Amplia Monthly Investment Letter

Stock market recovery continues

June was a fairly similar month to May. The key stock indices kept climbing upwards, with Euro Stoxx 50 gaining 6.40% and S&P 500 1.84%.

If May had witnessed "a crap rally" with the lagging sectors posting best performance, in June that trend came to an end. Of S&P 500's economic sectors, Information Technology recorded a performance of 7.14%, followed by Consumer Discretionary (+4.99%). The worst performers were Utilities (-4.66%) and Healthcare (-2.38%). This reinforced the phenomenon that has been visible from the start of the year: IT (+14.95%) and Consumer Discretionary (+7.23%) are the only positive sectors year-to-date. Were it not for Energy (-35.34%) or Financials (-23.65%), the year would actually look pretty good from the perspective of an equity investor.

This great disparity in the performance of the equity sectors has prompted pundits to coin a new phrase for the economic recovery: "the K recovery", meaning that the months following the stillstand of March and April will witness traditional economic activities drift towards new lows whereas the "new economy" companies will continue to flourish. Albeit simplifying, this concept is a welcome add to the classical predictions of a L-, U- or V-shaped recovery and neatly exemplifies the need to be selective.

Economic data improving

We addressed the disconnect between the equity markets and the real economy in the previous issue of this letter. Whilst the mismatch persists, there has been considerable improvement in the latest economic data points. Last week alone, Conference Board's US Consumer Confidence topped the expectations for June month clearly. US June unemployment rate came in at 11.1% versus the forecast 12.5%, with payrolls increasing by 4.8 million. Eurozone Economic Confidence indicator rose sharply from May and beat the expectations. Also, Eurozone Composite PMI was able to clinch a small gain versus May numbers and the economist consensus forecast in general.

The improving data, alongside central bank and government stimuli reduce the disparity between the real economy and financial markets. They also help some of the most vulnerable parts of the economy and financial markets, such as the service sector and capital-intensive businesses like small- to mid-sized manufacturing, by reducing their financing costs.

Tug-of-war of central bankers and virus threat

Our base case remains that the worst is over and the bull market will continue from here, be it at a more modest pace than in the previous months. The recent spike in new cases in the Americas and India emphasises the risk of a second wave lurking in the background. We do not believe however in a broad-based second lock-down. Rather, we expect any lock-downs to be local. This makes geographical and sectoral diversification of portfolios even more important than usually.

At the same time, we also believe that investor propensity to liquidate holdings as reaction to adverse news is high, given the generic nervousness of some investors. This is because a number of market participants are sitting at considerable profits following the rally of the previous months. Add to this the approaching US presidential election debate, and we may see considerable drops in investor mood in the months ahead. Nevertheless, we believe that the central banks stand ready to act if things took a turn to the worse and therefore any dips should be seen as a buying opportunity.

Our markets positioning

The virus is still wreaking havoc in many emerging markets (most notably India and Brazil) and therefore we remain cautious to emerging market equities and bonds. Many emerging and frontier markets have less tools in their financial toolkit to stimulate the economy without exacerbating external (fiscal) imbalances. Also, the long drop in many commodity prices (as measured by Bloomberg Commodity Index, for instance) that has continued since 2011 and accelerated in the aftermath of the COVID-19 outbreak, will hurt emerging markets over-proportionally compared developed markets.

We feel comfortable with European equities following the progress in stemming new COVID-19 infections and – at least some – political compromise regarding stimulus measures and EU-wide budget principles. We also favour select US sectors, most notably tech, due to their long-term secular growth prospects. We acknowledge that most indices are "pricey" in a historical context, if measured for example by current P/E figures versus their 10-year averages. This is however mostly because of the lower post-COVID earnings. Also, as explained in the previous issue, higher P/E ratios ought to be justified going forward thanks to the excessive monetary easing.

We still see considerable opportunities in credit. European and American credit spreads have room to improve, both in investment grade and high yield space. The prices in especially Nordic bond markets continue to lag the broader bond market. Many bonds saw their prices decline in March and April due to forced-selling by some fund managers without any significant change in credit fundamentals. Now, with money returning to the markets, this trend is changing, but we reckon it will take some months before prices start to fully reflect the underlying credit fundamentals again.

On the FX side, we would expect Pound Sterling to start gradually appreciating versus the currencies of its main trade partners as Brexit trade negotiations progress. Moreover, any downward movements on the equity markets could trigger a temporary flight to safety which would boost JPY, CHF and USD. Rather ironically, also a US domestic woe like a political scandal, could lead to temporary appreciation of the greenback. Else, if our base scenario of the gradual recovery continuing materialises, we would expect the risk-on currencies to also gain ground.

In Zurich on 6th July 2020,

with kind regards

Juho Kivioja

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