Overview

The fourth quarter of 2020 saw equity markets respond well to the prospect of an economic recovery, boosted by the launch of new vaccines against the coronavirus Covid-19 in spite of a resurgence of incidences with new variants. Markets also reacted positively to the election of Joe Biden as president-elect in the US and to the UK's agreement on a deal to leave the European Union. The continued prevalence of low interest rates and the introduction of an additional stimulus by various governments provided further support.

In October the continued resurgence of the coronavirus and renewed political concerns over the US election in particular contributed to some weakness in spite of encouraging economic data from China especially. The month of November saw a strong revival in equity markets and notably in sectors that had struggled during the Covid-19 pandemic, as investors took heart from the efficacy of new vaccines and took comfort in the eventual outcome of the US election. The month of December saw an eventful and complex year draw to a close with an improving degree of optimism on the outlook. Bond markets were helped by interest rates that stayed low while currency was a factor as the US$ weakened.

The pandemic took a considerable toll over the year: the total number of confirmed cases worldwide was just shy of 85m and the number of recorded deaths rose above 1.8m, according to the data collected by Johns Hopkins University. The new variants have added an extra challenge to the logistical ones of reaching full production and distribution of the various vaccines, for which there was encouraging news from clinical trials and then an accelerated approval process. The roll-out of those from Pfizer/BioNTech, Moderna and especially AstraZeneca/Oxford University, cheaper and easier to store, prompted increasing confidence of a return to a social and economic life less dominated by the virus, and less vulnerable to that toll on normal life.

The world economy has been recovering from the disruption of the initial lock-downs, led by countries in Asia which have been quicker to bring the pandemic under control and in particular by China, which has gained a relative advantage from the crisis. The World Bank has calculated that global GDP will have fallen 4.3% in 2020 and then will increase by some 4% in 2021; there is potential upside if there is a swift, effective vaccination programme but also the risk of a further recession if not.

There was uncertainty over the eventual outcome of the presidential election and on Donald Trump's gradual and ungracious departure from office, yet investors took as positive Joe Biden's victory, with the Democrats having sufficient control but limited scope for radical change. The UK's negotiations with the European Union did go down to the wire and there will still be some ramifications, but there was at least a deal of sorts if not yet for financial services.

The low level of interest rates has driven a search for yield and has helped to underpin equity valuations, as well as making large debt burdens affordable for now. Government budgets have been stretched and political divisions meant delays to proposals, yet in the US, the EU and Japan there have been further substantial packages of support, with more still expected.

Asset returns

The total return from the FTSE UK Gilts All-Stocks Index was 0.6% in the fourth quarter of 2020 to make one of 8.3% for the year as a whole, as ten-year yields moved from 0.23% at the end of September to 0.2% at the end of December. In the US ten-year yields rose in the period from 0.68% to 0.91% while in Germany yields were little changed if still negative at -0.57%. US Treasuries with a duration of 7-10 years saw a small loss while riskier bonds in emerging market debt in local currency and higher-yield debt did best in the period.

In equity markets the FTSE 100 rose 10.1% in the fourth quarter, which took the index from 5,866 to 6,461 but still left it 14.3% lower for the year given the sector exposure and concerns over Brexit. The FTSE 250 Index of mid-sized companies did better with a gain of 18.3% in the period while the FTSE SmallCap Index rose 23.3%, to give annual returns of -6.4% and 4.5% respectively. On AIM the quarterly gain was 20.6%, similar to that for the year as a whole. The FTSE All-Share had a total return including income of 12.6% for the quarter to take the final position for 2020 to -9.8%.

In the US the S&P 500 index rose a further 11.7% in the quarter to end 16.3% higher over the year, driven by the high weighting to technology-oriented shares, which also helped the NASDAQ index to gain 15.4% in the period and 43.6% in the year. The concentrated Dow Jones index saw a rise of 10.2% and the Russell 2000 index of smaller companies a rise of 31% in the quarter, to make returns of 7.3% and 18.4% respectively for the year.

In Europe the EURO STOXX 50 was 9.8% higher over the three months to December, making for a decline of 5.4% for the year, while smaller companies, as per the Euromoney index, did better with a gain of 14.9% in the quarter and 16.6% for 2020 as a whole. In Japan the Nikkei 225 index was 18.4% higher in the quarter and up 16% for the year.

The MSCI Emerging Markets index in US$ gained 19.3% in the quarter with the Brazilian, Indian and Korean indices doing well, and it was 15.8% higher for the year. The Shanghai market made 13.9% in 2020 after a gain of 7.9% in the last three months. The MSCI Frontier Markets index rose 10.9% in the last quarter but was still down 2.5% in 2020.

Sterling rose by 5.8% in the fourth quarter to close at a rate of $1.37:£ against the US$, which weakened against a basket of currencies. Against the euro, Sterling was 1.5% stronger to end the period at €1.12:£.

