CAPITAL MARKETS MONTHLY SEPTEMBER 2020

FIXED INCOME COMMENTARY

Average inflation targeting by the Fed – what does it mean for bonds?

In a reversal of recent price action, US treasury yields pushed higher and the yield curve steepened over the month of August 2020. This curve steepening was driven primarily by the long end where a dramatic seven-point fall in the Treasury 1.25% May-2050 resulted in a significant repricing from 1.19% to 1.48%. The context of this move was the large quantity of duration supply, which included USD 26bn of new 30-year bonds, USD 38bn 10-year notes and USD 25bn of the fledgling 20-year note. The total Federal Reserve System Open Market Account increased by a relatively modest USD 77bn last month, but purchases were focused at shorter maturities.

The benchmark ICE Bank of America 1-3 Year US Treasury Index returned -0.02% for August 2020, compared to a return 0.10% in July and 0.03% in June, as a moderate negative capital return component was generated by the rise in yields. The overall ICE Bank of America US Treasury Index declined by 1.21% over the past calendar month, almost exactly reversing the previous month's gain. This was driven by the sell-off in longer dated securities as the curve steepened.

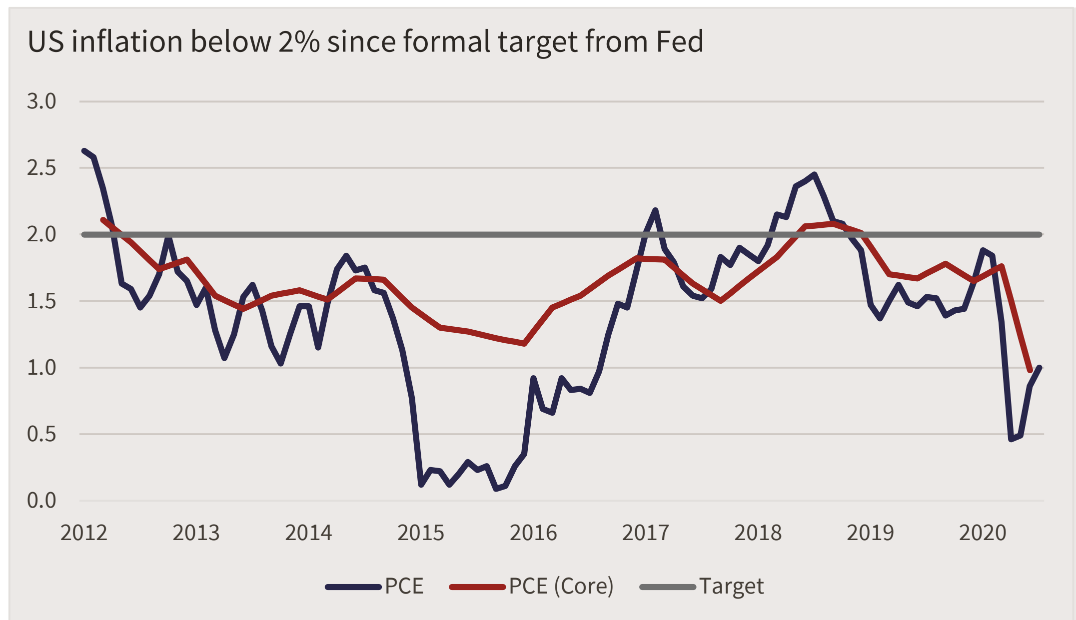
It is becoming increasingly clear that we are in a new paradigm for rates markets. Previously, key drivers included macroeconomic developments, performance of risk assets and geopolitical events. In recent months, the US treasury curve and credit spreads have been driven principally by monetary policy, fiscal policy and the developments of the coronavirus epidemic. Notwithstanding this, risks remain skewed towards higher bonds yields given the current proximity to lower bounds. Many scenarios exist, such as the early discovery of an effective coronavirus vaccine, which would almost certainly result in a significant upward move in bond yields. Aggressive easing of monetary policy, including very large-scale asset purchases by central banks suggests a risk of higher inflation over the longer term. However, over the near term, the contraction of GDP, the rise in the unemployment rate and the substantial output gap all point to lower inflation risks.

