Investment Review

Q3 2020

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1. Summary

The past quarter has been much steadier for world financial markets relative to the first half, despite continued economic restrictions and the fear of a broad resurgence of Coronavirus.

Governments and central banks continue to provide the fiscal support, market liquidity and 'whatever it takes' promise that financial markets are so accustomed to. Many asset classes have climbed the wall of worry and are showing positive returns year to date.

The UK economy and stock market continue to underperform global peers, for both structural reasons and a lack of confidence as we approach the end of the EU withdrawal agreement transition period.

With the expectation that economic prospects could worsen for companies and individuals next year, it is understandable that investors are showing concern for investment returns and portfolio values going forward and considering what, if any, action should be taken.

There are many potential outcomes in the months ahead and no matter what we think is most likely to happen, we should retain a healthy respect for our inability to make accurate predictions. The logical approach is to retain a diversified investment strategy and have a sufficient cash buffer to draw upon in case of an uptick in market volatility.

Mike Lea
Investment Director
Financial Planning Corporation LLP

- This investment review contains information and opinion and does not constitute advice.
- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

2. Market Performance (Year to Date)

UK Shares

The UK market as a whole has remained weak throughout Q3 with the FTSE 100 -4% (-20.2%) and the broader FTSE All Share -2.9% (-19.9%). The indices are well diversified by sector but the larger market weightings within the oil & gas, industrial and banking sectors continue to be a drag on the indices. Really, with the exception of technology focused businesses and healthcare, most sectors continue to face severe headwinds.

Politically the UK is not doing itself any favours on the international stage and foreign investors remain wary of increased currency risk as the end of the EU transition period is reached. That said, the pound has regained lost ground this year against the US dollar and is -2.7% having been -14.7% in March. This reflects more the dollar's recent weakness as the pound has made little progress against the euro and remains -7.3% this year.

We can have high confidence that the pound will see increased volatility in the coming quarter as news from the EU negotiations clarifies, or not, the position moving forward.

Global Shares

In pound terms, Emerging Markets performed the strongest in Q3 with the MSCI Emerging Markets returning +4.7% (+1.3%). MSCI China has returned +8.2% (+19.3%) as the world's manufacturer sees continued strong recovery. The OECD forecasts China to be the only G20 economy set for positive growth in 2020[1].

North America continues to power ahead with the S&P 500 +4% (+7.7%) thanks, again, to a handful of technology companies. The US moves back and forth on further fiscal stimulus but it is a question of when, not if, further support is provided. The election on 3 November is a major event and the policies that emerge could dictate future market trends. Democrat Joe Biden is favoured in the popular vote but that does not necessarily translate to the presidency because of the US voting system and the importance of a small number of 'swing' states.

In Japan, Prime Minister Shinzo Abe unexpectedly resigned due to health reasons. Mr Abe was the protagonist of transformative economic policies including improved corporate governance codes, increased immigration to fight an ageing population and ultra-loose monetary policy to stimulate inflation. It is thought that this movement is now unstoppable despite Mr Abe stepping down[2]. The Nikkei 225 index finished the quarter in positive territory +1.6% (+2.7%) and high-profile Berkshire Hathaway chief Warren Buffet brought attention to the region by investing $6bn in the country during the quarter.

[1] oecd.org/economic-outlook/

[2] The Economist – 'A new story at last' – 3/9/20

Fixed Interest

The view that interest rates will remain pinned to the floor in the short term has firmed recently, with 5-year UK government gilts showing slightly negative returns and 10-year returns still remaining low at just 0.28%.

The market suggests future inflation concerns are low, even though most central banks are now employing much looser inflation targets and seem quite willing to let prices rise. We suggest the bulk of gains in government bonds from yield compression/flight to safety has passed and returns have been negative in the quarter -1.3% (+8.2%).

UK corporate bonds have performed better +1.5% (+4.8%) as income hungry investors remain happy to pay more for a regular income. Corporations with a reason to exist in the future have ample opportunity to increase capital reserves through bond issuance at attractive financing rates. Many will use this firepower to take advantage of corporate development opportunities.

National Savings & Investments have disappointed savers with a significant reduction in rates payable effective 24 November. The popular Income Bond has fallen from 1.15% to 0.01% gross pa. It was only a matter of time as the government's annual net financing target of £35bn was firmly on schedule in Q2 due to strong fund inflows[3].

Property

The stamp duty holiday for residential property under £500,000 has brought forward demand. The Rightmove House Price Index shows annual prices coming to the market are +5%, with the 'second-stepper' market (3 or 4-bedroom homes) especially strong as people seek more space for home working[4].

