Weekly Digest

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"W"?

As I have commented on various occasions recently, the key topics that occupy investors remain depressingly familiar: Covid-19, the US elections, and Brexit. This week is no exception. Indeed, the news flow on all three fronts seems to be moving into overdrive again. The interaction between all three certainly had an effect on markets last week, and will surely do so this week as well. Let's have a quick update on all of them, with some focus on the key moving parts. For light diversion we will also have a look at a couple of topics that, in more normal times, might have been garnering more attention – central bank meetings and company earnings.

I'll start with the subject that has the potential to be resolved soonest – the US Presidential election. This has provided a field day for psephologists and conspiracy theorists alike, and Election Day is finally upon us. The last three weeks have seen national opinion polls tighten in favour of Donald Trump. On October 11th, Joe Biden had a lead of 10.3 points. That has been whittled down to just 7.2 (data from RealClearPolitics' poll of polls). That lead is tighter still in key battleground swing states such as Michigan, Pennsylvania and Wisconsin, the states that Mr Trump won by such a narrow margin in 2016 to swing the result. If Mr Biden prevails in these states, it will be well-nigh impossible for Trump to repeat his previous feat.

However, the die may well be cast before those results are known. Those who intend to stay up and watch events unfold will need to keep a close eye on Florida, which has 29 electoral college votes. Mr Biden still holds a small lead in the polls there, and if he does win conclusively, then his "base position" (which assumes that he starts with 233 electoral college votes in the bag owing to the "safe" states which are as good as guaranteed, such as California and New York) would rise to 262, meaning that Mr Trump would have to win all the swing states again at a minimum. The target for a majority is 270. Florida has a good record of delivering its count early, and so the finale could end up being a great anti-climax.

Although the main focus of attention has been on the presidential race, the Senate race is almost as important. This could well drag on longer, especially if both seats in Georgia are crucial to the result. This state requires a run-off if no candidate polls more than 50% of the votes, and these are slated to take place on 5th January. It might be the decider, or it might define the extent of the Democratic majority. That in itself would be important as it would determine how aggressive the Democrats could be in their policymaking.

I ran through some if the potential market outcomes last week, and so will not repeat them.

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However, the falls in equity markets last week have probably already served to discount some of the uncertainties (although it is impossible to disaggregate the Covid influence). That potentially leaves a bit more upside if the market receives the news it wants – a Democrat Blue Wave.

I should also outline what legal impediments there might be to a resolution. Conflicts can arise in four areas. First is the pre-election phase, which is now pretty much played out. This focused on how people cast their ballots, such as by mail or by drop-box; also on fine details such as how many signatures were needed on a ballot paper. The second is on Election Day itself, with potential challenges to the legitimacy of the vote. These would question the validity of voter registrations and the security if polling stations, for example. Then we move to Election Night, which might see legal challenges to absentee ballots reminiscent to the "hanging chads" issue of 2000. Finally, in the post-election phase, there might be accusations of fraud and ballot-rigging. If there are small margins, then recounts beckon. From the point of view of market certainty in the short term, a decisive outcome (either way) with a handy majority would be highly preferable to such legal proceedings.

Next on the agenda is Covid. There is no hiding the quantum leap in daily reported cases in a number of countries, although we continue to observe that death rates remain relatively well controlled. Even so, with such a big denominator, the percentage of hospitalisations threatens to overwhelm capacity, and thus we find ourselves facing Lockdown 2.0. Although nothing like as draconian as version 1.0, it will still have a negative effect on economic activity, even with the Chancellor's not-unexpected extension of the furlough scheme. With impeccably ironic timing, the US and many countries in Europe released economic growth figures for the third quarter last week, and these generally surpassed expectations. Now we are already seeing downgrades for fourth quarter estimates in the UK and Europe which predict that economies will shrink once more – hence the "W" of the title. On a brighter note, the forecasts for the first quarter of 2021 have edged up to reflect the potential recovery.

