



PRIVATE & CONFIDENTIAL
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General Economic Overview – Quarter 3 2020

The ongoing march of technological progress can be seen in recent quarters albeit at the expense of a pandemic that has caused a great deal of human suffering. The latest estimates have indicated that we can link over one million deaths to Covid-19 since the measurements began, with many more probably unrecorded. The third quarter has been less remarkable in stock market terms compared to the first two, as most investors have been waiting for more convincing signs of a recovery or clearer progress on vaccines.

The economic outlook has been varied, early in the quarter we had optimism on data coming through on retail sales and footfall, and businesses in the leisure and travel industry began to reopen. As we have moved into September however this has been dampened by rising coronavirus cases and more muted economic data. Governments around the globe had been supporting economies through employment schemes and fiscal spending, as well as industry tailored promotions such as 'Eat Out to Help Out' in the UK. This clearly had an effect and encouraged spending, leading to views that we would see a V shaped recovery, but it was perhaps inevitable that this would tail off as incentives reduced and we saw more regional lockdowns come into force.

We have also seen a large divide between stock market winners and losers. Whilst the S&P 500 has hit the news for reaching a record high recently, most of the companies in the benchmark have far less reason to celebrate as the advance has been propelled by the tech giants and other companies which have strengthened their market position during the pandemic. The recovery has had a number of single letter descriptions, but the one that potentially best describes what has happened is the letter K. This is based on the disparity we have seen in certain sectors with a sharp fall off followed by a recovery in sectors such as technology and healthcare but little recovery in areas such as energy or travel and leisure. No one letter will ever fully summarise the events of the last six months, but it can help us to consider what has been happening at a headline level.

Technology stocks seem to have received all the news flow, but gold has also been a strong beneficiary of the state of uncertainty in the third quarter of the year. This interest has caused a rise in the gold price from a low of $1160 in the summer of 2018 to a record high of $2073 in August making the metal one of the hottest trades this year for investors. Over $60bn has been invested in gold ETFs this year – 50% more than in 2009 during the financial crisis. Gold is being used as hedge against a frothy market as well as against rock bottom interest rates and a fall in economic output.

There has also been an increase in volatility in September as markets have reacted to the changing data on coronavirus. It was not unusual to see 2-3% market moves both up and down during September. Other assets have also reflected this uncertainty, with oil falling to just over $40 dollars a barrel.

Since our last review we have moved into a different phase of the recovery with economies expanding again rapidly at first but settling into a more subdued rate with structural changes such as home working more embedded into business behaviour. Much of this has been an acceleration of existing trends such as increasing online transactions, be that ordering food or other items.

Equity Markets

The Covid-19 pandemic has caught investors off guard, not least the bounce back in global equities. The US saw its fastest fall into bear market territory in March, but since then there has been the most rapid rebound into a bull market, with the most recent fund manager survey from the Bank of America showing that a growing number of fund managers accept this is now a new bull market, rather than a bear market rally. It does not appear that the rapid fall in markets, or the rebound, was driven solely by alterations in growth expectations. The fall in markets was only partly explained by a decline in corporate earnings expectations as analysts had expected a rebound to occur starting in 2021. Equities are valued on the present value of all future earnings and therefore one year in isolation only accounts for, at most, around 5% of a total value of a share. Furthermore, the decline in the risk-free interest rate has meant that future earnings are discounted back at a lower rate, and explains why markets trade on higher PE ratios when long term interest rates fall. Although hard to measure, there are also likely to have been swings in the equity risk premium which appeared to jump when the pandemic first hit, but returned to normal levels when central banks QE and other support measures for the market restored investor confidence. The Fed now appears to be willing to take unlimited action to prevent further market illiquidity and disruption, which means the equity risk premium should be much less volatile going forward, even if a second wave of the virus emerges.

Quarter three data shows that the main equity indices have risen around 3-4% over the quarter, with the main exception being the UK market which has fallen around 3%. The fall in the UK has put shares at one of the largest discounts to global markets that we have seen this century and offers investors who are prepared to take a higher risk an opportunity to capitalise. There are headwinds over and above Covid-19, such as Brexit, but a number of managers and economists believe these have perhaps been exaggerated on the downside. Elsewhere, the US is seen as overvalued but has been for some time and September did see some market falls particularly in tech stocks. China A share stocks grew in strength as the economy shows stronger growth than expected.

