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Cognitive Dissonance: the state of having inconsistent thoughts, beliefs, or attitudes, especially as relating to behavioural decisions and attitude change

Highlights:

- **As we look back on the summer of 2020 and what is, so far, a truly extraordinary year, what is striking is the number of conflicting realities that we are continuing to deal with. One is the ongoing state of disruption, as some public venues remain shuttered while air travel and tourism continues despite quarantine requirements and green lists. Beaches are full as office buildings sit empty and financial districts are a shadow of their former selves.**
- **The other source of conflict is the relentless march upwards of the US stock market, mainly driven by tech and healthcare stocks, as seen below, while the European stock market remains weak year to date despite a better macro backdrop in terms of coordinated monetary support. Gold and related stocks are also soaring year to date – perhaps in response to fears of monetary debasement as interest rates remain low and government spending surges.**
- **At a corporate level fortunes are mixed, in what some have termed the "K-shaped recovery". While certain "knowledge workers" have seamlessly transitioned to a remote working regime, the service and retail industries have seen tremendous pain, and lay-offs. This will exacerbate inequality in society as well as leading to diverging corporate fortunes. Looking at corporate fortunes through the lens of the bond market suggests that demand for high yield debt remains strong, with some notable exceptions in hospitality and energy**
- **When it comes to Covid-19 itself, case numbers continue to rise, more in clusters than in waves for now, while ICU admissions are modest and death rates remain far lower than in the Spring. Progress continues towards various therapeutic treatments (including recently convalescent plasma) and vaccines although the time frame remains uncertain as does the predicted duration of the "new normal".**

- **Geopolitically, US/China trade tensions continue although as of late August seemed to be thawing despite a flare-up over TikTok, as do concerns around Hong Kong's status, while a massive explosion in Beirut in early August augmented the fractions and near collapse in that region and pro-democracy protests in Belarus gained global attention.**
- **Time has moved more slowly for private assets – which live less in a mark to market world and are more based on long term trends.**

Current Macro Snapshot

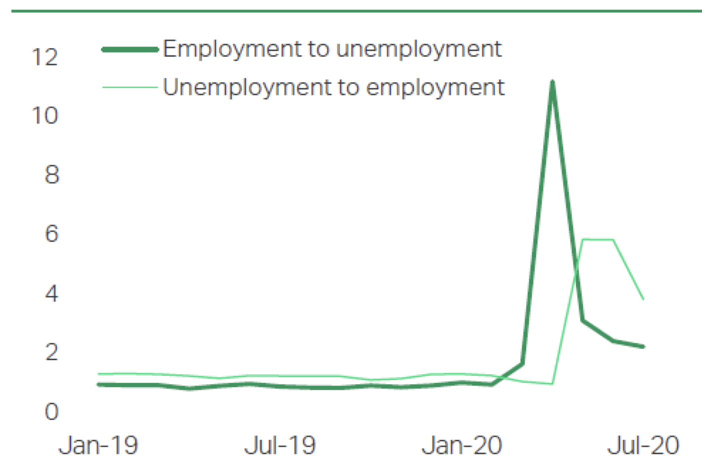
Coronavirus, as Autumn looms, confusion remains
At the date of our last quarterly update the global deaths and case numbers from Covid-19 had risen to 362,000 and 5.9 million, respectively, and testing was ramping up, while lockdowns were only at the start of their unwinding and in the UK they remained in full effect. Now as we look back on the summer, as of late August, the global deaths and case numbers from Covid-19 have risen to 817,000 and 23.8 million, respectively, and the pattern globally is similar – rising case numbers due to clusters in areas such as meat packing plants and factories with a high incidence of asymptomatic cases and a patchy contact tracing regime. Lockdowns have passed, for the most part, in most of the developed world, with the notable exception of New Zealand and the state of Victoria in Australia, which remains in a strict 6-week lockdown. As most of the Northern Hemisphere contemplates returning to school, considerable restrictions remain in place and it remains to be seen whether schools will return in person or whether the ongoing low hospitalization rates will result in fewer restrictions over time

