Cross-Asset Weekly

20 November 2020

US small caps have more upside

Small cap equities in the US have had a remarkable run since September – outperforming their large cap peers by 11%. We believe that they have further upside as valuations continue to be attractive, while earnings are expected to rise significantly in 2021. In our view, the economic recovery should provide further support to the more cyclical sectors of the US-equity market including small cap stocks.

One reason for our optimism on the US macro cycle is that the US housing market has experienced a soild V-shaped recovery. The data published this week suggest that there is even more upside momentum in the near term. This should offset some of the headwinds from the rise in COVID-infections that we experienced in recent weeks and which may increase further after Thanksgiving.

We also remain positive on the medium term outlook for the Swiss economy, given the potential for further upside in the manufacturing sector. Deteriorating trade data for October, high COVID-infection rates and (partial) lock-downs in most of Switzerland's neighbouring countries make us somewhat more cautious on the 4th quarter, however.

This week's highlights

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Cross-Asset Weekly

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US Macro

US housing market recovery to strengthen further

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The US housing market has experienced a true V-shaped recovery. The latest numbers suggest that there is more upside momentum in the near term, which should offset some of the near-term headwinds from the rise in infections. Fundamentally, the sector remains well supported and should contribute more positively to GDP growth.

Recent housing data have been encouraging

This week's data confirm the strength of the US housing market: Housing starts picked up to 1.53 million in October, beating expectations, while September numbers were revised up as well. In addition, the NAHB index, tracking housebuilders' confidence, reached an all-time high in November, pointing to further upside for construction activity.

Demand for housing will be strong

We see three main forces driving up demand for housing: (1) Household balance sheets are, on average, healthy. Debt ratios have fallen sharply in past years and savings are elevated. True, employment income has fallen considerably, but potential buyers tend to be the ones whose jobs have been less affected by the crisis. (2) The sharp drop in interest rates have kept mortgage payments as a share of income at relatively low levels (about 15%), despite higher house prices. The Fed has promised to keep its policy very loose for years to come, which should keep mortgage rates low even once the economic recovery accelerates. (3) Household formation was rising rapidly before the crisis. While it has dropped in recent months as the recession has hit young people relatively hard, it should pick up again next year as the pandemic retreats.

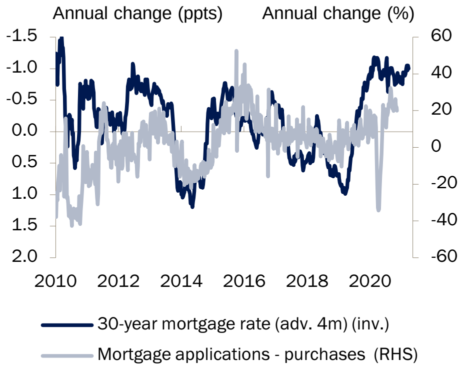
Construction activity has scope to strengthen a lot more

Supply conditions remain very tight. The stock of homes available for sale is at a historical low. Housing starts have rebounded sharply, but they are only back to their historical average. As a result, construction activity has scope to strengthen a lot more (Exhibit 2).

Residential investment should increasingly boost GDP growth

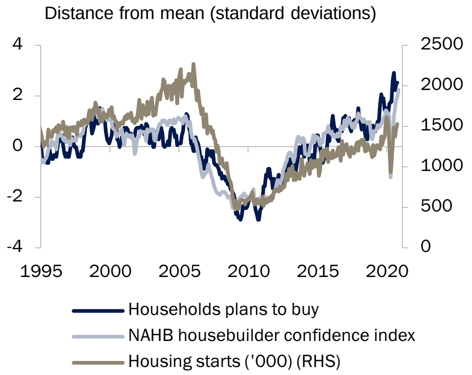
So what does this imply for the US economy outlook? Real residential investment should contribute more positively to GDP growth, offsetting some of the near-term headwinds from the rise in infections. Spending on durable goods should remain well supported as people tend to buy new furniture when they move to their new homes. Finally, house prices will probably accelerate next year, as new supply will take time to reduce shortages (Exhibit 3). This should provide an additional boost to consumer spending through a positive 'wealth effect'.

