Synopsis

One Disease; Three Themes

Consensus is looking for mean reversion in the wrong place

Asset Allocation Research
3rd April 2020

Three interesting ideas emerge from our regular reports. First, the volatility shock will almost certainly be as bad as 2008. Second, we believe that a long Technology /short Energy trade will have a positive pay-off no matter whether equity markets rise or fall. Third, our models are increasing exposure to EM Equities. We recognise this is a contrarian trade, but it is well-supported by our process and doesn't depend on one or two countries.

Contents

There is no big theme to the note this week. The world already has one and financial markets are as clueless as everyone one else at predicting the short and long-term consequences of Covid 19. So, this is just an assembly of ideas which arise from our regular reports.

Our first chart is an update on our all-asset volatility index. This has now risen to 281% - meaning that the realised volatility of our basket of 11 financial assets is 2.81 times its median over the last 25 years. It has taken five weeks to get to this level from its previous undisturbed state. The jump is now bigger and faster than the onset of the global financial crisis, which took nine weeks to develop, from late August to the end of October 2008. The period of elevated volatility then lasted another four months before our index finally topped out at 393% in March 2009.

Unless a miracle cure is announced in the next few weeks, we expect our index to match the peak of 2008, which implies another period of elevated volatility, lasting for the whole of the second quarter at least. We actually believe that the probability of a miracle cure is higher than most of the mainstream media realise, but the risk-reward ratio for taking this position is still not attractive.

Our second chart highlights an equity sector strategy which we believe will be effective in both up and down markets. Our tactical asset allocation models are close to maximum underweight in global equities, but most of our clients are obliged to maintain some exposure. They may be reluctant to give up all hope of a rally in the near future. We suggest that they should overweight Technology and underweight Energy in all regions. We note that Technology is outperforming while equities are falling and we believe that it will at least perform in line if they start to rally. On the flipside, Energy continues to underperform on the way down and we remain sceptical that it would outperform on the way up – especially if investors look at the trade on a risk-adjusted basis. Most regions also have a significant overweight position in Healthcare and underweight in Financials, but this is far more sensitive to market direction, which is why we prefer the Technology/Energy trade.

And finally, we focus on country allocation, with specific reference to Emerging Markets. The first thing to say is that the charts are all over the place. There is a group of countries which have languished at the bottom of the table for many months which are suddenly rallying and there are several from the top half which are starting to underperform. There are many more emerging markets in the first group than the second, which has the effect of increasing our exposure to EM Equities.

Some commentators take the view that these countries have more fragile economies than developed markets and are bound to suffer worse, but many of the examples they cite are from countries which are currently classified as frontier markets, which we do not include in our models. We cannot be certain that EM Equities will escape the effects of this terrible disease, but we prefer to be guided by our models rather than *a priori* assumptions. If we have to be contrarian, we will do it on a country, not a sector, basis.

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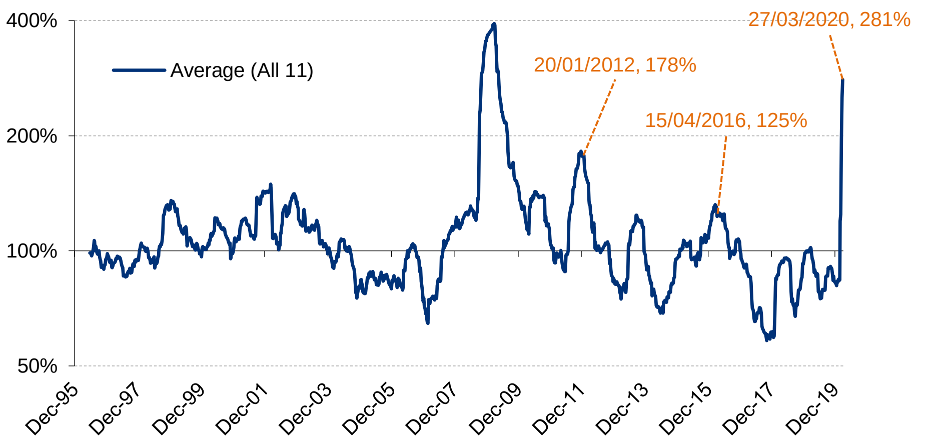
The index comprises 11 asset classes: 5 equity regions (all in US$), 4 fixed income categories and 2 alternatives - real estate and fixed income.

The spike in realised volatility is already bigger than the one at the onset of the GFC and it has happened over five weeks, not nine. There is more to come.