Political discontent and a flipped US election script
As nerves remain frayed from a disrupted year and furlough payments are under scrutiny, especially in the UK, domestic governments are under intense pressure both to streamline messaging and strike a balance between risk and economic activity. In the US the presidential election script has flipped as President Trump has been blasted for a less than empathetic approach to the unfolding Covid-19 crisis and, lately, issues at the post office which could cast a cloud over postal voting at the upcoming election. Currently, Joe Biden, the democratic challenger, leads in most battleground states, although the record stock market levels may provoke a return to the "it's the economy, stupid", narrative, that, pre-Covid, seemed likely to propel President Trump to another victory.

What shape will the economic recovery be?
As the V-shaped market recovery recedes in the rear-view mirror, the consensus is moving away from a V-shaped recovery in the economy. 2Q GDP figures were staggering in their scope around the world – while Spain lost 18.5% of its GDP (and one fifth of its consumption) while the US economy had its worst quarter on record, contracting 32.9% between April and June. [1] Many of these declines were from lower export numbers and lower capital investment. The numbers from the UK were equally dire, as GDP contracted by 20.4% in the 2Q, its most ever, although there was an 8% rebound in June.

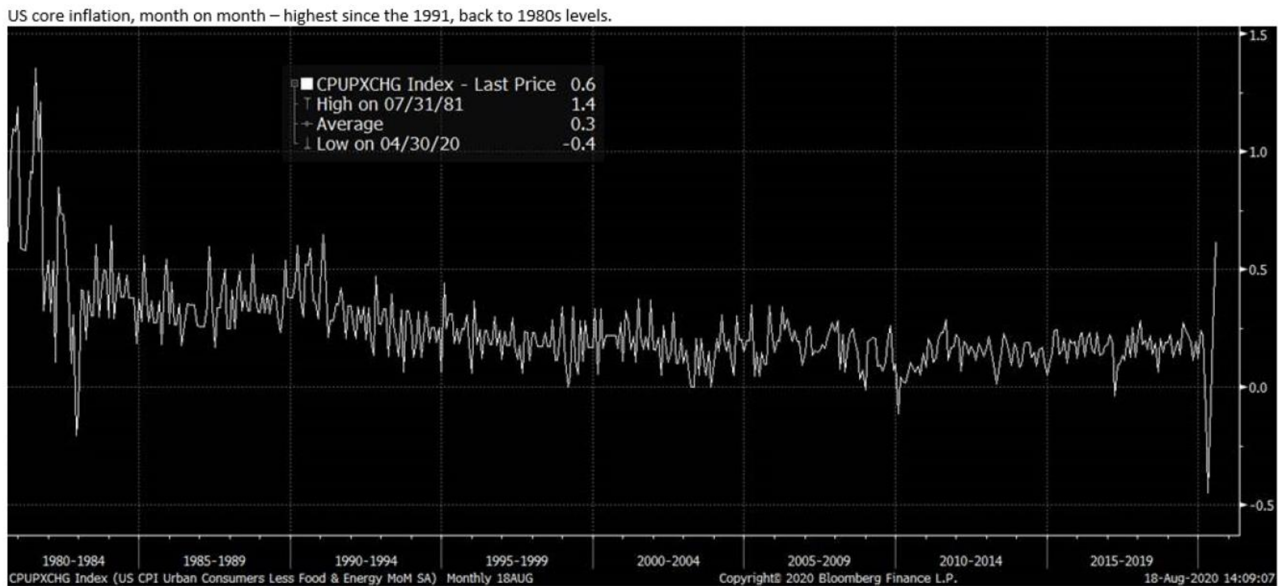
UK GDP growth, Quarter 1 (Jan to Mar) 2005 until Quarter 2 (Apr to June) 2020.
Office for National Statistics

