Investment Strategy Note

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ADCB بنك أبوظبي التجاري

The world after COVID19: the next 12 months, and the next decade

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> *"Protests over racial justice also have the potential to seed a new labour movement in the US".*
> Rana Foroohar, Associate Editor at the Financial Times, June 14 2020

> *"We can be proud of what has been done and of our country ... Of course this* [Covid19] *test also revealed flaws, weaknesses: our dependence on other continents to obtain certain products ... The only answer is to build a stronger, sustainable economic model, to work and produce more so as not to depend on others".*
> Emmanuel Macron, President of France, June 14 2020

A brave new world of redistribution and de-globalization

This is the third of a series of COVID19 special investment notes. In the first March 19 note I had confirmed our view that equity markets would rebound and that the major beneficiaries would be the so-called FAANGS, the well-known US tech behemoths, as well as other large cap technology growth stocks. In that note I used the word "socialism" to highlight how COVID19 would reinforce and accelerate the structural shift in US economic policies, from market friendly to labour friendly. Big changes take time of course. Nonetheless, by April the Financial Times' Editorial Board was formally endorsing such policies. Some FT editors are now seeing the recent *Black Lives Matter* demonstrations as a prelude towards a potential US labour movement, intent on promoting more "socialist" redistribution. How exactly redistribution will pan out needs to be seen. But it will come. It will come together with de-globalization, the move away from a "rules-based" multilateral world to a multipolar world centred around a few major competing powers, each aiming for self-sufficiency. In that sense, Macron's quote above is ever so revealing. He was, after all, the last leader of a major Western country elected on a platform of more, rather than less, international rules and multilateral cooperation.

This paper consists of two parts. The first part consists of one page summarizing our investment strategy over the next 12 months. The second part consist of less than two pages and offers some thoughts, not yet fully reflected in our investment strategy, about the next decade of de-globalization as well as redistribution in developed markets, and what it might mean for investments.

Charts and tables are provided in the appendix.

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So far we got it right, but what now? The next 12 months

As for the market rebound itself, never before has an equity correction in excess of 30% so rapidly been followed by a close to complete recovery. It is of course way too early to chant victory. Yet, the S&P500 is now up around 34% from the March 23 low, having earlier on surged more than 44% from that level. With the admittedly ominous exception of the 1929-30 recovery, in the past the US market did not re-test new lows once it had recovered by more than 40%.

- **The 12-month economic outlook: a recovery to a slow growth world of lower interest rates**
  The global economy remains of course in unchartered waters. Having said so, we continue to think that over the next 12 months the global economy remains on track for a recovery to a ***slow*** growth cycle with stubbornly ***low*** inflation and ***lower*** yields. The recovery will materialize because governments are ramping up stimulus (Chart A) so that consumers and companies preserve their balance sheets, and thus will be able to resume spending once lockdown measures will be relaxed. Governments are able to debt finance stimulus because central banks have virtually unlimited capacity to buy government paper (Chart B). Why are we moving to a world of slow growth? The simple answer is that we already have been in a world of slow growth since US households started deleveraging in the aftermath of the 2008 Global Financial Crisis (Chart C), thereby renouncing their traditional role of global buyer of last resort. US households will remain scarred by the COVID19 crisis, which is exacerbating inequality and demand compression. Thus the crisis will further accelerate deflation and secular US growth reduction (Chart D). Interest rates will move closer to “Japanese” and “European” levels (Chart E).

- **The 12-month outlook key risks: a second COVID19 wave and the US presidential elections**
  The key risk for our outlook is a resurgence of the spread of COVID19. At this stage those concerns are particularly acute in the US (Chart F), specifically in the states of California, Florida, Texas, Arizona and Georgia, which together count for more than a third of the US population. If significant lockdown measures will need to remain in place in major economies, the economic drawdown could well last into 2021, something we are currently not expecting.

  Our first risk (a second COVID19 wave) cannot be separated from our second risk (the US presidential elections). COVID19 mismanagement as well as political escalation by President Trump, before and after the elections, could pose a threat to economic growth. This would be bad for stocks, and in particular for cyclical and value stocks (i.e. mostly non-US equity markets). A Biden presidency on the other hand carries the risk of more taxation and regulations, and constitutes therefore a more obvious threat to long-term equity valuations.

