Investec

Market Commentary

October 2020

Overview

In previous commentary we attempted to explain the disconnect between what the Americans would call "Wall Street" and "Main Street": in everyday terms, why were share indices performing so much better than the economy? August ended with many shares, notably those beneficiaries of the current Covid crisis, trading at all-time highs. The world's largest stock market by some distance, the United States', also traded at historic peaks, dragging global indices up with it. By way of caveat, we also wrote: "It always feels a bit dangerous to be explaining on an ex post facto basis why markets have behaved as they have done. Often when such justifications are brought to bear it can signal that a trend is about to reverse."

Rarely has this writer displayed such intuition, because equities changed course almost immediately. It would be tempting to think that by explaining September's reversal we could magically create the circumstances for a strong rally in October. However, that would be no more than wishful thinking, as we face another month of Covid developments as well as tawdry political headlines as both the US presidential election and Brexit head towards their denouements.

It is important not to let our emotions get the better of us at such times. A review of September's UK equity market performance received from one investment bank described it as "bleak", although the FTSE 100 Index only recorded a decline of 1.5%. One wonders how they might describe a correction of 10% or more. The truth is that the shorter one's intervals between stock market observations, the greater the probability of experiencing negative returns. Based on daily data for the S&P 500 Index in the United States going back to 1929, Bank of America calculates the following: on a day-to-day basis, the probability of the index falling is 46%. That is almost a coin-toss! And given what we know of human psychology based on prospect theory and loss aversion, those down days will weigh more heavily on investors' emotions than the good days will lift their spirits. And so the first piece of advice is to exercise restraint in the frequency of checking portfolio valuations, especially in a world where much of this information is available instantly at the touch of a screen.

Of course, longer observation periods do not necessarily guarantee profits. The probability of negative returns for longer periods is as follows - one month 38%; one quarter 33%; one year 26%; three years 16%; five years 11%; and ten years 6%. Indeed, US equities, for which we have the most reliable long-term data, have only suffered two negative decades since 1800 – the 1930s and the 2000s, although three in real terms when inflation is taken into account - the 1920s, the 1970s and the 2000s. Our long-term projections for equities continue to suggest that the 2020s will not fall into these categories, although returns will fail to match the generous ones most recently achieved owing to the starting point for valuations.

In the end, in spite of the combination of short term swings in sentiment, investors' preferences for one sector over another, and the power of momentum to reinforce trends in a phenomenon described by investment guru George Soros as "reflexivity", market outcomes and individual companies' performance will be defined by their ability to generate sustainable profits. During times of heightened volatility, it is always worth bearing in mind the words of another sage, Benjamin Graham, generally considered to be the father of modern investing. In the short term the market is a voting machine, but in the long term it is a weighing machine.

Bearing all of that in mind, what did undermine equities in September, and what is the outlook now? The month began with a violent correction in technology stocks, notably the very large capitalisation companies that pack the upper echelons of US equity indices. Although the UK remains relatively light in technology, negative sentiment pervaded equities globally and the UK was affected too, if to a lesser extent. The exact cause of the sell-off was hard to pin down, but appears to have been exacerbated by an unwinding of highly speculative positions that had been accumulated in July and August, by both retail investors and, notably, the Japan-based investment firm Softbank. This primarily involved the purchase of "out-of-the-money" call options, which confer the right, but not the obligation, to buy shares above the current market price. Successfully deployed, this strategy can generate returns that are many multiples of the original stake. By the same token, if unsuccessful it can wipe out 100% of the capital invested. Even so, the potential for asymmetric profits is highly tempting when markets are displaying strong momentum, as they had been doing in previous months.

September also witnessed something of a setback on the Covid front. As holidaymakers returned from busy resorts, and schools and universities ground back into action, the numbers of daily positive tests began to rise in the UK, several countries in Europe, and many states in the US. Although, thankfully, mortality rates have remained relatively subdued, fear of wider outbreaks and of the potential for medical services to be overwhelmed encouraged governments to tighten social restrictions, pushing out the horizon for a return to normal activity and, with it, the economic recovery. At the same time, the hoped-for "silver bullet" of a vaccine remains tantalisingly out of reach. Expectations for the timing of widespread availability were at their nearest in August, and have since gradually receded. This is partially down to a lack of concrete news, but also to a growing realisation that the logistics of vaccinating whole populations are daunting, to say the least. Furthermore, a large percentage of the population has said that it will not be vaccinated anyway, and it is not yet clear what level of protection any vaccine will deliver, and for what duration. All in all, the outlook for businesses that depend on many people gathering in confined spaces has deteriorated again, highlighted by the closure of Cineworld's cinemas in the UK and the US. Matters have not been helped by politics, more on which in the country sections to follow.