Exhibit 1: Low rates to boost demand



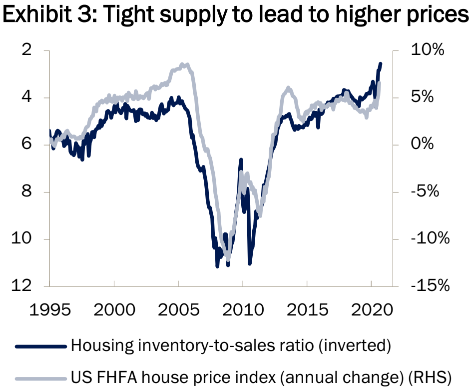
Source: Refinitiv, J. Safra Sarasin, 19.11.2020

Exhibit 2: More construction to come



Source: Refinitiv, J. Safra Sarasin, 19.11.2020

Exhibit 3: Tight supply to lead to higher prices



Source: Refinitiv, J. Safra Sarasin, 19.11.2020

US equities

US small cap: Rebound not yet complete

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Small cap stocks have rebounded strongly from their trough in March, with performance vs. large cap accelerating since September. The initial outperformance was driven by the value component, but growth stocks have participated over the past 3 months. There are good reasons to believe that they should continue to outperform: Tactical drivers, such as macro momentum and rates continue to point to the upside, while valuations are still attractive and not yet priced for an earnings rebound in 2021.

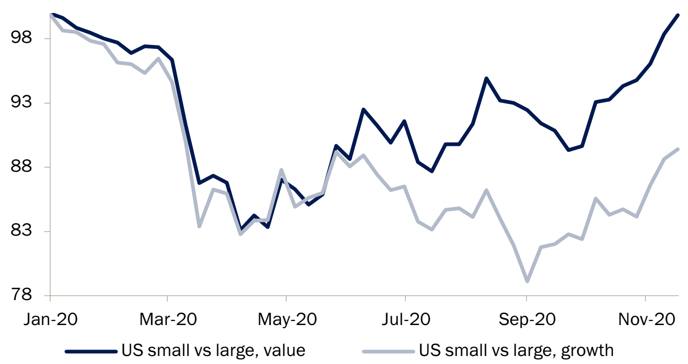
Small cap stocks have outperformed large cap stocks by 11% since early September

Small cap stocks have had a remarkable run since the beginning of September, outperforming their large cap counterparts by 11% in the US. This move has followed the rebound in economic activity as the US manufacturing ISM accelerated to almost 60, a level which usually marks the top of the cycle (Exhibit 1). Although both, the small cap value segment and the small cap growth segment managed to outperform recently, only the value component has so far closed the 2020 performance gap versus large cap (Exhibit 2). Naturally, the question is, how much more upside this trade has?

Exhibit 1: US economic data reaching a 2-year high

Source: Refinitiv, J. Safra Sarasin, 18.11.2020

Exhibit 2: Small cap outperformance since April driven by value stocks



Source: Refinitiv, J. Safra Sarasin, 18.11.2020

In our view, small cap stocks still have upside, as key drivers are pointing higher

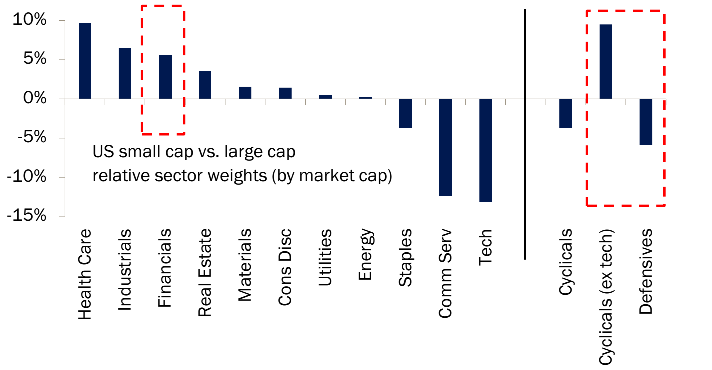
In our view, the trade has not yet run its course, given that:

- the tactical drivers of the trade continue to suggest more upside,
- valuations remain attractive and should re-rate on the back of
- a solid earnings recovery in 2021.

