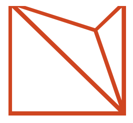


RUBRICS

Recovery Risks

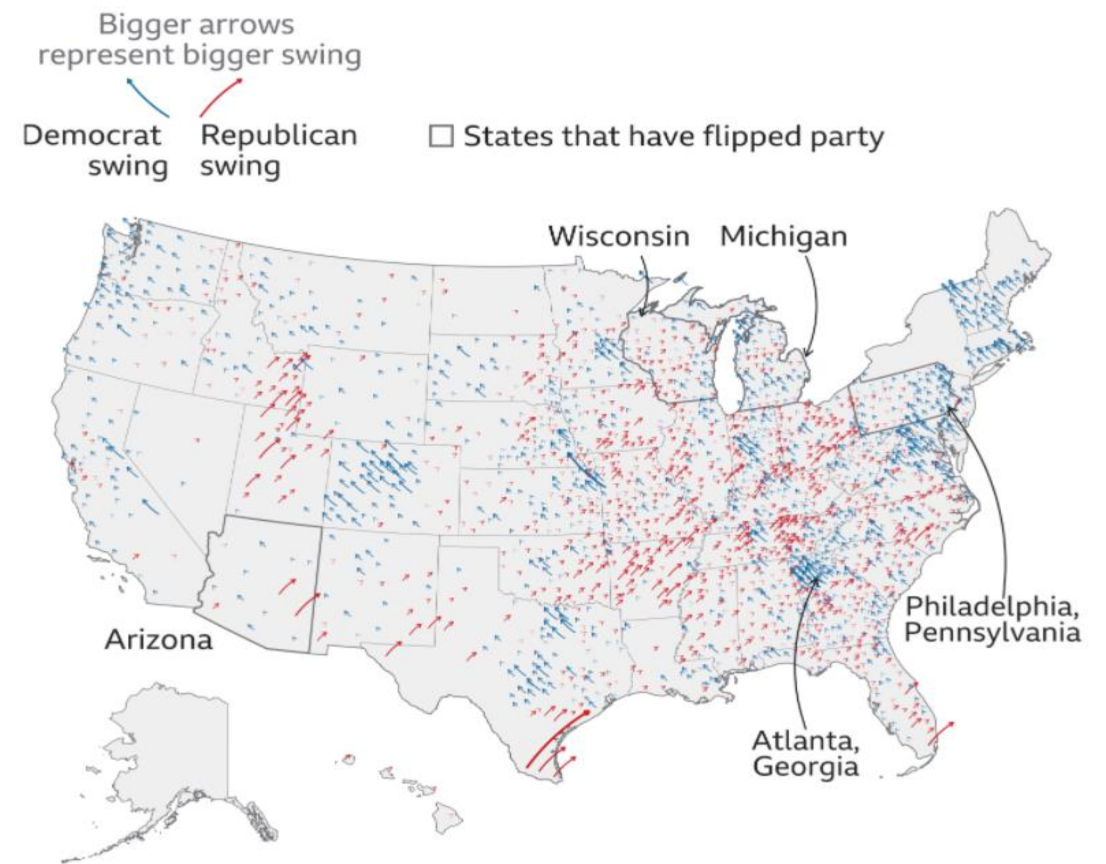
Fixed Income Macro View

rubricsam.com

Introduction

A notable November has so far given us a new US president (we expect), a Republican Senate (we think), and a vaccine to end the pandemic (we hope). Market reactions have been suitably volatile as the stream of news flow is digested. The net reaction has been a positive one with ‘value’ driven equity indices thus far outperforming on hopes of an earlier than anticipated end to the pandemic. We will discuss the market implications of this a little later, but first we will examine what the outcome of the US election might mean for the global economy in the months ahead.

