August 2020

A BULL IN A CHINA SHOP

Key macro themes

CN growth – China's economy has strengthened markedly since grappling with the original COVID outbreak (F1). Indeed, strong CN growth was a major factor in mitigating last quarter's global contraction. **We explore the factors behind China's rapid bounce back, and discuss whether the Asian giant will continue to outpace other regions** (p. 3-5).

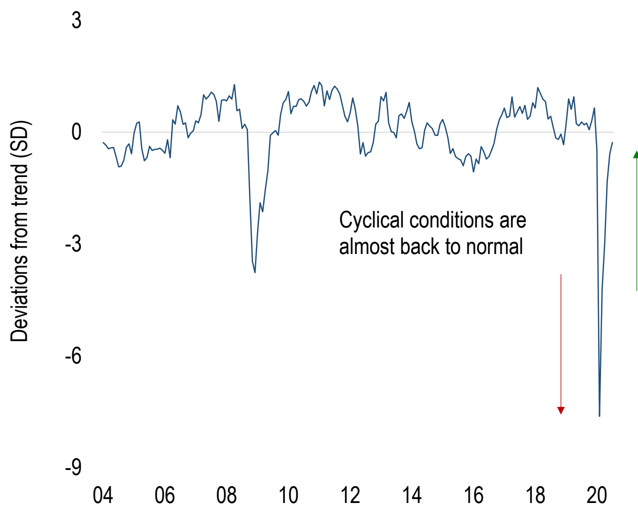
Investment strategy

Commodities – China's 'v-shaped' recovery is a major factor behind the ongoing commodity bull market. **We investigate the attractiveness of new commodity investments** (p. 6-7). Despite still high downside risk, we find raw material prices retain a very high upside (F2), justifying strong absolute and relative overweight positions on 12M holdings.

Crude oil – Within the commodity space, **crude oil investments have the highest probability of outperforming other risky assets**. We provide our latest views on the crude oil market, and compare the risk-reward trade-off on new oil investments versus equities and industrial metals – the asset class most exposed to CN economic shocks.

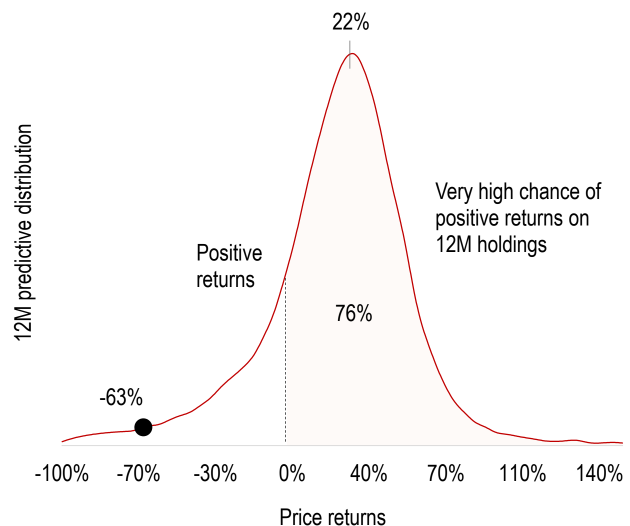
Charts of the month

F1: China has rebounded strongly
Numera China real activity index



Note: Index isolates common fluctuations across a panel of 20 CN economic indicators, thus abstracting from industry-specific (idiosyncratic) shocks: Source: Numera Analytics.

F2: Favourable commodity outlook
12M probability forecast - S&P GSCI



Note: 12M outlook for benchmark S&P GSCI commodity index. Expected returns are the mean of the distribution. Black dot is the 5% conditional value-at-risk, expected future losses below the 5% quantile. Shaded area denotes likelihood of positive returns. Source: Numera Analytics.

Economic activity:

- **DM growth** – *Recovery*. DM GDP fell 35% SAAR in Q2, more than quadrupling the losses experienced in Q4/08. Given recent mobility trends, our new base case is for DMs to contract 6.7% this year and to grow 5.2% in 2021. While forecast uncertainty is extremely high, there is a 75% chance that DM GDP will expand next year.

