Market Commentary

| 30th November 2020 |

Overview

The first ten months of 2020 had already provided sufficient excitement to satisfy a whole career in the City… and then came November! Thankfully, the catalysts for the month's activity were generally positive – at least for the majority of investors, if not for Donald Trump. His defeat in the US Presidential election, admittedly still to be conceded or formalised a month later, provided the first boost to risk assets. This was quickly followed, on three consecutive Mondays, by the release of data from a trio of SARS-CoV-2 vaccine trials, all of which reported efficacy rates well above levels that the majority of investors had dared hope for. Let us examine the effects of these developments in more detail.

The election had been a constant source of anxiety for months, a concern reflected in the elevated levels of futures on the VIX volatility index. Although opinion polls and betting markets had Democrat challenger Joe Biden pegged as a firm favourite, there was a persistent element of doubt. After all, memories of Mr Trump's "surprise" victory in 2016 remained fresh. Furthermore, there were fears that even if Mr Biden prevailed, the incumbent would challenge the vote and even encourage widespread disruption. According to a Goldman Sachs client survey in October, a "contested election" was the greatest risk to the equity market's equilibrium.

As it turned out, Mr Trump's efforts to pursue victory through the courts were consistently rebuffed and peace prevailed in the streets, allowing investors to focus on the benefits of his defeat. These include the expectation of a less contentious background for global trade, a factor that encouraged an immediate rally in several non-US markets, notably in the emerging world, but also in Europe. Of course, not everything is resolved. Apart from the drawn-out confirmation process for the Presidency, we also await the result of two run-offs for Senate seats in the state of Georgia, which will take place on 5th January. These are crucial to the final composition of the legislative branch of government. The Democrats have maintained control of the House of Representatives, but control of the Senate hangs in the balance. The

Republicans currently have 50 seats to the Democrats' 48. Should the Democrats win both remaining seats, they would achieve parity, with Vice-President-elect Kamala Harris holding the casting vote.
Although this would not truly represent the much-heralded "Blue Wave", which would have allowed the Democrats to pursue a more "progressive" agenda, it would still represent a shift further to the left. A new Democrat Senate Leader might also appoint rather less business-friendly Senators to various committees, with the names of former presidential hopefuls Elizabeth Warren and Bernie Sanders to the fore. Characters such as this would raise the threat of tighter regulation on industries such as Technology and Banking. Should the Republicans maintain control by winning just one of the Georgia seats, we can look forward to at least another two years of political stalemate.

This could be a mixed blessing. On the one hand, it would tether policy more towards the centre; on the other, it might create obstacles to some of Mr Biden's more stimulatory policies, as well as scupper the passing of a decent-sized support package for those affected by Covid-19. Even so, the difference between the two outcomes looks much narrower than was the case in the Presidential election, and therefore we expect minimal market disruption, although polling data from the Peach State might cause the odd wobble over a thinly-traded holiday period.

While Covid-19 is far from behind us, positive news on the development of vaccines provided equity markets with another strong boost. Although we had been expecting trial results to start being released around this time, what very few had anticipated was that the efficacy of the first vaccines would be greater than 90%. Not only might this encourage more individuals to be inoculated, but, critically, it should make it easier to achieve herd immunity. Armed with this information, investors were able to begin to plot a path out of the current socially restricted world.

While the vaccines will not provide immediate protection to all – owing to the logistical challenges of distribution – they have created some light at the end of what was becoming a very long and dark tunnel. There is optimism that activity can return to some sort of normality by the summer of 2021.
Testament to the game-changing nature of these announcements can be found in the extraordinary moves witnessed in various markets during November.

Deutsche Bank's monthly review of 38 non-currency asset classes reveals that 34 of them delivered positive returns, with only safe havens such as Gold, Silver and British and German government bonds losing ground. Europe's STOXX 600 Index posted the best monthly gain (13.7%) in its history. Global equity indices made new all-time highs.

But even those headline numbers fail to capture the more extreme price movements within markets. Companies and sectors most affected by Covid-related restrictions leapt higher, especially those with more stretched balance sheets which were at risk of running out of funds if lockdowns persisted for too much longer. Indeed, there was a biblical air to proceedings along the lines of "the last shall be first, and the first last". More details of the relative movements can be found in the regional sections later in this commentary.

