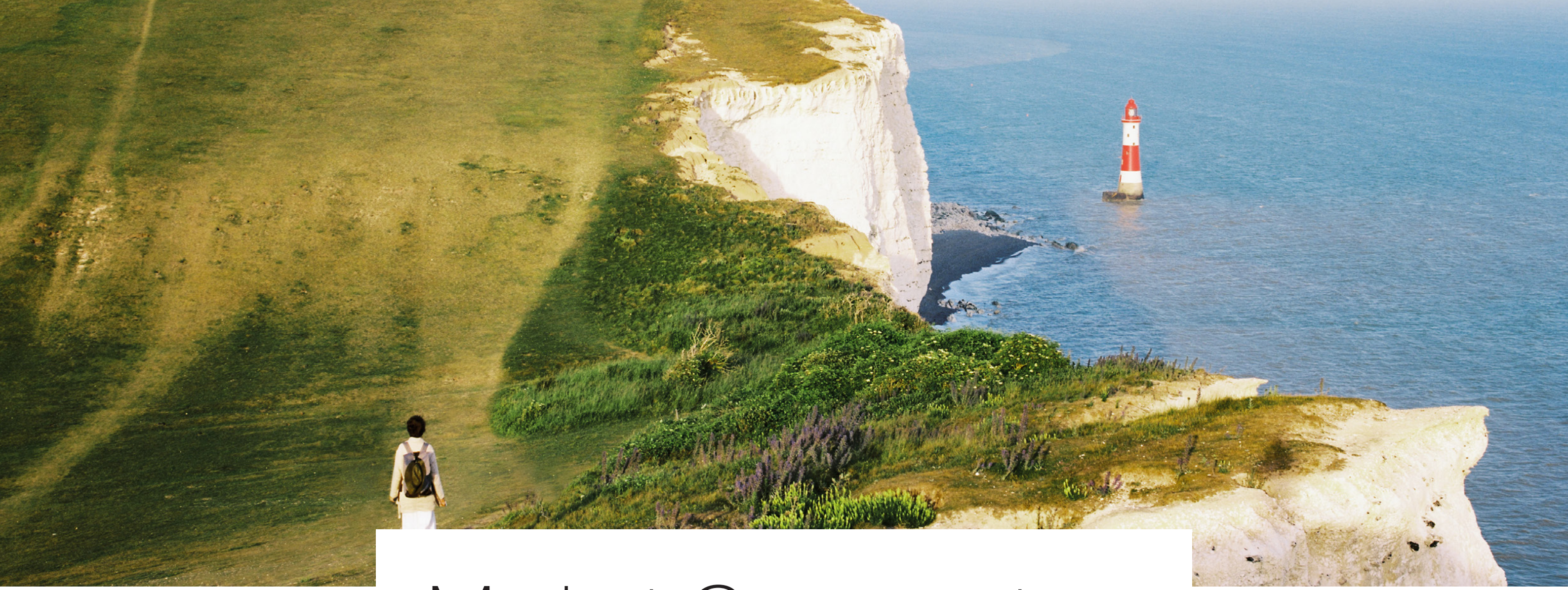

Market Commentary

| 31st December 2020 |

Overview

It is traditional at this time of year for our commentaries to include a brief retrospective of the previous twelve months, as well as an assessment of current conditions combined with some prognostication about the year ahead. Often the first element can be covered by a few statistics illustrating how various markets and asset classes have performed. This year, however, simple numbers are of limited use. They would fail fully to describe the rapid descent of nearly all financial assets in March, followed by the almost equally speedy recovery. Headline equity indices certainly do not capture the divergence of performance between the winners and losers from Covid-19. And neither would they pick up the extraordinary rotation in favour of "back to normal" plays once the first successful vaccine was announced in November. We will cover specific developments in more detail in the "Markets" section.

