Synopsis

The Pandemic Isn't Over Yet

New infections may be about to rise in Europe

Asset Allocation Research
February 26th 2021

The bond sell-off this week reflects a very bullish consensus about the pace of recovery from the pandemic, which we believe is not supported by the data. Daily infection rates have stopped falling in the EU and the governments of Germany, France and Italy may be forced to increase restrictions on mobility and economic activity. This would send a shockwave through bond markets – certainly in Europe and probably the US.

Contents | **Page**

Judging by recent price action at the long end of the US Treasury market, there is an overwhelming consensus that the end of the pandemic is in sight. This is supported by a fantastic rally in copper and crude oil. Equities are moving in sympathy, with Technology underperforming and Financials outperforming. These sector tilts are replicated all over the world, apart from China, suggesting that investors believe that the recovery will be global and synchronised. Most investors are not trying to be precise on timing, but they do believe in an uninterrupted, upward trajectory for the global economy. It is a clear and consistent narrative. However, we are increasingly concerned that it would fail a reality-check.

A brief glance at the John Hopkins University data on Covid-19 by country www.ourworldindata.org/coronavirus-data shows that daily infections in the EU have stopped falling. More worryingly, daily infections have been rising in France. The current 7-day average is 323 per million compared with a low of 162 in the first week of December. In Italy, they have stopped falling and started to tick upwards, with 229 vs 198 two weeks ago, and in Germany they have been flat-lining at 90 for the last 10 days, having previously fallen every day since the middle of January. This gloomy assessment is offset by better data in Spain and other countries, which previously had much higher infection rates, but the fact remains that the three largest economies in the Eurozone may have to tighten their lockdowns before they ease them. Any announcement of further restrictions is likely to send a shockwave through European bond and equity markets.

The counter argument says that the vaccination programme is about to accelerate dramatically across Europe. Leaving aside the issues of supply difficulties and anti-vaxers, the John Hopkins data also suggest that vaccination on its own is not enough to bring down infection rates. Israel has the most successful vaccination programme, but its daily new cases are still running at 415 per million. The UK rate has fallen from a peak of 852 in early January to 155 now, but the UK has had one of the strictest lockdown regimes in the world over that period. We are not epidemiologists and make no attempt to model the impact of new variants of the virus, but our simple assessment is that countries with slow vaccination programmes and relatively lax lockdown regimes will probably have to tighten them if more infectious variants become prevalent.

And so, we come the elephant in the room, what are the chances of the downward trajectory in US infections being reversed? The short answer is that we don't know. The current infection rate is 218, down from a high of 754 in January. There is no sign of any break in the downtrend and the US already has a faster vaccination programme than the EU and lower exposure to new variants. But it may only need a significant cluster of a new variant in a large state to change the headlines and have investors start to question their bullish assumptions.

Our investment conclusions are as follows: 1) The vaccines work and will eventually deliver a safe environment in which the global economy can be rebuilt. 2) It is increasingly unlikely that the economic recovery will be synchronized across all regions. Asia is already recovering; the US and the UK are probably on the right track, but there is a problem in the EU. 3) A significant tightening of lockdowns in the EU would reverse the bond sell-off we have just seen – certainly in Europe and probably in the US.

Harlyn Research

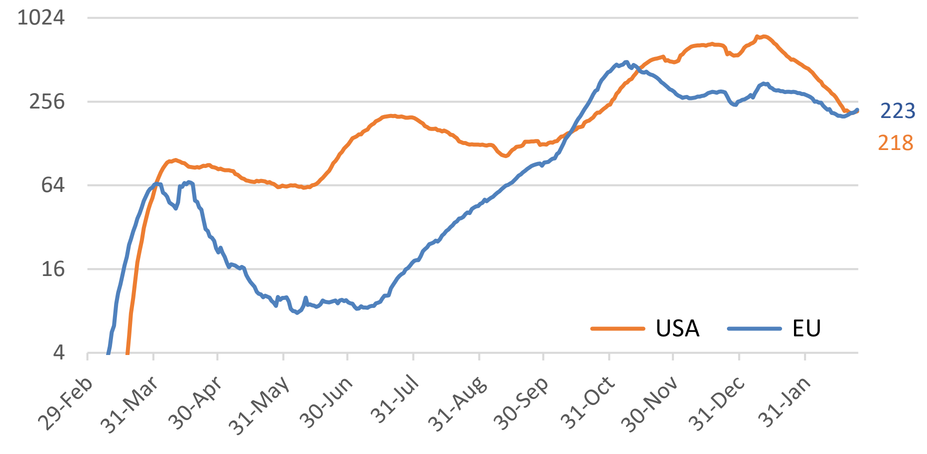
Simon Goodfellow
Cambridge, UK +44 7710 123 588
simon.goodfellow@harlynresearch.com

Harlyn Research LLP
www.harlynresearch.com

It is too soon to be sure that daily infection rates have stopped falling in the EU, but they could break out of the downtrend within the next week or two. The US still has a stable downtrend and now an infection rate just below the EU.

