SSA SWISS ADVISORS

MARKET OUTLOOK

26 June 2020

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Chief Investment Officer

Key points:

- **Keep equity exposure at neutral**
- **Expect gains for the equity market in line with the long-term average**
- **U-shaped recovery still most likely scenario**
- **Unemployment rate will remain high for the foreseeable future**
- **Zero probability that interest rates will move up this year**
- **S&P500 index - golden cross ahead – bullish signal**
- **Exceptional conditions in the FX market**
- **Keep fingers crossed and stay flexible**

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Market Outlook

After the string of unprecedented events in the first six months of 2020, we have to remain flexible in our approach for the second half of 2020. **This means that although we enter the second half with a neutral equity allocation, and are expecting gains for the equity market in line with the long-term average of 5-7% per year, we cannot rule out that sudden shifts within the asset allocation will become necessary as we go along.**

With that being said, our base case is that the cyclical equity bull market will continue. Volatility will probably remain elevated, but should diminish. The economy will begin to pick up and the US election cycle will grow in importance.

Although some global economic indicators that we are watching (for example the PMIs[1]) have picked up lately, they remain at historically depressed levels, indicating a long road until pre-COVID-19 GDP is restored. Current estimates for the global economy from the OECD and the World Bank are that GDP will decline between 5.2% and 6.0% in 2020. This would be the largest decline in the post-war era and double the drop observed during the Global Financial Crisis (GFC). **Our favorite economic scenario is still a U-shaped recovery with a stabilization in the second half of 2020 and a recovery only in 2021** (keep in mind that equity markets tend to bottom around a median of five months before a recession ends).

As mentioned in an older Market Outlook, the labor market recovery will be one of the main factors we have to watch in order to estimate the length of the current recession and the strength and durability of any recovery. Due to its flexibility and with nearly no government intervention, the US jobs market seems to be a good sample to look at. In Europe, we have more state support and therefore it will take longer to see the implication of the Covid-19 shutdown for the unemployment rate. In Switzerland for example the unemployment rate hardly moved up so far whereas in the US it spiked from a 50-year low to a post-World War II high in the span of two months. We doubt that all workers on temporary layoff will be re-employed quickly. Some businesses will not reopen after the pandemic, magnifying the risk that temporary layoffs will turn permanent. Large fiscal support provides a temporary lifeline during the lockdowns. However, it is fair to assume that if demand is slow to return or the health crisis is prolonged, more businesses will shut their doors permanently. **The conclusion is that labor market slack will remain excessive for the foreseeable future**, much like after the GFC, when the unemployment rate took more than seven years to return to its pre-crisis level in the US. This will weigh on consumer demand and create downside inflationary pressures. On the positive side for corporations, this will also keep unit labor costs low, which is positive for profit margins, creating a tailwind for the equity market.

Based on the actions of the major Central Banks and the forward guidance they have provided, it is clear that they will keep their policy rates at the effective lower bound. They will keep them at those levels not only for the remainder of this year, but at least for the next year or two. **There is zero chance that rates will move up.** Additionally, all major central banks have resumed large scale asset purchases to improve market functioning. Therefore, the argument that stocks are attractive relative to bonds remains in place.

Looking at the S&P500 index from a technical point of view, the prospects for a long-term uptrend will further improve if a so called "golden cross" can be established (where the 50 day moving average (green line) crosses the 200 day moving average (red line) on the upside (see chart below)). This would then form a more bullish scenario where global economic data increasingly confirms that the massive monetary and fiscal stimulus is having its intended expansionary impact and the chances of a sustained advance are increasing. It could also confirm that stocks have entered a new cyclical bull market within the secular bull that started 11 years ago.

What we can probably rule out as of today is that we will see a short-term retest of the March lows in the equity market. Although, based on historical data, such a retest was very likely, we do not expect it to happen anymore.

