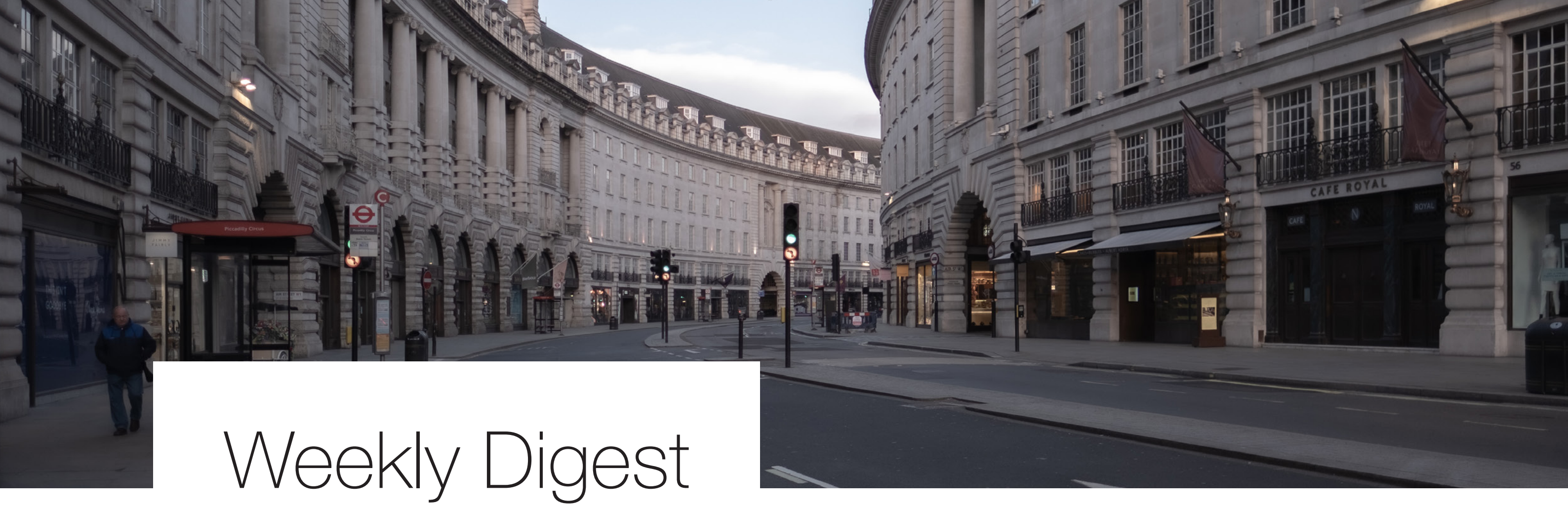

Weekly Digest

| 21 September 2020 |

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Head of Investment Strategy

Groundhog Day

Casting an eye back over last week's Digest, I felt tempted to send out the same text with just a few tweaks. Increasing cases of Covid and the potential introduction of even tighter social restrictions dominate the headlines again, while monetary policy discussions and Brexit still feature heavily in investment banks' previews of the week's forthcoming attractions. In the film Groundhog Day, Phil Connors, the lead character played by Bill Murray, is able to keep re-experiencing February 2nd until he achieves redemption by learning to act in a more compassionate and generous manner. Thus he is released from the spell and finally wakes up to discover it is February 3rd. Unfortunately we get no second chance to deal with the initial outbreak of Covid, and there continues to be an element of trial and error about the ongoing response, perhaps unsurprisingly.

Although the latest upswing in cases is widely described as a "second wave", there are plenty of eminent scientists who are of the opinion that we are experiencing no more than a continuation of the first wave. I'm not going to enter that debate. The key point is that the graphs of daily new cases in many countries definitely do have all the characteristics of a second wave. As I have observed in the past, the good news is that the number of deaths has not followed the trajectory of new infections, although that number of deaths will always be a laggard. The global seven-day average for deaths has remained close to five thousand since early May, since when the seven-day average of new cases around the world has risen from below a hundred thousand to more than three hundred thousand.

There are several reasons for this. First, the initial wave was visited upon an unprepared (mainly western) world. Second, the virus initially spread rapidly in the most vulnerable hosts, who are now better protected. Third, the medical profession has ascended a very steep learning curve in terms of treatment. Fourth, the denominator is now a lot bigger, in that we are testing a much larger percentage of the population. And finally, the age of those being recorded as infected is, on average, materially lower than it was six months ago - and if there is one very hard statistical correlation that stands out about Covid, it is that it is exponentially more deadly to older people.

While acknowledging that every death or severe illness is a tragedy in its own right, from an investment perspective we continue to view the situation as manageable. The latest virtual gathering of our Global Investment Strategy Group (GISG) last week concluded that we should leave our risk appetite at neutral (therefore taking no more or less equity risk in portfolios than as prescribed by the strategic asset allocation

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benchmarks). I know that some people see a neutral risk stance as something of a cop-out, but it still signals a positive long-term commitment to equities, which will, in most cases, constitute the bulk of portfolios.