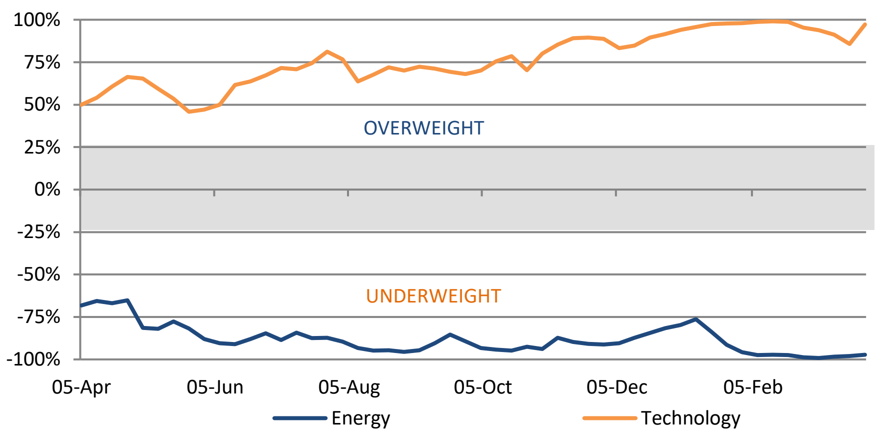
Fig 1 Harlyn all asset volatility index – since inception (log scale)



Source: Factset, Harlyn Research LLP

A short Energy/long Technology trade has worked in both bull bear markets over the last year. We don't think this will change, even if there is a sudden rally in equities. A bounce in the price of crude is possible, but $20/bbl to $50/bbl is a big ask – maybe not over three years, but definitely over one.

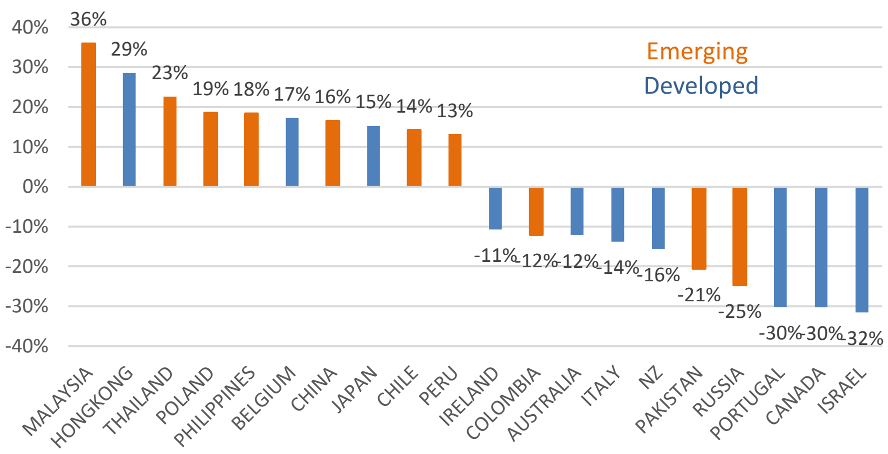
Fig 2 US equity sectors: recommended weights vs benchmark – last 52 weeks



Source: Factset, Harlyn Research LLP

The list of countries with the biggest increase in recommended weight vs benchmark is dominated by emerging markets. The bottom 10 are mainly developed countries. This may change, but it's a lazy assumption to say that EM Equities must inevitably underperform.

Fig 3 Change in rec. weight vs global benchmark: top and bottom 10 – last four weeks



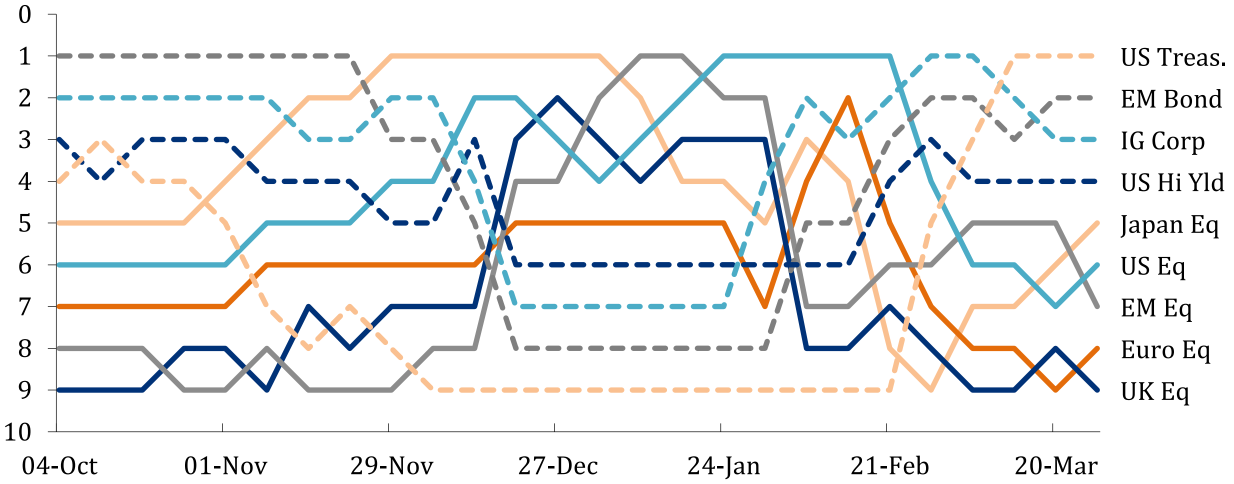
Source: Factset, Harlyn Research LLP

US Asset Allocation

Changes	**Japanese Equities jump to #5**
Leaders	No change to the top three, **US Treasuries #1, EM Bonds #2, Investment Grade #3.** Treasuries are now close to maximum overweight, so any further increase in their portfolio weight will be driven by declines in total equity exposure. EM Bonds are holding up much better than all US corporate bonds, while Investment Grade is clearly better than High Yield.
Laggards	**Japanese Equities #5** escape from the bottom three, and the **US** drops down to #7 to fill the gap. **Eurozone** and **UK Equities** are unchanged at #8 and #9 respectively. None of the regions is actually very far from its equity benchmark.
Our view	We have now reached the point where investors know that every major economy has the virus and that they are all more or less on the same trajectory – apart from Japan. If the number of new cases peaks in the US sometime in early May, we would expect to see a significant relief rally. However, we would also expect that to be followed by fears that recovery may take longer and the prospect of higher taxes or inflation in the future.

