KLEINWORT HAMBROS

SOCIETE GENERALE GROUP

Getting warmer

After steep declines at the onset of the COVID-19 crisis, stock markets have bounced back. However, they remain below pre-crisis levels and are still highly volatile. So where do they go from here? Fahad Kamal, Chief Market Strategist of Kleinwort Hambros, explains what the four main factors he watches are suggesting about the path ahead.

- **Economic regime**

  Despite surprisingly positive economic data recently, the global economy is on track this year to suffer its deepest recession since World War II. The World Bank's latest forecast (on 8th June) was for global output to contract by 5.2%, with per capita income falling in the largest proportion of countries since 1870. Although their lockdowns are easing, advanced economies are still expected to shrink by 7% this year. In perfect conditions, a rebound may begin as soon as the third quarter. Our inhouse macro-economic indicator has just switched from a regime of contraction into one of recovery, suggesting a favourable environment for risk-taking. However, this is a highly unusual situation, so we are awaiting further confirmation of economic stabilisation over the coming months.

- **Valuations**

  Valuations for equities – the largest source of risk and return in most portfolios – remain challenging in absolute terms. The US equity market, which represents nearly 60% of the global total, is currently trading at a forward price-to-earnings multiple of 22, the highest since 2002. That is expensive. However, with interest rates close to 0%, there is a good case for a higher than usual tolerance for valuations, particularly for large-cap companies which appear to be immune to the business cycle (often called secular growth stocks). Moreover, when compared with cash or government bonds, equities still have a clear advantage in terms of long-term expected returns. So, while equities are expensive, there are few attractive alternatives amongst the core asset classes.

- **Momentum**

  The second-quarter surge in equity markets illustrates why momentum is a critical factor in our asset allocation process. Markets don't have to follow expectations or even logic, and trends can prove to be self-fulfilling. We take a longer-term view of momentum and only assess it at month end. This helps us to avoid being caught in short-term market cross currents, guiding us to take advantage of those trends that have sufficient strength. As of the end of June, the global equity market had just tipped back into positive territory on the ten-month moving average metric that we favour. Should this be sustained, we will view it as positive for risk-taking.

- **Sentiment**

  Sentiment for risk assets, such as equities, has oscillated wildly over the last few months. Of the indicators we follow, some – for example, the S&P 500 Index net speculative positions – imply a certain bullishness. Others – such as the ten-year US Treasury net speculative positions – imply more bearishness. Overall, we are in neutral territory.

The bottom line

Taking all the above into account, we remain cautiously positioned in our portfolios. Risk assets remain volatile – for example, the most closely watched index of volatility is near 30, well above its long-term average – and thus more unpredictable than usual; they also appear expensive on most measures. Nevertheless, the signals we follow for the economic regime and momentum have shifted towards increasing risk in portfolios. Should these signals remain supportive, we may seek to take more risk in the months ahead.

Contact us

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