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# MONTHLY INVESTMENT OUTLOOK

May 2020

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# AT A GLANCE

- Is the Fed's put back at work?
- Hammered value names close to a bottom?
- Selectivity is key in the credit space.
- For now, the USD remains resilient despite Fed's balance sheet surging.

| | under-weight -- | - | neutral = | + | over-weight ++ |
|---|---|---|---|---|---|
| **ASSET CLASSES** | | | | | |
| Equities | | - | | | |
| Fixed Income | | | = | | |
| Alternative Inv. | | - | | | |
| Cash | | | | + | |
| **GLOBAL EQUITY REGIONS** | | | | | |
| USA | | | = | | |
| Europe | | - | | | |
| Switzerland | | | = | | |
| Japan | | | = | | |
| Emerging Markets | | - | | | |
| **FIXED INCOME** | | | | | |
| US Government | | | = | | |
| EU Government | | - | | | |
| Inflation-linked | | | = | | |
| IG Credit | | | | + | |
| High Yield | | - | | | |
| Emerging Hard CCY | | | | + | |
| Emerging Local CCY | | - | | | |
| SUB Financials | | | | + | |
| **FOREX** | | | | | |
| EUR/USD | | - | | | |
| GBP/USD | | - | | | |
| USD/JPY | | - | | | |
| USD/CHF | | | = | | |
| XAU/USD | | | | + | |

# INVESTMENT INSIGHTS

Is the Fed's put back at work? After failed attempts in March, when the US central bank decided to cut rates by 150 bps during two emergency meetings, it appears that the new game changer was the purchase of an unlimited amount of bonds, QE infinity. Indeed, credit spreads have declined significantly and the US equity market has clawed back 50% of its losses since then. Moreover, stress indicators are gradually returning to normal. Are main risky assets right to discount a solid economic recovery for the Q3 and subsequent quarters? Or, are they getting ahead of themselves, driven by huge liquidity injections that have flooded the system?

There is actually a clear disconnection between Wall Street and Main Street. Economic numbers have been bleak and unprecedented, with unemployment figures continuing to rise. In the US, 30 million people filed for unemployment claims (exhibit 1) over the last six weeks, and jobs were slashed by a large margin in the last labor report release (19.5 million jobs cuts). A surge in the unemployment rate will likely be on the cards for 2020 given the decisive rise above the 10% mark this week (14.7% according to the last labor report). In Europe, up to 59 million jobs are at risk, according to the latest report from McKinsey, and these negative developments will significantly impact the service sector through the demand channel, which will endure severe damages. As a matter of fact, the latest publication of the Markit Eurozone Service publication stood at 11.7, providing evidence that full country lockdowns are still proving harmful to many sectors.

Whilst supportive governments and central banks should help mitigate the extent of certain negative shocks, the reality will be a severe economic recession, with the IMF forecasting a 3% world GDP contraction in 2020. In the meantime, equity market valuations are moving above the top levels reached in December 2019, evidence that the old market playbook, in which the behavior of equity indices is driven by liquidity injections, is still alive.

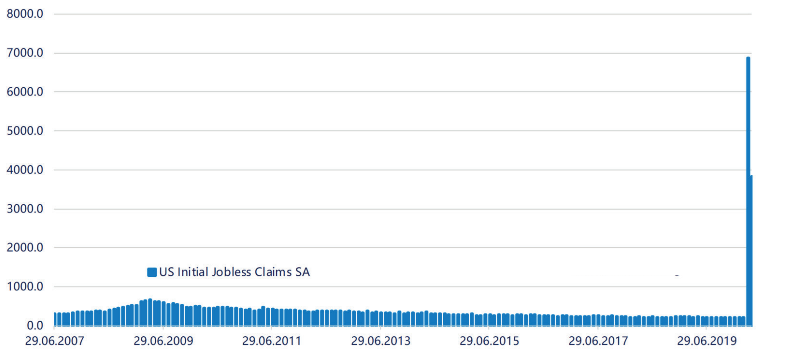
We acknowledge that valuation itself is not a good timing indicator for investing in risky assets, but when markets have already priced in for the perfection, i.e a "V" shape economic recovery in Q3, there is little buffer for facing unexpected external shocks. Thus, the medium term risk-adjusted potential has recently deteriorated.

