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Market View



BROAD EQUITY MARKET RECOVERY DESPITE ONGOING RISKS

The global stock market is currently more or less at the level where it was trading a year ago, even though the situation has changed completely since then. The oil price has collapsed, unemployment has skyrocketed and the global economy is in a deep recession. However, this development is not as unusual as it appears at first glance. The equity market is a massive discounting machine. It does not look at the present, but always ahead. Future corporate profits are being “discounted” from now until eternity. And since this is currently happening at an (interest)

rate of close to 0 globally, corporate earnings of 2021/2022 appear almost as relevant as the earnings of the coming quarters. How resilient the stock market has recently been is surprising though. Many market participants not only seem to be looking ahead, but are completely neglecting all current problems and are mentally in the middle of a recovery phase. Nevertheless, there are several risks for the world economy and for global equity markets that must be put into perspective.



Figure 1: Performance of International Equity Markets
Indexed to 100; All indices are in EUR, including net dividends and as of 06/30/2020
Source: Bloomberg, Bergos Berenberg



RISKS TO CONSIDER

One of the risks currently being discussed by market participants revolves around the unrest in numerous US cities following the death of African-American George Floyd at the hands of police officers. But however disturbing the developments may be from a human and moral perspective, the effects on capital markets should be limited as long as the situation does not devolve into something resembling a civil war. The Covid-19 pandemic remains another risk. This situation appears to be easing somewhat in the developed world. Even in the hotspot United States, daily deaths have declined rather steadily since the peak in April. However, the number of newly infected people has recently increased again in certain areas and the risk of a second wave of restrictions imposed by governments around the world remains. A renewed shutdown of the economy would be extremely detrimental for individual markets. However, US Treasury Secretary Steve Mnuchin has already proclaimed that the United States are not aiming for another nationwide lockdown.

A third risk is the trade dispute between the United States and China. The rhetoric has recently become much more belligerent, which seems opportune for both sides. Trump uses the subject for his political intentions during the current election campaign – and for China's President it also makes sense to demonstrate strength. However, we do not expect the dispute to escalate to the level of new tariffs. That would not be advantageous for the leader of either country in the current economic situation. Moreover, we see a very low probability that all three risks would escalate at the same time given that they appear to be negatively correlated with each other. Nevertheless, these risks will not dissipate in the second half of the year. Then, however, the US election campaign will be the most important issue as it is highly relevant for the economy and equity markets not only in the United States, but worldwide who the future occupant of the White House and especially who the parties holding majorities in the Senate and House of Representatives will be.



T H R E A T O F T A X I N C R E A S E S V S . T R A D E T E N S I O N S

The President, a new House of Representatives, and a third of the Senate will be elected in November. Donald Trump is running for the Republicans, Joe Biden for the Democrats. Biden represents the moderate camp of the Democrat party. Two issues of lasting concern for equity markets are taxes/regulation and the trade dispute with China. On balance, equity markets welcomed Trump's tax cuts and reduction of regulations. On the other hand, the trade tensions that Trump has repeatedly stoked have unsettled markets quite severely. If Trump wins another term, the trade stress would probably persist and possibly be exacerbated by a serious dispute with Europe. Presidential candidate Biden, on the other hand, declared his intentions to raise taxes and increase regulations. That would be rather negative for the US stock market in particular. Democrat voters are also not especially China-friendly, but a democratic President would probably be more restrained, which would be more pleasant for global equity markets. The capital market-related opportunities and risks of the two candidates seem to balance each other out. While the Presidency is important,

the distribution of power in the Senate and House of Representatives is just as important. For example, the approval of both chambers would be needed to enact a tax reform.

