HYMANS ROBERTSON

Capital Markets Update

Autumn 2020

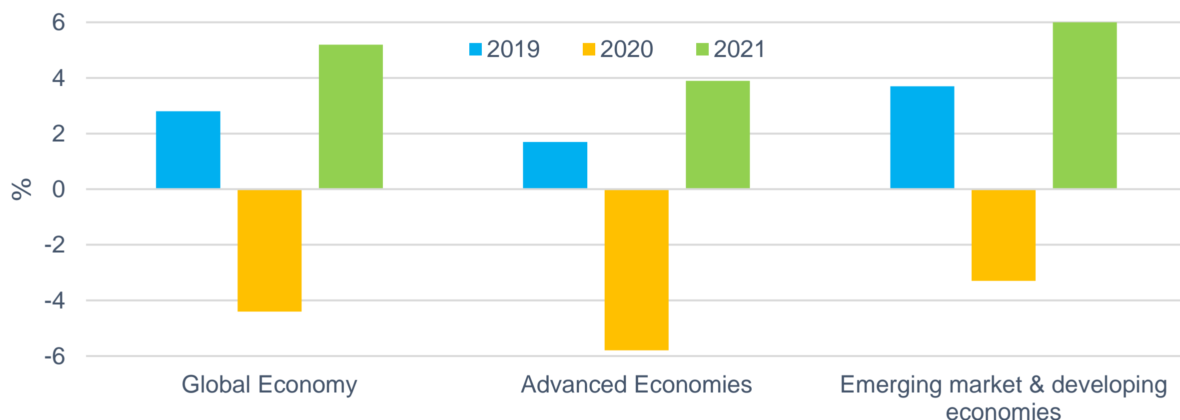
Global equity markets and sovereign bond yields rose, and credit spreads fell in Q3 amid a post-lockdown rebound in economic activity, a better than expected corporate earnings season and optimism over vaccine trials.

Buoyed by a recovery in Chinese activity, in particular, industrial metals prices rose 10.6%. However, while gold prices slipped back from record highs reached in July, they still rose 6.5% above end-June levels and oil prices slipped back as renewed restrictions weighed on demand expectations.

The Q2 global economic downturn was the sharpest contraction in modern history, but unprecedented fiscal and monetary support prevented it from being as bad as initially feared. The initial post-lockdown bounce in growth in large advanced economies was also stronger than anticipated. However, high frequency data, such as travel and navigation app usage, suggest the pace of recovery slowed over the summer, even before many economies, particularly in Europe, started re-imposing restrictions on activity. September's Composite Purchasing Managers' Indices, which combine manufacturing and services, pointed to continuing recovery in global activity, but at a more moderate pace in some regions. At a global level, the manufacturing sector appears to be faring better so far during the recovery, as a continued downturn in consumer services weighs on services activity.

The IMF World Economic Outlook forecasts global growth in 2020 will contract 4.4% this year followed by a 5.2% expansion next (Chart 1), leaving two-year global aggregate output a little above its end-2019 level. However, this is largely driven by the secular momentum of the Chinese economy. Elsewhere, the recovery in output is likely to be long, uneven and uncertain, with major advanced economies not expected to regain pre-pandemic output levels for several years.

