QUARTERLY MARKET OVERVIEW – OCTOBER 2020

"We naturally fear the unknown, and the future is always unknown"
– Peter Bernstein

As the global economy comes back to life, it is clear some parts may take much long or may never return to previous levels. Over the summer there was great optimism that we were finally turning the tide on COVID-19, however it seems the virus is fighting back.

In the UK, according to JP Morgan, testing was picking up around 14% of cases in March and April; this is now nearly 80%. Despite what we see and read; several updates have indicated that the UK is one of the best at reporting in the world. The fear for the government is the same; that cases convert into increased hospitalisation and fatalities.

There is a careful balancing act – governments need to stem the tide but at the same time they do not want to shut down economies.

It is worth remembering we have come a long way. On average, it takes 10 years to develop a vaccine. There are seven vaccines in phase 3, which means we could have a vaccine within 12 months. Production of some vaccines has already started and although it will take time to vaccinate everyone, this will be an amazing achievement and very positive for research and the development in the future. Once a vaccine is announced, this will start to change things very quickly in markets.

Also, we know a great deal more now about the virus than we did at the start of the year and therefore treatments have improved, and chances of survival are that much greater.

In the this update we will look at reasons why Asia may have responded better to this pandemic than the West.

Away from COVID-19, the next three months will be trying. The US Election at the start of November is the biggest headline, with the polls pointing to a Biden victory. However, even if the popular vote goes to Biden, the electoral college system favours Republicans and the margin will need to be around 3%-5% to give outright victory. It is far too early and close to call, but we cannot rule out a Trump win. What the market fears most is for Trump to contest the result and end up in office for a second term by default.

The tensions between China and the US have not lessened and we expect this to increase as Trump pushes for victory.

In the UK, by mid-October we will know more about whether a BREXIT deal will be struck. Where there was optimism that a fudge would be arrived at, it now seems most are hoping for a deal but with very little certainty.

There remain reasons to be optimistic:

1. Although some sectors will struggle, others are recovering, and there is a strong chance we will have a vaccine in the next few months. This should mean a return to some form of normality
2. The change by the US Fed to average inflation is a clear sign that interest rates are unlikely to rise for 5 years plus. Low interest rates, low inflation and QE are all positive for equity markets
3. There remains a wall of cash waiting to buy back into markets. Investors hunting for income must now climb the risk scale and equities become the only meaningful asset with liquidity which can provide sufficient yields. Also, as markets recover there is a fear of missing out which drives people to invest
4. The dollar has weakened this year, and this is positive for Emerging Markets, especially Asia, which is benefiting from lower oil prices and has responded better to the COVID-19 crisis. Their economies are recovering much quicker, Therefore, EM could be a good environment to invest
5. The UK understandably, is unloved and is under allocated. Whatever happens with BREXIT, it will ultimately give us “certainty”. This will be either we crash out, or we have a fudged deal. At some point investors will return to the UK market
6. If Governments remain supportive then we can expect more spending, especially around infrastructure

Sir David Attenborough recently joined Instagram stating, “saving our planet is now a communications challenge” and to this end, we are including a new section at the start of this report on the rise of sustainable investing. Many investors now want to know that they are also investing for good. The financial services sector needs to adapt to reflect this, and we will be sharing our thoughts as well.

In summary, it is unclear how things will look by year end, but I am sure many are already wishing for 2021. There are continuing uncertainties around a second wave and the economic implications, although other issues remain like the US election, Brexit and China/US tensions which took a back seat temporarily. In this update I will share my thoughts over the last three months, and things to consider going forward.

George Ladds

George Ladds, Director, October 2020

SUSTAINABILITY

Ethical investing funds became available to retail investors in the 1980s, however performance against mainstream investments was often poor. It always seemed like a trend; one that would remain on the sidelines.

However, there are now key changes moving sustainable investing into the mainstream, as well as growing evidence that the right investments provide investors with good returns and diversification.

