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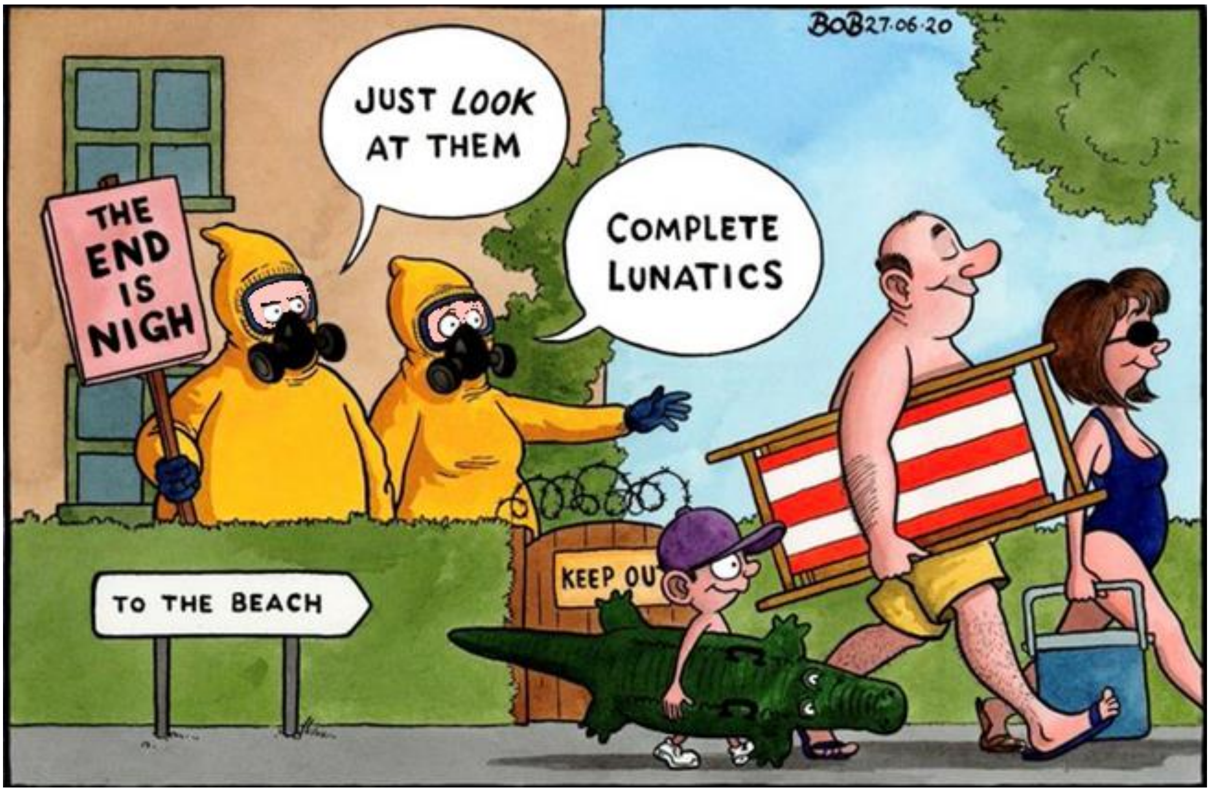

Which way to go?, Bob Moran, 27 June 2020

H1 2020 offers meaningful lessons

So we begin the second half of 2020, leaving behind us two of the most extraordinary calendar quarters in history. But the difference in experience from an investment perspective versus the general public and most of the economy could hardly be any more stark. Capital markets suffered the most rapid and one of the deepest bear markets in Q1, only to be followed by one of the highest ever recorded quarterly stock market gains in history (please see the table of asset class returns in the second article). The general public, and the economy in general, on the other hand spent Q2 bearing the full impact of the COVID-19 lockdowns. We review the last quarter in the context of the year so far in our next article: *Walking the tightrope: a quarter in review,* but most investors with globally-diversified investments would probably agree that as things stand right now, their portfolios have experienced a much better time than they have had personally.

