CROSSMONTHLY
July 2020

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REVIEW

All asset classes gained last month, with equities leading the charge (Figure 1). The MSCI ACWI outperformed all other asset classes in June and recorded its best quarter since the GFC, albeit recovering from a -21.26% in 1Q20. The rotation into cyclicals at the end of May extended to the beginning of June, but that quickly reversed after central bank reports highlighted potential weakness in the economic outlook of Europe and U.S. Despite that, U.S. equity indices managed to end the quarter strong, with the S&P 500 gaining a total return of +20.54% to register its best quarter since 1998. Meanwhile, Stoxx 600 and MSCI Asia ex-Japan (AXJ) saw total returns of +13.91% and +16.74% respectively. Emerging markets ex-Asia also saw a decent recovery from a disastrous 1Q20 to return +19.13% in Q2.

Fixed Income (FI) slightly underperformed equities solely based on their more resilient performance in 1Q20. Corporate credit, especially Developed Markets (DM) Investment Grade (IG) credit, saw an early boost after the Fed and ECB announced separate plans to purchase higher quality corporate debt from the market. Despite that, all major FI sectors saw positive MoM returns in June. Even commodities extended their gains from May to end the month positive – the Bloomberg Commodity WTI and Brent sub-indices saw total returns of +8.69% and +8.14% respectively while Gold gained +2.93%.

Despite a strong June however, several geopolitical risks are developing in the region. Last month saw North Korea blow up a joint-liaison office with South Korea. We also saw China increase its post-COVID aggression against countries including Taiwan, Philippines, Vietnam and Malaysia. The most significant clash was with India following a military confrontation along the Himalayan borders that resulted in many fatalities. Whilst there is an interim truce, India has moved ahead with banning a number of Chinese apps like WeChat and TikTok, and is reportedly mulling stricter rules and tariffs on Chinese imports including chemicals, steel, electronics, and heavy machineries. China is currently India's biggest source of imports with Beijing enjoying a trade surplus of about $50bn with New Delhi.

We saw the return of U.S.-China and U.S.-Europe trade issues. U.S. trade advisor Peter Navarro initially said the U.S. China trade deal was over in part because of the lack of transparency from the Chinese around the COVID-19 outbreak. However, he later walked back on his comments while Trump confirmed that the phase one deal with China remains "fully intact". Chinese officials have separately indicated they intend to comply with their commitments. Developments seen in June are a reminder of how volatile the situation can be. With Europe, the U.S. is reportedly weighing new tariffs on $3.1bn of exports from France, Germany, Spain and U.K. Exports such as beer, olives, gin and trucks are within the list of exports mentioned.

OUTLOOK

Figure 1 Multi-asset total returns in June and 2Q20

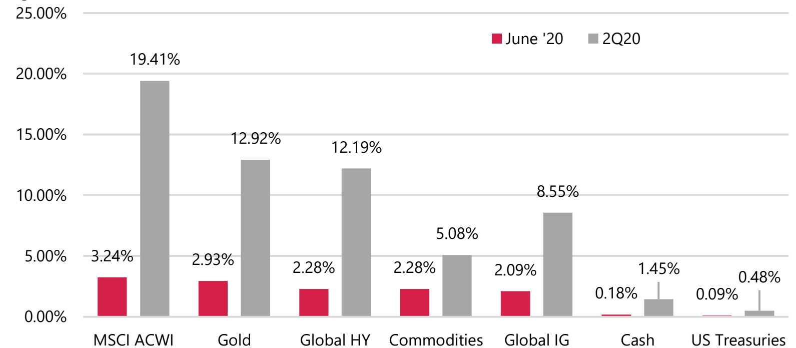
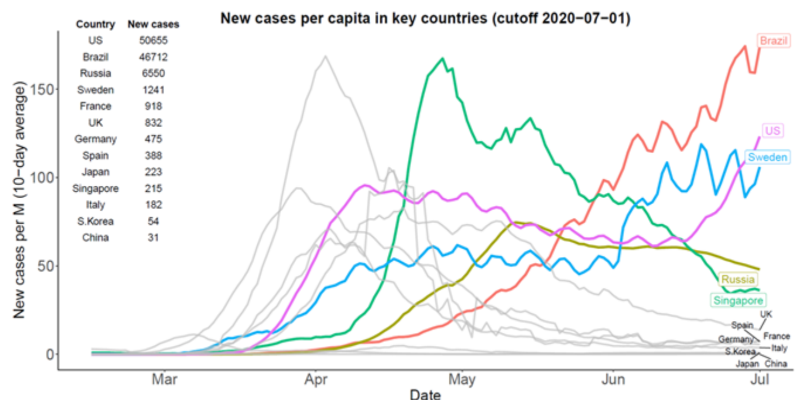