Such is the nature of markets, though, that many are already becoming concerned that all of this positive news might be too much of a good thing. Chief amongst the concerns is that a combination of enduring fiscal stimulus and a resurgence of demand might cause a burst of inflation. Certainly the low prices for many goods and commodities during the economic trough this year create a base effect that pretty much guarantees rising consumer price indices in 2021.

Of course, this is what central banks have spent much of the past decade trying to achieve. The question now is how much they will be prepared to tolerate. And also will higher inflation be more than just a one-year phenomenon?

Breakeven rates - indicators of the market's expectations for inflation which are derived from the prices of government bonds - are barely above where they were at the start of this year, although they have rallied strongly from the lows and appear to be trending higher. In the longer term, it is undeniable that the greatest disinflationary impulse from the growth in global trade and the outsourcing of labour to cheaper locations is behind us. Case closed, then? Not necessarily. Conversely it can also be argued that record high levels of global debt will weigh on activity (and therefore inflation), and there are always the persistent deflationary effects of technology advances and ageing populations to consider.

Perhaps the key consideration will be the response of central banks. If, as has been suggested by the US Federal Reserve (Fed), they are willing to allow inflation to "run hot" for a period to make up for past shortfalls relative to the 2% target, then financial assets can continue to prosper for longer.

If one combines that with an expected resurgence in corporate profitability next year, it will be right to remain fully invested for the time being.

Markets

US

Having led global indices higher for most of the last decade, the US equity market finally took on more of a supporting role in November, although it still powered to new peaks. This did not reflect any great pessimism about America's prospects. Indeed, if anything, the outlook for the economy next year has been enhanced. The main reason was market composition.

The relatively low growth and low inflation world of recent times had already contributed to the strong outperformance of companies with higher, more sustainable rates of growth. This group was epitomised by Technology stocks in particular, with their high margins and strong returns on capital creating an even greater attraction. These comprised almost 30% of the index pre-election/pre-vaccine. To that you can add other FAANG members such as Amazon (Consumer Discretionary), Facebook, Alphabet and Netflix (all Communications Services). Momentum had also been a factor in pushing this group to its most recent highs, and that evaporated spectacularly once the first vaccine trial data was released. Instead, investors gravitated towards companies that might recover along with the economy. Thus, the leading sector in November was Energy (+26.6%), followed by Financials (+16.8%). But Energy's long-term demise meant that its weighting was a mere 2.6% to start with, meaning that its overall influence on indices was limited.

UK

It seems incredible that, with just a month to go before the end of the transition period, we still have no definitive answer on the post-Brexit trade deal. We discussed the ramifications of either outcome (deal or no deal) last month, and they still hold true. Presumably we will have something more concrete to report next month. More happily, UK equities were a beneficiary of the vaccine news, mainly because the index is so heavily represented by Financials, Energy and Materials – almost 40% of the FTSE 100.

Brexit uncertainties suggest that global investors remain wary of committing themselves fully to the rally, and so there is potentially more upside ahead. One other tailwind for the market next year will be the potential return of Banks to the dividend-paying roster. Should that be the case, a yield of around 4% will appear attractive, especially relative to cash (0.1%) and 10-year Gilts (0.3%). However, in the longer term, it is not clear that the UK has a sufficiently high concentration of world-leading growth companies to merit a structural overweight.

Europe

Europe also benefitted from the market's internal rotation. Indices in Greece, Spain and Portugal, heavily weighted towards Banks, led the charge. These markets also enjoyed the tailwind of lower bond yields, as European Central Bank

(ECB) buying continued to compress spreads against, for example, German Bunds. Hard as it might seem to believe, less than a decade after the regional sovereign debt crisis, Portugal's 10-year bonds briefly sported a negative yield to maturity.

Joe Biden's victory was also a blessing, as it promises to thaw relations between the two trading blocs and lift the threat of punitive tariffs. But let us not be under any illusions. Europe is one of the more demographically challenged regions (alongside Japan), and will find higher trend growth and inflation harder to achieve because of that. Judicious stock-picking will be the key to long-term excess returns.

