Investment Views

October 2020

The US Election (part II)

In the year 2000, George W Bush and Al Gore contested the 54th US Presidential election. Whilst Gore won the popular vote (48.4% to 47.9%), George W won the Presidency with 271 electoral college votes (ECVs) to 266. Each US State is assigned a certain number of ECVs which are awarded to the candidate that wins the local contest.

On the night of the election, there was no clear winner with Florida still undecided; the "Sunshine State" accounted for a decisive 25 ECVs. The eventual result was so close it prompted an automatic recount and over a month of legal wrangling. Florida State court ruled that a manual recount should be performed, as questions had arisen over ballot papers being incorrectly disqualified by automated counting machines (the 'hanging chads' debacle). The Bush camp contested this ruling, with their appeal finally being heard in the US Supreme court. The latter ruled in favour of Bush, handing him the State by 537 votes or 0.009% of the local population.

Fast forward to 2020 and there is a real possibility that the November 3rd Trump/Biden election produces a narrow victory that, in turn, triggers legal challenges that end up in front of the US Supreme Court. It is thus noteworthy that the September passing of Ruth Bader Ginsberg, a liberal Supreme Court Judge, will likely herald the appointment of a more right-wing replacement; Amy Long Barrett.

Having been nominated by the President, Ms Barrett need only achieve the consent of the Republican dominated Senate. Despite a tight timetable, the pre-election ascent of Ms Barrett seems likely, which would create a conservative cabal on the Supreme Court bench. Of the 9 judges, 6 would be Republican appointees. As the Supreme Court is meant to be apolitical, if it has to rule on matters relating to the US election, it will have to tread carefully to avoid accusations of prejudice.

Looking a bit further out, this bias augurs a far more fundamental change for Americans. Appointed for life, the mix of Judges could now be set for many years. There will thus be plenty of time for conservative Americans to bring appeals before the Supreme Court covering laws on abortion, gun rights, immigration and universal healthcare (to name a few). The Court rulings shape the laws of US society.

As for the outcome of the Presidential election, whilst we suspect that Biden will triumph, we are more interested in who wins the two chambers of the US Congress. At the moment, the Republicans control the Senate with the Democrats holding the House of Representatives. This split impedes the passage of more extreme policies, as each chamber thwarts the more extravagant ambitions of the other. If this endures, the White House resident will be less important. Political dogma will cede to arguments on how best to support the stagnant US economy; both sides favour further fiscal largesse. Under this scenario, equity market probably resume their bumpy ascent.

However, if the Democrats win both Houses of Congress and the White House, Biden will have an opportunity to deliver a far more radical policy agenda. Markets will immediately focus on his more left leaning policies, including a $3.5 trillion stimulus package, corporate tax hikes and anti-trust regulation of big tech firms. Equities could soften along with the US dollar especially if the likes of Elizabeth Warren, Bernie Sanders and Alexandria Ocasio-Cortez find a voice in the new administration.

The US Election (part III)

As we 'went to press', the news broke of Trumps positive Covid test. At this time, it is unclear whether he is asymptomatic or whether he is (or will) become seriously ill. Given his age (74), his weight (heavy) and rumours of high blood pressure, he is firmly in the "at risk" camp. According to Statista, between January and May this year 34% of 70-79 year old Americans who caught the virus ended up in hospital.

If Trump is incapacitated by the virus, his Vice President (Mike Pence) steps in either temporarily or permanently. If the latter, Pence would run as the Republican candidate in the November election. Intriguingly, if he too is struck down, the Leader of the House of Representatives takes charge; in this case, the Democrat, Nancy Pelosi. Although unlikely, the latter outcome would trigger constitutional chaos.

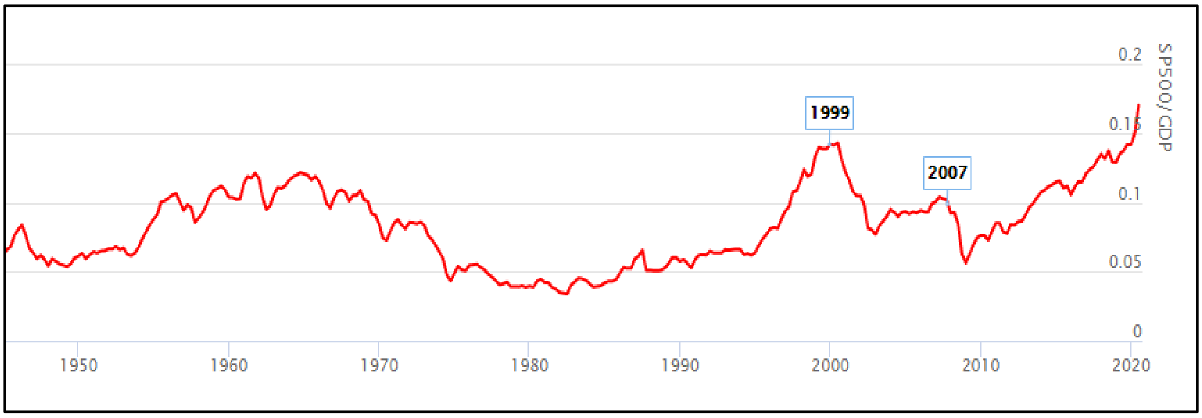
At first blush, this turn of events seems to improve Biden's chances; Betfair now puts the odds of a Biden Presidency at 65%. Although sympathy for Trump may solidify his base, it probably pushes undecided voters towards the Democrats. A key plank of the Trump election message, that the Covid crisis is over, looks shaky. Trump will also not be able to host large rallies in swing states, removing one of his most effective electioneering tactics.

