

Market Compass

December 2020



MARKET OUTLOOK

- The strong risk rally may appear reckless amid resurgent Covid-19 cases, persistent risks of a hard Brexit and a (likely) split new US government taking office in January.
- Yet markets are right in pricing recent vaccine news as a game-changer for the pandemic while central banks remain committed to extended stimulus.
- We thus slightly extend our pro-risk tilt, favouring Credit and (more prudently) Equities.
- A weakening US dollar favours exposure to Emerging Markets (EMs). Cash and Core Government Bonds remain unattractive.



Edited by
**MACRO & MARKET
RESEARCH TEAM**

A team of 13 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

UK

- + Fresh Covid-19 cases slowing
- + Vaccination to start in December
- Brexit hangs in the balance
- Q4 growth to recede

EUROZONE

- + Gradual easing of lockdown measures
- + ECB signalled policy action for Dec.
- + Vaccine news improved outlook
- PMIs signal contraction in Nov.

JAPAN

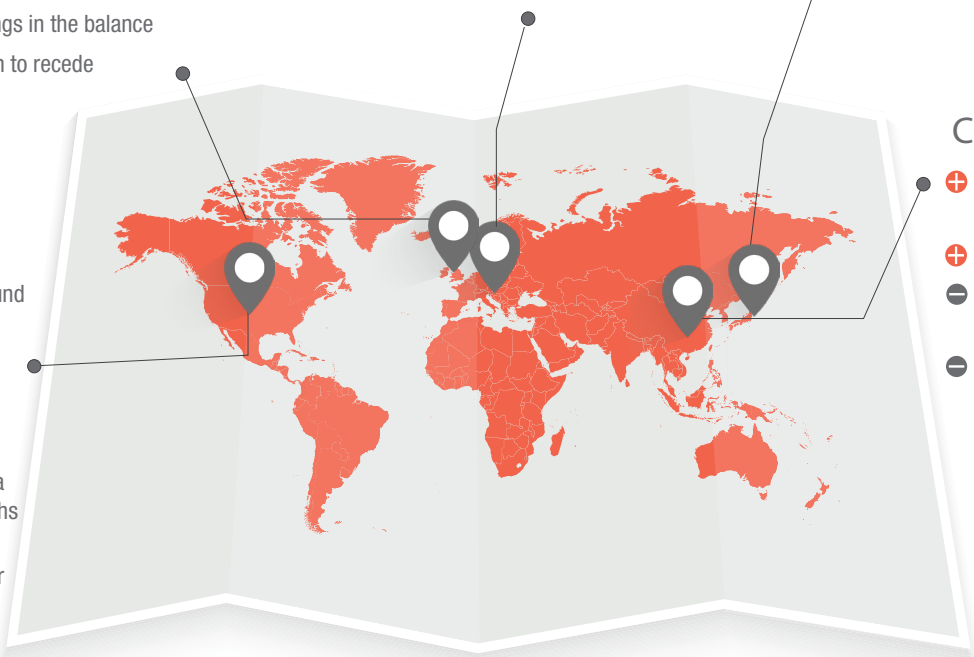
- + PM Suga instructed draft for fiscal package
- Deflation gaining pace
- Japan could not avoid a 2nd Covid-19 wave

US

- + Vaccine availability and high forced savings raise prospects of a strong rebound in spring...
- + ...While construction and manufacturing continue to power ahead
- Rising infection and lack of fiscal stimulus will lead to a worsening in the first months of the year...
- ! ...Possibly triggering further monetary stimulus

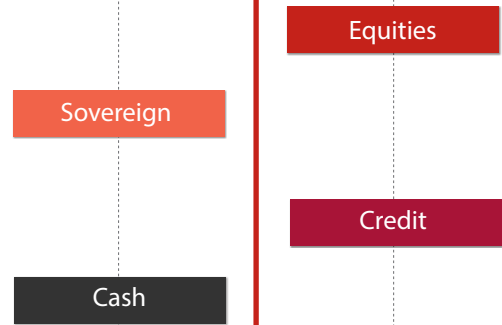
CHINA

- + Fresh Covid-19 cases not to lead to 2nd wave
- + Recovery ongoing
- People's Bank of China limits its action
- Deleveraging in real estate expected



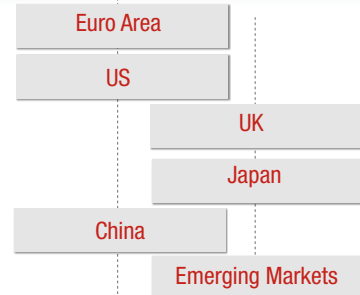
DIRECTION OF TRAVEL

- Prudent overweight (OW) in Equities and High Yield (HY) Credit
- Increase exposure to EMs, both Bonds and Equity
- Underweight (UW) in Core bonds
- Keep a sizeable OW in EUR Investment Grade (IG) Credit
- Underweight in Cash



Equities

- Short term, equities are to benefit from good news on the vaccine and continuing policy support.
- A low yield environment and recovering inflation expectations should prolong the equity overperformance vs bonds.
- We recommend tilt to Value and Cyclical. OW Japan, UK equities and EMs. Neutral EMU vs the US.