- **12-month outlook and key risks: our asset allocation (Table 1)**
  Even if a second COVID19 wave would not lead to more stringent lockdown measures, it could still severely damage consumer confidence, and thus aggregate spending. It makes sense therefore to maintain our neutral equity weight, fixed income underweight, and cash overweight. Equity is what must deliver the long-term return to our clients. COVID19 is accelerating structural changes that will further disrupt old economy companies. By sticking to quality growth companies at the expense of value and cyclical companies, we believe we can deliver those long-term returns.

- **The 12-month fixed income investment allocation (Table 2): a selective play on spread tightening**
  In a low-inflation world of slow growth, some debtors will inevitably face liquidity if not solvency issues. That is why our credit and emerging market strategies have focussed on selective quality bets, such as high quality GCC bonds or Russia, with only a few plays on excessive spread widening, such as Brazil. If, as we are expecting, global growth will remain sluggish through 2021, it makes sense to combine our selective emerging market bets with US Treasuries as a risk hedge. We thus maintain our current barbell strategy, but have shifted our duration from short term to medium-long term.

- **The 12-month equity investment outlook (Tables 3-5): equity bifurcation to continue**
  A low-inflation world of slow growth is not a good environment for value stocks and cyclical stocks. It remains a favourable environment for the disruptors, i.e. the quality growth stocks. Of course, as the economic recovery gains momentum growth stocks might suffer a little more in ***relative*** terms versus cyclical stocks. We expect this relative underperformance to be short-lived. With the release of the earnings for the second quarter of 2020, markets are likely to reassess the cost of the COVID19 lockdown measures, specifically for value and cyclical stocks.

Redistribution and de-globalization confirmed, but what about the future? The next decade

The next 12 months will see an exacerbation of global inequalities. This will also be reflected in an increase of concentration in capital markets, once more at the advantage of US large cap growth stocks. These developments are politically unsustainable in the long term. Thus the trend towards de-globalization will be reinforced, and the recent steps towards redistribution through the various post-COVID 19 stimulus measures will become increasingly permanent in nature. This will be bad for risk assets returns, in particular equity returns.

1) Redistribution: at a general level a bad development for risk assets, but ...

Since the 1980s there has been a consistent shift away of income from labour to capital. This shift has been perhaps the most important driver of the positive equity returns of the last 40 years. Chart G provides a simple illustration of the positive relationship between rising inequality (the shift of income away from labour to capital) and long-term US equity valuations. It also shows that in France (a reliable proxy for the major EU countries) the rise in inequality was much less.

1.1) Redistribution through taxation: the United States versus Europe and energy taxes

Europe versus the US

As for redistribution through taxation, European countries might need less of it than the US (Table 6). This perhaps also explains why Europe's long-term equity valuations are right now less generous than US equity valuations (Chart H), and European equities could do better in the upcoming era of redistribution. In Europe, redistribution might actually happen at the level of a much larger autonomous EU budget that transfers resources from the core- to the periphery countries. This might increasingly push Europe towards something that approaches a fiscal union. Such development would have positive implications for the euro and EU financial assets.

Energy Taxes

Taxation of course can be geared, and thus also have different implications for different sectors. Higher hydrocarbon energy taxes, for instance, appear likely candidates for financing social and infrastructure programs, especially if climate concerns come to the fore once more. Such taxes would be bad for equity returns in the traditional energy sector, but might leave other sectors relatively unscathed. Here too, there is more scope for increasing such taxes in the US than in Europe.

1.2) Redistribution through inflation: a more insidious, but perhaps less likely outcome

Inflation likely to be moderate but not priced in by financial markets

Today we live in a world of excess supply and excess savings. Inflation, let alone hyperinflation, is therefore unlikely a threat. Having said so, de-globalization will determine a global increase in supply constraints, as well as slower growth of the labour force in developed markets. Combine that with central bankers' fear of deflation and the temptation (or perhaps necessity) to monetize public debt, and you will come to the conclusion that – beyond the next two years - some increase in inflation is likely. It is very important to note that even moderate inflation is not priced in by financial markets.

