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Economic Background – August 2020

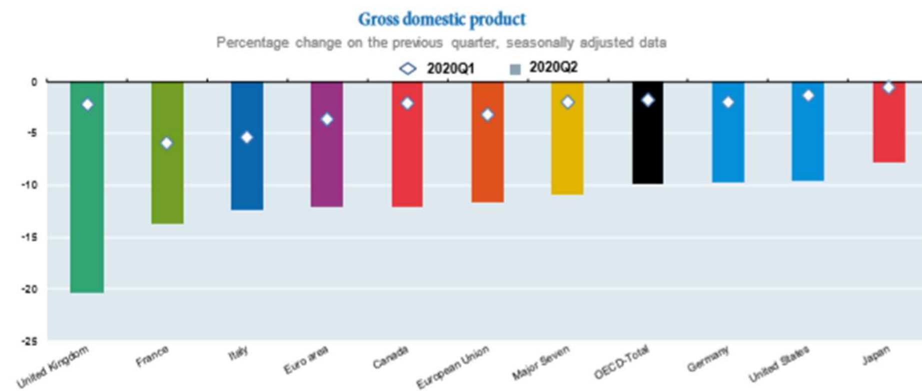
There's something going on that's not quite right[1]

The summer has been positive for risk markets, as the decoupling between the global economy and financial markets continues. US equity markets have continued serenely and aggressively to ever higher highs. However, looking a little more closely at the drivers and breadth of the indices reveals a more nuanced picture.

The strength of the market is surprising given the risks still apparent in the world. The Covid-19 virus has continued to spread, with over 27.5 million recorded cases around the globe. Whilst the growth rate has slowed in more developed regions, the rise continues in certain emerging markets. As schools and businesses return to a version of normality a reacceleration of cases in the developed world would put pressure on policymakers to go further than local lockdowns.

Mixed data

Whilst the short-term high frequency economic data remains mixed, it points to a continued global recovery during the third quarter, but there is concern that the recovery is already diminishing. During the past month we have had confirmation of the dire second quarter GDP data, summarised below by the OECD.



Source: OECD

Whilst it appears that the UK is an outlier in Q2 GDP growth, with the decline of 21.7%, economists believe this is due to the unusual way we measure health care prices in the UK and the reality is that the UK recession is much closer to the European average. The decline in the second quarter is still shocking and is the most since comparable records began in 1955. As it is the second consecutive quarterly decline in GDP, the UK has officially joined Europe, America, Japan and Australia in recession.

Global GDP is now expected to contract by between -3.5% and -4.7% over the year (prior estimates -2.9% to -4.2%). After a robust post-lockdown rebound in activity starting around May and early June, the pace of recovery seems to have slowed and stabilised between July-end and August. Since March we have had a significant global policy response of $20 trillion and 164 global rate cuts in 147 trading days. This has provided a huge support for risk assets, reducing real interest rates to zero or below.

Unemployment, however, remains a challenge. The OECD forecasting that the unemployment rate for the OECD countries could be 10% by the end of 2020, up from 5.3% in 2019. If there is a second pandemic wave the rate could go as high as 12%, delaying a jobs recovery until after 2021.

[1] Strange. R.E.M, 1987

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The latest unemployment data in the US has been slightly better than expected, but the unemployment rate remains elevated at 8.4%. Debate remains whether official figures are near reality as many people are being classified as employed even though they are absent from work. Negotiations relating to a new coronavirus relief bill continue to stall in Washington. Under the CARES Act an extra $600 per week of unemployment benefit was provided to workers who qualified for unemployment insurance. This extra financial support expired on 31 July. Since the beginning of August, those who have lost their jobs receive much less generous, unemployment benefits.

Within continental Europe there has been an increase in the number of Covid-19 cases, particularly in France and Spain. Governments have implemented targeted measures rather than blanket lockdowns. The euro area unemployment rate remains below 8% with governments persisting with their furlough schemes, which has allowed consumer confidence to return and retail sales to recover to pre-crisis levels. The creation of the €750bn European Union recovery fund has provided some further reassurance.