<u>More upside suggested by 3 tactical drivers: Macro momentum, US yields and HY spreads</u>

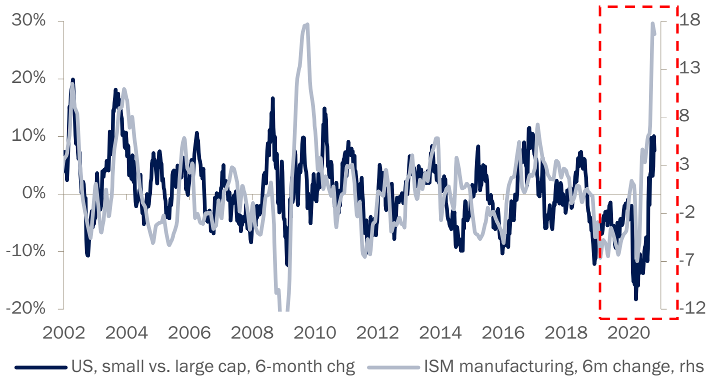
1) **Macro momentum**, i.e. 6-month changes in the ISM manufacturing.
   Small cap stocks tend to outperform when economic data improves, resulting from the high weighting of cyclical sectors, such as industrials, materials and consumer discretionary (Exhibit 3). While the relative performance may not fully catch up with ISM momentum, further upside from current levels appears likely (Exhibit 4).

Exhibit 3: Small cap is overweight cyclicals and financials



Source: Refinitiv, J. Safra Sarasin, 18.11.2020

Exhibit 4: Small caps outperform when macro momentum improves



Source: Refinitiv, J. Safra Sarasin, 18.11.2020

Higher US Treasury yields and lower HY spreads are supportive for small caps

2) **US yields**
The large weight of financials results in a high correlation between small cap performance and US 10-year yields (Exhibit 5). Those continue to suggest relative upside for small caps and should provide further support going forward, considering our view that rates should move higher in 2021.

3) **US HY spreads**
US small cap stocks are substantially more levered than large caps. Total debt to equity stands at around 135% (large caps at around 125%, Exhibit 7), with the gap for net debt to equity being even more significant (small caps at 110%, large caps at 80%). As a result, small caps tend to do well when HY spreads decline and underperform when HY spreads rise (Exhibit 6). The sharp drop in HY spreads over the past 6 months continues to suggest upside for small caps relative performance. While being a tailwind currently, we would highlight that leverage is a major weak spot of small cap stocks, raising its gearing but making it vulnerable to a deterioration of funding conditions.

Exhibit 5: Rising US 10Y yields are positive for small cap

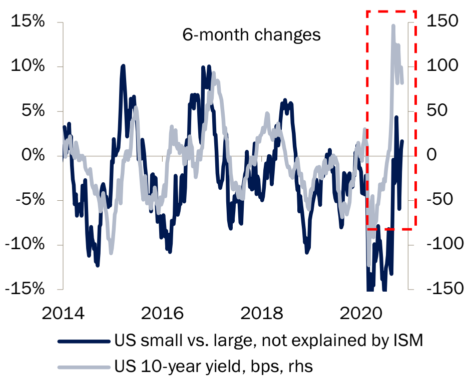
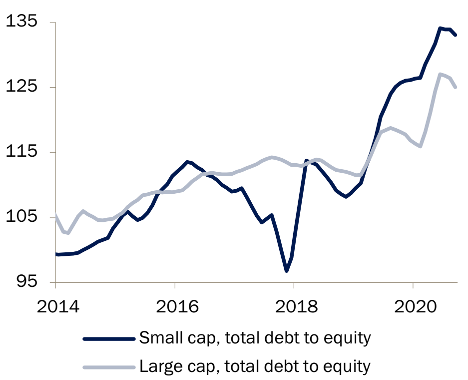


Exhibit 6: Small cap benefits from lower HY spreads…

Exhibit 7:…due to small cap stock's high leverage levels



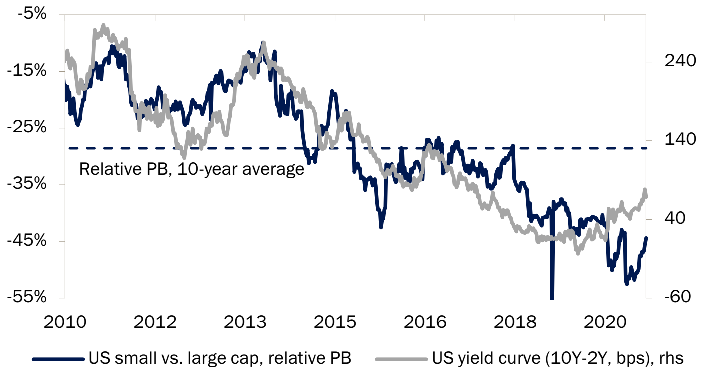
Source: Refinitiv, J. Safra Sarasin, 18.11.2020

