Sanctum View

September 21st, 2020

Communism Outpacing Democracy

- **US political uproar masks a loss of economic momentum allowing Chinese assets to take the lead**
- **The Fed confirms lower for longer …maybe much longer**
- **Better than expect Chinese economic data compares with some disappointments in the US**
- **Don't get carried away with the outperformance of value over growth in the US**
- **Europe struggles with further outbreaks of COVID19, and its starting to show in the data**
- **Eurozone equity markets rally faces challenges**

A politically challenged US sees its equity market lag China

We, like many, can only look in despair at the political challenges in the United States. In contrast, China continues to turn less drama and more solid performance from its asset markets. Chinese equities have now outperformed the US equity market is dollar terms by 18 percentage points over the past year. The gap has significantly widened since June. In the third quarter, US politics has got uglier, and the contrast between a robust Chinese economy and a stuttering US economy has been stark. We expect Chinese asset markets to continue to outperform the markets of seriously challenged Democracy of the United States.

Federal Reserve defines lower for longer

Last week's key event was the Federal Reserve monetary policy committee meeting. Like the US President, the Chair of the Federal Reserve is always challenged as to whether they should tell the truth for fear of setting off a panic. Let's just paraphrase what the Fed said at the end of their two-day meeting … don't worry but we believe that interest rates will have to stay close to zero until 2023, (and the miraculously) they will then revert to the (new normal) of 2.5%.

The backdrop to the Fed meeting was weaker than expected August US macro data. Retail sales fell 0.1% against market expectations, +0.3%. The statisticians also revised down July data. Industrial production was also weaker than expected, rising just 0.4% against market expectations of +1.0%.

While the US economy has rebounded well from its second-quarter low, there was no way that the economy could continue to barrel on when COVID-19 is keeping the dampers on economic activity. Back in March, the US authorities bought some time with a significant loosening of fiscal policy, tax cuts, government handouts and support for the unemployed. However, the US population can't fail to realise that these supports are diminishing as Congress continues its infighting about the scale of the next support programme.

China's economy provides positive surprises

There is a more convincing economic picture out of China where macro data was strong. August retail sales were up +0.5% versus expectations of down -0.5%. Fixed investment rose 9.3% month-on-month beating expectations (+7.3%) and industrial production was up 5.7% year-on-year seasonally adjusted against expectations of 5.3%. Emphasising the strength of growth still further, China's auto sales rose 11.7% year-on-year, suggesting a good deal of confidence amongst consumers. At the weekend, President Xi Xinping emphasised that the authorities still have several levers to use to support growth. Xi was speaking during a meeting on the country's 14th five-year plan (2021-25). Unlike many other parts of the world, the Chinese authorities have not had to stretch the envelope to support the economy in the wake of COVID19. Fiscal policy is not exceptionally expansive and monetary policy has remained mostly in check; hence the appreciation of the renminbi against the dollar.

As a reflection of the growing gap between the economic performance of the US and China, Chinese asset markets have performed very well since June. Part of the reason for the more recent US underperformance is the loss of momentum in the tech sector. Indeed September's month-to-date equity sector performance has got the debate going about whether there could finally be a resurgence of the performance of value. **Month-to-date, the S&P large-cap value index, has outperformed the S&P large-cap growth index by 4.6 percentage points. However, that value index outperformed by standing virtually still while the growth sector has fallen**

5.5%. Mind you, the FAANG index+ Microsoft is down 13.8% month-to-date.

It is difficult to see value outperform growth more positively in the absence of a sustained global cyclical recovery, accompanied by a pick-up inflation. However, we do believe there is a better argument for high dividend-paying stocks. Jay Powell's statement on behalf of the Fed that they are likely to keep rates close to zero for an extended period has focused investors back onto the equity market in the absence of yield in the bond market.

Eurozone equity market rally at risk?

Several macro data points this coming week should confirm investor intuition that the European recovery post-COVID has a different feel to the one in the USA and the rest of the world. This week, macro data for September is likely to show dimming industrial confidence as new COVID19 infections continue to rise. In Spain and France, new cases are now on par (or possibly higher) than in the initial phase. Thus far, the governments have not implemented new measures to contain the spread as rigorously as before. The reason might be that the fatality rate is possibly lower for now, and the authorities deem the perceived damage to the economy from a full lock-down as unacceptable.

Nonetheless, the continued surge in COVID19 cases in Europe will be damaging to especially the services sector in the affected countries – France, but particularly Spain. In Spain, the upcoming GDP number for the second quarter of 2020 may show a decline of about 18.5%, compounding the 5.2% drop in the first quarter.

In August the continental European equity markets saw a broadening of factors driving the markets performance. Investors will fear that some of that momentum will be lost if the eurozone has to go into a patchwork of lock-down. European equity market breadth improved in August as both value and small cap stocks performed taking over leadership from momentum plays.

What has saved the eurozone equity market in the eyes of international investors mind is the strength of the euro versus the dollar. In dollar terms the European index has rebounded eight percentage points versus the US S&P 500 in just a couple of weeks. With the Fed still very much on the back-foot particularly with fiscal policy issues still unresolved the euro should stay in the ascendancy but from here the relative performance of the eurozone will depend on how it handles a resurgence of COVID19. This week's data is only the first data point in that test.

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