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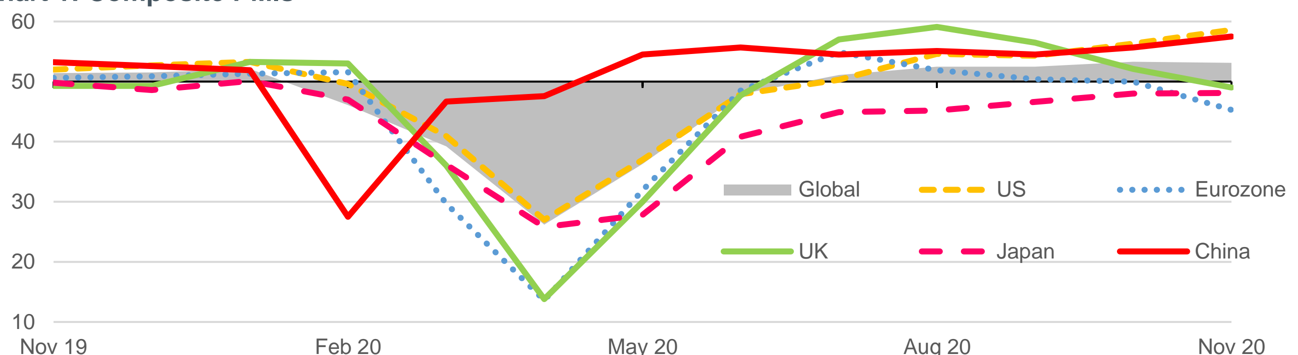
Capital Markets Update

Winter 2021

Announcements of effective vaccines allowed companies and markets to put near-term economic weakness in the context of a potential end to the pandemic in 2021. Global equity markets, oil and industrial metals prices rose in concert with US treasury yields in the fourth quarter.

Despite Q3 GDP releases showing a sharp initial rebound in economic activity, output remains well below end-2019 levels in most economies. Furthermore, the global economy is set to end 2020 on a weak note after many countries, particularly in Europe and the US, re-imposed restrictions to reduce COVID-19 infections. However, PMI surveys provide little evidence of a slowdown at a global level (Chart 1).

Chart 1: Composite PMIs

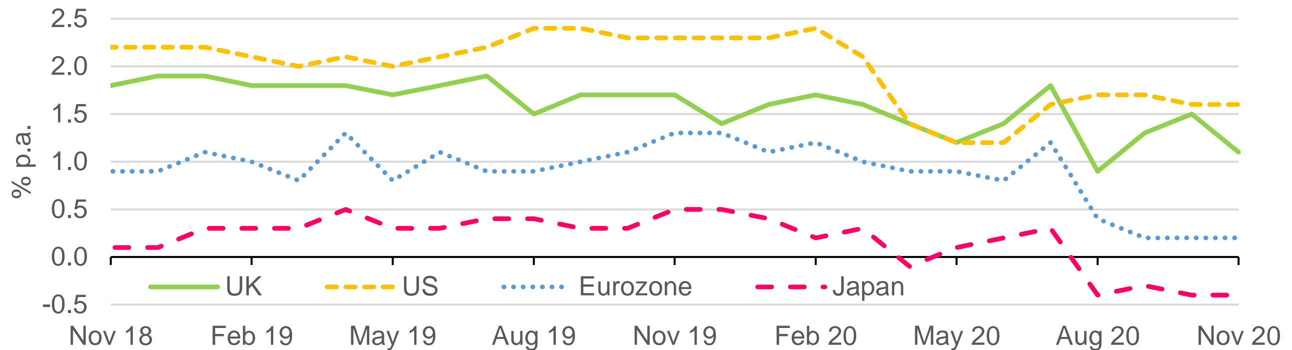


Eurozone and UK composite PMIs have fallen, but the global equivalent remains at a level signalling expansion, supported by solid readings in the US, China and elsewhere. Even in the Eurozone and UK, both manufacturing and services have held up far better than during initial lockdowns in spring. Once again, subject to looser restrictions and facing a stronger external environment, manufacturing has been far more resilient than services, remaining at a level typically consistent with strong expansion.

