KINGSWOOD

PROTECT AND GROW YOUR WEALTH

Q4 | 2020

INVESTMENT OUTLOOK

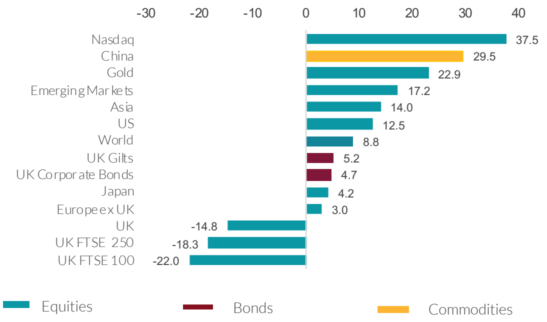
SUMMARY

- The pace of the global economic recovery has slowed following the initial sharp bounce in activity
- The surge in infections and new lockdowns point to renewed declines in GDP in the UK and Europe in Q4
- The latest vaccine news is a major step forward but does not represent a silver bullet
- Equity markets are now back above their all-time highs in February and seem to have little further upside near term
- Next year, by contrast, mass testing and vaccine roll-outs should mean the economic backdrop starts to improve
- This in turn should lead equity markets to resume their upward trend
- Within equities, we are cautious on the UK and US but are positive on Asia, particularly China
- Prospective equity returns are single digit but are significantly higher than for fixed income, especially government bonds

ECONOMIC AND MARKET OUTLOOK

This year, the performance of markets has varied enormously and highlighted the merits of a diversified portfolio. Technology stocks, Chinese equities and gold have been the big winners while UK stocks have nursed significant losses.

Market returns have varied enormously this year



Source: Refinitiv

The rebound in equity markets earlier in the year was one of the fastest ever and by September, global equities were back testing their all-time highs in February. They have had a volatile time since then but following the recent rally are now a little above their previous peak.

Global economic activity has echoed this pattern. The first stage of the recovery was very rapid with the US and Eurozone seeing record growth rates in the third quarter. But **growth in Europe and the UK now looks set to go into reverse** in the fourth quarter.

The wave of Covid infections has triggered renewed lockdowns not only here in the UK but also in Germany and France amongst other countries. Lockdown 2.0 is not as draconian as its predecessor and should also be considerably shorter. Even so, it will still pose a significant drag on activity near term.

Prospects for the new year look significantly brighter. As many as 170 vaccines are in development, with a dozen or so now in late stage trials. The recent news on the Pfizer vaccine, which is effective in preventing 90% of people from contracting the virus, is a major step forward but it is not a silver bullet.

A mass roll-out of vaccines will take time and logistical issues will be increased by the need to store the vaccine at ultra-cold temperatures. It is also far from clear what proportion of the population will be willing to be vaccinated and how long immunity will last. All the same, vaccines, along with faster testing and better contract tracing, should allow economies to continue their return towards normality next year.

Government policy should also be supportive with no early return to austerity, unlike in the aftermath of the global financial crisis. In the UK, the chancellor has now extended the furlough scheme until March and in Europe, funds should start to flow next year from the €750bn recovery plan.

In the US following Biden's victory, a new fiscal stimulus package should be agreed over the next couple of months. However, if as seems likely (this will only be confirmed on 5 January) the Republicans retain control of the Senate, its size will be considerably smaller than Biden had been intending. A hostile Senate will also put a nail in the coffin to most of Biden's market unfriendly policy proposals such as higher corporate taxes and more regulation.

Meanwhile, **central banks will continue to do what they can to support the recovery.** Interest rates look unlikely to be raised anywhere for the next three years or more and in the UK could still be lowered into negative territory if necessary.

There is also no end in sight to quantitative easing. The BoE has recently announced a £150bn increase in its QE program and the ECB should follow suit in December. Even so, the fact is that central banks have already used up most of their ammunition and fiscal policy will need to be the main source of any further stimulus.

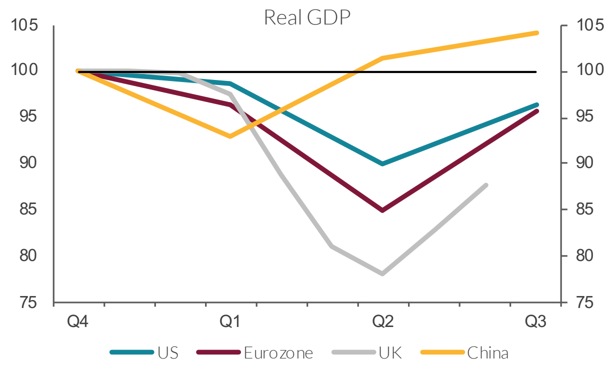
While economic activity in Europe and the UK, and to a lesser extent in the US, remains some way below pre-Covid levels, in China it is another story. GDP in China was up 4.9% in Q3 from end-2019, whereas in the US and Eurozone, GDP was 3.4% and 4.5% lower.