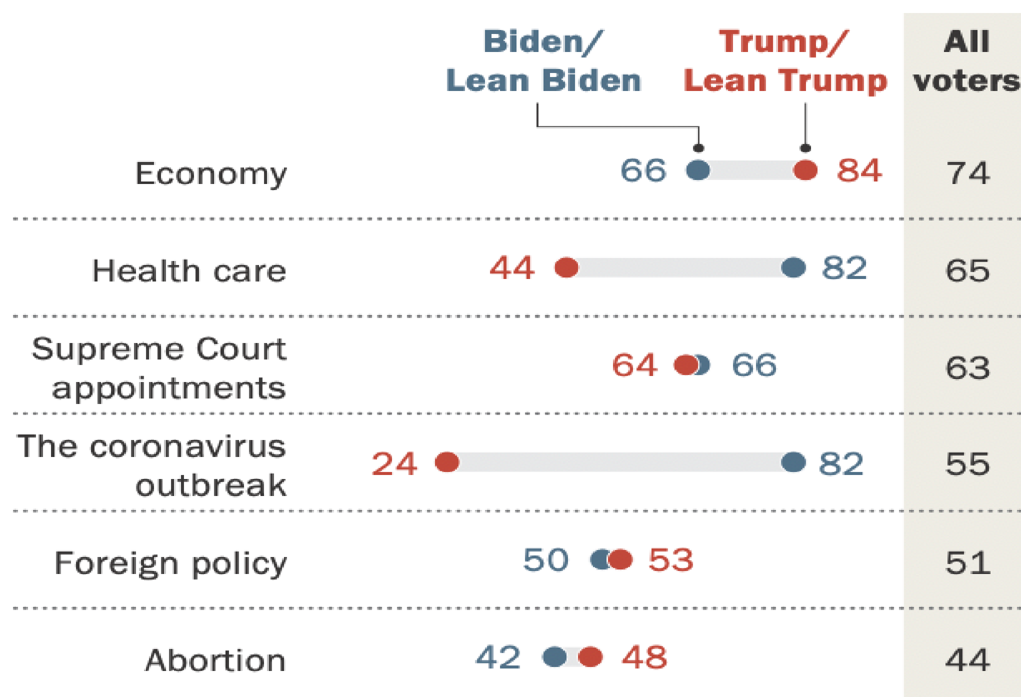
Party swing by county



Source: BBC

Trump and Biden supporters differ over importance of the economy, health care – and particularly the coronavirus

% registered voters who say each is ‘very important’ to their vote in the 2020 presidential election



Note: Based on registered voters.
Source: Survey of U.S. adults conducted Oct. 6-12, 2020.
PEW RESEARCH CENTER

Source: Pew Research Centre

MMT D.O.A?

By now it is clear even to Trump that the election is over. Biden, while receiving more votes than any President-elect in history, has won an unconvincing election. The much vaunted ‘Blue Wave’ never materialised and looking down the ballot, the Democrats will surely feel disappointed. The Senate, as things stand, will more than likely be in Republican hands. This may be the most important takeaway from the election as it means ***the heavily hyped paradigm shift to Modern Monetary Theory (MMT) and aggressive bottom-up fiscal spending will be side-lined for now.***

It is clear that those of us in Europe particularly, have been misreading the American psyche. ***What the election results have told us is that US remains a centre-right electorate, deeply suspicious of any perceived 'leftist' agenda.*** This includes policies such as universal healthcare which would, it appears, be considered socialist by a good deal of the population. While the majority have just about voted out Trump, they have certainly not endorsed a change of direction towards a more progressive agenda. The $2 trillion package muted by Nancy Pelosi must now seem a distant memory.

