Private Bank

CIO Strategy Bulletin

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Yields Are Too Low for the Eventual Post-Covid World

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Summary

- It is quite telling that world financial markets swung sharply on news of a Russian-made Covid vaccine that has no clear path toward global use. We see the market reaction as a "dress rehearsal" for a real post-Covid cyclical recovery.
- Investor positioning is crowded in interest-rate sensitive defensive assets such as gold, Treasuries and tech stocks. Tech has risen very sharply, aided by its fundamental value in proving solutions for social distancing in the Covid economy.
- Covid is not done restraining the world recovery or scaring investors. For longer-term portfolios, rotation between expensive Covid defensives and cheap Covid cyclicals is recommended. [1]
- We have never abandoned a focus on the *Unstoppable Trends* that have sought to protect equity investors this year. For now, one should hold a balance of the best values in both. To make room in portfolios, reducing exposure to the world's most expensive fixed income securities is wise.

Sputnik V is Not the Market's Vodka Tonic

The Russian vaccine announced Tuesday is unlikely to be the leading cure-all for Covid. News of a "Sputnik V"-style launch of a "Covid cure" on August 11 is one among many legitimate and speculative news releases for treatments that promise an end to the global pandemic. Many of these prospective pharmacological advances are in testing, but none are likely to be a "silver bullet" for Covid. In fact, Russia's entry was just beginning its Phase 3 testing with just 2,000 patients (a 30,000 patient trial is the Western standard) and was roundly criticized last week for its premature commercialization.

The "Tell"

Russia's vaccine announcement comes less than 90 days before the US election and may be part of Vladimir Putin's desire to bolster Russia's status and respect in the international community. Whether or not "Sputnik V" lands safely, the market reaction to Tuesday's announcement provides an important "tell" for investors. With no likely distribution in the West, the vaccine announcement caused 10-year US Treasury notes to plunge 0.75% in price and 30-year bonds to drop 2% in value. That day, the US yield curve steepened 6 basis points. The world's most expensive negative yielding debt fell in value (see **Figure 1**). And gold fell nearly 5%, its biggest daily drop in 7 years.

By week's end, we also saw news that US retail spending for July reached all time record high levels and manufacturing continued to rebound, both encouraging signs for an eventual post-Covid future (**see Figure 2**). That said, the world has not seen the end of "Covid

[1] Covid-defensives include information technology, health care, communications services, consumer staples, utilities and e-commerce sectors. Covid-cyclicals include industrials, financials, consumer discretionary excluding e-commerce, real estate, energy, and materials sectors

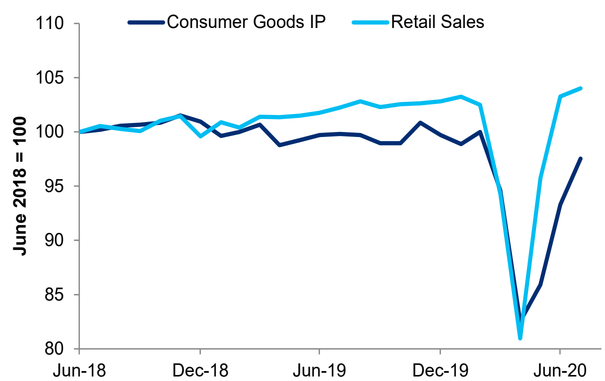
convulsions". Washington D.C. has remained deadlocked and it will be no sooner than early September before we know whether fading fiscal stimulus will be replenished during the US election season. While we know that both Republicans and Democrats want a bill, the dimensions of the bill remain in flux. If a compromise $1.5-2.0 trillion plan is agreed, it will likely contain $400B+ in aid to individuals and $250B for state and local assistance. These would be positive for the US economy as the huge gaps in state and local coffers would cause retrenchment of government services and further unemployment.

Here is what the "Tell" may be telling us…

1) Following a confirmed Covid treatment, global yields are likely to rise. A year from now, a doubling in 10-year US Treasury yields to 1.25% seems plausible. If Fed policy rates remain at zero as we expect, the yield curve would steepen sharply, though not far above its long-term average.
2) Overall share price indices may rally modestly on a post-COVID economic recovery, but the performance dispersion we have seen will allow opportunities for alpha as winning and losing sectors rotate. A rotation within the equity markets benefiting beaten down cyclicals, such as Financials, will accelerate.
3) Until better health care treatments for Covid are found, certain parts of the economy – such as hospitality and travel – will remain highly depressed. Recapitalizations of these companies will aid the winners.
4) Financial markets will continue to have periodic bouts of fear and relief. Bond yields, gold, value and growth stocks will exhibit negative correlations between assets tied to a cyclical recovery and those that are considered defensive.

