Market Review

Third quarter 2020

EQUITIES:	A bifurcated market as the covid fallout intensifies
BONDS:	Yield volatility tumbles amidst record monetary support
CURRENCIES:	The dollar's slide continues, but the RMB shines
COMMODITIES:	Precious metals surge as real yields turn negative

Most equity markets have continued to recover from the March lows, although regional and sector progress has been uneven. US tech stocks led the advance with cheap, economically sensitive stocks continuing to lag. Outside of the US, many major equity indices remain firmly in negative territory for the year-to-date. Given extended valuations in some parts of the market and elevated sector/regional correlation during periods of stress, stocks remain vulnerable to sudden, sharp corrections. That said, Central Banks and governments could limit downside by adding further stimulus on any renewed signs of economic/market weakness.

Nominal bond yields are close to zero and look to set to stay there given the lack of growth and inflation. In an effort to boost the latter, the Federal Reserve amended their mandate to target average inflation of 2%. They will now tolerate inflation above target to offset the recent period of sub-2% CPI. The ECB is considering a similar step. With real interest rates (yields minus inflation) set to stay negative, we recently added a position in Chinese bonds. They are one of the few government bond markets that still offer a meaningful yield and diversification benefits for conservative mandates; they tend to perform well when equities fall.

Negative real interest rates and continued economic uncertainty are bullish for precious metals; gold made a new closing high of $2,064/oz during August. Gold mining companies have also performed strongly as rising bullion prices and falling energy/input costs boost margins. The bullion and mining equities positions were again key contributors to returns over the quarter.

The US dollar continues to slide and is now down 9% since the March covid panic. Historically, a weaker dollar and low dollar rates benefit global liquidity and the outlook for non-US risk assets; for now, we await a firmer economic tone before adding to that trade. Whilst the dollar could soften further, we still feel it will catch a bid during periods of increased volatility.

Portfolios retain a cautious bias but we are using bouts of market weakness to add to target assets and core positions; volatility around the US election may offer further opportunities. When adding to risk positions, we are cognizant that Treasuries and Gilts offer less of a counter-balance than the last 30+ years; yields are rock bottom, limiting potential upside. That said, we firmly believe that Central Banks will limit any bond market downside; the chronically indebted global economy would be derailed by higher interest rates.

Equities

% change, total return	3 months	12 months
FTSE World Equity index USD	8.0%	10.4%
FTSE World Equity index GBP	3.5%	5.1%

Global stock markets have continued to recover from the Q1 rout. Although the FTSE World gained 8% in USD terms, it was lower when translated into other currencies given broad based US dollar weakness; the index gained 4% in GBP and EUR terms.

Whilst the headline index fared well, the regional and sector dispersion remains stark. Technology and consumer stocks have continued to dominate this latest upswing. Both the S&P 500 and tech-based Nasdaq indices made new highs in September; the US makes up c. 60% of the World Index. However, both then suffered a short, sharp correction of around 10% in just a few days. We think this pattern of behavior is likely to persist as expensive valuations remain vulnerable to changes in sentiment. The US election is the next test.

The share price of car and battery manufacturer Tesla made interesting viewing last quarter (chart 1). It has been one of the tech darlings leading the US market higher. The stock has appreciated over 13 times since its recent low in June 2019, rising to touch $500. After such a rapid rise, the share price then hit an “air pocket” with its value subsequently collapsing. Tesla lost one third of its market cap in five days, after the company was overlooked for inclusion in the S&P 500 index. As a result, active and passive fund managers had to unwind long positions causing a stampede for the door. The share price has since recovered most of the loss, but we remain cynical of the enduring value of Elon’s masterpiece

Chart 1: Tesla stumbles after its parabolic rise.

In Europe, German payments company Wirecard, a constituent of the Dax 30 index, was declared insolvent at the end of June after its auditor could not find €1.9bn of cash balances. One fund manager described the company accounts as having “more red flags than a communist rally”. The charismatic ex-billionaire CEO now sits in jail as echoes of Enron abound. The German regulators decision to ban short selling of the stock in 2019 looks a poor one in hindsight. They questioned the motives of the Financial Times (FT) journalist who exposed the scandal, accusing him of colluding with hedge funds to manipulate the stock price. The Eurostoxx 50 index was down -1% in Q3.