**THE QUOTE OF THE MONTH**

*"Like a war, there is continued severe uncertainty about the duration and intensity of the current shock."*

IMF
April 2020

**EXHIBIT 1: US INITIAL JOBLESS CLAIMS**

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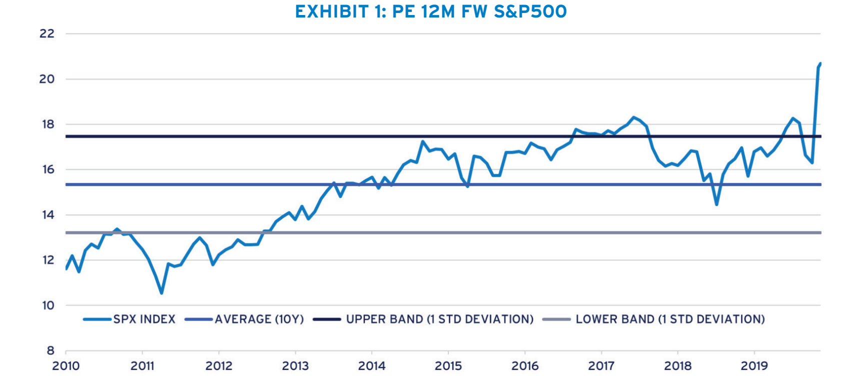
# EQUITIES

What a rollercoaster! After one of the worst months (-12.5% in March) since the 2008 financial crisis, the S&P 500 enjoyed a swift rebound in April, up 12.5%. How can the US equity index post the best month since 1987 when the US economy is facing the worst economic downturn since the Great Depression, with around 30 million of Americans claiming unemployment benefits over the last 6 weeks?

We find two arguments that may justify this "V" shaped recovery. First, central banks and governments have responded quickly to the COVID 19 crisis, by committing to a massive USD 14 trillion stimulus. Secondly, equity markets are forward looking, hence discounting a strong rebound in economic activity in the third quarter of the year and onwards. Whilst we cannot ignore these two observations, we are not convinced that there will be only modest economic damages when lockdown measures are completely lifted, unless there is a breakthrough, such as the emergence of a new vaccine. Therefore it will likely be late 2021 before we come back to the pre-crisis level, both in terms of economic output and company earnings. Moreover, the rebound in risky assets, coupled with the sharp deterioration of earnings per share (EPS), has mechanically pushed valuation to extreme levels (exhibit 1), hence limiting the medium term potential in our opinion.

We might expect to see an equity market relapse in the coming days based on the above factors. If such a scenario materialises, could it be an opportunity to chase the hammered value players? Or, should investors stick to the outperforming sectors, namely staples, healthcare and technology? Hit industries such as banks, energy and airlines have lost, on average, around 50% of their values in 2020 with earnings collapsing driven by the impact of COVID-19. Whilst these sectors do not give us much solace in their ability to cope with this challenging environment, a tactical catch up might take place, as most of the bad news appears to already be priced in. Unloved sectors might remain out of favour for longer, but adding exposure to some of them along with quality names might represent a good barbell strategy for the coming weeks.