2020 will no doubt go down in history as the "year of Covid". Secondary to that it will also be remembered as the year of one of the most fractious US presidential elections. For citizens of the UK, it also marked our final departure from the European Union, more than four-and-a-half years after the referendum on our membership. These three factors were mainstays of media commentary – at least two of them should be less influential in 2021. Covid, though, remains very much on the front pages. At the time of writing, record case numbers are being logged in a number of countries, not least the UK and the US. A winter surge of some degree had been expected owing to the fact that the virus is more easily spread indoors, but we are also having to contend with genetic mutations that appear to have increased the virus's reproductive rate.

The numbers of people being hospitalised with Covid are also breaking beyond the highs seen at the start of the pandemic. The pressure that this is putting on healthcare systems has necessitated greater restrictions on both social and business activities, although there remains much dispute about the efficacy and long-term side-effects of such measures.

Investec

Whatever one's opinions on such matters, investors have to focus on the facts in front of them and play the cards that they are dealt. Thus, despite the almost unremitting tide of doom-laden headlines, the overall outlook for 2021 is relatively upbeat. How on earth can that be - especially when there is widespread talk of asset price bubbles? Two key factors sustained markets during 2020: monetary and fiscal policy. Neither element of support is expected to be withdrawn in 2021. That might sound like a bold statement, but it can be justified. Lessons have been drawn from the aftermath of the financial crisis, when governments were urged to cut back spending to repair their balance sheets. Fiscal prudence, couched in terms of austerity, was even something of a vote-winner. That is no longer the case. August supra-national bodies such as the International Monetary Fund have reversed their opinion and now encourage the use of fiscal support. Even the EU Maastricht Treaty's rules on deficit limits, hitherto an uncomfortable but unavoidable hair shirt, are in tatters. It is notable that in the UK every reimposition of lockdown measures has been accompanied by an extension of furlough arrangements and a host of other handouts. Not long ago being a finance minister required a Grinch-like personality - now one can be Santa Claus every day! Perhaps it is no coincidence that the Chancellor, Rishi Sunak, is the most popular politician in the UK, at least according to one YouGov survey.

Of course, at some point all this new debt will have to be dealt with, but for now it is deemed to be sustainable thanks to historically low interest rates and bond yields, both of which are being suppressed by central banks. Quantitative Easing, or the purchase of financial assets by central banks in secondary markets, was supposed to be a temporary measure in response to the financial crisis but has become part of the everyday toolkit. The US Federal Reserve even extended its remit to the ability to purchase non-investment-grade corporate bonds. The Bank of Japan is the largest buyer of its own domestic equity market. Theoretically there is no limit to their buying power. In practice, there might be.

We have often commented in the past that, at the simplest level, the direction of financial markets is largely driven by the combination of liquidity and growth. If the liquidity taps are expected to remain open in 2021, a positive factor, what about growth? Here, too, the outlook is better. First of all, whatever we might make of current "lockdowns" (a term that is bandied about liberally, although it has no clear definition), they will not have the same shock impact on activity as they did at the outset of the pandemic. We are now much better prepared, and new working practices have been established. In aggregate, according to data calculated by Goldman Sachs, in April 2020 the global economy was operating some 20% below its peak level of just a couple of months earlier. Currently it is still about 9% below its peak. Even if progress is halting in the first quarter of 2021, it will still represent a massive expansion from the trough.

Second, and more practically, we have the effects of Covid vaccines to look forward to. It was news of the first Pfizer/BioNTech vaccine that galvanised markets in November. By any measure the successful development of vaccines in such a short period of time should be regarded as a triumph. Although we are bound to encounter some speed humps, ranging from manufacturing and distribution bottlenecks to side-effect scares, the direction of travel is clear, as is the will to complete the journey. It is impossible to put a firm date on when "normal" life might resume (and, indeed, what that normality might look like), but, in many countries, things should be looking a lot better by the summer, especially when one takes into account seasonal factors. Furthermore, there is evidence of increased net savings (admittedly this does not run through all echelons of society), and the potential for a release of pent-up demand for the things we have been unable to enjoy. Financial markets, as is their wont, will look to discount the recovery rather than focusing on today's bad news.