Stagflation not good for almost all assets

Inflation is itself a form of indirect taxation and, as such, it actually hits the poor (who consume a relatively larger share of their income) more than the wealthy. Nonetheless, combined with other forms of explicit taxation, inflation can reduce inequality in a country like the US with high levels of household debt. This is so because inflation reduces the real value of the debts, which are owned by the wealthy, and owed by the poor. Inflation is particularly bad for non-indexed bonds, but should benefit real assets, as well as value stocks. But the 2020s might well turn into a decade of stagflation, characterized by inflation ***and*** slow growth. In such scenario value stocks would also struggle.

2) **De-globalization: at a general level a bad development for risk assets, but ...**
De-globalization brings back to the fore industrial policies favouring national champions. Such policies are typically more concerned with employment, market share and national security issues, and less with equity returns. They will entail the breakdown of (the more efficient) global supply chains, another bad development for equity returns. Our equity strategist Kishore Muktinutalapati is constantly looking out for stocks that are resilient in a de-globalizing world and has summarized the criteria for spotting such stocks under the banner of Yellow Brick Road Investing.

2.1) De-globalization favours large markets and services, but the 2020s will also leave ample room for disruptors

Yellow Brick Road Investing certainly means opting for equity indices (of large countries) whose member-companies are more reliant on the domestic market than on international trade. Within sectors it broadly favours services over manufacturing stocks that will suffer from the breakdown of supply chains. Indeed, specifically within the tech sector, hardware and equipment, as well as semiconductors and semiconductor equipment, will continue to suffer, whilst the prospects of software and software services remain much more attractive. Companies that use, rather than produce, technology to disrupt domestically oriented traditional sectors also have an interesting future. Many, but not all, of these companies are listed in the STOXX Global Sharing Economy Index (Chart I) and in the ECPI Circular Economy Leaders Index (Chart J). Healthcare companies should also have good perspectives in an aging world. Finally, and perhaps cynically, defence stocks will of course also gain in a more nationalistic world.

2.2) De-globalization is bad for emerging markets, but what is an emerging market anyway?

As for emerging markets, de-globalization also means the end of hyper economic growth in China. More importantly, the quality of Chinese growth is changing as the country tries to transit from the globe's manufacturing hub to a more domestically driven economy. Clearly this is not good for commodities, and in particular industrial metals. Thus it is also not good for commodity exporting emerging markets. Already emerging market equities, outperformers during the first decade of this century, have been losing shine. However, whilst we expect overall emerging markets to remain under pressure, it will be important to distinguish ***within*** emerging markets. Emerging markets with larger domestic markets should do relatively well. In addition, the more advanced Asian emerging markets are adopting the new technologies of the 21st century, and should thus prove more resilient. More than anything else, the definition "Emerging Markets" is likely to lose importance as a unifying category.

TABLE 1: GENERAL ASSET ALLOCATION

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Cash			■	
Bonds	■			
Equities		■		
Alternatives		■		Overweight gold

Legend: *New* | *Old* | *No change*

Source: ADCB Asset Management

TABLE 2: FIXED INCOME ASSET ALLOCATION

	Underweight	Neutral	Overweight	Rationale
Duration			■	Increase duration as rates remain low for longer
US Treasuries			■	Increase duration to medium to long-term part of the curve
US Credit				HQ credits to perform well on the back of Fed's support
- Investment Grade		■		Fed's PMCCF and SMCCF to support spreads
- High Yield	■			Spreads to still discount default risk
European bunds		■		ECB asset purchases and dismal economic activity to act as a ceiling
European Credit				Weak growth concerns to dominate
-Investment Grade		■		QE program in the form of CSPP to provide support
-High Yield	■			Weak growth to put pressure, but relatively better placed compared to US HY
UK Gilts			■	UK gilt yields lower on economic uncertainty
Emerging market sovereign dollar bonds		■		EM USD sovereign to remain under pressure due to Covid-19 risks
- Brazil			■	
- Russia			■	
- High quality GCC			■	
Emerging market local currency		■		Co-ordinated policy easing to tighten spreads, but volatility in EM currencies to eat return
Emerging market corporate debt	■			High corporate leverage and lower corporate profitability is a risk

Source: ADCB Asset Management

TABLES 3-5: EQUITY ASSET ALLOCATION

Equity strategy - geographical asset allocation

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Heavy exposure to financials sector
UK		■		Stick with the benchmark
Japan		■		Prefer 'new economy' enablers
Asia Pacific ex Japan		■		Focus on new China vs. old China; neutral India
EM LatAm	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
GCC		■		Stick with the benchmark
Legend	*New*	*Old*	*No change*	

