Amplia Monthly Investor Letter

Equity rally resumes again

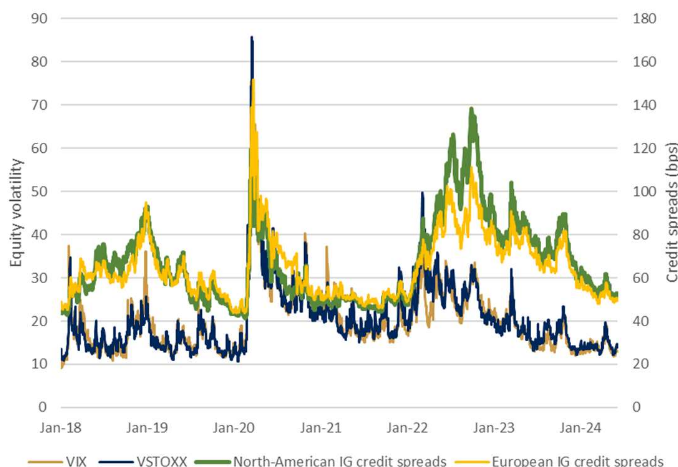
May was an eerily good month, with all major stock indices recording gains. The markets were led again by the big tech, as the advance of companies such as NVIDIA contributed to the NASDAQ 100's total return of 6.39%. The rest of the markets saw more modest gains, apart from the Swiss SMI (+6.95%) where our call for a currency-induced revival finally took off.

The fixed income indices followed the same pattern, with the broad investment grade indices Bloomberg US Aggregate Total Return and Bloomberg Europe Aggregate Total Return posting total returns of 1.31% and 0.04%, respectively.

Dwindling compensation for risk

It is striking that investors are shrugging off all concerns at this moment. The price of risk has returned to the pre-2022 lows. For example the VIX, the famous US equity implied volatility index and proxy of equity market nervousness, dove below 12 points in May: levels last time seen briefly in 2018 and 2019. Its European counterpart, the VSTOXX, behaved in a similar fashion by flirting with the 12-mark, a nadir which it previously touched in January 2020.

Meanwhile, the price of protection against investment-grade bond defaults also resumed its way down. The investment-grade credit-default swap indices of Markit CDX North America and its European sister index Markit iTraxx Europe both fell to lows last time seen in September 2021, as can be seen in the below chart:



Development of equity market volatility indices (left-hand axis) and investment-grade CDS Indices (right-hand axis) in the US and Eurozone since 2018. Source: Bloomberg, Amplia

It would be superstitious to say that we are nearing a big external shock that will shoot up the price of market risk into the stratosphere, as happened the previous times the market risk commanded such a little premium (January 2020 in the eve of COVID-19 as well as in Autumn 2021, the months preceding the Russo-Ukrainian war). But we know from history that the presidential election in the US has never been a "non-event", business as usual with no spillovers to the markets. It is also hard to recall an election when the political situation before the first debate on 27th June would have been so electrified, with political polarisation gaining ground in the US.

Therefore, even though we do not consider a sequel to the Capitol Hill riots of January 2021 – nor anything worse than that – our base case scenario, we think investors will reduce their market exposure over the summer, either by selling risk assets or buying protection, the latter of which will drive up the price of the aforementioned volatility and credit spread indices.

Seeking low-cost protection and staying invested

The problem of all pessimism is that the timing and magnitude of sell-offs is extremely hard to predict. However, with the volatility being so low and put options accordingly so cheap, buying out-of-the-money puts on single equities or equity indices, or alternatively going long on one of the volatility indices themselves may be advisable. Those with a credit portfolio may find it compelling to buy credit default swaps, or at least go up the credit ladder to avoid bigger spread widenings in their bonds by switching high yield to money market or high-grade bonds.

There are also ways of indirect, partial portfolio protection in a multi-asset context. These include building exposure in safe haven currencies such as the Swiss francs, Japanese Yen and these days also the US dollar, and buying long-term government bonds in those currencies, or in one's home currency if safe haven currencies are not available. The yield expectation is obviously not the same as in equities or high yield under normal circumstances, but we feel that now is not the time to drive full speed ahead.

Our current asset allocation

We remain moderately underweight in equities in our tactical asset allocation. The earnings are developing well but more progress is needed in the fight against the global inflation. Also, valuation multiples are becoming challenging following the considerable rally since the beginning of the year. We favor the US, Switzerland and the UK.

Within sectors, we continue to prefer consumer discretionary, technology, communications and pharmaceuticals. Some of these sectors may be cyclical but most of them should benefit from the re-industrialisation and re-shoring phenomena, topics that may take a prominent role in the upcoming US political agenda.

Within fixed income, we are underweight in high yield and focus instead on high-quality credit and government bonds across the maturity spectrum.

We favour the Swiss franc and the US dollar over the euro because of the former's safe haven status, and in the case of USD due to its interest rate differential.

Finally, we are slight overweight in cash, or money market investments, and stand ready to react should adverse events lead to a significant re-pricing of risks.

On 6th June 2024

Yours sincerely

Juho Kivioja