Figure 2: Declining number of new COVID-19 cases in most countries



Source: Morgan Stanley

Risk assets extended gains in June, buoyed by hopes of a faster recovery amid positive economic data globally. This happened against a backdrop of declining number of new COVID-19 cases in most part of the world (Figure 2). However, a pick-up in cases in States along the U.S. Sun Belt later in the month forced several states to halt reopening plans. Florida, Arizona, Nevada, South Carolina, Houston and Georgia all reported record daily infection cases while Houston and Arizona were close to running out of ICU capacity in hospitals – the only consolation was that this rise in infection was not accompanied by a similar rise in death rates. Meanwhile, signs of second waves in more prominent countries like Australia, China and Spain led their governments to reimpose lockdowns in certain parts of the country. Despite that, the pessimism was short-lived as positive developments around a vaccine by Pfizer and BioNTech quickly lifted sentiments.

Meanwhile governments and central banks continue to provide significant amounts of fiscal/monetary stimulus to protect both consumers and businesses – G4 central bank asset purchases this year significantly outpaces the quarterly purchases since the GFC. The Fed begun purchasing individual corporate bonds under its Secondary Market Corporate Credit Facility while outside the G4, China's PBoC announced its decision yesterday to temporarily purchase loans made to small business from local banks, using up to $60bn to boost the supply of lending to the real economy. PBoC also further noted that small companies would be allowed to delay loan payments to March 2021. Deputy governor Pan Gongsheng also reassured the public, explaining that this measure will not undermine any need to cut reserve ratios or interest rates.

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Outlook

Betting houses now ascribe a 59% probability Biden will win the US presidential elections on 4th November – a lead of 23% – and there is a growing (33% to 37%) chance of a 'blue wave' with Democrats winning all three elections. A separate poll of fund managers found 62% expecting a Biden win – a massive shift since last December when 70% predicted Trump to win.

As we get nearer to the election, and should Biden's lead remain daunting, investors will discount the increasing perceived threats of proposed Democrat legislation to the S&P 500 as Biden is viewed as likely to:

a) Favour an increase of corporate tax from 21% to 28% (Morgan Stanley thinks 25% is more likely) – a tax increase would knock 12% of FY21 earnings per share (EPS), reducing it to around +10% from an initial forecast of +21% albeit the FY21 EPS forecast range is wide;
b) Reduce drug prices hitting Pharmaceuticals;
c) Re-regulate Financials;
d) Be positive on clean energy relative to fossil fuels and so could reverse Trump's de-regulation and likely limit fracking for shale oil on Federal land;
e) Impact other sectors like Telecommunications, Industrials and other labour intensive sectors like Retailers, F&B and Healthcare through a $15/hr minimum wage, according to Morgan Stanley.

There is also a lot of uncertainty around what policies might be applied to the Information Technology sector – Biden has been vague but has criticized Facebook for allowing "misinformation". He said that he would look at Warren's proposals to break-up Big Tech and has noted Big Tech has too much concentration of power.

On the other hand, Democrats are likely to favour greater fiscal spending and provide more support for lending by the Fed to boost renewables and infrastructure spending. There is also some bipartisan support for restrictions on IT/social media and on drug prices.

Morgan Stanley highlights the risks for investors in this election are much higher as Biden's progressive tax plans are the starkest ideological difference since Lyndon B. Johnson's (LBJ) campaign promises in the '60s. However, the bulk of the risk comes if Democrats win all three elections as otherwise a GOP Senate would stall much of the more radical legislation and Democrats are not all on the same path either.

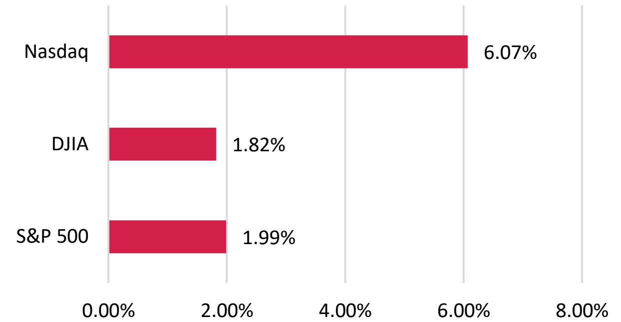
A Biden presidency is not seen in substance to shift too much from Trump's trade policy with China but the nuances will be different and discussions will be conducted in a more rational and diplomatic way. Biden was an effective manager under Obama and received praise for being the point person in helping address the aftermath of the Global Financial Crisis and so is expected to do a far better job than how the Trump administration handled the COVID-19 pandemic.