- **EM growth** – *Uneven recovery*. EM economic losses moderated in Q2 as China's 'v-shaped' recovery offset steep declines elsewhere. EM Asia should continue to outperform, with a 72% chance of outpacing total EM growth in 2021. LatAm is the most vulnerable region, as strict physical distancing continues to depress domestic activity.

Equity strategy:

- **DM stocks** – *Neutral*. DM stocks rose 6% since mid-July even as global mobility lost momentum. Low yields and a favourable global growth outlook improve the likelihood of positive real returns on 12M DM holdings, but left-tail risk remains extremely high. In relative terms, we favour EZ and CA stocks over US, JP and UK equities.

- **EM stocks** – *Neutral*. The risk-reward balance on EM stocks has improved versus July primarily owing to a drop in left-tail risk. While CN returns should stabilize now that activity has normalized, weak USD prospects and a bullish commodity outlook (p. 6-7) improve the upside for EMEA and LatAm stocks, both trading at a steep discount.

FICC strategy:

- **Fixed income** – *Overweight*. The choice to overweigh bonds depends critically on risk preferences. For balanced investors, US Treasuries remain more attractive than DM stocks, as QE and low inflation expectations continue to supress downside risk. We are less optimistic on EZ bonds, as we expect sovereign yields to increase somewhat.

- **Commodities** – *Overweight*. Industrial commodity prices rose 5.5% over the past month fueled by a weakening US dollar and stronger cyclical conditions in China (F1). There is a 76% chance that commodities will strengthen 12M out (F2), reflecting a projected improvement in global road traffic and a recovery in DM industrial activity.

- **US dollar** – *Underweight*. We maintain an underweight call on the USD, which we now believe will weaken against all major DM currencies over the next 12M. At 38%, the likelihood of the USD strengthening versus the EUR is at its lowest since Q1/17. The low probability reflects stronger EZ demand prospects and falling financial stress.

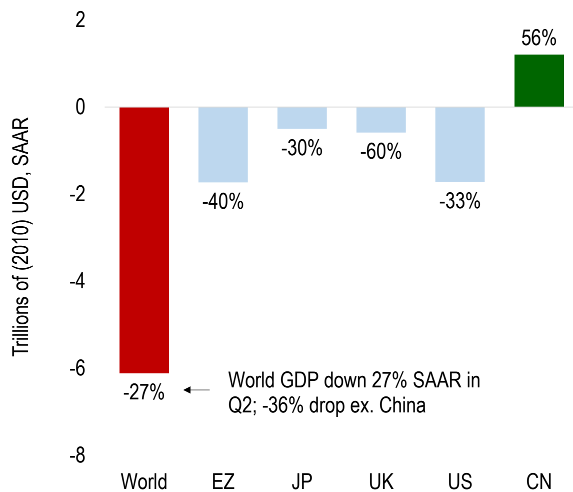
In this section:

- What explains China's 'v-shaped' recovery? (p. 3–4)
- Will China continue to outperform the world economy? (p. 4–5)

China bounces back – With most major economies having now reported Q2 GDP figures, **we estimate that the world economy contracted 27% SAAR in Q2**, a decline of roughly $6.1T (F3). This represents *by far* the steepest quarterly drop in global GDP over the post-WWII period, quadrupling the losses experienced in late 2008.

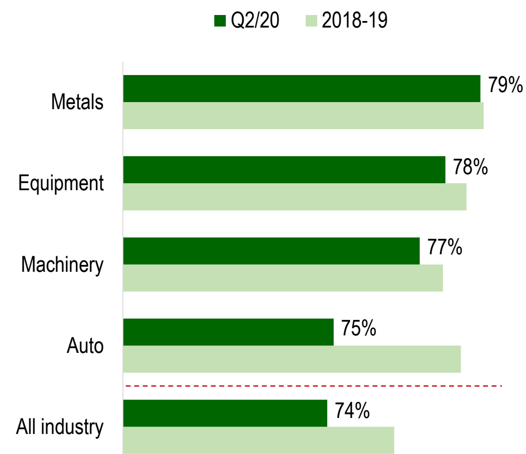
As we can see from F3 below, **the decline would have been considerably worse had China not experienced a 'v-shaped' recovery**. Real GDP expanded $1.1T (+56% SAAR) fueled by a sharp turnaround in manufacturing and construction, and is now merely 0.6% below its Q4/19 level. A healthy Chinese economy is a crucial ingredient for a sustained global recovery, both because of its size and its role as a major export market.