Chart 1: IMF World Economic Outlook Growth Projections October 2020



Source: IMF World Economic Outlook October 2020

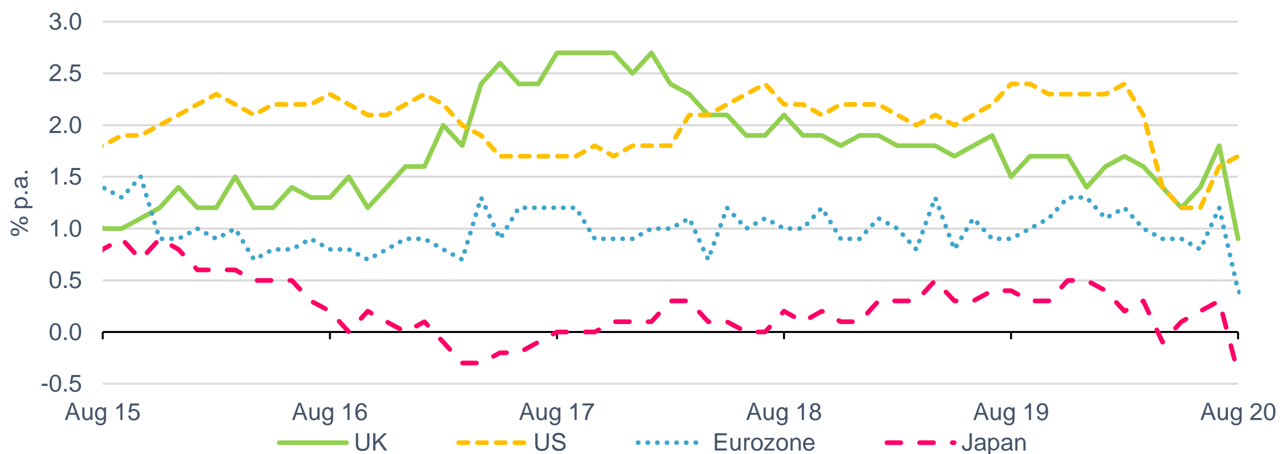
The IMF's near-term forecasts assume social distancing will continue in to 2021 but will fade over time as vaccine coverage expands and therapies improve, avoiding stringent national lockdowns. However, second waves of COVID-19 are increasingly evident, even in regions which had reduced transmission rates to low levels prior to re-opening. Latin America and Southern Asia are yet to see an end to their first wave.

The impact of a re-tightening of restrictions or, in a worst-case scenario, renewed national lockdowns which undermine the recovery or trigger a double dip remain key risks.

Employment and labour force participation at a global level remains well below pre-pandemic levels. US unemployment continues to fall from April's 14.7% peak and though labour markets have been far more resilient in the UK and Europe, the number of job cuts is rising and may accelerate as government support schemes are scaled back.

After rising more than expected in July, UK CPI inflation fell in August as the Eat Out to Help Out Scheme came in to effect. Globally, every major economy has seen its core inflation rate fall since end-2019 (Chart 2) and, though this is driven to a great extent by extreme price weakness in travel and clothing, which will abate, continued caution amongst businesses and consumers should keep a lid on inflation in the short term. Nonetheless, consensus forecasts are still for a fall in inflation this year to be followed by a modest increase in 2021.

