

Market commentary

October 2020

‘While rising debt is not a free lunch, that doesn’t mean we shouldn’t be buying lunch for everyone right now.’

- Kenneth Rogoff, Professor of Economics, Harvard University

Overview

The United Kingdom is suffering its deepest recession in modern times, caused by the lockdown needed to contain the coronavirus pandemic. The UK economy shrank by -20.4% in April, which followed a fall of -5.8% in March and according to the Bank of England, represents the deepest recession in 300 years. Allowing for inflation, the UK economy is the same size as it was in 2005 and this is mirrored somewhat in the performance of the largest 100 hundred companies in the UK, measured by the FTSE 100 Index. The headline index is currently at 5,800, which is the level it first reached back in 1998. In simple terms, had you invested £10,000 into a FTSE 100 tracker back in 1998, your investment would not have grown in capital terms throughout the last 22 years. However, during that time, you would have received approximately 5% per annum in dividends, which would have doubled your original investment. Essentially, investing in the FTSE 100 over that period has been a story of harvesting the dividend income and this remains as true today as it was back then. Back in 1998, if you had known how the FTSE 100 was going to behave, you could have invested in a portfolio of UK Government Bond (‘Gilts’) that would have provided an annual yield of 6%, without the inherent risk to your capital. Today, the ‘hunt for yield’ remains a primary goal for investment managers faced with the same dilemma, except that a UK Gilt portfolio invested over the next 10 years will now only yield a paltry 0.3% per annum. This has implications for the traditional ‘balanced managed fund’, which historically had a proportion of its assets in the stock market and a proportion of its assets in Gilts and/or corporate bonds to mitigate some of the risk during times of crises. Investment managers are increasingly investing in highly diversified and esoteric income streams to improve the income yield on portfolios. In response to the lockdown, the majority of the constituents of the FTSE 100 have cut or suspended their dividends to preserve their cash burn and this is likely to herald a resetting of equity dividend income at lower levels for investors, over the next few years.

The FTSE All-Share Index (measuring the performance of the top 640 listed companies in the UK) suffered a -35% decline from the start of the year to the lows reached at the end of March, before recovering to -20% down, at the current time of writing. The UK is still performing much poorer than other major stock markets, due to the dominance of the struggling banking and oil sectors and the lack of large technology companies.

The accommodation and food services sector (including hotels and restaurants) suffered a staggering -88.1% drop in business in April. In August, the economy was boosted by the ‘Eat Out to Help Out’ scheme and from government programmes such as the ‘Coronavirus Job Retention Scheme’ (or ‘Furlough Scheme’), helping to recoup 70% of lost economic output in the March and April downturn. In July, UK public sector debt rose sharply to over £2 trillion or 100.5% of Gross Domestic Product (a measure of the size of the economy) from 84.7% in March, representing an unprecedented acceleration in UK debt to pay for the cost of the schemes and exceeding national debt levels last experienced in 1963. Since May, there has been an easing of the lockdowns throughout the globe, which has kick-started economic recovery and economists’ projections are indicating that by the end of this year, the UK economy will have only shrunk by -10.4%, the United States will have dropped by -4.1%, the Eurozone by -7.8%, Japan by -5.4% and the Emerging Markets by -2.7%.

Despite a sharp rise in Covid-19 cases in the US, relative to other major countries, the US stock markets responded more positively than the UK and Europe, since the lows of late March, with supportive comments from Jerome Powell, the Chairman of the Federal Reserve (the US Central Bank) who said “...not even thinking about raising interest rates”. The US Federal Reserve will now use Average Inflation Targeting (AIT) in setting interest rates, implying that they will only raise interest rates when inflation has exceeded 2%. This is an important message to financial markets, providing implicit guarantees that interest rates in the US will stay close to zero until at least the end of 2023.

In July, the European Union approved 'The Next Generation EU', a €750 billion fund to help member states recover from the pandemic consisting of €390 billion of grants and €360 billion of loans to be distributed among member states. The European Parliament agreed that this should be established in conjunction with 'The European Green Deal', with the goal of net zero carbon emissions for the EU by 2050. It was designed not just to repair the short-term damage from the crisis but to revamp the long-term EU budget towards renewable energy projects especially wind, solar and clean hydrogen energy. It will channel investment into the installation of one million charging points for electric vehicles and will strengthen the rapid development of 5G networks, which will boost artificial intelligence, cyber security, super-computing, and cloud technology.