We have a S&P 500 target of 3,200-3,250 which is based on a YE21 16.5x price/earnings ratio and a normalised EPS recovery of 21%. Should US continue to suffer from a worsening COVID-19 situation relative to 'V'-shaped recoveries in Europe and China, where COVID-19 second waves have been modest and contained so far, we may see leadership in equities switch away from the S&P 500 or the Nasdaq. Add in the most ideological US election since LBJ's in 1964 – he defeated the conservative Goldwater in a landslide (486 Electoral votes to 52, and 45 to 6 states) – we might see further headwinds for US equities.

Equities

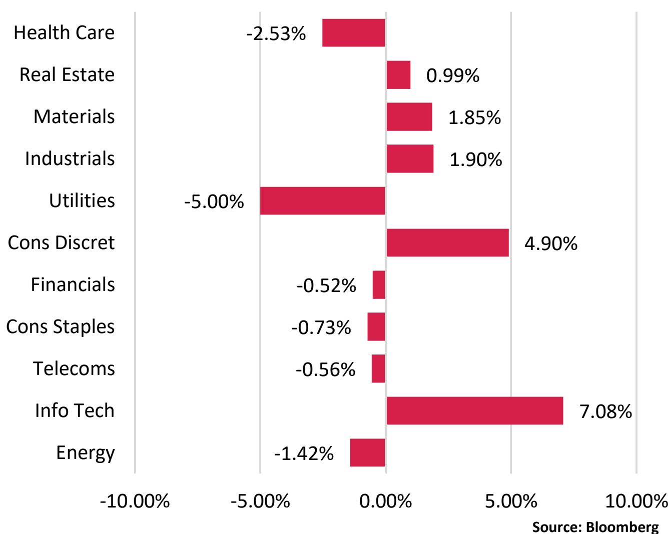
U.S. equity markets extended their May rally as optimism from improving economic data easily offset any concerns around a rise in COVID-19 infection cases. U.S. non-farm payroll exceeded analysts' expectations for the month, adding 4.8mn jobs relative to a consensus estimate of +3.2mn – the record gain in employment marked the second straight month of job additions. Private payroll data saw a huge positive revision for May as well, from a reported loss of -2.76mn to a gain of +3.07mn. We also saw an expansion in the June U.S. manufacturing gauge where the ISM Index jumped 9.5 points to 52.6 points and U.S. manufacturing PMI recovering to 49.6 (vs. est. 48.0).

Figure 3: US indices returns



Source: Bloomberg

Figure 4: S&P 500 sector returns



Source: Bloomberg

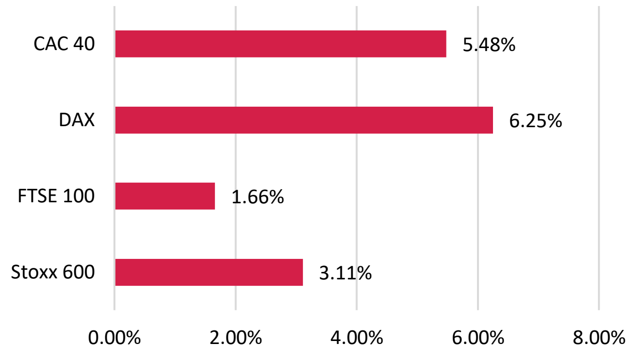
Five out of the eleven sectors in the S&P 500 closed higher in the month of June, with Info Tech and Consumer Discretionary leading gains at +7.08% and +4.90% respectively. Utilities were the major underperformers for the month, down -5.00%. Apple, Microsoft and Adobe were the major index movers for Info Tech sector, while the likes of Amazon, Home Depot and EBay drove returns for the Consumer Discretionary sector. Over the quarter, the S&P 500 was up +20.54%, while NASDAQ and DJIA were up +30.95% and +18.51% to close the best quarter for U.S. equities since 1998.