Chart 2: Core CPI inflation



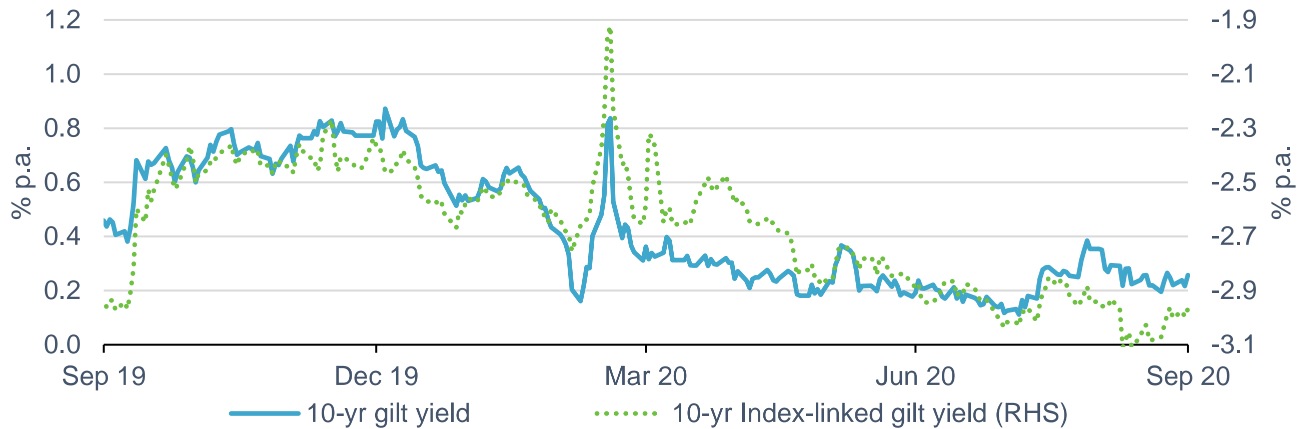
Source: Datastream

The weak inflationary backdrop has prompted further accommodative shifts from central banks. The US Federal Reserve's shift to "flexible" average inflation targeting, allowing above-target inflation to make up for periods of below-target inflation, likely means interest rate rises are even further away than previously envisaged. The Bank of England remain equivocal about the use of negative interest rates but market pricing suggests negative interest rates will be introduced at some point in 2021.

Government bonds

The behaviour of the major government bond markets in the third quarter suggested markets were focusing on the very subdued interest rate and inflation outlook, shrugging off the near-term economic bounce and massive fiscal deterioration. US 10-year treasury yields were little changed, German yields moved further into negative territory and UK 10-year yields rose slightly over the quarter.

Chart 3: 10-year government bond yields



Source: Bank of England

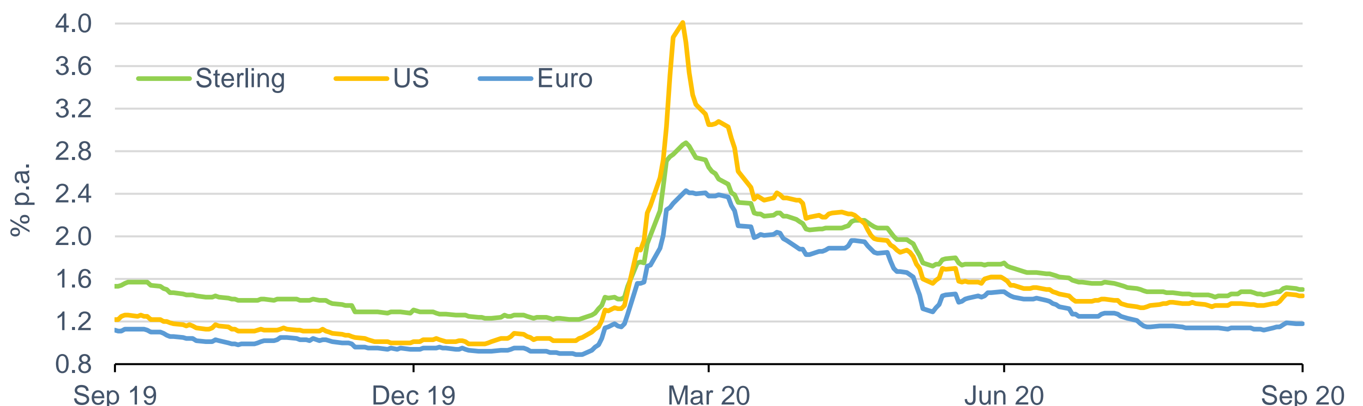
Equivalent UK index-linked yields edged below end-June levels (Chart 3). The delayed outcome of the consultation on the use of RPI as an inflation measure may have alleviated some medium-term downward pressure on implied inflation even as actual inflation fell. Swap market pricing[1] implies a probability in the region of 60% that RPI will be aligned with CPIH with no compensation.

Real and nominal gilt yields remain at very unattractive levels. But, while forecasts for UK growth and inflation continue to provide fundamental support, any rise in yields is likely to be very gradual and limited.

Credit

Global credit spreads ended the third quarter lower (Chart 4), as sentiment continued to recover. Although defaults have continued to rise and are likely to remain elevated, expected levels of future default eased over the quarter. Ongoing accommodative central bank policy and a rebound in economic activity have allowed companies to raise new finance, bolstering their ability to navigate the downturn. The proportion of the US high yield market trading at distressed levels has fallen towards average levels and the pace of net downgrades to credit ratings has slowed dramatically.