Fiscal Headwinds

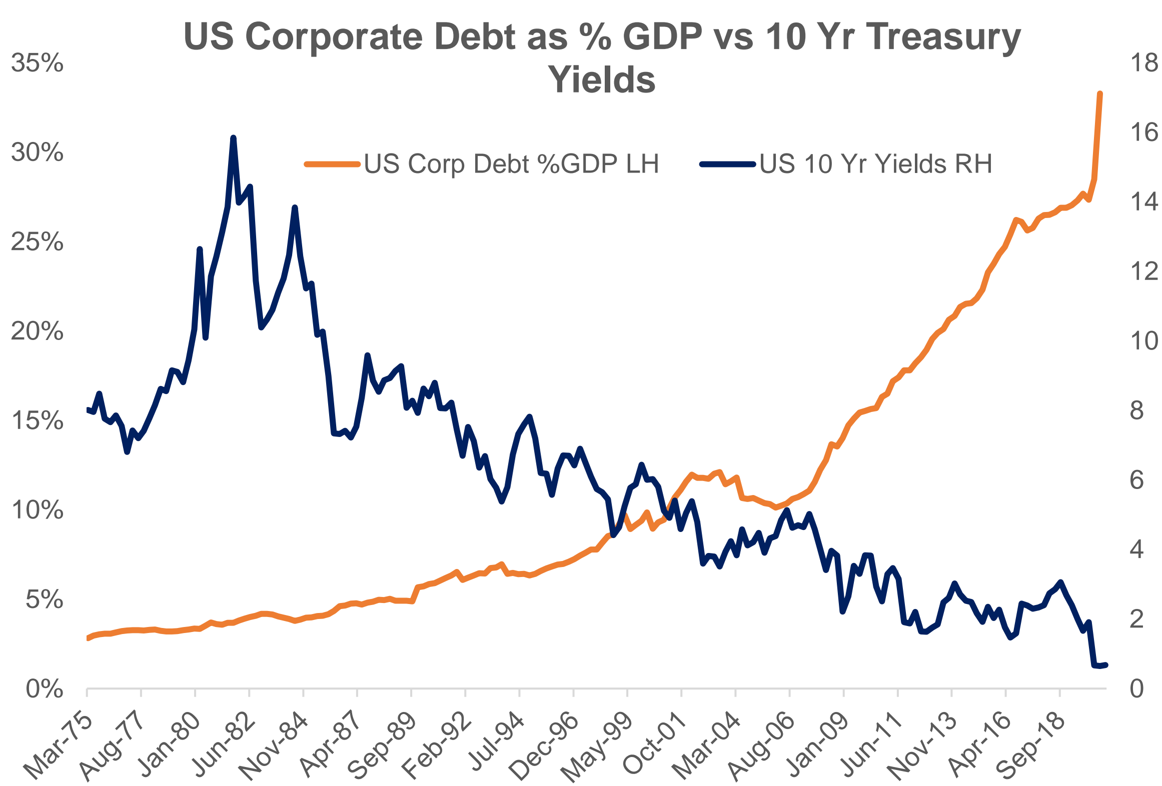
The US senate holds the balance of power in American politics. As things stand, it seems likely that the Republicans will hold the Senate following the Jan 5th runoff races. If so, House Speaker Mitch McConnell has openly said he is not in favour of a big spending programme. This marks a notable change in tune from Trumps' trillion dollar deficit of 2019. Given the poor showing from the Democrats in the House, they will feel the push for further heavy spending programmes did not go down well. The strategy of playing politics with the stimulus package has evidently back-fired.

Source: Bloomberg

Looking ahead, while we could see a scenario in which new (large) spending initiatives are financed by an increase in (corporate) tax revenue, this would be difficult to see with the Republicans in control of the Senate. Additionally, and with a more cynical eye, one wonders what political 'favours' are owed by the Democrats in return for the considerable election financing they received. ***The upshot of it all means large corporate/inheritance tax increases unlikely to materialise,*** with Trump's tax program quite possibly here to stay until 2025. We cannot ignore the fact however, that Biden remains an old style dealmaker. As a result we are likely to see form of infrastructure deal, but not one that will resemble the green new deal touted by the more progressive elements within Congress.

Vaccine Hope

Financial markets aside, the confidence that can stem from an effective vaccine is certainly the most positive aspect of recent news flow. With it can come renewed scope for businesses to start building inventory for the anticipated pick up in post pandemic demand.