The price of gold weakened then rallied in December to end the fourth quarter up 0.7% at $1898 per troy ounce, which was 25.1% higher than at the start of 2020. The spot price for a barrel of Brent oil rallied to end the period up 24.9% at $51, but still down by 23% on the $66 level at the start of the year. The major metal prices were all higher over the quarter, with platinum up a fifth, and agricultural commodity prices also moved sharply higher. The Vix index of expected volatility for the US equity market was 13% lower in the period, if still some two-thirds greater than at the start of the year. The price of bitcoins surged to the end of the year and remained volatile.

Outlook

There has been an optimism on the outlook in markets that has looked a little out of kilter with the still challenging environment, as the impact of the coronavirus Covid-19 persists. In part this is because markets are discounting the immediate outlook and focussing on the scope for a recovery in economies and in earnings over the course of 2021, in part as low interest rates have driven that search for yield and have served to justify higher valuations. The ebullience has seen some frothiness which might well continue yet. There are challenges from the high level of debt, if affordable for now, especially if inflation rises.

The pandemic of 2020 will have a protracted impact and has brought home the risk of similar outbreaks. The resilience or resurgence of the virus with its new variants ought not to have been a surprise and it has led to the imposition of further restrictions that will delay a full return to a more normal society and economy. A series of safe vaccines rolled out promptly and a range of treatments, expensive but cost-effective if they release hospital beds, will help to counter the virus over the course of the year.

While a full recovery is deferred the latest lockdowns will have a lower impact and there has been further encouraging data. Economic growth will be driven by Asia, with Chinese GDP expected to expand by 7.9% compared to nearer 3.5% in Europe and the US – although the US Federal Reserve has raised its own forecast for 2021 to 4.2% and expects output for 2020 to have been -2.4% compared to an earlier prediction of -3.7%. It is also notable that the global outcome in 2020 was more like 6.6% below earlier forecasts before the crisis and there will have been an impact on key investment, with money spent instead on dealing with the pandemic. China will have emerged stronger in relative terms in many areas. Some further stimulus will be key and is expected in the US.

Company profits were dented by the downturn, if not in all sectors, and will recover as will dividend payments with companies making up in large part for previous cuts. There may be fewer companies capable of a high sustained rate of growth, even if forecasts are strong for the current year, and there are more with what historically would have been an unsustainably high level of debt, affordable for now. But debt might constrain the level of re-investment for future growth.

There is certainly plenty of debt outside of companies. The Institute of International Finance has calculated that global borrowing reached $272tn in the third quarter of 2020 and an estimated $277tn at the end of the year, equivalent to 365% of global domestic product.

Interest rates have stayed low which has made the debt affordable. The Federal Reserve left its rates unchanged at a range of 0-0.25% although it did not propose to extend the duration of its balance sheet purchases as some had anticipated. The Bank of England likewise left interest rates on hold, at 0.1%, and its quantitative easing programme unchanged. The Bank of Japan maintained interest rates at -0.1% and announced a six-month extension to its package of measures designed to help companies. The European Central Bank extended its own programme and kept deposit rates at a negative 0.5%. In China the benchmark rate has been at 3.85%, by contrast.

Consumer price inflation has been subdued but commodity prices have been rising, with the oil price helped by proposed production cuts by Saudi Arabia. An extra stimulus in the US is likely to increase inflationary pressures and there are rising expectations that central banks will need to manage an increase in interest rates while avoiding the impact this has had in earlier years. There is a plausible argument that the end is coming to a generational shift in the worldwide supply of labour, given ageing populations and a shift from globalisation, and that this has been a powerful factor in keeping inflation low.

The optimism in markets has at times veered towards ebullience and is liable to be labelled as irrational exuberance. This has shown up in the increased amount of retail trading activity, to an extent on margin, in the high valuations afforded to special acquisition vehicles (with little more than a business plan or high-profile investor) and in the initial price movements of shares listed on stock exchanges, as with Airbnb whose shares doubled on the first day. There has been a substantial amount of corporate activity: the value of deals reached $3.6tn in 2020, down only 5% on 2019 after a total of $2.3tn in the second half. The sizeable deals in the fourth quarter included S&P Global's $44bn bid for the analytics company IHS Markit, the $35bn bid from AMD for US chip manufacturer Xilinx, Salesforce's $28bn bid for the chat app firm Slack and AstraZeneca's initial $39bn bid for the US biotechnology firm Alexion, although its value fell as investors questioned the strategy.