Source: ADCB Asset Management

Equity strategy - global sector allocation

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Global sectors				
Communication Services			■	Prefer US exposure over rest of the world
Consumer Discretionary		■		Prefer Internet & direct marketing retail
Consumer Staples		■		Prefer Household & personal products
Energy			■	Focus on capital discipline and makeover stories
Financials	■			Impeded by lower interest rates
Health Care		■		Prefer Biotechnology and Health care technology
Industrials		■		Prefer Commercial & Professional Services
Information Technology			■	New economy enablers
Materials	■			Structural weakness on a shift to 'new economy'
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Legend	*New*	*Old*	*No change*	

Source: ADCB Asset Management

Equity strategy - global factor/style/size allocation

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			Strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Avoid value in sectors facing disruption
Dividend yield			■	Prefer quality dividends and dividend growth
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Benefits from 'new economy' orientation
Legend	*New*	*Old*	*No change*	

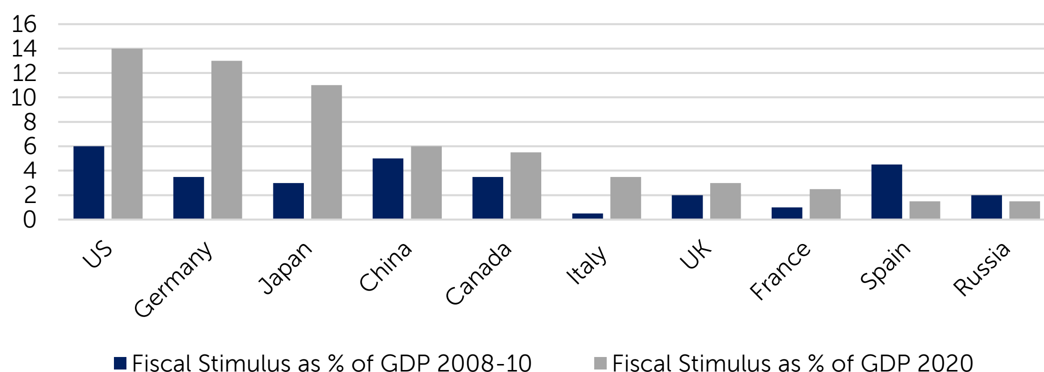
Source: ADCB Asset Management

TABLE 6: US HAS MORE REDISTRIBUTION TO DO

Economy	1985	2017	2017 before redistributive tax	After tax difference
US	0.33	0.39	0.51	0.12
UK	0.32	0.36	0.51	0.15
Germany	0.25	0.29	0.50	0.21
France	0.30	0.29	0.52	0.23
Sweden	0.20	0.28	0.43	0.15
Italy	0.29	0.33	0.52	0.18