Capital markets have not yet turned positive for the year across the board, but broadly speaking, on a 12-month basis, most portfolios are no longer showing losses. This stands in stark contrast with the state of economies around the world. After suffering the most severe downturn in history, much uncertainty remains over whether the steep economic recovery we have witnessed over the course of the past months will continue on the hoped-for V-shaped path, or will peter out into what would look like the mirror image of a square root sign (√). We should know more at the end of the summer and, in the meantime, we can take heart from the fact that the lack of monetary liquidity that drove markets to March's depths has turned to an abundance that is very hard to ignore.

Whether the current expectation of a gradual but near certain global recovery is misplaced or justified will, to a large extent, depend on whether those sectors of the economy that depend on social proximity for earning a living – and they make up a considerable proportion of western economies – can return to providing their services sooner rather than later. We have discussed the various factors determining this on these pages over the last weeks, but needless to say success in the coming months depends on the resilience of western societies against a return of high infection rates and, looking to end of the year, the arrival and efficacy of the many promising vaccines currently under development.

The news of the past week has been that the rebound in industrial production around the world has been far stronger and much more V-shaped than hoped for. Indeed, global manufacturing sentiment has already returned to where it was in February. Given manufacturing had been flagging somewhat last year, that is good news but also makes the recovery of hospitality, leisure and travel within the services sector all the more important.

Government investment programmes as announced on a daily basis around the world will help to accelerate the recovery of broader economic activity level and should counterbalance the loss of GDP in the services sector, but will only provide very limited employment alternatives to affected staff. A selective continuation of furlough programmes to support those sectors will therefore be crucial to prevent the current COVID recession developing into a classic recession on the back of unemployment. We noted the UK government's "*build, build, build*" initiative announcement as one such positive, but given the Prime Minister only mentioned a meagre £5 billion, while hinting at more to be forthcoming next week from his Chancellor, we decided to leave a deeper analysis until then.

On 'second-wave' concerns, it would appear that thus far only those regions that did not experience high infection rates in the first wave appear to be prone to a rebound in infection rates. The dynamics of the regional spreading in the US are reasonable evidence for this. It is also encouraging that, despite much more elevated infection rates in those southern and western US states that lifted lockdown before they had even suffered a first wave, there does not appear to be a proportional increase in fatalities. If it stays that way, it would be a clear indication that the medical profession is rapidly learning how to prevent severe COVID-19 cases from turning fatal – another point to suggest that even if a second wave was to hit, we do not have to necessarily expect a repeat of the lockdown experience of the past three months.

Unfortunately, geopolitical concerns are not instilling us with similar levels of optimism. China's decision to (mis-)behave – like all superpowers have historically – makes us nervous about its longer-term economic growth potential and we discuss this in the third article this week. On the other hand, Donald Trump's declining level of public support in the US, and Russia's increasing volume of Trump-mocking rhetoric, has us wondering whether his predictable campaign against foreign powers using sanctions and tariffs may be redirected from China towards Russia. Such tactics would be economically rational given the US economy is hardly dependent on Russia. After all, a swift US recovery may be quite dependent on access to cheap Chinese goods. We will watch and wait whether the message is getting through to the erratic US president before we turn as optimistic on the US as we recently have on the rebounding European economy.

Walking the tightrope: a quarter in review

We are halfway through the most disturbing year in generations and that much-used word won't go away: unprecedented. Over the course of the first quarter, it became steadily more probable that the coronavirus crisis that had started in China would engulf everything around us. In late February, stock markets finally faced up to the inevitable and nose-dived. Investors' mad dash for the exit accelerated throughout March, turning the sell-off into a sell-out of tradeable financial assets, resulting in the most rapid stock market crash on record.

In Q2, the global lockdown fears that had pushed equities off a cliff became reality and the world economy followed stock markets, falling into the fastest and deepest recession in history. And yet, once central banks pledged open-ended amounts of emergency liquidity to capital markets, the 'dash for cash' ended just as abruptly. Global stock markets regained their composure and climbed higher, based on the insight that Q1's illiquidity fears had driven markets lower than even a severe recession would justify.