UK

There was some encouraging data coming out of the UK in July and August as the economy expanded at a rate of around GDP 15% although output was around 10% lower than at the end of 2019. There has been a deceleration of activity in September with a rise in Covid-19 cases and the end of programmes like 'Eat Out to Help Out' in August. Growth in business activity also fell with the PMI falling from 59.1 to 55.7 showing falling optimism. This is likely to leave the economy some 6% lower than before the pandemic according to economists at KPMG. Recent statements from the Chancellor have also given markets a negative headwind as the furlough scheme is coming to an end and the new job support scheme has heightened fears of higher unemployment levels coming through in Q4. The UK has had a welcome boost from the strength of the housing market since the pandemic restrictions were reduced. Pent-up demand and a stamp duty holiday have helped to fuel demand but this may now be coming to an end as incentives are withdrawn.

There has been speculation over the Bank of England's intentions to potentially use negative rates in future attempts to keep the economy moving forward. This was unheard of several months ago but recent minutes from the B of E meeting indicated it was laying the operational groundwork for cutting rates below zero.

The threat of Brexit has again begun to raise its head after the focus on coronavirus, and the hope that a trade deal could be negotiated ahead of leaving the EU at the end of the transition period has receded.

The UK government has indicated that they want to override parts of Brexit deal to protect arrangements across the Irish border, which has been met with international and some internal condemnation. There has been some progress however, with a Japan / UK trade deal announced which is similar to the current EU deal but expands on areas where the EU was more restrictive – such as technology freedom – and it is estimated that it will increase trade by up to £15bn. Eventually this may lead to the UK joining the Trans Pacific Partnership (TPP).

High levels of uncertainty continue to put off international investors, even though the UK probably has one of the most attractive equity markets based on valuation comparisons across the globe.

US

The data for the economy will show a substantial decline in 2020, an elevated unemployment rate will hamper consumer spending, and investment and exports are set to suffer. While announced fiscal and monetary stimulus should help to cushion the downturn, possible further lockdowns and the lack of additional fiscal measures pose significant downside risks to the outlook.

Quarter three saw activity recovering as lockdown measures continued to ease, but the reopening has varied across states due to the uneven spread of new virus cases. In July, the unemployment rate dipped 0.9 percentage points, while retail sales edged higher, albeit at a softer pace than in May and June. The fall in industrial production eased slightly in July and in August the IHS Markit manufacturing PMI hit its highest level since January 2019. That said, consumer confidence dipped to a multi-year low in August due to the uncertainty surrounding the pandemic, and the lack of political agreement on further fiscal stimulus risks hurting the economy ahead.

The Fed has disappointed some investors with its recent comments on the economy by offering little in the way of additional support, but indicating that Congress needs to resolve its differences and approve the new support packages. Equities sold off sharply in late September on the news, or lack of it, and although they pledged they would not raise rates until inflation outstripped its 2% target, no new guidance was given on how the US balance sheet policy might be adapted to generate that inflation to aid the recovery. One criticism of the system is that the main street lending programme MSLP has not been widely taken up and this was supporting the small and medium sized businesses seen to be the backbone of the US economy. At the moment the Fed is seen as a crucial economic support with Congress locked in its own battle over stimulus packages which seems unlikely to be resolved until after the election.

President Trump continues to court controversy with his handling of issues such as the China trade negotiations and the battle for Tik Tok mixed in with his own high-profile tax affairs. The election is beginning to take centre stage in the US with his opponent Joe Biden running ahead in the polls although President Trump has caught up in recent weeks. (As we write this review President Trump has contracted coronavirus which may yet disturb the election timetable).

Europe

The effects of Covid-19 will almost certainly have a significantly negative effect on the Eurozone this year. Rising unemployment and income losses will hit consumer spending, investment will suffer amid elevated uncertainty, and collapsed foreign demand will hit exports. The economy is seen as contracting around 7-8% in 2020 with GDP growing to around 5% in 2021. Although economic sentiment continued to climb in July and August, consumer confidence sagged, most likely due to rising new Covid-19 infections and the tightening of restrictions in several countries. Moreover, after jumping to an over-two-year high in July, the composite PMI eased markedly in August as services activity virtually stalled. Concerningly, manufacturing and services jobs were cut for the sixth month running amid still-subdued demand. More recently the euro has strengthened threatening the recovery, but Christine Lagarde has been in the press indicating the ECB is not overly concerned about its rise. The issue has been widely raised in European capitals as any recovery could be slowed by its strength.

Certain sectors have been worse affected, outside of the obvious travel and leisure areas. Examples of a deteriorating service sector can be seen in several industries, but banking has been hit harder than most. Deutsche Bank is closing one in five branches as the use of online banking has risen in Europe. European banks have for some time been a cause for concern and a recent report from the ECB suggested there could be up to €1.4tn in non-performing loans. Whilst banks are in a much stronger position than in 2008, they still require ECB support and liquidity.