However, if the Covid-19 crises leaves deeper and longer lasting scars in the economy, we cannot rule out the possibility that another bear market is underway. Signals for this would be if the equity market has difficulties in making new highs and keeps on rolling over and over again. We would expect this to happen in a slower process than a sell-off which we saw in March. The equity market would probably

have small losses on a daily basis, but a downtrend would be established over several months. It is therefore utterly important that the current equity market strength remains in place.
We have seen in 1929, 1968 and 2000 that the all clear signal cannot be given too early. These years are examples of what we have to watch out for today (a cyclical bear market which developed after the initial rebound from the first sell-off). After the 1929 low, the DJIA rallied by 48%, the same as the gain to the current high in June, after which it dropped by -86% to the low in 1932. In 2001, the DJIA rallied from its initial low and moved 29% higher, only to drop -32% to a lower low in 2002. Following the initial sell-off in 1966, the DJIA uptrend lasted much longer than the other two. However, like the other two, the advance failed to produce new highs, with the 32% gain followed by a -36% drop to new lows in 1970.
Nevertheless, what is different today, is that the central banks and governments have reacted with stimulus responses that are unprecedented in terms of size and breadth. The decline in economic activity would have been much worse had it not been for quickly implemented monetary and fiscal stimulus. Therefore, as long as we get positive signals from the market, we give recovery the benefit of the doubt; the possibility exists that due to the huge amount of fiscal and monetary policy stimulus, economic activity might recover quicker and even fuel a temporary overshoot of economic growth in 2021.

