

Covid-19 “second wave”?

“It is too difficult to think nobly when one thinks only of earning a living.”

-Jean-Jacques Rousseau

Summary

The number of Covid-19 cases is on the rise globally, but thankfully the rate of death is far lower than the levels we saw in March-April this year. I do not see the “second wave” getting worse to the point that we see a widespread economic lockdown. Lockdowns don’t make the problem go away. You have to unlock sooner or later and then the infection spread accelerates again as it has now. Every country that locked down without having a strategy for what came next, followed medieval superstition, not science. Well done to Sweden for actually having a strategy. Shutting down an economy is not the way to deal with Covid-19. Protecting the vulnerable, practising safe measures and letting the non-vulnerable (who vastly outnumber the vulnerable) get on with their lives is a much better way.

The sell-off in equities during the last two weeks now seems to be behind us. However, October will be a very volatile month as we get closer to the November 3 US elections. The overall trend for US equities is still to the upside. “Don’t Fight the Tape” is still in place from a long-term perspective. With the recent comments coming out of the US Fed indicating that they do not expect fiscal stimulus, for now, expect the Fed to issue more aggressive forward guidance that will keep flattening the yield curve. How many equity investors are willing to lock in their money for a +0.66% return for 10 years in US Treasury bonds? I suspect, not many and that can mean only one thing – with nowhere to go to

generate income, investors will continue to take more risk and pile into equities.

Covid-19 “second wave”?

September saw the equity markets hit an air pocket – fear of a second Covid-19 wave, a lack of urgency on the part of the US policymakers to pass a new stimulus bill, the risk of a disputed election ahead and an overly valued technology stocks.

As if that were not turbulence enough, last week, communication by the US Federal Reserve (Fed) raised market anxiety that it may be out of ammunition.

As a result, the S&P 500 index (SPX) fell by -10% at one stage, before recovering some of the losses during the last few trading sessions.

S&P 500 (SPX) Index: 2-month price chart



Source: Bloomberg

Let's look at the concerns one-by-one and begin with the biggest: A Covid-19 “second wave.”

The number of cases is indeed on the rise globally, but thankfully the rate of death (chart below) is far lower than the levels we saw in March-April this year. This is not to say that the numbers cannot go higher, but at the same time the health-care system continues to have significant spare capacity and this gives countries some time to stabilise and reduce cases before the health system becomes overwhelmed.