Chart 4: Investment-grade corporate credit spreads



Source: ICE Index Platform and Credit Suisse

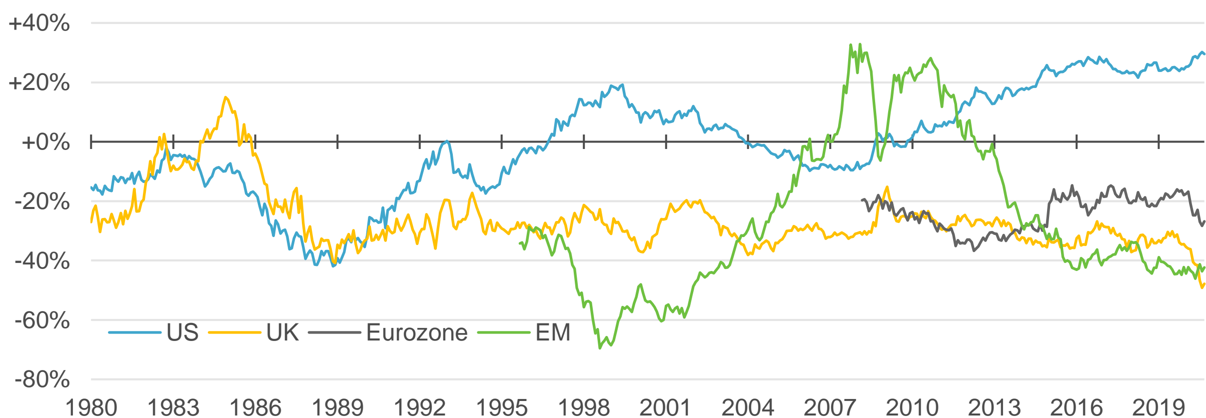
[1] BMO Monthly CPI Update: average 10-year gap between RPI and CPI in 10 years' time currently priced at 0.37% p.a. versus a long-term assumption of 0.90% p.a.

Global investment-grade spreads are now broadly in-line with historic medians, but sterling investment-grade spreads have fallen below their (slightly higher) historic median. Global speculative-grade spreads remained marginally above long-term median levels at the end of Q3.

Equities

Global equity markets produced a total return of 7% in Q3, supported by the ongoing improvement in the macroeconomic backdrop and a US earnings season that outperformed expectations. In general, cyclical sectors tended to outperform defensive sectors, although there were a few exceptions. Concerns over future energy demand were reflected in horrendous performance from the oil & gas sector; provisions for potential loan losses, low interest rates and flat yield curves continue to weigh on financials. Consumer goods did well as retail sales rebounded and consumer confidence improved following the initial easing of lockdown restrictions. Technology had an unspectacular third quarter, but the ability of technology companies to generate strong sales growth through the pandemic has heavily contributed to outperformance by the US market year-to-date.

