eQInsight

Market View Q4 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 November when we brought portfolios back to a neutral setting, took the final step in reducing UK equities and took a more positive view on Asia. Our views may change at any time.

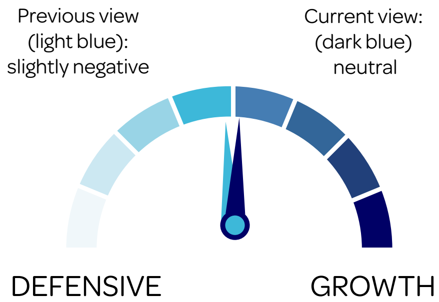
Overview

In the short term we remain in the grip of the coronavirus pandemic, but the medium-to-long term outlook is decidedly rosier.

Our change in tone reflects the great news which is of significantly higher than expected levels of efficacy for three coronavirus vaccine candidates, so far. We were always hopeful that scientific endeavour would prevail, but there was by no means any certainty.

We are not out of the woods yet. As the vaccines get approved, and while innoculations have already begun, it will take several weeks and months to produce and administer the tens of millions of vaccine shots for the most vulnerable members of society and our front-line workers. It will be months later when the billions of young, healthy children and adults will be invited to participate in vaccination programmes. Depending on the proportion of people that participate, we could be looking at a period of 6 - 12 months for risks to have subsided sufficiently and for sage advice on social restrictions, testing & tracing, to face redundancy.

Given the duration over which behaviours will have been changed, we continue to think there's a good chance some elements of these will become permanent. We still expect a different normal whence we came. As such, we think there is a risk of sustained high unemployment if economic resources go through a period of reallocation by vocation and geography.



So, the advent of vaccines is great news and we are optimistic, but it's a long road to recovery. Consequently, we are holding ourselves back from an overtly bullish stance but we have returned portfolios to a neutral setting for aggregate exposure to growth assets.

Within this, however, we are reducing our bias towards defensive sectors like consumer defensive and healthcare, while increasing exposure to industrial companies that will be more sensitive to a rebound in economic activity.

Growth assets

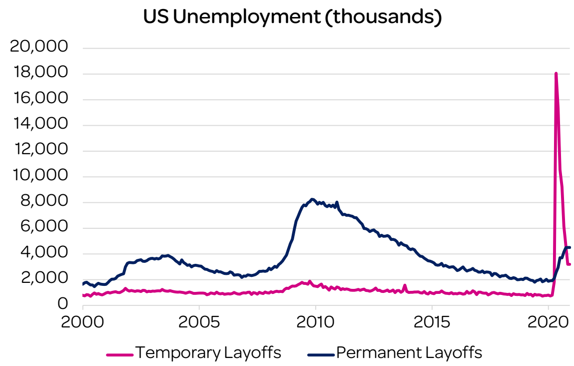
Growth assets have performed strongly since our last update. We update our positioning to reflect a more neutral stance within portfolios.

United States

While of clear significance, the US election was a huge distraction. The market now needs to start coming to terms with some difficult truths.

The US is facing its third wave of rising coronavirus infections, yes its third wave. Permanent unemployment levels are now higher than they were in the 2002 recession. The country's society is fractured and the risk of a period of civil unrest cannot be ruled out.

The path out of crisis and back to a strong and sustainable growth path is achievable. The economic crisis relies on a new fiscal spending package which may have to wait until President-elect Biden assumes office in January, but when coupled with the Fed's committment to low borrowing costs and expansionary monetary policy, recovery could follow quickly. The key issue that could impede the recovery is the pandemic which is clearly worsening. The advent of vaccines could not have come at a better time for the US, but without other measures, the vaccination programme will take several months before it starts to have an impact on the overall reproduction rate. In the short term we think it's prudent to maintain a neutral view and wait for more information on the plan of action from the new administration.