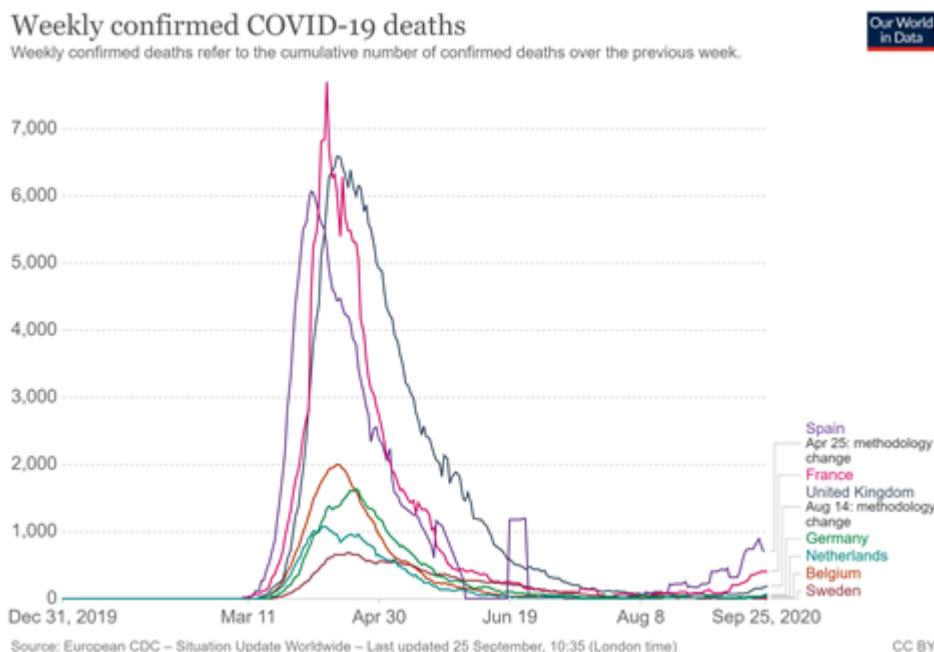
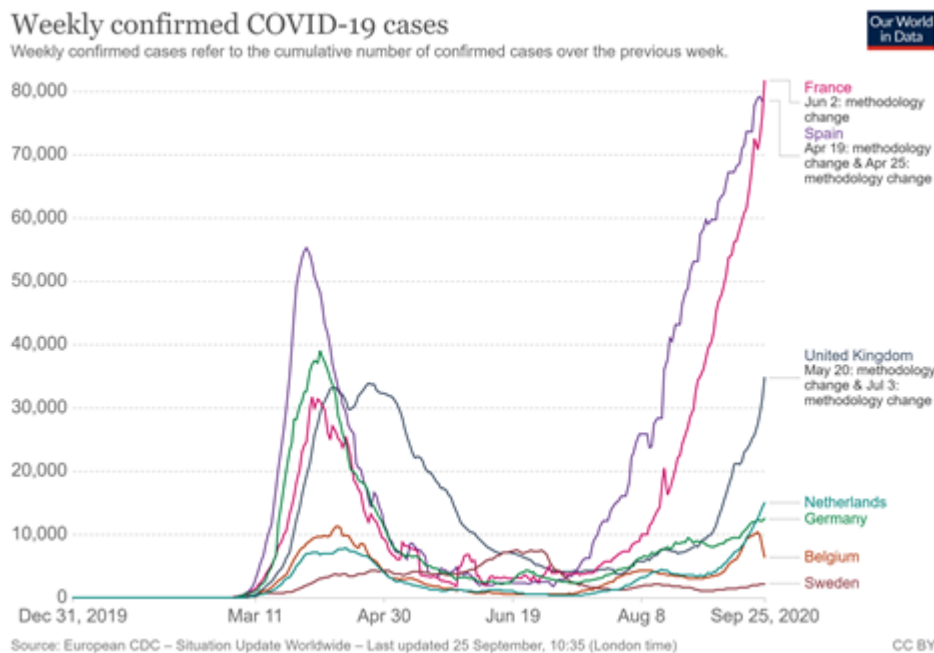
I do not see the “second wave” getting worse to the point that we see a widespread economic lockdown. Lockdowns don’t make the problem go away. You have to unlock sooner or later and then the infection spread accelerates again as it has now. I don’t like to call it “the second wave,” it’s more a resumption of the first wave.

Every country that locked down without having a strategy for what came next, followed medieval superstition, not science. Well done to Sweden for actually having a strategy. Sweden relied on precedent. They learnt from what had previously been done in response to pandemics. They let the virus circulate amongst the healthy population at a “controlled rate” using sustainable and targeted safe distancing measures that didn’t cripple the economy. Sweden is not having similar levels of flare-ups as Spain, France or the UK (chart below). The UK started off doing what Sweden did, but abandoned the approach very early on due to relentless criticism from a hostile media and those opposed to UK Prime Minister Boris Johnson.

Precautions yes, protection of the vulnerable absolutely but economy-destroying lockdowns? Clearly, no. The public is being blamed for the Government’s failings and short-sightedness across Europe so far and Sweden is being deliberately overlooked as it only highlights those failings. While the UK and other nations focus on “number of death’s,” in Sweden the focus has been more on life and what makes it worth living and realising that opening and shutting down an economy is not the way to deal with Covid-19. Protecting the vulnerable, practising safe measures and letting the non-vulnerable (who

vastly outnumber the vulnerable) get on with their lives is a much better way.

Weekly confirmed Covid-19 cases and deaths



Additionally, the number of deaths should not be looked at in isolation. Here are the statistics for the daily death rate in the UK (as reported in The Sunday Times recently): Cancer 450, Dementia and Alzheimer's 214, Coronary Heart diseases 180, Stroke 99, Flu and Pneumonia 29, Covid-19 17, Accidents at home 16, and Road accidents 5. Therefore, the death from

Covid-19 is about same as that from accidents at home and represents 4% of the daily deaths from Cancer, which as a disease sadly is going undiagnosed due to the disruption to normal health services.

