Morgan Stanley

INVESTMENT MANAGEMENT

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Coronavirus: Who is the ‘Smart Money’ Investor?

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MARKET PULSE |

ANDREW HARMSTONE

Managing Director, Lead Global Portfolio Manager, Global Balanced Risk Control Team

MANFRED HUI

Managing Director, Co-Lead Global Portfolio Manager, Global Balanced Risk Control Team

CHRISTIAN GOLDSMITH

Executive Director, Portfolio Specialist, Global Balanced Risk Control Team

Equity markets have recently risen in the face of significant scepticism – the proverbial ‘wall of worry[1]’– but equity positioning data suggest that many institutional investors, notably asset managers and pension funds, have above-average cash balances and are missing the ‘party’. In fact, despite risk assets and equities in particular appearing to have an upward bias, we have actually seen flows out of equity funds[2].

May was another positive month for global equities relative to bonds, although the price action was less exciting than in late March and April. Nevertheless, with institutional investors by and large sitting on the sidelines, it appears that individual investors are providing the bulk of the support for equities, begging the question of which group of investors is right – who is the ‘smart money’ investor?

Markets are clearly anticipating economic recovery and are looking through the enormous, astonishing levels of economic disruption that have resulted from the COVID-19 crisis, for example as demonstrated by record levels of unemployment. Moreover, in the absence of a coherent, coordinated response to the virus, countries and regions are at different stages in the control of the virus; the risk of reinfection therefore remains high, and we have already seen second waves of infections in regions that appeared to have effectively resolved the viral threat. So far, these second waves have been reasonably well contained, but premature re-opening in regions where the virus is still spreading, in the hope of limiting the economic damage, risks major setbacks and forced re-closures, as hospital facilities become overwhelmed. Should this happen, it could quickly derail the economic recovery story.

[1] Where markets appear to ignore a large number of negative factors and keep rising.

[2] Almost $160bn in outflows from equity mutual funds YTD 20 May 2020. Data is from the Investment Management Institute.

Bankruptcy rates, a primary concern for the global economy, are likely to increase sharply in coming quarters. One broad indicator of the pace of bankruptcies in the US, where a strong recovery is critical to global recovery, is the American Bankruptcy Institute's (ABI) count of US commercial business bankruptcy filings. Encouragingly, the latest ABI data show that Chapter 7 bankruptcies declined in April on a year-on-year basis, suggesting that bankruptcies in smaller firms have not yet seen an uptick. However, the ABI observed that whilst "the extraordinary measures taken by Congress and the Administration …. have likely staved off bankruptcy filings to date, as financial challenges continue to escalate amid this crisis, bankruptcy is sure to offer a financial safe harbor from the economic storm.[3]" Furthermore, in May, Google searches for the term 'bankruptcy' rose to their highest level since 2012; Google searches have historically led the ABI data, another reason to believe that more US bankruptcies are likely[4].

In Europe, we expect defaults to rise in Q3 2020, as recent government exemptions have allowed insolvent firms to delay filing for bankruptcy until September. Moreover, there are already other indications of stress for small businesses - according to European lobby group SMEunited, 90% of small and medium enterprises in Europe have reported being economically affected by COVID-19, with services hardest hit[5].

So in light of these potential issues, who is the 'smart money' investor? Those investors who have ridden the rebound since March's collapse in equity prices, or the majority of institutional managers who have remained defensively positioned? In seeking to evaluate which group is correctly positioned, one consideration is the aggregate actions of company CEOs and CFOs, who are arguably in the best position to evaluate the prospects of their respective businesses. In this context, we are currently seeking to understand why US corporations have issued record amounts of shares and of corporate debt. Could this indicate that company prospects have diminished to the extent that current pricing looks attractive, while before the coronavirus higher equity prices were not attractive enough to justify large equity issuance? If so, this suggests there may be room for prices to fall. Similarly, high debt issuance now may suggest management concerns that investor appetite for their debt will fall in the future, indicating a less favourable business outlook. From this perspective, the more defensive institutional managers may prove to be 'smarter' in the end!