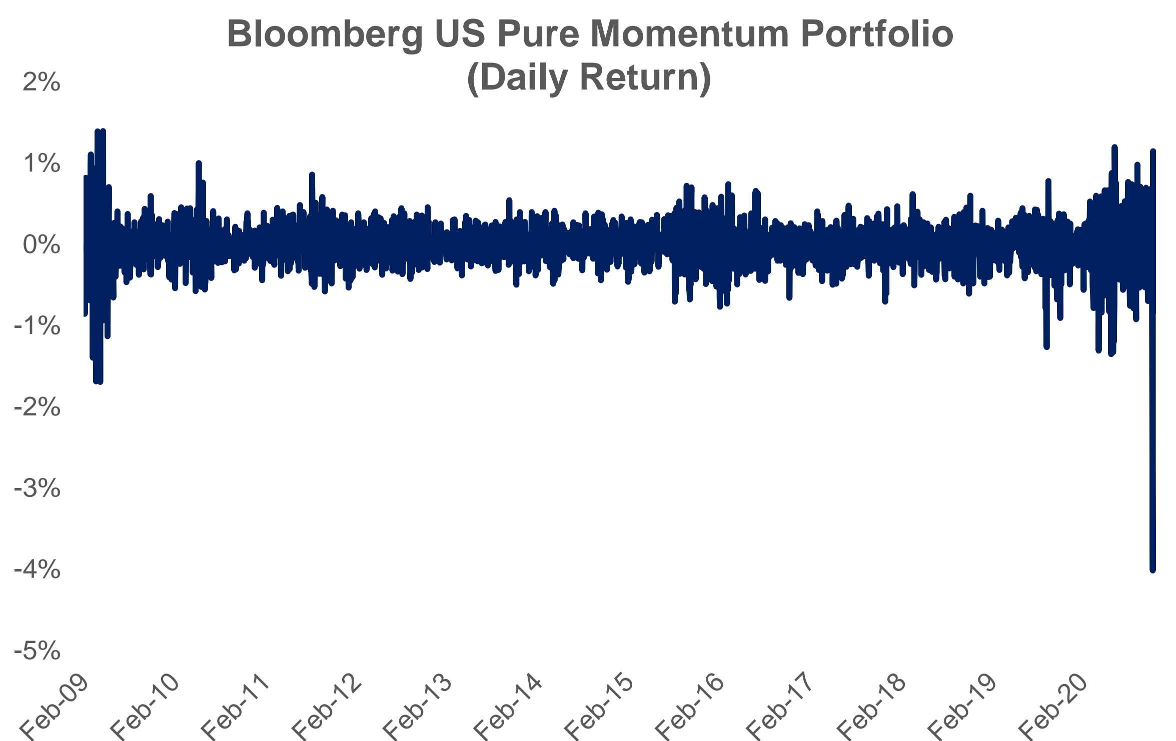


Source: Bloomberg

The Fed has stated they are happy to see inflation run hot and one should not expect them to be overly concerned with price rises. The bond market however might not be as easy to placate - which could sow the seeds of doubt in asset prices pretty quickly. The extent to which government bond yields can move higher will be clearly held in check by the amount of debt in the system. Higher yields will make extreme asset valuations look ever more extreme than before.

