Weekly Digest

| 19 October 2020 |

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A Hokey Cokey World

It is many years since I indulged in a full-blown hokey cokey (or hokey pokey for our South African readers), but I recall the experience as being great fun. Metaphorically speaking, there are a number of hokey-cokey-style dances taking place around the world currently, which involve the participants rushing closer to each other and then running away again, all the while in some confusion about the instructions that they are supposed to be following.

The main example is the ebb and flow of social restrictions being imposed by governments around the world to control the spread of Covid-19. When the Reproductive Number, infection rates and hospitalisations drop, we can all become more intimate with each other. As those numbers rise, the distancing becomes greater. And just like the dancer who doesn't know his right leg from his left leg, many people are not at all clear about what rules apply to them in terms of mingling with other households, whether it be indoors or outdoors, and why one part of the country might face a different set of rules to another. Mask or no mask? Aren't we all supposed to be in this together?

There are two other examples that come to mind. The first is the ongoing Brexit negotiations. The UK and the EU, having seemingly reached a solution encapsulated in the Withdrawal Agreement, now seem to be as far apart as ever. The Prime Minister's self-imposed deadline for making a deal passed at the end of last week, but talks continue. The months of uncertainty have been punctuated by sporadic reports that agreement is closer, but the dancers seem to be very shy of entering a group hug.

As we wrote last week, some of this looks like posturing, and we still believe that, on balance, some sort of deal will be reached. However, that deal will only be what would have been described earlier in the process as a "Hard Brexit". Citigroup's economics team puts a 70% probability on what they term a "Bare Bones Free Trade Agreement (FTA) with an implementation phase". They give another 10% to the same FTA, but with no implementation phase. Thus, a combined 80% probability of a "deal". That leaves 10% each for two "no deal" options, with and without implementation phases. The latter is the "cliff edge" outcome, perceived by markets to be the most economically damaging.

To confuse matters further, much has been made of a possible "trading arrangement with the EU like Australia's". Sounds like a solution, doesn't it, but for the fact that Australia has no trade deal with the EU, although has been negotiating one for more than two years. There do exist various

bilateral agreements between the EU and Australia on matters of security and other areas of mutually beneficial cooperation, but they do not constitute a trade deal. Most trade takes place under World Trade Organisation rules, with tariffs applied by the book.

As usual, the whipping boy in all of this will be the pound. Again citing Citigroup's analysis, there is a wide range of potential outcomes, which will have major implications for portfolios denominated in sterling, at least in the short term.

Under the best outcome from a market perspective (that is an FTA with an implementation phase), the pound rises to $1.38 (from $1.30), and to €1.15 (from €1.105). Under the "cliff edge no deal", the pound falls below $1.20 and to €1.04. If you probability weight all the outcomes, you get to $1.344 and €1.13, which helps to explain sterling's resilience to bad Brexit news at current levels.

The other hokey cokey is taking place in Washington in the form of stimulus package negotiations between Democrats and Republicans. The main players are Nancy Pelosi, the Democrat Speaker of the House of Representatives, and Steve Mnuchin, the Treasury Secretary, but the President regularly participates as well, mainly from his Twitter account. Since payments under the initial stimulus bill, the CARES Act, are now largely disbursed, there is increasing risk that the economy will waver once the safety net is withdrawn from beneath businesses that continue to be affected by restrictions and a new wave of unemployed workers. Equity market moves are attributed almost daily to the tone of bipartisan talks. Unsurprisingly, this has developed into a big political football with the election just two weeks away.

All of this uncertainty has undoubtedly created market volatility in the short term, but should not necessarily scare long-term investors. Brexit will (almost definitely) be decided one way or the other by 31st December; the US Constitution demands that a President is in place by Inauguration Day (20th January), potentially unleashing new funds, especially if we get the increasingly expected Democrat "Blue Wave"; and it is not beyond the bounds of possibility that a Covid vaccine might be approved (if not widely available) by year-end. If all three issues can be resolved to investors' satisfaction, there could be a very different tone to markets in 2021, not least in favour of those industries and companies that have been more negatively affected by Brexit and Covid, or which would benefit from a policy shift in the US.

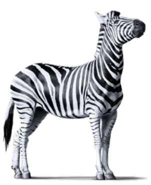
In trying to assess how much markets might react to news, it's always useful to get some feel for investors' current thinking. This is well expressed in various investment bank surveys, the latest of which were published by Deutsche Bank (DB) and Bank of America (BofA) last week. In this context I often remind myself of the following equation: Happiness equals Reality minus Expectation. So what are expectations now?

Given that most polls and betting odds suggest a win for Joe Biden, the next most important factor is whether or not the Democrats can secure the Senate, which would allow for the easier passage of policies. 52% of DB's survey respondents expect Democrat control of the Senate (27% Republican; 21% Don't Know), suggesting that if the Republicans hold the Senate (even if Biden wins the White House), there are grounds for disappointment, with deadlock remaining the order of the day on Capitol Hill. This is especially the case as a strong majority (83%) sees a stimulus package forthcoming within six months (split 41% this year and 42% in the first quarter of 2021). 78% expect the package to be within a range of one to three trillion dollars. If the outcome falls outside those parameters there is potential for strong market reactions in both directions.

I have been following DB's poll on vaccine expectations with interest for a while now. In answer to the question "when do you think the first working vaccine for Covid-19 will be available?", 39% think within six months and 42% in six to twelve months. Again, if progress is either accelerated or delayed relative to those timelines, expect to see a strong move.

In the BofA survey, as many as 60% of respondents expect the US election result to be contested, and so a decisive victory (either way) will be positive for sentiment. Indeed, investors' greatest fear (measured by expectations of volatility) is of a contested election (74%), with a Blue Wave Democrat win hardly registering (14%).

In terms of the shape of the economic recovery, there is hardly abundant optimism (which is a good thing!). 30% of people opted for a "W" (double-dip recession), 29% for a "U" (gradual), and only 19% for a "V" (strong). This all points to the possibility that positive vaccine news and a decisive Biden victory could ignite a lot interest in the more cyclical parts of the market, with that doubly the case for UK domestic cyclicals in the event of a market-friendly Brexit outcome.



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Last week’s Economic Highlights

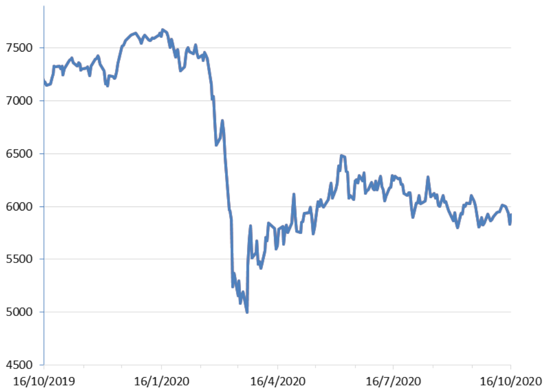
FTSE 100 Weekly Winners

Just Eat Takeaway	13.4%
Scottish Mortgage Investment Trust	4.6%
Experian PLC	4.0%
SSE PLC	3.7%
Polymetal International PLC	3.6%
Ocado Group PLC	3.3%
Bunzl PLC	3.1%

FTSE 100 Weekly Losers

Associated British Foods PLC	-8.3%
Hargreaves Lansdown PLC	-7.9%
International Consolidated Airlines	-7.5%
Whitbread PLC	-7.4%
Land Securities Group PLC	-6.8%
Next PLC	-6.6%
BT Group PLC	-6.3%

FTSE 100 Index, Past 12 Months



Source:FactSet

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