Investec

Market Commentary

August 2020

Overview

Neuroscientists suggest that humans need to have some knowledge of and control over just three specific factors to reduce their levels of stress. These are outcome, path and duration. In simple terms: Where are we going? How are we going to get there? And how long will it take? Such questions seem particularly applicable during the Covid outbreak, with the answers affecting government policy, economic behaviour and investment activities.

If one looks back to March, it is fairly clear that nobody had any real clarity on any of these issues. At a personal existential level nobody was going anywhere; whatever journey lay ahead of us featured the possibility of economic catastrophe and an overwhelmed healthcare system; and, despite initial hopes that lockdowns would be short, sharp and effective, the prospect of having to live with the threat of the virus stretched out beyond any comfortable time horizon. In retrospect it is hardly surprising that financial markets entered a tailspin.

Where are we now? It is fair to say that a huge amount of uncertainty persists. For example, in a recent survey conducted in the United States by Pew Research on the willingness of parents to send their children back to school, a third of respondents said “yes, as soon as possible”; a third said “definitely not for the foreseeable future”; while the other third replied “please, just tell me what to do!” Even so, views amongst investors are coalescing around some sort of timeline for living with the risks of the virus and the potential for a vaccine. In the latest Deutsche Bank fund manager survey a majority of respondents expected some form of strict social distancing to be with us for the next year, while 75% expected a vaccine to be available within a period of six to eighteen months. Admittedly that is quite a broad timeframe, but it does give us some parameters within which to work and to have some idea of what is currently discounted in markets.

We always underline the fact that markets tend to look ahead, sometimes by quite a considerable time, but it has been instructive to see the publication of second quarter Gross Domestic Product (GDP) data for several countries in the last month. Even if the trough of activity was generally reached in April, followed by a strong bounce, the second quarter overall will go down in history as the worst experienced in modern times. The euro zone, for example, suffered a contraction of 12.1%, ranging from -18.5% in Spain to -10.1% in Germany. The United States’s economy fell by 8.3%. We still await official data from the UK, but a figure of around –19% is expected. Only China amongst major economies managed to deliver a positive performance (+11.5%) in the second quarter, thanks to having been an early victim of the virus.

The third quarter, running from July to September, will almost inevitably see a decent recovery, but the pace and “shape” of that recovery remains a matter of much debate. Although the much-prized “V”-shaped bounce was widely experienced immediately following the nadir, this was as much a function of the depth of the recession as the strength of the recovery. If activity in a sector of the economy drops 90% and then doubles, it is still down 80%, after all. Now, with localised lockdowns and new quarantine conditions being reimposed following further outbreaks of the virus, the recovery seems to be flattening. There are even concerns that activity might turn down again, delivering the dreaded “W”-shaped trajectory.

Much now hangs on the response of governments. In the UK and Europe, furlough schemes have dampened the rise in unemployment, but even the UK Chancellor has acknowledged that they cannot be extended in perpetuity (although proponents of policies such as Universal Basic Income believe that its time has now come). It is also becoming clear that many high-profile High Street businesses are being forced to implement permanent job cuts at a time when job vacancies have plummeted. Difficult choices lie ahead between adding to an already mountainous fiscal deficit and letting the effects of Covid take their course. We believe that governments will continue to err towards the former course of action, although that will have its own eventual consequences, discussed below.

This “fiscal cliff” is most proximate in the United States, where the first wave of unemployment benefits and cash handouts is expiring and where Congress (at the time of writing) continues to be unable to come to an agreement about a new stimulus package. Again, though, we feel that the politicians will have little choice but to open the chequebook. This is especially the case ahead of the election. The incumbent Republicans need a stronger economy to have a fighting chance; the challenging Democrats don’t want to be seen to be impeding a recovery. For more on the US election, please see the “US” section below.

Investors’ biggest allies in the financial fight against Covid have been the world’s central banks, who have slashed interest rates (inasmuch as they were able to from a low starting point) and re-initiated asset purchase programmes with gusto. These measures were initially taken to provide liquidity to markets when it briefly evaporated in March. Subsequently, though, they have provided the demand required to soak up the burgeoning supply of sovereign debt issuance which has been needed to shore up households and businesses. While this has been convenient for all parties in the short term, it does raise the question of what happens to all that debt in the future. Previous attempts to reverse quantitative easing programmes have not gone well, with the resulting tightening of liquidity leading to sharp falls in asset prices.