F3: China mitigating global losses
World GDP by region - Q2/20



Note: Q2/20 global GDP growth. Bars break down the change in major economies, in trillions of USD and QoQ SAAR (%). Japan figure is based on monthly GDP estimate by the Japan Center for Economic Research. Source: World Bank, JCER, Numera Analytics.

F4: Heavy industry back to normal
CN capacity utilization rates (%)

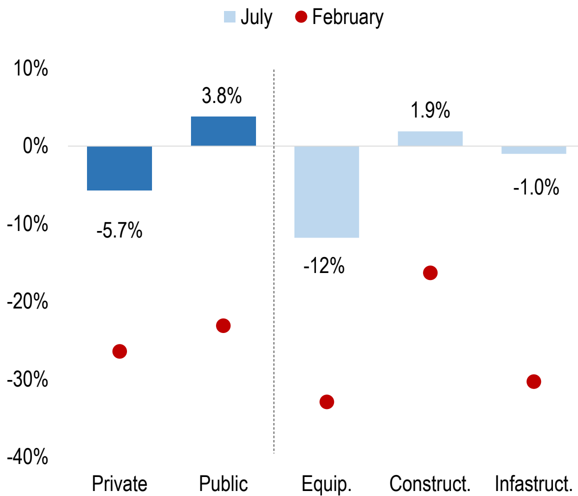


Note: Utilization rates compare actual production volumes to productive capacity. Source: China NBS.

Besides being the first major economy to ease control measures, **China has also benefited from its much greater exposure to heavy industry**. While demand for services was still subdued in Q2 due to social distancing, capital-intensive sectors such as machinery, metals and autos were all capable of normalizing operations (F4). The pick-up in capacity utilization rates was in turn facilitated by their limited reliance on labour supply, and because demand for capital and intermediate goods (domestically and elsewhere in Asia) has been fast to recover.

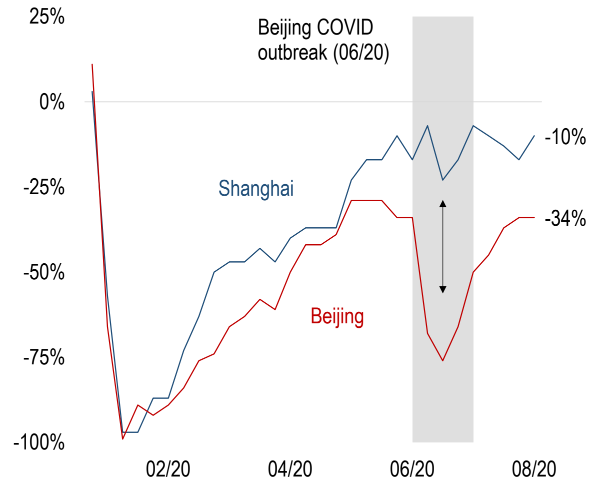
On the demand side, capital goods manufacturers have benefited from emergency fiscal stimulus, particularly from public investment projects. F5 below breaks down fixed asset investment by sector and project type. While private investment is still below pre-COVID levels, capital expenditure projects by the central government, local authorities

F5: Production aided by fiscal stimulus
CN fixed investment (year-to-date, %)



Note: Chart shows change in fixed asset investment by sector and type of asset. 'Public' includes state holdings and SOEs. Infrastructure excludes utilities. Source: China NBS.

