eQInsight

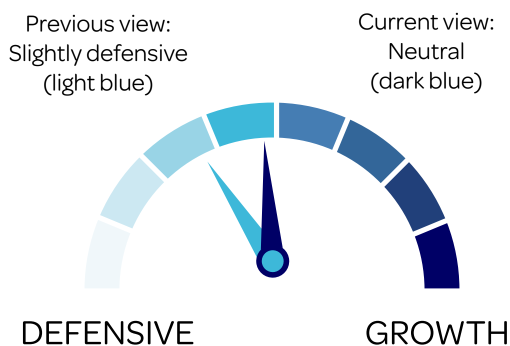
Market View Q3 2020

This document presents a summary of our investment views. It explains our latest thinking on world markets and the most recent decisions we have made about what to buy and sell within your portfolio.

The most recent changes happened in August when we took another step in reducing UK equities. Please note that our views may change at any time.

Overview

There has been no change to the biggest driver of risk which is still the coronavirus pandemic, along with government and central bank actions to combat the negative economic effects of social distancing measures. Despite this crisis being far from over, there have been new shots fired in the US-China battle. Given the surreptitious manner in which new security laws were introduced in Hong Kong, China now faces a much broader set of international condemnation. Adding the US election and Brexit into the equation, we anticipate a lot of noise during the second half of the year.



The dials in this update indicate our current positioning and whether this has changed since our last update. Here our overall positioning is shown: we currently have a neutral stance on growth vs. defensive assets. How this is reflected in your investment portfolio will largely depend on your risk profile – see the back page for details.

There are a huge number of open questions currently. In our opinion the most important one is about the level of unemployment seen globally. There remains a chance that unemployment will fall back to the low levels normally associated with economic expansions. In that case we would shift portfolios towards a more pro-cyclical stance. However, we are concerned that unemployment may remain elevated for a sustained period – as the world deals with social distancing requirements during a second wave of infections, and as the labour force reallocates itself by geography and by vocation. We think consumer behaviour could see long lasting changes.

On the flip side, we think governments will continue to opt for more targeted approaches to containing outbreaks wherever possible. In addition, fiscal and monetary support from governments and central banks will provide support to financial markets.

When there are structural changes underway, it is challenging to build portfolios that will do well in all scenarios. We think the most prudent course of action is to maintain an element of caution until there is greater certainty. We maintain our focus on high quality companies and within defensive sectors.

Growth assets

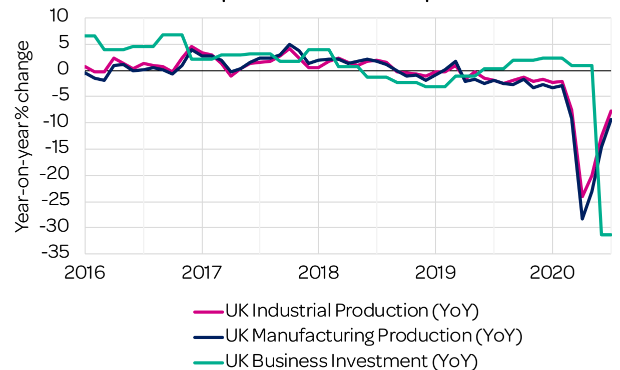
Growth assets have performed strongly since our last update and we have shifted our positioning to reflect a more neutral stance overall.

UK

Britain's progress with trade negotiations since passing the Withdrawal Agreement Bill has been slow, and recent tensions with the EU over the Internal Market Bill do not bode well for reducing the likelihood of a hard Brexit. We maintain our negative bias.

The ticking clock of Brexit passed the 30 June deadline to request any extension to negotiations. The increase in tensions earlier in September adds to our concerns that we are heading towards a cliff edge, hard Brexit. This risks the recovery in domestic assets from their coronavirus breakdown as manufacturing and industrial production will find it even more difficult to fully recover.

UK valuations for larger companies look attractive versus other markets, but the sector composition is unattractive with a longer-term view: it's hard to believe the returns from financial services companies and fossil fuels will be higher than those from technology and healthcare for example. We continue to maintain portfolio balance across industrial sectors and company sizes to remain as diversified as possible, but overall we feel there are better opportunities in other markets.