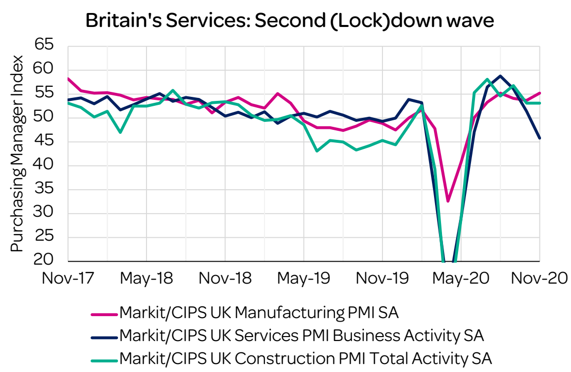


UK

Brexit is at the 11th hour. With pressure from the incoming US administration for the Good Friday Agreement not to be a casualty of Brexit, we see a trade deal as more probable. Attractive valuations lead us to upgrade our tactical view but we also take the final step in our strategic reduction to UK assets.

Come what may, when we leave the transition period on 31 December 2020, we will exit the EU's customs union. A trade deal would help significantly, and we think this is more probable now as Downing Street manoeuvres to placate President-elect Biden. We should have clarity on this any day now and the cloud of uncertainty over UK assets should finally be lifted, for better or worse.

In the short term, given ongoing social restrictions of one form or another, we think the outlook for manufacturing and industry is much stronger than the outlook for UK retail and personal services sectors (reflected in the chart of purchasing manager surveys). Also, as Brexit uncertainty is lifted, recent sterling strength could be maintained, possibly even extended. This acts as a headwind to foreign earnings, so we have tilted portfolios slightly more towards medium & smaller companies. As previously discussed, the sector composition of the UK market looks unattractive with a longer-term view and so we feel there are better opportunities in other regions. As such, we have also made the final reduction in our strategic weight to UK equities.



Europe

Much like the UK and other parts of the world, Europe is suffering from a second wave of the pandemic. This will hamper the recovery, especially for retail and personal services. But Asia's ongoing recovery, coupled with news of the vaccine, could support Europe's industrial sector.

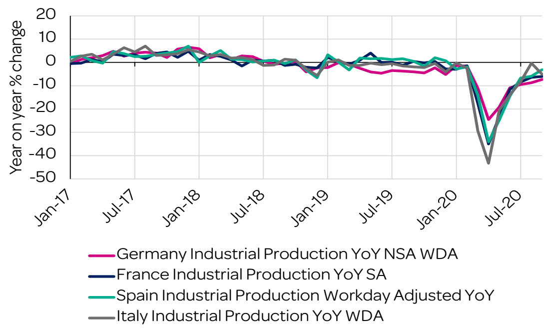
European equities are more heavily geared towards industrial and manufacturing activity than they are to discretionary consumer spending. So, while social distancing restrictions are in place, but full lockdowns are avoided in Europe; and while the economic recovery continues apace in Asia, European financial markets should be ok. With the added news of vaccines, companies can now plan for a return to the new normal with more confidence in the time frames involved.

But in the short term, we are concerned with rising unemployment, mainly from the services sector. This could develop into a greater headwind for the region, suppressing local demand.

The EU has also created the European Recovery Fund. This is the first time in history that member states have authorised the European Commission to borrow on the EU's behalf in aggregate. Through issuing so-called EU bonds, funds will be disbursed to member states as grants and loans. This is the first example of debt mutualisation in Europe and if it becomes a permanent feature of the EU's institutional set-up, it will bolster the architectural underpinnings of the eurozone.

Overall, for now we maintain a neutral view for the region.

