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INVESTMENT OUTLOOK

Since our last report, markets have experienced a second wave of Covid infections, the announcement of another UK lockdown accompanied by a resurrection of the furlough scheme, a downgrade of economic forecasts, a contentious US presidential election and the risk of a no deal Brexit. Yet equities have lost only a little ground. True, UK equities shed some 3% in Q3 and so far 1% in Q4 but US equities have held up better and are still close to year end levels.

We pointed out this seeming disconnect between equities and the economy last time and suggested markets were not prepared for a downswing in the economy which now seems underway. At least in the UK, we are back in the W shaped economic cycle with expectations for UK GNP in Q4 of a fall of 3% instead of a further rise. The explanation for this disconnect yet again is the proactive stance of fiscal and monetary policy with extraordinary measures being taken to protect the economy and stop unemployment rising. This contrasts with the 2008-10 policy response, when QE was introduced but fiscal policy moved towards so- called austerity. We are still awaiting the US fiscal package but the FED has said it will do whatever it takes.

It might seem difficult for markets to make further gains in the near term, given the deterioration in the economic outlook. There has been a near term bounce with the election of President Biden while certainly the arrival of a successful vaccination programme will boost sentiment strongly. Yesterday's announcement from Pfizer has done that and could boost consumer confidence too. That said, a period of consolidation would be welcome though volatility is not going to go away.

ECONOMY

The Bank of England announced a further £150bn of QE making a total of £450bn this year, doubling the stock of QE. This is to avoid credit becoming too restrictive but also to absorb the extra gilts being issued to fund the resumption of the furlough scheme. The resulting budget deficit could be closer to 20% GNP than the 15% we expected previously but because interest rates are so low, debt service costs are falling. The BoE now forecasts a fall in GNP of 11% for the year, down from 9% previously. This is even worse than the outcome in 1921 and a revised forecast of 7% recovery in 2021 means output will not recover 2019 levels until well into 2022. Unemployment at least is not seen as worsening with a forecast of 7.5% still. Brexit has not been resolved at the time of writing and adds further to the uncertainty of the economic outlook. A successful vaccination launch by year end could however raise confidence and boost recovery prospects.

In the US, we must assume Mr Biden's election survives legal challenge. While a bipartisan approach to the postponed fiscal package would seem sensible, there are doubts about its likelihood. The lack of a Democrat majority in the Senate has been taken positively by markets as likely to preclude less market friendly elements of the party platform such as corporation tax hikes. On monetary policy, the Fed made a significant shift in inflation targeting by indicating that the 2% policy objective could be disregarded for some years until any shortfall is made up. That combination of ultra- loose monetary policy and fiscal stimulus will support markets. Forecasts for GNP still indicate a much happier outturn than in the UK with a fall of 5-6% and certainly the Q3 recovery at 7% was above expectations.

In Europe, the pandemic course is following that of the UK and in consequence the major countries are following us into lockdowns of various descriptions. ECB president Lagarde has encouraged countries to increase fiscal support and is expected to increase QE while continuing with negative interest rates. Q3 GNP data was encouraging but expectations remain for falls of 8% for the year in economic activity, perhaps 6% only in Germany. Elsewhere, China , perversely perhaps, is showing definite signs of recovery and a return to normality as are other East Asian economies.

Ultra low interest rates and the absence of inflation have enabled fiscal policy to provide invaluable economic support this time round unlike during the financial crisis. QE has of course made it possible to finance levels of government debt that would have been inconceivable in past recessions. The hope is that it provides life support while infection rates drop to enable mass testing to gain traction until vaccinations can take over. That said, it is hard to see budget deficits being reined in for some time through a mix of tax rises and spending cuts that would be politically toxic. When will the bond markets rebel?

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MARKETS

In the reporting period, Q3, UK equities were the only major market to weaken with a fall of 4% while global equities rose 3% , led by the US. Year to date, the UK was down 20% while global equities rose 4% with the US up 10%, Europe down 6% and emerging markets broadly flat . While sterling has been flat against the dollar this year, at around 1.30, it has weakened some 6% against the euro so in local currency terms European markets have fallen some 12%. As we have said before, sectoral composition plays a role here. US IT stocks were up an astonishing 33% while the UK was dragged down by a 24% fall in resource stocks which feature heavily in the index unlike IT. To date in Q4, the UK market has weakened again on the bad news on infections and is still some 10% below the level reached in the earlier market rally whereas the US is holding onto gains mostly. As we go to press, though, markets are rising on the latest positive vaccination news.

The speed of the rally in US equities in particular has been astonishing. As we said last time, it has been the fastest since the 1929 crash. Historically, markets take time to grow out of recessions which normally arise from corrective monetary tightening. This time governments have responded immediately and decisively, with even Germany relaxing the purse strings so market recovery in the teeth of such bad news is not so irrational. The debate of course is how far it should go and with a second wave in the pandemic and with the business cycle, at least in the UK, morphing from a V to a W shape, the answer is probably it has gone far enough.

The US of course has not moved into lockdown though it carries much higher levels of unemployment without furlough so the economic recovery could continue, supporting market levels. Certainly, corporate earnings are coming in better than expected with a forecast of a year on year decline of 13%, far better than expected earlier. IT stocks like Apple and Amazon have reported good figures though these were expected and the sector is off its recent highs, Tesla in particular. European profits figures are more mixed but companies are reluctant to provide much guidance on 2021 prospects. At least in the UK, some companies are beginning to reinstate dividends though on a reduced basis and the banks are lobbying hard to be able to join in, given their capital ratios are so strong.

What of bond markets? Gilts have produced a positive return of 8% to end September across all maturities with long dated better still while index linked have returned 10%. Interestingly, the price of inflation has barely moved during the year with 20 year inflation priced at 3.2%. The reduction in index linked yields reflects the fall in nominal yields, eg 0.8% for 20 year gilts. Corporate bonds have returned 5% and spreads have narrowed in further in Q4 so they now stand at 145bp against 125 bp at the start of the year. As the economy progresses, we must expect more corporate failures though that is usually more of a threat in the high yield market which prices in a certain expectation.

There is somewhat more visibility in commercial property pricing now. Capital values have dropped some 5-10% with industrials holding up well along with retail warehouses and high street retail at the opposite end of the spectrum. All this in contrast with residential where prices appear to have risen some 7%. There is something of a revival in transactions and property funds have reopened for dealing.

INVESTMENT STRATEGY

The Committee endorsed the recommended investment strategy changes at its last meeting which focussed on the equity allocation with a pronounced shift further into global equities including greater allocations to small cap and emerging markets together with a renewed commitment to active management.

Long term capital market assumptions continue to expect equities to offer the highest returns though illiquid assets like private equity, infrastructure and private debt offer the so- called illiquidity premium to boost returns as compensation for being locked in. Fixed income returns trail other asset classes so unless they are being used for liability matching purposes, government bonds are unlikely to feature in pension funds. The fall in inflation in recent years has dampened the gains from our inflation hedging programme Though it has benefitted from the fall in nominal gilt yields, the inflation hedge itself is now producing negative return. The portfolio remains at risk from the RPI-CPI wedge if the government fails to compensate bond holders. Longer term , inflation may become a problem again.

Focus in the near term will be on transitioning the equity portfolios which is a complex operation with many moving parts involving the appointment of a transition adviser. The recommendation to break it into two parts, selling down the UK portfolio first will help simplify matters.

FOR FURTHER INFORMATION

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