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# Market Commentary

July 2020

## Overview

The first half of 2020 has certainly been extraordinary in so many ways. It is perhaps ironic that many commentators entered the year using the metaphor of 20/20 vision (that opticians use to describe perfectly normal eyesight) to make their predictions. As it turned out, nobody saw what was coming. Even those who had been vocal about the risks of a pandemic could not have foreseen the full effects on financial markets, nor, even more surprisingly in many ways, the subsequent recovery. A jungle explorer, the concept of whom we evoke occasionally, returning to civilisation after a six-month expedition, might find our newly acquired social behaviours a bit odd, but a quick glance at the value of his balanced investment portfolio, little changed from December 31st, would fail to capture the drama.

If one were to tell the story of the development of Covid-19 most simply, it would go something like this: awareness, complacency, concern, panic, relief, optimism, uncertainty. Taking those in turn, we became aware of a virus circulating in China quite early in the year, but it was initially deemed to be a containable localised problem. If there was to be disruption, it would be mainly in the supply of certain goods from China. It is difficult to believe now that many global equity indices made new highs during February, but that is certainly testament to the complacency. Concerns only really started to rise when the virus reached Italy and started to spread further around Europe, but the panic set in when it became clear that the only way to stop the infection spreading and overwhelming medical facilities was to impose stringent lockdowns which would have a destructive impact on economic activity. The nadir was reached in late March when liquidity started to dry up in the financial system as demand for cash soared, and it was only the intervention of central banks and governments with unprecedented amounts of monetary and fiscal stimulus that turned the tide and provided the relief. Hopes for the development of a vaccine then combined with a meaningful recovery in activity to inject an air of optimism into proceedings, even if this was not universally shared, which leads us to the present period of renewed uncertainty.

As we enter the second half of the year, the resurgence of cases in the United States and new outbreaks in China and Germany, combined with the relentless spread of the virus in many emerging economies, notably in South America, are testament to the fact that, for all the fighting talk of politicians and wishful thinking about an easy exit from lockdowns, it will not easily be contained. Michael Osterholme, the eminent epidemiologist and director of the Centre for Infectious Disease Research and Policy at the University of Minnesota, has likened the coronavirus to a forest fire which will keep burning until it has sought out every last source of fuel. Sadly, in this case, we are the fuel, and the fire will continue at least until some degree of herd immunity has been built up. On current reckoning, that means that 60% or more of the population will have had to either have had the virus or have been vaccinated against it. It is hard to find any credible source that suggests that even 10% of us has been infected yet (although there are wide local and regional variations), while the most optimistic timeline for the development of a vaccine does not have one widely available before the end of the year. A return to normal activities remains some way off.

Even so, it is in the nature of financial markets to anticipate the future. While it remains perplexing to many that share indices can be so buoyant while economic data remains so poor, investors, collectively at least, recognised that the decline in economic activity troughed some time during April. But there has been another potent factor helping to spur markets higher, and that has been the acceleration of certain trends that were already apparent. Global markets have been led by mega-capitalisation technology companies benefitting from the increased adoption of online services, whether that be in the disintermediation of physical retail outlets or the provision of facilities for working remotely. Furthermore, the present valuation of the future earnings and dividends of companies with attractive growth prospects has been bolstered by a falling discount rate. With interest rates set to remain low for some time, possibly several years, and with bond yields pinned down by central bank asset purchase programmes, there seems to be minimal probability of this support being removed soon.

What are the main threats to the current equilibrium? In the short term it would have to be another downward leg for growth. The most probable cause of this would be the reimposition of severe nationwide lockdown measures in response to a surge or second wave in the virus. Our central view is that there is little political, or indeed popular, appetite for such a course of action, although it cannot be ruled out. The play book now is to try to contain local outbreaks with minimal disruption through the use of testing and contact tracing. We have learnt that the majority of new infections are caused by a minority of "superspreaders", and so cutting them from the infection chain could be highly effective in containing the spread. We also observe that the adoption of habits such as obsessive sanitising, physical distancing and the wearing of masks has become more accepted and should therefore help to reduce the reproduction rate of the virus.