These are perilous times for companies that are affected by reduced demand. Even though credit markets remain open to those needing a financial bridge to the post-Covid world, the toll is getting expensive. To take two recent examples: Rolls Royce, the manufacturer of jet engines, has just committed to paying interest of 5.75% on a new seven-year bond. In 2018 it paid just 1.625% for ten years. Aston Martin, James Bond's preferred carmaker, has just agreed to pay 10.5% interest on bonds that are secured against its facilities and intellectual property. It pays 13.5% on further debt that is unsecured.

Meanwhile companies that don't need the cash continue to be offered terms close to (or even below) zero percent. As we saw in the aftermath of the financial crisis, this will only serve to cement the position of the winners as they are able to capitalise on cheap financing – potentially to hoover up distressed assets once those who have to pay higher rates submerge beneath their accumulated debts.
I'm not sure that this is the intention of current monetary policy, but it is how it might play out.

Brexit rumbles on towards its apparently conclusive deadline on 31st December. The mood music here seems to be slightly better, pointing towards a possible deal of some sort. Contact with a well-informed insider last week suggested limited progress on front-line issues such as the "level playing field" of state intervention, governance and fisheries, although news of some sort of resolution has emerged on the latter point over the weekend. However, he was much more upbeat about the progress on secondary issues such as Rules of Origin (a vital area for the automotive industry), sanitary issues, haulage and aviation. If these important, but less emotive, subjects can be put to bed, then he felt it would be more difficult for negotiators to back out of talks altogether for fear of losing those agreements, which would be economically damaging for both sides.

Boris Johnson still has the unenviable task of winning over the more staunch Brexiters in the party, at the same time as coping with Covid, which will test his powers of persuasion. Any

deal will also require top level talks with a number of European leaders, and so do not expect a final answer until closer to mid-November. I note that the pound and more domestically-focused companies' shares have taken a bit of a lockdown-related hit today, but any sort of Brexit deal would be unequivocally positive for both.

The third quarter earnings season has been relatively positive on both sides of the Atlantic, with results in aggregate coming in handily ahead of forecasts. One of the brightest spots has been Banks, where strong financial market trading volumes and lower-than-expected loan loss provisions were the key drivers. Capital ratios remain very strong, with surplus capital being reported across the industry – a phenomenon bolstered by the inability to pay dividends owing to regulatory constraint. While it is possible that bad debts will pick up again the longer that social restrictions exist, we have consistently maintained the opinion that the banking sector was not going to be the catalyst for the next market crisis, and that remains the case.

Even so, low price-to-book ratios are evidence that investors remain sceptical on two fronts: either more losses are on the way, in which case the book value is too high; or the industry will struggle to cover its cost of capital owing to low interest rates and flatter yield curves – or a combination of the two. The latter factors are very much in the hands of central banks, and those of the US and the UK are set to update policy this week. The US Federal Reserve set out its stall for a more relaxed attitude to inflation in September, and is expected to sit on its hands this week.

The Bank of England, meanwhile, is expected to expand is asset purchase programme (Quantitative Easing) by £100 billion to £845 billion. That will provide the government with ample support for increased expenditure as required to combat Covid. It is already abundantly clear that austerity has been consigned to history. Monetary and fiscal policy are increasingly joined at the hip.

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Last week’s Economic Highlights

FTSE 100 Weekly Winners

Flutter Entertainment PLC	4.9%
Natwest Group PLC	1.1%
HSBC Holdings PLC	1.0%
DCC PLC	-0.1%
Pearson PLC	-0.5%
Royal Dutch Shell PLC Class A	-0.7%
Antofagasta PLC	-0.8%

FTSE 100 Weekly Losers

Rolls-Royce Holdings PLC	-14.7%
BAE Systems PLC	-13.3%
M&G PLC	-13.1%
Prudential PLC	-12.6%
Standard Chartered PLC	-11.9%
International Consolidated Airlines	-11.5%
Taylor Wimpey PLC	-11.1%

FTSE 100 Index, Past 12 Months

Source:FactSet

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