Small cap valuations are yet not priced for an earnings rebound in 2021

<u>Valuations are attractive, in particular given a solid outlook for earnings in 2021</u>

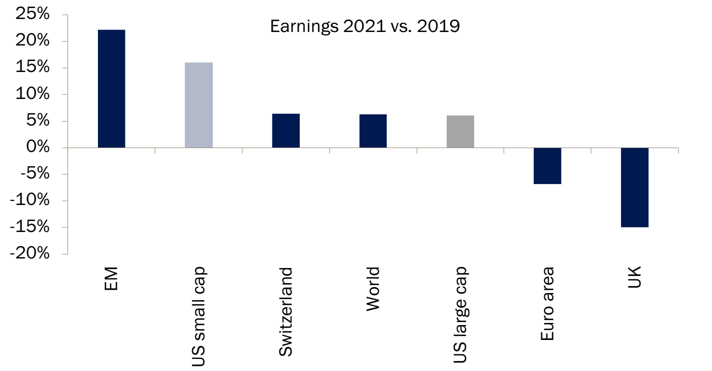
Small cap stocks have persistently underperformed since 2013, following the trajectory of value and in line with the decline in US 10-year rates. Over this time horizon, the small cap price-to-book ratio (PB) discount to large cap has dropped from about -15%, to around -45%, a 15-year low (Exhibit 8). There are good reasons to believe that relative valuations have troughed: Firstly, the relative price-to-book ratio tends to follow the US yield curve, a key driver of financials profitability. Given small caps' large financials weighting, this does not come as a surprise. At current levels, the yield curve is suggesting a 5% to 10% re-rating relative to large cap. The upside potential may rise further if the yield curve continues to steepen – a function of a strengthening recovery in 2021. Secondly, consensus expectations project a strong rebound in small cap earnings in 2021, more than compensating for the decline in 2020. 2021 small cap earnings are set to exceed their 2019 levels by 16% (Exhibit 9) with EM earnings being the only ones to see a stronger rebound over their 2019 levels.

Exhibit 8: Small cap valuations to re-rate as the yield curve steepens



Source: J. Safra Sarasin, 18.11.2020

Exhibit 9: Consensus implies full small cap earnings recovery in 2021



Source: J. Safra Sarasin, 18.11.2020

European Macro

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Swiss economy with a mixed start into Q4

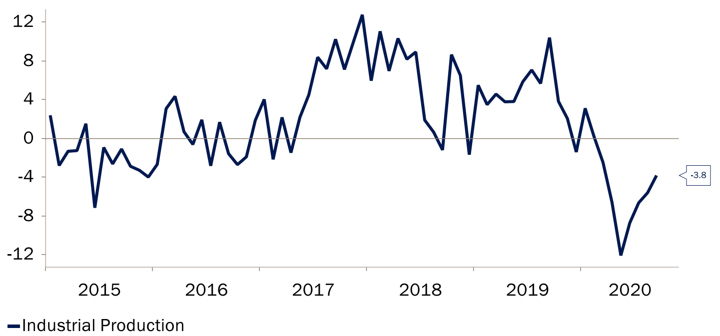
Initial economic data points for October show that the recovery going forward will not be as smooth is it was in the third quarter. Exports and imports declined by 0.5% and 3.4% mom, respectively. Although business surveys continue to improve, capacity utilization remains below average. The Swiss economy may do better than its European peers in the months ahead as it largely avoided lockdowns so far and relies less on contact-intensive services like tourism. Yet it is unlikely to defy the general trend in Europe that is taking more restrictive measures to bring infection rates down.

