COMMENTARY

1st July to 30th September, 2020

The quarter began with investors in an unambiguously bullish mood, which was at odds with data that evidenced the very worst of the global lockdown's impact on western economies. It ended with a much more circumspect tone, amid concerns over a second wave of Covid infections, the resulting re-imposition of social restrictions across the developed world and with hopes of an early vaccine breakthrough fading.

Although some way from their earlier highs, broad global equity benchmarks ended the period with healthy gains, while credit spreads followed a similar pattern of advance and partial retreat. Core sovereign bond yields were little changed, having already anticipated the monetary and fiscal initiatives that were announced by authorities during the quarter. After extending its losing run, the Dollar closed on a steadier footing, thanks in part to a Federal Reserve policy shift that suggested a more relaxed approach to inflation targets in future and which boosted interest in commodities.

Equities

In terms of the quarter's movements, it was a case of two steps forward and one step back, with September's decline representing the first negative month for broad global benchmarks, when measured in US Dollars, since March.

Equity Market Indices

Index	Q3-2020	YTD
MSCI World ($)	+7.52%	+0.37%
MSCI World (€)	+3.12%	-3.85%
MSCI World (£)	+3.09%	+3.11%
MSCI World (local ccy)	+6.29%	-0.33%
S&P 500 ($)	+8.47%	+4.09%
FTSE UK All Share (£)	-3.77%	-21.79%
MSCI Europe ex-UK (€)	+1.15%	-9.37%
Japan Topix (¥)	+4.28%	-5.57%
MSCI Asia ex-Japan ($)	+9.82%	+3.52%
MSCI Emerging Markets ($)	+8.73%	-2.93%
MSCI Emerging Markets (€)	+4.29%	-7.01%
MSCI Emerging Markets (£)	+4.25%	-0.28%

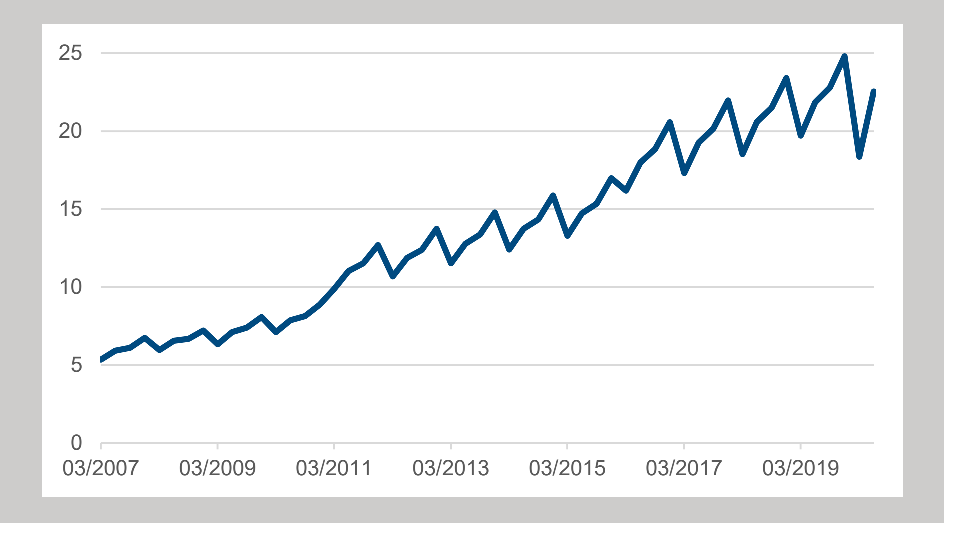
Source: Bloomberg

The buoyant conditions during July and August that extended markets' recovery from Q1's severe sell-off contrasted sharply with GDP releases that highlighted the full effect of lockdown measures on western economies. If there was one crumb of comfort to be had from the annualised 31.7% drop in US second quarter output, however, it was that the largest contraction ever recorded wasn't as bad as initially feared - the same could be said of the Eurozone's 14.7% annualised fall and the UK's -21.7% figure.

Meanwhile, forward-looking indicators, such as Purchasing Managers' Indices (PMIs) pointed to a healthy rebound in activity across both manufacturing and service sectors, with the most recent composite readings of 54.6 (US), 51.9 (Eurozone) and 59.1 (UK) pointing to a robust increase in activity, albeit to levels that are still significantly below those prior to the coronavirus pandemic.