Economic data over the month supported optimism within markets, with the University of Michigan survey edging up further to 78.1 in June from 72.3 a month earlier.

Equities

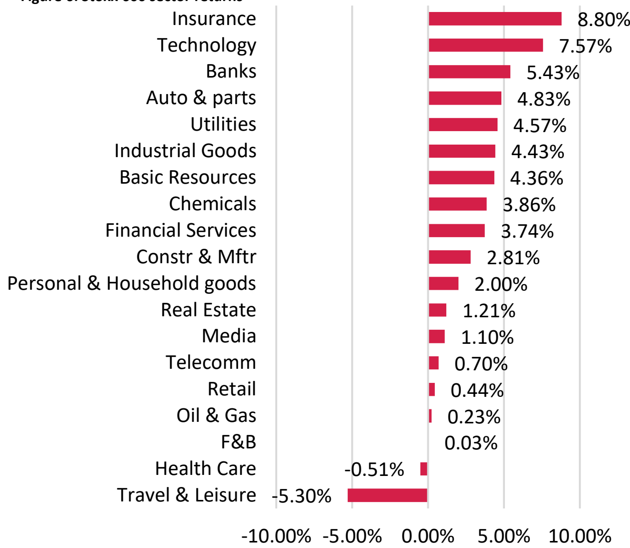
European markets edged higher for the month as well, as the ECB's move to expand bond-buying programs to US$1.5trn and potential agreement on an EU Recovery fund added to market optimism. However, despite STOXX 600's rally of +13.91% to close its best quarter since 2015, European equities remained outpaced by U.S. counterparts YTD. On a MoM basis, the STOXX 600 gained +3.11% while the FTSE and DAX were up +1.66% and +6.25% respectively. On a QoQ basis, the STOXX and FTSE were up +13.91% and +9.57% respectively.

Figure 5: European regional indices



Source: Bloomberg

Figure 6: Stoxx 600 sector returns



Source: Bloomberg

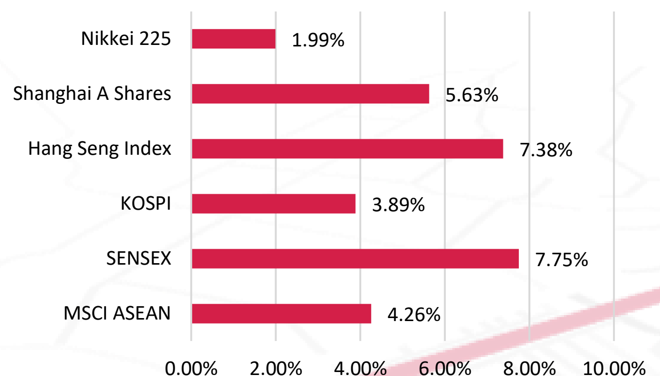
Within the STOXX 600, most of sectors eked out positive gains for the month with the exception of Travel and Leisure, while the Technology and Insurance sectors led gains. SAP, ASML and Prosus were the major index movers for the Technology sector, while for Insurance, Allianz, Prudential and AXA were the major index movers for the month.

Similar to the US, in Europe, Germany's ZEW economic sentiment survey reflected bullish sentiment – rising to 63.4 (vs. est. 60.0) from 51.0 a month earlier. Eurozone PMI numbers saw marked improvements across the board as well, rising closer to expansionary levels at 48.5 (vs. est. 47.5) for its highest reading in four months. On a country level, all countries across the eurozone enjoyed their best month since February, with France climbing back to expansionary levels at 51.7 while Spain moved close to expansionary levels at 49.7.

Markets in Asia closed higher across the board for the month, with the Hang Seng Index up +7.38% as markets shrugged off the impact of the new Hong Kong security law. On a QoQ basis, Nikkei is up +17.97% while HSI closed the quarter up +5.07%. The SENSEX outperformed its Asian peers, logging its best quarter in 11 years to close higher QoQ at +18.50%, while on a MoM basis, closed higher at +7.75%.

On the macroeconomic front, China's central bank cut re-discount and re-lending rates by 25 basis points, its first-rate cuts since 2016 to reduce funding costs for smaller firms and rural sectors. PMI numbers across Asia showed signs of recovery as well with Japan, South Korea and Taiwan all seeing PMI increases in June, but remain in contractionary levels below 50. Vietnam and Malaysia were the exceptions which saw PMIs reaching expansionary levels in Asia, with the former surging to 51.1 in June and the latter up to 51.0. China's Services PMI also hit its highest level in a decade, up to 58.4 (vs. est. 53.3) in the latest sign that the country's economic recovery is on track as it comes out of the coronavirus pandemic.