Source: Harlyn Research LLP

US Asset Ranking – Last 26 weeks



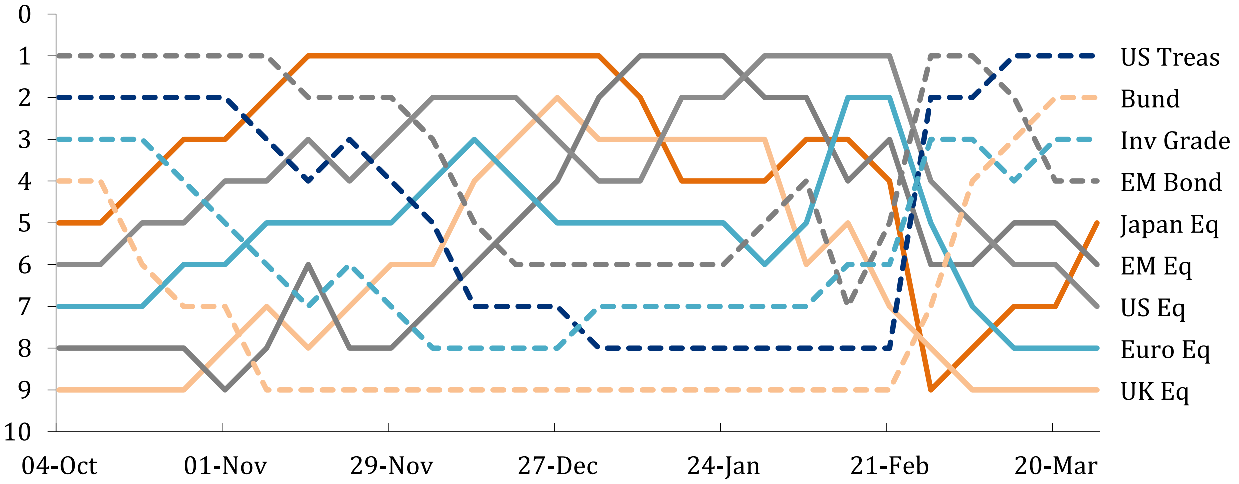
Source: Harlyn Research LLP

Europe Asset Allocation

Changes	**None**
Leaders	**EM Bonds #4** drop out of the top three and are much less attractive than they are to US investors. This is partly because of FX volatility, but mainly because of what they are compared against in the euro model vs the dollar model. **Investment Grade #3** is promoted, but it is still a long way behind **Bunds #2** and **US Treasuries #1.**
Laggards	Equities are now clustered at the bottom of the table. The ranking doesn't really matter that much because the model regards them all as equally horrible. But for the record, Japan escapes from the bottom three, replaced by **US Equities #7**, with the **Eurozone #8** and the **UK #9**.
Our view	Equity exposure literally cannot get any lower, which contrarians may regard as a sign that it is time to get back in. They may be right, if there is an early end to the pandemic, possibly as a result of some newly announced drug trials. However, it is worth remembering that similar logic produced a tragically false signal in 2008.

Source: Harlyn Research LLP

Europe Asset Ranking – Last 26 weeks



Source: Harlyn Research LLP

US Equity Sector Ranking

Changes

UPGRADE: Materials to Neutral from Underweight
DOWNGRADE: Utilities to Neutral from Overweight

Leaders

Utilities # 5 drop out of the top three and are downgraded to neutral. **Staples #4** also lose ground and are overtaken by **Communications #3. Healthcare #2** is just ahead and struggling to beat an important resistance level, but no such problems affect **Technology #1**, which is back to maximum overweight.

Laggards

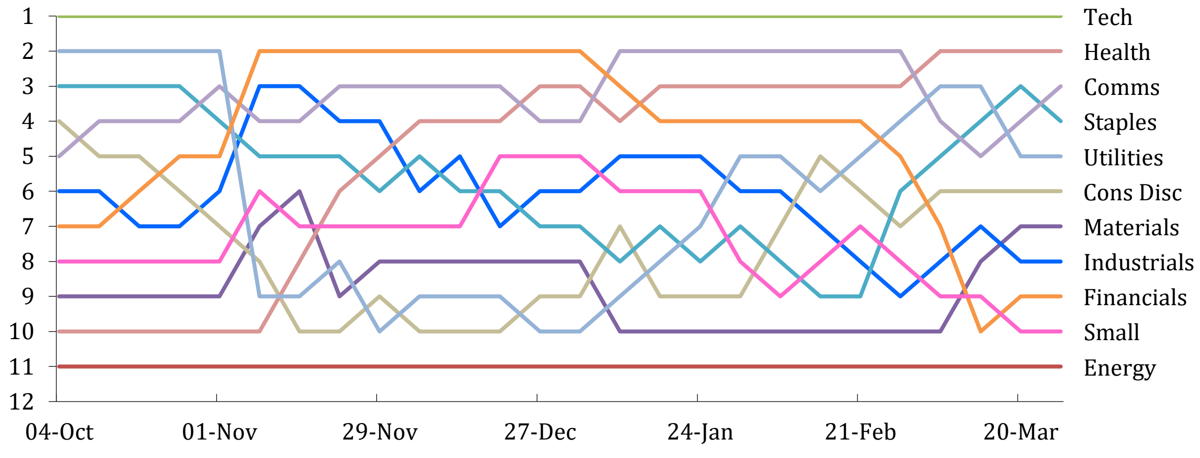
No change to the bottom three, **Financials#9, Small Caps #10, Energy #11.** Energy is still at maximum underweight and it will take a minor miracle to shift it from this position. Small Caps and Financials both stabilise after some significant declines, but it is too early to call the bottom.

