Smith & Williamson

Investment outlook

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

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COVID-19

Please visit our COVID-19 hub for insights and webinars on the personal finance and business implications of the outbreak:
www.smithandwilliamson.com/covid-19-hub

Investment outlook

COVID-19 continues to drive market risk

The pick-up in new COVID-19 cases in Europe that could cause another round of national lockdowns is a major risk to markets (see market highlights). The pandemic could also precipitate a confluence of other tail risks in the autumn. Some of these issues could include a no-deal Brexit, a disputed US election and a sell-off in technology stocks, each of which has the potential to put material downward pressure on equities (at home and abroad). We look at these potential tail risks below.

No-deal Brexit

The UK has already left the EU. However, by effectively reopening-up the legislated Withdrawal Agreement, Prime Minister Boris Johnson has raised the possibility that the UK may not get at least a very basic Free Trade Agreement on goods with the EU when the transition period expires at year end. The British government is changing the Withdrawal Agreement text on fears that in the event of no Free Trade Agreement, the EU could restrict trade between Great Britain and Northern Ireland and undermine the integrity of the UK.

The government is also concerned that the Northern Ireland Protocol (NIP) in the Withdrawal Agreement could potentially give the EU powers over UK state aid in perpetuity. The UK could make a case for reneging on some commitments made in the revised NIP in October 2019 around the government needing to play a larger role in helping the economy recover from the pandemic. Certainly, article 62 of the Vienna Convention on the Law of Treaties enables parties to discharge their legal obligations when there has been a "fundamental change in circumstances" since the treaty was signed. Given that the COVID-19 pandemic led to the biggest economic shock in modern history (see our September *Investment Outlook*), this surely constitutes such a change, and may be the reason behind the government's stance. Nevertheless, the EU is unimpressed that the UK is willing to make changes to commitments made less than a year ago. Boris Johnson has given the EU a deadline of 15 October to reach a Free Trade Agreement at the European Council meeting. If an agreement is not forthcoming, it could lead to volatility in financial and currency markets.

A disputed US election

Since the coronavirus crisis hit the media headlines at the start of this year, Joe Biden's strategy has been to make the November US election an effective referendum on President Trump's handling of the pandemic. In opinion polls President Trump's job approval rating slipped from 47% at the start of April to a low of 41% at the end of July, but as lockdown has ended it has steadily recovered to 45% currently[1].

For comparison, job approval rating data from Gallup show that in June of an election year, previous incumbents, like George H.W. Bush in 1992 on 37%, Jimmy Carter on 32% in 1980, and Gerald Ford on 45% in 1976, all lost office after one term on such low ratings[2]. The exception was Harry Truman, who was re-elected in 1948 on just 40%[3].

It is possible that the race for the keys of the White House is influenced by whether a COVID-19 vaccine is approved for distribution ahead of the election. Opinion polls could narrow further and potentially lead to a wafer-thin win for either Joe Biden or Donald Trump. Considering the partisanship between Democrats and Republicans, a tight election result would be hotly disputed, as it was when Republican George Bush was initially shown to have beaten Democrat Al Gore on 7 November 2000 by a slender margin in Florida. Given the closeness of the result, the Democrats demanded recounts. The S&P 500 fell over 8% during this period of political uncertainty until the Supreme Court ordered recounting to stop after 34 days[4].

Fast forward to today, the lingering concerns over COVID-19 are likely to boost voting by mail. This opens a whole array of risks, ranging from allegations of fraud, lost, uncounted or rejected ballots from voters unfamiliar to verification requirements. Given the time it will take to count voting by mail, the election result may not be known on the day. The election is on 3 November, but the deadline for all states to certify voting results is 8 December. Ultimately, unless there is a clear win for either side, the result could be disputed and that could undermine financial markets performance.

Sell-off in Big Tech

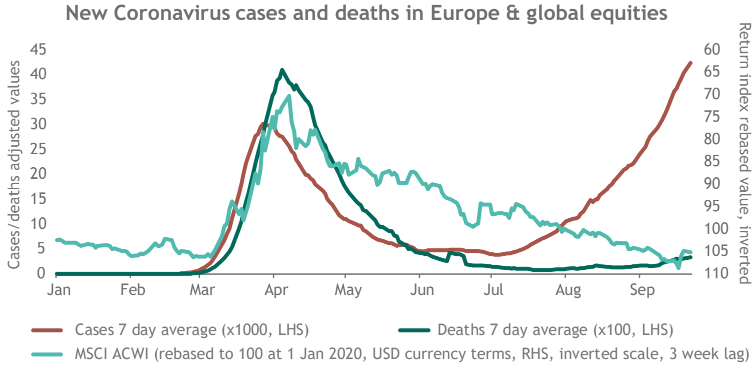
The so-called FAAMG (Facebook, Apple, Amazon, Microsoft and Google) basket of technology stocks have sold off in aggregate by 16% from peak to trough in September, the biggest correction seen since the market downturn in March[5]. Investors may be simply taking profits after such a strong run or getting apprehensive about increasingly demanding valuations. As the economy opens-up again competitors will be able to recover at least some market share,thus slowing FAAMG growth rates and reducing their relative attractiveness. The risk to equities is the size of the five FAAMGs, which collectively account for around a quarter of S&P 500 market cap and around 8% of global GDP[6]. A larger fall in the FAAMG stocks could lead to a broader equity market correction.

Summing up, even if an effective COVID-19 vaccine is found and used by the bulk of the population, related markets risks are likely to linger so we expect volatility to continue. Nevertheless, the unprecedented scale of response by policymakers, as well as an opening up of the global economy and pick-up in company earnings (see market highlights), are likely to support equity prices in the medium term and so, we remain positive.

