Weekly Digest

| 27 July 2020 |

John Wyn-Evans
Head of Investment Strategy

Too Low For Zero

I concluded last week's Digest with the following sentence: "All of the factors mentioned above create the environment for a possible market wobble in the short term, or at least increased levels of volatility." Those factors included worries about the speed of economic recovery, the potential for a further acceleration in Covid cases and some political risks as well. The wobble duly arrived, with some notable profit-taking in the high-profile US companies that have led markets recently. However, I rounded off by saying that any setback should be manageable and that there was limited expectation for a broader, deeper sell-off to develop. So far, so good.

Our Global Investment Strategy Group (GISG) met again last week and reached much the same conclusion. As a reminder, GISG sits at the apex of our asset allocation process. It is a collaboration between the UK and South African arms of the business, and, as such, we believe, gives us a unique world-view amongst our wealth management peer group. The role of GISG is to provide guidance as to the amount of risk investment managers can take in portfolios relative to strategic asset allocation benchmarks. More practically, it allows us to separate the process of where and how to deploy our risk budget, making tactical asset allocation a much cleaner process.

As you might expect, much of the discussion was about the trade-off between Covid-related economic risks on the one hand, and fiscal and monetary stimulus on the other. As for Covid itself, our current position is as follows (guided by Dr Jimmy Muchechetere, our fully medically qualified Healthcare analyst): 1) Progress on a vaccine is occurring at a greater speed than many had predicted. With four candidates already in late-stage human trials, it is increasingly probable that there will be a powerful new weapon in the anti-Covid armoury by early next year. (This view is supported by a new website I have discovered which features the work of a group of super-forecasters known collectively as the Good Judgement Project. Its estimated probability of the availability of a vaccine by the first quarter of 2021 has risen from 10% at the beginning of June to 40% currently); 2) New treatments (e.g. steroids, Interferon beta) and improved regimens are improving outcomes; 3) Better understanding of the virus has revealed ways to limit transmission (masks!); 4. Lower-than-feared mortality rates (0.5-1% of total infections, 0.1% of those under the age of 45), and a potentially lower threshold for herd immunity – since a high proportion of the population are now thought to be naturally immune (mainly the young). These factors, whilst not adding up to "Covid Case-Closed", support our belief that the virus is now a manageable condition and that any re-imposition of restrictions in major economies will therefore not be widespread or long-lasting.

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The initial economic recovery, if anything, has exceeded our expectations in terms of its acceleration from the trough (the famous "V"-shape alluded to by the Bank of England's Chief Economist), but does now appear to be flattening in response to the re-imposition of certain restrictions. Perhaps we are also witnessing the limitations of reopening in terms of new capacity constraints in offices and shops, as well as disruption to supply chains. There is also the reality of more permanent job losses in certain sectors, with Marks & Spencer and John Lewis being the latest high-profile employers to announce cuts. I note that the EY Item Club, a well respected economic forecaster, has over the weekend suggested that the UK economy might not regain its pre-Covid altitude until 2024. Even so, we remain of the opinion that government support will continue to flow (here and elsewhere), and that central banks will also keep policy exceptionally loose. And one massive difference between now and the financial crisis is that the banking sector continues to function normally.

Although I'm the person who gets to write much of our externally distributed content, it must not be forgotten that I am more than ably supported by a fantastic research team. I referenced our resident doctor earlier in the piece, and now it's time to introduce Shilen Shah. Shilen is the Bond Strategist on our Fixed Income team, and, unlike me, has an economics degree as well as a stint at HM Treasury under his belt. He drew our attention last week to the relentless fall in the real yields available on US Treasury Bonds, a development that has a wide-ranging influence on portfolios.

UK investors have long had to accept negative real yields on inflation-linked gilts, mainly thanks to regulator-driven demand for index-linked assets to match long-term liabilities (such as pension payments). This effectively guarantees a loss in real terms if the asset is held to maturity, but at least provides a degree of certainty. It is my personal opinion that the primary goal of any wealth management strategy should be to preserve the future purchasing power of current savings, and so you can see that negative real yields in the supposedly risk-free portion of the portfolio put a greater onus on the riskier elements to deliver good returns.