It is worth reflecting on this statement from the UN:

"The COVID-19 pandemic has destroyed lives, livelihoods, and economies. But it has not slowed down climate change, which presents ever-growing threats to people's health, jobs and safety. The stakes could not be higher: the science shows temperatures are in record-breaking territory, greenhouse gas levels are mounting, sea level is rising, and natural disasters are getting much worse.

As the world confronts the pandemic and embarks on recovery, there is growing recognition that the recovery must be a pathway to a green and sustainable economy that produces jobs and prosperity, reduces emissions, and builds resilience. From the science to the solutions……. the United Nations is bringing together all nations and peoples, so we leave no-one behind as we tackle the global climate emergency."

In this first update we will cover some of the current changes, and in future updates we will share thoughts from other investment managers.

<u>Governments</u>

There are significant changes happening globally.

The Paris Climate Agreement sets out a global framework to avoid dangerous climate change by limiting global warming to well below 2 degrees and pursuing efforts to limit it to 1.5 degrees centigrade.

The UN has developed 17 Sustainable Development Goals aimed at increasing prosperity and well-being whilst protecting the environment.

In our day to day lives we can see a greater drive towards recycling, the use of electric vehicles and although it seems small, regulation on the use of plastic bags. This is now very much in the forefront of our lifestyles.

Changing habits

The likes of Sir David Attenborough and Greta Thunberg are making people think about the world around them, and what we can do to make change happen. A recent Government survey indicated that 2 in 3 people think financial institutions should avoid investing in companies that harm people or the planet.

Millennials are twice as likely to think they have a social responsibility to ensure their pension is invested ethically.

In the current environment people are looking at how companies are looking after staff, how executives are paid, and they are using their voice to vote down executive pay where they feel they are not being socially responsible.

And this goes further, for example, to thinking about the coffee we buy, where we buy it and how it is sourced. There is little doubt the world is changing.

Legislation

There is legislation being produced where sustainability preferences must be included in the advice process. This is likely to come into place by the end of 2021, and we will provide updates when we receive more information.

Performance and diversification

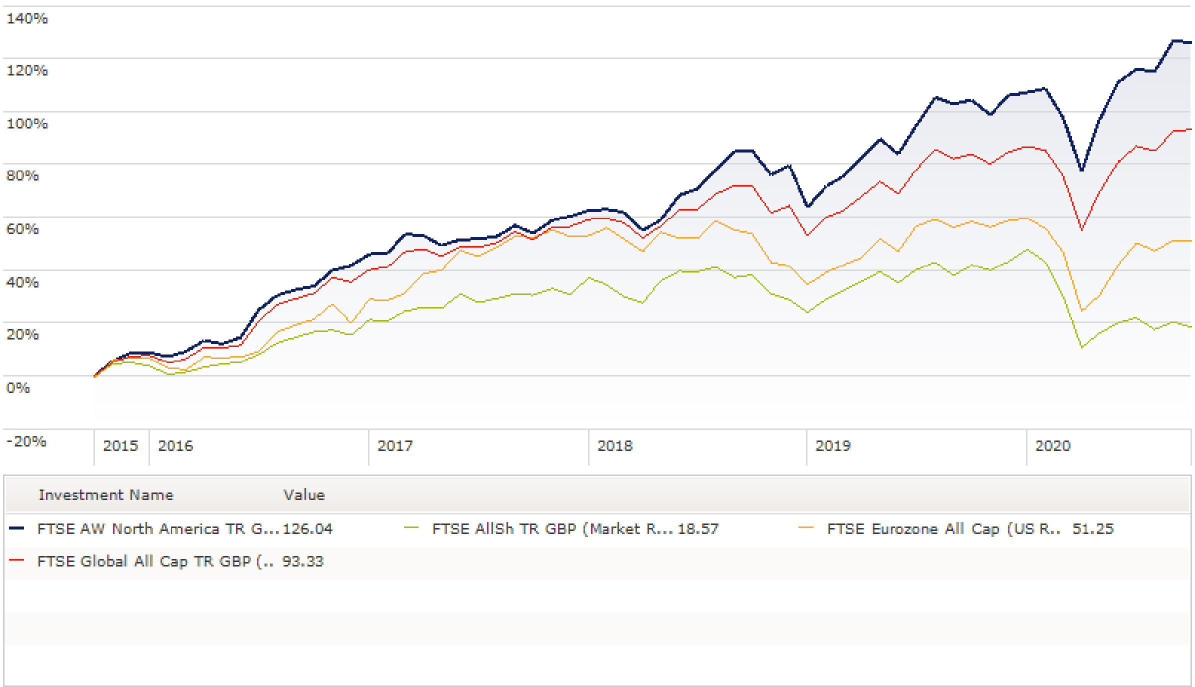
The recent market downturn demonstrated many of these investments were more resilient.