The deals also reflect the importance of technology and the appeal of assets that are set to benefit from the shift in the structure of economies: the pandemic has accelerated trends in a range of industries such as digital retail, cashless transactions and pet ownership. The Democratic party is likely to focus on the might of technology companies which seem to be unstoppable but do face regulatory scrutiny as well as competitive challenges, if between themselves. One new technology is the block chain that underpins bitcoin and other crypto-currencies, which have seen a surge in interest and in price. Bitcoin can see extreme volatility, in part as only a minimal part of its value is traded and in part as there is a pull between those who see it as the future and those who see it as having no intrinsic value. It may replace gold as a safe haven and hedge against inflation and has some advantages: a static supply (capped at 21m coins), easily (if not always safely) stored, readily divisible and of more appeal to the millennial generation.

In short the world has as often opportunities and challenges. It needs confidence in central banks, that they can find the right balance between putting a floor under markets at a time of crisis and also a cap at a time of excess. Their actions have compounded an imbalance of wealth, one factor that is likely to underlay continued political and geopolitical tension.

Asset allocation

Our current approach, from the conclusion of our latest quarterly investment committee, is to have portfolios nearer their longer-term neutral position within what are likely to be narrower ranges for each asset class.

We favour equities given the appeal in the earnings yield relative to lower yields from bonds or cash and in the potential for increasing dividends. We have a focus as before on resilience and on areas that offer decent growth, in Asia, or decent valuations, such as in the UK where the Brexit overhang has started to clear. For fixed interest positions we are mindful of the risk that higher inflation could bring and favour funds with a strategic approach or some protection, while alternative assets such as infrastructure can provide bond-like returns. Cash can earn next to nothing at present although it still provides flexibility and security at times of stress, albeit it can add to levels of stress when market timing seems awry.

UK

- Renewed lockdowns constraining economic progress
- Bank of England supportive and further government aid
- Deal reached with EU and Sterling stronger

The UK economy has been constrained by the continued impact of the virus, with the new strain increasing a different strain on many services, not just the NHS. The latest lock-down has seemed patchy yet it should start to help to contain the infection rate, as will vaccines as and when they are rolled out. Consumers have had less to spend money on and the savings ratio has broadly improved, with pent-up demand for when the restrictions ease.

The delayed recovery has prompted the Chancellor of the Exchequer to provide further support through furlough schemes and the like, as well as to defer the difficult decisions on which taxes to raise to address the budget deficit. Total borrowing was £246bn in the first half of the financial year to March when the Office for Budget Responsibility (in one meaning of the word) has forecast a total of £394bn, equivalent to a fifth of GDP while total debt of £2tn would equate to about 100% of output. For now it is affordable as the ratio of debt interest to revenue is nearly down to 2%, even as those revenues have diminished, well below the government's self-imposed limit of 6%. That is in part because the Bank of England has continued to purchase assets and to keep interest rates low, if not negative.

The conclusion of a deal with the European Union has avoided the potential disruption of a no-deal outcome although there will still need to be adjustments as well as compromises and some initiative to make the most of opportunities, given the distractions of the virus. There has also been no agreement as yet on equivalence in financial services. The outcome has helped to support Sterling and increased the appeal of the UK market given its relatively attractive valuations, which the £22bn of corporate deals in the last two months of 2020 might endorse.

Continental Europe

- Recovery at risk from renewed surge in virus and slow vaccination rates
- ECB following same policy and inflation below target
- Recovery fund of €750bn agreed if yet to be disbursed

As in the UK, Continental Europe has seen a degree of economic recovery but also sharp rises in the incidence of the virus, such as in Ireland, already vulnerable to revised trading with the UK. There have been renewed restrictions and to date vaccination rates have been slow, attributed to centralised procurement and to bureaucratic delays in particular countries or regions.

In December the European Central Bank said it would maintain the deposit rate at -0.5% for the Eurozone and that it would extend its programme of support measures into 2021 – it added a further €500bn to its planned debt purchases. Inflation was negative in December for the fifth successive month at -0.3%.

The EU did at least agree a revised budget and its €750bn recovery fund, a core element of which is a facility to help national economies make a transition to a greener and more digital basis, helping the appeal of the region.

North America

- Recovery dented by prevalence of virus
- Presidential election complex but clear Democrat victory
- Federal Reserve flexible on inflation with weaker US$ a factor

The US economy saw a reduction of 140,000 jobs in December, the first decline since the start of a recovery in May from the loss of 20.8m posts in April. There had been expectations of a small increase and while the numbers are liable to revision they are one indication that there are still challenges. There is the prospect of a greater stimulus from the Biden administration in addition to the $900bn that Congress finally agreed at the end of December.

The presidential election has proved ultimately decisive if still divisive, with a complexity that the storming of the Capitol buildings seems to exemplify. The Democrats' success in taking both Senate seats in Georgia in the January run-off gives them overall control and more scope to pursue their legislative agenda, with a further package of economic support key. This will entail tax rises in time although there is an apparent degree of realism in the administration.