Consensus forecasts a 4.2% fall in 2020 global GDP followed by a 4.8% expansion in 2021, though output in the major advanced economies is not expected to reach pre-pandemic levels until at least 2022. While vaccine developments have not altered the average projection (most forecasts already assumed social distancing would continue into 2021 but fade over time as vaccine coverage expanded and therapies improved), we believe the risks to the outlook are now more balanced. Though cases continue to rise at a global level, it appears increasingly likely that many advanced economies could vaccinate a large proportion of their most vulnerable citizens early this year, potentially paving the way for a more permanent relaxation of restrictions.

Sterling was volatile in the fourth quarter as Brexit talks approached their conclusion. It ended the period 1.5% higher in trade-weighted terms as the EU and UK reached a trade deal enabling tariff- and quota-free movement of goods. In trade-weighted terms, the US dollar and Japanese Yen, both typically considered safe-haven currencies, fell 4.3% and 1.2%, respectively, below end-September levels as economic sentiment improved.

Chart 2: Core CPI inflation

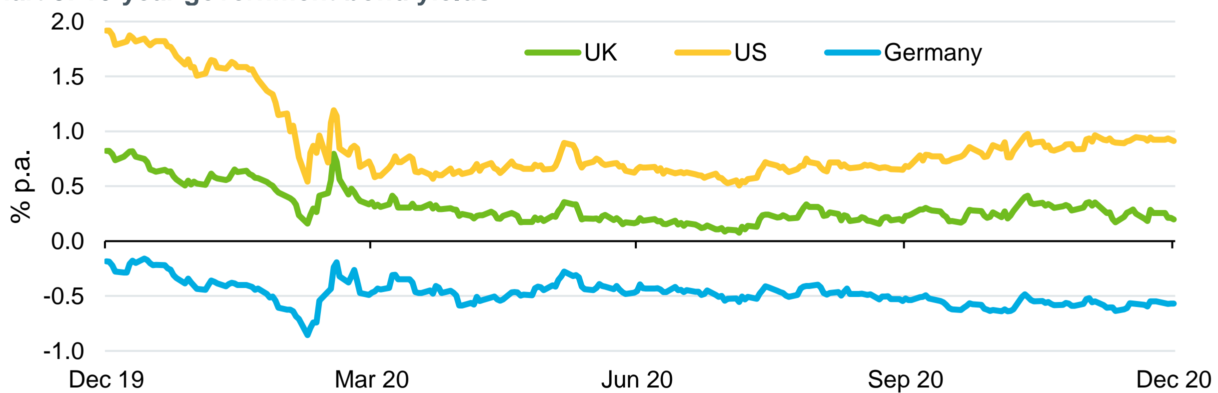


Some commentators fear the release of pent-up demand when the pandemic subsides could lead to a surge in inflation. However, most are more sanguine when GDP remains well below trend and unemployment is expected to rise. The consensus estimate is for a fall in inflation in 2020 to be followed by a modest increase in 2021. While a sustained rise in inflation, and the subsequent need to raise interest rates, would represent a risk to economic recovery and asset prices, the resilience of supply during the pandemic and a return to normality, that will probably be gradual, suggest any inflation pressure will be limited and interest rates are likely to remain low for an extended period.

Government bonds

10-year US Treasury yields rose as the economy continued to recover in Q4, but equivalent UK and German were little changed as near-term economic weakness prompted their central banks to increase asset purchases. In the UK, Brexit disruption may moderate the economic rebound expected in 2021 and the Bank of England has been looking at the implications of further easing through negative interest rates. Against that backdrop, very low yields are vulnerable to a less favourable fundamental background as growth and inflation recover and less technical support as monetary easing is replaced by short-term stability and longer-term tightening.