It is clear that up to a decade of growth will be wiped out in just one quarter. The task of rebuilding ahead can be illustrated by looking at labour markets – in the US there have been a net 13.2 m jobs lost and while 1.5 m were added last month, on this basis 9 months of similar growth would be required to recover the lost jobs, and this might be considered a best case scenario. The extraordinary impact that lockdown had on unemployment, has led to an unusual amount of churn in the labour market in the US:



Recovery plans diverge and inflation simmers in a surprising turn
While in the US there remains somewhat of an impasse with respect to the next round of stimulus, in Europe the Recovery Fund, agreed on July 21st, represented a cohesive policy response that shored up sentiment in the region's markets and the Euro. Inflation remains under scrutiny as supply chain disruptions have translated to higher costs of staples such as food and in particular meat, while a commitment to "lower for longer" interest rates suggests that central banks may be willing to tolerate higher inflation going forward. US core inflation is currently at the highest since 1991, and back to 1980 levels.

This marks a stark turnaround from only 3 months ago, when the expectation of lower demand seemed likely to result in more deflation than inflation. One shift is housing – while housing represents a significant share of the inflation basket and was originally anticipated to fall over the next 12-18 months, instead the housing market has been strong and even rallying in the US.

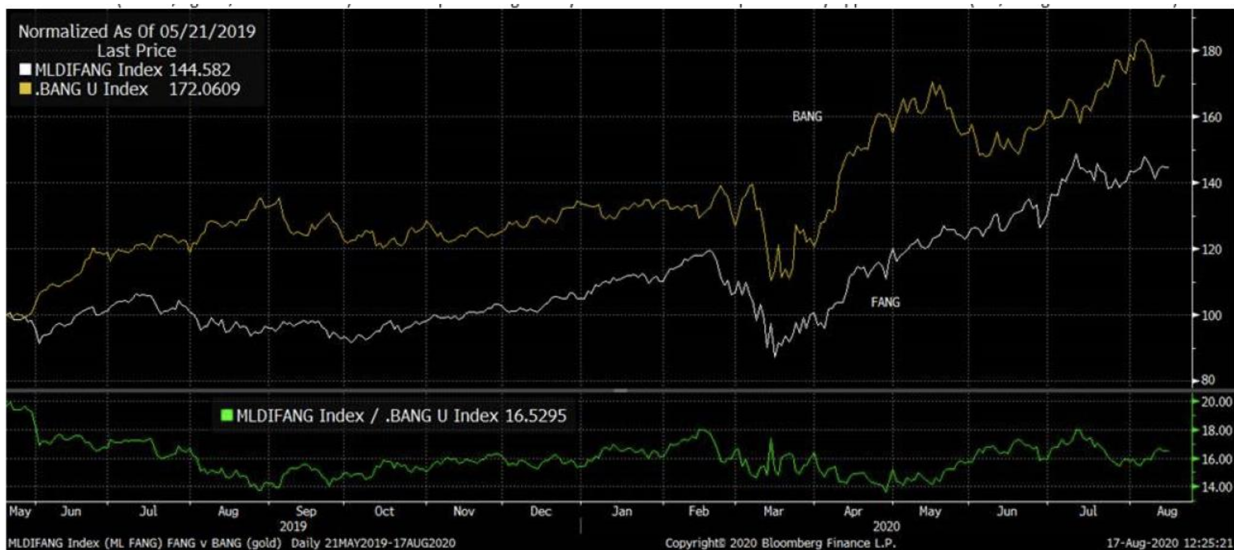


Source: Bloomberg

US Markets hit new record highs, but more cognitive dissonance

Both the S&P 500 and the Nasdaq saw record highs this month, but the strength remains heavily focused on tech and healthcare stocks as the chart below shows, in terms of flows as well as the dominance of a few large stocks. There is still some concern that the market has hit "bubble" territory, when compared to the dot-com bubble prior to the crash of 2000-2002 in terms of the forward P/E multiple.

The chart below illustrates the ongoing dominance of the FANGS, but it is also interesting to see how much gold related stocks (the so-called BANGS (Barrick, Agnico, Newmont Gold)) have performed, with this segment outperforming FANG year to date.

