Market Commentary

| November 2020 |

Overview

While August was unequivocally positive for equity investors and September similarly negative, October was, in footballing parlance, “a game of two halves”. Global indices rose healthily in the first half of the month before handing back all their gains and more in the second half, buffeted by Covid-19 developments and political uncertainty. Even so, the MSCI All-Countries World Index failed to breach its September low, which provides some grounds for optimism. Safe haven assets such as government bonds and precious metals did little to provide a counterbalance this time.

We adhere to the notion that markets are generally forward-looking in their nature, hence the frequent disconnect between current news (especially economic data, which arrives with a lag) and market performance, but they can also become extremely sensitive to current developments. This is even more the case when those developments cloud the outlook, because another feature of markets is that that while they have a reasonable ability to price risk (weighing the probabilities of various potential outcomes), they find it much harder to price uncertainty (where it is difficult to ascertain what those outcomes will be).

The main drivers of markets are somewhat split into the risk and uncertainty categories at the moment, and this has been reflected in increased volatility. For global investors, the key factors remain the US Presidential election and Covid, with central bank policy also featuring strongly. Domestically in the UK, Brexit retains the ability to generate substantial volatility. We will consider the influence of the US elections later in this commentary, with the caveat that publication deadlines mean that the story will have evolved by the time of distribution.

The future of Covid definitely falls into the realms of uncertainty, although not presently to the extreme degree of last March. Thus, while we expect markets to continue to display volatility around news, it should not be as extreme as it was then. We now have a much better understanding of how the virus is transmitted and who it most affects; the

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medical community has also developed more successful treatment protocols.

Even so, it is clear that the sheer number of cases that would develop if the virus were allowed to run free would mean that medical systems would quickly be overwhelmed even if the relationship between the denominator (number of cases) and the numerators (hospitalisation and fatality rates) remained constant. This remains the primary argument in favour of tighter restrictions on social engagement. It has come as no great surprise to us that the UK's member countries (as well as several other countries in Europe) have each imposed their own versions of Lockdown 2.0. Neither will it be surprising if these restrictions remain dynamic throughout the winter when activities are more confined to indoor settings. Investors have reacted accordingly, retreating once more from companies that are more affected.

Of course, all if this is subject to more progress on the scientific front. Successful widespread testing could allow much more targeted restrictions. Slovakia has just managed to test around two-thirds of its population, amounting to 3.6 million citizens, in a single weekend, which rather puts our own government's efforts into perspective. The positive test rate was just over 1%. Admittedly, the antigen test they used is not as reliable as the Polymerase chain reaction (PCR) test, but, at the margin, it has the ability to take more infectious people out of circulation.

The "silver bullet" that really excites everyone is a vaccine. Here, too, though, there remains much uncertainty. While vaccines are already being deployed in Russia and China (with side-effects and efficacy yet to be reported), Western democracies continue to wait for more definitive clinical trial data before authorising use. Investor surveys continue to suggest that market expectations for at least one vaccine being widely available centre on the first half of next year. Several of the companies involved in their development, including Astra Zeneca of the UK in collaboration with Oxford University, have suggested that meaningful trial results should be ready by early December. If that timeline begins to slip into the New Year, markets will not take kindly to the news.

Other caveats must be attached to vaccine hopes. There is no indication yet as to their efficacy, with the US Food & Drug Administration setting a relatively low hurdle of 50% to provide authorisation. Let us speculate that only 50% of the population is willing to be vaccinated. That would suggest a "protection rate" as low 25%, which would severely delay any hopes of reaching herd immunity quickly. Thus we would remain reliant on testing and social restrictions for a longer period with all the consequences that this would bring. Still, this would at least provide a base from which we could then work. When the trial data is released, efficacy rates will be a very important component. The higher, the better, as far as investors are concerned.

