

Market commentary

April 2021

‘It ain’t what you don’t know that gets you into trouble, it’s what you know that just ain’t so’ - Mark Twain

Overview

On the 9th November 2020, Pfizer and BioNTech announced they had a vaccine that was 90% successful against Covid-19, heralding a huge step forward in the fight against the pandemic. The news provided a boost to the outlook of the world economy and spurred a significant rally in equity markets. The immediate reaction to the news was a “sell the Working from Home (WFH) stocks” such as Zoom Video Communications and buy “back-to-normal stocks” such as cinemas, the airlines, cruise liners, commodities, and property. With government largesse in the form of furloughs, 2020 was a year where for many, the financial and economic blow of lockdown was softened. There has been a revolution in the powers of government in 2020 and this may well usher in an era of state planning, which was last fashionable in the 1940’s. The UK government’s support for households was £80 billion in 2020 including the Coronavirus Job Retention Scheme (CJRS) and Self-Employment Income Support Scheme (SEISS). As a result, public sector borrowing was 14.5% of the economy, the highest since the Second World War. Governments and central banks around the world are desperate to avoid an economic slump or depression, and there will be plenty of deficit spending to come, not least because the furlough policies may be hiding higher rates of unemployment and a sharp jump at this juncture, would be politically unacceptable after protracted lockdowns.

In the US, President Biden was swept into office in November 2020 and immediately announced a \$1.9 trillion stimulus bill called the American Rescue Plan (ARP), which should raise economic growth in the US in 2021, to a healthy 4.9% with positive knock-on effects for the rest of the world through stronger trade, as the world moves back to normalisation. The package will stimulate global economic growth, which is projected to rise to 5.3% for 2021 from a contraction of -4% in 2020, a level last experienced in 2010, after the previous financial crisis and will be one of the strongest recoveries in recent economic history. Alongside an incoming boom in growth for the advanced nations comes the risk of increased inflation, largely driven by higher commodity, oil and freight prices. It is critical that the short-term factors raising inflation moderate over the next year or so, as low and stable inflation is critical for monetary policy and the stability of financial markets. Whilst the emerging economies recovered strongly coming out of the last Great Financial Crisis in 2009, their poor infrastructure and lack of access to medical care and vaccines, will make their recovery from the pandemic significantly more challenging than their wealthy neighbours.

The UK’s success in the speed of vaccinating its population will help lift restrictions faster and aid its economic recovery. Real economic growth is expected to be a strong 5.3% in 2021 and should follow through into 2022 at 5.1% per annum. The household sector spent 2020 building up their savings, due to lower spending on holidays, eating out and entertainment, which could create a spending boom over the coming years as normality returns. However, there will be “scarring effects” as households take time to regain their confidence. Some spending patterns will change permanently as people choose to work from home and commute less. The rise in savings has been concentrated amongst better-off workers and retirees. Indeed, the Bank of England published research indicating that savings have increased amongst the top 20% of income earners, whilst low-income groups have either stopped saving or in the case of the unemployed are running down their savings.

Concerns are increasing that we are entering a new inflationary era and bond markets have reacted accordingly. In the US, the yield or interest rate, on the 10-year Treasury Bond in November 2018 was 3.2%. This tumbled over the next 18 months to an all-time low of 0.5%. For context, the peak interest rate for these bonds in 1981 was 15% and the rate has been falling ever since. In the last 9 months, the rate has risen sharply back up to 1.7%, rendering the servicing of government debt more expensive at a time when governments are borrowing huge amounts to soften the blow of covid.

In the near term, the hospitality sector will experience a revival, although capacity is likely to be restricted by government-imposed limits such as the number of people allowed in a café or restaurant at any given time, and the additional costs associated with re-opening businesses. By contrast, other sectors such as travel, and airlines have said that they will cut prices to bring customers back.

UK equities

The FTSE All-Share Index (a measure of the top 641 companies in the UK) produced a total return of +17.0% in the period under review (6th October 2020 to 5th April 2021) recovering all its 2020 covid losses, and trades close to its all-time highs. There have been many reasons for investors not to allocate money to UK equities in recent years, with the uncertainty of Brexit, the government's early mishandling of the covid crisis and the fact that much of the UK's largest companies are in unloved sectors such as energy, materials, and financial stocks. The UK is also notably light on technology stocks. By the end of 2020, the UK was considered one of the most hated asset classes for global investors, however, if one was to accept the premise that the greatest gains are to be made from buying the most out of favour asset classes, then the UK certainly qualifies for further consideration. The asset class is now trading at a 50-year low valuation relative to the US and an incredible 45% discount against the rest of the world (Source: Morgan Stanley October 2020).