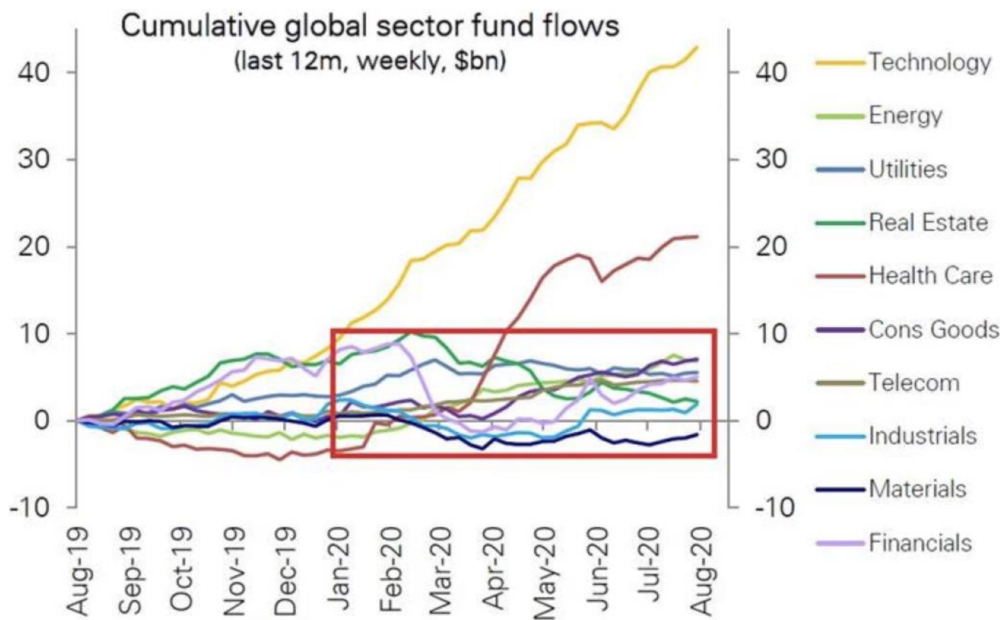


Source: Bloomberg

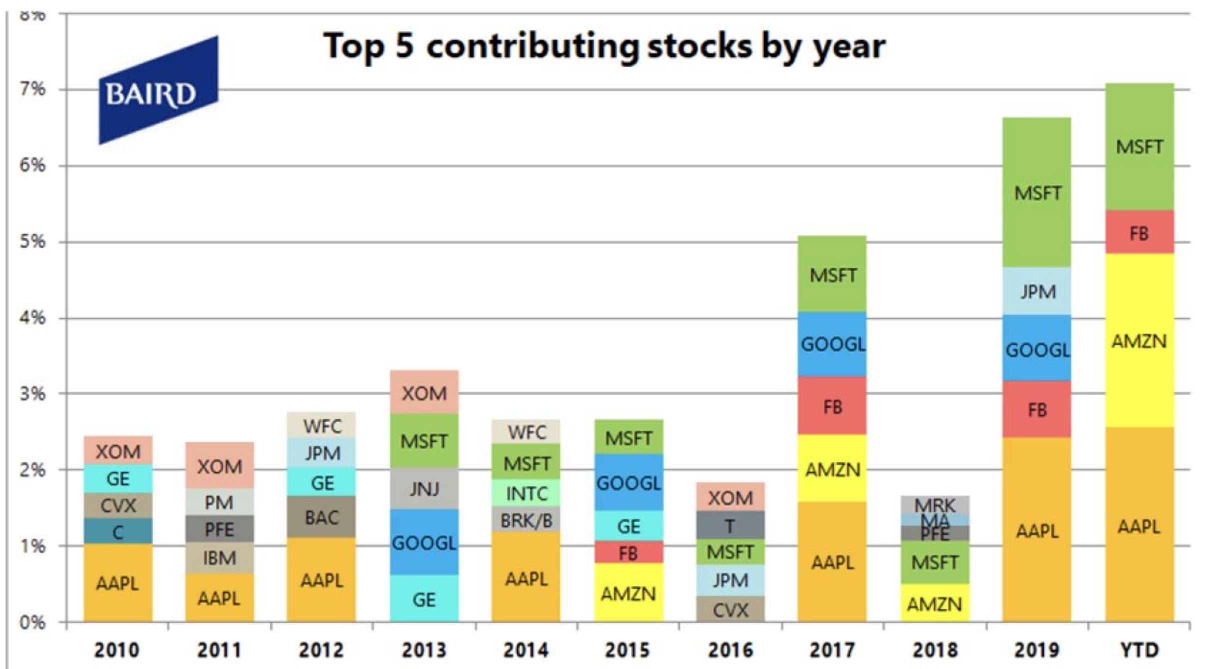
Notable underperformers have been the oil and gas sector, due to a high level of volatility amid the demand fluctuations due to the pandemic. The FTSE oil and gas sector is at multi-decade lows, at levels last seen in 1986 and 1992.

