Cave's Quarterly

Edition 19, Q3 2020 Round Up

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Second Wave

The first half of the year was a rollercoaster ride for investors, who witnessed the sharpest equity bear market in history, followed by the strongest 50-day rally. The summer months brought with them some much needed respite and a relative sense of calm returned to financial markets, with risk assets broadly trending higher through to October.

Despite record temperatures in August, there has been no let-up in the transmission of Covid-19. At the time of writing, over 35 million cases have been confirmed globally, with deaths linked to the virus now exceeding 1 million. With economic activity deliberately frozen to stem the pandemic, the near-term contraction is the worst since the Great Depression, and it remains to be seen how quickly people and companies are adjusting to life under the 'new normal.' There are, however, tentative signs of a recovery as the easing of strict lockdown regimes and reopening of businesses has started to give life to the spluttering global economy.

The reintroduction of local lockdowns and a new 10pm curfew for pubs and restaurants across the UK has cast a dark shadow on our economic outlook. Chancellor Rishi Sunak confirmed that the Coronavirus Job Retention Scheme will come to an end in October which looks set to put further pressure on households and businesses. A 'Winter Economy Plan' replaced the usual Autumn budget and in an effort to limit the rise in unemployment, a new 'Jobs Support Scheme' was announced and will run for six months from the start of November.

The level of monetary and fiscal stimulus delivered by Central Banks and governments to quell the virus shock remains unprecedented and continues to fuel a powerful bounce back in growth. The combination of better than expected corporate earnings, improving macroeconomic data, and encouraging progress around a vaccine has pushed markets higher for much of the third quarter. Headline risks for the coming months which could threaten the recent optimism of investors include heightened geopolitical tensions, the U.S. presidential election in November and a dreaded second wave of infections through Winter.

Global Equities

Here in the UK, the market backdrop remains complex. The seemingly never-ending Brexit saga continues with both sides struggling to find a compromise on the two most difficult sticking points in the trade talks: the EU's fishing rights in British waters, and the bloc's demands for a "level playing field" between British and EU companies. This protracted uncertainty continues to weigh heavy on sentiment towards UK corporates, which were already struggling in the face of the Covid-19 recession. The domestic FTSE All Share index, with its significant exposure to financials, energy and mining companies recorded a 4% decline over the 3-month period.

Lower for longer interest rate guidance from the major Central Banks continues to push investors towards growth focused companies, of which the US stock market has plenty. iPhone maker, Apple briefly became the world's first company to be valued at more than $2 trillion and despite a sizeable wobble at the start of September, the exceptional performance of stocks perceived to be benefitting from the crisis in the tech, healthcare, and fast-moving consumer goods sectors continues to supercharge US equity returns. The S&P500 and Nasdaq indices advanced 8% and 11% respectively over the quarter.

In Europe, recent news flow has been dominated by a notable uptick in the spread of the virus across France and Spain, as increased testing revealed daily case numbers surpassing levels seen at the peak of the crisis back in March. Prospects for the region have undoubtedly improved since the €750 billion 'Next Generation EU' recovery fund was signed off by the European Council, but the equity market has failed to make significant headway since July, owing to the more cyclical nature of company earnings and a lack of technology sector exposure. The Euro Stoxx 50 index closed out the third quarter marginally lower at -1%.

Performance across the Asia Pacific region has been generally positive in recent months. A flare up in trade tensions saw the U.S. place restrictions on Chinese companies, Huawei and TikTok but otherwise, the domestic economy has seen significant improvement. The Shanghai Composite Index added 8% as Q2 earnings results exceeded expectations and exports expanded strongly. Consumer and services sector data also pointed to growth. In Japan, the country's longest serving Prime Minister, Shinzo Abe resigned due to health reasons. Shares dipped briefly on the surprise news, but expectations for a continuation of his reflationary 'Abenomics' policies, and the potential for further stimulus saw the Nikkei 225 index recover swiftly. The benchmark posted a 4% rise in the third quarter.

Commercial Property

The economic fallout from the pandemic continues to take its toll on the UK commercial property sector, with tenants in the hospitality, leisure, food and beverage and retail sectors still teetering on the edge of collapse. Any positive sentiment that was building in the real estate sector following the successful 'Eat Out to Help Out' scheme has been firmly quashed after Boris Johnson announced new restrictions and guidelines which sees workers encouraged to work from home again and pubs and restaurants having to close their doors at 10pm. Without office workers, an evening economy or foreign tourists, big cities such as London will need to brace themselves for a very bleak winter.