They not only provided some downside protection but also benefited from the market correction. Research also indicated that ethical funds outperformed conventional funds in over 76% of time periods.

There is also significant diversification and choice for investors; even when compared to five years ago, the range of investments is much wider. Examples include renewable energy, social housing/infrastructure and active managers who work with companies to make positive change happen.

US, EUROPE & UK

Five year returns 1 October 2015 – 30 September 2020



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The West has struggled with this pandemic, with recent spikes in France, Spain, and the UK. Where we saw a V-shape recovery that is now levelling out and the economic recovery remains incomplete. It demonstrates the constraints on getting fully to normal, and much of that depends on the vaccine.

In Europe, the recovery fund reduces the risk of a breakup of the Union, and this may be much to do with the strengthening Euro. Europe has been pro-active in keeping people attached to jobs. The UK was behind the curve until the recent announcement by the Chancellor, however with around 4 million people on furlough there are worries about how many become unemployed. With the US, there is still no agreement on the stimulus package, and this is starting to impact consumer confidence and thereby spending.

The crisis has hit the lowest paid hardest and there will be jobs that disappear. We have seen acceleration in trends that perhaps would have taken 5 years to play out. The biggest risk remains unemployment, and re-employment, where people re-train to do something totally different.

The FTSE 100 is one of the world's worst performing major markets, however the PMI data is stronger than that from Europe and the US; high frequency data is improving and there is a general expectation of further positive data news.

Brexit remains a black cloud for both the UK and Europe. The UK remains confident with its recent trade deal with Japan and is positive about a deal with the US. Previous optimism that a deal would be struck with Europe has faded slightly to be replaced with realism about a no-deal Brexit. In the short term it could be negative for both Europe and the UK, pushing them into a recession (if we are out by then!). Longer term for the UK this optimism should return.

We would expect sterling to fall if there is no deal, but many economists do not believe this will necessarily be good for the FTSE. They feel there are too many factors at play including oil prices. The FTSE is currently in the wrong place with many unloved stocks. Higher interest rates, and a good economic environment would change that, but it does not seem to be likely any time soon.

Touching on COVID, the UK has the best data of any country with infection rates in the community at 0.1%. 80% of people testing positive have had no symptoms. The UK also potentially leads the way with the development of a vaccine. The Oxford team have passed Phase 1 and 2 of testing which shows it is safe and produces T-Cells and antibodies. Phase 3 testing has been running in Brazil and South Africa since June and more recently in the US. 30 million doses are expected to be ready by the end of September, with a total 100 million doses on order.

There is confidence that even if Oxford fail, a vaccine will be found soon. There are 7 vaccines in phase 3 and there is an 85% chance of approval when drugs are at this stage. It is important to remember it will take time to distribute, and like with the flu vaccine, the protection rate is only around 50%. So, the potential remains for anyone to catch COVID.

In the US, there is political division and therefore inequal response across the country to the situation. The number of cases is reducing, and the mortality rate is around 1%. Unemployment peaked near 23% and has dropped to about 10%. These are positive signs from the US but the failure to agree a follow-on package is concerning and the negative impact of this is evidenced by weaker consumer confidence and a slowdown in spending.