Regarding monetary policy, recent guidance from a number of central banks emphasised their lower-for-longer interest rate stance. Federal Reserve Chairman Powell's remarks at Jackson Hole late last month formalised a more accommodative Fed reaction function as he outlined the new strategy framework. He noted that the Fed now seeks to achieve inflation that averages 2% over time,

and therefore following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This represents the key new line on inflation in the new longer-run goals and strategy statement discussed by Powell at Jackson Hole.

Following this strategy update, the focus is now on how average inflation targeting is mapped to forward guidance on the funds rate. This is expected to be announced at the September Federal Open Markets Committee meeting.

The following chart shows the time series of PCE headline and core inflation since the 2% target was formally announced by the Fed in 2012. Note that at the start of monetary policy tightening in 2015, the PCE was just 1.3%. There has clearly been a significant accumulation of below-2% inflation over recent years.



Credit markets continued to perform reasonably well in August as credit spreads broadly contracted, with lower credit quality sectors outperforming. The following table from Bloomberg highlights some of the key SSA new issues over the past month. These securities are all investment grade sovereign, supranational and agency issues with a minimum amount outstanding of USD 250m. The Spread column indicates the mid-market level of OAS spread on 31 August 2020.

Issuer	Ticker	Coupon	Maturity	Rating	Issue	Spread	Ch. Sprd
Abu Dhabi Govt. International Bond	ADGB	0.75	9/2/23	AA	65	56	-9
Development Bank of Japan Inc	DBJJP	0.50	8/27/25	A+	32	30	-2
Inter-American Development Bank	IADB	0.25	11/15/23	AAA	11	11	0
Japan Finance Org. for Municipalities	JFM	0.63	9/2/25	A+	43	40	-3
Kommuninvest I Sverige AB	KOMINS	0.25	12/1/22	AAA	14	11	-3
Svensk Exportkredit AB	SEK	0.50	8/26/25	AA+	23	23	0

The two Japanese government agency issues, DBJ and JFM, arguably offered a small degree of new issue pricing concession, although the overall spread level remained expensive by historical standards. Subsequent secondary market price action was consistent with this view. Swedish Export Credit and Inter-American Development Bank issues were very aggressively priced, offering no concession, and in this instance, there was no spread compression in the ensuing secondary market.

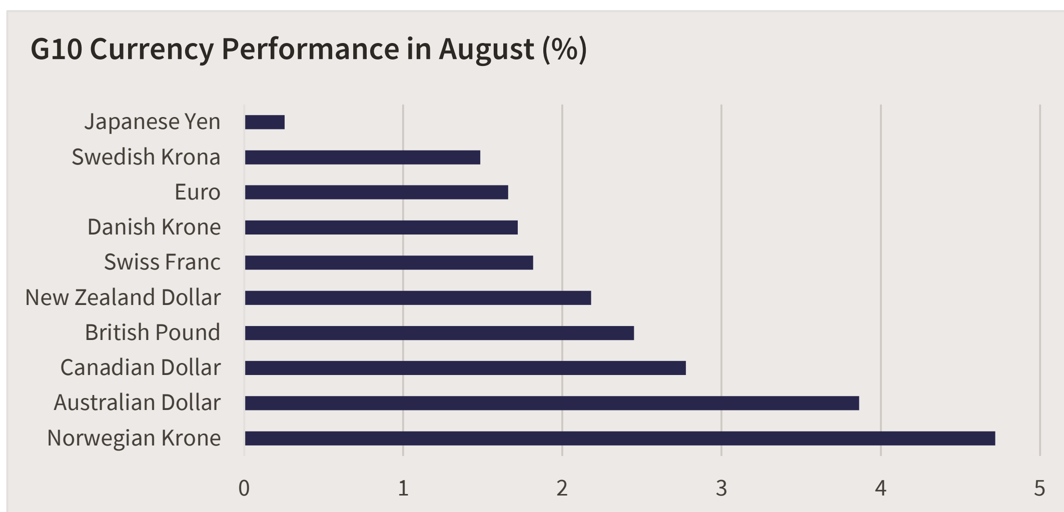
In conclusion, as we have discussed above, bond market valuations appear to have decoupled from macroeconomic parameters, at least in the near term. Central bank policy over the medium term will likely anchor short rates near the lower bounds while the risks continue to suggest a curve steepening bias predicated on significant ongoing supply and longer-term inflationary risks.

