SanctumView

October 19th, 2020

Picking Over the Laggards

- **Markets have a positive bias, but global growth has lost momentum**
- **Markets still reluctant to fully discount an emphatic Biden win**
- **A Biden win and a vaccine by the end of year could propel risk markets higher**
- **We search through the serial laggards to see where a bounce is possible**
- **Some pockets of Europe and Asian equity markets offer potential double digit rebounds**
- **Emerging market debt increasingly backstopped by the IMF**

Markets, while somewhat more volatile recently, continue to have a gentle, positive bias. However, the backdrop of global growth is not as convincing as it was a few months back. The resurgence of COVID19 cases has taken the wind out of the sails of global economic momentum as we move through the fourth quarter.

The markets will need a freshening up of the factors to drive risk assets higher. The market has half a bet on an emphatic win for Joe Biden in the US Presidential election. With 14 days to go, even allowing for an error in the estimation of the polls on the scale of that seen in the last election, Biden should still prevail. The other uncertainty is the timing of a vaccine for COVID19. Some drug companies are indicating they will release data at the back end of November to hopefully confirm that an effective vaccine has been found. Taken as a package a Biden win and a vaccine would do much to relieve the uncertainty of the past seven months.

A COVID19 vaccine could pave the way for a further round of fiscal easing. A government might be more prepared to spend money when it feels that potentially the multipliers of such spending could be much stronger than they have been over the past six months. Government spending through the crisis has plugged holes. Government spending with an effective vaccine in the background could be a catalyst for a more substantial economic recovery.

At this stage, we have to say that investors are reluctant to back an optimistic view with too much fire-power given the immediate backdrop remains difficult. However, our rosier scenario of the future is not beyond the realms of the possible in short order.

The natural reaction of most portfolio managers in the wake of such good news would be to look to buy markets that have serially underperformed over the past seven months. As we search through the equity market indices, double-digit negative returns are seen almost across-the-board in Europe and pockets in Asia. Below we assess the merits or otherwise of some of the main laggards.

UK

Amongst the major Europe markets, the UK is a standout: down 21% year-to-date. Unfortunately, COVID19 is one of two factors that is holding back the market's performance. The newspaper headlines still suggest that the UK could fall out of the EU only adding to the GDP growth downside. A recently released survey by the UK Investment Association showed that UK institutional allocation to UK equities had fallen below 30% for the first time. Investors remain concerned about the lack of exposure to growth sectors such as technology in the UK benchmark equity indices. As still a major market in developed market equity indices UK equities still have the benefit of likely inflows of capital should they get up a head of steam. We wouldn't write off something of a recovery, but investors probably think they still have time to wait.

Spain

The Spanish IBEX equity index is down 28% year-to-date one of the worst-performing European markets. However, the concentration of the index in the energy and financial sectors has sunk performance. Repsol, the energy stock is still down 54% year-to-date and the Spanish bank BBVA is down 51%; in fact, most of the banks are down between 40% to 70%. The index has also been weighed down by airline stock IAG -78%. Can the index rebound? You have dig down into the detail of individual stocks to get a sense of the dilemma facing portfolio managers. Melia Hotels is a good case in point. The stock is down 62% year to date. However, history suggests that it could have the power to recover. Back in the global financial crisis, the stock fell 88% from its peak of €17.9 to a low of €2.1 in March 2009. However, by the 30th September 2009, the stock had recovered to €6.9, a recovery of 228%. But today, analysts will question whether this is really the low for the share price (€3.01) with further lockdowns coming across Europe. Only last week Deutsche Bank analysts downgraded their recommendation on the stock to sell.

Asia also abounds with apparent opportunity for a rebound. The Singapore, Thailand and Indonesia markets are all down more than 20% year to date.

Singapore

The market is probably one of the safer bets for upside from a re-opening of global travel in the wake of a vaccine being found. While the local economy has been hit badly, the government's efforts to support the economy and local business have been effective at keeping local companies secure. The Singapore equity market has been a picture of stability since the rebound from the markets' low in March. From June onwards the index has marked time remaining around the same level for the past four months.

The openness of the economy and the lack of international movement of people weighs, particularly on the service sector companies. The general global malaise in financial stocks and real estate companies also hurt the market. However, the scale of the downside has been mitigated by significant support through very relaxed fiscal policy by the government. While local leisure companies such as Genting (SGD0.67) have been hurt by the crisis (-30%), they are still in good shape to take advantage of a recovery. Although analysts expect the company to be loss-making in 2020, they expect them to comfortably back to profitability in 2021.

Indonesia

In the Indonesian equity market, exposure to banks, energy and property sectors always placed it in the firing line when the virus hit. The economy is in the midst of its first recession since 1998, which is a testament to this strongly growing, relatively resilient economy. Foreign investors remain engaged with the market accounting for around 35% of daily traded volume compared to 44% before the COVID crisis having sold a net $2.3bn of equities in the year to date. The country has struggled to shake off the recession in the third quarter with growth still expected to be negative. However, fiscal easing should have a sufficient impact by the fourth quarter for growth to turn positive. The market remains on Asian investors watch list as the government continues to push a reform agenda.

Thailand

The Thai Stock exchange index is down 25% year-to-date in dollar terms. COVID19 challenges have been exacerbated by the political crisis that has engulfed the country in recent months. International investors have been spooked and have sold down both their bond and equity holdings. The relatively stable performance of the Thai Baht over recent months is a positive. However, we suspect that investors will look elsewhere for the moment preferring to wait for clarity on the political situation.

Emerging Debt, local and hard currency

Optically, the opportunity for significant recovery plays in fixed income does not look as compelling as it does in the equity markets. However, in an environment where government bond yields in the G7 world seems to be continually falling to new lows, investors looking for income should not despair.

We believe that an opportunity exists in emerging market debt, local currency and hard. The overall asset class has several things going for it.

The recent alertness of the IMF to the funding requirements of stressed EM sovereigns makes for a refreshing change in attitude. The IMF has made it clear that it stands ready to provide further assistance to the countries that require it. The statement possibly preludes a new phase in the lending attitude of the IMF, referring to a "New Bretton Woods". Countries with funding requirements specifically in the areas of hospitals and medicine, and a need to counter the balance of payments challenges of the virus, stand to benefit from the remaining $900 million that the IMF has at the ready for just that. To date, only $100 million has been disbursed.

Secondly, a risk-on sentiment in global markets has thus far been correlated with a weaker USD (mostly). The combination of good yield plus a stable to positive currency backdrop could be just what local currency debt needs to deliver good numbers and good diversification for multi-asset investors.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)