Solid momentum in the manufacturing sector but trade weakened lately

The Swiss economy continued its recovery in the third quarter. Production in the secondary sector grew by 4.8% qoq driven by a strong rebound in industrial production, construction and energy. With a growth rate of 3.3% mom in September alone the dynamic seems to carry over into the fourth quarter (Exhibit 1). The improving KOF business situation survey and the below average capacity underutilization would support this view (Exhibit 2). However, trade data for October moderate our optimism somewhat. Both exports and imports declined and remain significantly below January levels (Exhibit 3 and 4). Additionally, it needs to be mentioned that Switzerland has one of the highest COVID-infection rates in Europe. While it has largely avoided lock-downs so far, demand –in particular for its tourism sector - is likely to decline, as its neighbours are more cautious.

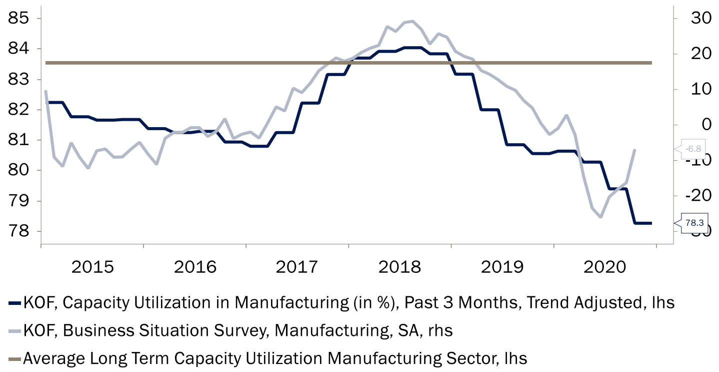
Exhibit 1: Industrial production continues to recover in September

Switzerland: Swiss Federal Statistical Office, Industrial Production, in % yoy, wda, nsa



Source: Macrobond, J. Safra Sarasin, 19.11.2020

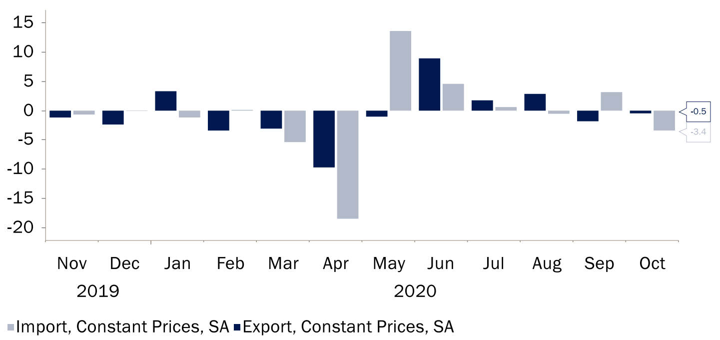
Exhibit 2: Business situation improves but has way to go



Source: Macrobond, J. Safra Sarasin, 19.11.2020

Exhibit 3: Exports declined for a second month

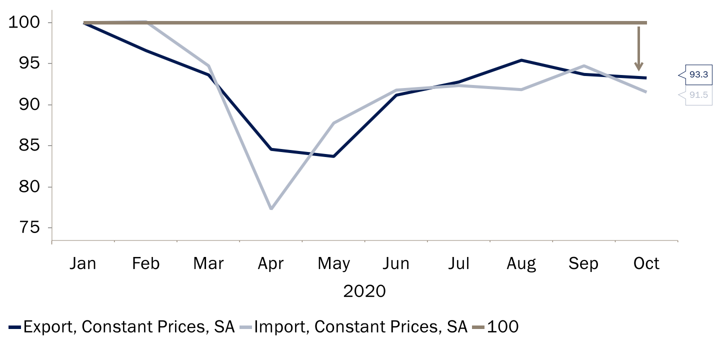
Switzerland, Foreign Trade, Constant Prices, SA, in % mom