Asset allocation changes

Our risk-targeted approach takes into account current levels of volatility, which have been falling. Therefore, whilst our fundamental outlook tells us it is still too early to move decisively back into risk assets, this week we have modestly increased our risk positioning, while remaining defensive overall. Crucially, we have implemented the bulk of this modest increase in risk assets via fixed income credit asset classes, in accordance with our latest tactical preferences.

Our analysis of US high yield spreads suggests that default risk has been priced in by credit markets. Consequently, this week we have upgraded US high yield from underweight to neutral. We have also added to European high yield, US investment grade and EM Sovereign Debt, not because we have changed our view, but rather as we increased risk via credit we also added to these positions.

Finally, this week within equities, we upgraded Brazilian equities to overweight. Despite a relatively strong month, as of 31 May Brazilian equities were the worst-performing asset class at a country level, year-to-date.

[3] American Bankruptcy Institute. www.abi.org/newsroom/press-releases/total-april-bankruptcy-filings-fall-46-percent-over-last-year-commercial

[4] Google Trends. https://trends.google.com/trends/explore?date=2007-05-01%202020-06-01&geo=US&q=%2Fm%2F01hhz and www.goldmansachs.com/insights/pages/daunting-debt-dynamics-f/report.pdf

[5] SMEunited. smeunited.eu/news/a-view-on-the-covid-impact-on-and-support-measures-for-smes

They continue to see significant relative downward revisions to earnings. We think consensus is too bearish on the earnings outlook and expect Brazilian equities to outperform in the months ahead. The key to the outlook is Brazil's exports to China. The improvement in the Chinese economy boosts imports of Brazilian products, whilst continuing trade tensions with the US favour Brazil's soya bean industry.

Tactical Preferences

We have provided an overview of our latest tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			Current		
Eurozone		Current			
UK			Current		
Japan		Current			
Asia ex Japan				Current	
China				Current	
Emerging Markets			Current		
LatAm			Current		
Brazil			Previous	Current	
Global Consumer Staples				Current	
Global Infrastructure			Current		
Global Property		Current			

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit			Current		
US High Yield		Previous	Current		
European High Yield		Current			
EM Sovereign Debt HC				Current	
EM Sovereign Debt LC			Current		
US Treasuries				Current	
US Inflation			Current		
German Bunds		Current			
EU Peripheral Bonds			Current		
JGBs			Current		
Commodities					
Gold				Current	
Industrial Metals			Current		

Current positioning

Previous positioning

Source: MSIM GBaR team, as of 3 June 2020. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes.

Broad Asset Allocations

We have provided the latest effective asset allocation weights of each of our five Luxembourg SICAV funds in the following table, as of 4 June 2020.

	VOLATILITY P.A. [1]	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %*	
					PHYSICAL	SYNTHETIC*
MS INVF Global Balanced Risk Control Fund of Funds (EUR)	4% – 10%	31.0	52.9	4.1	11.4	0.6
MS INVF Global Balanced Income Fund (EUR)	4% – 10%	27.4	51.5	4.3	14.0	2.7
MS INVF Global Balanced Fund (EUR)	4% – 10%	33.0	52.9	4.2	9.6	0.3
MS INVF Global Balanced Defensive Fund (EUR)	2% – 6%	11.2	71.9	3.4	7.3	6.2
MS INVF Multi-Asset Risk Control Fund (USD)	4% - 10%	25.3	57.4	4.1	3.6	9.7

*Synthetic cash created from derivatives positions.
We have provided the effective weights for 4 June 2020 at the time of publication. Weights may deviate marginally from these weights after publication due to data revisions.

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management. Allocations are subject to change on a daily basis and without notice. For information only and not a recommendation to buy or sell specific investment strategy. MS INVF standards for Morgan Stanley Investment Funds. [1.] Volatility targets are indicative ranges. There is no assurance that these targets will be attained.

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