European Industrial Production
Pace of recovery moderates



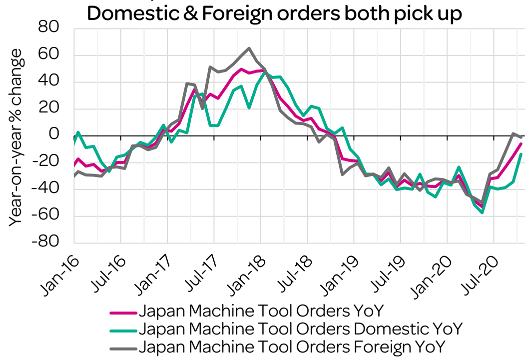
Japan

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 technology companies involved in 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. We find support for this with Japanese machine tool orders which are close to unchanged now versus a year ago. (See chart)

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. The advent of vaccines should provide just that, but we hold back on a more bullish stance because of the risk of some weakness from global labour markets in the short term. Japan also has a new prime minister. Yoshihide Suga picks up the reigns from Shinzo Abe who has stepped 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 Japan's market valuations relative to other regions, we think there are merits to being slightly overweight.

Japanese Machine Tool Orders
Domestic & Foreign orders both pick up



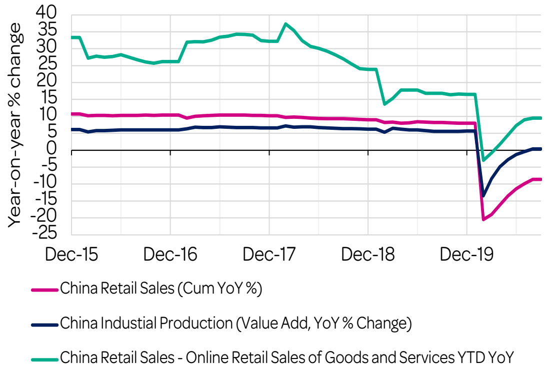
Asia Pacific

China's recovery from the ongoing pandemic is testament to their ability and resolve to manage the problem. Not only has China's economy caught up from lost output earlier in the year but the expected rate of growth is now unchanged relative to pre-pandemic levels.

The successful recovery of China and other Asian countries, together with their ability to keep the pandemic at bay despite occasional flare ups of cases, is testament to a few factors. Firstly, given historic experience with SARS, the test and trace systems are vastly superior to anything we have in the west. Secondly, they enjoy a high degree of compliance with healthcare guidance, through either social norms or through strength of government control. Thirdly, their border control, including mandatory quarantine, is quite a lot stricter than in the west.

The result is their economies are pretty much back to normal and it looks like this is now true of both internal and external demand (exports). Another positive driver for the region is a change in economic growth policy in China. The so called "dual circulation" strategy aims to support its established manufacturing & export industries but also to nurture the development of its internal consumer market. Aggregate statistics for the Chinese consumer are misleading given the massive wealth divide that can be observed in the country. Given the huge scale of the population, it might be surprising to know there is a population cohort within China of similar scale to the US and with similar income levels to several other developed market countries. Taken together, this has led us to upgrade our view for the region.

Chinese recovery moderates



Other Emerging Markets

Vaccine news is supportive of cyclical exposures, such as that found in sectors like commodities which dominate the Latin American equity market. There is potential for a weaker US dollar that would also be supportive.

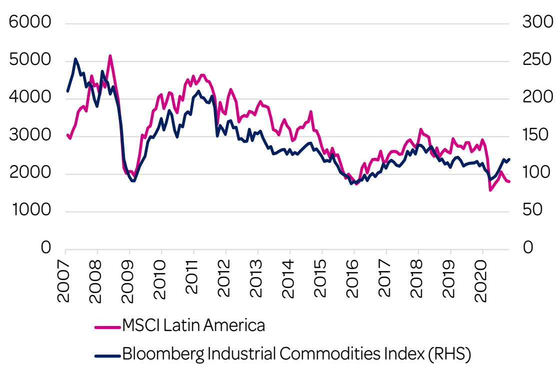
There is some good news for most emerging markets, which is their significantly younger population. We know the virus causes fewer issues for younger people and so the spread of the virus itself is likely to be less debilitating than were such a situation to occur in developed markets.