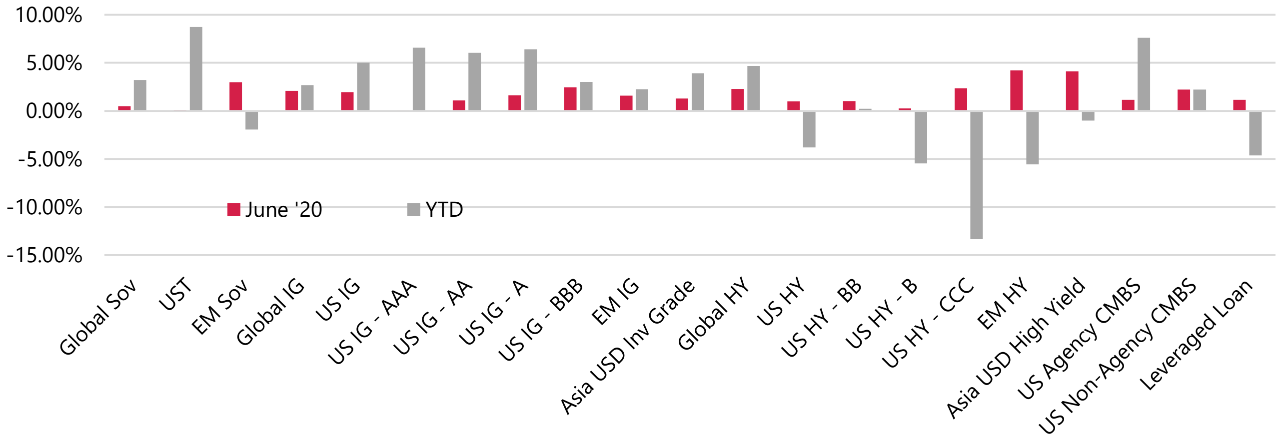
Figure 7: June performance of major Asian indices



Source: Bloomberg

Fixed Income

Figure 8:FI sector returns



Source: Bloomberg

All FI sectors were positive again in June. Lower quality credit led gains last month, given how the recovery there has lagged other sectors since March. Even within broad sectors, i.e. Sovereigns, IG, High Yield, we saw the lower quality parts of each sector outperform.

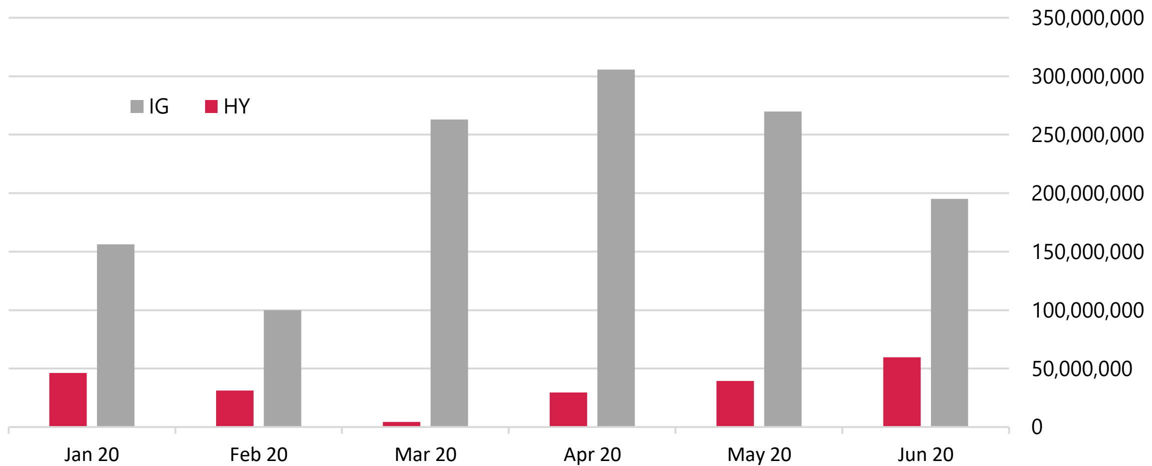
Rates, especially in the US, remained rangebound through the month. Volatility was slightly elevated at the start in the long end of the curve, but yields quickly reverted back to levels seen through April and May. Duration spreads (2y10y and 5y30y) on the US Treasury curve also quickly reverted back to its earlier range (Figure 9) after widening at the start of the month together with the equity rotation into cyclicals. Markets have also priced in assumptions of yield curve control (YCC) being implemented on US rates. While this matter has been mentioned by several Fed members and was discussed at the June FOMC – a small group of analysts and economists surveyed by Bloomberg see the Fed adopting some form of the policy in 4Q20 at the latest – the Fed appears to prefer leaning on forward guidance for now. Their dot plot shows no change in policy rates until at least 2022.

