(Weekly Pandemic) Market Commentary – Financial rotation in ten charts

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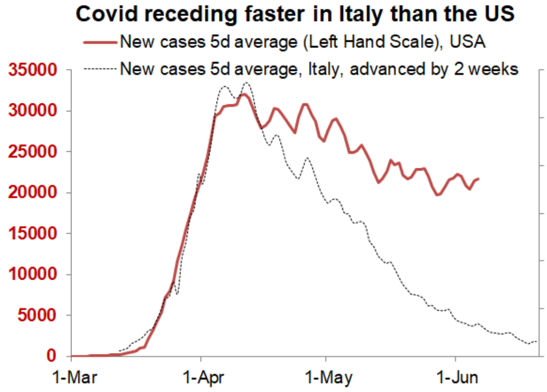
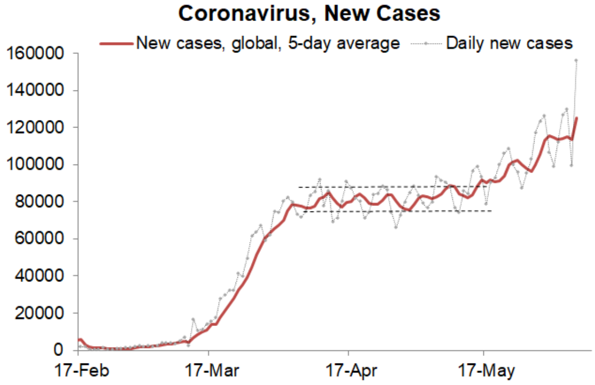
Research, Generali Insurance Asset Management S.p.A. SGR

- **The number of new Covid-19 cases has surged to record highs, as the US improvement sharply lags the European one, while the virus is vivid in selected EM countries.**
- **But financial markets are celebrating the reopening of the global economy, exemplified by the far better than expected US employment report for May.**
- **Financial rotation has accelerated, with laggards and cyclicals assets catching up with a vengeance. The rotation may continue into summer – with much greater moderation – as the global economy springs back to life and global investor pessimism fades.**
- **RIDE the dollar pullback… Extraordinary debt monetization, dovish forward guidance from the Fed and the November election may well feed the fast pullback of the dollar. This would be generally positive for risk assets, and most beneficial to EM equities, which have lagged in the recent catch-up.**
- **… But FADE the bond sell-off. A new chapter in the cyclical recovery trade has seen bond yields jump higher. This may be the single biggest threat to the risk rally. We cannot exclude a positioning flush – but see the rise in yields as clearly unsustainable.**

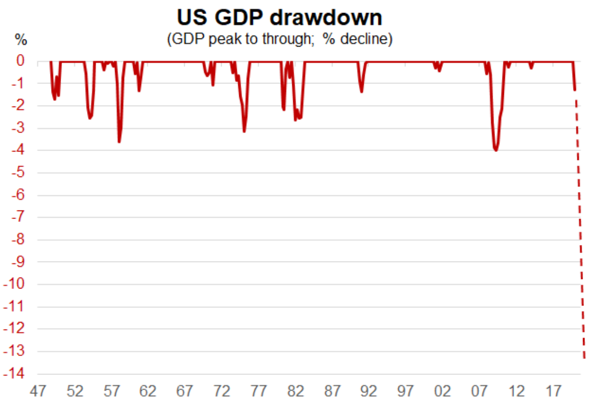
Social distancing makes a huge difference. Covid has receded in the developed world, and much faster in countries that have observed strict social distancing, for instance much faster in Italy than in the US (see chart). The mass protests (George Floyd), notwithstanding their merit, may only aggravate the matter in the US. Arguably, those countries successively flattening the curve now may be more exposed if and when a second Covid-19 wave appears. But given the hopes of future medical breakthroughs and the uncertainties regarding the persistence of the immunity, there is little doubt that **flattening the Covid-19 curve has been a life-saving strategy**. Sadly, the situation remains critical in some emerging market economies. In fact the global number of new cases increased in late May and hit new record highs in early June (see chart). In the first six days of June, new cases globally averaged 120k per day, up from 84k/day over the same period in May. So the world is not out of the woods. Risks are balanced: a medical breakthrough (a drug or later on a vaccine) would accelerate social normalisation but for now (or this autumn) the main threat consists in a new wave of contagion as social distancing eases off.