In the medium term, another threat would be what we might describe as a policy mistake. This would come in the form of a tightening of policy by either governments or central banks. Neither looks at all probable at the moment. Austerity has been consigned to history, and the message from sovereign bond markets is that fiscal largesse and higher deficits are the lesser of evils. Voters are responding positively to increased spending plans. However, the support of central banks is also a large component of the support for bonds, and we have seen in the past, most recently in the final quarter of 2018, the negative effects of premature or too aggressive tightening of monetary policy. For now, though, central banks are unanimous in their promise of enduring loose policy. Jay Powell, the chair of the US Federal Reserve (Fed), recently commented that the Fed is "not even thinking about thinking about raising [interest] rates".

In the longer term, and currently much debated in investment circles, is the threat of inflation. This is the dog that failed to bark after the financial crisis in spite of the massive increase in money supply, something which is being repeated now, only to an even greater degree. One school of economists believes that such monetary stimulus inevitably leads to higher inflation, with time being the only uncertainty. Inflationists also cite the possible reversal of globalisation as a factor, this being caused in part by nationalist politics and also by the shortening and strengthening of supply chains in the light of Covid-related disruption. Rampant fiscal deficits are the icing on the cake. On the other side of the argument are those who believe that new technologies and demographic trends, mainly ageing populations, are inherently disinflationary. They also see demand remaining subdued in a more highly indebted post-Covid world. Inflation is almost certainly not an imminent threat, but an analysis of long-term portfolio returns shows that it is the most pernicious environment for investors, with both bonds and equities tending to lose value at the same time. It will be important to be positioned correctly should the threat materialise.

### Markets – UK

UK Equities remain at the back of the performance pack of major developed markets. Market composition has been a key factor, with heavy exposure to Oil & Gas and Banks being the main culprit. Dividend cuts

have been a negative factor owing to the effects of Covid on profitability as well as regulatory pressure to preserve banks' balance sheet strength. We now estimate that dividend distributions in 2020 will be less than half those made in 2019, thus reducing the relative yield advantage that the UK market used to enjoy over others. The UK also still suffers from its persistent and disappointing lack of exposure to Technology. As we pass through the deadline for extension of the Brexit transition period beyond the end of 2020 without any being requested, the threat of a disruptive departure from the EU trading bloc remains real, although it will now be harder to disaggregate the effects from those of Covid. That threat has again been recognised recently in relative weakness of the pound.

## US

The Technology-heavy NASDAQ Composite Index is well into positive territory for the year to date, reflecting the huge step up in demand for online solutions and the high valuations placed on them. However, it is hard to see the same set of cards being played again, even if the hand won't be thrown in either. The second half of the year will see greater emphasis on domestic politics, with the Presidential election in early November. The market is not entirely sure what it wants. On the one hand, a victory for Democrat candidate Joe Biden promises a more collaborative approach to global trade and diplomacy, on the other it brings the threat of tighter regulation and higher taxes. There is always the possibility that a cornered Donald Trump will launch risky initiatives that unsettle investors. Much will also depend on whether or not the Democrats also gain control of the Senate, which would make the passage of policy easier – although far from straightforward owing to the phenomenon known as the filibuster. Greater volatility is to be expected as we approach polling day.

## Europe

Europe has had what might be described as a relatively "good crisis", even if it got off to a very poor start when Italy became the epicentre of the coronavirus outbreak. Lessons were learned in the aftermath of the financial crisis. This time the European Central Bank immediately loosened policy and provided ample liquidity, rather than waiting several years for its own existential crisis to force it to act. And whereas austerity was the order of the day a decade ago, the social safety net was deployed early in most countries to keep workers employed who would otherwise have been laid off. Political leaders have generally emerged with their reputations intact or even burnished, as in the case of Germany's Angela Merkel. After many years of underperformance, the case is being made for a rehabilitation of the Continent in the eyes of investors, especially if global growth continues to recover.