UK data has shown an improvement in consumption with growing retail sales. Services data shows expansion through August, however there is concern over unemployment here too. The latest (June) data shows the unemployment rate is at 3.9%, however it does not include the existing 3 million workers that are still furloughed. As the furlough scheme is withdrawn in October, the unemployment rate is set to rise.

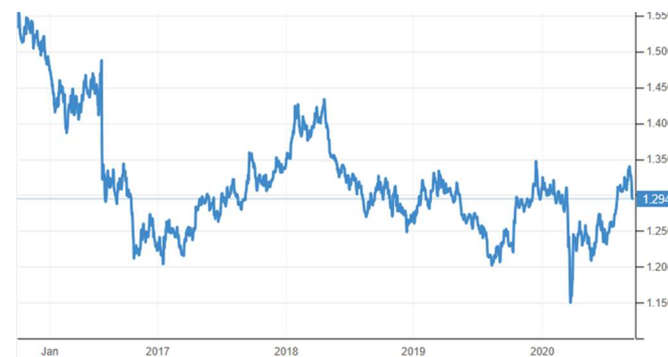
The manufacturing data produced by China continues to suggest that the economic recovery is still in place however retail sales contracted by 1.1%, implying that the recovery has not yet trickled down to households.

Uncertainties straight ahead

Whilst the policy response from governments and central banks have provided support to people, businesses and financial markets, uncertainties remain about the virus and a potential vaccine. Furthermore, there are serious political and geo-political risks in the months ahead.

Brexit negotiations between the UK government and European Union (EU) negotiators have restarted in early September, as both sides try to agree to an arrangement before the UK exits the EU. Talks have not started smoothly with the UK government admitting it will break international law in a ‘specific and limited way’ with regards the Brexit treaty relating to Northern Ireland. The legal changes were explained as necessary to “disapply” EU law once the UK leaves the EU, ensuring that Northern Ireland businesses do not have to fill in export summary declarations when sending goods to Great Britain. Aside from this legal standpoint significant differences remain. Will pragmatism prevail or will the UK trade on WTO terms with the EU in the new year? Any immediate effect will be felt in Sterling, for either scenario. A comprehensive free trade agreement with the EU will likely see Sterling rise above its 2019 highs against the dollar of 1.45 (GBP/USD) and thus dampen the earnings expectations of FTSE 100 companies (80% of revenues are sourced abroad). Likewise, in a no-deal scenario we should see Sterling fall towards and perhaps below where it has traded in 2020, thus providing support to the earnings of FTSE 100 companies.

GBP/USD Exchange Rate



Source: Trading Economics

The US-China confrontation continues to twist and turn. US President Trump is likely to keep pressure high ahead of the elections (wishing to appear strong), without breaking from the deal. However, the Chinese reaction to further provocation is uncertain. More recently the US has imposed sanctions on Chinese and Hong Kong officials, in response to Beijing imposing a national security law in Hong Kong. In retaliation, China is sanctioning 11 Americans including Senators Marco Rubio and Ted Cruz.

With the first US Presidential debate scheduled for the end of September, markets and the world are focussing on the potential outcomes of 3 November. The US Presidential race is still very uncertain, and a contested result is likely whoever the winner is. Certainly, a Biden win and a Democratic sweep of both houses on Congress would move markets. It would likely usher in higher corporate taxes, wealth taxes, regulation but also larger fiscal support. A Joe Biden win without control of Congress will likely dampen any fiscal support.