Source: Bloomberg

As the chart below shows, investor sentiment has been solidly behind healthcare and tech stocks, in the US, with other sectors seeing virtually no inflows. This is an extraordinary distortion and suggests that the support for the market at these levels may be tenuous.



The chart below also illustrates how different stocks have represented the bulk of the market strength:

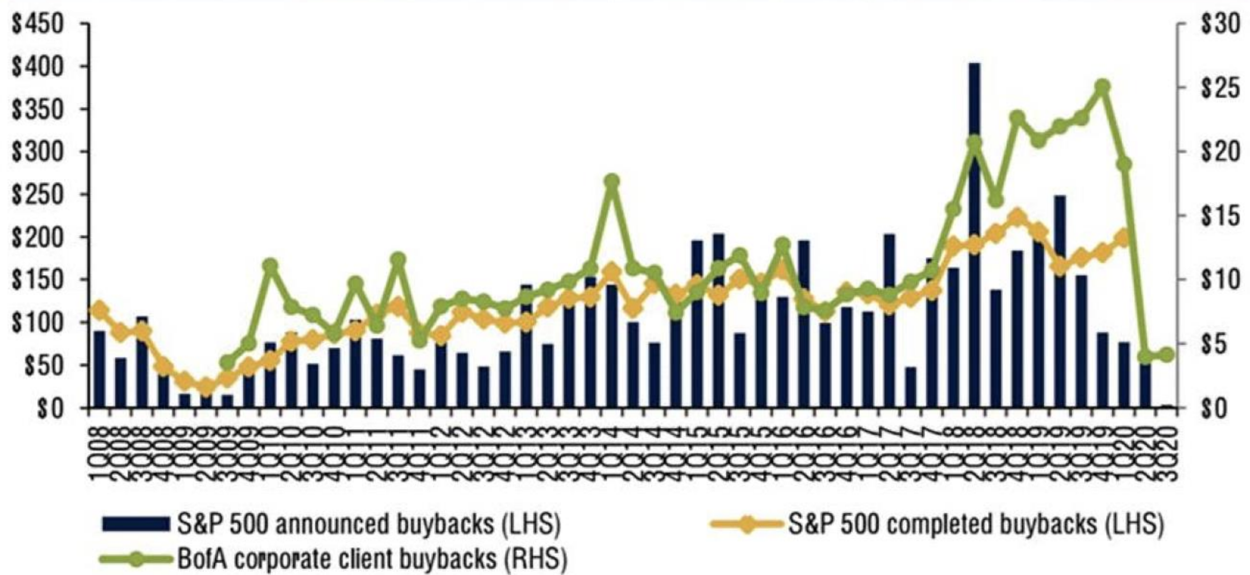


Source: Baird

Some analysts have signalled caution at what they perceive to be frothy, overly-exuberant behaviour such as the reframing of old economy stocks with elements of the new “buzz words” of the era – such as ESG, sustainability, and new tech-like growth. This may indicate that the market is priced to perfection. Another notable shift in technicals is the slow-down in share buybacks – as the chart below indicates. Share buy-backs, when a company buys back its own stock, were pervasive in 2018-2019 as corporations sought to return cash to shareholders after enjoying new corporate tax cuts. They acted as an important source of demand which drove markets higher, and were frowned upon as balance sheets came under scrutiny in the early days of the Covid-19 pandemic. The removal of this demand feature makes the recent run-up in markets even more remarkable