If approval is granted for vaccines that do not require specialised cold storage, it could be the light at the end of the tunnel for the tourism economy. However, as we note continually, Latin American equity market prospects are highly correlated to industrial metals which are dependent on infrastructure spending. We think there are good prospects for increased infrastructure investment, but in the immediate term we are seeing most governments that could spend significant sums, focused on supporting their local businesses and individuals. This is obviously internal spending, so we think a longer-term shift could be coming, but we're not there yet.

Additional caution comes in the context of the US-China tech rivalry where a lot of spending is being directed toward technological infrastructure upgrades which are often significantly cheaper (and involve different commodities) than building new roads and bridges.

In the short term we continue to be defensively positioned.

Latin America tied to industrial commodities



Defensive assets

While holding ourselves back from a more overtly bullish outlook, we maintain a neutral exposure to the defensive qualities of bonds.

Government bonds

The outlook for government bonds is complex.

Governments are racking up national debt at an astonishing pace. To put it in context, the volume of debt issuance and central bank purchases is roughly double the scale relative to the Great Financial Crisis. Outside a crisis period, this would be a massive red flag and bring government credibility into question. However, with national central banks committed both to buying large amounts of government debt and to keeping interest rates low, it means there is a huge buyer to hoover up all the new issuance while debt service costs (the interest paid on borrowing) is kept at historic lows.

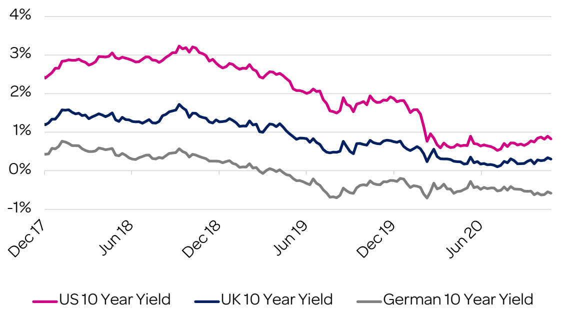
This combination means government credibility is maintained. This sounds like a magic money tree, which we all know doesn't exist. But as long as everyone is doing it, on a relative basis, government bonds look ok and prices don't move, relatively speaking. Eventually the debt will be repaid, the relevant currency and government bonds will devalue, or economies will grow into the debt burden.

The difference this time (relative to the Great Financial Crisis) is that instead of central banks pumping money into the banking system, the money is going directly to central governments. From there, it's getting 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 the size of the pandemic induced economic hole is so large that this government spending will simply help break our fall - things aren't as bad as they could have been. Looking further out, we see potential for this spending 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 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.

Bonds: in for a turn?



Corporate bonds

Central banks have flooded the corporate bond market with cash as well, aiming to prevent another crisis in the credit markets. The bonds of high-grade companies (which have lower levels of debt) are being bought in huge quantities by the US Fed, 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. 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.

Although not our base case, there is a risk of a disorderly exit from the EU by the UK. This could see shareholder outflows from “open ended property funds” and pose the risk these funds need to suspend redemptions again. 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 possibility 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 are 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.

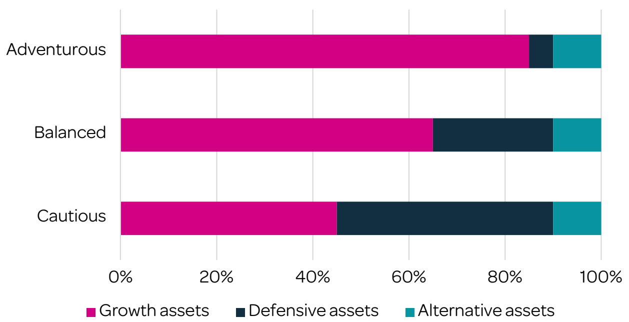
Our preference is for discretionary strategies over systematic.

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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