F6: Mobility has not fully recovered
CN urban traffic congestion (YoY %)



Note: Chart compares year-on-year changes in traffic congestion in Beijing and Shanghai. Source: TomTom Traffic Index

and SOEs have rebounded strongly, and are up 3.8% year-to-date. This also explains why spending in construction and infrastructure is so much stronger than equipment investment – typically undertaken by the private sector.

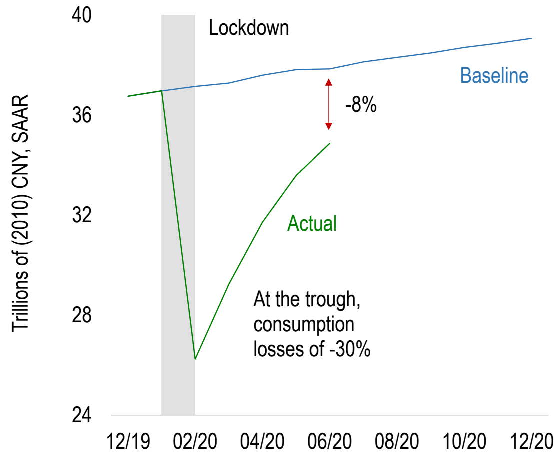
Much like in 2009, Beijing has chosen to finance investment projects through the expansion of credit. Social financing is up 14T CNY year-to-date, causing national debt to expand about 20 points to a staggering 265% of GDP. While rapid credit growth partly reflects higher demand for loans, the PBOC (China's central bank) has also reported a spike in the loan approval rate, consistent with the government's goal to ease financing conditions temporarily.

Will China outperform? – Despite making a remarkable comeback, **the Chinese economy remains about 4% below its pre-pandemic path** (i.e. the level of GDP expected absent the COVID shock). What is preventing the economy from fully recovering is still weak household spending, which remains constrained by low consumer confidence and persistent mobility restrictions.

While most businesses and schools have reopened nationwide, some social distancing rules remain in place. We can see from F6, for example, that road travel in major cities – while much stronger than in Q1 – is still down double digits versus its year-ago level. The much weaker performance of Beijing since June is a reminder of the sensitivity of demand to new COVID outbreaks, and a testament to the deeply uncertain nature of the economic outlook.

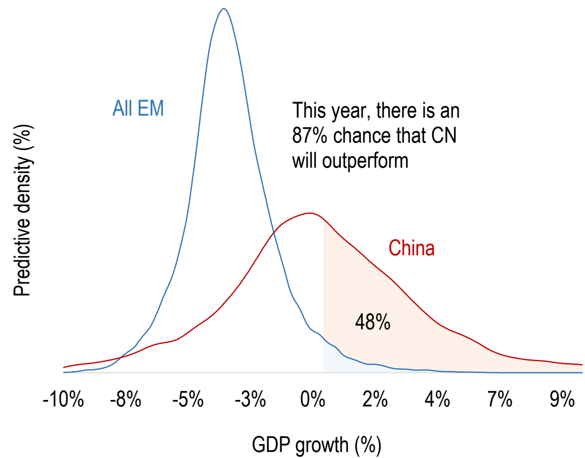
In line with mobility trends, household spending has improved markedly versus February but is still far from normalizing. We can see this from F7, which compares actual retail sales to a no-shock baseline. Since the current consumption gap (-8%) is twice as wide as that for the economy as a whole (-4%), this suggests **consumption should replace investment as the key growth driver in coming quarters**.

F7: Still room for further improvement
COVID impact on CN retail trade



Note: Chart shows evolution of CN real retail sales in 2020 versus a no-shock baseline. The gap is the impact of the COVID shock. Source: NBS, Numera Analytics.

F8: China should lead EM recovery
2020 probability forecasts (%)



Note: Chart compares probability forecasts for EM and CN GDP growth for full-year 2020. Shaded area denotes the likelihood of positive growth. Source: Numera Analytics.

In our view, **the most likely outcome for full-year 2020 is for CN GDP to be flat versus 2019**, but the uncertain path of the virus (and brewing geopolitical tensions with the US) vastly widens the range of potential outcomes. F8 shows our probability forecasts for EM and CN GDP growth for full-year 2020. Notice from the distribution in red that growth rates anywhere from -4% to 4% this year are all plausible scenarios.