Asset class returns as per 30 June 2020

Asset Class	Index	Q2/2020	Q1/2020	YTD	2019	3-yr to 30/6 annualised	June
Commodities	Brent Crude Oil Price	57.2	-57.3	-33.0	17.9	-5.4	9.1
Equities	NASDAQ Composite (US Technology)**	31.4	-4.2	20.8	31.4	19.1	6.1
Equities	S&P 500 (USA)	21.0	-14.1	3.9	26.4	12.6	2.0
Equities	MSCI All Countries World	19.6	-16.0	0.5	21.7	6.1	3.3
Equities	MSCI Emerging Markets	18.5	-18.4	-3.3	13.8	1.9	7.4
Equities	MSCI Europe ex-UK	18.1	-17.5	-2.6	20.0	1.8	4.9
Equities	Nikkei 225 (Japan)	12.0	-11.1	-0.4	15.0	1.6	0.0
Commodities	Goldman Sachs Commodity Index	10.9	-38.4	-31.7	13.1	-8.7	5.1
Commodities	LBMA Spot Gold Price	10.7	12.6	24.7	14.2	12.5	2.7
Equities	FTSE 100 (UK)	9.1	-23.8	-16.9	17.3	-1.6	1.7
Bonds	£-Sterling Corporate Bond Index	9.0	-5.6	2.9	11.0	4.5	1.6
Equities	FTSE4Good 50 (UK Ethical Index)	8.2	-23.7	-17.4	13.9	-3.7	1.5
Bonds	Barclays Global Aggregate Bond Index	3.7	6.5	10.4	2.7	5.5	0.9
Bonds	FTSE Gilts All Stocks	2.5	6.3	8.9	6.9	5.9	-0.6
Cash rates	Libor 3 month GBP	0.2	0.2	0.4	0.9	0.7	0.0
Inflation	UK Consumer Price Index (annual rate)*	-0.2	0.1	-0.1	1.3	-	-0.2
Property	UK Commercial Property (IA Sector)*	-1.3	0.4	-2.9	-0.8	0.9	-1.1

Data sourced from Morningstar as at 30/06/20. All returns in GBP
**** to end of previous month (31/05/20).; ** Nasdaq 100 for Q1/2020***

What began as a rebound from a market overreaction turned into a full-on bull market during Q2, which many high-profile commentators and investors are labelling as much a dislocation between the 2020 COVID-19 economic fundamentals and markets as the Q1 market crash was at the other end of the spectrum. Yet what all these comments fail to recognise is that both sides of this year's extraordinary market gyrations have been amplified like never before by swings in actual and perceived monetary liquidity.

In late February and March, the existential fear of so many investors was that the available liquidity would not be enough. But since April, confidence has held firm that whatever stresses may bear down on the world economy, lack of money will not be one of them. It is true that central banks were at the heart of this incredible reversal of sentiment, but the notion that the market recovery has been entirely on the back of central banks' money creation fails to recognise that their actions unlocked and brought back private investor liquidity in even larger volumes.

As a result, and despite the economic hardship of the global lockdown containment unfolding beneath them, equities experienced one of their best quarters on record.

In the US, the technology-heavy NASDAQ saw its best quarterly percentage return since 2001, the S&P 500 its best since 1998 and the Dow Jones Industrials index its best since 1987. Oil prices, which sunk to incredible depths after a production war between suppliers just as demand was vanishing, climbed an eye-watering 57.2%. This is despite the US oil futures market registering one of the most extraordinary market events of many a year. Prices briefly turned negative, as maxed-out storage forced contract holders to pay others to take the oil off their hands.

