

N+1 SINGER

END OF YEAR EQUITY MARKETS REPORT

DECEMBER 2020 // WRITTEN BY JAMIE CONSTABLE





EQUITY MARKETS INTRODUCTION

Last year we wrote "what would the 2020's bring for investors?" Nobody in their wildest imagination could have foreseen the year we have just had! A pandemic, the like of which none of us ever envisaged seeing in our lifetimes. Governments and governance systems have been tested globally. Liquidity has been pumped into the global economy in amounts that make the response to the 2008/9 Financial Crisis pale by comparison. Some \$20 trillion or 25% of world GDP!

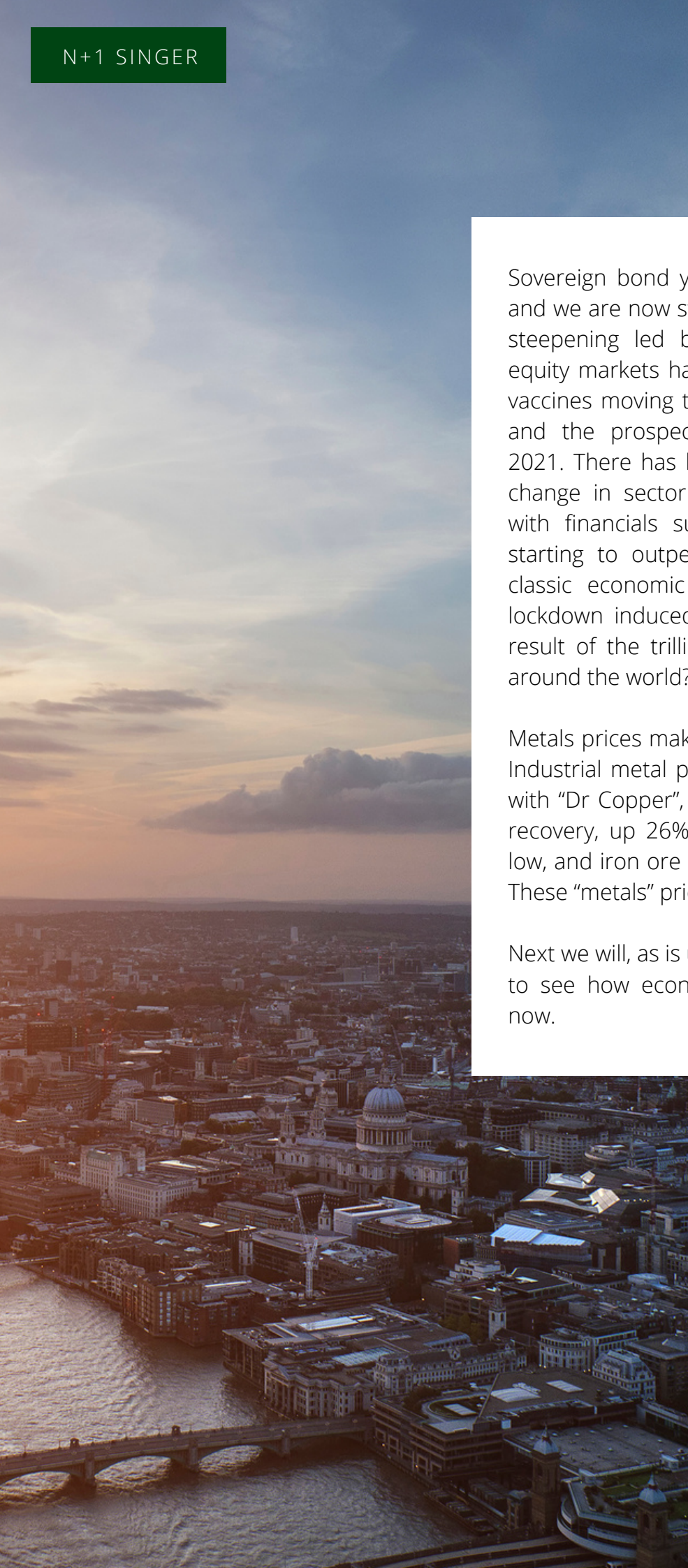
In our half year report we wrote of the Covid "First Wave". As we come to the end of 2020, we are confronted by the "Second Wave" that the scientists said would come. They also said that it would potentially be worse than the first. So far, that is not the case, and it will hopefully stay that way. True, some of the countries that were seen to have managed the first wave well have suffered worse in the second, but that is, I expect, a combination of a developed false sense of security and simply that the population with no immunity is larger than for others now the second wave has hit. The medical profession have rapidly learnt the best techniques to treat Covid and, as a result, the mortality rate has dropped significantly. The strains on healthcare systems continue, though.

