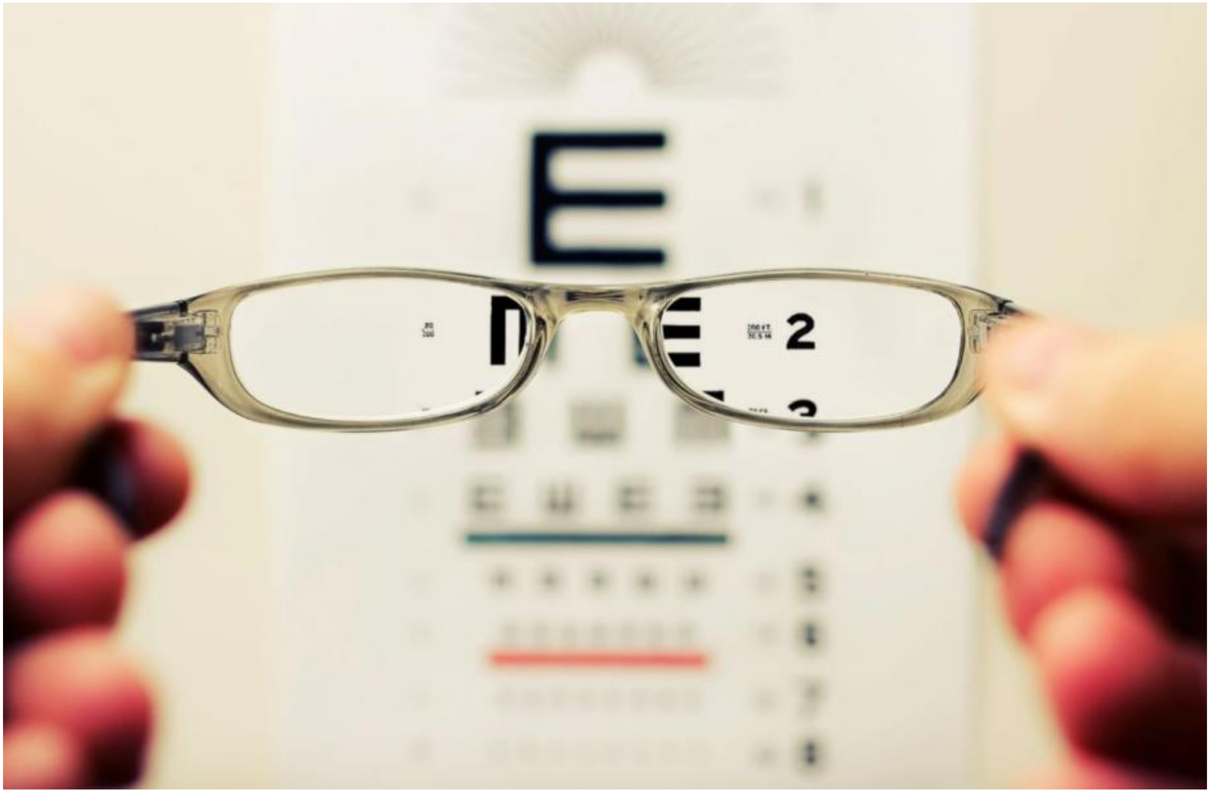
Rathbones Investment Update Q4 2020: Time to put on the varifocals

Depending on what lens you choose, the value of equities can vary widely. We've looked through as many as we can, and we're maintaining a vigilant optimism.



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Should investors view value through the lens of economic output and related profits, or through a lens that's relative to the money supply? Through the first lens, it might look like the rally in global stock markets has become too disconnected from economic reality; through the second, they might appear not to have rallied far enough. For example, the ratio of US market capitalisation to GDP (one of Warren Buffet's favourite indicators of value) is near all-time highs (value is at all-time lows). But place money supply (M2) in the denominator, and the ratio is around the 100-year average.