Chart 3: 10-year government bond yields



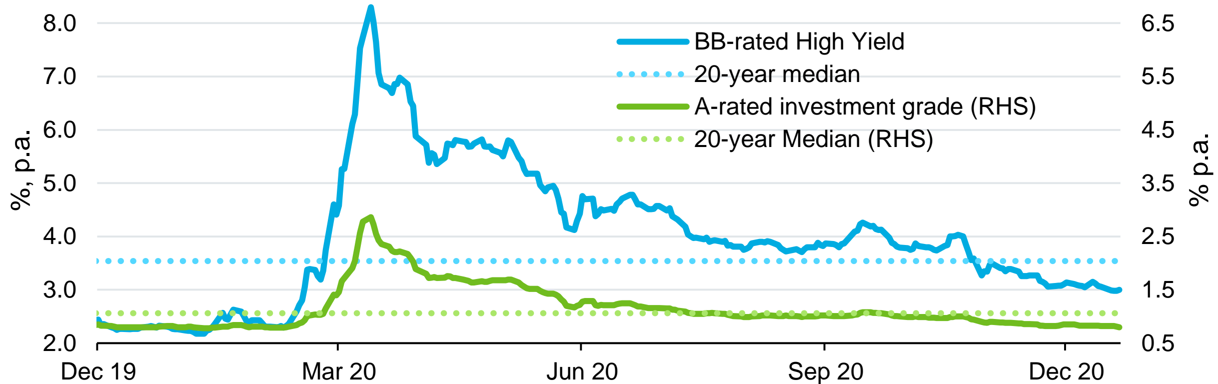
Despite the government's announcement that RPI will be aligned with CPIH (c.1% p.a. lower) in 2030, with no compensation for index-linked gilt holders, implied inflation actually rose at longer terms. This may suggest markets had not only fully discounted the change but expected it might take effect earlier.

Credit

Unusually for a period of financial stress, companies have been able to raise huge amounts of debt to see them through near-term disruption. This increase in leverage, coupled with falling profits, has resulted in lower interest coverage, despite a significant decline in yields. Although default rates have risen – to 8.4% in the last 12 months to November[1] in the US high yield market – the accommodative funding conditions have helped keep them well below the peaks of previous crises. However, it is likely defaults could remain elevated as companies lose government support.

[1] Moody's Weekly Market Outlook issuer-weighted default rate

Chart 4: Global investment-grade and speculative-grade corporate credit spreads

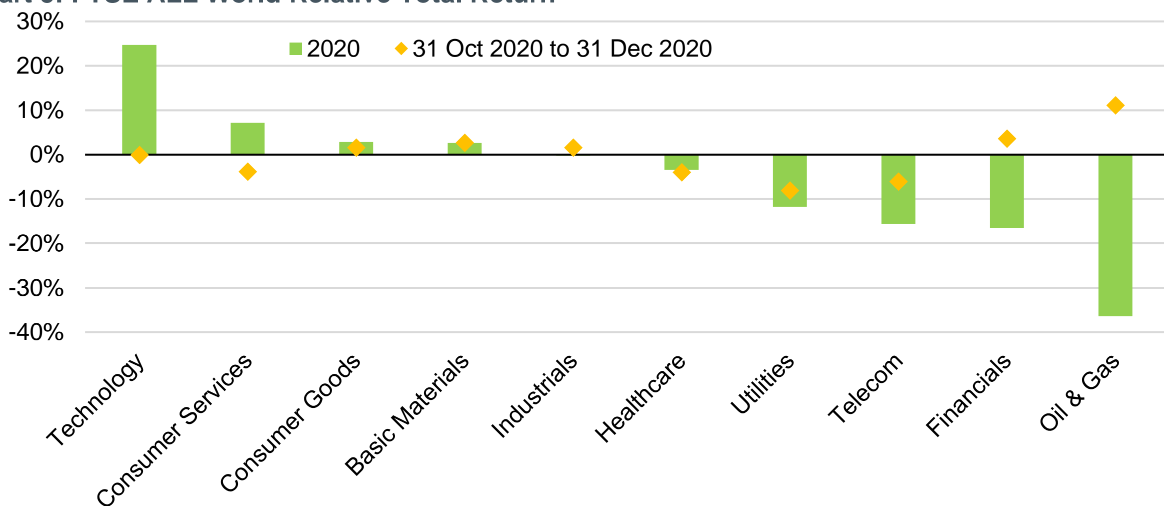


Nonetheless, global credit spreads have retraced much of the widening seen in Q1 and are now well below longer-term medians (Chart 4). Credit assets which have seen less direct policy support, such as asset-backed securities and leveraged loans, look to offer better value than similarly rated fixed-interest corporate bonds.

Equities

The pandemic-induced recession has been notable by its creation of winners and losers: "social distancing" stocks, mainly in the technology sector, have benefitted not only from their ability to grow earnings while most other stocks saw huge pressure on profits, but also from the decline in the discount rates used to ascribe a present value to their future earnings. Progress towards a vaccine has, to an extent, reversed this narrative since the start of November as cyclical sectors benefitted from improving economic sentiment (Chart 5).

