integrity asset management

Market Synopsis – September 2020

The global economy is at a complex juncture, buffeted between forces that will either propel its recovery or sink it. The tailwinds will predominate in this contest, which suggests that the business cycle remains in an upswing, albeit a volatile one. The following four tailwinds underpin the developing economic bounce:

1. Pent-up demand and the inventory cycle

The economy is making up for the collapse of both cyclical spending and production at the end of Q1 and into Q2. Inventories of finished products have sharply declined in the past six months. In the US, rapidly shrinking inventories are supercharging the uptick in the new-orders-to-inventories ratio. Similar dynamics are occurring in China, Europe, and Japan – see Figure 1.

2. Broad-based Chinese stimulus

An aggressive stimulus campaign followed China's swift actions to contain the domestic spread of COVID-19. These policies are generating economic dividends that will percolate through the global industrial and commodity sectors – this stimulus-driven recovery will provide a crucial boost to the global business cycle. Beijing's unconstrained credit easing is the source for the turnaround in China's cyclical and capital expenditures outlook. Hence, the sharp increase in China's credit and fiscal impulse foreshadows a powerful rebound in imports and in global industrial production because Chinese capex demands plentiful commodities, industrial goods, and capital goods – see Figure 2 on the following page.

3. Significant global policy response

Policymakers in the other G-10 countries also did not wait to deploy their economic arsenal when the economic crisis erupted. Governments have racked up their largest budget deficits since World War II. Monetary authorities also moved quickly to ease financial conditions. Broad money supply growth among advanced economies has skyrocketed, global corporate bond issuance stands at a record USD 2.6 trillion, and excess liquidity points to continued industrial production strength.

4. Stronger industrial production feedback loops

Industrial production estimates for the major advanced economies are all moving up after experiencing massive collapses starting late Q1 and into Q2. These estimates encapsulate many influences, and their uniformly positive message is very encouraging. A virtuous cycle has probably been unleashed: As industrial production