The result of this for economies is that as Lockdown 2.0's were applied to economies, most countries have kept their economies functioning at a much higher level than in Lockdown 1.0 – i.e locked down the workplace a lot less. The areas that have suffered the most the second time around have, not surprisingly, been hospitality and travel. In the western developed economies where services make up the predominant proportion of economies – it is 80% in the UK – then the scars on economies with respect to lost output from Covid will likely be deeper and longer-lasting than those more exposed to manufacturing.

Fast forward to November where you are waiting for 1 vaccine, and then 3 come along at once! The result was that November equity market performance was, for a number of markets, the best monthly performance on record! Those stocks worst hit by the pandemic bounced the most. To be fair, only one vaccine has been approved so far, but the other two shouldn't be too far behind.

The scale of the hit to global GDP varies widely from economy to economy. To set the scene, it looks like 2020 will see global GDP contract by 4.1% with a 4.9% bounce back forecast for 2021. The range of forecasts for 2021 is pretty wide at the moment, not least because of the unknown scale of the Covid pandemic through the winter season in the Northern Hemisphere. As such, a western world economic recovery (at least for countries with domestic economies) is likely to be H2 weighted as the percentage of populations vaccinated grows. A "V" shaped recovery? Not quite. More like a wonky "W" I feel!



An aerial photograph of London, England, taken from a high vantage point looking down at the city. The River Thames flows through the lower left of the frame, with several bridges crossing it. The city's skyline is visible, featuring numerous buildings, including the prominent dome of St. Paul's Cathedral. The sky is filled with soft, orange and yellow clouds, suggesting a sunset or sunrise. The overall tone is warm and atmospheric.

Sovereign bond yields have been at negative levels and we are now starting to see country's yield curves steepening led by the US. As mentioned above, equity markets have been enlivened by the burst of vaccines moving through approvals and into roll-out and the prospects of improving growth through 2021. There has been signs of a, perhaps, tentative change in sector leadership within equity markets with financials such as banks and "value" stocks starting to outperform. Are we thus looking at a classic economic recovery from a pandemic and lockdown induced recession? Or is this all just the result of the trillions of dollars of liquidity washing around the world?

Metals prices make it look like it is a classic recovery. Industrial metal prices are already at elevated levels with "Dr Copper", seen as the indicator of economic recovery, up 26% in 2020 and 68% from the 2020 low, and iron ore up 50% and 67% from its year low. These "metals" prices are both at multi-year highs.

Next we will, as is usual in this review, travel the world to see how economies fared and where they are now.

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ASIAPAC

Many countries here are effectively still islands cut off from the rest of the world; even if they are not physically islands themselves.

The type of lockdown perpetuated through Asia has tended to be more extreme than in the West, with the populace more willing to accept that. As a result, the second wave had not reached the amplitude seen, for example, in Europe. Looking into 2021 China is gradually ramping up its aggression against those it sees as its foes with Australia bang centre of the cross-wires at present. It looks like the UK is on the list for the Chinese “wolf” diplomats too, as they increase the pressure in Hong Kong.

For China (the source of Covid, of course) the economic recovery has led the world and is the only major country forecast to grow GDP in 2020 and by c.2% exiting the year at over 6% year-on-year for Q4. 2021 growth is forecast at a world-leading 8.1% weighted to H1. At that rate, as we move through 2021, China will be putting the brakes on. That will be key to 2021 sector allocation, especially for those like the miners, which have already moved higher on aforementioned higher metals prices, and for export lead economies like Germany. The Chinese relationship with the new President in the US will, of course, be key. We expect it to remain relatively strained not least because of concerns over human rights in China.

Japan is forecast to grow over 2% in 2021. India is likely to lead the region with growth of c.13% in fiscal 2021/22.



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EUROPE

As we end 2020 the European economy is likely entering a double dip, with the export-led economies like Germany and Italy fairing better than those more domestically driven. The fall is unlikely, though, to be as far as in the first wave. The seemingly never ending strength of the Euro is one facet that could impinge on the exporters. Why has it been so strong with the dollar weak? Some huge stimulus packages culminating in the delayed €750 billion Pandemic Recovery fund – have Poland and Hungary taken the place of the UK as the EU “troublemakers”? – are partly why we have seen this strength.