Over the last three months, the Bank of England has surveyed the spending intentions of households with increased savings built up in 2020, concluding that 60% of respondents prefer to keep their money on deposit and the remaining 40% are spending it by paying off debts, putting a deposit on a property, investing, topping-up pensions and making home improvements. Only 5% of over 80's expect covid to pose a significant risk after receiving two vaccine doses, suggesting their increased participation in the economy. Heightened uncertainty on spending and investment plans are a continuation of the new UK-EU trade arrangements as UK goods exports to the EU fell by 46% in January, while goods imported from the EU fell by 30%. Early evidence suggests that firms are beginning to adjust to the new rules and exports recovered in February back to similar levels last seen in 2019.

According to the Labour Force Survey, employment has fallen by 650,000 and unemployment has risen to 4.9% over the past year. However, given the sizeable effect of covid on the economy, the increase in unemployment so far is relatively muted. Her Majesty's Revenue and Customs (HMRC) are the best single source for the data in their role in monitoring company payrolls and they report that the numbers are closer to 800,000, although there is some suggestion that many workers have taken to setting up self-employment, in response to their altered personal employment prospects.

Business activity in service firms, such as accountancy, with work relating to taxation, mergers and acquisitions, IT services and factors relating to working from home is at pre-covid levels, whilst in contrast, business travel, corporate hospitality, events, marketing, and advertising remain markedly lower than pre-pandemic levels. Logistic companies are suggesting that the disruption at the EU border with the new customs requirements is starting to ease but is nevertheless weighing on trade activity. Companies are reporting severe disruption to the transportation of goods to Northern Ireland from Great Britain, particularly for animal products and foodstuffs. Manufacturing output continued to improve as customers are starting to rebuild their stocks and there are early indications that demand from Australia, the US and China has risen. Construction output improved modestly, supported by public infrastructure projects and the building of private housing and the demand for logistics and warehousing facilities remains strong. Housing market activity is very strong as the trend for people moving out of cities to larger properties continues unabated.

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 +20.6% in the full period under review. Professional investors are aware of a decade long under-performance of the so-called traditional, value stocks versus the highly disruptive, high-growth technology stocks, which have become such a dominant feature of the US market.

Historically, value stocks have out-performed growth stocks over sustained periods of time, with intermittent periods of growth out-performance, most noticeably in the tech boom of the early 2000's. It appears at face value that we are experiencing an unprecedented level of technological change, however, there is no strong quantitative evidence to suggest that there has been any degradation in returns on capital or profitability of the more traditional "value stocks" compared with their long-term historical averages, as share prices would have you believe. The under-performance of "value stocks" over the last decade can be attributed simply to cheap stocks getting cheaper and growth stocks getting ever more expensive. There are several reasons for this, but historically low interest rates, the market power of index tracking products and high levels of government and central bank intervention are key factors in causing significant market distortions.

Technological destruction is not a new phenomenon, as automobiles replaced horses, the light bulb replaced kerosene lamps and candles. The growth of low-cost manufacturing in Japan and Korea, disrupted many traditional manufacturing industries in the US in the 1970's and 1980's. The only constant over time has been change. The only difference this time around is that the growth cycle seems to have lasted much longer. Microsoft was a value stock a decade ago and was being disrupted by mobile technology such as Apple. Apple was heading for bankruptcy in 2000 and tobacco was thought to be a dying industry in the early 1990's, before producing some of the best returns over the next 25 years. As this current boom rolls on and the market capitalisations of favoured names mushroom, investors are losing all sense of scale, or at least choosing to ignore it. According to Bloomberg research, non-profitable technology stocks have out-performed profitable tech stocks by a factor of 5 since March 2020 and is surely unsustainable. Indeed, since the discovery of the vaccine and subsequent rise in interest rates, unloved "value stocks" have performed well relative to the technology sector, given that technology stocks are very sensitive to rising interest rates. How long this persists, remains to be seen but it is more likely that the performance gap between value and growth will close over the coming years.

