Sanctum View

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Reality Holds Back the recovery

- **Markets stuck between discounting the hopes for the vaccine and the reality of building COVID cases.**
- **Economists mark back their growth forecasts for the fourth quarter.**
- **Central bankers give every indication of remaining supportive, indeed they may even reinforce their easy monetary policies in the coming months.**
- **In reality government bonds are still well supported.**
- **Equities are trying to focus on the medium term but fear the potential damage of a weak fourth quarter.**
- **Asia's RCEP trade pact is a very significant positive for the region**

There are times when, as a portfolio manager, it is better to watch than chase the daily twists and turns. While we all want to hope that a vaccine is at hand and we can get back to normal the reality of COVID cases and the ongoing political saga in the United States are the reality.

The last few weeks we all had to become interpreters of US polls, legal experts on the US voting and counting system, and now experts on the efficacy and distribution process for any new vaccine. This has been a trying time for human emotions. The FT reports that on November 6th, in the early days after the US election polling, some 30 of the top US industrialists were so concerned about the president's claims that the election was rigged that they had an emergency meeting.

Some of the turnarounds in asset prices last weeks were breath-taking. Cruise liner stocks were up 30% on Monday alone, before settling back 10% the following day. Airline, hotel and travel stocks were up 15-25%. The energy sector was one of the best on the week with the sector up 17%. However, remains one of the few equity sectors down over six months.

However, the resurgence of the virus has restricted the equity relief-rally, on the back of news of encouraging vaccine trial data. Europe and the United States are dealing with a significant second wave that is quickly soaking up the resources of their respective health services. 52% of Italy's hospital beds are taken up with COVID cases. Although thankfully the death rate is so far a fraction of what it was back in the second quarter, the fact that hospitals are filling up fast has put governments under pressure to have, at the very least, localised lockdowns. US cases have been well past the 100,000 cases per day for the past ten days with several states deciding to go into lockdown. Worryingly, the US the daily rate has risen from 100,000 to the current 184,000 in a matter of a few days. Still, the population appears to pay scant regard to the risks. People still have to be persuaded to wear a mask, and the Federal government is still largely complicit in not taking the threat seriously enough.

Economists expect Europe's lockdowns to put the region's economy back into recession. However, a likely -7 to 10% quarter-on-quarter annualised rate of decline is much more modest than the -30% witnessed in the second quarter.

With such (distressing) noise, it is difficult for investors to focus on the medium term. However, the markets movements at the start of last week gave us an insight into the kind of market we might imagine, if, and when, the vaccine takes effect, and when the global economy is back on a better footing. Below we set out a few thoughts about the medium-term around which we have stronger conviction while accepting that we will have to live through volatile times in the coming months.

- **We expect central banks to maintain very loose monetary conditions.** A panel discussion last week between the Chair of The Fed Reserve, the President of the European central bank, and the Bank of England, provided ample support for the thought central banks are in no rush to shut down their very loose monetary policy even if we have a vaccine at hand. The central bankers were at pains to argue that the COVID-19 challenge may have significantly damaged medium-term growth leading central banks to take the view that they may have to maintain an easier policy with some considerable time ahead.

- **Low-interest rates will encourage investors to be heavily biased towards risk assets.** We expect investors to be pro equity in the absence of any significant rise in short term interest rates. Currently, we do not believe that many investors have a positive bias towards equities. Here in Asia, many investors went into the election with cash or long position in bonds. It is also clear the hedge funds have not had an unusually long equity position and preferred to play credit or duration as a strategy. Corporate cash flows have been building up, and many companies may still end up reverting to share buybacks as we go through 2021, providing another fillip to the equity market.

- **Current inflation is well contained despite the disruptions to global supply chains.** Recent economic data has provided little support to those expecting a take-off in inflation and certainly provides no catalyst for a marked rise in long term interest rates. Last week inflation data in both China (0.5% YoY) and the United States (core PCE inflation 1.4%) came in below expectations. Indeed, over the coming six months, economists expect Chinese consumer price deflation which could allow the central bank to cut interest rates modestly.

One question left unanswered by last week's move is where US long-term interest rates will rest if the vaccine finally gets approved? Last week's treasury market moves showed volatility and investor indecision. The US 10-year government bond yield started the week at around 84 basis points before rocketing to 96 basis points on the news of the vaccine on Monday. Midweek the 10-year yield tested the one per cent level; however, by the end of the week it was back below 90 basis points. As we mentioned earlier, the lack of inflation pressures plus second round of COVID 19 infections is likely to keep growth and inflation in check coming months. It's also worth noting that Jay Powell stressed that long-term US growth might have structurally taken a hit from COVID-19 holding back potential labour market growth and productivity in the years to come.

There is also an active debate about how far the US Federal Reserve will allow the 10-year to rise. There has been an active discussion amongst fed policymakers about extending the duration of their bond purchases and hence dampening any rise in long term interest rates. The Fed must also feel under pressure to maintain the loose monetary policy in the absence of any leadership around a further package of fiscal easing. Indeed, it still seems the most likely outcome said the next budgetary package agreed by the house and Congress would have to wait until we have a new president.

Although long rates have not risen as much as some Treasury bears may have forecast, the rise has still been sufficient to encourage a rise in bank share prices. The modestly steeper yield curve certainly helps bank sector profitability. Adding to the surge in banking shares has been the evidence that the very aggressive provisioning that banks took in the Q2 results may have been too aggressive. Many banks have been releasing some of these provisions in Q3, providing a tailwind to earnings, when it was a headwind before. Among a universe of 66 banks, 15 released reserves as reported by the end of October.

A significant feather in the cap of Asia was achieved with the agreement on the RCEP trade

pact. The agreement between 15 countries that make up an area third of the world's population (2.2 billion people) and GDP ($26.2 trillion) to form the world's largest trading bloc was signed last week after several years of talks and preparation. There should be two mains reasons to take note of this agreement is something much more significant that just a piece of paper and a broad statement of intent. First, it comes in the wake of ousted President Trump's high-profile removal of the US from the TCP. This agreement sends a strong signal from Asia that it has not lost faith in open trade as a growth engine. Second, some of the provisions in the agreement, as reported, are very consequential. For example, the agreement includes a tariff elimination of some 92% on goods, with 65% of service sectors fully opened with increased foreign shareholding limits.

The changes from RCEP, on the face of it, are not mere adjustments. While not nearly as market moving as vaccine news, they may well move the Asian economy another step or two forward as the global growth engine of choice for the next number of years. Apart from the hitherto more successful COVID response, the trade deal potentially paves the way for the region to be more integrated in the Chinese push for technological advance and further financial market liberalisation.

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