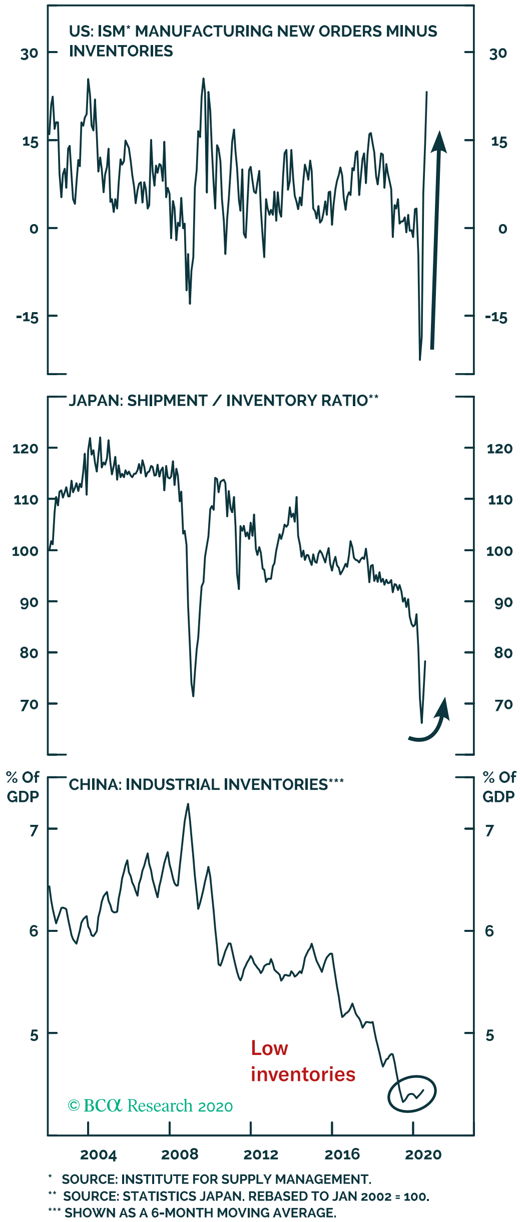


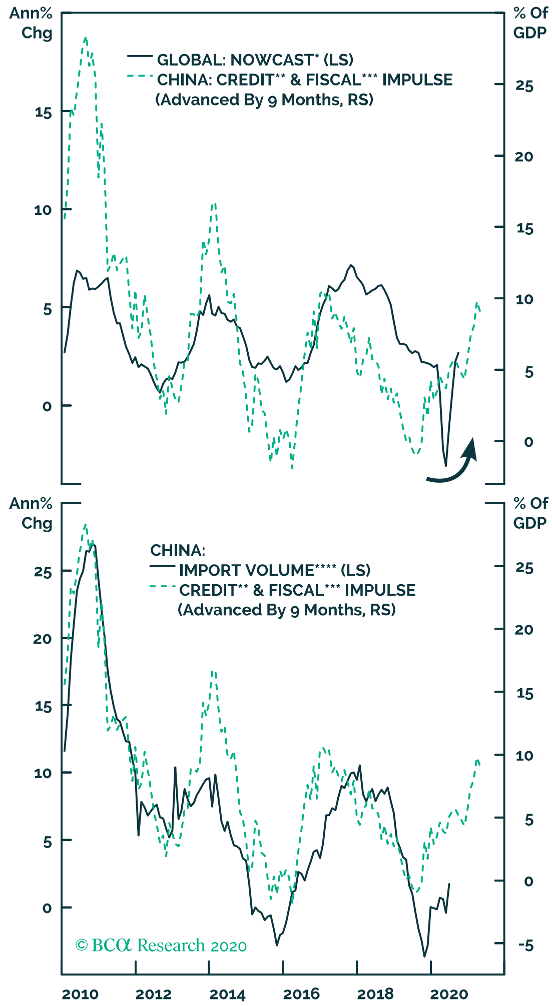
Figure 1 – Sharp inventory drawdowns

recovers, then so will income, which will fuel the demand expansion and thus, more production.

It is not plain sailing for these tailwinds though. Three near-term concerns still hang over the global economy:

1. Fiscal stimulus hiccups in the US

While fiscal policy was just what the doctor ordered in late Q1 and Q2, Washington's performance in the past three months has been questionable. The CARES Act's expanded USD 600 per week unemployment benefit lapsed at the end of July. This benefit, along with one-time USD 1,200 stimulus cheques, pushed disposable income higher by 7.5% during the past five months.



* SOURCE: BCA CALCULATIONS.
** CUMULATIVE AGGREGATE FINANCING EXCL. EQUITY FINANCING, LGFV SWAP FROM 2015 TO 2018 AND LOCAL GOVT. SPECIAL BONDS ISSUANCE.
*** GENERAL (CENTRAL AND LOCAL) GOVERNMENT MANAGED FUNDS SPENDING AND SPECIAL INFRASTRUCTURE FUND FROM 2015 TO 2017.
**** SHOWN AS A 12-MONTH MOVING AVERAGE.

Figure 2 – China's stimulus paying dividends

Thankfully, households managed to save a large proportion of the government support. Consequently, consumption remained strong in August, despite limited help from the federal government. The short-term outlook for consumption is however fragile because households cannot continue to tap into their savings forever. We ultimately expect US fiscal policy to turn accommodative again. There is no appetite for fiscal austerity. Both political parties are moving in a more populist direction, which usually signals larger budget deficits.

2. Rising permanent job losses

The US unemployment rate has fallen from a high of 14.7% in April to 8.4% in August. This bright picture, however, hides a negative development: The number of permanent job losses has quickly escalated, reaching 4.1 million last month – see Figure 3. This problem is unfortunately not unique to the US. In the UK, an unemployment cliff looms on 31 October when there will be an end to government schemes allowing firms to receive funds if they do not permanently sever their links with furloughed workers. The UK's unemployment rate of only 4.1% is bound to surge when these support measures disappear. In continental Europe, similar stimulus programs could also be rescinded during the rest of the year and into 2021. The weak health of small businesses accentuates risks to the labour market. In the US, for instance, 21% of very small firms will run out of money by the end of the year if the government does not provide supplemental help. Closing these businesses will push up permanent joblessness even more and thus further weaken consumption.

* SOURCE: BUREAU OF LABOR STATISTICS.

Figure 3 – Permanent job losses increasing

3. Evolution of the COVID-19 pandemic

The global number of daily new cases continues to trend higher, with the 7-day average reaching a record high of nearly 300,000 this week. The number of daily new cases in the EU has risen above its April peak. Spain and France have been particularly hard hit. Canada is also seeing a pronounced rise in new cases. In the US, the number of new cases peaked in July. However, the 7-day average has been creeping up since early September, raising the risk of a third wave. On the positive side, mortality rates in most countries remain well below their H1 levels. There is no clear consensus as to why the virus has become less lethal. Better medical treatments, including the use of low-cost steroids, have certainly helped. A shift in the incidence of cases towards younger, healthier people has also lowered the overall mortality rate. In addition, there is some evidence that the virus may be evolving to be more contagious but less deadly. It would not be surprising if that were the case: After all, a virus that kills its host will also kill itself. Lastly, pervasive mask wearing may be mitigating the severity of the disease by reducing the initial viral load that infected individuals receive. A smaller initial dose gives the immune system more time to launch an effective counterattack. In addition, it appears that tangible progress is being made in developing a vaccine.

