Investment Strategy Group
Investment Update
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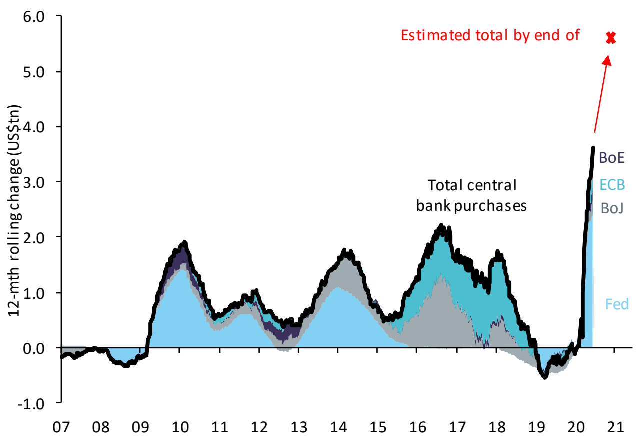
Most major equity markets posted further gains over June, continuing what has been a strong recovery from the lows seen in mid-to-late March. In fact, the likes of the S&P 500 recorded its strongest quarterly gain in more than two decades over the June quarter. As we have discussed previously, the magnitude of policy stimulus delivered, the re-opening of economies from lockdown and optimism around an eventual medical solution to COVID-19 have all been powerful stimulatory forces that have enabled investors to look through much of the economic damage this year and instead focus on the eventual earnings and economic landscape next year and beyond. The recovery in markets has been powerful and rapid. That said, we are sensing it is now beginning to run into a little more resistance. The pace of broad market gains has begun to slow and dispersion in regional market performance has also started to surface. After the strong performance over the past three months, it is only natural in our view that markets at least pause for breath. Price action has become more volatile, which is something we believe could persist over the coming months.

There is now a rigorous debate across the investment community about where equity markets go from here. Views range from an expectation of further strong gains into the rest of the year and beyond, to those arguing that current market levels are not justified, and a correction is overdue. Below we touch on some of the reasons put forward by each camp (it is far from an exhaustive list), as well as our own thoughts. Ultimately, the debate about where markets go from here appears to hinge on a view about what matters most for markets right now: liquidity or fundamentals.

The case to remain bullish

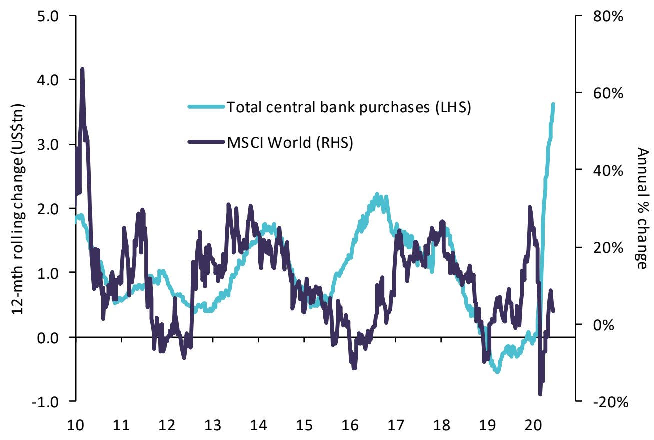
- **Liquidity is abundant.** Right now, central bank printing presses are working overtime, with some estimates suggesting that quantitative easing (QE) by the Federal Reserve, ECB, Bank of Japan and Bank of England will be greater than US$5tn this year alone, well above previous peaks (left-hand chart below). All that liquidity needs to find a home and over the past decade there has been a reasonable correlation between the pace of central bank asset purchases and the performance of risk assets, like equities (right-hand chart below).