In the US in contrast, Treasury Inflation-Protected bonds (TIPs) have nearly always offered a real positive yield – meaning that for buy-and-hold investors they could generate both positive nominal and real returns without taking any credit risk. That "free lunch" has now been taken off the menu. Two factors have driven this. First there is central bank policy. The US Federal Reserve (Fed) remains committed to very loose policy, a stance to which it will recommit at this week's meeting, and upon which it may possibly even expand in a Framework Review that is due to be released later this year. The idea of allowing inflation to "run hot" to hit a through-cycle target of 2% is being widely touted, and there is also widespread talk of some sort of "yield curve control" which will keep a lid on nominal bond yields. We can also infer from bond volatility indices that markets are not expecting yields to shift much in the foreseeable future.

The other factor is rising inflation expectations. Whereas bond yields and inflation expectations collapsed in tandem in March, their paths are now diverging. The ten-year breakeven rate (the market-derived expectation for inflation over the next decade) has risen around 1% from the lows as growth has recovered. Even now, though, it only stands at around 1.5%, well below the Fed's 2% target, suggesting no hurry to tighten policy.

I'll let Shilen explain the technical stuff: "Historically, changes in real yields are correlated to changes in expectations of real GDP growth. Therefore it would not be unexpected to see real yields fall further if US GDP growth weakens again. Additionally, as has happened over the last few months, better US economic data may also lead to higher breakeven rates rather than an increase in nominal bond yields, with the Fed's policy action anchoring current nominal Treasury yields. In this scenario if breakeven rates rise whilst nominal yields remain stable, real yields will fall further."

This has consequences. Falling real yields depress the cost of capital and the discount rate for riskier assets such as equities. The phenomenon especially favours growth stocks with high returns on capital thanks to the mathematical effect on the net present value of future cash flows. Thus one cannot rule out further gains for the current market leaders despite what they have achieved so far. In fact they would be much more vulnerable to a collapse in inflation expectations which would increase real yields (unless the Fed moved to negative interest rates and took the yield curve deep into negative territory, which it does not yet appear inclined to do).

Another beneficiary of falling real yields has been the precious metals sector, with gold hitting all-time highs and silver catching a ride on its coat-tails. The opportunity cost of owning precious metals (which have no yield, and, in their metallic form, are costly to store and insure) has rarely been lower.

Given that they are deemed to hold their value over time as well as to provide insurance against currency debasement, we believe that they will continue to attract support.

In case you didn't catch the reference, this week's title gives a nod to Elton John's 1983 album of the same name. For now we can also sing along to Side 1, Track 2: "I'm Still Standing".

Last week's Economic Highlights

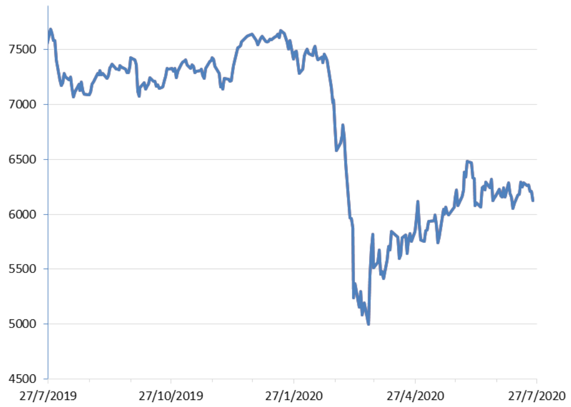
FTSE 100 Weekly Winners

Polymetal International Plc	11.8%
Sage Group plc	10.0%
Hargreaves Lansdown	9.5%
Kingfisher Plc	9.2%
Fresnillo PLC	9.2%
Unilever PLC	6.9%
Intermediate Capital Group plc	3.2%

FTSE 100 Weekly Losers

GVC Holdings PLC	-15.7%
Melrose Industries PLC	-10.7%
Burberry Group plc	-10.6%
IAG	-9.3%
M&G Plc	-8.5%
Taylor Wimpey plc	-8.3%
Prudential plc	-8.2%

FTSE 100 Index, Past 12 Months



Source:FactSet

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