The last data point for all charts is 24th February 2021

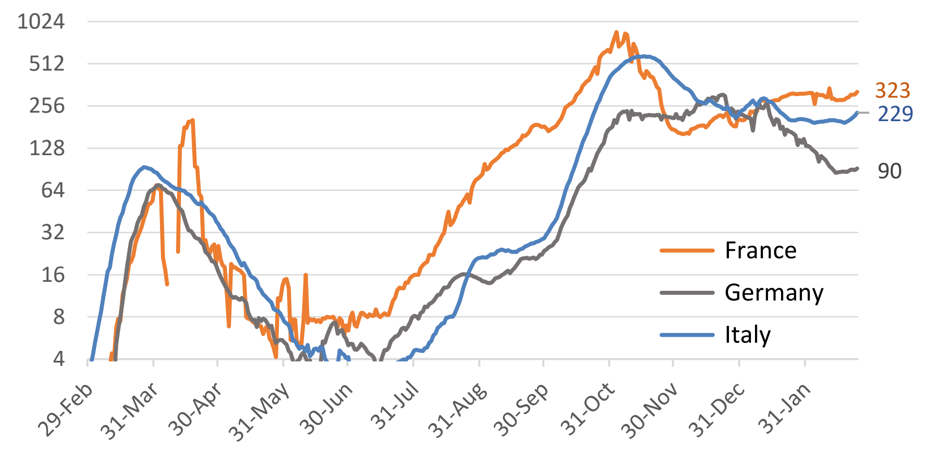
Fig 1 USA & EU: daily new cases of Covid-19 per million people (7-day average)



Source: John Hopkins University, Harlyn Research LLP

The good news in the EU comes from Spain and other countries which previously had a much higher than average infection rate. However, the three largest economies in the Eurozone are no longer contributing to this good news. There is a clear uptrend in France and a new one may be starting in Italy - and possibly Germany.

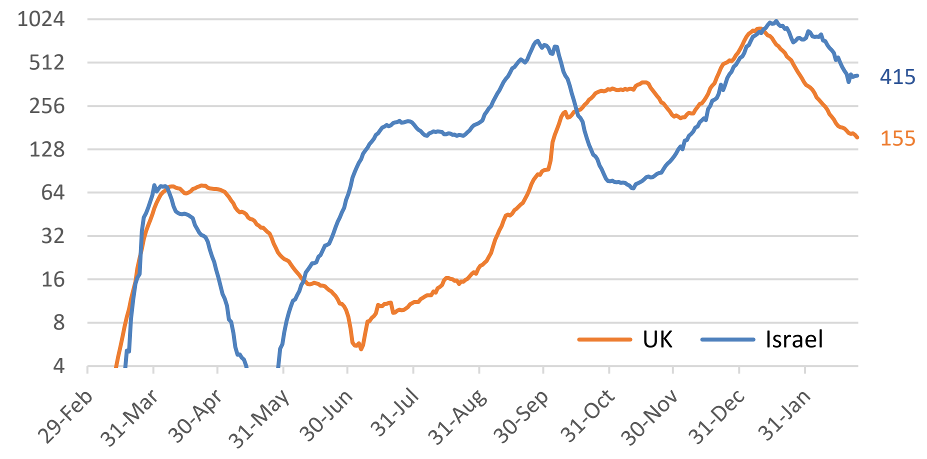
Fig 2 Selected EU countries: daily new cases of Covid-19 per million (7-day average)



Source John Hopkins University, Harlyn Research LLP

All progress towards vaccination targets is good news, but it is not enough on its own to stop the spread of infection. Israel and the UK have the two most advanced vaccination programmes, but the UK has a far stricter lockdown regime.

Fig 3 UK & Israel: daily new cases of Covid-19 per million (7-day average)



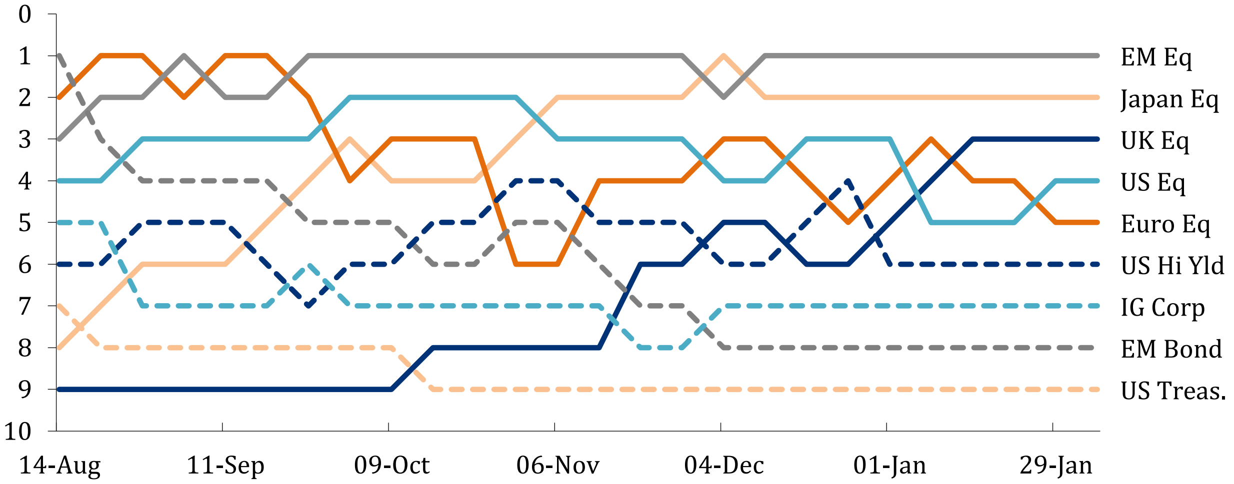
Source John Hopkins University, Harlyn Research LLP