The scale of the injection of the funds from this European Central Bank ('ECB') borrowing into certain economies should not be underestimated, with there also being a large redistribution from the wealthy to the poorer. Croatia and Bulgaria receive 10% of pre-pandemic GDP, Greece 9%, Portugal 5.4% and Spain 3.4%. Combined with the 7 year budget, the total comes to €1.89 trillion. Part of governments' plans is a huge investment in the green economy, such as hydrogen, as governments start to get real on climate change.

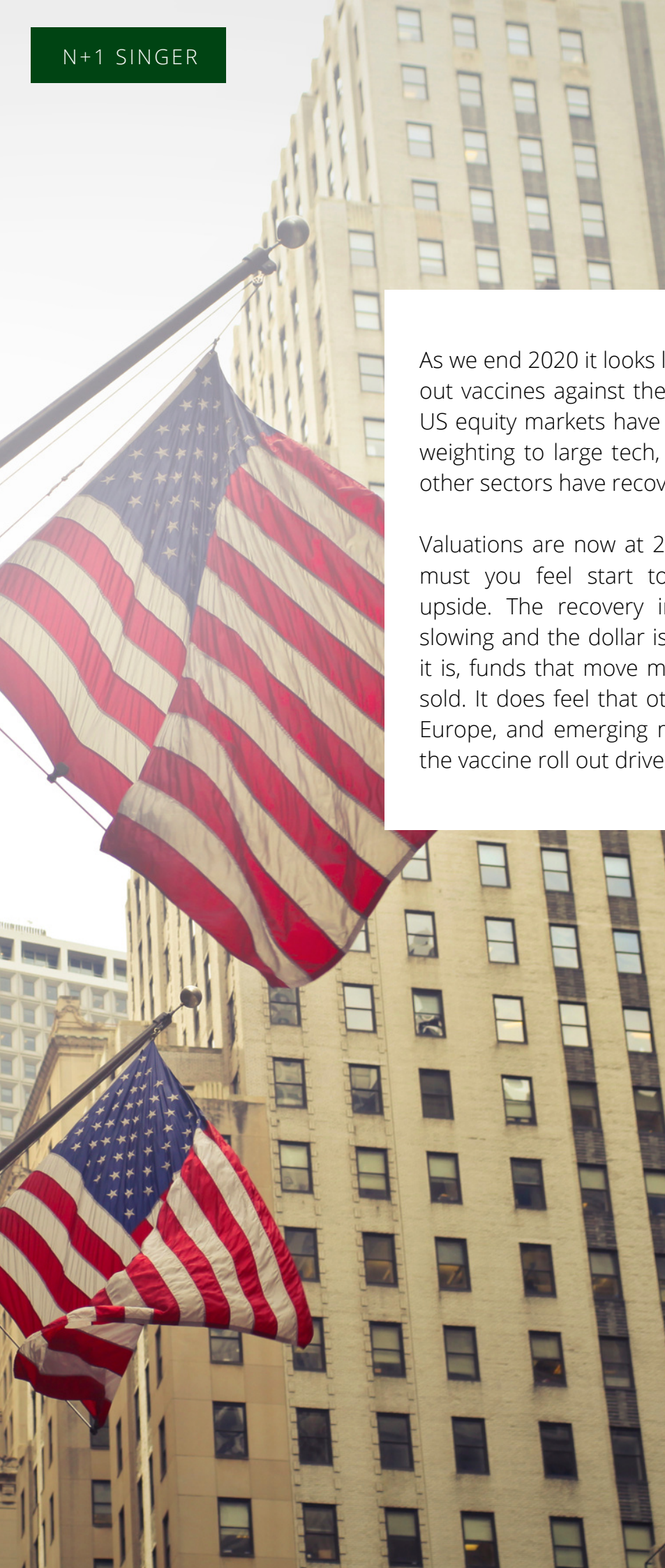
EU GDP is forecast to bounce by 4.6% in 2021 after a fall of 7.2% in 2020. These forecasts are probably both susceptible to downward revision as second wave lockdowns grow, and it could be a long winter. Recovery is thus going to be very H2 weighted. Countries like Spain, Greece and Portugal will be more dependent on vaccines driving the return of tourism. Experience to date has shown, though, that people are likely to be very keen to travel once they are allowed to. Finally, a no-deal Brexit would likely further suppress H1.