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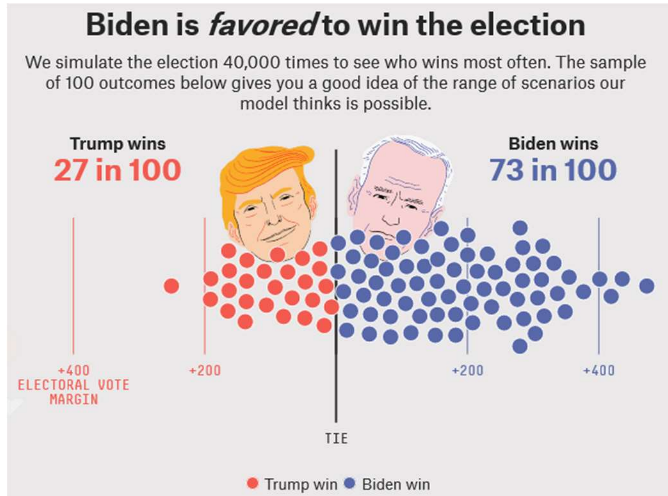
A Donald Trump victory will likely embolden the incumbent President to go further than he has already, good and bad. So far Joe Biden has the lead in the national polls and betting markets, but this has narrowed since the Republican National Convention. According to Nate Silver's FiveThirtyEight model Biden is also predicted to win, 73 times in 100. Much will change over the next 8 weeks.



Source: FiveThirtyEight

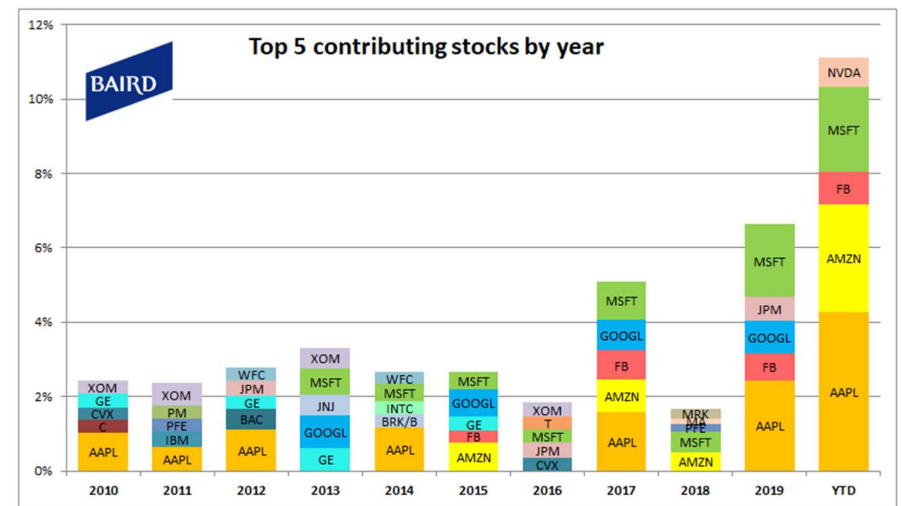
The eventual scenario is uncertain, with asymmetric risks for specific industries. There are signs that these risks are being priced into markets. Future contracts on the Vix (measure of future volatility on the S&P 500), due to mature around 3 November show an unusual bulge in pricing. Whilst not predicting the direction of markets this indicates that investors are pricing in volatility before and after the election.

Despite this uncertainty share valuations in some sectors have returned to pre-Coronavirus levels. Other sectors are far from recovering and there are many companies which have been kept afloat with subsidies and debt. US companies have doubled the amount of debt refinancing this year against 2019, moving out the duration of the debt.

Everyone's got options

It is odd then against this backdrop that US equity markets accelerated in August to new all-time highs, with the Nasdaq returning 11.2% and S&P 500 7.1% over the month. The US market is expensive compared to other markets and its own history, trading on a price to earnings (P/E) ratio of 23x 12-month forward earnings. However, this is distorted by growth stocks which in aggregate are trading on P/E multiples of 30x. For the more larger momentum driven companies the multiples are much greater than this.

Certain companies seem priced for perfection and the valuation dispersion is extreme, offering investors selective opportunities. The divergence between the big five mega caps and high-growth large caps and the rest of the market is huge. The top 5 contributing stocks in the US are Apple (AAPL), Amazon (AMZN), Facebook (FB), Microsoft (MSFT) and NVIDA (NVDA), which have contributed to over 11% of the total return for the S&P 500 this year. The other 495 stocks in the S&P 500 have generated a net loss overall.



