and the Democratic House of Representatives has tried to pass large spending bills, which hit a wall at the Republican Senate and the White House.

Hence, while some commentators suggested initially that a Biden victory would translate into a sell-off, that is far from being a certainty. The opposite is also true, and a Trump victory, depending on the outcome for the Senate, could actually unsettle markets.

If the psychological aspect points at caution dominating investment decisions in the fourth quarter, fund managers are also going to be under pressure to achieve higher returns. With the world's top central banks keeping interest rates low, investors are hard-pressed to find yield, while maintaining a modicum of safety.

This is a particularly pressing issue for big institutional investors such as pension funds and insurers. These companies have statutory yield requirements to be able to cover their liabilities.

The world's key central banks nearly stopped adding new liquidity during September



According to the US National Association of Retirement Administrators, at the end of last year, pension funds managing about US$4.8 trillion in assets had budgeted an average nominal return of 7.22% a year for the next 40 years.

considering that 30-year US Treasuries bonds are yielding 1.64%, the statutory returns stated above could be very hard to achieve unless these funds take some more risk in their portfolios. Hence, in the coming months, some of these large funds, as well as many individual investors, may start to revisit their asset allocation to add more risk as a way to get closer to their budgeted returns.

Taking traditional portfolio management theory into account, these investors seeking higher returns will either have to add more risk assets to their portfolio, or borrow money to increase the overall amount of assets they manage.

In either case, that should increase the demand for assets that offer higher returns, either through promising high growth, or better yields. Being more specific, that normally means more technology-related and small-cap stocks, more private equity, and larger allocations to junk-rated and emerging market bonds.

Developing nation debt, however, faces an important constraint in the value of the US dollar. After losing nearly 10% of its value against a basket of other currencies, the dollar rallied in late September as investors weighed the potential for more monetary stimulus in the US versus other developed nations. Still, by late October, the US dollar was in retreat again as investors weighed the probability of more stimulus and deeper deficits in the US.

For now, the Fed is unlikely to make any additional stimulus announcements before the election, leaving the door open for other central banks to weaken their currencies by adding liquidity. Ultimately, though, all that money will have to find a home, and given where interest rates are, it will probably be in risk assets.

Equities

♦ **The virus resurgence could prompt technology to lead markets again.**

♦ **However, the bull market has begun to extend to other sectors, which signals that it could continue.**

♦ **The liquidity available and the relative strength of the dollar could determine which indices outperform.**

♦ **Materials, industrials, and small-caps are probably most likely to benefit from a rotation away from technology .**

The last two quarters were among the best in history for stock investors, as equity markets priced-in the economic recovery after the pandemic-led lockdowns. However, the gains so far have focused mostly in large-cap technology companies.

This prompted questions over the sustainability of the bull market. In September, however, the NASDAQ Composite index underperformed, the Russell 2000 US small-cap index, sending a positive signal to the bulls. The apparent rotation, however, took its toll on the stock markets in September, with some of the key indices down as much as 10% at one point in the month.

Investors were also pricing-in increased uncertainty related to the US election outcome, and to more fiscal stimulus in many developed countries. While the volatility could continue into November, the momentum of this year's gains so far could still push stock prices higher, even if the very short-term could be choppy.

Liquidity will likely remain plentiful and rates, low, which could keep stocks attractive. And with the US dollar index having dropped nearly 5.7% since the beginning of April, developed nations are likely to increase global liquidity further.

Investors still hold a lot of cash. Money market fund assets increased by US$1.1 trillion in the first weeks after the 23 March market nadir. Since then, some US$400 billion is estimated to have returned to equities, but about US$700 billion is still in near-zero-yielding, cash-like instruments.

All this suggests that the renewed bull market in equities is far from over. Indeed, some say it is only just getting started. While valuations for some stocks may look high relative to history, at no time in history have rates been this low, or liquidity this plentiful. Hence, sell-offs may well be opportunities to restore equity portfolio allocations to neutral, before the possibility of selected moves to overweight.

Cyclical sectors have vastly underperformed so far this year and could start catching up

However, investors reentering the market after the fastest-ever recovery must keep in mind that equities are long-term investments and should be approached with a systematic stock selection methodology and effective risk controls.

