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Investment review - Q3 2020

30 September 2020

After such a strong recovery in asset prices during the second quarter of the year, it was perhaps somewhat inevitable that the summer months would be characterised by a period of general consolidation. It has been good not to lose ground in recent months, but making further headway has also been quite hard, particularly since so many varying scenarios, with different market implications, have remained on the table.

For much of the past quarter the US stockmarket has, once again, delivered some of the better returns, driven higher by the continued appetite for growth stocks and in particular the big technology heavyweights within the main market. The UK stockmarket, in contrast, has largely trod water, the mood being dampened by a combination of bleak economic data and greater awareness that the end of the Brexit transition period is looming, and a trade deal has yet to be done.

Coming to terms with uncertainty and managing expectations

The coronavirus has understandably been central to everything of late, but financial markets do now appear to be coming to terms with the prospect of having to live with the uncertainty of the pandemic, and its economic consequences, for an extended period. That has at least created a modicum of stability in recent months. In many ways this stability has been both helpful and welcomed after the frenetic volatility of the first half of the year, allowing more sensible assessments to be made of where headwinds and tailwinds are likely to emanate from going forward, and when.

It is still far from clear what shape the recovery will take, but it has at least been encouraging to observe, particularly around mid-summer, a strong recovery in some leading economic indicators in both the manufacturing and services parts of many economies. These indicators do, however, now show some signs of plateauing. The undercurrent of an escalation in COVID-19 cases around the world is understandably causing feet to hover nervously over brake pedals again, but there is some reasonable justification for believing that second-wave effects will not be as devastating on lives and the world economy as the first wave, particularly since we do now seem in a better position to manage the virus. We are also, hopefully, a little closer than we were to finding a vaccine solution.

Whilst acknowledging that economic forecasting is still prone to greater error than usual, everything does suggest that recovery expectations for the remainder of the year and into next should be toned down and the chances of a global recovery to pre-COVID levels of economic output are still quite some way off. But this does not necessarily mean that investment opportunities are drying up. On the contrary, continued levels of central bank stimulus, low interest rates and subdued inflation continue to sugar-coat a variety of risk assets.

Taking a balanced and active approach

Against a backdrop of uncertain economic data and likelihood of a resurgence of coronavirus taking hold over the winter months, balanced with all the positives stemming from continued stimulus, maintaining a neutral stance on equity positioning does still seem appropriate. It is worth noting that our current 'neutral' equity market stance for our varying strategies is exactly in line with our longer term, strategic positioning – i.e. it is not a negative or especially cautious stance. We will deviate from this to the upside when we are particularly confident about the future and will do the opposite when we are not. Our confidence and conviction to place more capital at risk may currently be absent, but equally we see little need to reduce stockmarket commitments whilst inflation is contained and so much policy accommodation remains in place.

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As outlined in our various recent communications we have, however, been very active over the summer months in redistributing the capital already committed to stockmarkets into those areas where we see greater longer-term opportunity. This has principally focused on increased allocations to the US and Asia, and reductions in UK stockmarket exposure. The final quarter of the year is unlikely to pass without some form of incident or heightened volatility that might allow an increase in stockmarket exposure. We can envisage, for example, market moves around the US Presidential Election or the Brexit trade deal deadline potentially providing an opportunity to deploy some of the cash currently being held, but equally it could tip us in the other direction if the economic or policy picture looks more troublesome.

Capturing demand for US technology innovators

Without wishing to labour the point too much, a swift economic recovery does not appear imminent, particularly since a vaccine solution is by all accounts some way off and we are now facing the reality of a return to more restrictive measures over the winter months. The prospect of a disputed or delayed US election result might also extend the period of uncertainty and timing of any economic recovery. These ongoing, restraining influences on the world economy are therefore likely to cause investor interest to be concentrated on those areas of the market that can still capture the pockets of greater demand. This suggests that many of the 'big technology' companies, including the likes of Microsoft, Amazon and Apple, will remain in vogue: they have unique global positioning, being at the forefront of many of the technology and consumer-led changes going on in the world.

In the past few weeks profit-taking in many of these high-profile technology names has brought their valuations back to more acceptable levels. With the virus situation escalating again, we expect the recent sell-off in this part of the overall market to be brief, but it has provided us with an opportunity to introduce some more focused exposure to technology-related companies in particular. We have specifically targeted investment funds tracking, or closely aligned with, the NASDAQ 100 Index in the US. This is not just a technology index – it tracks the largest non-financial companies listed on America's NASDAQ stock exchange and does emphasise the 'big technology' names. However, whilst around half of the index is exposed to the technology sector, the remainder is allocated to a wide range of consumer services, wholesale and retail trade, and biotechnology companies. The common theme is that there is a high proportion of companies considered to be on the front line of innovation.