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USA

The Presidential Election has been and gone, although the Tweeter in Chief is still claiming voter fraud despite there being no evidence of this. Will he really be allowed/able to make a second tilt at the Presidency in 2024? Moving forward, we have a Democrat President with a Republican Senate, unless there is a big shock in Georgia Senate elections in January. Thus, for at least the first 2 years of his Presidency and until the mid-terms, Biden could be a hamstrung President with regard to getting policy through. What is sure, though, is that with Biden in the White House, Yellen as Treasury Secretary and Powell at the Fed (targeting inflation to move above 2% for a period) then they will be allowing the US economy to “run hot” boosted by higher spending (as much as they can get it through Congress) with forecast growth at 3.5% – but it could be higher after falling by 2.9% in 2020.

The US Covid second wave is lagging Europe as it did for the first. The policy under Trump means that the US has paid a heavy human price but, by keeping the economy pretty much open, the economic price has been a lot lower than the rest of the world. Democrat policy will be for more expansive spending – with questions on taxes – but the difficulty they are having getting a new c.\$1 trillion support deal through further illustrates the fractious nature of US politics.



As we end 2020 it looks like the US is in a battle to roll out vaccines against the growth of the second wave. US equity markets have led the world driven by their weighting to large tech, the FAANGS (if you will), but other sectors have recovered strongly, too.

Valuations are now at 2000 tech boom levels which, must you feel start to, constrain on share price upside. The recovery in the US labour market is slowing and the dollar is weakening and, as we know it is, funds that move markets i.e. the dollar is being sold. It does feel that other markets such as the UK, Europe, and emerging markets offer better value as the vaccine roll out drives economic recovery.

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UK

The UK cannot, I am afraid, be seen to have fared well through 2020! The GDP fall of c.11.4% is the worst performance in the developed world alongside Spain! Yes, I am afraid Italy did perform better. A statistic for the history books, but UK GDP fell by 25% between February and April! GDP is now forecast to grow by 5.4% in 2021 with the forecast having recently been as high as +7.6%. Unemployment is seen as peaking at 7.5% in Q2. With Covid lockdowns tightening into the end of 2020 and the potential prospect of Lockdown 3.0 in Q1 2021, the economic bounce back is being pushed out. Add to that the prevarications over Brexit – they aren't going to layer a no-deal Brexit on top of Lockdown 3.0 are they? – and it does not currently feel great. There will be a strong bounce back we feel, though, as do equity markets. The consumer savings ratio (see later) has jumped and when the Covid brakes have been released, we have already seen the propensity to spend these savings is high.

Government Borrowing

Turning to UK government borrowing for the 2020/21 financial year, it is forecast to be £394 billion from the £40 billion forecast at the start of the year. UK total government debt is now over 100% of GDP. The UK Chancellor, Sunak, is already worrying about the huge scale of the increase in the government's balance sheet as he announced no salary increases for the Public Sector excl. the NHS in his Autumn Statement. He further said that borrowing at these levels is unsustainable. At current interest rates and gilt yields, then there is not too much of a problem but if inflation were to return (see below) then the problem could grow very quickly. How the UK, and the rest of the world for that matter, decides to tackle the question of the huge increases in government debts over the past year will be a key determinant of how fast the UK and global economy can grow looking forward.

At the last minute the government's Furlough scheme was extended to March and then most recently to April after being meant to end at the end of October.

A foretaste of lockdowns to come in early 2021 I fear. Is this deferral of economic pain or will the government continue to stand behind sustaining employment? Like in Europe, economic recovery in the UK is likely to be H2 weighted for 2021 hit by Covid and Brexit, with the question being when it gathers pace through Q2?

2021 – Looking ahead

Finally, let's uncover the crystal ball and attempt to look further at what 2021 might bring.

If 2020 was the year of Covid, 2021 could well be the year of the vaccine. Roll outs of the Pfizer vaccine have now started in the UK, US and Canada and other countries are likely to follow rapidly with the only major constraint being how quickly they can produce it. In the wings is the Moderna vaccine, and then likely the AstraZeneca-Oxford University one.