G4 Central Bank Security Purchases



Source: Bloomberg, JBWere Investment Strategy Group

CB Asset Purchases and Equities



Source: Bloomberg, JBWere Investment Strategy Group

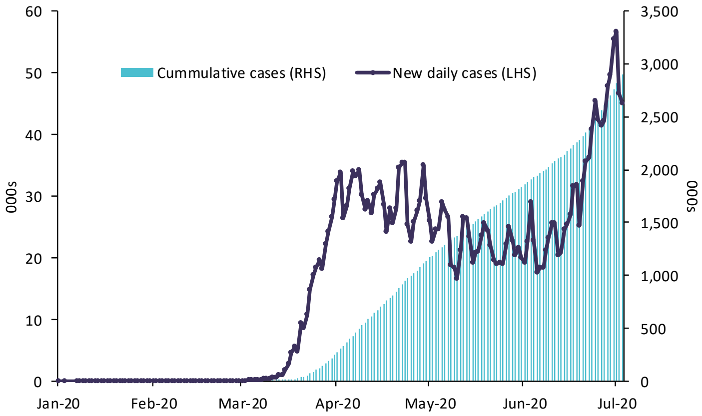
- **Fundamentals are now improving.** As economies emerge from lock-down we are now seeing a natural bounce in economic activity. In fact, in some cases, the recovery in economic data is occurring faster than expectations. As such, many economists are now revising *up* their forecasts for economic activity. In addition, after plunging over recent months, analyst's earnings revisions have also now started to turn positive, which in the past has provided positive momentum for equities.

- **There is still plenty of institutional cash on the side lines, which will be forced to be put to work at some point.** Based on data from the Investment Company Institute, total equity long-term mutual funds and ETFs have experienced cumulative outflows of over US$130bn since mid-February. Moreover, the latest quarterly institutional client survey by one of our primary research partners found that median cash holdings as a percentage of AUM were still sitting at 10%, which is more than two times average levels.

The case to be cautious

- **Markets have already priced in this better news.** Even with optimistic assumptions for corporate earnings in 2021, markets are trading on reasonably 'rich' valuations. For example, based on consensus expectations for 2021 company earnings-per-share (of ~US$160), the S&P 500 is currently trading on P/E ratio of over 19 times, which is the highest since 2002. Abundant liquidity is one thing, but history is littered with episodes of ignoring fundamentals at your peril.
- **Yes, fundamentals are improving, but this reflects pent-up demand.** While recent economic data has looked better than expected, suggesting that some forecasters were overly pessimistic, economies are currently in the pent-up demand phase of the recovery. Households that were not able to spend during lockdowns (and so saving levels increased by default) are now catching up on missed opportunities. But once the reality of higher unemployment, lower income growth and the unwind of some fiscal support programs sets in, spending is likely to settle at a lower more disappointing rate, with corporate earnings expectations to follow suit.
- **The virus is not yet under control.** While the virus is still tragically ravaging parts of the developing world, developed countries are not out of the woods either. As of now, there is no clear evidence that the virus has become any less infectious and so it is only natural that as countries ease social distancing restrictions that flare ups and new outbreaks can be expected, which would be most worrying in places were effective contract tracing frameworks are not in place. That is arguably occurring in parts of the US, where new case numbers have accelerated again (chart below) forcing some states to reinstate restrictions, questioning the economic recovery scenario that markets have arguably priced in.

US COVID-19 Cases



Source: Refinitiv Datastream, JBWere Investment Strategy Group

Our view

To us, there are compelling elements of both arguments above. There are both plausible upside and downside scenarios for markets over the coming six months that make having a high level of conviction towards near-term market direction difficult at present. While we could be accused of 'sitting on the fence', we instead feel that the tension and opposing forces in markets right now just mean that it is not the environment to be making a bold asset allocation call. We have not done that in the MAS Funds through this crisis (outside of holding modestly higher levels of cash currently) and feel that that has been the correct approach. We also feel that the 'quality' screens we employ together with some of the specific investment decisions we have made over the past three months also add an additional layer of protection and resilience to the MAS Funds.

Looking beyond the next six months or so, we retain a constructive view towards equities. Equity risk premia remain elevated, courtesy of historically low bond yields, and signal decent relative return prospects for equities in time. In that regard, if we were to see any meaningful pull-back in markets over the coming months, whether due to the reasons highlighted above, or perhaps because of information learned from the upcoming US Q2 earnings session (where many analysts will be looking for a reinstatement of some level of company guidance), the approaching US election, or the fact that some key fiscal decisions will need to be made in many economies as fiscal support measures expire, we would view this as an opportunity to increase the allocation to growth assets within the MAS Funds. This has been the reason we are currently holding modestly higher levels of cash across the Funds relative to strategic targets – it is in order to keep some dry powder to take advantage of market opportunities if and when they present themselves. In that regard, we maintain a 'buy the dip' mentality.

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