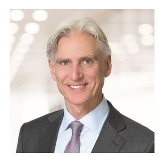
7 August 2020 – Market Update
Global markets:
Are the easy gains behind us?

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

Q2 2020 saw the US and eurozone both suffer their sharpest quarterly contraction in GDP[1] on record. In contrast, asset markets reflected great optimism as global equities recorded their strongest quarterly returns in over a decade,[2] supported by positive economic surprises, generous government packages and the rebound after depressed economic activity in March and April 2020. It appears that equity markets have front-run the economic recovery. However, mounting evidence continues to support our belief that the underlying damage to the economy is likely to result in an economic shock, despite elevated valuations suggesting that the market is not pricing this in.



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We maintain our belief that caution is warranted as easy gains from the re-opening of the economy are likely behind us and we continue to see sustained, sporadic outbreaks of COVID-19. Whilst positive momentum in economic data started to emerge during the second half of Q2, we believe the next chapter in the recovery is a reversal of this. In this note we provide an update on a number of factors likely to derail the recovery:

Household uncertainty over future finances is set to rise in 2H 2020

Government-funded furlough and supplementary income schemes have likely delayed rather than prevented a rise in unemployment, while at the same time meaningfully supporting consumption in recent months. The

[1] US GDP contracted 9.5% quarter-on-quarter (annualised 32.9%). The eurozone seasonally adjusted GDP contraction was 12.1%. Sources: U.S. Bureau of Economic Analysis (BEA) www.bea.gov/data/gdp/gross-domestic-product release date 30 July 2020 advance estimate and Eurostat – European Commission, news release 31 July, preliminary flash estimate for the second quarter of 2020.
[2] MSCI ACWI Index (USD) up 18.7%, Bloomberg, as of 30 June 2020.

most visible debate in regard to the extension of government payments has taken place in the US. Since the last note, Congress has not yet approved a new spending package, despite the expiration on 31 July of the US Federal Pandemic Unemployment Compensation (FPUC) programme, resulting in households facing a near term loss of income. Without any Federal supplement to state benefits for the average unemployed person, income falls to 45% of previous employment income. Moreover, even with the Federal and State support available at the time, the US Bureau of the Census reports that over 20%[3] of unemployed renters missed June's rent.

Temporary unemployment likely to become permanent unemployment

The combination of expiring furlough scheme benefits, rising bankruptcies and new resurgences in COVID-19 cases suggest that many individuals deemed temporarily unemployed are likely to become permanently unemployed in the coming months. The first signs of unemployment starting to tick higher again were evident in the US jobless claims data released at the end of July. After a steady decline in continuing claims since the 8 May peak, claims have climbed to 17.0mn (from 16.2mn) in the week ending 18 July[4]. Our analysis shows, unsurprisingly, that continuing claims are a strong explanatory variable for consumption and in the near term we expect consumers' willingness to spend to decline.

Earnings have beaten a low bar

In a similar manner to the economic data, Q2 earnings have beaten a low bar. For two-thirds of companies in the S&P 500 which had reported so far this earnings season, EPS at the index level was 22%[5] above expectations, as of 31 July 2020. Despite upside surprise being extremely strong versus an historical average of 4%-6%, price action in stocks has been muted. In Q2 2020, generally the positive response to a company beating earnings was muted and even negative, while companies who missed earnings often had significant negative stock price reactions. Companies may have accelerated write-offs in Q1, knowing that the quarter would be bad no matter what and thereby "flattering" Q2 earnings. If this is true, realising the better Q2 earnings were "optical" and a result of this potential acceleration of write-offs, the market did not react as positively as it would normally. Looking ahead, the key question is whether earnings revisions can continue to move higher, and in turn push stock prices higher. Our base case is that the optimism for 2021 earnings is already in the price and the combination of reduced liquidity attributable to summer and a lack of positive catalysts in the upcoming months, makes markets vulnerable to a correction.

Tactical Positioning

Since our last note on 24 July, we have not made any changes to our broad asset mix beyond minor adjustments to help maintain target volatility in our portfolios. However, we have made a key tactical change:

[3] U.S. Census Bureau Household Pulse Survey, Week 12. Data collected between 16 July 2020 to 21 July 2020.

[4] US Department of Labor. News Release Unemployment Insurance Weekly Claims. Published 30 July 2020 www.dol.gov/ui/data.pdf

[5] Source: Bloomberg.

US dollar

We moved from neutral to underweight the US dollar and to overweight euro. The US monetary and fiscal stimulus have removed the interest rate differential advantage which was one of the biggest supports for the US dollar compared with other developed markets. The nominal rate differential is indicating the EUR/USD could regain 1.25, which would be an 8% upside from current levels.

Furthermore, with many US states struggling to contain COVID-19, this puts the US economic recovery at greater risk. Though Europe has had its own struggles, overall better virus control should lead to a faster domestic recovery. In addition, if we do not encounter a broad-based second wave of the pandemic, the euro should benefit from the cyclical recovery. The eurozone has also received a boost from the swift approval of the EU Recovery Plan and overall Europe's fiscal and current account balances are both stronger than the US.

It is important to note that a weaker US dollar is also positive for global growth. As the US dollar is still the world's major liability currency, US dollar weakness translates into a loosening in global financial conditions.

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 7 August 2020.

	VOLATILITY P.A. [1]	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %*	
					PHYSICAL	SYNTHETIC*
MS INVF Global Balanced Risk Control Fund of Funds (EUR)	4% – 10%	31.4	61.9	2.0	4.1	0.6
MS INVF Global Balanced Income Fund (EUR)	4% – 10%	26.5	55.2	2.1	10.1	6.1
MS INVF Global Balanced Fund (EUR)	4% – 10%	32.4	55.9	2.1	7.7	1.9
MS INVF Global Balanced Defensive Fund (EUR)	2% – 6%	13.3	70.0	1.6	6.5	9.7
MS INVF Multi-Asset Risk Control Fund (USD)	4% - 10%	25.6	58.3	2.3	3.6	10.2

*Synthetic cash created from derivatives positions.
We have provided the effective weights for 7 August 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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