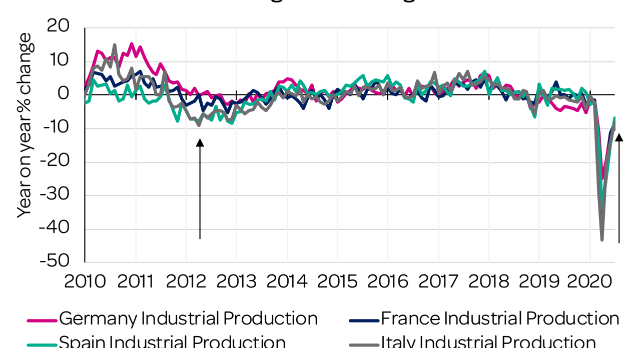


Europe

Europe's industrial recovery from the coronavirus-induced shutdown is underway, but activity levels remain some way off expansive. The European Recovery Fund will support the economy, but broader strength will depend on stability in global trade and between the US and China.

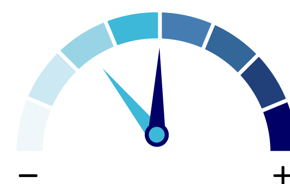
European equities are more heavily geared towards industrial and manufacturing activity than discretionary consumer spending. So while social distancing restrictions are in place but lockdowns are avoided, the European recovery should continue to support markets. But with rising numbers of coronavirus cases in France, Spain and elsewhere, together with deteriorating relations between China, the US and the rest of the world, concerns are rising that the recovery will run out of steam.

The launch of the European Recovery Fund is the first example of debt mutualisation in Europe. Member states have authorised the European Commission to borrow from capital markets on behalf of the Union as a whole. Cash raised by issuing 'EU bonds' will be disbursed to member states as grants and loans. If it becomes a permanent feature of the EU's institutional set-up, it will bolster the architectural underpinnings of the eurozone.



United States

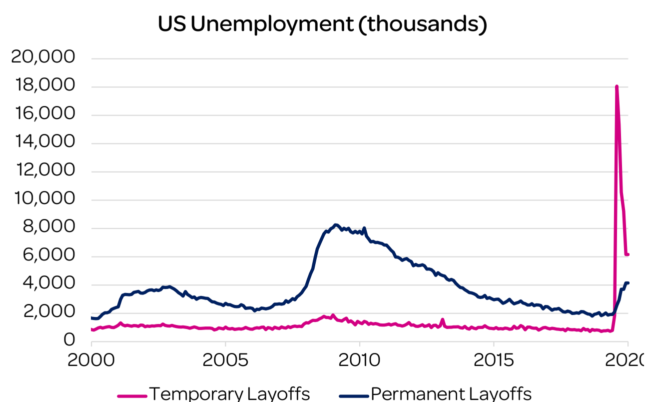
The US faces rising unemployment with a second wave of infections that is not yet fully under control. Meanwhile, social divisions are growing while November's election looms, posing a real risk to the peaceful transition of power.



Previously we wrote about the need to balance increased economic activity with rising case numbers. After an initial increase in activity, the last 3 months has been relatively stable, albeit at significantly lower than levels in previous year: the second wave in the US has started to subside, but remains a long way from being under control.

We also highlighted the level of unemployment. Thankfully the monolithic rise in temporary unemployment has started falling just as sharply. But the rise in permanent unemployment concerns us – extending beyond hospitality this can be seen across various sectors. It has already reached levels last seen during previous recessions, and we see limited prospects for it falling in the short term.

Counterbalancing this is fiscal and monetary stimulus on an Herculean scale. We see a long road to recovery that warrants caution and consequently a neutral stance.