What stops investors becoming terminally depressed in the face of these challenges is the enduring promise of more monetary and/or fiscal stimulus. While it might not always be forthcoming on a proactive basis, it will almost certainly be unleashed in reaction to a marked deterioration in either economic or financial conditions. This expectation sets up something of a safety net under financial assets for the moment, although the ensuing Pavlovian "buy-the-dip" mentality of investors potentially stores up other troubles for the future.

Another supportive factor for both equities and corporate bonds is the historically low level of interest rates and bond yields. Making any sort of decent return in a balanced portfolio will require owning more of the former. This is the phenomenon widely known by the acronym TINA, which stands for 'There Is No Alternative". After years of increasing bond weightings in an ultimately vain effort to match assets with liabilities, many defined benefit pension schemes are now changing tack. Individual investors who are members of defined contribution schemes or who manage their own affairs do not face the same legal and regulatory liabilities, but still have to consider how to grow their assets and generate future retirement income.

Markets – UK

The widely touted deadline for reaching a Brexit deal with the European Union is October 15th, a date that is fast approaching. Negotiations between the two sides appear to have become stuck on the issues of state aid and fishing rights. In theory neither should have the capacity to undermine the whole process, but both are totemic in their own way to each side. The EU remains committed to the concept of the "level playing field", while the UK appears not to trust the EU not to use any state aid rules to interfere in other policy areas. Meanwhile fishing rights, despite being a tiny part of the overall economy, are a strong

symbol of sovereignty. The pound has once again been caught in the centre of the debate, weakening on fears of a "No deal" Brexit (still very much the worst case scenario in the eyes of the majority of investors), and rallying on news of constructive talks. These currency movements feed through to the equity market, with a weaker pound being supportive of (usually larger capitalisation) companies with a high proportion of earnings generated overseas. Our central view remains that a skinny "fig leaf" deal will be signed, possibly not until November.

US

Even as this commentary is being written, markets have been thrown into further disarray by news that the President and the First Lady have tested positive for the coronavirus. Next month's commentary will be written as the election votes are being counted. Markets were already displaying a heightened sense of uncertainty around the outcome, both in terms of the identity of the victor and how long it might take for him to be officially declared. The latter factor certainly has the capacity to increase market volatility in the short term, especially if the count is close and mailed-in ballots end up being decisive. Owing to the laborious counting process and late deadlines for postal submissions in certain key states, we could be talking days or even weeks of indecision. And that's before polls are potentially contested, possibly in the courts. This makes the rush to appoint Ruth Bader Ginsburg's replacement on the Supreme Court bench even more charged with political importance, and why Donald Trump is determined to have his choice of the conservative Amy Coney Barrett approved without delay. But whatever the delay in confirming the election result, we can be pretty certain of one eventually, and so this is just another storm which we will have to ride out with hatches battened down. In the best case scenario for the longer term, it might even provide some welcome opportunities to deploy cash reserves into our favoured companies and investment themes.

Europe

For a region that has had its own share of political uncertainty in recent years, many European leaders must be heaving a sigh of relief that they only have Brexit and Covid to occupy them currently. That's not to belittle either of those difficulties, but Brexit is generally deemed to be far more deleterious to the economy of the UK than to the EU27. Covid, on the other hand, recognises no national boundaries, and is subject only to the competence of governments and the discipline of citizens in adhering to social distancing protocols (with the admitted caveat that laws and recommendations differ widely depending on where you are). Earlier confidence that Europe had "had a good crisis" following a dreadful start has been undermined by a resurgence in new cases in recent weeks, especially in Germany, France and Spain. However, the European economy and its stock markets are well positioned to take advantage of the eventual global recovery, and its leaders have, so far, shown a willingness to provide support for businesses and individuals in a timely manner.