This market confidence has reverberated into the commercial property market with a number of property funds previously gated now on the cusp of re-opening to investors. Industrial property and warehousing remain buoyant, whereas retail and leisure sectors continue to struggle. The trend of 're-purposing' to find alternative uses for vacant property has emerged but will take time to wash through.

Gold

The gold price is worth a mention, which although flat in the quarter has returned 24.4% for the year. The inclusion of gold in a portfolio divides opinion but buyers have emerged in the face of an influx of money into the system, resulting in fear of inflation (little evidence) and low returns from other defensive assets. As the economic cycle progresses, dependent upon when/if a vaccine is rolled out, then gold may see more muted interest in the absence of price inflation.

[3] nsandi-corporate.com/news-research/news/nsi-reduce-interest-rates-24-november-2020

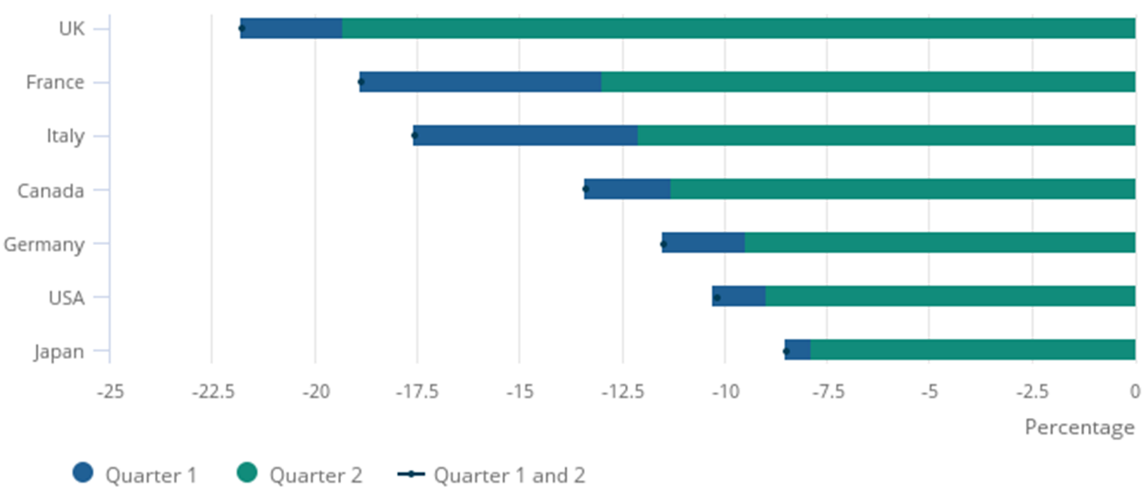
[4] rightmove.co.uk/news/house-price-index/september

3. UK Economic Position

It was confirmed that UK GDP contracted by a record -21.8% during the first half of 2020, the largest of any G7 country. This reflects the structure of the UK economy and the influence of the servicing sector, which has been severely impacted by the lock down.

Figure 3: There has been a record contraction in the G7 economies in the first half of 2020

Real G7 GDP, Quarter 1 to Quarter 2 2020



Source: Organisation for Economic Co-operation and Development, Office for National Statistics

Whether it be the active bond buying of the Bank of England to keep interest rates low, the residential stamp duty holiday to spur activity, or the reluctant continuation of the job furlough scheme, the UK economy needs support.

When the government suggested ending the furlough scheme we thought this would be very damaging and potentially stall an economic recovery. The labour force is the most important actor in the economy and needs protection, irrespective of cost, when it cannot play its part.

It would be a major policy error to force companies, otherwise solvent in times of free movement and consumption, to shed their workforce dramatically. There may well be some company lives being prolonged by public money, but this is not the time to be sorting the wheat from the chaff. Rampant unemployment would be bad in so many ways.

[5] ons.gov.uk/economy/nationalaccounts/uksectoraccounts/articles/quarterlyeconomiccommentary