UK equities

The FTSE All-Share Index produced a total return of +10.8% in the period under review (6th April 2020 to 5th October 2020) but remains down -20% on the year. The UK economy grew strongly in June by 8.7% and 6.6% in July as the populous was released from the lockdown. The construction sector rebounded sharply, while manufacturing and services made some solid recovery gains. Unsurprisingly, the defence sector never fell, while most other economic sectors have much further to go. The accommodation and food services sector remains at 60% below pre-covid levels highlighting the desperate state of hospitality. In aggregate, consumer spending has fallen much more than household incomes due to a cautious approach by households to preserve cash, particularly with wages tenuously supported by over 9 million people being furloughed. Spending involving high levels of social interactions has fallen the most, whilst spending on staples, such as food and energy has remained consistently above pre-covid levels, reflecting the fact that people have been largely confined to their homes.

UK companies raised a significant amount of finance since the outbreak, amounting to about £70 billion in the four months leading up to June. This was triple the amount raised the same time last year. Much of the larger companies have tapped the financial markets for funds, but the government has also stepped in, lending £50 billion in Bounce Back Loan Schemes (BBLs), the Coronavirus Business Interruption Scheme (CBILS) and the Coronavirus Large Business Interruption Scheme (CLBILS) and an additional £17 billion under the Covid Corporate Financing Facility (CCFF). The retail and travel sectors are struggling to access finance and will struggle on into the new year. Aircraft departures are still 60% below normal levels, whilst google searches for theatre tickets are down over 80%. Restaurant attendance is still 50% below normal levels. Without a significant rise in unemployment at this juncture, household bank deposits have increased by £17 billion a month over the course of four months since the start of the crisis, due to savings on entertainment. A survey carried out by the Office for National Statistics (ONS) on the social impacts of Covid-19 suggests that 60% of adults would still feel uncomfortable about going to the cinema and 50% feel uncomfortable about eating in restaurants. The share price of Cineworld is down over 85% since March reflecting these attitudes.

The pandemic has had a profound effect on the UK labour market with businesses having to adapt to a change in working practices. Many businesses are expected to reduce the size of their work forces leading into the new year, although the extension of the furlough scheme will continue to slow the rate of unemployment. According to the Bank of England, unemployment is projected to rise to 7½%, but will likely persist at these elevated levels for a few years, in line with the experience of past recessions. Heightened uncertainty about the future path of Covid-19 will weigh heavily on labour demand as firms remain cautious. Structural unemployment remains a serious concern for the government, as staff made redundant by hospitality firms for example, will be unable to look for alternative jobs in the sector, as all firms will reduce their hiring and it will take years for those permanently unemployed from the sector to re-train and find jobs in different industries.

On the corporate front, the Rolls Royce Group came to market to raise money in a rights issue, given the depressed outlook for the aerospace industry over the next 2-3 years, whilst the worst performing shares on the year are unsurprisingly populated by banks, oil and gas producers, travel and leisure and commercial real estate.

International equities

The S&P 500 Index, used as a broad measure of the total investment return achieved by the largest 500 publicly quoted companies in the US, rose strongly by +38.2% in the full period under review, recovering all of its losses from the beginning of the crisis.

The US market stands out amongst other developed nations as very expensive on valuation grounds but that has been the case for many years, whilst continuing to outperform other overseas markets. Facebook, Apple, Microsoft, Amazon and Google have been the beneficiaries of many trends, which accelerated throughout the crisis, such as the use of technology, cloud computing, working from home, online shopping and many more. In a world of virtually no growth elsewhere, investors have prized companies that can demonstrate steady growth characteristics. Even so, current share prices have baked in some heroic forecasts for the future and a sound investment portfolio should be fully diversified on a wider geographical basis.

The US Federal Reserve's economic projections show that it intends to run the economy 'hot' for a period to drive inflation up, whilst enjoying the benefits of stronger growth and lower unemployment. However, the new policy amounts to a significant increase in financial repression and three years of zero interest rates await. This will be a challenge for both savers and investors and will likely intensify the 'search for yield'. Investors can buy US government bonds (Treasury Bonds), but they currently yield a lowly 0.7% per annum. There are negative affects to this inflation policy, and it will be felt most by income seeking investors, who understand that they need a significantly larger pot of money to generate relatively low levels of regular income. Investors looking for higher interest rates are being forced into riskier investment portfolios to increase returns, but they are being exposed to higher levels of leverage (borrowing to invest) and increased financial instability. Permanent, ultra-low interest rates can also produce undesirable asset bubbles. Investors are grateful to the Federal Reserve for supporting financial markets, which had threatened to seize up in March but the price to pay will be greater future instability.