Emerging Markets

Last month we highlighted the composition of the UK and US equity markets and how that influences their relative performance. This month we turn our attention to Emerging Markets (EM), a label that remains far too general to capture the details. Although countries in South and Central America, Eastern Europe and all over Asia carry the EM designation, two-thirds of the MSCI EM Index is comprised of just three countries: China (42.5%), Taiwan (12.5%) and South Korea (11.5%). Within those countries' indices there are single companies that in turn account for very high weightings, namely Alibaba (19.8%) and Tencent (14.4%) in China, Taiwan Semiconductor (45%) and South Korea's Samsung (34%). Between them they account for 23.5% of the EM Index, not so different to the situation in the US which seems to attract much more attention. Whereas historically EM indices were chock-full of banks and industrial cyclicals, it is clear that technology now plays a far greater role. While that might not be a bad thing, investors should certainly be aware of the exposures they are assuming, especially if using index funds as their preferred vehicle.

Fixed Income

Government bond investors might have had more fun watching paint dry in September. Yields, already pinned lower by central bank intervention, failed to move by more than a few basis points generally, and the asset class even failed to find much new support when equities headed lower. With yields so derisory, bonds have an increasingly difficult time providing the necessary counterbalance to weaker equities. By the same token, central bank asset purchases currently diminish the risk of yields breaking sharply higher. This cap was made heavier by the fact that forward inflation indicators fell back in response to Covid-related fears of a more prolonged period of economic weakness.

One of the more persistent debates in monetary circles concerns the merits of negative interest rates. These are currently in force in Europe, Switzerland and Japan, with limited evidence that they have boosted either growth or inflation. If anything they have only served to extend the lives of so-called "zombie" companies that survive only to service their debt but contribute nothing by way of productivity gains. The supposed benefits of cheap borrowing are offset by the needs of savers to accumulate more savings to make up for the loss of interest. Banks find it very hard to generate a decent net interest margin in this environment. Sweden's central bank turned its back on the whole idea having been one of the first to adopt negative rates, citing the damage to the financial system and the economy.

Meanwhile, members of the Bank of England's Monetary Policy Committee who have aired their views publicly are nowhere near reaching any sort of consensus. Even the Bank's Governor has floated both sides of the argument in recent weeks, perhaps making him deserving of the title "Unreliable Boyfriend 2.0" (predecessor Mark Carney having been the original version for his shifting policy views). In any event, it is impossible to envisage the base rate rising from its current 0.1% in the foreseeable future.

UK Gilts have delivered a total return of -1.23% over the last three months and +3.41% over the last year. Index-Linked Gilts returned -2.3% and -0.12% over the same respective periods. Emerging Market sovereign bonds produced a total return of -2.35% in sterling over the three months to end September (-2.44% over 12m). Global High Yield bonds delivered +0.23% (-0.54% over 12m).

Conclusion and Outlook

In these commentaries we strive to balance the factors that drive markets. When all the news is so negative and when the delivery of the news (with few exceptions) is designed to prey on our emotions, it can sometimes be hard to remain objective. This is why we stick to our tried and tested investment processes, which are also always evolving. One of the strengths of Artificial Intelligence and Machine Learning functions is that they learn from experience, both good and bad. We would apply the same belief to our processes, with the additional opinion that we can also make more subjective value judgements about the future when they are required. Some of the biggest market dislocations occur when correlations between certain asset classes break down. Computers are not best equipped to capture these shifts in advance, and, in fact, often contribute to the mayhem as they catch up with the new paradigm.

One of our key tenets currently is that the Covid crisis is very much a health and medical crisis, and not a financial one. It is also our belief, without being incautious, that current science is capable of delivering solutions that will mitigate Covid's worst effects, if not eliminate them totally. We face existential risk from the moment that we are born. We haven't quite worked out how to calibrate the new set of risks thrust upon us by Covid, but we will. That is in the nature of humanity, otherwise we would never have evolved this far. The same applies to investing, which, ultimately, is all about the successful balancing of risk and reward over a meaningful time period. And the longer the investment horizon, the better one's odds of success.

John Wyn-Evans
Head of Investment Strategy

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