Figure 9: Fed Dot Plot & UST duration spreads

Source: Bloomberg

Fixed Income

Figure 10: Investment Grade and High Yield 2020 new issuance total volume



Source: Bloomberg

Within corporate credits, the momentum seen over April and May is starting to fade amid rising risks in the market. Spreads have also narrowed considerably since March, thus reducing the margin of safety considerably. According to data from Lipper, inflows into both IG and HY mutual funds peaked around the last week of May and the first week of June, but started fading over the course of the month, with HY mutual funds seeing their first outflow amounting to $5.55bn as investors took profit after a strong Q2. Activity in the primary market slowed too with decreasing volumes of new IG issuances while HY only saw eight new issues (amounting $1.3bn) in the last week of June (Figure 10).

Focusing on US HY, Sky Harbour, a fund house that specialises in HY credit, expects a slightly higher default rate in this sector of 9-10% by YE20, with it reverting back to long-term average levels of around 4.5% by YE21. They think the bulk of the defaults this year have already happened over the past few months and are seeing a positive trend so far. In addition, the strength of new issues YTD has allowed many companies to bolster their liquidity profiles, thus risk is reduced in their opinion. However, markets were also quick to price that in and spreads have narrowed to 687bps by the end of June. This is just about 52bps and 172bps wider than their year-end spread estimates for the US HY (635bps) and US HY ex-Energy (515bps) sectors.

Moving forward, despite the improving macroeconomic data that has come out, we are seeing risks of a pick-up in the number of COVID-19 infections amid rising geopolitical risks while the asset class seem to be approaching full value. This reduces the risk/reward tradeoff for the asset class and we would recommend to hold off on increasing any exposure in the near-term.

FX

Figure 11: Spot returns of peers against the USD

			Spot Returns
Asia	South Korean Won	KRW	2.91%
	Thai Baht	THB	2.80%
	Indonesian Rupiah	IDR	2.29%
	Taiwanese Dollar	TWD	1.59%
	Philippine Peso	PHP	1.56%
	Singapore Dollar	SGD	1.42%
	Malaysian Ringgit	MYR	1.40%
	Offshore Chinese Renminbi	CNH	0.92%
	Indian Rupee	INR	0.03%
	Hong Kong Dollar	HKD	0.01%

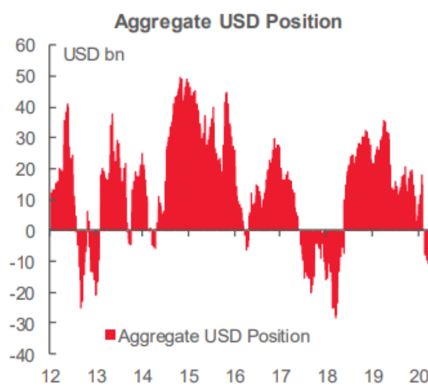
			Spot Returns
G10	New Zealand Dollar	NZD	4.38%
	Australian Dollar	AUD	3.72%
	Norwegian Krone	NOK	2.16%
	Swiss Franc	CHF	1.67%
	Canadian Dollar	CAD	1.42%
	Danish Krone	DKK	1.41%
	Euro	EUR	1.35%
	Swedish Krona	SEK	1.33%
	British Pound	GBP	1.07%
	Japanese Yen	JPY	0.33%

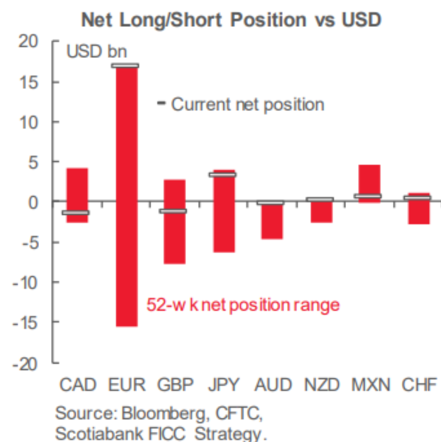
Source: Bloomberg

Currencies continued to rally in June as risk-on appetite. Stronger equities fuelled by the recovery of global macro data, combined with marginally low interest rates, have led a softer dollar against its relative peers (Figure 11). The DXY maintained its post-COVID-crash range between 97.64 and 96 as aggregate short USD positions – the relative longing of peer pairs - continued to climb. According to Scotiabank's take on CFTC data (Figure 12), investors increased their net USD shorts by USD 1.3 billion to USD17.35 billion, making it the highest in the last two years.