Figure 1: Global Negative Yield Bond Value in US $Trillions

Figure 2: Industrial Production of Consumer Goods vs US Retail Sales



Source: Bloomberg Barclays Indices and Haver Analytics as of August 14, 2020.

Richly Priced Government Bonds and Tech Stocks

Beware of bonds here.

Nominal US 10-year yields at 0.65% and inflation-linked "real-return" bonds "yielding" -1.0% have a significant way to rise before they present a compelling risk-adjusted return for investors. While these bonds offer greater portfolio value than their yield alone (please see our Mid-Year Outlook and **Figure 13**), they may experience negative absolute returns in a post-COVID world. Note that no US nominal paper is negative yielding, just *negligible yielding*, so there are even worse valuations in other developed bond markets, where long-term real yields can be as low as -2.0%.

The impact of collapsing bond yields has juiced some of the world's asset markets, increasing the risk of an unwind in these markets, too. As we discussed in our CIO bulletin of July 12 (*The Dangers of Growth at Any Price*), in a *severe, but narrow* economic contraction where policy rates are deliberately dropped and credit markets respond in tandem, the valuations of industries that are still growing become stretched. We have seen this is many tech shares and have advised investors to limit their holdings within US equities for TMT (Tech, Media and Telecom) to 50%; significantly less for total portfolio wealth.

So, What Happens When Yields Rise?

Zero interest rates imply that there is no *opportunity cost* to hold gold. In other words, zero-yield gold *out earns* negative yield bonds. Both a stable store of value and a future growth opportunity can be discounted at a higher *present value* when rates plunge **(see Figures 3-4)**. But what happens if yields rise? We saw the answer last Tuesday, as economically sensitive value shares like Financials and Industrials rallied in price while tech shares and gold fell.

In our view, this is a "dress rehearsal" for a real post-Covid recovery. The nature of the economic recovery may not be a particularly strong spur for *broad* US indices. Markets have been discerning and rational, overall. Shares that have done well are in industries that have done well. For “Covid defensives,” particularly TMT **(see Figures 5-6)** the possibility of subdued returns or a period of growing earnings/cash flow without a corresponding further increase in share prices appears likely.

As **Figure 7** shows, a future drop in unemployment would not likely be a reason for *broad share markets* to rally. Large cap US growth stocks have already done so. But for many US and global cyclical shares, an employment rebound would signal further gains after trailing so badly behind “defensive tech” **(see Figure 8)**.

Figure 3: US 10-Year Treasury Yield, US “Pure Growth” Index and Gold Price

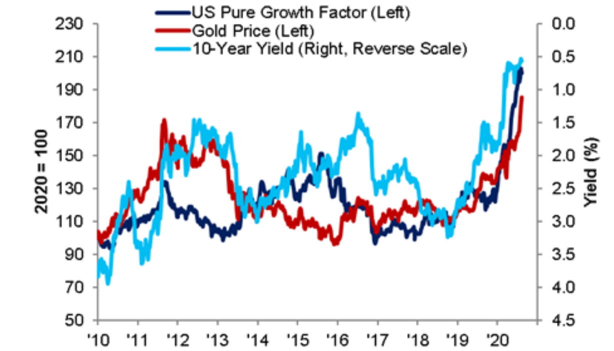
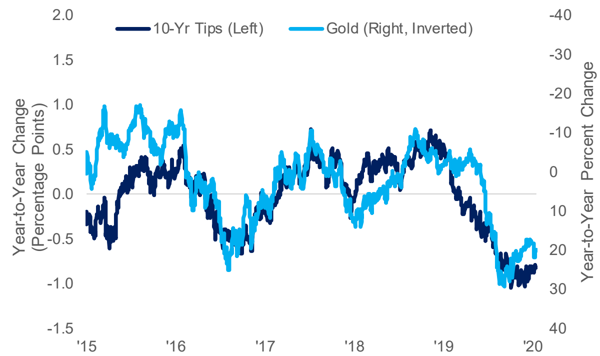


Figure 4: US 10-Year Inflation Linked Real Bond Yield vs Gold Price Year/Year % Change



Source: Bloomberg and Haver Analytics as of August 14, 2020.