US Asset Allocation

Changes	**None**
Leaders	No change to the top three, **EM Equities #1, Japan #2, UK Equities #3.** The total equity weighting continues to increase and is now close to maximum. EM Equities increase their lead within the equity model as commodity exposure combines with strength in Asian technology. This is unusual and may only be temporary. Japan has found an important support level, while the UK benefits from its exposure to cyclical sectors and the ongoing strength of sterling.
Laggards	No change to the bottom three, **Investment Grade #7, EM Bonds #8, US Treasuries #9**. US Treasury exposure has virtually stopped falling, chiefly because it can't go much lower. Investment Grade and EM Bonds lag far behind High Yield, but Investment Grade is holding steady, while EM Bonds are still falling.
Our view	The levels of realised and implied volatility remain stubbornly high in the US, suggesting that providers of liquidity think that the chances of an equity correction are higher than most commentators and many investors believe. We acknowledge this risk but think that any correction would likely be self-correcting, either because of central bank action or a powerful "buy-the-dip" mentality. Absent any correction, we think that the ranking within regions is likely to remain unchanged for some time.

Source: Harlyn Research LLP

US Asset Ranking – Last 26 weeks



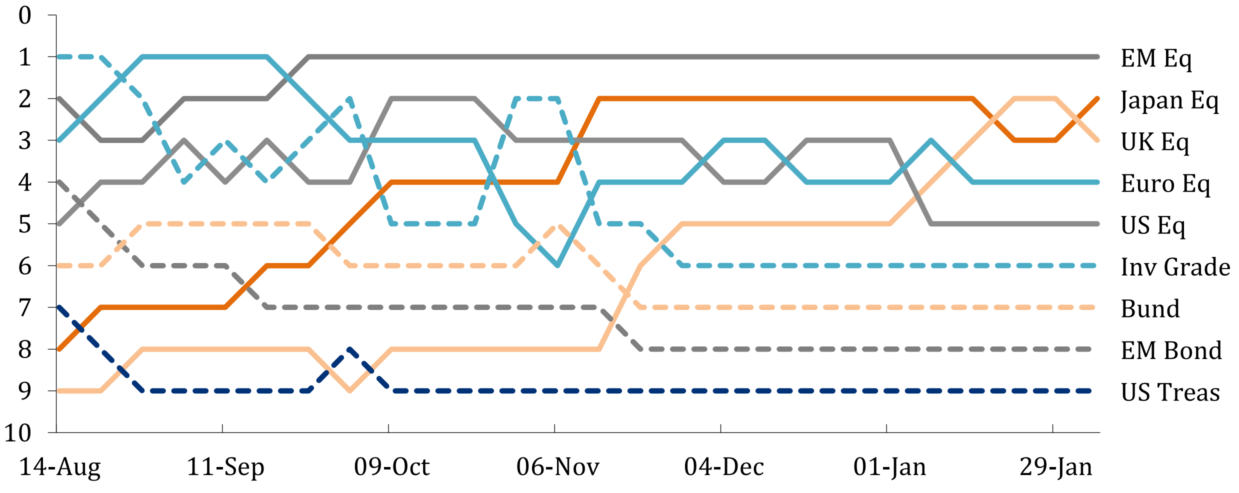
Source: Harlyn Research LLP

Europe Asset Allocation

Changes	**None**
Leaders	No change to the top three, **EM Equities #1, Japanese Equities #2, UK #3.** EM Equities are the clear leader and manage to increase the gap over Japan, thanks to their sustained momentum and the broadening of the rally to countries outside Asia. Japan also gains weight, but the UK (and the other regions) lose a little ground, despite the increase in total equity exposure.
Laggards	No change to the bottom three: **Bunds #7, EM Bonds #8, US Treasuries #9.** The fixed income category is dominated by a massive overweight in euro Investment Grade. EM Bonds have a higher yield, but will only start to look attractive once there is clear evidence that the dollar has stabilised.
Our view	Many euro and dollar-based investors are obsessed about finding the right balance between US and Eurozone equities, but our models suggest that they are scrapping over the two last positions. The real opportunity lies in Emerging Markets (particularly Asia). Together with Japan, these economies are already recovering from the pandemic. The UK is next in line and has greater sectoral exposure to a global, cyclical upswing. We still believe in a strong recovery this year, but there is increasing evidence that it will not be as synchronous as previously expected. Regional and sectoral exposure is about to become a lot more important.

Source: Harlyn Research LLP

Europe Asset Ranking – Last 26 weeks



Source: Harlyn Research LLP

US Equity Sector Ranking

Changes

UPGRADE: Financials to Overweight from Neutral
UPGRADE: Energy to Neutral from Underweight
DOWNGRADE: Consumer Discretionary to Neutral from Underweight

Leaders

Consumer Discretionary drops to #5 and is downgraded to neutral as investors start to move away from the "everything at home" trade. This allows **Financials #3** to move in the equal and opposite direction. They only just fail to overtake **Technology #2** but are likely to do so in the near future, given the divergence in the two sectors' leading indicators. **Small Caps #1** are still the clear leader, but the best of the rally is probably behind us.