Our view

At one level, this is an easy market to trade. Make sure you have a very big overweight in Technology and a very big underweight in Energy and the relative performance will almost take care of itself, no matter whether the index is rising or falling. If you want to, you can extend this to Healthcare and Financials, but anything more risks adding needless complexity.

Source: Harlyn Research LLP

US Equity Sector Ranking – Last 26 weeks



Source: Harlyn Research LLP

Pan European Equity Sector Ranking

Changes

DOWNGRADE: Small Caps to Underweight from Overweight
UPGRADE: Telecom to Neutral from Underweight
UPGRADE: Materials to Neutral from Underweight

Leaders

No change to the top three, **Utilities #1, Healthcare #2, Technology #3.** Utilities are now tied with Healthcare for the top slot. Both have experienced resistance over the last two weeks, but as we noted last time, Utilities are more affected by the coming recession than Healthcare. Technology is no longer regarded as cyclical may actually thrive on the current situation.

Laggards

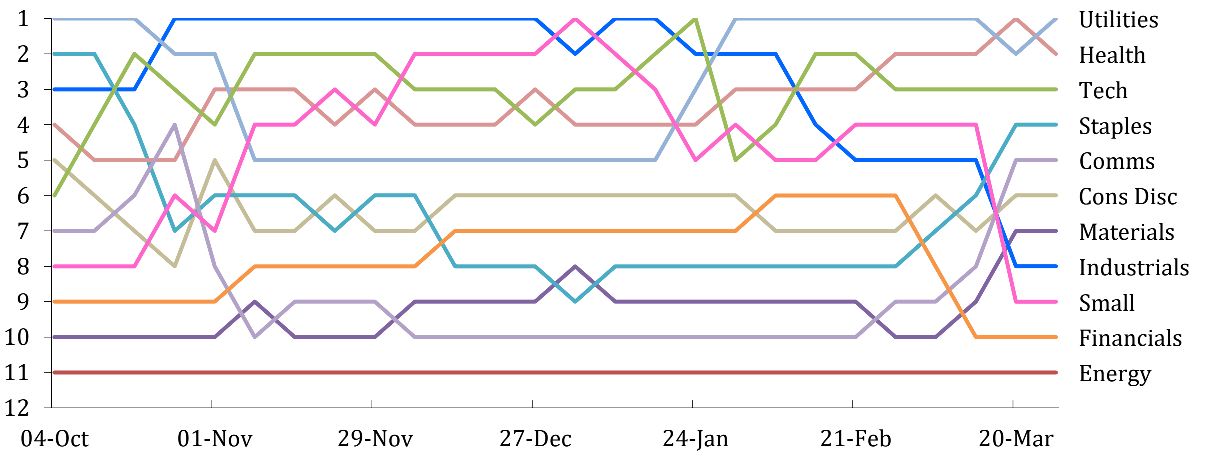
Materials #7 are upgraded and escape from the bottom three. In their place are **Small Caps #9,** which are downgraded straight from overweight to underweight in one hit. This is how an illiquid market can damage your wealth when things go wrong. **Financials** are unchanged at #10, but there is further downside before they reach reliable support. **Energy #11** is still close to maximum underweight.

Our view

Last week was an up-week for global markets so all the beta-related trades went into temporary abeyance. Like the US, it is a relatively easy task to outperform the index in current conditions, so long as you stay underweight Financials and Energy. They are very cheap on conventional metrics but it is hard to see how they will earn their cost of capital over the next two years. It is much harder to get the overweight part of the equation correct, but it's not strictly necessary.

