DECALIA

INVESTMENT INSIGHTS

MONTHLY ISSUE #66
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"GLOCALISATION *1.0*"

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- The Covid-19 shock is driving individuals, companies and governments to look inward
- Supply chains, particularly – but not only – in critical industries, stand to be overhauled
- Reshoring and greater operational resilience will, however, come at a certain cost

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- Growth is troughing as economies re-open, but the path to full recovery will be long
- Sentiment is caught between the improving macro backdrop and virus resurgence concerns
- Caution should remain the byword given uncertainties and unappealing valuation

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- Equities – Slight underweight reflecting mixed near-term visibility & rich valuation following the Q2 rebound
- Fixed Income – Lower for longer expected returns: still light on duration and selective on credit
- Forex – Favouring funding currencies such as the USD, CHF or JPY as portfolio diversifiers

Editorial View

"Local is the new cool"

- The Covid-19 shock is driving individuals, companies and governments to look inward
- Supply chains, particularly – but not only – in critical industries, stand to be overhauled
- Reshoring and greater operational resilience will, however, come at a certain cost

Summer is here, but the coronavirus pandemic has no doubt disrupted many holiday plans. With airlines only just resuming their activity and cross-border travel not yet fully unrestricted (not to mention concerns about a potential second wave of contaminations), tourism is likely to take a decidedly local turn during the next few weeks. A welcome opportunity to (re)discover nearby leisure offerings!

But the reshoring trend will extend well beyond the summer season and the household sector. Because of the shock that it inflicted to both the demand and supply sides of the economic equation, as well as its quasi-simultaneous planetary impact and the uncertainty regarding its duration, this unprecedented health crisis has served to expose the limits of "just-in-time", globalised business models, that have become ultra-dependent on Chinese manufacturing. Going forward, supply chains stand to be overhauled, be it because of top-down political pressures or bottom-up corporate decisions – and not just in the fields of medical equipment and pharmaceutical compounds.

With the coronavirus-induced recession compromising his chances of re-election (since William McKinley in 1900, no incumbent has won a second mandate in such economic circumstances), President Trump has further stepped up his rhetoric against China. New tariffs on imports could be announced, and a number of means to incentivise US companies to shift sourcing away from China are being mulled by US lawmakers and officials. Under discussion are potential tax breaks, new rules imposing local content and corporate/industry subsidies, with the controversial idea of a multi-billion fund to help companies that make essential goods bring production back to the US even being floated.

Other Western countries, having seemingly suddenly realised how critical certain industries are to the functioning of their economies and what dire consequences supply chain bottlenecks can have, are also attempting to spur companies to reshore procurement and manufacturing, pointing out the added potential benefits in terms of domestic employment.

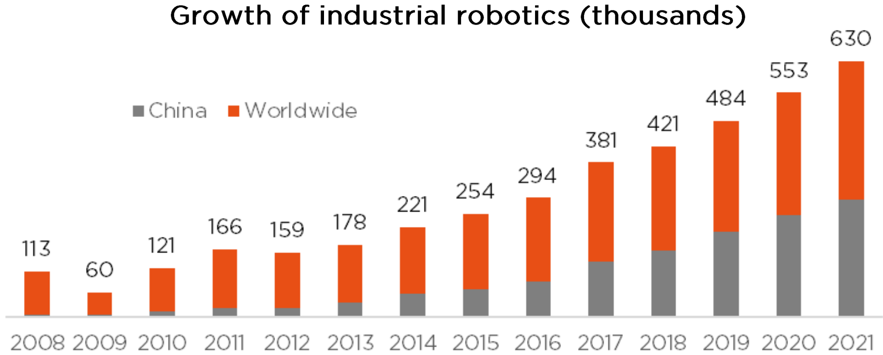
As for company managements, a number appear to be shifting away from a purely cost-based approach to one that puts greater emphasis on operational resilience. From an inventory management perspective, this could involve moving from a "just-in-time" to a "just-in-case" model. Capital expenditures are also likely to increasingly be directed towards robotics and automation, areas in which rapid technological advances could facilitate – even accelerate – reshoring efforts.

Beware, however, of excessively protectionist measures. In the EU Trade Commissioner's words: "strategic autonomy does not mean that we should aim for self-sufficiency". The four-decades long globalisation process did bring about considerable benefits, lifting over a billion people out of poverty. Also, reshoring might be easier said than done. Companies that exit China could have to leave behind the machine tools and moulds that equip their production sites, forego their manufacturing intellectual property, pay closure taxes and lengthy contractual wage obligations and, above all, risk losing their good access to what should become the largest consumer market in the next decades.

All told, and as often, it will be a matter of finding the right balance between two extremes: unbridled offshoring and complete insularity. Welcome to Glocalisation 1.0 !