For those (the majority, I hope) willing to take a longer-term view of their investments, the following observations from Deutsche Bank's latest Long-Term Returns Study should provide some encouragement. "Since 1800, US equities have had only two negative decades in nominal terms: the 1930s (-0.5% p.a.) and the 2000s (-0.9%). There have been three in real terms (1910s: -2.8%, 1970s: -1.5%, 2000s: -3.4%)". The odds, then, continue to favour making positive returns in the decade ahead (although valuation comparisons with 2000 for some areas of the market also suggest that it will not be a vintage period for returns).

As for Bonds: "Ten-year Treasuries and corporate bonds have never seen a negative-return decade in nominal terms, but six of the twelve decades since 1900 have seen a negative real return from Treasuries, including four successive decades from the 1940s." Let's think about that statement in more detail. If you assume that buying the current ten-year bond and holding it for a decade is how this was measured, then it has been inevitable that no losses would have been experienced in nominal terms because the yield-to-redemption has always been positive, generally around mid-single digits. Although that remains the case in, for example, the UK (0.15%) and United States (0.65%), it is not the case in Germany (-0.52%), France (-0.24%) or Switzerland (-0.53%). In nominal terms, at least, anyone who buys today in those three countries and holds for ten years is guaranteed to receive less than they paid. There are sound reasons for this decision-making. Some of the buying is forced upon financial institutions by regulators. Some buyers from outside these territories might believe that by exposing themselves to a potentially stronger currency such as the euro or the Swiss franc they will make up their losses with foreign exchange gains. Then there are the outright pessimists – either those who believe that they can make shorter-term capital gains as yields shift even further into negative territory in the event of greater economic dislocation, or those who envisage even greater losses ahead for riskier assets such as equities.

That deals with the "nominal" (pre-inflation) world. What about the "real" (post-inflation) world? Obviously much will depend on the inflation outcome. While some buyers of low and negative-yielding bonds sincerely believe that they will make positive returns in real terms because inflation will turn out even lower, they are by no means taking their cue from current market indicators. Here in the UK, the ten-year "breakeven" inflation rate, which is inferred from the yield gap between conventional and index-linked bonds, is a whopping 3.14%, which implies a loss of around a third in purchasing power over the next decade for today's buyer of a ten-year gilt. US investors find themselves in a slightly more favourable position, starting with a higher yield and a lower breakeven rate of 1.66%. Expectations for inflation in Europe are even lower, sitting at 0.73% in Germany, for example. Thus it is very hard to see government bonds contributing a great share of positive portfolio returns in the years ahead.

What about equities in the "real" world? The historical data suggests that they are a better store of value than bonds, even if they will provide a bumpier ride along the way (in investment-speak, they are more volatile). Equities provide investors with a claim on the profits and cash generated by the underlying companies. Over time the revenues of companies tend to rise in line with inflation because the prices they charge are a key element of inflation itself. Yes, employment and interest costs can impinge on margins in the short term, but they will tend to revert to some sort of happy medium over time.

The important thing for investors is to match the time horizon of their assets with those of their liabilities. For those not seeking to access savings for a decade, exposure to equities should be much more tolerable. Indeed, for those still contributing to their investments, short-term volatility provides

a better entry point from a valuation perspective, Despite all the attention that markets pay to today's news and current profits, Goldman Sachs calculates (using a dividend discount model) that ninety-three percent of the present value of the US equity market is derived from projected dividends paid beyond year five (with sixty-nine percent beyond year twenty). The figures for Europe are eighty-nine and fifty-two percent respectively. Obviously these numbers come with all sorts of caveats about the sustainability of those dividends, but, on the whole, I believe that their methodology is sound.

All of this will be worth bearing in mind over the next few weeks. Although the GISG remained risk-neutral on its eighteen month investment horizon, it also noted greater short-term risks, with deteriorating Covid news, increased geopolitical tensions, and a potentially disruptive US presidential election just a few weeks away amongst reasons for a modicum of caution.

Last week's Economic Highlights

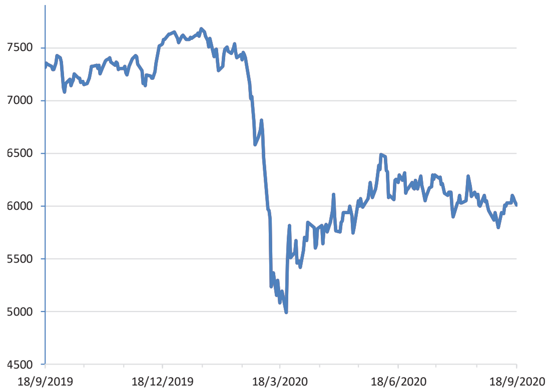
FTSE 100 Weekly Winners

Ocado Group PLC	24.3%
Experian PLC	6.1%
Next PLC	5.7%
J Sainsbury PLC	5.0%
Evraz PLC	4.9%
Mondi PLC	4.8%
Flutter Entertainment PLC	4.6%

FTSE 100 Weekly Losers

International Consolidated Airlines Group	--16.8%
Rolls-Royce Holdings PLC	-14.2%
Polymetal International PLC	-12.2%
Barratt Developments PLC	-6.4%
BP PLC	-6.2%
HSBC Holdings PLC	-5.9%
Standard Chartered PLC	-5.3%

FTSE 100 Index, Past 12 Months



Source:FactSet

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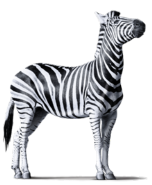

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