Emerging Markets

There is a substantial group of "China-watchers" who have been predicting the demise of the country, its economy and its ruling Communist Party for as long as one can remember. We can only assume that they are somewhat miffed by the success of China's response to Covid-19, especially as China looks set to outperform the rest of the world in terms of growth. The OECD's latest assessment predicts that China's GDP will be almost 10% above its end-2019 level by the end of 2021. Next on the list is South Korea at just 2%. Of developed economies, only the United States (barely) scrapes into positive territory over that period. Still, it's a known psychological trait of humans to double down on their views in the face of facts that don't support their opinion – a phenomenon known as the "Backfire Effect". It's not unlike "Confirmation Bias' – just worse. The latest iteration of this is to point to the increase in corporate defaults this year – some even in State-Owned Enterprises. We last commented on this trend as far back as 2014, suggesting that, to borrow a Chinese proverb, it was the equivalent of "killing a chicken to scare a monkey". This holds that a low value item can be sacrificed to send a message to something larger and more dangerous. China appears to be using its current period of relative strength to sacrifice a few expendable corporate entities in the name of warning other, larger ones to rein in their excesses. Theoretically, this will have the effect of extending the cycle without creating bubbles. We continue to believe that the Chinese economy has more open road ahead.

Fixed Income

Government bonds were surprisingly resilient in the face of such positive developments for risk assets, which was, primarily we believe, down to the incessant purchases by central banks. The Bank of England increased the ceiling for its purchases by £150bn at its November meeting. Possibly not coincidentally, the Chancellor announced a plethora of extended and new fiscal support packages at the same time. The ECB is set to increase its Pandemic Emergency Purchase Programme in December. Joe Biden has nominated ex-Fed chair Janet Yellen as his Treasury Secretary. We are of the opinion that central banks and Treasury departments are increasingly joined at the hip. Whether one chooses to call this Modern Monetary Theory is a matter of taste. It certainly has most of the attributes.

Because of this, as was alluded to earlier, the inflation debate rages. As does the one about the integrity of fiat currencies. In other circumstances we might expect government bond yields to be substantially higher. Historically, the 10-year Gilt yield has tended to settle around the same level as nominal GDP growth. Obviously 2020 has been an outlier, but let us theorise that the UK's trend GDP growth is around 1.5%, with inflation hitting the Bank of England's 2% target. That would suggest a 3.5% yield. That would have very negative connotations for balanced portfolio returns, delivering severe capital losses to bondholders and forcing a derating of equities via a higher discount rate. Which might well be why it won't be allowed to happen, at least not until the global economy is on a much surer footing. Such high bond yields would also substantially increase the interest bills for governments on newly issued debt – something that would be highly unwelcome. Remember that Quantitative Easing and zero-interest rate policies were supposed to be temporary emergency measures in the aftermath of the financial crisis. We should not be surprised to see them endure well into this decade too.

UK Gilts have delivered a total return of 0.48% over the last three months and 5.12% over the last year. Index-Linked Gilts returned 2.25% and +8.09% over the same respective periods. Emerging Market sovereign bonds produced a total return of 2.4% in sterling over the three months to end October (2.97% over 12m). Global High Yield bonds delivered -0.12% (+4.43% over 12m).

Conclusion and Outlook

Events during November provided a welcome reminder that market-influencing news can also be positive. It would have been very easy this year to become a lot more defensive in one's asset allocation and not to have participated in the post-March recovery.

Financial markets tend to looks months, if not years, into the future. What they hate most is uncertainty, and it was that, combined with an evaporation of liquidity, that created March's air pocket. Liquidity was immediately restored courtesy of central bank intervention, catalysing the first leg of the recovery. Now we look set to embark on the next leg as certainty grows about life beyond Covid. At the same time the human race can also take some pride in the scientific advances that have enabled the development of vaccines in record time.

Of course it will not be straightforward. The colder months of winter in the Northern Hemisphere, along with seasonal festivities, are tailor-made to produce more opportunities for the virus to be transmitted, leading to the potential for further social restrictions. More high-profile High Street brands will probably be forced into administration or painful restructuring, with the ensuing threat to jobs. But those businesses that survive will have the opportunity to prosper again; and those that have done well through the crisis can build on that performance. As ever, short-term concerns will continue to provide well-informed investors who have a longer investment horizon with a wealth of opportunities.

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