The UK market continued to lag. The FTSE100 lost 5% as cyclical sectors like banks, oils and industrials continued to struggle. With nearly 70% of underlying company revenues generated overseas, a firmer sterling also acted as a headwind. UK mid-caps performed better than their large cap peers with the FTSE 250 up 1%; a “less bad” domestic economy aided sentiment.

Gold miners continue to perform strongly. The FTSE Gold Mines index gained another 11% last quarter, as the gold bullion price added 6%. The mining stocks have more than doubled since their March lows. With energy accounting for c. 25% of their costs, the fall in the oil price has also boosted margins and free cashflow metrics. Whilst volatility is set to endure, we see further upside in both bullion and the gold miners; they remain high conviction allocations across portfolios.

In Japan, Prime Minister Shinzo Abe announced that a recurrence of his ulcerative colitis would end his tenure. He has been the longest-serving PM in Japan’s history. The Chief Cabinet Secretary, Yoshihide Suga, was swiftly endorsed as his successor. At first blush, he seems to represent a continuation of the market-friendly, ‘Abe-nomics’ reforms; the local index rose 4%. Japanese stocks appear well supported by cheap valuations and robust balance sheets; many carry net cash unlike their highly indebted western peers.

Finally, our holdings in domestic China A shares continued to outperform. The Shanghai composite was up 8% this quarter. Whilst we expect plenty of China bashing and trade war rhetoric in the run up to the US election, the market remains one of the cheapest globally and offers focused exposure to the ongoing emergence of the Chinese consumer.

Bonds

10-year yield	30.09.20	30.06.20	31.03.20
US treasury	0.69%	0.66%	0.67%
UK gilt	0.23%	0.17%	0.36%
German bund	-0.52%	-0.46%	-0.48%
Australian treasury	0.79%	0.87%	0.77%

As noted in the last review, the volatility of US Treasury yields has collapsed as the Federal Reserve becomes the dominant buyer. Long term bond yields were largely unmoved this quarter. The 10yr Treasury yield finished broadly unchanged around 0.7%pa; a stark contrast to the more optimistic reflationary outlook in equity markets.

Speaking at the virtual Jackson Hole summit, Chairman Powell announced a change to the Federal Reserve's inflation target. In future, the Central Bank will target an 'average' inflation rate of 2%, allowing them to overshoot the target to compensate for prolonged periods of sub-2% inflation. This gives policymakers greater room to stimulate the economy without then having to intervene early to choke off incipient inflation with higher rates. The move was widely expected but still speaks to a macro backdrop of scarce growth and ever more desperate interventions. Low nominal rates and higher inflation (i.e. negative real rates) is good news for gold and inflation-linked bonds but would normally be a headwind for conventional bonds. Absent a deflationary shock, the upside for 'conventionals' now looks modest. That said, potential downside will likely be limited by the introduction of yield curve control policies, should the need arise. The Central Banks all understand that a sharp rise in yields would crush the global economy, given the pervasive levels of over-indebtedness in both the public and private sectors.

At the end of the quarter, ECB president Christine Lagarde seemed to open the door to a similar average inflation goal, saying that the approach should be considered as part of a Central Bank strategy review. The results of the study are due in September 2021, following a covid-enforced delay. The scope of the review also includes a discussion of how inflation is measured. The German bund finished the quarter at minus 0.5% with EZ inflation also slipping into negative territory by the quarter-end.

In the UK, the Bank of England caused some confusion in the Gilt market when Governor Andrew Bailey ruled out negative interest rates, contradicting the minutes from the September Monetary Policy Committee meeting. The Governor said: "Yes it's in the tool bag, but that does not imply anything about the probability of us using negative interest rates at the moment." He later clarified that they wanted to check that commercial banks could operate with a negative rate, should they ever choose to use one. The MPC kept rates at 0.1% and maintained the level of QE at £745bn. The ten year Gilt yield remained at 0.2%, identical to the latest headline UK CPI reading.