In Europe, the FTSE Europe (excluding UK) Index, which is a measure of the performance of stock markets in continental Europe rose by 21.4%, all but erasing the losses caused by the crisis. Europe has evolved over the last 10 years with the rapid expansion of health care, the information technology sector and industrial sector, whilst becoming less reliant on the financial sector and energy production. The Covid-19 crisis has accelerated several trends already in place, such as the importance of life saving equipment and drugs, with large pharmaceutical companies partnering with smaller biotech companies for health based solutions. The demand for electric vehicles is fuelling demand for semi-conductor materials and computer chips, whilst the development of advanced biofuels will play a key role in industries that cannot easily be electrified. At the heart of the European Recovery Fund is the Europe-wide net zero emissions targets for 2050. In the long run, these industries will represent the faster growing and more sustainable areas of investment against the backdrop of tepid global economic growth, which is hindered by very high and rising global debt levels.

Fixed interest securities

The ten-year UK Gilt yield is a paltry 0.3%, which is the estimated annualised return an investor should expect to receive over ten years and remains below the current rate of inflation. The equivalent US 10-year Treasury bond yield is 0.7%. The US and UK government bonds are low risk but offer poor nominal investment returns over ten years. The main risk to investing in these assets is inflation, eroding the real purchasing power of capital over time.

Over the last five years, a fundamental pillar of finance has been turned on its head. In a bold monetary experiment, negative interest rates were adopted in Europe and Japan to stimulate economic growth and improve inflation expectations. Savers are being penalised and borrowers are being rewarded. In response, normally risk-averse savers have been pushed out of cash earning nothing, towards investing in higher yielding, riskier bonds. Bonds issued by companies and governments are traded on financial exchanges and as the price of a bond rises, the yield (the interest rate) falls. "Central banks have been buying up more debt than governments can throw at them", said Mark Dowding, Chief Investment Officer at BlueBay Asset Management.

Prices have now been pushed so high that a staggering \$17 trillion of bonds trade globally with negative yields. For example, a 10-year investment in a German government bond will currently lock in a -0.4% per annum return. Perversely, this is a signal that some investors are happy to lock their capital up for 10 years, in return for small losses. The covid crisis has confirmed that governments and central banks will intervene heavily in the bond markets to support prices and fixed income portfolio managers have little choice in assuming that this will continue indefinitely.

Commercial property

The Covid-19 crisis has had a short-term impact on the office sector, accelerating flexible working trends but whilst it may be fashionable to declare the end of office working, the facts on the ground are the opposite. Rent collection remained above 80% in June and the industrial sector collected over 70% of rents. Only the retail sector was struggling at close to 50% of available rent collection. Whilst there are challenges in the short-term, it is widely believed that Covid-19 has triggered a new paradigm, where employees split their working weeks between the office and the home. This will depend on the sector in which they work and the structural changes that the employer faces, but changes will likely happen slowly over time. Most importantly, surveys are suggesting that offices provide a communal setting for business interactions, which remain crucial and as anyone with young children will testify, a sanctuary away from distractions and where productivity can be maximised. Pre-pandemic there was already a quiet revolution taking place in the office sector fuelled by the rise in technology and serviced offices, focussing on flexibility, wellness, and dynamism. In the 2010s, occupational density ratios were 1 person to 12 (1:12) square metres but this was being squeezed down to 1:8 by the end of the decade. Covid has taken us back to the 1:12 ratio, but there are already signs that this number is coming down. In 2021, it is likely that we will observe some rental volatility in some markets as firms take stock of their future requirements. Supply is already constrained in London as redevelopment of offices was taking place before the pandemic towards alternative uses, but covid has all but stopped the development of the more speculative projects. With a vaccine in place, it is plausible to forecast a recovery in 'Corporate Britain' and the trend for demand of carbon neutral, sustainable buildings will accelerate, as it was before the pandemic.

Alternative asset classes

Gold traded at an all-time high in July at \$2,070 an ounce. It started the year \$1,520 an ounce and now trades at \$1,940, a gain of 27% on the year. Oil plummeted to below \$10 a barrel in April as demand fell precipitously but has since staged a recovery to \$37 a barrel.

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If you would like to find out more or speak to one of our advisers, please contact us: t. 01727 837128 e. info@ifpc.co.uk

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Indices performance statistics are for the period 6th April 2020 to 5th October 2020, total return with income reinvested. Returns are stated in local currency terms unless explicitly stated otherwise.

Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.

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