Markets Review - to end August 2020

THORNTONS INVESTMENTS

Market Returns

(Total returns in £)	1 month	3 months	6 months	1 year
UK Equities	1.8%	-0.9%	-7.9%	-14.3%
Global Equities	5.2%	6.8%	12.1%	8.0%
UK Gilts	-3.1%	-3.2%	1.1%	2.4%
UK Property	0.0%	-0.4%	-3.8%	-2.9%
Gold	-2.5%	4.7%	16.3%	17.1%
Commodities	5.1%	7.6%	-7.7%	-17.0%
Sterling	0.6%	2.5%	-1.0%	4.0%

Returns to 31st August 2020. Source: Thomson Reuters

Market Overview

Early GDP reports for the second calendar quarter have revealed the hit to economic activity caused by Covid-19 lockdown measures, with UK GDP declining 20% and the EU GDP -12%. These reports should mark the low point, with recent business surveys showing a strong recovery in sentiment as restrictions were removed. Stock markets have recovered strongly from the March lows, however, much of that has been driven by the remarkable rise of a select number of technology stocks. At the time of writing the market value of Apple has just surpassed that of the entire FTSE100.

The UK has lagged other stock markets and appears to remain under a Brexit cloud. The US dollar has been notably weak over the summer on a combination of rapidly rising Covid-19 cases, rising political tensions (both domestic and foreign) and falling bond yields. In contrast the euro rallied on the back of EU agreement over a €750bn recovery fund.

Aside from the tech titans reporting further rapid growth through peak lockdown, companies reporting results to the end of June have been mixed. Even though they have generally beaten estimates, the estimates had been massively cut and many companies are unable to give forward guidance due to the considerable uncertainty they are still operating under. As a result, price moves, and volatility remain at elevated levels.

Economic recovery now feels as though it is two steps forward, one step back, as Covid-19 remains highly infectious, forcing the re-introduction of restrictions in some cases. Governments and central banks continue to offer support and for many areas of the economy this remains crucial, with the unwinding of relief measures likely to cause some distress. News on vaccine development remains positive and success here is now critical for a return to normal. However, as we hear on a daily basis, it will not be enough to save many businesses.

Oil, with its sensitivity to economic activity, has been the most volatile of markets. Brent oil dropped to $10 per barrel in April and has since recovered to $40 plus, all compared to a price of $70 at the start of the year. A broad global agreement to cut oil production from May and a pickup in demand, especially in China, has driven the recovery. However, there is now a 'lower for longer' outlook for oil with both BP and Shell cutting energy price forecasts and their dividends, Shell for the first time since the Second World War. Iron ore and copper have seen their prices rise, although this is due to South American supply constraints as much as Chinese demand recovery. In general, though, commodity prices remain subdued. Gold and silver continue to shine, as real interest rates turn more negative, a hedge against risk and a possible return of inflation.

Property funds have suspended daily dealings, citing an inability of independent valuers to give confidence in valuations, although deals are still taking place. REITs have dropped to significant discounts to stated property values, but retail property focused companies are reporting significant non-payment of rents. Although it is too early to know how demand for office and industrial property will be affected, there was little surplus property prior to coronavirus and paid rental yields are substantially above bond yields.

With the Bank of England and other central banks employing their full range of quantitative easing (QE) tools, and an essential promise to do whatever it takes, bond yields have been heavily compressed. Most UK gilts out to 10 years now return a small negative yield. This is increasingly forcing investors to accept higher levels of risk for any return. With rapidly rising government deficits central banks are now forced buyers of government debt, in order to prevent a collapse in bond markets. This is creating an environment where financial stresses are more likely to get played out in currency markets.

With most companies having withdrawn guidance, it is clear that they are as uncertain about how long restrictions will remain in place and what recovery will look like, as everyone else. All companies are impacted, but to varying degrees. Some, in the leisure, hospitality and travel industry, have found operating to be unprofitable and are having to lay off workers, or are simply unable to survive. This has been reflected by a sharp rise in bad debt provision by banks across the world. Other companies are able to operate at varying levels until some sort of normality returns. A few have even found they have benefitted from the turmoil. Stock markets, however, have reset to reflect much of this and will now digest company results and economic data as it reveals the depth of the impact, or otherwise on business.

The lifting of restrictions as infection rates declined has hit a bit of a speed bump, with increased human interaction inducing spikes in infection rates. Some regions have had to reintroduce restrictions, but with increasing capacity to test and treat hopefully they will remain local only, although this will require a high level of compliance by those affected. Broad confidence is the key, we will need as much as possible to aid fuller economic recovery. Medical science resource is being poured into treatment and prevention of Covid-19 and we remain optimistic on this front.

Political stress is undoubtedly being amplified by economic stress currently. A rapid economic recovery would be universally welcomed, but still appears to be some way off. The stock market is largely looking past this year, but is likely to remain volatile, whilst the level of uncertainty remains so high. Once there are one or more effective vaccines available, life will be able to fully return to normal. This should be the catalyst to allow markets to look forward with confidence again.

Market Outlook

Equities	Stock markets, particularly overseas, have staged strong recoveries from the March lows, with the US climbing to new highs. Company results to the end of June generally beat reduced expectations, with technology stocks powering ahead during Covid-19 lockdowns. There are signs of economic recovery as we move through the summer, but many companies are unable to give forecasts due to the continued level of uncertainty as recorded cases of Covid-19 rise again in Europe and the US. As we wait for viable vaccines, governments and central banks continue to offer support, helping underpin stock market valuations.
Fixed Interest	Central bank buying has helped government bonds surge, and yields fall, particularly in the US and UK. This has brought the UK yield curve close to zero, or negative, over the next five years. The 'hunt for yield' means investment grade bonds also offer very little yield. As in August, bonds are susceptible to sell-offs. High yield bonds are sensitive to deteriorating credit quality.
Commercial Property	Property fund difficulties persist, with a second quarter of reduced rental income payments and most property funds still suspended, due to uncertainty over market values. Whilst the outlook for retail remains problematic and uncertain for office property, industrial property continues to offer an attractive headline yield and diversification benefits (where not listed).
Alternative Assets	Infrastructure investment funds offer benefits for exposure to physical assets, often with attractive inflation linked contracts, and growth connected to improved connectivity and de-carbonising economies. However, as with private equity, there has been significant capital applied to these investments, reducing investment yields and increasing vulnerability to any rise in the cost of debt. Absolute Return strategies have shown some defensiveness but offer low returns and we continue to choose sparingly.
Cash	The 'safety' of cash is counterbalanced by zero interest rates and a lack of protection against inflation.

Thorntons Investments September 2020