What is much more likely, however, is for China to outperform other regions in the medium term. T1 shows our EM 'growth dashboard' for 2021. Each row shows the probability that a given country will outpace other EMs next year. **There is a 68% chance that China will outpace EMs as a whole**, with very high probabilities versus non-Asian countries. The chances of outperformance diminish 3-5 years out, however, as the credit-fuelled recovery endangers productivity growth by encouraging an inefficient allocation of capital.

T1: EM growth dashboard	Likelihood of stronger 2021 growth than:					
Region	All EM	CN	IN	BR	MX	RU
All EM		32%	30%	68%	63%	84%
China	68%		51%	73%	70%	81%
India	70%	49%		81%	76%	93%
Brazil	32%	27%	19%		67%	66%
Mexico	37%	30%	24%	33%		61%
Russia	16%	19%	7%	34%	39%	

Note: Each row tracks the probability of GDP growth in a given region outpacing other emerging markets (including the regional aggregate) in 2021. The columns are the object of comparison, so a green shade represents a higher probability of higher GDP growth than that region. Source: Numera Analytics.

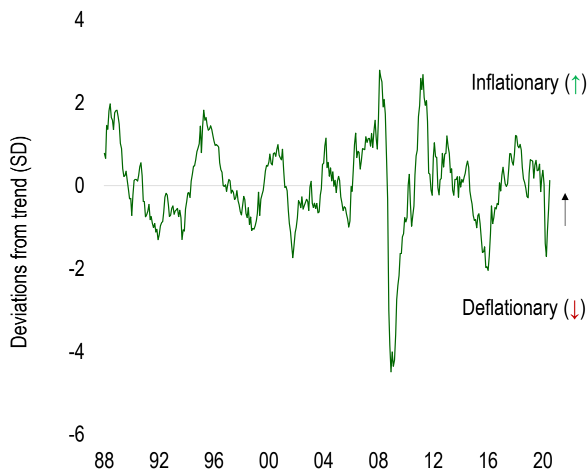
In this section:

- Implications of CN growth on commodity markets (p. 6–7)
- How attractive are new commodity investments? (p. 7)

Commodities rebound – China's 'v-shaped' recovery has important asset price implications, most notably for commodity investments. As the world's largest buyer of metals and grains, and third largest consumer of oil & gas (behind the US and the EU), rapid output growth in China has a large knock-on effect on raw material prices. China's role is evident from F9, which tracks worldwide demand for industrial commodities. **Unlike global GDP, commodities demand has now reverted to trend** after plummeting early in the pandemic.

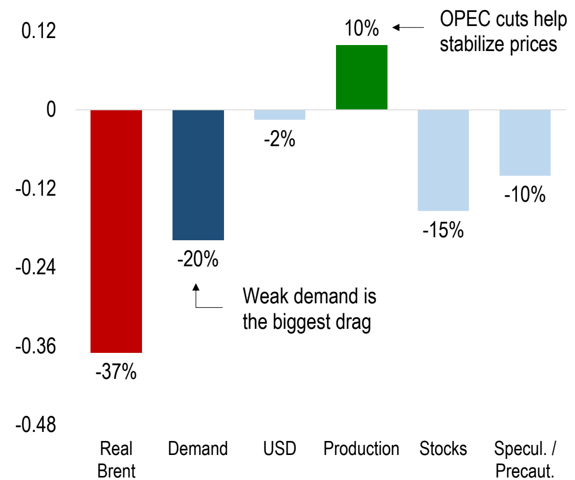
Stronger CN activity, USD depreciation and improved trader sentiment have lifted overall commodity prices by 20% since early June. The diverging performance between China and the rest of the world, as well as the capital-intensive nature of China's recovery (see p. 3-4) also help explain differences across commodity segments. While base metals are trading 6% above their pre-COVID level, crude oil prices are still down nearly 40% year-to-date.

