Sanlam

Wealth

A monthly market outlook from the Wealthsmiths™

September 2020

A complex investment landscape as valuations rise and returns fall

Equity and fixed income markets sustained their remarkable recovery last month thanks to continued government funding. But as prices rose, potential returns fell, and value became harder to find. Meanwhile, the US dollar weakened, and sterling-based investors experienced negative returns on investments with dollar earnings and US exposure, which is adding further complexity to an already challenging outlook.

Equities are expensive but remain the asset class of choice

As a result of equity markets seemingly shrugging off the Covid-19 crisis, valuations are back to where they were at the start of the year, and opportunities are hard to find as investors flock to the relative safe haven of value stocks. Take Apple, for example. Previously their shares traded at approximately 10 times their earnings, but currently they are trading at 30 times their earnings, meaning they are going to have to achieve significant growth to justify such a valuation.

But given the outlook for global economic growth is subdued, and the opportunity for companies to achieve significant earnings growth is limited, investors may well be setting themselves up for a disappointment. The trouble is – they have nowhere else to turn and taking increased risk in search of return has become par for the course.

A fast recovery for fixed income

This has been exacerbated by fixed income markets also making an impressive recovery, which has diminished future returns. High yield bond spreads are narrowing, and government bond yields are zero. Investors really need to do their homework and choose wisely, since there is a high risk of default.

The Sanlam approach

Stock selection is key in equities as there will be few winners and many struggling companies. We will keep some of our equity exposure in essential infrastructure while maintaining a focus on resilient, well capitalised businesses. This is balanced by investment in absolute return strategies, which seek to capitalise on market volatility and earn a positive return regardless of whether markets are going up or down. We are also managing our exposure to companies that earn revenue and profits in the US, the reasons for which are explained in more detail in our Investment View.

> Equities are priced to deliver modest returns with limited margin for safety. This is making stock selection very important as companies are prone to disappointing market expectations. Investors are increasingly having to accept credit risk to obtain reasonable long-term returns.

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11.6%

The amount the US Dollar has fallen against Pound Sterling since 18th March 2020.

Source: Morningstar, 20th August 2020

Investment view:
Should we be worried about the US?

The United States has long been the powerhouse of the global economy, and the US dollar has been the world's go-to reserve currency for nearly 50 years. A change to that status would have significant repercussions for us all. So, as the US Dollar continues to lose value, investors are well advised to be mindful of the implications.

Could the US dollar lose reserve currency status?

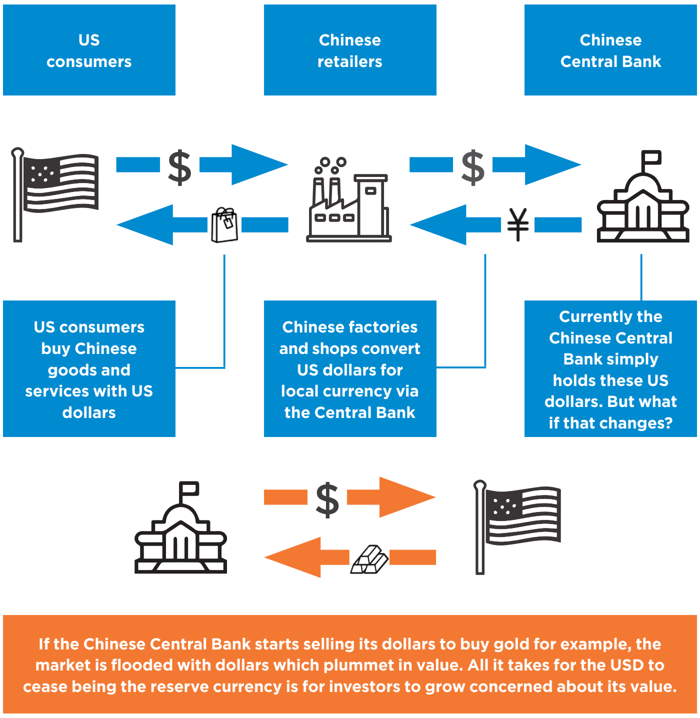
Being a reserve currency means the US Dollar is held in large quantities by central banks and large financial institutions around the world. That's because it is seen as stable, and likely to retain its value. But what happens if those central banks and financial institutions lose faith in it? If they start offloading the US Dollar in significant quantities, perhaps buying cheaper currencies such as the Euro or investing in gold, it will rapidly devalue and could lose its reserve currency status. While the likelihood of this happening is low, it is a risk nonetheless, and one we must take seriously since it would result in a major shift in the global economy.

What threatens the status quo?

A significant threat to the US Dollar is China. For many years, the US and China have had a mutually beneficial arrangement, whereby the US has bought cheap, mass-produced products from China to fuel consumerism, and has paid for those products in US Dollars. The Americans have effectively lived beyond their means by giving up wealth to consume more than they produce, while the Chinese have acquired that wealth by consuming less than they produce.

With political risks at large, the Chinese Central Bank could start selling its US dollars, effectively flooding the market, and rapidly devaluing the currency. Worryingly, if the US Dollar continues to depreciate against other major currencies, the Federal Reserve has limited resources to restore confidence thanks to its aggressive monetary easing.

But it's not all bad news. A weaker dollar restores US trade competitiveness, and they remain dynamic leaders in important industries such as technology, pharmaceuticals, and healthcare. And let's face it, realistically there is no clear alternative currency.



The Sanlam approach

While the probability of the US losing its reserve status is low, it would have a very high impact on our investors, so we must account for it within our portfolios. We need to look carefully at companies that produce earnings in dollars and have US exposure. To mitigate the risk, we will instead consider investing in companies that provide goods and services to creditor nations, such as Europe, Japan, China, and Emerging Market economies.