FOREIGN EXCHANGE COMMENTARY

When fundamentals do not really matter anymore, and a perfect storm is about to hit.

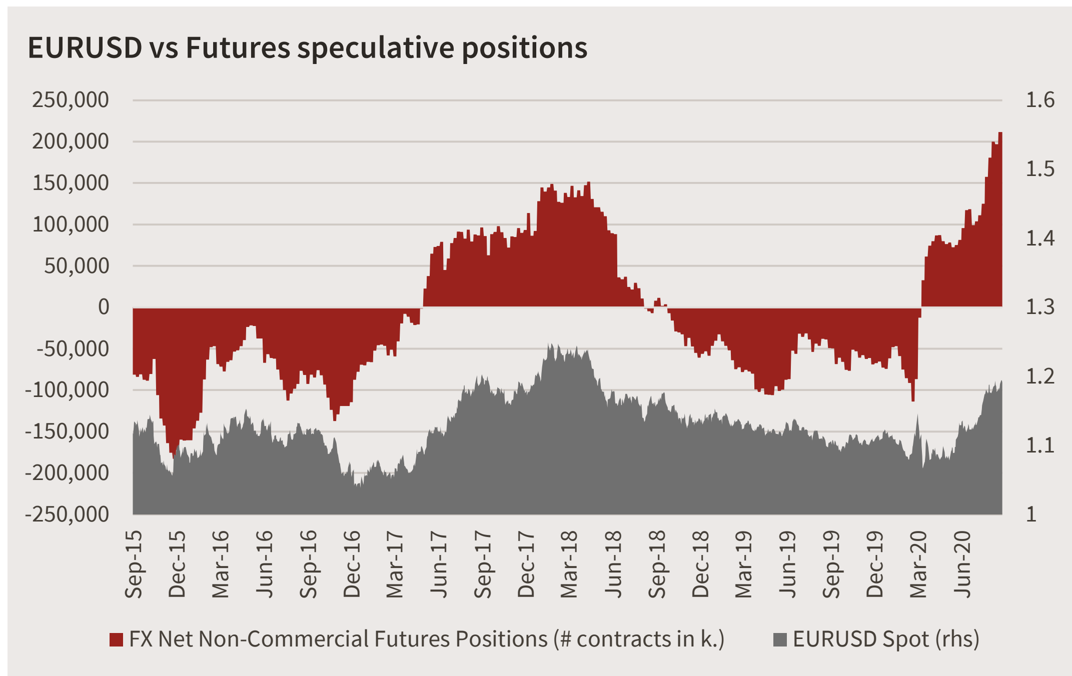
August was one of the hottest months recorded in the last decade, not only from the meteorological point of view, but also from the financial markets' perspective. The great divergence between economic fundamentals and market valuations has left many strategists puzzled. For some, technology came to the rescue with various market algorithms deploying weather-forecasting models (please see applications of the 'Markov chain' theorem) in the investment strategies processes.

As for the foreign exchange market, a broad-based continuation of the previous month's trends was witnessed. The US Dollar weakness was the key theme, with the US Dollar index (DXY) testing 92.00, the level last seen in May 2018. However, a closer look inside the G10 bloc shows that this weakness was not evenly distributed. The top three performing currencies', i.e. the Norwegian Krone (NOK) the Australian Dollar (AUD) and the Canadian Dollar (CAD) gains exceeded 2.5% with the NOK being the G10 best performer gaining 4.70%. The Japanese Yen was the second (after the USD) 'worst' performing currency, advancing against the greenback by a meagre 0.20% while the EUR which represents the biggest weight (57.6%) in the DXY advanced 1.66%. For a detailed G10 performance, please see the table below)



The uneven distribution of currency cross gains and the structure of the DXY explains its relatively 'modest' underperformance in August (1.29%), especially when compared with the previous month when the index experienced one of the worst monthly performances (-4.15%) seen in a decade.