Last year we talked of M&A being buoyant and ditto as we enter 2021 with a large number of UK companies being taken over in 2020 from RSA to G4S to Codemasters to Hastings to McCarthy & Stone to IMI mobile and on and on. More of the same to come in 2021? I expect so, with growing business confidence and rising equity ratings. But at the other end of the spectrum we expect to see the return of IPO's, which have been rare sights in recent times. Investors are, we feel, looking for new investment opportunities – especially with so many companies having left the quoted arena.

If we have learnt one thing from stop-start nature of lockdowns in the UK it is that as the brakes are released the consumer wants to spend. To date, that has been concentrated on the Englishman's castle or maybe a new castle somewhere greener! The savings ratio in the UK has jumped by almost the most across G7, from 6.5% in 2019 to 19.4% in 2020, an unprecedented delta. The question, then, is how quickly this falls back to norms? If it fell rapidly, then it would lead to a huge boost to the economy – think how the US consumer has been for a number of years; the driver of US growth. Current economic forecasts expect the savings ratio to only fall back slowly, but we feel that may be being too cautious given current evidence and the gathering confidence vaccines could bring.

The government seems intent on not letting unemployment rise. With services being 80% of the UK economy a large rise – the OBD is forecasting 7.5% in Q2 which is a long way from 4.9% now – is, we feel, the major risk to the UK recovery. To date, the furlough scheme has been the job protection scheme used by the government with some 5 million still covered by it. The ending of this, which is now planned for April, will be a key moment in 2021.

Brexit

The immediate threat is a no trade deal Brexit. In any case, a deal done this late in the process – we suggest an abdication of responsibility to their electorates by the UK and European governments – is unlikely to help a recovery in growth in H1 2021, especially when combined with the Covid second wave and the developing new hard lockdowns. The ending though of the Brexit uncertainty (didn't we write that last year too!) has to be seen as a positive for the UK.

The UK government are attempting to move forward with their agenda for the UK post Brexit. They have a chance to establish a new framework for the UK of the 2020's. The Energy White Paper looks to be a start. There will, hopefully, be a whole lot more to come to make the UK an attractive and dynamic destination for businesses and inward investment through 2021 and beyond. As we have written on previously, infrastructure spend is key as is the "greening" of the economy. Have we yet seen the fund flows into UK equities that we have talked of previously? Some maybe in Q4, but I am afraid the statistics paint a picture of the long-term outflows continuing with over \$2 billion out over October and November. Using EPRF Global data, for retail funds total monies out now amount to \$42 billion – 17% of total assets held – since the Brexit vote in June 2016. Amongst institutional fund managers, UK weightings are at all-time lows, too, down from 9% to 5.8% across the same period. Whilst we are talking about fund flows, we could not help to notice that ESG funds received inflows of \$65 billion in 2020 – 3x the amount they received in 2019.

That leaves the UK, arguably, the cheapest market in the developed world. We have written that before, but look at all the inwards M&A and companies taken over. Someone is noticing and asset allocators are going to notice it sooner or later as the UK is soon to leave Brexit behind, whatever the outcome after 4 years of uncertainty.

Inflation

Finally, a word on Inflation. As you have now read metals prices are at multi-year highs and huge amounts of stimulus have been applied to the global economy with M2 and M3 broad money supply growth at the highest levels seen since the 2008-9 financial crisis. Yield curves are showing signs of steepening. At the same time, capital investment has stalled under the pandemic with some capacity likely now made redundant by pandemic driven changes.

Could a rapid recovery bring back inflation? There are some early signs that the “reflation” trade is gathering momentum in markets. For inflation to be more than a transitory jump it needs to move from prices into wages. Will the balance of power shift from the company to the workforce? China will likely be a big determinant of this, as will the continuing deflationary impact of technology and digitisation, the latter accelerated by the pandemic. This acceleration in digitisation is another trend likely to continue apace into 2021, which we could write another whole piece on.

Returning to inflation, it is potentially another reason to be more cautious on US equities – as inflation rises the rising discount rate makes those future technology company earnings less valuable. Inflation can help and hinder governments with their hugely inflated balance sheets. On the one hand it can help inflate away the debt, but on the other the servicing cost could well rise markedly. Inflation is of course a lot better for equities than it is for bonds! Inflation is something we need to keep an eye on as 2021 progresses.

No doubt, come the end of 2021, we will be writing on something not covered above, but hopefully in a place where we can freely associate and move around the world at will again. Have a restful and safe holiday.



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An aerial night photograph of London, showing the River Thames, several bridges, and illuminated city buildings. The image is used as a background for a white text box.

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