Despite these positive observations, many major countries are now fighting a second wave of infections, which may surpass the first wave. Many schools have re-opened and winter in the Northern Hemisphere is approaching (which will force people to congregate inside), bringing with it the regular flu season. This backdrop still represents an elevated hurdle to overcome for large swaths of the service sector, especially leisure, food, hospitality, and travel. While these industries account for only 10% of GDP in the US, they contribute roughly 25% of employment. If governments toughen social distancing rules and implement localised lockdowns, then the service sector will act as a drag on GDP and employment.

What does this all boil down to from an asset allocation perspective?

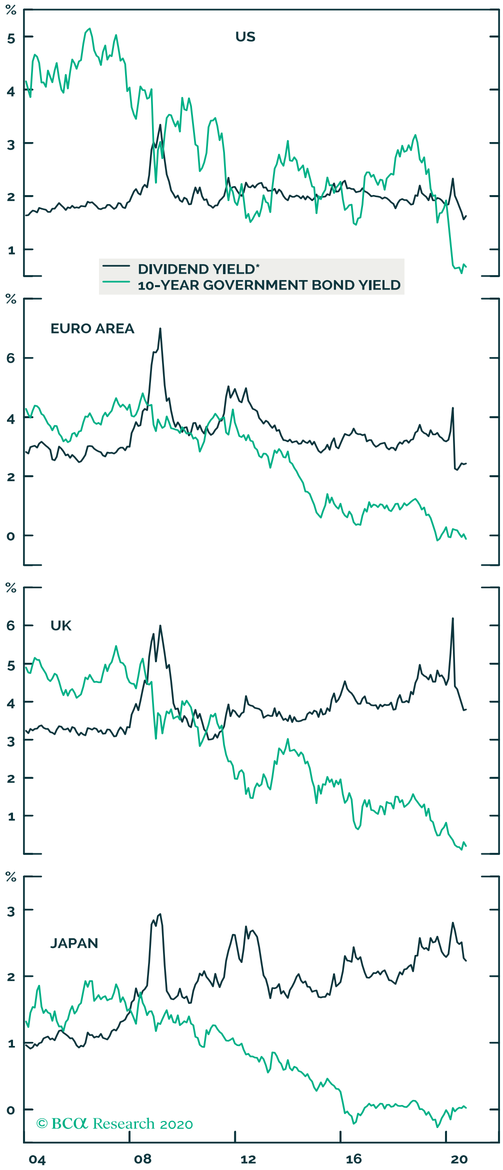
An acceleration in the number of COVID-19 cases and the rising probability that the US Congress will fail to pass a stimulus bill before the November election could push equities and other risk assets lower in the near term. We hence maintain a larger than normal cash positions in the short run which can be deployed if equities resume their correction.

Provided that progress continues to be made towards developing a vaccine and US fiscal policy eventually turns stimulative again, equities will regain their footing, rising by 10% – 15% from current levels over a 12-month horizon.

Negative real bond yields will continue to support equities. The 30-year TIPS yield has fallen by over 90 basis points in 2020. Even if one assumes that it will take the rest of the decade for S&P 500 earnings to return to their pre-pandemic trend, the deep drop in the risk-free component of the discount rate has still raised the present value of future S&P 500 cash flows by nearly 20% since the start of the year.