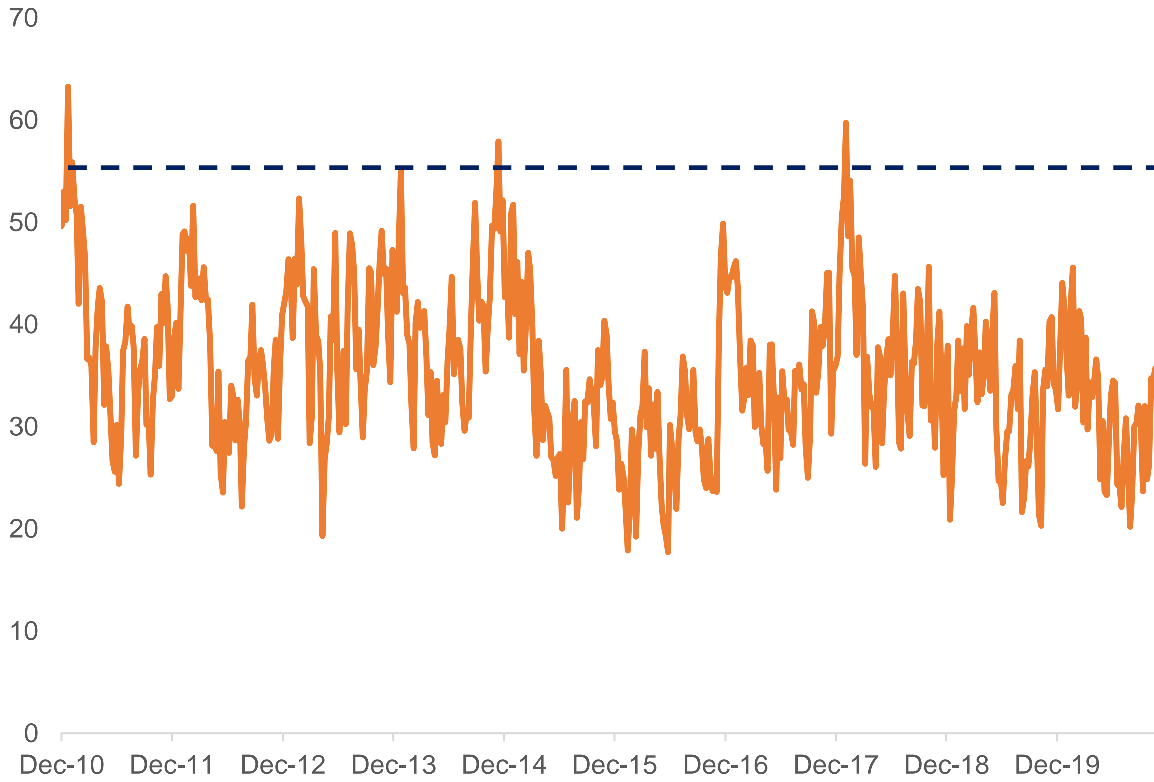
Asset Prices – Short Term Positivity

The initial reaction post election was telling in respect of the increase in the prices of gold, bitcoin and the FAANGs – more QE for longer. The release of the vaccine news from Pfizer sparked a marked turnaround in this reaction as investors and speculators had to quickly readjust to the reflation story once again. ***In fact the violent nature of some of the moves spoke more about market positioning than the vaccine news itself (see chart below)***. This whipsaw in market views may not quite be over yet, but as we view things today the prevailing theme appears to be one of light at the end of the long pandemic tunnel.



Source: Bloomberg

The chart above represents the largest one day drop on record of a pure momentum based portfolio – one which replicates a long position in high momentum companies (i.e. growth) and a short position in low momentum companies (i.e. value).



Source: Bloomberg

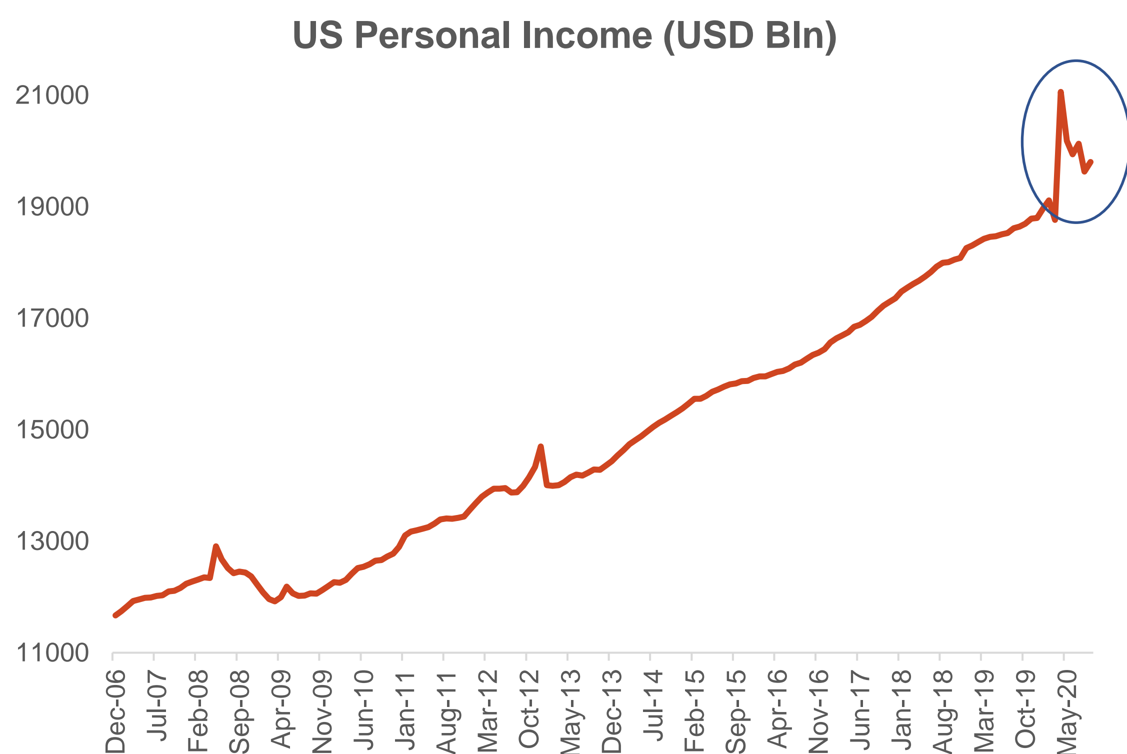
The positivity surrounding the successful vaccine trials is most welcome for both economies and societies around the world. However the picture for the markets may not be as clear. ***Bullishness (see chart above) is approaching all time highs at a time when the resurgence of COVID-19 and the absence of immediate fiscal support are problems that cannot be solved by a vaccine rollout (no matter how imminent).*** The aftermath of the election continues to paint a picture of an extremely divided America. Biden will struggle to unite the country in what has become a bitterly partisan fight against the virus. Full nationwide buy-in for new measures will be difficult, as indeed it might be for a prospective vaccine. Certainly more so than wall street is currently predicting.