Source: Macrobond, J. Safra Sarasin, 19.11.2020

Exhibit 4: Exports and imports not at pre-COVID levels yet

Switzerland, Foreign Trade, Constant Prices, SA, 01.01.2020 = 100



Source: Macrobond, J. Safra Sarasin, 19.11.2020

Economic Calendar

Week of 23/11 – 27/11/2020

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 23.11.2020						
FR	09:15	Markit France Manuf. PMI	Nov P	Index	--	51.30
	09:15	Markit France Services PMI	Nov P	Index	--	46.50
GE	09:30	Markit Germany Manuf. PMI	Nov P	Index	54.70	58.20
	09:30	Markit Germany Services PMI	Nov P	Index	45.50	49.50
EU	10:00	Markit Eurozone Manuf. PMI	Nov P	Index	--	54.80
	10:00	Markit Eurozone Services PMI	Nov P	Index	--	46.90
UK	10:30	Markit UK Manuf. PMI	Nov P	Index	--	53.70
	10:30	Markit/CIPS UK Services PMI	Nov P	Index	--	51.40
US	15:45	Markit US Manufacturing PMI	Nov P	Index	52.50	53.40
	15:45	Markit US Services PMI	Nov P	Index	56.00	56.90
Tuesday, 24.11.2020						
GE	08:00	GDP SA QoQ	3Q F	qoq	8.20%	8.20%
FR	08:45	Business Confidence	Nov	Index	--	90.00
GE	10:00	IFO Business Climate	Nov	Index	90.20	92.70
	10:00	IFO Expectations	Nov	Index	--	94.00
US	16:00	Conference Board Cons. Conf.	Nov	Index	98.00	100.90
	16:00	Richmond Fed Manufact. Index	Nov	Index	--	29.00
Wednesday, 25.11.2020						
US	14:30	Durable Goods Orders	Oct P	mom	1.30%	1.90%
	14:30	Durables ex Transp.	Oct P	mom	0.30%	0.90%
	16:00	PCE Deflator MoM	Oct	mom	0.00%	0.20%
	16:00	PCE Core Deflator MoM	Oct	mom	0.00%	0.20%
	16:00	Univ. Mich. Sentiment	Nov F	Index	77.00	77.00
Thursday, 26.11.2020						
JN	06:00	Leading Index CI	Sep F	Index	--	92.9
EU	10:00	M3 Money Supply YoY	Oct	yoy	--	10.40%
Friday, 27.11.2020						
JN	00:30	Tokyo CPI	Nov A	yoy	-0.50%	-0.30%
FR	08:45	CPI EU Harmonised MoM	Nov P	mom	--	0.00%
	08:45	CPI EU Harmonised YoY	Nov P	yoy	--	0.10%
	08:45	GDP QoQ	3Q F	qoq	--	18.20%
EU	11:00	Economic Confidence	Nov	Index	--	92.90
	11:00	Industrial Confidence	Nov	Index	--	-9.60

Source: Bloomberg, J. Safra Sarasin as of 20.11.2020

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	-0.49	-1	-2	0.0
German Bund 10 year (%)	-0.57	-3	-39	2.8
UK Gilt 10 year (%)	0.32	-2	-55	4.2
US Treasury 10 year (%)	0.83	-6	-104	10.1
French OAT - Bund, spread (bp)	23	-1	-7	
Italian BTP - Bund, spread (bp)	122	0	-38	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10'517	20.2	-0.1	2.1
DAX - Germany	13'109	19.5	0.3	-1.2
MSCI Italy	690	23.1	3.2	-11.4
IBEX - Spain	7'960	34.3	2.6	-14.7
DJ Euro Stoxx 50 - Eurozone	3'461	22.5	0.7	-5.4
MSCI UK	1'781	21.0	0.0	-14.8
S&P 500 - USA	3'582	25.6	1.3	12.7
Nasdaq 100 - USA	11'985	31.2	1.4	38.4
MSCI Emerging Markets	1'200	18.7	1.6	10.0

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.91	5.9	-0.4	-6.2
EUR-CHF	1.08	4.2	0.0	-0.6
GBP-CHF	1.21	8.4	0.2	-5.1
EUR-USD	1.19	6.0	0.3	6.0
GBP-USD	1.33	9.0	0.6	1.1
USD-JPY	103.8	6.5	-0.8	-4.6
EUR-GBP	0.90	7.9	-0.2	4.8
EUR-SEK	10.21	5.6	-0.7	-2.4
EUR-NOK	10.69	9.2	-1.5	8.3

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	74	10.5	0.3	-9.1
Brent crude oil - USD / barrel	43	39.8	3.3	-35.4
Gold bullion - USD / Troy ounce	1'867	19.1	-1.2	23.2

Source: J. Safra Sarasin, Bloomberg as of 20.11.2020

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