Laggards

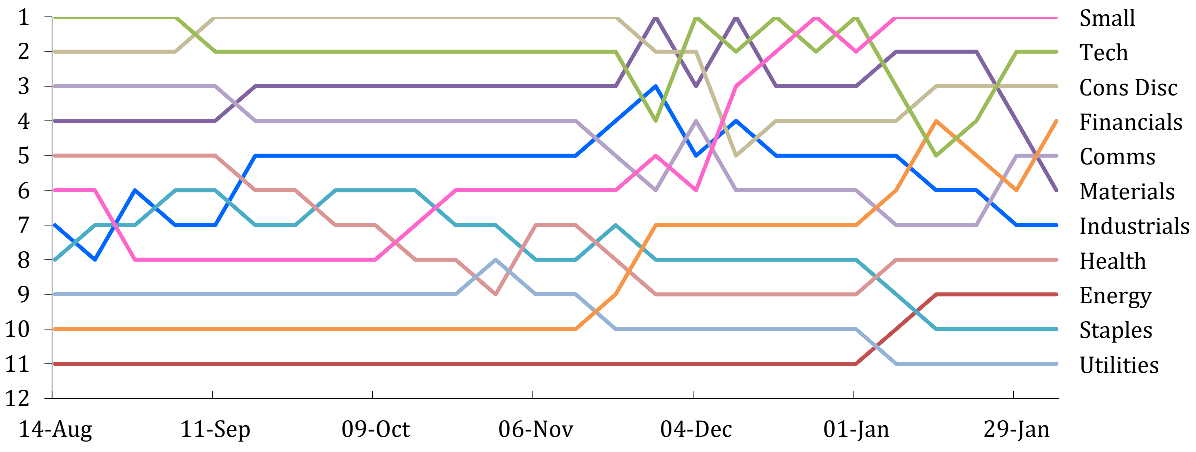
Energy #8 is upgraded to neutral and escapes from the bottom three. If the speed of the current rally is maintained, it will be in the top half of the table sometime next month. **Healthcare** drops to #9, ahead of fellow defensives **Staples #10** and **Utilities #11.**

Our view

The first leg of the recovery trade has achieved maturity with the twin upgrades of Financials and Energy. The next question is whether a rise in real bond yields will be enough to force major deratings in Technology and **Communications #4**. Our view is that it probably will be.

Source: Harlyn Research LLP

US Equity Sector Ranking – Last 26 weeks



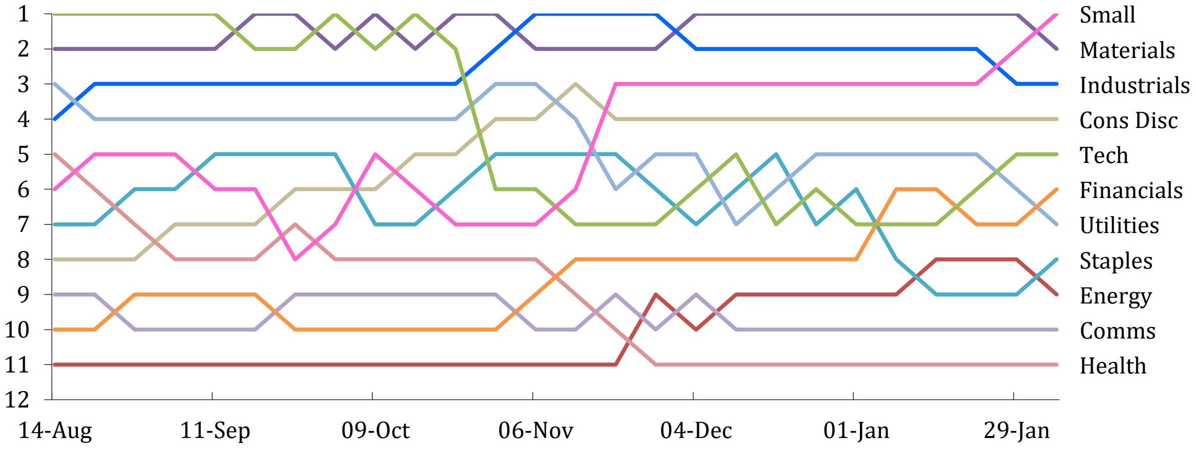
Source: Harlyn Research LLP

Pan European Equity Sector Ranking

Changes	**DOWNGRADE: Utilities** to Underweight from Neutral **UPGRADE: Energy** to Neutral from Underweight **UPGRADE: Technology** to Underweight from Neutral
Leaders	No change to the top three, except that **Materials #1** overtake **Small Caps #2.** This is slightly against the run of play, given that Small Caps is still in an unbroken uptrend and only has a topping lead indicator, while Materials has a deteriorating one and a sideways trend. The spectacular rally in commodities is the obvious cause, but it may have gone too far, too fast. **Industrials #3** are moving sideways, well ahead of their nearest challenger.
Laggards	**Energy #7** escapes from the bottom three and is upgraded to neutral. Resuming its recent uptrend. It is replaced by **Utilities #9**, which have endured a sudden, but not very surprising, sell-off. **Telecom #10** and **Healthcare #11** now look as though they have stabilised, but we do not expect any rally in the near future.
Our view	The upgrade to **Technology #4** feels like a one-week wonder and there is still a powerful downtrend at work. By contrast, the uptrend in **Financials #6** looks very robust. It mirrors the uptrend in the US sector and has broken through some important long-term downtrends and resistance levels. Remember that many of the major European banks have significant exposure to the US yield curve. Note also that the bottom four places are all occupied by defensive sectors, with **Consumer Goods** at #8.