The US saw the shortest bear market of just 34 days. The S&P is at the third highest valuation ever with 24 times earnings, in 1999 this was 30 times. Companies are beating analysts' expectations, and many believe this will continue.

The election, however, is another storm brewing. The states to watch are Arizona, Georgia, Florida, North Carolina, Pennsylvania, Wisconsin, and Michigan. Trump's rating has dropped from 54% to 31% but he leads in areas like the economy and crime. Biden leads when it comes to healthcare, and coronavirus. The polls point to a Biden victory, but this is far from certain and the markets fear no clear result which ultimately ends up in Court.

The other concern with the US is inflation complacency. In the 1960s/70s it was not just the oil crisis. At the time there was a full employment policy goal, great society fiscal package for low income earners, low interest rates for government borrowing, sluggish productivity, and increased government interest in private companies as well as increased dominance of large firms. This all sounds very much the same as today, and there are concerns that inflation could race ahead.

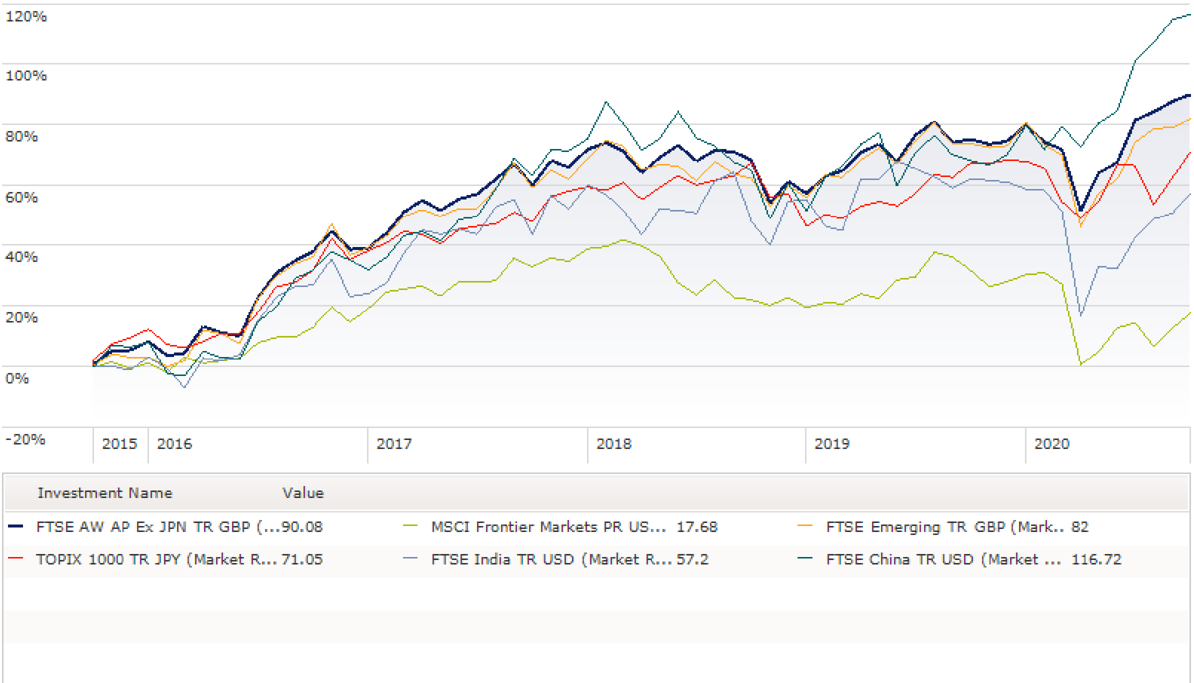
In summary, there are many factors at play now. There are concerns that the recovery bridge has not reached the other side, and all the money invested so far could be wasted if new policies are not put in place especially in the US. Income is also being squeezed, in 2013 there were $16 billion of negative yielding bonds, this is now $14 trillion!