## Emerging Markets

Not for the first time, there has been a wide divergence among emerging markets (EM) around the world. China, first in and first out of the downturn, can boast positive performance for the year so far, with domestic technology shares booming. At the other end of the scale Latin America continues to wrestle with a rising number of infections and questionable political leadership. Past profligacy in many countries also weighs on any hopes for better fortunes. Two things could turn the tide for EM as a whole. First, if the global economy continues to recover, demand for commodities and an uptick in global trade should be beneficial. Second, weakness of the dollar would signal better times for the global economy, as well as improving the solvency of those emerging countries and their companies that carry large dollar-denominated debts.

## Fixed Income

Government bond yields have remained very low despite the continuing recovery in risk assets and the burgeoning levels of supply. This is testament to the amount of support offered by central banks through their asset purchase programmes as well as ongoing regulator-driven demand from commercial banks and pension funds. As an example, the 10-year UK Gilt traded at an all-time low yield of 0.15% at the end of June despite the fact that the government faces an annual fiscal deficit of around £350bn. The Bank of England has scooped up almost all of the issuance so far this year and increased its buying power by another £100bn at the last meeting of the Monetary Policy Committee. Interestingly, only the Bank's chief economist, Andy Haldane, voted against the expansion, believing that economic recovery was proceeding faster than the Bank had expected. The other eight members preferred to err on the side of caution.

Indeed, that is the way that we expect the majority of central bankers to lean for some time to come. The threat of too little demand and deflation is deemed to be worse than the threat of too much demand (relative to supply) and rising inflation, owing to the huge accumulation of debt in both the public and private sectors. Central banks run a difficult line, though. On the one hand they must not allow inflationary expectations to drop precipitously, and so they continue to anchor to their preferred 2% level for the Consumer Price Index. On the other they do not want inflationary expectations to run away either. While there is a case for allowing inflation to "run hot" for a limited period to balance the times when it has failed to meet its target, central banks would not want to be perceived as having lost control of it either, a situation labelled in markets as "falling behind the curve". Given the amount of trial and error involved in current monetary policy in such exceptional circumstances, the odd misstep is almost inevitable, but, as in the last decade, we would expect to see a fairly swift course correction.

UK Gilts have delivered a total return of 2.45% over the last three months and 11.18% over the last year. Index-Linked Gilts returned 10.17% and 10.03% over the same respective periods. Emerging Market sovereign bonds produced a total return of 11.32% in sterling over the three months to end June (+3.31% over 12m). Global High Yield bonds delivered 12.59% (-0.65% over 12m).

## Conclusion and Outlook

As we close the book on what has been a sometimes traumatic, but always fascinating, first half of the year, it does feel as though we are entering the next phase of the Covid-19 challenge. Markets have become less volatile, even if volatility measures remain markedly higher than they were before the outbreak. The learning curve has been steep for the medical community, politicians, central bankers and investors alike, but our understanding of the virus and its effects are much greater, if far from complete. The trough of economic activity has been passed and markets can look to the future with a greater degree of certainty.

Even so the situation is far from resolved, and therefore we continue to hold back from overweighting risk assets in portfolios relative to a neutral benchmark. If one were to look for clues as to investors' underlying mistrust, look no further than the price of gold, which has just reached its highest level since 2012. Although it divides opinion, it remains widely valued as an asset that is deemed to provide protection against a number of risks – inflation (as a real asset it tends to hold its value), deflation (owing to the risk to the financial sector if debts cannot be serviced), and geopolitical risk (a classic safe haven in times of international stress). A more aggressive approach will not be warranted either until markets offer a more compelling value opportunity, or greater certainty on the containment of the virus arrives in the form of an effective and widely available vaccine.

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IWI553 v1 07/20

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