Source: Harlyn Research LLP

Pan-European Equity Sector Ranking – Last 26 weeks



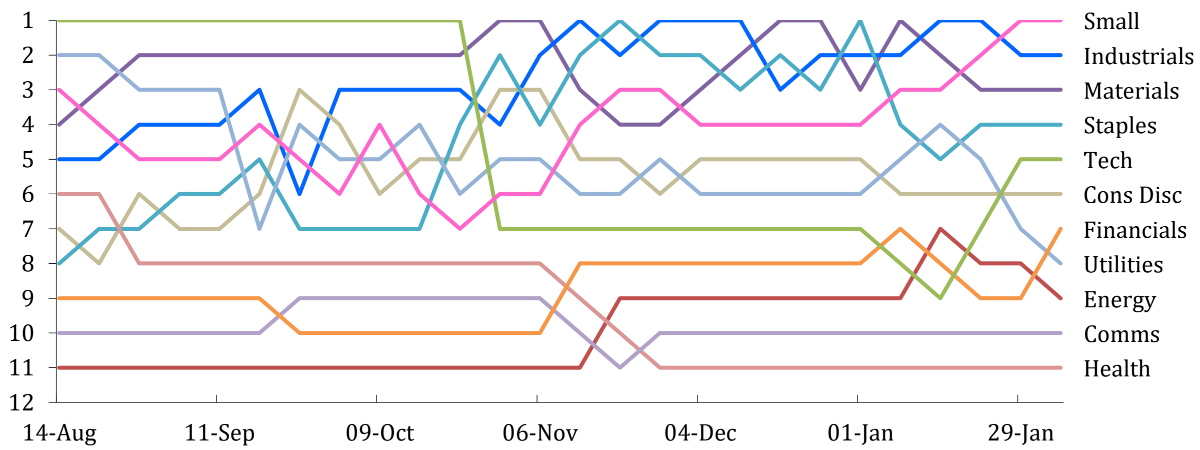
Source: Harlyn Research LLP

Eurozone Equity Sector Ranking

Changes	**UPGRADE: Technology** to Overweight from Neutral **DOWNGRADE: Utilities** to Underweight from Neutral
Leaders	**Industrials #1** are back on top of the table thanks to some profit-taking in **Small Caps #2.** However, Industrials have a high-conviction deteriorating lead indicator and are close to long-term structural resistance, while Small Caps are stable and a long way below previous cyclical highs. **Materials #3** manage to keep their place in the table but have clearly peaked and looking vulnerable.
Laggards	**Energy #8** manages to escape the bottom three, thanks to a collapse in **Utilities #9**, which is thematically consistent with the recovery trade, but looks a little overdone to us. We would not be surprised to see a rally if the newsflow on Covid changes. **Telecom #10** and **Healthcare #11** are swapping places deep in underweight territory.
Our view	**Financials #6** are being dragged higher by the rally in the US sector and the fact that they are undoubtedly cheap on a price to book basis. However, there are not many Eurozone banks which have a significant exposure to the US yield curve and the ECB has already indicated that it is uncomfortable with any further steepening of the curve in Europe. We are happy to increase exposure to Insurance, but would not chase the banks any higher.

