Investec

Market Commentary

September 2020

Overview

If Fred Trueman, the irascible cricketer and, later, commentator, had been a financial strategist, his views on current markets might well have been: "I don't know what's going off out there". Such sentiments are also widely expressed in the comments section of articles on the Financial Times website. A chart from the Federal Reserve Bank of St Louis (its website is a treasure trove of publically available information), which plots broad US stock market returns against current economic performance, shows the present situation to be an extreme outlier. In a data series going back to the beginning of the 1970s, equities have never done so well against such a recessionary background.

Bearing all of that in mind, the Overview section of this month's commentary will be devoted to trying to square this particular circle. 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. It also reminds us of The Queen's question about the financial crisis: "Why did nobody see it coming?" In fairness, the direction and composition of market movements from the lows in March have been very much as we expected. However, we cannot deny that the magnitude has taken us by surprise.

First of all, we must always remember that markets are forward-looking – they discount future expectations and have little interest in the present, let alone the past. Thus the trough of economic activity that was reached in April, when the global economy was, on best estimates, operating around 17% below its recent peak levels, is already ancient history, even if the effects are still only now being fully recognised in official economic data and company reports. The market is already anticipating a return to some sort of normal activity, and hopes are pinned on the development of a vaccine. Investor surveys suggest that around three-quarters of market participants expect a vaccine to be widely available between the end of this year and the end of 2021. As long as the schedule does not slip too far into 2022 (which would suggest a second northern hemisphere winter to contend with), Covid is less likely to be capable of delivering another sucker punch to investors. While this is far from declaring "coast clear", the sentiment prevails that a navigable route can be found.

The second factor to take into account is the powerful force of liquidity. Developed world central banks have once again unwound the firehoses, with their balance sheet expansion expected to peak on a year-on-year basis at over $6 trillion. While this latest flood of liquidity was initially aimed at providing structural support to financial markets and the financial system in general in March, we now seem to have returned to a regime that is specifically supporting asset prices with a view to creating and sustaining wealth that "trickles down" into the real economy. Problematically, this policy only serves to increase the inequality gap, as it disproportionately favours those with financial assets. For now, that seems to be acceptable, but could well energise populist forces in future, increasing the probability of higher redistributive taxes. Still, logically, it's probably better to have taxable gains than no gains at all, even if we know that Prospect/Endowment Theory dictates that paying any future taxes on current accumulated wealth will be painful.

Fiscal largesse must also be taken into account. Governments have stepped in to provide "bridging finance" to ensure that companies and individuals make it to the other side of the Covid trough. This support has taken the form of both actual cash handed out or spent and guarantees for loans made by banks. Whether or not this can be labelled "stimulus" is up for debate. After all, it is largely replacing spending that has been curtailed by Covid. However, there is more than a suspicion that some sort of cat has been let out of the bag. There is no sign, so far at least, of the fabled "bond vigilantes", the much-feared bond managers who would demand a much higher yield to hold sovereign debt. Of course, their guns might just have been spiked by the power of Quantitative Easing, but the enduring low yields have tempted finance ministries to believe that there is endless appetite for more issuance. Is this the advent of Modern Monetary Theory? Maybe not in so many words, but if it looks, walks and quacks like a duck…

The by-product of such low bond yields, when combined with a recovery in inflation expectations, has been negative real interest rates, with the measure in the US reaching -1.1%. This is a powerful turbocharger for equity valuations, notably the Net Present Value element of Dividend Discount/Discounted Cash Flow Models. One piece of research that came to our attention calculated that the reduction we have witnessed in the US real 10-year bond yield in the last eighteen months from +1% to -1% is worth an extra TEN points on the Shiller Cyclically-Adjusted Price/Earnings Ratio, taking it from 18x to 28x! It is evident that investors who live in the nominal world are unwilling to take this into account.

The two other key drivers to a discounted cash flow model are marginal cash flow returns-on-capital (and their sustainability) and growth. The overlapping central section of the Venn diagram that covers all factors contains the group of US companies collectively and variously known as the FAANGs, FANGAMs or the Amazing Eight, whose businesses, great as they already were, have been positively transformed by Covid. These stocks have been responsible for more than all of the gains this year in the S&P 500 Index. Stocks which share similar characteristics in other markets have also prospered.