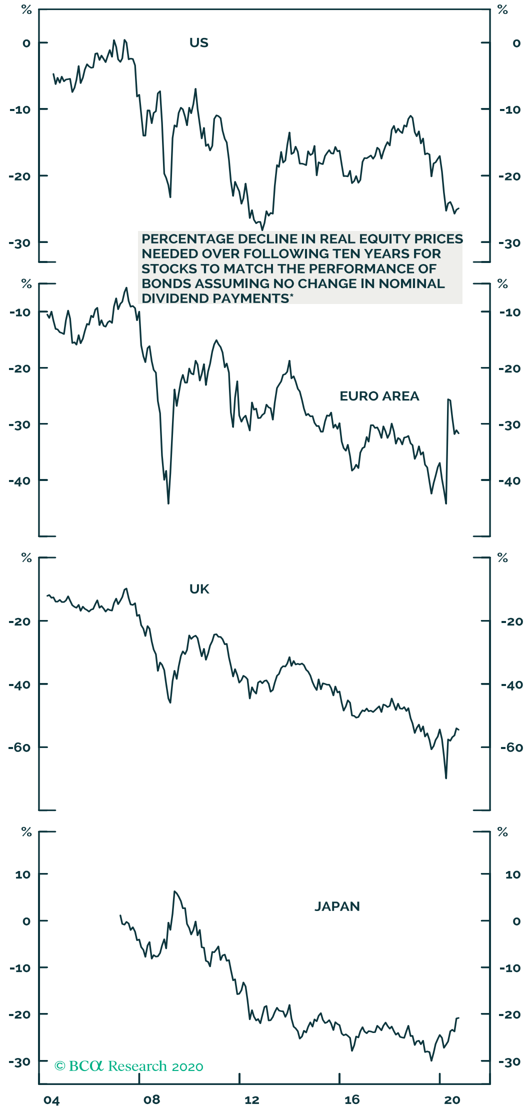
Thanks to these exceptionally low real bond yields, equity risk premia remain elevated. The TINA mantra reverberates throughout the investment world: There Is No Alternative to equities. To get a sense of just how powerful TINA is, consider the fact that the dividend yield on the S&P 500 currently stands at 1.67%. That may not sound like much, but it is still a full percentage point higher than the paltry 0.67% yield on the 10-year Treasury note – see Figure 4a on the following page. Imagine having to decide whether to place your money either in an S&P 500 index fund or a 10-year Treasury note. Dividends per share paid by S&P 500 companies have almost always increased over time. However, even if we make the pessimistic assumption that dividends per share remain unchanged for the next ten years, the value of the S&P 500 would still have to fall by 10% over the next decade to equal the return on the 10-year note. Assuming inflation averages around 1.9% over this period, the real value of the S&P 500 would need to drop by 25%. The picture is even more dramatic outside the US: In the Euro area, the index would have to fall by over 30% in real terms for investors to make more money in bonds than equities. In the UK, it would need to fall by over 50%! See Figure 4b on the following page.

Against this backdrop, it would be no surprise that we see little upside in global bonds. Elevated cash holdings provide ample dry powder to allocate to equities as and when these correct. Gold should also do well. The yellow metal has come down from its August highs, but should benefit from a weaker USD over the coming months, and ultimately, from a more stagflationary environment later this decade. Finally, we reiterate the conclusions of recent Market Synopses that the current macro-economic backdrop and changing market conditions are favouring non-US as well as (eventually!) value equities.



* SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).

Figure 4a – Relative yields: Equities vs bonds



* CALCULATIONS ARE BASED ON THE DIFFERENCE BETWEEN INTEREST AND DIVIDEND INCOME OVER 10 YEARS (DEFLATED BY THE 10-YEAR INFLATION SWAP RATE). ASSUMES THAT NOMINAL DIVIDENDS DO NOT CHANGE DURING THE 10-YEAR HORIZON. BASED ON MSCI INC. DATA (SEE COPYRIGHT DECLARATION).

Figure 4b – TINA in pictures

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 885.82	-4.2%	24.3%	24.0%
Brent Crude	40.95	-9.6%	-38.0%	-32.2%
USDZAR	16.6861	-1.4%	19.4%	9.8%
EURZAR	19.5594	-3.3%	24.6%	17.2%
GBPZAR	21.5503	-4.9%	16.2%	16.7%
JSE All Share TRI	8 443.38	-1.6%	-2.5%	2.2%
JSE Resources TRI	3 788.93	-3.0%	12.3%	26.8%
JSE Industrials TRI	14 738.74	-1.7%	6.9%	5.9%
JSE Financials TRI	6 284.86	3.4%	-33.1%	-29.0%
JSE Listed Property TRI	1 006.30	-3.0%	-46.4%	-45.9%
S&P 500	3 363.00	-3.9%	4.1%	14.9%
Euro STOXX 50	6 907.80	-2.3%	-13.1%	-4.7%
FTSE 100	5 569.85	-1.5%	-20.2%	-15.6%
Nikkei 225	38 259.49	0.8%	-0.2%	15.0%
Hang Seng	70 041.51	-6.4%	-14.2%	-5.3%

Source: Bloomberg, as at 30 September 2020

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