**EXHIBIT 1: PE 12M FW S&P500**

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| under-weight -- | - | neutral = | + | over-weight ++ |
|---|---|---|---|---|

## GLOBAL EQUITY REGIONS

| -- | - | = | + | ++ |
|---|---|---|---|---|
| | | USA | | |
| | Europe | | | |
| | | Switzerland | | |
| | | Japan | | |
| | Emerging Markets | | | |

## U.S. EQUITY SECTORS

| -- | - | = | + | ++ |
|---|---|---|---|---|
| | | | | Healthcare |
| | | Industrials | | |
| | | | Financials | |
| | | Energy | | |
| | | Cons. Discret. | | |
| | Cons. Staples | | | |
| | | | | Technology |
| | Utilities | | | |
| | | Comm. Services | | |
| Materials | | | | |

## EU EQUITY SECTORS

| -- | - | = | + | ++ |
|---|---|---|---|---|
| | | Healthcare | | |
| | | Industrials | | |
| | Financials | | | |
| | | Energy | | |
| | | | Cons. Discret. | |
| | | | Cons. Staples. | |
| | | | | Technology |
| | | Utilities | | |
| | | Comm. Services | | |
| Materials | | | | |

# BONDS

| under-weight -- | - | neutral = | | over-weight + | ++ |
|---|---|---|---|---|---|
| **FIXED INCOME** | | | | | |
| | | US Government | | | |
| | EU Government | | | | |
| | | Inflation-linked | | | |
| | | | IG Credit | | |
| | High Yield | | | | |
| | | | Emerging Hard CCY | | |
| | Emerging Local CCY | | | | |
| | | | SUB Financials | | |

The past month has seen unprecedented economic and market events, as well as policy responses. Who could have imagined in January this year that key rates in the US would be cut to zero and that the bellwether 10-year Treasury yield would touch a historical low of 0.31%? Or that US high yield spreads would sky rocket to 1100bps (still shy of the 1971bps peak in 2008)? That oil future contracts would trade in negative price territory as demand was collapsing and as traders were ready to pay not to be physically delivered ? The list is long and daunting, and outlines again the severity of the COVID-19 outbreak and its ramifications within the world economy and the financial markets.

The transition has been abrupt, from an enthusiastic start of 2020, where green shots of a global economic recovery were multiplying, to possibly the worst crisis since 1930s depression according to the IMF. It is astounding how a microscopic virus can bring the world economy to its knees. The response of both central banks and governments across the globe have been as strong as the disaster, with unprecedented measures being implemented, both monetary and fiscal, amounting to trillions of dollars. "Whatever it takes" as per the famous Mario Dragui 2012 quote, which has since been repeated by many political leaders during this crisis. Or "unlimited QE" as the Fed says...

Indeed, central banks are now buying more and more credit assets, with some of them (such as the Fed) including highyield issuers in the scope of their purchases. Buyers of last resort, and this is massive. The impact on spreads has been very strong; they have retraced about 50% of their March widening, and this is probably not yet over. Hopefully, as of today, the health situation seems to be improving and many countries are contemplating an easing of their lockdown measures. This is good news, but it seems that financial markets have already decided that between the U- or L- or V-shaped recovery scenarios, the latter is the most probable. We are less bullish and believe there will be more unexpected hurdles on the road towards renascent growth, with many questions remaining unanswered, notably concerning the mountain of debt created by governments and widening deficits: a sword of Damocles which may lead to another crisis or surging inflation. So, even when the outbreak is behind us, it seems the hangover could last for quite some time...

We therefore keep a defensive credit approach, favouring investment grade issuers, with a strong focus on sound balance sheets and strong business models. The only sector where we have slightly increased our risk allocation is emerging markets in hard currency, where current carry is high and very attractive on a risk-return basis.

