wealthify

INVESTMENT OUTLOOK Dec 2020

VACCINE RAISES HOPES AS SECOND WAVE PAUSES RECOVERY

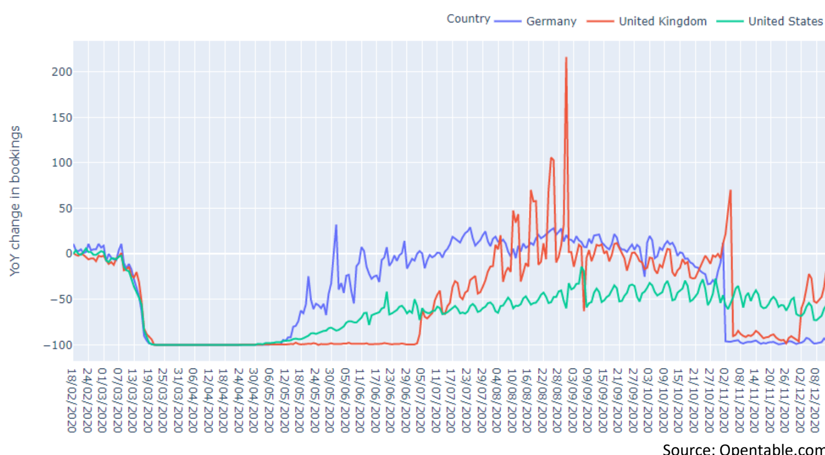
While the Covid-19 second wave caught many investors and governments off-guard, markets have taken encouragement from initial reports of a successful vaccine trial. However, the current level of Covid-19 cases saw the resumption of partial lockdown restrictions across much of Europe and some US states. Again, the restrictions focus heavily on tourism, restaurants, and the arts, weighing predominately on the Service sector significantly more than the Manufacturing sector. This reinforces our cautious optimism surrounding the challenges of reopening without a widely rolled out vaccine. That said, policy makers are continuing to provide significant fiscal and monetary support, although the lack of follow-through fiscal support in the US during Q4-2020 (so far) has been a disappointment. This is likely to be addressed when the 117th US congress returns in mid-January 2021. Globally, economic data for the fourth quarter will be impacted by the late-October/early-November initiated lockdowns.

Unfortunately, while consumer sentiment had rebounded from lows earlier in the year, it has dipped once more as unemployment has drifted higher. Broadly speaking, consumer behaviour has pointed to a significant increase in savings through the pandemic, supporting the medium-term outlook for spending activity. However, it is our view that more optimism is needed to encourage pent-up demand to follow through aggressively. We still believe that the worst is behind us, but unfortunately activity levels will remain volatile going into 2021. Market movements continue to be dominated by expectations around the recovery's shape, which depend on the duration of tighter social distancing rules, which in turn are driven by infection rates. The resulting impact on economic growth means the current recovery trajectory remains as a jagged-U shape, but the risk of a 'W' shaped recovery still cannot be ruled out. Other global considerations include Brexit and US-China trade relations, but these are likely to have a marginal impact compared to Covid-19.

SHARES OVER BONDS FOR THE LONG TERM

Global share prices have recovered significantly since March's low, but the recent moves have shown how important the successful introduction of a vaccine and reducing the spread of Covid-19 is. That said, looking past the near-term uncertainty, the long-term outlook continues to favour shares over bonds. A key factor is that central banks have accelerated support via Quantitative Easing (QE), which is when they (electronically) print money to purchase assets like government bonds. This recovery has another significant difference – massive fiscal easing - which is financed by increased government debt issuance (bond sales). Global bond yields have fallen dramatically (meaning bond prices have risen) since the start of the year due to risk aversion and global central bank rate cuts, however as the outlook has improved, bond yields have recovered somewhat. Similarly, there is likely to be increasing inflationary concerns the longer the pandemic persists. We retain broad global property exposure, as post-Covid we expect cash flows to recover, outside the retail sector's well-known difficulties in the longer term.

Impact of Lockdowns on Restaurant Bookings



Source: Opentable.com

TOP RISKS

Coronavirus lingers longer than expected, or countries see a third wave of cases

Stock markets remain highly sensitive to changes in the rate of infection. A vaccine is key to further gains.

Markets lose faith in government and central banks

Central banks have slashed rates, and many are actively providing additional easing. Fiscal support remains key.

Rising political turmoil

Global political unrest has not disappeared. US and China trade relations are temporarily more constructive, aiding growth, but this could easily reverse.

Brexit

Brexit has taken a backseat to C-19. But the process remains the UK's, and to a lesser extent's the EU's, greatest economic unknown. The UK's uncertain trade relationship with the rest of the world weighs on UK shares.

Higher unemployment

Most governments have taken positive steps to cushion businesses and employees from the impact of C-19. The withdrawal of this support coupled with any structural change in the economy, particularly in the service sector remains a risk.

This document has been prepared by Wealthify's Investment team and the opinions expressed here are theirs.