Figure 5: Price to Book (P/B) & Forward Price to Earnings (P/E/): Growth vs Value shares

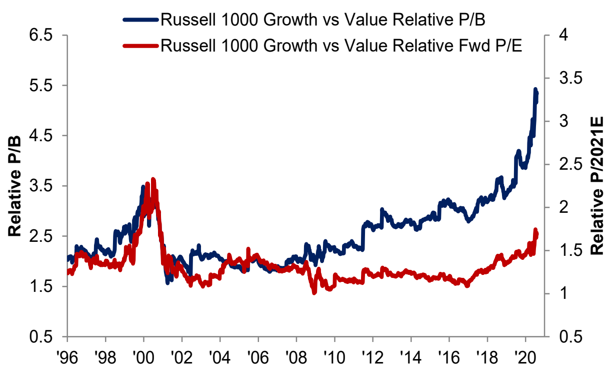
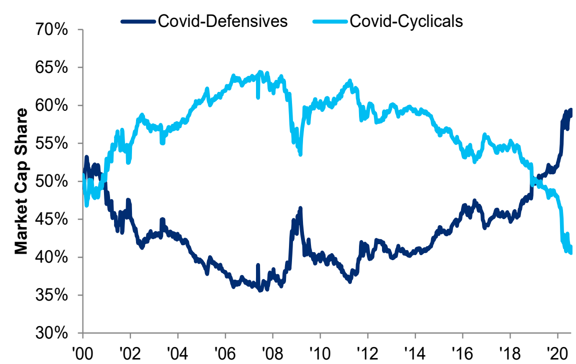


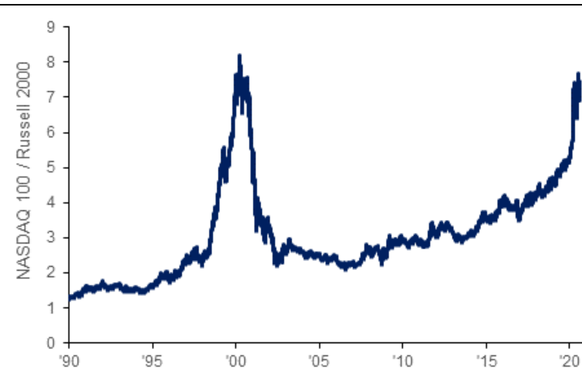
Figure 6: Global Covid cyclicals and defensives market capitalizations % of Total



Source: Bloomberg and Haver Analytics as of August 14, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Figure 7: S&P 500 vs US Unemployment Rate, 12-month change

Figure 8: US Nasdaq 100/Russell 2000 relative performance



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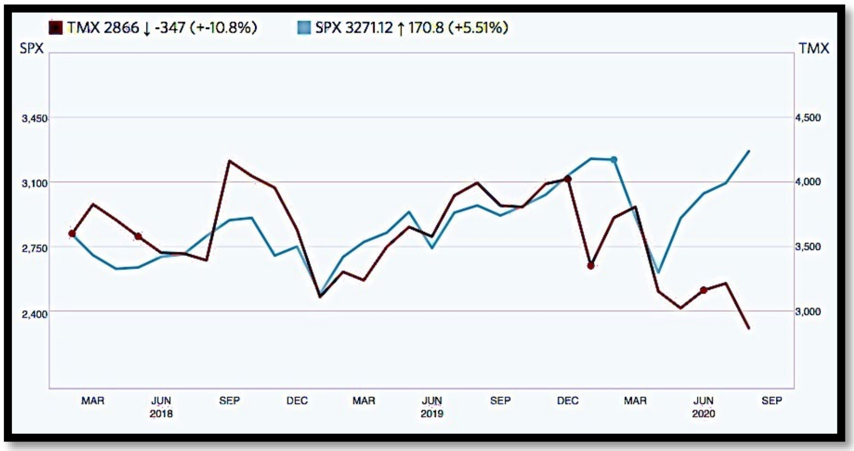
Frequent Hangovers Rather Than A Smooth Recovery

We do not expect that Covid-19 will provoke market shocks as deep as the economic shutdown did during the first wave in February and March. The world is far more prepared for an onslaught of infections. Business resilience has been better than expected, as consumers continue to shop and the substitution of particular goods and services within overall demand deepens. When people can't travel, they buy more televisions. When they can't go into a store, they buy online. Macroeconomic policy, while imperfect, is positioned far differently now than was the case in March. Nonetheless, we are not convinced that the world has seen the end of growth scares and shocks from COVID. There will be hangover effects.

