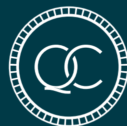

MARKET COMMENTARY - OCTOBER 2020

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

Equity markets paused for breath in September after a steady rebound from the 23 March low. The global economic recovery continues but a second wave of COVID-19 in Europe and regional lockdowns are a timely reminder that the pandemic still has some way to run. Although over 50 vaccines are under development, they are unlikely to be available until well into 2021.

The US market touched another new high in early September before retreating nearly 10% intra-month on profit-taking and pre-election nerves but still ended Q3 up 7% - almost 50% above the March low. Other markets saw similar, albeit less extreme, moves. The UK had another weak month and ended the quarter down 3%. Currency movements boosted international equity returns for sterling-based investors resulting in a positive return of 3.2%. Yields on UK conventional 10-year gilts remained flat at around 0.2%. Brent crude ended the period unchanged at $41 while gold was slightly higher at $1,906.

While the economic recovery has surprised on the upside in recent months, global output is not expected to return to pre-COVID levels until 2022. None of the major economies have emerged unscathed although there are significant regional variations. Google mobility reports suggest that the return to workplaces has been higher in emerging economies than the developed world but retail and recreational activity is lower. The recovery is most advanced in China, Taiwan and Vietnam as a result of good virus control and their competitive advantage in producing goods which are in high demand - notably consumer electronics, IT and medical equipment. Countries like India that did not manage the virus well and those exposed to international travel - Hong Kong, Singapore and Thailand - have lagged. However, as the structure of the global economy evolves and the developed world seeks to re-shore production, the outlook for Asia may become less attractive. Japan has also lagged with machine tool orders

still bottoming and disappointing exports creating a soft labour market. Although the change in Prime Minister is unlikely to alter economic policy, there may be pressure for additional fiscal measures to prevent further disinflation.

In the US, credit/debit card data suggests that the recovery in consumer spending has flattened in recent months with overall spending 5%-10% below pre-COVID levels. Surprisingly, high income households have been notably more cautious which may reflect a softening in small business activity in marked contrast to optimistic ISM business surveys, especially for new orders. New jobless claims have fallen faster than expected but continuing claims and unemployment remain at recessionary levels. While the acceleration in ecommerce is positive for digital disruptors, it means some job losses may be permanent. Employment concerns will affect consumer confidence even if large-scale lockdowns are avoided.

The easing of restrictions in Europe just before the peak holiday season was a boost for tourism which represents a significant part of several economies. Although manufacturing and exports are steadily improving, a second wave of infections and quarantining is likely to dampen the nascent recovery. The euro 750bn EU Recovery Fund was approved as a one-off measure but, at 5.5% of GDP, it is a substantial fiscal initiative marking a change in German policy. Using a similar mechanism to development banks, the EU Commission will issue AAA bonds to support grants and loans prioritising investment in digital and green projects.

UK GDP fell 20% in Q2 and, even though it has since recovered strongly, is likely to end 2020 down 9% - at the bottom of the league table and just above Spain. Despite very low return to workplace data, there have been broad-based gains across major sectors with industrial production slightly ahead of domestic-orientated services and construction. There is no light at the end of the tunnel for the hospitality sector and the Eat Out discount scheme - used more than 60m times in August - appears to have been a temporary respite. The Coronavirus Job Retention Scheme has helped forestall a wave of layoffs but hours worked have fallen sharply. When this initiative ends in October, the new Job Support Scheme should soften a rise in unemployment. As in other economies, the fiscal budget has expanded dramatically and in the short-term is being funded by record issuance. The long-term approach appears to be a greater tolerance of inflation and tax increases. The possibility of a "hard" Brexit has resurfaced although modest sterling weakness suggests a deal could emerge by late October.

FTSE ALL SHARE

Source: Refinitiv Datastream 01/10/2020

FTSE BRIT GOVT ALL STOCK

Source: Refinitiv Datastream 01/10/2020

FTSE ALL WORLD £ - TOT Return IND

Source: Refinitiv Datastream 01/10/2020

Central banks continue to be supportive and in late August the Federal Reserve enhanced its fiat money printing credentials with a commitment to keep policy ultra-accommodative until any "shortfall" in employment is eliminated. In addition, by allowing inflation to exceed the 2% target, the Fed shifted its trade-off between growth and inflation. As this policy evolution had been well flagged, with inflation so low the short-term impact on bonds and financial markets was limited. Although quantitative easing has tended to result in steeper yield curves - on the basis that printing money leads to inflation - the scale of asset purchases is such that they have remained flat. Judging by Japan's experience over the last decade, this could remain the case for the foreseeable future. However, given the extent of COVID fiscal stimulus, we expect yields to nudge up and it will be important to monitor how this is absorbed in a zero interest rate environment.

These exceptionally accommodative policies have boosted the relative attraction of equities versus bonds with the ratio now back to pre-crisis levels. This suggests that market valuations leave little room for disappointment albeit corporate earnings have so far surprised on the upside. We expect markets to remain volatile in the run-up to the US presidential election and do not anticipate significant sector rotation in view of the structural and cyclical challenges facing year-to-date under-performers. This particularly applies to banks - which are contending with low interest rates, flat yield curves and dividend restrictions - and energy. High exposure to these sectors may mean the UK market continues to lag. The companies we expect to outperform include those with a high proportion of visible/recurring revenues, flexible cost bases and the ability to grow despite economic conditions.

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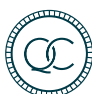

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