Source: Harlyn Research LLP

Pan-European Equity Sector Ranking – Last 26 weeks



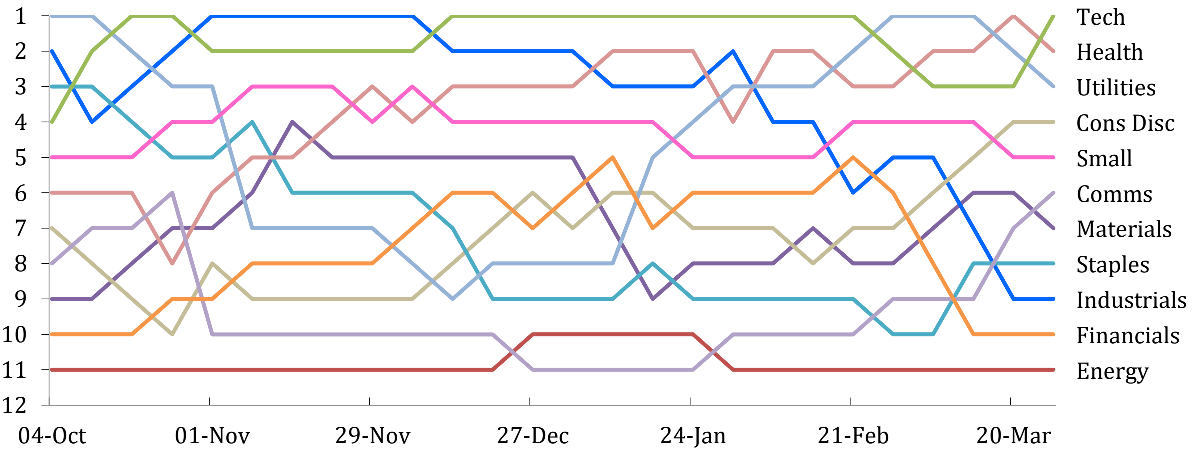
Source: Harlyn Research LLP

Eurozone Equity Sector Ranking

Changes	**UPGRADE: Consumer Services** to Overweight from Neutral **UPGRADE: Consumer Goods** to Neutral from Overweight **UPGRADE: Telecom** to Neutral from Overweight **DOWNGRADE: Industrials** to Underweight from Neutral
Leaders	No change to the top of the table, except that **Technology #1** overtakes **Healthcare #2** and **Utilities#3**, bringing in the Eurozone into line with the US as regards the top two places. These three are a long way clear of the rest of the index, and will probably remain so for as long as the crisis lasts.
Laggards	**Industrials #9** are downgraded to underweight and have just hit a new 20-year low. The decline has paused this week because of the general rally, but it would be a brave investor who jumped in now. **Financials #10** have also found a support level dating back to last year, but further downside looks likely. **Energy** is #11, as it was before anybody had heard of the corona virus.
Our view	One piece of good news is the relative strength of the consumer-related sectors. **Consumer Goods #8** are upgraded to neutral, while **Consumer Services #4** are upgraded to overweight. However, the main message is to be underweight the sectors which are going to suffer in the next few months and not to be tempted by cheap valuations. The bottom will be obvious when it comes.

Source: Harlyn Research LLP

Eurozone Equity Sector Ranking – Last 26 weeks



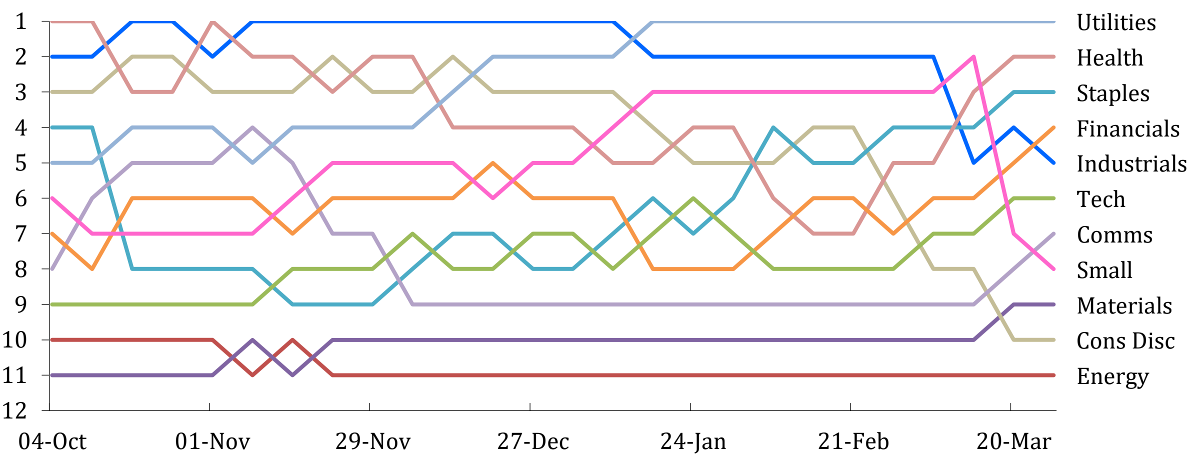
Source: Harlyn Research LLP

UK Equity Sector Ranking

Changes	**UPGRADE: Telecom** to Neutral from Underweight **DOWNGRADE: Small Caps** to Underweight from Overweight **DOWNGRADE: Consumer Services** to Underweight from Neutral **DOWNGRADE: Industrials** to Neutral from Underweight
Leaders	**Small Caps** drops out of the top three and is replaced by **Consumer Goods #3,** which struggles to get through an important resistance level. **Utilities #1** and **Healthcare #2** both go sideways. Utilities may have peaked while Healthcare may have further upside. These three defensive sectors are a long way clear of the rest of the index and are the only ones rated overweight.
Laggards	**Telecom #7** is upgraded and escapes from the bottom three and the new joiner is **Consumer Services #10** which is downgraded, mainly because the appalling news coming out of the retail sector. **Materials** stay at #9, but have bounced off support while **Energy i**s still #11.
Our view	The big loser is **Small Caps**, which drops from #2 to #8 in two weeks and which is downgraded straight from overweight to underweight. There is no obvious explanation why the UK is so much worse than the Eurozone, but who are we to argue with the decisions of thousands of investors. There is still the potential for further downside.