For the sake of balance and prudence, how could this rosy scenario be blighted? Variants of the virus that were resistant to the current vaccines would be especially unwelcome, even if the manufacturers believe that they would be able to make the necessary tweaks to ensure their continued effectiveness. Still, at best, we could be looking at delays of at least several months in the vaccination programme. The other main risk would be a tightening of policy. Although, as noted above, we believe this risk to be minimal, it cannot be ignored. The main reasons that it might happen are twofold. The first is that we make a sufficiently strong recovery to obviate the need for fiscal support. That, in many respects, might be described as a "high class problem", and one which markets could take in their stride.

More worrying would be a surge in inflation expectations as demand returns, possibly running into supply constraints. This, in turn, could lead to higher bond yields, and thus more expensive funding of government debts. Furthermore, a higher discount rate would potentially undermine the valuation case for equities, especially those "longer duration" stocks that have been beneficiaries of the "stay at home" trade. Much will depend on central banks' attitude to inflation and higher bond yields. The current consensus is that they will "look through" short-term inflation spikes and also continue to suppress bond yields. Whether those courses of action create other problems of excess further down the line remains to be seen, and we will monitor those risks accordingly.

Markets

US

US equity indices led the way in 2020 (S&P 500 +18.4%). This was not down to better management of Covid or the economy, but more to do with having the right stock and sector exposure for the times. The Information Technology sector accounts for around 27% of the market's weighting. Add Amazon and Tesla (both classified as Consumer Discretionary) and one gets closer to a third. Not only were many of the companies in the IT sector short-term beneficiaries of Covid, they were also deemed to have superior "long duration" earnings streams that became more valuable with the fall in discount rates. It is hard to see the same set of cards being played again in 2021, although that is very different from saying that one should make a long-term bet against successful businesses. Even so, should a broader-based global recovery take hold in 2021, the US would be a laggard, in all probability. Within the market, leadership would pass to more cyclical sectors. Intriguingly, and worryingly for some, Professor Robert Shiller, promoter of the cyclically-adjusted price/earnings ratio (CAPE), and long-time worrier about elevated valuations, changed his tune in November, citing the attractive excess return available from equities over risk-free government bonds. An echo of economist Irving Fisher's assertion in October 1929, just nine days before the greatest crash of all, that equity prices had reached a "permanently high plateau"?

UK

The other side of the coin with the US as "heads" had the UK as "tails" (FTSE 100 -11.4%). Again, this was as much about market composition as anything, although Brexit could be blamed at the margin for holding back any enthusiasm for more domestically-oriented companies. With the risk of a "No Deal" outcome now behind us, there is potential for global investors to return to the UK after several years of net disinvestment. The market could also be bolstered by corporate predators, and we have already seen signs of interest, notably in the bid for insurance company Royal & Sun Alliance. Banks are likely to reinstate dividends in 2021, and Energy, another large sector, could benefit from global recovery, although it will also be fighting against the tide of outflows driven by environmental concerns. In a period when vaccine developments have been a primary driver of markets, it is interesting, if not ironic, that AstraZeneca and Glaxo SmithKline were the largest index point detractors from the FTSE 100 in the second half

of the year. That also offers some evidence of the discounting nature of financial markets.

Europe

Europe's big win in 2020 was agreeing a €750bn stimulus package that would be funded jointly through the issuance of an EU bond. True to form, it took some seven months from inception to ratification, but served to underline the increasingly integrated nature of EU finances. With Christine Lagarde, who has long supported greater integration of monetary and fiscal policy, now fully bedded in at the European Central Bank, policy looks set to remain supportive. A positive side-effect has been to decrease the spread of peripheral bond yields relative to those of Germany, increasing the sustainability of debt loads in countries such as Spain, Italy, Portugal and Greece. The election of Joe Biden would also appear to reduce the threat of a damaging trade war with the US. These benefits, supported by an enduring trade surplus, have been supportive of the euro. It will be interesting to see how much more euro strength the ECB will tolerate, and what action it might take.