Central banks remain committed to keeping capital markets awash with cash, come what may. They achieve this predominantly by buying up government and corporate bonds with money they create. Those who are selling their bonds to the central banks are left with an abundance of released capital which, by the simple rules of supply and demand, pushes down and keeps the cost of capital at the lowest levels known in recent history. This has afforded governments free rein to expand their fiscal programs and plug the gap between now and normality, safe in the knowledge that whatever debt they issue will not saddle their budgets with painful interest burdens for the foreseeable future. What has turned 'risk-free' government bonds also 'return-free' has made equities look attractive by comparison, just as long as the prospect of economic growth returning eventually remains viable, and corporate defaults are kept to a minimum as pledged by governments and central banks. As such, equities have been boosted by even mild recovery news.

On a regional level, our big call for Q2 was that emerging markets would fare better than developed markets. This was mainly based on the positive outlook for China, whose assets account for around a third of the MSCI EM index (and much more in many actively managed EM funds) and which came out of its lockdown while the rest of the world entered it. Domestic fiscal and monetary support meant it could provide demand for exports from surrounding countries in Asia, despite a drop-off in global demand. Sure enough, the MSCI EM index returned 18.5% over the last three months, with a 7.4% jump in June alone.

Looking ahead, that positive case has waned somewhat. That early advantage has mostly gone as other major regions – particularly the European Union (EU) – have also opened up, and China's reluctance to pump up their already notorious credit bubble with further liquidity has led to less supportive financial conditions there than elsewhere. Meanwhile, the political risks around China have increased dramatically. Human rights crackdowns in Xinjiang, and the recent effective end to Hong Kong's autonomy, have ratcheted-up tensions with China's largest trading partners. US legislators have already passed multiple anti-China bills with more on the way, and other nations look set to follow suit.

From an investment perspective, we note the difference here with Europe, where economic policies have been surprisingly strong and supportive, and political risks have subsided. Not only has the European Central Bank made monetary policy as supportive as possible, but there has been genuine progress towards a coordinated fiscal response for the first time in years. Europe is also similarly export-heavy, and so should be in a prime position to take advantage of any rebound in global activity. As such, the positive sentiment now seems to be shifting from China and wider emerging markets to Europe.

We are still optimistic for the US economy, but cautiously so. The US Federal Reserve has continued to boost liquidity, but has slowed the pace of its injections. It has achieved the turn in investor sentiment it set out to and is now aiming to find the balance between what continuous support is required and what might cause 'malinvestment issues' further down the line. The added complication, however, is that those US states that had relatively few coronavirus cases earlier in the year are now experiencing worrisome increases, a consequence of easing lockdowns before the first wave of infections had swept across them. Interestingly, we note that expectations for November's presidential election has had little or no impact on capital markets – with investors seemingly indifferent between the two candidates. Instead, how well the authorities can contain local outbreaks – and how quickly company earnings can bounce back post-lockdown – will probably dictate markets from here.

The same is true for most of the world. With markets swimming in liquidity – and just a small proportion of private investor liquidity having been unlocked by the shift in sentiment – it is now all about earnings improvements. Current analyst expectations are that we will have to wait until the end of 2021 before earnings are back at late 2019 levels. Signs of a faster rebound should send markets higher, even at elevated valuations. But signs of a slower recovery could send markets down again.

For China as a superpower, global disapproval comes with the territory

The national security law that China imposed on Hong Kong this week might be Beijing's boldest political decision in years. For some time, the Communist Party has been chipping away at the "one country, two systems" principle contained in the 1984 Sino-British Joint Declaration. It has now smashed it to pieces in one fell swoop. By granting itself sweeping powers to imprison Hong Kong citizens for life over vague sedition charges, Beijing has declared (not just to Hong Kong but the world) that there is one country, one system, one party.

State media has portrayed the law as a necessary response to unrest, targeting only an extreme minority. But, as demonstrated by the millions in the streets and a landslide victory in November's local elections, pro-democracy activists have majority support. Those activists are well aware what the law means for their own movement. Pro-democracy group Demosisto has now disbanded, and one activist has skipped bail and fled the city, fearing his own safety.