Source: Harlyn Research LLP

UK Equity Sector Ranking – Last 26 weeks



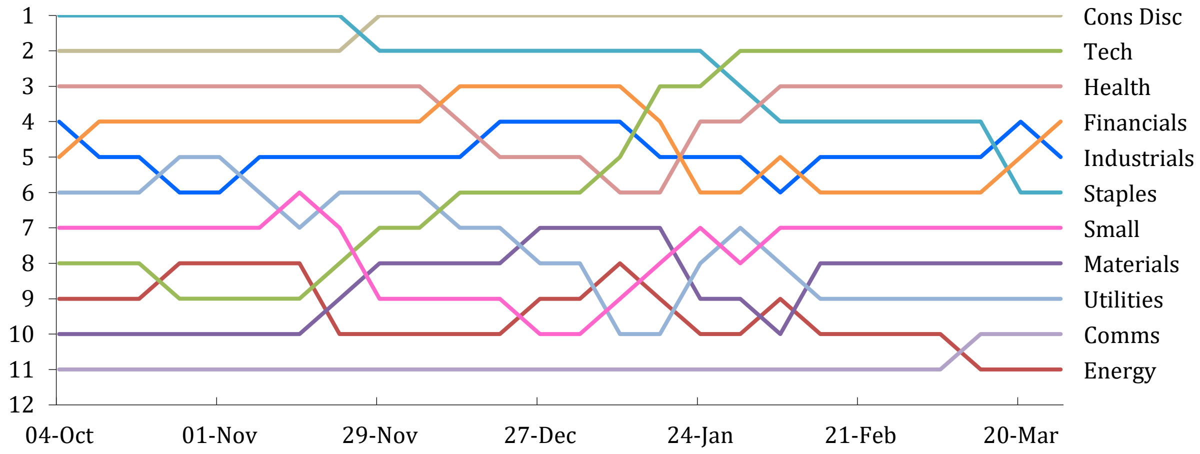
Source: Harlyn Research LLP

China Equity Sector Ranking

Changes	**None**
Leaders	No change to the top three, **Consumer Services #1, Technology #2, Healthcare #3.** Consumer Services have stopped losing ground, while Technology has experienced a surge, which may take it back to its all-time high. Healthcare is stable, which is a nice way of saying that it has lost momentum.
Laggards	No change to the bottom three, **Utilities #9, Telecom #10, Energy #11.** Energy is flat, while the other two sectors stage minor rallies, neither of which is strong enough to suggest that there will be a major breakout.
Our view	Yet again, the Chinese equity market is calm while all others are frantic. We cannot know how much of this is due to official and semi-official support operations versus a genuine recovery in risk appetite. In the last resort, it doesn't matter, this is the record which investors will use to assess the damage wrought by the virus. By comparison, with the West, it doesn't look too bad.

Source: Harlyn Research LLP

China Equity Sector Ranking – Last 26 weeks



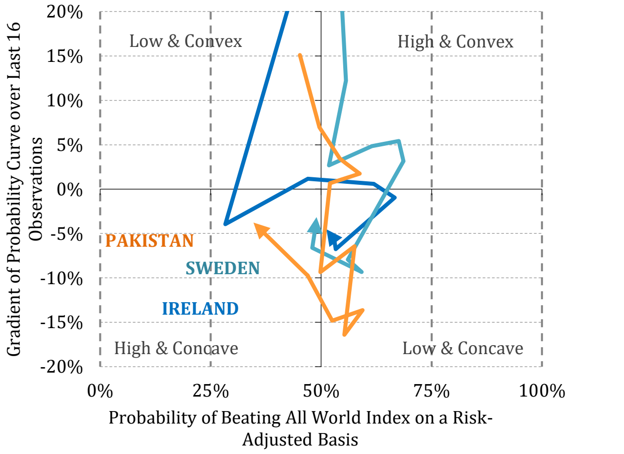
Source: Harlyn Research LLP

Global Equities Relative to All World Index ex US

Negative Watch	Sweden, Pakistan, Ireland (no new entries)
Positive Watch	Hong Kong, Malaysia, (no new entries)
Leaders	Denmark, Taiwan, **China, New Zealand (new entries)**
Laggards	Peru, Poland, **Brazil, Colombia (new entries)**
Our view	This has been an extraordinary month in equity markets. It is fitting that we have an equally extraordinary set of charts to describe it. The combination of "underweight, gapping up, high conviction" is one which we expect to use for one or at the most two countries each week. This week, we apply it to eight. Their identity is not important, their number is. It suggests that global equity markets are attempting a high-speed, universal rotation. Everything which was up, will be down and everything which was down will be up. If it happens, it would be unprecedented – even by comparison with 2008. But, as we know to our cost regarding Covid 19, just because something is unprecedented, it doesn't mean it can't happen.