Not all is negative however as German and French business confidence indicators reached their highest levels for seven months despite rising coronavirus infection levels. The IFo Institute in Munich said its business climate index rose from 92.5 to 93.4, its highest since March. They remain below pre-pandemic levels and were more positive in construction and manufacturing than in the service sector. The ECB has helped by pushing cheap funding at companies, at negative rates, with some €175bn being lent so far. This ties in with some fund manager surveys which saw managers investing more in Europe than other regions during September.

Asia & Emerging Markets

Perhaps one of the more encouraging commentaries we can make this quarter is on the progress in Asia, and in particular, China after the initial issues created by the pandemic. China remains the largest and most important economy within Asia and this year sees the end of the 13th 5-year Plan. Next year will see the start of the 14th 5-year Plan and the leadership in China have been meeting over this, and over the next few months some direction will emerge, although a similar emphasis to the last Plan is expected.

Growth prospects in China have been improving in recent months, reflecting a stronger-than-expected recovery which continues to gain traction, despite a challenging external environment, mostly due to solid dynamics at home. Economists are forecasting GDP growth in 2020 of around 2% which compares to negative growth in other leading global economies. Retail sales returned to growth in August as consumers gradually came back and cross-provincial travel increased. Looking forward, the economy will benefit from strong overseas demand for medical products and technological devices as well as solid new infrastructure investment. The new infrastructure initiative, which was rubberstamped during May's National People's Congress, seeks to upgrade China's industries and accelerate digital transformation. Industrial production growth also picked up in August, led by gains in advanced technologies. Although the external sector continued to fare well in August, risks are looming on the horizon as some of China's main trading partners are suffering heavily from the consequences of the pandemic. A re-escalation of trade tensions with the US and a second wave of Covid-19 are the main downside risks.

In the region's second largest economy, India, the picture has been very different with GDP falling quite dramatically. Plummeting household spending and freefalling fixed investment led the downturn amid a spike in the unemployment rate as non-essential businesses were forced to shut. That said, government consumption accelerated, while a steeper fall in imports led the external sector to positively contribute to GDP. In the most recent quarter, the economy has gained some momentum but remains depressed due to a soaring number of new Covid-19 cases. Industrial production shrank at a less severe pace in July, while the services PMI gained some traction in August, although it still signalled a deterioration in the services sector. On a brighter note, the manufacturing PMI rebounded in August, suggesting an expansion in activity. India remains a country with huge potential and with Modi in charge, one which has a decisive and well supported leadership.

In other economies the situation has been more difficult as controlling the pandemic without an effective health service and infrastructure has been much more problematic. Emerging markets outside of Asia have been harder hit and this is where a large GDP shortfall, compared to what was forecast for 2021 is likely to occur. Latin America, South Africa and Russia have been hard hit by the virus, and while it has been better managed in Russia, this country has had to contend with the collapse in the oil price putting its budgetary position under severe pressure. In all these countries, a lack of fiscal headroom has meant implementing support measures for consumers has not been possible and as a result recessionary conditions are likely to prevail there for significantly longer than in Asia. Countries such as Mexico and Brazil have mishandled the coronavirus crisis.

Fears over the health of the Argentine economy continue after newly restructured dollar bonds slumped in value. The restructuring of debt has come at a difficult time for a government trying to rebuild its economy. Handling of the virus has not been seen to be effective and a fall in GDP of around 12% is expected this year. Investors hope the government will be more explicit about its plans to stabilise the economy and promote growth.

Mexico has political uncertainty and, even with a populist president, Mr Lopez Obrador has had campaigners camped out in the capital protesting against various problems, including the handling of the pandemic. Further east the Turkish central bank has had to raise rates to protect the lira with the repo rate moving from 8.25% to 10.25%.

All in all, within the emerging world Asia, and especially North Asia, remains best placed for an economic rebound, and these economies will remain fast-growing compared to both the emerging and developed world. Within Asia cultural factors mean that individuals have a strong desire to make more of themselves and there is still a generation of people who have moved from poverty to being better off and want to progress further. This will continue to be a driver of Asian economies. With supportive valuations and the likelihood of further significant US dollar strength diminished, Asia looks well placed to outperform over the remainder of the year.

Japan

Perhaps the biggest news this quarter was not economic but political, with the retirement of Prime Minister Shinzo Abe. Mr Abe had been a landslide choice for voters and he was a progressive Prime Minister. His replacement, Yoshihide Suga, was a popular choice in the political arena and is likely to continue the reforming momentum. Within 24 hours of becoming Prime Minister he created the post of Minister for Digital Transformation with an agenda to set up a digital agency.