Source: Harlyn Research LLP

Eurozone Equity Sector Ranking – Last 26 weeks



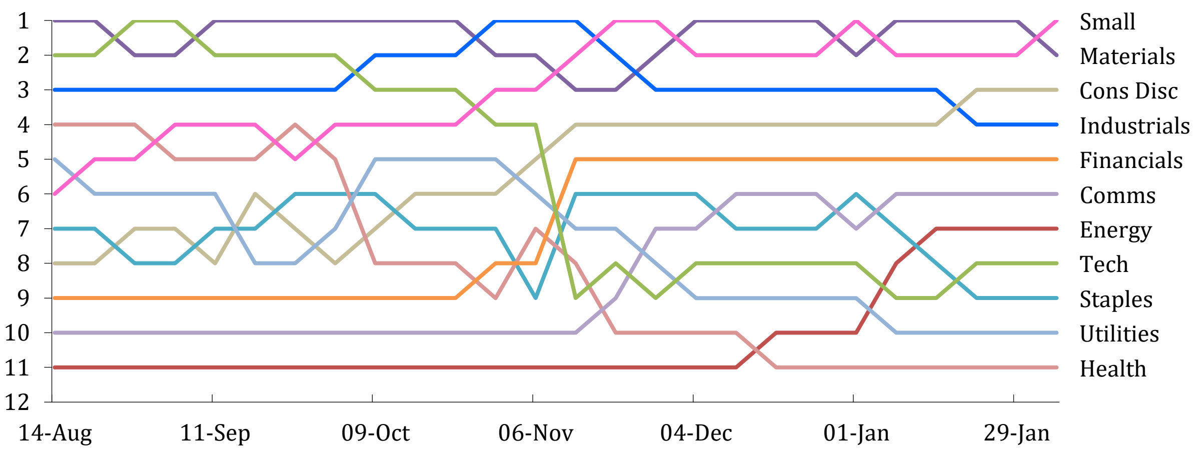
Source: Harlyn Research LLP

UK Equity Sector Ranking

Changes	**UPGRADE: Financials** to Overweight from Neutral **UPGRADE: Energy** to Neutral from Underweight **DOWNGRADE: Industrials** to Neutral from Overweight
Leaders	**Financials #3** are upgraded to overweight and overtake **Consumer Services #4** to join the top three. They have been close to the upgrade for several weeks and the steepening of the yield gap has been enough to clinch this. **Materials #1** overtake **Small Caps #2,** reversing the move the we saw in our last report. These two sectors have been swapping places since early December and their continued leadership is a sign that the UK and global recoveries are still on track.
Laggards	No change to the bottom three, **Consumer Goods #9, Utilities #10, Healthcare #11.** All three drift lower and none shows any sign of an imminent rally. All three have further to fall before they hit their all-time lows.
Our view	**Energy #7** finally clinches the upgrade to neutral and we expect the uptrend to continue for some time as there is no sign of resistance. We also believe that we have entered a new oil price regime centred around \$60-70/bbl, with the risks to the upside. This would be consistent with the rise in other commodity prices and with the steepening of the yield curves round the world.

Source: Harlyn Research LLP

UK Equity Sector Ranking – Last 26 weeks



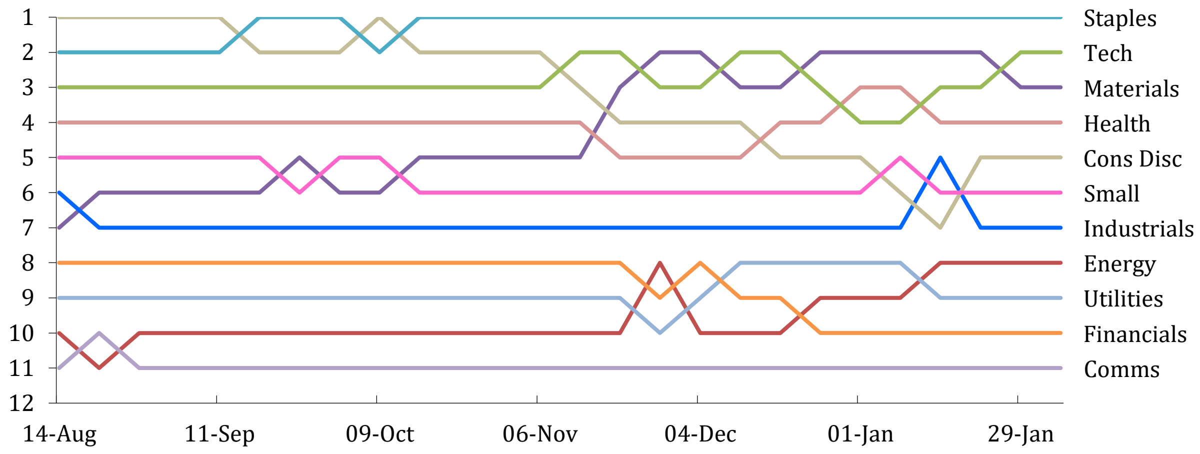
Source: Harlyn Research LLP

China Equity Sector Ranking

Changes	**None**
Leaders	No change to the top three, **Materials #2** and **Technology #3** swap places again. This just restores the situation to where it was a few weeks ago, before a counter-trend rally in Tech and a bit of profit-taking in Materials. **Consumer Services** are still #1, but no longer at maximum overweight. All good things come to an end. Even though the sector may outperform for several more weeks/months, we would use any strength as an opportunity to reduce exposure.
Laggards	No change to the bottom three, **Utilities #9, Financials #10**, **Telecom #11.** All three are trending gently lower, without the slightest hint of a rally. Financials have just set another new 16-year low, in complete contrast to the euphoria breaking out in the sector elsewhere. Telecom and Utilities are performing in line with their global counterparts.
Our view	Yet again, there are no upgrades or downgrades. Other than the downgrade to **Consumer Services #6,** caused by Alibaba, there have been no lasting or significant changes to the recommended weight of any sector since late November. This was understandable in the run-up to the Lunar New Year, but it begins to look a little strange, especially in the context of the new US administration's rethink on its stance towards China and the accelerating recovery.

Source: Harlyn Research LLP

China Equity Sector Ranking – Last 26 weeks



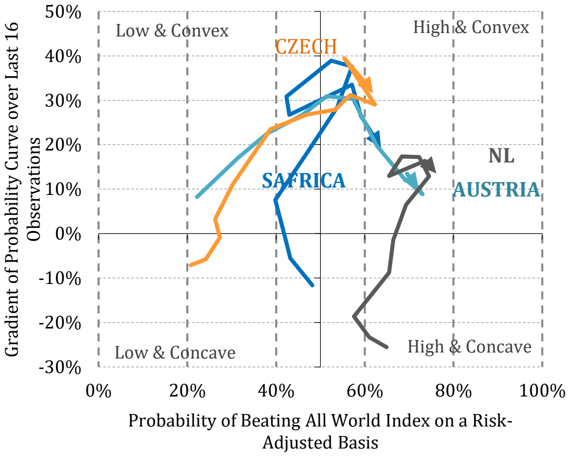
Source: Harlyn Research LLP

Global Equities Relative to All World Index ex US

Negative Watch	Japan, USA, Denmark, **Mexico (new entry)**
Positive Watch	Czech Republic, **Chile, Hong Kong, Hungary (new entries)**
Leaders	Korea, Taiwan, India, **Netherlands (new entry)**
Laggards	Pakistan, Malaysia, Ireland, Swiss (no new entries)
Our view	Japan and the USA are still on the negative watch list. For the US it's the heavy weighting in Technology that is dragging the country down, as multiples for all growth stocks contract. For Japan, it more about the absence of Energy and Materials, coupled with the fact Financials cannot outperform if the BoJ keeps its iron grip on the long end of the yield curve. The new entries onto the positive watch list are really a collection of special situations, apart from Hong Kong, which is a surprise. It is more lowly-rated than China, so this may just be some post New Year catch-up. Alternatively, it may be a signal that the investment community is no longer so concerned by the political protests which dominated the headlines last year. Money talks.

