Sanlam

Wealth

A monthly market outlook from the Wealthsmiths™

August 2020

A considered approach as equity markets continue to rise

As the world emerges from lockdown, the full extent of the damage done to economic output and company balance sheets is yet to be fully understood. How, and when, economic growth can recover will be of extreme importance to investors. But for now, they are trusting that governments will continue to do "whatever it takes" to keep companies afloat.

A case of misplaced confidence?

The financial assistance from governments has led to equity market resilience, despite the global economy facing one of the worst recessions it has ever experienced. As investors struggle to find returns from less risky assets, such as bonds, they feel compelled to take more risk, which has resulted in equities recovering to pre-Covid levels, as Chart 1 below shows.

Chart 1: Equity Returns in GBP

Despite this optimism, the reality is that we can expect to see slower economic growth, higher unemployment, and lower profits for some time to come. Ultimately, company earnings drive returns and finding companies with a good growth outlook will become harder, which makes careful stock picking so important. Today's high valuations rely on businesses generating good results, which makes the rise to such confident levels somewhat surprising.

The Sanlam Approach

With political, economic, health and banking risks at large, it's important to diversify across different asset classes so that no single risk dominates the potential outcome. Since equity valuations are high, and bond yields are nearly zero, we diversify portfolios using gold, absolute-return strategies (such as hedge funds) and real assets (such as roads, energy, and infrastructure). While we must accept that taking some risk is necessary, these strategies hedge against falling equity markets and can provide longer-term inflation-proof returns. Of course, we don't completely shy away from equities, but we select them carefully for their growth prospects amid the economic uncertainty.

> We do not attempt to predict the direction of markets, but rather focus on what we own in the fund. We expect our approach of buying strong companies at attractive valuations, and then holding them, to generate good returns over the medium to long term.

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-0.003%

On 20th May, the UK Government sold a bond with a negative yield for the first time, meaning investors are agreeing to be paid less than they lent when the bond matures.

Source: Bloomberg

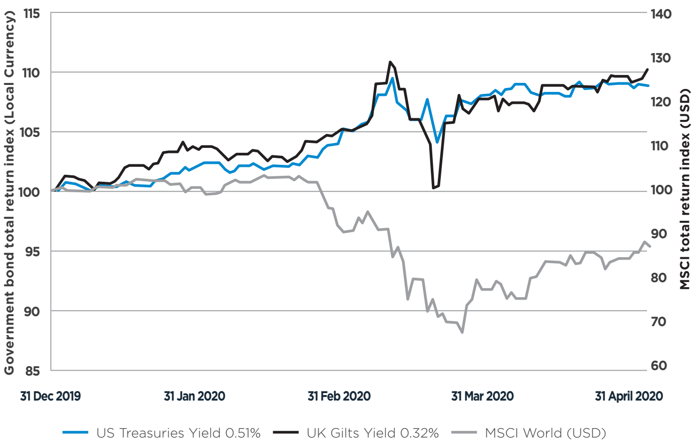
Investment view:
Have government bonds lost their charm?

Government bonds have always had their place. They offer a guaranteed return over a specified period and are the foundation of most diversified portfolios. But with the UK government selling bonds with a negative yield for the first time in recent weeks, are they losing their appeal?

Other than central banks, pension funds and passive mutual funds - all of which may find themselves having to buy negative-yielding bonds - it's hard to understand why anyone would invest money knowing they will ultimately get back less than they invested. Bonds traditionally act as a hedge against falling equity markets and, as Chart 2 shows, we saw them do just that earlier this year. As equity markets fell, US and UK government bond returns climbed towards 10 per cent. (The pullback shortly afterwards was due to the sudden, and decisive, flood of monetary stimulus on the market.)

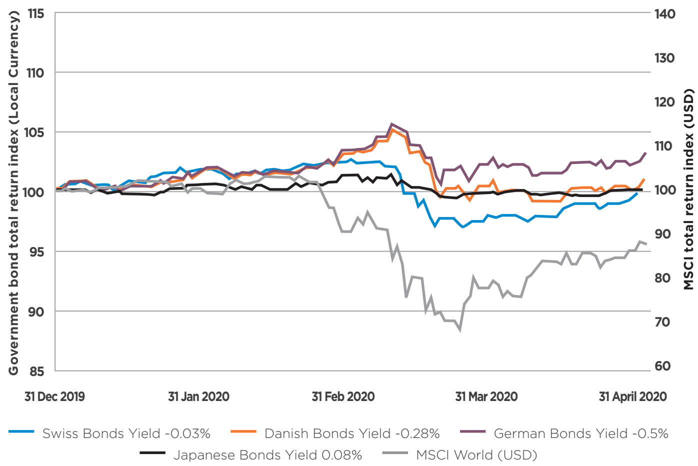
In contrast, when we look at how negative-yielding bonds performed at the same juncture, we see a very different picture. Chart 3 shows that these bonds yielded no return at all, and in some cases yielded a negative return. The correlation between bonds rising as equity markets fall breaks down in this scenario, and these bonds failed to protect their investors.

Chart 2: Positive yielding sovereign bonds perform as expected



Yield to Maturity as at 6th July 2020. Source: MSCI and Bloomberg.

Chart 3: Limited benefit from negative-yielding bonds



Yield to Maturity as at 6th July 2020. Source: MSCI and Bloomberg.

The Sanlam View

In the face of an unprecedented level of monetary stimulus and a recession worse than any we have ever known, it's clear that government bonds have indeed lost their appeal. For now, at least, we will need to look elsewhere for a hedge against equities and other riskier assets. As we discussed earlier, we are looking towards gold, absolute-return strategies and real assets to do that for us, albeit with slightly more risk than a government bond.

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