Asset Prices - Longer Term Uncertainty

We felt that overly stimulating asset prices in April, while effective in the short-term, would very quickly create future headwinds to a sustainable economic recovery. ***As soon as the recovery becomes self-fulfilling, the more likely the market will start to price in some removal of stimulus, potentially sowing the seeds of renewed market volatility.*** 2013's taper tantrum sowed the seeds of the sharp drop in commodity prices seen in 2014 while the Fed's QT programme ended in a remarkable policy turnaround in late 2018. However, this time it won't be the Fed that spooks the market, rather the lack of future fiscal support that will be the problem. Sooner or later economic reality will take hold as it did in 2018, 2016, 2013, 2010 and 2008. When growth disappoints so do financial markets.

Source: Bloomberg

The difference between previous periods and March 2020 was the nature of the response – a combination of an unprecedented spike in monetary liquidity and more importantly a dramatic fiscal expansion. Indeed such was the nature of the latter that overall incomes grew in the 6 months after the largest economic shut down the world had ever seen.



Source: Bloomberg

The Federal Reserve has been very clear since October 2019 that they were running out of ammunition. With the purchase of corporate bonds and ETF's in March it looks likely that they have fired their last bullets. ***As they have said repeatedly it is now up to the politicians to make the next move - without a real spending programme the recovery is in danger of stalling.***

A striking feature of the recovery has been the unprecedented level of monetary and fiscal stimulus that have managed to keep many businesses afloat. Indeed such has been the success of policy that bankruptcy filings in the US[1] have actually fallen by 30% compared to a year ago. Whilst this has certainly saved some viable businesses and many jobs, it has also created a surge in so-called zombie firms. Many companies will continue to limp on in industries that may struggle to ever come back to pre-Covid levels. ***In this way the process of creative destruction[2] is stifled somewhat with inevitable consequences to longer term productivity***.

We continue to believe fundamentally that it is economic growth and not market liquidity that matters most. After 10 years of top down, liquidity driven policy, the global economy is firmly enveloped in a zero interest rate paradigm with little sign of escape. Financial markets can be fooled into thinking this is sufficient to justify excessive valuations for a while (indeed longer than many may have expected) but surely not indefinitely. As the economy continues to emerge from the crippling pandemic, a change of tack to a more bottom up driven approach would be welcome, however we are not holding our breath.

1. US New Bankruptcy Cases Total Filings. Source: Bloomberg
2. A term coined by Joseph Schumpeter in 1942 referring to the process in which new, more productive businesses replace older less productive ones