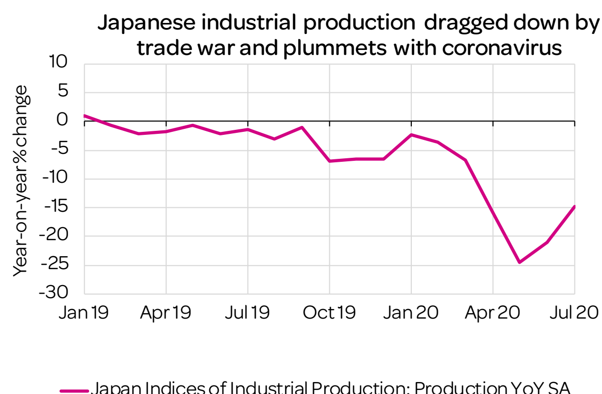
Japan

Like Europe, the Japanese market is highly geared to the level of manufacturing activity around the world. Its market is dominated by industrial companies making machinery and cars, and many technology companies involved in robotics & automation.

This expertise in making machinery, cars, robotics & automation makes the region attractive in the long term. We think many companies will seek to increase the level of automation in their production lines and will aim to do this closer to their end markets. In the short term, the outlook is contingent on some semblance of a return to normal and a fall in uncertainty that allows businesses to invest in their manufacturing processes and technology.

Japan also has a new prime minister. Yoshihide Suga picks up the reigns from Shinzo Abe who is stepping down due to ill health. Given Mr Suga's previous position as chief cabinet secretary of 8 years, he won a landslide victory in party elections to lead the ruling Liberal Democratic Party. We think this means continued support for monetary stimulus by the Bank of Japan.

Considering the region's low valuations and high cash balances, we think there are merits to being slightly overweight.



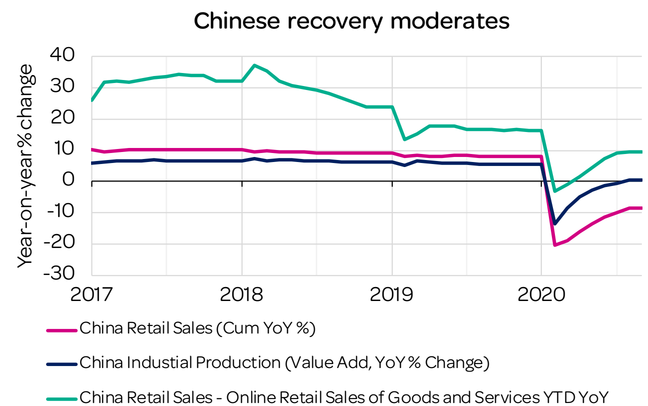
Asia Pacific

China was the first country in and out of a coronavirus lockdown, but things are not yet 'back to normal'. After an initial bounce, Chinese growth is settling at lower levels than before. Other Asian countries face similar headwinds.

Given their experience with SARS and swine flu, China, South Korea and others were much quicker to impose lockdowns and put effective testing and contact tracing systems in place for coronavirus. Although industrial production and retail sales in several Asian countries slowed down dramatically in the first few months of the year, this provided an opportunity to 'get back to normal'. However, since the external demand picture is weak the rebound has been petering out over the last few months and growth is stabilising at lower levels. Of particular interest is how Chinese e-commerce fell in a similar way to industrial production and retail sales, whereas in developed markets we saw a stark divergence as consumer demand shifted online.

China looks set to face further international condemnation from the US, UK and EU – suggesting its economic activity levels may take longer to recover.

However, this would also suggest better chances of support for Chinese consumers. We have begun more detailed research into this investment opportunity but remain cautious in the interim.

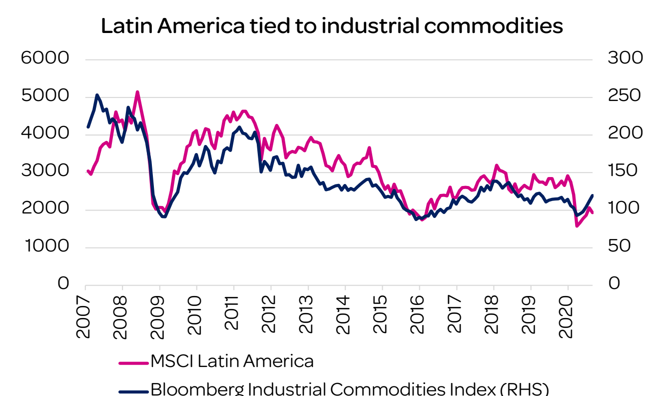


Other Emerging Markets

As well as being tied to pro cyclical sectors like commodities, Latin America is still suffering its first wave of the coronavirus. We have also seen the virus spread into frontier markets. We maintain our reduced exposure.