Two lenses are better than one

We embrace a pluralistic approach. We want to look through as many lenses as we can. Omitted variables can be a large source of bias in financial forecasting. That means acknowledging that plentiful liquidity is supporting equity markets, driving down opportunity costs, forcing investors up the risk curve to satisfy their required returns, and focusing investor psychologies on that terrible acronym TINA – there is no alternative. Plentiful liquidity is also driving down firms' cost of capital. Even after the second quarter's extraordinary collapse in output, aggregate return on invested capital is still likely to be comfortably above corporate borrowing costs this year (although this will vary greatly between sectors and companies). When this aggregate spread is positive, equities tend to outperform bonds and cash. With central banks becoming even more dovish we expect more monetary stimulus, especially from America, which would be positive for risk assets. Central banks also have an enormous amount of unused capacity available for alleviating any renewed stress in financial conditions. That should also keep corporate borrowing costs low even if the economic environment deteriorates again.

So for all those reasons – and because markets have so far weathered a second wave of COVID-19 in many major countries, such as the US and Japan – we don't think this is a good time to take money out of risk assets.

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Running out of steam?

At the same time, we see a heightened risk of a market set-back. For that reason, our assessment of the risk-reward trade-off over the next six months warrants cautious positioning and a bias towards 'growth' and 'quality'. There is considerable scope for the economic recovery to stutter, and for data to disappoint investors' expectations. It may not, but the huge uncertainty over how this unprecedented recession will play out means that the risks are elevated. This is especially the case given that consensus earnings expectations are for 2021 profits to exceed 2019's in all global sectors bar finance and real estate. Rathbones' equity analysts are sceptical of many of the industry-wide forecasts for 2021 earnings.

We also note that there are already some signs that the initial recovery may be running out of steam, especially in Europe. There isn't enough data yet to firmly conclude a change in trend, but these initial signs certainly add to the risks. Global PMI surveys of business confidence confirm a slower pace of improvement. In many economies, the manufacturing PMI in particular has fallen back into contractionary territory, while industrial production remains 5-10% below pre-COVID levels. Ordinarily, PMI surveys would send persistent positive signals for many months after their recessionary lows. This is no ordinary recovery. After a resurgent May and June, retail sales in many countries contracted in July, and again in America in August. Sure, retail sales may have already recovered their losses from the second quarter, but they only account for around a third of total consumer spending. And with spending on consumer services still depressed, retail sales need to continue to provide some offset. The Conference Board, the respected American think tank, expects its much-watched Leading Economic Indicator to weaken substantially during the final months of 2020.

Unemployment continues to be the biggest risk. To be sure, equity markets historically recover from recessions when unemployment is still high. But that's because markets see the green shoots in the leading indicators of activity and assume that unemployment will soon start to fall in the linear and consistent manner that it has invariably done before. It is conceivable that unemployment may get stuck this time, however. It may even increase again in the fourth quarter if a significant number of temporarily laid off or furloughed staff aren't re-employed. We see a few worrying signs under the bonnet of the US employment data. US unemployment has fallen quickly from a peak rate of 14.7% to 8.4%. Excluding those labelling themselves "temporarily unemployed", however, unemployment is still creeping up. Counting only those who have been unemployed for between 15 and 26 weeks – broadly, those laid off because of the pandemic – the unemployment rate rose in August to double the peak seen in the global financial crisis. If these people move into the next cohort – unemployed for more than 27 weeks – then history suggests they may find it difficult to ever find a new job, which would be a significant headwind to a continuing recovery. The latest Census Bureau Pulse Survey found 87% of small businesses that had laid off workers are struggling to rehire them because of the lingering health crisis.

Favouring growth and quality

Drawing all of this together – the plentiful liquidity and low cost of capital together with the heightened macroeconomic risks seemingly underappreciated by market valuations – we believe it makes sense to remain broadly invested but with a continued preference for growth and quality cyclical companies. In our last quarter-end outlook, we explained why we are unperturbed by their relatively expensive valuations. In aggregate, our analysis suggests that growth stocks are not as prone to following the overall market as less pricy 'value' stocks (they have a lower beta), hold less debt, appear more immune to the bankruptcy cycle, and are less exposed to geopolitical risks. We believe their high valuations are underpinned by the increasing scarcity of growth opportunities and a flat yield curve (little difference between short and long-term yields, suggesting inflation and interest rates are expected to stay low into the foreseeable future). Despite the volatility in some high-profile technology names at the beginning of September, growth indices remain near all-time highs relative to value indices.