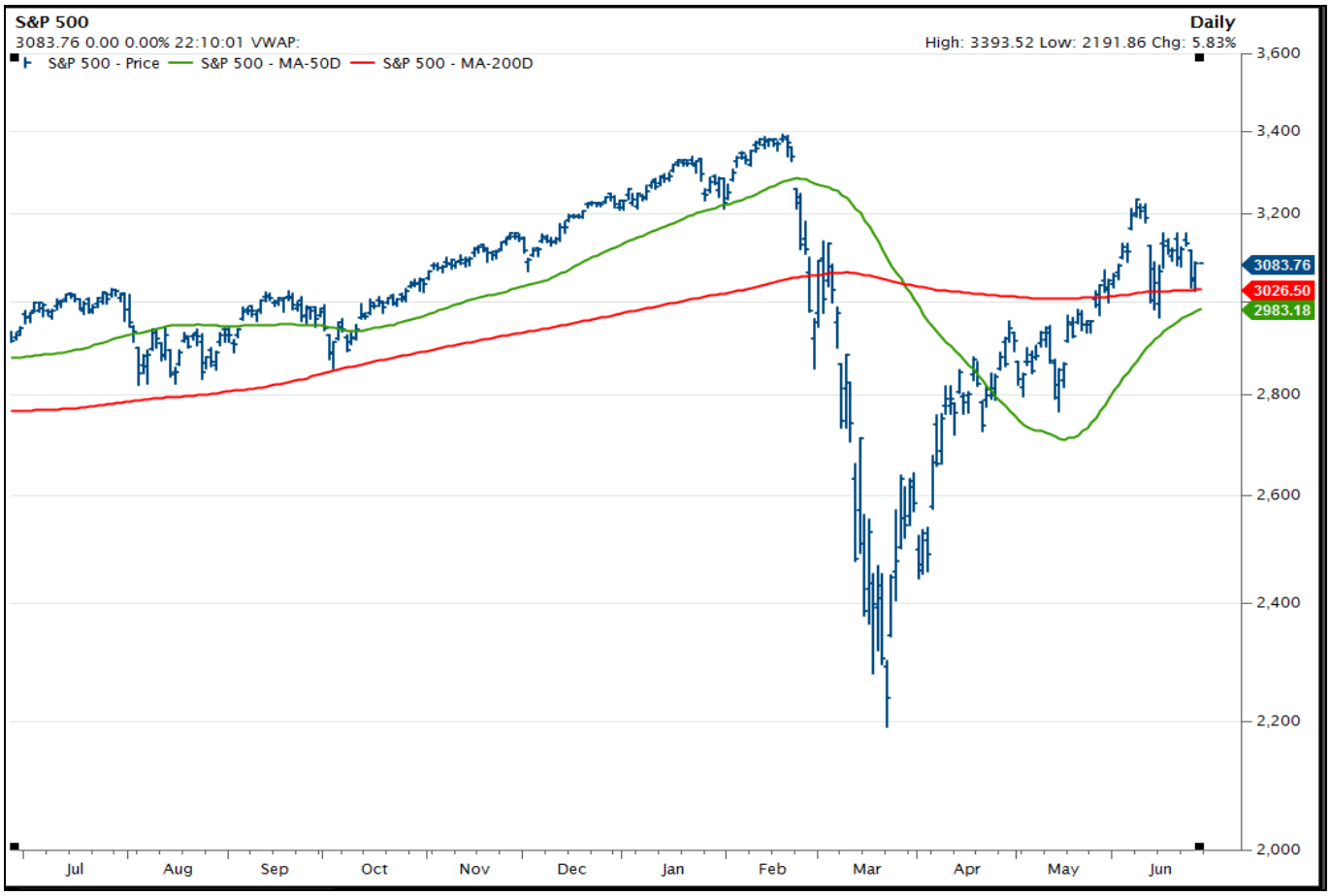


Chart S&P500 with moving averages / source: Factset

Forex

Lately there was an interesting article in the Financial Times (available upon request) about the current conditions in the Foreign Exchange (FX) market. Since the Covid-19 crisis started, the FX market has no longer followed its normal valuation pattern.

Under normal conditions, exchange rates are valued on the basis of the outlook for growth and interest rates in the countries concerned. The better the outlook of a country is, the higher its currency is valued. **Since the drastic actions taken by central banks worldwide, currencies have traded more with stock market moves than with other fundamentals.**

At first sight, this does not make sense, but there are different factors at work. First, interest rates in major economies have been cut to near zero. So, one of the most important factors in currency valuation got wiped out. Second, the analysts' dispersion of growth expectations varies so much that also growth forecast are nearly worthless. Therefore, FX trading has been reduced to the belief that central banks will do whatever necessary to fight the crisis. Fundamental economic indicators have simply not been relevant. **The currencies are now trading in negative correlation to the stock market**, meaning that as the S&P500 falls, the USD rallies and as the S&P500 recovers, the USD sells off. These moves can be understood by considering the intervention of central banks and governments. Rate cuts, asset-purchasing programs and massive fiscal stimulus lead to a rally in share prices, but weaken the currency, as more money is printed and vice-versa. Therefore the recent behavior of FX markets is rather logical. Interesting is that in the first half of 2020, the EUR, the CHF and the JPY traded in a quite narrow range against the USD despite the very high volatility in the equity markets during this period (see chart below).

