Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
September 2020

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Investment outlook

An improving UK economic outlook, but with labour market uncertainty

August is a month littered with important anniversaries in British history. These include the 400th anniversary of the Mayflower's departure from Southampton in its first attempt to reach North America (5 August), the 75th anniversary for Victory in Japan in the UK (15 August) and the 250th anniversary for when explorer Captain James Cook claimed Eastern Australia for Great Britain and renamed it New South Wales (21 August). Another date, 12 August, could possibly be added to the list for future posterity. It was the day the UK reported a record non-annualised 20.4% real GDP decline in the second quarter of 2020[1], in response to government lockdowns to limit the spread of the coronavirus.

We make four observations from the GDP data. First, the previous worst decline (-12.2%) occurred during the third quarter of the 1921 recession, as the country struggled in its transition to a peacetime economy from the first World War and from the Spanish flu influenza pandemic that lasted until 1920[2]. Second, GDP has fallen to a level last seen in 2002, so effectively erasing 18 years of growth[3]. Third, the fall was four times deeper and six times faster than during the Global Financial Crisis. And fourth, the quarterly GDP decline was more than twice that of the US and worse than all other EU member states[4]. The UK's poor relative economic underperformance was largely due to the length of the lockdown, which was necessitated by our densely populated country and the slow initial response of the government. For instance, non-essential shops closed for 84 days in the UK, compared to 30 days (Germany), 55 days (Italy) and 58 days (France)[5].

However, the second quarter UK GDP data is now history. As many lockdown measures have been lifted, the more recent monthly data showed an 8.7% real GDP rise in June which is an encouraging sign that the economy is moving in the right direction[6]. The Bank of England expects GDP growth to be only 5% below the level of a year ago by the fourth quarter of 2020[7]. There is evidence that stimulative policy actions are feeding through to the economy, and particularly in the important residential property sector. Chancellor Rishi Sunak's decision to raise the stamp duty threshold from £125k to £500k, has seen a record number of new home buyer enquiries in July, according to the Royal Institute of Chartered Surveyors housing survey[8].

Significantly for UK equities, a recovering economy is being reflected in higher projections of company earnings: the consensus now forecasts +2% Earnings Per Share growth over the next 12 months, a sharp reversal from a -14% projected decline at the end of May[9]. The improving fundamental backdrop has helped lift the MSCI UK equity index by nearly 20% from its low in March[10].

Even after this rally though, UK stocks are still down 22% since the beginning of the year, weighed down by dividend cuts, uncertainty over Brexit and its relatively more difficult coronavirus experience[11].

A key test will be how the economy fares as the government reins back policy support for the labour market. This has already started with the Job Retention Scheme being scaled back in stages. Employers will now have to pay pension contributions and National Insurance for furloughed workers in August, 10% of wages in September, rising to 20% in October when the scheme finally ends. It is not clear how many furloughed workers will lose their jobs and what impact this would have on the recovery.

The US "fiscal cliff" risk for equities

Across the pond, investors have shrugged off higher coronavirus new cases as well as selective retightening of restrictions in many states plus the start of the US November election campaign where Joe Biden is currently favourite. The S&P 500 is up over 50% from its low in March and trading close to an all-time high thanks to the dominance of the big five technology companies[12]. Improving economic activity and labour data, better than expected company earnings in the second quarter, hope for a future COVID-19 vaccine and a super-dovish Federal Reserve have all contributed to US stock returns, and particularly the Big Tech stocks.

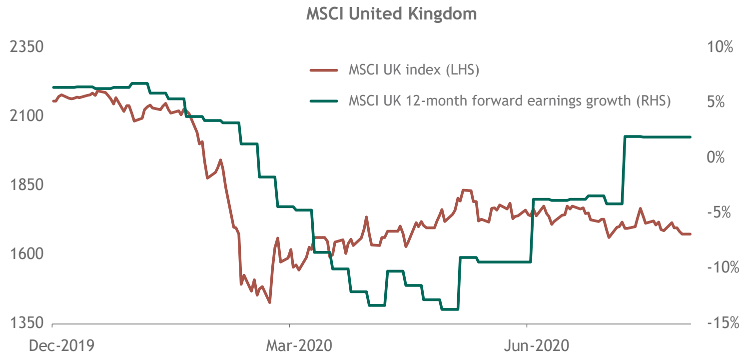
Nevertheless, given that an increasing share of personal income is made up of federal stimulus payments, investors are perhaps a little complacent about the risk of a so-called "fiscal (aka benefits) cliff" that could undermine the economic recovery. A bipartisan agreement in Congress to pass a second stimulus program is widely assumed. President Trump's recent executive orders to bypass Congress and provide coronavirus relief funding should be viewed as only a temporary fillip for the economy. The available cash for additional unemployment insurance will only last around a month before it runs out and it is unclear whether his plan of a payroll tax deferral (note it is not a tax cut) will encourage consumers to spend more. It is not certain whether the President's unilateral action has helped negotiations in Capitol Hill or delayed them, as it lessened the need for urgent legislation before the holiday break.

The bottom line is that without additional government stimulus, US household incomes could fall like Wile E. Coyote chasing the Road Runner off a cliff in a Looney Tunes cartoon. Under that scenario, the US recovery could come to an abrupt halt and put downward pressure on equities more broadly.