Finally, we mustn't forget TINA. This acronym stands for "There Is No Alternative" – in this case for assets that are riskier and which offer higher prospective returns than bonds, especially in the income department. Although it could apply equally to corporate bonds and a host of alternative assets, equities are seen as the main beneficiary. The effects of TINA can also be exaggerated by the fact that much of the money flowing into equities these days is channelled into passive index funds (with Vanguard being the industry behemoth). These funds are insensitive to price or valuation. By their nature they also have to invest more of the money into the biggest stocks. This creates its own momentum. It's fair to say that this is largely a US phenomenon, but with the US market being so influential and dominant in size, it has a huge gravitational effect on the whole world. For the record, Apple, which recently topped a $2 trillion market capitalisation, is now bigger than the whole of the UK's FTSE 100!!

What could unhinge this trend? An unacceptably high Covid surge that threatened to overwhelm the healthcare system and trigger new severe lockdowns has to be a possibility, although, as with the shark in Jaws, once you've seen it for the first time it does not have the same capacity to shock again. Rising bond yields in the face of potentially rising inflation are probably the greatest threat, although matters are complicated by the uncertain reaction function of central banks – will they let inflation "run hot" while also anchoring bond yields? That would greatly affect relative sector performance within the market. As we have discussed in past commentaries, the inflation debate remains wide open, and it is one to which we will undoubtedly return.

In the meantime, perhaps market commentators should stick to using another one of Fred Trueman's more famous quotes: "Unless something happens that we can't predict, I don't think a lot will happen"!

Markets – UK

Although much is made of the potential distorting effects of passive index funds and their price and valuation-agnostic approach to buying (and selling), it helps if the prospective main beneficiaries of the inflows are performing well operationally. At the start of 2020, the largest company in the FTSE 100 Index was HSBC, accounting for a 6.3% weighting.

Following a torrid eight months in which Banks have seen their profitability come under pressure from a combination of shrinking net interest margins and potential Covid-related bad debts, HSBC's shares have fallen 46% and now account for just 4.3% of a (smaller) market. Lloyds, Barclays and NatWest (formerly RBS), while not as large, have suffered a similar fate. The other leg of the UK stock market wearing a cement boot has been Energy. The combined weight of BP and Royal Dutch Shell has fallen from 14.4% to 9.1% this year. It is very hard for an index to make progress in these circumstances, and this stands in rude contrast to the US market, where a majority of the leaders have been Covid winners. Such winners in the UK, including Ocado (now 0.76% vs 0.31%) and Scottish Mortgage Investment Trust (now 0.94% vs 0.45%), have been too small to compensate.

US

News services such as the BBC tend to quote the Dow Jones Industrial Average as a measure of US stock market performance, even though the index is something of an anachronism. For a start it only contains thirty companies. Secondly, its daily moves are derived from the dollar share price of its constituents rather than the weighting by market capitalisation. Theoretically if any stock went to zero, so would the whole index! However, it remains a barometer of economic and market sentiment. The index was rejigged at the end of August to account for a four-for-one stock split by Apple. Although it will remain the largest company in the more representative S&P 500 Index, Apple now only ranks seventeenth in the Dow Jones Average, with its weight falling from 12% to around 3%. Therefore something had to be done to reflect the changing nature of the underlying economy. Out went Exxon Mobil (which was the largest company on the planet not too long ago), Pfizer (a still-favoured pharmaceutical giant) and Raytheon Technologies ("old-school" Aerospace and Defence). The newcomers are Salesforce.com (an enterprise software company that has been a beneficiary of Covid-related disruption), Amgen (Biotech) and Honeywell (a broader industrial technology company with some pedigree in the development of quantum computing). The biggest companies in the index, by dint of their hefty share prices, are now United Healthcare (health insurance and hospitals) and Home Depot (the US equivalent of B&Q, but rather more successful). Something to bear in mind the next time you hear a news bulletin.