Our recent move to further increase the US stockmarket exposure, via a more overt technology-centric investment, expands the existing solid exposure in client portfolios to broader-based and perhaps lesser-known technology companies further down the market capitalisation scale. Our external US fund managers, especially, have not been shy in building up exposure and technology-based themes are prominent in most of their portfolios.

But it is becoming harder to define what is meant by a technology company. The lines have become blurred. In 1996, when Amazon was first formed, it firmly considered itself a technology company, but is now unquestionably the largest 'consumer discretionary' stock in the world. Some care often needs to be exercised, therefore, over the labels placed on companies for the convenience of stockmarket sector categorisation. All manner of companies, even those exposed to more cyclical aspects of the economic cycle, have technology so deeply embedded in their business models that it is often hard to give them a precise label. So, maintaining good exposure, as we are, to a diverse range of companies that are embracing technology is just as important as having investments in those firms which are facilitating the transformation of the world economy.

Shifting away from the UK

The plight of the UK economy has again been highlighted in recent data releases, whilst the latest government directive encouraging a resumption of working from home, based on a new spike in coronavirus cases, is likely to result in further economic pain.

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On top of this, UK-EU trade deal negotiations do not appear to be going smoothly: the delicate situation with the EU has been inflamed by the UK government's intention to over-write critical elements of the Withdrawal Agreement via its Internal Market Bill. Relationships appear strained and this recent episode appears to have damaged the UK's credibility and increased the likelihood of there being no agreement on trade terms before mid-October – that point being the last scheduled opportunity for European Council members to meet to discuss and a trade deal before the transitional period ends. All of this is likely to compound the issues faced by the UK economy and cause sterling to remain under pressure.

Even if we do get some better news on the trade front, we expect the pound to remain under threat from fundamental weakness in the UK economy relative to many of its close peers. The current gap of more than 20% this year (in sterling terms) between the performance of UK stockmarket and many other developed markets, only partially accentuated by the weak currency, is a sad reflection of the UK's deteriorating position on the world stage. We do not expect this gap to narrow any time soon.

When the previously mentioned portfolio realignments are complete, around 80% of clients' stockmarket exposure will be exposed to what we believe will be more vibrant economies and stockmarket opportunities outside the UK. Other world economies are not without their own problems, but what we are witnessing is a greater divide developing between stronger and weaker economic regions – in effect a breakdown of globalisation – that requires even greater accentuation in portfolio positioning.

Backdrop remains supportive for risk assets

Leaving the coronavirus to one side, the other important news for markets to absorb in recent weeks has been the US Federal Reserve's ('Fed') announcement that it intends to adopt a more flexible form of average inflation targeting, allowing inflation to rise above its 2% target without it automatically triggering action to alter interest rates. This initially spooked fans of the US dollar and sent the gold price higher, but this has now subsided.

The Fed's new monetary policy strategy marks a major shift in the way the authorities view the relationship between economic growth and inflation. It is becoming increasingly clear that the Fed's ability to deliver on its desired policy outcomes is being compromised by COVID-19 and therefore the central bank will probably need to do even more to sustain the US recovery, let alone try to nudge inflation towards and above its 2% target. This backdrop points to an extended period of very low policy that should remain supportive for risk assets, continuing to make both stockmarkets and traditionally lower-risk assets like bonds appealing investments.

At some point the prospect of higher inflation is likely to prompt a re-think in investment strategy, but for the time being we believe that inflationary forces will be kept at bay and, therefore, interest rates are likely to remain anchored at exceptionally low levels, possibly for several further years to come. This means that a variety of risk assets still have the capacity to deliver a real (i.e. positive, in inflation-adjusted terms) return in the coming years.

Continued focus for final quarter

There are still plenty of trip hazards for us to be mindful of as we go into the final quarter of the year, but as noted markets are likely to continue to lean on the support offered by highly accommodative policy conditions and a moderate pace of economic recovery. It won't be an easy ride from here, but directing, as we have in recent months, a higher proportion of investible capital into parts of the world economy that are likely to continue to drive things forward should pay dividends.

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Risk warnings

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