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Graeme Keyes' outlook to the new year, 16 Dec 2020

Goodbye to all that

December usually has a ring of 'Silent Night' in the investment world and, in a year where practically all else has changed, at least this has stayed the same. In the UK, news that millions more would be placed under tougher restrictions over the Christmas period may have felt deflating, but it was hardly unexpected and failed to get a peep out of capital markets.

The same goes for the other big headlines of the past week. Brexit negotiations were yet again kicked down the road, now with the European Parliament declaring that a deal must be agreed by Sunday to have any hope of being ratified in time (with a fiery look in their eyes saying *this time we really mean it*). The US election officially ended, with the Electoral College confirming President-elect Joe Biden's victory and Republicans finally offering their congratulations (Donald Trump and his 'MAGA' supporters notwithstanding). Further progress came on the European Union's €1.8 trillion recovery fund, after Hungary and Poland dropped their 'Rule of Law mechanism' complaints. And the US Federal Reserve (Fed) extended its debt purchase programme, but stopped short of calls to lengthen the average maturity of its bond purchases. All big stories, very little news.

Nonetheless, we come to the end of a year to forget, amid a crisis to remember. And, as 2021 approaches, there is a sense that a chapter is closing. Vaccines have been approved and are being rolled out across the UK and US, with the world set to follow. Britain's future arrangements with our largest trading partner will soon be settled – one way or the other. And, the most divisive US President in modern times is in his final days in office. We refer readers to our 2021 outlook released last week for a more detailed breakdown of our future expectations. But below, we look into these stories and what changes they may bring from before.

COVID

The pandemic and global shutdown has wreaked havoc on the global economy, leading to the largest downturn in activity ever recorded. But with the vaccination programme now in full swing, the end is in sight, hopefully. Markets appear to have priced in a lot of this hope.

With restrictions now re-imposed on swathes of the global population, it might be hard for investors to get more excited about the near future. But immunised populations will lead to a thawing of the economic ice age, and – barring any crises of a different nature – another leg up in activity is practically a certainty.

UK headlines last week noted a new strain of coronavirus infecting hundreds in some areas. While understandably scary, we should remind ourselves this is not surprising. Viruses exist because they mutate. There is little to suggest this new strain is bad news – either in terms of its effects or its resistance to vaccines. Crucially, vaccine researchers do not seem especially worried, given that new vaccine methods can potentially adjust relatively quicky to new versions of the virus.

We are confident in rebounding activity next year, but 1st January will not bring the old normal back. For the first half of 2021 at least, the economic outlook should improve but it may not be strong. Much depends on how effectively vaccinations can be implemented and further spread contained. We wrote in last week's outlook that, for financial risk assets particularly, a big rebound has already been priced in. Although Investors are not inordinately optimistic (as we discuss further down), to see upside in markets, we will need the expected economic growth to clearly translate into corporate profit growth. Due to historically easy financial conditions, this is a likely outcome, but we should be wary. Even if activity comes back strongly, that does not necessarily mean companies and markets will benefit.

US

The pandemic has been so all-encompassing it is easy to forget what the big stories even were before it. But the Donald Trump presidency has been a phenomenon all of its own. For markets, there have been plenty of positives to come out of the White House over the last four years – tax breaks and supercharged US growth foremost among them. But every silver lining has been accompanied by a grey cloud. From his first days in office, Trump launched a series of trade wars against the US' biggest trading partners. Tit-for-tat tariffs on Chinese goods, barriers to trade and finger-pointing at the EU have all greatly upset the globalised world order built up since the 1980s. The President has managed to rip the fabric of the global economy in a way that would have seemed unthinkable five years ago.

With Joe Biden in the White House, the world can certainly expect some respite. But we should not get ahead of ourselves. Trump received the second-highest vote tally of any presidential candidate in November, a clear signal that Trumpism is not going away any time soon. This is sure to affect the politics of the Republican Party, still favourite to retain control of the Senate, which could block vast portions of Biden's agenda. Even if Biden successfully undoes the Trump-era changes domestically, the international stage is a different story. The era of unfettered globalisation is over and is not coming back, evidenced by the fact that anti-China sentiment has rare bipartisan support in Washington.

Even here though, a Biden presidency comes with an undoubtable improvement on the last four years, and should at least bring stability to international relations. Trump's erraticism on the world stage made it impossible to predict where negotiations of any kind would end up, or what damage would be done along the way. Even if policy itself does not change too much, the mere fact of having a less incendiary president will be a plus for markets.