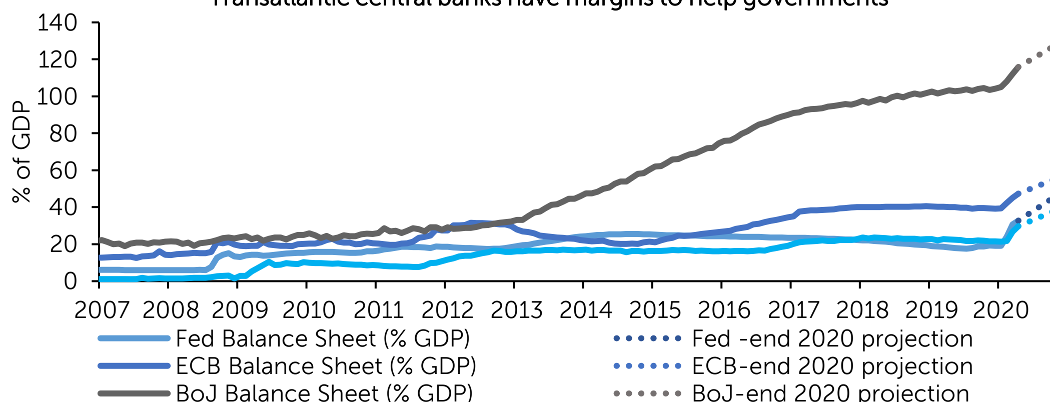
Source: OECD

Chart A



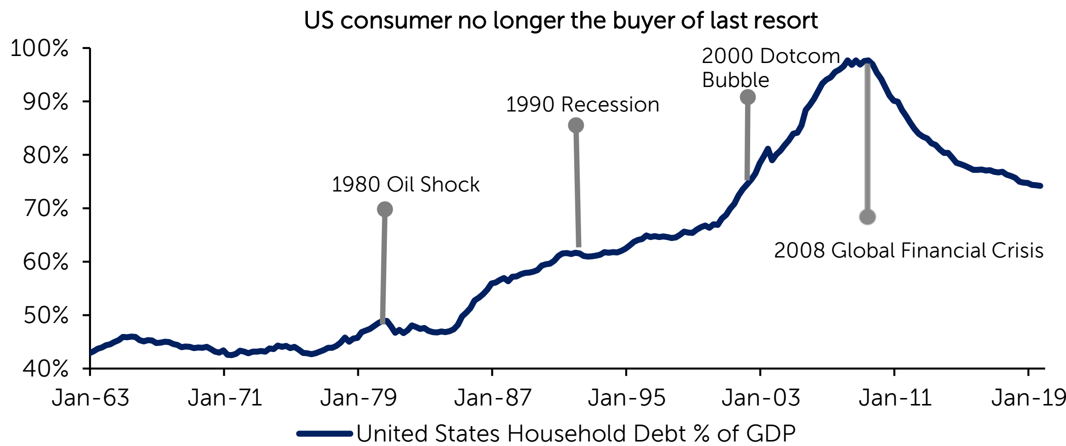
Source: Bloomberg, IIF, BCA Research, ADCB Asset Management

Chart B



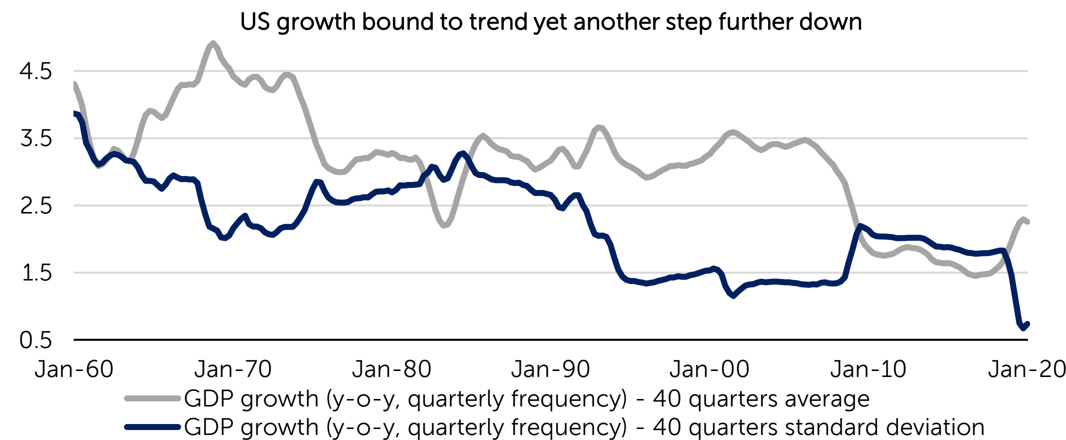
Source: Fed, ECB, BoJ, BoE, Bloomberg, ADCB Asset Management

Chart C



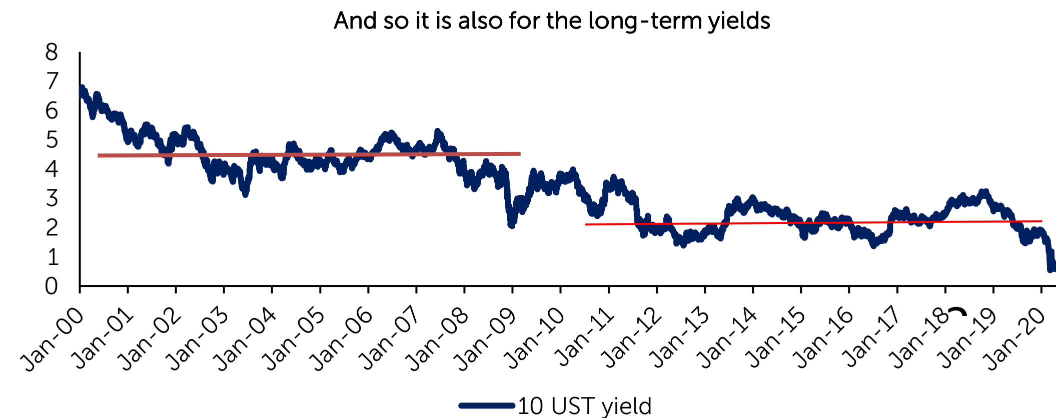
Source: Federal Reserve Bank of St Louis, Bloomberg, and ADCB Asset Management