Since the 1997 handover, Hong Kong has been an international gateway in and out of China. But with autonomy now effectively ended, its future as an incredibly beneficial hub for international trade and finance for both sides is in serious doubt. The US has ended the region's special trading status as of 30 June, and the British government has offered a route to citizenship for around three million Hong Kong citizens, with other countries following suit. Hong Kong businesses with a focus on China's vast domestic market will have little choice but to accept the new environment, but those with a more international focus may well prefer a move to non-Chinese commercial centres in East Asia, like Singapore, Taipei or Seoul.

For China, what is most staggering is that this reaction was fully expected – but Beijing decided it was a risk worth taking. The Communist Party has never been a stranger to international scorn (last month was, after all, the 31st anniversary of the Tiananmen Square massacre). In recent years, though, China has become even less concerned about how its actions are perceived. The People's Republic has intensified its military control of the South China Sea, and last month entered a deadly border skirmish with India. Just last week, reports pointed to sterilisation and forced birth control of the Uighur Muslims in Xinjiang, over a million of whom are still imprisoned in Chinese re-education camps.

As brutal as those moves are, none have generated the worldwide focus that (economically important) Hong Kong has. In the discussions leading up to the 1984 agreement, the British government successfully convinced China that keeping the city free was in its interest – after Deng Xiaoping told Margaret Thatcher that he could "walk in and take the whole thing" that afternoon.

It may be that Beijing feared that Hong Kong's explicit dissent could provoke similar outbursts on mainland China. It may be that the consequences of the trade tussles and the virus aftermath created opportunity. Either way, Beijing has decided that its interests have changed, and that its economic, military and political clout is enough to withstand any negative fallout from its actions.

It could well be wrong. The US, China's largest trading partner, has already passed multiple bills against Chinese businesses and there is now strong anti-China sentiment in both American political parties. Donald Trump has made China-bashing a pillar of his presidency, but his election opponent Joe Biden has recently tried to out-tough him on China. With the election now just four months away, and China not backing down, further sanctions look likely.

On the other hand, the pandemic-induced global recession could ease the pressure on China in the short term. China is tightly weaved into the fabric of the global economy, and with governments desperate to avoid a lengthy and damaging downturn, they may have no choice but to deal with Chinese businesses for the foreseeable future.

For all the bad press China has received in western media recently, its exports seem to be relatively unaffected. Having gone through their strict lockdown earlier than most, Chinese companies have now started up production strongly. But with other countries having cut back consumption throughout lockdown, inventories have built up significantly. The global economy has begun whirring again, and so China is now pushing its inventory stock out and increasing its exports dramatically. This can be seen in the rise in the Baltic freight indices, measuring the price of shipping. In stock market terms, the Shanghai Composite index is one of the few major equity indices to see (slightly, at the time of writing) positive returns for the year so far.

That is why our economic outlook for China in the short-term is still positive, despite the political headlines. But over the medium and long-term, things are more complicated. Wider-reaching sanctions – or stealth sanctions in form of regulatory changes in the western world – remain a threat. So multi-nationals will have to think about supply chain diversification, to remain flexible or at least establish the resilience that has been so lacking over the COVID-19 crisis. China also seems prepared to stick to its previous aim of opening up China's capital markets. But what risk premia should foreign investors attach to Chinese assets?

Furthermore, there are a few question marks regarding China's growth model. In recent years China has successfully shifted the driver of its growth model from export-led to domestic-led demand. However, domestic debt has been building up, and Chinese leaders are highly aware of it – hence their reluctance to go for a 'bazooka-style liquidity' boost in their current post-COVID environment. China could deal with these domestic imbalances internally, but it would be much easier with the help of continued export growth. And here, it's not only sanctions which are an issue. The very personal impact of the COVID crisis on every global consumer potentially bestows a formidable marketing issue on Chinese products. China's President Xi Jinping has stated he wants to escape the "middle income trap" and climb up the prosperity ladder by becoming a leading player in global research and development. Again, while a lot can be achieved in its vast domestic market, international co-operation and spillovers (an economic event when one condition positively influences another seemingly unrelated event) are vital to support innovation. Regarding multinational corporations, China will, of course, retain its attraction of being a huge market, on which many corporates globally depend to generate growth.