1-4 & 6 Bloomberg, data as at August, calculations by Smith & Williamson Investment Management
5 IMF, Ourworldindata.org, as at August 2020
7 Bank of England, as at August 2020
8-12 Refinitiv datastream, data as at 24 August 2020

Equities

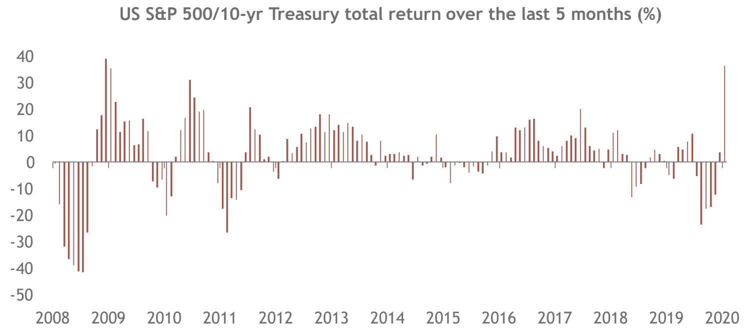
Recent data releases have shown that reopening and supportive government policies are having a positive impact on the UK economy. For example, UK real retail sales (including online) are back to pre-COVID-19 levels. This improving outlook prompted analysts to raise their forecasts for UK company earnings over the next twelve months. However, the MSCI UK index still struggles to reach pre-COVID-19 levels due to idiosyncratic risks such as uncertainty over Brexit (see chart).



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 September 2020

Fixed income

US equities outperformed US Treasuries over the last 5 months by 36%, this was the largest 5-month outperformance since 2009. Investors dumped bonds, particularly those at the long end of the curve as Federal Reserve chairman Jerome Powell, used a speech at the annual Jackson Hole symposium (which this year took place online) to outline a subtle change in policy, whereby the bank would target longer term average inflation of 2%. While there was little detail about how this might be specifically achieved, investors took this to mean the Fed might be amenable to slightly higher inflation in the short term, making fixed income bonds less attractive.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 September 2020

FX and commodities

The sell-off in March due to COVID-19 saw the value of sterling fall briefly to $1.15, its lowest level since the 1980s. The initial shock caused a flight to safety pushing the US dollar higher against other major currencies. However, as lockdowns have eased and economies have started to recover, sterling is now trading at $1.34, its highest-level since the start of the year. While this performance has been an encouraging development for the UK, the ongoing Brexit trade negotiations could lead to an increase in volatility as we approach the deadline for a deal before year end.

Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 September 2020

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.1	6.6	6.5	91.9
MSCI UK	1.5	-1.6	-16.0	13.4
MSCI UK Broad	2.2	-0.8	-14.6	14.6
S&P 500	5.1	6.6	10.9	125.7
MSCI Europe ex UK	2.2	5.7	0.6	55.6
MSCI Japan	5.5	-2.2	0.6	55.0
MSCI Pacific ex Japan	3.7	8.2	-7.9	64.1
MSCI Emerging Markets	0.2	10.5	4.5	77.2
Bonds				
iBoxx GBP Gilts	-3.2	-3.4	2.6	29.4
iBoxx USD Treasuries	-4.3	-3.0	4.7	47.2
iBoxx GBP Corporate	-0.8	2.8	3.9	33.9
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	4.6	27.4	-25.4	-9.3
Gold ($/ounce)	-0.4	13.7	28.7	74.1
GBP/USD	2.0	8.3	9.9	-12.9
GBP/EUR	0.9	0.7	1.2	-18.4
EUR/USD	1.1	7.5	8.6	6.7
USD/JPY	0.3	-1.6	-0.1	-12.5

Glossary of terms

Bonds – The relationship between price and yield. Yield is the return you get on a bond. When the price of a bond changes prior to maturity due to supply and demand pressures, so does its yield. When the price of a bond goes up due to demand, the yield goes down to compensate. This is so the bond's fixed rate of return (coupon) remains relatively constant – and vice versa. A bond's price and its yield are inversely related. A key factor which influences a bond is the prevailing interest rate. When interest rates rise, the prices of bonds fall, thereby raising yields. This is because the older bonds are sold in order to buy new higher yielding bonds.

Equities – A stock or any other security representing an ownership interest.

Fed – Federal Reserve Bank.

FX – Foreign Exchange.

GDP – Gross Domestic Product.

GFC – The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

IMF – International Monetary Fund

Monetary policy – Actions of a central bank or other agencies that determine the size and rate of growth of the money supply which will affect interest rates.

V Shaped Recovery – Real GDP growth trajectory.

Key macro data	Latest	2020 Consensus forecast	Spot rates	31-Aug	Yields (%)	31-Aug
UK GDP (YoY%)	-21.7	-9.73	GBP/USD	1.33	MSCI UK	4.7
UK CPI Inflation (YoY%)	1.0	0.80	GBP/EUR	1.12	MSCI UK broad	3.66
Bank of England Base	0.10	0.10	EUR/USD	1.20	10 Year Gilt	0.27

All values and charts as at 31 August 2020. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Thomson Reuters Datastream and Bloomberg

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

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For further information

Contact	Direct line	Email address
Daniel Casali	020 7131 8985	daniel.casali@smithandwilliamson.com
David Goebel	020 7131 8908	david.goebel@smithandwilliamson.com
Sam Pham	020 7131 8352	sam.pham@smithandwilliamson.com
Sarah Giarrusso	020 7131 4218	sarah.giarrusso@smithandwilliamson.com

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