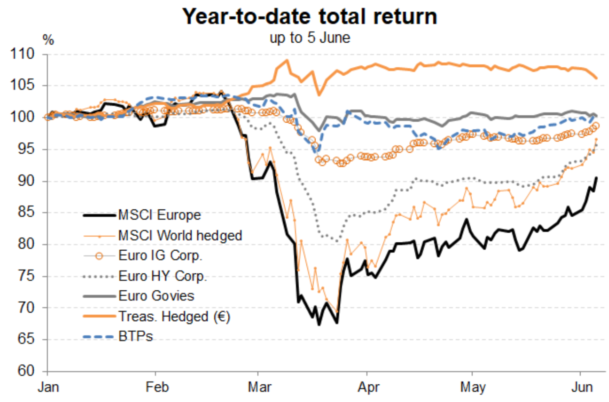




Financial markets: policy trumps the economy. The ECB on Thursday 3 June cut its euro area (EA) forecast to -8.7%. Ours stands at -10%; we see global growth at -4.8% this year. We estimate that in just two quarters, US GDP has lost at least 13%. This is three times the drawdown experienced during the Great Financial Crisis (GFC). **In the Euro area, GDP has probably dropped by about 18% from peak to bottom, again three times the shock of the GFC**. The impact on balance sheets and employment are such that business expenditures and consumer spending will be durably impaired. Pent-up consumer demand will ensure a strong recovery in Q3, but do not read too much into it; we will be lucky if by the end of 2021global GDP has fully recovered.

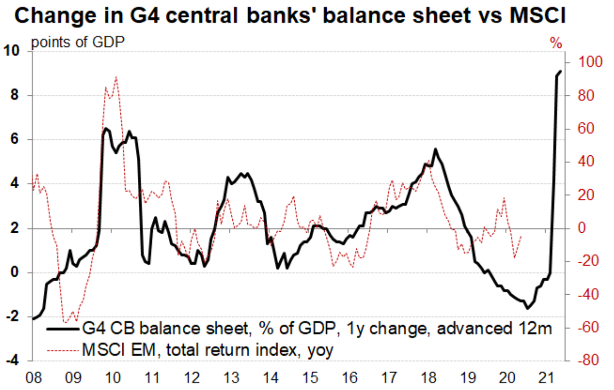
Yet for now financial markets are celebrating the reopening of the global economy. Investors were particularly cheerful on Friday when **US non-farm payrolls (NFPs) were reported up 2.5 mln over May**, vs. consensus expectation of a 7.5 mln drop – the greatest forecast miss ever. NFPs came is sharp contrast to rather gloomy signals from jobless claims and the ADP private employment report. Jobless claims only track the negative side (job losses) of the equation, and there is no similar high-frequency data on the positive side (hiring). Of course the 2.5 mln jobs need to be seen in the context of the 22 mln jobs lost in the previous two months. The jobless rate is still at very high at 13.3%, and would be 3 points higher without classification error. Still, other data have also suggested that the **economy is turning a bit earlier than expected**. Notwithstanding our not-so-upbeat view of a swoosh recovery, there is little doubt that **data will look rather strong over summer**.