Chart of the Month

Growth of industrial robotics (thousands)



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Global Strategy

Not yet out of the woods

- Growth is troughing as economies re-open, but the path to full recovery will be long
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- Caution should remain the byword given uncertainties and unappealing valuation

Sentiment is caught between positive economic surprises and virus resurgence concerns, especially in the US where speed and precipitation were probably confused. Uncertainties thus remain as to the length and "shape" of the recovery. While the first part of a rebound is always the easiest and fastest, the rest of the journey is set to take more time. Pullbacks could occur as unemployment rates will not recede that fast, and specific sectors may continue to suffer accordingly. Moreover, both capex and consumption spending will not recoup all of the past few months' losses immediately, suggesting a jobless and incomplete recovery. In other words, it will not be the usual path out of recession – so long as a vaccine or an effective treatment is not available.

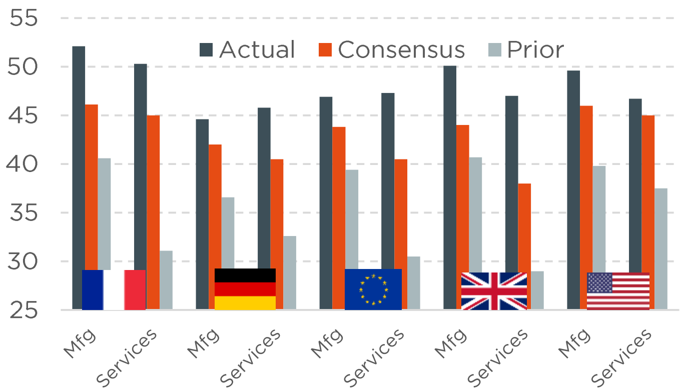
There is no denying that massive central bank and state interventions have played a major role in providing a safety net for the economy and a very resilient floor for financial markets, propelling a stronger and faster than expected rally in equity indices. Some disappointment could lie ahead if this support proves less effective than hoped.

As a result, equity markets are now pausing after their strong and rapid bounce since March-end. Even in terms of market leaders, we are now seeing some churn, as re-opening hiccups challenge the classical V-shaped recovery playbook. Obviously, we cannot rule out potential violent sector rotations towards value and cyclical stocks at some point. But, as long as there is no evidence of a sustainable acceleration in nominal growth, these should prove temporary.

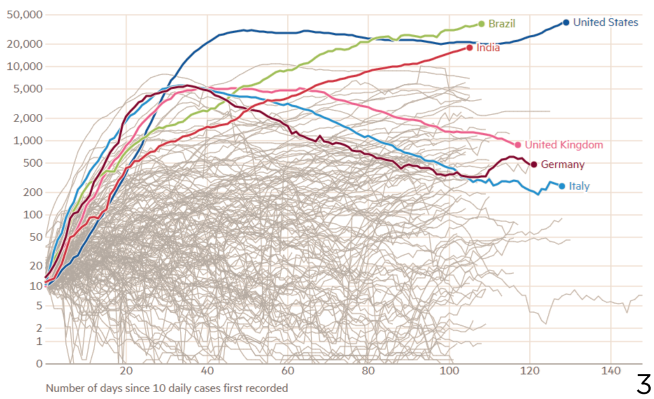
With lower for longer expected returns in the fixed income space, there are not many places to turn to for yield and/or capital appreciation in real terms… Relative to bonds, equities' appeal indeed remains evident, even if they do look expensive in absolute terms based on most historical metrics. All this suggests limited near-term upside potential, barring some sentiment euphoria that would temporarily drive multiples higher. For sure, TINA (There Is No Alternative) and FOMO (Fear Of Missing Out) are still around, but they are prone to disappear fast when clouds gather up on the horizon. So, after a completely unexpected and extremely volatile first semester in the markets, the next six months are unfortunately unlikely to be much easier, given the thick fog still surrounding the overall outlook.

At the portfolio level, this translates into a slight underweight and underweight allocation to equities and bonds, respectively. Within equities, we keep our preference for more resilient diversified markets such as Switzerland and the US, while favouring high-quality large cap stocks with a growth bias. That said, we have somewhat rebalanced our positioning by adding carefully selected recovery stocks, either directly or through more diversified vehicles. Moreover, we still consider tactical hedging strategies on an opportunistic basis. In the fixed income segment, we remain cautious and highly selective, both on govies and credit. Elsewhere, we retain our overweight stance on gold. Among (slightly overweight) alternative investments, we have downgraded real estate to neutral given the challenging environment and lack of visibility on some specific segments. Finally, in FX, we still avoid the GBP and EM currencies and retain a slight underweight on the EUR, favouring the "quality" of the CHF in relative terms.