As discussed in the July report, the EURUSD cross August performance didn't surprise us as in the base case scenario we expected the upward trend to be extended with the 1.2020 level being the initial target and even a move further towards 1.2150, where the major resistance is located, wasn't ruled out. This view, based on the technical picture, has hardly changed. However, over the recent weeks we have observed the dramatic increase in the US Dollar bearish 'bets' particularly in the EURUSD cross (Please see the chart below).



This picture, showing a decade high concentration of the EUR 'longs' against the US Dollar, together with the 'expensive valuations of other market assets (US equity indices, HY credit spreads) suggests that the positive global investment sentiment is abnormally high. This potentially warrants an outburst in volatility, which may overshadow the DXY technical picture and ultimately result in a slowing if not reversing of the US Dollar 'bear' trend.

We do closely monitor the volatility surface which has already started sending warning signals, treating it as an unsophisticated but proven and accurate 'weather bell' of a perfect storm which may not be as far as many risk takers think.

EQUITY MARKET COMMENTARY

The fundamental picture yet to catch up with markets

United States

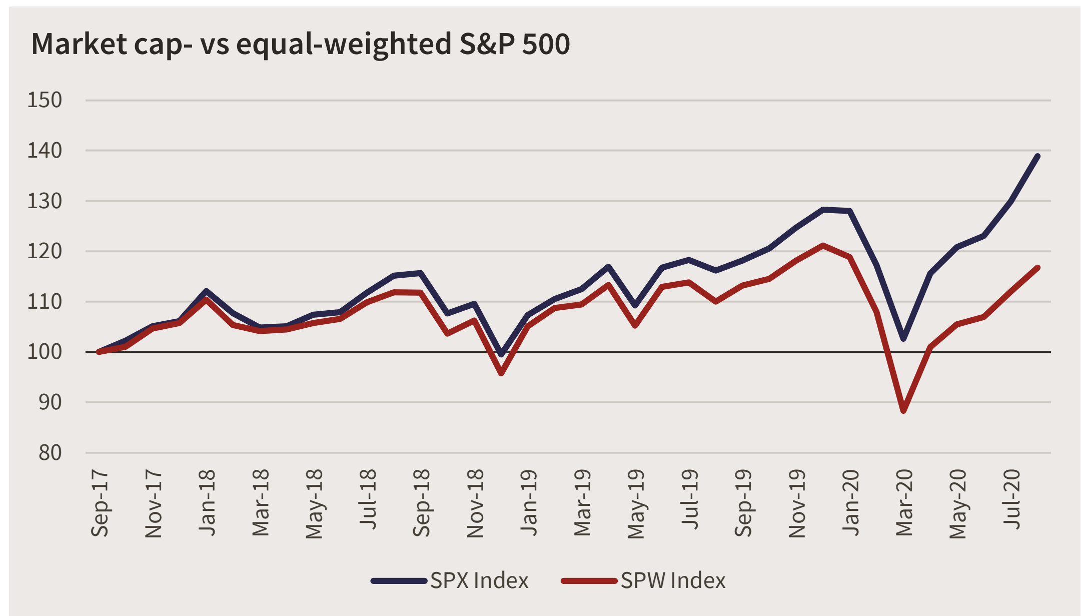
US equities, via the S&P 500, surpassed the all-time highs from February on a total return basis, despite the lack of progress for a further fiscal stimulus package. An astonishing feat when you consider that in late-March the index was down as much as -33.79% from those highs. Macro data was supportive with employment data positive while the US housing data, both starts and permits for July advanced. Geo-political concerns gyrated over the period but took on a slightly more positive tone by the end of the month. In terms of Covid news, while the number of infections continues to rise, the level of fatalities and hospitalisations are looking much more positive. Secondly, vaccine developments were progressing with a number of different drugs going through second and third level testing.