At the extremes, the outcomes could be either highly deflationary or inflationary. In the former case the levels of debt would overwhelm the ability of debtors to service their obligations, leading to widespread bankruptcies. In the latter, inflation could be engineered by governments and central banks to reduce the real value of debt over time through a process known as financial repression. The latter course, painful as it would be for responsible savers, is generally deemed by policymakers to be the lesser of two evils. Both will require some creative asset allocation on the part of investment managers to maintain the real value of portfolios.

For all the pain that has been suffered, though, there have been some outstanding winners from the crisis so far, and these are growth stocks, mainly in the Technology sector, which have benefitted from the accelerated adoption of online behaviour from internet shopping to working from home. Years of potential future progress have been compressed into months. Furthermore, the value placed on the earnings of these companies has been turbo-charged by collapsing bond yields. While one cannot deny the rosy prospects for such companies, it is harder to envisage yet another dramatic re-rating ahead. In other circumstances, one might look to the cheaper sectors of the market to take up the running, but their fate is closely tied to Covid-related developments and therefore difficult to predict with any certainty. Two of the largest, optically cheapest, and worst performing sectors are Banks and Energy, but both have major problems to overcome to regain the full faith of investors. Banks will struggle to earn decent returns on capital in a low interest rate, flat yield curve environment; while Energy companies must grapple with the transition to a greener economy.

Markets – UK

UK Equities continue to lag many other major markets owing to a lack of exposure to the Technology sector and an overexposure to Banks and Energy. Both of the latter will contribute heavily this year to a sharp

reduction in dividend payments. Unhelpfully, the UK is also deemed to have been less effective than many countries in containing Covid. Almost unnoticed, the deadline for requesting an extension of the Brexit transition has passed, thus leaving only a narrow window within which to negotiate trade terms. The sides remain unable to agree, most notably, on fishing rights and the concept of the "level playing field" which pertains to regulatory standards. The possibility of a "no deal" Brexit at the end of the year, in which we fall back on World Trade Organisation standard tariffs, cannot be dismissed, and would be unwelcome to British businesses already suffering from the effects of the virus.

US

The US equity market has been the stand-out performer this year, mainly thanks to the gains made by the four biggest stocks, Apple, Amazon, Microsoft and Alphabet (Google). It is fair to say that no other market contains such a concentration of heavy-weight global leaders in industries that have benefitted from Covid, and so one must take that into account when comparing performance across markets. One could say that the US market has performed well despite the poor showing of its political leaders, and they will be under increasing scrutiny as we approach the presidential election in November. Currently Joe Biden, the Democratic challenger, is well ahead in polls, most importantly with a lead in the decisive swing states. The odds also marginally favour a "blue wave" sweep of all three seats of power – the House of Representatives, the Senate and the White House. Under normal circumstances the potential for the easy passage of more left-leaning policies would be undermining investor confidence, but the presidency of Donald Trump has been anything but normal in the eyes of many, and the more diplomatic approach to foreign policy expected of Biden would be welcomed. Even so, there is potential for volatility ahead, especially if the President contests an adverse result, as he has threatened to do.

Europe

Europe continues its rehabilitation in the eyes of investors, and this has been most notably seen in the appreciation of the euro against the dollar. It has risen from a year's low of $1.07 to $1.18. This has happened for a number of reasons. US interest rates have fallen further, thus closing the interest rate differential; the European Central Bank, unlike during previous crises, was fast to act in providing stimulus and support to the banking sector; the EU has finally managed to pull together a stimulus package that will be supported by euro-denominated bonds; Europe is deemed to have dealt with the coronavirus in a relatively efficient manner (which has, unlike in many other regions, increased support for incumbent leaders); and Europe's economy is seen as more positively exposed to a potential global recovery. No doubt Europe retains a number of longer-term structural problems, including weak demographics and financial imbalances within the euro zone, but cyclically it looks better placed to take advantage of any incipient post-virus recovery.