Figure 9: Thomas Manufacturing Index 2018 – August 2020



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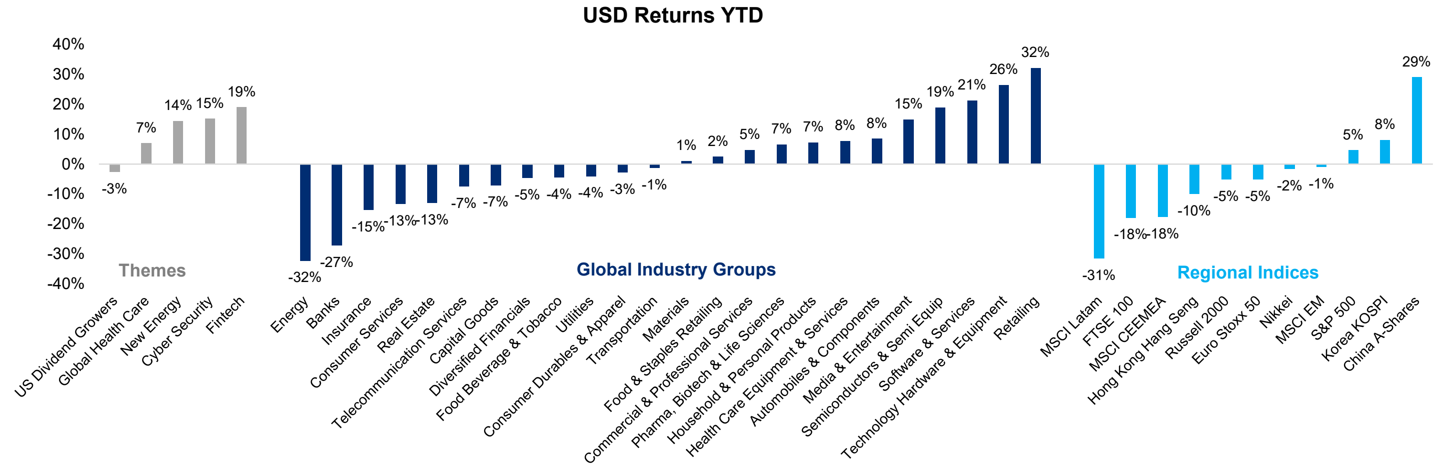
You can see how much room there is for recovery by looking at the Thomas Manufacturing Index or "TMX", a new index that measures industrial activity and investment in the United States and Canada. (TMX leads the stock market when industrial activity is driven by long term investments or major shifts in the manufacturing sector. Conversely, the index lags the market when there are sustained sharp upward or downward trends in stock prices.) Since the pandemic began, there has been a lag in the recovery for manufacturing, a trend we expect to reverse as sustained consumer and business activity and inventory depletion, supply chain enhancements and on-shoring all drive demand higher.

For long-term portfolios, we retain our belief in *Unstoppable Trends.* These trends have been Covid beneficiaries, seeing unexpected growth due to their value to businesses and consumers alike. The world economy's ability to adapt to social distancing (see **Figure 10** and our CIO Bulletin from last week: Why the Global Economy is Poised for Accelerating Growth) is a prime example of their long-term value. That said, we are NOT buyers at any price. Instead, we have gradually shifted our tactical asset allocation to expose portfolios to beaten down Covid-cyclicals by making room via reduced global fixed income and cash allocations.

Figure 10: Our Long-Term Themes Continue To Perform Well in 2020:
Digitization, Invest in Longevity, Asia Development, New Energy



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What to Do for Yield or How Much Cash Do I Really Need?

As we noted in our *Mid Year Outlook*, US corporate credit markets have required an unprecedented fiscal and monetary bailout for the second time in 15 years. We have retained small over-weights in US Treasuries, because the US has a bailout mechanism in the form of its monetary printing press **(see Figure 11)**. We are also overweight selected US and Eurozone high yield bonds in certain portfolios (please see our July Quadrant).