Technology could continue to lead the market in the months ahead especially given the potential for a second virus wave that will reiterate the potential earnings power of companies that enable workers to stay away from the office. However, some names in this space now feature extreme valuations. Despite this, the technological advances they represent could continue to attract investors.

Other areas, such as industrial and materials sector companies, could benefit from a new round of global fiscal stimulus, especially if in 2021 government spending is directed at infrastructure. Hence, there has been recently a partial rotation towards 'value', as fund managers diversify their portfolios.

Among the laggards, financial stocks, the second worst-performing group in the S&P 500 over the past six months, may face continued headwinds, given the potential for higher debt defaults and lower margins amid low interest rates. Energy may offer some value too. The sector was the worst-performer in the past six months as investors grappled with reduced oil demand and still strong supply. However, the supply/demand dynamics could change for the better during 2021. Still, as noted before, investors must pick the names carefully.

A weaker dollar could also help the sector, as it could support selected emerging markets. The share of Chinese equities in global equity tracking indices, for instance, has been increasing and this could also support developing nation stocks.

Bonds

♦ Bond volatility is likely to continue to drop as central banks become bigger buyers and more of them adopt yield curve control.

♦ Investment-grade corporate and emerging market spreads still have room to tighten.

♦ The willingness of central banks to buy high-yield supports the asset class despite rising defaults.

Much of the doom being predicted in the second quarter relating to corporate and emerging bond markets has failed to materialize. Defaults have risen, but they have come far short of initial analyst forecasts. Investors can thank central banks for this.

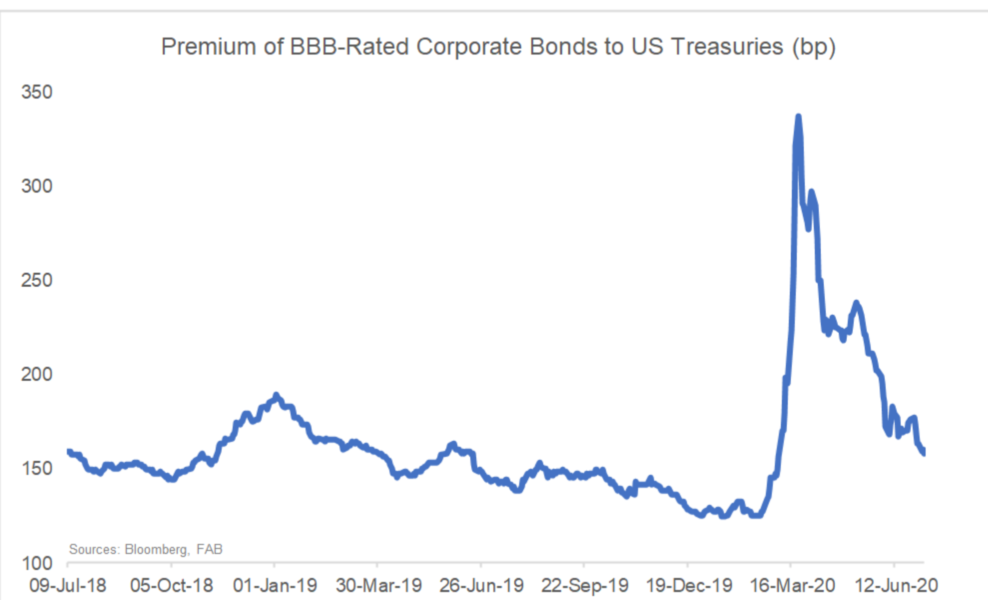
With arguably the broadest availability of money in history, many highly-leveraged companies have been able to borrow more and avoid the worst outcomes. This has also resulted in record bond issuance. According to Bloomberg, US companies rated below IG have already issued US$364.9 billion in bonds so far this year, an all-time record for the asset class, which has helped many of them avert defaults and even bankruptcy.

Emerging markets have seen similar activity, with US$2.33 trillion sold by late October, making this already the third biggest year for issuance in the space so far. Corporates have issued more than US$2.99 trillion of bonds so far this year, more than the full-year issuance in the past two years, and some 80% of the all-time record marked in 2016.

Despite so much bond supply, yield premiums for all of these categories of debt shrank significantly in the third quarter, although they arguably still have room to drop further. Using Bloomberg Barclays indices as the standard gauge, US corporate high-yield spreads fell 110 basis points in the past three months, while EM and corporate dollar debt fell respectively 59 basis points and eight basis points respectively.