Source: Baird

Other momentum companies like Tesla Inc. (+74% in August) have had stellar summers. Why? Speculation driven from retail investors at online discount brokers. Industry data shows that small trader accounts purchased $40 billion of premium in call option contracts over the last month. In its simplest form a call option contract provides the buyer with the opportunity to obtain significant exposure to a stock for a relatively small price. They provide leverage (100x, 150x, 200x), but they can also result in a 100% loss of the money staked in the premium. A call option can expire and become worthless if the stock price fails to move above a specified price by a specified time.

What is noticeable about the activity (speculation) is that it is concentrated in call options expiring with a short-term time horizon of less than 2 weeks and mostly on tech/momentum companies. The broker (market maker) who traders buy these options from hedges their

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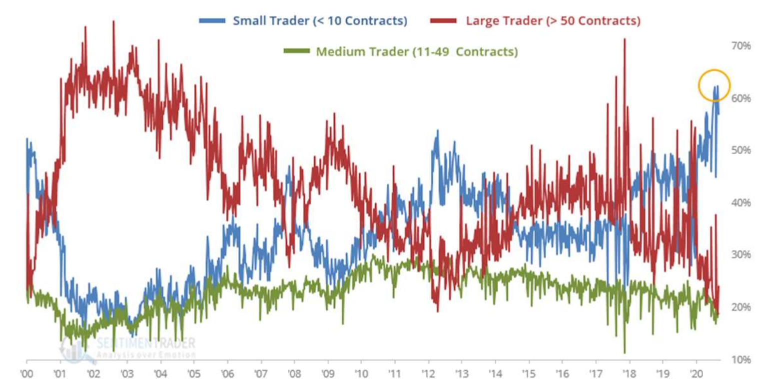
exposure by buying a certain amount of the underlying shares in the market. If the share price increases more the market maker needs to buy more stock and so short-term option buying can accelerate moves in trending stock prices. It turns a relatively small amount of option premium into a reinforcement mechanism: stock up; option moves higher; market maker hedges the flows by buying the stock. Conversely when the stock moves down; the option price moves lower; market maker can un-hedge and sell stock.

The other major buyers of these options are hedge funds and the Japanese conglomerate SoftBank who has been unmasked as the 'Nasdaq whale' by the Financial Times and others. The impact of this derivative trading is significant. Goldman Sachs noted that single stock option trading volume exceeded share volumes for the first time this summer and over the past few weeks the nominal value has averaged $335bn a day, 3x the average within 2017-2019. This call option buying spree by institutional and retail investors coincided with an increase in the Vix, the implied volatility on the US index. The Vix has been aided higher by institutional buying of put options (as noted earlier) especially around the 3 November date.

These crowded trades in a small number of names started to unwind at the end of August and early September as implied volatility (Vix) and the price of call options skyrocketed. The share prices of Apple (-19%) and Tesla (-39%) have fallen precipitously in a matter of days, with other sector names falling as well. Given their size in the market they have brought the market down too, with the Nasdaq falling over 9% from the end of August to 8 September.

Undeterred by the falling prices in early September, the small trader cohort have added to their existing bets after the market falls on 8 September. In the coming weeks market watchers will be focussed on 18 September (quadruple witching day), when the quarterly individual stock options expire alongside options on stock futures, indexes and stock index futures.

> *Over the past four weeks, retail traders have generated exposure accounting for nearly 1.7% of the S&P 500's entire market cap. In the coming weeks, most of these contracts are going to expire, exposing traders who bought the underlying stocks as a hedge. Unless they sell - and that's a lot of stock to sell.*
>
> *Jason Goepfert, Sundial Capital Research*



Source: Sundial Capital Research, Options Clearing Corp

Now we know what has aided certain stock prices higher in the short term it will be interesting to see how these trades unwind and the effect it will have on parts or all the market.

Chris Davis
Chief Investment Officer

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