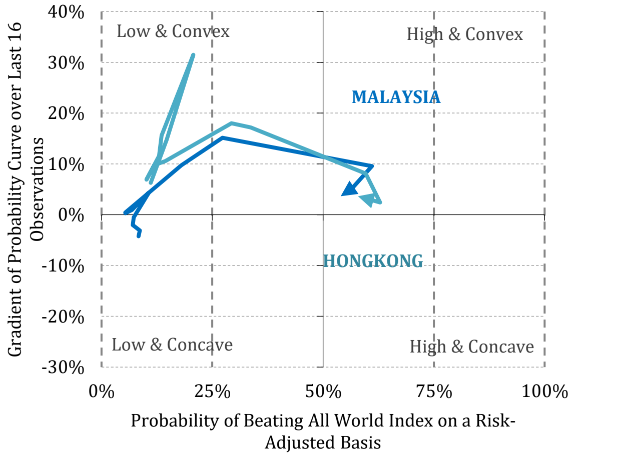
Source: Harlyn Research LLP

Negative Watch List



Source: Harlyn Research LLP

Positive Watch List



Source: Harlyn Research LLP

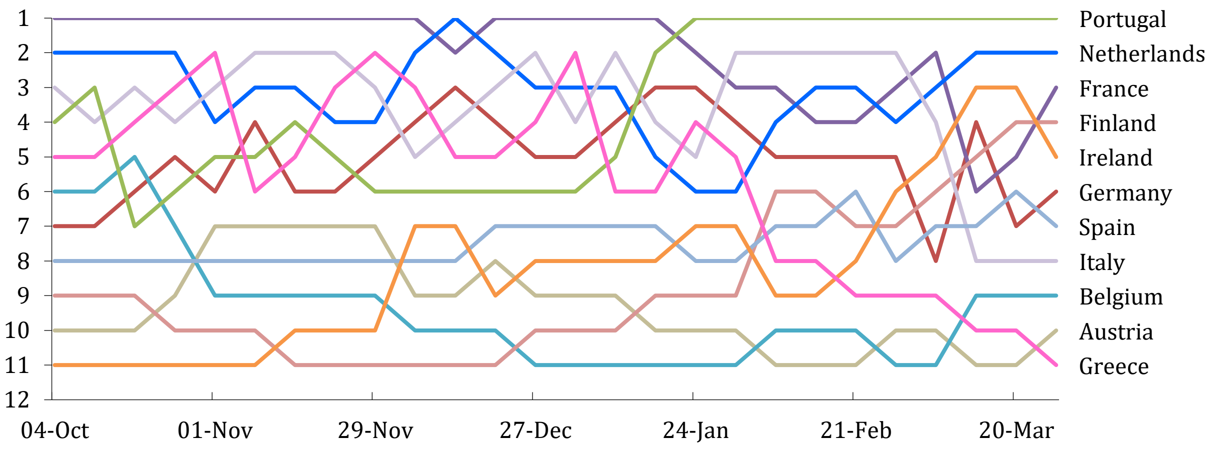
These charts compare the average PRATER score with gradient of the probability curve (a measure of whether PRATER improves or declines based on the periodicity of the sample.) The negative watch list highlights countries which are moving towards the bottom left quadrant, with a falling average PRATER and a concave, downward-sloping curve – i.e. the shorter the sample the lower the score. The positive watch list highlights countries which are moving towards the top right quadrant, with a rising average PRATER and a convex, upward-sloping curve. As with all clock charts, investors should not assume that individual countries rotate around the origin. They may move from top-right to bottom-right, or top left to bottom left, without entering either of the other quadrants.

Eurozone Equities: Country Ranking

Changes	**UPGRADE: Italy** to Neutral from Underweight **DOWNGRADE: Ireland** to Neutral from Overweight
Leaders	**France #3** bounces back into the top three, helped by the fact that **Ireland #5** is downgraded to neutral after a sudden surge two weeks ago. **Portugal** stays at #1, while the **Netherlands #2** makes good progress and may finally be breaking out of a downtrend that has been in place since Q2 2019.
Laggards	**Belgium** stays at #9, but starts to make good progress, while **Greece #11** and **Austria #10** are tied together at the bottom of the table. The three are still a long way below the rest of the index and the only countries rated underweight.
Our view	**Italy #8** stays at #8, but recovers somewhat from the double downgrade that it suffered last time. It is back up to neutral and has managed to set a level which may well provide important support in the coming months. As you would expect, the chart has become much more volatile over the last four weeks, and Italy is not the only example of the model moving one way in an exaggerated fashion only to retrace over the next few weeks.