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US
And so to the US elections. As we go to print, on the morning after the polls closed, the only thing that is clear is that the result is not clear. Projections suggest at best a narrow winning margin for either candidate, and a tie is not impossible. Markets have given their clues as to how they feel about the respective candidates. The Democrat Blue Wave promised a hefty fiscal stimulus package, a greener economic agenda and tighter regulation of dominant technology platform companies, leading to strong performance for the infrastructure and green energy sectors. Sovereign bond yields rose under this narrative, discounting greater supply and the potential for higher inflation. A Democratic President and House of Representatives with a Republican Senate would offer, at best, a watered-down version of that vision; at worst, a political stalemate in which no policies are passed.

The only other outcome that now looks probable is that we are left with the status quo in terms control, although Mr Trump has not offered much in the way of a manifesto for a second term. Could it be a more aggressive stance towards China, in areas such as trade, intellectual property and the ongoing power struggle? Or will he pivot towards Europe? We just don't know yet. More positively for US risk assets, he will, in all probability, remain generous on expenditure and taxes, and he will also be less likely to rein in the power of the large technology companies. This all points towards similar patterns as we have experienced in recent years: growth stocks will be favoured over cyclicals, with large capitalisation stocks outperforming small caps; US financial assets would be preferred to those outside the US.

Of course, that is just taking into account the Trump factor, and one then has to overlay the influence of Covid. Any development that mitigates the effects of the virus would be a boon for those industries that have suffered most, which could lead to a powerful rotation within the market. Headline indices might be relatively calm in such a scenario, but there would be a lot of movement beneath the surface.

UK

Our central view has been that the UK and the EU27 would reach some sort of deal in the seemingly interminable Brexit negotiations, as much for pragmatic reasons as ideological ones. Why layer further economic uncertainty onto Covid-related stress? Why risk another Scottish independence referendum? Why risk alienating the Americans (assuming a Democrat win) over the Irish Border/Good Friday Agreement when we want to sign a trade deal with them. Deadlines have been ignored throughout, but the 31st December should finally provide the hardest of buffers. That being the case, and given the practicalities around preparing the final agreement, negotiations are unlikely to continue far beyond mid-November. The outcome, binary as it is – "deal" or "no deal" – opens up two highly divergent paths for the pound and UK equities. A "no deal" scenario which would see the UK having to trade with Europe on World Trade Organisation terms, with fixed tariff levels on goods, is expected to send sterling tumbling once more. One credible forecast we have seen projects $1.20 (versus a current $1.29) and €1.04 (vs €1.10). In this scenario, as in 2016 when the referendum result was announced, large capitalisation overseas earners (for which read the FTSE 100) would strongly outperform the small and mid-caps (FTSE 250 and below). By the same token, a deal along the lines of Europe's recent agreement with Canada – quota and duty free for most goods – would send markets in completely the opposite direction ($1.38; €1.15 – domestic earners outperforming the multinationals).

Europe

Europe's fortunes appeared to be improving in the third quarter. GDP rebounded 12.7% against expectations of 9%, and company earnings handily beat forecasts. At the time of writing, 85% of companies reporting had either matched or beaten expectations, with an average beat of 17%. Interestingly, though, and betraying other concerns, beating the consensus was rarely a passport to a strong share price performance, while companies missing forecasts were severely punished. A prime example was SAP, Europe's leading Technology company. Its shares fell more than 20% on the day of its results as it downgraded future growth and margin expectations based on lower capital expenditure by its customers and greater investment in its own business. Although it is clear that the success of countries such as Germany in containing the first wave of the virus has not been repeated in the second wave, we continue to believe that the Continent is well placed to benefit from a recovery in global trade when it eventually arrives.