Emerging Markets

China remains the lead performer amongst emerging markets in 2020. It was first into the coronavirus crisis as well as first out and the government has applied plenty of stimulus to the economy, especially in terms of kick-starting infrastructure projects. However, it has been more difficult to persuade consumers to revert to their previous spending habits, and there has been a divergence in the recovery between the manufacturing and service sectors. A strong economy remains the bedrock of the Communist Party's ability to rule without social disruption, and therefore, if past form is any guide, it will continue to provide stimulus as required. Generally across emerging markets, the most welcome development has been a near 10% fall in the trade-weighted value of the US dollar, which amounts to a significant loosening of liquidity for those countries and companies with large dollar obligations. A weaker dollar has also, historically, been a signal of higher confidence in the global economy, which tends to augur well for EM on a relative basis.

Fixed Income

Both UK and US ten-year sovereign bond yields hit new all-time lows in July, falling to 0.08% and 0.52% respectively. That might seem at odds with the recovery in economic activity from April's low point and also the high levels of debt issuance to support fiscal stimulus programmes, but speaks more to the expectation that the respective central banks are destined to keep interest rates very low for several years. Indeed, futures markets are speculating that they might even have to set negative rates in the event that the recovery stalls.

Another feature of recent weeks has been the recovery in expectations for future levels of inflation, although they have hardly reached alarming levels. In the US, for example, the ten-year breakeven inflation rate (effectively the difference between nominal and index-linked Treasury yields) has risen by around 1% to 1.58% since March's low. This is partly down to the fact that a deeper recession was averted, but also to potential changes in Federal Reserve (Fed) policy. Whereas historically the Fed was focused on not allowing consumer price inflation to rise beyond 2%, it is now contemplating allowing inflation to average 2% over an economic cycle (although the period has yet to be properly defined). The idea is that inflation will "run hot" to make up for previous shortfalls.

It is hard to shake off the feeling that we are the subjects of a radical monetary experiment with unknown consequences. Remember that Quantitative Easing and zero-interest rate policies were meant to be temporary measures to deal with the aftermath of the financial crisis and they are now seen as a standard element of the central bank tool kit. Given that overall debt ratios are now even higher, it would be wise not to rule out even more extreme policy measures being adopted. These bring with them the risk of mistakes which will be harder to bear given the lack of income.

UK Gilts have delivered a total return of -0.11% over the last three months and 9.38% over the last year. Index-Linked Gilts returned 5.78% and 6.96% over the same respective periods. Emerging Market sovereign bonds produced a total return of 8.69% in sterling over the three months to end July (-4% over 12m). Global High Yield bonds delivered 8.01% (-4.8% over 12m).

Conclusion and Outlook

News flow has inevitably been dominated by Covid-19 for much of this year, and that seems set to continue. The market has done its usual efficient job in sorting out the initial winners from the losers, although investment opportunities will be thrown up in cases where gains and losses have been over-extrapolated. Much will depend on the development of a vaccine, and its wider availability. We retain some optimism that the financial and intellectual firepower being directed at the problem increase the chances of a successful outcome, but are insufficiently confident to want to be overweight risk assets within a balanced portfolio. However, we are also of the opinion that the worst of the downturn is well behind us, and therefore happy to retain a full weighting to equities, with a continued bias towards companies with stronger balance sheets that are capable of generating consistently high returns on capital.

The Brexit denouement, the US presidential election and the ongoing trade and diplomatic tensions between the US and China appear to be the main topics that could provide some distraction from Covid during the rest of the year, although they hardly represent light relief. It is clear from investor surveys, though, that these worries are well recognised and therefore represent what we would now term "known unknowns", with, hopefully, limited capacity to deliver nasty surprises.

John Wyn-Evans
Head of Investment Strategy

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have positions or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. Copyright Investec Wealth & Investment Limited. Reproduction prohibited without permission.

investecwin.co.uk

Member firm of the London Stock Exchange. Authorised and regulated by the Financial Conduct Authority. Investec Wealth & Investment Management Limited is registered in England. Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.
IWI553 v1 08/20