Market Update

6th of August 2020

Dear Investor,

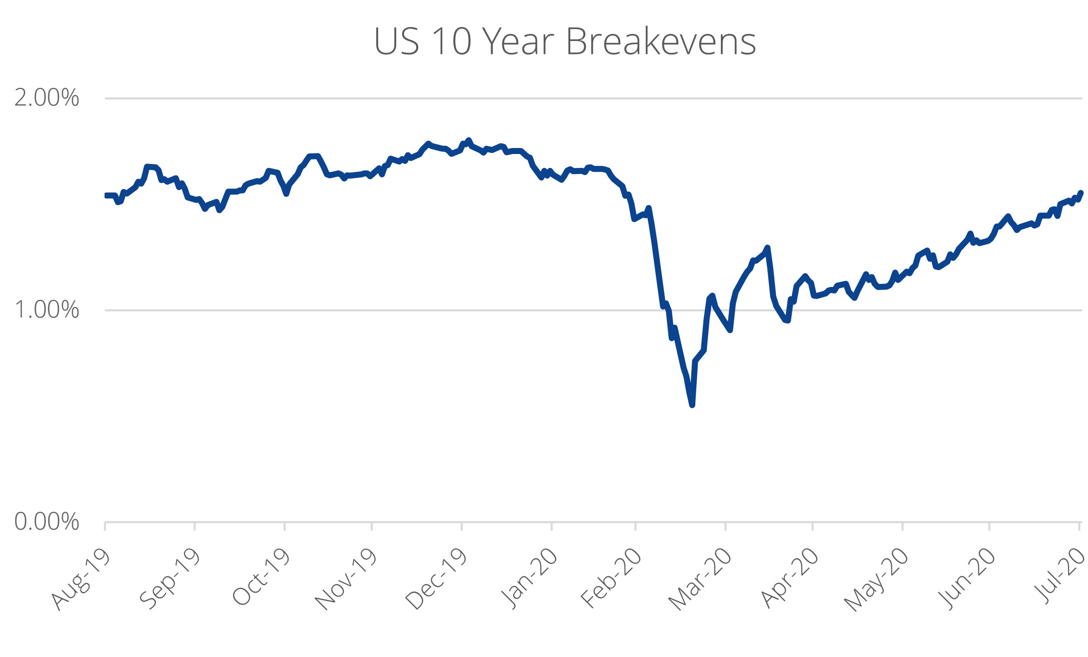
This edition of the Market Insight publication is a direct continuation of our thoughts expressed in the 4 June 2020 piece. We would encourage you to read both publications in conjunction for complete clarity.

As a short summary, the last 2 months have seen a continuation of the major trends seen since the lows of March 2020, with the key market driver being the ongoing descent in US real rates to all-time lows. This has led to a clear outperformance of US equities, and especially the Technology sector, together with a major rally in Gold prices to all-time highs not seen since 2011. Within our investment playbook, we remain positively biased to US equities, with an ongoing sector preference towards Technology and Health care, while growing increasingly more cautious on Global equities overall at current prices following the massive rally from the lows on 23 March. We remain constructive on Gold, but now believe the next leg will not come before 2021. In Credit, our preference for the lower-end of the Investment Grade spectrum BBB-BB USD space remains intact, with the caveat that credit spreads there have also normalized to fundamental fair value, in our view.

As of yesterday's close, US equity markets continue to power ahead, with S&P 500 closing at 3,327 on 5 August (versus the high of 3,386 on 19 February pre-Covid-19). Nasdaq-100 even breached the 11,000 mark, closing at an ALL-TIME high of 11,125 (+27.4% for the year now).

In our opinion, what is driving this move can be best summarized by the chart below. The chart depicts the evolution of the 10-year US breakeven, which effectively measures mid-term inflation expectations in the US. This has increased from 0.55% on 19 March to 1.58% as of last night.

10-year US Breakeven: Mid-term inflation expectations are going higher (thanks to the FED)