Source: Harlyn Research LLP

Eurozone Equities Country Ranking – Last 26 weeks



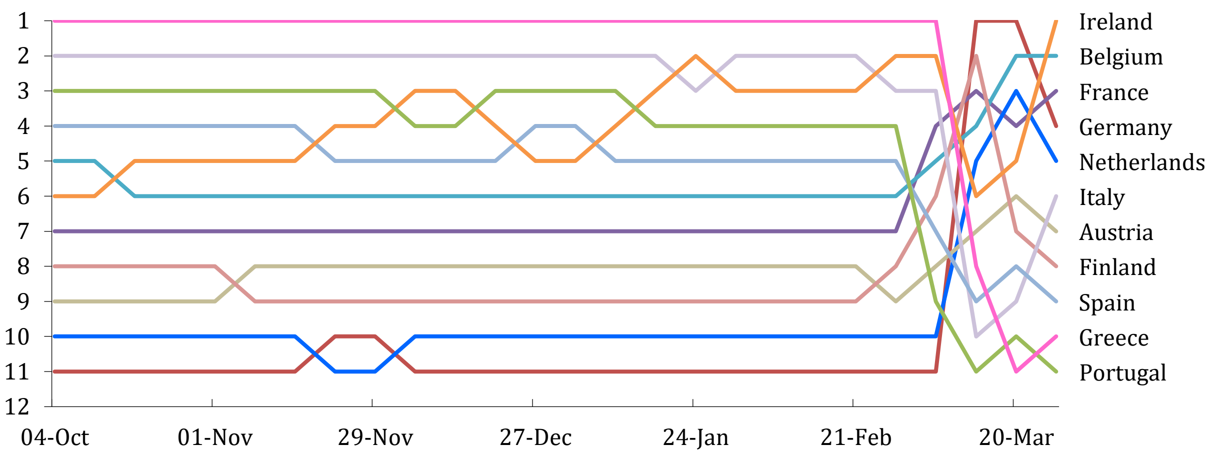
Source: Harlyn Research LLP

Eurozone Government Bond Ranking

Changes	**UPGRADE: France** to Overweight from Neutral **UPGRADE: Belgium** to Overweight from Neutral **UPGRADE: Ireland** to Overweight from Neutral **UPGRADE: Italy** to Neutral from Underweight
Leaders	Only **France #3** manages to maintain its position in the top three. Germany and Finland drop out. **Ireland #1** and **Belgium #2** come in. The rankings and the weightings are all over the place following a tumultuous couple of weeks and may not have settled down even now.
Laggards	The bottom three is really a bottom two. **Portugal #10** and **Greece #11** are way below the rest of the table. Technically speaking, **Spain is #9**, but it is effectively tied with Austria and Finland and only just below a benchmark weighting.
Our view	The extreme underweights on Greece and Portugal are funding a set of very marginal overweights at the top of the table, which is why the upgrade/downgrade balance is so skewed. From an ECB perspective, this is still far from ideal, but at least **Italy #6** has rallied strongly and averted the death spiral that seemed all too real two weeks ago. The fight is not over yet, but it is Round one to the ECB.

Source: Harlyn Research LLP

Eurozone Government Bonds Ranking– Last 26 weeks



Source: Harlyn Research LLP

Harlyn's Process and Product Range

We ask a simple question over and over again. Are your clients being adequately rewarded for the risks you run with their money? Few, if any, other research products ask this question. We have pioneered a range of probability-based asset allocation techniques and developed a proprietary approach with the acronym PRATER. It stands for Probability of Risk-Adjusted Excess Total Return and was developed to answer the following questions: -

- What is the probability that equities are on course to beat bonds? Or that one equity sector on course to beat another sector (or the index)?
- What is the probability that the margin of outperformance will compensate for the extra risk of buying equities instead of bonds or the sector vs the index?
- Given these probabilities what combination of asset classes and sectors / countries will give us the best return per unit of risk and the best chance of minimising our drawdown in a falling market?

Most traditional research techniques (e.g. earnings growth, PE ratios, yield curves, yield gaps) are poor predictors of future performance. Often this is because the forecasts themselves are inaccurate. But sometimes the price of asset falls without any change in the fundamentals simply because investors think that it has become riskier relative to another asset. We monitor these changes every week, and systematically incorporate them into our recommendations. The result is a "sell-discipline" which is consistently powerful and effective. We frequently identify assets which are misbehaving before an explanation based on traditional techniques has become apparent. Our "buy-discipline" also works, but we are not unique in this. We are not scared to change our recommendation when risk conditions change.

Most research houses tell the market what they think. Harlyn listens to what the market thinks, and tells you. Individual opinions don't matter very much. Aggregated opinion does. Please visit our website www.harlynresearch.co.uk/process/ for a fuller explanation.

Our product range is constantly evolving, and we are always happy to do project work for our retained clients. This is a brief overview of the main areas we cover on a weekly basis. Most of the models in the left-hand column are incorporated into the more complex models shown in the other two columns, but they frequently generate important signals in their own right.

Harlyn's Product Range

Binary models	Sector / country models	Combined Models
UK Equity vs UK Gilts	UK Equity sector model	UK multi-asset
US Equity vs US Bonds	US Equity sector model	US multi-asset
Eurozone Equity vs Bunds	Eurozone Equity sector model	Euro multi-asset
Japan Equity vs JGB's	Pan Europe Equity sector model	UK hedged multi-asset
EM Equity vs US Bonds	Japan Equity sector model	US$ hedge funds
Asia-Pac vs US Bonds	US High Yield by sector	World ex US countries
China Equity vs PBC Bonds	US Investment Grade by sector	US stock selection report
Commodities vs US Bonds & US Equities	Eurozone Equities by country	
REITs vs US Bonds	Eurozone Government Bonds by country	

Source: Harlyn Research LLP

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