There is some good news for most emerging markets, which is their significantly younger population. We know the virus causes fewer issues for younger people and so the spread of the virus itself is likely to be less debilitating than were such a situation to occur in developed markets. But it is still devastating.

In the longer term, and in the absence of a vaccine, the risk of infection could see a continued depression in tourism. But as we have previously discussed, Latin American equity market prospects are highly correlated to industrial metals that are dependent on infrastructure spending. Given the weaker global demand outlook, many countries are turning to infrastructure spending to shore up growth. These are often multi-year spending programmes and so are unlikely to become an immediate tailwind, especially in the context of the US-China tech rivalry where a lot of spending is being directed toward technological upgrades rather than building new roads and bridges.



Defensive assets

Given our slightly cautious outlook, we maintain a neutral exposure to bonds.

Government bonds

The outlook for government bonds is complex.

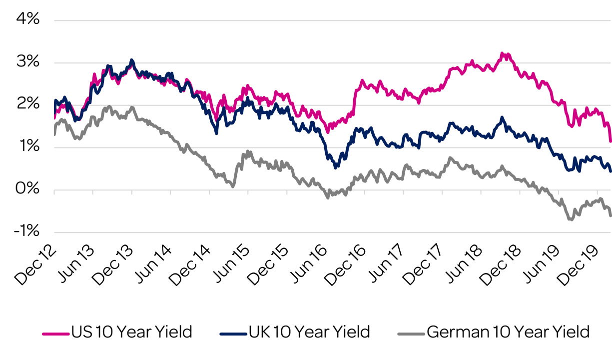
Firstly, governments are issuing huge amounts of bonds. Ordinarily this would be negative for the outlook, but when most developed markets are doing the same thing, everyone looks similar on a relative basis. Couple this with a commitment from central banks (in developed markets, to varying degrees) to buy all the government bonds they can lay their hands on, and it is hard to see a materially negative outlook. On the flipside, given how expensive government bonds are, it is equally hard to see a materially positive outlook.

The volume of central bank purchases is just as big as the amount of debt being issued by governments, and it's happening at almost double the scale as the purchases made in the aftermath of the Great Financial Crisis. But this time, instead of pumping money into the banking system with hope of it trickling down into the real economy, the money is going directly to governments. From there, it is being funnelled straight out into the wider economy – either through direct transfers to individuals or through grants and loans to companies and charities.

In the short term, we think that the economic hole that needs to be filled is so deep that all this government spending will do is cushion the drop. In the short term, this means things aren't as bad as they might have been. Looking further out on the horizon, we see risks that this spending will continue to circulate through economies around the world, creating growth and possibly also creating inflation.

Although people have worried about inflation at times over the last few decades, it has remained low and stable. We think the conditions this time mean it has a higher chance of materialising. Importantly, few people

Bond yields plumb new lows



today have experience investing in a higher inflation environment, which compounds the potential for this phenomenon to become a major risk factor. This is because inflation is bad for bonds and, if it gets too high, it can be bad for equities too. Consequently, we have been gradually increasing our exposure to inflation-linked bonds that protect bond investors by paying a real (inflation adjusted) yield.

Corporate bonds

To prevent another crisis in credit markets due to coronavirus, central banks have flooded this part of the system with cash too. The bonds of high-grade companies (which have lower levels of debt) are now being bought in huge quantities by the US Federal Reserve, the European Central Bank and the Bank of England.

In a similar way to government bonds, the upside from these expensive levels is limited, but so too is the downside. With such a big backstop, we are comfortable holding high grade corporate bonds from quality issuers, though with a preference for US issuers.

Alternative assets

Property

Our view on other asset classes is more constructive than property and so we maintain a low exposure.