We expect the dollar maintain its range of 97.64 to 96 as currencies have been moving systematically with the market's risk-on sentiment. We believe that this risk-on sentiment will remain fragile. Our concern is the disparity between the market's positivity against a backdrop of escalating coronavirus cases which has given rise to the term of a "second wave". Although we do not foresee economies making the same mistake of inducing self-paralysis, one must not ignore the length and breadth that this imposes on a "V" shaped recovery.

Figure 12: USD Positioning





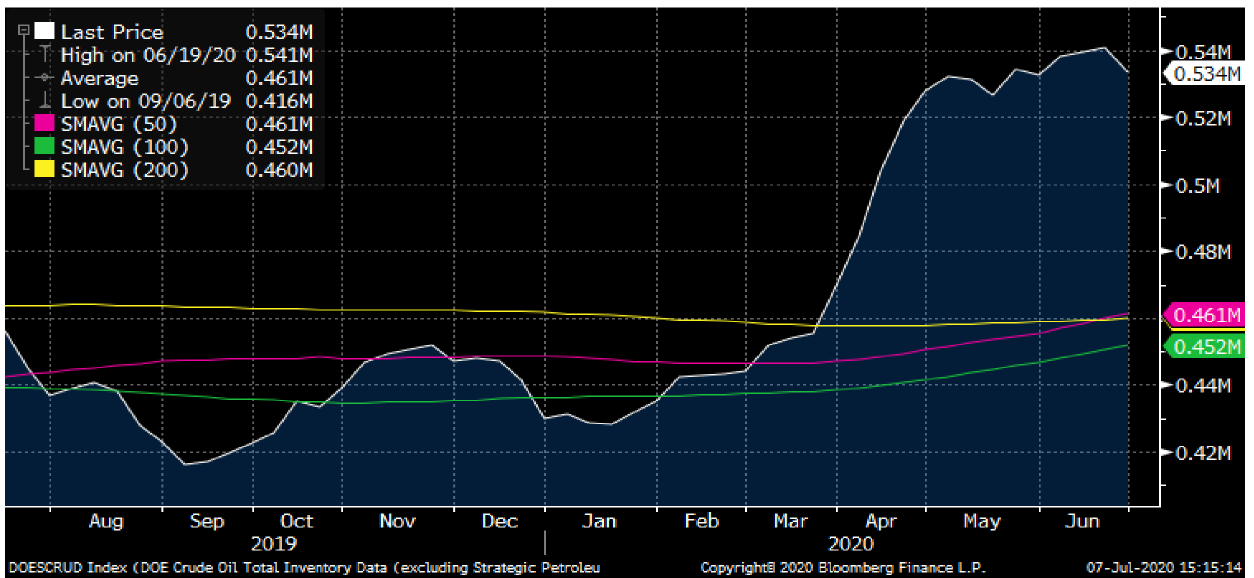
Commodities

We previously noted that the two overarching factors that supported the oil price were compliance cuts from OPEC+ as well as a return of consumption in China. We continue to maintain our stance that oil has established a solid floor of $20 per barrel based on OPEC+'s commitment to supply cuts as well as the rate of recovery of the global economy.

June's inventory data (Figure 13) has shown us that the revival in the U.S. economy has placed a dent in supplies while we expect the return in demand relative to a low base effect during the COVID slowdown will continue to support oil prices. We believe that a technical range at $49.02, the current 200 day moving average, will likely be the next point of resistance for Brent.

We expect the current rate of coronavirus infections to initiate a string of minor actions by governments to tighten and attempt to curb the infection curve once again, while this does not mean a rapid decline in the oil price, it does infer that oil demand still faces several obstacles albeit helped thus far by OPEC+'s efforts to slowdown global supply.