Importantly, China and much of Asia have so far managed to head off a major secondary surge in infections. The region should over the coming months remain the main area of strength in the global economy.

Inflation has recovered some of the sharp oil-related decline earlier in the year and should continue to trend higher. Social distancing measures will increase operating costs and the massive monetary and fiscal stimulus also poses upside risks. So too does the recent surge in personal savings rates which could fuel a surge in spending if consumers were ever to regain their confidence.

Against that, unemployment looks set to remain relatively high which will exert downward pressure on wage growth. On balance, we expect **inflation to rise to 2% or higher** over the next couple of years. The Federal Reserve has recently announced it will tolerate an overshoot of its 2% target and other central banks are also moving in the same direction.

GDP still significantly below pre-Covid levels – except in China



Source: Refinitiv

Where does this leave equity markets? **Near term, we see little further upside** following their recent bounce. Even with the latest vaccine developments, the news on Covid remains worrisome with infections still rising. The US elections also remain a source of some uncertainty with the make-up of the new government still not completely clear. Last but not least for the UK, Brexit remains a wild card.

Market valuations are also now on the high side. The 2-year forward-looking price-earnings ratio for global equities has rebounded from a low of 10.3 in March to 19.0, a 20-year high.

At first sight, this seems little short of extraordinary with the world in the midst of a pandemic. However, the very low level of interest rates means these valuations should prove sustainable as equities still look reasonable value relative to bonds. Even after this year's substantial dividend cuts, the gap between the dividend yield and government bond yields remains higher than normal in the US and UK.

All the same, current valuations leave little room for error and increase the **potential for market volatility near term** while the economic recovery remains under pressure. Corporate earnings, however, are supportive with the current reporting season in the US proving not half as bad as feared.

Next year, **as economic prospects start to improve, the scene should be set for further gains in equities.** That said, with earnings rather than any additional valuation re-rating likely to drive further increases, prospective returns are not that large. Even so, they should still be considerably higher than those from fixed income.

Return prospects look particularly dire for conventional government bonds, with 10-year yields all of 0.4% in the UK and 0.9% in the US. Even though central banks have all but confirmed there will be no rise in rates for the foreseeable future, bond yields still look set to edge higher as inflation pressures slowly build. This in turn will lead to capital losses and could produce negative returns overall.

As for corporate bonds, spreads have reversed the bulk of the sharp widening earlier in the year and are now around 30bp above pre-Covid levels. Yields are 2-2.5% in the UK and US and prospective returns should be of a similar magnitude, with some modest further spread compression offsetting any rise in government bond yields. While these **returns should be significantly lower than for equities,** the downside risk is also considerably smaller now that corporate bonds benefit from central bank purchases.

POSITIONING

We retain a small underweight in equities, with allocations in portfolios a little below the levels we would expect in the long term. With the outlook for equities looking quite uncertain over the next couple of months but rather brighter further out, this continues to look appropriate.

We remain cautious on UK equities. They have underperformed global equities by as much as 25% this year and the UK market now makes up a mere 3.8% of the global equity index.

On the positive side, valuations look cheap. The P/E ratio is now over 25% lower than for the rest of the world with the structure of the UK market accounting for some, but not all, of this sizeable discount.

However, the underperformance has in good part been warranted by the poor performance of the UK economy which has been one of the worst hit by Covid. With the new lockdown threatening a double-dip in the economy and Brexit looming, it is difficult to be that optimistic on the outlook.

At the time of writing, it is still unclear whether the UK will reach a trade deal with the EU. But even if there is a deal, it will be a bare bones affair. It is hard to believe, at least initially, that Brexit will not be disruptive – deal or no deal.

Within UK equities, we have a tilt to small and mid-cap. While they have now recovered the bulk of their underperformance in the sell-off, we believe there is room for some further catch-up next year.

We are also somewhat wary about US equities. Covid infections are still rising rapidly and mean increasing social distancing measures may have to be enforced. The relative valuation of the US market is also more extreme than normal, with the US P/E ratio now some 40% above the rest of the world. This is double the premium seen on average in the past.

Still, this is not as worrying as it seems. In part, it is just down to the technology sector, which trades on high valuations and makes up some 30% of the US market. We believe current tech valuations should prove sustainable as the sector's growth prospects have been reinforced by Covid and remain strong even with the tech giants now facing a regulatory crackdown.

All the same, if the global economic backdrop improves over coming months, the US may suffer from a rotation by investors into cheaper more cyclical markets. Continued dollar weakness is also quite probable and usually associated with US equities underperforming.