F9: Demand for raw materials on the rise
Numera commodities activity index



Note: Index isolates common fluctuations across a panel of 18 industrial commodities, thereby abstracting from market-specific (idiosyncratic) supply shocks. Index adjusts for USD moves. Source: Numera Analytics.

F10: Oil still well below pre-COVID levels
Drivers decomposition - Oil prices (6M YTD)



Note: Contribution of market drivers to change in real Brent prices versus 12/19. 'Demand' captures changes in broad economic activity and oil-specific demand shocks. Speculation is proxied by net long NYMEX oil positions. Source: Numera Analytics.

F10 breaks down the contribution of selected market drivers to the decline in real oil prices during the first half of the year. **Weak demand and a large inventory overhang account for most of the drop in oil so far this year**. Unlike metals, which depend largely on CN manufacturing and construction, oil usage is tied to global transportation, which remains impaired by restrictions of movement both within and across regions.

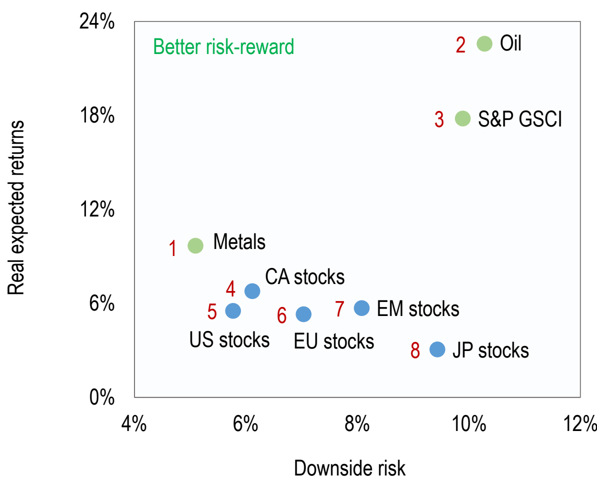
The $25 / bbl increase in oil prices since late April (Brent is trading at $45 / bbl) is, in turn, a consequence of improved road travel and a 12M bbl / day reduction in oil supply, which in combination have helped restore the market balance.

Despite these improvements, **we believe Brent is roughly $10 / bbl below its 'fair' value**, weighed down by bearish trader sentiment and low precautionary purchases by end-uses, given high stock volumes.

Are new investments advisable? – For broad commodity investments (as measured by the S&P GSCI), we currently estimate a 76% chance of positive returns one-year out, with 20%+ expected nominal price returns (see F2 in p.1). **While raw materials are extremely volatile, their upside today is *much* higher than for other risky assets**, making them a very interesting alternative to new equity investments – even for balanced investors.

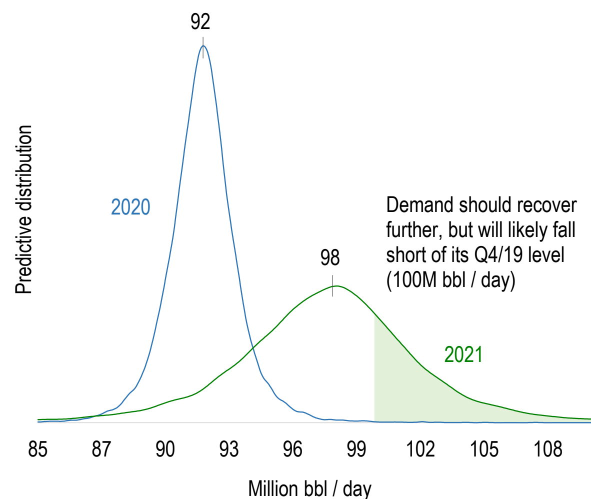
F11 compares the risk-reward balance for 12M holdings on major stocks, the S&P GSCI and its crude oil and base metals sub-components. Industrial commodities are more attractive one-year out, reflecting expectations of stronger global mobility and industrial activity, and a projected weakening of the USD. Oil and metals are similarly attractive, as the much higher upside for the former compensates for higher expected losses. **We strongly recommend absolute and relative overweight positions for overall commodities and both sub-classes**.