We are also seeing an acceleration of existing structural changes – working from home, with increased online activity and no signs this will change. Some jobs will disappear completely. Longer term, there are fears over higher taxes, inflation, and Government interference but this is currently less worrying as countries climb out of this crisis.

As a final curve ball for the UK, there are growing concerns that a Scottish referendum could be on the cards once more, with a greater push this time and growing support. When mixed with what has been seen as poor handling of COVID, and Brexit, this could leave the UK out of favour for some time to come.

EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 October 2015 – 30 September 2020



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There is little doubt that certain Asian economies have exited this crisis in better shape. Evidence points to enhanced consumer behaviour where they are more likely to use face masks and social distancing. The infrastructure is already in place (for example temperature controls at airports) and both mobile tracking and data privacy has been better used in managing the virus. There tends to be a higher level of respect for the government and police, which gives higher levels of compliance as well as collective values and moral responsibility.

A weaker dollar and lower oil prices also help, combined with lower inflation, lower interest rates and a more stable currency. Emerging markets make up 60% of global economic activity and a significant part of global GDP.

It is a part of the world under-owned by investors, and in part this is due to the fears over trade tensions and de-globalisation.

Global GDP over the next 20 to 30 years will be driven by China and India. China's population is 1439.30 million, India 1380 million and the US 331 million. China is the dominant force and its major trading partners are Taiwan, Malaysia, and Vietnam, not the US. In fact, 60% of trade in Asia is within the region.

Technology is at the heart of the dispute with the US and China, with other Asian countries leading the way in digitalisation, smart cities, AI and 5G. In China, the likes of Baidu, Tencent and Alibaba work with the government, whereas in the US big tech names are facing potentially higher taxation and more Government interference.

The corporate sector tends to be in a better place and there is a decreasing dependence on Western economies. It is felt that Asia will lead the world in the 4th industrial revolution. China does not need the US consumer to have a long runway of growth. India has strong underlying fundamentals.

As countries move away from China, countries like India, Indonesia and Vietnam are all benefiting. Where urbanisation in the US is around 82%, in Vietnam this is 37% and India 34%. In China, this is still only 60%, another factor in the ability for these economies to grow further.

Africa is interesting, especially countries like Nigeria and Egypt. There are governance issues, however these are countries to watch going forward. The argument that globalisation changes through COVID and consumers no longer want to buy things from around the world seems unlikely. We have seen rising importance of Chinese healthcare and thereby their collaboration with healthcare providers across the world, due to the scientists they have. They have three companies working to develop a vaccine.

The US is becoming ever more isolated because it has so many sanctions against different countries, which means former partners turn away to forge new trade paths.

In terms of the virus, South Korea, Hong Kong and Japan have seen second waves, but these have not been as severe, and they have been quick with lockdowns. There has been a significant uplift in manufacturing data from Malaysia, Singapore, Taiwan, and China. India has struggled to contain the virus, but many believe the next five years could be a crucial period for the country.

Risks however, include China vs India border issues, North Korea, Russia, Taiwan tensions with China and US interference. The benefits of these regions far outweigh the risks.

In summary, the story in Asia and Emerging Markets remains positive. It has underperformed the US over the last five years, but it has proved resilient in the recent crisis and seems to be coming out stronger. A weaker oil price and dollar will only benefit the region. The US trade tensions do not help but ultimately the sway of the US is weakening, and a Biden victory could be good, along with a more conciliatory message. But even with Trump, the cards are stacked against the US to turn a tide that is growing stronger daily.

Just touching briefly on Japan and Abe resigning, the general view is that there will be a continuation of what is already happening because momentum is behind the changes.