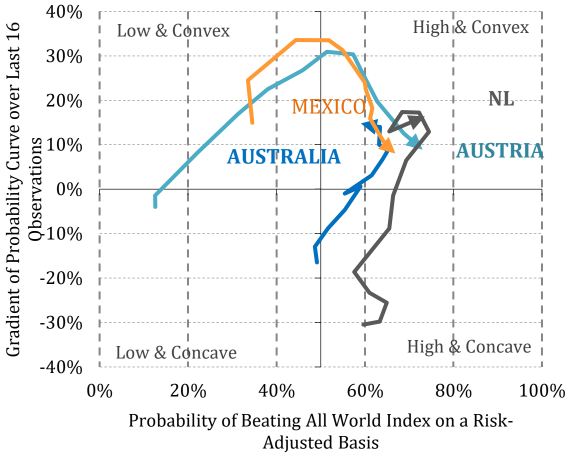
Source: Harlyn Research LLP

Negative Watch List



Source: Harlyn Research LLP

Positive Watch List



Source: Harlyn Research LLP

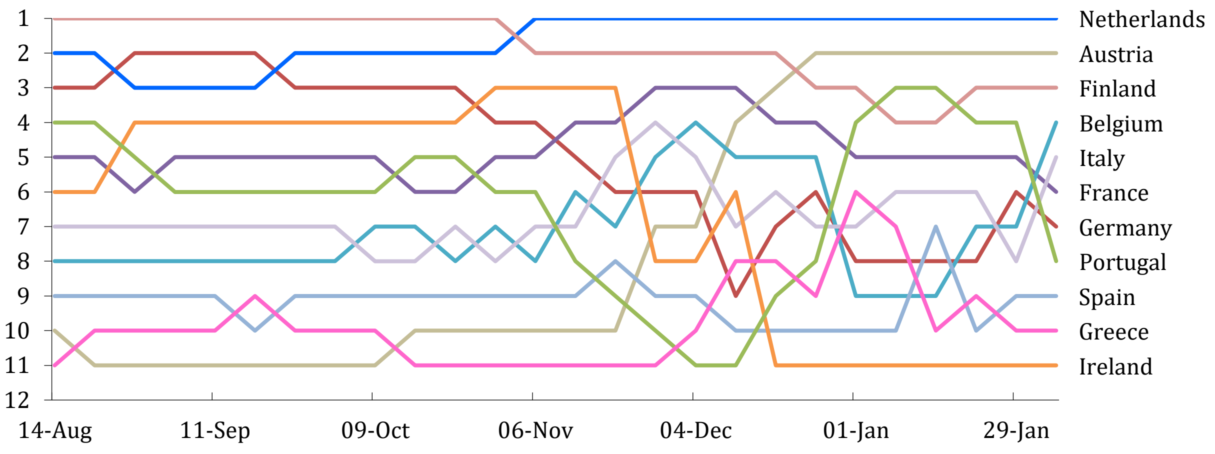
These charts compare the average PRATER score with gradient of the probability curve (a measure of whether PRATER improves or declines based on the periodicity of the sample.) The negative watch list highlights countries which are moving towards the bottom left quadrant, with a falling average PRATER 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	**DOWNGRADE: Greece** to Underweight from Neutral
Leaders	No change to the top three, **Netherlands #1, Austria #2, Finland #3,** but Finland has suffered a significant reverse and is only just above a group of four countries, Belgium, Italy, France and Germany. The Netherlands still has a good lead thanks to its heavy weighting in Technology, while Austria benefits from exposure to Energy and a banking sector geared to Emerging Markets, which are starting to outperform.
Laggards	**Ireland #11** is the clear loser over the last three months, falling fast and already close to a multi-year low. It was also the only country rated underweight**,** but it has now been joined by **Greece #10,** which is only just below **Spain #9** and **Portugal #8.** These three countries are all threatened by another summer of cancelled holidays and quarantine.
Our view	We are still seeing big and erratic moves in the middle of the table as entire sectors and countries are driven by Covid newsflow. None of them look particularly attractive or investible, so we will stick with the four clear recommendations (two overweight and two underweight) and ignore the rest, until things have calmed down a bit.