Whereas the US and Europe would appear, for now at least, to be following a "tick-shaped" path (our last commentary refers), China's recovery has taken on more of a V-shaped profile. There, second quarter GDP growth of 11.5% followed Q1's 10.0%, which, if the latest composite PMI of 54.5 is anything to go by, puts the world's second largest economy on track to regain pre-pandemic levels by the year-end in nominal, if not real, terms.

China GDP (CNY trn)



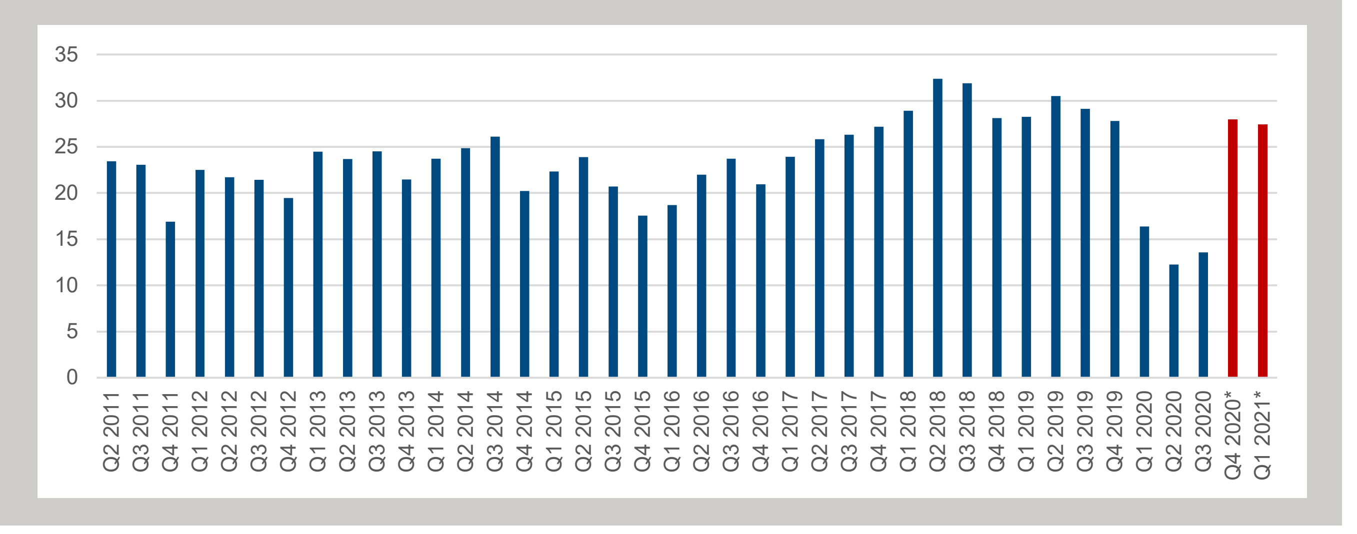
Source: Bloomberg

Adding to the markets' positive tone during the early part of the period under review was the announcement, in July, of a €750 billion EU recovery fund: a combination of grants and loans, which, along with a seven-year €1.07trn fiscal package was agreed by the single market's leaders in a remarkable and uncharacteristically short period of just four days – an indication of both their collective resolve and the scale of the challenge at hand. In the US, the Federal Reserve also pitched in with an extension of its emergency lending programme beyond the original September expiry date to the year-end, however deep divisions between Democrats and Republicans meant that a multi-trillion Dollar fiscal package to replace the outgoing support provided by earlier relief programmes failed to materialise.

That impasse, in combination with, among other things, fears of renewed lockdown measures and growing uncertainty over the outcome of the upcoming presidential election, began to weigh on the US market during the latter part of the quarter and made for a shaky end to the period. Those "other things" included unusual levels of activity in the options market, which have been attributed in part to the burgeoning number of day traders who have gravitated to financial markets - and in particular mega-cap technology stocks - from sports betting during lockdown. The resulting volatility saw the tech-heavy Nasdaq Index drop by more than 10% in the space of just three days during early September and the developed world MSCI World (local currency) Index shed 7.20% before retracing some of the decline late on.

As surmised within our last commentary, despite making for truly woeful reading, with aggregate earnings for the MSCI benchmark's 1600+ underlying constituents down 25.10% from Q1's already depressed levels and 59.80% below last year's corresponding figure, the Q2 reporting season appeared to have no negative impact on investor sentiment. In fact, the opposite was true, since, remarkably, thanks to companies' cautious guidance and analysts' overly pessimistic forecasts, the number of positive earnings surprises exceeded previous records. Unsurprisingly, the response of the analyst community has been to raise their forecasts for future quarters, which, though by no means unique, is certainly unusual within a historical context at this point in the annual cycle.