The US Federal Reserve had adopted a more flexible strategy, ready to hold interest rates at low levels even if inflation were to run over its target of 2%. The economic stimulus has been a factor in the weakness of the US$, with its own inflationary implications, and bond yields have risen as an indication of a higher future rate.

Japan, north-east Asia and Australasia

- Structural potential in Japan if challenges
- Improvement in global trade and regional economies
- Higher commodity prices helping Australia

In Japan there has been a further wave of Covid-19 cases, modest perhaps in terms of the total population but enough to prompt further restrictions which will limit what had been a robust recovery, with consumer demand strong and the job market resilient. The new prime minister Suga Yoshide announced his first and the country's third stimulus package, in itself equivalent to 3.5% of GDP and as elsewhere with an emphasis on cleaner technology. The country may yet miss out on the potential boost of hosting the Olympics yet retains the scope to benefit from structural reforms and improved business returns.

The improvement in the global economy and trade has helped the region, which has also had the benefit of dealing effectively with the coronavirus in part given the lessons learnt from the SARS epidemic and similar outbreaks. Taiwan has minimised incidences through the clever use of technology and a different approach to quarantine: a payment of some £27 a day for citizens observing it as required and a potential fine 1,000 times greater for breaking it.

The renewed growth in China has boosted demand for products and also for commodity imports, usually a benefit to Australia although the country is dealing with an extended

diplomatic dispute with China that has led to trade wars over wine, while also needing to quench severe bushfires.

China, India and Emerging Markets

- Chinese economy seeing further growth and strong exports
- India challenged by virus which has accelerated structural reform
- Latin America with recovery potential and Asia resilient

China's economy has been in the ascendancy and now accounts for some 17% of world GDP, having managed to grow in 2020 based on strong exports and robust consumer demand. This compares to the share of 22% for the US, which is the largest merchandise trading partner of 38 countries compared to 64 for China, in spite of the pressure of trade wars. The challenges for China as before seem more political and geopolitical, as in the treatment of Hong Kong and in the apparent disappearance of Jack Ma, the founder of Alibaba, who has been under pressure from the authorities. China's financial markets have also grown in prominence as well as in value.

In India the economy has by contrast struggled but retains its potential for future growth. UBS has forecast that the economy will have contracted by some 7.5% in the fiscal year to end March 2021 and then will grow by 11.5% in the year to 2022, helped by consumer demand and government reforms if vulnerable to the virus as elsewhere.

As before other emerging markets have seen a benefit from the recovery in global demand and to an extent by weakness in the US$. Latin America has struggled with a number of economic and political concerns yet may now improve; in South Africa a new strain of the virus has been a further complication; and in south-east Asia there are the benefits at least of the regional resilience. Emerging Markets are usually defined by their financial status and by inclusion in the index produced by MSCI, which from November included Kuwait which was re-classified from being a Frontier market – leaving Vietnam as the largest such and one with promising potential still.

Property, commodities and other alternatives

- Property markets helped by low yields but having to adapt
- Strong rally in oil price and commodities broadly higher
- Gold less lustrous but still gaining
- Potential in private equity

Property has historically been a significant component of alternative assets, if share-based and if more international now. In the UK there have been attractive opportunities in the more resilient sectors such as online distribution warehouses, which continue to flourish. This has been reflected in prices which had been depressed for more distressed areas such as retail and leisure. The portfolios also hold wider tangible or real assets, primarily in infrastructure.

The price of oil rallied in the fourth quarter, helped by renewed demand and also by the prospect of some production cuts such as those Saudi Arabia proposed early in 2021. The price was still down for the year as a whole and there remain longer-term issues on the future role of oil, but this was still a significant improvement from the lows at the height in

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the crisis in 2020. There are opportunities in clean energy overall including in hydrogen, if at an early stage. Other commodity prices have also risen, a trend which is likely to continue and will be a factor in inflation expectations.

Gold has traditionally been an asset that serves as a hedge against inflation as well as holding an allure at times of market stress. The continued expansion in central bank balance sheets has called into question the sustainability of fiat currencies, which might all seem vulnerable, and gold is unlikely to be displaced by crypto-currencies as yet. Gold mining shares provide an exposure geared to the gold price if also dependent on other factors, such as energy prices as an important input.

The private equity sector has been volatile historically on public markets, in part as liquidity has been limited, and it has been notably cyclical. The current stage of the cycle is somewhat hard to pinpoint yet there are opportunities through private equity to gain exposure to an improvement in the corporate outlook and to newer businesses especially in technology.

Low interest rates have driven a search for income and for alternatives to high-quality bonds, corporate or government, as the yields they provide are largely low or even negative. A range of alternative assets can help and as before hedging strategies, when their liquidity is good, can justify a role in portfolios to help to smooth volatility.

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