When it comes to China, two things are often taken for granted. First, that its economy will inevitably become the world's largest. And second, that its investment universe would inevitably be integrated into the western financial system. But both of those things require that the country maintains strong trade links with the rest of the world. Even with China's impressive recent strengthening of its domestic economy, the stellar growth seen over the last two decades cannot continue if it becomes decoupled from its major trading partners. And, while there has been huge demand for Chinese domestic assets from overseas investors, that demand could be dented if those assets come with big political risks. That fear will prove particularly valid should it mean the free flow of capital is restricted as a consequence.

Those are the risks China faces on its current course. Under Xi Jinping, the country seems happy to take them, perhaps assuming that achieving superpower status means it can get away with latent negative global sentiment, just as the US did for so many decades. As with many governments, continued electoral support hinges greatly on a successful recovery from the COVID recession. Taking those risks will likely pay off for Xi over the short-term, but the long-term picture looks far less certain.

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6th July 2020

Global Equity Markets

Market	Fri 15:34	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6158.9	-0.0	-0.4	↗	↘
FTSE 250	17307	1.1	193.6	↗	↘
FTSE AS	3412.9	0.2	6.5	↗	↘
FTSE Small	5051.0	0.4	22.1	↗	⇘
CAC	5003.7	1.9	94.1	↗	↘
DAX	12540.7	3.7	451.3	↗	→
Dow	25827	0.3	81.8	↗	→
S&P 500	3130.0	1.5	46.2	↗	⇗
Nasdaq	10207.6	1.9	190.6	↗	↗
Nikkei	22306.5	-0.9	-205.6	↗	→
MSCI World	2227.7	3.3	70.5	↗	→
MSCI EM	1023.5	2.5	24.6	↗	→

Top 5 Gainers

Company	%
Whitbread	8.7
easyJet	7.7
TUI	7.3
Smiths	7.0
Assoc. Brit. Foods	6.5

Top 5 Decliners

Company	%
DS Smith	-10.2
Hargreaves Lansdown	-5.7
J Sainsbury	-4.9
Rolls-Royce	-4.5
Unilever	-4.2

Currencies

Pair	last	%1W
USD/GBP	1.245	1.0
GBP/EUR	0.903	0.8
USD/EUR	1.12	0.2
JPY/USD	107.50	-0.3
CNY/USD	7.07	0.2
Bitcoin/$	9,093	-1.1

Commodities

Cmdty	last	%1W
Oil	42.49	3.6
Gold	1774.3	0.2
Silver	18.02	1.2
Copper	270.8	1.8
Aluminium	1621.0	3.2
Soft Cmdties	334.9	-0.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.19	+0.02
UK 15-Yr	0.41	+0.01
US 10-Yr	0.67	+0.03
French 10-Yr	-0.11	+0.02
German 10-Yr	-0.43	+0.05
Japanese 10-Yr	0.03	+0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	22.2	18.5	13.5
FTSE 250	3.0	22.9	24.1	14.4
FTSE AS	4.2	23.6	19.1	13.6
FTSE Small	3.9	13.3	-	13.8
CAC	2.1	20.1	22.9	13.7
DAX	3.0	23.7	19.6	12.7
Dow	2.5	19.2	23.5	15.3
S&P 500	1.9	22.4	24.9	16.3
Nasdaq	0.8	32.4	30.5	18.4
Nikkei	1.9	26.2	21.6	16.9
MSCI World	2.2	21.9	23.2	15.5
MSCI EM	2.6	16.9	16.6	12.0

UK Mortgage Rates

Mortgage Rates	Mar	Jan
Base Rate Tracker	2.19	2.17
2-yr Fixed Rate	1.42	1.39
3-yr Fixed Rate	1.68	1.65
5-yr Fixed Rate	1.70	1.68
10-yr Fixed Rate	2.37	2.38
Standard Variable	3.66	3.66

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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6th July 2020

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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