Amplia Monthly Investment Letter

Recovery continues

The stock market recovery continued in May, albeit at a more modest pace than in April. S&P 500 gained 4.53% in May, finishing the month over 3'000 points for the first time since 5th March. In Europe, the trend was similar, with EuroSTOXX 50 gaining 4.18% for the month.

Although the gains were fairly even between different sectors, S&P 500's Information Technology sector once again outperformed its peers. Also, there were sporadic signs of a "relief rally" amongst the most battered stocks. For instance, TUI AG and Lufthansa AG gained 32.6% and 12.1%, respectively. Small caps, as measured by Russell 2000 index, gained 11.45% in just the two final weeks of the month. This conveys a picture of investors bargain-hunting riskier stocks in anticipation of a continued recovery.

Real economy versus stock markets

Most of the investors who advocate a strong second leg down in equity markets – and stay in cash for that reason – argue that those who rush to the markets now ignore the bad shape of the real economy. Since this argument has been so centrally displayed in the public debate, we will focus on it in this issue. We yield the point to market sceptics: normally falling GDPs, company revenues and profits would not pair well with rising stock prices. There are however a few things that have led us to become more optimistic lately.

Firstly, most European economies have unwound many of the social distancing measures without a significant uptick in new COVID-19 infections. This has considerably lowered the prospect of new movement restrictions and buoyed consumer sentiment. On the corporate side, May manufacturing PMIs came in at 50.6 for China and 39.4 for the Eurozone, the former signalling economic expansion and the latter a clear improvement from the previous month.

Secondly and most importantly, we think that asset prices have room to go higher even in a no-growth environment for one simple reason: the central banks. Exactly 12 years ago, on 2nd June 2008, Fed's balance sheet totalled to 0.895 trillion dollars. Six years later, on 2nd June 2014, this balance sheet had ballooned to 4.331 trillion dollars as a result of expansionary monetary policy to combat the financial and the Euro area crises. This vast amount of money never really left the financial system. Fed had absorbed a tiny bit of this liquidity before the COVID-19 crisis broke out. On 1st June 2020, Fed's balance sheet stands at 7.097 trillion, a whopping uptick of 693% in just 12 years.

Why does this matter? It matters because the commonly used money supply measures such as M2 make out the bulk of the liabilities side of the balance sheet. Indeed, M2 money supply has increased by 135% in the US in the past 12 years. Such an increase in the money supply should in the medium- to long-term result in inflation of prices of assets, goods and services. Whilst generic price inflation has been subdued in the developed world since the financial crisis (for a number of reasons), asset prices have risen sharply.

Part of this phenomenon is explained by the key central banks (Japan, Eurozone, US, UK) buying not only the traditional securities such as sovereign bonds, but increasingly also commercial assets: commercial papers, bonds, equities and ETFs. Assuming central banks are trustworthy in their communication to the public, both the proportion of commercial assets bought (as % of total purchases) and the absolute amount of quantitative easing should increase. In other words, there will be more money out chasing the same bonds and stocks. This increase in demand of securities should keep the asset prices rising, even if nothing happened in the real economy.

What assets should one buy in an inflationary environment? The answer is real assets, such as real estate and commodities, and stocks. These assets (apart from commodities) have also performed very well since the financial crisis started, and if the policy response to the crisis is similar as last time, so should the playbook be.

Our markets positioning

Accordingly, we have increased our equity allocation lately. Whilst some of the worst performing sectors, such as energy and industrials, may perform best now if the investor mood stays buoyant, we prefer to play it safe and keep a considerable weight on structural winners: IT, consumer discretionary and pharmaceuticals.

On the bond markets, the development has continued to be positive as well. Five-year European investment-grade credit spreads have fallen further to circa 70 basis points. Should the ECB expand today its current *Pandemic Emergency Purchase Programme*, credit spreads may fall further, thereby boosting bond prices. The same phenomenon is taking place in the US, too.

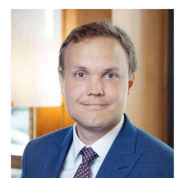
Some parts of the credit market are however lagging the broader bond markets. High yield and non-rated sectors have only experienced a nascent recovery, and we continue to see most upside in these parts of the credit markets. Indeed, for example the SEK-denominated corporate bond market has barely seen any new issues since late February, and this congested re-financing demand should soon erupt with plenty of corporate issuers coming to the market.

With regards to FX, risk-on currencies (EUR, SEK, NOK) have continued their ascend against safe-haven currencies such as USD, JPY and CHF. This has corrected the valuations to more reasonable levels, and we have no clear favourites to overweight. Those investors who want to diversify their investments should do so now: taking some currency risk at these levels to get access to new sectors and markets may be feasible.

In Zurich on 2nd June 2020,

with kind regards

Juho Kivioja



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