P R E S I D E N T I A L E L E C T I O N :

T R U M P A N D B I D E N A R E C U R R E N T L Y H E A D - T O - H E A D

Basically, there are four conceivable scenarios for the election outcome. In the first two scenarios, the Republicans control the Senate and the Democrats control the House of Representatives, as it is currently the case. In the first scenario, Trump is President, in the second Biden is President. In the two other scenarios, one of the two parties holds the Presidency and controls both houses of Congress. Above all, the scenario in which the Democrat Biden has a free hand and can therefore enact his party's planned tax increases could adversely affect markets and even make



US equities less attractive compared to the rest of the world. But the outlook of Trump no longer being in the White House should lead to some relief outside of the United States. According to prediction markets, the probability of such a scenario coming to pass is not very low at the moment (see Figure 2). Based on our in-house tool, however, the probability of Trump or Biden winning the race is currently about 50:50, although Trump's popularity continued to decrease in recent weeks. The probability of the Democrats retaining the

House of Representatives is approximately 80 to 20. By contrast, the race for control of the Senate will be very close, with a small number of states determining the outcome, as in the case of the Presidential election. The senate races in Iowa, Maine, and North Carolina will be particularly decisive.

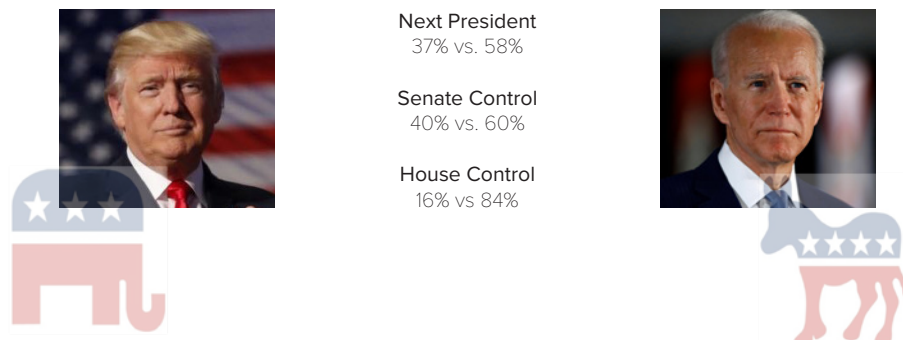


Figure 2: US Election Probabilities
Source: Election Betting Odds, Betfair, PredictIt, Bergos Berenberg, Data as of 06/30/2020



HOW THE ELECTION OUTCOME WILL AFFECT DIFFERENT SECTORS

The election outcome will affect individual sectors differently. If Trump's tax reform can be reversed, sectors such as consumer staples and utilities will likely suffer as these have benefited the most from the reduced corporate tax rate. Energy plays an important role in the campaigns of both parties. If the Democrats are in charge, renewable energy would benefit and conventional US energy stocks would suffer. If the Republicans are in charge, the situation would be the exact opposite. Moreover,

pharmaceuticals and tobacco would probably come under pressure if the Democrats take power. The perception of Trump's crisis management will be a major election issue. The economy and healthcare will also be important. A strong economic recovery would probably increase Trump's prospects. However, stock market prices are also important for voters in the United States (unlike in Germany) because the retirement savings of many Americans are tied to the stock market's performance. All things considered, a very close race can be expected from today's point of view and the balance of power in the Senate is a matter of great interest to equity markets, along with the Presidency.

NEUTRAL EQUITY ALLOCATION WITH A REGIONAL FOCUS ON US EQUITIES

Despite the above mentioned risks, we hold on to our neutral equity quota as we expect a volatile sideways trend for markets over the coming months. Compared to bonds, the valuation of equities remains relatively attractive. The return on equities is notably higher than the return on bonds and the

enormous liquidity provided by central banks and fiscal policy around the world is just as supportive. A neutral positioning at best and a cautious sentiment (as a contra indicator) further support equities. Regionally, we continue to favour the US stock market for the coming months and above all the large



cap segment. Compared to the rest of the world, we expect the US gross domestic product to decline significantly less in 2020, particularly because of the quick and bold measures of the US Fed. In addition, US companies have shown greater resilience during past crises and subsequent recoveries. The US stock market also has a structural advantage as it includes sectors that are more likely to benefit from this crisis: technology, healthcare and the recently created communications sector, which includes companies such as Alphabet and Electronic Arts.