Europe

Despite witnessing a resurgence of Covid cases during the summer holidays, Europe has benefitted from renewed investor support. This is most evident in the recovery of the euro, which now buys almost $1.20 versus just $1.07 back in March. Although this is partially a function of a weaker dollar, it also reflects greater confidence in the ability of Europe to recover from the ravages of Covid. European leaders, on average, are deemed to have handled the situation well, not least by providing immediate and substantial fiscal support. Germany, long an advocate of "hair shirt" fiscal policy, has undergone a damascene conversion. It has committed close to 40% of GDP to direct financial support and bank loan guarantees, second only to Japan in terms of relative scale (and Japan cast off its hair shirt many years ago). The European Central Bank has also been instrumental in improving investors' perceptions of the Continent, with the relatively newly-appointed President, Christine Lagarde, opening the monetary taps in a timely manner. Relative valuations continue to look attractive in Europe, although a more durable recovery will also require a pick-up in global trade, an influence to which Europe is more highly exposed than, for example, the US or the UK.

Emerging Markets

Historically, a weakening US dollar and prospects for a recovery in global trade have been positive for Emerging Markets on a relative basis, and there have been tentative signs of this beginning to happen again. Even so, it will take more concrete evidence that the world is moving decisively beyond Covid to provide a real boost. The announcement of a widely available vaccine could be the catalyst. China continues to provide the rest of the world with a potential template for recovery, and reported that Industrial Profits in the country had risen 19.6% from a year earlier. Even if we should treat some of the official data from China with a degree of scepticism, it suggests that the recovery is on track, helped on, as in the West, by fiscal and monetary stimulus. Another big influence in the autumn will be the outcome of the US election. Although a Biden victory would suggest a more dignified approach to diplomacy, there is no reason to believe that a Democrat-controlled White House and Congress would go soft on China. If anything, they are even more exercised about issues such as human rights and corporate governance. Expect Biden to corral traditional economic allies (such as Europe and Japan) to present a united front towards the Chinese.

Fixed Income

In August bond investors finally had to come to terms with the fact that bond yields can rise as well as fall, delivering capital losses. And nowadays, with yields being as low as they are, there is virtually no income to offset those losses. Within a balanced portfolio, at least, equities have continued to perform well, and therefore any losses on bonds can be viewed as a foregone "insurance premium" against negative developments in the riskier asset classes.

Both UK and US 10-year yields hit all-time lows at the beginning of the month, reaching 0.07% and 0.5% respectively, before rising to end the month at 0.31% and 0.7%. Hardly heady levels, by any means, but a notable trend shift. This was driven by three factors. First was the sense that fiscal expenditure is increasingly "off-the-leash", which will lead to higher sovereign bond issuance. Second was the fact that the amount of central bank purchases was scaled back. Finally, and much more explicit, was Federal Reserve chairman Jay Powell's speech at the Jackson Hole symposium of central bankers in which he confirmed that the Fed will tolerate inflation greater than 2% to achieve average consumer price inflation of around 2% over the cycle, and also pay greater heed to unemployment rates. Given recent experience, there is quite a lot of catching up to do. Adding to the uncertainty, he gave no indication as to what upper level of inflation he would be willing to tolerate.

To reflect these developments, the US 10-year breakeven inflation rate (effectively a market-derived forecast based on the yield offered on inflation-linked bonds) has risen from a low of 0.55% in March to 1.80%, which is exactly where it was at the start of the year. The equivalent rate in the UK has risen from 2.66% to 3.14%.

UK Gilts have delivered a total return of -3.2% over the last three months and +2.42% over the last year. Index-Linked Gilts returned -3.42% and -2.08% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.13% in sterling over the three months to end August (-+2.81% over 12m). Global High Yield bonds delivered +0.35% (-4.18% over 12m).

Conclusion and Outlook

Although the news continues to be dominated by Covid, markets are looking beyond the immediate effects of the virus, and that is a natural course of action. Our central view is that harsh lockdowns are no longer tolerable politically, economically or socially. We are also of the opinion that so much medical and financial resource is being directed at both the treatment and containment of the virus that positive progress is, if not inevitable, then highly probable.

Turning to the longer term, our focus will increasingly turn to central banks' persistent, yet so far futile, efforts to raise the rate of consumer price inflation – as opposed to financial assets, where they have been pretty successful. This will potentially have a huge bearing on bond yields, and thus the valuation of all financial instruments. Following forty years of a global disinflationary trend, future inflation expectations remain relatively subdued. A marked shift in expectations could trigger a meaningful change in asset allocation and portfolio construction for the whole decade ahead.

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