CASH

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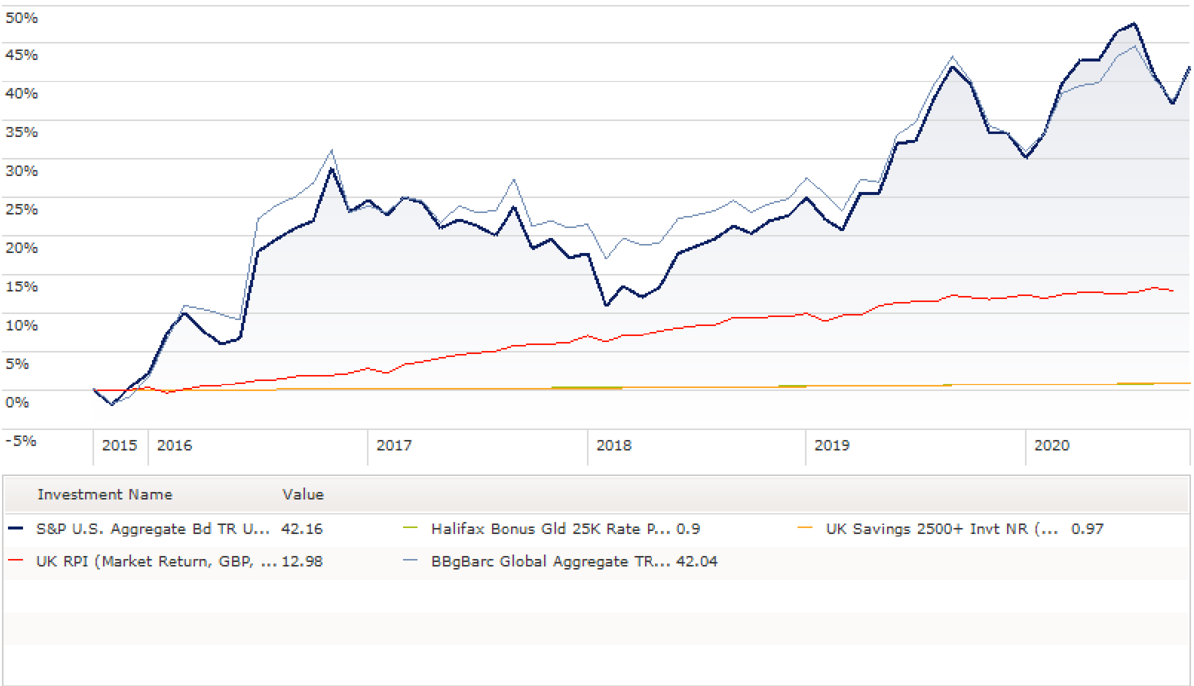

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There are essentially two messages from this update:

1. Interest rates are not going up any time soon and this could be five years or more
2. Debt with zero or negative yields is now £14 trillion, meaning to find income from debt means investors must increase their risk exposure

The message for the last ten years will likely be the same for the next 10 years. It remains challenged and over time with inflation is a negative returning asset class.

CONCLUSION

Much of the update has focused on COVID and this remains a situation we are struggling to contain. It normally takes 10 years to develop a vaccine and this time it could be ready in less than 12 months which will be a game changer. This also has a massive implication for development of future vaccines.

We also understand the virus better and the ability to manage and cure people who have it. In many cases people do not realise they have it, or the symptoms are very mild. Some may look upon Asian countries negatively, although clearly those populations have responded well as there is a greater sense of cohesion which has no doubt helped economies recover quicker.

The world will recover eventually but the massive structural changes which were coming through have been accelerated because of COVID, where some businesses will simply not exist now. It is likely that parts of Asia and Emerging Markets will just get stronger.

In the short term, the US election will be interesting and although everything points to a Biden victory, we should not assume Trump will not win. The worst situation will be a contested/close result with Trump being the named eventual winner. This has happened before, and markets do not like this.

In the UK, there is always hope until there is no longer hope! We should prepare for no deal which may not be as bad as we think. Our currency could be weakened, and a longer recession could be consequences, but long term we have a platform to work from. Another Scottish referendum could be damaging, and this is something to watch for.

In summary, we have seen economies recover but for many this has stalled. Until there is a way forward, likely a vaccine or cure, economies will work under capacity. However, with seven vaccines in phase 3 we can be optimistic about positive news in the coming months.

Source: Charts have been sourced from Morningstar. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.