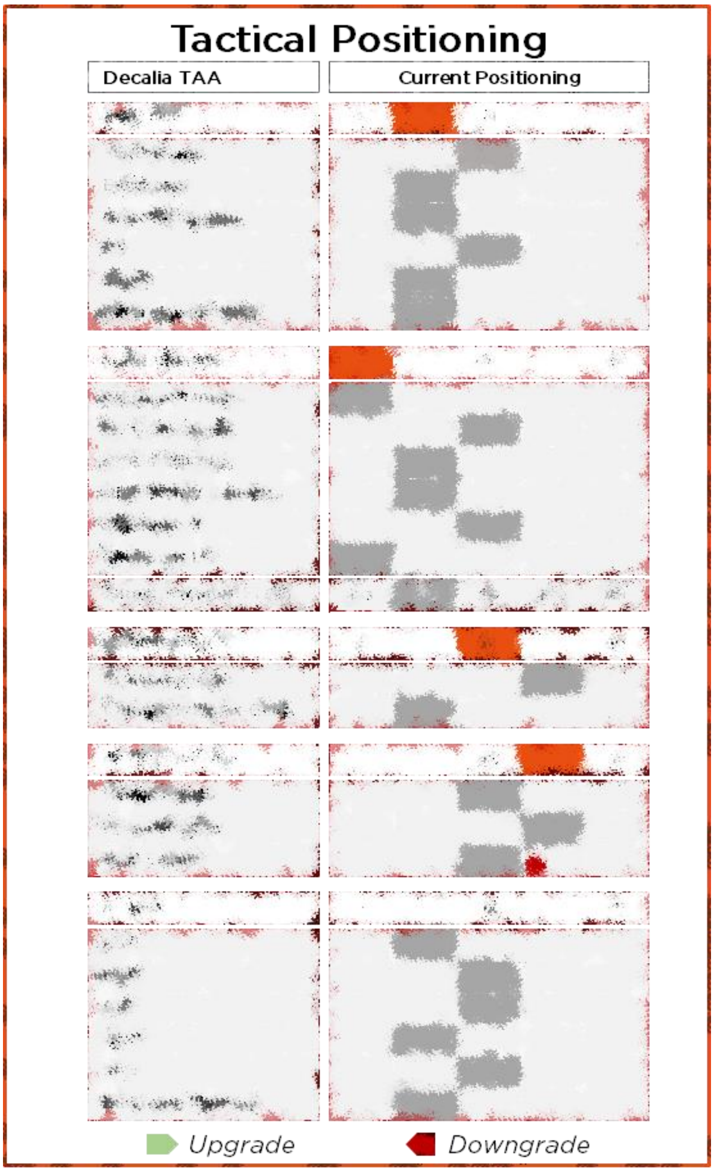
June prel. PMI indices: surprising on the upside

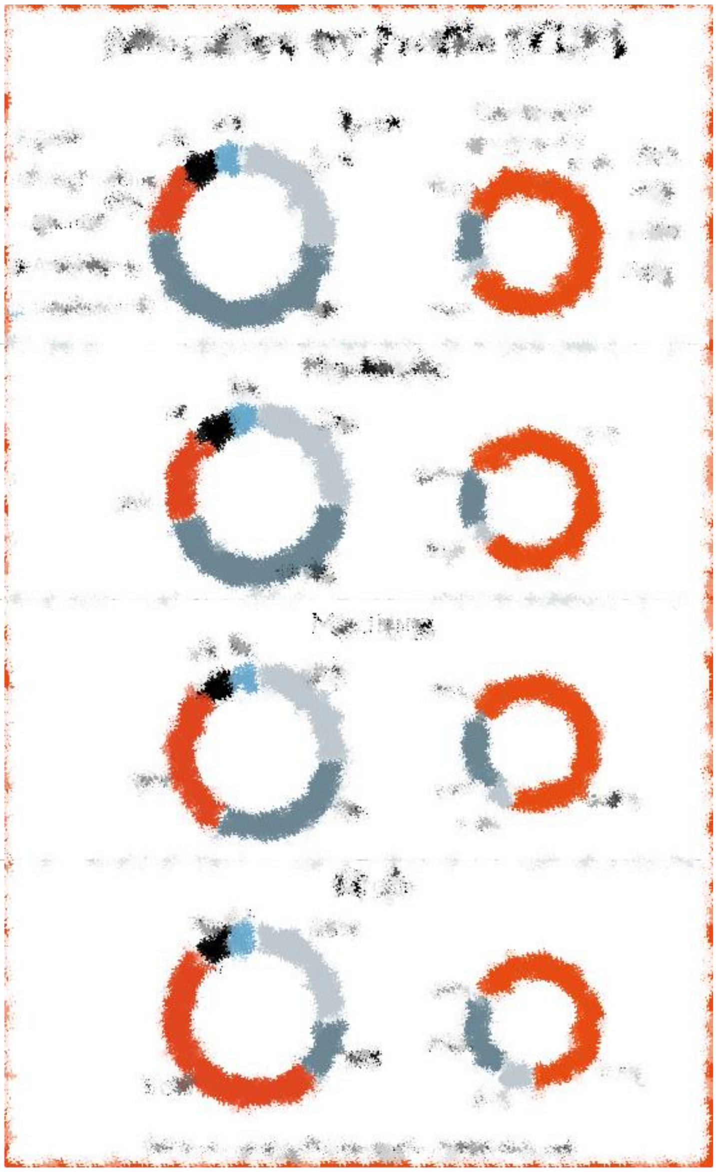


New cases of Covid-19 in selected countries
No flattening yet in the US and in most EM



Asset Allocation





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