Chart D



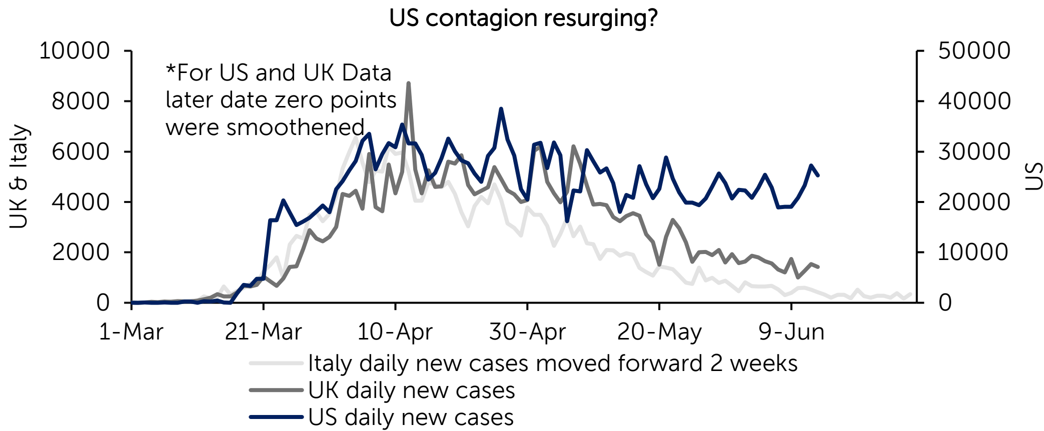
Source: Bloomberg, ADCB Asset Management

Chart E



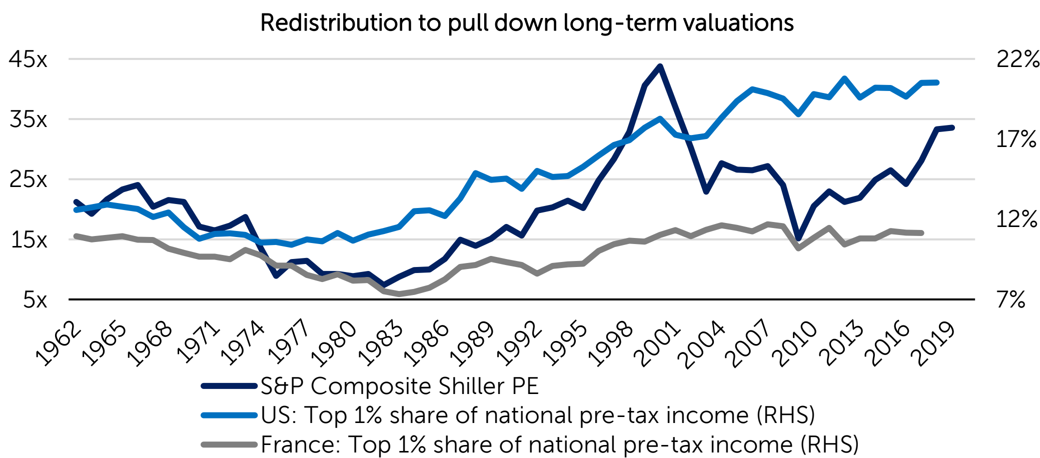
Source: Bloomberg, ADCB Asset Management