We remain positive on Asia and emerging markets, particularly China. The latter accounts for over 40% of these regional indices and has outperformed by over 20% this year

China remains attractive with growth set to remain considerably stronger than elsewhere. Chinese equities should benefit from the strength of the domestic economy even if US-China trade tensions continue. Valuations, meanwhile, are reasonable. Along with Asia and emerging markets more generally, China trades at a significant discount to developed markets.

We are broadly neutral on both Japan and Europe. In Japan, improving corporate governance and cheap valuations are positives but the poor long-term growth prospects of the economy are a headwind. As for Europe, valuations are also on the low side. However, the second wave of infections has been unexpectedly severe and the structural defects of the eurozone remain longer-term concerns.

We maintain a sizeable exposure to thematic investments and believe Covid has only strengthened the rationale for allocating to particular sectors and themes. We have long had exposures to technology and artificial intelligence and plan to retain these for the reasons mentioned already.

We also have an allocation to healthcare. Increased demand from an ageing population and rapid biotech innovation are both long term attractions. Environmental change is another major area of growth, with governments, companies and investors all increasingly focused on climate change and ESG.

Infrastructure is another theme we favour as it offers enhanced inflation protection and should benefit from increased government spending. Finally, we retain an allocation to frontier markets where cheap valuations and strong growth prospects are the allure.

We are underweight fixed income as prospective returns are limited with yields so low. The majority of our allocation is to higher grade corporate bonds where return prospects are rather better than for government bonds. We have only a limited allocation to the latter both because of their poor prospective returns and their reduced ability to provide protection in a major risk-off move.

Lower risk alternatives, which should provide moderate returns regardless of the moves in bonds or equities, **look attractive** in this environment and we have recently made an allocation in this area.

Lastly, **we have an allocation to gold** which has had a very good year. The rally in the gold price has stalled in the last few weeks but should have further to run in the medium term with rates set to remain super-low and inflation likely to trend higher.

Rupert Thompson
Chief Investment Officer

MARKET VIEWS

	Previous view	Change	Current view	
Lower Volatility Assets				
Cash	🔴	-	🔴	Remains unattractive with interest rates so low
Government Bonds	🔴🔴	-	🔴🔴	Yields to trend higher from very low levels and prospect is for zero/negative returns
Corporate Bonds	🔵	-	🔵	Spreads are low and prospective returns are limited although higher than for government bonds
Index-linked Bonds	🔴	⇧	🟡	Inflation to trend higher and offers some protection for fixed income heavy portfolios
Lower Volatility Alternatives	🔵🔵	-	🔵🔵	A considerably more attractive source of return and protection than government bonds
Higher Volatility Assets				
Equities	🔴	-	🔴	Volatility expected near term but renewed gains likely next year as economic prospects improve
Higher Volatility Alternatives	🔵	-	🔵	Equity exposure with downside protection is appealing given significant uncertainties remain
Property	🔴🔴	-	🔴🔴	Illiquidity is problematic and Covid is a big headwind for retail and office space
Gold	🔵	-	🔵	Well supported by low rates and hedge against risk of further major equity sell-off
Equities				
Regions				
UK	🔴	-	🔴	Valuations are cheap but economic outlook relatively poor - partly down to Brexit
US	🔴	-	🔴	Large tech exposure is positive but valuations high and economic recovery to benefit other markets more
Europe ex UK	🔴	-	🔴	Latest surge in infections putting recovery at risk and long-term structural problems remain
Japan	🟡	-	🟡	Valuations are cheap but long term weakness of economy is a concern
Asia ex Japan	🔵🔵	-	🔵🔵	China is key attraction as Covid under control and economy has rebounded faster than elsewhere
Emerging Markets	🔵	-	🔵	Similar argument as for Asia which accounts for lion's share of emerging market indices
Themes				
Global Infrastructure	🔵	-	🔵	Offers enhanced inflation protection and a beneficiary of increased government spending
Global Technology & AI	🔵🔵	-	🔵🔵	Strong growth prospects reinforced by Covid but valuations higher and regulatory headwinds
Global Healthcare	🔵🔵	-	🔵🔵	Good growth prospects and cheap valuations more than make up for US political risk
Frontier Markets	🔵	-	🔵	Very cheap valuations attractive as is structural reform and good demographics
Environmental Change	🔵🔵	-	🔵🔵	Climate change to remain major growth area and increasing focus for corporates and investors
Small & Mid Cap Stocks	🟡	-	🟡	Scope for some further limited outperformance next year as economic recovery continues

Our view reflects our assessment of the relative attractiveness of each asset class after taking into acccount its riskiness/volatility

Change = change in view over the last quarter

🔵 = Positive 🔴 = Negative 🟡 = Neutral