One support for the market was the announcement by the Federal Reserve of some revisions to their longer-run goals and monetary policy strategy. The first is that the FOMC will now look to achieve an inflation rate averaging 2% over time, so that if there is a period as in recent years when inflation has undershot the target, policy can then aim for an inflation rate above the 2% target for the period afterwards. Under this new framework, the Fed is likely to refrain from tightening rates until inflation overshoots the 2% target. The Fed also subtly changed its language on employment, which is likely to mean that low unemployment alone would not lead them to hike rates. Fed policy has been a key driver of the 57% US equity rally (measured by the S&P 500) since the post-COVID-19 low point in March. Ultra-low interest rates make it rational for investors to pay more for a given dollar of equity earnings, justifying higher valuations.

US/China tensions remained high, especially regarding Chinese-owned software companies deemed to pose national security risks. However later in the month tensions declined slightly after both Larry Kudlow, Director of the United States National Economic Council and Peter Navarro, the Director of the Office of Trade and Manufacturing Policy, said that the Phase One deal reached with China was on track. With regard to the US presidential race we got the news that Democratic nominee and former Vice President Joe Biden had picked California Senator Kamala Harris as his own vice presidential running mate and it was confirmed that President Trump had accepted the Republican nomination for President.

The S&P 500 was up another +7.2% (total returns), breaching 3500, whilst the NASDAQ saw an even larger +9.7% advance over the month. August has been a particularly quiet month for the S&P with only 2 sessions seeing a daily trading range eclipse 1%, with the Vix trading at 22. The index has not seen such low volatility since the market was reaching new highs back in February prior to the pandemic. In terms of sector gains technology again led, with Apple's market cap passing the $2tn mark for the first time ever – the first US company to do so. It has to be remembered that Apple's market cap dipped below $1tn on March 23rd. For context it took four decades for Apple to reach a $1tn market cap in 2018. Lagging behind, utilities and energy declined despite crude oil prices increasing.

A critical review of the markets highlights the continuing theme of momentum and concentration risk, namely the lack of breadth of gains when you dig below the surface. The S&P 500 is more heavily dependent on just a handful of stocks than at any point in the past 40 years, with the ten largest stocks in the index accounting for nearly 30% of the S&P 500 market cap. A comparison of the market cap S&P 500 versus the equal weighted index shows that for the year to date, the market cap has generated 8.3%, while the equal weighted index has a loss of 3.67%



A stronger Euro curtails market gains

Europe

European equity markets underperformed developed markets, with the Euro Stoxx 600 advancing by 2.9%, not helped by the stronger euro and also deteriorating virus news including German Chancellor Merkel warning that the recent increase in cases meant that it would not be possible to ease restrictions further.

Early on, equites in Europe outpaced those in the US, as positive macro data aided the rebound in cyclical value plays including autos and construction. The final July manufacturing PMI readings showed stronger economic momentum in Europe than in the US and it was the first time the measure was in expansion for the Euro area since January 2019. Secondly the German IFO business climate beat consensus expectations in August with an increase to 92.6 (vs. 92.1 expected).

Looking at sector performance, travel and leisure stocks in Europe outperformed, which may have been partly driven by positive vaccine news early on. The positive vaccine news was from Novavax, which announced that its experimental vaccine generated antibody responses four times higher than those seen in people who had recovered from the disease. Financials saw strong gains early on; however poor earnings results from SocGen and HSBC who cited trading losses and a weak economic outlook respectively, hindered performance. This combined with insurers, AXA and Munich Re withdrawing growth targets and 2020 guidance respectively, pointing to the high levels of uncertainty in the economic outlook promoted profit taking. In terms of negative contributors, defensive sectors healthcare and utilities headed the list due to the rotation trade.

Japan the key driver on valuation grounds?

