TOO FAR, TOO FAST?

MARKET FLASH

JUNE 2020

Does this rally have legs?

With the CAC having surged back to 5000 points not too long after brushing up against an intraday low of 3600 on 16 March, and with the Nasdaq now up by 8% on the year to date, it's time to ask a simple question. Does this rally have legs and will we at last see the long-awaited rotation?

My view is that it's a little with interest rates, where I ultimately threw in the towel. Low productivity, a lack of structural reforms, and, moreover, a double supply-side and demand-side Covid-19 shock had nipped in the bud any possibility that potential growth could accelerate sufficiently to push up cyclical and value stocks.

The awakening of Europe

Et pourtant (as Charles Aznavour, the French singer, said in a famous song), the European Union does appear to have achieved new momentum in its construction by embracing the themes of solidarity and coordination on the path towards more federalism. The plan put forth by Angela Merkel and Emmanuel Macron could very well get "old Europe" back in the race for competitiveness and attractiveness, a race that it had dropped out of for almost 20 years.

Of course, there are words, and there are deeds. So stay tuned, even though this challenging year 2020 just keeps throwing surprises at us.

A phase of high unemployment that could very well drag on

We are still seeing a widening disconnect between optimism on the financial markets and how the real economy is actually doing, which depends on reining in unemployment, particularly in the US.

Unfortunately, employment could take far longer to recover than production, as those sectors hardest hit by social distancing are precisely those that employ the most people. In the US, the leisure and hotel sector accounts for 11% of jobs, but just 4% of growth. Retailing, meanwhile, accounts for 10% of jobs, but just 5% of production. As a result, if these two sectors operate at half their pre-Covid capacity, production will shrink by 4.5%, and employment will collapse by 10.5%.

Conversely, sectors that have been the least hit by social distancing account for relatively few jobs but for far more growth. Financial activities, meanwhile, account for just 6% of jobs, but 19% of growth, and IT just 2% of jobs, but 5% of growth.

Ultra-accommodative policies are reducing the risk of depression

If economies restart but social distancing continues – either as a matter of policy or by personal choice – growth could rebound strongly, but not jobs. If so, central banks would have no other choice but to stick to their current ultra-accommodating monetary policy and even ratchet it up. Would this be such a bad thing? Not really, given how high "central bank money" has sent asset valuations to new highs.

A downside risk in the short term

We do see some downside risks emerging in the short term on the financial markets. A correction could be triggered by renewed Sino-US tensions, an escalation in Hong Kong, or a second wave in the pandemic as economies open back up. We are also keeping an eye on ongoing unrest and political turmoil in the US.

That being said, even taking all these risks into account, they will not necessarily be able to deviate the trajectory of a reversion to the mean in risky assets in the medium term, which, in our view, is being driven by four factors:

- A broad rotation into equities that is still lacklustre
- Prompt and flexible action by central banks in addressing companies' financing problems
- A structural shift in the environment of liquidity and interest rates
- An expected economic recovery, driven by a steady lifting of lockdowns.

With this in mind, the key to performance in the coming months will be asset selection (by sector, style and geography), more than the weighting of risky assets.

We should see things more clearly in our investment strategy that we will present later in June.

Keep staying safe.

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