Notwithstanding the drop, high-yield spreads remain 165 basis points higher, while EM and corporate bond premiums are respectively 121 basis points and 38 basis points above all-time lows. There appears to be plenty of room for the prices of these kinds of bonds to rise.

The yield premium of triple-B-rated corporate bonds has retreated but remains high



Given the participation of central banks in the bond markets, these premiums could move closer to their historic lows in the coming year, barring periods of volatility.

In fact, it could be argued that part of the reason why the premiums have not fully returned to normal, despite the bond purchase programs of the Bank of Japan, the European Central Bank and the Federal Reserve, is because there has been such significant supply of new bonds. Once these bond sales abate, premiums could shrink and prices could rise further, as central banks will remain significant buyers of bonds, reducing the total amount of them available for other investors.

Furthermore, low or negative rates for government bonds continue to support demand for corporate, emerging market and high-yield debt. In fact, given the high return requirements of pension funds and other institutional investors, a larger portion of the bond allocation of portfolios could start to move away from government bonds and into lower-rated debt, adding to the demand for them.

Falling bond volatility is also likely to contribute to this move toward lower-rung credits. The ICE Bank of America Merrill Lynch MOVE bond volatility index touched an all-time low of 36.97 in late September as investors factored-in the likelihood that the Federal Reserve will join the Bank of Japan in adopting yield curve control.

That approach ensures that even if inflation starts to creep up and market rates rise as a result, the central bank steps in to ensure that interest rates remain low. This prospect suggests that higher yields, particularly in longer-term government bonds, may be seen as opportunities to add exposure to them.

Such central bank intervention suggests that bonds will continue to be an important building block of portfolios, and that some of the classes of notes still have room to gain in the months ahead, even as the average yield on government debt is now near all-time lows.

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Currencies

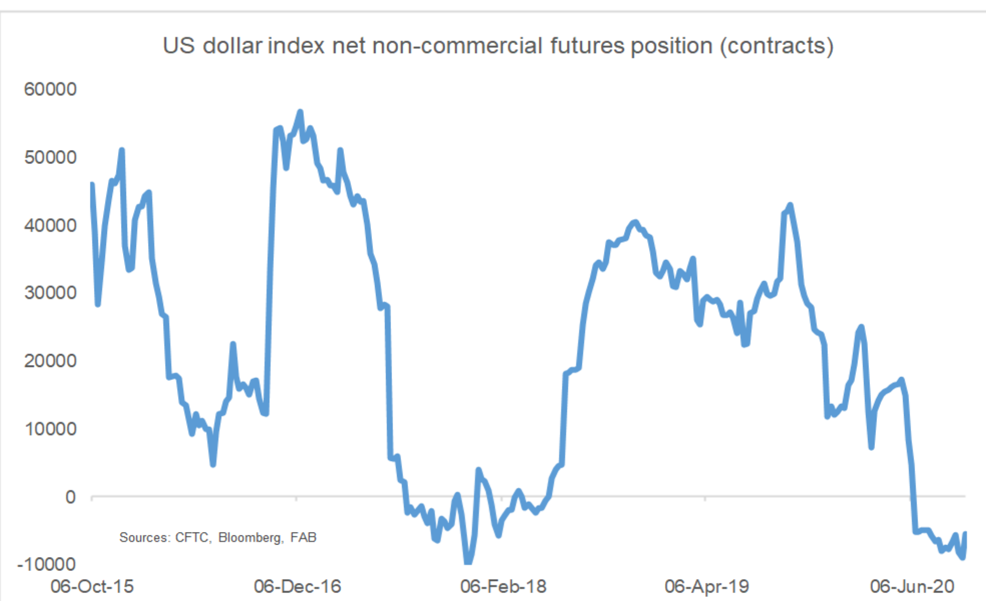
♦ **The fall in the US dollar index seems to have paused, although within a still-weakening 'big picture' trend.**

♦ **How much incremental stimulus is rolled out in the various countries, including the US, will help establish the direction of flows in the months ahead.**

♦ **Emerging markets face bigger risks as many of the countries engaged in quantitative easing and could see further currency depreciation.**

The Federal Reserve has been wildly successful not only at normalizing financial conditions, but also in weakening the US dollar. That could help inflation and GDP growth in the US recover faster than expected (which has already started to happen). It could, however, detract from inflation and growth in other countries.