Chart 23: Big drop-off in announced buyback programs

S&P 500 announced and completed buybacks and BofA corporate client buybacks by qtr ($bn),1Q08-present



Source: Bloomberg, Haver/S&P, Bank of America (for corp. client buybacks), BofA US Equity & US Quant Strategy

Global divergences
US markets have run up notably more than European markets this year, as the valuation comparison below shows. The differential between the markets is now quite significant, which is particularly curious in light of the considerably more robust European backstop in the form of the European Recovery Fund.

Figure 12: MSCI Eurozone vs US P/Book

Emerging markets look to have a mixed near-term outlook, as China is very much leading the recovery from the Covid-19 disruption and is already showing positive quarterly GDP growth of +3.2% year on year in Q2 2020. China's recovery will determine the outcome in divergent emerging markets, while some markets, such as in Latin America and South Africa look impaired in the medium term at least. An interesting data point on the likely medium and long-term outlook for emerging markets though is the differential in infrastructure spending that is coming up as can be seen below. As meaningful investments in infrastructure (including data networks) in emerging markets dwarf those of developed markets (see below) there is a real likelihood that gaps in productivity will start to close. The UK commitment is notable here as a % of GDP among its peers.

	Allocation (USD)	% of GDP	Timeline
India	1.44 tn	53	2024
Indonesia	412 bn	37.5	2024
Taiwan	12 bn	2	2023
Malaysia	23 bn	7.2	No timeline
Turkey	336 bn	38.6	2023
South Korea	3.6 bn	0.2	2019
China	4 tn	33.5	No timeline
Mexico	45 bn	3.9	2024
Brazil	68 bn	3.4	2020
	Approx US$10 tn		

	Allocation (USD)	% of GDP	Timeline
Canada	260 bn	15	2028
EU	1.2 tn	6.4	2027
Germany	170 bn	4.5	2023
UK	850 bn	31.5	2030
Japan	68 bn	1.4	2020
US	2 tn	10	Not approved, no timeline but bipartisan support
	Approx US$4.5 tn		

Source: Refinitiv, Credit Suisse, January 2020.

Currency movements:
The USD had a relatively weak quarter, reaching a two-year low in July, while Sterling rose 6.5% against the currency over the past 3 months and the Euro gained even more (+7.6%). Most of this was due to signalling from the US Fed about lower interest rates as well as the poor news relating to the Covid-19 pandemic in the US in particular. This will impact the global non-Sterling assets in the portfolio leading to an erosion of returns in Sterling terms. The chart below shows the meaningful move off the bottom in late March of 1.14.85. Sterling is currently near the top of its 52-week range.

Source: Marketwatch

Individual Asset Class Performance

- Equities
- Fixed income
- Private Assets: Spotlight on Private Credit

Equities: Global differences persist and grow larger

Following the decisive move into V-shaped recovery territory over the course of the second quarter, June was a fairly flat month, although clearly driven by the "stay at home" stocks such as Zoom and Peloton, the at-home fitness equipment manufacturer. The UK stock market was lack lustre in comparison due to the dominance of banking and energy stocks in its mix.

In July there was notable divergence in global equity markets. The US market continued to add impressive gains, despite an appalling GDP number for the second quarter and indications that the Covid-19 outbreak was far from under control, even in states that had looked to have well managed the outbreak initially. The US dollar weakened and this drove strength in Emerging Markets, which tend to benefit from a weaker dollar. The Nasdaq is up a staggering 28% for the year to date, while the S&P is up just over 6.5% and the Dow Jones Industrial Average is flat to slightly negative. Emerging markets are also in positive territory with a return of close to 10% for the Shanghai Composite, while the Hang Seng continues to suffer from the overhang of unrest there, and is down by around the same amount.