MSCI World Index EPS quarter-on-quarter (USD)



*Estimated
Source: Bloomberg

At the quarter-end, this puts the aforementioned MSCI index on a forward price / earnings ratio of 24.15x according to Bloomberg figures, which was only surpassed in recent history (ever?) at the peak of the technology bubble twenty years ago. That, we would argue, is sobering in itself, but given an outlook that is perhaps more clouded than at any time since the global financial crisis, it suggests that, even after allowing for the supportive monetary backdrop and resilient nature of the businesses that currently make up a sizeable chunk of the benchmark, a measured approach to equity markets is warranted. Accordingly, we have maintained our “house view” tactical risk score at one or two notches below neutral and will continue to trim portfolios’ exposure back to model weightings after any periods of prolonged strength.

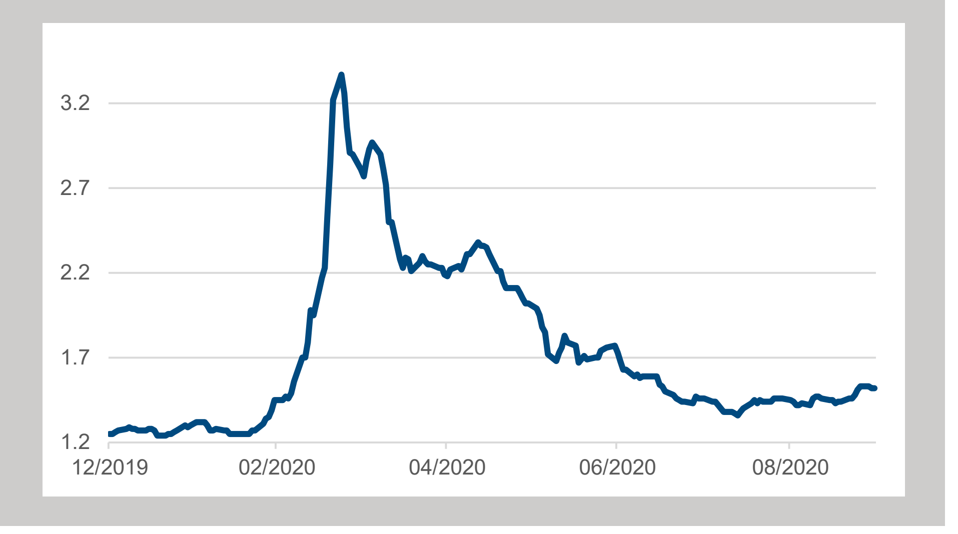
Bonds

Measured by the Bloomberg Barclays >1yr Indices, core Sovereign bond markets, were little changed (US +0.14%, Germany +0.39% and UK -1.30%), with their respective ten-year benchmark yields up 28 basis points (bps) to 0.69%, down 68 bps to -0.52% and up 6bps to 0.17% over the quarter.

After the EU’s stimulus “bazooka”, arguably the most significant event on the monetary policy front was the announcement by the Federal Reserve that it would change its policy to target a 2% inflation rate “on average” and “over time”. Based on markets’ response, this would suggest that policy rates can be expected to remain lower for longer and that there will be a greater tolerance for inflation above that 2% figure. With the possibility of negative interest rates gaining traction in the UK and the ECB sending very clear messages through its actions, we’d find it very difficult to argue otherwise. While it means the risk of meaningful capital loss from investing in these markets is diminished, it’s also the case that, with yields anchored at or near historic lows for the foreseeable future, the rewards for doing so over any meaningful period are at best unappealing, albeit diversification benefits remain.

Although a further narrowing in yield spreads reduces the opportunity set within credit markets to some degree, investment grade corporates, high yield and the various sub-sets of emerging market debt continue to offer the potential for useful returns, as demonstrated by the gains recorded across the piece over the period under review. With those spreads moving lower, however, the limitations of a conventional “buy and hold” approach to credit markets become more apparent. As such, we believe our preferred approach, which focuses on niche market areas and / or employs flexible strategies that include active hedging and shorting techniques, is more appropriate than ever.

US BBB Corporate Credit Spread (bps vs UST)



Source: Bloomberg

Currencies

Continuing the pattern from earlier quarters, the risk-on conditions that prevailed throughout July and August saw further weakness in the US Dollar, which, measured by the DXY Spot Index slipped 5.39% to a 27-month low before a partial recovery left it 3.60% from its opening level. Of the 16 other major currencies listed by Bloomberg, only the Brazilian Real (-2.53%) lost ground in USD terms. Conversely, the Mexican Peso (+4.60%) Danish Krone (+4.36%), Pound Sterling (+4.30%) and Euro (+4.26%) headed the list of gainers.