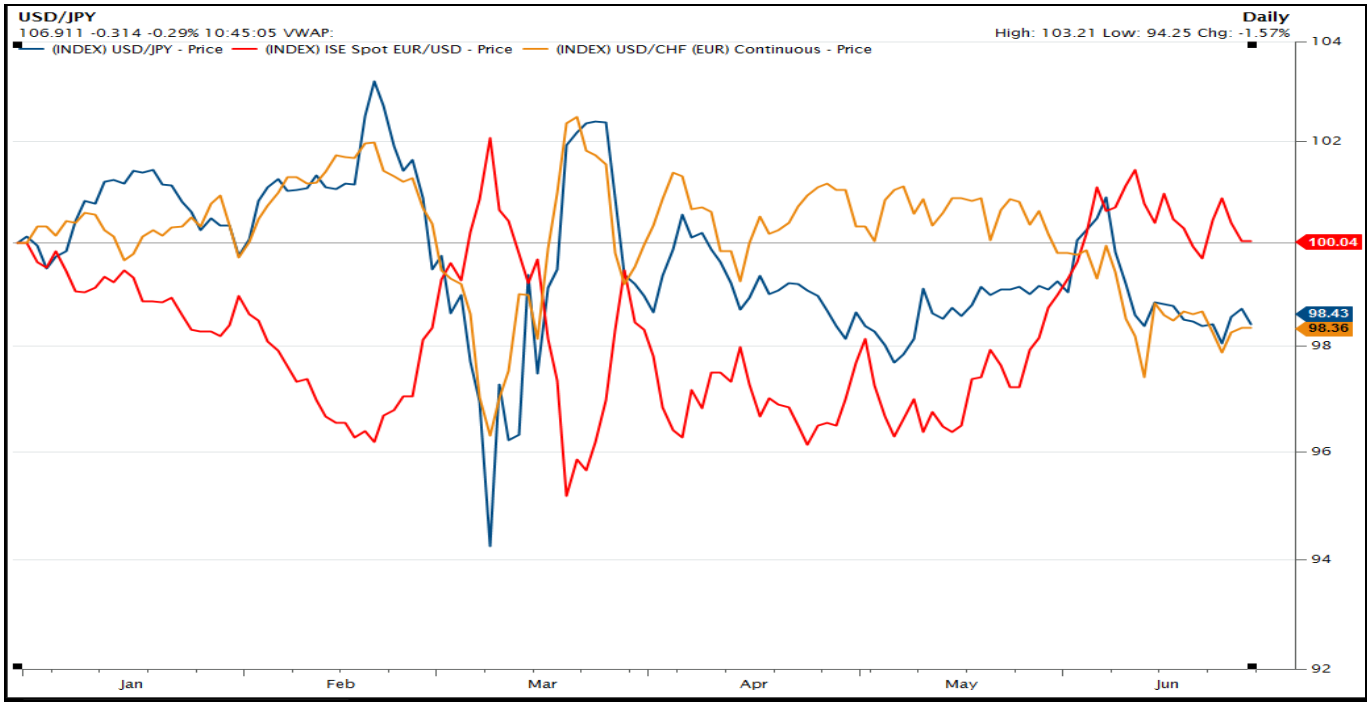


Chart USD/JPY, EUR/USD, USD/CHF / source: Factset

Without a clearer understanding of the economic impact of Covid-19, broader sentiment will continue to drive the currency market. At one point however, normal market relationships will re-establish and interest rate differentials will play a dominant role again.

The difficulty will be to estimate the impact of Covid-19 on the different countries and the damage done to the underlying economies. At the moment, this cannot be done. Most probably, the confusion will last for the next few months, making it much harder to value currencies properly than during normal times.

On a side note, finance has another scandal. Wirecard. What a shame for a country like Germany. How can 1.9 billion EUR cash just disappear and the auditors and regulators did not see it? As a former auditor, I always thought that cash balances are the easiest to reconcile. Obviously it must have been more difficult in this case and it shows – once again – that diversification is key in our business. On top of this, don't let greed and emotions guide your investment process and decisions.