Second, the next stimulus bill better known as 'Coronavirus Aid, Relief, and Economic Security Act' (CARES) II is not dead as the markets feared last week, and the Democrats are preparing a new proposal. The Republicans are unlikely to agree to the \$3.5 trillion bill the House passed in May and the White House has indicated it could support spending as much as \$1.5 trillion. Monday evening, the House Democrats released a \$2.2 trillion coronavirus relief package that would restore \$600 weekly jobless benefits that expired in July, and include another round of direct checks to Americans, at \$1,200 per taxpayer and \$500 per dependent according to the text. The package would also extend the Paycheck Protection Program (PPP), which expired in August, leaving more than \$130 billion in funding unused. A vote is possible later this week. Centrist Democrats are concerned by the optics of a failure by Democrats to pass a bill, with the elections less than a month away, have been pressuring Speaker Nancy Pelosi to put forward another aid bill, even if it is smaller than the bill the House passed in May.

Third, the sell-off in technology stocks seems to have abated, and it was a welcome relief, given the lofty valuations reached in a very short time. I am still underweight tech stocks and wouldn't look to add to the sector this side of the election.

Lastly, the risk of a disputed election is probably the most disruptive risk lying ahead for markets and volatile times are upon us, as evidenced by the performance of equities in September. If your investing horizon is greater than 12-months, then I wouldn't worry about cutting any long positions, as any election driven volatility is likely to be resolved by Q1 2021, if not before. I believe President Trump

will to win and there will be many opportunities ahead in the equity markets as he looks to lower taxes, spend and cut regulations. However, given the importance of postal ballots in this election, if the results were delayed, the very short term moves in the market could be quite violent and not conducive to the health of any short-term trades in the portfolio.

Markets and Economy

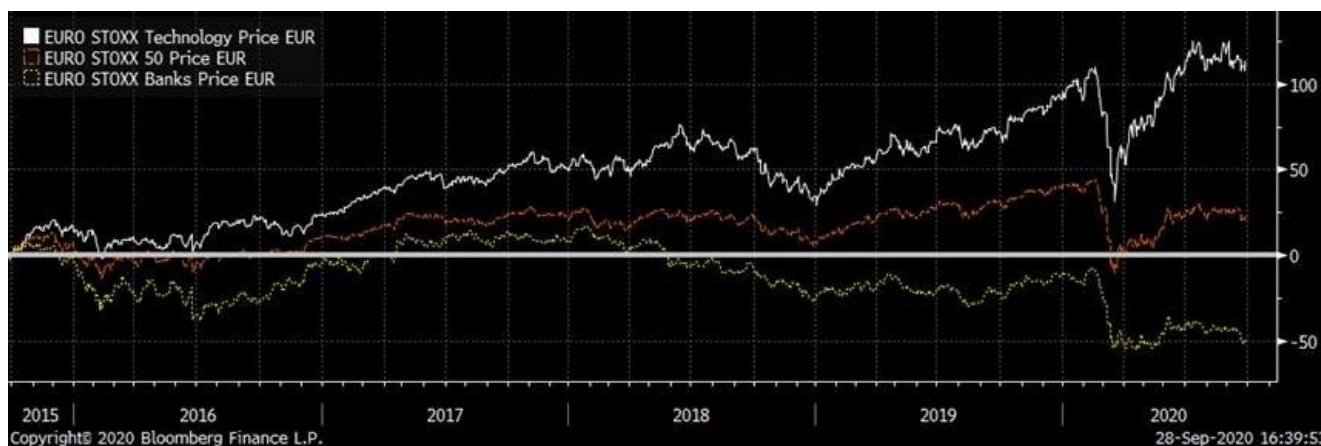
Before discussing equity market performance, I would like to share an important update.

Europe's blue-chip index, the Eurostoxx 50 (SX5E) which serves as a key benchmark for European equity portfolios as well as an important underlying index for structured products and futures trading is changing, and changing for good.

The last few years has seen the underperforming stocks (banks primarily) – Generali (G IM), UniCredit (UCG IM), Deutsche Bank (DBK GY), E.On (EOAN GY), Saint-Gobain (SGO FP), Unibail-Rodamco (URW NA), Société Générale (GLE FP), BBVA (BBVA SM) fall out of the index and be replaced by companies in the technology, retail and chemical sectors such as – Adidas (ADS GY), Amadeus IT (AMS SQ), Linde (LINU GY), Kering (KER FP), Deutsche Boerse (DB1 GY), Adyen (ADYEN NA), and Prosus (PRX NA).