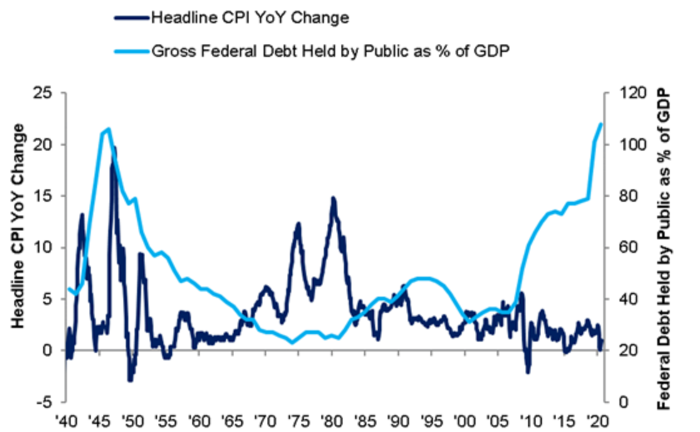
Much of the fixed income universe is an imperfect store of value rather than a positive real-return investment **(see Figure 12)**. Thus, an investor needs to ask "how much cash do I intend to keep in cash over the coming years?" For most investors, current cash allocations are simply too high.

We have written before about areas where investors can still earn real yields. Mortgage REITS are one such area. Even with some dividend cuts, prospective yields for residential and commercial mortgage-related assets may be 9%. With less leverage, high grade, single-A-rated non-agency commercial mortgage backed securities yield nearly 6%. This is more 2-3X comparably rated US corporate bonds which have benefited from direct purchases by the Federal Reserve. Further afield, preferred shares in large financials make sense. Fed stress tests showed strong equity capital in market stress scenarios far worse than at present.

And then there are dividend equities. If one combines "cyclical shares" positioned for recovery in a post-COVID world with "dividend payers", there could be compound benefits. As noted, we would do so by limiting, not eliminating the fastest growing US tech firms within holdings.

Finally, if you are holding cash and "waiting for the equity market to correct," the following is a potential strategy. As **Figure 13** illustrates, unlike yields, implied volatility has stayed relatively high. In this illustrative example, selling volatility could possibly earn 4%-6% with the potential to buy broad equities in a scenario where they fall by 10%-20% in price. Thus, the strategy would earn a yield while waiting for an entry point. Enhancing portfolio yield via dividend paying stocks and selling volatility are both strategies to consider in the current market setting.

Figure 11: US Treasury debt as % of GDP and Inflation



Source: Haver Analytics as of August 14, 2020.

Figure 12: US 10-Year Treasury and 1-Month Libor Rate (%)

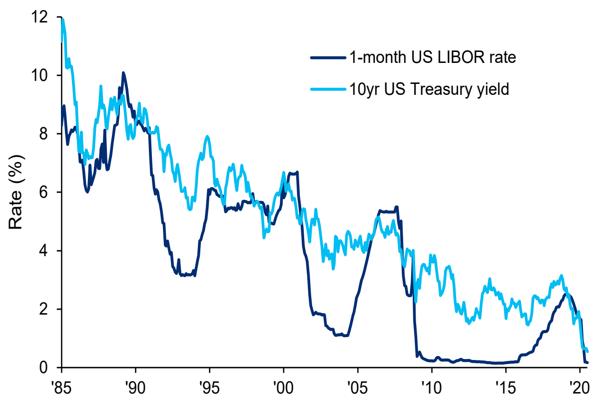


Figure 13: S&P 500 Implied Volatility as a % of the Spot Index Price

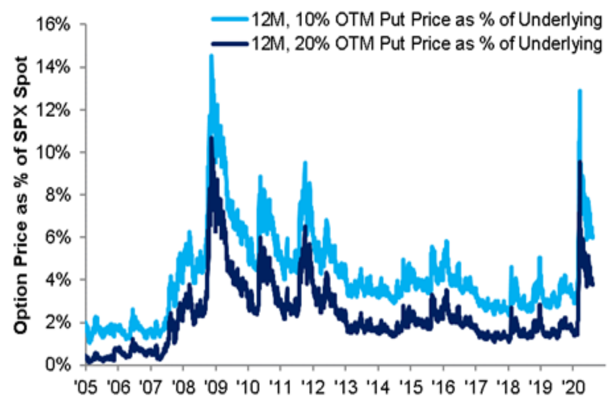


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Figure 14: US Treasury and IG Corporate Bond Returns During Years With Falling Equities

	S&P 500 Total Return Index	Bloomberg Barclays US Treasury idex	Bloomberg Barclays US corporate index
1974	-26.5	7.1	-5.9
1977	-7.2	2.7	3.2
1981	-4.9	9.2	3.0
1990	-3.1	8.5	7.1
2000	-9.1	13.5	9.1
2001	-11.9	6.7	10.3
2002	-22.1	11.8	10.1
2008	-37.0	13.7	-4.9
2018	-4.4	0.9	-2.5
	correlation to equities in decline years	-0.51	0.45

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