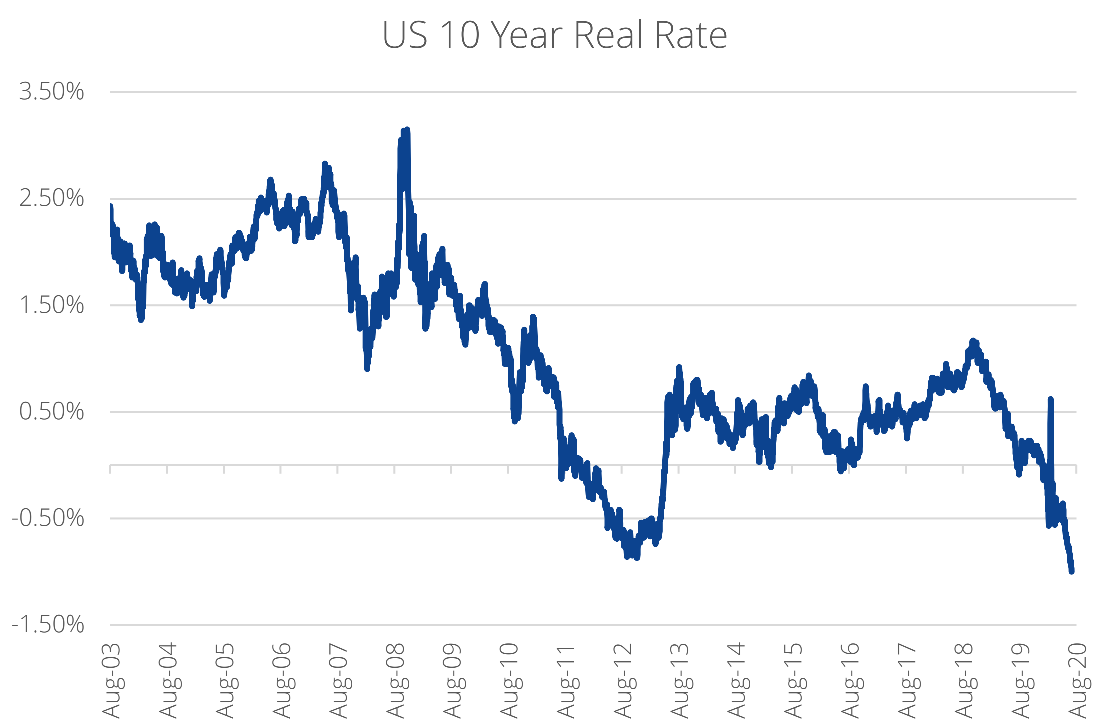
Source: Nahmani Grunder

As we had noted on numerous occasions in April and May, **any equity market rally would have to go hand-in-hand with higher mid-term inflation expectations and declining real rates in the US.** This has effectively happened, with the FED delivering on its role as lender of last resort and flooding the system with cash via its balance sheet.

Through its open-ended QE program initiated at the beginning of March, which has taken its balance sheet from $ 4.2 trillion to $ 7.0 trillion since then, the FED has made sure that long-term US nominal rates, the 10-year Treasury yield, remain well anchored in the 0.5% – 0.8% range while mid-term inflation expectations slowly crept back up towards the pre-Covid-19 range of 1.6 – 1.8%.

This has also meant that 10-year US real rates have gone from +0.6% at the depth of the crisis on 19 March to an all-time low of -1.02% as of last night.

10-year US real rates are now at -1.02%, an all-time low



Source: Nahmani Grunder

Global equities have been rallying right alongside Global corporate credit while the curve has flattened, and Gold broke out above$ 2,000 / oz. to all-time highs, as 10-year real-rates continues to descend to unprecedented levels. Clearly, in an environment of an ever expanding FED balance sheet within the overall context of scarce growth opportunities, we have rightly experienced higher and higher Technology valuation multiples, with, for example, US Software EV/Sales multiples expanding from 10x -12x before Covid-19 to 18x – 20x post Covid-19. The US Software ETF IGV has delivered a return of +29.6% for the year-to-date 2020 period, as of last night.

While the Technology sector multiples have benefitted from declining real rates in a scarce growth environment, the rest of the market continues to struggle. This is best illustrated by the return gap between the S&P 500 up +3% for the year versus the S&P 500 Equal Weighted that is still down -6.1%. **In a highly uncertain political and economic environment, investors have flocked to structural growth companies, which are less exposed to the travails created by the Covid-19 and have much stronger balance sheets**. On the latter point, please note that Alphabet had a net cash position of $ 105 billion by the end of Q2 2020, with Apple at $ 70bn, Microsoft at $ 50bn and Facebook at $ 48bn. Excluding these 4 companies and the financials, the remaining S&P 500 constituents carry $ 4.0 trillion of net debt with net debt / EBITDA of 2.25x! Being levered and cyclical in current times is not a good combination, and the stock prices of such companies reflect this unfavorable mix.

The S&P 500 has now effectively already reached the low-end of the 3,300 – 3,600 target range we had set for the index by mid-2021 though. We initiated this target range in mid-April, when everyone thought we were being excessively optimistic. But as we pointed out then, if one assumed that S&P 500 earnings would normalize by 2021, and reach the same levels as in 2019 by then, the flood of liquidity by the FED would make sure that market would be propelled higher via expanding earnings multiples. Our target range was based on a P/E 2021e of 22.0x at that time, versus a 5-year average of 18.2x between 2014- 2019. **On the earnings front, Q2 2020 has so far been very strong** (70% of companies in S&P 500 reported) with reported earnings coming in +22% above expectations on an aggregate basis, and we have increased our 2020e S&P500 EPS estimate from $ 114 to $ 129.9 on the back of these releases. For Q2 2020 specifically, we now see S&P 500 EPS to decline "only" by -35.0% year-on-year (YoY) on a revenue decline of -10% YoY, despite representing the eye of the Covid-19 storm. Interestingly, Technology sector actually has so far reported an aggregate revenue increase of +3.6% YoY, showing its defensive, and structural growth characteristics. Amazon reported 40% YoY revenue growth in Q2, with Microsoft at +13%, Apple at +11% and Facebook at +10% to name a few… **Our confidence in our 2021 S&P 500 EPS estimate of $ 163.6 is much higher now post the Q2 results season.** The other interesting takeaway from the Q2 reports so far is the major outperformance of the US versus other developed markets. Compared to the US EPS decline of -35% YoY in Q2, Europe is currently on track to deliver EPS decline of -49% YoY with Japan even worse at -59% YoY.