Unsurprisingly, with so many people at home, the forecast for returns from commercial property are highly uncertain. Even over a 5 year forecast horizon, property investment professionals see an incredibly wide range of possible returns, even within sectors. Unsurprisingly, the outlook for shopping centres and standard retail are the bleakest as the impact of e-commerce accelerates.

Although yields are higher than in most bond markets, property is an illiquid asset class. For this reason, we continue to have a nuanced view on the sector.

With the UK's exit from the EU on the horizon, we are concerned about the risk of shareholder outflows from "open ended property funds". This poses the risk of these funds needing to suspend redemptions as some of them did in the immediate aftermath of the EU referendum and others have done again more recently. As such we have no funds of this type.

Meanwhile, for "property investment trusts" it is buyers and sellers of shares on stock exchanges that provide liquidity to one another and hence there is no risk of suspensions, though there is a risk of share price falls. Here, we are targeting exposure to those funds with the lowest exposure to the retail and office sectors, but we are comfortable continuing to own industrial and retail warehouse focused exposures, where available.

Commodities

We have limited exposure to commodities, favouring precious metals over industrial commodities.

As discussed earlier, with the fiscal purse strings having been loosened and with greater potential for infrastructure spending, there is the potential for higher industrial commodity prices. This improvement in our view would best be expressed through commodity sensitive companies rather than direct commodity holdings.

With precious metals, we know that gold has a negative relationship with real yields, i.e. gold rises when real yields fall. For real yields to fall, interest rates need to fall faster than inflation or rise slower than inflation.

Interest rates have already fallen materially but inflation expectations also fell hard given material concerns about the outlook for growth. Looking forwards, we see limited potential for interest rates rising but if inflation expectations start to rise (if the economic recovery gathers pace), there is potential for gold prices to rise.

Absolute Return

We maintain our focus on discretionary strategies.

Higher levels of uncertainty continue to cloud over financial markets, and this is upsetting otherwise stable market relationships. This means some funds that manage risk solely by portfolio diversification may be less reliable than historically while other funds that rely on quantitatively derived relationships between assets may find those relationships becoming unpicked.

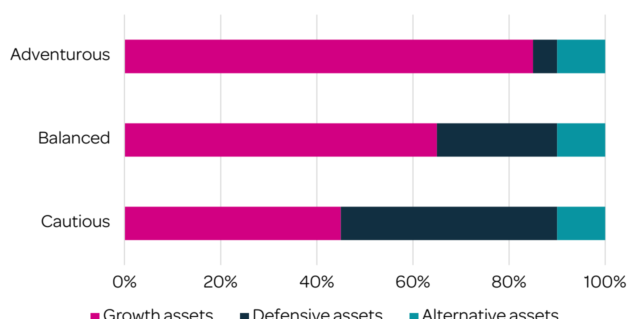
Our preference is for discretionary strategies over systematic.

How does this relate to my portfolio?

Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world these ingredients fall into three broad categories: **growth assets** (used to build capital), **defensive assets** (used to preserve capital) and **alternative assets** (that sit somewhere in between).

The overall 'flavour' of a portfolio is determined by its **risk profile**. Broadly speaking, more cautious investors will have more defensive assets in their portfolios, while more adventurous investors will have more growth assets.

Here is what three typical portfolios might look like:



Growth assets consist mainly of **equities** (shares in public companies). We invest in equities regionally, based on the size and relevance of different markets to UK investors. Growth assets also include other riskier investments such as **high yield bonds**. Defensive assets consist of other types of **bonds**. Alternative assets include **property**, **commodities** (raw materials) as well as more complex financial instruments such as **hedge funds**.

The views outlined in this document will influence how we manage your portfolio. For example, we may decide to increase your exposure to one region at the expense of another. The dials give an indication of whether we are positive or negative on each asset class:

However, our job as your investment manager is to make sure that the risk profile (or overall 'flavour') of your portfolio stays consistent.

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Please remember that past performance is not a guide to future returns. The value of investments and income derived from them can fall as well as rise, and you may get back less than you originally invested.