Alternatives

The prospects for gold and other precious metals remains bullish against a backdrop of rising political tensions and trillions of dollars' worth of fiscal and monetary stimulus being pumped into the global economy. Nervous investors continued to seek a safe place to put their money and protect themselves against a possible pick-up in inflation, which combined with a weaker US dollar, provided a strong tailwind for the yellow metal to reach a record high price of $2,074 in August.

Weak import data from Asia called into question China's ability to continue propping up global oil demand. The trend of rising inventories was, however, reversed in the third quarter and oil prices closed out higher at around $42 per barrel.

Fixed Interest

The significant news over the quarter came from the annual Jackson Hole Economic forum held in August, where the US Federal Reserve signalled a major shift in its approach to managing inflation. The Central Bank unveiled a new policy framework amounting to average inflation targeting (AIT), whereby the Fed will now allow a temporary overshoot of its 2% target to compensate for periods of below-target inflation. This should see interest rates kept historically low for a prolonged period. Yields on the UK 10-Year Gilt and the US 10-Year Treasury Note stood at 0.23% and 0.68% respectively at the end of September, a flat return over 3 months.

In this supportive environment, investment grade and high yield credit outperformed, with most companies taking advantage of record low borrowing rates to repair balance sheets, improve liquidity and extend debt maturity. While leverage has risen across the corporate world, debt has become more affordable and default rates remain stable.

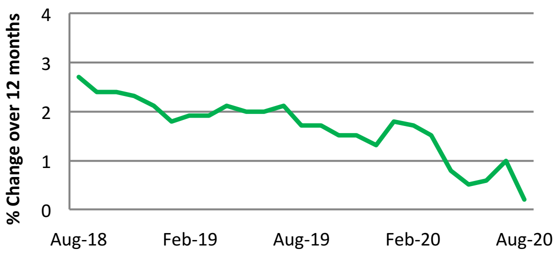
Outlook

Heading into the final months of 2020, we anticipate a challenging fourth quarter for investors. We expect heightened market volatility around the U.S. election, as uncertainty looms over the likely winner, what policies will be implemented and whether the result itself will be contested or delayed due to a surge of mail-in votes. We also deem a meaningful second wave as a key risk to investor sentiment. With infection rates likely to increase through the colder winter months, the development of an effective vaccine that can be distributed to the masses will be needed to underpin the global economic recovery.

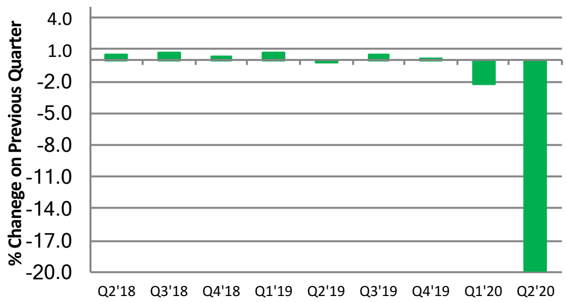
As ever, we remain vigilant and continue to favour an investment strategy which focuses on long term fundamentals and diversification, both regionally and by asset class.

A year in numbers

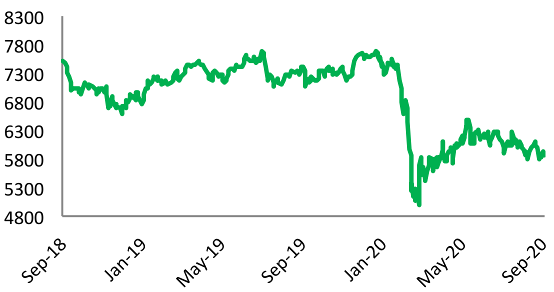
UK Consumer Prices Index (CPI)



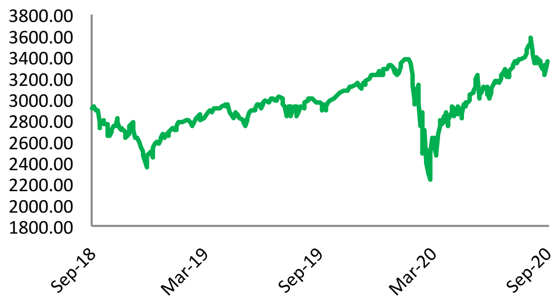
UK Gross Domestic Product



FTSE 100 Index



S&P 500 Index



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