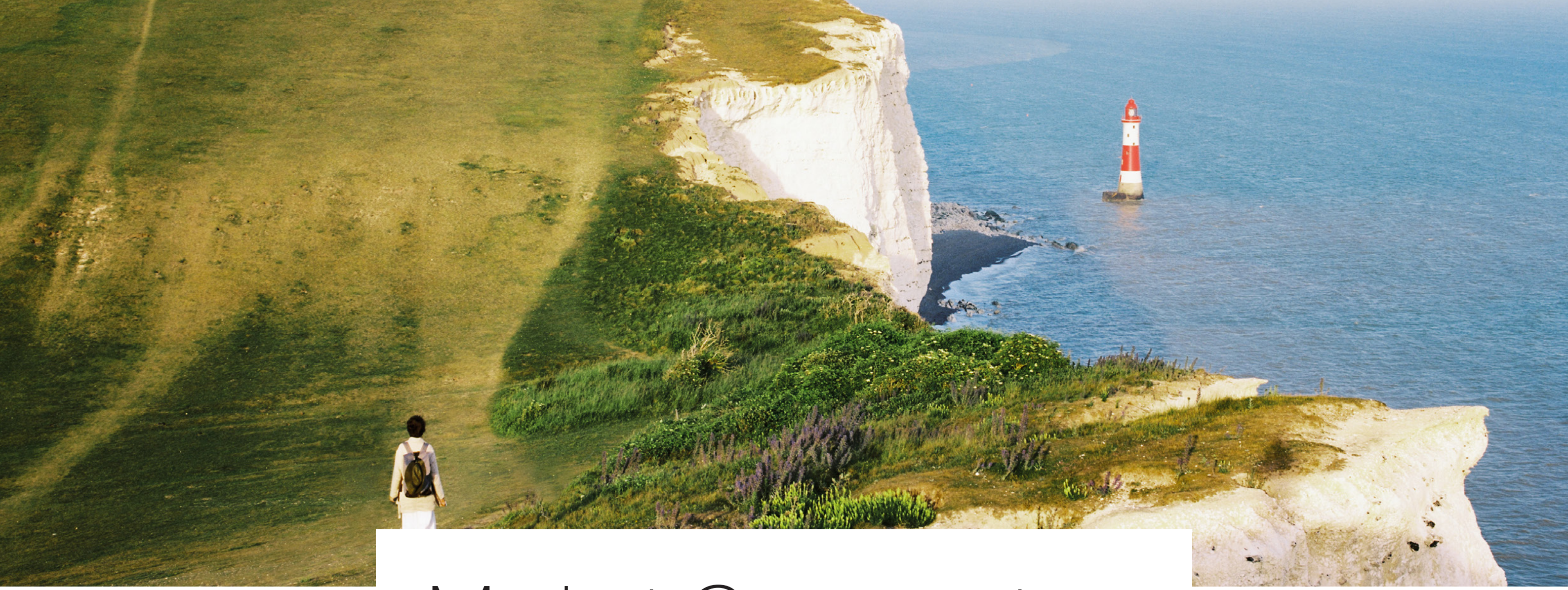

Market Commentary

| 31st January 2021 |

Overview

As January goes, so goes the rest of the year. That's the view of some stock market commentators, and is also a useful investing short-cut for those not willing to put the hard yards into their analysis. Even so, as you will read in the United States section below, there is some statistical support for the claim, and so many will give it credence.

January certainly provided little respite from the squalls that buffeted us through 2020, and although some of the major uncertainties that were overhanging financial markets through the final quarter of 2020 have been reduced, they have not necessarily been entirely resolved. The effects of Covid-19, US political unrest and Brexit come immediately to mind of the more event-driven factors, but longer-term challenges including climate change and social inequality are ever present. We also experienced two bouts of revolutionary behaviour in the US: first with the storming of the Capitol; then with retail investors who upset the established order of things with their attack on short positions in a number of, supposedly, unattractive companies. More positive constants were the soothing tones of central bankers and finance ministers, who remain committed to providing support to the financial system and the economy.

The first big event of 2021, which set an initially positive tone for markets, was the Democratic Party's victory in both Senate run-off races in Georgia. This tied the Upper House at 50/50, with new Vice-President Kamala Harris holding the casting vote. The cause for celebration was two-fold. Uppermost in investors' minds was the prospect of increased stimulus for the economy, with notable support for long-term projects tied to infrastructure and decarbonisation, as well as more funds to tide citizens over the Covid crisis. Second was the fact that such a slim majority would water down the threat of more socialist or "progressive" policies, such as tax increases. With bond markets still seemingly willing to pick up the bulk of the stimulus bill, the stage was set for upgraded growth expectations.

At that juncture, of course, markets were still facing Donald Trump's denial of Joe Biden's Presidential election victory, a state

of affairs that culminated in an angry mob storming the Capitol in Washington. Although the event was undoubtedly shocking and created widespread media coverage, it barely registered in financial markets, with investors taking the view that it would have little bearing on the final outcome of the election or on the wider economy. Thus it proved, and Mr Biden eventually moved into the White House on schedule on 20th January. We continue to await agreement on the next Covid-related stimulus package, with a substantial gap remaining between the Democrats' proposal of $1.9 trillion and the Republicans' counter-offer of $618 billion. Market expectations continue to centre on a final figure of around $1.1 trillion. Unfortunately this sort of horse-trading is likely to remain a feature of Congressional activity at least until the mid-term elections in 2022, creating the potential for higher volatility.