If this narrative builds, markets will increasingly focus on the impact of a Biden victory (see previous article). Regardless, there is already a hefty bet on increased market volatility after the November vote. It is worth remembering that, if the election proves to be relatively uneventful (eg. Biden gets a clear win), unwinding this position could temporarily drive stocks higher as investors are forced to cover sizeable negative bets.

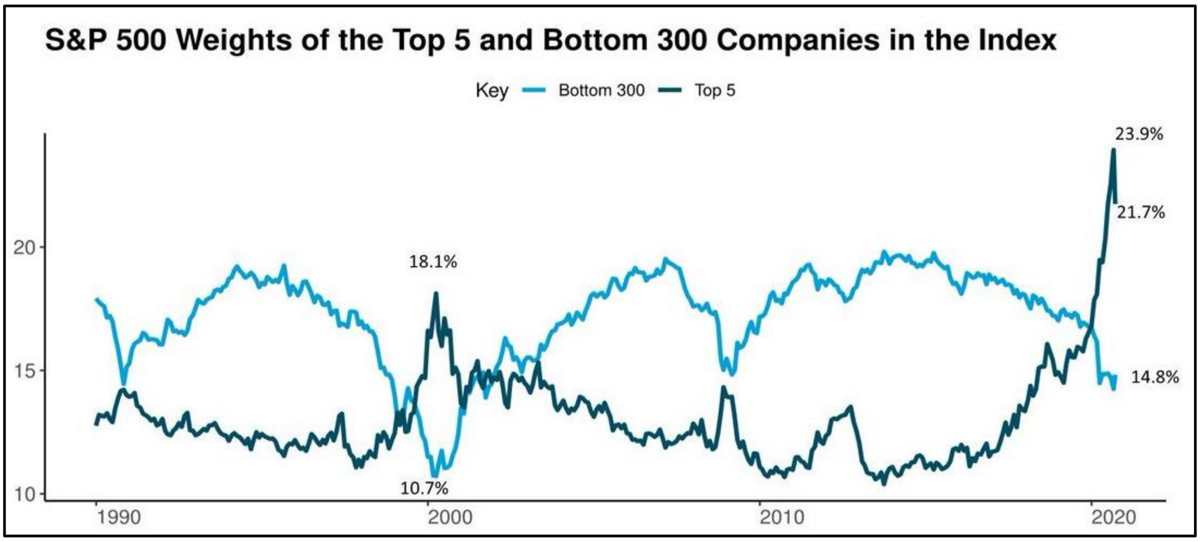
Of course, before we write off 'The Donald', we note that doctors are now far better at managing virus symptoms, improving his chances of a speedy recovery. With 4 weeks until the election, if he bounces back quickly, this episode could work in his favour. Trump could trumpet his vitality, compared to 'sleepy Joe', and double down on his belittling of the whole Covid crisis. Watch this space...

In 2019 S&P500 profits rose 0.6%; the index rose 29%. This disconnect between profits and the US stock market has become even more pronounced this year. Having slumped 32% in the second quarter, profits are now forecast to fall 18% during 2020, yet the S&P500 ended September up 6% for the year-to-date.

This leaves US stocks firmly in the expensive camp. Investors are now paying 22 times forecast earnings (a P/E of 22x), versus a 10 year average of 15 times. Turning to Warren Buffet's favoured metric, the value of the S&P500 relative to the value of US GDP (chart below), we are now in unchartered territory for the post-war period. The higher the measure, the more expensive the market.



The rally is also increasingly narrow, driven by a tight coterie of mega-cap tech names. Whilst the tech-heavy Nasdaq100 is up 25% this year, the Russell 2000 index (US small caps) is off 10%. As the chart below attests, the top 5 companies in the S&P500 now account for c. 22% of the index value, with the bottom 300 slumping to 15% (*source: the Leuthold Group*).



As we noted in the July edition of Investment Views, with US Treasury yields anchored at sub-1%, these lofty valuations could endure and even grind higher; US equities look relatively cheap on an earnings yield basis. However, the higher we climb, the more fragile this rally becomes. Any shock to the economic or political narrative will be met with bouts of gut-wrenching market turbulence.