We have added a new position in Chinese government bonds (CGBs), hedging out the currency risk. Chinese 10 year government bonds offer a positive nominal yield of 3.1%pa which, unlike most other developed markets, translates into a positive real yield. CGBs have also typically acted as an effective counter-balance to global equities, rallying during periods of stockmarket turmoil. Given the relatively high starting yields, this is an attractive characteristic for our balanced portfolios. CGBs should also benefit from structural buying as they are now being included in various emerging market and global bond benchmarks. After our purchase, FTSE Russell announced they would include CGBs in the widely followed World Government Bond Index (WGBI) from October 2021 onwards. The FT estimates it could trigger $140bn of inflows into the asset class.

US credit spreads (the extra yield on corporate debt) tightened over the quarter, in line with the general 'risk-on' timbre. The lowest rung of investment grade borrowers ('BBB' rated) offered a 1.5% premium to Treasuries at the end of September; 0.2% less than the end of June. US High Yield borrowers (sub-investment grade) paid an average 5.2% spread, down from 6.3%. Whilst spreads are not back to their early year lows, credit risk is less attractive given the low level of underlying Treasury yields. That said, given the effective Fed backstop, spreads look less likely to rise to levels witnessed in March; 'BBB' spreads peaked around 3.4%. We are looking to add to flexible credit managers on any pullback.

Currencies

Rate versus USD	30.09.20	30.06.20	31.03.20
GBP	1.292	1.240	1.242
EUR	1.172	1.123	1.103
AUD	0.716	0.690	0.613

Having previously discussed the prospects for a weaker dollar in Q3, it duly obliged. The trade-weighted US dollar index (DXY) fell by 4% in Q3. It is now 9% weaker than the March covid peak, touching a two-year low in August (chart 2). Whilst we do not believe the dollar's role as the world's reserve currency faces imminent danger, it remains relatively expensive compared to other major currencies. Although we suspect the greenback may continue to trend lower over the coming years, especially if a fiscally profligate Biden secures the White House and both Houses of Congress, it should continue to catch a bid during "risk off" periods. This is doubly so given the large dollar short positions that have amassed in recent months.

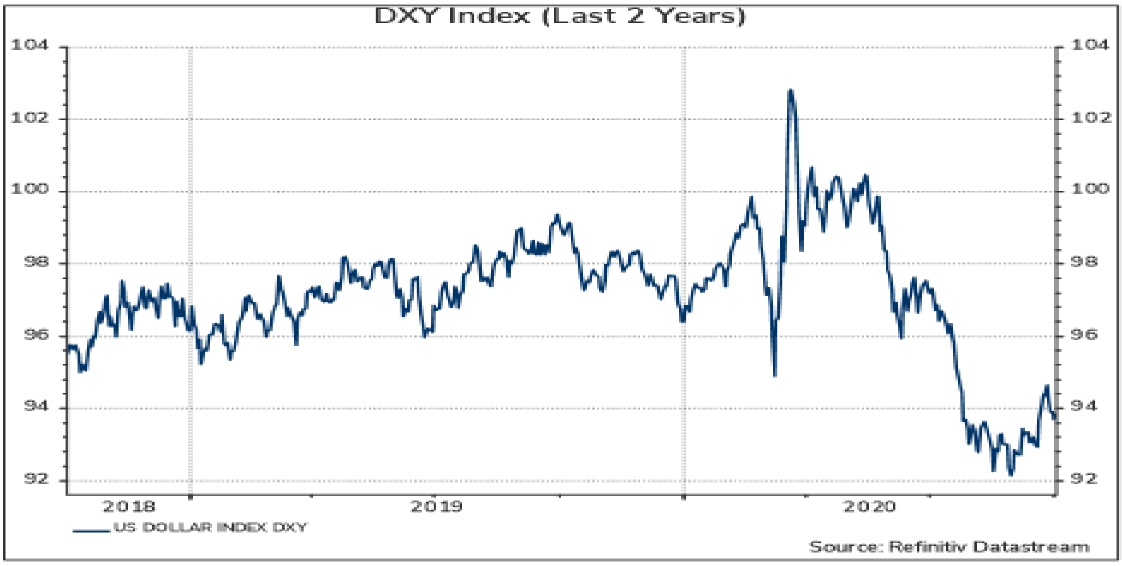

Chart 2: The trade-weighted US dollar has weakened since March.