Unsurprisingly, the influence of Covid remains hard to escape. November's vaccine-related euphoria has given way to a less optimistic mindset. The key concerns revolve around variants and the timescale for achieving herd immunity through vaccination programmes. Virus mutations were to have been expected, as viruses tend constantly to adapt in an effort to optimise their ability to spread. More gratifyingly, though, they also need to ensure that their hosts – in this case humankind – survive to be able to continue transmitting the virus. Thus, over time, and given sufficient opportunity to mutate, it is not unreasonable to think that Covid's current existential threat will diminish. However, in the meantime we are still faced with the current rapid spread and the risk that healthcare systems are overwhelmed, hence the need for the imposition of more restrictions on social activity.

The fact that lockdowns have been imposed once more, and, in many cases, especially in Europe, extended, has delayed the "great re-opening" of economies, which has led to a hiatus, or even reversal, in the outperformance of sectors and stocks that are most exposed. No doubt some companies will find their cash resources in danger of being exhausted, leading to the need to raise more capital; others will fail completely. However, we remain of the opinion that the path and outcome of the vaccine-drive recovery are firmly established – it is only the duration that is in question. In this regard, we continue to have faith in the ability of the scientific community to counter the threats of Covid variants in the long term. It is also worth noting that the UK is a global leader in the testing of genetic variations, which might give us a lead in combatting the risks. That being the case, investors will have to display a little patience, particularly if other countries are slower to adapt, leading to a real possibility of extended curbs on international travel, but now is not the moment to throw in the towel. It is clear that aggregate household savings have been built up substantially, given limited opportunities to spend, promising a release of pent-up demand of epic proportions for hospitality and events.

January's other excitement involved a narrative worthy of a conspiracy theory-driven film or television series, namely the GameStop saga – although "flash-in-the-pan" might be a more accurate label. Still, it caused a few days of ructions, which were manifested in in the reversal of major global equity indices. The popular narrative has it that a fearless band of retail investors in the US ganged up on the hedge fund industry to exert a squeeze on their short positions in GameStop shares (and then others) – that is to force them to buy back shares that they had sold (but crucially did not own previously) in the belief that the company's fortunes were on the wane. Leaving aside any debate about the morality of short-selling, that was not an unreasonable position to take, given that GameStop is a physical retailer of video games, a service that has substantially migrated online – think Blockbuster Video vs Netflix et al. In reality, it looks like an exceptionally well targeted and executed operation by an individual or small group who then recruited an army of retail investors to provide the necessary firepower. Many of these investors will have been motivated by an opportunity to make some quick-and-easy profits as well as by the boredom of sitting at home waiting for Covid to go away, all funded with cheques from the government. Some were undoubtedly roused to revolution by the promise of bringing down a hedge fund – still the bêtes noires of the financial industry in the eyes of many – and possibly even the whole capitalist edifice. Suffice to say that they failed, although a few bloody noses were suffered.

Remembering what happened at the Capitol, it is hard to escape the suspicion that there is a substantial minority of the US population that is angry at the scale of inequality and lack of opportunity (although some of them, as in the days of football hooliganism, are probably just in it for the fighting). In 2016 the US electorate thought that Donald Trump would provide the necessary rebalancing, and now that baton has been passed to Joe Biden and the Democrats. If he has listened, there almost inevitably lies some redistribution of wealth ahead, but probably not to the extent that successful companies that are good stewards of capital will not continue to provide decent returns for investors.

Markets

US

The S&P 500 Index, having started the year on the front foot, ran into headwinds later in the month, ending 1.1% lower. We would not usually comment on such a minor monthly move, but stock market lore has it that the rest of the year follows the path of January. There is some statistical support for this assertion. Data going back to 1872 informs us that the market has fallen in January 53 times. On 31 of those occasions (58%) the index was down for the year – on average 14.8%. If that sounds worrying, then it was up in the other 22 years, meaning that the average performance after a down January was a more palatable -2.4%. For the record, the S&P rose in January 96 times, and maintained those gains on 75 occasions (78%). The average annual gain after the winning Januaries was an impressive 17%, or 11.2% taking the down years into account. Perhaps the key point here is that markets go up more often than they go down. In the end, this is an interesting bit of fun, but not anything to build an investment stance upon. Neither will the market's direction be defined by the outcome of the Super Bowl, which for many years had an uncanny ability to predict the stock market's direction, depending on which "conference" (i.e. league) the winner came from!