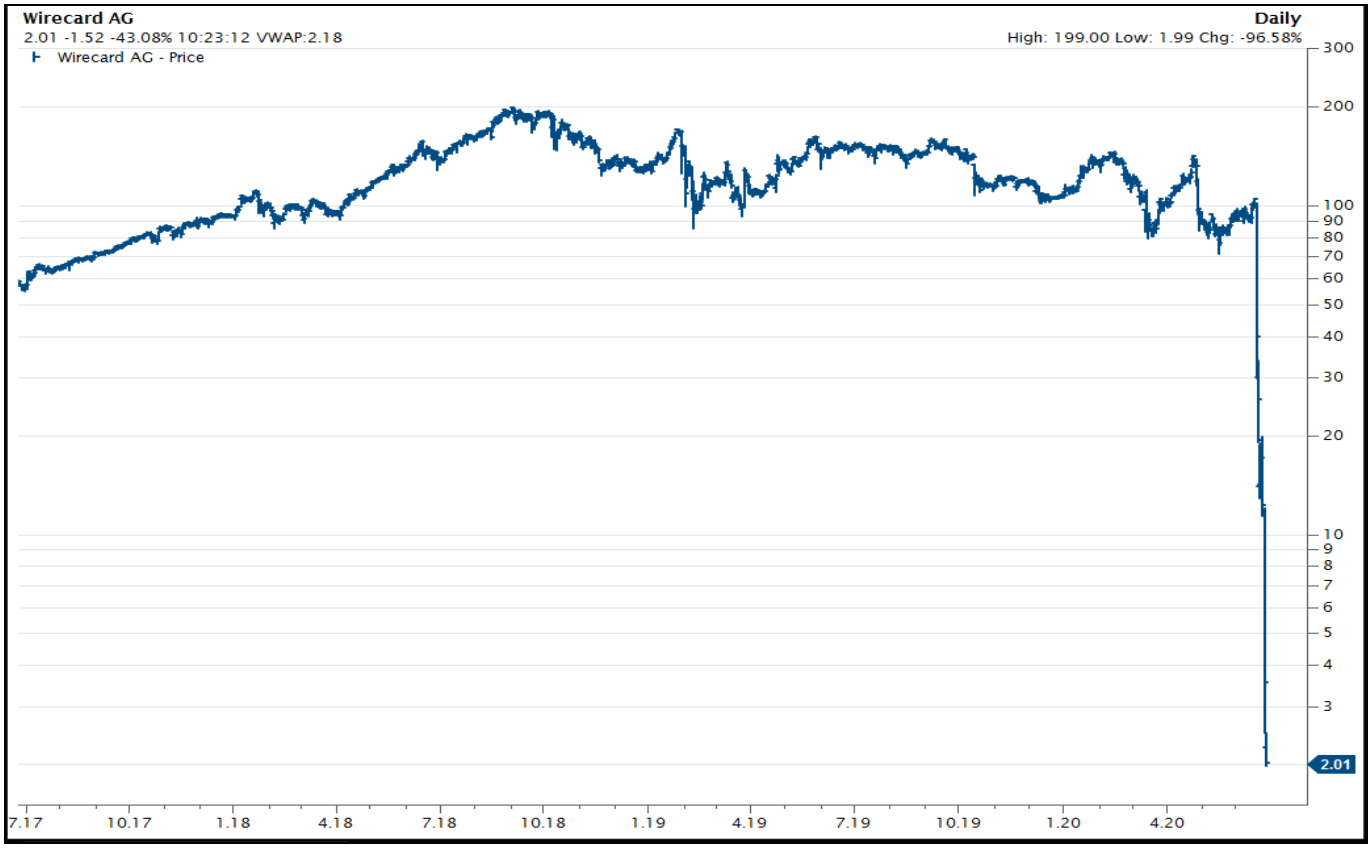


Chart Wirecard / source: Factset

Please do not hesitate to contact us if you have further questions.

Let's hope we have a quiet summer and everybody can recover from the extraordinary events.
Best Regards
Ivo

1) The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It is a diffusion index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

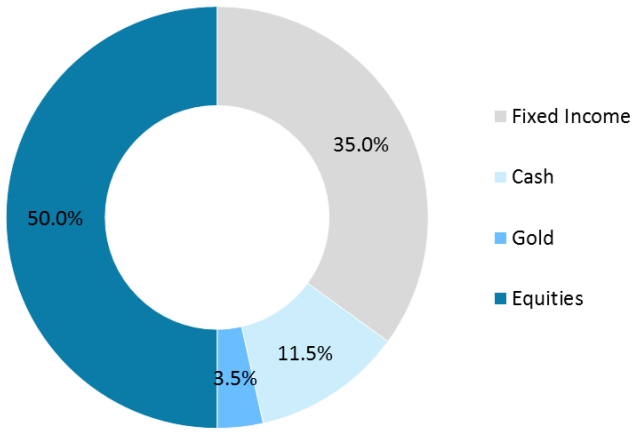
Source: Ned Davis Research, Financial Times

Asset Allocation

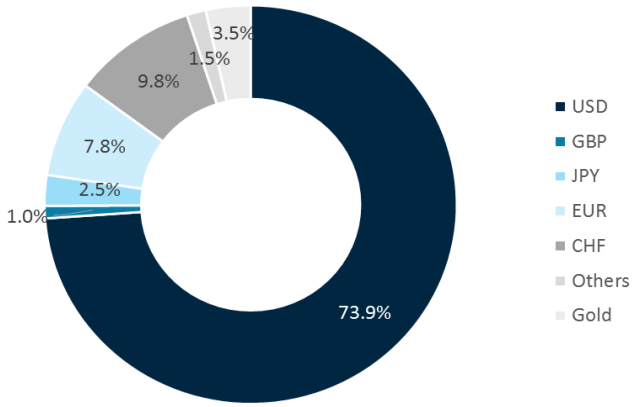
Given the factors described, we keep our equity allocation at neutral. (USD and CHF Balanced details below).

Current Allocation USD Balanced

Asset Allocation

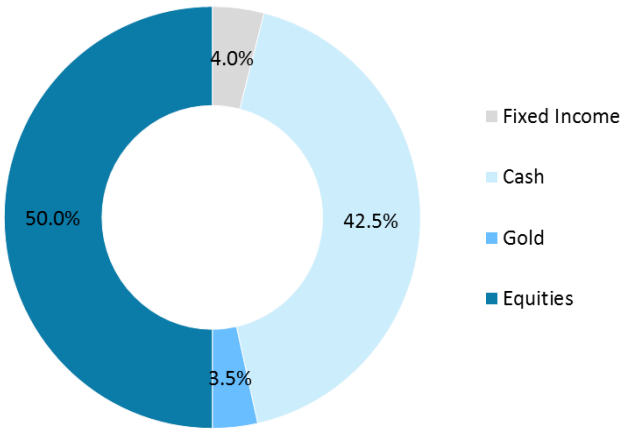


Currency Allocation



Current Allocation CHF Balanced

Asset Allocation



Currency Allocation