Source: Harlyn Research LLP

Eurozone Equities Country Ranking – Last 26 weeks



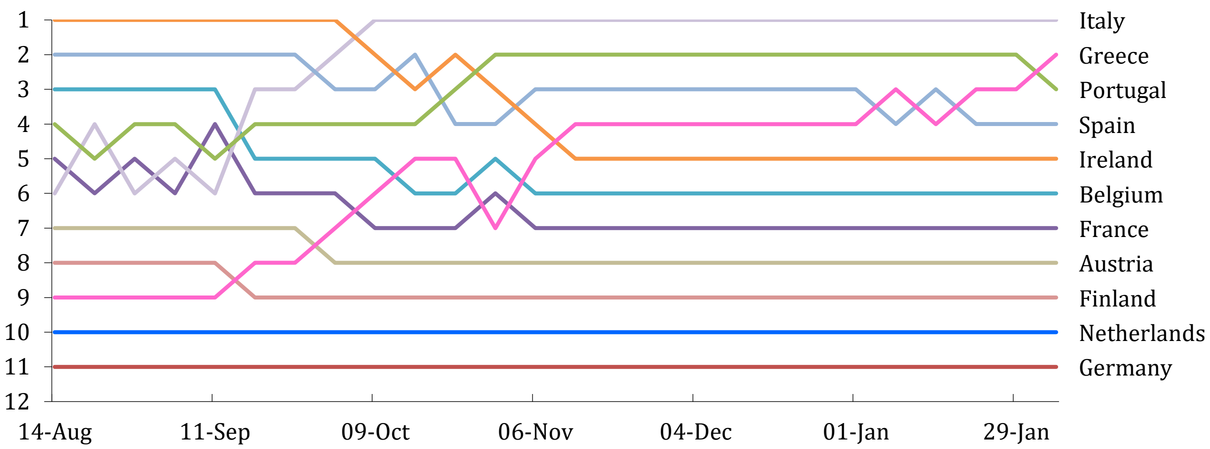
Source: Harlyn Research LLP

Eurozone Government Bond Ranking

Changes	**DOWNGRADE: France** to Underweight from Neutral **DOWNGRADE: Ireland** to Neutral from Overweight
Leaders	No change to the top three, except that **Greece #2** overtakes **Portugal #3. Italy #1** increases its lead at the top of the table following news of the appointment of Mr Draghi as the next Prime Minister, which is all part of the fiscal stimulus story. The results of him not being confirmed by Parliament do not beat thinking about.
Laggards	No change to the bottom three, **Finland #9, Netherlands #10, Germany #11.** All attempts at finding any sort of support have been vanquished by the newsflow coming out of Italy.
Our view	As predicted in our last report, **France #7** is finally downgraded to underweight, meaning that there are now only two countries, **Ireland #5** and **Belgium #6** left in neutral territory. The active weight of the model now stands at 46% vs an all-time high of 53% and an average of 35%. In other words, there is more room for yield convergence, but we starting to move into rarified atmosphere.

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

Disclaimer

This document has been produced by Harlyn Research LLP (“Harlyn”), an Appointed Representative of Stoneware Capital LLP ("Stoneware"), which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the "FCA"), appearing on the FCA register under No: 451073. The investment products and services of Harlyn and Stoneware are only available to professional clients and eligible counterparties; they are not available to retail (investment) clients.

In sending you this document, we have categorized you as a professional client or we have categorised you as falling within the exemptions set out in the UK Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 and Order 2005 in particular at paragraph 14 (investment professionals), paragraph 21 (certified high net worth individuals), paragraph 22 (high net worth companies etc), paragraph 23 (certified sophisticated investors), 2005 Order Schedule 2, paragraph 1 (self-certified high net worth individuals) and 3 (self-certified sophisticated investors), and any person outside the United Kingdom to whom this document may be lawfully sent; if this is not the case then please inform us immediately. We are not registered as an investment advisor with the SEC and therefore any information about our investment products or services is not directed at nor intended for US investors.

This document does not form or form part of any offer to issue or sell or the solicitation of an offer to subscribe for or purchase any investment. Recipients should reach their own conclusions about the merits of individual investments and inform themselves of and observe all applicable laws and regulations, including any taxation or exchange control legislation, which may be relevant in connection with any investment before considering the purchase of any such investment.

The value of investments may go down as well as up and past performance is not necessarily a guide to future performance. Investing in financial markets involves a substantial degree of risk. Nothing described herein is intended to imply that an investment is “safe”, “conservative”, “risk free” or “risk averse”. This document does not consider the specific investment objective, financial situation or particular needs of any client. The information and opinions contained herein are for background purposes only and do not purport to be full or complete and the forecasts contained herein are for illustrative purposes only and are not to be relied upon. The information herein reflects prevailing conditions and the judgment of Harlyn as of this date, all of which are subject to change. Although Harlyn has taken all reasonable care to ensure that the information contained within this document is accurate at the time of publication, no reliance may be placed for any purpose on the information or opinions contained herein or their accuracy or completeness and no representation, warranty or undertaking, express or implied, is given as to their accuracy or completeness by Harlyn or Stoneware.

The partners, employees, associates and other clients of Harlyn or Stoneware may have a long or a short position in entities described within this document. Should this situation arise, we manage this eventuality in line with our conflicts of interest policy, a copy of which is available on request.

Neither Harlyn nor Stoneware accept responsibility or liability for any losses, loss of profit, direct or indirect or other consequential losses or other economic losses suffered by any person arising from reliance upon any information, statement or opinion contained herein accordingly. Neither this document nor any information contained therein may be reproduced, redistributed or published, in whole or in part, for any purpose.

The registered address of Harlyn Research LLP is The Green, High Street, Fowlmere, Herts SG8 7SS, England, Companies House Partnership No: OC369433. The registered address of Stoneware Capital LLP is 9 Althorp Road, London SW17 7ED, England, Companies House No: OC319201.