Emerging Markets

Although it happened just after the end of the month, it is worth commenting on an extraordinary

development in China/Hong Kong. The Initial Public Offering of fintech company Ant Financial, a subsidiary of online monolith Alibaba, was due to become the largest of all time, but was pulled just two days ahead of the proposed listing date. Often IPOs are postponed owing to market conditions, but not in this case. The postponement (which it is assumed to be for now) was the result of changes to the financial regulatory environment. As is often the case when it comes to events in China, the facts are not abundantly clear, but it appears that tighter regulation of the scale of loans and level of interest rates lies ahead, both of which would undermine profitability. However there is intense speculation that the founder, Jack Ma, incurred the wrath of Chinese Communist Party (CCP) officials by making comments recently that heavily criticised the state-owned banks, and that he is being brought to heel. One would hope that everything becomes clearer with the passage of time, but it is a warning that, ultimately, all activity in China is subservient to the CCP. One has to make investments in China cognisant of this reality.

Fixed Income

Fixed income, at least when it comes to government bonds, is something of a misnomer, as income remains hard to come by. Indeed, in several European countries yields are negative across all maturities, with German 10-year Bunds yielding -0.64%. The situation in the UK is barely brighter, with the 10-year Gilt currently offering a yield-to-maturity of 0.23%. Given that 10-year inflation expectations in the UK are for an average of 3.1%, a loss of value in real terms is guaranteed if held for the full duration – assuming, of course, that the market's ability to forecast inflation is vaguely correct. Inflation remains a hot topic for central bankers and investors alike. Central bankers want it to be higher than it currently is, having decided in the early nineties that a level of 2% provides just about the right incentive for steady economic growth. However, demographic trends (ageing and stagnating populations in key countries) and increasing debt levels, along with the beneficial aspects of global trade, have conspired to pin consumer prices, especially those of traded goods, below the desired level. Not even the extreme monetary policies of the last decade or so have moved the needle substantially. Thus investors remain sceptical of the central banks' powers to levitate consumer price indices, notably in the US, Europe and Japan.

However, the latest rounds of fiscal stimulus and monetary policy easing eclipse anything we have seen in recent decades, and the US Federal Reserve has committed to allowing inflation to run higher than its preferred 2% target to compensate for pervious shortfalls. It would be unwise to dismiss the potential for higher inflation out of hand just because we have not witnessed it for a while – or recency bias as a psychologist would call it. It's worth remembering that very few envisaged the long period of disinflation that begun in the 1980s following the harrowing inflationary experience of the 1970s. The fact that Covid-related factors affecting supply might distort the short-term picture, makes the job of discerning any change in long-term inflation trends even more difficult, suggesting that government bond yields might well become more volatile than we have been used to. The matter will be further complicated if central banks resort to suppressing the longer end of the yield curve in an attempt to bolster governments' ability to service their increased debts.

UK Gilts have delivered a total return of -2.15% over the last three months and +4.77% over the last year. Index-Linked Gilts returned -2.29% and +6.17% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.65% in sterling over the three months to end October (+1.74% over 12m). Global High Yield bonds delivered +1.8% (+3.77% over 12m).

Conclusion and Outlook

We continue to be mired in a period of unusually great uncertainty. Politics, health and social trends can be added to the disruptive effects of developing technologies. And yet this tends to be how the human race makes progress. Wars, revolutions and technological breakthroughs regularly punctuate history, but we must never lose sight of the fact that, in the long term, committing one's savings to a sensible combination of financial assets has been the sensible course of action. There is no reason to think that this time is different. Yes, there will be ebb and flow, but experience has taught us that timing exit and entry points to markets is not a sustainable strategy, whereas compounding returns is.

While not wishing to make light of current travails, we are as confident as we can be that issues such as the US election, Brexit and even the effects of Covid are transitory. We also know that other challenges will reveal themselves in future. But strong, innovative companies will continue to prosper. We can also balance the risk in portfolios with assets that protect against worst-case outcomes. The current cacophony provided by media outlets competing for our attention can sometimes be deafening. Our job is to filter out the noise, control our emotions, and to focus on the long-term health of the portfolios under our care.

John Wyn-Evans
Head of Investment Strategy

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