F11: Oil and metals both attractive
Risk-reward comparison - Risky assets



Note: Real USD total expected returns versus downside risk for 12M investments on global commodities (green dots) and major stocks (blue dots). Numbers rank assets by their Omega ratio for balanced investors. Source: Numera Analytics.

F12: Demand should strengthen further
Global oil consumption - 2020/21



Note: Chart shows probability distributions for average oil consumption worldwide in 2020 and 2021. Base scenario is the mean of each distribution. Shaded area denotes the likelihood of oil demand exceeding 100M bbl / day in 2021. Source: Numera Analytics.

The very high upside on crude oil reflects strong potential demand gains, low CAPEX and the fact that oil is trading at a discount. As show in F12 above, global oil consumption should average 98M / bbl day or more in 2021 on the back of further improvements in mobility as social distancing becomes largely voluntary.

The uncertain path of the virus, however, increases downside risk on oil investments (e.g. demand may grow less than expected if air travel remains 70-80% below capacity). In contrast, metals have a lower downside as the recovery in CN industry has already materialized, making their outlook less uncertain. When investing in commodities, we therefore suggest a more balanced approach between oil and metals than that implicit in the oil-heavy S&P GSCI.

1. Investment recommendations

Position:

Underweight	Neutral	Overweight
● (red)	● (yellow)	● (green)

Note: Underlying probability distributions can be made available upon request.

Global investment calls[1] Asset class	Absolute	Relative[2]	Downside risk[3]	Comments[4]	Last change[4]
DM equities *World MSCI TR*	Neutral	-	Very high	Falling downside	May 20
Canada	Overweight	Overweight	High		Mar. 20
Europe	Overweight	Overweight	High		Jun. 20
Japan	Overweight	Neutral	High	Upgraded (abs / rel)	Sep. 20
United Kingdom	Underweight	Underweight	Very high	Downgraded (abs)	Sep. 20
United States	Neutral	Neutral	Very high	Risks downgrade (abs)	May 20
EM equities *EM MSCI TR*	Neutral	Neutral	Very high		May 20
Fixed income *10Y US Treasury*	Neutral	Overweight	Moderate	Downgraded (abs)	Sep. 20
Germany 10Y	Underweight	Neutral	Moderate		Jun. 20
Japan 10Y	Underweight	Underweight	High		May. 20
EM	Overweight	Overweight	High	Upgraded (abs)	Aug. 20
Cash	-	Overweight	Low	Strong overweight	Feb. 20
Commodities *S&P GSCI TR*	Overweight	Overweight	High		Jul. 19
Crude oil	Overweight	Overweight	High		Jul. 19
Gold	Overweight	Neutral	Moderate		Jul. 20
US dollar *USDX (ICE)*	Underweight	-	Moderate		Jul. 20
USD vs. CAD	Underweight	-	High		Feb. 20
USD vs. EUR	Underweight	-	Moderate		Jul. 20
USD vs. GBP	Underweight	-	Moderate		Jul. 20
USD vs. JPY	Neutral	-	Low		Apr. 20

1. Investment recommendations for 12-month holding period (Sept. 2020 - Aug. 2021).
2. In every case, relative performance versus World MSCI TR. Please see charts on p. 9 for a full asset comparison.
3. Downside risk compares to historical probabilities of specific asset class undergoing extreme losses (left tail risk).
4. Indicates change in position and warns of potential changes; last column tracks changes in absolute position.

2. Asset comparison

Charts compare expected gains to potential losses for individual assets over a 12M holding period. Numbers in red rank assets by their risk-reward ratio. To rank investments, we divide excess returns (against a minimum acceptable rate) to the downside risk measure. The resulting metric is the 'Omega ratio', a measure of investment quality that explicitly considers risk preferences. The investment calls on p.9, in turn, depend on the evolution of the Omega ratios over time, which signal whether investors should increase, maintain or reduce their exposure to specific assets. The top panel is the ranking for balanced investors, who attach greater value to assets with a low likelihood of undergoing extreme losses. The bottom panel ranks assets for growth investors, with a higher risk tolerance.