Brexit is about to mean Brexit

The pound has declined by about 5% versus the dollar over the last few weeks, and our analysis suggests that's been driven predominantly by the rising probability of a 'no-deal' Brexit. With just four weeks to go until the official deadline, the betting markets now assign a 51% chance of 'no deal'. We agree that it's too close to call. Oxford Economics estimates that a 'no deal' would lower UK GDP by c.1 percentage point by the end of 2022 relative to its current baseline of Brexit with a free-trade agreement. The risks are to the downside, however, given the backdrop of a massive recessionary shock and the UK's fragile consumer services and hospitality sectors. Britain may also struggle to sign new trade deals with other countries to offset trade and productivity losses if the government is seen to be breaking international law by reneging on agreements about running state aid/subsidies after it leaves the EU. State aid and the principle of fair competition is a prominent feature of all trade deals and one on which negotiations often get stuck.

We would expect a 'no-deal' Brexit to cause considerable volatility in the pound. Under former Governor Mark Carney, the Bank of England sat on the fence when pressed on the appropriate policy response to 'no deal', because it was uncertain about whether it would be more of a supply shock than a demand shock. Under Governor Andrew Bailey, the Bank appears to be taking a more dovish view, so more stimulus could be expected, particularly as the Treasury lessens some key fiscal policy supports (e.g. replacing the furlough scheme and the talk of tax rises). This could add to downward pressure on the pound.

The poor performance of the UK since the referendum is well known, as is the high likelihood that leaving the EU with or without Prime Minister Boris Johnson's deal will make the UK relatively worse off. Most independent economic researchers forecast that UK GDP, relative to current arrangements, will be between 3% and 6% worse off in seven to 10 years if the UK and EU sign a free trade agreement. The Treasury was even more pessimistic in its 2018 assessment, but this view is old news and widely held. That's why the pound has fallen by 15-20% since 2015. Today, the crucial question is: will the UK's already rather poor economic performance become so much worse relative to the rest of the world that its exchange rate looks overvalued? Our analysis suggests not. But this is a long-term assessment. Exchange rates are volatile beasts, impossible to forecast over the short term with any conviction, and there is a significant risk that the pound would fall sharply if a 'no-deal' Brexit were confirmed.

We will write to you again when negotiations have been concluded.

Abe resigns, his legacy continues

Japanese equities have performed relatively well this year. We believe their resilience is attributable to a combination of stable dividends, a high proportion of stocks in favourable sectors, a weaker yen and exposure to growth and quality factors (especially low leverage and high cash balances).

Neither the equity market nor the yen were disturbed by the news of former Prime Minister Shinzo Abe's sudden health-related resignation. We believe investors were right to be sanguine. Paradoxically, Mr Abe's resignation makes it more likely that his policies – broadly viewed as a major reason for Japan's relative success over the last 10 years – will continue beyond 2021, when he was due to step down anyway, than if he had carried on. That's because there would have been a full leadership contest, with votes cast by the 1.09 million rank-and-file party members. But, due to COVID-19, the leadership was elected by the party's 394 lawmakers and 141 prefectural representatives. That secured the top spot for Chief Cabinet Secretary Yoshihide Suga, Mr Abe's right-hand man.

Through a combination of loose monetary policy and structural reform, ‘Abenomics’ has successfully supported large firms. The gap between Japanese return on assets and that of other major markets is historically narrow. Profitability has been improving, companies are increasingly expanding overseas, and there is a greater belief that a sharp appreciation of the yen won’t happen again. Good corporate governance is well baked in and has strong backing within the key regulatory agencies and ministries.