This has started to set off alarm bells in some of those countries, which are looking at more monetary stimulus partly as a way to curtail currency strength. Just in September, officials of the European Central Bank and the Reserve Banks of Australia and New Zealand publicly stated they were concerned about the economic impact of the strength of their currencies.



If some of these key central banks start to add even more stimulus, and, more importantly, they outdo the Federal Reserve, their collective action could reverse the trend of weakness in the US dollar. Until the end of September, it remained more profitable to borrow in US dollars and invest in government bonds (even negative yielding ones) in Japanese yen or euros, once the hedging costs are accounted for. More stimulus in these currencies could reverse that equation.

For now, futures positions still suggest investors see the dollar weakening further. As of 29 September, there were still 5,555 more outstanding futures contracts banking on a drop in the dollar than there were similar contracts betting on a rise. That was less than the record 9,146 net short contracts recorded on 22 September, but still indicates that speculators see more dollar weakness ahead.

Of particular interest will be the direction of the Chinese yuan, which has become an important driver of the overall performance of emerging market currencies. It has also shown a high correlation to the euro.

Speculators were still very significantly net short the dollar at the end of September

Chinese authorities have allowed the yuan to appreciate over the past two quarters, but they seemed to have started drawing a line on the sand toward the end of the third quarter, moving the daily fixing weaker than expected. Similar to Europe and some other developed nations, China is contending with the impact of the weaker US dollar on its exports and growth.

As for other developing nations, the dynamics are slightly different. Countries from Indonesia to Brazil have resorted to quantitative easing (when the central bank buys bonds directly from the government, effectively 'printing money'). That could have a particularly large effect on the value of their currencies which, unlike the US, Japan or Europe, are not widely used across the world.

Indeed, while the MSCI Emerging Markets Currency index has gained 4.53% in the past two quarters, the performance across various developing nations has been quite different. The Turkish lira, for instance, dropped nearly 13% in the period against the dollar, and the Brazilian real was down 5.9%. On the other side of the spectrum, the Mexican peso and the South African rand rallied 16.3% and 16.1% respectively.

This suggests that, as developing nation central banks engage in more unorthodox monetary policy, investors are ever more aware of the overall fiscal and trade balance of the countries doing it. In line with the performances stated above, Turkey and Brazil have continued to exhibit a large current account deficit this year, even after their currencies fell. Both countries have also moved their benchmark rates so aggressively that government bonds now offer negative yields when inflation is accounted for.

Over time, naturally, the hunt for yield is likely to drive investors back into emerging markets. And the significant depreciation that some of these currencies have suffered in the past two years would also help spur more exports and economic growth. However, that dynamic may only start unfolding next year.

Commodities

♦ Supply and demand for many products is close to an inflection point: if demand recovers with a better economy, it will coincide with supply reductions, causing prices to rise.

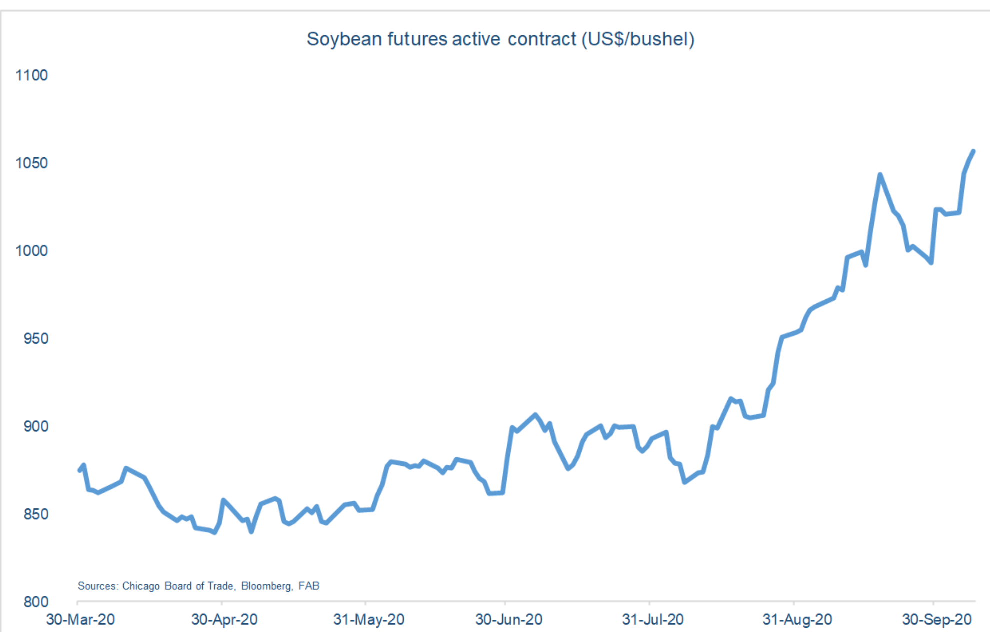
♦ Some prices have already rallied , but could have further to go.