Figure 13: US Department of Energy Crude Oil Inventory



Source: Bloomberg

Markets

Name	30.06.2020	29.05.2020	MTD	YTD	Total Return MTD	Total Return YTD
Equities						
MSCI ACWI Index	524.91	509.47	3.03%	-7.14%	3.24%	-5.98%
S&P 500	3100.29	3044.31	1.84%	-4.04%	1.99%	-3.09%
DJIA	25812.88	25383.11	1.69%	-9.55%	1.82%	-8.44%
NASDAQ	10058.77	9489.87	5.99%	12.11%	6.08%	12.74%
RUSSELL 2000	1441.37	1394.04	3.40%	-13.61%	3.54%	-12.99%
Russell Top 200	764.54	747.97	2.22%	-1.46%	2.36%	-0.50%
STOXX 600	360.34	350.36	2.85%	-13.35%	3.11%	-11.75%
Euro Stoxx 50	3234.07	3050.20	6.03%	-13.65%	6.49%	-11.97%
FTSE 100	6169.74	6076.60	1.53%	-18.20%	1.67%	-16.78%
Dax Index	12310.93	11586.85	6.25%	-7.08%	6.25%	-7.09%
CAC 40	4935.99	4695.44	5.12%	-17.43%	5.49%	-16.20%
MSCI AXJ	648.80	601.46	7.87%	-5.73%	8.38%	-4.69%
Stock Exchange of Thailand	1339.03	1342.85	-0.28%	-15.24%	-0.27%	-13.18%
Jakarta Composite	4905.39	4753.61	3.19%	-22.13%	4.17%	-20.45%
Philippines Stock Exchange	6207.72	5838.84	6.32%	-20.57%	6.64%	-19.47%
NIKKEI 225	22288.14	21877.89	1.88%	-5.78%	2.00%	-4.74%
KOSPI Index	2108.33	2029.60	3.88%	-4.07%	3.89%	-3.82%
Nifty 50	10302.10	9580.30	7.53%	-15.34%	7.59%	-14.81%
S&P BSE SENSEX 30	34915.80	32424.10	7.68%	-15.36%	7.75%	-14.97%
Straits Times Index	2589.91	2510.75	3.15%	-19.64%	3.85%	-17.75%
Hang Seng Index	24427.19	22961.47	6.38%	-13.35%	7.39%	-11.87%
Shanghai Comp	2984.67	2852.35	4.64%	-2.15%	5.64%	-1.01%
SHANGHAI A SHARE	3128.46	2989.86	4.64%	-2.11%	5.63%	-0.98%
S&P/ASX 200	5897.88	5755.69	2.47%	-11.76%	2.61%	-10.05%
MSCI AC ASEAN Index	636.32	613.48	3.72%	-20.38%	4.27%	-18.55%
MSCI EM Ex. Asia Index	1047.33	1007.53	3.95%	-28.49%	4.09%	-27.26%
MSCI EM Asia Index	541.42	502.34	7.78%	-4.36%	8.26%	-3.43%
MSCI EM Index	995.10	930.35	6.96%	-10.73%	7.37%	-9.71%
Fixed Income					**MTD bps**	**YTD bps**
US10YT Yield	0.6561	0.6526	0.54%	-65.78%	0.35	-126.14
US2YT Yield	0.1485	0.1603	-7.36%	-90.54%	-1.18	-142.06
Bunds 10Y Yield	-0.4540	-0.4470	-	-	-0.70	-26.90
Global Investment Grade	526.93	522.29	0.89%	2.98%		
Global High Yield	1348.65	1318.63	2.28%	-4.66%		
Forex						
EURUSD	1.1234	1.1101	1.20%	0.19%		
USDJPY	107.9300	107.8300	0.09%	-0.63%		
USDSGD	1.3936	1.4135	-1.41%	3.54%		
GBPUSD	1.2401	1.2343	0.47%	-6.46%		
AUDUSD	0.6903	0.6667	3.54%	-1.68%		
US Dollar Index	97.3910	98.3440	-0.97%	1.04%		
China RMB Spot Currency	7.0640	7.1372	-1.03%	1.45%		
Offshore Deliverable CNY	7.0699	7.1332	-0.89%	1.55%		
Gold/Oil						
Brent Crude	41.15	35.33	16.47%	-37.65%		
Generic 1st Crude Oil, WTI	39.27	35.49	10.65%	-35.69%		
Gold Spot Price	1780.96	1730.27	2.93%	17.38%		