Chart F



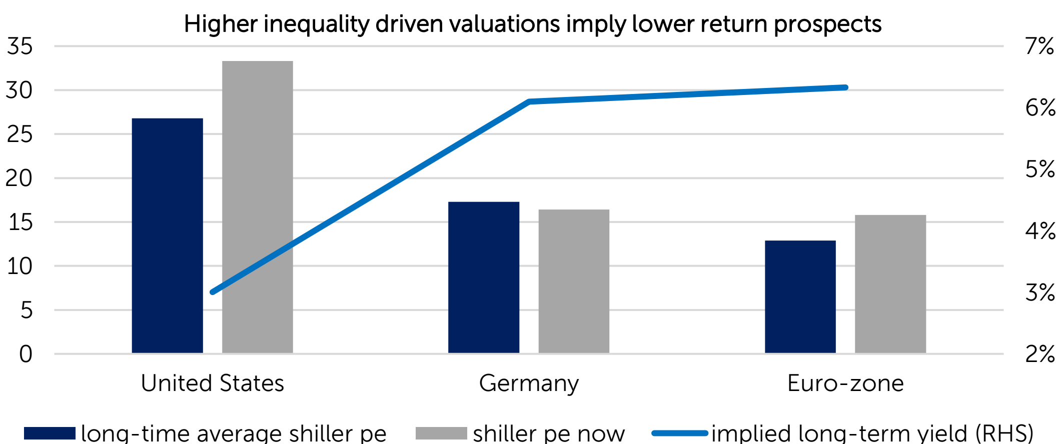
Source: Bloomberg, ADCB Asset Management

Chart G



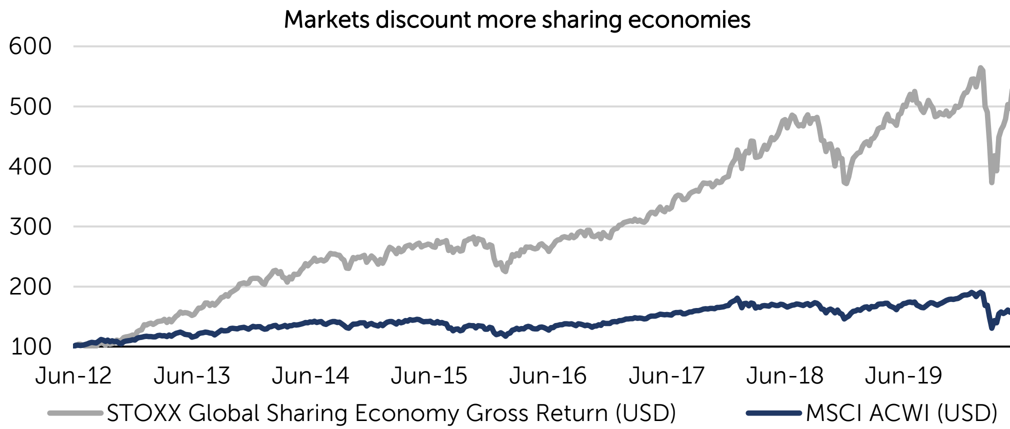
Source: Factset, World Inequality Database (www.wid.com)

Chart H



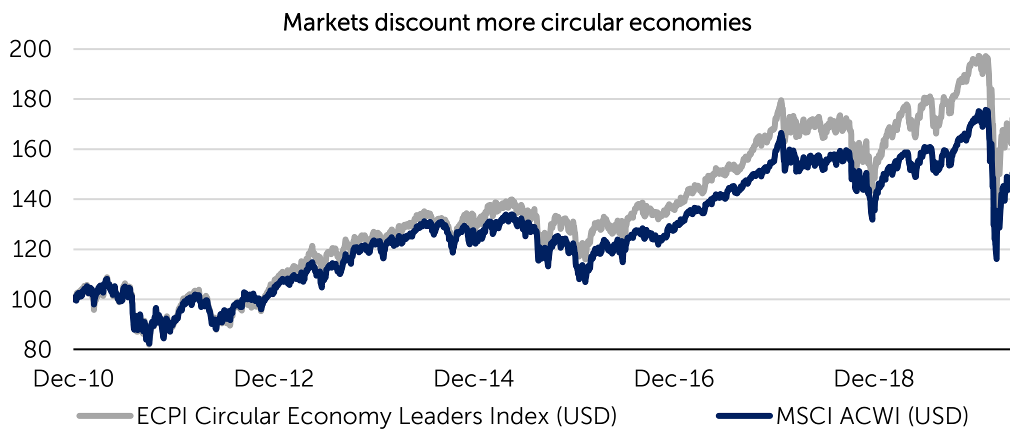
Source: Factset

Chart I



Source: STOXX, Bloomberg, MSCI, ADCB Asset Management

Chart J



Source: ECPI, Bloomberg, MSCI, ADCB Asset Management

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