Chart 5: Shiller price/earnings ratio relative to MSCI World Index



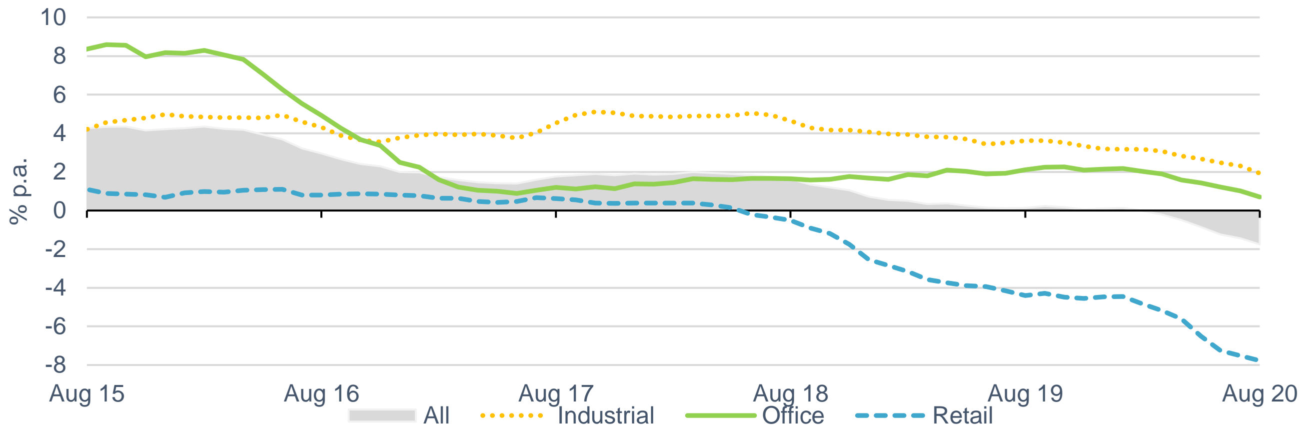
Source: Datastream

With prices rising as a downturn in reported corporate profits started to feed into historic numbers, global equity valuations, in aggregate, moved further above long-term averages. More striking is the divergence of valuations across regions (Chart 5). Notwithstanding any fundamental support for the performance of the technology sector, the US is now at its greatest premium to MSCI World for decades. In contrast the UK, weighed down by its higher than average exposure to financials and oil & gas sectors, looks cheap relative to history.

Property

The rolling 12-month total return on the MSCI UK Monthly Property index continued to decline in the third quarter, although the deterioration has moderated over the last couple of months. Capital values, in aggregate, have fallen 7.8% in the year to August, predominantly due to an 18.6% fall in the retail sector – retail capital values continue to fall month by month, but declines in office valuations have slowed, while industrial valuations have actually edged higher in the third quarter.

Chart 6: UK property rolling 12-month annual rental growth



Source: MSCI UK Monthly Property Index

In aggregate, annual rental growth is negative (Chart 6) and a recent survey of UK commercial property published by the Royal Institute of Chartered Surveyors shows rent expectations and occupier demand are the worst they have been since the Global Financial Crisis. Significant amounts of rent due in the third quarter remain unpaid, although, with more businesses re-opening, collection rates have improved compared to last quarter. There has also been a sufficient increase in transaction and letting activity to encourage valuers to remove material uncertainty clauses from the vast majority of UK commercial properties subject to recent valuation. This has allowed most core balanced property funds that had suspended redemptions to re-open by the end of September.

Conclusion

Unprecedented policy support has, for the moment at least, eased the worst fears about the scale and duration economic downturn and goes some way to explain the sustained revival in investor sentiment. However, a surprisingly strong short-term economic bounce has already lost steam and the risks remain high while COVID-19 remains endemic in much of the world. It is increasingly difficult to justify prices even taking a relatively optimistic economic outlook.

We retain our underweight position to equities: not only does the outlook for earnings remain highly uncertain, but valuations are once again beginning to look a little stretched. A challenging fundamental backdrop and demanding valuations also lead us to remain underweight property. With investment-grade spreads moving below long-term median levels, we would now be more neutral between investment- and speculative-grade in corporate credit markets and have a modest bias in investment-grade portfolios towards asset-backed securities. Given our overall cautious assessment of risk assets, we continue to advocate holding more cash than required by strategic considerations. For those reluctant to hold cash within growth portfolios, non-directional assets – such as insurance-linked securities, macro hedge funds and absolute return diversified growth funds – may offer an attractive alternative, though these assets will require some assessment of active manager skill.

Chris Arcari
Senior Investment Research Consultant
chris.arcari@hymans.co.uk
0141 566 7986

This communication has been compiled by Hymans Robertson LLP based upon our understanding of the state of affairs at the time of publication. It is not a definitive analysis of the subjects covered, nor is it specific to the circumstances of any person, scheme or organisation. It is not advice, and should not be considered a substitute for advice specific to individual circumstances. Where the subject matter involves legal issues you may wish to take legal advice. Hymans Robertson LLP accepts no liability for errors or omissions or reliance upon any statement or opinion.

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities. A member of Abelica Global.
© Hymans Robertson LLP.