In Summary

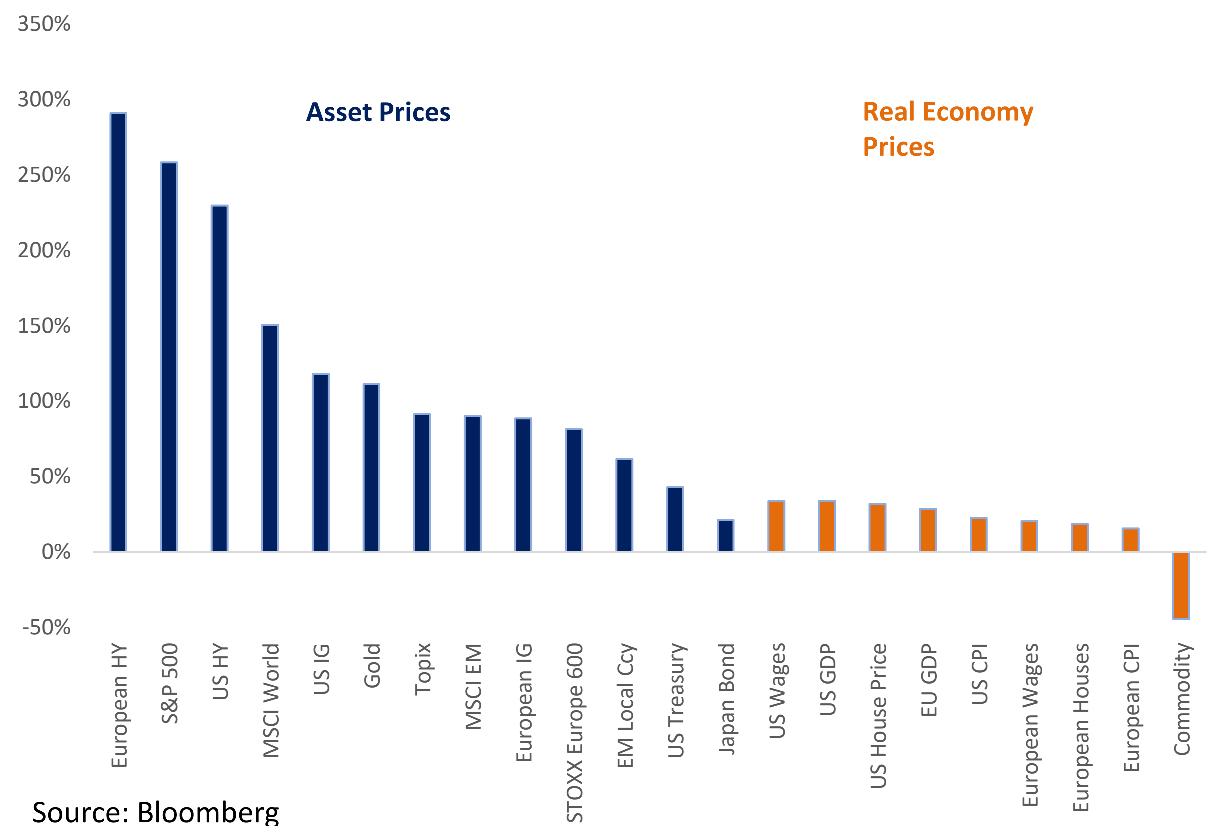
Capital markets are feeling well insulated right now, thanks to an abundance of monetary and fiscal stimulus. With the excellent news on the vaccine front, the economic outlook is also is starting to brighten up. If we add to the mix a plethora of bullish investment research notes, we have the perfect recipe for an upside-only environment for risk assets. There remain however a few unanswered questions: What are we getting paid for our money? What kind of policy mix will we see? What kind of recovery will materialise?

Answering the first question is easy - we are simply not getting a lot for our money. Asset prices are sky high thanks to extreme levels of central bank intervention stemming, ultimately, from the fear of a financial crisis coinciding with a pandemic. As a result, a full recovery was priced in to risk assets as far back as June. Credit markets have never offered less in yield alongside record issuance, while recovery rates on defaults have never been lower. With the exception of local EM FX, most markets are within touching distance of valuations never before seen. ***As the markets have repeatedly shown us, (e.g. January 2016 and December 2018) even the slightest disappointment can drive volatility significantly higher*** – you don't need a pandemic for that.

Source: Bloomberg

Policy Mix - Only a few weeks ago there was a strong feeling that a Democrat Blue Wave in the US was going to usher in a new era of economics. That idea however, was roundly rejected by the US electorate. Looking elsewhere, after the EU commission spends its EUR 750bln, the likelihood that a vaccinated economy would allow for further rounds of coordinated fiscal stimulus is extremely low. Even in China we have seen some recent hesitance on further stimulus given the current issues around its credit markets and fiscal deficits. ***The future therefore looks like it may be strikingly similar to the past in terms of policy mix.*** A lot of excitement in the capital markets, but ultimately limited follow through on the real (post pandemic) economy. Monetary policy doesn't have the influence it once had and even central banks worry about the boom-bust cycles it creates – hence they are crying out for a bottom up approach.