The economy was hit hard in Q2, according to preliminary GDP estimates, as the pandemic wreaked havoc on both the domestic and external sectors. Private consumption plunged on the back of restrictions enacted in April and May, with retail sales falling nearly 10% during the period, and softening foreign demand saw exports tumble across the quarter. This year, GDP is projected to contract sharply as domestic demand falls amid diminished consumption and investment, and the delaying of the Tokyo Olympic Games will hit tourism. Substantial fiscal and monetary stimulus should soften the downturn, although stubbornly high Covid-19 case rates throughout August cloud the outlook. There has been a recovery in Q3, but recent data suggests a fairly mild rebound: PMIs for both manufacturing and services were still subdued through August.

As with much of the developed world, equity markets have been more volatile and have traded with greater frequency without moving out of the current trading range.

Fixed Interest

An interesting feature of the bond market at the moment is the tightness of spreads between government and investment grade bonds. Spreads widened considerably in March and April at the height of the uncertainty but have come in a long way since then, indicating that the bond market at least believes the worst of the crisis is over. This contrasts with the banking sector which is provisioning for significant levels of bad loans. US bank's loan loss reserves have risen by $110bn since the crisis began and are now equivalent to 2.2% of their loan portfolios, the highest since the financial crisis in 2012. Historically reserves and spreads have moved together but they are now diverging because of rock bottom rates and the backstopping of the bond market by the Federal Reserve which is scrambling the signals the market normally operates within. Banks also reserve based on models and accounting rules not the supply and demand that drives credit markets. It remains to be seen which market is reading the conditions more accurately, but it does raise the broader issue that many traditional market dynamics and interactions have changed in the pandemic.

We have seen a significant increase in the level of government debt, the highest since wartime, but at the same time the cost of borrowing is at all-time lows. The clearing price is being artificially set by government agencies like the Bank of England and the Fed, with the B of E holding close to 50% of the country's stock of debt. How long will investors accept that this increasing burden can be financed before they back away? At some point debt has to be repaid and assuming there is a longer term sustainable economic recovery, governments will need some inflation and potentially higher taxes to address this.

Currently, these distortions in markets mean different things to different areas of the fixed income market. Investment grade credit is closely linked to government bond yields and it is likely these will stay low for the time being with negative returns possible. Investors may have to expect a return of capital rather than a return on capital. Duration will probably be a key area to get correct – longer duration assets have proven to be a good source of return including more recently index linked bonds, but moves in the yield curve over the medium term may mean holding shorter duration assets is the sensible strategy for protecting returns. High yield always has the potential for a better return with a higher risk. At the moment default rates seem to be relatively low given the state of the economy but rates for financing debt are very low and the fear of zombie companies operating because of this is a threat to future default levels, should rates head upwards again.

The case for holding government debt is less convincing at this point although general economic uncertainty means it is still worth a place in portfolios as a safety valve. Investment grade is more attractive although with tight spreads in place the opportunities remain limited. High yield and emerging market debt hold greater opportunity but will be more volatile.

Property

During March we saw the suspension of all physical property funds as the FCA's material uncertainty clause came into operation. The suspension applied to a fund where more than 20% of its assets were subject to material valuation uncertainty, which then resulted in the suspension of funds so that all customers could be treated fairly. This clause was applied across the whole UK property market due to a lack of evidence of transactions, rapidly altering covenants, an inability to inspect property, as well as government mandated closures. This affected both daily traded and institutional funds, bank lending and

REIT NAV valuations. Funds and properties were still being valued but this clause meant a high degree of caution was attached to the valuation. A lack of evidence causes valuations to be more qualitative and sentiment driven rather than quantitative. This was intended to be a short-term tool and we have now seen the clause removed from almost all property assets, allowing property funds to start, or at least plan, their re-opening.

The FCA enquiry into illiquid funds such as these will be released in November and it is likely to recommend extended exit periods for investors subject to this being possible for the current level of platform technology.

The UK response to Covid-19 is still evolving, and the medium-term impacts on the asset class is only starting to come into focus. Some trends are becoming apparent and there is no doubt the virus has accelerated existing trends, with significant differences between subsectors, and between different parts of some sub-sectors.