Emerging Markets

China remains the "big beast" in EM, accounting for 41% of the weighting. South Korea and Taiwan (both 13%) are the next largest components, followed by India (8%). EM is therefore highly oriented towards Asia, which, in current times, is no bad thing, as the region has coped relatively well with Covid, thanks to strict rules (and enforcement) and the benefit of past experience with viruses. South America and South Africa, by way of contrast, have not done as well. Although there are various definitions of what constitutes "emerging" as opposed to "developed" - generally pertaining to governance, degree of access, GDP per capita, for example - they fail to provide the whole picture. China, through Alibaba and Tencent, is a world leader in mobile payments technology and usage. The world would struggle to function without Taiwan's semiconductors. Should the global economy recover as expected in 2021, EM is also well placed to benefit from a bounce in international trade. A weaker dollar, resulting from loose fiscal and monetary policy in the US, would provide the icing on the cake, as EM risk asset performance tends to benefit from such a trend.

Fixed Income

Thanks to the continued support of central bank purchases and regulation-driven institutional ownership, government bond yields remain lower than they might be if left to their own devices. The same goes for corporate bonds, where the attractions of superior income have encouraged buyers who might not normally tolerate the associated risks. This situation might well persist for a while yet. However, the returns will be low – there is not much yield to speak of, and capital gains would require yields to fall even further. This is one of the arguments put forward as to why asset allocators have little option other than to increase equity weightings.

As we have alluded to on several occasions in the past, the greatest threats to the current equilibrium in bond markets are a return of inflation and the reaction function of central banks. It's worth reiterating the point. Historically, the 10-year Gilt yield has tended to settle around the same level as nominal GDP growth. If we theorise that the UK's trend real GDP growth is around 1.5%, with inflation hitting the Bank of England's 2% target, the yield should be around 3.5%. Given the current yield of 0.24%, a move to 3.5% would deliver capital losses of around a third. Hardly what is expected of the supposedly "safe" element of a balanced portfolio. The truth is that we do not expect central banks to allow this to happen – at least not quickly or in a manner that would disrupt financial stability. This will continue to force investors to take more risk to generate any sort of real return.

UK Gilts have delivered a total return of 0.63% over the last three months and 8.27% over the last year. Index-Linked Gilts returned 1.1% and +10.47% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.71% in sterling over the three months to end December (1.92% over 12m). Global High Yield bonds delivered -1.82% (+3.72% over 12m).

Conclusion and Outlook

Perhaps one of the great faults of the financial services industry is the desire to assign simple labels to everything. We are familiar with the increasing levels of polarisation within politics – Remain vs Leave; Republican vs Democrat, for example – in which there is little tolerance for the views of the other side. In markets this plays out in the arguments between "value" and "growth" investors; between the merits of "cyclicals" and "defensives"; between supporters of emerging vs developed markets. Currently it is also seen in the daily swings in the fortunes of companies that represent "work from home" and "back to the office". Our framework is agnostic to the label, and focuses more on the ability of a business to generate a decent return on capital relative to its cost of capital, and, crucially, how the future stream of cash flow is valued today.

The longer term challenge for investors will be to generate returns in a balanced portfolio sufficient to meet their future needs from a starting point of very low prospective returns from the fixed income allocation. To use the industry jargon, investors will have to spread their net wider to "extract risk premium". That means exposing oneself to higher volatility, which one must always consider relative to one's investment horizon. The longer the horizon, the more risk and volatility that can be tolerated. Return without risk is not an option. Or, as the great Wayne Gretzky put it in ice-hockey parlance: "You miss 100% of the shots you don't take".

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