Asia

Developed Asia markets advanced with strong gains for the period as the FTSE Developed Asia Pacific Index gained 6.45%. In terms of country gains, Japanese stock markets were the key drivers, advancing by 8% over the period aided by the perceived view that the global economy was improving following a second quarter where Japanese GDP fell nearly 28% on an annualised basis, reflecting the pandemic lockdown and related disruptions and the decline in global demand. In corporate news Berkshire Hathaway's move to invest a total of about $6 billion in five Japanese trading companies appears to reflect Warren Buffett's bullish view on Japan's stock market, which has badly lagged behind the S&P 500 index in recent years. Japan's capitalisation weighted Topix index looks inexpensive relative to the S&P, trading on 15 times projected earnings for the Japanese fiscal year ending in 2022, a discount to the S&P 500, which trades for around 20 times. In other news Prime Minister Shinzo Abe said he would resign to undergo treatment for a chronic illness, ending his run as the country's longest serving premier in an announcement that surprised some members of his party.

Emerging Markets

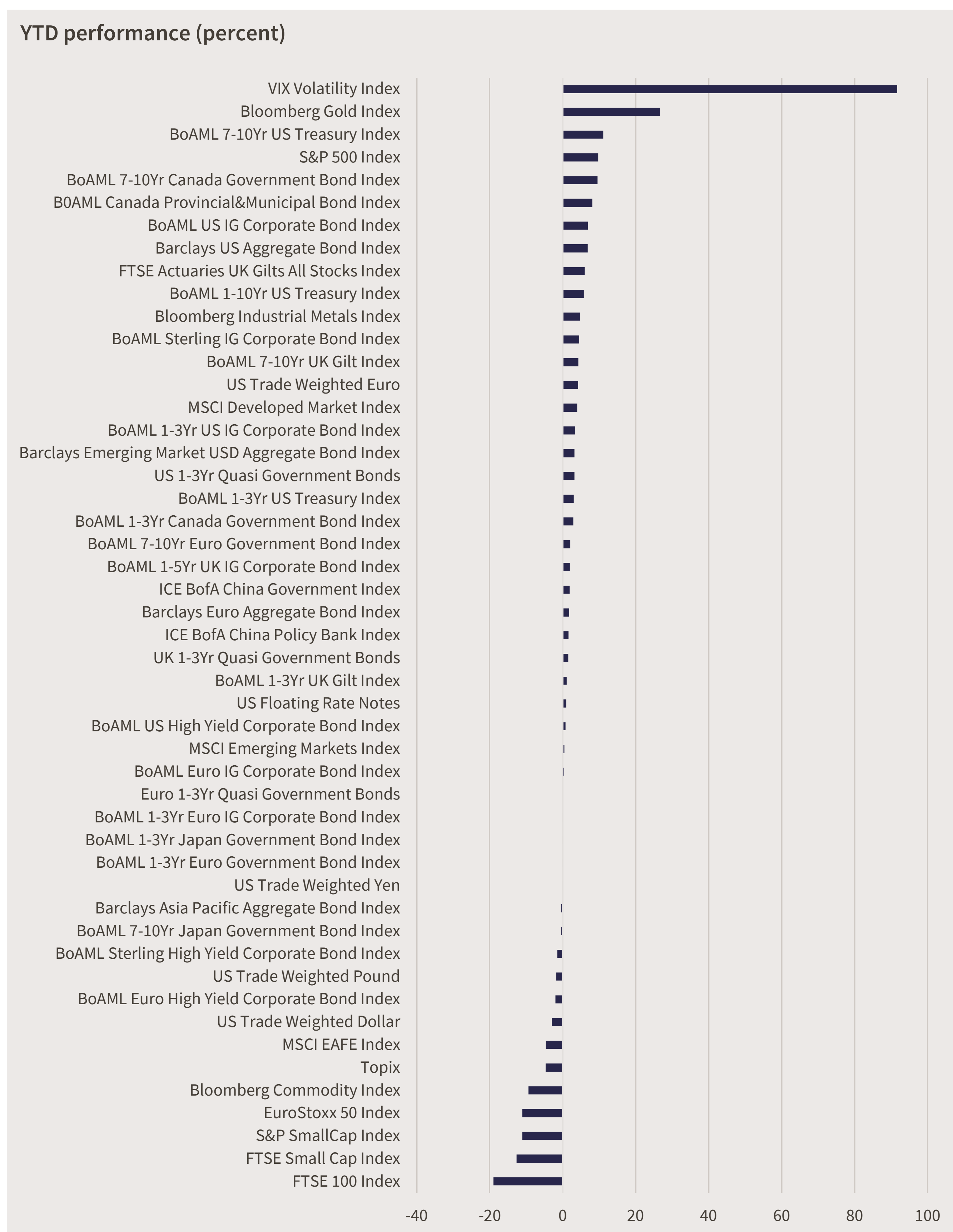
After two months of outperformance EM equities underperformed DM in August 2020, as covid cases continued to rise in India and Brazil. This is set to weigh on the economic data, either through continued restrictions, renewed lockdowns or a tightening of border restrictions. EM returns of 2.1% were across the major regions. EM returns were driven down by LatAm, which fell 6.4%, which was hit by the currency depreciation. EM Asia and EM EMEA were relatively better at 3.2% and 1.4% respectively.