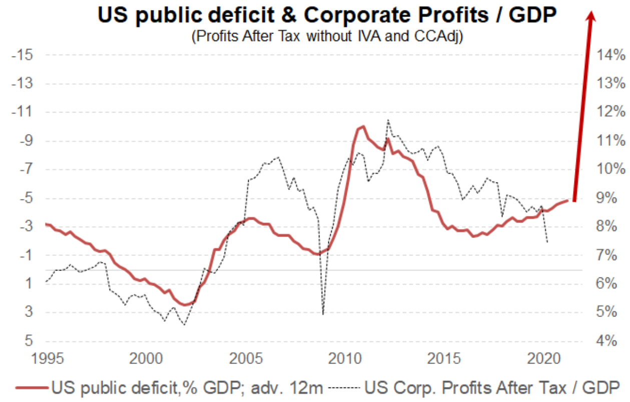




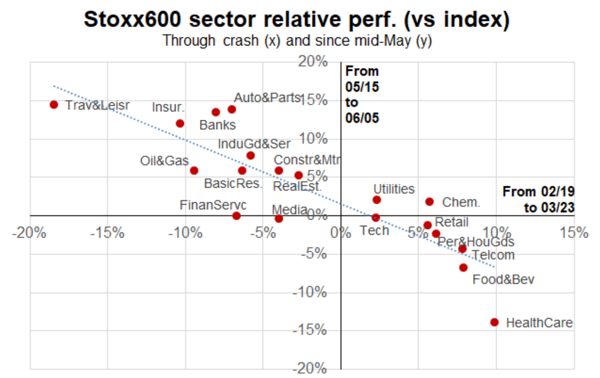
Beyond the better economic data, it is policy that remains the life blood of risky assets. The ECB last Thursday announced an extension of its Pandemic Emergency Purchase Programme (PEPP) from €750bn to €1350bn and from December 2020 to June 2021; it also committed to reinvesting the maturing PEPP principal payments until end 2022, basically ensuring that its balance sheet will be durably bloated. Almost simultaneously, Germany announced a €130bn (3.8% of GDP) fiscal initiative for 2020-21; this includes 2% of discretionary stimulus for this year (1.5%) and next (0.5%), in the form of a temporary VAT cut, a one-off family support, help to local governments etc. We also expect the EC's proposal of a €750bn Recovery Fund (6% of EU GDP) to be ratified with limited watering down. US policy makers are working on an additional fiscal package, in the region of $1 trillion, which will likely push the US public deficit above 20% of GDP!

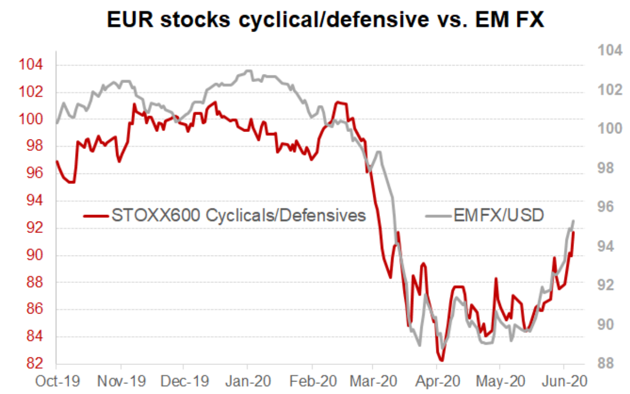
The two charts below highlight how policy can profoundly impact financial markets. The balance sheet of G4 central banks is up by almost 10 points of GDP already this year. By yearend we should be close to 20 points. **Historically money printing has supported risky assets**, e.g. equity prices (left-hand chart). QE in 2020 is dwarfing all previous episodes. **Over the past 25 years fiscal deficits have also benefited corporate profits disproportionately**. This may be less true this time, because the impulse from tax cuts and globalization will be missing. Still profits will recover faster than GDP (right-hand chart), and this already contributes to bolstering equity valuation.





Financial rotation towards laggards and cyclical assets. Our portfolio recommendations retains a pro-risk bias. Until now this has been a cautious tilt, skewed towards IG credit and defensive stocks. In hindsight our small equity overweight recommendation since early April has been too cautious; the S&P has already recouped 82% (!) of its losses. Also over the past three weeks, laggards and cyclical assets have started to outperform. The left chart below shows that European equity sectors that suffered the worst (best) performance during the crash (from 19 February to 23 March) have recorded the best (worst) performance since mid-May; for instance contrast Travel & Leisure and Insurance with Healthcare and Food & Beverage. EM currencies, a very cyclical asset, are bouncing back while cyclical stocks are outperforming defensive (right-hand chart); likewise, European equities are catching up with the US a bit.