As the dollar slid, both the Euro and Sterling gained 4%; the GBP/EUR rate remained largely unchanged at €1.10. Boris Johnson imposed a new deadline of 15th October for Brexit trade talks to conclude, else Britain will have to accept a 'hard Brexit' and WTO trade terms. In an effort to generate negotiating leverage, he further raised the stakes by publishing the Internal Market Bill (IMB). The IMB is contentious because it breaks international law by overriding part of the (recently signed) EU Withdrawal Agreement. Despite this 'strong arm' tactic the trade talks continued. Whilst we expect an 11th hour agreement, this is by no means a given. Any 'hard Brexit' turmoil should present an opportunity to buy Sterling and UK equities; both are already cheap, but currently for good reason.

The Chinese RMB also gained 4% against the dollar, marking one of the best quarters for the currency since the Global Financial Crisis. The RMB appreciated to 6.79 from 7.06. The lack of large-scale Chinese fiscal and monetary stimulus in response to the covid crisis has been striking, making the RMB relatively attractive as others aggressively expand money supply to stimulate growth.

Stepping back from the daily noise, the RMB has remained relatively stable throughout the US/China trade war as China takes further steps to internationalise the RMB and reduce its reliance on the dollar. China posted a current account surplus of $110bn in Q2, whilst foreign investors continued to add to Chinese stocks and bonds. The latter is a multi-year phenomenon as Chinese representation in global stock and bond indices is on the rise.

Finally, emerging market currencies performed less well, despite the dollar swoon; resource rich currencies led the decline. The Russian Rouble fell by 8% whilst the Brazilian Real slumped by 3%. Sentiment towards the Rouble was adversely affected by the unfolding popular revolt in Belarus and the suspected poisoning of Alexei Navalny, a prominent critic of Vladimir Putin. The depressed oil price was also a factor.

Commodities

% change	3 months	12 months
Oil (WTI)	1.6%	-20.6%
Gold bullion USD	5.9%	28.1%

Oil prices were broadly flat last quarter. The US WTI oil contract rallied 2%, whereas the European Brent equivalent was off 1%. Oil prices remain significantly lower than 12 months prior, unsurprising given the unprecedented demand shock to the global economy. The temporary over-supply led to negative WTI prices back in April, but the worst of the dislocation now looks to be over. The fate of oil market rests on the pace of the demand recovery and, as importantly, how quickly supply shrinks either via OPEC coordination or shale oil/Canadian tar sands bankruptcies. The balance is hard to judge at this time.

Energy companies have performed poorly for a number of years, dragged lower by a weak oil price and a structural shift to renewables. The valuation had become sufficiently interesting for us to initiate a small position in a thematic energy ETF in Q2. However, we were forced to reassess in light of deteriorating company fundamentals. Most of the energy supermajors (Exxon, Shell, BP, Shell, Total, etc.) have been forced to write down the value of the assets on their balance sheet in light of lower oil prices; in several cases, more aggressively than we forecast. Total was a good example, taking a $7bn hit from its Canadian oil sands assets (which typically require $100/barrel oil to be profitable). Shell cut its book value by $22bn in June. Several oil companies also chose to permanently re-base their dividends to lower levels. Whilst we anticipated that covid would lead to dividend cuts and balance sheet impairment, the extent of recent losses means that debt levels have risen more sharply than we modelled, leaving dividend cover extremely tight. We suspect there might be further bad news to come and so exited our position at a slight loss.

The price of gold bullion rose to a record high in August (chart 3), reaching an intra-day high of $2,075/oz and comfortably surpassing the previous peak of $1,911; it ended the quarter 6% higher. Silver posted an even more impressive gain, rising 28% in Q3 (from $18 to $23); it is now 37% higher than this time last year. Precious metal prices continue to find support in an era of negative real (inflation-adjusted) interest rates and pervasive fiat currency debasement. The Fed's new symmetrical inflation target (see Bonds above) means that real interest rates can move to even more negative levels, given that Central Banks are highly unlikely to raise nominal interest rates any time soon. The upside in silver looks compelling; it reached $50 in 2011, more than double its current price.

Chart 3: The gold price makes a new high.

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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