UK

With Brexit deal negotiations finally despatched to the boundary, prospective investors in UK equities have less of an excuse to continue shunning them. However, it has been hard to discern any sort of stampede into the market beyond the initial celebrations. Our past comments about the unhelpful composition of UK indices have tended to centre on the low Technology weighting (1.2% at the end of 2020, using MSCI Index data), which has done extremely well globally, and the high relative exposure to Energy (9.3%) and Financials (18.5%), two sectors that have been under a cloud for some time. It is worth pointing out that two other large sectors have also struggled to perform recently, mainly, it appears, because they lack the short-term characteristics currently in favour with investors – either out-and-out growth, or the potential for rapid gains in a post-Covid recovery. These are Consumer Staples and Healthcare, with the latter also mistrusted ahead of possible policy changes by the new Biden administration. The good news is that both Banks and Energy are candidates to benefit from recovery, and that Staples and Healthcare continue to generate strong compounding returns that will be valued by longer-term investors.

Europe

It says much about investors' faith in the EU's fiscal stimulus package and continued support of the European Central Bank (ECB) that the latest collapse of an Italian coalition government caused barely a ripple in markets. The yield

spread of Italian government bonds remains close to its low point against the German Bund, and the euro has been stable. This is in stark contrast to the recent past. This time the diminished threat of power being wrested away from the centre by the more radical parties is helpful too. At the time of writing, the task of forming a new technocratic government has been handed to former ECB President Mario Draghi, the man credited with saving the euro with his "whatever it takes" speech in 2012. He is viewed as a safe pair of hands. Meanwhile, with the Italian government's poor response to Covid having been a catalyst for the collapse of the coalition, Europe as a whole is struggling to get up to speed in terms of vaccine distribution, partly owing to its own more conservative approach to vaccine approval as well as insufficient supplies. We continue to believe that these shortfalls will be rectified in good time.

Emerging Markets

The secular arguments for investing in Emerging Markets are well rehearsed: an expanding middle class; generally younger populations; the adoption of western habits of consumption. To those one can add the cyclical opportunity of a post-Covid recovery, which will tend to boost overall levels of global trade, to which EM is more exposed. The sheer size of China in the index (40%) means that developments in that country will be key to performance, although our favoured managers continue to identify attractive opportunities in smaller countries, many of which have fared exceptionally well during Covid. The election of Joe Biden, furthermore, provides the potential for a less confrontational attitude to global trade. China itself is conflicted between damping the more speculative areas of the economy, notably real estate and some parts of the stock market, and maintaining strong consumption by a population that still saves almost half of its income. China showed the rest of the world a clean pair of heels in terms of economic growth in 2020, and the performance gap will inevitably close in 2021. But we do not expect the government to put the brakes on too hard.

Fixed Income

Having had to contemplate a deflationary shock in March 2020, the bond market has shifted 180 degrees and is now starting to worry about inflation. This is most evident in the "breakeven" rate, which is derived from the difference between the yields of conventional and inflation-linked bonds. In the US, this has bounced from a low of 0.55% to 2.16%; in the UK from 2.67% to 3.14%; and in Germany from 0.23% to 1.13%. Hardly the 1970s, but such trend changes can unsettle markets. Thus we have seen bond yields rise from their lows, although they remain capped by central bank intervention.

The next big challenge will emerge as we enter the second quarter of 2021, when inflation prints will be compared with the low outcomes a year earlier. These will be exacerbated by short-term supply constraints which have been evident in the prices of, for example, shipping containers, semiconductor chips and even cardboard boxes. It is expected that headline US inflation could approach or even breach 3%. The number in the UK could be even higher if unanticipated Brexit-related "red tape" costs find their way into prices. It remains our opinion that this will represent a temporary spike, although it is quite possible that expectations of future inflation will rise with current readings, upsetting markets for a period.

UK Gilts have delivered a total return of -0.1% over the last three months and 2.8% over the last year. Index-Linked Gilts returned -2.68% and +2.88% over the same respective periods. Emerging Market sovereign bonds produced a total return of -2.49% in sterling over the three months to end January (-1.92% over 12m). Global High Yield bonds delivered -0.54% (+2.44% over 12m).

Conclusion and Outlook

January has provided further reminders that the path of markets is rarely smooth. Indeed in any year it is typical that close to half of all trading days will result in equity markets closing lower than the previous day. We, as humans, experience the "losing" days more viscerally than the "winning days". It is important to control one's emotions and to focus on longer term outcomes, especially in the times in which we live. The temptation to time markets, to trade in and out, can be our worst enemy, and many studies have illustrated the underperformance accrued by being out of the market for just a handful of the best days. One renowned global fund manager released a study of its own accounts which revealed that its best-performing clients fell into two categories – those who had forgotten they had accounts… and those who were deceased!

There's never a bad time to remind ourselves of the words of some all-time investment greats. First, bearing in mind the travails of a few hedge funds caught up in the short squeeze, this from John Maynard Keynes: "Markets can remain irrational longer than you can remain solvent". This is most apposite to those who are running positions funded by borrowed money, which is certainly not the case for us. Next is Benjamin Graham with his aphorism that "in the short run the market is a voting machine; in the long run it is a weighing machine". This asserts that the underlying or intrinsic value of an investment will always ultimately be recognised. Finally, Graham's most famous acolyte (and now, of course, an investment deity in his own right), Warren Buffet: "Price is what you pay; value is what you get". One can do a lot worse than to stick to these three principles.

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