MARKET INSIGHT

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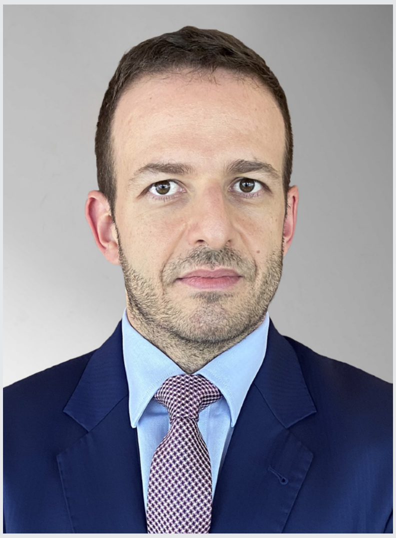

FADI BARAKAT
HEAD OF MARKETS AND PRODUCTS
DUBAI

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THE DISCONNECT BETWEEN THE REAL ECONOMY AND FINANCIAL MARKETS

It seems counterintuitive to be buying financial assets while jobless rates are going up across the globe, yet at the time of writing the S&P 500 surpassed the 3,000 mark. We find ourselves wondering if current levels are justified, will it go on, and just how exactly did we get here?

No asset class was spared in the recent market correction and the world was coming to a "sudden stop", a term used to describe the abrupt reduction of capital flows into a nation's economy, often accompanied by economic recession and market corrections.

KEYNES AND FRIEDMAN WORKING TOGETHER

Governments in developed countries have been quick to react; several Covid-related assistance programs have been put in place to help absorb the financial impact of the crisis. In the US, the economic relief package of over $2 trillion introduced by President Trump on 27 March helps to protect the American people from the public health and economic impacts of Covid-19. Similarly, European leaders have agreed to supporting jobs, businesses and the economy at an EU level, and on 23 April, endorsed a €540 billion package of three safety nets for workers, businesses and member states.

In parallel, over a period of six weeks central banks provided liquidity in extraordinary amounts, buying government bonds, corporate debt, MBS and ETFs.

With the exceptional support coming from both monetary and fiscal policy, it is no surprise to see markets rebounding to current levels, or is it?

MARKETS ARE FORWARD LOOKING

The economy and markets are interrelated but do not move in lockstep. Markets constantly adjust in anticipation of economic change, while analysts and strategists digest financial and economic forecasts to project trends and estimate future asset valuations. That said, black swans do exist, and markets sell off very quickly, as they did in early March.

Is the market right this time? Is it over? In order to answer these questions we must look at the drivers behind the recent movement. First and foremost, the unprecedented purchases of financial assets by central banks give us the first clue. By reducing short-term interest rates to zero and buying the long-dated maturities, the yield curve moved sharply lower and yields on ten year US treasuries tumbled to record lows. When "risk free" returns are so low, equity risk premium drops, inciting increased buying of equities in the hope of earning higher returns in the long run.

Secondly, Covid-19 will not last forever. A strategy to re-open economies has been set, and as cases slowed down businesses were getting ready to function normally again. We will be seeing a new normal where handshakes and crammed airplanes will probably be a thing of the past, but humans have adapted and evolved through the toughest of times, and this is no exception. Eventually, treatment for the virus will drastically improve, hence people will be more inclined to living their usual lives again.

Lastly, governments largely absorbed the impact of job losses, temporary layoffs, and business closures. While the weak perished and the strong survived, visibility improved and the markets reacted. It is important to mention that a large number of layoffs are temporary, thus inflating unemployment numbers, so we must be cautious in analysing past data.

MEASURED RISK TAKING IS KEY

What is the market pricing? If we use the broadest measure of valuation, the estimated 2020 year end P/E of the S&P 500 is 25.00 and 19.50 for 2021. This is telling us that indeed current levels may seem elevated; however, the future is more in line with long-term averages. For European markets, the valuations are generally less rich due to their lower growth prospects and margins. The estimated 2020 year P/E of the Eurostoxx 50 is 20.00 and is expected to be at 15.3 for 2021.

The numbers for both benchmark indexes indicate that we are returning to high optimism levels – whether this is justifiable or not time will tell. What we know right now is that there is little room for negative surprises and most upside is likely priced in. There will be hiccups on the way to recovery, and the market won't continue in a straight line. Somewhat elevated volatility will remain for the foreseeable future, or at least until a long-term solution to the disease has been found. As major world economies go back to work and, schools and businesses re-open, we will gain in confidence to stay invested in line with our philosophy of long-term growth.

In our view, the real test will be the next quarter earnings and future guidance.

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