Chart 5: FTSE ALL World Relative Total Return

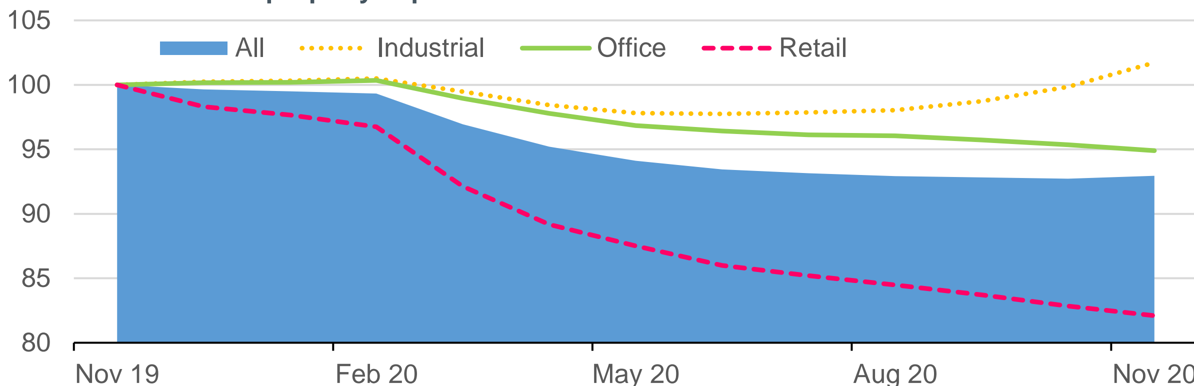


Global equity valuations at, or near, record-high levels continue to mask stark divergences across sectors and regions. Cheaper valuations in regions such as Europe and the UK, with their higher-than-average cyclical exposures, may suggest there is further room for the value rotation to run. However, while rises in government bond yields are limited and gradual, longer-duration growth sectors, such as technology, may well remain in favour in spite of high valuations. Vaccine rollouts should see significant pressure on COVID-19 laggards ease, but the disruption caused by the pandemic may accelerate longer-term trends. A rapid increase in technological adoption and efforts to de-carbonise the global economy would lend further fundamental support to the "winners" while weighing on old-economy cyclical sectors, such as oil & gas. Partly as a result of this tension between current valuations and longer-term prospects, we would not advocate taking any strong regional, sectoral or stylistic position.

Property

The 12-month total return on the MSCI UK Property index was -1.9% to end-November, though monthly returns have been positive since July. Capital values, in aggregate, have fallen 7.1% in the year to November, predominantly due to an 17.9% fall in the retail sector (Chart 6). Retail capital values continue to fall month by month, and the decline in office values has accelerated in the last 3 months. A recovery in industrial capital values, up 5.6% since July, highlights the continuing divergence between property sectors: the pandemic has accelerated the longer-term trend from in-store to online spending, increasing demand for logistics and warehousing facilities.

Chart 6: UK commercial property capital value index



Aggregate rents have fallen 2.4% over the last year, although the month-on-month falls that have occurred since February have levelled off. Retail rents and, at a slower pace, office rents continue to fall, but annual rental growth in the industrial sector not only remains positive but rose in November. Rent collection remains a challenge for landlords; the issue was probably at its height in the initial lockdown earlier in the year, but the recent re-imposition of restrictions may limit the immediate improvement.

Conclusion

Policy interventions have been instrumental in supporting economies, and vaccine developments have further boosted economic sentiment. The risks to the outlook are undoubtedly more balanced, but delays to the deployment of vaccines and the spread of COVID-19 in the intervening period remain downside risks. Falling interest rates have supported valuations but further monetary easing seems incompatible with the rebound in growth and earnings expected. As such, a repeated boost from large falls in interest rates looks unlikely in the years ahead and the low starting point for yields translates to a bleak outlook for government bonds. Given the compression of investment- and speculative-grade corporate bond spreads, investors may increasingly consider alternative credit assets that have seen the least direct policy intervention, where valuations are less demanding.

Valuations in global equity markets look elevated even allowing for the likely economic rebound and earnings recovery. A rotation into cyclical sectors is underway but differentiation between an easing of shorter-term pressures and the acceleration of longer-term trends, both caused by COVID-19, may limit its persistence. A balanced approach across regions, sectors and styles is preferred. The creation of winners and losers extends to property: the mix of what constitutes an optimal property portfolio will continue to change. However, property in aggregate is likely to remain an important source of diversification and yield.

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