Bonds

- Sovereign yields remain stable, inflation expectations up.
- Strong ECB commitment will limit any yield increase.
- Overperformance of euro area non-core sovereign bonds likely to continue for the time being.
- We maintain a positive view on Credit due to ECB support.



Duration

- Neutral duration recommended.



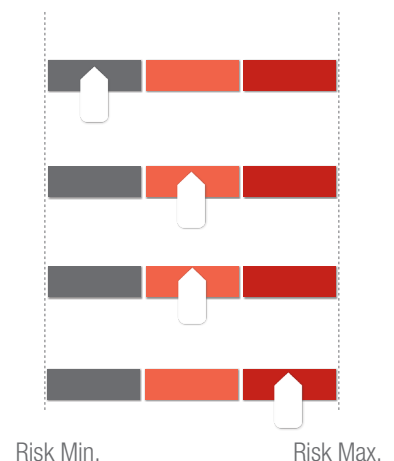
Currencies

- Despite short-term Covid concerns, USD to weaken on easing political uncertainties and vaccination progress.
- EUR/USD will benefit, with new ECB's December measures unlikely to harm the EUR.
- A cheap JPY will benefit from more favourable real yields, while capital flows may turn more supportive.



TOPICS TO WATCH!

- Slow vaccine distribution and public resistance will force to longer-lasting lockdown
- Political gridlock in the US prevents policy action
- Escalating US/China conflicts, especially in the final weeks of Trump's term
- No-deal Brexit



SPECIAL FOCUS

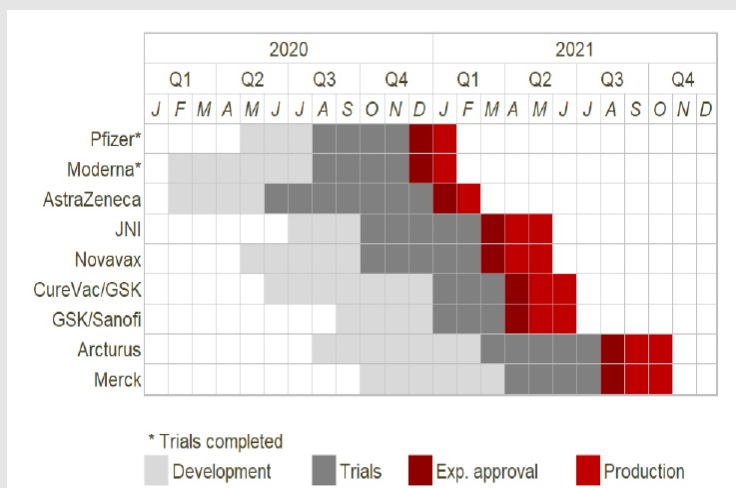
The road to COVID-19 immunity

Reassuring news on vaccines by Pfizer/BioNTech (Nov. 9, and a week later by Moderna) are dominating markets, accelerating the post-election boost to risky assets. In particular, vaccine efficiency rates of 95% from phase 3 trials will likely make broad-based vaccinations feasible soon. Admittedly, hopes on a third product by AstraZeneca seem shaker, and this may matter for the euro area, which is more reliant on this vaccine. Additionally, broader inoculations efforts may still run into severe side effects, public resistance or logistics issues. Yet, with at least four more vaccines potentially available by the spring there is also the possibility of an ever quicker rollout.

In a realistic scenario, vulnerable age groups and front-line health care workers may be vaccinated in Q1 2021 in the US and Europe, allowing for a meaningful relaxation of containment measures in spring. Herd immunity - requiring vaccination or antibodies by about 60% of the population - may even be reached by mid-year. Here what matters will be the logistic capability of each country and the level of acceptance of vaccination. Therefore there may be differences across countries in the speed at which restrictions are lifted.

Once this is done, the ensuing recovery of constrained businesses, pent-up demand and a stronger rise in confidence bode well for a marked economic rebound over spring and summer. A faster recovery will help the euro area recoup pre-crisis GDP levels already by late 2021 - and even in Q3 in the US.

VACCINE DEVELOPMENT TIMELINE



Source: Companies' websites, December 2020

GLOSSARY

BREAK-EVEN INFLATION MEASURES

Break-even inflation measures the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality. If inflation averages more than the break-even, the inflation-linked investment will outperform the fixed-rate. Conversely, if inflation averages below the break-even, the fixed-rate will outperform the inflation-linked.



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