Mainland China led the rally in EM Asia, gaining 5.6%, despite industrial production in mainland China rising by less than expected and retail sales contracted by 1.1%. Consensus growth for China has seen upgrades predicated on an acceleration in Infrastructure investment amid continued funding support from both the central and local governments.

Market performance (percent)

Equity Indices:	Aug 2020	YTD	1 Year	3 Years Ann.	5 Years Ann.
MSCI Developed Market Index	6.27	4.00	14.39	9.73	10.16
S&P 500 Index	7.19	9.74	21.94	14.50	14.44
S&P SmallCap Index	3.99	-11.07	-0.55	3.81	7.46
FTSE 100 Index	0.46	-18.96	-14.32	-3.27	3.10
FTSE Small Cap Index	3.67	-12.62	-2.25	-0.66	5.25
MSCI EAFE Index	5.14	-4.61	6.13	2.34	4.72
EuroStoxx 50 Index	3.86	-11.04	-2.47	1.01	2.64
Topix	8.02	-4.66	9.78	2.38	3.34
MSCI Emerging Markets Index	2.21	0.45	14.49	2.83	8.65
Aggregate Bond Indices:					
Barclays US Aggregate Bond Index	-0.81	6.85	6.47	5.09	4.32
Barclays Euro Aggregate Bond Index	-0.54	1.80	-1.02	2.77	2.63
Barclays Asia Pacific Aggregate Bond Index	0.27	-0.41	-0.58	1.03	1.47
Barclays Emerging Market USD Aggregate Bond Index	0.54	3.24	5.44	4.66	6.18
Government Bond Indices (1-3 Yrs):					
BoAML 1-3Yr US Treasury Index	-0.02	3.02	3.43	2.57	1.86
BoAML 1-3Yr UK Gilt Index	-0.05	1.12	0.90	0.60	0.69
BoAML 1-3Yr Euro Government Bond Index	-0.06	-0.14	-0.67	-0.04	0.08
BoAML 1-3Yr Japan Government Bond Index	-0.07	-0.13	-0.53	-0.19	-0.11
BoAML 1-3Yr Canada Government Bond Index	0.01	2.88	2.79	2.08	1.24
Quasi Government Bonds (1-3 Yrs):					
US 1-3Yr Quasi Government Bonds	0.05	3.22	3.67	2.99	2.27
UK 1-3Yr Quasi Government Bonds	0.03	1.55	1.51	1.14	1.29
Euro 1-3Yr Quasi Government Bonds	-0.03	-0.04	-0.66	-0.17	0.00
Government Bond Indices (1-10 & 7-10 Yrs):					
BoAML 1-10Yr US Treasury Index	-0.20	5.82	5.38	3.77	2.88
BoAML 7-10Yr US Treasury Index	-0.83	11.11	8.54	6.13	4.71
BoAML 7-10Yr UK Gilt Index	-1.40	4.28	1.83	3.19	4.10
FTSE Actuaries UK Gilts All Stocks Index	-3.06	6.02	2.42	4.24	5.03
BoAML 7-10Yr Euro Government Bond Index	-0.66	2.08	-1.15	3.49	3.52
BoAML 7-10Yr Japan Government Bond Index	-0.49	-0.42	-2.59	0.14	0.75
BoAML 7-10Yr Canada Government Bond Index	-1.25	9.58	5.50	4.86	2.94
B0AML Canada Provincial&Municipal Bond Index	-1.66	8.10	5.70	6.17	4.55
Investment Grade Corporate Bond Indices:					
BoAML 1-3Yr US IG Corporate Bond Index	0.25	3.41	4.44	3.47	2.97
BoAML 1-5Yr UK IG Corporate Bond Index	0.39	1.97	2.64	2.32	3.08
BoAML 1-3Yr Euro IG Corporate Bond Index	0.17	-0.08	-0.35	0.34	0.69
BoAML US IG Corporate Bond Index	-1.15	6.90	7.45	6.39	6.12
BoAML Sterling IG Corporate Bond Index	-0.93	4.57	4.29	4.47	6.21
BoAML Euro IG Corporate Bond Index	0.13	0.32	-0.90	1.90	2.59
China Indices					
ICE BofA China Government Index	-0.47	1.90	2.97	4.81	3.73
ICE BofA China Policy Bank Index	-0.14	1.58	3.14	5.21	4.03
High Yield Corporate Bond Indices:					
BoAML US High Yield Corporate Bond Index	0.98	0.75	3.71	4.50	6.27
BoAML Sterling High Yield Corporate Bond Index	1.25	-1.45	2.56	3.57	5.76
BoAML Euro High Yield Corporate Bond Index	1.43	-1.96	-0.23	2.14	3.87
Currencies & Commodities:					
US Trade Weighted Dollar	-1.56	-3.01	-4.93	0.03	-0.84
US Trade Weighted Pound	1.01	-1.81	4.83	2.00	-2.96
US Trade Weighted Euro	0.42	4.24	3.20	-0.43	1.62
US Trade Weighted Yen	-0.94	-0.16	-3.82	1.33	2.36
Bloomberg Commodity Index	7.60	-9.36	-4.79	-4.68	-4.21
Bloomberg Brent Crude Oil Index	4.52	-37.60	-26.47	-2.55	-7.89
Bloomberg Gold Index	0.58	26.69	26.29	12.91	10.56
Bloomberg Industrial Metals Index	8.26	4.76	5.04	-1.29	4.84
Other					
US Floating Rate Notes	0.23	0.96	2.08	2.53	2.18
VIX Volatility Index	4.91	91.65	39.15	35.57	-1.46