This rebalancing away from financials, which now represent under 5% of the index (down from a peak of over 20% in 2010), is good for the index and for investors tracking the index via passive funds or structured products. The European bank stocks index (SX7E) is still down nearly -90% from its June 2007 high, whereby over the last 5 years Eurostoxx Tech index (SX8E) has outperformed the SX7E by +165% (see chart below)

Eurostoxx 50 (SX5E), Eurostoxx 50 Technology (SX8E) and Eurostoxx Banks (SX7E): 5-year price chart



Source: Bloomberg

Surging technology and healthcare stocks are increasing their influence over European stock markets, as the role of car and energy companies gets reduced. This tilt away from “old economy” sectors like banks, cars and energy companies and the move towards “new economy” sectors such as technology and healthcare will serve the index well. In the SX5E, technology is now the largest sector at 15% and with healthcare, together add up to 25% of the index.

Moving on to US markets, despite the pullback last week, US stocks continue to outperform the rest of the world -except China and the tech-heavy NASDAQ Composite – (see table below)

Benchmark Equity Index Performance (2019 & YTD)

Ticker	Name	Country	2019 Performance (Lcl Ccy)	Year-to-23 March 2020 Performance (Lcl Ccy)	23 March 2020 to Today Performance (Lcl Ccy)	2020 Year-to-Date Performance (Lcl Ccy)
CCMP Index	NASDAQ COMPOSITE INDEX	US	35.2%	-23.5%	61.6%	23.5%
SHCOMP Index	SHANGHAI SE COMPOSITE	China	22.3%	-12.8%	21.0%	5.5%
SPX Index	S&P 500 INDEX	US	28.9%	-30.7%	49.1%	3.2%
NKY Index	NIKKEI 225	Japan	18.2%	-28.6%	37.3%	-2.0%
MXIN Index	MSCI INDIA	India	8.5%	-36.0%	52.5%	-2.4%
DAX Index	DAX INDEX	Germany	25.5%	-34.0%	46.4%	-3.4%
INDU Index	DOW JONES INDUS. AVG	US	22.3%	-34.9%	47.7%	-3.8%
MXEF Index	MSCI EM	Emerging Markets	15.4%	-32.0%	41.0%	-4.1%
IMOEX Index	MOEX Russia Index	Russia	29.1%	-26.0%	29.2%	-4.4%
MXTR Index	MSCI TURKEY	Turkey	20.0%	-26.0%	18.9%	-12.1%
SX5E Index	Euro Stoxx 50 Pr	Europe	24.8%	-33.6%	29.0%	-14.4%
HSI Index	HANG SENG INDEX	Hong Kong	9.1%	-23.0%	8.4%	-16.6%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	31.6%	-45.0%	47.2%	-19.1%
FTSEMIB Index	FTSE MIB INDEX	Italy	28.3%	-33.8%	22.2%	-19.1%
CAC Index	CAC 40 INDEX	France	26.4%	-34.5%	23.2%	-19.4%
UKX Index	FTSE 100 INDEX	Great Britain	12.1%	-33.8%	18.2%	-21.7%
IBEX Index	IBEX 35 INDEX	Spain	11.8%	-34.8%	7.6%	-29.8%

Source: Bloomberg

The sell-off of the last two weeks now seems to be behind us. However, as I pointed out in the section above, we will see

more volatility as we get closer to the November 3 election. October will be a very volatile month, although the overall trend for US equities is still to the upside.

“Don’t Fight the Tape” is still in place from a long-term perspective, as the S&P 500 index (SPX) remains in a bull market and within its long-term uptrend channel. Besides the Fed’s regime of “lower for longer” is positive for equities.

With the recent comments coming out of the Fed indicating that they do not expect fiscal stimulus, for now, expect the Fed to issue more aggressive forward guidance that will keep flattening the yield curve and that can mean only one thing – with nowhere to go to generate income, investors will continue to take more risk and bid up equities.