INVESTMENT TYPE	OUTLOOK	RATIONALE
SHARES		
UK	+	Despite Covid-19 taking the headlines, negative sentiment driven by Brexit is a large additional hurdle to investor appetite. This is surprising given UK shares have a heavy weighting to overseas earnings, at around 70% for FTSE-100 and around 50% for FTSE-250). Recent events see UK shares being historically cheap, despite the UK government and Bank of England providing significant policy support to help offset the negative economic impact. If the Brexit process is smoother than expected or postponed allowing a longer negotiating window, then any associated positive reaction should see significant support for UK shares. However, this may be lessened if the pound quickly rises in value too. The risk of a disorderly Brexit process should not be ruled out, hence our bias for FTSE-100 over FTSE-250 within this allocation.
US	=	Much of US share prices gains over the last decade were driven by the tech sector, which remains cash-rich in this difficult environment. However, there is the possibility that other markets, given their lower valuations, will finally play catch-up. The US saw a strong initial monetary and fiscal policy response to Covid-19, although this has not seen further follow-through given political posturing. However, caution remains around the short-term outlook given the lack of progress against the pandemic, which with differing lockdown measures across states continues to reflect a disjointed response.
Europe ex UK	=	The European Central Bank continues to provide significant monetary support. However, fiscal responses across the region differ significantly. Crucially, the region is heavily exposed to the global trade cycle which has understandably slowed this year. The lockdown has also been particularly economically challenging for Europe, with generally longer and more severe lockdowns in place. Longer-term, a key risk remains that US-China trade tensions widen to include Europe. Current valuations are comparatively appealing, but not cheap.
Japan	+	Japanese share valuations remain relatively cheap. The economy and country have fared comparatively well against Covid-19. Government spending support has been significant and twinned with the Bank of Japan (BoJ) providing further and faster purchases of government bonds. If the global recovery falters, and JPY strengthens, it would deliver a double punch to the Japanese stock market's crucial exporters. Despite his departure as Prime Minister, the continuation of Abenomics (providing fiscal and monetary support) appears certain, any reversal would be a significant blow. That is unlikely to happen before the next election, planned for late 2021.
Emerging Markets	=	Emerging markets (EM) share performance had a difficult Q1-2020, but Q2 saw much of this lost ground regained. Swift government measures have seen a quick stemming of virus infection rates in many countries. The drop in US interest rates has been particularly supportive for this region. But as current valuations are firmly above historical averages, it is important to note that the region cannot recover in isolation. The drop in global interest rates, in particular those seen in the US has been supportive for EM, although a sharper than expected reversal would be a concern.
Asia Pacific ex Japan	=	The region, so far, has held up comparatively well during 2020, with the Chinese stock market being one of the best performers. However, ApacXJ as a whole is still highly dependent on global trade, in particular with China and the US. Share prices have risen firmly, and valuations are no longer cheap. We look for further policy spending packages to provide support, but the region also has further monetary room to move. Post-Coronavirus, US-China trade tensions are the overriding concern, but other ApacXJ countries do benefit from this situation.
FIXED INCOME		
Government bonds		
UK	=	UK government bonds (gilts) have benefited from continued Brexit uncertainty. Despite historically low yields and significant fiscal easing, pension and insurance firms remain persistent buyers. Covid-19 aside, the main concern is a disorderly exit from the EU, which could trigger a growth shock and sustained inflation driven by a weakened pound. The UK continues to offer diversification due to idiosyncratic factors such as Brexit.
US	=	Investor risk aversion, combined with the coronavirus economic shock, has already provided significant support to US bonds. However, investors see potential for further easing from the Federal Reserve as it has a greater ability to ease further than other central banks due to continued high demand for US dollars, especially for funding and liquidity needs.
Europe ex UK	-	We believe Eurozone government bonds are overvalued given their continued distortion by Quantitative Easing. The resumption of ECB QE is likely to cap yields, but political risks and budgetary concerns may see them move higher intermittently. Concern also remains around the long-term debt sustainability of the periphery compared to the core.
Japan	-	Japanese bonds offer little income and remain severely distorted due to the BoJ's "Yield Curve Control" program. While the BoJ might alter this program, there's little expectation for significant medium-term change. Shares are the more attractive way to capture Japan's economic improvement.
Emerging Markets	+	EM government bonds continue to offer a strong yield premium compared to Developed Markets. Similarly, their currencies appear undervalued, offering an additional supportive factor. Comparisons of the current situation with the 1998 EM crash are overdone, with external debt, Foreign Exchange reserves, and overall fiscal prudence significantly firmer.
Corporate Credit		
UK	=	The Bank of England's (BoE) expanded bond buying program will likely provide continued support, at the cost of distorting the market further. These bonds provide diversification within the corporate sphere. We are reluctant to increase our position as spreads are back to normal levels following significant policy support.
US	=	Economic concerns caused corporate yields to rise significantly before the Fed announced so-called QE infinity, causing corporate yields to drift lower. However, yields are still higher than those seen recently due to economic concerns. As with other regions, we prefer Investment Grade over High Yield, given that the additional risk premium available is unconvincing.
Europe ex UK	-	The ECB's newly expanded bond buying program has stretched this market further. These bonds are uncompelling, particularly compared to shares.
Japan	-	Like Japanese government bonds, Japanese corporate bond prices have been distorted by QE. We prefer share exposure, especially whilst Abenomics continues.
Alternatives & Thematics		
Environmental	+	Companies that focus on reducing their environmental impact often have a competitive advantage as they tend to have greater resource efficiency, leading to lower costs. They may also experience lower downside risks due to more robust corporate governance, and this can support greater diversification benefits.
Global Real Estate	=	While Covid-19 has placed this asset class under pressure, we see this strain as being resolved post-Covid. The retail sector's woes are well documented, but a sectorally and regionally diverse portfolio remains fundamentally appealing given constrained supply and low-interest rates which also provide a buffer.