As we have mentioned previously on numerous occasions and highlighted in our last commentary, one of the few areas in which one can still find assets that appear attractively valued relative to their fundamentals is in the emerging world. For EM currency bulls, however, as shown by the JP Morgan Emerging Markets Currency Index, whose 0.41% gain versus the Dollar lagged a developed market currency basket by some distance, the near decade-long wait goes on.

JP Morgan Emerging Markets Currency Index

Source: Bloomberg

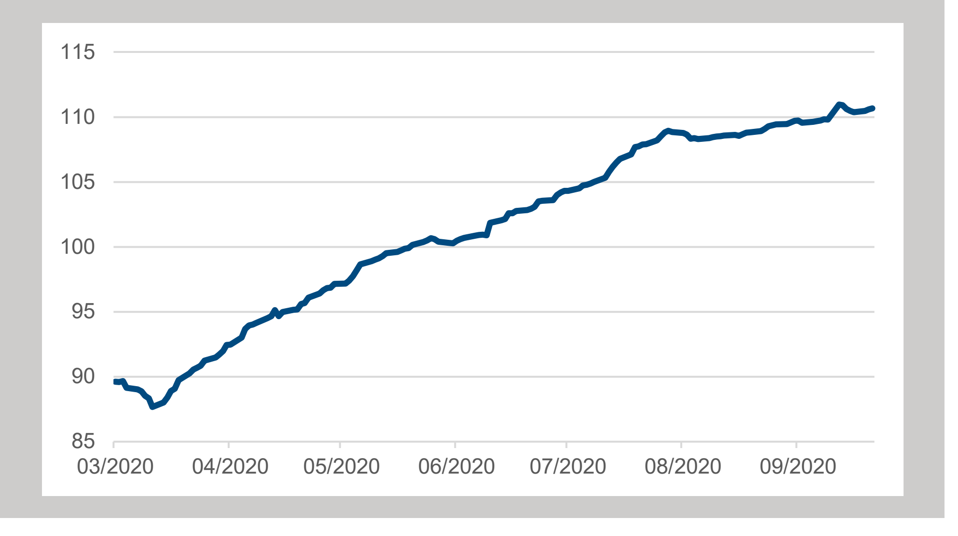
Commodities

A combination of strong gains from multiple individual contracts and few negative returns saw the broad Refinitiv (formerly Thompson Reuters) CRB Index post an increase of 7.54%, despite the modest advance in its largest (23%) component, Crude Oil – the West Texas Intermediate "front month" futures contract was up just +1.29%. A +24.93% rise in Silver, +20.41% for Lean Hogs, +17.80% in Natural Gas, +17.08% for Zinc, +15.28% in Cocoa and +15.21% for Soybeans was evidence of the breadth of demand across the range of complexes. The relatively small increase in the oil price (Brent Crude was up 2.42%) was somewhat underwhelming, given the improved levels of economic activity implied by forward-looking data, the recent(ish) large-scale production cuts agreed by producer nations, an unusually high level of compliance among those producers to their reduced quotas and reports of declining OECD inventories. Despite those favourable dynamics, market participants would instead appear to be looking past those positive factors to focus on the likely reintroduction of lockdown measures, as Covid infection numbers rise in the west.

Gold's winning run now stretches to eight calendar quarters, thanks to a further rise of 6.40% in the spot bullion price to USD1,897.90 per troy ounce. For investors in the yellow metal that was actually something of a disappointing outcome when viewed within the context of intra-quarter movements, which saw the price surge more than 15% from its opening mark to a record peak of USD2,060.59 in the first week of August. This volatility was somewhat at odds with the continued healthy investment demand evidenced by the steady increase in aggregate holdings of Exchange Traded Funds (ETFs), which continue to hit record levels. Our technical analysis suggests that, rather than being symptomatic of a speculative "blow-out" that often accompanies market peaks, this represents a bout of short-term overenthusiasm that has now been corrected and the medium term prognosis for gold remains favourable.

Though it's difficult to be certain, the fact that there was a meaningful increase in speculative (i.e. non-commercial) activity across many commodities occurred during a quarter in which the Fed appears, at the margin, to have relaxed its view on inflation is no coincidence. That event certainly seems to have ignited a greater interest in commodities among commentators and strategists. Whether that will translate into further market gains remains to be seen.

ETF Gold Holdings (m oz)



Source: Bloomberg

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