Source: Bloomberg. Performance for the period ending 31 Aug 20 (Local currency, Total Returns).


YTD performance (percent)
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B0AML Canada Provincial&Municipal Bond Index
BoAML US IG Corporate Bond Index
Barclays US Aggregate Bond Index
FTSE Actuaries UK Gilts All Stocks Index
BoAML 1-10Yr US Treasury Index
Bloomberg Industrial Metals Index
BoAML Sterling IG Corporate Bond Index
BoAML 7-10Yr UK Gilt Index
US Trade Weighted Euro
MSCI Developed Market Index
BoAML 1-3Yr US IG Corporate Bond Index
Barclays Emerging Market USD Aggregate Bond Index
US 1-3Yr Quasi Government Bonds
BoAML 1-3Yr US Treasury Index
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BoAML 7-10Yr Euro Government Bond Index
BoAML 1-5Yr UK IG Corporate Bond Index
ICE BofA China Government Index
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UK 1-3Yr Quasi Government Bonds
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MSCI Emerging Markets Index
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BoAML 1-3Yr Japan Government Bond Index
BoAML 1-3Yr Euro Government Bond Index
US Trade Weighted Yen
Barclays Asia Pacific Aggregate Bond Index
BoAML 7-10Yr Japan Government Bond Index
BoAML Sterling High Yield Corporate Bond Index
US Trade Weighted Pound
BoAML Euro High Yield Corporate Bond Index
US Trade Weighted Dollar
MSCI EAFE Index
Topix
Bloomberg Commodity Index
EuroStoxx 50 Index
S&P SmallCap Index
FTSE Small Cap Index
FTSE 100 Index
-40
-20
0
20
40
60
80
100

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