**EXHIBIT 1: US 10Y TREASURY YIELD AND US IG CORP SPREAD**


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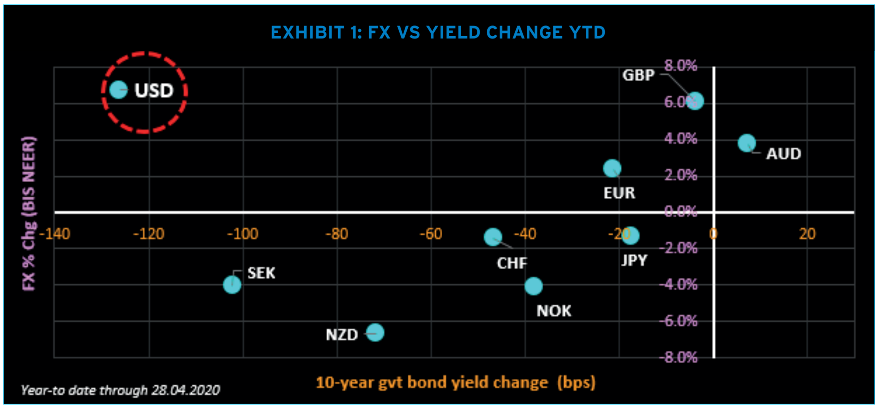
# FOREX

| FOREX | under-weight -- | - | neutral = | + | over-weight ++ |
|---|---|---|---|---|---|
| EUR/USD | | EUR/USD | | | |
| GBP/USD | | GBP/USD | | | |
| USD/JPY | | USD/JPY | | | |
| USD/CHF | | | USD/CHF | | |
| AUD/USD | | AUD/USD | | | |
| XAU/USD | | | | XAU/USD | |
| EUR/JPY | | EUR/JPY | | | |
| EUR/GBP | | | EUR/GBP | | |
| EUR/CHF | | | EUR/CHF | | |

The numbers from the Fed's "whatever it takes" program are staggering, with its balance sheet (BS) expanding by 58% to $6.57 trillion (+$2.41 trillion) since the beginning of March. The mainstream narrative is now that the US dollar should weaken in the wake of the Fed's QE infinity program and the loss of its yield appeal as the main central bank joined the ZIRP (zero interest-rate policy) club. In the short-term, however, we believe that when the Fed rapidly expands its BS, the USD first follows along. That is what happened during the global financial crisis in H2 2008: The Fed's BS expanded by 130% in three months and the DXY surged by around 12%. It was only when the pace of BS expansion slowed that the USD gradually gave back some of its advance. There is probably no causality in this instance, as the common denominator might lie in the crisis backdrop, a period when the Fed's BS surges and when there is increased demand for the greenback, but we see signs that this scenario will repeat itself and that it is only when the COVID-19 crisis fades that the USD will eventually weaken.

The USD may have lost the throne as the highest yielding currency in G10, but we argue this has no material impact for now as we expect the market to continue shrugging off interest rate differentials and instead focus even more on GDP growth forecasts. In this regard, we see the US faring better than the rest of the world, thanks to their flexible labour market and unmatched monetary and fiscal easing conducted by an extremely proactive Fed and the US government. In fact, we see the US as being in an exceptionally strong position, as they recently saw their currency appreciate while sovereign bond yields collapsed and the Fed massively expanded its BS (c.f. exhibit 1). The US have the ability, even the privilege, to borrow without paying up in the form of a weaker currency or higher yields, (albeit at the cost of an overvalued currency), most likely because it remains the main reserve currency. The recent divergence of speculator positioning (CFTC data) and price action is illustrative: as the Fed started to inflate its BS, speculators increased USD shorts, (and EUR longs), but the US dollar index rose by around 8% trough to peak in March. In our opinion, this shows that dollar strength is driven almost entirely by real money investors.

Although we are keeping our short-term positive outlook for the greenback, the longer-term outlook appears bleaker, as the price to pay for the immediate government support is a budget deficit expected by Congress to almost quadruple to $3.7 trillion, while the IMF expects the current account deficit to increase by 0.5% of GDP until 2021 (to 2.8%). The US should thus be among the very few countries with a twin deficit above 5% of GDP.

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**CÉDRIC ÖZAZMAN**
CHIEF INVESTMENT OFFICER

**NICOLAS BESSON**
DEPUTY CHIEF INVESTMENT OFFICER

**MARCO BONAVIRI**
SENIOR PORTFOLIO MANAGER

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