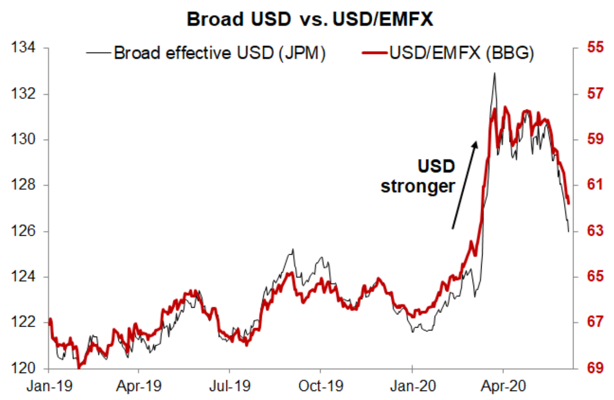


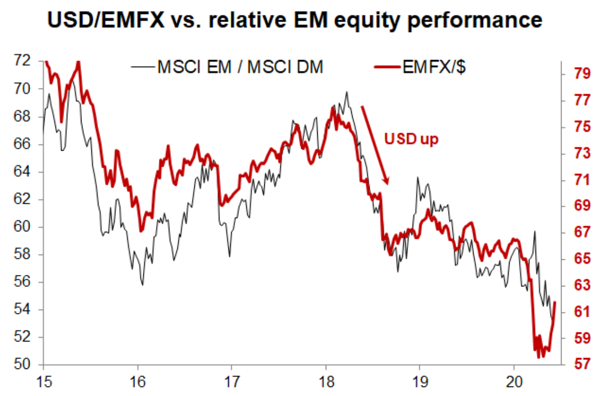


Conclusion: Are investors getting carried away and too optimistic about the economic recovery? Maybe, but the recent rotation primarily reflects short covering. In fact surveys suggest that investors have been rather defensive through the financial rebound of the past two months. Cash positions are still large and equity funds have generally suffered outflows (the past week's flows suggest this may be turning, though). Credit funds (IG and HY) have seen inflows – large ones recently – and the credit spread compression has accelerated. But there is still a mountain of cash in money market funds. The rotation may continue into summer (with much greater moderation) as the global economy resuscitates and global investor pessimism fades.

Our view of a swoosh recovery, rather than a V, argues against a full-blown financial upswing. Typically, we see the recent rise in bond yields as overdone: 10-year Bund yields have jumped from almost -0.60% to -0.28% in five weeks. 10-year Treasury yields jumped by 15bp last week, half of that on Friday's strong employment report. Some will see this as a warranted move – the new chapter of the cyclical recovery trade. This has caught most investors by surprise, though; in fact positioning may facilitate and feed the bond sell-off. Yet, **we will treat spikes in bond yields as a buying opportunity**. Indeed, the rise in bond yields might be the single biggest threat to the risk rally. There is so much debt in the system, so much more corporate and sovereign debt in particular following the recession, that the economy simply cannot afford higher yields. A continuation of the upward move in yields would quickly reverse the equity and credit rally, and mechanically cap bond yields. Fundamentally, we expect the latter to stay low in an environment dominated by disinflation and central bank buying.

Finally we will be watching FX trends very closely. The US dollar soared in March, but has now given back more than half of its gains. The dollar sell-off has been significant since mid-May (nearly -5% on an effective basis). Extraordinary debt monetization, very dovish forward guidance from the Fed and the November election **may well feed the pullback of the dollar. This would be most beneficial to EM equities**, which have lagged in the recent catch-up.





Author:
Chaigneau Vincent
Vincent.Chaigneau@generali-invest.com

www.generali-investments.com

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