To be sure, Abenomics has not been an unqualified success. It has failed to generate positive feedback between the corporate and household sectors. Disappointing wage rises have resulted in secular stagnation in household incomes and domestic demand. A series of structural reforms to raise productivity and economic dynamism, especially those tackling labour market rigidities, have yet to bear fruit. The entry and exit of firms also remain anaemic which indicates that economic dynamism is still missing. Mr Suga’s previous role as a backroom official makes his policy positions unclear. His inaugural speech gave little away, but he did focus on reforming and digitalising cities, which should make for some attractive growth opportunities.

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Emerging markets and COVID-19

That many Asian countries have weathered the pandemic better than many of their developed market counterparts has led some commentators to speak more positively about emerging market (EM) assets. For sure, EM equities are relatively cheap on common valuation metrics such as prices relative to earnings, but as we have written before this metric isn’t that helpful when it comes to geographic allocation. Some of the extraordinary amount of money created by central banks in the developed world this year will find its way into emerging markets, particularly as yield repression pushes investors into riskier assets over time. The dollar is overvalued and with US fiscal and monetary policy becoming relatively looser, it may start to weaken. That would be a boon for emerging market firms who tend to borrow heavily in dollars. And emerging markets are likely to deliver greater economic growth than their developed counterparts over the next two years.

However, broadly speaking, we are much more circumspect. Emerging equities have underperformed the developed market benchmark almost every year since 2011. Their economies may offer stronger growth, but if market expectations are unrealistic about how strong that growth will actually be, then their stock markets will underperform. Furthermore, emerging markets depend more on trade, and the cyclical and structural outlook for trade is worse than it is for GDP. If the global economic recovery falters, emerging markets are less able to deliver effective stimulus than developed economies, due to the large number of people employed informally or who don’t have a bank account. Similarly, they are less well placed to deliver a vaccine effectively (especially as it is likely a vaccine will require a coordinated two-shot delivery). We would need to be more certain about the strength of the global recovery to upgrade our view.

A new president for America?

Six weeks ago, the betting markets gave Joe Biden a greater than 60% chance of taking the keys to the White House. But that's all changed. Mr Biden's odds are now only slightly better than Mr Trump's. Considering the margin of error, it's too close to call.

Is it, "The economy, stupid"?

Our analysis suggests that the single best predictor of American presidential elections is the economy. Inspired by the work of Yale economics professor Ray Fair, we developed an econometric model based on the outcomes of the last 10 elections at state level. Given the extraordinary nature of the COVID recession, in which unprecedented fiscal support caused personal income per capita to increase dramatically, the model was suggesting Mr Trump was still in a good position, so long as something didn't happen in Q3 to decimate GDP or cause unemployment to spike. Even employing alternative specifications to avoid the distortion, Mr Trump's chances are still good.

Or is it, "The virus, stupid"?

Could this be a rare election in which something else is more prominent in voters' minds than the economy? With 70% of Americans at the end of August still either "very" or "somewhat" worried about infection from COVID, and with only 40% of independent voters approving of the way Mr Trump has responded to the health crisis, it is unsurprising that Mr Biden is giving the virus top billing. His chances are maximised if he can keep voter attention focused away from the economy.

As we noted in "Biden his time", an article in our last Investment*Insights*, some of the least market-friendly Democratic policies are less likely to be enacted. That's because they would need to win both the presidency and control of the Senate. The odds of a Democrat 'clean sweep' (White House, Senate, House) are unclear. They have improved considerably recently to 50/50, according to PredictIt, a relatively untested politics betting website, yet Washington insiders think they are much lower. And on foreign policy towards China, the US's largest trading partner, and plans to spend big on infrastructure, Mr Biden is not too dissimilar to his rival. Meanwhile, an unresolvable election is only a small risk, in our opinion, yet it could trigger a large market reaction, potentially worse than if the Democrats make a clean sweep. So a clear-cut victory for either candidate is probably the best outcome to hope for.