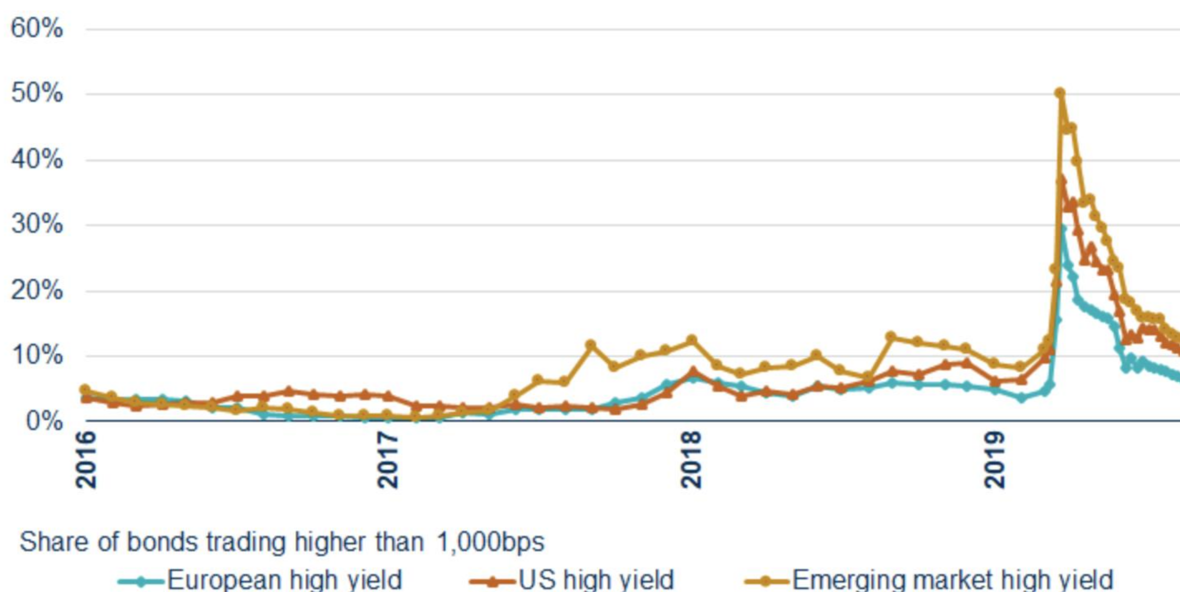
In contrast, the Eurozone and UK markets were weak, as their own negative GDP numbers loomed, while rising virus levels and volatile quarantine requirements and travel restrictions meant that certain areas were likely to see less convincing economic recoveries. The FTSE remains -20% year to date as at August 26, while the Eurostoxx has added 6% over the past 3 months and is now down only 10%. This perhaps reflects the less severe hit to GDP experienced by countries such as Germany (-10% compared to -18% for Spain) and the sizeable positive impact to sentiment of the European Recovery Fund.

Fixed Income/Credit: low rates drive demand, US high yield sees its best month in nine years

The central bank funding commitments have shored up credit markets, by dampening volatility and boosting inflows, as have the commitment to keep interest rates lower. The outlook for credit markets is also bolstered by stronger earnings, as overall more visibility has entered and enabled better forecasting, although cash flows remain depressed.

Within high yield indices the average strength has improved as fallen angels have continued to drop out of investment grade, and weaker names are removed from the index through defaults.

It is also interesting to note that the "distress ratio" which looks at the share of bonds trading at a discount (due to expected distress or default risk) is trading at back to normal levels, even in emerging markets.



Source: ICE Bond Indices, as at August 2020.

This is matched by a decline in yields (see below), reflecting solid demand, and the fact that the asset class of US high yield had its best month in 9 years in July.