As investors, we are being forced to accept greater volatility and potential downside in pursuit of lower potential returns, with further equity market gains dependent on near zero base rates and the ongoing flow of monetary and fiscal stimuli. It thus becomes ever more important to find assets that can help reduce this potential volatility when building client portfolios.

It is tempting to over-weight non-US equities. Whilst some regions and sectors have offered attractive returns and low correlation to US stocks this year (most notably our Gold mining and China A share positions) global equities continue to show high correlation during periods of markets stress. Even if the UK, Europe, Asia and many emerging markets are far cheaper and remain 10-20% lower this year, the March sell-off reminds us that they move in lockstep with the US when uncertainty rises. Deeply unloved sectors, like Financials and Energy, are also interesting but one has to believe in a reasonably vigorous period of economic reflation to harvest decent returns; an outlook we struggle with on a 12-18 month view.

Traditionally, one would own Treasuries or Gilts to offset the risks of equity investment. However, with 10-year yields suppressed by quantitative easing, they offer less and less protection. To illustrate, for a 10-year Gilt price to gain 10%, the current yield of 0.2% would need to fall to -0.9%; in the US, the equivalent Treasury yield would need to fall from 0.7% to -0.4%. Whilst this is possible we note that, after years of deflation and stagnation, Japanese benchmark bonds yield -0.01%.

We thus find ourselves drawn to gold bullion (for reasons that we shared last month), whilst accepting that bullion holdings can have bouts of equity-like volatility. Although gold rose 6% during the 3rd quarter, it fell back 9% from its August high of $2,064/oz. We have also initiated a holding in Chinese Government debt, taking advantage of its worst quarter since 2013.

At the end of September, a 10-year Chinese Government bond (CGB) yielded 3.15%. This is a record spread (extra yield) over a US Treasury of 2.5%. With Chinese inflation running at 2.4% pa, the CGB also offers a positive real yield of 0.8% pa; the equivalent US Treasury offers -0.6% pa. There is thus more room for yield compression (and price rises) during times of stress.

The Chinese bond market is also set to experience vast structural inflows as major indices start to include CGBs in their benchmark mix. The influential Bloomberg Barclays Global Aggregate bond index now has 6% in Chinese bonds, having phased in the exposure since April 2019; the index covers $54 trillion of bonds. The FTSE Russell and the JPMorgan Emerging Market indices are following suit. Major institutional investors are benchmarked against (and thus heavily influenced by) these indices, forcing them to add exposure. This flow creates a structural bid for CGBs and also increases liquidity. It is important to remember the political risks that come with any Chinese investment; this argues for a modest rather than oversized exposure. However, we take comfort from the mainland's commitment to open up its domestic market to overseas flows and see (marginally) calmer US/Chinese relations once the noisy histrionics of the US election pass.

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives Cash	Gold Miners China A Shares Sustainable yield Japan	Inflation-linked, Emerging Market, China	Gold, Volatility Strategies
–	Equities Bonds	European US Technology	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	30 September 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2920	-3.4%	4.2%	5.1%
CHF	1.0859	-1.9%	2.9%	8.4%
AUD	0.7162	-2.9%	3.8%	6.1%
JPY	105.4800	-0.4%	-2.3%	-2.4%
EUR	1.1721	-1.8%	4.3%	7.5%
BOND YIELDS (10 yr)				
UK	0.23	-0.08	0.06	-0.25
US	0.69	-0.02	0.03	-0.98
Germany	-0.52	-0.13	-0.07	0.05
Australia	0.79	-0.19	-0.08	-0.23
Japan	0.01	-0.04	-0.01	0.23
EQUITIES				
US. S&P 500 (USD)	3,363.00	-3.9%	8.5%	13.0%
UK. FTSE 100 (GBP)	5,866.10	-1.6%	-4.9%	-20.8%
FTSE Europe Ex UK (local)	259.71	-1.1%	0.9%	-5.2%
Japan. Topix (JPY)	1,625.49	0.5%	4.3%	2.4%
China. Shanghai Comp (RMB)	3,218.05	-5.2%	7.8%	10.8%
HK. Hang Seng (HKD)	23,459.05	-6.8%	-4.0%	-10.1%
Australia. All Ords (AUD)	6,009.34	-3.8%	0.1%	-11.6%
FTSE Asia Pac ex Japan	572.63	-2.5%	8.5%	10.8%
FTSE World (USD)	661.25	-3.4%	7.4%	8.0%
FTSE World (GBP)	758.32	0.0%	2.7%	2.9%
COMMODITIES				
Oil (WTI)	40.22	-6.2%	1.6%	-20.6%
Gold	1885.82	-4.2%	5.9%	28.1%

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