Recovery - The upshot of this is that the recovery will likely be long on expectations and low on reality. After the initial vaccine boost to economic activity, central banks will compel themselves to try and take a step back from direct interference in the capital markets. It is then that the economic scars of the pandemic will start to emerge. The investment cycle we so desperately need to build long term momentum will simply not arrive - thanks in part to the stampede towards share buyback programmes. ***If we didn't get much of an investment boom in the last cycle, its even less likely this time out with even greater economic uncertainty and more encumbered corporate balance sheets***. Trend growth will be lower, debt levels much higher, zombie companies more prevalent and monopolies more intrusive. A significant move to a cleaner world has already started, but while that will bring new winners to our economies it will also bring losers that will be unable to participate due to skill shortages.



Markets are currently priced for perfection, and not for the economic reality of a world coming to terms with, higher inequality, lower productivity and a policy mix not conducive to building a brighter future'. Wall Street will love it in the short term (record deal making on the cards), but for how long can the capital markets outperform the real economy? Longer than many can possibly imagine I am sure, assuming no policy errors. However central bankers made lots of mistakes over the last decade and cleaned up the mess with even more liquidity and debt. Government policy makers are in the driving seat now and given what we have seen over the last four years it should not given one comfort to throw caution to the wind just yet.

IMPORTANT INFORMATION

Rubrics Global UCITS Funds Plc is a variable capital umbrella investment company with segregated liability between sub-funds; incorporated with limited liability in Ireland under the Companies Acts 2014 with registration number 426263; and authorised by the Central Bank of Ireland pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, as amended). This document is for information only and does not constitute an offer or solicitation to deal, whether directly or indirectly, in any particular fund. Nothing in this document should be taken as an expressed or implied indication, representation, warranty or guarantee of performance whether in respect of income or capital growth. No warranty or representation is given as to the accuracy or completeness of this document and no liability is accepted for any errors or omissions that the document may contain. The Key Investor Information Documents ("KIIDs") and prospectus (including supplements) for Rubrics Global UCITS Funds Plc are available at www.rubricsam.com. The management company of Rubrics Global UCITS Funds Plc is Carne Global Fund Managers (Ireland) Limited (the "Management Company"). The Management Company is a private limited company, incorporated in Ireland on 16 August, 2013 under registration number 377914. The investment manager of Rubrics Global UCITS Funds Plc is Rubrics Asset Management (Ireland) Limited (the "Investment Manager"). The Investment Manager is a private company registered in Ireland (reference number:613956) and regulated by the Central Bank of Ireland in the conduct of financial services (reference number:C173854). Details about the extent of its authorisation and regulation is available on request. Rubrics Asset Management (UK) Limited is an appointed representative of Laven Advisors LLP, which is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Reference number: 447282). Laven Advisors LLP is not authorised to promote products to retail clients, all communications originating from either Laven Advisors LLP or Rubrics Asset Management (UK) Limited is therefore intended for professionals and eligible counterparties only. Data Source: © 2020 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. www.morningstar.co.uk.
For South African investors: In the Republic of South Africa this fund is registered with the Financial Sector Conduct Authority and may be distributed to members of the public. In addition to the other information and warnings in this document, the Financial Sector Conduct Authority of South Africa requires us to tell South African recipients of this document that collective investment schemes are generally medium to long-term investments, collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending and that a schedule of fees and charges and maximum commissions is available on request from the manager. Because foreign securities are included in the investments within this collective investment scheme, we are also required to disclose to you that there may be additional risks that arise because of events in different jurisdictions: these may include, but are not limited to potential constraints on liquidity and the repatriation of funds; macroeconomic risks; political risks; foreign exchange risks; tax risks; settlement risks and potential limitations on the availability of market information.

Additional Information for Switzerland: The prospectus and the Key Investor Information Documents for Switzerland, the articles of association, the annual and semi-annual report in French, and further information can be obtained free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, tel.: + 41 22 7051178, fax: + 41 22 7051179, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Ile, CH-1204 Geneva. The last share prices can be found on www.fundinfo.com. For the shares of the Funds distributed to non-qualified investors in and from Switzerland and for the shares of the Funds distributed to qualified investors in Switzerland, the place of performance is Geneva.