3. UK Economic Position cont.

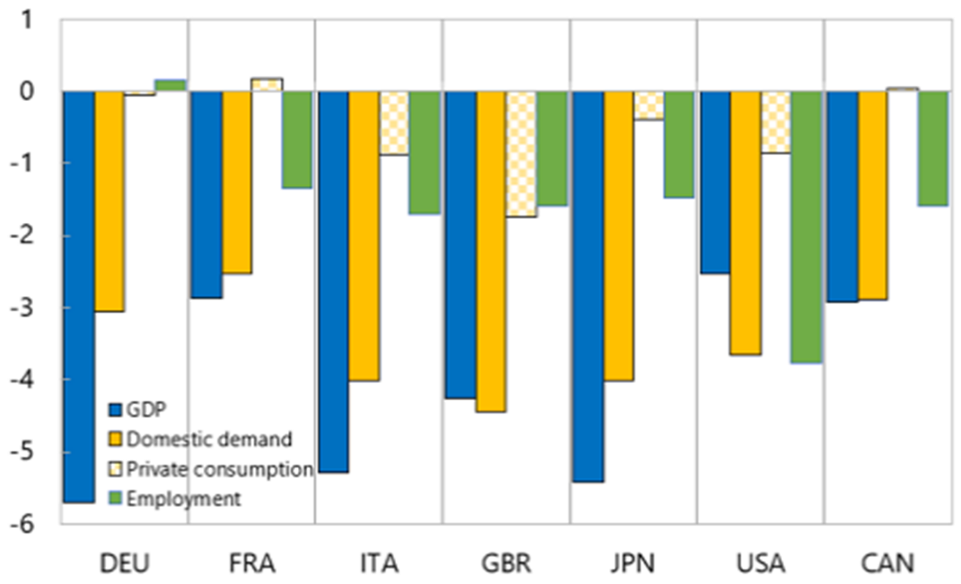
We hesitantly use the phrase ‘return to normal’, but once the virus is contained then market forces will decide which companies/jobs are viable in a smoothed, rather than sudden fashion.

It seems the UK is following the German ‘Kurzarbeit’ blueprint. This social insurance works by reducing hours yet protecting incomes, thereby instilling confidence and supporting aggregate demand. Germany was the only G7 country that did not experience a fall in employment in 2009. The UK needs to ensure that workers are protected in 2021, as even though the wheels have slowed it will be harder to get moving should they stop.

Standing out from the crowd

Germany stands out among G7 peers for keeping employment stable during the GFC*.

(Percent change, 2009)



Sources: WEO and IMF staff calculation.
*GFC: global financial crisis

4. Growth v Value Factors

There has been an established trend for many years now whereby stocks that exhibit 'growth' factors (high earnings forecasts, low dividends) have outperformed 'value' stocks (priced below internal company worth, higher dividends). The valuation divide between the two factors has not been as stretched since the dot com era in 2000[6]. Since the outbreak of the virus this performance variance has been amplified as investors flock towards the small cohort of companies seemingly best placed to survive and prosper in the current economic environment. The chart below shows the 1-year performance of the respective MSCI World Indices:

There is a strong argument that there is more at play here than just company fundamentals. Investors are paying ever more for a piece of the growth and a 'fear of missing out' (FOMO) is apparent. Animal spirits seem alive and well.

The law of large numbers will, eventually, weigh on those company shares that are priced to perfection. They cannot continue to grow at the rate they have and the factor gap can unwind quickly. Investors should be wary of this and avoid concentration in certain sectors despite how attractive it may seem. It is interesting to consider that stocks seem to become more alluring as they get more expensive.

[6] Bloomberg – Points of Return – 3/9/20.

5. Looking Forward

Clients will note we have been suggesting a modest increase in risk positioning within portfolios, where suitable. This is a recognition that returns from defensive assets will be lower moving forward. This is a fact.

When our full year review is published in early January the UK will either have a trade deal (of some description), or not, but it is impossible to say what the impact on financial markets will ultimately be, whatever the agreement. Many think it to be a certainty that the outcome will be negative for the UK, but perhaps it will not be.

Professor Elroy Dimson of the London School of Business defined risk as meaning "more things can happen, than will happen". There certainly feels the possibility of a wide number of outcomes so for those in the game of prediction then, good luck.

However, when the facts do arrive, we will be able to make more informed decisions as to how, if at all, we alter our strategic asset allocation for clients. As ever, it remains logical with the many uncertainties ahead of us that we prepare for a number of outcomes through a diversified investment approach.

> "Well, when events change, I change my mind. What do you do?"
>
> (Paul Samuelson – Nobel Laureate Economist)

Invest With Confidence

At the heart of what we do is a simple goal – to help you achieve and maintain financial independence, provide for those who rely on you and live life well.

We do that by providing the financial planning and investment advice you need to secure your future.

We recognise that investors with similar risk profiles may have very different objectives, tax positions and personal circumstances so we adopt a bespoke approach in each case. There are no 'off the shelf' solutions.

We focus on choosing the right blend of assets, managing risk, and minimising tax and costs. Our strategies consistently deliver. Our investment philosophy is founded on a number of key principles which have served our clients well for more than 30 years:

- Differentiate savings from investment
- Understand and manage risk
- Get the "investment recipe" right
- Avoid market timing
- Fear inflation
- Manage tax and costs
- Process is paramount

We believe you win by not losing and this core principle lies at the heart of our investment approach. To find out more, get in touch.

01704 571 777

info@fpc.co.uk

fpc.co.uk

Lancaster Terrace,124 Station Road,
Ainsdale, Southport, PR8 3HL

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