S&P 500 EPS per calendar year with P/E bands

	2015a	2016a	2017a	2018a	2019a	2020e	2021e
Operating EPS	118.20	119.08	132.95	162.91	164.58	129.9	163.6
Growth (YoY)		*0.7%*	*11.6%*	*22.5%*	*1.0%*	*-21.1%*	*25.9%*
Price low	1867.6	1829.1	2257.8	2351.0	2447.9	2237.4	
Price high	2130.8	2271.7	2690.2	2930.8	3240.0	3386.2	
Price close	**2043.9**	**2238.8**	**2673.6**	**2506.9**	**3230.8**	3327.7	
P/E low	15.8	15.4	17.0	14.4	14.9	17.2	
P/E high	18.0	19.1	20.2	18.0	19.7	26.1	
P/E close	17.3	18.8	20.1	15.4	19.6	25.6	20.2
P/E range	15.8 - 18.0	15.4 - 19.1	17.0 - 20.2	14.4 - 18.0	14.9 - 19.6		

Source: Nahmani Grunder

Nonetheless, we believe the easy money from the Covid-19 virus-induced market lows of March 2020 has now been made, and **equity markets are now clearly ahead of the underlying fundamentals, in our view**. As such, the **risk/return at current levels are evenly distributed at best between further upside towards 3,600 over the next 12 months versus a possible downside path towards 2,900 levels.** We remind ourselves every day not to fight the FED, but at the same time we believe that there are some <u>key known unknowns which could rather represent headwinds to markets over the next 3 – 6 months:</u> (1) The US Presidential elections on 3 November, especially with respect to a potential reversal of the Trump corporate tax cuts (2) Escalating US/China tensions (3) Timing, efficacy and, importantly, abundant supply of a Covid-19 vaccine. **Collectively these unknowns can set us up for a much more volatile, rocky Q3/Q4 2020 period, in an otherwise fully valued market, both for equities and credit.** Our approach is to put on a more cautious hat for the next 3- 4 months, while continuing to stick with our preferred Technology and Health care sectors in our equity portfolios. Within Technology, it might be time to switch some positioning from Software to Internet and Hardware. On a stock specific basis, we are very surprised that there has been no follow-on to Micron from the massive Apple beat in Q2. Apple confirmed again that their next generation 5G iPhone will be launched by late-October, and we believe Micron will be a massive beneficiary of this 5G handset cycle.

Furthermore on Rates & FX , the EURUSD has moved from 1.1234 at the end of June to 1.1840 currently, on the back of the agreement on the EUR 750bn Eurozone pandemic recovery fund during July and the reduction in interest rate differentials between the US and the rest of the world . **We have always had periods of excessive Eurozone optimism in the past, only to be pulled back to reality** in Europe's persisting backdrop of stagnation. We think this will be the case again this time. Additionally, we **continue to believe that the US economy will regain its pre-Covid-19 levels much earlier than the Eurozone**, despite some of the ongoing problems the US is facing in stabilizing the Covid-19 outbreak. Thus, short-term rates might start to move higher again in the US towards the end of 2021/early 2022, extending interest rate differentials to the benefit of US at that time again. **Our base case thus is EURUSD going back to the 1.10 – 1.15 with a 12-month view**. In the very short-term though, there are certain, potentially adverse, unknowns, which can create further volatility in USD, especially as we approach the November US Presidential elections. Thus, for non-USD portfolios with meaningful USD exposure, it could be worthwhile to take advantage of attractive hedging costs to mitigate any potential short-term negative currency effects on performance. In that regard, just a year ago, in August 2019, hedging USD currency risk for a CHF portfolio had an annualized cost of 3.3% (today it stands at 1%), within the same time frame for a EUR based portfolio hedging USD currency risk had an annualized cost of 2.85% (today it stands at 0.75%). We also continue to keep a positive bias towards the CHF relative to EUR, given our mid-term economic worries for the Eurozone.

In regard to Gold , the move to 2,000/oz. since late June has been driven by the combination of a weaker USD and, more importantly, the ongoing descent in 10-year US real rates, as discussed above. Can 10-year US real rates decline even further to negative territory from here? We believe the FED has the willingness the keep 10-year nominal rates well anchored at 0.6 - 0.8% amidst record Treasury issuance of $ 112bn to come in August and $ 947bn in Q3. Accordingly, **inflation expectations would need to increase towards 2.0% for Gold prices to rally further, in our view**. This is possible during 2021, but clearly this is not our base case over the next 3-months.

All the best,

The Nahmani Grunder Investment Team