Where this is likely to do the most good is on environmental policy. Climate change can only be tackled at the global level, and Biden has already promised to re-join the Paris Accord when taking office. The EU is already in the process of drafting plans for unified global climate standards (including taxonomy of activity and CO_2 trading standards) and has been eyeing China as a potential partner here for some time. With the green movement top of Biden's agenda, European politicians are likely to find a willing partner in the US. This marks a huge change from the last four years – and could well be the first real test of how far world leaders are willing to go to cooperate in the face of global problems.

UK

Brexit means Brexit. But with less than two weeks until the UK stops operating under EU law, we are still trying to figure out exactly what *that* means. To recap, we have stressed many times that the stakes are too high and the barriers too low for Britain and the EU to not reach some form of trade deal before we crash out on 1st January. The last few weeks have been a real test of that faith, but we are still in agreement with implied market expectations that we will at least see a 'skinny deal' by the end of the year. Even if we do not, however, the point remains that – for better or worse – the Brexit drama is in its season finale.

After nearly five years of constant Brexit chatter, that is as welcome as it is difficult to comprehend. There are various points to consider here, however;

First, whatever the outcome, the simple fact that businesses and individuals will be able to trade with certainty over the future conditions will be a huge relief. As always with Brexit, even here we have to add a word of caution: if the UK exited the EU without any trade deal, and fell back onto World Trade Organisation (WTO) terms, it is likely that at some point, trade negotiations would start again. This relies simply on the fact that most countries globally strive for agreements on top of WTO standards. With a no-deal Brexit, the starting point would of course be one of "tabula rasa" (clean slate).

Second, this does not mean that things will all be fine – even if a skinny deal is reached. To a large extent, the Brexit damage is already done, with businesses having confirmed plans to cease UK operations and years of divestment from global investors contributing to extremely weak productivity in Britain. But third, there may still be upside in UK assets – if only for the fact they have been so underbought for so long.

There is another aspect of all this. While 2021 will be the year when Brexit gets put to bed, this does not necessarily mean the end of confrontational international politics. Any deal achieved by the end of this year will have significant gaps in it – on the services and financial sector in particular – and those areas will need ongoing negotiations, perhaps indefinitely (as is the nature of international regulation). Given that Boris Johnson's government has already set the tone to brinkmanship, we could see more of it in the future.

This belies a deeper political point: Johnson's government is the *Brexit government*. Fighting hard for Britain against stifling foreign politicians is its primary mandate. This means the UK is the mirror opposite of the US. Over there, international issues (with China) remain, but with a less combative administration. Here, the issues are clearing, but the combative administration remains. The substance will be different next year, but the style could well be the same – and that in itself presents problems for markets.

We have already seen glimpses of this on the aforementioned environmental policy. While the EU is keen to set up international regulations for CO_2 standards, the UK will operate its own CO_2 trading regime from January 2021. There is certainly scope for co-operation, but for now the facts point towards fragmentation, not a global carbon market. CO_2 markets are still in their infancy, but signs are emerging that national interests could lead to a grab for market share, rather than a coordinated attempt at solving global issues.

Of course, none of this is set in stone, and the recent departure of Johnson's Chief Adviser Dominic Cummings, brought suggestions that the combative style of politics might be waning for this government. This has not borne out yet, but we wait to see what 2021 brings.

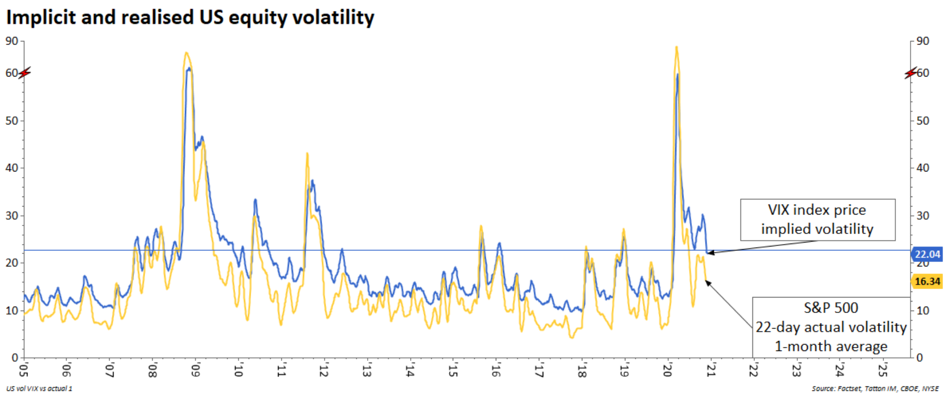
And all the rest…

Equity markets last week were, yet again, broadly positive. The Fed's Open Market Committee made no substantive policy changes, but (reading between the lines) it tweaked its statement from November's "loose monetary policy for some time" to "REALLY loose monetary policy for as long as we could possibly need". Few would disagree that policy is ultra-loose, given that Goldman Sachs' measure of US financial conditions has plunged during December to the easiest level since it started in 1991. It has surpassed the previous levels seen after the 1998 Emerging Market Debt crisis (and Russia's default) when the Fed acted to cut rates by 0.75%, despite a strong economy. The dot.com bubble ensued.