Private Assets: Spotlight on Private Credit

As noted above, as the distress ratio has fallen in fixed income, it has equally been less of a concern in private credit although idiosyncratic risk will remain in areas such as hospitality and services. In general the managers in this area cite the "multiple thumbs on the scale" of government and central bank intervention to have distorted the real performance trajectory of assets, allowing private credit players to have more of an "amend, extend" and even "pretend" reality as managers move from chaos to stabilization mode.[1] Many managers expect that it is too early to see the true impact of the crisis on markets although most

Private credit is expecting to benefit from banks pulling back in lending, as well as the large body of dry powder that has built up in recent years as investors seek higher yielding credit assets. Other operators also expect the opportunity set in distressed debt to open up, as more constrained debt holders are forced to offload holdings. A clear indication of demand is the report from Preqin that global fund raising in distressed debt and special situations strategies rebounded to $34 billion in the second quarter from a multi-year low of $22 billion in the previous quarter. For many investors in this area, there is now an ability to be far more selective about investment opportunities – and to focus on companies that have shown themselves to be more resilient in recent months.

[1] https://www.pionline.com/alternatives/private-debt-managers-see-stellar-opportunities-asia-despite-uncertainties

Outlook

So where do we go from here?

Each quarter I revisit the outlook made in the previous quarterly update and throughout 2020 the outlooks have been couched in the uncertainty around the scale of the Coronavirus outbreak as well as how economies will rebuild. With every month we seem to learn more, but uncertainties still loom. As vaccine trials continue and new therapies are developed, there is hope on the horizon and markets react accordingly. However, there are also mixed messages around the efficacy of a vaccine, and the need for mandatory policies on vaccination as well as for multiple boosters. Meanwhile, students prepare to return to school with a checkered set of policies for social distancing, PPE, distance learning (in universities) and other radical changes. And still we wait the outcome from the pending easing of furlough payments are eased and the true impact on employment is revealed (likely to be late in the year). In the months ahead it will also be interesting to watch for the following:

- **How long do Covid disruptions continue?** Despite a return to tourist activities in the summer office blocks are empty, public transport is considered high risk and mass events remain cancelled for the foreseeable future. As the days shorten and grow cooler and activities move indoors it seems inevitable that cases will rise but it remains to be seen whether action will be coordinated as it was in the Spring (even if inadvertently) or divergent. While some countries such as France and Italy have pledged not to shut down again, others remain more open to it, and quarantines have essentially smothered trans-Atlantic travel as well as short-haul business flights.

- **Corporate Confidence** We cited last quarter Marks and Spencers' "never the same again" strategic shift in its business model, which has already seen large scale layoffs. On the other hand retail delivery services (such as Tesco) are hiring by the 1000s and this indicates a re-tooling that, as in the case of much this year, is happening at warp speed, just as consumers have adapted to mask-wearing. Some corporates though, which were already under pressure, are now either throwing in the towel or on life-support as "zombie companies". Some have blamed this on an overly zealous focus on liquidity and not solvency, as instead of focusing on whether a company should exist in its current state the short-term focus has been on enabling it to stay current on its cash needs. It is true that much of the pandemic related crisis revealed a liquidity crisis in the near term as revenues were paused, but perhaps this tidal wave of corporate loans and stimulus payments, as well as paycheck protection, provided a lifeline that some corporates should never have received. Over coming weeks it will be important to watch how corporates are dealing with the new shape of customer demand and whether they evince the confidence to stay the course.

- **Close to decision time in US politics** The Covid-19 outbreak has become increasingly politicized in the US, and as election time nears the rhetoric is getting increasingly divisive. Meanwhile another country, New Zealand, has used the Covid-19 lockdown to delay their election, and regime change does not seem imminent throughout Europe, or much of Asia currently. As the challenger, Joe Biden, is an erstwhile moderate Democrat, albeit one whose policy positions have been pulled to the left, it is unclear how markets would view a Biden victory. The message he is sending is one of "healing" of the rifts in the country and around the world in terms of the US position in foreign affairs, so it can be expected tha the net impact of a Biden victory would be neutral to positive. This will be a source of risk and volatility though as November nears.

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August 26, 2020