♦ Crude oil prices seem stuck in a range, awaiting demand recovery next year, with analysts mindful that any supply response at that time could limit upside price potential.

♦ Gold is taking a breather, but remains in an uptrend.

Few asset classes have their value so clearly determined by supply and demand as commodities. Hence, many investors look at them as a bellwether of where the global economy is, and its destination.

Right now, commodities seem to be sending two messages: demand could pick up faster than expected next year, and many supply reductions because of pandemic-related measures cannot be easily reversed. Both of these factors appear to be net-bullish for commodity prices as a class going into next year.



Raw material prices, as measured by the Bloomberg Commodities index did not bottom out until 29 April, unlike stocks which saw their nadir on 23 March, around the time massive fiscal and monetary stimuli were unveiled in the US. That was largely a result of oil prices, which collapsed in April, when futures fell into negative territory for a brief period.

The Bloomberg Commodities index has rallied 18.3% from the low to the end of the third quarter. Metals paced gains, with iron ore prices having gained 52.25% in the second and third quarters, while copper was up 35% and silver rallied 66.27% in the same period. These were buoyed by better-than-expected demand from China and hopes that western economies will start to invest in infrastructure, which would boost demand for metals further.

Meanwhile, some key agricultural products have also gained. Soybeans, which are used for cattle feed and in many processed food products, rallied 16.64% in the past two quarters, while rice prices have been on a rollercoaster.

Soybean prices have risen as supply has been hampered and demand has returned

There may still be a tailwind for some of these products. Many of the producers of agricultural goods saw interruptions in their sowing season and, in the case of soybeans, fires have disrupted production in Argentina. These point to potentially lower production next year, when world economic growth could be accelerating.

A weakening dollar and more potential inflation also could support higher, or at least stable, prices for commodities in the coming months. Even oil prices have stabilized lately, appearing to hold in a range of US$40-US$45/barrel for Brent.

The demand outlook for crude oil could be better than expected for the next year, as people opt for cars instead of public transport and a recent trend towards buying larger automobiles continues. However, the moves in oil prices have been determined more by supply lately. While better discipline from OPEC+ is still required, a round of bankruptcies of shale oil producers in the US has probably offset any OPEC+ marginal ill-discipline.

However, potential caps to upside in crude oil prices remain, including from OPEC+ countries, which will normalize production rates as soon as practicable. Then, for instance, there is the question of Iran.

Senator Joe Biden has indicated he may rejoin the Joint Comprehensive Plan of Action, which would allow Iran to start limited exports of oil again. That could bring back at least 500,000 barrels/day of oil if it happens. Libya is also moving towards returning to normal production. That could add volatility to energy prices.

Gold, meanwhile, was hit by some profit-taking in the third quarter. That may have been partly because of depreciation in the currencies of Russia and Turkey, which have a significant part of their reserves in the metal. Still, the selling did not reverse the uptrend and retail investors continued to pour into ETFs for the metal. That, along with recently-increasing inflation expectations suggests the yellow metal’s bull market remains intact.