1-3 Real Clear Politics, data as at 24 September 2020
4-5 Refinitiv Datastream, data as at 30 September
6 Refinitiv Datastream, calculations by Smith & Williamson, data as at 30 September 2020

Equities

The recent uptick in COVID-19 cases in Europe has seen the risk of a second wave come to fruition. The number of cases has started to overtake those seen back in March however, the response in global equities has not been as severe. The three key reasons behind this difference are firstly, the continued rhetoric of government and monetary policy makers to do whatever it takes to support the economic recovery continues to prop up the market. Secondly, this wave of cases has not been coupled with a sharp rise in deaths and therefore, most governments are less inclined to impose national lockdowns. Finally, the reaction in equity markets will largely be dependent on the scale of the potential lockdowns. However, for now we don't see this to be undermining the global economic recovery.

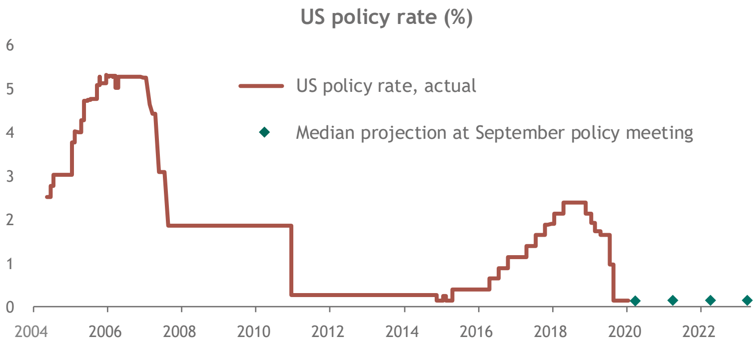


To note: ACWI = All Country World Index, LHS = Left Hand Scale, RHS = Right Hand Scale, 3 week lag = data has been pushed back by 3 weeks

Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 28 September 2020

Fixed income

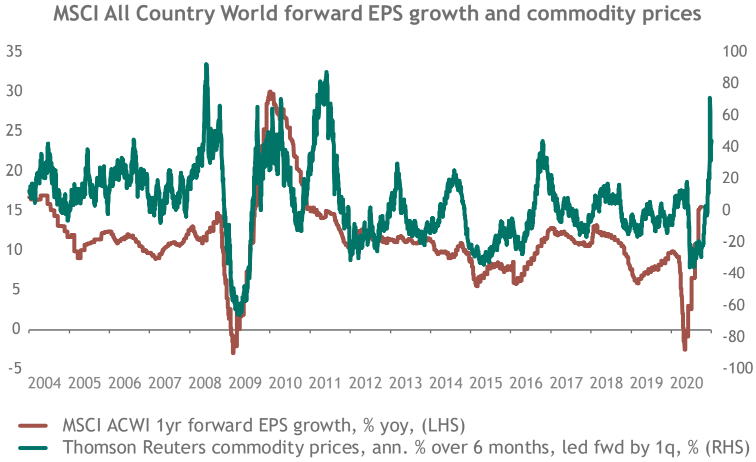
At the September policy meeting the US Federal Reserve has formally adopted an average inflation target of 2%. This new framework means that the central bank will tolerate inflation prints of 2% or higher over the medium term, in order for inflation to make up years of undershooting the 2% target since the Global Financial Crisis. Consequently, policy rates are not expected to increase anytime soon. The chart shows policymakers' interest rate projection at the September meeting, showing that the median rate setter is likely to leave rates unchanged at current levels until 2023.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 28 September 2020

FX and commodities

Commodity prices can be an interesting leading indicator of stock market performance. That's partly because commodities are a raw ingredient for a lot of goods produced by companies, so when prices are low, future company profitability may be higher and vice versa. The price of commodities is also more generally related to global economic growth, so as commodity prices increase, the global economy is likely to be doing well which is naturally beneficial for companies generally. The chart shows the relationship between the Thomson Reuters Commodity Index (a broad index of commodities including energy, agriculture, industrial and precious metals), and the change in forward earnings growth from world equities. Rising commodity prices suggest equity earnings may increase further.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 30 September 2020

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	0.3	3.5	5.8	96.5
MSCI UK	-1.6	-4.6	-19.7	15.1
MSCI UK Broad	-1.7	-3.6	-18.5	16.1
S&P 500	-0.4	4.1	9.8	127.1
MSCI Europe ex UK	0.6	1.3	0.2	61.9
MSCI Japan	4.7	2.3	2.3	71.3
MSCI Pacific ex Japan	-2.6	-2.5	-10.4	63.3
MSCI Emerging Markets	1.9	4.8	5.7	83.3
Bonds				
iBoxx GBP Gilts	1.6	-1.3	3.7	29.8
iBoxx USD Treasuries	3.9	-3.9	3.1	41.8
iBoxx GBP Corporate	0.4	1.6	4.3	34.6
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-9.2	-0.6	-32.7	-13.7
Gold ($/ounce)	-3.5	6.5	28.9	70.5
GBP/USD	-3.4	4.6	4.9	-14.7
GBP/EUR	-1.5	0.2	-2.5	-18.8
EUR/USD	-1.9	4.4	7.6	5.1
USD/JPY	-0.5	-2.2	-2.4	-11.9

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	30-Sep	Yields (%)	30-Sep
UK GDP (YoY%)	-21.5	-9.90	GBP/USD	1.29	MSCI UK	4.72
UK CPI Inflation (YoY%)	0.2	0.90	GBP/EUR	1.10	MSCI UK broad	3.76
Bank of England Base	0.10	0.10	EUR/USD	1.17	10 Year Gilt	0.19

All values and charts as at 30 September 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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