Equity bears have been so wrong for so long but it doesn’t stop them from incessantly predicting the next correction, every time they see a -5% pull back. Meanwhile, the SPX keeps notching new highs.

Investors value equities with reference to a “risk-free rate”- the 10 Year US Govt bond (USGG10) yield to put it simply. When you buy equities, you take into account the return you would get compared to the return you are foregoing by not investing in “risk-free” asset. The Question is – do I buy Microsoft (MSFT US) or the US 10Y bond?

The Yield on the US 10y bond is currently +0.66% (in comparison, the SPX dividend yield is +1.83%). During the last two big equity sell-offs in 2007 and in 2000, the USGG10 yields were +5% and over +6% respectively (see chart below).

S&P 500 index, US 10 Year Treasury yield: 20-year price chart



Source: Bloomberg

At that time, if you felt nervous about stock valuations, you could say to yourself – well, equities look expensive/speculative and moving to US Govt bonds offering a risk-free return of +5-6% seems a good bet. When enough people did that in response to any scare, you had a deep correction.

Now, how many equity investors are willing to lock in their money for a +0.66% return for 10 years? I suspect, not many.

It's better to have blue-chip stocks in the portfolio that pay a dividend and give you an "option" on future earnings, than to get stuck with a bond with +0.66% yield for 10 years. Of course, all of this can change if the Fed indicates it is looking to raise interest rates, but we've just been told by the Fed that "interest rates will have to stay near zero through 2023."

A reflation trade will eventually come and when it comes it will very likely be slow and steady and well preambled and telegraphed, given how carefully the Fed has been managing the messaging. In the present circumstances, if you still have to hold a bond, please hold a majority of floating-rate bonds and not long duration fixed-rate bonds.

I continue to be bullish on equities with consumer stocks – both Staple (XLP) and Discretionary (XLY) are my favourite sectors to pick stocks from. I however, warn of a volatile 4-6 weeks period ahead, as we see the pre and post-US election events play out.

Benchmark US equity sector performance (2019 & YTD)

Ticker	Name	Country	2019 Performance	Year-to-23 March 2020 Performance	23 March 2020 to Today Performance	2020 Year-to-Date Performance
XLK US Equity	TECHNOLOGY SELECT SECTOR SPDR	US	47.9%	-23.2%	64.4%	26.2%
XLY US Equity	CONSUMER DISCRETIONARY SELECT SECTOR SPDR	US	26.7%	-30.2%	66.6%	16.2%
XLC US Equity	COMM SERV SELECT SECTOR SPDR	US	29.9%	-24.8%	47.2%	10.7%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	US	21.6%	-37.6%	64.3%	2.6%
XLV US Equity	HEALTH CARE SELECT SECTOR SPDR	US	17.7%	-26.7%	39.1%	1.9%
XLP US Equity	CONSUMER STAPLES SELECT SECTOR SPDR	US	24.0%	-22.8%	30.2%	0.6%
XLI US Equity	INDUSTRIAL SELECT SECTOR SPDR	US	26.5%	-40.1%	58.3%	-5.3%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	US	22.1%	-30.5%	31.0%	-8.9%
XLRE US Equity	REAL ESTATE SELECT SECTOR SPDR	US	24.7%	-34.2%	37.8%	-9.3%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	US	29.2%	-42.6%	34.5%	-22.8%
XLE US Equity	ENERGY SELECT SECTOR SPDR	US	4.7%	-60.7%	27.5%	-50.0%

Source: Bloomberg

The rally in EUR/USD seems to be over for now and the weakness will help the Eurozone stocks as will a let-up in Covid-19, which will most definitely come. On a 12-month basis and also bearing in my mind the changes we have seen in the SX5E index (as outlined above), I would recommend the SX5E as a buy.

We have also seen a -20% sell-off in Silver and an over -10% sell-off in Gold this month. As I've pointed out in the past and on my email updates – a reflation trade will come, but not so soon. Investing in Gold is insurance and be prepared for the volatility and sharp moves. It's best to buy Gold on pullbacks and accumulate a 5-10% holding in a portfolio, over time, for a rainy day and forget about it until the rainy actually arrives.

For specific stock recommendations, please do not hesitate to get in touch.

Best wishes,

Manish Singh

Manish Singh, CFA