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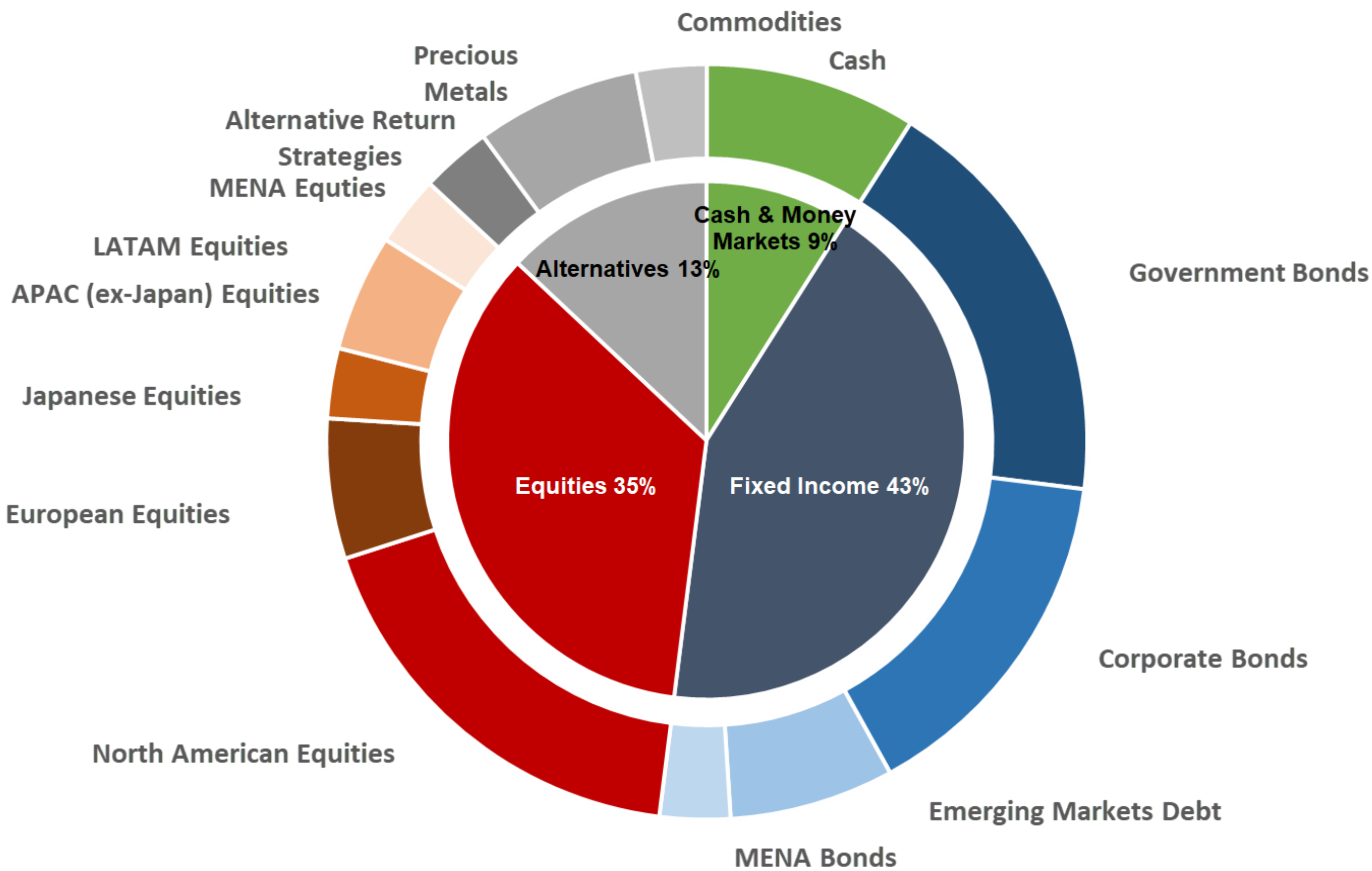
Current Tactical Asset Allocation



Tactical Asset Allocation (in %) 30.06.2020

	Conservative		Balanced		Growth	
	Portfolio	Benchmark	Portfolio	Benchmark	Portfolio	Benchmark
Cash	8	5	9	5	10	5
Fixed Income	70	70	40	40	10	10
Equities	16	15	42	40	68	65
Alternative Investments	6	10	9	15	12	20

Notes: 1 - Performance shown is for our model portfolios and is not a composite of the performance of actual client mandates. While our goal is that each client mandate will closely mirror the holdings and performance of our models, client account performance may, and does, vary according to several factors. 2 - The performance of the model portfolios is calculated gross of management fee, and brokerage charges, if any. The performance for 2014 is calculated based on the Tactical Asset Allocation at the time. 3 - Inception date is 31st October, 2013.

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