Retail provides the clearest indication of this trend: anecdotal evidence suggests retail footfall was down around 80% during lockdown, however within the sector the impact has not been evenly distributed. Retailers selling goods deemed essential have remained open for business, including supermarkets and pharmacies. With unemployment already increasing and spending habits changed by necessity as a result of the lockdown, it is unlikely consumers will return to the high street in sufficient numbers to prevent more businesses following the likes of Laura Ashley or Debenhams into administration. This environment highlights the value of stock picking investments based on tenant-by-tenant due diligence, which ensures assets generate sufficient revenues for occupiers to allow them to trade profitably and continue to pay rent. Rents have clearly been affected and a similar pattern has emerged with retail and leisure sectors the worst affected and industrials, warehousing and offices still being relatively robust. The shutdown is gradually being lifted but there are still restrictions which limit the ability of properties to move back to full pre-lockdown usage. Property fund managers have been actively managing their portfolios during the suspension period with many increasing cash levels by selling assets but not all managers are in the position of having high enough cash reserves to deal with the potential level of redemptions. The likelihood is that we will see negative capital returns from several commercial property sectors in 2020 but with certain sectors like warehousing and industrial sectors continuing to thrive.

The lockdown period has accelerated change in the office sector and the future emphasis may be more about quality of space than quantity with an increase in working from home and flexible working arrangements. The lockdown also accelerated change in retail with many businesses extolling the virtues of click and collect, leading some managers to believe that a lot of property will still be required, albeit in a different format.

The global REIT / property securities market is sensitive to interest rate movements with the global REIT space dominated by US assets, therefore the path and outlook for US interest rates and US economic growth will be important influences on future returns. These assets offer investors a way into holding commercial property, but they are much more closely correlated to equity market volatility and may increase portfolio risk.

The position for many investors in direct property is probably now as much about liquidity, access and timeframe requirements as it is about the diversification that direct property can provide. With FCA changes soon to be published this may become more difficult to manage for those with a shorter-,term investment horizon as access to funds could be more restrictive. Fundamentally, direct property can offer low correlations to other asset classes so should not be ignored but clearly practicalities need to be factored into any investment decision.

Summary

The significant recovery in markets in quarter two was followed by a more uncertain and more volatile period in quarter three when investors have been more concerned about the future strength of the global economy and the short- and long-term effects of the pandemic. There are a number of issues arriving to add complexity to the current situation. In the UK there is Brexit, in the US the election, and political disruption is factoring in across the globe with examples in Mexico and Belarus. The support mechanisms are still in place however, with most central banks backing bond markets and governments focusing on keeping unemployment numbers from reaching uncomfortable levels. Global GDP data has improved from the unprecedented levels we saw earlier in the year, which was perhaps to be expected as lockdowns receded, but there will still be a significant reduction in activity over 2020 when the data is evaluated with only China perhaps offering a positive GDP number for this year. Many observers are predicting a return to improved growth levels in 2021 but this may be dependent on the production of a vaccine which is still uncertain, although significant progress has been made.

An interesting debate amongst investors has started to challenge the traditional methods of building portfolios to manage risk and return. For much of the last 40 years the tried and tested method of a 60/40 portfolio of stocks and bonds has delivered an inflation adjusted return of around 7%. It is difficult to see how this can continue if bond yields are at all-time lows, equity valuations at close to highs and inflation potentially a longer -term threat with the current levels of stimulus. Whilst equity markets may not fall, we are certainly facing a period of higher volatility and the correlation of bonds and equities, after a long period of being negative is likely to increase, which leads to greater portfolio risk. If we get inflation in the future and interest rates rise the threat of capital depreciation in bonds naturally increases. Does this mean a larger equity weighting for portfolios in the future? – possibly, but we also need to be looking to alternatives as a way of diversifying – perhaps long / short equity, infrastructure or commodities. Many of these areas are viewed as more complex options so care is needed but investors and advisers should consider this changing landscape and prepare ahead of it happening.

2020 will be written down as a very unusual year. Whilst we have only got to the end of the third quarter the negative effect on global growth has been significant and will be reflected in the end of year numbers. The recovery is very fragile and uncertain although good progress has been made and whether there is a second wave of the pandemic or not countries are far better prepared than they were in March this year.

The markets have clearly been saying for a while that the economics of the post-pandemic world will be different. In some instances, it seems some businesses and practices have leapt forward more than a decade. This change is not a revolution but an evolution of the trends already in progress. Central bank largesse in tightening credit spreads has helped equity markets and, as noted in previous commentaries, this environment is rarely negative for investors. Covid-19 has altered the prospects for many sectors in very different ways: homeworking, home schooling, and home entertainment have all benefitted technology names, whilst home eating has boosted food delivery stocks. The trend to home shopping has further accelerated. Markets are forward looking and the progress to date both on vaccine trials and improved treatments continue to allow markets to look across the valley to the better times of 2021 and 2022. Covid-19 means that we will not see a recovery across all sectors, and this disruption means the process of creative destruction has polarised the world of winners and losers to a greater degree than many investors will previously have experienced.

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