In Europe, the FTSE Europe (excluding UK) Index, which is a measure of the performance of stock markets in continental Europe rose by +12.0%, now trading above the pre-covid levels of last February. The roll-out of vaccines has been woeful across Europe and after the Eurozone economy contracted by -6.8% in 2020, it is projected to only grow by 3.6% in 2021, significantly lower than other advanced nations. The delays in vaccinating the population could mean that Europe misses out on the lucrative tourism season this summer, as it largely did last year, but expectations are that the Eurozone will pick up significantly in 2022 as restrictions are relaxed.

Economic growth across the emerging markets is expected to rebound by a healthy 7% in 2021, moderating to 4.9% in 2022. China was one of the few economies to grow in 2020 and remains at the top of the growth tables with a very healthy expansion of 9% projected for 2021. As in many parts of the emerging world, a short bout of inflation will act as headwinds due to rising energy and food prices. Brazil and India have had very poor government responses to the covid crisis and the higher levels of inflation and recovery growth surge, may even lead to rises in interest rates, in the short-term.

Fixed interest securities

The ten-year UK Gilt yield is a paltry 0.8%, 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 1.6%. US and UK government bonds are considered 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.

The traditional income seeking investor will need to search for higher levels in other asset classes but even investment grade corporate bonds are offering low, nominal interest rates and professional investors are reluctant to take on more risk in high yield bonds, due to record high corporate borrowing levels by companies with little wriggle room to service their debts. Higher income levels can be found in emerging market bonds denominated in US Dollars, whilst specialist corporate, floating rate notes provide reasonable yields with added protection against rising interest rates.

Commercial property

The performance of the broad based MSCI Liquid Real Estate Index was 7.6%, following a -28% top to bottom decline from February to March 2020, when the covid crisis first hit. Commercial property landlords are sensing that a recovery is underway, although conditions remain very tough for office buildings and retail outlets. Tenant demand is dominated by the industrial and logistics sector, with activity at its highest since 2015. The government announced new rules extending Permitted Development Rights (PDR) to allow commercial premises, including retail, to be converted into residential premises. For the coming 12 months, capital value expectations remain firmly negative for office and retail properties, whilst the industrial sector is expected to see some capital growth. Data centres and aged care facilities are offering the highest capital growth expectations, whilst hotel values are in decline.

Working from home (WFH) is expected to stay and will result in companies and employees adopting a “hybrid model”, mixing a few days in the office with a few days working from home. Surveys carried out by Savills, McKinsey and Deloitte found that more than half of employees consider, that they have either maintained or increased productivity, while working from home. However, 45% of employees are missing social interaction, 31% missing collaboration at work and 25% are missing networking. Sectors such as finance, insurance, management, IT, telecoms, and education are most suitable for this hybrid model. Firms are renewing leases that are coming up for consideration, with anecdotal evidence that they have decided to kick the final decision on methods of work, down the road. A surveyor at Knight Frank best describes this as “Office occupiers are still working through the impact of Covid-19 on working practices. Undoubtedly, all businesses are concerned as to how best they can retain and recruit staff and the role that the office has in this. It is clear, that businesses will require significant lease flexibility moving forward, to quickly respond to changes in the business environment.” Portfolio managers have been reducing their exposure to shopping centres and high street retail and re-deploying their capital to industrial building and logistic warehouses. Dis-investment from retail has totalled £3.6 billion over the last 5 years and is largely factored in. Across the broader UK commercial property sector for balanced property funds, the average net income yield i.e. income from rents, is still averaging 3.4%, which is higher than government and corporate bonds.

Alternative asset classes

Copper prices are up 126% since March 2020 and iron ore prices are booming in anticipation of a strong global recovery, post covid. The Baltic Dry Index, which tracks the cost of moving freight around by ship has soared by over 700% since last March. Capesize vessels, the largest type, with an average capacity of 180,000 deadweight tonnes are fetching \$41,500 a day for immediate hire, almost eight times last years average. “China’s insatiable appetite for iron ore has been the single most important factor,” said Ulrik Uhrenfeldt Andersen, chief executive of Golden Ocean, the largest listed owner of capesize ships. Commodity markets are trading very strongly although there are early indications that prices are becoming detached from the underlying fundamentals of the market.

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Indices performance statistics are for the period 6th October 2020 to 5th April 2021, 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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