The Fed's sentiments helped maintain investor optimism. Of course, equity indices are trading at very high valuations, with the S&P 500 ending the year at a price/earnings ratio of 27 times 2020 expected earnings. So, have investors lost all caution? Are they taking any insurance?

Options are a way that investors can insure their portfolios against downside. According to multiple reports, options trading across different markets has been growing through the course of the year. In the past, that has been a warning sign for financial stability, given that options can be used to gear up positions. This is no ordinary year, however. Much like the crisis of 2008, 'external' risks (such as the virus and its impacts on politics, events which can happen without notice) are perceived as high. At the same time, policy responses have been huge and will bring benefits should those risks fail to materialise.

If investors judge that the market's upside is good, but risks are still close by, investors will buy the market and be prepared to pay a relatively high premium for protecting against downside. Should the cost of protection start to fall, investors can then afford to buy a bit more upside. Even though markets have become less volatile over the past few weeks, options premia have not cheapened much. Indeed, investors remain prepared to pay an historically high price for protection, as we can see by using the VIX index in the chart:



This shows that – even though equity markets are expensive at price-to-earnings ratios and are pricing in a hefty economic recovery next year – the risks are still clear, and investors are still cautious. As and when the risks lessen, investors should become less fearful, option premia will fall further, and equity markets should reap the benefits. Here's to a good 2021.

Global Equity Markets

Market	Fri 15:09	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6543.8	-0.0	-3.0	↗	↗
FTSE 250	20150	+2.7	+527.8	↗	↗
FTSE AS	3697.4	+0.5	+17.0	↗	↗
FTSE Small	6059.5	+1.6	+93.4	↗	↗
CAC	5536.6	+0.5	+29.0	↗	↗
DAX	13674.8	+4.3	+560.5	↗	↗
Dow	30231	+0.6	+184.9	↗	↗
S&P 500	3707.8	+1.2	+44.3	↗	↗
Nasdaq	12739.8	+2.9	+361.9	↗	↗
Nikkei	26763.4	+0.4	+110.9	↗	↗
MSCI World	2674.9	+2.0	+53.0	↗	↗
MSCI EM	1273.0	+1.2	+15.3	↗	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Barratt Devts	+11.2	AstraZeneca	-7.9
Persimmon	+9.7	Carnival	-4.5
Melrose	+9.2	Brit-AM Tobacco	-4.3
ITV	+8.9	Micro Focus Int'l	-3.9
Taylor Wimpey	+7.4	Vodafone	-3.8

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.350	+2.1	Oil	51.75	+3.6
GBP/EUR	0.907	+1.0	Gold	1882.7	+2.2
USD/EUR	1.22	+1.1	Silver	25.88	+7.8
JPY/USD	103.34	+0.6	Copper	360.0	+2.2
CNY/USD	6.54	+0.1	Aluminium	2053.0	-0.3
Bitcoin/$	22,497	+24.3	Soft Cmdties	379.7	+0.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.24	+0.06
UK 15-Yr	0.45	+0.05
US 10-Yr	0.92	+0.03
French 10-Yr	-0.34	+0.04
German 10-Yr	-0.58	+0.06
Japanese 10-Yr	0.01	-0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.2	19.7	21.8	13.9
FTSE 250	1.9	17.3	28.3	15.0
FTSE AS	3.0	19.1	19.9	14.0
FTSE Small x Inv_Tsts	2.0	16.5	-	24.0
CAC	2.0	22.2	28.0	14.3
DAX	2.7	23.4	19.9	13.1
Dow	2.0	22.1	24.8	15.8
S&P 500	1.6	26.7	26.2	16.9
Nasdaq	0.7	37.7	32.8	19.2
Nikkei	1.6	27.6	25.2	17.3
MSCI World	1.8	25.7	24.9	16.0
MSCI EM	2.0	20.1	19.7	12.2

UK Mortgage Rates

Mortgage Rates	Nov	Oct
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.83	1.84
3-yr Fixed Rate	2.05	2.03
5-yr Fixed Rate	2.02	2.02
10-yr Fixed Rate	2.50	2.48
Standard Variable	3.62	3.62

* 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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

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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